ECB preview: Gut feeling vs model-based judgement

With the new tensions between hawks and doves, a 25bp rate cut at next week's meeting looks like a typical European compromise. However, a larger rate cut should not be excluded entirely

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Somehow, we are back at where we were ahead of the European Central Bank's October meeting. The only difference this time around is not whether to cut or halt but rather whether to cut by 25bp or by 50bp. As ahead of the October meeting, there are good arguments for both options. At the October meeting, the ECB saw "risk management" as a key argument for the 25bp rate cut. The cut was a preemptive cut.

Since the October meeting, confidence indicators have weakened, while headline inflation has accelerated. Stagflationary tendencies are a very uncomfortable situation for the ECB. At the same time, negative risks have clearly increased. Think of the potential adverse effects from US economic policies over the coming months but also political instability in the two largest eurozone economies and now even a public finance crisis in France.

Downside risks have increased

The problem for the ECB is that these possible risks will not be reflected in the latest round of staff projections. Not only was the cut-off date of these forecasts before the latest political woes in France, the ECB normally also applies a “no policy change” assumption. With a pinch of irony, in the case of France, this assumption has received a completely new meaning. Anyhow, the ECB’s official staff projections will hardly show any changes from September. We could see a slight downward revision to growth and inflation in 2025 and probably unchanged forecasts for 2026. This alone would not be enough to alter the course of gradual rate cuts.

However, even if the official forecasts won’t provide big changes, the gut feeling of many ECB officials will be less benign and much more concerning. There is a high risk that on the back of Trump, France and Germany, eurozone growth will come in much weaker than the ECB’s projections will show. The only problem for the ECB to preemptively react to the current political woes is that it could be seen as intervening in national politics on the behalf of France. This is speculation the ECB would clearly rather avoid. The old comment from 2016 by then European Commission president Jean-Claude Juncker 'because it's France' is an argument the ECB could not use, at least not publicly.

Gut feeling vs model-based judgement

The ECB’s rate cut in October was largely seen as a move to get ahead of the curve. Having been slow to address rising inflation and arguably late in stopping rate hikes last year, the ECB appeared determined to get ahead of the curve and return interest rates to neutral as quickly as possible. For the doves, this is a no-brainer, and for the hawks, the argument might be that getting rates back to neutral quickly could be enough to avoid another episode of unconventional monetary policy with quantitative easing and negative interest rates further down the line.

At next week’s meeting, a 50bp rate cut decision would nicely tie into the October motive of rate cuts as risk management and a strong signal that the ECB is seriously trying to get ahead of the curve. It would be a security move to preempt any potential risks for the eurozone economy coming from the next US administration's potential economic policy choices and political woes in France and Germany. A 25bp rate cut decision would rather follow the cautious meeting-by-meeting approach, being a typical European compromise between doves and hawks.

We think that the ECB will be hesitant to really walk the walk on getting ahead of the curve and will cut rates by 25bp next week. To bring a bit more dovishness and to signal that the ECB is not getting cold feet in its quest to get ahead of the curve, we expect the ECB to communicate that it will continue bringing rates towards neutral levels and that it no longer rules out bringing rates into easing territory.

Eventually, it will all come down next week to the question whether the ECB will follow its gut feeling on everything that could happen over the coming months as a result of latest political developments or whether it sticks to the reality reflected in the staff projections, not taking into account all eventualities.

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