Global Macroeconomic Monthly Review

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Key Issues and Table of Contents

The Global Economy – Overview (p. 4)

- *US GDP contracted in the second quarter of 2022, while in the euro bloc GDP increased above market expectations.*
- *However, high natural gas and crude oil prices are expected to intensify the energy crisis in Europe and the euro bloc economy is expected to enter into recession in the second half of 2022.*
- *Rising COVID morbidity in Japan is expected to lead to a slowdown in GDP growth.*
- *The Chinese economy has started to recover from the regional COVID lockdowns; however, economic growth in the third quarter of 2022 is expected to moderate.*
- *Inflation in the developed countries continued to climb at the end of the second quarter of 2022, while inflation in the OECD reached a double-digit rate in June.*
- *Inflationary pressures have led to a tightening in the monetary policies of the central banks, despite concerns of a substantial economic slowdown.*
- *These concerns have led to an inversion in the yield curve of the US; an opening of the yield differentials between the peripheral countries in the euro bloc, and Germany and France, which are considered to be strong and stable economies; as well as a reduction in the differential between the long- and short-term yields in Britain.*

United States (p. 8)

- *Real GDP in the US contracted 0.9% in the second quarter of 2022, following a contraction of 1.6% in the first quarter.*
- *Despite the contraction in GDP over two consecutive quarters, it appears the American economy has not entered into recession.*
- *The labor market remains strong, and the unemployment rate is still low.*
- *Housing demand weakened against the backdrop of rising mortgage rates, which have led to a substantial drop in the number of homes sold.*
- *In the July' interest rate statement, the Fed strengthened its hawkish stance and hiked the interest rate by an additional 75bps to 2.25% - 2.50%.*
- *Annual inflation dropped in July from 9.1% to 8.5%.*
- *Recessionary concerns led to a decline in the longer-term yields alongside a relative rise in the yields of short-term government bonds, which led to an inversion of the yield curve.*

Euro Bloc (p. 12)

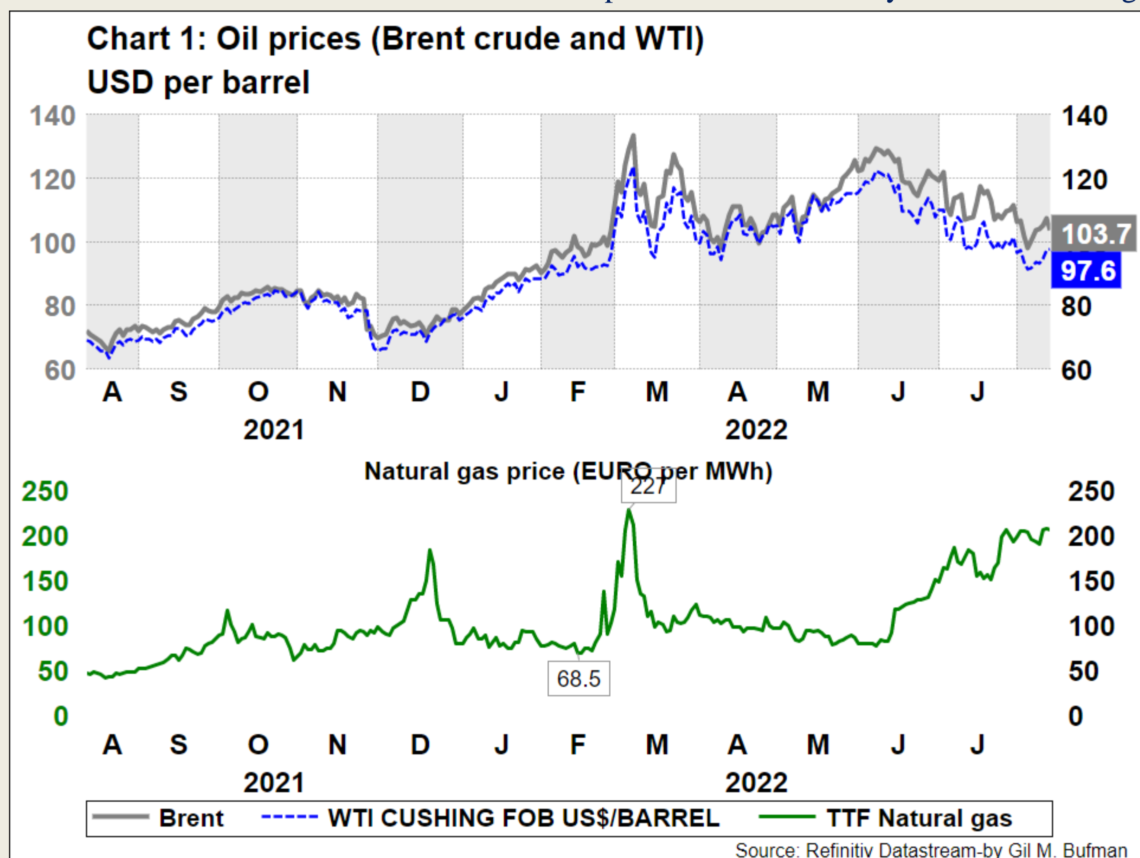
- *Euro bloc GDP increased more than expected in the second quarter; however, we estimate the euro bloc economy will enter into recession in the second half of 2022.*
- *Rising energy prices are heavily weighing on manufacturing and have led to a drop of consumer confidence.*

- *The Italian economy is entering the current crisis at a time of high uncertainty arising from the political crisis in the country, coupled with problematic debt/GDP dynamics that may worsen with the expected slowdown in economic activity.*
- *Annual inflation in the euro bloc continued to rise in the beginning of the third quarter of 2022, reaching a rate of 8.9%.*
- *The ECB hiked its interest rate by 50bps and unveiled its Transmission Protection Instrument (TPI) scheme for the purpose of preventing any additional significant expansion in yield spreads.*
- *Yields on the bonds of the largest euro bloc economies fell in July, against the backdrop of concerns regarding recession.*
- *The yield differentials between the bonds of Italy and those of Germany and France increased.*

<u>**The Global Economy -- Overview**</u>

Economic activity: US GDP contracted in the second quarter of 2022, while in the euro bloc GDP increased above market expectations. However, high natural gas and crude oil prices are expected to intensify the energy crisis in Europe and the euro bloc economy is expected to enter into recession in the second half of 2022. Rising COVID morbidity in Japan is expected to lead to a slowdown in GDP growth. The Chinese economy has started to recover from the regional COVID lockdowns; however, economic growth in the third quarter of 2022 is expected to be moderate.

