Wide Angle Shot: Pyrrhic victory on ECB rates, TPI as "hidden" Eurobonds?

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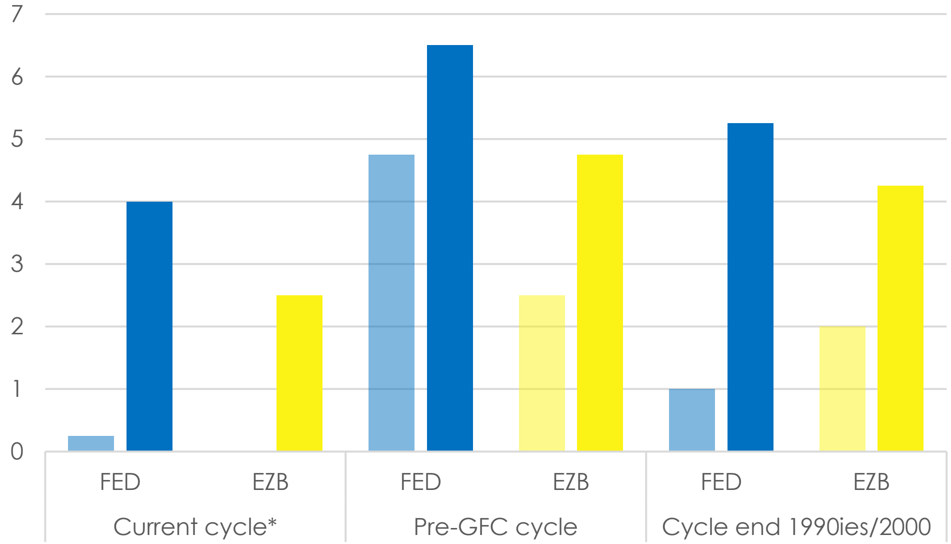
In July, ECB opened a new chapter in its monetary policy. After eight years, negative rates policy has come to an end. For the third time in history a bold 50bp hike was delivered plus further determined hikes were announced. Attention is drawn to a new government bond purchase programme TPI, which is supposed to prevent (strong) increases in yields of (indebted) euro countries. We think markets will challenge the ECB ... maybe also courts.

Historic ECB day for several reasons

21 July 2022 could go down as a historic day in the history of the European Central Bank (ECB) and the euro.

- Firstly, ECB has completed the **exit** from the **negative interest rate policy** that has characterized the money market with exceptionally low/negative nominal interest rates since 2014 (in contrast to the USA). Later, "compensation mechanisms" and much need for corrections in the banking sector became necessary. With the end of negative interest rates, the legacy of Mario Draghi's monetary policy was also partially laid to rest, on the very day he failed as Italian prime minister.

Key rates Europe & US (%)
Current (expected) cycle and past cycles



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** expected rate hikes ECB 250bp, US 375 bp; GFC = Global Financial Crisis*

