Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

Data Insights: ECB and Euro Area Economy Monitor

Thursday, July 27, 2023

Today's monetary policy decision: how the language changed from prior meeting

~~15 June~~27 July 2023

Inflation ~~has been coming down~~continues to decline but is ~~projected~~still expected to remain too high for too long. The Governing Council is determined to ensure that inflation returns to its 2% medium-term target in a timely manner. It therefore today decided to raise the three key ECB interest rates by 25 basis points.

The rate increase today reflects the Governing Council's ~~updated~~ assessment of the inflation outlook, the dynamics of underlying inflation, and the strength of monetary policy transmission. ~~According to the June macroeconomic projections, Eurosystem staff expect headline inflation to average 5.4% in 2023, 3.0% in 2024 and 2.2% in 2025. Indicators of underlying price pressures remain strong, although some show tentative signs of softening. Staff have revised up their projections for inflation excluding energy and food, especially for this year and next year, owing to past upward surprises and the implications of the robust labour market for the speed of disinflation. They now see it reaching 5.1% in 2023, before it declines to 3.0% in 2024 and 2.3% in 2025. Staff have slightly lowered their economic growth projections for this year and next year. They now expect the economy to grow by 0.9% in 2023, 1.5% in 2024 and 1.6% in 2025~~The developments since the last meeting support the expectation that inflation will drop further over the remainder of the year but will stay above target for an extended period. While some measures show signs of easing, underlying inflation remains high overall. The past rate increases continue to be transmitted forcefully: financing conditions have tightened again and are increasingly dampening demand, which is an important factor in bringing inflation back to target.

~~At the same time, the Governing Council's past rate increases are being transmitted forcefully to financing conditions and are gradually having an impact across the economy. Borrowing costs have increased steeply and growth in loans is slowing. Tighter financing conditions are a key reason why inflation is projected to decline further towards target, as they are expected to increasingly dampen demand.~~

The Governing Council's future decisions will ensure that the key ECB interest rates will be ~~brought to levels~~ set at sufficiently restrictive levels for as long as necessary to achieve a timely return of inflation to the 2% medium-term target~~and will be kept at those levels for as long as necessary~~. The Governing Council will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, its interest rate decisions will continue to be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission.

~~The Governing Council confirms that it will discontinue the reinvestments under the asset purchase programme as of July 2023.~~

<u>The Governing Council also decided to set the remuneration of minimum reserves at 0%. This decision will preserve the effectiveness of monetary policy by maintaining the current degree of control over the monetary policy stance and ensuring the full pass-through of the interest rate decisions to money markets. At the same time, it will improve the efficiency of monetary policy by reducing the overall amount of interest that needs to be paid on reserves in order to implement the appropriate stance. The details of the change to the remuneration of minimum reserves are provided in a separate press release to be published at 15:45 CET.</u>

Key ECB interest rates

The Governing Council decided to raise the three key ECB interest rates by 25 basis points. Accordingly, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will be increased to 4.~~00~~<u>25</u>%, 4.~~25~~<u>50</u>% and 3.~~50~~<u>75</u>% respectively, with effect from ~~21 June~~<u>2 August</u> 2023.

Asset purchase programme (APP) and pandemic emergency purchase programme (PEPP)

The APP portfolio is declining at a measured and predictable pace, as the Eurosystem ~~does not reinvest all of~~<u>no longer reinvests</u> the principal payments from maturing securities~~. The decline will amount to €15 billion per month on average until the end of June 2023. The Governing Council will discontinue the reinvestments under the APP as of July 2023~~.

As concerns the PEPP, the Governing Council intends to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024. In any case, the future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance.

