

Forecasts of the Interest Rate on the ECB Deposit Facility

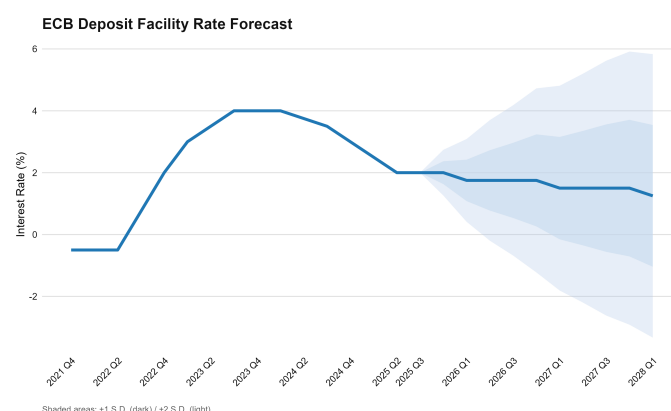
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At their latest policy meeting, the ECB Governing Council decided to keep the interest rate on the deposit facility unchanged at 2.00% while not committing to any predetermined trajectory for future rate adjustments. Building on our forecasts for inflation dynamics and the projected deviation of output from its potential level, we anticipate a gradual easing cycle comprising three 25bps cuts on the deposit facility interest rate. The first reduction is expected in Q1 2026, bringing the rate to 1.75%, followed by a second cut in Q1 2027 to 1.50%, and a final decrease in Q1 2028 establishing the rate at 1.25%. This 75bps easing cycle reflects our view that moderating inflation and a widening output gap will warrant supportive monetary policy to ensure inflation stabilizes sustainably at the ECB's 2% target.

On October 30th, the ECB Governing Council decided to keep the interest rates on the deposit facility unchanged at 2.00%, maintaining the current monetary policy stance following the easing cycle that began in June 2024. The decision to keep interest rates on the deposit facility at 2.00% reflects the Governing Council's assessment that previous rate cuts have been sufficient to address the evolving economic conditions while keeping inflation stable around target. Future interest rate decisions will depend on the Council's evaluation of inflation projections and associated risks, considering recent economic and financial indicators, core inflation trends, and the effectiveness of monetary policy transmission mechanisms. Importantly, the Council maintains full discretion in its decision-making process and explicitly does not commit to any predetermined trajectory for interest rates.

Taking into account the trajectory of inflation in the upcoming quarters and the predicted deviation from potential output, we expect interest rates on the ECB deposit facility to continue their downward trend throughout 2026, 2027, and 2028. Building on our inflation and output gap forecasts, we anticipate that the ECB will implement a gradual easing cycle consisting of three 25bps rate cuts over the three-year forecast horizon. This monetary policy easing trajectory reflects our assessment that the combination of moderating inflation dynamics and a deteriorating output gap will create the necessary conditions for the Governing Council to adopt a more accommodative policy stance. Specifically, we expect a first rate cut in Q1 2026 bringing the deposit facility rate to 1.75%, timed to coincide with the initial signs of economic slack emerging in the euro area economy. This would be followed by another 25bps cut in Q1 2027, reducing the rate to 1.50%, as the output gap continues its transition into negative territory and inflation pressures further subside. Finally, we anticipate a third and final cut in Q1 2028 bringing the policy rate to 1.25%, which we view as the terminal rate for this easing cycle—a level that provides meaningful monetary accommodation while remain-

ing above the effective lower bound and preserving the ECB's policy space for future adjustments. The cumulative 75bps reduction from the current 2.00% level represents a calibrated policy response designed to support economic activity and ensure inflation stabilizes sustainably at the ECB's 2% medium-term target, without prematurely constraining the recovery or reigniting inflationary pressures.



Our forecasts for the output gap imply a euro area economy undergoing a significant transition from above-potential growth to below-potential conditions over the 2025-2028 period. Starting from 2025 Q4, our model projects a robust 1.24% output gap, indicating an economy operating well above its sustainable capacity. However, this positive gap steadily erodes throughout the forecast horizon, crossing into negative territory by 2027 Q3 and reaching -0.52% by 2028 Q1. Based on our analysis of the economic outlook for the euro area, we have reasons to believe that our model may underestimate the economic slack in upcoming quarters and we expect the output gap to turn negative sooner than the projected 2027 Q3, thereby supporting our prediction of an expansionary monetary policy stance.

Our assessment for the trajectory of the output gap diverges from the model's baseline projection due to

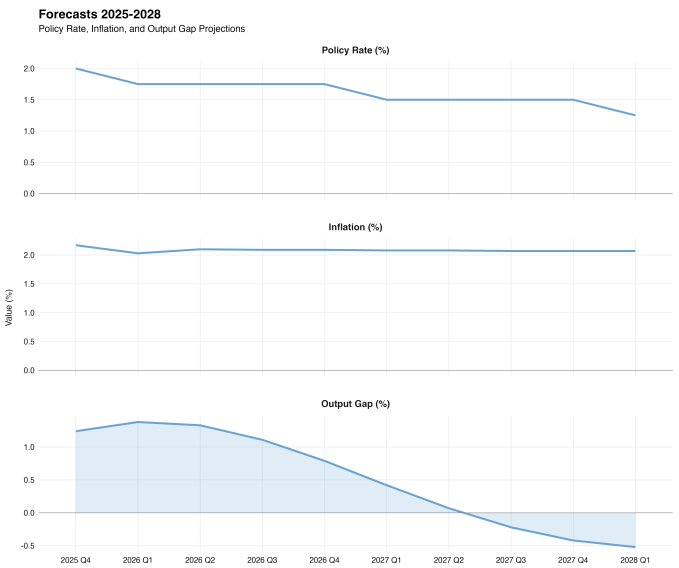
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significant downside risks not fully captured in current data. The considerable uncertainty surrounding US tariffs will likely continue to adversely impact euro area economic performance, creating headwinds for export-driven growth and business investment given the region’s high trade openness and vulnerability to external demand shocks. Additionally, weakness in the labor market may further hinder growth in coming quarters, with employment indicators showing deceleration and leading indicators pointing to softening hiring intentions across key sectors. This labor market fragility could translate into subdued wage growth and weaker household consumption, further constraining the recovery trajectory.

