ECB – Doves ascendant

Dr. Marco Wagner

At its meeting next Thursday, the ECB will raise interest rates by another 50 basis points. But meanwhile, the doves – who dominate the Governing Council more than ever, according to our "Hawkometer" – are already positioning themselves. At the May meeting they are likely to push through a slower pace of rate hikes and then end the rate hike cycle at a deposit rate of 3.25%.

Next Thursday, another rate hike by 50 bp

The ECB's interest rate decision next Thursday should be a done deal. ECB President Lagarde had already indicated at the press conference after the meeting in mid-December that rate hikes of 50 basis points could be expected at the coming meetings. Several Council members have since also expressed this view. According to our count, 13 of the 18 voting Council members have already explicitly spoken out in favour of a 50 basis point rate hike or given corresponding indications.

On Thursday, the ECB is expected not only to decide on higher interest rates, but also to announce further details on the tapering of its bond portfolio. This could be about the reduction in the different portfolios (government, corporate bonds, etc.) or about the flexibility the ECB allows itself on the timeline. In mid-December, the Council members decided that the portfolio under the APP bond-buying programme should decrease by an average of €15bn per month between March and June.

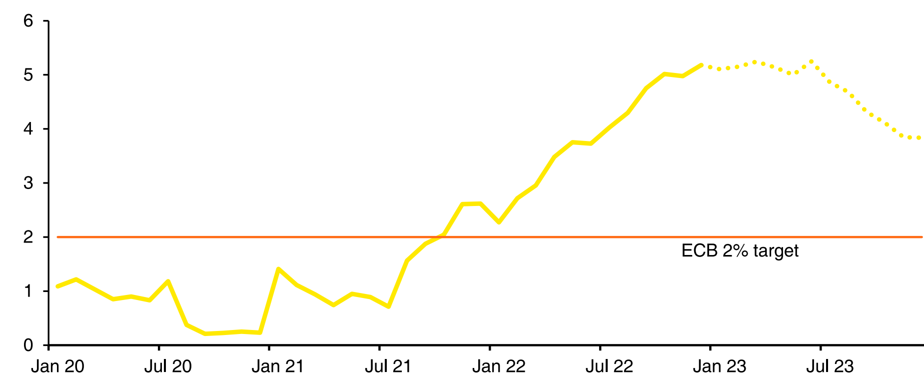
In March yet another 50 bp step

While we do not expect any big surprises at next Thursday's meeting, the rumour mill is already bubbling with a view to the subsequent meeting in March. According to agency reports, the ECB could slow down its pace of interest rate hikes in March. But there are several reasons for a further increase of 50 basis points:

- **High core inflation**: It is true that the inflation rate is likely to fall significantly in the course of the year. However, this does not apply to core inflation (excluding volatile energy and food prices). In fact, it is likely to remain above 5% until June and only decline moderately in the second half of the year (Chart 1). It has been shown in the past that even one-off shocks such as abrupt increases in energy prices are transmitted to all sectors over several years. Moreover, the "3D" – de-globalisation, de-carbonisation and demographics – will drive underlying inflation for years to come.

