ECB Watch

AIB Treasury Economic Research Unit

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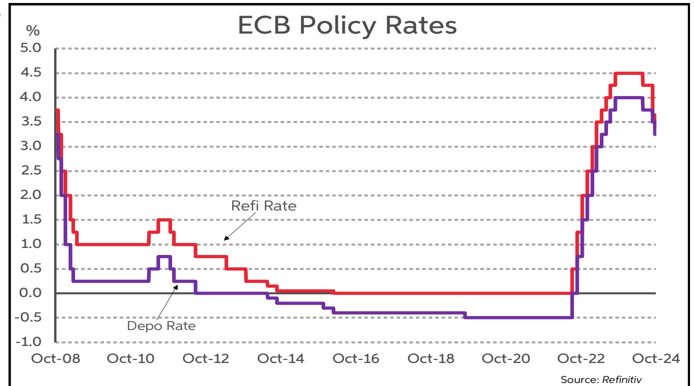
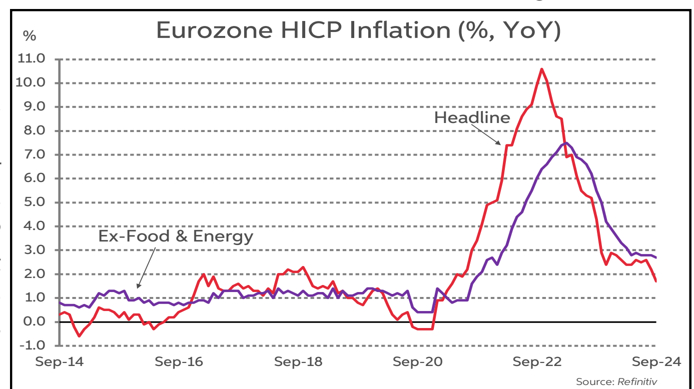
ECB cuts again, with another cut on the cards in December

The October meeting of the ECB's Governing Council saw the central bank cut interest rates for a third time this year. It reduced rates by 25bps, with the Deposit rate lowered to 3.25%, while the Re-fi rate was decreased to 3.40%. Today's policy easing represents the first consecutive rate cuts from the ECB in 13 years, as it also lowered rates at its previous meeting in September. Prior to this, it commenced its easing cycle in June, while it kept rates on hold at its July meeting. Today's decision by the ECB to cut rates was unanimous.



The meeting statement outlined the rationale for the rate cut. It noted that the decision was based on its updated assessment of (1) the inflation outlook, (2) dynamics of underlying inflation and (3) strength of monetary policy transmission. In relation to these three factors, the ECB stated that the incoming data indicates that the "disinflationary process is well on track", the inflation outlook has been "impacted by recent downside surprises" in activity metrics and that monetary policy remains "restrictive". Meanwhile, in the press conference, President Lagarde commented that a raft of indicators, including headline and core inflation, as well as the PMIs are 'all heading in the same direction-downwards'.



The most recent set of macro forecasts from the ECB were published at the September meeting. These forecasts saw a slight downward revision to its near term growth expectations. This downgrade reflected the ECB's assessment of a weaker contribution from domestic demand over the coming quarters than previously assumed. The central bank is forecasting GDP growth of 0.8% (was 0.9% previously) for this year. For 2025, it expects GDP growth of 1.3% (from 1.4%). Meanwhile, the ECB sees GDP averaging 1.5% in 2026 (was 1.6%). However, it was noted once again today by President Lagarde, that the risks to economic growth remain "tilted to the downside".

In terms of the outlook for headline inflation, the September forecasts were left unchanged from the June projections. The ECB expects inflation to average 2.5% this year, 2.2% in 2025 and at 1.9% in 2026. However, it did revise modestly higher its core inflation projections for this year and next year, owing to higher than envisaged services inflation. It expects the core rate to average 2.9% this year (was 2.8%), and 2.3% (from 2.2%) in 2025. The projection for 2026 was left unchanged at 2.0%.

Aside from today's policy decision, a key focus for markets, was what guidance, if any, would be forthcoming from the ECB on future rate cuts. In this regard, President Lagarde once again emphasised that the ECB is not pre-committing and remains "data dependent".

ECB Macroeconomic Forecasts for the Euro Area

(%)	2023	2024	2025	2026
HICP	5.4	2.5	2.2	1.9
Real GDP	0.5	0.8	1.3	1.5

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $83.2 in 2024, $76.1 in 2025, $73.2 in 2026

Source: ECB, September 2024

However, while she denied she was 'opening the door' to further easing in December, her comments suggest that a rate cut at its final meeting of 2024 (Dec 12th) remains a distinct possibility. She stated that between now and then, the ECB will be receiving quite an array of data. The tone of President Lagarde's comments on the economic outlook were notably downbeat today, including numerous references to the weak PMI data. **Therefore, unless incoming data surprise to the upside of expectations, which seems unlikely, the ECB's data dependent approach will likely see it cut rates again December.** This would see the Deposit rate end the year at 3%. Prior to today, this scenario was already fully priced in by markets and today's meeting outcome/tone has reinforced markets expectations on this. Further out, the market is anticipating that rates could fall to a low of between 1.75%-2.00 by the end of 2025. Rates bottoming out in and around 2% towards the end of next year seems a reasonable expectation given the subdued outlook for the Eurozone economy.

