ECB – the double rate cut

Dr. Marco Wagner

The ECB is likely to cut the deposit rate by 25 basis points in the coming week. It is even likely to cut the main refinancing rate by 60 basis points in order to reduce the spread between the two rates and thus keep volatility on the money markets low. Communication is likely to be a balancing act, as some doves in the Council would probably like to see a back-to-back rate cut in October in view of the economic risks, while other Council members would prefer to proceed with caution. We expect three further rate cuts in December, March and June and are therefore more conservative than the market.

The double rate cut in September

An interest rate cut by the ECB next week should come as no surprise to anyone. Markets have already fully priced in such a move, and all analysts surveyed by Bloomberg expect it. Firstly, inflation fell significantly from 2.6% to 2.2% in August. Even if this was largely due to lower energy prices, the ECB is likely to see this as a positive sign. Secondly, according to ECB data, collective wages in the eurozone rose by 3.6% in the second quarter, which was noticeably slower than in the previous five quarters, when they had risen by more than 4% and in some cases even by just under 5%. Thirdly, some members of the ECB's Governing Council are becoming increasingly concerned about the weak economy. To summarize, the governor of the Banque de France, Villeroy de Galhau, recently stated in an **interview**: "It would be fair and wise to decide on a further rate cut." In this respect, the deposit rate is likely to fall by 25 basis points to 3.50%.

At the same time, the main refinancing rate is likely to be reduced by as much as 60 basis points to 3.65%. When adjusting their "**operational framework**" in March, the central bankers decided to reduce the spread between the main refinancing rate and the deposit rate from 50 to 15 basis points. This is intended to incentivise banks bidding in the weekly operations or through the 3-month TLTROs, for which also deposit rate +15 basis points is applied. This should limit the potential scope for volatility in short-term money market rates, even if excess liquidity gradually decreases and banks return to using the main refinancing instrument. The spread between the marginal lending rate and the main refinancing rate will remain at 25 basis points, meaning that it should fall to 3.90% in September.

Back-to-back rate cut in October?

Speculation has now arisen about another interest rate cut at the following meeting in October. The futures markets are signaling a probability of around 40%. One argument for this could be that inflation in August was only just above the 2% target at 2.2% and is unlikely to change much in September and October due to base effects and the current low energy prices. In addition, the doves in the ECB Governing Council are increasingly emphasizing their concerns about the weak economy. In fact, the ECB experts are also likely to lower their economic forecast slightly (Table 1). In the ECB doves' argumentation, a weaker economy – and a recession that cannot be ruled out – would significantly reduce inflationary pressure and thus create the risk that inflation may undershoot the 2% target. In this logic, the ECB should not wait too long to cut interest rates in order to avoid falling behind the curve. After all, the ECB has a symmetrical inflation target, which, according to **Villeroy**, means that missing the target on the downside is just as undesirable as missing it on the upside.

Table 1 - ECB cuts growth forecasts

Commerzbank's perception on ECB experts' September projections; in parentheses: ECB June projection; growth and inflation rates in percent

	2024	2025	2026
GDP growth	0.7 (0.9)	1.2 (1.4)	1.6 (1.6)
Inflation	2.5 (2.5)	2.2 (2.2)	1.9 (1.9)
Core rate	2.8 (2.8)	2.2 (2.2)	2.0 (2.0)

Source: ECB, Commerzbank Research

Nevertheless, a further rate cut in October is not our base case scenario. For example, Lithuania's central bank president Gediminas Šimkus, whom we consider to be a "neutral" central banker, described a rate cut in October as "quite unlikely" in an **interview** on

Tuesday. This is because many Council members – including some from the dovish camp – continue to emphasize the importance of projections for their interest rate decisions. At the moment, looking forward seems more important to many than looking "in the rear-view mirror" at the figures that have already been published. One important reason for this is that – as ECB President Lagarde also explained at an earlier press conference – inflation is influenced by special effects in 2024 in particular and therefore the "true" inflation trend cannot be clearly identified. In this respect, it is necessary to continuously compare the actual inflation rates with the ECB experts' projections in order to strengthen confidence in future developments, but to base interest rate decisions more on the forecast. In addition, the weaker economy is likely to be a contentious issue among the Council members. This is because a number of Council members, particularly conservative ones, do not see any danger of inflation undershooting.

