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ECB minutes signal growing divide about size of future rate hikes

The just-released minutes of the European Central Bank's meeting in March suggest there is a growing divide within the Governing Council. A 50bp rate hike is still on the table next month but the split among members argues in favour of a 25bp compromise

European Central Bank President Christine Lagarde

The ECB's March meeting took place against the background of banking and market turbulence, a new set of macro projections – which were already outdated as they had been prepared prior to the banking turmoil – and an end to the ECB’s forward guidance. In the end, the central bank decided to hike interest rates by another 50bp and did not show any concern about the banking turmoil and speculations of a smaller-sized hike or even a pause.

With only two more weeks to go until the next ECB meeting, there is little doubt that it will continue hiking rates. The only question seems to be whether the ECB will opt for 25bp or 50bp. With the recent calming of financial market stress, pausing the hiking cycle is unlikely to get any support from the Governing Council.

Let’s have a quick look at the main factors determining the ECB’s decision at the May meeting, based on the just-released minutes of the March meeting and recent developments.

Inflation developments

Headline inflation in the eurozone has started to come down but almost exclusively due to energy price base effects. Core inflation remains stubbornly high and has recently even increased. Back at the March meeting, the ECB had a discussion on whether core inflation was already at a turning point but couldn't identify any hard evidence. At the same time, there were "a number of members seeing risks as tilted to the upside over the entire horizon", adding doubt to the staff projections of inflation converging to 2% in 2025.

Over the last year, inflation has morphed from a supply-side issue to a demand-side issue. Yesterday, ECB Executive Board member Isabel Schnabel gave a speech and presented a chart showing that current inflation can almost entirely be explained by demand factors. This change in the nature of inflation is still the most convincing argument for more rate hikes.

Given that interest rates and market prices are almost back to where they were prior to the banking turmoil, the March staff projections are currently probably more accurate than they were during the March ECB meeting. There is, however, one striking element: while the ECB expects the eurozone economy to return to its potential growth rate at the start of 2024, inflation will continue to come down until 2025. We doubt that this combination is feasible, but think that either inflation will remain stickier if the ECB's growth forecast is correct or that growth will have to be weaker to get inflation back to target.

Banking turmoil

The minutes of the March meeting confirm the message sent at the March press conference: the banking sector in the eurozone is resilient, with strong capital and liquidity positions. The ECB was confident that announced liquidity measures and the general resilience of the banking sector would "alleviate the current market tensions". An interesting point was made, namely that "the transmission of monetary policy impulses was likely to be stronger at times of market stress than in calmer times".

It wasn't a problem in March and it will not be a big issue in May. The ECB will only focus on the impact of the recent turmoil on lending and activity.

Transmission of monetary policy tightening so far

The minutes reveal a first discussion on lags of the transmission of monetary policy, leading to a broader debate in two weeks on how far rates should still be hiked. There seems to be a growing divergence between ECB members favouring the view that "in the past, the effect of monetary policy had been continually overestimated, which might happen again", while others argued that there was a risk "that the impact of monetary policy tightening was being underestimated". This growing split was also illustrated by the fact that some ECB members preferred to pause the rate hike cycle at the March meeting, according to the minutes.

What to expect from the ECB May meeting

As the banking crisis seems to be contained, the ECB will stick to the widely-communicated distinction between using interest rates in the fight against inflation and liquidity measures plus other tools to tackle any financial instability. The fact that there are still no signs of any disinflationary process, discounting energy and commodity prices, as well as the fact that inflation has increasingly become demand-driven, will keep the ECB in tightening mode.

We still think that the turmoil of the last few weeks should have been a clear reminder for the ECB that hiking interest rates, and particularly the most aggressive tightening cycle since the start of the monetary union, comes at a cost. In fact, with any further rate hike, the risk that something breaks increases. However, judging from the latest comments, the ECB is currently rather back to where it was prior to the March meeting: strictly determined to break inflation. The rather benign view on potential adverse effects from the current tightening seems to be back.

At the current juncture, both a 25bp and a 50bp rate hike seem to be on the table for the May decision. The next inflation print and the latest Bank Lending Survey, both to be released only a few days ahead of the May meeting, will tip the balance. The growing divide within the ECB, signalled in today's minutes, is probably the best argument for a compromise of a 25bp rate hike. In fact, it would also make more sense as the ECB has already entered the final phase of its tightening cycle. A phase that should be characterised by a genuine meeting-by-meeting approach and a slowdown in the pace, size and number of any further rate hikes.

Still, despite growing opposition by the doves, we definitely cannot rule out a 50bp rate hike. It wouldn't be the hawkish surprise.

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