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Economic Research

Economic Insight

Data the ECB keeps an eye on

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Table of contents

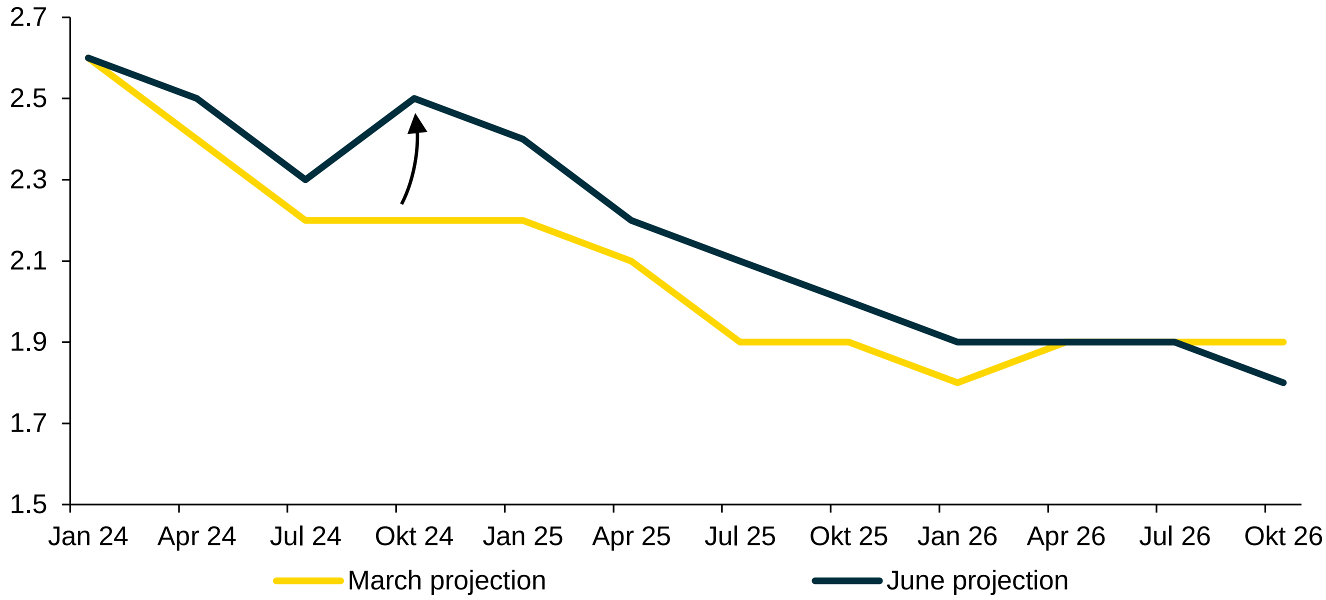
Market participants are engaged in a fierce debate over what will happen to the ECB's key interest rates in the coming months. We discuss which indicators eurozone central bankers are likely to pay attention to and which of them could spark further controversy.

Attractive new inflation projection

The ECB's main focal point will continue to be inflation and whether it develops following expectations. President Lagarde already discussed official projections during the press conference at the March meeting. She expects continuous ups and downs caused by a number of special effects over the coming months. The ECB economists have already accounted for this belief in their projections. By now, particularly forecasts for the fourth quarter of 2024 and the first quarter of 2025 have been raised. Meanwhile, estimations stipulating a fundamental downward trend have been left unchanged so that the 2% inflation target would finally be reached in the second half of 2025 (Chart 1). From the doves' perspective, this new projection is especially attractive since outcomes could still be consistent with expectations even if actual inflation picks up again towards the end of the year provided inflation stays low over the summer. Considering this, even the one or other hawkish council member could get convinced of further interest rate cuts. With this in mind, the Lithuanian **Šimkus**, whom we classify as belonging to the hawkish camp, signalled at a press conference the day after the rate cut: "If economic developments match those in the forecasts, this will mean less and less need for restrictive monetary policy."

