ECB: INTO A NEW ERA

The ECB Governing Council has surprised markets by a 50 bp 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. The data dependency of further rate hikes and the vagueness about the triggers for using the TPI may lead to an increase of the volatility in interest rates and sovereign spreads whereby investors try to understand the ECB's reaction function.

The ECB meeting last Thursday had been eagerly awaited based on the expectation that the policy rate would be increased and that a tool to address unwarranted sovereign spread widening would be unveiled. This was indeed the case as far as the latter was concerned with the introduction of the Transmission Protection Instrument (TPI), whereas in terms of the interest rate decision, the meeting has brought us into a new era: the deposit rate is no longer negative and forward guidance has been dropped.

The comparison of the monetary policy statement of the June and July meetings (see table 1) shows to what extent the message has changed. The intention in June was to raise rates 25 basis points (bp) in July but eventually the Governing Council went for 50 bp, based on its assessment of the inflation risks and *"the reinforced support provided by the TPI for the effective transmission of monetary policy."* This new instrument 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 new message is that further normalisation of interest rates will be appropriate - which means that rates are still too low - but that further moves will depend on the data and will be decided on a meeting-by-meeting approach[1]. The idea of following a 'sustained path' has been dropped, which may reflect unease about how quickly the euro area economy might react to the rate hikes and about the consequences of uncertainty about gas supply during the winter months.

In a rising rate environment, forward guidance serves to steer interest rate expectations of market participants. Now that it has been dropped, attention will focus on what would represent a neutral setting: when will rates reach a 'normal' level? For the answer to this question, we will have to wait, given Christine Lagarde's answer to a journalist's question: *"If you are asking me next 'What is the neutral setting?' At this point in time I don't know."* Admittedly, estimating the neutral policy rate is very challenging, but in the absence of forward guidance, providing a range would be useful as a reference for market participants when forming their expectations.[2]

The other important decision of the meeting was the introduction of the Transmission Protection Instrument (TPI). Its deployment will be based on a threefold assessment. Firstly, by looking at a range of indicators, whether the evolution of spreads is unwarranted based on country-specific fundamentals. Secondly, whether a jurisdiction is eligible[3] and, finally, making a judgment call about the proportionality

GOVERNMENT BOND YIELD (10-YEAR)

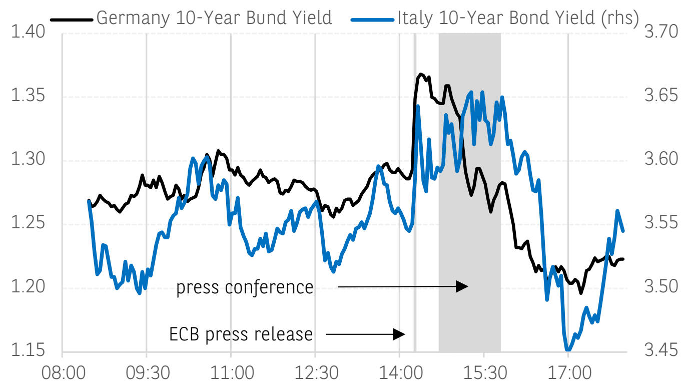

CHART 1 SOURCE: BLOOMBERG (07/21/2022), BNP PARIBAS

1. *"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".* Source: ECB, Monetary policy statement, press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 21 July 2022.

2. In the US, this reference point is provided by the FOMC members' longer run projection for the federal funds rate.

3. The criteria include: compliance with the EU fiscal framework, absence of severe macroeconomic imbalances, fiscal sustainability and complying with the commitments

> The data dependency of the pace and size of further rate hikes and the vagueness about the triggers for using the Transmission Protection Instrument (TPI) may lead to an increase of the volatility in interest rates and sovereign spreads.

of the purchases - which are not restricted *ex-ante* - considering the threat to the transmission of monetary policy.

Concerning the eligibility criteria, the Governing Council will take the four categories into account but will decide *"in sovereignty in respect to eligibility to the TPI."* The new instrument should allow the Governing Council *"to more effectively deliver on its price stability mandate."*[4]

What this specifically means has been explained during the press conference: the introduction of TPI made it possible to raise the policy rate more than projected on the occasion of the June meeting. With the introduction of the TPI, the Governing Council now has three instruments to influence the behaviour of sovereign spreads, the other two being the flexible reinvestment of redemptions under the PEPP and Outright Monetary Transactions. Each instrument has its own rationale, as explained in table 2.

