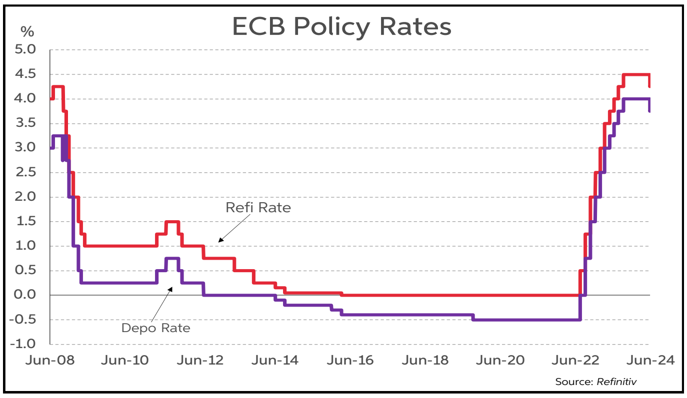
ECB Watch

AIB Treasury Economic Research Unit

6th June 2024

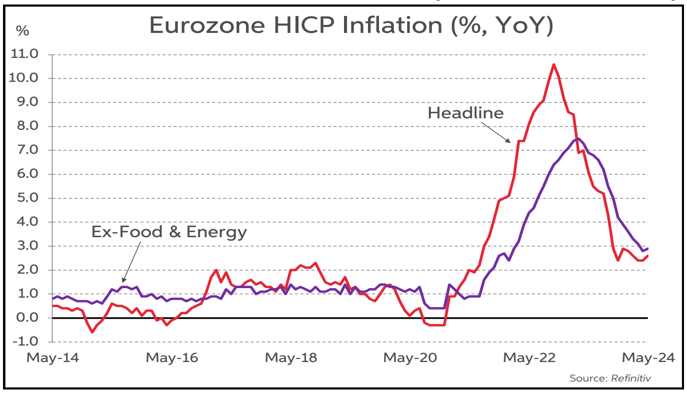
ECB lowers rates as expected, but non-committal on future cuts

The ECB's Governing Council meeting for June saw the central bank cut its key interest rates by 25bps. The Deposit rate was lowered to 3.75% (from 4.00%), while the refi rate was reduced to 4.25% (from 4.50%). The June rate changes follow five consecutive policy meetings where the ECB kept rates on hold, having been in a rate hiking cycle between July'22 to September'23. All bar "one Governor" within the Governing Council were in favour of the decision to cut interest rates. The rate cuts were very much in line with expectations, with the ECB giving clear guidance in the lead up to today's meeting of their intention to ease policy.



The rationale for cutting rates was outlined in the meeting statement. The ECB commented that now was the appropriate time to reduce the degree of monetary policy restriction against the backdrop where "inflation has fallen by more than 2.5 percentage points" since September'23, the "inflation outlook has improved markedly" and "underlying inflation has also eased". Meanwhile, in the press conference, President Lagarde stated that the ECB's confidence in the inflation outlook "has been increasing" over recent months. She cited two reasons for this increased level of confidence in the path of inflation. Firstly, the recent downtrend in inflation and secondly, due to the "reliability and solidity" of its inflation projections.

Today also saw the ECB provide an update on its outlook for the Eurozone economy with the publication of its latest staff forecasts. There was a slight upward revision to near term growth forecasts compared to their March edition. The ECB is now 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 is of the view that the risks to economic growth are "balanced in the near term but remain tilted to the downside over the medium term".



Meanwhile, it revised higher its inflation forecasts today. The ECB noted that despite progress over recent quarters, domestic price pressures remain strong amid elevated wage growth and that "inflation is likely to stay above target well into next year". 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.

With today's rate cuts well flagged, the focus for markets was on what insight, if any, the ECB would provide on additional policy easing over the coming months. In this regard, the ECB was non-committal on when it anticipates cutting rates again. President Lagarde emphasised that the central bank would be "data-dependent" and take a "meeting-by-meeting" approach, and that the ECB "is not pre-committing to a particular rate path". When questioned in the press conference on whether the ECB was now in a "dialling back phase", she would not be drawn on this, although she did state this is a "strong likelihood". However, at the same time, she emphasised "what is very uncertain is the speed at which we travel and time it will take".

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

Market rate expectations for the ECB had been relatively stable over the last number of months. There was a modest firming in futures contracts in the immediate aftermath of the meeting amid the lack of any concrete guidance on the timing/pace of future rate cuts. The market is now anticipating around 35bps of additional easing from the ECB by year end. **Our view is that a further 50bps of rate cuts from the ECB over the remainder of 2024 is a reasonable expectation** if underlying inflation, including wage growth, which the ECB will continue to scrutinise closely, shows further signs of moderating. This would see the Deposit rate end the year at 3.25%.

