Central Banks

Hike or pause in September, question not resolved

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- **The ECB raised key interest rates by 25 bps as already preannounced**
- **No guidance on rates for further meetings, future decisions will be data dependent**
- **The ECB also announced that the remuneration of minimum reserves will be reduced to zero**

The European Central Bank (ECB) has taken the expected step of raising key interest rates by 25 basis points, reaching 3.75% for the deposit rate and 4.25% for the refinancing rate. However, what caught the attention was the ECB's signaling of a potentially uncertain path ahead. Particularly, **the ECB has left the door open to either raising again or pausing at the next on 14 September. The decision will be dependent on incoming data,** creating a more data-driven and meeting-by-meeting approach, reflecting the central bank's proximity to the terminal rate.

Regarding **economic activity, the ECB observes that the near-term outlook has deteriorated due to weaker domestic demand** resulting from high inflation. The ECB emphasized that weakness is particularly evident in housing demand and business investment, with some spillover effects on external demand. It was highlighted that momentum is slowing and is expected to continue in the short term. **President Lagarde emphasized the transmission of monetary policy not only to financial conditions but also to the real economy,** particularly impacting the housing sector and investment. On inflation, **the ECB acknowledged that it continues to be high, particularly core inflation, providing the ECB with a reason to maintain pressure for a further rate hike if necessary.** The central bank recognizes that inflation is expected to decline gradually but will likely remain elevated for a considerable period of time.

In an unexpected move, the ECB decided to set the remuneration of minimum reserves at 0%, effectively reducing interest rates from the Deposit Facility Rate (3.75%) to 0%. This decision affects approximately 165 billion euros of minimum reserves across the Eurozone, resulting in an estimated impact of about 6.2 billion euros annually. Comparatively, the ECB pays around 135 billion euros annually on excess liquidity, given that excess liquidity hovers around 3.6 trillion euros. The ECB clarified that this decision will not preempt the outcome of the ongoing review of its operational framework.

The dovish tone dominating ECB President Lagarde's post-policy press conference had clear spillover effects on markets today, with European sovereign yields experiencing declines, particularly following her emphasis on the slight change in the ECB's statement, possibly signaling a path towards a monetary pause. Shorter tenors of the yield curve, like the 2-year and 10-year yields, led the decline (2Y -8bp, 10Y -4bp). However, these falls were reversed due to the dragging effect of US yields, which surged (2Y and 10Y +9bp) due to robust US GDP growth in 2Q22 (2.4% QoQ saa; consensus 1.8%; previous quarter 2%) and tight labor market indicators.

Summing up, today's ECB meeting largely aligned with expectations, except for the surprise decision on remuneration of excess reserves. **The central bank is now at a critical juncture, where future decisions will heavily rely on incoming data. While our forecast still leans towards a further rate hike in September** (reaching a terminal rate of 4% for the deposit rate), **recent data weaknesses and ECB communications before and during the meeting have increased the likelihood of a potential pause and the possibility of no further hikes.**

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, ~~15 June~~27 July 2023

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

Inflation ~~has been coming down~~continues to decline but is ~~projected~~still expected to remain too high for too long. 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.

The rate increase today reflects our ~~updated~~ assessment of the inflation outlook, the dynamics of underlying inflation, and the strength of monetary policy transmission. ~~According to the June macroeconomic projections, Eurosystem staff expect headline inflation 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~~The developments since our last meeting support our expectation that inflation will drop further over the remainder of the year but will stay above target for an extended period. While some measures show signs of easing, underlying inflation remains high overall. Our past rate increases continue to be transmitted forcefully: financing conditions have tightened again and are increasingly dampening demand, which is an important factor in bringing inflation back to target.

~~At the same time, our past rate increases are being transmitted forcefully to financing conditions 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 key ECB interest rates will be ~~brought to levels~~ set at sufficiently restrictive levels for as long as necessary 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 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 Governing Council confirms that it will discontinue the reinvestments under the asset purchase programme as of July 2023.~~

We also decided to set the remuneration of minimum reserves at zero per cent. This decision will preserve the effectiveness of monetary policy by maintaining the current degree of control over the monetary policy stance and ensuring the full pass-through of our interest rate decisions to money markets. At the same time, it will improve the efficiency of monetary policy by reducing the overall amount of interest that needs to be paid on reserves in order to implement the appropriate stance.

The decisions taken today are set out in a ~~press release~~press release available on our website. The details of the change to the remuneration of minimum reserves are provided in a separate press release to be published at 15:45 CET.
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 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, amid a drop in private and public consumption. Economic growth is likely to remain 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 are uneven: manufacturing continues to weaken, partly owing to lower global demand and tighter euro area financing conditions, while services remain resilient.~~

The near-term economic outlook for the euro area has deteriorated, owing largely to weaker domestic demand. High inflation and tighter financing conditions are dampening spending. This is weighing especially on manufacturing output, which is also being held down by weak external demand. Housing and business investment are showing signs of weakness as well. Services remain more resilient, especially in contact-intensive subsectors such as tourism. But momentum is slowing in the services sector. The economy is expected to remain weak in the short run. Over time, falling inflation, rising incomes and improving supply conditions should support the recovery.

The labour market remains ~~a source of strength. Almost a million new jobs were added in the first quarter of the year and the~~ robust. The unemployment rate ~~stood~~stayed at its historical low of 6.5 per cent in ~~April. The average number of hours worked has also increased, although it is still somewhat below its pre-pandemic level~~May and many new jobs are being created, especially in the services sector. At the same time, forward-looking indicators suggest that this trend might slow down in the coming months and may turn negative for manufacturing.

