The great transatlantic divergence

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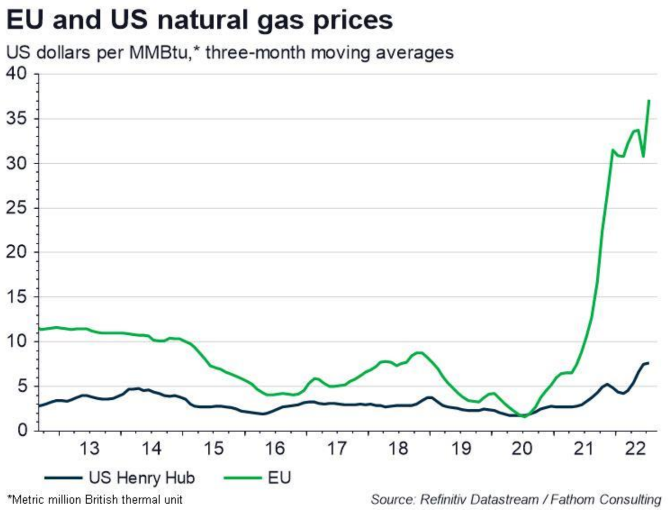
An unprecedented divergence has emerged between the EU and US on the rate of inflation expected in one year's time, something we highlighted in a research note last week. While this can largely be explained by the difference in natural gas prices, the policy divergence between the US and EU may offer an explanation too: investors may believe that the Fed is more willing to move rates and deal with inflation than its counterpart in the EU.



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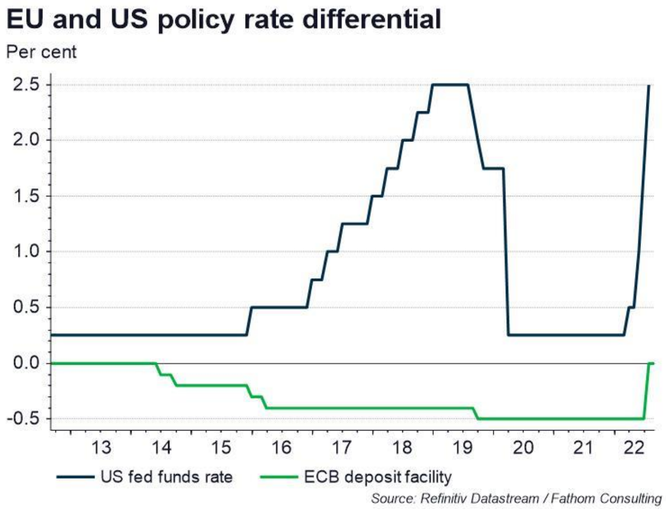
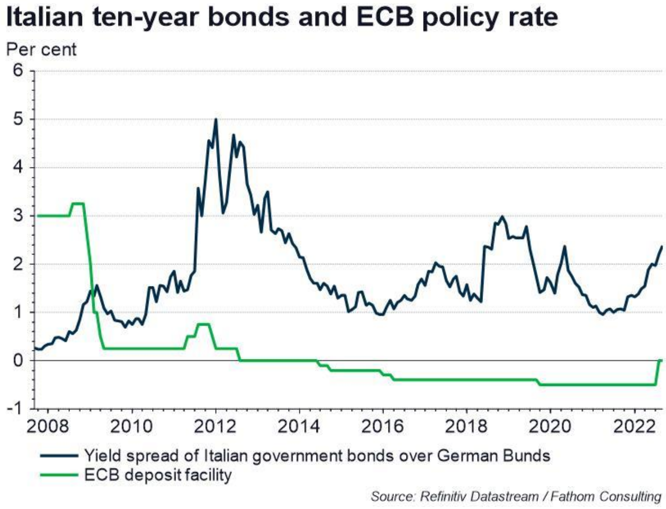


This divergence raises a series of important economic issues and questions. Among them is the ability of the ECB to raise interest rates without prompting a rise in the yield spreads between the bonds of European peripherals and German Bunds. The last time the ECB's deposit facility rate was above zero, the euro area was in the throes of a debt crisis. Things may have changed since then, but a significant increase in the policy rate could raise the question of debt sustainability once again.



Because of this, the ECB is likely to err on the side of caution when raising interest rates in the coming months. And this could also help to explain the current interest rate differential between the US and EU. Moreover, the high price of natural gas in Europe has more to do with supply disruption than with demand – meaning that even sharp increases in the policy rate may not do much either to lower the price of European natural gas or to reduce the first-round impact of that on inflation. The fear is that the rise in gas prices could have second-round effects, and push up the prices of other goods and services, as well as wages.

Equally, the ECB must also contend with a negative economic outlook for the single currency bloc, in part due to the hit to consumers' disposable incomes that the rise in energy prices will have. Indeed, we think that a recession in Europe is almost inevitable, and may already have begun – the question is how deep it will be, not whether it will happen. On this basis there

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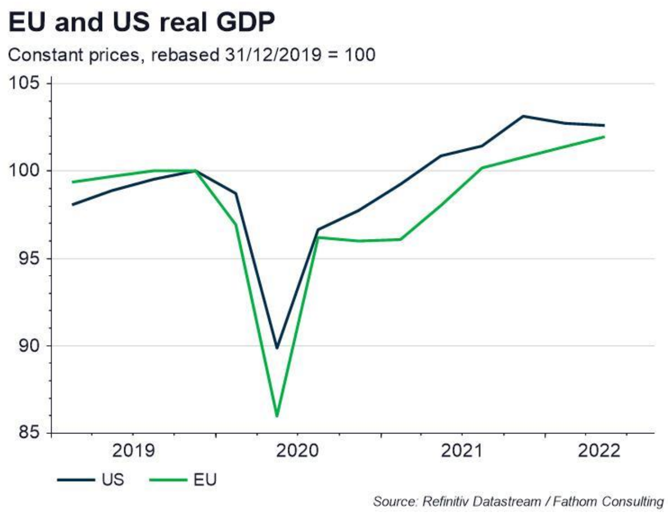
would be little point in the ECB hiking rates aggressively and exacerbating the downturn, especially if this policy lever is unable to do much to reduce the first-round impacts of gas prices on inflation — and if the economic downturn dampens second-round price pressures without the need for central bank intervention.



The ECB will face a series of difficult questions when setting interest rates in the coming months. These factors, coupled with possible gas shortages and the related economic damage they would cause, lead us to conclude that the economic prospects in the US for the year ahead, while not too great themselves, are rosier than those in the EU. All of these issues, and more, will be discussed in more detail in our upcoming *Global Outlook, Autumn 2022*.

Further reading:

Weather and gas supply will dictate depth of EU recession

Euro area stability — a tale of two leaders

Global Outlook, Summer 2022: Update

The bumpy road to climate transition

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