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MACRO MORNING BRIEFING

October 16, 2024

ECB Needs to Recalibrate

25bp cut to acknowledge growth risks is late

- Recession for 2024 now the base case for Germany
- ECB needs to look at the prospect of 2025 growth not recovering
- External sector remains a challenge, despite services focus

Forecast misses a major risk

Considering the language adopted by ECB President Lagarde during the September post-decision press conference, it is quite remarkable that the base case for Thursday's decision is now for a cut. A month ago, she simply reaffirmed the strict "data-dependent" approach when asked about the prospects of an October cut. At the time, she noted that there was "confidence" in inflation returning to target "in a timely manner." Importantly, when confronted with the deterioration in the Germany economic outlook, she merely stated that it was "anticipated."

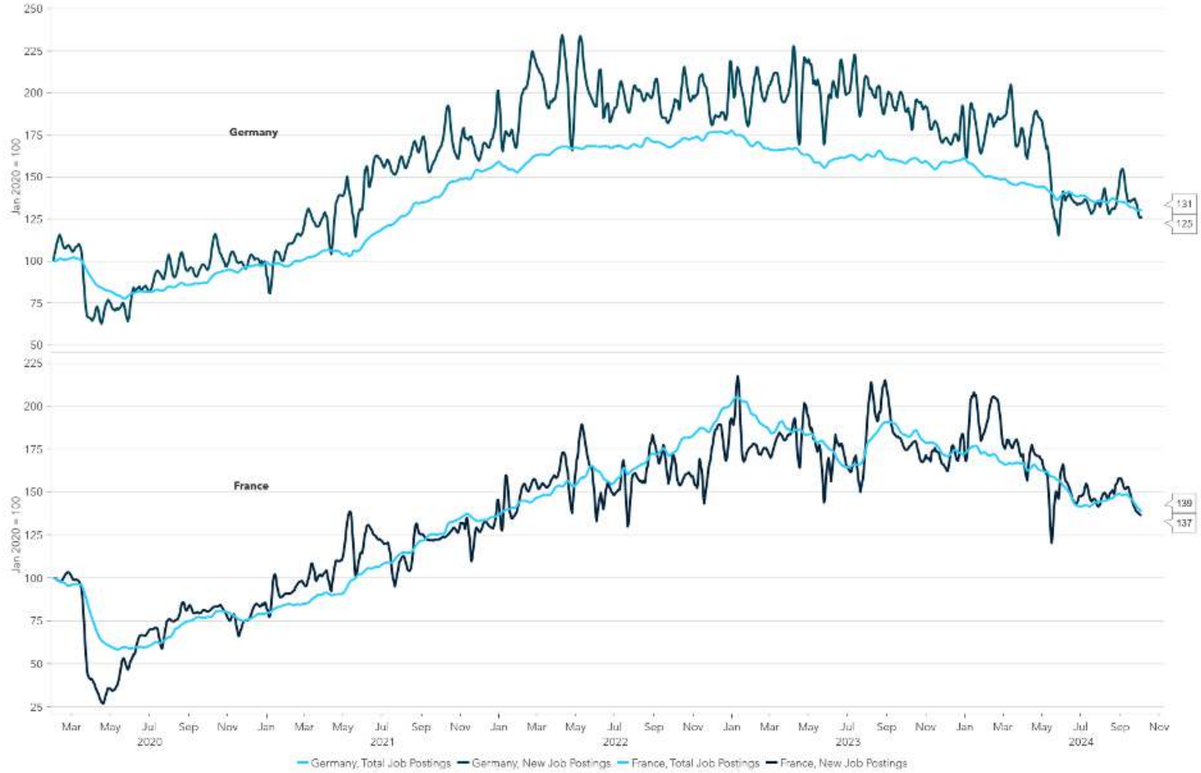
Barely two weeks later, however, after a new round of poor data releases, including lower than expected inflation prints for September and ongoing weakness in Purchasing Manager Indices, she noted that confidence in the inflation path had been "strengthened" but crucially she said that this would be "taken into account" at the October meeting.

It is difficult to envisage any material change in the Eurozone economy during those two weeks, and the "net cost" to policy guidance by making October a "live meeting" would have been limited in any case. In our view, this has cost the Eurozone valuable time in factoring in easier financial conditions. The urgency at present is for the ECB to get ahead of data – which the Fed appears more willing to do – rather than react in kind.

