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ECB between Scylla & Charybdis: Stagflation vs. Fragmentation
Spyridon V. Branis
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Abstract

The euro area economy has been looking more like (the picture in) the U.S. and the U.K.: wage growth accelerates and inflation is getting stickier. Those concerns have pushed the European Central Bank (ECB) to act faster to tighten monetary policy. By leaving behind nearly a decade of negative interest rates, EU government bond yields in the periphery have crept into the "danger zone". The ECB is thus faced with a dilemma. It needs to tighten monetary policy in order to rein in unexpectedly high inflation and at the same time to prevent fragmentation of financial markets across the eurozone. The euro area may be about to experience something new: fragmentation in its financial markets in a situation characterized by stagflation. As Italian government bond yields climb, officials in Frankfurt assembled a new backstop anti-fragmentation tool for sovereign debt to make sure they can hike rates as needed to cool inflation. The developments and the public debates that had led to ECB's July 21 & September 8, October 27 and December 15 meetings decisions on interest rate hikes and the new anti-fragmentation tool are presented and discussed. The accumulated clouds of persistent inflation, the Russian-Ukrainian conflict, the energy crisis, Italian debt sustainability and the upcoming eurozone recession are presented in sync with market expectations and interest rate projections. A forward guidance, for the ECB policy in 2023 is presented. ECB will stay hawkish to anchor inflation expectations until core inflation is safely on target.

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"I don't think we are going to go back to that environment of low inflation . . . there are forces that have been unleashed . . . that we're facing now that are going to change the picture and the landscape within which we operate."
Christine Lagarde at Sintra ECB Forum on Central Banking, 29 June 2022

"History shows that fragmentation comes not only with a high economic cost to growth and jobs, but also potentially a high political one, with loss of public confidence in European institutions."
Lorenzo Bini Smaghi, Chair of Société Générale and a former member of the executive board of ECB, Financial Times Opinion article, 24 June 2022

"Having waited too long to raise interest rates as inflation built up, central banks are scrambling to control it without tipping their economies, and indeed the world, into deep recession."
Kenneth Rogoff, The Age of Inflation Easy Money, Hard Choices, Foreign Affairs, November/December 2022

Introduction

Skyrocketing energy prices have been deepening the negative supply shock hitting the European economy. High inflation along with growing recession risk have been fundamental forces for the ongoing flattening of the EUR curve, with a broader inversion in sight. Market direction is shifting depending on whether inflation or recession is in the spotlight. It is choppy, but with a bias for higher yields, despite their declining sensitivity to upward repricing of terminal rates. The market sees the ECB hiking to 2%-2.5% range. This is at the upper-end of the perceived neutral range. Yet, the risk of a shift into a durably higher inflation regime, and thereby a higher nominal neutral rate [i.e. rate that neither stimulates nor slows growth, bringing the overall economy's output into line with its potential while stabilizing inflation], is under-priced.

Europeans experienced a more fragile economy in 2022 that risks buckling under the threats of energy rationing, record inflation and tighter monetary policy. Germany, Europe's largest economy, has emerged as the region's weak spot, with its large industrial base suffering disproportionately from surging energy costs and a persistent shortage of supplies. Meanwhile, services aren't seeing the same kind of tourism boom that's tiding over countries around the Mediterranean as vacation travel picks up post-COVID.

Private-sector output is shrinking, adding to signs that a recession in the euro zone is now more probably than not. Business confidence indicators from Germany, France and Italy have confirmed that direction. In the meantime, political turmoil in Italy has pushed peripheral sovereign bonds yields higher increasing the cost of financing for governments, corporations and mortgages.

ECB President Christine Lagarde's comments following the July 21 decision, along with another pickup in inflation to just under 9% suggested she's leaning toward a bigger move: "*We have to bring inflation down to 2% in the medium-term*, she said. "*It's time to deliver*."

Most central bankers around the world are now firmly fixated on addressing the biggest inflation threat since the 1980s. This was certainly the theme that dominated the Jackson Hole Fed symposium at the end of August 2022. Unable to influence the supply side of the economy, central bankers have been entirely focused on slowing demand with restrictive monetary policy. Recessions would be accepted as the lesser of two evils.

The purpose of this paper, is to study the evolution of ECB Government Council members thought and actions through 2022. This study shows how ECB has been completely overwhelmed by inflation dynamics and was forced to a paradigm shift led by the Federal Reserve of USA. As a reminder, in 2021 the ECB had ruled out the possibility of even a small rate hike in 2022.

But in the course of 2022, there was the gradual and measured approach for rate hikes which was replaced by a surprise 50bps rate hike in July and additional jumbo rate hikes of 75bps on September 8 and October 27, finally settling to 50bps increase in December 15. This transformation led from forward guidance approach to the so-called meeting-by-meeting (MBM) approach on interest rates and inflation. This strategy should have been introduced much earlier as it would have prevented the ECB from making the described communication mistakes. The MBM approach, however, is also an approach which opens the door widely for speculation and volatility as it makes it harder to read the ECB's reaction function.

A summary, for the ECB policy in 2023 is presented at the end of the paper. ECB is still far from neutral rate and shy QT suggests higher rates. The ECB will need to stay hawkish to anchor inflation expectations until core inflation is safely on target. With little experience of how markets and the economy will respond, some volatility in markets is likely to happen.

ECB's Outlook on eurozone economy during the first quarter of 2022

Over the period of the first two months of the 2022 current year, risks from rising rates enhanced the concerns that inflation in Europe will remain high for longer and that the ECB would end its quantitative easing (QE) policy and start hiking rates sooner than expected have pushed Euro area sovereign bond yields higher.

In the middle of February 2022, money markets were pricing close to two 25bps hikes for 2022 and nearly three 25bps hikes for 2023. Once the ECB when started its normalization path, it would likely raise rates fairly steadily until there was a negative economic or financial shock to halt it.

The main financial shock that investors were concerned about was a disorderly rise in sovereign bond yields, especially for those countries with high debt levels (Italy and Greece). The spread between Italian and German long-dated bond yields had widened significantly in February.

Although market dynamics may cause it to widen further, the economic sentiment was rather positive. For several reasons:
• Government debt interest payments as a percentage of GDP are historically very low, especially considering the cost of borrowing, net of central banks' profits from QE.
• Extremely low interest rates over the past decade have enabled governments, especially those with high debt burdens, to increase the maturity of their liabilities and lock in lower interest rates for longer.
• Even if market rates rise further, government debt interest payments are unlikely to rise fast or high enough to generate budgetary problems, or concerns over debt sustainability.
• The policy structure around sovereign debt - from the ECB (large-scale asset purchases, Outright Monetary Transactions - OMTs) to the EU (Resilience and Recovery Fund) - is far more credible and effective than the almost non-existent structure just over a decade ago.

Even when QE ends the ECB would be active in bond markets for peripheral debt. It had committed to not start to shrink its Pandemic Emergency Purchase program (PEPP) portfolio until 2025 and had committed to not shrink its Asset Purchase Program (APP) portfolio until after an "*extended period after it has begun to raise interest rates*". This was widely interpreted to be a couple of years, so around 2025 as well. That meant the ECB would continue to reinvest in maturing Italian bonds.

Since its December 16, 2021 meeting, the ECB had given itself the optionality to reinvest the proceeds from some maturing bonds flexibly. This meant that it could potentially reinvest maturing German bonds into Italian bonds if spreads were to widen uncomfortably. It also had the option to restart PEPP.

In summary, fiscal, financial and monetary policies were in February 2022 far more supportive of peripheral bond markets than they were a decade ago. Nevertheless, downside risks existed. A key precondition was that, all these policies are only effective in an environment of political stability and co-operation. The election of populist or anti-EU governments could lead to a deterioration in fiscal and financial conditions and prevent the successful implementation of Next Generation EU (NGEU i.e. European Union Recovery Instrument from the COVID-19 pandemic).

In particular, the election of an anti-EU far-right government in Italy in September 2022 could trigger wider spreads, much as was the case in 2018.

The Picture in May 2022- ECB likely to step up tightening despite risk of stagflation

The talk among European banking circles in the beginning of May 2022 was that the ECB was increasingly hawkish. Having signaled an increased possibility of ending APPs in 3Q-2022 at the April 14, 2022 meeting, a flurry of ECB speakers had been supporting the market's view of a first rate hike in July 2022 and at least three hikes this year.

The next ECB meeting on June 9 2022 was expected to confirm that the conditions for hiking rates have been met (i.e. an inflation forecast reaching 2% well ahead of the end of the projection horizon, and durably for the rest of the period, and sufficiently advanced progress in underlying inflation to be consistent with inflation stabilizing at 2% in the medium term).

This confirmation also implied an urgent need to end QE by the end of June (or early July). Of particular concern for the ECB were be the signs of de-anchoring inflation expectations, requiring a credible response by the ECB to prevent price-wage spirals. Money and capital markets expected three 25bps hikes for the rest of 2022, starting in July.

ECB stopped adding new bonds to its PEPP holdings in March, buying of Italian debt under the program fell across April-May, which showed the ECB had not adjusted re-investments across states, indicating that it was not yet uncomfortable with spreads.

While the ECB needed to revise up its forecasts for inflation, GDP growth was likely to be revised down at the June meeting, highlighting the downside risks to growth. ECB was likely to conclude that there were no signs of an imminent recession, with the reopening of the economies and household and corporate balance sheets able to resist the headwinds of higher inflation and uncertainty for 2022. Next year, however, supportive wage growth and possibly fiscal policy were likely to be needed to maintain the momentum.

In the case inflation expectations rise further, or the euro become even weaker, even 50bp hikes could soon be necessary. The hawks within the ECB Governing Council also wanted to discuss quantitative tightening (QT) soon, not to put all the burden of tightening on the deposit rate.

On the inflation front the numbers were not encouraging: Inflation was at record high but softer from November 2021. Inflation rose to a new record high of 7.5% yoy in April, up 1.6pps from March. In fact, food, goods and services prices were all at record highs.

Energy inflation peaked in March due to government support measures, although there is a risk it could re-accelerate if gas imports from Russia were disrupted. The expectations were: stronger food and core inflation, as intensifying Russian sanctions and China lock downs exacerbate already stretched supply chains and raise input costs.

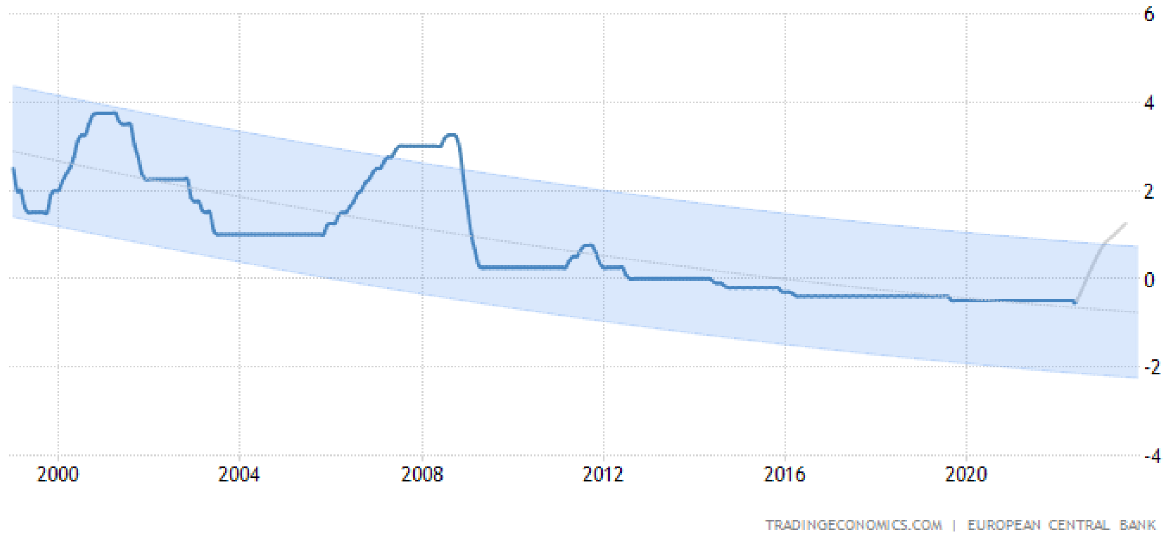
Market participants expected inflation to peak at 7.7% yoy in September and then start decelerating as the negative energy price effect picks up sufficiently. Inflation should then rapidly decline, but it likely won't return to the ECB's 2% would target until late 2023.

By the middle of May 2022, markets expected that the ECB would likely step up tightening despite looming risk of stagflation.

ECB June 9 Meeting: ECB leaves bond investors "high and dry" as buying ends

At the ECB meeting at Amsterdam on June 9, policymakers saw no need to come up with a new tool to rein in borrowing costs for the euro zone's most indebted countries, as the ECB embarked on its first rate hikes in more than a decade. The ECB wound down its multi-trillion-euro bond-buying program and penciled in at least two increases in interest rates this summer to fight record-high inflation.

ECB's Deposit Facility Rate



But, despite widening spreads between safe-haven Germany and debt-laden Italy and Greece, the central bank disappointed investors who were hoping for continued support via a new scheme.

ECB's announcement that it would end its Asset Purchase program on July 1 before raising interest rates later next month caused those spreads to widen further on June 9. Italy's climbed to as much as 226bps, near its highest since the height of the COVID-19 pandemic in 2020, as the yield on its 10-year bond surged over 15bps. The interest spread of Italy and Greece compared with Germany, has risen by 90 and 120bps respectively this year, already their largest annual rises in years.

Policymakers did not think current conditions amounted to financial fragmentation (i.e. if yields increase very sharply and at different maturities, this can cause excessive differences) - a big issue for a central bank making policy for 19 very different economies. The topic was only briefly discussed at the meeting and there was no debate about announcing a new program. There had been no progress on this since a seminar in April and work would only resume in September.

ECB President Christine Lagarde told a news conference the ECB would deploy new instruments if needed but she provided no details of what they would look like. "*If it is necessary, as we have amply demonstrated in the past, we will deploy either existing adjusted instruments or new instruments that will be made available.... But we are committed - committed - to proper transmission of our monetary policy and as a result fragmentation will be avoided to the extent that it would impair that transmission.*"

Pressed for details on when such flexibility would kick in, Lagarde said: "*There is no specific levels of yields increase, or lending rates or bond spreads that can unconditionally trigger this or that... We will determine on the basis of circumstances, of countries, how and when that risk is likely to materialize and we will prevent it,*" she added.

Market instant reaction was dramatic. The ejection of the Italian spread over 250bps - a level that it is considered a "dangerous zone" and which was noted again in March of 2020 and in May 2018 when the country was experiencing a political crisis - with the performance of 10 years bond to exceed 4% and move to the highest levels since the end of 2013, sent waves of concern about the sustainability of the Italian debt and brought in the word "fragmentation" to the fore. This in combination with the launch of spreads and in other vulnerable countries such as Greece (25% increase in just two weeks, over 300bps), could not help but "mobilize" Christine Lagarde.

The Italian bank stocks lost 11% in two days since June 9. ECB's failure to announce the creation of a new anti-fragmentation tool (AFT) caused the sovereign spread to widen significantly and sparked concerns over Italian banks' Common Equity Tier 1 (CET1). Without the aforementioned tool, the challenging macroeconomic environment and possible political turbulence to come, could make Italy one of the most vulnerable European countries. As a result, Italy's country risk had been rising, hitting banks.

In summary, ECB made the "mistake" of not providing any details on the implementation of a new spreads support mechanism at its June 9 meeting, with markets testing Lagarde's "*whatever it takes*" determination.

For the record, back in March 17, during a speech in Frankfurt am Main, Christine Lagarde had insisted - for the first time in vague terms - on the Governing Council's readiness to "*use a wide range of instruments to address fragmentation... If necessary, we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalization.*"

According to the minutes published one month later on July 7, "*A number of members expressed an initial preference for keeping the door open for a larger hike at the July meeting. They remarked that the current signal should not be seen as an unconditional commitment, since the Governing Council needed to retain the discretion to adjust the size of the interest rate move in case new information available for the July meeting materially affected the medium-term inflation outlook.*"

Some council members have called for a 50bps hike later this month to curb record inflation. The minutes highlighted policymakers' fears that inflation could anchor, saying that "*The risk to the medium-term inflation outlook included a durable reduction in the production capacity of the economy, persistently high energy and food prices, inflation expectations rising above target [i.e. the 2%] and higher than anticipated wage rises.*"

"*The risk of inflation expectations loosening was considered particularly high as inflation expectations adjusted to recent developments,*" the minutes said. However, they added that "*if demand weakened in the medium term, it would ease price pressures.*"

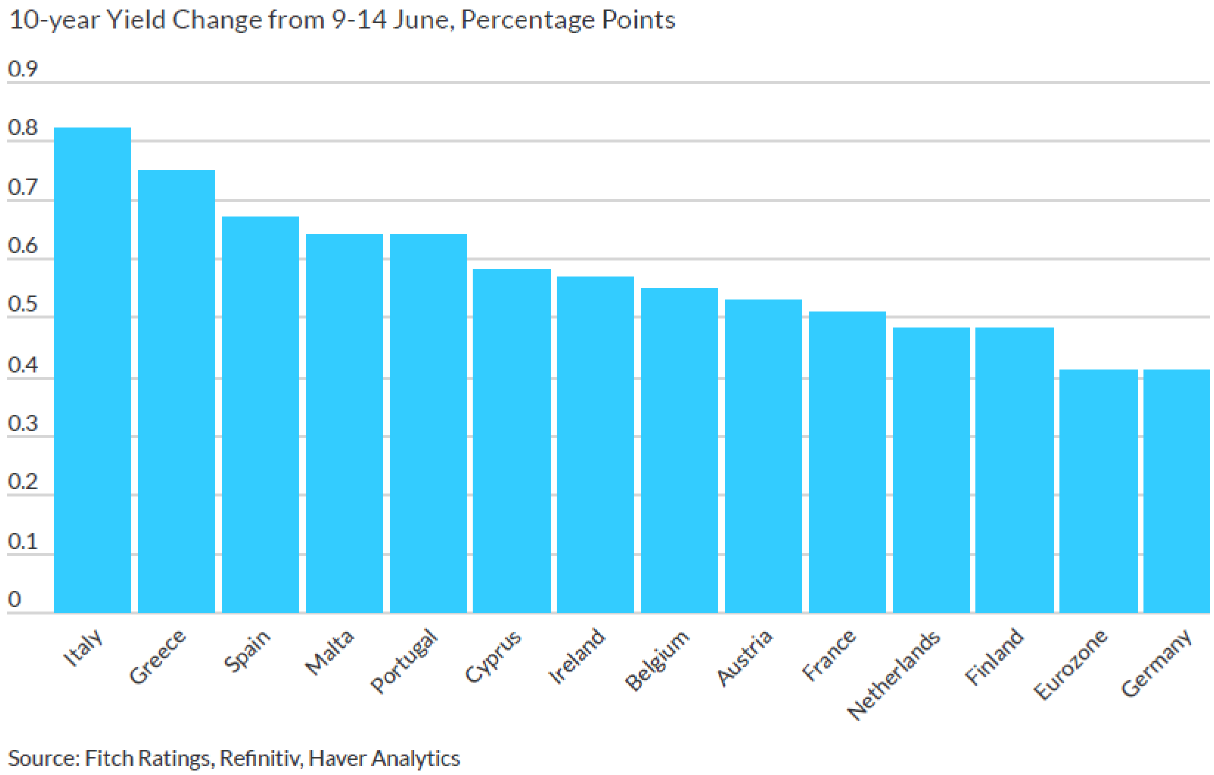
The minutes of the ECB's June meeting showed a Governing Council deeply concerned about the inflation outlook, but also split about the appropriate pace for normalization given substantial uncertainty.

One camp within the ECB seemed to have favored a larger hike in July. Against this backdrop, the explicit opening up to a lager hike in September can be seen as a compromise. The minutes contain some discussion around the meaning of gradual, a word used for the interest rate path after September. The anticipated anti-fragmentation tool was not a prominent subject for discussion.

The road to June 15 - Ad Hoc Meeting

It was late at night on Tuesday June 14 when the members of the Governing Council of the European Central Bank received on their mobile phones the notification from Christine Lagarde that the next day, Wednesday June 15 at 11.00 Frankfurt time, an extraordinary virtual-meeting would be held to discuss current market conditions. ECB officials were taken aback as they had just met a few days ago (June 9) for a regular central bank monetary policy meeting in Amsterdam, and there was no indication then that they would "say it again" so soon.

Most of Governing Council members and central bankers were in their home countries, apparently worried about the strong sell-off that had taken place that day in the bond market. This was the reason why Lagarde said that "*it's time to act*", while she was in London on a planned trip to receive an honorary degree from the London School of Economics. The 25 ECB members had been notified 27 months ago, in March 2020, when Lagarde, amid a lock down signaled the activation of the emergency PEPP program.



What alarmed Lagarde's sudden decision to hold an emergency meeting was the speed at which the yields and spreads of southern countries, especially Italy, skyrocketed in just a few days, with concerns about a new crisis returning and the market to test the determination of ECB. Of course, the recommendations of the hawks of the Board also played a role in this in their various statements, for a more aggressive increase in interest rates.

June 15 Ad Hoc Meeting Short Statement

At the surprise ad hoc ECB meeting to discuss how the bank should handle the rapid sell-off in bond markets and the risks of fragmentation, ECB released only a short statement of 149 words, concluding that the pandemic has left lasting vulnerabilities that are contributing to the uneven transmission of monetary policy.

The ECB Governing Council decided that it would apply flexibility in PEPP re-investments to preserve the functioning of the monetary policy transmission mechanism. The ECB would exercise PEPP reinvestment flexibility across both time and jurisdictions. Moreover, the Governing Council mandated the acceleration of the completion of the design of a new anti-fragmentation instrument but stopped short of providing details on what a backstop could look like. It was expected that ECB to announce the details of this backstop at the July 21 meeting. Fragmentation risk is Governing Council's language for non-fundamental sovereign stress in the euro area that risks undermining the smooth transmission of monetary policy.

While flexible PEPP re-investments are immediately actionable, the Council fell short of agreeing on the AFT and therefore announced further internal work "*to accelerate the completion of the design of a new anti-fragmentation instrument for consideration by the Governing Council*". This wording likely means there is not yet consensus within the Council on the way forward and the most appropriate design of such a tool.

It also suggested that current financial conditions were not seen to warrant more action above and beyond PEPP reinvestment policy and that the Council will first want to see how far it can get just using PEPP re-investments.

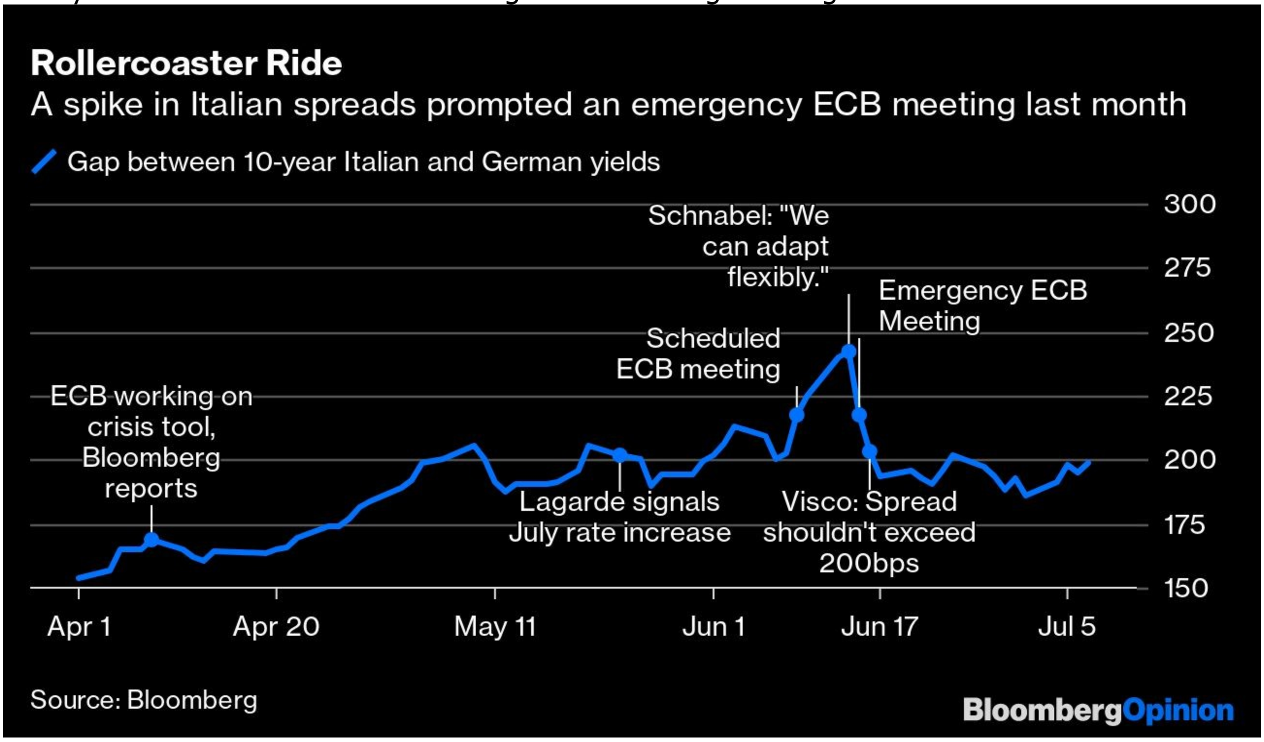
The ECB estimated that about €17bn of bonds expire each month - €12bn of which are in core countries. Redirecting that money to struggling markets creates a defense that may ease stress for now. Flexibility may also involve front-loading re-investments - meaning the ECB could buy new bonds before older securities mature.

The ECB could exercise PEPP reinvestment flexibility across two main dimensions: across time and jurisdictions. Indeed, with PEPP re-investments conceived as an AFT, the key determinant of their effectiveness will be the amount of re-investments that can be mobilized in a short amount of time to support vulnerable sovereigns. On the time dimension, one could rely on ECB practice to infer how much reinvestment the ECB might be willing to pull forward.

The ECB reinvested in full the proceeds of maturing securities under the PEPP and public sector purchase program (PSPP), and in order to avoid local dislocations following large redemptions, it smothered reinvestment over a period ranging from several weeks to several months. This suggests that, while there existed a large degree of discretion in the operational process, the ECB was unlikely to pull forward more than 18-24 months' worth of re-investments.

On the country on the allocation of re-investments, the ECB communication pointed in principle to full flexibility. However, while this flexibility was already a feature of net PEPP purchases, it has been exercised only sparingly, at the height of the market tensions of the spring of 2020. Operationally, exercising significant flexibility in the country allocation of re-investments also involves a high degree of coordination among National Central Banks (NCBs) which bear 80% of PEPP holdings on their balance sheets. This could point to a limited willingness to sustain capital key [i.e. the percentage Euro area NCBs' contributions to the ECB's capital] deviations in a period extending beyond a couple of months.

Analysis indicated that, while the full mobilization of flexibility in re-investments could provide some relief, it is probably not sufficient as a crisis-fighting tool. PEPP's flexibility was welcome but the program was limited in size. Instead progress in the design and implementation of a backstop facility was needed to be more meaningful in anchoring sovereign credit.



Given the June 15 communication, the Governing Council would announce the details of the new anti-fragmentation instrument at its July 21 meeting. The new tool would likely embed:
• flexibility to allocate purchases across jurisdictions, the yield curve and time,
• no ex ante limit on the purchase volume,
• no consolidation of holdings with other ECB sovereign bond portfolios,
• some conditionality on economic reforms, and
• sterilization of purchases.

The main distinguishing features of such an instrument compared with the OMT program would be greater flexibility in the allocation of purchases and the design of conditionality.

Like its predecessors, the new ECB backstop would likely face legal challenges focusing on a possible violation of the prohibition of monetary financing, the principle of proportionality, and possibly the prohibition of privileged access. The most critical features of a backstop - as described above - would be the absence of an allocation principle, such as the ECB capital key, the lack of an ex ante limit on purchases and the non-consolidation of holdings with other sovereign bond portfolios. While regular asset purchase programs with a standard monetary policy objective have to observe stricter limits, the European Court of Justice ultimately ruled in favor of the OMT, which had similar features, in recognition of the emergency nature of the program with the specific objective of preserving the singleness of the Euro area.

In summary, three issues were at stake: (i) Bond markets apply stress to ECB, (ii) PEPP flexibility does not seem to be enough and (iii) long-term solutions must involve EU governments.

Although the sell-off in bond markets since the June 9 meeting had been impressive, the ECB chose to act in line with its commitment to preserve the functioning of its transmission mechanism.

While spreads would have been a concern, liquidity conditions and one-way trades would have convinced the ECB that it was time to use its first line of defense, namely the flexibility of the PEPP re-investments.

Little detail had been revealed, but PEPP flexibility gave the ECB the ability to front-load the reinvestment of around €200-300bn of maturing PEPP bonds over the coming year and deviate significantly with regards to the capital key. This should put some pressure back into bond traders seeing peripheral spreads as a one-way bet, and indeed the markets appear to be giving the ECB the benefit of the doubt. Without much detail on a possible new fragmentation instrument, however, the stabilization may only be temporary.

While one can imagine additional steps the ECB could have taken (applying flexibility to the APP re-investments, adding some €250bn of fire-power, or new Targeted Longer-Term Refinancing Operations TLTROs), a more comprehensive solution would be to allocate an envelope, say of €750bn, for the sole purpose of fragmentation fighting.

This would draw on the experience of the PEPP, being fully flexible and without the need to spend the full amount. It would likely also need to be sterilized by withdrawing a corresponding amount of liquidity, in order to not contradict the normalization of policy needed due to the high inflation outlook.

However, the ECB tried this kind of intervention with the Securities Market Program (SMP) during the euro area sovereign debt crisis and was heavily criticized for supporting selective sovereigns without any conditionality. This quickly led to the abandonment of the SMP, with the OMT instead replacing it. Crucially, the OMT assumed the role of supporting an European Stability Mechanism (ESM) led rescue, with the ESM formulating the conditions and necessary reforms a country must make for the support to be granted.

The new facility would probably involve the ECB purchasing bonds of specific countries to contain spreads. In theory, the OMT (created in 2012 but never used) could do this but it is subject to ESM conditionality, which countries may be unwilling to subject themselves to.

Given the complexity, and possible domestic reluctance to any ESM program (although conditionality could be relatively lax), the ECB wanted to be able to lean against bond markets sufficiently early to gain time for more comprehensive solutions, suggesting that a new ECB purchase program could be what is on its mind.

Even if the ECB could deliver a sizable anti-fragmentation purchase program, eventually governments would need to sit down and discuss necessary reform, further fiscal integration and/or orderly debt restructuring mechanisms. The ECB could certainly play a supportive role, but not without conditionality as it would otherwise imply risks to its primary objective of price stability.

The proposals on what form the new mechanism would take included very light conditions, such as countries' compliance with the Commission's annual financial recommendations or implementation of the NGEU reforms - something that is happening anyway, so it can not be considered conditionality in the sense of having a memorandum as the OMT program had.

At the same time, the goal for each EU country spreads is to reach a level that corresponds to its public finance figures and stabilize them. Thus, it will be activated when the spreads show that they "escape" and especially when this launch is rapid and not due to temperamental factors (e.g. fiscal course, political instability). However, the level per country that the ECB considers “no acceptable ” is not known at the moment.

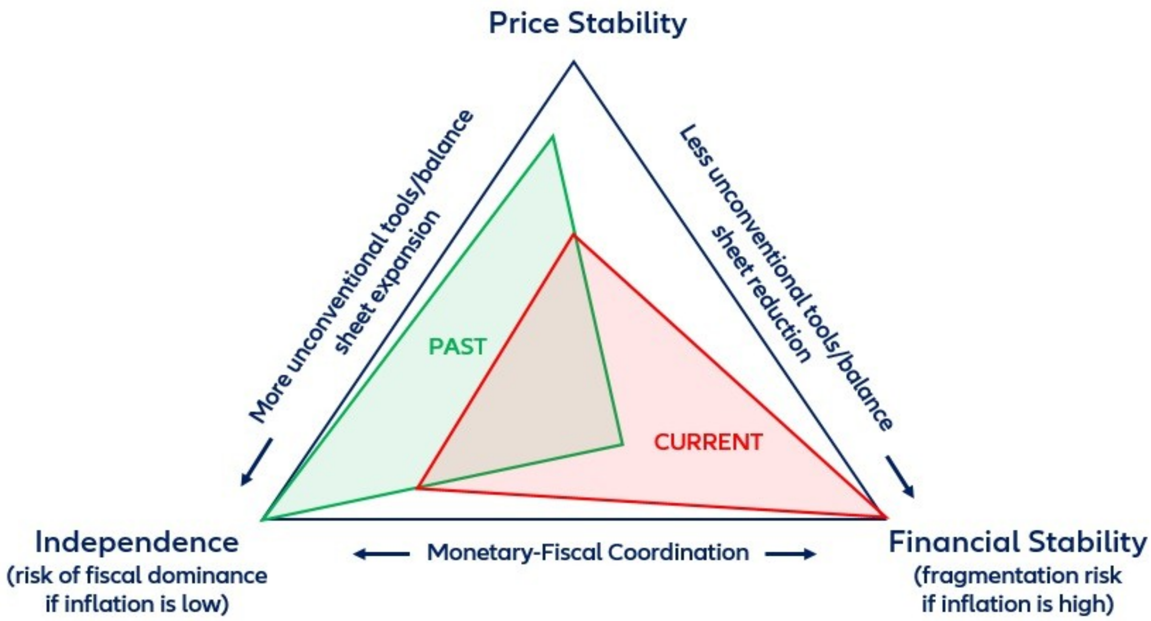
In summary, the trigger point for activating purchases under the new backstop is going to be non-fundamental fragmentation risk - so basically a sense that yields are moving rapidly away from levels that are consistent with fundamentals. The ECB would not come out with a specific target for spreads. But it's going to be a more holistic assessment where the Governing Council makes the decision when yields and spreads are moving in an undesirable fashion, away from underlying fundamentals in a way that undermines monetary transmission.

The hard part will be deciding when to intervene. "*The difficulty will be about the gray zone in between what is warranted and what is not and that is the area of moral hazard we have to navigate,*" Pierre Wunsch head of Belgium's central bank and ECB Governing Council member, said to Financial Times, on July 6.

Therefore, it would be complicated to design the new tool. ECB would not unveil any specific detail on the level of yields, spreads and their respective rate of changes that would define an orderly versus a disorderly regime.

It's a difficult balancing act because on the one hand ECB needs to tighten policy to cool inflation pressures, but on the other hand it needs to make sure EU avoids this fragmentation risk, which could undermine its efforts to get inflation down in an orderly fashion. The backstop tool is likely to be effective in anchoring sovereign credit and in protecting the hiking cycle.

ECB risk trilemma shifting from deflationary to inflationary environment



Options for the new anti-fragmentation tool - AFT

Option No.1 Keeping the balance sheet size constant:

A first option suggested in a Bloomberg report (June 16) would consist of increasing purchases of peripheral bonds, while simultaneously keeping the total size of the monetary policy portfolios unchanged. This would in turn imply the need for an outright sale of other securities in the portfolios, most likely core countries' bonds.

Such an option would be appealing in that would lead to yield compression in the periphery, while keeping the overall amount of QE stimulus unchanged. But the option would also face non-negligible hurdles.

First, as it would be tantamount to engaging in QE in the periphery and to QT in core countries, it could lead to undesired effects on growth and inflation, contributing to a fragmentation in the euro area macroeconomic outlook.

Second, it would require a high degree of coordination among NCBs.

For the proposal to succeed, some NCBs would need to stand ready to assume financial losses in order to create space for peripheral NCBs to increase their domestic holdings. But beyond the core vs. periphery issues, things could get more blurred for semi-core countries.

Ultimately this option looks as rather impractical. A softer variant could instead imply not reinvesting maturing core bonds and, with the "balance sheet space" generated, purchase peripheral bonds. While this option seems less problematic, it would significantly restrict the flexibility of the new program and would make it barely distinguishable from the flexible reinvestment policy within PEPP.

<u>Option No.2 Sterilizing the reserve injection (allowing the balance sheet to grow):</u>

The other option, would be a re-edition of the absorption design under the SMP, where QE purchases were "sterilized" with 1-week reverse repo operations (SMP-FTOs: Fine Tuning Operations) aimed at absorbing the new liquidity (i.e. weekly SMP Liquidity Absorbing Operation). ECB may offset the inflationary impact of any bond purchases by raising a matching amount of deposits from banks.

Notably, such sterilizations, which are supposed to "*ensure that the monetary policy stance will not be affected*", are also a feature of the OMT program. New purchases therefore would lead to an expansion of the monetary policy portfolios and hence the total balance sheet size of the Euro system and to the creation of new reserves. The sterilization would aim at absorbing exactly these reserves in the form of a different liability item on the ECB's balance sheet.

Through portfolio shifts or shifts in the composition of the ECB's liabilities, the "sterilization" of new purchases as ultimately not having a meaningful economic impact in present circumstances given the large amounts of excess liquidity in the system and the Euro system being a major holder of all euro area sovereign issuers. However, the ECB could see it as an important ingredient in reducing the legal risk of any new program, as well as a preemptive step to prepare for times when a sterilization may be more meaningful, e.g., when excess liquidity is lower.

Above and beyond the technical design of the program, there are many questions remain unanswered on the shape of the anti-fragmentation tool, including whether purchases that come in limited-size or whether they will be open-ended, whether an explicit level of yields will be targeted, and whether and what conditionalities will be attached to the program. The meeting (annual ECB Forum on Central Banking) in Sintra on 27-29 June could be an opportunity for the ECB to provide more guidance on what to expect.

Notably, such sterilizations, which are supposed to "*ensure that the monetary policy stance will not be affected*", are also a feature of the OMT program. New purchases therefore would lead to an expansion of the monetary policy portfolios and hence the total balance sheet size of the Euro system and to the creation of new reserves. The sterilization would aim at absorbing exactly these reserves in the form of a different liability item on the ECB's balance sheet.

Inflation is more of a concern now than when the PSPP and PEPP were created, and providing additional liquidity to support spreads may prove a double-edged sword. Therefore, the ECB could 'sterilize' the purchase of peripheral bonds, i.e., remove the same amount of money from circulation.

Speaking on June 20 to Italian newspaper Corriere della Sera, the Governor of Bank of France François Villeroy de Galhau gave the first hints for the anti-fragmentation tool. He said the ad hoc meeting was the best proof that there are no limits on the ECB's commitment to ensuring stable prices and protecting the euro.

"*This should be a backstop instrument. It should be available as much as necessary, so as to make our no-limits commitment to protect the euro very clear.. The more credible such instrument, the less it may have to be used in practice. This is how a backstop works*," he said.

Villeroy, said a tool specifically devised to combat fragmentation was necessary to ensure the orderly transmission of monetary policy across the euro zone's member countries. While the program would have rules the ECB would also have the freedom to exercise its judgment and that market interventions should be sterilized, meaning that they would be done in ways that do not affect its monetary policy stance.

He added that bonds purchased would not necessarily need to be held until maturity but rather until after market tensions subside. "*In other words, we could be more agile in buying but also in selling after some time,*" Villeroy said.

The Italian conundrum

The challenge facing policy makers is not letting the financing costs of the most indebted euro members soar into non-viable territory. How high is too high? Italy's central bank Governor Ignacio Visco said in June 16 that "*… a differential in the yields of 10-year Italian and German bonds of less than 150 bps would be justified by the fundamentals... Levels above 200 bps are certainly not,*" Visco told a conference, organized in Milan by the Osservatorio Permanente Giovani-Editori (Permanent Observatory for Young People and Editors) and the Intesa San Paolo Bank.

His comments were based on a internal work by the Bank of Italy, published in "Questioni di Economia e Finanza (Occasional Papers)" of Banca d'Italia in September 2022. The valuations are based on a panel model for the main euro-area countries, whose indications are compared with those of models for individual countries; in both cases, the level of the public debt-to-GDP ratio, short- and medium-term growth expectations and medium-term inflation expectations, and the unemployment rate are considered to be the fundamental variables.

Current Italian yields are too high from a debt sustainability perspective. It is estimated that an average borrowing cost of ~3% is required to keep the Italian debt-to-GDP ratio stable. The average cost of borrowing of the Italian government was at a historically low level of 2,4% in 2021.

That said, the level Italian yields reached before the ECB's emergency meeting on June 15 - i.e., 1y and 10y BTPs [Buoni del Tesoro Poliennali] yields averaging ~4.2 and ~4.4% respectively over the coming years – would be unsustainable. Italian rates would need to come down by at least ~120bp to stabilize the Italian debt-to-GDP ratio.

Since the ECB's announcement on June 15 that it would start reinvesting PEPP flexibly and accelerate the design of a new 'fragmentation tool', the 10y BTP-Bund spread has narrowed by 50bp to 193bps as of June 17 but remain at levels above the 2014-17 average (~140bps).

Even this is far below the levels reached during the 2012 sovereign debt crisis, when Italy paid almost 500bps more than Germany for long-term bonds. But with Italy's debt now even higher than in the last crisis, officials worry the country could find itself trapped in an unsustainable spiral of rising debt costs.

This “danger zone” means that yields have moved up to levels where the risk of rising debt and fiscal stress has gone up. It doesn’t mean it’s inevitable, but we are in a place where these fiscal concerns could suddenly reappear and lead to a fragmentation of financing conditions for reasons that are unrelated to the fundamentals of the Italian economy.

Moreover, they are still above levels consistent with a stable debt/GDP ratio. So more is needed. Any further decline should depend on the details of the new tool (no size limit and appropriate level of conditionality).

Although the average borrowing cost is expected to jump to 2,9% in 2022, the abrupt increase is largely driven by high inflation, given 12% of Italian sovereign bonds are inflation linked. Otherwise, the cost of borrowing would adjust only slowly to higher yields, as only a portion of the portfolio matures and is re-invested each year.

Indeed, the pass-through from changes in sovereign yields to borrowing costs is gradual. Around 77% of Italian sovereign bonds outstanding carry a fixed rate, meaning the carry-over from historical yields is large. Lower yields have enabled the Italian government to extend the weighted average maturity of its liabilities and lock in lower interest rates for longer, making interest payments less sensitive to short-term fluctuations in rates.

Italy's primary budget deficit (not including debt servicing costs) was just under 4% of GDP in 2021 and it has a relatively poor record when it comes to absorbing EU funds.

Furthermore, Italy has about €200bn in debt to roll over later this year and an additional €305bn next year. The average weighted maturity of Italian government debt is roughly 7 years. This compares with about 18 years for Greece.

A failure to bring borrowing costs down – either due to an insufficient "tool" or due to yet tighter monetary policy – could worsen political risks down the road. A quicker and sharper fiscal consolidation could well revive questions over the viability of EU membership in the periphery.

Such a scenario would require a quicker and sharper fiscal consolidation, which could well revive questions over the viability of EU membership in the periphery. Indeed, this may increase Italians' mistrust toward EU institutions and support for populist and anti-EU parties ahead of general elections in spring 2023. This would feed back into debt sustainability concerns and increase concerns over Italy exiting the EU. An Italian exit would possibly pull the rest of GIPS countries (Greece, Italy, Portugal & Spain) out from EU.

Overall, fragmentation risks are unlikely to fully dissipate until the EU's integration is completed (including a complete banking and fiscal union) and risks of EU exit are minimized. Recent crises have pulled European countries closer and promoted some regime change to EU fiscal policy making. Even if the NGEU is still for now a 'one time only' program, it demonstrated the EU's capacity and willingness for action when it comes to keeping the bloc together. The current challenges could spur another round of solidarity and well accelerate fiscal integration further down the road.

The Greek case

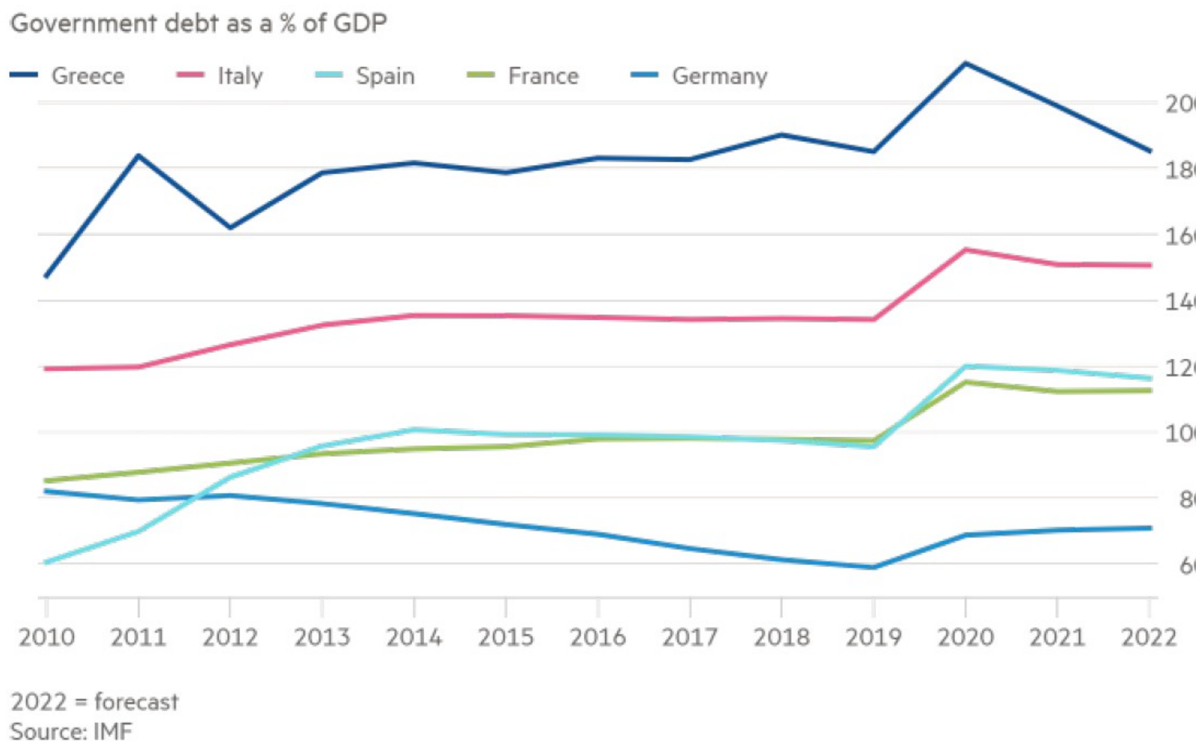
Responding to a question on what fiscal steps Greece should take next year, and what an increase in ECB interest rates could mean for Greece - during the Press conference after Eurogroup meeting (June 16) - ESM Managing Director Klaus Regling mentioned among other things the following:

"Indeed a big step today [i.e. the end of enhanced surveillance for Greece], but at the same time, it's also right to say that Greece faces a particular situation because the debt the debt-to-GDP ratio is the highest in euro area. But then it's very important to put this into the right context because the debt service that Greece has to pay out of its budget on this high debt level is relatively low. It's lower than in some other euro area countries where the debt ratio is lower. And the reason is that 60% of Greek public debt is with official creditors. 50% of the Greek debt is with the EFSF and ESM ….
….In addition, you may remember that one element of the debt decisions that were taken in 2018 by the Eurogroup at the end of the Greek program was to protect a certain share of Greek debt and to fix the interest rates through derivatives and swap operations. So a certain part of Greek debt is not affected at all by current market moves, even when it needs to be refinanced. So there are several protections built into the program and therefore I'm not worried that the interest rates that have been rising around the world will lead to any particular problem for Greece."

Bond market participants taking into the account the current structure of Greek debt (official sector 60% / private sector 40%) and the average yield for the official debt at 1.4% commented that there will be cause for concern if the 10-year bond yield rate exceeds 6%-6.5%. In addition, Greece has a safety cushion net around €37bn that can keep her out of capital markets for at least 2 years, without issuing new debt.

Again on the positive side, the last three years, there have been twelve different upgrades from different rating agencies. The last one happened in April this year, when S&P moved Greece to BB+, which is just one notch below investment grade. The objective of the Greek government is to try to reach investment grade status. The 40% that is financed in the markets needs to be refinanced from time to time so it can benefit from low interest rates. The average weighted maturity of Greek government debt is about 18 years. Moving to investment grade, is a big step in that direction.

The ECB has waived the eligibility requirements for Greek government bonds in PEPP program. In March, the ECB also announced that it "*reserves the right to deviate also in the future from credit rating agencies' ratings if warranted, in line with its discretion under the monetary policy framework*".



On the negative side, interest rate increases will not affect only Greek state financing. The Greek private sector will have to pay higher interest rates and eventually to suspect investment plans. At the end of the road the most severe threat would be the return of recession. Continued spill overs from the war in Ukraine via sharp reduction in the gas supply over the past few weeks are a risk. Flows to improve again once the pipeline maintenance period is over in mid-July, but a complete cut of the Russian gas supply would push the euro area to recession, and that's something that could reignite sovereign worries. On top of that energy costs, electricity & gas bills, the disruption of global supply chains will lead to the reduction of Greek GDP growth, as it has become more visible in EU countries.

The recent pressure on Greek bank shares has been driven by a widening of Greek sovereign yield spreads. This is despite the ECB's continued support to allow national central banks to accept as eligible collateral in Euro system refinancing operations Greek government bonds (GGBs) that do not satisfy the Euro system's minimum credit quality requirements but fulfill all other applicable collateral eligibility criteria, for at least as long as re-investments under the PEPP continue until end-2024. Steep widening of the sovereign spreads have the potential to impact capital levels, and feed into the banks via higher cost of funding, translating into higher interest rates for loans, and can impact household and corporate sentiment.

Sintra ECB Forum on Central Banking

The ECB president at Sintra (Portugal) ECB Forum on Central Banking on June 28 reiterated to raise the policy rates for the first time in 11 years and provided some guidance for September meeting and the rate path thereafter.

The word "inflation" was mentioned fifty-two times! A good part of the speech was dedicated to the inflation shocks hitting the euro zone economy, the persistence of inflation and the uncertainty about growth, in regard to monetary policy normalization.

Under these circumstances, the orderly transmission of monetary policy is paramount. Lagarde acknowledged that ECB "i*s conducting monetary policy in an incomplete monetary union, in which its policy has to be transmitted through 19 different financial and sovereign bond markets.*" The divergence of spreads in rapid and disorder way beyond the country economic fundamentals was her basic concern.

According to Lagarde:
"…..In such conditions – when we have what we describe as unwarranted fragmentation – preserving policy transmission is a precondition for returning inflation to our target.... But in order to preserve the orderly transmission of our policy stance throughout the euro area, we need to ensure that this repricing [i.e. the rise of risk-free rates] is not exacerbated and distorted by destabilizing market dynamics, leading to a fragmentation of our original policy impulse. That risk of fragmentation is also affected by the pandemic, which has left lasting vulnerabilities in the euro area economy. These vulnerabilities are now contributing to the uneven transmission of the normalization of our policy across jurisdictions."

On June 30 Reuters cited banking sources on ECB's next steps tackling the fragmentation issue. According to news agency, ECB will buy bonds from GIPS countries with some of the proceeds it receives from maturing German, French and Dutch debt in a bid to cap spreads.

The ECB was ready to kick off this re-balancing on July 1 to prevent financial fragmentation among euro-zone countries from getting in the way of its plan to raise interest rates - with an additional scheme due to be unveiled on July 21.

The ECB has divided the EU's 19 countries into three groups - donors, recipients and neutrals - based on the size and speed of a rise in their bond spreads in recent weeks. The spreads are gauged against German bonds, which serve as a de-facto benchmark for the single currency area.

The ECB would channel towards the recipients part of the cash from maturing bonds it bought from "donor" countries under its PEPP, with neutrals acting as a buffer.

The lists, which would be reviewed monthly, mirror the division between peripheral and core countries that emerged at the time of euro zone's first debt crisis a decade ago.

Recipients include a handful of countries perceived by investors as riskier due to their high public debt or meager growth, such as GIPS countries. The donor group is made of around half a dozen so called core countries considered safer and includes Germany, France and the Netherlands.

While redemptions in July and August are substantial, the ECB knows that merely reinvesting of the proceeds would not be enough to calm investors. So it has sped up work on a new tool that will allow it to make new purchases where they are needed if a country meets certain conditions.

Central bankers had yet to decide whether to announce the size of the scheme, as they hope its mere announcement will stabilize markets and they may not have to use it.

As a follow-up, Fabio Panetta, Member of the Executive Board of the ECB, during the keynote speech, at the European Parliament's Innovation Day "The EU in the world created by the Ukraine war", Brussels July 1, he emphasized that:

"Action to prevent fragmentation is therefore not at odds with the normalization of monetary policy. On the contrary, it is a necessary condition for us to have the freedom to adjust our stance as needed to bring inflation back to 2%. This is required to ensure that the desired monetary policy stance is reflected not only in the financing conditions of countries perceived as vulnerable to fragmentation, but also in the financing conditions of the other countries.

In the vulnerable countries, fragmentation would lead to capital outflows and an increase in yields, resulting in financing conditions that would be too tight. It could trigger self-fulfilling financial tensions. At the same time, the least vulnerable countries would experience capital inflows that would compress yields, resulting in financing conditions that would be too loose and inflation that would be too high compared with our intended monetary policy impulse. And this would trigger even greater divergence and undesirable outcomes that would go against our monetary policy objective.

So acting against fragmentation, countering any excessive reaction by market yields to the normalization of our monetary policy, is not just consistent with our mandate; it is necessary for us to fulfill that mandate. And it is in the interest of all euro area countries. If we didn't act, the result would be inadequate financing conditions across the euro area, with a weaker, fragmented economy and less scope for us to adjust our stance. And this would inevitably be reflected in a weaker exchange rate."

Bundesbank President warnings on ECB backstop tool

Joachim Nagel's comments during a Virtual keynote speech at the Frankfurt Euro Finance Summit on Monday July 4 were the first sign of serious disagreement at the ECB over its plan to develop a new asset purchase tool to counter any "unwarranted" surge in the bond yields of more vulnerable countries once it starts raising interest rates. Nagel had recalled that the main mission of the ECB was the control of high inflation and not the fight against fragmentation.

Joachim Nagel speech broke with recent convention of keeping disagreements behind closed doors to publicly set out strict terms intended to ensure the ECB steers clear of monetary financing. He had already questioned the need to promise such a tool at an emergency meeting on June 15.

Arguing for the need of an anti-fragmentation instrument, he emphasized that:
"....The Member States now have the task of bolstering confidence in their future fiscal policies. Against such a backdrop, it surprises me that the escape clause for deviation from the fiscal rules was recently already extended to 2023. Furthermore, there sometimes seems to be the impression that fiscal rules will no longer be truly binding in future.
… It would be fatal if governments were to assume that the Euro system will ultimately be ready to assure favorable financing terms for the Member States.
I would thus caution against using monetary policy instruments to limit risk premia, as it is virtually impossible to establish for sure whether or not a widened spread is fundamentally justified. One can easily find oneself in dire straits.
….For me, it is clear that unusual monetary policy measures to combat fragmentation can be justified only in exceptional circumstances and under narrowly-defined conditions."

Nagel laid out three conditions, ECB would have to decide whether an anti-fragmentation instrument should be activated based on monetary policy considerations.
"• Interest rate spreads are fundamentally unjustified at the observed level. In other words, they are the result of excesses in the financial markets.
• Individual Member States are not receiving the monetary policy signals as intended. In other words, the transmission mechanism is impaired.
• The above is limiting the Euro system's ability to maintain price stability in the euro area."

The German central banker set out a number of parameters for any new instrument, including:
• that it be "*strictly temporary*" and be designed in a way that it did not hamper efforts to bring inflation back down to the central bank's target [i.e. "*orientation of monetary policy*"].
• any new instrument would have to be justified solely on monetary policy grounds, [i.e. principle of proportionality, sufficient guarantees to prevent it from entering into conflict with the ban on monetary financing of governments].
• that it should provide governments with "sufficient incentives" to achieve sustainable debt levels.

To sum-up the tone of his remarks suggested a likely hard-fought battle will ensue before any final accord on a measure is reached. The prospect that such opposition might water down the efficacy of any tool has been raised by economists and columnists.

Nagel's statements have set the scene for yet another brutal fight among policy makers that risks sparking a summer of discontent in the bond market. As surging inflation ends the era of negative rates and quantitative easing in the euro zone. When Italian 10-year borrowing costs spiked above 4% in mid-June, the ECB was forced to hold an emergency meeting to calm the capital markets. Its pledge to "*accelerate the completion of the design of a new anti-fragmentation instrument*" has worked as a stop-gap.

Nagel's Terms
The Bundesbank chief wants limits on an ECB crisis tool

• Any measure needs clear justification on three points:

1. Interest-rate spreads are fundamentally unjustified and reflect financial-market excesses
2. The transmission mechanism is impaired in individual countries
3. Such effects are limiting the ECB's ability to maintain price stability in the euro area

• If a new instrument were deemed necessary, three conditions should apply:

1. It must not interfere with monetary policy and, if necessary, its effects should be neutralized
2. It should be justified solely on monetary policy grounds, be proportionate and contain sufficient guarantees to avoid financing governments
3. Countries would need to have incentives to conduct fiscal and economic policies in a sustainable manner; effective fiscal conditionality is "indispensable"

Bloomberg

Nagel's speech, though, suggests nothing was settled yet. His hard line approach risks leaving economically weaker euro nations, notably Italy and Greece, at the mercy of bond traders if markets start to doubt the ECB's commitment to counter any sudden spike in sovereign funding costs. It's a back-to-the future moment that makes Lagarde's already difficult job balancing the interests of the 19 countries using the euro that much more strenuous. The euro is seriously unimpressed, weakening to a 20-year low against the dollar and close to breaching parity.

If Nagel gets his way, the program could end up neutered and ineffective. So far the ECB has trailed deploying an already existing flexibility, reinvesting its existing portfolio as bonds mature so that, for example, the proceeds of a redeemed German bond could be spent on Italian debt.

For the PEPP this amounts to about €10bn per month, far below its regular monthly purchases of €40bn earlier this year, although extending it to the full asset purchase program would boost that firepower. Still, if market stresses occur when redemption monies are insufficient to hold back the tide, bond traders will smell blood.

To successfully curb consumer prices after years of wanton stimulus, the ECB needs to increase borrowing costs, but it cannot do that if the unity of the euro zone is at stake.

At the same Summit at Frankfurt am Main, July 4, Luis de Guindos, Vice-President of the ECB, also spoke reiterating the ad-hoc meeting communique of June 15:
"*It is instead critical that financing conditions move broadly in sync across the euro area when we change our stance. For two equally sound firms in the euro area, a change in the monetary policy stance should lead to a similar reaction in their financing conditions, no matter in which country they are domiciled. Should that not be the case, we will react to prevent fragmentation, with suitable safeguards to prevent moral hazard. Preventing fragmentation allows us to adjust our monetary policy stance at the appropriate pace and stabilize inflation at our target.*"

The vexing issues of safeguards and legality

Christine Lagarde told its forum in Sintra, Portugal, that "... *the new instrument will have to be effective, while being proportionate and containing sufficient safeguards to preserve the impetus of Member States towards a sound fiscal policy*."

This means countries are likely to have to meet certain fiscal conditions before the ECB can buy more of their debt. Some conditions may already exist, such as the structural reforms countries agreed to carry out in return for their share of the EU's €800bn Next Generation pandemic recovery fund. They could also be linked to the EU's budget rules, even though these are suspended until the end of 2023.

According to central bank officials, the ECB is planning to ask the European Commission to police any conditions linked to the new instrument. Otherwise the central bank is steering governments on fiscal policy, which is against its mandate.

The ECB is also considering an extra requirement for countries to commit to a medium-term fiscal sustainability plan. This could be part of the commission's annual monitoring of national budget plans.

Any strings attached are likely to be less onerous than those for the ECB's OMT, an earlier bond-buying program that requires a rescue package from the ESM, together with tough reform requirements. The OMT has never been used and the ESM's involvement is seen as politically toxic in southern EU countries - especially Italy.

A unanimous decision by the ECB's Governing Council to buy unlimited amounts of sovereign bonds across the maturity spectrum when their interest rates increase in a disorderly way could be the most powerful announcement to prevent fragmentation this summer, but not necessarily the most credible announcement.

If the ECB were certain it would never need to activate the AFT by announcing a facility with unlimited purchase capacity, it would certainly do so. But, in the event that the ECB ever needed to use the AFT, unlimited purchases of government bonds would likely not meet the proportionality criteria.

The AFT would be legally and politically contested. The ECB's previous purchases of sovereign bonds have been challenged repeatedly in Germany's constitutional court and most observers expect similar moves against its latest plan.

The ECB could face legal challenges brought about by citizens of some member states as it has happened in the past, ultimately preventing the use of the AFT, as its potential benefits of preventing market fragmentation could be outweighed by costs in terms of:

- credit risk the Euro system would hold on its balance sheet;-
- a potential breaching of the no bail-out clause and the Treaty prohibition of monetary financing; and
- the ability of the ECB to bring down inflation to 2%, the ECB’s primary objective.

Also, importantly, the commitment of unlimited purchases would likely turn to be time-inconsistent, as presumably disagreement in the Governing Council would rise as the ECB buys more bonds issued by high-debt countries.

Unlike the yield curve control policy of Japan’s central bank, which is buying as many bonds as needed to cap the country’s borrowing costs at a fixed level, the ECB is unlikely to target a specific bond yield for each nation and will instead use its judgment on when to intervene.

At the end of the road, financial markets could test the determination of the central bank to avoid fragmentation, putting pressure on individual countries by pushing up their sovereign bond yields.

The challenge ahead lies in designing a policy mix that simultaneously lends credibility to the ECB's commitment to bring inflation down to target while minimizing the risk of economies falling into such a path. Some degree of co-ordination between monetary and fiscal authorities will be necessary.

National fiscal authorities should embark on credible fiscal consolidations that will not damage growth. This time around the EU Next Generation pandemic recovery fund will help to shield public investment from the tightening.

A degree of fiscal discipline should be reintroduced to reduce fiscal risks and moral hazard. Some fiscal support to low income households and small to medium-sized enterprises could be funded via European low interest rate loans, as was done during COVID-19.

At the same time the ECB, by internalizing the impact of a tighter fiscal stance on growth and inflation, could commit to tightening monetary policy less and in a very gradual way. It needs to ensure its actions do not make the job of the national fiscal authorities even more economically and politically challenging.

Although not easy to co-ordinate, this seems a realistic compromise that could put the euro area on a more virtuous trajectory than the one in which high-debt governments continue to run large primary deficits, while the ECB tightens monetary policy.

Due to these trade-offs, a facility with a large pre-specified capacity and a pledge to expand it - if needed or a one that implicitly limits the amount of purchases for each sovereign by constraining the maturity of bonds that could be bought, as in the case of the OMT that targets only bonds with a residual maturity up to three years, could be a compromise the Governing Council might settle on. After all, this could be a more credible, although initially disappointing, outcome.

ECB 's AFT has a working name, but will not arrive soon!

On the ECB front, Central Bank's technical teams were proceeding with a "stress test" of various scenarios for the new AFT in EU government bond markets, while at the political level a solution is being sought for the terms and the legal wording. The political and technical difficulty of the undertaking may lead the ECB to slightly delay the announcements, i.e. towards the end of the month, instead of July 21st.

According to Bloomberg news on July 7, the new tool is being referred to as the Transmission Protection Mechanism (TPM). Formal discussions proceeded at a scheduled meeting on June 6 though a lot of work is still to be done. European Central Bank policy makers aren't yet displaying certainty that it will be ready at their July 21 decision.

Fundamental disagreements have ultimately to be overcome, debates over tactics are persisting and there's a considerable amount of detail to process. Among topics that continue to feature in discussions are ensuring the measure doesn't counteract interest-rate hikes, what conditions should apply to any government benefiting from it, and potential legal hurdles.

Italian bonds extended their slide after the news, raising the 10-year BTP yield premium over its German peer [Bund] by eight basis points to 203bps, a three-week high.

ECB's Governing Council members public statements (July 4 to July 11)

Responding to Nagel's public statements Bank of France Governor Francois Villeroy de Galhau sought to reassure that the new measure will be large and nimble enough that it won't actually need to be used.
"*...It's not about political concern to help such or such a government. For monetary policy to be effective, it needs to be transmitted to all of the eurozone's economic actors...It is probable that the existence alone of this instrument allowing fast and massive intervention if needed is sufficient, without needing to activate it,*" Villeroy told Les Echos newspaper on July 7.

He added that if it were used, then bonds purchased could be sold before maturing once the market tensions subsided and the liquidity created by the purchases could be "sterilized".

Later the same day, his Greek colleague, Yannis Stournaras, confirmed the name of the measure. "*A new instrument -- the transmission protection mechanism, or TPM -- is also under consideration to temper fragmentation episodes.... "I think that at the end of the day we will agree on this transmission protecting mechanism",* he said on a panel during the 26th Annual Economist Government Round table at Grand Resort Lagonissi, Greece.

Stournaras added that excessive wage demands are not observed in Europe. " *We don't observe important second round effects in wages in Europe*. *Up to now we haven't observed any excessive wage demands.*"

Eventually, the scale of the program will be key; as Olivier Blanchard, the former chief economist of the International Monetary Fund (IMF), said on Twitter: size matters, on July 6. In his words: "*History lesson. The larger the amount a central bank credibly commits to limit self-fulfilling increases in spreads, the less likely it is to have to use it, the more likely it is to succeed. Conversely, the smaller the amount, the more likely it is to have to use it, and to fail.*"

Germany's Bundesbank, disagreement at the ECB on July 4 for providing a new support tool to the euro zone's most indebted countries had a follow-up by Lars Feld, Lindner's personal economics policy advisor on July 8.

In comments published in Der Spiegel magazine on Friday July 8, he urged the ECB to attach conditions to any aid in order to promote economic reforms. "*Anyone who wants money from the central bank out of turn must be prepared to provide something in return.... This includes reforms supervised by independent institutions; anything else would endanger the stability of the monetary union*" Feld said.

According to Reuters Feld's comments are unusually prescriptive advice from a German government official on policy at the independent ECB. Sources have told the new agency that the new instrument to buy more southern European bonds is likely to come with strings attached, such as that a country's debt is deemed sustainable by the ECB or that it complies with the European Commission's fiscal rules and economic recommendations.

But tying the new program with the EC's recommendations or the ECB's own assessment was still seen as less stringent and more politically palatable than the ECB's previous rescue scheme, which required countries in distress to apply for a full-on bailout.

The chorus of public statements on the TPM instrument continued on July 9. In an interview with Bloomberg Television in Aix-en-Provence, France, ECB Governing Council member Yannis Stournaras signaled an optimistic point of view. He said that there was a "*very good debate*" going on about the instrument, expressing his confidence in a "*consensual and effective solution*" that would, he hopes, will surprise the markets "*on the positive side*".

"*I believe there is a lot of truth in the idea that if we convince the markets that this is going to be a powerful tool, we may not need it*," the Bank of Greece governor said. . "*We'll have it on the shelf. It's the right scenario.*" But he declined to go into specifics about the conditions euro zone members might have to meet to be eligible for the aid.

He underlined that the instrument is however necessary in the absence of broader reforms of the European Union. "*We might have episodes of fragmentation not because of policies, but simply because we are an imperfect economic and monetary union.... We should fix that, but until that's done the ECB needs to consider the transmission mechanism,*" Stournaras said.

On the inflation front, he said that ECB's plan to raise the deposit rate by a quarter point this month is "*very likely*" to materialize. Regarding the next meeting in September 8, Stournaras said "*we'll see what the data says both on the inflation front but also on the activity front.*"

He predicted that price growth starting to slow towards the end of the year and approaching the medium term target of 2% in 2024. But it is currently more than four times that level.

"*I won't be able to tell you where it will peak because it depends on exogenous factors that cannot be measured by models. It may depend on geopolitical considerations..... There are stagflationary winds blowing – there's no doubt about that,*" Stournaras said, pointing out that Europe is not yet experiencing stagflation. "*But at the moment we don't expect negative growth this year or next year.*"

Nagel stroked back on Monday July 11. During a CFS-IMFS Special Lecture at Goethe-Universität in Frankfurt on Digital Euro, he reiterated his previous stand that ECB should model its upcoming bond-buying scheme, on the one it announced during the debt crisis. "*Design should be based on the experience of the OMT program... The tool shouldn't give the impression of discouraging fiscal policy consolidation*", Nagel said.

The Bundesbank President spoke again at change of office at the Bundesbank's Regional Office in Bavaria next day on July 12. He raised the bar for ECB intervention on government markets saying that "*... the financial markets are now making a greater differentiation between different risks due to the changed monetary policy outlook.... I assume that these price developments are fundamentally justified, as long as there is no evidence to the contrary."*

His main argument is that such spreads are not always justified by economic fundamentals and that they create fragmentation or uneven financing conditions across the 19 countries.

The trade-off between inflation and growth. Impact of ECB policy decisions during the next 18-24 months

The outlook is for inflation to remain well above targets for at least another year, and higher if we were to be hit by another commodity price shock. High inflation and a tighter monetary policy stance are still on the cards, along with an Italian election, the recent respite of recession fears looks temporary. Demand needed to be held back to let supply catch up, as the cost of reducing high inflation later would be even higher. While the ECB shares the same goals with Fed, BoE and BoC, the message is more blurred, as the ECB must contend with nineteen national debt issuers and no common safe asset.

The questions left hanging are how long the ECB - legally - can support individual countries, to what extent it compromises the inflation outlook, and how to assure debt sustainability at higher interest rates. Governments have to be ready for credible collective support and national reform measures.

Clear communication will thus be crucial. On the new anti-fragmentation tool, it could be argued that the trigger for intervening to ease financing conditions in individual countries should be an impaired transmission mechanism that impacts the ECB's ability to deliver price stability.

This would seem possible only if inflation in the affected countries looked certain to undershoot significantly and sufficiently for the euro area average to also undershoot. Any other reason for intervening, such as an imprecise assessment of "unwarranted" spreads, the speed of adjustment across countries or equally dividing the burden to slow euro area inflation, could imply that the ECB would be willing to accept a longer period of overshooting, which would need to be explained.

A bigger issue than fragmentation could be the level of the Bund yield if ECB does not bring inflation under its control. This is problematic as debt sustainability concerns arise even at relatively low interest rates in Europe. Maintaining anchored inflation expectations will thus be of the essence going forward, with worrying signs emerging from accelerating wage growth and persistent commodity price pressures.

ECB has admitted that it got inflation wrong, which means that the policy stance is not optimal and that adherence to forward guidance has not been helpful. The new anti-fragmentation tool could imply larger rate hikes, especially after summer.

Economic outlook highly uncertain, with rising risks of gas disruptions from Russia. Even though recession is not on the cards in the near term, growing market fears and weakening confidence, driven by fears of energy supply disruptions, increase the risks of self-fulfilling expectations.

ECB may have to keep tightening policy, even through a light recession, if wage acceleration and continued high energy prices result in rising inflation expectations. Raising the policy rate at least to the bottom of the range of estimates of the natural rate (1-2%) makes sense in order to be in a better position next year to address the inflation outlook.

