Minutes of the ECB's December meeting confirm easing bias

Doubts about the eurozone economy and increasing concerns about inflation undershooting support the ECB's easing bias. Another 25bp rate cut at the upcoming meeting looks likely

European Central Bank President Christine Lagarde

At the ECB's December meeting, the most notable topics included the debate over the size of the rate cut (25bp vs 50bp), a still relatively optimistic outlook for growth and inflation, and the decision to temporarily disregard any potential impact of the US elections on the eurozone economy. The minutes offered some interesting insights on these matters.

The highlights

- An increasing easing bias is evident, as ECB staff projections suggest that meeting the forecasts necessitates rate cuts in line with market expectations. According to the December baseline projections, lower policy rates and further easing of financing conditions are essential for stabilising inflation.
- More easing bias as the ECB focussed on the speed of further rate cuts but not the general need for rate cuts. "In terms of risk management, in the event of upside shocks to the

inflation outlook and/or to economic momentum, monetary easing would be able to proceed more slowly than the path embedded in the December projections. Equally, in the event of downside shocks to the inflation outlook and/or to economic momentum, it would be able to proceed more quickly."

- The ECB has finally stepped away from 2.0% as the definition of its inflation target. The minutes state: "...the disinflation process was sufficiently advanced for the emphasis in communication to be adjusted, from expressing determination to ensure that inflation would 'return to the target' to pledging that it should 'stabilise sustainably at the target'. This alternative expression better described the Governing Council's primary task on an ongoing basis."
- Doubts about growth forecasts in staff projections. "However, the point was made that even after the downward revision to GDP growth over the projection horizon, the baseline probably remained too optimistic. It was based on the assumption that the trade policies of Europe's key trading partners would remain unchanged and stronger foreign demand would support euro area exports. Although it was fully acknowledged that the projections were reasonable in such uncertain times, trade policies in the United States, above all, could play out in an adverse direction. While the effects on euro area growth would be clearly negative, the impact on inflation was rather uncertain."
- The word "undershooting" came up three times. "It was remarked that, if the economy did not pick up, the likelihood would increase that inflation would undershoot the target further down the road."
- Intense discussion on a 25bp versus 50bp rate cut. "Some members noted that a case could be made for a 50bp rate cut at the current meeting and would have favoured more consideration being given to the possibility of such a larger cut. These members emphasised the deterioration in the euro area economic outlook over successive projection exercises and stressed that the risks to growth – amid many global and domestic political uncertainties – were tilted to the downside. A larger rate cut would provide insurance against downside risks to growth."

All in all, the minutes clearly show the ECB's easing bias based on doubts about the growth forecasts and the growing risk of inflation undershooting.

ECB to continue cutting rates

The next ECB meeting is in two weeks. The only really interesting data points until then will be PMIs and the Ifo index, as well as on the day of the ECB meeting the first estimate for fourth-quarter GDP growth and the European Commission's economic sentiment indicator. This means that, with all available information so far, the ECB will be confronted with a mild version of stagflationary tendencies: continued sluggishness of the economy and accelerating inflation. This is a complication for the ECB, potentially widening the current divergence between hawks and doves.

However, comments from ECB officials since the start of the year suggest that higher inflation in December and possibly also in January will not stop the central bank from cutting rates further. At 3%, the deposit interest rate is still restrictive and too restrictive for the current weak state of the eurozone economy. The recent surge in bond yields has also worsened financial conditions in the eurozone. Even if some argue that there is very little monetary policy can do to solve structural issues, political instability and uncertainty in many countries will force the ECB to continue doing the heavy lifting.

Also, as long as the current inflationary pressure is anticipated to diminish over the year, the ECB is likely to overlook the present inflation resurgence. While the experience of being slow to address rising inflation will deter the ECB from adopting ultra-low rates, the desire to stay ahead of the curve remains a compelling reason to return interest rates to neutral as swiftly as possible.

All of this means that we see the ECB continuing to cut rates. Bringing rates at least to the upper end of estimates for the neutral interest rate, ie 2.5%, looks like a no-brainer. If the eurozone economy remains weaker than the ECB's December forecasts predict, cutting rates further will become unavoidable. Let's not forget that the ECB's December forecasts used a terminal rate of below 2%. Just to deliver the outcomes of the December forecasts means that the ECB will have to cut rates by a total of 100bp. The next ECB meeting in two weeks will bring the next cut.

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