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MONETARY AFFAIRS

Preview: ECB On Hold in February,

As a Strong Euro Keeps a Lid on Inflation

By

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Executive Summary

- **Expected Decision**: *We expect the ECB to remain on hold in February.* In line with consensus, at the February 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.
- **Policy Discussion:** *Investors see the ECB's "good place" becoming less comfortable amid euro strength, geopolitical risks, and uneven but resilient growth*. Policymakers have signaled no urgency to adjust rates, with inflation near target and markets pricing a prolonged hold through 2026. While energy prices could briefly pull inflation lower, resilient wage growth should keep domestic inflation elevated, supporting a patient, data-dependent stance.

  Beneath this consensus, divisions are widening. Doves point to weak growth momentum, tight financial conditions, and the risk of a mild inflation undershoot, also driven by EURO strength; while the hawks within the GC focus on wage pressures and firmer GDP. With lending conditions tighter than the headline depo rate suggests and disinflation continuing, the case for two additional 25bp cuts in mid-2026 is strengthening, even if the ECB avoids signaling this for now.

  Market pricing reflects these cross-currents. The euro's rise above \$1.20—driven largely by dollar weakness tied to U.S. policy uncertainty—has increased concerns about disinflation, even as higher energy prices partly offset this effect. Markets now price roughly a 30% chance of an ECB cut in September, while fading expectations of a 2027 hike, with FX dynamics and gradual shifts in global portfolios adding further complexity to the policy outlook.

Key Picture: European Central Bank Key Forecasts – 2025-2028

		2025*f*		**2026*f***		**2027*f***		**2028*f***
	Latest reading	December Projections	September Projections	December Projections	September Projections	December Projections	September Projections	December Projections
GDP *(real growth, y-o-y)*	1.3	**1.4**	**1.2**	**1.2**	**1.0**	**1.4**	**1.3**	**1.4**
Inflation *(%, y-o-y)*	1.9	**2.1**	**2.1**	**1.9**	**1.7**	**1.8**	**1.9**	**2.0**
Core-inflation *(%, y-o-y)*	2.3	**2.4**	**2.4**	**2.4**	**1.9**	**1.9**	**1.8**	**2.0**
Unemployment *(%, y-o-y)*	6.2	**6.3**	**6.4**	**6.2**	**6.3**	**6.1**	**6.1**	**5.9**

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

Analysis

- **EXPECTED DECISION**: *We expect, in line with consensus, the ECB to remain on hold in February.* At the Governing Council (GC) meeting on February 5th, 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 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** *Investors see the central bank under pressure to reassess its "good place" amid euro strength, geopolitical risks, and mixed but resilient euro area growth data.* ECB policymakers signaled no urgency to adjust rates, with inflation near target and markets pricing a prolonged hold through 2026. The ECB kept rates at 2% in December and raised growth forecasts, indicating a high bar for any policy shift. Officials stressed patience amid uncertainty—from AI to trade risks—without signaling a bias toward easing or tightening. While energy prices may briefly pull inflation below target, resilient wage growth keeps domestic inflation elevated, supporting expectations that price growth will return to around 2% over time.

  The consensus masks growing divisions over 2027, with doves worried about weak growth, tight financial conditions, and a mild inflation undershoot on the back of renewed EUR strength, while hawks focus on wage pressures and firmer GDP. Ending conditions remain tighter than the headline depo rate suggests, growth momentum looks weak, and disinflation is continuing. Combined, these factors strengthen the case for two additional 25bp rate cuts in June and September 2026, even if the ECB avoids signaling this for now.

  While rates are widely expected to stay unchanged, cross-currents are intensifying: euro strength is weighing on inflation projections, energy prices are rising due to cold weather and geopolitical tensions, and renewed AI-driven market volatility is denting risk appetite. As a result markets now price roughly a 30% chance of an ECB rate cut in September, up from under 10% a week ago, while expectations for a 2027 rate hike have fallen.

  Trump's trade threats and reversals have driven a sharp appreciation of the euro, which briefly rose above $1.20, its highest level since 2021. ECB officials are increasingly concerned that sustained euro strength could further depress inflation, already projected to run below the 2% target this year and next. Economists note, however, that the ECB focuses more on the speed and breadth of currency moves than on specific exchange-rate levels, and that the trade-weighted euro has risen more modestly as the move largely reflects dollar weakness. While the ECB is unlikely to react directly to currency moves, higher oil and gas prices may partly offset the euro's disinflationary impact.

  Concerns over U.S. policy credibility and Federal Reserve independence add another layer of uncertainty, even if the choice of Kevin Warsh as next Fed Chair may ease some of these tensions. Perceptions of looser U.S. monetary policy could weaken the dollar further, reinforcing euro strength and weighing on euro-area inflation, while higher U.S. yields could still spill over into European borrowing costs. Separately, Dutch pension funds are reassessing large U.S. exposures amid shifting geopolitics. Although a rapid reallocation is unlikely, even gradual reductions—particularly through higher dollar hedging—could have meaningful FX effects, reinforcing recent dollar depreciation and complicating the ECB's policy outlook.

- **ECONOMIC ANALYSIS:** *Eurozone GDP growth held steady in Q4, closing 2025 on a solid note despite elevated uncertainty.* The outlook for 2026 is improving as investment supports a modest cyclical rebound, though structural challenges remain.

  The euro zone economy grew faster than expected in Q4, expanding 0.3% versus a 0.2% forecast, as stronger consumption and investment offset weak exports and U.S. trade uncertainty. Annual growth reached 1.3%, beating expectations, underscoring the bloc's resilience despite trade tensions, Chinese competition, and geopolitical strains.

