Central Banks

Staying the course to tame inflation

Sumedh Deorukhkar / Agustín García / Miguel Jiménez / Maria Martinez
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- **The ECB raised its key interest rates by 25 bps, affirming that it is not pausing and practically committed to further hike in July**
- **In a hawkish move, staff inflation projections were revised upwards, mainly due to labor cost pressures, though the ECB does not see a price-wage spiral**
- **On QT, the ECB confirmed the discontinuation of the reinvestments under the APP as of July 2023**

The ECB covered further ground in its fight against inflation today as it raised all its three key interest rates by another 25 bps, attributing the widely anticipated move to its updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission**; nonetheless made clear that its journey is not over**. Today's unanimous decision increases the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility to 4.00%, 4.25% and 3.50% respectively. While the ECB has slowed its pace of rate hikes to more standard increments of 25 bps since May, **President Lagarde made clear today that it is "not done yet"**. In this context, a hike at the next meeting in July is confirmed, unless there is a material change in the baseline scenario. Today's action on rates was accompanied by confirmation of discontinuation of reinvestments under the APP as of July 2023 and more importantly, quarterly revisions to ECB's growth and inflation projections.

ECB's updated inflation projections were marked by upward revision to core inflation despite the fact that some components of inflation are softening. **While headline inflation revisions were marginal**, by 0.1 pp each to 5.4% in 2023, 3% in 2024 and 2.2% in 2025, revisions to core inflation were more significant, especially over the near to medium term. Core inflation was revised up to 5.1% in 2023 (+0.5pp), 3% in 2024 (+0.5pp) and 2.3% (+0.1pp). The new projections are broadly in line with our own. **The fact that headline inflation is set above 2% in two-year time allows them to justify the continuation of their tightening process.**

The main reason for lifting core inflation projections is related to the tight labor market, in particular to higher expected labor costs, which was particularly stressed by President Lagarde in today's post policy conference. Despite denying a wage-price spiral, the ECB expects higher unit labor costs, which according to their own figures seems to be related to softer productivity growth, meaning strong labor market but weak growth in Q1. Lagarde also mentioned that services have a strong wage component.

Growth is expected to be weak in the short term, but to strengthen during the year. GDP growth projections were revised downward for 2023 and 2024 to 0.9% (-0.1 pp) and 1.5% (0.1 pp) respectively compared to March 2023 projections but remain unchanged at 1.6% for 2025. **The revisions were attributed to higher than anticipated impact of tightening credit supply conditions in 2023 and a weaker net exports**, especially in 2024, which together would offset stronger domestic demand.

At today's meeting, there was **no surprises on Quantitative Tightening;** the ECB confirmed that it will only discontinue reinvestments under the program as of July 2023, which was already announced at the May ECB monetary policy meeting. Regarding **liquidity,** concerning the upcoming strong **TLTRO repayment in June** (totaling €477bn), Lagarde stated that **this repayment has been known for a long time**, and **banks have already made their funding plans**. She added that normal open-market operations are always an option (at the MRO rate of 4.0%) if needed.

Initially, there was a strong market reaction in EZ long and short-term interest rates during the meeting, which can be attributed to the relative hawkish tone implicit in the new core inflation projections. The 10Y German yield rose by 12bps but trimmed its gains post disappointing US jobless claims data. The 2Yr German yield also reversed the initial increases but continues to rise by approximately 11bps, reflecting the market's pricing in of an additional rate hike by the ECB in July, and a higher probability of another rate increase in September, which has risen above 50%. The euro remains strong and is appreciating by 0.7%, surpassing the 1.09 mark.

All in all**, a further 25bp rise in July seems fully discounted now.** After that, it will be data dependent, but the hawkish tone provided today reinforces our upward bias for a further 25 bps rate hike in September.

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, ~~4 May~~ 15 June 2023

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

~~The inflation outlook continues~~Inflation has been coming down but is projected to ~~be~~remain too high for too long. ~~In light of the ongoing high inflation pressures, the~~ We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. The Governing Council therefore today decided to raise the three key ECB interest rates by 25 basis points. ~~Overall, the incoming information broadly supports the~~

The rate increase today reflects our updated assessment of the ~~medium-term~~ inflation outlook, the dynamics of underlying inflation ~~outlook that we formed at our previous meeting. Headline~~, and the strength of monetary policy transmission. According to the June macroeconomic projections, Eurosystem staff expect headline inflation ~~has declined over recent months, but~~ to average 5.4 per cent in 2023, 3.0 per cent in 2024 and 2.2 per cent in 2025. Indicators of underlying price pressures remain strong~~.~~, although some show tentative signs of softening. Staff have revised up their projections for inflation excluding energy and food, especially for this year and next year, owing to past upward surprises and the implications of the robust labour market for the speed of disinflation. They now see it reaching 5.1 per cent in 2023, before it declines to 3.0 per cent in 2024 and 2.3 per cent in 2025. Staff have slightly lowered their economic growth projections for this year and next year. They now expect the economy to grow by 0.9 per cent in 2023, 1.5 per cent in 2024 and 1.6 per cent in 2025.

