INSTITUTE OF INTERNATIONAL MONETARY RESEARCH

Governing Council meeting, ECB. 21/07/2022

First rate rise in 11 years

As announced at its previous meeting, the ECB raised interest rates for the first time in 11 years following the meeting of its Governing Council on 21st July. The increase in the main policy rate, however, was 0.5% rather than the 0.25% it had previously indicated. The deposit rate, which had been reduced below zero as far back as 2014, was also increased by 0.5%, taking it up to 0%. The ECB also announced the approval of the Transmission Protection Instrument (TPI). This is essentially an ad-hoc bond purchase scheme allowing the ECB to support the more heavily indebted Eurozone countries. It is possible that one reason why the ECB has not thus far been keen to raise interest rates to counter surging inflation is its fear of widening bond yield spreads. For example, last month, the yield on 10-year Italian government bonds rose above 4% whereas German 10-year Bunds are currently trading at just under 1.25%. Any increase in borrowing costs across the entire Eurozone is likely to exacerbate the difference in yields between the member states, which rose to 5% at the height of the Eurozone crisis a decade ago. The ECB is keen to avoid a repeat of this scenario and hopes that today's announcement will calm the bond markets and ultimately, prevent the fragmentation of the single currency bloc.

Another reason for the ECB's hesitancy is the dependence of several member states, notably Germany, on Russian energy, especially gas. The German economy has been very weak recently and there are fears that not just Germany but the whole Eurozone might be facing a recession. The money numbers suggest that growth is likely to slow. The annualised quarterly growth rate point of M3 broad money fell from 5.1% in the three months to April to 3.3% a month later. The winding up of the asset purchase schemes will have been a factor here and higher borrowing costs are likely to slow money growth further. The press release following today's announcements indicated that the ECB will consider a further rate hike at its next meeting, scheduled for 8th September. It does not intend, however, to run off or sell any assets purchased under the Pandemic Emergency Purchase Programme before the end of 2024 and the reinvestment of maturing assets may he linked to the TPI.

Consumer prices rose by 8.6% in the year to June. Inflation rates for some member states are much higher, with the figures for both Estonia and Lithuania now above 20%. The Eurozone has suffered particularly badly from spiralling producer prices, which have risen at an annual rate of more than 35% for the last three months. Some of these increases will inevitably have to be passed on to consumers, which points to a continuation of high levels of inflation for some time. The raising of interest rates by central banks in an attempt to bring down inflation *in the short term* has not proved successful as it is dealing with a problem which took place two years ago – namely the huge surge in broad money in 2020. Nonetheless, most central banks across the world are now committed to some sort of monetary tightening. So far, the stock of bank loans to businesses and consumers in the single currency bloc has continued to grow at a reasonable level, creating new bank deposits, which are money. Higher borrowing costs will inevitably dampen enthusiasm for risk, but if the ECB persists in reinvesting the assets it purchased in 2020-21, rather than running them off or selling them (as the US Fed and the Bank of England intend to do) money growth may only slow rather than contract and thus avoid a recession on the scale which could well affect the USA, where money balances are already decelerating at a rate unprecedented for decades.

You can access further details on the latest monetary developments in the Eurozone in our latest **monthly report and video** at https://mv-pt.org/monthly-monetary-update/.