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Krishna Guha | Marco Casiraghi

ECB – NOT ENOUGH DOWNSIDE IN INFLATION TO DELIVER 50 IN DEC, SCHNABEL VS LANE / VILLEROY FRAMES THE DEBATE

Eurozone inflation for November came in a bit better than expected but fell short of the decisive break lower in services in our view needed to deliver a 50bp rate cut in December and we reiterate that we think the market is wrong to view this as a 50-50 or better.

But the battle over ECB strategy is heating up, and advocates of a 50 could prevail in Q1.

Political turmoil and market stress in France, along with the threat of Trump tariffs – which Lagarde suggested the EU should respond to by increasing purchases of US imports – add to the complex backdrop.

Villeroy de Galhau Thursday made an open call for the ECB to be open to 50bp type moves and broke the taboo among policymakers on discussing the possibility that rates might need to go below neutral as we and the market believe.

This follows comments from Lane and Schnabel that – not for the first time – frame out the two sides of the debate at the ECB.

Lane Monday at the Bank of England Watchers conference laid the intellectual foundations for a possible 50, stating that the ECB needs to be "agile" and flexible regarding the speed and scale of rate cuts if downside risks materialize, with an uncertain neutral rate less relevant than the shock-response.

We read him as retaining an option on 50 in December, but more focused on into 2025.

Schnabel Wednesday in her Bloomberg interview pushed back against 50 in December, saying that while nothing is excluded "I have a strong preference for a gradual approach" and digging in against the idea of going below neutral.)

We read her as also warning colleagues a 50 in December would be viewed as signaling the ECB does think it needs to go below neutral, with market rate pricing and the euro taken even lower.

This note unpacks the debate, and how actual policy may evolve.

One key disagreement is over whether Trump trade wars should be primarily viewed as increasing downside risk to medium term underlying inflation via weaker growth (Lane) or net inflationary via tit-for-tat tariffs, euro weakness and geoeconomic fragmentation (Schnabel).

We think the ECB will stick to 25s every meeting for now at least until rates are close to 2, but a 50 in Q1 plausible. We reiterate we think the ECB ultimately cuts to 1.5 per cent.

November EZ headline inflation rebounded to 2.3 per cent from 2.0 per cent in October on a 12-month basis as expected, but core printed about 0.1 p.p. below consensus, coming in at 2.7 percent, stable from October.

Services inflation – a key measure for domestically-generated inflation – only fractionally decreased, with the 12-month rate decreasing to 3.9 percent from 4.0 per cent in the previous month after rounding to the first decimal place. As a result, services inflation continues to hover close to the rate observed since November of last year.

At the national level, headline inflation remained stable in Germany at 2.4 per cent, undershooting consensus of 2.6 per cent, as moderation in food prices seems to have offset unfavorable energy base effects. In contrast, HCIP inflation increased by 0.6p.p. in Italy and Spain, and 0.1p.p. in France.

THE LANE / DOVISH FRAMING

Lane set out the dovish framing in a two-step Monday first with a macro-oriented Les Echos interview that set out the generic dovish case and then the BoE Watchers speech that broke new ground on the policy implications, including the need to be open to a 50bp move, whether in December or at a later stage.

Lane remained optimistic about a firming in the cyclical recovery in Europe on the back of a lagged response to rising wages while recognizing this has not materialized in force to date, but underlined that restrictive policy has been weighing on activity. The framing here on growth is cyclical not structural. This does not exclude the idea that Europe faces serious structural challenges too, but sees a large cyclical component monetary policy can and should be calibrated to shape in line with the inflation target.

On inflation, Lane noted the need for further progress on domestically-generated services inflation, but argued that there are grounds for growing confidence that inflation will return sustainably to 2 per cent next year.

“In the absence of new shocks, this balance could be achieved in the sense that restrictive policy will no longer be needed.”

The ECB should “not remain restrictive for too long” otherwise “the economy will not grow sufficiently and inflation will, I believe, fall below the target.” This is the emerging risk of undershooting in the out-years, now central to the doves arguments.

He flagged the importance of the new projections, which may confirm confidence in inflation returning to target, but also indicate upside and downside risks.

