Weak growth, more ECB rate cuts

Dr. Jörg Krämer

The Purchasing Managers' Index, an important leading economic indicator for the eurozone, is close to the recession threshold for the second month in a row. We have therefore lowered our growth forecast for the winter half-year. Moreover, since inflation is likely to be somewhat lower for a while due to lower energy prices, we now expect not just three, but five further ECB interest rate cuts (deposit rate mid-2025: 2.0%). By contrast, the picture for the US economy, which continues to grow robustly, has hardly changed.

Euro area: Less growth in the winter half, …

The Purchasing Managers' Index, an important leading economic indicator for the eurozone, is close to the recession threshold for the second month in a row (title chart). We take this seriously and are lowering our forecast for GDP growth for the winter half-year. For the quarters thereafter we still expect a moderate economic recovery with growth rates slightly above trend growth, because the pain of past ECB interest rate hikes is fading and two-thirds of the increase in energy prices from 2022/23 has now been reversed.

Due to the weaker starting point, we are lowering our 2025 growth forecast for the euro area from 1.1% to 0.9%. For Germany, which is suffering from competitive problems, we now expect growth of just 0.2% in 2025 (previously: 0.5%), which means we remain significantly more cautious than the average of the economists.

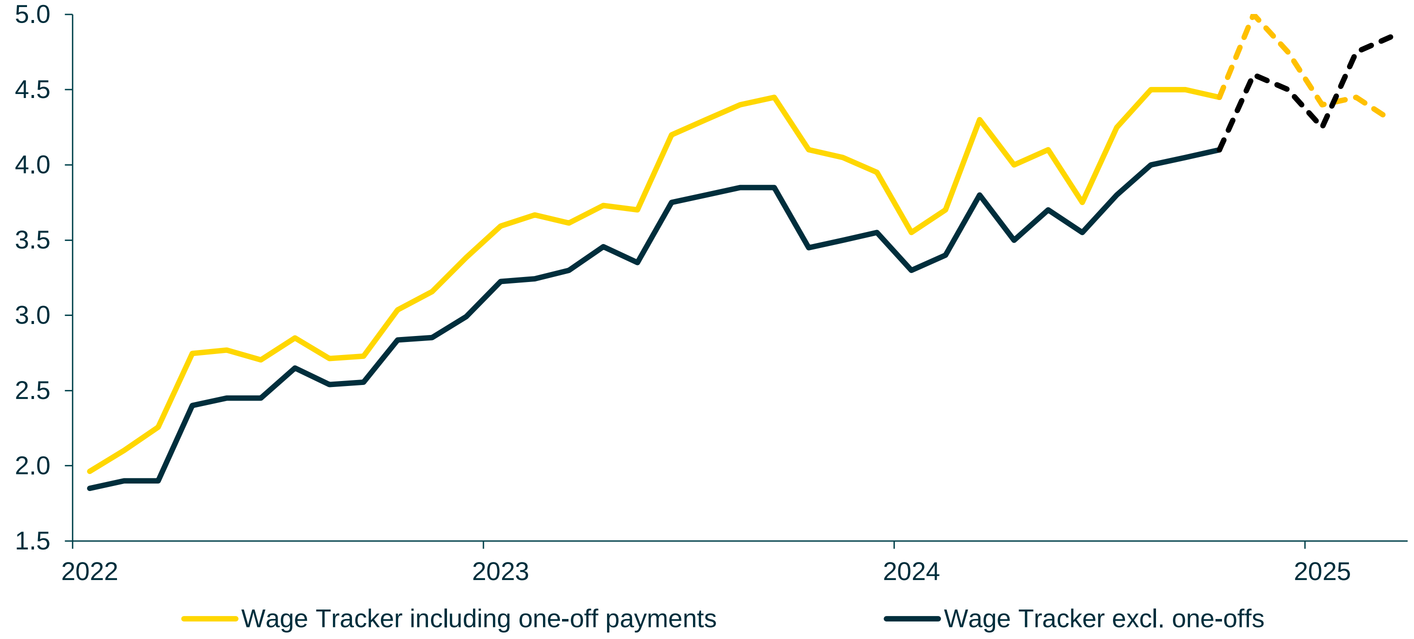
… which, together with falling energy prices, pushes down inflation, …

The low economic growth in the winter half-year is likely to exert some pressure on the underlying price pressure, i.e. the rise in consumer prices excluding energy and food (core inflation). However, the significant decline in energy prices, which is likely to feed through to core inflation via transport services, is more important. The core measure of consumer prices should rise temporarily at annualized rates consistent with the ECB's 2% target during the winter half-year.

A similar situation was observed in the fall of last year. However, this effect petered out after the turn of the year 2023/24 and the strong rise in wages again dominated core inflation, causing it to rise at rates well above the ECB target in annualized terms. We expect a similar situation from spring next year onwards – especially since the increase in collectively agreed wages has now settled at a high 4.5%, with no sign of a slowdown yet (Chart 1).

Chart 1 - Strong wage growth

ECB Wage Tracker based on contractual wage agreements in seven eurozone countries, percentage change on the year



Source: ECB, Commerzbank Research

... but the inflation problem has not been solved for good

We therefore fundamentally stand by our forecast that the inflation problem has not yet been entirely resolved. There are also structural reasons for this, such as deglobalization, decarbonization and demographics, which are causing aggregate supply to grow more slowly. Since the ECB Governing Council, which is dominated by doves, is unlikely to respond by tightening monetary policy sufficiently, inflation will ultimately exceed the ECB's target of 2%.