The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

Refinancing operations

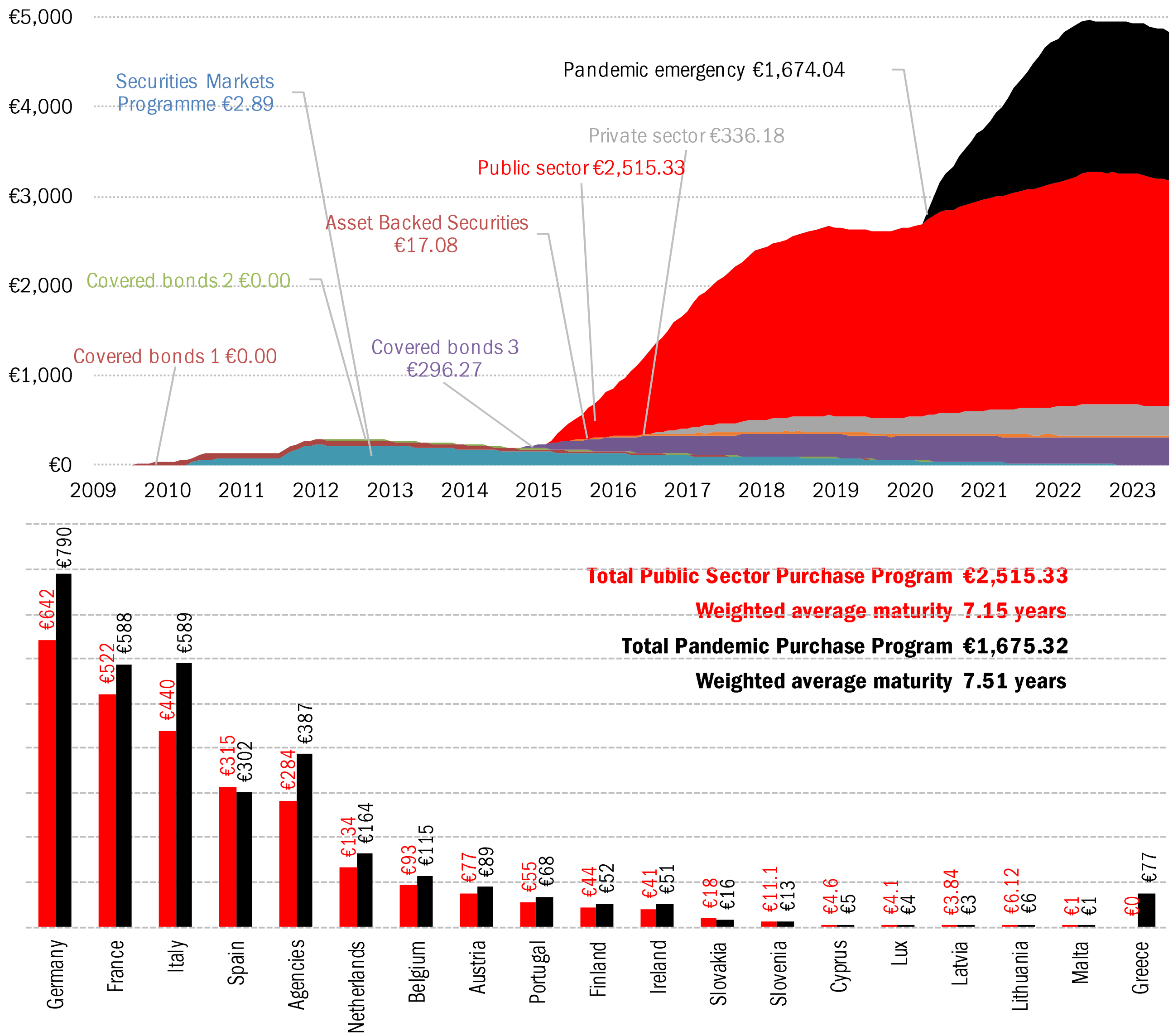
As banks are repaying the amounts borrowed under the targeted longer-term refinancing operations, the Governing Council will regularly assess how targeted lending operations and their ongoing repayment are contributing to its monetary policy stance.

The Governing Council stands ready to adjust all of its instruments within its mandate to ensure that inflation returns to its 2% target over the medium term and to preserve the smooth functioning of monetary policy transmission. Moreover, the Transmission Protection Instrument is available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across all euro area countries, thus allowing the Governing Council to more effectively deliver on its price stability mandate.

The President of the ECB will comment on the considerations underlying these decisions at a press conference starting at 14:45 CET today.

