ECB Watch

AIB Treasury Economic Research Unit

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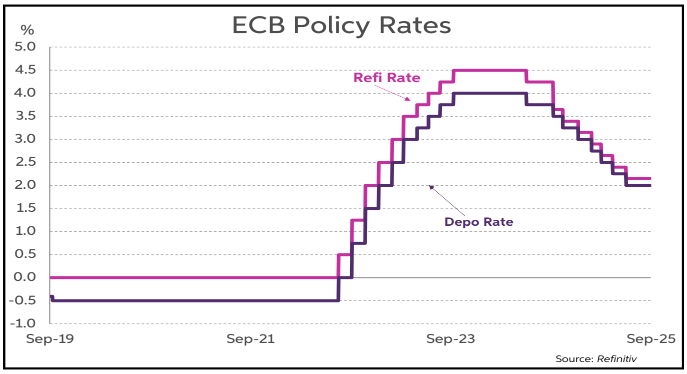
ECB remains on hold amid balanced view of growth risks

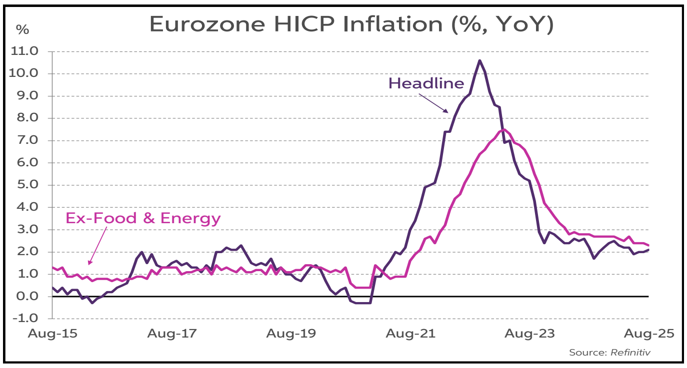
The ECB's Governing Council meeting for September saw the central bank leave interest rates on hold for a second consecutive occasion. The deposit and refi rates were maintained at 2.00% and 2.15%, respectively. The 'unchanged rates' outcome was widely expected by markets. The last time the ECB altered its interest rate policy was at its June meeting when it cut rates by 25bps for a fourth successive time. In total, the central bank has cut rates by 200bps since it started its easing cycle in June 2024. Today's decision to keep policy on hold was once again unanimous.



The September meeting statement from the ECB was very short, and offered little in the way of new guidance. It also provided sparse rationale for the decision to keep rates on hold, other than to note that inflation "is currently at around the 2%" target and "its assessment of the inflation outlook is broadly unchanged". Instead the meeting statement focused on its updated set of macro staff projections that were published today and helped to inform the Governing Council's policy deliberations/decision.

Overall, the updated batch of forecasts paint a broadly similar outlook to those published in June. The September edition of its GDP projections contained only minor revisions, with the ECB more optimistic on the near-term growth prospects. It is now forecasting Eurozone GDP growth of 1.2% (was 0.9%) for this year. It sees GDP averaging 1.0% in 2026 (was 1.1% in June) and continues to anticipate growth of 1.3% in 2027. These latest GDP projects still embody a subdued growth outlook for the Eurozone economy. **However, the ECB no longer views the risks to its economic outlook as being tilted to the downside. Instead, it is now of the view that growth risks have "become more balanced".**

In terms of its inflation outlook, the ECB expects headline HICP to average 2.1% (was 2.0%) this year and 1.7% (was 1.6%) in 2026. For 2027, it sees inflation averaging 1.9% (was 2.0%). The core rate is expected to average 2.4% (no change) this year. The projection for 2026 was unchanged at 1.9%, while the core rate for 2027 was revised marginally lower to 1.8% (was 1.9%). Overall, these projections suggest that the ECB maintains a benign outlook for inflation. The meeting statement noted that "indicators of underlying inflation remain consistent" with its 2% medium term target, although it also emphasised that the inflation outlook "remains more uncertain than usual" due to ongoing global trade policy tensions.



President Lagarde's comments during the press conference suggest that while the ECB retains a willingness to ease policy again, if required, there was no indication of any appetite within the Governing Council for additional rate cuts in the near-term. She repeated the statement's references to a data-dependent, meeting-by-meeting, and not pre-committing approach to its future policy deliberations. However, her comments during the Q&A section of the press conference add credence to the view that the ECB's easing cycle may be over. She stated the ECB's policy setting continued to be "in a good place" and that "inflation is where we want it to be".

Market expectations have firmed marginally, by circa 2-3bps, in the immediate aftermath of today's ECB's meeting. The market is now less sure that the ECB will cut rates again. Futures contracts are currently attaching around a 50% probability (was around 60% pre-meeting) of another 25bps by mid-2026. **Our view since the start of the year has been that the deposit rate will settle at 2%.** The tone emanating today from the ECB reinforces our assessment of 2% being the trough.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2024	2025	2026	2027
HICP	2.4	2.1	1.7	1.9
Real GDP	0.8	1.2	1.0	1.3

Forecasts are mid-point of a range and based on the assumption that Brent crude oil prices will average $69.7 in 2025, $65.1 in 2026, and $65.1 in 2027. *Source ECB, September 2025*