Chart 1 - Core inflation remains well above 2% ECB target

Consumer prices excluding energy, food and tobacco, in per cent year-on-year

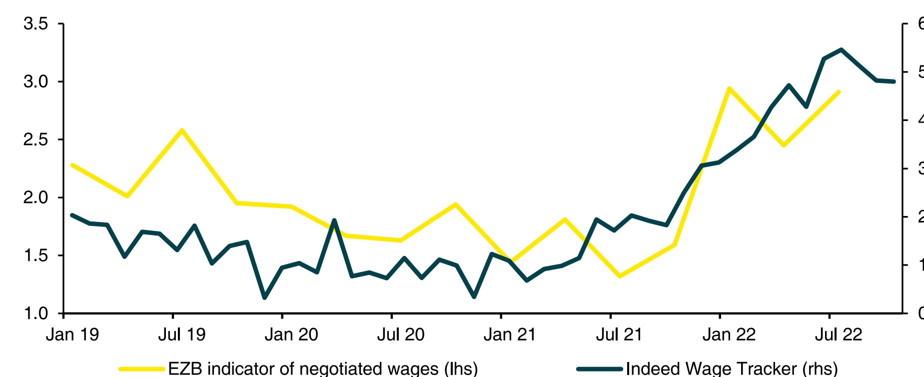


Source: Eurostat, Commerzbank Research

- **Accelerating wages**: As several speeches and background reports suggest, the ECB is focusing on wage developments in particular, as they are a key determinant of companies' costs and thus of inflation. Since the beginning of 2022, the increase in the ECB's collectively agreed wage indicator has accelerated significantly to almost 3% by the third quarter (Chart 2). At the same time, a wage indicator developed by the Central Bank of Ireland in conjunction with the internet platform Indeed suggests that wages continued to rise strongly in the fourth quarter, even if these are only salaries for offered jobs. ECB chief economist Lane writes in his **"Economic Outlook for the Euro Area"** of 6 January that due to the collective agreements concluded last year, collective wages should rise by a good 4% in 2023.

Chart 2 - Strong wage incease

ECB indicator of negotiated wages, Wage Tracker of the Internet platform Indeed based on offered salaries, in percent year-on-year



Source: ECB, Commerzbank Research

The doves in the Governing Council are getting louder

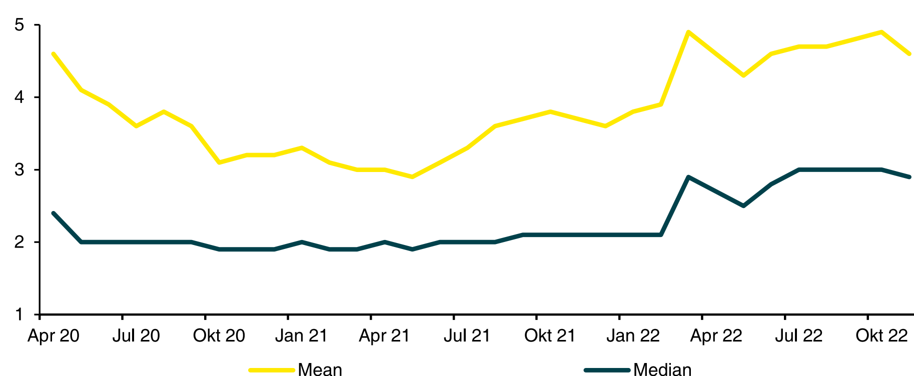
Hence, in March, the ECB is likely to raise its interest rates by another 50 basis points. But in May it will probably reduce the pace of its rate hikes to 25 basis points, which is supported by three arguments:

- Headline inflation is likely to fall noticeably from March onwards, and the forecasts of the ECB and other analysts are likely to point significantly downwards for the rest of the year. This should also be helped by the now significantly lower energy prices. Gas is currently quoted on the world market at around 60 euros per MWh, even lower than before Russia's invasion of Ukraine. A barrel of crude oil currently

costs less than 90 US dollars. In addition, consumer inflation expectations, which are important for the ECB, fell in November (Chart 3), although the inflation rate had peaked in October – i.e. shortly before the survey – at 10.6%.

Chart 3 - Long-term inflation expectations have fallen recently

ECB consumer survey on their inflation expectations in 3 years, in per cent



Source: ECB, Commerzbank Research

- In any case, at the May meeting the deposit rate – after two 50 basis point steps in February and March – would already be at 3% and thus clearly above the 2% which the ECB Governing Council considers neutral in the sense that it ensures inflation of 2% in the long term. From the perspective of the ECB Governing Council, monetary policy would already be noticeably restrictive at this point.

- These fundamental arguments come along with an ECB Governing Council that, according to our analysis, is dominated by the doves – i.e. by Council members whose basic monetary policy stance tends to favour a loose monetary policy. According to our "Hawkometer", the doves currently outnumber the hawks - i.e. those who are basically in favour of a tight monetary policy in the Governing Council - by a clear margin of 11:6 (title chart). In our classification of the Council members into the groups of hawks, neutrals and doves, we partly use more than ten years of public statements as a basis for determining the "true" basic monetary policy stance of the individual Council members. Accordingly, there were few changes in updating the Hawkometer (**find more details here**).

