WELLS FARGO

International Commentary — May 23, 2024

European Central Bank Carefully Approaching Its Easing Cycle

Economist(s)

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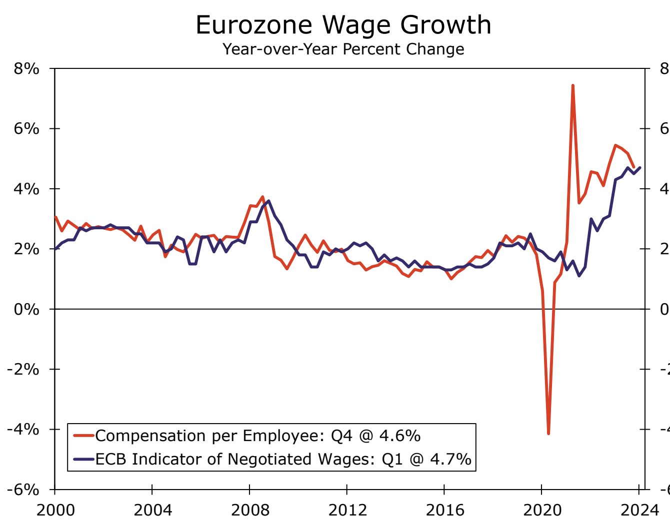
Summary

- This week saw some key Eurozone data which, we believe, reinforces our outlook for an initially gradual approach by the European Central Bank (ECB) toward easing monetary policy. The Q1 labor cost index and the ECB's Indicator of Negotiated Wages both suggested wage pressures persisted into early 2024, while the May PMI surveys suggested Eurozone recovery is continuing and indeed gathering momentum.
- While we expect the ECB to deliver its clearly signaled 25 bps rate cut in June, we then expect a pause in July before the ECB resumes with another 25 bps rate cut in September. By the fourth quarter, we expect wage and price pressures will have subsided sufficiently for the ECB to deliver back-to-back 25 bps rate cuts in October and December. Our base case envisages 100 bps of rate cuts this year, with the ECB's Deposit rate ending 2024 at 3.00%.
- If wage or price inflation fails to slow as much as we expect, the risk is tilted to a lesser 75 bps of cumulative easing to 3.25% over the rest of this year. That said, even with this risk scenario, the 75-100 bps of rate cuts we forecast is more than the easing currently priced in by market participants. Considering market pricing, and our forecast for the respective monetary policy paths of the European Central Bank versus the Federal Reserve, we see some potential for a weaker euro trend through until late 2024.

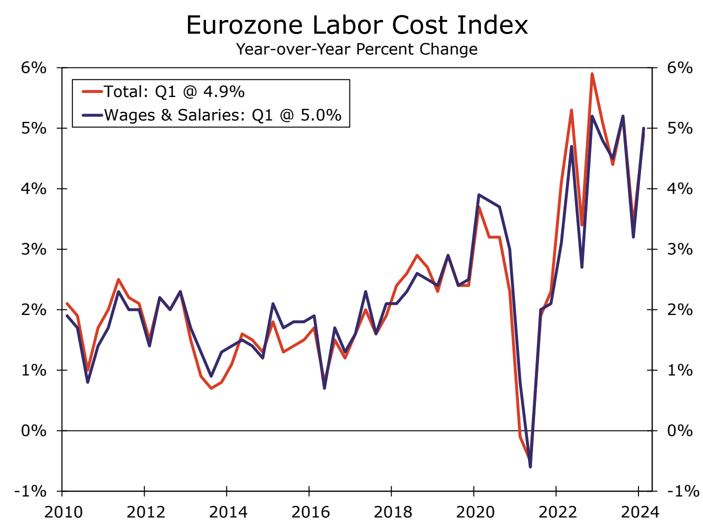
Eurozone Wage Pressures Persist Into Early 2024

This week has seen the release of some key economic figures which, in our view, are unlikely to derail the European Central Bank's (ECB) plans to cut rates at its June monetary policy announcement, but could influence its approach to easing monetary policy over the second half of this year. For many months, ECB policymakers have highlighted the significance of wage growth and services inflation as indicators of domestic inflationary pressures. In that context, ECB policymakers have expressed a preference to assess wage trends from early this year as they contemplate monetary easing.

This week's data suggests that labor cost pressures extended into the first quarter of 2024. One closely followed metric, the ECB's Indicator of Negotiated Wages, firmed slightly to 4.7% year-over-year, up from 4.5% in Q4, and matching the cyclical peak seen in Q3 last year. To be sure, part of the firming in negotiated wages was attributed to one-off payments, and the quickening was also in part driven by Germany, the region's largest economy, where negotiated pay rose by 6.2% in Q1. In related commentary on its website, the ECB said that separate wage tracker data for the first few months of the year suggest that negotiated wage pressures are moderating, which would support the ECB's forecast of some deceleration of elevated wage pressures as 2024 progresses. The flash estimate of the Eurozone labor cost index was also released this week. While not as closely followed, and also more volatile than the Indicator of Negotiated Wages, the labor cost index also suggested elevated wage growth persisted in early 2024. Total labor costs firmed to 4.9% year-over-year, while wages & salaries firmed to 5.0%. Although this measure of Eurozone labor cost growth still appears to be on an overall downtrend, the Q1 outcome does suggest labor costs are easing only gradually.