New backstop tool expected: Details before ECB meeting on July 21

ECB has never had to tackle fragmentation risk during periods of financial tightening but only in the context of recessions, when monetary policy accommodation "lifts all boats" and helps contain sovereign spreads as interest rates decline. Managing fragmentation risk from financial tightening is a new situation and outside the spectrum of the ECB's traditional tools to support aggregate demand.

Without a fiscal union, or a properly functioning banking union to remove the national sovereigns from their de-facto underwriting of banks in their countries, the transmission of monetary policy through the banking system will be uneven, and dependent on the creditworthiness of the individual sovereigns. This means that two competing businesses in Germany and Italy, face different funding costs, even if they individually enjoy the same creditworthiness, for no other reason than their geographical location inside the same currency union and Single Market. If not addressed, this will ultimately turn into an unsustainable distortion in the euro zone.

To be more specific, the distortion of financing conditions for the private sector applies only to those who depend on financing through the banking systems, i.e. predominantly SMEs and households, as opposed to the bigger corporates which can access capital securities markets.

The good news is that the share of European corporations, which depends on banks – as opposed to securities - for their financing, has declined measurably in recent years. According to data from the Financial Stability Board, the share of euro zone banking assets in total financial assets has declined from around 63% ten years ago to barely more than 40% in 2020.

Of course, from a monetary policy perspective, those roughly 40% who depends on bank financing needs to face broadly similar financing conditions across the euro zone, regardless of what country they reside in.

Following the indication at the recent ad-hoc meeting that the ECB is speeding up the completion of its new anti-fragmentation tool, the main details of the backstop were likely to be announced on July 21. ECB commentary generally supported this expectation, although a number of recent comments - including by Bundesbank President Nagel – have suggested that disagreement around some of the parameters persisted, indicating that some details might not be released on Thursday July 21.

Anti-Fragmentation Public Talk

Date	Speaker	Comment
15/06/22	ECB Ad Hoc Meeting	"the Governing Council decided to mandate the relevant Eurosystem Committees together with the ECB services to accelerate the completion of the design of a new anti-fragmentation instrument for consideration by the Governing Council."
20/06/22	Villeroy de Galhau (Bank of France)	"This should be a backstop instrument. It should be available as much as necessary, so as to make our no-limits commitment to protect the euro very clear, [...] The more credible such instrument, the less it may have to be used in practice. This is how a backstop works."
28/06/22	Lagarde (ECB President)	"The new instrument will have to be effective, while being proportionate and containing sufficient safeguards to preserve the impetus of Member States towards a sound fiscal policy."
01/07/22	Panetta (Member of the Executive Board of the ECB)	"So acting against fragmentation [...] is not just consistent with our mandate; it is necessary for us to fulfil that mandate."
04/07/22	Nagel (Deutsche Bundesbank)	"I would thus caution against using monetary-policy instruments to limit risk premia. One can easily find oneself in dire straits."
04/07/22	de Guindos (Vice President of ECB)	"we will react to prevent fragmentation, with suitable safeguards to prevent moral hazard."
10/07/22	Stournaras (Bank of Greece)	"I believe that there is a lot of truth in the idea that if we convince markets that this is going to be a strong tool, we might not need it, [...] We'll have it on the shelf. This is the good scenario."

The TPM backstop key features are likely to be:
i) unlimited in size to maximize its firepower and announcement effect
ii) entail macro conditionality, that it would be linked to the EU's existing macro surveillance framework, although the details remain uncertain.
iii) any purchases will be flexibly allocated and sterilized via the liability side of the balance sheet
iv) qualitative criterion is necessary for activating purchases under the tool, mirroring the decision process around the PEPP purchase pace. The instrument has to focus on avoiding "non-fundamental" fragmentation risk without providing quantitative trigger levels for sovereign spreads.

The new anti-fragmentation mechanism should be built on the flexible PEPP. To be credible to markets, the amount available for interventions would need to be nearly unlimited, but the ECB could also announce a large envelope that could be topped-up (maybe €500bn initially with no obligation to use the full amount). ECB had to buy around €40bn of bonds per week at the start of the pandemic in March 2020. Given that we are looking at fragmentation rather than a broad-based stress event, the sums should be significantly lower, although markets may only be convinced if there is sufficient fire power to cover vulnerable countries' gross debt issuance for up to a year (over €300bn for Italy alone).

Conditionality is needed, to add legitimacy to supporting individual countries. ECB will rely on the conditionality and supervision of the New Generation EU funds framework. Still, one outstanding question is what the ECB would do if a country does not follow the conditions set out or even reverses the reform agenda (e.g. after an election).

Conditionality is widely expected to be looser than for the OMT and linked to the EU's existing macro surveillance framework. The details of how the conditionality will be defined and implemented, however, remain uncertain.

The first option is to connect the backstop to the EU-wide fiscal rules, consistent with President Lagarde's speech at the Sintra Forum stating that the new tool requires "*sufficient safeguards to preserve the impetus of Member States towards a sound fiscal policy.*" The practical issue with a link to the fiscal rules, however, is that EU's Stability and Growth Pact (SGP) is currently suspended and in need of reform in light of the pandemic surge in debt.

The second option is to connect the new instrument to the ESM, requiring countries to apply for a tailor-made program with lighter conditionality than a full macro adjustment program. While this would entail weaker conditionality than the OMT, the political hurdle implied might complicate the timely activation of the backstop tool.

Third, the anti-fragmentation tool could be linked to the Recovery Fund [i.e. NextGenerationEU], enabling the ECB to purchase bonds of countries that are fulfilling the conditions of the NGEU and supporting "*general economic policies in the Union*". A link to the NGEU would leverage the post-pandemic surveillance framework and allow for coordination with fiscal policy in times of sovereign stress (i.e., combine the activation of ECB purchases with front-loaded disbursements from NGEU). While significant uncertainty remains around the conditionality structure, a link to the NGEU and the fiscal rules is most likely.

The new bond buying would be fully sterilized, via the same withdrawal of liquidity in weekly auctions as was the case with the SMP. Legal challenges are likely, and it will be difficult for the ECB to defend sustained interventions in favor of individual countries, as this encroaches on fiscal policy.

ECB would not reveal any particular levels of targeted yields or spreads, keeping in mind the difficulty of establishing "equilibrium" levels. Interventions should be more flexible and opportunistic than in the PEPP, only intervening tactically to contain certain market movements, much in line with a loose exchange rate intervention policy. With rising interest rates, there is already acceptance that spreads could widen, and the ECB will want to make sure any such widening is orderly against any speculative attack.

Regarding the activation of purchases under the new tool, the Governing Council could announce a qualitative criterion following, for example, Board Member Isabel Schnabel's definition of non-fundamental fragmentation risk when "*yields rapidly diverge from economic fundamentals*."

The process for deciding whether purchases need to be activated is likely to mirror that of the PEPP pace, which was designed to ensure "*favorable financing conditions,*" for which ECB officials monitored a dashboard of financial indicators. The Governing Council would not focus on a single indicator (such as the level of sovereign spreads) but to monitor a range of fragmentation signals, including sovereign yields and spreads, levels and changes, prevailing macro conditions, and so on.

In terms of sequencing, ECB is expected to first make active use of reinvestment flexibility under PEPP and flag rising fragmentation risk before any purchases under the backstop are activated.

With several lines of defense – PEPP re-investments, the anti-fragmentation purchase program, and finally an OMT, which would bring in the ESM, tougher conditionality, and possible debt restructuring – we think it should be possible to deter a more prolonged bond market attack, thereby buying time for other policymakers.

Irrespective of what the ECB does however, in the coming years, euro policymakers will have to address the difficulty and stigma of turning to the ESM, conduct painful structural reform, and move the EU's fiscal integration forward.

In order to avoid another fight regarding the legality of buying peripheral debt, ECB would have a stronger case if it proceeded with QT, in order to pursue price stability, while leaving room for larger deviations from the capital keys.

This could even include temporary periods, during which the ECB would increase the holdings of individual sovereigns, while overall reducing public sector bond portfolios. For instance, if the ECB were to proceed with a modest €15bn per month reduction in the PSPP and PEPP portfolios, but left out Italy, Spain and Portugal, around €55bn would be "freed" up that could be used to buy more of these countries sovereign debt, while still reducing the balance sheet.

Selling assets to support vulnerable countries would have a greater positive impact on spreads, but at the same time raise the level of yields as more supply is released back into the market. While remaining controversial from the perspective of country equality perspective, the ECB could still find it easier to defend actions to secure price stability via core yields, i.e. the lowest yields. It could be argued that core bond yields are less price elastic, suggesting that the yield impact could be relatively small on core yields from a gradual reduction in the ECB's bond portfolios.

During the Eurogroup meeting on July 12 the creation of an informal task force of officials to monitor the markets during the summer break was discussed. Summer is a period in which low liquidity and thinly staffed trading floors can give rise to disruptive movements in bond yields and stock markets. The group would scan for emerging market hazards and have the power to convene policymakers if trouble erupts.

The search for closer co-ordination between institutions and member states speaks to a broader concern among finance ministries - namely the risk of disjointed or contradictory action by different member states that ends up eroding, rather than shoring up, market confidence.

The 19 euro zone finance ministers say they have already agreed not to boost demand via extra borrowing next year, to ensure they don’t further stoke inflationary pressures.

Holding a clear agreed line will, however, be much easier said than done. Italy is the main focus of member states’ concerns, given the risk that Rome will fall behind on its reform commitments or fail to keep a tight grip on public borrowing.

Brussels 2022 Economic Forecast

On July 14, Brussels has lifted its forecasts for inflation this year and in 2023 whereas reducing again its progress outlook, because the power disaster fueled by Russia’s conflict in Ukraine continues to hammer Europe’s financial system.

Inflation is now predicted to hit 7.6% this year within the euro space, in response to the European Commission - in contrast with the earlier forecast of 6.1%. Inflation will fall to 4% in 2023 - nonetheless far above the European Central Bank’s 2% goal and considerably greater than the prediction of 2.7% in its spring forecast.

Table 1: Gross domestic product, volume (percentage change on preceding year, 2003-2023) 05.07.2022

	5-year averages							Summer 2022 Forecast		Spring 2022 Forecast	
	2003 - 07	2008 - 12	2013 - 17	2018	2019	2020	2021	2022	2023	2022	2023
Belgium	2.6	0.7	1.4	1.8	2.1	-5.7	6.2	**2.3**	**1.3**	*2.0*	*1.8*
Germany	1.6	0.7	1.8	1.1	1.1	-4.6	2.9	**1.4**	**1.3**	*1.6*	*2.4*
Estonia	8.2	-1.7	3.0	4.1	4.1	-3.0	8.3	**1.6**	**1.9**	*1.0*	*2.4*
Ireland	5.2	-1.4	8.9	9.0	4.9	5.9	13.5	**5.3**	**4.0**	*5.4*	*4.4*
Greece	4.1	-5.5	-0.3	1.7	1.8	-9.0	8.3	**4.0**	**2.4**	*3.5*	*3.1*
Spain	3.5	-1.3	1.9	2.3	2.1	-10.8	5.1	**4.0**	**2.1**	*4.0*	*3.4*
France	2.0	0.4	1.2	1.9	1.8	-7.8	6.8	**2.4**	**1.4**	*3.1*	*1.8*
Italy	1.1	-1.4	0.4	0.9	0.5	-9.0	6.6	**2.9**	**0.9**	*2.4*	*1.9*
Cyprus	4.5	0.1	1.3	5.7	5.3	-5.0	5.5	**3.2**	**2.1**	*2.3*	*3.5*
Latvia	9.9	-2.7	2.7	4.0	2.5	-3.8	4.5	**3.9**	**2.2**	*2.0*	*2.9*
Lithuania	8.7	-0.4	3.2	4.0	4.6	-0.1	5.0	**1.9**	**2.5**	*1.7*	*2.6*
Luxembourg	4.7	0.6	2.9	2.0	3.3	-1.8	6.9	**2.6**	**2.1**	*2.2*	*2.7*
Malta	3.0	2.5	7.4	6.2	5.9	-8.3	10.4	**4.9**	**3.8**	*4.2*	*4.0*
Netherlands	2.3	0.0	1.7	2.4	2.0	-3.9	4.9	**3.0**	**1.0**	*3.3*	*1.6*
Austria	2.6	0.6	1.2	2.5	1.5	-6.7	4.8	**3.7**	**1.5**	*3.9*	*1.9*
Portugal	1.1	-1.4	1.4	2.8	2.7	-8.4	4.9	**6.5**	**1.9**	*5.8*	*2.7*
Slovenia	4.8	-1.0	2.4	4.4	3.3	-4.2	8.1	**5.4**	**1.0**	*3.7*	*3.1*
Slovakia	7.3	2.0	2.7	3.8	2.6	-4.4	3.0	**1.9**	**2.7**	*2.3*	*3.6*
Finland	3.6	-0.7	1.0	1.1	1.2	-2.2	3.0	**1.8**	**1.2**	*1.6*	*1.7*
Euro area	2.2	-0.3	1.5	1.8	1.6	-6.4	5.3	**2.6**	**1.4**	*2.7*	*2.3*
Bulgaria	6.4	1.4	1.9	2.7	4.0	-4.4	4.2	**2.8**	**2.3**	*2.1*	*3.1*
Czechia	5.5	0.2	3.0	3.2	3.0	-5.5	3.5	**2.3**	**2.0**	*1.9*	*2.7*
Denmark	2.0	-0.4	2.2	2.0	1.5	-2.0	4.9	**3.0**	**1.2**	*2.6*	*1.8*
Croatia	4.8	-1.8	1.7	2.9	3.5	-8.1	10.2	**3.4**	**2.9**	*3.4*	*3.0*
Hungary	3.5	-0.8	3.2	5.4	4.6	-4.5	7.1	**5.2**	**2.1**	*3.6*	*2.6*
Poland	5.0	3.4	3.3	5.4	4.7	-2.2	5.9	**5.2**	**1.5**	*3.7*	*3.0*
Romania	6.5	0.6	4.5	4.5	4.2	-3.7	5.9	**3.9**	**2.9**	*2.6*	*3.6*
Sweden	3.5	0.7	2.6	2.0	2.0	-2.2	5.1	**1.3**	**0.8**	*2.3*	*1.4*
EU	2.4	-0.1	1.7	2.1	1.8	-5.9	5.4	**2.7**	**1.5**	*2.7*	*2.3*

Growth in the euro area, in the meantime, will probably be weaker than beforehand forecast within the euro space, at 2.6% this year and 1.4% in 2023. Growth throughout the broader EU will probably be 2.7% in 2022 and 1.5% in 2023.

Russia's invasion of Ukraine has put additional upward pressures on energy and food commodity prices. These are feeding global inflationary margins , eroding the purchasing power of households and triggering a faster monetary policy response than previously assumed.

The EU economy remains particularly vulnerable to developments in energy markets due to its high reliance on Russian fossil fuels, and weakening global growth detracts from external demand.

Overall, the EU economy is set to continue expanding, but at a significantly slower pace than expected in the Spring 2022 Forecast.

Table 3: Harmonised index of consumer prices, (percentage change on preceding year, 2003-2023) 05.07.2022

	5-year averages							Summer 2022 Forecast		Spring 2022 Forecast	
	2003 - 07	2008 - 12	2013 - 17	2018	2019	2020	2021	2022	2023	2022	2023
Belgium	2.0	2.5	1.3	2.3	1.2	0.4	3.2	**9.4**	**2.9**	*7.8*	*1.9*
Germany	1.8	1.7	1.0	1.9	1.4	0.4	3.2	**7.9**	**4.8**	*6.5*	*3.1*
Estonia	3.9	4.5	1.6	3.4	2.3	-0.6	4.5	**17.0**	**4.7**	*11.2*	*2.5*
Ireland	2.8	0.6	0.2	0.7	0.9	-0.5	2.4	**7.3**	**3.3**	*6.1*	*3.1*
Greece	3.3	2.9	-0.4	0.8	0.5	-1.3	0.6	**8.9**	**3.5**	*6.3*	*1.9*
Spain	3.2	2.3	0.5	1.7	0.8	-0.3	3.0	**8.1**	**3.4**	*6.3*	*1.8*
France	2.0	1.9	0.6	2.1	1.3	0.5	2.1	**5.9**	**4.1**	*4.9*	*3.1*
Italy	2.3	2.4	0.6	1.2	0.6	-0.1	1.9	**7.4**	**3.4**	*5.9*	*2.3*
Cyprus	2.5	2.7	-0.4	0.8	0.5	-1.1	2.3	**7.0**	**3.3**	*5.2*	*2.7*
Latvia	6.5	4.6	0.8	2.6	2.7	0.1	3.2	**15.5**	**6.0**	*9.4*	*3.5*
Lithuania	2.4	4.7	1.0	2.5	2.2	1.1	4.6	**17.0**	**5.1**	*12.5*	*3.0*
Luxembourg	3.0	2.7	0.9	2.0	1.6	0.0	3.5	**8.5**	**3.0**	*6.8*	*2.3*
Malta	2.1	2.9	1.0	1.7	1.5	0.8	0.7	**5.6**	**3.3**	*4.5*	*2.6*
Netherlands	1.7	1.9	0.9	1.6	2.7	1.1	2.8	**9.4**	**3.3**	*7.4*	*2.7*
Austria	1.9	2.3	1.5	2.1	1.5	1.4	2.8	**7.4**	**4.4**	*6.0*	*3.0*
Portugal	2.7	1.9	0.6	1.2	0.3	-0.1	0.9	**6.8**	**3.6**	*4.4*	*1.9*
Slovenia	3.6	2.7	0.6	1.9	1.7	-0.3	2.0	**7.6**	**4.9**	*6.1*	*3.3*
Slovakia	4.9	2.7	0.4	2.5	2.8	2.0	2.8	**10.5**	**8.2**	*9.8*	*6.8*
Finland	1.0	2.7	0.9	1.2	1.1	0.4	2.1	**6.4**	**2.8**	*4.5*	*2.3*
Euro area	2.2	2.1	0.7	1.8	1.2	0.3	2.6	**7.6**	**4.0**	*6.1*	*2.7*
Bulgaria	5.9	4.6	-0.5	2.6	2.5	1.2	2.8	**12.5**	**6.8**	*11.9*	*5.0*
Czechia	1.8	2.7	1.0	2.0	2.6	3.3	3.3	**13.9**	**5.8**	*11.7*	*4.5*
Denmark	1.6	2.4	0.4	0.7	0.7	0.3	1.9	**7.5**	**3.4**	*5.1*	*2.7*
Croatia	2.7	2.9	0.6	1.6	0.8	0.0	2.7	**8.2**	**3.6**	*6.1*	*2.8*
Hungary	5.4	4.9	0.9	2.9	3.4	3.4	5.2	**11.8**	**7.6**	*9.0*	*4.1*
Poland	2.1	3.7	0.3	1.2	2.1	3.7	5.2	**12.2**	**9.0**	*11.6*	*7.3*
Romania	9.5	5.7	0.8	4.1	3.9	2.3	4.1	**11.1**	**7.2**	*8.9*	*5.1*
Sweden	1.5	1.9	0.9	2.0	1.7	0.7	2.7	**6.6**	**3.6**	*5.3*	*3.0*
EU	2.4	2.4	0.7	1.8	1.4	0.7	2.9	**8.3**	**4.6**	*6.8*	*3.2*

With the latest data, there has been some evolution of the euro area looking a bit more like the U.S. Headline inflation of 8% to 9% in the U.S., U.K. and euro area, and the numbers here have continued to surprise on the upside. Now, the euro area inflation picture has been different from other countries in a number of respects. There's a higher energy contribution in Europe; it's about twice as large as in the U.S. Core inflation and wage growth so far have been weaker, which has basically been because the labor market is less overheated than for example in the U.S.

Market forecasting ECB main interest rate before July 21 ECB meeting

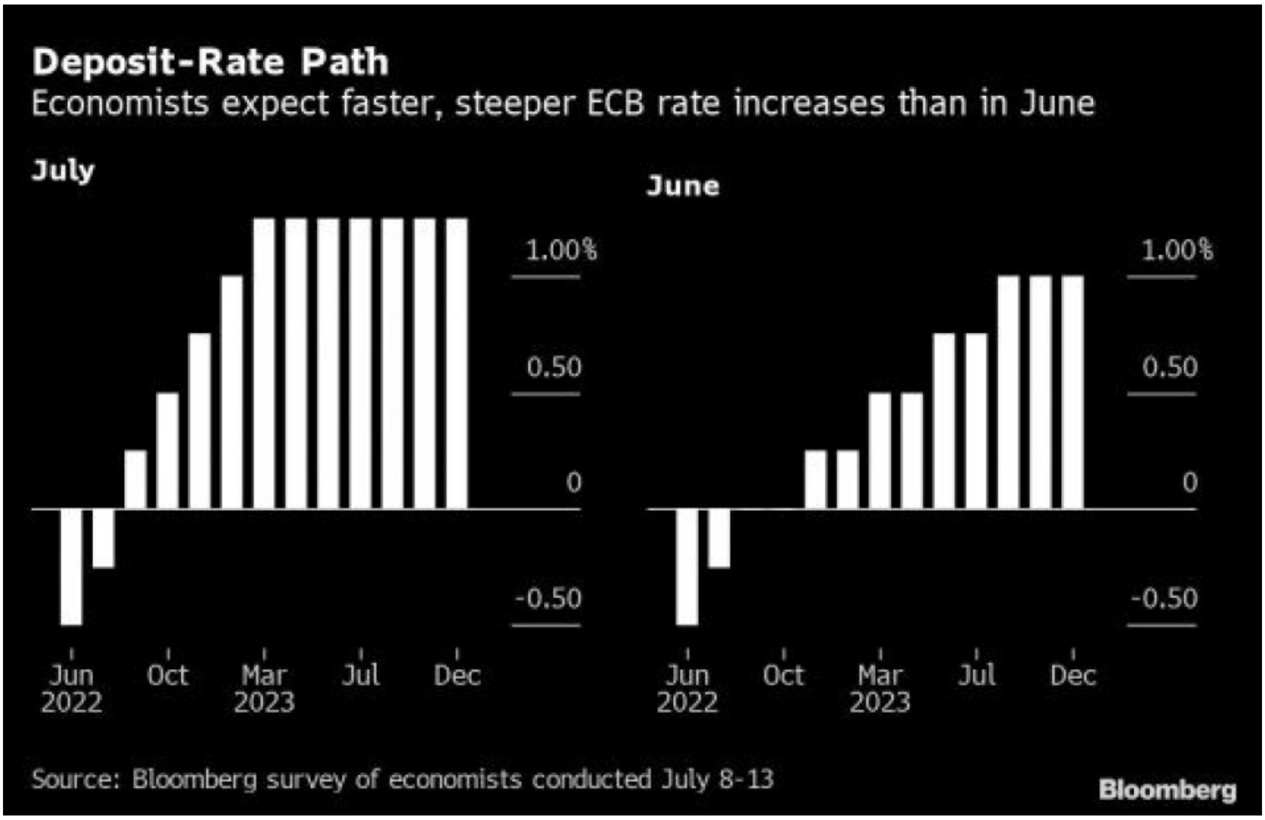
Deposit facility rate forecast expected a 25bps hike in July, 50bps in September and October while a 25bps hike in December this year to a terminal rate of 1.75% in 2023, taking into account that the risk of larger moves should inflation expectations show more signs of de-anchoring.

The ECB could also consider a gradual reduction in the balance sheet while simultaneously allowing temporarily larger deviations from the capital key, adjusting them over the life of the programs. We expect a 25bps hike in July and another 125bps this year with the risk that significantly more will be needed.

But the euro area inflation picture has started to look more like the U.S. and U.K. If you look at core inflation over the last six months, it's been running essentially at the same level. Inflation expectations have been rising and wage growth has stated to accelerate. It's still below U.S. and U.K. levels, but it's not going to rise further from here.

The bottom line is that inflation is also likely to remain above 2% for the next two to three years, and that does mean there's more urgency for the ECB to act. That said, the underlying inflation pressures for Europe are still lower and so ECB doesn't need to hurry quite as much as the Fed.

Meanwhile, on the inflation front, German steel workers just struck a deal for a 6.5% increase in their wages. Although it is wary of reading such a piece of news as a massive generalized increase in wages across the euro area, one could take it as a signal of increasing risks of higher-for-longer inflation dynamics, further complicating the task of the ECB.



HICP Inflation Rate – Overall Index Euro area

The Euro system staff macroeconomic projections from the beginning of June expected euro area consumer price inflation to average 6.8% for 2022 and still come to 3.5% in 2023. And in 2024, the average inflation rate is projected to still be slightly in excess of our 2% inflation target.

The ECB is planning to start raising interest rates in July for the first time since 2011, beginning with a quarter percentage point increase, followed by a bigger rise in September.

Market forecasted that the Governing Council would lift off with 25bps in July, followed by 50bps hikes in September and October. Then ECB would return to a more gradual 25bps pace at the December meeting, followed by three more 25bps hikes in 2023, including February, March and June to a terminal rate of 1.75%. The risk of a complete stop of Russian gas flows, however, skews the risk to the pace of hiking to the downside beyond the near-term meetings.

The ECB is facing a "risk trilemma" as its hawkish monetary policy pivot raises the specter of fragmentation risk, which threatens to impede the efficient transmission of monetary policy. At its next meeting on July 21, the ECB would have to deliver on an anti-fragmentation tool that convinces the markets, keeps some constructive ambiguity, respects legal boundaries, and does not hinder the pace of policy normalization.

However, the tool could only serve as temporary measure since it fights the symptom rather than the cause. While the ECB can compress default risk premia driving potential fragmentation (and could provide incentives for fiscal prudence through conditionality), it cannot directly address re-denomination risk. Thus, the normalization of monetary policy puts more pressure on an effective rules-based fiscal governance in the euro zone.

The Italian conundrum: Part II

The Government crisis in Italy is complicating a politically sensitive plan devised by the European Central Bank to support indebted euro zone countries on the bond market before it even starts in earnest.

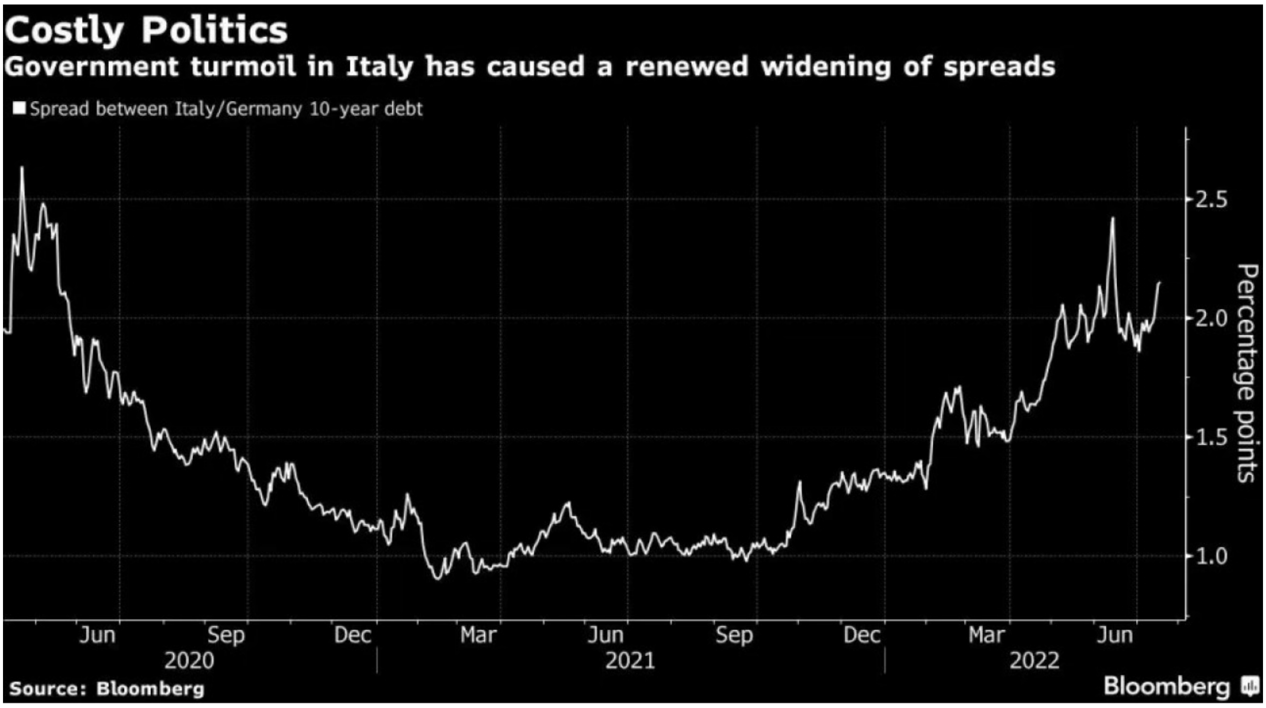
The rise was most acute in Italy, largely due to investors pricing in slower economic growth and the impact of higher interest rates on its €2.5 trillion debt pile.

But the latest surge in Italian bond yields and in the borrowing premium it pays over safe-haven Germany had been harder to interpret, as markets responded to fears of a collapse of Mario Draghi's government, whose fate hangs in the balance.

Italian bond yields rose sharply last week after the Five Star Movement, which is part of Draghi's national unity government, refused to support him in a confidence vote, prompting the prime minister to offer his resignation. Although the president rejected him, the Italians were waiting to see if Draghi was willing to stay on or if the country would hold early elections. Any sign that the prime minister would resign was likely to lead to a rise in Italy's borrowing costs.

With Draghi facing a new confidence vote in parliament on 20 July, investors were concerned that, if a new government is formed either before or after elections due by summer 2023, Rome may not maintain compliance with Next Generation EU funding conditions. Any significant ECB corrective action would be impossible. This would send bond market spreads spiraling higher between stronger and weaker members of monetary union. And it might depress the euro further on the foreign exchanges – another factor stoking inflation.

This left the ECB in the awkward position of determining which part of the spread widening is "unwarranted" - or giving up buying Italy's bonds altogether.



That decision has legal implications, as intervening in the middle of a government crisis would provide fresh ammunition to those who have accused the ECB, via its market transactions, of breaking the law by getting involved in politics. Such criticisms - along with lawsuits challenging a long-running ECB asset purchase scheme – have been prominent in Germany.

When the ECB announced its plans on June 15, the closely watched spread between Italian and German 10-year bonds had hit a two-year high of 250bps. That helped narrow it to 186bps. It was back around 222bps on July 15 as investors weighed hopes of Draghi - Christine Lagarde's predecessor as ECB president - staying against the risk of new elections, at which polls suggest the far-right Brothers of Italy may emerge as the biggest party.

In 2018, the ECB stayed put when Italian spreads widened after the formation of what was then seen as a populist, eurosceptic government. But in 2022, the worries about higher rates and political concerns were harder to disentangle.

The ECB's new tool to counter unwarranted jumps in euro-area borrowing costs may be tested sooner than expected as fresh political uncertainty engulfs Italy. With Prime Minister Mario Draghi's government on the brink of collapse, the spread between 10-year Italian bonds and their German counterparts has surged past 200bps - a threshold the country's central bank chief has previously called unjustified. That risks raising pressure on the ECB to make its instrument easier to activate.

Political drama is unlikely to trigger the instrument -- at least not to shore up Italian bonds. "*It will not be used if the spread widens during a time of political crisis in Italy -- it's not just because of resistance from the Germans, but it's also a legal issue... In this circumstance, the gray area might be way too gray for the ECB to intervene. Perhaps the usefulness of this tool might be to shield other countries from spillovers from Italian political developments*," according to Silvia Ardagna, head of European economics at Barclays, speaking to Bloomberg Television. Many economists believe that this is the kind of fragmentation that the ECB should not try to fight.

The turmoil in Italy showed how difficult it will be for the ECB to distinguish the impact of unwarranted speculation from more justified movements in interest rates based on bleak economic prospects.

As well as political upheaval in Italy, markets also worried about a growing energy crisis in Germany, where officials are nervously waiting to find out if Russia would turn the gas back on July 21 after a scheduled 10-day maintenance period for one of its main pipelines to Europe. If the gas does not flow or if there are further delays in winter, several EU countries that rely on it are set to impose energy rationing, starting with heavy industrial users, which is likely to trigger a severe economic downturn across the bloc.

The ECB's plan to tackle unwarranted fragmentation in the euro zone bond markets has already been met with icy welcome from officials from more frugal northern countries such as Germany, Austria and the Netherlands.

Their concerns are that the ECB is overreacting as bond markets adjust to the prospect of rising interest rates. By trying to keep borrowing costs low for highly indebted countries, they fear the central bank will encourage fiscal sluggishness and could stray into "monetary financing" of governments, in violation of the EU treaty.

"*If [the scheme] crosses the line between monetary and fiscal policy, it will be politically toxic in Northern Europe*," warned Lars Feld, an economics professor at Albert-Ludwigs-University of Freiburg who advises the German finance minister.

Investors are concerned that early Italian elections could lead to a government led by Giorgia Meloni's Brothers of Italy party, which falls outside Draghi's coalition, has roots in post-fascist politics and leads opinion polls.

ECB Bank Lending Survey (BLS): Signs of fragmentation?

Bank lending rates are notoriously difficult to interpret given different financing preferences across countries and borrowing growth does not give an accurate view either. The ECB's own bank lending survey does provide some interesting insights, allowing for a qualitative assessment into whether changes in lending conditions (cost of borrowing) and credit standards (for the approval of loans) are happening.

2022 Q2 data were published on July 19 showed a considerable tightening of credit standards for enterprises in France and Italy, while in Germany and Spain, the percentage of banks reporting tightening was flat or declined. In France, this was mainly due to lower risk tolerance and higher perceptions of risk, while in Italy, the cost of funds and balance sheet constraints played a role.

The latter seems to be the main factor to look at when considering financial fragmentation. Also important is that the terms and conditions for loans to enterprises have tightened. This was mainly visible in Italy and Spain where margins, on average, and riskier loans compared to the benchmark have

For mortgages, the picture is mixed. In terms of tighter conditions, Germany and Spain saw much stricter conditions to provide home loans while rates went up most in Spain and Italy, where most banks indicated a strong increase.

So there are some differences in tighter credit conditions and standards between the larger countries with Italy and Spain both seeing above-average tightening overall. The reasons for tighter conditions and whether this makes it necessary to act are fuel for debate.

Tighter standards and slowing demand for loans are a warning sign for the ECB. The overall outcome from the survey is perhaps more worrisome for the ECB. Considerable tightening of credit standards and increased borrowing costs indicate that investment is set to suffer in the months ahead, especially as the survey indicates that demand for borrowing for fixed investment dropped dramatically in 2Q. With significantly tighter standards and lower demand for mortgages as well, the impact of tighter conditions will be felt throughout the economy and is set to contribute to the economic slowdown.

Just ahead of the ECB's first rate hike in more than a decade, financial conditions have already tightened significantly and this is contributing to an economy already slowing down. This tells something about neutral rates – which are likely to be much lower than most expect – and how much the ECB can ultimately raise rates this cycle.

Addressing vexing questions on the new instrument

The most important question was whether the new tool to address unwarranted sovereign spread widening would be unveiled on July 21. The rationale for such an anti fragmentation instrument is well understood but its design and use raise several questions. Key features of the TPM including timing and duration, conditionality, trigger points for intervention and sterilization or neutralization of the proceeds are all highly sensitive. If a half-formed or ambiguously worded TPM emerges, a market sell-off may ensue.

Where is the threshold to call a spread widening 'unwarranted'?

Answering this question is a challenge because years of asset purchases as well as the COVID-19 pandemic and the ECB's policy reaction (PEPP) have influenced interest rate differentials between euro area countries. Moreover, the recent spread widening occurred in an environment of rising yields on German government bonds, which are used as a benchmark in the euro area.

Ending PEPP and APP leaves a gap. Net purchases under the ECB's government bond facilities – APP and PEPP – stopped at the end of June. These purchases are reflected in the Eurosystem's greatly expanded €4.9tn public and private sector bond portfolio.

Should the ECB be clear or ambiguous on this threshold and on its reaction when it would be reached?

The former would imply that thresholds - such as, according to the Bank of Italy calculations, 200bps for the BTP-Bund spread - are communicated with the hope that this would slow down speculation when the market is approaching this level: investors might fear that intervention by the ECB would be imminent. However, the opposite cannot be excluded, with investors testing the determination of the central bank in defending a certain spread.

This would call for keeping some ambiguity, although this would inevitably trigger questions during the press conference that follow the Governing Council meetings. The reaction function not only concerns the threshold level for spreads but also, if the spread would have moved beyond, how quickly the central bank would try to bring it back below.

What is the appropriate frequency of communicating on the market interventions?

Under the OMT program, which were introduced in September 2012 following Mario Draghi's famous speech in July that year but never used, the aggregate holdings of the Eurosystem and their market value would have been published on a weekly basis and the country details on a monthly basis. Frequent communication about the threshold and market interventions would show decisiveness, but it would also suppose that the policy is effective. Otherwise, there would be a credibility problem that would make matters worse.

How to avoid a conflict with the monetary policy stance?

Bond purchases by the central bank imply the creation of high-powered money. This would need to be sterilized if it would run into conflict with the monetary policy stance, e.g. during a rate hike cycle. Under OMT, the transactions would also have been sterilized.

The next question concerns moral hazard and, hence, conditionality. When the ECB intervenes to address unwarranted spread widening, what are governments supposed to do in return in terms of fiscal policy?

When the ECB intervenes to address unwarranted spread widening, public finances of the targeted countries benefit - a significant increase in the borrowing cost is being avoided - which raises the question of what governments are supposed to do in return in terms of fiscal policy? Bundesbank president Joachim Nagel recently argued in favor of designing the bond buying scheme based on the experience of OMT to avoid giving "*the impression of discouraging fiscal policy consolidation*".

On the other hand that due to the stigma effect, there had been a reluctance to resort to an ESM program but that Next GenerationEU had shown it is possible to have conditionality without strong stigma effects. This message was recently echoed by Fabio Panetta, who insisted that the PEPP and Next Generation EU "*clearly show that there are other possibilities that involve flexibility and cooperation, rather than confrontation, between Europe and its Member States.*" The debate within the Governing Council would probably be intense.

With the ending of the APP and PEPP, the ECB cannot buy specific government debt without an outside authority setting conditions. Strictures set in 2016 by the German constitutional court – in relation to Draghi's (never used) OMT program decided in September 2012 – constrain the Bundesbank's participation in any new measures. In particular the court rules that any such action should be short term only and should be reversed as soon as the conditions warranting it are no longer in place.

Will the fragmentation tool be credible enough to get it pass the legal barriers?

President Christine Lagarde knows any anti-fragmentation measure is likely to be scrutinized by Germany's constitutional court. Every one of the ECB's past bond-buying programs has provoked lawsuits, with each getting progressively more complicated to resolve.

Most legal challenges have failed until now, though cases against the ECB's PEPP program are still pending. As a reminder, in a 2020 judgment over QE, Germany's top judges conditionally prohibited the Bundesbank from implementing ECB policies, in a ruling that legal scholars described as a "*declaration of war*" on the primacy of EU law and led to a political standoff with the EC.

Given that history, the Governing Council's creation of a tool that can facilitate interest-rate increases while stemming subsequent market speculation on Italy's public finances may involve more legal considerations than any monetary policy decision since the euro was founded.

The challenge is to ensure any plan conforms to the ECB's mandate of delivering price stability and doesn't directly finance governments. That means a decision, on when and under what circumstances it could buy bonds, needs to be matched by safeguards and conditions countries must fulfill in exchange.

The burden of determining if a measure can run that gauntlet would fall on the ECB's chief legal official, Chiara Zilioli, a Harvard-educated former Fulbright scholar with a doctorate from the European University Institute in Florence. Lagarde's own background as a lawyer may draw her attention to the detail too.

On the positive side, ECB may be helped by a generational change at Germany's highest court. A critical judge has already left the chamber responsible for cases involving Germany and the EU. Three more out of a total of eight will leave within the next 18 months.

Even so, "...*it could take years of litigating before officials can be sure of being on a sound footing. Legal uncertainty will hang over the ECB like the sword of Damocles. That risks reining in the ECB because policy makers can't be absolutely sure they're in the clear. It also threatens to undermine the tool's full effectiveness if markets get the impression there are legal problems ahead,*" said Armin Steinbach, a professor of law and economics at Hautes Études Commerciales (HEC) in Paris, who previously worked at Germany's finance ministry.

Does the relationship between Lagarde and Nagel face pressure?

The relationship between Lagarde and Joachim Nagel, which started the year positively, may now be under strain. Appointed at the end of last year, Nagel has been allotted the difficult task of both securing majorities on the ECB council and helping tighten monetary policy. He now faces a similar predicament to that of Jens Weidmann, his predecessor: finding himself in a structural minority on the council in key decisions.

There are differing interpretations of the reasoning behind the hastily arranged meeting on 15 June, upsetting plans for key council members (including Nagel) to make speeches at an event in Milan that day. Some believe that recourse to emergency procedures marked a return to Draghi's well-honed tactics of narrowing the council's freedom of maneuver.

In apparent defiance, on July 4, Nagel warned of the difficulty in deciding whether divergences in bond yields met legal tests for justifying ECB corrective action. This could take place only "*in exceptional circumstances and under narrowly defined conditions*."

ECB under market pressure to do more just before July 21 meeting

The preliminary call for a 25bps hike from the ECB reflected what markets expected in June. A 25bps, was always likely to be the ECB way. But that seems to have changed in July 19. ECB could be on the verge of a 50bps hike.

ECB policymakers were considering raising interest rates by a bigger-than-expected 50bps at their meeting on Thursday to tame record-high inflation, according to Reuters sources on July 19.

The ECB was set to deliver its first rate hike in more than a decade on Thursday July 21 against a difficult economic backdrop exacerbated by the war in Ukraine. Inflation is high and rising while economic growth has slowed and a political crisis in Italy is keeping investors on edge.

But the risk of a recession in the euro zone, particularly if Russia turns off the taps to natural gas supplies, made some ECB governors more cautious about choking growth.

Market expectations have been consistently more upbeat on what the ECB could be doing. Markets could argue that there are many good reasons to go the full 50bps. Here are a few:

• Even if it does not solve the inflation issue, it at least pushes against it,

• It gets rates out of negative territory, which is not a natural state in the first place, and

• It shores up the EUR, which remains under big pressure to the downside.

In comparison, the Fed has hiked rates 12 times since the last time the ECB did in 2011, the Bank of England has raised rates 7 times and only the Bank of Japan has not raised rates at all.

While the ECBs long-awaited rate lift-off brings it closer to the more than 80 central banks that have already raised this year, it still trails the likes of the Federal Reserve, which began hiking in March and opted most recently for a jumbo 75 basis-point increase.

Whats more, just as it gets under way, the case for caution is stacking up. A recession is increasingly likely in Europe and would be amplified if Russia halts winter energy supplies. Elsewhere, a political crisis in Italy showed how quickly government-bond markets can become unnerved, while the euro recently slipped to parity with the US dollar, feeding record inflation that is four times the 2% target.

EUR/USD jumped well above 1.0200 on July 19 following the Reuters news that the ECB was actively considering a 50bps rate hike. Chief ECB Economist Philip Lane would reportedly make the official proposal at the meeting, and markets were attempting to gauge how many members of the Governing Council would be happy to back such a move. Only three members were explicitly backed a half-point hike before the "quiet period" kicked in, and markets were attaching a 50% chance of a 50bps move.

The Italian conundrum: Part III

Another thread to keep an eye on in Europe: Italy's Prime Minister Mario Draghi tendered his resignation Thursday morning on July 21, paving the way for fresh elections and opening a new chapter of political uncertainty.

The government crisis crystallized the previous day, when after Mario Draghi's address to the Senate the 5SM [i.e. Five Star Movement], the League and Forza Italia decided not to take part in a confidence vote on a cost of living aid package worth €26 billion. After the collapse of the national unity government, President Mattarella dissolved parliament and called a snap election in early October

Draghi resignation, affirmed that the political conditions needed to effectively meet the targets set by his government were no longer in place. He said that in order to complete his task, a new coalition agreement should be built from scratch to restore the necessary level of cohesion between the parties supporting the government.

In doing so, he left little room for ambiguity, setting his own conditions, touching upon themes such as the revision of the citizenship income (a stronghold for the 5SM) and opening up to competition taxi licenses and seaside concessions (strongly opposed by the League).

His address was received badly not only by the 5SM, but also by the League and, more surprisingly, by Forza Italia. They all decided not to take part in the confidence vote, which was eventually passed, mainly due to abstentions.

As PM Draghi was not voted down in parliament, he would likely be called to run the government for ordinary affairs until the elections.

Italian bond and stocks sold off sharply on concerns that the political crisis would delay reforms needed as Italy taps into post-pandemic recovery funds from the European Union. BTPs yields rose Thursday July 21 on the expectation that Draghi would resign. The yield on the 10-year government bond rose to 3.635% at around 10 am. local time, while the 10y BTP-Bund spread increased to 233bps; it was around 1% at the start of the year.

In addition, stock markets were lower on Thursday's news. Italy's main index, the FTSE MIB, traded 2% lower in mid-morning trade with banking stocks leading the declines.

There are a number of reasons why investors are concerned about Italy. First and foremost, opinion polls point to a fragmented parliament, meaning that new elections could result in tough coalition negotiations.

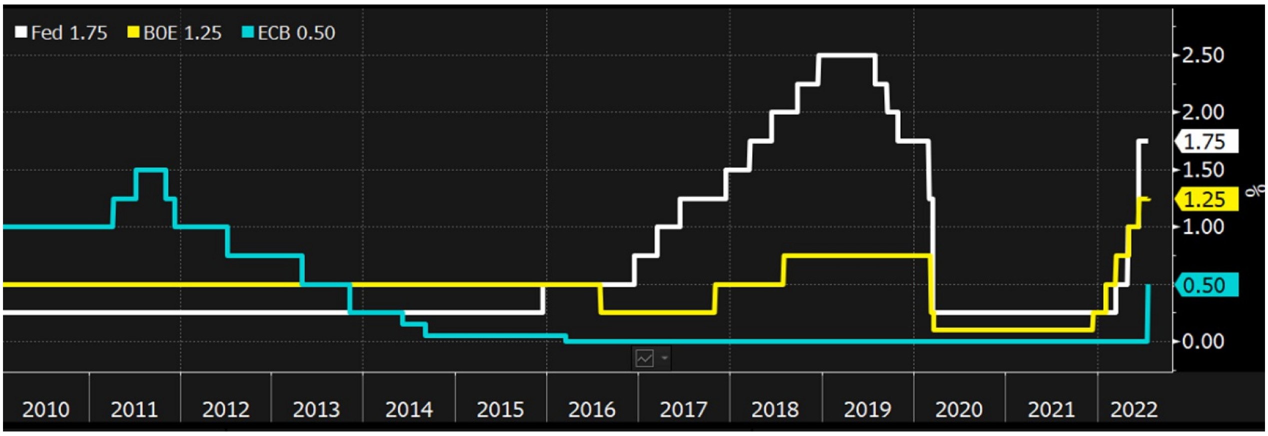
At the same time, Italy has one of the highest debt piles in Europe, is facing record inflation and its growth prospects are limited. This macroeconomic context becomes particularly challenging as the ECB prepares to lift interest rates, which could hamper the economic performance of Italy going forward.

Draghi's resignation was a big blow to Italy's ability to deliver policies and reforms over the near term. There would be delays and disruptions with early elections, and most likely no budget by year's end.

ECB July 21 Meeting Decisions

The ECB Governing Council surprised markets by a 50 bps rate hike and by dropping its forward guidance and moving to a data-dependent tightening cycle. This may reflect unease about how quickly the euro area economy might react to the policy moves and about the consequences of uncertainty about gas supply during the winter months. Another key decision was the introduction of the Transmission Protection Instrument (TPI), a tool to address unwarranted spread widening that would weigh on the effectiveness of monetary policy transmission.

ECB Governing Council took three main decisions at its meeting on July 21:



• ECB officials hiked key policy rates by 50bps and thus deviated from their previous initial intention for a 25bps rise. Lagarde motivated the 50bps move with stronger inflation data than anticipated in June and the announcement of the new TPI. She noted that inflation pressures have broadened further and that most measures of underlying inflation have risen further, skewing risks to the inflation outlook to the upside. ECB prioritized ending negative rates - that looked increasingly out of sync in light of upward surprises to inflation - and accelerating its normalization path over predictability with this step.

• The Governing Council dropped its previous guidance for a *"larger increment"* in September and instead adopted a "*meeting-by-meeting*" approach. Lagarde noted that the 50bps hike implied that guidance for the rise in September is no longer applicable. The Governing Council indicated that further normalization is appropriate and that today's larger hike does not necessarily change the terminal rate [i.e. 2%], but that the future rate path is data dependent.

• Governing Council reached unanimous agreement to approve the new anti-fragmentation tool TPI. The new tool is designed to "*support the effective transmission of monetary policy*" and "t*o counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the Euro area.*" Lagarde noted that the Governing Council will consider multiple market and transmission indicators such as the cost of borrowing for governments and businesses to determine whether market dynamics are disorderly and not warranted by country-specific fundamentals. Moreover, TPI purchases would be terminated either upon a durable improvement in transmission, or if the Governing Council concludes that persistent tensions are due to country fundamentals.

The fact that the TPI was agreed, defying reports of a possible delay, as well as a string of higher than expected inflation signals, together with additional pressure from the Fed via a weaker euro, was likely instrumental in tipping the balance from 25bps to 50bps. What seems to have swung the decision in favor of 50bps was unanimous support for the TPI. Although energy prices may dampen headline inflation in the near term, no major improvement in the core inflation outlook is expected.

Governing Council members were rushed into finalizing the new instrument sooner than they would have liked by a sell-off in Italy's bond market, which deepened the same day after the country's prime minister and former ECB president Mario Draghi resigned, triggering a widening spread between yields on the debts of Italy and Germany.

ECB MONETARY POLICY STATEMENT, JUNE VERSUS JULY	
Monetary policy statement 9 June 2022	Monetary policy statement 21 July 2022
In line with our policy sequencing, we intend to raise the key ECB interest rates by 25 basis points at our July monetary policy meeting.	We decided to raise the three key ECB interest rates by 50 basis points and approved the Transmission Protection Instrument (TPI). The Governing Council judged that it is appropriate to take a larger first step on its policy rate normalisation path than signalled at its previous meeting. This decision is based on our updated assessment of inflation risks and the reinforced support provided by the TPI for the effective transmission of monetary policy.
Looking further ahead, we expect to raise the key ECB interest rates again in September. The calibration of this rate increase will depend on the updated medium-term inflation outlook. If the medium-term inflation outlook persists or deteriorates, a larger increment will be appropriate at our September meeting ..., beyond September, based on our current assessment, we anticipate that a gradual but sustained path of further increases in interest rates will be appropriate. In line with our commitment to our two per cent medium-term target, the pace at which we adjust our monetary policy will depend on the incoming data and how we assess inflation to develop in the medium term.	At our upcoming meetings, further normalisation of interest rates will be appropriate. The frontloading today of the exit from negative interest rates allows us to make a transition to a meeting-by-meeting approach to our interest rate decisions. Our future policy rate path will continue to be data-dependent and will help us deliver on our two per cent inflation target over the medium term. In the context of our policy normalisation, we will evaluate options for remunerating excess liquidity holdings.

Source: ECB

The comparison of the monetary policy statement of the June and July meetings shows to what extent the message has changed. The intention in June was to raise rates 25bps in July but eventually the Governing Council went for 50 bps, based on its assessment of the inflation risks and "*the reinforced support provided by the TPI for the effective transmission of monetary policy.*" TPI could be used should spreads react disproportionately to the unexpectedly large hike in the policy rates. In June, the forward guidance was very clear: a further rate increase was expected for the September meeting and possibly a larger increment would be appropriate. Beyond September, "*a gradual but sustained path of further increases in interest rates will be appropriate*" but this "*will depend on the incoming data and how we assess inflation to develop in the medium term.*"

The drop of forward guidance

At the end of 2021, Lagarde already gave her own personal forward guidance that she was not expecting rate hikes in 2022. The forward guidance decided at the June meeting was as much unnecessary as wrong. In times of high uncertainty, forward guidance is no longer a tool any central bank should be using. With this in mind, one has to be very cautious when making any predictions of what the ECB will do beyond September.

ECB was unable to react to soaring inflation by raising rates as early as many policymakers wanted because of a commitment to forward guidance that it has now ditched after nine years.

ECB president Christine Lagarde said on Thursday July 21 that "*..We are much more flexible; in that we are not offering forward guidance of any kind... From now on we will make our monetary policy decisions on a data-dependent basis, [we] will operate month by month and step by step.*"

Two of the bank's Governing Council members told the Financial Times they believed it would have raised rates at least a month earlier if they had not been bound by guidance that rates would not rise until it stopped buying more bonds in early July.

"*A reasonable number of people on the council wanted to do 25 basis points in June,*" said one ECB rate-setter. "*Locking ourselves into forward guidance was unhelpful in that respect.*" A second council member said the benefit of a June increase was outweighed by "*the loss of credibility*" that would have resulted from breaking its guidance on the timing of when asset purchases would end, adding: "*It tied our hands.*"

The insights underline how central banks are struggling to provide reliable guidance on their monetary policy plans after being caught out by the rapid surge in inflation to 40-year highs. In addition, the ECB is grappling with an European energy crisis and political instability in Italy.

However, Lagarde did provide some guidance on the future direction of rates, signaling more rises ahead. "*At our upcoming meetings, further normalization of interest rates will be appropriate,*" she said, adding that the central bank aimed to "*progressively raise interest rates to [a] broadly neutral setting. That's where we want to arrive at*".

Lagarde declined to estimate the neutral rate of interest - the optimal level where an economy is neither overheating nor being held back — but other council members put it between 1% and 2%, meaning its deposit rate still has some way to go from zero now.

The ECB chief also ditched the word "gradual" in describing its rate-rising plans. She only used the word once in press conference - to describe wage growth - compared with seven times in June.

TPI, the ECB's new anti-fragmentation tool: A deep-dive analysis

The main parameters of the TPI are broadly as expected. Purchases are ex ante unrestricted (with the size depending on the severity of the risk to policy transmission) and activation is subject to macro eligibility criteria. President Lagarde stressed that the ECB is capable to "*go big*" with purchases under the TPI, if needed, but that the Governing Council would rather not use the tool.

The Governing Council set out a set of criteria to assess the eligibility of countries for purchases under the TPI, requiring countries to pursue "*sound and sustainable fiscal and macroeconomic policies.*" These include:

- compliance with the EU fiscal framework
- absence of severe macro imbalances
- fiscal sustainability and
- sound and sustainable macro policies, complying with the Recovery Fund.

The new tool is able to buy a potentially unlimited amount of sovereign debt, but eligibility is tied to a broad fiscal and macro assessment, leading us to expect that the instrument will only be used sparingly, as a backstop, and only at much higher spread levels that we are currently seeing.

While a link to EU-wide macro criteria was expected, the TPI entails a longer-than-anticipated list of conditions. At the same time, President Lagarde stressed that these criteria will only be "*indicative*" and that the Government has sole direction over the assessment of these conditions, and will use "*judgment and discretion.*"

The TPI press release included the following line: "*Purchases of private sector securities could be considered, if appropriate.*" While lacking additional details, the TPI could limit the under performance of peripheral credit to the extent that corporates begin to see larger country-specific premiums, noting that the peripheral-core basis has doubled to 32bps since the start of the year.

The presentation of the new anti-fragmentation instrument was a particular focus, especially in light of the current political situation in Italy. The announcement was broadly in line with market expectations, with the ECB able to purchase potentially unlimited amounts of sovereign debt with a maturity of between 1-10 year (fully sterilized, thus not having an impact on the overall size of the Eurosystem balance sheet) to "*counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy*" - but leaving questions about how it defines "*unwarranted*" and "*disorderly*" and if reactions to political dynamics are included (noting that it is not always straightforward to distinguish between speculation and fundamentals driven dynamics in practice).

The use of the tool is also subject to certain eligibility criteria tied to the sound conduct of fiscal policy, as assessed by bodies such as the European Commission, the IMF, the ESM and other institutions, with the Governing Council retaining ultimate discretion however.

These criteria have the potential to further blur the line between fiscal and monetary policy, as assessments of fiscal policy now could indirectly impact the transmission of monetary policy. The level of detail about the TPI presented generally exceeded expectations, but plenty of questions around its use remain. Given the conditionalities attached, it will only be used sparingly, as a backstop, and that spreads would likely have to widen substantially more than we have seen to date. Lastly, we note that the tool is likely not yet operational, pending the publication of the underlying legal acts (which might provide further insights) and that the legal grounds of the tool may be potentially challenged - as other unconventional ECB instruments have been.

Lagarde's press conference suggested that the spread widening the ECB has in its cross-hairs is the self-fulfilling kind, where bond prices deteriorate for no other reason than market participants expect them to do so. ECB will not tolerate markets dynamics which, rather than reflecting economic realities, create their own. And it will intervene, without limits if necessary, to prevent this.

The ECB's eligibility criteria for using the new instruments draw heavily on the economic governance mechanisms in the European Commission and the eurogroup of finance ministers. Among other things, to shore up a country's bonds under TPI, the ECB will look at whether the government in question is abiding by the commission's and eurogroup's recommendations. The central bank is telling elected leaders not to outsource essentially political judgments, daring them to own the decisions that determine whether a country should be protected against speculative attacks.

The ECB is making more use of its neglected secondary mandate. That mandate is often forgotten or outright denied. But subject to stabilizing prices, the central bank is legally obliged by the EU treaties to support the bloc's general economic policies. It is doing so while simultaneously reminding everyone who has the authority to determine those policies. The onus is on politicians to get their policies in order - but if they do, the ECB will support them and prevent market panic.

Lack of clear guidance also applies TPI. The TPI is a new instrument in the ECB's toolkit. It looks either to be un-finalized or flexible, not to say intentionally obscure, somewhere between PEPP re-investments and the OTM bazooka. The OMT can be activated in the event of a major crisis. The TPI, a second line of defense after the flexibility of PEPP re-investments, was designed to buy time and allow the ECB to hike rates towards neutral without being constrained by unwarranted market volatility.

The New Anti-Fragmentation Tool (TPI)	
Main Aim	The TPI "will ensure that the monetary policy stance is transmitted smoothly across all euro area countries"
Purchases	"The scale of TPI purchases depends on the severity of the risks facing policy transmission" "Purchases are not restricted ex ante" TPI is focused on public sector securities with a remaining maturity of 1-10 years Purchases of private sector securities could be considered
Eligibility	ECB has four criteria: Compliance with the EU fiscal framework No severe macroeconomic imbalances Sustainable public finances "Sound and sustainable" macroeconomic policies -- including complying with commitments under the EU recovery fund
Activation	Activation to be based on a comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria, and a judgment that the activation of purchases under the TPI is proportionate to the achievement of the ECB's primary objective
Purchases will be stopped if	there's a durable improvement in transmission, or the ECB concludes that persistent tensions are due to country fundamentals
Creditor treatment	The Eurosystem accepts the same (pari passu) treatment as private or other creditors
Balance-sheet control	Purchases to be conducted so that they cause no persistent impact on the overall Eurosystem balance sheet or on the monetary policy stance
Other programs	PEPP reinvestment flexibility will continue to be the ECB's "first line of defense" ECB highlighted that the Outright Monetary Transactions, which has never been used, is also part of its toolkit

As raised by a number of journalists in the press conference, would widening spreads due to domestic political factors be sufficient to activate the instrument? And would it require a Governing Council decision and be pre-announced? The TPI is unrestricted ex ante (i.e. fully flexible), and that interventions would require a serious threat to the transmission mechanism and disorderly market dynamics rather than being triggered at any particular level of rates or spreads.

However, it remains to be seen to what extent and for how long the ECB will be willing to intervene. Given the uncertain Italian political situation, the ECB will likely need to stand ready to activate the TPI already in the coming weeks.

Regarding the TPI and BTPs, there are three important points: First, all EU members are eligible for the TPI. Second, there is no ex-ante limit. Finally, the TPI can be activated on the basis of specific criteria, with the Governing Council being the only one to assess the situation and to decide the activation. It seems that the bar to activate the TPI is pretty high, which is behind the renewed selling pressures on BTPs.

With the 10y BTP/Bund spread wider by 40bp in a couple of days, with the Italian election only two months away and given the TPI implementation constraints, further selling pressures on BTPs are likely.

The ECB unveiled its new crisis tool, TPI, for which ECB stated will help ensure the effective transmission of monetary policy during the rates normalization process. This instrument can be activated to counter unwarranted, disorderly market dynamics. Once it is activated for a specific country, the ECB will be able to purchase public sector securities (central government, regional or agencies) in the 1-10y sector. The scale of purchases will depend on the severity of the risks to policy transmission, as judged by the governing council.

All countries would be eligible, subject to some broad conditions around the EU fiscal framework and sound macroeconomic policies as defined by the EU, excluding countries with severe macroeconomic imbalances or where debt sustainability is clearly an issue (as defined by the ECB, EC, ESM or IMF).

The more opaque and subjective issue is at which point the tool would be activated for a specific country, or what would define an unwarranted, disorderly widening of spreads., The ECB is being deliberately vague about the metrics it would use. It would be up to the Governing Council's discretion to agree upon this after thoroughly assessing whether to activate the tool and what size response is needed.

Considering the opaqueness, as well as the discretionary element and need for consensus within the Governing Council, the process appears to be very complicated, which hints at the ECB's preference to not use it unless it has to. This is consistent with the TPI being a second line of defense, with PEPP reinvestment flexibility mentioned in the press release and in the press conference as the first line of defense (a third line of defense, also mentioned, would be the OMT program). In our view, it seems that the most obvious way to activate the TPI would be to see a significant widening of spreads first: this tends to bring more consensual decisions. The political situation in Italy, Russia's leverage with regards to gas supply, and higher interest rates will all help widen spreads first.

At some point, of course, the TPI could be activated. We know little about effective it will be, or whether it merely act as a deterrent, keeping widening forces in check. The mechanism looks similar to the ECB's previous SMP and OMT programs, but the criteria for activating this new instrument remains vague, as the ECB is still taking a flexible and more opaque approach.

Comparison of TPI with SMP and OMT

Name	Annoucement	End	Limit	Amount	Maturity	Conditions	Sterilisation	Seniority	Country
Securities Markets Programme (SMP)	May 2010	Sep 2012	Unlimited	€220bn	2-10 years*	No	Yes	Senior	Ireland, Portugal, Italy, Spain, Greece
Outright Monetary Transactions (OMT)	Sep 2012	-	Unlimited	-	1-3 years	EFSF/ESM programme	Yes	Pari passu	-
Transmission Protection Instrument (TPI)	Jul 2022	-	Unlimited	-	1-10 years	(1) EU fiscal framework (2) Macroeconomic balances (3) Fiscal sustainability (4) Macroeconomic policies	Likely	Pari passu	-

A country doesn't have to apply for ECB support, this is up to the ECB's discretion. All in all, it could work as conditions are lighter than with previous programs and the size is unlimited. It might not be a whatever-it-takes but rather a whatever-we-want tool.

New ECB tool will not purchase supranational bonds. The ECB detailed the parameters of its new TPI. TPI purchases will be "*focused on public sector securities i.e. marketable debt securities issued by central and regional governments and agencies*", meaning that supranational bonds will not be eligible to the TPI.

With the introduction of the TPI, the Governing Council now has three instruments to influence the behavior of sovereign spreads, the other two being the flexible reinvestment of redemptions under the PEPP and OMT.

In conclusion, ECB's own work is not done, however. TPI will work best as credible deterrence: an instrument you could use but most likely will not have to. But Lagarde, wants to keep markets somewhat in the dark: "*There are certain components [of TPI] that are best kept unpublished, undisclosed, uncommented upon*", she said. She also volunteered that "*we would rather not use it*", although "*if we have to use it, we will not hesitate*". As it is, the ECB is likely to be tested by financial markets before too long.

Post ECB meeting during a news press conference on July 22, ECB policymaker Francois Villeroy de Galhau said that ECB will be determined in using its new bond-buying scheme to combat financial fragmentation between euro zone countries if it needs to be used.

"*If needed, we will be as determined in activating (the program) as we have been in setting it up, and there are no pre-defined limits on the amount of possible purchases... Starting the increase in interest rates faster does not mean that (the cycle of increases) will end higher*," Villeroy said.

But the usual suspect struck back. The German academic behind the ECB's biggest court setback is weighing legal action against the ECB's new bond-market shield, which he sees as "blatant" aid to Italy and other debt-laden states.

Markus Kerber professor of public finance at Berlin's Technical University is taking aim at TPI, saying these potentially unlimited debt purchases were chiefly aimed at helping Italy, the euro zone's biggest debtor, and that they violate European Union rules barring the ECB from financing states.

"*The ECB will openly become the underwriter of state debt. This is a blatant case of state financing... Any purchase made under TPI could be declared "null and void*" Kerber told Reuters in an interview on July 29 and that he was discussing with his clients whether to file a complaint against the scheme.

Kerber argued the ECB's stipulation that it must intervene whenever it sees as an excessive divergence in borrowing costs between different countries runs against the EU's support for free competition.

He also criticized the ECB's decision to buy bonds from PIGS countries with some of the proceeds it receives from maturing German, French and Dutch debt, in a bid to cap those spreads. "I*f the ECB says that a yield spread of more than 2% between Italy and Germany is unwarranted, it is replacing the markets. How would the ECB even know that?*" he said.

In the past, German judges upheld in 2021 the ECB's massive purchases of government debt during the coronavirus pandemic. In a prior case, the European Court of Justice found that it was acceptable for the ECB not to set a cap on how much it could buy as long as appropriate safeguards were in place.

The Italian conundrum: Part IV

On July 19, PM Draghi failed to get votes of confidence from some of his largest coalition members at the Senate, with Lega, Forza Italia and M5S deciding to not participate in the vote. Both Lega and Forza Italia announced their intentions to not participate following Draghi's 'take it or leave it' speech and given his reluctance to consider their demands to axe M5S from the coalition government. Despite PM Draghi having more supporters than detractors among those who voted, he clearly saw no viability for the current coalition and handed in his resignation (for a second time). This time, President Matarella accepted and dissolved Parliament. New elections are set for 25 September.

With Draghi as caretaker until the elections, a key question is what happens with the budgetary process for 2023 as well as the securing of NGEU disbursements due later in the year. It is likely to see efforts to pass ambitious reforms stall. Political parties seeking to raise their profile heading into the elections will tend to promise fiscal loosening measures, complicating the approval of the next budget law as well as Italy's ability to meet milestones for the NGEU funds due to be disbursed in December. These included measures to reduce tax evasion, implement judicial reform and pass a competition law. The next government will need to make some tough decisions, particularly if Italy runs higher deficits.

Debt sustainability concerns will likely start to grow with 10yr BTP yields north of 4%. Whereas the cost of servicing debt remains historically low, a key metric to follow is the differential between growth and interest cost, especially with Russian tactics regarding gas supply increasing the risk of a recession. Regardless of the growth outlook, if 10yr BTP yields rise substantially above 4%, we will start to see a worsening of the trajectory of debt to GDP.

S&P sees Italy as vulnerable to rate hikes due to its high debt rollover rates, and a 100bps increase in marginal borrowing costs could push Italy's interest expenditure to GDP ratio up by about 0.8pps by 2025. Moody's estimates that a 100bps increase in the cost of funding would add c.3% to Italy's debt burden by 2025. A shortfall in growth would accelerate the process: a 1.5pp below Moody's baseline forecast would see Italy's debt rising as soon as next year.

Late July polls for the 2023 election point to victory for the right-wing bloc (Brothers of Italy, League and Forza Italia), with c. 45% of the votes. Brothers of Italy is the largest party in that coalition. Of course, polls could change in the coming months, but markets will be worried about Bank of Italy's clear stance on some issues, which could clash with the rest of the EU, namely public deficits, Italian law prevailing over EU law and immigration policies. With political crises having a very large impact on BTP spreads, market projections must take into account some degree of stress from politics, though baseline forecast is consistent with a much lower stress than in 2018.

BTPs should be under pressure for the remainder of 2022 for reasons beyond just political risks, namely higher ECB policy rates and pressure on global credit spreads. BTP-Bund could be in the 260-300bps range by year-end. However, one factor that could exacerbate widening pressure is a worsening of the energy crisis, as Russian gas accounts for more than 12% of Italy's total energy consumption.

A collapse in growth at a time of rising interest rates will bring the spectre of debt sustainability to the fore, with debt levels likely to rise. A fiscal response to such a crisis would likely mean higher deficits, and any perception that Italy might find it difficult to get NGEU disbursements could add to this pressure.

Will TPI help Italy? Most analysts do not believe the ECB's new tool will be of much use if Rome falls into a deep self inflicted political crisis - for instance, if a new government refuses to carry out the structural reforms agreed as part of the EU recovery fund.

When asked about Italy, Lagarde said: "*Political matters are for the democratic process of each and every member state and that is certainly the case for the country you are referring to.*" She added that "*differences in local financing can legitimately arise*", suggesting that the ECB would not intervene if it judged investors to be responding to justified concerns about the direction of Italian economic policy.

Draghi's government had negotiated to receive around €200 billion from the EU's post-pandemic recovery fund, in return to make Italy more competitive and business-friendly. Rome, in short, was encouraged by the rest of the bloc to make painful reforms. Draghi said on Wednesday July 20, that to receive the next tranche of cash, worth €19bn, Italy had 55 separate targets by the end of 2022. These reforms must be supported to prevent future crises by growing Italy.

It is unclear who will form the new government after the upcoming elections, which are scheduled for September. But the 17-month Draghi government may have put in place important guardrails for what comes next – as there is a high price in EU funds for moving away from its agenda. And by linking access to the TPI with continuing these reforms, the ECB has further tightened incentives for the next government not to deviate from it or risk a major sell-off of Italy's debt.

On July 28, Italy issued €2bn worth of 10-year BTP debt at a 3.46% yield, a decline of 0.01pps compared with the previous auction on June 30, according Italy's public debt office. It also sold €2.75bn worth of 5-year debt at a 2.82% yield - the highest borrowing cost since the wake of the euro zone debt crisis in 2013.

The figures contrast with Germany, the region's benchmark borrower, which has seen the borrowing costs it has paid at sales of new debt fall in recent weeks. Berlin sold 10-year Bunds at a yield of 0.94% on July 27, compared with 1.22% at an auction in early July.

The widening gulf shows how investors are demanding more compensation for the risk of holding Italian bonds after prime minister Mario Draghi resigned earlier in July. It also means the rise in yields on secondary markets where bonds trade is filtering in to Rome's public finances.

Less fiscal discipline and faltering on ambitious agenda aimed at boosting the country's competitiveness and long-term growth prospects could jeopardize Rome's access to €200bn of EU funding from the bloc's COVID-19 recovery program.

ECB is unlikely to use its new TPI to tackle Italy's domestically created problems caused by political volatility. A political crisis is the exact opposite of the circumstances where they Governing Council wants to use it. If the Italian-German spread goes over 250 bps points and others PIGS spreads are rock-solid, the ECB would say it's an Italian problem. If it starts impacting everyone else, then the central bank will declare that EU has an issue with fragmentation.

