

ECB raises rates again, leaves options open about further hike

As had been well signalled, the July meeting of the ECB's Governing Council saw the central bank raise rates by a further 25bps, pushing the key deposit rate up to 3.75%. It brings the total amount of rate tightening in this cycle, which began last July, to 425bps. It was the third meeting in a row that rates were hiked by 25bps. This followed the 50bps hikes implemented in March, February and December and two 75bps rate rises seen last autumn. The smaller hikes suggest that the ECB is moving closer to its desired terminal rate level.

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 stagnating since last autumn and headline inflation moving markedly lower to date in 2023. Core inflation, though, is proving very sticky, especially in the services sector, meaning that further policy tightening was warranted today. Indeed, in explaining the basis for the 25bps hike, the ECB noted that while inflation is set to fall further over the remainder of the year, it will stay above target for an extended period and underlying inflation remains high overall.

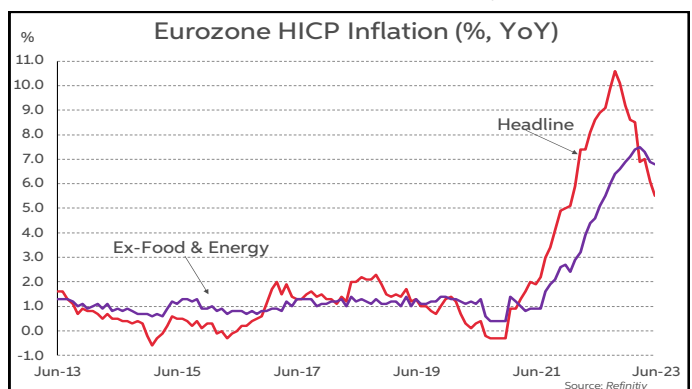
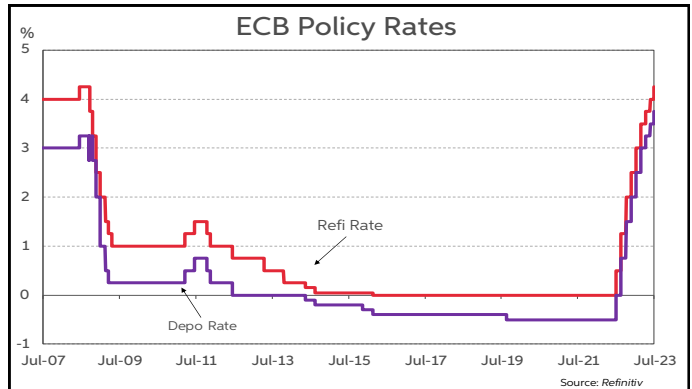
Unlike at recent meetings, **the ECB did not signal today that a further rate hike is in store**. It was more circumspect in its language. President Lagarde did not reprise the previous ECB policy guidance that it was not done yet and had more ground to cover in tightening policy. **Instead, the ECB opened the door to putting policy on hold, while at the same time not ruling out that rates may have to go higher**. A key change in the meeting statement is that rates would be **set** at sufficiently restrictive levels to bring inflation back down to 2%. Previously, it had said rates would be **brought** to sufficiently restrictive levels to achieve this.

The ECB strongly emphasised today that it will follow a data-dependent approach in making future rate decisions, with considerable weight also given to its assessment of the inflation outlook. President Lagarde said the ECB is no longer in forward guidance mode and will put a heavy emphasis on incoming data in making rate decisions at upcoming meetings. **A rate hike over the balance of the year remains a possibility**. The next round of ECB staff quarterly macro forecasts, which will be presented at the September meeting, could also play a key role in deciding whether or not rates are to be hiked further.

In this regard, the ECB staff quarterly macro forecasts published in June show that it sees the headline HICP rate averaging 5.4% in 2023, 3.0% in 2024 and 2.2% in 2025. The core HICP rate, which excludes food and energy, is projected to average 5.1% for 2023, 3.0% in 2024 and 2.3% in 2025. In terms of GDP growth, it is forecast at 0.9% this year, picking up to 1.5% in 2024 and 1.6% in 2025. Recent weak data from the Eurozone point to downside risks to the already low 2023 GDP growth forecast of 0.9% and 2024 projection of 1.5%. Indeed, the ECB noted today that past rate increases are dampening demand.

The market is only partially pricing in one further 25bps rate hike later this year. Rate cuts of 75bps are then anticipated by markets during 2024, commencing in the second quarter, which would bring rates back down to 3.25%. A further reduction of 25-50bps in rates is priced for 2025. Given the continued 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 cut more slowly than is currently envisaged by markets**.