Furthermore, what was “anticipated” in the September forecasts should be questioned on all accounts. ECB staff projections have been static across all key indicators over the past year, and this raises the prospect of a material downward revision, which in turn should support the comprehensive re-pricing of certain Eurozone assets that better reflect fundamentals, irrespective of external factors. Crucially, we believe such an alignment would require not only December to be in play, but also the prospect of a 50bp cut if there is a fundamental revision of expected outcomes across the ECB’s forecast horizon.

As usual, the hawks will continue to point to upside risk in wages as the main barrier to any form of easing, let alone the more forceful type. High-frequency data for Germany and France continue to point to easing in the form of new and existing job postings, but there is no sign of acceleration in the process. Consequently, there isn’t a case for any forecast revision in wages yet, and the high absolute level of job openings relative to pre-pandemic levels supports demand robustness for labour, irrespective of the source. The ECB is fully aware that services demand – led by the public sector – continues to drive labour market strength. Leading indicators support this view, with the final September Services Purchasing Managers’ Index (PMI) noting that although job cuts accelerated for the third successive month and “accelerated slightly to the quickest recorded for more than four years, the rate at which employment fell remained only modest.” Expectations for business activity up ahead, however, continued to deteriorate and supports our view that the risk to activity levels remains to the downside. The one caveat to the outlook remains industrial action and outcomes from collective bargaining rounds, as wage demands from key Germany unions are still very high.

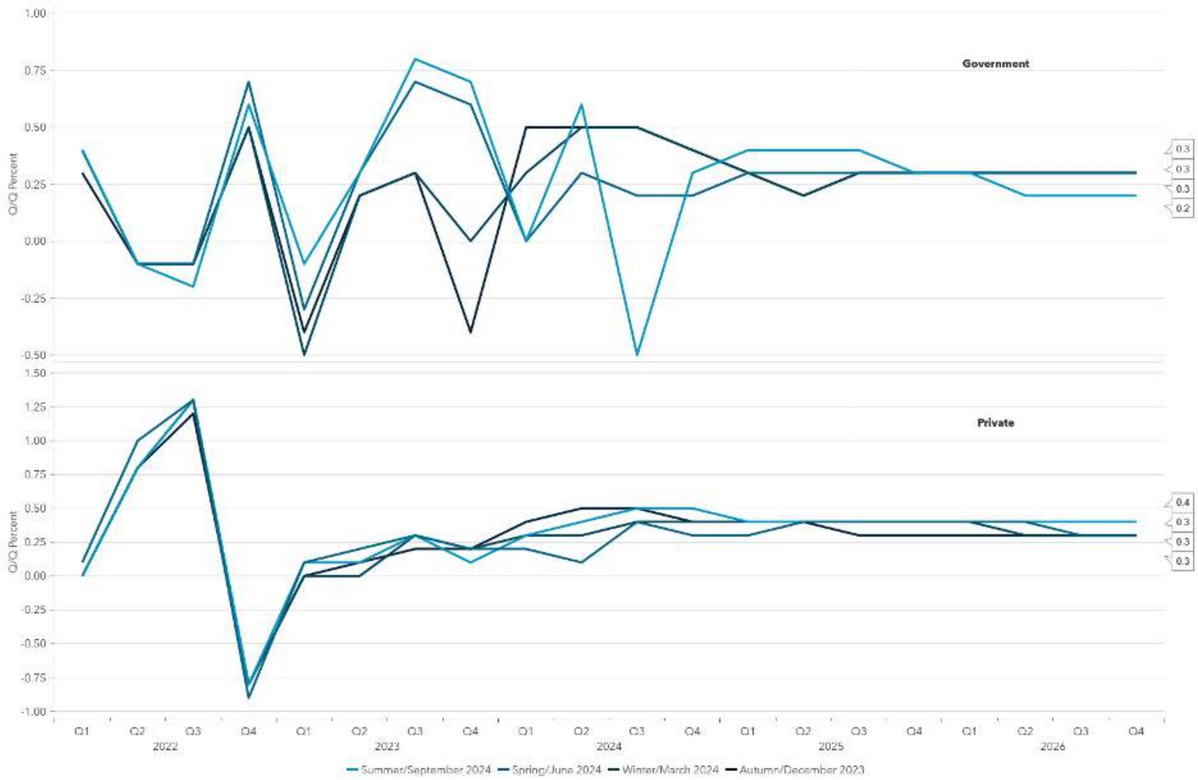
Exhibit #1: High-frequency Labour Market Data



