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Data Insights: ECB and Euro Area Economy Monitor

Thursday, December 14, 2023

Today's monetary policy decision: how the language changed from prior meeting

14 ~~September~~December 2023

~~Inflation continues to decline but is still expected to remain too high for too long.~~ The Governing Council today decided to keep the three key ECB interest rates unchanged. While inflation has dropped in recent months, it is likely to pick up again temporarily in the near term. According to the latest Eurosystem staff projections for the euro area, inflation is expected to decline gradually over the course of next year, before approaching the Governing Council's 2% target in 2025. Overall, staff expect headline inflation to average 5.4% in 2023, 2.7% in 2024, 2.1% in 2025 and 1.9% in 2026. Compared with the September staff projections, this amounts to a downward revision for 2023 and especially for 2024.

Underlying inflation has eased further. But domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs. Eurosystem staff expect inflation excluding energy and food to average 5.0% in 2023, 2.7% in 2024, 2.3% in 2025 and 2.1% in 2026.

The past interest rate increases continue to be transmitted forcefully to the economy. Tighter financing conditions are dampening demand, and this is helping to push down inflation. Eurosystem staff expect economic growth to remain subdued in the near term. Beyond that, the economy is expected to recover because of rising real incomes – as people benefit from falling inflation and growing wages – and improving foreign demand. Eurosystem staff therefore see growth picking up from an average of 0.6% for 2023 to 0.8% for 2024, and to 1.5% for both 2025 and 2026.

The Governing Council is determined to ensure that inflation returns to its 2% medium-term target in a timely manner. ~~In order to reinforce progress towards its target, the Governing Council today decided to raise the three key ECB interest rates by 25 basis points.~~

~~The rate increase today reflects the Governing Council's 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. The September ECB staff macroeconomic projections for the euro area see average inflation at 5.6% in 2023, 3.2% in 2024 and 2.1% in 2025. This is an upward revision for 2023 and 2024 and a downward revision for 2025. The upward revision for 2023 and 2024 mainly reflects a higher path for energy prices. Underlying price pressures remain high, even though most indicators have started to ease. ECB staff have slightly revised down the projected path for inflation excluding energy and food, to an average of 5.1% in 2023, 2.9% in 2024 and 2.2% in 2025. The Governing Council's past interest rate increases continue to be transmitted forcefully. Financing~~

~~conditions have tightened further and are increasingly dampening demand, which is an important factor in bringing inflation back to target. With the increasing impact of this tightening on domestic demand and the weakening international trade environment, ECB staff have lowered their economic growth projections significantly. They now expect the euro area economy to expand by 0.7% in 2023, 1.0% in 2024 and 1.5% in 2025.~~

Based on its current assessment, the Governing Council considers that the key ECB interest rates ~~have reached~~are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to ~~the timely return of inflation to the target.~~this goal. The Governing Council's future decisions will ensure that ~~the key ECB interest~~its policy rates will be set at sufficiently restrictive levels for as long as necessary.

The Governing Council will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, ~~the Governing Council's~~its interest rate decisions will be based on its 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.

The key ECB interest rates are the primary tool for setting the monetary policy stance. The Governing Council also decided today to advance the normalisation of the Eurosystem's balance sheet. It intends to continue to reinvest, in full, the principal payments from maturing securities purchased under the pandemic emergency purchase programme (PEPP) during the first half of 2024. Over the second half of the year, it intends to reduce the PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

Key ECB interest rates

~~The Governing Council decided to raise the three key ECB interest rates by 25 basis points. Accordingly, the~~The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will ~~be increased to~~remain unchanged at 4.50%, 4.75% and 4.00% respectively~~, with effect from 20 September 2023~~.

Asset purchase programme (APP) and pandemic emergency purchase programme (PEPP)

The APP portfolio is declining at a measured and predictable pace, as the Eurosystem no longer reinvests the principal payments from maturing securities.
~~As concerns the PEPP, the~~The Governing Council intends to continue to reinvest, in full, the principal payments from maturing securities purchased under the ~~programme until at least~~PEPP during the ~~end~~first half of 2024. ~~In any case,~~Over the ~~future roll-off~~second half of the year, it intends to reduce the PEPP portfolio ~~will be managed to avoid interference with the appropriate monetary policy stance.~~by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

