ECB walks tightrope between growth and inflation

The ECB cut interest rates for a second time this year at the September policy meeting of its Governing Council, but a cautious trajectory for rate cuts in the coming months risks choking off an anaemic growth profile across the Eurozone. The Deposit rate was lowered by 25 basis point (bps) to 3.50% while the Refinancing rate was cut by 60bps to 3.65%, which included the previously announced reduction in the spread between it and the Deposit rate from 50bps to 15bps. The rate cuts were very much in line with market expectations, but much uncertainty surrounds the future pace of easing. In this regard, President Lagarde was purposely vague in her outlook. She emphasised that the ECB is not pre-committing, and that it will continue to take a 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. While an October cut has been all but ruled out by markets, this implies a 50bps cut in December. However, the exceptional caution of the ECB means it is likely to move slowly for now.

This might leave it behind the curve in early 2025 if Eurozone macro data continues to undershoot expectations, and mean a 50bps cut may be necessary at that point. Of the main engines of Eurozone growth, the German economy remains in the doldrums, while ongoing political uncertainty in France is weighing on sentiment, and could in turn blunt French growth in the coming months. Indeed, the ECB revised down slightly its near term outlook for growth compared to its last forecast in June. President Lagarde also noted the risks to economic growth remain "tilted to the downside". The most likely path for now is that the ECB will cut in line with its quarterly forecasts, rather than at consecutive meetings, unencumbered in its sole mandate of achieving 2% inflation. This may well place it at odds with the US Fed, which could cut rates at successive meetings, given its renewed focus towards the labour market side of its dual mandate.

Indeed, the market spotlight will be focused on the US Federal Reserve this week, as it is widely expected to cut rates for the first time this cycle. However, there is some uncertainty as to whether the Fed will opt for a 25bps or a 50bps cut this week, with the market split on its positioning ahead of the meeting. Aside from the policy decision, Chair Powell's press conference and the updated interest rate projections will be under the microscope, as investors look for guidance on the future path of policy. Markets are currently pricing in an aggressive cutting cycle in the US, with rate cuts worth 115bps expected by year end. Elsewhere, the Bank of England also meets this week, but is expected to hold rate steady for now.

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