ECB Watch

AIB Treasury Economic Research Unit

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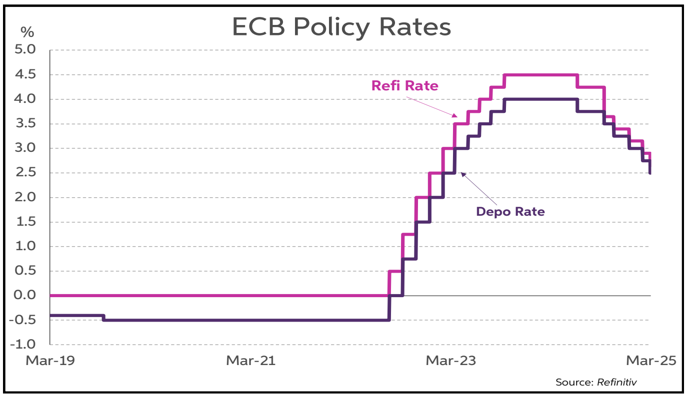
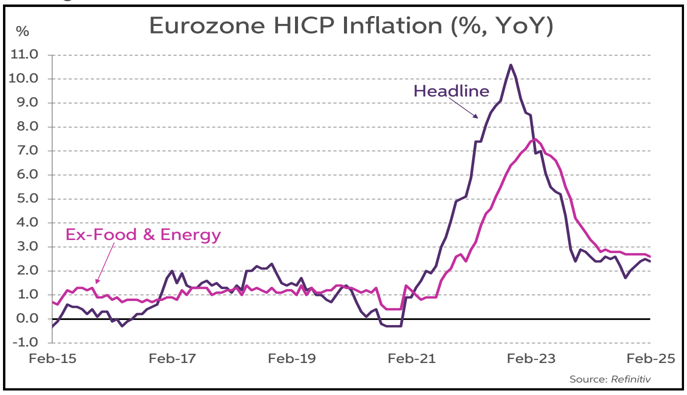
ECB cuts again, but the policy outlook is less clear

The March meeting of the ECB Governing Council saw the central bank cut interest rates for a second consecutive time this year. It reduced them by 25bps, with the Deposit rate lowered to 2.50%, while the Re-fi rate was decreased to 2.65%. This marked the sixth 25bps rate cut since the ECB started its easing cycle last June. The changes to official interest rates were in line with market expectations. The decision was by consensus, with one Governing Council member (Holzmann) abstaining from the vote.



The meeting statement outlined the ECB's rationale for its decision to cut interest rates again, based on the updated "assessment of the inflation outlook, the dynamics of underlying inflation and the strength of the monetary policy transmission". In this regard, the Governing Council noted that "the disinflation process is well on track", with inflation continuing to develop "broadly as staff expected". However, in an important change to the meeting statement, the ECB now states that "monetary policy is becoming meaningfully less restrictive", although the impact of past rate hikes is still acting as a "headwind to the easing of financing conditions".

The March ECB meeting also saw the release of the latest set of macro forecasts. Growth expectations were downgraded. The ECB is forecasting GDP growth of 0.9% (from 1.1%) for this year. It sees GDP averaging 1.2% in 2026 (was 1.4%) and is pencilling in growth of 1.3% for 2027 (unchanged). This is a very subdued growth outlook. It should be noted though, that the staff projections do not factor in the EU's plan to increase defence spending, or the announcement to change the debt brake and to set-up a €500bn infrastructure fund, in Germany. At the press conference, President Lagarde highlighted that these plans could be "a boost to the European economy".



In terms of the outlook for headline inflation, the March forecasts saw modest revisions from the December projections. The ECB expects inflation to average 2.3% this year (from 2.1%) and 1.9% in 2026 (unchanged). For 2027, it sees inflation averaging 2.0% (from 2.1%). The upward revision in headline inflation for 2025 reflects stronger than previously anticipated energy price dynamics. However, the core rate is now expected to average 2.2% this year (from 2.3%). The projection for 2026 was revised marginally higher to 2.0% (was 1.9%), while further out, it is anticipating core inflation to average 1.9% during 2027 (unchanged). Overall, it is clear that the ECB maintains a benign outlook for inflation in the Eurozone.

As referenced above, the 25bps rate cut was fully priced in by markets. Therefore, investors were focused on what guidance, if any, was provided by the Governing Council in relation to the outlook for official Eurozone interest rates. In this regard, the meeting statement continued to emphasise that the central bank will follow a "data-dependent" and "meeting-by-meeting approach" and is not "pre-committing". President Lagarde doubled-down on this point, stressing that the "uncertainty is huge", meaning that the ECB will have to be "agile" when setting policy. Notably, she stated, **"If the data points to a pause, we will pause, if the data points to a cut, we will cut".** Thus, while the ECB maintains a willingness to cut rates again if warranted, the direction of monetary policy has become less clear.

