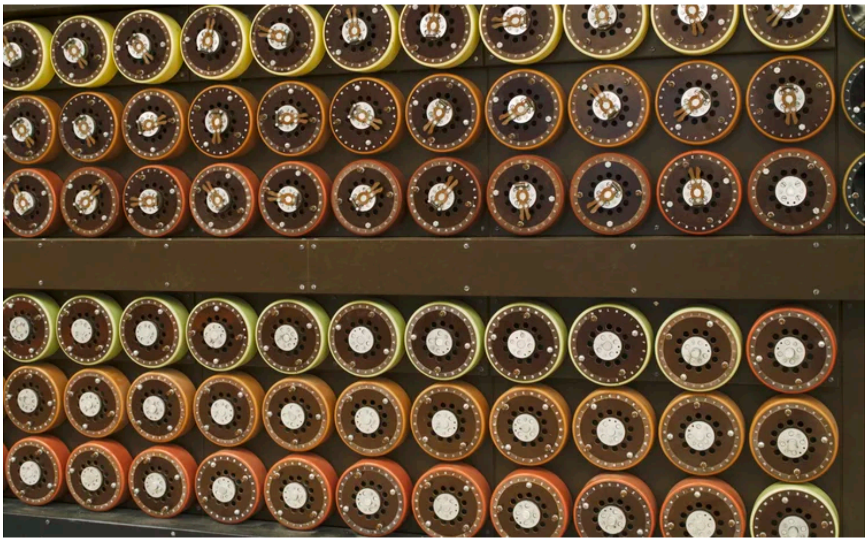
Decoding the decoupling in US and eurozone inflation

ECB rates cut and Fed's refusal to follow suit point to differing fundamentals in stateside and EU economies



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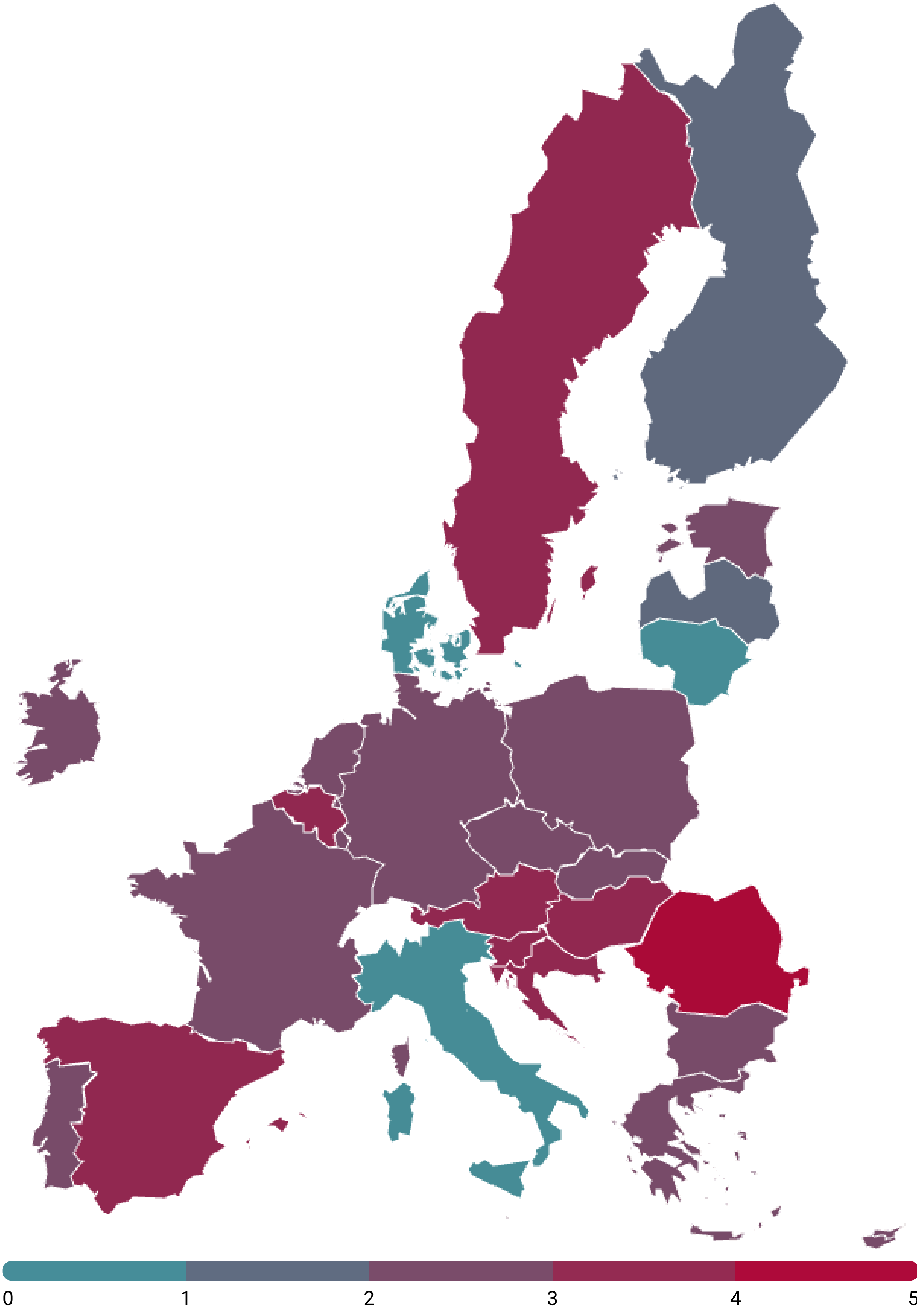
When the European Central Bank (ECB) decided to cut interest rates on June 6, the decision was hardly unexpected. The data on implied interest rate futures over the previous weeks had shown a rates cut to be a virtual certainty.

