Article | 12 September 2024

After ECB rate cut, Lagarde signals further cuts to come

European Central Bank President Christine Lagarde refrained from giving any forward guidance, other than saying that the direction for rates was "pretty obvious". We think that after some hesitation, the ECB will eventually have to cut rates more aggressively

The ECB delivered the expected rate cut today and kept the door wide open for further rate cuts. The timing of these rate cuts, however, is still uncertain.

The ECB cut the deposit interest rate, which is the new policy rate, by 25bp. Don't forget that the spread between the deposit rate and the refi rate will be lowered to 15bp next week as a result of the ECB's review of its operational framework. This means that as of next week, the deposit rate will be at 3.5% and the refi rate at 3.65%.

Latest batch of forecasts supported today's rate cut decision

The reasons for today's rate cut seem obvious: headline inflation has continued to come down and the ECB's own growth and inflation forecasts have confirmed the ECB's macro picture of the last months. In the latest staff projections, GDP growth in the eurozone is expected to come in at 0.8% in 2024, 1.3% in 2025 and 1.5% in 2026, slightly lower than in the June projections. Interestingly, the ECB has significantly delayed the date when the eurozone economy will be back to its potential growth rate. This is now scheduled to happen only in the second quarter of 2025, one year later than in the June projections. Still, the ECB's growth forecasts look a bit optimistic, banking on a strong global economy and private consumption to recover.

Headline inflation is expected to come in at 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026, unchanged from the June projections. During the press conference, ECB President Christine Lagarde stressed that the ECB's forecasts were now forecasting inflation to be back at 2% by the end of 2025 for the fifth consecutive quarter. Services inflation, even though not explicitly forecast in the ECB projections remains one of the ECB's main concerns, according to Lagarde. However, when looking at the staff projections, let's not forget that current market futures are already lower than the assumptions used in the ECB's forecasts, which means that using today's futures would actually deliver even lower inflation forecasts.

What's next for the ECB?

In today's press conference, President Lagarde didn't give any further guidance on the future path for the ECB, besides emphasising the Bank's meeting-by-meeting or data-dependency approach. It is clear that in the eyes of the ECB, this communication last seen at the July meeting worked perfectly well. Whether this was indeed due to the communication or simply because markets were more interested in the Federal Reserve rather than the ECB over the summer remains to be seen. Given the still high uncertainties, the ECB will probably also want to bank on something when taking the next rate decision. And as controversial as they sometimes are, the staff projections are the best thing to hold on to. Therefore, the next rate cut looks likely in December, not October, also given that there will not be a lot of important data releases between now and the October meeting. Lagarde's remark that the path for rates was "pretty obvious" also signals another cut is coming.

When we look at the ECB and use an assessment for how the eurozone economy will develop over the coming months, we expect the Bank to eventually step up the pace of further rate cuts. Not this year, but next year. Why not this year? Because currently, German wage negotiations and increasing selling price expectations still point to some stickiness of inflation. And given that the ECB's track record of predicting inflation on its way up is rather weak, the ECB will want to be entirely sure before engaging in more aggressive rate cuts.

A weakening eurozone growth outlook should be the trigger to eventually go for more aggressive rate cuts. Back in July, the ECB had already shifted the risk assessment to its growth outlook to "tilted to the downside". Given that the ECB's forecasts have been structurally overestimating the timing and the strength of the eurozone economy, it only seems to be a matter of time before a bleaker growth outlook will translate into more aggressive rate cuts. The soft landing in the US and the impact on the eurozone could be that trigger.

All in all, the ECB did not only cut rates today but kept the door wide open for further rate cuts to come. There is a high risk that the ECB's growth forecast for the eurozone is still too optimistic and that it eventually will have to cut rates more aggressively.

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