JULY 2022

Flash
ECB raises rates: first in 10 years

Summary

1. **ECB raises policy rates for the first time in a decade** by 0.5%, lifting the deposit rate to zero and the repo rate to 0.5%.
2. **We expect the ECB to raise policy rates further in Q3 and Q4 this year**, with the deposit rate ending 2022 at 1.0%.
3. **Recession fears continue to dominate** inflation fears, with 10-year bond yields falling as global economic activity continues to slow. The risk of Eurozone recession allows the ECB to progress on a meeting by meeting basis, deciding on the basis of economic data. Much still depends on the future path of European energy prices.
4. **The ECB also introduced a new Transmission Protection Instrument** to cap any excessive movements in Eurozone government bond spreads (by buying sovereign bonds), given the recent widening in the Italian-German 10-year bond spread on Italian political uncertainty.
5. **Impact on financial markets: relatively limited** thus far in currency markets with the EUR/USD exchange rate hovering close to USD1.02 per 1 euro. Bond yields have continued to decline from recent peaks as medium-term inflation expectations continue to recede.

The Facts: ECB raises policy rates more than expected on 21 July

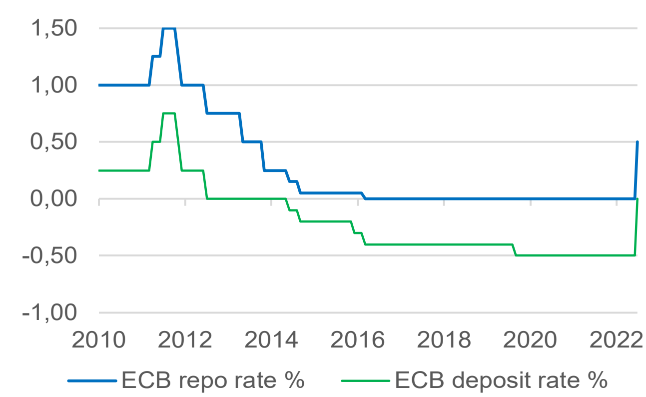
The European Central Bank held its regular council meeting to decide interest rates on Thursday 21st July. They decided to raise policy rates by half a percent, i e. 50 basis points, more than expected by some market participants. This is the first time in almost ten years that they have raised policy rates.

Why has the ECB waited so long before acting?

In retrospect; they perhaps should have raised rates well before now, given the actions of other central banks around the world who began to increase interest rates several months ago.

But there is a difference for the ECB with other central banks like the US Federal Reserve, in that US inflation is partly caused by high wage inflation, which has forced the US Federal Reserve to act earlier. This is less true in Europe, where high inflation is caused much more by the Russia-Ukraine conflict and the consequent impact on energy prices. This represents the bulk of the inflation pressures in Europe. That being said, having a negative deposit rate, i.e. an interest rate below zero, was anomalous given high inflation.

ECB DEPOSIT RATE RISES TO ZERO FOR THE FIRST TIME SINCE 2014



Source: Bloomberg

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What do we expect the ECB to do for the rest of this year and beyond?

We expect the ECB to continue to raise interest rates. The deposit rate, which was negative at -0.5%, has returned now to 0%, following the half a percent rise in policy rates. We expect further rate rises in September, October, and maybe December, to arrive at a 1% deposit rate by the end of this year. This implies another cumulative 100 basis points in interest rate increases within the next few months.

In 2023, we would expect the ECB to raise rates further. So we would go from 1% to at least 1.5% in 2023.

What economic impact will this decision have?

In the short term, we do not expect much effect on the Eurozone economy, because going back to a 0% deposit rate does not really present a drag on the economy. The drag on the European economy comes from painfully high energy prices, which hurt companies and the consumer, rather than from these marginal interest rate decisions by the ECB.

Should the ECB raise rates further, as we expect, then it will start to have an effect both on growth, which is already very weak in Europe, and also hopefully on inflation, to bring down the inflation rate to more manageable levels over the medium term.

What other considerations does the ECB need to take into account at the moment?

Today, the ECB needs to consider not only high inflation rates, but also the continuing uncertainty and impact on the European economy coming from the Ukraine conflict. This remains very difficult to predict, but certainly it does tend to weigh both on economic growth directly and also indirectly on financial markets, because financial markets do not like uncertainty.

A second key consideration is political uncertainty, particularly in Italy, one of the major members of the Eurozone where Prime Minister Mario Draghi has just resigned. We do not know what type of government we are likely to have in the next few months. So there is that uncertainty in Italy specifically to deal with as well.

We see these as the two main considerations at the back of the mind of the ECB at the moment.

What impact do we see on the euro and on financial markets?

If we look at currency markets, the Euro recently reached parity versus the dollar, i.e. 1 euro for 1 US dollar. The euro has since risen a little bit off that base to USD1.02 per 1 euro. So we have seen a very small recovery in the euro thus far. In three months we expect this rate to move slightly higher, to USD1.03 per euro, and in twelve months time we would expect it to get back to USD1.12. So we look for a modest re-appreciation of the euro against the dollar as the ECB raises rates.

In terms of bond markets, we have seen a fall in long-term bond yields as recession fears continue to dominate fears of persistently high inflation. The German 10-year bund yield has fallen to 1.07% at the time of writing as medium-term inflation expectations decline.

Since the end of April, the 5-year, 5-year euro inflation swap rate has fallen from 2.5% to just 2% today, reflecting these lower medium-term inflation expectations.

Eurozone stock markets continue to recover from recent lows as long-term bond yields decline, but sectors such as Banks, that should benefit from a higher ECB deposit rate, have not yet reacted to this surprise ECB move.

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