ECB Watch

AIB Treasury Economic Research Unit

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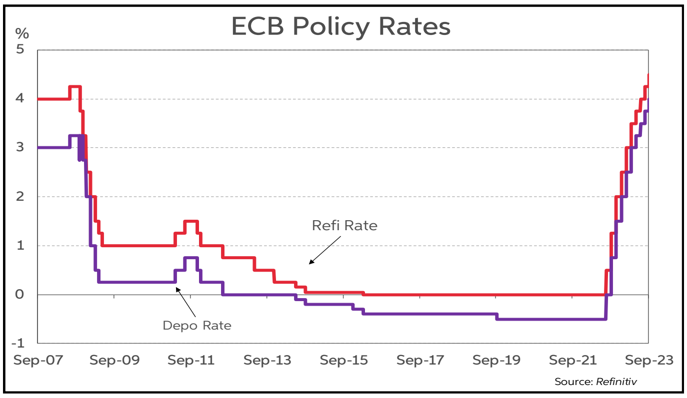
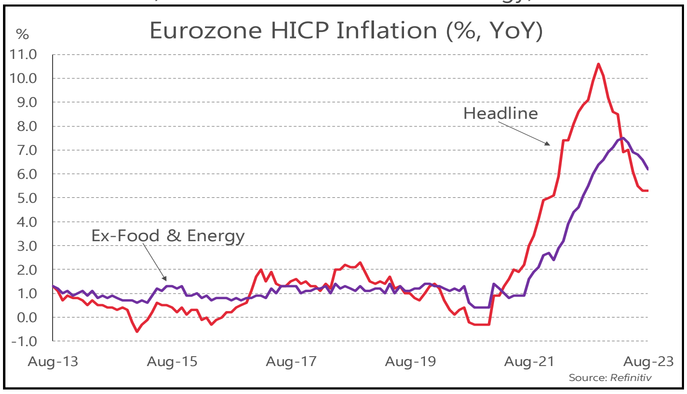
ECB Depo rate hits 4%, likely to be the peak

The September meeting of the ECB's Governing Council saw the Central Bank raise rates by a further 25bps, pushing the key deposit rate up to 4.00%. It brings the total amount of rate tightening in this cycle, which began last July, to 450bps. The ECB's decision to hike was not unanimous. Instead, President Lagarde, noted that there was a "solid majority" in favour of a rate increase.



In the lead up to today's meeting, the market had attached around a 65% probability to a 25bps rate hike. **In explaining the basis for the 25bps hike, the ECB noted that while inflation continues to decline, it is still "expected to remain too high for too long".**

In this regard, the ECB today released its latest staff quarterly macro forecasts. Its revised higher its outlook for headline inflation for 2023 and 2024*.* It now sees the headline HICP rate averaging 5.6% (was 5.4%) this year, 3.2% (was 3.0%) in 2024 and 2.1% (was 2.2%) in 2025. Meanwhile, its projection for the core HICP rate, which excludes food and energy, were revised slightly lower for 2024-25. It is forecasting the core rate to average 5.1% (no change) for 2023 , 2.9% (was 3.0%) in 2024 and 2.2% (was 2.3%) in 2025.



Meanwhile, it lowered "significantly" its GDP growth forecasts amid the increasing impact of monetary policy tightening on domestic demand and the weakening in global trade. It is anticipating GDP growth to average 0.7% (was 0.9%) this year, 1.0% (was 1.5%) in 2024 and 1.5% (was 1.6%) in 2025. The ECB commented today that the risks to its economic outlook remain tilted to the downside.

In terms of guidance on the rate outlook, while the ECB was not willing to say that's rates have peaked, the text of its meeting statement and President Lagarde's press conference comments suggests that it has now completed its rate hiking campaign. The ECB stated today that it considers that its key interest rates "have reached" levels, that if maintained for a "sufficiently" long time horizon will have a substantial impact on reaching its 2% inflation target in a timely manner**. However, it retained the flexibility to hike again by stating that it remains in a "data-dependent" mode and will ensure that rates "will be set at sufficiently restrictive levels for as long as necessary**".

ECB Macroeconomic Forecasts for the Euro Area

(%)	2022	2023	2024	2025
HICP	8.4	5.6	3.2	2.1
Real GDP	3.4	0.7	1.0	1.5

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $82.7 in 2023, $81.8 in 2024 and $77.9 in 2025

Source: ECB September 2023

Futures contracts suggest that the market is of the view that today's rate hike represents the final one in the ECB's tightening cycle. The market envisages rates remaining at their current 4% level through to the end of this year and into the first half of 2024. Futures contracts are pricing a rate cut by June 2024 and see rates ending next year near to 3.25%. This would represent 75bps of rate cuts over the course of 2024. A further reduction of 25-50bps in rates is priced for 2025. However, in light of the continued focus within the ECB on maintaining a restrictive policy for as long as necessary in the face of sticky inflation, **rates may be cut more slowly than is currently envisaged by markets, unless the economy enters recession**. The ECB's forecasts envisage a pick up in the pace of activity next year, which if proved to be correct, would seem unlikely to be accompanied by monetary easing.

