The ECB's Outsourcing Problem

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Research

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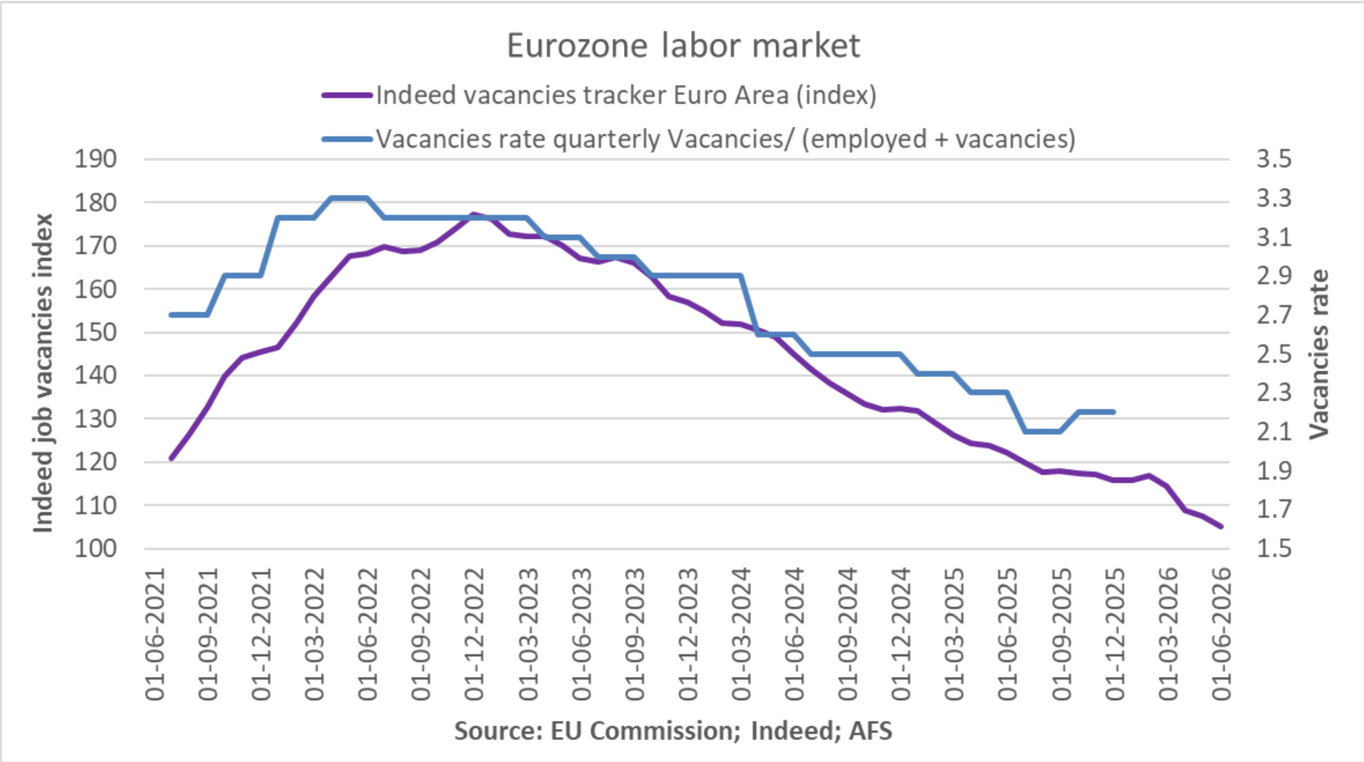
Mullahs and the Madman in the White House

- **Outsourcing**. Or off-shoring. Those used to be the magic words. Remember, back in the days, when the collective West outsourced and offshored its manufacturing base to Asia? Those were the days.
- **Nowadays, perhaps only the ECB is in the business of outsourcing.** Outsourcing monetary policy to the Mullahs in Tehran and that erratic, mercurial man in the White House. Of course, our central bank overlords in their glitzy tower in Frankfurt will vehemently deny such a thing. They claim that they have skillfully dropped forward guidance and instead adopted a stance of max optionally. Not committing to anything in any way. And data dependent. That goes without saying. However, a veteran and truly skilled (truly skilled! Really!) ECB-watcher sees right through central bankers' subterfuge and semantic games. Max optionality is a euphemism for 'we have no clue'.
- **ECB-speakers lifted the veil on their cluelessness during the honeymoon period in the weeks after the US and Iran signed the Memorandum of Understanding.** Oil prices fell much, much more than our central banker friends had ever anticipated. One Governing Council member after the other cast doubt on additional rate increases. When Belgian central bank chief Wunsch (a bellwether for the Council) said on July 1 that one hike might suffice, I seriously started to consider changing my forecast from a final quarter point hike in September to no more hikes this year and the next. With the benefit of hindsight, I went with the flow (pretty bad). But not as bad as The Economist magazine, which managed to bottom-tick Brent futures prices to the day – on July 2 – exactly two months after they top-ticked prices:

- **A not so wise US President once said "fool me once, shame on… shame on you.** Fool me – you can't get fooled again." If the Americans and Iranians revive their Memorandum of Understanding between now and the September meeting, I don't think the ECB will take the bait again. They will still raise rates come September. Perhaps only President Trump going to Tehran and embracing the Ayatollah will prevent them from pulling of what I expect to be the final hike. Let's see.
- **All-determining geopolitical drama aside, there's also a thing called Eurozone economic data.** The data since the June Governing Council meeting, while a mixed bag, has been generally positive. Monthly business survey data, especially those from Eurozone satellites, show that the Eurozone economy is recovering. The EU Commission's Economic Sentiment index shows that the nadir of the war-induced slowdown (not a slump, not a recession) was in April and May. The Swiss KOF leading index and the Swedbank Sweden export orders sub-index both rose notably in June. In the case of the former, that was in part a story of improvements in manufacturing and foreign demand. If the

KOF index and Swedbank PMI are still as prescient as they have often been in the past, Eurozone survey data will follow suit over the course of the summer.

