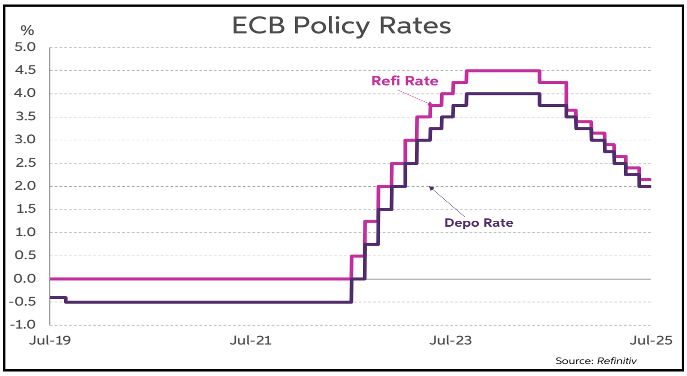
ECB Watch

AIB Treasury Economic Research Unit

24th July 2025

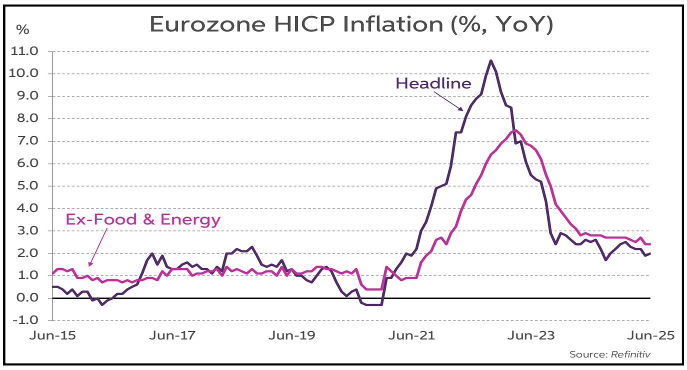
ECB on hold with no signs of a near term rate cut

The July ECB Governing Council meeting saw the central bank leave interest rates on hold. The deposit and refi rates were maintained at 2.00% and 2.15%, respectively. This was the first ECB meeting of 2025 where the central bank refrained from lowering rates. However, this outcome was very much in line with market expectations. At each of its previous four meetings this year, the ECB had cut rates by 25bps, bringing the total magnitude of rate cuts to 200bps since the started of the easing cycle in June 2024. Today's decision to keep policy on hold was unanimous.



The meeting statement from the ECB was very short, and offered little in the way of new guidance for the market to digest. However, it did provide some rationale for today's decision to leave interest rates unchanged. The statement noted that "inflation is currently at the 2% medium-target", and that "the incoming information is broadly in line with the Governing Council's previous assessment of the inflation outlook". The ECB also highlighted that "domestic price pressures have continued to ease", while "the economy has so far proven resilient". Against this backdrop and given "the environment remains exceptionally uncertain, especially because of trade disputes", the ECB opted not to alter rates today.

The most recent detailed assessment by the ECB on the economic outlook was published at its previous meeting in June. These updated GDP projections contained only minor revisions. The ECB is continuing to forecast GDP growth of 0.9% for this year. It sees GDP averaging 1.1% in 2026 (was 1.2% in March) and is pencilling in growth of 1.3% (no change) for 2027. This is a very subdued growth outlook. The ECB commented today that it continues to views the risk to its economic outlook as remaining tilted to the downside. However, it also noted that that if trade and geopolitical tensions eased, sentiment and growth would likely be higher.



In terms of its inflation outlook, the June forecasts saw downward revisions. The ECB expects inflation to average 2.0% (was 2.3%) this year and 1.6% (was 1.9%) in 2026. For 2027, it sees inflation averaging 2.0% (no change). The core rate is expected to average 2.4% (was 2.2%) this year. The projection for 2026 was revised marginally lower to 1.9% (was 2.0%), and the core rate is anticipated to remain at that level in 2027. Overall, these projections suggest that the ECB maintains a benign outlook for inflation. Indeed, at today's press conference President Lagarde stated that her inflation expectations are, "strongly anchored around 2% in the short term, but also in the long term".

However, the key point emphasised by President Lagarde at today's press conference, was that the ECB is now in a "wait and watch situation". When questioned about a potential undershooting of inflation, she stated that the ECB would not be moved by a "minor deviation", and that the 2026 forecasts have an undershoot baked in already, largely due to base effects. On the flip-side, when asked if the resolution of trade tensions could shift focus away from a rate cut and towards potential rate hikes, she kept her options open, and stated she "would not exclude anything for sure". At the same time, when discussing the near-term outlook more generally, President Lagarde reiterated the message from previous ECB meetings, that the central bank will follow a "meeting-by-meeting" and "data-dependent" approach to set the appropriate stance of monetary policy. **However, the bar for another rate cut from the ECB appears to have risen since June.**

Market expectations have firmed today in response to the ECB's messaging. The market is now less sure that the ECB will cut rates again. Futures contracts are now attaching a 65% chance to a rate cut by year end, and an 80% probability of a terminal rate of 1.75% by mid-2026. **Our long-held view is that the deposit rate will settle at 2% this year.** However, given the heightened level of uncertainty that remains, a rate cut cannot be completely ruled out. Overall though, the tone from today's ECB meeting reinforces our outlook for a 2% terminal rate.

