ERSTE Group

Week Ahead

Focus: ECB's Transition Protection Instrument (TPI)

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ECB, Monetary Policy Transmission and Spreads

On July 21, the ECB presented the Transmission Protection Instrument (TPI). With this, the Governing Council has given itself a third tool to prevent the fragmentation of the euro area through the divergent transmission of monetary policy. What do these technical terms mean? At the core, it is about the possibility to counter a rapid rise in the yields of individual countries' government bonds, if necessary. Sharply rising yields on national government bonds also have an impact on the interest rates of fixed-interest loans in the respective member countries and thus on the cost of financing also for private individuals and companies. This would slow down the economy in the affected country more than in the other countries. This would be a fragmentation of the euro area, as the transmission (transmission) of the ECB's monetary policy would be inconsistent within the currency area.

The Governing Council defines the objective of the TPI in terms of being able to "counter unwarranted and disorderly market dynamics". The means to do so are purchases of government bonds in the secondary market. There will be no determination in advance as to the extent. According to the ECB, the amount of purchases will depend on the risks to the transmission of monetary policy. This means that as many funds as necessary will be used to stabilize the situation. The key points of the TPI are generally very vaguely formulated, which will give the Governing Council room for maneuver in its decisions if necessary. This is particularly true for the decision to trigger the TPI, which will be taken by the Governing Council. A number of criteria are to be taken into account, including whether sound and sustainable financial and economic policies are being pursued by the country. Ultimately, however, it will be a discretionary decision by the Governing Council. Two reasons have been defined for ending purchases under TPI: Either in the event of a "durable improvement in transmission" (monetary policy), which translates into a stabilization of the bond market concerned, or if the persistent tensions in the bond market are attributable to country fundamentals.

With the TPI, the ECB Governing Council has given itself another tool to intervene in the event of market distortions. The TPI ranks between the existing tools PEPP reinvestments and the OMT. The first line of defense is the PEPP reinvestments, which are scheduled to run until the end of 2024 under current ECB plans. Under PEPP, securities with a volume of almost EUR 1,700 billion had been purchased by March 2022. The ongoing redemptions of this portfolio will be used for new purchases, with the ECB – as needed – taking leeway in how the latter are distributed. The ECB calls this flexibility. The latest data show that this flexibility was used in June and July. Redemptions of German and Dutch bonds, for example, were used to buy more Italian and Spanish government bonds to give support to these securities in very turbulent markets. Finally, the ECB also has the OMT program, which is only used in severe crises.

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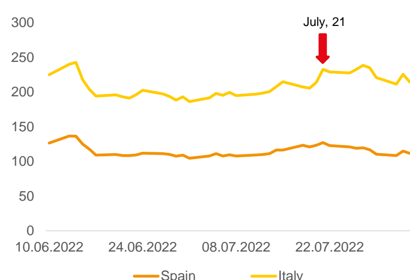
Note: Past performance is not necessarily indicative of future results
GDP growth forecasts (y/y, %)

Here, the ECB's support is tied to strict conditions, such as compliance with a prescribed restructuring program by the country in question.

It was no coincidence that the ECB's first interest rate hike since 2011 and the presentation of the TPI coincided. The Governing Council did not know in advance how bonds, especially of highly indebted countries, would react to the first of probably several rate hikes and wanted to signal to the markets that it could intervene if necessary.

Rising interest rates are, of course, a burden on public budgets. However, higher inflation at the same time means additional revenues for the government. Furthermore, higher interest rates only affect the part of the public debt that is maturing and thus has to be refinanced. Thus, there is usually time to react to the higher interest rates in terms of fiscal policy. However, a sell-off on the markets and thus a massive increase in financing costs in a short period of time deprives policymakers of this time. This is precisely what the TPI is designed to prevent.

10yr Spread over Germany, in basis points



Source: Market data provider, Erste Group Research

On July 21, not only was the TPI presented, but Italian Prime Minister Draghi also announced his resignation. Nevertheless, the yield spreads between Italian and German government bonds have actually narrowed since, a change to which the ECB's measures have probably made a significant contribution. The further development of yield spreads will depend on political decisions and risks. In concrete terms, it is therefore in the hands of Italian politicians during the election campaign and the subsequent formation of a government to move the markets or not. Higher key interest rates per se, together with the stabilizing effect of the ECB programs, should not trigger a sell-off.

Economic calendar

Ctry	Date	Time	Release	Period	Consens	Prior
Eurozone						
USA						
	10-Aug	14:30	Inflation y/y	Jul	8.7%	9.1%
China						
	10-Aug	3:30	Inflation y/y	Jul	2.8%	2.5%

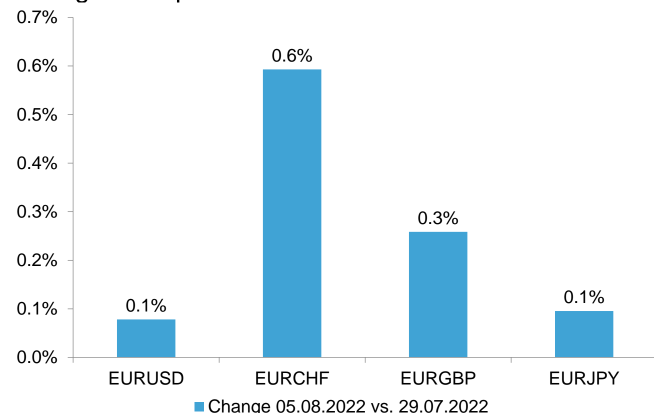
Central bank events

	Date	Time	Representative	Forum	Location
ECB			No monetary policy relevant events		
Fed			No monetary policy relevant events		

