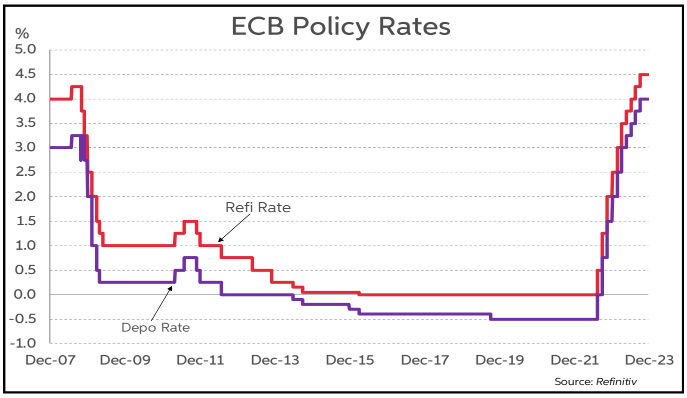
ECB Watch

AIB Treasury Economic Research Unit

14th December 2023

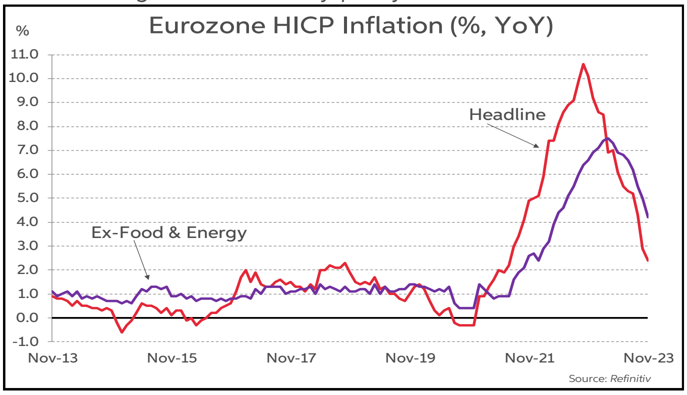
ECB holds the line on tight policy as pressure builds for rate cuts

The December meeting of the ECB's Governing Council saw the Central Bank maintain its key deposit rate at 4%, which was in line with expectations. It represented the second consecutive policy meeting that the ECB has not hiked rates since it began tightening policy in July 2022. The last rate hike was in September. In total, it has increased rates by 450bps in this cycle. The decision to keep rates unchanged was unanimous.



The ECB today repeated the key message from its previous two meetings that it considers interest rates to have reached levels, that if maintained for a sufficiently long time horizon, would make a substantial contribution to reaching its 2% inflation target, in a timely manner. **It noted the marked fall in inflation in recent months, with the headline HICP rate dropping to 2.4% in November.**

However, the ECB highlighted that domestic price pressures remain strong, reflecting high wage inflation in particular. Unit labour costs rose by 6.6% in Q3 2023, which is far above the level consistent with a core inflation rate of 2%. It reflects both strong upward pressure on wages and negative productivity growth and is a clear concern for the central bank. The ECB repeated that it will continue to follow a data-dependent approach in making future monetary policy decisions and will **ensure that rates are sufficiently restrictive for as long as necessary to restore price stability.**



The ECB's latest staff quarterly macro forecasts were published after today's meeting. These saw a slight lowering of its 2023-2024 growth projections amid the increasing impact of monetary policy tightening on domestic demand and the weakening in global trade. The ECB is now forecasting GDP growth of 0.6% is 2023 (was 0.7%), 0.8% (was 1.0%) in 2024 and 1.5% in both 2025 and 2026. The ECB views the risks to the economic outlook as still being tilted to the downside.

Meanwhile, there were reductions to the ECB's 2023-24 inflation forecasts. It now sees the headline HICP rate averaging 5.4% (was 5.6%) this year, 2.7% (was 3.2%) in 2024, 2.1% in 2025 and 1.9% in 2026. Its projections for the core HICP rate, which excludes food and energy, were revised lower too for 2023-24. It is forecasting the core rate at 5.0% (was 5.1%) for 2023, 2.7% (was 2.9%) in 2024, 2.3% (was 2.2%) in 2025 and 2.1% in 2026.

Against the backdrop of very weak growth and rapidly declining inflation, **futures contracts have been pricing in sharp rate cuts for 2024.** They see rates being reduced by 150bps next year, starting in April, with a further 25bps cut priced in for 2025. This would see the deposit rate being lowered to 2.25% by end 2025. **These expectations were little changed following today's meeting,** despite the ECB emphasising the need to maintain a restrictive policy stance in the face of continuing inflationary pressures, especially in the labour market. **Its inflation forecasts are also based on far fewer rate cuts in 2024 than markets expect.** Inflation will need to decline more quickly than the ECB anticipates, including wage costs, if it is to deliver on the 150bps of easing priced in for 2024. In this regard, the ECB confirmed there was no discussion on rate cuts at today's meeting.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2023	2024	2025	2026
HICP	5.4	2.7	2.1	1.9
Real GDP	0.6	0.8	1.5	1.5

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $84.0 in 2023, $80.1 in 2024, $76.5 in 2025 and $73.6 in 2026 *Source: ECB December 2023*

Finally, the ECB announced today that it will speed up the pace of quantitative tightening during 2024, via changes to PEPP reinvestments. It will continue to reinvest, in full, the principal payments from maturing securities under its PEPP programme during the first half of 2024. **It intends to lower the PEPP portfolio by €7.5bn per month on average over the second half of the year and discontinue PEPP reinvestments at the end of next year**. The ECB will be anxious, though, to ensure that this does not lead to a marked widening of euro area sovereign bond spreads.

