Investment Managers

155 – 24 October 2022

Investment Institute Macroeconomics

Plumbing issues

- As the European Central Bank (ECB) will likely hike by 75 bps this week, focus is on how the central bank deals with excess reserves, with significant ramifications for fiscal policy and financial stability.
- With Boris Johnson out of the leadership race, the shift to prudent fiscal policy is irreversible in the UK in our view

We assume most of our readers ordinarily don't spend much time thinking about their house plumbing, but we also know from experience that when a plumbing issue emerges it becomes difficult to think about anything else until it is resolved. The European financial system may well be facing one of those "plumbing issues". While this week's ECB Governing Council meeting is ostensibly about delivering another hike – we expect 75 basis points, in line with consensus – they may also address their nagging excess reserves problem. As obscurely technical as it may seem, this is major, since remunerating those reserves at a growing deposit rate entails a significant cost to the central bank…and ultimately the governments' coffers, at a time when the fiscal space is narrowing.

The ramifications for liquidity are not straightforward: while "encouraging" the early unwinding of TLTROs – one of the available levers to diminish excess reserves - would set free a significant amount of bonds at a time of collateral scarcity, moving too fast on Quantitative Tightening would add to already challenging conditions on the bond market. We expect the ECB to choose prudence on the latter and postpone decisions. Yet, we continue to be concerned with the speed at which monetary policy is tightening everywhere, which mechanically raises the risk of financial stability accidents.

The UK has been a source of global stress lately. The market reaction last Friday upon news that a significant number of Members of Parliament (MPs) were ready to back a return of former Prime Minister (PM) Boris Johnson signalled a preference by investors for a fiscally prudent brand of conservatism which Johnson would have had difficulty embodying, even if he would probably have kept Jeremy Hunt as Chancellor had he won. With Johnson out of the race on Sunday night, the new fiscally prudent stance is solidified, whoever from the two remaining candidates – Rishi Sunak, now the clear favourite, or Penny Mordaunt – wins. They both supported Brexit, but we maintain the view we held last week: with a diminished capacity to steer a lone macroeconomic course, some gradual improvement in the relationship with the European Union (EU) is now the only workable option.

When variable rates hurt

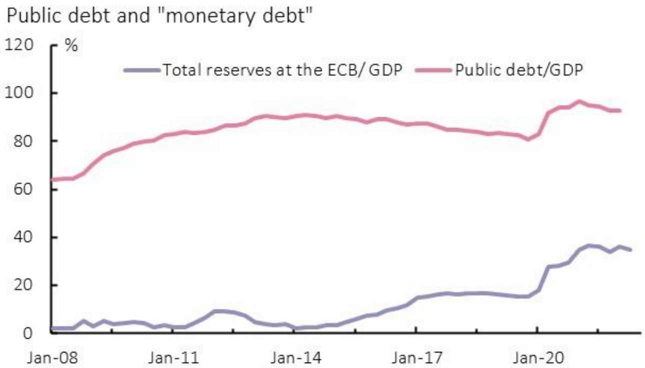
If we consider the balance sheet of the State and the Central Bank as a whole, then Quantitative Easing (QE) has the power to transform a fixed rate public debt into a floating rate debt. This capacity was very useful in the pre-inflationary phase as it magnified the space available to fiscal policy. It is becoming problematic today, as central banks tighten monetary policy.

When the central bank buys government bonds by creating money, this new liquidity returns to the liabilities of the central bank as excess reserves remunerated at the deposit rate. If this rate is negative - as was the case until very recently for the ECB - then the income of the central bank, and therefore the dividend it pays to the State, increases, while the State pays to itself the interest on the bonds held by the central bank. **The public authorities - once again taken here as a whole - decide themselves on an increasing part of their cost of financing.**

In terms of strict monetary policy, this approach is perfectly understandable when deflationary risks abound. Taken individually, each commercial bank will normally seek to minimize the cost of its excess reserves by redirecting as much as possible of its assets towards more profitable investments, e.g., loans to the private sector (especially if there are specific incentives, in particular via the conditionality of Targeted Long Term Refinancing Operations – TLTROs) or towards long-term government bonds, thus reducing the cost of financing the entire economy. But this is magic so powerful that it helps understand the importance of the independence of monetary policy. Indeed, this gives the central bank the possibility to insulate the government's funding costs from market pressure.

