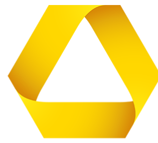

Economic Research

Economic Insight

ECB – Limited room for rate cuts

14 May 2024

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There is hardly any doubt that the ECB will cut interest rates for the first time at the beginning of June. This raises the question of how many interest rate cuts will follow and at what level the interest rate will end up in the long term. We analyse why the ECB will hardly be able to lower the deposit rate below 3%.

According to the interviews and comments of ECB Governing Council members, a first interest rate cut in June is a foregone conclusion. The Governor of the Banque de France, Francois Villeroy de Galhau, is looking further ahead: "... once the first rate cut has been decided, we will have two less frequently mentioned but more important choices, regarding the speed of the fall and the landing zone."

We assume that the ECB will cut its interest rates a total of four times, starting in June, quarterly at each meeting with new projections, by 25 basis points each time. This would probably correspond most closely to the current ideas of many ECB Governing Council members, who speak of "gradual" rate cuts. In addition, many Governing Council members believe that meetings at which new projections are presented are the best time to make monetary policy decisions. The main argument against a faster pace, i.e. more or larger steps, is probably – as explained by Lagarde at the press conference and now repeated by a number of ECB Governing Council members – that the path of inflation will be bumpy, at least for the remainder of this year. After the four interest rate cuts we forecast, a deposit rate of 3% would be reached in spring 2025. We see several reasons why the key interest rate is unlikely to fall significantly below this level in the foreseeable future:

#1: Special factors primarily driving the disinflation

An analysis by ECB experts suggests that core inflation in the eurozone since 2021 has been driven by global special factors, among other things, and that their phasing out since the summer of last year was mainly responsible for the fall in core inflation (Chart 1).[1] In their study, **Bańbura et al (2024)** identify supply chain bottlenecks and energy shortages as special effects. On the other hand, core inflation adjusted for these special effects (dark line in Chart 1) has been quite persistent in recent months. Taking the April figure into account, a very slight downward trend can be seen at best. The traditional drivers (labor market, supply and demand conditions) remain relatively unyielding.
In view of the fact that the eurozone economy has avoided a recession, demand and investment are already picking up again and the labor markets are still working at full

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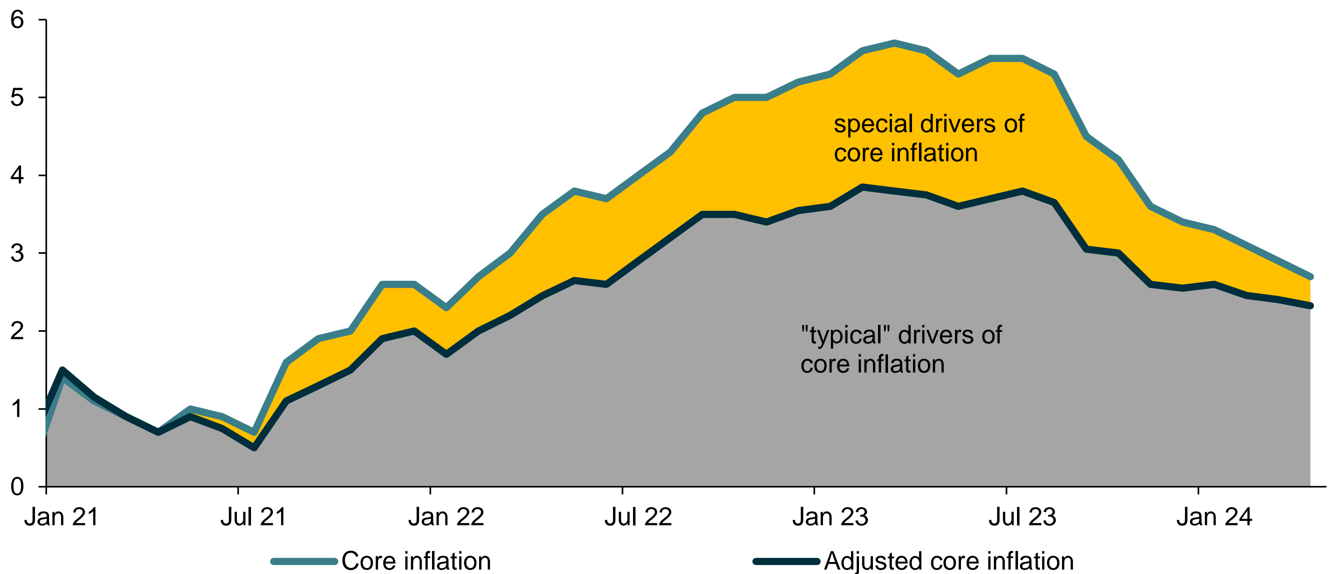
utilization, the traditional drivers of inflation are unlikely to lose their strength any time soon.

