Creating Opportunities

Central Banks

The ECB paving the way for a June cut

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- **The ECB maintained key rates unchanged**
- **New operational framework to be unveiled on 13 March**
- **Downward revision of staff inflation and growth forecasts, aligning with our outlook**
- **Mrs. Lagarde's comments strengthen our call for a first rate cut in June**

There were no surprises in the monetary policy decisions announced by the European Central Bank (ECB) at today's meeting, **keeping the three key interest rates unchanged for the fourth meeting in a row.** However, Mrs. Lagarde left some clues about what the next course of monetary policy will be, especially regarding the expected easing cycle that will presumably be carried out throughout 2024. Beyond the interest rates decision, it was disclosed that the **new operational framework will be unveiled next week**, underscoring the necessity for a thorough examination of a complicated and technical matter.

Lagarde's wording throughout the press conference has **strengthened our expectation of a start to the downward cycle next June**. This perception comes from **a more dovish stance, amidst a downward revision of macroeconomic expectations** for growth and inflation, keeping an eye on wages that remain robust but show signs of moderation. **Financial markets reacted with volatility to the information** provided throughout the press conference. Following the release of inflation forecasts, markets took a dovish stance with the euro initially dropping 0.2% and 2-year and 10-year German bond yields falling by 7 basis points, but recovered their prior levels during the Q&A after Lagarde´s hinted that an April rate cut is not very likely.

During the press conference, attention was focused on the timing of potential interest rate cuts. **Mrs Lagarde emphasized that the ECB is awaiting comprehensive data due by June to inform future policy decisions.** Current inflation figures indicating progress towards the 2% target are not yet convincing enough for policy changes. The ECB is looking forward to more detailed upcoming data on economic activity, wage trends, and profit margins to solidify the grounds for any adjustments. While preliminary insights are expected in April, a fuller dataset will be available by June. Furthermore, **Lagarde made clear that today's meeting agenda did not include discussions on lowering interest rates. However, discussions on reversing the ECB's restrictive stance have already begun.** This indicates that, very likely, there will not be a rate cut in April, leaving the possibility of a first reduction in June, should the data not indicate ongoing inflation persistence, in line with our expectation of a move in June.

Additionally, during the press conference Lagarde **dismissed the idea that the timing of a rate cut depends on when the Fed begins its easing cycle**. She said that the ECB operates on its own accord and will undertake whatever actions are necessary at the moment they are required.

Regarding ECB staff forecasts, on the economic outlook, **the ECB cut GDP growth projections for this year from 0.8% to 0.6%.** The 2024 growth revision confirms the current weakness of the economy in the face of lower consumer spending, moderating investment and weaker export performance. **The ECB also maintained the 1.5% projection for 2025 and slightly upgraded the figure for 2026 (from 1.5% to 1.6%)**. These new ECB´s figures are in line with our outlook. The recovery of real household incomes and exports are the main assumptions for the medium-term recovery of the economy, this latter one based on the gradual fading of the effect of past interest rate hikes and a stronger foreign demand with a reduced likelihood that disruptions in the Red Sea will lead to major supply disruptions.

On inflation, **a revision of projections was expected**, primarily due to a lower contribution from energy prices, **but it was lower than what the consensus was anticipating**. **The new ECB's inflation outlook, revised from 2.7% to 2.3% this year and reaching the 2% target in 2025 and below in 2026 to 1.9%, is also in line with our view**. The downgrade of projections is also noticeable for core inflation in 2025, which is lowered to 2.1%, almost in line with the target. This forecast already includes the effect of the withdrawal of compensatory energy tax measures, estimated at a 0.3% increase in headline inflation, which was moderated compared to December's estimation due to the timing of the withdrawals in some countries. Moreover, as with growth, the ECB does not see a significant effect of the disruption to shipping in the Red Sea on inflation.

The main upside risk and the main topic of discussion during the press conference was the evolution of labor costs and the effect on services inflation, which remains sticky. This is the key variable of concern for the ECB, which is optimistic about the moderation of the latest available data for the fourth quarter of 2023 but cautious and watchful about the forthcoming data available for the first quarter of this year, most of which will be ready for the June meeting. This cautious optimism is shown in their **new forecasts for unit labor cost growth, which they expect to continue to decelerate to 3% by the end of 2026**, thanks to compensation per employee moderation in the forecast horizon and a higher productivity from 2025 onwards. In the case of 2024, the ECB expects unit profits to be negative and thus cushion the relatively strong growth in labor costs.

In sum, **this meeting further supports the expectation of an initial rate cut in June in line with our forecasts.** The updated projections match our own; however, for the typically cautious ECB, this month's figures might be considered dovish. Nevertheless, the ECB needs to verify that core inflation, particularly from services and consequently wages, moderates as expected.

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, ~~25 January~~7 March 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. ~~The incoming information has broadly confirmed~~Since our ~~previous assessment of the medium-term~~last meeting in January, inflation ~~outlook. Aside~~ has declined further. In the latest ECB staff projections, inflation has been revised down, in particular for 2024 which mainly reflects a lower contribution from ~~an~~ energy~~-related upward base effect on headline inflation, the declining trend in~~ prices. Staff now project inflation to average 2.3 per cent in 2024, 2.0 per cent in 2025 and 1.9 per cent in 2026. The projections for inflation excluding energy and food have also been revised down and average 2.6 per cent for 2024, 2.1 per cent for 2025 and 2.0 per cent for 2026. Although most measures of underlying inflation ~~has continued, and~~ have eased further, domestic price pressures remain high, in part owing to strong growth in wages. Financing conditions are restrictive and our past interest rate increases ~~keep being transmitted forcefully into financing conditions. Tight financing conditions are dampening~~ continue to weigh on demand, ~~and this~~which is helping ~~to~~ push down inflation. Staff have revised down their growth projection for 2024 to 0.6 per cent, with economic activity expected to remain subdued in the near term. Thereafter, staff expect the economy to pick up and to grow at 1.5 per cent in 2025 and 1.6 per cent in 2026, supported initially by consumption and later also by investment.

