Investment Managers

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Investment Institute Macroeconomics

Leaky Pipes

- “Non-decisive” dataflow shifts the emphasis to the duration of restrictive monetary conditions: a “plateau” rather than a “peak.” It can still be painful though as the long end of the curve is adjusting.
- The Euro area’s complex “pipeworks” – the ESM and the ECB’s balance sheet – are calling for attention again.

The absence of any smoking gun in the recent dataflow in the US, either pointing at “runaway inflation” or conversely at a hard landing of the real economy, is supporting the new emphasis put on the length of time monetary policy conditions will be kept restrictive, rather than on how much further the tightening needs to go. A plateau rather than a peak, to borrow words from Francois Villeroy de Galhau. Being patient and gently but surely taming inflation by maintaining restrictive conditions for longer than initially expected but without going into stratospheric territory can help mitigate financial stability risks. While such an approach may be optimal from a macro point of view, it can still be painful marketwise, as even the long end of the curve is adjusting to the idea of central banks keeping rates significantly above equilibrium possibly over several years.

Tough monetary conditions for long will test the Euro area’s institutional set-up. The monetary union (EMU) operates as a very complex and evolving set of “pipe-works”. 10 years ago, the sovereign crisis triggered much institutional creativity, and the European Stability Mechanism (ESM) was a key source of progress. The current dispute around its reform, revived by Italy, is a reminder that EMU is still in a state of flux. We explore here what the decision by Rome to postpone the ratification of ESM 2.0 reveals about the dividing lines across the union.

Still, the Eurosystem – the ECB combined with the national central banks – is EMU’s most important pipework. The massive growth of its balance sheet is what kept it together. Yet, the legacy of QE – massive deposits at the Eurosystem now paid a substantial rate - is also taking the form of significant income loss for the central bank, and ultimately governments. With the bulk of the contraction brought by the early repayment of the TLTRO now executed, we explore other avenues to shrink the balance sheet. The most obvious option – bringing forward the end of the reinvestment of PEPP – would come with some financial stability risks.

A plateau rather than a peak

The Federal Reserve (Fed)'s current communication is based on a mix of implicit forward guidance – the dot plot telling us that we should expect two more rate hikes this year – and data dependence. That the Fed will strike again at the end of this month has been a given for some time in our view – and that is fully priced by the market – but what the central bank will do in September is much more open in forward pricing, which makes every data release important. Unfortunately, the much-awaited payroll batch released last Friday does necessarily provide much information in this respect.

It was a mixed affair. Job creation came out lower than expected in June, and downward revisions to the recent past have changed the picture slightly. On a 3-month annualized basis, **employment growth in the private sector has finally moved (marginally) below the pre-pandemic trend (Exhibit 1). Wage dynamics remain however too strong.** Earning per hour have been standing on a plateau around 4.5%yoy since the beginning of the year, still too high to be consistent with a swift return to 2% inflation, especially against the background of flat to negative productivity change. Earning per week had been decelerating more convincingly, as working time was declining, reflecting some underlying softness in the US labour market, but there was a small rebound in June (Exhibit 2).

