Central Banks

The ECB signals the end of the hiking cycle

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September 14 2023

- **The ECB raises key interest rates by 25 bps, but not by unanimity**
- **Future decisions will depend on data, with an emphasis on the expectation that rates will remain high for a long period**
- **Growth projections have been substantially revised downwards, while inflation was revised slightly upwards**

The ECB raised key interest rates by 25bp, in line with our expectations, in a decision that was very open ahead of the meeting. This move comes amid indications of slowing economic growth, although inflation levels remain high. Notably, **the decision was not taken unanimously** and was preceded by a lively debate within the Governing Council. As a consequence of this move, the interest rates for main refinancing operations, marginal lending facilities, and the deposit facility will be adjusted to 4.5%, 4.75%, and 4.00%, respectively.

The ECB stressed that today's decision reinforces its **commitment to reach its inflation target.** Nevertheless, **the ECB signaled the conclusion of the current cycle of rate increases, while keeping the door open for further adjustments if necessary.** President Lagarde stated that **future moves will continue to be data-dependent, and the ECB cannot definitively declare this as the peak of the cycle.** She made it clear that the **emphasis will now be on maintaining high interest rates for an extended period**, in line with our baseline scenario. "The key ECB interest rates have reached levels that, if maintained for a sufficiently extended period, will significantly contribute to the timely achievement of our inflation target. The Governing Council's future decisions will ensure that these key ECB interest rates are maintained at sufficiently restrictive levels for as long as needed. The Governing Council will maintain a data-dependent approach when determining the appropriate level and duration of these restrictions."

On the transmission of the monetary policy, Lagarde stated that the **transmission of policy appears to be more efficient and faster than in previous hiking cycles**. This marks a new development, as some ECB members had previously suggested that in the current cycle, the monetary transmission channel was taking longer.

The updated staff forecasts show **upward revisions to headline inflation** to 5.6% and 3.2% (+0.2 pp each) and marginally downward revisions by 1pp to 2.1% in 2025. Meanwhile, core inflation remains at 5.1% in 2023 and is revised marginally downward by 0.1 pp to 2.9% and 2.2% in 2024 and 2025, respectively. These projections remain broadly in line with our own. What does change from June's view is that **they seem to be more confident about inflation converging closer to target in 2025** (at 2.1%).

This upward revision in headline inflation was driven by the **upward path of energy prices**, but over the projection horizon they are anticipated to decrease, as the impact of previous energy price shocks and other price pressures diminishes. Meanwhile, core inflation also is projected to decline but **strong labor cost growth in the service sector is expected to gradually become more prominent** in a tight labor market.

GDP growth is expected to stagnate in the short term and moderately strengthen in the medium term. Projections have been revised downwards substantially for 2023 and 2024, as expected, to 0.7% (-0.2 pp) and 1.0% (-0.5 pp), respectively, and marginally downward for 2025 to 1.5% (-0.1%) compared to June 2023[1].

The growth revisions were attributed to a **weak manufacturing sector** and to the incipient slowdown in the service sector, both of which were dragged down by **tighter financing conditions on private demand and weaker foreign demand**. However, the current weak private consumption is expected to start on the road to recovery in the second half of 2023, as

[1] The projection of 0.7% growth for 2023 does not seem to incorporate the official downward revision of growth in Q2 by Eurostat, from 0.3% q/q to 0.1%. Hence, their "revised" figure would be closer to 0.5%.

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real disposable income recovers on lower inflation levels and rising wages. For the 2024 downward revision, they point to **carryover effects** as the cause. **This makes clear that the ECB is not expecting a recession ahead.**

Regarding **quantitative tightening, Lagarde said that it was not discussed,** especially the possibility of starting the end or partial stop of PEPP reinvestments earlier than expected (currently, the guidance is to maintain total reinvestments until December 2024). Moreover, she made it clear that they did not discuss any potential outright sales of APP either.

All in all, today's ECB meeting largely aligned with our expectations. It is clear that after this hike the ECB is prepared for a long pause and probably the end of the hiking cycle, although further rate hikes cannot be completely ruled out as inflation could surprise to the upside and the ECB has said that it remains in a data-dependent mode.