Source: Market Data Provider, ECB, Federal Reserve, Erste Group Research

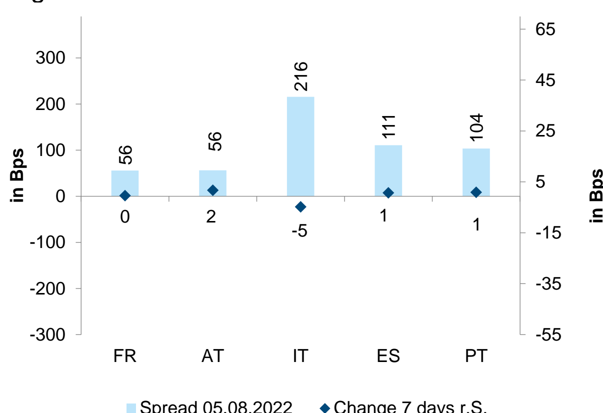
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
Changes compared to last week



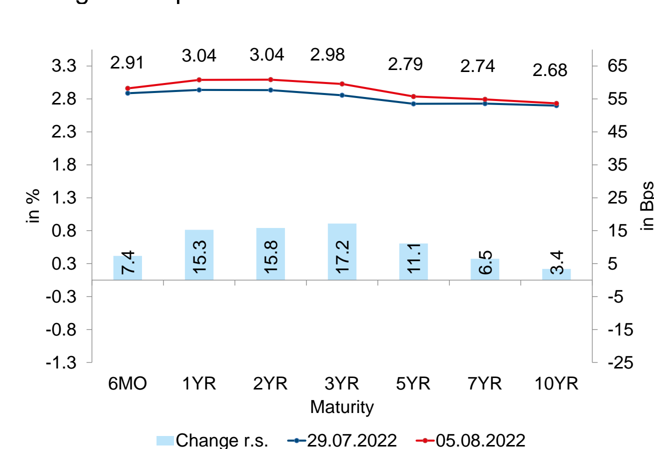
Source: Market Data Provider, Erste Group Research

Eurozone spreads vs. Germany
10Y government bonds



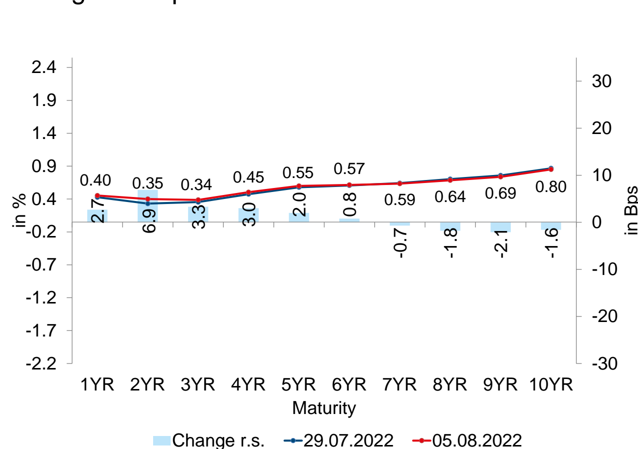
Source: Market Data Provider, Erste Group Research

US Treasuries yield curve
Changes compared to last week



Source: Market Data Provider, Erste Group Research

DE Bund yield curve
Changes compared to last week



Source: Market Data Provider, Erste Group Research

Forecasts[1]

GDP	2020	2021	2022	2023
Eurozone	-6.5	5.3	2.7	1.8
US	-3.5	5.7	2.1	1.7

Inflation	2020	2021	2022	2023
Eurozone	0.3	2.6	7.6	3.9
US	1.2	4.7	8.0	3.0

Interest rates	current	Sep.22	Dec.22	Mar.23	Jun.23
ECB MRR	0.50	1.00	1.25	1.25	1.25
ECB Deposit Rate	0.00	0.50	0.75	0.75	1.00
3M Euribor	0.27	0.72 ↓	0.72 ↓	0.80 ↓	0.97 ↓
Germany Govt. 10Y	0.80	1.20	1.20	1.20	1.30
Swap 10Y	1.64	1.90	1.80	1.70	1.80

Interest rates	current	Sep.22	Dec.22	Mar.23	Jun.23
Fed Funds Target Rate*	2.33	2.88	3.38	3.38	3.38
3M Libor	2.83	3.04	3.46	3.46	3.46
US Govt. 10Y	2.69	3.00	2.70	2.60	2.50
EURUSD	1.02	1.03	1.05	1.10	1.13

*Mid of target range

In case of changes to our forecasts compared to the previous issue, arrows show the direction of the change.
Source: Market Data Provider, Erste Group Research

[1] Note: In accordance with regulations, we are obliged to issue the following statement: Forecasts are not a reliable indicator of future performance.

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