Exhibit 1 – Slightly below the pre-pandemic trend - finally

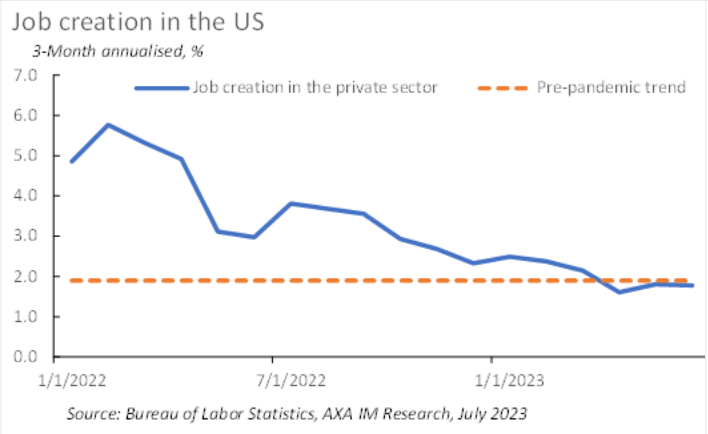
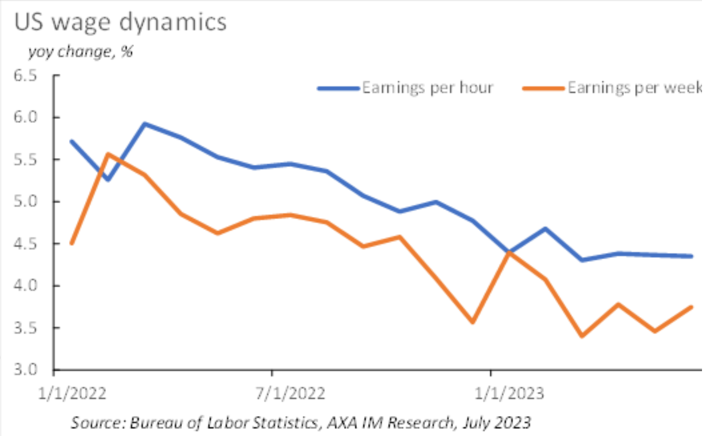


Exhibit 2 – But wage growth is still too high



How could this affect the Fed's decision-making and communication? In a nutshell, we **think this supports the recent shift in emphasis from the *level* of "peak policy rates" to the *time* the central bank will keep them in restrictive territory**. Indeed, as long as there was no tangible sign the economy was responding to the central bank tightening, it made sense to continue moving rates up at a brisk pace and consider a very high terminal rate. But it is increasingly difficult to argue that policy transmission is being impaired. The labour market landing may be too slow, but it is landing, and consumption is also decelerating – we discussed this at some length last week. Credit origination is also slowing down. So, conditions are already restrictive, and they are being reflected in the dataflow, albeit without enough alteration of the wage and price dynamics so far. **The central bank must now balance the advantages of pushing rates much higher against the risk of triggering nasty financial stability effects**. The impact of high rates on default probabilities and the general health of the financial system is more and more plainly discussed by the central banks, quite eloquently so in the latest Bank of International Settlements annual report. Financial stability disruptions usually occur in reaction to the *speed* of the change in interest rates because borrowers need to deal with steep increases in refinancing costs which they had not time to prepare for, among other reasons.

Being patient and gently but surely taming inflation by maintaining restrictive conditions for longer than initially expected but without going into stratospheric territory can help mitigate those financial stability risks. The cost to economic growth would remain substantial, but possibly better distributed over time: rather than going through a brutal decline followed by an equally sharp recovery, GDP would wallow for long in "shallow recession". The cumulated

GDP loss over two years may not be too different across the two trajectories, but the benefit to *trend* growth would lie in the mitigation of the risk of falling into the kind of deep economic contractions with lasting adverse effects on labour and capital supply which usually come with financial crises.

This "higher, but not too high, for much longer" approach may be optimal from a macro point of view, but it can still be painful for the markets. Since the beginning of June, the US 2-year yield has risen by 61 basis points (bps) to hit nearly 5% last week, as investors are pushing back the timing of the first rate cut by the Fed. But this is increasingly getting transmitted to the longer end of the curve. The US 10-year rate exceeded 4% at the end of last week, rising by 45bps since early June. Inflation expectations have barely moved (the 10-year break-even inflation rate rose by only 11bps), real rates are thus providing by far the biggest contribution. This probably reflects the re-assessment of the Fed's readiness to maintain a tough policy stance for long.

