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ECB preview: The long dovish shift

Next week's challenge for the European Central Bank is how to keep all options open without sounding too dovish but also not too detached from reality

ECB President Christine Lagarde

In recent weeks, remarks from ECB officials have illustrated that the time of peaceful consensus within the Governing Council is over. Some members have said they remain open to the prospect of a further rate hike, others have said it is too early to discuss rate cuts, and still others have acknowledged that rate cuts will indeed be considered in the course of 2024. Experienced ECB watchers know that such a varied list of comments can only mean that the discussion of what to do next is in full swing. ECB officials use public statements to influence the debate behind closed doors.

In this regard, Isabel Schnabel's interview at the start of this week was remarkable as it represented a clear dovish shift, now also at the level of the ECB's Executive Board. It was not a shift that opened the door to a rate cut immediately but rather a natural next step amid the 'higher for longer' narrative; rate cuts can no longer be excluded next year. To some extent, Schnabel simply set the blueprint for the ECB's communication next week: do nothing but keep all options open, all while sounding neither too dovish nor too detached from economic reality.

Three things to watch next week

ECB's take on the economy

Although soft indicators have stabilised at low levels recently, the weak macro economic backdrop no longer justifies rate hikes, even for the hawks. But when meeting next week, the ECB will not only be looking at the weakening of growth and sharper-than-expected drop in eurozone inflation. They will also have to consider the still relatively solid labour market and wage growth. And with core and headline inflation still above target, any discussion on imminent rate cuts would be premature.

As the ECB is not only focusing on recent developments but has to look ahead, a new update of the ECB's staff projections will be another important piece of evidence in the discussion next week. Back in September, these projections had the eurozone economy return to potential growth of around 0.4% quarter-on-quarter by the start of next year and inflation to average 2.9% year-on-year in the final quarter of 2023 and 3% YoY in 2024. With the latest developments and the full impact of monetary policy tightening still having to unfold, we expect a downward revision to both the GDP growth and inflation forecasts. Needless to say, the lower the ECB's growth and inflation forecasts for 2024 and 2025, the higher the likelihood of rate cuts.

The last mile

We heard several ECB speakers talking about the very last mile in the process of bringing inflation back to target. The idea behind this was that bringing inflation down to the broader range of 2% to 4% is relatively easier than bringing it back to 2%. This is the reason policymakers have stressed the need to keep rates 'higher for longer'. The ECB will very likely repeat this message but we will watch for any signs of how this last mile is likely to play out. Is the home stretch seen as the drop to 2.0% or could it be 2% to 3% or 'around 2%' ? An important element of the last mile will be wage settlements. To further change the ECB's stance towards dovishness, wage growth needs to stabilise. It will take until the spring for the Bank to get some more certainty here.

The ECB's bond purchases

ECB President Christine Lagarde ignited fresh speculation about an earlier end to the reinvestments under the Pandemic Emergency Purchase Programme when she spoke at the European Parliament. Back then, Lagarde said that "this is a matter which will come probably for discussion and consideration within the governing council in the not too distant future and we will re-examine possibly this proposal". Some market observers expect the ECB to add more flavour to this issue next week. We think that it is still too early for a decision and that an earlier unwinding of the reinvestments will be part of a trade-off between rate cuts and withdrawing liquidity.

The long dovish shift

Disinflation in 2023 was mainly the result of energy and fiscal policy base effects. The disinflation of 2024, on the other hand, is likely to be the result of ECB tightening over the last two years. Even if the ECB is now gradually turning more dovish, there is still a risk that the Bank continues to underestimate the pace of disinflation, just as it underestimated the strength and pace of surging inflation in 2021 and 2022. The irony could very well be that by learning from the first mistake, the ECB ends up making another one. That said, as Isabel Schnabel noted in the aforementioned interview, the ECB is willing to err on the side of caution after more than two years of above-target inflation. For now, however, it is too early to judge whether the ECB is ahead or already behind the curve. Given the track record of the last few years, the central bank simply can't afford to anticipate what might happen, it will have to wait until it happens. With this in mind, the dovish shift will be a protracted one before it eventually leads to rate cuts.

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