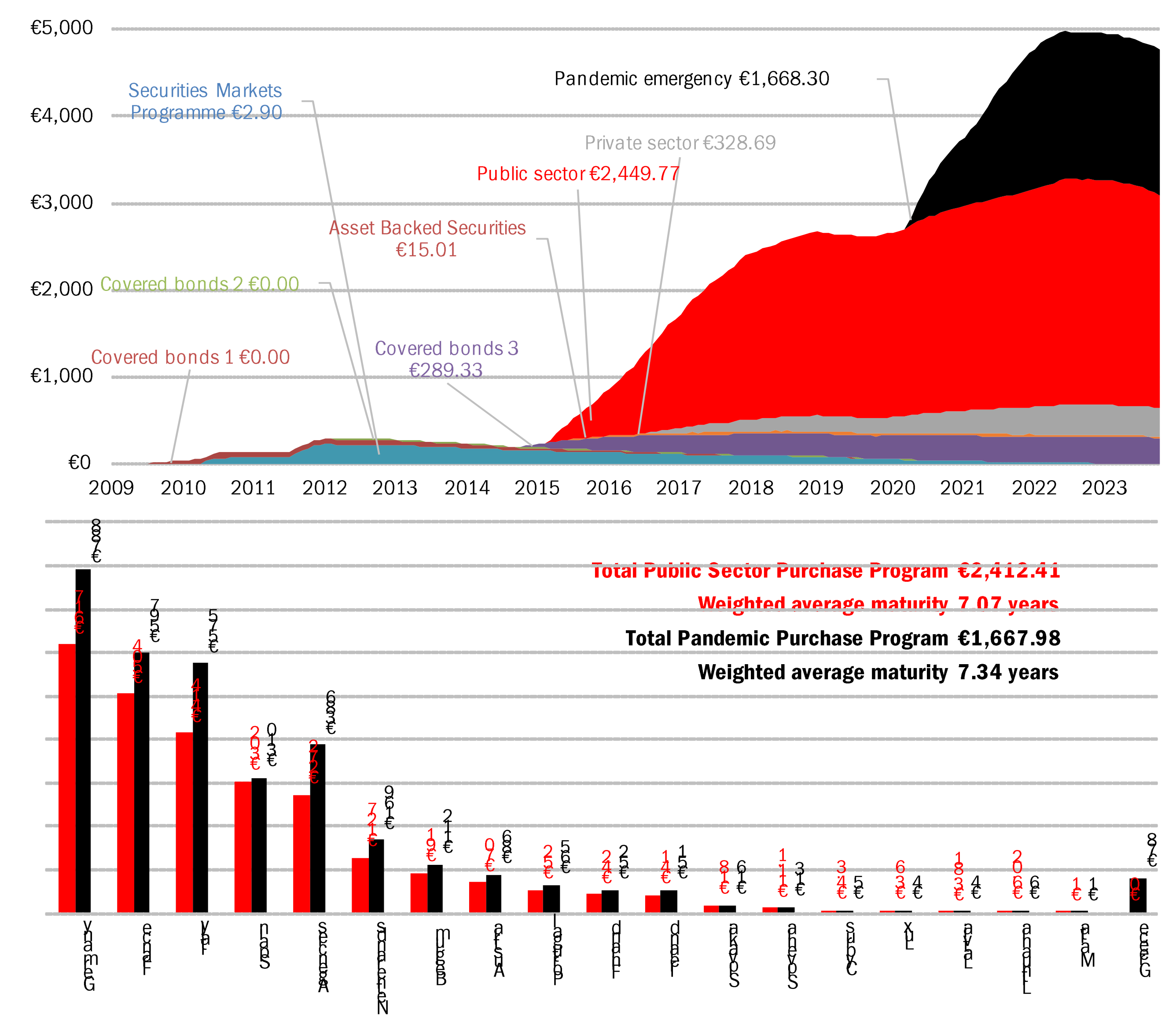
Refinancing operations

As banks are repaying the amounts borrowed under the targeted longer-term refinancing operations, the Governing Council will regularly assess how targeted lending operations and their ongoing repayment are contributing to its monetary policy stance.

The Governing Council stands ready to adjust all of its instruments within its mandate to ensure that inflation returns to its 2% target over the medium term and to preserve the smooth functioning of monetary policy transmission. Moreover, the Transmission Protection Instrument is available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across all euro area countries, thus allowing the Governing Council to more effectively deliver on its price stability mandate.