Communication is key

In terms of communication, the challenge next week is likely to be to express the view of the doves in the Council, but at the same time not to fuel expectations of a quick further move. The ECB will no doubt continue to emphasize in the communiqué that interest rate decisions are data-dependent and are made on a meeting-by-meeting basis. However, even these fairly neutral statements could now be explosive. In view of the low inflation and weaker economy, which are giving the doves a boost, many could well interpret this as an indication of an immediate interest rate cut. However, the ECB is likely to want to avoid this, especially as it is unlikely to deviate from its policy of not pre-committing. In this respect, ECB President Lagarde is likely to point out the special effects on inflation during the press conference, emphasize the different opinions in the Council on the economy and the particular importance of the projections.

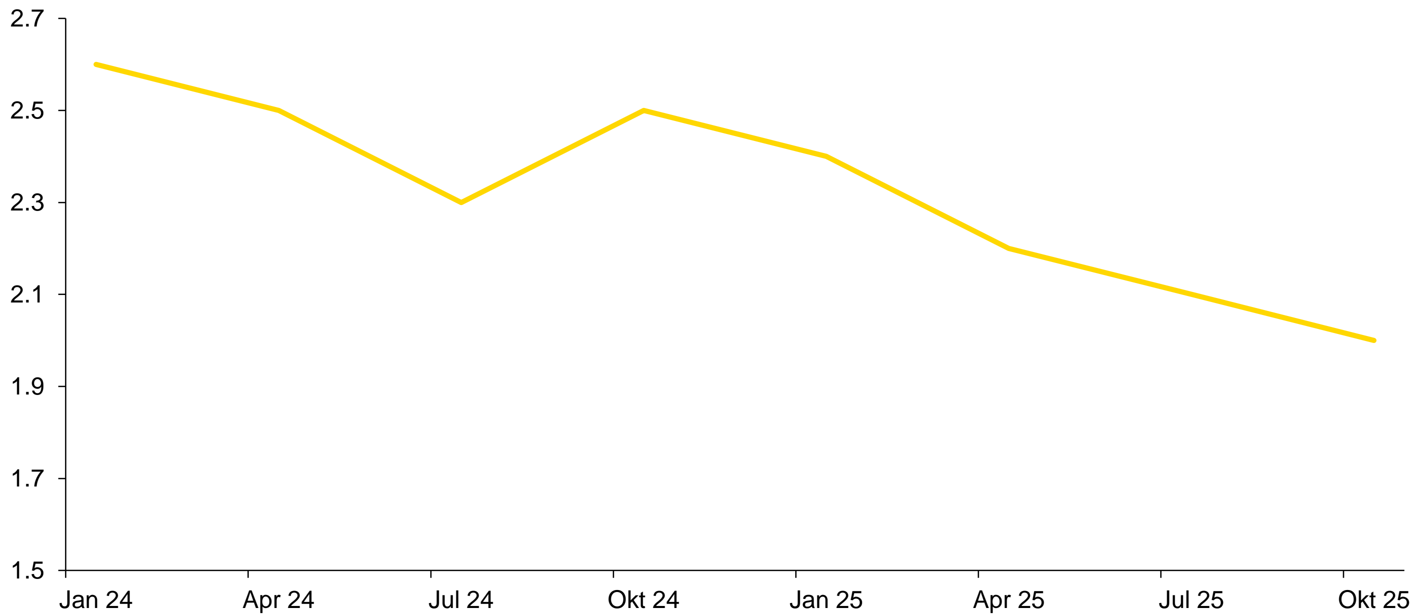
In principle, further interest rate cuts until mid-2025

However, this does not change the fact that there will be further interest rate cuts in the coming months. Firstly, the ECB Governing Council is dominated by monetary policy doves, who will increase the pressure on the remaining Council members to loosen the monetary reins. And there is likely to be some leeway here for some hawks too. After all, the ECB considers the natural interest rate – which neither stimulates nor slows down the economy and is compatible with inflation of 2% – to be (in nominal terms) between 2% and 2.5%. In this respect, the next interest rate cuts are likely to be justifiable from the point of view of most Council members, as they merely reduce the degree of restriction but do not loosen the monetary reins.

Secondly, a number of Council members have expressed the view that interest rate cuts are possible as long as inflation remains in line with expectations, i.e. the ECB projections. In this context, Latvia's central bank governor Mārtiņš Kazāks, who we classify as a hawk, said in an interview in August that he believes interest rate cuts are possible even if inflation moves sideways. He made this assessment at a time when the inflation rate was still 2.6%. In this respect, it is quite conceivable that the dove-dominated central bank will also cut interest rates in December if inflation picks up again in the meantime and as expected in the projections. In the view of Croatia's central bank chief Boris Vujčić, whom we rate as a "neutral" member of the Council, "gradual interest rate cuts" are possible if the inflation outlook holds. And after all, the ECB has included a temporary pick-up in inflation in its projection before inflation should fall again in the course of 2025 (Chart 1).

