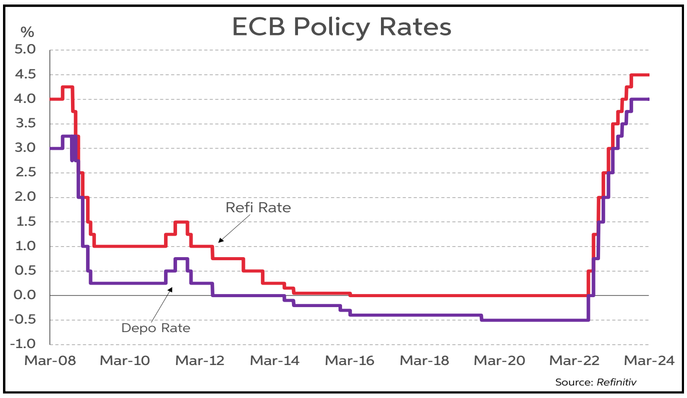
ECB Watch

AIB Treasury Economic Research Unit

8th March 2024

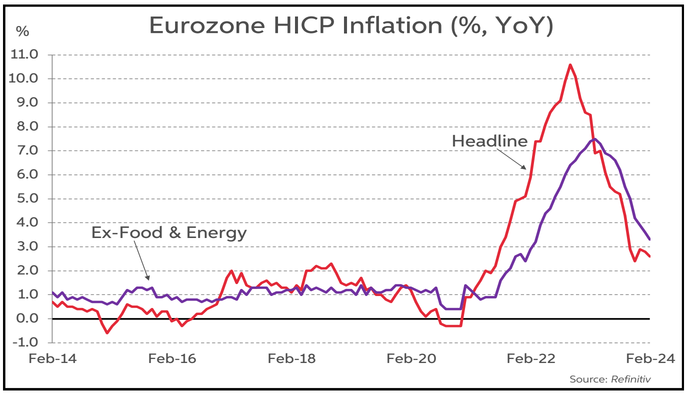
ECB starts slow pivot towards potential June rate cut

The March meeting of the ECB's Governing Council saw the central bank maintain its key deposit rate at 4%. This outcome was in line with expectations. It marked the fourth consecutive policy meeting that the ECB has kept rates unchanged. The decision to leave rates on hold was unanimous. Meanwhile, President Lagarde noted that the Governing Council did not discuss rate cuts at this month's meeting.



There was no major changes to the ECB's mindset regarding the interest rate outlook. It once again **repeated the key message that it considers interest rates to have reached levels, that if maintained for a sufficiently long time horizon, will make a substantial contribution to reaching its 2% inflation target, in a timely manner**. The ECB also re-emphasised that it will follow a data-dependent approach in making future monetary policy decisions and will ensure that rates are sufficiently restrictive for as long as necessary to restore price stability.

However, the ECB did indicate that a rate cut in June was a possibility. President Largarde commented that the ECB will have a "little" data in April, but will have "a lot more" for the June meeting and "it matters because we are data dependent". The ECB will be looking for more progress on reaching their inflation target. President Lagarde highlighted that there was one area of inflation that was not yet declining. Domestic inflation, which is influenced heavily by price dynamics in the services sector, which in turn is informed by wage increases. Therefore, the President stated that the ECB will try to be "laser focused" on (1) wages, for confirmation of a moderating trend and on (2) profits, to determine if they "absorb and act as a buffer for the wage increases".



In terms of its assessment of the Eurozone economy's performance, the ECB published its latest staff forecasts. These saw a slight lowering of its near term growth projections amid the increasing impact of monetary policy tightening on domestic demand and the weakening in global trade. The ECB is forecasting GDP growth of 0.6% (from 0.8%) in 2024. For 2025 and 2026, the ECB's growth forecasts were little changed, with GDP expected to rise by 1.5% next year and by 1.6% the year after (compared to 1.5% for both previously). However, the ECB retained its view today that the risks to the economic outlook remain tilted to the downside. **Meanwhile, it revised lower its inflation forecasts to take on board a lower contribution from energy prices.** It sees the headline HICP rate averaging 2.3% (was 2.7%) this year, 2.0% (from 2.1%) in 2025 and kept its 2026 forecast unaltered, at 1.9%. Its projections for the core HICP rate, which excludes food and energy, were also revised lower for 2024. It expects the core rate to average 2.6% (was 2.7%) this year, 2.1% (from 2.3%) in 2025 and 2.0% (was 2.1%) in 2026.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2023	2024	2025	2026
HICP	5.4	2.3	2.0	1.9
Real GDP	0.5	0.6	1.5	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $79.7 in 2024, $74.9 in 2025, $72.2 in 2026 *Source: ECB March 2024*

Over the last number of week's market rate expectations for the ECB have firmed, with less rate cuts now envisaged for this year. In the initial aftermath of the January Governing Council meeting, the market was pricing in around 140bps of easing for this year. However, against the backdrop of a raft of ECB remarks suggesting that rate cuts were not imminent, the market had already adjusted its expectations in the lead up to the March meeting. Futures contracts were pricing in around 90bps of policy easing over the remainder of this year, starting with a first rate cut in June. In reaction to the ECB lowering its growth and inflation forecasts for 2024, futures softened slightly yesterday, and are now pricing in around 100bps of rate cuts this year. At the press conference, President Lagarde was asked about the re-pricing of market expectations since January and how they aligned with her own view, to which she responded that they "seem to be converging better". This suggests that current market expectations for around 100bps of rate cuts this year are broadly aligned with the ECB's rate outlook.

