Central Banks

The ECB held steady and attempted to temper expectations of early rate cuts

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- **The ECB keeps rates unchanged. Rate cuts were not discussed “at all”**
- **PEPP reinvestments to slow in 2H24, then stop at the end of 2024**
- **Forecasts for inflation and growth next year were lowered with wage evolution in focus**

At today's monetary policy meeting, **the ECB maintained rates at 4% for deposit facility and the main refinancing operations rate at 4.5%**, aligning with market expectations. The expectations for this ECB meeting were primarily focused on the **potential implications of the Federal Reserve’s recent dovish stance,** which had sparked a significant market rally. However, Mrs Lagarde sought to distance herself from this tone and highlighted the **ECB’s commitment to data dependency,** especially regarding domestic inflation, with a **particular emphasis on wage evolution and firms’ profits** in coming months.

As for **forward guidance,** the repeated phrase in the statements during the last months, “inflation is expected to remain too high for too long”, has been deleted this time, which could signal a dovish stance in the ECB communication. However, Mrs Lagarde emphatically noted that **the ECB should “absolutely not” lower its guard against inflation,** underscoring that **rate cuts were not a topic of discussion “at all”** during the meeting. Indeed, the **persistence of the phrase “rates will be maintained at sufficiently restrictive levels for as long as necessary”** in the statement suggests that this move towards dovishness remains relatively slight and the balance seems clearly tilted at the moment towards more **hawkish guidance.**

In a somewhat unexpected move, the ECB decided to expedite the normalization of its balance sheet. **The ECB has announced a gradual phase-out of the reinvestments under the PEPP,** starting six months earlier than previously planned. The program will continue with full reinvestment during the first half of 2024; however, **in the second half of the year, the intention is to reduce the PEPP portfolio by approximately EUR 7.5 billion per month, which is about 50% of the reinvestments,** totaling around EUR 45 billion for 2024. Ultimately, **the plan is to cease reinvestments by the end of 2024**. During the Q&A, President Lagarde emphasized that this decision was backed by a significant majority of the governing council members. Furthermore, she made it clear that the decision on PEPP reinvestment is completely independent of interest rate decisions, underlining that the two policies are not interconnected. Interest rates remain the primary tool. Given her recent statements, this decision was anticipated.

The economic weakness and lower inflation data observed in recent months are reflected in the ECB's new macroeconomic projections, with both **inflation and growth downward revisions especially in the coming year**. In inflation, the revision is also due to a **lower forecast for energy prices**, while there is no change for 2025, which differs from our energy outlook. In detail, the **headline forecast drops 0.2pp in 2023 to 5.4% (5.5% BBVA), 0.5pp in 2024 to 2.7% (2.5% BBVA) and maintains the outlook of 2.1% (1.8% BBVA) in 2025**, where the inflation target will be reached in the third quarter. Despite this revision, Ms. Lagarde was cautious especially for the coming months where a **rebound is expected due to energy base effects** and the reversal of some fiscal support measures, as well as the **renegotiation of wages** in a labor market that is still expected to remain tight.

On growth, the projections worsened in an environment of **economic weakness**, especially in manufacturing with **uncompetitive energy prices**, **lowering 0.1pp to 0.6% in 2023 (0.4% BBVA), 0.2pp to 0.8% in 2024 (0.7% BBVA) and maintaining 1.5% in 2025 (1.7% BBVA)**. Activity is still expected to pick up from early 2024 due to the aforementioned **strength in employment and wages**, which together with falling inflation will increase households' real disposable income. Improved external demand prospects will also contribute positively.

To sum up: **Today's meeting effectively countered the Fed's overly dovish stance from yesterday by signaling a cautious approach**. Nevertheless, the recent unexpected inflation developments, the outlook for commodities, and the clear weakening of economic activity have led the ECB to revise down its GDP and inflation forecasts for the coming year, aligning with our predictions. The decision to expedite the conclusion of PEPP reinvestment was anticipated and has been communicated effectively. The ECB plans to proceed gradually, thereby mitigating the risk of financial instability in the debt markets.

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).

~~Athens, 26 October~~Frankfurt am Main, 14 December 2023

Good afternoon, the Vice-President and I welcome you to our press conference. ~~I would like to thank Governor Stournaras for his kind hospitality and express our special gratitude to his staff for the excellent organisation of today's meeting of the Governing Council.~~

The Governing Council today decided to keep the three key ECB interest rates unchanged. ~~The incoming information has broadly confirmed our previous assessment of~~ While inflation has dropped in recent months, it is likely to pick up again temporarily in the near term. According to the latest Eurosystem staff projections for the ~~medium-term~~euro area, inflation ~~outlook. Inflation~~ is ~~still~~ expected to ~~stay too high for too long,~~decline gradually over the course of next year, before approaching our two per cent target in 2025. Overall, staff expect headline inflation to average 5.4 per cent in 2023, 2.7 per cent in 2024, 2.1 per cent in 2025 and 1.9 per cent in 2026. Compared with the September staff projections, this amounts to a downward revision for 2023 and especially for 2024.