Today's ECB policy announcement prompted some reaction on markets. It saw Eurozone yields move lower. On the currency front, the euro lost ground against the dollar, which was in part due to the market anticipating that Eurozone rates have peaked as well the dollar benefitting from better than expected US macro data. The EUR/USD pair traded below the $1.07 level, hitting a low of $1.0650

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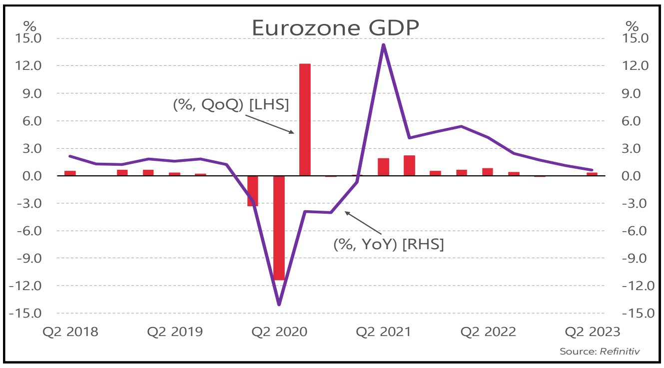
Eurozone economy loses further momentum

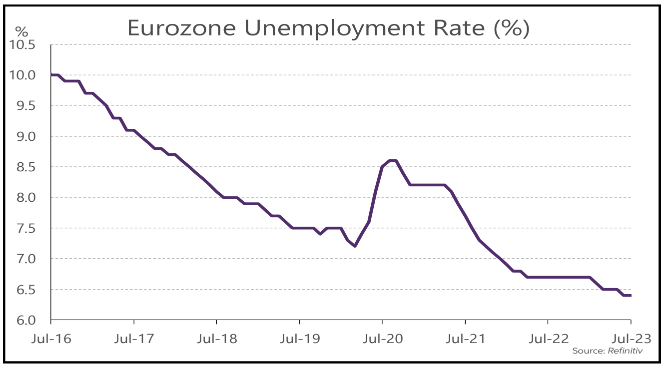
The Eurozone economy expanded by a meagre 0.1% in the second quarter. This follows a 0.1% expansion in Q1 also, and a 0.1% contraction in Q4 of last year. The underlying breakdown of Q2 GDP growth shows that household expenditure remained flat for the second quarter running, as the squeeze on real incomes from higher inflation and interest rates weighed on consumption. Meanwhile, slight increases in investment and government spending, each contributed 0.1 percentage points (p.p.) to growth. Elsewhere, a fall in exports (-0.7%) and a slight rise in imports (+0.1%), meant net trade knocked 0.4 p.p. from GDP, although, this was partly offset by higher inventories. Overall then, the Eurozone has narrowly avoided entering a technical recession, but the economy has been broadly stagnant since Q3 2022.



Survey data suggest the Eurozone economy has lost further momentum in the third quarter. The services PMI averaged 54.4 in the second quarter, but declined to 50.9 in July, and to 47.9 in August. The August reading was the first below the key 50 level since last December, and marked the quickest pace of contraction in the sector since February 2021. Meantime, the manufacturing PMI averaged 44.7 in Q2, and stayed well in contraction territory, at 42.7 and 43.5, respectively, in July and August. Furthermore, new orders continued to plummet at a sharp rate, indicating that demand conditions remain very weak in the manufacturing sector. Meantime, the EC economic sentiment index, which has been trending lower since the start of the year, continued to do so in Q3, falling to 93.3 in August, its lowest level since November 2020. Elsewhere, consumer confidence remains at relatively low levels.

The available hard data have also been quite weak. Retail sales fell by 0.2% in July, having increased in both May and June, and were 1% lower in year-on-year terms. Meanwhile, industrial production declined by 1.1% in July, having contracted by 0.3% in Q1 and 1% in Q2. Like retail sales, industrial output is also lower year-on-year, down 2.2%. Overall, the data suggest that GDP could contract in Q3. Monetary aggregates also continued to weaken in July, with M3 money supply falling by 0.4% and credit growth to households slowing to 1.7% y/y.

In terms of the labour market, conditions remain tight. The unemployment rate fell to a new all-time low of 6.4% in May, and stayed at that level in June and July. At the same time, employment was up by 0.2% in Q2, and overall, it is estimated there are five million more people in employment now, than before the pandemic. Tight conditions are contributing to increased labour costs. The most recent official data show that hourly wages and salaries increased by 4.6% y/y in Q1.



Regarding inflation, the headline rate has fallen sharply from its peak of 10.6% last October. It declined to 5.3% in July, and remained at that level in August. However, inflation has become more broad based, with services inflation rising from 4.4% in December, to 5.5% in August. Furthermore, the core rate that excludes energy, food, alcohol and tobacco, has been in a narrow 5.0-5.7% range since last October, and stood at 5.3% in August. The ECB staff projections are for headline inflation to average 5.6% this year, down from 8.4% in 2022, while core inflation is expected to be 5.1% in 2023. The headline HICP rate is forecast to fall to 3.2% in 2024, and to 2.1% in 2025.

Overall, the Eurozone economy has been virtually stagnant over the past number of quarters in the face of, increased uncertainty stemming from the War in Ukraine, high inflation and rising rates, as well as, weaker global growth. The German economy, the largest in the Eurozone, has performed particularly poorly, falling into recession in Q1, before flat-lining in Q2. However, the labour market remains strong and there has been a marked fall in headline inflation since last autumn, although, it still remains elevated. It is expected that activity will start to pick up some momentum late this year, as inflation falls back further, and household savings rates decline, supporting consumption. **The IMF is forecasting Eurozone GDP growth of 0.9% in 2023, and 1.5% in 2024. The ECB is projecting the economy will expand by 0.7% this year and by 1.0% in 2024. However, given the recent weak trends in the data, the risks are tilted to the downside of these forecasts.**

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