How bold is the ECB?

The ECB will cut its key interest rates next Thursday. After that, we expect quarterly rate cuts of 25 basis points each until a deposit rate of 3% is reached in spring 2025. The improving economy and a core inflation rate that remains stubbornly above its target due to the continued strong rise in wages should make it difficult for the ECB to cut interest rates further.

Dr. Marco Wagner

Juni interest rate cut is a done deal

The time is ripe for a first rate cut next Thursday, say almost all ECB Governing Council members – even those from the hawkish camp. It does not matter that wages in the eurozone rose somewhat more strongly again in the first quarter (4.7%, after 4.3% in the fourth quarter of 2023). On the contrary, the officials hint at the ECB's experimental wage indicators (wage tracker) which, in their opinion, points to decreasing wage pressure. The central bankers see their projections of declining inflation confirmed. The ECB experts are only likely to publish a slightly higher forecast for core inflation for 2024 on Thursday, as the data at the start of the year was slightly higher than expected. For the same reason, they are likely to forecast slightly higher growth for 2024 (table). The projections for 2025/26 should to remain unchanged, though.

Table 1 - ECB to confirm 2025/26 inflation and growth forecasts

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

	2024	2025	2026
GDP growth	0.8 (0.6)	1.5 (1.5)	1.6 (1.6)
Inflation	2.3 (2.3)	2.0 (2.0)	1.9 (1.9)
Core rate	2.7 (2.6)	2.1 (2.1)	2.0 (2.0)

Source: ECB, Commerzbank Research

The central bankers are likely to cut their key interest rates by 25 basis points next week. Even monetary policy doves such as ECB Vice President Luis de Guindos expect a "prudent approach, which would argue in favor of a reduction of 25bp." Moreover, this is in line with market expectations and expert forecasts, and the ECB is unlikely to surprise with a more significant rate cut.

The central bankers will hardly provide any guidance for the subsequent interest rate path next week. Instead, the ECB is likely to continue to state that interest rate decisions "will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction, and we are not pre-committing to a particular rate path."

No rate cut in July ...

There is certainly a risk that the numerically superior doves in the ECB Governing Council will seize the opportunity and push for a second interest rate cut in July. If the inflation figures in May and June turn out to be low, this would not be out of the question. The doves could argue that, despite a first rate cut in June, real interest rates are unlikely to fall in view of the downward trend in inflation and that monetary policy will therefore remain restrictive. However, some Council members, such as Estonian Madis Müller, have now explicitly spoken out against a rapid further rate cut in July; other Council members – even from the dovish camp, such as the Spaniard Pablo Hernández de Cos – have spoken of proceeding with caution after the June move. We therefore still do not expect a rate cut in July.

... but in September, December and March

Comments and interviews in recent weeks suggest that the majority of ECB Governing Council members favor a 'gradual' approach. As a result, interest rate decisions are likely to be made on a quarterly basis and on the meeting dates with new projections. Some Council members, such as the Belgian Pierre Wunsch and the Frenchman François Villeroy de Galhau, suggested that the ECB experts' projections should once again be given more weight alongside the hard data. After all, as ECB President Lagarde explained at the last press conference, although the inflation trend is likely to continue to point downwards, it could temporarily increase again in the coming months due to a number of special effects.

Furthermore, according to ECB Chief Economist Philip **Lane**, whom we consider to be in the dovish camp, the aim in 2024 is not to normalize monetary policy, but to reduce the degree of restriction. In our view, this argues in favor of further interest rate cuts in September, December and March 2025 of 25 basis points each, so that a deposit rate of 3% would be reached next spring. After that, the key interest rate is unlikely to be cut any further.

Landing zone for deposit rate likely to be around 3%

Since the beginning of the year, market expectations have come noticeably closer to our forecast (title chart). While the futures markets had priced in six interest rate cuts for this year in January and saw the deposit rate at 2% from mid-2025, they now expect fewer than three full interest rate cuts this year and see the deposit rate at around 2.75% at the end of 2025.

