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ECB July Meeting Reaction: ECB goes big, but euro rally falters

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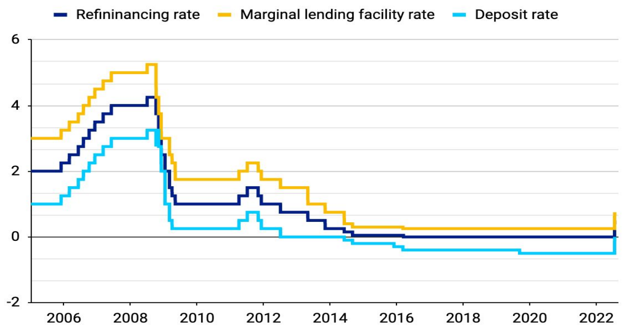
ECB goes big, but euro rally falters

The European Central Bank delivered a larger-than-expected 50 basis point interest rate hike on Thursday afternoon, as policymakers in the bloc grapple to rein in the sharp increase in inflation in the Euro Area.

We have been saying for some time that the ECB was well behind the curve in raising interest rates, and that it had much more room to exceed market expectations than its major peers. With inflation breaking to fresh highs, the euro still trading near parity on the dollar, and the Nord Stream 1 gas pipeline reopening on Thursday, there was a general consensus that a half a percentage point hike would be appropriate, even if it wasn't universally expected. Yet, despite the growing risk of a Euro Area recession in 2022, the Governing Council opted to raise all three of its deposit, refinancing and marginal lending facility rates by 50 basis points following this week's meeting - the first rate hikes in the bloc since 2011. Following yesterday's decision, the ECB ends an 8-year era of negative rates.

Figure 1: ECB Key Interest Rates [%] (2005 - 2022)



Source: Bloomberg Date: 22/07/2022

Prior to the meeting, the debate centred around both the magnitude of the well telegraphed interest rate hike, and the details on the bank's new anti-fragmentation tool. Regarding its rate decision, the ECB noted that a larger move than previously signalled was appropriate, considering the updated assessment of inflation risks and the introduction of the Transmission Protection Instrument (TPI). The Governing Council also indicated that a further normalisation of interest rates was on the way. The bank called yesterday's hike 'frontloading' but was, however, non-committal with regards to the scale of further rate increases. Importantly, President Lagarde mentioned that the previous guidance for the September meeting no longer applies.

Both the statement and Lagarde's press conference stressed data-dependence. The ECB will take a 'meeting-by-meeting approach' to rate decisions, which seems sensible considering the rapidly changing outlook and balance of risks. This is a clear shift from the bank's previous approach, which placed a stronger emphasis on providing forward guidance. President Lagarde's comments regarding the economic outlook were mixed. She reiterated that a recession is not the ECB's baseline scenario in 2022 or 2023, but stated that the horizon is 'clouded'. She also stated that inflation will remain 'undesirably high' for some time, and risks to the outlook 'have intensified, particularly in the short term'. Lagarde also mentioned an impact of weakening euro on inflation pressures.

Transmission Protection Instrument (TPI)

After the ad-hoc meeting in mid-June, the ECB confirmed that it was working towards creating a solution to address fragmentation risk in the bloc, following an increase in bond yield spreads of periphery countries. At the July meeting, the instrument was approved by the Governing Council and, according to Lagarde, the decision was unanimous.

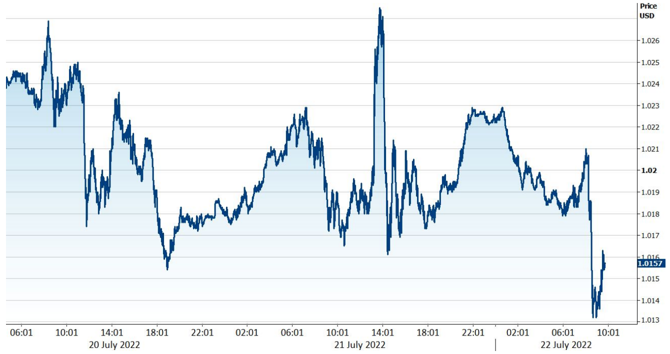
As the name suggests, the tool is designed to ensure a smooth transmission of the ECB's monetary policy across all Euro Area countries. The new instrument 'can be activated to counter unwarranted, disorderly market dynamics'. Under TPI, the Eurosystem 'will be able to make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals'. Importantly, the ECB did not restrict purchases upfront, and emphasised adjustment to the scale of purchases to the severity of issues at hand.

TPI purchases are set to focus on public sector securities although, if appropriate, the bank may consider buying private sector assets. The Governing Council outlined a set of eligibility criteria, which will be taken into account when deciding on activation of the new tool. President Lagarde stressed that all Euro Area members will be eligible for the TPI. The activation of the tool will depend on the market situation. Vice-president de Guindos stressed that the Council 'will not hesitate' to use the tool, although it would rather not do so.

How did the euro react to the announcement?

The reaction in the euro was interesting. The common currency initially rallied, as markets were only pricing in around a 50/50 chance of a 50bp move. It did, however, quickly give up all of its gains and returned to around the 1.02 level on the US dollar, where it was prior to yesterday's rate decision. We think that this retracement largely has to do with Lagarde's communications on the TPI, which didn't quite provide the level of detail that market participants were hoping for.

Figure 2: EUR/USD (20/07/2022 - 22/07/2022)



Source: Refinitiv Date: 22/07/2022

As we have commented in recent weeks, 50 is very much the new 25 when it comes to monetary policy normalisation in the current hiking cycle. We think that this applies to the ECB, and expect to see at least one more 50 bp rate increase at the next Governing Council meeting in September. The scale of moves beyond then will likely be highly dependent on upcoming inflation prints, energy supply developments and the possibility of a Euro Area recession. An increased risk of the latter may tip the balance in favour of a more cautious approach.

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