As painful as it is for investors, all this helps the Fed – and all central banks engaged in taming inflation, as the US bond market continues to exert a massive influence globally – since financial conditions at large get more restrictive and contribute to dampening aggregate demand without the need of delivering too many additional hikes in policy rates. This keeps live our hope that the Fed will not have to hike beyond July. This also means that a pause after July – still unlikely given the general tone from the Governing Council – is not completely out of question for the European Central Bank (ECB). We note that in his speech at the Rencontres Economiques in Aix, Banque de France Governor Francois Villeroy de Galhau signalled that the terminal rate may not be too far, but rather than hitting a peak, it should be best described as reaching a plateau.

Can the Italian government fully shake its economically populist DNA?

The downward revision in the first estimate of the June Purchasing Managers Index (PMI) – with the composite indicator now in contraction territory at 49.9 – is another reminder that aggregate demand is already being tamed in Europe as well. It is probably unsurprising in this context that **some government voices are now being heard against the ECB stance, with Giorgia Meloni explicitly criticizing the rate hikes last week**. Her jibes are not limited to the central bank. She is taking a tougher tone when addressing the overall economic framework of the Euro area.

It was not obvious however that Rome would be among the first to break the truce. Indeed, the honeymoon between the market and Italy continues, despite the persistent hawkish messages from the European Central Bank. The Bund/BTP spread has easily digested the rate hikes and – maybe more importantly – the end of the Asset Purchase Programme (APP) reinvestments. The resilience of the Italian economy helps, and focus is more on Germany's current struggle, and although Italian inflation continues to exceed the Euro area average, unlike in Spain, there is no visible gap with the performance of some of the core countries. But more fundamentally, we think the main contributor is the pragmatic approach to economic policy which Rome has been espousing since the current coalition has come to power. Indeed, it would be difficult to spot glaring differences between Draghinomics and Melonomics. Yet – and even if the market has not seized on this issue – the first real signs of tension between Rome and Brussels (and Frankfurt) are emerging. There is no reason to be overly alarmed at this stage – **the spat is more about principles than actual policy divergence**, but this warrants some attention.

The reform of the European Stability Mechanism (ESM) is the most obvious bone of contention. After an initial spat in 2019, the Italian government in 2021 under the previous administration signed amendments to the ESM treaty of 2012, but this still needed to be endorsed by parliament. The Treasury – under the control of Lega's Finance Minister Giorgetti – published a note arguing that the ESM reform could ultimately benefit Italy. Yet, his position is clearly not consensual within the coalition, and the lower house of parliament has decided last week to postpone the ratification until November of this year (Italy is the only member state missing). To understand what is at stake, we need to follow the genealogy of the controversy.

Created in the heat of the sovereign crisis 10 years ago, the ESM has been the clearest embodiment of financial solidarity across Euro area countries, lending (under strict conditionality) to countries which had been cut from the market, or would have faced trouble funding a much needed bank recapitalisation (e.g. Spain) and its institutional status lends it a sense of permanence which the powerful, but time-limited "Next Generation" programme doesn't convey. To make the monetary union more "crisis-proof," it makes a lot of sense to allow the ESM to operate outside the pure sovereign support realm and act as a financial backstop to the European bank resolution framework. Such "plugging" has been agreed in principle in 2019 and set at a maximum of EUR68bn in the 2021 agreement.

There was another aspect to the reform of the ESM: the introduction of "single limb" Collective Action Clauses (CACs) in all new public debt issued by the members to reduce the capacity of investors to hold out in case of restructuring. To understand how it works, the best is to borrow the ESM's own wording: *CACs "help make sovereign debt restructuring more orderly and predictable. A sovereign state's bonds are typically divided into a number of different issuances, or "series" (with different maturities, interest amounts, etc.). Single-limb CACs allow the majority vote to take place at the level of all these "series" combined, without the need for a majority at the level of the holders of each individual "series"*'". Finally, the amended ESM would add another weapon to its arsenal: it would make it easier for member states to apply for "precautionary credit lines", (PCCLs) which comes with lighter conditionality and would strike at an earlier stage of market pressure. The market should weigh in the possibility of an aggressive "short peripheral" speculative movement being counteracted by this nimbler form of ESM intervention, and this should reduce the risk premium on heavily indebted sovereigns.

