ECB Preview: Lagarde's swan song

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Research

Arne Petimezas
Director Research
+31 20 522 0244
a.petimezas@afsgroup.nl

Barbarians at the gates, Lagarde out

- **For the record: the ECB will deliver a well-telegraphed 25bps rate hike at the September Governing Council meeting while remaining uncommitted to the outcome of future meetings despite hawkish inclinations coming to the fore.** No surprise here. Regardless, the focus at the meeting will not be rates or the finer details of monetary policy (more on that later). Politics will rule the roost.
- **The barbarians are at the gates in France and Germany.** French far right leader Marine Le Pen is likely to win the 2027 Presidential election and become President. In Germany there is now a non-trivial chance that the so-called grand coalition of the centre-right CDU/CSU and the centre-left SPD will collapse before the next federal elections in 2029. If elections are held, the far right anti-euro AfD will become the biggest party. And I believe it will get the chancellorship.
- **The ominous political outlook has unnerved the establishment and the European job carrousel – the ECB included – has started in earnest.** To future proof the central bank against any 'odd' nominees that the anti-establishment parties might bring forward. First on the chopping block is President Lagarde herself, whose terms officially ends late 2027.
- **At the July ECB press conference, Lagarde basically said that she will quit by the end of the year.** Rumor has it that she is still lining up to chair the World Economic Forum. While the job might serve her personal preferences well, I was told, I don't see the WEF having any relevance when globalism is in its death throes – to put it mildly. Perhaps it is a springboard for a return to French politics. I have no clue.
- **Since time immemorial former ECB Governing Council members Klaas Knot and Pablo Hernandez de Cos have topped ECB watchers' rankings as Lagarde most likely successor though nobody really knows why.** In the Bloomberg polls on Lagarde's succession I cluelessly followed consensus by marking either Knot or De Cos as the next President. I don't believe anyone has a clue except Goldman Sachs.
- **Jokes aside, earlier in the month the veil on Lagarde's succession was lifted ever so slightly.** German media reported that Board Member Isabel Schnabel will leave early to take up a job at the IMF. That would leave the Board without any German representation. Then I read the news that Bundesbank President Nagel would meet Chancellor Merz this week. And Nagel, who wasn't that hawkish to begin with, has been remarkably soft as of late. Unlike Schnabel, Nagel follows the ECB party line of not commenting on future meetings. And he has been a supporter of loose German fiscal policy. So, his fiscal and monetary

views align better with the stereotypical dovish South European views. Then again, for low deficits one must look south, not north these days.

- **Bottom line, if asked at gunpoint to guess the next ECB President, it would be Nagel or a third German.** Then again, Chancellor Merz's position is not that great – how many political capital does he have left anyway?
- **Undoubtedly, I expect that policy will take a backseat at the presser.** Journos will valiantly try but fail to get Lagarde admit anything of substance on the job carousel. Still, she might ad-lib some clue on her succession. That's simply following past precedent.
- **Regarding monetary policy, I have recently penciled in another quarter point hike.** Namely for the December meeting. While ESTR swaps have firmly priced in said hike (I am late I'm afraid), sell-side consensus still firmly believes the September hike will be the last for a while.
- **The ECB press conference will tilt hawkish.** But Lagarde will in no way tee up another hike – the uncommitted, one-meeting-at-a-time stance will stay in place. The no forward guidance for guidance that paradoxically has not resulted in cliffhanger interest rate decisions.
- **Given better than expected Q2 GDP growth figures, the moderate improvement in Eurozone survey data in Q3, and the upturn in global economic growth as per the JPMorgan global manufacturing PMI, I expect a marginal upgrade to staff GDP forecasts for this year.** And perhaps for next year too. Given the relentless rise in natural gas prices even before the mid-August cut-off date for projections, staff will nudge 2026 and 2027 inflation forecasts a tad higher. I see core inflation a bit higher than before (hence the additional rate hike in December) but I don't know if staff will raise theirs too.
- **And speaking of those forecast, the ECB has the 'luxury' of better growth despite higher than expected energy prices.** Oil prices are modestly above staff's baseline scenario while natural gas futures prices are between adverse and severe.
- **On the money market side, I will be very attentive to further clues on a possible increase in Minimum Reserve Requirements.** Which, it must be emphasized, is now part of the baseline in my money market spread forecasts.
- **I want to conclude with Lagarde's eulogy – as President of course.** While Lagarde obviously failed as a communicator or a market wizard – she's absolutely not like her predecessor Mario Draghi – I think she has done a pretty good job since 2023.
- **Since 2023, inflation rather painless glided to two percent.** If you take headline and not core, the ECB actually hit its target on the eve of the Iran war. Core needed a bit more work, but we are only talking decimals here. Forward guidance is gone (phew) but outcomes of monetary policy meetings are rather predictable. In a good way because there's no doubt that the ECB will raise rates if it thinks it has to. The contrast with Federal Reserve Chairman Warsh's fumbling could not be starker.
- **Lagarde herself and her colleagues aren't saying that the market is wrong.** They've adopted a laissez faire attitude to us instead. Great stuff.
- **And I don't even blame the ECB for the pandemic inflation.** Yes, the ECB dishonestly claims that it isn't to blame for the price level jumping by twenty to twenty five percent in the span of a couple of years. Instead, it blamed Arabian oil sheiks, a big ship stuck in the Suez canal, low water levels in the Rhine, greedy unions, profiteering businessmen, Russians, Ukrainians, useless solar panels (because clouds blocked out the sun), useless windmills (too little wind),

spendthrift politicians – the list goes on and on. Really, the ECB had nothing to do with enabling that stuff. As Milton Friedman famously quipped, inflation is always and everywhere a monetary phenomenon. Nuff said. In any case, Lagarde & Co did not wait for the clouds to disappear, for the wind to blow again, for the Rhine level to rise, businessmen turning into saints and cutting profit margins, unions stop demanding fatter paychecks, etc. The ECB raised rates aggressively. And the rest is history.

- **The inflation served its purpose well: the pandemic giveaways were simply 'funded' with the inflation tax.** Which is what historically happened during similar circumstances. Think wars. There's an omerta on central bankers admitting as much. And, as a financial economic historian by training, I don't blame Lagarde for following the code of the central bankers' guild.