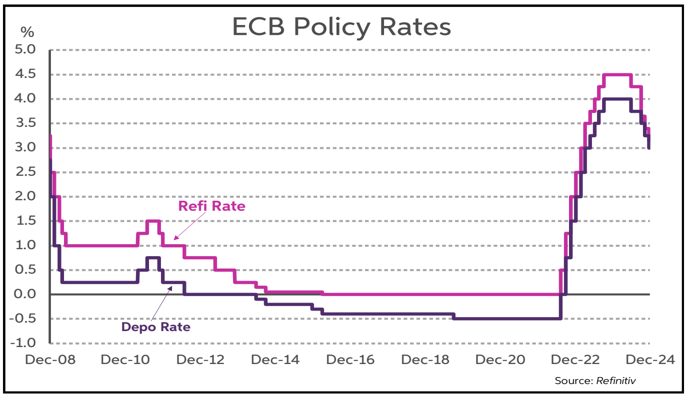
ECB Watch

AIB Treasury Economic Research Unit

12th December 2024

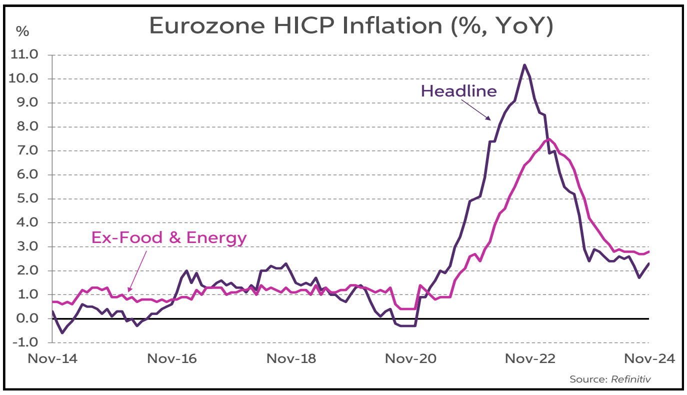
ECB cuts as expected and turns more dovish

As expected, the final ECB Governing Council meeting of 2024 saw it cut interest rates for the fourth time this year. It reduced them by 25bps, with the Deposit rate lowered to 3.00%, while the Re-fi rate was decreased to 3.15%. The ECB commenced its easing cycle in June, and followed with rate cuts at its September and October meetings. Today's decision by the ECB to cut rates was unanimous.



At the press conference, President Lagarde elaborated on the Governing Council's decision to reduce interest rates again. She stated that there had been "some discussion" on a 50bps cut, but all Council members "rallied" to a 25bps cut. This was based on the fact that inflation is seen as converging towards its 2% target for the sixth forecasting round in-a-row, that wages and profitability are "heading in the right direction" and because the risks to inflation are seen as being two-sided.

The December round of macro forecasts saw a downgrade to the central bank's growth expectations. This downgrade reflects the ECB taking into account the latest macro indicators, which suggest the economy is "losing momentum". The central bank is forecasting GDP growth of 0.7% (was 0.8% previously) for this year. For 2025, it expects GDP growth of 1.1% (from 1.3%). Meanwhile, the ECB sees GDP averaging 1.4% in 2026 (was 1.5%) and in its first published forecast for 2027, it is pencilling in growth of 1.3%. This is a very subdued growth outlook, with the modest recovery based on the assumption of rising real incomes boosting consumption and business investment. President Lagarde, noted once again today that the Governing Council views the risk to economic growth as remaining "tilted to the downside". **In terms of the outlook for headline inflation, the December forecasts also saw modest downward revisions from the September projections.** The ECB expects inflation to average 2.4% this year (was 2.5% previously), 2.1% in 2025 (from 2.2%) and 1.9% in 2026 (no change). For 2027, it sees inflation averaging 2.1%. It continues to expect the core rate to average 2.9% and 2.3%, this year and next year, respectively. The projection for 2026 was revised marginally lower to 1.9% (was 2.0%) while further out, it is anticipating core inflation to remain at 1.9% during 2027.



With today's rate decision fully priced in by markets, the key focus was what guidance, if any, the ECB would provide on the outlook for Eurozone interest rates for 2025. On this matter, a change in the meeting statement indicates that the ECB has more of a dovish bias than it did in October. It dropped the reference for the need for a "sufficiently restrictive" policy rate. However, at the same time President Lagarde continued to emphasise that the ECB is not pre-committing and remains "data dependent". She also referenced the highly uncertain outlook but did state that a lot will be clarified in the next few months in relation to global trade policy and Eurozone politics. She also commented that there was no discussion within the Governing Council at this month's meeting on the 'neutral rate'.

