Flash Economics

N° 18
February 21, 2025

Will weak growth temper euro zone inflation as the ECB believes?

The ECB is very confident about the inflation outlook.

In its press release of 30 January 2025, it wrote: 'Most measures of underlying inflation suggest that inflation will settle at around the target on a sustained basis', the latter being 2%.

It is this favourable outlook for inflation that enables the ECB to conduct a monetary policy that is ever less restrictive in order to bolster economic activity.

In the past (at the beginning of 2001, at the end of 2008 and at the end of 2011), when the ECB began to cut interest rates, inflation was well above 2% (in June 2001 it was 2.9%, in spring 2008 it reached 4% and in October 2011 it was 3%), but fairly quickly (in spring 2002, at the end of 2008 and in the first quarter of 2013), the weakness in economic activity caused inflation to fall back below 2%.

Will it be the same today? There are grounds for scepticism given that:

- The euro zone is not in recession but only enjoying weak growth (the growth forecasts for 2025 of the various institutions range from 0.8% to 1.3%);
- The absence of productivity gains means that, even with weak growth, employment is increasing, and the labour market remains therefore tight, with high wage inflation, particularly in services.

Patrick Artus
Senior Economic Advisor
patrick.artus-ext@ossiam.com
@PatrickArtus

Marketing communication: this document is a marketing presentation. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research; and it is not subject to any prohibition on dealing ahead of the dissemination of investment research.

The ECB cuts interest rates as it believes inflation will revert to the 2% target by the end of 2025

The ECB cut the deposit rate to 2.75% at the end of January 2025 (Charts 1A/B) and has expressed its confidence that inflation and core inflation will revert to 2% by the end of 2025.

Chart 1A
Euro zone: European Central Bank Deposit Rate (as %)

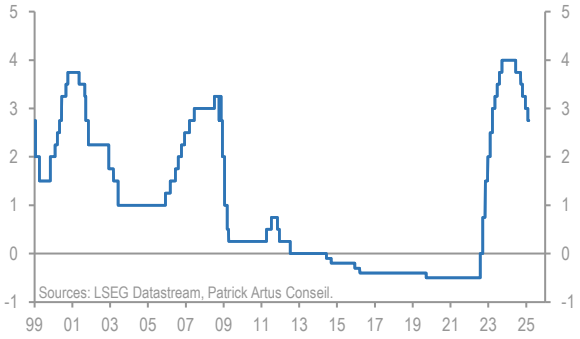
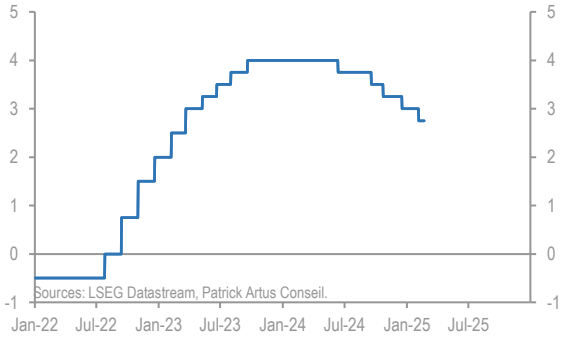


Chart 1B
Euro zone: European Central Bank Deposit Rate (as %)



It is therefore logical, given this inflation forecast, for the ECB to cut its key interest rates (the financial markets are expecting the ECB to end up with a rate of around 2%, Chart 2), given that the euro zone economy is weak (Charts 3 and 4).

Chart 2
Euro zone: Euribor contracts (3-month)

