

ECB Preview: September 2022

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Details:

Monetary policy decision: 13:15BST/14:15CET, Thursday 8 September 2022

Press conference: 13:45BST/14:45CET, Thursday 8 September 2022

Expected links:

Monetary Policy Decisions:

<https://www.ecb.europa.eu/press/govcdec/mopo/html/index.en.html>

Interest Rate Announcements:

https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

ECB Press Conference Video:

https://www.ecb.europa.eu/press/tvservices/webcast/html/webcast_pc_youtube.en.html

Bloomberg: MEDI <Go>

MNI Point of View (POV):

Hiking By Less Than 75bp Could Be Risky For The ECB

- It is a close call, but we expect the ECB to hike by 75bp at the September meeting.
- With inflation getting closer to double digits and the ECB already well behind it peers, hiking by 'only' 50bp could risk undermining the perceived commitment to restoring price stability.

Despite dropping forward guidance given the current heightened degree of uncertainty, the ECB's position on the policy rate path is relatively clear. There has been a notably hawkish shift since the July meeting, hiking in 25bp increments is no longer being discussed and the terminal rate is likely to be in the 1-2% range. So, we know that the ECB is in tightening mode and we have a reasonable idea of where the GC would like to get to (in the first instance). The two substantial unknowns are the pace of tightening and whether or not the ECB would continue hiking into a recession.

As others have commented, the September decision is finely balanced, but we come down on the side of a 75bp move. Inflation continues surprising higher, European gas prices have soared, the Fed has set a precedent by recently hiking in 75bp increments, and the window of opportunity to frontload rates in the euro area is narrowing.

As we detail in *ECB Communication: The Detail* (see below), policymakers have become increasingly hawkish. At the most hawkish end, Boštjan Vasle stated “I support an interest-rate increase that could exceed 50 basis points”, Madis Müller argued that “75 basis points should be among the options for September given that the inflation outlook has not improved”, and arch hawk Robert Holzmann suggested “In light of deteriorating inflationary developments a hike of 50 basis points is the minimum for me” and that “75 basis points should be part of the debate.” Klaas Knot also suggested that a 75bp hike should be considered.

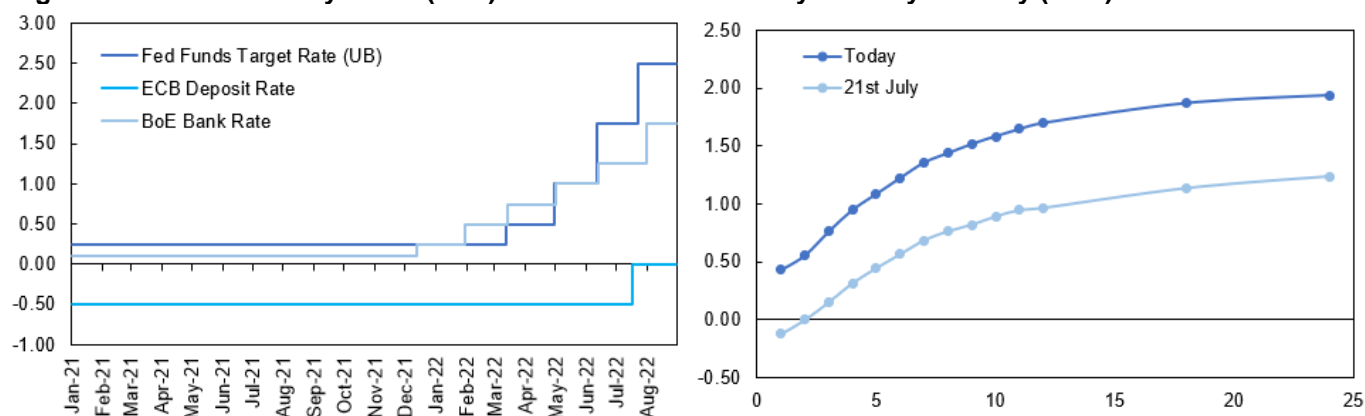
While these comments are not wholly surprising given the hawkish bias of the speakers, we note that Isabel Schnabel, who had previously been closely aligned with Phillip Lane in initially downplaying the persistence of the inflation shock, has turned increasingly hawkish. In a recent policy speech, she stated “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.”

However, it is clear that there are other influential members of the GC who support a more measured approach. Chief Economist Philip Lane, for example, has argued in favour of having ‘meeting-by-meeting’ assessments and that policy rates could be hiked at “a steady pace, that is neither too slow nor too fast, in closing the gap to the terminal rate...”, which seems to imply a 50bp pace. Francois Villeroy de Galhau, meanwhile, warned that the ECB should not be ‘unnecessarily brutal’ in raising interest rates.

Again, the decision seems finely balanced between hiking by 75bp or 50bp, but we would view Lane’s comments as setting the minimum pace at 50bp with the bias in direction of a larger move. At this point, it could be quite risky for the ECB to hike by ‘only’ 50bp. The ECB is well behind the pack in terms of normalising monetary policy given that headline inflation is getting closer to double digits and the main policy rate stands at just 0.0%. Failing to hike by 75bp (or more!) would raise the question of ‘if not now, when?’ giving the severity of the inflation shock.

If the ECB hiked by 50bp and, as is the new policy, refrains from providing forward guidance, the bank’s commitment to price stability could come in to question. The lack of forward guidance means that more of the signal is now contained in the policy rate decision itself. At this current juncture, hiking by 50bp is unlikely to be interpreted as paving the way for larger hikes at a subsequent meeting. Conversely, a 75bp move would reinforce the ECB’s commitment to rein in inflation and would leave open the possibility of similar such moves in the future if deemed necessary.