There are three main reasons explaining Rome's misgivings. One is the historical distrust for the ESM in large segments of the current ruling coalition. Italy managed to avoid having to trigger ESM support 10 years ago – to the relief of many European policymakers since a loan commensurate with significantly supporting Italy would have strained the ESM capacity – and the massive social and political cost that other countries under programme had to endure. For sovereignists, there is nothing palatable in seeing a national economic policy dictated – and assessed – by external institutions. The second is the idea that anything which could raise the probability of a restructuring – such as the introduction of single-limb CACs – would disproportionately affect the risk premium of the most indebted member states, among which Italy ranks high. A third one is that blocking the advent of ESM 2.0 might give Rome some leverage in another, possibly more fundamental battle: the reform of the Stability and Growth Pact. **Giorgia Meloni has publicly criticized the latest proposals from the European Commission to change the fiscal surveillance system for creating a too big burden on high debt countries**, *en passant* colliding with the even more hawkish ideas tabled by German Finance Minister Christian Lindner, as well as demanding some changes to the reforms negotiated with Brussels in exchange for the Next Generation funds.

In our view, **this reflects more rhetorical, or ideological opposition to the "Brussels consensus" than the product of Italy's actual economic limitations**. We covered last month the Stability Programmes produced by the 8 largest economies in the Euro area and the Italian one came out, in our opinion, as quite realistic. Unlike most other countries which continue to posit nominal GDP growth exceeding long-term interest rates over the whole horizon of the programme, Italy assumes the opposite from 2024 onwards, which we think is a very reasonable take on market forces, but of course makes it harder to generate a "spontaneous", or painless reduction in the public debt ratio. Despite this impediment, the Italian P-stab is consistent with the European Commission's two main rules in its new proposal for highly indebted countries: delivering a discretionary fiscal consolidation effort of at least 0.5% of GDP per year and getting the debt ratio at the end of the programme lower than at the beginning. Given Italy's good historical record in delivering fiscal consolidation in the past, this should be well within its capacity, and the adverse impact on the real economy of such efforts would be in any case blunted by the ongoing disbursements of the Next Generation EU funds until 2026.

So far, Meloni's coalition has focused more on social/cultural issues, allowing economic issues to play second fiddle. Fratelli d'Italia thrived in the local elections and in the national opinion polls and pursuing such strategy has probably helped. Yet, **the opposition to the ESM reform and the very blunt approach to the negotiations around the fiscal surveillance framework could be interpreted as a sign that the coalition cannot completely escape its populist DNA in economic affairs and its distrust for many European projects**. For instance, in some quarters of the current coalition, even the light PCCLs are regarded with a lot of suspicion as they see them as designed by core countries to protect other peripherals against the contagion of a restructuring they would "force upon Italy." Populists are not always opposed to the idea of debt restructuring, but in Italy this hits a nerve since more than two third of public debt is held domestically, with a large chunk in banks while households directly own a sizeable share. Italian political circles are acutely aware that the first victims of any restructuring would be citizens and the local financial system.

The ESM's amended charter is however quite clear though that restructuring should not be the first port of call. True, Giampaolo Galli, an economist who criticised it in a constructive manner in 2019, made the – right in our view – point that it should *also* take on board explicitly a proper weighing of the pros and cons of a restructuring in terms of financial stability – rather than a pure, one-way analysis of debt sustainability. Yet, it is very difficult to paint the ESM as a "restructuring machine" and even with the protection of PCCLs**, it's highly unlikely that any European government would take the risk of plunging any peer into a restructuring given the difficulty of assessing contagion risks ex ante.**