  Spain remained the main growth engine with a 0.8% expansion, while Germany grew 0.3%, slightly above forecasts but still subdued. Italy also surprised on the upside, and France grew as expected. Looking ahead, early 2026 indicators are encouraging, with improving sentiment, stable inflation, low unemployment, and Germany's fiscal expansion expected to support growth, even as exports remain a drag.

  Euro area inflation eased to 1.9% in December, down from 2.1% and below expectations, falling under the ECB's 2% target for the first time since May. Core inflation edged down to 2.3% from 2.4%, supporting expectations that rates will stay on hold. Inflation declined in most member states, with the lowest rates in Cyprus, France, and Italy, and the highest in Romania, Slovakia, and Estonia. Services remained the largest contributor to inflation, followed by food, alcohol and tobacco, and non-energy industrial goods.

  According to an ECB survey, Euro zone consumers lifted their longer-term inflation expectations to a record in December, with five-year expectations rising to 2.4%, above the ECB's target. One-year expectations held at 2.8%, while three-year expectations edged up to 2.6%. Despite the uptick, consumers still expect inflation to ease over time, supporting the ECB's view that policy is well positioned. The central bank is widely expected to keep rates on hold, though uncertainty, particularly around U.S. economic policy, remains elevated.

  Euro zone business activity held steady in January as weaker services growth offset a slower contraction in manufacturing, with the composite PMI unchanged at 51.5 but below expectations. Services eased to a four-month low, while factory output showed tentative stabilization, though demand remained weak and employment fell for the first time since September.

- **MARKET IMPLICATIONS:** Expect a neutral market reaction, in the absence of additional communication during the press conference. To put things into context, *In the bond market,* Germany's 10-year Bund yield retreated from a 10-month high as policymakers weighed the deflationary impact of a stronger euro on the policy outlook. Since the last meeting on December 18 and as of February 3 the yields on a: *i)* 10y German bund rose by 3 bps to around 2.88% (+3 bps y-t-d); and *ii)* 2y German bund fell by 3 bps to 2.10% (-3 bps y-t-d). In the periphery of the Eurozone, the 10y Italian bonds are virtually unchanged and stay at 3.50% since the last meeting. The gap between Germany and Italy's 10Y yields is at around 61 bps. *In the currency space*, the euro moved back toward a five-year high, despite volatile global FX conditions. Gains were supported by optimism around a landmark EU–India trade agreement, seen as boosting euro-area growth and resilience to global trade shocks. Since last meeting in December and as of February 3, EUR/USD increased by 0.6% to around 1.18 (+0.4% y-t-d). *In the equity space,* European equities moved higher, with rising metal prices and sustained momentum in technology and AI lifting risk sentiment. The Eurostoxx 50 rose by 5.1% since the last meeting in December to 6036,06 as of February 3 (+3.2% y-t-d).

- **MACROECONOMIC ANALYSIS (APPENDIX):** *The eurozone closed 2025 with solid growth despite weak exports and escalating U.S. trade tensions.* Q4-2025, the eurozone GDP advanced by 0.3% q-o-q (*c:* 0.2%; *p*: 0.4%). Spain led growth with its strongest quarter in a year, expanding faster than expected on strong household consumption and investment. The Netherlands grew 0.5% on export strength, while Germany and Italy each posted 0.3%, both beating forecasts. France grew 0.2% as expected, its weakest quarterly pace since Q1 2025. Eurozone GDP rose 1.3% y-o-y (*c:* 1.2%; *p*: 1.4%). above the 1.2% forecast. For 2025, growth reached 1.5%, up from 0.9% in 2024 and above the European Commission's 1.3% projection.

  Leading indicators point to a pause in private-sector growth, with services still expanding and manufacturing returning to modest growth. In January, the *HCOB Eurozone Composite* PMI was at 51.5 (*c:* 51.8; *p:* 51.5). *Services PMI* decreased to 51.9 (*c*: 52.6; *p:* 52.4). *Manufacturing PMI* rose to 49.4 (*c*: 49.1; *p*: 48.8).

  Eurozone unemployment dips matching the record lows seen in late 2024. In December, *unemployment rate* edged down to 6.2% (*p*: 6.3%). The number of unemployed decreased by 61K to 10.79mn. Amongst the largest Euro Area economies: *i)* the unemployment remained at 5.6% in December in Italy; *ii)* the unemployment rate rose to 7.7% (*c:* 7.6%) in Q3 in France; and *iii)* in Germany the seasonally adjusted jobless rate held steady at 6.3% (*p*: 6.3%) in January. The 'youth unemployment rate' – measuring job-seekers under 25 years old – fell to 14.3% in December. Wages and salaries in the EZ eased to by 3.0% y-o-y (*p*: 3.8%) in Q3-2025.

  It was the first sub-2% inflation reading since May, strengthening expectations that the ECB will keep rates on hold for longer. In December: *i) headline inflation* eased to 1.9% y-o-y (*c:* 2.0%; *p:* 2.1%); and *ii) core inflation* – which excludes food and energy prices – cooled to 2.3% y-o-y (*c:* 2.3%; *p:* 2.4%). In Germany, annual CPI inflation eased off to 1.8% y-o-y (*c*: 1.8%; *p*: 2.3%). In France, the inflation rate cooled to 0.8% y-o-y (*c*: 0.8%; *p*: 0.9%). In Italy prices inflation increased to 1.2% y-o-y (*c*: 1.2%; *p:* 1.1%).