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MONETARY AFFAIRS

Preview: ECB To Stay on Hold in October, And Signal No Urgency To Cut Rates

By

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Executive Summary

- **Expected Decision**: *We expect the ECB to remain on hold in October.* In line with consensus, at the October Governing Council (GC) meeting – to be held in Florence – 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.
- **Policy Discussion:** *The ECB appears comfortable maintaining the policy rate at 2% for now, with no imminent plans for additional easing.* Its stance remains firmly data-dependent, emphasizing flexibility rather than pre-commitment. The baseline outlook points to modest GDP growth of around 1% next year and a gradual convergence of inflation toward the 2% target. With inflation near target and growth steady, Lagarde reiterated the ECB is in a "good place," signalling stable rates through year-end. Markets still price an 80% chance of one more cut by 2026, while Germany's fiscal push should modestly lift growth and prices amid lingering global fiscal concerns.

  Recent data have offered little reason for a policy shift. While sentiment indicators such as the PMIs and Germany's Ifo index have improved slightly, hard data remain weak, and key releases—including inflation and third-quarter GDP—arrive only on the day of the policy decision. In the absence of market stress or widening French spreads, there is little justification for activating backstops such as the TPI or OMT.

  Risks remain tilted to the downside. Renewed U.S. trade tensions, a stronger euro, or delays in German fiscal stimulus could weigh on growth and competitiveness. Should these risks materialize—or if the ECB's 2028 inflation projection falls below 1.7%—further rate cuts could follow in December or March. For now, with inflation steady and fragmentation limited, policymakers consider monetary conditions appropriately calibrated.

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

		2025*f*		2026*f*		2027*f*	
	Latest reading	September Projections	June Projections	September Projections	June Projections	September Projections	June Projections
GDP *(real growth, y-o-y)*	1.5	**1.2**	**0.9**	**1.0**	**1.1**	**1.3**	**1.3**
Inflation *(%, y-o-y)*	2.2	**2.1**	**2.0**	**1.7**	**1.6**	**1.9**	**2.0**
Core-inflation *(%, y-o-y)*	2.4	**2.4**	**2.4**	**1.9**	**1.9**	**1.8**	**1.9**
Unemployment *(%, y-o-y)*	6.3	**6.4**	**6.3**	**6.3**	**6.3**	**6.1**	**6.0**

Source: ECB '*Macroeconomic projections*' June *and* September *2025 Note:* Latest readings: 1. GDP for Q4 2024; 2. Unemployment for August 2025; 3. Inflation for September 2025. *Inflation = Harmonized Index of Consumer Prices (HICP).

Analysis

- **EXPECTED DECISION**: *We expect, in line with consensus, the ECB to remain on hold in October.* At the Governing Council (GC) meeting on October 30th, 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. The December meeting will be more relevant, given the updated staff forecasts, but the possibility of a rate cut seem lower than current market expectations.

  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 appears comfortable maintaining the policy rate at 2% for the time being, with no imminent plans for additional easing.* Its stance remains firmly data-dependent, emphasizing responsiveness to incoming indicators rather than pre-commitment to a policy path. The baseline outlook foresees a modest improvement in euro area GDP growth over the coming year, alongside a gradual convergence of core inflation toward the 2% target.

  With inflation close to target and growth proving resilient, ECB President Lagarde reaffirmed that monetary policy is in a "good place," supporting expectations of stable rates through year-end. Markets still price in roughly an 80% probability of one additional rate cut by 2026, while Germany's fiscal expansion is projected to provide a modest boost to growth and inflation that year. At the same time, lingering concerns over fiscal sustainability in the U.S., Japan, and France continue to temper investor confidence.

  Recent data releases have provided little impetus for a policy shift. Apart from modest improvements in sentiment indicators such as the PMIs and the Ifo index, incoming data remain limited, with key figures, namely inflation, third-quarter GDP, and Commission sentiment surveys, set to be released only on the day of the policy decision.

  Nevertheless, several downside risks persist. Both external and domestic shocks, such as renewed trade tensions under a potential Trump administration or further euro appreciation, could undermine growth momentum and erode competitiveness, particularly in export-oriented sectors. Should these adverse developments materialize, the ECB is expected to respond with additional rate cuts as necessary to safeguard price stability and support activity. Particular attention will be paid to the 2028 inflation forecast, as any projection below 1.7% would strengthen the case for additional easing.

  On the fiscal side, expansionary measures in Germany, particularly in infrastructure and defense, are likely to provide a near-term boost to aggregate demand. Moreover, institutional backstops such as the ESM's Outright Monetary Transactions (OMT) facility could be activated should French spreads widen excessively, while the Transmission Protection Instrument (TPI) remains available to address unwarranted contagion in other member states. For now, however, financial fragmentation appears contained, with no significant widening in sovereign spreads or signs of systemic stress. In the absence of acute market stress or widening sovereign spreads, particularly in France, there is little justification for activating instruments.

Thus, with euro area growth stabilizing around 1% and inflation hovering near the 2% target, policymakers broadly consider monetary conditions to be appropriately calibrated. If projections will provide a clearer basis for discussion.

