PREVIEW: ECB Policy Announcement due Thursday 4th May 2023

- **ECB policy announcement due Thursday 4th May; rate decision at 13:15BST/08:15EDT, press conference from 13:45BST/08:45EDT**
- **Consensus and market pricing look for a 25bps hike, taking the deposit rate to 3.25%**
- **Focus will fall on clues over the ECB's tightening ambitions beyond May**

OVERVIEW: Consensus looks for a 25bps hike in the Deposit Rate to 3.25%, according to 57/69 analysts surveyed by Reuters, whilst the remaining 12 look for a 50bps increase. Market pricing concurs with the consensus as 25bps is priced at around 78% vs. 22% for 50bps. As it stands, messaging from policymakers has suggested that the policy options will be between a 25bps and 50bps hike, with the Bank required to deliver further tightening to bring inflation back to target. Given the political nature of the GC, it is expected that 25bps will be the compromise between the hawks and doves who will also be jostling over how high the terminal rate will reach in the coming months, with markets currently priced for the Deposit Rate to reach 3.65% in July, which would imply 25bps hikes in May and June with a 60% chance of a further 25bps increase in July.

PRIOR MEETING: Despite market pricing ahead of the meeting being around 65% in favour of a 25bps hike, the ECB defied calls for such a move and stuck with its February guidance of a 50bps increase. The Governing Council justified this by noting that inflation was projected to remain too high for too long. With regards to financial stability, the statement noted that “the euro area banking sector is resilient, with strong capital and liquidity positions. In any case, the ECB’s policy toolkit is fully equipped to provide liquidity support to the euro area financial system if needed”. From a guidance perspective, the GC is no longer guiding towards rate hikes and merely refers to “rate decisions”, which will be data-dependent. At the follow-up press conference, Lagarde noted the Board proposed no other option compared to the one taken. This decision was adopted by a very large majority, though three or four did not support the decision and wished to wait for more time. In the wake of the meeting and press conference, Reuters ECB sources noted the debate at the meeting was for either 50bps, or an unchanged decision, and that policymakers opted for the 50bp move after the SNB lifeline to Credit Suisse, while there was no discussion of a 25bp move. Bloomberg sources also noted that policymakers feared that ditching their 50bp hike guidance might panic investors, while on the terminal rate, hawkish officials still saw rates well above the current 3% level, although the doves questioned whether the peak may be lower than initially thought.

RECENT ECONOMIC DEVELOPMENTS: Headline inflation in the Eurozone rose to 7.0% in April from 6.9%, whilst the core metric (ex-food and energy) fell to 7.3% from 7.5% and the super-core to 5.6% from 5.7%. In terms of market-based measures, the 5y5y inflation forward stands at around 2.47% vs. circa 2.33% at the time of the March meeting. On the growth front, the flash print for Q1 Q/Q GDP came in at 0.1% vs. Exp. 0.2% (prev. 0.0%), with the Y/Y rate at 1.3% vs. Exp. 1.4% (prev. 1.8%). The modest growth in the region was underpinned by the milder-than-expected winter and lift from the Chinese reopening which helped the Eurozone avoid what was originally forecast to be a quarterly contraction. More timely survey data saw the April Eurozone Composite PMI rise to 54.4 from 53.7, with the uptick driven by the encouraging performance in the service sector, whilst manufacturing continued to slip further below the 50 mark. The accompanying release noted "indices for the euro zone show a very friendly overall picture of an economy that continues to recover. However, a closer look reveals that growth is very unevenly distributed." In the labour market, the Eurozone unemployment rate remains at the historic low of 6.6%. The latest ECB Bank Lending Survey (Q1) showed a net 27% of EZ banks reported a tightening of lending standards for companies, while 38% reported a fall in demand for credit from companies. Furthermore, the decline in firms' net demand for loans was bigger than expected by banks in the previous quarter and the most since the global financial crisis.

RECENT COMMUNICATIONS: Since the prior meeting, President Lagarde (31st March) has noted that the rate-hike push is beginning to work, but there is still ground to cover on rates with core inflation too high. Chief Economist Lane (25th April) noted that current data suggests the ECB has to raise interest rates again at the upcoming meeting; beyond the May 4th meeting, further rate hikes will depend on data. The influential Schnabel of Germany (20th April) noted that "People talk a lot about a potential peak in core inflation. I would not overemphasise the peak as such, because what really matters is that inflation is returning to our two percent target over the medium term. We need to see a sustained decline in core inflation that gives us confidence that our measures are starting to work". Villeroy of France (24th) suggested that there may be a need for some additional interest rate hikes, but they must be limited in number and size. Belgium's Wunsch (24th April) said he would not be surprised if rates reach 4% at some point, whilst the decision in May will be between a 25bps or 50bps hike. At the dovish end of the spectrum, Italy's Visco (20th April) has cautioned that the risk of doing too much is at least as big as the risk of doing too little and the ECB still needs to see the full effects of rate hikes (21st April). His Italian colleague, Panetta (22nd March) suggested that banks will pass on rates more than in the past. For the hawks, Netherland's Knot has said the ECB may need to raise interest rates again in June and July – on top of the expected 25bps hike in May. Austria's Holzmann (12th April) has stated that the inflation outlook argues for another 50bps rate hike in May.

RATES/BALANCE SHEET: Consensus looks for a 25bps hike in the Deposit Rate to 3.25%, according to 57/69 analysts surveyed by Reuters, whilst the remaining 12 look for a 50bps increase. Market pricing concurs with the consensus as 25bps is priced at around 78% vs. 22% for 50bps. As it stands, messaging from policymakers has suggested that the policy options will be between a 25bps and 50bps hike with the Bank required to deliver further tightening to bring inflation back to target. Given the political nature of the GC, it is expected that 25bps will be the compromise between the hawks and doves who will also be jostling over how high the terminal rate will reach in the coming months, with markets currently priced for the Deposit Rate to reach 3.65% in July, which would imply 25bps hikes in May and June with a 60% chance of a further 25bps increase in July. Also of note, the findings of the latest ECB BLS will likely have dampened some calls for a 50bps move this month given the pronounced tightening in credit standards for loans to firms and for house purchases. As a reminder, from a guidance perspective, the GC is no longer guiding towards rate hikes and merely refers to “rate decisions”, which will be data-dependent. Making the case for a more hawkish move by the ECB, SocGen (published before inflation data and the BLS) suggests a compromise between hawks and doves could be to raise rates by 50bps and keep QT at EUR 15bln/month Q3. Expanding further on the balance sheet aspect of the announcement, SocGen notes that the June decision on the future of QT could potentially play a role whereby, if the amount was expanded to EUR 20/bln a month, due to the small amount of redemptions in Q3, it would mean the ECB "would have less market presence over the summer months, when liquidity is lower anyway and the US debt ceiling problems may cause additional market stress". It remains to be seen whether or not this potential outcome will have any bearing on the upcoming decision, but it is definitely a factor to consider when the June meeting comes into view.