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## FLASH NOTE – TRUMP SHOCK AND EUROPE: ECB'S LANE MAKES DOVE CASE, BUT SHORT OF A CLEAR DRIVE FOR 50 IN DEC

ECB chief economist Lane has set out the dove case for viewing the Trump shock to Europe as a negative growth shock that will weaken domestic inflation pressures – and cautioned the ECB "should not remain too restrictive for too long".

His comments indicate tolerance for a weak euro. But they stop short of a clear and obvious drive for a 50bp cut in December, which we think is unlikely absent a surprise clear-cut break lower in the next inflation print.

Lane told Les Echos there is uncertainty over Trump policies and they could have a number of implications for the eurozone but the "most important issue" is "an increase in protectionism is bad for the world economy."

He said the impact on the eurozone would depend on how quickly, aggressively and universally tariffs are imposed by the incoming US administration, but noted that even in the case in which tariffs are imposed partially and gradually this will "still generate a lot of uncertainty" that could "inhibit investment in Europe" and "make consumers reluctant to spend."

Lane played down the inflationary impact from euro weakness, saying it "is a factor but only one factor and it is important not to isolate it from the full analysis." We interpret this as meaning euro weakness is a symptom of the shock, it is not the shock. Re-routing of China exports from the US to Europe at low prices could offset this some.

Lane said more protectionism would "impair the growth rate of the European economy" which would be "likely to reduce inflationary pressures". The ECB would need to strike a balance between "external pressure" on inflation – "which may be stronger from the US but weaker from China" – and "possibly less domestic pressure on inflation."

Domestic inflationary dynamics are likely to be more important for the medium term outlook in the eurozone as elsewhere. This aligns with our view the ECB will ultimately need to cut rates down to around 1.5 per cent – moderately below neutral – assuming a less than decisive policy response from Europe's political leadership.

We think Lane personally would be sympathetic to the argument the ECB should consider a 50bp cut in December to get ahead of these dynamics. However, we do not think his comments signal this is likely.

Asked whether it might be useful to move faster on reducing rates, Lane said the ECB would move "meeting by meeting" based on how inflation is developing and upside and downside risks – and noted that while a year ago there were still concerns that it would be difficult to come down from 10 per cent inflation to 2 per cent inflation quickly "there's probably less concern about that now."

We view this as a hint that Lane personally would be open to thinking about a 50bp cut to accelerate the process of removing restraint and get ahead of Trump shocks. But we think this is not the central view on the Council, with high uncertainty and uncertainty over the net impact of Trump shocks on inflation, and hawks viewing Trump shocks as negative growth but putting net upward pressure on inflation.

Lane himself offered other comments that suggest no immediate drive for a 50, at least absent a surprise break lower in inflation.

Lane said the process of bringing inflation back under control is “not quite over because we need services inflation to come down” and talked about how “over the course of next year” the ECB needs to see “a kind of rebalancing” with services inflation coming down and allowing the ECB to achieve the 2 per cent inflation target “even if there’s some upward pressure on the prices for energy, food and goods.”

He said the final leg of bringing inflation back to 2 per cent on a sustainable basis “could indeed be covered next year” and in the absence of new shocks “this balance could be achieved in the sense that restrictive policy will no longer be needed.”

Elsewhere he talked about moving rates down “over time” – though warning that if this was too slow inflation could end up falling below target (we think it will).

So we read his comments as most consistent with a base case in which the ECB continues to move rates down a quarter point at every meeting rather than slowing down once rates move below 3 per cent (as hawks have advocated for) until the policy rate reaches a neutral setting we think is close to 2, and not the still more aggressive 50 in December.

This is the trajectory advocated by De Guindos and Stournaras in recent days.

We think a 50bp cut at some point is possible, but requires a break lower in domestic services inflation and/or wages in some combination. If this miraculously appeared in the next inflation print and inflation break-evens weaken further, there could be a late effort by doves to put 50 in play for December.

But more likely, the potential window for a 50 is March, by which time services inflation and wages are more likely to have turned lower, Trump tariffs will be in motion, and inflation break-evens may break the tie as to whether Trump shocks are inflationary as hawks believe, or disinflationary as doves believe.

Lane only talked about removing restraint – we think the ECB will likely have to ultimately go below neutral to provide some accommodation to shore up inflation and prevent it from falling persistently below target.

But we note that he said the concept of neutral – which applies in the absence of shocks – may not be particularly relevant to the outcome on rates next year. This in our view at least implicitly recognizes that rates might end up below neutral – as they might end up above neutral – in response to Trump and other shocks.

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