THEMATIC

The ECB's ability to raise rates will depend on the strength of the antifragmentation tool

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The ECB is determined to tighten its monetary policy in the face of record high inflation levels. However, it is addressing that risk by cooling inflation down or pushing the economy into recession or triggering a spike in peripheral debt borrowing costs, as in 2012. The markets are already sounding the alarm about what may lie ahead. Italian government bond yields jumped past 4% this month for the first time since 2014 as investors are concerned about the ECB's first step in normalising its monetary policy.

High inflation remains a major challenge

- In May, Eurozone headline inflation reached another record of 8.1%. Inflationary pressures have been exacerbated by the war in Ukraine and ongoing lockdown measures in China. Global supply chains remain under pressure. Energy prices stand 39% above their levels of one year ago.
- We do not expect headline inflation to peak before October. In addition, underlying inflation has been rising further and could continue to surprise on the upside in the second half of the year. On the one hand, more and more companies should continue to raise their prices to compensate for the record jump in production costs. On the other hand, demand in the Eurozone could be supported by targeted government support or rising wages.

Skyrocketing inflation remains the ECB's top priority

The European Central Bank remains determined to fight against inflation.

- The ECB remains much more focused on the risk of inflation expectations becoming unanchored than on the downside risks weighing on growth. "The longer inflation numbers are at the high level where they are, the more likely it is that wages negotiations, entry-level salaries, and renegotiations of existing agreements will actually take place." (Christine Lagarde).
- Central banks are afraid of losing their credibility. "Inflation is undesirably high and is expected to remain above our target for some time." "The Governing Council will make sure that inflation returns to our two per cent target over the medium term." (Christine Lagarde).
- We are therefore maintaining our forecast of a 25bp hike in July, followed by 50bp hikes in September and October.

In tackling the path of inflation, the ECB faces two dilemmas:

- A central bank has few "tools" to fight cost-driven inflation without hurting growth. Indeed, inflation in the Eurozone is being driven primarily by exogenous factors, including high-energy costs and supply chain disruptions. The ECB wants to tighten its monetary policy to limit the spread of price rises across sectors.
- Tighter monetary policy is increasing financial fragmentation across the Eurozone. When it comes to financial fragmentation, we need to watch peripheral government bond yields and not just spreads. The cost of debt cannot be higher than nominal growth, over a long period, for heavily indebted countries. They are wary of high level of debt in Europe, in particular in Italy.

Tighter monetary policy is increasing financial fragmentation across the Eurozone

The ECB's ability to raise rates will depend on the strength of the anti-fragmentation tool.

- The markets are already sounding the alarm. Italian government bond yields jumped past 4% this month for the first time since 2014, as investors are concerned about the ECB's first step in normalising its monetary policy.
- ECB sovereign debt purchases should be targeted. Inflation levels no longer allow the ECB to implement large-scale asset purchase programs to keep peripheral sovereign bond yields at low levels. The ECB wants to limit upward pressure on spreads using: (1) flexibility in PEPP reinvestment and (2) an "anti-fragmentation tool". We expect the details of the new backstop to be announced in July.
- At the Forum of Central Banks in Sintra, the ECB President, Christine Lagarde, explained that "the new instrument must be effective while being proportionate and including sufficient guarantee mechanisms to preserve the momentum of the Member States towards a sound budgetary policy". The challenge for the ECB is to tread the fine line between the remit of the governments and that of the central bank.
- The ECB's ability to raise rates will depend on the strength of the anti-fragmentation tool
- Developments on the euro rate market will strongly depend on developments in the energy sector, political choices (fiscal support) and monetary choices (arbitrage between inflation and growth, anti-fragmentation tool).

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