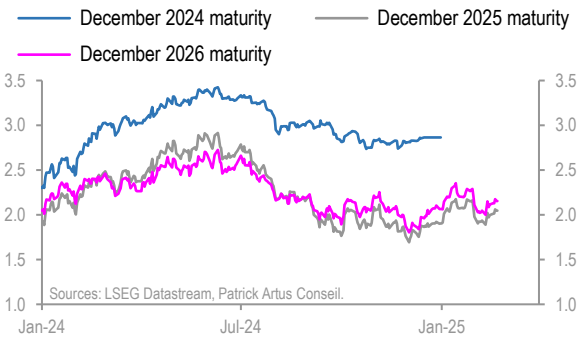


Chart 3
Euro zone: Real GDP

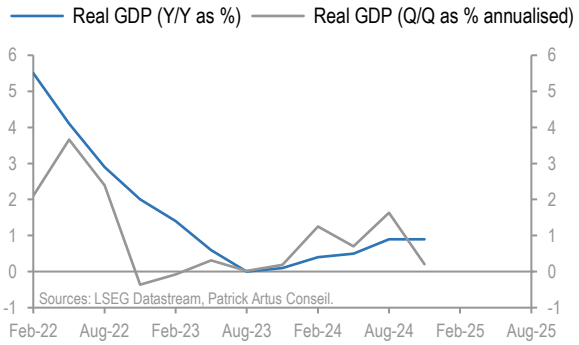
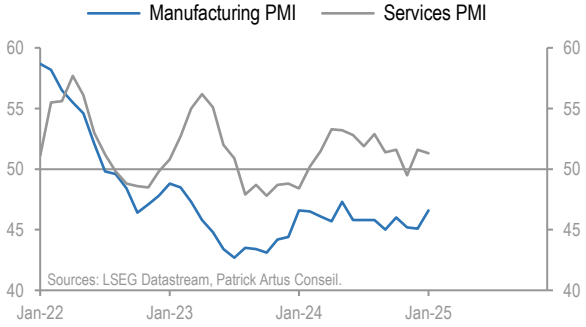


Chart 4
Euro zone: Manufacturing and services PMI (indices)



In the past, the ECB has cut interest rates with inflation still significantly above 2%.

We review **three inflationary episodes in the past: the period 2000-2002, the period 2007-2008, the period 2011-2012** (we consider the post-Covid period to be special), **Chart 5**.

.

Chart 5
Euro zone: Inflation (as %)



Each of these three inflationary shocks was marked by **a rise in ECB interest rates, followed by the beginning of a downward correction in interest rates while inflation was still above 2%** (**Charts 6A/B/C**).

Chart 6A
Euro zone : Euro repo rate and inflation (as %)

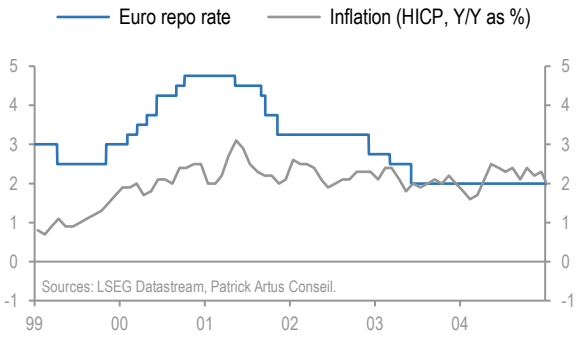


Chart 6B
Euro zone : Euro repo rate and inflation (as %)

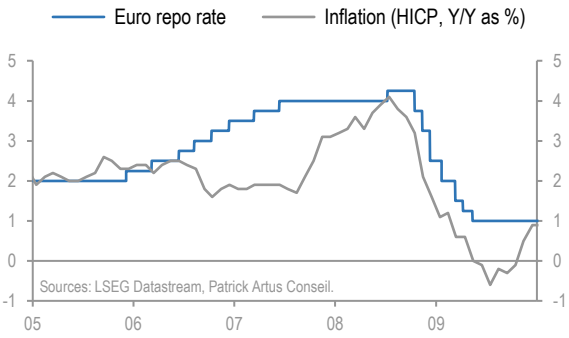
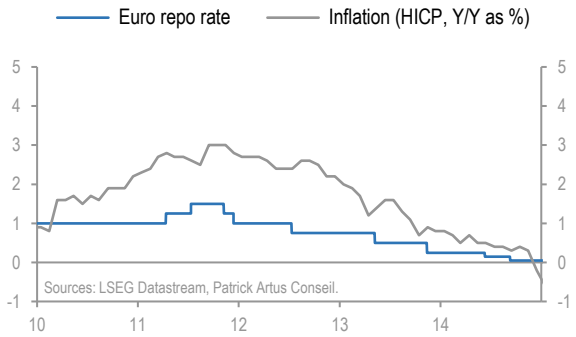


Chart 6C
Euro zone : Euro repo rate and inflation (as %)



Subsequently, with the weakness in activity (**Charts 7A/B**), **inflation fell fairly rapidly** and dropped below 2%.

