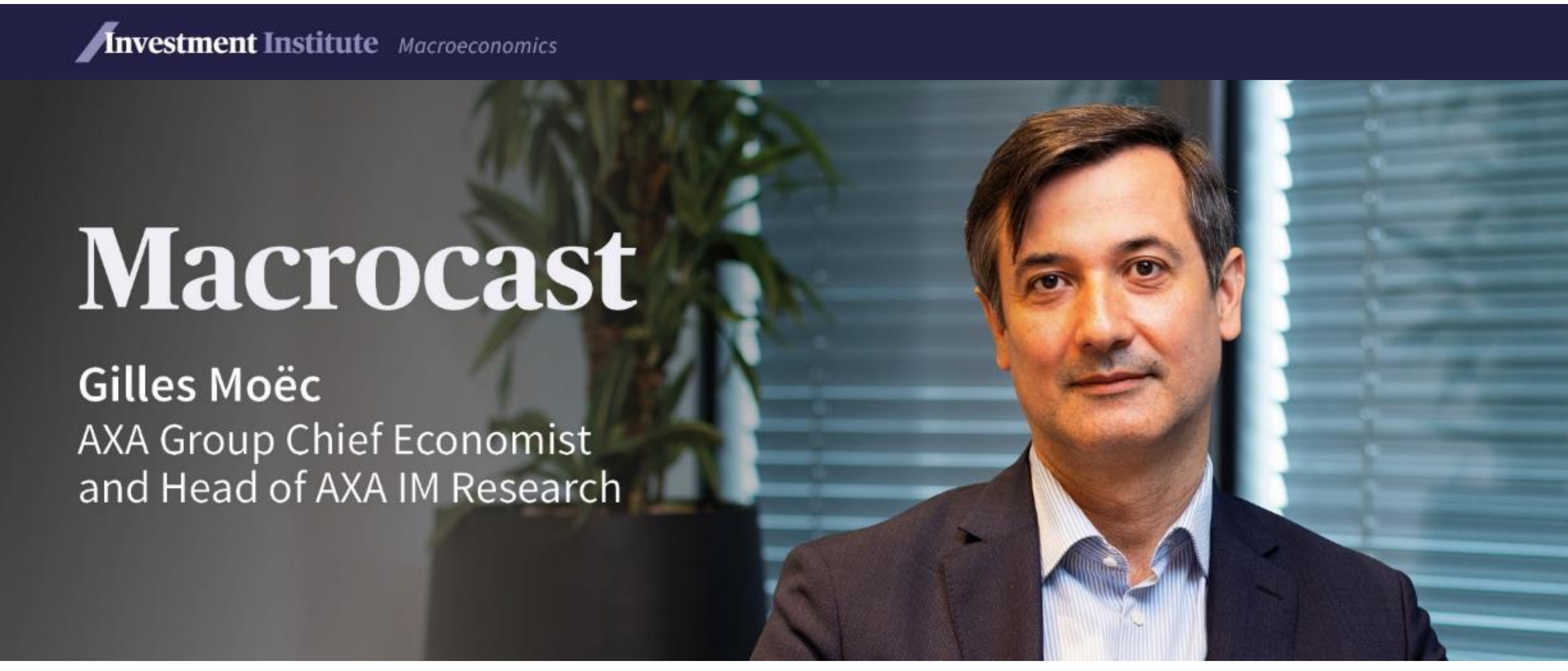
197 – 2 October 2023



Rocking the Boat

- We take another look at Italy which came under market pressure last week. Beyond the developments in Rome, the discussions at the ECB on banks' reserve requirements and PEPP are not helping.
- Unexpected 6-week respite on the US government shutdown came at the expense of support to Ukraine.

The "Table Mountain" approach to monetary policy may not bring the expected sense of "peace and quiet." The bond market has been very active across the Atlantic and, as usual, the weaker signatures get under pressure. Even if we should not overstate the magnitude of the turmoil last week, Italian long-term yields approaching a 200bps spread vis-à-vis Bunds deserves some attention.

