EUROZONE: RATE CUTS UNDERWAY, BUT THE ECB REMAINS ON ITS GUARD

The first cut in policy rates by the European Central Bank on 6 June came as no surprise, as the committee members had largely prepared the ground ahead of the decision. The timing and scale of future easing is more uncertain, given the continuing strong pressure on wages, high inflation in services, and the resurgence of tensions in global shipping. We expect two further interest rate cuts in 2024, at a pace of one per quarter (September and December).

While our forecast for the terminal rate has not changed from our March forecast (the rate on the deposit facility would stabilise at 2.50% by the second half of 2025), we have postponed our expectation of a cut from 2024 to 2025. The second half of 2024 will also see a slight increase in the ECB's quantitative tightening, with the partial reinvestment of assets held under the Pandemic Emergency Purchase Programme (PEPP), leading to an additional net reduction in the ECB's balance sheet of EUR 7.5 bn per month. This development is only the first step before the PEPP reinvestment programme comes to an end on 1 January 2025. Since July 2023, the ECB has no longer reinvested securities acquired through the Asset Purchase Programme (APP).

A THWARTED TRIPTYCH

However, the ECB's latest internal projections, published on 6 June, will not encourage it to relax. Compared with the March figures, the June estimates include upward revisions for GDP growth in 2024 (+0.3 percentage points, to 0.9% in 2024) and a slight fall for 2025 (-0.1 pp, to 1.4%). However, it is on the cost side that the most significant revisions are to be found. Firstly, on consumer prices (HICP), with an upward revision in inflation of 0.2 pp for both 2024 and 2025 (to 2.5% and 2.2% respectively), but also and above all on unit labour costs (ULCs), where significant revisions, extending to 2026, should be noted[1]. For the time being, labour costs in the Eurozone are not slowing as much as expected, and this dynamic, coupled with a slight fall in productivity, is fuelling a robust rise in unit labour costs. This is mainly the case in countries whose economies are relatively more industry-focused, and where inflation rates have fallen more lately - notably in the Netherlands (ULCs rose by 8.5% y/y in Q1), Germany (+6.9%), Austria (+10.6%), Croatia (+12.5%) and Latvia (13.2%). The triptych hoped for by the ECB - wage moderation, rising productivity and falling corporate margins - is not quite there yet, even though the ECB has noticed a sharp decline in the contribution of corporate margins to inflation since the second half of 2023[2].

After stabilising at 0.3% q/q in the second quarter of 2024, real GDP growth in the Eurozone is expected to strengthen slightly in the third quarter (+0.4% q/q) to converge with the expected growth rate for the United States. The PMI indices have gradually recovered since the start of the year (composite at 52.2 in May), although the indicators for the manufacturing sector, while also improving, are still at a very low level (47.3). Industrial activity in the Eurozone, which is held back primarily by the slowdown in the German economy, also remains exposed to an escalation in trade tensions between Brussels and Beijing. The European Commission has raised its voice in recent months, increasing customs duties on electric vehicle batteries and certain plastic components imported from China, as well as launching new anti-dumping investigations (medical products, biofuels) that could ultimately lead to new sanctions. The Chinese authorities have so far responded with restraint, targeting mainly the food sector (pork), spirits (cognac) and certain chemical products (thermoplastics). However, broader retaliatory measures, targeting manufactured goods and certain critical raw materials on which Europeans are heavily dependent on China, would have a completely different resonance. Furthermore, the stagnation of manufacturing employment in the Eurozone – and its new low as a share of total employment in Q1 2024 (12.8%) – illustrate the region's difficulties in kickstarting a genuine reindustrialisation dynamic, which will in any case be slow to materialise, given the time needed to build new infrastructures.

GROWTH AND INFLATION

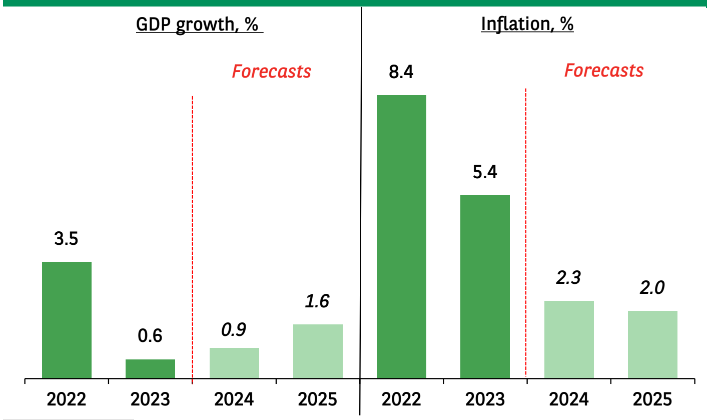

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

STAYING THE COURSE

The expected strengthening of activity in the second half of 2024 should support some job creation in the Eurozone, although the effects of monetary tightening on companies' financial conditions could lead to losses elsewhere. At this stage, the supply-demand imbalance on the labour market remains significant, with a relatively high job vacancy ratio (2.6% in Q1 2024, according to Eurostat), which contributed to a historic fall in the Eurozone unemployment rate to 6.4% in April. It is remarkable that the unemployment rate continues to fall, despite the stagnation of activity in the Eurozone between Q4 2022 and Q4 2023.

Following the European elections held from 6 to 9 June, the balance of power within the Strasbourg parliament has shifted in favour of the European People's Party (EPP) and the ultra-conservative parties. However, the possibility of maintaining a large coalition majority between the EPP, the Socialist Democrats (S&D) and the centrists (Renew) should limit the risk of legislative deadlock, even if agreements will be more difficult to reach than before. The entry into force in May 2024 of several major programmes (*Critical Raw Material Act, Net Zero Industry Act*) will also help the European Union to maintain a strategic course.

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1 The forecasts for 2024, 2025 and 2026 have been raised by 0.3 pp (to 4.7%), 0.2 pp (2.5%) and 0.4 pp (2.1%) respectively.
2 See Isabel Schnabel, The ECB's monetary policy: towards price stability, slide 14, 12 June 2024.