The strategy of the Italian government of using the ESM ratification as a tool to dilute further the fiscal surveillance system is limited in our view by the fact that it does not easily fit with the other member states' interests. Indeed, the other peripherals – which have already ratified it – would be the biggest beneficiaries of ESM 2.0, since it would create a bigger backstop to deal with banking crises which their national finances could not easily address and would give them the additional benefit of the PCCL. Some of them may agree politically with Italy's misgivings on the fiscal surveillance system, but their public finances are sufficiently in order not to make this a central concern (Portugal for instance). On the other side of the core/peripheral divide, Germany does not need ESM 2.0, nor any kind of ESM support, so could live happily with the old version if Italy insists on not ratifying the new one. **We thus fail to see how Rome could easily build a wide enough coalition against the fiscal surveillance system by taking ESM two hostage.**

Ultimately, we are concerned that the ESM 2.0 framework could indeed be pushed into the long grass beyond the end of this year. This would be unlikely to trigger much move in the market in the present circumstances, but this would prolong some of the in-built deficiencies of the monetary union. Besides, as much as we do not believe Italy can easily build a coalition against the ESM reform, we can see the beginning of a generic "North/South" divide re-emerging on many aspects of the Euro area policy framework. France has also voiced its concerns over the fiscal surveillance reform, and Bruno le Maire stated in Aix last Saturday his interest for an upward revision in the ECB's inflation target, which is unlikely to be welcome in Frankfurt. It is probably only natural that these debates creep up when "the going is getting tough", but all these disputes could leave some "bad blood" across member states. This would be unfortunate now that it is getting increasingly clear the ECB is impatient to roll back its own balance sheet, which could gradually leave some fragile signatures exposed.

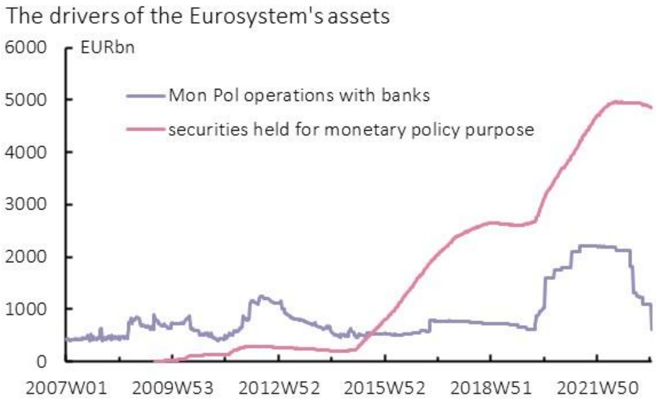
We need to talk about the ECB balance sheet

We suspect the last thing our readers want to focus on now that summer is starting in earnest is the central bank's inner plumbing. There is however an issue which may incentivize the ECB to accelerate the normalisation of its balance sheet: it is losing money, and fast.

The rise in the ECB's balance sheet is the product of massive lending to the banking sector, in particular via Targeted Longer-Term Refinancing Operations (TLTROs), and – predominantly – the purchases of securities through the various Quantitative Easing (QE) programmes (Exhibit 2). The corollary on the liability side is the accumulation of a huge pile of bank deposits on the ECB books. When the Deposit Facility Rate (DFR) was negative, this was painful for banks – although this was partly alleviated by making the TLTROs very generous and then "tiering" the quantum of excess reserves subject to the negative DFR. Symmetrically, now that the DFR is very positive and rising, it's affecting the