What happens when inflation comes back? The central bank pushes the deposit rate into positive territory. The increase in their remuneration applies to the entire stock of excess reserves - nearly 5,000 billion euros at the ECB today - with an *immediate* cost for the central bank and therefore the revenue of the State. This contrasts with the usual mechanics through which a monetary tightening affects government debt dynamics. Under normal circumstances – but we haven't had those for a very long time - the increase in market interest rates reacting to the central bank signals only applies to the government refinancing flows, with therefore a very *gradual* impact on public resources**. Switching to variable rates therefore becomes more penalizing when interest rates rise.** This is true for households and corporates, and it also holds for governments. This may sound mind-numbingly technical and obscure – the sort of often harmless wizardry often performed in monetary economics – but it really matters. To get a sense of the magnitude of the problem in the Euro area we have plotted in Exhibit 1 excess reserves held by commercial banks at the central bank and public debt in the traditional sense of the word both expressed as a percentage of GDP.

Exhibit 1 – Monetary funding is a reality

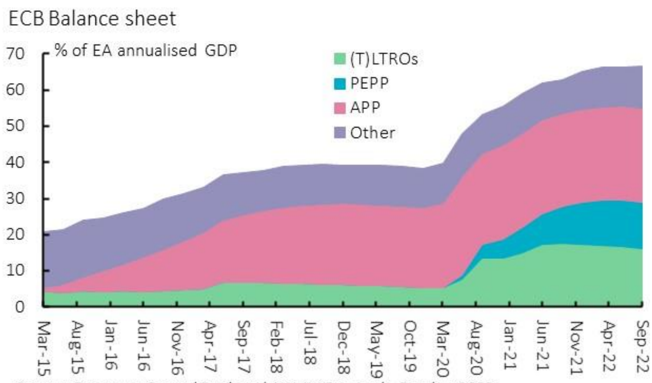


Source: European Central Bank, Eurostat and AXA IM Research, October 2022

We simulate what would be the impact of moving the deposit rate to 3% - which is the current market expectation for the peak in 2023 – on the entirety of the excess reserves held by commercial banks onto their account at the ECB (or to be more precise at the Eurosytem, since they are held by the national central banks) compared with shifting the whole yield curve by 3.0%. The latter shock would take 8 years to be fully passed to the government's net interest payments (the average time it takes to roll the existing stock of debt), which would result in an incremental deterioration in the fiscal balance of 0.35% of GDP the first year. **The shock through excess reserves would depress the fiscal balance by 1% of GDP in one shot.** No small change at a crucial moment, when governments will probably start to steer their public debt trajectory towards calmer seas.

We remember writing when the ECB launched its last salvo of TLTROs that the ECB was sending a very strong message since it had designed an instrument which would automatically trigger a financial loss for the central bank. Indeed, the borrowing cost of these last operations would be calculated as the *average* deposit rate over the lifetime of the operation. This meant that in a tightening phase, the cost commercial banks would face on their TLTRO borrowing would *always* be lower than the interest they would earn on merely parking their excess liquidity – in part created by those TLTROs, true, some of the excess liquidity will start disappearing spontaneously thanks to the unwinding of the TLTROs. Still, as Exhibit 2 illustrates, TLTROs borrowing account for only about a quarter of the ECB's assets. Besides, if nothing is done, the cost could still be in the vicinity of 0.8% of GDP in 2023.

