ZURICH

Topical Thoughts
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# Pressure mounts on the ECB to act

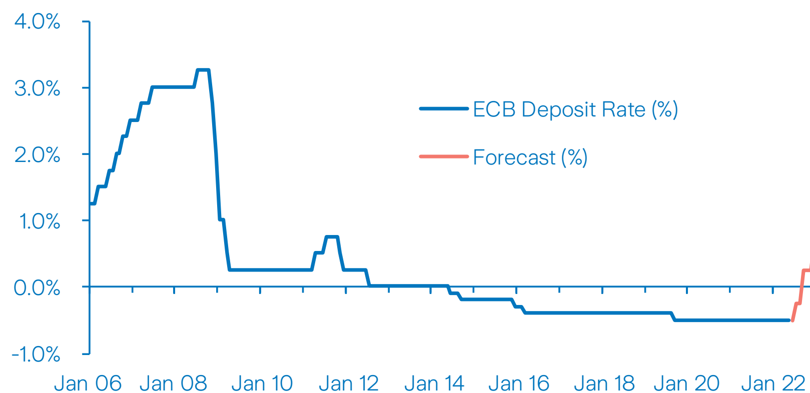
The ECB will need to guard against fragmentation risks as it raises rates

With inflation in the Eurozone hitting fresh record highs, the ECB is coming under increasing pressure to exit negative policy rates sooner rather than later. While some commentators may be concerned that raising rates will slow the recovery, we would welcome such a development and do not think that the process of exiting negative interest rates is likely to materially slow the economy down by itself. However, the ECB will have to guard against a further large widening in Eurozone government bond spreads, so-called 'fragmentation risk'. Indeed, it should be prepared to restart a government bond buying programme if needed, which would effectively usher in a period of yield curve control for the region.

**Time for action**

Pressure is increasing on the ECB to exit negative interest rates. Eurozone inflation hit a fresh record high of 8.1% YoY in May, and core inflation rose to 3.8%, both well above the ECB's 2% symmetric inflation target. However, the ECB is currently still engaged in Quantitative Easing (QE), buying around EUR 30bn of assets in May (mainly Eurozone government bonds) and is scheduled to buy around EUR 20bn in June through its Asset Purchase Programme (APP). The ECB has already said that net asset purchases under the APP will end on July 1. However, the ECB's main policy rate, the deposit rate, which it first moved into negative territory in 2014, is currently sitting at -0.5%. Such an extremely accommodative monetary policy no longer seems appropriate given the current high and increasing pace of inflation.

**ECB expected to raise rates in July for first time in 11 years**




Source: Bloomberg

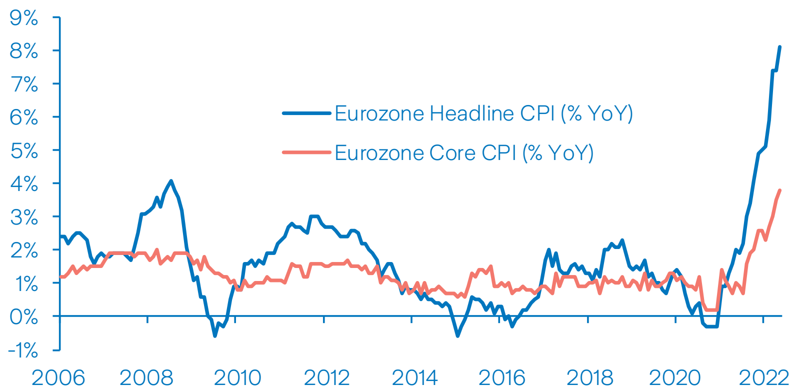
Front cover image source: iStock

### Energy inflation hits record highs

Admittedly, a large part of the current high inflation rate in the Eurozone is due to energy and food price inflation, which the ECB can do little about in the short term. Energy inflation has hit record highs in 2022 and is contributing around four percentage points to the total headline inflation of around 8% (i.e., around half of the total headline inflation rate is due to energy prices). Food price inflation is contributing around another one percentage point to headline inflation.

