ECB Watch

AIB Treasury Economic Research Unit

AIB

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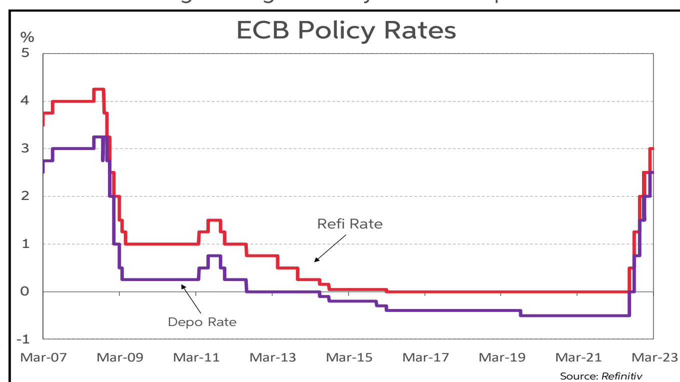
ECB sticks to its guns and hikes rates by a further 50bps

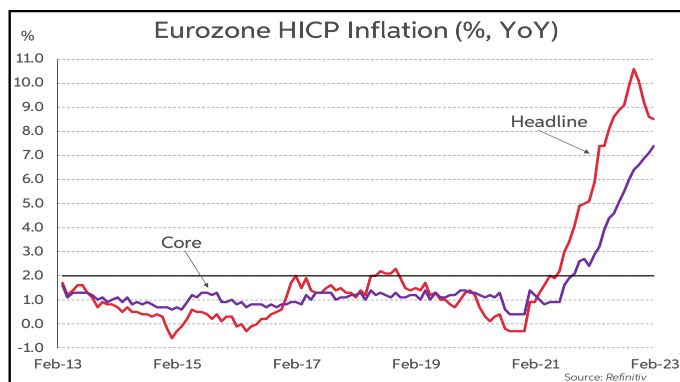
The March meeting of the ECB's Governing Council saw the central bank raise rates by 50bps, which brings the key deposit rate up to 3%. It follows similar sized moves in February and December. These came after two 75bps hikes in interest rates in the autumn and the initial 50bps move in July. It brings the total amount of rate tightening in this cycle to 350bps.



The recent volatility in financial markets had cast doubts about whether the ECB would raise rates by the full 50bps that it had clearly guided. Recent inflation data, though, have been disappointing, especially core inflation, making it difficult for the ECB to move away from the previous guidance.

Indeed, the ECB was quite blunt, with the opening line of its statement noting "inflation is projected to remain too high for too long". It commented today's 50bps hike was required to ensure a timely return of inflation to the 2% medium-term target. However, unlike at its early February meeting, it refrained from giving policy guidance in relation to the rate decision at its next policy meeting on May 4th. This is not that surprising given the extreme volatility on financial markets in recent days. It did indicate, though, that if economy performs in line with the latest ECB macro forecasts, a further tightening of rates would be required, but there is much uncertainty about the economic outlook with the risks tilted to the downside.

Futures contracts have been particularly volatile in recent days, moving from pricing in Eurozone rates rising to above 4% to possible rate cuts later in the year. **Post today's meeting, they are pricing in the possibility of one further hike of 25bps this summer, but that this would be reversed around the end of the year,** with little change in rates next year. Thus, rates are seen remaining at close to 3%. The ECB noted that the elevated level of uncertainty reinforces the importance of a data-dependent approach in its future rate decisions.



The ECB also published it latest staff quarterly macro forecasts today, which were compiled before the recent tensions emerged on financial markets. Economic activity has held up better than expected over the winter and this has resulted in an **upward revision to its 2023 Eurozone GDP forecast to 1.0% from 0.5% in its December projections.** This suggest that the Eurozone should avoid the short, shallow recession that was previously anticipated by the ECB. Its growth projections for 2024 and 2025 were lowered slightly from 1.8-1.9% owing to the tightening of monetary policy, but are still relatively strong at 1.6% in both years. The risks to the forecasts are to the downside.

The sharp fall in wholesale energy prices, in particular natural gas in recent months, has seen **the ECB cut it 2023 HICP inflation forecast from 6.3% to 5.3%.** It also lowered its inflation forecast from 3.4% to 2.9% for 2024, with the rate seen at 2.1% in 2025. However, it noted that price pressures remain strong and are becoming more broad based across the economy. **All core HICP rates continue to accelerate.** The core rate that excludes energy and unprocessed food rose from 7.1% to 7.4% in February. Meanwhile, a narrower core measure that excludes energy, all food, alcohol and tobacco increased from 5.3% to 5.6% in the same month. Thus, **the ECB sees underlying inflationary pressures remaining more persistent and upped its forecasts by circa 0.4 p.p. for all core inflation metrics in 2023.**

ECB Macroeconomic Forecasts for the Euro Area

(%)	2022	2023	2024	2025
HICP	8.4	5.3	2.9	2.1
Real GDP	3.4	1.0	1.6	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $82.6 in 2023, $77.8 in 2024 and $73.9 in 2025

Source: ECB March 2023

The ECB said that it is monitoring current market tensions closely and stands ready to respond as necessary to preserve price and financial stability. In particular, it said the ECB policy toolkit **is fully equipped to provide liquidity support to the euro area financial system if needed.** It views the Eurozone banking system as resilient, with strong capital and liquidity positions.