Exhibit 2 – TLTRO unwinding won't do "all the trick"



Source: European Central Bank and AXA IM Research, October 2022

True**, in principle, the ECB could just ignore the cost of persistent excess reserves**. Theoretically, there is nothing which prevents a central bank from operating with a deteriorated capital position or even in negative equity, since it makes good on its liabilities in a currency which it can always create. In the real world however, there at least three issues a central bank needs to consider. First, financial losses – even "paper ones" – could alter the public's confidence in the institution. Second, an independent central bank is always reluctant to go "cap in hand" asking for a recapitalisation from its shareholders (the national governments). Third, **paying billions of euros to banks for holding the safest possible form of liquidity may trigger criticisms from the public as the manifestation of undue support** to the banking industry at a time when the rise in interest rates should in any case lift its margins.

There are two main – not mutually exclusive – mechanisms for the central bank to manage the problem. It can act on the quantity of excess reserves by "mopping up" QE – first by ceasing to reinvest bonds that are about to expire and then more aggressively by selling those it holds on the market (Quantitative Tightening). Or it can modify the conditions for remunerating reserves, for example by lowering the deposit rate to zero above a certain holding threshold. The latter, codenamed "reverse tiering" would be the symmetric approach to the one taken to alleviate the cost on banks of the negative deposit rate.

This latter is even more attractive in the case of the ECB since it must manage the "comet's tail" of TLTROs. **With the disappearance or attenuation of the "carry", the banks would seek to unwind the TLTROs as quickly as possible – they can be paid back ahead of term - thus accelerating the reduction of the ECB's balance sheet**. Incentivizing early TLTRO repayments by reducing the carry on the banks' asset side (i.e., by cutting the interest they can earn on their excess reserves) is much less damaging to the ECB from a legal or credibility points of view than retroactively changing the terms of the TLTROs themselves to "flush out" the liquidity. As the sell-side literature is burgeoning on these matters, we were intrigued by a solution put forward by several houses: calibrating the threshold beyond which reserves would no longer earn interest according to each bank's current TLTROs take-up.

The acceleration of the Quantitative Tightening (QT) could result in an excessive tightening of financial conditions – its impact is much more difficult for the central bank to calibrate than a "classic" hike in the key policy rate. Given the current uncertainty in financial markets, it's likely that the ECB would choose to proceed by careful steps, first with gradually diminishing the size of the reinvestments and then at long last selling the remaining principal. Anyway, on the Pandemic Emergency Purchase Programme (PEPP) fraction of QE, the central bank has already committed to wait until the end of 2024 at least.

Note that from the point of view of the macroeconomic impact, the reduction in the remuneration of excess reserves may go in the opposite direction than QT, since it would push banks to redirect their allocation towards risky assets. There as well, it's likely that the ECB would want to tread carefully and position the threshold beyond which excess reserves are no longer remunerated quite far.

Note that, technically, at least one other option exists. The ECB could "mop up" excess cash by issuing its own securities – ECB bills. This would be in essence the same thing as bank notes (the most intuitive form of central bank liability) but such introduction would require careful planning, in particular to gauge the competitive impact it could have over the bond market. We don't think this could be feasible as a response to the current, urgent problem.

The ECB choices will also have some consequences on liquidity scarcity, a theme which has been more in focus lately. Janet Yellen has deplored a lack of liquidity in the United States (US) treasury market at the International Monetary Fund (IMF) annual meetings two weeks ago. Last week, the German debt management agency announced that it had purchases some of its own debt (to be more precise they issued to themselves EUR54bn worth of debt) to lend the bonds through the repo market, to help deal with collateral scarcity. QT and the unwinding of TLTROs will have the effect of raising the quantum of bonds available in the market…but of course with a commensurate reduction in cash. **Reducing liquidity in the plentiful money market to improve it on the bond market may make sense as tension is acute in the former, but the continuation of the monetary policy tightening will both reduce the level of liquidity in the *overall* system and push towards higher market rates.** Irrespective of the technical decisions, the central bank can make to alleviate the pain, those two trends – lower overall liquidity and higher rates – are conducive to more financial stability risks. There is no "free lunch" there.

So, what will the ECB do and say next week?