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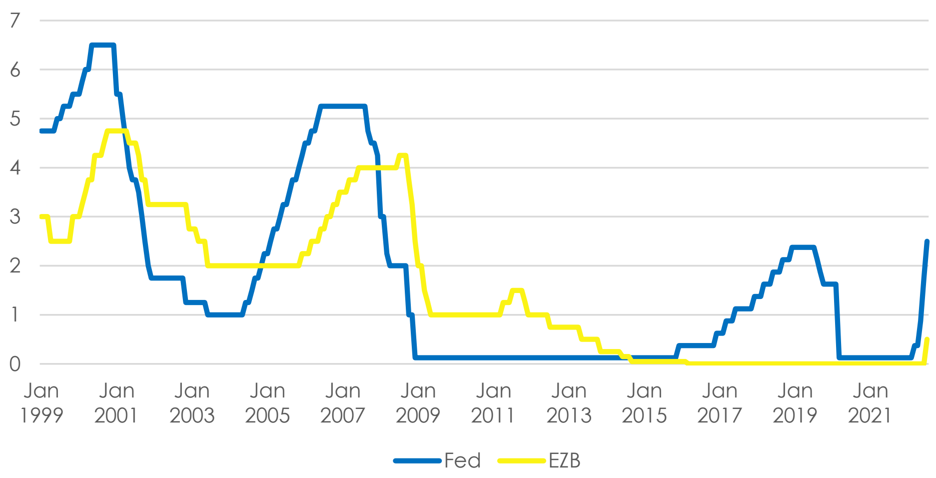
- Secondly, it was **only the third time** in history that ECB raised interest rates **by 50bp**. The last time for such a move was two decades ago (April 2000). Usually, ECB has implemented rate hikes of 25bp. The ECB is traditionally a less activist central bank than, say, the US Fed, with usually a different "reaction function".
- Thirdly, 21 July will most likely mark the **beginning of a longer-lasting process of interest rate normalisation**, after a special phase of monetary policy non-reaction in Europe and the partial decoupling from international key interest rate trends in the last decade. The end of the current interest rate policy journey was — deliberately — left open by ECB President Christine Lagarde. Not only did the negative interest rate policy come to an end on 21 July, but also the interest rate policy "promises" or **forward guidance** that were used extensively under Mario Draghi. Under its new head Lagarde, the ECB had long been more hesitant to make too many forward commitments. Now the ECB chief dared to turn around her forward guidance within days. Interestingly, this all points to **more data-driven monetary policy decisions** at the ECB and thus **more interest rate and capital market volatility.**
- Fourthly, it is all the more astonishing that the ECB wants to (**permanently) limit the structurally increasing interest rate** and financial market fluctuations in the euro area with **a new government bond purchase instrument, the TPI** (Transmission Protection Instrument). Here again, special correction mechanisms seem to be introduced through the back door.

Like us, President Christine Lagarde described the latest ECB meeting in July as historic. Her argument refers to the **unanimity** of all 25 Council members **on the core decisions**. The superficial unanimity should not obscure how different the interests of the national central bank presidents, but also of the ECB Executive Board, are. The fact that a unanimous decision was reached is probably due to the willingness of the **"doves" and "hawks"** in the ECB Governing Council **to compromise.** For in themselves, the two core decisions (significant interest rate tightening, TPI) are contradictory.

Key rates euro area & US (%)



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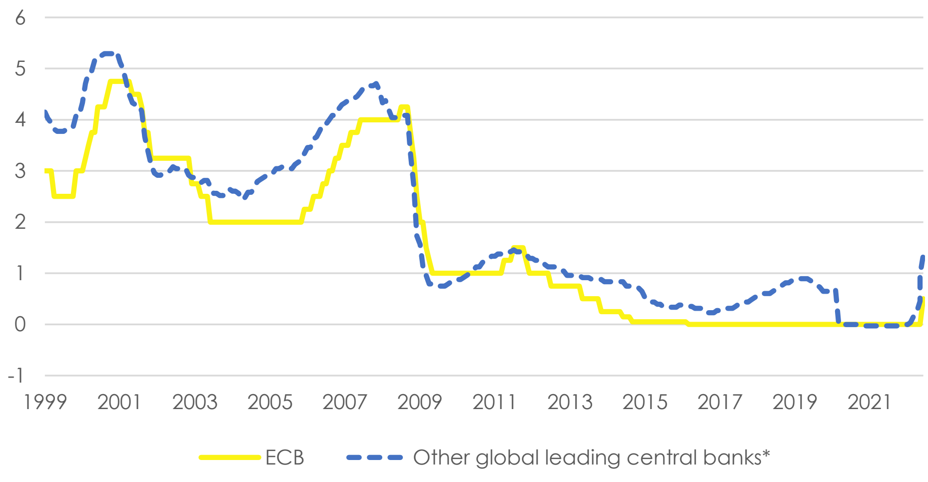
Only third interest rate hike cycle in euro history

