Playing it by ear

ECB post-meeting comment

RaboResearch
Global Economics & Markets
mr.rabobank.com

Bas van Geffen, CFA
Senior Macro Strategist
+31 30 712 1046

Contents

Summary

- The ECB delivered a semi-surprising 50bp hike, ending an era of negative policy rates.
- This wasn't only a trade-off between the hawks and doves in return for an anti-fragmentation instrument; the ECB again sounded more hawkish regarding the inflation outlook.
- Further hikes will be appropriate, but the Council dropped all guidance regarding the size of these hikes. Instead they will shift to a meeting-by-meeting approach.
- We maintain our call for 50bp in September, with upside risks of 75.
- We are however pencilling in another 50 in October, assuming the outlook doesn't deteriorate significantly, and assuming that the TPI will effectively limit spread widening – though it may very well be put to the test first.

Policy decisions

- The ECB announced a **50bp rate hike**. The Council dropped its forward guidance, leaving future moves fully up to economic developments.
- The **Transmission Protection Instrument** was approved. Purchases *"will not be restricted ex ante"* and will focus on the 1 to 10 year segment of the curve.
- Lagarde mentioned quite a shopping list of eligibility criteria relating to fiscal soundness, but their assessment offers quite a bit of grey area.
- The ECB will evaluate options for remunerating excess liquidity holdings, in an attempt to counteract the undesired **TLTRO** arbitrage. No measures were announced, though.

Whereas we had expected the anti-fragmentation tool to be the highlight of today's meeting, the changes in interest rate policy are at least as noteworthy. The ECB delivered a 50bp hike, which was partly due to inflation concerns, and partly a trade-off in return for a relatively unrestricted Transmission Protection Instrument (TPI). After this surprise hike, the Council has finally given up trying to predict its own next steps, dropping most of its rates guidance. Seeing the ECB's continued inflation concerns, we have pencilled in two follow-up hikes of 50bp.

Policy rates: two more 50bp hikes?

Lagarde mentioned two reasons for the 50bp hike: the availability of an anti-fragmentation instrument and the updated assessment of inflation risks. Particularly the latter suggests that further hikes are forthcoming. We maintain our call for a 50bp hike in September, but seeing the growing concerns about the inflation outlook, we have pencilled in another 50bp for October.

50 wasn't just a concession to the hawks

While we were admittedly still in the 25bp camp, the decision to hike by 50bp didn't come as a complete surprise. However, the reasons for the larger move *were* somewhat unexpected. As we noted in our preview, the risk of a 50bp hike were non-negligible due to the horse-trading regarding the anti-fragmentation tool. It is very likely that the hawks demanded a faster hiking cycle in return for a less restricted Transmission Protection Instrument (see below). Moreover, as we concluded, an effective TPI was a prerequisite for a faster, yet still orderly, hiking cycle. Lagarde also admitted this herself, stating that the tool allowed the ECB to "go big".

However, it did strike us as somewhat surprising that Lagarde stressed the Council's updated assessment of inflation as a second reason, considering that there had not been much talk of a potentially larger move ahead of the meeting. Nonetheless, President Lagarde –again– sounded more hawkish regarding the latest inflation developments, noting that *"inflation risks remain to the upside and have intensified, particularly in the short-term"*. Moreover, the ECB is clearly still concerned about the elevated inflation expectations.

The recent depreciation of the exchange rate was one of the main risks that had materialised since the June meeting, according to Lagarde. However, as we feared ahead of the meeting, so far the ECB's 50bp hike has failed to provide EUR much support – though this may also be related to the reception of the TPI.

Two more 50bp hikes to follow?

After yet another last-minute change of plans, the ECB now appears to have given up on predicting its own next steps. The ECB has dropped most of its forward guidance, including June's message that a larger step would likely be appropriate in September. Instead, Lagarde argued that the larger increase today allows the ECB to shift to a meeting-by-meeting approach, with each subsequent decision being fully data dependent.