Our call for a 75bps rate hike is uncontentious for this Thursday, and well- priced in the market. Hawkish messages have been accumulating over the last few weeks, pushing market pricing over 3% by the spring of 2023. In September, the "forward guidance" – it reappeared almost as quickly as it had disappeared, just not the same one – was clear: *"over the next several meetings the Governing Council expects to raise interest rates further to dampen demand and guard against the risk of a persistent upward shift in inflation expectations"*. There may be a discussion on keeping exactly the same wording. Indeed, keeping the plural at the October meeting signals that the tightening would continue into 2023. Christine Lagarde in September indicated that "several" probably meant "more than two, including this one, and less than five" – i.e., that a pause after December was possible. If the depo rate hits 1.5% this week, followed by a 50bps move in December, then the upper end of what Banque de France Governor had indicated as the "neutral range" would be hit at the end of 2022, which in his view should call for a bit more prudence in the quantum/pace of tightening. In our view, the hawks' sway on the Governing Council is likely to be strong enough to carry the day and keep the formulation unchanged this week – arguing it's flexible enough (taking it literally it does not exclude "skipping" a meeting, or delivering only 25bps in December), but we expect lots of questions from journalists on this. The ECB has put itself in a bit of a delicate position by arguing it is taking decisions "meeting by meeting" while in practice giving strong indications on the next steps.

In general, **in the face of upward surprises on inflation and hawkish signals from the central bank we recognize that our own call – that indeed the ECB would be "stopped out" at 2% - is at risk**. The direction of travel at this stage is that the ECB will go further relatively quickly. 3%, the market pricing, still looks quite high in our view given the tightening in overall financial conditions in the Euro area – we highlighted last week that the "refinancing gap" for corporates is the widest since the Great Financial Crisis of 2008-2009 – but going to 2.5% looks increasingly likely. It seems that two forces – on top of a decidedly uncooperative dataflow – are fuelling the ECB's hawkishness. First, fiscal policy. The decision by Berlin to unleash another significant stimulus to shield its economy against the persistently high cost of energy – while it may dampen inflation in the next few months – can convince the central bank that it needs to do more on its side to "dampen demand". Second, we think the Federal Reserve (Fed)'s "gravitational pull" continues to exert a significant influence over the ECB, given the risk of allowing another depreciation of the euro, now that Janet Yellen has made it clear at the IMF annual meetings that the US was not in the mood of trying to curb the dollar. We can see the market expecting a narrowing of the gap between US and Euro area policy rates, from more than 200bps in July to c.150bps today (see Exhibit 3).

Exhibit 3 – Expected transatlantic policy gap narrowing

Source: Bloomberg and AXA IM Research, October 2022

So, in a nutshell, for this week we expect the ECB to maintain a language consistent with further hikes upon delivering 75bps this time, but without providing clarity on the quantum of the next moves. We expect the ECB to introduce "reverse tiering" – possibly calibrated according to the banks' TLTRO take-up - to speed up the reduction in excess reserves. The ECB could choose to wait until December to go deeper into the technical aspects of dealing with excess reserves but coming up with hard decisions now could convince banks to make fuller of the next early repayment window. However, we think a majority of the Governing Council will choose to postpone further any discussion of Quantitative Tightening. We think the principle of action there may be announced in December, or early in 2023, but with delayed implementation – towards the spring. With financial stability rising, we don't think the central bank will want to "rock the boat" here.

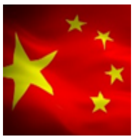
Another leader's race …or not!

The market reaction on Friday – the 2-year yield rose by more than 40bps from the Thursday trough - upon news that a significant number of MPs were ready to back a return of Boris Johnson signalled a clear preference by investors for a fiscally prudent brand of conservatism which the former Prime Minister would have had trouble embodying. He clashed at numerous occasions with his Chancellor of the Exchequer and rival Rishi Sunak on the fiscal stance. When he voiced criticism at some of Liz Truss' plans, it was not about the substance of her tax agenda. True, he probably would have kept Jeremy Hunt as Chancellor had he won, to avoid immediate market pressure. However, volatility would have been harder to curb as investors may have i) anticipated tension with Hunt in the run-up to the elections in 2024, with the PM seeking some fiscal loosening in the last budget of the current parliament, and ii) maintained some risk premium in the UK given the potential for further political instability. Indeed, a return of Boris Johnson to 10 Downing Street would have coincided with hearings on whether he misled parliament over "Partygate" – with the possibility to see Boris Johnson suspended from the Commons.

