

ECB: Tightening in the Face of Adversity

Energy and Italian turmoil are the latest risks to the eurozone's recovery.

By Ryan James Boyle



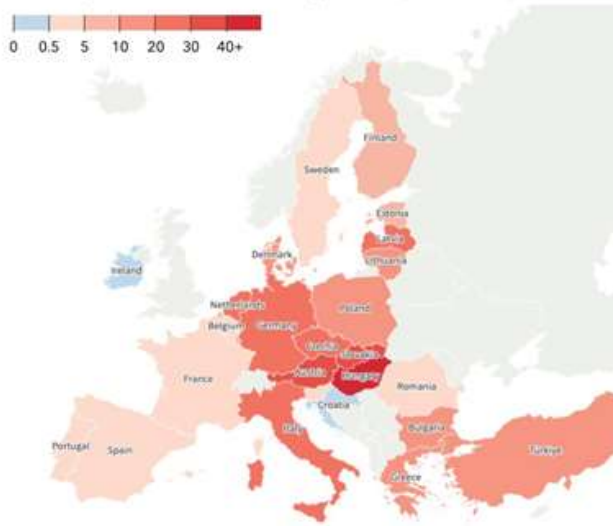
Ten years ago this week, Mario Draghi uttered **his now-famous vow** that “the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.”

What a decade ensued: for Draghi, for the European Central Bank (ECB) and for the euro area. While there have been some positive periods for all of them, each has arrived at a critical turning point. And each must be wondering whether Europe can do enough to avoid a divisive recession.

Russia's invasion of Ukraine, and the ensuing retaliatory sanctions, were a severe setback for the euro area. Just as the bloc's members were moving towards normalcy after the challenges presented by COVID-19, a war on its eastern border impaired the recovery. Russia's greatest point of economic leverage is their ample supply of natural gas. Nations in the eastern portion of Europe, including Germany, Hungary and the Czech Republic, lead the dependency on Russian energy, but even distant Italy sources over **a quarter** of its gas from Russia. In July, after planned downtime, Russia restored gas flows of only 40% of the capacity of its Nord Stream 1 pipeline to Germany, then cut that volume in half.

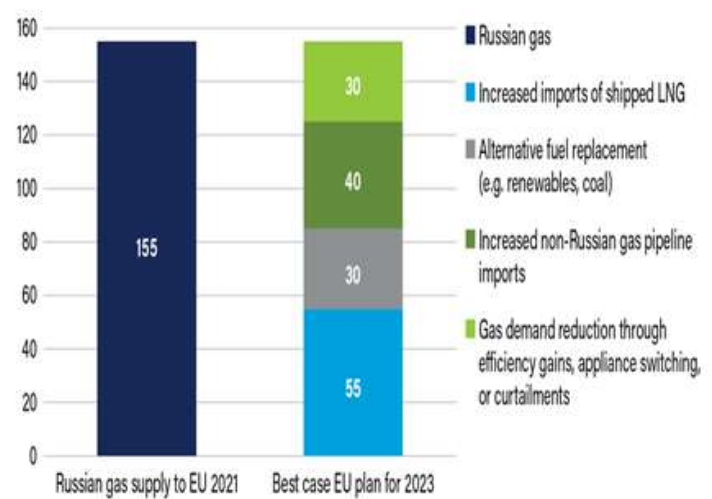
Russian gas dependence

(Russian gas as a share of total energy consumption, 2020, percent)



Potential EU plan to reduce reliance on Russian natural gas

billion cubic meters



Sources: IMF, Eurasia Group

Russia's leverage has limits. The bulk of its natural gas supply and infrastructure are near its western border. While it still has **willing trade partners** in Asia, Russia is not equipped to reroute its gas flows in that direction. And if Europeans rise to the challenge of surviving the winter with diminished Russian supply, any future threats of curtailment will pack much less of a punch. This yields little hope for denouement this year.

European nations have maintained their resolve against this threat, setting a plan to ration and prioritize gas usage. Most European nations will reduce consumption by 15% starting in August. **Building gas inventories** for winter is the most immediate task. If rationing is needed, households and electric generation will take priority, with industrial uses the first to be limited. Lower production may tip export-led economies like Germany and Italy into recession. The **International Monetary Fund estimates** German gross domestic product (GDP) may fall by 2.7% next year in the event of a full Russian cutoff. Farther western nations with little dependence on Russia will be subject to fewer constraints, but the effects of curtailment present a risk to the full continent. Lower output could start a new set of supply chain complications.

As if this uncertainty wasn't already elevated enough, the euro area's third-largest constituent has again fallen into disarray. In an unlikely turn of events following his tenure as ECB president, Mario Draghi found his way into the role of Italian prime minister in March 2021,

guiding his nation through the depths of COVID. His first year on the job earned **plaudits** for steering the economy's fast recovery and nascent reforms, especially after the nation lagged in the prior cycle. But the debates over energy rationing, and broader division over support for Russia and Ukraine, contributed to the fall of the Italian coalition and Draghi's decision to resign.

The rancor is no mere political spectacle. Italy's receipt of its next tranche of €19 billion of European Union (EU) post-pandemic recovery funds is dependent on meeting 55 economic and administrative reform targets before the end of this year. Its citizens may be accustomed to intervals without a functioning government, but this stretch may cause more economic loss than its many past episodes. Current polling suggests September's election will favor its more right-leaning parties, who will be less willing to accommodate EU-centric reforms or shared burdens of energy conservation.

Italy's government turmoil is a distraction from important regional challenges.



Though Russia casts a shadow and Italy causes commotion, the ECB still has a tough job to do. Like all other areas, the bloc faces runaway inflation. Last week, the ECB announced a 50 basis point increase to its deposit rate, ending the eurozone's era of negative rates. **Further hikes are likely**, even though indicators like purchasing managers' indices suggest the economy is slowing down. The ECB will have difficult choices as it balances inflation and growth. In addition, the ECB launched a new asset purchase vehicle, the Transmission Protection Instrument (TPI). The TPI will give the ECB wide discretion to keep its members' sovereign debt costs moving consistently. When countries' yields diverge in a "disorderly and unwarranted" manner, purchases can be directed to calm sell-offs and ensure stability. TPI will try to prevent contagious stress episodes that can particularly weigh on fiscally strained nations like Italy. Central bank mandates have regained attention in today's inflationary environment, especially discussion of the Federal Reserve's widely-cited mandate of stable prices and maximum

employment. The ECB has a different dual mandate, **chartered** to keep inflation stable and to more broadly support the EU's economic policies. The TPI effectively gives a new tool to enact the latter portion of the mandate. TPI support will only be offered to nations abiding by the economic governance recommendations of the European Commission. The TPI intends to make monetary policy more cohesive, but economic differences and **wide bond spreads across member states** will make it difficult to implement.

The ECB's asset purchases will be targeted to reduce spreads and augment policy.

Draghi's "whatever it takes" statement offered important reassurance at a moment of terrible uncertainty. Europe was in a prolonged stretch of decline and stagnation, with doubts growing about the sustainability of the common currency. His determination helped to restore confidence, and paved the way for a solid expansion in the second half of the last decade. Today, in both Italy and across the region's governments, the time has come for leaders to show similar resolve. Without effective leadership, the eurozone will have a difficult decade ahead.

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