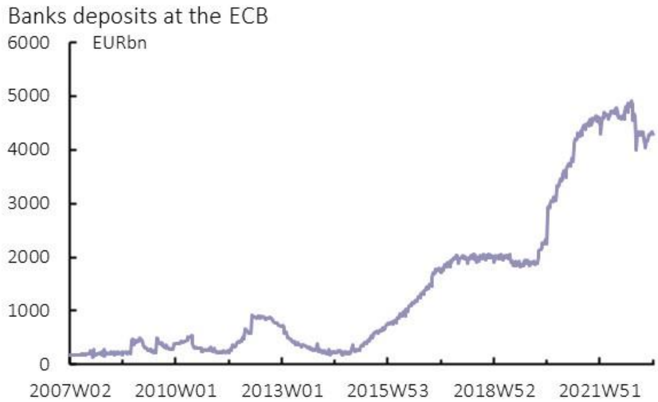
Eurosystem income. **Paying 3.5% on nearly EUR4tn of bank deposits comes at a cost of EUR140bn annually, i.e., 1% of the Euro area GDP, unmatched by the revenues on the asset side**, since the bonds bought under QE mostly came with a low, or even negative yield (Exhibit 4). Such an Asset and Liability Management (ALM) mismatch is in principle unproblematic for the central bank – at worst they could operate in negative equity – but this still results in a lower dividend paid to governments which are already struggling to put back their finances in order. Pushing the reasoning a bit further, we can follow the approach chosen by Arnaud Mares, Chief European Economist at Citi, in one of his recent papers. If one takes the balance sheet of central bank and the government together, what QE has done is that it has turned a good chunk of the government's fixed rate debt into floating rate liabilities. This is coming back to bite now. Central banks are always concerned with the risk of seeing their independence from governments eroded. Becoming a "cost centre" would not help in this respect.

Exhibit 3 – QE legacy in the Eurosystem assets



Source: ECB and AXA IM Research, July 2023

Exhibit 4 – Massive rise in increasingly costly deposits



Source: ECB and AXA IM Research, July 2023

What to do then? **There has been quite some relief on the asset side after the ECB changed the terms of the TLTROs retroactively to incentivize early repayments, but this is now close to being exhausted and the bulk of the asset growth coming from Quantitative Easing (QE) will only slowly decline as the ECB has stopped reinvesting the securities held under the "ordinary" Asset Purchase Program** (APP) from July. On the liability side, the ECB can hardly stop paying DFR on excess reserves, in a sort of "reverse tiering", since banks would then try to lend this cash on the money market, which would then take the effective "base rate" of the economy below the DFR, which is exactly the opposite of what the central bank is trying to do in its fight against inflation. In addition, this would raise thorny "distributional issues" across the Euro area since excess reserves are very unequally distributed (they are mostly in core countries' banks). True, the ECB could stop paying DFR on mandatory reserves (note that until the end of 2022 they used to be remunerated at the higher Main Refinancing Operations rate – MRO). By construction, they cannot be lent out, but it is now a tiny fraction of total deposits on the ECB books (Exhibit 5).

So, what could move the dial more substantially? Well, the "nuclear option" would be to sell the QE portfolio rather than just stopping the reinvestment, but even the hawks may balk at the likely adverse market reaction while having to deal with "crystallised losses" by selling heavily discounted bonds. We think that more realistically, **stopping reinvesting Pandemic Emergency Purchase Programme (PEPP) too is going to become very tempting**, even if that stands for a smaller fraction of the balance sheet than the APP (Exhibit 6). As of now, the ECB pledges to reinvest until "at least the end of 2024". This could be brought forward.

