Sunday Wrap

Greetings from my favorite café here in Berlin Mitte:

Eurozone inflation continues to fall as we are approaching the end of the base effect of the original supply shock. On Friday, we learned that eurozone headline inflation declined further from 6.1% to 5.5% in June. The headline grabber was the tumbling Spanish inflation number, now at 1.6%, well below the magic 2%, although the passthrough to core, at 5.9%, is still at work. (Yes, the German headline number increased a bit, but that doesn't change the story; Spain also had a couple of those hiccups on the way down).

Granted, Spain is running ahead of the rest of the eurozone. The regulatory link in Spain between electricity prices and whole sale gas prices delivered an earlier - and larger – impact of the surging gas prices on headline inflation, which is now reversing. But the rest of the eurozone will follow, for sure. If you plot Spanish and eurozone headline inflation on a chart, you'll see how Spain leads the eurozone average by quite precisely four months (h/t Patrick Krizan of Rolls Royce Power Systems). And core will then follow, of course, as the lower energy prices are passed through into core.

As I have argued ad nauseum, the eurozone inflation story is a pretty straight-forward case of a massive energy supply shock (with a few bells and whistles), as opposed to a case of overheating demand. It was therefore always bound to come back down to the 2%-area all by itself, as it's now well on its way to do – even before the monetary policy tightening has begun to bite for real. Once the full effects of the tightening shows up, it'll hurt growth from its already position.

So, what better time to discuss "macroeconomic stabilization in a volatile inflation environment", which is exactly what the ECB did at this past week's annual forum in Sintra.

Sintra is one of my favorite annual events, and this year was the best Sintra conference I have been to. It featured an exceptionally good line-up of speakers presenting great papers, debating with their discussants and the audience, including the policymakers, the key issue of inflation and monetary policy. The agenda and conference papers are here, and highly recommended:

ECB Forum on Central Banking 2023: Macroeconomic stabilisation in a volatile inflation environment

In today's note, I'll summarize my key take-aways:

The conference didn't come off to a great start. At Monday night's welcome dinner, IMF First Deputy MD, Gita Gopinath delivered a speech, titled "Three Uncomfortable Truths For Monetary Policy". The three claimed truths were that (i) inflation is taking too long to get back to target, (ii) financial stress could generate tensions between central banks' price and financial stability objectives, and (iii) we are likely to experience more upside inflation risks than before the pandemic.

I didn't love her speech for two reasons: First, to claim that those three postulates, or assessments, are "truths", and therefore not open for debate, seemed odd to me, not least in front of an audience of policymakers, academics and private sector economists. (But maybe this is a question for her speechwriter?)

Second, and more importantly, Gopinath concluded that "now is the time to face [these] three uncomfortable truths" and that under certain conditions, e.g. fiscal expansion, "there could well be a case for pre-emptive tightening", which, in her telling, "would also reduce the financial stability risks likely to accompany a rapid exit from low rates". To argue for pre-emptive tightening after the past 12 months' unprecedentedly fast tightening did not seem persuasive to me (and I am being polite here) – and it left many of us in the audience wondering if this talk would have fitted better a year ago.

But by Tuesday morning we were back on track. In her opening speech, ECB President Lagarde discussed the different phases of inflation, laying out the analytical and policy issues that the ECB is facing right now. I agreed with the analytics with one important exception: Considering the risk of a price-wage spiral, Lagarde referred to the expected cumulative 14% nominal wage from here to the end of the forecasting period.

In my view, the more relevant starting point for that discussion would have been the onset of the inflation shock, as opposed to now when real wages are already in deep negative territory. On ECB estimates (from June), cumulative wage growth from the onset of the inflation shock to the end of the forecast period is 20%. And for the same period, ECB staff estimates cumulative headline inflation to be 21% - i.e., no expected real wage growth! My point is simply that the 14% cumulative wage growth, mentioned by Lagarde (and the implied roughly 4% real wage growth), is no more than compensation for the falling real wages over the last couple of years, and is therefore not necessarily inflationary, depending on what happens to productivity and profit margins.

Maybe Lagarde's focus on the (for me, less relevant) 14% estimated nominal wage growth was what led most people to interpret her speech as a hawkish message. But I disagree with that interpretation. I feel pretty confident that Lagarde did not travel to Sintra to send a different message than what she had delivered at the last press conference – which, in a nutshell, is "a rate hike in July is a virtual given, and then we'll see what the data and the September forecast show".

