Why the ECB cuts interest rates yet again

Dr. Jörg Krämer

On Monday, ECB President Lagarde surprisingly indicated that the ECB could cut its key interest rates again at its next meeting in just two weeks. We analyze the background and what could happen next with ECB interest rates.

Another interest rate cut in just two weeks

At the last ECB press conference three weeks ago, ECB President Lagarde indicated that another interest rate cut was unlikely at the next Governing Council meeting in October. The expected fall in the inflation rate in September was due to special factors, which is why inflation will rise again in the fourth quarter. During the press conference, the probability of an interest rate cut in October fell to around 25%.

In the meantime, the picture has changed markedly. Market participants now see a 90% probability of such an early rate cut. This was triggered by weak leading economic indicators and, in particular, inflation data from France and Spain at the end of last week, which were massively below the consensus expectations. Added to this was a **speech** by Lagarde to the European Parliament on Monday. She said that "disinflation has been accelerating over the last two months". All of this will be taken into account at the October meeting. These are indications of an imminent rate cut that a central banker could hardly formulate more clearly. We therefore changed our forecast on Monday immediately after Lagarde's speech and now expect an additional rate cut of 25 basis points at the meeting intwo weeks. We expect a deposit rate of 2.5% for the middle of next year (previously: 2.75%).

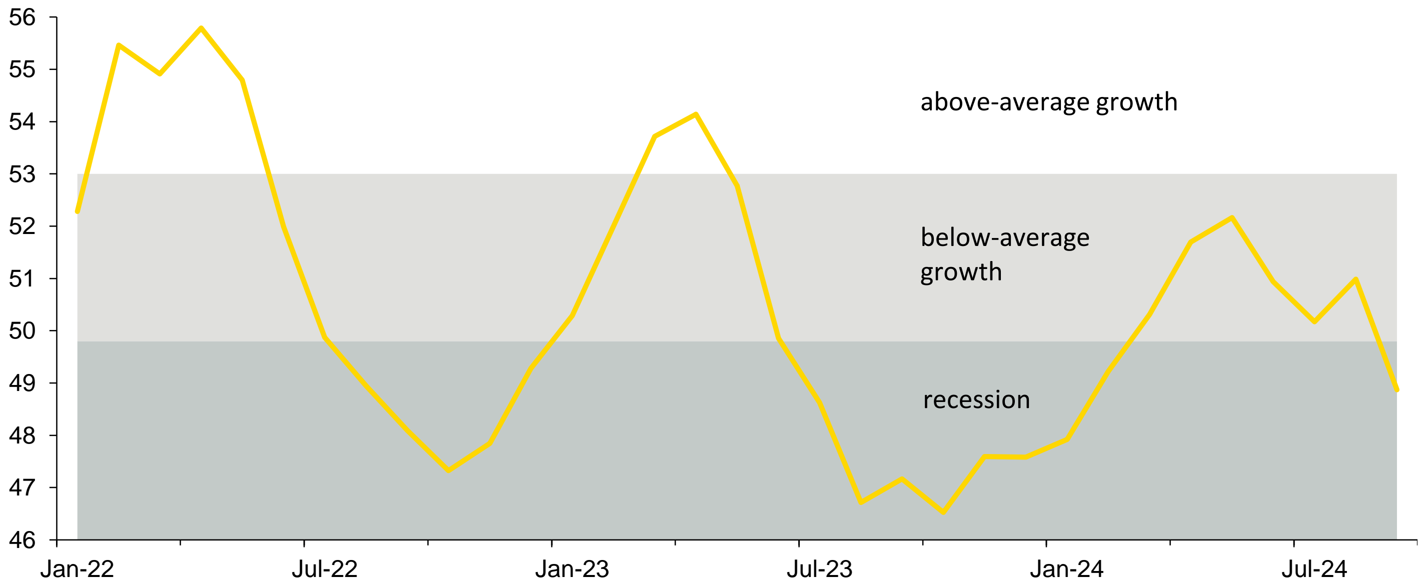
Increased economic risks

The recent unexpectedly weak leading economic indicators point to an interest rate cut as early as October. This applies in particular to the composite purchasing managers' index for the eurozone. It fell sharply in September following a temporary rise in August. This important leading indicator for the eurozone's GDP is now back in a range in which the economy has often contracted in the past (Chart 1). The Ifo business climate also deteriorated significantly in September. After four consecutive declines, the trend of this equally important sentiment indicator is now clearly pointing downwards.

The increase in economic risks is likely to be related to the sharp rate hikes in 2022/23 that the central banks of Western countries were forced to make due to high inflation. Added to this is the continued weak growth in China as measured by the PMIs and China's shift towards greater economic autarky, which is why exports from the euro countries to China have fallen by around a fifth in the last five years. In some countries, such as Germany, the reform backlog and the loss of confidence in government economic policy also play a role.