Nevertheless, the decision by Austria to vote against the cut highlights an issue the ECB will have to address sooner or later: the wide divergence in inflation levels across eurozone member states at a time when the central bank is targeting a 2% weighted average level of inflation.

In Austria, inflation is currently around 4%, which helps to explain the country's resistance within the ECB's governing council. Yet in Italy inflation is already below 1%, and other eurozone economies – think of Lithuania, for example – are moving towards deflation.

Meanwhile, France and Germany have had high interest rates and inflation levels of just over 2% for some time. If the EU's two biggest economies had the same levels of inflation as Austria, the ECB would not have cut rates.

EU inflation rates



Source: Trading Economics, author's own conclusions

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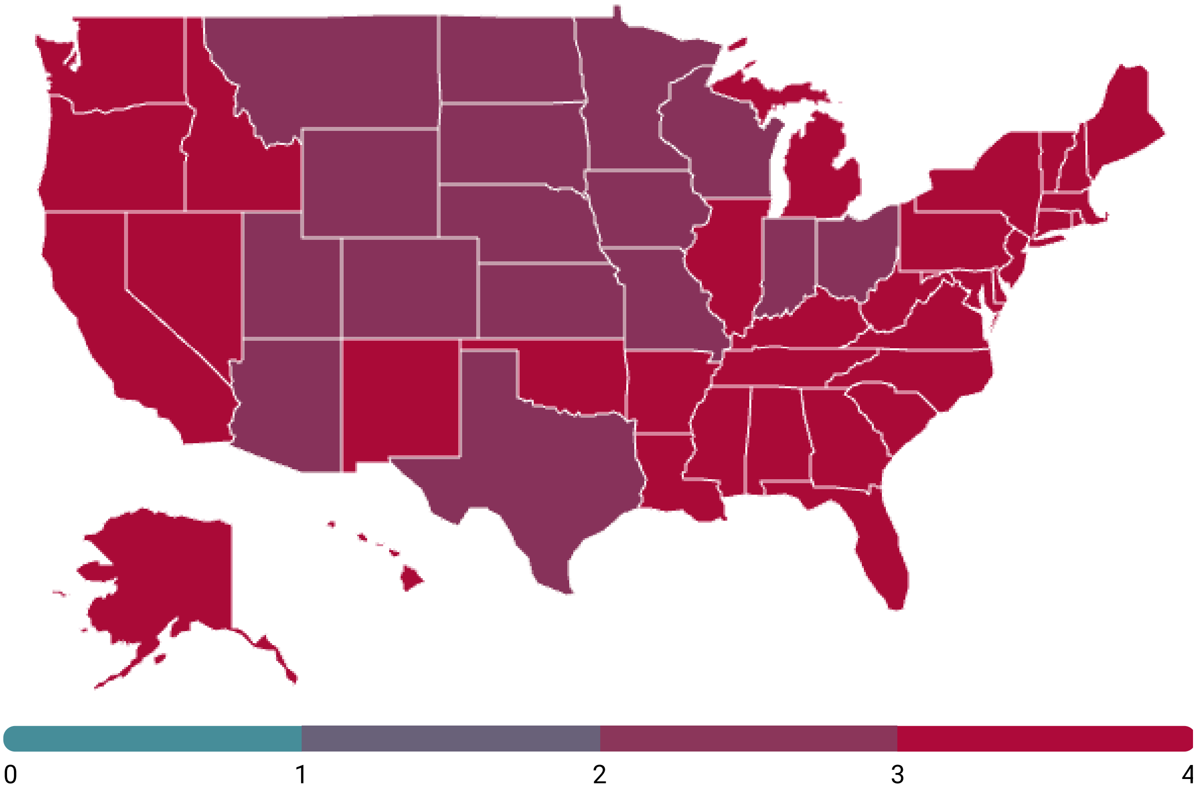
The existence of inflation differentials between countries sharing the same currency should not be underestimated when assessing eurozone members' competitiveness. Those countries where inflation is highest are generally at a disadvantage: the cost of capital is greater, production costs and goods prices are higher, and there is therefore a risk of crowding out, especially for companies producing **perfect substitutes**.

This dynamic is exacerbated by the fact that the euro is a currency without a state. Credit risk levels have risen in certain eurozone member states, leading to overall risk differentials within the bloc as a whole. Once again, the countries with the highest interest rates are at a competitive disadvantage.

New continent, old problems

The problems that come with using weighted averaging to set central bank inflation targets are not confined to the eurozone. In the US, Pennsylvania has an inflation rate of just under 2%, while Florida's is the highest in the country at around 4%. The big difference between the US and the eurozone, however, is that the Federal Reserve's full awareness of the problem, and the country's sizeable national budget, allow for appropriate transfer policies to mitigate the risks.