Underlying inflation has eased further. But domestic price pressures remain elevated, primarily owing to strong~~. At the same time, inflation dropped markedly in September, including due to strong base effects,~~ growth in unit labour costs. Eurosystem staff expect inflation excluding energy and ~~most measures of underlying inflation have continued to ease.~~ food to average 5.0 per cent in 2023, 2.7 per cent in 2024, 2.3 per cent in 2025 and 2.1 per cent in 2026.

Our past interest rate increases continue to be transmitted forcefully ~~into~~to the economy. Tighter financing conditions~~. This is increasingly~~ are dampening demand, and ~~thereby helps~~this is helping to push down inflation. Eurosystem staff expect economic growth to remain subdued in the near term. Beyond that, the economy is expected to recover because of rising real incomes – as people benefit from falling inflation and growing wages – and improving foreign demand. Eurosystem staff therefore see growth picking up from an average of 0.6 per cent for 2023 to 0.8 per cent for 2024, and to 1.5 per cent for both 2025 and 2026.

We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. Based on our current assessment, we consider that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal. Our future decisions will ensure that our policy 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. In particular, our interest rate decisions will 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 are our primary tool for setting the monetary policy stance. We also decided today to advance the normalisation of the Eurosystem's balance sheet. The Governing Council intends to continue to reinvest, in full, the principal

payments from maturing securities purchased under the pandemic emergency purchase programme (PEPP) during the first half of 2024. Over the second half of the year, it intends to reduce the PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

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.

1.1. Economic activity

~~The euro area economy remains weak. Recent information suggests that manufacturing output has continued to fall. Subdued foreign demand and tighter financing conditions are increasingly weighing on investment and consumer spending. The services sector is also weakening further. This is mainly because weaker industrial activity is spilling over to other sectors, the impetus from reopening effects is fading and the impact of higher interest rates is broadening. The economy is likely to remain weak for the remainder of this year. But as inflation falls further, household real incomes recover and the demand for euro area exports picks up, the economy should strengthen over the coming years.~~

~~Economic activity has so far been supported by the strength of the~~ The euro area economy contracted slightly in the third quarter, mostly owing to a decline in inventories. Tighter financing conditions and subdued foreign demand are likely to continue weighing on economic activity in the near term. Prospects are especially weak for construction and manufacturing, the two sectors most affected by higher interest rates. Services activity is also set to soften in the coming months. This is due to spillovers from weaker industrial activity, fading effects from the reopening of the economy and the broadening impact of tighter financing conditions.

The labour market~~.~~ continues to support the economy. The unemployment rate stood at ~~a historical low of 6.4~~6.5 per cent in ~~August.~~October and employment grew by 0.2 per cent over the third quarter. At the same time, ~~there are signs that the labour market is weakening. Fewer new jobs are being created, including in services, consistent with~~ the ~~cooling~~weaker economy ~~gradually feeding through to employment~~is dampening the demand for workers, with firms advertising fewer vacancies in recent months. Moreover, even though more people are in work, the total number of hours worked edged down by 0.1 per cent in the third quarter.

As the energy crisis fades, governments should continue to roll back the related support measures. This is essential to avoid driving up medium-term inflationary pressures, which would otherwise call for even tighter monetary policy. Fiscal policies should be designed to make our economy more productive and to gradually bring down high public debt. Structural reforms and investments 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 and digital transitions. To that end, it is important to swiftly agree on the reform of the EU's economic governance framework ~~should be concluded before the end of this year and~~. Moreover, it is imperative that progress towards Capital Markets Union and the completion of Banking Union ~~should~~ be accelerated.

1.2. Inflation

Inflation dropped ~~to 4.3~~over the past two months, falling to an annual rate of 2.4 per cent in ~~September, almost a full percentage point lower than its August level. In the near term, it is likely to come down further, as the sharp price increases in energy and food recorded in autumn 2022 will drop out of the yearly rates. September's~~November according to Eurostat's flash release. This decline was broad-based. ~~Food~~Energy price inflation ~~slowed again, although it remains~~fell further and food price inflation also came down, despite remaining relatively high ~~by historical standards. In annual terms, energy prices fell by 4.6 per cent but, most recently, have risen again~~overall. This month, inflation is likely to pick up on account of an upward base effect for the cost of energy. In 2024, we expect inflation to decline more slowly because of further upward base effects and ~~become less predictable in view of~~ the phasing-out of past fiscal measures aimed at limiting the ~~new geopolitical tensions~~repercussions of the energy price shock.

Inflation excluding energy and food dropped by almost a full percentage point over the past two months, falling to ~~4.5~~3.6 per cent in ~~September, from 5.3 per cent in August.~~November. This ~~fall was supported by~~reflects improving supply conditions, the ~~pass-through of previous declines in~~fading effects of the past energy ~~prices,~~shock and the impact of tighter monetary policy on demand and ~~corporate~~on the pricing power~~. Goods~~ of firms. The inflation rates for goods and services ~~inflation rates~~ fell ~~substantially,~~ to ~~4.1~~2.9 per cent and 4.~~7~~0 per cent respectively~~, with services inflation also being pulled down by pronounced base effects. Price pressures in tourism and travel appear to be moderating~~.

