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Preview: ECB To Remain on Hold In September Given Reduced Policy Uncertainty

By

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Executive Summary

- **Expected Decision**: *We expect the ECB to remain on hold in September.* In line with consensus, at the September Governing Council (GC) meeting, we expect the European Central Bank (ECB) to keep its main policy rates i.e. its *i)* interest rate on the 'main refinancing operations' at 2.15%; *ii)* interest rate on the 'marginal lending facility' at 2.40%; and the key *iii)* 'deposit facility' at 2.00%.

  The ECB is expected to maintain its data-dependent, meeting-by-meeting approach, reaffirming its three-pronged reaction function. In July, traders cut the odds of a September ECB rate cut to 25% after Lagarde said the Bank was "in a good place," with inflation expected to stabilize near 2%, a signal markets took as ruling out further cuts next year.

- **Policy Discussion:** *The ECB has likely ended, for now, its rate-cutting cycle after 200 bps of easing since mid-2024, with growth stable and inflation near target.* Most economists expect the deposit rate to remain at 2% through year-end, and possibly into 2026, as policymakers describe the current backdrop as a "soft landing." July minutes and recent data, including stronger Q2 growth, improved sentiment, a modest inflation uptick, and a stabilizing EU–US trade deal, support hawkish voices favoring a pause, though a new cut later this year cannot be ruled out after the ECB will have observed the size and frequency of the upcoming cuts from the US Federal Reserve, starting in September.

  Policymaker Isabel Schnabel emphasized that rates should stay unchanged, calling current policy "mildly accommodative" and warning tariffs, food prices, and fiscal expansion could lift inflation above 2% by 2027. While not signaling hikes, she noted global monetary tightening may arrive sooner than expected. September's meeting will also be politically sensitive, as Lagarde must reaffirm the ECB's backstop without granting France exemptions from fiscal rules after its confidence vote—making the press conference a balancing act between market reassurance and conditionality.

- **Changes to Macroeconomic Forecasts:** *The ECB will update forecasts in mid-September to reflect the EU–U.S. trade deal, with 2025 inflation already revised to 2%.* Growth is set to slow in Q3 after a strong, tariff-driven start, as importers front-loaded purchases ahead of U.S. levies. Plans for sector-specific tariffs on pharma and semiconductors remain unclear. Looking ahead, inflation is expected to drift sideways or lower, bottoming near 1.5% in early 2026. Slowing wages, weak retail sales, China's overcapacity, and a stronger euro should keep goods prices subdued, while services inflation eases. With inflation near target and growth modestly positive, the ECB is likely to hold rates steady through 2025–26.

Key Picture: European Central Bank Key Forecasts – 2024-2027

		2025*f*		**2026*f***		**2027*f***	
	Latest reading	June Projections	March Projections	June Projections	March Projections	June Projections	March Projections
GDP *(real growth, y-o-y)*	1.5	**0.9**	**0.9**	**1.1**	**1.2**	**1.3**	**1.3**
Inflation *(%, y-o-y)*	2.1	**2.0**	**2.3**	**1.6**	**1.9**	**2.0**	**2.0**
Core-inflation *(%, y-o-y)*	2.3	**2.4**	**2.2**	**1.9**	**2.0**	**1.9**	**1.9**
Unemployment *(%, y-o-y)*	6.2	**6.3**	**6.3**	**6.3**	**6.3**	**6.0**	**6.2**

Source: ECB '*Macroeconomic projections*' June *and* March *2025 Note:* Latest readings: 1. GDP for Q1 2025; 2. Unemployment for July 2025; 3. Inflation for August 2025. *Inflation = Harmonized Index of Consumer Prices (HICP).

Analysis

- **EXPECTED DECISION**: *We expect, in line with consensus, the ECB to remain on hold in September.* At the Governing Council (GC) meeting on September 11th, we expect the European Central Bank (ECB) to keep its main policy rates i.e. its *i)* interest rate on the 'main refinancing operations' at 2.15%; *ii)* interest rate on the 'marginal lending facility' at 2.40%; and the key *iii)* 'deposit facility' at 2.00%.

  In terms of *forward guidance*, the ECB will stress that it remains data-dependent and the decisions will be still taken meeting-by-meeting, with its usual three-pronged approach about its reaction function confirmed. Looking ahead, the ECB is expected adopt a cautious, data-dependent approach. In July, traders dialled back expectations for a September ECB rate cut, pricing in just a 25% chance, as Lagarde struck a cautiously optimistic tone, saying the ECB is "in a good place" as inflation is projected to stabilize around the 2% target in the medium term. Thus, markets interpreted her comments as a sign that another round of rate cuts next year is unlikely.

  In terms of *Balance Sheet policies*, the GC has decided to move forward with the normalization of the balance sheet. GC confirmed that it will reduce the Eurosystem's holdings of securities under the PEPP. As of December 2024, the ECB has stopped re-investing the PEPP proceedings. The process for reducing PEPP holdings will generally follow the same approach as the APP.