Chart 1 - Inflation hump at the turn of the year 2024/25

ECB inflation expectations according to March and June projections, in per cent



Source: ECB, Commerzbank Research

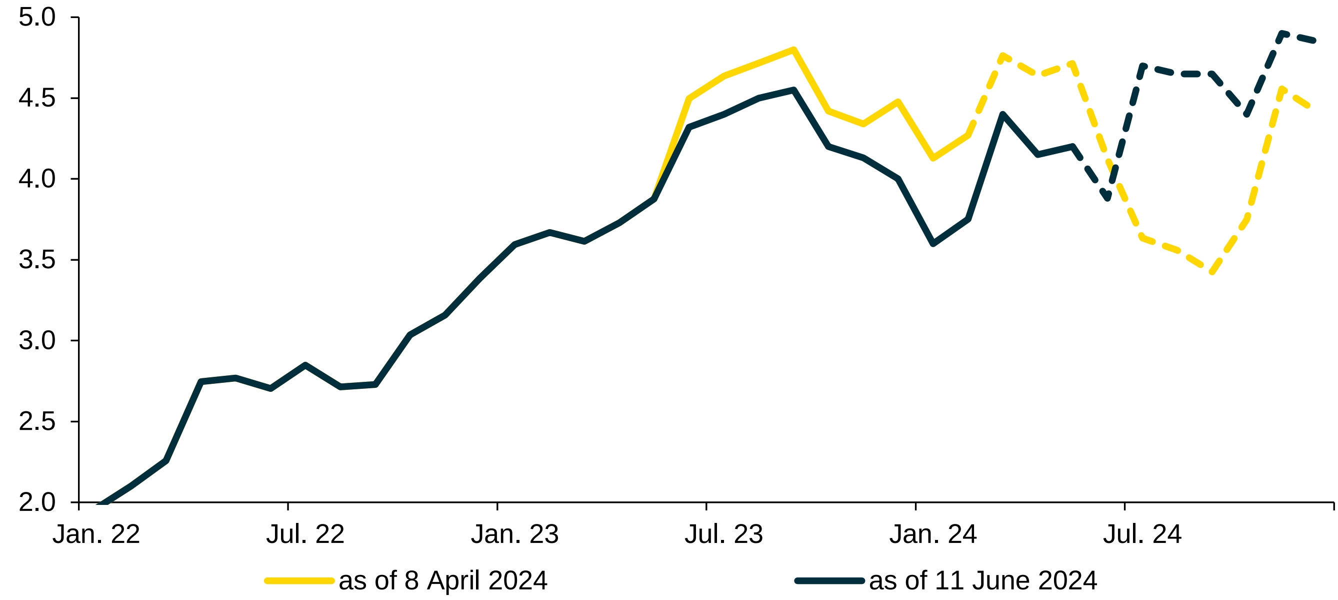
Praying wages back to health?

In this context, labour costs play an important role for the ECB. The central bank is counting on wage growth gradually slowing down. Looking at especially large wage increases at the beginning of the year, the ECB points to special effects as the main driver, particularly in Germany. According to the Bundesbank, the causes were mainly the tax-free inflation compensation premia. These premia still contribute heavily to wage growth as of now, but should be completely eliminated in 2025 (see **June monthly report**). At the same time, the ECB is assuming that, in the coming quarters, productivity will increase decently to partially offset the sharp rise in labour costs for companies. As a result, labour cost increases should only have a very limited impact on consumer prices.

However, in our view, the productivity increases assumed by the ECB are too optimistic and the experimental wage indicators are also currently pointing in a different direction. While the members of the ECB's Governing Council had still argued that wage growth was slowing at the April meeting on the basis of this data, these figures have since been revised significantly. According to the latest figures, wage increases between summer 2023 and spring 2024 were slightly lower, but the trend for the coming months is clearly pointing upwards, meaning that the strongest wage growth is still to come (Chart 2). However, even with these developments, the ECB economists' inflation picture ("bumpy ride") should provide sufficient degrees of freedom.

Chart 2 - Strongest wage increase still to come

ECB Wage Tracker: Wage indicator based on seven euro countries, including special payments, in per cent year-on-year



Source: ECB, Commerzbank Research

The oil price could help

In addition, lower oil prices could play into the hands of the ECB doves. At the beginning of June, the price of North Sea Brent crude fell below USD 80 per barrel for a few days; in comparison, Brent was trading above USD 90 at times in early to mid-April. If the price of this critical commodity remains at lower levels, the doves in the ECB Governing Council could use this to substantiate their conjecture. In any case, the Greek **Stournaras** is of the opinion: "In my view, headline inflation is our target and is the most important, because core simply follows it."

A favourable argument for the doves: the real interest rate ...

