

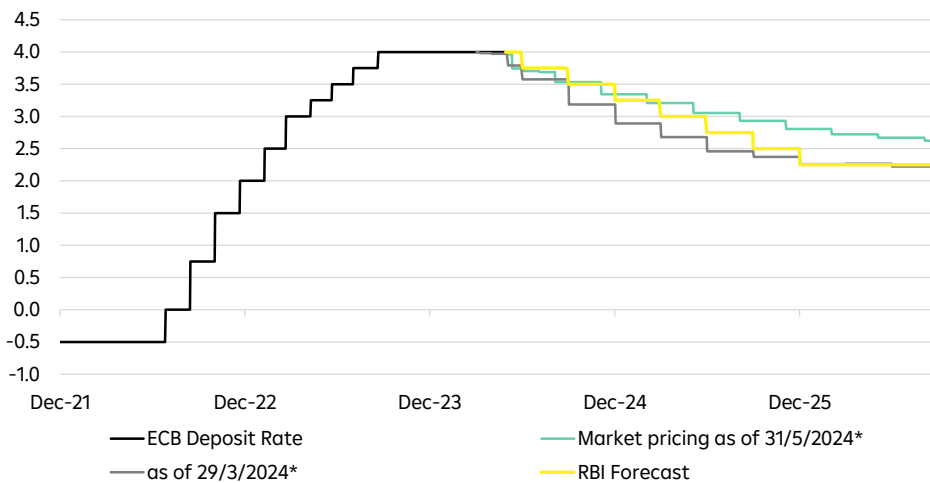
ECB Watch: The path beyond June

Anything but a rate cut at the June ECB meeting would be a big surprise. Given how well the ECB has prepared markets and analysts for its change of course, it's natural that most attention is already centered around the question: what's next? ECB Governing Council members have so far been eager to emphasize that the path beyond June is uncertain. We attempt to bring some light into the dark, by sketching scenarios for the future path the ECB might take. Knowing that the ECB's path is data-dependent, we still think that our long held view of a cautious quarterly rate cutting cycle by the ECB is the most likely outcome.

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Certainty about June but uncertainty about the path beyond



* based on short-term forwards of the €STR OIS curve transformed to reflect the ECB's deposit rate
Source: LSEG, RBI/Raiffeisen Research

At its last monetary policy meeting in early April, the ECB Governing Council assessed that a rate cut would be appropriate if confidence in achieving the inflation target further increases. Since then we have received first quarter GDP, two months of inflation data and information on wage growth. GDP growth was released above expectations. The ECB projected 0.1% quarter-on-quarter growth for Q1'24 while the first (not final) release reflects a growth rate of 0.3%. Inflation data were mixed. While inflation was released in line with expectations in April, May inflation was above expectations, core services inflation in particular. While May inflation can be seen as a setback, the mix of data has increased the ECB's confidence and **key interest rates will be decreased this week**, as many Governing Council members have stated in public appearances. The change in monetary policy should already be well reflected on financial markets and thus not come as a surprise. So far so good.

The focus will almost entirely be on whether the ECB provides any signals about the **future rate setting path**. What seems clear is that the ECB will continue to opt for a data

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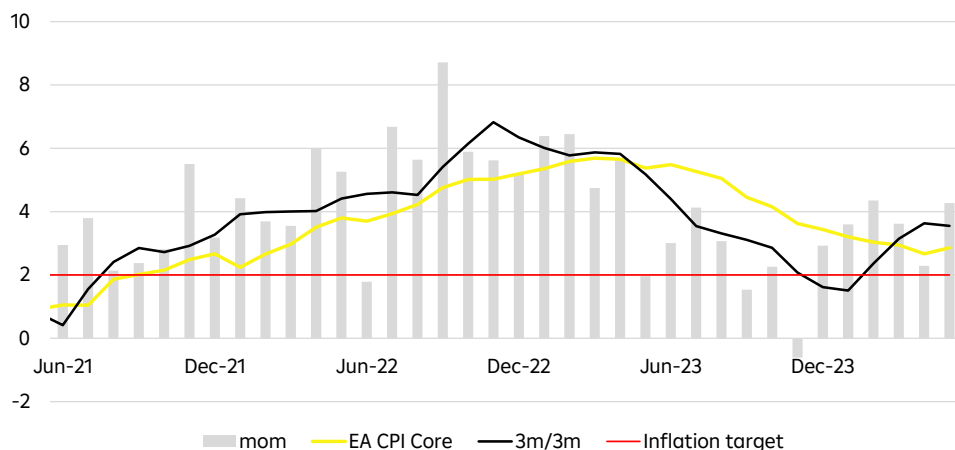
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dependent approach to ensure full flexibility. The ECB will keep its current preference for taking decisions meeting-by-meeting based on incoming data and the evolving outlook. This is not too special as central banks have responded to changes in the data also in the past. Expressing an indicative key rate path which is conditional on the ECB's economic outlook would reduce uncertainty and at the same time does not tie the ECB to a particular path. The FOMC's quarterly key rate outlook as part of the Summary of Economic Projections serves this purpose.