Inflation dynamics throughout the forecast period demonstrate persistent price pressures that remain stubbornly above the ECB’s 2% target. Beginning at 2.17% in 2025 Q4, inflation declines only marginally to 2.07% by 2028 Q1—a mere 10 basis point reduction over the ten-quarter horizon despite the economy moving from significantly above potential to notably below potential. This remarkable stickiness, with inflation persisting 7-17 basis points above target even as economic slack accumulates, suggests underlying structural challenges including wage indexation mechanisms, supply-side constraints in services and food sectors, and ongoing second-round effects from previous energy and commodity price shocks.

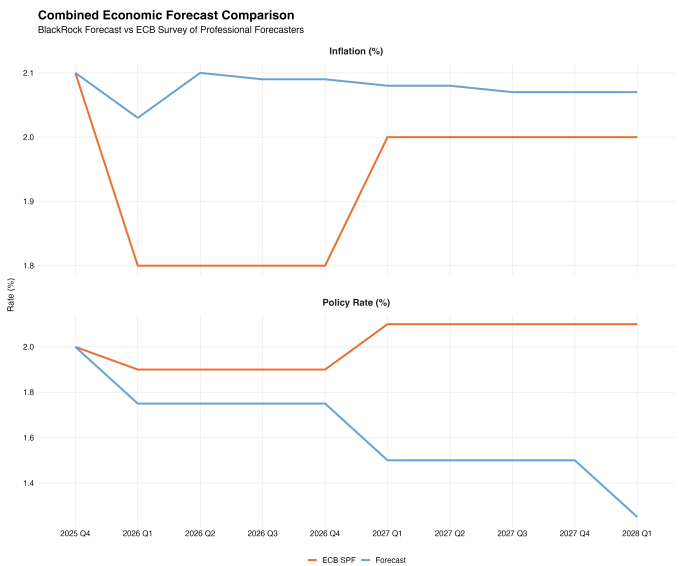


Quarter	Policy Rate	Inflation	Output Gap
2025 Q4	2.00	2.17	1.24
2026 Q1	1.75	2.03	1.38
2026 Q2	1.75	2.10	1.33
2026 Q3	1.75	2.09	1.11
2026 Q4	1.75	2.09	0.79
2027 Q1	1.50	2.08	0.42
2027 Q2	1.50	2.08	0.07
2027 Q3	1.50	2.07	-0.22
2027 Q4	1.50	2.07	-0.42
2028 Q1	1.25	2.07	-0.52

While our forecast anticipates sustained easing to 1.25% by early 2028 reflecting concerns about persistent economic weakness, the ECB SPF consensus expects only a brief cut to 1.90% followed by a reversal back to 2.10%, suggesting divergent views on whether the euro area economy will require prolonged

accommodation or policy normalization. In contrast to the ECB SPF consensus which envisions only a modest initial reduction to 1.90% in early 2026 followed by a notable reversal that sees rates rising back to 2.10% by 2027, our forecast anticipates a sustained easing cycle with rates declining to 1.25% by early 2028. This fundamental difference reflects contrasting views on the medium-term economic outlook: our forecast implies concerns about weakening growth warranting sustained accommodation, while the SPF consensus suggests a more resilient economy requiring a return to moderately restrictive policy.

Our forecast maintains inflation persistently above the ECB’s 2% target at 2.07–2.10% through 2028 Q1, diverging substantially from the ECB SPF consensus which anticipates a sharper disinflation to 1.8% in 2026 before recovering to target by 2027. Starting at 2.1% in 2025 Q4, our forecast shows inflation remaining stable around 2.07–2.10% through 2028 Q1, consistently above target. In contrast, the ECB SPF consensus projects inflation dropping sharply to 1.8% by early 2026, where it remains through 2026 Q4 before gradually recovering to 2.0% by early 2027. This substantial gap—ranging from 20 to 30 basis points during 2026—reflects our view of more persistent inflation dynamics, ongoing supply-side pressures, and greater skepticism about the speed of convergence to target.



These contrasting forecasts ultimately reflect different assessments of the euro area’s underlying economic dynamics and the balance of risks facing policymakers. The ECB SPF consensus appears premised on an economy that achieves a “soft landing” with sufficient momentum to warrant policy normalization by 2027, viewing any near-term weakness as cyclical rather than structural. Our forecast, with its sustained low-rate environment, implies greater concern about persistent economic slack, weaker underlying demand, or heightened downside risks that require the ECB to maintain accommodation for longer. The fact that our inflation forecast remains close to target despite lower policy rates suggests we anticipate either a wider negative output gap than the SPF consensus or reduced sensitivity of inflation to monetary policy.