ECB Watch

AIB Treasury Economic Research Unit

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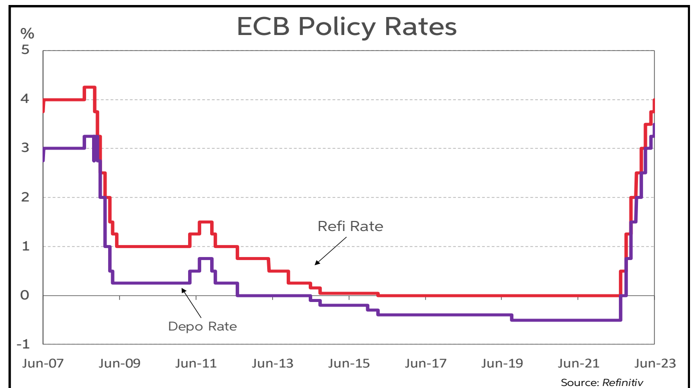
ECB hikes rates by a further 25bps, but not done yet

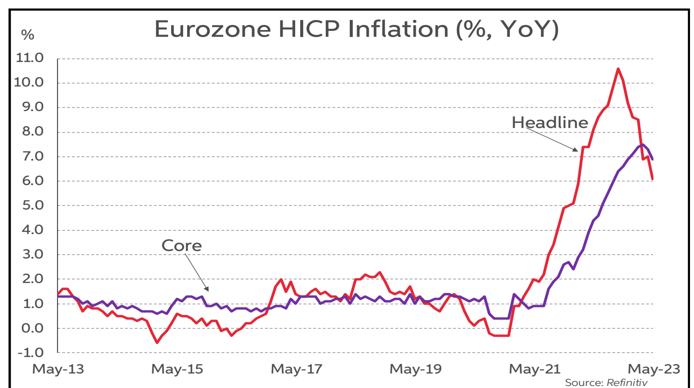
As had been widely expected, the June meeting of the ECB's Governing Council saw the central bank raise rates by a further 25bps, pushing the key deposit rate up to 3.5%. It brings the total amount of rate tightening in this cycle, which began last July, to 400bps. However, the ECB has slowed the pace of rate increases to 25bps at its last two meetings, following the 50bps hikes implemented in March, February and December and two 75bps rate rises seen last autumn.



Today's 25bps rate hike was in line with market expectations. **The ECB had given clear signals in the run up to today's meeting that a further rate increase was in the pipeline,** despite the economy entering a technical recession and headline inflation moving markedly lower to date in 2023. Core inflation, though, is proving very sticky, especially in the services sector, meaning the ECB remains on a rate tightening path.

Indeed, **the ECB was again quite blunt today in its meeting statement, noting that while inflation has been coming down, it is still projected to remain too high for too long.** It indicated that the 25bps hike was required to ensure a timely return of inflation to the 2% medium-term target. **President Lagarde also clearly indicated today that the ECB has more ground to cover in tightening policy. She said that the ECB is not done yet and added a further rate hike is very likely at the Council's next policy meeting in July.** Markets were already looking for a 25bps hike in July and are beginning to price in the possibility of a further rate increase in the autumn also, which would bring the deposit rate to 4%. We note that rates in some other economies have been hiked already to 4% or above, with rates in the UK, US, Australia, New Zealand and Canada, all now in a 4.0-5.5% range.

The ECB commented that future decisions will ensure that policy rates will be brought to levels sufficiently restrictive to bring inflation back down to the 2% target level and will be kept at those levels for as long as necessary. The ECB emphasised again today that **it will continue to follow a data-dependent approach in its future rate decisions,** with a heavy emphasis also on the assessment of the inflation outlook.



In this regard, the ECB published its latest set of staff quarterly macro forecasts today. There was little change to its headline inflation forecasts from March. The headline HICP rate is seen averaging 5.4% in 2023, 3.0% in 2024 and 2.2% in 2025. However, **the core rate forecast, which excludes food and energy, was revised up significantly,** from 4.6% to 5.1% for 2023 and 2.5% to 3.0% in 2024, before falling to 2.3% in 2025.

In terms of GDP, this year's forecast was lowered slightly from 1% to 0.9%, while the previous forecast for growth of 1.6% in 2024 was also lowered to 1.5%. For 2025, the growth rate was unchanged, with the economy still seen as expanding by 1.6%.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2022	2023	2024	2025
HICP	8.4	5.4	3.0	2.2
Real GDP	3.4	0.9	1.5	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $78.0 in 2023, $72.6 in 2024 and $70.4 in 2025

Source: ECB June 2023

The markets are close to pricing in two further 25bps rate hikes by the ECB in H2 2023. Rate cuts of 75bps are then anticipated by markets during 2024, commencing in April, which would bring rates back down to 3.25%. A further reduction of 25-50bps in rates is priced for 2025. Given the firm focus of the ECB today on maintaining a restrictive policy for as long as necessary in the face of sticky core inflation, **rates may be slower to be cut than is presently envisaged.**

The market reaction to today's meeting saw some firming of futures contracts as they begin to contemplate rates getting to 4%. **The euro also made some gains**, rising towards $1.09. Overall, though, the meeting outcome was largely as expected.

