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Minutes of December meeting show ECB still not spelling out rate cuts

The European Central Bank is more cautious about the growth outlook but far from relaxed about inflation. The minutes of the ECB's December meeting show that the Bank was still far away from discussing rate cuts. This is unlikely to change at next week's meeting

ECB President Christine Lagarde

Due to the Christmas break, the minutes of the ECB's December meeting are only released one week ahead of the next meeting. Who needs yesterday's stories, you might ask yourself. Well, when it comes to the ECB, we simply read everything and the just-released minutes of the December meeting still have some interesting insights for next week's meeting.

Here are the main highlights from the December minutes

Growing concern regarding the economic outlook. The minutes show that some ECB members "argued that the December staff projections for growth in the near term might be too optimistic overall", pointing to recent soft indicators but also more structurally to the risk that private consumption will not pick up in 2024.

Finally talking about structural weakness. For a long while, the ECB had basically ignored the risk of structural weakness in the eurozone economy. At the December meeting, this seems to have changed as the staff projections incorporated a lower estimate for potential eurozone growth.

Unanimous on inflation. The debate on inflation, its drivers and its outlook was very unanimous in December. The disinflationary trend was acknowledged and the importance of actual inflation outturns stressed. It seems as if the ECB currently sees actual inflation numbers as the best driver of inflation expectations.

The last mile. Some time was spent on the discussion of the last mile in bringing inflation back to target. Some ECB members mentioned high services inflation as a clear challenge for this last mile. “Further progress in disinflation thus rested on a number of benign assumptions and on inflation expectations remaining well anchored. In addition, potential rigidities in prices and wages – stemming for example from backward-looking features of wage negotiations – and the impact of structural shocks on the economy and inflation dynamics could well contribute to “last mile”-type delays in disinflation.”

Rate cuts still not spelled out. The only mention of rate cuts in the minutes was when talking about market expectations. In the ECB’s policy discussion, there was no debate on rate cuts. Instead, “it was stressed that there was no room for complacency and that it was not the time for the Governing Council to lower its guard. Caution was warranted, as inflation would probably pick up in the near term and there were continued uncertainties in relation to wages and underlying inflation dynamics. This suggested that it was still too early to be confident that the task had been accomplished.”

What to expect from next week's meeting

Looking at next week’s meeting, we argued in our ECB preview that the Bank should resist the temptation to push back very aggressive market expectations about coming rate cuts. Well, it seems as if ECB officials did not read our preview. In fact, recent days saw an explosion of national central bank governors commenting on the possibility and timing of rate cuts. There were, in fact, so many different comments as to make ECB watchers dizzy, wondering why the Bank had not extended the quiet period or at least convened an official Governing Council meeting in Davos. In the end, it was ECB President Christine Lagarde who had to weigh in, hinting at a first rate cut in June. Funnily enough, it was only in November that Lagarde was quoted as saying that the ECB would not start cutting rates for “the next couple of quarters”. Once again providing evidence that central bankers should refrain from giving too-explicit forward guidance.

In any case, even if actual growth continues to turn out weaker than the ECB had expected every single quarter, as long as the eurozone remains in de facto stagnation mode and doesn’t slide into a more severe recession, and as long as the ECB continues to predict a return to potential growth rates one or two quarters later, there is no reason for the ECB to react to more sluggish growth with imminent rate cuts. Also, the job to bring inflation back to target is not done yet. In the coming months, inflation developments will be determined by two opposing trends: more disinflation and potentially even deflation as a result of weaker demand, but also new inflationary pressures due to less favourable base effects, new inflationary pressures as a result of the tensions in the Suez Canal as well as government interventions in some countries, above all Germany.

Against this background of rather more upside than downside risks to inflation, any rate cut at the current stage doesn’t make any sense, at least not in the eyes of the ECB. In fact, the new inflationary risks bring back the Arthur Burns argument. No central banker wants to be another Arthur Burns, the Fed chairman in the 1970s who is often said to have cut interest rates prematurely, preparing the ground for a second inflation leg. Or, to put it differently, central bankers missed the inflation upswing; they now want to be fully sure of the inflation downswing and will, therefore, by definition be staying well behind the curve.

In the past, central bankers invested a lot of (communication) effort in being readable and predictable. At the current juncture, however, the question is whether the ECB should really care about market expectations. The irony of market pricing right now is that it makes the need for actual policy rate cuts less urgent. Financing conditions have eased since early December, doing the work actual rate cuts should do: supporting growth but also pushing up inflation risks. Consequently, the more aggressive the market prices future rate cuts, the less needed and likely those cuts will be.

Over the last few days, ECB officials have not been able to resist the temptation to push back market pricing - at the risk of being overtaken by actual events and data. With Lagarde's comments from yesterday, the course is set for next week's meeting. The main challenge will now be not to change communication and guidance once again.

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