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 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 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 has remained robust.~~ The economy remains weak. Consumers continued to hold back on their spending, investment moderated and companies exported less, reflecting a slowdown in external demand and some losses in competitiveness. However, surveys point to a gradual recovery over the course of this year. As inflation falls and wages continue to grow, real incomes will rebound, supporting growth. In addition, the dampening impact of past interest rate increases will gradually fade and demand for euro area exports should pick up.

The unemployment rate~~,~~ is at ~~6.4 per cent in 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, demand for labour is slowing, with~~. Employment grew by 0.3 per cent in the final quarter of 2023, again outpacing economic activity. As a result, output per person declined further. Meanwhile, employers are posting fewer job vacancies~~-~~, while fewer firms are reporting that their production is being ~~advertised~~limited by labour shortages.

Governments should continue to roll back energy-related support measures to ~~avoid driving up medium-term inflationary pressures.~~allow the disinflation process to proceed sustainably. Fiscal and structural policies should be ~~designed~~strengthened to make our economy more productive and competitive, ~~as well as to~~expand supply capacity and 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~~A speedier implementation of the Next Generation EU programme ~~–~~and more determined efforts to remove national barriers to deeper and more integrated banking and capital markets can help increase investment in the green and digital transitions and reduce price pressures in the medium term~~, while supporting the green and digital transitions. Following the recent ECOFIN Council agreement on the reform of the~~ . The EU's revised economic governance framework~~, the legislative process should be concluded swiftly so that the new rules can~~ should 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 out of the annual inflation rate, although the rebound was weaker than expected. Aside from this base effect, the overall trend of declining inflation continued.~~edged down to 2.8 per cent in January and, according to Eurostat's flash estimate, declined further to 2.6 per cent in February. Food price inflation ~~dropped to 6.1 per cent in December. Inflation excluding energy and food also declined~~ fell again, to ~~3.4~~5.6 per cent~~, due to a fall~~ in ~~goods inflation to 2.5 per cent.~~January and 4.0 per cent in February, while energy prices in both months continued to decline compared with a year ago but at a lower rate than in December. Goods price inflation also fell further, to 2.0 per cent in January and 1.6 per cent in February. Services inflation ~~was stable~~, after remaining at 4.0 per cent for three months in a row, edged lower to 3.9 per cent in February.

~~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~~Most measures of underlying inflation declined further in ~~December. The elevated rate of wage increases~~January as the impact of past supply shocks continued to fade and tight monetary policy weighed on demand. However, domestic price pressures are still elevated, in part owing to robust wage growth and falling labour productivity ~~are keeping domestic price pressures high, although these too have started to ease.~~. At the same time, ~~lower unit profits have started~~there are signs that growth in wages is starting to moderate ~~the inflationary effect of~~. In addition, profits are absorbing part of the rising ~~unit~~ labour costs~~.~~, which reduces the inflationary effects.

Inflation is expected to continue this downward trend in the coming months. Further ahead, it is expected to decline to our target as labour costs moderate and the effects of past energy shocks, supply bottlenecks and the reopening of the economy after the pandemic fade. Measures of ~~shorter-term inflation expectations have come down markedly, while those of~~ longer-term inflation expectations ~~mostly stand~~remain broadly stable, with most standing around 2 per cent.

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~~major 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 inflation comes down more quickly than expected and rising real incomes mean that 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 push energy prices and freight costs higher in the near term and ~~hamper~~disrupt global trade. Inflation could also turn out higher than anticipated if wages 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~~. Moreover, inflation could decline more quickly in the near term if energy prices evolve in line with the recent downward shift in market expectations of the future path for oil and gas prices~~.

1.5. Financial and monetary conditions

Market interest rates have ~~moved broadly sideways~~risen since our ~~last~~January meeting~~. Our restrictive~~ and our monetary policy ~~continues to transmit strongly into~~has kept broader financing conditions restrictive. Lending rates on business loans ~~declined slightly, to 5.2 per cent in November~~have broadly stabilised, while mortgage rates ~~increased further to 4.0~~declined in December and January. Nevertheless, lending rates remain elevated, at 5.2 per cent for business loans and 3.9 per cent for mortgages.

~~High borrowing rates, with the associated cutbacks~~Bank lending to firms had turned positive in ~~investment plans and house purchases, led~~December, growing at an annual rate of 0.5 per cent. But, in January, it edged lower, to 0.2 per cent, owing to a ~~further drop in credit demand~~ negative flow in the ~~fourth quarter, as reported~~month. The growth 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~~continued to weaken, falling to 0.3 per cent on an annual basis in January. Broad money – as measured by ~~their customers.~~

~~Against this background, credit dynamics have improved somewhat but overall remain weak. Loans to firms stagnated in November compared with a year earlier – after contracting in October – as the monthly flow of short-term loans rebounded. Loans to households~~M3 – grew at a subdued ~~annual~~ rate of 0.~~5~~1 per cent.

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 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 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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