Central Banks

New tool aids bold exit from negative rates as inflation risks intensify

Javier Castro / Sumedh Deorukhkar / Miguel Jiménez / Maria Martinez
July 21 2022

- **All key benchmark interest rates were hiked by 50 bps, larger than previously signaled, justified by high inflation risks, and introduction of a new policy tool**
- **The Transmission Protection Instrument (TPI) was introduced to address fragmentation risk. All countries will be eligible under four conditional criteria.**
- **Economic outlook has evolved towards deceleration, while inflation pressures have broadened. But a potential recession is yet not included for neither this year nor the next one**

The ECB, in a bold and unanimous decision, announced a 50 bps rate hike across all its key benchmark interest rates today and introduced a new anti-fragmentation tool, the Transmission Protection Instrument (TPI), aimed at ensuring effective monetary policy transmission across the entire Euro Area. The motivation to depart from ECB's June signal of a 25 bps hike today followed by a possible larger hike in September was, as explained by President Lagarde, twofold. First, a clear realization of upside risks to inflation - elevated and broadening price pressures alongside a sharp depreciation of the Euro which has implications on inflation outlook. Second, the reassurance provided by the ECB's now enhanced toolkit of instruments, with the addition of the TPI, besides the extant PEPP reinvestment flexibility and the Outright Monetary Transactions (OMT) to address potential concerns over fragmentation risks. Lagarde clearly linked both decisions, as the insurance that TPI provides for unwarranted/disorderly market dynamics allows for a faster pace of interest rate hikes.

Today's big move, however, does not change the terminal benchmark rate. The ECB will henceforth calibrate its rate decisions based on incoming data, on a meeting by meeting basis with much more flexibility and not offering forward guidance of any kind. President Lagarde acknowledged that while the ultimate goal of progressively achieving interest rates to neutral setting is unchanged, neutral setting is unknown given the underlying uncertainty. Nonetheless, she recognized that the ECB is accelerating the exit and following the path of normalization that it has charted out.

Regarding the TPI, it came broadly in line with what we expected. All countries will be eligible under this new instrument, and it will make it possible to purchase unlimited quantities of both public bonds (with maturities ranging from 1 to 10 years) and private sector securities, although without any explicit mention of sterilization measures for now. Besides, four eligibility criteria will apply: 1) compliance with the EU fiscal framework, 2) absence of severe macroeconomic imbalances, 3) sustainable trajectory of public debt (according to both ECB and other institutions' analysis), and 4) sound and sustainable macroeconomic policies (compliance with the RRF and the EC's European Semester). Moreover, it will be used in combination with the flexibility of the PEPP reinvestment policy, and as a second line of defense. In principle, the idea is that the TPI is a backstop that will not be necessarily used.

The ECB expects further deceleration in the Euro Area economic outlook, with the effects of the Ukraine war and its implications on energy supply and related costs as the main source of downside risks to growth. That said, the strong labor market, underlying fiscal support, built up savings and economic reopening post pandemic provide some elements of growth support. In this context, the ECB does not see recession in the Euro Area neither this year nor the next year under its baseline scenario. Meanwhile, inflation pressures have broadened and most measures of underlying inflation have risen further, exacerbated by the undesirable second round impact of energy costs and a depreciating Euro. ECB sees risks to the medium term inflation outlook emanating from a durable worsening of production capacity, inflation expectations rising above target and higher than anticipated wage rises. This means inflation would remain undesirably high and expectedly remain above ECB's target for some time. However, a weakening in demand could reduce pressures on prices.

All in all, there is a clear frontloading of interest hikes in exchange of the TPI, which is positive in some aspects (unanimity and unlimited quantities) but undefined on others (how to exactly measure conditionality and details on sterilization). This combination of faster rate hikes and a new instrument is most welcome as it signals ECB's decisive yet prudent approach to monetary policy making in a limiting and highly uncertain environment.

PLEASE NOTE: **TRACKING CHANGES IN FOLLOWING STATEMENTS**

in black, wording common to both the current and previous statements, in light grey and crossed, previous wording that was replaced by new wording, in blue and underlined (YES, TRACK CHANGES ARE THERE ON PURPOSE).