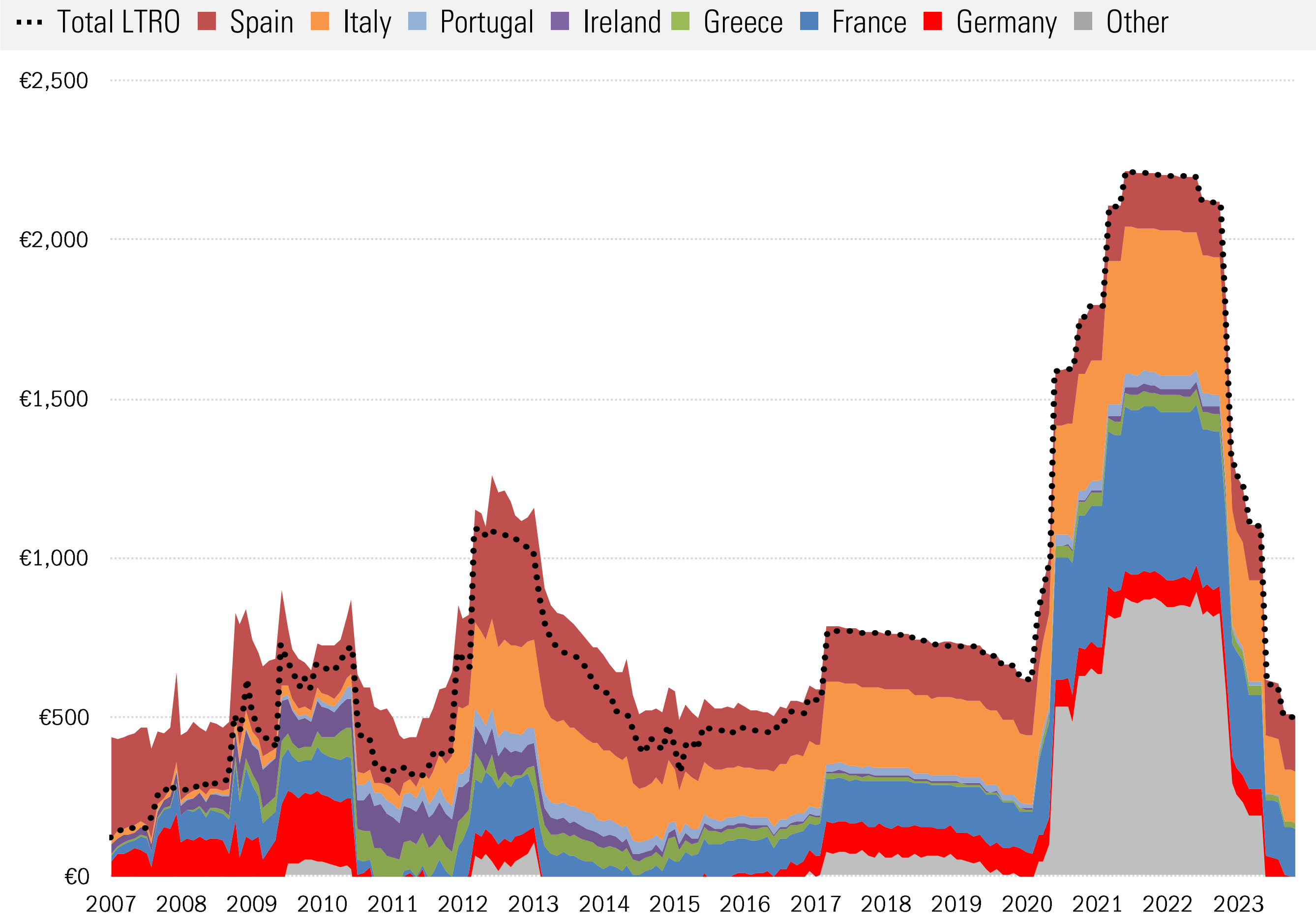
Source: FOMC, TrendMacro analysis

Euro-QE (€ billions)