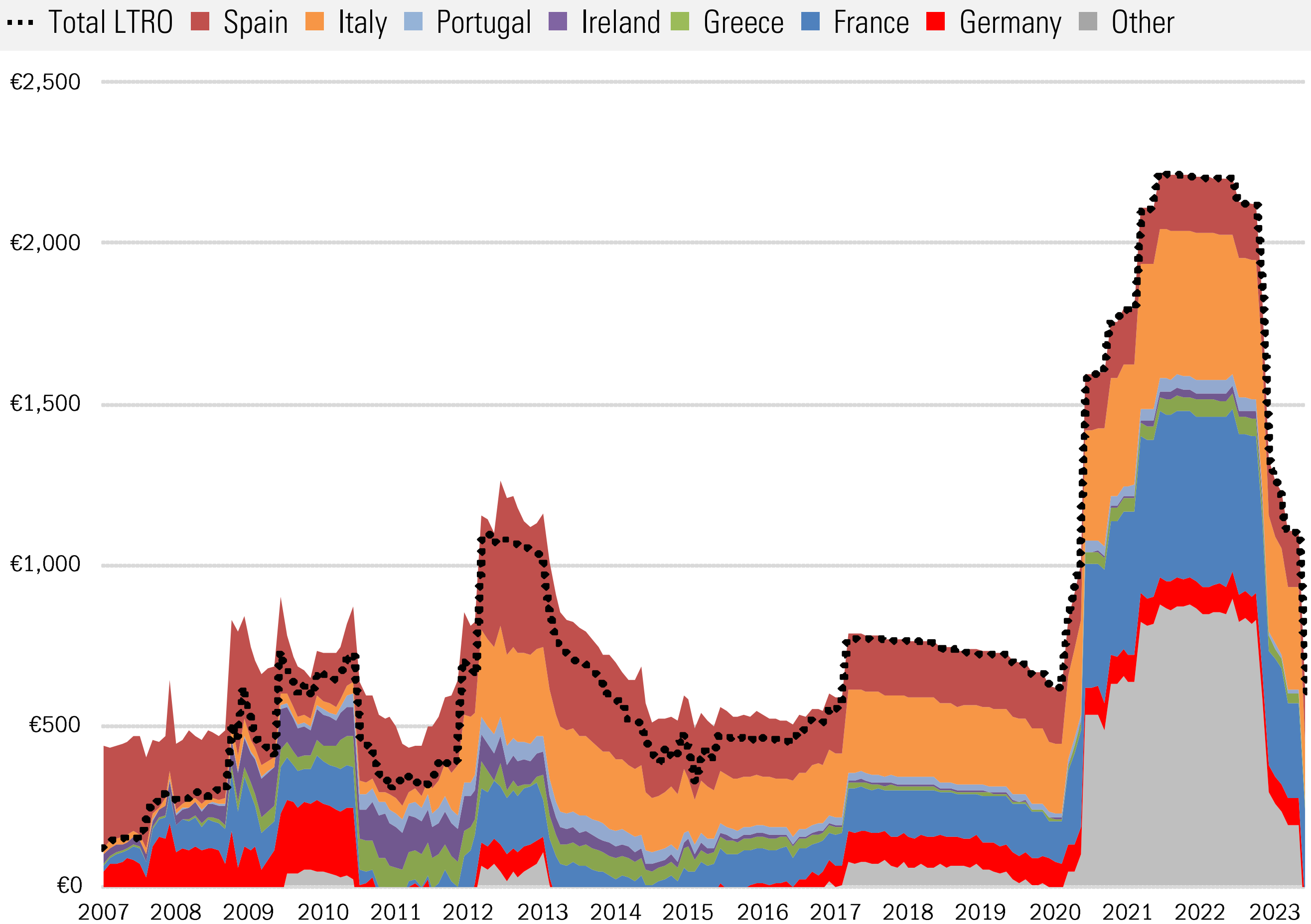
Source: FOMC, TrendMacro analysis

Euro-QE (€ billions)



Source: ECB, TrendMacro calculations

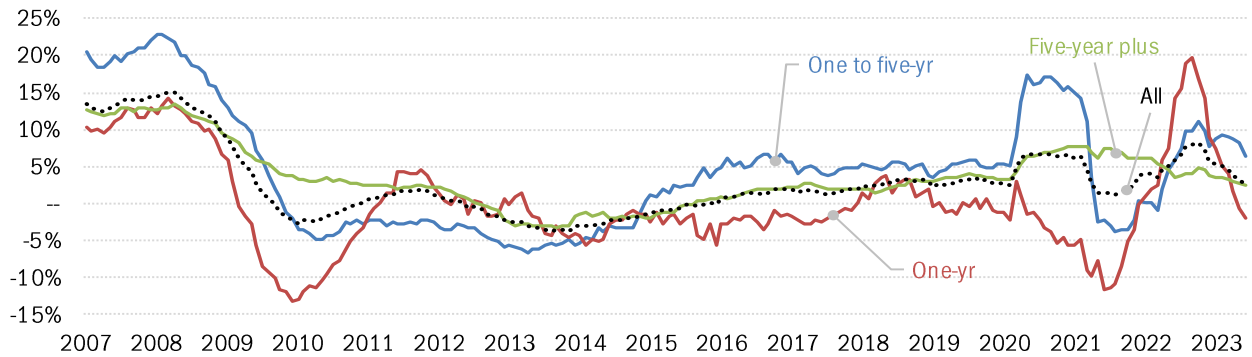
Banking system dependency: borrowing from the ECB (€ billions)