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~~ and are gradually having an impact across the economy. Borrowing costs have increased steeply and growth in loans is slowing. Tighter financing conditions are a key reason why inflation is projected to decline further towards our target, as they are expected to increasingly dampen demand.

Our future decisions will ensure that the ~~policy~~key ECB interest rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target 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~~interest rate decisions will continue to be 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.

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~~ confirms that it will discontinue the reinvestments under the ~~APP~~ asset purchase programme 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 ~~grew~~has stagnated in recent months. As in the fourth quarter of last year, it shrank by 0.1 per cent in the first quarter of 2023, ~~according to Eurostat's preliminary flash estimate. Lower energy prices, the easing of supply bottlenecks and fiscal policy support for firms and households have contributed to the resilience of the economy. At the same time,~~amid a drop in private ~~domestic demand, especially~~and public consumption~~,~~. Economic growth is likely to ~~have remained weak.~~

~~Business and 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~~weak in the short run but strengthen in the course of the year, as inflation comes down and supply disruptions continue to ease. Conditions in different sectors of the economy~~. The~~ are uneven: manufacturing ~~sector is working through a backlog of orders, but its prospects are worsening. The services sector is growing more strongly, especially~~continues to weaken, partly owing to ~~the reopening of the economy~~lower global demand and tighter euro area financing conditions, while services remain resilient.

~~Household incomes are benefiting from the strength of the~~ The labour market~~, with~~ remains a source of strength. Almost a million new jobs were added in the first quarter of the year and the unemployment rate ~~falling to a new~~ stood at its historical low of 6.5 per cent in ~~March. Employment has continued to grow and total hours worked exceed pre-pandemic levels. At the same time, the~~ April. The average number of hours worked ~~remains~~ has also increased, although it is still somewhat below its pre-pandemic level ~~and its recovery has stalled since mid-2022~~.

As the energy crisis fades, governments should roll back the related support measures promptly and in a concerted manner to avoid driving up medium-term inflationary pressures, which would call for a stronger monetary policy response. Fiscal policies should be ~~oriented towards making~~designed to make our economy more productive and gradually ~~bringing~~bring 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. ~~In this regard, we welcome the publication of the European Commission's legislative proposals for the~~The reform of the EU's economic governance framework~~, which~~ should be concluded soon.

1.3. Inflation

~~According~~Inflation fell further to 6.1 per cent in May, according to Eurostat's flash estimate, ~~inflation was~~ from 7.0 per cent in April~~, after having dropped from 8.5 per cent in February to 6.9 per cent in March. While base effects led to some increase in energy~~. The decline was broad-based. Energy price inflation, ~~from -0.9 per cent in March to 2.5 per cent~~which had risen in April, ~~the rate stands far below those recorded after the start of Russia's war against Ukraine.~~resumed its downward trend and was negative in May. Food price inflation ~~remains elevated, however, standing~~fell again but remained high at ~~13.6 per cent in April, after 15~~12.5 per cent ~~in March~~.

~~Price pressures remain strong.~~ Inflation excluding energy and food ~~was 5.6~~declined in May for the second month in a row, to 5.3 per cent from 5.6 per cent in April. Goods inflation decreased further, to 5.8 per cent from 6.2 per cent in April~~, having edged down slightly compared with March to return to its February level. Non-energy industrial goods~~. Services inflation fell ~~to 6.2 per cent in April, from 6.6 per cent in March, when it declined~~ for the first time in several months~~. But services inflation increased to 5.2 per cent in April~~, from 5.~~1 per cent in March. Inflation is still being 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~~2 per cent to 5.0 per cent. Indicators of underlying price pressures remain strong, although some show tentative signs of softening.