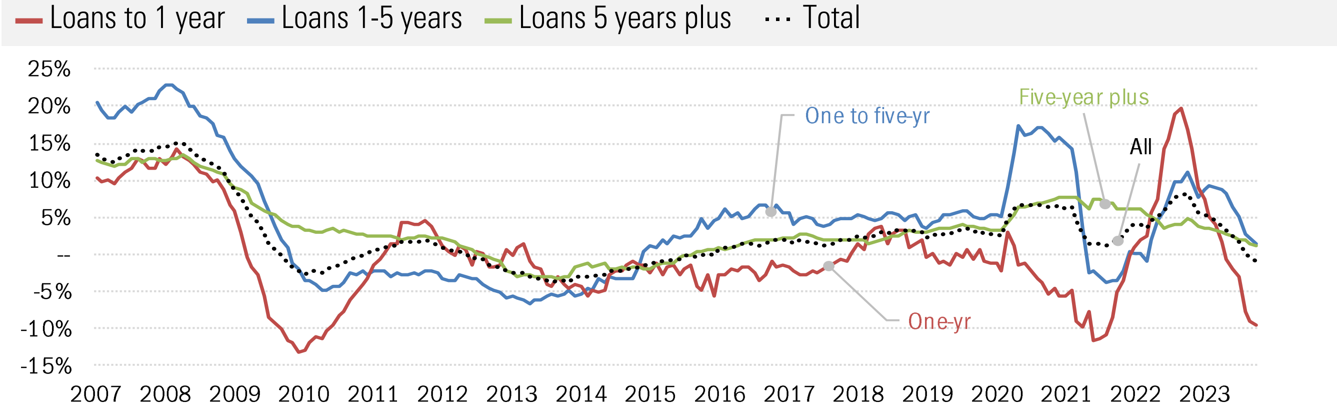
Source: ECB, TrendMacro calculations

Banking system dependency: borrowing from the ECB (€ billions)



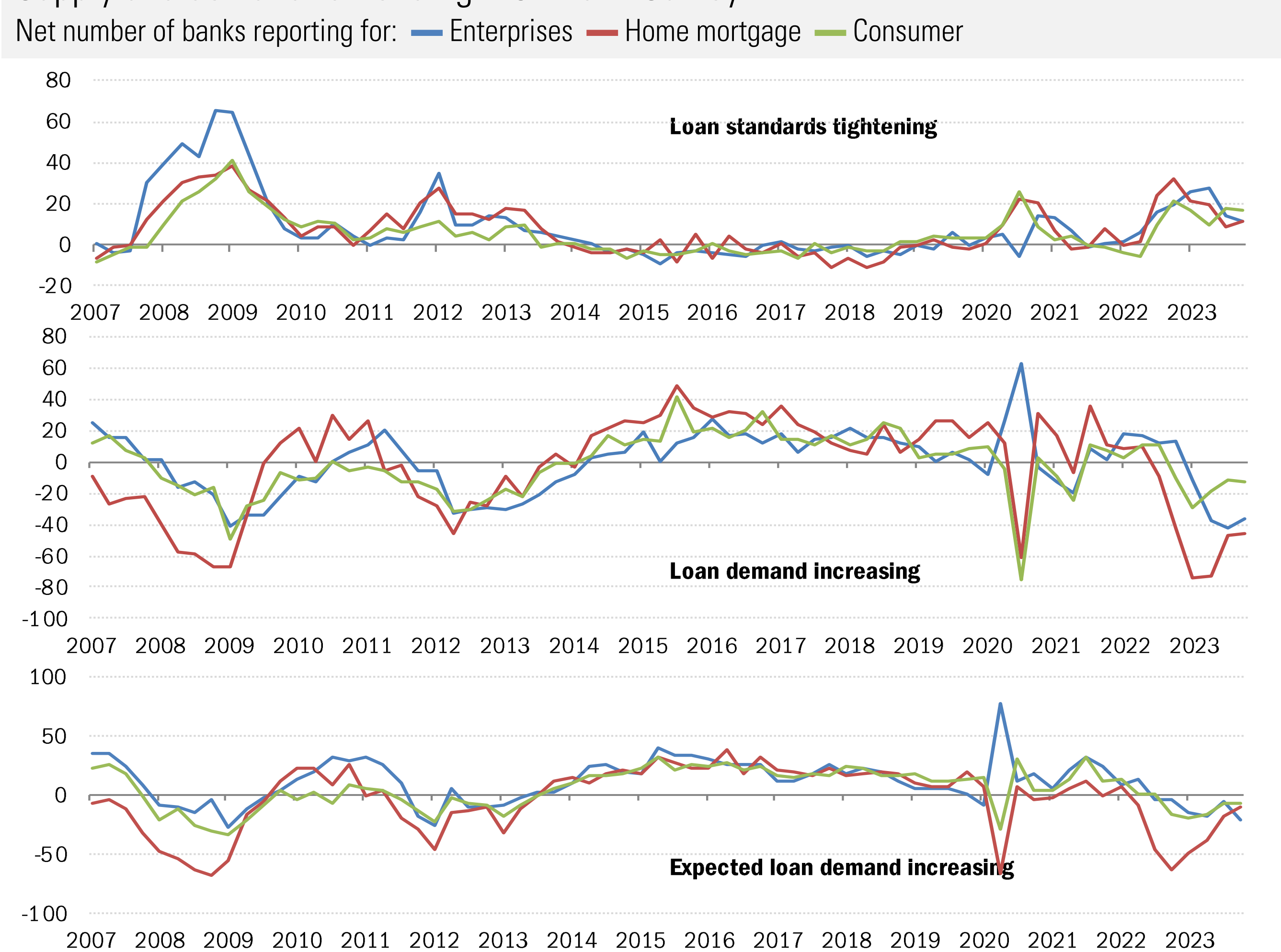
Source: ECB, National central banks, TrendMacro calculations