Fig 1. Central Bank Policy Rates (LHS) % & ESTR OIS Curve By Monthly Maturity (RHS) %



Source: MNI, Bloomberg

Aside from the pace of tightening, the other unknown is whether the ECB would hike into a recession. Again, opinions on this matter seem to differ. Isabel Schnabel argued at Jackson Hole “Even if we enter a recession, we have little choice but to continue the normalisation path”, while Fabio Panetta suggested “If we will have a significant slowdown or even a recession, this would mitigate inflationary pressures”. We previously argued that the ECB would need to make a judgement call on whether the slowdown in demand, or an outright contraction, would be sufficient to mitigate the supply side shock and allow inflation normalise. Given the severity and persistence of the inflation shock, and likelihood that supply bottlenecks will linger, a particularly severe fall in output would likely be required to return inflation to target. At this point it seems more likely that the eurozone will enter a relatively mild recession, which

would require the ECB to continue hiking policy rates towards the neutral rate, and likely slightly above (in our view, beyond 2.0%).

Baseline Scenario: The ECB hikes by 75bp and indicates that policy rates will continue to be raised at subsequent meetings on a 'meeting-by-meeting' basis. The medium-term inflation forecasts are revised higher and the growth forecast for 2023 is revised sharply lower (close to, but still above, zero).

Hawkish Scenario: The ECB hikes by 75bp, indicates that such a move is a 'normal' adjustment and stresses that it may be necessary to continue hiking into an economic downturn given the severity and persistence of the inflation shock. Updated staff macroeconomic projections significantly raise up medium-term inflation forecasts, including the 2024 projection, while also indicating only a mild downward revision to 2023 growth.

Dovish Scenario: The ECB hikes by 50bp, stresses a 'gradual' and 'orderly' approach to normalising monetary policy and highlights the mounting downside risks to economic growth. Revised staff macroeconomic projections indicate an outright recession in 2023.

mni Central Bank Watch - ECB

05 September 2022

MNI ECB Data Watch List						2Y History	Hit / Miss	Vs Trend	Surprise Index	Z-Score	
Inflation											
HICP	% y/y	Current 9.1	3m ago 8.1	3m Chg ↑	6m ago 5.9	6m Chg ↑					1.66
Core Inflation	% y/y	4.3	3.8	↑	2.7	↑					1.29
Oil Prices	\$	96.5	122.8	↓	101.0	↓					-1.01
Sy/Sy Inflation Swap	%	2.14	2.16	↓	1.87	↑					-0.48
Economic Activity											
Eurozone PMI (Comp)	Index	48.9	54.8	↓	55.5	↓					-1.11
Industrial Production	% y/y	2.4	-1.1	↑	1.9	↑					1.17
Business Climate Indicator	Index	0.83	1.26	↓	1.83	↓					-1.73
Consumer Confidence	Index	-24.9	-21.2	↓	-9.6	↓					-0.74
Monetary Analysis											
Narrow Money (M1)	% y/y	6.7	8.2	↓	9.2	↓					-1.67
Broad Money (M3)	% y/y	5.5	6.1	↓	6.5	↓					-1.38
Loans to Non-Fin Corps	% y/y	6.6	4.5	↑	3.8	↑					1.76
Loans to Households	% y/y	4.5	4.3	↑	4.4	↑					0.88
Consumer / Labour Market											
Retail Sales	% y/y	-0.9	4.2	↓	8.5	↓					-0.82
Unemployment Rate	%	6.6	6.7	↓	6.9	↓					-1.37
Labour Costs (Quarterly)	% y/y	3.8	-0.1	↑	1.6	↑					1.13
Employment (Quarterly)	% y/y	2.4	2.2	↑	-1.7	↑					0.75
Markets											
Equity Market	Index	3473	3789	↓	3924	↓					-0.86
Bund Yield	%	1.57	1.12	↑	0.14	↑					1.35
10y BTP Spreads	%	238.8	199.7	↑	157.1	↑					-1.42
EUR TWI	Index	116.97	119.97	↓	120.02	↓					-0.98

Source: MNI, Bloomberg

Summary of Analyst Views

- The majority of analysts expect a 75bp hike at the September meeting, although a significant minority are erring on the side of caution. Regardless of whether a larger or smaller hike is expected, most analysts view this as a finely balanced decision.
- Where explicitly indicated, policy rates are either expected to hit a terminal rate by the first quarter of 2023, or the ECB will pause the tightening cycle as the severity of the regional economic slowdown becomes clearer.

Fig 2: Analyst Projections For ECB Policy Rate Changes

	Sep-22	Oct-22	Dec-22	Feb-23	Mar-23	May-23	Jun-23	Jul-23	Sep-23	Oct-23	Dec-23
Barclays	+75	+50	+25	0	0	0	0	0	0	0	0
BNP Paribas	+75	+50	+25	+25*							
Commerzbank	+75	+50	+25	+25							
Danske	+75	+50	+25*								
Goldman Sachs	+75	+50	+25	+25*							
HSBC	+50	+25	+25								
ING	+50	Hike									
JP Morgan	+75	+50	+25	0	0	0			2 x +25		
Natixis	+75		+ cumulative 125*								
NatWest	+75	+75	+25	0	0	0					
Nomura	+75	+50	+50	+25	0	0	0	0	-25	-25	-25
Morgan Stanley	+75	+50	+25	+25	+25*						
Nordea	+50	+50	+25			+25					
RBC	+50										
SEB	+75	+50	+50								
Swedbank	+75	+50	+25*								
TD Securities	+50										
UBS	+50	+50	+25	+25	+25	+25*					
UniCredit	+50										

* indicates explicitly identified terminal rate. Data is compiled using all available information on the projected policy rate path.

Analyst Views

Barclays

- The ECB is expected to hike the deposit rate by 75bp in September, followed by a 50bp hike in October and 25bp in December, having previously expected a 50bp, 25bp, 0bp sequence. The new projected path takes the policy rate to 1.50% by year-end. No further rate hikes are expected in 2023.
- The arguments in favour of a larger September hike are that it would signal a clear determination to tame inflation, it would exploit the window of opportunity to hike while the labour market is tight and economic activity is not yet contracting, and it would still mean that monetary policy is relatively accommodative assuming a neutral rate of 1-2%.
- Barclays stresses that more aggressive hiking could undermine the perceived fiscal sustainability for some countries and eventually motivate the ECB to trigger the new TPI.
- President Lagarde could indicate that discussions will take place in coming meetings on ending APP reinvestments, which would be a hawkish development. Barclays does not believe that the ECB will end APP reinvestments this year. Moreover, the ECB is unlikely to contemplate an end to PEPP reinvestments as these are considered to be a first line of defence against fragmentation risks.
- The ECB will also announce at the September meeting that it will maintain the tiered system of excess reserves remuneration.