Chart 1 - ECB expects inflation hump towards year-end

ECB June projection on inflation, in per cent



Source: ECB, Commerzbank Research

Thirdly, growth is likely to remain subdued for the time being. This means that the economic recovery that many had already expected is being delayed. We even assume that this will take a few more quarters, which would provide the doves with a further argument for cutting interest rates. Specifically, we expect interest rates to be cut by 25 basis points in December, March and June.

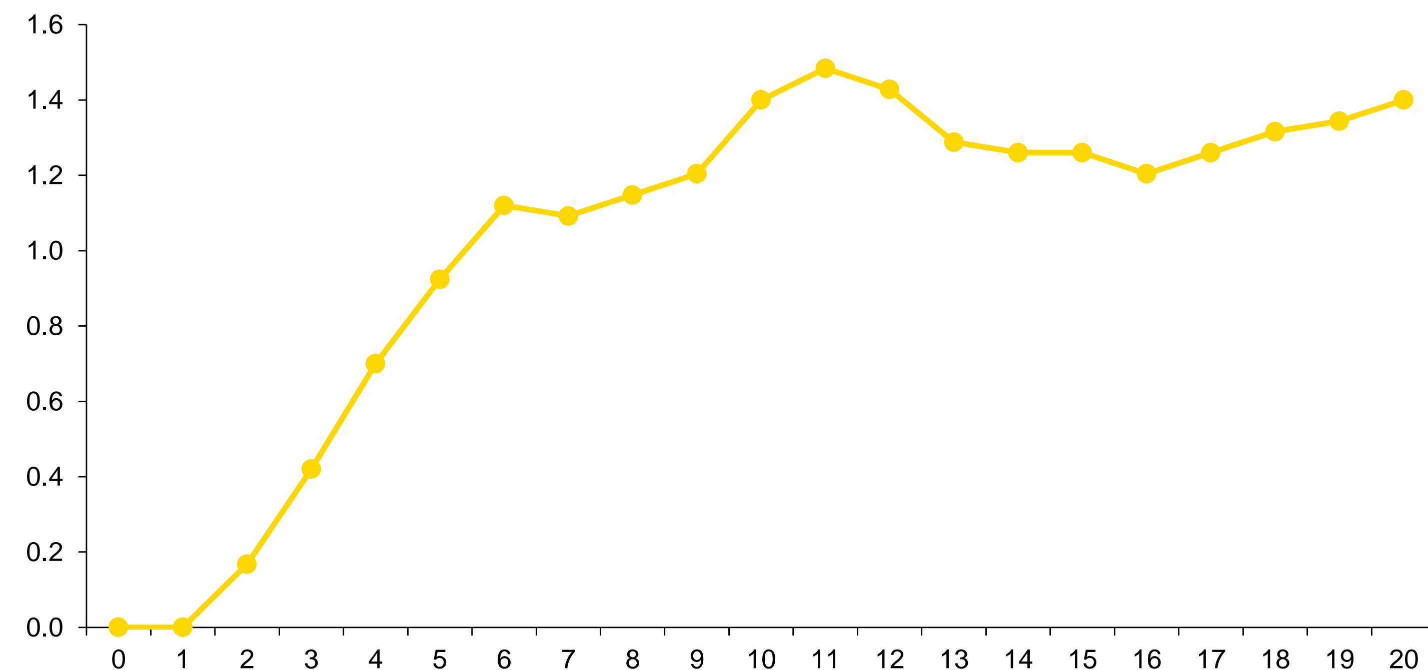
Summer 2025: the end of rate cuts

However, with a deposit rate of 2.75% then reached, the interest rate cuts are likely to come to an end for the foreseeable future. Over the course of the coming year, the ECB Council members should gradually realize that inflation is more persistent than expected, i.e. that it has not been completely defeated. In the long term, structural inflation drivers such as de-globalization, which is likely to continue in the coming years, suggest this. Added to this are the cost-intensive investments in the energy transition as well as the ageing of society and the associated decline in the workforce.