- The GDP of the US contracted in the first half of 2022, representing two consecutive quarters; however, the economic indicators do not reflect a substantial recession in economic activity, as private consumption, exports, and the labor market all remain strong. On the other hand, in the euro bloc the GDP increased above expectations in the second quarter, while the GDP of Germany did not contract despite the effects of the energy crisis and the war in Ukraine. Yet, in the second half of 2022, the energy crisis in Europe is expected to greatly intensify and the euro bloc is likely to enter into recession; meanwhile, the economic slowdown in the US economy in the third and fourth quarters of 2022 is expected to be more moderate. The continuing intensification of tensions between China and Taiwan is likely to severely raise concerns in the markets and to lower the cooperation of Western corporations with China, which is likely to intensify the economic slowdown.
- The high energy prices across Europe (see Chart 1) are expected to continue to impact households and corporations in 2022-2023; however, the impact is expected to moderate in the second half of 2023 once the winter season passes. This is mainly because natural gas

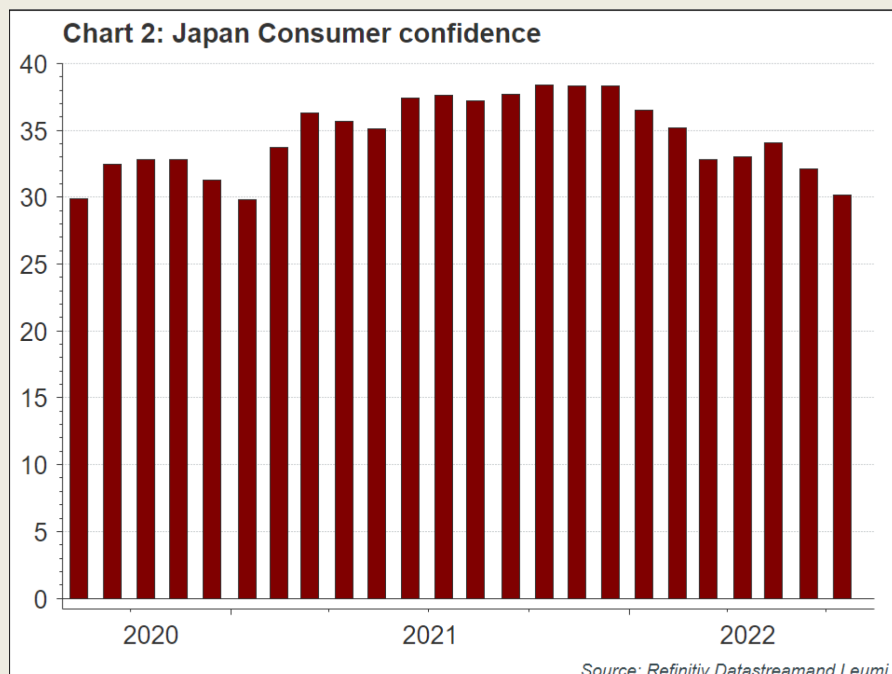


prices are expected to remain high, also in a scenario involving the signing of a nuclear deal with Iran, which is likely to ease the global surplus demand for oil. The energy shortage heightens the chances for an energy rationing policy with the start of the winter season, when household demand for natural gas rises. Such a policy is likely to mainly hurt the industrial manufacturing of European countries, especially those countries that do not have substantial alternative energy sources. The rise in energy prices is expected to cause households to forego other types of consumption, particularly in the winter season when household expenditures on energy increase, which is likely to cut into private consumption. The slowdown in private consumption, together with the expected negative impact on manufacturing, are expected to be factors that will lead the euro bloc economy into recession in the second half of 2022.

- In Britain, initial indicators show weakness in economic activity in the beginning of the third quarter of 2022. However, the slowdown is expected to be more moderate than the case in Germany and in the other large economies of the euro bloc. Britain is influenced as well by the sanctions imposed on Russia and the rise in prices to consumers, which are expected to weigh on the consumption of households. Despite worries regarding the global economic slowdown, the consumer confidence survey indicates the expectation for an increase in investments and for rising employment. This development supports the hypothesis that the slowdown in Britain's economic activity will be more moderate than in the euro bloc countries, despite expectations that the inflation rate will continue to rise to a double-digit rate during the final quarter of 2022. We estimate UK GDP growth in 2022 will still be positive for the year; however, there is a very substantial risk of recession in 2023.
- In Japan, the drop of consumer confidence in the beginning of the third quarter (see Chart 2), coupled with the rise in morbidity due to a renewed spread of the coronavirus, are expected to lead to a slowdown in private consumption in the third quarter of 2022. This slowdown in household consumption is expected to keep the GDP level around the level it was at in the end of 2019, prior to the initial spread of the coronavirus. This situation requires the central bank of Japan to maintain its expansionary monetary policy, in contrast to the trend of tightening monetary policy occurring in the large economies around the world.
- In India, the picture appears different compared to the developed countries. Preliminary indicators show a continued growth in manufacturing in the beginning of the third quarter of 2022, coupled with slower growth in services. This comes against the backdrop of an easing in the inflationary pressures that stems from, among other things, easing in the energy and food components. India is expected to be less exposed to the crisis in the energy market, despite the fact that India is the third largest oil importer in the world, since the country has started to purchase energy from Russia at reduced prices. However, the expected slowdown in global activity is likely to adversely affect India's exports, due to declines in external demand, which will lead to a slowdown in the growth rate of India's GDP.
- The GDP of China contracted 2.6% in the second quarter of 2022 (q/q, seasonally adjusted), this being the first contraction in the Chinee economy since the outbreak of the coronavirus crisis in the first quarter of 2020. This was mainly due to the lockdowns that were enforced in areas throughout the country experiencing a breakout of the coronavirus pandemic during March-May, which hurt the economic activity of manufacturing and services in these areas.

