ECB keeps rates on hold as euro area moves towards recession

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The European Central Bank (ECB) decided at its meeting on Thursday not to lift interest rates after 10 consecutive rises. But the decision did not reflect an improvement in the European economy as official inflation levels start to come down.

Rather, the main motivation appears to have been a worsening of the euro zone economy which is on the brink of a recession led down by its main component, Germany.

In her opening remarks to the press conference on the decision, ECB president Christine Lagarde, after noting that inflation was still expected to stay "too high for too long," provided an overview of the worsening outlook.

"The euro area economy remains weak," she began. "Recent information suggests that manufacturing output has continued to fall. Subdued foreign demand and tighter financing conditions are increasingly weighing on investment and consumer spending. The services sector is also weakening further. This is because weaker industrial activity is spilling over to other sectors, the impetus from reopening effects is fading and the impact of higher interest rates is broadening. The economy is likely to remain weak for the rest of the year."

The best prospect she could advance was that as inflation came down further, household incomes recovered, and exports picked up, "the economy should strengthen over the coming years."

The latest data confirm the downbeat ECB outlook. While inflation fell in September to 4.3 percent from 5.2 percent in August, higher borrowing costs and energy prices, combined with a slowdown in international trade, are having a major impact.

Data from S&P Global showed that activity in manufacturing and services was down to its lowest level since November 2020 at the worst point of the pandemic. Excluding the pandemic months, the fall in activity was the sharpest since 2013.

The downturn is being led by Germany. Business surveys showed that private sector economic activity contracted for the fourth straight month in a row in October. This is amid what a *Guardian* report described as a "collapse in manufacturing output, suggesting the country may have already entered a recession."

The industrial sector also suffered "a new shock on Thursday, when shares in the engineering firm Siemen Energy plunged as it sought a bailout from the German government, after a string of technical problems and higher costs such as at its wind turbine arm.

According to the Bundesbank, the country's central bank, the economy is likely to have shrunk in the third quarter this year, following zero growth in the second quarter and a 0.1 percent contraction in the first.

The ECB does not expect conditions in the euro zone to improve and they could get worse.

"The risks to economic growth remain tilted to the downside," Lagarde said. "Growth could be lower if the effects of monetary policy turn out to be stronger than expected. A weaker world economy would also weigh on growth."

The data is also emerging on the effect of monetary policy since the ECB began lifting rates 15 months ago as Lagarde reported.

Funding has become more expensive for banks, with interest rates for business loans and mortgages rising.

"Higher borrowing rates, with the associated cuts in investment plans and house purchases, led to a further drop in credit demand in the third quarter… Moreover, credit standards for loans to firms and households tightened further. Banks are becoming more concerned about the risks faced by their customers and are less willing to take on risks themselves," she said.

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Expanding on this point, she said banks were saying they were more attentive to risk and also that corporates were "putting a brake on their investment because of the level of interest rates."

Despite the worsening economic situation, Largarde insisted the pause in rate increases was not the prelude to cuts.

In response to a question as to when and at what level would the ECB begin to cut rates, she said the issue was "not discussed at all, and the debate would be absolutely premature." She then emphasised the point, adding "even having a discussion on a cut is totally premature."

Noting that Lagarde mentioned several times that the "economy basically stagnates," one questioner asked whether there was a risk that the ECB might have gone too far in its rate increases.

This was brushed aside as Lagarde insisted the "mission" was to return inflation to 2 percent.

Besides the impact of higher ECB rates on the economy there are also concerns about the effect of the bond market selloff. This has seen the yield rise on the US 10-year Treasury, in many ways the benchmark for the global financial system. This approached 5 percent, for the first time since before the global financial crisis of 2008.

Yields at this level were not a problem in the past, in fact they were quite normal. However, more than a decade of ultra-low interest rates and the trillion of dollars pumped into the financial system by central banks have transformed the situation.

The mountain of debt and speculative deals built up during the period of so-called quantitative easing are now susceptible to sudden shifts in the bond market and could become a risk for financial stability.

Asked about this, Lagarde said that the movement in bond yields was outside the euro area and was not directly related to its fundamentals. She then handed the question over to ECB vice-president Luis de Guidos.

He indicated that it was an issue of concern.

"The increase in yields is something we are looking at very carefully. Why? Because the main risk that we have identified in the past, and continue to identify in the near future, is very high valuation in different kinds of assets."

In the real estate market, he continued, an increase in yields "can give rise to an important correction."

"So this is something that we are taking into consideration very, very closely and simultaneously all the factors such as the higher yields can have an impact on the non-bank financial intermediaries."

This is a reference to hedge funds and other financial institutions outside the banking system which play an increasingly important role.

There was a "concentration of potential vulnerabilities" in term of liquidity risks and mismatches that can give rise to problems in this area "that is not totally isolated from rest of the financial system" because it has "important liaisons with the banks."

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