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Another rate cut from the ECB and the next stop is 'neutral'

Christine Lagarde's comments at the press conference suggest the European Central Bank is on its way towards neutral interest rates, but there is no clear consensus over the right pace just yet

ECB President, Christine Lagarde, at Thursday's news conference

3%

ECB deposit rate

A 25bp cut

The ECB drops a key policy line

The ECB cut interest rates by 25bp, bringing the deposit rate to 3%, its lowest level since March 2023. This decision reflects a compromise between growth and inflation worriers, a gut feeling vs. a model-based approach and doves against hawks. At the same time, the ECB has dropped the reference to "*keeping interest rate sufficiently restrictive for as long as needed*". That means it's keeping the door wide open for more rate cuts to come.

ECB’s macro assessment almost looks like a Goldilocks scenario

Since the October meeting, European confidence indicators have weakened, while headline inflation has accelerated. Stagflationary tendencies are a very uncomfortable situation for the ECB. At the same time, negative risks have clearly increased. Think of the potential adverse effects of US economic policies over the coming months, political instability in the two largest eurozone economies, and now even a public finance crisis in France. Still, the ECB today tried to describe a rather more encouraging picture of the eurozone economy.

During the press conference, President Christine Lagarde pointed to better-than-expected growth in the third quarter and an economy that “*should strengthen over time*”. That's despite the fact that the economy had started to lose some momentum, and some sectors found it challenging to remain competitive. Still, according to Lagarde, risks to the outlook were still tilted to the downside.

This still relative optimism was also reflected in the latest ECB staff projections, which have eurozone GDP growth come in at 0.7% in 2024, 1.1% in 2025, 1.4% in 2026 and 1.3% in 2027. In September, staff projections were slightly more optimistic at 0.8%, 1.3% and 1.5% between 2024 and 2026.

The 2025 forecast looks particularly optimistic. The bank has not taken into account Trump and France and is still banking on a return of the consumer. At face value, these forecasts even look like a Goldilocks scenario: too good to be true.

The ECB is highly confident that inflation will settle down at around 2%. According to the staff projections, it is expected to average 2.4% in 2024, 2.1% in 2025, 1.9% in 2026, and 2.1% in 2027.

In September, staff projections had seen inflation coming in at 2.5%, 2.3% and 1.9% in 2024, 2025 and 2026.

The new forecast expects core inflation to be 2.9% in 2024, 2.3% in 2025, and 1.9% in both 2026 and 2027.

When looking at these forecasts, don’t forget that they take market expectations on future interest rates into account. So, to get to these growth projections, the ECB would have to deliver the rate cuts expected by markets at the cut-off date two weeks ago. Back then, markets expected interest rates to be cut to below 2% by next summer.

Gut feeling vs. a model-based judgement, round 2

The rate cut in October was – as the ECB called it – a risk management rate cut. So, in our words, gut feeling and growth worries were stronger than data dependency. Today, it returned to the model-based judgement, taking comfort from a projected disinflation trend but also from a relatively benign growth outlook. This is what's allowing the ECB not to rush to lower rates but to take it step-by-step. Still, high domestic inflation also seems to prevent the ECB from cutting more aggressively.

And here's another example that the ECB has stopped listening to its gut feeling, at least today. Lagarde commented during the Q&A session that it was too early to react to any economic policies possibly coming from the new US government. This suggests that it's now back to focussing more on current data rather than being forward-looking.

All of this makes us think that looking ahead, the risk for Europe's central bank will now be that while it is still highly guided by the past mistake of underestimating inflation and reacting too late, it could now end up overestimating growth and being too late to react again. How the ECB would react to a stagflationary scenario, which is also still possible, remains unclear.

Forced to do the heavy lifting, even if they'd rather not

Today's meeting was the last of the year, one in which the ECB took a u-turn from the u-turn made in 2022. Aggressive rate hikes in 2022 and 2023 have now been followed by four rate cuts. Judging from today's comments, the ECB is now looking to bring interest rates to neutral levels, wherever this neutral level might be. Lagarde suggested during the press conference that ECB staff saw the level of the neutral rate between 1.75% and 2.5%.

Given the high risk that its growth outlook is too optimistic, at least in the short term, going to neutral might not be enough. As much as the ECB tries to rightly point the finger at governments to use structural reforms to improve growth prospects, with political woes in France and Germany, the risk is high that the bank will still have to do the heavy lifting, at least over the coming months. This is why we expect more cuts, and we'll reach 1.75% by next summer.

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