



R&R Weekly Column
By Brunello Rosa



The ECB Is Finally Moving To Stop The Fragmentation Of Its Transmission Mechanism

All of the largest and most influential central banks in the world held their policy meetings in the last couple of weeks. The US Federal Reserve adopted the largest increase in its policy rate since 1994 last week, with a [75bps increase taking its Fed funds target range up to 1.50-1.75%](#). Until a couple of days before the meeting, [the Fed seemed to be excluding such a possibility](#). But then the May inflation figures, showing [CPI at 8.6%, a 40-year high](#), [convinced the Fed](#) to adopt the emergency measure of increasing its target range so quickly (as did the inflation expectations gauge measured by the University of Michigan survey, which showed the potential of an initial de-anchoring). This move by the Fed may be replicated in July, if inflation prints do not start to convincingly and steadily decrease.

Also last week, the Bank of England [increased its Bank Rate by 25bps to 1.25%](#), marking the fifth consecutive rise since December 2019. Again, the choice was motivated by the latest figures on inflation, showing [an increase in CPI by 9% y/y in May](#). Three out of 9 Monetary Policy Committee members would have preferred a larger increase in policy rates, of 50bps to 1.50%. But the majority of the MPC preferred a more cautious approach, given the risk of recession [highlighted in last month's Monetary Policy Report](#). Similarly, the Swiss National Bank (SNB) increased its policy rate by 50bps, to -25bps; [a surprise move, marking the first rate increase in 15 years](#). The SNB feared a de-anchoring of inflation expectations, even if that meant a temporary strengthening of the CHF.

To conclude the week, the [Bank of Japan went in the opposite direction, and left its policy stance unchanged](#), undeterred by the peer pressure. In effect, Japan faces a different combination of impacts from the war in Ukraine and the pandemic on its growth and inflation outlook, and can afford to keep its policy stance much looser than other major central banks.

Finally, the ECB held [an unscheduled policy meeting on Wednesday](#), which followed the [regular meeting in June](#) that clearly left the market unsatisfied. On June 9th, the ECB announced two rate increases in July and September, to combat inflation. But kept its “constructive ambiguity” on what it would be prepared to do in case fragmentation in the transmission mechanism of monetary policy were to emerge. Following the meeting, intra-EMU spreads rose again, with the BTP/Bund spread at 10y maturity reaching levels (above 200bps) last seen in 2018-19 during the Conte 1 government, supported by the euro-sceptical majority Lega–M5S coalition.

During the emergency meeting, the ECB's Governing Council [decided to task the relevant Committees](#) with finalising the design and implementation of a new facility specifically aimed at reducing the fragmentation of the transmission mechanism (and therefore the intra-EMU spreads). [In our preview](#), we mentioned how we thought that the “constructive ambiguity” approach was certainly insufficient to prevent the market from testing the ECB's anti-spread resolve, and that a much more explicit reference to a facility explicitly aimed at reducing the market fragmentation was needed. The ECB thought initially that they could do without it, but then had to capitulate under the pressure of the market. In July they will probably reveal what this facility is about.

Our Recent Publications

- Flash Review: Bank of England Increases Rates by 25bps in June, by Brunello Rosa and Nato Balavadze, 16 June 2022
- Flash Review: Fed Front-Loads Its Tightening Cycle With A 75bps Hike in June, by Brunello Rosa and Nato Balavadze, 15 June 2022

- Flash Preview Change: Fed To Increase Rates by 75bps in June and July, by Nouriel Roubini, 14 June 2022
- GEOPOLITICAL CORNER: Are Biden's, Putin's, And Xi's Choices Over The War In Ukraine Really Rational?, by John Hulsman, 14 June 2022

Looking Ahead

The Week Ahead: Inflation Accelerates In UK; In DMs PMIs Expected To Fall; Consumer Confidence To Remain Low In US and EZ

In the US, June's Michigan Consumer Sentiment is expected to fall to 50.2 (*p*: 58.4). The flash data for S&P Global in May is expected to show: *i*) services PMI rising slightly to 53.6 (*p*: 53.4); *ii*) manufacturing PMI falling to 56.4 (*p*: 57.0).

