ECB cuts rates by 25bp and keeps door wide open for more

The European Central Bank decides to play it safe and cut rates by 25bp. Dropping the reference to 'restrictive' monetary policy suggests there are more rate cuts to come

ECB President, Christine Lagarde

The door is wide open for more cuts

The level of the ECB's deposit rate now stands at 3%. And, clearly, less is more. No, this is no recommendation for the upcoming Christmas menu; the ECB's decision to cut interest rates by 25bp also doesn't mean that all of a sudden, it has become a supporter of the degrowth theory, simply embracing and accepting weak growth in the eurozone.

Instead, today's decision reflects a compromise between growth and inflation worriers, a gut feeling vs a model-based approach and doves against hawks. At the same time, the ECB has dropped the reference to still-needed restrictiveness, keeping the door wide open for more rate cuts to come.

Playing it safe

Since the October meeting, confidence indicators have weakened, while headline inflation has accelerated. Stagflationary tendencies are a very uncomfortable situation for the ECB. At the same time, negative risks have clearly increased. Think of the potential adverse effects of US economic policies over the coming months, political instability in the two largest eurozone economies, and now even a public finance crisis in France.

The problem for the ECB is that these possible risks will not be reflected in the latest round of staff projections. Not only was the cut-off date of these forecasts before the latest political woes in France, but the ECB normally also applies a "no policy change" assumption. With a pinch of irony, in the case of France, this assumption has received a completely new meaning. This is what made today's decision so difficult: follow your gut feeling or, rather, the model-based approach. The ECB decided to play it safe and cut by 25bp.

New forecasts almost predict 'Goldilocks'

Quickly turning to the new staff projections, inflation is expected to average 2.4% in 2024, 2.1% in 2025, 1.9% in 2026 and 2.1% in 2027.

Core inflation is expected to come in at 2.9% in 2024, 2.3% in 2025 and 1.9% in both 2026 and 2027.

At the same time, ECB staff haven't lost their optimism regarding growth, expecting eurozone growth to come in at 0.7% in 2024, 1.1% in 2025, 1.4% in 2026 and 1.3% in 2027.

Particularly, the 2025 forecast looks very optimistic, as the ECB has not taken into account Trump and France and is still banking on a return of the consumer. At face value, these forecasts even look like a Goldilocks scenario. Too good to be true.

Still fighting past mistakes, running the risk of making new ones

Looking ahead, the risk for the ECB will now be that while it is still highly guided by the past mistake of underestimating inflation and reacting too late, it could now end up overestimating growth and being too late to react again. Let's hear what ECB president Christine Lagarde has to say on today's decision and the outlook for the ECB at the press conference starting at 2.45pm CET.

Author

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