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ECB caught in the French drama

The European Central Bank meeting on 29 October is not expected to result in an interest rate hike. Instead, the French crisis is increasingly eroding the need for additional rate hikes



With the surge in bond yields on the back of the crisis in France, we expect the ECB to remain on hold at next week's meeting

Back in September, the ECB surprised markets with a more hawkish message, at least between the lines. With headline inflation higher for longer and core inflation expected to increase in 2027, the stage seemed set for at least one more rate hike at the December meeting. Some even speculated about a back-to-back increase in October.

One month later, and after a severe fiscal and political crisis in France, the ECB is unlikely to repeat the hawkish tone at next week's meeting. At face value, macro developments since the last meeting would still justify another rate hike. Headline inflation increased again in September and most leading indicators point to continued resilience in the eurozone economy. However, the surge in bond yields on the back of the French crisis is already imposing a new restrictive monetary policy stance. In fact, the surge in German bond yields since the September meeting has already had roughly the same impact on growth and inflation as an additional 25bp rate hike. For France, it's closer to a 50bp hike. Or in other words, the bond market has taken over the ECB's job.

All of this means that the ECB is very likely to stay on hold next week and will delay any next

rate hike decision to December. This is when new staff projections will be available and when there will also be more insights into whether higher energy prices will eventually bring knock-on effects on the rest of the economy or not. In fact, there are three main parameters that, in our view, will determine the ECB's path going forward: i) the length and intensity of the war in the Middle East. The longer oil prices remain elevated, the higher the probability of more rate hikes; ii) the knock-on effects of higher energy prices. So far, there has hardly been any pass-through of higher energy prices in the rest of the economy. If this remains the case, the need for further rate hikes drops. If it doesn't, the likelihood of new rate hikes goes up. iii) France. Any solution to the current French fiscal woes could bring some relief to bond markets and allow the ECB to continue hiking rates. Without any solution, bond markets have taken over the ECB's role, making rate hikes less likely (and less needed).

Because it's France

Even if France does not play a role in the ECB's policy statement next week, it will be an important element at the press conference. Political and fiscal concerns in France, and the resulting widening in French spreads, have raised questions about whether the ECB could intervene through the Transmission Protection Instrument (TPI), which allows it to purchase securities issued by member states whose financing conditions have deteriorated for reasons not justified by country-specific fundamentals. However, before activating it, the Governing Council considers a cumulative set of criteria to determine whether the countries concerned are pursuing sound and sustainable fiscal and macroeconomic policies. In practice, this includes compliance with the EU fiscal framework, which would, at a minimum, require the proposed French budget to be fully adopted.

The ECB has nevertheless left itself some discretion, stating that the intervention criteria "will be dynamically adjusted to the unfolding risks and conditions to be addressed". This brings back memories of the famous "because it's France" by former European Commission President Jean-Claude Juncker. Generally speaking, the ECB will be in a difficult position: intervening too quickly in support of France may be viewed unfavourably by other member states and interpreted as monetary financing of the debt of a country unwilling to follow the rules. That argues strongly against early intervention. Also, don't forget that the leadership changes at the ECB over the next months (Schnabel, Lane, Lagarde) could also affect how the ECB views TPI.

Given the challenges of justifying the activation of TPI at present, we expect the ECB to adopt a three-pronged approach to address the French crisis.

1. The first line of defence is a more dovish approach to policy rates. As bond markets are currently taking over the ECB's job of inserting a more restrictive monetary stance on the economy, there is less need for the ECB to hike rates aggressively, or to hike rates at all. In fact, the ECB has already started to prepare for this option, as ECB president Christine Lagarde recently noted that "while growth has been resilient, since our last

meeting long-term interest rates have risen notably, which will slow growth and reduce pass-through by more than projected in our September exercise".
2. The second line of defence would be a covert return to bond purchases. The ECB could instead pause quantitative tightening temporarily and reinvest maturing bonds in its portfolio 'flexibly', sending a positive signal to bond markets. This had already happened during the Covid period.
3. Last but not least, should contagion in eurozone bond markets intensify, we expect the ECB to eventually trigger the TPI. As long as France remains non-compliant with the European fiscal rules, the ECB might even consider purchasing bonds from almost all eurozone countries, except for France.

All in all, next week's ECB meeting looks set to be uneventful on action but clearly not on words.

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