Even though Lagarde was quoted as saying that the September guidance was *"no longer appropriate"*, we don't see this as an indication that the ECB is looking to slow down. Indeed, considering that the Council again stressed their unease with the current inflation outlook, we maintain our call for another 50bp move in September. Risks to this call are skewed to the upside, but we believe that the ECB is more likely to deliver a subsequent hike than embarking on a 75bp move in September. We have therefore added another 50bp hike in October to our forecast.

There are two key assumptions behind this new forecast. First of all, this assumes that the TPI will effectively limit fragmentation risks in the Eurozone. Secondly, this assumes that the economic outlook does not deteriorate too sharply in the next couple of months. While we still believe that the ECB's next set of forecasts will probably require a downward revision of the growth forecasts, it also looks as though the Council's tolerance towards growth risks has increased somewhat as long as inflation remains uncomfortably high.

These two potential downside risks are offset by the upside risk of more persistent inflationary pressures, and all-in-all, we therefore see risks to our view for the remainder of 2022 as roughly balanced. Despite the upgrade of our 2022 call, we remain of the view that the ECB's hiking cycle will probably be relatively short-lived, assuming that a recession will eventually block the ECB from further normalisation of its interest rates. The Council itself doesn't seem to have a clear idea how far they will take the hiking cycle: Lagarde said that at this point in time, she does not know what that neutral rate might be. *"We will cross that bridge when we cross that bridge."*

Table 1: Updated ECB expectations

	Hike	*Deposit facility rate*
September	50bp	0.50%
October	50bp	1.00%
December	25bp	1.25%

Source: Rabobank

Anti-fragmentation: TPI bound to be tested?

On paper, the TPI appears to be a relatively powerful instrument. Its size is not limited from the outset, and despite a long list of eligibility conditions there appears to be sufficient grey area for the ECB to argue that any country is eligible. Nonetheless, the fact that a lot is left to the Council's discretion does run the risk that the market will test the TPI before it fully believes its power.

In another surprise move, the (working) name of the ECB's anti-fragmentation tool was changed from Transmission Protection Mechanism to Transmission Protection Instrument. If activated, the TPI purchases will focus on bonds issued by sovereigns, regional governments and agencies with a remaining maturity of 1 to 10 years. The size of these purchases is not limited, and does not appear to be bound by any rules like the issuer limits embedded in the APP. However, as the ECB notes, *"the scale of TPI purchases would depend on the severity of the risks facing monetary policy transmission."* This is clearly an acknowledgement of the earlier court rulings on the OMT programme, and an attempt to avoid a new legal challenge without hamstringing the TPI from the outset.

Oddly enough, the ECB did indicate that any purchases will be sterilised in order to ensure that *"they cause no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance."* However, the ECB has not released any details *how* it would do so. While we still believe that liquidity draining operations are the most likely sterilisation instrument – at least in the early days of the TPI – the desire to limit the impact on the balance sheet does suggest that the ECB may still be contemplating the sale of assets acquired under its other programmes. After all, although purchasing assets under TPI while conducting liquidity draining operations at the same time would neutralise the impact on excess liquidity and hence the policy stance, it would still see the ECB's balance sheet increase in size as both assets and liabilities are added.

Eligibility and activation: a significant grey area

The unlimited capacity of the TPI was certainly welcomed by the market, but the relatively long list of eligibility criteria caused some concerns – even though President Lagarde stressed that all countries will be eligible. Specifically, the TPI requires four criteria:

1. Compliance with the EU fiscal framework;
2. Absence of severe macroeconomic imbalances;
3. A sustainable trajectory of public debt; and
4. Sound and sustainable macroeconomic policies, which means compliance with the plans submitted for the Recovery and Resilience Facility as well as the European Commissions' country specific recommendations.

While this long shopping list of fiscal may have caused some consternation in markets, we currently see no reason why any country would be ineligible. Moreover, there appears to be some grey area that allows the Council sufficient discretion as regards the fulfilment of these conditions; especially seeing that the debt sustainability will not only be based on external sources, but also the ECB's internal analysis.