We are now looking ahead to the **third rate hike cycle in the history** of the ECB. The first was from November 1999 to October 2000, the second from December 2005 to 2008. Interestingly, the rate hike cycles ended after **225bp**. However, the starting level was clearly in positive territory at 2.5% (1999) and 2.0% (2005) and significantly higher than now. Given these "flat" monetary policy cycles, the latest **50bp rate hike** to start with is **remarkable**. As recently as 9 June and in the "old thinking" of pre-fixing, Ms Lagarde announced in the press conference an interest rate move of 25bp for July, possibly 50bp then in September. But ECB had to take note that the inflation path from May (8.1%) to June (8.6%) has unexpectedly increased again. In addition, the ECB was increasingly the focus of criticism for having underestimated inflation for a long time when it was at its highest level in 50 years. Meanwhile, other central banks around the world have already taken strong steps to raise interest rates and have announced further measures. The US Federal Reserve has already put its money where its mouth is with 225bp of hikes so far (incl. the 75bp as of July 27).

ECB under (global) pressure to act

In this environment, ECB had to follow suit, because central banks do not act in a vacuum, but **influence** each other, among other things **through international interest rate and exchange rate** channels. Since the euro has lost 17% of its value against the USD in the last 18 months, a strong interest rate signal was also needed to stabilise the exchange rate or to **focus on fighting inflation**. As energy and commodity prices are traded in USD, the significant depreciation of the euro has pushed up energy prices in the euro area far more than in the US or China. Imported inflation puts an additional burden on companies and consumers alike via the exchange rate effect, while the lower euro exchange rate has hardly any stimulating effect in the current global economic environment. ECB has no influence on energy prices, but in coordination with the Federal Reserve's monetary policy it can influence the exchange rate. The ECB's long extremely expansionary stance by international standards played a significant role (alongside economic and political risks) in the euro's depreciation.

Key rates euro aare & global perspective (%)



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** Average USA, Canada, Australia, Switzerland, Sweden*

Accelerated interest rate journey upwards

With the latest interest rate move, ECB has made a U-turn towards prioritising inflation. The Governing Council's updated assessment of inflation risks suggests that even **more such 50bp rate hikes** should be decided at the upcoming meeting(s) in the course of 2022. For the September meeting in particular, the Governing Council has already indirectly committed itself: On September 9, **new ECB economic projections** will be published, and there is a high need for revisions in the light of the "current" June projections (HICP 2022: +6.8%, 2023: +3.5% and 2024: +2.1%). We already see the increasing pressure on the core inflation rate much more critically than the ECB — at least according to its previous forecasts. And since Christine Lagarde has abolished forward guidance and **monetary policy decisions** are **data-dependent** and reassessed month by month as well as influenced by the ECB's quarterly inflation projections, a striking rate hike in September is not a bold announcement. The upcoming economic forecasts in December could bring further upward revisions to inflation estimates.

ECB leaves end of the interest rate cycle open

ECB chief Lagarde has left **open how far the interest rate journey** will go upwards. The question of the **neutral interest rate**, which has neither an expansionary nor a restrictive effect on the economy and price formation, is still disputed in the ECB Council. It is probably currently set at plus/minus 1.5%. However, Christine Lagarde indicated at the July press conference that demographics and productivity could move the neutral interest rate slightly upwards in the future or that it could be more in the range of 1.5-2 %. As stated, the two rate hike cycles in ECB's history so far have brought a total rate increase of 225bp each. This is at least a good indication for the current interest rate journey, which **we expect to be as high as 250bp**. Given the current record inflation, a **shorter time horizon to target** can be assumed than in the past. Moreover, the current inflation environment may force the ECB — if we avoid a deep recession in Europe — to initially raise the key rate into the **slightly restrictive range** or at least to the upper edge of the neutral interest rate range in 2023, with inflation risks weighted higher.