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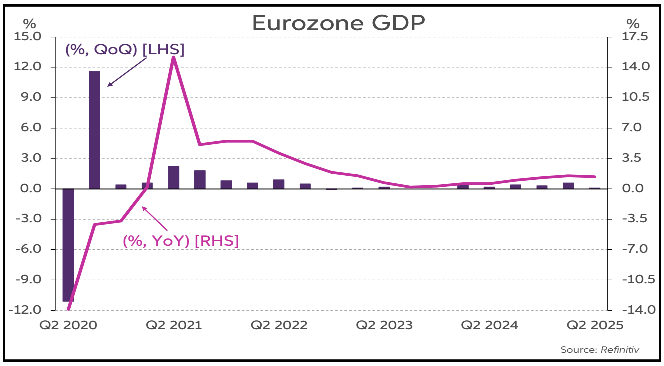
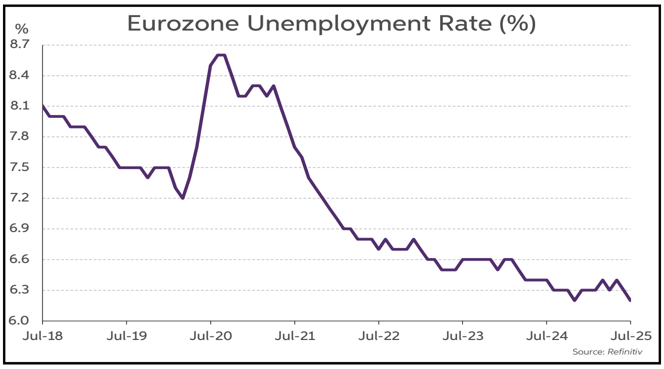
Eurozone growth slowed sharply in Q2



The Eurozone economy gathered some momentum at the start of the year, with GDP rising by 0.6% q/q in Q1, which was the fastest pace of growth since Q2 2022. However, growth slowed sharply to just 0.1% q/q in Q2 of this year, as tariff related front-running unwound. The underlying breakdown for Q2 shows that consumption rose by a meagre 0.1% in the quarter, contributing 0.1 percentage points (p.p.) to growth. Similarly, government expenditure added a further 0.1 p.p. to the total. However, a sharp 1.8% fall in investment knocked 0.4 p.p. from output. In terms of external trade, exports declined by 0.5% in the quarter, while imports were flat, meaning net trade clipped 0.2 p.p. from GDP. This was offset by a sharp increase in inventories though, which boosted growth by 0.5 p.p.. Regarding the large national economies, Germany continued to perform poorly (-0.3% q/q), as did Italy (-0.1% q/q), while France gained some steam (+0.3% q/q), and Spain expanded at a solid pace (+0.7% q/q).

The available data for Q3 have been mixed. Retail sales, the only available hard data so far in Q3, declined by 0.5% in July, erasing the 0.6% rise from the month prior. Spending on food, fuel and online decreased in the month. Meanwhile, both the manufacturing and services PMI have improved so far in Q3, albeit they are consistent with very modest rises in activity levels at best. The latest release shows the manufacturing PMI moved above the key 50 level for the first time since June 2022, and it has averaged 50.3 in July and August, compared to 49.3 in Q2. Similarly, the services PMI has averaged 50.8 during the same period in Q3, compared to 50.1 in Q2. At the same time, industrial and services sector economic sentiment have risen slightly in the third quarter, although consumer and investor confidence have deteriorated.



Regarding the labour market, conditions remain solid. Employment expanded for a seventeenth successive quarter in Q2, up by 0.1% q/q and by 0.6% y/y. It means that the number of people at work has risen by 8.4m or 5.1% since the end of Q4 2019. At the same time, the unemployment rate is at its all-time low at 6.2% in July. Despite tight conditions though, wage growth has cooled somewhat. Wages in the Eurozone rose by 2.5% y/y in Q1, down from 4.3% y/y in Q1, and 5.2% y/y a year earlier. Furthermore, the Indeed wage tracker - a more frequent measure of wage pressures - indicates that wages have risen more slowly in recent months. It shows that wages rose by 2.5% y/y on average in the three months to July, down from 3.5% y/y during the same period in 2024.

On the inflation front, a gradual downtrend has emerged this year. The headline rate stood at 2.5% in January, but it declined in the first half of the year, falling to a low of 1.9% in May before edging higher to 2.0% in June and July, and to 2.1% in August. Meantime, underlying inflation, which had been quite sticky, stuck between 2.6-2.9% since April '24, eased to 2.4% between May-July, before inching down to 2.3% in August. This is partly due to a drop in services inflation this year, which stood at 3.1% in July. Looking ahead, the ECB expects inflation to average 2.1% this year, 1.7% in 2026, and 1.9% in 2027. Core inflation is forecast to be 2.4% this year, and 1.9% in 2026-27.

In summary, the Eurozone economy registered an uptick in growth at the start of 2025, albeit it lost momentum in Q2. Furthermore, the available data suggest activity levels have expanded only modestly so far in Q3. The Eurozone is also facing a number of challenges at present, most notably the ongoing political turbulence in France. However, it is worth noting that the trade framework agreement with the US is not as taxing as some had feared. At the same time, the labour market remains in good shape. Meanwhile, the recent bout of disinflation and rate cuts in the first half of the year should support real incomes and consumer spending. Higher fiscal spending in Germany on defence and infrastructure, as well as higher defence spending at the EU level could support growth in the medium-term. Proposed changes to the EU budget, which would combine regional and agricultural funds into a single pot for countries to dole out, may also support economic development in the medium to long-term, although the budget won't come into effect until 2028. For now though, moderate rates of growth are expected to remain the norm in the Eurozone. The ECB sees GDP expanding by 1.2% this year and by 1.0% in 2026.

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