Marketing Communication

Pulse

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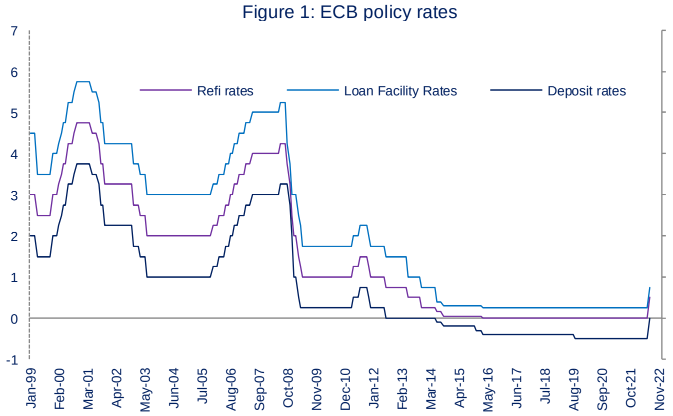
A bumpy road ahead for the ECB

Following Italy's PM Mario Draghi definite resignation, all eyes were on the July ECB meeting which was the occasion for several novelties. Contrary to the 25bp expected for the main refinancing rate, and signalled in June, the three policy rates were increased by 50bp. Two preliminary observations: this is the first time in its history the ECB lifts his effective rate by 50bp one shot, and second ECB introduces a dose of discretion in the conduct of its monetary policy at the expense of its future forward guidance. The likely and progressive end of the ECB's forward guidance echoes to monetary surprises seen over the past few weeks. After detailing the ECB's announcements, we focus on the reasons behind the abandonment of forward guidance and how much credit investors are giving to the ECB's normalization.

After 8 years, back to zero !

The main refinancing rate was raised to 0.5% and the deposit rate is now back to zero for the first time since 2014. The marginal lending rate[1] is set to 0.75%. President Lagarde defended the Governing Council decision by indicating the decision was taken unanimously insisting therefore on the strong commitment of the Board to carry out the missions defined in its mandate. The Governor has also insisted on the ECB's high dependency to the incoming data. As such, the decision was cemented on concerns over inflation risks, which still take priority over growth risks so far, and on the newly announced Transmission Policy Instrument tool (or anti-fragmentation tool see below) would enable the Euro Area removing any sovereign risk. However, although the ECB did acknowledge that the economy is slowing and risks to growth were on the rise, an ongoing recovery remained as the central bank's central scenario.

Figure 1: ECB policy rates



Several developments about inflation were mentioned: upside surprise in June's headline print. Headline inflation reached 8,6% in June (yoy) while core continued to increase to xx% yoy); continued broadening of price pressures; and the weakening of the EUR. In addition, today's release of the Survey of Professional Forecasters came in line with the ECB's worries as respondents have revised up their inflation expectations for 2022, 2023 and 2024. These stand at 7.3%, 3.6% and 2.1%, respectively, 1.3, 1.2 and 0.2 percentage points higher compared to three months ago. Now, all of them above the 2% long-term target.

Constructive ambiguity and end of forward guidance

Abandoning the forward guidance seems to be a "new normal". But why? This can be partly explained by the atypical nature of the economic cycle we are currently experiencing. Since March 2020, the volatility of the business cycle stayed elevated increasing central bank dependency to the economic data news-flow. From a general perspective, a volatile macroeconomic cycle cannot be addressed by being tied to a forward guidance. This context implies for central banks to keep room for maneuver, i.e. be able to surprise. **Surprises could be now the rule!**

Particular attention was paid to the details of the newly developed anti-fragmentation tool, named as Transmission Protection Instrument (TPI). Overall, although purchases will not be restricted ex-ante and thus could be seen as open-ended and will focus on public sector securities but could also consider private ones, the instrument effectiveness remains to be seen. The language used to describe the tool does leave plenty margin of manoeuvre to make judgement calls at each specific case. For instance, the lack of reference to what would trigger the activation of the tool risks being a source of disagreement among ECB members. In addition, the country eligibility criteria: "compliance with EU fiscal framework…"; "absence of severe macroeconomic imbalances…", make us wonder why a country that meets those conditions would require assistance in the first place.

This constructed ambiguity appears as an implicit but timid "whatever it takes" stance. However, this same ambiguity is likely to be challenged by markets at some point, especially if heightened political and credit risk push sovereign spreads wider. While markets were seeing a 50% probability to see a 50bp hike and there are arguably plenty of reasons to remain as flexible as possible, the ECB's decision represents a material blow to the central banks hardly earned forward guidance policy tool. It is true that President Lagarde acknowledge that by frontloading hikes now they will be able to transition to a meeting-by-meeting approach to interest rate decision, this decision could backfire the ECB in the future.

Bottom line

Taking all the above into account, we believe that the ECB may now be looking to raise interest rates more than that we had previously envisioned. Before the meeting, our expectation for yearend were to see the deposit rate at 1% and the main refinancing rate at 1.25%. We have now increased both expected levels by 25bp, to 1.25% and 1.5%, respectively. However, its achievement remains highly dependent on the extent of the economic impact induced by exogenous factors, such as the war in Ukraine and Nord Stream pipeline pressures. Indeed, the increasing likelihood to see a recession by that time, is risking seeing a repeat of "Trichet Syndrome"[2]

[1] The marginal lending facility rate is the interest rate banks pay when they borrow from the ECB overnight. When they do this, they have to provide collateral, for example securities, to guarantee that the money will be paid back

[2] Rising inflation expectations in 2008 and 2011 led ECB to hike despite signals of the financials and Eurozone debt crises were already being felt.

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