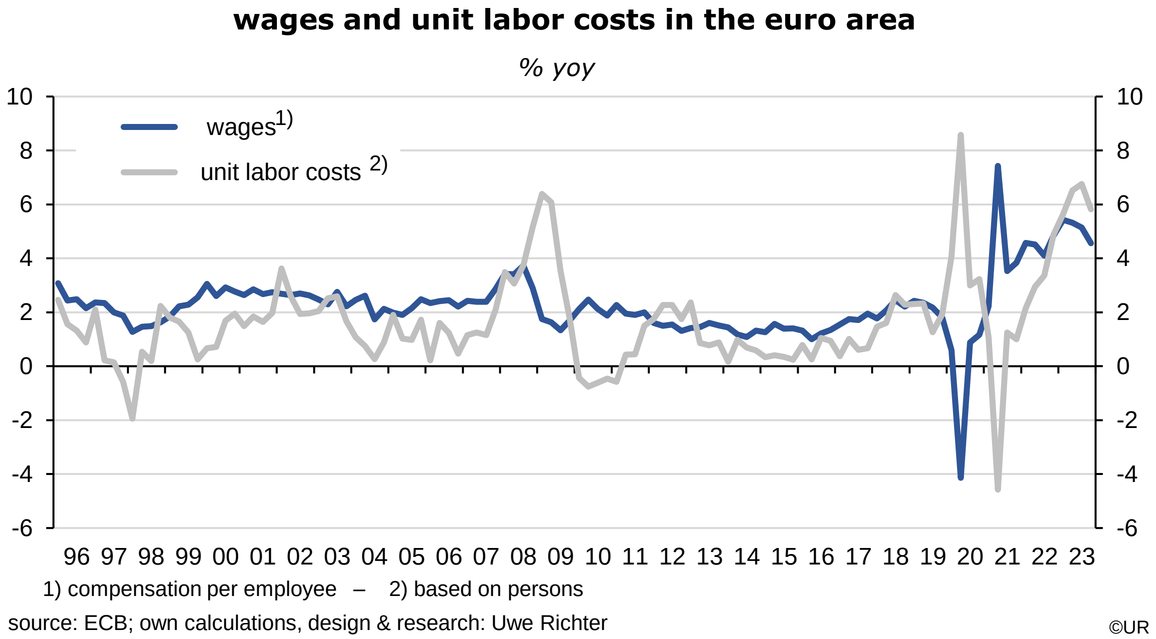
Euro area: lower inflation and lower policy rates ahead

Mainz, March 13, 2024 | *Dieter Wermuth*

Christine Lagarde has more or less announced last Thursday that European policy rates will be cut at the June 6 meeting of the Governing Council. It would be the turning point in this cycle and probably means 25-basis point reductions of both the deposit and main refinancing rates. They have been at highs of 4.0 and 4.5% since last summer. Inflation has come down more than expected while economic growth continues to disappoint. Since real GDP is presently only 3.0% higher than in the pre-Corona fourth quarter of 2019, the output gap is so large by now that firms are unable to raise output prices as much as they would like. The ECB estimates that consumer price inflation rates – which have fallen from a peak of 10.6% y/y in the autumn of 2022 to 2.6% last month – will come down further and gradually approach the 2% target. With the equilibrium refinancing rate in the order of 2.5% (2% target inflation plus 0.5% productivity growth), it is thus likely that policy rates will fall by altogether about 200 basis points, perhaps by 25 per quarter. Should weak growth persist, and robust labor markets finally come to an end, the cuts could be even larger.

The main uncertainty is labor costs. Goods prices may continue to fall, if not as rapidly as in 2023, but wages and unit labor costs remain in the order of 4 ½ and 6% y/y as workers have some success in their attempt to make up for the recent loss of purchasing power. Benign labor market conditions have strengthened their position in wage negotiations. In other words, the main domestic source of inflation could yet interrupt the overall disinflation process.



Will it? Data on this front come with a large time lag, they are quarterly, not monthly, and not all are seasonally adjusted. The ECB is uncertain about the exact dynamics in labor markets at this point and therefore prefers to wait until first quarter 2024 numbers are in.