The credit drought: loans to non-financial businesses (YOY growth)



Source: ECB, TrendMacro calculations

Supply and demand for lending: ECB Bank Survey



Source: ECB, TrendMacro calculations

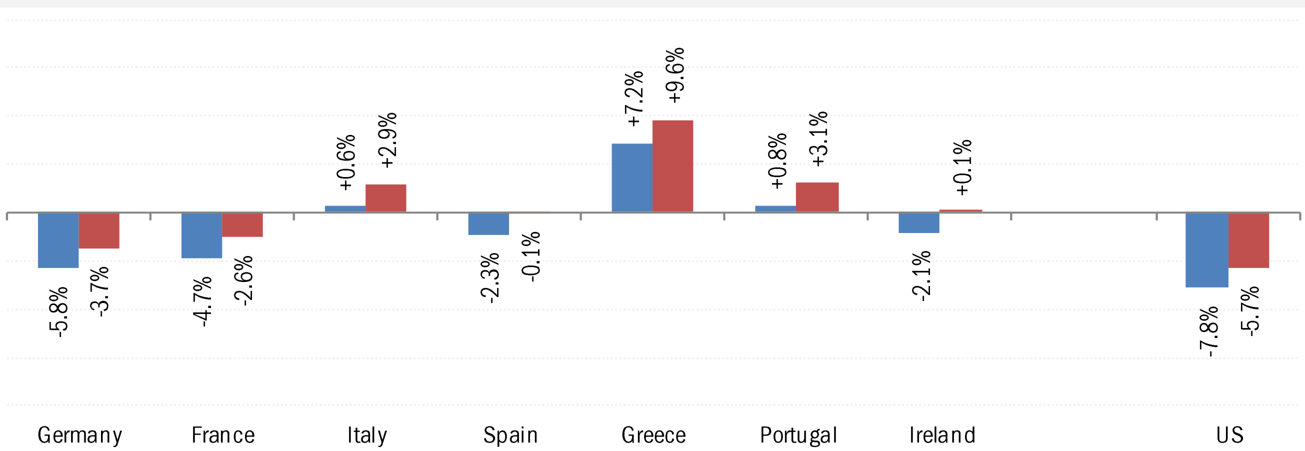
Sovereign stress monitor: 10-year bond spreads

· High · Low · Last

	2000 to present		Trailing 12m	
Germany				
Spread to US	High 0.74%	Dec '08	High -0.98%	Apr 24
Last -1.84%	Low -2.76%	Oct '18	Low -2.12%	Oct 31
France				
Spread to Germany	High 1.32%	Dec '11	High 0.65%	Oct 9
Last 0.54%	Low -0.01%	Jan '05	Low 0.42%	Jan 19
Italy				
Spread to Germany	High 5.28%	Dec '11	High 2.18%	Dec 19
Last 1.76%	Low 0.09%	Nov '04	Low 1.56%	Jun 16
Spain				
Spread to Germany	High 5.52%	Aug '12	High 1.15%	Oct 9
Last 1.00%	Low -0.05%	Nov '04	Low 0.91%	Jun 16
Greece				
Spread to Germany	High 33.13%	Dec '11	High 2.24%	Jan 3
Last 1.25%	Low 0.09%	Jan '05	Low 1.16%	Dec 5
Portugal				
Spread to Germany	High 14.61%	Jan '12	High 1.04%	Dec 20
Last 0.67%	Low -0.54%	Jun '06	Low 0.64%	Jun 16
Ireland				
Spread to Germany	High 8.67%	Jun '11	High 0.56%	Dec 30
Last 0.34%	Low -0.67%	Jun '07	Low 0.30%	Dec 6