The meeting outcome was largely as expected. **Thus, there was little change in futures contracts** as they remain of the view that one more 25bps hike is a possibility, which would bring rates up to 4%. Bond markets were also little changed.



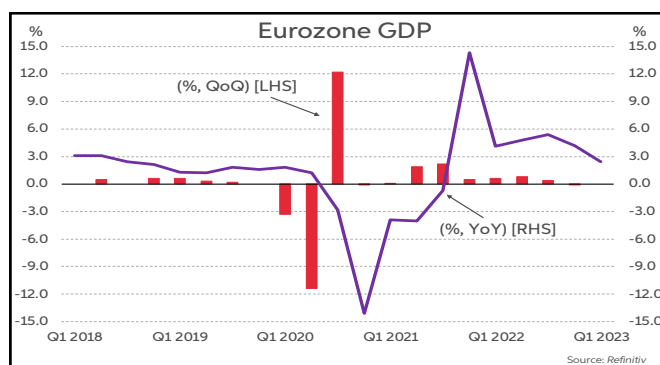
ECB Macroeconomic Forecasts for the Euro Area				
(%)	2022	2023	2024	2025
HICP	8.4	5.4	3.0	2.2
Real GDP	3.4	0.9	1.5	1.6

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

Eurozone economy narrowly avoids technical recession

Eurozone GDP stagnated in Q1 2023, having contracted by 0.1% in Q4, meaning the economy narrowly avoided 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 significant 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 German economy has lagged well behind the others, with GDP declining by 0.5% in Q4, and by 0.3% in Q1. In contrast, the French economy saw growth of 0.2%, and the Spanish and Italian economies, by 0.6% respectively, in Q1.

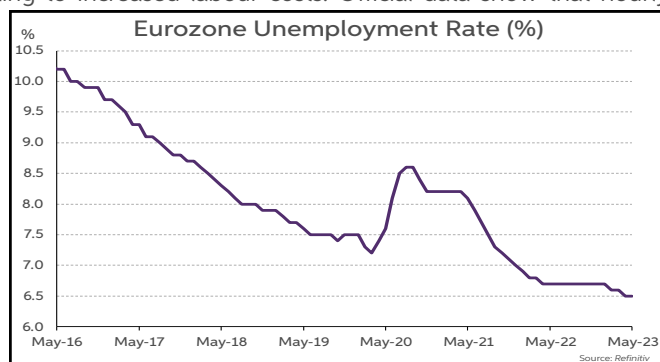


Meanwhile, the available hard data for Q2 point towards continued stagnation in activity levels, at best. Having contracted in both February and March, retail sales flat-lined in April and May. In year-on-year terms they were 2.9% lower in May. Elsewhere, industrial production rebounded by 1% in April, before increasing by 0.2% in May, but this needs to be viewed in the context of the very sharp 4.4% fall in output in March. Furthermore, survey data for Q2 have also been mixed. The manufacturing PMI has been in contraction territory for the past year, and deteriorated further in Q2, averaging just 44.7, compared to 48.2 in Q1. However, the services sector has continued to outperform, averaging 54.4 in Q2, up from 52.8 in Q1, consistent with an increase in the pace of expansion in activity. Meantime, both the services and industrial EC sentiment indices have deteriorated throughout Q2. In contrast, consumer confidence maintained its upward trend in the quarter, albeit from a very low level.

The limited data for July show that consumer confidence improved again at the start of Q3. The flash services PMI remained consistent with expansion in the month also, albeit, at 51.1, it was the slowest pace since January. Elsewhere, the manufacturing sector PMI declined once more, falling to 42.7, its lowest level since May 2020. Notably, German manufacturing is deep in the doldrums, with the sector PMI at a very weak level of 38.8 in July.

In terms of the labour market, conditions remain very tight. The unemployment rate fell to a new all-time low of 6.5% in April, and stayed at that level in May. At the same time, 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 data show that hourly wages and salaries increased by 4.6% y/y in Q1.

Regarding inflation, the headline rate has fallen sharply from its peak of 10.6% last October. It declined to 5.5% in June, down from 6.1% in May. This largely reflects the big increases in energy costs in spring 2022 dropping out of the annual rate. However, inflation has become more broad based, with services inflation rising from 4.4% in December, to 5.4% in June. Furthermore, the core rate that excludes energy, food, alcohol and tobacco, has been in a narrow 5.2-5.7% range since December, and stood at 5.5% in June. 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%, 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 during 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 is forecasting Eurozone growth of 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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