As we suggested earlier, the ECB gave little guidance as to when the TPI might be used. The ECB will use *"a comprehensive assessment of market and transmission indicators"*, as well as *"a judgement that the activation [...] is proportionate to the ECB's inflation objective"*. By keeping these parameters very vague, the ECB avoids that the market will focus on particular yield or spread levels. However, the fact that a lot regarding the eligibility and activation is left to the Governing Council's discretion may invite the market to test the ECB's resolve; particularly after Lagarde noted that the Council *"prefers not to use the TPI, but will not hesitate [to do so]"*.

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Global

Michael Every
Senior Macro Strategist
Michael.Every@Rabobank.com

Europe

Elwin de Groot
Head Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Stefan Koopman
Senior Macro Strategist
UK, Eurozone
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Teeuwe Mevissen
Senior Macro Strategist
Eurozone
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Bas van Geffen
Senior Macro Strategist
ECB, Eurozone
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Erik-Jan van Harn
Macro Strategist
Germany, France
+31 6 300 20 936
Erik-Jan.van.Harn@Rabobank.nl

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 88 721 8329
Maartje.Wijffelaars@Rabobank.nl

Wim Boonstra
Senior Advisor

+31 30 216 2666
Wim.Boonstra@Rabobank.nl

Americas

Philip Marey
Senior Macro Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Une
Senior Macro Strategist
Brazil
+55 11 5503 7347
Mauricio.Une@Rabobank.com

Gabriel Santos
Macro Strategist
Brazil
+55 11 5503 7288
Gabriel.Santos@Rabobank.com

FX Strategy

Jane Foley
Head FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
LatAm FX
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Rates Strategy

Richard McGuire
Head Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Credit Strategy & Regulation

Matt Cairns
Head Credit Strategy & Regulation
Covered Bonds, SSAs
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Paul van der Westhuizen
Senior Analyst
Financials
+31 88 721 7374
Paul.van.der.Westhuizen@Rabobank.com

Cas Bonsema
Senior Analyst
ABS, Covered Bonds
+31 6 127 66 642
Cas.Bonsema@Rabobank.com

Agri Commodity Markets

Carlos Mera
Head of ACMR
+44 20 7664 9512
Carlos.Mera@Rabobank.com

Michael Magdovitz
Senior Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Europe	+31 30 216 9045	Hans.Deusing@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
Adam Vanderstelt	Australia, New Zealand	+61 2 8115 3102	Adam.Vanderstelt@rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Short-term Interest Rates

Marcel de Bever	Global Head	+31 30 216 9740	Marcel.de.Bever@Rabobank.com

Bonds & Interest Rate Derivatives

Henk Rozendaal	Global Head Fixed Income	+31 30 216 9423	Henk.Rozendaal@Rabobank.com

Solutions

Sjoerd van Peer	Global Head	+31 30 216 9072	Sjoerd.van.Peer@Rabobank.com

Relationship Management

Rogier Everwijn	Global Head	+31 30 712 2440	Rogier.Everwijn@Rabobank.com
Rob Eilering	Banks	+31 30 712 2162	Rob.Eilering@Rabobank.com
Petra Schuchard	Insurers		Petra.Schuchard@Rabobank.com
Duurt Jan van Dijk	Asset Managers	+31 30 712 2389	DuurtJan.van.Dijk@Rabobank.com
Javier Alvarez de Eerens	MDB	+31 30 712 1015	Javier.Alvarez@Rabobank.com
Christel Kleinhaarhuis	Fintech		Christel.Klein.Haarhuis@Rabobank.com

Capital Markets

Herald Top	Global Head	+31 30 216 9501	Herald.Top@Rabobank.com
Christopher Hartofilis	Capital Markets USA	+1 212 808 6890	Christopher.Hartofilis@Rabobank.com
Ian Baggott	Capital Markets Asia	+852 2103 2629	Ian.Baggott@Rabobank.com
Willem Kröner	Global Head ECM	+31 30 712 4783	Willem.Kroner@Rabobank.com
Harman Dhami	DCM Syndicate	+44 20 7664 9738	Harman.Dhami@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

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A summary of the methodology can be found on our website