10-year sovereign bond total returns, trailing 12-months

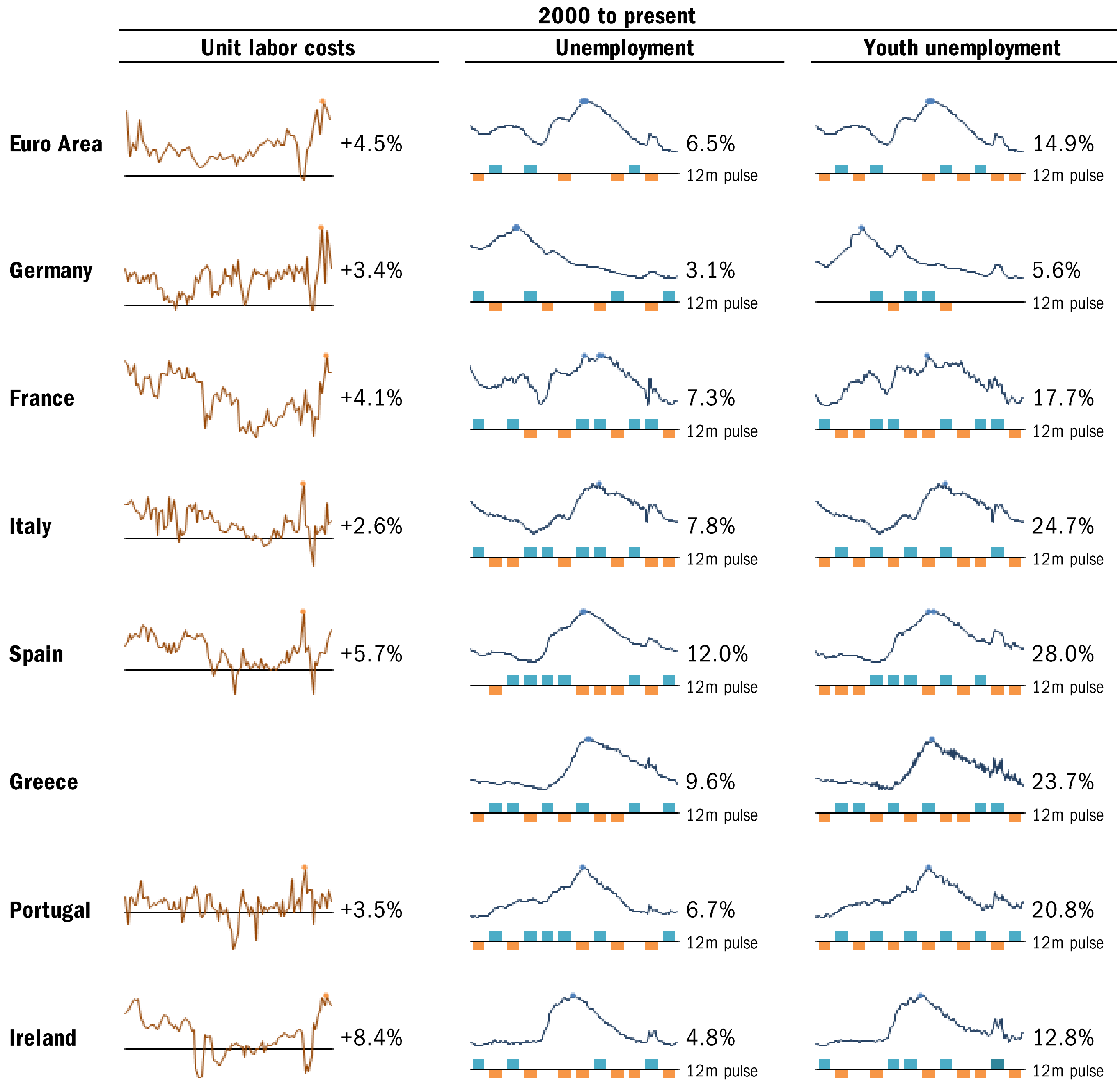
EUR USD



Source: Bloomberg, TrendMacro calculations

Labor market in intensive care

ULC: Nominal, quarterly YOY   UE: · High   12m pulse: monthly improvement or worsening in rate of change



