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MACRO MORNING BRIEFING

September 11, 2024

ECB to Continue Easing, Reluctantly

Services inflation risk the focus for ECB

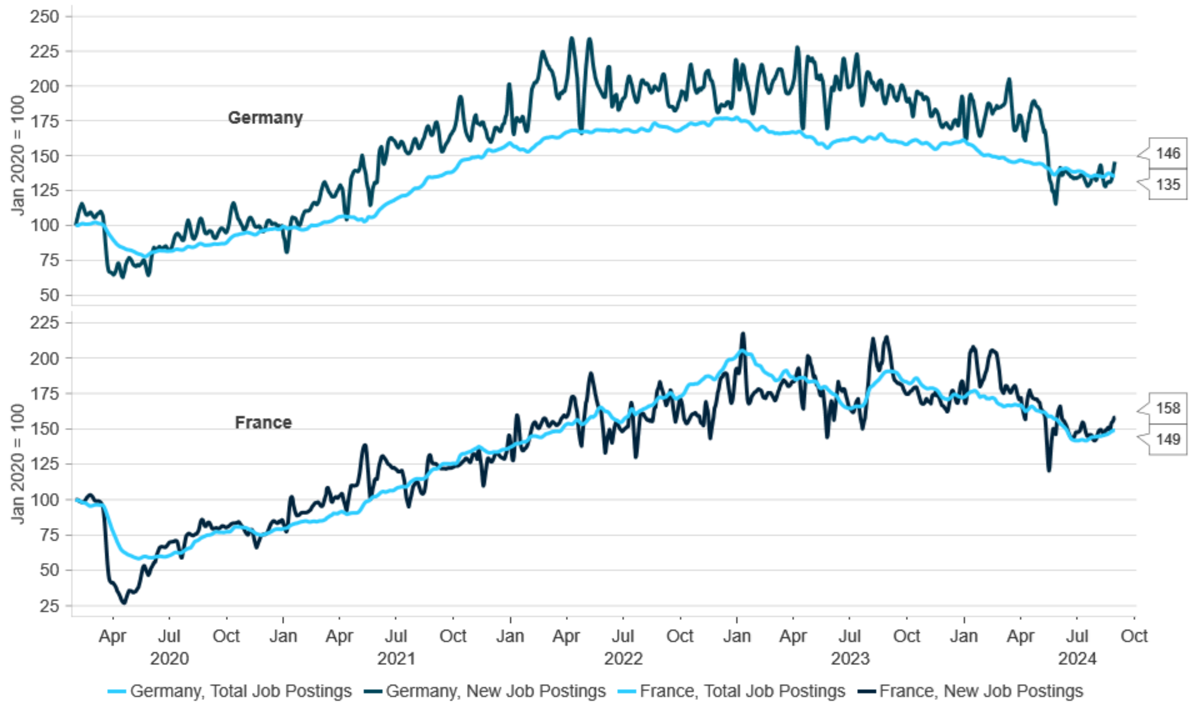
- Despite severe data deterioration, the ECB will continue its wage inflation focus
- Euro sensitivity to ECB expectations limited until Fed provides clarity
- Draghi report recommendations clear, implementation less so

ECB unlikely to commit to consecutive cuts

Compared to the Fed decision later this month, the ECB update this week almost feels like an afterthought. The market unanimously expects the deposit rate to be cut by 25bp to 3.5%, while the ECB will also reduce the spread between the main refinancing operations rate and the deposit rate to 15bp. This decision was announced in March. There is no debate over the scale of the cut, but markets will await guidance regarding the remainder of the year.

Our view is clear – the deterioration in the European manufacturing sector is existential and requires support from as many institutions as possible, as well as structural reform. Scarring in what has been Europe's most productive sector is underway and this will have very damaging consequences for the economy over the longer term. EUR valuations are elevated while the latest PPI figures show China is in deflation. As such, strong easing – at the very least to cap the EUR's strength – needs to be signaled. However, the ECB will most likely stress the challenges in bringing down core inflation. As it is within its right to do so given the lack of an employment mandate, sectoral challenges cannot be addressed by monetary policy. Be that as it may, we believe such an approach is imbalanced and suboptimal for the economy.

