

ECB Preview: 'One is none' or 'one and done'?

A rate cut at next week's European Central Bank meeting looks like a done deal. Even this week's inflation and sentiment indicator data are unlikely to stop the central bank from cutting. To paraphrase R.E.M.: "oh no, they've said too much, they set it up"



The eurozone's wage growth drop is firming up expectations of a 25bp cut from the ECB next month

With an entire choir of ECB Governing Council members once again singing about rate cuts, anything other than a cut of 25bp next week would be a major surprise, not to mention a severe reputation loss for the central bank. In the past, rate-cut cycles were mainly triggered by either a recession or a crisis. Fortunately, none of these is currently threatening the eurozone economy. Consequently, there is no pressing need for the ECB to cut rates or to engage in a longer series of rate cuts. Instead, the ECB will cut rates not so much because it has to, but simply because it can. Or as Chief Economist Philip Lane put it: the ECB will "remove the top level of restriction".

Is inflation really fully under control?

Over recent months, the ECB has shown increasing confidence in its own forecasts and forecasting abilities. This confidence reached a new all-time high last week when ECB President Christine Lagarde stated that inflation was now under control. This confidence, however, might have been a bit premature. In fact, incoming inflation data since the start of the year has been slightly stronger than anticipated, mainly due to the service sector, and at least in the coming months inflation

could come in somewhat higher than the ECB had projected.

Remember that in its March projections, the ECB expected headline inflation to dive below 2% in the third quarter of 2025 and growth was expected to be back at potential by the fourth quarter of this year. These forecasts, however, were not only based on the technical assumptions of oil prices falling back to roughly \$75/bbl and a constant exchange rate but also on market expectations of some 150bp rate cuts by the end of 2025. At next week's ECB projections, somewhat higher oil price futures could slightly push up inflation forecasts, while higher interest rates should argue for somewhat lower inflation projections. At the same time, however, wage growth has not slowed down, yet, and both wage growth and inflation developments are likely to be bumpy. Wage developments, in particular, will remain crucial. Higher-than-expected wage growth in the first quarter was immediately dismissed by an ECB blog entry, which pointed to several one-off factors, base effects and a catching-up effect. More timely indicators according to the ECB, still point to wage moderation. However, as the blog entry also indicated that the March projections had assumed wage growth of 4.1% year-on-year this year, the risk of a reassessment remains high.

For next week, the new staff forecasts will hardly show any changes. We expect a slight upward revision of growth and inflation for this year but no changes to the profile and the timing of inflation dropping below 2%. At the same time, however, the risks of inflation remaining sticky and not being entirely under control are increasing.

The rationale behind next week's rate cut

At face value, the recent improvement in confidence indicators as well as a re-acceleration of inflation and higher wage growth could argue against a rate cut next week. However, the ECB's own communication over the last two months has made it almost impossible not to cut. Therefore, the rationale behind the cut will be to very gradually reduce the level of monetary policy restrictiveness without ending restrictiveness. With such a move, the ECB would actually again become a forward-looking central bank, instead of a central bank mainly focusing on actual inflation - a result of the newly gained confidence in its own forecasts. To put it simply, the ECB's forecasts of inflation dropping below 2% and staying there from the second half of 2025 onwards give the ECB the room to gradually reduce rates in line with the market expectations included in the staff projections.

'One is none' or 'one and done'?

Philip Lane's [interview](#) with the Financial Times also indicated that Lane, at least, is in favour of a series of rate cuts as he said that "the data flow over the coming months will help us decide the speed at which we remove more restrictiveness". So in his mind, it appears to be a question of pace not whether the ECB will remove more restrictiveness. However, looking beyond June, we think that the path for the Bank is anything but clear. The risk of reflation has clearly increased. Not only has US inflation been a good leading indicator for eurozone inflation over the last two years and is currently on an upward trend again, but there are also other factors closer to home pointing to new inflationary risks. The cyclical rebound in economic activity as well as structural labour shortages and upward pressure on wages could easily put the ECB's own inflation projections at risk again.

The question of whether next week's rate cut will fall into the category of 'one is none' or 'one and done' will remain unanswered but one thing is clear: a longer substantial rate-cut cycle will only materialise if inflation quickly returns to 2%. Any signs of reflation and also stronger economic

activity would limit the ECB's room for manoeuvre. This is why we expect a hawkish cut next week and an ECB that will, at least at the press conference, try not to give any forward guidance.

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