The economic recovery of the country in the third quarter is expected to be relatively slow, due to the effects of the slowdown in global growth and the inflationary pressures around the world. The Chinese labor market started to recover during the second quarter of 2022; however, the unemployment rate remains slightly higher than that in the final quarter of 2021. In addition, imports remain slightly below the level from the second half of 2021, which indicates the economy has still not fully recovered.

- Looking ahead, the continuation of heightened inflationary pressures, together with the energy crisis, are expected to be the main factors that will negatively affect the economic growth rate in the second half of 2022 and the beginning of 2023. The impact on European countries is expected to be more severe, and the euro bloc economy is expected to contract in the second half of 2022. Growth in the US is expected to slow substantially as well, yet it appears the US will not enter into recession. The Japanese economy is also expected to slow, against the backdrop of high morbidity in the country that is expected to affect private consumption. On the other hand, the Chinese and Indian economies are expected to continue to grow in the second half of 2022, with a slowdown in the growth rate of exports due to the expected weakness in external demand from the developed economies. The International Monetary Fund (IMF) revised downward in July 2022 its growth forecasts for the developed economies, against the backdrop of heightened inflationary pressures and the rise in risks in the markets. In the IMF's opinion, global GDP will increase 3.2% in 2022, and by 2.9% in 2023. The GDP of the US is expected to increase this year by 2.3%, and in 2023 by 1.0%. The GDP of the euro bloc is expected to grow in 2022 and in 2023 by 2.6% and 1.2%, respectively. The GDP growth forecasts for China and India were revised downward as well. In contrast, the GDPs of the South American countries, especially Brazil and Mexico, were revised upward; however, these are expected to increase by a rate below the average of the developing countries. The GDP of Russia is expected to contract 6.0% in 2022. This forecast is 2.5 percentage points greater than the previous forecast, indicating that the damage to the Russian economy resulting from sanctions is expected to be more moderate compared to the



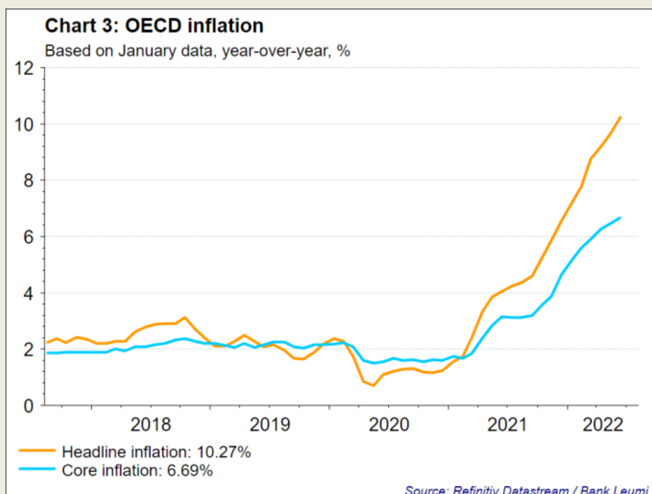
initial estimates. Russia is expected to be the only economy that is expected to experience a contraction in GDP also in 2023, whereas in all the other countries there is expected to be economic growth next year. In our view, growth is expected to be more moderate. Global GDP is expected to grow in 2022 by 2.6% and by 2.3% in 2023. US GDP is expected to grow in 2022 by 1.7% and in 2023 by 0.7%, while Euro area GDP is expected to grow in 2022-2023 by 2.8% and 0.9%, respectively.

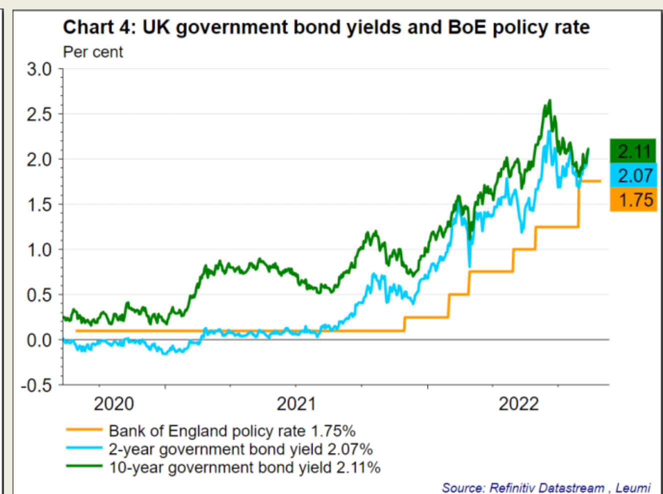
Inflation and monetary policy: inflation in the developed countries continued to climb at the end of the second quarter of 2022, while inflation in the OECD reached a double-digit rate in June. Inflationary pressures have led to a tightening in the monetary policies of the central banks, despite concerns of a substantial economic slowdown. These concerns have led to an inversion in the yield curve of the US; an opening of the yield differentials between the peripheral countries in the euro bloc, and Germany and France, which are considered to be strong and stable economies; as well as a reduction in the differential between the long- and short-term yields in Britain.

