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What if energy prices fall again?

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With a little luck, inflation could be close to 2% by the end of 2024

Yesterday the Federal Statistical Office published the German inflation rate for September: 10%. And it's about to get worse. LBBW Research sees inflation at the beginning of 2023 at over 12%. 2022 and 2023 will show the highest average inflation rates in Germany since the end of World War 2.

The course of inflation remains highly dependent on further developments of price increases for electricity, gas & Co. Those prices themselves depend in turn partly on decisions made in the Kremlin and in Qatar (how much LNG do we get when and at what price?). But also from political decisions in Berlin, such as the concrete design of the gas price brake, which was also unveiled yesterday.

The course of inflation hinges primarily on energy prices

Energy prices can not only rise, they can also fall again. The futures markets are pointing to this possibility. We expect that by May 2023 the prices for housing including ancillary costs and transport will have risen by around 20%, compared to the month before the war broke out in February. After that, we expect only slow price increases. By then utility contracts should have been adjusted for most households. Assuming that prices fall again by a quarter of the mentioned increase by the end of 2024 and everything else remains the same, then inflation would fall below the inflation target again in early 2024 (see "slight reduction" scenario in the chart). If energy prices remain constant after May 2023, the inflation target could be reached again in early 2025.

All of this signals how imponderable any inflation forecast necessarily is at the moment. Nevertheless, it is good that the ECB has resolutely taken a course towards normalizing interest rates.

Peak inflation in Germany in early 2023

Germany: Inflation with different assumptions about energy prices

Source: LBBW Research

This signals to markets and collective bargaining parties that the Governing Council, too, heard the shot.

The central bank must now act courageously to ensure that inflation expectations do not become unmoored. Inflation expectations are still anchored close to the 2% target in the medium term. A price-wage spiral is not (yet) recognizable for the time being. And with the approaching severe recession, wage deals could be more moderate than may observers have feared.

A wage-price spiral is not (yet) recognizable

Rate hikes, please, with a sense of proportion

But it would be a mistake if the ECB tried to smash inflation with one interest rate hammer after the other. As strange as it might sound in a 10% inflation world: there is such a thing as too aggressive rate hikes. We don't have excess demand. Rather, there is a risk of a Europe-wide recession. Investments and consumption are collapsing. Frankfurt does not need to help there.

The very hawkish monetary policies in Poland, the Czech Republic and Hungary show that the central bank cannot catch supply-side inflation even if it aggressively raises interest rates.

Normalize now before the recession bites

In a recession, interest rate increases are difficult to explain. The ECB should therefore go all out again at the next meeting with 75 basis points. We expect the deposit rate at 2.25% (currently 0.75%) by the end of the year and a top rate of 3% by spring. That is sensible.

In the recession, the ECB will shy away from raising interest rates

If, contrary to current hopes, inflation expectations take on a life of their own and a price-wage spiral is set in motion, then the central bank would have to step it up a few notches. We will hopefully never find out whether she has the courage to do so.