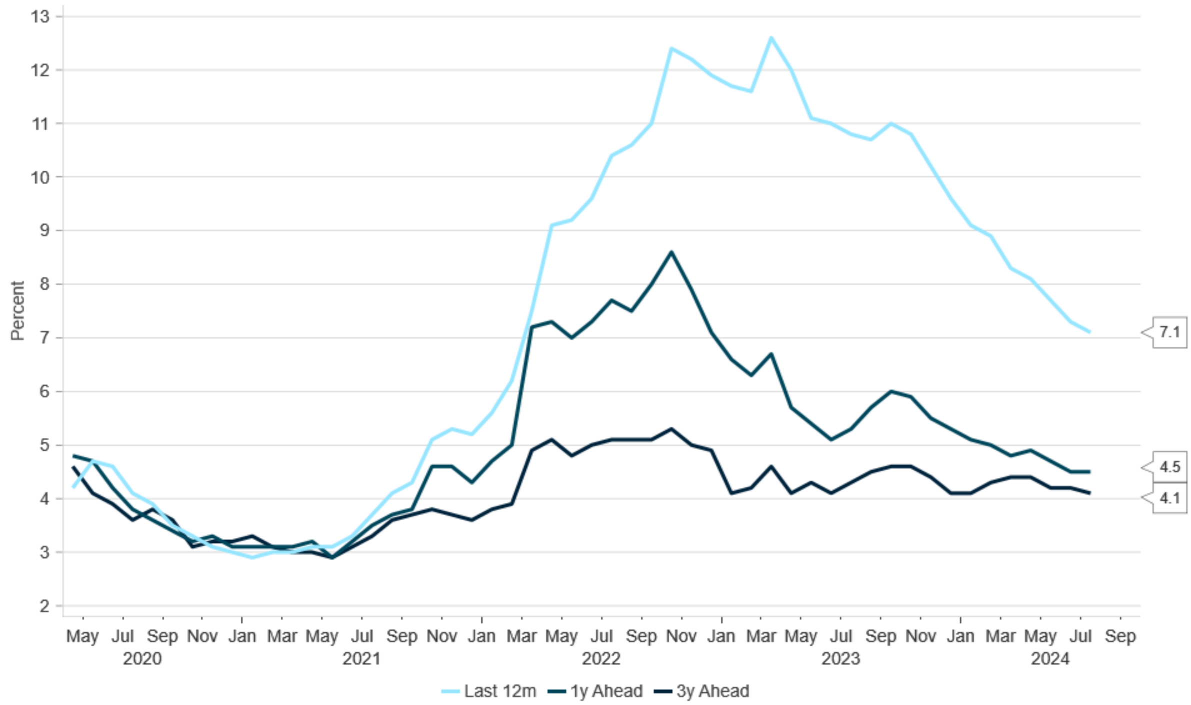
Exhibit #1: Labor Market Developments



Source: Macrobond, BNY

Even so, the wage focus is already set, and the latest high-frequency labor market indicators (Exhibit #1) suggest that the loosening in German and French labor markets has stopped over the last few months. The Governing Council will likely read this as presenting an upside risk (or removing downside risks) to wage growth. Persistence is also clear in inflation expectations (Exhibit #2) as forward inflation expectations have also stopped falling and remain stuck at 4.0% or higher on a 1-year and 3-year forward-looking basis. We expect the Governing Council to cite the lack of progress in reaching inflation targets across the forecast horizon as a reason to remain cautious on future easing.