Due to high demand and tight supply, oil and natural gas prices have risen sharply in recent months. The spike was not just due to the Russian invasion of Ukraine on February 24 as prices were increasing even before then. Natural gas prices in Europe more than quadrupled over the course of 2021 and while they have fallen back somewhat recently, they are still currently around three times higher than they were a year ago in June 2021. Meanwhile, oil and food prices continue to grind higher, and the Russian invasion of Ukraine is likely to keep the prices of these commodities high going forward. Indeed, food prices could well spike higher over the next new few months and quarters given that there are few signs of a resolution to the geopolitical crisis yet and both countries are big producers and exporters of agricultural products. What's more, measures of Eurozone core inflation have also picked up sharply in recent months as very high producer price inflation due to rising input costs gradually feeds through the production chain to higher consumer prices.

**Both core and headline inflation continue to surge**

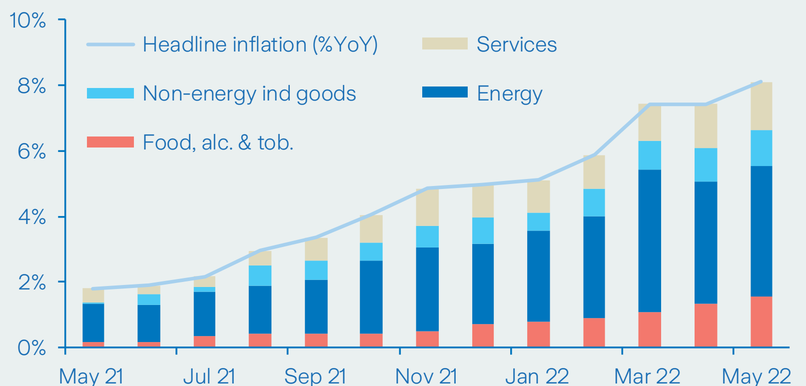



Source: Bloomberg

### Stagflation risks increase the longer headline inflation rates stay high

As mentioned earlier, in the short term, there is not much that the ECB can do about high energy prices and food prices. Nevertheless, the ECB should be concerned that current high inflation rates do not become ingrained in the economic system, for example by raising long-term inflation expectations. Persistently high inflation creates economic uncertainty for households and businesses and can also create instability in asset markets, with the danger of a stagflationary scenario similar to the 1970s when a wage-price spiral developed. Wage agreements struck so far this year between employers and unions do not seem to be suggesting such a development, and there is still some slack in labour markets in the Eurozone, but the risk increases the longer such record high headline inflation rates continue.

**Energy and food prices are the biggest contributors to Eurozone inflation**




Source: Bloomberg, ZIG

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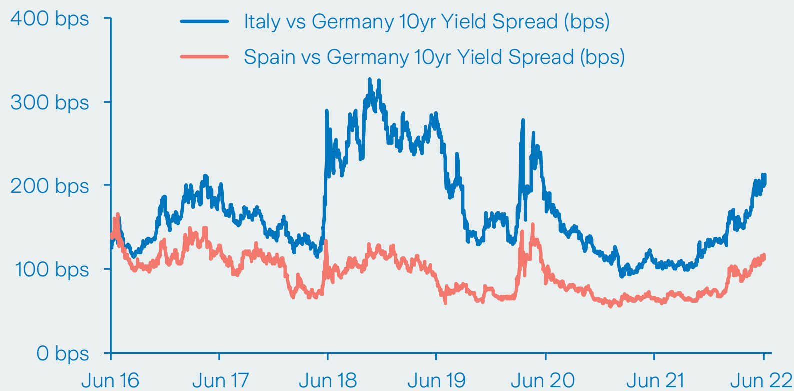
**Negative interest rates distort the financial system**
The ECB is discussing the size and pace of future rate hikes and how and when to exit negative interest rates. On May 23, in a blog posted on the ECB website, Christine Lagarde said that it was planning to raise interest rates at its July 21 monetary policy meeting and then to raise interest rates again at its September 8 meeting, so as to 'exit negative interest rates by the end of the third quarter'. This implied a 25bp pace of rate increases at the July and September meetings. Her comments were echoed by ECB Chief Economist Philip Lane a week later in an interview on May 30, where he explicitly mentioned that the ECB would proceed gradually in 25bp rate hike steps. However, other members of the ECB governing council have called for a more rapid exit from negative interest rates. For example, Austrian central bank governor, Robert Holzmann, called for a 50bp rate increase recently, as have other so-called 'hawks' on the ECB governing council. Indeed, more recently, at the June 9 ECB monetary meeting Lagarde stated that it would raise interest rates by 25bp in July, and then 50bp in September if high inflation persisted.

