ECB Rate Cuts Expected Next Year

The Eurozone economy stagnated between autumn 2022 and mid-2023, with flat domestic spending and a decline in exports offset by higher inventories. The data since mid-year, though, suggest the economy could now be entering recession. Retail sales fell sharply by 1.3% in August after a fall of 0.1% in July. Industrial production expanded by 0.6% in August, but this followed a contraction of 1.1% in July. Monetary aggregates also continue to weaken, with M3 money supply falling by 1.2% and credit growth to households slowing to 0.8% year-on-year in September.

Survey data also suggest the Eurozone economy has weakened further since mid-year. The services PMI readings came in below 50 in August and September, thus moving into contraction territory. The manufacturing PMI, which was already struggling, averaged a very weak 43.2 in the third quarter. Meanwhile, the EC economic sentiment index, which has been trending lower since the start of the year, fell to 93.3 in September, its lowest level since November 2020.

The latest ECB bank lending survey also showed that credit conditions tightened further and loan demand fell sharply in the third quarter, as higher rates weighed on activity. Meantime, the limited amount of survey data available for October suggest the economy continues to weaken. The Eurozone PMIs fell further in October, while consumer confidence deteriorated for the third month running, from already low levels.

Overall, the Eurozone economy has been coming under pressure over the past number of quarters in the face of high inflation and rising interest rates, as well as weaker global growth and increased geo-political uncertainty. The IMF is forecasting Eurozone GDP growth of 0.9% in 2023, and 1.5% in 2024. The ECB is projecting the economy will expand by 0.7% this year and by 1.0% in 2024. However, given the recent weak trends in the data, the risks are tilted to the downside of these projections. Indeed, as already noted, the economy may well enter recession in the second half of this year, with growth also likely to be much lower than forecast in 2024.

Against the backdrop of rising recession risks and with inflation now in sharp decline, futures contracts indicate that the market is of the view that ECB rates have peaked, and will start to be lowered from around mid-2024. They see the first 25bps cut next June, with two more in the second half of 2024, and another 25bps cut in 2025, taking rates down to 3%.

Market expectations for significant rate cuts next year seem to be out of tune with the ECB's firm focus on maintaining a restrictive policy for as long as necessary to bring inflation down to target. In this regard, though, the ECB's macro forecasts do not envisage a recession that would accelerate the fall in inflation back to 2%.

ECB policy will remain very much on hold in the near-term and it is most unlikely to signal anytime soon that policy easing could be on the agenda next year. Indeed, President Lagarde has stated that any talk of rate cuts is totally premature. However, if the economy is indeed hit by recession, then rate cuts next year would seem likely.

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