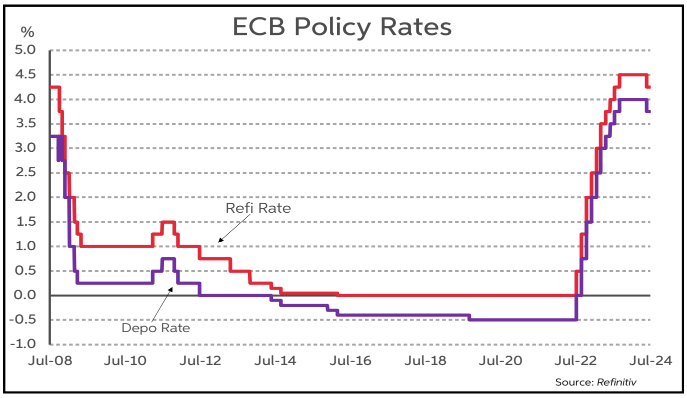
ECB Watch

AIB Treasury Economic Research Unit

18th July 2024

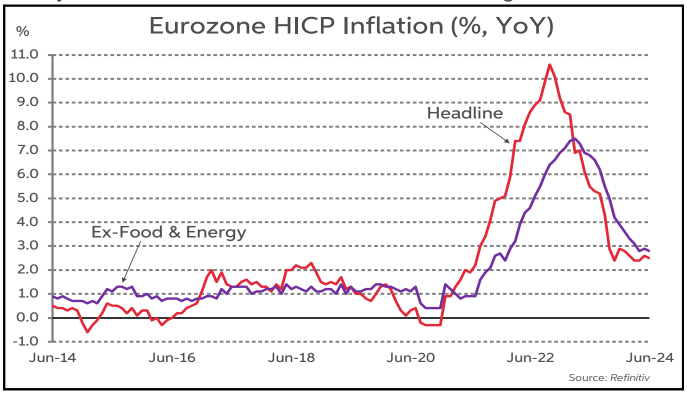
ECB keeping its options open for a September cut

The ECB meeting for July saw the Governing Council keep its key interest rates unchanged. This means that the Deposit rate remains at 3.75% while the refi rate stays at 4.25%. The 'hold' on rates in July follows the 25bps rate cut implemented in June to the main interest rates. This represented its first rate change in six meetings after previously being on a rate hiking cycle. Today's decision by the ECB to keep its policy rates unaltered was unanimous.



In its meeting statement, the Governing Council stated that incoming data indicates that the Eurozone economy continued to grow in the second quarter, "but likely at a slower pace than in the first quarter". It noted that the recovery continues to be lead by the services sector, while industrial production and goods exports "have been weak".

The most recent set of macro projections from the ECB were released at its last meeting in June. This forecast update saw a slight upward revision to its near term growth forecasts compared to the March edition. The ECB is forecasting GDP growth of 0.9% (from 0.6%) in 2024. For 2025 and 2026, the ECB's growth forecasts were little changed, with GDP expected to rise by 1.4% (was 1.5%) and 1.6% (no change), respectively. The ECB noted in today's statement that the "risks to economic growth are tilted to the downside".



Meanwhile, it revised higher its inflation outlook in its June forecasting round. It now sees the headline HICP rate averaging 2.5% this year (from 2.3%), 2.2% (was 2.0%) in 2025 and at 1.9% (no change) in 2026. It expects the core rate to average 2.8% this year (was 2.6%), 2.2% (from 2.1%) in 2025 and 2.0% (no change) in 2026. The ECB stated today that recent data remains consistent with its medium term inflation outlook, with inflation "expected to decline" towards its 2% target "over the second half of next year".

With today's lack of policy changes from the ECB very much expected, the focus was on what guidance, if any, the central bank would give regarding the potential for further rate cuts over the coming months. The meeting statement provided no new insight in relation to this. It continued to note that the Governing Council will follow a "data-dependent and meeting-by-meeting approach" to determine the appropriate interest rate setting. It also re-emphasised that it is not "pre-committing to a particular rate path". Meanwhile, at the press conference, President Lagarde reiterated this approach. **However, in response to a number of questions on the possibility of rate cuts at its next meeting on September 12th, she did state that September "is wide open" and any decision will be determined by incoming data over the coming weeks**. President Lagarde also commented that "it is clear between now and September, we will be receiving a lot of information". **In other words, the ECB is not ruling out a rate cut in September, while at the same time maintaining flexibility around any decision on rates.**

Market rate expectations for the ECB have remained relatively stable over the last number of months. Broadly speaking, since the last ECB meeting in June, the market has been pricing in around 50bps of rate cuts between now and year end. In the aftermath of today's meeting, the market is attaching a lower probability to the chance of a rate cut in September compared to the start of the week (65% vs 90%), with the next rate cut not now fully priced in until its October meeting. **Our view remains unchanged and we continue to believe that a further 50bps of rate cuts from the ECB over the remainder of 2024 is a plausible scenario** if underlying inflation, including wage growth, shows further signs of moderating. This would see the Deposit rate end the year at 3.25%.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2023	2024	2025	2026
HICP	5.4	2.5	2.2	1.9
Real GDP	0.5	0.9	1.4	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $83.8 in 2024, $78.0 in 2025, $74.5 in 2026