Chart 7A
Euro zone: Real GDP (Y/Y as %)

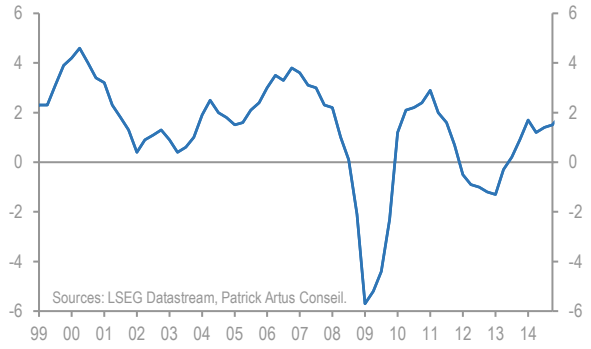
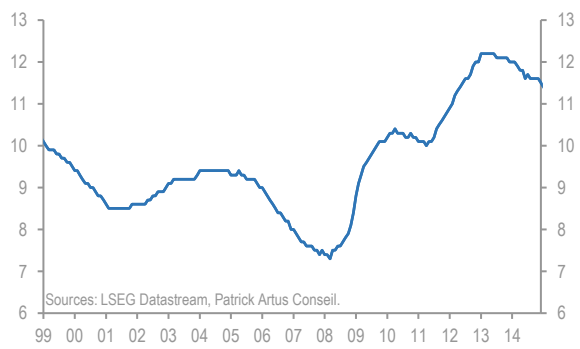


Chart 7B
Euro zone: Unemployment rate (as %)



In all three episodes, the ECB was right to start cutting interest rates while inflation was still above 2%.

Will this inflation dynamic appear again today?

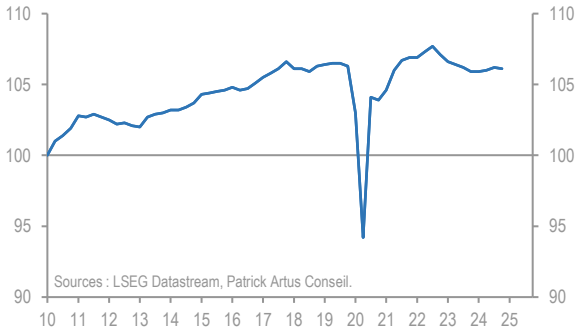
In 2001, 2008 and 2011, the ECB lowered its interest rates against a backdrop of economic weakness in the euro zone, while inflation was still above 2%. Subsequently, economic weakness pushed inflation back below 2%, so the ECB's behaviour was beneficial and had no negative impact on its credibility.

But will this downward trend in inflation prompted by weak growth appear again today?

There are several reasons **to question this view.**

1. **The eurozone is not in recession, it is just experiencing weak growth (Chart 3 above**), the 2025 growth forecasts for the eurozone range from 0.8% to 1.3% (0.8% for Goldman Sachs, 1.0% for the Conference Board, 1.1% for the ECB, 1.2% for S&P, 1.2% for the IMF, 1.3% for the European Commission, 1.3% for the OECD).
2. **Productivity in the euro zone is stagnating further (Chart 8),** which implies that:

Chart 8
Euro zone: Productivity per head (2010.Q1 = 100)



- Unit labour costs continue to rise rapidly (Chart 9);

Chart 9
Euro zone: Unit labour cost and nominal labour compensation per employee (Y/Y as %)



- **Employment continues to rise, despite weak growth** (**Chart 10**), which keeps the labour market tight (**Chart 11**), and thus generates swift wage increases (Chart 9).