The former PM ruled himself out, despite claiming he had enough MPs support to qualify for the membership vote. We think his decision not to run in the end was triggered was the news of some of his key former supporters shifting their allegiance. A crucial development in our view was Steve Baker's very public support of Rishi Sunak. Steve Baker leads the European Research Group (ERG), the "extreme Brexiter" faction in the Tory party, which had been key in supporting Liz Truss against Rishi Sunak in the previous leadership race. **This would indicate that even some of the most ideologically motivated MPs in the ruling party are ready to back a more centrist line**, possibly to preserve the party's chances in the general elections in two years.

Two candidates remain in the race as we write, Rishi Sunak and Penny Mordaunt. To be nominated they need the support of 100 MPs (closing time at 2 pm on Monday). According to unofficial counts, Sunak is close to 150, with Mordaunt very far from the threshold. It's possible that some of the MPs who were supporting Johnson will shift to Mordaunt, getting her above the line. Assuming the two candidates get 100 MPs' support, the parliamentary group will vote again. The candidate arriving in second place will be given the opportunity to withdraw. Otherwise, the leadership will be decided by Friday by an electronic vote of the Tory party membership.

It may well be that Sunak could become PM without a membership vote, assuming he is the only one making it to the 100 threshold or if Mordaunt withdraws. If this goes to the membership vote, Mordaunt has a chance, given her popularity with the rank and file. Her economic views are not well known, but she has been increasingly positioning as a "One Nation Tory", a brand which is usually allergic to fiscal adventures. In any case, we stick by the point we made last week. The crash of the Truss/Kwarteng experiment has disqualified unfunded fiscal activism for long in the UK. Even if both Sunak and Mordaunt supported Brexit, they are realists and probably understand it is time to reduce as much as possible friction with the EU. With the likes of the ERG still in the frame – and their support for Sunak may reflect a willingness to influence the likely winner - we would discard any possibility of spectacular, quick moves on this still hot and divisive topic, but gradually, we are confident we should see a more constructive approach to the UK/EU relationship.

