Euro Policy Brief

What we see now can be described as stagflation

The ECB has still not managed to significantly dampen domestic price pressures in the euro area. Tightened monetary policy is cooling the economy, but the effect on prices has yet to be fully felt. August's core inflation rate of 5.3 per cent measured by Eurostat was just as high as in January and May, and only slightly weaker than in July. Anyone who has travelled in Europe this summer could see - at the latest when looking at their restaurant bill - that inflation has hit services with a vengeance. Across all sectors, wage growth has taken off as labour markets remain tight, although jobs are being cut in individual sectors such as construction. The odds are that, despite the slowing of the economy, catch-up wage growth will continue into next year, heralding another round of price increases. Thus, the current phase can only be described as stagflation.

Inflation proves more persistent than expected

It looks like the Governing Council is now facing the consequences of having hesitated too long to begin hiking interest rates last year, and being too quick to slow down its rate steps. The self-reinforcing effects of inflation and the impact lag of interest rate policy may have been underestimated. In Jackson Hole in August, ECB President Lagarde let slip how great the concerns in the Council are in the meantime. In her speech she described the danger of a regime change and pointed to the fundamental shifts in the global economy: the geopolitical divide, trade fragmentation, the energy transition, supply constraints and tight labour markets. She concluded: "In that setting, we will have to be extremely attentive that greater volatility in relative prices does not creep into medium-term inflation through wages repeatedly 'chasing' prices. That could make inflation more persistent if expected wage increases are then incorporated into the pricing decisions of firms, giving rise to what I have called 'tit-for-tat' inflation." Her speech reads as a delayed echo of the warnings from former Bundesbank President Jens Weidmann to his ex-colleagues in the Per Jacobsson Lecture in June 2022. At that time he emphasised: "An aggressive response to inflation shocks is advisable when there is uncertainty about the degree of inflation persistence. The cost of assuming a too low inflation persistence is higher than making the opposite mistake."

The interest rate peak is near, but not yet reached

What will the ECB Governing Council decide on 14 September? Observers don't agree. Some believe the Council will announce an interest rate pause; it'll wait to see how much the economy cools in autumn, and whether core inflation starts to fall significantly. Others expect the Council to demonstrate its resolve in the face of stagflation, and take another rate step. Statements by members of the Council support this view.

French Governor François Villeroy de Galhau told journalists: "We are close - or very close - to the peak point of our interest rates. He added: "We are still far though from the point where we could envisage cutting them." Villeroy's opinion is in the middle of the Council's range, and he has always been good at predicting future decisions. We follow his words and expect a deposit rate of 4.0 per cent. That should be the interest rate peak for now. The Council would thus show more determination than we have given it credit for in recent months.

So the interest rate peak will soon be reached, but what happens next?

There is little to suggest that the European economies will slide into a severe recession. Only then would the central bank be forced to ease interest rates again soon. Much more likely is a scenario in which the economy weakens, but doesn't crash. In this scenario, labour will remain scarce because the retirement of the baby boomers is proceeding apace. In Germany, this will affect the 1958 cohort next year, reaching the statutory retirement age of 66. Other fundamental factors also point to continued price pressures even in a stagnation scenario: geopolitical bloc formation, trade fragmentation, commodity scarcity, decarbonisation costs and disrupted energy markets. In 2024, the ECB could thus be confronted with a situation in which the inflation rate falls only very slowly. But the Council would probably try to avoid further interest rate hikes - although it might keep the option of steps upwards as well as down open in its communication. It would, however, have the option of reducing the Eurosystem's balance sheet more quickly by gradually suspending the reinvestment of bonds held in the "Pandemic Emergency Purchasing Programme" (PEPP).

Will the ECB have to activate the Transmission Protection Instrument?

The longer the interest rate level remains elevated and the faster the central bank shrinks its balance sheet, the more the market is likely to understand that the economy is moving to a new interest rate regime in the medium to long term. This would lead to a rise in longer-term interest rates, so that the yield curve would normalise. And that would have consequences for the financial situation of highly indebted countries, because ever larger parts of the sovereign debt would have to be refinanced at higher rates. Heavily-indebted Italy is already desperately looking for sources of money to keep its budget in balance. Banks are being milked and state property is being sold. But even in financially sound countries like Germany, the long-overlooked position of interest expenditure in the budget will come back into view. Meanwhile, bond markets are still calm. The spread - which Italy is observing with a wary eye - is holding at a tolerable 170 basis points. But we've seen in the past how quickly calm can vanish. And structurally, the situation becomes more fragile day by day as interest rates remain elevated. This increases the likelihood of disruptions, and the activation of the Transmission Protection Instrument (TPI) may come closer.

We will keep a close eye on further developments. Having accompanied the rate hike cycle reaching its peak, we will from now on provide briefings as events may warrant.

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