Chart 10
Euro zone: Employment (Y/Y as %)

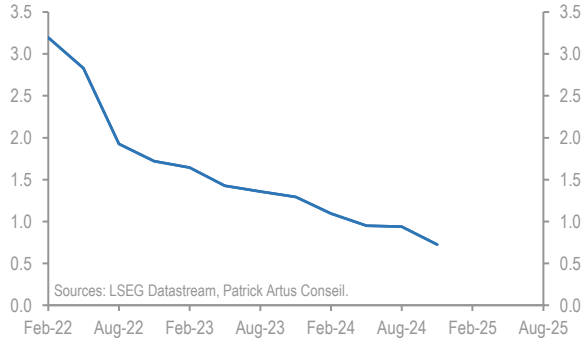
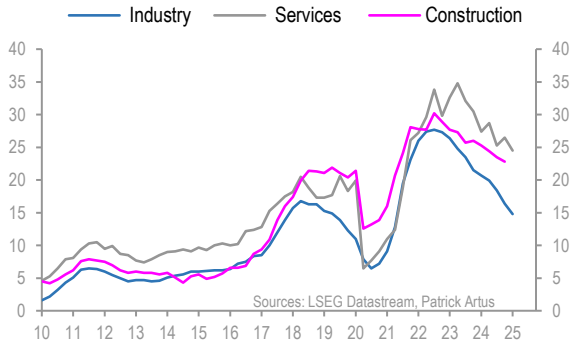
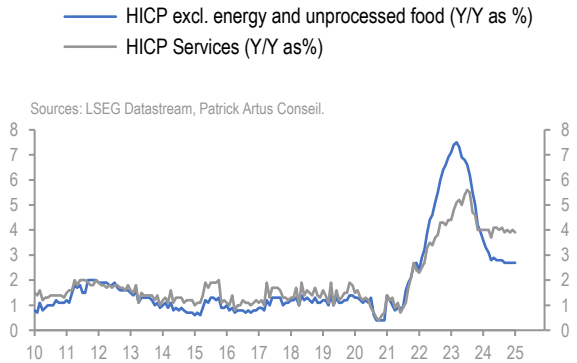


Chart 11
Euro zone: Companies experiencing recruitment difficulties (as %)



As a result, wage-led inflation, i.e. underlying inflation, should remain fairly high (inflation excluding energy and unprocessed food was 2.8% in December 2024), while the rise in services prices should be strong (4.0% in December 2024), **Chart 12**.

Chart 12
Euro zone: Core inflation and services inflation (as %)



Summary: is inflation behaving differently today than in the past?

In the past, the ECB was able to cut interest rates while inflation was still above 2%, during periods of weak growth, because weak growth would subsequently push inflation below 2%.

But it is not certain that this dynamic of inflation driven down by weak growth is still valid today.

Indeed:

- The growth forecast for 2025 in the euro zone is not extremely weak;
- The absence of productivity gains is inflationary, both directly and through the permanent tension on the labour market that it implies.

Disclaimer

Ossiam, a subsidiary of Natixis Investment Managers, is a French asset manager authorized by the Autorité des Marchés Financiers (Agreement No. GP-10000016). Although information contained herein is from sources believed to be reliable, Ossiam makes no representation or warranty regarding the accuracy of any information of which it is not the source. The information presented in this document is based on market data at a given moment and may change from time to time. This material has been prepared solely for informational purposes only and it is not intended to be and should not be considered as an offer, or a solicitation of an offer, or an invitation or a personal recommendation to buy or sell participating shares in any Ossiam Fund, or any security or financial instrument, or to participate in any investment strategy, directly or indirectly. It is intended for use only by those recipients to whom it is made directly available by Ossiam. Ossiam will not treat recipients of this material as its clients by virtue of their receiving this material. All performance information set forth herein is based on historical data and, in some cases, hypothetical data, and may reflect certain assumptions with respect to fees, expenses, taxes, capital charges, allocations and other factors that affect the computation of the returns. Past performance does not predict future returns. Any opinions expressed herein are statements of our judgment on this date and are subject to change without notice. Ossiam assume no fiduciary responsibility or liability for any consequences, financial or otherwise, arising from, an investment in any security or financial instrument described herein or in any other security, or from the implementation of any investment strategy. This information contained herein is not intended for distribution to, or use by, any person or entity in any country or jurisdiction where to do so would be contrary to law or regulation or which would subject Ossiam to any registration requirements in these jurisdictions. This material may not be distributed, published, or reproduced, in whole or in part.