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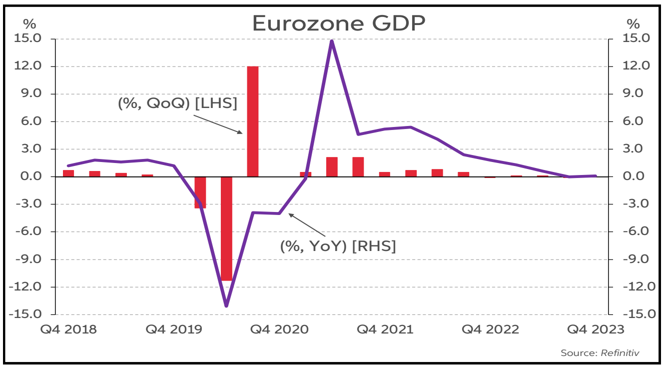
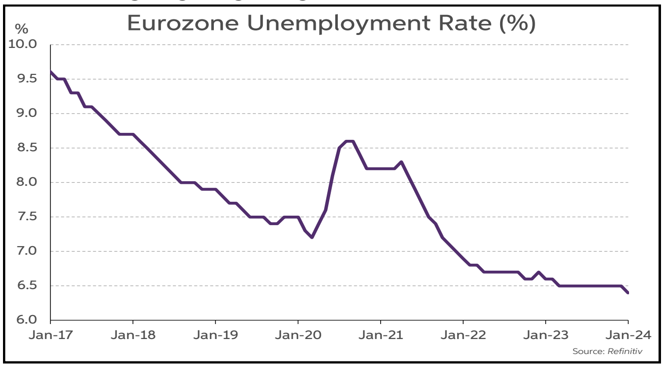
Eurozone economic outlook remains muted

The Eurozone economy has essentially flat-lined for five consecutive quarters. GDP contracted by 0.1% in Q4 2022, before expanding by 0.1% in the first and second quarters of 2023. However, growth fell by 0.1% again in Q3 2023, before stagnating in the final quarter of the year. **Overall, GDP rose by just 0.5% in 2023, down from 3.5% in 2022,** as the post-pandemic rebound faded, and the squeeze on real household incomes from elevated levels of inflation and higher interest rates weighed on activity. Among the largest national economies, Italy and France registered modest growth of circa 0.8% last year, while the Spanish economy expanded by 2.4%. The German economy continued to struggle though, contracting by 0.3% in 2023, owing to falls in consumption, government expenditure and investment.



Survey data suggests activity in the Eurozone remained muted at the start of 2024, albeit there are tentative signs that the economy may be bottoming out. The manufacturing PMI has been in contraction territory for 21 straight months. However it has edged higher recently, and has averaged 46.6 so far in Q1, up from an average of 43.9 in Q4, signifying a slower pace of contraction in the sector. Meantime, the services PMI printed in February above the key 50 level for the first time since July. At the same time though, the EC Economic Sentiment Index has inched lower in January and February. Consumer confidence also deteriorated in January, before rebounding modestly in February. Industrial and services sector sentiment remains subdued as well. **In terms of the available hard data, retail sales rose by a meagre 0.1% in January, following a sharp 0.6% contraction in December.** In year-on-year terms, retail sales were 1.0% lower in January.

Meanwhile, labour market conditions remain tight. After printing in a 6.5%-6.6% range since February 2023, the unemployment rate registered a new all-time low of 6.4% in January 2024. Employment rose by 0.3% in Q4 and was up 1.2% y/y. **Tight conditions are contributing to elevated wage growth.** Negotiated wages increased by 4.5% y/y in Q4. Furthermore, the indeed wage tracker - a more frequent measure of wage pressures - indicates that wages were up 3.9% y/y in the three months to January. The ECB is clearly concerned about elevated earnings growth, with President Lagarde making specific reference to ongoing wage negotiations across the bloc for the second consecutive press conference.



Regarding inflation, the headline rate fell throughout last year. However, more recently it has proved to be somewhat sticky. Having declined to a low of 2.4% in November, its lowest level since July 2021, it rose to 2.9% in December, and printed at 2.8% in January. Encouragingly, the flash reading indicates headline inflation eased to 2.6% in February. Furthermore, core inflation has remained on a clear downward trend in recent months. The ex-food and energy rate dropped to 3.3% in February. Meantime, the core rate that excludes energy, food, alcohol and tobacco declined to 3.1%, its lowest level since March 2022. However, it should be noted that services inflation remains elevated and has been quite sticky, suggesting that underlying price pressures remain high. It stood at 3.9% in February, having run at 4% in the three months prior. **The updated ECB staff projections are for headline inflation to average 2.3% in 2024, 2.0% in 2025 and 1.9% in 2026, with core inflation moving back to 2.1% next year and to 2% in 2026.**

Overall, the Eurozone economy has been virtually stagnant over a year in the face of high inflation and rising rates, weaker global growth as well as on-going uncertainty stemming from the War in Ukraine. The German economy, the largest in the Eurozone, has performed particularly poorly. However, it is worth noting that the Eurozone labour market remains strong, and there has been a marked fall in inflation since autumn 2022. Regardless, the most recent forecasts for the Eurozone economy have been scaled back. **The IMF is forecasting Eurozone GDP growth of 0.9% in 2024, while the ECB is projecting the economy will expand by 0.6% this year.** Looking ahead, growth is expected to accelerate next year, to 1.7% according to the IMF, while the ECB sees the economy growing by 1.5% in 2025. However, given the weak trends in the recent data, the risks are tilted to the downside of these projections.

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