Since ECB has long underestimated the persistence of inflation and is now reacting late, significant interest rate hikes are necessary. This is because the effective **time lag of conventional monetary policy measures** until the price formation process (in contrast to unconventional direct market control) takes a long time, i.e. 6 to 18 months, and this is especially true in the bank-financed euro area. Thus, it is also clear that this first step will have virtually no impact on the inflation rate in the coming months. Interest rate hikes in 2022 will have a dampening effect on prices in the course of 2023 at the earliest. But with its energetic first interest rate step and announced further ones in this tone, ECB wants to keep **second-round effects in check**. There is also great urgency to do so, as the European labour market is extremely robust despite stagflationary tendencies. Wage increases for 2023 will be substantial. In Austria, we expect wage agreements that could have a six before the decimal point.

First success: inflation expectations and financial markets react positively

In anticipation of a tighter monetary policy by the ECB with a commitment to the mandate of price stability, **inflation expectations** on the financial market have **fallen back to the 2%** price target mark since the press conference on 21 July. This is the lowest level since the beginning of March 2022. As inflation expectations are an important input factor for monetary policy assessments, this can be chalked up as a success. A firming above the 2% mark, as already achieved in May 2022 with 2.5%, would have a negative impact on the wage-pricing process and make it more difficult to fight inflation. Financial markets (EUR/USD, stock markets, bond markets) have otherwise reacted to the ECB turnaround in a rather restrained to slightly positive manner. The widening of the **yield differential** between **German and Italian 10-year government bonds** to 240 basis points has occurred primarily due to the German yield decline, which Italy was only insufficiently able to follow due to the current government crisis. What we would like to emphasize is that we now see a prolonged period of market uncertainty regarding ECB's interest rate path. Ultimately, many market observers are asking themselves **how far the ECB** will get in the **interest rate policy cycle** before cyclical risks dominate and how much normalization a (tacit) **pact between hawks** (restrictive interest rate policy) **and doves** (expansionary monetary policy, cushioning interest rate hikes) in the ECB Governing Council will allow for.

TPI: QE in a hiking cycle - market and legal test to come

And this brings another key decision of the ECB Governing Council to the fore: the announcement of a **new instrument TPI** (Transmission Protection Instrument). Whether the new name — previously there was talk of an anti-fragmentation instrument — reflects the intentions of the spread limits is to be judged rather skeptically. The new name conjured out of a hat is supposed to suggest that it is "only" about safeguarding monetary policy transmission, not about capital market fragmentation in the euro area. Nevertheless, it is interesting that **with the announcement** of the much-needed **normalization of monetary policy**, a **new "crisis instrument" is simultaneously launched** and/or an implicit continuation of quantitative easing is pursued in order to perpetuate government bond purchases (beyond reinvestments from existing bond purchase programmes). One must critically question this instrument for several reasons.

- A **government bond purchase programme** is a one-sided **instrument of expansionary monetary policy** or serves to raise inflation expectations. It is therefore inconsistent with a cycle of interest rate hikes in the face of inflation risks. The additional money creation would have to be neutralised and/or the government bond holdings in the ECB balance sheet would have to remain constant - which is currently not foreseeable or practicable.
- Virtually **no hard conditions** have been formulated for eligible states. The **ECB** will also not publish the criteria and wants to **decide on TPI use alone.** Only four vague general formulas have been mentioned by President Lagarde: Compliance with EU fiscal rules, no severe economic imbalances, sustainability of public budgets and sound and sustainable economic policies. The door is wide open to the scope for assessment. In any case, critics can be expected to sue, regardless of how and to what extent the TPI will/must be used. We think that **lawsuits** may well result in higher ex-ante transparency and accountability obligations for the ECB. The latter are the anchor of central bank independence and should also be observed by ECB.
- The TPI is activated when **"unwarranted, disorderly market dynamics"** set in. What is meant by this? Who and which institution presumes to know which yield differentials between states are "fundamentally" justified? Here, too, arbitrariness is to be feared. Especially since, as already discussed, yield differentials are a complex interplay of many fundamental and/or political factors. In this respect, we expect the **market to test ECB**. This is also because the ECB under its current leadership does not have the nimbus of market control as it did under Mario Draghi, and there is certainly the threat of some political volatility in Italy in the further course of the year.
- Since the **TPI** can be used **without limits** (time, volume) and there are no exit criteria, the ECB is **close to** the border of **monetary public finance.** For this reason, too, we see high risks of legal action. A limitation in terms of time and/or content to special phases in monetary policy would have been more expedient than a non-limitation - also taking into account the risk of lawsuits. Critical market observers see the TPI as a **de facto** introduction of **Eurobonds** through the back door, an interpretation that should not remain hidden from the German Federal Constitutional Court.