Exiting negative rates implications for Europe's Banks

Existing negative rates an important step towards improved returns across European banks. As negative rates have weighed on returns across European banks, a return to positive rates should support improved profitability and return on capital. Markets estimate that each 25bps change in rates increases Profit before Taxes (PBT) by 10% on average across. With the market pricing over 100bps in further rate hikes through the rest of 2022 and a terminal rate of close to 150bps in 2023, the pass-through of higher rates to support improved Net Interest Margin (NIM) in the sector in coming years.

The key moving pieces:

<u>TLTRO:</u> The ending of the 50bps bonus rate on TLTRO lending from July this year will reduce Net Interest Income (NII) for the banks starting at the beginning of H2.

Deposit Charges: Many banks have reached deposit charging agreements with customers (typically corporate customers): these charges are expected to erode rapidly.

Deposits: As rates rise, some of the benefit will be passed through to depositors. The speed and quantum of this pass-through will differ between countries: broadly speaking we assume no pass-through for the first 50bps (from -50bps to 0%) and full pass-through above 100bps.

Loans: Similarly, banks may be unable to reprice all of their loans by the amount of rate rises. In that context, we also note banks often have floored loans in place and currently benefit from the ECB's deposit tiering. That said, the withdrawal of liquidity could also support asset margins.

Funding Mix: A bank's structural interest rate sensitivity is driven by its zero-interest-rate funding mix – overnight deposits and tangible equity – as a higher portion of these two elements on a bank's balance sheet drive higher rate sensitivity. Both components have grown as a percentage of bank balance sheets in recent years, with overnight deposits across the Euro Area now accounting for 37% (€5.48tn) of the total deposit base, up from 24% prior in May 2014 (immediately prior to negative rates).

Hedging: Banks generally hedge out duration mismatch on the asset/liability side. Disclosures on these hedges are limited and can differ significantly bank to bank; however in general they spread the benefit from higher rates out over a period of 3-5 years.

Fiscal Policy Measures: Unexpected taxes (e.g. Poland, Spain) and faster-than-expected increases in regulated savings products (e.g. Livret A in France) have the ability to delay or offset the benefit from higher rates.

Capital Pressures: As rates rise and bond prices fall, banks take negative mark-to-market impacts on securities held for sale: this impact is then gradually recouped through the higher yield realized to maturity.

However, in the face of slowing economic activity and high inflation the focus turns to credit quality. As economic activity in Europe slows and inflation remains persistently high, there is scope for higher credit costs to outweigh the benefit from higher rates in the near term (Δ NIM – Δ CoR = < 0), on both the corporate side (slower economy) and the consumer side (pressured discretionary incomes). The latest Bank Lending Survey (published by the ECB for Q2 on July 19th) points to a slowdown in demand for longer-term corporate lending and household lending. Based on a long-run Cost of Equity (CoE) we believe bank shares are currently pricing in c.100bps Cost of Risk (CoR) for 2023: for context, this implies recession-like levels of credit costs, above the level seen in 2020 and closer to Global Financial Crisis (GFC) levels.

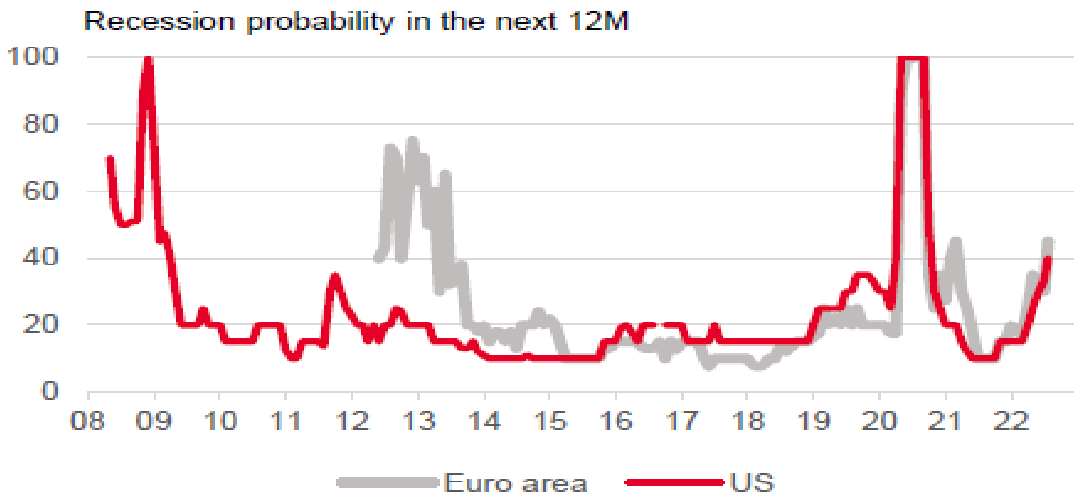
Growing like-hood of recession

ECB decision showed that the hawks must have got cold feet, fearing that the promised higher than 25bps rate hike in September would be washed away by the looming recession. The agreement on a TPI had to be paid for by the doves with a stronger rate hike.

The rate hike will not bring down inflation in the short run - not even on the demand side of the economy, which will react much more to the looming recession than to any ECB action. The hike, as well as potential further hikes, are all aimed at bringing down inflation expectations and to restore the ECB's damaged reputation and credibility as an inflation fighter. The decision shows that the ECB is more concerned about this credibility than about being predictable. This matters more than forward guidance.

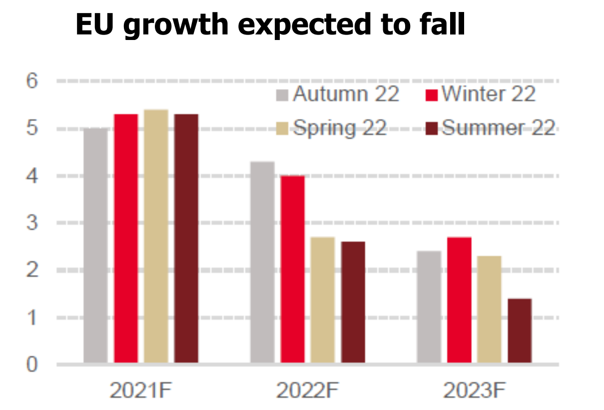
Even if the ECB still keeps the idea of a series of rate hikes alive, the window for such a series is closing quickly as high energy and commodity prices, supply chain frictions and the war in Ukraine are all very likely to push the euro zone economy into recession towards the end of the year.

The energy crisis, broadening of price increases and tightening financial conditions are generating an increased perception of imminent recession risk. Bloomberg consensus sees a 45% chance of an euro area recession in the next 12 months, up from 15% or so in late 2021. Other than during the pandemic period, this is the highest recession probability in the euro area since summer 2012, ahead of the recession of 2013.

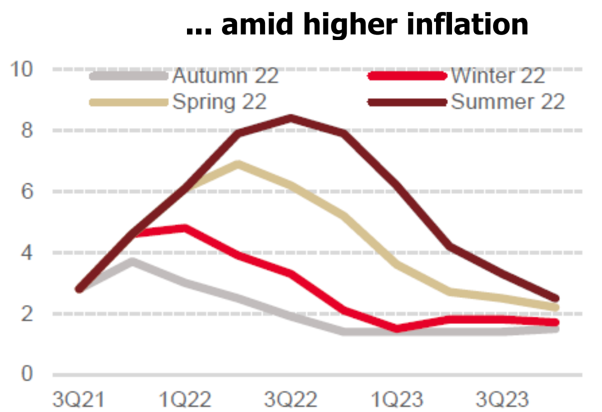


Source: Bloomberg

The EC slashed the euro area's economic outlook while raising inflation forecasts in its latest report. It now sees real GDP growing by only 1.4% in 2023 rather than 2.3% it expected in spring 2022. It also expects inflation to peak in 4Q22 and average inflation to reach 7.4% in 2022 and 4% in 2023 (versus 6.8% and 3.5% respectively in June's ECB projections). The EC's previous report in spring lists four downside risks: energy market shocks, trade deterioration, tightening financial conditions and pandemic-related lockdowns. The summer interim report pointed out that all of the risks, except the trade deterioration, have materialized. And they could still worsen.



Source: European Commission



Source: European Commission

The last ECB Bank Lending Survey shows that credit standards tightened for firms and households in 2Q22, driven by increasing risk perception and decreasing risk tolerance among banks. This is mostly visible in France and Italy. Also, in Italy, but not yet in other countries, the cost of funds and balance-sheet constraints have contributed to tighter credit standards, a sign of fragmented financial conditions. Overall, euro area firms' demand for loans has been supported only by financing needs for working capital (likely related to higher energy and raw material prices), while fixed investment had a dampening impact on firms' net demand for loans (for the first time since 1Q21). This negative impact from investment is being seen in all countries. It indicates that corporates are postponing investment in the current uncertain environment.

Russian gas supply is a new risk premium in the market. Nord Stream 1 gas flow restarted on 21 July after maintenance works and is expected to reach 40% capacity in the near term. But the threat of a total shutdown remains a major risk for the European economy.

Recent IMF research analyses output losses in Europe due to Russian gas cut-off. According to the IMF, if physical constraints impede gas flows, the negative impact on economic output would be especially significant (possibly as much as -6% of GDP) for Hungary, Slovakia and the Czech Republic. Italy would also face a big impact (-3.5/-5.5%) due to its high reliance on gas in electricity production. The effect on Austria and Germany would be less severe but still significant (-1.8/-2.8%), depending on the availability of alternative sources and the ability to lower household gas consumption.

The impact would be around 1% for other countries (including Greece) with sufficient access to international LNG markets. The IMF's estimates suggest that uncertainty channels would add notably to the economic impact of a full shut-off. The impact would peak next year and then fade as alternative gas supplies become available. The rise in wholesale gas prices could also increase inflation significantly, by about 2pp on average in 2022 and 2023.

The euro zone composite Composite Purchasing Managers' Index (PMI) has fallen below 50 in July from 52 in June to 49.4 in July. This, according to the survey, signals contraction. Euro zone is moving rapidly towards a recession. July's PMIs release on July 22, indicated that euro area growth has stalled, as the headline composite index fell just below the neutral 50 mark separating expansions from contractions. The fall was broad-based, with similarly sized falls seen across manufacturing and services, as high energy prices and macro uncertainty due to the ongoing Ukraine crisis depressed investment activity, confidence, and spending.

Overall, manufacturing (and Germany) is now in recession while services (and France) stands just above at 50.6 from 53. The details of the release give little reason for optimism looking forward: not only did manufacturing output fall to 46.1, but new orders now also stand at a deeply negative 42.6, with export orders at a similar level.

Recession might arrive early. Euro area growth is expected to stall in 3Q22 before heading for a recession between 4Q22 and 1Q23. PMIs downside surprise highlights the risk of an earlier contraction, perhaps starting in the current quarter.

Slowing growth means slowing inflation? July's PMIs furthermore suggest that slowing growth is now also gradually reducing price pressures, with both input and output prices in the industrial sector down sharply compared to spring, and services prices also seemingly past their peak. Inflation will continue increasing in the coming months before peaking in September but then downward pressure will on core due to the anticipated recession. The ECB hiked by 50bps, but the deteriorating growth environment will lead to a pause in the hiking cycle by year-end, after the ECB has seen convincing evidence that inflation has peaked and is on a downward trajectory.

On July 25,Germany's most prominent leading indicator, the Ifo index, took a strong nosedive at the start of the third quarter. In July, the Ifo index fell sharply to 88.6, from 92.3 in June. Both the current assessment and expectations component dropped, with the expectations component experiencing the sharpest drop since March and the third largest drop since the pandemic started.

The latest Ifo index number illustrates that the list of downside risks for the German economy is getting longer and longer.

On July 28, European Commission's economic sentiment indicator (ESI) plunged from 103.5 in June to 99 in July, now below its long-term average. Among the bigger member states, the ESI declined significantly in Spain (-5.0), Germany (-4.9) and Italy (-3.4), while it remained broadly stable in France (-0.1) and the Netherlands (+0.2).

Industrial confidence declined markedly (-3.5) on the back of increasing headwinds, with the worsening energy crisis most probably one of the main culprits. All forward-looking indicators now point to a contraction in the coming months. Order books have deteriorated, inventories are at too high a level and production plans have been scaled down.

Sentiment in the services sector also fell back significantly (-3.4). Confidence in the retail sector (-1.6) and the construction sector (-0.4) declined but to a lesser extent. Consumer confidence declined again (-3.2) and the outlook for the personal financial situation over the next 12 months is now at the lowest level ever. High inflation and the soaring costs of energy are, of course, major headwinds.

On July 29, another ugly inflation reading for July 2022. Annual inflation rate in the Euro Area increased to a new record high of 8.9% in July of 2022 from 8.6% in June, preliminary estimates showed. Prices continued to accelerate for food, alcohol & tobacco (9.8% vs 8.9% in June); non-energy industrial goods (4.5% vs 4.3%), and services (3.7% vs 3.4%) but eased slightly for energy (39.7% vs 42%). Both supply-side problems causing high inflation and the second-round effects resulting from this show no imminent sign of relief.

Food inflation also continues to trend up as higher transport costs, shortages and uncertainty around Ukrainian supply have pushed up producer prices which are still being priced through to the consumer.

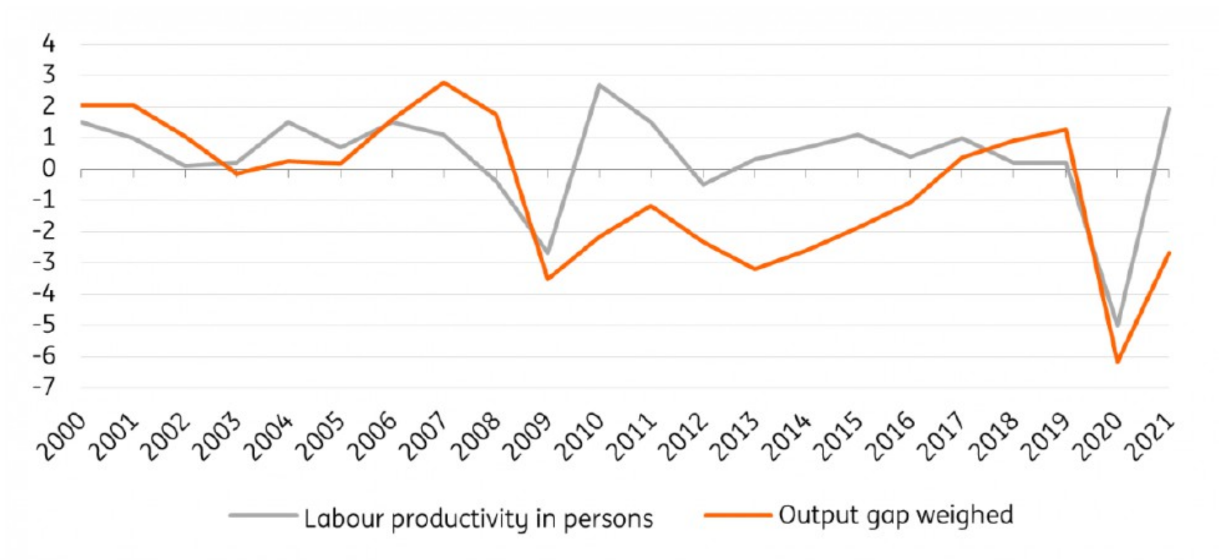
Core inflation is also still on an upward trend and at 4% is well above the ECB's target. While a smaller percentage of businesses have indicated that they are increasing prices at this point, we do expect the core rate to continue its upward trend in the months to come as input costs for businesses remain elevated in a large number of sectors, which is putting pressure on margins. Goods inflation increased from 4.3 to 4.5% and services inflation from 3.4 to 3.7% in July, which shows that businesses are still passing higher costs onto consumer.

Even though euro zone GDP growth was still slightly positive in the 2Q22 - it grew by 0.7% qoq on COVID tourism rebound - demand is already cooling significantly at this point. Manufacturing has been suffering from supply chain problems and has experienced fading demand in the meantime. The German economy, heavily reliant on manufacturing, trailed the euro zone average with stagnation in GDP in the second quarter.

The stronger growth number came despite stagnation in the bloc's biggest economy Germany, where high inflation and fears of a gas crisis triggered by the war in Ukraine have caused consumer and business sentiment to plummet. It might be the economy's last hurrah before ever-higher inflation and supply chain problems cause a mild recession in the second half of the year.

Another weakness was seen in goods consumption. Consumers may have been spending on services such as trips and eating out, but they are also suffering from purchasing power squeezes due to high inflation. Retail sales, for example, have been on a downward trend for some time already and probably contributed negatively to GDP in the second quarter already

Despite rising core inflation, very little of this is demand-driven. High input costs are therefore likely to be the main driver behind the rapidly rising consumer prices with some service sectors like tourism perhaps being the exception.



Source: Eurostat

Final point but not the last one. High inflation and low unemployment will push up wage growth in 2022 and 2023. At the same time, labor productivity growth is expected to come down significantly. This makes it plausible that unit labor costs will rise by more than 2%. That would be a threat to price stability, but other drivers of inflation will come to the rescue.

While the expected wage growth may be too low to compensate fully for inflation, it could still be high enough to keep upward pressure on inflation going and thereby threaten price stability in the euro zone. Labor cost increases of 3-3.5% are at the higher end of wage growth developments that are in line with the ECB’s inflation target of 2%.

ECB chief economist Philip Lane considers wage growth of 3% still to be in line with the ECB's medium-term target of 2% inflation, as it accounts for roughly 1% productivity growth in the medium term.

Although the pandemic and the end of furlough schemes can have unpredictable effects on employment and thereby on productivity, for the period ahead productivity growth will come down significantly. Not only because it will, as usual, take time to downsize employment in response to the economic slowdown, but also because this downsizing to be limited this time around. Given the widespread labor shortages, companies are likely to refrain as much as possible from the usual round of layoffs to avoid not being able to service extra demand once the economy recovers – especially if the downturn is mild.

The combination of an increase in wage costs of 3-3.5% and a decline in productivity growth makes it very plausible that labor costs per unit of production will increase by more than 2% in 2022 and in 2023, thereby putting upward pressure on the ECB’s 2% inflation goal.

Labor costs make up the largest part of production costs in most companies. But other drivers of inflation expected to dominate the development of inflation in the near term. Energy prices will not rise as fast over the next 12 months as they did during the last 12 months. This will push down inflation strongly over the next 12 months. Also, the steep decline of real wages in 2022 will lead to a slowdown in the growth of consumer demand and thereby also put downward pressure on inflation.

So, although labor costs will keep upward pressure on core inflation in the euro zone, the increase in these costs will not prevent inflation from coming down to 2% towards the end of 2023.

With a recession looming and inflation reaching new highs, the question is how the ECB will respond to an economy which is already cooling down. 50bps in September is definitely still on the table.

August's statistical releases: Recession ante portas

Eurozone corporate supply announced on August 2, amounted to only €2.6bn in July, a record low for monthly supply. The current higher rates and wider spreads environment has pushed all-in funding costs higher. Furthermore, with corporates starting 2022 more cash rich than ever and many corporates having pre-funded over 2020 and 2021 to take advantage of the low yield environment, there is little urgency for corporates to come to market.

Eurozone sales reported on August 3, fell by -1.2% MoM in June, rounding out a serious contraction for the quarter. Declines were seen across sales categories but were largest in non-food products. All large eurozone economies saw contracting sales, with the sharpest declines seen in Germany and the Netherlands. As 2Q GDP growth surprised on the upside, it is expected that tourism and other consumer services performed very strongly, marking a sharp contrast with slumping sales on the high street.

Retail sales have been declining steadily since November and have slid well below the pre-pandemic trend of sales growth. The large squeeze in real incomes that eurozone consumers are experiencing is starting to bite. The re-balancing of consumption away from goods to services now that services are widely accessible again following the pandemic, has also played a role in the weakening of retail trade.

Services consumption is now also weakening in the eurozone as reopening effects are fading, and a surge in tourism is about to end, it is likely that consumption will contract in the coming quarters. That would result in a mild recession in the eurozone. For ECB, these indicators pointing to an economy that is sliding towards recession.

On August 5, the latest Istat data showed that Italy's industrial production has its limits. Seasonally-adjusted Italian industrial production fell by 2.1% month-on-month (-1.1% MoM in May), clearly worse than expected. Only energy production expanded, while consumer, intermediate and, more intensely, investment goods, posted monthly contractions. In 2Q22, seasonally-adjusted industrial production posted a 0.6% QtQ gain over 1Q22.

In July, manufacturing business confidence fell three points on the month, driven by a sharp decline in both domestic and foreign orders. Manufacturing PMI data also turned down: the headline index, at 48.5 in July, fell into contraction territory for the first time since June 2020.

It seems likely therefore that in 3Q22, industry will act as a drag on quarterly growth, leaving the onus of growth on services, from the supply side angle. A minor GDP expansion for Italian GDP in 3Q22 is expected, based on a continuation of the reopening effect hinging on tourism and financed by a re-composition of consumption from durable goods to services. A fully-fledged industrial recession over 3Q22 would add downside risks to that call.

Eurozone industrial production announced on August 12, jumped in June. Growth in production was mainly driven by a continued surge in capital goods production while consumer and intermediate goods production shrank MoM. This shows that the base on which production was growing in June was more feeble than the headline figure tell us.

The outlook for eurozone manufacturers remains worrying. Weakening demand seems to be ongoing as purchasing power issues continue and while supply chain problems are easing they have by no means been solved. In addition, soaring energy prices are set to hinder production and margins for manufacturers from here on. While June looked decent in terms of production, the months ahead are likely to see further weakening. That leads to a contacting eurozone economy in the second half of this year.

August's ZEW reading announced on August 16, adds to the bad news out of Germany. The long list of risks and challenges the German economy is facing makes a recession in the second half of the year almost inevitable.

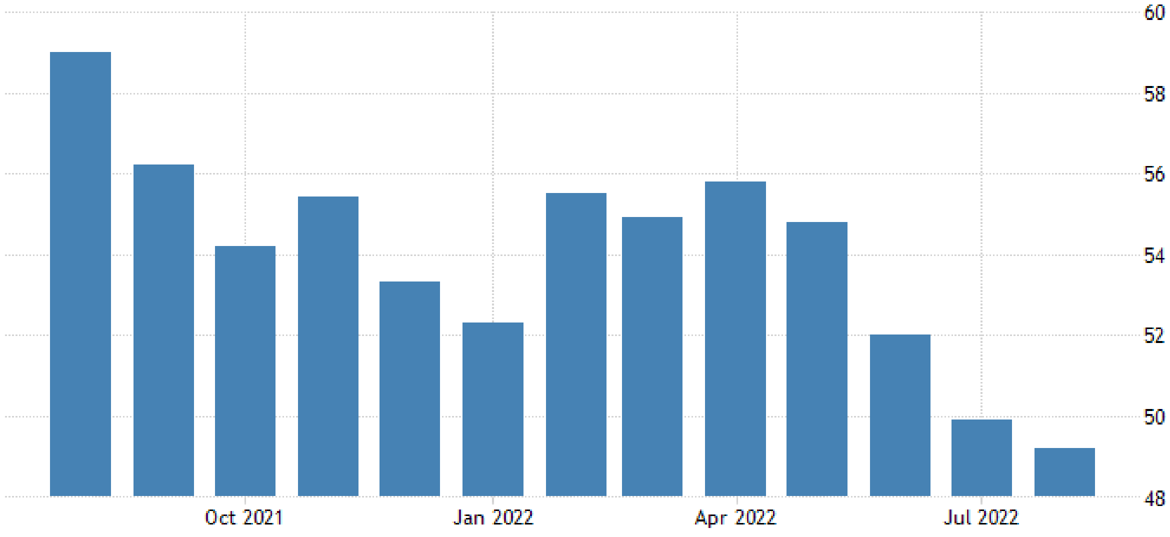
Germany's ZEW index reported on August 16, fell to -55.3 in August, from -53.8 in July. The ZEW index is now close to its all-time low seen during the financial crisis. The current assessment also weakened to -47.6 from -45.8 in July, the lowest level since April 2021. The reasons are clear: the long series of risks and challenges for the German economy has become even longer in recent weeks, with two recent additions: low water levels and a gas levy (see below).

ZEW index reflects financial analysts' views, which obviously do not always reflect business or consumer confidence. What the ZEW index has signaled better than other indicators in the past, however, are turning points.

August's Eurozone business activity PMI indicator announced on August 23. The composite PMI index fell from 49.9 to 49.2. The survey continuous to hint a contraction that started in the 3Q2022. The manufacturing output PMI ticked up a bit in August but remained deep in contraction territory at 46.5. New orders continue to fall and inventory build-up is very strong, which reflects the squeeze in demand that the eurozone economy is currently experiencing.

The services PMI fell rapidly in August to a level indicating stagnation in activity at 50.2 from 51.2. Demand also weakened for the service sector as the post-pandemic rebound in consumer spending on services is fading rapidly.

Eurozone PMI Indicator



While high costs continue to play a major role in weakening demand, the pace of inflation seems to be fading among manufacturers and in the service sector. Weaker demand and easing input prices are helping selling price inflation moderate a bit, but the question is whether this can last at a period that natural gas and electricity prices are reaching new records again.

While the PMIs indices suggested that services activity is slowing notably - Southern Europe still had significant room to grow in services, especially COVID-sensitive activities like tourism. The available data on summer travel pointed to a firm tourism season with hotel bookings up strongly during the summer - which could support growth meaningfully in the South, particularly in Spain, Portugal and Greece.

The list of arguments why the German economy was sliding into a winter recession is getting ever longer. The question wasn't about whether there would be a recession but rather how severe and how long it will be. On August 25, Germany's Ifo index, just dropped for the third month in a row, coming in at 88.5 in August, from 88.7 in July. This is the lowest level since June 2020. Expectations remain close to their all-time lows and were only worse in December 2018 and April 2020. Germany's PMI readings on August 23, have already suggested that the economy is in contraction territory.

Earlier the same day, the details of German GDP growth in 2Q22 brought some positive surprises. Growth was slightly revised upwards to 0.1% QtQ, from zero in the first estimate, which finally brought the German economy back to its pre-crisis level.

Private consumption surprised to the upside (+0.8% QtQ) and even more importantly was revised upwards significantly in the first quarter to +0.8% QtQ, from initially -0.1% QtQ. It was net exports and the construction sector which weighed on economic activity in 2Q22.

According to ECB date released on August 26, lending to euro zone companies continued to surge in July, beating expectations for a slowdown due to rising recession fears and plans by lenders to tighten access to fresh credit.

This is somewhat surprising given higher interest rates, low confidence and banks indicating tighter credit standards and weaker demand for borrowing. Lending to businesses in the euro area expanded by 7.7% in July after 6.9% a month earlier, while credit growth to households slipped to 4.5% from 4.6%, fresh data showed on Friday.

Banks that tightened access to credit already in the 2Q22 said they were likely to be even more cautious in the 3Q22, as high fuel prices and war in Ukraine deplete savings and confidence.

Money growth continues to slow rapidly as the ECB has stopped QE and increased interest rates. Growth in the M3 measure of money circulating in the euro zone, meanwhile, eased to 5.5% from 5.7%, partly a reflection of the end of ECB money printing. The tightening of the monetary stance is adding to concerns about economic growth, as signs are becoming clearer that the economy could have already started a mild recession at this point.

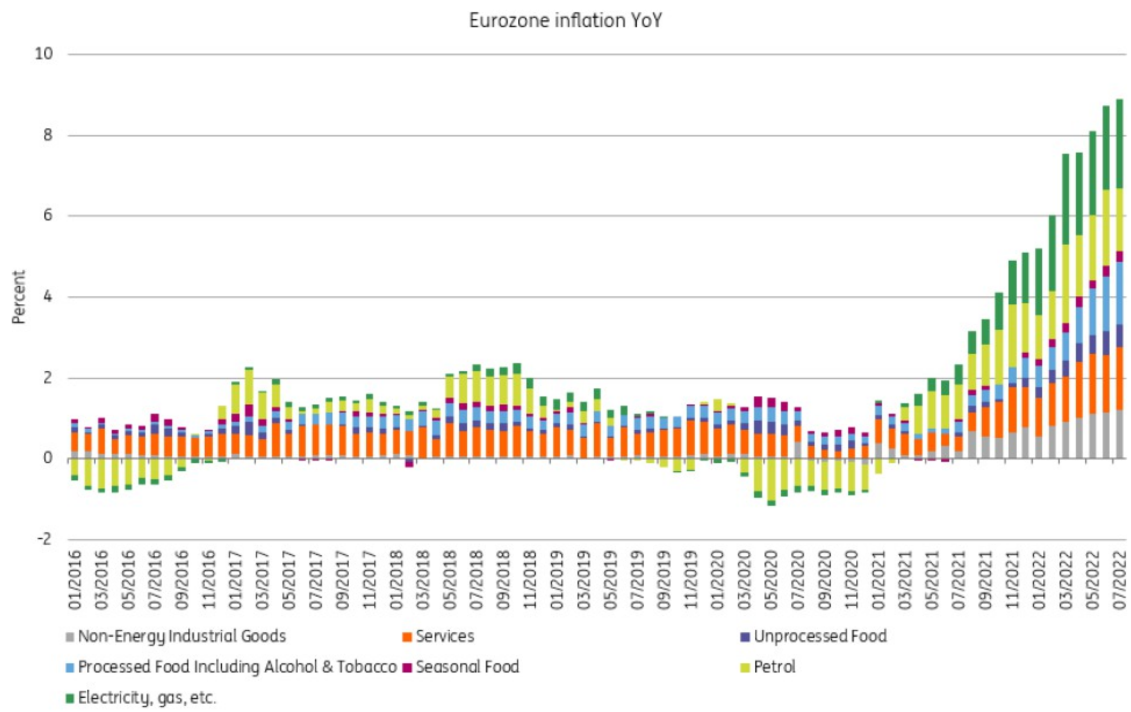
On August 30, the Economic Sentiment Indicator (ESI) was reported. It fell modestly from 98.9 to 97.6 in August. Both industry and services indicate weakening economic activity. Meanwhile, recession prospects are causing more moderation in selling price expectations for the months ahead.

A recession is drawing closer as businesses are becoming more pessimistic about economic activity. Recent production for industry and demand for the services industry fell considerably in August and the manufacturing sector indicates rapidly weakening order books. Input price pressures force businesses to charge higher prices to protect their margins. It is to be feared that slowing demand will make this increasingly difficult, forcing companies to cut back on investments and new hirings. The question was how jumps in gas and electricity prices would put pressure on margins, which could lead to more pressure on core inflation in the months ahead.

All not so quiet on the Inflation front....

On the supply-side inflation pressures are fading, but specific ones in eurozone remain critical. There has been a significant turnaround in a few factors that have driven up prices over the past two years. Supply chain problems have been fading, which is causing prices for transport and inputs to decline again. Container prices, which are now almost 50% below their peak from September 2021. The number of eurozone businesses experiencing problems from a lack of equipment is declining. There has also been a relief in global agriculture prices, which have dropped to levels seen before Russian-Ukraine conflict. Oil prices have also been sliding, which has had a favorable impact on global fuel prices.

But in Europe some factors are set to keep supply-side inflation elevated for the time being. The low gas supply and low water levels are keeping pressure on prices higher than elsewhere. Another peak in natural gas prices has been reached, which is currently almost 10 times as high as it was in early 2021. With concerns about fill levels in the winter and expensive LNG imports especially in Germany used to fill storage up to 80%, it is likely that prices will remain elevated throughout the year.



Source: Eurostat, ING Research

Energy prices are also impacted by the troublesome low water levels. This is causing problems in cooling nuclear plants and river transportation of coal supply. Furthermore, the low water levels are hampering manufacturing production in Germany as supplies are harder to transport.

The recent announcement (August 15) by the German government on a gas levy will push up retail gas prices much higher as early as October, contributing to headline inflation. Other European governments will follow the German example (Greece has already followed suit), which in turn would add to inflationary pressure in the winter.

On the demand-side the pressures continue to play a secondary role to inflation in the eurozone. Supply-side factors remain dominant, which continues to make the ECB's role in bringing inflation down limited. Real wage growth is vastly negative at the moment, and household consumption has far from recovered to prepandemic levels.

Even though the economy is still in recovery mode according to the latest GDP figures for the 2Q22, a recession is looming. Consumers have been spending on services due to a post lock down effect, but retail sales have already been trending down since November and consumer confidence is at an all time low in the eurozone. Higher inflation will have a significant effect on spending in the months to come.

The eurozone is in for a tough second half of the year. The peak in inflation is hard to determine as energy prices are currently incredibly unpredictable and still have a dominant effect on headline inflation, and even on core as businesses have to price through higher energy costs to consumers at these prices. A peak above 9% headline YoY inflation is logical at this point, but a jump to above 10% is clearly not unimaginable given the high market gas prices.

For the ECB, it is not about current headline inflation but about future inflation and inflation expectations. The bank knows very well that it can do little to actively bring down inflation in the short run and we doubt that, contrary to the Fed, the ECB would be willing to push the eurozone economy into recession. In fact, it doesn't have to as the eurozone economy is already heading that way. For inflation, this means that companies' ability to pass through higher costs to consumers will drop quickly; in fact, it has already started to.

The ECB currently has two main goals: anchoring inflation expectations and normalizing monetary policy. As for inflation expectations, only business inflation expectations have come down somewhat. The US example, however, shows that even more aggressive rate hikes are less powerful in bringing down survey-based inflation expectations than global commodity prices. The latest drop in US inflation expectations seems to be the result of dropping gasoline prices and not so much of the latest Fed rate hikes. This leaves the ECB with at least normalizing monetary policy.

ECB will take a less aggressive approach than the Fed and what markets are currently pricing in. A recession, a winter energy crisis, and an ongoing war simply argue against overly aggressive rate hikes.

Christine Lagarde has recognized the impact of runaway inflation on the lives of Europeans. Responding to a question during an interview with magazine Madame Figaro published on August 25, she made a rare public acceptance of the inner ill-workings on macro-economic projections.

"*I know we will return to an inflation rate close to 2%, but when? Over what time period? And what will the impact be? We can no longer rely exclusively on the projections provided by our models - they have repeatedly had to be revised upwards over these past two years. There are things that the models don't capture. Sometimes the unexpected happens. So we have to pay attention to traditional indicators while also monitoring empirical data and what we expect to happen in terms of geopolitics, energy price developments and demographics.*"

She also added, that ECB needs to take climate change into account when making decisions as it has a clear impact, especially on inflation. *"If more and more climate disasters, droughts and famines occur throughout the world, there will be repercussions on prices, on insurance premiums and on the financial sector. We need to take that into account."* She also said that she could imagine that different environmental, social and governance standards will be harmonized and tightened rather quickly.

On August 30, Eurostat, the statistics office of the European Commission, released a flash estimate of consumer price growth for August 2022 which hit a record 9.1% up from 8.9% in July, itself the highest level in the euro's 23-year history, fueling fears that rising prices would be embedded in the economy. Core inflation increasing from 4% to 4.3%.

The increase was mainly seen in processed food and goods prices, but services also ticked up slightly. Energy inflation fell for the second month in a row on base effects and lower petrol prices, despite soaring gas and electricity prices. The main concern is the surprise increase in goods inflation. The increase from 4.5% to 5% was much larger than expected and fuels worries about second-round effects from the input cost shock lasting longer.

Euro-zone government bonds sold off, boosting yields after the data was released, reflecting growing expectations that the ECB will raise interest rates by 0.75% for the first time in its history.

Germany's 10-year yield rose 7bps to 1.58% after the inflation figure was published, while Italy's 10-year yield rose more than 10 bps to 3.93%. The euro fell below the value of the US dollar to $0.9979, adding further inflationary pressures by raising the price of imports into the eurozone.

The Italian Conundrum: Part V

On August 5, in an unscheduled rating review, Moody's affirmed Italy's local and foreign-currency long-term and senior unsecured ratings of Baa3 but revised the outlook to negative from stable. Moody's review is scheduled for 30 September, but it decided to revise the outlook ahead of the review on a non-scheduled date.

This follows S&P's revision of Italy's outlook to stable from positive on 26 July. Moody's believes the current environment no longer supports the stable outlook and the resignation of former PM Mario Draghi has significantly altered the sovereign risks in Italy. The Moody's rating is currently at a historical low and just one step away from sub-investment grade status.

Growth and fiscal developments delivered positive surprises in 2021 and early 2022, but risks to Italy's credit profile have been accumulating more recently because of the economic impact of Russia's invasion of Ukraine and domestic political developments, both of which could have material credit implications.

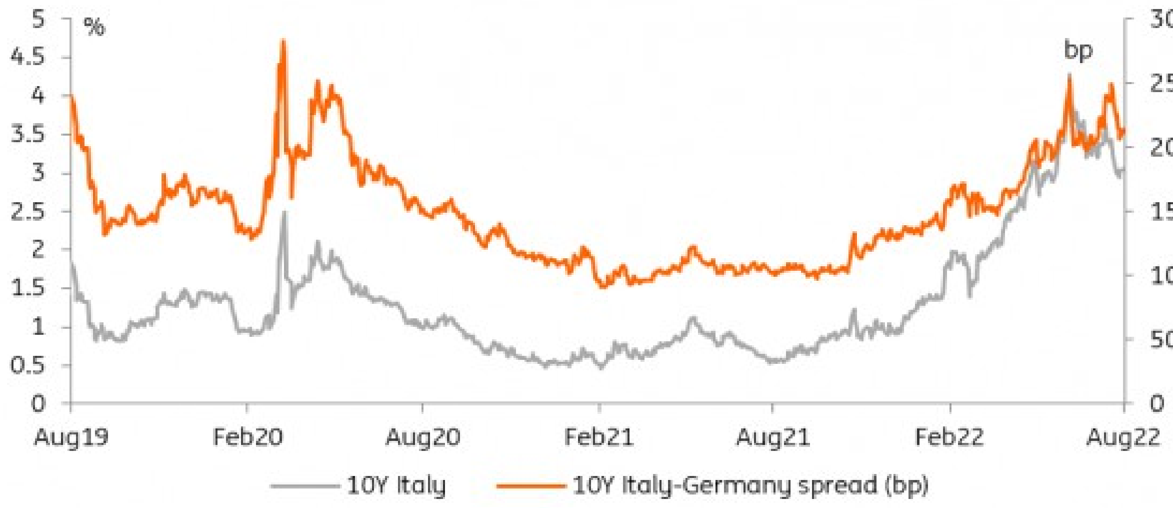
Moody's outlook revision reflects three main factors:
• Heightened risks that the political environment will impede the implementation of structural reforms, including those contained in Italy's National Recovery and Resilience Plan (NRRP);
• Increased risk that energy supply challenges will weaken economic prospects;
• Risks that Italy's fiscal strength will be further weakened by sluggish growth, higher funding costs, and potentially weaker fiscal discipline.

A future eurosceptic government in Italy would increase the tensions with the EU and reduce the likelihood of structural reforms that are needed to unlock access to the NGEU funds.

Italy is at a stage where it needs the fund to support its economic recovery and boost its potential economic growth, so a stable government is particularly critical at this point. In addition, Italy relies heavily on Russian gas imports, and further cuts in gas supply from Russia will put Italy's economy at risk. Improvements in Italy's debt affordability in recent years are also set to reverse as the ECB normalizes its monetary policy.

Finally, the rating reflects Moody's assumption that core euro area countries will support Italy in case of need, a view that has been confirmed by the ECB's recent announcement of the TPI.

The spread of Italian government bonds had seen a notable tightening up until August 5 after ECB data earlier had confirmed that central banks were deploying vast amounts to aid periphery bond spreads within its flexible PEPP reinvestment policy.



The tightening trend has hit a unexpected obstacle on August 8, with the key 10y BTP-Bund spread bouncing off the 200bps threshold and re-widening to 208bps. Ahead of the snap elections in September political uncertainty still looms large as was highlighted by one party quitting a center-left alliance surrounding the Democratic Party only days after it had been formed in an attempt to offer a counterweight to the right wing bloc led by the Brothers of Italy party.

Although the break in primary market supply after Italy canceled bond auctions in August, should also offer near-term support for Italian bonds. In addition, ECB's flexible use of PEPP re-investments aims to limit the fall-out on Italian bonds for the time being.

Moody's will downgrade Italy's rating to Ba1 only if the election results make it believe that Italy's medium-term growth prospects have significantly deteriorated. Although Italy's right-wing parties have become less extreme than before, negative rating actions by S&P or Fitch could happen later this year. In the unlikely event of a rating downgrade to Ba1, the market impact could be large, as many funds would be forced to sell their BTP holdings due to the restrictions in their investment mandates.

In local political arena, general elections will take place in late-September. An alliance including Brothers of Italy, the anti-immigration League and ex-premier Silvio Berlusconi's Forza Italia would command 49% of votes, opinion polls show, well ahead of its divided political rivals. Meloni's party, which has roots in post-war neo-fascism, opposed Draghi's agenda and has a eurosceptic past, may capture 24% of the vote.

High on the alliance's agenda is slashing taxes to boost consumer demand. While the group has yet to publish an official manifesto, its plans include extending a flat tax rate of 15% to self-employed workers earning up to €100,000pa from €65,000pa currently. A bolder plan to extend the treatment to all workers and pensioners could however lower the government's tax revenue by around €40bln a year, or more than 2% of Italy's annual GDP. That would make it harder to reduce public debt, seen at 147% of GDP this year.

Meloni's coalition also wants to make changes for the €200bln NGEU plan agreed with the European Commission. Reality check: the war in Ukraine suggests more funds could be spent on energy infrastructure. Yet any changes will need Brussels' backing, putting at risk the disbursement of cash crucial to lift Italy's growth.

Finally, Meloni also favors a bigger state presence in corporate Italy. That may endanger agreed privatizations such as that of Alitalia's successor ITA and of banking lender Monte dei Paschi di Siena.

At last, Italy needs the support of investors to refinance its debt. Market jitters forced a previous anti-establishment executive to curb expensive fiscal projects in 2018 and 2019. ECB signaled in July it will intervene to support countries facing speculative attacks only if they abide by Europe's fiscal rules and don't blow up their public finances. And further rising of BTPs yields suggests Italy cannot take bond markets for granted.

Italian bonds have endured significant fluctuations in recent months. The spread between BTP-Bund spread was around 230bps on August 22, its highest level for almost a month, highlighting anxiety over the outcome of Italy's election next month and expectations of further rate rises by the ECB.

Hedge funds ramp up bets against Italy's bond market

Market value ($bn)

Source: S&P Global Market Intelligence
© FT

The market negative news on Italy piled-up at the end of August. Hedge funds have lined up the biggest bet against Italian government bonds since the global financial crisis on rising concerns over political turmoil in Rome and the country's dependence on Russian gas imports.

The total value of Italy's bonds borrowed by investors to wager on a fall in prices hit its highest level since January 2008, at more than €39bn, according to data from S&P Global Market Intelligence, published by Financial Times on August 25.

The IMF warned in July that a Russian gas embargo would lead to an economic contraction of more than 5% in Italy and three other countries, unless other nations shared their own supplies.

Investors also consider Italy to be among the most vulnerable countries to the ECB's decision to unwind its stimulus programs by raising interest rates and halting the bond purchases that have propped up the country's €2.3tn debt market.

Italian bonds have already sold off in August as investors respond to the rising uncertainty. The yield on Italy's 10-year debt has risen to 3.7%, pushing the spread with Germany's debt to 230bps from 137bps at the start of the year.

Some hedge fund managers showing caution for the trade, saying that ECB's recently announced TPI will limit upside to yields, by intervening in the markets supporting the Italian debt. Others think that TPI is little deterrent to placing a bearish bet. Such a move [i.e. ECB to just buy Italian bonds] would act as a signal for ECB to provide support to countries lacking fiscal discipline.

The Upcoming German Conundrum

A European recession is now part of the economic consensus. It is no longer a question of if, nor of when, but of how bad things will get over the winter months. This owes in large part to higher energy prices and throws an even greater policy challenge to the ECB. Even if it hikes 50bps in September, the meeting and accompanying forecast should see it finally acknowledge the dismal economic prospects facing the eurozone.

ECB faces the unenviable task of choosing between tightening financial conditions to fight an inflation problem it is ill-equipped to resolve, or to stand pat in the face of higher than-expected inflation.

The war in Ukraine has probably marked the end of Germany's very successful economic business model: importing cheap (Russian) energy and input goods, while exporting high-quality products to the world, benefiting from globalization. The country has been in the middle of a complete overhaul, accelerating the green transition, restructuring supply chains, and preparing for a less globalized world. And these things come on top of well-known long-standing issues, such as a lack of digitization, tired infrastructure, and an aging society.

On August 15, the German government announced a gas levy for households and businesses, which will come into effect in October. This surcharge was set at €0.024 per KWh. August gas prices were around €0.17 per KWh. This levy is meant to cover the additional costs incurred by gas providers, as higher wholesale gas prices couldn't be passed through to consumers, yet.

According government estimates, the levy will lead to an additional cost of around €500 million pa for a four-person household. However, the coming winter, energy providers will be able to pass through higher energy prices to consumers as they can adjust prices once a year. The government announced that it is looking into compensating measures for lower income households, possibly an increase in child benefits, income tax reductions or direct financial support. Such measures could smoothen the negative impact of the levy on growth but not on inflation.

As many parts of Europe, Germany has been hit by a long, unprecedented drought. Water levels have been dropping continuously over the summer and last week, the water level on Rhine River fell under the critical 40 cm mark. Barges can no longer be loaded at full capacity but at a maximum of one-third and some routes will be canceled. This is not where it stops. Industry facilities at the shores of the Rhine will increasingly have problems to use water for cooling.

Back in 2018, low water period only came in late-September. This time around, low water levels have come earlier and there is little rain relief in sight. To make things worse, waterways are essential for coal transportation, which in turn is needed to offset fewer gas from Russia. This means, the low water levels will do more economic harm than in 2018. The low water levels are expected to shave off at least 0.5 percentage points of GDP growth in the 2022.

With the new levy and the impact from the low water levels, inflation rates at double-digit levels almost look like a done deal for the final quarter of the year and it would need an economic miracle to avoid a recession in the second half of the year. For the entire year, GDP growth us expected to come between 0.5% and 1%.

In August 2022, German inflation accelerated to a 40-year high of 8.8% YoY. Consumer prices were mainly driven by rising energy and food costs. German energy prices rose by 35.6% and food prices by 16.6%. Core inflation, excluding food and energy, rose to 3.1%, from 2.8% in July.

German inflation continued to rise despite government measures including lower excise duties on fuel and energy and a €9 monthly train ticket subsidized. Many of the measures would expire in September, which means that inflation is likely to rise even higher.

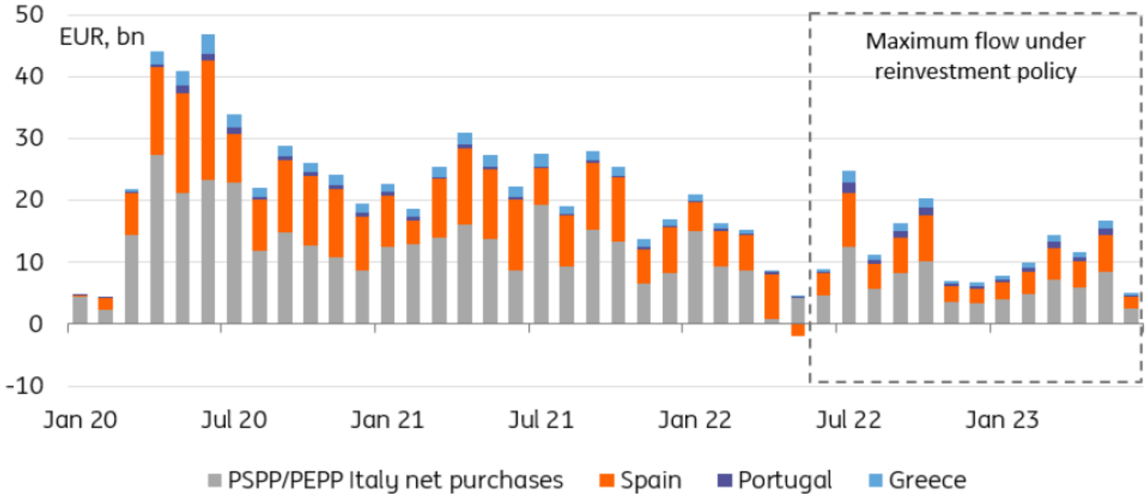
For the ECB, the increase in German headline inflation would further heat up the internal debate on what to do next. The ECB is willing to follow in the Fed's footsteps and leave traditional monetary policy thinking behind. Instead of aiming at longer-term inflation developments and expectations, it is the actual headline inflation which apparently must be brought down. Definitely not an easy task with inflation that is mainly driven by supply-side forces. The ECB has been under enormous pressure to act, even with a looming recession.

In the coming weeks and months, these longer-term changes would be overshadowed by shorter-term problems: high inflation, possible energy supply disruptions, and ongoing supply chain frictions. In August, these shorter-term problems have become larger as low water levels and the new gas levy have added to inflation and recession concerns.

PEPP in operating mode – TPI ready to be activated: One month later

At its July 21 meeting, the ECB unveiled its fragmentation fighting apparatus: a set of tools aimed at preventing the excessive widening of sovereign spreads. The question is whether these tools can prevent spreads from blowing out further.

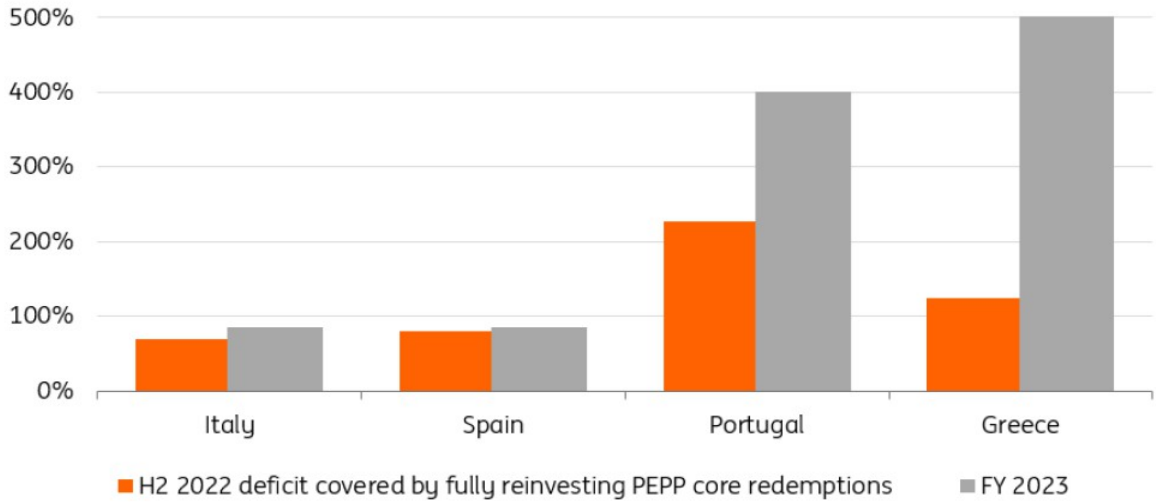
Whilst Italian politics rightly get a lot of attention, the genesis of the recent jump upwards in sovereign spreads starts with central banks scrambling to tighten policy in the face of higher inflation. As an era characterized by not only ever lower interest rates, but also abundant liquidity injections in order to depress the cost of credit in financial markets, comes to an end, it is understandable that sovereign spreads would widen.



Source: Refinitiv, ING

When asked about how it intends to tackle the widening of spreads, ECB continues to point to its first line defense, the flexible re-investment of its PEPP holdings. Markets, however, doubt that it alone will be enough if investor confidence in peripheral government bonds is really put to the test.

The details on the TPI instrument are scarce as the ECB appears to see some value in "constructive ambiguity". Background reports have since suggested that the average monthly PEPP redemptions amount to €17bn, of which €12bn are in core countries. Other reports have said that the ECB has categorized countries into three groups: "donors", "neutrals" and "receivers".



Source: Refinitiv, ING

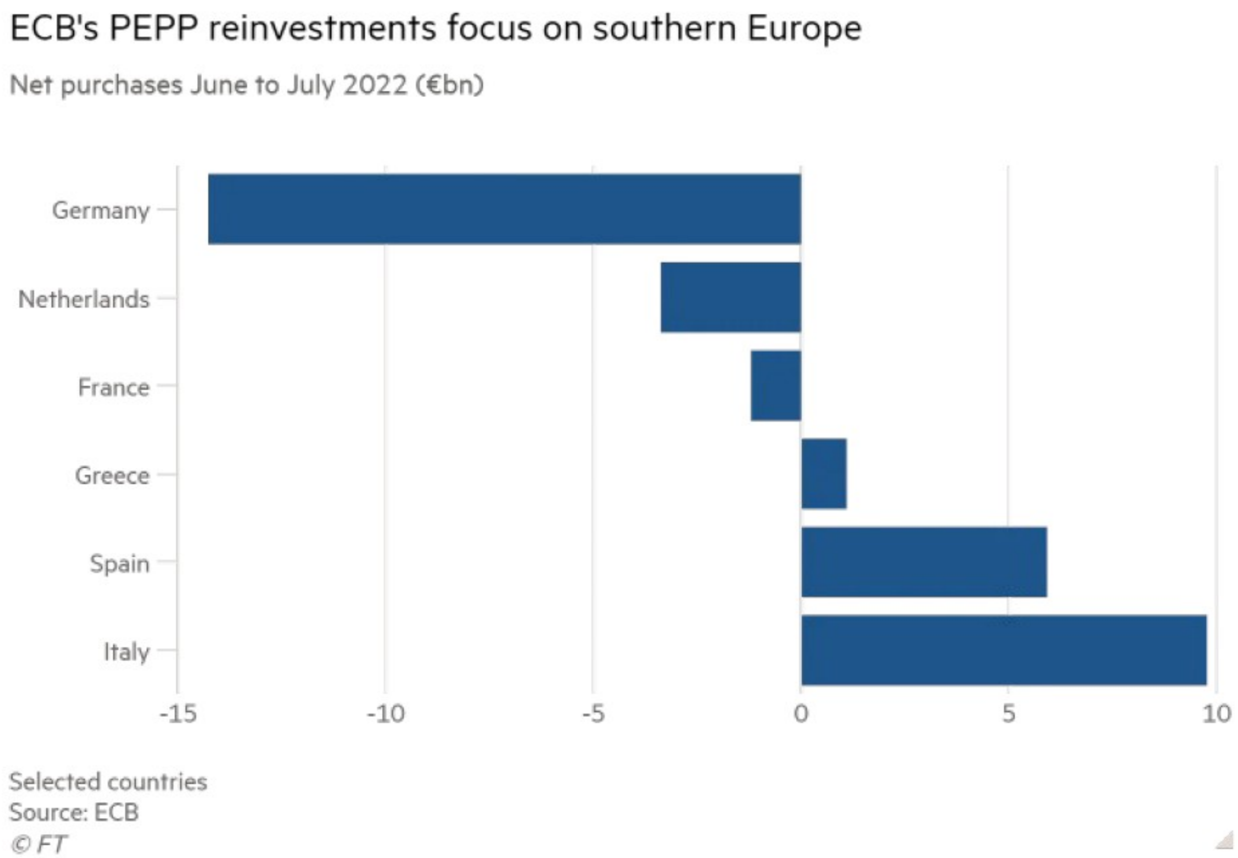
Put into context, that, were they used to their full potential, reinvestment flow would be enough to roughly cover Italy's and Spain's general government deficit in 2H22 and 2023. However, under that best-case scenario, the peripheral bond purchases in the 12 months from July 2022 will only amount to 75% of the purchases in the 12 months, period, when PEPP purchases were already being tapered. At full speed, PEPP reinvestment should cover most peripheral net financing needs.

PEPP data are only reported on a bi-monthly basis, with the first batch relating to purchases in the months of June and July coming in early August, and the next one relating to purchases in August and September coming in early October. July purchases may give an early indication of how aggressive the ECB intends to be, but, since these will be lumped together with June, before the reinvestment policy started, it will be difficult to take a definitive signal from them.

In fact, according to released ECB's data on August 2, 2022, the ECB injected €17bn into Italian, Spanish and Greek markets, while allowing its portfolio of German, Dutch and French debt to fall by €18bn, between June and July.

The BTP-Bund spread has since narrowed to about 210bps after the ECB committed to pushing back against fragmentation. The ECB last month said flexibility in deploying PEPP re-investments would be the "*first line of defense*" in its attempt to keep a lid on so-called spreads.

While the ECB is yet to use the new TPI tool, its use of PEPP re-investments shows how eager policymakers are to keep spreads under control. It is clear from public comments from various ECB speakers that TPI is there not to be used. ECB allows itself potentially unlimited sovereign purchases if unwarranted spread widening occurs, under heavy conditionality. Simultaneously, investors have been watching Italian spreads cautiously to see when the ECB may step in, with many deeming 250bps, an important mark.



The ECB may well conclude that these conditions are fulfilled for most sovereigns, including Italy, but some of the program's credibility hinges on how long the ECB can keep its support up if a government sets its country on a diverging course with the EU's fiscal and reform recommendation.

TPI, is a more distant prospect and come with heavy political baggage. It is clear the ECB would only use it in the most extreme cases. The irony is that this tool is so credible in fighting monetary-induced spread widening that spreads are unlikely to widen much for this specific reason. On the other hand, the TPI is more likely to be activated for edge cases, when its use is more controversial, and so when markets have reason to doubt it would ride to the rescue.

ECB Governing Council members rift on future rate hikes

On August 18, ECB's board member Isabel Schnabel gave a speech at Hochschule der Deutschen Bundesbank in Hachenburg town of Rhineland-Palatinate state. She has made it clear that ECB is not losing its inflation focus. The ECB, too, is not done yet and she signaled another larger hike – in this case, 50bps – for September 8.

During an interview with Reuters, she said that ".. *in July we decided to raise rates by 50bps because we were concerned about the inflation outlook... The concerns we had in July have not been alleviated... I do not think this outlook has changed fundamentally.... I would not exclude that, in the short run, inflation is going to increase further... These inflationary pressures are likely to be with us for some time; they won't vanish quickly... It will take some time until inflation gets back to 2%.*

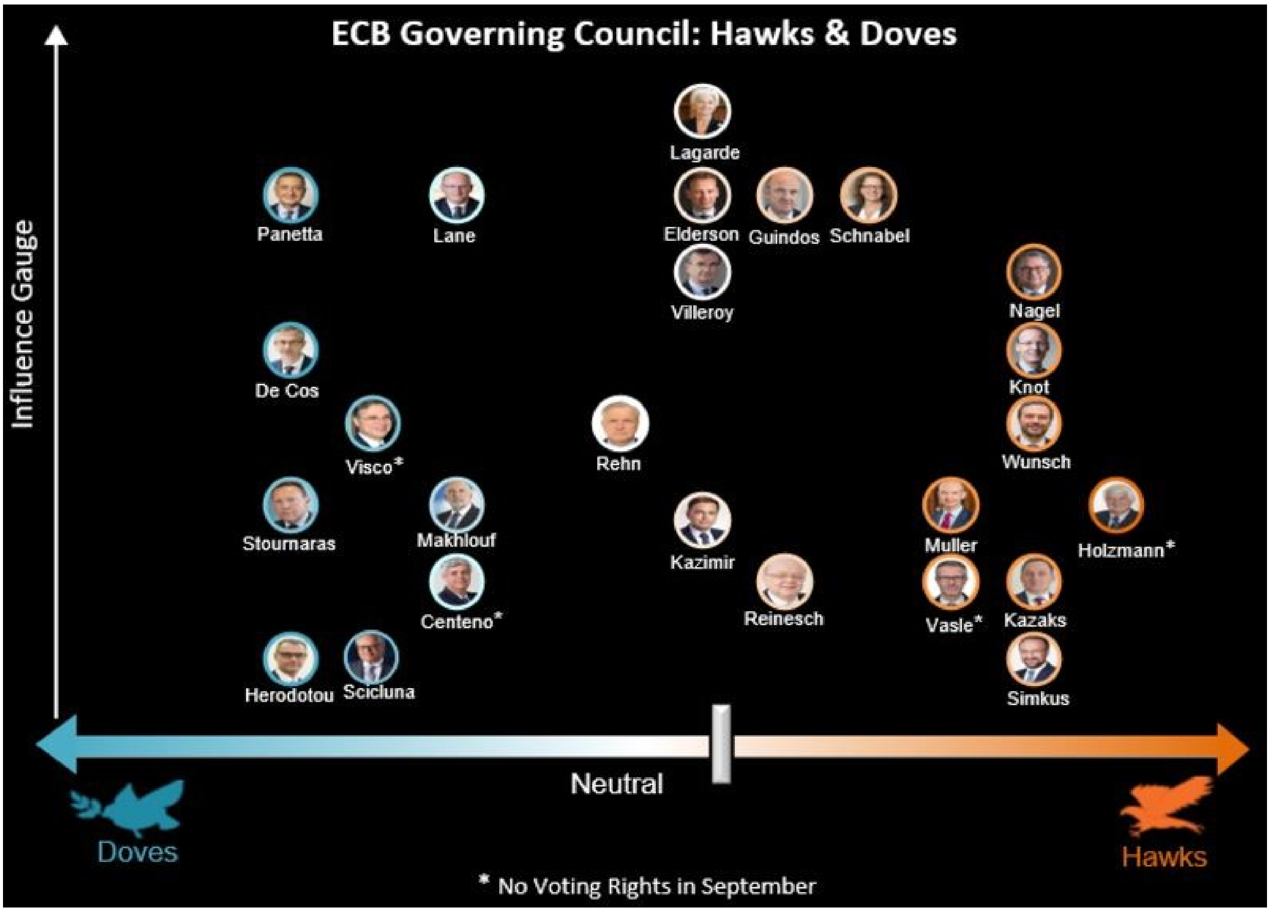
"There is a strong indication that growth is going to slow and I would not rule out that we enter a technical recession, especially if energy supplies from Russia are disrupted further.. Downside risks to economic growth have also increased due to additional supply-side shocks, caused by droughts or the low water levels in major rivers... It seems that, out of the larger euro area countries, Germany is hit the hardest."

"Even if we entered a recession, it's quite unlikely that inflationary pressures will abate by themselves... The growth slowdown is then probably not sufficient to dampen inflation."

A rate hike in September is seen a done deal with policymakers split between 25 and 50 bps. Schnabel's comments suggested she is likely to advocate a bigger increase. The problem is that at 8.9%, inflation is more than four times the ECB's 2% target and could still go higher even as surging energy costs sap purchasing power and slow growth. She added that real short-term rates remain deep in negative territory and the ECB was "*quite far*" from becoming restrictive.

Schnabel noted that ECB projections have been wrong in recent quarters so actual price growth figures need to be given greater weight in policy decisions.

For the ECB its rate hikes come just as a recession, induced by surging oil prices, looms large over the bloc. Tightening policy while entering a recession risks exacerbating any downturn. While a recession will dampen price pressures, on its own it will not be enough to get inflation back to target.



Source: Bloomberg Economics

Another complication is that rate hikes are bound to push up borrowing costs disproportionately on the bloc's periphery, putting more indebted nations like Italy or Greece at greater risk. But for Schnabel, the markets were more stable now even if volatility remains elevated and liquidity is low.

On the same day, Martins Kazaks, ECB's Governing Council member said in an interview with Latvia's TV3 that ECB will continue to hike interest rates, since "*...at the moment what we see is that that inflation is unacceptably high, in Latvia above 20%.*"

He added that "*Monetary policy already from last December became more restrictive: In the beginning, we were decreasing support programs and in the past few months also significantly increasing interest rates and we will continue to increase interest rates with the goal not to allow inflation" to become entrenched.... It would be more painful to let inflation continue... To fight inflation you need also fiscal policy and structural policy.*"

The avalanche of public statements continued on August 20. Bundesbank chief Joachim Nagel told the Rheinische Post Saturday edition in an interview that "*Given the high rates of inflation, further interest rate steps need to be taken.... Recent months have shown that we need to take a meeting-by-meeting approach to interest rate decisions... It will be crucial to keep medium-term inflation expectations stable at 2%. I am confident that the ECB Governing Council will implement the necessary monetary policy measures."*

The inflation outlook has deteriorated further, however and price growth in Germany could even exceed 10% in the coming months. The last time double-digit inflation rates were measured in Germany was over 70 years ago. The rate was 11% in the fourth quarter of 1951 according to Nagel as saying. *"There is a growing probability that German inflation will be higher than previously forecast and that, on average next year, we will have a six before the decimal point."* Nagel said, indicating a big upside risk to the Bundesbank's previous 4.5% projection for 2023.

Still, the ECB should not hesitate to raise rates, Nagel said, adding that he was satisfied with the July decision. "*Given the high rates of inflation, further interest rate steps need to be taken. This is what is generally expected, too,*" Nagel said, though he declined to discuss the size of the September move.

Speaking on Germany's prospects he mentioned its dependence on Russian gas makes it more vulnerable to the war in Ukraine, while a recent drought has made the Rhine difficult to navigate. *"If the energy crisis intensifies, a recession this winter would appear likely... In the first half of the year, the German economy was still faring reasonably well under difficult conditions. If, however, further supply problems are now added to the equation due to persistent low water levels, the economic outlook for the second half of the year would deteriorate further..*"

Nagel called on employees to keep an eye on the economic situation when negotiating wages. The fact that German inflation is being driven in large part by energy *costs "...as we have to spend more of our economic output on energy imports, there is not so much scope for distribution domestically. Wage bargainers have acted very responsibly over the past 25 years. I am confident that they will do so this time as well.*".

On August 22, Bundesbank reiterated Nagel's statements in a monthly report: recession in Germany, is increasingly likely and inflation will continue to accelerate and could peak at more than 10% this fall.

"Declining economic output in the winter months has become much more likely... The high degree of uncertainty over gas supplies this winter and the sharp price increases are likely to weigh heavily on households and companies.... Overall, the inflation rate could reach 10% in autumn... The upside risk for inflation is high, in particular in the event of a complete stoppage of gas supplies from Russia."

Talking at a panel discussion of the Annual Congress of the European Economic Association at Bocconi University in Milan on August 23, ECB's Board Member Fabio Panetta exposed a rift among policymakers. He indicated that ECB must exercise caution with further rate hikes as a looming recession could ease inflationary pressures, lessening the need for central bank action.

"*We may have to adjust our monetary stance further, but .... we have to be fully aware that the probability of a recession is increasing... If we will have a significant slowdown or even a recession, this would mitigate inflationary pressures*," Panetta said.

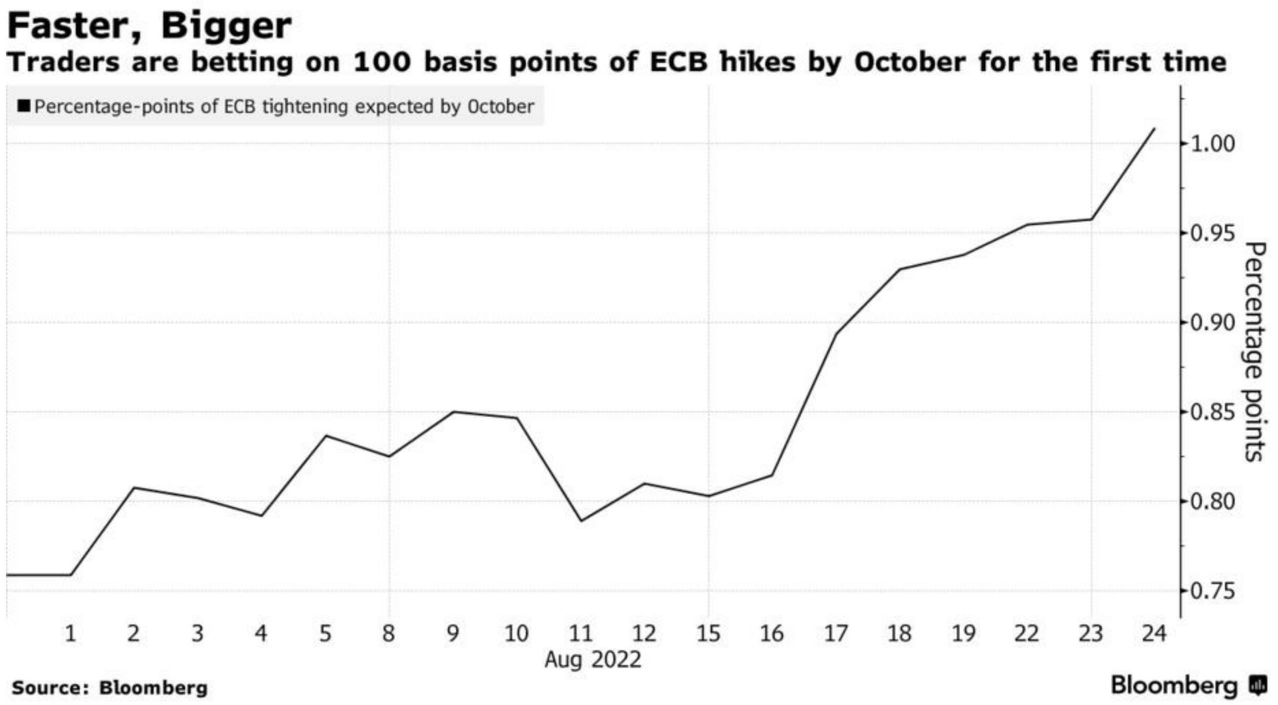
Any adjustment in monetary policy "*needs to be strictly data dependent, taking fully into consideration the condition of the euro-area economy... This implies first of all to be fully aware that the probability of a recession is increasing in the euro area because of the consequences of the pandemic, of the shock to commodity prices of recent months, because of the war and its consequences for trade and uncertainty,"* he said.

Panetta also argued that interest rates, once adjusted for inflation, are "*not too far away*" from what is considered neutral, which neither stimulates nor holds back growth.

"*If you look at the evolution of market rates in recent weeks, then you would see that taking into account expected inflation, real rates are actually not too far away from what could be estimated as their neutral level and they're not out of line with estimates of the Taylor Rule,*" Panetta said.

On the commodity prices front he argued that "*..we should consider very carefully the dynamics of commodity prices.. The most recent dynamics suggest that commodity prices are actually falling,* *with the notable exception of gas. We know gas prices respond to other factors, geopolitical factors."*

Overall Panetta signaled a cautious stance on monetary policy. "*Adjustments are possible, but the most recent evolution of the economy should induce us to exercise one of the main virtues of central bankers, which is prudence*," he said.



But the European Money Markets have started betting a more aggressive rate hike at the next ECB meeting on September 8. According to Bloomberg news-wire on August 24, traders have raised wagers the ECB will take bolder action to tame surging prices as the euro area struggles with record energy prices, exacerbated by Russia's war in Ukraine.

Money markets are now fully pricing a percentage-point of policy tightening by the October monetary meeting, which would take the deposit rate to 1%, a level last seen more than a decade ago, according to swaps tied to the decision date. Any such increase would immediately be passed on to corporate and mortgage loans.

Traders have been left in the dark on the future path of ECB rate hikes since it broke with its tradition of giving forward guidance at the last meeting on July 21. It shocked many investors in raising rates by a 50bps, saying it would take a "*meeting-by-meeting approach*" thereafter.

