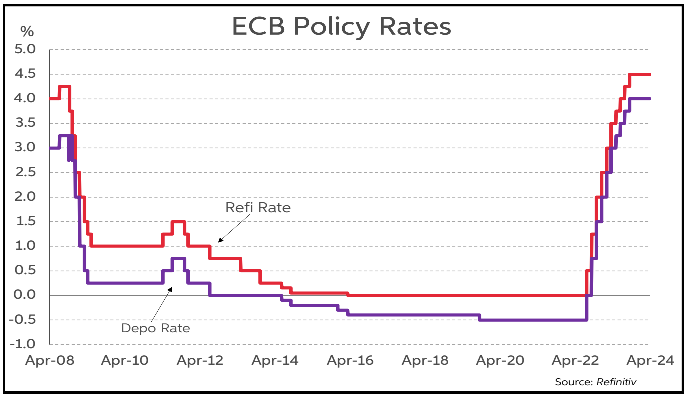
ECB Watch

AIB Treasury Economic Research Unit

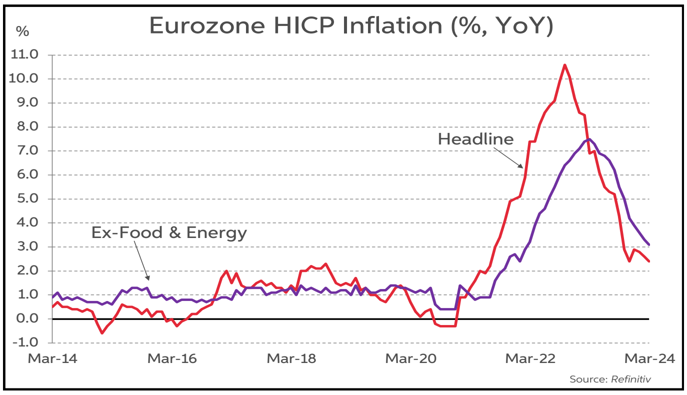
11th April 2024

ECB signals June rate cut on the cards

As widely anticipated, the ECB's Governing Council meeting for April saw the central bank maintain its key deposit rate at 4%. It marked the fifth consecutive policy meeting that the ECB has kept rates unchanged. There was "consensus" rather than unanimity within the Governing Council on the decision.



With no expectation of any rate change from the ECB today, the focus was on what signals the ECB would give regarding cutting rates in June. President Lagarde stated at the March meeting that the ECB will have a "little" data in April, but will have "a lot more" in June and "it matters because we are data dependent". In this context, in the word's of President Lagarde today's meeting statement contained a new "important sentence". The ECB stated that if its updated assessment of the inflation outlook (which will happen in June) gives it further confidence that underlying inflation is converging to its 2% target, it would be "**appropriate to reduce the current level of monetary policy restrictions"**. The ECB also re-emphasised that it will follow a data-dependent approach in making future monetary policy decisions and maintained flexibility by stating it is not "pre-committing to a particular rate path". **Overall though, today's update from the ECB signals that a rate cut is very much on the cards for its next meeting on June 6th.**



In its rationale to keep rates unchanged at the April meeting, the central bank noted that recent macro data has "broadly confirmed" its previous assessment of the medium term inflation outlook. The ECB commented back in March that it was paying close attention to wage increases. This is because it is a key factor driving price dynamics in the services sector. This in turn is a prominent influence on domestic inflation, which has remained elevated. It noted today that while "domestic inflation remains high, wages and unit profits grew less strongly than anticipated" in Q4'2023 and recent data point to a "further moderation in wage growth". **It was also noteworthy during the press conference that President Lagarde stated that the Governing Council is "not going to wait until everything goes back to 2%" before they ease interest rates.**

The ECB assessment of the Eurozone economy was that while activity remained weak in Q1, survey data indicate a "gradual recovery over the course of this year". Its most recent forecasts were released at the March meeting. They saw a slight lowering of its near term GDP growth projections amid the increasing impact of monetary policy tightening on domestic demand and the weakening in global trade. The ECB is now forecasting GDP growth of 0.6% (from 0.8%) in 2024. For 2025 and 2026, the ECB's growth forecasts were little changed, with GDP expected to rise by 1.5% and 1.6%, respectively. The ECB retained its view today that the risks to the economic outlook remain tilted to the downside. **Meanwhile, it revised lower in March its inflation forecasts.** It sees the headline HICP rate averaging 2.3% this year, 2.0% in 2025 and at 1.9% in 2026. It expects the core rate to average 2.6% this year, 2.1% in 2025 and 2.0% in 2026.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2023	2024	2025	2026
HICP	5.4	2.3	2.0	1.9
Real GDP	0.5	0.6	1.5	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $79.7 in 2024, $74.9 in 2025, $72.2 in 2026

Source: ECB March 2024

Market rate expectations for the ECB had been relatively stable for much of the period since the last Governing Council meeting. **However, in the last number of days, there has been some firming in pricing, amid spillover effects from US and UK markets developments.** Futures contracts are pricing now pricing in around 75bps of easing for the ECB by the end of this year. This compares to 90bps of cuts envisaged at the time of the last meeting in March. Our assessment, based on incoming data which shows that underlying inflation is moderating, combined with ECB rhetoric, is that 75-100bps of rate cuts from the ECB over the remainder of 2024 is a reasonable expectation.

