

ECB slows pace of rate hikes to 25bps, but is not pausing

The May meeting of the ECB's Governing Council saw the central bank raise rates by 25bps, bringing the key deposit rate up to 3.25%. Thus, the ECB has slowed the pace of rate tightening following 50bps hikes in March, February and December and two 75bps rate increases last autumn. Indeed, it was the smallest rate hike in the current cycle. It brings the total amount of rate tightening in this cycle, which began last July, to 375bps.

Today's 25bps rate hike was in line with market expectations. **The ECB had given clear signals in the run up to today's meeting that a further rate increase was in the pipeline**, despite the growing downside risks to the outlook for the economy.

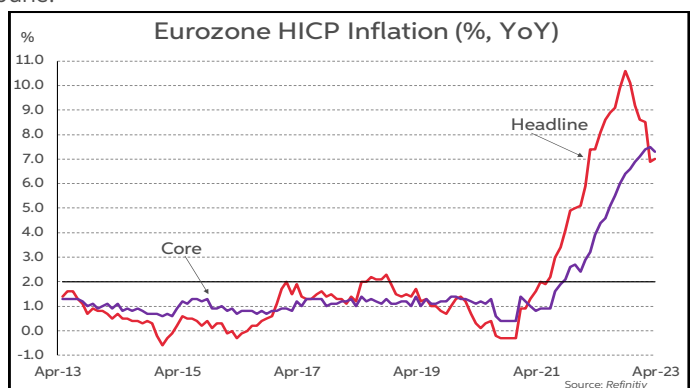
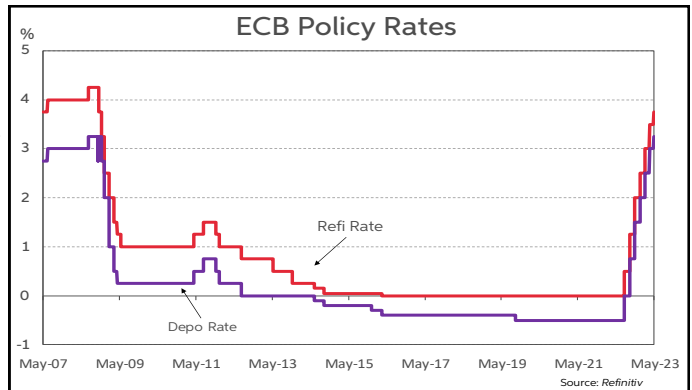
Inflation in the euro area remains high at 7%, with core inflation proving very sticky. This made it difficult for the ECB to do anything other than increase rates further today in its bid to restore price stability.

Indeed, **the ECB was again quite blunt in its meeting statement, noting that the projection for inflation continues to be for it to remain too high for too long.** It indicated that the 25bps hike was required to ensure a timely return of inflation to the 2% medium-term target. **President Lagarde clearly indicated that the ECB has more ground to cover and is not pausing. Thus, a further tightening of rates is on the cards**, with the ECB saying that future decisions will ensure that policy rates will be brought to levels sufficiently restrictive to bring inflation back down to the 2% target level and will be kept at those levels for as long as necessary. Thus, another 25bps hike can be expected in June.

There is much uncertainty about the economic outlook, both in regard to growth and inflation. This has been evident in the divergence of views that have emerged on the ECB Governing Council in recent weeks about the future course of monetary policy. The ECB emphasised again today, though, that it will continue to follow a **data-dependent approach in its future rate decisions. In particular, rate decisions will continue to be based on the ECB's assessment of the inflation outlook.**

Somewhat surprisingly, rate contracts softened today and the euro lost some ground following the ECB policy decision. **Futures contracts are pricing in that the ECB will hike rates by another 25bps at its next policy meeting in June and are currently discounting that rates will be increased by just a further 12.5bps in the third quarter.** This would take the deposit rate up to a peak level of 3.625%. Rate cuts of close to 100bps are then anticipated by markets during 2024. Given the firm focus of the ECB today on bringing inflation under control and maintaining a restrictive policy for as long as necessary in the face of sticky core inflation, **rates could well go higher than is currently priced in by markets** and may be slower to fall back to below 3%, as is presently envisaged in future contracts for next summer.

The ECB published its last set of staff quarterly macro forecasts in March. These were compiled before the tensions emerged in the global banking sector. The Eurozone 2023 GDP forecast was revised higher to 1.0% from 0.5% in its December projections. GDP growth is seen at 1.6% in both 2024 and 2025. **Banks, though, have reported a further substantial tightening in credit standards for loans to firms and household mortgages in Q1** as well as weakening loan demand. This is a downside risk to growth forecasts and seems to have **been a factor in dialling back the rate hike today to a more standard 25bps.** Meanwhile, the ECB cut its 2023 HICP inflation forecast in March from 6.3% to 5.3%. It also lowered its inflation forecast from 3.4% to 2.9% for 2024, with the rate seen at 2.1% in 2025. However, sticky core inflation is an upside risk to these forecasts.

