EUROPEAN CENTRAL BANK

The metamorphosis of hawks and doves into owls

Remember Kafka? Today, the ECB held fire for the second consecutive meeting, sending clear messages that the bar for action is getting higher. Put another way, Lagarde does not like hawks or doves, but prefers their transformation into owls—lovely creatures that can rotate their necks to see their surroundings, beyond just peripheral vision. Out of metaphor, the Governing Council (GC) of the ECB is already in a *"good position"* and has the luxury of waiting and watching the surroundings. The GC will continue to follow a *"data-dependent and meeting-by-meeting approach"* to determining the appropriate monetary policy stance, *"without pre-committing to a particular rate path."* Uncertainty has abated, and risks are *"more balanced"* but still tilted to the downside for both growth and inflation.

- **The carnival of the animals.** Owls rotate their necks to see their surroundings because their eyes are fixed in their sockets, but they have evolved several adaptations to prevent injury and maintain blood flow. These include more cervical vertebrae, special bones and vascular structures with air pockets that cushion blood vessels, and a blood-pooling system in their skull. This combination allows them to turn their heads up to 270 degrees! This is probably the aim of the GC of the ECB, i.e., some evolution that enables policymakers to have a broader view, ready to react to changes in data, with a meeting-by-meeting approach and without any pre-commitment. Today's decision achieved unanimity, and the impression is that the bar is getting higher for any move, or to use Lagarde's words, the ECB should not try to *"overengineer"*. Moreover, uncertainty has somewhat abated, notably trade uncertainty, although geopolitical uncertainty remains high. Risks have become more balanced but are still skewed to the downside. This suggests that if further adjustment is needed, it will most likely be another rate cut.
- **Today's decision:** After having reduced the deposit facility rate from a peak of 4.00% to 2.00% in June, the Governing Council (GC) of the European Central Bank (ECB) unanimously decided to leave key interest rates unchanged again at today's meeting, for the second time in a row:
  - **Interest rates: Unchanged.** The interest rates on the deposit facility, the main refinancing operations and the marginal lending facility will remain unchanged at 2.00%, 2.15% and 2.40%, respectively.
  - **PEPP & APP & Financing: Unchanged.** The GC confirmed the normalisation of the Eurosystem's balance sheet at a *"measured and predictable pace"*. Absent reinvestment of principal payments from maturing securities, the GC will continue to view Quantitative Tightening as *"working on the back burner",* meaning it has no impact on monetary policy decisions, as indicated in the past.
  - **TPI: Unchanged.** The statement on the Transmission Protection Instrument (TPI) was a photocopy of that in previous meetings. Admittedly, there was more attention than usual to any possible change. The wording says that it *"is available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across all euro area countries, thus allowing the Governing Council to more effectively deliver on its price stability mandate."* But what if market developments are *"warranted"*? President Lagarde was skilful in avoiding giving a clear answer. Still, the boundaries of possible ECB intervention are clearly outlined in the old TPI communiqué. Over the past few months, the ECB has seen a narrowing of spreads, lower interest rates, increased liquidity, and a calm situation in sovereign bond markets. So, no need to worry, for now.
- **Policy approach: Placing more emphasis on risk scenarios.** The communiqué remained largely unchanged and somewhat dry compared to July. *"Inflation is currently at around the 2% medium-term target, and the Governing Council's assessment of the inflation outlook is broadly unchanged."* The GC had an in-depth discussion about risks, including international risks, in line with the recent revision of its strategy. Not only do GC members discuss the balance of risks, but also their details and the factors involved. Their body structure may also be evolving to accommodate this, and they may increasingly resemble owls. The GC will continue to follow a *"data-dependent and meeting-by-meeting approach"* to determining the appropriate monetary policy stance, *"without pre-committing to a particular rate path"*.

