

ECB preview

Clear divisions within Governing Council

- Economic weakness is broadening, lower inflation going forward
- A very close call, but hawks are likely to get another and final 25bps hike

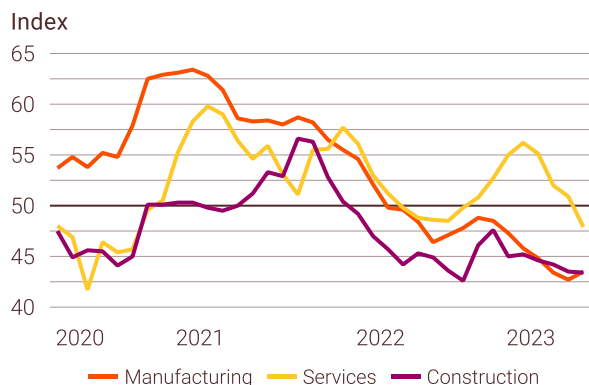
More evidence of economic weakness emerged during recent months – in August euro area services PMI fell to 47.9, while manufacturing PMI increased slightly to 43.5 but remained in a clearly contractionary territory. Both headline and core inflation eased to 5.3% in August and albeit it remains well above the ECB's target, most forward-looking indicators point to a continued if not sharp decline during the coming months. We forecast headline inflation to fall to 2% by spring next year and core inflation to follow during the next summer. Thus, it is very likely that the ECB staff macroeconomic projections will be revised downwards for 2024 – current expectation of 1.5% GDP growth is too optimistic, while forecast of an average annual inflation (both headline and core) to stay at 3% is on a cautious side.

The Governing Council seems to be increasingly more divided whether interest rates have become sufficiently restrictive to bring down euro area inflation down to 2 percent. During the recent weeks some governing council members have expressed the opinion that markets are under-pricing the probability of another hike, while others seemed to be more concerned with the weakness of growth. This bifurcation is reflected in the market expectations, where the probability of a hike in September is currently close to 35%, while the probability of a hike in October is at 25%. We think that dovish hike is more likely than the hawkish pause – if the ECB stops now, it will be done. Further easing in inflation and even more evidence of economic weakness would make it more difficult (and less sensible) to resume interest rate hikes in October. Thus, we maintain our forecast that the ECB will hike all rates by 25 basis points this Thursday and will start cutting rates in April of 2024.

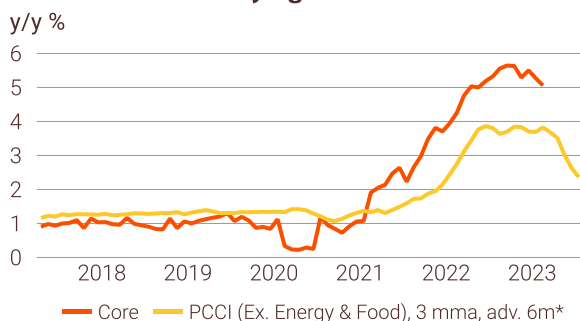
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Euro area PMIs



Measures of underlying inflation



* The Principal common component of inflation (PCCI) is one of the indicators published by the ECB. It is an attempt to isolate common inflationary force across products and countries
Sources: Swedbank Research & Macrobond

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