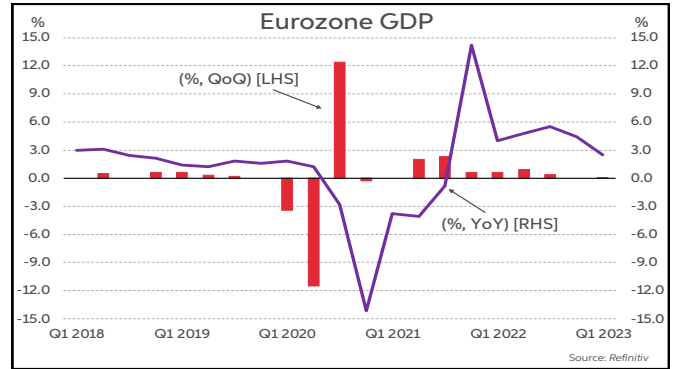


ECB Macroeconomic Forecasts for the Euro Area				
(%)	2022	2023	2024	2025
HICP	8.4	5.3	2.9	2.1
Real GDP	3.4	1.0	1.6	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average \$82.6 in 2023, \$77.8 in 2024 and \$73.9 in 2025
 Source: ECB March 2023

Sluggish Eurozone growth expected in 2023

The Eurozone economy lost considerable momentum in the second half of 2022. GDP stagnated in the three months to December having expanded by 0.4% in Q3, as the squeeze on real household incomes, from elevated levels of inflation and higher interest rates weighed heavily on consumer spending. **Growth was very muted in the first quarter of 2023, with GDP expanding by a meagre 0.1% q/q.** Although, Eurostat has not yet provided the underlying breakdown of the Q1 Eurozone GDP, details provided by some of the national statistic offices indicate that domestic demand remained weak in Germany, France, Italy and Spain.



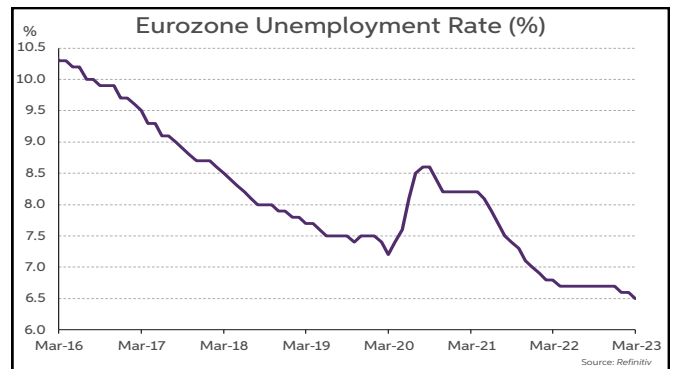
However, growth continued to vary among the large Eurozone economies in the first quarter of 2023. The heavily energy reliant and export orientated German economy continued to lag behind the others, with GDP stagnating in Q1, having contracted by 0.4% q/q in Q4 2022. In contrast, French GDP rose by 0.2% q/q at the start of this year, while the Italian and Spanish economies grew more quickly, with both expanding by 0.5% q/q.

Meanwhile, labour market conditions remain very tight. The unemployment rate fell to 6.7% last April and remained at that level until year end, before edging lower to 6.6% in January and February. It inched down again in March, to a new all-time low of 6.5%. At the same time, the latest available employment data, which are for Q4 2022 also indicate that the labour market is performing well. Employment was up by 0.3% in Q4 for a year-on-year gain of 1.5%. Overall, it is estimated there are four million more people in employment now, than before the pandemic. Tight conditions are contributing to increased labour costs. Official Eurozone wage data show that hourly wages and salaries increased by 5.4% y/y in the fourth quarter of 2022.

Regarding inflation, headline HICP stood at 7% in April, up slightly from 6.9% in March, but well below the peak of 10.6% last October. The fall in headline HICP largely reflects a sharp decline in energy prices. However, inflation has become broad based, with services price inflation rising from 4.4% in January, to 5.2% in April. Meanwhile, the core rate that excludes energy, food, alcohol and tobacco declined for the first time since last June, falling to 5.6% in April, from 5.7% in March. The ECB staff projections are for headline inflation to average 5.3% this year, down from 8.4% in 2022. Core inflation though is expected to be higher this year, averaging 4.6% in 2023, compared to 3.9% last year. Both rates are forecast to fall below 3% in 2024, and back towards 2% in 2025.

Elsewhere, the limited amount of survey data available for April have been mixed. One thing that is clear though, is that the services sector is continuing to outperform manufacturing. The services PMI rose to 56.2 in April, its highest level in a year, while the EC services sector sentiment index also improved. Meanwhile, the manufacturing PMI remained in contractionary territory for the tenth consecutive month, falling to 45.8, its lowest level since May 2020. The EC industrial sentiment index deteriorated in April also. Meantime, consumer confidence has continued to trend higher, although, it is still well below its level seen ahead of the Russian invasion of Ukraine last February.

Overall, growth in the Eurozone has slowed sharply over the past number of quarters. However, the economy has proved to be more resilient than expected in the face of high inflation and rising rates, and it appears to have avoided the recession that was once feared. Furthermore, the labour market remains strong and wholesale energy prices have continued to fall so far in 2023.



However, the war in Ukraine could continue to weigh on economic activity, while there is still some uncertainty around gas supplies for next winter.

The volatility on financial markets and recent stresses in parts of the global banking system also represents a new downside risk to growth. It is expected that activity will remain sluggish in the first half of the year, but pick up some momentum in H2 as inflation falls back further. **Both the IMF and OECD are forecasting Eurozone growth of 0.8% in 2023 and around 1.5% in 2024. Meanwhile, the ECB is projecting the economy will expand by 1.0% this year and 1.6% in 2024, although these forecasts, predate the recent problems in parts of the banking system.**

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