European Central Bank makes "precautionary" cut in interest rates

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In an expected decision after it had been forecast by leading officials, including its president, Christine Lagarde, the European Central Bank (ECB) cut its interest rate by 0.25 percentage points at its meeting on Thursday, almost two years after its rate-tightening cycle began.

The ECB had insisted that its decisions were "data dependent" and that it would only begin to cut rates when it saw inflation coming down to its target of 2 percent. While inflation in the euro zone has moved down from more than 10 percent in October 2022 to 5.2 percent a year later, and is now at 2.6 percent, the latest data showed an increase—the first for this year.

This prompted opposition on the governing council from the head of the Austrian central bank, Robert Holtzmann, who said following the meeting that "data-based decisions should be data-based decisions."

However, he was in a minority of one, and, given the previous indications that a rate cut was in the offing, a factor that had been taken on board by financial markets, the governing council clearly decided that it needed to cut its rate lest failure to do so caused turbulence.

Apart from the immediate considerations, the decision was motivated by the need to try to counter the ongoing stagnation of the euro zone economy, which flat-lined all of last year and has only shown tentative signs of a recovery, with a 0.3 percent increase in GDP in the March quarter.

As an article in the *Financial Times* (FT) noted on the eve of the decision: "By starting to lower rates again, the bank is set to breathe fresh life into housing markets, business investment and consumer spending."

In an editorial comment after the cut was announced, the FT described it as a "pragmatic, precautionary move," adding that with inflation starting to come down, "the impact of the high cost of credit is starting to receive more attention." Keeping rates too high for too long could mean that inflation fell too far and would "take growth with it."

In her prepared statement to a press conference following the decision, Lagarde said that after five quarters of stagnation, the economy was now growing again, albeit the key manufacturing sector was only stabilising at "low levels."

The risks to growth, she said, were "balanced in the near term, but remain tilted to the downside over the medium term" and a "weaker world economy or an escalation in trade tensions between major economies would weigh on euro area growth."

Lagarde did not spell out the source of those tensions, which flow from the economic war being waged by the US against China and the demand from Washington that Europe join it in imposing tariffs and other restrictions against China in the area of green technology, such as electric vehicles.

Concerns about the world economy are not misplaced. Europe is all but stagnant, likewise the UK and Japan. In China, which has provided crucial support for the global economy in the period since the global financial crisis of 2008, the official growth target of the Xi Jinping government is little more than 5 percent—the lowest in more than three decades.

But while the ECB moved to ease its "restrictive" monetary policy in order to provide some limited stimulus, it is by no means abandoning it, as Lagarde made clear in the course of her press conference.

Asked whether the decision was the start of a series of rate cuts or "one and done," she said, "I cannot confirm that it is the dialing-back process that is underway. There is a strong likelihood, but it will be data-dependent and what is very uncertain is the speed

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at which we travel and the time that it will take."

After the meeting, the *Financial Times* reported that "several members" of the governing council said another rate cut in July seemed unlikely "because of recent rises in inflation and wages growth."

The most significant set of data the ECB will take into account is the level of wage increases, to which Lagarde referred on several occasions.

In her prepared remarks, she noted that "domestic inflation remains high," while wages "are still rising at an elevated pace, making up for past inflation." In reality, wage increases are well below the level of the price hikes that have cut the living standards of workers in Europe and internationally.

Asked about wage data that had showed an increase in pay levels, she said the questioner was "quite right to bring me back to wages, because, because wages matter enormously in a tight labour market when it comes to services," and wages were at the root of the increased costs in this area.

Back in May, the German Bundesbank, whose representatives are regarded as among the more "hawkish," said wages in Germany had been rising faster than expected, and there were "risks to the disinflation process" that could mean "high price pressure on services could last longer."

In response to a question on whether, in the light of the decision, taken under conditions where the latest data showed an uptick in prices, "some people might get the impression the ECB doesn't take the combat of inflation seriously enough anymore," Lagarde said the ECB took the fight against inflation "very seriously."

The interest rate move was a moderation of the central bank's restrictive stance, she said. "And we will continue to be restrictive as long as necessary to bring inflation to 2 percent in a timely manner. Have no doubt about that."

But under conditions where US interest rates continue to remain at an elevated level, one of the consequences of the decision will be to push down the value of the euro and increase the prices of imports into the eurozone, tending to increase the inflation rate.

It is too early to say yet, but the divergence between the US and other central banks—the Canadian central bank cut its rate following earlier decisions by the central banks of Brazil, Mexico, Switzerland and Sweden—may lead to turbulence in currency markets, where the Japanese yen and the Chinese renminbi are already experiencing significant downward pressure.

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