- The inflation rate in developed countries continued to rise at the end of the second quarter of 2022, with an additional increase occurring in the beginning of the third quarter. In the US, the annual inflation rate reached 9.1% in June, but decrease in July to 8.5%, while in the euro bloc inflation rose in June to an annual rate of 8.9%. Price increases occurred in most of the components, with an emphasis on energy and food. In addition, the average annual inflation in the OECD increased in June to a double-digit rate of 10.3% (see Chart 3), reflecting the largest rise in prices since 1988. In approximately one-third of the OECD countries annual inflation is at a double-digit rate. Core inflation in the OECD increased more moderately, reaching an annual rate of 6.7% in June, indicating that the rise in prices is also occurring in the core components and any moderation in inflation in 2023 is expected to be slow.
- The rise in inflation over time is leading to a tightening in monetary policy by the central banks, despite concerns regarding a substantial economic slowdown in the second half of 2022. The US Fed hiked its federal funds rate by 75bps in July to a range of 2.25-2.50%, and additional rate hikes are expected in each of the remaining FOMC meetings in the second half of 2022, such that by year-end 2022 the Fed interest rate will reach to around 3.5%. The ECB as well initiated a round of rate hikes with a 50bps increase in July, above the expectations in the market. In the euro bloc as well, additional rate hikes are expected in the upcoming monetary committee meetings; however, the pace of rate hikes by the ECB is expected to be more moderate compared to that of the Fed and the interest rate in the euro bloc is expected to reach 1.00-1.50%.
- In England, the central bank hiked its interest rate 50bps to 1.75%, and additional rate hikes are expected until the rate reaches 3.00%. This is due to the rise in inflation that reached an annual rate of 9.4% in June, above the expectations in the market, and also above the forecasts of the central bank of England. Inflation is expected to continue to climb in September-October, and perhaps even to reach a double-digit rate, which supports a continuation of tight

monetary policy despite the substantial slowdown in economic activity. The monetary tightening is expected to be expressed through continued rate hikes, coupled with the sale of government bonds that the central bank holds in reserves.

- Concerns regarding a substantial economic slowdown have led to a decline in yields to maturity on US government bonds and to an inversion in the yield curve. Concerns about a recession in the euro bloc, against the backdrop of expectations for an intensification of the energy crisis in Europe, led to declines in the yields of the long-term bonds of the larger economies of Europe. In addition, the yield differentials between Italy, and Germany and France, widened as well, this due to structural problems in Italian debt that raise the risk of a debt crisis in Italy with the intensification of the economic crisis and the slowdown in growth. These yield differentials reflect the expectations for different effects from the interest rate hikes and from the energy crisis on the various economies in the euro bloc. A similar trend of declining yields exists also in Britain, where the yields on the short- and long-term government bonds fell throughout July (see Chart 4), while the drop in the long-term yields was larger. Meanwhile, the differential between the yields of the government bonds with durations of two years and of 10-years narrowed; however, the yield curve did not invert.





<u>United States</u>

Economic activity: Real GDP in the US contracted 0.9% in the second quarter of 2022, following a contraction of 1.6% in the first quarter. Despite the contraction in GDP over two consecutive quarters, it appears the American economy has not entered into recession. The labor market remains strong, and the unemployment rate is still low. Housing demand weakened against the backdrop of rising mortgage rates, which have led to a substantial drop in the number of homes sold.

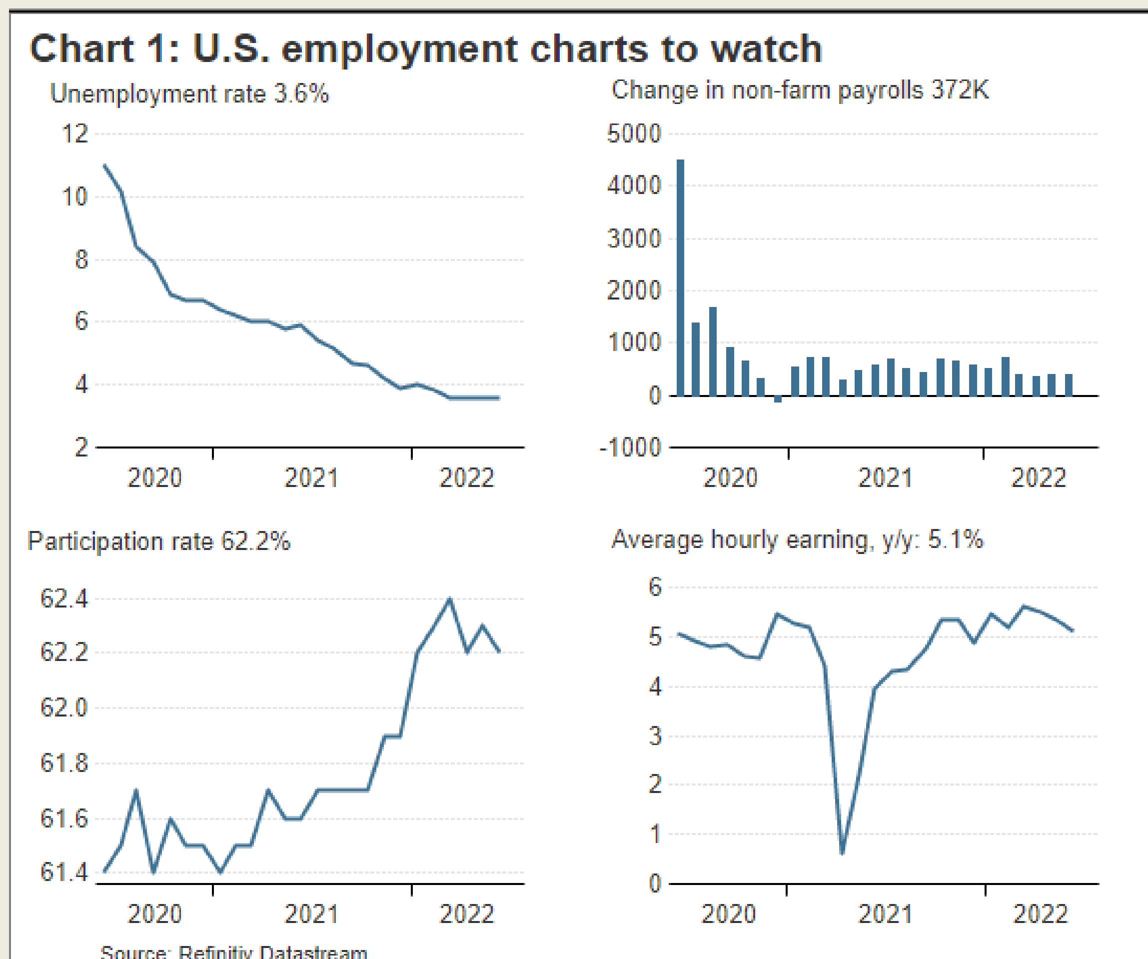
- The real GDP of the US contracted by an annual rate of 0.9% in the second quarter of 2022, after it had contracted also in the first quarter, by an annual rate of 1.6%. This is the initial estimate, which is expected to be revised toward the end of August. This decline partially reflects technical factors, with an emphasis on an extraordinary drop in inventories in the