1.1. Christine Lagarde, President of the ECB,

Luis de Guindos, Vice-President of the ECB

~~Amsterdam, 9 June~~Frankfurt am Main, 21 July 2022

Good afternoon, the Vice-President and I welcome you to our press conference. ~~I would like to thank President Knot for his kind hospitality and express our special gratitude to his staff for the excellent organisation of today's meeting of the Governing Council.~~

~~High inflation is a major challenge for all of us. The~~Today, in line with our strong commitment to our price stability mandate, the Governing Council ~~will~~took further key steps to make sure ~~that~~ inflation returns to our two per cent target over the medium term.

~~In May inflation again rose significantly, mainly because of surging energy and food prices, including due to the impact of the war. But inflation pressures have broadened and intensified, with prices for many goods and services increasing strongly. Eurosystem staff have revised their baseline inflation projections up significantly. These projections indicate that inflation will remain undesirably elevated for some time. However, moderating energy costs, the easing of supply disruptions related to the pandemic and the normalisation of monetary policy are expected to lead to a decline in inflation. The new staff projections foresee annual inflation at 6.8 per cent in 2022, before it is projected to decline to 3.5 per cent in 2023 and 2.1 per cent in 2024 – higher than in the March projections. This means that headline inflation at the end of the projection horizon is projected to be slightly above our target. Inflation excluding energy and food is projected to average 3.3 per cent in 2022, 2.8 per cent in 2023 and 2.3 per cent in 2024 – also above the March projections.~~

~~Russia's unjustified aggression towards Ukraine continues to weigh on the economy in Europe and beyond. It is disrupting trade, is leading to shortages of materials and is contributing to high energy and commodity prices. These factors will continue to weigh on confidence and dampen growth, especially in the near term. However, the conditions are in place for the economy to continue to grow on account of the ongoing reopening of the economy, a strong labour market, fiscal support and savings built up during the pandemic. Once current headwinds abate, economic activity is expected to pick up again. This outlook is broadly reflected in the Eurosystem staff projections, which foresee annual real GDP growth at 2.8 per cent in 2022, 2.1 per cent in 2023 and 2.1 per cent in 2024. Compared with the March projections, the outlook has been revised down significantly for 2022 and 2023, while for 2024 it has been revised up.~~

~~On the basis of our updated assessment, we~~ We decided to ~~take further steps in normalising our monetary policy. Throughout this process, the Governing Council will maintain optionality, data-dependence, gradualism and flexibility in the conduct of monetary policy.~~

~~First, we decided to end net asset purchases under our asset purchase programme (APP) as of 1 July 2022. The Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key ECB interest rates and, in any case, for as long as necessary to maintain ample liquidity conditions and an appropriate monetary policy stance.~~

~~Second, we undertook a careful review of the conditions which, according to our forward guidance, should be satisfied before we start raising the key ECB interest rates. As a result of this assessment, the Governing Council concluded that those conditions have been satisfied. Accordingly, and in line with our policy sequencing, we intend to~~ raise the three key ECB interest rates by ~~25~~50 basis points ~~at our July monetary policy meeting.~~and approved the Transmission Protection Instrument (TPI).
~~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.~~

~~Third, 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.~~

~~Within the Governing Council's mandate, under stressed conditions, flexibility will remain an element of monetary policy whenever threats to monetary policy transmission jeopardise the attainment of price stability.~~

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. It will support the return of inflation to our medium-term target by strengthening the anchoring of inflation expectations and by ensuring that demand conditions adjust to deliver our inflation target 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.

We assessed that the establishment of the TPI is necessary to support the effective transmission of monetary policy. In particular, as we continue normalising monetary policy, the TPI will ensure that our monetary policy stance is transmitted smoothly across all euro area countries. The singleness of our monetary policy is a precondition for the ECB to be able to deliver on its price stability mandate.

The TPI will be an addition to our toolkit and can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area. The scale of TPI purchases depends on the severity of the risks facing policy transmission. Purchases are not restricted ex ante. By safeguarding the transmission mechanism, the TPI will allow the Governing Council to more effectively deliver on its price stability mandate.

In any event, the flexibility in reinvestments of redemptions coming due in the pandemic emergency purchase programme (PEPP) portfolio remains the first line of defence to counter risks to the transmission mechanism related to the pandemic.

The decisions taken today are set out in ~~full in~~ a ~~press release~~press release available on our website. The details of the TPI are described in a separate press release to be published at 15:45 CET.
I will now outline in more detail how we see the economy and inflation developing~~,~~ and will then explain our assessment of financial and monetary conditions.