Now three QE programmes to choose from

According to the press text and statements by Christine Lagarde, the **TPI** joins the quantitative measures as **third instrument.** The flexible **re-investments** of the PEPP (Pandemic Emergency Purchase Program) remain the main instrument for capital market steering. In addition, the less popular **conditional OMT** (Outright Monetary Transactions) is (for the time being) **pushed into insignificance** by the TPI. If Mario Draghi's OMT programme was already called "Fat Berta" in 2012, the TPI is (for the time being) even more powerful! It is possible that with the benefit of hindsight the ECB's turnaround in interest rate policy in July 2022 will be a **Pyrrhic victory** for the **"hawks"** in the ECB Governing Council — from the mostly budget-stable countries, where the interest rate turnaround was partly "celebrated". For a **faster and more or less unavoidable normalization of interest rates,** which was necessary anyway, the **unlimited TPI** was apparently **installed in exchange.** We think a timing and volume limitations would have been justifiable and possibly less short-sighted. A later conceivable judicial containment of the ECB should not be conducive to the credibility of the institution and financial market stability.

Fighting symptoms instead of causes - the example of Italy

Once again it becomes clear that the **ECB can fight symptoms** (rising yields) with ever new instruments, but the **causes lie far beyond its sphere of influence. Italy**, for example, does not primarily have a budget and debt problem, but a **growth and productivity problem**. Since 2007, Germany (with strong immigration!) has recorded an increase in GDP/capita of +10.1%, Italy a decline of -8.8%! Italy is also paradoxically helped more by solid rate hikes than by lax monetary policy in an inflationary environment. The more the ECB raises its key rates, the more long-term inflation expectations remain close to the 2% price target. The first success since the ECB meeting has become visible in this. As a result, capital market yields rise less than with lax monetary policy because the inflation premium is priced lower in bond yields. At times in recent months, the inflation premium in the euro capital market has been 0.5% (with inflation expectations of 2.5%). As confidence in a vigorous fight against inflation and its success increases, long-term capital market yields are significantly lower. Since Italy secures its financing needs on the capital market and not on the money market, vigorous interest rate hikes are **not per se counterproductive** for countries **with high financing needs**.

Strategic victory of the "doves" over the "hawks"?

Overall, the "**doves"** in the ECB Governing Council have **probably won a strategic victory over the "hawks**". A more or less unavoidable accelerated interest rate path (supporting structurally lower market yields) as well as the TPI suit the fiscally weak euro states. The incentives for responsible budgetary policy at the national level have again fallen by the wayside. Instead, **TPI** allows for a **limitation of financial market warning signals** regarding national economic policies. The use of the unloved OMT and ESM (in an extreme scenario, debt restructuring would be possible here) is not foreseeable. Moreover, in times of high inflation, a competition of populist money spending is now to be feared. Thus, we see the euro continuing to be burdened. Especially since we think that the TPI will still bring some legal repercussions and need for clarification — which the "hawks" in the ECB Governing Council may be counting on. We think that the **financial markets will test ECB** in the coming months to see how much interest rate and capital market volatility it is willing to allow — which is what has been put forward ... and now shall be once again limited through the back door with the (unlimited) TPI.

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