- **Staff projections:** The inflation outlook remains largely unchanged. Current staff projections show headline inflation at 2.1% in 2025, slightly above previous estimates of 2.0%. Most notably, they point to higher 2026 inflation from 1.6% to 1.7% but a lower forecast from 2.0% to 1.9% for 2027. While this marginal revision should not be overinterpreted, it reflects downward risks for inflation, partly due to a stronger EUR, which is now included in forecasts. More detailed quarterly projections reveal interesting shifts. The anticipated drop in inflation to 1.4% in 1Q26 was eliminated. Current forecasts suggest inflation will only ease to 1.6% in 1Q26, remaining at 2.1% and 2.0% in the last two quarters of 2025, a significant revision from the 1.7% and 1.8% forecasted in June. Inflation in 2026 is expected to decline but less than previously forecasted, and in 2027 it is projected to rise again, with the last two quarters at 2.0%. The June forecast for core inflation (excluding energy and food) predicted a decline to 1.9% in both 2026 and 2027, after 2.4% in 2025. The projection remains unchanged for 2025 and 2026, but is revised down to 1.8% for 2027, indicating a somewhat lower trajectory (Figure 4). As President Lagarde stated, *"the disinflationary process is over. We continue to be in a good place."*

- **Staff projections: GDP growth stronger in the near term but weaker over the medium term.** Staff projections show an upward revision in GDP growth to 1.2% in 2025, from 0.9% expected in June. The growth projection for 2026 is slightly lowered to 1.0%, while the forecast for 2027 stays unchanged at 1.3%. Interestingly, near-term projections remain disappointing. The expected -0.1% qoq contraction in 3Q25 and a 0.3% qoq rebound in 4Q25 are adjusted to 0.0% and 0.2%, respectively, meaning that the significant upward revision in growth was due to better-than-expected performance earlier in 2025. In my view, recent leading indicators suggest a slightly improved near-term outlook, so 2025 GDP growth may end up at 1.3% or even 1.4%. Even President Lagarde acknowledged that *"there is positive underlying momentum."* While the labour market is somewhat softening, it remains very resilient. Easing financial conditions should benefit consumer spending, investment, and overall activity. Fiscal policy remains slightly expansionary. However, the ECB staff does not expect GDP growth to accelerate significantly. Indeed, growth is projected to be flat at 0.3% from 1Q26 through to the end of 2027 (annualised at 1.3%) (Figure 5). If 2H25 performs better than expected (as I believe), this could create a positive base effect for 2026 (i.e. a 1.2% growth rate for the entire year instead of 1.0%), although the final year's growth rate may be slightly lower. These growth rates are slightly above potential with a downward risk. Again, there is not much to write home about.

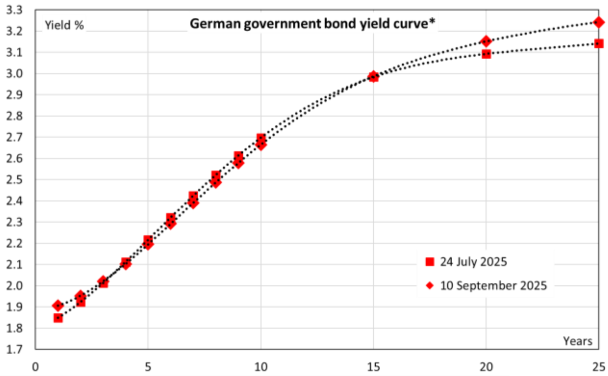
- **Bottom line: A high bar for action.** In July, President Lagarde noted that rate-setters had switched to a *"wait and watch"* attitude. Since then, trade uncertainty has abated, but the effects of tariffs are still to be seen. After the 5 June meeting, most observers still expected another rate cut in July (this was not my view: see *"In a 'good position' to navigate the uncertainty"*, 5 June). Yet, I have maintained a call for a final rate cut in December. Now, I have decided to remove the final cut. However, there may still be a chance of a rate reduction in March or June 2026 (projections for late 2025 are already quite low for both economic growth and inflation). Nonetheless, a rate cut is no longer in my baseline scenario.

