EUROPE ECONOMICS UPDATE

ECB to cut deposit rate to just 1.5%

- **In light of the worsening outlook for economic growth and inflation in the euro-zone, we are making major downward revisions to our ECB interest rate forecast. We now think the Bank will implement back-to-back 50bp rate cuts in December and January, and take the deposit rate down to 1.5% by mid-2025.**
- Recent developments suggest that the outlook for the economy has deteriorated. We now expect meagre growth, at best, at the start of the fourth quarter which will be below the 0.2% q/q expansion shown by the ECB's September projections and the consensus forecast of 0.3%.
- It is difficult to see a substantial improvement in growth next year. Consumers have been reluctant to increase spending, despite increases in spending power, and real income growth is likely to slow next year. Moreover, firms' investment plans are subdued because the manufacturing sector is facing major structural problems, and governments are increasingly tightening fiscal policy even as their economies slow. With protectionism likely to increase and the euro-zone losing competitiveness, a rapid pick-up in exports seems unlikely. **We think GDP growth will remain weak next year, in contrast to the widespread assumption that it will accelerate significantly.** (See Chart 1.)
- **At the same time, the labour market is loosening and wage growth slowing.** The unemployment rate is now at a record low, but we suspect that partly reflects a fall in its equilibrium level. The vacancy rate has fallen a long way over the past two years and the share of firms reporting labour shortages has declined. Surveys of firms' hiring intentions point to a further cooling in labour demand to come. Also, wage inflation is likely to continue falling now that headline inflation has fallen a long way.
- We expect the unemployment rate to increase in the coming quarters, albeit only gradually. And while it will remain low by historical standards, it's worth remembering that before the pandemic the labour market was not tight enough to generate wage growth that was consistent with the ECB hitting its inflation target. So policymakers shouldn't want or expect the labour market to return to pre-Covid conditions.
- **We also expect inflation to undershoot the target significantly over the next two years.** Recent outturns have been broadly in line with our forecasts but below the ECB's projections. The headline rate dropped to 1.7% in September and while it will pick up a bit in the next few months, it will be much lower than the 2.6% that the ECB forecast it to average in Q4. And the core rate will be well below the 2.9% that the ECB's forecasts show for Q4. So the Bank will have to make some fairly chunky downward revisions when it updates its projections in December, at least to the near-term outlook.
- **In 2025 and 2026, we think headline inflation will average around 1.5%.** (See here.) That's partly because we forecast energy inflation to remain negative as crude oil and natural gas prices decline. But core goods inflation is already well below 2%. With wage growth slowing and the labour market weakening, we have nudged down our assumptions for core inflation (see Chart 2), taking our forecasts for headline inflation even further below the ECB and consensus projections.

Chart 1: Euro-zone GDP (% q/q)

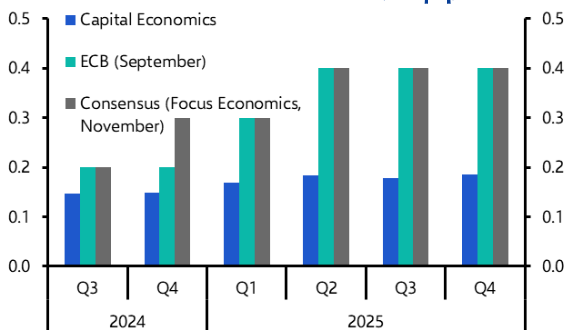
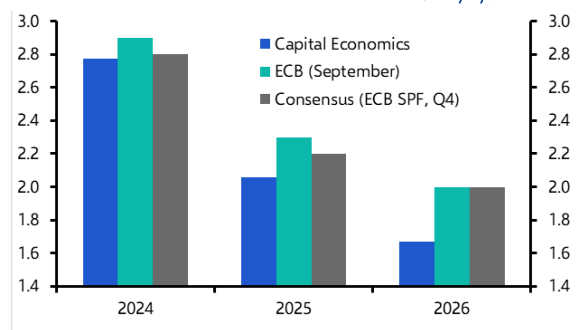


Chart 2: Euro-zone Core HICP (% y/y)



Sources: Focus Economics, ECB, Capital Economics

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- **Against this backdrop, the mood on the ECB Governing Council has already darkened and we think policymakers will want to move quite rapidly to a neutral policy stance, which ECB staff interpret as a deposit rate of around 2-2.5%.** The reduction to the inflation projections which the Bank will make in December will show that, having already fallen below the target, inflation is expected to remain around 2% in the coming years, so policymakers will find it difficult to justify leaving monetary policy restrictive for much longer. We therefore think the Bank will make two successive 50bp rate cuts, in December and January, to bring the deposit rate down from 3.25% to 2.25%.
- **Beyond that, policymakers are likely to become increasingly focused on the downside risks to inflation as the economy fails to pick up and core inflation subsides.** Provided there are no major surprises in the inflation data, we think the Bank will revert to 25bp rate cuts after January and reduce rates three more times, bringing the deposit rate to 1.5% by mid-2025. This is a faster pace than is currently priced in by financial markets and would bring rates below where the market sees the “terminal” level. (See Chart 3.)
- **Finally, we think the ECB is likely to press on with quantitative tightening** in order to bring the balance sheet back to what they see as the appropriate size, shrinking the balance sheet by ~€35bn per month over the rest of this year and €43bn per month in 2025. (See Chart 4.) This means the Bank will have to use interest rates as the main tool for setting monetary policy.

Chart 3: ECB Deposit Rate & Forecast (%)

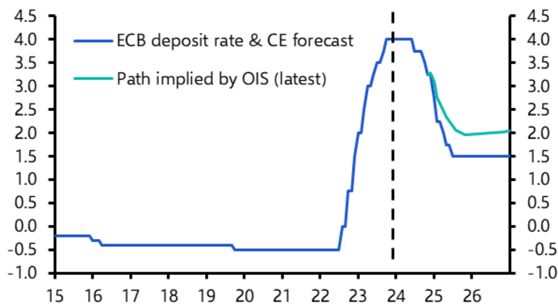
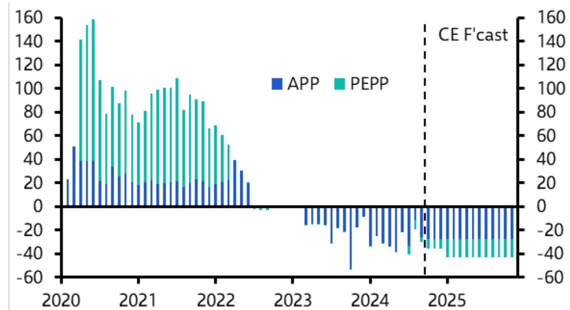


Chart 4: ECB Monthly Net Asset Purchases (€bn)



Sources: LSEG Data & Analytics, Capital Economics

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