

The ECB needs a smooth transmission and a smooth transition

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Markets Insight



Central bank at a critical juncture as it prepares leadership changes at time of strains in bond markets

The European Central Bank is once again at a critical juncture ahead of a major reshuffle of its governing council.

It meets on Thursday after fresh strains have emerged in European bond markets in recent weeks. Growing concerns over a fiscal crisis in France have led to a widening in the spread of sovereign bond yields, fuelling speculation at times that the ECB will have to intervene to stop financial stress from spreading to other countries.

That comes as the bank prepares for a new president, chief economist and an executive board member in charge of market operations in 2027. Faced with increasing risks to the growth and inflation outlook, the ECB needs to ensure the smooth transmission of its monetary stance and a smooth transition in leadership.

The ECB has been in similar situations before, but this time looks different – in terms of the inflation outlook, the geopolitical context and personnel dynamics.

Energy prices remain stubbornly elevated, and early signs of the second-round effects of that on consumer prices are emerging. While underlying inflationary and wage pressures have remained contained for now, they have not eased either. With the not-so-distant experience of the 2022 crisis in mind, concerns that inflation expectations may become entrenched are likely to be weighing on ECB policymakers. Unless growth slows abruptly, a hawkish bias is likely to remain the default option for now.

Meanwhile, broad financial conditions have tightened amid a rise in bond yields driven by a combination of global and domestic factors, including geopolitical tensions, the

surge in AI-driven corporate borrowing, and fiscal concerns. The latest ECB Bank Lending Survey suggests banks are already tightening lending standards, while demand for new loans is weakening.

Higher borrowing costs and tighter credit conditions should reduce the need for further increases in policy rates, all else equal, but the ECB is facing a bigger communication challenge.

On the one hand, it has the appropriate toolkit to address financial fragmentation across the euro area member states. In particular, ECB staff must be squarely focused on the repo market, a key transmission channel of monetary policy to the real economy, ready to intervene in case of stress. From a technical perspective, preventing a liquidity crisis is the easy part.

On the other hand, the ECB can only ensure financial stability to the extent that it does not fuel moral hazard. Buying French debt without strict conditions would be legally and politically unacceptable. Pre-emptive ECB intervention in the French bond market looks highly unlikely ahead of an uncertain high-stakes presidential election in spring 2027.

Alternatively, any hint that the ECB may activate the bond-buying tool known as the Transmission Protection Instrument would risk making French problems worse. This tool was created in 2022 to prevent fragmentation in the Eurozone bond markets but it comes with conditions and has never been used so far. Tweaking the TPI conditionality to make France eligible may be politically toxic in other countries.

Ideally, verbal intervention would suffice. The question is whether proverbial constructive ambiguity

can work in France's case – a communication strategy the ECB has long relied on to signal willingness to intervene while preserving flexibility.

These trade-offs come at a time when heads of state and government will need to agree on a large package of nominations for the ECB's executive board in coming months. President Christine Lagarde's term officially ends in October next year, but there has been some speculation she may announce her departure early to allow governments to decide on all executive board replacements before the French election. The changeover will inevitably raise questions about the direction of policy under the next leadership.

In that context, Klaas Knot's self-described approach of "principled pragmatism" looks particularly relevant. The former president of the Dutch central bank and a contender for the top job argued that the ECB would need to keep acting decisively to preserve monetary transmission in the future without becoming a substitute for fiscal or political action.

Pablo Hernández de Cos, the former governor of the Bank of Spain, is another strong candidate with the credentials and experience to run the ECB. Both have been in charge during previous economic and fiscal crises. Whoever gets the job will need to strike the right balance between principles and pragmatism in the next one.

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