Chart 1 - Sticky underlying inflation

Core inflation and core inflation adjusted for global supply bottlenecks and energy price shocks according to Bańbura et al. (2024), in per cent



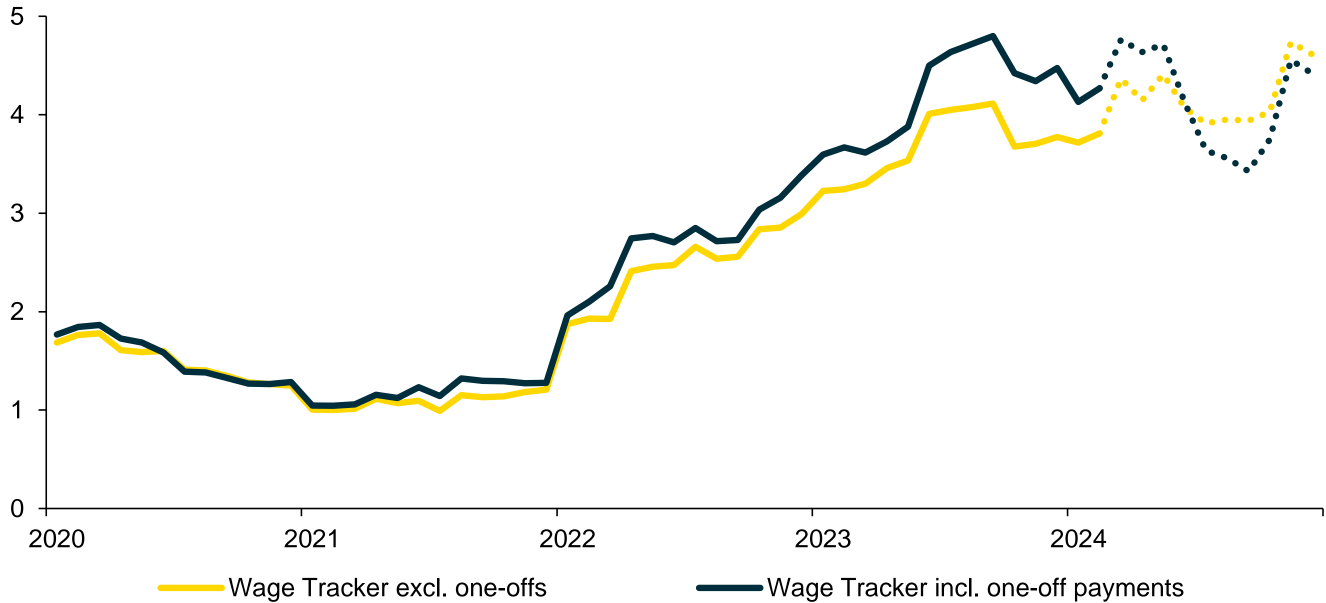
Source: ECB, Commerzbank Research

#2: Rapidly rising labor costs meeting low productivity

This fits with the picture that wages should continue to rise sharply in the coming months. According to the ECB's Wage Trackers, collectively agreed wages alone are likely to rise by an average of more than 4% over the rest of the year (Chart 2). Accordingly, wages actually paid, which have been rising much faster for some time, are likely to increase even more strongly. What is being neglected in the public debate: According to the **ECB SAFE survey**, the approximately 12,000 companies surveyed assume that non-wage costs in both the service sector and industry will rise even more strongly than wages in the coming months. Non-wage costs account for slightly more than half of production costs for service providers and even more in the manufacturing sector.

