

## Three things to watch at this week's ECB meeting

We expect further subtle changes to the European Central Bank's communication next week, paving the way for a June rate cut. However, the latest macro data should have increased the pressure on the ECB to act even earlier. Here is what we expect from next week's meeting



The eurozone's wage growth drop is firming up expectations of a 25bp cut from the ECB next month

With inflation dropping further and the eurozone economy remaining weak, the debate on rate cuts will be more heated than ever at the 7 March ECB meeting. However, stubborn underlying inflation, particularly services inflation, uncertainty regarding wage developments and the never-ending confidence in an economic rebound in the eurozone will prevent the ECB from cutting rates – at least at next week's meeting. As long as the ECB is not willing to accept that inflation is roughly returning to target but instead pushing for an exact landing point of 2%, rate cuts should only be on the agenda at the June meeting. This is when enough data points will be available, either confirming that the inflation beast has really been tamed or pointing to renewed upward pressure on prices.

Needless to say, at next week's ECB meeting, all eyes will be on any communication changes and hints at the next steps. Here are three things worth watching:

## Fresh round of staff projections

A fresh round of staff forecasts will support the discussion. Back in December, the ECB expected GDP growth to come in at 0.8% this year and 1.5% next year. Inflation was expected to come in at 2.7% this year and 2.1% next year. More importantly, these headline numbers mask what we consider a rather optimistic growth outlook, with 0.2% quarter-on-quarter in the first quarter and the eurozone economy returning to potential growth of 0.4% QoQ by the third. As regards inflation, the most important element was the prediction that it would return to 2.0% in the third quarter of 2025. Any downward revision to the growth profile and any signs that inflation could reach 2% earlier than the third quarter of next year would open the door to earlier rate cuts.

The problem with the ECB forecasts, however, is the so-called technical assumptions, i.e., oil and gas prices, interest rates and the exchange rate, pointed to a slight downward revision of the ECB's inflation forecasts in the first weeks of February. In recent days, the renewed increase in oil prices would automatically change these forecasts. The sensitivity of the ECB's projections to market shifts should make the central bank more hesitant to use the forecasts as its sole argument for any change in policy.

### 2 Potential changes to communication

The European Central Bank is not really known as a central bank that makes quick shifts in its policy decisions. Instead, next week's meeting is likely to mark another cautious and gradual shift in its inflation assessment, opening the door to rate cuts in June. Remember that over recent months, the ECB's communication regarding rate cuts has gradually changed from "we didn't even spell 'rate cuts'" to "it was too early to discuss rate cuts" in January. If the Bank were to say that members "had a first discussion on preconditions for rate cuts" or "we decided to start this discussion at the next meeting", this would mark a further shift in the direction of policy easing. Another way to signal upcoming changes to the policy stance would be for the ECB to adjust its risk assessment to both the inflation and growth forecasts. A "balanced" risk assessment to the inflation outlook would be a strong signal in favour of rate cuts.

In any case, the main challenge for the central bank – and ECB President Christine Lagarde – will be regaining ownership of the narrative. Since the start of the year, the cacophony of national central bankers commenting on the timing of future rate cuts has resembled a noisy atonal choir. We sometimes wonder whether central bankers should really be trying to give any forward guidance that goes beyond the next meeting. Instead, what could help at next week's meeting would be a further clarification of the central bank's reaction function, e.g., which piece of data the ECB wants to see before deciding on rate cuts. This would also help to streamline the very chaotic and very noisy choir of ECB officials' comments.

### 3 More details on the ECB's reaction function

One elegant way of steering the markets' expectations would be to further clarify the ECB's reaction function. Currently, we think that three criteria need to be fulfilled before the ECB will start cutting rates: i) long-term inflation forecasts (which currently have inflation back at 2.0% from the third quarter of 2025 onwards) need to remain unchanged; ii) nominal wage growth needs to come down to around 4%; and iii) actual inflation should be at least around 2.5% for a few months, as the central bank would fear harming its credibility when cutting rates with an actual inflation rate of around 3%. Of course, any unexpected severe financial market stress or a severe recession in the eurozone economy could trigger an earlier rate cut. Any such clarification would

signal more agreement within the Governing Council.

Looking beyond the timing of a first rate cut, the next question is how far and how fast the ECB would go. Here, the fact that the eurozone economy is not in recession, and that risks to inflation and the inflation outlook remain to the upside (be it due to cyclical but also structural drivers) plays an important role. Financial market participants still seem to be betting on a simple and swift reversal of the rate hikes of the last two years. However, this kind of turnaround traditionally only takes place if the economy falls into a severe recession.

## Paving the way for a June rate cut

All in all, even without any rate action, next week's ECB meeting promises to be a very exciting one. With recent macro data, the pressure on the ECB to cut rates earlier has gone up. We still think that the ECB has good reasons to resist that pressure and to push back expectations. Nevertheless, the subtle changes in the official communication should continue, sending more precise signals for a June rate cut.

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