Article | 30 May 2025

ECB to cut rates by 25bp next week amid questions on the direction of travel

We expect the European Central Bank to cut rates by 25bp next week, as the risk of inflation undershooting more than offsets economic resilience

ECB President Christine Lagarde. A 25bp cut from the central bank won't do any harm if the economy continues to prove resilient or trade tensions fade away, and it will have been exactly the right decision if resilience falters

When gossip and broader European topics get more attention than the upcoming rate decision, the European Central Bank has to be on the right track when it comes to fulfilling its mandate of price stability. This could, at least, be the conclusion we can draw from looking at this week's main ECB events.

First, ECB President Christine Lagarde talked about a 'global euro moment' in a speech in Berlin, then an article in the Financial Times on a potential early exit from the ECB for Lagarde to lead the World Economic Forum brought in a good portion of gossip. Monetary policy or the future path of ECB interest rates? Nowhere to be seen.

Risk of inflation undershooting more than offsets economic resilience

The reason for the apparent absence of a controversial debate can only be that another 25bp rate cut at the 5 June ECB meeting is a done deal. However, the discussion could be more heated than market participants currently think. In fact, while there are plenty of reasons for the ECB to continue cutting rates, the central bank's hawks will no doubt find some arguments for putting their foot on the brakes.

Arguments for a 25bp rate cut

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 as a result of 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 alone should shave off roughly 0.3ppt off of the ECB's inflation forecasts. Remember that back in March, the central bank had expected headline inflation to come in at 2.3% in 2025, 1.9% in 2026 and 2.0% in 2027.

Chances are high that the ECB's staff projections next week will already show inflation dropping below 2% this year, roughly one year earlier than predicted in the March forecasts. At the same time, the disinflationary impact from the recent tariff saga has increased the risk of inflation undershooting, paving the way for another rate cut next week.

Arguments against a rate cut

Up until now, mainly due to frontloading effects, the eurozone economy has proven to be rather resilient, surprising to the upside in the first quarter. Soft indicators released since 2 April are more a reflection of ongoing uncertainty and the constant back-and-forth on tariffs than providing clear guidance on where the economy is heading.

This unexpected resilience, as well as an even less clear outcome than ever in the trade negotiations and tariff announcements, could motivate some ECB members to pause the rate-cutting cycle and instead wait until its July meeting.

Admittedly, the latest developments in the trade and tariff saga have somewhat strengthened the case for a pause next week. However, the expected downward revision of the inflation forecasts and a much earlier drop in headline inflation to below 2%, alongside the rising risk of inflation undershooting, should tilt the balance towards a 25bp rate cut. It is another rate cut that can be titled as an insurance or risk management cut. It won't do any harm if the economy continues to prove resilient or trade tensions fade away, and it will have been exactly the right decision if resilience falters.

Expect questions on the direction of travel, not only for interest rates

The press conference on Thursday could be more interesting than we've seen recently. Not only because we expect some questions on the WEF story and Lagarde's personal ambitions to live in a house with a lake view – but also because of hints at what could come next.

Unless trade tensions return with a vengeance, our suspicion is that the ECB would like to 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 more resilient the eurozone economy is, the more worried the ECB will be about the potentially inflationary impact of German fiscal stimulus in 2026 and beyond. We're therefore very curious to hear more about the famous direction of travel, both for the ECB and Christine Lagarde.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

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