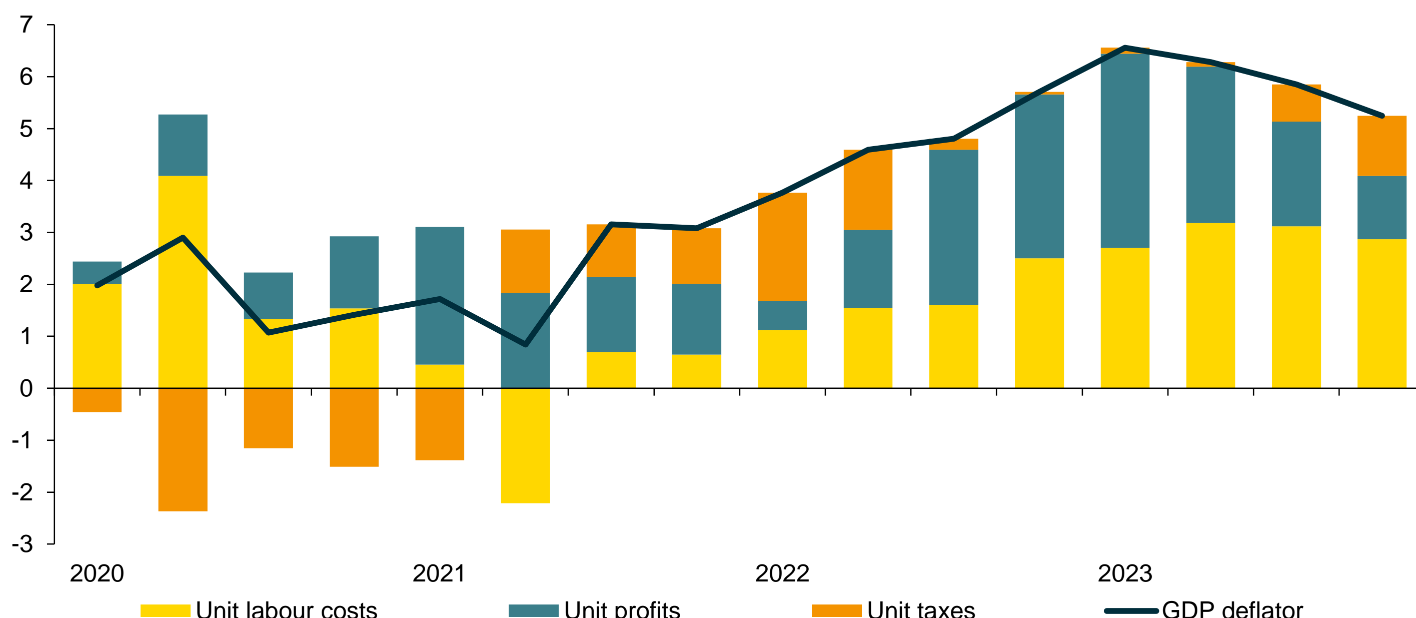
One reason for the diminishing expectations of interest rate cuts was probably the recent improvement in economic data. The euro economy grew unexpectedly strongly in the first quarter compared to the fourth at 0.3% (ECB & consensus: 0.1%). At the same time, the Purchasing Managers' Index for the economy as a whole has improved noticeably, suggesting a further economic recovery in the coming months. For various reasons, this argues against a drastic reduction in interest rates in the coming quarters:

- Firstly, this weakens the argument of some ECB Governing Council members that interest rate cuts should stimulate the weakening euro economy. Even if this is not the ECB's primary objective, more and more Council members have recently been contrasting the benefits of a tight monetary policy (limiting inflation) with what they see as the associated costs (weak growth).

- Secondly, the improved economy could give companies greater scope for price increases again, especially as capacity utilization in many sectors is likely to remain quite high. This topic was prominently discussed last year in particular, when corporate profits made a significant contribution to inflation alongside wages (Chart 1). Over the course of 2023, the contribution of profits decreased noticeably. However, the economic recovery of the euro economy that began at the start of the year and is likely to continue over the course of the year could ensure that profits increase significantly again, especially as the eurozone was able to avoid a noticeable recession and is therefore still operating at the limits of its capacity, which should increase companies' pricing leeway.

Chart 1 - The end of profit inflation?