private sector, and it also stems from a contraction in real economic factors, such as declines in investments and government expenditures. In the first quarter of 2022, there was also an unusual impact from the opening of the ports and the rise in imports on GDP, which fell as a result of an extraordinary jump in imports.

- These factors offset the rise in exports and in private consumption. The rise in private consumption stemmed from an increase in the consumption of services that more than offset the decline in the consumption of goods. The increase in imports, which represents a factor that lowers the calculation of GDP, hampered the growth rate. The rise in imports stemmed from the easing in the logistical restrictions on the ports. However, export growth was greater than the growth in imports, and net foreign trade had a positive contribution to the GDP.
- The contraction in real GDP in two consecutive quarters represents a popular definition of a recession. However, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), which is authorized to identify the peaks and troughs of the business cycles of economic activity and to declare a recession, defines a recession as a substantial drop in economic activity that spreads across the sectors of the economy and continues for more than several months. The committee analyzes a wide variety of indices, with a large emphasis on the labor market and on employment, as well as on manufacturing indices and the revenues of the domestic market. The great importance of the indices of the employment market, and particularly the monthly employment data, stems from the fact that there is an overlap between employment peaks and the peaks in business activity. Occasionally, the rise in the unemployment rate precedes the peak in economic activity, such that it is possible the unemployment rate will rise together with continued growth of activity, yet the growth will be by a rate below the regular trend. Furthermore, the unemployment rate tends to continue to climb also after economic activity has reached a low within the business cycle, and it reaches its peak only a number of months after the business cycle in economic activity has reached a trough.
- Despite the contraction in GDP, the labor market remains strong, and in particular, the unemployment rate remained at its low level of 3.6% in March-June, after in the beginning of 2022 it continued the downward trend it had been experiencing over the last two years (see Chart 1). Consequently, we estimate the committee of the NBER will not immediately declare the economy is in recession, unless new data will be released that support this, with an emphasis on data that will indicate weakness in the labor market. Additional support for this estimate that the economy is still not in recession can be found in the data on domestic purchases by the private sector, which increased in the first half of 2022. This figure excludes the effects of inventory and foreign trade that were heavily affected by the supply disruptions during the coronavirus crisis. Furthermore, the weakness in activity is not broad and there are sectors of the economy in which activity continues to grow, such as the manufacturing sector and industrial exports.
- Consequently, a few additional months are required in order to confidently determine if the economy has indeed entered recession, or instead if it is only a substantial slowdown in the growth rate. However, the slowdown in real GDP is expected to influence the interest rate decisions of the Fed more quickly, and this development is expected to be a factor that

moderates the pace of rate hikes in upcoming FOMC meetings, in the event the rise in inflation expectations will not intensify.

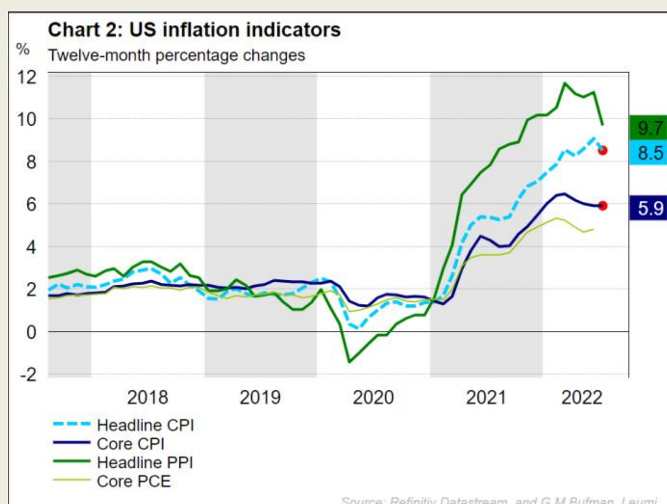
- New home sales contracted in each month in the first half of 2022, while existing home sales contracted as well in the months February-July 2022, reaching their lowest level of the last two years, even falling below their level from before the outbreak of the coronavirus crisis. This decline in sales stems mainly from the rise in mortgage interest rates, which stems primarily from the rise in the financing costs of credit suppliers due to the Fed interest rate hike that has led to an increase in the yields on US government bonds. The average rise in interest rates on 30-year mortgages accelerated in March-June 2022, peaking at the highest rate seen since the end of 2008, or 5.8%, compared to an interest rate of just 3.1% at the end of 2021. In our view, the continuing rise in interest rates, as is expected, will continue to negatively affect home sales, which will lead later on to a substantial slowdown in the rate of price increases on housing, and is likely to also lead to a complete halt in the rise in prices.
- Looking ahead, the weakness in economic activity is expected to continue in the coming months, yet the American economy will apparently not slide into a broad recession. Economic activity in the housing market is expected to remain weak in the coming months, against the backdrop of the continuing rise in interest rates, which is expected to lead to declining demand. In our view, the GDP of the US will grow 1.7% in 2022, while in 2023 the growth rate is likely to moderate further as the GDP is expected to increase just 0.7%. However, the existing risks in the market are likely to lead to more moderate growth in 2022.

