Economic Research View

Europe: Review on July ECB's Governing Council

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Atsushi Matsumoto, CFA

Senior Economist

While the ECB has decided upon an additional rate hike, the policy statement and President Christine Lagarde's comments stressed that the ECB's stance has taken a data-dependent approach. Weaker economic data and disinflation seem to be behind this, and if the data moves broadly in line with recent trends, the ECB's outlook will be downwardly revised, warranting a pause, at least, at the September meeting.

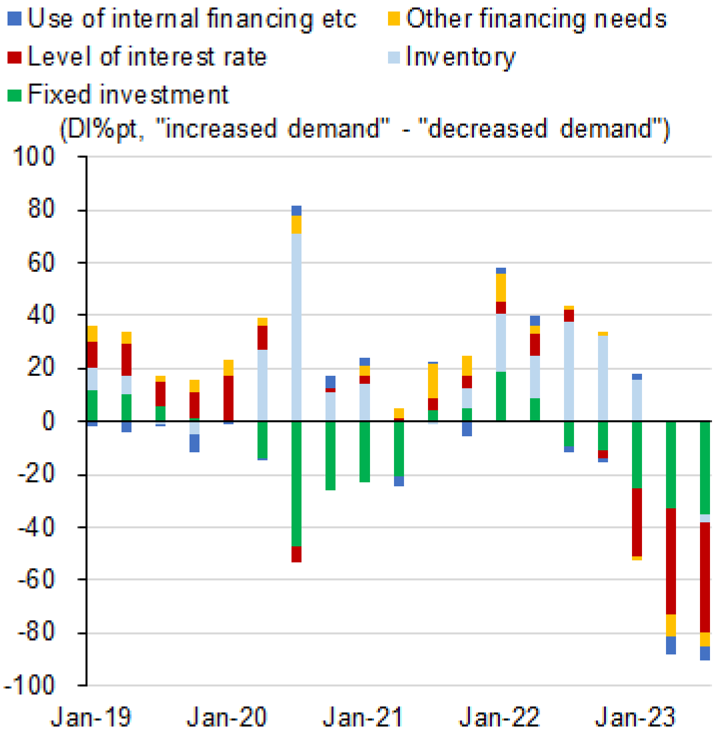
The ECB decided a rate hike of 25bp, but refrained from clear messages for future decisions, stressing a stance of data-dependence

- The Governing Council in July unanimously decided to raise the policy rates by 25bp as widely expected. As for future decisions, there were big changes in the policy statement and President Christine Lagarde's comments, both of which I think strengthened the data-dependent approach of the ECB.
- A sentence regarding future decisions in the policy statement was changed to "*ensure that the key ECB interest rates will be set at sufficiently restrictive levels*" from "*ensure that the key ECB interest rates will be brought to (such) levels*", and Lagarde said that this change was "*not random or irrelevant*". The expression in June had implied that the monetary policy was not restrictive enough (that's why the communication then was "*the policy rates will be brought to*" restrictive levels), while the one in July signaled that the policy could be restrictive already.
- And, while Lagarde had stressed "*we have ground to cover*" in June, this month, in response to a question asking if the ECB had more ground to cover, she said "*At this point in time, I wouldn't say so…*", adding "*the data… will tell us whether or how much we have ground to cover…*". This suggested a possible pause at the next meeting in September. Indeed, she said "*we might hike and we might hold*". In addition, she mentioned that if the next decision is holding, "…*it would not necessarily be for an extended period of time…*", suggesting that the Fed's type of pausing (skipping one meeting) would possibly be considered.
- All in all, the communications above have meant that the ECB's stance has shifted to a data-dependent approach from what could previously be interpreted as a partial data-dependence (recall that, until June, the ECB had pre-committed an additional hike while stressing a data-dependent approach).

Weaker economic momentum and disinflation seem to be behind the changes in the ECB's stance. The ECB's outlook for the GDP and inflation could be downwardly revised, and if that happens, a pause at the September meeting will be possible

- What made the ECB's communications change so much? Changes in the ECB's assessment for the economy and inflation implied that the ECB is now less concerned about upside risks for the outlook of the economy and inflation. Rather, the ECB seems to be aware of downside risks.
- As for the economy, Lagarde explained "the near-term economic outlook for the euro area has deteriorated, owing largely to weaker domestic demand" and "The economy is expected to remain weak in the short run", which I think was partly due to weaker PMI in July. The ECB's assessment for this weakness was very important: she linked the weakness to tighter financial conditions by saying "financial conditions… are increasingly dampening demand". I think that the latest Bank Lending Survey had supported this assessment because the Survey had shown that higher interest rates had dampened demands for bank loans (Fig1).

Figure. 1 Factors to affect demandes for bank loans



Note: Nomura Asset Management based on ECB data.

- And regarding the inflation, the policy statement said "*The developments since the last meeting support the expectation that inflation will drop further…*", signaling some optimism for the continuity of disinflation.
- I think that these communications implied that a possibility of downward revisions of the GDP and inflation outlook in September would be increasing (albeit marginally). Certainly, we have to continue checking all the economic data we have until the next meeting. But, as long as the data moves broadly

in line with recent trends, the GDP and inflation outlook will be downwardly revised, which will warrant a pause, at least, at the September meeting.

*This commentary is based on personal views of the author and does not necessarily represent Nomura Asset Management house view.