Against the backdrop of anaemic growth and weakness in incoming data, futures contracts have been anticipating an aggressive pace of rate cuts from the ECB next year. Following today's meeting there was no notable impact to market expectations. The market is pricing in the potential for around 125bps of policy easing in 2025. This would see the Depo rate level off in the region of 1.75%. Our view is that the ECB may not cut rates to the extent that the market is envisaging. **A scenario where the Deposit rate settles in and around the 2% level seems a reasonable outcome given the muted growth outlook for the Eurozone economy.**

ECB Macroeconomic Forecasts for the Euro Area

(%)	2024	2025	2026	2027
HICP	2.4	2.1	1.9	2.1
Real GDP	0.7	1.1	1.4	1.3

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $81.8 in 2024, $71.8 in 2025, $70.1 in 2026 and $69.2 in 2027 *Source ECB, December 2024*

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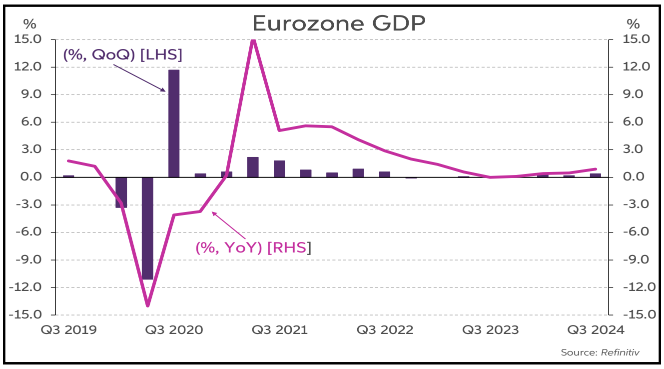
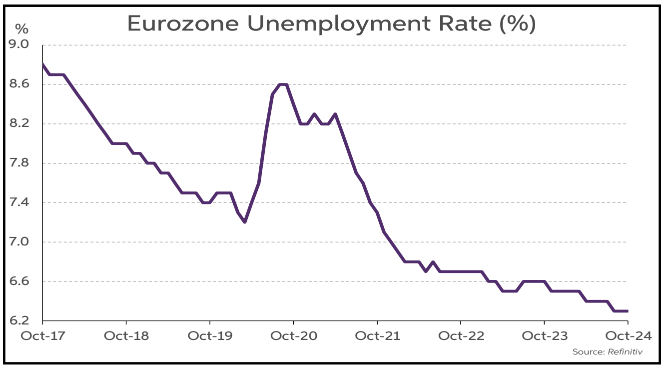
Eurozone economy remains fragile



Having essentially flat-lined between the end of 2022 and 2023, the Eurozone economy returned to growth this year. However, it should be noted that the economy expanded only modestly, with GDP rising by 0.2-0.4% q/q in the first three quarters of the year. The underlying breakdown of Q3 GDP shows that consumption rose strongly by 0.7% in the quarter, contributing 0.4 percentage points (p.p.) to growth. Encouragingly, investment rebounded by 2% in Q3, having contracted throughout H1, adding 0.4 p.p. to GDP. Government expenditure contributed a further 0.1 p.p. to the total for a second consecutive quarter. Changes in inventories also boosted output by 0.4 p.p.. However, net trade knocked a chunky 0.8 p.p. from growth in the quarter, largely owing to a hefty 1.5% fall in exports.

Meantime, the limited available data for the fourth quarter suggest the economy has lost momentum. Retail sales (the only available hard data so far) contracted by 0.5% in October, albeit they were up 1.9% in year-on-year terms. **Furthermore, survey data have been on a weakening trajectory in Q4.** The services PMI moved back into contraction territory in November, falling to 49.5, its lowest level since January. At the same time, the manufacturing PMI remains firmly in contraction mode, where it has been since July 2022. It printed at 46.0 in October before falling to 45.2 in November. The main EC economic sentiment indicator has also deteriorated in Q4, while consumer confidence fell to its lowest levels since June in November.

Regarding the labour market, conditions remain tight. The unemployment rate registered a new all-time low of 6.3% in August, and it has stayed at that level in September and October. Meanwhile, employment expanded for a fourteenth successive quarter in Q3, up by 0.2% in the quarter and by 0.9% y/y. It means that the number of people at work has risen by 7m or 4.7% since the end of Q4 2019. Tight conditions are contributing to elevated wage growth. The ECB negotiated wages metric increased by 5.4% y/y in Q3, the fastest pace of increase since Q1 1993. However, the Indeed wage tracker - a more frequent measure of wage pressures - indicates that wages have been rising more slowly in recent months. It indicates that wages rose by 3.2% y/y in September, the slowest rate of increase since January 2022, and down from 3.9% y/y in August. Wages were up 3.3% y/y in October.



On the inflation front, little progress has been made in recent months. 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. Furthermore, since then it has reaccelerated to 2.3% in November. Meantime core inflation is proving to be quite sticky. The ex-food and energy rate has been stuck between 2.6-2.8% since April, and it printed at 2.7% in October and November. The core rate that excludes food, energy, alcohol and tobacco was also running at 2.7% in the past three months. Services inflation, in particular remains elevated, although it did inch marginally lower to 3.9% in November. **ECB staff projections are for headline inflation to average 2.4% this year and to fall to 2.1% in 2025, 1.9% in 2026 and 2.1% in 2027.**

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.** Recent data indicate the economy is on a weakening growth trajectory. Furthermore, political turbulence in France and Germany, as well as fiscal issues in the former and poor growth prospects in the latter, pose significant potential headwinds for the Eurozone overall. A more protectionist and isolationist US may also weigh on Eurozone growth prospects. Against this backdrop, most growth forecasts have been revised lower. The IMF sees GDP expanding by 0.9% this year and 1.5% next year, while the ECB is anticipating growth of just 0.7% and 1.1% over the same period.

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