Economic Research Unit

Economics Weekly

Bank of Ireland

Weak economic outlook for euro area

Yesterday's decision by the ECB to cut its deposit rate by a further 25bps to 3.5% came as no surprise to markets. The overnight index swap curve now implies the ECB will cut the deposit rate at least once more in 2024, falling to 3.12% in December and to 1.85% by end-2025. Perhaps more striking were the downward revisions to the ECB's forecast for GDP growth in 2025. The ECB is now forecasting a 1.3% expansion, down 0.1 percentage points since the last projections in June. The ECB highlighted recent surveys that have pointed to weaker than expected business and consumer confidence and spending. The clear fear here is that the ECB may have already tightened its monetary policy more than sufficiently to curb HICP inflation, but is still overly optimistic in the expectation a consumer led recovery will emerge in 2025.

ECB cuts interest rates as expected: Yesterday, the ECB cut its main interest rates, as expected, by 25bps with the deposit rate cut to 3.5%. A technical change in the way the ECB implements its monetary policy stance means that from September onwards the main refinancing rate will be set just 0.15% above the deposit rate (vs 0.5% previously). The decision wasn't a surprise to markets, so put limited downward pressure on the euro, currently trading at $1.109 against the dollar. The overnight index swap (OIS) curve now falls to 3.12% by end-2024, implying one further cut is fully priced in this year, at either the October 17th or December 12th policy meetings, and then to 1.85% by end-2025.

ECB downgrades its growth outlook: Perhaps more striking than the rate decision itself were the downgrades to the ECB's economic forecasts. The ECB now expects 0.8% and 1.3% GDP growth in 2024 and 2025 respectively, both revised down by 0.1 percentage points. The ECB's commentary noted the 0.3% and 0.2% increases in GDP in Q1 and Q2 2024 respectively had been largely driven by net trade. However, the ECB has pared back the consumption driven recovery it expects in 2025. Specifically, recent surveys had pointed to subdued consumer confidence and elevated household savings. Similarly, recent data on business investment had also pointed to weaker momentum.

PMI data point to subdued conditions: August's euro area composite PMI at 51.0 was only slightly above the 50 no-change level; albeit at a 3-month high driven by a sharper upturn in the services sector. However, new orders, especially export orders shrank, pointing to more difficult conditions going forward. Notably, the PMI survey indicated private sector employment contracted in August for the first time since early 2021. Business confidence also slipped, to its lowest level so far in 2024. At the country level, the German reading was 48.4, a five-month low and indicating contraction. This follows news German GDP contracted unexpectedly, by 0.1%, in Q2 2024.

HICP inflation to pick-up in final quarter: The clear fear is that the ECB has tightened its monetary policy more than sufficiently to curb GDP growth and inflation. However, the ECB expects HICP inflation to pick-up slightly in Q4 2024, reflecting energy price base effects, but also reversal of Covid-19 era temporary tax cuts and subsidies, which have added to volatility in HICP inflation. Nonetheless, the rise in HICP inflation in Q4 could lead investors to refocus on the risk of inflation persistence, limiting further downward pressure on longer term rates, even if there is further evidence that the euro area recovery is faltering. The ECB's forecast is for HICP inflation to average 2.5% in 2024, before falling back towards the target, at 2.2% in 2025 and 1.9% in 2026.

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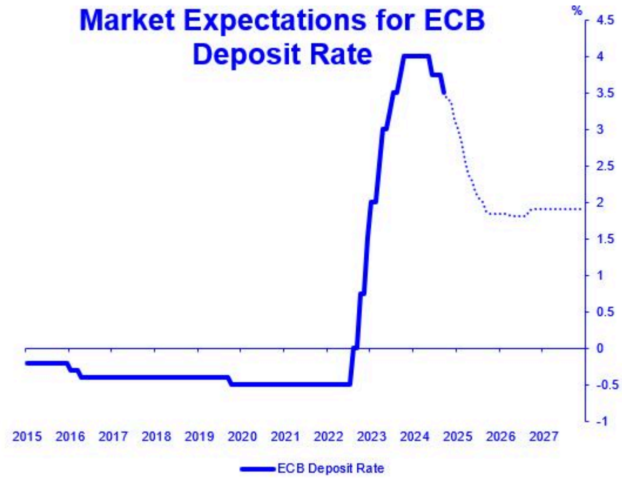

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