In the EZ, June's Consumer Confidence is seen increasing to -20.8 (*p*: -21.1), albeit remaining at historical low levels. The flash data for S&P Global/CIPS in May is expected to show: *i*) services and manufacturing PMI falling to 55.5 (*p*: 56.1) and to 53.9 (*p*: 54.6) respectively; and *iii*) composite PMI decreasing to 54.0 (*p*: 54.8).

In the UK, in May, data for inflation is expected to show: *i*) CPI inflation surging to 9.1% y-o-y (*p*: 9.0%); *ii*) monthly inflation decelerating to 0.6% m-o-m (*p*: 2.5%); and *iii*) core-inflation easing slightly to 6.0% (*p*: 6.2%). In May, monthly retail sales are likely to shrink -0.9% (*p*: 1.4%), whereas retail sales are expected to recover slightly to -4.8% y-o-y (*p*: -4.9%). The flash data for S&P Global/CIPS in May is expected to show: *i*) services and manufacturing PMI falling slightly to 53.0 (*p*: 53.4) and 53.8 (*p*: 54.6) respectively; and *ii*) composite PMI falling too to 52.7 (*p*: 53.1).

The Quarter Ahead: French Elections; European Commission Backs Ukraine Candidacy; EU Launches Legal Action Against UK

The result of the French legislative elections left President Macron without a clear majority in parliament. Macron's party won 245 seats (vs 289 needed for a majority), Mélenchon's leftwing coalition NUPES won 131, Le Pen's party got 89 seats and the Republicans 61, other parties 51. Macron will likely have to form a coalition with the Republicans to have a stable majority in parliament.

European leaders visited Kyiv a day before the European Commission was due to make recommendation on whether to give Ukraine an EU candidate status. The executive body of the EU recommended the Ukraine be granted candidate status.

EU set to take legal action against UK over scrapping parts of the post-Brexit deal for Northern Ireland. The Northern Ireland Protocol allowed Northern Ireland to stay in the EU's single market. Now with the new proposal by Johnson's government, goods flowing into Northern Ireland would be checked under UK or EU rules and it aims to minimize costs and paperwork for businesses in the UK. EU says that unilateral modification of the deal breaches an international law. The case is expected to go to independent arbitration.

Last Week's Review

Real Economy: Inflation Reached Other Record Highs In The EZ; UK Unemployment Fell In The UK; CBs Turned Hawkish

In the US, in May, PPI slightly declined to 10.8% y-o-y (*c*: 10.9%; *p*: 10.9%).

In the EZ, in May, *i*) CPI inflation rose to 8.1% (*c*: 8.1%; *p*: 7.4%); *ii*) core-inflation increased to 3.8% y-o-y (*c*: 3.8%; *p*: 3.5%); and *iii*) CPI inflation rose to 0.8% m-o-m (*c*: 0.8%; *p*: 0.6%). Among the largest EZ economies, in May: *i*) in Germany CPI inflation accelerated to 7.9% y-o-y (*p*: 7.4%) as expected; *ii*) in France CPI Inflation increased to 5.2% y-o-y (*p*: 4.8%) as expected; and *iii*) in Italy, inflation reached 6.8% y-o-y (*c*: 6.9%; *p*: 6.0%). June's ZEW economic sentiment index recovered somewhat to -28 (*p*: -29.5).

In the UK, unemployment rate in April rose slightly to 3.8% (*c*: 3.6%; *p*: 3.7%).

CBs turned hawkish. In the US, the Fed rose its target Fed funds target range by 75bps to 1.5% - 1.75%. In the UK, the BoE increased its Bank Rate to 1.25%. The Swiss National Bank increased its policy rate by 50bps to -0.25%.

Financial Markets: Stock Market Drops; Yields Rose Over Inflation And Rate Fears; Dollar Is Up, Whereas Oil and Gold Are Down

Market Drivers: investor sentiment weakened, hampered by: *i*) policy tightening; *ii*) slipping U.S. retail sales; and *iii*) continuing inflation fears. The sentiment turned significantly bearish, as investors weigh the monetary policy tightening against the slowing economic growth. Over the fears of 'hard landing' the major U.S. stock indexes fell and the S&P 500 Index recorded its worst week since March 2020 and entered a bear market.