Chart 2 - No abating wage growth in 2024

ECB Wage Trackers incl./excl. one-off payments, percentage change on the year



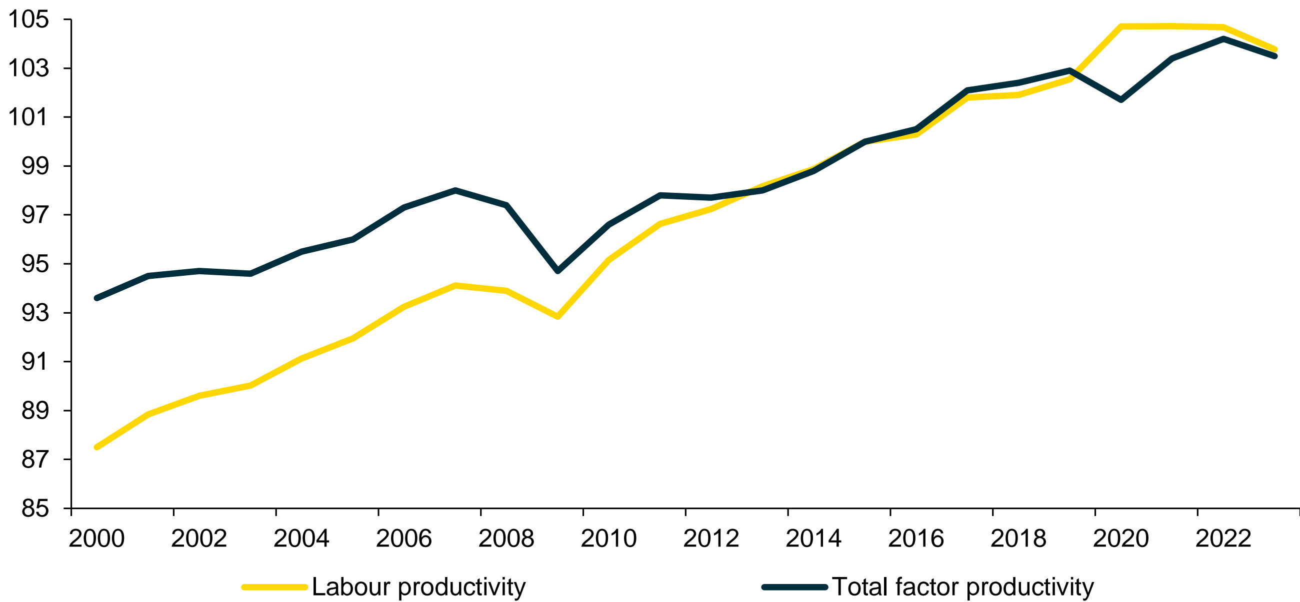
Source: ECB, Commerzbank Research

In this respect, it may be appropriate to consider the other input costs for companies in addition to the much-discussed wages. Whether and to what extent rising wages and non-wage input costs drive consumer price inflation depends on two factors: productivity and the pricing power of companies.

Productivity progress has been extremely meager in recent years (Chart 3). Labor productivity, measured on the basis of hours worked, has only risen by an average of 0.4% per year over the last five years, while overall economic factor productivity – economists refer to this as total factor productivity (TFP) – has only increased by 0.2% per year over the same period. If this weak trend continues – and we currently see no good reason why productivity should rise significantly in the foreseeable future – the slow progress in productivity will hardly be able to cushion the rise in corporate costs.

