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Review: ECB Cuts Rates And Pledges "Ready and Agile" In the Future

by

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Executive Summary

- **Decision Made:** *The European Central Bank (ECB) delivered another rate cut in April,* i.e *i)* interest rate on the 'main refinancing operations' to 2.40%; *ii)* interest rate on the 'marginal lending facility' to 2.65%; and especially the key *iii)* 'deposit facility' to 2.25%. The ECB didn't pre-commit "to a particular rate path," and future decisions will be taken meeting-by-meeting, following its usual three-pronged approach about its reaction function confirmed. The decision was unanimous. In the future, ECB's decisions will be informed by two main concepts: "Readiness and Agility," to respond to incoming shocks.
- **Policy Discussion**: *Amid rising trade policy uncertainty, the ECB is pivoting decisively toward growth***.** It cut interest rates by 25 basis points to 2.25%, down from a mid-2023 peak of 4%, citing persistent tariff tensions and a weakening outlook. The move, priced in by markets with 94% certainty, was unanimously agreed, with no support for a larger cut.

  Tariff turmoil—especially from the U.S.—has been a key factor behind the shift, as it weighs on business confidence, investment, and consumer spending. And also because it impacted the Euro in an unfavourable way, i.e. by making it stronger. Lagarde described the current environment as a "negative demand shock" and warned of continued risks from geopolitical tensions, market volatility, and climate-related price pressures.

  Although the eurozone likely grew in Q1, the ECB remains cautious. Inflation is easing, with most indicators pointing to a gradual return to the 2% target. However, a stronger euro could lower inflation, while higher import prices or extreme weather could push it back up.

  Lagarde also challenged conventional benchmarks, calling it "meaningless" to assess monetary restrictiveness based on the neutral rate—a concept she dismissed as irrelevant in a world full of shocks. The ECB dropped the term "restrictive" from its statement and signaled it is keeping its options open, with expectations high for further rate cuts.

Key Picture: European Central Bank Key Forecasts – 2024-2027

		2024*f*		2025*f*		2026*f*		2027*f*	
	Latest reading	March Projections	December Projections	March Projections	December Projections	March Projections	December Projections	March Projections	December Projections
GDP *(real growth, y-o-y)*	1.2	**0.8**	**0.7**	**0.9**	**1.1**	**1.2**	**1.4**	**1.3**	**1.3**
Inflation *(%, y-o-y)*	2.2	**2.4**	**2.4**	**2.3**	**2.1**	**1.9**	**1.9**	**2.0**	**2.1**
Core-inflation *(%, y-o-y)*	2.4	**2.8**	**2.9**	**2.2**	**2.3**	**2.0**	**1.9**	**1.9**	**1.9**
Unemployment *(%, y-o-y)*	6.1	**6.4**	**6.4**	**6.3**	**6.5**	**6.3**	**6.3**	**6.2**	**6.1**

Source: ECB '*Macroeconomic projections*' December *2024 and* March *2025 Note:* Latest readings: 1. GDP for Q4 2024; 2. Unemployment for February 2025; 3. Inflation for March 2025. *Inflation = Harmonized Index of Consumer Prices (HICP).

Analysis

- **DECISION MADE**: *On April 17, the ECB cut its key interest rates, marking its seventh reduction in borrowing costs since June 2024.* In line with consensus, and in an unanimous decision, the European Central Bank (ECB) cut its main policy rates by 25 bps i.e *i)* interest rate on the 'main refinancing operations' to 2.40%; *ii)* interest rate on the 'marginal lending facility' to 2.65%; and especially the key *iii)* 'deposit facility' to 2.25%. The GC highlighted that Transmission Protection Instrument can be activated to address unjustified and disorderly market conditions that threaten the smooth transmission of monetary policy across the euro area.