Source: Datastream and Wells Fargo Economics

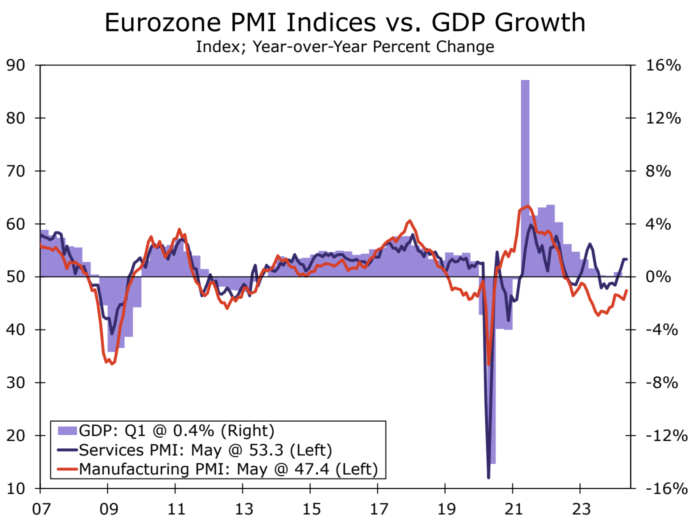


Source: Eurostat and Wells Fargo Economics

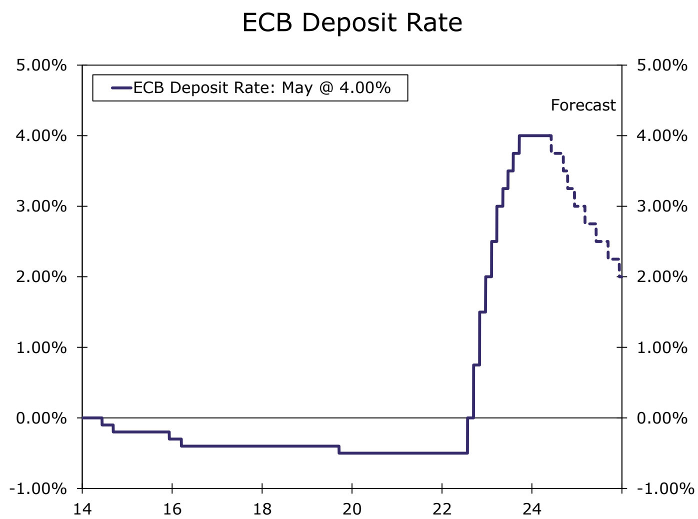
In this week's other key Eurozone data, the May PMI surveys suggested the region's economic recovery is continuing to gradually gather momentum. The manufacturing PMI increased to 47.4 in May, the best reading since February 2023 and consistent with a slower pace of contraction for the industrial sector. In another encouraging sign, the new orders sub-index rose to 47.5, the highest reading since May 2022. With respect to the region's largest economies, both the German and French manufacturing PMIs rose in May. For the Eurozone service sector, the May service PMI held steady at 53.3, the fourth month in a row that index has been in expansion territory. Among the more constructive details for the services index, the new business component rose to 53.6 in May, which is the highest reading since April of last year. By country, the details were a bit mixed, with Germany's services PMI increasing in May while the French services PMI declined. Still, considering the overall trends across both the manufacturing and services sectors, the Eurozone composite PMI rose to 52.3 in May, the highest reading since May of last year. Altogether we view the May PMI surveys as consistent with a strengthening economic recovery as the year progresses, suggesting the risk to our Eurozone 2024 GDP growth forecast of 0.8% could be tilted to the upside.

A Gradual Beginning to European Central Bank Easing

Given the clear signals from ECB policymakers on a likely June rate cut—a signal that was repeated by ECB President Lagarde as recently as Tuesday this week—we don't believe this week's data will derail the ECB's plans to begin easing monetary policy at its 6 June announcement. **We still expect the ECB to lower its Deposit Rate by 25 bps to 3.75% at its June meeting. However, persisting wage growth combined with strengthening recovery supports the case for the ECB to adopt a gradual approach to rate cuts during the early stages of its monetary easing cycle. We expect the ECB to hold rates steady in July, before delivering another 25 bps rate cut in September.** By the fourth quarter we expect that Eurozone wage growth and underlying inflation will have slowed sufficiently for the ECB to deliver rate cuts at its October and December meetings especially if, as we forecast, the Federal Reserve has begun lowering interest rates as well. If realized, that would see the Deposit rate lowered by a cumulative 100 bps this year to end 2024 at 3.00%. Of course, should wages or underlying inflation fail to slow as much as we expect, the risk is for the ECB to continue lowering interest rates at a 25 bps per quarter, or every other meeting pace, which would see a cumulative 75 bps of rate cuts this year to a Deposit Rate of 3.25%. However, even incorporating this risk scenario, our outlook envisages between 75-100 bps of ECB rate cuts this year, more than the 59 bps of easing currently priced in by market participants. Considering market pricing, and our forecast for the respective monetary policy paths of the European Central Bank versus the Federal Reserve, we see some potential for a weaker euro trend through until late 2024.



Source: Datastream, Bloomberg Finance L.P. and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

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