- The ECB will proceed with a meeting-by-meeting approach and not provide further guidance on future rate increases.
- Expected headline inflation forecast revisions: 2022:+1.3pp to 8.1% , 2023 +1.1pp to 4.6%, 2024: unchanged at 2.1%
- Expected GDP forecast revisions: 2022: +0.3pp to 3.1%, 2023 -1.5% to 0.6%, 2024:-0.1pp to 2.0%

BNP Paribas

- The ECB is expected to deliver a 75bp hike at the September meeting.
- This decision is unlikely to be taken unanimously with recent speeches from Philip Lane and Isabel Schnabel illustrating the internal debate over hiking speed.
- BNP sees valid arguments for normalising gradually, including elevated uncertainty, subdued wage growth, a deteriorating economic outlook and the potential pressure on periphery bond spreads from delivering a larger hike.
- Nonetheless, ultimately BNP expects the hawks on the GC to prevail.
- It is likely that the ECB will stress a meeting-by-meeting approach and that a 75bp hike in September would not be indicate similar moves at subsequent meetings. The ECB will also indicate that faster tightening now does not imply a higher terminal rate.
- BNP's new base case scenario envisages a 75bp hike in September followed by a 50bp hike in October, 25bp in December and two additional 25bp hikes in Q1 to reach a terminal rate of 2.0%.
- However, there is a risk that the ECB could pause the tightening cycle if the recession proves deeper than expected, and conversely there is a risk of moving beyond the 2% level if there are signs of inflation expectations de-anchoring and/or second-round effects.

Commerzbank

- The ECB will hike by 75bp at the September meeting.
- While the ECB will follow through on the comments made at Jackson Hole with further policy rate tightening, Commerzbank believes that another 75bp hike is unlikely since they are nearing the neutral rate.
- Instead, Commerzbank expects a 50bp hike in October and 25bp in December and February 2023.
- The litmus test for the ECB and its resolve to rein in inflation will not come until early 2023. At this point the hard data should show that the eurozone has slipped into recession.
- Commerzbank believes that the ECB will pause the tightening cycle in the spring of 2023. Nonetheless, they believe that a deposit rate at 1.75% would be far from sufficient to anchor inflation at the 2% target.

Danske

- Danske have now changed their September ECB call and now expect a 75bp hike, followed by a 50bp hike in October and 25bp hike in December. This is a +25bp revision from the previously expectations for the September and October meetings.
- Danske now sees the terminal rate being 1.50%.
- The ECB is not expected to make any further announcements on the APP reinvestment policies until December at the earliest. At that stage, policymakers would need to take into account the severity of the euro area recession.

Goldman Sachs

- The ECB will hike policy rates by 75bp at the September meeting.
- Thereafter, the ECB will hike by 50bp in October followed by two more 25bp hikes to a terminal rate of 1.75%.
- The inflation picture has deteriorated further since July, revised staff macroeconomic projections are likely to show a large upgrade to the inflation forecasts (and a downgrade in growth, but not a technical recession) and recent ECB commentary has been hawkish.

- The ECB will retain the 'meeting-by-meeting' approach and not provide any further forward guidance on rates. However, the GC will indicate that a 75bp hike is a normal step.
- While balance sheet policies may be raised during the meeting, GS believes that the focus will be on the deposit rate. Discussion on ending APP reinvestments is more likely later in the year.

HSBC

- The ECB is expected to hike the deposit rate by 50bp in September.
- Given recent inflation developments and comments from policymakers, there is a big risk of a 75bp move.
- However, with a recession looming and some policymakers pushing for a 25bp move in July, HSBC believes that a 50bp hike is more likely.
- Beyond September, the ECB is expected to hike by 25bp in October and December before pausing the tightening cycle.
- This is underpinned by the assumption that if energy prices stabilise and headline inflation starts to fall, then the risk of inflation expectations de-anchoring would similarly fall. In addition, demand is likely to weaken and the ECB needs to take into account the impact of aggressive tightening on fiscal positions in the most indebted countries.
- Nonetheless, there is a risk of a steeper tightening cycle given that there remains a risk of a wage-price spiral.
- Expected headline inflation forecast revisions: 2022 +1.4pp to 8.2%, 2023 +2.2pp to 5.7%, 2024 +0.1pp to 2.2%
- Expected core inflation forecast revisions: 2022 +0.3pp to 3.6%, 2023 +0.3pp to 3.1%, 2024 unchanged at 2.3%
- Expected GDP forecast revisions: 2022 +0.1pp to 2.9%, 2023 -2.5pp to -0.4%, 2024 -0.4pp to 1.7%

ING

- The ECB is expected to hike by 'only' 50bp in September. ING believes that a 75bp hike would be a step too far for the doves on the GC, but it cannot be ruled out entirely. A 50bp move would be a compromise which leaves the door open for further hikes.
- ING expects the ECB to hike again in October, but has difficulty seeing further hikes into a winter recession.

JP Morgan

- JPM now suspects a 75bp hike in September having previously anticipated a 50bp move.
- Regardless of a larger-than-expected September hike, JPM continues to forecast a 50bp hike in October and 25bp hike in December with the deposit rate reaching 1.50% by year-end.
- A pause in the tightening cycle is still expected in H123 given the likely contraction in GDP, with two subsequent 25bp hikes in the second half of that year taking the deposit rate to 2.00%.

Natixis

- The ECB is now expected to hike by 75bp in September.
- Natixis expects the hiking cycle to end in March with a deposit rate of 2.0%, implying a total of 250bp of tightening since July this year.
- Expected headline inflation forecast revisions: 2022: +1.2pp to 8.0%, 2023: +0.5pp to 4.0%, 2024: unchanged at 2.1%
- Expected core inflation forecast revisions: 2022 +0.3pp to 3.6%, 2023 unchanged at 2.8%, 2024 -0.1pp to 2.2%
- Expected GDP forecast revisions: 2022: -0.2pp to 2.3%, 2023: -0.6pp to 1.5%, 2024: +0.2pp to 2.3%.