Lane emphasized that Trump tariffs represent a looming negative shock to eurozone growth, particularly if imposed quickly and aggressively, but even if imposed only selectively and gradually due to uncertainty effects on investment and consumption.

France & Germany already doing that w their foolish politics

He played down the inflationary consequences of euro weakness, in effect arguing that this is a symptom of the shock not the shock, and argued that the Council would need to “strike a balance in our assessment between external pressure on inflation – which may be stronger from the United States but weaker from China – and possibly less domestic pressure on inflation.”

Although Lane did not say this explicitly, domestic inflation dynamics are what matters for the medium-term outlook. Further, in Lane’s analysis, a shortfall in inflation is implicitly fundamentally cyclical in nature and both potentially caused by and amenable to monetary policy actions.

Lane framed his arguments – at this stage at least – in terms of getting back to a neutral setting that does not restrict activity unduly in a sufficiently timely manner to avoid weak growth generating a persistent inflation undershoot.

But he also questioned whether a return to neutral will necessarily be the anchoring principle in 2025, sidestepping questions about the wisdom or otherwise of moving into accommodative territory below neutral by framing policy more in terms of shock and response – which could of course generate a policy path that does move below neutral.

“I would question whether next year the world will be neutral, in the sense of there being no major shocks.”

The innovation in his BoE Watchers speech was to go on to make the case for a “flexible” meeting by meeting approach that ensures policy is “response to the ever-changing economic landscape” with the ECB being “open-minded about the speed and scale of adjustments” depending on the scenario it finds itself in.

To date, Lane argues, confidence in a return of inflation to target “has been growing for some time” and in response the ECB has gradually reduced its policy rate, consistent with gradualism under uncertainty.

But gradualism is “not a universal principle” and certain circumstances “demand a more forceful response” as was the case when the ECB hiked rates 75bp twice in late 2022 – such that policy conduct should in effect be state contingent. More recently “precautionary” risk management principles had led the ECB both to deliver the final hike and cut in October as well as September.

Lane said it is “essential that we are agile in responding to risks that might crystallize and new uncertainties that might emerge.” This suggests both risk management and crystallization of risks could potentially warrant a faster level shift lower in rates, potentially delivered via one (or more) larger cuts to get back to a neutral-ish setting quickly and enable further timely reductions if needed under unfolding shocks.

This approach is predicated on the idea that the inflation target is symmetric and that it is important to prevent inflation slipping even moderately below 2 per cent in a persistent manner over the medium term, for risk of allowing expectations to slip lower again as in the post-GFC, pre-pandemic period.

THE SCHNABEL / HAWK FRAMING

Schnabel played down the significance of the plunge in PMIs saying she was not particularly surprised given political developments in Europe and the US, emphasizing the need to wait for the hard data.

She acknowledged that the eurozone economy “is still stagnating” but ascribed this to a “combination of cyclical and structural weakness” in a “very volatile and uncertain global environment.” In her assessment there are still grounds to expect some cyclical firming, and the structural part – critically – is not solvable by monetary policy.

She does not see risk of recession at this moment, with the labor market in aggregate holding up well with low unemployment, though the ECB will “need to monitor” signs of labor market weakening in some countries (our view: watch Germany.)

Schnabel agrees that tariffs "pose some downside risks to economic growth" but on inflation "it's more complicated" with weaker growth and China dumping disinflationary but tariffs and euro weakness inflationary – and a baseline view that reduced globalization "should on net have an inflationary effect."

She would like help from governments – with structural reforms to address structural weakness in all countries and fiscal easing for investment where there is fiscal space (Germany).

On inflation, the starting point is that services inflation at 4 per cent has made no progress over the past year, and the ECB will need to see more progress here supported by more moderation in wages.

She was not particularly hawkish on wages, noting that surveys plus the most recent wage deals suggest this moderation will unfold over time. Overall, therefore the disinflation process is seen "on track" with inflation heading back to target next year supporting rates moving back to neutral.

Schnabel emphasized that she would like to move rates lower "gradually" due to the need to confirm a shift lower in services inflation, the risk of new shocks and uncertainty around neutral, with some evidence that evidence of restraint is fading.