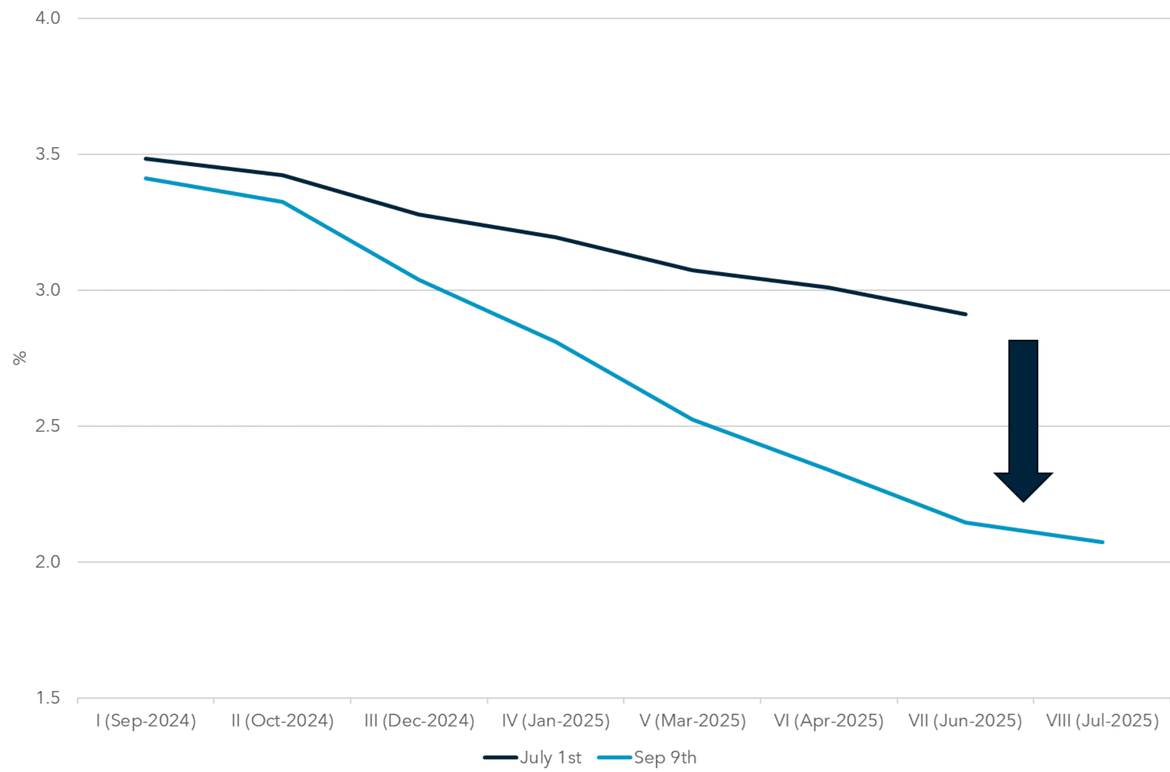
Exhibit #2: Eurozone Inflation Expectations



Source: Macrobond, BNY

Even if the ECB surprises to the dovish side and adopts a greater focus on supporting growth, we question for now whether this will be enough to drive down EUR valuations. After all, the rates market has been very forthcoming in pricing in additional cuts over the next year (Exhibit #3) and at various points in August, an additional reduction of 75bp through year-end was the market's base case, yet it coincided with EURUSD performing very strongly. As such, the current environment remains very much driven by dollar retrenchment as US rates decline, and the balance of adjustments in asset allocation remains skewed against dollar positions. The recent very strong bond sales in the UK and Italy (the Tesoro announced EUR 130bn demand for 30-year BTPs for yesterday's auction) are a clear sign of rotation taking place. Rebalancing will continue until the Fed's new path – notwithstanding other US-specific factors – is fully priced, or unless the dollar smile can reassert itself earlier, but that would require much more adverse global growth and risk conditions. Otherwise, we only expect valuation adjustments on well-funded crosses, such as EURJPY, EURCHF and EURNOK.

Exhibit #3: Change in Rate Expectations



Source: Bloomberg, BNY

The ECB may claim that structural factors are de jure beyond its remit over the longer term, but it is inescapable that without progress on productivity, the ECB's policy room will remain very narrow. Consequently, it would be appropriate for President Lagarde to be interrogated over the ECB's input and her views on her predecessor's report on European competitiveness, which was released on Monday. Unsurprisingly, the word "existential" is being used by Mario Draghi, and given the recent developments in the automotive industry and warnings from the PMI surveys, much of the industrial sector would agree with the warnings.