However, even cyclical factors will continue to drive inflation noticeably. Based on a **study** by the Bank for International Settlements (BIS) and our own estimations, the strong rise in wages in recent quarters will be reflected in consumer price inflation for years to come. Accordingly, it will take around three years for the wage increase to be fully reflected in consumer price inflation. The wage increase of around 5% per year in recent years will therefore only have its greatest impact in the coming quarters and will then generate inflationary pressure of around 1½ percentage points (Chart 2).[1]

Chart 2 - Wage inflation translating gradually into consumer price inflation

Model estimate: Impact of a 5% wage increase over four quarters on consumer price inflation, based on a BIS study, in percentage points, quarterly values



Source: BIS, Commerzbank Research

In order to cushion the strong wage increases, the ECB is relying on the assumption that productivity will increase again. Specifically, the ECB expects productivity to rise again at a rate of just over 1% from 2025. However, this is likely to be an ambitious assumption. After all, between 2015 and 2019 – i.e. in the years leading up to the coronavirus pandemic and in a period of quite reasonable economic growth – this rate was just 0.6% per year.

Conclusion: Gradual interest rate cuts until mid-2025

All in all, we continue to expect the deposit rate to be cut in September, December, March and June – by 25 basis points in each case. Provided that inflation is in line with the expectations of the ECB Governing Council members and the inflation outlook points in the right direction from their point of view, there should be nothing to avert this – especially as the economic recovery is likely to be further delayed, which should be another argument for many council members to loosen the monetary reins. The interest rate cuts should end when it becomes clear over the course of next year that inflation is more persistent than expected. With our forecast that the rate cuts will end in the middle of next year – when a deposit rate of 2.75% would be reached – we are markedly more conservative than markets, which are pricing in a deposit rate of 2.25% by the end of 2025.

[1]In its **study**, the BIS examines the effect of wage increases on producer prices. According to this study, a wage increase of 1% leads to an increase in producer prices of a good 0.5% after about three years. We estimate the extent to which an increase in producer prices is transferred to consumer prices – differentiated by goods and services. For goods in the eurozone, our estimates point to a factor of just under 0.4. As there are no sufficiently long data series available for services, we use approximate figures for the USA, which suggest a factor of around 0.8 (while estimates for the eurozone over a short period lead to a similar result). With a corresponding weighting for goods and services in the consumer price index, we calculate an overall factor of 0.56, with which producer price increases spill over into consumer prices. (back to the text)

Research contacts (E-Mail: firstname.surname@commerzbank.com)

Chief Economist
Dr Jörg Krämer
+49 69 136 23650

Economic Research

Dr Jörg Krämer (Head)
+49 69 136 23650

Dr Ralph Solveen (Deputy Head; Germany)
+49 69 9353 45622

Dr Christoph Balz (USA. Fed)
+49 69 9353 45592

Dr Vincent Stamer (Euro area, World trade)
+49 69 9353 45800

Dr Marco Wagner (ECB, Germany, Italy)
+49 69 9353 45623

Bernd Weidensteiner (USA, Fed)
+49 69 9353 45625

Tung On Tommy Wu (China)
+65 6311 0166

Interest Rate & Credit Research

Christoph Rieger (Head)
+49 69 9353 45600

Michael Leister (Head Rates)
+49 69 9353 45610

Rainer Guntermann
+49 69 9353 45629

Hauke Siemßen
+49 69 9353 45619

Ted Packmohr
(Head Covered Bonds and Financials)
+49 69 9353 45635

Marco Stoeckle
(Head Corporate Credit)
+49 69 9353 45620

FX & Commodities Research

Ulrich Leuchtmann (Head)
+49 69 9353 45700

Antje Praefcke (FX)
+49 69 9353 45615

Tatha Ghose (FX)
+44 20 7475 8399

Charlie Lay (FX)
+65 63 110111

Michael Pfister (FX)
+49 69 9353 45614

Volkmar Baur (FX)
+49 69 9353 26854

Thu-Lan Nguyen (FX, Commodities)
+49 69 9353 45617

Carsten Fritsch (Commodities)
+49 69 9353 45647

Barbara Lambrecht (Commodities)
+49 69 9353 45611

Tung On Tommy Wu (China)
+65 6311 0166

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Analysts

Dr. Jörg Krämer
Chief Economist
+49 69 136 23650
joerg.kraemer@commerzbank.com

Bernd Weidensteiner
Senior Economist
+49 69 9353 45625
bernd.weidensteiner@commerzbank.com

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Commerzbank Offices

Frankfurt	**London**	**New York**	**Singapore**
Commerzbank AG	Commerzbank AG	Commerz Markets LLC	Commerzbank AG
DLZ - Gebäude 2, Händlerhaus	PO BOX 52715	225 Liberty Street, 32nd floor,	128 Beach Road
Mainzer Landstraße 153	30 Gresham Street	New York,	#17-01 Guoco Midtown
60327 Frankfurt	London, EC2P 2XY	NY 10281-1050	Singapore 189773
Tel: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000