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Why an ECB rate cut next week is less obvious than markets think

We expect the European Central Bank to cut rates by 25bp next week but think that a hawkish surprise cannot be excluded entirely

We think an ECB rate cut is less obvious than the market

After another batch of weak sentiment indicators and headline inflation below 2% for the first time in more than three years, financial markets' verdict was clear: the ECB has to and will cut rates again at next week's meeting. We, however, think that the decision to cut rates will be much more controversial than markets currently think.

Remember that at the ECB's September meeting press conference and in the two weeks following that meeting, the official ECB message was clear: the ECB felt very comfortable with a very gradual pace of reducing monetary policy restrictiveness, ie a gradual and measured pace for rate cuts. The October meeting would come too early for the ECB to see any fundamental change of its own growth and inflation assessment. The December meeting was clearly the preferred option for the next rate cut as it will be a meeting with updated macro projections. In short, after the September meeting the stage was set for a quarterly pace for rate cuts. Are one batch of weak sentiment indicators and dropping headline inflation now really reason enough to overhaul the September strategy?

Arguments for an October rate cut

There is more to a rapidly deteriorating outlook for growth and inflation than just recent data. In fact, sentiment indicators had already come down since June and all soft indicators point to lower growth in the third quarter than in the second quarter. In its September projections, the ECB had already expected eurozone GDP growth to come down to 0.2% quarter-on-quarter in the third quarter, from 0.3% QoQ in the second quarter, but risks are now clearly tilted to the downside.

While the drop in headline inflation in September was still mainly driven by favourable energy price base effects, annualised monthly price changes have come down significantly over the last months and currently point to an undershooting rather than overshooting of headline inflation.

Finally, the latest series of disinflationary data let the ECB doves fly high again, with several ECB officials explicitly opening the door to an October cut.

Arguments against an October rate cut

So far, there hasn't been any hard macro data released since the ECB's September meeting. The fear of a further weakening of economic momentum is purely driven by sentiment indicators. The same sentiment indicators that not too long ago the ECB often described as being not entirely reliable. Also, losing of some economic momentum is already incorporated in the ECB's staff projections. Markets took comfort from the fact that ECB member Isabel Schnabel in a speech recently said that "We cannot ignore the headwinds to growth". In the same speech, however, Schnabel also underlined the fact that monetary policy could do very little to solve structural weaknesses.

As regards inflation, ECB President Christine Lagarde had already telegraphed the drop in headline inflation at the September meeting. And, indeed, with headline inflation at 1.8% year-on-year in September, it was exactly in line with the ECB's own projections. Looking ahead, headline inflation is still highly dependent on oil price developments. While the drop in oil prices in September was an important driver of falling headline inflation, the ongoing tensions in the Middle East have pushed up prices again over the last two weeks. Finally, available country data suggest that services inflation remains high. This is another argument for the ECB not to cut rates next week.

While ECB hawks had been relatively silent, feeding rate cut speculation, it was ECB Vice President Luis de Guindos, who on Friday warned against claiming victory too early regarding inflation.

Could markets force the ECB to cut next week?

Financial markets were fast with their verdict: the ECB will cut rates next week. In the past, market expectations tended to push central banks, and the ECB in particular, into next steps; just to avoid disappointing markets and potentially causing adverse market reactions.

Such a pattern of a central bank having to follow market expectations, however, rather plays a role in a tightening cycle than in an easing cycle. Particularly in the eurozone, as the ECB uses market expectations regarding interest rates in its technical assumptions for the forecasts. In a tightening cycle, delivering less rate hikes than priced in by markets can mean that inflation and growth will eventually come in higher than in the base case scenario. Consequently, it would take longer for the ECB bring inflation back to target. In an easing cycle, however, delivering less rate cuts than priced in by markets actually means lower inflation (and lower growth). In a situation in which it is far from sure that inflation will sustainably be back to target, is an outcome the ECB could more easily live with. Therefore, the risk that markets could force the ECB – against its will – into a more aggressive easing is currently low.

A very close call for a rate cut

We are far less certain than financial markets that the ECB will actually cut rates next week. The main question for the ECB will be how it interprets the distinction between data dependence and data point dependence. If all of recent data is regarded as one big data point, there is no reason to cut at the October meeting. If it is regarded as one big series of disinflationary data, it is. In any case, if the ECB decides to cut rates next week, this would mark an important change in its own reaction function. It would be a rate cut to bolster growth. The advantage of such a rate cut would be that the ECB would then suddenly be on a meeting-by-meeting rate cut cycle, hoping to be ahead of the curve and lowering the level of monetary restrictiveness just in time before a more economic accident would happen.

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