As often, pressure on the Italian bond market was triggered by the combination of some national policy moves (an upward revision in the deficit trajectory) and deteriorating cyclical indicators. A third ingredient is the noise coming from the ECB on a swifter action on its balance sheet. We thought Christine Lagarde had put this to rest when she stated at the last post-meeting press conference that terminating the reinvestment of PEPP had not even been discussed at the Governing Council. Yet, more avenues are being opened, e.g., the possibility to significantly raise the Minimum Reserve Requirement of banks to force a transfer from excess reserves to non-interest-bearing mandatory ones. While this may read as an obscure technical move, the distributional consequences could be significant, triggering an asymmetric additional tightening in monetary conditions detrimental to peripheral countries. The financial stability and macro consequences of such action, combined with good news last week on the European inflation front, should convince the ECB to move cautiously, but we do not think national governments have taken the full measure of the changes at work at the central bank. It may be slow, but the ECB's balance sheet is only heading in one direction, and fiscal policy needs to adjust to this new reality.

Meanwhile, in the US a last-minute stopgap has given us a 6-week respite in the shutdown drama, but additional funding to Ukraine was a collateral victim. It is tempting to connect this to the electoral victory of Robert Fico in Slovakia to find that more cracks are appearing in the consensus in the West to stand with Kyiv.

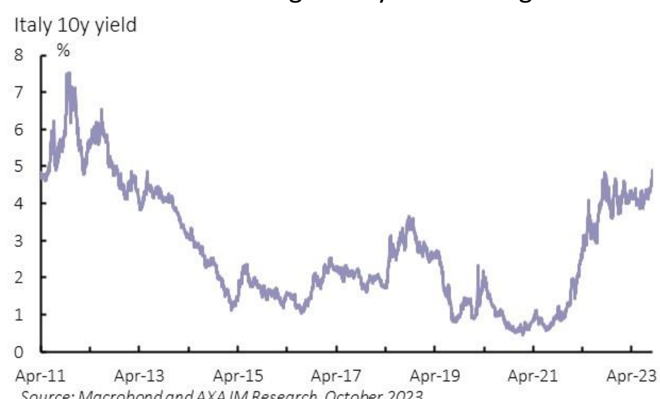
The end of the Italian honeymoon?

As the bond market is taking the measure of the central banks' "Table Mountain" narrative, the most fragile signatures are coming again under some pressure. Italy was in focus last week, with the 10-year spread between BTP and Bunds flirting with 200bps (195bps on Friday close), a threshold which is normally indicative of idiosyncratic stress. The move was still modest when taking a long historical perspective on the spread. We have seen quite a few flare-ups since 2018 which did not leave any lasting damage (see Exhibit 1), but the *absolute level* of yields also matters. Indeed, 10-year yields have flirted with 5% last week, the highest since 2013 when Italy was barely recovering from the sovereign crisis (see Exhibit 2) and are deep into positive *real* territory when considering inflation expectations. The Italian government had made provisions for a higher level of interest rates in the Stability Programme transmitted to the European Commission last spring, but their assumptions now look optimistic (4.2% for 2023 and 4.4% for 2024 for long-term rates).

Exhibit 1 – BTP-Bund spread in perspective

Source: Macrobond and AXA IM Research, October 2023

Exhibit 2 – Absolute long-term yields are high



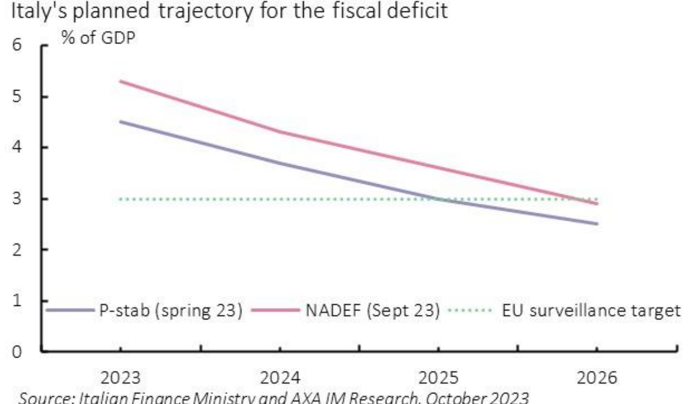
Source: Macrobond and AXA IM Research, October 2023