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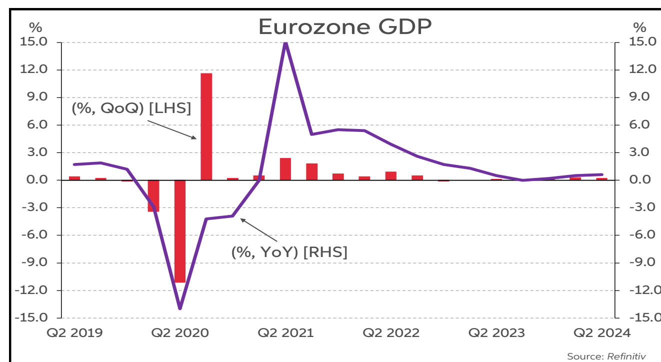
Eurozone outlook remains challenging

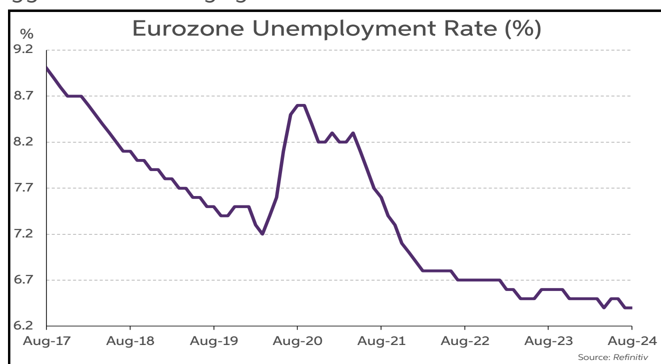
The Eurozone economy returned to growth in the first half of 2024, having essentially flat-lined between the end of 2022 and 2023. However, it should be noted that the economy expanded only modestly, with GDP rising by 0.3% q/q in Q1 and by 0.2% q/q in Q2. The underlying breakdown of Q2 GDP shows that for the second quarter running, net trade made the largest contribution to growth. Exports rose by more than imports, resulting in net trade adding 0.5 percentage points (p.p.) to the total. Government expenditure contributed a further 0.1 p.p. to GDP. Meantime, household consumption had a negligible impact on growth. At the same time, investment fell sharply by 2.2% in Q2, knocking 0.5p.p. from output. Among the four largest economies, Spain continued to perform the best, with activity rising by 0.8% q/q. The French and Italian economies both expanded by 0.2% q/q, while the German economy remained moribund, contracting by 0.1% in Q2.



Survey data suggest the Eurozone economy may have lost further momentum in the third quarter. The services PMI averaged 52.1 in Q3, down from an average of 53.1 in Q2, largely owing to a reading of 51.4 in September, its lowest since February. Meantime, the manufacturing PMI - which has been in contraction territory for over two years - deteriorated to 45.5 in the three months to September. This compares to an average of 46.3 in the three month period to June and is consistent with a sharper pace of contraction in the sector in Q3. Elsewhere, the EC sentiment industrial and services sector indices were little changed in Q3, although the consumer confidence measure did register some improvement. **The available hard data have also been mixed.** Retail sales flat-lined in July before rising by a modest 0.2% in August. Meanwhile, industrial production expanded by 1.8% in August, having contracted by 0.5% in July. Overall though, industrial output was just 0.1% higher year-on year in August.

Regarding the labour market, conditions remain tight. The unemployment rate remained at its all-time low of 6.4% in August. Furthermore, employment rose by 0.2% in Q2 and was up 0.9% y/y. Tight conditions are contributing to elevated wage growth, which is a key concern for the ECB. Although, the ECB negotiated wages metric increased by 3.6% in Q2, down from 4.7% in Q1, the Indeed wage tracker - a more frequent measure of wage pressures - has been trending higher in recent months. Overall, this suggests that earnings growth remains robust.

On the inflation front, the headline rate fell to 1.7% in September, its lowest level since April 2021, and below 2% for the first time since June 2021. However, the decline in September was widely expected, and it was largely driven by a sharp fall in energy prices. Little progress has been made in core inflation in recent months. The ex-food and energy rate edged down to 2.7% in September, having printed at 2.8% in the three months prior. Meantime, the core rate that excludes food, energy, alcohol and tobacco, also stood at 2.7%, a touch below the 2.9% rate it was at throughout the summer. Furthermore, services inflation is still elevated and has been quite sticky. It inched down from 4.1% in August to 3.9% in September, its first sub-4% reading since April. Looking ahead, the ECB expects the headline rate to drift higher throughout Q4, while core inflation is projected to trend lower over the coming months.



Overall, the Eurozone economy has gathered some momentum in 2024, but economic growth is quite fragile. On a positive note, the labour market is strong, with employment rising and unemployment at an all-time low. Secondly, the trade balance returned to surplus in 2023, and has continued to widen this year. Meanwhile, there has been a marked fall in inflation since its peak. Further rate cuts and disinflation should support real incomes and in-turn consumer spending. **However, the outlook for the Eurozone is challenging and the risks are plentiful.** Wage pressures are high, and this is contributing to sticky services inflation. Weaker global growth as well as geopolitical tensions may stymie activity. Furthermore, fiscal issues in France and poor growth prospects in Germany, as well as political uncertainty in both, pose potential headwinds for the Eurozone. Against this backdrop, most forecasters expect weak economic growth in the Eurozone in the near term. The IMF sees GDP expanding by 0.9% this year and 1.5% next year, while the ECB is anticipating growth of just 0.8% and 1.3% over the same period.

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