

## ECB preview: 50bp next week but how far will the ECB still go?

A 50bp rate hike next week looks like a done deal. The more heated debate at the European Central Bank will be about the path for monetary policy beyond the March meeting



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ECB president Christine Lagarde's de facto pre-announcement at the February meeting, the ECB discussion reflected in the minutes of the meeting and official comments since the February meeting all show that a 50bp rate hike next week is a done deal. The discussion will rather focus on steps beyond the March meeting and how to communicate them.

### Stagnating economy and stubbornly high inflation

While there have been some positive developments in confidence indicators since the start of the year, hard data is still anything but rosy. Interestingly, two downward revisions of German GDP data and one downward revision of Irish GDP data brought the eurozone economy at the brink of recession in the fourth quarter of 2022 and another stagnation in the first quarter cannot yet be excluded. As regards sentiment indicators, consumer confidence remains low and actual assessment components are still weak. After the inventory build-up at the end of last year, production could still remain sluggish. It is far from certain that the Chinese reopening will be

sufficient to shift the eurozone economy into a higher gear.

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Lower energy prices have led to lower headline inflation than expected in December and will continue to push down headline inflation further. As of March, there should be a sharp negative base effect from energy prices. Also, the ECB's very own consumer expectations survey this week showed a further drop in consumers' inflation expectations. At the same time, however, core inflation continued to increase and there are no signs of a peak, yet. Selling price expectations in industry have come down significantly but remain close to all-time highs in services, suggesting that the pass-through of higher input prices to consumers is far from being over. Add to this higher nominal wage growth this year and next year and it is easy to understand the ECB's concern about stubbornly high core inflation.

Macro developments since the February meeting have not brought any relief for inflation and the inflation outlook, which is why a 50bp rate hike looks like a done deal.

## Heated discussion about path and pace of monetary policy beyond next week's meeting

Up to now, the ECB has been surprisingly unanimous on rate hikes. Recent comments by ECB officials, however, suggest that the debate at the ECB will become more heated again. While chief economist Philip Lane and others argue for a more cautious approach, which could lead to a slowing of the rate hike pace and a not so far away pause or end, the hawkish camp, currently headed by Isabel Schnabel, argues in favour of further firm tightening.

The publication of a new round of macro projections at next week's meeting will do little to change the actual rate decision but will give clear insights in where the discussion within the ECB about future rate hikes is heading to.

## New projections to show lower inflation in 2024 and 2025

Compared with the December forecasts, the external environment and the so-called technical assumptions have changed drastically. Remember that back in December, the ECB had still penciled in gas prices to average 120 euro per MWh in 2023 and 98 euro in 2024; based on market futures. These futures would currently result in average prices of around 50 euro per MWh for this year and next year. The other most significant change stems from interest rates, as 3m Euribor rates should now average almost 100bp more and 10-year bond yields around 60bp more than in the December forecasts. Add to this lower oil prices and a stronger euro exchange rate and anything other than a downward revision of the ECB's inflation projections for 2024 and 2025 would be a strong surprise. Anything other than a downward revision would also indicate that the ECB has actually become more alarmed about underlying inflation. Back in December, the ECB had expected headline inflation to average 3.4% and 2.3% in 2024 and 2025 respectively, and core inflation at 2.8% and 2.4%.

Finally, we will have a very close eye on the ECB's growth projections. Not so much on the actual numbers but on the underlying profile. If the ECB sticks to its previous view that the eurozone

economy will return to pre-pandemic growth rates already in the second half of this year, the risk of further rate hike overshooting increases. If the ECB gets closer to our own view of rather subdued growth going into 2024, our call of the terminal rate for the deposit rate at 3.5% looks realistic.

## Several options for the ECB beyond next week's meeting

If the hawks remain in the driver's seat, the growth outlook becomes more upbeat and inflation remains stubbornly high, there is a high risk that the ECB could actually continue with 50bp rate hikes. In such a scenario, the ECB would bring policy rates to new historical highs, even if the risk of a policy mistake increases. We are still surprised to see that even the hawks at the ECB seem to underestimate the risk aggressive monetary policy tightening can (and will) have on the economy.

If the opposition of the doves increases, the ECB will have to take a more moderate approach to further monetary policy tightening. In such a scenario, which is our base-case scenario, the ECB would hike rates by 25bp in May and June and then pause its hiking cycle. In this scenario, the argument prevails that it will simply take some time before the full impact of the ECB's tightening so far will materialise.

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Don't expect that a final decision on what will come after the March meeting will already be taken next week. Between March and the next meeting in May, important data releases like an update of the Bank Lending Survey and initial first-quarter GDP growth data will be available. These are two important pieces of evidence that could tilt the balance in either direction; continue hiking rates until actual inflation comes down or prepare to pause to better assess the impact of the rate hikes so far. An instrument to bring hawks and doves closer together is obviously Quantitative Tightening. More aggressive policy rate hikes against a very slow reduction of the ECB's bond portfolio or less aggressive rate hikes but a faster reduction of the bond portfolio could be the trade-off.

In any case, with the recent repricing in financial markets of the ECB's next steps, the heat is on. Not only for the ECB but also for ECB president Lagarde at the press conference. In the past, fine-tuning of market expectations at the press conference often failed. Therefore, it could very well be that the ECB chooses a very defensive communication strategy, stressing the meeting-by-meeting approach and (hopefully) suppressing any need to give forward guidance.

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