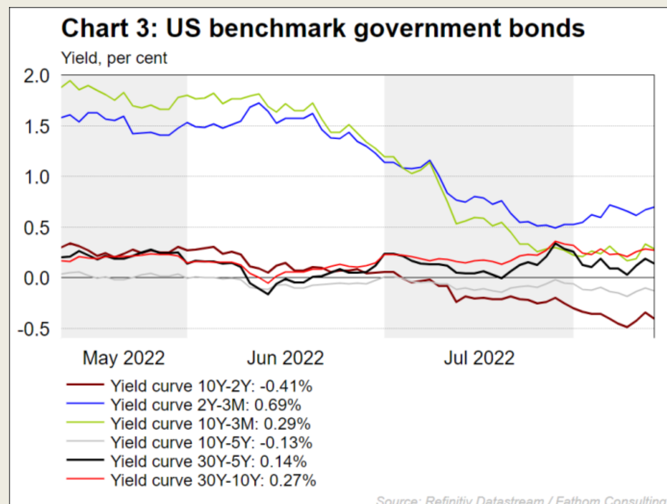


Inflation and monetary policy: in the July interest rate statement, the Fed strengthened its hawkish stance and hiked the interest rate by an additional 75bps to 2.25% - 2.50%. Annual inflation dropped in July from 9.1% to 8.5%. Concerns regarding a recession led to a decline in the longer-term yields alongside a relative rise in the yields of short-term government bonds, which led to an inversion of the yield curve.

- Inflation over the trailing 12-month period decrease in July from 9.1% to 8.5% (see Chart 2) and there is a high likelihood of another decrease in August. the decrease was mainly due to the decrease in the fuel price and a further decrease in the energy component is expected in August, due to the decrease in crude oil prices. However, food prices continued to rise in the beginning of the third quarter of 2022. Core inflation, which does not include food and energy, increased in July by a monthly rate of 0.3%, yet on an annual basis it remined unchanged at a rate of 5.9% against the backdrop of the significant drop in airline fares. The decline in annual inflation rate is expected to continue in the second half of 2022, which may signal that inflation has peaked. However, developments in the energy crisis in Europe may affect the global oil price and consequently slow down the decline in energy price for consumer in the US, which may lead to a slower decline in the inflation rate.
- In the July interest rate decision, the Fed hiked rates by 75bps to a range of 2.25-2.50%. The decision to hike the interest rate by this amount occurred against the backdrop of the continuing rise in the annual inflation rate in the US, which reached 9.1% in June, coupled with an additional increase in inflation expectations in the market.
- In our view, the initial signs of a decline in the inflation rate, stemming mainly from the drop in the price of gasoline to consumers, coupled with the weakness in economic activity, will lead to the Fed being more cautious in its approach toward hiking the interest rate in the upcoming monetary committee meetings through the remainder of this year. The main focus of the Fed is on lowering the inflation rate to the target of 2%, such that the monetary committee is expected to continue to hike the rate in each of the upcoming meetings to a level of about 3.50% by year end-2022. In the medium-term, in the event inflation will indeed fall in the coming year, then there will be room to lower the nominal interest rate back down closer to the long-term rate, which the Fed defines as 2.5%.
- The concerns regarding recession increased the demand for short-term US government bonds and lowered the demand for the long-term bonds of the US. Consequently, short-term yields (3-months and 2-years) increased throughout July, whereas long-term yields (5- and 10-years) fell over the course of the last month. Yields on 30-year bonds fell as well, yet more moderately compared to the declines in the 5- and 10-year yields. These changes in the market led to a substantial decline in the steepness at the short and medium portions of the yield curve (see Chart 3), while a portion of the curve (2Y-10Y, 5Y-10Y) actually inverted in the second week of July and remained inverted during the whole month. These developments reflect the concerns of investors regarding the economy's slide into a slowdown. In contrast, the longer end of the curve (5Y-30Y, 10Y-30Y) did not invert and the steepness of the curve at this section even increased during the second half of July. This development indicates the market's belief that even if the economy will enter into a marked slowdown, this not expected to be deep and extended. In our view, the concerns in the market

regarding recession are expected to continue to affect the market in the coming months, and we estimate the yield curve will remain inverted in the second half of the year and the yields of bonds with durations of 10 years will remain within a range of 2.6-3.0%.