NatWest

- The ECB is now expected to hike by 75bp in September from 50bp initially.
- NatWest then expects the ECB to hike by 75bp in October and 25bp in December.

Nomura

- Having initially called for a 50bp hike in September, Nomura is now expecting a 75bp move.
- This revision is underpinned by continued inflation surprises since the last meeting, elevated core and supercore inflation, and concerns about inflation expectations becoming unanchored.
- Nomura now expects 50bp hikes in October and December (25bp was previously pencilled in for December) with the policy rate hitting 2.0% in February 2023.
- In addition, Nomura has pushed back the projected start of the cutting cycle to September 2023 from mid-2023 previously and also expects a further 25bp cut. The deposit rate is now expected to be cut by 75bp to 1.25% by end-2023, where it will remain until 2024.

Morgan Stanley

- Morgan Stanley has revised their September policy rate call and now opt for a 75bp hike instead of 50bp, followed by a sequence of smaller hikes that take the terminal rate to 2.0% in March 2023.
- More specifically, a 50bp hike is expected in October followed by 25bp hikes in December, February and March.
- If instead the ECB were to opt for a 50bp hike in September, MS would then expect the policy rate path to feature two additional 50bp hikes and two 25bp hikes which would take the deposit rate to the same terminal level of 2.0%.
- While MS expects the first hints of a discussion about the timeline to stop APP reinvestments by the end of the year, they are more sceptical about outright sales of assets. Moreover, focus at the September meeting will be on the future path for rates, with the ECB having little capacity to begin discussing balance sheet policies.
- Expected headline inflation forecast revisions: 2022: +1.1pp to 7.9%, 2023: +0.5pp to 4.0%, 2024: +0.1pp to 2.2%
- Expected core inflation forecast revisions: 2022 +0.5pp to 3.8%, 2023 unchanged at 2.8%, 2024 unchanged at 2.3%
- Expected GDP forecast revisions: 2022: +0.4pp to 3.2%, 2023: -1.1pp to 1.0%, 2024: +0.2pp to 1.9%.

Nordea

- The ECB is expected to hike by 50bp in September, but the possibility of a larger move is not discounted.
- The majority of the GC is most worried about inflation risks with the ECB likely to continue hiking rates almost no matter how the economic outlook evolves.
- Beyond September, Nordea expects a 50bp hike in October and 25bp in December. By then, inflation is expected to have peaked and the economy may already be in recession.
- An additional 25bp hike is expected in the first half of 2023, taking the deposit rate to 1.50%.

SEB

- SEB believes that the size of the next rate hike and APP reinvestments will be taken together. A 50bp hike would mean an earlier start to balance sheet reduction, while a 75bp hike would allow a decision on APP reinvestments to be pushed back. Ultimately SEB sides with a 75bp hike for September.
- Beyond September, the ECB is expected to hike by 50bp in October and December, taking the deposit rate to 1.75% and refi rate to 2.25% by end-2022.
- Expected inflation forecast revisions: 2022: +1.5-2.0pp, 2023: +1.5-2.0pp

Swedbank

- The ECB is now expected to hike by 75bp in September from an initial call for 50bp.
- Swedbank then expects the ECB to hike by 50bp hike in October and 25bp in December.
- This would take the deposit rate to 1.50% by year-end. Swedbank argues that while the market envisages additional tightening in 2023, they believe that declining inflation and economic weakness will be evident by the end of the year and will result in the ECB ending the hiking cycle.

TD Securities

- Although the decision is finely balanced, TD errs on the side of caution and is expecting a 50bp hike at this week's meeting.
- Chief Economist Philip Lane is likely to be in the driving seat with respect to the policy decision.
- TD notes that the governing council is split on the magnitude of the September hike, but more aligned on the perceived terminal rate.

UBS

- The ECB is expected to hike by 50bp in September, although the decision on whether to hike by 50bp or 75bp will be a close call.
- The rate decision will be underpinned by updated staff macroeconomic projections which will show slower growth and higher inflation forecasts.
- UBS has revised its October policy rate call and now expected a 50bp hike having previously targeted a 25bp move. A further 25bp hike is expected in December.
- In 2023 the ECB is expected to hike by 25bp in February, March and May, which would take the deposit rate to 2.0%. This would mark the end of the tightening cycle.
- The press conference is likely to feature questions on APP and PEPP reinvestments, but President Lagarde is expected to not give much away at this point.
- Expected headline inflation forecast revisions: 2022: +1.3pp to 8.1%, 2023: +0.6pp to 4.1%, 2024: unchanged at 2.1%
- Expected GDP forecast revisions: 2022: +0.2pp to 3.0%, 2023: -1.1pp to 1.0% %, 2024: Unchanged at 2.1%.

UniCredit

- The ECB is expected to hike policy rates by 50bp. However, UniCredit note that this is a very close call with many hawkish policymakers pushing for a 75bp move.
- UniCredit sees a possible compromise might involve a steady pace of 50bp hikes until the deposit rate reaches the middle of the 1-2% range that the ECB regards as the neutral rate.

ECB Communication: The Detail

Although August is typically a quiet month for policy communication, the urgency of the unfolding energy crisis and continued surge in inflation has prompted several high impact statements from GC members. Moreover, the spread within the GC over the speed of policy tightening appears to be widening. While the most hawkish members are pushing for ever larger policy rate increases to rein in inflation and ward of the risk of expectations becoming unanchored, the more dovish policymakers are urging a measured step-by-step approach given heightened uncertainty and a deteriorating economic outlook.

Economic Outlook

On the economic front, there is broad consensus that the outlook is deteriorating, albeit with some differences of opinion over the likelihood of a recession.

Ignazio Visco stated on July 28:

["There is a risk of a recession"](#)

And indicated that in this scenario the ECB would:

“need to discuss what to do”.

Mārtiņš Kazāks stated on August 4:

“Growth in the world economy has become slower, inflation is higher than forecast, risks of recession have increased”

Olli Rehn added August 28:

“..it's quite likely that the euro-zone economy is slowing down. It's slowing down as we speak”.

