Central Banks

A hawkish cut

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- **The ECB cut key interest rates by 25bp, as universally expected, but gave no clues about the path of further rate reductions**
- **Growth and inflation forecasts have been revised upwards, reflecting recent data surprises. This makes today's move a "hawkish cut"; but the medium term outlook remains broadly unchanged**
- **The ECB remains on a "data dependent" mood. We expect two further cuts this year**

As widely anticipated, the ECB decided to cut its key interest rates by 0.25 percentage points, in line with our forecast and the previous ECB forward guidance. This decision, which was **nearly unanimous**, with only one member voting against it, marks the first interest rate cut since 2019, therefore moving the interest rate on the main refinancing operations to 4.25%, the marginal lending facility to 4.50% and the deposit facility to 3.75%.

With the focus on whether this rate cut marks the beginning of a continued cycle of monetary easing and what specific commitment path the Governing Council will take, Mrs. Lagarde emphasized that **future decisions will be data-dependent on a meeting-by-meeting basis**. Hence, she denied the possibility of any pre-commitment path of interest rates, making it clear that **this cut does not necessarily signal the beginning of an easing cycle**. She put the focus on the level and dynamics of inflation and the transmission of monetary policy, which will be the key factors to decide further rate cuts. Beyond the no pre-commitment to any particular rates path, Lagarde assured that **the monetary policy stance "will continue to be restrictive as long as necessary"**. Hence, the tone of Lagarde's wording together with the upward revision of inflation and GDP signal that this decision can be interpreted as a **"hawkish cut"**, causing a soft market reaction, with European sovereign yields increasing and the euro appreciating.

Beyond future interest decisions, the other relevant aspect of this meeting was the **rationale behind this reduction**, despite recent data showing stronger-than-expected growth, inflation and wages, which surprised to the upside in the last released data to 4.69% (negotiated wages) on an annual basis. To justify the rate cut today despite stronger data, Mrs. Lagarde highlighted that **inflation has been on a clear downward trend** since the ECB began raising rates in mid-2022. She noted that the ECB has managed to reduce inflation from two-digit rates to 2.6%. **On wages, she acknowledged the slight upward surprises but attributed these to specific one-off situations** in certain countries, such as Germany. She also noted that interest rates still remain at a restrictive level and above the neutral rate, justifying that **the new rate levels are still high enough to return inflation levels to the target**.

These upside surprises in wage growth and their translation into more persistent than expected services inflation rates in the first quarter have led **upward revisions of the ECB staff inflation projections by 0.2pp in both 2024 and 2025, to 2.5% and 2.2%**, respectively. Similarly, the core rate is revised up 0.2pp to 2.8% in 2024 and 0.1% to 2.2% in 2025. Also, the staff takes into account recent geopolitical tensions and **revises upward both oil and natural gas prices** over the projection horizon. Despite these upward revisions, **the ECB's target of around 2% will still be achieved by mid-2025**, but with some volatility along the way. This is because the components outside of services and energy remain on a clear path of deceleration.

On activity, the projections were revised upwards mainly by the incoming first-quarter data, especially thanks to a better export performance. **The ECB therefore revises its growth forecasts by 0.3pp to 0.9% in 2024 and cuts by 0.1pp to 1.4% in 2025**. **The main driver of growth remains a recovery in real household incomes** that will encourage households to spend more in the face of lower inflation and high wage growth rates. The household savings rate will remain high due to remaining economic uncertainty and high interest rates, but will normalize in the medium term at the same time that real income growth moderates. The rest of the components will not be as decisive in this economic recovery, although the improvement in external demand will benefit investments to some extent in 2024, together with the support of the Next Generation EU funds.

Overall, **no major news has come out today as the rate cut was universally expected and the ECB does not want to pre-commit to the path of future cuts**. We still expect two further cuts this year, in September and December, if there are no major surprises in the outlook for inflation during the rest of the year.

PLEASE NOTE: **TRACKING CHANGES IN FOLLOWING STATEMENTS**

in black, wording common to both the current and previous statements, in light grey and crossed, previous wording that was replaced by new wording, in blue and underlined (YES, TRACK CHANGES ARE THERE ON PURPOSE).

1.1. Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB

Frankfurt am Main, ~~11 April~~6 June 2024

Good afternoon, the Vice-President and I welcome you to our press conference.

The Governing Council today decided to ~~keep the three key ECB interest rates unchanged. The incoming information has broadly confirmed our previous assessment of the medium-term inflation outlook. Inflation has continued to fall, led by lower food and goods price inflation. Most measures of underlying inflation are easing, wage growth is gradually moderating, and firms are absorbing part of the rise in labour costs in their profits. Financing conditions remain restrictive and our past interest rate increases continue to weigh on demand, which is helping to push down inflation. But domestic price pressures are strong and are keeping services price inflation high~~lower the three key ECB interest rates by 25 basis points. Based on~~.~~

~~We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. We consider that the key ECB interest rates are at levels that are making a substantial contribution to the ongoing disinflation process. Our future decisions will ensure that our policy rates will stay sufficiently restrictive for as long as necessary. If~~ our updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, it is now appropriate to moderate the degree of monetary policy restriction after nine months of holding rates steady. Since our meeting in September 2023, inflation has fallen by more than 2.5 percentage points and the inflation outlook has improved markedly. Underlying inflation has also eased, reinforcing the signs that price pressures have weakened, and inflation expectations have declined at all horizons. Monetary policy has kept financing conditions restrictive. By dampening demand and keeping inflation expectations well anchored, this has made a major contribution to bringing inflation back down.