- **Not all is well in the Euro Area economy.** Far from it. Growth is still running below trend by a wide margin and the labor market remains a sour spot. Vacancies according to the very timely Indeed index are trending lower and lower, month after month:



- **The picture of lower labor demand is confirmed by survey data.** According to the EU Commission's monthly business survey, hiring plans in manufacturing, services, and construction are weaker than they were at the start of the year. Employment growth in the first quarter was a weak 0.3 percent annualized, the lowest rate of growth since long before the pandemic.
- **Now, the equity market might not mind a weakening labor market and a smaller labor share in national income.** Especially if productivity picks up on the back of the AI boom. But the ECB – and thus the bond and rates market – do care. It likely neutralizes one source of potential inflation: wages. The softening labor market is perhaps the reason why ECB-speakers, including the hawks, are remarkably unconcerned about so-called second round effects rearing their ugly heads. For those initiated in central bank jargon, second round effects mean price increase begetting further price increases, and wage increases in particular.
- **And speaking of inflation, war-induced energy price increases should boost headline inflation by 1.4 to 2.1 percentage points, depending on the strength of the pass through of higher futures prices into real world energy prices.** Headline inflation, which fell below two percent last winter, will peak at 3.2 to 3.9 percent. Mind you that I am referring to the monthly peak for the year-on-year change in inflation. That's different from ECB staff forecast, which relates to the average annual rate of monthly inflation in a year.

- **I expect the energy shock to ultimately boost the much more important core reading by 0.2ppt to 0.3ppt.** That estimate is based on the Bank of Italy's research on the 2021-2022 energy shock. Which measured the pass through of energy futures prices to the energy price sub-index in the HICP, and then its effect on underlying prices (core inflation). The table below shows the percentage difference between pre-shock prices (which happens to be year-end in each episode) and the month when futures prices were on average the highest.

Percentage increase in prices compared to year-end

	Crude oil	Natural gas	Electricity
2007-2008	47	--	--
2010-2011	57	--	--
2021-2022	53	106	94
2025-2026	68	91	50

Source: Bloomberg; AFS

- **The 2007-2008 and 2010-2011 episodes were pure oil price shocks, with oil prices roughly increasing by half.** The current shock is less severe than the 2021-2022 shock, when natural gas and electricity prices increased by around 100 percent. Plus, the duration of higher energy prices was longer four years ago while the level of oil prices was much higher. Concurringly, the energy price sub-index in the HICP rose by almost thirty percent between December 2021 and September 2022. Since the outbreak of the Iran war, the energy price sub-index is up a much more measured seven percent (YTD increase 8.4 percent).
- **The estimated boost of core inflation, which should peak at 2.6 percent, assumes a high pass-through.** Which was true during the 2021-2022 energy crisis because of the post-pandemic tidal wave of demand on the back of easy fiscal and monetary policy and a tight, hire- anyone-with-a-pulse labor market. In the present, the labor market is soft and softening further. There is no wall of demand. Monetary policy is probably slightly restrictive and fiscal deficits are smaller, with no overall easing of the Euro Area fiscal stance. On the supply side of things, the picture is fuzzy, but probably not as bad. Back then, plenty of supply was offline because of lockdowns. Then the energy crisis hit hard because Russian gas was simply switched off overnight. Right now, we're facing a crisis of losing a good chunk of crude oil and natural gas supply, but not an on-off switch situation.
- **For the record, the monthly peak readings for core and headline in the wake of the 2021-2022 crisis were 5.8 percent and 10.6 percent, respectively.** That's what you get when a wave of over-stimulated demand hits lower supply. Whether or not the pass through of energy prices in the present is strong or not, a 0.3ppt or 0.2ppt boost to core is nitpicking. A simple Taylor rule gives us a 2.5 percent deposit rate with either increase.

Future modelled rate	
Neutral rate HLW	0.1
Natural unemployment rate (SPF)	6.1
Unemployment actual	6.1
Core CPI	2.5
Prior ECB rate	2.25
Unadjusted Taylor Rule estimate	3.10
With 0.75 inertia	2.46

- **With the Taylor rule's rival, the Orphanides-Wieland rule, I arrive at higher estimate for the deposit rate: 2.75 or 3.0 percent**. Clearly, the Orphanides-Wieland rule is more in line with ESTR OIS pricing than my plain and simple Taylor rule. In any case, given my armchair geopolitical expert's view on the Iran war (the worst is behind us, energy prices won't return to spring levels, and that Memorandum of Understanding will likely be revived), I just don't see more than one rate hike, namely in September.
- **And to conclude with the sundry stuff that is the next Governing Council meeting – the one next Thursday – it will be a boring non-event.** The ECB will stick to its we-don't-have-a-clue stance – ahem, max optionality. But like in June, the undertones of President Lagarde's remarks should lean towards a hike in September. That's assuming she's not waffling and fumbling and making a mess of ECB communication again.