Central Banks

Slower hikes but not a pause

Sumedh Deorukhkar / Miguel Jiménez / Maria Martinez

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- **The ECB raised its key interest rates by 25 bps, affirming that it has more ground to cover, it is not pausing, and there are more rate hikes in the pipeline**
- **The hawkish tone on inflation was maintained given still significant upside risks to the inflation outlook**
- **On QT, the ECB expects to discontinue the reinvestments under the APP as of July 2023**

The ECB, today, raised all its three benchmark interest rates by 25 bps, its softest hike in this cycle, thereby raising the rate on the main refinancing operations, the marginal lending facility and the deposit facility to 3.75%, 4.00% and 3.25% respectively. The rate action, which was in line with our expectations, was accompanied by a reiteration that there is more ground to cover on tackling inflation. The **ECB made it quite clear that interest rates will continue to be raised in the future** to levels that are sufficiently restrictive and that the ECB was "not pausing". Today's meeting was also marked by ECB's decision to discontinue the reinvestments under the APP as of July 2023.

Striking an equally hawkish tone as seen in previous meetings meant that the ECB has not let its guard down on fighting inflation, which it said **"**continues to be high for too long". Lagarde warned of "still significant upside risks to the inflation outlook" which "warrants monitoring". While headline inflation has declined over recent months, to 7% in April, from a peak of 10.7% last October, underlying pressures remain strong, with core inflation near all-time highs of 5.6% last month. Internals suggest that even as non-energy industrial goods inflation is easing, the pick-up in services inflation is worrisome. Factors driving Euro Area inflation pressures include past energy cost increases and supply bottlenecks, pent up demand from reopening of the economy and rising wages together with profit margins.

Notwithstanding the hawkish tone, today's statement did include two dovish elements. First, a new reference to the post-hiking cycle environment, noting that "policy rates will be kept at those levels for as long as necessary", meaning, the ECB wants to start talking about the next phase, once the terminal rate is reached. **Second, a visible reference to the results of the latest Bank Lending Survey** as an important input in ECB's pre and post policy discussion. Lagarde reflected that the survey results do reflect the transmission of monetary policy to credit, "past rate increases are being transmitted forcefully to euro area financing and monetary conditions", and now it was necessary that the Central Bank's actions also transmit to activity and inflation.

On quantitative tightening (QT), the **ECB expects that the APP reinvestments will stop from July** (currently reduction is €15bn per month), in line with our own expectations; from that date onwards QT should amount to around €30bn per month. The announcement came earlier than expected but the ECB made clear that given the market absorption, the current €15bn run off has been accepted by markets smoothly, and they decided to provide predictability on this issue. Moreover, Mrs Lagarde emphasized that this decision only applies to APP reinvestments, making clear that as regards the PEPP, there was no change in its intention to reinvest the principal payments from maturing securities purchased under the program until at least the end of 2024.

On the possibility of further liquidity operations following the upcoming strong TLTRO repayment in June (totalling €477bn), Lagarde said that banks have prepared for it and there is a lot of liquidity available. She added that normal open-market operations - with full allotment - are always an option (at the MRO rate of 3.75%), **suggesting that there is no indication at the moment for implementing a bridge LTRO.** However, she did highlight that the ECB can still be "inventive", if needed.

Overall, today's meeting makes it clear that following the widely expected next rate hike in June (to 3.50%/4.00%, depo/refi rate), more rate increases are quite likely, although they will also depend on the nature of incoming activity data and, in particular, inflation data. For the moment, the ECB does not seem overly worried about the spillover effects of banking troubles in the US (though they remain vigilant), but has minced no words to express its concerns over inflation and its resolve to bring it down.

PLEASE NOTE: **TRACKING CHANGES IN FOLLOWING STATEMENTS**

in black, wording common to both the current and previous statements, in light grey and crossed, previous wording that was replaced by new wording, in blue and underlined (YES, TRACK CHANGES ARE THERE ON PURPOSE).

1.1. Christine Lagarde, President of the ECB,

Luis de Guindos, Vice-President of the ECB

Frankfurt am Main, ~~16 March~~4 May 2023

Good afternoon, the Vice-President and I welcome you to our press conference.

