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Economic Briefing

# ECB switches off the autopilot

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**As expected, the ECB cut its key interest rates by 25 basis points today, but switched off the autopilot. However, the economic risks stemming from possible US tariffs and the dominance of doves in the ECB Governing Council continue to suggest that the ECB will lower its deposit rate to 2.0% by the summer. However, we consider this to be risky in view of the inflationary effect of rising military spending across Europe.**

In the run-up to the ECB Governing Council meeting, there was widespread speculation as to whether or not the ECB would describe its monetary policy as "restrictive" again. The Council members probably discussed this intensively. The result was the formulation that "monetary policy is becoming meaningfully less restrictive". The ECB is thus signaling that, after six interest rate cuts, it sees less room for further interest rate cuts. This is also supported by President Christine Lagarde who did not repeat the previous statement that the "direction of travel" is clear (i.e. downwards). Instead, she emphasized the high level of uncertainty – in particular with regards to trade policy, which the ECB blamed today for the slightly reduced growth forecasts for 2025 and 2026 (chart, table). Depending on how the facts develop, the next decision could be a rate cut or a pause. All in all, the ECB has switched off the autopilot today.

## Two further rate cuts

As before, we expect two further rate cuts, which would bring the deposit rate to 2.0% by the summer. One reason for this is the possibility of massive increases in US tariffs against the EU, which would cause exports to the US to collapse. Importantly, this would quickly dampen economic activity, while the planned additional government spending, particularly for defense, would only increase inflation risks in the long term. An ECB Governing Council that is dominated by doves is likely to focus primarily on the increased economic risks, especially as core inflation has recently fallen somewhat.

## The role of relaxed fiscal rules

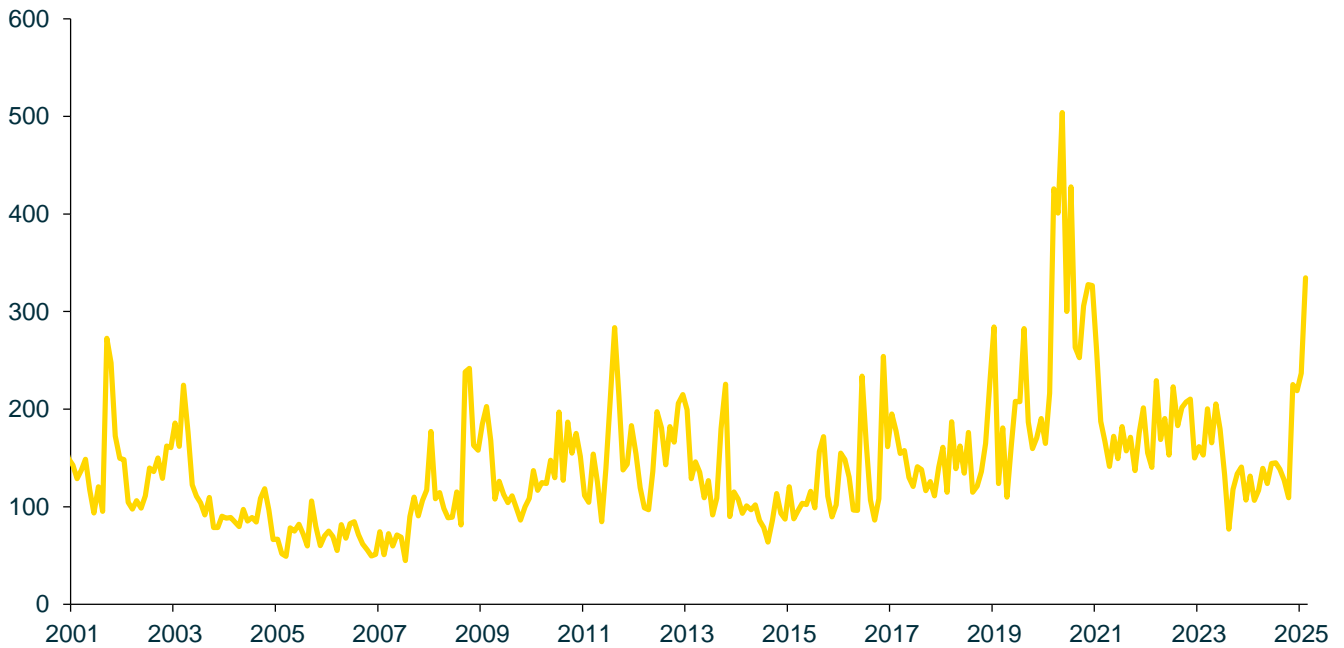
However, regardless of our forecast we would recommend the ECB to be very cautious when lowering interest rates and to end rate cuts in case of doubt. This is also due to the fact that eurozone countries will massively increase their military spending in view of the threat from Russia. After the de facto end of the constitutional debt brake in Germany, the government is likely to spend an additional amount on defense and infrastructure that corresponds on average to 2½% of GDP over the next ten years. In the other eurozone countries, the fiscal stimulus is unlikely to be quite as strong because many



are already very heavily indebted. Nevertheless, the fiscal stimulus for the eurozone as a whole will also be strong. This poses a noticeable risk of inflation in the longer term, as the additional government spending is hitting economies that are already operating at high capacity.

**Chart 1 - Significant US policy risk**

Index of US economic policy uncertainty based on the evaluation of keywords in newspapers, Index



Source: Economic Policy Uncertainty, Commerzbank Research

**Table 1 - ECB lowers growth forecasts**

ECB experts' March projections; in parentheses: ECB December projection; growth and inflation rates in percent

	<b>2025</b>	<b>2026</b>	<b>2027</b>
GDP growth	0.9 (1.1)	1.2 (1.4)	1.3 (1.3)
Inflation	2.3 (2.1)	1.9 (1.9)	2.0 (2.1)
Core rate	2.2 (2.3)	2.0 (1.9)	1.9 (1.9)

Source: ECB, Commerzbank Research



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