ECB Watch

AIB Treasury Economic Research Unit

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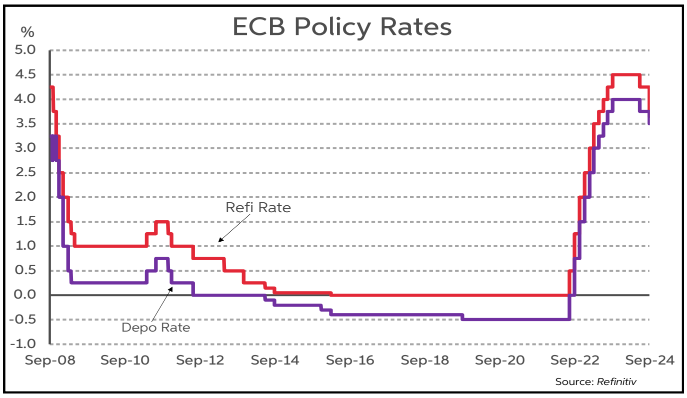
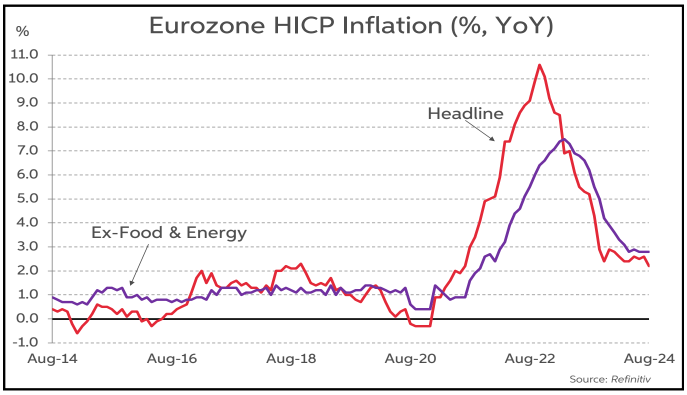
ECB cuts as expected, but vague guidance on rate outlook

The ECB cut interest rates for a second time this year at the September policy setting meeting of its Governing Council. The Deposit rate was lowered to 3.50%. Meanwhile, the refi rate was cut to 3.65%, which entailed a previously announced technical adjustment of a reduction in the spread between the Depo and Refi rates from 50bps to 15bps. Today's rate cuts were very much in line with market expectations. The previous rate cut from the ECB and the start of this easing cycle occurred in June, when the Depo rate was reduced from 4.00 to 3.75%. Today's decision by the ECB to ease policy was unanimous.



The meeting statement outlined the rationale for the rate cut. It noted that the "dynamics of underling inflation" combined with the "strength of monetary policy transmission" means that it is "appropriate" to ease monetary policy again. In the press conference, President Lagarde elaborated further, outlining three tenets to its policy decision. Firstly, she emphasised the consistency in its "inflation outlook", which reinforces its confidence in the ECB's economic projections, which see inflation at 2% before the end of 2025. Secondly, she discussed "underling inflation", and signs that it is abating, while acknowledging that domestic price pressures are still persisting. Thirdly, she commented that the Council's assessment of the "transmission of monetary policy" shows that policy remains restrictive.

Today also saw the release of the ECB's latest set of macro projections. The September forecast update saw a slight downward revision to its near term growth expectations compared to the June edition. The central bank stated that this downgrade reflects its updated assessment of a weaker contribution from domestic demand over the coming quarters than previously assumed. The ECB is now forecasting GDP growth of 0.8% (from 0.9%) for this year. For 2025, it lowered marginally its GDP forecast to 1.3% (from 1.4%). Meanwhile, the ECB now expects GDP to average 1.5% in 2026 (was 1.6%). However, it was noted once again by President Lagarde, that the risks to economic growth remain "tilted to the downside".



In terms of the outlook for headline inflation, the forecasts were left unchanged from the June projections. The ECB continues to see the 'topline' HICP rate averaging 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 now 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%. The ECB commented that incoming data remain consistent with its medium term inflation outlook, with inflation "expected to decline" towards its 2% target "over the second half of next year".