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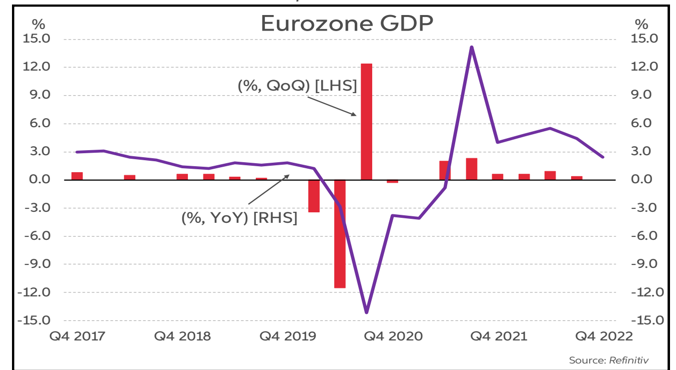
Sluggish Eurozone growth expected in 2023

The Eurozone economy lost considerable momentum in the second half of 2022. GDP stagnated in the three months to December having expanded by 0.4% in Q3 and 0.9% in Q2. The squeeze on real household incomes from elevated levels of inflation and higher interest rates weighed heavily on consumer spending in Q4. Consumption fell by 0.9% in the quarter, clipping 0.4 percentage points (p.p.) from GDP. Similarly, investment contracted by 3.6%, knocking 0.8 p.p. from the total, although, this was after a very sharp rise in Q3. Meantime, a significant increase in government spending added 0.2 p.p. to growth. Net trade, boosted GDP by 0.9 p.p., but this was almost entirely driven by a significant fall in imports of 1.9% in Q4, as exports increased by just 0.1%.

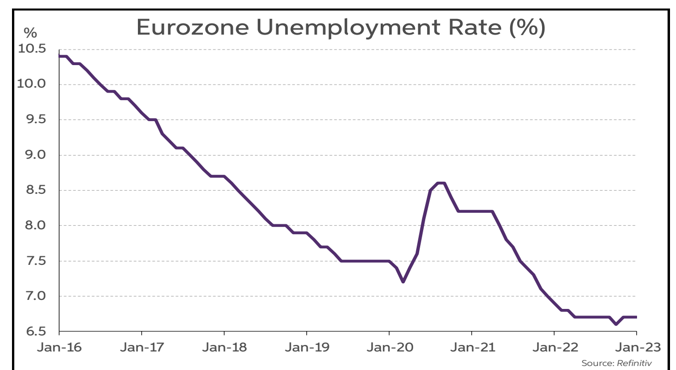


Overall, the Eurozone economy grew by 3.5% last year, down from 5.5% in 2021 as the economy rebounded strongly from the COVID-19 pandemic. However, growth in 2022 varied among the large Eurozone economies. The heavily energy reliant and export orientated German economy expanded by just 1.9% last year. In contrast, the French (+2.6%), Italian (+3.9%) and Spanish (+5.4%) economies grew much more quickly.

Survey data suggest the Eurozone economy has regained some momentum in the first quarter of 2023. Having moved into expansion territory for the first time since July in January, the services PMI rose to 52.7 in February. Meanwhile, the manufacturing PMI has averaged 48.7 so far in Q1 versus 47.1 in Q4. Similarly, the EC services and industrial sector sentiment indices improved in January, before falling back slightly in February. 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. **In terms of the limited amount of hard data available, both retail sales and industrial production rebounded in January, having declined sharply in December.**

Regarding inflation, headline HICP fell to 8.5% in February, down slightly from 8.6% in January, and a peak of 10.6% last October. The fall in headline HICP largely reflects a sharp decline in energy prices. However, inflation has become broad based, with services price inflation rising from 4.4% to 4.8% in February. Meanwhile, the core rate that excludes energy, food, alcohol increased from 5.3% to 5.6%. The ECB staff projections released today, show headline inflation averaging 5.3% this year, down from its December forecast of 6.3% reflecting sharp falls in wholesale energy prices. Core inflation though is expected to be higher this year. Meanwhile, the headline HICP forecasts for 2024 and 2025 were also revised downwards to 2.9% and 2.1%, respectively, from 3.4% and 2.3%.

Meanwhile, labour market conditions remain very tight. The unemployment rate edged lower throughout last year, falling to an all-time low of 6.6% in October, before stabilising at 6.7% during the winter months. At the same time, employment continued to rise throughout 2022. It was up by 0.3% in Q4 for a year-on-year gain of 1.5%. 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. A measure of wage growth inflation for some of the large Eurozone economies, based on job postings data, indicate that wages have risen by 4.8% y/y in December, down from a peak of 5.5% in September.



Overall, the Eurozone economy has proved more resilient than expected in the face of high inflation and rising rates. Growth has slowed considerably, but the economy is expected to avoid the recession that was once feared. The labour market remains strong and there are signs the economy regained some momentum at the start of 2023, helped by a fall in energy prices and supportive fiscal policies.

However, the war in Ukraine could continue to weigh on economic activity, while there is still uncertainty around gas supplies for next winter. The volatility on financial markets also represents a new downside risk to growth. It is expected that activity will remain sluggish in the first half of the year, but pick up some momentum in H2 as inflation falls back. **The IMF is forecasting Eurozone growth of 0.7% in 2023 and 1.4% in 2024. The ECB is projecting the economy will expand by 1.0%his year and 1.6% in 2024. These forecasts, though, predate the recent instability on financial markets and problems in parts of the banking system.**

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