Central Banks

The decision for a September rate cut is wide open

Carlos Castellano / Maria Martinez

July 18 2024

- **The ECB keeps rates steady, as broadly expected**
- **The guidance on rates remains unchanged, with the ECB not pre-committing to a particular path**
- **The ECB seems to be more worried on growth dynamics and reiterates the one-off nature of the recovery in real wages as a driver for the stickiness of service prices**

Today's ECB policy adhered to broader expectations of maintaining the status quo on policy rates. **After the June rate cut, the ECB's decision today to leave the three key interest rates unchanged came as no surprise, in line with our expectations**. The interest rate on the main refinancing operations and on the marginal lending and the deposit facilities will remain unchanged at 4.25%, 4.50%, and 3.75%, respectively. **The agreement reached by the policymakers on the rate decision was unanimous**. In this regard, Mrs. Lagarde stressed that what **was equally unanimously determined was the commitment to be data-dependent, deciding on a meeting-by-meeting basis without any predetermined rate path. This follows closely the previous meeting guidance.**

Regarding the question of what they will do in September (whether they will cut rates or not), Lagarde emphasized that the **next monetary policy meeting will be "wide open," as they are expected to have significantly more information during the summer** to decide whether another rate cut is warranted. Lagarde made clear that this data-dependency refers to a whole set of indicators, not just single ones (to avoid perhaps the excessive attention given to releases of wages data in the second quarter), with particular attention to **three crucial elements underpinning their inflation outlook**: wage growth, corporate profit margins, and productivity.

Regarding the first of these three elements, **wage growth**, the ECB has been relatively confident that the evolution is **in line with its projections**, and that the recent staggered path is the **result of the recovery of real wages** in a context of collective bargaining and, therefore, one-offs. This is key because services' (the most wage sensitive component) are the ones that have ticked up in the most recent data, in contrast to most of the other components, that were stable or edged down. Also in line with its forecasts, the fall in corporate profits in the first quarter is a sign for the ECB that **part of these catch-ups of real wages have been buffered by companies**. The ECB's projections are also backed by recent surveys that indicate that profits will continue to be dampened in the near term and that, although wage growth is expected to remain high this year, in the next two years there would be a significant slowdown, compatible with reaching the 2% inflation target in the second half of 2025.

On the third element, productivity, the ECB sees a slight improvement in the latest data but they expect a further advance, given the expected demand pick-up. However, there has been a certain change to a **slight dovish undertone regarding activity**. The ECB is aware that the recovery continues, but less strong than expected, which is reinforced by Ms. Lagarde's comment that growth in the second quarter was probably slower than the first quarter. Now the ECB considers that the **risks are to the downside**, while in the last meeting it only mentioned downside risks in the medium term, with special focus on a weak manufacturing sector and a demand for credit by firms that remain muted.

Today's ECB meeting did not offer much new information, as widely expected, and no interest rate change was decided. The main interest lay in discerning the tone of the ECB's statements regarding the timing of the next rate cut. **The upcoming meeting in September is poised to be pivotal,** with policymakers awaiting more comprehensive data to guide their decision-making process. **This meeting further supports our expectation of two rate cuts of 25bps each in September and December, until the end of the year, with a risk that there may be only one**. In this regard, financial markets reacted mildly to the ECB statement and press conference; sovereign yields declined slightly, while expectations for a 25bp interest rate cut at the September meeting remained high (80%), despite Lagarde stating that the September decision is widely open.

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, ~~6 June~~18 July 2024

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

The Governing Council today decided to ~~lower~~keep the three key ECB interest rates ~~by 25 basis points. Based on~~unchanged. The incoming information broadly supports our ~~updated~~previous assessment of the medium-term inflation outlook~~, the dynamics~~. While some measures of underlying inflation ~~and the strength~~ticked up in May owing to one-off factors, most measures were either stable or edged down in June. In line with expectations, the inflationary impact 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~~ high wage growth 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.~~been buffered by profits. Monetary policy ~~has kept~~is keeping 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~~ are still high, services inflation is elevated~~,~~ and headline inflation is likely to ~~stay~~remain above our 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. 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. 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

~~After five quarters of stagnation,~~The incoming information indicates that the euro area economy grew ~~by 0.3 per cent over~~in the ~~first~~second quarter~~ of 2024. The services sector is expanding,~~, but likely at a slower pace than in the first quarter. Services continue to lead the recovery, while industrial production and ~~manufacturing is showing signs of stabilisation at low levels. We~~goods exports have been weak. Investment indicators point to muted growth in 2024, amid heightened uncertainty. Looking ahead, we expect the ~~economy to continue to recover as higher wages and improved terms of trade push up~~ recovery to be supported by consumption, driven by the strengthening of real incomes~~. Stronger~~ resulting from lower inflation and higher nominal wages. Moreover, exports should ~~also support growth over the coming quarters, as~~pick up alongside a rise in global demand~~ for goods and 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 labour market remains resilient. The unemployment rate ~~edged down to~~ was unchanged, at 6.4 per cent in ~~April,~~May, remaining at its lowest level since the start of the euro. ~~Companies are still posting many job vacancies, though slightly fewer than before.~~Employment, which grew by 0.3 per cent in the first quarter, was supported by a further increase in the labour force, which expanded at the same rate. More jobs are likely to have been created in the second quarter, mainly in the services sector. Firms are gradually reducing their job postings, but from high levels.