Past increases in energy costs are still pushing up prices across the economy. Pent-up demand from the reopening of the economy ~~and by rising wages. The information available~~also continues to drive up ~~to March suggests that indicators of underlying inflation remain high.~~

inflation, especially in services. Wage pressures ~~have strengthened further as employees, in a context of a robust labour market, recoup some~~, while partly reflecting one-off payments, are becoming an increasingly important source of inflation. Compensation per employee rose by 5.2 per cent in the first quarter of the ~~purchasing power they have lost as a result of high inflation.~~ year and negotiated wages by 4.3 per cent. Moreover, firms in some sectors ~~firms~~ have been able to ~~increase their profit margins on the back of mismatches between supply and~~ keep profits relatively high, especially where demand ~~and the uncertainty created by high and volatile inflation.~~has outstripped supply. Although most measures of longer-term inflation expectations currently stand at around ~~two~~2 per cent, some indicators ~~have edged up and warrant continued monitoring~~remain elevated and need to be monitored closely.

1.4. Risk assessment

~~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 war against Ukraine also continues to be a significant downside risk to the economy. However, 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~~The outlook for economic growth and inflation remains highly uncertain. Downside risks to growth include Russia's unjustified war against Ukraine and an increase in broader geopolitical tensions, which could fragment global trade and thus weigh on the euro area economy. Growth could also be slower if the effects of monetary policy are more forceful than projected. Renewed financial market tensions could lead to even tighter financing conditions than anticipated and weaken confidence. Also, weaker growth in the world economy could further dampen economic activity in the euro area. However, growth could be higher than projected if the strong labour market and receding uncertainty mean that people and businesses become more confident and spend more.

Upside risks to inflation include potential renewed upward pressures ~~that could send retail prices higher than expected in the near term. Moreover,~~ on the costs of energy and food, also related to 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 or profit margins, could also drive inflation higher, including over the medium term. Recent ~~negotiated~~ wage agreements in a number of countries have added to the upside risks to inflation~~, especially if profit margins remain high. The downside risks include~~. By contrast, renewed financial market tensions~~, which~~ could bring inflation down faster than projected. Weaker demand, ~~due~~ for example ~~to a more marked slowing of bank lending or~~due to a stronger transmission of monetary policy, would also lead to lower price pressures ~~than currently anticipated~~, especially over the medium term. Moreover, inflation would come down faster if declining energy prices and lower food price increases were to pass through to other goods and services more quickly than currently anticipated.

1.5. Financial and monetary conditions

~~The euro area banking sector has proved resilient in the face of the financial market tensions that arose ahead of our last meeting.~~ Our monetary policy ~~rate increases are being transmitted strongly to~~ tightening continues to be reflected in risk-free interest rates and ~~to the~~broader financing conditions. Funding conditions are tighter for banks and credit is becoming more expensive for firms~~, households and banks. For firms~~ and households~~, loan growth has weakened owing to~~. In April lending rates reached their highest level in more than a decade, standing at 4.4 per cent for business loans and 3.4 per cent for mortgages.

These higher borrowing rates, together with tighter credit supply conditions and lower loan demand~~. Our latest bank lending survey reported a tightening of overall credit standards, which was stronger than banks had expected in the previous round and suggests that lending may weaken~~, have further~~.~~ weakened credit dynamics. The annual growth of loans to firms declined again in April, to 4.6 per cent. The month-on-month changes have been negative on average since November. Loans to households grew at an annual rate of 2.5 per cent in April and increased only marginally month on month. Weak ~~lending has meant that money growth has also~~bank lending and the reduction in the Eurosystem balance sheet led to a continued ~~to~~ decline in annual broad money growth to 1.9 per cent in April. Month-on-month changes in broad money have been negative since December.

In line with our monetary policy strategy, the Governing Council thoroughly assessed the links between monetary policy and financial stability. The financial stability outlook has remained challenging since our last review in December 2022. Tighter financing conditions are raising banks' funding costs and the credit risk of outstanding loans. Together with the recent tensions in the US banking system, these factors could give rise to systemic stress and depress economic growth in the short term. Another factor weighing on the resilience of the financial sector is a downturn in the real estate markets, which could be amplified by higher borrowing costs and a rise in unemployment. At the same time, euro area banks have strong capital and liquidity positions, which mitigate these financial stability risks. Macroprudential policy remains the first line of defence against the build-up of financial vulnerabilities.

1.6. Conclusion

~~Summing up, the inflation outlook continues~~Inflation has been coming down but is projected to ~~be~~remain too high for too long. ~~In light of the ongoing high inflation pressures, the~~The Governing Council therefore today decided to raise the three key ECB interest rates by 25 basis points~~. Overall, the incoming information broadly supports the assessment of the~~, in view of our determination to ensure that inflation returns to our two per cent 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~~target in a timely manner.

Our future decisions will ensure that the ~~policy~~key ECB interest rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target 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~~interest rate decisions will continue to be 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.

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
www.bbvaresearch.com