Episodes of stress on the Italian bond market are more often the product of a combination of several factors than "mono-causal". It usually takes actual or expected policy changes in Rome, together with deteriorated cyclical conditions and uncertainty on the form and quantum of support Italy could receive from European institutions (the ECB in particular). We can find traces of all these ingredients in the current configuration.

The immediate cause of the spread flare-up was the publication of the updated fiscal trajectory (NADEF) by the government. The deficit target for 2023 was revised up from 4.5% to 5.3%, without any ambition to correct this until the end of the Stability Programme's horizon. The aim of bringing the deficit below 3% of GDP is pushed from 2025 to 2026 (see Exhibit 3). Italy would not be the member-state taking the longest (France in its own P-stab is targeting only 2027), but given Italy's public debt issue the "re-profiling" of Rome's fiscal consolidation effort is likely to raise eyebrows in Brussels, as Italy plans to only barely stick to the bare minimum requirement of the reformed fiscal surveillance framework as it is currently discussed (that debt falls by the end of the forecasting horizon), with public debt at 139.6% of GDP in 2026, down by only a whisker from 140.2% in 2023 (see page 16 of the NADEF for the summary table). Technically, the NADEF is currently under parliamentary scrutiny in Italy and will be transmitted to the Commission in only two weeks, but the substance is unlikely to change.

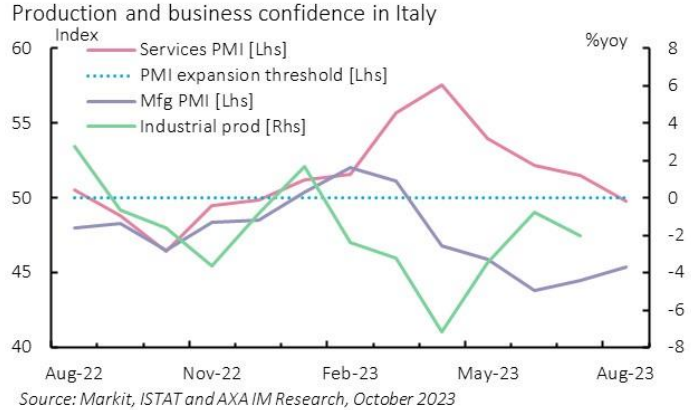
In all fairness, **the current government inherited a large fiscal bill from its ante-predecessor**, the Conte administration, which launched the "Superbonus" in 2020 – a very attractive subsidy designed to help homeowners improve the energy efficiency of their dwellings at a massive – and initially understated - cost to the public purse. Although Giorgia Meloni's government dramatically curbed the system's generosity, as of August 2023 another EUR25bn had been spent on it by the government relative to the end of last year (some 1% of GDP). Moreover, on top of the drift attributable to the "superbonus", the government is planning to push ahead with its social measures (a rise in child benefits and a reform of the income tax).

Exhibit 3 – A more leisurely pace



Source: Italian Finance Ministry and AXA IM Research, October 2023

Exhibit 4 – Business confidence and output heading south



Source: Markit, ISTAT and AXA IM Research, October 2023

Italy is also dealing with some setbacks on the denominator of the deficit and debt ratios. GDP for Q2 2023 was revised down to a decline of 0.4%qoq from an initial estimate of -0.3%. The contrast with the country's quite robust performance since the reopening is stark, and precisely the curtailment of the Superbonus and its very favourable impact on residential investment is playing a role. Once fiscal support is removed from the equation, the engines of the Italian economy are sputtering. As can be seen in Exhibit 4, industrial production has been in decline (in year-on-year terms) since the beginning of this year, and services are now following suit: the PMI in this sector is converging towards the already depressed level of its manufacturing counterpart and has just fallen (marginally) in contraction territory. The Italian government has duly revised down its growth assumptions in the NADEF, expecting only 0.8% for 2023 instead of 1.0% in the P-Stab. Even this revised forecast may not that obvious to deliver: it would take a GDP rebound of 0.15%qoq on average in the second half of the year, which is not consistent with the current dataflow.