Source: ECB June 2024

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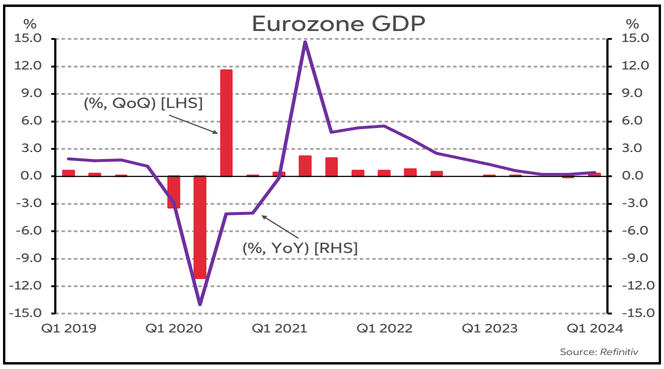
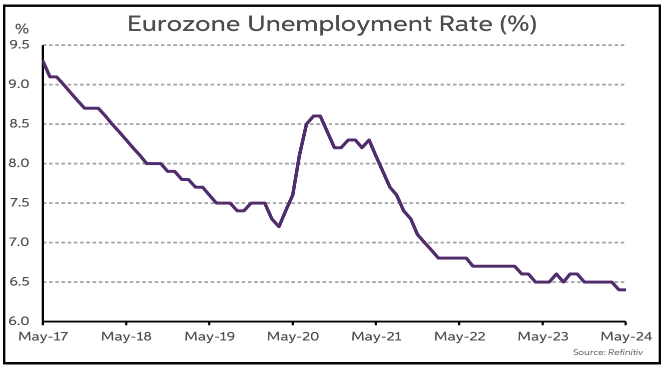
Eurozone economic outlook remains challenging



Having essentially flat-lined for five consecutive quarters between the end of 2022 and 2023, the Eurozone economy has shown signs of life during the first half of 2024. The economy returned to growth expanding by 0.3% q/q in Q1. Among the four largest economies, Spain continued to perform the best, with activity rising by 0.8% q/q, followed by Italy, where output increased by 0.3% q/q. The German and French economies both expanded by 0.2% q/q. Meantime, the underlying breakdown of Eurozone GDP shows net trade made the largest contribution to growth, adding 0.9 percentage points (p.p.). Government expenditure (+0.0 p.p.) and consumer spending (+0.1 p.p.) had a negligible impact on activity. Investment and inventories both knocked 0.3 p.p. from output, as the impact of higher interest rates continued to weigh on the former. Overall though, the Eurozone economy gathered some momentum in Q1.

However, the available hard data for Q2 have been quite weak. Retail sales declined by 0.2% in April, before rebounding by a meagre 0.1% in May. It means they were just 0.3% higher in year-on-year terms. At the same time, industrial production stagnated in April and fell by 0.6% in May. **Meanwhile, survey data have been mixed in Q2.** The manufacturing PMI has been in contraction territory for the past two years. Furthermore, it averaged 46.3 in Q2, little changed from its average of 46.4 in Q1. In contrast, the services PMI has been in expansion mode since February, and the pace of expansion has accelerated, as reflected by the index averaging 53.1 in Q2, compared to 50.0 in Q1. Similarly, the industrial EC sentiment index has deteriorated in Q2, while the service indicator has been little changed. Elsewhere, consumer confidence has continued to edge slightly higher throughout Q2.

In terms of the labour market, conditions remain tight. The unemployment rate declined to a new all-time low of 6.4% in April and stayed at that level in May. Furthermore, employment rose by 0.3% in Q1 and was up 1.0% y/y. **Tight conditions are contributing to elevated wage growth, which is a key concern for the ECB.** The ECB negotiated wages metric increased by 4.7% y/y in Q1, up from 4.5% y/y in Q4. Furthermore, the Indeed wage tracker - a more frequent measure of wage pressures - rose sharply to 4.2% y/y in June, up from 3.5% y/y in May.



On the inflation front, the downward trend in the headline rate has stalled in recent months. After printing at 2.4% in March and April, headline HICP rose to 2.6% in May, and came in at 2.5% in June. Likewise, core inflation has made little further progress in Q2, having also been on a clear downward path. The ex-food and energy rate was at 2.8% in June, while the core rate that excludes energy, food, alcohol and tobacco, stood at 2.9%. This compares to rates of 2.7% and 2.9%, respectively, in March. Furthermore, services inflation remains elevated and has been quite sticky. It rebounded to 4.1% in May from 3.7%, and stayed at that level in June.

Overall, the Eurozone economy appears to have gathered some positive momentum in 2024, with activity rebounding in the opening months of the year, albeit there have been signs of softening in Q2. The labour market remains strong, with employment continuing to rise and unemployment at an all-time low. Meanwhile, there has been a marked fall in inflation since Autumn 2022. Further rate cuts and disinflation should support real incomes and in-turn consumer spending, albeit the near-term path for inflation may be somewhat bumpy between now and year end. **However, the outlook for the Eurozone remains challenging.** Wage pressures remain elevated, and this is contributing to sticky services inflation. Despite already having cut rates once, it is clear from the remarks by President Lagarde today that more progress on the inflation front will be need for the Governing Council to reduce the restrictiveness of monetary policy further. Weaker global growth as well as on-going geopolitical tensions and political uncertainty, particularly in France, may stymie activity. Against this backdrop, most forecasters expect weak economic growth in the Eurozone this year. **Both the IMF and the ECB are forecasting Eurozone GDP growth of 0.9% in 2024.** Looking ahead, growth is expected to accelerate next year, to 1.5% according to the IMF, while the ECB sees the economy expanding by 1.4% in 2025.

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