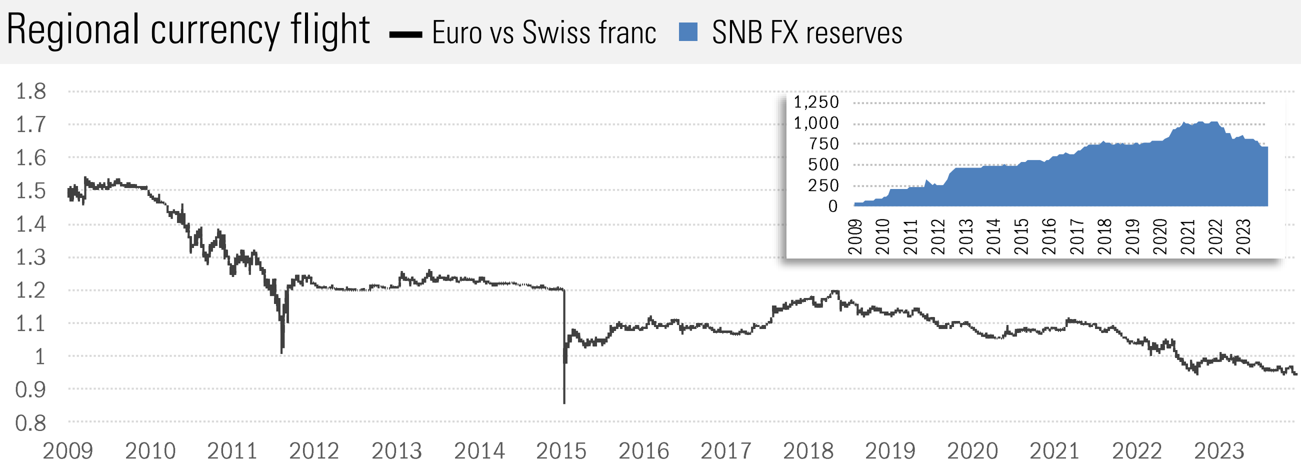
Source: Eurostat, TrendMacro calculations

Purchasing Manager Indices

Manufacturing	Last	Prev	13-month history	***Services***	Last	Prev	13-month history
Eurozone Nov	44.2	43.1		Eurozone Nov	48.7	47.8	
UK Nov	47.2	44.8		UK Nov	50.9	49.5	
Germany Nov	42.6	40.8		Germany Nov	49.6	48.2	
France Nov	42.9	42.8		France Nov	45.4	45.2	
Italy Nov	44.4	44.9		Italy Nov	49.9	51.2	
Spain Nov	46.3	45.1		Spain Nov	51.0	51.1	
Ireland Nov	50.0	48.2		Ireland Nov	54.2	52.6	
Netherlands Nov	44.9	43.8					
Austria Nov	42.2	41.7					
Greece Nov	50.9	50.8					
Czech Rep Nov	43.2	42.0					