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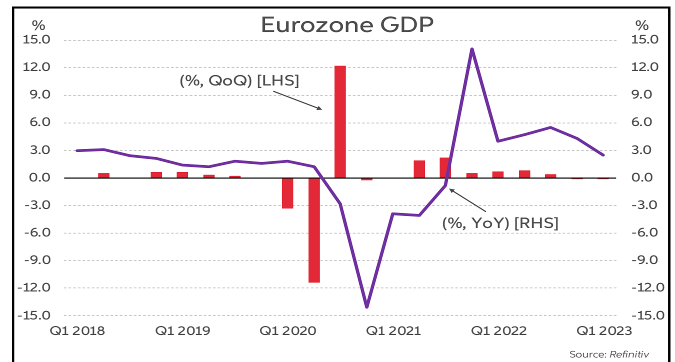
Eurozone economy enters a technical recession

The Eurozone economy has lost considerable momentum since last summer. GDP fell by 0.1% in the final quarter of 2022 and again in the opening quarter of 2023, with the economy thus entering a technical recession. The squeeze on real household incomes, from elevated levels of inflation and higher interest rates, has weighed on consumer spending, while exports have weakened in the face of slower global growth. There was also a marked decline in government spending in Q1 2023.

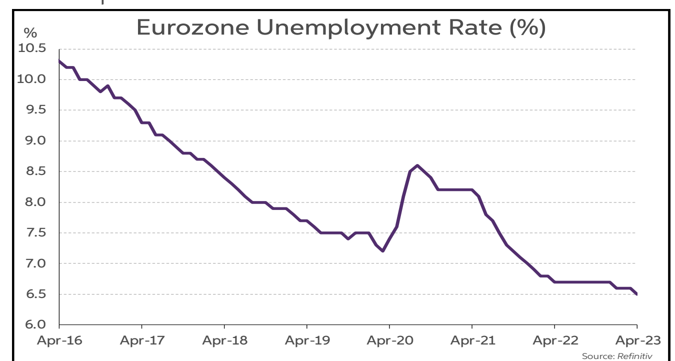


However, there has been a marked variation in the performances of the larger Eurozone economies over the past year. The heavily energy reliant and export orientated German economy has lagged well behind the others, with GDP declining by 0.5% in Q4, and by 0.3% in Q1, to leave it down by 0.5% on its Q1 2022 level. By contrast, the French, Italian and Spanish economies saw growth of 0.2%, 0.6% and 0.5%, respectively, in the first quarter of 2023, with strong year-on-year growth rates for Italy and Spain in particular, at 1.9% and 3.8%.

In terms of the available Q2 data, retail sales stagnated in April, meaning they were 2.6% lower in year-on-year terms. Industrial output rebounded by 0.8% in April, but remained quite weak overall, having declined by a chunky 3.8% in March. **Elsewhere, the survey data available for April and May have been mixed.** One thing that is clear though, is that the services sector is continuing to outperform manufacturing. The services PMI rose to 56.2 in April, its highest level in a year before easing back to a still strong 55.1 in May. In contrast, the manufacturing PMI remained in contractionary territory for the eleventh month running, falling to 44.8, its lowest level since May 2020. The EC industrial sentiment index deteriorated in May also. Meantime, consumer confidence has continued to trend higher, although, it is still well below its level seen ahead of the Russian invasion of Ukraine last February.

Meanwhile, labour market conditions remain very tight. The unemployment rate fell to 6.7% last April and remained at that level until year end, before edging lower to 6.6% from January to March. It inched down again in April, to a new all-time low of 6.5%. At the same time, the latest available employment data, which are for Q1 2023 also indicate that the labour market is performing well. Employment was up by a strong 0.6% in Q1 for a year-on-year gain of 1.6%. Overall, it is estimated there are four million more people in employment now, than before the pandemic. Tight conditions are contributing to increased labour costs. Official Eurozone wage data show that hourly wages and salaries increased by 5.1% y/y in the fourth quarter of 2022.

Regarding inflation, the headline HICP rate has fallen sharply from its peak of 10.6% last October. It fell to 6.1% by May, down from 7.0% in April. The fall in headline HICP largely reflects a sharp decline in fuel prices, and the big increases in energy costs in spring 2022 dropping out of the annual rate. Inflation has become more broad based, though, with services price inflation rising from 4.4% in December, to 5.0-5.2% in the March to May period. However, the core rate that excludes energy, food, alcohol and tobacco declined to 5.3% in May from a tight 5.6-5.7% range in the previous three months. The ECB staff projections are for headline inflation to average 5.4% this year, down from 8.4% in 2022. Core inflation though is expected to be higher this year, averaging 5.1% in 2023, compared to 3.9% last year. Both rates are forecast to fall to 3% in 2024, and back towards 2% in 2025.



Overall, growth in the Eurozone has slowed sharply 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. 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 in the second half of 2023, as inflation falls back further, and household savings rates continue to decline, supporting consumption. However, higher financing costs and tighter credit conditions will weigh on investment. **Overall, the IMF and OECD are forecasting Eurozone growth of 0.8-0.9% in 2023, and around 1.5% in 2024. Similarly, the ECB is projecting the economy will expand by 0.9% this year and by 1.5% in 2024, with growth of 1.6% expected in 2025.**

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