- **ECONOMIC ANALYSIS:** *The slowdown reflects fading Q1 tariff front-loading and rising caution amid U.S. trade uncertainty.* In Q2 2025, euro area GDP rose marginally by 0.1% quarter-on-quarter (c: 0.1%; p: 0.6%). On an annual basis, output expanded by 1.5% (c: 1.4%; p: 1.6%), broadly matching forecasts and signalling a stabilization in growth momentum. The IMF expects euro area growth to remain resilient despite U.S. tariffs, though this resilience will come at the cost of higher public spending and rising debt. In its updated World Economic Outlook, the Fund projects growth of 1.2% in 2025, slightly above July's forecast, but a modest slowdown to 1.1% in 2026. The relative outperformance reflects strong fiscal support, particularly from Germany, rather than underlying strength in private demand.

  Lagarde reiterated that the inflation outlook remains unusually uncertain, citing the volatile global trade environment as a source of both upside and downside risks. The ECB now sees growth at 1.2% in 2025 (vs 0.9% in June), 1.0% in 2026 (vs 1.1%), and 1.3% in 2027 (unchanged), as tariff-related risks have partially eased following the new trade deal. Still, renewed tensions could weigh on exports, investment, and consumption. On inflation, projections were revised slightly higher to 2.1% in 2025, 1.7% in 2026, and 1.9% in 2027. Lagarde stressed that "the disinflationary process is over," implying limited room for further rate cuts. With growth near potential and inflation around target, policy normalization is expected to pause, reinforcing the ECB's data-dependent stance.

  Elevated uncertainty and higher tariffs are the main drags, only partly offset by recovering consumption and fiscal easing in Germany. The euro area's debt ratio is expected to rise from 87% of GDP in 2024 to 92% by 2030, driven largely by Germany's defense and infrastructure spending. With growth near potential and inflation hovering around the ECB's 2% target, the IMF expects the deposit rate to remain steady at 2% through 2029. European exporters have so far passed on U.S. tariffs rather than absorbing them—German car export prices have stayed broadly stable—a positive sign for the industrial sector. Still, the negative impact of protectionism is likely to intensify as temporary mitigating factors fade and global trade fragmentation deepens. Chirstine Lagarde noted that U.S. tariff threats initially boosted trade flows, subsequent stock adjustments slowed activity—leaving euro area GDP up 0.7% in H1 2025 before moderating.

- **MARKET IMPLICATIONS:** *The Euro zone government bond yields continue to fall, tracking U.S. Treasuries as investors renewed bets on Fed easing and sought safety amid U.S. credit concerns.* Markets see an 80% chance of one more rate cut by 2026, while Germany's fiscal expansion is expected to lift growth and prices modestly in 2026. Meanwhile, concerns over fiscal sustainability in the U.S., Japan, and France continue to weigh on sentiment. To put things into context, *In the bond market,* since the last meeting on September 11 and as of October 27 the yields on a: *i)* 10y German bund decreased by 3 bps to around 2.62% (+25 bps y-t-d); and *ii)* 2y German bund fell by 2 bps to 1.98% (-11 bps y-t-d). In the periphery of the Eurozone, the 10y Italian bonds decreased by 1 bps to 3.40% since the last meeting. The gap between Germany and Italy's 10Y yields is at around 78 bps. *In the currency space,* over the past month, the euro has weakened as mounting political turmoil in France and disappointing economic data from Germany unsettled investors. since last meeting in September and as of October 27, EUR/USD fell by 0.8% to around 1.16 (+5.4% y-t-d). *In the equity space,* European stocks rebounded as investors digested the delayed release of U.S. inflation data alongside a wave of corporate earnings reports. The Eurostoxx 500 rose by 6.0% since the last meeting in September to 5710,45 as of October 27 (+16.1% y-t-d).

- **MACROECONOMIC ANALYSIS (APPENDIX):** *The Eurozone GDP growth matches expectations.* 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 1.5% (*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:* -0.1%).

  Leading business indicators reflect the sharpest pace of expansion. In June, the *HCOB Eurozone Composite* PMI rose to 52.2 (*c:* 51.0; *p:* 51.2). *Services PMI* increased to 52.6 (*p:* 51.3). *Manufacturing PMI* increased to 50.0 (*c*: 49.5; *p*: 49.8).

  Eurozone unemployment fell matching its record low. In August, *unemployment rate* edged up to 6.3% (c: 6.2%; *p:* 6.2%). The number of unemployed increased by 11K to 10.84mn. Amongst the largest Euro Area economies: *i)* the unemployment in Italy rose to 6.0% (*p:* 5.9%) in August; *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 September. The 'youth unemployment rate' – measuring job-seekers under 25 years old – stood at 14.0% in August. Wages and salaries in the EZ rose by 3.7% y-o-y (*p*: 3.5%) in Q2-2025.
  Eurozone core inflation rose to the highest since April. In September: *i) headline inflation* rose to 2.2% y-o-y (*c:* 2.0%; *p:* 2.2%); and *ii) core inflation* – which excludes food and energy prices – increased to 2.4% y-o-y (*c:* 2.3%; *p:* 2.3%). In Germany, annual CPI inflation rose to 2.4% y-o-y (*c*: 2.5%; *p*: 2.2%). In France, the inflation rate increased to 1.2% y-o-y (*c*: 1.2%; *p*: 0.9%). In Italy prices inflation stood at 1.6% (*c*: 1.6%; *p*: 1.6%).