And Pierre Wunsch stated on August 30:

“We are probably going to go for some kind of slowdown, maybe a technical recession, maybe even worse”.

Perhaps reflecting his argument in favour of more aggressive front-loaded tightening, Robert Holzmann downplayed the probability of a severe recession, stating on August 31:

“I don't think there will be a major and strong fall in output that will create a crisis situation because we are still highly accommodative.”

Inflation

There is no hiding the severity of the inflation shock and recent commentary on price pressures has turned increasingly hyperbolic and metaphoric.

Yannis Stourouaras argued on August 30 that the eurozone is experiencing a:

“perfect inflation storm which is mostly supply-side driven”

And described inflation as a:

“hydra multi-headed monster”.

Robert Holzmann stressed the historical magnitude of the inflation shock and the need to show determined resolve, stating on August 31:

“We have inflation that hasn't been for 40 years”

“So it's important to have the cards on the table and say we want to get inflation down as quickly as possible.”

Providing a somewhat measured assessment, François Villeroy de Galhau argued on August 31:

“Things are starting to calm or even reverse for some raw materials except energy. However, inflation is spreading to the rest of the economy, including the services sector. This justifies our mobilization”

The impact of the slowdown in economic activity, and potential outright recession, on the inflation picture has elicited a range of opinions. At the more dovish end, Fabio Panetta suggested on August 23:

“If we will have a significant slowdown or even a recession, this would mitigate inflationary pressures”

While Isabel Schnabel warned on August 18 that a recession may not be enough to rein in inflation and hinted that the ECB could have to continue hiking into a recession:

“Even if we entered a recession, it’s quite unlikely that inflationary pressures will abate by themselves”

“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.”

“..policy makers should also not pause at the first sign of a potential turn in inflationary pressures, such as an easing of supply chain disruptions. Rather, they need to signal their strong determination to bring inflation back to target quickly.”

Inflation Expectations

Debate around inflation expectations is also starting to heat up. The ECB’s previous reticence to accelerate the tightening cycle stemmed in part to the lack of evidence on second-round effects and inflation expectations becoming unanchored. However, there are embryonic signs of inflation expectations starting to push higher.

Joachim Nagel argued on August 30:

“The longer inflation remains elevated, the higher the risk that inflation dynamics and medium-term inflation expectations become entrenched at an elevated level as well,”

“To avoid a de-anchoring of inflation expectations, the Eurosystem shouldn’t leave any room for doubt about its determination to fight inflation.”

Isabel Schnabel highlighted the shift in the right tail of the distribution with respect to inflation expectations on August 27:

“For both consumers and professional forecasters, we are also observing a marked increase in the right tail of the distribution – that is, the share of survey participants who expect inflation to stabilise at levels well above our 2% target. Option prices in financial markets paint a similar picture”.

“...for the euro area, the ECB’s consumer expectations survey shows that people who are financially more literate and who see themselves as playing a relevant role in actual price and wage-setting have recently revised their medium-term inflation expectations to a larger extent than other survey participants.

“This is a source of concern. Unlike for consumers who form their expectations based on their experience of inflation, the higher inflation expectations of financially literate people are unlikely to subside if and when inflation starts decelerating. This increases the probability of second-round effects.”

Adding on August 28:

“Both the likelihood and the cost of current high inflation becoming entrenched in expectations are uncomfortably high”

Philip Lane also discussed the right-tail shift in inflation expectations on August 29, while not drawing any specific conclusions on whether or not recent developments would provide malign.

“...market-based indicators of inflation risk and the right-tail of responses in the expert and household surveys also clearly show that the risk of inflation not returning to target in a timely manner is priced by market participants and feared by some survey respondents. As indicated in our recent monetary policy statements, such above-target revisions to some indicators of longer-term inflation expectations warrant close monitoring.

In tracking these right-tail indicators, two conjectures are especially relevant. In one direction, more attentive traders, experts and individuals may identify more quickly a persistent shift in inflation dynamics,

while inattentive participants adjust more slowly. Under such scenarios, as highlighted in the pioneering work of Ricardo Reis, right-tail measures will be leading indicators for a generalised revision in long-term inflation expectations.

However, under other scenarios, the right tail might be populated by those who over-react to high spot inflation readings and mis-perceive as permanent what turns out to be a temporary increase in the inflation rate. In these scenarios, the right-tail will not serve as an accurate leading indicator of generalised long-term inflation expectations”.

Frontloading Vs Step-By-Step

There is now a clearly evolving internal debate over the speed of policy tightening. For those that are concerned about a looming recession, or believe that a contraction in output can take the place of sustained policy tightening in reining in inflation, a measured data-dependent step-by-step approach is required. While for those policymakers who believe that high inflation and heightened uncertainty means that the ECB cannot afford to take a gamble on whether or not inflation expectations will become unanchored, a more aggressive approach with frontloaded tightening is required. This split is epitomised by the apparent divergence between Philip Lane (favouring the former) and Isabel Schnabel (favouring the latter), when both were more closely aligned at the start of the inflation shock in arguing that the shock itself would prove transitory.

Joachim Nagel stated on August 1:

“We can and must now do everything we can to prevent the current high level of inflation from becoming entrenched”

“Otherwise we run the risk of having to raise interest rates all the more abruptly and significantly later on”

Further arguing on August 30 that the ECB should continue hiking regardless of rising recession risks:

“We shouldn’t delay the next interest-rate steps for fear of a potential recession”

With respect to the September meeting, Nagel stated on August 31:

“There is an urgent need for the Governing Council of the ECB to act decisively at its next meeting to combat inflation”

“We need a strong rise in interest rates in September. And further interest-rate steps are to be expected in the following months.”

Robert Holzman similarly argued on August 31 for a more aggressive approach:

“We still see a major task in front of us and we need to address this task with determination, which means we need to move as quickly as possible toward and quite likely beyond the equilibrium interest rate.”

Reflecting her increasingly hawkish shift, Isabel Schnabel argued on August 27 that the ECB should err on the side of caution and show more determination in reining in inflation to prevent the risk of inflation proving more persistent:

“For the first time in four decades, central banks need to prove how determined they are to protect price stability”

“There are two broad paths central banks can take to deal with current high inflation: one is a path of caution, in line with the view that monetary policy is the wrong medicine to deal with supply shocks.