Even as traders priced in more aggressive tightening in the near term, wagers indicate the ECB will subsequently slow the pace of rate increases into 2023. They see interest rates hitting 2% only by September next year.

The release of July 20-21 ECB's Minutes

The minutes of the ECB's July meeting released on August 25., showed a Council concerned about the inflation outlook and fragmentation risks, leading to a broad consensus around a larger-than-anticipated 50bps hike and the introduction of TPI.

ECB policymakers appeared increasingly worried that high inflation was getting entrenched, even as the risk of a recession loomed in the bloc. The accounts showed policymakers felt price pressures were now big enough that the ECB had to demonstrate its determination to act.

Still, the released minutes reveal some interesting insights. Here are the most important points:

• The discussion on the TPI took actually place before the discussion on hiking interest rates. The TPI was agreed upon unanimously. The minutes stated that "*The Governing Council approved the TPI with the broad conditions and safeguards set out in the dedicated press release.*" Members have stressed the importance of eligibility requirements and safeguards to keep the tool as a backstop. Particularly, it has been noted that the tool should "*avoid weakening incentives for governments to pursue sound economic policies*", and that the tool will have a "*clear framework for its activation*". Combined, there seems to be relatively high bar for the activation of the tool.

• Concerns about the weak euro came on top of the policy-relevant discussion, with "*Members widely noted that the depreciation of the euro constituted an important change in the external environment and implied greater inflationary pressures for the euro area, in particular through higher costs of energy imports invoiced in US dollars.*"

• Recession is still a forbidden word in the ECB's dictionary as it was only used nine times. ECB minutes mainly said that "*It was argued that even a recession would not necessarily diminish upside risks, especially if it was related to a gas cut-off or another supply shock implying a further increase in inflation*," adding that other council members argued low growth would "*itself take care of low inflation*".

• On the inflation front the minutes showed that "*Inflationary pressures were judged to have intensified. Persistently high inflation posed an increasing risk of longer-term inflation expectations becoming un-anchored.*" ECB's July minutes have showed that policy makers were concerned about the inflation outlook, noting that particularly the near-term but also the medium-term inflation picture has continued to deteriorate, with risks further tilted to the upside.

• Wage growth remains key for the ECB to identify second-round effects as "*Members agreed that the persistence of inflation depended, to a large extent, on the behavior of wages. Wage growth, also according to forward-looking indicators, had continued to increase gradually over the last few months but still remained contained overall.*"

• The rate hikes by 50bps were supported by a "*very large*" majority rather than the frequent unanimity seen in policy decisions, with few ECB members calling for the initially precommitted 25bps. The fact that many ECB officials, including ECB president Christine Lagarde, had publicly consistently repeated the intention to hike by 25bps since the June meeting was explained by "*The Governing Council thereby took a larger first step on its policy rate normalization path than signaled at its previous meeting, applying the stated principles of data-dependence and optionality. This was seen as providing a clear signal of its determination to act and to fulfill its mandate.*"

• Still, policymakers highlighted that the big July move, was front-loading and should not be seen as heralding a more aggressive interest rate path. "*A decision to raise interest rates by 50bps at the present meeting should be regarded as front-loading ... rather than indicating a change in the rate to be expected as the end-point of the normalization cycle,*" the accounts showed.

The main takeaway from the ECB minutes was the signaling of more hikes to come as the outlook for inflation worsened. The larger increase of 50bps in July should be understood as a front-loading of the normalization process, but not as a change of the end-point of the cycle. This end-point will only crystallize once interest rates get closer to it, and it probably remains a moving target.

The central view was that ECB's July meeting underlined its new approach to normalization: we can do whatever we want, whenever we want. The minutes illustrate how the momentum within the ECB changed between the June and the July meeting and also stress its determination to continue hiking rates as the minutes repeatedly underline that the ECB is on a path of normalization. The discussion at the July meeting shows that growth concerns are mounting but that the ECB is still divided on the risk of an outright recession in the eurozone.

For now, the ECB intends to reinvest maturities of the APP "*for an extended period of time past the date when it started raising the key interest rates*". PEPP maturities will be reinvested at least until the end of 2024. The flexibility of PEPP re-investments was highlighted as the default option to counter risks to the transmission mechanism related to the pandemic. No direct conclusions were drawn in the minutes, but Isabel Schnabel and Bundesbank's Joachim Nagel hinted that the balance sheet would have to be considered at some point, earlier in August.

Adjusting the reinvestment guidance may offer the ECB another lever on monetary policy, although eurozone is at a time where flexible re-investments are used to contain sovereign spreads, talking about reducing re-investments could prove counterproductive.

Looking forward, ECB is currently pursuing two main goals: anchoring inflation expectations and normalizing monetary policy. As for inflation expectations, only business inflation expectations have come down. The US example, however, shows that even more aggressive rate hikes are less potent in bringing down inflation expectations than global commodity prices.

The latest drop in US inflation expectations seems to be the result of falling gasoline prices and not so much of the latest Fed rate hikes. This could be a hint for the ECB that a series of more aggressive rate hikes might be too much of a good thing. This leaves it with at least normalizing monetary policy. Any neutral level of a policy rate also depends on the state of the economy. In a robust growth environment, the neutral rate will be higher than in a low growth or even recessionary environment.

The Jackson Hole "revelation" - 75bps rate hike by ECB?

The economic policy symposium sponsored by the Federal Reserve Bank of Kansas City Jackson Hole, Wyoming this year (August 26-27 2022) had the title "Reassessing Constraints on the Economy and Policy."

Top officials from the world's biggest central banks coalesced around a simple message in Jackson Hole this weekend: They are ready to follow through with higher interest rates, even if it does some damage.

Federal Reserve Chair Jerome Powell, signaled that the US central bank was likely to keep raising interest rates and leave them elevated for a while to stamp out surging consumer prices.

Powell dropped expectations about how high US interest rates could be hiked and for how long as the Fed grapples with excessive price pressure, driven in part by supply-side factors but also excessive demand.

The chairman of the US central bank warned that efforts to cool the economy are likely to require an "extended period" of low growth, a weaker labor market and "some problems" for households and businesses.

Powell said a failure to successfully rein in inflation now will lead to higher costs going forward, suggesting the Fed is unlikely to end the tightening cycle anytime soon.

He told the annual gathering of monetary policy makers that the road ahead will "*bring some pain to households and businesses*" in the US, an "*unfortunate cost of bringing down inflation*."

It was a litany of hawkish comments by Fed and ECB officials at Jackson Hole. Powell's keynote speech endorsed a longer period of higher rates setting off another opportunity of selling government bonds in US and Europe, boosting the dollar and hurting stocks and credit.

ECB speakers in their comments in Wyoming backed a significant rate increase at the council meeting next week with the rising probability of a 75bps rate hike. Reading between the lines, it illustrated how the ECB is trying to make up for lost time by not raising rates sooner.

Reuters news agency had already reported that some officials wanted to discuss a hike of that magnitude. European bonds immediately slumped as market traders priced in a more aggressive pace of rate increases by the ECB, betting on a 50%/50% chance of a 75bps hike at its September rate decision for the first time. Such a move would be the biggest-ever single increase by the ECB and would take its key interest rate to 0.75%, the highest level since November 2011.

Two-year German bond yields -- which are the most sensitive to changes in monetary policy -- surged to 1.05%, the highest level in more than two months.

More specifically, on Friday August 26, Klaas Knot, Netherlands' Central Bank president and a member of the ECB's Governing Council, said in an interview with Dutch national broadcaster NOS that he favored large interest rate hikes to tame inflation. He was speaking from Jackson Hole, Wyoming.

"*Europe's inflation problem is so large at this moment that I think it's our duty to raise rates every six weeks until the moment that inflation stabilizes,*" Knot told the broadcaster. He favored another hike of at least 0.5% and possibly 0.75% at the ECB's Sept. 8 meeting in Frankfurt.

The same day, Austria's Robert Holzmann speaking to Bloomberg news agency, a top hawk on the Governing Council, said a 50bps step should be "*the minimum*" at the Sept 8 decision. But he added at Jackson Hole gathering that 75bps "*should be part of the debate*".

On August 27 on the sidelines of the economic symposium ECB policymaker Martins Kazaks, Latvia's central bank chief said that a euro zone recession is now very likely but that alone will not bring down inflation and the ECB should opt for a big rate hike next month.

"*With this high inflation, avoiding a recession will be difficult, the risk is substantial and a technical recession is very likely. In Latvia, a recession is part of a baseline scenario... Front-loading rate hikes is a reasonable policy choice... We should be open to discussing both 50 and 75bps as possible moves... From the current perspective, it should at least be 50,*" Kazaks told Reuters.

The problem for ECB officials is that at 8.9%, inflation is more than four times the ECB's target and it is still likely to go higher before a slow retreat. Underlying inflation, which filters out volatile food and energy prices, is also uncomfortably high, indicating that some of the inflation is now getting embedded in the economy via second round effects.

Kazaks said the central bank should reach the neutral level, which neither brakes not stimulates the economy, in the first quarter of next year. "*If we see that we need to go beyond the neutral, I have no doubt we will.. If we don't see significant decreases in core inflation, we may need to go beyond the neutral. But let's not get ahead of ourselves.*"

He added that the ECB should reduce its balance sheet at some point but, for now, it should predominantly deal with interest rates.

Expressing a centrist on the bank's rate-setting Governing Council, Villeroy said at a panel of the Economic Symposium that rates should keep rising until the ECB hits the neutral level, which is somewhere between 1% and 2%. "*We could be there before the end of the year, after another significant step in September.*"

But Villeroy emphasized that the ECB was willing to go higher than the neutral level, if needed. "*Have no doubt that we at the ECB would if needed raise rates further beyond normalization: bringing inflation back to 2% is our responsibility; our will and our capacity to deliver on our mandate are unconditional,*" he added.

ECB Executive Board member Isabel Schnabel, the 2nd day's most anticipated speaker, urged her colleagues to act with determination to slow price increases that in Europe are nearing 10% and in the US are above 8%.

Schnabel, said that European monetary policy should remain tight for an extended period of time. Her remarks, echoed those of Federal Reserve Chairman Jay Powell, who vowed the previous day to "*keep it up*" to tamp down inflation.

"*Central banks are likely to face a higher casualty rate compared to the 1980s, even if prices are more responsive to changes in domestic economic conditions, as the globalization of inflation makes it harder for central banks to control price pressures,*" Schnabel. said.

The casualty ratio measures how much pain central banks will have to inflict in terms of weaker growth and reduced job creation to bring inflation back under control.

"*Both the likelihood and the cost of current high inflation becoming entrenched in expectations are* *uncomfortably high. In this environment, central banks need to act forcefully. They need to lean with determination against the risk of people starting to doubt the long-term stability of our fiat currencies.*"

Schnabel called for *"strong determination to bring inflation back to target quickly. If a central bank underestimates the persistence of inflation – as most of us have done over the past year and a half – and if it slowly adapts its policies as a result, the costs could be significant.*"

Schnabel, is one of the most influential figures in central bank policy as head of market operations. She warned that "*unprecedented strains on pipelines, tight labor markets and continued caps on aggregate supply threaten to fuel an inflationary process that is becoming harder to control the more hesitant we are.*"

Inflationary expectations are rising among the public and professional forecasters, many of whom expect prices to continue to rise above the ECB's 2% target for several years, Schnabel said, adding that the institution's credibility is at stake.

She acknowledged there was a risk of recession, but told her fellow policy makers that "*even if we enter a recession, we have basically little choice than to continue our normalization path*" - chiming with Powell's remarks the day before that "*reducing inflation is likely to require a sustained period of below-trend growth*."

Central Banks should also keep going even if growth suffers and people start to lose their jobs. "*Even if we enter a recession, we have basically little choice but to continue our policy path*," Schnabel said. "*If there were a de-anchoring of inflation expectations, the effect on the economy would be even worse.*"

"*Regaining and preserving trust requires us to bring inflation back to target quickly,*" Schnabel said. "*The longer inflation stays high, the greater the risk that the public will lose confidence in our determination and ability to preserve purchasing power."*

Following remarks by Villeroy and Schnabel, who both highlighted the need for a determined response at the ECB's upcoming meeting and beyond, Olli Rehn who heads the Finnish central bank, told Bloomberg Television on the same day, that ECB must act forcefully to contain record inflation and keep expectations for future price growth anchored as the weak euro exacerbates a surge in energy costs.

"*The reality is that we have excessively high inflation globally, also in Europe - that's why it's action time,*" Rehn said. "*The next step will be a significant move in September, depending on the incoming data and the inflation outlook.*"

"*Monetary policy is now facing the dual dilemma of on the one hand maintaining inflation expectations anchored, and on the other hand avoiding that we would push the economy into a recession,*" Rehn said. "*We have a severe energy crisis in Europe" and "it's quite likely that the euro-zone economy is slowing down. It's slowing down as we speak*."

With interest rates set to continue to rise, a debate is about to pick up about when the ECB should consider reducing its bond holdings after years of asset purchases - a process commonly referred to as quantitative tightening (QT).

"*It's premature to start publicly talking about QT in the European context. We may each other think about that, but the time will be ripe later to discuss decisions concerning how to continue normalization of monetary policy as it regard asset purchases.*"

A somewhat more urgent debate for the ECB is how to remunerate trillions of euros of excess reserves, now that interest rates are no longer negative. "*That's something that - in my view - we should discuss,*" Rehn said. "*We have some preparation discussions going on in this regard, but we will see to that in the forthcoming meetings - in plural.*"

But the debate within Governing Council continued unabated. ECB's chief economist Philip Lane, speaking at a panel of the Annual Meeting 2022 of the Central Bank Research Association (CEBRA) in Barcelona on August 29, 2022, he insisted that the ECB should raise interest rates at a "*steady pace*" until the end of its hiking cycle, partly to maintain room to correct the policy path if circumstances change.

Lane, one of the Governing Council's most-dovish members seems to put the break after some of his colleagues in Jackson Hole floated a 75bps hike at September 8 meeting.

"*A steady pace - that is neither too slow nor too fast - in closing the gap to the terminal rate is important for several reasons,*" Lane said, without expressing a preference for the Sept. 8 policy decision. "*The appropriate size of the individual increments will be larger the wider the gap to the terminal rate and the more skewed the risks to the inflation target*", Lane said.

The term "terminal" rate is an open question and it refers to high point of the current hiking cycle. Policymakers have said the ECB should get to the neutral rate, which neither stimulates nor cools the economy, somewhere around the turn of the year. This rate is estimated at around 1.5% to 2%, suggesting a hike at every remaining policy meeting this year.

Lane's comments feed into a debate over the best way forward after the ECB raised rates for the first time in more than a decade last July.

The Irish official said "*While upside risks to inflation are currently more intense than downside risks, Multi-step adjustment path towards the terminal rate also makes it easier to undertake mid-course corrections if circumstances change....f the incoming data call for a downward shift in the terminal rate, this would be easier to handle under a step-by step approach... A multi-step adjustment path towards the terminal rate also makes it easier to undertake mid-course corrections if circumstances change.*"

Lane also said that the deteriorating economic outlook made it more difficult to plot the appropriate course, recognizing the fact that the Governing Council has a difficult job to do navigating the eurozone economy out of inflation and approaching recession.

Supporting Lane's extra dovish view, Yannis Stournaras who heads the Bank of Greece in an interview with Econostream during a conference of European Forum at Alpbach in Austria on August 30, he acknowledged the clear need for further euro area monetary policy normalization, but argued strongly against any approach not characterized by gradualism and thus rejected rate moves of unusually large magnitude.

Stournaras accepted the view that the situation warranted further increases in official borrowing costs until reaching the neutral rate, whilst urging policymakers to keep in mind that gathering economic storm clouds augured at least a slowdown if not perhaps a full-blown recession.

'*This is why I believe in normalizing policy rates only gradually, because in my view it is misguided to hike to a very high level at the risk of then having to backtrack and start cutting rates.. A gradual approach is the only appropriate one,*" he said.

That overly aggressive hiking could quickly backfire, costing the ECB credibility and creating avoidable economic harm, was far from the only argument in favor of going strictly 'step by step', he said. Extremely elevated uncertainty and the exclusively supply-side origin of current European inflation also warranted 'being careful and prudent', he said.

Stournaras agreed that the TPI approved by the Governing Council at its July meeting was *'a powerful instrument'* that mitigated earlier concerns about an adverse market reaction to monetary tightening. However, he made clear that the new tool did not reconcile him to a step of 75 basis points.

'*I don't want to pre-empt our discussion in the Governing Council, but I prefer to stay gradual and flexible',* he said when asked about a hike of that magnitude. *'After all, gradualism, optionality, flexibility are the three principles that guide our monetary policy changes.'*

Asked outright what could induce him to change his mind about the appropriateness of 75bps, Stournaras said that wage growth was for him the key medium-term indicator. *'If wage growth were to become economically unwarranted, then I would say, "Yes, okay, we need to act aggressively"*, he said.

Agreeing with Rehn, Stournaras noted that while a change to the tiering system applied to the remuneration of reserves was also coming eventually, this was '*not a point of urgency at this point*', and could be delayed a little while yet. It was also still soon, he said, for a discussion about how to reduce the ECB's balance sheet, swollen by years of massive asset purchases.

Monetary tightening, of which there had been a lot since last December, he said. Asked whether he would still describe financing conditions as very accommodative, he replied, '*They've become tighter. They're accommodative but they've become tighter.*'

Still, he agreed that the euro area remained far removed from a financially restrictive environment. It was essential that this remain the case for now, he urged, also given that the only durable solution to the present energy-driven inflation was '*huge investment in renewables*''.

'If we make financial conditions difficult, this investment will not take place', he said. 'All these arguments make me believe that we should err on the side of caution rather than on the side of speed in the monetary policy adjustment.'

Even if the ECB started preliminary discussion of the subject of QT, which he did not rule out as soon as next week, *'I don't think we're anywhere close to actual action on that front'*, he said.

The dovish statements continued on September 1. Mário Centeno Governor of Banco de Portugal, urged European policymakers to avoid taking rushed pro-cyclical measures in response to high inflation.

"*We should be worried and act - as consumers and policymakers - about the inflation numbers we've seen. But we also have to remember the need to think longer-term in these processes... and we should be guided by patience... Pro-cyclical policies are all we should avoid*", he said, adding there is a need for greater coordination of national policies, but also at the European level.

Centeno said that "*the forecast of all institutions, including the Bank of Portugal, is that inflation will decelerate and will gradually return - probably more gradually than we wanted - to levels consistent with the ECB's objectives.*"

See you in September.... Preparing for ECB Meeting on September 8

With the Federal Reserve taking the initiative at the Jackson Hole symposium, the ECB appeared poised for a highly dynamic move at the September 8 meeting.

This would mean that not only the ECB would repeat, at the very least, the 50bps hike rate of July, but it would likely to proceed to an increase of 75bps. However, the statements of the ECB's chief economist, Philip Lane, shown moderate stance, demonstrating that the final decision at September 8 meeting would not just easy, but there would be once again a fierce confrontation.

The hawkish statements by ECB members caused turmoil in the bond markets, with the Greek 10-year yield exceeding the barrier of 4% and the spread to widen to 259bps. The August consumer price data on Eurozone, released on August 30 hit a record 9.1% up from 8.9% in July, raising a new alarm.

In Italy, the 10-year yield was found close to 3.87% with an increase of about 20bps and with the spread against the German at 236bps, a month high. Markets expect to see the spread at 300bps, if the ECB proceeds with an aggressive increase of 75bps. The more aggressive the interest rate increases, the higher the chance ECB to use the new tool, the TPI, for the bonds of countries that would confront a dangerous high cost of borrowing.

Even the German 2-yr bond, which is considered the most sensitive to changes in interest rates, jumped 20bps and soared to 1.17%, at the highest level since mid-June, while the 10-year Bund yield rose 15bps to 1.55%, also at a two-month high.

In the FX markets, euro weakening, has underlined the worsening outlook for inflation as energy is priced primarily in dollars. The euro has lost more than 12% of its value since January 2022, while bets of investors that it would lose value have reached the highest level since the pandemic hit Europe about two years ago, as the risk of recession rises.

With headline inflation at a new record high and continued passing through of high energy prices to consumers and corporates in the coming months, many ECB officials have sounded the alarm bells. At Jackson Hole, Isabel Schnabel gave a very hawkish speech, calling for aggressive hiking of interest rates in order to prevent inflation expectations from de-anchoring or a price-wage spiral from kicking in. '*Caution*', Schnabel said, was the wrong medicine to deal with the current supply shocks. Instead, she called for a '*forceful*' response even at the risk of lower growth and higher unemployment. Other ECB members followed, calling for a 75bps rate hike. Some explicitly argued to bring the policy rate above its neutral level. Only ECB chief economist Philip Lane took a moderate stance, calling for a gradual approach.

The debate about 50 or 75 bps rate hike in order to bring inflation down in the eurozone would be difficult to resolve within the ECB Governing Council. The economy is far from overheating and would almost inevitably fall into a winter recession, even without further rate hikes. In such a situation, gradual normalization of monetary policy makes sense, trying to break a supply-side inflation with steady rate hikes. Instead, ECB in order to demonstrate its determination to bring down inflation would easily be interpreted as panic.

The newest ECB staff projections, would also be released on September 8. Two things would be of importance: how negative or positive would the ECB be on the eurozone's growth outlook for the winter and what would be the inflation projections for 2024. In June, the ECB expected GDP growth to come in at 2.1%. As regards 2024 inflation, the June projections had annual inflation at 2.1%. The more downward revisions we will get on both projections, the less likely the suggested aggressive rate hikes will be.

Another issue for September 8 ECB meeting, refers to the debate on QT which would also due to start in 2022. The minutes of the July meeting already featured an oblique reference to balance sheet forward guidance. In addition to the reduction the repayment of TLTRO funds would cause, the ECB has committed to keeping the size of its PEPP bond portfolio constant until at least the end of 2024. Like its rate hike signals in 2022, this guidance was at risk.

An earlier reduction in the size of its APP portfolio was possible. With the exact wording being "*an extended period of time past the date when it starts raising the key interest rates*", the clock is ticking. Even if it only occurs in 2024, balance sheet reduction would be a sea change in ECB policy. The ECB is still growing its peripheral bond pile thanks to its PEPP reinvestment policy, and a majority of economists expected it to activate its TPI in 2022 or 2023, which would result in more buying.

A reduction of its almost €5trn bond portfolio would add to the policy tightening delivered through rate hikes. The problem in the eurozone is that a shrinking bond portfolio would deliver sharply different degrees of tightening from one member state to the next. This is the very reason why the ECB would a net buyer of Italian bonds and a net seller of German ones. An overall reduction of its bonds portfolio would be possible but likely at differentiated speeds. The ECB should tread carefully if it wants to avoid yet more widening in sovereign spreads.

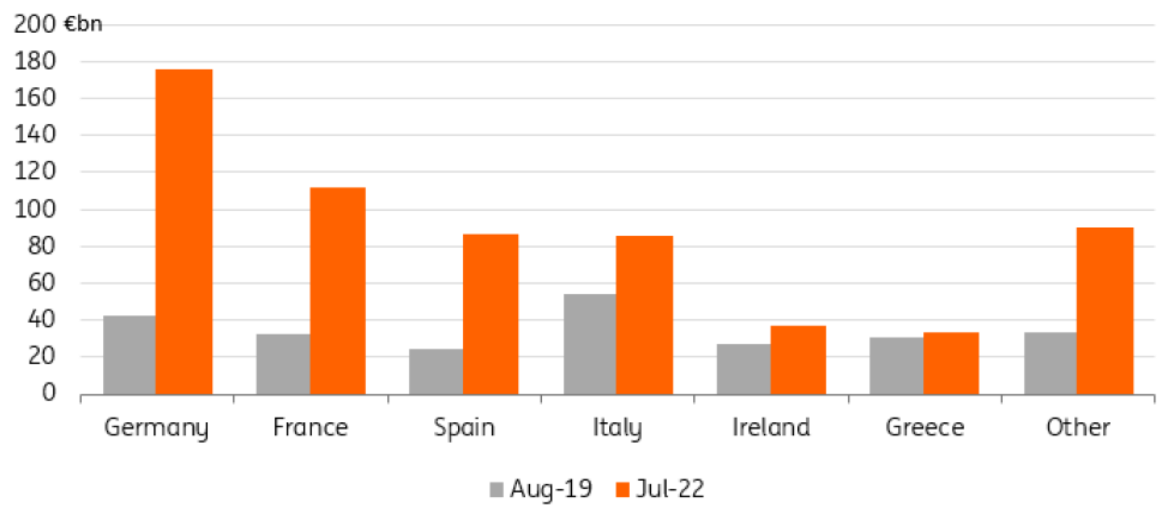
Some policymakers have even suggested that the ECB is beginning to shrink its €8.76tn balance sheet in summer 2022, by reducing the amount of money it reinvests from maturing bonds in its €5tn securities portfolio. But it seems unlikely that this would be decided before October or December.

But the ECB's sense of urgency in tackling inflation had overtaken concerns about the damage an aggressive rate hike would do to the euro-zone economy ahead of the monetary meeting. Several ECB Governing Council members said they were focusing more on current record levels of inflation to guide policy, moving away from an earlier, more moderate approach that depended mainly on where they expected prices to be two years from now.

Jürgen Stark, an aggressive German economist and former ECB director, asked in a letter to the Frankfurter Allgemeine Zeitung why Schnabel gave Jackson Hole's main speech and not Lagarde or Lane, suggesting there could be a "*redistribution of responsibilities*" in the bank's board.

Indeed, Lagarde didn't attend the Federal Reserve symposium at Jackson Hole, Wyoming, contributing to a six-week vacuum of specific monetary remarks from her. She did provide some hint, in a Madame Figaro interview on Aug. 25, that, "*We can no longer rely exclusively on the projections provided by our models - they have repeatedly had to be revised upwards over these past two years.*" That's hardly a clear expression of strategy. But the markets have been pushing the ECB into a corner in the meantime. The ECB spokesman said Lagarde was in "*constant contact*" with the 11 of its councilors who were in Jackson Hole and pointed out that her president had not always been present.

Ballooning government central bank deposits are a problem as their remuneration is capped at 0%



Source: Refinitiv, ING

In addition to hike rates, the 25 members of the ECB's Governing Council were expected to discuss ways to drive up bank funding costs. Policymakers want to prevent commercial banks from earning billions of euros in interest on about €4.5tn euros in deposits with the central bank.

The ECB has provided €2.2tn in subsidized loans at rates as low as -1% during the pandemic to encourage banks to continue lending, but with interest rates rising, it could bring more than €20bn for the private sector, which is politically unpalatable and contradicts efforts to tackle inflation.

Government cash deposits held at ECB were remunerated at the ECB's deposit facility rate, but importantly that remuneration was capped at 0%. Germany’s and Austria’s debt agencies no longer want to lend securities against cash through repo lending. Such change had been highlighted by reports that Germany’s and Austria’s debt agencies were planning to change their repo rules. They no longer would want to lend out their securities against cash, but only against other collateral. This would reduce repo lending or boost demand for safe bonds, all exacerbating the existing collateral shortage which had been created by the ECB's vast buying programs.

Eurozone government deposits at their respective central banks amount to around €600bn in August 2022, fluctuating between €600 to €700bn over the past year. Pre-pandemic they were in the region of €200 to €300bn, already up from around €50 to €150bn before negative interest rates and then QE were introduced. But it was the pandemic that has led governments to build up vast cash buffers. Remuneration at the negative depo rate did not matter, it was actually better than deep negative market rates.

Another element behind the shift within the Governing Council was that, after a year of underestimating inflation, many ECB members were losing faith in the models they relied on to predict where prices are headed. Because the impact of monetary policy decisions takes at least 18 months to affect the economy, those models used to be the reference point for decision-making.

On the TPI front, disruptive market situations could come up from varied sources from ECB's 75bps rate hike. First, aggressive ECB rate of interest rises would harm financial progress prospects in nations with extraordinarily excessive ranges of public debt, akin to Greece and Italy.

Second, it might very well be a political rupture, such because the anticipated victory in Italy’s September 25 elections for a right-wing bloc that’s signaling it might attempt to rewrite the phrases of entry to the EU Recovery Fund.

Third, the disruption would orient traders to seek high-risk, high-return alternatives in taking positions that achieve from widening yield spreads between totally different euro space authorities bonds. The eurozone, which lacks a full fiscal, banking and capital markets union, these alternatives exist simply as they did when Greece and different nations fell into bother greater than a decade in the past.

Just before ECB meeting on September 8, doves had mounted a last minute, and coordinated, push to a more gradual approach to policy normalization. Mário Centeno (Governor of Banco de Portugal), Yannis Stournaras, and to a lesser extent Martins Kazaks and Edward Scicluna (Governor of the Central Bank of Malta), in articles published in “The EUROFI Views Magazine” September 2022 issue for the Eurofi conference held in Prague (7, 8, 9 September 2022).

They seemed to push back against the barrage of hawkish comments that have colored ECB communications in August. The disagreement on the face of it does not seem insurmountable, but they highlighted that whatever policy decision would taken on September 8, a 75bps hike was not yet set firm. It’s significant to mention, that the hawkish minority was led by both German representatives (Schnabel, Nagel) on the Governing Council. This means it had teeth.

The main takeaway from the four doves was that they did highlight the policy trade-off between fighting inflation and safeguarding growth, something the hawks, and other central banks such as the Fed, had been at pains to dismiss.

The EUROFI Views Magazine, September 2022 Issue

Martins Kazaks
• If underlying price pressures strengthen further, however, officials could maintain their swift pace of raising borrowing costs
• The persistence of core inflation and its impact on inflation expectations along with wage dynamics will be key to determine whether a steady pace of interest-rate hikes should be maintained,
• The risks of a broad-based and protracted recession with a reductive impact on inflation would point towards a slower pace of rate hikes or a pause.

Mário Centeno
• A clear tightening or even too fast a normalization could unwarrantedly destabilize the transmission mechanism and the real economy, making it harder to achieve the inflation target beyond the short run
• In face of supply shocks, monetary policy ought to be patient; more so given its unprecedented nature
• Even with large shocks and hence unusually high levels of inflation, it is likely that this policy of slow normalization is consistent with inflation converging to target
• We cannot take for granted that inflation expectations will remain anchored under every circumstance; that is why we should be ready for a strong response if inflation expectations destabilize

Yannis Stournaras
• I believe that inflation has reached close to its peak and will begin a steady deceleration. My view is mainly based on an assumed moderation in energy and commodity prices and a gradual easing of the supply bottlenecks
• In the forthcoming meetings, a further progressive normalization of policy rates will be appropriate, in a meeting-by-meeting approach. Both the timing and the pace of moves will depend on the evolution of our assessment with respect to inflation risks, which may reflect supply disruptions, but also contractionary pressures on prices
• Any resurgent fragmentation risks that would undermine the smooth transmission of the normalization of our monetary policy across all member-states of the euro area must be forcefully confronted

Edward Scicluna
• The Transmission Protection Instrument, or TPI, has been conceived to ensure that the monetary policy impulse is transmitted evenly across the union, thus preventing the ongoing normalization from falling disproportionally on households and firms domiciled in more vulnerable jurisdictions
• While there are clear monetary policy justifications for this instrument, drawing the line between warranted and unwarranted interventions represents a major challenge

Ultimately ECB forward guidance, for it hasn't abandoned the idea of steering market expectations despite what it says, should be taken with a pinch of salt by markets. In addition to a wide range of opinions within the Governing Council, the range of possible economic outcomes into this winter should in turn convince markets that it would very difficult to predict ECB policy even a few meetings into the future.

In that gentle, it might be smart for the ECB, if it raises rates by 75bps, to clarify that is an uncommon front-loading step aimed toward reducing the extent at which it lastly stops rising interest rates, presumably in 2023.

The presidency of Christine Lagarde looked increasingly rudderless as the hawks on the Governing Council were taking back control following eight years of negative rates. A clearly divided council was not going to calm markets. Lagarde was appointed for her political acumen rather than her economic chops, but if the ECB decided on a 75bps - instead of repeating a half percentage point - it would suggest she's no longer really in control.

Euro money-market futures don't believe dovishness will prevail. They've almost fully priced in what would be the largest hike in the euro's operational history: from zero to 0.75%, as well as further hikes up to 2% by the first months of 2023. This may seem unrealistic with faltering economic growth, but traders needed to hedge for unexpected rate exposure.

Last but not least, on the statistical macro data front, eurozone unemployment was released on September 1. It fell from 6.7% to 6.6% in July, continuing the steady trend of declining unemployment. The rate is currently well below the natural rate of unemployment, which suggested upward pressure on wages.

There are few signs so far that a wage-price spiral in the eurozone would continue. The ECB tracker of negotiated wage growth in the eurozone showed that it slowed to 2.14% in the second quarter, from 2.84% in the first quarter.

Trade data released on September 2, added to the long list of growth concerns for the German economy in the 2H2022. German exports disappointed at the start of the 3Q2022 and dropped by 2.1% MoM in July. Imports also decreased, by 1.5% MoM, lowering the trade surplus to €5.4bn, from €6.2bn in June. Exports to Russia as a result of the sanctions almost came to a standstill and fell by another 15% MoM. Lower energy imports from Russia were the reason for German imports from Russia to drop by more than 17% MoM.

Trade is no longer a growth driver but has become a drag on German growth. Since the 2Q2021, the growth contribution of net exports has actually been negative. Global supply chain frictions, geopolitical risks and rising production costs are the obvious drivers behind this new trend.

On September 5, eurozone retail sales were released. They increased by 0.3% in July, which is small enough for this uptick to be in line with the downward trend seen in recent months. Food and fuel caused the small increase in July as all other items saw a decline of -0.4% in terms of sales volumes. A strong increase in Germany and the Netherlands masked declines in the other large eurozone markets.

The outlook remained rather bleak for the rest of 2022 as real incomes would go through an unprecedented squeeze due to high inflation and lagging wages. For the ECB doves it was a clear evidence that the economy is moving into contraction territory.

Monthly German industrial orders have been dropping since February 2022 and the September 6 release was, unfortunately, no exception. In July, industrial orders dropped by 1.1% MoM, from -0.3% MoM in June. On the year, orders were down by almost 14%. Domestic new orders as well as orders from other eurozone countries were down significantly.

Shrinking order books add to current recession fears. With surging energy prices and fading new orders, the outlook for the German industry is anything but rosy.

On September 7, according to the German statistical office release, in July 2022, industrial production in real terms was down by 0.3% on the previous month on a price, seasonally and calendar adjusted basis, from an upwardly revised 0.8% MoM in June. On the year, industrial production was down by 1.1%.

For Germany's industrial backbone, small and medium-sized enterprises, higher energy prices look like a ticking time bomb. With ongoing pressure on consumers' disposable incomes, companies' pricing power is fading. German government third relief package presented on September 4 provided only very limited support for this segment of the economy. Judging from the first macro data for the 3Q2022, the German economy was sliding into recession.

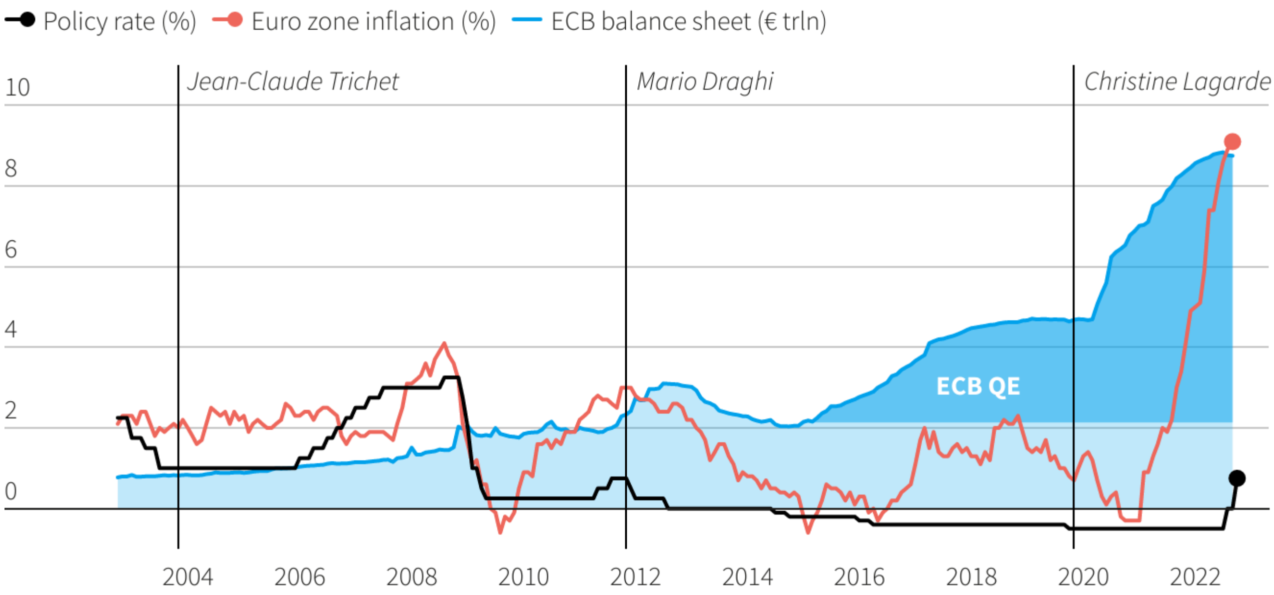
ECB September 8 Meeting Decisions

In a unanimous decision, which added a hawkish twist, the ECB Governing Council raised its key policy rate from 0% to 0.75%, marking the largest rate increase in its history and the return to positive territory after 8 years with a negative deposit facility rate. Concerns about surging inflation and a de-anchoring of expectations outweighed concerns about a growth slowdown this winter.

The ECB raised the three key interest rates by 75bps. The new deposit facility rate (i.e. the interest rate banks receive for depositing money with the ECB overnight - DFR) is 0.75%, the interest rate on the main refinancing operations (i.e. the cost at which banks can borrow from the ECB for a period of one week - MROs) is 1.25%, and the rate on the marginal lending facility (i.e. the cost for banks to borrow overnight - MLF) is 1.50%.

German bonds sold off after the ECB meeting, with the yield on 2-year debt, which is sensitive to changes in interest rate expectations, rising 28bps to 1.37% - its highest level in 11 years. The 10-year Bund yield, seen as a proxy for borrowing costs across the eurozone, rose 17bps to 1.74%. Italian bond prices also fell, with the 10-year yield climbing 22 bps to 4.09%, according to Tradeweb data.

ECB hikes policy rate by record 75bps



Source: Refinitiv Datastream | Reuters, Sept. 8, 2022 | Vincent Flasseur

The ECB specifically announced that it will continue to hike "*rates further to dampen demand and guard against the risk of a persistent upward shift in inflation expectations*".

The decision in favor of the larger step sent a signal of determination to markets that the ECB is serious about regaining its inflation-fighting credentials and that is it willing to accept costs in terms of lower growth to ensure price stability. The decision showed that Lane's influence in ECB decisions has been significantly diminished.

The ECB has given up on inflation targeting and forecasting and has joined the group of central banks focusing on bringing down actual inflation. It's not so much a new strategy based on conviction but rather a strategy based on missing alternatives.

The reason behind the 75bps move was simple: uncomfortably high inflation paired with a loose policy stance, leading to a need to move quickly to neutral. When asked about both neutral and terminal rate, the ECB's President did not provide for a clear estimate, however announced that the ECB is still far away from a rate that would allow inflation to converge to the 2% inflation target. Lagarde made convincing comments, regarding the need to front-load a tighter policy stance.

The 75bps increase was a belated recognition that the ECB was too late and is now forced to play catch-up after being caught out by the breadth of price increases beyond energy since the end of 2021. Raising sooner and more aggressively would not have stopped the upswing in services prices because of the strong tourist season. By the same token, an earlier rate increase would not have stopped the spillover of energy and gas inflation to other goods.

The broad support for the ECB's hawkish turn was later confirmed by press reports. Chief Economist Lane's presentation to the council reportedly struck a decidedly more hawkish tone than his latest public speech, which was then widely viewed as an attempt to counterbalance the prior hawkish barrage.

The rate hike would not determine whether or not the eurozone economy slides into recession and would also not make the recession more or less severe. Any recession in the eurozone in the winter would be driven by energy prices and not by interest rates.

During the press conference, Lagarde stated that the anticipation of the next steps by the ECB as expressed in market pricing was "*not perfectly accurate, but not a bad market assumption in current conditions*". While this is clearly a conditional statement, ECB would continue towards large hikes, particularly in October and December. The next flash CPI release is due on 30 September and will be the signpost for what happens at the next meeting on 27 October.

Lagarde got entangled in a discussion on whether there would be two to five further hikes, seemingly suggesting that rates could peak early next year. In contrast, she deflected all efforts to discuss where the neutral or terminal rate could be, instead preferring to stress that rates are too low and that further hikes would be needed, decisions that would be taken meeting-by-meeting, depending on the data.

Regarding QT, would reportedly also be part of the discussion at the next non-policy setting meeting in early October 5. The ECB had deemed any adjustments to its reinvestment policy of APP and PEPP as premature, and would continue to fully reinvest principal payments from maturing securities for as long as necessary to maintain ample liquidity, with PEPP re-investments ending at the earliest at the end of 2024.

According a Financial Time report on September 10, the ECB would probably decide by the end of 2022 to reduce the number of maturing bonds it replaces in a portfolio of mostly government bonds that it didn't expand until July 2022. The proposed shift, which causes a central bank's balance sheet to contract, could take effect in the first quarter of 2023.

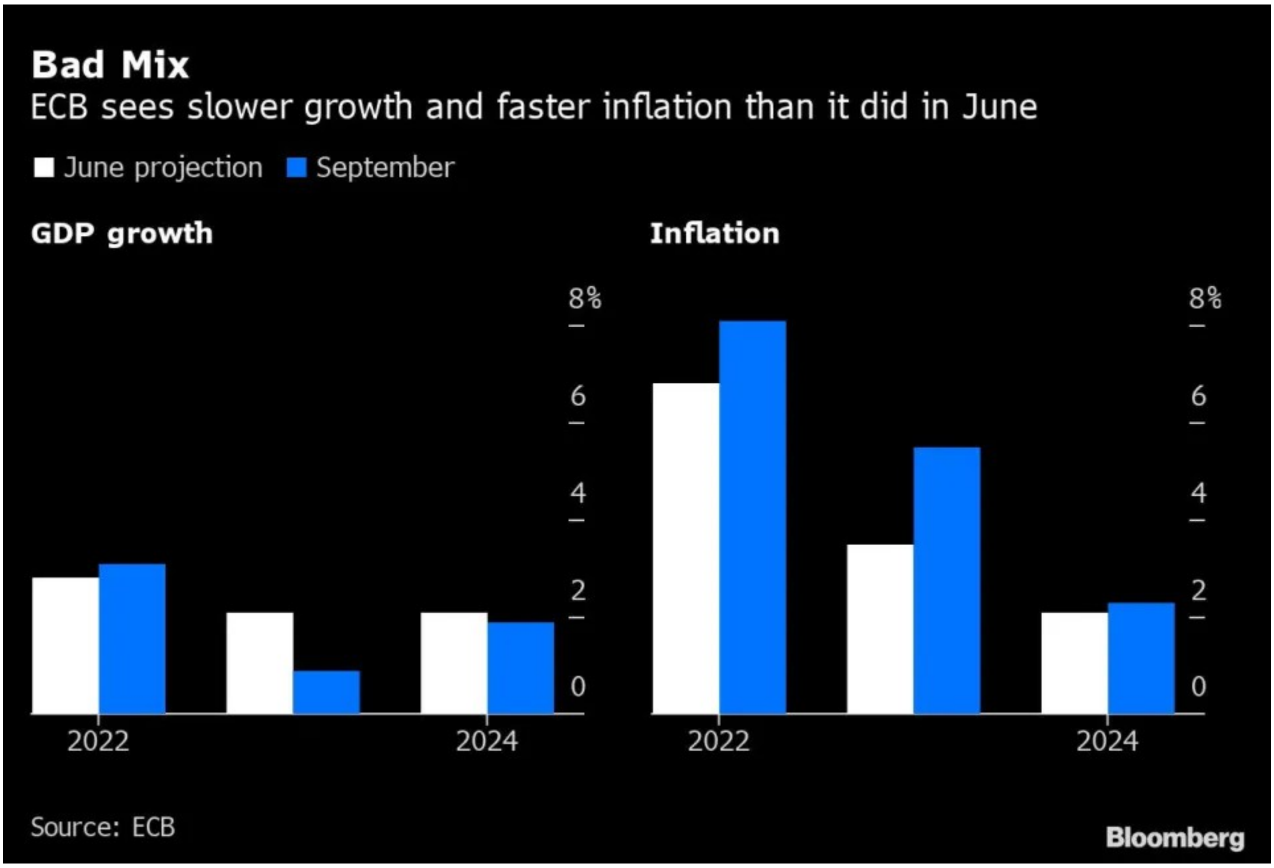
The discussion on the ECB's balance sheet contraction would start on October 5 at the Governing Council meeting in Cyprus, when it would not take any monetary policy decisions. An announcement on the matter is unlikely until later in the year.

Euro zone bond yields jump after FT story on ECB balance sheet reduction. Italy's 10-year bond yield was last up almost 9 basis points on the day at 4.03%, while Germany's 10-year Bund yield was up 1bps at around 1.71% after falling 5 bps earlier in the session.

The lack of progress on QT and a still deteriorating inflation outlook would force the ECB to continue hiking to above neutral in 2023, even in the face of weakening growth. Market analysts expectations run for two more 50bps hikes in 2023, with an unchanged three 25bps hikes in 2023.

The President has re-confirmed during the press conference that the ECB currently sees the policy rate as the most "*appropriate, efficient and proportionate instrument*" and would evaluate the reinvestment policy of its APPs further down the line. No further information had been provided on the new TPI, however the President has reassured that the ECB is ready to use the tool, should the conditions warrant it.

In its updated staff macroeconomic projections, the ECB revised markedly higher the path for inflation, while maintaining a fairly benign view on GDP growth. Inflation expectations are running high, with few signs that inflation is slowing down in the near term and the 2024 headline estimate revised up to 2.3% in the ECB's projections, as well as a significantly more benign assessment of the growth outlook than our own, as the ECB still sees relatively robust growth of 0.9% next year and an above potential 1.9% in 2024.



The ECB not only sees no recession in its base case, but also assumes limited lasting damage from the energy crisis. It also presented a downside scenario with its projections, based on the assumption of a full Russian gas and seaborne oil cut off and no diversification of supply, which would lead to a recession of -0.9% in 2023.

While no changes have been announced on excess liquidity remuneration policy, the ceiling on government deposits has been temporarily removed. It has temporarily removed the ceiling of 0% for remuneration of government deposits, which will now remain at Deposit Facility Rate (DFR) or Euro Short-Term Rate (€STR), whichever is lower, until 30 April 2023. Until then government debt agencies have time to think of alternatives for their roughly €500bn in central bank deposits.

Combined with 75bps rate hike, if the ECB left the remuneration unchanged, government deposits would have probably been taken out of their respective national central banks, and placed into money markets, in search of a better yield. Such inflow of liquidity would further augment the scarcity of high quality collateral, which has been affected by years of ECB asset purchases. In general, the ECB does not want to retain particularly high levels of government deposits, explaining the temporary nature of the measure.

The supply of German debt, the euro area's safe asset, has been a particular concern for investors. An even deeper shortage could have depressed overnight rates, hindering the transmission of ECB rate hikes into the financial system and the broader economy at a time of record-high inflation.

On the positive side, on September 9 Germany's finance agency said it would not need to invest its central bank cash deposits in new ways for the time being. Austria's Treasury said on the same day that although a change in its cash strategy was not imminent, it aimed to decide and apply a new one "*well before*" April 2023. It was studying plans including lending securities in return for other securities, rather than cash.

More action would be needed to sort out the collateral scarcity problem affecting the transmission mechanism, either by giving non-banks access to the deposit facility, introducing a reverse repo facility or by issuing short-term debt securities.

Post ECB September 8, Government Council members statements

On September 9, Bank of France Governor Francois Villeroy de Galhau said the the ECB must be "*orderly and determined*" with rate increases after hiking by a record 75bps on September 8. The out-sized rate increase doesn't mean the ECB has developed a "*jumbo habit.*" "*That's what needs to be avoided by acting in an orderly, but determined way,*" Villeroy said.

Regarding the economic outlook for France, Villeroy said the Bank of France expects a "*strong slowdown*" in 2023 despite higher-than-expected output in recent months. "*If I dare say it in three verbs: 2022 resistance, 2023 slowdown, at least, and 2024 recovery,*" Villeroy said.

Peter Kazimir, in a statement on the website of Slovakia's central bank, which he heads, said the ECB's decision to raise interest rates by 75bps was necessary and correct. He called for "*resolute hikes*" to tackle "*unacceptably high*" price gains. For him eurozone inflation is "*unacceptably high.*" He saw more hikes in the near future to get inflation under control.

On the same day, Klass Knot told Dutch radio that the ECB must raise interest rates further to prevent record euro-zone inflation from spilling over into wages, reinforcing the hawkish message. The 75bos move was a "*powerful and big signal but more steps should follow,*", warning of a "*big risk of second-round effects*."

In separate remarks n Prague, Knot warned that inflation can "*eat away*" at consumption and investment capacity, and "*frustrate*" financial planning.

The aggressive tone was evident among other colleagues, too. Estonia's Madis Muller warned that delaying rate rises too much risks needing a "*much sharper brake on the economy*" later to bring prices under control.

Stournaras speaking at the Prague Financial Forum organized by Eurofi, according to a transcript of his remarks sent by Bank of Greece, said that the ECB hasn't reached yet the neutral interest rate, which could range between 1.5% to 2%.

Stournaras said that the bank's path to normalization "*should not be taken lightly... We may have large losses in output and we should be cautious,*" he warned. He also said fiscal policy needs to retain a stance that isn't in conflict with what monetary authorities are doing, and that it needs to support the most vulnerable. "*It needs to combine taxes on the windfall gains of certain energy producers and subsidies for the losers,*" he said.

Stournaras pointed out that inflation in Europe is mainly driven by supply shocks, such as the pandemic and the energy implications of the war in Ukraine. "*Seventy-five percent of the disruptions in consumer prices come from only one commodity -- natural gas,*" he said. On the other hand, there has been no evidence up to now of second-round inflation effects, he added.

Centeno the Portuguese central bank chief said in an interview in Prague, a day after the ECB rate hike, that the ECB must tread carefully at upcoming meetings after signaling its determination to fight record inflation with a jumbo interest-rate increase this week.

While the decision to accelerate hikes was "*very important,*" officials must "*remain predictable and acting at the margin in as small steps as possible... The worst-case scenario for a policy maker is to be seen going back and forth in decisions and going after the data,*" he said.

He described Thursday's decision as "*front-loading. It means that we're acting faster than we envisaged in June or even in July... That doesn't mean that we're moving the end point up.*"

According to Centeno, a trained labor economist, fiscal policy or excessive wage settlements shouldn't undermine those effort,. "*Wages can't increase above what the market can pay,*" he said. The ECB's decision makes "*all participants in those negotiations very much aware of the risks we may face... I really would like to urge labor-market participants not to be too exuberant.*"

Bundesbank president Joachim Nagel speaking to Deutschlandfunk during a radio interview on September 11, said that ECB would be required to continue raising interest rates if the current trend in consumer prices continues.

"*Thursday's step was a clear sign and if the inflation picture stays the same, further clear steps must follow*". He declined to comment on the size of such moves, saying the central bank is data dependent.

"*Inflation may peak at more than 10% in December.. In the course of 2023, the inflation picture is likely to weaken somewhat. The rate is likely to be at a far-too-high level of over 6%,"* he said.

Raising rates to fight inflation pressures may become more difficult if the region goes into recession, though Mr Nagel said his clear challenge is "*getting the inflation development under control again — and that is a shared belief within the ECB council, in my opinion."*

While there "*currently are some indications that the economy could stagnate or even contract in the second half of 2022 and that this trend could continue into next year, any recession may be shallow,*" according to Mr Nagel.

"*In the end, stable prices are much more important for medium-term, long-term growth, for a good outlook for the euro area.. We may need to overcome a dry spell, but for now at least it looks like this dry spell and the decline in economic output will not be severe.*"

Speaking in a separate interview on Dutch television, Frank Elderson member of the Executive Board of the ECB on the same day, said more hikes will come as "*it's very important that the* *expectations that the people have on how the inflation will develop in the medium to long term will not become un-anchored."*

"*It is vital that people and companies or actors in the economy in general maintain their trust that we as the ECB will reach our of target of 2 per cent inflation*," Mr Elderson said.

On September 13, Gediminas Simkus the Lithuanian central bank chief said that the ECB should raise interest rates by at least 50bps at its October meeting. He said that the end-point of the cycle of hikes isn't important right now.

"*Inflation trends are strong. Therefore, at least a 50 basis-point increase is needed*". Simkus didn't exclude a repeat of this month's tightening step. "*Data doesn't change that fast, so we need to respond.*"

Simkus also said: Government support is needed to ease the effect of the energy crisis but measures should be targeted. Aid shouldn't spur inflation and while the ECB is aware of the region's economic slowdown, its focus is on prices.

On September 14, did a major shift in monetary policy surface? ECB Chief Economist Philip Lane opening remarks at Money Market Contact Group meeting (MMCG) in Frankfurt am Main, seemingly endorsed the hawks' narrative in a speech that was another clue that the central bank has experienced a significant shift in its reaction function. This was no guarantee of ever-increasing interest rates, but this meant that the hawkish skew in the market reaction to future economic releases could be stronger than in the 1H2022.

He first explained the September 8, monetary policy decisions, before turning to the transmission of ECB's interest rate moves in the money market.

He mentioned ECB resorted to 75bps interest rate hike, that marks a "*major step*" in transitioning "*from the prevailing highly accommodative level of policy rates towards levels that will ensure the timely return of inflation.*" The unusually large interest-rate hike "*appropriate*," he said, while signaling that future steps are likely to get smaller. This transition would require the central bank to keep raising rates "*over the next several meetings... The appropriate size of an individual increment will be larger, the wider the gap to the terminal rate and the more skewed the risks to the inflation target,*" he stated.

On the new staff projections he pointed out that "*the most important driver of these upward revisions is the exceptional increases in the assumptions for wholesale prices for gas and electricity over the coming months. In addition, faster growth in nominal wages is also a significant contributor to higher and more persistent inflation, while exchange rate depreciation has also added to price pressures.*"

Regarding money markets, Lane's speech was also a reminder that collateral scarcity issues would remain despite the ECB offering a delay to governments in finding alternative avenues to place their liquidity. Until April 2023, they would continue to earn the euro short-term rate on their deposits at the central bank, which at least delays the time when more demand emerges for already scarce collateral. What the ECB has not addressed, however, is the initial collateral shortage, which Lane blamed in part on interest rate uncertainty and rates volatility.

Philip Lane said that the European Short Term Rate (ESTR) was "*especially important*", given it underpins gauges used to determine market expectations of future central bank policy, and that officials would also "*remain attentive to the spread between different money market rates as well as collateral scarcity concerns*".

In a more moderate dovish approach, on September 15, Luis de Guindos, Vice-President of the ECB, speech at the CIRSF (Research Centre on Regulation and Supervision of the Financial Sector) Annual International Conference 2022 "The future of the EU financial system in a new geo-economic context", he said that ECB must prioritize the fight against inflation over growth concerns and needs determined policy steps to stop high price growth from getting entrenched.

"*Monetary policy needs to be focused on price stability... Determined action is essential to keep inflation expectations anchored, which in itself contributes to delivering price stability and avoids second-round effects in inflation... We need to guard against second-round effects such as the risk of a persistent upward shift in inflation expectations,*" he said.

De Guindos used the phrase "*determined action*", repeating the adjective used by Lagarde to describe latest interest hike.

But Mario Centeno appeared to differ on the same day about the size of the next moves, pointing to some disagreement over whether last week's jumbo increase should be repeated. Centeno, however, said the central bank should take "*as small steps as possible*" in raising rates so as not to destabilize the economy.

During a Keynote intervention at the CIRSF Annual Conference he said that "*A scenario of going back and forth in the decisions would undermine the credibility of monetary policy. Monetary policy must remain predictable and acting at the margin in as small steps as possible.*"

He mentioned the fragmentation risks have undermined the transmission mechanism of monetary policy, that led to the creation of the new TPI mechanism which allows for a clearer separation between market stabilization and policy stance goals.

"*Importantly, the TPI does not dispense the adoption by Member States of sound and credible fiscal policies. The evident necessity of the TPI can be seen as a consequence of the remaining fragilities of our monetary union... It is critical to complete the banking union in all its three pillars (supervision, resolution and a common deposit insurance),*" he said.

Lagarde spoke in front of an audience of French high school students at the French central bank, in Paris on September 16. She said that the ECB "*absolutely*" wants to avoid high inflation leading to excessive upward pressure on wages, and its recent interest-rate hikes should signal its determination to meet its price target.

"*We have more supply shock than demand shock, but we have both, so we're obliged to act taking account of this complicated mix of supply and demand,*" Lagarde told the audience of students.

"*So what we have to do as the central bank is we have to be focused on our price-stability target, which we've set at 2% over the medium-term... So we have to use all the monetary policy tools available to us to reach this target.*" Lagarde emphasized price stability priority before growth.

The same day, Luis de Guindos told Expresso, a Portuguese newspaper during an interview that the eurozone's economic slowdown - or possibly recession – would not be enough to control inflation, and the ECB would have to keep raising interest rates.

"*The slowdown of the economy will reduce demand pressures, which will lower inflation... But, simultaneously, we have to act from the monetary policy standpoint to keep inflation expectations anchored and avoid second-round effects.*"

"*More hikes might come in the next few months - how many times and by how much will depend fundamentally on the data - and we underscore our full determination to make inflation converge toward our definition of price stability.*"

Guindos expressed his concerns on euro depreciation. "*Further depreciation of the euro could be detrimental to inflationary pressures. On the contrary, if the euro stopped depreciating, this could be positive and support the fight against inflation. I hope that the recent depreciation trend is reversed in the near future.*"
Guindos reiterated on September 19 that the exact number of further interest rate increases by the ECB will depend on upcoming macroeconomic data. He spoke at the annual meeting Consejos Consultivos organized by Banco Sabadell in Madrid.

"*Monetary policy always tries to act to fight inflation, that will have an effect on consumer spending and investment by companies... and further interest rates increases will depend on economic data. Inflation is the biggest pain for European population,*" he said.

Speaking at the German Central bank's Open Day in Frankfurt, on September 17, Nagel - one of the ECB's more hawkish rate setters - acknowledged the economy would slow but said he doesn't expect a severe economic downturn. "*I don't see a hard recession,*" he said. "*It doesn't look like it will be too terrible.*"

"*We're still very far away from interest rates that are at a level that is appropriate given the current state of inflation... More needs to happen, rates have to go up - by how much is still to be determined,*" he said. "*We're still a good way off*" from the neutral rate.

While saying that annual consumer-price growth may peak at 10% in December and warning that Germany would face a "*tough winter*" with the risk double-digit inflation rates, Nagel indicated he's confident that the situation would get better.

Nagel also said that the ECB's next actions will depend on data and highlighted policy makers commitment to get inflation back to the institution's 2% goal. "*We're very aware of our responsibilities and will do whatever is necessary to bring inflation down again - I can't promise miracles,*" he said. Getting there "*won't be a sprint, it may be a middle distance run, I just hope it isn't a marathon.*"

Markets have been used to Nagel's calling for rates to move a lot higher to control inflation, but also the Bundesbank sees increasing signs of recession even if worst-case scenarios can be avoided. Underscoring the ECB's new determination, he made clear that the economic slowdown by itself will not be enough to bring down inflation; monetary policy would need to do its job as well.

Chief Economist Philip Lane speaking at Cantillon Lecture in Wexford Ireland during the on the 45th DEW Annual Economic Policy Conference on September 17, said that the ECB could raise interest rates into 2023, causing pain for consumers as it tries to depress demand that is now increasingly adding to sky high inflation.

Lane had signaled several more hikes, the added nuance now being that this might even happen in the face of a mild recession. "*We do think that this is going to dampen demand, we're not going to pretend this is pain free,*" Lane told the conference. "D*emand is now a source of inflation pressure, it was not six or nine months ago in the same way it now is.*" At 0.75%, the ECB's deposit rate is still too low as it continues to stimulate the economy, so the ECB's job is not yet done, Lane added.

Lane had argued for months that the current inflation is primarily due to the shock caused by expensive energy prices. Monetary policy is largely powerless against such supply shocks so the ECB was among the last major central banks to hike rates. But price growth has now broadened out and started to seep into all aspects of life while robust consumer demand is also driving prices.

Lane added that the euro zone economy is likely to flatten over the winter months and a recession could not be ruled out given high energy prices and a shortage of natural gas. "*If we think our base case is to barely grow, a technical recession - falling into a mild recession - cannot be ruled out,*" he said separately in an interview with Irish broadcaster RTE.
Another warning shot was launched on September 19. According to ECB supervisor Andrea Enria, the eurozone banking sector has been robust ahead of a possible recession but the ECB would still be asking lenders to review capital projections given what would likely to be a difficult winter.

"*We are pushing banks to focus very much on their concentration of exposures towards sectors which are particularly dependent on energy and fragile to energy shocks*," Enria told at the Single Resolution Board Annual Conference in Brussels.

"*So, we are asking banks to review their capital projections under severe, adverse scenarios and we will engage in a dialogue with them.*"

Enria noted that firms involved in financing commercial real estate, residential real estate and consumer finance are particularly exposed to rising borrowing costs and warrant attention. He added that there has been also the issue of exposures to energy derivatives clearing, the last few months.

On September 20, Christine Lagarde spoke at Karl-Otto-Pöhl Lecture organized by Frankfurter Gesellschaft für Handel, Industrie und Wissenschaft in Frankfurt. She emphasized that the ECB may need to raise interest rates to a level that restricts economic growth in order to cool demand and combat unacceptably high inflation.

"*If there were evidence that high inflation risked de-anchoring inflation expectations, then the policy rate that is compatible with our target would lie in restrictive territory,*" she said.

She added that if the current supply shock caused by expensive energy lowered the bloc's potential, the ECB would also have to act to cool demand.

While Lagarde said medium-term expectations were "relatively" well anchored around the target, it would be "unwise" to take this for granted. She noted that consumers' inflation expectation is rising rapidly and the euro zone was also shifting from a low inflation environment to an extremely high one, both a risk to longer-term expectations.

Lagarde also warned about the dangers of high price growth triggering a wage-price spiral that would entrench inflation in a hard to break cycle. The ECB president, however, provided no clues about the October rate hike and only repeated that the ECB would decide its next moves meeting by meeting.

In tandem, Schnabel told German news website t-online in an interview on September 22 that the euro zone is facing an economic downturn but inflation is still far too high, so interest rates need to keep going up.

"*A looming downturn would have a dampening effect on inflation... However, the starting point of interest rates is very low, so it is clear that we need to continue raising rates.*"

While Schnabel did not yet consider a recession the base case for the euro zone, she warned that it may be unavoidable in Germany, the 19 country bloc's biggest economy. Schnabel did not hint which way she was leaning but merely said the ECB would do whatever is needed to get inflation under control.

The same day, Schnabel told a conference organized by financial firm Spuerkeess of Luxembourg, that eurozone inflation is set to go higher and price growth is likely to be more persistent than earlier thought, defending the ECB's plans to raise interest rates further.

"*There are reasons to believe that inflation may even go up a bit further over the short term. "Inflation may actually be more persistent than we originally thought,*" she said, adding that price growth has broadened out and there is now a large share of goods with price growth over 3%.

She played down a key inflation concern, arguing that wage growth, a condition for durable price growth, is still relatively muted. "*Wages give us some comfort that this second-round effects have not materialized yet,*" Schnabel said, adding that the risk of a wage-price spiral has to be monitored "very carefully".

While inflation is on the rise, economic growth is suffering and Schnabel said the risk of a recession was increasing. While that would normally mean a jump in the jobless rate, Schnabel said companies are struggling with labor scarcity so they may retain workers because re-hiring them later could be more costly.

Bundesbank President Joachim Nagel speaking in a lecture at the University of Lucerne, Switzerland, on September 23, reemphasized the need that ECB should keep raising interest rates and should also stop bond purchases when they have fulfilled their purpose.

Nagel backed those plans but also voiced support for rolling back some of the unconventional measures, such as replacing maturing bonds with new ones.

"*Our special measures need to be quickly resolved once they've fulfilled their purpose - that means I'm clearly for a reduction of our balance sheet. A phase of such high inflation that we're forced to hike rates just doesn't mesh with a huge portfolio from asset purchase programs.*"

While the ECB has not been buying new debt, it has continued to reinvest the billions of euros maturing each month in its €5tn euros worth of bond holdings. Re-investments in a €3.3tn APP are due to run indefinitely but a growing number of policymakers want to cut these holdings and a debate on letting some papers expire is expected to start next month.

Nagel did not take a view on the size of an October rate hike but said rates must rise even if this dampens growth. *"The fight against inflation comes with burdens... It is likely to dampen growth temporarily... But doing nothing and letting things run their course is not an option... Inflation eats away at wealth. It deprives economic participation because it hits the weakest hardest. It therefore contradicts the claim of 'prosperity for all,*" he said.

Nagel also said that it's too early to discuss where the so-called neutral rate - the level at which monetary policy neither constricts nor stimulates.

Finally, Nagel addressed the possible use of the ECB's recently unveiled crisis tool, the TPI. Any decision to activate it must be based on a "*comprehensive assessment*" of market and transmission indicators so that any disruption of policy transmission is sufficiently documented, he said, having in mind the upcoming Italian elections on September 25.

On September 26, a plethora of ECB speakers made public statements.

At first, ECB Vice President Luis de Guindos told the conference organised by Asociación Española de Directivos (AED) in Madrid that eurozone inflation is becoming increasingly broad while growth is weakening as the bloc struggles with the fallout from Russia's war in Ukraine.

"*We are seeing that in the third and fourth quarters there is a significant slowdown and we may find ourselves with growth rates close to zero,*" de Guindos said.

De Guindos did not give any clue what magnitude any next increase in interest rates would look like but added that future moves would be "*data-dependen*t", saying that inflation pressures had increased recently.

In addition, he mentioned that banks in the eurozone will have to raise provisions to cope with the consequences of the economic slowdown due to the fallout from Russia's war in Ukraine.

"*The economic slowdown will lead to a potential increase in insolvencies (...) we are already trying to get the banks to bring forward their plans because it is going to have an impact without a doubt. Let's not be blinded by the short term effect, banks will have to increase provisions,*" he added, recognizing a short-term boost for banks from higher interest rates.

Pablo Hernandez de Cos, who heads the Bank of Spain, during his speech at the La Caixa Economy and Society Foundation Chair said that the ECB will remain "*extremely vigilant*" of expectations for consumer prices to ensure they don't surpass its medium-term goal

"We'll also have to watch out for a possible de-anchoring of medium- and long-term inflation expectations above 2%. In the coming months, we'll remain extremely vigilant of these indicators."

De Cos, has been part of a chorus of ECB officials that agree more rate hikes are needed to fight record high inflation, stressing that upcoming economic and inflation data are key to decide to the pace of monetary tightening. Interest rates should reach a level that allows for the progressive convergence of inflation to the ECB target, de Cos said.

In his speech, he said monetary-policy normalization is already raising financing costs for households and business, which should help contain price pressures. He urged fis cal authorities to refrain from too much spending that could exacerbate inflationary pressures.

Gediminas Simkus, the Lithuanian central bank chief speaking to reporters in Vilnius, said that the ECB will raise borrowing costs in October by at least a halfpoint as inflation pressures worsen.

"*Based on data I see now, the inflationary trends are intensifying. There are a few options on the table. Other factors will also influence decision-making - including price expectations and employment"*, he said.

Speaking later to Bloomberg, Simkus said a contraction in Europe would "*have a dampening effect on inflation."* But, he added, that *"doesn't mean the Governing Council shouldn't take decisions.*"

They could include paring back the trillions of euros of bonds the ECB accumulated during recent crises. "*We shouldn't waste time in delaying talks, discussions and planing on QT,*" Simkus said. "*It's an important issue. It's one instrument in normalizing monetary policy.*"

At third, President Christine Lagarde testified at the Hearing of the Committee on Economic and Monetary Affairs of the European Parliament (EP). Lagarde repeated the ECB's most recent message that interest rates will need to rise over the next several policy meetings even as growth slows substantially.

"*We expect to raise interest rates further over the next several meetings to dampen demand and guard against the risk of a persistent upward shift in inflation expectations*," Lagarde told European Union lawmakers Monday in Brussels.

She warned that support for households and businesses by European governments has been too broad, suggesting it risks interfering with the ECB's efforts to steer price gains back toward the 2% target from almost five times that now.

"*There are more measures that are across the board than measures that are specifically tailored to the most in need.... The approach is not necessarily conducive to a well coordinated fiscal and monetary policy,*" Lagarde said.

Lagarde mentioned that salaries might still advance in light of the region's jobs market and the steep trajectory of prices. "*Wage dynamics remain contained so far. However, resilient labor markets and some catch-up to compensate for higher inflation are likely to push up wage growth.*"

There have been some worrying signs for the ECB. Hourly salaries increased 4.1% in the eurozone in the second quarter from a year ago - the strongest surge in at least a decade. The central bank's own survey of consumers in July found on average they expected inflation to be 7% in a year's time - up from 5% in February.

Trade unions have also been demanding much higher wages. IG Metall, Germany's biggest union, has demanded an annual wage rise of 8% for 3.8mn metal and electrical workers - among them many in the country's huge car industry. In Austria, unions this month demanded a 10.6% wage increase for the nation's 200,000 metal workers.

Christine Lagarde also said the ECB would consider shrinking its balance sheet only once it has completed the "*normalization*" of interest rates. That suggests that only once rates have reached the so-called neutral level will the Governing Council address what to do with the trillions of euros of debt the Eurosystem holds.

"*When we have completed our monetary policy normalization, using the most appropriate, efficient and effective tool, that are the interest rates, then we will ask ourselves: how, when, at which rhythm, at which pace, we use the other monetary tools that we have available, including quantitative tightening,*" Lagarde said. "*But that will take place in due course, in due time, once we are completing the normalization process, and exhausting the benefit of what we regard as the most appropriate tool at the moment.*"

The comments seemed to disagree with remarks by Bundesbank President Joachim Nagel the previous week that the ECB needs to start shrinking its bond portfolio built up during recent crises.

Last statement for the day, Bundesbank President Joachim Nagel speaking at the Symposium on "Payments and Securities Settlement in Europe - today and tomorrow" hosted by the Deutsche Bundesbank, said that ECB must continue to raise interest rates decisively as the risk is high that inflation will get stuck at levels above its 2% target.

"*The risk that long term expectations get de-anchored remains high,*" Nagel said in a speech. *"Further decisive action is required to bring the inflation rate down to 2% in the medium term... When expectations are de-anchored, businesses and firms lose trust in a central bank's willingness to bring inflation under control and adjust with higher wage growth, thereby perpetuating rapid price growth.*"

Mario Centeno, Portugal's central bank governor, speaking in Lisbon on September 27, said that nflation expectations are anchored to the ECB's medium-term target even though consumer price rises will be steeper and longer than originally thought.