~~Inflation is projected~~The inflation outlook continues to ~~remain~~be too high for too long. ~~Therefore~~In light of the ongoing high inflation pressures, the Governing Council today decided to ~~increase~~raise the three key ECB interest rates by ~~50~~25 basis points~~, in line with our determination~~. Overall, the incoming information broadly supports the assessment of the medium-term inflation outlook that we formed at our previous meeting. Headline inflation has declined over recent months, but underlying price pressures remain strong. At the same time, our past rate increases are being transmitted forcefully to euro area financing and monetary conditions, while the lags and strength of transmission to the real economy remain uncertain.

Our future decisions will ensure ~~the~~that the policy rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target~~. The elevated level of uncertainty reinforces the importance of~~ and will be kept at those levels for as long as necessary. We will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, our policy rate decisions~~, which~~ will continue to be ~~determined by~~based on our assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission.

~~We are monitoring current market tensions closely and stand ready to respond as necessary to preserve price stability and financial stability in the euro area. The euro area banking sector is resilient, with strong capital and liquidity positions. In any case, our policy toolkit is fully equipped to provide liquidity support to the euro area financial system if needed and to preserve the smooth transmission of monetary policy.~~

~~The new ECB staff macroeconomic projections were finalised in early March before the recent emergence of financial market tensions. As such, these tensions imply additional uncertainty around the baseline assessments of inflation and growth. Prior to these latest developments, the baseline path for headline inflation had already been revised down, mainly owing to a smaller contribution from energy prices than previously expected. ECB staff now see inflation averaging 5.3 per cent in 2023, 2.9 per cent in 2024 and 2.1 per cent in 2025. At the same time, underlying price pressures remain strong. Inflation excluding energy and food continued to increase in February and ECB staff expect it to average 4.6 per cent in 2023, which is higher than foreseen in the December projections. Subsequently, it is projected to come down to 2.5 per cent in 2024 and 2.2 per cent in 2025, as the upward pressures from past supply shocks and the reopening of the economy fade out and as tighter monetary policy increasingly dampens demand.~~

~~The baseline projections for growth in 2023 have been revised up to an average of 1.0 per cent as a result of both the decline in energy prices and the economy's greater resilience to the challenging international environment. ECB staff then expect growth to pick up further, to 1.6 per cent, in both 2024 and 2025, underpinned by a robust labour market, improving confidence and a recovery in real incomes. At the same time, the pick-up in growth in 2024 and 2025 is weaker than projected in December, owing to the tightening of monetary policy.~~

The key ECB interest rates remain our primary tool for setting the monetary policy stance. In parallel, we will keep reducing the Eurosystem's asset purchase programme (APP) portfolio at a measured and predictable pace. In line with these principles, the Governing Council expects to discontinue the reinvestments under the APP as of July 2023.

The decisions taken today are set out in a ~~press release~~press release available on our website.
I will now outline in more detail how we see the economy and inflation developing and will then explain our assessment of financial and monetary conditions.

1.2. Economic activity

The euro area economy ~~stagnated~~ grew by 0.1 per cent in the ~~fourth~~first quarter of ~~2022, thus avoiding~~2023, according to Eurostat's preliminary flash estimate. Lower energy prices, the ~~previously expected contraction. However~~easing of supply bottlenecks and fiscal policy support for firms and households have contributed to the resilience of the economy. At the same time, private domestic demand ~~fell sharply. High inflation, prevailing uncertainties and tighter financing conditions dented private~~, especially consumption ~~and investment, which fell by 0.9 per cent~~ , is likely to have remained weak.

Business and ~~3.6 per cent respectively~~consumer confidence have recovered steadily in recent months but remain weaker than before Russia's unjustified war against Ukraine and its people. We see a divergence across sectors of the economy. The manufacturing sector is working through a backlog of orders, but its prospects are worsening. The services sector is growing more strongly, especially owing to the reopening of the economy.

