Flash Economics

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The ECB's curious decision

The ECB has decided to cut its interest rates by 25 basis points on June 6, 2024, while giving no precise indication of further moves and acknowledging that wage inflation remains strong.

This decision is surprising when one considers the outlook for inflation in the eurozone:

- Unit labour costs (wages per capita adjusted for labour productivity) rose by more than 5% year-on-year in the first quarter of 2024, with wages per capita up by 4.7% year-on-year and productivity still falling;

- Service prices accelerated to 4.1% year-on-year in June 2024, in line with the rise in labour costs;

- The prices of industrial products are set to rise faster in the future, as raw material prices recover and import prices rise in the eurozone;

- Finally, growth in the eurozone is picking up (0.3% in the first quarter of 2024), and if this growth continues, the labour market will remain tight, and corporate profit margins will no longer decrease.

It is therefore to be feared that the ECB will have to revise its inflation forecasts upwards again (currently 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026).

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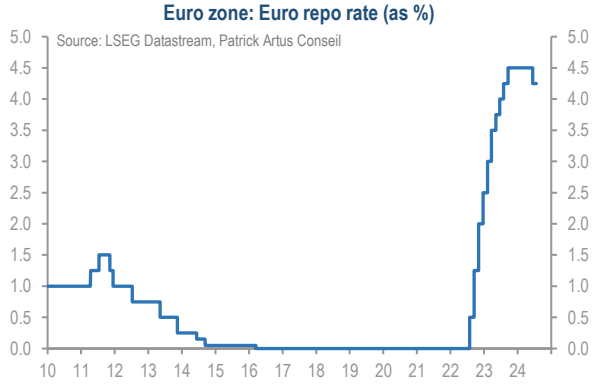
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The ECB's surprising decision

On June 6, 2024, the ECB announced **a 25-basis point cut in its interest rates** (by 4.25% for the repo rate and by 3.75% for the deposit facility rate) (**Chart 1**). During its July meeting, the ECB decided to leave rates unchanged.

Chart 1
Euro zone: Euro repo rate (as %)

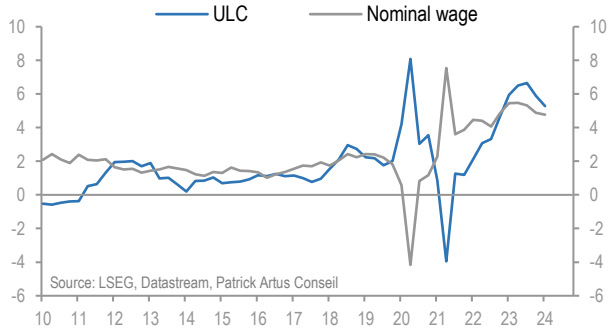


It gave no indication of future changes in interest rates and acknowledged that wage inflation remained strong in the eurozone. We believe that **the ECB's decision is surprising,** and that in the past it would not have lowered its interest rates in the same economic situation.

Why the ECB's decision is surprising

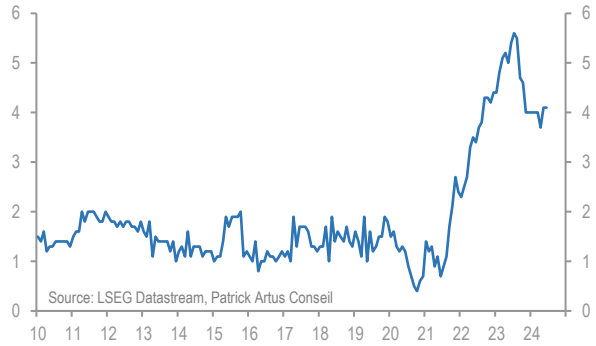
1. **Wage inflation still very high.** **Unit labour costs** (wages per capita adjusted for labour productivity) **rose by more than 5% year-on-year in the first quarter of 2024**, with wages per capita up 4.7% year-on-year and productivity per capita still falling **(Chart 2).**

Chart 2
Eurozone: Nominal wage per capita and unit labour costs (Y/Y as %)



2. **The prices of services are accelerating again** (by 4.1% year-on-year in June 2024, Chart 3) which is in line with the rise in unit labour costs.

Chart 3
Eurozone: Consumer price index for services
(HICP, Y/Y as %)



3. **The prices of industrial products will rise faster in the future** (they rose by 0.7% year-on-year in June 2024, Chart 4), on the recovery in industrial metals prices (Chart 5) and maritime freight costs (Chart 6).

Chart 4
Eurozone: Consumer price index for industrial goods
excluding energy (HICP, Y/Y as %)

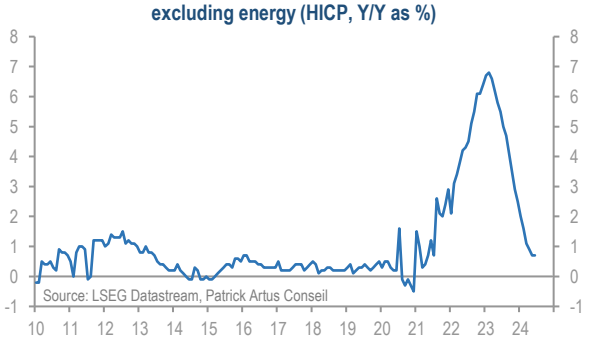


Chart 5
Price of industrial metals (100 : 01.01.2010)

