ECB and Fed reactions to the current turmoil

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After yesterday's surprisingly large 50 basis point rate hike, the ECB is likely to raise its deposit rate further to 3.5% in the coming months, contrary to market expectations. After all, market turbulence should gradually subside and underlying inflation remains high in the euro area. The Federal Reserve is also expected to continue its rate hike process next week, raising its key rate by 25 basis points. However, due to the problems faced by some US banks, we have lowered our forecast for the peak of their key rate from 6.0% to 5.5%.

ECB delivers 50 basis points after all...

Yesterday, the ECB did not let the market turbulence dissuade it from raising its deposit rate by 50 basis points to 3.0% as announced at the beginning of February. According to ECB President Lagarde, there was even a large majority in favor. The ECB responded to the latest market turbulence by holding out the prospect of rapid liquidity support, should that become necessary (**statement**).

... and rates are set to increase further

What happens next after yesterday's rate decision will depend heavily on whether the market turbulence subsides or not. Ultimately, the central banks and supervisory authorities reacted decisively. For example, U.S. authorities have guaranteed the deposits of the two affected regional banks even beyond the legal limit of $250,000 and have offered funding lines to all banks, accepting bonds as collateral without haircuts. It is clear that no one wants to risk a second Lehman, i.e. a disorderly failure of a bank, which led to a global uncertainty shock and a deep recession in the fall of 2008.

All in all, we expect the market turbulence to gradually subside in the coming months. Then the ECB is likely to focus more on the inflation problem again, which has rather intensified since the February meeting:

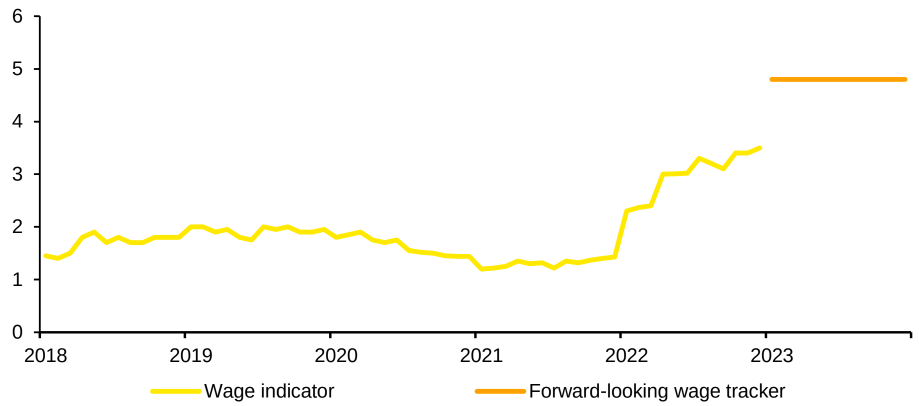
- Core inflation rose from 5.3% to 5.6% in February, clearly exceeding the ECB's expectations. This is also due to the fact that the above-average rise in prices for services has a higher weight in the updated basket of goods due to the normalization of consumer habits according to Corona. Core inflation is expected to be above the 5% mark by the fall.

- Wage growth has accelerated significantly. According to ECB estimates, the collective wage agreements concluded so far for 2023 suggest a 5% increase in collectively agreed wages this year, with wages actually paid likely to rise more strongly (Chart 1). The sharp rise in wages suggests that core inflation will fall only slightly in 2024 and remain stubbornly high.

Due to the pronounced inflation problem and the presumably subsiding market turmoil, the ECB is likely to raise its deposit rate further to 3.5% in the coming months, with steps of 25 basis points each expected for the next two meetings. Our key rate forecast is thus well above forward rates, which imply effectively unchanged ECB rates for the rest of the year. However, we have lowered the expected interest rate peak from 4.0% (our forecast from before the Silicon Valley Bank failure) to 3.5%. This is because, in the view of the Governing Council members, the current market turmoil could dampen bank lending – and thus growth and ultimately inflation. Moreover, the market turbulence is likely to have made the ECB more sensitive to the side effects of higher key interest rates.

