

## ECB's 'good place' threatened by tariffs and a stronger euro

The stronger euro and latest tariff threats have added to the European Central Bank's disinflationary concerns. In our view, it is not enough to justify a rate cut on 24 July, but rather very likely at the September meeting



ECB President Christine Lagarde

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With the June decision to cut the main policy interest rate to 2%, the ECB thought it was in a ‘good place’, hoping for some typical wait-and-see monetary policy over the coming months.

We had also expected a kind of ECB summer lull, secretly hoping to watch the July ECB press conference while relaxing with a summer cocktail in hand. Well, so much for wishful thinking. The reality looks different once again, and the ECB’s ‘good place’ has become somewhat less comfortable recently due to the new tariff threat for Europe and the continued strengthening of

the euro.

Next week's meeting, which initially looked like a summer breather, has become more exciting.

## **A stronger euro and new tariff threats bring more disinflationary risks**

In recent months, the euro's appreciation has dominated financial markets. Since the start of the year, the euro has climbed roughly 15% against the US dollar and about 7% in nominal effective exchange rate terms. Even since the ECB's June meeting, the euro's effective exchange rate has risen another 2%. Although there has been some levelling off recently, the stronger euro is now a clear concern for policymakers. While the overall impact may seem modest, current exchange rates – if sustained – would mean the ECB's inflation forecasts for this year and next would be slightly lower than anticipated in June.

Historically, the ECB has been reticent about exchange rate movements, typically asserting that it has no explicit exchange rate target and considers the euro's value as just one among many policy transmission channels. That's why the recent flurry of comments from ECB officials about the stronger euro has been so surprising. Vice President Luis de Guindos even called levels above 1.20 USD/EUR “tricky and complicated.” It's worth remembering that it's not a specific level, but the pace of appreciation, that usually worries the ECB.

In 2004, then-president Jean-Claude Trichet described a rapid move from 0.87 to 1.30 USD/EUR as “brutal.” His successor, Mario Draghi, was less dramatic but still noted that exchange rate strength amid low inflation was a serious concern. Next week, it's likely the ECB will take a cautious tone, downplaying the currency's level but noting its potential to fuel disinflation.

There's another complication: President Donald Trump's latest threat of 30% tariffs on European goods. In June, the ECB's baseline scenario assumed just a 10% tariff, and even the downside scenario only went up to 20%. A 30% tariff would be more damaging to the eurozone economy, even if European retaliation eventually pushed inflation higher.

## **ECB set to stay on hold next week, but not done with cuts – yet**

All things considered, a wait-and-see approach remains the most probable course of action for the ECB next week. With the next potential tariff escalation not expected until 1 August, there's little reason for a pre-emptive rate cut now. The ECB's policy is to act on measures only once they're in effect, not when they're merely announced. These days, it is a wise decision. At the same time, the strengthening of the euro since the last meeting has not been strong enough to justify a rate cut next week. This is why, despite higher uncertainty and probably only after a heated debate, we expect the ECB to stay on hold next week.

The stronger euro and the renewed tariff threats are clearly increasing disinflationary pressures for the eurozone, risking inflation undershooting and increasing the likelihood of more ECB rate cuts. However, given the longer-term risks of higher, not lower, inflation on the back of fiscal stimulus, the ECB will be very reluctant to opt for preemptive rate cuts at the current juncture. We maintain our forecast for another rate cut at the September meeting, though it seems President Christine Lagarde's summer break may be shorter and less tranquil than originally hoped.

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