Then we were off to a series of presentations of papers with discussants as well as panels. If you don't have time to read them all, my favorites were Silvana Tenreyro's paper, "Monetary policy in the face of supply shocks: The role of inflation expectations", with some very important observations on the role of expectations, and Pierre-Olivier Gourinchas and IMF colleagues' paper on "Fiscal policy in times of high inflation", which included some spectacular charts comparing the eurozone with the US, including with respect to the drivers of inflation. Do take a look at least at these two papers and tell me why the Fed and the ECB acted in such similar ways to so different events!

In a nutshell, my key take-away from this formal part of the conference was this: The academic experts presenting papers and discussing them all sent a decisively dovish message (with the possible exception of Annette Vissing-Jorgensen on optimal balance sheets), while policymakers all conveyed intentions of further rate hikes.

I'm not sure the ECB intentionally picked academics with dovish papers (I understand they had to reshuffle a bit very late due to a drop-out), but it certainly provided a clear contrast to the policymakers, who all wanted to communicate their intentions of further rate hikes. To the policymakers' credit, they took it in stride and happily engaged in the discussions. But it did leave an impression that Europe is now in a rate territory above what the best available science would suggest is justified by the sources of inflation and the outlook for growth and inflation. (Yes, music to my ears, but if you conclude differently from the papers, please do let me know!)

So where does it all leave my thinking about eurozone rates going forward? I'll make two points:

First, it'll take a major data or other surprise for the ECB not to hike rates by another 25bp in July. But September is considerably more uncertain than markets presently think. In my assessment, the odds are that the ECB will end its recent policy of pre-announcements and - at the July press conference - leave its intentions for September open, awaiting the incoming data and the new forecast.

I saw the Reuters story from Sintra that a majority of the GC members they had talked to at the conference expect to hike in September, but I wonder about their sample. My sense is that – on their present thinking - maybe a bit less than one third of the GC would need to see a more-than-realistic decline in core inflation between now and September to abandon their wish to hike to 4.0%, so they have probably told the journalist that they intend to push for a hike. A roughly similar number of GC members would like to see rates left at 3.75% in September, assuming the data come in broadly as expected. And the last one third (and some) truly sit on the fence and want to see the data and the revised forecast before making up their minds. I include Lagarde in this latter group.

If the present general outlook (of falling headline inflation and a bit stickier core inflation, along with indicators suggesting the eurozone is pulling back out of recession, although without any prospect of proper growth) holds between now and the September meeting, then I could imagine that they'll hike to 4.0%. But I'm more worried about the growth outlook than most, and the risk to inflation is - in my view - quite clearly towards a faster decline. Consequently, if I were a betting man - and I'm not! - I would assign a lower than 50% probability to a September hike.

Second, and related, it's becoming increasingly clear that the ECB is getting increasingly frustrated with the market pricing in a rate cut already in 2024. This is not what anyone at the GC (that I know of) is thinking at the moment. More importantly, the concern is the easier financial conditions that transmits from this markets pricing to the real sector.

Yet, persuading markets that there is no rate cut in the pipeline is tricky. After all, we do move in cycles and, in addition, the further they hike rates due to present inflation, the greater the probability of a (potentially deep) recession. I'm not the only one thinking this will be the most likely outcome. For example, those trading the Bund curve seem to agree.

The policy conclusion of this is that if you want to stay at the terminal rate for longer, and therefore don't want markets to price in a rate cut within the next 12-18 months, you'll have to communicate persuasively that another rate hike remains at least as likely as a cut. The prerequisite for making that statement credible is to stop hiking before you get to an interest rate which markets view as too high for getting the balance right between the speed of the decline in inflation and the short-term economic costs associated with such a rapid decline. I believe this is Francois Villeroy de Galhau's fundamental argument, as he has expressed it recently in various speeches and interviews.

In my assessment, if the ECB hikes to 4.0% in September in the face of the rapidly declining inflation and now increasingly weak growth indicators, they'll have very little chance convincing markets that they'll stay there all though 2024.

And on that note – and now a bit over-caffeinated (to stay with the theme of overdoing a good thing) – I'll head out to watch the tail-end of the Velocity Berlin 2023. A lovely event in this fabulous city.

Best

Erik

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