Exhibit 5 – It’s mostly excess, not mandatory reserves

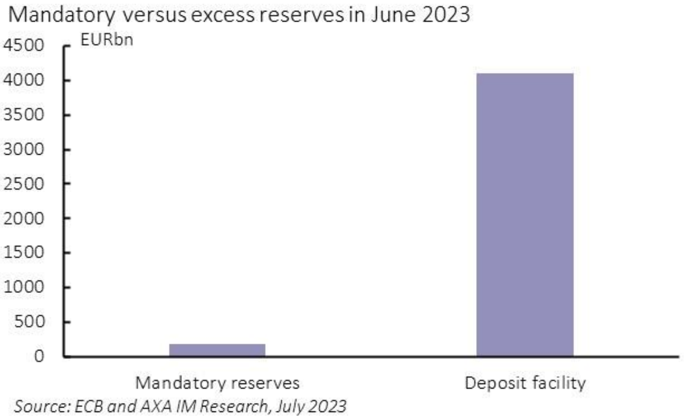
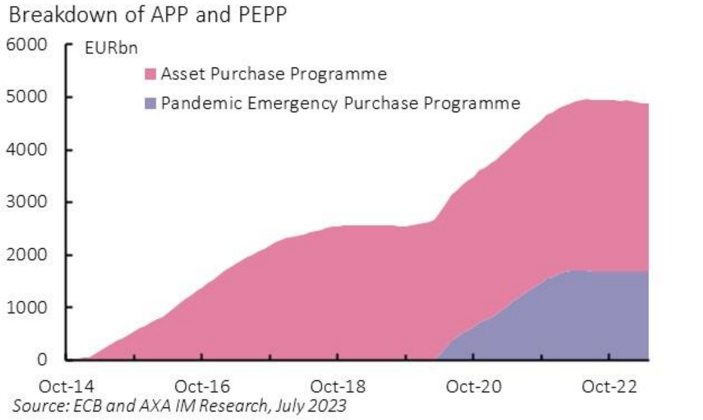
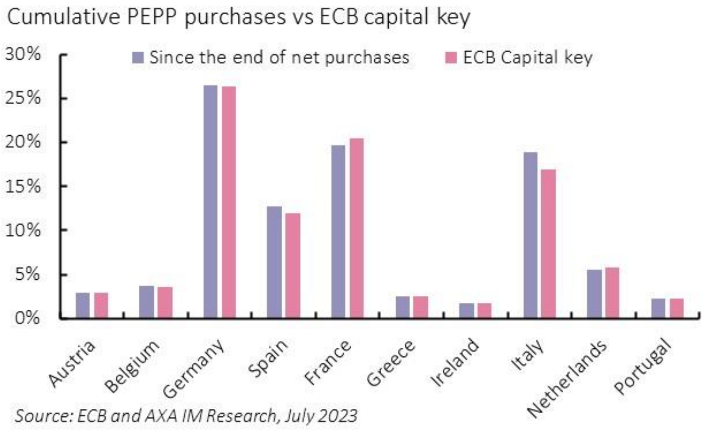


Exhibit 6 – PEPP is smaller, but still chunky

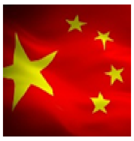


This would not help with the financial stability risks we mentioned in the first section. While it is not easy to substantiate theoretically, empirically it is easy to show that changes in the central bank’s balance sheet can have significant effects on risky assets beyond the pure interest rate channel. To this usual issue we would add one that is specific to the Euro area. **If PEPP is soon to follow the APP’s fate, the ECB could no longer tweak the allocation of the reinvestments across signatures as a first line of defence in case of “unwarranted spread widening”** on a sovereign’s funding costs. Exhibit 7 shows that there has been some small distance taken from the “capital key” which normally apportions QE across member states, and Italy has been the main beneficiary. Without the “reinvestment tweaking” tool, the ECB could be forced to consider using its Transmission Protection Instrument (TPI) earlier, which the central bank has always presented as only a second line of defence and one they clearly hoped never to have to use.