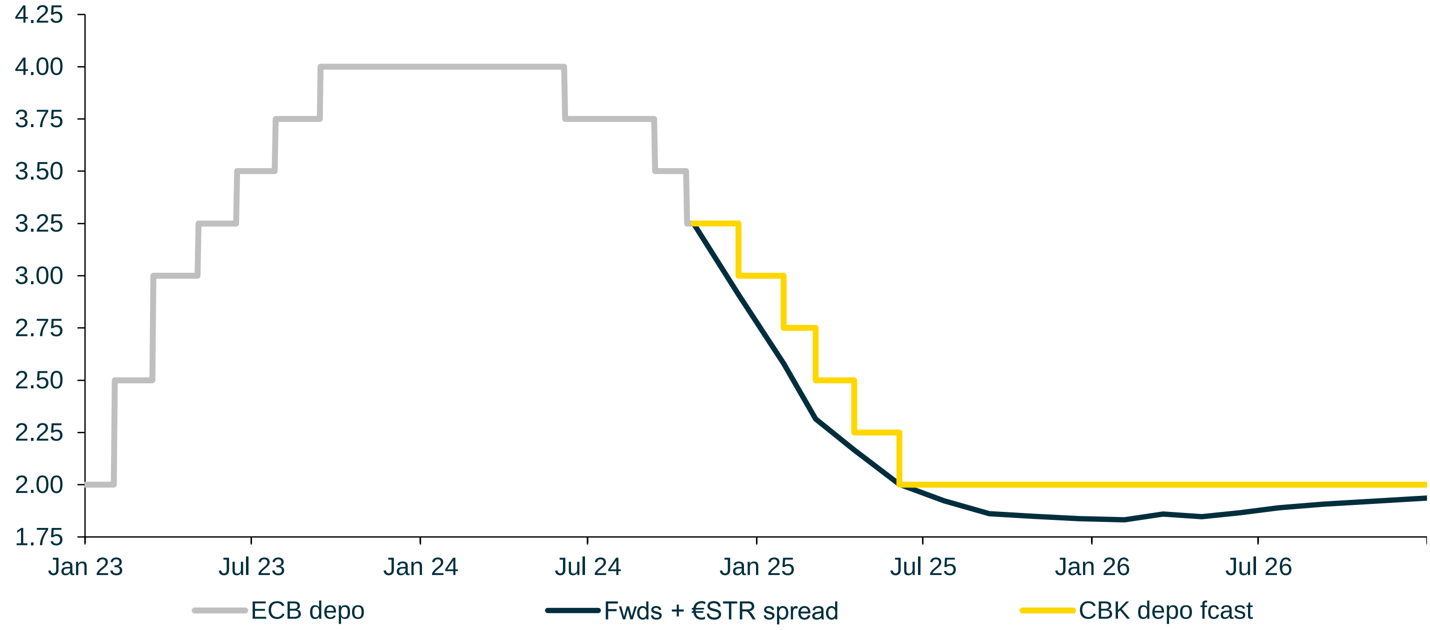
ECB: More rate cuts

At the press conference last week, ECB President Christine Lagarde cited the fall in leading economic indicators as a key argument for lowering policy rates again just five weeks after the interest rate cut in mid-September. If we now expect less economic growth and slightly lower core inflation for the winter half-year, the ECB is likely to maintain the increased rate cut pace after the turn of the year, contrary to previous forecast. The ECB will lower its rates also in January and April, even if it then does not publish revised forecasts for economic growth and inflation.

We therefore forecast an ECB deposit rate of 2.0% in mid-2025 (previously: 2.5%). Thereafter, the ECB is likely to end its interest-rate cutting process because the leading indicators will recover and the underlying inflation trend will pick up again (chart 2). Many members of the ECB Governing Council regard 2.0% as a neutral level in any case, one that neither boosts nor slows the economy and that leads to an inflation rate consistent with the 2% ECB target.

Chart 2 - ECB likely to cut depo rate to 2%

ECB deposit rate, actual development, market expectations calculated from forwards and Commerzbank forecast, in percent p.a.



Source: Bloomberg, Commerzbank Research

USA: No signs of a recession

Unlike in the eurozone, the US economy has recently surprised on the upside. While many investors were still fearing a recession in late summer, the US labor market has recently picked up. Already published montly economic data suggest strong 3% GDP growth for Q3. We have therefore slightly raised our US growth forecast for the average of 2024 from 2.5% to 2.7%. Due to the better starting point, we have also revised the expected increase for 2025 upwards from 1.5% to 2.0%. We have largely confirmed the inflation forecasts, which are slightly above the 2% mark. Accordingly, we continue to feel comfortable with our US key interest rate forecasts. We continue to expect six additinonal rate cuts by 25 basis points each. The upper limit of the interest rate corridor (currently 5%) would then reach 3.5% in mid-2025.

Financial markets: higher bond yields and a weaker euro

The revised economic forecasts have an impact on our financial market forecasts:

Bonds: Bond yields have recently risen markedly in both the US and the euro area because investors have priced out exaggerated rate cut expectations with regard to the Fed. Yields should fluctuate around this elevated level in the coming months. In the euro area, they should rise somewhat from the spring onwards, when a rebound in leading indicators signals that the economy is picking up a little and the ECB is ending its rate-cutting process.

EUR-USD: The pricing out of exaggerated US interest rate cut expectations has recently strengthened the dollar and pushed down EUR-USD. In addition, we no longer regard the ECB's interest rate cut expectations in the market to be exaggerated. We are therefore retracting our forecast of significant EUR strength in 2025 and now only expect slightly higher EUR-USD levels. This is mainly because the US economy is expected to grow somewhat more slowly next year.

DAX: The DAX has benefited from the expectation of falling key interest rates. Past experience shows that it should remain on this pattern, provided a recession in the US is avoided, which we assume. Of course, this does not rule out interim declines – for example, if doubts arise about the business model of highly valued AI companies.

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