Markets Expect ECB Rate Cuts in 2024

Markets are of the view that we have seen the final ECB rate hike, following last Thursday's 25bps increase, which brought the key deposit rate up to 4%. The ECB commented that the marked tightening of monetary policy since July 2022 will have a substantial impact in terms of bringing inflation back down to its 2% target in a timely manner. It warned, though, that rates will need to be maintained at current levels for a sufficiently long period of time to ensure their inflation goal is met, suggesting that monetary easing is not on the horizon anytime soon.

Markets, though, are of a different view and see rates starting to be cut by mid-2024, with the deposit rate being lowered to 3% by autumn 2025. However, the latest set of ECB staff macro forecasts would not seem to be consistent with rate cuts next year. Inflation is seen averaging 3.2% in 2024, while the economy is projected to regain momentum, with GDP growth picking up to 1% next year and 1.5% in 2025. As the ECB notes, though, the risks to its growth forecasts are tilted to the downside. The Eurozone economy has stagnated over the past year. It expanded by a meagre 0.1% in both the first and second quarters of 2023. This followed a 0.1% contraction in GDP in the final quarter of last year.

Survey data suggest the economy has lost further momentum in recent months. The services PMI averaged 54.4 in the second quarter, but declined to 50.9 in July, and 47.9 in August. The latter was the weakest reading since February 2021. Meantime, the manufacturing PMI fell deeper into contraction territory, at 42.7 and 43.5, in July and August, respectively. The EC economic sentiment index, which has been trending lower since the start of the year, fell to 93.3 in August, its lowest level since November 2020.

The latest real economic data, which are for July, have also been weak. Retail sales fell by 0.2% in the month, while industrial production declined by a sharp 1.1%. Monetary aggregates also continued to weaken in July, with M3 money supply falling by 0.4% and credit growth to households slowing to 1.7% in year-on-year terms. Overall, the data suggest that GDP could contract in the third quarter.

It is clear that the combination of the sharp tightening in financial conditions on the back of ECB rate hikes, elevated inflation and a slowdown in global growth are all weighing heavily on the Eurozone economy. The ECB expects activity to pick up momentum as real incomes rise on the back off falling inflation, higher wages and a strong labour market. However, employment growth is slowing and the lagged effects of monetary tightening combined with subdued global growth are significant headwinds for the economy.

Stagflation could remain the order of the day for the Eurozone into next year, with a risk that the economy could fall into recession. It may well be that markets believe a recession is indeed on the cards for the Eurozone. This would accelerate the path for a return of inflation to 2%, paving the way for the rates cuts that are expected next year by the markets.

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