Central Banks

The ECB does not close the door to early rate cuts

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- **The ECB keeps rates steady, as broadly expected**
- **Discussion of rate cuts is seen as premature, but Pres. Lagarde does not close the door to rate cuts in the second quarter**
- **The ECB seems a moderately less worried on inflation dynamics**

As widely anticipated, **the ECB maintained its status quo today, holding all its key policy rates unchanged** for the third meeting in a row. Hence, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility remained unchanged at 4.50%, 4.75% and 4.00%, respectively. In the absence of any news in monetary policy decisions, the primary focus was on **discerning the ECB's tone regarding the timing of anticipated rate cuts.**

The financial markets interpreted both the ECB's official statement and the subsequent press conference as **leaning towards a dovish stance**, amid growing concerns about the overall growth outlook while maintaining a moderate view on inflation dynamics. Moreover, **Mrs. Lagarde did not want to explicitly rule out an early rate cut in April.** This dovish stance has raised the implied probability of a rate cut in April by 22 percentage points, from 48% to 70%, as discounted by markets during the meeting. Nonetheless, **the market still maintains the 100% probability of a rate cut as early as June**.

This somewhat dovish stance of the ECB press conference in comparison with the previous ones, coupled with hints by several ECB officials of a possible rate cut around the summer months, has ultimately encouraged presumptions of an early rate cut to slow the economic downturn. But **the ECB's approach remains firmly dependent on ongoing economic data,** especially in terms of labor market tightness, while Lagarde also emphasized that it was premature for the ECB Governing Council to discuss rate cuts yet.

In this respect, the weaker-than-expected data observed in December has made the **ECB to be moderately less worried on inflation dynamics**, mentioning that most core inflation measures are slowing and that long-term expectations have already declined to around 2%. **Risks to inflation are balanced**, with price risks related to the Red Sea crisis overshadowed by the topic of salary evolution. Although these geopolitical risks and potential supply bottlenecks are closely monitored, the ECB thinks their impact is limited for the time being as there is now greater shipping capacity than during the pandemic period. In this sense, they continued to push for the withdrawal of energy-related support measures and focus on policies that improve competitiveness.

Despite the fact that the labor market remains robust, the **ECB sees a good evolution of wages with no risk of second round effects** as there are improvements in some wage indicators. The Statement also mentions the fact that lower unit profits have begun to moderate the inflationary effect of rising unit labor costs and that demand for labor is slowing, with fewer vacancies being advertised.

Some **moderation was observed in the growth prospects** based on a certain rebound or stabilization detected in the recent surveys published and the expected recovery of real income. However, they see activity likely to have stagnated in the last quarter of 2023 and weakness likely to continue in the near term.

During the Q&A session, **the ECB confirmed that it is close to completing its operational framework review**. Lagarde mentioned they expect it to be ready by **the end of spring,** which is a **slightly later than initially anticipated.** This is especially notable given that early last year the ECB had expressed its desire to conclude the review before the year's end. Still, Lagarde said that the review process is advancing rapidly. However, she also emphasized the importance of recognizing that the outcomes of this review might not significantly impact the short term, indicating a shift towards a longer-term focus in the ECB's strategic planning.

All in all, today's ECB meeting did not offer much new information. It was widely expected that no interest rate change would be decided today, and the main interest lay in discerning the tone of the ECB's statements regarding the timing of the first rate cuts. In this respect, **the message conveyed today was relatively dovish, as Lagarde did not seize the opportunity to rule out an early cut.**

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, ~~14 December 2023~~25 January 2024

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

The Governing Council today decided to keep the three key ECB interest rates unchanged. ~~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 euro area, inflation is expected to 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~~The incoming information has broadly confirmed our previous assessment of the medium-term inflation outlook. Aside from an energy-related upward base effect on headline inflation, the declining trend in underlying inflation has continued, and our past interest rate increases keep being transmitted forcefully into financing conditions. Tight financing conditions are dampening demand, and this is helping to push down inflation.

~~Underlying inflation has eased further. But domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs. Eurosystem staff expect inflation excluding energy and 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 to the economy. Tighter financing conditions are dampening demand, and 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.

1.2. Economic activity

~~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 euro area economy is likely to have stagnated in the final quarter of 2023. The incoming data continue to signal weakness in the near term. However, some forward-looking survey indicators point to a pick-up in growth further ahead.

The labour market ~~continues to support the economy.~~has remained robust. The unemployment rate ~~stood~~, at 6.~~5~~4 per cent in ~~October and employment grew by 0.2 per cent over the third quarter.~~November, has fallen back to its lowest level since the start of the euro and more workers have entered the labour force. At the same time, ~~the weaker economy is dampening the~~ demand for ~~workers~~labour is slowing, 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~~being advertised.