On the inflation outlook, Schnabel argues that while the risks to a sustainable return of inflation to 2 per cent are now more balanced, "I don't see a significant risk of an undershoot, in particular one that would warrant a response from our side." There are two aspects to this – limited likelihood of a sizeable undershoot, and, the idea that if there is an undershoot for structural reasons, it may not be amenable to monetary accommodation, and it would be unwise to waste valuable policy ammunition that might be needed in the event of a future cyclical shock trying to fix this.

This leads to the basic punchline, which is that while markets think the ECB will need to go below neutral to an accommodative posture, "from today's perspective I do not think that would be appropriate."

She even took a step further by suggesting current market pricing is off as "markets seem to assume that we will need to move into accommodative territory. From today's perspective, I do not think that would be appropriate." This is contrast with Lagarde's approach of not directly commenting on market rate expectations.

The rejection of the idea that the ECB will likely need to move into accommodative territory in turn underpins the reluctance to cut quickly, including via a possible 50bp move, as this would quickly close much of the remaining gap to neutral, and would thus most obviously make sense if the idea was to press on below neutral.

We think she is not the only policymaker who will be wary of moving below 2 per cent and back to a low-rate regime outside a severe downturn / crisis.

Like others, she flagged the importance of waiting for the new projections, suggesting that these would likely show inflation remaining close to target in the medium term, but also played down the significance of out-year 2027 projections for real time conduct of policy given elevated forecast uncertainty (and probably knowing that 3-year out projections largely reflect judgment).

Finally – in a sign of where the battlelines may well be drawn a year from now – Schnabel argued that the ECB "should be more relaxed about moderate deviations (in either direction) from our target.

This implies that it might not be worthwhile to either cut rates to very low levels or bring back QE / forward guidance to prevent inflation from running say at 1.7 or 1.8 per cent for some time. Schnabel presents this as a symmetric concern, though doves will see this as bringing back the old debate as whether “below but close to 2 per cent” might be acceptable.

WHERE THIS NETS OUT

We think the line of least resistance – embraced by the center of the Council – will be to cut 25bp every meeting until the deposit rate is 2 or close to it, at which point the Council will judge that it is at neutral and be tempted to pause, if circumstances permit, in particular if the euro is already very weak and in danger of breaking parity.

A 50bp cut in December is unlikely, although a number of influential ECB Council members are trying to keep the door open. On Thursday, Villeroy said “seen from today, there is every reason to cut on December 12th. Optionality should remain open on the *size* of the cut, depending on incoming data, economic projections and our risk assessment.”

But we think there is a bigger chance of a 50bp cut in Q1, with March particularly plausible on the grounds that the cyclical recovery will likely still be stalled out, there may have been a clearer downside break in inflation, unemployment may be moving up in Germany and elsewhere, and Trump trade actions may have crystalized downside risks to activity and domestic inflation, which will all feed into a new round of projections that will be led by the more dovish ECB staff. This is particularly the case if inflation break-evens, which have already fallen materially but to levels roughly consistent with the 2 per cent target (before adjusting for risk premia) break below levels plausibly consistent with the inflation target in the medium term. This would help break the impasse on the Council.

With or without a 50bp cut, we think the ECB is likely to end up cutting below neutral, with a base case of 1.5 per cent. This assumes a less than adequate response from Europe’s political authorities to take some of the burden away from the central bank.