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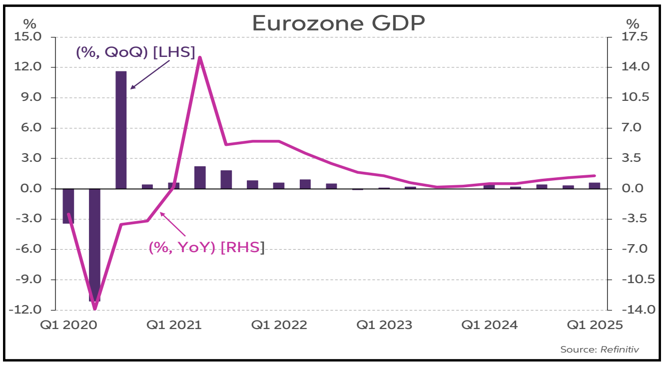
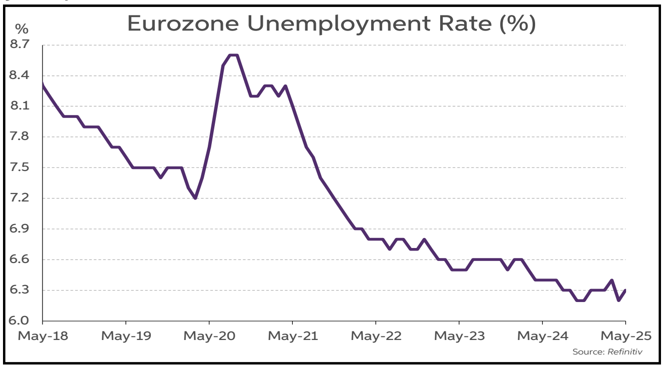
Despite uptick, Eurozone growth to remain modest



Having registered very modest growth over the past two years, the Eurozone gathered some steam at the start of 2025. Overall, the economy expanded by 0.8% in 2024, up from 0.5% in 2023. However, GDP rose by 0.6% q/q in Q1 2025, the fastest pace of growth since Q2 2022. In year-on-year terms, Eurozone GDP was up by 1.5% in the quarter. Both domestic demand and net trade boosted GDP in Q1. Consumer spending increased by 0.2% q/q, adding 0.1 percentage points (p.p.) to growth, while investment jumped by 1.8%, contributing 0.4 p.p. to the total. Exports rose by 1.9% (this was partly due to tariff front-running), outpacing a 1.4% increase in imports, meaning net trade boosted GDP by 0.3 p.p.. Meantime, government spending was flat, and inventories clipped 0.2 p.p. from growth.

However, the available hard data for Q2 have been mixed at best. Retail sales continued to rise steadily in April, increasing by 0.3%, following similar rates of expansion in the two months prior, but they contracted sharply by 0.7% in May. Furthermore, the contraction in May was broad-based, with all of the major subcategories declining. Meanwhile, industrial production has been volatile recently. Production rebounded by 1.7% in May following a 2.2% decrease in April. However, this came after a strong first quarter, which means industrial output was 3.7% higher in year-on-year terms in May. **Meanwhile, survey data for Q2 are consistent with a more moderate pace of expansion.** The services sector continues to outperform manufacturing, albeit the gap between the two surveys has narrowed. Indeed, the average services PMI reading fell to 50.1 in Q2, down from 51.0 in Q1, whereas the manufacturing PMI increased to 49.3 in Q2, compared to 47.6 in Q1. Elsewhere, consumer confidence has steadily improved throughout the summer, having fallen sharply in April.



Regarding the labour market, conditions remain tight. Employment expanded for a sixteenth successive quarter in Q1, up by 0.3% q/q and by 0.9% y/y. It means that the number of people at work has risen by 8.6m or 5.2% since the end of Q4 2019. At the same time, the unemployment rate is near its all-time low at 6.3% in May. Despite tight conditions though, wage growth has cooled somewhat. Wages in the Eurozone rose by 2.5% y/y in Q1, down from 4.3% y/y in Q1, and 5.2% y/y a year earlier. Furthermore, the Indeed wage tracker - a more frequent measure of wage pressures - indicates that wages have risen more slowly in recent months. It shows that wages rose by 2.8% y/y on average in Q2, down from 3.3% y/y during the same period in 2024.

On the inflation front, a gradual downtrend has re-emerged this year. The headline rate stood at 2.5% in January, but it declined throughout the first half of the year, falling to a low of 1.9% in May, before edging higher to 2.0% in June. Meantime, underlying inflation, which had been proving to be quite sticky, stuck between 2.6-2.9% since April '24, eased to 2.4% in May and remained at that level in June. This is partly due to a drop in services inflation this year, which stood at 3.3% in June. Looking ahead, the ECB expects inflation to average 2.0% this year,1.6% in 2026, and 2.0% in 2027. Core inflation is seen as running at 2.4% this year, and at 1.9% in the period 2026-27.

In summary, the Eurozone economy maintained a modest pace of growth last year, before registering an uptick in activity levels at the start of 2025. Furthermore, the labour market remains strong, with employment rising and unemployment near its all-time low. Secondly, the resumption of the disinflationary trend and rate cuts in the first half of the year should support real incomes and consumer spending. At the same time, higher fiscal spending in Germany on defence and infrastructure, as well as higher defence spending at the EU level could support growth in the medium-term. Proposed changes to the EU budget, which would combine regional and agricultural funds into a single pot for countries to dole out, may also support economic development in the medium to long-term, although the budget won't come into effect until 2028. **In the meantime, the Eurozone faces a number of significant challenges.** Most pressingly, the bloc must agree a trade deal with the US to avoid 30% tariffs, which is higher than previously outlined in April. Thus, despite the recent uptick, moderate rates of growth are expected to remain the norm in the Eurozone. The ECB sees GDP expanding by 0.9% this year and by 1.1% in 2026.

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