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Economic Insight

ECB – All quiet on the inflation front?

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The trade war and falling oil prices are currently lowering inflation. But in the long term, inflation risks dominate. The ECB should not lower its policy rates further next week.

The ECB is likely to lower its deposit rate again at its meeting next week – bringing it down to just two percent. It will probably justify the step with Trump's tariff increases which are burdening the Eurozone economy and, at least in the short term, lowering inflation.

Trump's tariffs lower both growth ...

At first glance, the arguments for lower policy rates are clear. The announcement of high US tariffs in early April was a shock for the global economy. In the Eurozone, many companies fear that they will lose their important US business, even though Trump may not raise tariffs as much in the end. In any case, economic risks have increased significantly.

... and inflation

At the same time, Trump's tariff policy is dampening inflation risk in the Eurozone in the short term, which also justifies lower key interest rates. China is likely to try selling some of the goods that it can no longer export to the US in the Eurozone instead. The higher supply tends to lower prices. Additionally, oil prices have recently fallen massively because companies are demanding less energy due to the cooling economy caused by tariffs, and OPEC countries are producing more oil in a bid for market share. Finally, Trump's tariff plans have also weakened the dollar. The corresponding appreciation of the euro makes imports cheaper – and further dampens inflation. In the short term, inflation in the Eurozone is likely to fall towards the ECB's target of two percent. With a bit of luck, it could even be below it in July (chart 1).

However, long-term inflation drivers still lurk in the background

However, it is too early to sound the all-clear. Long-term inflation drivers still lurk in the background, which the ECB must keep an eye on in its interest rate policy. If globalization lowered inflation in the two decades before the coronavirus pandemic, de-globalization is likely to increase it. Trump's tariff shock has dealt a fatal blow to the rules-based global trading system. In this climate, other countries are also becoming more protectionist and will ultimately impose higher tariffs on US goods. Trump is too much of a protectionist to reduce tariffs to zero percent within the framework of deals. Furthermore, the EU and other countries also tend to protect their own industries. Higher tariffs and de-globalization therefore point to higher inflation in the Eurozone in the long term. Additionally, there are other structural inflation drivers that the ECB must not overlook:

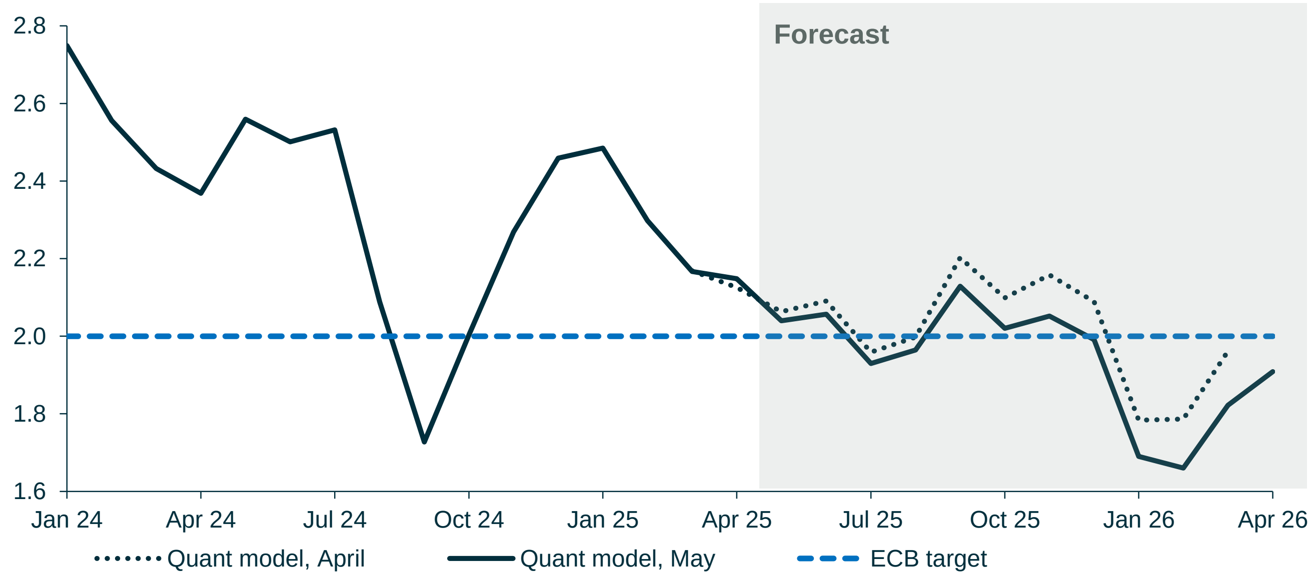
- Firstly, the proportion of the working age population is declining not only in the Eurozone but also in North America and in the developed countries of Asia – and thus simultaneously in all economically important regions of the world. This shortage of labor improves the bargaining position of workers and unions and drives wage costs up.
- Secondly, de-carbonization and rising CO2 prices are likely to increase inflation in the Eurozone. Higher CO2 prices and other climate policy instruments will trigger many investments, the costs of which companies will ultimately pass on to consumers.
- Thirdly, with its new fiscal package, Germany has effectively abolished its constitutional debt brake. Although investments in defense and infrastructure are called for, this represents a departure from stability-oriented fiscal policy. This is likely to encourage other Euro area countries to significantly increase spending sooner or later. This is all the more true as the political fringes are strengthening in many countries and traditional parties are forming coalitions, even though their economic policy positions often differ significantly. They cover these contradictions, as in Germany, with debt-financed additional spending. However, these increasing government expenditures meet economies, such as Germany's, which are suffering from a shortage of skilled labor. Much of government money is likely to translate into higher prices.

Citizens are aware of all these inflation risks. According to an ECB survey, they expect an average inflation rate above the ECB's target of two percent in three years. Additionally, a Bundesbank survey shows a growing proportion of citizens expecting considerably higher inflation.

Given these circumstances, a new wave of inflation could build up quickly. The ECB should not continue cutting its interest rates just because Trump’s tariff policy is temporarily lowering inflation.

Chart 1 - Eurozone inflation will continue to fall

Consumer price index in the euro area, year-on-year rate in %, as of May 2025 Commerzbank quant-forecasts



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