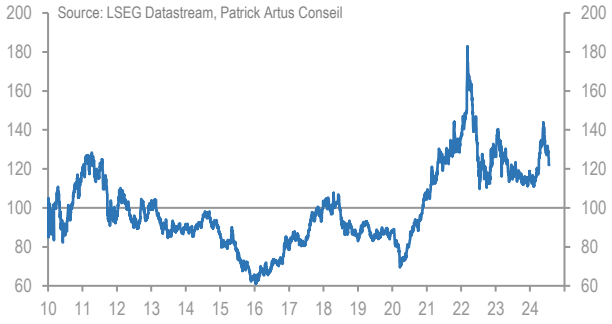
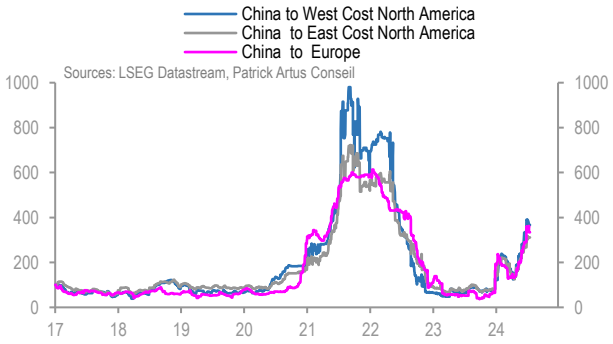


Chart 6
Maritime freight cost
(Freightos Container Index, 100 : 09.01.2017)



4. **The growth of the eurozone is picking up again** (Chart 7), to 0.3% during the first quarter of 2024 compared with 0.1% for the whole of 2023; if this growth goes ahead, the labour market will no longer remain tight (Chart 8 and 9), and corporate profit margins will no longer decrease. (Chart 10).

Chart 7
Euro zone: Manufacturing and services PMI (indices)

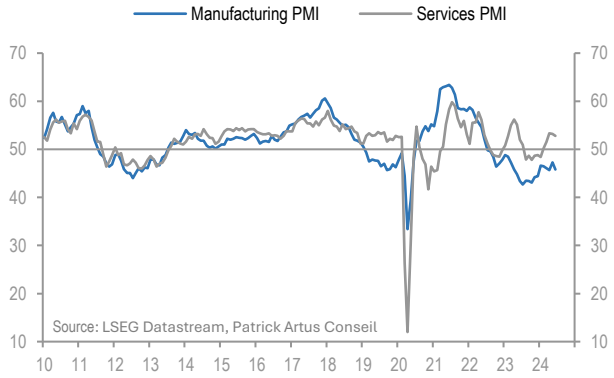


Chart 8
Companies experiencing recruitment difficulties (standard deviation from the average*)

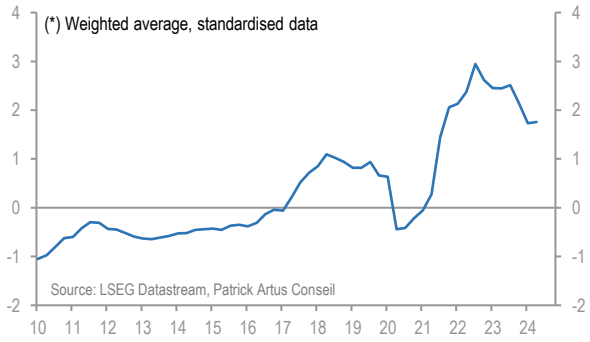


Chart 9
Euro zone: Ratio between number of job vacancies and number of job seekers

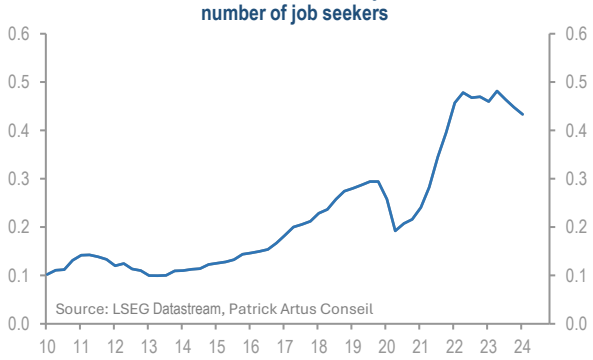
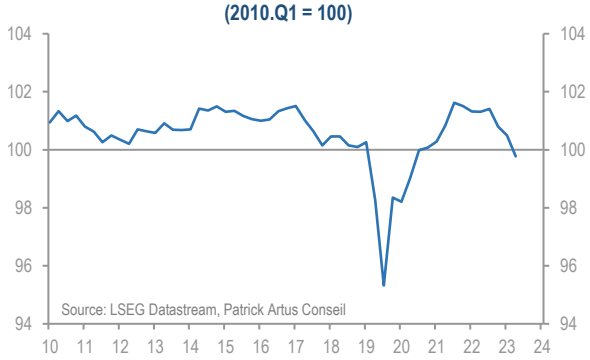


Chart 10
Ratio between GDP deflator and unit labour cost (2010.Q1 = 100)



Summary: the ECB's inflation expectations continue to be revised upwards.

The ECB is now forecasting inflation of 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026.

But :

- if the labour market remains tight and unit labour costs rise rapidly,
- so if service prices continue to rise sharply,
- if manufacturing prices accelerate,

it can be expected that the ECB's inflation expectations will continue to be revised upwards, as well as expectations for interest rates. (Chart 11).

Chart 11
Euribor Contracts (3-month)



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