  In its forward guidance, the ECB stated that the decisions will be still taken meeting-by-meeting, with its usual three-pronged approach about its reaction function confirmed, especially in current conditions of uncertainty. The ECB is not on a pre-set rate path. In the future, ECB's decisions will be informed by two main concepts: "Readiness and Agility," to respond to incoming shocks.

  In terms of *Balance Sheet policies,* the GC has decided to move forward with the normalization of the balance sheet in June. GC confirmed that it will reduce the Eurosystem's holdings of securities under the PEPP, as reinvestment stopped in December. The process for reducing PEPP holdings will generally follow the same approach as the APP. The APP portfolio is gradually decreasing at a steady and predictable rate, as the Eurosystem has stopped reinvesting the principal from maturing securities.

- **POLICY DISCUSSION:** *Amid rising trade policy uncertainty, the ECB is shifting its focus firmly toward growth.* The ECB Bank cut interest rates by 25 bps, bringing the deposit facility rate down to 2.25% from its mid-2023 peak of 4%, amid mounting concerns over euro zone growth due to global tariff tensions. Markets had largely expected the move, with a 94% chance of a cut priced in. During the press conference, Lagarde confirmed the ECB's rate cut was unanimous—no one argued for a larger move like 50 basis points. While this option was discussed, the decision reflected a shared view.

  Recent tariff turmoil—despite some easing of U.S. and retaliatory measures—as a major driver behind the ECB's decision, given persistent fears about its impact on economic growth. The central bank is maintaining a cautious stance—keeping its options open as trade tensions weigh on confidence and dampen the economic outlook. Market turbulence linked to tariffs may weaken domestic demand and, in turn, lower inflation, while extreme weather could drive food prices higher than expected. The ECB sees deteriorating conditions and may cut rates below neutral if tariffs prove deflationary.

  The ECB acknowledges that the economic outlook remains highly uncertain, with risks skewed to the downside, as Lagarde described the current environment caused by Trump's tariffs as a "negative demand shock". Geopolitical tensions, market volatility, and trade disruptions are dampening business investment, while consumer caution may further slow spending. Still, early data suggests the euro area likely grew in the first quarter, as Lagarde confirmed during the press conference. On inflation, most indicators point to a sustained return to the 2% target. Domestic inflation has eased since late 2024. However, risks remain: a stronger euro could help lower inflation, while rising import prices may push it back up.

  On broader strategy, Lagarde dismissed the idea of a "neutral rate" as meaningful in today's volatile world. "If anyone thinks we're in a shock-free environment," she quipped, "they should raise their hand—or have their head examined." The ECB, she concluded, must stay alert to new shocks and ready to respond accordingly. Given the forward-looking view on the economy is gloomy, the sentiment on further cuts is high.

  Lagarde called it "meaningless" to assess the current level of monetary policy restrictiveness, noting that such judgments depend on comparisons to a neutral rate—which assumes a shock-free world. Her comments came after the ECB dropped the term "restrictive" from its statement. Lagarde explained that while the term made sense earlier in the tightening cycle, it no longer applies in today's uncertain environment.

- **ECONOMIC ASSESSMENT:** *The growth outlook has worsened due to escalating trade tensions.* The euro area outlook remains highly uncertain amid rising trade barriers, financial market tensions, and geopolitical risks, all of which are weighing on business investment and consumer spending.

Still, the economy has shown signs of resilience. Growth likely resumed in Q1, with manufacturing stabilizing and unemployment falling to a euro-era low of 6.1% in February. Strong labour markets, higher real incomes, and supportive monetary policy are expected to sustain demand. New national and EU-level initiatives—particularly in defence and infrastructure—should further support manufacturing, as reflected in recent surveys. Given today's geopolitical environment, structural and fiscal reforms are more urgent than ever. The European Commission's Competitiveness Compass offers a roadmap, including completing the savings and investment union and advancing the digital euro. Governments must pursue sustainable public finances while prioritizing growth-enhancing reforms and strategic investment.