With the bloc's annual inflation rate running at close to 10%, the ECB has lifted interest rates by a combined 125bps to 0.75% over its last two meetings. It is likely to keep on raising rates in the coming months, said Centeno.

As long as inflation peaks persist, it "*won't be possible to have the desired predictability of monetary policy. Therefore, our collective effort, at European level, must be directed to reach the peak of inflation as soon as possible,*" he said.

He warned governments against enforcing "*pro-cyclical fiscal policies*" such as packages to help families and companies to deal with inflation so that the ECB's monetary and government's fiscal policies "*do not cancel each other out*."

The chorus of officials pressing for continued big increases in borrowing costs, continued on September 28. Speaking an Atlantic Council event in Frankfurt, ECB president Christine Lagarde said that "*we will do what we have to do, which is to continue hiking interest rates in the next several meetings",* adding that the bank's "*first destination*" was to lift rates to the "*neutral rate*" that neither boosted nor restricted growth.

"*Our primary goal is not to reduce growth, our primary goal is not to put people on the dole, our primary goal is not to create a recession, our primary objective is price stability and we have to deliver on that... If we're not delivering it would hurt the economy far more than if we do deliver.*" Lagarde said inflation had been "*more persistent and of a magnitude that nobody expected*".

Other members of the ECB's rate-setting governing council also spoke out the same day.
Finnish central bank chief Olli Rehn, a moderate on the ECB council, told Reuters that " *there is a case for taking a decision on another significant rate hike, be it 75 or 50 bps or something else.. There's a stronger case for front-loading and determined action.*"

Rehn said neutral may be reached by Christmas. He echoed several of his colleagues on the 25-member Governing Council in saying October's meeting presents a choice between hiking by 50 or 75 bps, the latter being fully priced in by money markets, by the end of September.

Peter Kažimír, Slovakia's central bank governor and a more hawkish ECB council member, said: "*Seventy-five basis points is a very good candidate for [us to] maintain the pace of tightening, but it's also necessary to wait for fresh data*."

Austrian central bank chief Robert Holzmann, another hawk, also expressed his support for a 75 basis-points rise. Speaking in Brussels the same day, Holzmann said officials are ready to raise borrowing costs to levels that may hamper economic growth as they seek to tame unprecedented inflation. Elevated price gains are likely to persist for a while, he said.

Holzmann warned that fiscal aid to help households over the spike in energy costs shouldn't interfere with ECB efforts to bring inflation back to the medium-term target of 2%. He urged governments to focus support on the weakest in society and said he prefers energy-saving measures to price caps.

The Lithuanian central bank chief Gediminas Simkus speaking to Bloomberg Television on September 29, said that a move of 100bps would "*definitely*" be too much at the moment, and that 50bps is the minimum. "*75 basis points would be my choice,*" he said from Vilnius. "*I wouldn't be surprised to see even higher inflation for September for the euro area.*"

"*Timely interest-rate hikes, even if they may seem quite a mouthful at the moment, means we might end up at a lower level than if we were taking smaller steps now and forced to implement more hikes later*," he said later in a separate interview.

Simkus called on the ECB to start talks "*as soon as possible*" on reducing its balance sheet, a view echoed by his Estonian peer Madis Müller at the same event.

Speaking later in he day on CNBC, ECB chief economist Philip Lane said the central bank should avoid doing "*too much in one go*" and increase rates over several months after what he described as "sizeable moves" in the last two meetings.

Lane said the ECB "may well" have to go into restrictive territory, meaning a level of interest rates that curbs the economy. That is generally seen as a level of interest rates above 2%.

While few governors ventured to estimate where interest rate hikes could end, Spain's Pablo Hernandez de Cos said in a speech in Bilbao on the same day that Bank of Spain's models suggested a significantly lower terminal rate than markets now expect. "*On the basis of current information, the median terminal rate value across models is at 2.25%-2.50%,*" he said.

On possible QT, he said that "*quantitative tightening could potentially cause market turmoil. This could imperil the policy normalisation path at a time in which all our efforts should be focused on it.*"

De Cos said that if the ECB started to run down its balance sheet sooner than markets now expect, that would lower the terminal rate, which suggests a trade-off between rate hikes and balance sheet operations.

"Right now frontloading other debates may in my opinion have a destabilising effect that we really need to avoid," Centeno said when asked if it was time to discuss quantitative tightening. "We have a path towards normalisation of monetary policy and that's the focus right now."

In paralell, Portuguese central bank chief Mario Centeno told Bloomberg TV that the ECB should focus on interest rate policy over balance sheet operations as its deposit rate is still far from the neutral rate, the bank's intermediate goal.

By the end of September 2022, post-meeting comments by ECB officials have stayed on the hawkish side of the spectrum. The ECB's communication increasingly sounded like that of the Fed, and has had so far followed in the Fed's footsteps. Officials have admitted the possibility of a recession, and that it would neither be sufficient to bring down inflation on its own, nor deter the ECB from its tightening mission.

The conclusion in financial markets had been that the ECB is on autopilot for another couple of meetings, or however long it takes to bring rates to neutral.

Most market participants would put that figure around 2% in the deposit rate, implying at least 125bps of hikes, which probably takes us to December 2022. Of course, market pricing has been for more hikes than that, they have priced the deposit rate rising above 3% by mid-2023, reflecting the view that policy would have to be brought to restrictive territory.

Eurozone economy standing in September 2022

Stubbornly high August CPI in USA was released on September 14 and has increased fears that the Fed would need to slow demand even further to bring inflation back to its 2% target. This period recalls the early 1980s experience with Paul Volcker at the helm of the Fed. To put the inflation genie back in the bottle, Volcker took policy rates to 15% and was prepared to accept recession as collateral damage. No one in the market thought that the Fed funds policy rate was going above 10% in the near future, but inflation release did see the terminal Fed policy rate re-priced to 4.30% from 4.00%.

After re-pricing of the Fed cycle the ECB would struggle to out-hawk the Fed. That was not a surprise given the US economy went into this inflation crisis with an economy operating above capacity - unlike the negative output gap in the eurozone.

It would be interesting to see how the ECB would factor in the September 14 announced measures by the EC to cap energy prices. There was still some uncertainty on whether the EU government's efforts to freeze hikes in energy bills would have a predominantly dovish impact on central banks (as inflation would be lower) or a hawkish impact as the economic impact would be smaller and that allows more tightening.

How the measures by EU members to cap energy bills would be embedded into the ECB's policy assessment, is been a significant factor that might cause a further divergence between the doves and hawks within the Governing Council.

As a first response, Christine Lagarde speaking in Frankfurt on September 20, she mentioned that if the supply shock caused by expensive energy lowered the bloc's potential, the ECB would also have to act to cool demand.

In summary the ECB, has a single mandate for inflation. That fact may help to understand the rapidly adjusting course, first with a 50bps hike and then a 75bps hike. In terms of communication, the ECB leaned heavily into its single mandate to frame the hikes.

The next key debate on rate hikes has been whether it can stop at a so-called '*neutral*' level or whether it would still need to cool the economy even though it is heading towards recession. But the neutral rate is "*unobservable*", which is a central bank speak, for nobody really knows its exact level. There are countless estimates but it is essentially a theoretical rate and only known after the fact, potentially years later.

What is certain is that the neutral has been on a downward trend for decades, mostly because of the euro zone's weak potential growth rate, the aging of its population and low productivity improvements.

Two of ECB's policy makers in September 2022 ventured public guesses and even raised their estimates, putting the neutral well above the current 0.75% deposit rate. Francois Villeroy de Galhau has put the rate at below or close to 2% versus his previous estimate for 1% to 2%. Yannis Stournaras has lifted his estimate to "*around 1.5%, or even 2%*" from between 0.5% to 1.5%.

Market economists also tend to put it in the 1.5% to 2% range, making it one of the lowest neutral rates among major economies.

But policymakers have started talking about the need to go above the neutral and there has been a rapid upward shift in market expectations. Investors have started observing the terminal rate, or the peak of the hiking cycle at over 2.5% sometime in spring 2023 after a steady pace of hikes.

The issue is that inflation is too high and too persistent, raising the need for decisive action. Not only is headline inflation at a record high, underlying price growth is also more than twice the ECB's target and even longer-term expectations are moving above 2%.

In practical terms, a considerably higher risk of stagflation in the European context exists. More of the inflation in the euro area is from food and energy, which would not respond much to changes in employment. ECB would continue hiking until the hard data, not just surveys, clearly demonstrate the economy is in contraction. The ECB is acting true to its mandate and is more single-mindlessly focused on inflation.

Since June 2022, wholesale electricity and gas prices have been skyrocketing, and the first adverse impacts of historically high prices on industries that are highly gas and electricity intensive have appeared, with temporary output reductions or plant closures.

So far, the euro area economy has remained resilient. This was old news, but it highlighted the resilience of the euro area economy to shocks, i.e. inflation, supply chain disruptions and the Russia/Ukraine conflict. conflict. Meanwhile, households have been hit by a big inflationary shock, but the fall in real disposable income has been limited by a strong acceleration in labor compensation and government support, while thanks to past accumulated excess savings, consumers are benefiting from a full reopening of the economy.

On the statistical front, sharp drop in industrial production July industrial production was reported on September 14. It fell by 2.3%, reversing gains made in May and June. Manufacturing weakness to continue over the 2H2022 mainly due to an environment of slowing new orders and continued supply-side problems.

For the rest of 2022 and the early months of 2023, the outlook would remain relatively bleak. The energy crisis has started to result in production cuts across the eurozone for the most gas-intensive producers and other supply problems have faded but not disappeared. On top of that, demand for goods is also weakening. Businesses reported that new orders have slowed again in August, which means that inventories are rising and backlogs of work are falling. Overall, this suggests modest production expectations for the 2H2022 in manufacturing.

Headline inflation soared to a record high of 9.1% YoY in August, with core inflation rising 4.3% YoY, EU statistics office Eurostat confirmed on September 16, driven by sharply higher energy and food prices, and was likely headed towards double figures.

Consumer price inflation in the 19 countries using the euro rose 0.6%MoM and by 9.1%YoY, the highest rate since the euro was created in 1999. Energy remains the largest contributor and comes with upside risk. Eurostat said that 3.95% of the YoY change came from more expensive energy and 2.25% from food, alcohol and tobacco.

The trend in core inflation is worrying. Core inflation prices were still 5.5% higher than a year earlier, from 5.1% in July. Industrial goods were 5.1% more expensive than 12 months earlier, with services prices up 3.8%.

Moreover, fears of more pipeline inflation have been rising, with labor compensation accelerating (4.9% YoY in 2Q22). Core inflation would continue rising in early 2023 due to higher wage growth as well as higher electricity and gas prices feeding through to goods prices.

Given the worrying strength in both headline and core inflation, forceful ECB action would be inevitable, with no room for prudence. The aim is to quickly reach a more neutral policy stance.

No wonder QT was not discussed. Taking it at face value, not using QT should imply higher rate hikes.

In France, the business climate was released on September 22. It deteriorated again in September, dropping two points over the month to 102. Although still above its long-term average, the business climate erased all its post-pandemic gains and was equal to its April 2021 level. All major sectors of activity are participating in this deterioration, except for construction. In both industry and services, it is mainly the outlook components that were deteriorating, while order books were shrinking. The sectors that benefited most from the post-COVID rebound in summer 2022, notably accommodation and catering, were the ones that felt that the outlook had deteriorated the most for the coming months. In all sectors, the perceived economic uncertainty has increased.

The eurozone consumer confidence indicator was released on September 22. It decreased by 3.5 points to -29.9 in September of 2022. It is the lowest reading since the series began in 1985, as consumers fret about the economic outlook after Russia halted indefinitely energy supplies through Nord Stream 1 and the ECB stepped up its monetary policy tightening.

Investors were expecting a further drop in economic contraction territory in the eurozone with the release of September PMI. Actually, on September 23, the eurozone PMI suggested the region may already be in recession. The composite PMI was below 50 – signaling contraction – for all three months of the third quarter. That should keep European sentiment weak in the coming months.

Both services and manufacturing activity are now well below 50. This is a broader indicator of activity, which adds to signs that a shallow recession began in 3Q2022. Led by Germany, which saw its composite PMI drop to 45.9 in September, the eurozone saw its composite PMI fall to 48.2. Both services and manufacturing output are well below 50 at 48.9 and 46.2, respectively, signaling broad-based contracting business activity.

Supply chain problems disturb production, but weaker global demand has caused backlogs of work to fall as new orders are decreasing quickly. Production stoppages due to high energy costs are also adding to declining production in the manufacturing sector.

With the end of tourism season, the services PMI pushed deeper into negative territory as consumers have been starting to become more cautious in spending as energy bills rise across the monetary union.

The surge in gas and electricity prices in August has led to further price pressures, even though other costs have been moderating due to weakening global demand. This confirms the stagflationary environment that the eurozone is currently in.

Germany's prominent leading indicator sent more recession signals on September 26. In September 2022, the Ifo index dropped to 84.3 from 88.5 in August. This has been the fourth consecutive drop. Expectations were at their lowest level since the financial crisis. The main reason for a further weakening in economic sentiment is clear: high inflation and its implications on corporate costs and consumer demand.

Order books have started to shrink, and high energy and commodity prices have been weighing on demand and putting pressure on profit margins. Companies could no longer pass through higher costs to consumers as easily as in the first months of 2022.

In the coming weeks and months, these longer-term changes will be overshadowed by shorter-term problems: high inflation, surging energy prices, ongoing supply chain frictions and weakening global demand. A recession is inevitable. However, contrary to previous recessions like the financial crisis or the pandemic, the German economy doesn't look as if it is dropping like a stone but rather sliding into a long winter recession.

On September 29 release, the eurozone sentiment indicator (ESI) dropped markedly for the month. The drop from 97.3 to 93.7 indicated a likely contraction in the economy in 3Q2022. Selling price expectations have been on the rise again, increasing the risk of a longer period of stagflation in the eurozone economy.

Industry, production expectations dropped sharply. Backlogs of work have fallen as new incoming orders disappointed and in some industries production has been reduced as high energy costs impact the profitability of production. With energy costs still at unsustainable high levels for energy-hungry industrial sectors, this has been adding to the bleaker outlook for industrial production.

For the services sector, confidence fell even more as the post-pandemic catch-up demand is fading and the purchasing power squeeze is starting to bite. The services indicator dropped from 8.1 to 4.9 as businesses indicated that demand has recently weakened and they are becoming gloomier about demand in the months ahead.

On the contrary, selling price expectations have been increasing again as businesses face higher energy costs again. This could prolong a period of stagflation in the eurozone economy. For the ECB, the increase in selling price expectations would only strengthen the desire for rate hikes for the October meeting.

The highlight of the last week of September in the eurozone, was the eurozone CPI report on September 30. Inflation hit a new high for the 11th consecutive month as energy prices continued to rise.

Consumer prices in the eurozone rose 10% YoY in September, accelerating from 9.1% in August, which was already the highest level in the euro's 23-year history. Governments were forced to intervene by spending hundreds of billions of euros to shield consumers and businesses from energy costs. Energy prices rose 40.8% in September, up from 38.6% the previous month.

Prices for food, alcohol and tobacco in the eurozone rose 11.8%, up from 10.6% in August. Core inflation, rose 4.8%, up from 4.3% in August.

The overall eurozone figure was lifted by German inflation, which hit a new 71-year-high of 10.9% in September after the expiry of government measures to cushion the impact of the energy crisis.

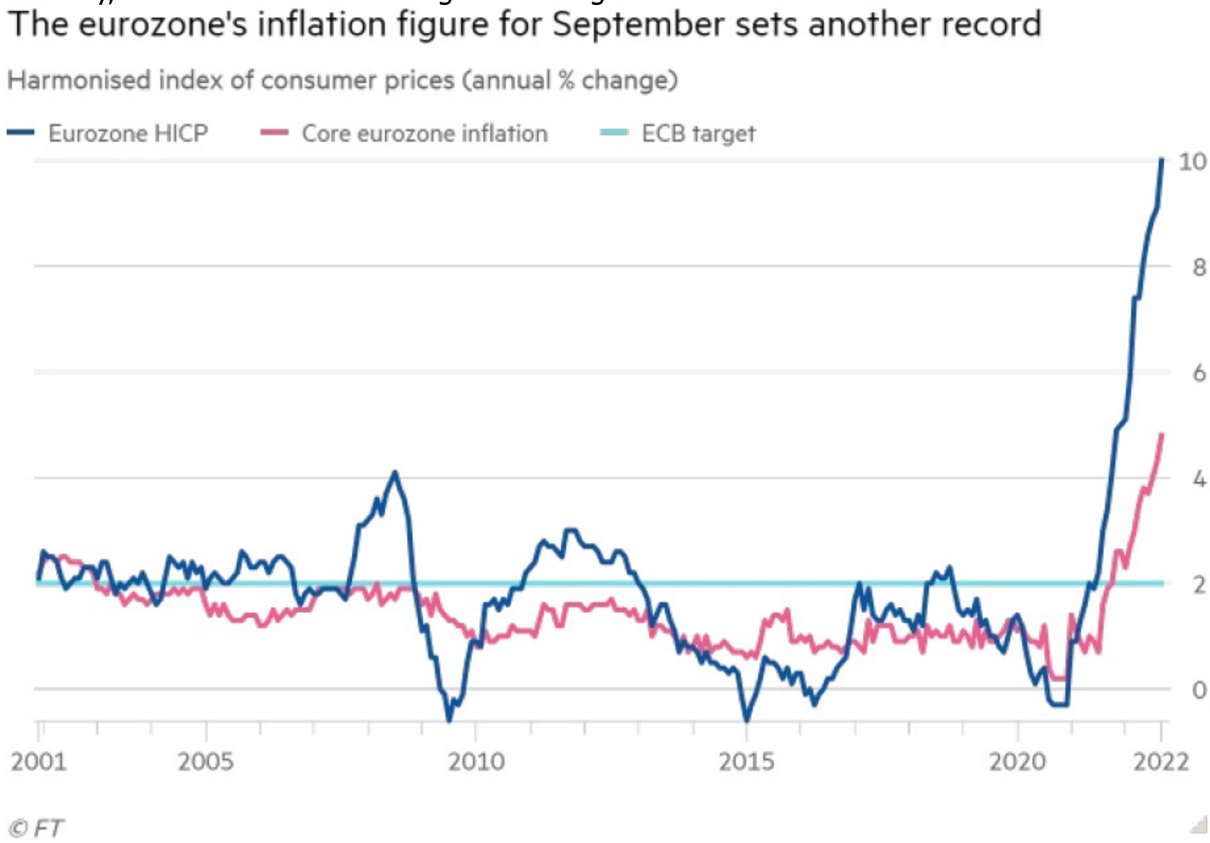
Germany on September 29 became the latest EU country to announce further measures to reduce energy costs for consumers and businesses. Berlin aimed to spend €200bn on capping gas and electricity prices.

Such a CPI figure should bring the European Central Bank out in force and cement expectations for a 75bps hike on October 27.

The September 26 OECD forecasts raised their projection for eurozone inflation next year by 1.6% to 6.2%, noticeably exceeding the ECB's own outlook. Hours later, ECB President Christine Lagarde reiterated that her officials also see the danger of a higher outcome.

"*The risks to the inflation outlook are primarily on the upside, mainly reflecting the possibility of further major disruptions in energy supplies,*" she told EC lawmakers. "*We expect to raise interest rates further over the next several meetings to dampen demand and guard against the risk of a persistent upward shift in inflation expectations.*"

The end of summer discounts on public transport and fuel helped drive a gain there to 10.9%, the highest headline rate seen in the Group-of-Seven industrialized economies since the energy crisis struck. Italy, the Netherlands and Belgium saw significant accelerations too.



On the fiscal policy front, eurozone deficit to remain high in 2022, but gradual fiscal tightening from 2023. Budget deficit at 4.8% in 2022, slightly down from 5.1% in 2021 (a fiscal easing of 0.8p of GDP). Country National Stability Programs published last April 2022, pointed out to an increase in their 2023 structural balances and a reduction in their public spending ratios. This stance would likely change in the 2023 budget bills in fall 2023, with measures to help alleviate energy costs.

A rough estimate, looking at the trade balance of energy products, suggests that the energy burden will increase by 34pp of GDP in 2H22 and 2023, compared to normal levels (pre-pandemic) or 2021. Assuming only half of the increase is covered by state coffers, this would mean an increase in the public deficit of at least 1.5% of GDP albeit potentially offset by a new windfall tax.

A gradual fiscal tightening has been projected, mostly due to a higher share of tax receipts. Even with high public deficits, the September increase in bond yields should not lead to higher debt ratios in coming years, thanks to strong nominal GDP growth and long debt maturity.

On the bond market front, eurozone government bond spreads have proved resilient. Before the Italian general elections of September 25, Italy's sovereign bond spreads over Germany had proved quite resilient. Not just due to the political uncertainty but also in the face of the ECB's rate hikes. The 10-yr BTP-Bund spread had been around 225bps, that had been below levels observed late in August and early September 2022 ahead of the 75bps ECB hike. The ECB has been watching more about the speed than the magnitude of spread widening.

The consequences of ECB's rate hikes

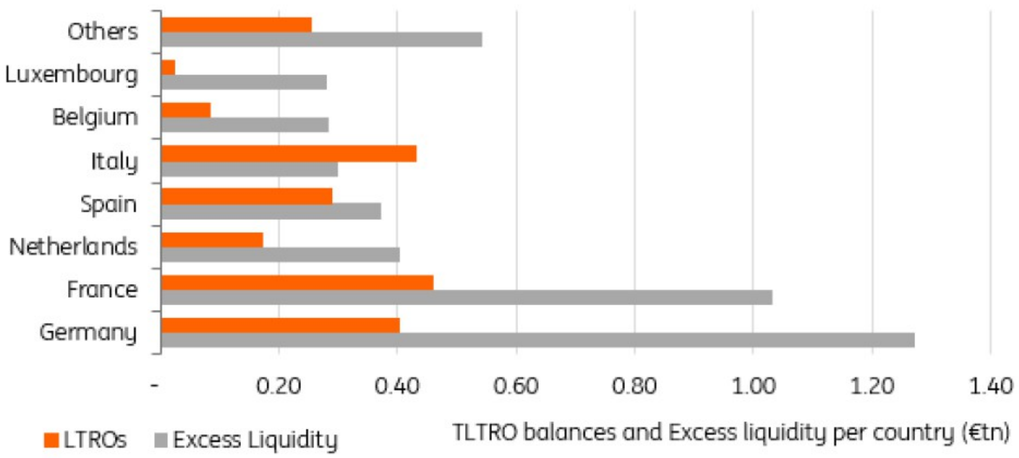
ECB hikes have not been without costs. The deposit facility rate has reached at 0.75%, the rate that the ECB has to pay to banks on the excess liquidity (EL) it had injected into the system via bond purchases and via TLTROs.

ECB has been studying ways of cutting a subsidy to banks that stands to cost it tens of billions of euros in interest. To fight runaway inflation, the ECB has raised the rate it pays on the 4.6 trillion euros worth of banks' reserves that exceed requirements from -0.5% to 0.75% in less than two months.

At these deposit rates, this means interest payments of €34.5bn per year, and if rates reach the 2.5% peak, this would amount to €115bn.

This leaves the ECB on the hook for tens of billions of euros in annual interest on those reserves and threatens to burn a hole in the capital of the central banks in countries where most of the those reserves sit, with the Netherlands and Belgium have already been warning about imminent losses.

The distribution of excess liquidity and TLTRO balances is different across countries



Source: ECB, ING

ECB policymakers feel justified in taking action if that is needed to preserve capital, noting that lenders had benefited from the ultra-cheap loans in the past. It also puts the ECB in the politically uncomfortable position of subsidizing banks at a time when the public is struggling amid high inflation.

Banks in particular stand to make a guaranteed profit on three-year loans they have taken out from the ECB itself because the average interest they pay on those TLTROs has been lower than what they can earn by depositing that same cash at the central bank.

For these reasons ECB staff have been examining ways to pay less, such as not paying interest on any cash that banks have borrowed from the central bank itself. ECB could soon announce a tiered remuneration of excess liquidity. Proposals include only remunerating excess reserves below or above a threshold or scrapping interest on minimum reserves - those that banks have to keep at the ECB and which currently yield 1.25% a year.

Other Potential designs include the form tiering of EL that depend on the ECB's goals:
- If the aim is simply to offset the benefit offered through TLTROs and to give incentives to banks to repay the existing balance, then remunerating a proportion of EL proportional to TLTRO balances at 0% is the way to go.
- If, on the other hand, the ECB is digging in for a long period of high-interest rates, and high excess liquidity (the remaining portion refers to the size of its bond portfolio, which will take a lot longer to unwind than TLTRO balances) then it may opt to remunerate at 0% either: a) A multiple of banks' required reserves. This is what it did in 2019, with the multiple set at 6x or b) A proportion of banks' EL.

The Swiss National Bank (SNB) was the first one to actually implement a reserve tiering system on September 22. It said that it would only pay interest on reserves "*up to a certain threshold*".

Banks' sight deposits at the SNB up to a certain threshold would earn the SNB policy rate, i.e. 0.5%, and 0% on balances above that threshold. In parallel, the SNB announced it would conduct liquidity-absorbing operations, i.e. Open Market Operations (OMOs). In effect, the SNB rate should remain the marginal rate in CHF money markets, and tiering should act as an incentive for banks to participate in liquidity-absorbing operations. SNB's actions would remove liquidity from the system as it tightens policy in order to get inflation under control. SNB's additional goal seems to be to make sure higher policy rates are transmitted to the economy.

As was hinted at by President Lagarde at the September 8 press conference, the ECB could soon announce measures to address this cost issue, possibly by introducing a tiered remuneration of excess liquidity and subjecting parts of it to a zero interest rate remuneration. Nagel's statements at Lucerne on September 23 on this matter, supported the need for a fix.

Policymakers only briefly discussed this topic at their September 8 meeting and are expected to revisit it at a retreat in Cyprus on October 5 or at their policy gathering on October 27 - when the ECB would set to raise rates again.

The ECB would again effectively micro manage banks' profitability, but more importantly the choice of design can determine the impact on money market rates. ECB would make sure that the deposit facility rate remains the marginal policy interest rate determining market pricing. This requires that a large enough portion remains subject to the depo rate. Lowering that portion would of course lower the ECB's cost, but may prove more disruptive for money markets with increasing re-balancing of the unevenly distributed excess liquidity across jurisdictions.

The reduction in EL resulting from early TLTRO repayments, and other liquidity draining operations, would push money market rates higher relative to the ECB deposit rate. Interbank lending rates would be the first area where we expect a reaction as banks move to replace TLTRO funding. In time, greater competition among banks would emerge to attract wholesale deposits. Both would push Euribor fixings higher relative to ESTR. This should also contribute to pushing ESTR fixings above the deposit rate, and closer to the refinancing rate.

ECB's different options would affect member countries in different ways. Italian banks, for instance, have borrowed more from the ECB than they have deposited there in excess reserves, while the opposite is true for most other countries and especially for Germany, France and the Netherlands.

An additional problem would be that the ECB has to justify any decision on monetary policy grounds, i.e. the financial solidity of central bank's balance sheet through its levels of capitalized reserves.

Meanwhile money markets traders in the euro zone have started pricing in a chance of an ECB rate cut late in 2023, as traders bet the bank may end up over-tightening monetary policy by delivering a series of big rate hikes.

Since September 8 meeting, traders have increased their bets on larger moves. Traders have been certain that the ECB will deliver a second 0.75bps rate hike in October as policy makers step up the battle against searing inflation. An increase of that size would double the key rate to 1.5%, its highest since 2008. The move in rates pricing coincided with a speech by ECB President Christine Lagarde at the European Parliament.

The moves in euro zone money markets echo what has been happening in the United States. There, the Federal Reserve has also been front-loading rate hikes, delivering a combined 200bps of increases since May.

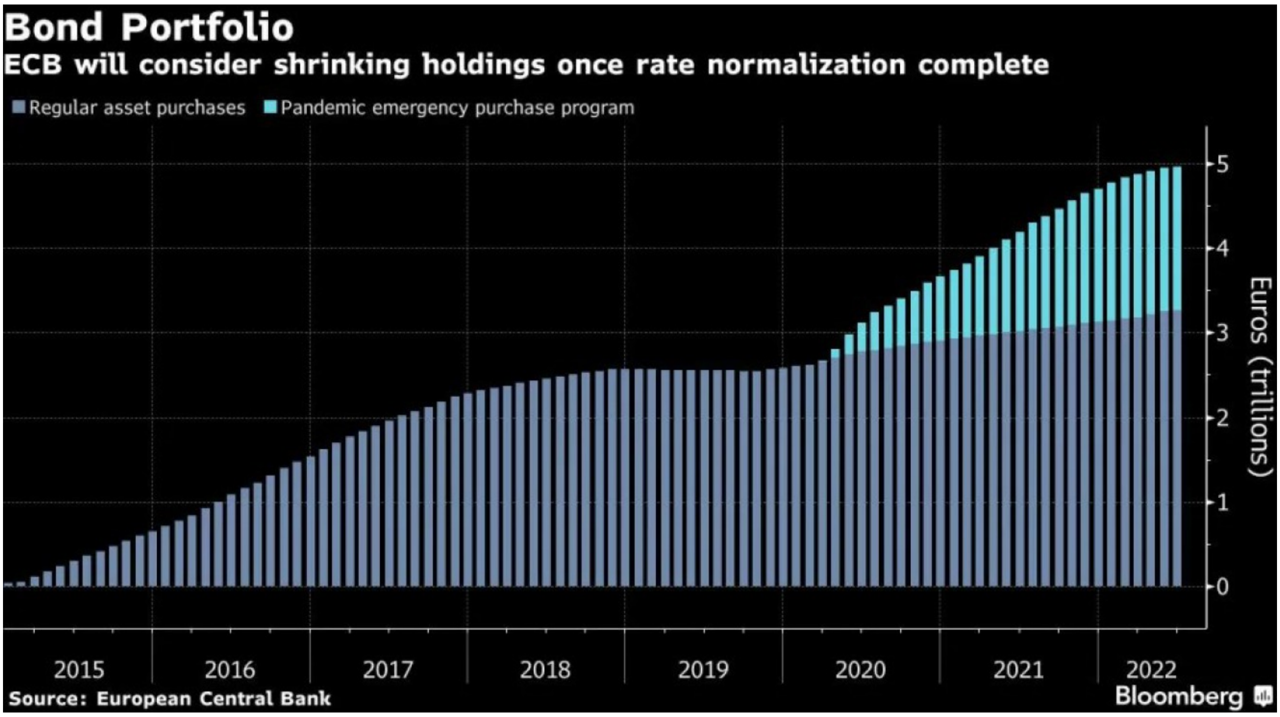
Another headache for ECB has been the lending over trillion of euros to Eurozone banks in the form of multi-year loans, that needs to mop up cash to battle runaway inflation.

Banks have borrowed under the ECB's third TLTRO program €2.1tn, after choosing to give back just €6.5bn euros on September 15 repayment window.

Banks could make a guaranteed profit on that cash, which they had borrowed when rates were lower, by simply parking it at the ECB and they're unlikely to find such cheap funding anywhere else on the market. But this is the opposite of what the ECB needs in its fight against inflation.

But lenders haven't fully taken that hike on board and they were lending to each other at just 0.66%, the one-month swap on the ECB's ESTR overnight rate.

ECB policymakers broached the subject at the September 8 meeting but judged that proposals aimed at making excess cash less attractive needed more work. A decision might still come before the ECB's next policy meeting on October 27.



A last problem but not the least. A shortage of high-quality assets in the euro area has been keeping a lid on short-term borrowing costs, a development that could endanger the ECB effort to tighten financial conditions.

The cost of borrowing cash against German government bonds in repo markets, where dealers and funds look for short-term financing, has only climbed 57bps since the September 8 decision.

It's has been a symptom of years of central bank bond-buying that has helped inflate the amount of excess money in the system to a record €4.7tn and reduced the stock of government bonds available to trade. The imbalance wasn't a problem when the ECB was keeping financial conditions loose, but lately too much cash has been chasing a limited number of high quality securities, acting as a damper on rates.

Repo market pricing has been still choppy as markets adjust to the ECB's changes, but already the reaction looks different to that seen following the previous 50bps hike in July 2022. Then, it was primarily repo rates for transactions using specific securities as collateral that remained lower.

Post September 8 meeting, the dynamic has spread to deals that can use a broad pool of different government securities to lend against, as well as transactions that use French and Italian securities.

Other lending rates, such as ESTR, which is based on banks' unsecured overnight borrowing costs, did react more fully to the hike, fixing 74.5bps higher. Analysts had been concerned that the spread between ESTR and the ECB's deposit rate could diverge further on a jumbo hike, which would have more significant impact for monetary policy transmission. This has been reminder that collateral scarcity issues would remain.

The ECB has also faced the problem that its rate hikes are not properly transmitted into all corners of the money market. Collateral scarcity is affecting core rates with Germany's 3m treasury bills still trading some 40bps below ESTR OIS (euro short-term rate overnight indexed swap). The ECB has prevented at least a worsening of the situation by remunerating the vast government cash holdings at national central banks that would have otherwise pushed into the tight market for collateral.

But this is only a temporary fix and the ECB may eye other central banks' approaches, in this case, the SNB's issuance of central bank bills – which is essentially converting excess liquidity into collateral. It does not address the issue of the ECB being left with rising interest costs as it has started to remunerate banks' excess liquidity holdings.

Prospects of the ECB running down its Bund holdings and Germany announcing plans on September 28 to increase its 2022 funding by €22.5bn might have been thought to help ease the collateral scarcity issue plaguing the Bund market. But the notion of the ever so conservative German financing agency upping its issuance have channeled concerns over broader government deficit increases in the eurozone. This is against the backdrop of unease surrounding Italy, fragile geopolitics and a central bank pulling back at the same time.

Another point of friction has emerged: A tug of war between fiscal and monetary policy. Tensions between governments and central banks have been flaring up. Central banks want to squeeze demand, but governments want to support incomes.

Some euro zone governments are using fiscal measures to help households but this increases already high budget deficits and, by supporting demand, adds to inflationary pressures.

Subsidies on electricity and natural gas bills, fuel rebates, and cheap public transport tickets have been just some of the ways European governments are trying to cushion the impact of surging energy prices. While these policies would lower prices in the short-term, the eurozone's central bankers worry they risk boosting demand and forcing interest rates to go even higher in the longer term.

If these fiscal measures are too generous or broad-based, they will boost consumers' spending power and undo the cooling effect on demand from higher rates, keeping inflation higher for longer in the medium term.

Investors globally have been growing increasingly concerned that monetary policy and fiscal policy are out of sync. Central banks worry that expensive government support measures would lead to greater inflation, forcing them to raise rates higher.

In the UK, tensions have reached boiling point. Chancellor Kwasi Kwarteng's new economic strategy, which includes a £150bn energy price cap and £45bn of tax cuts funded by extra borrowing, caused a sell-off in bond markets after investors judged it would lead to more inflation and require bigger rate rises by the Bank of England

The BoE said on September 26 it would assess the plan's impact on demand, while reminding everyone of its aim *"to ensure that demand does not get ahead of supply in a way that leads to more inflation over the medium term*".

The ECB, where fiscal policy is handled by 19 different governments, has an extra worry. Higher government debt levels may raise the spectre of a debt crisis and deter it from raising rates as high as needed to tackle inflation.

Christine Lagarde summarized these concerns speaking at European Parliament on September 26, saying countries using their budget to protect citizens from high food and energy costs must be careful not to fuel further price growth.

"*It is essential that fiscal support used to shield those households from the impact of higher prices is temporary and targeted. This limits the risk of fueling inflationary pressures, thereby also facilitating the task of monetary policy,*" Lagarde said.

In a more forceful mode, reflecting IMF's proposals on the public finance handling of energy costs, Philip Lane, the ECB's chief economist called on eurozone governments to tax rich people and companies more to finance support for those hit hardest by the region's energy crisis.

Lane's remarks were published at Austrian newspaper Der Standard in an interview on September 27, after the UK government's latest budget, which includes a tax cut for the highest earners, triggered a sell-off in bond markets and sharp depreciation of the pound.

Lane said governments faced a clear trade-off in choosing how to finance measures to support those hit hardest by the energy crisis. "If you support those in need through higher taxes, it has less of an effect on inflation than if you increase deficits," he told the, becoming more specific than usual in providing advice as a central bank official to politicians on tax policy.

Lane's comments supported the EU's plan to raise €140bn from a levy on excess profits in the energy sector to spend on measures cushioning the blow of high prices, which was due to be discussed by policymakers on September 30. The EU has not, however, advocated higher taxes for wealthier citizens.

"*From the point of view of fairness, but also from a macroeconomic perspective, governments should support the income and consumption of those households and firms that are suffering the most. The big question is whether part of this support ought to be financed by tax increases for those that are better off,"* said Lane.

Lane said that while "*it won't be possible to avoid somewhat higher deficits*" in the short term, "*there has to be a clear time limit*". Stressing the importance of lower deficits in 2023 *to help tackle inflation, he said: "This does not mean moving towards austerity, just moving away from expansionary policy.*"

Lane predicted energy prices would stabilize by the middle of 2023 and said inflationary pressures should subside as supply chain bottlenecks ease and higher rates slow demand.

He also warned that workers and companies would both have to accept lower incomes because of higher energy costs - which he estimated had increased from about 1% of eurozone gross domestic product to 5%. "*In order to get back to lower inflation, we need to realize that corporate profitability will decrease for a while and that wages will not fully keep up with inflation for a while either.*"

An EU Central Bank on alert! The case of De Nederlandsche Bank (DNB)

On September 9, the president of the Dutch central bank wrote what may have been the most remarkable letter of his career: it said that the ECB's interest rate hikes will lead to losses for De Nederlandsche Bank (DNB) for the first time since 1932.

DNB published the letter on its website on September 20. Its news on the monetary situation in the eurozone was so explosive that it shocked the Nationale Bank van België's (NBB) private shareholders. This resulted in them doing something that the state - which is the sole shareholder of the central bank in other euro countries - cannot do: they decided to sell off their shares.

The Belgian central bank is owned half by the state and half by private shareholders. Unlike most other eurozone central banks, NBB's shares are traded on the Euronext stock exchange in Brussels. The central bank therefore has a market value and that value suddenly collapsed.

The next day, pending a press release by representatives of the Belgian central bank, trading in NBB shares was temporarily suspended. Once trading resumed, NBB shares dropped even further in value: in just a few days, the share price plummeted from €1,600 to €860.

The NNB press release made it clear in the very first sentence what had caused the sudden drop in share price: '*The Nationale Bank van België took note of the letter written by Mr Klaas Knot, President of De Nederlandsche Bank, to Mrs Sigrid Kaag, Dutch Minister of Finance, with the subject heading "letter regarding DNB's capital position", which was published yesterday on the DNB website.*'

What was it in Knot's letter that so scared the Belgian shareholders? Well, it was a profit warning: *'The current high inflation was not foreseen and therefore necessitates a tightening of monetary policy. This will lead to interest-rate hikes and subsequent losses for DNB.'*

In essence, this meant that the ECB decided that the national central banks had to pay higher interest rates to private banks than DNB had expected. Knot's Belgian counterparts had remained silent on the similar problems that they faced, but the publication of the DNB letter put them on the spot. The NBB had to admit that '*based on its most recent risk scenarios' the bank was* *expecting losses too,* adding: *'The risk analysis indicates that losses will further increase over the coming years.'*

This problem is not limited to Belgium and the Netherlands, but would affect all countries of the eurozone. It is the first time since the Great Depression of the 1930s that multiple central banks would make a loss.

Several countries throughout the eurozone are facing a similar problem. To absorb the losses of their central banks, European taxpayers risk having to pay tens or even hundreds of billions of euros ayear. Meanwhile private banks haver got that same amount of money without having to do anything in return.

The losses originate in the explosive growth of central bank reserves, due to the QE policy. Because interest rates could not be lowered any further and to counter the threat of deflation, the eurozone's national central banks bought up tens of billions of government and corporate bonds each month. They did so through the APPs, which were financed with central bank reserves, the interbank money that the central bank creates itself.

In addition, private banks were able to borrow central bank reserves very cheaply, via TLTROs. They would sometimes even receive money on these loans, as the loans had a negative interest-rate for prolonged periods of time. Off the record, bankers were often heard calling these TLTROs '*a gift from the central bank*'. European commercial banks have made ample use of this free money: in October 2022 there were around €2.2tn of extremely cheap long-term loans on their balance sheets.

The €2.2tn in reserves borrowed by European banks through TLTROs come on top of their increased reserves due to the APP. As a result, total reserves of these commercial banks have exploded: from €235bn in 2015 to nearly €4.7tn in September 2022.

Up until July 2022, when interest rates had been negative, that mountain of reserves did not negatively affect the profitability of the central banks in the eurozone. While private banks could borrow cheaply via TLTROs, they also had to pay the central banks negative interest on their central bank reserves. This provided the national central banks with a source of income.

The ECB has raised the interest rate on most of these reserves to 0.75%, with the idea that banks would simply pass these interest rate hikes on to the client. That would make saving more attractive, borrowing more expensive, and investing less profitable – with the aim of discouraging spending and thus curbing inflation.

But as policy rates were raised, the excess liquidity in the banking system suddenly became a cost item: the central bank now pays the private banks 0.75% interest on their excess reserves. Meanwhile, the income on the interest on government and corporate bonds that the central banks acquired through the APPs remains minimal. After all, these securities date back to the period of negative interest rates.

For the joint European central banks, the reserves are already costing €30bn pa. If the interest rate rises to 3 or 5%, the central banks will lose between €120bn and €200bn pa.

It is worth noting that the losses at DNB and the Bundesbank are above the average because they took a tough stance during the euro crisis. For the PSPP, the northern central banks did not want to share risk via the capital key, which is normally used to distribute risk over the national banks within the European central banking system. As a result, the northern central banks now own bonds with lower interest rates than the central banks of the southern euro countries. For example, the interest rate on Italian and Spanish government bonds is higher than the interest rate on Dutch or German bonds. Had the Northern European countries opted for risk sharing with other euro countries, their income from interest would now be higher.

A possible solution. The option of reducing interest payments on reserves has been on the table. The ECB had been using this policy measure for the past three years. On October 30 2019, the ECB set up a two-tier system, exempting part of the banks' excess reserves from interest payments.

This happened when policy interest rates were negative, which meant that banks had to pay for their reserve deposits with the central bank. The ECB accomodated private banks with an exemption: they no longer had to pay interest on a large part of their reserves. However, the ECB abandoned the tiering system on September 8, 2022.

The decision whether or not to remunerate reserves or raise reserve requirements has implications that reach far beyond price stability. Instead of acting as stewards of seigniorage income, the national treasuries could become the cost bearer of interest payments to private banks, due to an ECB policy decision. This would have serious implications for the national budgets of member states, without their democratic parliaments having any say in the matter.

Governments could intervene with an option of their own: they can simply choose to raise bank taxes. Belgium has been already considering this move. In Spain, the government has been arguing that the '*extraordinary*' profits enjoyed by the banking sector warrant a '*windfall tax*' on banks. The Spanish government has drawn up a proposal and officially asked the ECB for its opinion on the matter.

Higher bank taxes would result in a triangular interdependency in which central banks pay interest to commercial banks, governments replenish central banks' equity, and private banks' surplus profits are taxed to cover these government expenses. It is a cumbersome, roundabout approach, but it could be a last resort to prevent passing on the costs of the ECB's unconventional policies to European citizens.

On October 12, Reuters newswire cited anonymous sources from within ECB who claim that the central bank was considering various options to reduce the interest payments on reserves, including reinstalling the two-tier system and changing the terms of the TLTROs. *'Paying interest on these excess reserves deplete central banking profits, limiting their ability to pay cash into national budgets and depriving the state of vital income. That risks putting political pressure on central banks around the euro zone. In extreme cases, central banks could even deplete their own capital, possibly forcing governments to recapitalize lenders*.'

The monetary policy case for attractive conditions of TLTRO III has been entirely gone, therefore the ECB would very likely going to address the issue. The ECB has been tightening financing conditions to address inflation. The ECB has multiple options to address the issue of ciommercial banks free ride like a) change the TLTRO pricing formula and introduce a third special interest rate period, b) recoup the stimulus by changing the remuneration on a part of bank's excess liquidity holdings or, c) increase the minimum reserve requirements and lower its remuneration.

Policymakers reviewed various options at a seminar earlier in October to change the rules of these TLTROs, all of which were deemed somewhat problematic because they raised a legal or political hurdle, or went counter to other policy goals, according to Reuters newswire reporting from the sidelines of the International Monetary Fund and World Bank annual meetings in Washington.

All market participants, expected ECB to address the TLTRO issue at the next meeting in October. There has been no reason to wait, given the TLTRO gross margin has been kept rising with every adjustment to the rate path, and excess liquidity has not been getting substantially smaller - at least until June 2023, when TLTRO III.4 matures. Introducing a policy change at the October meeting would provide banks ample time to adjust their early repayments figures ahead of December submission date, with the policy then coming into play afterwards.

The Italian Conundrum: Part VI - Italy's election results

Italy’s election results were in line with expectations: the right-wing coalition led by Giorgia Meloni has secured a solid majority in both the Senate and the House. The process to form a government would take a few weeks. A new Meloni government could be installed by the end of October. Markets would closely focus on the choice of key ministers (especially the Finance and Foreign Affairs ministers) as an early test of Meloni’s pledges to respect EU fiscal rules and Italy’s stance on international politics.

The new goverment will quickly be put to the test, since it would take over an increasingly struggling economy exposed to a high risk of recession this winter. Questions about budget decisions and relationships with the EU might start to emerge at some point and could favour a widening of the BTP-Bund spread, although downside risks for the eurozone’s peripheral bonds primarily stem from quantitative tightening discussions at the ECB Governing Council.

On the fiscal front, Meloni would likely be in a position to effectively oppose calls for more deficit from Matteo Salvini, the leader of Lega. The new budget would have to be approved before year-end. The outgoing Mario Draghi government would set up the macro framework and the budgetary framework. This should prevent any meaningful deviation from the set track in the short run.

Furthermore, Meloni would have to clarify her stance on the international positioning of Italy. If adhesion to the Atlantic Pact seems not at stake, the relationship with Brussels and big eurozone countries would have to be clarified. Even though the participation in the euro project has been reaffirmed in the program, the notion of doing so while defending national interests has yet to be qualified. A potential area of conflict for 2023, will emerge when the new European fiscal rules will be discussed.

The main driver of Italian bonds over the coming weeks and months would ikely to be the broader tone in financial markets. The ECB’s shift to hawkishness has been a particular worry, and so is the prospect of it reducing the size of its bonds portfolio through QT.

Any Italy-EU confrontation on Meloni’s party's core themes like immigration might trigger some adverse market reaction further down the road, and that fiscal decisions might be scrutinised more if she presses forward with tax cut proposals.

In terms of macro-date, market analysts have forecasted that the real GDP will fall by 0.4% QtQ in the 4Q22, followed by a 0.2% QtQ drop in the following quarter. The industrial sector, have been affected by disruption linked to the war in Ukraine and the rise in production costs.

The combined effect of budget-constrained consumption and softer industrial production would make a GDP contraction in the fourth quarter almost unavoidable, marking the start of a technical recession.

Given households’ decreasing purchasing power, private consumption is likely to shift over to “essential” goods and a reduced willingness to purchase durable goods. In July, household confidence was at its lowest since March 2013, before edging up in August. But September data showed that consumer confidence fell back to July’s level. Consumers were increasingly concerned about economic developments and expected a deterioration in household economic conditions.

The unemployment rate fell back to 7.9% in July, almost 2 points below the prevailing level before the Covid-19 global pandemic. Nevertheless, the working-age population is still a long way from a return to its level of three years ago, which inevitably suppresses the unemployment rate.

TPI debate continues in September 2022

TPI is considered as a potentially powerful tool that could ultimately be effective in anchoring sovereign credit in Europe, given its unrestricted nature and the Governing Council's unlimited commitment to Euro. However, the lack of clarity on the conditions under which TPI would be activated suggests that market participants could test the ECB's resolve, especially in the context of the sharp increase in political uncertainty in Italy.

Moreover, the TPI would not alleviate fundamental fragmentation risk, including the election of a government that pursues policies that are inconsistent with the eligibility criteria to activate the backstop. In this case, Euro area governments would likely be required to find a fiscal solution to fundamental sovereign risk.

While it is clear that the ECB will not shy away from intervening in the bond markets if there is a run on individual countries, it remains unclear for how long the ECB could sustain such interventions. The ECB mentions that purchases could be terminated if there is a durable improvement or "*based on an assessment that persistent tensions are due to country fundamentals*". TPI purchases would be sterilized to avoid interference with the price stability objective, but it is not clear how such liquidity absorption would take place (selling assets or certificates of deposit).

The four criteria for assessing eligibility appear sufficiently vague to allow interventions in support of most countries. It is unclear to what extent a lack of government or the election of parties with fundamentally different views on fiscal sustainability would affect the ECB's actions. Another question is how easy it will be to assess debt sustainability, depending on underlying assumptions such as the appropriate interest rate, fiscal policy and realistic productivity growth.

While some of the opacity over the TPI is intentional, it also looks as if the ECB did not have enough time to settle all the details, which suggests that there could be material differences of option over how to activate and launch the TPI if and when it is needed. The hope is that TPI activation would not be needed, but the ECB would be wise to prepare for the worst and demonstrate its commitment and determination, even in the short term.

TPI is a iteration rather than a radical departure. There is no doubt that there would be a challenge to its legitimacy in the German Constitutional Court, and there is certainly a misunderstanding of how much it can hope to achieve with the euro zone officials. But these differences have been largely quelled by the overwhelming objections in principle, notably from the Bundesbank and the German finance ministry, which the ECB faced a decade ago in an attempt to expand the range of its instruments. And compared to the convulsions of hysteria about Greece leaving the euro, there is notably less hyperventilating commentary about the currency's breakdown this time around.

In conclusion, more work needs to be done to give the euro a stable governance structure, including euro zone-wide banking and capital market reforms and expanding the pool of safe euro-denominated assets. Until that happens, expectations from the time of the euro's launch that it will soon challenge the dollar as a global currency will continue to be proven wrong. The dollar's share of international funding fell after 2000 to the advantage of the euro, but regained that lost ground by 2020.

A strong public disagreement of the new backstop was raised by Luis Garicano, visiting professor of economics at Columbia Business School in an Opinion article published by Financial Times on September 21, 2022.
He warned that such an instrument must not undermine sound fiscal and economic policies. In this case, the absence of effective conditionality leads to atrocious incentives for countries, politicians and, crucially, voters.

Commenting on the four criteria for a country to be eligible [i.e. compliance with the EU fiscal framework; absence of severe macroeconomic imbalances; sustainable debt, according to the analysis of several institutions; and compliance with other EU recommendations], he emphasized that:

"*.. In practice, the first is suspended given the fiscal rules. The second and fourth do not seem effective since they offer large discretion for judgment by the EC. On the last, the commission has been giving free rides to all countries in their recovery plans.... Whether it does this for supposedly good, Keynesian reasons or for bad, political economy reasons, is irrelevant. And, based on sufficiently optimistic assumptions, a declaration by the institutions that debt is sustainable is no real hurdle.*"

He continued his criticism on the fiscal front, having in mind the upcoming Italian elections on September 25:
"*The TPI is not accompanied by a fiscal backstop from eurozone countries. So, if the ECB stops intervening "based on an assessment that persistent tensions are due to country fundamentals", the state supported will face a fiscal crisis. But the ECB will want to avoid sovereign debt restructuring, so it will be trapped into continuing support.*"

His last shot was at the ECB's leadership. "*The creation of such a largely unconditional instrument is a mistake, and one that Draghi avoided while at the helm of the ECB. The instrument he devised at the height of the euro crisis, the OMT program, provided all the right incentives as it could only be activated with the backing of the ESM, and an approved reform program. The coming winter will test this weak institutional set-up. As long as the eurozone does not move towards a true fiscal and banking union, it is likely to reveal the unsustainable nature of the current construction of the euro.*"

Speaking at the European Parliament on September 26, Christine Lagarde, responding to a question about Italy's likely next government, she said that the ECB won't use its latest emergency scheme to buy the bonds of countries that make "*policy errors*". It was indirect criticism to coalition partner Matteo Salvini, who has called for increasing the government deficit.

Asked in the European Parliament whether the ECB could deploy its TPI to help Italy, Lagarde wouldn't name any country but said the scheme was only there to support fiscally prudent countries while others should apply for a bailout.

"*It's (used in) a situation where ... there are disorderly market dynamics that are not justified by fundamentals or by economic policy errors that will have been made. Those are more relevant for the OMT,*" she added in reference to the OMTs, a separate bond-buying scheme which requires a bailout from the EU.

At the end of September, the ECB's problem has been crystallized in its handling of Italian sovereign bond markets. ECB officials appeared confident that they have taken necessary precautions - the TPI stands ready to buy Italian bonds should their spreads spiral out of control. They continue to highlight the importance of further tightening, including starting the discussion on quantitative tightening. Albeit ECB arch-hawk Holzmann commenting that a 100bp hike in

October would likely be too much could be interpreted as an attempt to curb all too excessive expectations.

The release of September 8 ECB's Minutes

On October 6, the minutes of the ECB's September meeting were released. They showed a Council concerned about the inflation outlook, leading to a consensus for a record 75bps hike.

The ECB raised the three key interest rates by 75bps. The new deposit facility rate (DFR) is 1.50%, the interest rate on the main refinancing operations (MROs) is 2.00%, and the rate on the marginal lending facility (MLF) is 2.25%.

Inflation took the center stage. The accounts showed that all policymakers agreed on "t*aking a further step on the path of monetary policy normalization*" as euro area inflation surged to 9.1% in August. The Council was clearly concerned about the inflation outlook, seeing risks as tilted to the upside over the entire projection horizon.

The European Central Bank's rate-setters expressed concerns over the potential for "*self reinforcing*" inflation, with governments' fiscal packages and the weakness of the euro threatening to push up prices for years to come.

Governments' response to the energy crisis constituted "*an upside risk to inflation*," according to the ECB. Members agreed that measures to tackle energy prices should not be too broad, and instead should be "*temporary and targeted at the most vulnerable households and firms in order to limit the risk of fueling inflationary pressures.*"

On the back of inflation concerns, a large number of members supported moving towards a neutral rate at a faster pace, hiking by 75bps. Some members expressed a preference for hiking by 50bps instead, stating that a hike of such magnitude would be sufficient to signal a determined interest rate normalization and mitigate inflationary pressures, if part of a "*sustained path*". It was also argued that "*growth concerns should not prevent a needed forceful increase in interest rates*". Notably, a recession was no longer seen as being sufficient to bring inflation down to 2% over the medium term, reinforcing the case for rapid policy normalization.

The minutes warned that a number of indicators pointed to an increased risk of inflation staying high over the long term. "*The longer high inflation persisted, the higher the risk that inflation expectations could become un-anchored and the costlier it would be to bring them back to target,*" said the minutes. Overall, inflation risks remained "*tilted to the upside over the entire projection horizon,*" the minutes said.

Despite the large rate increases over the summer, the ECB members said that the key policy rates remain "*significantly below the neutral rate*," at which they neither stimulate nor limit activity.

While the Council had deemed any adjustments to its reinvestment policy of APP and PEPP as premature, it noted that the balance sheet continues to still provide "*significant monetary policy accommodation*" and that all instruments can be adjusted to ensure that inflation returns to the 2% target. ECB might adjust forward guidance regarding APP re-investments at the October meeting, opening the door for a decision to change its APP reinvestment policy at the December meeting, effective from the first quarter of 2023.

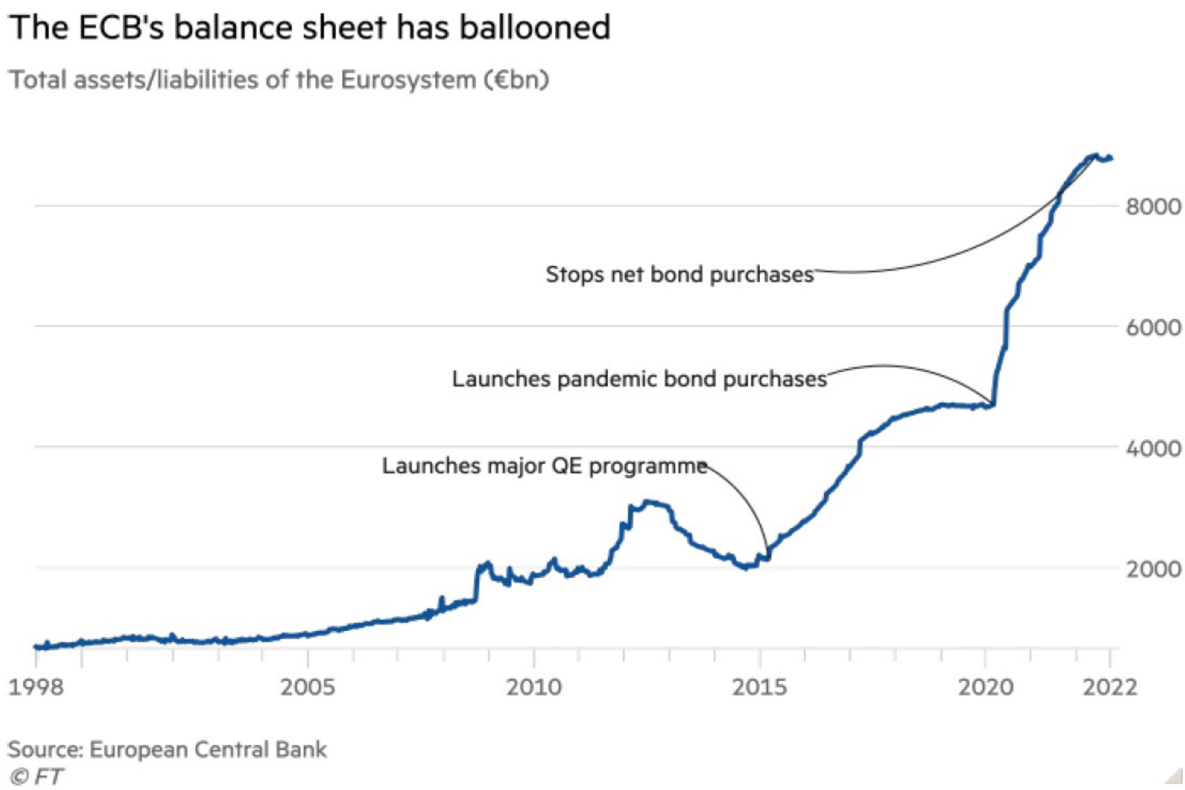
The tune for the October ECB Meeting: "I just can't get enough" (*Depeche Mode song*)

Since the Jackson Hole conference in August, the ECB has become more aggressive. It has lost confidence in its medium-term inflation forecast, it has been focusing much more on current inflation. That explains why the ECB has targeted to get rates back to neutral as fast as possible and has been even willing to go a bit further, as long as the recession is not creating too much unemployment. Indeed, when faced with the policy mistake of too much inflation or severe recession, central bankers appeared solely focused on bringing down inflation - even if it increases the risk of a more severe downturn.

The ECB has been seeing the potential risk of fiscal policies pushing it towards more aggressive tightening than otherwise. ECB **President Lagarde** urged cooperation between central banks and their governments. The remarks of the **Dutch Central Bank's Klaas Knot** reflected some unease when he said that he was not sure whether all fiscal measures were targeted enough.

And looking beyond rate hikes, the talk of QT has been already becoming more concrete. President Lagarde confirmed **yesterday** that the Council had started deliberations on the topic. Other members have already been more specific about the ECB's plans for its balance sheet. France's **Villeroy** reiterated that the balance sheet reduction should commence after the normalization of rates, first with the repayments of the TLTROs, where a good part expires in the middle of next year, and then by a gradual reduction of the asset purchase program portfolio as re-investments are phased out. This could start before 2024.

It was also Klaas Knot who remarked that bond markets had become more sensitive to debt sustainability issues, and thus "*a process like QT – it should be predictable, it should be gradual, it should be even a little bit boring*".



The Bank of England experience of having to renew bond purchases to ensure market functionality has left many convinced that there is little central banks can do to meaningfully reduce their balance sheets, especially if there are also fiscal sustainability doubts.

This has raised the prospect of financial (and/or fiscal) dominance, in which central banks are constrained by financial stability in what they can do to address inflation, implying a medium-term upward risk to inflation.

Comments over the years by various ECB members suggested that it has been far from clear how the ECB's balance sheet could normalize. This would imply that the balance-sheet tool is asymmetric, used to fight low inflation but not high inflation. Others have focused on a desired reduction in excess liquidity to normalize market rates back to the MRO rate, while others have stressed the need for a spread between long-term and short-term rates to help banks perform their inter-mediation role effectively.

The ECB would need to tread carefully with any QT so as not to trigger financial market turbulence or fragmentation. Equally important would be the way euro area fiscal policymakers implement and communicate their plans to shield consumers from higher energy prices while ensuring debt sustainability.

While the German energy package of €200bn could be seen as generous (from a country with fiscal policy room), some modest fiscal tightening would be necessary in 2023 despite the measures to alleviate the cost of the energy crisis, with high inflation helping to keep down the deficit and debt-to-GDP ratio.

For QT to work smoothly, it would be important for the ECB to apply as much flexibility as possible. One way of delaying QT while still reducing the balance sheet would be to prioritize the run-down of the TLTRO loans. There has been some talk of punishing banks that have been enjoying the very favorable borrowing conditions, boosted during the pandemic, without lending much to the real economy, something that could make it less attractive for banks to hold these loans and speed up the repayments. However, it would not be easy to do so (for legal and practical reasons).

As to real QT, a gradual tapering of re-investments could be expected - by not selling back bonds to the markets, something that could result in bigger losses - to start in 2H2023.

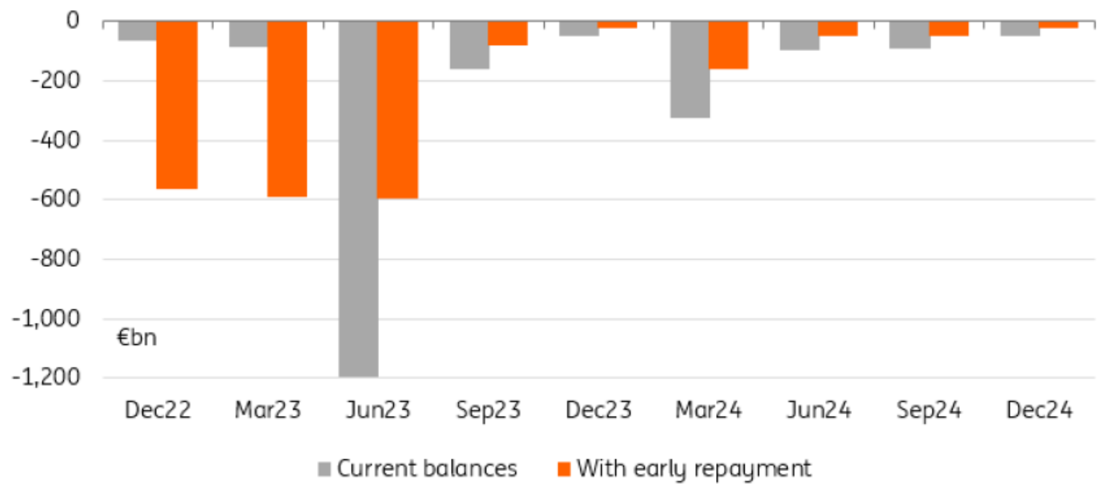
Finally, the ECB should make use of flexibility when pursuing QT, especially regarding the capital key. Although this is a key principle, supported by the European Court of Justice, focusing on the bond yields of the core countries (or lowest yields) initially could provide a more balanced transmission of higher long-term yields while reducing the risks of fragmentation.

Given the inflation outlook, it is difficult to see why the lowest yields (e.g. Bund) could not be significantly higher, something that could be difficult with the current spreads. Inflation being so far off the target would be an exceptional factor for the deviation from the capital keys, while it would also be crucial to explain that any deviations would be corrected over time, as currently is the case. While this would not eliminate the risks from fragmentation (especially if there are fiscal sustainability concerns), it could counter the trend of higher spreads as the Bund moves higher.

While balance-sheet reduction offers no particularly attractive options, the ECB needs to ask itself if countering fragmentation risk is worth the risk of higher inflation premia and a bloated balance sheet or if it is better to have higher long-term yields with a reduced balance sheet. Crucially, does failing to reduce the balance sheet simply not mean that rates will need to go higher?

Persistent press reports in October suggested a change in ECB liquidity policy as soon as the 27 October meeting. As rates rise, so will the amount of interest paid to banks on the €4.7tn of excess liquidity in the system. The ECB has a number of options at its disposal to reduce what is perceived as a subsidy to banks, stemming in part from around €2.1tn of cheap TLTRO loans. It would also reduce the risk of central bank losses and thus of operating at with negative equity as DNB letter has noted in September 2022.

The ECB should succeed in causing early TLTRO repayments



Source: ECB, ING

The most immediate target would be to push banks to reduce their TLTRO balances faster. The largest repayment is due in June 2023 but maturities stretch to as far as end-2024. By making TLTRO carry-negative a large chunk of these loans would be repaid. It would be understandable that some banks keep some TLTRO balances as a precaution. Out of the €2.1tn TLTRO balances a first €0.5tn early repayment in December 2022, and another €0.5tn in March 2023, once year end funding uncertainty has eased, would be realistic.

Excess liquidity (EL) has been still high enough that an immediate €1tn drop should not affect money market rates much, but there is a catch. If the price of liquidity will not change much, the credit premia should rise on the combined effect of less liquidity chasing yields, and on a slightly greater systemic risk resulting from less abundant central bank funding at a time when the economy is heading into a severe recession.

Another important implication of an earlier reduction of EL might be a change of dynamic in the repo market. Early TLTRO repayments means easing collateral scarcity. The impact would be mostly indirect because core repo rates have remained below the ECB's deposit rate, offering no incentive to banks to get their liquidity away in exchange for collateral.

An earlier reduction in EL would compound other factors with a more direct effect on collateral scarcity. Governments in the eurozone are expected to increase their borrowing to finance energy support packages, including the €200bn German plan, but with possible joint EU issuance also adding to the supply of safe collateral. QT would in all likelihood be phased out and would also serve to ease the pressure on the collateral market by reducing the size of ECB bond hoarding.

The above doesn't address the important issue of government deposits being remunerated at 0% (down from the deposit rate currently) after end-April 2023. Some of this liquidity would find itself deposited back at commercial banks, denting the effect of early TLTRO repayments, but the balance would still amount to an significant incentive for government entities to push cash out in exchange of collateral.

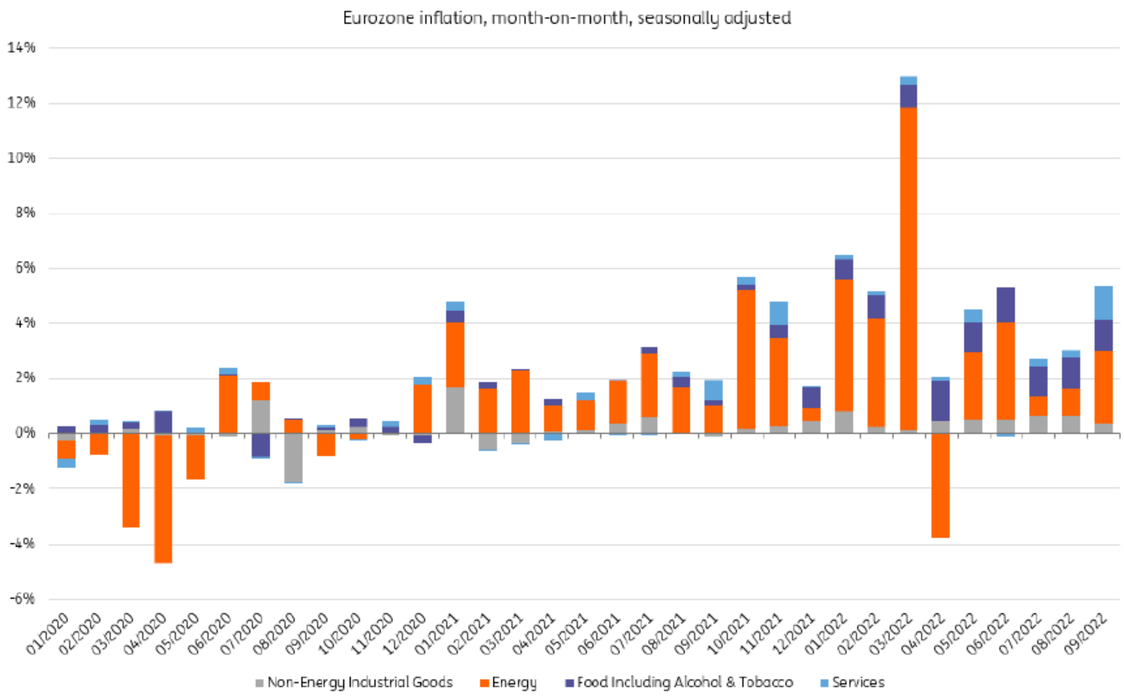
October month started with some key statistical announcements. As reported on October 5, German exports rebounded in August 2022, increasing by 1.6% MoM. On the year, exports were up by more than 18%. Imports also decreased, by 3.4% MoM, further lowering the trade surplus to €1.4bn. The war in Ukraine has succeeded by forcing the German trade surplus to disappear. High energy prices and structurally weaker exports contributed to this. Trade is no longer a growth driver but has become a drag on German growth.

Export order books have weakened significantly in recent months as the global economic slowdown, high inflation and high uncertainty leave clear marks on (not only) German exports. Even if transportation costs have started to come down and global supply chains have improved somewhat, the outlook for the German export sector remains mixed, at best.

On October 12, eurozone industrial production date were released. Industrial production increased by 1.5% in August after a -2.3% drop in July. This was much better than expected but still does not erase losses from July. France, Italy and Spain all experienced decent to strong growth in August, while Germany remained the exception with another month-on-month loss in production. This is the third consecutive month of declines in German production.

Industrial production is generally volatile from month to month. All survey data and anecdotal evidence point toward a more significant slump ahead as demand has been weakening and high energy costs are forcing businesses to slow production or stop it altogether in certain energy-intensive sectors. The upside risk to that view comes from improving supply chains, which could unlock some backlogs of production.

The final estimate of eurozone inflation for September was adjusted down from 10% to 9.9% on October 19. The jump in September was mainly driven by the end of the German €9 ticket for public transport as most other services saw stable price growth compared to last month. Package holidays' inflation was elevated over the summer but dropped back in August and September.



Source: Eurostat, Macrobond, ING Research

Energy inflation saw another uptick in both fuel and electricity and gas categories on a monthly basis due to the bounce back in oil prices and pass-through to the consumer of the August peak in gas prices.

