Bond Blog

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PGIM FIXED INCOME

ECB : We're not a "Jack of all Trades"

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As expected, the ECB delivered another 25 bps cut at its December meeting, bringing the policy rate to 3.0% by year end. The ECB also confirmed that its balance sheet plans remain on track, despite recent market nerves around French debt. The Governing Council sees the disinflationary process still tracking to reach its 2% inflation target, which is a remarkable achievement after inflation peaked at more than 10% a little over two years ago.

Despite the latest policy developments, December's meeting was all about what comes next for the central bank with President Lagarde not only indicating that policy decisions are not on a pre-determined path, but also stressing that the region's significant challenges are not for it to solve alone. Indeed, Lagarde emphasised that the ECB cannot serve as a "jack of all trades" when it comes to supporting the European economy.

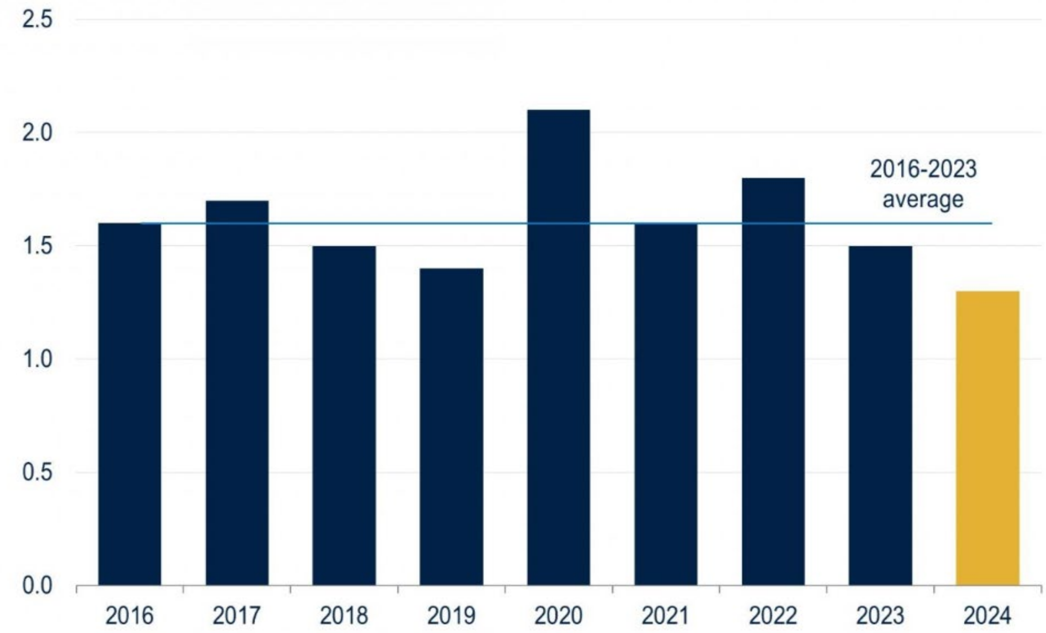
Our Take on the Meeting

President Lagarde confirmed that the ECB continues to see rates as restrictive and, with inflation viewed as on track to target, that additional rate cuts lie on the horizon. That said, our take on the December meeting is that it leaned hawkish. This is despite the Governing Council having discussed the possibility of going 50 bps at this meeting.

The tone of the press conference and the signal provided by the updated ECB staff forecasts strongly indicates that the ECB sees its job as nearly finished. We found the updated staff forecasts for 2027 particularly interesting. The ECB expects inflation to rise to 2.1% in 2027 (so above target), and yet, it also expects medium-term growth to deteriorate to 1.3% (notably lower than the 1.6% expected in Dec 2023; see Figure 1). Above-target inflation at the end of the ECB's forecast horizon signals the need for monetary policy to lean tight. Equally, with next year's growth expected to come in at 1.1% - not far below the ECB's view of a 1.3% medium-term growth potential - the minimal gap to the growth potential stands as another point that may not currently warrant increased policy accommodation beyond 2025.

Instead, Lagarde emphasised the need for reforms as set out in the Draghi and Letta reports.[1] She added that identifying and implementing remedies to structurally weak growth is not part of the mandate for the central bank, which cannot serve as "a jack of all trades." All of which suggests that the ECB may be signalling that it may be closer to the end - as opposed to the middle - of its easing cycle. Prior to the meeting, the market was expecting 150 bps of rate cuts. For our part, we're maintaining our forecast for 100 bps of additional policy rate cuts in 2025, which would take the deposit rate to 2.0%.

FIGURE 1: The ECB's Deteriorating Growth Outlook (%)



Source: Macrobond.

Market Reaction

The markets found the ECB developments somewhat disappointing. Prior to the meeting, a lofty six additional 25 bps cuts were priced in, and the 10-year German bund yielded 2.15%. Considering that weak data will soon be needed to justify 125 bps of cuts going forward, the bund yield consequently rose to 2.20%.

With the ECB clearly stating that it cannot be all things for the European economy, we'll closely monitor for future developments pertaining to the Draghi and Letta reports, such as a capital markets union and revival of the European securitisation market.

1. Draghi, Mario "The Future of European Competitiveness – A Competitiveness Strategy for Europe," 9 September 2024, and Letta, Enrico "Much More than a Market – Empowering the Single Market to deliver a sustainable future and prosperity for all EU Citizens," April 2024.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, PGIM Fixed Income, as of December 2024.
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