Source: ECB, National central banks, TrendMacro calculations

The credit drought: loans to non-financial businesses (YOY growth)

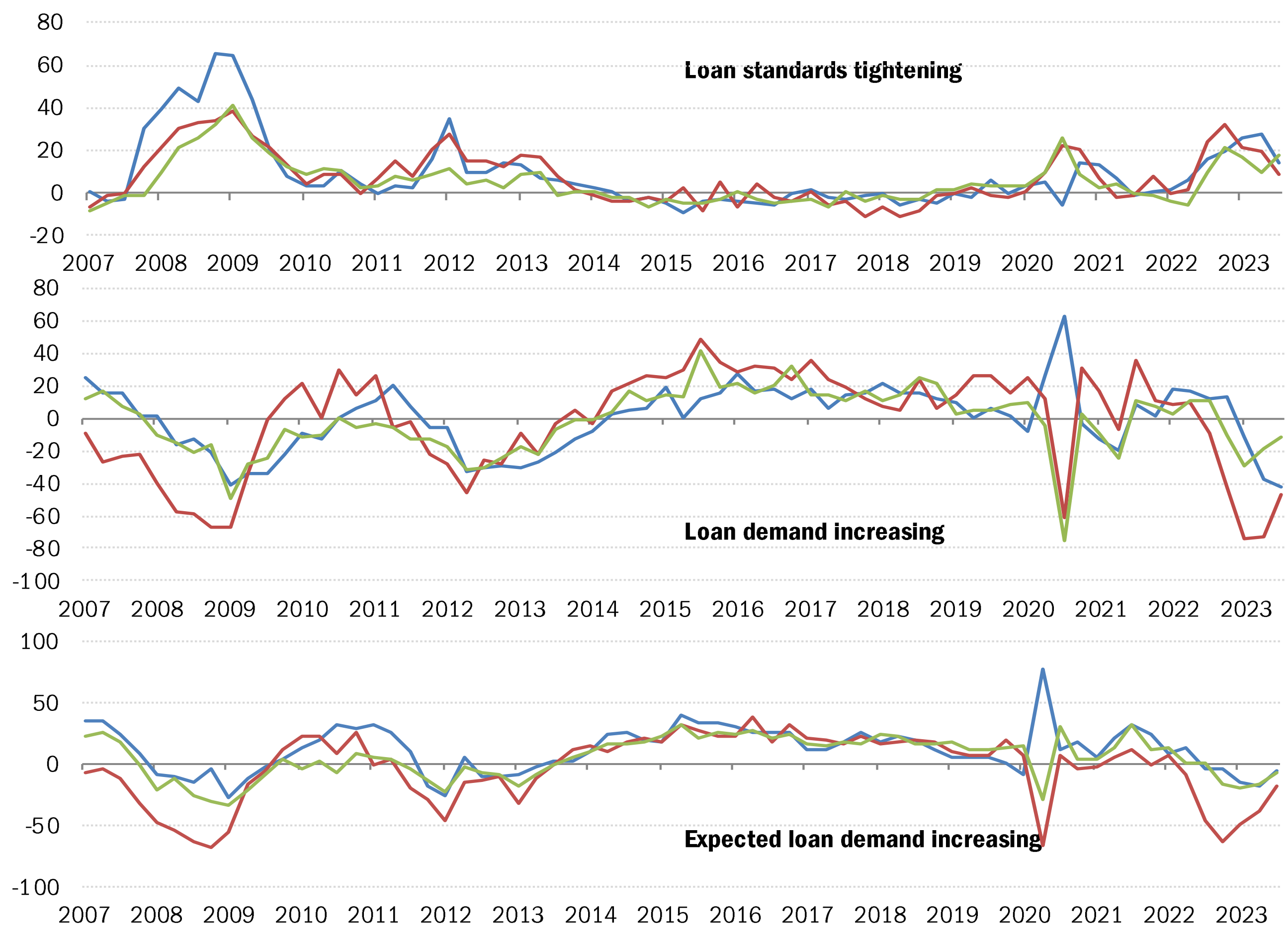
Loans to 1 year · Loans 1-5 years · Loans 5 years plus · Total



