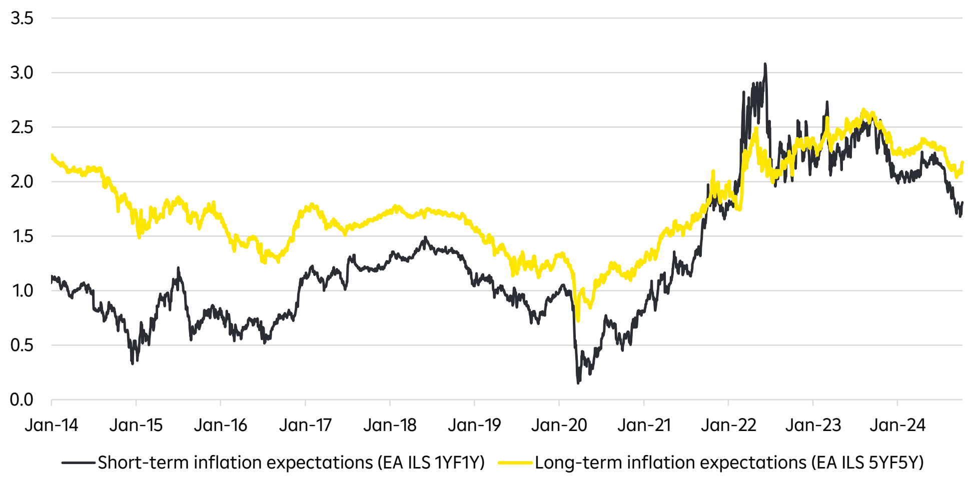
ECB Watch: “It moves after all!”

We now expect that the ECB will cut interest rates again in October. We see many good reasons and interesting background factors on top of the recent positive inflation print for the increased degree of monetary policy flexibility at the European Central Bank, which is beneficial for the euro area overall.

Following the **most recent ECB interest rate cut** in **September**, it still appeared that the Governing Council **did not** want to **commit itself** to a **clear policy statement** regarding further and imminent rate cuts. Furthermore, at that time there was still a clear focus on the elevated service price inflation. However, it was always clear that ECB would act in line with incoming data. Moreover, the official statement after the September meeting was, of course, a “power-political” compromise within the ECB Governing Council between hawks and doves. The doves would have liked to have started the rate-cutting cycle much earlier than June, would have stopped the hiking cycle earlier, and consider the current interest rate level to be clearly too restrictive. But now the **data has spoken**, the situation has changed. ECB is moving more quickly to lower interest rates, including the very next meeting in October. In principle, a higher degree of **monetary policy flexibility** is useful in times of **increased (economic downside) risk** and also means a return to traditional monetary policy without long-term forward guidance – also vis-à-vis financial market participants.

Market sees inflation at 2% in the long term, even lower in the short term



ILS = Inflation Linked Swap
Source: LSEG, RBI/Raiffeisen Research

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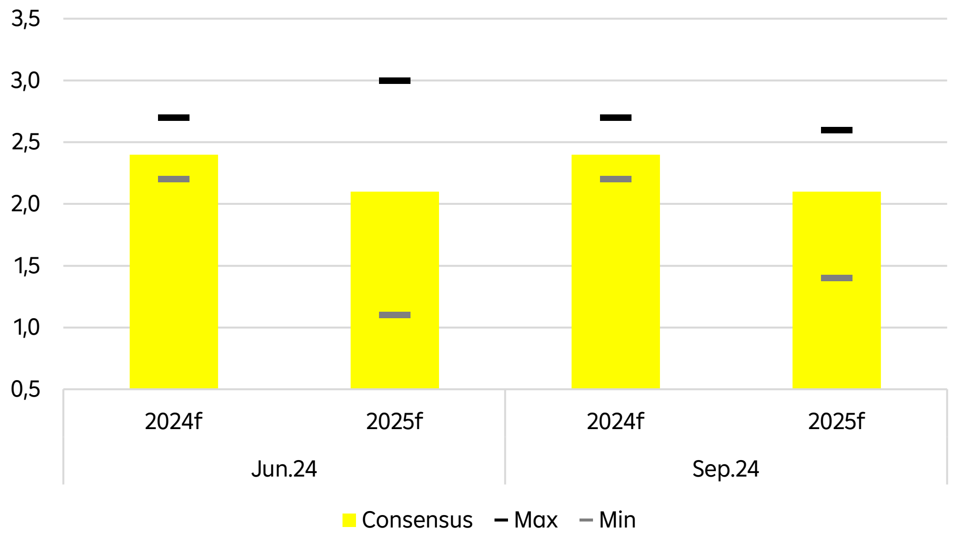
ECB: If the data is surprising, I readjust my direction of travel