- **POLICY DISCUSSION:** *The ECB has likely finished cutting rates for now, with stable growth and inflation near target keeping policymakers at ease.* With ECB officials sounding hawkish after the summer break, the ECB is expected to keep rates on hold. In the Sept 1–4 poll, 66 of 69 economists predicted the ECB would hold the deposit rate at 2% on Sept 11, following 200 bps of cuts between June 2024 and June 2025. Nearly 60% expect rates to stay unchanged through year-end, while a slim majority see them at 2% or higher by end-2026. Economists describe the current situation as a "soft landing," giving the ECB scope to pause. Thus, the ECB is expected to have finished cutting rates, with stable growth and near-target inflation leaving policymakers comfortable.

  September's ECB meeting may be more contentious than markets expect. While some doves within the GC will see some merit in a preemptive cut to prevent euro strength and inflation undershooting, the majority at the ECB is focused on resilience and solid recent data. For now, the Bank seems content to stay put, though an additional cut later this year remains possible, after the ECB will have observed the size and frequency of the upcoming cuts from the US Federal Reserve, starting in September.

  The July minutes and recent comments show the bar for another cut is high. Several summer developments support a wait-and-see stance: a limited but stabilizing US–EU trade deal, solid Q2 GDP growth, improving business sentiment, and a small uptick in August headline inflation—all strengthening the hawks' case for holding steady in September.

  However, as July minutes show some ECB members remain concerned about inflation undershooting. The case for rate cut rests on three points: the fragile US–EU trade deal could easily unravel; updated technical assumptions on rates and FX point to weaker growth and inflation in 2026; and aggressive Fed cuts could push the euro higher, adding downside pressure on inflation.

  ECB policymaker Isabel Schnabel said interest rates should remain unchanged, as the eurozone economy has proven resilient to U.S. tariffs and inflation risks remain tilted to the upside. After ending a year-long easing cycle in July, the ECB is in wait-and-see mode, with Schnabel arguing the current 2% rate is already "mildly accommodative" and further cuts are unnecessary. She highlighted strong domestic demand and Germany's planned fiscal stimulus as support for growth, while warning tariffs are inflationary by raising input costs and disrupting supply chains. Along with rising food prices, she sees inflation risks above the ECB's forecasts, potentially exceeding 2% by 2027.

Although not advocating immediate hikes, Schnabel suggested global monetary tightening may come sooner than expected given trade fragmentation, fiscal expansion, and ageing demographics. She downplayed concerns over a stronger euro, noting limited pass-through to prices, and said she would reconsider her stance only if inflation expectations materially diverged from the 2% target—an outcome she considers unlikely.

This ECB meeting will follow a French confidence vote, raising concerns not about rates but about potential ECB support if bond yields spike. The press conference will be delicate, as Lagarde must reaffirm the ECB's backstop without suggesting unconditional support. She will likely stress that the Transmission Protection Instrument applies only to countries meeting EU fiscal rules—criteria France does not currently fulfill. While the ECB has some flexibility, it is unlikely to give France an upfront exemption. Unlike Juncker's famous quip a decade ago, "because it's France", Lagarde is unlikely to offer the same leeway.

- **ECONOMIC ANALYSIS:** *The slowdown reflects fading Q1 tariff front-loading and rising caution amid U.S. trade uncertainty.* The eurozone economy grew just 0.1% q-o-q in Q2 2025, its weakest since late 2023 and sharply down from 0.6% in Q1, Eurostat confirmed. The slowdown was led by Germany, where GDP fell 0.3% as U.S. tariffs hit exports and factory orders slumped. German factory orders fell for a third straight month in July, underscoring weak demand. Investment (-1.8%) and exports (-0.5%) also contracted, while imports flattened after a Q1 surge. Household spending rose modestly (0.1%), and public spending rebounded (0.5%), keeping the ECB cautious on rate cuts. Among major economies, output shrank in Germany and Italy but expanded in France (0.3%) and Spain (0.7%). Year-on-year, GDP rose 1.5%.

  Headline inflation edged up slightly to 2.1% y-o-y in August from 2.0% y-o-y in July, staying near the ECB's 2% target and reinforcing expectations that interest rates will remain steady in the near term. The increase, driven by higher unprocessed food prices and a smaller drag from energy costs, slightly exceeded forecasts. Core inflation held at 2.3%, defying expectations of a dip to 2.2%, though services inflation eased to 3.1% from 3.2%. Energy prices are still lower than a year ago, though food inflation continues to rise.

  While overall inflation has slowed sharply after years of volatility, analysts expect further easing, supported by weaker wage growth, lower international prices, and a stronger euro keeping energy costs subdued.

  In terms of leading business indicators, slowing services offset stronger manufacturing, despite the first uptick in new orders since May 2023. The HCOB Composite PMI edged up to 51.0, a 12-month high but still signaling sluggish growth. Domestic demand supported the modest improvement, while export orders fell at the fastest pace since March. Spain remained the strongest performer, followed by Italy, while Germany slowed and France stayed in contraction despite a slight rebound.

