ZURICH | Topical Thoughts
July 2022

The ECB exits negative rates with 50bp hike

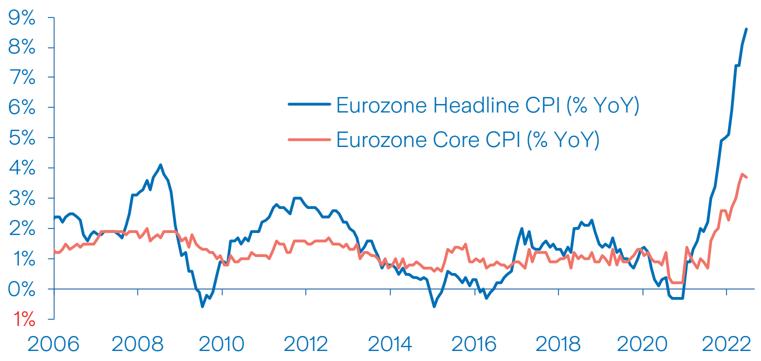
The larger rate increase is offset by unlimited TPI

The ECB surprised with a 50bp rate increase on July 21, 2022 compared to the 25bp it had previously indicated. However, the ECB also announced a new anti-fragmentation tool potentially unlimited in size, the Transmission Protection Instrument (TPI), to contain volatility in Eurozone government bond markets. We welcome the quick exit from negative interest rates and think that not limiting the size of the TPI ex-ante was also the right decision. Paradoxically, it makes it less likely to be needed. However, the Eurozone still faces a difficult economic outlook over the next few quarters, with increasing signs that the region is slipping into recession.

No more negativity

At its monetary policy meeting July 21, 2022 the ECB surprised with a 50bp rate increase, raising its deposit rate from -0.50% to zero. This was a larger rate hike than the 25bp increase it had indicated for this month as recently at its June 2022 monetary policy meeting and was clearly driven by the still elevated levels of inflation in the Eurozone. The deposit rate was first cut into negative territory in 2014 and with this first rate rise in eleven years, the ECB has now exited its negative interest rate policy. We welcome this development as we have argued for some time that negative interest rates are counterproductive and distort the economy and financial markets.

Eurozone inflation continues to hit record highs



Source: Bloomberg

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The ECB also announced some of the details of the Transmission Protection Instrument (TPI) designed to 'counter unwarranted, disorderly market dynamics' and by implication a large widening in periphery government bond spreads. The ECB said that TPI purchases, if they were to happen, would be focused mainly on government bonds with a remaining maturity of one to ten years, while 'purchases of private sector securities could be considered, if appropriate'.

Importantly, the ECB said that there would be no ex-ante limits on the size of a potential TPI intervention. Indeed, ECB President Christine Lagarde said that 'The scale of TPI purchases depends on the severity of the risks facing policy transmission. Purchases are not restricted ex ante'. If the new instrument had been limited in size it would have been potentially less credible and more likely to be tested by the market. Paradoxically the larger in size it is, the less likely it will be needed to be used at all. This is a point we have also made previously (see our June 10, 2022 Topical Thought, "Pressure mounts on the ECB to act").

Overall, the decision seems to have been a practical compromise between hawks and doves on the ECB's governing council. The hawks obtained a larger initial rate increase, while the doves obtained a TPI instrument potentially unlimited in size, essentially a large monetary bazooka that could be used if needed to calm down periphery bond market volatility and spread widening, and the ECB probably is hoping that it will never actually need to be used at all.