Table 1. Eurozone inflation

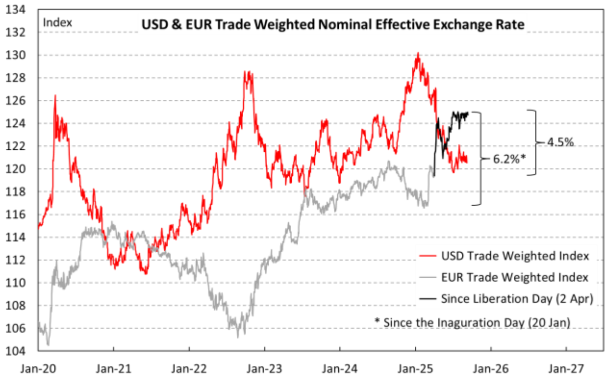
	Weight	% yoy									% mom
		Jan-25	Feb-25	Mar-25	Apr-25	May-25	Jun-25	Jul-25	Aug-25	3m avg	Jul-25
All-items HICP	1,000.0	2.5	2.3	2.2	2.2	1.9	2.0	2.0	**2.1**	2.0	**0.2**
All-items excluding:											
energy	906.0	2.6	2.6	2.5	2.8	2.5	2.5	2.5	**2.5**	2.5	**0.2**
energy, unprocessed food	863.4	2.7	2.6	2.5	2.7	2.4	2.4	2.4	**2.3**	2.4	**0.3**
energy, food, alcohol & tobacco	712.8	2.7	2.6	2.4	2.7	2.3	2.3	2.3	**2.3**	2.3	**0.3**
Food, alcohol & tobacco	193.3	2.3	2.7	2.9	3.0	3.2	3.1	3.3	**3.2**	3.2	**0.0**
processed food, alcohol & tobacco	150.6	2.6	2.6	2.6	2.4	2.9	2.6	2.7	**2.6**	2.7	**0.2**
unprocessed food	42.7	1.4	3.0	4.2	4.9	4.3	4.6	5.4	**5.5**	4.8	**-0.4**
Energy	94.0	1.9	0.2	-1.0	-3.6	-3.6	-2.6	-2.4	**-1.9**	-2.8	**-0.6**
Non-energy industrial goods	256.3	0.5	0.6	0.6	0.6	0.6	0.5	0.8	**0.8**	0.6	**0.3**
Services	456.5	3.9	3.7	3.5	4.0	3.2	3.3	3.2	**3.1**	3.2	**0.3**

Source: LSEG (Datastream), Eurostat, LC-MA calculations.

Figures 1 and 2. A steepening of the German yield curve; euro appreciation is significant but not massive.

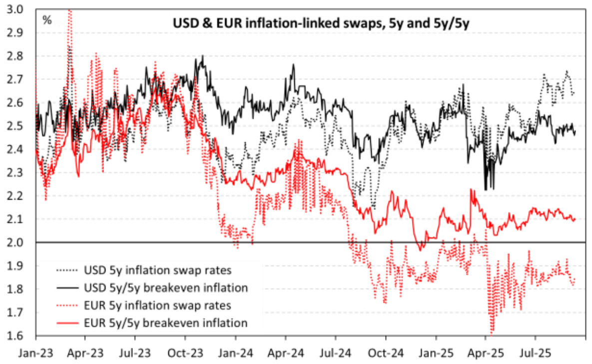


Source: LSEG (Datastream), LC-MA calculations. * Constant maturity yields.

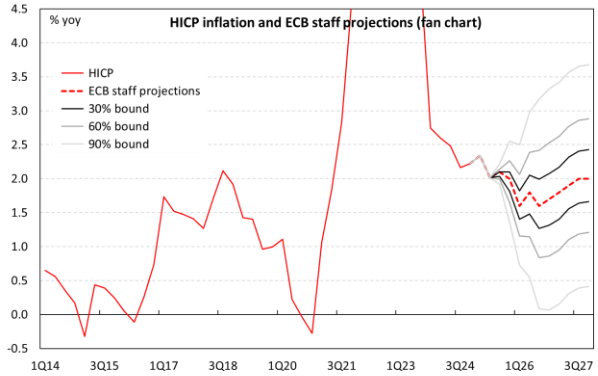


Source: LSEG (Datastream), LC-MA calculations.

Figures 3 and 4. Breakeven inflation has stabilised; ECB's projections show inflation declining until 1Q26.

