Why the ECB is unlikely to leave its 'good place' just yet

We expect the ECB to remain on hold at next week's meeting, although the debate between supporters of holding steady and those favouring a rate cut will likely be more heated than markets have priced in

We think the discussion at next week's ECB meeting looks set to be more controversial than markets are currently pricing in

With a large number of European Central Bank officials having returned from the summer break with rather hawkish comments, we are folding and expect the ECB to stay on hold at next week's meeting. Still, be it because we are sore losers or there are still good dovish arguments, a rate cut next week or later this year should not be entirely ruled out.

Arguments for staying on hold

The minutes of the July meeting, as well as official ECB comments since the end of the summer break, have stressed that the bar for yet another rate cut from the central bank is set high.

At least at first glance, several more favourable developments over the summer have strengthened the wait-and-see stance: the 'it-could-have-been-worse' trade agreement between the US and the EU, a decent second quarter GDP growth reading, and still-improving business sentiment indicators, which have strengthened rather than weakened the case for staying on hold at the September meeting. The final piece of evidence that the hawks will bring into the ECB's Governing Council meeting room next week is the small increase in headline inflation in August.

Arguments for another rate cut

At the same time, however, the July minutes also showed that at least some ECB members were – and probably still are – concerned about a possible inflation undershooting. Policymaker Olli Rehn's interview with the Financial Times proved that these dovish thoughts and concerns have not disappeared over the summer. In fact, there are several good reasons for these concerns:

1. A growing awareness among eurozone policymakers in general that the trade framework agreement between the US and the EU is anything but set in stone. The built-in conditionality on many aspects has left sufficient room for new escalations.
2. Just judging from the developments of the so-called technical assumptions, i.e., interest and exchange rates, the fresh round of ECB projections should bring a slight downward revision to inflation and growth for 2026.
3. And finally, even if the ECB fiercely disputes that it reacts to monetary policy in other countries, a Federal Reserve starting an aggressive series of rate cuts could lead to further strengthening of the euro and therefore the risks of inflation undershooting.

'Because it's France'

Next week's ECB meeting comes after the vote of confidence in the French parliament. We will not speculate on the outcome of this vote here, but it is clear that the latest economic and political developments in France could become a matter of concern for the ECB as well. Not so much regarding the interest rate decision, but rather potential ECB support in the event of surging French bond yields.

In turn, the ECB press conference could be more delicate than usual as President Christine Lagarde needs to avoid repeating her 2020 mistake of casting doubt about her 'whatever it takes' ambitions, while at the same time emphasising that ECB support cannot be taken for granted. In fact, Lagarde will have to stress that the Transmission Protection Instrument (TPI) can only be activated for countries that actually comply with European fiscal rules or are at least following the given adjustment paths – a condition France currently does not fulfil.

To be sure, the central bank has some leeway; it stated in its TPI document that "the criteria will be an input into the Governing Council's decision-making and will be dynamically adjusted to the unfolding risks and conditions to be addressed", but it seems very unlikely that it will give France a free pass upfront. Almost 10 years ago, when asked why France had received more leeway on adhering to the fiscal rules, former European Commission President Jean-Claude Juncker answered, "because it's France". We are unlikely to see Lagarde repeating such an answer when it comes to TPI.

A final rate cut later this year cannot be ruled out, yet

All in all, the discussion at next week's ECB meeting looks set to be more controversial than markets are currently pricing in. For us, next week's meeting is an example that central bank watchers sometimes need to distinguish between what a central bank should do and what it will do. While we still have some sympathy for another, rather preemptive, rate cut to avoid unwarranted euro strengthening and inflation undershooting, we also see a majority at the ECB not sharing this view and instead stressing signs of resilience and recent hard data.

The ECB currently doesn't look willing to leave its 'good place', though a rate cut later this year should still not be ruled out.

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