In terms of market expectations, futures contracts suggest traders expect the ECB to pause in April, before cutting rates again by 25bps in June. In total, 40bps of policy easing from the ECB is anticipated over the remainder of this year. **This would see the Deposit rate end the year at circa 2%**. Given the muted growth outlook and continued downtrend in inflation, the Deposit rate settling in and around the 2% level by end year seems a plausible scenario in our view.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2024	2025	2026	2027
HICP	2.4	2.3	1.9	2.0
Real GDP	0.7	0.9	1.2	1.3

Forecasts are mid-point of a range and based on the assumption that Brent crude oil prices will average $74.7 in 2025, $70.3 in 2026, and $68.7 in 2027 *Source ECB, March 2025*

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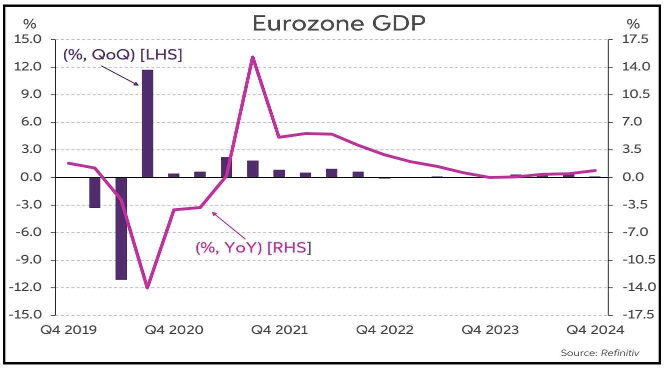
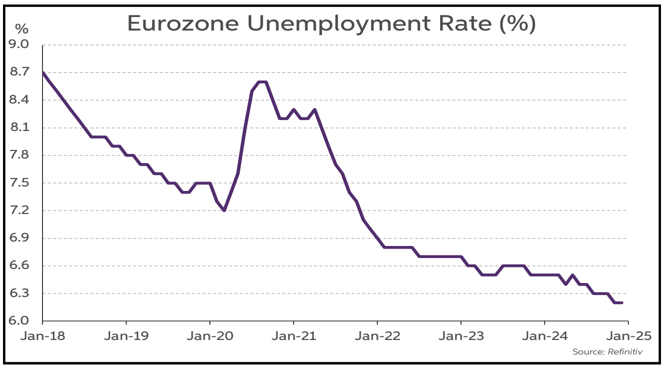
Growth remains muted in the Eurozone



The Eurozone economy registered modest growth in 2024. However, the expansion in activity levels was modest, with GDP rising by 0.2-0.4% q/q in the first three quarters of the year, and by just 0.1% in Q4. **Overall, the economy expanded by 0.7% in 2024, up from 0.5% in 2023.** Among the largest national economies in the region, growth continued to be uneven. Germany remained in the doldrums, with GDP contracting for a second consecutive year, by 0.2% in 2024, amid a continued slump in the manufacturing sector and weak consumer spending. In contrast, the Spanish economy registered robust growth of 3.1% last year, while the French and Italian economies recorded more modest expansions of 1.1% and 0.5%, respectively.

Survey data suggests activity in the Eurozone remained muted at the start of 2025, albeit there are tentative signs that the economy may see some improvement in the pace of growth. The manufacturing PMI remains firmly in contraction mode, where it has been since July 2022, but it rose to 47.6 in February, its highest level in two years. Overall, it has averaged 47.1 so far in Q1, up from 45.4 in Q4, consistent with a slower pace of contraction in the sector. Meanwhile, the services PMI has stayed in expansion territory, averaging 51.0 so far in Q1, compared to 50.9 in Q4. At the same time, the EC Economic Sentiment index has trended upwards at the start of the year, supported by broad-based improvements in consumer, industrial and services sector confidence. **In terms of the available hard data though, retail sales fell by 0.3% in January, having flat-lined in December.** In year-on-year terms, retail sales were 1.5% higher in January.



Regarding the labour market, conditions remain tight. The unemployment rate remained at its historic low of 6.2% in January. Meanwhile, employment expanded for a fifteenth successive quarter in Q4, up by 0.1% q/q and by 0.9% y/y. It means that the number of people at work has risen by 7.9m or 4.9% since the end of Q4 2019. Tight conditions are contributing to elevated wage growth. The ECB negotiated wages metric rose by 5.4% y/y in Q3, the fastest pace of increase since Q1 1993, before easing to 4.1% y/y in Q4. However, the Indeed wage tracker - a more frequent measure of wage pressures - indicates that wages have been rising more slowly in recent months. It suggests that wages rose by 3.1% y/y on average between November and January, the slowest rate of increase since February 2022.

On the inflation front, the downtrend has been more limited in recent months. The headline rate fell to a low of 1.7% last September, its lowest level since April 2021, but re-accelerated to 2.5% in January before edging lower to 2.4% in February. Meantime, core inflation is proving to be quite sticky. The ex-food and energy rate has been stuck between 2.6-2.9% since April'24, albeit, it eased to the bottom of this range in February. The core rate that excludes food, energy, alcohol and tobacco had been running at 2.7% in the five months to January, before inching down to 2.6% in February also. Services inflation in particular remains elevated, although it slowed to 3.7% in February, its lowest level since April 2024. Looking ahead, the ECB expects core inflation to average 2.2% this year, before falling to 2.0% in 2026, and settling at 1.9% in 2027.

In summary, the Eurozone economy saw a modest uplift in activity last year but economic growth remained muted. On a positive note, the labour market is strong, with employment rising and unemployment at an all-time low. Secondly, a resumption of the disinflationary trend this year and further rate cuts should support real incomes and consumer spending. At the same time, political turbulence in France and Germany has quietened for now, albeit fiscal issues in the former and subdued growth prospects in the latter still pose substantial potential headwinds for the Eurozone overall. However, the announcement of higher fiscal spending in Germany on defence and infrastructure, as well as higher defence spending at the EU level should support growth in the medium-term. **Overall, the outlook for the Eurozone remains challenging.** A more protectionist and isolationist US may also weigh on Eurozone growth. US policies are already generating significant uncertainty which could harm the open Eurozone economy. Against this backdrop, the ECB sees GDP expanding by 0.9% this year and by 1.2% in 2026.

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