On the **inflation front**, a **great deal of moderation** is the order of the day. In September, euro area inflation surprised on the downside, as did service price inflation. Although **core inflation** for services only fell to 4.0% (4.1% in August), the underlying momentum weakened more significantly. The key question is whether this is the beginning of more pronounced core services disinflation – as the leading indicators suggest – or whether price momentum will pick up again. **One month** of **good data** does not yet constitute a trend and is **usually not** enough to encourage a **central bank** to **act.** But we believe this time is different! Moreover, it should also be emphasized that **financial markets** have now written off the **inflation shock** in the euro area. The market's medium and longer-term **inflation expectations** are now clearly within the ECB's target range. External observers' medium-term **inflation forecasts** for the euro area (2025) are now also much closer to the ECB's target and show significantly less dispersion than in the past. In this respect, ECB has delivered on its very explicit inflation mandate or its **"robust inflation control mandate"** (which it emphasized during the inflation crisis). That said, ECB is now well positioned to further reduce the degree of monetary policy restriction. That's the data. More recent **remarks** by euro **central bankers**, including "centrist" (e.g. governor of the French central bank) and more hawkish ones, also point to imminent rate cuts. All in all, the slightly increasing downsides to the 2025 growth outlook, weaker inflation momentum as well as the current dovish orientation of rates markets — particularly after the Fed surprise — should lead to another ECB cut as early as October. Moreover, the market is currently pricing a rather dovish ECB rate path and given that the short-term inflation rate has already settled below 2%, **ECB may not want to risk surprising** the **market** with a hawkish stance. A non-cut in October would now be such a surprise. Furthermore, further **aggressive interest rate cuts** by the **Fed** cannot be ruled out in the course of 2024 (our base case scenario sees US rates falling at least by 75bp or 0.75% by year-end). In our view, ECB would therefore be well advised to continue signaling a firm but modest rate cutting course for the time being, powering ahead of Fed once again in October. We expect a **25bp ECB interest rate cut** in **October** and in **December**. We continue to expect a quarterly rate cut cycle in the first half of 2025. However, if the disinflationary momentum inside the euro area continues, a faster approach cannot be ruled out.

Euro area: Inflation forecasts (HCPI, % yoy)



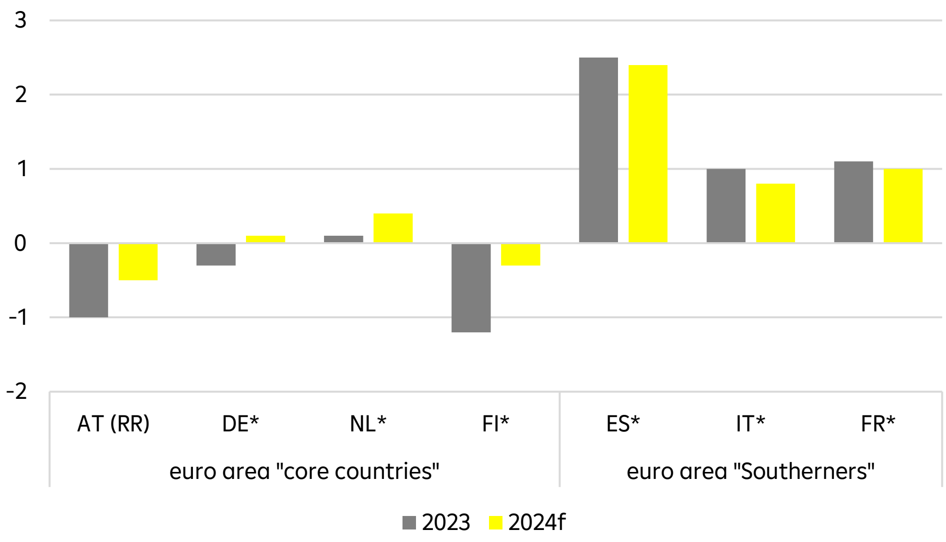
Source: FocusEconomics Consenus, RBI/Raiffeisen Research

New quality discernible in monetary policy deliberations within ECB

The latest developments following the September interest rate cut also point to a **"healthier" monetary policy discourse** inside the **ECB Governing Council** under acting

ECB President Lagarde. Her predecessor sometimes explicitly positioned himself in the **dovish camp**, liked to make long-term commitments, and **hawkish monetary policymakers** felt isolated. Although the current ECB President Lagarde can be said to have a slightly dovish bias, she clearly and correctly sided with the hawkish camp during the inflation crisis. In recent weeks, the **dovish camp** seems to have gained some ground again at the **ECB**. Representatives of this school of thought believe that the previous interest rate cuts starting in June possibly came too late, they continue tp point to the weak credit and economic development inside the currency bloc. Therefore, a moderate additional rate cut of 25bp would continue to signal **vigilance** on the **inflation front** and would be a good compromise between hawks and doves. In light of the above, we also see it as a vote of confidence in the "new" ECB decision-making that even **outspoken monetary hawks** (Bundesbank President Nagel) are de facto **allowing** for a **rate cut** in **October;** leaving aside the perma-hawk and Austrian central bank governor. We think that the recognizable increase of flexibility within the ECB Governing Council across monetary policy camps is good for the institution itself and, above all, for the European economy. Furthermore, current economic weakness in the euro area is concentrated precisely in the so-called (Western European) "core countries" with a traditionally more hawkish orientation of their national central bank representatives (Germany, Finland, Austria, partly the Baltic states), which among other things shall also facilitate an October interest rate cut.

Real GDP (% yoy)



** Forecasts according to Consensus FocusEconomics (September 2024), for Austria Raiffeisen Research Forecast; "core countries" euro countries with a strong historical orientation towards the German Bundesbank and/or "hard currency" or "low inflation policy", "Southern countries" euro member states with a historically stronger orientation towards general economic policy steering by national central banks (incl. a somewhat higher inflation tolerance)*

Source: Focus Economics, RBI/Raiffeisen Research

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