Exhibit 7 – A little help to Italy



The “spread controlling” potential of PEPP reinvestments may ultimately convince the Governing Council to take the pain and keep this fraction of the balance sheet untouched until the end of next year, but the debate illustrates again how disentangling monetary policy from financial stability protection is impossible and may call for some implicit trade-offs.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Payrolls (Jun) slowed to 209k, previous months revised lower by 110k – first downside surprise in 15mn. Unemp dipped to 3.6%; earnings growth rose by 0.4%mom • Broader labour data surprised higher, including Challenger job cuts, although JOLTS (May) fell to 9.8mn • ISM manu (Jun) fell to 46.0, but services rose to 53.9 • Vehicle sales (Jun) rose to 15.7mn (saar) still solid • 10-year yields rose >4% for the first time since January	• CPI inflation (Jun) headline expected to fall towards 3%, core to edge lower to 5% • PPI inflation (Jun) signalling further disinflation, with headline expected <1% (core to slow to 2.5%) • Import & export prices (Jun), imp -5.9%yoy in May • Michigan Uni consumer sent (Jul,p) for more firming/bottoming. Plus 5-10yr inflation expectations • Fed publishes latest Beige book
	• Final PMIs (June) were revised lower: Mfg at 43.4, Svcs at 52 and Comp at 49.9 in contraction territory • IP (May) was a touch lower in Germany (-0.2%mom) but new orders unexpectedly rose by 6.4%mom • Retail sales (May) was flat (0%mom), food consumption lower again • EMU producer prices (May) came at -1.9%mom	• Final inflation figures in Ge, Fr and Sp. Worth to have a look at what is happening in Svcs sector in Ge and Fr after surprisingly lower inflation • Euro area industrial production (May)
	• BoE DMP inflation exp'tions (Jun) edge lower 3m&1y, but BEI 5y/5y rise, threatening 50bps BoE hike in Aug • Market pricing rises to expect 6.50% BoE peak • PMIs (Jun), manu falls to 46.5, servs to 53.7 • New car registrations (Jun) at 25.8%yoy from 16.7%	• Labour market – any signs of easing – employment growth, unemployment and earnings watched • GDP (May) – drop expected with bank holiday and strikes, consensus -0.3% • Chx speaks at Mansion House, MIFID II chgs exp'td • BoE Credit Conditions Survey (Q3) – first post SVB
	• Tankan surveys (Q2) confirm the good momentum on economic activity. All components across sectors and type of companies improved • Household spending (May) fell by 1.1%mom	• Machinery orders (May) • Monitoring comments by BoJ members on the possibility to widen the current YCC or shorten the maturity on 5y as soon as July meeting
	• Caixin manufacturing PMI fell to 50.5 from 50.9	• June inflation • Trade figures for June • Data on new loans for June
	• CB: Malaysia (3.0%), Poland (6.75%) & Romania (7.0%) stood on hold • Inflation (June) fell in Korea (2.7%), Hungary (20.1%), Indonesia (3.5%), Peru (6.5%), Philippines (5.4%), Taiwan (1.8%) Thailand (0.2%) & Turkey (38.2%) • Industrial production (May) shrank in Korea (-7.3%), Hungary (-4.6%) & Thailand (-3.1%)	• CB: Korea (3.50%) & Peru (7.75%) are expected to stay on hold • CPI (June): Brazil, Colombia, Czechia, India, Romania & Russia • Preliminary Q2 GDP data in Singapore • Industrial production (May): Colombia, India, Malaysia, Mexico, South Africa & Turkey

Upcoming events		
	US:	Mon: Wholesale inventories (May); Tue: NFIB small business optimism (Jun); Wed: CPI (Jun), -ex food & energy (Jun), FED publishes Beige book; Thu: PPI (Jun), -ex food & energy (Jun), Weekly jobless claims (Jul 8); Fri: Michigan consumer sentiment (Jul)
	Euro Area:	Tue: Ge CPI (Jun), Ge HICP (Jun), Ge ZEW survey current & economic expectations (Jul), It industrial prod (May); Wed: Sp HICP (Jun); Thu: EU20 Industrial prod (May), EU20 ECB account, Fr HICP (Jun)
	UK:	Tue: BRC retail sales monitor (Jun), ILO unemployment (May), Avg earnings (May), -ex bonuses (May); Wed: BoE financial stability report; Thu: RICS housing survey (Jun), Monthly GDP (May), Index of services (May), Industrial prod (May), Manf and construction output (May), Total trade balance (May), Trade in goods (May), BoE credit conditions survey (Q2)
	Japan:	Mon: Current account balance (May), Trade balance (May), Economy watchers survey (Jun); Wed: Private 'core' machinery orders (May); Fri: Industrial prod (May)
	China:	Mon: CPI (Jun), PPI (Jun); Thu: Exports & Imports (Jun), Trade balance (Jun)

Our Research is available online: www.axa-im.com/investment-institute