Holger Schmieding, Chief economist | holger.schmieding@berenberg.com | +44 7771 920377

ECB PREVIEW: NO TIME FOR A PAUSE

Berenberg Macro View

For once, the policy decision seems to be straightforward this week. Like most observers, we expect the European Central Bank (ECB) to cut rates by 25bp on Thursday. Although the ECB will emphasise as usual that its further actions are data dependent, ECB President Christine Lagarde will probably not say anything at the press conference in Slovenia to correct market expectations for another 25bp move on 12 December. If so, the fourth cut since the ECB started to relax its stance in June would take the policy-relevant deposit rate to 3% before the end of the year.

The trends in the real economy and inflation support the case for lower rates. At its last council meeting on 12 September, the ECB had already lowered its staff projections for **real GDP** growth for each year of the 2024-2026 forecast horizon by 0.1 ppt. Since then, the composite purchasing managers index (PMI) for the Eurozone fell further from 51.0 in August to 49.6 in September, dipping below the 50 line that separates growth from contraction in this survey of the private economy for the first time since February. In a similar vein, the European Commission's economic sentiment index dropped to 96.2 in September from 96.5 in August. The new setback was driven largely by a more negative assessment of order books in manufacturing (down to -25.5 from -23.6, far below the long-term average of -12.4). This pushed sentiment in the highly cyclical industrial sector to -10.9, its lowest level since July 2020.

Helped by lower oil prices, **headline inflation** decelerated from 2.2% in August to 1.8% yoy in September, the lowest level since April 2021. Whereas core inflation remains sticky, receding merely to 2.7% yoy in September after 2.8% in August, it has stayed on the downtrack. The big surge in wages to recoup losses in purchasing power from the earlier spike in energy and food prices seems to be petering out. Amid below-trend growth in real GDP, the ECB is becoming more confident that wage inflation and other sources of underlying inflation pressures will ease further. Although base effects from a 4.8% decline in energy prices from September to December 2023 and the current rebound in oil prices due to escalating tensions in the Middle East will likely propel headline inflation to c2.2% again by December, the ECB will probably look through these energy effects.

Reacting to the data, the ECB has already shifted its tone. Whereas the ECB had suggested on 12 September that it may wait for new staff projections on growth and inflation in December before easing again, a long list of **ECB speakers** has indicated over the last two weeks that an October move is on the cards. Even Bundesbank president Joachim Nagel said on 8 October that he is "open" to an October cut. Nagel is usually seen as one of the more hawkish council members. His French counterpart, Francois Villeroy de Galhau, went even further on 9 October, emphasising that a cut in October is "very likely, and that it will not be the last".

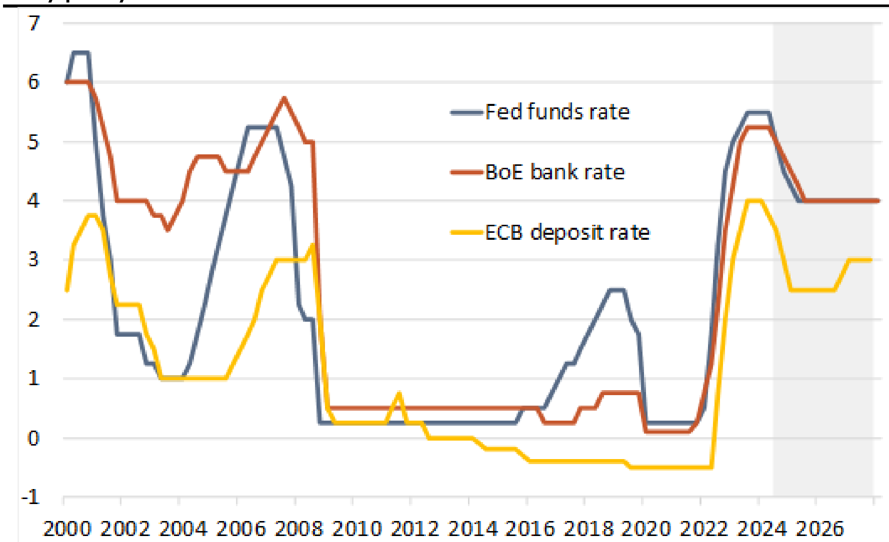
Upon presenting new staff estimates on 12 December, the ECB will probably have to nudge down its forecast for growth in 2025 (currently 0.8%) again. Short of a major upside surprise in core inflation or in economic sentiment surveys, the ECB looks set to reduce rates by a further 25bp in December. For early next year, we expect two further 25bp cuts to take the deposit rate to a trough of 2.5%.

The big picture: the overreaction risk

Central banks often act too late – but then by too much. When the ECB belatedly started to raise rates from July 2022 onwards in response to the V-shaped recovery from the pandemic and the subsequent surge in inflation, we had repeatedly argued that it would be wise for the ECB to not go beyond a deposit rate of 3.5%, modestly above the roughly neutral rate of c3%. The persistent weakness in growth (Q2 2024 GDP up merely 0.1% on its Q3 2022 level) supports our assessment that the ECB went too far by raising the deposit rate to 4%. In our view, the mostly imported surge in inflation would have subsided with a less restrictive stance almost as rapidly as it has done since late 2022. Looking ahead, we now see a risk that, upon cutting rates, the ECB may make the reverse mistake and ease policy too much in response to growth that has almost persistently underperformed ECB projections over the last two years.

Next year, inflation should not be a major issue. Due to subdued growth until spring 2025 and amid easing wage pressures, headline and core inflation will likely get close to 2% over the course of 2025. However, this will not hold for 2026 and 2027, in our view. In a lagged response to a return to normal growth, which we – and the ECB – expect for spring next year, wage inflation will likely rebound c4% in 2026 after less than 3.5% next year. Structural labour shortages should see to that. Normal growth in demand will allow firms to pass on higher costs to consumers. If the ECB lowers the deposit rate to well below 3% in 2025, it will probably have to raise it back to 3% in late 2026 or early 2027. Whereas markets are betting on a deposit rate of 2.1% by the end of next year, we expect the ECB to stop easing at 2.5% and return to 3% in early 2027.

Key policy rates: more cuts to come – but not to ultra-low levels



Upper limit of Fed funds target rate, BoE bank rate, money market rate for ECB. Sources: ECB, Fed, BoE, Berenberg projections