As ECB Policy Gradually Diverges, Impatience May Loom

Katharine Neiss, PhD, Deputy Head of Global Economics and Chief European Economist
Guillermo Felices, PhD, Global Investment Strategist

The ECB's expected rate cut on Thursday contrasts the Federal Reserve's decision a day earlier to hold its policy rate steady. The growing divergence between the policy trajectories partially reflects Europe's subpar growth, clearer signs of labour market easing, and growing confidence that inflation will sustainably converge to the ECB's 2% target. That said, the ECB did not convey any urgency for the need to cut rates more aggressively from here. Rather, it maintained the narrative that declining rates and rising household real incomes should, eventually, support European growth.

Our Take on the Meeting

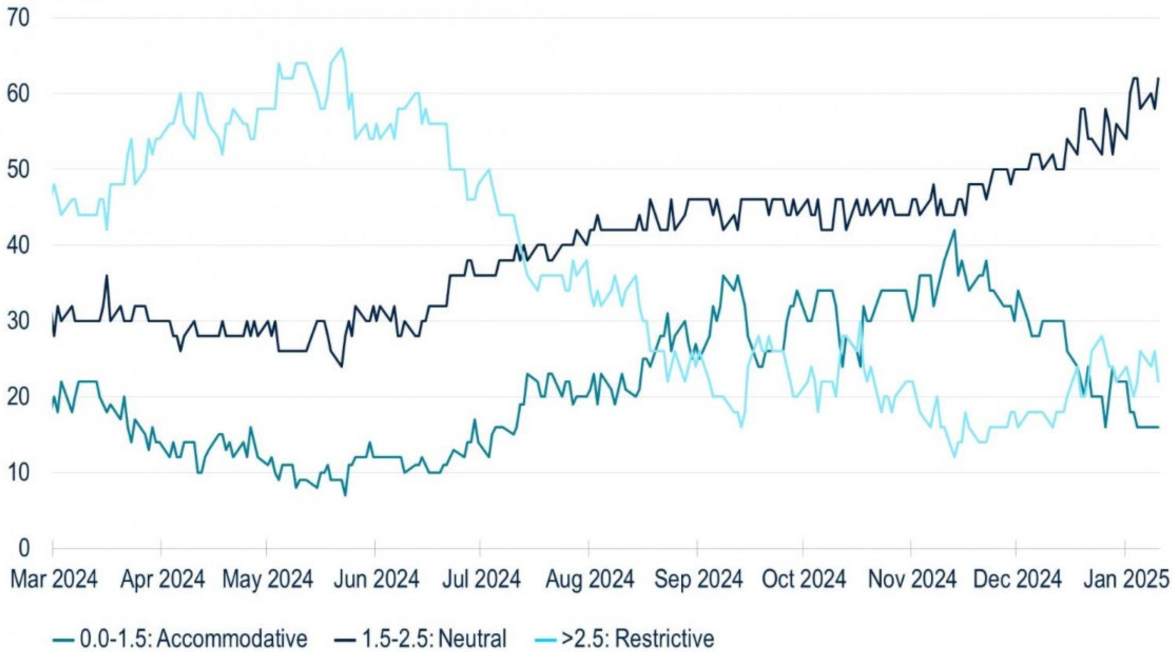
Although rates have come down 125 bps in less than a year and now stand at 2.75%, the ECB's assessment is that monetary policy remains restrictive. To the extent that there were any developments at the January meeting, it was that the ECB continues to show little sense of urgency to cut rates more quickly. For example, President Lagarde confirmed that there was no discussion by the Governing Council of cutting rates by 50 bps at the January meeting. Instead, the ECB has retained its projection narrative that consumers and firms should eventually support growth. This has been the ECB's view for many months now, but the more time that passes without a tangible recovery, the less and less likely that narrative crystallises.

Indeed, President Lagarde noted that come March, the Governing Council would have the benefit of more data as well as an updated staff assessment. This suggests that if the hoped for resurgence in consumption and investment fails to materialise, we could see an updated assessment in which below neutral rates would be warranted. For now, we are sticking to our call for three more back-to-back 25 bps rate cuts until June when the ECB potentially pauses its cutting cycle at 2%. The ECB's staff assessment of neutral real interest rates is an important input into our expectation, and President Lagarde said such an assessment would be published in early February.

Market Reaction

Since late last year, European front-end rates have shifted from a very pessimistic assessment of the euro area outlook to one that is less dire. In the fourth quarter of last year, front-end rates rallied, and European risky assets sold off (including EUR/USD, credit, and equities) as investors worried about a weakening economy, rising political risks (notably in France), and the risk of tariffs. For example, the teal colored "Accommodative" line in Figure 1 shows the probability that markets attached to rates falling below neutral was about40% late last year. Since then, those risks have moderated, and that probability has fallen to about 15%.

FIGURE 1: Front-end rates markets have shifted to a lower probability of deep ECB cuts since November 2024 (%)



Source: PGIM Fixed Income

For now, markets continue to expect a gradual approach to the cutting cycle, and the ECB has now caught up with that “patient” view. But as President Lagarde mentioned, the outlook remains highly uncertain. The ECB and investors will remain attentive to incoming data, the outcome of U.S. economic policy, and geopolitical developments.

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