But going by the German index of labor costs – which was only +2.5% y/y in Q4 – there is no need to worry too much about this cost factor. The June rate cuts are a near-certainty. For financial investors, it makes therefore sense to borrow at floating (money market) rates and to buy long-duration assets.

The present yield of 2.3% for 10-year German government bonds, the euro area benchmark, may seem low, but it has been around zero percent for no less than seven years before (2016 to 2022). If markets move in this direction again, ie down by about 200 basis points, large capital gains can be expected. Borrowing at fixed long-term rates, for example for the purchase of real estate, will probably turn out to be premature.

European short and long-term interest rates*)

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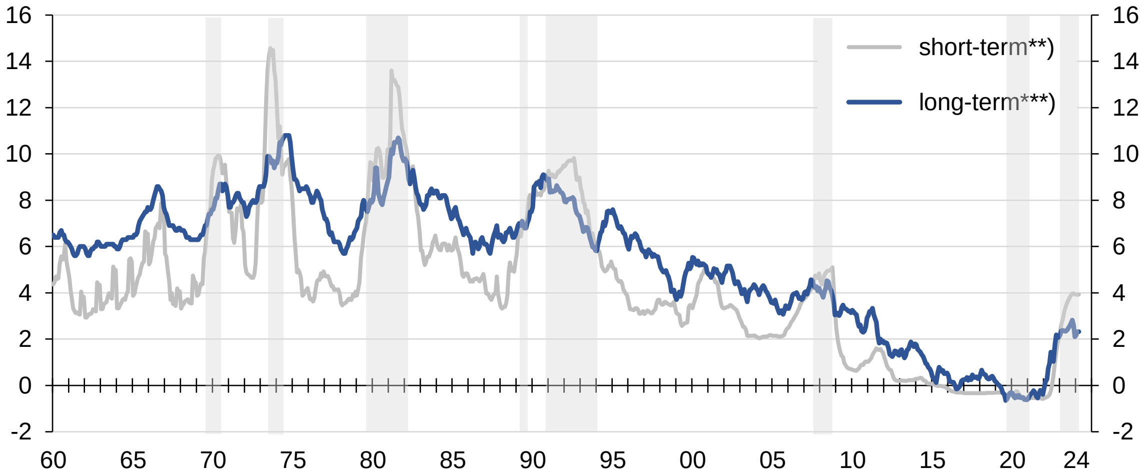

*) monthly averages; last value March 2024 own estimate – **) until 1998 3m money market rates reported by Frankfurt banks, from 1999 to present 3m Euribor – ***) 10-year Bund yield –
Note: shaded areas indicate periods of inverted yield curves
sources: Deutsche Bundesbank, OECD; design & research: Uwe Richter ©UR

Going forward, the main question is whether we are presently near a new “normal” of 2 to 2 ½% for long-term triple A bonds in Europe or whether this has just been an outlier, an interruption in a secular disinflationary process. The world economy continues to expand briskly, at rates of about 3%, while the international division of labor continues to intensify, no matter that this is the opposite of what we hear from the media. Emerging economies keep combining low labor costs and modern technology, driving productivity growth. In purchasing power terms, they already account for the biggest share in global GDP. From a European perspective, export and import prices will therefore remain on a down trend and keep overall inflation in check, including wages.

Add to this low capacity utilization rates in advanced economies and the answer to the above question is: no, there will be no new wage-inflation spiral in Europe, nor globally. Corona and the oil and gas price explosions were probably one-time events. Under the (admittedly heroic) assumption that there won’t be shocks like these in the future, I am sure that very low inflation will soon return to Europe. An important contributing factor could be a big decline of stock markets which have reached frothy valuations, especially in the US.

Combined with profit taking, a deleveraging of positions and subsequent banking crises, deflation fighting could be back on the monetary policy agenda. Japan after 1989 all over again, but on a global scale, and government bonds as the ultimate safe haven? I am aware that there are usually many more predictions of such disasters than the number of actual disasters. In any case, it would not hurt to be prepared and to make contingency plans.

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