Cautious monetary easing in the eurozone has started

The eurozone economy continues to recover, but there are no reasons to expect a significant acceleration in growth. With some pockets of inflationary pressures still hanging around, the ECB's rate-cutting cycle will unfold very slowly

Sentiment indicators in the eurozone are showing signs of improvement – but they're not quite signalling 'full steam ahead' just yet

Policy normalisation has started

As widely expected, the European Central Bank cut its leading interest rates by 25bp, removing the '*top level of restriction*', as ECB Chief Economist Philip Lane put it in an FT interview. This is the first time the ECB has cut rates since 2019. However, the Bank also acknowledges that monetary policy will have to remain restrictive this year and that a back-to-back rate cut in July is very unlikely.

With the economy improving, albeit only gradually, and inflation remaining somewhat volatile, the ECB can afford to tread carefully in its monetary easing cycle. It is important to note that this is not a recessionary situation in which the ECB must bring interest rates into stimulatory territory; this is merely a normalisation cycle. We see two further rate cuts this year, although there is a significant chance we might get only one. In any case, the deposit rate is likely to be brought down to 2.50%, presumably the neutral rate, by the end of 2025 and subsequently remain at that level for some time to come.

Marginally better sentiment indicators

The PMI and the European Commission's sentiment indicator improved in May, though the levels don't yet signal *full-steam ahead*. The eurocoin indicator, which tries to capture the underlying GDP growth pace of the eurozone, actually declined to 0.18% in May from 0.26% in April. And even though the eurozone unemployment rate fell to a historically low level of 6.4% in April, consumers are actually worrying more now about a potential rise in unemployment than at the start of the year.

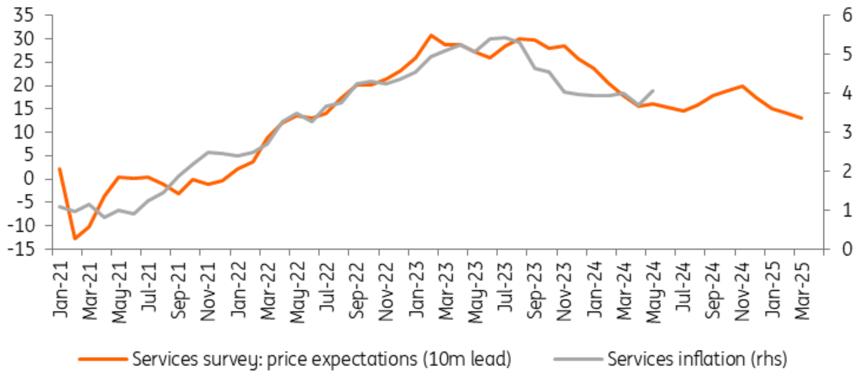
Credit growth for both households and non-financial companies remained rather subdued in April. On the brighter side, the downturn in industry is losing momentum and might start to grow again in the second half of this year, once the inventory overhang has been absorbed.

Growth remains stuck in first gear

So, sentiment indicators are mixed but at least they're pointing to continuing growth. That said, a number of member states are likely to get caught in the excessive deficit procedure, forcing them to put in place a more restrictive budgetary policy in 2025. And, as we've pointed out before, the expected US slowdown later this year might also put a lid on any growth acceleration in Europe.

We therefore pencil in a rather boring growth profile, with GDP growth hovering around 0.3% over the next six quarters. That results in 0.8% GDP growth this year and 1.4% in 2025.

Services inflation remains sticky



Source: Source: LSEG Datastream

Inflation risk is skewed upwards

Inflation is another story. Up till now the downward trend was clear. However, the May figures show that temporary accelerations in inflation cannot be excluded. Negotiated wage increases actually rose to 4.6% year-on-year in the first quarter. And though the ECB was quick to downplay the figure in a blogpost, mentioning one-offs as the main culprit, high wage increases remain inflationary, especially in services. And services inflation already increased from 3.7% in April to 4.1% in May. To be sure, the European Commission's survey of selling price expectations in services moderated in May, though they remain above the historical average. We see 2.4% headline inflation this year and 2.1% next year, but we have to admit that the risk is clearly skewed upwards. And we think the same is true for the ECB.

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