The other path is one of determination. On this path, monetary policy responds more forcefully to the current bout of inflation, even at the risk of lower growth and higher unemployment. This is the “robust control” approach to monetary policy that minimises the risks of very bad economic outcomes in the future.”

“When the degree of inflation persistence is uncertain, optimal policy prescribes a forceful response to a deviation of inflation from the target to reduce the risks of inflation remaining high for too long.

In this case, it is largely irrelevant whether inflation is driven by supply or demand. If a central bank underestimates the persistence of inflation – as most of us have done over the past one-and-a-half years – and if it is slow to adapt its policies as a result, the costs may be substantial

In the current environment, these risks remain significant. Unprecedented pipeline pressures, tight labour markets and the remaining restrictions on aggregate supply threaten to feed an inflationary process that is becoming harder to control the more hesitantly we act on it.”

Schnabel finished her speech by concluding:

“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.

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

Philip Lane, meanwhile, argued for a more measured approach, suggesting on August 29 that the September meeting reflected a new phase of policy normalisation:

“...this new phase will consist of a meeting-by-meeting (MBM) approach to setting interest rates”.

And that the ECB should aim for a middle-ground in terms of the scale of policy tightening:

“A steady pace (that is neither too slow nor too fast) in closing the gap to the terminal rate is important for several reasons.

First, there is uncertainty about the transmission of policy rate changes to overall financing conditions, such that it makes sense to allow the financial system to absorb rate changes in a step-by-step manner”.

“Second, the current high uncertainty about inflation dynamics and monetary policy transmission means that a multi-step adjustment path towards the terminal rate also makes it easier to undertake mid-course corrections if circumstances change.”

Scale of Tightening

Although not every policymaker has been forthcoming with a specific policy rate hike proposal, there does not appear to be support for minimal 25bp hikes. The dividing line between being dovish and hawkish at this stage comes down to whether a policymaker supports a 50bp or 75bp hike in September.

At the more dovish end, François Villeroy de Galhau stated on August 27:

“We can be gradual, but we should not be slow and delay normalization until higher inflation expectations force us into aggressive interest-rate hikes,”

“What remains essential, however, is to be orderly, in order to avoid undue market volatility and ultimately economic volatility.”

While avoiding a specific target, Olli Rehn indicated on August 28 that the September meeting requires a significant policy rate adjustment:

“The reality is that we have excessively high inflation globally, also in Europe -- that’s why it’s action time,”

“The next step will be a significant move in September, depending on the incoming data and the inflation outlook.”

Commenting on August 30, Pierre Wunsch suggested hiking above what is considered the ‘natural’ rate:

“I think the consensus is we have to move quickly to a level that at some point ... will be restrictive,”

At the more hawkish end, Klaas Knot argued on August 26:

“The inflation problem in Europe at the moment is so big that I think our job is to raise interest rates every six weeks until the inflation picture stabilizes around 2%”

In the same interview for the Dutch broadcaster NOS, Knot is reported to have argued for an increase of ‘at least 0.5 percentage points and possibly even 0.75 percentage points in September’, although the direct quote was not provided in the news article.

Knot further stated on August 30:

“The broadening and deepening of our inflation problem generates the need to act forcefully,”

“A swift normalization of interest rates is an essential first phase, and some front-loading should not be excluded.”

Madis Müller was more explicit on August 30:

“75 basis points should be among the options for September given that the inflation outlook has not improved,”

“Still, I’m going into the meeting with an open mind and I want to both see the new projections and hear my colleague’s arguments”

As was Boštjan Vasle on August 30:

“I support an interest-rate increase that could exceed 50 basis points”

Robert Holzman stated on August 26:

“In light of deteriorating inflationary developments a hike of 50 basis points is the minimum for me,”

“But also 75 basis points should be part of the debate.”

Exchange Rate

The depreciation of the euro has received further attention in light of the imported energy price pressures which are fuelling inflation. Olli Rehn stated on August 28

“Certainly we are monitoring the exchange rate,”

“This indirect channel is important -- we are monitoring it and are looking at it as one indicator”

“It’s already a significant consideration” in setting monetary policy.

Luis de Guindos stated on July 29 that while the ECB does not target the exchange rate:

“it is a very important macroeconomic indicator that we take into account”

“Undoubtedly, the depreciation of the euro has been one of the factors behind the high inflation and the rise in energy prices denominated in euro”

“The exchange rate was of course considered in our discussion last week”

ECB Inter-Meeting Communication

Date	Time	Speaker	Event
22/07/2022	08:00	François Villeroy de Galhau	ECB's Villeroy speaks in Paris
22/07/2022	09:00		ECB Survey of Professional Forecasters
26/07/2022	18:00	Pablo Hernández de Cos	ECB's de Cos Speaks about Inflation in Barcelona
28/07/2022	14:00	Ignazio Visco	Speech on payment security in Paris
29/07/2022		Luis de Guindos	Interview with Postimees conducted by Tõnis Oja on 25 July https://www.ecb.europa.eu/press/inter/date/2022/html/ecb.in220729~a9e5203ad4.en.html
04/08/2022	09:00		ECB Economic Bulletin Overview
18/08/2022		Isabel Schnabel	Presentation "Inflation in the euro area - causes and outlook" at Hochschule der Deutschen Bundesbank https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220818~fb82d12ac0.en.pdf?25025e01d1fe08eba6924f171f18ba8c
18/08/2022		Isabel Schnabel	Interview with Reuters conducted by Balazs Koranyi and Frank Siebelt on 16 August 2022 https://www.ecb.europa.eu/press/inter/date/2022/html/ecb.in220818~a2a774e937.en.html
23/08/2022	12:00	Fabio Panetta	Presentation "Policy panel on central bank digital currencies" at the Annual Congress of the European Economic Association at Bocconi University in Milan https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220823~26022f4481.en.pdf?f27a4366952a0310a327d752566ddfb7
25/08/2022	12:30		ECB Publishes Account of July Policy Meeting