  Services growth eased (PMI 50.5), while manufacturing posted its fastest output increase in nearly 3.5 years. Employment hit a 14-month high on stronger hiring in services, though factories cut jobs. Price pressures also picked up, with input costs and output prices rising, complicating the ECB's inflation outlook.

- **CHANGES TO ECONOMIC FORECASTS:** *Updated forecasts in mid-September will factor in the EU-U.S. trade deal, with inflation for 2025 already revised down to 2%.* The ECB expects eurozone growth to slow in Q3 2025 after a strong start, noting that resilience so far has been distorted by tariff front-loading. Lagarde highlighted that importers stockpiled goods in early 2025 ahead of U.S. tariffs. She added that U.S. plans for sector-specific tariffs on pharmaceuticals and semiconductors remain uncertain.

  Looking ahead, inflation is likely to drift sideways or slightly lower, with the lowest readings expected in early 2026, potentially as low as 1.5% y-o-y Slowing wage growth should help contain services inflation, while a strong euro, weak retail sales, and China's overcapacity will keep non-energy goods prices subdued. Overall, the core inflation outlook is likely to remain broadly unchanged. Seasonal patterns may temporarily lift annual readings, but underlying pressures are easing. With inflation within sight of 2% and growth modestly positive, the ECB can maintain current policy rates through 2025 and 2026.

- **MARKET IMPLICATIONS:**. *The pause is widely expected, so little market reaction should we expected about that*. European long-dated bond yields hit multiyear highs on mounting fiscal worries, while the dollar strengthened and gold reached a record. Germany's 10-year Bund yield climbed from 2.1% in January to 2.79% in late August. To put things into context, *In the bond market,* Since the last meeting on June 5 and as of July 21 the yields on a: *i)* 10y German bund decreased by 3 bps to around 2.67% (+30 bps y-t-d); and *ii)* 2y German bund edged up by 2 bps to 1.93% (-15 bps y-t-d). In the periphery of the Eurozone, the 10y Italian bonds decreased by 4 bps and trades around 2,67% since the last meeting. The gap between Germany and Italy's 10Y yields is at around 87 bps. *In the currency space,* since last meeting in July and as of September 5, EUR/USD fell by 0.3% to around 1.17 (+6.1% y-t-d, as growing rate-cut expectations weigh on dollar. *In the equity space,* European stocks reversed early gains to close lower Friday, weighed down by energy and financials, as weak U.S. payrolls data fueled concerns over the world's largest economy. The Eurostoxx 500 fell by 1.4% since the last meeting in July to 5321,45 as of September 5 (+8.2% y-t-d).

- **MACROECONOMIC ANALYSIS (APPENDIX):** *The Eurozone GDP growth grew in Q1, marking the strongest expansion since Q4-2023.* In Q2-2025, the eurozone GDP advanced marginally by 0.1% q-o-q (*c:* 0.1%; *p*: 0.6%). On an annual basis, GDP advanced by 1.4% (*c:* 1.4%; *p:* 1.6%). Among the largest economies in the bloc, German economy shrank by 0.3% q-o-q (*c*: -0.1%; *p:* 0.3%). France's GDP advanced marginally by 0.3% q-o-q (*c*: 0.3%; *p:* 0.1%). Italian economy contracted by 0.1% q-o-q (*c:* -0.1%; *p:* 0.3%).

  Business Confidence remains largely stable, despite concerns over U.S. tariffs and economic headwinds in the Euro Area.In June, the *HCOB Eurozone Composite* PMI rose to 51.0 (*c:* 51.1; *p:* 50.9). *Services PMI* decreased to 50.5 (*c:* 50.7; *p:* 51.0). *Manufacturing PMI* increased to 50.7 (*c*: 50.5; *p*: 49.8).

  Eurozone unemployment fell matching its record low. In May, *unemployment rate* edged down to 6.2% (c: 6.2%; *p:* 6.3%). The number of unemployed declined by 170K to 10.81mn. Amongst the largest Euro Area economies: *i)* the unemployment in Italy declined to 6.0% (*p:* 6.1%) in July; *ii)* the unemployment rate stood at 7.5% (*c:* 7.5%) in Q2 in France; and *iii)* in Germany the seasonally adjusted jobless rate held steady at 6.3% (*p*: 6.3%) in August. The 'youth unemployment rate' – measuring job-seekers under 25 years old – edged down to 13.9% (*c:* 14.3%) in July. Wages and salaries in the EZ rose by 3.4% y-o-y (*p*: 4.1%) in Q1-2025.

  Eurozone inflation is close to the target. In August, preliminary estimates showed that: *i) headline inflation* rose to 2.1% y-o-y (*c:* 2.0%; *p:* 2.0%); and *ii) core inflation* – which excludes food and energy prices – stood at 2.3% y-o-y (*c:* 2.2%; *p:* 2.3%). In Germany, annual CPI inflation rose by 2.2% y-o-y (*c*: 2.1%; *p*: 2.0%). In France, the inflation rate fell to 0.9% y-o-y (*c*: 1.0%; *p*: 1.0%). In Italy prices inflation inched lower to 1.6% (*c*: 1.7%; *p*: 1.7%).

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