Beyond the short-term cyclical issue, any deterioration in the long-term growth prospects would be problematic for Italy given its debt level. After years of stagnation, "Draghinomics" and the advent of the Next Generation EU project allowed to shift the narrative away from the "zero trend growth" which had become a frequent assumption when building (scary) debt sustainability scenarios for Italy. The spring P-Stab was based on a lasting and significant improvement in potential growth, with GDP gains never falling below 1% through the forecasting horizon (from an estimate of potential at 0.1% for 2020). Of course, patience is needed to reap the benefits of the boost to investment and the structural reforms brought about by the Next Generation framework, but a risk is that the market extrapolates from the *current* mediocre performance of the Italian economy to revise its rosier assessment of the long-term trend. Irrespective of the discussion on trend growth, the 1.2% GDP gain expected for 2024 by the government in the NADEF looks very optimistic (we are at 0.1% and the consensus at 0.7%).

ECB's balance sheet problem makes a comeback

We argued last year that the honeymoon between the market and the Italian government would be put to test the minute the economy falters and politics gets tougher, but another key ingredient in our view had to be the assessment of the degree of protection the BTP market would benefit from the European Central Bank (ECB). Giorgia Meloni has been among the few heads of governments in the Euro area who have been explicitly critical of the ongoing monetary policy tightening. But **the key issue for Rome now is not so much the policy rate as the pace of Quantitative Tightening. On that front, despite a clear statement from Christine Lagarde in the Q&A session following the Governing Council meeting, doubts now abound.**

The resorption of the balance sheet can take many forms, but before we get there, we need to explore again the reasons why this should happen. We can think of "pure" and "impure" reasons to voluntarily shrink the central bank's balance sheet. Monetary policy transmission is the first "pure" reason to think about. Arguably, an excessive level of

liquidity in the financial system can dampen the impact of policy rate hikes on the real economy. This would be the case for instance if banks, awash with liquidity, and chasing too little credit demand, were reluctant to pass to the private sector the increase in policy rates, or if long-term yields stayed glued too low under the pressure of the stock of bonds held by the central as a legacy of Quantitative Easing (QE).

We find it difficult to argue the Euro area is faced with a policy transmission problem. Rates levied on loans to corporates and households have risen sharply (they are now above 4% on average) and the speed of their convergence to the policy rate has been at least in line with the previous episodes of tightening. The change in the conditions of the Targeted longer-term refinancing operations (TLTROs) – which has already accelerated the pace of reduction of the ECB's balance sheet - has made banks' funding more sensitive to the signals from policy rates. True, the yield curve remains inverted, but long-term yields have moved up quite significantly this year, including in "core countries". This was explicitly acknowledged by Christine Lagarde at her last press conference, noting that policy transmission is *"strong and stronger than we have seen in previous cycles"*. Accordingly, **we do not see any urgency to hasten the reduction in the ECB's balance sheet in the current circumstances**, especially since signals are accumulating that a recession is looming in the Euro area.

The more "impure" reasons have to do with the Eurosystem's own profit and loss account. Huge excess reserves held by banks on their account at the central bank are a legacy of past use of unconventional policy instruments. Although it has been receding thanks to the end of the reinvestment of the ECB's "ordinary" QE programme, the APP (Asset Purchase Programme) and the expiry/accelerated reimbursement of the bulk of the TLTROs, banks still had close to EUR 3,700bn sitting at the Eurosystem's deposit facility a week ago, now remunerated at 4%, thus entailing a cost to the Eurosystem of nearly EUR150bn per annum. In addition, given how low yields were when bonds were purchased under the QE programmes, holding them to maturity does not protect against losses. The Bundesbank posted for 2022 its first loss since 1979. It was offset by the provisions accumulated on purpose since 2019 but according to Buba those provisions will not be large enough to absorb the full expected cost in the years ahead. While central banks can perfectly operate in negative equity, this of course depletes the dividend which national central banks (NCBs) can pay to their governments, triggering potentially tricky political difficulties, especially in the countries where public opinion is generally unconvinced by lax monetary policy and fond of fiscal rectitude.