Chart 3 - Weak productivity gains in the euro zone

Labour productivity based on working hours and total factor productivity, index 2015=100



Source: ECB, Ameco, Commerzbank Research

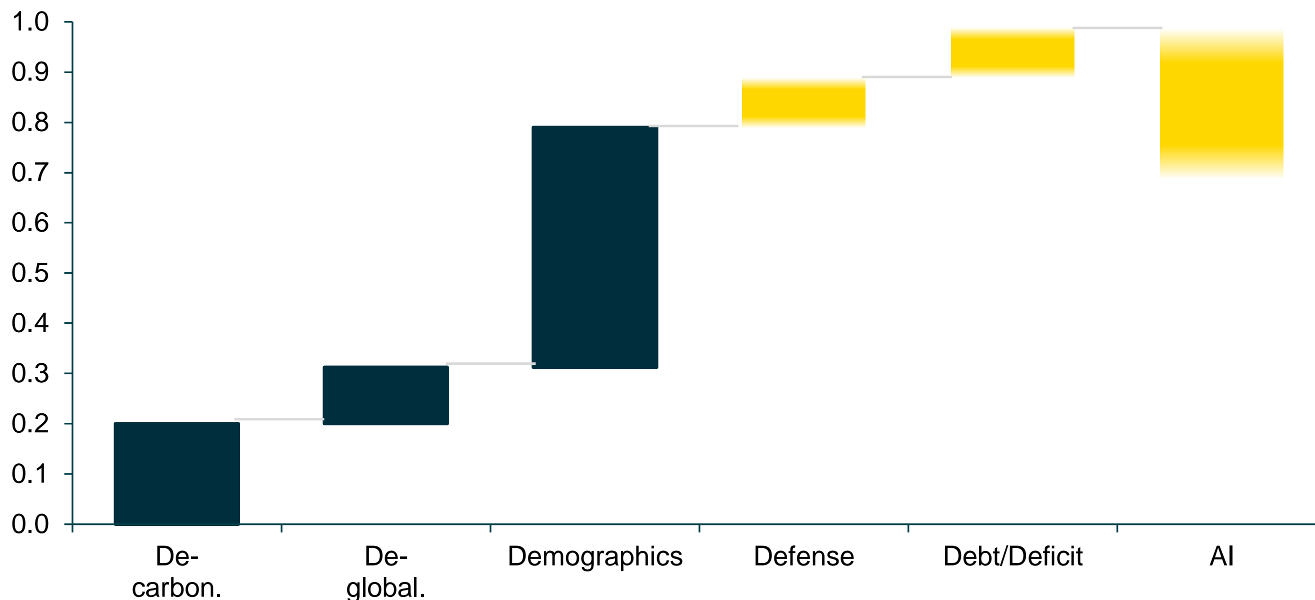
The question remains as to the pricing power of companies, i.e. the extent to which they can pass on their rising costs to consumers. According to ECB Governing Council member Vujcic (interview on 26 February 2024), competition on the goods markets has returned to normal after the exceptional situation in the coronavirus years, meaning that companies should have less scope for price increases. In fact, this can hardly be proven on the basis of data. Ultimately, therefore, the only option is to look at companies' intentions to raise prices. According to the **ECB's SAFE survey** mentioned above, the companies surveyed from the beginning of February to March expect a fairly decent increase in sales prices of around 3½% over the next twelve months.