~~As the energy crisis fades, governments~~Governments should continue to roll back ~~the~~ energy-related support measures~~. This is essential~~ to avoid driving up medium-term inflationary pressures~~, which would otherwise call for even tighter monetary policy.~~. Fiscal and structural policies should be designed to make our economy more productive and competitive, as well as to gradually bring down high public debt ratios. 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~~Following the recent ECOFIN Council agreement on the reform of the EU's economic governance framework, the legislative process should be concluded swiftly so that the new rules can be implemented without delay. Moreover, it is imperative that progress towards Capital Markets Union and the completion of Banking Union be accelerated.

1.3. Inflation

Inflation rose to 2.9 per cent in December as some of the past fiscal measures to cushion the impact of high energy prices dropped ~~over the past two months, falling to an~~ out of the annual inflation rate ~~of 2.4 per cent in November according to Eurostat's flash release. This decline~~, although the rebound was ~~broad-based. Energy~~weaker than expected. Aside from this base effect, the overall trend of declining inflation continued. Food price inflation ~~fell further and food price inflation also came down, despite remaining relatively high overall. This month, inflation is likely~~ dropped 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 the phasing-out of past fiscal measures aimed at limiting the repercussions of the energy price shock.~~

6.1 per cent in December. Inflation excluding energy and food ~~dropped by almost a full percentage point over the past two months, falling to 3.6 per cent in November. This reflects improving supply conditions, the fading effects of the past energy shock and the impact of tighter monetary policy on demand and on the pricing power of firms. The inflation rates for goods and services fell to 2.9 per cent and 4.0 per cent respectively~~also declined again, to 3.4 per cent, due to a fall in goods inflation to 2.5 per cent. Services inflation was stable at 4.0 per cent.

~~All~~Inflation is expected to ease further over the course of this year as the effects of past energy shocks, supply bottlenecks and the post-pandemic reopening of the economy fade, and tighter monetary policy continues to weigh on demand.

Almost all measures of underlying inflation declined ~~in October, but~~further in December. The elevated rate of wage increases and falling labour productivity are keeping domestic price pressures ~~remained elevated, chiefly because of strong wage growth together with falling productivity.~~high, although these too have started to ease. At the same time, lower unit profits have started to moderate the inflationary effect of rising unit labour costs. Measures of shorter-term inflation expectations have come down markedly, while those of longer-term inflation expectations mostly stand around 2 per cent~~, with some market-based indicators of inflation compensation declining from elevated levels~~.

1.4. 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 in the Middle East are key sources of geopolitical risk. This may result in firms and households becoming less confident about the future~~.~~ and global trade being disrupted. Growth could be higher if rising real incomes ~~raise~~mean spending increases by more than anticipated, or if the world economy grows more strongly than expected.

Upside risks to inflation include the heightened geopolitical tensions, especially in the Middle East, which could ~~raise~~push energy prices and freight costs higher in the near term~~, and extreme weather events, which could drive up food prices.~~ and hamper global trade. Inflation could also turn out higher than anticipated if ~~inflation expectations were to move above our target, or if~~ wages ~~or profit margins increased~~increase by more than expected or profit margins prove more resilient. By contrast, inflation may surprise on the downside if monetary policy dampens demand by more than expected, or if the economic environment in the rest of the world worsens unexpectedly~~, potentially owing~~. Moreover, inflation could decline more quickly in ~~part to~~the near term if energy prices evolve in line with the recent ~~rise in geopolitical risks~~downward shift in market expectations of the future path for oil and gas prices.

1.5. Financial and monetary conditions

Market interest rates have ~~fallen markedly~~moved broadly sideways since our last meeting ~~and lie below the rates embedded in the staff projections~~. Our restrictive monetary policy continues to transmit strongly into broader financing conditions. Lending rates ~~rose again in October~~on business loans declined slightly, to 5.~~3~~2 per cent ~~for business loans and 3.9~~in November, while mortgage rates increased further to 4.0 per cent ~~for mortgages~~.

~~Higher~~High borrowing rates, ~~subdued loan demand~~ with the associated cutbacks in investment plans and ~~tighter loan supply have~~ house purchases, led to a further ~~weakened~~drop in credit demand in the fourth quarter, as reported in our latest bank lending survey. While the tightening of credit standards for loans to firms and households moderated, they remained tight, with banks concerned about the risks faced by their customers.

Against this background, credit dynamics~~.~~ have improved somewhat but overall remain weak. Loans to firms ~~declined at an~~ stagnated in November compared with a year earlier – after contracting in October – as the monthly flow of short-term loans rebounded. Loans to households grew at a subdued annual rate of 0.~~3~~5 per cent ~~in October and loans to households also remained subdued, growing at an annual rate of 0.6 per cent. With weaker lending and the reduction in the Eurosystem balance sheet, broad money – as measured by M3 – has continued to contract. In October it fell at an annual rate of 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.~~

1.6. Conclusion

The Governing Council today decided to keep the three key ECB interest rates unchanged. 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 ~~the timely return of inflation to our target.~~this goal. Our future decisions will ensure that ~~the key ECB interest~~our policy 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.

~~We are now ready to take your questions.~~

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