Eurozone: Deflator of gross domestic product, in per cent compared to previous year; contribution of wages, profits and taxes, in percentage points



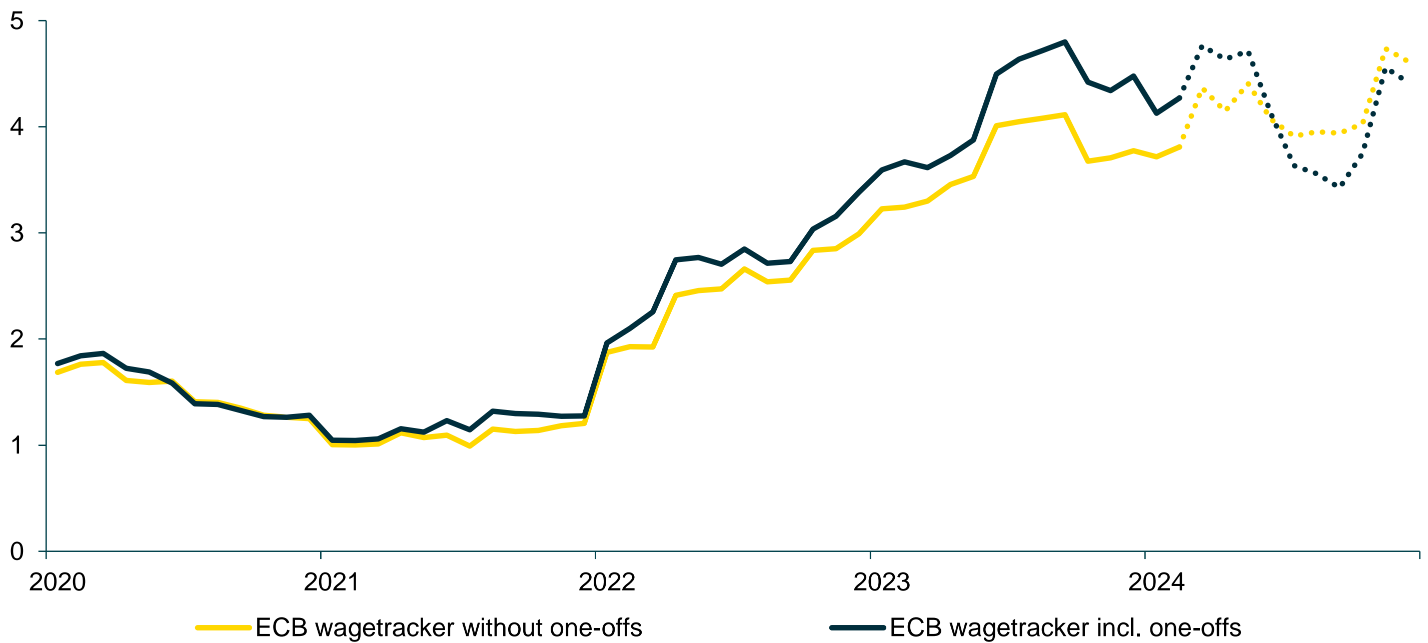
Source: Eurostat, Commerzbank Research

- Thirdly, wages are likely to continue to rise rapidly. The ECB's experimental statistics indicate that collectively agreed wages will increase by more than 4% on average in 2024 (Chart 2). Wages actually paid are likely to rise even faster. The **Bundesbank** also anticipates further strong wage increases in Germany. According to the bank, trade union wage demands currently range between

7% and 15% over a twelve-month period, which is still high by historical standards. Due to the still widespread labor shortages and the high willingness to strike, the collective bargaining results are likely to be more in favor of the unions, which should drive wage inflation and thus services inflation in particular. Even if Germany does not represent the eurozone as a whole, developments in the largest eurozone country clearly show the upside risks for eurozone inflation.

Chart 2 - Collective wages continue to rise strongly

Experimental ECB Wage Tracker based on collective labour agreements from seven eurozone countries; dashed lines: forward-looking variant based on collective agreements covering this period, in per cent year-on-year



Source: ECB, Commerzbank Research

Markets: A burden for the euro

Next week's meeting is likely to be largely irrelevant for the euro-dollar exchange rate. The market has already fully priced in the 25 basis point interest rate cut. Anyway, an interest rate difference of ¼ percentage point per annum is not significant. Rather, the exchange rate depends on the outlook for the interest rate path and whether the ECB appears to be a central bank that keeps inflation risks low. Generally, we trust the Fed to do more to combat inflation than the ECB, which is reflected in fewer interest rate cuts and a higher interest rate level in the US in the medium term. We see EUR-USD at 1.04 at the end of the year.

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 935345800

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

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

Christoph Weil (Euro area, France, Switzerland)
+49 69 9353 45589

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

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