Lagarde's comments suggest stronger euro could restart cutting cycle

Comments by European Central Bank President Christine Lagarde at today's press conference suggest that the exchange rate is indeed the weak spot in the Bank's 'good place'

We will have to wait for individual statements of ECB members over the next days to get a better feeling of the tone and intensity of today's discussion. However, judging from Christine Lagarde's comments at the press conference, we get the impression that the view on how to deal with the stronger euro is still fluid. As is the assessment of whether or not a more 'global euro' would coincide with a currency strengthening.

The facts are clear: the ECB decided unanimously today to keep interest rates unchanged. The official policy announcement as well as Lagarde's comments illustrate that the ECB still sits comfortably in its 'good place'. And, with the eurozone expected to grow at around potential and inflation to remain somewhere around 2%, there are very few arguments for challenging the ECB's good place.

As the last ECB rate cut dates back to June last year, it's fair to say that the bar to cut again is very high. However, looking at the history of the central bank's rate-cutting cycles, a longer period of inactivity after a series of rate cuts does not automatically mean that the ECB is done. In 2012 and 2024, we saw two occasions where it restarted a cutting cycle that initially looked to be over.

Stronger euro remains weak spot in ECB's 'good place'

Looking ahead, Lagarde's comments seemed to create more confusion than certainty over the next ECB move. Instead of simply sticking to the well-known phrases like 'we don't pre-commit' or 'we remain data-dependent', comments on the risk assessment and particularly on the exchange rate were very fluid. As in December, the risk assessment no longer concludes with the balance of risk but rather lists all upside and downside risks. When asked, Lagarde stated that risks were currently broadly balanced.

As regards the exchange rate, Lagarde repeated the well-known ECB refrain that the exchange rate is not a policy target but an important element in the growth and inflation forecasts. However, she tried to downplay the strengthening of the euro, stressing that the current level was broadly in line with the historical average. Lagarde also stated that a stronger international role of the euro would not have to go hand in hand with a stronger currency. Here, we would object. In any transition towards a more important international role for the euro, an appreciation of the currency would seem inevitable. In the end, a more attractive currency means more demand for it which, in turn, strengthens the exchange rate. Needless to say that up to now the 'global euro moment' has been more dream than reality.

Stronger euro could still force the ECB to restart cutting cycle

We still think the ECB wants to remain in its 'good place' for as long as possible. And the hints that Isabel Schnabel dropped in December about a potential rate hike are clearly off the table for now. If the ECB were to leave its good place, the first move would almost certainly be a cut rather than a hike – at least in the near term.

Whether driven by general market unease or, more specifically, by the strengthening of the euro, there is still a risk of inflation undershooting over the coming months. If the euro were to strengthen again after the recent rebound of the US dollar, for example towards 1.25 EUR/USD by the March meeting, there is a high risk that the ECB's inflation forecasts will show inflation staying below 2% for three years in a row, possibly even below 1.8%. While no one would perceive this as a deflationary risk, such an inflation undershoot could raise doubts about how symmetric the ECB's inflation target really is and hence still encourage more dovish ECB members to push for an insurance rate cut.

Whether Europe likes it or not, today's ECB meeting brings back memories of the old saying "our dollar, your problem".

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