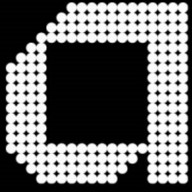

Research Institute - Insight

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#Europe / #Monetary Policy / #Inflation

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ECB hikes 50bps despite banking sector fears

The European Central Bank (ECB) is maintaining its inflation focus for now, compartmentalising the job of raising interest rates from volatility in the global banking sector.

Key Takeaways

- Despite stresses in the banking sector, the ECB today delivered the 50bps hike it indicated at its previous meeting.
- The Eurozone is already well into a steep hiking cycle. But core inflation remains at an all-time high.
- The Bank's press release stresses that it stands "ready to respond as necessary" to further deterioration in the financial sector, and President Lagarde noted the depth of the policy toolkit available should that deterioration materialise.
- The ECB maintains that the banking sector is resilient and well-capitalised.
- In contrast to the previous meeting, no concrete guidance regarding policy decisions at upcoming meetings was given. All communications stressed the data dependence of the path of policy at the current juncture.
- We forecast 25bps hikes in May and June, but it is hard to express much confidence at this stage.

A 50bps hike despite financial volatility

The European Central Bank (ECB) today hiked rates by 50 bps, in line with our expectations. This comes despite some commentators suggesting a slower pace of tightening in response to stress in the banking sector.

Indeed, market pricing suggested a strong possibility of a 25bps hike before the decision was announced. However, as the ECB's press release makes clear, inflation is – for the moment at least – its number one concern: "Inflation is projected to remain too high for too long."

A "large majority" of the Governing Council voted for the 50bps hike, although notably 3 or 4 members apparently advocated for a pause.

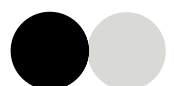
Out-of-date forecasts, but they show the ECB's inflation concern

In the fast-moving macroeconomic and market environment, the ECB's forecast changes are perhaps not so useful an indicator of its current thinking, being already two weeks out of date. However, the revisions do illuminate the broad contours of the macro dynamics informing monetary policy decisions.

Most important is the upward revision to the 2023 core inflation forecast, which is now expected to average 4.6% after recent unexpected strength. Our own forecast is slightly higher still, at 4.8%. The ECB's 2024 and 2025 headline and core inflation forecasts also sit above 2%, which suggests the ECB is not expecting its policy actions so far to achieve its price stability aim.

Meanwhile, the GDP growth forecasts were revised up in 2023 (to 1.0%), and down in 2024 and 2025 (both to 1.6%). The former revision comes off the back of recent resilience in the data flow, lower energy prices, and continued labour market robustness. However, our own forecast suggests slower growth amid the recession we are expecting later this year.

Furthermore, the ECB's forecasts do not capture the increasing risk of stresses in the banking sector weighing on other segments of the economy. We think the ECB could find itself facing a worse growth backdrop than its current forecasts suggest as the latter half of 2023 unfolds.



“A lot more ground to cover”

Unsurprisingly, Lagarde refused to be drawn on the specific path of policy rates at upcoming meetings, strongly stressing that these decisions will be data dependent.

However, the statement and press conference did suggest that the ECB is very much focused on the task of fighting inflation. Future rate decisions are going to be based on “the assessment of the inflation outlook in light of the incoming economic and financial data”, “the dynamics of underlying inflation”, and “the strength of monetary policy transmission”.

Moreover, Lagarde said that, should the macroeconomy evolve in line with the ECB’s current baseline scenario, there is “a lot more ground to cover”. In any scenario where underlying inflation indicators do not ease “the fight against inflation will not stop”.

If the current banking sector stresses ultimately prove contained, and the strength in underlying inflation persists, more hikes should be expected.

But this is a big “if”, and the path of policy is highly uncertain at the current juncture. We think underlying inflation is going to be persistent until a more meaningful growth moderation occurs, and, in theory, that requires further rate hikes in the near term. But we also just don’t know exactly how banking sector worries are going to play out.

Perhaps our bigger conviction is that, as and when the economy turns weaker, interest rates could be cut later this year.

Compartmentalising inflation and banking sector worries

While inflation is the ECB’s primary concern for now, Lagarde of course stressed the commitment to financial stability. For now, the ECB is running the line that there is no trade-off between these two aims.

The ECB’s position is that it is “ready to respond as necessary” should financial stability be threatened. Lagarde appealed to the depth and diversity of the ECB’s toolkit in the event of bigger stresses.

The ECB’s view is that these two considerations require different monetary policy tools. Were the situation in the banking sector to deteriorate, the ECB’s response would be through liquidity support like TLTROs and even the Transmission Protection Instrument.

The statement argued that the “Euro area banking system is resilient, with strong capital and liquidity positions”. We agree that banks are better capitalised, and the ECB’s policy toolkit is better equipped to deal with tensions in the sector. But we also know how quickly sentiment can turn in the sector.

Sticking with our forecasts for now, but a very uncertain outlook

We are (somewhat uncomfortably) forecasting 25bps hikes in both May and June. This is 25bps less cumulative tightening than our previous forecast, reflecting the tightening in financial conditions that has occurred and the likely curtailing of some bank lending to the real economy. But amid the fast moving situation, we will remain as data and events dependent as the ECB itself.

More broadly, the read across from the ECB to other central banks is that the first instinct will be to try to compartmentalise the fight against inflation and financial stability concerns. For now, they seem likely to press ahead with near-term rate rises alongside shows of liquidity support for banks. The course of banking sector stresses will ultimately decide whether this is possible.

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