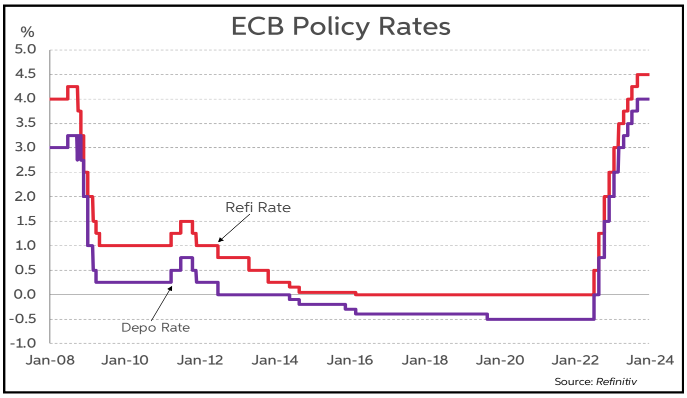
ECB Watch

AIB Treasury Economic Research Unit

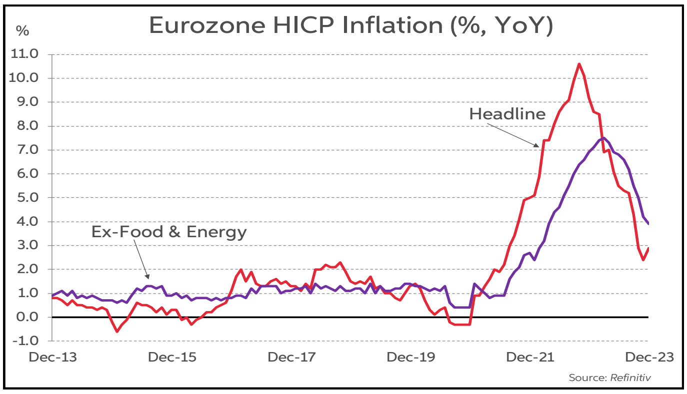
25th January 2024

ECB on hold for third straight meeting

The first policy setting meeting of the ECB's Governing Council for 2024 saw the Central Bank maintain its key deposit rate at 4%. This was very much in line with expectations. It represented the third policy meeting in-a-row that the ECB has not hiked rates. It started its tightening cycle back in July 2022 with the last rate hike occurring in September of last year. In total, the ECB has increased rates by 450bps over this period.



The ECB has started this year with a similar attitude to where it ended 2023 **repeating the key message that it considers interest rates to have reached levels, that if maintained for a sufficiently long time horizon, will make a substantial contribution to reaching its 2% inflation target, in a timely manner**. It noted that aside from an energy related base effect on headline inflation, the declining trend in underlying inflation has continued, and that the impact of its rate tightening cycle continues to be transmitted forcefully into financing conditions. **The ECB also repeated that it will 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. In this context, President Lagarde stated that the ECB will be paying close attention to wage growth developments, underlying inflation metrics, particularly in services as well as inflation expectations.



In terms of its assessment of the Eurozone economy's performance, it said that activity is likely to have stagnated in Q4 2023, with incoming data pointing to further near term weakness, while forward looking metrics suggest there is potential for a pick up in growth further ahead. The ECB's most recent staff quarterly macro forecasts were published at the December meeting. These saw a slight lowering of its near term growth projections amid the increasing impact of monetary policy tightening on domestic demand and the weakening in global trade. The ECB is forecasting GDP growth of 0.8% in 2024 and 1.5% in both 2025 and 2026. The ECB retained its view today that the risks to the economic outlook remain tilted to the downside.

It revised lower its inflation forecasts in December. It sees the headline HICP rate averaging 2.7% (was 3.2%) this year, 2.1% in 2025 and 1.9% in 2026. Its projections for the core HICP rate, which excludes food and energy, were also revised lower for 2024. It expects the core rate to average 2.7% (was 2.9%) this year, 2.3% in 2025 and 2.1% in 2026.

While the ECB continues to emphasise the need to keep its key interest rates sufficiently restrictive for a sufficiently long period of time, futures contracts continue to price in a fairly aggressive pace of rate cuts this year. This is in an environment of very weak growth and rapidly declining inflation. As a result, the main focus on today's meeting from a market viewpoint, was what signals, if any, would be forthcoming from the ECB around the potential timing of the first rate cut.

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*

During the press conference President Lagarde did not explicitly rule out the chance of a rate cut in April. On the back of this, the market moved from attaching a 70% probability of an April rate cut, to a 95% chance. On reflection this would seem to be a bit of an over-reaction with **President Lagarde stating during the same press conference that the consensus in the Governing Council was that it was premature to discuss rate cuts.** She also noted that the ECB needs to see further progress in the disinflation process to be confident that it will meet its inflation target on a sustained and timely basis. **Overall, the market is envisaging rates being reduced by around 140bps this year.** The market sees the deposit rate in and around 2.5% by the end of the year and being lowered to near 2.00% by end 2025.