Source: ECB, TrendMacro calculations

Supply and demand for lending: ECB Bank Survey

Net number of banks reporting for: Enterprises · Home mortgage · Consumer

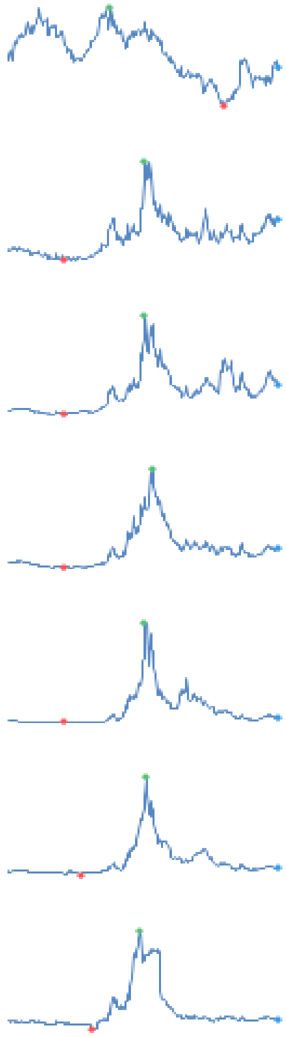


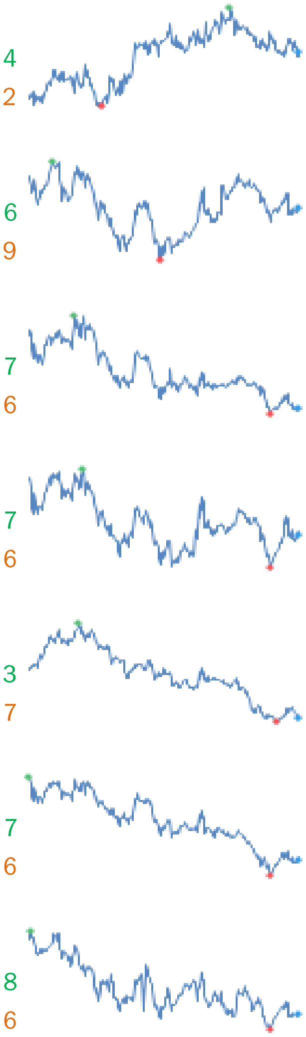
Source: ECB, TrendMacro calculations

Sovereign stress monitor: 10-year bond spreads

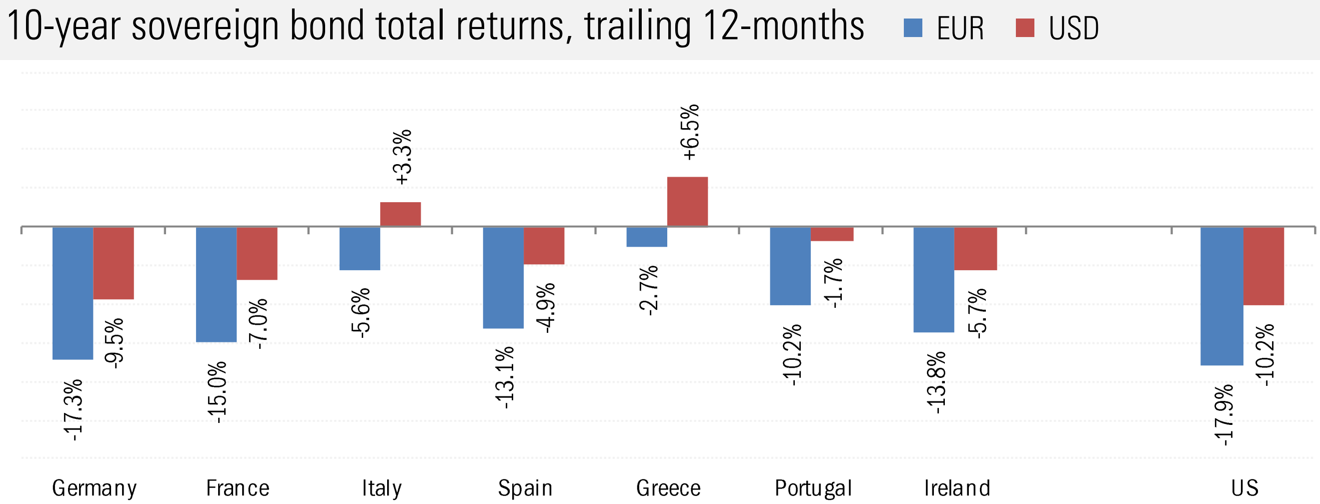
· High · Low · Last

	2000 to present			Trailing 12m	
Germany Spread to US, Last -1.41%	High 0.74%	Dec '08		High -0.98%	Apr 24
	Low -2.76%	Oct '18		Low -1.96%	Nov 2
France Spread to Germany, Last 0.53%	High 1.32%	Dec '11		High 0.63%	Aug 26
	Low -0.01%	Jan '05		Low 0.42%	Jan 19