Despite the importance of the decisions, the market reaction was short-lived. Bund yields jumped upon the news of a 50 basis points hike but then drifted lower for the remainder of the session (chart 1). Surprisingly, considering the characteristics of the TPI[5], the spread between Italian and German government bonds widened significantly during the press conference but dropped in a second stage (chart 2). The equity market reacted erratically (chart 3), rising on the news of the rate increase, declining during the press conference and rebounding thereafter. Finally and unsurprisingly, the euro jumped on the news of the bigger than expected rate hike, but this movement was short-lived and reminds us of the cyclical environment and risks that are weighing on the euro (chart 4).

To conclude, the data dependency of the pace and size of further rate hikes and the vagueness about the triggers for using the Transmission Protection Instrument (TPI) may lead to an increase of the volatility in interest rates and sovereign spreads whereby investors are trying to understand the ECB's reaction function. One can also expect two recurring questions during the press conference after the Governing Council meeting: how far are we from the neutral rate and, in case of a spread widening, was it warranted?

William De Vijlder

submitted in the recovery and resilience plans for the Recovery and Resilience Facility and with the European Commission's country-specific recommendations in the fiscal sphere under the European Semester. Source: ECB, The Transmission Protection Instrument, 21 July 2022.

4. Purchases under the TPI will be conducted in such a way *"that they cause no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance."* Source: see footnote 3.

5. The eligibility criteria do not seem to be very demanding.

GOVERNMENT BOND YIELD SPREAD ITALY-GERMANY

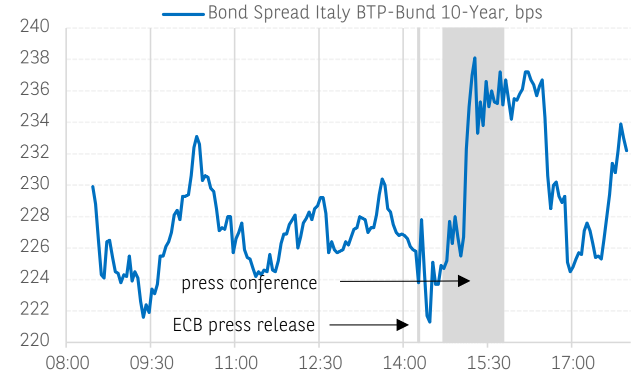

CHART 2 SOURCE: BLOOMBERG (07/21/2022), BNP PARIBAS

EURO STOXX 50

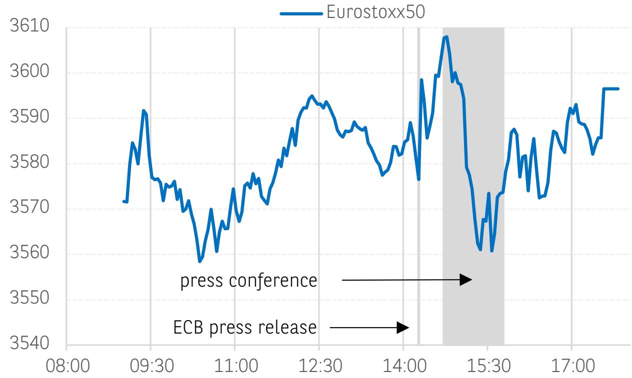

CHART 3 SOURCE: BLOOMBERG (07/21/2022), BNP PARIBAS

EUR IN USD

CHART 4 SOURCE: BLOOMBERG (07/21/2022), BNP PARIBAS

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.

TABLE 1 SOURCE: ECB

ECB TOOLS TO ADDRESS SPREAD WIDENING*

Tool	Role
PEPP (flexible reinvestment of redemptions)	To deal with unwarranted fragmentation risks that are created as a result of pandemic risks.
Outright Monetary Transactions	To deal with unwarranted impairment to transmission that are caused by redenomination risks and that are country-specific.
Transmission Protection Instrument	This tool is not related to redenomination risks**, but to the unwarranted, disorderly market dynamics that can impair the proper transmission of monetary policy throughout the euro area.

TABLE 2 SOURCE: ECB

*SEE FOOTNOTE 4. **REDENOMINATION RISK "IS THE COMPENSATION DEMANDED BY MARKET PARTICIPANTS FOR THE RISK THAT A EURO ASSET IS BEING REDENOMINATED INTO A DEVALUED LEGACY." SOURCE: ROBERTO A. DE SANTIS, A MEASURE OF REDENOMINATION RISK, ECB WORKING PAPER 1785, APRIL 2015.