~~Under~~Household incomes are benefiting from the ~~baseline, the economy looks set to recover over the coming quarters. Industrial production should pick up as supply conditions improve further, confidence continues to recover, and firms work off large order backlogs. Rising wages and falling energy prices will partly offset the loss~~strength of ~~purchasing power that many households are experiencing as a result of high inflation. This, in turn, will support consumer spending.~~

~~Moreover,~~ the labour market ~~remains strong, despite the weakening of economic activity. Employment grew by 0.3 per cent in the fourth quarter of 2022 and~~, with the unemployment rate ~~stayed at its~~ falling to a new historical low of 6.~~6 per cent in January 2023~~5 per cent in March. Employment has continued to grow and total hours worked exceed pre-pandemic levels. At the same time, the average number of hours worked remains somewhat below its pre-pandemic level and its recovery has stalled since mid-2022.

~~Government~~As the energy crisis fades, governments should roll back the related support measures ~~to shield the economy from the impact of high energy prices should be temporary, targeted and tailored to preserving incentives to consume less energy. As energy prices fall and risks around the energy supply recede, it is important to start rolling back these measures~~ promptly and in a concerted manner~~. Measures falling short of these principles are likely to drive~~ to avoid driving up medium-term inflationary pressures, which would call for a stronger monetary policy response. ~~Moreover, in line with the EU's economic governance framework and as stated in the European Commission's guidance of 8 March 2023, fiscal~~Fiscal policies should be oriented towards making our economy more productive and gradually bringing down high public debt. Policies to enhance the euro area's supply capacity, especially in the energy sector, can also help reduce price pressures in the medium term. ~~To that end, governments should swiftly implement their investment and structural reform plans under~~In this regard, we welcome the ~~Next Generation EU programme. The~~publication of the European Commission's legislative proposals for the reform of the EU's economic governance framework, which should be concluded ~~rapidly~~soon.

1.3. Inflation

~~Inflation edged down~~ According to Eurostat's flash estimate, inflation was 7.0 per cent in April, after having dropped from 8.5 per cent in February~~. The decline resulted from a renewed sharp drop~~ to 6.9 per cent in March. While base effects led to some increase in energy ~~prices. By contrast, food~~ price inflation ~~increased further, to 15.~~, from -0.9 per cent~~, with~~ in March to 2.5 per cent in April, the ~~past surge in~~rate stands far below those recorded after the ~~cost~~start of ~~energy and of other inputs for food production still feeding through to consumer prices.~~

~~Moreover, underlying~~Russia's war against Ukraine. Food price inflation remains elevated, however, standing at 13.6 per cent in April, after 15.5 per cent in March.

Price pressures remain strong. Inflation excluding energy and food ~~increased to~~was 5.6 per cent in April, having edged down slightly compared with March to return to its February ~~and other indicators of underlying inflation have also stayed high.~~level. Non-energy industrial goods inflation ~~rose~~fell to 6.~~8~~2 per cent in ~~February, mainly reflecting~~April, from 6.6 per cent in March, when it declined for the ~~delayed effects of past supply bottlenecks and high energy prices. Services~~first time in several months. But services inflation~~, which rose~~ increased to ~~4.8~~5.2 per cent in ~~February,~~April, from 5.1 per cent in March. Inflation is ~~also~~ still being ~~driven~~pushed up by the gradual pass-through of past energy cost increases~~,~~ and supply bottlenecks. In services, especially, it is still being pushed higher also by pent-up demand from the reopening of the economy and ~~rising wages~~by rising wages. The information available up to March suggests that indicators of underlying inflation remain high.

Wage pressures have strengthened ~~on the back of~~ further as employees, in a context of a robust labour ~~markets and employees aiming to~~ market, recoup some of the purchasing power they have lost ~~owing to~~as a result of high inflation. Moreover, ~~many~~in some sectors firms ~~were~~have been able to ~~raise~~increase their profit margins ~~in sectors faced with constrained~~on the back of mismatches between supply and ~~resurgent~~ demand~~. At the same time,~~ and the uncertainty created by high and volatile inflation. Although most measures of longer-term inflation expectations currently stand at around two per cent, ~~although they~~ some indicators have edged up and warrant continued monitoring~~, especially in light of recent volatility in market-based inflation expectations~~.

