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ECB, Fed and the Hidden Inflation Risks

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Abstract

The European Central Bank and the US Fed are celebrating the fall in inflation with generous interest rate cuts. However, the official consumer price indices do not capture all of the inflationary pressure. Wage demands remain high. Ample liquidity in the banking system could devalue the euro and thus increase the prices of imported goods. If inflation rises again, confidence in central banks and currencies will continue to wane.

Zusammenfassung

Die Europäische Zentralbank und die US-amerikanische Fed feiern den Rückgang der Inflation mit großzügigen Zinssenkungen. Doch die offiziellen Verbrauchpreisindizes erfassen nicht den gesamten Inflationsdruck. Die Lohnforderungen bleiben hoch. Viel Liquidität im Bankensystem könnte den Euro abwerten und so die Preise importierter Güter erhöhen. Steigt die Inflation wieder an, wird das Vertrauen in die Zentralbanken und die Währungen weiter schwinden.

The world is relieved. The rise in consumer prices has fallen significantly in both Europe and the USA. After peaks of 10.6 per cent in the euro area (October 2022) and 9.1 per cent (June 2022) in the USA, 2.5 per cent was measured in the USA in August 2024 and 1.8 per cent in the euro area in September. In Germany, inflation was as low as 1.6 per cent.

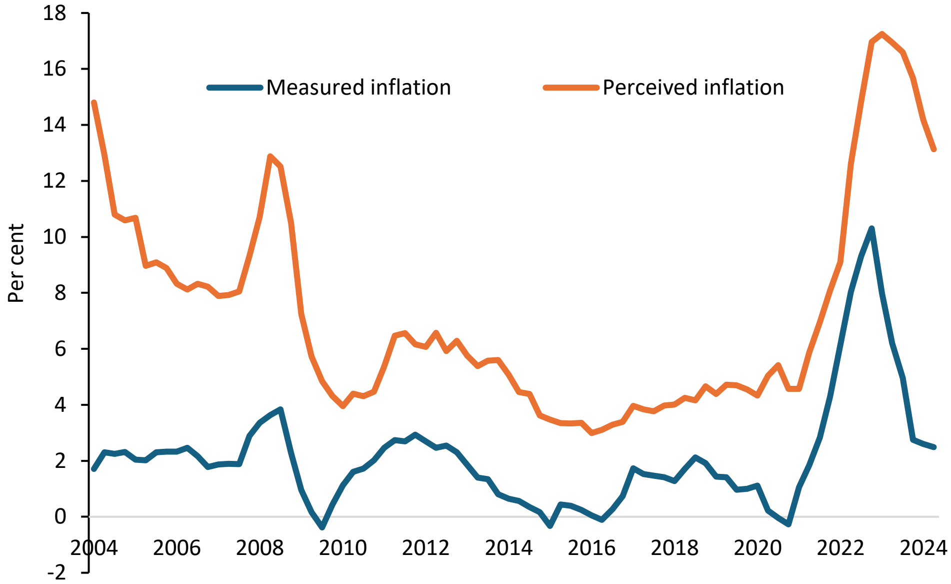
In June, the European Central Bank cut its key interest rates by 0.25 percentage points, even though the inflation target of 2 per cent had not yet been reached at the time. This was followed in September by a further 0.25 percentage points for the interest rate on the deposit facility and 0.6 percentage points for the main refinancing rate. US Federal Reserve Chairman Jerome Powell cut interest rates unexpectedly sharply by 0.5 percentage points in September.

Further interest rate cuts have been signalled here and there. The ECB and Fed seem to assume that inflation has been defeated. In the view of Deutsche Bundesbank President Joachim Nagel, the great wave of inflation is coming to an end. Philipp Lane, chief economist at the European Central Bank, is once again worried about chronically low inflation. Jerome Powell wants to focus the Fed's policy more on the labour markets. Nevertheless, the central bankers could be wrong for three reasons.

Firstly, the official consumer price indices do not capture all inflationary pressures. In the euro area, price increases for owner-occupied housing, cost increases for public goods such as bridges and healthcare as well as asset price increases as for shares are excluded. Another reason for the (unrealistically?) low measured loss of purchasing power could be the fact that, when measuring prices, increases in the quality of industrial goods lead to lower prices in the index, while deteriorations in the quality of services do not result in higher prices.

Indeed, many people in the USA and Germany feel that their purchasing power has fallen significantly. The increased prices for food and services – for instance for restaurants - are hurting. It is not without reason that Donald Trump is campaigning in the US with the slogan "bacon is through the ceiling". At 13.1 per cent, perceived inflation in the euro area in the second quarter of 2024 was far higher than officially measured inflation (see Figure 1). A further increase in the price level - even if only by 2 per cent per year - means a further loss of purchasing power for people.