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 are key factors that would help foster innovation and increase investment in the green and digital transitions. We welcome the European Commission's recent guidance calling for EU Member States to strengthen fiscal sustainability and the Eurogroup's statement on the fiscal stance for the euro area in 2025. 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.

1.3. Inflation

Annual inflation ~~rose~~eased to 2.5 per cent in June, from 2.6 per cent in May~~, from 2.~~. Food prices went up by 2.4 per cent in ~~April, according to Eurostat's flash estimate. Food~~ June – which is 0.2 percentage points less than in May – while energy prices remained essentially flat. Both goods price inflation ~~declined to 2.6 per cent. Energy price inflation increased to 0.3 per cent, after recording negative annual rates for a year. Goods price inflation continued to decrease in May, to 0.8 per cent. By contrast,~~ and services price inflation ~~rose markedly, to~~were unchanged in June, at 0.7% and 4.1~~ per cent from 3.7 per cent in April.~~

~~Most~~% respectively. While some measures of underlying inflation ~~declined further in April, the last month for which data are available, confirming the picture of gradually diminishing price pressures. However, domestic~~ticked up in May owing to one-off factors, most measures were either stable or edged down in June.

Domestic inflation remains high. Wages are still rising at an elevated ~~pace~~rate, making up for the past ~~inflation surge.~~ period of high inflation. Higher nominal wages, alongside weak productivity, have added to unit labour cost growth, although it decelerated somewhat in the first quarter of this year. Owing to the staggered nature of ~~the~~ wage ~~adjustment process~~adjustments and the ~~important role~~large contribution of one-off payments, growth in labour costs will likely ~~fluctuate~~remain elevated over the near term~~, as seen in the pick-up in negotiated wages in the first quarter.~~. At the same time, ~~forward-looking~~recent data on compensation per employee have been in line with expectations and the latest survey indicators signal that wage growth will moderate over the course of ~~the~~next year. ~~Profits are absorbing part of the pronounced rise in unit labour costs, which reduces its~~ Moreover, profits contracted in the first quarter, helping to offset the inflationary effects of higher unit labour costs, and survey evidence suggests that profits should continue to be dampened in the near term.

Inflation is expected to fluctuate around current levels for the rest of the year, ~~including due~~partly owing to energy-related base effects. It is then expected to decline 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~~past inflation surge. Measures of longer-term inflation expectations 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 ~~over the medium term~~. A weaker world economy or an escalation in trade tensions between major economies would 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 also stem from the heightened geopolitical tensions, which could push energy prices and freight costs higher in the near term and disrupt global trade. Moreover, extreme weather events, and the unfolding climate crisis more 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~~The policy rate cut in June has been transmitted smoothly to money market interest rates~~.~~, while broader financial conditions have ~~risen since our April meeting.~~been somewhat volatile. Financing costs ~~have plateaued at~~ remain restrictive ~~levels~~ as our ~~past~~previous policy rate increases ~~have worked~~continue to work their way through the ~~financial system.~~transmission chain. The average interest ~~rates~~rate on new loans to firms ~~and on new mortgages were~~edged down to 5.1 per cent in May, while mortgage rates remained unchanged ~~in April, at 5.2 per cent and~~ at 3.8 per cent ~~respectively~~.

~~Credit~~ Credit standards for loans remain tight. According to our latest bank lending survey, standards for lending to firms tightened slightly in the second quarter, while standards for mortgages eased moderately. Firms' demand for loans fell slightly, while households' demand for mortgages rose for the first time since early 2022.

Overall, credit dynamics remain weak. Bank lending to firms and households grew at an annual rate of 0.3 per cent in ~~April, down slightly~~ May, only marginally up from the previous month. ~~Loans to households continued to grow at 0.2 per cent on an annual basis.~~ The annual growth in broad money – as measured by M3 – rose to 1.6 per cent in May, from 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 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 ~~lower~~keep the three key ECB interest rates ~~by 25 basis points~~unchanged. We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. 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. 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

DISCLAIMER

The present document does not constitute an “Investment Recommendation”, as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (“MAR”). In particular, this document does not constitute “Investment Research” nor “Marketing Material”, for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA on its website www.bbvaresearch.com.

ENQUIRIES TO:
BBVA Research: Azul Street, 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain).
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 25
www.bbvaresearch.com