Italy Spread to Germany, Last 1.63%	High 5.28%	Dec '11		High 2.53%	Sep 27
	Low 0.09%	Nov '04		Low 1.56%	Jun 16
Spain Spread to Germany, Last 1.02%	High 5.52%	Aug '12		High 1.22%	Oct 7
	Low -0.05%	Nov '04		Low 0.91%	Jun 16
Greece Spread to Germany, Last 1.29%	High 33.13%	Dec '11		High 2.84%	Oct 3
	Low 0.09%	Jan '05		Low 1.22%	Jun 27
Portugal Spread to Germany, Last 0.71%	High 14.61%	Jan '12		High 1.12%	Jul 27
	Low -0.54%	Jun '06		Low 0.64%	Jun 16
Ireland Spread to Germany, Last 0.40%	High 8.67%	Jun '11		High 0.67%	Jul 28
	Low -0.67%	Jun '07		Low 0.35%	Jun 16





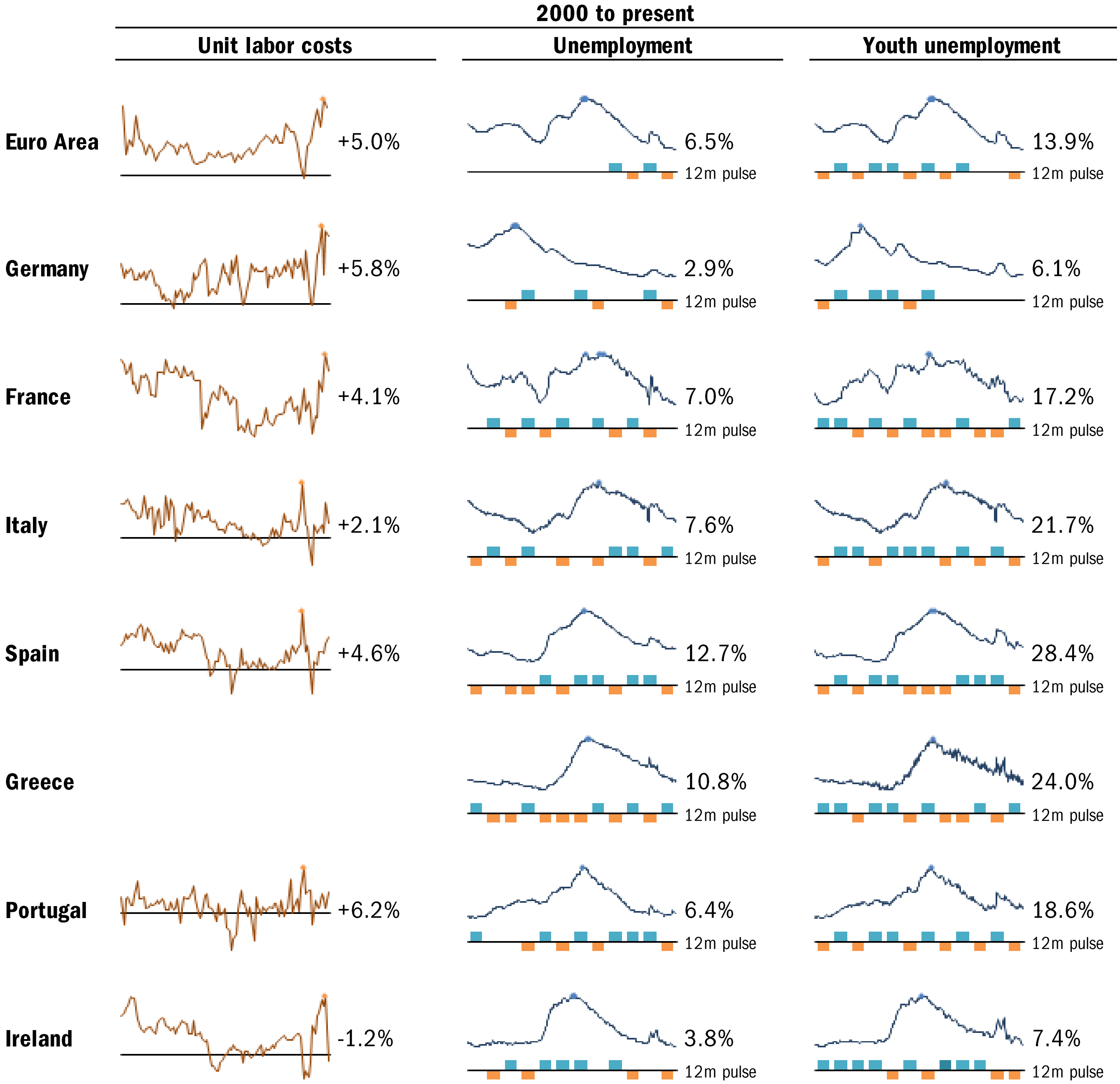
10-year sovereign bond total returns, trailing 12-months