Source: Markit, TrendMacro calculations

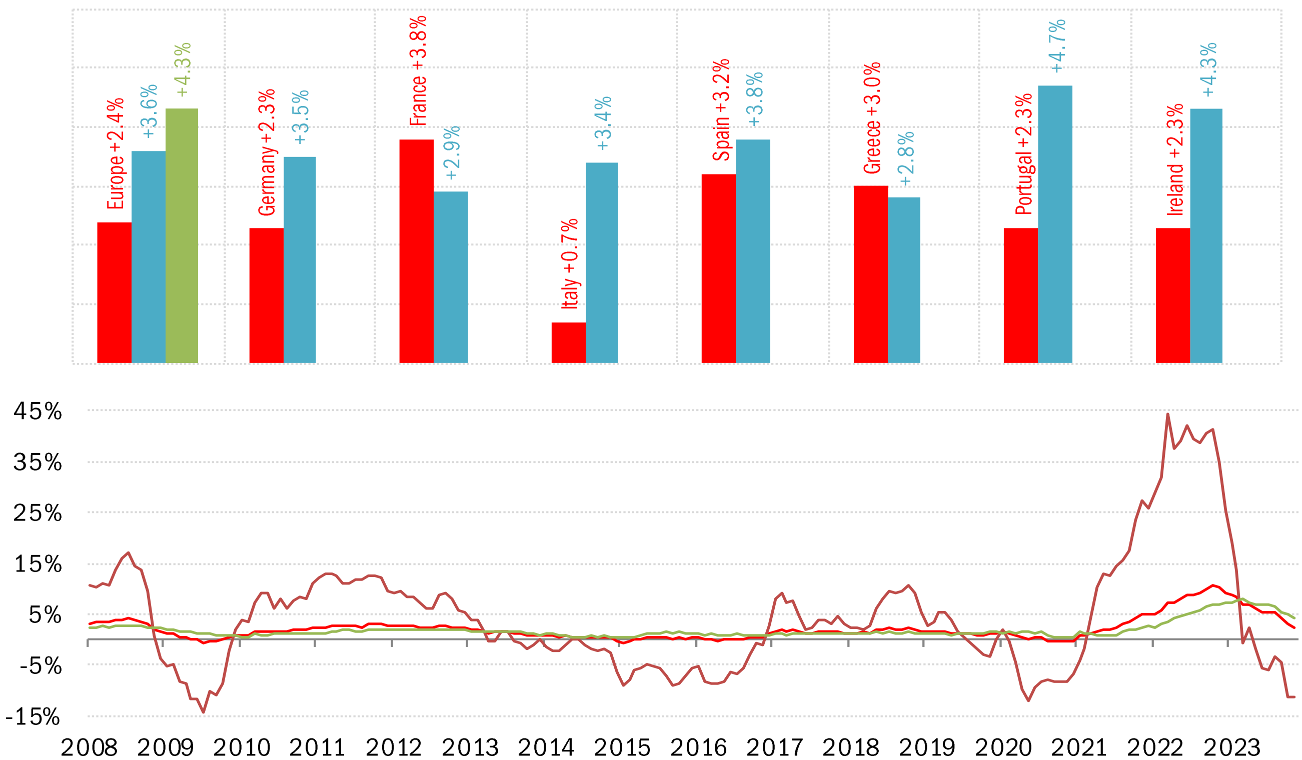
Regional currency flight



Source: Bloomberg, TrendMacro calculations

Euro area consumer inflation, year on year

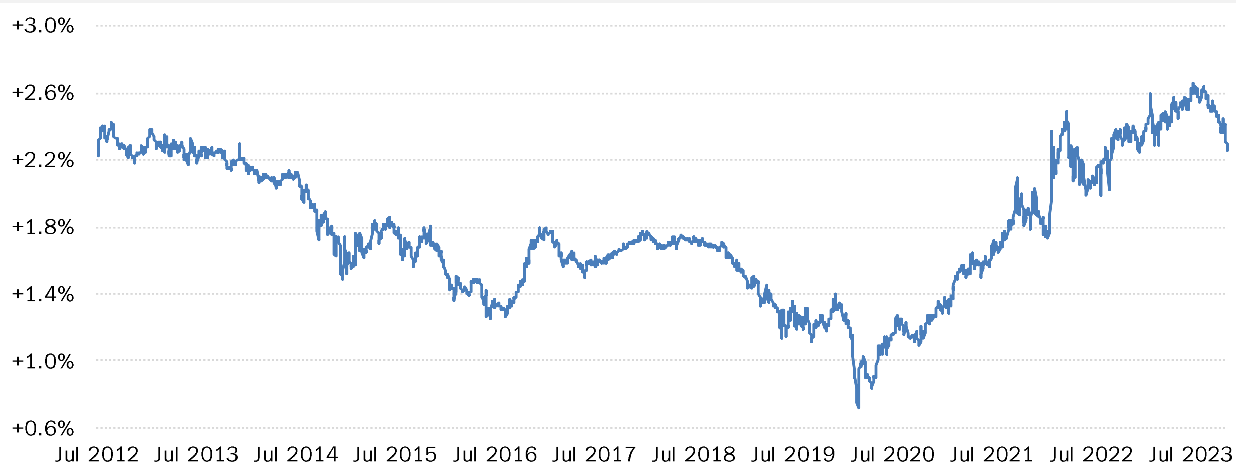
Country: Headline Ex-food and energy Ex-energy Euro area: Headline Energy Ex-energy



Source: Eurostat, TrendMacro calculations

Draghi's old dashboard: Swap-implied inflation expectations since "Whatever it takes"

5-year inflation-swap rate, 5 years forward



Source: Bloomberg, TrendMacro calculations