If you are having problems viewing this message view the online version.

Economic Research Unit

Economics Weekly

Bank of Ireland

ECB won't be held back by the Federal Reserve

Given an ECB rate cut on June 6th is now seen as a near-certainty, attention will soon turn to how rapidly the ECB can cut rates over the next two years. One view has been the ECB will have limited scope because divergence from the Federal Reserve will place downward pressure on the euro. However, the euro area is a relatively closed economy so the impact of any currency depreciation onto HICP inflation is limited. Also, the current divergence between ECB and Fed policy rates is not exceptional. Rather, the ECB's median estimate of the nominal natural policy rate is close to 2%. This highlights rates could decline more rapidly than market expectations for the ECB's deposit rate to fall to 2.76% rate by end-2025 and 2.56% by end-2026. Of course, there is also the risk that if current rates of HICP inflation above 2% prove more persistent than expected, this could limit the ECB's scope to cut rates.

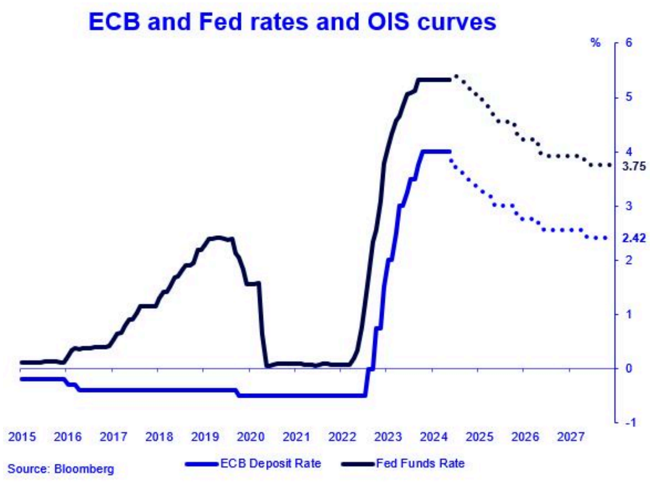
ECB set to become first major Central Bank to cut rates: Options prices currently imply a 90% probability that the ECB will cut rates by 25bps at the next meeting on June 6th. Given a June rate is now seen as a near certainty, the question now is how far the ECB will eventually cut rates from current restrictive levels. The Overnight Index Swap (OIS) curve suggests the deposit rate will fall from 4% currently to 3.37% by end-2024, 2.76% by end-2025 and 2.56% by end-2026. This is actually a marked change in view. In early 2024, the OIS curve implied the ECB would eventually cut rates below 2%, to 1.8% by end-2025. Is this upward revision to expectations for medium-term ECB rates justified?

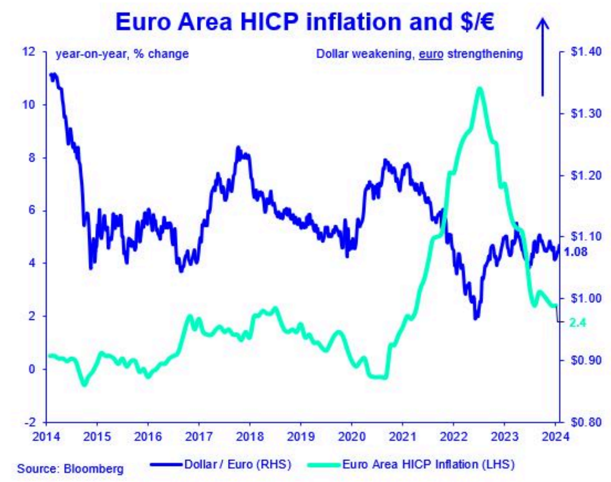
The ECB can diverge from the Federal Reserve: One reason markets may have revised up their forecasts for rates is a perception is the ECB cannot diverge from the Federal Reserve, without putting downward pressure on the dollar/euro exchange rate and stoking inflation. However, the euro area is a relatively closed economy. Imported goods and services make up only a small portion of consumer price indices. Also, it is the euro effective exchange rate (measured against a trade-weighted basket of currencies, not only the dollar) that counts for inflation. The ECB has estimated a 10% depreciation in the effective exchange rate, a rare event, would add just 0.4 percentage points to HICP inflation.

The current gap between ECB and Fed rates is not unusually large: Since the inception of the euro the ECB has consistently set rates below those in the United States, reflecting Europe's poorer structural growth prospects and weaker demographic trends. The current gap between ECB and Fed rates, or that priced in by OIS curves, is not unusually large. For example, in early 2015 the ECB began quantitative easing, accompanied by a sharp euro depreciation from above $1.30 to $1.05. The following four years saw the Fed hike rates above 2%, while ECB rates remained negative. Despite this divergence, euro area HICP inflation stayed well below 2% through most of the period.

The ECB median estimate of the nominal natural rate is close to 2%: In January 2024 the ECB published estimates of the natural rate (r*), the real interest rate that is neither expansionary nor contractionary. Put another way, r* is the real rate that will likely prevail once current energy, supply-chain and other shocks affecting GDP and inflation fade. These estimates are driven by long-run economic drivers such as productivity growth, demographics and risk aversion. Though uncertain, the ECB's median estimate of r* was close to zero (or 2% in nominal terms) demonstrating the downside risks to the current market view that rates will stay above 2.5%. Of course, should current rates of HICP inflation above 2% prove more persistent than expected the ECB's scope to cut rates will be reduced.

Group Chief Economist: Conall MacCoille





Contact Us at economics@boi.com