25/08/2022		Christine Lagarde	Interview with Madame Figaro conducted by Morgane Miel on 13 July 2022 and published on 25 August 2022 https://www.ecb.europa.eu/press/inter/date/2022/html/ecb.in220825~7c5db6d1b3.en.html
27/08/2022	14:00	Isabel Schnabel	Speech "Monetary policy and the Great Volatility" at the Jackson Hole Economic Policy Symposium organised by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220827~93f7d07535.en.html
29/08/2022		Philip Lane	Remarks "Monetary policy in the euro area: the next phase" for high-level panel "High Inflation and Other Challenges for Monetary Policy" at the Annual Meeting 2022 of the Central Bank Research Association (CEBRA), Barcelona https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220829~b9fac50217.en.html
30/08/2022	12:15	Boštjan Vasle	Speech on the economic outlook at the Bled Strategic Forum
30/08/2022	17:00	Robert Holzmann, Yannis Stournaras, Pierre Wunsch & Madis Müller	Discussion at the Alpbach Forum in Austria
01/09/2022	11:30	Mário Centeno	Participation in the panel "Financial Capitalism and Sustainability" at the Estoril Conference hosted by the Nova SBE University near Lisbon

MNI Policy Team

MNI: Inflation Strengthens Hawks' Resolve In EU Debt Talks

31st August

By David Thomas

High inflation and additional government spending to help consumers and business cope with higher prices are strengthening the resolve of more fiscally conservative European Union states to resist any further extension of the waiver on the bloc's borrowing limits and to press for a prompt resumption of talks to reform the rules, officials told MNI.

While officials cannot rule out the possibility that the so-called Escape Clause from the Stability and Growth Pact's borrowing rules, first enacted to help member states cope with the Covid pandemic and now due to run until next year, will be extended once again by the European Commission in response to soaring energy prices, they insisted that this is very unlikely.

“From what we are hearing, the Commission has decided that you can no longer postpone because of uncertainty, because we have been operating in an uncertain environment for the past three years and it seems like it will stay there for months or even years,” one source said.

Talks on reforming the Stability and Growth Pact, pushed back as governments responded to the Russian invasion of Ukraine, can be delayed no longer, fiscal hawks insist, with the loosening of borrowing limits initially hoped for by some southern European states now superseded by what is likely to be a [light-touch reform](#) focussing on interpretative changes. (See [MNI: Gas Shortages To Delay EU Fiscal Rules Overhaul-Officials](#))

Germany’s recently-published position paper on fiscal rules reform, involving no amendments to current legislation, has set the scene for discussions between the Commission and EU states, officials said. The Commission is now preparing a “high-level orientation” on reform, which will be followed by a discussion among member states, hopefully leading to agreement and a Commission proposal for more concrete changes in the spring of 2023.

LIMITED REFORM

Key tenets of the pact including a 60% cap on public debt to GDP and a 3% of GDP limit on budget deficits are set to remain.

“The kind of ambition we are talking about is not great. No one questions the 60% or 3%, an official said.

While there is agreement that rules on the pace at which overly-indebted states can return to permitted levels need to be softened, calls by countries including France and Italy for exemptions from borrowing caps for priority investments to finance the green transition, higher defence spending and cope with immigration have been rejected, officials said.

High inflation makes the current situation very different from the Covid era when subdued rates of price increases and business lockdowns supported the case for broad fiscal support, officials said, noting that help for consumers and businesses hit by energy price hikes must be targeted and temporary.

“In view of what is going on right now, the aim is to go back to a normal economic policy framework and back to some rules that would frame the actions of governments,” the source added. “We have no reason to believe inflation will cease to be a problem in the coming months.”

One official said that the ECB’s new Transmission Protection Instrument, allowing it to shore up prices of sovereign bonds which come under market attack, could also strengthen the hand of the hawks in the reform talks, as otherwise there would be little incentive for states to pursue fiscal discipline.

“If we don’t go back to rules this time, we have to start questioning what is the purpose of them,” the official said.

MNI: EU Said To Draft Electricity Reform Before Crisis Meet31st August*By Jason Webb*

The European Commission is working on a proposal to reform the 30-year-old design of the bloc's electricity market ahead of a Sept. 9 emergency meeting of energy ministers, after Germany and Austria joined France, Italy, Spain and Portugal in applying intense pressure in favour of change, EU officials said.

Officials expect a draft reform aimed at decoupling the retail electricity price from gas prices by the end of this week, to be discussed by EU ambassadors and then by the EU's Energy Working Party next week.

Existing market mechanisms have led to soaring electricity prices for consumers and businesses and windfall profits for energy companies, despite the fact that prices for renewable energy have been much lower than for gas.

GERMANY ADDS TO CLAMOUR

A so-called Iberian Solution' which would have capped gas prices at EUR40-50 per MWH, has been mooted and rejected as too customised for the specific situation of Spain and Portugal, both of which have a very different energy mix to the rest of the EU and little interconnection to the rest of the Union's electricity market, officials said.

Germany and Austria have recently joined France, Italy, Spain and Portugal in pushing for reform. In public Germany continues to stress that it is well prepared for winter, with gas storage levels now well over 80% of capacity, but Russia's latest announcement of a three-day maintenance closure of Nordstream 1 has renewed concerns. (See [MNI INTERVIEW: EU Ahead Of Target In Winter Gas Build-Up](#))

MNI SOURCES: Majority Sufficient For ECB's New TPI Tool

29th July

(MNI) London - A majority on the Governing Council will be sufficient to activate the European Central Bank's new Transmission Protection Instrument, with decisions to be based on a varying range of indicators depending on the circumstances, Eurosystem sources told MNI, adding that fallout from fiscally irresponsible policies would not qualify as meriting assistance.

The choice of market metrics to determine whether bond spreads are detached from economic fundamentals and interfering with the transmission of monetary policy will be decided on a case-by-case basis, one official said, noting that consideration of the eligibility for TPI would first depend on the four conditions of financial sustainability set out by the ECB.

But in its [press release](#) on Jul. 21, the ECB said the four criteria would only be an "input" into the Governing Council's decision-making.