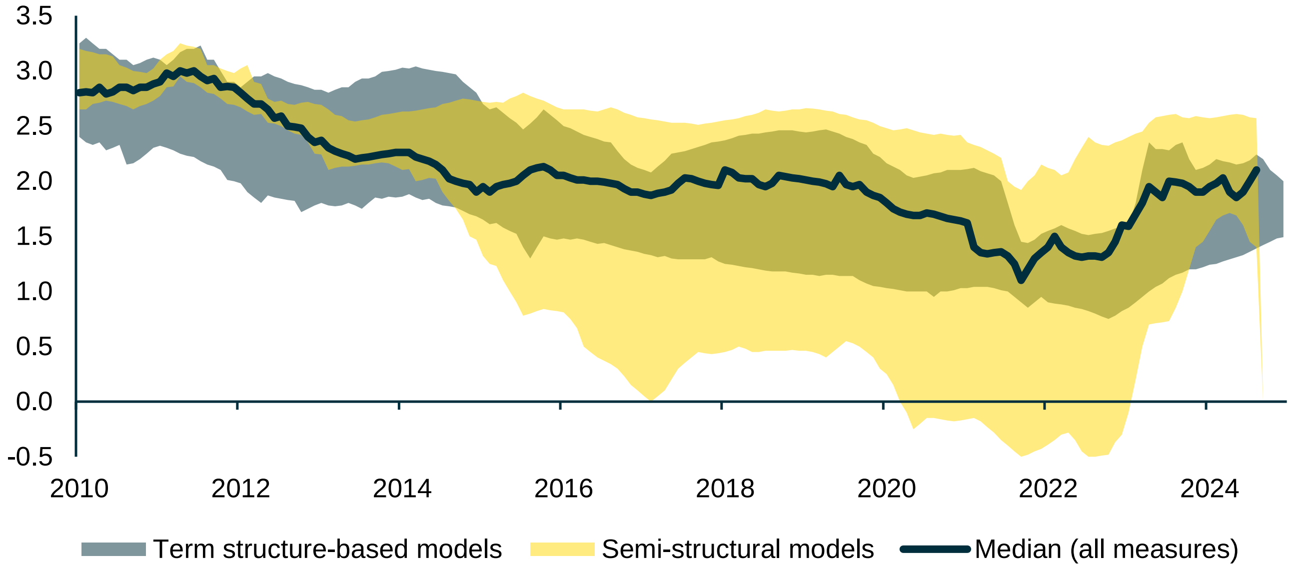
Over the next few months, the doves on the ECB's Governing Council are likely to turn their attention back to real interest rates. The reason for this is a downward trend in inflation which would cause real interest rates to rise if nominal key interest rates remain unchanged. **Scicluna** argues: "Our monetary policy is very restrictive and is becoming even more restrictive in real terms with inflation going down." If an increase in real interest rates is to be prevented, the central bank would have to cut interest rates accordingly. Based on the ECB's inflation projection, nominal interest rates would have to fall in accord with market expectations for real interest rates to remain at their current level in the coming months.

... and the neutral interest rate

At the same time, some ECB Governing Council members repeatedly emphasise the difference between the key interest rate and the natural interest rate – which neither slows down nor stimulates the economy and is compatible with an inflation rate of 2%. Admittedly, this is a somewhat opaque concept, as the neutral interest rate cannot be observed but can only be estimated. Nevertheless, central bankers have it in their repertoire in order to at least get a feel for the limits of monetary policy. As the Frenchman **Villeroy de Galhau** recently explained – in line with an analysis in the

ECB Bulletin – most central bankers are currently likely to place the nominal neutral interest rate at around 2% (Chart 3)[1] – with the exception of the German Schnabel, who recently said that the neutral interest rate could rise in the future in her speech **"R(ising) star?"** . In the eyes of the doves in the ECB Governing Council, a neutral interest rate of around 2% means that a few interest rate cuts simply make monetary policy somewhat less restrictive. Therefore, they would argue that there is room for further interest rate cuts without letting the reins slip.

Chart 3 - ECB sees neutral interest rate at around 2%
Estimates of the nominal neutral interest rate based on various models, in per cent



Source: ECB, Commerzbank Research

Euro-dollar bone of contention

One last important variable that some ECB Governing Council members and journalists have been talking about for some time now is the euro-dollar exchange rate. In view of the expected increasing divergence between the ECB's and the Fed's key interest rates, questions about the implications of the exchange rate for the ECB's monetary policy are becoming more frequent. Essentially, there are two lines of argumentation: Firstly, a weak euro makes imports more expensive — it imports inflation, so to speak. This applies not only to goods that Europe purchases from the USA, but also to a much wider range of goods, as a large proportion of global trade is invoiced in dollars. However, this effect should be quite manageable as the market has already widely priced in the risk of diverging interest rate paths. Hence, in our view, the potential for an even weaker euro should be limited. Secondly, "higher for longer" policy by the Fed, i.e. persistently high interest rates in the US, could also be transmitted to the eurozone via international financial markets and tighten financing conditions on our side of the Atlantic. Overall, the exchange rate channel could be inflationary and the long-term while the interest rate channel is rather disinflationary with respect to the eurozone. In the near future, the ECB Governing Council will likely debate which of the two effects they expect to dominate.

Market should not underestimate the power of doves

At the end of May/beginning of June, financial markets priced in just one further interest rate cut by the end of 2024. However, by now, expectations have adjusted and markets predict roughly two interest rate cuts by the end of the year. It is likely that increasing concerns about France inspired this change of heart. Still, irrespective of this, we warn against underestimating the influence and reasoning skills of dovish ECB Governing Council members. Therefore, we are sticking to our view that, looking forward, the ECB will cut interest rates twice by the end of this year, as well as in March 2025.

As a result, the deposit rate would then remain at 3%. Henceforth, however, the scope for additional interest rate cuts is likely to be exhausted. We believe this is the case, because, by then, it should become increasingly clear that inflation is, in fact, more persistent than expected. By that time, even the doves should be unable to argue in favour of further interest rate cuts.

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[1] In the **Economic Bulletin**, the ECB experts estimate the real neutral interest rate, to which we add the inflation target of 2% in order to obtain a representation of the nominal neutral interest rate. (back to the text)

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