Source: Macrobond, BNY

One of the main triggers for the ECB's pivot was probably related to confirmation that the German economy would most likely fall into a recession this year. This doesn't come as a major surprise but as the structural issues surrounding the German economy come to the fore, across the forecast horizon the bigger issue is whether the ECB's current base case of renewed expansion in 2025 or beyond is achievable. We highlighted recently how the GDP forecasts issued by the OECD for next year lean heavily on private sector growth as public sector demand is going to be more constrained. Looking at the ECB's current forecasts, the contribution from the private sector is expected to outpace the government sector government sector over the next two years, but the Composite PMI for the Eurozone warned that the general outlook for the private sector is one of continued deterioration, but current forecasts point to stable quarterly growth at 0.4%q/q (Exhibit #2). Given the ECB was comfortable with its policy outlook when forecasts for the private sector stood at 0.3%q/q, upcoming prints at below this level would imply a meaningful downgrade of the Eurozone economy.

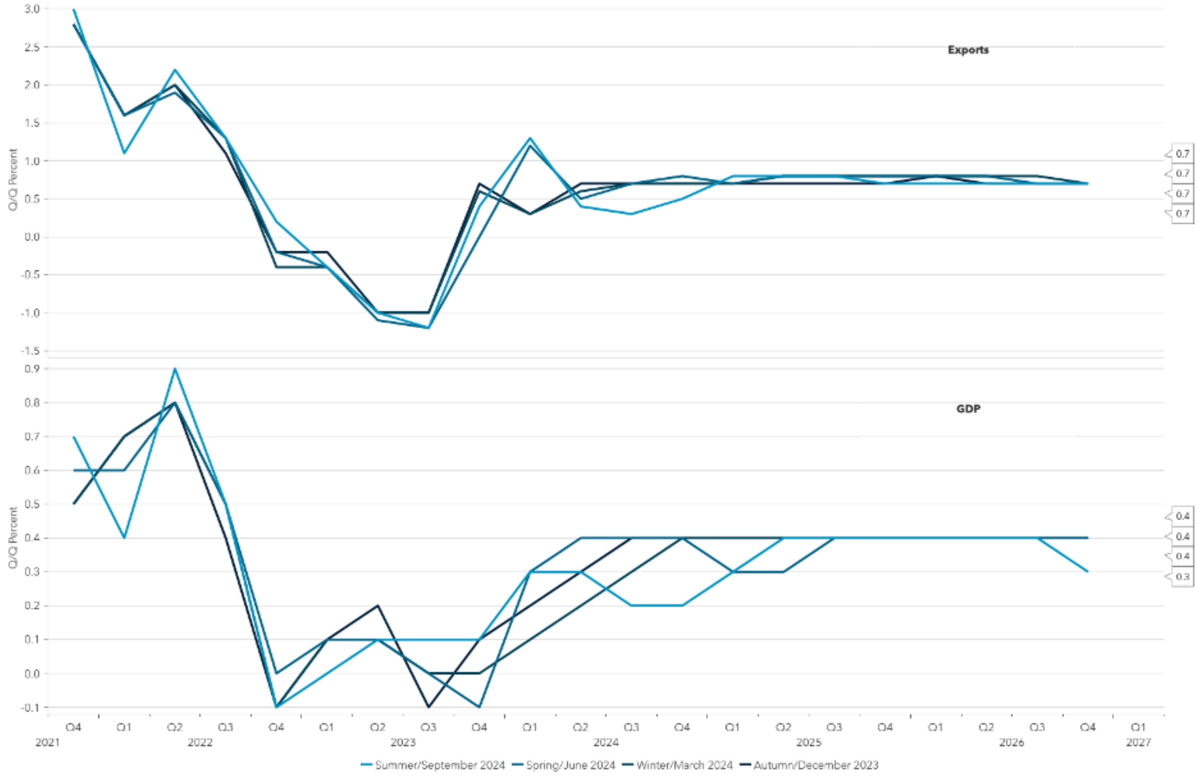
Exhibit #2: ECB Projections, Consumption



Source: Macrobond, BNY

Meanwhile, the external environment also needs to be considered. The ECB's export growth forecasts for 2025 and 2026 have been remarkably stable throughout the last four forecast cycles but with the Fed having cut by 50bp and China's stimulus efforts not indicating any redirection toward consumers so far, we believe export growth risk remains to the downside. In addition, the staff projections will struggle to account for severe tariff risk, which will have direct and indirect implications for monetary policy. Returning to the recover or even stabilization view for 2025 and 2026, we note that there is nothing in the language of the ECB's Governing Council or staff projections which point to structural issues in the manufacturing sector. We appreciate that for political reasons the ECB may not be able to opine lest the implication arise of an industrial policy recommendation, which is not within the ECB's remit. However, risk scenario analysis requires a heavier weight on such outcomes and the resulting asymmetry means that growth expectations for exports and broader growth (Exhibit #3) could be undershot.