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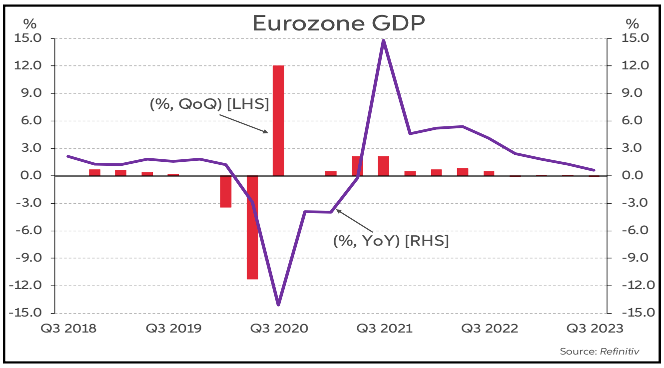
Eurozone economic outlook remains muted but uncertain

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 2023. However, growth fell by 0.1% again in Q3 2023. Among the large national economies, France and Italy have registered modest growth of 0.8% in the first three quarters of 2023. However, the German economy has struggled as of late. The first reading of full year GDP showed it contracted by 0.3% in 2023, owing to falls in consumption, government expenditure and investment.

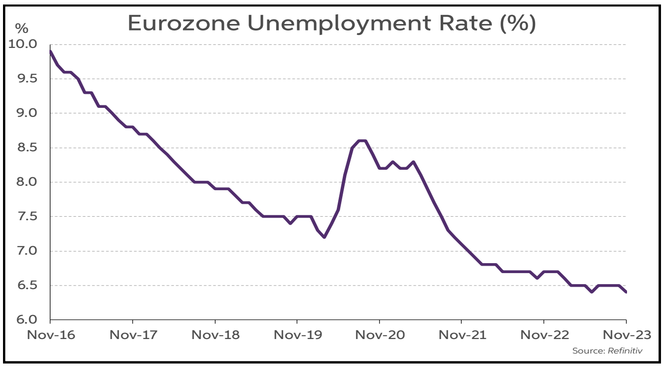
Survey data suggest the Eurozone economy continued to flirt with a technical recession in Q4. The manufacturing PMI has been in contraction territory for 19 straight months. Although it has edged higher recently, it averaged just 43.9 in Q4, broadly in-line with its Q3 average of 43.2, signifying a continued sharp pace of contraction in the sector. Meantime, the services PMI has also printed below the key 50 level for the past six months. Furthermore, it averaged just 48.4 in Q4, down from 49.2 in Q3. However, the EC Economic Sentiment Index inched higher throughout Q4, albeit off a low base. It stood at 93.6 in September, its lowest level since November 2020, before rising to 96.4 at year end.



Meanwhile, the available hard data for the fourth quarter were subdued also. Retail sales rose by 0.3% in October, before falling by the same amount in November. In year-on-year terms, retail sales were 1.1% lower in November. Meantime, industrial production declined by 0.3% in November, after contracting by 0.7% in October, and by 0.9% in September. Annually, industrial output was 7% lower in November. Monetary aggregates continued to weaken in November, with M3 money supply falling by 0.9% and credit growth to households slowing for a fifteenth consecutive month, to just 0.5% y/y, its lowest rate since May 2015.

The very limited data available for January, indicate the Eurozone economy remained on a weak footing at the start of 2024. Consumer confidence deteriorated for the first time since October, falling to –16.1 in January. However, there are very tentative signs that the economy may be bottoming out. Although both the manufacturing and services PMIs stayed in contraction mode in January, the former rose to 46.6, its highest level since March 2023. The EU Sentix also improved for a third consecutive month in January.

In terms of the labour market, conditions remain tight. After printing in a 6.5%-6.6% range since February, the unemployment rate registered a new all-time low of 6.4% in November. Meanwhile, employment rose by 0.2% in Q3 and was up 1.3% y/y. **Tight conditions are contributing to higher wages.** Hourly wages increased by 5.3% y/y in Q3. The ECB is clearly concerned about rising earnings growth, with President Lagarde making specific reference to ongoing wage negotiations across the bloc at today's press conference.



Regarding inflation, the headline rate has fallen sharply from its peak of 10.6% last October. It declined to just 2.4% in November, its lowest level since July 2021, before rising to 2.9% in December. Encouragingly, core inflation has remained on a clear downward trend in recent months. The ex-food and energy rate dropped to 3.9% in December. 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, fell to 3.4% in December. **The current ECB staff projections are for headline inflation to average 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 on-going uncertainty stemming from the War in Ukraine, high inflation and rising rates, as well as weaker global growth. There are signs the Eurozone may have entered a shallow recession in Q4 2023. The German economy, the largest in the Eurozone, has performed particularly poorly. However, it is worth noting that the Eurozone labour market remains strong, and there has been a marked fall in inflation since autumn 2022. Regardless, the most recent forecasts for the Eurozone economy have been scaled back. **The IMF is forecasting Eurozone GDP growth of 1.2% in 2024, while the ECB is projecting the economy will expand by 0.8% this year.** However, given the weak trends in the recent data, the risks are tilted to the downside of these projections.

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