The eurozone composite PMI flash estimate was released on October 24. It fell to a lower-than-expected 47.1 in October, from 48.1 in September. This has been not only a 23-month low but is also the fourth consecutive month that the PMI has been below the 50 boom-or-bust level, clearly suggesting negative GDP growth.

The manufacturing PMI came out at 46.6, while the services sector PMI is now at 48.2. The steepest downturns were seen in the most energy-dependent industries, such as chemical and plastics and basic resource sectors. Industrial powerhouse Germany saw the fastest decline in activity, while in France growth merely stalled.

Manufacturing orders saw the biggest drop since April 2009, while the decline in new business inflows into service sector companies was the strongest since June 2013. Backlogs of orders fell for a fourth consecutive month, especially in manufacturing.

While there was still modest employment growth in October, there seems to be job cutting at some firms and hesitancy to hire in the wake of the uncertain economic outlook. This means that the job market is likely to be less of a support for consumption in the coming quarters.

On October 25, the Ifo index was reported to drop for the fifth consecutive month and came in at 84.3, from an upwardly revised 84.4 in September. While expectations improved somewhat from very low levels, the current assessment component weakened further.

This was one of the last important economic data the ECB disposed of in the run-up to the meeting of the Government Council on October 27. The ECB has made it clear that a downturn would not deter it from tightening monetary policy, as long as inflation is not brought under control. With inflation hovering around 10%, the bank surely wants to restore its credibility.

ECB October 27 Meeting Decisions

In line with the market consensus forecast, the ECB hiked by 75bps on October 28, from 0.75% to 1.5%, continuing the swift hiking pace it started at September 8 meeting. The decision was in line with the assessment by the ECB made at the September meeting. Contrary to the rate hike decisions in July and September, the size of the latest rate hike seems to have been uncontested and broadly supported by all ECB members. Euro area inflation had previously surged to a record 9.9%Y in September, putting pressure on the central bank to take another large step towards neutral.

The Governing Council did not think that the economic downturn alone would be sufficient to tame euro area inflation, and hence policy rates would continue increasing. The statement however hinted that the ECB might be done with the fast pace of 75bps hikes as "*substantial progress in withdrawing monetary policy accommodation*" has been made, and would shift to a more moderate pace.

The initial statement read dovish. The ECB removed its reference from hiking at the "*next several meetings*" to "*expects to raise rates further*", although Madame Lagarde appeared to push back at the press conference. She said that more hikes could be expected, that the ECB has not yet completed the process of monetary policy normalization, and might have to go into restrictive territory, although the amount and magnitude of hikes, as well as the level of the terminal rate, would depend on future data and an assessment of what rate would be needed to bring inflation back to 2% in the medium term.

Madame Lagarde did outline a framework for future rate hikes and their size. She said it would depend on (i) the inflation and economic outlook; (ii) the monetary policy tightening already undertaken; and (iii) the lag with which monetary policy affects the economy.

Market participants forecasts have been split between a smaller 50bps and a 75bps hike in December 2022 and two additional 25-50bps hikes in February and 25bps March 2023, reaching a peak terminal rate of 2.5% to 3.5%, above the common range of 1.5-2.0% for neutral rate.

The ECB addressed the issue of too favorable TLTROs by adjusting the TLTRO pricing formula for a third special interest rate period. The central bank has introduced a "*last interest rate period*", where the applicable TLTRO rate would be indexed to the average applicable key ECB interest rates over this period. For the majority of banks, that means an average of DFR, resulting in a zero gross margin. The last interest rate period would run from November 23 and would last until the maturity date or early repayment date of each respective TLTRO. This decision would raise the average interest rate banks pay on TLTROs by bringing it in line with its DFR from that point.

As a reminder TLTRO loans were offered to banks at 0.5% below the ECB's deposit rate to encourage them to keep lending during the pandemic. Banks could earn a big profit simply by putting the money they borrowed back at the central bank to benefit from its sharply rising deposit rate. But the ECB has stopped this from November 23, after which the rate on the loans would track its deposit rate.

The cost of the TLTRO tranches for banks that have met the lending benchmarks would move to at least 1.5% after 23 November (to the level of the deposit rate as of 2 November), but the level for the remainder of any tranche would most likely be higher than this as the ECB continues to hike rates. Until 23 November, the banks would enjoy the very attractive rates based on the average of the operation until November.

This could lead to significant early repayment of the outstanding €2.1tn in the coming months, possibly halving it (1/3 of APP redemptions from 2Q2023). The case for TLTRO III has been entirely gone. In the additional press release on TLTRO re-calibration the ECB has outlined, that in the current inflationary environment, the TLTRO terms were not acceptable from a perspective of policy rate transmission to bank lending conditions, and a re-calibration was required to ensure that TLTRO III contributes towards normalization of bank funding costs and financing conditions.

The ECB will also introduce an additional early repayment date before the 23 November, in order to allow banks to repay before the new conditions kick in, and to avoid a year-end volatility in the money markets arising from early repayments. Banks should "*notify the relevant NCB at least one week in advance of the additional early repayment date*". There would be further two additional early repayment dates on the 25 January 2023 and 22 February 2023. Banks have been given the option to take the new conditions or repay early.

Market repayments estimates vary. A lower bound of TLTRO III early repayments scenario for November amounts to €350bn, while the upper bound range could come out to €850bn. This would be around ~40% of the remaining TLTRO III borrowings, as banks are motivated to exit their TLTRO III holdings confronting the zero gross margin DFR. The Liquidity Coverage Ratios (LCR) across the EU market remain high (~160% as of 2Q2022) and banks have been equipped with sufficient liquidity, therefore a large share of banks might repay even beyond their original excess take-up.

In order to streamline the framework, the minimum reserves would be remunerated at DFR instead of Main Refinancing Operations rate (MRO), acknowledging that the operational target is DFR. The central bank has cut the interest rate it pays on minimum reserves deposited by banks by 0.5% from its main refinancing rate to its deposit rate to align it "*more closely with money market conditions*".

Minimum reserve requirements (MRRs) have been remunerated at MRO, which is a relic from the time the ECB was operating a corridor system, steering rates to the middle of the corridor (at MRO rate). Paying the MRO rate for deposits that banks have to hold, makes sense when money market rates are close to that rate and liquidity allocated to banks in the ECB's refinancing operations was also priced at MRO.

Under a floor system, money market rates are closer to the DFR rate and banks no longer pay the MRO rate to borrow funds from the ECB (demand in MROs is zero for all practical purposes). So the change in the remuneration of MRRs is consequential, reflecting the fact the ECB is operating a floor system with the DFR as its operational target. In fact, by aligning the remuneration of minimum reserves banks are required to hold at the ECB from the refinancing rate to the deposit rate, the ECB ends a subsidy regime to banks, which would have amounted under current MRRs and a corridor (the spread) between the two of 50bps would save the ECB €840mln pa, on the €164bn of bank minimum reserves.

Unlike the change to TLTRO terms, this will now become a permanent feature of ECB policy, however. Still, this is somewhat good news for banks, in the sense that the remuneration rate could have been dropped lower, to 0%.

The repayment of TLTRO loans would be positive, since it was likely to free up more collateral and it had already lifted some money markets rates. By releasing the collateral tied up with these loans, early repayment by banks could bring money market rates up almost 0.5% towards the ECB's higher refinancing rate of 2%. EU's big banks have grown increasingly concerned about a lack of high-quality liquid assets in Europe's financial markets and the International Capital Market Association (ICMA), which represents the bond market's biggest traders, had urged the ECB to take action to address this.

The ICMA, which represents the bond market's biggest traders, said it had become concerned about the functioning of Europe's €10tn repo markets because of a scarcity of liquid assets, and excess liquidity in the region's banking system. ICMA's warning had come before ECM Meeting, amid fears climbing global interest rates and poor trading conditions that have heightened the risk of market instability.

"*Rising dysfunction in the market could imperil the transmission of monetary policy,*" ICMA wrote in a letter to the ECB's director-general of market operations, signed by division heads at BlackRock, Axa Investment Managers, Barclays and UBS, on October 25. ICMA warned "*pressures on short-term markets and collateral scarcity could be further accentuated*" by the October 27 ECB Meeting changes to its €2.1tn of ultra-cheap TLTRO loans to banks.

The collateral shortage concerns mostly German government bonds. Whether TLTRO repayments help with this shortage depends on how much German sovereign collateral has been posted at the ECB in the first place, and whether the banks that posted it do repay their loans early.

German collateral released by TLTRO repayments itself might not be much, but overall paying down the TLTROs can mean on aggregate less excess liquidity chasing the same high quality collateral so dearly in demand. This all adds to additional lending on repo announced by the German treasury to finance the energy support measures, further supply in 2023, and eventually quantitative tightening. More broadly, the age-old problem of collateral shortage is now a monetary transmission problem, suggesting the ECB would be keen to prevent the shortage from worsening.

Despite the fact that the ECB had already started discussing changes to its APP reinvestment policy prior to the October meeting, the forward guidance on APP re-investments has not changed. However, as the business case for APP (deflation risks have been receding) has become obsolete, President Lagarde suggested that the gradual adjustment to APP re-investments would be a topic for the December 2022 decision.

The TLTRO amendment bought time for the ECB before considering proper QT handling. QT discussion would be the next issue at the ECB's December meeting focusing on the reduction of the balance sheet on the path to normalization. While the language on APP reinvestment remained unchanged in the policy decision statement, President Lagarde did announce in the press conference that there would be a decision on the parameters of QT (without a decision about timing) in December. QT would in any case not take the form of outright asset sales, but rather a very gradual tapering of APP re-investments.

Madame Lagarde explicitly said that there would be a lag between the announced decision at the December meeting and QT’s eventual implementation. The ECB intends to start tapering APP re-investments in 2Q2023. Warning the markets in December should give the ECB ample time to assess the market reaction before finalizing decisions by March 2023. In 2Q2023 a reduction in the reinvestment of the private-sector programs is expected, to be followed by the PSPP in 3Q2023 and the PEPP in 2024.

Inflation outlook has given reason for ECB to proceed rapidly with QT, barring any deeper recession this winter, and therefore bring forward a tentative QT start to March 2023. A new TLTRO-IV would not be expected next year, although conditions and fragmentation in the bank funding market might still see the need for ECB support to more vulnerable banking markets, especially if credit growth stalls materially in 2023.

The ECB did not mention the TPI in the statement, but in response to a question on the TPI, ECB's President was clear the issue was not discussed at October 27 meeting, however the narrative around TPI might strengthen as we enter a period of passive QT at the start of 2023.

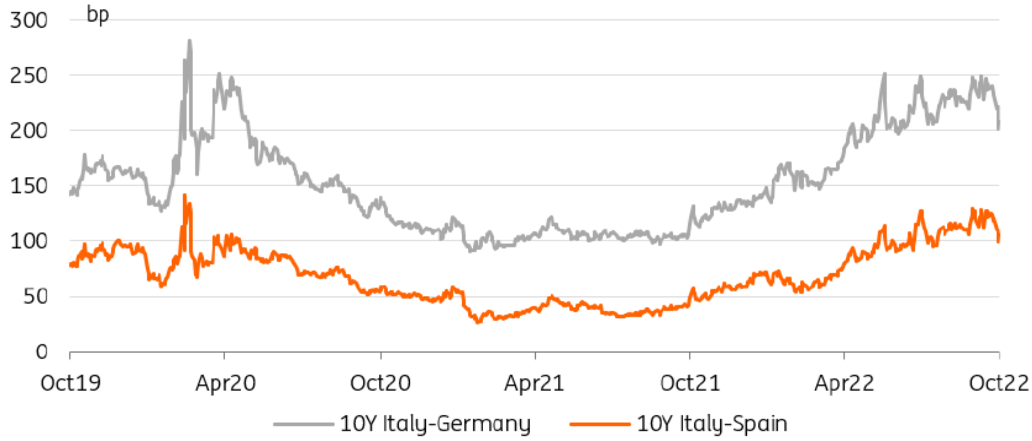
The economics outlook continues to darken, with the latest PMIs suggesting negative growth at the start of 4Q2022. The ECB did not present new projections, but President Lagarde acknowledged that the likelihood of a recession has increased. She furthermore pushed back against suggestions that we might be approaching the ECB's bear case scenario in the Q&A, which has 2023 growth at -0.9%Y compared to their 0.9%Y base case.

Several ECB policy makers have noted that a growth slump might do little to reduce inflationary pressures, meaning that the deteriorating outlook for GDP might have less of an impact on the policy path than one might otherwise expect. Growth concerns have been making a comeback as recession fears intensify.

On the market front, bond markets rallied and the euro fell as investors detected signs that the central bank was increasingly worried about a downturn and may stop raising rates earlier than expected. German 10-year yields fell to 1.95%, 24bps lower than their level ahead of the interest rate announcement. Riskier eurozone government debt rallied even more sharply.

The clearest dovish signal was that QT had not been discussed further at the meeting. A decision for the key parameters has been left for December with an actual start date for quantitative tightening to follow later. The ECB has not set itself on a preset course. The market’s reaction was clear with the yield spread of the 10Y Italian BTP bond vs. German Bund tightening by more than 10bps closer towards 200bps again.

Peripheral bonds are the main beneficiaries of an ECB perceived to be less hawkish



Source: Refinitiv, ING

After growing political criticism of the ECB's sharp tightening of monetary policy in October, President Christine Lagarde made clear on that rate-setters would not bow to such pressure, saying "*we have to do what we have to do*" to tackle inflation, which is now five times their 2% goal.

Italy's new prime minister Giorgia Meloni had said before the ECB meeting that tighter monetary policy was "*considered by many to be a rash choice*". Meloni's remarks came a week after France's president Emmanuel Macron warned he was worried about central banks "*smashing demand*" to tackle high inflation.

The latest rate hike provided further evidence of the extreme paradigm change at the ECB. A year ago, ECB president Christine Lagarde still said at a press conference that "*the lady is not tapering*". Since summer 2022, the ECB has conducted the most aggressive rate hikes in its history, despite a war in Europe, little signs of an overheating economy but rather indications of a looming recession and record high inflation, which is mainly driven by high energy and commodity prices.

The ECB, has woken up very late to the fact that even if inflation is driven by supply-side factors, too high inflation for too long could damage a central bank's credibility and plant the seeds for unwarranted second-round effects.

Post ECB October 27 events: Doves against Hawks

Italy's consumer confidence data for October released on ECB October Meeting day. It showed falls in all business sectors except services, taking it to the lowest level since March 2013. The question remains: whether the Italian economy managed to avoid a contraction in the third quarter.

The almost five-point fall in consumer confidence (i.e. from of 94.8 to 90.1) was driven by a steep decline in the difficulties people have in purchasing durable goods and saving for the future. The general worry about current economic conditions have been a big concern. The re-opening effect after COVID lockdowns, which helped consumption over the first half of the year and part of the summer, has coming to an end as confirmed by the steep fall of confidence among tourism businesses.

On the last day of October, the reported Eurozone inflation surged to a record high of 10.7% in October, keeping the pressure on the ECB to continue raising interest rates despite a sharp slowdown in growth in the third quarter. The increase in eurozone consumer prices accelerated from 9.9% in September, which was already the highest in the 23-year history of the euro.

It was the 12th consecutive month that inflation has set a record high in the eurozone, taking it to more than five times the ECB's 2% target. Hot inflation data again for Germany (11.6%) but also France (7.1%) and Italy (12.8%) clearly skew the risk to the upside for the eurozone.

Eurostat said energy prices rose 41.9% in October, up from 40.7% the previous month. Prices of food, alcohol and tobacco rose 13.1%, up from 11.8% in September. Eleven of the euro area's 19 countries had double-digit levels of inflation and in the three Baltic countries it remained above 20 per cent. However, inflation slowed in almost half the bloc's member states.

The closely tracked measure of core inflation, which excludes more volatile energy and food prices to give economists a clearer idea of underlying price pressures, rose 5%, up from 4.8% in September. In other words, inflation has not peaked.

Overall there has been clear evidence that the second round effects of the supply-side shocks to the economy keep pushing up inflation despite moderating demand.

The slightly more dovish tone at the ECB press conference on on October 27 indicated that such rate hikes as the 75bps, not to be a feature of forthcoming meetings, especially since a recession has been drawing closer. But the CPI data would provide more ammunition for the hawks to show that there is no need to make a sudden dovish pivot yet.

In summary, inflation cannot be fought effectively by monetary policy that has the most effect with a big lag. And hawks cannot expect GDP to keep surprising on the upside forever.

Since the last ECB Meeting the ECB has sought to distance itself from the idea that it was nearing a "*dovish pivot*" and Lagarde renewed her pledge to tame consumer-price growth. She told Irish broadcaster RTE's "The Late Late Show" on October 28 that "*defeating inflation is our mantra, our mission, our mandate*". Tweeting a quote from her interview, she said "that's why we have to raise interest rates, because we want to tame inflation."

The stronger than expected rise in eurozone inflation would likely to make it harder for the ECB to consider slowing or stopping its tightening of monetary policy anytime soon.

Klaas Knot, head of the Dutch central bank told at Dutch TV show Buitenhof on October 30 that a third 75bps increase "*would be possible, but it's too early to say*" despite a recession "*becoming more and more likely.... We will take a significant interest step again in December... We are not in even half-time yet*", Knot said.

"*We are still returning interest rates towards their neutral level, for which we will also need the December meeting.... From 2023 we will play the second half, with smaller interest rate steps and by shrinking our balance sheet... Then we will be in the zone where we will effectively cool down the economy, which is necessary to bring inflation down from 10% to 2% in the next 18 to 24 months*", the Dutch central bank president concluded.

Gross domestic product figures published the same day by Eurostat confirmed eurozone growth slowed in the 3Q2022, rising 0.2% from the previous quarter. The figure marked a slowdown from growth of 0.8% in the previous quarter. Growth accelerated slightly in Germany, but France, Italy and Spain reported sharp slowdowns.

It was a positive surprise for eurozone GDP. While cracks in the eurozone economy have been clearly showing, the economy continued to expand in the third quarter. In Germany, this was mainly due to the last legs of the consumer rebound, while in France consumption growth had already stalled. Investment was the positive surprise in France. Spain experienced fast slowing growth but the tourism recovery prevented the economy from going into the red in the third quarter. Consumer confidence has been near historical lows as real wage growth is at a multiple-decade low. Retail sales have already been trending down over recent quarters. The reopening of economies boosted services, but that effect is now fading. Economy is expected to contract over the coming quarters.

After the releases of eurozone CPI and GDP data, the bond rally on the back of the ECB meeting proved short-lived. Some of the ECB's better known hawks come to the fore to state that the ECB's next move would still have to be sizable – the Dutch central bank's Knot thinks December would be a decision between 50bps and 75bps. It is remarkable that the forward money market rate for December has actually tracked quite closely to 2% since mid-September.

Clearly, the ECB is now using a meeting-by-meeting approach. But the central bank would still have an eye on the longer rates, which Chief Economist Lane had pointed out were the more relevant rate for many corporates to determine financial conditions. France's Villeroy had suggested that the ECB could take into account among other things a forward real interest rate as a measure of tightening already delivered.

A good indicator is for instance a 5y5y forward real rate – after all the ECB had already had quite a fixation in the past on the 5y5y forward inflation swap – then this measure only turned positive late in August to reach 1%, but only to decline 50bps since early October again.

The ECB has been keen to see such a measure to relax already considerably before having clear evidence of inflation retreating more lastingly. The latest inflation data showed that the supply side shock has continued to ripple through to core and consumer price dynamics. A sustainable dovish rally in market rates would be materialized when ECB sees evidence of declining inflation first.

The rhetoric of ECB speakers after the upside surprise in eurozone inflation numbers was a development to follow.

On November 1, at an interview of Christine Lagarde, with the Latvian news outlet Delfi, she largely repeated October 27 policy message: "*Our mandate is price stability and we have to deliver on that using all the tools we have available... We are determined to do what is necessary to bring inflation back to our 2% target... The destination is clear, and we are not there yet,*" Lagarde said without specifying where rate hikes might end. "*We will have further rate increases in the future.... The longer inflation stays at such high levels, the greater the risk that it spreads throughout the economy,*" Lagarde added.

The same day, Germany's Joachim Nagel and Spain's and Spanish central bank chief Pablo Hernández De Cos, firmly reiterated that there is still a long way to go in tightening. Both gave a joint interview with Frankfurter Allgemeine Zeitung newspaper.

Both policymakers agreed that the ECB still had more to do with interest rates, after raising the deposit rate by 200bps points in three months. "*I am convinced that this is not the end of the rate hikes,*" Nagel said. "*There's still a long way to go.*"

De Cos also took a somewhat more cautions tone on rates but said he was convinced the ECB was not yet done. He also said an interest rate that is consistent with the ECB's 2% inflation target might still be a long way off.
Joachim Nagel told that the ECB should start shrinking its oversized pile of government debt at the start of next year, outlining an ambitious timetable for reducing an €8.8tn balance sheet.

Spanish central bank chief Pablo Hernandez de Cos, meanwhile cautioned against hasty action, calling for careful and "*very gradual*" steps because the ECB did not fully understand the implication of the balance sheet reduction.

Speaking on November 2 in Dublin, the Irish central bank chief Gabriel Makhlouf said officials would decide on what action to take on a meeting-by-meeting basis, based on incoming economic numbers. "*I'm going to sit there and look at the evidence, see what the data is telling us*," he said. Makhlouf also said the ECB will only begin QT in 2023.

On November 3, Eurostat reported that the eurozone unemployment continued to fall in September, dropping below 11mn people for the first time and taking the region's jobless rate to a new low of 6.6%, according to data published by the European Commission's statistics arm.

The same day, Bundesbank President Joachim Nagel has attended the Nueva Economía Fórum in Madrid, where he has spoken on various topics, including issues surrounding the energy crisis in Europe, high inflation and the digital euro.

He re-iterated that the ECB should hike interest further to bring inflation back under control. "*The ECB should not refrain from further hike rates, we need to increase them further to bring inflation down to our mid-term target,*" Nagel said. He did not however want to speculate when the path of higher borrowing costs would end and added that the euro zone was in a different situation to that of the United States.

The same day, Christine Lagarde continued to declare that a recession in the eurozone would not be enough to stop the ECB raising rates further, underlining policymakers' determination to quash inflation despite the risks to growth.

Lagarde attending a conference hosted by the Latvian central bank in Riga, Latvia, said said that a "*mild recession*" in the eurozone would not be enough to "*tame inflation*" on its own. A recession was not yet her baseline scenario for eurozone, but if it happened it would not be sufficient for the ECB to "*just let it roll out*" to bring inflation down to its 2%.

Her statements came hours after the US Federal Reserve dashed market expectations that it would soon pivot towards a less aggressive monetary policy stance. Lagarde said the ECB would be "*influenced by the consequences*" of the Fed's action, but it did not need to "*progress at the same pace or under the same diagnosis of our economies*".

Lagarde mentioned that the US economy had much stronger demand and an "*extremely tight labor market*" compared with the eurozone, where there is one unemployed person for every 0.3 job vacancies, unlike the US that has double the number of vacancies than jobless people.

Although, the ECB must pay attention to the U.S. Federal Reserve, which influences global markets, but it cannot just mirror its policy moves, Christine Lagarde said. But she pointed out that the ECB, could not simply mimic the Fed because economic conditions were different in the 19-country euro zone.

"*We have to be attentive to potential spillovers... We are not alike and we cannot progress either at the same pace (or) under the same diagnosis of our economies*", Lagarde said. She conceded the ECB was "i*nfluenced by the consequences*" of Fed action through financial markets and especially the euro's exchange rate. "*Clearly the exchange rate matters and has to be taken into account in our inflation projections,*" Lagarde said, repeating her commitment to bring inflation down to the ECB's 2% target.

The debate between ECB rate-setters has been intensifying ahead of December's meeting. Some are pushing for it to maintain the pace of rate rises to ensure inflation does not spiral out of control, while others warn it risks overshooting the amount of monetary tightening needed.

Speaking alongside Lagarde, Latvian central bank governor Martins Kazaks said rates needed to rise "*much higher*" and there was no need to pause the hikes at the turn of the year.

Fabio Panetta, an ECB executive board member - one of the most dovish ECB board members - warned in a keynote speech at the ECB Money Market Conference in Frankfurt am Main, on the same day. "*When calibrating our stance, we need to pay close attention to ensuring that we do not amplify the risk of a protracted recession or trigger market dislocation.*" He said residential property markets and non-bank financial institutions were among those areas "*vulnerable to adverse loops, with falling prices and rising rates feeding into higher debt refinancing costs, especially as falling real incomes make those costs less affordable*".

He also said week that wage pressures were so far contained but that the central bank needed to be "*extremely vigilant*". But the ECB expects growth in average wages to pick up from 4% in 2022 to 4.8% in 2023, reflecting tight labor markets, rising minimum wages in some countries and compensation for rising costs exacerbated by Russia's war in Ukraine.

France and Germany have raised the minimum wage several times over the past year and offered employers tax breaks for one-off payments to help staff cope with rising living costs. Unions have also been increasingly assertive on pay, with industrial action shutting down oil refineries in France in October and Germany's IG Metall has begun warning strikes as it has been seeking an 8% wage rise for almost 4mn workers.

Lagarde's point on Fed actions were also underscored by ECB board member Fabio Panetta and Bank of Italy governor Ignazio Visco. In his own speech, Panetta said the eurozone was more vulnerable than the United States to a global economic slowdown and higher energy prices, and that the Fed's tightening was already taking its toll, meaning the ECB needed to be cautious.

Specifically, he argued that the ECB should avoid raising interest rates too fast because that could excessively hurt economic growth, home prices and the financial markets.

"*If these bigger-than-expected increases are interpreted as signaling a higher terminal rate, rather than simply front loading the normalization, we could have a stronger impact on financing conditions – and ultimately on economic activity – than intended,*" Panetta said.

At an event of OMFIF's Institute for Economic and Monetary Policy ECB policymaker Ignazio Visco said that the ECB should not be expected to react in the same way as the Fed and backed market expectations for lower rates in the euro zone than in the United States.

"*I don't think that we should expect really to react (in) the way the Fed has done,*" the Bank of Italy's governor told the event. He also said market expectations for the ECB's deposit rate to peak at 3% next year were "*in the range*" once that rate was corrected for the inflation premium, putting it "a little bit below that".

His Portuguese peer Mario Centeno in an interview with Portuguese newspaper Publico, went even further by saying the ECB had already completed a large part of the rate hikes it sees as needed after 200bps worth of increases since July, which have left the deposit rate at 1.5%.

During a speech by Luis de Guindos, Vice-President of the ECB, at Energy Prospectives event organized by IESE Business School and Naturgy Foundation in Madrid on November 4, he said the ECB will continue to focus on dampening demand and capping inflation expectations to prevent the current, fast price growth from taking hold in the euro area. *"Monetary policy must remain focused on reducing support for demand and guarding against the risk of a persistent upward shift in inflation expectations,"* de Guindos told the event.

At a lecture by Christine Lagarde, organized by Eesti Pank and dedicated to Professor Ragnar Nurkse at Tallinn Estonia, on November 4, she signaled that the central bank was determined to do its part and called on the 19 governments of the euro zone to avoid fueling prices with overly generous spending.

Lagarde acknowledged the ECB's interest rate increases worked with a lag, but she argued policymakers did not have the luxury of waiting to see their full effect. "*If we were to see, for example, inflation becoming more persistent and expectations being at risk of de-anchoring, we could not wait until the full impact of the policy measures materializes... We would need to take additional actions until we are more confident that inflation will return to target in a timely manner,*" she said.

In an interview published by Politico later on the same day, Greek central bank governor Stournaras said there was a trade off between fiscal and monetary policy. "*If we want to bring down inflation under the current circumstances without much damage to financial stability and without the interest rates skyrocketing, monetary and fiscal policy cannot go in opposite directions,"* he said. *"If fiscal policy is very relaxed, then, unfortunately, that means that interest rates are going to the sky, which we don't want to happen."*

Greece's Stournaras also said in his interview he would have preferred smaller rate hikes and any move to unwind the ECB's €3.3tn euros bond-buying program should be "*cautious and gradual*".

What has complicated central bankers' decisions has been the fact that they have rushed so much toward policy normalization that they could not see the full impact of their decisions yet. It takes at least six to nine months before monetary policy changes have found their full way into the real economy. This time lag increases the risk of overshooting. At the same time, however, the stickiness of inflation over the last two years has also increased the risk that a premature end to tighter monetary policy would be insufficient in returning the inflation genie to the bottle.

On November 4, German industrial orders were reported. They plunged by 4% MoM in September, from -2% MoM in August. On the year, industrial orders were down by almost 11%. Since the start of the year, German order books have shrunk by almost 15%. The order book deflation, has sent a clear signal that the long slide into recession continues.

Industrial production data released on November 7, confirmed that the German economy stumbled but didn't fall in the third quarter. But the long slide into recession continues. In September 2022, industrial production excluding energy and construction was up by 0.7% MoM, compared with August 2022. The production of consumer goods was up by 1.4% and the production of capital goods by 1.1%

In more detail, the order book deflation has continued with monthly industrial orders dropping by 4% MoM in September; the seventh monthly drop since February. Exports dropped marginally in September. With export order books also shrinking, the outlook for exports has worsened. As a result of increased energy imports at much higher prices, the trade surplus has almost disappeared. While Germany was used to trade surpluses between €10bn and €20bn per month, the surplus has shrunk to a range of €1bn and €4bn.

During the first week of November, the German federal government and the 16 federal states agreed on a number of key measures and details on the €200bn aid package:

- The introduction of a €49 monthly transport ticket enabling travelers to use short-and-medium-distance public transportation nationwide. The exact timing of the introduction remains unclear.

- *Gas prices would be capped at €0.12/KWh, while electricity would be capped at €0.40.*
- *Households and companies would get one-off compensation (not payment) in December based on the gas invoice down payment (not actual consumption) in September.*
- *The federal government and state governments also confirmed that the state rent subsidy would be increased by an average of €190 a month and would be paid to 1.4 million more people than before.*

According to the government, the above measures amount to close to €90bn fiscal stimulus worth more than 2% of GDP. The problem with many of these measures, however, is the timing and implementation.

On November 7, Francois Villeroy de Galhau, France's central bank chief told the Irish Times that the ECB must not stop raising interest rates until underlying inflation has clearly peaked, but it may slow the pace of hikes once rates hit a level that starts to restrict growth.

"*As long as underlying inflation has not clearly peaked, we shouldn't stop on rates.... We are not far from the neutral rate, beyond which our hiking pace could be more flexible and possibly slower,*" he said.

Luis de Guindos told Politico in an interview published on November 8, ECB would start the QT process "*sooner or later, for sure in 2023*", adding that the bank would continue to raise interest rates to bring inflation back in line with its definition of price stability.

"The characteristics and the timing of our (quantitative tightening), which may overlap or not with the process of normalizing the interest rates, will be discussed in December," he said, adding that the ECB would proceed with a lot of prudence and caution and should start by "*not fully reinvesting the maturing securities in our portfolio*" - as the Fed is doing - rather than actively selling some bonds as the BoE has started to do.

Luis de Guindos said tackling inflation required rates to keep rising to tighten financing conditions. *"It will reduce aggregate demand, both consumption and investment.. But it's the only possible way forward that we have because doing nothing would be much worse*." He also left the door wide open for another jumbo 75bps interest rate hike at the upcoming December policy meeting.

The remarks from de Guindos, who has been widely perceived as a centrist on the ECB's Governing Council, came as the bank has faced criticism from leaders like French President Emmanuel Macron and Italian Prime Minister Giorgia Meloni, who have expressed worries over the speed at which the ECB is raising rates and the implications this may have on growth.

Last month, Italy's prime minister Giorgia Meloni said that tighter monetary policy was "*considered by many to be a rash choice*", while French president Emmanuel Macron warned he worried about central banks "*smashing demand*" to tackle inflation.

Nagel speaking at at the Deutsche Bundesbank's symposium "Banking supervision in dialogue", Frankfurt am Main, he said large rate hikes were necessary.

"I will ... do my utmost to ensure that we, the Governing Council of the ECB, do not let up too early and that we continue to push ahead with monetary policy normalization - even if our measures dampen economic development," adding large rate hikes were necessary. "*Because in a situation where monetary policy gets behind the curve, the overall economic costs would be significantly higher,*" Nagel said.

The same day, at the hawkish end, Belgium's Pierre Wunsch making his remarks to an audience at the Geneva Graduate Institute, stated the ECB may need to hike more than markets expect if the economic downturn remained mild. Such hawkish signaling might be motivated by real rates having failed to rebound from their late October slump.

"*Our monetary-policy response will ultimately depend on the severity of the coming economy slowdown. If the slowdown is shallow and accompanied by a further rise in inflation - and inflation expectations - real interest rates will have to move above market consensus*" of 3%.

An alternative scenario would be one where "*the slowdown is more severe and leads to lower inflation, leaving expectations broadly moored,*" said Wunsch. His base case is for a recession that won't be "*very deep*" because of fiscal support.

Wunsch said that the severity of an economic contraction may ultimately depend on the tussle between employers and their staff over wages. "*Workers and firms still have to agree on who foots the bill for higher energy prices,"* he said.

"Both have market power, and it may take a few iterations, or worse a deeper recession, before they can agree on how to share the burden." He added that employees have taken "*most of the hit so far*." "*Like others, I am not sure bygones are bygones, and therefore expect the pass-through of inflation to wages to increase in the coming months,*" he said.

The governor said that while he and his colleagues can try to look at prior energy crises in the 1970s and 1980s for guidance, "n*either the models nor the references to the oil shocks are valid*" right now. "*Policy-making is becoming a matter of faith*," he said. "*Informed faith -- but faith nonetheless*".

A modest increase in eurozone retail sales by 0.4% MoM in September was reported on November 8. It was a disappointing third quarter in terms of consumer spending. The consumer in general has started to reign in spending as the cost-of living crisis continues and reopening effects from the pandemic fade. The effect of inflation is very apparent in retail sales as consumers bought -2.6% lower volumes in September than in June of last year but have spent 8.1% more. Netherlands and Germany led the way with 1.3 and 0.9% MoM increases respectively, while France, Italy and Spain all saw more or less stable retail trade compared to last month.

In YoY terms, the overall result was lowered by a 2.4% fall in the sales of food, drinks and tobacco and a 0.3% decline in sales of non-food products, which was not offset by a 3.7% increase in the sales of fuels for cars.

The outlook for retail sales has remained bleak. While that is not necessarily a strong predictor of household consumption, movements as pronounced as this have always been associated with a contraction in consumption.

On November 10, three of the ECB's most outspoken policy hawks called for raising interest rates to a level that weakens growth in order to curb high inflation.

Isabel Schnabel, the leading voice among policymakers who favor higher borrowing costs, picked up on the higher persistence of inflation in her talk on November 10, while pointing out that the risk of inflation expectations de-anchoring remains. There is no time for complacency and rates will likely have to move into restrictive territory to rein in inflation. Neutral won't cut it, even as the probability of a recession in the euro area increases.

She told an audience at the Bank of Slovenia in Ljubljana that the ECB should press ahead and likely reach "*restrictive territory*". "*There is no time for monetary policy to pause... We will need to raise rates further, probably into restrictive territory to bring inflation back to our medium-term inflation target in a timely manner.*"

"*It's clear that the risk of a recession has gone up, given the data that we've seen.. There's the impression that if there's a recession, this recession probably is not going to be very deep and not very prolonged,*" Schnabel said. This means it may "*not be sufficient to bring inflation down as much as is needed in order to get back to our inflation target over the medium term*," she said.

Schnabel pointed out that "..*only a deep recession with a sharp rise in unemployment could be expected to significantly dampen inflation pressure... This is currently unlikely, not least due to the robust labor market, large excess savings and the massive fiscal support*."

The Slovenian central bank's governor Bostjan Vasle, and his Slovak counterpart Peter Kazimir repeated her prediction moments later on the same panel.

"*What's needed in my opinion are further increases in interest rates, and here we'll most probably have to go beyond the levels which are currently understood as neutral rates,*" Vasle said. Vasle called for the ECB to start unwinding its multi-trillion-euro bond holdings next year as part of its fight against inflation.

Kazimir agreed, saying the time for accommodative monetary policy was over. "*We'll have to go further, more to the restrictive part,*" he said. He also said euro zone governments were spending too much to support households through the energy crisis, adding to already excessive inflationary pressures. "*The measures adopted at present are often far from the transitory and targeted interventions we would like to see,*" Kazimir told the event.

At the end of the day, Bundesbank President Joachim Nagel made similar remarks when colleagues of a normally similar hawkish persuasion were out in force. Nagel said in a speech in Ettlingen, Germany that the ECB must take clear steps to bring down record-high inflation. "*We must act decisively,*" adding that he sees the prospect of more interest-rate hikes.

He also renewed his call for a reduction of the ECB's balance sheet, which includes almost €5 tn of bonds bought during recent crises. "*The question increasingly arises as to why the development of bond yields in the euro zone is being braked by the reinvestment policy,*" he said. "*I find it inconsistent to move short-end rates in one direction and longer-end rates in the other direction. When you have two policy normalization tools at hand, it doesn't make sense to use just one of them.*"

Nagel's comments likely represent a call on the ECB to start unwinding those bond holdings - legacy of a decade spent trying to boost inflation when it was too low - even before its last rate hike, which the market expects in the summer. The ECB said it would begin discussing how it reinvests proceeds from bonds that mature (key principles of QT) at its Dec. 14-15 meeting.

Nagel warned that inflation in German is likely to average above 8.5% this year and above 7% in 2023. He also predicted an economic contraction during 4Q2022 and in the first three months of 2023.

On Friday November 11, Spanish central banker Pablo Hernandez de Cos told Bloomberg TV's Maria Tadeo at an event in northeastern Spain that the ECB might announce the start date for a reduction of its balance sheet at its December meeting.

"*It will depend if we see the need in December to announce that date... Whether we are clear about the need to start the process right away or not necessarily.*"

On hiking rates further, he said that "*...the fact that we have raised rates by 75bps… does not mean that this will be the future pattern, it will depend on the data*", re-iterating a policy cautious stance.

Luis de Guindos speaking at XXVII Encuentro de Economía en S'Agaró organized by Fundació Internacional Olof Palme in Frankfurt, he mentioned that financial investors might be underestimating the "*persistence of inflation*", as he listed possible risks to financial stability. He added there needed to be a clear deceleration in headline and underlying inflation for expectations about future ECB interest rate hikes to stabilize.

Robert Holzmann governor of the Austrian National Bank, among the ECB's most hawkish officials, told an economic reporters' club in Vienna the same day that he does not yet know how he would vote at the ECB's December meeting and the exact decision would depend on data, especially the central bank's economic forecasts.

"*Everything is possible - that we keep going with (a) 0.75% increase but equally that we perhaps will limit ourselves to 0.5.% It is all open, everything is possible but it will depend on our forecasts,*" Holzmann said.

Fabio Panetta among more dovish ECB Governing Council members, speaking at CEPR-EABCN euro area business cycle dating committee conference on 'Finding the Gap: Output Gap Measurement in the Euro Area' in Florence on November 14, said that the ECB must keep raising rates but needs to avoid over-tightening as that could destroy productive capacity and deepen an economic downturn.

"*If we were to compress demand in an excessive and persistent manner, we would face the risk of also pushing output permanently below trend. For as long as inflation expectations remain anchored, monetary policy should adjust but not overreact. The uncertainty surrounding supply and demand dynamics requires us to remain prudent as regards how far the adjustment needs to go,*" he said.

In a notable concession to policy hawks, Panetta argued that tightening could even reach a level where the ECB would restrict growth, but this needs solid justification.

"*Being prudent does not rule out the possibility of us having to move from withdrawing accommodation to restricting demand. But in the absence of clear second-round effects, we would need convincing evidence that the current shocks are likely to keep having a more adverse effect on supply than on demand*," Panetta concluded.

Cypriot policymaker Constantinos Herodotou, meanwhile, told Greek newspaper Naftemporiki, that a slowdown in the pace of hikes could soon come. "*The closer we are to the neutral range of interest rates ... the rate of increase in interest rates may need to be adjusted to ensure that we have sufficient evidence from the real economy over the effects of monetary policy,*" he said.

The same day, ice President Luis de Guindos during the closing keynote speech at the opening conference of the 25th Euro Finance Week in Frankfurt, he pointed out that eurozone wage growth may finally be picking up but longer-term inflation expectations are still anchored around the European Central Bank's 2% target.

"*Incoming wage data and recent wage agreements indicate that wage dynamics may be picking up, which warrants continued monitoring. However, to date, inflation expectations have remained anchored,*" de Guindos said.

De Guindos added that the ECB would continue to raise interest rates, proceeding "*with prudence*", to get inflation back to target, even if this process takes an "*extended*" period.

Industrial production data were released the same day. Eurozone industry production increased by 0.9% in September and that resulted in a total quarterly increase of 0.5% for 3Q2022. Production categories were a mixed bag, so there was no broad-based improvement. Capital goods and non-durable consumer goods production saw strong growth while intermediate, durable consumer goods, and energy production all declined. Germany was the only large country that recorded growth, while France, Spain and Italy all saw production contract.

But businesses continue to report falling new orders as demand is fading and inventories have increased. Weaker production for winter months as the catch-up effect for production is unlikely to last much longer.

The ECB's biannual Financial Stability Review (FSR) was held in Frankfurt on November 16. The FSR provides an overview of potential risks to financial stability in the euro area. It aims to promote awareness in the financial industry and among the public of euro area financial stability issues. It is published twice a year.

The FSR said that there is an 80% chance that the euro area will enter a recession. Furthermore, the report also raised concerns that firm and household defaults are likely to occur, owing to fragile balance sheets, rising interest rates, and a tightening of financial conditions.

The ECB also warned that vulnerabilities might materialize simultaneously and possibly reinforce each other. The ECB warned of rising stability risks for everyone from lenders to governments and households as the economic outlook darkens and officials battle record inflation. The cost-of-living squeeze is hurting people’s ability to service debts, while Europe’s worsening growth prospects threaten corporate profits.

Banks, meanwhile, might have to set aside more money for bad loans next year, according to the ECB. It cited “*a further sharp deterioration in the economic outlook*” and, to a lesser extent, higher expected short-term interest rates.

It also flagged potential dangers to public finances as governments borrow to cushion the impact of the energy crisis, further downward pressure on equities and said house prices may be peaking after a years long advance.

Following large expenditure during the COVID-19 pandemic, euro-area governments have spent the equivalent of about 1.4% of output to soften the impact of the energy shock, according to ECB estimates. It warned that “*most of these measures are untargeted,*” doubling down on advice that aid should be temporary and aimed at those those most in need.

In indirect hint was mentioned by the report on the fragmentation issue. “*The increase in interest rates is weighing more heavily on fiscal positions than previously anticipated. As such, a further* *deterioration in financial conditions could change market sentiment toward some of the more vulnerable euro-area sovereign issuers*."

In addition real estate markets might be "*at a turning point*" as the rise in borrowing costs dents demand for new loans. "*There are signs that the real-estate expansion of recent years could come to an end, with overvaluation estimates and mortgage rates now standing at their highest levels in more than five years. Similarly, financing conditions in commercial real-estate markets have tightened, potentially reversing the post-pandemic recovery*," ECB said.

ECB Vice President Luis de Guindos speaking at the FSR presentation said that risks to the eurozone's financial stability are on the rise as the economy heads for a likely recession so any reduction in the ECB's bond holdings is likely to be gradual to keep markets calm.

The ECB must prioritize its fight against high inflation because that will in turn improve the currency bloc's overall financial stability, Guindos said. "*It's very difficult to have financial stability without price stability,"* he told a news conference. *"I think that the main risk now for financial stability, for growth, is to have inflation at very high levels.*"

"*Risks to financial stability in the euro area have increased amid soaring energy prices, elevated inflation and low economic growth. All of these vulnerabilities could unfold simultaneously, potentially reinforcing one another,*" the ECB said in the FSR text.

Guindos said that any cut in the bank's pile of mostly government debt is likely to be gradual and "*passive*," meaning some bonds will be allowed to expire but none would be sold. "*My personal view is that QT has to be implemented with a lot of prudence. The exercise of QT is much more delicate as we have more limited experience than in the case of increasing rates, so I think we will start, and this is my personal view, with passive QT,"* he told news conference.

"*While the banking sector has recently seen a recovery in profitability as interest rates have risen, there are incipient signs of asset quality deterioration, which may require larger provisions. High levels of government debt following the pandemic, paired with tighter funding conditions, limit the scope for fiscal expansion measures that do not trigger risks to debt sustainability"*" the ECB's FSR text added.

His remarks, was a response to critics by politicians comments on rapid rate hikes by the ECB that have been fueling market volatility and exacerbating a downturn, so the ECB's own actions might be harming stability.

Bank of Italy Governor Ignazio Visco, said in a speech ["Ugo La Malfa lectures"] at the Italian Chamber of Deputies in Rome that the ECB must continue to raise interest rates but there has been a growing case for increased caution in policy tightening after a string of aggressive moves.

"T*he need to continue with restrictive policy is ... evident, although reasons to follow a less aggressive approach are gaining ground*". He warned of the risk of policymakers being set on a pre-determined path and said future monetary policy decisions must be based on data and evidence.

Visco, who has been among the more dovish ECB officials, pointed out that threats to financial stability have increased and the macroeconomic scenario has deteriorated in many countries. "*There's a risk that excessively quick and large rate hikes could amplify and slow economic activity, bringing price dynamics well below target*," Visco said.

For this reason any decisions taken by the ECB need to be pondered with the "*utmost attention, without formulating ahead of time more or less realistic routes to follow*," he said.

Spanish central bank chief Pablo Hernandez de Cos speaking at the Annual Convention held by the Asociación de Mercados Financieros in Madrid, the same day, also sounded caution, arguing that even if there was "some way to go" with rate hikes, any reduction in the ECB's balance sheet must be "very gradual".

He said the central bank must also take into account a higher probability of a recession and should keep in mind that a rapid reduction in bond holdings could trigger market volatility. "*All these arguments point, in my view, to the need for the balance sheet reduction in the euro area to be very gradual and predictable,*" he said.

De Cos also argued that the ECB should first absorb the impact of commercial banks repaying ultra cheap funding to the ECB over the coming months before it stops fully re-investing expiring debt.

The day continued with Bank of France's governor Francois Villeroy de Galhau stattements. He spoke at the French German Business Forum in Paris. He said that the ECB would probably raise interest rates again in December to a "*normalization range*" of around 2% to combat surging inflation. The central bank would likely to continue to raise borrowing costs beyond the end of this year, though it may be "*more flexible and possibly less rapid*," he said. "Jumbo rate hikes will not become a new habit," the governor said.

He strongly committed to inflation target and timing. "*Faced with persistent inflation, we have therefore demonstrated our resolve to bring it down to our target level. Let me reiterate here what is not only our forecast, but also our commitment and our capacity: together with the Governing Council, alongside Christine Lagarde, we are going to bring inflation down to 2% within two or three years.*"

Madis Muller, a hawkish ECB official who heads Estonia's central bank speaking to Bloomberg TV in Tallinn he re-iterated that the central bank should deliver another "*substantial*" increase in interest rates in December. "*It's clearly necessary to continue raising interest rates. I think that the December decision should still mean a substantial additional increase in interest rates.*" Muller said he'd consider moves of 50 or 75 basis points to be substantial.

In conclusion, November 16 was a turning point date. ECB officials appeared to have dialed down their hawkishness. When arch-hawk Holzmann of the Austrian central bank has been mindful that too strong tightening would not just lead to stagnation but to a recession, then markets should take note.

The ECB's shift was later in the day corroborated by a Bloomberg story suggesting that momentum for a further 75bps move was lacking. That the ECB could eventually slow once the key rate approaches a neutral level – seen around 2% – has not been news. With a view to the December meeting the ECB's hawks might ask for more progress on QT in return for less aggressive action on rates. The tightening of monetary policy could thus just rely to a growing degree on the balance sheet.

According to Bloomberg news, ECB policymakers might slow down interest-rate hiking with only a 50bps in December. Initial discussions suggested a lack of momentum for another 75bps move the sources said, declining to be identified because Governing Council deliberations are private.

Among the reasons cited have been mounting recession risks, the possibility that consumer-price pressures would weaken, and the prospect that a 50bps move in the deposit rate to 2% would reach close to a so-called neutral level that no longer stimulates the economy. The need to bargain over a start to balance-sheet reduction was also cited.

But with a month to go before the ECB's final decision of the year on Dec 15, officials still have plenty of time to make up their minds. Against a backdrop of market expectations for a 50bps hike, hawkish policymakers haven't tried much to counter that view by insisting on a third consecutive increase of 75 basis points.

On November 17, the final release of October eurozone inflation was 0.1% lower than the flash, at 10.6% YoY. Core, meanwhile, printed unchanged at 5.0% YoY. Underlying inflation showed no respite. Euro-area inflation has been accelerating. Furthermore, inflation continues to broaden, with an increasing number of items exhibiting YoY inflation of more than 2% This is unlikely to be welcome news for the ECB.

By the end of the day, a regional wage agreement in Baden-Württemberg would pave the way for broader wage developments and showed the ECB that second-round effects would kick in next year but should be dampened.

Employers and unions in the metal and electronics industry in Baden-Württemberg reached a new wage agreement. Wages would be increased by 5.2% in June 2023 and by 3.3% in May 2024. There would also be a tax and social security contributions exempt, one-off payment of €3,000. While this is a regional wage agreement, it would have knock-on effects on other regional and sectoral wage negotiations. Almost four million people in Germany work in the metal and electronics industry.

The deal should reduce the risk of large second-round effects, where supply-related cost rises begin to have an impact on wage demands and other prices. For the ECB, it signals that second-round effects remain dampened and that a lower, subdued inflationary pressure can last for longer.

On November 18, Christine Lagarde maintained the hawkish tone by delivering a speech at the European Banking Congress in Frankfurt. She said interest rates may need to be lifted to levels that restrict economic expansion in order to drive down inflation that's rocketed to more than five times the official target.

Her remarks went some way to undermining hope, which has supported government bond prices this month, that central banks around the world, and particularly in the United States, are nearing the end of their interest rate hikes.

Lagarde said that the "*risk of a recession*" has increased, but that a downturn on its own won't be sufficient to tame soaring prices. "*We expect to raise rates further and withdrawing accommodation may not be enough. Ultimately, we will raise rates to levels that bring inflation back down to our medium-term target in a timely manner.*"

But after the two 75bps hikes, the appetite for such jumbo moves might be waning, especially as forecasts point to a winter recession for the eurozone. Internal discussions have suggested a 50bps hike might be more likely at the December 15 meeting, so long as November's inflation reading doesn't produce another upside surprise.

"*Inflation in the euro area is far too high,*" Lagarde said. "*Historical experience suggests that a recession is unlikely to bring down inflation significantly, at least in the short run.*"

On QT, the president reaffirmed key principles that would apply and would be laid out in December. "*It is appropriate that the balance sheet is normalized in a measured and predictable way,*" Lagarde said.

This indicated that the ECB has plans to start shrinking its €3.2tn APP in a gradual way in 2023 by steadily increasing the amount of maturing securities that it would not replace via new purchases.

Bundesbank President Joachim Nagel and Dutch central bank Governor Klaas Knot also spoke at the conference. Both made the case for lifting the ECB's 1.5% deposit rate into "*restrictive*" territory, a level commonly seen as above 2% where the bank puts a brake on growth.

They also argued for the need to start winding down the bank's massive pile of government debt, hoovered up over the past decade when the ECB was still fighting anemic inflation.

But the comments also contained plenty of nuance, which some saw as signaling a potential compromise between conservatives, who are pushing for rapid tightening, and a small number of policy doves, mostly from the bloc's southern periphery.

The ECB still has a "*long way*" to go before interest rates peak, as inflation could also take an extended period to come down, Klaas Knot said. "*We still have a long way to go,*" Knot said when asked where rates could peak.

"*As the stance of monetary policy tightens further, it will become more likely that the pace of (rate) increases will slow,*" he said. "*As long as we are confronted with monthly upward surprises in inflation, as long as measures of underlying inflation are picking up 0.2%, 0.3% every month, I'm more worried about us doing too little, than I am about us doing too much,*" he added.

A slowdown after back-to-back 75bps hikes would not be a surprise, but the comments from a key hawk - Joachim Nagel - have been still likely to temper rate hike expectations.

Bundesbank President Joachim Nagel continued to insist on continue taking "*decisive steps*" on interest rates. "*It would be wrong to hold back on further decisive steps for fear of a downturn. The Governing Council has made important steps on the path of monetary-policy normalization. But we cannot stop here.*"

"*If high inflation threatens to become entrenched, we must resolutely raise our key rates further and adopt a restrictive stance,*" he said. "*If we don't act decisively now, we run the risk of having to tighten monetary policy all the more later.*"

Nagel Nagel also renewed his push for beginning the bond run-off at the start of 2023, an earlier date than advocated by most others, suggesting that more modest rate hikes could be coupled with a quicker start of quantitative tightening. "*We should start reducing the size of our bond holdings at the beginning of next year by no longer fully reinvesting all maturing bonds. The additional tightening would help to bring inflation down. And it would underline our strong determination to bring inflation back to our target.*" , Nagel said.

A compromise has been taking shape focused on the balance sheet reduction, even if the ECB has been set to maintain its bias for over-tightening. The grand bargain between hawks and doves in the ECB Governing Council has been shaping up ahead of the December meeting, which could mean slower hikes in exchange for earlier and/or faster QT.

Knot also advocated a quick start to QT process, arguing that it would cut inflation and lower the required peak interest rate to control price growth. Still, ECB chief Lagarde said rates would remain the ECB's primary policy tool and the balance sheet run off is more likely to take place in the background.

ECB's Chief Economist Philip Lane speaking in an interview published on November 21, by Market News International (MNI) said that the central bank would raise interest rates again in December and next year to fight inflation but those increases may well be smaller than the most recent ones.

"*One platform for considering a very large hike, such as 75bps, is no longer there. The more you've already done on a cumulative basis, that changes the pros and cons of any given increment*", he said.

He continued saying that the ECB was not about the pause its hiking cycle but "*to move at the appropriate time to smaller increment I don't think we're going to be on a meeting-by-meeting basis interconnecting the interest rate decision with the pace (of bond re-investments) for the next month or two. It should be probably more mechanical than that*", Lane said.

Regarding inflation next year he said the outlook for 2024-25 was more mixed. "*For those years the forecast will have to balance the fact that inflation has a knock-on effect, for example, on the wage mechanism. But on the other hand, we do have the fact that the financial conditions are far different than what we had going into the September forecast.*"

Philip Lane's view appeared to coincide with Mario Centeno's statements at a conference in Lisbon, later in the day. Asked whether he thinks the ECB should raise interest rates by less than 75 basis points, Centeno said: *"I don't like to talk about increases before (meetings)...(but) I think there are conditions in place - many conditions - for the increase to be less than that number*".

On the inflation front, Centeno who has been among the more dovish officials emphasized that "*We have to invert this tendency of inflation so that we can have more predictability of monetary policy in the next few months*". He also called for restraint in wage increases and company margins as this "*could help the ECB a lot in combating inflation*".

And he continued by making remarks on QT. "*We have a wide set of instruments at the ECB. The interest-rate instrument is the preferred instrument to fight inflation. When inflation reaches its peak and its trajectory becomes predictable, other instruments may come to be used. We have to reduce the size of our balance sheet*."

Francois Villeroy de Galhau speaking during an interview with France 5 television, said that inflation should reach its peak in France and in eurozone by the first half of 2023. Villeroy added that inflation should be back to ECB's target around 2% by two or three years.

The saga of public statements went on the next day, November 22. Finnish ECB policymaker Olli Rehn addressing Finland's Parliament about the state of European and Finnish economy amid the energy crisis stemming from the war in Ukraine, he said that the ECB would continue to raise interest rates, and the pace of its hikes would be determined by the rate of inflation and the overall economic situation.

Joachim Nagel in his turn opened the door to smaller interest rate increases but said there was still a long way to go in raising borrowing costs. Nagel, among the ECB's hawks who generally favor higher rates, told journalists in Frankfurt: "*Even 50 basis points is a strong rate move. I didn't participate in this 75-or-50 discussion because I didn't think that was really helpful,*" Nagel said.

Nagel backed using market prices, rather than economic models, given the current, uncertain prospects. "*Regardless of how the numbers come in, I think the inflation picture will continue to be strong for 2023. And possibly even in 2024, we still won't be where we actually want to be, which is back near 2%,*" he said.

He added that Germany was likely to experience a mild recession next year and that he didn't expect the Bundesbank to need a taxpayer bailout as a result of the large interest payments it has to make and on the losses on the bonds it bought on the ECB's behalf. He reaffirmed his call to start shrinking the ECB's bond holdings early next year.

Clemens Fuest, the head of Germany's Ifo economic institute told Reuters that the ECB would certainly raise its interest rates considerably, though how far it ultimately goes would depend on how the economic situation develops. "*The ECB still has quite a long way ahead of it. That's simply because it just started late.*"

On the German economy Fuest was optimistic about its prospects. He said could possibly face a mild recession if a gas shortage is avoided this winter. "*We also see that industry is coping surprisingly well - at least in the short term - with the energy shortage and the high energy costs.*"

He indicated that de-industrialization should be a serious concern for Germany in the long term, especially in energy-intensive companies, as it loses out to more attractive locations. Other burdens, including a shortage of skilled workers and protectionism would also increasingly come into play, he added.

Governing Council member Gediminas Simkus at an interview with WMI on the sidelines of an Austrian National Bank conference in Vienna said that the ECB must lift interest rates by at least 50bps in December to tackle record inflation. He considerd a larger move up to 75bps still an option.

"*It's clear that 50bps is a must,*" the Lithuanian central bank chief said. "*Because we still see very strong inflation pressures and we need to dampen them as soon as possible to prevent a de-anchoring of inflation expectations. 75 is also possible*." Without seeing the updated inflation and economic-growth projections, which will offer a first glimpse at 2025, "*it's a bit premature to make judgments,*" he said.

Like several of his Governing Council colleagues, Simkus indicated that an economic contraction won't significantly alter the ECB's course, saying "*I don't think it's going to be deep and I'm sure that the recession on its own will not solve the inflation issue.*"

"*We're not driven by the number of meetings at which we need to achieve a terminal interest rate. What we need is the result, which is 2% inflation in the medium term. And if needed, we'll go beyond March. That's absolutely clear for me,*" he said.

With an announcement on the basic principles for reducing the size of the ECB's bond portfolio expected following the December meeting, Simkus said it should be "*should be prudent, it should be cautious, not hasty, but rather sooner than later.*"

There are various options for tightening, Simkus said, pointing to the likely starting point of ceasing to reinvest bonds acquired under the APP, and, at some point later, doing the same with the PEPP. "*Excess reserves and excess liquidity is substantial in the banking industry, and this is something that may well end up also in discussions in the Governing Council. But at the moment, in this very stormy, gloomy, uncertain environment, I don't think we should pre-commit too much.*"

Robert Holzmann, head of the National Bank of Austria at an interview with Financial Times in Vienna, backed a third straight 0.75% rise in mid-December. His comments underlined the potential for a clash at the next meeting, with policymakers split between keeping up the pace and switching to smaller increases on the back of signs of a recession.

Holzmann said that he could "*see no signs that core inflation is reducing*" in the eurozone and he expected only a "*flattening out of growth, or a mild recession*", rather than a deep downturn. Another big rate rise "*would give a strong signal about our determination. It would tell businesses and trade unions we are serious so don't underestimate us, be careful," he said.*

Holzmann said interest rates could have to rise to the point where they "*caused pain*", but he added "*hopefully it won't come to that*". He said it was important to raise rates "*early*" to stop businesses and households betting that high inflation would endure. "*Afterwards the pain is much, much larger,*" he said.

But Holzmann added he was still "*open to changing my mind*" based on the ECB's new quarterly economic forecasts, being released on December 15.

Holzmann said there were no signs of a 1970s-style wage-price spiral. "*I have not heard messages from industry in Germany and Austria that they fear that 'OK if we get these wage increases we need to pass them on',*" he said.

On QT, Holzmann said this could start before it had finished raising rates, adding that it was important to avoid short-term borrowing costs rising above long-term ones. An inverted yield curve, would be a challenge for Europe's banking sector, which relies on being able to borrow cheaply in the short term to make longer-term loans at higher rates. "*We have to make sure it doesn't get to that point,*" Holzmann said.

On November 23, the eurozone composite PMI data were released. It came in at 47.8 in November, slightly better than in October but nonetheless confirms a contraction in the business economy. Overall demand continued to decline as consumers cut spending amid a cost of living crisis, according to PMI a survey.

While the eurozone economy still showing positive growth in the 3Q2022, the recession has started in the 4Q2022 and PMI figures confirmed that. The slight increase in the PMI was mainly driven by the manufacturing PMI, which saw an uptick from 43.8 to 45.7. New orders continue to decline. The pace of decline in services was similar to October. New orders continue to decline here too, and businesses are becoming increasingly reluctant to hire on the back of sluggish economic activity.

The same day, ECB Vice-President Luis de Guindos at the opening speech of XXIX Encuentro del Sector Financiero "Retos y oportunidades de un sector en transformación" organized by Exploited in Madrid, said that the ECB would keep raising interest rates until it brings inflation down to around its 2% mid-term goal even though the euro zone economy has been heading towards recession.

He said that the magnitude of next interest rate hike in December it would depend on upcoming ECB projections and inflation readings on November 30. "*I can tell you that our approach will always be the same, we will continue to raise interest rates to a level that allows us to ensure that inflation converges towards our definition of price stability,*" De Guindos said.

De Guindos said that inflation would remain around current levels of around 10% in the coming months, adding that the persistence of inflation pressures should not be underestimated. "*It is very important to look at the evolution of underlying inflation and possible second round effects because they will determine the response of monetary policy.. We also believe core inflation will be high in coming months.'*" De Guindos said.

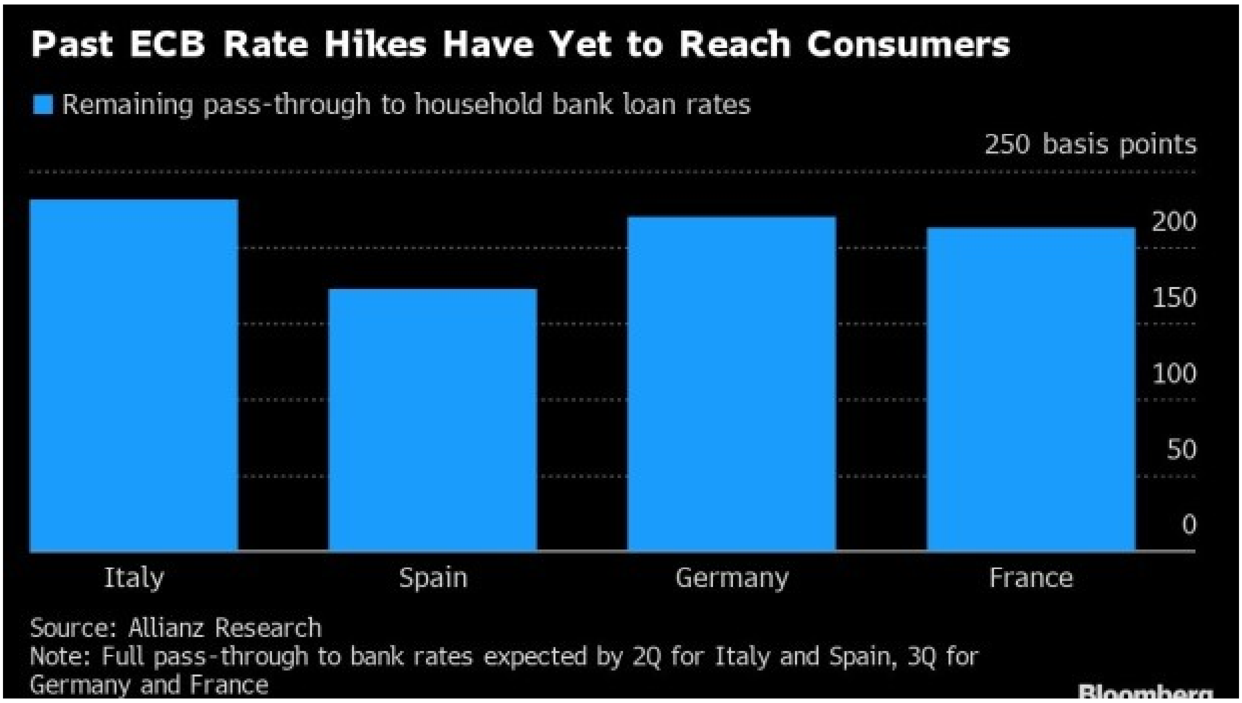
ECB policymaker Mario Centeno said in an interview at Reuters that ECB should slow the pace of interest rate hikes from December and send a clear message that 75bps increases are not the norm, as inflation would likely to peak in 4Q2022.

"*We are nearing rate levels that we consider compatible with price stability in the medium term, which means that the idea that 75bps are the norm cannot materialize. It's important to end this cycle of increases in a credible fashion, and more important than the (rate hike) number itself is to* *transmit this narrative to the public … We are really efforting to transmit that predictability about the future and I expect the December meeting to be very clear on that*," he said.

Centeno said inflation data suggested inflation would peak the last quarter of 2022. He cited World Bank estimates that prices for energy, minerals, food and fertilizers would decline next year. In his view, high inflation is not entrenched in Europe and there are no second-round effects from wage increases, which have been well below inflation so far.

At 1.5%, the ECB's main interest rate has been close to a theoretical "*neutral*" rate that keeps inflation in check without undermining growth, Centeno said. Asked about market estimates of a 3% "*terminal*" rate, he said it was more difficult to define than the neutral rate, but expected "*the December meeting to be very constructive and useful for the most correct identification of this ceiling*".

Centeno said that QT would be a "*slow, gradual*" process, but that "*there is no doubt that it has to be reduced*" to help transmit anti-inflationary monetary policy. He added that must first ensure so doing QT would not jeopardize financial stability.



On November 24, Germany's most prominent leading indicator, the Ifo index, staged a strong rebound, increasing to 86.3 in November, from 84.5 in October. Expectations improved significantly to 80.0, from 75.9 in October.

Ifo index added to optimistic hopes that the German economy might avoid a winter recession. These hopes have been built on the back of several government stimulus packages, filled national gas reserves, a better and faster adaption of businesses and households to reduce gas consumption, and hopes that consumers would sustain the energy crisis.

A sharp fall in European wholesale energy prices combined with an easing of supply chain bottlenecks has encouraged hopes that eurozone inflation could be about to peak, especially after price growth in the US slowed in October.

But new orders have dropped since February and inventories have started to increase again, a combination that never bodes well for future industrial production. High energy prices are gradually being passed through to consumers, therefore gradually weighing on private consumption.

The same day, Isabel Schnabel, ECB's Board member speaking at BoE Watchers' Conference in London said the ECB has "*limited*" room to raise interest rates in smaller increments because government policies to cushion households and businesses from soaring energy prices would keep eurozone inflation higher for longer.

She warned that market expectations of a shift to smaller rate rises at its meeting next month had lowered borrowing costs, making it harder to move to a slower pace of monetary tightening.

She signaled to continue with rate rises of 75bps. "*The largest risk for central banks remains a policy that is falsely calibrated on the assumption of a fast decline in inflation, and hence on an underestimation of inflation persistence*".

Schnabel said the impact of government support measures meant the ECB would have "*to raise rates further, probably into restrictive territory*", whereby growth would be constrained, to bring eurozone inflation down from a record level of 10.6% in October and back to its 2%.

"*Many fiscal measures that are popular among the electorate, such as tight price caps or broad-based subsidies, risk fueling medium-term inflation further. This could ultimately force monetary policy to raise interest rates beyond the level that would be seen as appropriate without fiscal stimulus*", she said.

With expectations rising that eurozone inflation will soon peak Schnabel commented: "*Markets' expectations of a 'pivot' have recently worked against our efforts to withdraw policy accommodation, bringing the actual policy stance further away from the stance that is required to bring inflation back to target... Incoming data so far suggest that the room for slowing down the pace of interest rate adjustments remains limited, even as we are approaching estimates of the 'neutral' rate*."

Schnabel remained true to her role as prominent hawk. Her speech was a clear push-back against any notion of the ECB materially slowing its tightening process. She could hardly have become more explicit in her disapproval of market expectations. She has remained one voice on the ECB GC, even if an important one.

The potential for a clash at the ECB's rate-setting meeting in December has become more visible, with policymakers split between keeping up the pace and switching to smaller increases on the back of signs of a recession.

In a different mode, Luis de Guindos speaking at the Analysis Forum in Milan forecasted that inflation in the euro area will hover around its current level over the next few months before starting to decline at some point during the first half of 2023.

On November 25, ECB chief economist Philip Lane Euro writing at The ECB Blog on the subject of Inflation Diagnostics, he revisited the eurozone wage growth debate. He said that it could keep pushing up inflation for years but this does not signal a permanent shift in wage dynamics and current indicators underlying inflation may be misleading.

On the contrary some members including Isabel Schnabel, have argued for preemptive action as undoing these wage pressures was more costly than acting early.

But Lane, took a more measured view in ECB blog post - a monster of mere 17,000 phrases - arguing that "*The staggered nature of wage setting means that the adjustment of nominal wages* *to the cumulative increase in the cost of living will play out over several years.. This means that, even after energy and pandemic factors fade out of inflation measures, wage inflation will be a primary driver of price inflation over the next several years.*"

He also disagreed with readings into underlying inflation data, a key focus of several policymakers, because it may be skewed by the unusual economic shock of the pandemic and the energy shock. "*The current values of these measures may overstate the medium-term persistent component of inflation in this highly atypical environment. It is unlikely that the standard measures of underlying inflation are sending the same signals about the likely persistence of inflation dynamics than under more standard macroeconomic conditions,*" he said.

On November 27, GC member Gabriel Makhlouf told Ireland's Sunday Independent newspaper in an interview, that the ECB would likely increase interest rates by smaller increments next year if further hikes are needed.

Makhlouf said that his mind is open on the size of that hike. "*When we get into next year, the likelihood is that if the rates go up, they'll go up by smaller increments. Then we'll have to see what's happening to the euro area economy - so we can judge how much more we need to do. And over what pace do we need to do it... I think by the second half of next year we'll see it (inflation) lower.*"

By the end of November, it became obvious that Philip Lane and Isabel Schnabel had contrasting views on whether the euro zone central bank should scale down its interest rate increases and even on how to measure inflation.

On rate hikes, Lane said many arguments for another 75bps rate hike were "*no longer there*". The sequential economic shocks of the COVID pandemic and energy price spike meant current inflation readings should be taken with a pinch of salt because projections show a rapid decline, he added.

Schnabel meanwhile pushed back on the notion of smaller rate hikes and took a jab at economic projections, emphasising that the longer inflation was allowed to remain high, the greater the risk that it would take root.

On the prospect for wages, they were also at odds. Lane said should be "*closely monitor(ed)*" for any sign of an undue acceleration while Schnabel called on the ECB to "*prevent a wage price spiral" before it even happens, given that wages are moving up "up relatively quickly*".

Their disagreement added to investor uncertainty about the size of the ECB's next interest rate hike in December, and on where borrowing costs may eventually peak.