1.2. Economic activity

~~In the near term, we expect~~ Economic activity ~~to be dampened by high energy costs, the deterioration in the terms of trade, greater uncertainty and the adverse~~ is slowing. Russia's unjustified aggression towards Ukraine is an ongoing drag on growth. The impact of high inflation on ~~disposable income. The war in Ukraine and renewed pandemic restrictions in China have made~~purchasing power, continuous supply ~~bottlenecks worse again. As~~ constraints and higher uncertainty are having a ~~result, firms~~ dampening effect on the economy. Firms continue to face higher costs and disruptions in their supply chains, ~~and their outlook for future output has deteriorated.~~

~~However,~~although there are ~~also~~ tentative signs that some of the supply bottlenecks are easing. Taken together, these factors ~~supporting~~ are significantly clouding the outlook for the second half of 2022 and beyond.

At the same time, economic activity ~~and these are expected~~continues to ~~strengthen over~~benefit from the ~~months to come. The~~ reopening of ~~those sectors most affected by the pandemic and~~ the economy, a strong labour market~~, with more~~ and fiscal policy support. In particular, the full reopening of the economy is supporting spending in the services sector. As people ~~in jobs, will continue to support incomes and consumption. In addition, savings accumulated~~ start to travel again, tourism is expected to help the economy in the third quarter of this year. Consumption is being supported by the savings that households built up during the pandemic ~~are~~and by a ~~buffer~~strong labour market.

Fiscal policy is helping to cushion the impact of the war~~. Targeted and temporary budgetary measures protect those people~~ in Ukraine for those bearing the brunt of higher energy prices~~ while limiting~~. Temporary and targeted measures should be tailored so as to limit the risk of ~~adding to~~fuelling inflationary pressures. ~~The swift implementation of the investment and structural reform plans under the Next Generation EU programme, the "Fit for 55" package and the REPowerEU plan would also help the euro area economy to grow faster~~Fiscal policies in all countries should aim at preserving debt sustainability, as well as raising the growth potential in a sustainable manner ~~and become more resilient to global shocks~~to enhance the recovery.

1.3. Inflation

Inflation ~~rose~~increased further to 8.~~1 per cent in May. Although governments have intervened and have helped slow energy inflation,~~6 per cent in June. Surging energy prices ~~stand 39.2 per cent above their levels one year ago.~~were again the most important component of overall inflation. Market-based indicators suggest that global energy prices will stay high in the near term ~~but will then moderate to some extent.~~. Food ~~prices~~inflation also rose ~~7.5~~further, standing at 8.9 per cent in ~~May~~June, in part reflecting the importance of Ukraine and Russia ~~among the main global~~as producers of agricultural goods.

~~Prices have also gone up more strongly because of renewed~~Persistent supply bottlenecks for industrial goods and ~~because of~~ recovering ~~domestic~~ demand, especially in the services sector, ~~as our economy reopens.~~are also contributing to the current high rates of inflation. Price ~~rises~~pressures are ~~becoming more widespread~~spreading across ~~sectors.~~more and more sectors, in part owing to the indirect impact of high energy costs across the whole economy. Accordingly, most measures of underlying inflation have ~~been rising~~risen further.

We expect inflation to remain undesirably high for some time, owing to continued pressures from energy and food prices and pipeline pressures in the pricing chain. Higher inflationary pressures are also stemming from the depreciation of the euro exchange rate. But looking further ahead, in the absence of new disruptions, energy costs should stabilise and supply bottlenecks should ease, which, together with the ongoing policy normalisation, should support the return of inflation to our target.

The labour market ~~continues to improve, with unemployment remaining at its~~remains strong. Unemployment fell to a historical low of 6.~~8~~6 per cent in ~~April~~May. Job vacancies across many sectors show that there is robust demand for labour. Wage growth, ~~including in~~ also according to forward-looking indicators, has ~~started to pick up~~continued to increase gradually over the last few months, but still remains contained overall. Over time, the strengthening of the economy and some catch-up effects should support faster growth in wages. ~~While most~~Most measures of longer-term inflation expectations ~~derived from financial markets and from expert surveys~~currently stand at around two per cent, ~~initial signs of~~although recent above-target revisions ~~in those measures~~to some indicators warrant ~~close~~continued monitoring.