Chart 1 - Wages picking up strongly

ECB Collective Wage Indicator, forward-looking collective wage indicator: weighted average of collective agreements concluded in 2022 for 2023; in percent year-on-year; according to ECB Chief Economist Lane's speech in Dublin on 6 March 2023



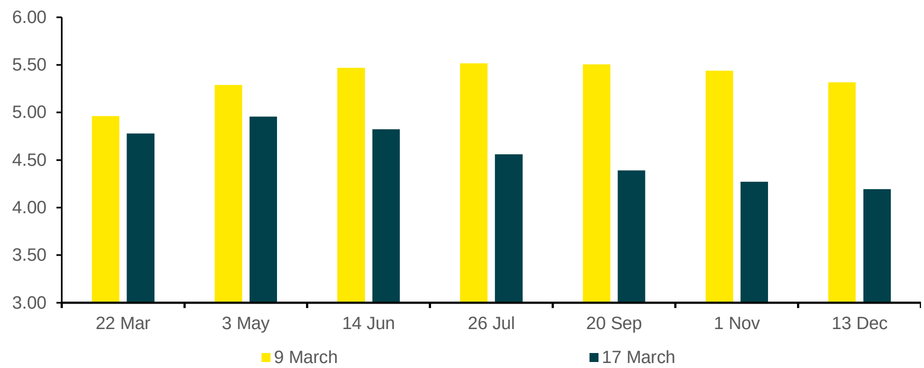
Source: Lane (2023), Commerzbank Research

Fed: To hike or not to hike

The recent turbulence on the financial markets, which started with the failure of two U.S. banks, has also upset the Federal Reserve's monetary policy roadmap. While most observers initially expected the Fed to hike the fed funds target range 50 bp to 5.00%-5.25%, the markets now even doubt whether the FOMC moves 25 basis points. From June onward, market participants now even see significant rate cuts; expectations for fed funds have been reduced by 150 basis points for the end of the year; the markets are now pricing in rate cuts for the second half of the year (Chart 2).

Chart 2 - Financial markets expect Fed to cut rates soon

Implied fed funds rate based on fed funds futures for upcoming FOMC meeting. Futures prices on 9 March and 16 March



Source: Bloomberg, Commerzbank Research

Expectations of what will happen to key rates are subject to extreme uncertainty and should therefore be viewed with considerable caution. If the situation on the financial market does not calm down sufficiently by the time of the meeting, the Fed will probably give priority to stabilizing the market in the short term and cancel the rate hike.

Actually, the Fed did not want to be embarrassed by such "firefighting" actions again. The plan was to separate any sectoral problems in the banking system from monetary policy in the narrower sense which is geared to macroeconomic objectives. This should be accomplished by regulation and with the provision of liquidity if necessary (for example, via the newly created "Bank Term Funding Program" with favorable conditions). If the Fed succeeds in keeping the financial market problems in a box, it could turn its attention back to the inflation problem.

Inflationary pressures have not subsided so far, ...

For this problem has by no means been solved yet. This is best illustrated by looking at a number of the commonly used indicators of underlying inflation, focusing on those parts of the basket of goods that are considered to be particularly meaningful in terms of the trend.[1] Taken together, these data do not suggest that underlying price pressures have eased significantly over the past twelve months (table 1).

Table 1 - Underlying inflation still very high

Consumer price index and personal consumption expenditures deflator, year-on-year change in %, Feb 23: if not yet available, data for January

Measure of underlying inflation	Feb 22	Feb 23
Core CPI	6.40	5.50
FRB Cleveland Median CPI	4.80	7.20
FRB Cleveland 16% Trimmed-Mean CPI	5.80	6.50
Atlanta Fed Sticky CPI	4.50	6.70
Core PCE	5.40	4.70
Market-Based Core PCE	5.10	4.90
FRB Dallas Trimmed-Mean PCE	3.80	4.60

Source: Atlanta Fed, Commerzbank Research

... thus the Fed will (maybe) hike rates 25 basis points

The forecast of the Fed decision at next week's meeting is very uncertain due to the volatile situation. What is relatively clear is that a 50 bp rate hike is off the table. We now assume that the Fed will raise key rates by 25 basis points. Otherwise, the markets would probably already safely assume that the interest rate cycle is at an end and that it is only a matter of time before the Fed cuts again. Then the Fed would first have to convince market participants again that it will continue to raise rates after a pause in order to fight inflation. This poses the risk of additional volatility in the markets.

As for the outlook going forward, the current turmoil shows that the tighter monetary policy is having an impact and is leading to negative consequences in parts of the economy. Accordingly, the Fed is likely to proceed more cautiously and raise interest rates in 25 bp steps to 5.50% (previously, we expected 6.00%). Moreover, we see our forecast confirmed that the US economy will slide into recession in the second half of the year, to which the Fed is likely to respond with the first interest rate cuts in early 2024.

[1] In some cases, volatile prices for energy and food are excluded (core rate), the focus is on more inert prices (sticky price index), the focus is on the median of price increases for individual goods, or certain extreme price movements are excluded (trimmed mean). (back to text)

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In accordance with ESMA MAR requirements this report was completed 17/3/2023 07:40 CET and disseminated 17/3/2023 07:40 CET.

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