Flash Economics

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The contradictory nature of the ECB's short-term interest rate policy and liquidity policy

With a deposit rate of 2%, the ECB has an expansionary interest rate policy given that underlying inflation was 2.4% in May 2025. This expansionary policy is justified by the falling inflation rate and the prospect of weak growth.

But the ECB is further reducing the size of its balance sheet rapidly (by €1,900 billion since November 2022, i.e. quantitative tightening), which is pushing up long-term interest rates (the estimated effect of a €1,000 billion reduction in the size of the ECB's balance sheet on the eurozone 10-year interest rate is around 35 basis points[1]).

Why this contradiction between the ECB's interest rate policy and its liquidity policy? If expected growth is indeed weak and inflation is less and less of a problem, it is counterproductive to pursue a policy that pushes up long-term interest rates.

Patrick Artus
Senior Economic Advisor
patrick.artus-ext@ossiam.com
@PatrickArtus
Patrick Artus

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(1) Akkaya R., Hutchinson J., Jørgensen K., and Skeppås E., (2024) *Quantitative Tightening: How do shrinking Eurosystem bond holdings affect long-term interest rates?,* The ECB blog https://www.ecb.europa.eu/press/blog/date/2024/html/ecb.blog241114~6a3182c0bd.en.html

Expansionary short-term interest rate policy

The deposit interest rate is now 2% in the eurozone (**Chart 1**), which corresponds to an expansionary monetary policy since underlying inflation was 2.4% in May 2025 (**Chart 2**), and the real short-term interest rate is therefore negative and below growth, in the short or long term.

Chart 1
Euro zone: European Central Bank Deposit Rate (as %)

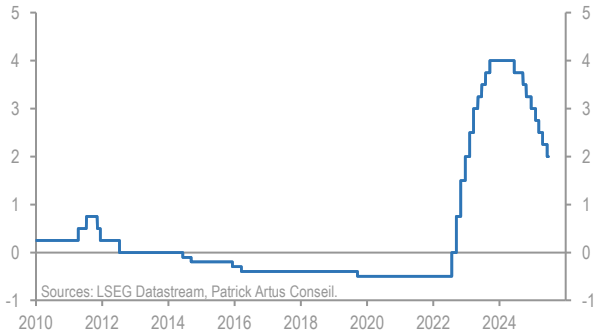
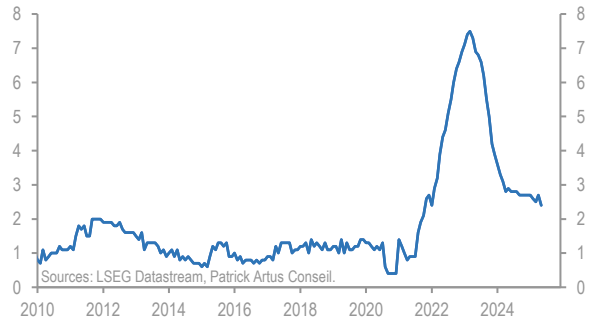


Chart 2
Euro zone: Core inflation
(HICP excl. energy and unprocessed food, Y/Y as %)

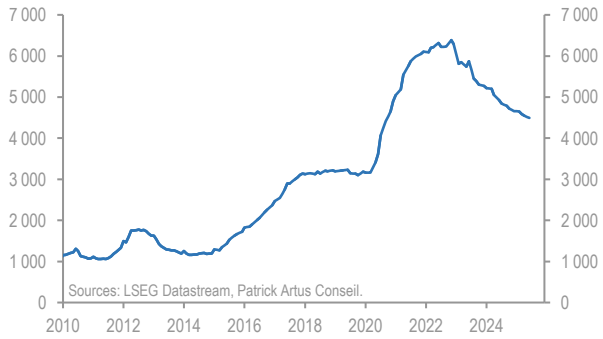


This expansionary monetary policy is justified by the drop in inflation and the expectation of weak growth (the consensus is currently for growth of 0.6/0.7% in 2025).

Restrictive liquidity policy

The ECB continues to rapidly reduce the size of its balance sheet (by 1,900 billion euros since November 2022) (i.e. quantitative tightening), **Chart 3**.

Chart 3
Euro zone: Monetary base (EUR bn)



The ECB's own research estimates that a €1 trillion reduction in the size of the ECB's balance sheet leads to **a 35-basis point rise in the eurozone long-term interest rate**. The ECB's liquidity policy has therefore been increasingly restrictive since November 2022. Admittedly, the size of the ECB's balance sheet is still larger today than it was at the beginning of 2020 (€4,500 billion compared with €3,100 billion), but it has fallen by €1,900 billion since its peak at the end of 2022.

Summary: why this contradiction between the ECB's short-term interest rate policy and its liquidity policy?

The ECB's short-term interest rate policy is thus expansionary, while its liquidity policy is restrictive. It is long-term interest rates that influence investment (in housing and business) and the trend in the public debt ratio.

If the ECB really believes that inflation is no longer a problem in the eurozone, that growth is going to be weak, and that investment needs (for the energy transition, the digital transition, the financing of disruptive innovations) are going to be considerable, it is illogical to retain a liquidity policy (reducing the size of its balance sheet) that pushes long-term interest rates higher and higher.

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