At the same time, despite the progress over recent quarters, domestic price pressures remain strong as wage growth is elevated, and inflation is likely to stay above target well into next year. The latest Eurosystem staff projections for both headline and core inflation have been revised up for 2024 and 2025 compared with the March projections. Staff now see headline inflation averaging 2.5 per cent in 2024, 2.2 per cent in 2025 and 1.9 per cent in 2026. For inflation excluding energy and food, staff project an average of 2.8 per cent in 2024, 2.2 per cent in 2025 and 2.0 per cent in 2026. Economic growth is expected to pick up to 0.9 per cent in 2024, 1.4 per cent in 2025 and 1.6 per cent in 2026.

We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. ~~were to further increase our confidence that inflation is converging to our target in a sustained manner, it would be appropriate to reduce the current level of monetary policy restriction. In any event, we~~We will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim. We will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction~~, and we~~. In particular, our interest rate decisions will be based on our assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. We are not pre-committing to a particular rate path.

The Governing Council today also confirmed that it will reduce the Eurosystem's holdings of securities under the pandemic emergency purchase programme (PEPP) by €7.5 billion per month on average over the second half of the year. The modalities for reducing the PEPP holdings will be broadly in line with those followed under the asset purchase programme (APP).

The decisions taken today are set out in a ~~press release~~press release available on our website.
I will now outline in more detail how we see the economy and inflation developing and will then explain our assessment of financial and monetary conditions.

1.2. Economic activity

~~The~~ After five quarters of stagnation, the euro area economy ~~remained weak in~~grew by 0.3 per cent over the first quarter~~. While spending on~~ of 2024. The services sector is ~~resilient,~~expanding, and manufacturing ~~firms are facing weak demand and production~~ is ~~still subdued, especially in energy-intensive sectors. Surveys point to a gradual recovery over the course of this year, led by services. This recovery is expected to be supported by rising real incomes, resulting from lower inflation, increased~~showing signs of stabilisation at low levels. We expect the economy to continue to recover as higher wages and improved terms of trade~~. In addition, the growth of euro area~~ push up real incomes. Stronger exports should ~~pick up~~ also support growth over the coming quarters, as ~~the~~ global ~~economy recovers~~demand for goods and ~~spending shifts further towards tradables.~~services rises. Finally, monetary policy should exert less of a drag on demand over time.

Employment rose by 0.3 per cent in the first quarter of this year, with around 500,000 new jobs created, and surveys point to continued job growth in the near term. The unemployment rate ~~is at~~edged down to 6.4 per cent in April, its lowest level since the start of the euro. ~~At the same time, the tightness in the labour market continues to gradually decline, with employers~~ Companies are still posting ~~fewer~~many job vacancies, though slightly fewer than before.

~~Governments should continue to roll back energy-related support measures so that disinflation can proceed sustainably.~~ National fiscal and structural policies should aim at making the economy more productive and competitive, which would help to raise potential growth and reduce price pressures in the medium term. An effective, speedy and full implementation of the Next Generation EU programme, progress towards capital markets union and the completion of banking union, and a strengthening of the Single Market would help foster innovation and increase investment in the green and digital transitions. Implementing the EU's revised economic governance framework fully and without delay will help governments bring down budget deficits and debt ratios on a sustained basis.~~ National fiscal and structural policies should be aimed at making the economy more productive and competitive, which would help to reduce price pressures in the medium term. At the European level, an effective and speedy implementation of the Next Generation EU programme and a strengthening of the Single Market would help foster innovation and increase investment in the green and digital transitions. More determined and concrete efforts to complete the banking union and the capital markets union would help mobilise the massive private investment necessary to achieve this, as the Governing Council stressed in its statement of 7 March 2024.~~

1.3. Inflation

~~Inflation has continued to decline, from an annual rate of ~~Annual inflation rose to 2.6 per cent in ~~February to~~May, from 2.4 per cent in ~~March~~April, according to Eurostat's flash estimate. Food price inflation ~~dropped~~declined to 2.~~7~~6 per cent~~ in March, from 3.9 per cent in February, while energy~~. Energy price inflation ~~stood at -1.8~~increased to 0.3 per cent~~ in March~~, after ~~-3.7 per cent in the previous month.~~recording negative annual rates for a year. Goods price inflation ~~fell again~~continued to decrease in ~~March~~May, to ~~1.1~~0.8 per cent~~, from 1.6 per cent in February. However~~. By contrast, services price inflation ~~remained high in March, at ~~rose markedly, to 4.~~0~~1 per cent from 3.7 per cent in April.

