ECB signals a summer pause after today's rate cut

Following today's 25bp rate cut, comments from the ECB's press conference suggest Board members are in no hurry to cut rates again at the July meeting – unless there is a new escalation of trade tensions. Still, as we see more disinflationary pressures materialising, the ECB could cut rates one more time in September

ECB President Christine Lagarde during today's press conference

The European Central Bank (ECB) has cut interest rates to the lowest level since December 2022, bringing the deposit rate to 2%, from 2.25%. Rapidly fading inflationary pressures have given the ECB ample room to bring interest rates into neutral territory.

With the risk of inflation undershooting currently increasing and disinflationary trends probably spilling over into the domestic economy, today's rate cut will not be the last, even if ECB President Christine Lagarde's comments at the press conference suggest that room for further rate cuts will be limited.

Risks of inflation undershooting have increased

Inflationary pressures in the eurozone are receding faster than expected. Not only did US President

Donald Trump make the European economy great again – for one quarter, as frontloading of exports and industrial production boosted economic activity – he also made inflation almost disappear.

The strengthening of the euro exchange rate and the drop in oil prices due to erratic US economic policy have increased disinflationary pressures in the eurozone. And while there had been some countermovement in recent weeks, the nominal effective exchange rate of the euro is still some 3% higher and oil prices some 10% lower than at the ECB's March meeting and the last round of ECB forecasts. These two developments are also reflected in the ECB's latest staff projections which show headline inflation coming in at 2% in 2025, 1.6% in 2026 and 2% in 2027.

At the same time, the ECB staff projections show GDP growth averaging 0.9% in 2025, 1.1% in 2026 and 1.3% in 2027. Even if the eurozone economy has shown some unexpected resilience and trade tensions could still fade, the risk of inflation undershooting target has become pressing enough for the ECB to cut rates once again.

During the press conference, President Lagarde also shared some insights into additional risk scenarios conducted by ECB staff. Needless to say that a further escalation of trade tensions would have adverse effects on the eurozone economy, while less severe outcomes would lead to stronger growth and somewhat higher inflation.

As Lagarde noted during the press conference, with today's rate cut, the ECB believes it is well-positioned to navigate the challenges ahead. In other words, the ECB seems to see itself in neutral territory – despite Lagarde clarifying that the concept of a neutral interest rate was not part of today's discussions.

Summer rate cut pause

Looking ahead, Lagarde's comments during today's press conference suggest that the ECB is in no hurry to continue cutting rates. For now, the ECB sees the acceleration of disinflationary pressure mainly as transitory due to energy prices and the stronger euro. Unless trade tensions return with a vengeance, be it at the end of the current 90-day pause or at another time, we suspect that the ECB will stick to a wait-and-see approach over the summer. It will take a bit longer to understand whether the current disinflationary risks are merely one-offs or whether they signal a broader trend.

At the same time, the ECB still sees a more optimistic longer-term picture for growth on the back of German fiscal stimulus and European intentions to step up defence spending. It is this longer-term optimism which should limit the room for further rate cuts. However, as we still expect the current disinflationary trends to partly spill over into the domestic economy, and the cooling labour market should bring down wage growth quickly, we wouldn't call today's rate cut the last one this year.

As much as the ECB today tried to give the impression that the job of bringing back inflation is basically done, the risk of some aftershocks from recent developments on growth and inflation should provide enough room for at least one more rate cut after the summer. Unless trade tensions escalate again, the often mentioned direction of travel for the ECB over the summer is clear: vacation, before cutting rates once more in September.

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