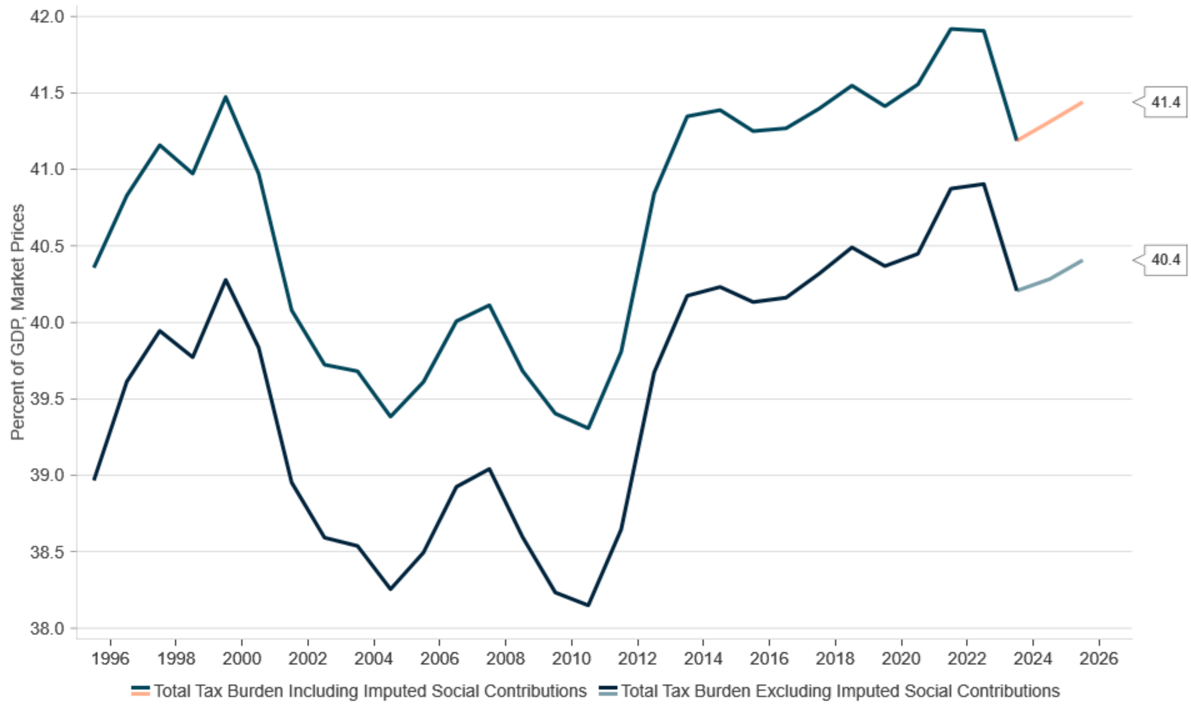
The headline-grabbing elements of the report with which many would agree include the need to reduce regulation and boost defense spending. Meanwhile, there are other consistently controversial topics in the European Union such as greater public investment, funded by jointly issued debt. The current German government has already dismissed such prospects, and we expect the "frugal four" (Austria, Denmark, Sweden and Finland), and possibly other EU countries as well) to fiercely resist such efforts in the next round of negotiations over the next Multiannual Financial Framework (MFF) from 2028 to 2035. Although any such changes will be well beyond the ECB's forecast horizon, any progress toward joint issuance could help significantly reduce term premia in Eurozone sovereign debt markets – which will impact financial conditions, around which monetary policy calibration takes place.

Even if by some minor miracle, the EU can achieve its "Hamiltonian moment" in the coming decade and launch a joint issuance facility, it is far from guaranteed that said investment can automatically result in better productivity and competitiveness growth. After all, this is what Next Generation-EU (NGEU) was designed for and the results remain patchy. The automotive sector is the prime example of how subsidies can initially foster innovation and competitiveness in an industry, but serious misjudgments in public demand are coming through. Industrial policy is essential, but the market needs to play a commensurate role.

This brings up a broader point about the size of the state in general. Europe's expectations are different, and the state is always expected to play a larger role in the economy and growth. However, as President Lagarde warned in her 2023 Sintra speech, the public sector generated the most employment growth but also saw a decline in productivity. She warned that such trends could persist over the "the next few years." Even though Draghi's investment proposals are designed to generate new employment growth in highly-productive, innovative sectors, the initial expansion in government spending could only exacerbate productivity issues in the public sector. It appears that aggressive reduction in the size of the state is not on the cards, simply because it is not seen as realistic. We can see that higher nominal GDP growth has helped reduce the tax burden (Exhibit #4) in recent years, but the figure is expected to rise again in 2025.

Draghi's report only talked about the "cost of tax compliance" inhibiting the growth of enterprises and scope for reducing complexities, rather than the level or burden of tax itself. Theoretically, tax burdens can decline based on stronger real growth gains, but the demographic and productivity outlook precludes swift gains. At least through the current ECB forecast horizon, we doubt there will be much relief from public sector and public services-based inflation persistence for the ECB.

Exhibit #4: Fiscal Burden to Rebound in 2025



Source: Macrobond, BNY

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Please direct questions or comments to: iFlow@BNY.com

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