Annual inflation eased to 2.2% in March. Energy prices declined, food inflation rose slightly, goods inflation was stable, and services inflation continued to fall—now half a point lower than at end-2024. Underlying inflation continues to moderate. Domestic inflation has declined, with wages easing and productivity gains slowing unit labour costs. Wage growth is expected to keep falling in 2025, supported by ECB wage data and corporate contacts. Unit profits also fell at end-2024, further dampening domestic inflation. Long-term inflation expectations remain anchored around 2%, supporting a sustained return to target.

Downside risks to euro area growth have risen amid escalating global trade tensions, which are likely to weigh on exports, investment, and consumption. Weaker financial market sentiment could tighten financing conditions and increase risk aversion, further dampening economic activity. Geopolitical tensions—such as Russia's war in Ukraine and the conflict in the Middle East—add to uncertainty. However, increased defence and infrastructure spending may support growth.

Trade disruptions also heighten inflation uncertainty. Falling energy prices and a stronger euro could suppress inflation, especially if export demand weakens or excess global supply is redirected into the euro area. Financial stress may reduce domestic demand and inflation, while supply chain fragmentation and higher defence spending could push prices up. Climate-related shocks may further raise food prices.

Risk-free rates have declined amid rising trade tensions, while equity markets dropped and corporate bond spreads widened. The euro has strengthened as investor confidence in the euro area remained relatively firm. Before recent volatility, lower policy rates had reduced borrowing costs for firms, with loan rates falling to 4.1% in February and debt issuance costs to 3.5%. Lending to firms rose by 2.2%, and debt issuance grew by 3.2%. However, banks tightened credit standards slightly in early 2025 due to rising economic risks, and business loan demand dipped. Mortgage rates rose to 3.3%, but lending to households grew, supported by easing credit standards and strong demand.

For the first time in the history of the ECB, the GC has spoken about the digital euro, urging other policy areas to introduce the necessary legislation to become operational. Lagarde emphasised that these policy areas (EU Commission, Council, Parliament) will need to approve as soon as possible the Competitiveness Compass (so Draghi Report), the Savings and Investment Union (or Capital Markets Union, i.e. the Letta Report on the single market) and the digital euro legislation. Lagarde herself, responding to a question, discussed at length of the threat posed by the incoming USD-backed stablecoins, which are very different from crypto-assets, and the necessity of rolling out the digital euro as a response to that threat.

- **OUR TAKE:** *The ECB is likely to cut rates also in June.* While the ECB didn't want to pre-commit, as in 6 weeks many other shocks can still occur, it is quite likely that the ECB will cut rates in June as well – if they wanted to pause, they would have done today. Plus there's a broad agreement that 2% for the deposit rate is the sort of "neutral level" on which everybody in the GC can agree, and therefore both the hawks and the doves will want to reach that level sooner rather than later. What happens after that will depend on how economic and financial conditions will unfold.

- **MARKET REACTION AND IMPLICATIONS:** *Euro zone bond yields edged lower after the ECB cut rates and highlighted tariff-related risks.* After the decision, in the bond market the *2y German Schatz* yield edged up to 2.28% The *10y bund* yield were down by 2.5 bps to 2.48% during Lagarde's press conference now it trades around 2.46%. *2y German Bund* yield is down too to as low as 1.68% from around 1.8%. In the EZ periphery, *Italy's 10y BTP* yield hit lowest since March 4 to around 3.65%. As for now, the 10y BTP-Bund spread stands at 117 points. *In the currency space,* DXY climbed to 99.56 following the ECB's 25bps rate cut, reflecting concerns over eurozone weakness. Lagarde's emphasis on "exceptional uncertainty" dampened euro sentiment, boosting the dollar. EUR/USD fell 0.3% to 1.1368, as the ECB signaled a cautious, data-driven stance with no aggressive policy moves ahead. *In the equity space,* European markets trimmed earlier losses but stayed in the red after the ECB announced a rate cut. The Stoxx 600 index was down 0.5%, with all sectors except oil and gas posting declines.