1.4. Risk assessment

~~Risks relating to the pandemic have declined but~~A prolongation of the war ~~continues to be a~~in Ukraine remains a source of significant downside risk to growth~~. In particular, a major risk would be a further disruption in the~~, especially if energy ~~supply to the euro area, as reflected in the downside scenario included in the staff projections. Furthermore, if the war~~ supplies from Russia were to ~~escalate, economic sentiment could worsen,~~be disrupted to such an extent that it led to rationing for firms and households. The war may also further dampen confidence and aggravate supply-side constraints ~~could increase, and~~, while energy and food costs could remain persistently higher than expected. A faster deceleration in global growth would also pose a risk to the euro area outlook.

The risks ~~surrounding~~to the inflation ~~are primarily~~ outlook continue to be on the upside and have intensified, particularly in the short term. The risks to the medium-term inflation outlook include a durable worsening of the production capacity of our economy, persistently high energy and food prices, inflation expectations rising above our target and higher than anticipated wage rises. However, if demand were to weaken over the medium term, it would lower pressures on prices.

1.5. Financial and monetary conditions

Market interest rates have ~~increased in response to the changing outlook for inflation~~been volatile as a result of the pronounced economic and ~~monetary policy. With benchmark interest rates rising, bank~~geopolitical uncertainty. Bank funding costs have ~~increased, and this~~ risen in recent months, which has increasingly fed into higher bank lending rates, in particular for households. ~~Nevertheless, lending~~While the volume of bank lending to households remains strong, it is expected to decline in view of lower demand. Lending to firms ~~picked up in March. This was because of the continued need to finance investment and working capital,~~

~~against the backdrop of increasing~~has also been robust as high production costs, ~~persisting supply bottlenecks~~inventory building and lower reliance on market funding~~. Lending to households also increased, reflecting~~ have created a continued need for credit from banks. At the same time, demand for loans to finance investment has declined. Money growth has continued ~~robust demand for mortgages~~to moderate owing to lower liquid savings and lower Eurosystem asset purchases.

~~In line with our monetary policy strategy, the Governing Council has undertaken its biannual in-depth assessment of the interrelation between monetary policy and financial stability. The environment for financial stability has worsened since our last review in December 2021, especially over the short term. In particular, lower growth and increasing cost pressures, as well as rising risk-free rates and sovereign bond yields, could lead to a further deterioration in the financing conditions faced by borrowers. At the same time, tighter financing conditions could reduce some existing financial stability vulnerabilities over the medium term. Banks, which started the year with solid capital positions and improving asset quality, are now facing greater credit risk. We will watch these factors closely. In any case, macroprudential policy remains the first line of defence in preserving financial stability and addressing medium-term vulnerabilities.~~

Our most recent bank lending survey reports that credit standards tightened for all loan categories in the second quarter of the year, as banks are becoming more concerned about the risks faced by their customers in the current uncertain environment. Banks expect to continue tightening their credit standards in the third quarter.

1.6. Conclusion

Summing up, ~~Russia's unjustified aggression towards Ukraine is severely affecting the euro area economy and the outlook is still surrounded by high uncertainty. But the conditions are in place for the economy~~inflation continues to ~~continue to grow and to recover further over the medium term.~~

~~Inflation is~~be undesirably high and is expected to remain above our target for some time. ~~We will make sure that inflation returns to~~The latest data indicate a slowdown in growth, clouding the outlook for the second half of 2022 and beyond. At the same time, this slowdown is being cushioned by a number of supportive factors.

The Governing Council has today decided to raise the key ECB interest rates and approved the TPI. At our upcoming meetings, further normalisation of interest rates will be appropriate. 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.~~ Accordingly, we decided to take further steps in normalising our monetary policy. The calibration of our policies will remain data-dependent and reflect our evolving assessment of the outlook.~~

We stand ready to adjust all of our instruments within our mandate~~, incorporating flexibility if warranted,~~ to ensure that inflation stabilises at our two per cent target over the medium term. Our new TPI will safeguard the smooth transmission of our monetary policy stance throughout the euro area as we keep adjusting the stance to address high inflation.

Research

Creating Opportunities

DISCLAIMER

The present document does not constitute an “Investment Recommendation”, as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (“MAR”). In particular, this document does not constitute “Investment Research” nor “Marketing Material”, for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

ENQUIRIES TO:
BBVA Research: Azul Street, 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain).
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 25
bbvaresearch@bbva.com www.bbvaresearch.com