Global Equities: Decreased w-o-w (MSCI ACWI, -5.8%, to 584.6). The US S&P 500 index fell significantly (-5.8% w-o-w, to 3,674.8). In the EZ, shares were down (Eurostoxx 50, -4.5% w-o-w, to 3,438.5). In EMs, equities declined (MSCI EMs, -4.7%, to 1,004.6). Volatility rose to 30.9 (VIX S&P 500, 52w avg.: 22.6; 10y avg.: 18.1).

Fixed Income: w-o-w, 10-year US treasury yields increased (+7 bps to 3.2%). The 2-year US Treasury yields were up too (+10 bps to 3.17%). The German 10-year bund yield increased (+16 bps to 1.66%).

FX: w-o-w, the US Dollar Index was up (DXY, 0.3%, to 104.5; EUR/USD -1.9%, to 1.052). In EMs, currencies weakened (MSCI EM Currency Index, -0.6% w-o-w, to 1,672.6).

Commodities: w-o-w, oil prices fell (Brent, -6.9% to 113.6 USD/b), as worries over recession and subsequent cutting demand for energy rose. Gold prices decreased w-o-w (-1.8% to 1,841.9 USD/Oz) following a stronger dollar and rising U.S. Treasury yields.



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Abbreviations, Acronyms and Definitions

a	Actual	LN	Northern League, Italy
AKP	Justice and Development Party, Turkey	MSS	Five Star Movement, Italy
ann.	annualized	m-o-m	Month-on-month
ARS	Argentinian Peso	mb	Million barrels
avg.	Average	mb/d	Million barrels per day
bn	Billion	MENA	Middle East and North Africa
BoC	Bank of Canada	MHP	Nationalist Movement Party, Turkey
BoE	Bank of England	mn	Million
BoJ	Bank of Japan	MPC	Monetary Policy Committee
bpd	Barrels per day	NAFTA	North-American Free Trade Agreement
bps	Basis points	NATO	North Atlantic Treaty Organization
BS	Balance sheet	OECD	Organization for Economic Cooperation and Development
c	Consensus	Opec	Organization of Petroleum Exporting Countries
C/A	Current account	p	Previous
CB	Central bank	P2P	Peer-to-peer
CBB	Central Bank of Bahrain	PBoC	People's Bank of China
CBK	Central Bank of Kuwait	PCE	Personal Consumption Expenditures
CBT	Central Bank of Turkey	PE	Price to earnings ratio
CDU	Christian Democratic Union, Germany	PM	Prime minister
CNY	Chinese Yuan	PMI	Purchasing managers' index
CPI	Consumer Price Index	pps	Percentage points
DJIA	Dow Jones Industrial Average Index	pw	Previous week
DJEM	Dow Jones Emerging Markets Index	QCB	Qatar Central Bank
d-o-d	Day-on-day	QAR	Qatari Riyal
DXY	US Dollar Index	QE	Quantitative easing
EC	European Commission	q-o-q	Quarter-on-quarter
ECB	European Central Bank	RE	Real estate
ECJ	European Court of Justice	RBA	Reserve Bank of Australia
EIA	US Energy Information Agency	RRR	Reserve Requirement Ratio
EM	Emerging Markets	RUB	Russian Rouble
EP	European Parliament	SWF	Sovereign Wealth Fund
EPS	Earnings per share	tn	Trillion
EU	European Union	TRY	Turkish Lira
EUR	Euro	UAE	United Arab Emirates
EZ	Eurozone	UK	United Kingdom
Fed	US Federal Reserve	US	United States
FOMC	US Federal Open Market Committee	USD	United States Dollar
FRB	US Federal Reserve Board	USD/b	USD per barrel
FX	Foreign exchange	UST	US Treasury bills/bonds
FY	Fiscal Year	VAT	Value added tax
GCC	Gulf Cooperation Council	VIX	Chicago Board Options Exchange Volatility Index
GBP	British pound	WTI	West Texas Intermediate
GDP	Gross domestic product	WTO	World Trade Organisation
IMF	International Monetary Fund	w	Week
INR	Indian Rupee	w-o-w	Week-on-week
IPO	Initial public offering	y	Year
IRR	Iranian Rial	y-o-y	Year-on-year
JPY	Japanese yen	y-t-d	Year-to-date
k	thousand	ZAR	South African Rand
KSA	Kingdom of Saudi Arabia	2y; 10y	2-year; 10-year



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