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ECB minutes show controversial debate on real disinflationary trend

The just-released minutes of the European Central Bank's October meeting show that even before the US election, growth concerns had clearly taken over, but not all ECB members were convinced that the disinflationary trend was here to stay



Remember that while the rate cut decision in October made sense, it deviated from the usual emphasis on data dependency, shifting instead towards reliance on data point dependency and gut feeling. It looks as if a month of weaker sentiment indicators and a bigger-than-expected drop in headline inflation created a queasy gut feeling in many ECB members. The fear of falling behind the curve for the third time in three years seemed to have triggered a shift towards stepping up the rate-cut efforts.

The minutes from today indicate that, despite some scepticism within the ECB about the persistence of the disinflationary trend, concerns about growth and the use of a rate cut as a risk management strategy ultimately influenced the decision to implement the October rate cut.

Here are the most interesting statements from the minutes:

The October rate cut as a risk management move. “This proposal [to cut rates] was motivated by prudent risk management. If the slowdown signalled by indicators of economic activity and the downside surprise to inflation proved to be temporary, a decision to cut rates at the October meeting could, ex post, turn out as merely having brought forward a December cut. By contrast, if the data suggested a more persistent weakness, which confirmed a stronger disinflationary process, cutting at the current meeting would, ex post, signal a nimble adjustment of policy to changing macroeconomic conditions.”

Increasing concerns about the eurozone’s growth outlook. “The weaker incoming data were seen to increasingly raise the question of what should drive the projected economic expansion.”

Growth worries will weigh on the inflation outlook. “It was argued that the downside risks to economic growth implied downside risks to the inflation outlook, reflecting a natural correlation of risks, at least in the case of demand shocks. There were still upside and downside risks, but it was felt that the upside risk had become less intense and the downside risk more pronounced.” And: “As a result, inflation would probably now reach the 2% target somewhat earlier. It could thus be lower in 2025 than previously expected.”

Controversial discussion on the inflation outlook. While the hawks seemed to be a bit more cautious “A large, persistent undershooting of the 2% inflation target requiring a sustained policy response remained unlikely”, the doves saw a risk of inflation undershooting 2% already in 2025.

Not all ECB members initially supported the October rate cut. “A few members initially expressed a view that they would have preferred to accrue more information and to wait until December when a comprehensive assessment of the medium-term outlook for inflation was available. However, these members could see the precautionary risk management case for cutting now, and thus expressed their readiness to support the proposal.”

Debate on 25bp or 50bp at December meeting still on

October was the month of an important turnaround at the ECB. Instead of inflation concerns related to still-high and sticky domestic inflation, it seems that growth concerns have become the predominant factor driving monetary policy. As a result, the ECB has stepped up the pace at which it is reducing interest rates.

A big motive for the ECB’s October cut seems to have been the need to get ahead of the curve. Having been slow to address rising inflation and arguably late in stopping rate hikes last year, it

now appears 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. That's what the ECB labelled as 'risk management'. However, with eurozone GDP growth in the third quarter being higher than the ECB's September projections (0.4% quarter-on-quarter vs 0.2%) and inflation rebounding in October, some ECB members might start to doubt the chosen U-turn.

Looking ahead, with the results of the US election, risks to the eurozone growth outlook have clearly shifted to the downside; both in the short and longer run, posing an even more complicated challenge for the ECB. In fact, the risk of a more stagflationary environment has increased. If the ECB's gut feeling doesn't change, given this stagflationary scenario and the additional downward pressure on growth from US policies, the question for the December meeting is no longer if the ECB will cut rates again, but whether the cut will be by 25bp or 50bp.

For the hawks, 50bp currently still looks like a bridge too far, while the doves might again use the risk management argument to achieve this result. The next batch of sentiment indicators will not only bring a first indication of the potential impact of the US elections on the eurozone economy but could also tilt the balance towards either 25bp or 50bp. Today's minutes suggest that the December decision will again be a very close call.

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