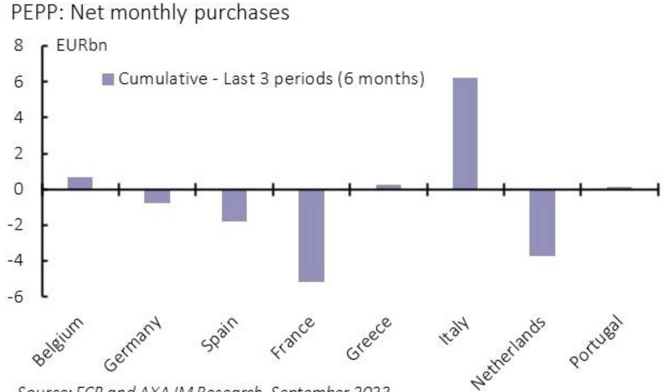
What are the avenues opened to the ECB to accelerate the reduction of its balance sheet and ameliorate its profit and loss position? **Engaging in active selling of the stock of bonds still held is a non-starter**, since it would crystallise the losses (the current market price of bonds is significantly lower than the price at which they were bought), without even mentioning the disruptive impact it would have on the market, probably triggering a tightening in overall financial conditions which would go beyond what even the hawks would want to see to curb inflation. Stopping the reinvestment of the bonds held under the Pandemic Emergency Purchase Programme (PEPP) - for now expected to continue until "*at least the end of 2024*" - would be a less extreme option. For a country like Italy though, the consequences could be significant.

Flexibility around the PEPP reinvestment is the ECB's explicit "anti-fragmentation" tool. Indeed, while the ECB's capital key is the reference for the apportionment of the reinvestments across national bond markets, the ECB has been proceeding with some margin of deviation. We show in Exhibit 5 how Italy has been a net beneficiary of these deviations over the last 6 months: There have been net purchases of BTPs, "offset" by net sales of mainly French and Dutch bonds. Of course, EUR6bn of purchases would not move the dial much, but it is the *possibility* of even more flexibility which is helping to contain tension on the Italian market.

Once PEPP reinvestments stop, there would only remain a "virtual" instrument, the Transmission Protection Instrument (TPI), which has never been used and is still vaguely defined. While PEPP reinvestments are unconditional, bond buying under TPI refers to complying with the European fiscal surveillance framework. The precise wording of how the ECB would assess this has been left unclear on purpose but **relying on TPI would make the market much more sensitive to the quality of the policy debate between national governments and the European Commission**. Given the latest news on the Italian fiscal front, this would not help.

Another option would focus on banks' reserves. Several members of the Governing Council have mentioned the possibility to raise the minimum reserve rate (MRR), which has been stuck at a low 1% since December 2011 (in clear, banks must maintain mandatory cash reserves on their account of the central bank to the tune of 1% of their own eligible deposits). How would this help with the ECB's own profit and loss account? Simply because last July the Governing Council decided to stop paying interests on mandatory reserves, while continuing to remunerate excess reserves at the deposit rate. Banks transferring cash from "excess" to "mandatory" reserves would automatically receive less income in total from the ECB. We provide an illustrative simulation in Exhibit 6. We pushed the Money Market Rate (MMR) from 1 to 4% - based on the range mentioned in a Reuters' dispatch on the current debate on reserves at the ECB. The relief to the Eurosystem would reach EUR20bn annually. If the Governor of the central bank of Austria had his way, the MMR would be bumped even more, as per his statement about a 5-10% level last week.

