A “neck breaking” exercise

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Is the ECB arriving to a Catch 22 situation? Arguments favoring the recent rate cuts must beweighed against arguments going in the other direction. A still fragile inflation outlook and a front of maturing debt clouds the picture.

“Have we broken the neck of inflation? Not yet. Are we in the process of breaking that neck? Yes”. So spoke Christine Lagarde, president of the European Central Bank (ECB), after the third consecutive rate cut decision by the ECB’s governing council on October 17. The first part of Lagarde’s claim is certainly correct, the second is somewhat more debatable.

After the October 17 decision, the ECB’s deposit rate stands at 3.25%, its main refinancing facility rate at 3.40% and its marginal lending facility rate at 3.65%. Contrast these nominal policy rates with the 1.7% annualized headline inflation rate reached in September, and one gets real policy rates (i.e. the nominal ones adjusted for inflation) in the 1.5% to 2% fork. That looks quite comfortable given the ECB's desire to, in Lagarde's labelling, "break the neck of inflation". But … two caveats to this feeling of comfort need to be formulated.

The first caveat concerns the inflation rate. The recent decline in headline inflation is almost entirely due to the fall in energy prices. These can easily veer back in the upward direction, especially given the war in the Middle East and other geopolitical tensions. Moreover, the inflation rate in the service sector of the economy, representing two thirds of the total economy, remains stubbornly high. It runs around 4% on an annualized basis.

Another worrying aspect of the picture concerns core inflation, i.e. headline inflation with the volatile energy and food prices taken out. Core inflation stood in September of this year at 2.6%, following almost half a year of being stuck around this number. It is generally recognized that the core inflation rate gives a better picture of the real underlying inflationary forces percolating through the economic system than the headline inflation. Contrasting the present nominal policy rates with the core inflation rate, one gets real policy rates in the 0.5% to 1% fork. This is much less comforting if the ECB really wants to break inflation's neck.

It bears recalling that as the headline inflation rate grew in 2021 and in the first half of 2022 most ECB governing council members pointed to the low core inflation rate as a reason to reject the calls for a tightening of monetary policy through higher interest rates. More recently, the argument about the discrepancy between the headline and the core inflation numbers has been subtly pushed to the background. Will this be proven over time to again be a mistake?

The second caveat to the feeling of comfort relates to long term interest rates. As opposed to the shorter term policy rates discussed above, these longer term interest rates are not directly fixed by central banks. They can nevertheless have a substantial impact on them through the buying and selling of bonds (i.e. quantitative easing respectively quantitative tightening). Currently, Germany's 10-year interest rate stands at 2.3%, France's at 3%, Spain's at 3% and Italy's at 3.5%. Contrasted against the 2.6% core inflation rate, one gets real rates that are negative for Germany and only marginally positive for the three others. Again, this is not exactly comforting when breaking inflation's neck is the objective. Moreover, the flat or even slightly negative yield curve (i.e. the curve one gets when interest rates are put on a curve starting with the very short term ones and going up to the very long term interest rates) is an open invitation for more speculative behavior and hence further bubbles.

The October 17 decision to cut for the third consecutive time the short term policy rates would have been perfectly defendable if the ECB had simultaneously moved to place upward pressure on longer term interest rates. The central bank can achieve that goal by accelerating the rundown of its very swollen balance sheet through the sale of bonds from its portfolio. Such action opens the potential for the ECB having to book losses on its portfolio. That is of course unpleasant, but independent central bankers should be "man or woman enough" to deal with this. Any unpleasantness is , of course, also a consequence of decisions taken by the central bank in the past.

The above remarks and caveats tend to fuel the contrary feeling that arguments other than the ones pertaining to the decision "to break inflation's neck" have played an (important) role in recent decision making. The argument that lower interest rates are needed to stimulate our struggling economies is not impressive for me. Of course, lower rates will support some activity, but we all know by now that monetary stimulus is at best a short term drug for the economy. A more convincing case can be made that it is the wall of maturing debt in the coming period that has had an impact on the central bank's rate cut decisions.

The Global Debt Report of the OECD sets the scene. For the combined OECD area, public debt stood at $ 54 trillion at the end of 2023, an increase of $ 30 trillion since 2008. A further run-up to the tune of $ 2 trillion is expected for 2024. The total global outstanding corporate debt increased from $ 21 trillion in 2008 to $ 34 trillion by the end of 2023. Very low interest rates stimulated a sharp increase in non-investment grade bonds (i.e. low quality, if not speculative, bonds). Outstanding non-investment grade bonds reached $ 3.4 trillion at the end of 2023.

The "wall of maturing debt" results from the fact that 40% of the outstanding sovereign bonds will mature by 2026. The corresponding number for corporate bonds stands at 37%. This means that something like $ 45 trillion debt will mature in the period up to the end of 2026 (some of this maturing already happened in the past months of 2024). Large parts of this maturing wall was taken up during the long period of extremely low interest rates. It is a foregone conclusion that the maturing debt will have to be refinanced on a massive scale, for the public as well as the corporate sector, at higher interest rates than the initial ones. The potential of this reality to create mayhem in the financial markets, and from there in the real economy also, is too large to ignore. But the Catch 22 trap for central banks like the ECB is evident.

It is imperative that the ECB, and other major central banks, take arguments relating to financial stability fully into consideration when policy decisions are being made. Hence, reducing interest rates when one is approaching a wall of maturing debt that has to refinanced on a massive scale makes sense. All the more so in the context of an highly unstable environment and clouded economic perspectives. One can only hope at this point, however, that these actions do not ultimately lead to a strengthening inflation's neck instead of breaking it.