US inflation rate



Source: US Bureau of Labor Statistics, author's own conclusions
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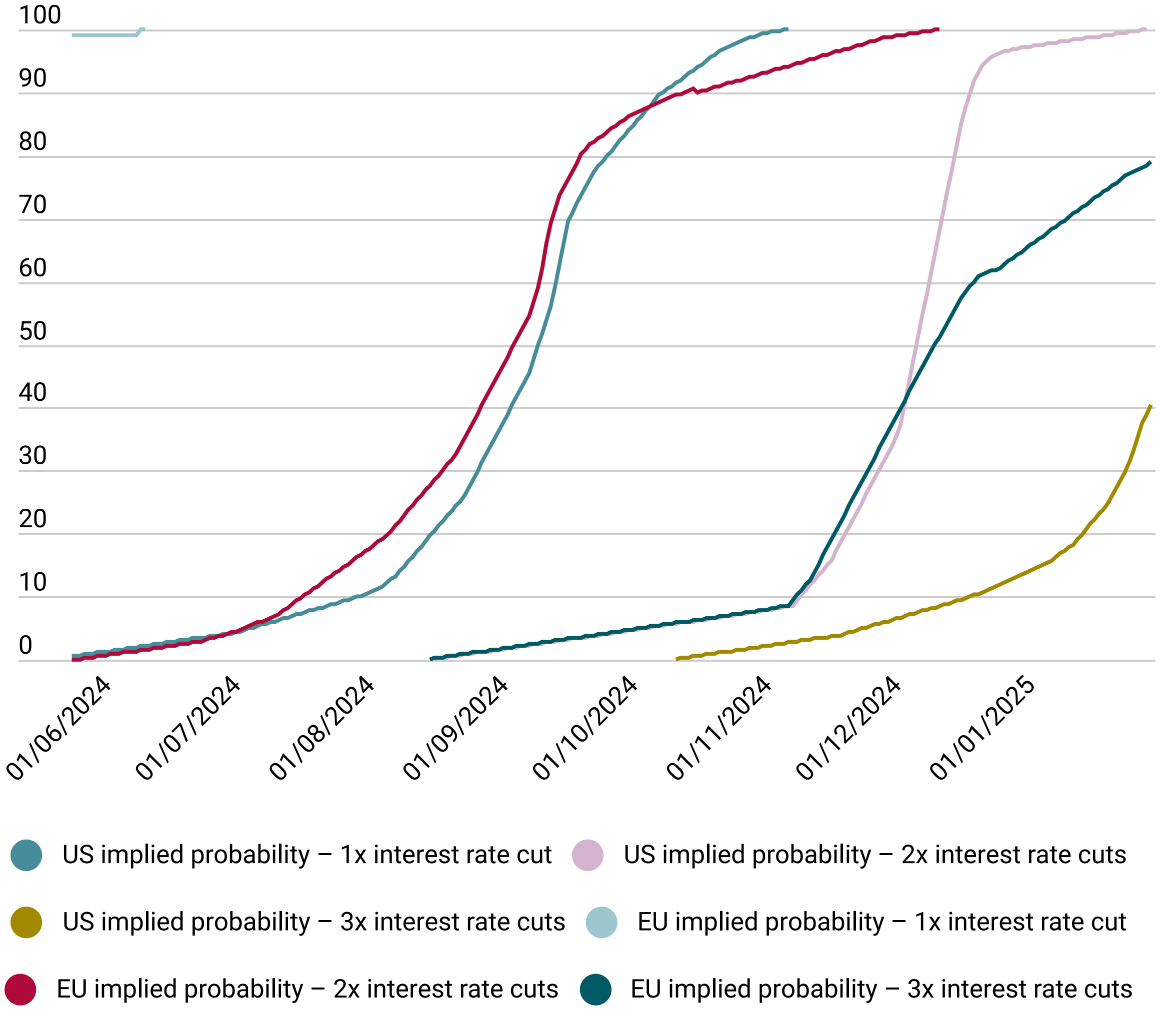
In any case, the ECB's rates cut will have obvious advantages for the eurozone, starting from the fact that it has definitively established the decoupling between US and eurozone inflation. Over the past few months, rising inflation in the US and falling inflation in the eurozone prove that the two inflation trends have structurally different determinants. The theory of a four-month lag between US and eurozone inflation trends no longer appears valid.

It is now evident that the rise in inflation in the US was largely driven by an increase in aggregate demand resulting from an expansionary fiscal policy and the trend towards full employment. Higher prices were triggered by increases in production levels, inventories and wages.

By contrast, the rise in eurozone inflation was the result of a decrease in aggregate supply caused by the energy crisis that followed Russia's invasion of Ukraine. The structural changes in energy supply chains since 2022 have been effective in tackling the energy crisis. This has paved the way for a lowering of inflation, which in Europe reacted to global macroeconomic trends in the way most orthodox economists would have predicted. It is therefore unsurprising that the ECB has set its sights on reaching the 2% target by 2026 - a slightly longer timeframe than it had adopted previously.

Futures implied probability of interest rate cuts



Source: European Central Bank, US Federal Reserve, author's own calculations
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The interest rate futures data suggests we can expect two more cuts from the ECB before the end of the year. The data on Fed funds futures, by contrast, show that the markets expect a ***quieta non movere*** scenario, at least until November's US presidential election.

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