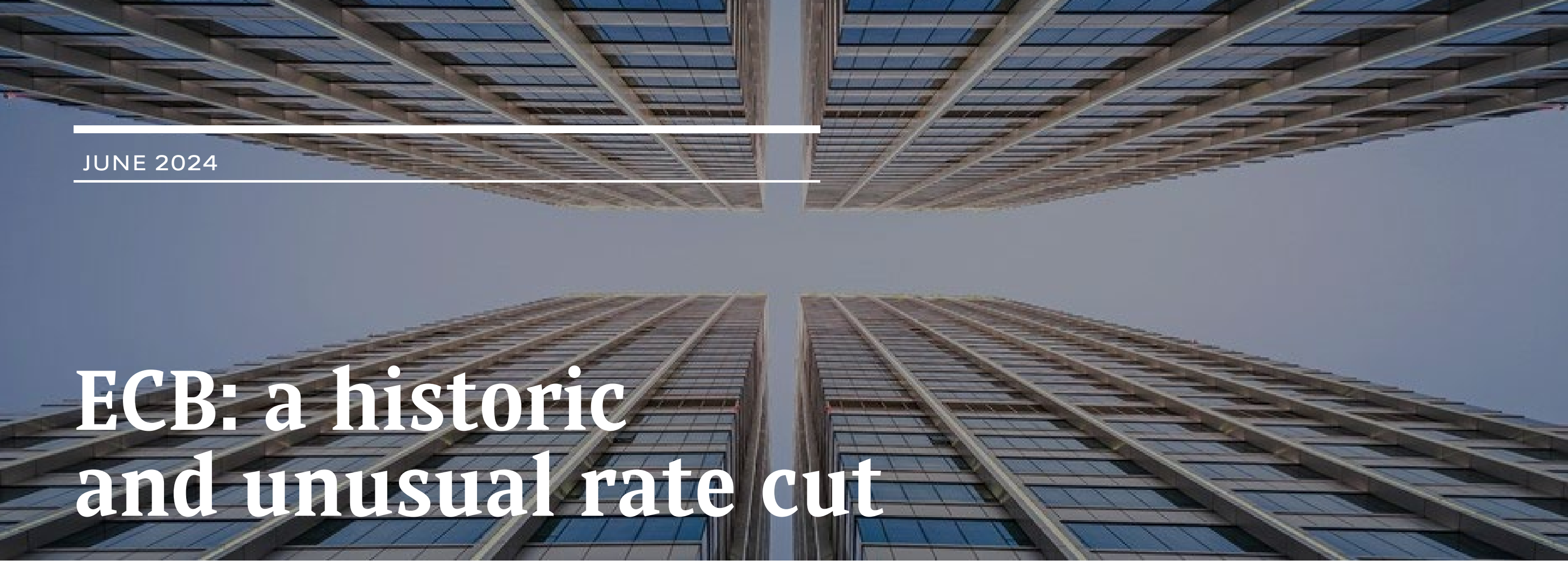

JUNE 2024

ECB: a historic and unusual rate cut

Key messages

- An unusual rate cut in many respects.
- The ECB remains data dependent. No commitment to a calendar of future rate cuts.
- We expect two more 25 basis points rate cuts this year (September and December) and three next year.

As widely expected, the ECB cut interest rates by 25 basis points on 6 June. The key interest rate is now 3.75% for the deposit rate (the rate at which commercial banks can deposit money with the ECB overnight), 4.25% for the refinancing rate (the rate at which commercial banks can borrow money from the ECB for a period of one week) and 4.50% for the lending rate (the rate at which commercial banks can borrow money from the ECB overnight).

This decision was not surprising, but it was unusual to say the least. First, it is the first time in history that the ECB has cut rates before the US Federal Reserve. Second, because they are cutting rates while growth is accelerating, and unemployment is at a record low. Third, because they are cutting rates while revising up their forecasts for both headline and core inflation for this year and next. The ECB staff projections now see headline inflation averaging 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026. Core inflation (excluding energy and food) is projected to average 2.8% in 2024, 2.2% in 2025 and 2.0% in 2026.

Nevertheless, the ECB judged that the rate cut was necessary to moderate the degree of monetary restriction based on its three-pillar analysis: the assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. The ECB has gained greater confidence in its inflation forecasting models, which allow it to be more forward-looking rather than reacting to past data. The ECB medium-term inflation forecast (2026) is 1.9% for headline inflation and 2.0% for core inflation, i.e. below/at the 2% target.

Yet, the ECB remains data dependent and is probably annoyed that the Fed still seems to be months away from cutting rates. ECB President Lagarde aimed to manage expectations low. She expressed caution during the Q&A session. While confident about wage growth decreasing, she remained hesitant to confirm the start of the rate-cutting cycle, likely to prevent volatility in the EUR/USD exchange rate.

Our base case is that slower inflation will allow the ECB to cut rates again in September and December this year, followed by three more cuts in 2025. We forecast the end of the rate-cutting cycle at the end of 2025, when the deposit rate reaches 2.50%, which is close to the neutral rate, the rate that is neither accommodative nor restrictive.

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