Source: Bloomberg, TrendMacro calculations

Labor market in intensive care

ULC: Nominal, quarterly YOY UE: · High 12m pulse: monthly improvement or worsening in rate of change



Source: Eurostat, TrendMacro calculations

Purchasing Manager Indices

Manufacturing	Last	Prev	13-month history	***Services***	Last	Prev	13-month history
Eurozone Jul	42.7	43.4		Eurozone Jul	51.1	52.0	
UK Jul	45.0	46.5		UK Jul	51.5	53.7	
Germany Jul	38.8	40.6		Germany Jul	52.0	54.1	
France Jul	44.5	46.0		France Jul	47.4	48.0	
Italy Jun	43.8	45.9		Italy Jun	48.4	50.5	
Spain Jun	48.0	48.4		Spain Jun	53.4	56.7	
Ireland Jun	47.3	47.5		Ireland Jun	56.8	57.0	
Netherlands Jun	43.8	44.2					
Austria Jun	39.0	39.7					
Greece Jun	51.8	51.5					
Czech Rep Jun	40.8	42.8					

Source: Markit, TrendMacro calculations

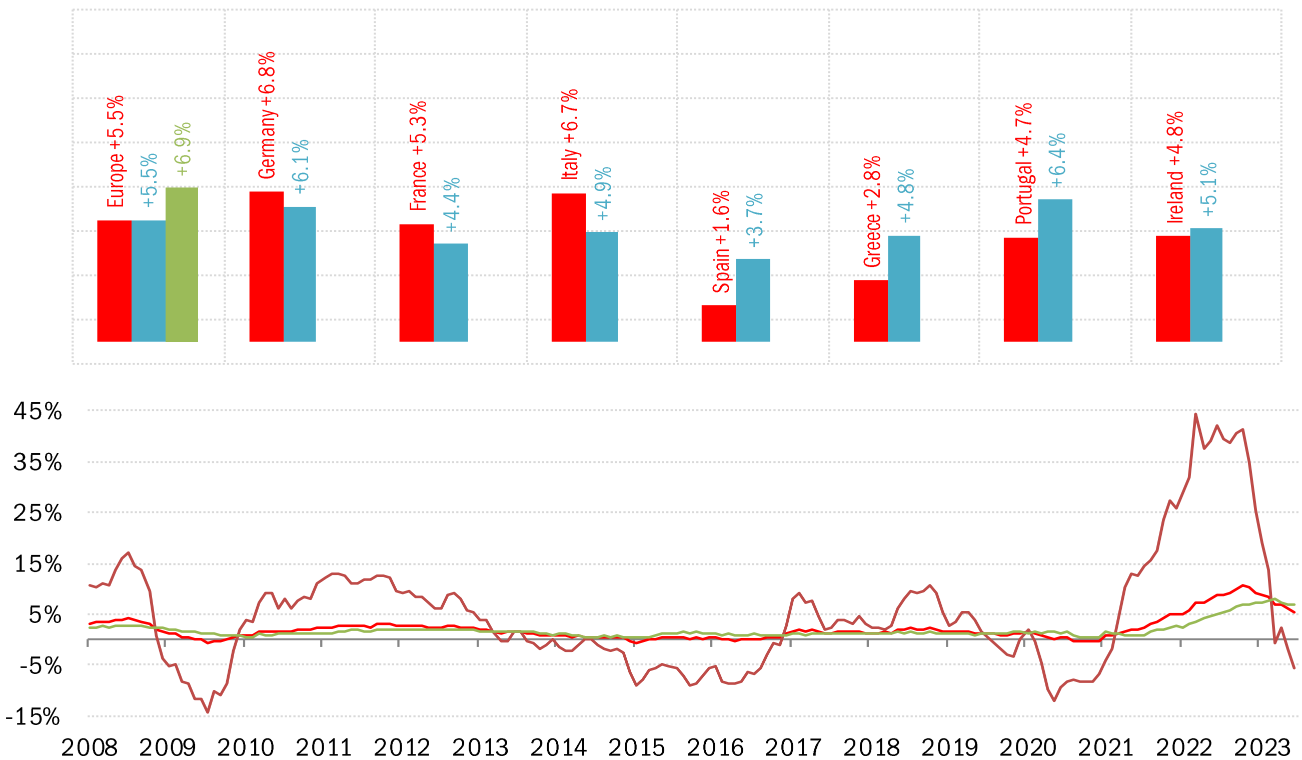
Regional currency flight

Euro vs Swiss franc · SNB FX reserves

Source: Bloomberg, TrendMacro calculations

Euro area consumer inflation, year on year

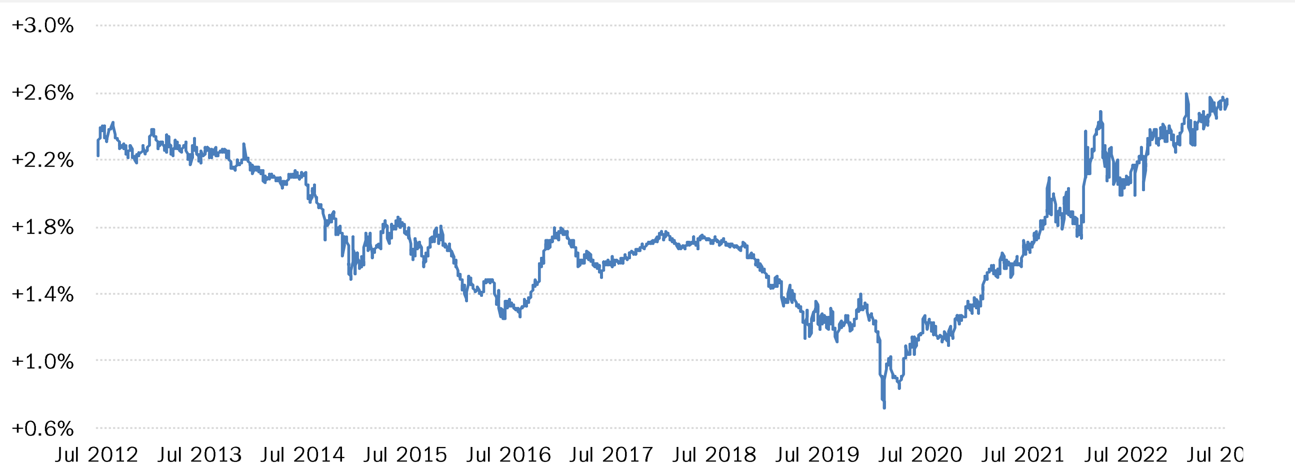
Country: Headline Ex-food and energy Ex-energy Euro area: Headline Energy Ex-energy



Source: Eurostat, TrendMacro calculations

Draghi's old dashboard:
Swap-implied inflation expectations since “Whatever it takes”

5-year inflation-swap rate, 5 years forward



Source: Bloomberg, TrendMacro calculations