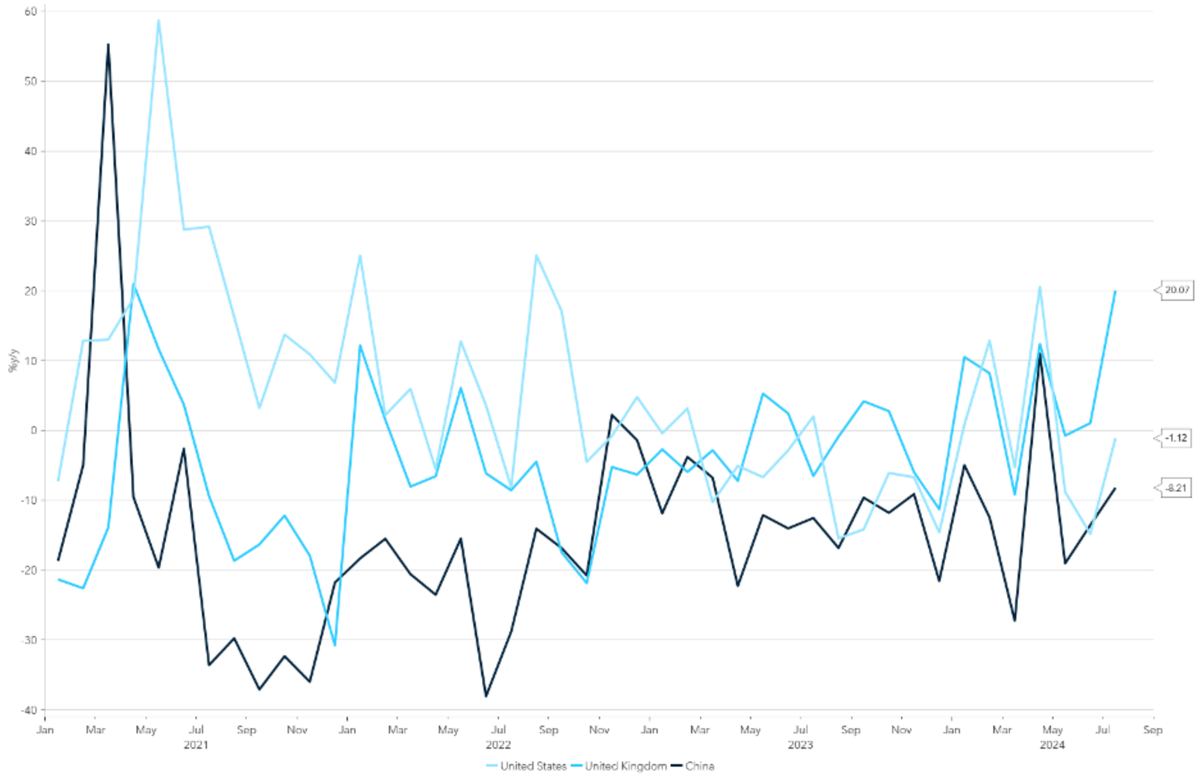
Exhibit #3: ECB Projections, Exports and GDP



Source: Macrobond, BNY

For now, there are initial signs that the Eurozone’s key growth partners are showing some signs of stabilization in demand. Export growth to the US is particularly strong and the recent pullback in Fed easing expectations suggests that this segment of external demand does not represent a strong risk to current forecasts. Exports to the UK and China have also stabilized but continue to show contraction (Exhibit #4). Despite the prospect of major fiscal adjustments up ahead in the US, UK and China, we underscore the need for the ECB to get ahead of potential trends rather than wait for data confirmation. The ECB accounts indicated that the risk of “undershooting the target was now becoming non-negligible.” By the time this becomes “material” it will be too late.

Exhibit #4: German Export Growth



Source: Macrobond, BNY

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