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ECB is forced to cut rates again this week

Trade tensions and the stronger euro will push the European Central Bank to cut rates again this week

After the March meeting, the ECB seemed set for a pause at the next meeting. With interest rates at the upper end of the range for neutral interest rates estimates, taking a breather looked appropriate. Particularly as the europhoria after the German fiscal u-turn and strong European intentions to spend more on security and defence had clearly improved the eurozone's growth outlook. However, since 'Liberation Day', a pause is no longer an option.

US tariffs on the EU and many other countries have brought back growth concerns for the eurozone, at least in the nearer term. The strengthening of the euro as well as the drop in energy prices has added to the disinflationary forces the current trade tensions will have for the eurozone. As a result, the ECB, which looked hesitant to decide between a pause and a next rate cut only a few weeks ago, will have to continue its current easing cycle this week. As in October, a rate cut this week can easily be labelled as an insurance cut; a cut that can't do any harm, while staying on hold would not only cast doubt about the ECB's willingness to bolster growth but could also lead to a further and unwarranted strengthening of the euro. In case you missed it, the trade-weighted exchange rate of the euro is currently at the highest level since the start of the monetary union.

With the expected rate cut, the ECB will also have to change its communication. Instead of 'monetary policy is becoming meaningfully less restrictive', the ECB is likely to flag that at 2.25%, the deposit rate would now be within the range of neutral interest rates.

Looking further ahead, there are at least two main challenges for the ECB. The ongoing trade tensions as well as a high level of uncertainty could force the ECB to cut interest rates further than it would currently like to admit. At the same time, the strengthening of the euro exchange rate, not only vis-à-vis the dollar, will insert more disinflationary pressure on the eurozone. Pre-empting some of this pressure could push the ECB to at least verbally open the door to accommodative monetary policy.

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