"The debt sustainability condition gives a very clear signal of what the ECB's holistic approach looks like," the source said. "If there is an IMF model, the European Commission has another model, the ESM has another and the national banks others ... we will look at them all, and since they are all imperfect, we can learn from each of the different pieces."

While the Governing Council will seek consensus for any decision, it did not discuss the rules of any vote on whether to deploy its new tool at its meeting last week, nor [the precise conditions](#) which would call for its use, other sources said.

AVOIDED DISAGREEMENT

“We discussed and agreed the framework of the TPI, but there are still things we have not yet fully discussed or agreed. In part that is because there was no urgency for an agreement now, but as there was no urgency, there was no need for us to discuss what we were clearly going to find disagreement on,” said one.

The effect of telling markets that TPI has been activated will be key, another source said.

“Maybe they would announce that TPI is activated for country XYZ, and maybe not the amount, or the pace of purchases. Markets get ahead of themselves, and sometimes kind of diminish any monetary policy,” the source said.

The pace of bond purchases could be decided by the Governing Council on the basis of a normal majority, perhaps on a two-weekly or a week-by-week basis, the source noted.

Last week’s meeting decided to give the Governing Council control over whether to activate the tool, after what several sources conceded was horse-trading in return for a 50-basis-point hike rather than the 25 favoured by doves and signalled in the ECB’s own guidance.

Reinvestments of expiring bonds under the Pandemic Emergency Purchase Programme remain the first line of defence against volatility. Countries not deemed deserving of TPI and which were unable to withstand market pressure would have to rely on the Outright Monetary Transactions facility, which requires them to agree a programme with the European Stability Mechanism.

While the TPI will be powerful, it is not equivalent to the “whatever it takes” promised by former ECB president and current Italian prime minister Mario Draghi when announcing OMT in 2012, noted another source. (See [MNI INTERVIEW: ECB’s Simkus Says New Tool May Never Be Used](#))

“The main battle was to retain Governing Council discretion,” the source said, referring to last week’s meeting. “This is not whatever it takes because it simply cannot be so – one, we are tightening, and two, Draghi’s statement worked because nobody really cared looking into the details of OMT. Now the emperor is naked.”

ITALIAN ELECTIONS

Irresponsible fiscal behaviour will not warrant deployment of TPI, the source said, pointing to concerns over Italy which is heading for Sept. 25 elections following the implosion of Draghi’s coalition.

“Chaos and lack of direction, commitment are a fundamental reason why markets may sell Italian debt,” the source said. “This would in principle call for not activating the TPI and instead offering OMT as the only way forward or else. That day, if it comes, the ECB will face a genuine Lehman moment.”

The ECB would be unlikely to deploy TPI before a new Italian government is formed, and would not do so later to save it from the consequences of a lack of commitment to fiscal responsibility, another source said.

“We would let the market play and discipline such political promises,” the source said. “We would let the market do its work.”

National credit ratings, while relevant, will not directly affect TPI eligibility, sources said. Sources declined to comment on whether central banks within the eurosystem could be obliged to buy bonds issued by other eurozone countries’ governments.

“Regardless of the answer on whether there will be resharing, it does not affect the effectiveness or power of the instrument,” one source said.

MNI SOURCES: Italy Meets Criteria For ECB's New Crisis Tool

27th July

By Santi Pinol

(MNI) Rome - The European Central Bank's new Transmission Protection Instrument marks a break with the punitive approach taken in the past by European authorities to countries struggling with debt problems, two Italian government officials told MNI, adding that Italy meets the four criteria to be eligible for assistance under the facility should that be necessary.

In order to qualify for TPI assistance, a country has to be compliant with European Union fiscal frameworks, be free of severe macroeconomic imbalances, and have sustainable public finances and sound economic policies, conditions which the sources indicated were satisfactory to Italy, and which differ from the tougher requirements, including signing up for a European Stability Mechanism Programme, imposed by the ECB's Outright Monetary Transactions facility.

The TPI, which would be deployed to buoy [eurozone member states' bonds](#) if spreads diverge from economic fundamentals and is likely to be used at some point, completes the toolkit for the ECB, following the creation under its then president and current Italian Prime Minister Mario Draghi in 2012 of the OMT, whose unlimited firepower has proven such a deterrent that it has never had to be used, the sources said.

The new tool is a sign that the European Union has changed its approach towards financially weaker countries since the debt crisis, said the sources, who are close to Italy's economic policy making.

“Compared to ten years ago, there is a new air in Europe, which appears to be more equipped than in the past to face economic and financial crises,” one source said. “The mistakes of the past cannot be repeated.”

PAST APPROACH "PUNITIVE"

The sources pointed to what one called the “punitive attitude” taken towards Greece as its economy entered crisis, adding that this had “echoed the sad experience of conditional financing by the IMF to developing countries.”

The difference in approach seen with the TPI partly derives from the pandemic's legacy of significant additional indebtedness even for the healthiest eurozone economies, reducing the differences between member states' fiscal positions, one of the officials said, adding that the focus of investors is shifting towards the ability of Europe to “act together as a bloc” and away from individual countries.

While aspects of the TPI have yet to be clarified, some of the conditions are based on Stability and Growth Pact rules on government borrowing which were eventually likely to be relaxed, one of the sources noted.

As Italy heads for Sept. 25 elections which polls suggest might result in a government led by the far-right Brothers of Italy, the officials noted that the ECB and EU authorities will not be more demanding of a new government simply because of its ideological orientation but that much of the bloc's new financial architecture, like the NextGenerationEU pandemic recovery package as well as the TPI rely on mutual trust.

“It is wise to respect the rules that we ourselves have helped to define,” one official said.

Draghi, who is continuing as caretaker until the appointment of a new prime minister, following the implosion of his coalition earlier this month, has been arguing strongly for Italian governments to commit to engaging with European institutions. (See [MNI: Draghi To Push Through Court Reform, Start Budget-Aides](#))

“In that sense, the Draghi agenda has transmitted something to our country,” said one of the officials, adding that several of Italy’s main political parties are now claiming to be the inheritors of his technocratic policies.

Italy’s next government should act “with confidence, seriousness and awareness that Europe is our true insurance for the future,” one of the officials said.