Core inflation momentum elevated due to persistence of services prices

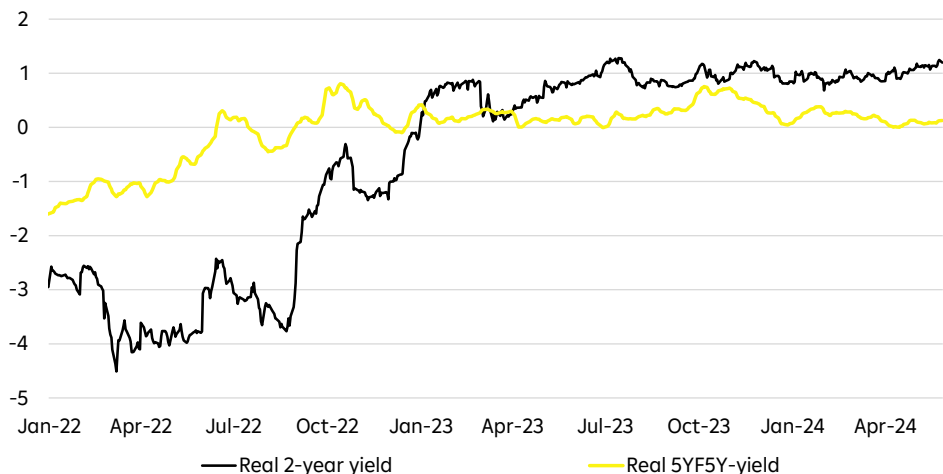


Source: LSEG, RBI/Raiffeisen Research

Scenario 1: The baseline unfolds

Our and the ECB's baseline inflation outlook reflects limited disinflation for the remainder of the year 2024. The underlying inflation momentum is easing only gradually and stays higher than what would be consistent with the inflation target. Inflation persistence in core services prices mainly due to only gradually declining wage growth is behind this pattern of core inflation. Over the year 2025 price growth reverts to the target. At the moment we see this to be the most likely path of inflation. For monetary policy we judge the inflation dynamics of 2024 to be consistent with a gradual approach by the ECB. Gradual we interpret as the ECB decreasing key interest rates by 25 basis points each quarter based on a new set of economic projections to see whether the assumptions have held up well. Inflation moving broadly sideways will provide the ECB with less signals than over the past two years on how to adjust monetary policy. With inflation having fallen below 3% the ECB will, however, feel comfortable to unwind some of the monetary policy restriction it has imposed. And the data show clearly that the ECB's monetary policy is in restrictive territory, so why stop after one 25 basis points rate cut in June.