1.4. Risk assessment

~~Risks to the outlook for economic growth are tilted to the downside. Persistently elevated~~Renewed financial market tensions, if persistent, would pose a downside risk to the outlook for growth as they could tighten broader credit conditions more strongly than expected and dampen confidence. Russia's ~~unjustified~~ war against Ukraine ~~and its people~~also continues to be a significant downside risk to the economy~~ and could again push up the costs of energy and food. There could also be an additional drag on euro area growth if the world economy weakened more sharply than expected.~~. However, ~~companies could adapt more quickly to the challenging international environment and, together with the fading-out of the energy shock, this could~~ the recent reversal of past adverse supply shocks, if sustained, could spur confidence and support higher growth than currently expected.

The continued resilience of the labour market, by bolstering household confidence and spending, could also lead to higher growth than anticipated.

There are still significant upside risks to the inflation outlook. These include existing pipeline pressures that could ~~still~~ send retail prices ~~even~~ higher than expected in the near term. ~~Domestic factors, such as a persistent~~Moreover, Russia's war against Ukraine could again push up the costs of energy and food. A lasting rise in inflation expectations above our target, or higher than anticipated increases in wages ~~and~~or profit margins, could also drive inflation higher, including over the medium term. ~~Moreover, a stronger than expected economic rebound in China could give a fresh boost to commodity prices and foreign demand.~~Recent negotiated wage agreements have added to the upside risks to inflation, especially if profit margins remain high. The downside risks ~~to inflation~~ include ~~persistently elevated~~renewed financial market tensions~~ that could accelerate disinflation. In addition, falling energy prices could translate into reduced pressure from underlying~~, which could bring inflation ~~and wages. A weakening of demand, including owing to a stronger deceleration of bank credit or a stronger~~down faster than projected~~.~~. Weaker demand, due for example to a more marked slowing of bank lending or a stronger transmission of monetary policy, would also ~~contribute~~lead to lower price pressures than currently anticipated, especially over the medium term.

1.5. Financial and monetary conditions

~~Market interest rates rose considerably~~The euro area banking sector has proved resilient in the ~~weeks following our last meeting. But the increase has strongly reversed over recent days in a context~~face of ~~severe~~the financial market tensions~~. Bank credit to euro area~~ that arose ahead of our last meeting. Our policy rate increases are being transmitted strongly to risk-free interest rates and to the financing conditions for firms~~ has become more expensive. Credit to~~, households and banks. For firms and households, loan growth has weakened ~~further,~~ owing to ~~lower demand and~~higher borrowing rates, tighter credit supply conditions~~. Household borrowing has become more expensive as well, especially owing to higher mortgage rates. This rise in borrowing costs and the resultant decline in demand, along with tighter~~ and lower demand. Our latest bank lending survey reported a tightening of overall credit standards, ~~have led to a further slowdown~~which was stronger than banks had expected in the ~~growth of loans to households. Amid these weaker loan dynamics,~~previous round and suggests that lending may weaken further. Weak lending has meant that money growth has ~~slowed sharply, driven by its most liquid components~~also continued to decline.

1.6. Conclusion

Summing up, the inflation ~~is projected~~outlook continues to ~~remain~~be too high for too long. ~~Therefore~~In light of the ongoing high inflation pressures, the Governing Council today decided to ~~increase~~raise the three key ECB interest rates by ~~50~~25 basis points~~, in line with our determination~~. Overall, the incoming information broadly supports the assessment of the medium-term inflation outlook that we formed at our previous meeting. Headline inflation has declined over recent months, but underlying price pressures remain strong. At the same time, our past rate increases are being transmitted forcefully to euro area financing and monetary conditions, while the lags and strength of transmission to the real economy remain uncertain.

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In any case, we stand ready to adjust all of our instruments within our mandate to ensure that inflation returns to our medium-term target and to preserve the smooth functioning of monetary policy transmission.

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ENQUIRIES TO:
BBVA Research: Azul Street, 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain).
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 25
bbvaresearch@bbva.com www.bbvaresearch.com