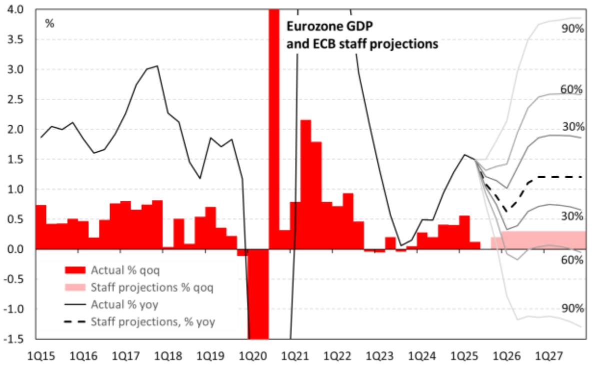


Source: LSEG (Datastream), LC-MA calculations. Note: not adjusted for risk premia.

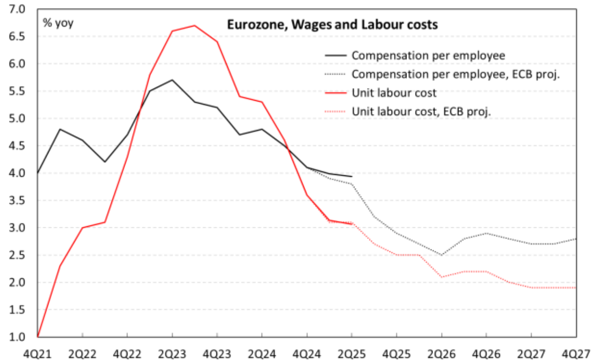


Source: LSEG (Datastream), Eurostat, ECB, LC-MA calculations.

Figures 5 and 6. Only a transitory setback expected in 3Q25 GDP; wages not declining as expected.

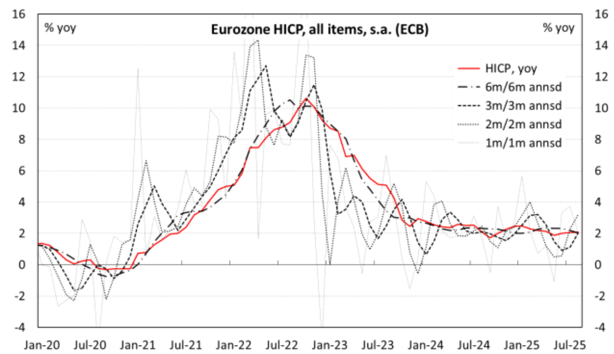


Sources: LSEG (Datastream), Eurostat, ECB, LC-MA calculations.

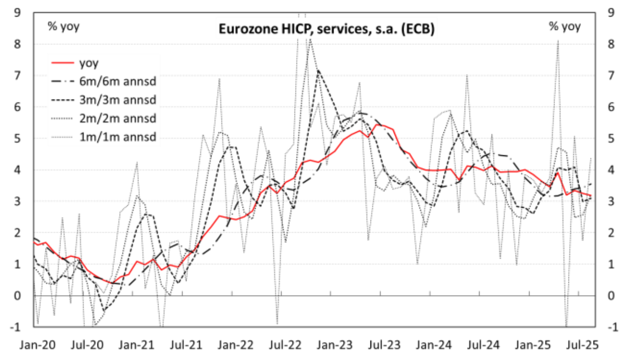


Source: LSEG (Datastream), ECB, Eurostat, LC-MA calculations.

Figures 7 and 8. S.a. annualised headline has stabilised around 2.0%, while services inflation has eased.

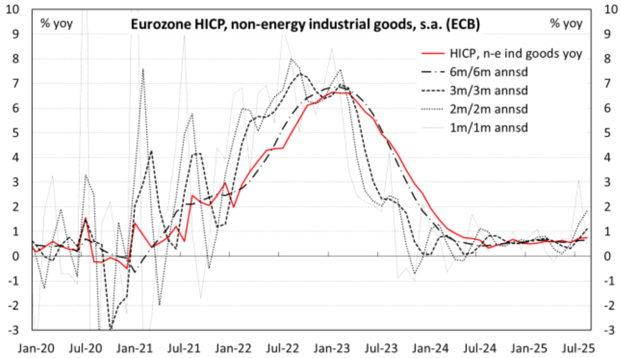


Source: LSEG (Datastream), Eurostat, ECB, LC-MA calculations.