#3: The "5D" structural inflation drivers

While wages are typically one of the cyclical factors, there are a number of structural factors that will drive inflation in the coming decade at least. There is often talk of the "3D": decarbonization, deglobalization and demographic change. Three recent studies estimate the impact of these three factors on inflation up to 2030, whereby we only show the conservative results of the studies in Chart 4; in doubt, the effects on inflation could be even higher: according to a **study by the IMF**, the energy transition in the eurozone could generate inflationary pressure of at least 0.2 percentage points per year, assuming that the goals of the Paris Agreement are implemented. An **ECB study** examines the effects on inflation if the current trend of fragmentation of world trade continues and globalization is reversed to the level of the mid-1990s. According to the study, this would be 0.15 percentage points more expensive for consumers per year. Another **ECB study** comes to the conclusion that demographic change has an inflationary effect of around half a percentage point per year.[2]

Chart 4 - Ageing society is a powerful driver of inflation

Annual effect of structural drivers on inflation until 2030, in percentage points; petrol: based on IMF World Economic Outlook (2022), ECB (2023) Economic Bulletin, ECB (2017) Working Paper 2006; yellow: stylised effect



Source: ECB, IMF, Commerzbank Research

Meanwhile, many are adding defense and public debt/deficits to the "3D". Despite the restrictive monetary policy, the industrialized nations in particular are still largely operating at their capacity frontiers, which is reflected in the robust labor markets, for example. In such an environment, investments in defense lead to resources being channeled into this area of the economy and diverted away from the production of "normal" goods, which makes those more expensive to produce when resources are scarce. A similar argument applies to government debt/deficits. By distributing funds in the form of investment subsidies etc. – which is reflected in high budget deficits and rising government debt – demand is fueled, which leads to faster rising prices in the economy as a whole when resources are scarce. Studies point in this direction, but the extent of the effects varies greatly, so that we only show them stylized in the chart (yellow columns with diffuse edges).

The counter-argument that artificial intelligence (AI) could offset these price-driving effects does not hold water in our view. We do not see AI as a revolution that will generate such advances in productivity overnight that the price pressure of 5D could be offset. Rather, we see AI as an evolution that will have to continue to develop over the coming years and be integrated into operational processes, thereby only continuously fostering productivity and only partially offsetting inflationary pressure (see **Week in Focus "Will artificial intelligence boost productivity?"**).

#4: The natural interest rate r* is near 3% rather than 2%

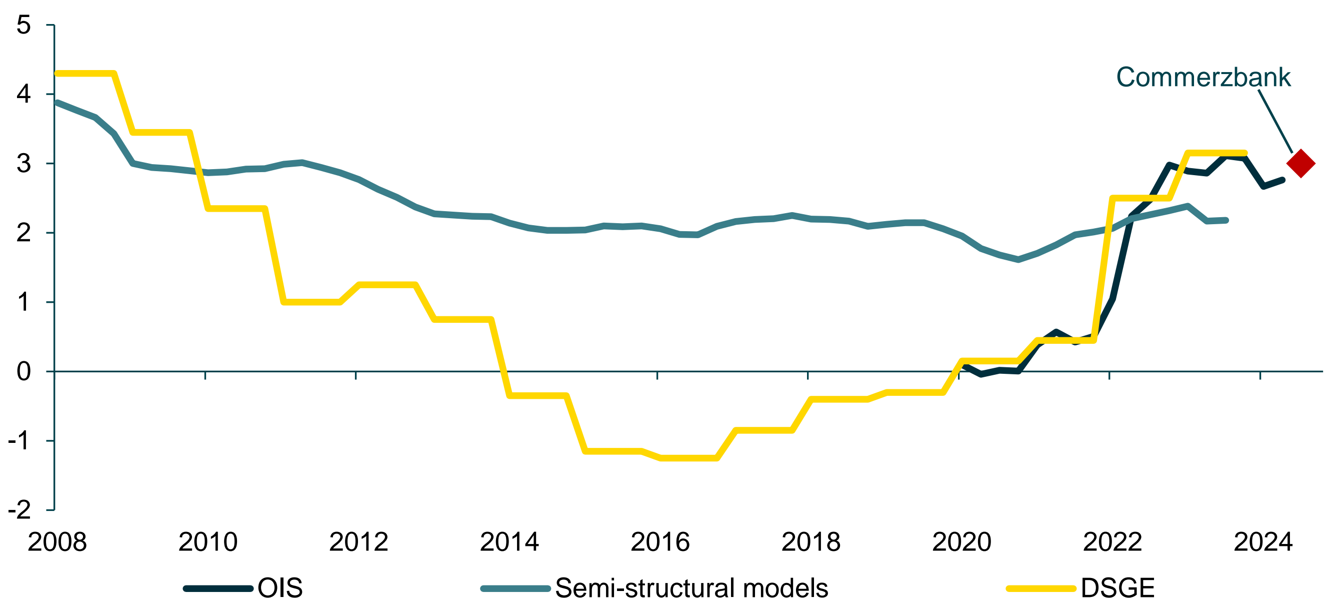
More recently, the question of the ECB's "landing zone" has brought the natural interest rate back into the discussion. This describes the interest rate at which monetary policy neither stimulates nor slows down the economy and which is compatible with 2% inflation. Unfortunately, the natural interest rate is not observable in reality, but can only be estimated using economic models. Nonetheless, central bankers are constantly looking at it in order to have at least rough target coordinates for their monetary policy.