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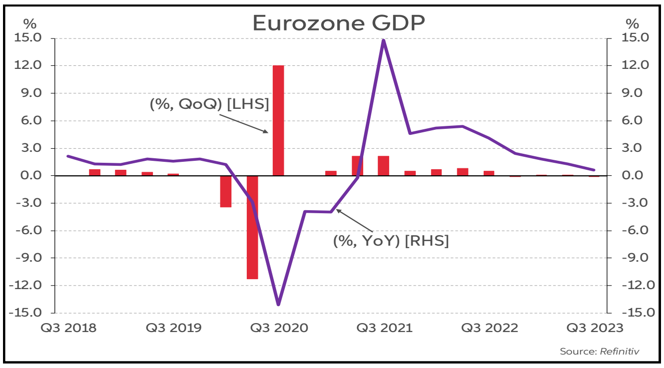
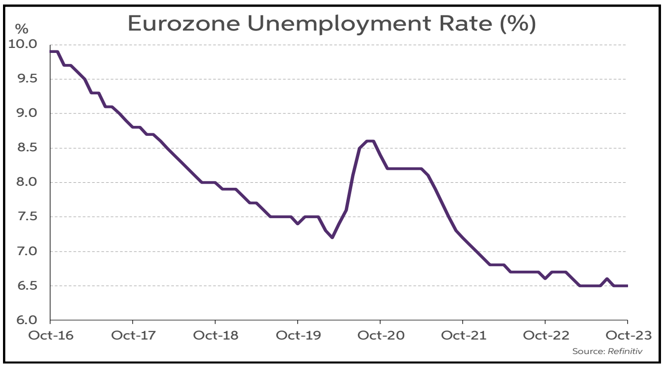
Eurozone economy on verge of recession

The Eurozone economy has essentially flat-lined for four consecutive quarters. GDP contracted by 0.1% in Q4 2022, before expanding by 0.1% in the first and second quarters of this year. However, growth fell by 0.1% again in Q3 2023. The underlying breakdown of GDP in the third quarter shows consumption rose by 0.3%, having stagnated in the previous two quarters. Meanwhile, fixed investment and government expenditure also increased modestly. However, when taken together, these three components contributed just 0.2 percentage points (p.p.) to growth. Elsewhere, the impact from external trade was negligible, as a decline in exports was offset by a similar fall in imports. Inventories though, knocked 0.3 p.p. from output. Overall then, the Eurozone has narrowly avoided entering a technical recession in the past year, with the economy broadly stagnant since Q3 2022.



Meantime, the data available for the fourth quarter of this year have remained weak. Retail sales rose by a meagre 0.1% in October, having declined throughout Q3. In year-on-year terms, retail sales were 1.2% lower in October. Meanwhile, industrial production declined by 0.7% in October, after contracting by 1.0% in September. Annually, industrial output was 6.6% lower in October. Monetary aggregates also continued to weaken in October, with M3 money supply falling by 1.0% and credit growth to households slowing for a fourteen consecutive month, to just 0.6% y/y, its lowest rate since June 2015. **Survey data also suggest the Eurozone economy has lacked momentum so far in Q4.** The services PMI has been in contraction territory for the past four months. It averaged 48.2 in October/November, down from 49.2 in Q3. Meantime, the manufacturing PMI has averaged 43.7 so far in Q4, which is broadly unchanged from its level of 43.2 in the third quarter. Elsewhere, the EC economic sentiment index inched slightly higher to 93.8 in November. However, it had been trending lower from the start of the year to September, when it reached 93.4, its lowest level since November 2020.

In terms of the labour market, conditions remain tight. The unemployment rate has levelled off at a historic low, and been remarkably steady so far this year. It has printed at either 6.5% or 6.6% in every month since February, and stood at 6.5% for a third consecutive month in October. Meanwhile, employment rose by 0.2% in Q3 and was up 1.3% y/y. **Tight conditions are contributing to increased labour costs.** Hourly wages and salaries increased by 4.6% y/y in Q2. **Unit labour costs continue to rise strongly, increasing by 6.6% y/y in Q3**. This reflects strong wage growth and negative productivity, with employment rising faster than output.



Regarding inflation, the headline rate has fallen sharply from its peak of 10.6% last October. Prices unexpectedly fell by an outright 0.5% in November, meaning inflation declined to just 2.4%, its lowest level since July 2021. Encouragingly, core inflation has also decelerated more quickly than expected in recent months. The ex-food and energy rate dropped to 4.2% in November, down from 5% in October, and an average of 6.1% in Q3. Meantime, the core rate that excludes energy, food, alcohol and tobacco, had been in a narrow 5.0-5.7% range since last October, before easing to 4.5% in September, and to just 3.6% in November. **ECB staff projections are for headline inflation to average 5.4% this year and to fall to 2.7% in 2024, 2.1% in 2025 and 1.9% in 2026.**

Overall, the Eurozone economy has been virtually stagnant over the past year 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, flat-lining in Q2, before contracting again in Q3. However, it is worth noting that the Eurozone labour market remains strong, and there has been a marked fall in inflation since last autumn. Nevertheless, the most recent forecasts for the Eurozone economy have been scaled back. **The IMF is now forecasting Eurozone GDP growth of 0.7% in 2023, and 1.2% in 2024. The ECB is projecting the economy will expand by 0.6% this year and by 0.8% in 2024.** However, given the weak trends in recent data, the risks are tilted to the downside for these projections. Indeed, the economy may enter a shallow recession in the final quarter of this year.

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