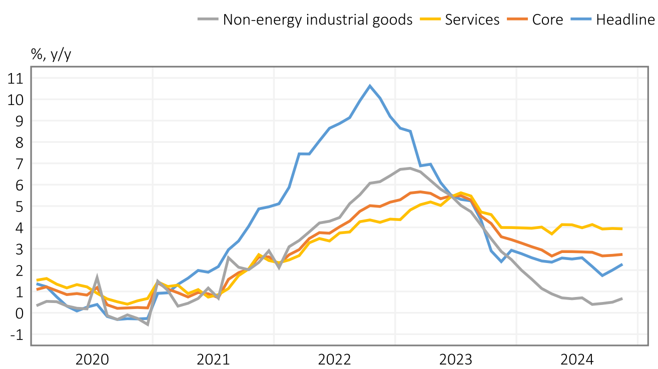
Eurozone Inflation

Percent, y/y

	Aug-24	Sep-24	Oct-24	Nov-24
Headline HICP				
Eurozone	2.2	1.7	2.0	2.3
Germany	2.0	1.8	2.4	2.4
France	2.2	1.4	1.6	1.7
Italy	1.2	0.7	1.0	1.6
Spain	2.4	1.7	1.8	2.4
Core				
Eurozone (HICP, ex food/energy/tob./alc.)	2.8	2.7	2.7	2.7
Germany (CPI, ex food/energy)	2.8	2.7	2.9	3.0
Italy (CPI, ex food/energy)	1.9	1.8	1.8	1.9
Spain (CPI, ex food/energy)	2.7	2.4	2.5	2.5
Services				
Eurozone (HICP)	4.1	3.9	4.0	3.9
Germany (CPI)	3.9	3.8	4.0	4.0
France (CPI)	3.0	2.4	2.3	2.5
Italy (CPI)	3.2	2.8	2.7	2.8

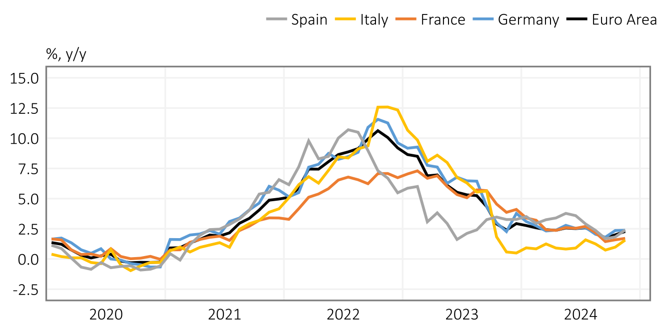
Source: Eurostat, Macrobond, Evercore ISI

Eurozone HICP Inflation



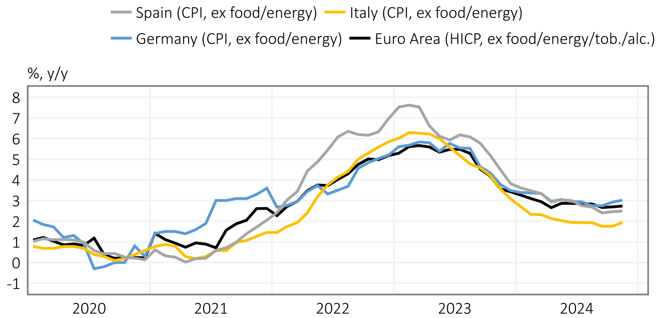
Source: Evercore ISI, Eurostat

Eurozone Headline HICP Inflation



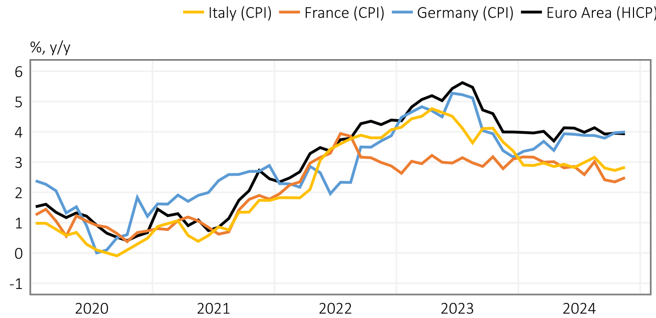
Source: Evercore ISI, Eurostat, German Federal Statistical Office (Statistisches Bundesamt), French National Institute of Statistics & Economic Studies (INSEE), Italian National Institute of Statistics (Istat), Spanish National Statistics Institute (INE)

Eurozone Core Inflation



Source: Evercore ISI, Eurostat, German Federal Statistical Office (Statistisches Bundesamt), French National Institute of Statistics & Economic Studies (INSEE), Italian National Institute of Statistics (Istat), Spanish National Statistics Institute (INE)

Eurozone Services Inflation



Source: Evercore ISI, Eurostat, German Federal Statistical Office (Statistisches Bundesamt), French National Institute of Statistics & Economic Studies (INSEE), Italian National Institute of Statistics (Istat), Spanish National Statistics Institute (INE)

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