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Moritz Kraemer -- Chief Economist

LBBWResearch@LBBW.de

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Inflation falls faster than expected. But core inflation remains too high.

In the face of all the pessimism that I regularly encounter at customer events, here's some really good news. And an unexpected one at that: Inflation in the euro area fell to 2.9% in October. This was reported by the European statistics authority Eurostat on Tuesday. In September, the rate was still 4.3%. A year ago, in October 2022 it was even in double digits.

The restrictive monetary policy is working

It was therefore right for the ECB not to raise interest rates at its council meeting in Athens last week. It was the first meeting without a hike since the summer of 2022. Now the central bank must be patient and let the transmission from monetary policy to the real economy take effect.

This is because there is always a certain amount of time between an interest rate hike and the deceleration of the real economy. Just like when you drive a car, you don't come to an immediate stop after applying the brake. Among economists, the rule of thumb is 12-18 months until the monetary stimulus has been fully absorbed by the real economy. Monetary policy has certainly contributed to the significant slowdown in economic momentum in Europe.

Even though the German data for the first half of the year was just revised a tad upward: Europe is firmly in the grip of an economic crisis. Investment and consumption are declining in this environment. The first signs of a weakening labor market are becoming visible. Corporate profit expansion, which had further fueled inflation after the opening of the economy and supply chain problems, is now also shifting into reverse. Above all, however, the sharp year-on-year drop in energy prices led to the decline in inflation (see chart).

Euro area inflation at 2.9%. A year ago it stood at 10.6%!

Euro Area and Component Inflation (October 2023)

Source: Eurostat

Core inflation in focus: still far too high

But the drop in energy prices disguises the sizeable challenges that remain in getting inflation lastingly back under control. If we remove the volatile elements energy and food from the consumer basket, we arrive at the core rate of inflation. Core inflation growth rates are also falling, to 4.2% in October from 4.5% in September and from the peak of 5.7% in March. But as the adjacent chart shows, its decline is much slower. And since energy prices are unlikely to continue to fall as drastically as they have recently, the ECB is rightly looking primarily at the core rate. And there, we are still a long way from the 2% target.

Inflation in the euro area

Source: Eurostat

What they are watching in the Euro tower

LBBW Research expects that inflation rates close to the 2.0% target will not be consistently realized before 2025. In inflation busting, as in a long-distance race, the last kilometers are the hardest. The ECB will therefore leave interest rates unchanged until well into the second half of next year, despite lower than expected inflation. Lagarde & Co. are primarily concerned about second-round effects. And here, in particular, about wage agreements that could perpetuate inflation. Especially for services, which account for almost half of the basket of goods. The example of Austria is instructive: unlike in Germany, employees there have largely managed to translate high inflation into corresponding wage increases. This increases the cost pressure. At 4.9%, Austrian inflation in October was correspondingly higher than in our country (3%).

Fear of price-wage spiral

The ECB will do its utmost to counteract an "Austrification" of the euro area as a whole. Hopes of rapid interest rate cuts are therefore unlikely to be realized.