Whether the ECB proceeds in 25bp or 50bp steps over the next few months and quarters or some combination thereof is not the most important point from our perspective. We have long argued that negative interest rates are counterproductive and distort the financial system, so exiting negative interest rates should be a good thing for the economy. Negative interest rates can endanger financial stability, create perverse incentives for saving and investing, as well as create asset bubbles, whilst at the same time impacting financial institutions profitability and ability to lend. However, the process of ending negative interest rates should not be done in too disruptive a manner.

**The ECB needs a credible plan to deal with fragmentation risks**
It is crucial that the ECB also has in place a backstop should there be a large widening in government bond spreads between periphery and core government bond yields, which the ECB calls fragmentation risk. Much wider government bond spreads in the region would raise the cost of borrowing and spending for countries with large debt burdens and could be a substantial drag on growth for these countries. In an extreme scenario a widening in Eurozone government bond spreads could trigger investor fears of another Eurozone sovereign debt crisis developing. It is important to emphasize that this is not our base case scenario. The institutions of the EU and the Eurozone region are stronger than they were a few years ago with the development of the NextGenerationEU initiative including more common issuance of debt at an EU level. Nevertheless, there is no room for complacency and the ECB should clearly set out its intentions under the risks of such a scenario and have a bond buying programme already prepared that it could activate if needed and make this clear to investors. Paradoxically, the more credible this measure the less likely it will need to be used in large amounts.

**Periphery spreads are already at their widest in two years**

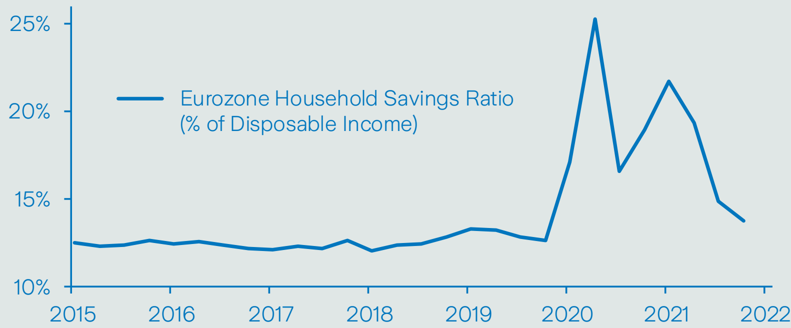



Source: Bloomberg

### 2011 (and 2008) all over again?

The ECB's timing on raising interest rates has not been great in recent years. The last time it engaged in a rate tightening cycle was in 2011 (just before the Eurozone debt crisis) and the time before that was in 2008, just ahead of the Global Financial Crisis (GFC), and there is clearly a risk that it will tighten policy again just ahead of another downturn. While we do not think that the global economy will tip into recession this year, we do think the risk of a mild recession by the second half of 2023 is high. The ongoing squeeze on consumers' real incomes will gradually translate into lower spending growth, especially once households have eaten into their excess savings buffer that they had built up recently. In addition, ongoing economic and geopolitical uncertainty will likely weigh on companies' hiring and investment plans

**Households have built up excess savings, but these will not last indefinitely**




Source: Bloomberg

### Conclusions

We do not think that the key determinant of whether the Eurozone tips into recession is whether the ECB raises interest rates a few times this year and next. Rather, in 2022, the biggest near-term risk is of a further escalation in the war in Ukraine, which could lead to natural gas flows into Europe stopping and/or gas having to be rationed over the winter months.

Assuming that does not happen and looking further ahead to 2023, the continued squeeze on real incomes is likely to eventually lead to households cutting back on spending, especially once they have used up their excess savings. A few rate hikes by the ECB are unlikely to change the chances of this happening either way as it will not make a big difference to the cost of borrowing for most households and companies, while controlling long-term inflation expectations and preventing them from becoming de-anchored is an extremely important policy objective to support growth in the long term.

Therefore, to control inflation expectations and maintain its credibility the ECB should not hesitate in exiting negative interest rates which are counter-productive anyway in our opinion and in the long-term can endanger financial stability. At the same time, however, the ECB should have a plan in place to prevent periphery spreads from widening too much, as this could weigh on growth more substantially. The ECB has said that it will act if needed, and we think it should flesh out these plans as clearly as possible and be ready to prevent fragmentation risks getting out of hand.

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