Exhibit 5 – Italy benefits from PEPP reinvestment flexibility



Source: ECB and AXA IM Research, September 2023

Exhibit 6 – A magic, 20bn euros trick

In EUR bn		Volume	Cost to the ECB (DFR at 4%)
Today	Mandatory reserves	162.5	0
	Excess reserves	3660	**146.4**
If Mandatory reserves rate brought to 4% (no change in other factors)			
	Mandatory reserves	650	0
	Excess reserves	3172.5	**126.9**

Source: ECB weekly financial statement and AXA IM Research, September 2023

The impact on banks of such a shift could be significant, albeit ambiguous. The first issue is of course a reduction in banks' profitability, but they could respond in opposite ways from the point of view of monetary policy transmission. They could either choose to offset the decline in the income they derive from their reserves by either (i) raising the interest rate they charge on their loans (i.e., tightening monetary conditions) or (ii) reducing the interest rate they pay on their clients' deposits (loosening monetary conditions through a decline in the incentive to save). We think that in the current configuration banks would in majority choose the first option. Bank lending is by far the dominant form of funding for the corporate sector in the Euro area – a key difference with the US. Most businesses have no real alternative to accepting higher interest rates on their loans. On the liability side though, banks face competition from asset managers. Reducing the interest rate, they serve on their term deposits would push their clients to shift their assets towards money market funds. There is thus little doubt in our mind that raising the reserve requirement would on the whole trigger an extra-tightening in monetary conditions. Another issue is of a regulatory nature. Excess reserves count towards the banks' Liquidity Coverage Ratio (LCR) (they are requested to hold high quality assets to cover the entirety of their net cash outflows over a stress period of 30 days), but not mandatory ones. Some banks would need to rush to acquire high quality assets to comply with their LCR obligations – to the detriment of funding the economy by originating loans. Supervisory authorities could of course change their mind and ease the constraint, but this complicates the matter.

Beyond the overall macro effect, **distributional consequences need to be considered**. Excess reserves are not equally shared across the Euro area. Banks in core countries are in general in a comfortable position. They could easily shift their excess reserves to the mandatory ones while still maintaining a large buffer. These banks would lose some future income, but they would merely bring back into zero interest mandatory reserves some of the liquidity they had acquired "on the cheap" when monetary policy was very lax. This would not be the case in many peripheral countries. A lot of banks there would not have enough excess reserves to fill the mandatory bucket if the MMR were significantly hiked. In practice, they could be forced to borrow cash from the ECB at the Main Refinancing Operation rate (MRO), currently at 4.50%. **This would trigger an asymmetric tightening across the Euro area, with Italy as one of the collateral victims**.

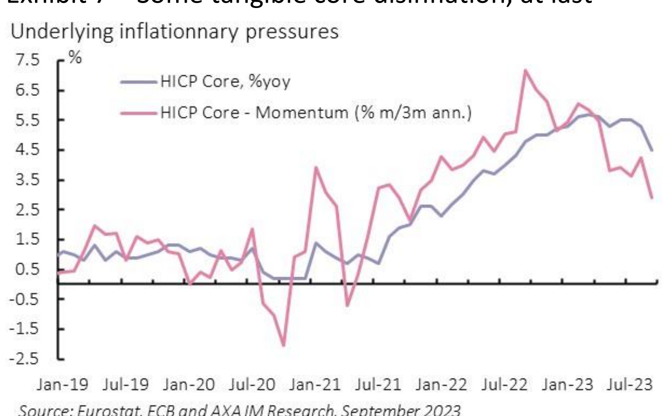
The degree of enthusiasm at the Governing Council in favour of reopening these various Pandora boxes is unclear. Christine Lagarde stated in the last Q&A that they had not discussed PEPP. The minutes of the July Council meeting suggest that those in favour of a radical overhaul of the reserve system faced robust resistance, and the formulation *"overall, caution was expressed against using the minimum reserve ratio as an active instrument for adjusting the monetary policy stance*" was reassuring.

