

ECB preview: a 25bp compromise rate hike

With only one week to go until the next European Central Bank 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. We think that 25bp is the most likely outcome but might revise our call after Tuesday's Bank Lending Survey and inflation data



Christine Lagarde,
president of the
European Central Bank

Let's have a quick look at the main factors determining the ECB's decision at the 4 May meeting:

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 even increased recently. Back at the March meeting, the ECB discussed 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. ECB Executive Board member Isabel Schnabel recently hinted in an interview with *Politico* that even reaching the peak in core inflation was not necessarily a sufficient condition to alter course.

More generally speaking, the ECB's main concern is that inflation has morphed from a supply-side issue to a demand-side issue. 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 confirmed 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 problem 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 revealed the 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.

Still, the narrative in official comments has now finally convincingly shifted to a meeting-by-meeting approach. Next Tuesday – when eurozone inflation, credit growth and the results of the last Bank Lending Survey are released – will be a crucial day for assessing the current state of play of how much of the tightening so far, and the latest banking turmoil, are already affecting the real economy.

25bp rate hike is a good compromise, but Tuesday could still tip the balance

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. If the hawks were to remain in the driver's seat, the terminal rate would probably be at 3.75% or 4%.

However, 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. It is also a strong argument for the doves at the ECB. In fact, with any further rate hike, the risk that something breaks increases. Still, 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. Consequently, with the continuing and gradual impact of monetary policy tightening so far, a looming recession in the US and a potential credit crunch in the eurozone, the risk is high that every next rate hike could turn out to be a policy mistake.

For next week, both a 25bp and a 50bp rate hike seem to be on the table. The next inflation print, credit developments and the latest Bank Lending Survey, all to be released next week, will tip the balance. We think that given the growing divide within the ECB, a rate hike of 25bp would be a typical European compromise. However, we will revisit our call after Tuesday's data flood.

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