The ECB has said it would not provide any guidance about future moves but be "*data-dependent*". This statement has saved ECB from more painful changes of tack after ECB President Christine Lagarde went from all but ruling-out rate hikes in the beginning of 2022 to presiding over the steepest tightening cycle in the euro's history.

December meeting would ultimately come down to November's underlying inflation data, due out on November 30. The hawks have been in the driver's seat all year and it would come down to the November inflation number. If core inflation is higher then the doves would have a difficult time arguing for a slowdown.

The public divergence also deals another blow to Lagarde's aim of bringing concord among the 25 members of the GC. Unlike in Draghi's time, where the six-person Executive Board was mostly united behind a sometimes domineering president, now the people who run the ECB have been often at odds too.

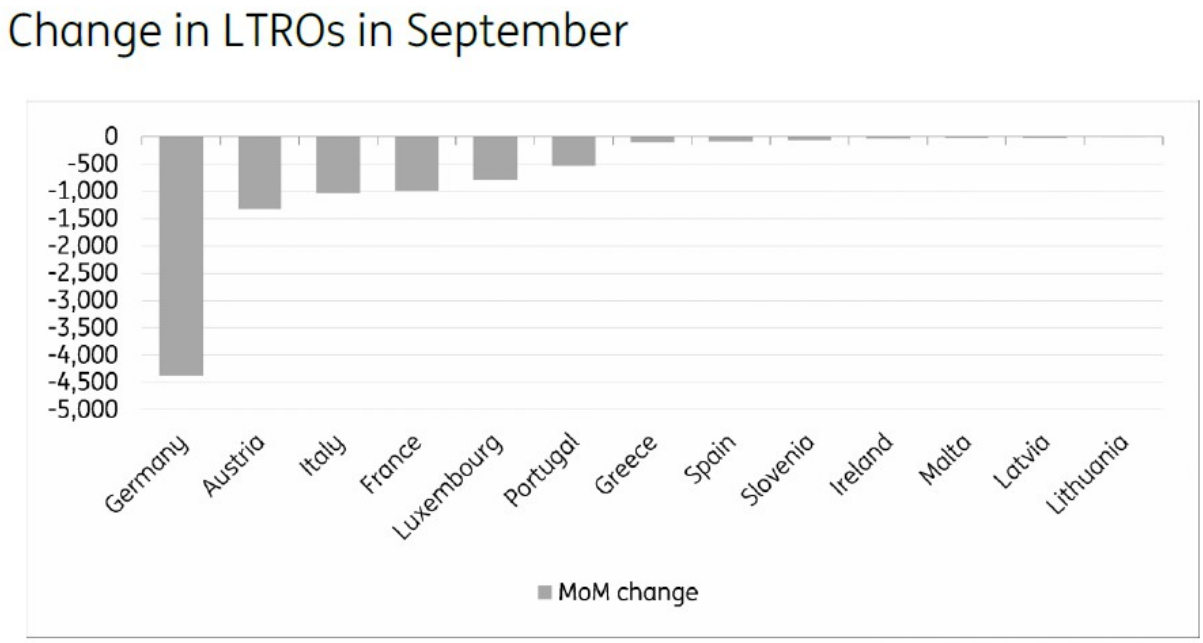
Schnabel and Luis de Guindos have emphasised core inflation, which strips out volatile food and energy prices, as a key metric to watch. Fabio Panetta has fought a long and largely lonely fight to get the ECB to take a gentler rate-hiking path, recently receiving support from several members of the GC.

ECB and German Government interventions on TLTROs

Based on the ECB data published 1 November, German banks in particular paid down their TLTRO drawings in September 2022. German banks' usage of LTROs declined by €4.4bn in September to €399bn. In addition, banks in Italy paid down €1bn of their drawings with the total now at €431bn and Austrian banks paid back €1.3bn with their usage now at €85bn. French banks' LTROs were down by less than €1bn in September with the total still at €459bn.

Since October 2021, i.e. at the time of the maximum LTRO drawings, the LTROs have dropped especially in Germany (-€41bn), followed by France (-€26bn) and Italy (-€18bn).

The repayment activity seems to coincide at least partly with bond issuance. French and German banks have been especially active in 2022 in printing new debt, with their supply running €28bn and €21bn ahead of 2021 YTD levels. Italian and Spanish banks have shown less strong increases over 2021 so far this year. Spanish banks are perhaps planning to rely more on existing liquidity reserves for LTRO refinancing. Instead, we consider that Italian banks face higher pressure to refinance their LTRO redemptions via bond markets.



Source: ING, ECB

In total, EU Banks paid back €6.5bn of their TLTRO-III drawings in September. The size of the operation in November stood at €2.1trn. The next repayment possibility for banks would be the date when the new TLTRO terms kick in with the settlement date set to November 23. Banks were expected to announce their intentions by November 16 with the publication of the data set for November 18.

The ECB balance sheet had in November €8.7tn in total assets, with about €5tn in the monetary policy portfolio and about €2.1trn in TLTROs. The ECB's calculation of excess liquidity in the form of reserves is around €4.6tn, an upper bound on the reduction. Much of this shrinkage would happen as TLTROs are repaid, independent of any shedding of securities holdings.

The first large TLTRO operation, with around €1.2trn outstanding, will mature in June 2023, but the ECB changed the pricing terms so more than €500bn would be repaid as early in November. Over the next 9 months about €1.5trn TLTROs would likely be repaid.

For securities holdings, there is the APP and the PEPP. The ECB has said PEPP re-investments continue until the end of 2024. For the APP, the ECB would start discussing a runoff in December. Some passive runoff would start in 1Q2023 and gradually increase and reach around €400bn of by the end of 2024.

The ECB balance sheet would shrink as banks repay TLTROs, not by the market having to buy more securities. The difference is important, because the run off of TLTROs would be anticipated and controlled by banks, and thus should have a limited effect on financial conditions and the availability of credit. If banks repay early, the funds are not needed. Tapering APP re-investments would similarly have only a modest effect. Not all QT is created equal.

On a positive note, collateral scarcity has been easing in November. A primary factor was the German treasury's decision in late October to boost the amount of bonds lent on the repo market, by €54bn, to finance part of its energy support package. Bloomberg reported - according to people familiar with the plan - on November 8, that net issuance of German debt should reach €45bn in 2023, nearly three times the originally planned €17bn.

Other factors, such as the increased rumors of ECB intervention, or hopes that early TLTRO repayments would release some collateral might have helped, but considered only as secondary drivers of the collateral situation.

On November 10, the ECB raised the amount of bonds it can lend against cash to €250bn euros, a bid to satisfy demand for high-quality liquid assets around year-end. Market participants often struggle to find high-rated bonds, such as Germany's, that they can borrow and use as collateral in financial trades.

"*The Governing Council raised as of today the limit for the Eurosystem's securities lending against cash collateral from €150bn euros to €250bin euros,*" Schnabel said in a tweet. "*This is a precautionary measure to ease collateral scarcity and support market functioning around the year-end.*"

Years of bond purchases under the ECB's QE programs have exacerbated a shortage of collateral in Europe, making it more expensive for traders to borrow securities in the repo markets and provide liquidity to clients. The scarcity threatens to get more acute toward the end of the year as banks scale back on lending to meet regulatory requirements.

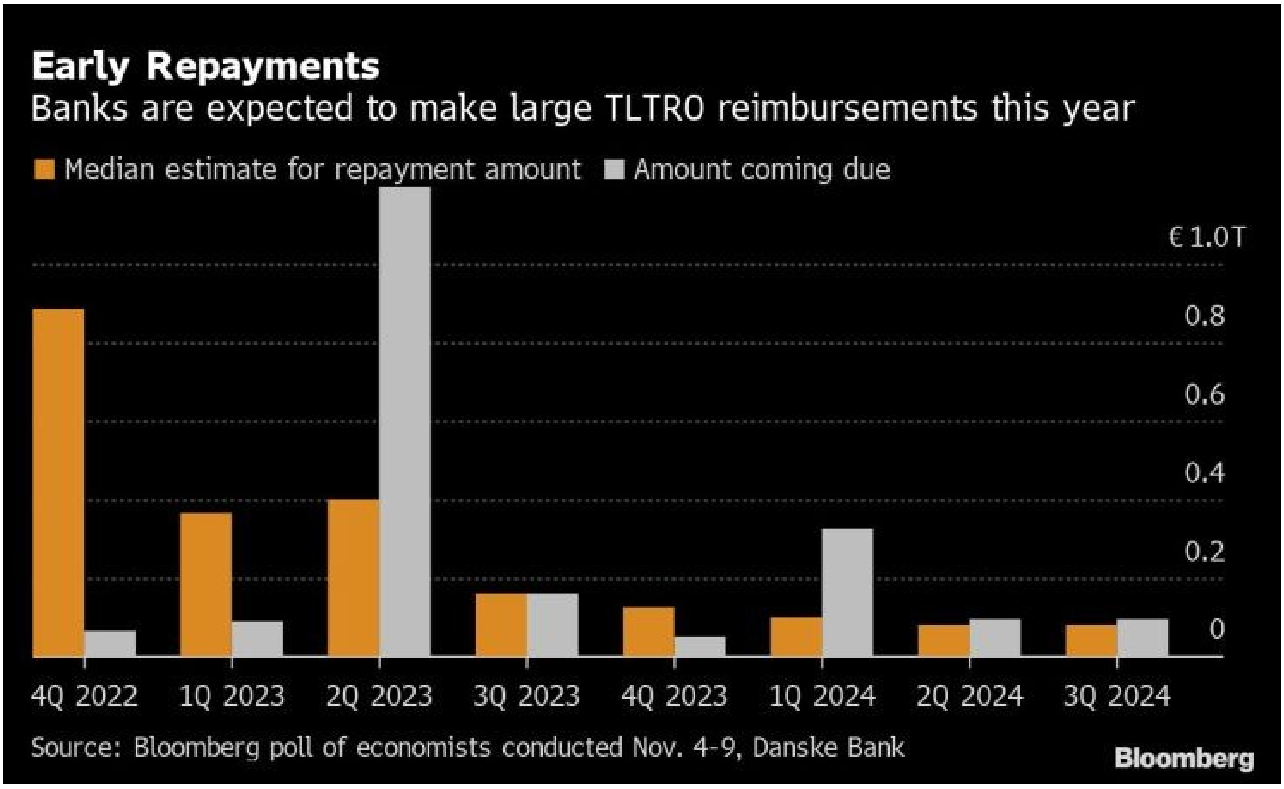
This was a response to October's ICMA warning on dislocations that could even hinder the ECB's ability to tighten policy by keeping money-market rates depressed, and called on policy makers to address the issue.

Looking at the daily data through September, daily lending against cash never exceeded €100bn, which should be testament to the rather expensive conditions of this facility. But markets are also going into the upcoming year-end from an already much more strained starting point, so this increased backstop should be taken as a positive signal and further acknowledgment that the ECB is heeding market concerns.

In mid-November, after ECB officials toughened the terms of the program to aid their fight against inflation the ECB would probably receive several hundreds of billions of euros in early repayments of TLTROs loans by the end of 2022.

Estimates varied widely on how much of the €2.1 trillion in outstanding cash would be returned by the end of November, the first available opportunity for repayments. Banks had until November 16 to notify the ECB if they want to do so. Results for the first repayment opportunity would be published on November 18.

The median Bloomberg estimate from a survey of economists was for €600 billion (projection range €200bn - €1.5tn), followed by €285 billion at the next scheduled date in December. Analysts expected more than €1.6 trillion to be returned by the end of the 2Q2023.



Luis de Guindos speaking at the FSR news conference on November 16, expected a "*sizable*" early repayment of its TLTRO loans to banks, and reckons that would help ease a collateral shortage in the financial system.

"*Always at year-end, as you know perfectly, we see more tensions in terms of the scarcity. Simultaneously, the repayment of TLTRO will create a little bit of relief, additional relief*," he told reporters, highlighting how policy makers have already taken action.

He also said officials would consider in December meeting whether to stop reinvesting securities bought up as part of monetary stimulus. "*We will discuss about the reduction of our balance sheet. I think this is important in terms of both to reduce the excess liquidity that we see in the marketplace, and secondly as well to alleviate the situation of scarcity of collateral.*"

Questioned on whether euro-area officials should follow the Federal Reserve with a so-called reverse repo operation to ease collateral scarcity, Guindos was unconvinced. Tensions in the US are "*more acute*" and "*much sharper that in the euro area.*"

On November 18, ECB announced that eurozone banks would return €296.3bn of TLTRO loans to the ECB on November 23. The repayment represents just under 15% of the total outstanding amount of cheap TLTRO loans, which were used during the pandemic to keep credit flowing to households and businesses, but the biggest drop in excess liquidity in the euro's 22-year history.

"*These sizable early repayments reduce the Eurosystem balance sheet and thereby contribute to the overall normalization of monetary policy, which is needed to bring inflation back to target over the medium term,*" ECB board member Isabel Schnabel said on Twitter.

The published breakdown showed that majority of the repaid funds are from TLTRO III.4, with 25% of the operation already repaid. The country-level breakdown of the November early repayment would only be available at the beginning of January.

The smaller-than-expected repayment may not be what the ECB was hoping for. Officials have fretted that the shift in economic conditions since the TLTRO program was rolled out means the loans risk distorting their efforts to tame soaring prices, while also worsening a shortage of collateral needed for money markets to operate effectively.

Several possible factors were behind this small fraction. German and other core banks have only limited government-debt purchases financed by TLTROs and continue to regard the loans as attractive from a cost perspective. Some bank treasurers might choose to wait until the next one on December 21 to have better visibility on the state of their balance sheet before year-end results.

Other banks might still be inclined to repay substantial amounts in December or January, buying more time, since there is no real rush. Some banks were not ready to repay early, due to hedging policies, as the cost of liquidating the contract would outweigh the cost of keeping the TLTRO III funds. Lastly, some banks are likely to hold onto the TLTRO funds until maturity in order to avoid replacing them with more costly funding.

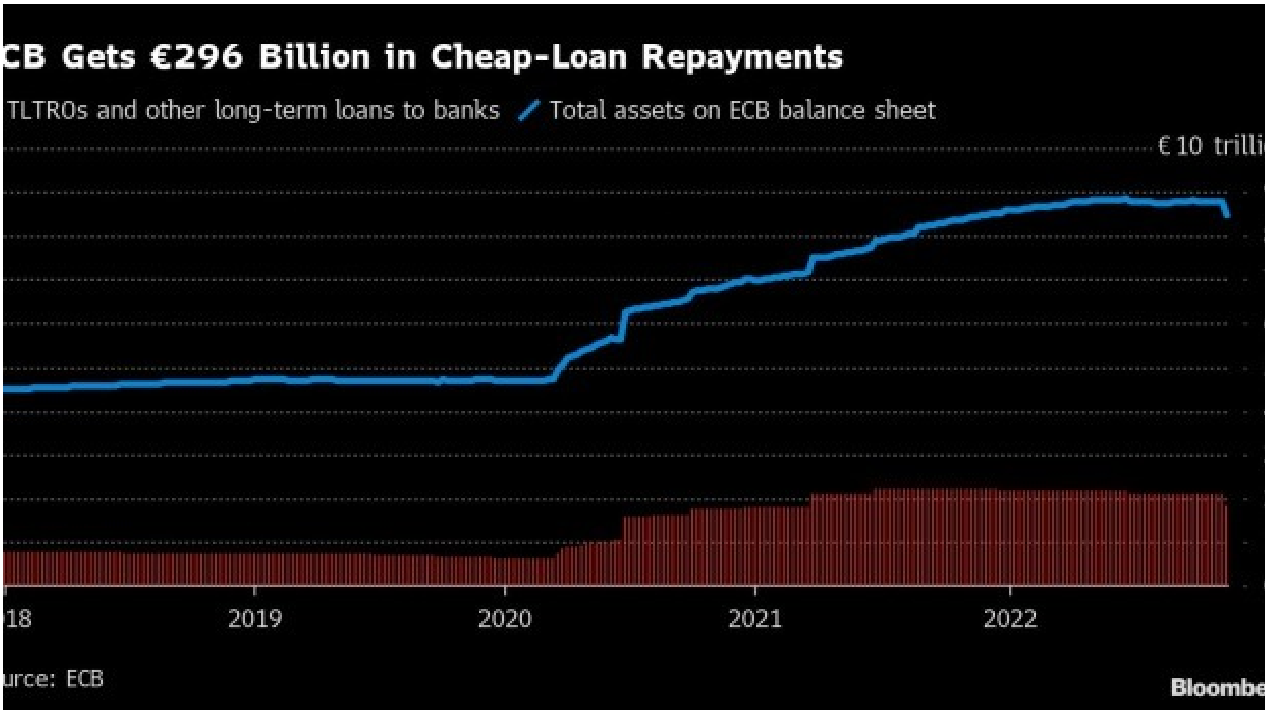
The greatest impact from the repayments was likely to be seen in peripheral countries, which would see a bigger proportion of their government bonds come back on the market after being locked at the ECB as collateral for the TLTRO loans.

The other area of focus for the ECB is money markets, in which banks lend to each other for a short time. Those markets have been hampered by the ECB's policy for years as banks could not find high-quality bonds to use as collateral for borrowing or did not have an incentive to do so when they could simply tap TLTRO for subsidized loans.

Lenders would have further options for reimbursement in each of the next four months, and then on a quarterly basis. But the hawks at the ECB may add this to their list of reasons to begin QT early in 2023.

The early repayments of TLTRO III funds in November, indicated that more is to come in the next early repayment dates, as banks hold on to the zero margin funds a bit longer.

The lower-than-expected repayment has not solve the collateral scarcity. The impact on excess liquidity, and on money market rates as well as collateral scarcity, is expected to be limited. The ECB might need to introduce a new long-term funding facility for banks, albeit on less generous terms, if banks come under stress. The ECB has little experience with the effect of reducing its balance sheet, which is just below €9tn.



Even talk of a start to quantitative tightening (QT) in early 2023 has been met with a shrug by the capital markets. Market participants doubt the hawks would get their way. But the most important reason is that a key detail is missing: how quickly would the balance sheet reduction occur. Most would assume a reinvestment cap that will be lifted very progressively throughout 2023, but there has been little by way of information on that front so far.

Waiting for ECB to lay out the "key principles" of the QT program on December 15, with kick-off expected in the first few months of 2023, many questions have been raised by the markets:

<u>How QT is supposed to work?</u> Through QT, the ECB will mop up the liquidity created by QE by shedding its bond holdings. This should raise the cost of money and cool credit and investment.

<u>What would look like in practice?</u> The ECB has hinted that it doesn't plan to sell its bonds but will instead simply stop replacing some of those that mature.

<u>Will the ECB copy the FED?</u> ECB policymakers have been adamant that they want QT to be predictable and gradual, so don't expect too much variation.

<u>How much money are we talking about here?</u> The ECB bought €3.3tn worth of assets under APP, most of which are government bonds. These have an average maturity of just over seven years and analysts expect the ECB to reduce its portfolio by only €15-20bn per month on average. That means it would take the ECB a long time to run down its balance sheet if it doesn't sell assets. The ECB also has a separate PEPP, worth €1.7tn. It has said it will keep reinvesting proceeds from that scheme until the end of 2024.

<u>What does it mean for borrowers?</u> The ECB has been a major buyer of government bonds since 2015. This is set to change under QT, forcing euro zone governments - most of which are still running deficits - to raise money from private investors. UniCredit estimated the market would need to absorb an additional €500bn worth of euro zone government bonds in 2023, the biggest increase since 2010.

Should we expect market turmoil? Markets seem to have already priced in some QT, with yields on government bonds across the euro zone climbing to multi-year highs in September before a pullback in November.

Germany's 10-year bonds have been yielding 1.8% compared to minus 0.4% a year ago while similar bonds for highly indebted Italy have been at 3.7% in the beginning of December. But the ECB has already provided a safety net for these countries, in the form of TPI to avoid fragmentation.

The release of October 27 ECB's Minutes

According to the minutes published one month later on November 24, they showed a GC concerned about inflation, leading to consensus for a 75bps hike. Growth was seen as slowing with a technical recession as the baseline, although not in itself sufficient to bring inflation back to 2%.

There was a discussion on the potential severity of a looming recession, with a common view that a shallow recession would not be enough to bring down inflation. The ECB did not see the banking sector through which a shallow recession could become a deeper and longer recession but rather the housing market and eventually the labor market.

"*It was argued that, in the event of a shallow recession, the Governing Council should continue normalizing and tightening monetary policy, whereas it might want to pause if there was a prolonged and deep recession, which would be likely to curb inflation to a larger extent.*"

The minutes revealed intensifying concern among governing council members about "*an increasing risk that inflation might become entrenched and that second-round effects and a wage-price spiral could emerge*".

The accounts of the ECB's October meeting show a large support for a 75bps hike, as eurozone inflation surged to 9.9% YoY in September and the Council saw risks as tilted to the upside over the entire projection horizon. A few members however supported a smaller 50bps hike, as the decision was accompanied by other tightening measures (TLTROs, minimum reserves). The Council noted that with the 75bps hike "*a substantial progress in withdrawing monetary policy accommodation*" has been made, suggesting that a slower pace of hikes could lie ahead. Further rate hikes even into the restrictive territory were expected. The pace of hikes would be generally data-dependent and be decided in a meeting-by-meeting approach.

It remained unclear what the ECB has in mind as a neutral level for interest rates. In some paragraphs, it is said that a "*neutral level*" should be reached swiftly, while in other paragraphs, the entire concept of a neutral or terminal interest rate is debunked.

A clear monetary policy case was seen for adjusting the TLTRO pricing formula, while potential unintended side-effects were acknowledged. Members highlighted that in the current inflationary environment the old TLTRO terms stood in the way of full transmission of the intended tightening to bank lending conditions. The adjustment was also seen as potentially alleviating collateral scarcity, in turn supporting a smoother and more efficient pass-through to money market rates. The TLTRO related balance sheet normalization was seen as a "*first step before considering a reduction*" of the APP portfolio.

Reducing the TLTROs was seen as a necessary first step before considering the reduction of bond holdings. An assessment of the repayments after the adjustments of the TLTROs and impact of financing conditions would also inform the discussion to be had on reducing the re-investments of the bond portfolio in December. Reducing the TLTROs was seen as a necessary first step before considering the reduction of bond holdings

There has been some interdependence between the TLTROs, QT and even rate hikes in the minds of the ECB. According to the minutes TLTRO repricing was "*more efficient*" than trying to achieve the same objective through an earlier start of QT or more aggressive interest rate hikes. The first voluntary repayment in November 23 of €296.3bn was on the low end of expectations and had also limited market impact. Ahead of the December meeting there would be one more repayment opportunity to consider. That amount will be closely watched as it could also be part of the bargaining process between hawks and doves when they decide on the pace of further hikes.

Members saw a need to "*discuss the reinvestment strategy for the APP portfolio*" in the next monetary meeting in December. Combining the minutes with President Lagarde's statement during the press conference and that the Council has already discussed APP re-investment policy at the non-monetary policy meeting in October, ECB might decide on a gradual adjustment to the APP reinvestment policy at the December meeting, effective from the 1Q2023.

While the October decision was very uncontroversial and supported by a large majority, later comments by ECB officials suggested that the discussion at the December meeting would be much more heated and controversial. The dovish voices have again become louder, while the hawks seemed to be prepared to slow down the pace of rate hikes. All members have been expecting data releases and forecasts to be presented at the December meeting.

The tone of the meeting account contrasted with the markets' initial relatively dovish interpretation of October's press conference and clearly signaled that policy tightening has some way further to go. The big bargain between doves and hawks would be around QT i.e. the shrinking of the ECB's balance sheet. Earlier and more significant QT could be the bargaining chip for an end to rate hikes. For the record, the clearest dovish signal out of October ECB meeting was actually the absence of a further discussion on QT.

Lagarde's warnings at European Parliament. CPI print lost in translation

Christine Lagarde addressing the European Parliament (EP) at the Hearing of the Committee on Economic and Monetary Affairs on November 28, said that eurozone inflation has not peaked and it risks turning out even higher than currently expected, hinting at a series of interest rate hikes ahead. She said said that borrowing costs will continue to rise even as economic activity slows down in the face of record inflation.

Lagarde said high uncertainty, tighter financial conditions and softening global demand are weighing on growth, which is "*expected to continue weakening for the remainder of this year and the beginning of next.*"

Her comments, canceled out the speculation that the ECB was about to take a gentler path with future rate increases. "*We do not see the components or the direction that would lead me to believe that we've reached peak inflation and that it's going to decline in short order*," Lagarde told the European Parliament.

She added that ECB economists still saw clear risks that inflation readings could come in higher than expected. "*Whenever I ask my top-notch economists at the ECB and I ask about the risks, the answer that I get for the moment is, that risk is to the upside... We are committed to bringing inflation down to our medium-term target, and we are determined to take the necessary measures to do so. We expect to raise rates further to the levels needed to ensure that inflation returns to our 2% medium-term target in a timely manner.*"

Isabel Schnabel and Philip Lane, have been disagreeing over the outlook for inflation and interest rates, leaving market participants puzzled over the ECB's next policy moves. Lagarde, who praised the debate between Lane and Schnabel, said both questions depended on a number of variables including wages and inflation expectations.

Lagarde's comments to members of EP (MEPs) indicated that the ECB was not ready to slow down. "*How much further we need to go, and how fast we need to get there, will be based on our updated outlook, the persistence of the shocks, the reaction of wages and inflation expectations, and on our assessment of the transmission of our policy stance,*" Lagarde said.

But she used a phrase also had been used by Federal Reserve Chair Jerome Powell. "*We clearly have to continue increasing interest rates ... and my suspicion, although I do not want to venture too much into the future, is that we still have a way to go,*" she said.

Lagarde's comments signal there would to be a lively debate at December's ECB meeting, with policymakers split between keeping up the pace of rate rises to avert a wage-price spiral and switching to smaller increases on the back of signs of a recession.
The core of her message was not new: the ECB would continue tightening policy even as the economy weakens into 2023. This may require taking the deposit rate rising above 2%. Between the lines, it seems the central bank's communication has been increasingly preparing markets for a recession, and for the risk that hikes have to continue regardless.

Earlier in the day, the Dutch central banker Klaas Knot speaking at conference in Paris, said that Europe should be ready for a "*protracted period*" in which the ECB returns inflation to the goal. "*To bring inflation back to target we will need a protracted period of time at which at least growth is below potential because otherwise we will never get the disinflation going," he said. "My worry is still inflation, inflation, inflation.*", he said.

He was more explicit in his remarks, saying: "*We are still in the process of merely removing accommodation, removing stimulus, so then to already talk about the risk of over-tightening is a bit of a joke*," answering the concerns which were expressed by Fabio Panetta, a few weeks ago.

Knot also urged caution about the ECB's expectations for a rapid decline in inflation over the next several years and about the prospect of an imminent recession while warning about the risk of wages driving up prices. "*If you look at the most recent wage deals, they're clearly not in line with sort of having a 1% productivity growth plus a 2% inflation target*," Knot said.

The next day November 29 the chorus of public statements continued. Luis de Guindos during the virtual opening remarks at XIII Encuentro Financiero organized by Expansión in Spain emphasized that ECB must continue monitoring underlying inflation as it determines what dose of monetary-policy tightening is needed to tame record price gains. "*The signal we have to keep following is the evolution of underlying inflation. This will tell us how inflation can evolve in coming months.*" Inflation probably held above 10% in November, while underlying price growth was about 5%, according to Guindos.

Pablo Hernández de Cos talking to Spanish lawmakers in Madrid said that it's unclear how far the ECB will need to go in hiking interest rates. "*Given the enormous uncertainty that exists, it is not possible, however, to anticipate to what extent we should raise interest rates to ensure our medium-term inflation target.*"

De Cos, a dovish policymaker, spoke after Spanish data showed inflation eased for a fourth month in November. He has previously cited research by his institution suggesting that a terminal rate of 2.25% to 2.5% would bring inflation down to the ECB's 2% target by the end of 2024. He also expects underlying inflation, which excludes volatile items like energy and food, to start easing in the spring.

The same day, the Economic Sentiment Indicator (ESI) was released. It increased slightly in November from 92.7 to 93.7, mainly due to a consumer rebound, but still at depressed levels. The overall picture continues to show a mild recession, but also more signs of slowly fading inflation pressures.

Industry sentiment decreased from -1.2 to -2 in November, the lowest reading since January 2021. The service sector also saw the indicator for recent demand deteriorate further in November. The retail sector noticed a slight improvement in demand.

Signs of a changing inflation picture have slowly become more apparent. Energy prices have moderated somewhat, which has helped headline inflation readings for November stay on the low side. But easing supply-side pressures, lower wholesale energy prices, weakening demand and higher volumes of stock has been causing businesses to become somewhat less keen to increase prices, according to this survey.

Before the release of eurozone CPI, the ECB warned in its publication of the Consolidated Financial Statement of the Eurosystem that it might make a loss as high inflation forces it to raise interest rates and foot the bill of a decade of aggressive money printing.

The ECB must make huge interest payments to commercial banks on some €5tn worth of deposits it created via massive bond purchases and cheap loans the last decade. Those stimulus tools, were now likely to push the ECB and some of its shareholders, such as the central banks of Germany, the Netherlands and Belgium, into the red.

"*We have to fight (inflation) by raising interest rates, which results in higher interest expenses that we pay to banks,*" the ECB said. "*In this case our profit falls, and we might even make losses.*"

The Dutch national central bank had openly acknowledged the risk that it might need a recapitalization by its government in September, though Dutch finance minister Sigrid Kaag later cautioned this was "*not yet on the table*".

The ECB said it had other lines of defense. On top of depleting its provisions, it might tap any income that national central banks make on their monetary policy operations. And it might defer any remaining loss by writing it on its balance sheet as a claim against future profits - a possibility also cited by the Bundesbank.

"*It is important to remember that central banks are not like ordinary companies: they can lose money and still operate effectively.. Still, the principle of financial independence implies that national central banks should ultimately always be sufficiently capitalized,*" the ECB said.

The final day of November was reserved for eurozone's CPI data. Consumer prices in the eurozone grew by 10.0% in November after a 10.6% increase in October. Energy prices accounted for the bulk of the slowdown while food price inflation, a key worry, continued to accelerate, data from Eurostat showed on November 30. The drop, from 10.6% in October, was the biggest since 2020 and was attributed to slower advances in energy and services costs.

Eurozone inflation eased far more than expected, raising hopes that sky-high price growth is now past its peak and bolstering the case for a slowdown in ECB rate hikes in December. The prospect of weakening price pressures would bring relief to the ECB after the frustration of half a year of figures repeatedly exceeding economist forecasts.

It coincides with US statistics from October that went in the same direction, emboldening some Fed officials to consider a downshift in the pace of rate hikes.

While the dip in headline prices, strengthens the case for more measured ECB action, CPI data could also fuel fears that inflation would prove more persistent than expected.

Energy inflation has been the most important driver of the decline going from 41.5% to 34.9%. Excluding food and fuel costs, inflation rose to 6.6% from 6.4%, defying expectations for a drop, while an even more narrow measure that also excludes alcohol and tobacco - the core CPI measure - was unchanged at a record 5%. Inflation for processed food, alcohol and tobacco, a key category, meanwhile accelerated to 13.6% from 12.4%. Services inflation slowed slightly to 4.2%.

Inflation moderated in Germany, Italy, Spain and the Netherlands. CPI's fell in 14 of the 19 eurozone countries, increasing in only three and held steady in two (France and Italy). The biggest drop was in the Netherlands, where inflation slid from 16.8% to 11.2%. France had the lowest inflation rate at 7.1% and Latvia the highest at 21.7%.

ECB and market economists have excepted that inflation would decline through 2023 and return to the vicinity of 2% by the end of 2024. Such a rapid decline lacks historical precedence, some policymakers have warned, suggesting that small decline would be unlikely to be a game-changer for where rates end up over the cycle of monetary tightening.

Whether this has been the peak in inflation remains to be seen. Another episode in the energy crisis could easily push inflation back up again and core inflation usually proves to be sticky after a supply shock.

For the ECB though, tentative signs of inflation peaking have been mounting, evidence of a wage-price spiral continues to remain absent and the environment has been turning recessionary. That is likely that he ECB would hike of 50bps in December.

The ECB has rightly shifted the focus of the policy debate to core inflation and its persistence, being well aware that any drops in the volatile headline inflation can lead to false conclusions. Isabel Schnabel has been the most vocal about still worrying underlying trends. Chief Economist Lane has employed a more measured tone in his November 25 expansive blog, though, warning not to read too much into current measures of core inflation.

In summary, the November inflation readings could bring a down tick but might not be enough to conclude that inflation has peaked. The eurozone numbers followed a string of weaker consumer-price readings from around the euro region. The important thing determinant of subsequent 12 months ECB actions lies in how a lot and fast core inflation recedes.

But the problem remains: The ECB had anticipated CPI to peak 12 months ago, so confidence in its forecasting potential has been undermined. Ahead steerage about the place rates of interest are headed has been ditched in favor of meeting-by-meeting information dependency. This has led to a cautious rethinking by the ECB board of how to present its inflation approach to maintain the GC's appearance of unity.

It has been quite the journey for Lagarde, starting in August 25 with an interview with Madame Figaro in which she declared "*we can no longer rely exclusively on the projections provided by our models. They have repeatedly had to be revised upwards over these past two years.*" In an October 28 interview with Irish state broadcaster RTE, Lagarde said "i*nflation had come out of nowhere*". A tougher approach came in a Bloomberg News interview in early November, when she said that recession alone will not be "*sufficient to tame inflation*".

The public rhetoric battle among the ECB board members has been heating up as as to if the ECB can ease its 75bps interest-rate jumps. But Lagarde would have to be on top of her game, at the press conference after the December 15 meeting, to persuade markets that the GC remains united.

The road to December 15 Meeting

Despite eurozone economy moving into recession, unemployment as reported on December 1 has continued to trend down. While German unemployment seems to have bottomed, southern Europe has still been experiencing declining unemployment. Spain, Greece and Italy all saw the rate drop in October. The latest rate of 6.5% has been a new historic low since 1998 and has been consistent with rising nominal wages.

From here on, the labor market is set for a slowdown. Companies have been scaling back their hiring intentions and signaling a slowdown in employment growth.

From a different angle, Andrea Enria, the ECB's top bank oversight official, who spoke to European Parliament public hearing on Banking Union scrutiny in Brussels the same day, called for banks to prepare for the risk of a wave of losses on loans after Russia's invasion of Ukraine caused a spike in gas and power prices and made it harder for consumers and companies alike to service their debt.

"*A number of banks seem to use relatively mild macroeconomic assumptions in their adverse scenarios, which translates into a moderate impact on their capital ratios*" in calculations submitted to the ECB in late October, he said. "*Supervisors will closely scrutinize capital planning and challenge management actions to ensure an appropriate level of conservatism.*"

Enria said banks' risks related to energy-intensive corporate borrowers "*are a particular area of supervisory attention.*" While, there have limited signs of distress so far, many affected industries "*are at the beginning of the value chain, where disruptions can trigger chain reactions,*" he said.

Chief Economist Philip Lane during a presentation at the Banque de France / EUI conference "Headwinds: upcoming macroeconomic risks" in Florence said rising incomes will help drive economic growth in Europe. The "*balancing act*" is ensuring that wage growth isn't too strong and doesn't cause inflation to accelerate.

Yannis Stournaras a dovish ECB board member said in an interview with German newspaper Handelsblatt published on December 1 that further hikes in borrowing costs should be gradual, following the most aggressive bout of monetary tightening since the euro was introduced.

"*Additional rate increases must be gradual and depend on the inflation outlook while considering the recession risks and the impact on financial stability. Monetary policy is not particularly adept at dealing with supply shocks but it can help*," he said, adding that governments should help damp inflation as long as Russia is using energy as a weapon.

With the beginning of December the ECB was about to enter a new phase in its fight against inflation, probably heralding more contentious decisions on monetary policy. Starting in December, interest-rate increases would be accompanied by an extra lever for tightening as balance-sheet unwinding takes shape, all complicated by a likely recession.

More tension would be expected within the ECB as rates approach neutral range. Whatever ECB members do about raising borrowing costs on December 15, their decision would almost certainly bring them to a level roughly deemed to no longer stimulate growth. That would bring central bank's policy to the point that as future increases to tame inflation, a move above neutral rate would actually send the economy into a recession. Then there's the question of how high borrowing costs should ultimately rise.

In the meantime, the ECB would also need to settle the question of how to start QT. The design of that policy might end up reflecting a compromise decision that also encompasses the size of the December rate hike and the pace of future move. But price pressures are showing faint signs of peaking . Underlying pressures have remained way too strong.

On December 2, Christine Lagarde spoke at a panel session "*Growth and Inflation Dynamics*" at Bank of Thailand's 80th Anniversary Conference "*Central banking amidst shifting ground*" jointly organised with the Bank for International Settlements (BIS) in Bangkok.

In Bangkok, Lagarde led the chorus warning that inflation must be anchored and the outlook would remain uncertain for some time. "*We are going through a very very challenging time where ground is shifting under our feet,*" she said.

She warned that some European governments' fiscal policies could lead to excess demand, and that fiscal and monetary policies need to work in synch for sustainable, balanced economic growth. Lagarde said fiscal policy that is <u>temporary</u>, <u>targeted</u> and <u>tailored</u> can play an important role in cushioning Europe from the energy crisis.

"*Those three Ts can help alleviate energy shocks and put a cap on inflation expectations. Fiscal policies that create excess demand in a supply constrained economy might force monetary policy to tighten more than would otherwise be necessary. Regrettably, at the moment, at least some of the fiscal measures that we are analysing from many of the European and particularly euro area governments are pointing in the direction of the latter category,*" she said, referring to measures that could trigger excess demand.

"*We need higher investment and structural reforms to remove the supply constraints and ensure that potential output is not impaired by the changing global economy. And that's a big question and an uncertainty that we have. And in a world where external demand is more uncertain, we will also need to strengthen the domestic supply and demand through higher productivity growth,*" she said.

"*Given this exceptional uncertainty, what we central bankers have to do is to actually deliver a monetary policy that anchors expectations, so those expectations remain moored to target. We need to signal to the public, to the observers, to the commentators, that in all scenarios, inflation will return to our medium term target in a timely manner. This is the best we can do in the current environment,*" Lagarde explained.

Finally, Lagarde made a comment on the dollar's strength. It has been having less of an impact on the euro area than it is on emerging economies.

"*Conventional wisdom will tell you that we do not target any exchange rate. Obviously we are monitoring and are very attentive to variation of exchange rates and in particular we are monitoring carefully what has been an appreciation of the dollar,*" she concluded.

Luis de Guindos during a closing speech at a financial event organized by OK Diario in Madrid the same day, said that the ECB needs to focus on bringing inflation down to its 2% mid-term goal and therefore keep raising interest rates despite a deceleration in the pace of price rises in November.

"*Inflation is starting to decelerate, but that deceleration has to be stable.. Inflation could hover around 7% by mid-2023*". However, he noted that the ECB should avoid an "*M-shaped evolution of* *inflation*" where it would accelerate again after slowing down, as well as avert its stabilisation clearly above 2%. "*Our fundamental objective, our mandate is to bring inflation to our definition of price stability, which is 2%,*" De Guindos said.

He added that the ECB was expected to raise interest rates further at this month's monetary policy meeting where it would also decide on how to reduce its balance sheet.
Bundesbank President Joachim Nagel closed the public remarks in Darmstadt for the day. He spoke at the 72nd Monetary Workshop "Inflation - Role and Possibilities of Monetary and Fiscal Policy" at Schader-Campus.

He argued that the ECB probably doesn't need to manage a planned roll off in its bond portfolio, highlighting "*sufficient resilience*" in financial markets. "*If we don't replace maturing bonds in our APP portfolio, our holdings shrink automatically: month by month by what expires. Markets should be able to cope with a passive rolling off from the first quarter of 2023,*" he said.

Not replacing maturing bonds would be the "s*implest and most transparent way*" to reduce the ECB's balance sheet, Nagel said. It would impact the whole yield curve, consistent with the institution's interest-rate increases, address collateral shortages and reduce excess liquidity, and also underscore the GC's determination to return inflation to its 2% target.

Nagel said more rate hikes are needed, pointing to risks that long-term inflation expectations might unanchor if policymakers don't act forcefully. While forecasts signal a slowdown in price pressures in the medium term, upward revisions in the past point to high uncertainty.

Speaking in a joint television interview on German channel Phoenix on December 4, Bundesbank President Joachim Nagel and Bank of France Governor Francois Villeroy de Galhau said the ECB's tightening push would eventually tame price growth that's currently running at five times its goal.

"*We'll bring inflation back to 2% by the end of 2024 or 2025,*" Villeroy said. "*This isn't just a forecast, a projection. It's a commitment.*"

Nagel commented on a third straight 75bps move and a 0.5% step. He said the decision would be guided by the latest data. "*We'll have new projections for 2023, 2024 and for the first time for the year 2025. This will be the basis for our decision. It's clear that rate increases must continue.*"

Asked how long borrowing costs will rise, Villeroy said "*for as long as necessary.*"

Regarding governments actions on surging energy costs, Nagel and Villeroy urged a return to more balanced budgets soon. "*A special situation is a special situation, but at some point it's over,*" Nagel said. "*The signal from fiscal policy must clearly be a return to the debt brake*" and an adherence to European fiscal rules, he said.

In a second interview the same day, Francois Villeroy de Galhau, said on French LCI television, that the ECB should raise interest rates by 50bps to help tame surging consumer prices, who added that inflation would peak during the first half of 2023.

"*I think it's desirable to bring rates to 2%, so a rise of 0.5% or 50bps.*" Using a football analogy, Villeroy said an increase to 2% would mark the end of the first half to reach a normalization of rates in a game that has reached a turning point.

"*In the second half of the match, rates will continue to rise but I can't say where this will stop,*" he said. The second half of the inflation fight would be longer and it could take another two to three years to get prices fully under control. "*This isn't only a prediction, this is a commitment,*" he said.

Villeroy said on LCI he couldn't rule out a recession for France and the euro zone, but that if it happened, it would be limited and temporary. "*We can say today that France and Europe will dodge a hard landing. We see a slowdown today, not a collapse of the French and European economies.*"

On QT process he said that "*I think it would be wise to start to reduce in 2023,*", adding that this should begin with the so-called APP holdings in the "*first half of the year, clearly but cautiously and progressively.*"

Villeroy continued his public statements on December 5. His comments reinforced the message from ECB's top bank oversight official, Andrea Enria, who had said supervisors would push lenders to ensure they're maintaining sufficient financial reserves. ECB has warned of loan losses as soaring natural gas and power prices make it harder for consumers and companies to service debts.

Addressing the Conference of the French Prudential Supervisory and Resolution Authority (ACPR) in Paris, Villeroy reiterated that while French banks remain solid and should benefit from rising interest rates, heightened volatility and slower economy growth in Europe should keep them vigilant on capital projections [like dividend distribution and share buybacks which are submitted to an explicit authorization from the supervisor].

Villeroy reiterated the importance tighter rules on shadow banking. "*We can't claim to know where the next crisis would come from. It is high time for us to advance in the strengthening our regulatory framework of non-bank financial institutions, in all its dimensions, whether micro or macro-prudential.*", he concluded.

Irish central-bank chief Gabriel Makhlouf speaking at the Institute of International and European Affairs in Dublin the same day, said that the ECB should raise borrowing costs by at least a 0.5% to curb surging consumer prices. "*To continue on our path to bring inflation back to our 2% target, I see a 50bps increase in interest rates as the minimum needed at our December meeting. We have to be open to policy rates moving into restrictive territory for a period. It is premature to be talking about the end-point for policy rates amid the prevailing levels of uncertainty.*"

Later, Makhlouf speaking to Reuters in an interview when asked how comfortable he was with market pricing of a terminal rate just below 3%, he said: "*I think starting to talk about where we're going to end up is probably premature and I can see scenarios where we go beyond 3%. I'm not sure it (inflation) has peaked, I'm reserving judgment on that but I would hesitate to say that it's peaked. Just the fact that it's fallen in the flash estimate for November, you know one swallow doesn't make a summer.*"

The terminal rate, a key market-based indicator, often cited by the ECB, stood at 2.4% in December, well above the 2% target, and has moved up even as policy is tightened.

On the stat front, the declining trend in eurozone retail sales continued in October after a brief uptick in September. The drop of 1.8% MoM was broad-based. Food and non-food retail sales declined with only fuel sales ticking up. Germany and France both experienced drops around 3% while the Netherlands saw a small dip. Spain was the exception among bigger countries with an increase of 0.4%.

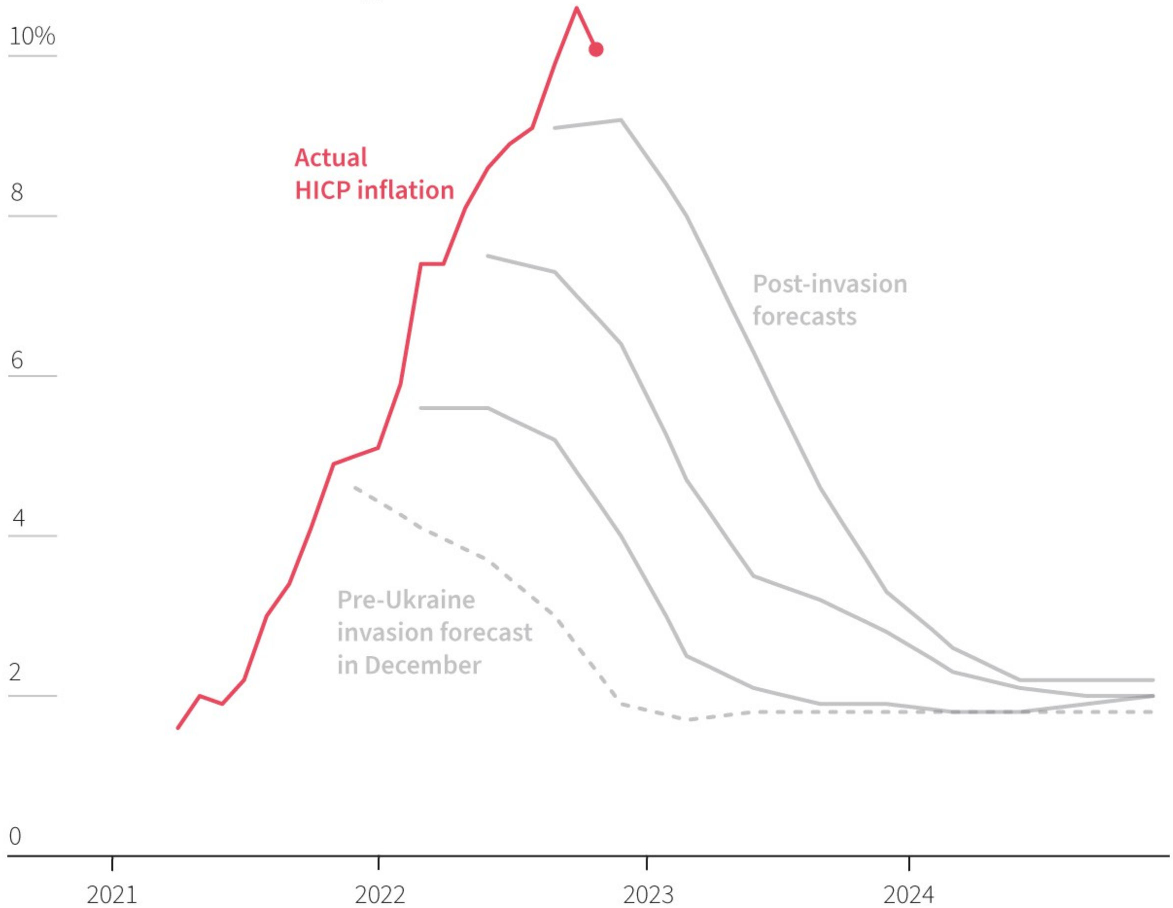
Retailers have been stocking up as supply-side problems have been fading, but demand has also quickly started to fade. That has resulted in quickly filled storage sites and uncertainty about whether sales will live up to expectations in the holiday period. The number of retailers that expects to raise prices fell in November.

All hawkish voices have pushed in favor of a QT start as soon as early 2023. Although the QT has been expected to take the form of a progressive phasing out of APP redemptions, Joachim Nagel - expressing a minority sect within the GC - had pointed out that markets were able to handle an abrupt end.

Capital markets have their saying too. The decreasing spread between euro sovereign yields has led to the conclusion that QT has not been a big deal, and has emboldened the hawks. In the first week of December, Italy-Germany 10Y spreads stood below 190bps just one week before the ECB would have taken decisive steps towards unwinding its bond portfolio. Most market participants expect that the decision on QT would widen the spreads, even if the effect might not be felt immediately.

Inflation outpaces ECB projections

The central bank has made conservative estimates on inflation despite Russia cutting gas supplies to Europe in response to Western sanctions over its invasion of Ukraine. Tight energy supplies, in turn, have fanned inflation to record-highs.



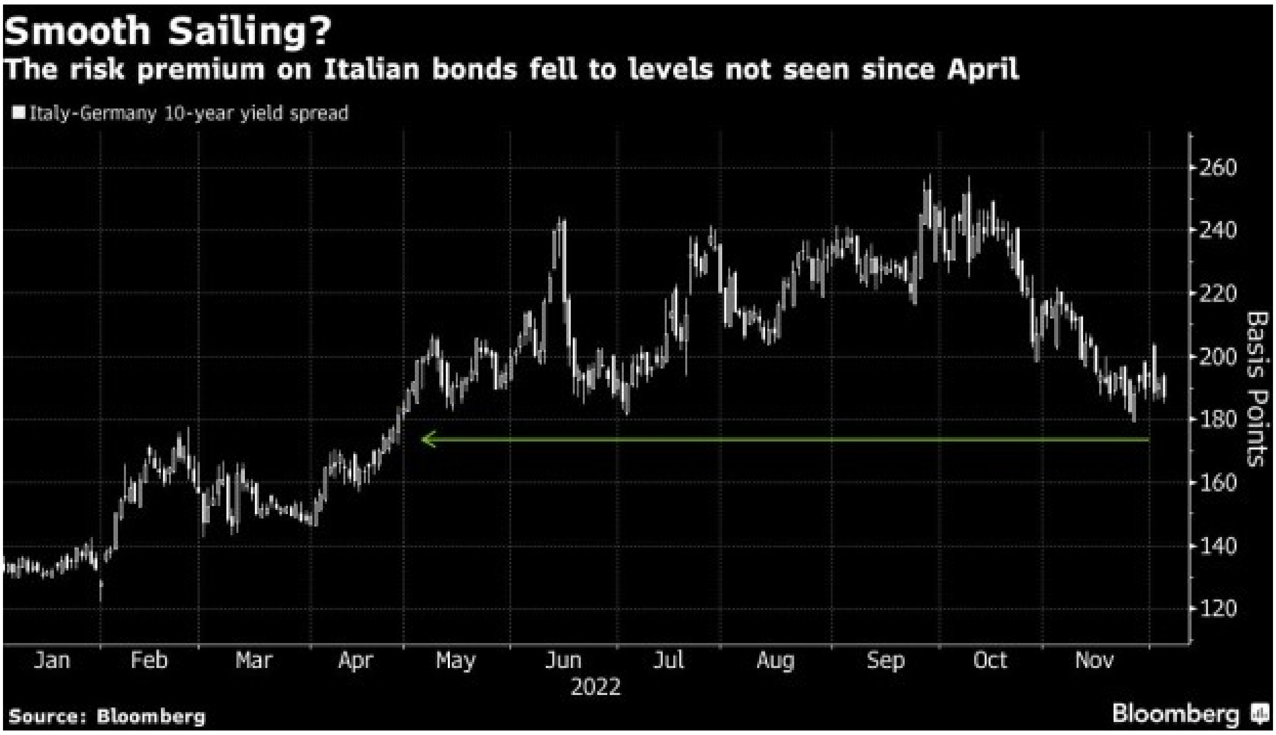
Sources: Eurostat, Refinitiv Datastream

Riddhima Talwani, Kripa Jayaram | Reuters, Dec. 7, 2022

On December 6, the ECB published the monthly/bimonthly APP and PEPP updates. It cut holdings under its PEPP of southern European nations' bonds over the last two months, picking up German and Dutch debt instead.

The ECB didn't use the flexibility offered by the PEPP's redemption to lean against wide sovereign spreads in the months of October and November. On the contrary, data show that it increased its holding of core (Netherlands and Germany) and reduced its holding of periphery (Spain, Portugal and Italy).

The spread between 10-year German and Italian bond yields, shrunk to 190bps from levels above 250bps following Italy's election in September, suggesting growing confidence in the new government.



The sense of calm that has narrowed the gap between German and Italian debt yields would embolden policymakers as they announce principles for QT. But the danger of renewed bond spread volatility has remained intact.

That's the challenge for ECB's GC: a combined strategy to reduce the balance sheet on December 15 along with an rate hike of at least 50bps. Uncertainty over the eurozone economic outlook, the path for rates and governments' borrowing needs might disrupt the calm.

ECB officials have already congealed around the idea of running QT in the background to minimize the distraction to investors, and to use rates as their main policy tool. Most GC members seem to favor of a measured and predictable approach, rolling off maturing bonds rather than selling them outright.

But Joachim Nagel hinted on December 2 that such measures probably won't be needed, observing that markets show "*sufficient resilience*" and "*should be able to cope with a passive rolling off.*"

It has been unclear how much more debt governments would have to issue if energy relief needs to be propped up - and how investors will respond. The ECB has warned that excessive support may force additional rate hikes. Any concerns about debt sustainability risk being complicated by a possible watering down of eurozone fiscal rules that remain suspended in 2023.

Italy shows the greatest such vulnerability in the eurozone. Moody's Investors Service has warned that public-finance targets might be missed.

Officials insist they have the tools to fight any turmoil, ranging from flexible re-investments of PEPP purchases to TPI activation. But market participants have remain skeptical on the calm to last.

The same day , German industrial orders report indicated that they rebounded in October without reversing the negative trend. Industrial orders increased by 0.8% MoM in October, from -2.9% MoM in September. Since the start of the year, German order books have shrunk by almost 15% and have fallen in seven out of ten months. The decline in German industrial orders is one important signal that shows that the long slide into (industrial) recession continues.

Chief Economist Philip Lane told in an interview to newspaper Milano Finanza published on December 6, that the ECB would have to raise interest rates several more times to tame price pressures, even if headline inflation has been close to its peak.

"*We do expect that more rate increases will be necessary, but a lot has been done already. I would be reasonably confident in saying that it is likely we are close to peak inflation. But whether this already is the peak or whether it will arrive at the start of 2023, is still uncertain,*" he said according to the paper.

Lane did not explicitly endorse a 50bps move over a bigger increase but repeated his case for a slowdown. "*We should take into account the scale of what we have already done. So the basis for the decision will be different. Given the significant increase in (natural gas) prices, I don't rule out some extra inflation early next year. Once we are past the initial months of 2023, later on in 2023 - in the spring or summer - we should see a sizable drop in the inflation rate. That said, the journey of inflation from the current very high levels back to 2% will take time.*" Lane said.

Asked whether the inflation rate might drop to 6%-7% in 2023, Lane said that "*the initial downshift from the current high rates will be to around that level*" with a further reduction to follow. Still, "*we do think there will be a second round of inflation,*" Lane said, citing bigger-than-usual pay increases over the next three years. "*That is why it will take some time to return to our 2% target. So the second round effects will drive inflation next year and in 2024.*"

On December 7, German industrial production data were released., It decreased by 0.4% MoM in October. On the year, industrial production was up by 0.8%. Production in the energy-intensive sectors, however, dropped by 3.6% MoM and is down by almost 13% compared with October last year. On the upside, activity in the construction sector grew by 4.2% MoM.

Industrial production data has been the final part of the entire batch of hard October macro data. Despite the uptick in the Ifo index and the PMI, the German economy has not fallen off a cliff but continues its long slide into recession. Retail sales were down sharply, exports were down and industrial production was down; activity in the construction sector was the only growth driver.

New orders have dropped by almost 15% since the start of the year and inventories have started to increase again after the summer, a combination that never bodes well for future industrial production. High energy prices are gradually being passed through to consumers, therefore gradually weighing on private consumption. The government's fiscal stimulus is substantial enough to cushion the contraction and to turn a severe winter recession into a shallow one.

ECB's monthly survey on eurozone consumer expectations was released the same day. Median inflation expectations over the next 12 months rose to 5.4% in October from 5.1% in September, while expectations for inflation three years ahead were unchanged at 3.0%, the ECB said. In addition, economic growth expectations for the next 12 months declined to -2.6% from -2.4% in September while unemployment is seen rising and income growth is expected to trail inflation.

Peter Kazimir, the head of Slovakia central bank, signaled support for a third straight 75bps hike rate increase during an interview in Bratislava. "*It was a pleasant number last month, but I'm afraid it would be too soon to celebrate an inflation peak. It wouldn't be right to slow down the monetary tightening because of a single better inflation number. I still see many reasons to continue in the set pace of policy tightening.*"

His comments were the strongest in support of pushing with jumbo moves at December Meeting. Kazimir, one of its more hawkish officials, has seen consumer-price growth hit a record 14.5% in his homeland.

Speaking a day before the quiet period preceding ECB rate meetings kicks in, Kazimir said that eurozone downturn on the back of surging energy costs would probably turn out to be "*a technical and a short-term recession*," he said. "*That's one of the reasons why we should have courage to make another step of a similar size as previous meetings. I would prefer a step that would move us to the restrictive-policy phase in a way that would be relatively painless.*"

On QT he claimed that it is inevitable. "*I don't think there are any doubts that it will happen*". He called for balance-sheet reduction to be conducted "*in a transparent and gradual manner*" to ensure "*it's predictable and won't increase market uncertainties.*"

The ECB's December meeting would one of the few meetings at which the central bank would take a decision after the Fed and not before it. The ECB seems to be increasingly concerned that the fiscal stimulus and support measures announced could extend the inflationary pressure.

A fresh round of ECB staff projections would obviously have an enormous impact on the ECB's discussion and decision. However, given the growing skepticism regarding their own forecasts and models, even an official forecast of inflation slowing to 2% by 2025 might no longer be sufficient to calm the more aggressive central bankers at the ECB.

Isabel Schnabel has been one of the more hawkish voices to watch after her Jackson Hole speech in late August. Taking into account her November 24 comments that "*Incoming data so far suggest that the room for slowing down the pace of interest rate adjustments remains limited, even as we are approaching estimates of the "neutral" rate.*", 75bps has been still on the table.

More remarkable was an interview that ECB Chief Economist Philip Lane gave on December 6. The fact that "*the medium term can be longer if the deviation of inflation is not too great, but should be shorter if we have a big inflation gap to fix*" suggested that for Lane, a return of inflation to 2% only in 2025 would be insufficient to stop rate hikes.

Lane's more hawkish remarks seemed to be putting the 75bps hike back on the agenda. The Overnight Index Swap (OIS) market for ECB's rate December meeting edged up to a 67bps hike on December 7 from 54bps a day earlier.

As of December 10, ECB policymakers were divided over the eurozone outlook. Lane and Isabel Schnabel, who lead the economic debate on the ECB board, had given contrasting views.

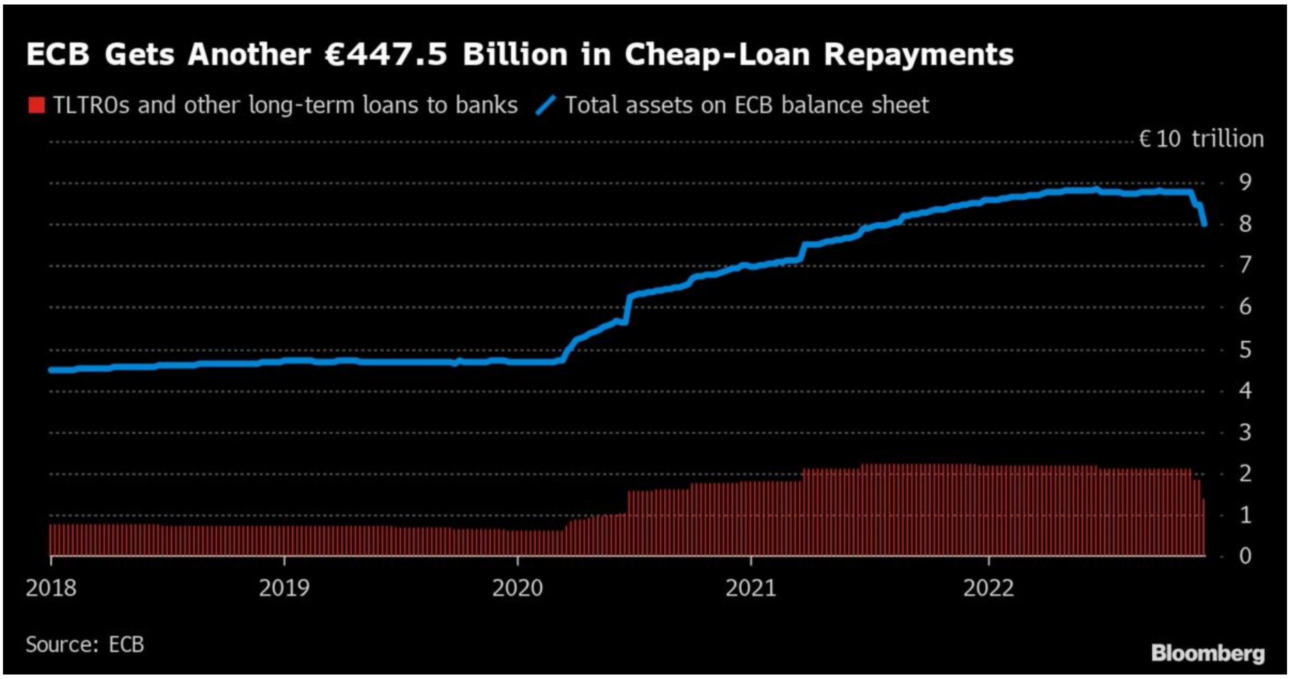
Lane believed high price growth would start to subside in 2023. Schnabel argued that the longer inflation has been allowed to remain high, the greater the risk that it takes root. Lagarde could be pressed on how she views the sparring between top officials. A compromise could be the outcome.

The real anxiety for ECB has been the uncontrollable energy prices. ECB expressed in a formal opinion on November 8 its concerns on proposed EU rules aimed at tempering natural gas price spikes through a "*market correction mechanism*". ECB warned that they might actually jeopardize financial stability and need to be redesigned.

"*The ECB considers that the current design of the proposed market correction mechanism may, in some circumstances, jeopardize financial stability in the euro area.... The mechanism's current design may increase volatility and related margin calls, challenge central counter-parties' ability to manage financial risks, and may also incentivize migration from trading venues to the non-centrally cleared over-the-counter market*," the ECB said an opinion signed by President Christine Lagarde. Instead, the EU should merely have the "*possibility*" to seek the ECB's advice, the ECB added.

TLTRO repayments have been seen as an important first step in the balance sheet reduction process. The amounts repaid could also inform the decision on the reduction of the asset portfolios. According to the October minutes the GC deemed the TLTRO re-calibration "*more efficient*" than trying to achieve the same objective through an earlier start of QT or more aggressive interest rate hikes. That would imply another disappointing repayment could prompt a more hawkish reaction from the Council to achieve the desired pace of policy tightening – be it via rates or faster QT.

However, one should also be aware that year-end considerations could influence repayment decisions. There is an overarching desire by the ECB to withdraw the exceptional accommodation provided via its balance sheet. The ones that have benefited the most from QE also most at risk for an adverse market reaction. Especially sovereign bond spreads of the eurozone periphery have proven remarkably resilient so far.

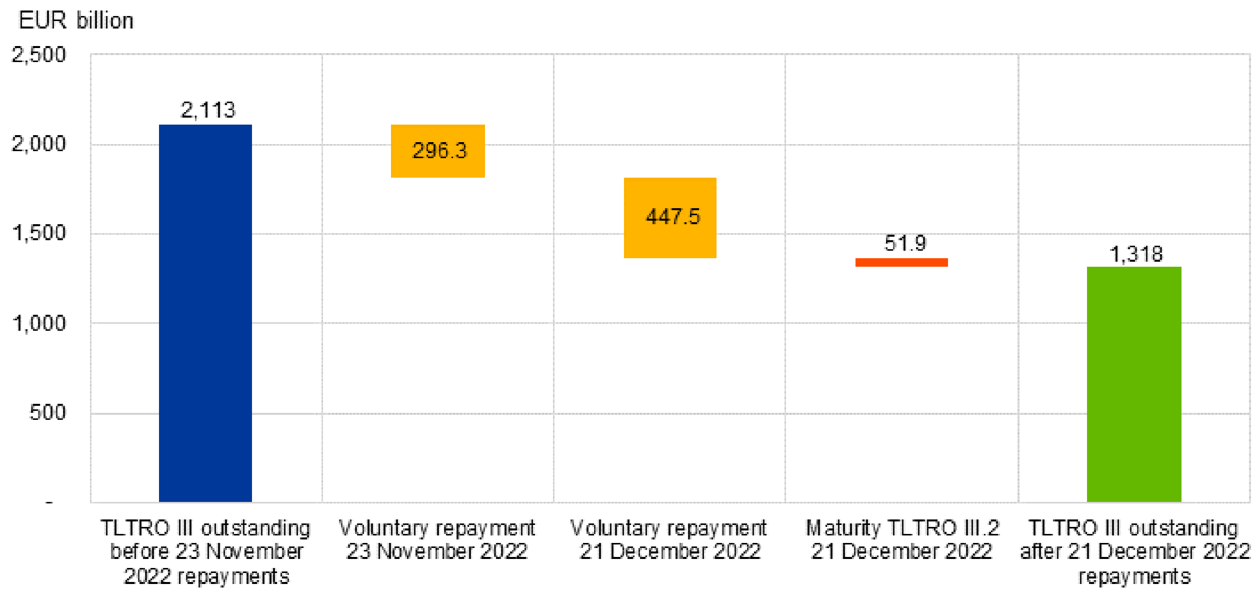


On December 9 ECB announced that eurozone banks would return by December 21 another €447.5bn in TLTRO loans. The total early repayment of outstanding loans across November and December sum up to €743.8bn, after the central bank had toughened the terms of the program to help fight double-digit inflation.

The early repayment would shrink the outstanding amount of TLTRO loans by about 25%. The median forecast in a Bloomberg poll of economists had been for €333bn to be given back for December, though the range of predictions was wide. In November, €296.3bn was returned. Next TLTRO repayment would be announced on January 13, 2023.

Another €51.9bn of TLTROs would mature before the end of 2022, bringing the overall tally of outstanding ECB loans to about €1.32tn, Executive Board member Isabel Schnabel said via Twitter.

Raising TLTRO financing costs stopped banks from earning risk-free interest income by parking cash back at the ECB. While the measure sparked concerns by some lenders, ECB President Christine Lagarde insisted it's necessary to ensure the "*best possible transmission*" of monetary policy.



Source: ECB

The early repayments are expected to raise bank funding costs and temper demand, all in the hope this will ease inflation. At €8.5tn the ECB's balance sheet has been exceptionally large by historic standards. The next step would be to let some of the €5tn euros of debt it holds expire but this process would likely to be gradual and the reduction would set to be small, at least initially.

Before December meeting a couple of statistical data were released. On December 13, German investor sentiment staged another recovery in December, reaching its highest level since the war began in Ukraine.

The ZEW economic institute said its economic sentiment index had risen for a third consecutive month to -23.3 from -36.7 in November. The improved outlook follows unexpected economic growth in the 3Q2022, hopes that double digit inflation could be nearing its peak and relatively full gas storage.

On December 14, eurozone industrial production was reported by Eurostat. October's 2% decline ended period of resilient industrial growth, adding to signs of likely recession. October saw consistent declines among the largest economies: -0.9, -2.6 and - 1% in Germany, France and Italy, respectively.

Higher gas and electricity prices have forced many of Europe's energy-intensive companies, such as chemicals, metals, fertilizers and glass manufacturers, to cut or even close production in Europe and shift some operations to lower-cost regions. Output in energy-intensive sectors fell 2.6%, the sixth consecutive monthly drop, taking the decline since the start of the year to almost 10%.

The biggest monthly drop was a 3.9% decline in energy production, following strikes at French refineries. But there were also declines in the production of durable consumer goods, such as bicycles and fridges, intermediate goods, such as steel and sugar, and capital goods, such as machinery. Compared with a year earlier, overall industrial output was still up 3.4%.

Overall, the trend in production has been stagnant. Industry has been dealing with slowing new orders but at the same time, has seeing some relief from easing supply-side problems. Although October saw a small decline in production, car manufacturing was up 25% since March.

Approaching the December 15 announcements, the markets had been concerned with two issues: eurozone inflation forecasts and QT vs. sovereign issuance.

According to a leak reported by Reuters News on December 14, the ECB expected inflation to remain above its 2% target for the next three years, signaling its fight against runaway prices has been far from over. The new projections, higher than markets have been expecting, would put inflation above 2% in 2024 and just above it in 2025.

Some ECB policymakers, particularly among "hawks" who favor higher rates, have voiced skepticism about its forecasts and called for a greater focus on current readings.

The second issue refers to the ECB's termination of bond-buying. But rising yields and a frail eurozone mean that QT should be slow. Frankfurt has been late to QT. The BoE first started shrinking its government bond portfolios by actively selling bonds before they mature in February, and the Fed followed suit in June.

The ECB would not be expected to start selling assets for several years., but instead may simply stop replacing maturing bonds in its €3.4tn PEPP. Joachim Nagel called for an early and aggressive stop to re-investments in the first quarter of 2023, but others urge caution and the slowdown is expected to begin only in the second quarter of 2023.

The end of bond-buying would mean that investors such as banks and insurers would have to buy more debt, even as eurozone governments have been running large fiscal deficits. Eurozone governments are set to issue more debt in 2023 to cover the cost of shielding households and businesses from the impact of high energy prices. In 2023, the capital markets would have to absorb about €300bn more of eurozone government debt.

Markets have warned that EU member states' increased debt issuance, coupled with less bond buying from the ECB, could revive concerns over whether the high debt levels of some countries are sustainable and spark fears of a repeat of the region's 2012 sovereign debt crisis.

If bond yields do spike, the ECB could step in with TPI. Yet such a tool may exacerbate tensions on the governing council, further unsettling markets. The real dangers of a disorderly exit mean the ECB has little choice but to remove the punch bowl slowly.