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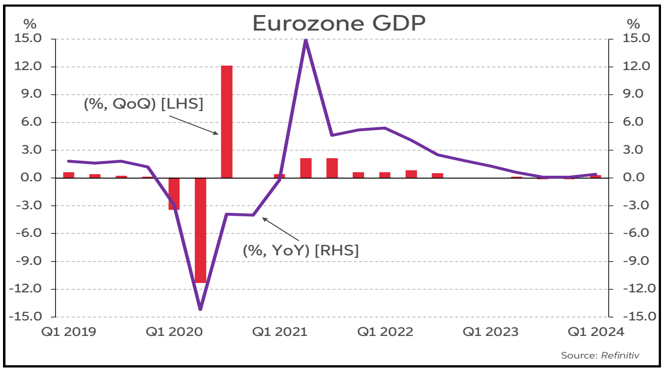
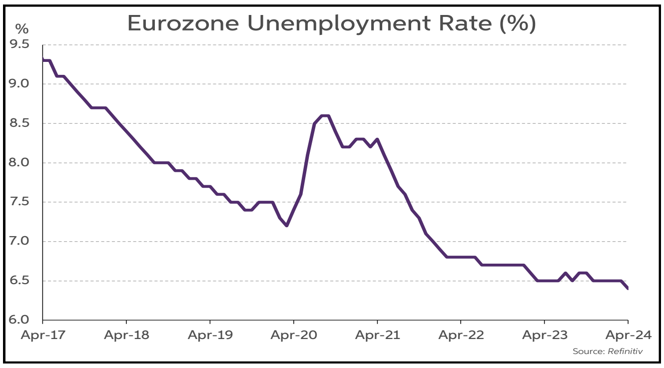
Eurozone economy gathering positive momentum

Having essentially flat-lined for five consecutive quarters between the end of 2022 and 2023, the Eurozone economy has shown signs of life at the start of 2024. The economy exited a shallow technical recession, with GDP returning to growth in the first quarter of the year, expanding by 0.3% q/q. In year-on-year terms, Eurozone GDP was up by 0.4%. Among the four large national economies, Spain continued to perform the best, with activity rising by 0.7% 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 at the start of 2024.



In terms of the available data for Q2, retail sales fell by 0.5% in April, having expanded by 0.7% in March. It means they were flat in year-on-year terms in April. **In contrast, the survey data available for April and May are consistent with improving economic conditions.** The PMIs indicate that the services sector continues to outperform manufacturing. The manufacturing PMI has been in contraction territory for 25 straight months. However, it has been trending steadily higher recently, signalling a slowdown in the pace of contraction in the sector. It rose to 47.3 in May, its highest level since March 2023. Meantime, the services PMI has printed in expansion mode for the last four months and jumped to 53.3 and 53.2 in April and May, respectively. Consumer confidence has also risen in Q2. Meanwhile, the EC industrial and services sentiment indices rebounded in May, having edged lower in April.

Elsewhere, labour market conditions remain tight. The unemployment rate declined to a new all-time low of 6.4% in April, having hovered in a narrow 6.5-6.6% range since February 2023. Furthermore, employment rose by 0.3% in Q1 and was up 1.0% y/y. **Tight conditions are contributing to elevated wage growth.** The ECB negotiated wages metric increased by 4.7% y/y in Q1, up from +4.5% y/y in Q4. However, the indeed wage tracker - a more frequent measure of wage pressures - signalled a slowdown in pay growth recently, with wages up by 3.4% y/y in April, down from +3.7% y/y in March. The ECB remains concerned about elevated earnings growth, although, at today's press conference, President Lagarde acknowledged that wage pressures are moderating.



On the inflation front, the downward trend in the headline rate during the spring, reversed course in May. After printing at 2.4% in March and April, the lowest levels since July 2021, headline HICP rose to 2.6% in May. At the same time, core inflation, which had also been on a clear downward path recently, edged higher. The ex-food and energy rate increased to 2.8% in May, from 2.7%, while the core rate that excludes energy, food, alcohol and tobacco, rose to 2.9% from 2.8%. Furthermore, services inflation remains elevated and has been quite sticky. It rebounded to 4.1% in May from 3.7%. However, a key driver of the rebound in inflationary pressures in May was the impact of subsidised public transport costs in Germany last year washing through the index. **The updated ECB staff projections are for headline inflation to average 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026, with core inflation moving back to 2.2% next year and to 2.0% in 2026.**

Overall, the Eurozone economy appears to have gathered some positive momentum in 2024, with activity rebounding in the opening months of the year. 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. However, wage pressures remain elevated, and this is contributing to sticky services inflation, which is still too high. It should be acknowledged though, that there are signs wage pressures are moderating. Against this backdrop, the ECB felt confident enough to reduce the level of restrictiveness of monetary policy at today's meeting. 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 in the second half of 2024. Weaker global growth as well as on-going uncertainty stemming from geo-political tensions may also stymie activity. Indeed 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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