David McNamara
Chief Economist
david.g.mcnamara@aib.ie

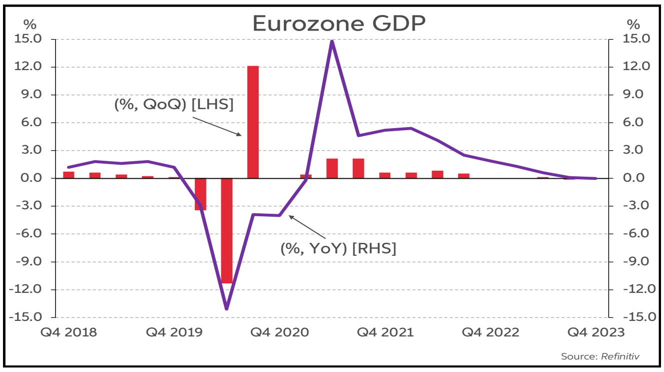
John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

Eurozone economy shows tentative signs of improvement

The Eurozone economy essentially flat-lined for five consecutive quarters between the end of 2022 and throughout last year. True to form, GDP growth stagnated in the final quarter of 2023. **Overall, GDP rose by just 0.5% in 2023, down from 3.5% in 2022,** as the post-pandemic rebound faded, and the squeeze on real household incomes from elevated levels of inflation and higher interest rates weighed on activity.

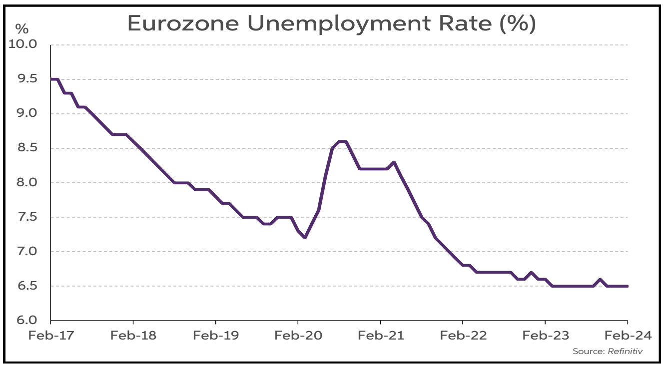
Survey data suggests activity in the Eurozone remained muted at the start of 2024, albeit there are tentative signs that the economy may be bottoming out. The manufacturing PMI has been in contraction territory for 22 straight months. However it has edged higher recently, and averaged 46.4 in Q1, up from 43.9 in Q4, signifying a slower pace of contraction in the sector. Meantime, the services PMI printed above the key 50 level for the first time since last July in February, and improved further to 51.5 in March. Overall, it averaged 50.0 in Q1, up from 48.4 in Q4. At the same time though, the EC Economic Sentiment Index inched lower in January and February, before rebounding modestly in March. Consumer confidence also deteriorated at the start of the quarter, but it rose to its highest level since the Russian invasion of Ukraine, in March.



In terms of the limited available hard data, industrial production remains volatile. Output contracted by 3.2% in January, wiping out a 1.6% increase in December. However, the drop was largely driven by a whopping 29% fall in Irish production figures, which are notoriously distorted by contract manufacturing. Encouragingly, German industrial production has increased in the first two months of the year. Retail sales stagnated in January and fell by 0.5% in February. In year-on-year terms, retail sales were 0.7% lower in February.

Meanwhile, labour market conditions remain tight. The unemployment rate has been between 6.5-6.6% since February 2023. Employment rose by 0.3% in Q4 and was up 1.2% y/y. **Tight conditions are contributing to elevated wage growth.** Negotiated wages increased by 4.5% y/y in Q4. However, the indeed wage tracker - a more frequent measure of wage pressures - indicates that wages were up 3.7% y/y in Q1, down from 3.9% y/y in Q4. The ECB remains concerned about elevated earnings growth, although, at today's press conference, President Lagarde acknowledged that wage pressures are moderating.

Regarding inflation, the headline rate has resumed its downward trend this spring. Having rose to 2.9% in December, and printed at 2.8% in January, the flash reading indicates it eased to 2.4% in March. Furthermore, core inflation has remained on a clear downward path in recent months. The ex-food and energy rate dropped to 3.1% in March. Meantime, the core rate that excludes energy, food, alcohol and tobacco declined to 2.9%, below 3% for the first time since February 2022. However, it should be noted that services inflation remains elevated and has been quite sticky, suggesting that underlying price pressures remain high. It stood at 4% for a fifth consecutive month in March. **The ECB staff projections from March are for headline inflation to average 2.3% in 2024, 2.0% in 2025 and 1.9% in 2026, with core inflation moving back to 2.1% next year and to 2% in 2026.**



Overall, the Eurozone economy has been virtually stagnant for over a year in the face of high inflation and rising interest rates, weaker global growth as well as on-going uncertainty stemming from the War in Ukraine. However, it is worth noting that the Eurozone labour market remains strong, and there has been a marked fall in inflation since autumn 2022. Furthermore, some greenshoots of a potential rebound in activity have emerged in the opening months of 2024. The ECB has also laid the groundwork for it to be able to cut interest rates, likely as soon as its next meeting in June. Most forecasters though, expect weak economic growth in the Eurozone this year. **The IMF is forecasting Eurozone GDP growth of 0.9% in 2024, while the ECB is projecting the economy will expand by 0.6% this year.** Looking ahead, growth is expected to accelerate next year, to 1.7% according to the IMF, while the ECB sees the economy growing by 1.5% in 2025.

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AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit

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