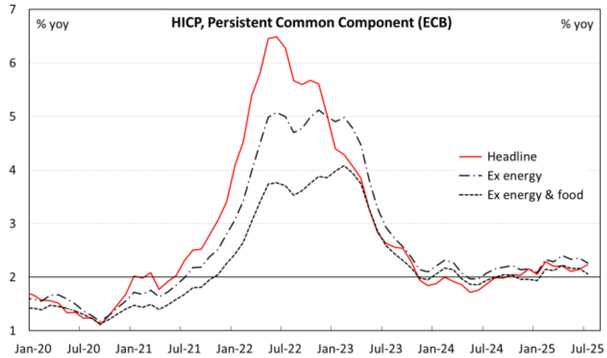


Source: LSEG (Datastream), Eurostat, ECB, LC-MA calculations.

Figures 11 and 12. Stable non-energy goods prices; Persistent Common Component inflation edging higher.



Source: LSEG (Datastream), Eurostat, ECB, LC-MA calculations.



Source: LSEG (Datastream), Eurostat, ECB, LC-MA calculations.

Table 2. ECB staff macroeconomic projections for the Eurozone

	September 2025				June 2025			
(annual percentage changes)	2024	2025	2026	2027	2024	2025	2026	2027
Real GDP	0.8	1.2	1.0	1.3	0.8	0.9	1.1	1.3
Private consumption	1.1	1.3	1.3	1.3	1.0	1.2	1.2	1.2
Government consumption	2.3	1.6	1.1	1.1	2.6	1.6	1.2	1.0
Gross fixed capital formation	-2.1	2.1	1.7	1.8	-1.8	0.7	1.7	1.9
Exports [1)]	0.7	1.3	1.1	2.5	1.1	0.5	1.6	2.6
Imports [1)]	-0.2	2.8	2.0	2.7	0.2	1.9	2.0	2.7
Employment	1.0	0.6	0.5	0.5	1.0	0.6	0.5	0.6
Unemployment rate (% of labour force)	6.4	6.4	6.3	6.1	6.4	6.3	6.3	6.0
HICP	2.4	2.1	1.7	1.9	2.4	2.0	1.6	2.0
HICP excluding energy	2.9	2.5	2.0	1.9	2.9	2.5	2.0	2.0
HICP excluding energy and food	2.8	2.4	1.9	1.8	2.8	2.4	1.9	1.9
HICP ex energy, food and Δ in indirect taxes [2)]	2.8	2.3	1.9	1.8	2.8	2.4	1.9	1.9
Unit labour costs	4.7	2.8	2.2	1.9	4.7	2.8	2.1	2.0
Compensation per employee	4.5	3.4	2.7	2.7	4.5	3.2	2.8	2.8
Labour productivity	-0.2	0.6	0.5	0.8	-0.1	0.4	0.7	0.8
General government budget balance (% of GDP)	-3.1	-2.9	-3.2	-3.4	-3.1	-3.1	-3.4	-3.5
Structural budget balance (% of GDP) [3)]	-3.0	-2.9	-3.1	-3.3	-3.1	-3.1	-3.4	-3.5
General government gross debt (% of GDP)	87.4	88.0	89.1	89.8	87.5	88.4	89.6	90.3
Current account balance (% of GDP)	2.6	2.4	2.5	2.5	2.7	2.7	2.6	2.6

Notes: Real GDP and components, unit labour costs, compensation per employee and labour productivity refer to seasonally and working day-adjusted data. Historical data may differ from the latest Eurostat publications owing to data releases after the cut-off date for the projections.
1) This includes intra-euro area trade.
2) The sub-index is based on estimates of actual impacts of indirect taxes. This may differ from Eurostat data, which assume a full and immediate pass-through of indirect tax impacts to the HICP.
3) Calculated as the government balance net of transitory effects of the economic cycle and measures classified under the European System of Central Banks definition as temporary.
4) The fiscal policy stance is measured as the change in the cyclically adjusted primary balance net of government support to the financial sector. The figures shown are also adjusted for expected grants under the Next Generation EU (NGEU) programme on the revenue side. A negative figure implies a loosening of the fiscal stance. The fiscal stance, as well as the general government budget balance and the structural budget balance, has been adjusted for the fiscal projection period (2022-25) for the estimated impact of a statistical reclassification in Italy. For past data, affecting in part also the fiscal stance for 2022, this adjustment will be available in the context of Eurostat's forthcoming April 2023 excessive deficit procedure notifications