European Central Bank: inflation and interest rate developments

Description

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Following successive interest rate hikes and the policy of gradual quantitative easing in the developed economies over the last two years, emerging macroeconomic conditions appear to be conducive for a change in course, primarily in the Eurozone.

Although the Governing Council of the ECB decided to keep interest rates unchanged at its last meeting on April 11, its post-meeting announcement was perceived by a plethora of analysts as indicative of a path of gradual interest rate cuts, most likely starting in June. The two main points of the announcement are as follows:

First, with respect to price developments, the ECB states that its previous assessment of a reduction in medium-term inflation has been confirmed, mainly due to the containment of increases in food and energy prices, and despite the maintenance of services prices at high levels. At the same time, it is emphasized that the increase in wages is moderate, while companies absorb part of the increase in costs through their profits.

Second, regarding the next policy steps, the ECB's Governing Council points out that it remains committed to securing its medium-term inflation target of 2%, despite the recommendations of a number of economists for a variation to 2.5 – 3%. Simultaneously, the ECB acknowledges that funding conditions remain sufficiently restrictive and that the current interest rate level is making a substantial contribution to the ongoing disinflation process. Finally, the ECB makes an unequivocal statement whereby, if inflation continues to converge towards target, it would be ‘’appropriate’’ to pursue a gradual downward adjustment of interest rates.

The ECB’s Governing Council makes it clear that its decisions will be taken on a meeting-by-meeting basis and that it will pursue a data-dependent approach. Turning, therefore, our attention to data, the latest Eurozone figures confirm the convergence of the general price level to the ECB’s target, as March inflation was contained to 2.4%. At the same time, economic activity within Europe remains subdued, while there are large financing needs concerning, indicatively, the technological and green energy transitions, the competitiveness of industries, taking into account intensified competition, from the Eastern hemisphere in particular, social issues, including the key subject of immigration, as well as a continuously expanding defense budget. It is also noted that, prior to the ECB’s meeting in June, data regarding wage demands and negotiations will be available. Should these be positive, the most likely outcome of the meeting will be to reduce borrowing costs by 25 basis points.

In such a scenario, the ‘’tradition’’, according to which the ECB follows the decisions of the US Federal Reverse, would be reversed. Empirically, the dollar-euro exchange rate indirectly affects the EU’s monetary policy since the ECB’s Governing Council knows, all too well, that a devaluation of the euro versus the dollar leads to incremental effects on European price levels. However, today’s macroeconomic data on the two sides of the Atlantic is diverse. In the US, inflation remains at higher levels, around 3.4%, while annual GDP growth for the fourth quarter of 2023 also stood at 3.4%. Even though US growth slowed down to 1.6% in the first quarter of 2024, reflecting the effects of the restrictive monetary policy and higher imports driven by dollar strength, the economy continues to perform relatively well.

Not coincidentally, the IMF has warned the US about the long-term effects of an expansionary monetary policy. The divergence between the EU and the US becomes more explicit when considering official statements. During the latest ECB press conference, its President, Christine Lagarde, admitted that the economy remained weak in the first quarter of 2024 and that risks to economic growth remain tilted to the downside. On the contrary, a few days earlier, Federal Reserve’s Chairman, Jerome Powell, clearly stated that recent readings on US job gains and inflation have come in higher than expected, indicating that the Fed will remain cautious about its decisions to cut interest rates and fueling the debate over the merits of a ‘’higher for longer’’ interest rate policy.

At this point, it would be important to state two additional factors that need to be accounted for within the Eurozone.

Firstly, decisions on monetary policy in the Eurozone tend to be complicated due to dissimilar economic conditions of its Member States. The traditional differences between the European North and South are an example, as they reflect diverse macroeconomic performances and economic structures and dissimilar policy approaches to dealing with imbalances. Within this context, the ECB’s Transmission Protection Instrument (TPI), which was approved in July 2022 to support the effective transmission of monetary policy across all euro area countries, could prove beneficial. The TPI operates through secondary market purchases of public debt (and, if appropriate, private sector debt) at times when a Member State is experiencing disorderly market dynamics. However, the TPI’s eligibility criteria may exclude certain Member States, in effect contributing to the divergence across the EU, e.g. Italy’s persistent fiscal deficits have recently led to an announcement that the country will be placed under excessive deficit process, precluding its eligibility for TPI support.

Secondly, geopolitical factors are crucial. Although currently oil prices remain relatively subdued, compared to previous crises, should the conflict in the Middle East expand, combined with adverse developments on the Russia-Ukraine front, inflationary pressures will intensify, forcing the ECB to have second thoughts about the benefit of lowering interest rates.

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