ECB minutes mark the next step on a very long road to rate cuts

The just-released minutes of the ECB's January meeting underlined the very gradual shift towards eventual rate cuts

ECB President Christine Lagarde

The European Central Bank is not really known as a central bank that makes swift shifts in its policy decisions. The minutes of the ECB's January meeting nicely illustrate the currently ongoing shift in the ECB's inflation assessment, but the very cautious and gradual shift suggests that rate cuts in Spring are highly unlikely. Instead, the ECB will want to wait until first quarter data confirms receding inflationary pressure, a modest economic recovery and no acceleration of wage growth to slightly reduce the current monetary policy restrictiveness.

Here are the highlights from the minutes.

Inflation is coming down

The ECB seems to be satisfied with the disinflationary process of 2023, stating that the "decline in inflation was coming at a relatively mild cost in terms of economic activity". Also in the discussion, the view emerged that risks to the inflation outlook could have shifted to the downside. At the same time, however, the longer-term projection of inflation returning to 2% should not yet be taken for granted, as this process “remained fragile and depended on a number of benign assumptions materialising”.

More worried about the economy

The ECB’s assessment of economic developments sounds more cautious than before. Satements like “the Governing Council still needed to see clear signs that the recovery was on track” do not really reflect conviction.

Wage developments remain key

The minutes stress that the “medium term component of wage dynamics and the evolution of inflation expectations remained crucial”. Interestingly, the minutes state that wage growth of around 5% “was not necessarily an excessive number during a catching-up phase”, indicating that – as important as wage growth in the first quarter will be for rate decisions – the ECB has no threshold number in mind.

Rate cuts were spelled out, but are not yet a serious option. Remember that during the press conference in January, ECB President Christine Lagarde said that the central bank had concluded that it was too early to discuss rate cuts. That was another subtle change from the “we didn’t discuss rate cuts” and “we didn’t spell rate cuts” in previous meetings. The minutes confirm this discussion. The ECB has at least for the first time spelled out rate cuts but still considers “the risk of cutting policy rates too early was still seen as outweighing that of cutting too late”. Here, it doesn’t come as a surprise that reputational costs are mentioned.

What to expect from the next ECB meeting

Two weeks from now, the ECB will meet again and judging from again a tsunami of different and diverging views and comments by Governing Council members since the January meeting, the debate on rate cuts is definitely on. In short, the different comments sound like risk assessments, ranging from the risk of cutting too early to cutting too late.

A fresh round of staff forecasts will support the discussion but these are unlikely to steer it into a certain direction. Why? The so-called technical assumptions, i.e., oil and gas prices, interest rates and the exchange rate, pointed to a slight downward revision of the ECB’s inflation forecasts in the first weeks of February. In recent days, the renewed increase in oil prices would already automatically change these forecasts. The sensitivity of the ECB’s projections to market shifts should make the central bank more hesitant to use the forecasts as its sole argument for any change in policy. More generally speaking, we don’t think that in two weeks the ECB will be ready to go any further than publicly repeating what we have heard already: that the ECB could look into rate cuts in the coming months.

Nevertheless, any rate cut decision will not be as easy as financial markets have priced in. There is the more general fear for the ECB that moving too early on rates could bring back inflation. The central bank will have found some comfort in a recent IMF working paper which concluded that most “unresolved episodes” of fighting inflation had involved “premature celebrations” when inflation had declined initially. This conclusion was drawn from an analysis of over 100 inflation shock episodes since the 1970s. In fact, we think that three criteria need to be fulfilled before the ECB will start cutting rates: i) long-term inflation forecasts (which currently have inflation back at 2.0% from the third quarter of 2025 onwards) need to remain unchanged; ii) nominal wage growth needs to come down to around 4%; and iii) actual inflation should be at least at around 2.5% for a few months, as the ECB would fear harming its credibility when cutting rates with an actual inflation rate of around 3%. Of course, any unexpected severe financial market stress or a severe recession of the eurozone economy could trigger an earlier rate cut.

Looking beyond the timing of a first rate cut, the next question is how far and how fast the ECB would go. Here, the fact that the eurozone economy is not in recession and risks to inflation and the inflation outlook remain to the upside (be it due to cyclical but also structural drivers) plays an important role. Financial market participants still seem to bet on a simple and swift reversal of the rate hikes of the last two years. However, this kind of a turnaround traditionally only takes place if the economy falls into a severe recession. As this is not our base case scenario (and also not the ECB's), we expect the ECB to only very gradually engage in a series of rate cuts. At least for this year, rate cuts by 25bp at meetings with new macro forecasts look like the most plausible scenario for this cautious and gradual rate cut cycle.

All in all, the minutes of the ECB's January meeting mark another subtle change of tone and content in the central bank's discussion and are a very small step towards eventual rate cuts. The March meeting will probably be the next small step with a further fine-tuning of communication. We still believe that we'll have to wait until June to see the first rate cut.

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