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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, ~~14 September~~27 July 2023

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

Inflation continues to decline but is 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. ~~In order to reinforce progress towards our target, the~~The Governing Council therefore today decided to raise the three key ECB interest rates by 25 basis points.

The rate increase today reflects 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 September ECB staff macroeconomic projections for the euro area see average~~The developments since our last meeting support our expectation that inflation ~~at 5.6 per cent in 2023, 3.2 per cent in 2024 and 2.1 per cent in 2025. This is~~ will drop further over the remainder of the year but will stay above target for an ~~upward revision for 2023 and 2024 and a downward revision for 2025. The upward revision for 2023 and 2024 mainly reflects a higher path for energy prices. Underlying price pressures remain~~extended period. While some measures show signs of easing, underlying inflation remains high~~, even though most indicators have started to ease. ECB staff have slightly revised down the projected path for inflation excluding energy and food, to an average of 5.1 per cent in 2023, 2.9 per cent in 2024 and 2.2 per cent in 2025.~~ overall. Our past ~~interest~~ rate increases continue to be transmitted forcefully~~. Financing~~: financing conditions have tightened ~~further~~again and are increasingly dampening demand, which is an important factor in bringing inflation back to target. ~~With the increasing impact of our tightening on domestic demand and the weakening international trade environment, ECB staff have lowered their economic growth projections significantly. They now expect the euro area economy to expand by 0.7 per cent in 2023, 1.0 per cent in 2024 and 1.5 per cent in 2025.~~

~~Based on our current assessment, we consider that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our target.~~ Our future decisions will ensure that the key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary~~. We will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.~~ to achieve a timely return of inflation to our two per cent medium-term target. 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.

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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 ~~economy is likely to remain subdued in the coming months. It broadly stagnated over the first half of the year, and recent indicators suggest it has also been weak in the third quarter. Lower demand~~near-term economic outlook for the euro ~~area's exports and the impact of tight~~area has deteriorated, owing largely to weaker domestic demand. High inflation and tighter financing conditions are dampening ~~growth, including through lower residential~~spending. This is weighing especially on manufacturing output, which is also being held down by weak external demand. Housing and business investment~~. The services sector, which had so far been~~ are showing signs of weakness as well. Services remain more resilient, ~~is now also weakening. Over time, economic momentum should pick up, as real incomes are expected to rise, supported by~~ 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 ~~wages and a strong labour market, and this will underpin consumer spending~~incomes and improving supply conditions should support the recovery.

The labour market ~~has so far remained resilient despite the slowing economy.~~remains robust. The unemployment rate stayed at its historical low of 6.~~4 per cent in July. While employment grew by 0.2~~5 per cent in ~~the second quarter, momentum is slowing. The~~ May and many new jobs are being created, especially in the services sector~~, which has been a major driver of employment growth since mid-2022, is now also creating fewer jobs~~. 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 ~~continue to~~ 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 ~~an even~~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 ~~– which would be supported by the full implementation of the Next Generation EU programme –~~ can 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 before the end of this year~~ and progress towards Capital Markets Union should be accelerated~~.

1.3. Inflation

~~Inflation declined to 5.3 per cent in July but remained at that level in August, according to Eurostat's flash estimate. Its decline was interrupted because energy prices rose compared with July. Food price~~

~~inflation has come down from its peak in March but was still almost 10 per cent in August. In the coming months, the sharp price increases recorded in the autumn of 2022 will drop out of the yearly rates, thus pulling inflation down.~~

Inflation came down further in June, reaching 5.5 per cent, after 6.1 per cent in May. Energy prices fell again, dropping by 5.6 per cent, year on year. Food price inflation continued to slow but remained high, at 11.6 per cent.