~~Most~~All measures of underlying inflation ~~continue to decline. At the same time,~~declined in October, but domestic price pressures ~~are still~~remained elevated, chiefly because of strong~~, reflecting also the growing importance of rising wages.~~ wage growth together with falling productivity. Measures of longer-term inflation expectations mostly stand around 2 per cent~~. Nonetheless,~~, with some market-based indicators ~~remain~~of inflation compensation declining from elevated ~~and need to be monitored closely~~levels.

1.3. Risk assessment

The risks to economic growth remain tilted to the downside. Growth could be lower if the effects of monetary policy turn out stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict ~~triggered by~~in the ~~terrorist attacks in Israel~~Middle East are key sources of geopolitical risk. This may result in firms and households becoming less confident ~~and more uncertain~~ about the future~~, and dampen growth further. Conversely, growth~~. Growth could be higher ~~than expected~~ if ~~the still resilient labour market and~~ rising real incomes ~~mean that people and businesses become more confident and spend more~~raise spending by more than anticipated, or the world economy grows more strongly than expected.

Upside risks to inflation ~~could come from higher energy and food costs. The~~ include the heightened geopolitical tensions, which could ~~drive up~~raise energy prices in the near term, ~~while making the medium-term outlook more uncertain. Extreme~~and extreme weather~~, and the unfolding climate crisis more broadly, could push~~ events, which could drive up food prices ~~up by more than expected. A lasting rise in inflation expectations above our target, or~~. Inflation could also turn out higher than anticipated ~~increases in~~ if inflation expectations were to move above our target, or if wages or profit margins~~, could also drive inflation higher, including over the medium term.~~ increased by more than expected. By contrast, ~~weaker demand – for example owing to a stronger transmission of~~inflation may surprise on the downside if monetary policy ~~or a worsening of~~dampens demand by more than expected or the economic environment in the rest of the world ~~amid greater~~worsens unexpectedly, potentially owing in part to the recent rise in geopolitical risks~~ – would ease price pressures, especially over the medium term~~.

1.4. Financial and monetary conditions

~~Longer-term~~Market interest rates have ~~risen~~fallen markedly since our last meeting~~, reflecting strong increases in other major economies. Our~~ and lie below the rates embedded in the staff projections. Our restrictive monetary policy continues to transmit strongly into broader financing conditions. ~~Funding has become more expensive for banks, and interest rates for business loans and mortgages~~Lending rates rose again in ~~August~~October, to 5.~~0~~3 per cent for business loans and 3.9 per cent ~~respectively~~for mortgages.

Higher borrowing rates, ~~with the associated cuts in investment plans and house purchases, led to a further sharp drop in credit~~subdued loan demand ~~in the third quarter, as reported in our latest bank lending survey. Moreover, credit standards for loans to firms and households tightened further. Banks are becoming more concerned about the risks faced by their customers and are less willing to take on risks themselves.~~

~~Against this background,~~ and tighter loan supply have further weakened credit dynamics ~~have weakened further. The annual growth rate of loans to firms has dropped sharply, from 2.2 per cent in July to 0.7 per cent in August and 0.2 per cent in September.~~. Loans to ~~households~~firms declined at an annual rate of 0.3 per cent in October and loans to households also remained subdued, ~~with the growth~~growing at an annual rate ~~slowing to 1.~~of 0.6 per cent ~~in August and 0.8 per cent in September. Amid weak~~. With weaker lending and the reduction in the Eurosystem balance sheet, ~~the annual growth~~broad money – as measured by M3 – has continued to contract. In October it fell at an annual rate of ~~M3 fell to -1.3 per cent in August – the lowest level recorded since the start of the euro – and still stood at -1.2 per cent in September~~1.0 per cent.

In line with our monetary policy strategy, the Governing Council thoroughly assessed the links between monetary policy and financial stability. Euro area banks have demonstrated their resilience. They have high capital ratios and have become significantly more profitable over the past year. But the financial stability outlook remains fragile in the current environment of tightening financing conditions, weak growth and geopolitical tensions. In particular, the situation could worsen if banks' funding costs were to increase by more than expected and if more borrowers were to struggle to repay their loans. At the same time, the overall impact of such a scenario on the economy should be contained if financial markets react in an orderly fashion. Macroprudential policy remains the first line of defence against the build-up of financial vulnerabilities, and the measures in place contribute to preserving the financial system's resilience.

1.5. Conclusion

The Governing Council today decided to keep the three key ECB interest rates unchanged. ~~The incoming information has broadly confirmed our previous assessment of the medium-term inflation outlook. Inflation is still expected to stay too high for too long, and domestic price pressures remain strong. At the same time, inflation dropped markedly in September, including due to strong base effects, and most measures of underlying inflation have continued to ease. Our past interest rate increases continue to be transmitted forcefully into financing conditions. This is increasingly dampening demand and thereby helps push down inflation.~~

We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. Based on our current assessment, we consider that rates are at 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 ensure such a timely return. We will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.

The Governing Council intends to reduce the PEPP portfolio over the second half of 2024 and to discontinue its reinvestments under the PEPP at the end of 2024.

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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