Chart 1 - Index slides into recession territory

Euro area composite PMI, seasonally adjusted monthly figures



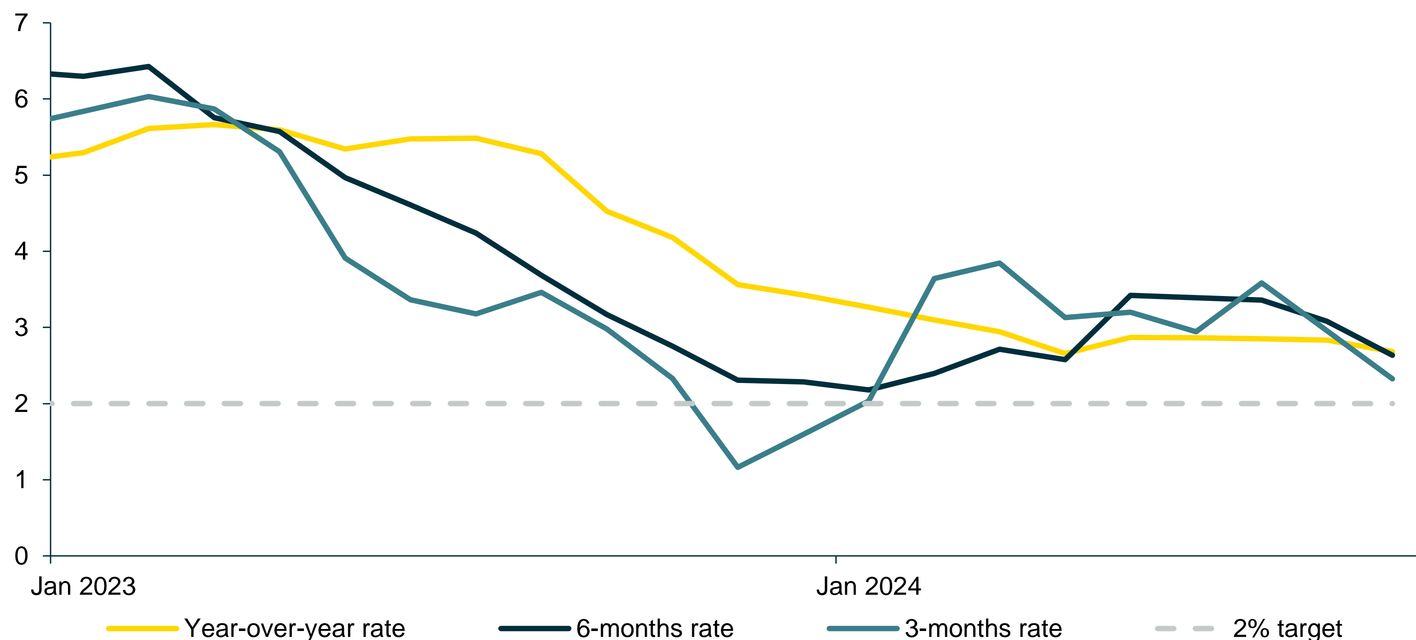
Source: S&P Global, Commerzbank Research

Inflationary pressure eased recently

Another reason for a rate cut at the October meeting is inflation. At 1.8%, inflation in the eurozone was below the 2% mark for the first time in quite a while, and core inflation excluding energy, food, alcohol and tobacco fell further from 2.8% to 2.7%. Compared to August, core consumer prices rose by only 0.1%. This means that the momentum of the underlying price increase has cooled noticeably of late (Chart 2). This may also be due to the significant fall in energy prices, which usually has an impact on certain components of core inflation, such as transportation services.

Chart 2 - The core rate points downward again

Consumer price index excluding energy, food, alcohol and tobacco, seasonally adjusted, change over 3, 6 and 12 months, in % p.a.



Source: ECB, Commerzbank-Research

The ECB seizes the moment

It is true that consumer prices have recently risen more slowly than before. However, it is also true that the inflation rate in September did not fall more sharply than the economists surveyed had expected. Measured against the ECB's expectations, inflation was only 0.1 percentage points lower on average in the third quarter. The fact that the ECB is nevertheless already signaling a rate cut for October is likely to be primarily due to the unexpectedly weak leading economic indicators and the fact that the ECB Governing Council, which is dominated by doves, is generally inclined towards a loose monetary policy. Christine Lagarde, for example, signaled an early rate cut even before the publication of inflation data for the eurozone, but shortly after the publication of unexpectedly low inflation data in France and Spain. Apparently, the ECB has taken advantage of individual low inflation data and cemented the already existing rate cut expectations for October with Lagarde's speech. The ECB's monetary policy is not purely data-driven, as it always claims.

What could happen next

An early rate cut in October does not mean that the ECB will simply skip the rate move widely expected for December. Rather, for various reasons, we expect it to maintain the higher pace for the time being and cut its deposit rate again by 25 basis points to 3.0% in December:

- **GDP:** The broad-based slump in leading economic indicators has undoubtedly increased the growth risks for the winter half-year, even if companies are more and more coming to terms with past rate hikes and even if two-thirds of the energy price increase from 2021/22 has been reversed.

- **Inflation:**Falling energy prices are likely to continue to lower core inflation for a while. For example, a 10% fall in oil prices will cause core inflation to fall by 0.2 percentage points in the medium term.

- **ECB:** As doves by far outnumber hawks in the ECB council, the ECB will continue to lean towards a loose monetary policy and will not be guided exclusively by macroeconomic data.

The ECB is likely to return to a slower pace of interest rate cuts (one cut per quarter) only until after the turn of the year, once the leading economic indicators have recovered and the currently low underlying inflationary pressure picks up again due to the continued high wage settlements. The ECB deposit rate is likely to reach 2.5% by the middle of next year.

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