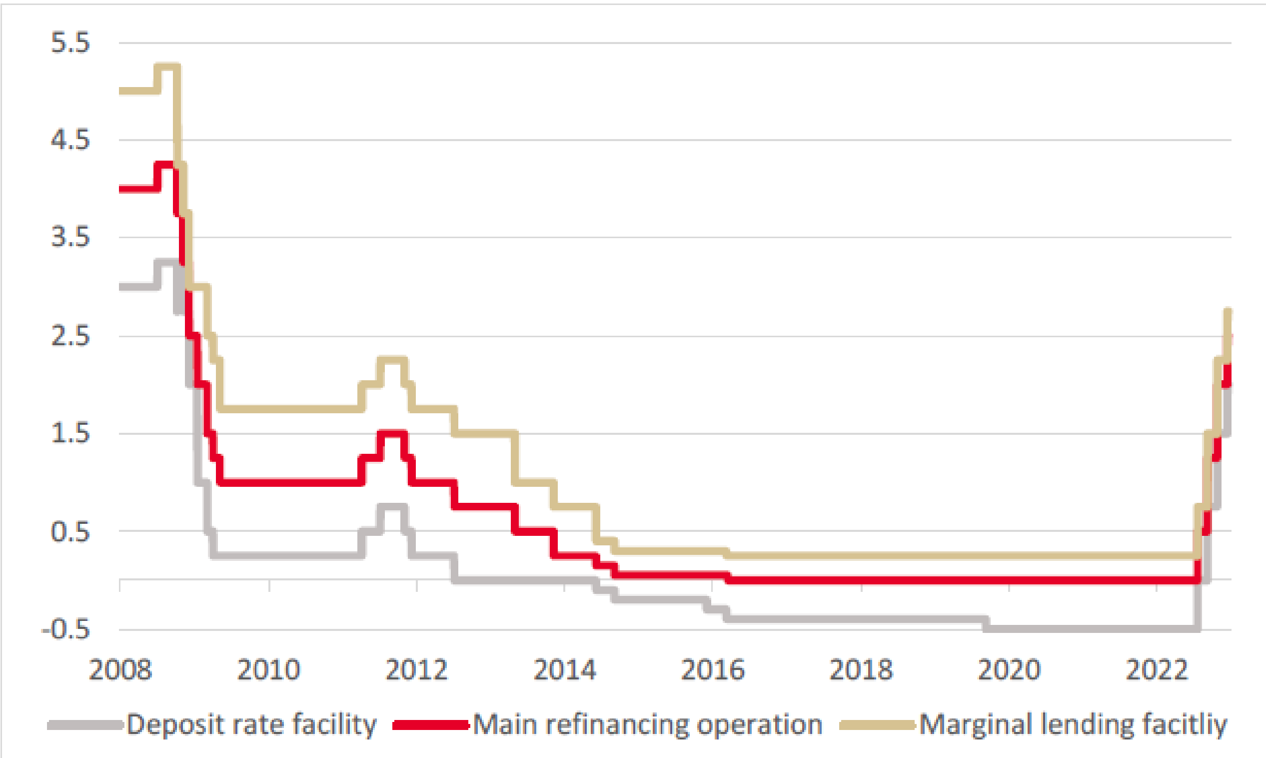
Because of concern about how debt markets might react to the move, the ECB is expected to say it would begin the process gradually, by only reinvesting marginally less of the proceeds from bonds that mature than it does at present.

In total, analysts expect the ECB to reinvest about half the €350bn it receives from bonds maturing next year in its €3.3tn asset purchase program, which is the central bank's largest QE scheme. It is due to continue re-investments in a separate €1.7tn pandemic emergency purchase portfolio until at least the end of 2024.

ECB December 15 Meeting Decisions

In line with the market consensus forecast, the ECB raised the three key interest rates by 50bps. The new deposit facility rate (DFR) is 2.0%, the interest rate on the main refinancing operations (MROs) is 2.50%, and the rate on the marginal lending facility (MLF) is 2.75%. In addition, the ECB adjusted the forward guidance on APP to start tapering re-investments from March 2023. The central bank signaled more rate hikes at a "*steady pace*" given inflation projected above target in 2025.

ECB's Key Interest Rates



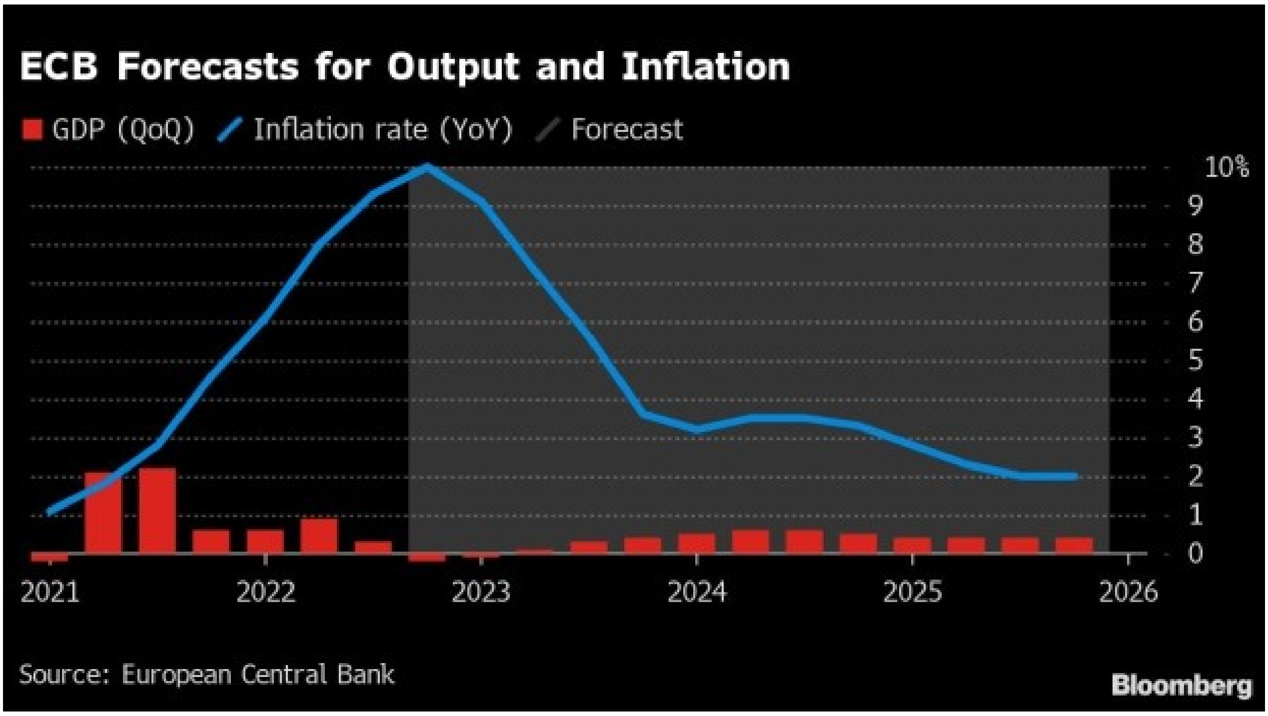
The forward guidance provided a clear indication of more hikes to come at the next meetings in February and March to restrictive levels as inflation was seen above target throughout the projection horizon. The ECB adjusted the forward guidance on APP re-investments, and would start APP QT from March 2023 at a decline of €15bn per month on average until June 2023 "*and its subsequent pace will be determined over time"*.

The proposed pace represents a circa 50% decline in possible re-investments arising from APP redemptions in those four months. The subsequent pace will be determined over time, and the ECB will provide further details on the reinvestment tapering at the meeting in February.

Size of balance sheet remains an issue. Cryptically, the ECB mentioned that by the end of 2023, it would review its operational framework for steering short-term interest rates, which would provide information regarding the endpoint of the balance sheet normalization process. ECB would face a legal problem holding government bonds on its balance sheet in the medium term, something that may favor a slower reduction of the private sector programs or further TLTROs.

In line with previous statements, the ECB did not mention the TPI in the statement. But President Lagarde has confirmed that the ECB has been ready and willing to activate TPI if required. The potential threshold of the BTP-Bund spread remained consistent with macroeconomic fundamentals after the meeting as it increased merely by 15bps. Close attention would have to be paid to the BTP-Bund spread after the February meeting, as details of the APP tapering will be announced, as well as during the months of large redemptions.

The ECB has adjusted its inflation forecasts for 2023 upwards to 6.3%YoY and 3.4%YoY in 2024. For 2025, the ECB sees inflation moving lower but remaining above target, with headline averaging 2.3%YoY in the year. The ECB remains fairly positive on the GDP growth outlook in 2023, at 0.5%YoY, a -40bp downgrade against September (0.9%Y), projecting a short-lived and shallow recession. The ECB maintained a positive view for the longer run. The growth forecasts are fairly strong in 2024 (1.9%YoY) and again in 2025 (1.8%YoY).



President Lagarde stressed that not too much should be read into this change of speed: the ECB's hiking cycle has not come to an end. Other central banks may pivot, not so the ECB, according to President Lagarde. This hints at the ECB being currently further away from its terminal rate than the Fed and also the BoE. While delivering a smaller hike, the ECB pre-committed to another 50bp rate hike in February, and suggested this sustained pace of hiking could be maintained for longer than that.

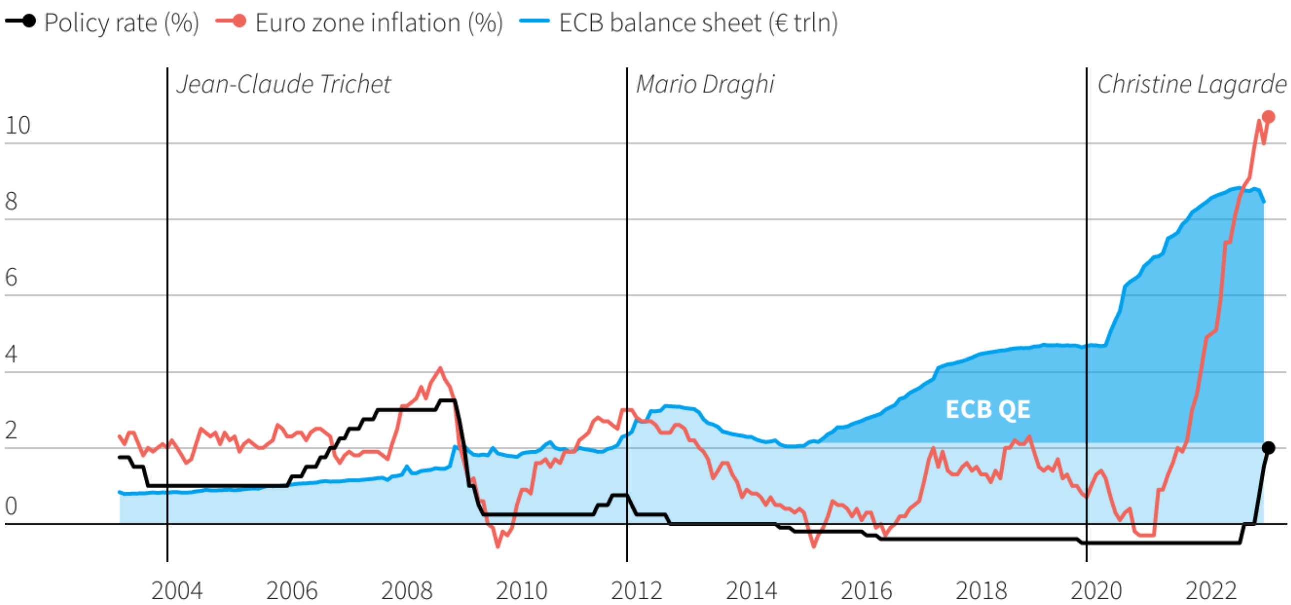
An unconfirmed Bloomberg article reported that a source familiar with the matter said that there was more than a third of Governing Council Members in favor of a 75bps rate hike, and that a pre-commitment for 50bps in February together with a rapid pace of APP tapering was negotiated in exchange for 50bps.

According to Reuters, the compromise helped her secure a majority for the decision although 8-10 policymakers out of 25 remained sceptical - an unusually high proportion. About half a dozen of the dissenters held out even after the compromise while others said they could live with a 50bps move as long as Lagarde coupled it with a hawkish message in her news conference.

The Governing Council opted for the 50bps move proposed by Chief Economist Philip Lane, after a debate on the merits of a bigger increase that resulted in a compromise on the overall decision. Hawkish policymakers relented in their insistence on a bigger increase because they prioritized the messaging on future moves and a firm agreement to promptly start reducing the ECB's balance sheet, according the Bloomberg Newswire.

The planned reduction in bond holdings adds a new element to rate bargaining among the GC's members and might have helped garner support for a smaller hike from the panel's more hawkish officials. Several had pushed for an early start to QT, while their more dovish colleagues have fretted over the deteriorating economic picture and voiced a preference for less aggressive action on rates.

ECB hikes rates again



Source: Refinitiv Datastream | Reuters, Dec. 15, 2022 | Vincent Flasseur

Core inflation has been the key driver of the ECB's inflation projections, and the labor market is a key driver of core. The ECB only expects a 20bps uptick in unemployment next year, from 6.7% to 6.9%, followed by falls in 2024 and 2025 – reaching a record low of 6.6%. Employment growth forecasts were revised up across the board too. Compensation per employee and unit labor costs forecasts were revised up very meaningfully. Large real wage losses in 2022 and next would be compensated by several years of elevated wage growth to recoup purchasing power, keeping the pressure on services and core inflation above target.

In summary, the ECB answer was clear: a smaller hike with a very hawkish message. The following phrases were surprisingly hawkish: "*interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target. Keeping interest rates at restrictive levels will over time reduce inflation by dampening demand and will also guard against the risk of a persistent upward shift*".

With December 15 announcement, it has become clear that the ECB wants to first fully exploit interest rates as the main instrument to fight inflation and that the balance sheet reduction would stay on the back burner.

During the press conference, ECB president Christine Lagarde confirmed a strong determination to continue hiking interest rates on the back of strong upwardly revised inflation forecasts, the explicit willingness to enter and stay in restrictive territory and the start of QT.

"*Anybody who thinks that this is a pivot for the ECB is wrong. We should expect to raise interest rates at a 50 bps pace for a period of time. We have more ground to cover, we have longer to go and we are in for a long game,*" Lagarde told a news conference.

The ECB gave the impression that it has just got started its hiking cycle. The phrase that "*interest rates will still have to rise significantly at a steady pace*" and that "*keeping interest rates at restrictive levels will over time reduce inflation*" illustrates that the last doves must have left the ECB building.

Lagarde added some flavor by saying that increments of 50bps for a period of time looked about right and at a steady pace. This implied, the ECB would probably hit the deposit rate at 3.5% by the end of 2023.

The ECB slowed the pace of rate rises, in line with the Fed and BoE, but Lagarde stressed that investors should not see this as a sign it was about to stop. She said it was "*tempting to assume that all central banks are doing the same thing all the time. If you compare us to the Fed, we have more ground to cover, we have longer to go.* She warned of a further half-point rate rise at the ECB's next meeting in February and *"possibly the one after that and possibly thereafter... We are not slowing down. We are in for the long game*."

A large body of economists also worry that the hawkish noises coming out of ECB are real and that policymakers would go too far, generating a deeper recession than officials want or think necessary to tame price rises. Many ECB watchers believe, that he central bank was too pessimistic on inflation and too optimistic on growth in its latest forecasts, leaving it at risk of raising interest rates too far.

Post ECB December15 events: Approaching the end of 2022 with Lagarde's three T's

On December 16, composite PMI was released. It improved from 47.8 to 48.8 in December. This still signaled contraction, but the contraction in the eurozone economy was likely mild. The easing of contraction was noted in both the manufacturing and services survey.
Germany's Ifo index, staged a strong rebound on December 19 release. It increased to 88.6 in December, from 86.4 in November. The index is back at a level last seen during the summer. Both the current assessment and the expectations components improved in December

By the end of December, Europe's energy crisis has opened new divides, characterized by member states' respective shares of energy intensive industries and by their degree of dependency on fossil fuels. While EU initiatives do include some financial solidarity, the bulk of measures to protect households and business have been financed at the national level and with significant disparity of design.

Germany tops the list in terms of euros made available, while France ranks high on price regulation measures. This later factor is particularly visible on inflation, with headline consumer inflation in November at 7.1% in France, compared with 11.3% in Germany and 12.6% in Italy.

With the European energy crisis unlikely to be quickly resolved, there has been a concern that such marked difference on fiscal measures could become a source of further fragmentation.

Top of the list is the risk that fiscal support measures will further fan inflationary pressures, pushing the ECB to engage additional monetary policy tightening. It is with good reason that ECB president Christine Lagarde has repeatedly warned that fiscal support measures should meet a three Ts test "***temporary, targeted and tailored*** *to preserving incentives to consume less energy*".

For European Commission in its autumn forecast, 70% of measures taken in the EU to mitigate the impact of high energy prices for 2022 fell into the "*untargeted*" category. Further monetary policy tightening could unduly tighten financial conditions for some member states, which would show up in bond yield spread widening.

The ECB had such risks in mind in designing its TPI. This yet untested anti-crisis bond-buying instrument would, however, arguably only be used if significant market dislocations occur. The slow grinding costs of "*moderately too tight*" financial conditions would probably be left unchecked.

Eligibility for the TPI, moreover, includes a look at compliance with the EU fiscal rules, that are due to come back into force in 2024, albeit in a revised form. The windfall tax gains that many governments initially enjoyed on the back of pandemic-related economic restarts and higher inflation will probably prove short-lived. Member states with high public debt levels could well find that fiscal room would be much reduced in 2024.

With Europe probably facing a prolonged energy crisis, the three Ts of the ECB are not just a mantra, but a condition to avoiding a new euro crisis.

The saga of ECB's policy makers public statements continued unabated after the December 15 meeting.

Francois Villeroy de Galhau speaking to BFM Business radio the next day that the fight against inflation wasn't over, adding it should peak during the first half of 2023 before easing. "*We finished the first half (of the match), but the match is not over. We are committed to bring inflation back to 2% by the end of 2024, end 2025*," he said.

Villeroy reiterated that inflation should peak some time during the first half of 2023 before going down and that the European economy should escape a hard landing next year.

The same day the ECB hawk Robert Holzmann told a news conference at the National Austrian Bank in Vienna that the ECB's message is serious about fighting inflation and it was a strong signal equivalent to a bigger increase in interest rates. "*It is a toughly hawkish statement that for me is equivalent to the 75bps (increase previously suggested).*"

Mario Centeno speaking to a news conference in Lisbon during Bank of Portugal's December Economic Bulletin presentation closed the public statements for the day.

"*Returning to the 75 bps rise is an event with very low probability... because there is a very obvious approximation to the neutral rate, because of the maturity that the monetary policy already has and the need to be cautious going forward*," he said. "*In February there is likely to be another 50 basis point rate hike,*" Centeno added.

He said the range of estimates pointed to a neutral rate "*between 1.75% and 2%, a little above 2% but not much above. Every rise in interest rates due to having a restrictive effect must make us think a lot...the risk of overreacting is very great*," he said, noting that the ECB is determined to reduce inflation and that "*the decisions will be taken meeting after meeting, dependent on the data available*".

ECB's Vice-President Luis de Guindos re-emphasized Lagarde's strong statements on inflation on December 19. Speaking at Forum Europa in Madrid he said that "*There will be more interest rate hikes, until when, I don't know. I am absolutely honest, I don't know.* <u>The measures we have taken are not enough, we have to take additional measures,</u>" indicating that the central bank was committed to bring inflation down to its 2% mid-term goal.

The same day Peter Kasimir spoke as the National Bank of Slovakia in Bratislava. He presented its quarterly macroeconomic outlook. He said that the inflation outlook requires the ECB to continue with its strong policy response, and interest rates will need to go into "*restrictive*" territory [i.e. a level of rates that causes the economy to slow] and stay there longer, ECB policymaker Peter Kazimir said on Monday.

"*The resolve to continue resolutely will have to be maintained for at least the whole of the next six months. I even think that in order to tame inflation, it will not only be necessary to move (rates) into the restrictive zone, but it will be necessary to stay there much longer*," Kazimir said in an emailed statement.

He stressed significant tightening remained ahead and laid out plans to drain cash from the financial system as part of its fight against runaway inflation. According to him, risks for the economy were clearly downward while inflation risks were upward. He said fiscal policy was starting to add to price risks. "*The current view of future inflation, which we do not currently see on target even in 2025, forces us to proceed very vigorously, and I fully agree with that,*" he said.

Bundesbank President Joachim Nagel asked the German public for patience in bringing down inflation, warning in an interview with broadcaster N-TV on December 19 that the impact of rate rises could take up to two years to take effect.

Nagel pointed to the bank's four successive hikes this year as evidence it was taking action against inflation but said he did not expect it to fall significantly until 2024. "*I need to ask for some patience*," Nagel said. He added that the Bundesbank expected lower inflation rates in Germany in December because of a gas price brake, but that they would remain at around 7% in 2023 before going back significantly in 2024.

On December 20 Francois Villeroy de Galhau told BFM TV- that the French and broader European economy should not suffer any "crash" or "hard landing". *"France should be able to avoid a recession,*" he added. On December 17, the Bank of France forecasted that the French economy is on course to slow from 2.6% growth in 2022 to only 0.3% in 2023, in an update of its long-term economic outlook.

ECB's Vice-President Luis de Guindos during an interview with Le Monde, Paris said that ECB might raise interest rates at its current pace for a "period of time" to curb inflation. "*We have no choice but to act. Increases of 50bps may become the new norm in the near term. If we do nothing, the situation would be worse because inflation is one of the factors behind the current recession.*"

De Guindos also said he was concerned that markets could underestimate the persistence of inflation and that they might consider fiscal policy to be incompatible with monetary policy. Banks have a solid capital position and can withstand a shock, de Guindos said, adding that he had more doubts about non-banks, notably hedge funds, which have highly illiquid assets and accumulated risky assets.

Isabel Schnabel said in an interview published to German newspaper Frankfurter Allgemeine Zeitung, on December 24, that the ECB must be prepared to take the heat and raise interest rates further, including by more than the market expects, if that is needed to bring down inflation.

"*Whether we will still need to go higher than that will depend on the future inflation outlook.*" She added that the ECB will focus on medium-term inflation expectations, rather than current readings, and saw little risk of raising borrowing costs too far at present given that real interest rates are still very low.

Following the December 15 rate increase, several ministers in Meloni's right-wing government criticized the ECB the next day and said it risked helping Russia's efforts to undermine the EU economy. Commenting on the hike which caused borrowing costs for debt-laden Italy to soar, Schnabel said the ECB should weather the pressure. "*We can expect increasing push-back and we need to withstand it,*" *she said in the interview.* "*That's exactly why central banks are independent.*"

On December 26, Dutch governor Klaas Knot one of the governing council's more hawkish rate setters, signaled ECB will keep raising rates as 'second half' of tightening cycle begins. He told the Financial Times that, with five policy meetings between December 2022 and July 2023, the ECB would achieve "*quite a decent pace of tightening*" through 50bps rises in the months ahead before borrowing costs eventually peaked by the summer.

"*The risk of us doing too little is still the bigger risk. We are just at the beginning of the second half,*" Knot said. Deciding when it had tightened policy enough would be the "*main challenge*" for the ECB next year. Knot said financial stability risks were "*much clearer on our radar screen now*". It was no coincidence, he said, that before starting to raise rates in July the ECB had set up the TPI tool to counter the risk of fresh turmoil.

The Dutch central banker acknowledged that, in 2011, the ECB should "*probably have paid a little bit more attention*" to low levels of underlying inflation, before raising rates in response to surging oil prices. Knot added that the ECB had been too late to respond to price pressures and should have stopped asset purchases in late 2021, instead of March 2022.

Commenting on the leaks that a third of council members argued for continuing with 75bps rises, Knot said that by shifting to smaller rate moves, "*we grant ourselves a little bit more time along the way as we tighten into 2023 to evaluate the effects of our tightening*".

Knot acknowledged there was a communication challenge for the ECB to convince businesses and households of the benefits of raising rates during a downturn. But he said much "*depends on the depth of the recession and we have to keep in mind that even if inflation is falling, it is coming off incredible peaks*".

According yo Knot recent data indicated any recession would be "*short and shallow*". On the labor front, he expected "*lots of labor hoarding, even in a recession*" would keep eurozone jobless levels near a recent record low of 6.6%. He predicted that a record 6.4% annual growth in Dutch wages in November "*might happen in other countries with a certain delay. Why would workers settle for a hit to their purchasing power in current labor market conditions?*"

He acknowledged that the war in Ukraine created "*genuine uncertainty*" that was beyond the ECB's control, but said the best it could do was to focus on bringing down inflation, which he called "*a regressive tax that nobody voted for*".

The Dutch central bank recently warned that it expected €9bn of losses over the next four years because rising rates mean it would pay far more on bank deposits than it earns from its bond holdings. Knot said it was "*uncomfortable that the central bank is taking the hit*", though he estimated it could "*plug the hole*" without a bailout by withholding dividend payments to the government for "*years, if not decades*".

The last day of the year ECB President Christine Lagarde gave an interview to the Croatian newspaper Jutarnji. Croatia will join the eurozone on January 1, 2023 as the euro currency bloc's 20th member.

She admitted that eurozone wages have been growing quicker than earlier thought and the ECB must prevent this from adding to already high inflation.

"*We know wages are increasing, probably at a faster pace than expected. We must not allow inflationary expectations to become de-anchored or wages to have an inflationary effect.*"

Lagarde said the central bank must "*take the necessary measures*" to lower inflation to 2% from its current rate of near 10%. "*We need to be careful that the domestic causes that we are seeing, which are mainly related to fiscal measures and wage dynamics, do not lead to inflation becoming entrenched.*"

Lagarde highlighted that the "*recession we feared is likely to be short-lived and shallow,*" citing her institution's most recent forecasts., provided there are no additional shocks.

Monetary vs. Fiscal Priorities

By the end of December 2022, the message from the world's top finance chiefs was loud and clear: rampant inflation is here to stay and taming it would take an extraordinary effort, most likely a recession with job losses and shock-waves through emerging markets.

Official interest rates would be increased to bring inflation under control, whatever the short-run cost to the economy, because not doing enough now would entail an even bigger economic cost subsequently. Central banks spent decades building their credibility on inflation fighting skills and losing this battle could shake the foundations of modern monetary policy.

Inflation is near double-digit territory in many of the world's biggest economies, a level not seen in close to a half century. With the notable exception of the United States, a peak would still months away.

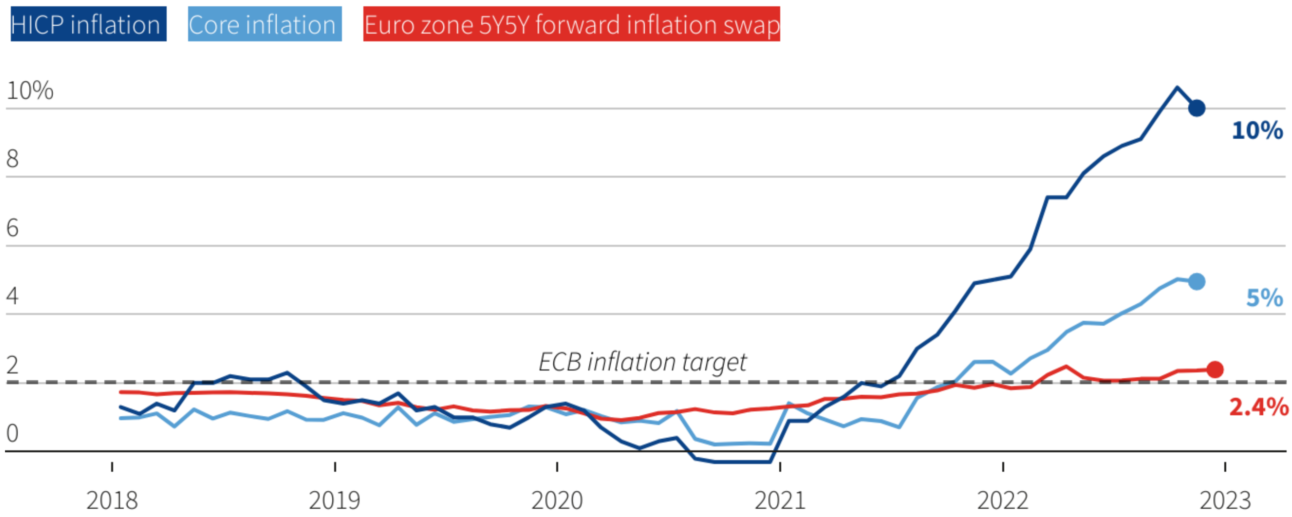
The complication has been that central banks for the most part appear to have only limited control. For one, high energy prices, a function of Russia's war in Ukraine, is creating a supply shock on which monetary policy cannot control.

Spending by governments, also outside central bank control, exacerbates the problem. One study presented at Jackson Hole argues that half of U.S. inflation is fiscally driven and the Fed would fail to control prices without government cooperation.

Lastly, a new inflation regime may be setting in that would keep upward pressure on prices for an extended period. Deglobalization, the realignment of alliances due to Russia's war, demographic changes and more expensive production in emerging markets could all make supply constraints more permanent.

Euro zone inflation off record highs

But inflation and the five-year/five-year forward gauge of market inflation expectations (5Y5Y) still above ECB's 2% target.



Source: Refinitv Datastream | Reuters, Dec. 7, 2022 | By Kripa Jayaram

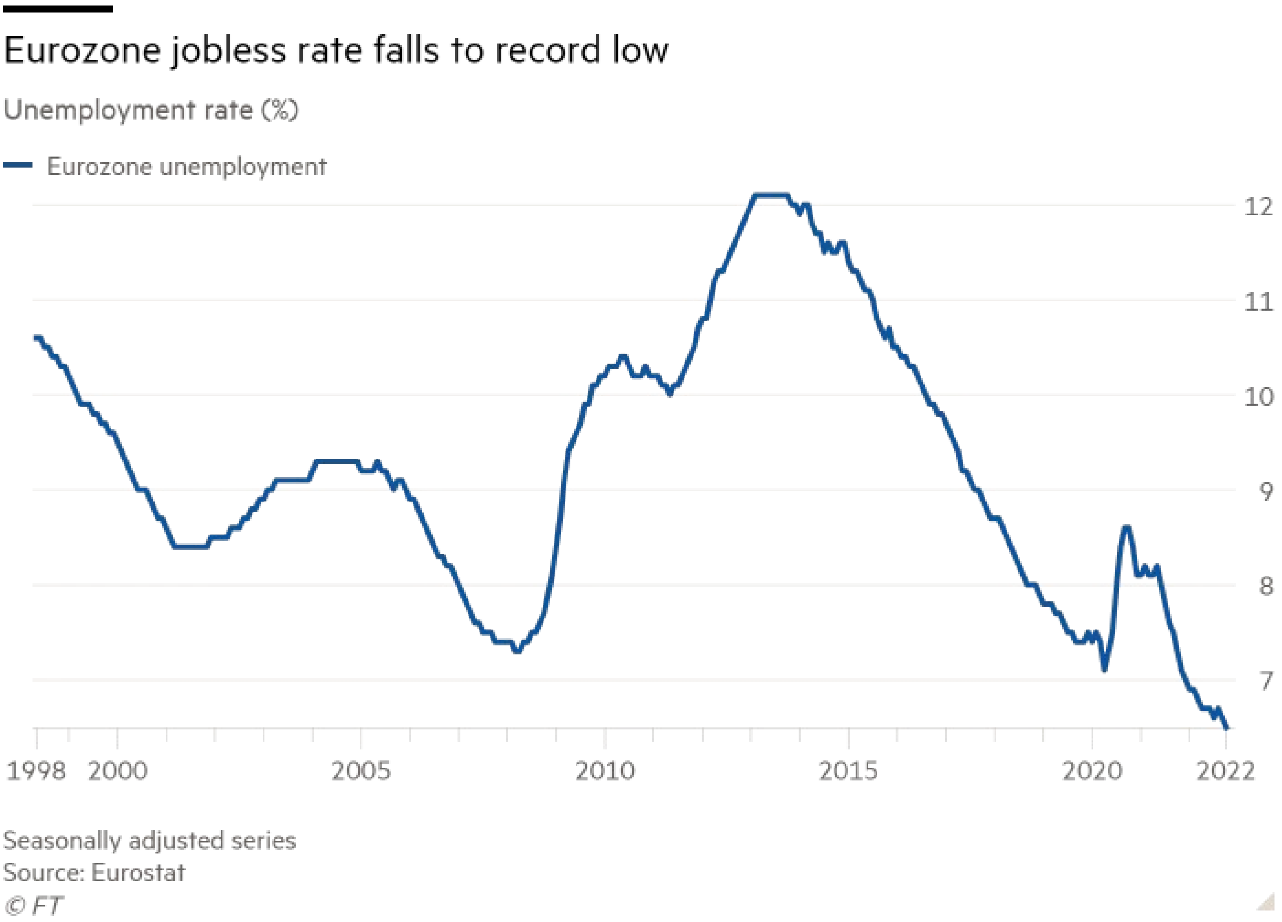
On November 22, the European Commission urged eurozone governments to coordinate fiscal policies for 2023 so as not to clash with the ECB's efforts to curb inflation and should keep up investment during the expected economic slowdown. EC's recommendations are part of the EU's annual policy coordination under which the EU executive arm works out the best policy mix for the currency bloc as a whole.

It was the first time EC publicly came in-line with IMF and ECB recommendations on fiscal policy. "*The economy faces a year of challenges. But if we remain united and pursue a coordinated policy response, we are well-placed to face them. Euro area countries should refrain from broad-based fiscal expansion while delivering targeted support for the most vulnerable,*" Economy Commissioner Paolo Gentiloni told a news conference.

One key problem has been the size of support that governments provide to households and businesses to deal with record high energy costs, with the wealthiest, Germany, offering a help package more than twice the size of rich peers France and Italy. Such support not only distorts competition in the EU's single market, but also acts as a fiscal stimulus and works against the ECB's efforts to bring down record-high inflation, the Commission has said.

The negative effect is amplified by the fact that 70% of the government support measures are broad and would be hard to remove, rather than temporary and targeted to the most vulnerable in the economy, the Commission said. "*(They should) ensure that support provided to households and companies that come under financial stress because of the energy crisis is cost-effective, temporary, and targeted to vulnerable ones, in particular SMEs,*" it said.

It recommended governments set up a system under which the state would subsidize a certain level of energy consumption, but anything above it would have to be paid at the higher, market price, ensuring there is an incentive for energy savings.



The Commission also urged governments not to cut public investment as the economy enters a technical recession a task that would be made much easier by grants available from the EU's post-pandemic recovery fund.

But if governments do not phase out current support against the energy price shock after the first three months of 2023, this would complicate the fight with inflation, Gentiloni said.

The same day OECD, the Paris-based organization published its latest Economic Outlook, containing analysis and projections for the world economy for 2023. Its main suggestion: The world's central banks must keep raising interest rates to fight soaring and pervasive inflation, even as the global economy sinks into a significant slowdown.

The OECD raised forecasts for 2023 inflation compared with its September projections and predicted price increases the following year would remain well above many central bank targets: at 2.6% in the US, 3.4% in the euro area and 3.3% in the UK.

"*Right now controlling inflation has to be the top priority otherwise we might end up with a wage-price spiral like we had in the 1970s, or we end up with a situation that inflation becomes so entrenched that the pain needed to control it will be even greater. Risks of over-shooting are certainly less than risks of inaction,*" OECD's interim chief economist, Alvaro Santos Pereira, told Bloomberg News in an interview.

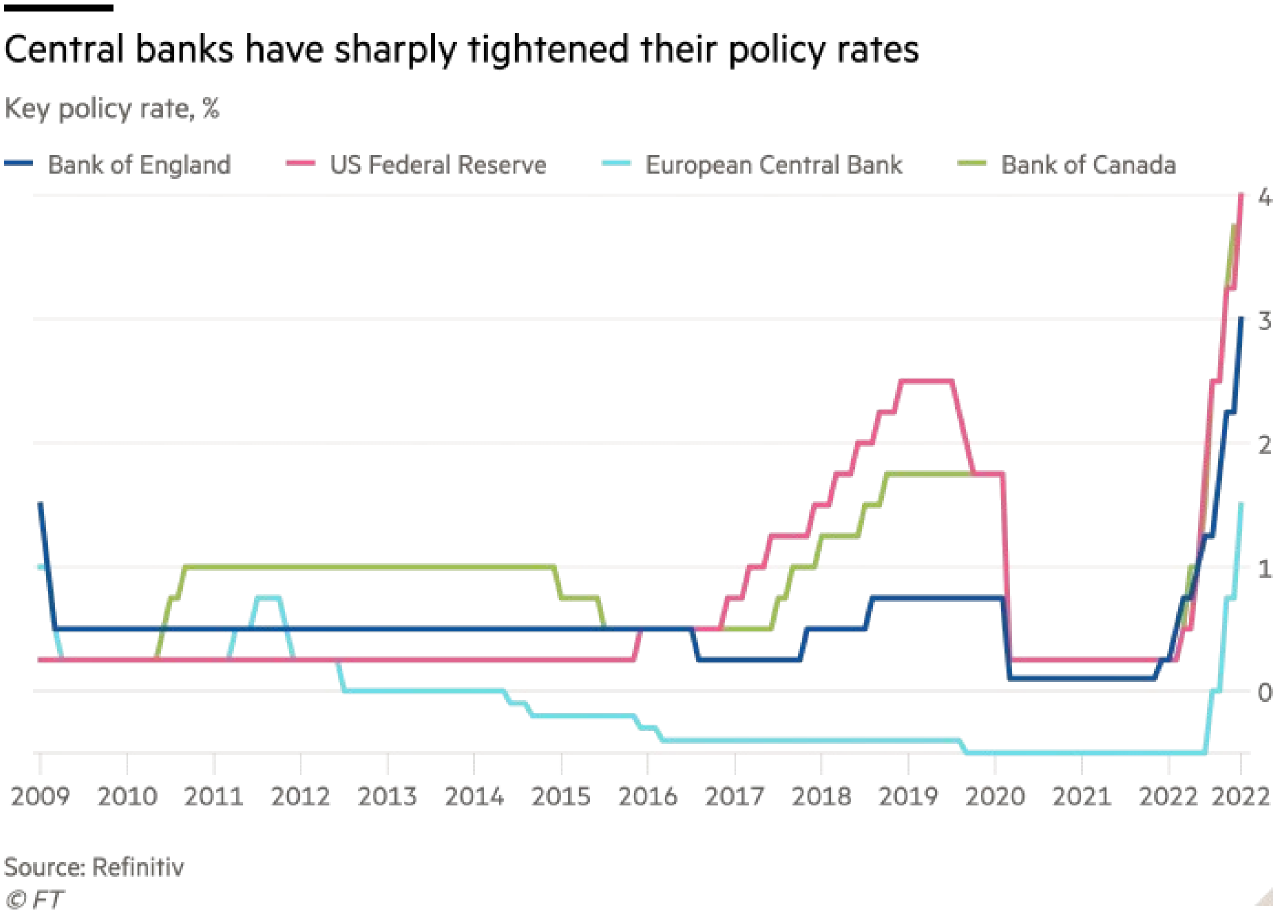
The OECD said that while the global economy will suffer a "*significant growth slowdown,*" it isn't currently forecasting a recession. Indeed, it revised up some of its growth predictions, notably for the euro area, where it now sees a 0.5% expansion in 2023 instead of the 0.3% it forecast in September.

Pereira cautioned that fiscal policy support in Europe must be better targeted, however, to ensure it protects only vulnerable households without further stoking inflation or over-burdening public finances. "*In the fight against rising prices, it is also essential that fiscal policy works hand-in-hand with monetary policy. Fiscal choices that add to inflationary pressures will result in even higher policy rates to control inflation,*" Pereira said in an introduction to the OECD's latest economic report.

The end a great experiment

A great experiment in monetary policy came to an end in 2022. On July 21, ECB announced its largest rate hike in two decades, cutting its benchmark rate to just 0%. Never before, over the course of some 5,000 years of lending, have interest rates sunk so low. Those who lament the consequences of easy money are quick to blame the central bankers. But the problem stems from the strict inflation mandates they have to follow.

In 1990, the Reserve Bank of New Zealand became the first central bank to set a formal target. In 1997, Bank of England (BoE) was also targeted, as was the ECB when it opened a year later. After the global financial crisis, both the Fed and the BoJ jumped on board.



The problem is that when an institution is guided by a specific target, critical judgment is usually suspended. This problem is well known in monetary policy makers circles. In the 1970s, Charles

Goodhart of the London School of Economics noted that when the BoE focused on a specific measure of the money supply, the measure's previous relationship with inflation broke down.

Inflation targeting is true to its form. Thanks in large part to globalization and technological advances, inflationary pressures eased in the 1990s, allowing central bankers to cut interest rates. After the dotcom crisis at the turn of the century, fears of deflation led the Federal Reserve to set the Fed rate at a post-war low of 1%. A global credit boom followed. The subsequent failure unleashed even stronger deflationary pressures. The Fed continued to cut its key rate to zero. Interest rates in Europe and Japan turned negative for the first time in history.

Over the next decade, central bankers justified their actions by referring to their inflation targets. Yet these goals caused a number of corruptions and disruptions. Ultra-low interest rates pushed the US stock market to near-record valuations, sparking: the "*everything bubble*" in a wide variety of assets ranging from cryptocurrencies to vintage cars. Forced to "chase yield", investors took more risk. The fall in long-term interest rates hurt savings and led to a massive increase in pension deficits. Easy money kept zombie companies afloat and flooded Silicon Valley with blind capital.

Businesses and governments took advantage of cheap credit to take on more debt. Most economists assume that interest rates simply reflect what's going on in what they call the "*real economy*." The era of ultra-low interest rates has thrown the global economy far out of balance.

During the pandemic, central bankers were still trying to meet their inflation targets as they cut interest rates and squeezed trillions of dollars, much of which was used by their governments to cover the extraordinary costs of lock-downs. Now inflation is back and central banks are trying to regain control without crashing the economy or triggering another financial crisis.

Global economic activity flashes red

Composite Purchasing Managers' Index (PMI) across major economies. **Expansion** > 50 > **contraction**

2022	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Germany	53.8	55.6	55.1	54.3	53.7	51.3	48.1	46.9	45.7	45.1	46.3
U.S.	51.1	55.9	57.7	56.0	53.6	52.3	47.7	44.6	49.5	48.2	46.4
Euro Zone	**52.3**	**55.5**	**54.9**	**55.8**	**54.8**	**52.0**	**49.9**	**48.9**	**48.1**	**47.3**	**47.8**
Australia	46.7	56.6	55.1	55.9	52.9	52.6	51.1	50.2	50.9	49.8	48.0
UK	54.2	59.9	60.9	58.2	53.1	53.7	52.1	49.6	49.1	48.2	48.2
France	52.7	55.5	56.3	57.6	57.0	52.5	51.7	50.4	51.2	50.2	48.7
Japan	49.9	45.8	50.3	51.1	52.3	53.0	50.2	49.4	51.0	51.8	48.9
Italy	50.1	53.6	52.1	54.5	52.4	51.3	47.7	49.6	47.6	45.8	48.9

Source: Refinitiv Datastream | Reuters, Dec. 5, 2022 | By Vincent Flasseur

Elected parliamentarians and governments cannot continue to evade their responsibility. They need to rethink central bank mandates, taking into account the impact of monetary policy not only on short-term inflation, but also on asset valuations (especially real estate), leverage, financial stability and investment.

Politicians are now blaming central bankers for inflation rates. This can help distract governments from their own shortcomings. But it further undermines the reputation of central banks, which were already damaged by the financial crisis.

History provides strong evidence that politicians cannot be trusted in determining monetary policy. Rather than simply parrying criticism and hiding behind their previously largely successful track record since independence, it is in the interest of central bankers and the public that they begin to rebuild their reputation. Both the technicalities and the legitimacy of independent monetary policy are now under scrutiny.

Central banks also need to become more flexible. The past two years have shown that traditional economic models are of little help when geopolitical, public health and supply chain factors become so dominant. The wisdom of offering forward guidance has been further questioned. And relying on historical trends – such as the previous decade of low and stable inflation – should not blind policymakers to the idiosyncrasies of current and future trends.

Central banks reaction function has changed. It follows a paradigm shift of many central banks as witnessed at the Jackson Hole symposium in August 2022. A paradigm shift that is characterized by central banks trying to break inflation, accepting the potential costs of pushing economies further into recession. This is similar to what we had in the early 1980s. With the current paradigm shift, central banks are trying to get ahead of the curve - at least ahead of the curve of the 1970s and 1980s.

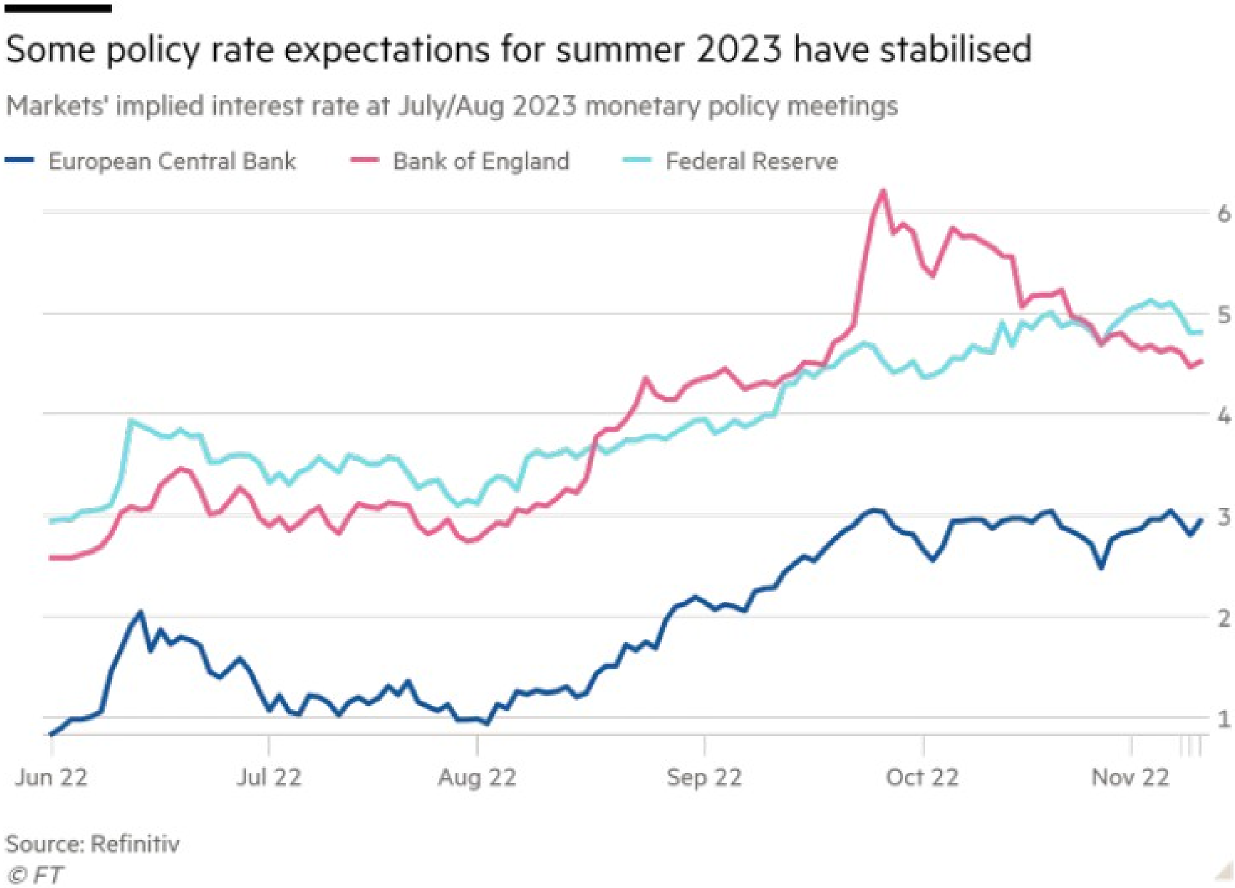
Whether the paradigm shift of central bankers is the right one or simply too much of a good thing is a different question. What is striking is the fact that central bankers have implicitly moved away from measuring the impact of their policies by medium-term variables and expectations towards measuring it by current and actual inflation outcomes. This could definitely lead to some overshooting of policy rates and post-policy mistakes.

The mounting expectations that central banks would increase rates, even if their economies fall into recession, has prompted concern from the World Bank. The Washington-based organization warned on September 15 that policymakers risked sending the global economy into recession next year.

Central bankers such as Schnabel have signaled that, with inflation set to remain close to record highs for the foreseeable future, they are no longer prepared to put their faith in economic models that show price pressures declining over the next couple of years.

While most of the inflation seen in Europe remains the result of the surge in energy prices triggered by the war in Ukraine, there have been increasing signs in both the single currency area and the UK that price pressures have become more widespread and more entrenched.

The era of negative interest rates in Europe ended on September 22 as Swiss National Bank terminated negative interest rates. It raised interest rates by 75bps to 0.5%, bringing the rate into positive territory for the first time since 2015. A reverse tiering system and a reduction in liquidity were also announced.



Critics of the aggressive monetary easing have become more vocal. "*In retrospect, it turned out to be a mistake, not only in theory but also in the internal politics of the ECB. The only significant effect of negative interest rates was to keep the euro lower, which had a limited impact anyway in a deflationary world,*" said Lorenzo Bini Smaghi, president of French bank Société Générale, who left the ECB's Governing Council before cutting spending. rates below zero in 2014.

As a reminder, the ECB's last rate cut to -0.5% in 2019 proved so controversial in savings-obsessed Germany that top-selling tabloid newspaper portrayed Mario Draghi, the then central bank chief, as a vampire sucking savers' accounts.

Returning to the optimum neutral rate level, the question remains. At first glance, it is a vague concept. In simple terms, it is the level at which the policy rate is neither accommodative nor contractionary. What is its level in the euro area? Complicated econometric models could be used to estimate it.

A Reserve Bank Of Australia (RBA) paper by Assistant Governor Luci Ellis - published in October 2022 - illustrated, that estimates can vary wildly with a range of up to 2.50%. Its estimation is only made more complicated by unconventional monetary policy measures (asset purchases, forward guidance, credit easing policies, etc.). Since the introduction of such measures, analysts have tended to focus on the shadow rate to understand how accommodative a country's monetary policy is. In essence, the shadow rate is what the policy rate would be with the same level of accommodative monetary policy stance without unconventional measures.

For the level of the neutral rate, rather than trying to estimate it, it is more important to keep in mind what central bankers think it might be, as it is the point at which central banks are likely to become more cautious in the hiking cycle and slow the pace at which they raise policy rates. In particular, Villeroy made clear that in his view the ECB must be careful once it reaches the neutral rate and thereafter proceed with caution in the hiking cycle. In the case of the euro area, both Villeroy and Holzmann have said that in their mind it is around 2%.

Central Banks' Mea Culpas

Central bankers are now desperately trying to contain a problem they allowed to happen: inflation. That has eroded their credibility in the eyes of investors and society at large.

US Fed Chair Jerome Powell acknowledged in June 2022 that "*with the benefit of hindsight, clearly we did*" underestimate inflation. Christine Lagarde, his counterpart at the ECB made similar concessions, and Reserve Bank of Australia Governor Philip Lowe said in May that his team's forecasts had been "*embarrassing.*"

The first step for the newly humbled monetary policymakers is getting prices back under control without creating economic havoc. Next they must transform the way central banks operate. For some experts, that means three things: paring down their mission, simplifying their messaging and preserving flexibility.

The Fed's big miss on inflation has led Powell to start invoking the lessons of Paul Volcker, who famously tamed it in the 1980s. When reckless lending eventually blew up the housing and credit markets in 2008, then-chair Ben Bernanke deployed the Fed's balance sheet in ways that hadn't been seen since the Great Depression.

Coming out of the COVID-induced recession, it looked as if central bankers had pulled it off again, led by Powell. Their coordinated response in March 2020 put a floor under asset prices and kept bond yields low, helping governments fund the massive spending needed to support millions of unemployed people. With inflation still low, central bankers extended their responsibility by tackling problems such as climate change and inequality - including setting a new goal of "*broad-based and inclusive*" employment. Meanwhile, stocks, bonds and cryptocurrencies were racing higher.

Then consumer prices went up, and central bankers didn't see it coming. The Fed's new policy framework prevented a more aggressive approach to inflation. The Federal Open Market Committee's (FOMC) simply lost sight of its primary role, which has been to maintain price stability.

As a reminder, monetary policy works through central bankers' manipulation of points along the yield curve - essentially the price of money over different periods of time. Central bankers provide signals about whether to expect interest rates to rise, fall or trend sideways, and traders in the financial markets buy and sell vast quantities of bonds accordingly.

Those moves percolate through the broader society, influencing pension account balances, business and consumer confidence and views on future price movements. That's what determines whether the central bank policies work or not.

In 2022, as the Fed, ECB and the BoE changed drastically their outlooks for the economy and inflation, there was a pretty massive failure to communicate how policy would address those changes.

In the Fed system Thomas Barkin, Richmond Federal Reserve President, was poring over the latest inflation-related data one morning in June 2022 when he saw an alarming sign. Prices had surged in May, after a slight drop in April that had raised hopes that a recent uptick in inflation would be short lived. The Fed began increasing rates in March but its officials remained divided over how much it needed to raise them until the consumer prices data published in June ended the debate.

Barkin said the data, which triggered a U.S. bond market sell-off, prompted him in a call with Fed chairman Jerome Powell to give his support for a bigger interest rate increase than the one the Fed had all but promised to announce days later. "*Move as fast as possible without breaking things*," Barkin said to Powell.

Before the prices data published in June, Fed officials had aired different views about how temporary the inflation spike would prove to be and what action was needed. The new numbers showed how deeply rooted it was and that the small hikes made till then (May 5, 50bps) were not working.

Powell enacted a flurry of conversations with FOMC members in the wake of the data, for that week, as the world's most powerful central banker sought to end months of parrying over whether to take tougher action to tame inflation. Within days, the Fed announced a larger-than-expected 75bps hike on June 16, its biggest single step in nearly 30 years and what was to become part of its steepest rise in interest rates since the 1980s. It was the cue for central banks around the world to join a reversal of decades of cheap money policies.

Explaining the June hike, Powell told reporters afterwards that only once or twice in his decade long Fed career had such game-changing data dropped so close to a rates decision. To those who say he was too slow to act, he has acknowledged on several occasions with "*hindsight*" he would have acted sooner.

By contrast, the BoE, had already received a lot of criticism for letting inflation get out of control, has also been criticized for how it handled a run on Britain's currency and government bonds after Prime Minister Liz Truss's government proposed a deficit-busting tax overhaul in October 2022. First the central bank was accused of dragging its feet before helping to manage the fallout when the pound dropped to an all-time low against the dollar, and then investors were shocked when the BoE pledged an abrupt end to emergency gilt purchases. In the end, it was Truss who took the blame, resigning after just 44 days.

After the annual summer gathering of central bankers in Jackson Hole, Wyoming, Fed officials fanned out onto the public circuit. In one 24-hour period, three top Fed officials spoke about the economic outlook at three different events and with three different tones.

Esther George (Kansas City Fed) emphasized steadiness over speed, Christopher Waller (St. Louis Fed) signaled support for a 75bps hike at the next meeting, and Charles Evans (Chicago Fed) said he was open to 50bps or 75bps. It's a similar story at the ECB, where at least 19 of its primary officials were out giving speeches in the last week of September alone.

The Fed's shift to a more aggressive stance helped forge a majority for tougher action at the ECB. By early summer, a hawkish group was pushing the ECB to commit to more than just a token 25bps rate rise and take a cue from the Fed.

Concerns that the rate hikes could lead to an explosion in the borrowing costs of indebted euro states - especially Italy - led in June to an agreement to help those countries with TPI that would if needed be activated to prop up their debt.

At a July ECB meeting, the hawks - led by Isabel Schnabel, Klaas Knot and Joachim Nagel - pushed for a bigger move than the 25bps signaled to markets. The hawkish group, coordinating by phone and in-person meetings, sought to convince Chief Economist Lane they now had a majority inside the rate-setting GC for such a decision. The ECB announced a 50bps rate increase in July.

A third common prescription for central banks: Give up forward guidance. That practice, first adopted in the early 2000s, aims to tell the public the likely direction of monetary policy. The problem: It's too hard to predict the future. And it can lock policymakers into a particular mindset.

In an October 12 speech, Fed Governor Michelle Bowman blamed the FOMC's forward guidance for its failure to tackle inflation sooner: "*The committee's explicit forward guidance for both the federal funds rate and asset purchases contributed to a situation where the stance of monetary policy remained too accommodative for too long - even as inflation was rising and showing signs of becoming more broad-based,*" she said.

The forward guidance won't end until central bankers stop speaking so often. The sheer number of speeches by central bank policymakers in a given week, and the seeming desire of these speakers to expound on their own subjective expectations for the economy and monetary policy, means that even when the official communication is shying away from specific guidance, there is still plenty for markets participants to become interested in their statements.

Communicating policy objectives gets more difficult as inflation climbs. It can be quite difficult to provide coherent and consistent guidance in a tightening cycle. Central bank communication in the current context has thus become even more challenging than the actual policy actions.

Of course, central banks would continue to play a crucial role in their economies, even if they dial back the rhetoric and scrap more difficult-to-measure goals such as the promotion of inclusive growth. They would continue to serve as guardians of financial stability, providing cash when markets seize. And they would find ways to stimulate economic growth when it's needed again.

But if they heed the lessons of 2022, markets and the public can expect rarer, clearer and less ambitious policy communication - a new era of central bank humility stemming from their failure to prevent the inflation shock.

The Path Ahead

The ECB now giving more importance to actual inflation prints rather than its own inflation forecasts. This implies that the ECB is likely to continue hiking rates in 1H2023, even if the euro area enters a recession. From that standpoint, and given expectations that euro area inflation may print above 8% in spring 2023, pricing of early 2023 meetings firmly below 50bps looks timid. Lagarde stressed that the ECB "*can no longer rely exclusively on the projections provided by our models*".

Inflation concerns have not diminished since the July meeting and euro weakness is not helping. In the current energy supply shock situation, the exchange rate pass-through to inflation "*matters more*". Besides, the latest ECB minutes have stressed signs of a pick-up in wage growth and a higher risk of second round effects on inflation.

Deeply negative real EUR rates mean ample room for rate hikes. Real short-term rates remain in deeply negative territory, meaning that eurozone is quite far away from the point where ECB policy becomes restrictive.

Even if inflation is peaking, it has been doing so near four-decade highs. Global pressures might be easing, but core inflation, has been still high - particularly services prices, which have been influenced by wage growth. A higher cost of credit would restrain domestic demand pressures. Though inflation expectations have fallen and there have been some nascent signs that labor market tightness may soften, central banks are right to be wary about high prices persisting.

Monetary policy theorists suggest that central banks need to raise rates above "*neutral*", beyond which they have a contractionary impact on the economy. Though estimates vary, and change with time, by some measures the BoE and Fed may already be there, with the ECB closing in. Even when this biting point is reached, how much higher to go and what level to stay at is complicated.

With the Fed and BoE shedding their bond holdings, via QT, which the ECB has been also initiating, it is also uncertain how changes in central bank balance sheets may impact inflation and financial stability.

It might be sensible for central bankers to lower the pace of their rates increases in 2023, while waiting for clearer evidence that domestic price pressures are cooling before leveling off. Being alert to global shocks will also be important. Getting the interest rate right will not be simple. Though inflation may have peaked, one thing is for certain: it is far too soon to declare it beaten.

Conclusions: What to expect from ECB in 2023?

Recession: GDP growth for the first 9 months of 2022 has been better than expected, rising faster than potential, by 0.6%, 0.8% and 0.3% QoQ respectively, despite the shocks stemming from inflation, energy, supply chain disruptions and the war in Ukraine.

But business surveys have weakened materially in 2H2022, pointing to much softer growth or even recession this winter. A technical recession is likely to be mild and shallow. Major buffers to recession in Europe are high accumulated savings, solid corporate balance sheets, tight labor markets and still-protective fiscal policy.

Inflation peak: Inflation has continued to climb in 2022, with inflation expectations rising. Headline inflation hit 10.1% YoY in November, with core inflation at 5% YoY. Gasoline, wholesale electricity and gas prices have recently receded. Energy remains the largest contributor and poses upside risks given the uncertainty on energy supplies and the potential for a surge in wholesale prices. Government measures have cushioned much of the impact so far, but there are risks of further upward price adjustments if government measures fade and energy prices stay high.

The trend in core inflation is particularly worrying, as the energy price shock is feeding through and wage growth adjusting upwards. Core inflation is expected to hit 5.3% YoY in 1H2023 due to a higher wage growth forecast as well as higher electricity and gas prices feeding through to goods prices.

ECB's QT not large enough to lower inflation. The risk of market instability favors a slow start to QT with little impact on inflation. Rates and the TLTRO will thus do the heavy lifting in 2023.

Wage-Price growth: The data already points to an acceleration in wage growth to 4.4%YoY in 2023. A recent key indicator wage deal in Germany resulted in wage increases of 5.3% as of June 2023 and 3.2% as of May 2024, with an additional generous tax-free bonus of €1,500 each year (worth around 3.2% of regular pay per year). Should other deals mirror this, the risk is that companies will need to raise prices to compensate. We also believe the labor market will remain tight, as companies with strong balance sheets retain workers who have become increasingly difficult to recruit Consequently, the risk of a wage-price spiral is high.

Economic trends divergence across countries: Germany, with high energy dependency on Russia before the war in Ukraine, has been particularly hard hit by the uncertainty shock over energy supplies. In addition, weather conditions and supply problems caused widespread disruptions in Germany over the summer, resulting in a depressed economic outlook. Germany, with a high share of energy-intensive industry, is expected to be the only country to enter a shallow recession over the winter, despite relatively large room for fiscal support.

Similarly, Italy was highly dependent on Russia for its energy before the war but has managed well in sourcing gas supplies from other parts of the world. In addition, the return of tourism, the continuation of economic reform, supported by NGEU funds, and reduction of corporate debt is adding resilience to the Italian economy. In Spain, with rates rising fast, household consumption is vulnerable given that the bulk of mortgages there are on variable rates.

Over the medium term, Germany, where industry still makes up an large share of the economy (24%), the risk is that permanently higher energy prices will result in another round of offshoring. Combined with the electrification of the car industry, this would weigh more on employment than in other countries. Germany may be the euro area country in greatest need of economic reform currently, something the government seems well aware of.

However, across the eurozone, and particularly in countries with high public debt (Italy and Greece), economic reform will need to be high on the policy agenda in view of the challenges posed by the energy transition, climate change, and a much less accommodative ECB.

<u>Italian Debt:</u> While higher bond yields will take years to feed through fully to Italy's public debt, due to the long period of low interest rates and a long average maturity of outstanding bonds (7 years), bond yields have already reached levels that put the spotlight on debt sustainability (10yr BTP at ~4.5%).

In the short term, the ECB's re-investments and NGEU funds will help but in the medium term, there is a need to improve the growth outlook and productivity. While the new government looks set to continue most of the previous (Draghi) government's reform efforts, speedy implementation resulting in tangible outcomes is needed to keep bond markets stable and/or reduce the spread to Bunds.

The 4.5% YtM, for the Italian 10-year bond yield is above the interest rate level at which the debt ratio would remain stable. This leads at some point turn on Italy, forcing a period of austerity or demanding that EU institutions provide help. A financial turmoil in Italy would thus also constitute a systemic risk for the eurozone.

<u>ECB tightening:</u> With weak or stagnant growth over the winter but no deep recession, the ECB will continue raising interest rates in 2023, up to 3.5%-3.75% by July (i.e. up to the terminal rate), even though the nominal neutral rate is about 1.5%-2%. The terminal rate is highly uncertain as well the nominal one. Taking this into account, the question shifts to how fast the economy will react to higher rates and for how long the ECB will need to keep a restrictive policy stance for a timely return of inflation to target.

The concept of a neutral policy rate is further obscured by the fact that the ECB has a very large asset portfolio, with little communication yet on its medium-term outlook. With the policy rate broadly back at neutral, it thus makes sense to start reducing the balance-sheet to complement further tightening into a restrictive policy stance. However, with little knowledge about how markets will receive additional supply of bonds, the risk is that the ECB feels constrained by markets, thus requiring a higher terminal rate than what markets currently anticipate.

<u>ECB restrictive policy duration:</u> In its 2021 strategy review, the ECB made its reaction function less pre-emptive by stating that it would leave policy rates unchanged until inflation reaches the target "*well-ahead of the end of its projection horizon*" and durably for the rest of the horizon, supported by developments in underlying inflation. Given the high uncertainty of inflation forecasts, a similar approach could apply when trying to reduce inflation.

This would imply that a restrictive stance would only be gradually abandoned once inflation, with a high degree of confidence, looks set be around the target of 2% in 2024, and thus see rates starting to be cut back towards neutral in late 2024.

ECB risks a deep recession to achieve its target: The ECB is committed to meeting the target, but is greatly reluctant to tighten policy aggressively if inflation is decelerating fast and inflation expectations stay anchored to the target while the risk of recession remains high. Current data and trends should also take priority over the medium-term inflation forecasts given the high uncertainty and their poor track record.

Only if inflation expectations suggest some de-anchoring would there be a need for the ECB to stay very hawkish. However, the notion of allowing transitory periods of moderate overshooting following long periods of forceful and persistent monetary policy action, as expressed in the 2021 strategy review, is not likely to be relevant again after such a large overshoot as this year and next.

Balance-sheet reduction though QT: As the policy rate has rapidly moved to neutral, the ECB should now be increasingly focused on reducing the balance sheet to achieve a more balanced yield curve tightening. ECB took steps to withdraw the favorable financing conditions of TLTRO.

The official reason to end the favorable financing conditions as of November 23 was that the acute phase of the pandemic has ended and the unexpectedly rapid rise in inflation. In November and December, banks repaid €296bn and €498bn of the outstanding €2.1tn at the first two possible repayment dates. A reduction by at least half by early 2023 and to below €500bn is expected by mid-2023.

There is much uncertainty with regards to the impact of QT on inflation and growth and the trade-off between rates, TLTRO and asset holdings. ECB research suggests that the rate instrument is the more effective tool. The policy rate is the most effective tool for reducing inflation, but QT is needed for more balanced tightening and positive yield curves.

The size of the balance sheet matters for the policy stance but also for liquidity. The chance of the ECB holding sovereign bonds in the long term given the legal constraints and lack of deflation risks is diminishing. The value of TLTRO and the private-sector programs could thus be reassessed should liquidity needs be high.

The ECB will proceed with a controlled run-off, starting March 2023, running at €15bn per month until June. Given lower redemptions, the ECB to continue at a pace of €15bn/month in 3Q. Should markets handle these volumes well, the ECB may want to ramp up the run-off to about €20-25bn per month in 4Q, and likely start the run-off of the PEPP earlier than at the end of 2024.

ECB's unique problem - Multi-sovereign bond market: 19 different bond markets, each display its own vulnerabilities in terms of market- and country-specific characteristics. This has led to significant fragmentation in the past that the ECB has needed to find innovative solutions to. For instance, we think the Italian 10-year bond yield is already above the interest rate level at which the debt ratio would remain stable, making it hard for the ECB to reduce its holdings significantly without risking a more significant market sell-off.

Similarly, with monetary policy being relied on for so long, some complacency and moral hazard could have crept in for fiscal policymakers and their readiness to stabilize economies via sustainable fiscal or, more importantly, structural policies. This could amount to fiscal dominance, transmitted via financial markets, reducing the ECB’s ability to implement QT.

ECB alleviates collateral scarcity: So far, the ECB has only taken small measures to counter the impact of collateral scarcity and the risk of the overnight rate not closely following the rise in the deposit facility rate. In September, it temporarily removed the 0% ceiling for remunerating government deposits, and in October it raised the limit for the securities' lending program, against cash collateral, from €150bn to €250bn. In addition, the early repayment of TLTRO loans should further release collateral.

Consequently, the ECB currently does not seem overly worried about any transmission problems, and with QT next year, the scarcity issue should further ease. Should the issues arise again, there are a number of potential solutions, including introducing a reverse repo facility, giving non-banks access to ECB facilities or even issuing securities

ECB's losses and the political cost: Central banks prefer to avoid large losses from selling bonds that were bought when rates were low and sold when rates have risen (and prices fallen). While this does not matter much for a central bank balance sheet, it matters for the dividends it pays to the finance ministries. The political backlash of realizing large losses could thus discredit central banks and QE in particular.

To avoid such losses, the easiest option is to hold the bonds to maturity and be paid back in full. This is likely the reason why both the Fed and the ECB mainly aim to reduce their bond holdings by ending full re-investments. Only the BoE has the true independence to focus on inflation as the Treasury will cover any losses that the Bank makes on its bond holdings in the Asset Purchase Facility (APF).

All the above, imply that normalizing the balance sheet, especially for the ECB, will need to be made very gradual over many years rather than impacting much on the policy stance as a tool for reducing demand and inflation. As many feared, the rise in inflation and interest rates has now reduced the possibility of getting out of the QE portfolios without losses or without compromising the inflation outlook. It will thus be necessary for the ECB and the NCBs to communicate transparently on the scale of possible losses, and over which time-span, to minimize the political and public backlash.

At last, markets will be keen to understand the options available to the ECB, its views on a '*neutral*' balance sheet and the trade-off between various instruments. A restrictive policy stance is needed to contain wage-price spirals and think a high degree of certainty will be needed before easing policy. The 2025 strategy review will be an opportunity to take stock of changes to the inflation regime.

ECB activation of TPI: TPI is predominantly a tool to deter markets from excessive speculation. Based on the flexibility of the PEPP, it could be used relatively extensively at an early phase of a bond market sell-off, which may focus on a sovereign that unduly has caught the markets' attention.

A blow-out of bond yields and spreads to levels clearly not sustainable would be needed. For the ECB to intervene, it would likely also need to be clear that the country in question has an ambition to agree to EU-wide solutions and rescue packages. ECB interventions would then ideally be temporary and targeted, with the bank acting as a '*market maker of last resort*' rather than a '*buyer of last resort*'.

However, for that to be successful, fiscal authorities would need to be prepared to make the necessary adjustments to regain market confidence. For a country with high debt and poor productivity growth, the risk is that even then it will not be sufficient to calm markets. Given the difficulties of QT, it would not be implausible to expect central banks to consider QE more useful for market stability purposes, with temporary interventions, rather than for fighting inflation in the future.

In the case that TPI is not enough, solvency rather than liquidity becomes an issue. The ECB alone will not be able to support a country's debt. Instead, the ECB will need to act via other channels, primarily the OMT program under the umbrella of an ESM rescue. If ESM funds are insufficient to steady the situation, negotiations at the highest EU level will again become pressing, with the options of further euro area fiscal integration or orderly restructuring debt then discussed. In the absence of these options, the threat of a euro area exit would resume.

If credit conditions worsen and fragmentation reappears, we would not rule out new TLTROs to support bank lending and counter fragmentation. In addition, the ECB may want/need to keep the instrument as a permanent facility for longer-term lending if liquidity needs remain high in the future. Similarly, keeping private sector bonds, rather than government bonds, on the balance sheet for sustained periods to support ample liquidity is likely easier from a legal standpoint.

In summary, the ECB is still far from neutral rate and shy QT suggests higher rates. A year after core inflation first rose above 2% (in December ca. 5%), the ECB is still only scaling back accommodation. Including the balance sheet, the policy stance looks far from neutral, and it will need to go higher for longer. The ECB will need to stay hawkish to anchor inflation expectations until core inflation, about one year ahead, is safely on target. The ECB will need to continue its gradual tightening until there is certainty that the target can be achieved. With little experience of how markets and the economy will respond, some overshooting or undershooting is likely to happen.

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