As the energy crisis fades, governments should roll back the related support measures promptly and in a concerted manner. This is essential to avoid driving up medium-term inflationary pressures, which would otherwise call for a stronger monetary policy response. We welcome the recent Eurogroup statement on the euro area fiscal stance, which is consistent with this assessment. Fiscal policies should be designed to make our economy more productive and to gradually 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~~.~~, while supporting the green transition, which is also being furthered by the Next Generation EU programme. The reform of the EU's economic governance framework should be concluded ~~soon~~before the end of this year.

1.3. Inflation

Inflation ~~fell~~came down further ~~to~~ in June, reaching 5.5 per cent, after 6.1 per cent in May~~, according to Eurostat's flash estimate, from 7.0 per cent in April. The decline was broad based.~~. Energy ~~price inflation, which had risen in April, resumed its downward trend and was negative in May. Food price inflation~~ prices fell again, dropping by 5.6 per cent, year on year. Food price inflation continued to slow but remained high, at ~~12.5~~11.6 per cent.

Inflation excluding energy and food ~~declined in May for the second month in a row,~~edged up to 5.~~3~~5 per cent ~~from 5.6 per cent~~ in ~~April.~~June, with goods and services following diverging trends. Goods inflation decreased further, to 5.5 per cent, from 5.8 per cent ~~from 6.2 per cent~~ in ~~April. Services~~May. Conversely, services inflation ~~fell for the first time in several months, from~~rose to 5.~~2~~4 per cent, from 5.0 per cent in May, owing 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~~robust spending on holidays and travel and also ~~continues to drive up inflation, especially in services. Wage pressures, while partly~~ reflecting ~~one-off payments~~upward base effects.

The drivers of inflation are changing. External sources of inflation are easing. By contrast, domestic price pressures, including from rising wages and still robust profit margins, are becoming an increasingly important ~~source of inflation. Compensation per employee rose by 5.2 per cent in the first quarter of the year and negotiated wages by 4.3 per cent. Moreover, firms in~~driver of inflation.

While some ~~sectors have been able to keep profits relatively~~measures are moving lower, underlying inflation remains high~~, especially where demand has outstripped supply~~ overall, including owing to the persistent impact of past energy price increases on economy-wide prices. Although most measures of longer-term inflation expectations currently stand at around 2 per cent, some indicators remain elevated and need to be monitored closely.

1.4. Risk assessment

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~~ expected, or if the world economy ~~could further dampen economic activity in the~~weakens and thereby dampens demand for euro area~~. However~~ exports. Conversely, growth could be higher than projected if the strong labour market, rising real incomes and receding uncertainty mean that people and businesses become more confident and spend more.

Upside risks to inflation include potential renewed upward pressures on the costs of energy and food, also related to Russia's ~~war against Ukraine.~~unilateral withdrawal from the Black Sea Grain Initiative. Adverse weather conditions, in light of the unfolding climate crisis, may push up food prices by more than projected. 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~~

~~wage agreements in a number of countries have added to the upside risks to inflation.~~ By contrast, ~~renewed financial market tensions could bring inflation down faster than projected. Weaker~~weaker demand~~,~~ – for example ~~due~~owing to a stronger transmission of monetary policy~~,~~ – would ~~also~~ lead to lower price pressures, 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 the prices of other goods and services more quickly than currently anticipated.

1.5. Financial and monetary conditions

Our monetary policy tightening continues to be ~~reflected in risk-free interest rates and~~ transmitted strongly to broader financing conditions. ~~Funding conditions are tighter for~~ Risk-free interest rates over short to medium-term maturities have increased since our last meeting and funding has become more expensive for banks~~ and~~, in part owing to the ongoing phasing-out of the ECB's targeted longer-term refinancing operations (TLTROs). The large TLTRO repayment in June went smoothly, as banks were well prepared. Average lending rates for business loans and mortgages rose again in May, to 4.6 per cent and 3.6 per cent respectively.

Higher borrowing rates and the associated cuts in spending plans led to a further sharp drop in credit ~~is~~ demand in the second quarter, as reported in our latest bank lending survey. Moreover, credit standards for loans to firms and households tightened further, as banks are becoming more ~~expensive for firms and households. In April lending rates reached~~ concerned about the risks faced by their ~~highest level in more than a decade, standing at 4.4 per cent for business loans and 3.4 per cent~~ customers and are less willing to bear these risks. Tighter financing conditions are also making housing less affordable and less attractive as an investment, and demand for mortgages has dropped for the fifth quarter in a row.

~~These higher borrowing rates, together with tighter credit supply conditions and lower loan demand, have further weakened credit dynamics. The~~ Against this background, the annual growth rate of ~~loans~~lending continued to ~~firms declined again~~decrease in ~~April,~~June, falling to ~~4.6~~3.0 per cent~~. The month-on-month changes have been negative on average since November. Loans to~~ for firms and 1.7 per cent for households~~ grew at an annual rate of~~, with annualised growth rates of 0.0 per cent and -0.2~~.5~~ per cent in ~~April and increased only marginally month on month. Weak bank~~the second quarter respectively. Amid weak lending and the reduction in the Eurosystem balance sheet~~ led to a continued decline in~~, the annual growth rate of broad money ~~growth~~fell to ~~1.9~~0.6 per cent in ~~April. Month-on-month changes in broad money have been negative since December.~~

~~In line~~June, 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~~an annualised growth rate of -1.1 per cent 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~~second quarter.

1.6. Conclusion

Inflation ~~has been coming down~~continues to decline but is ~~projected~~still expected to remain too high for too long. The Governing Council therefore today decided to raise the three key ECB interest rates by 25 basis points~~, in view of our determination to ensure that inflation returns to our two per cent medium-term target in a timely manner~~.

Our future decisions will ensure that the key ECB interest rates will be ~~brought to levels~~ set at sufficiently restrictive levels for as long as necessary 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 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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