A key focus for markets today, was what guidance, if any, would be forthcoming from the ECB on future rate cuts. In this regard, President Lagarde was vague. She emphasised that the ECB is not pre-committing, and that it will continue to take a data dependent, meeting-by-meeting approach, meaning the declining path of rates is not predetermined. Market rate expectations for the ECB over recent weeks have tended to lean towards the Deposit rate ending the year at 3%. In other words, an additional 50bps of easing before year end. In the aftermath of today's meeting, the market has lost some conviction in this expectation, although the possibility of two further rate cuts has not been ruled out entirely. **We continue to be of the view that the ECB will implement one more 25bps cut this year. We think the central bank will remain on hold at its next meeting on October 17th and cut by 25bps at its last meeting of 2024, on December 12th. This would see the Depo 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	0.8	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

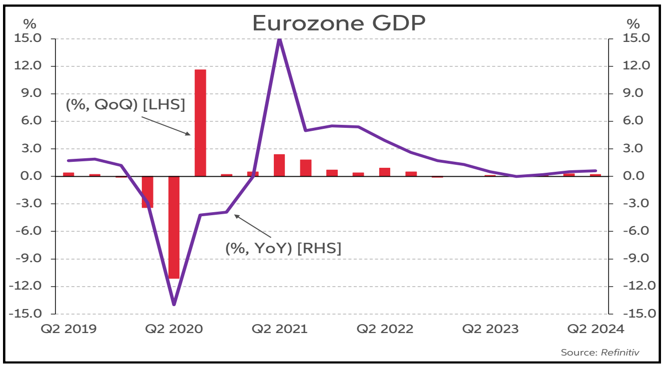
David McNamara
Chief Economist
david.g.mcnamara@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

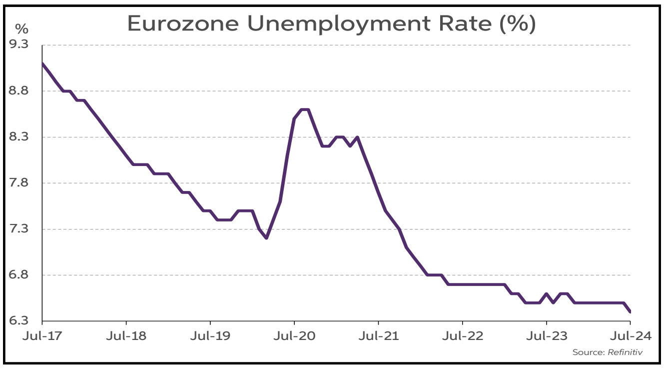
Economic growth remains fragile in the Eurozone

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 declined by 0.1% in the quarter, clipping 0.1 p.p. from growth. At the same time, investment fell sharply by 2.2% in Q2, knocking 0.4 p.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 growth remained meagre at best in the third quarter. The services PMI averaged 53.1 in the second quarter, but fell to 51.9 in July and printed at 52.9 in August, suggesting a slower pace of expansion in the sector. Meantime, the manufacturing PMI - which has been in contraction territory for over two years - printed at 45.8 in each of the last three months, indicating that conditions in the sector have continued to deteriorate at a consistent rate. Elsewhere, the EC sentiment industrial and services sector indices have been little changed so far in Q3. At the same time, consumer confidence declined slightly in August, ending a run of seven consecutive monthly improvements. **The limited available hard data have also been quite weak.** Retail sales rebounded by a marginal 0.1% in July, having contracted by 0.4% in June. Overall, retail sales were –0.1% lower in year-on-year terms in July.

Regarding the labour market, conditions remain tight. The unemployment rate moved back to its all-time low of 6.4% in July. 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.** However, the ECB negotiated wages metric increased by 3.6% in Q2, down from 4.7% in Q1, while the Indeed wage tracker - a more frequent measure of wage pressures - has been little changed in recent months. This suggests that although earnings growth remains robust, there are tentative signs it is starting to slow.



On the inflation front, the headline rate fell to 2.2% in August, its lowest level since July 2021. However, there has been little progress in core inflation in recent months. The ex-food and energy rate stayed at 2.8% in August, for a third successive month. Meantime, the core rate that excludes energy, food, alcohol and tobacco, also stood at 2.8%, a smidge below the 2.9% rate it was at throughout the summer. Furthermore, services inflation is still elevated and has been quite sticky. It rose to 4.2% in August, up from 4% in July, and it has only registered a sub-4% reading once since September 2022. Looking ahead, the ECB is projecting headline inflation will average 2.5% this year, and 2.2% in 2025.

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 continuing to rise 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 elevated, and this is contributing to sticky services inflation. Weaker global growth as well as on-going geo-political 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 this year. **The updated ECB staff projections are for GDP growth of 0.8% in 2024.** Growth is forecast to accelerate next year though, to 1.3%. Longer-term, the Eurozone faces a number of challenges, which will require increased co-operation and investment to boost productivity, as outlined in a well-received recent report by former ECB President Draghi.

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit