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Negative impact of ECB tightening cycle and banking turmoil is unfolding

Weaker demand for loans, tighter lending standards and already muted loan growth support our view of a 25bp rate hike at Thursday's European Central Bank meeting

Christine Lagarde, president of the European Central Bank

We have just seen two of the three pieces of data being published today that are likely to tilt the balance at Thursday's ECB meeting towards either a 50bp or a 25bp rate hike.

Just-released loan growth data and the results of the Bank Lending Survey support our call for a compromise 25bp hike.

Weaker demand for loans points to subdued growth

The March ECB meeting took place at the height of the banking turmoil without a direct or visible impact on the eurozone banking sector or the real economy. Still, the discussion at the March meeting showed growing concern amongst ECB officials, putting more focus than ever on today's data releases and any hints at the potential impact on the transmission of monetary policy tightening so far.

And indeed, credit conditions have clearly tightened since the start of the banking turmoil, according to April's Bank Lending Survey results. At the same time, demand for loans also dropped strongly, driven by higher interest rates, lower investments and the weakening housing market. The pace of net tightening in credit standards is at the highest level since 2011 as the net percentage of banks reporting a tightening stands at 27%. Surveyed banks also reported a strong net decrease in demand from firms for loans or drawing of credit lines. At the same time, the net decrease in demand for housing loans remained strong and was close to the drop reported in the last quarter. Interestingly, the drop in demand for corporate loans was much more spread across eurozone countries; in the first quarter of the year, it was mainly German banks which reported a drop in demand for corporate loans, now France, Italy and Spain are also reporting a sharp drop.

This slump in demand for new loans was also reflected in the March monetary developments. The annual growth rate of adjusted loans to households decreased to 2.9% in March from 3.2% in February, while the annual growth rate of loans to corporates dropped to 5.2% in March, from 5.7% in February. More importantly, after the February drop in monthly flows, the monthly flow of credit to the private sector was only marginally positive. The outflow of deposits also continued in March. While this outflow in February was driven by retail deposits and financial corporations, it is now also corporates withdrawing deposits.

Weaker demand for loans, tighter lending standards and already weak loan growth all point to a weakening of growth momentum in the eurozone economy in the months ahead.

Very strong transmission of current tightening cycle

Back at the March meeting, ECB president Christine Lagarde said that three factors were key in the ECB's current policy decisions: "The inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission". The first part of today's super data Tuesday suggests that in regards to the current ECB's tightening cycle, the transmission is strong with this one...

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