Governing Council meeting, ECB. 08/09/2022

All lending rates increased by 0.75%

Six weeks after the first rate hike in 11 years, the ECB raised the cost of borrowing by a further 0.75% following the meeting of its Governing Council on 8th September. The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will be increased to 1.25%, 1.50% and 0.75% respectively, with effect from 14th September. This sharp monetary tightening has been driven by a desire to bring consumer price inflation down to the ECB's 2% target following prices rising by 9.1% in the year to August – the highest rate of inflation since the launch of the single currency in 1999. (It should be mentioned that some euro member states have much higher rates of inflation. All three Baltic States are currently seeing prices rise by more than 20% per annum.) Unlike the Bank of England or the US Federal Reserve, the ECB has no plans to reduce its balance sheet by running off or selling assets purchased under either the 2019 Asset Purchase Programme (APP) or the larger 2020 Pandemic Emergency Purchase Programme (PEPP). The money from maturing assets will be re-invested in ad-hoc bond purchases from the governments of the more heavily indebted Eurozone countries, notably Italy and Spain. This move, announced in July's meeting and labelled the Transmission Protection Instrument (TPI), is an attempt to prevent the widening of the spread in 10-year bond yields. The ECB is keen to avoid a repeat of the Sovereign Debt Crisis of 10 years ago, when the spread rose to 5%. Thus far, the gap between the yield on 10-year German Bunds and 10-year Italian Government debt is less than 2½%, thanks largely to the yield on Bunds rising to its highest level since January 2014.

The press release from the ECB acknowledged that these increases in the costs of borrowing have been implemented at the same time as the Eurozone economy is weakening, with the increase in energy prices being cited as the main culprit. It is true that several member states, including Germany, have been very dependent on Russian energy, especially gas. The principal cause of record levels of inflation is, however, the monetary stimulus of 2020. PEPP boosted the ECB's balance sheet by €1,850b. Broad money growth soared to a record annualised rate of 22% in the three months to May 2020 and remained at an elevated level for most of the period up to March 2022 when the asset purchases were terminated. Given that there is often a time lag between a monetary stimulus and its effect on consumer prices, it is therefore highly probable that the ECB's actions this month will have little effect in the short term. Indeed, producer prices rose by a record 37.9% in the year to July and companies will inevitably try to pass many of these extra costs to consumers. Inflation could therefore rise even higher before it starts to fall. The annualised rate of broad money growth stood at 5.4% in the three months to July. This is towards the upper end of the range compatible with the ECB's 2% inflation target. Deposits created by new lending both to businesses and households are driving the growth in M3. This increase in borrowing costs may dampen what has been quite a significant increase in bank credit since the start of the year.

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