ECONOMICS

RATE CUTS: ECB FIRST, FED SECOND

Dr. Jörn Quitzau, 11 April 2024

- **The ECB is keeping the key interest rate constant, and thanks to the downward trend in inflation, interest rates could fall soon.**
- **Following the surprisingly high US inflation figures in March, the Fed is unlikely to cut key interest rates until later in the year.**
- **If the ECB loosens monetary policy before the Fed, this is likely to weigh on the EUR/USD exchange rate**.

As expected, the European Central Bank (ECB) did not change its key interest rates at its meeting today: The main refinancing rate remains at 4.50% and the deposit rate at 4.00%. In view of the downward inflation trend in the eurozone - the inflation rate fell to 2.4% in March - and the new data available by then, a rate cut in June is quite possible. Unusually, this would mean that the ECB would complete its monetary policy turnaround before the US Federal Reserve.

Yesterday's inflation data from the US makes it unlikely that the Fed will cut interest rates in June. US inflation rose again in the first few months of the year, from 3.2% in February to 3.5% in March. The core rate of inflation (excluding energy and food) is moving sideways at a high level of 3.8%. In the eurozone, the core rate fell from 3.1% in February to 2.9% in March. This seems to confirm more strongly in the US than in the eurozone that the last mile is the hardest in the fight against inflation. In addition, the labor market report published last Friday for March was once again strong and monetary policy stimulus is therefore not yet necessary.

Both central banks will definitely want to avoid inflation flaring up again after an initial rate cut, which could force monetary policy to change direction again. It is therefore important to firstly have a clear downward trend in inflation rates and secondly to have the central banks' 2% target within sight. As monetary policy works with a time lag, the inflation rate does not necessarily have to have already reached the 2% target when interest rates are first cut. The high key interest rates continue to have an effect, meaning that monetary policy can be eased even when inflation rates are slightly higher. This is the case in the eurozone, but not yet in the US. The risk of a premature turnaround in monetary policy is therefore greater in the US than in the eurozone.

Market players are disappointed to note that the interest rate cut expectations for the US are gradually being withdrawn. However, one positive aspect should not be underestimated: The US economy has coped surprisingly well with the tighter monetary policy. It is proving robust. If the Fed continues to focus on fighting inflation while the ECB cuts interest rates in June, the euro exchange rate will remain under pressure. This would keep import prices high. However, this price-increasing effect will probably not be enough to stop the ECB from easing. ECB President Lagarde emphasized at today`s press conference that the exchange rate is only one of several channels through which monetary policy impacts inflation.

It will be interesting to see how the central banks deal with this, if inflation rates settle slightly above the 2% mark in the medium term. In view of the high core inflation rates and various structural price drivers (demographics, de-globalization, CO2 pricing), there is a lot to be said for inflation that is no longer compatible with the price stability defined by the central banks. The big question is whether the central banks will then develop a higher inflation tolerance or whether they will strictly adhere to the 2% target.

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