Figure 1: Perceived and officially measured inflation in the euro area

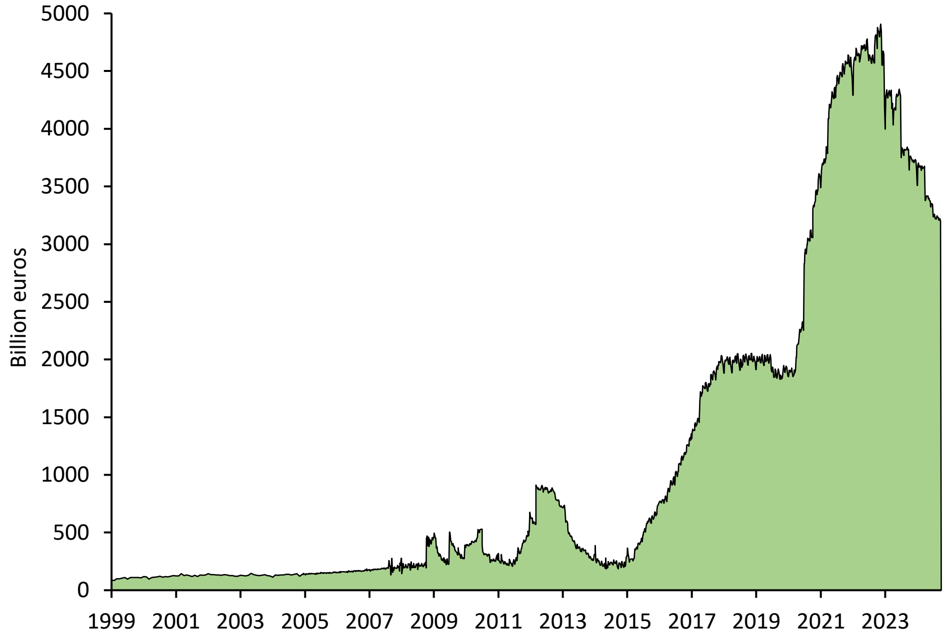


Source: ECB and European Commission. Perceived inflation = median.

It is therefore not surprising that the trade unions are demanding. *"The inflation rate may be falling, but prices at the till are still high for people,"* said Christiane Benner, Chairwoman of the influential German trade union IG Metall. The German trade unions in the chemical industry, retail and the railway sector have negotiated substantial wage increases. The fact that the bargaining power of employees has grown significantly is inter alia due to the fact that the public sector has emptied the labour market by having strongly have increased its labour demand. Prices are rising in line with wage costs, as can be seen from the continuing significant rise in service prices (+3.8 per cent in September in Germany).

Secondly, there is still a lot of liquidity in the financial system of the euro area. In the course of the ECB's immense bond purchases and rescue loans during the financial, sovereign debt and coronavirus crises, commercial banks' deposits with the Eurosystem have risen dramatically (see Figure 2). From July 2022, the ECB raised the interest rate on the banks' deposit facility with the Eurosystem sharply from -0.5 per cent to 4.0 per cent in September 2023. This provided the banks considerable risk-free income on these deposits. In contrast to its rescue loans, the ECB is only very hesitant to reduce the high bond holdings that have created large parts of the deposits, which has supported the commercial banks' interest income.

Figure 2: Deposits of commercial banks with the Eurosystem



Source: ECB.

However, the ECB is now lowering the interest rate on the deposit facility again. The deposit facility rate has fallen from 4.0 per cent in September 2023 to 3.5 per cent recently, and further interest rate cuts have been signalled. Commercial banks are thus losing an important source of income that they can only make up for by granting more loans. However, a significant increase in demand for loans is uncertain despite falling interest rates. In Germany, companies are not investing due to rising unit labour costs and the government's erratic economic policy. Rampant regulation and growing trade barriers are depressing profits and thus the willingness to invest. Demand for property is likely to remain subdued due to high prices and rigid regulation.

It is therefore likely that if interest rates fall, banks will export more capital abroad, where the economy is doing better. Interest rates in Germany are still significantly lower than in the US, which makes US government bonds more attractive. Accelerated capital outflows would lead to a devaluation of the euro, which would make imported goods, especially raw materials and energy, more expensive. This would drive prices in the euro area even higher.

Thirdly, from a historical perspective, high government debt and inflation have always been closely linked. Public debt is historically high in many industrialised countries. In the USA, it is over 35 trillion dollars. Immense spending commitments for social security and ambitious green transformation plans seem to leave governments in Europe little room for manoeuvre for spending cuts.

With the so-called transmission protection instrument, the ECB has created the possibility of buying unlimited amounts of bonds from highly indebted euro countries. It has also announced its intention to structurally hold bonds on its balance sheet. This will enable the ECB to prevent potential sovereign debt crises in Italy or France, but debt levels will remain high. In the USA, neither Donald Trump nor Kamala Harris seemed to be giving much thought to saving.

There are also many signs of further burdens, particularly in Europe. Ageing societies are putting public pension systems in a precarious position. The cost problems of ongoing migration have not been solved. The stumbling industry is crying out for immense subsidies. A property crisis is smouldering in Germany, which could escalate if interest rates remain high. And EU climate policy is throwing more and more sand into the gears of the European economy.

All of this could explain the hasty interest rate cuts by the Fed and particularly the ECB. Even if the officially measured inflation rates appear to allow interest rate cuts, the inflation problem is likely to be anything but solved. Apart from the official consumer price indices, the prices of shares, property and gold are already pointing upwards again.

While the central banks only reacted to the sharp rise in consumer price inflation with a significant delay from 2022, they have now eased monetary policy before the inflation targets were or are reached. This could indicate that the debt-addicted US and the reform-averse Europe still see inflation as the only politically viable solution to uncontrolled spending obligations.

Whether inflation is measured correctly or is once again reflected in an uncontrolled rise in asset prices seems irrelevant. The high perceived inflation signals that the lost trust in currencies and political decision-makers has not yet been regained. Thus, the loss of confidence in the leading international currencies is likely to continue.

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