Interest rate high from May at 3.25%

In May, the high point of deposit rates should thus be reached at 3.25%. After that, the ECB will probably leave interest rates unchanged for some time. We consider rate cuts later in the year – as currently forecast by some other analysts and market participants – unlikely. From our perspective, inflationary pressures will remain high and the ECB will not succeed in pushing inflation to the 2% ECB target on a sustainable basis with a deposit rate level of 3.25%. At the same time, given their numerical inferiority in the ECB Governing Council, the hawks are unlikely to prevail with their demand for even higher interest rates.

Fed to dial down rate hike to 25 bps

Bernd Weidensteiner

The Federal Reserve is likely to raise the target range for federal funds by just 25 basis points next week, having already shortened the rate hike to 50 basis points at its last meeting. The economy is cooling down as desired, and inflationary pressure seems to be easing noticeably. The rate peak is therefore no longer too far away.

Rate hikes are applying the brakes on the economy ...

The Fed raised its key interest rates by 425 basis points last year, an unusually high pace of rate hikes. The goal of the more restrictive policy is to slow economic growth enough to reduce price pressures and bring inflation back down to the central bank's 2% target in the medium term. There are signs of success here: Residential construction, which is particularly sensitive to interest rates, has cooled significantly, economic sentiment indicators have fallen, and recently industrial production and retail sales have also weakened.

... the inflation rate is falling

In addition, the inflation rate has passed its high and has fallen noticeably again. Although it is still well above the Fed's 2% target, it is moving in the desired direction. This is partly due to the weakening of various special effects and the significant decline in energy prices, but the underlying trend has also weakened somewhat.

... and wage growth might be past its peak

The decisive factor for the Fed, however, is wage development. This is the main factor determining the trend in service inflation. Last year, the tight labor market caused wages to rise much faster. In the fourth quarter, however, the upward trend was probably broken. Average hourly earnings still increased by 4.7% year-on-year in Q4, after 5.2% in Q3 (chart). Hourly earnings should be interpreted with caution, as they are susceptible to changes in the composition of the workforce (this also explains the jumps in the Corona crisis). A better measure, since it is adjusted for these effects, is the employment cost index ECI. Here, too, there are already signs of a slight easing. Q4 figures will be released next week. The Fed will take a close look at whether the easing in hourly earnings is also reflected here.

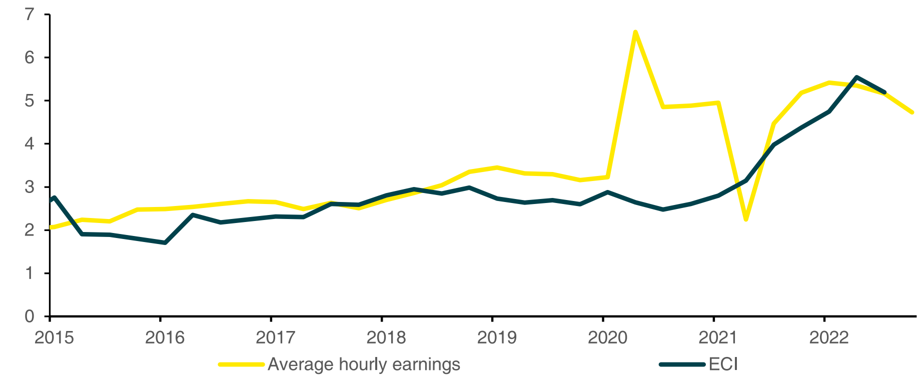
... therefore a small rate hike is on the cards

Apparently, worries about a wage-price spiral have abated at the Fed, as indicated most recently by Fed Vice Chair Lael Brainard. Fed officials repeatedly point to the lags in the effects of monetary policy. As we near the interest rate peak, therefore, it seems appropriate for the Fed to proceed more cautiously so as not to overtighten the interest rate screw. In a speech, Governor Waller explicitly advocated a smaller interest rate step of 25 basis points, and regional Fed representatives took the same line.

We therefore expect the target range for key rates to be raised by 25 basis points to 4.50-4.75% at next week's meeting, thus changing our previous forecast. The Fed is likely to raise rates a bit more after that, to slightly above 5%.

Chart 1 - Is wage inflation already past its peak?

Employment cost index for private industry and average hourly earnings, annual rates of change in %, quarterly data.



Source: IHS, Commerzbank Research

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