Yet, the constant bickering on this issue is raising the probability that "something will give" in the coming months on the balance sheet conundrum. In an optimistic scenario, this will amount to a small upward revision in the MMR (say to 2%) back to where it was before December 2011, on the occasion of the ECB disclosing its overall new operational framework (at some point in the first half of 2024), and the PEPP issue won't be reopened before the beginning of next year. This assumes that the hawks get nervous in the face of mounting financial instability. In any case, in the medium term we firmly believe governments need to brace themselves against the consequences of a normalisation of the central bank's balance sheet, which will compound the headaches triggered by the rise in policy rate, at a time when the pace of their planned fiscal consolidation is hesitant.

Pleasant surprise on Euro area inflation

What may make the ECB's less impatient to accelerate further the reduction of its balance sheet was the good news on the inflation front last week. We have been lamenting since the end of the spring the contrast between the tangible deceleration in core consumer prices in the US and the very timid progress seen in the Euro area. The September print fortunately at last reflected a more robust pace of disinflation, with core falling to 4.5% year-on-year, significantly more than the market was expecting (4.8%) and significantly down from the August release (5.3%). This was not attributable to some random base effect. Our favourite measure of momentum – looking at the 3-month annualised rate – suggests an even better pace of disinflation (see Exhibit 7).

Exhibit 7 – Some tangible core disinflation, at last



Source: Eurostat, ECB and AXA IM Research, September 2023

Concerns over energy prices are of course blurring the picture, and the pace of headline disinflation may be difficult to maintain. If oil prices were to reach and maintain themselves at USD100/bbl. over the entirety of 2024, we would expect a drift of 0.5 percentage point of headline inflation from our forecast. Yet, doves may be able to convince a majority of the Governing Council to treat this more as another dent in the real economy, with the usual adverse effect on purchasing power, than as the promise of more second-round effects ahead. As our habitual readers know, we think it is the deterioration in cyclical conditions – increasingly obvious in the Euro area – which ultimately will bring aggregate inflation closer to target.

Ukraine and US political dysfunction

The combination over the weekend of a last-minute budget stop-gap deal in the US which leaves additional funding to Ukraine out and the victory of a pro-Russian leader in the general elections in Slovakia sheds some light on some cracks emerging in the West's support to Ukraine.

The last-minute deal tabled by Republican House Speaker Kevin McCarthy on Saturday - swiftly endorsed by the Senate and signed into law by President Biden on the evening of the same day – prevents a government shutdown until mid-November. **The motion however left out extra funding for Ukraine** (USD6bn negotiated at the Senate) – a growing point of focus for the right-wing of the Republican party. True, Republican Senate leader Mitch McConnell co-signed with the Democratic leader of the majority in the Senate a public letter calling for the continuation of support to Ukraine to signal bi-partisan commitment, but at least the optics are concerning.

Moreover, 90 Republican Representatives voted against the final motion, and one of them has already announced he would table a "motion to vacate" forcing a new vote on the House Speaker. In an optimistic narrative, McCarthy needs a simple majority of the whole House to win again, so technically could survive the defection of some members of his caucus with the helping hand of the Democrats, which would usher in a "majority coalition" allowing the US government to operate more normally – and extra funding to Ukraine to materialise. This would however break with the recent trend of US politics. Republican Speaker Boehner resigned in 2015 when he realised that he could not survive politically without Democratic support. There is a risk that the US stays mired in legislative stalemate through the last year of Biden's current mandate, which would in any case complicate matters on support for Ukraine.