Most measures of underlying inflation ~~fell~~declined further in ~~February~~April, the last month for which data are available, confirming the picture of gradually diminishing price pressures.~~ While~~ However, domestic inflation remains high~~, wages and unit profits grew less strongly than anticipated in the last quarter of 2023, but unit~~. Wages are still rising at an elevated pace, making up for the past inflation surge. Owing to the staggered nature of the wage adjustment process and the important role of one-off payments, labour costs ~~remained high, in part reflecting weak productivity growth. More recent~~will likely fluctuate over the near term, as seen in the pick-up in negotiated wages in the first quarter. At the same time, forward-looking indicators ~~point to further moderation in wage growth~~signal that wage growth will moderate over the course of the year. Profits are absorbing part of the pronounced rise in unit labour costs, which reduces its inflationary effects.

Inflation is expected to fluctuate around current levels ~~in the coming months and to ~~for the rest of the year, including due to energy-related base effects. It is then expected to decline ~~to~~towards our target over the second half of next year, owing to weaker growth in labour costs, the unfolding effects of our restrictive monetary policy, and the fading impact of the energy crisis and the pandemic. Measures of longer-term inflation expectations ~~remain~~have remained broadly stable, with most standing at around 2 per cent.

1.4. Risk assessment

The risks to economic growth are balanced in the near term but remain tilted to the downside~~. Growth could be lower if the effects of monetary policy turn out stronger than expected.~~ over the medium term. A weaker world economy or ~~a further slowdown in global~~an escalation in trade tensions between major economies would~~ also~~ weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East are major sources of geopolitical risk. This may result in firms and households becoming less confident about the future and global trade being disrupted. Growth could also be lower if the effects of monetary policy turn out stronger than expected. Growth could be higher if inflation comes down more quickly than expected and rising confidence and real incomes mean that spending increases by more than anticipated, or if the world economy grows more strongly than expected.

Inflation could turn out higher than anticipated if wages or profits increase by more than expected. Upside risks to inflation ~~include~~also stem from the heightened geopolitical tensions, ~~especially in the Middle East,~~ which could push energy prices and freight costs higher in the near term and disrupt global trade. ~~Inflation could also turn out higher than anticipated if wages increase by more than expected or profit margins prove~~ Moreover, extreme weather events, and the unfolding climate crisis more ~~resilient~~broadly, could drive up food prices. By contrast, inflation may surprise on the downside if monetary policy dampens demand more than expected, or if the economic environment in the rest of the world worsens unexpectedly.

1.5. Financial and monetary conditions

Market interest rates have ~~been broadly stable~~risen since our ~~March~~April meeting ~~and wider financing conditions remain~~ . Financing costs have plateaued at restrictive~~.~~ levels as our past policy rate increases have worked their way through the financial system. The average interest ~~rate~~rates on ~~business~~new loans ~~edged down~~ to ~~5.1 per cent in February, from 5.2 per cent in January. Mortgage rates were 3.8 per cent in February, down from 3.9 per cent in January.~~

~~Still elevated borrowing rates and associated cutbacks in investment plans led~~ firms ~~to further reduce their demand for loans in the first quarter of 2024, as reported in our latest bank lending survey. Credit standards for loans remained tight, with a further slight tightening for lending to firms and a moderate easing for~~and on new mortgages were unchanged in April, at 5.2 per cent and 3.8 per cent respectively.

~~Against this background, credit~~ Credit dynamics remain weak. Bank lending to firms grew ~~marginally faster in February, at~~ at an annual rate of 0.~~4 per cent, up from 0.2~~3 per cent in ~~January. Growth in loans~~April, down slightly from the previous month. Loans to households ~~remained unchanged in February,~~continued to grow at 0.~~3~~2 per cent on an annual basis. ~~Broad~~The annual growth in broad money – as measured by M3 – ~~grew at a subdued rate~~rose to 1.3 per cent in April, from 0.9 per cent in March.

In line with our monetary policy strategy, the Governing Council thoroughly assessed the links between monetary policy and financial stability. Euro area banks remain resilient. The improving economic outlook has fostered financial stability, but heightened geopolitical risks cloud the horizon. An unexpected tightening of global financing conditions could prompt a repricing of ~~0.4 per cent in February~~financial and non-financial assets, with negative effects on the wider economy. Macroprudential policy remains the first line of defence against the build-up of financial vulnerabilities. The measures that are currently in place or will soon take effect are helping to keep the financial system resilient.

1.6. Conclusion

The Governing Council today decided to ~~keep~~lower the three key ECB interest rates ~~unchanged~~by 25 basis points. We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. ~~We consider that the key ECB interest rates are at levels that are making a substantial contribution to the ongoing disinflation process. Our future decisions will ensure that our policy rates will stay sufficiently restrictive for as long as necessary. If our updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission were to further increase our confidence that inflation is converging to our target in a sustained manner, it would be appropriate to reduce the current level of monetary policy restriction. In any event, we~~We will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim. We will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction~~, and we~~. In particular, our interest rate decisions will be based on our assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. We are not pre-committing to a particular rate path.

In any case, we stand ready to adjust all of our instruments within our mandate to ensure that inflation returns to our medium-term target and to preserve the smooth functioning of monetary policy transmission.

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