Inflation excluding energy and food ~~fell~~edged up to 5.~~3~~5 per cent in ~~August, from 5.5 per cent in July~~June, with goods and services following diverging trends. Goods inflation ~~declined to 4.~~decreased further, to 5.5 per cent, from 5.8 per cent in ~~August~~May. Conversely, services inflation rose to 5.4 per cent, from 5.0 per cent in ~~July and 5.5 per cent in June,~~ May, owing to ~~better supply conditions, previous drops in energy prices, easing price pressures in the earlier stages of the production chain and weaker demand. Services inflation edged down to 5.5 per cent but was still kept up by strong~~robust spending on holidays and travel and ~~by the high growth of wages. The annual growth rate of compensation per employee remained constant at 5.5 per cent in the second quarter of the year. The contribution of labour costs to annual domestic inflation increased in the second quarter, in part owing to weaker productivity, while the contribution of profits fell for the first time since early 2022~~also reflecting upward base effects.

~~Most~~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 driver of inflation.

While some measures ~~of~~are moving lower, underlying inflation ~~are starting to fall as demand and supply have become more aligned and the contribution~~remains high overall, including owing to the persistent impact of past energy price increases ~~is fading out. At the same time, domestic price pressures remain strong.~~

~~Most~~on economy-wide prices. Although most measures of longer-term inflation expectations currently stand at around 2 per cent~~. But~~, some indicators ~~have increased~~remain elevated and need to be monitored closely.

1.4. Risk assessment

~~The risks to economic growth are tilted to the downside. Growth could~~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 expected, or if the world economy weakens~~, for instance owing to a further slowdown in China.~~ and thereby dampens demand for euro area 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 unilateral withdrawal from the Black Sea Grain Initiative. Adverse weather conditions, ~~and~~in light of the unfolding climate crisis ~~more broadly, could~~, may push up food prices ~~up~~ by more than ~~expected~~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. By contrast, weaker demand – for example ~~due~~owing to a stronger transmission of monetary policy ~~or a worsening of the economic environment outside the euro area~~ – would 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.

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1.5. Financial and monetary conditions

Our monetary policy tightening continues to be transmitted strongly to broader financing conditions. ~~Funding~~ Risk-free interest rates over short to medium-term maturities have increased since our last meeting and funding has ~~again~~ become more expensive for banks, ~~as savers are replacing overnight deposits with time deposits that pay more interest and~~in part owing to the ongoing phasing-out of the ECB's targeted longer-term refinancing operations ~~are being phased out.~~(TLTROs). The large TLTRO repayment in June went smoothly, as banks were well prepared. Average lending rates for business loans and mortgages ~~continued to increase~~rose again in ~~July~~May, to 4.~~9~~6 per cent and 3.~~8~~6 per cent respectively.

~~Credit dynamics have weakened~~Higher borrowing rates and the associated cuts in spending plans led to a further~~. Loans to firms grew at an annual rate of 2.2 per cent in July, down from 3.0 per cent in June. Loans to~~ sharp drop in credit demand in the second quarter, as reported in our latest bank lending survey. Moreover, credit standards for loans to firms and households ~~also grew~~tightened further, as banks are becoming more concerned about the risks faced by their customers and are less ~~strongly, by 1.3 per cent, after~~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.

Against this background, the annual growth rate of lending continued to decrease in June, falling to 3.0 per cent for firms and 1.7 per cent ~~in June. In~~for households, with annualised ~~terms based on the last three months~~growth rates of ~~data, household loans declined by~~ 0.~~8~~0 per cent~~, which is~~ and -0.2 per cent in the ~~strongest contraction since the start of the euro~~second quarter respectively. Amid weak lending and the reduction in the Eurosystem balance sheet, the annual growth rate of ~~M3~~broad money fell ~~from~~to 0.6 per cent in June ~~to~~, with an ~~all-time low of -0.4 per cent in July. In~~ annualised ~~terms over the past three months, M3 contracted by~~ growth rate of -1.1~~.5~~ per cent in the second quarter.

1.6. Conclusion

Inflation continues to decline but is 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. In order to reinforce progress towards our target, the~~The Governing Council therefore today decided to raise the three key ECB interest rates by 25 basis points. ~~Based on our current assessment, we consider that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our target.~~

Our future decisions will ensure that the key ECB interest rates will be 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. We will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. ~~. We~~In particular, our interest rate decisions will continue to ~~follow a data-dependent approach to determining~~be based on our assessment of the inflation outlook in light of the incoming economic and financial data, the ~~appropriate level and duration of restriction~~dynamics of underlying inflation, and the strength of monetary policy transmission.

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