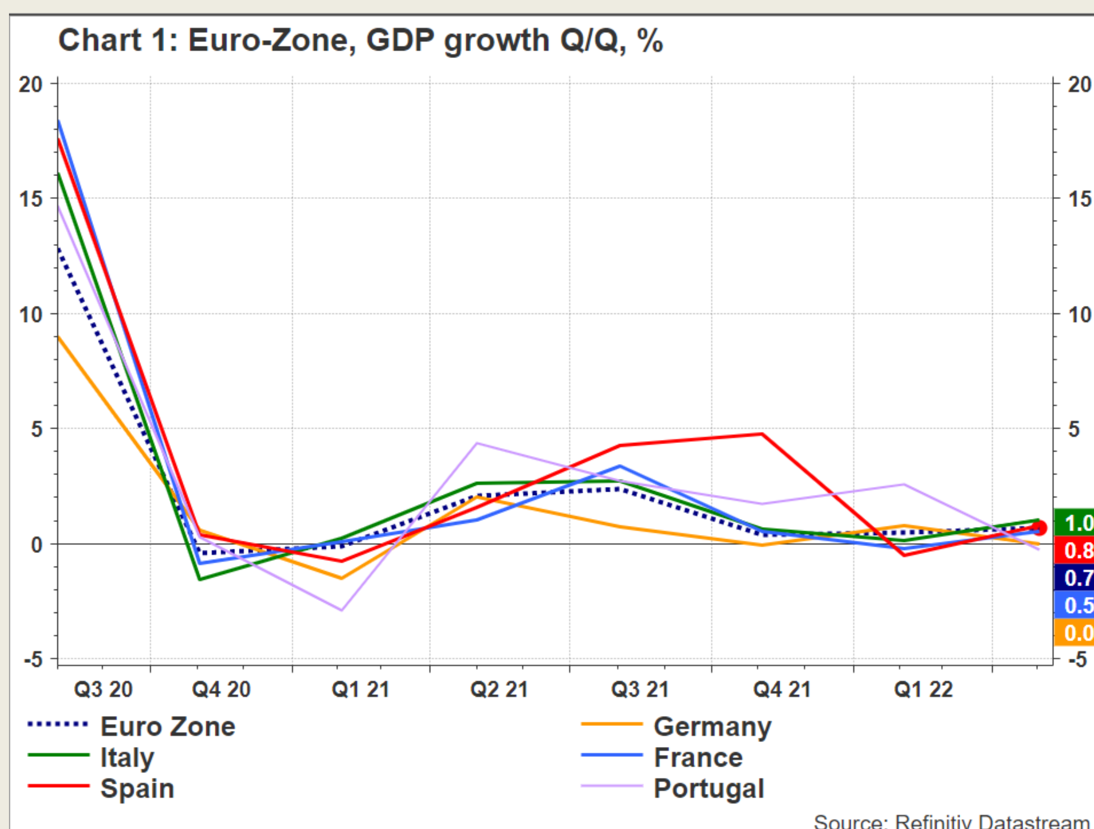
The Euro Bloc

Economic activity: euro bloc GDP increased more than expected in the second quarter; however, we estimate the euro bloc economy will enter into recession in the second half of 2022. Rising energy prices are heavily weighing on manufacturing and have led to a decline in consumer confidence. The Italian economy is entering into the current crisis at a time of high uncertainty arising from the political crisis in the country, coupled with problematic debt/GDP dynamics that may worsen with the expected slowdown in economic activity.

- The GDP of the euro bloc increased 0.7% in the second quarter of 2022 (q/q, see Chart 1). This growth is substantially greater than the forecasts in the market that had expected a moderate increase of around 0.2% (q/q), alongside even more pessimistic forecasts. In our view, this latest growth figure does not provide a good indication of the state of the economy later this year, and we forecast the euro bloc economy will enter into recession in the second half of 2022. This is due to the lack of any real solutions to the energy crisis in Europe, which is expected to worsen greatly in the upcoming winter season when household energy demands will increase. The situation may bring the European economy to an extreme state of energy rationing for factories, and as a result, economic activity will suffer. This concern is reflected in natural gas prices in Europe, which have risen to record levels of over €200 per MWh. The increase in energy prices, with an emphasis on natural gas, is expected to burden households and the manufacturing sector, and together with expectations for interest rate hikes by the ECB, a substantial slowdown in the economic activity of the euro bloc is expected in the coming months.
- In a country breakdown, Germany's GDP in the second quarter of 2022 remained unchanged compared to the first quarter, contrary to forecasts that expected the effects of the war in Ukraine and the energy crisis would lead to a certain contraction in German GDP. In France

and Italy, GDP increased in the second quarter by 0.5% and 1.0% (q/q), respectively, rising more than 1% above their year-end 2019 levels, prior to the coronavirus outbreak. In Spain, GDP grew in the second quarter of 2022 by 1.1% (q/q), yet remains approximately 2.6% below the GDP level before the spread of the coronavirus. This development indicates that this strong growth is still the result of the economy's recovery from the economic crisis that hit Spain more severely than the other major economies in the euro bloc.

- The rise in energy prices is severely weighing on German manufacturing. Consumer confidence fell in the beginning of the third quarter, and the composite PMI and the Ifo business climate index for Germany both fell in July, indicating the German economy is in a deep slowdown. This is due to the high energy prices, especially the rise in natural gas prices throughout Europe, and concerns regarding an intensification of the energy crisis in Europe in the coming months. These concerns have led to declines also in the services, trade, and construction components, which indicate that the slowdown in activity is occurring in most of the sectors of the economy.
- The political crisis in Italy heightens the degree of uncertainty in the country, and it appears the center-right coalition is strengthening its power as elections approach. However, we estimate that in contrast to what occurred in the 2018 elections, the government that will be elected is not expected to raise doubts on the agenda regarding Italy's continued membership in the euro bloc. This is in light of the change in the approach of the politicians and the public with respect to the advantages of continued membership in the euro bloc during this difficult economic period. In our view, the government that will be chosen is expected to implement loose fiscal policy and to firmly pass substantial reforms. Consequently, Italy is likely to lose some access to assistance funds from the European Union (EU). The elections process is



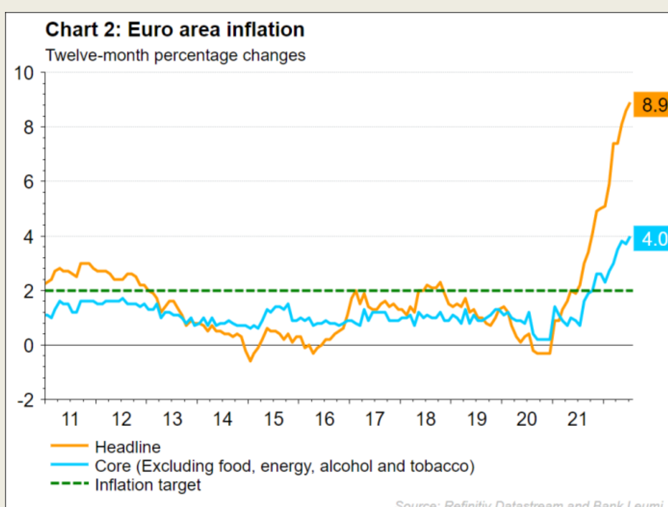
expected to delay the implementation of the economic recovery fund, which is likely to weigh on growth in the second half of 2022 and in 2023. This slow growth, coupled with the rise in yield differentials, which we will detail later on, is expected to hamper Italy's ability to reduce its debt/GDP ratio, particularly during 2023, and together with the increase in the fiscal deficit – the public debt / GDP ratio is expected to continue to climb in 2023. The deterioration in the Italian debt forecast represents the largest challenge to the Italian economy in the medium-term.