Inverted real yield curve signals restrictive monetary policy



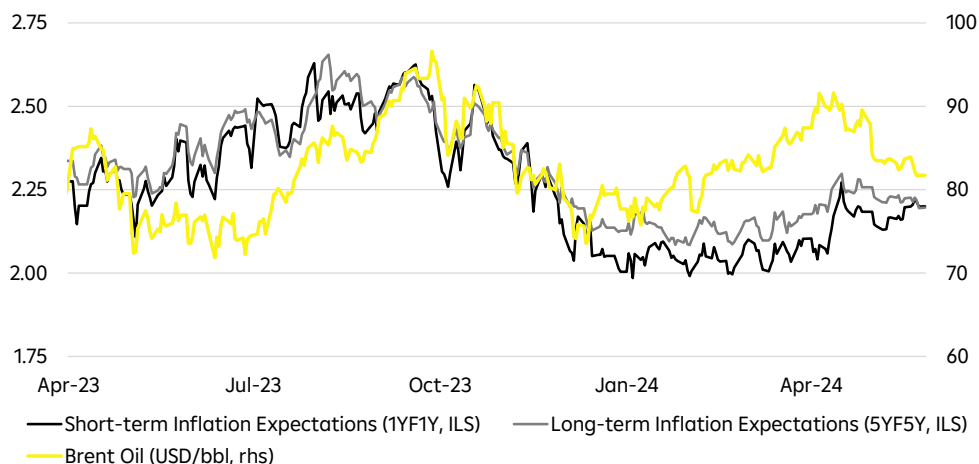
Real yield = OIS - ILS

Source: LSEG, RBI/Raiffeisen Research

Scenario 2: Upside inflation risks materialize

This brings us to scenario 2. The ECB stops its gradual, patient and data-dependent path - as outlined in scenario 1 - as upside inflation risks materialize. Please mind, inflation risks are currently tilted to the upside. Geopolitics is the obvious suspect but also inflation persistence as seen in May could be the source. Would inflation momentum stay around current levels, core inflation would, first, move sideways at just below 3% only to move above 3% in the final months of the year. Core inflation could end the year 2024 above its starting level, should inflation momentum not ease from current levels. Uncertainty about the magnitude of spillovers of elevated wage growth to services prices is a risk in that direction. In such a scenario rate cuts could be put on ice to avoid financial conditions to ease. By doing so, the disinflationary impact of restrictive monetary policy would be prolonged. This wait-and-see approach could not only be triggered by core services inflation momentum failing to ease. An energy price shock triggered by geopolitical risks materializing has enough inflationary potential to push the ECB's consensus towards high-for-longer.

Energy price shocks have the potential to spill over to inflation expectations



Source: LSEG, RBI/Raiffeisen Research

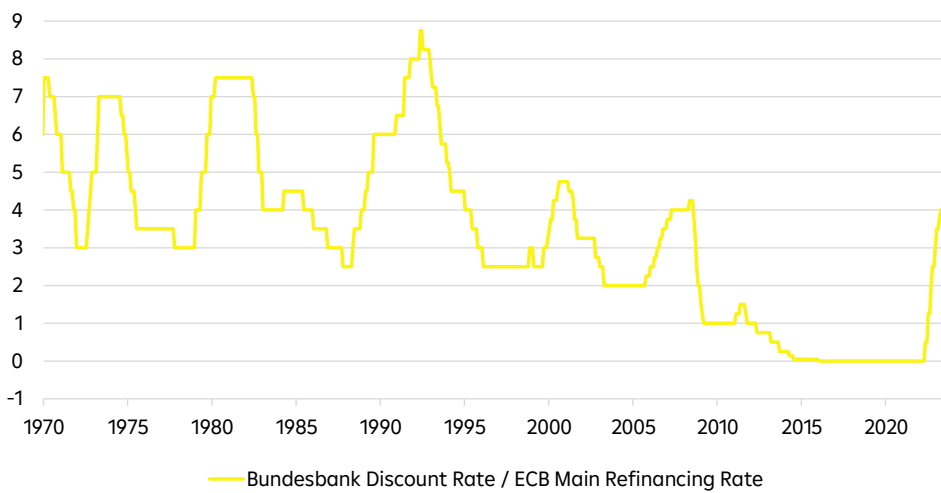
Scenario 3: Something breaks

While a high-for-longer scenario - like scenario 2 - is the more likely alternative to the baseline, one can also think about conditions in which the ECB needs to decrease interest

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rates more quickly. On the one hand, rate cuts at each meeting could occur should disinflation prove to be more pronounced than currently expected by the ECB - 2% inflation target is reached in the second half of 2024 instead of in the year 2025. Weaker (global) demand due to a delayed transmission of (overly) restrictive monetary policy could be a source. On the other hand, there could also be an even faster rate cutting cycle should more pronounced stress emerge in the economy / financial sector. Rate cuts are not the first line of defence when it comes to financial stress, as liquidity providing measures are used to calm pockets in the financial sector. Yet, if financial conditions tighten for the broader economy beyond what is desirable from a monetary policy perspective, rate cuts might well be on the table. In the end, most rate cutting cycles have occurred in response to an economic / financial crisis rather than as a normalization to a neutral stance. As crisis are notoriously hard to forecast, timing a fast track rate cutting cycle is hard at best. Moreover, at present there are no indication for an imminent crisis. Hence, by us and markets the ex ante probability of scenario three is considered as lower than of alternative two.

Is this time different? Past rate cutting cycles have reacted to crises



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
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
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
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
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
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
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
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
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
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