QNB Economics
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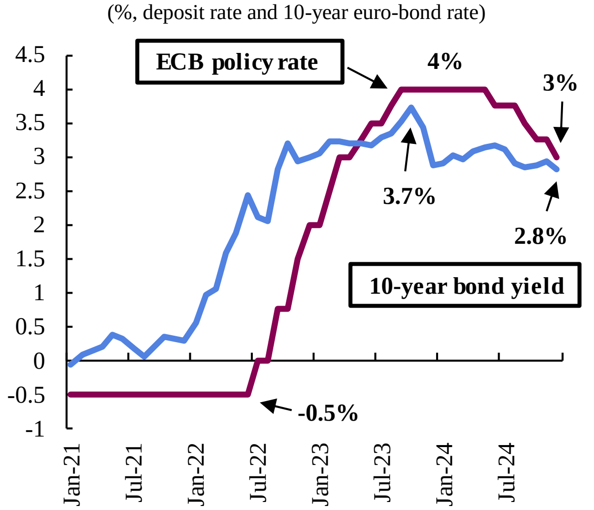
The Euro Area economy sets the stage for deeper ECB rate cuts

Skyrocketing inflation was finally brought under control last year after an unprecedented cycle of policy rate increases by the European Central Bank (ECB). The ECB began the record tightening sequence of 10 consecutive rate hikes in mid-2022, taking the benchmark deposit rate to 4%. After a period of highly-restrictive monetary policy, helped by the gradual normalization of supply chains, inflation steadily descended from its peak of 10.6% towards the 2% target of monetary policy. In June last year, the ECB Governing Council finally felt confident that price pressures had been subdued, and began the new phase of interest rate cuts, progressively taking the benchmark deposit rate to 3% in December.

Recently, several ECB Council members have cautiously signalled that they expect policy rates to reach a level that no longer restricts economic activity by mid-2025. Going forward, the path of interest rates needs to be carefully calibrated, as the balance of risks gives more weight to economic stagnation than to inflation concerns. In our view, the current economic outlook favours a more aggressive monetary easing cycle than is expected by the consensus. In this article, we discuss the three main factors that support our views.

ECB and Long-Term Euro Interest Rates
(%, deposit rate and 10-year euro-bond rate)

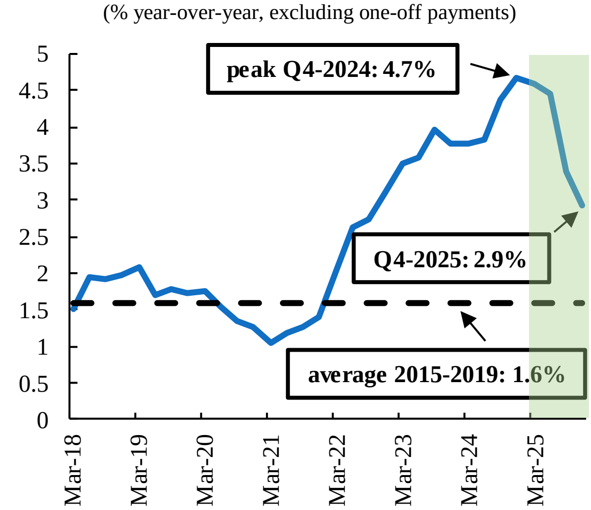


Source: ECB, Haver Analytics, QNB Economics

First, with prices already under control, there is now an increasing risk that inflation drops too far below the objective of the ECB. The latest prints of consumer prices show that monthly inflation, in annualized terms, has already fallen below the 2% target of monetary policy. Furthermore, inflation displays a downward trend that could drive it further below the target. The Survey of Professional Forecasters by the ECB already shows inflation expectations of 1.9% for both 2025 and 2026.

Labor market conditions provide useful evidence of inflation pressures. The ECB has begun to make publicly available its Wage Tracker Index, a measurement that gathers and aggregates data from thousands of collective bargaining agreements, providing valuable forward-looking information regarding the evolution of wages. After reaching a peak in Q4-2024, the wage tracker shows a rapid deceleration going forward, reflecting a sharp easing of wage pressures. In a context of below-target inflation and falling wage pressures, a deflation spiral is now becoming a conceivable threat on the horizon. A deflation environment is negative for the economy, as households and firms delay expenditures and investment to benefit from lower prices in the future, generating a negative economic feedback loop. The dangers represented by low inflation, and even the possibility of a deflation spiral, should press the ECB to a more rapid reduction of its policy rates.

Euro Area Wage Tracker
(% year-over-year, excluding one-off payments)



Source: ECB, QNB Economics

Second, the Euro Area has remained on the verge of a recession during the last couple of years, and its economic growth performance is likely to remain underwhelming. For the last half-year, the prints of the Purchasing Managers Index (PMI) have pointed to a stagnant economy. The PMI is a benchmark survey-based indicator that provides a measurement of improvement or deterioration in economic conditions. The composite PMI, which tracks the joint evolution of the services and manufacturing sectors, has remained below or close to the 50-point threshold that separates contraction and expansion in overall activity. Importantly, real GDP growth forecasts for 2025 have been on a downward trajectory since mid-2024. According to the Bloomberg consensus survey forecasts, the Euro Area will deliver 1% growth this year, only slightly above the 0.8% estimated for 2024, and markedly below the long-term average of 1.4%. The weak economic outlook for the Euro Area increases the likelihood of faster interest rate cuts by the ECB.

Third, financial conditions remain restrictive on the back of still-high policy rates and the steady contraction of the central bank balance sheet. The current level of the deposit facility interest rate at 3% is close to one percentage point (p.p.) above the rate that is typically considered "neutral" for the economy, which neither stimulates nor restrains economic activity. Similarly, although long-term interest rates have come down from their peak in October of last year, they still remain close to their decade highs. Long-term interest rates are key for the economy, given their influence on business investment and household demand. Additionally, the ECB continues to revert the balance sheet expansion that was put in place during the pandemic, a normalization that is restraining the availability of credit. As a result of lower liquidity and higher credit costs, credit volumes are still contracting in real terms, signalling to the ECB that monetary conditions are excessively restrictive.

All in all, while the consensus expects a 2% policy rate by the end-2025, we believe the ECB will take the benchmark rate to 1.75% on the back of a balance of risks that should lean more heavily on economic growth risks over inflation concerns.

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