Meanwhile, **Robert Fico's party came out first of the general elections in Slovakia.** During the campaign he made it explicit he would oppose further military help to Ukraine (his country had been one of the most supportive so far). True, his party's score was only marginally above 20% and he is very far from securing a majority. He would need to form a coalition with the leader of the Social-Democrats – a former member of Fico's party – who does not seem to share his views on the conflict. Immediate consequences may thus be limited, but it is still quite a notable development that it has been possible again to come first in an election in central Europe on such a platform – after Hungary in April 2022 – even if domestic rather than foreign issues dominated the campaign.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• House Republicans struggle to propose bill to avert shutdown • GDP revisions. Q2 unch at 2.1% (saar), but weaker consumer spending and stronger investment • HH spending & income (Aug) rise 0.4%, saving rate falls again to 3.9% from (upward revised) 4.1% • PCE inf (Aug) up to 3.5%, core dips to 3.9%-27m low • New and pending home sales fell sharply in Aug.	• A government shutdown looks likely: shutdown would prevent the release of all government data, including payrolls, JOLTS vacancies and consumer credit • ISM mfg & services (Sep) for signs of softening • ADP employment survey & Challenger job cuts as guide to labour market developments • Vehicles sales (Sep) slowing, but resilient
	• EMU headline and core flash HICP dropped more by 0.9pp and 0.8pp to 4.3%yoy and 4.5%yoy • French and Italian budgets showed limited fiscal consolidation for next year • EMU credit origination stabilising in August • EC surveys (Sep) provided mixed picture: business stabilising, but consumer confidence falling	• New car registrations for September • Euro area retail sales for August • German industrial orders for August
	• GDP (Q2) unrevised at 0.2%qoq, but prior quarters revised, so yoy increase to 0.6% from 0.4%. Consumer and government spending revised lower, but total and business investment revised higher • Consumer credit (Aug) 5-yr high, mtg apps fall again	• Nationwide house prices (Sep) likely to set fresh 14-year low • BRC shop prices (Sep) - gauge ongoing disinflation • BoE inflation expect's (Sep) falling trend to continue • PMIs (Sep, f) confirming weakening trend
	• Tokyo CPI (Sep) headline dips to 2.8%, ex-fresh food & energy falls by more to 3.8% from 4.0% • Unemployment rate (Aug) rise to 2.7% from 2.6% • Industrial production (Aug, p) flat on month after 1.8% fall in July	• Tankan survey (Oct), key large manufacturers index broadly unchanged • PMIs (Sep, f), preliminary readings fell both sectors • Leading indicator (Aug, p)
	• Industrial profit (Jan-Aug) narrowed to -11.7%yoy, from -15.5% for Jan-Jul	• Sat (30 Sep): NBS PMI mauf and non-mauf (Sep) • Sun (31 Set): Caixin PMI manf and non-manf (Sep)
	• CB: Czechia (7.0%), Colombia (13.25%), Hungary (13.0%), Mexico (11.25%) remained on hold & Thailand +0.25% to 2.50%. Some hawkishness out of the COPOM minutes, MNH and Banxico MPC comments	• CB: India (6.5%), Romania (7%) expected on hold. Poland (6%) risk of yet another cut. Peru (7.5%) expected to cut by 25bp to 7.25% • CPI in Indonesia, Korea, Thailand, Philippines, Peru, Colombia, Brazil, Uruguay (Sep) • Manufacturing PMI (Sep) across the board

Upcoming events		
	US:	Mon: Manf PMI (Sep), ISM manf index (Sep); Tue: JOLTS Job openings (Aug) (poss); Wed: ADP employment change (Sep), Services PMI (Sep), Factory orders (Aug) (poss), ISM non-manf index (Sep); Thu: Trade balance (Aug) (poss), jobless claims (29 Sep) (poss); Fri: labour market report (Sep) (poss)
	Euro Area:	Mon: EA, Ge,Fr,It,Sp Manf PMI (Sep), EA,It Unemp (Aug); Wed: EA,Ge,Fr,It ,Sp Services PMI (Sep), EA Composite PMI (Sep), EA PPI (Aug), EA Retail sales (Aug); Thu: Fr,Sp Industrial production (Aug); Fri: Ge New manf orders (Aug)
	UK:	Mon: Manf PMI (Sep); Tue: BRC Shop price index (Sep); Wed: Services PMI (Sep); Thu: Constructions PMI (Sep), Nationwide HPI (Sep)
	Japan:	Mon: Tankan Manf index (Q3), Manf PMI (Sep)
	China:	Sat: NBS PMI manf and non-manf (Sep); Sun: Caixin PMI manf and non-manf (Sep)

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