In fact, there are numerous estimates of where the natural interest rate could lie (Chart 5):

- We see the nominal natural interest rate at around 3% and refer to Edmund Phelps' "Golden Rule of Capital Accumulation", according to which the natural interest rate should correspond to the long-term growth potential of an economy. We place the real growth potential of the eurozone at around 1%, plus the inflation target of 2%.
- Market-based estimates based on overnight index swaps (OIS) – which Governing Council member Villeroy once mentioned as an acceptable approximation for r* – and the general equilibrium model (DSGE) presented by Governing Council member Schnabel in her speech **Rede "Rising r*"** also place the (nominal) natural interest rate at around 3%.
- Semi-structural models – which include the well-known Holston-Laubach-Williams model – see the natural interest rate somewhat lower. However, it has also risen noticeably again in this model class over the past two years.

ECB Governing Council member Schnabel (in her **speech "Rising r*"**) and the **Bank for International Settlements (BIS)** have analyzed impressively that the neutral interest rate could rise even further. While persistently weak productivity growth and an aging society should continue to push r* down, other challenges of our time, however, are likely to offset this and ultimately even outweigh it. Huge investments will be necessary for the energy transition alone. Advancing digitalization, automation and the use of artificial intelligence will also require large sums of investment. In addition, countries and companies will have to spend a lot of money to protect themselves against geopolitical risks such as energy price shocks, supply chain bottlenecks and military threats.

Chart 5 - Natural interest rate probably around 3%
Estimates of the natural interest rate (nominal): General equilibrium model (DSGE), median of semi-structural models, overnight index swaps 1-year forward in 9 years, Commerzbank estimate, in per cent



Source: ECB (Schnabel's speech 20 March 2024), Bloomberg, Commerzbank Research

Conclusion: limited scope for interest rate cuts

In the short term, the ECB's picture is likely to be quite accurate, namely that inflation should continue to fall over the remainder of 2024, albeit with fluctuations. However, the reasons mentioned above suggest that there is a huge underlying structural inflationary pressure that will drive inflation in the coming years. The central bankers will therefore only have a window of opportunity for interest rate cuts in the coming months, which we believe will close in the spring of next year. The ECB's room for manoeuvre for further interest rate cuts will be limited as high inflationary pressure then becomes increasingly visible.

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[1] We have already written about this in our **Economic Insight "Sticky euro inflation – an update"** and continued the ECB experts' model. (back to the text)

[2] We have extrapolated the effect estimated by the ECB experts in the 2017 study using figures from the UN population projections for the individual eurozone countries up to 2030. According to this, the aging of the population in Europe could drive inflation here by around 0.5 percentage points per year. (back to the text)

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In accordance with ESMA MAR requirements this report was completed 14/5/2024 08:16 CEST and disseminated 14/5/2024 08:16 CEST.

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