Country/ Region	What we focused on last week	What we will focus on in next weeks
	• Empire and Philly surveys (Oct) more -ve than expted • NAHB survey (Oct(, housing starts and existing home sales (Sep) all fell more sharply than previous months • Jobless claims fall back after 2 weeks of increase • President Biden gave 15mn barrels of oil release from Strategic Petroleum Reserve, meeting 180mn promise	• Fed Reserve in purdah – we expect 0.75% hike in Nov. • US GDP (Q3) expect 2.4% (saar), firmer outurn than previously expected driven by trade. • PCE inflation (Sep), core and headline expected higher • Employment cost index (Q3) expected softer than Q2's 1.3% • New home sales (Sep) expected to reverse Aug's 29% rise
	• Oct Ge ZEW indices less pessimistic than expected but still very deteriorated • EMU final Oct HICP reached 9.9% (-0.1pt); pass-through from higher energy prices are still on going, Svcs prices are less under pressure (-0.1%mom). To be confirmed in Oct though • Ge Sep PPI fall is modest (2.3%mom/45.8%yoy)	• Several indices for consumers (confidence) and businesses (PMIs, Ifo, EC) to be released with most likely same conclusion: a deterioration in economic environment and or a stabilization at very low levels. Flash PMIs would be interesting to assess further contagion to services sector • Prelim GDP (qoq): Ge (-0.4%); Fr (0.2%); Sp (0.8%) • EMU-4 Oct HICP to be released
	• Liz Truss resigns as PM after just 45 days in office • CPI inflation (Sep) rises to 10.1% with broad based strength in prices • Retail sales (Sep) fell sharply in September by 1.4%mom leaving spending down 3.3% on the quarter • Public sector net borrowing came in £3bn higher than expected at £20bn	• Voting rounds in Tory party leadership race with New PM expected to be announced by 28 Oct. Sunak, Mordaunt and Johnson seen as frontrunners. • UK flash PMIs (Oct) expected to decline on weaker output • Nationwide House Prices (Oct) • CBI Industrial survey (Oct)
	• Yen falls breaks ¥150 per dollar level that prompted intervention last month • Trade balance (Sep) narrowed from all-time lows on higher exports and lower oil prices • CPI (Sep) headline expected to rise to 3% • Whether MoF intervenes in currency markets as Yen weakens	• BoJ Oct meeting we expect all policy tools to remain unchanged and updated quarterly economic outlook • Further FX intervention from the MoF as currency markets as Yen weakens • Tokyo CPI (Oct) • Labour market data (Sep)
	• President Xi reiterates the critical importance of 'Economic Development' in China's continued advancement at the 20th Party Congress • Discussions on 'security' also elevated, covering food, energy, tech, supply chain and national security • Xi lauds the Zero COVID policy as a success, suggesting little chance of an imminent policy pivot	• New leadership line-up will be revealed at the first Plenum of the 20th Party Congress • Q3 GDP and September activity data may be released after its scheduled publication was delayed • Market will watch for signs of further COVID policy recalibration as case numbers fall and the Congress draws to a close
	• CB: Indonesia hiked +50bps to 4.75%. Turkey cut 150bps to 10.5% • Korea first 20-day exports (Oct) shows weakening • Sep inflation (yoy) edged down in S. Africa to 7.5% • The monthly economic activity index (Aug) accelerated (yoy) in Brazil, Colombia & Peru • Q3 GDP (qoq) picked up to 1.5% in Singapore	• CB: Colombia is expected to hike +25bps to 4.5% while Turkey should cut again by 100bps to 11.0%. Brazil (13.75%), Hungary (13.0%) & Russia (7.5%) to stay on hold • Q3 GDP figures in Korea & Taiwan • Annual inflation (Sep) should accelerate in Singapore • Unemployment (Sep) data in Mexico, Peru & Singapore • Industrial prod (Sep) numbers in Russia, Singapore & Taiwan

Upcoming events		
	US:	Mon: Manf & services 'flash' PMI (Oct); Tue: C-S and FHFA HPI (Aug), Conference Board consumer conf. (Oct); Wed: Goods trade bal. (Sep), New home sales (Sep); Thu: GDP (Q3), Core PCE prel. (Q3), Weekly jobless claims (22 Oct), Durable goods orders (Sep); Fri: Core PCE (Sep), Personal income/spending (Sep), Employment cost indx (Q3), Final sales (Q3), Michigan cons. sentiment & inflation expectations (Oct), Pending home sales (Sep)
	Euro area:	Mon: EU19 Composite, manf & services 'flash' PMI (Oct), Ge & Fr manf & services 'flash' PMI (Oct); Tue: IfO business climate indx (Oct); Wed: EU19 M3 (Sep), Fr Insee consumer conf. (Oct); Thu: ECB announcement, ISTAT business & consumer conf. (Oct); Fri: EH19 Business conf. (Oct), EU4 HICP (Oct), Ge GDP (Q3) & CPI (Oct), Fr GDP (Q3) & Cons. spending (Sep), Sp GDP (Q3)
	UK:	Mon: Composite, manf & services 'flash' PMI (Oct); Tue: BoE Huw Pill speaks, CBI Ind. Trends survey (Oct&Q4) Thu: CBI Distributive Trades survey (Oct)
	Japan:	Mon: Manf 'flash' PMI (Oct); Fri: BoJ announcement
	China:	Thu: Ind. profits (Sep)

About AXA Investment Managers

At end of December 2021, AXA IM employs over 2,460 employees around the world, operates out of 23 offices across 18 countries and is part of the AXA Group, a worldwide leader in insurance and asset management.

Visit our website: http://www.axa-im.com
Follow us on Twitter: @AXAIM & @AXAIM_UK
Follow us on LinkedIn: https://www.linkedin.com/company/axa-investment-managers
Visit our media centre: www.axa-im.com/en/media-centre