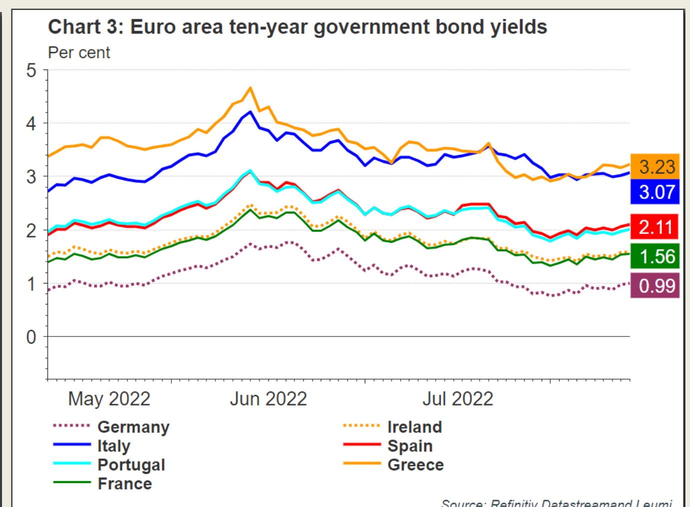
- Looking ahead, the energy crisis in Europe is expected to intensify with the start of the winter season, and to substantially hamper economic activity. The most adversely affected from this situation are expected to be the countries with a high dependency on the supply of natural gas, and those economies in which industrial manufacturing represents a substantial proportion of GDP. The International Monetary Fund (IMF) lowered its GDP forecast for the euro bloc. According to the revised figures, the GDP of the euro bloc will grow 2.6% in 2022 and by 1.2% in 2023. In our view, growth is expected to be more moderate and Euro Area GDP will increase by just 0.9% in 2023. The GDP of Germany is expected to increase only slightly in 2022, representing the lowest growth rate among the largest euro bloc economies. In 2023, Italy is expected to grow 1.1%, and Germany is expected to grow by 0.7%. Economic growth risks appear to tilted to the downside.

Inflation and monetary policy: annual inflation in the euro bloc continued to rise in the beginning of the third quarter of 2022, reaching a rate of 8.9%. The ECB hiked its interest rate by 50bps and unveiled its Transmission Protection Instrument (TPI) scheme for the purpose of preventing any additional significant expansion in yield spreads. Yields on the bonds of the largest euro bloc economies fell in July, against the backdrop of concerns regarding recession. The yield differentials between the bonds of Italy and those of Germany and France increased.

- The consumer price index used in the euro bloc, the harmonized indices of consumer prices (HICP), continued to climb in June, and the initial estimate for July indicates an additional increase in inflation as well, to an annual rate of 8.9% (see Chart 2). This increase stems mainly from energy prices, which rose in July slightly more moderately compared to June, coupled with the rise in food prices. Due to government intervention, the rise in energy prices was moderate compared to the rise that should have occurred in light of the surplus demand for natural gas in Europe. The strong demand for natural gas indicates that additional fiscal support is required in order to prevent an increase in energy expenditures by households, particularly in the final quarter of this year and in the beginning of 2023. In our view, even in an optimistic scenario involving a decline in energy prices in the second half of 2022, in annualized terms the prices are still expected to remain high. In addition, the acceleration in inflation in the food components is expected to continue in the near term, despite the decline in agricultural commodities prices. Furthermore, the annual inflation in the non-energy goods and in the services components continued to increase as well, which contributed to the rise in July's core inflation to 4.0%. These data indicate that the problem of inflation is widespread and any moderation in the rise in prices is expected only later on and in a gradual manner.

- In the July monetary meeting, the ECB hiked the central bank interest rate by 50bps, above the expectations that were in the market prior to the announcement. In our view, the ECB will continue to hike interest rates also in the upcoming meetings by an additional 100-150bps. This decision led to an increase in the interest rates on deposits from minus 0.5% to 0%, and expectations in the market indicate the interest rate on deposits will continue to climb until reaching 1.00-1.50%, and perhaps even above this range.
- The ECB's rate hike increases the risk on the debt of Italy, which is one of the three strongest economies of the euro bloc. This move by the ECB also raises the risk on the debt of the peripheral countries of Europe, with an emphasis on Greece, Spain, and Portugal. In order to prevent a debt crisis, the ECB unveiled its TPI scheme, which is designed to deal with extreme situations involving the spreads between the yields on the bonds of the weak economies and the yields on the bonds of the strong economies in the euro bloc. We note that the TPI is intended to prevent further substantial broadening of the yield spreads, but not to narrow the existing spreads in the market.
- The implementation of this tool and the scope of intervention through its usage will be in accordance with the subjective decisions of the ECB regarding the level of the spreads and their rate of increase that justifies the use of the TPI. The main advantage of the TPI is that the scope of purchases through its framework is determined in advance, and thus in this manner the ECB is able to signal to the markets the degree of aggressiveness, and this process strengthens the effectiveness of the ECB's intervention in the markets. This is in contrast to the strategy of recycling bonds purchased during the coronavirus period within the framework of the Pandemic Emergency Purchase Program (PEPP). Under this scheme, through which the ECB redeems the bonds of the stronger governments, such as Germany, France, and Holland, and purchases the bonds of the weaker economies, the moves by the ECB are known to the market only after the fact, and the absence of transparency lowers the efficiency of this strategy.
- Bond yields in the euro bloc fell throughout July (see Chart 3), against the backdrop of concerns about recession in the second half of 2022. The yield differentials between the bonds of Italy and the bonds of Germany and France widened in July against the backdrop of concerns about a debt crisis in Italy, despite the unveiling of the ECB's TPI scheme. This





increase in spreads still reflects the expectations that the effects of the interest rate hikes will be inconsistent across the various countries in the euro bloc. In our view, as long as concerns in the markets will increase with respect to the long-term risks, there is likely to be a substantial short-term impact on the bond spreads of Italy and of other peripheral countries in Europe. Apparently, substantial steps will be needed on the part of the EU leadership and the ECB in order to deal with the upcoming challenges, and there may also be a need for increased "fiscal unity" and for purchase arrangements of government debt by the ECB.

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