Leaving behind forward guidance

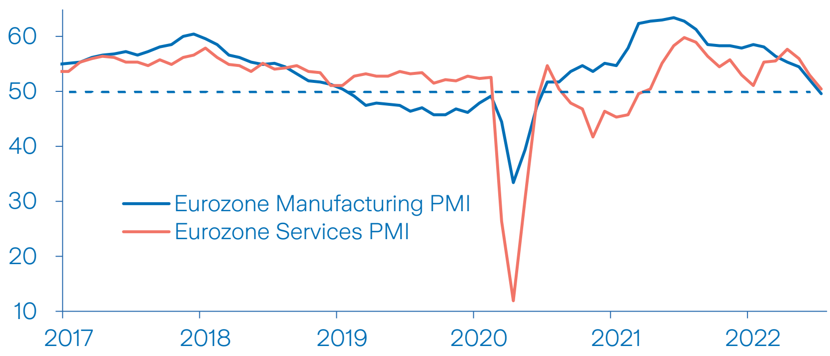
The ECB also departed from previous policy by saying that from now on monetary policy decisions will be 'on a data-dependent basis' and 'will operate month by month and step by step', thereby abandoning or at least reducing emphasis on its previous policy of forward guidance where it would indicate its plans for monetary policy. For example, previously, the ECB had given a strong hint that it was likely to increase interest rates by 50bp or more at its September 8, 2022 monetary policy meeting whereas now it has given itself more flexibility.

The ECB is trying to get rate increases in whilst it can

Lagarde also referred to 'front-loading' rate increases, and this makes sense. With the economic outlook deteriorating, the longer it waits the harder the ECB may find it to engage in further rate increases. We still expect a 50bp rate increase at the September 2022 meeting followed by just 25bp some time in Q4, and then think the ECB will have to stay on hold in 2023 as by then the Eurozone economy will be in recession, if not before.

Indeed, the July 2022 Eurozone Flash PMI data released the day after the ECB meeting are concerning, with the Eurozone Manufacturing PMI already below the 50 expansion/contraction level and the Services PMI approaching that level. Both the Manufacturing and Services PMIs were worse than consensus expected and worryingly forward-looking indicators within the survey such as new orders are already well below 50 and deteriorating.

The Eurozone is heading towards recession



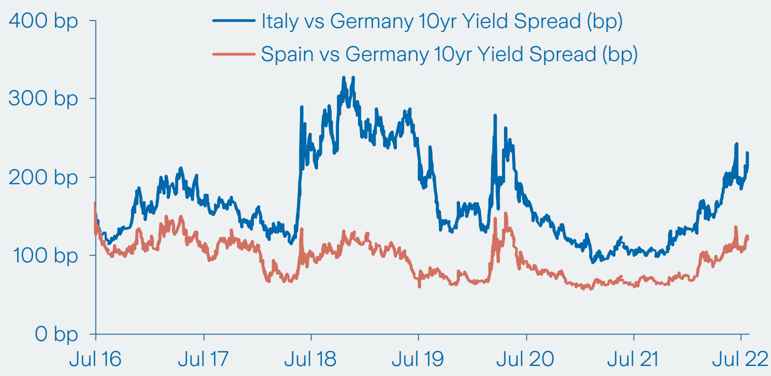
Source: Bloomberg

Image source: iStock

Expect a volatile summer for Italian bond spreads
On the same day as the ECB meeting was held, Italian Prime Minister Mario Draghi resigned. Fresh elections have been called for September 25, 2022 and the centre-right parties are currently leading in the polls and expected to form the next coalition government. However, from an investor perspective, anything compared to Mario Draghi's technocratic leadership could be seen as second best.

Italian government bond spreads relative to Germany's have already widened in response to the political uncertainty, but Lagarde refused to comment on whether the ECB would intervene and it is probably too early for the ECB do so. Italian bond spreads will therefore likely remain volatile over the summer months and at least until a new government is in place.

Italian bond spreads widen further on political volatility



Source: Bloomberg

The next Italian government will have strong incentives to regain investor confidence

Investors are attaching an extra risk premium to Italian assets and will likely require some extra yield until the election results are available, a new coalition government is formed, and the 2023 budget is decided. However, we do not anticipate a repetition of the Eurozone debt crisis. As well as the ECB now having more tools to prevent such a development, the institutions of the Eurozone are also more robust with common debt issuance at the EU level, for example, agreed during the Covid crisis within the context of the NextGenerationEU EUR 800bn stimulus package. Indeed, whatever new government is in place in Italy, it will have a strong incentive to continue with economic reforms and infrastructure investment in order to continue receiving funds from this package.

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