

# Italy to play low 2019 deficit card to avoid EU procedure



EU Commission threatened Rome with disciplinary steps; 2019 deficit could be 2% of GDP or lower, officials say; league economics chief says 1.8% is possible; coalition still undecided how to use savings emerging Reuters Rome Italian coalition officials say the country's public accounts are throwing up positive surprises this year, strengthening Rome's hand as it tries to ward off a possible Euro-pean Union disciplinary procedure. Recent data suggest the deficit this year will not only be below the European Commission's forecast of 2.5% of gross domestic product (GDP) but could even be below the 2.04% agreed with Brussels in December, two senior coalition members said. However, it remains to be seen how far the anti-austerity government will actually slash its current 2.4% target, because some in the 5-Star Movement, one of the

two ruling coalition parties, want the savings that are emerging to be quickly spent on new expansionary measures.

The other ruling party, the League, is pushing for deep tax cuts, but only from 2020. It is also not certain that an unexpectedly low 2019 deficit would be enough to convince Brussels that Italy's finances are on a sustainable path. But the latest data at least give Rome fresh arguments – something that looked impossible a few months ago. The Commission on Wednesday paved the way to disciplinary steps against Italy, complaining that its debt had risen in 2018 instead of falling and would continue to do so. It said Rome had also not reined in its annual budget deficit as promised in 2018 and would continue to run excessive deficits this year and next. A disciplinary procedure, which could eventually end in fines, had already been averted at the last moment in December when Italy cut its original 2.4% deficit target for this year to 2.04%, with the agreement of the Commission. In April, Italy restored the original 2.4% target because of a slump in growth, while the Commission forecast 2.5%.

Prime Minister Giuseppe Conte surprised observers when he said on Wednesday, in response to the Commission, that a deficit of 2.1% was possible. But now, senior officials in the government of the right-wing League and the anti-establishment 5-Star say it could be even lower. Claudio Borghi, the League's economics chief, told Reuters 1.8% was possible if current trends continue. The main reason for the surprise trend is that two flagship government measures – an early retirement option and a new means-tested welfare benefit – are proving less popular, and therefore less costly than expected. Taken together, it now looks as if the combined cost of the two policies will be €4bn (\$3.4bn) less than was set aside in the 2019 budget, Borghi said.

This estimate was confirmed by a government member closely involved in economic policy, who asked not to be named. Borghi said tax amnesties allowing people to settle disputes with the

authorities by paying a limited sum had yielded more than expected, as had measures against tax evasion. Among these, the requirement from January this year that a copy of virtually all transactions must be transmitted electronically to the taxman produced squeals of protest from companies but has bolstered sales tax revenues. State coffers have also been swelled by out-of-court settlements with several large multinationals accused of tax evasion, the largest of them a €1.3bn deal with Kering, the holding company of fashion house Gucci.

A senior Treasury official declined to confirm Borghi's 1.8% 2019 deficit projection but said it now looked "possible" that the deficit would be 2% or lower. Public finance data so far this year has been encouraging. The central government deficit for the first four months was just €1.5bn above last year's equivalent figure – below the trend projected in Rome's 2019 Stability Programme, which forecasts that the full-year deficit would rise by €16bn. Tax revenues through April were up 1.0% year-on-year despite a stagnant economy, compared with an official full-year target of 0.6% growth. In addition, dividend payments by the central bank and state-owned enterprises will also exceed the projections in the Stability Programme by more than 0.1% of GDP, the Treasury said in documents sent to Brussels this month.

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## **Can euro replace dollar as world's dominant currency?**



Reuters/ London

Should European countries want the euro to replace the dollar as the world's dominant reserve currency, the Sino-US trade war may offer a window of opportunity.

The souring of ties between the world's two largest economies will indicate the extent to which China can switch some of its giant reserve holdings to another hard currency and also point to the limitations the eurozone faces in providing a viable alternative.

In the post-World War Two era, no asset has ever fully matched US government bonds for size, liquidity and credit quality.

It is the closest any global security has come to being perceived as a cash-like, risk-free asset with over \$16tn worth of paper in circulation.

Yet, a year into a bitter tariff war, there are some signs of Beijing's discomfort at being both the United States' biggest trade adversary and one of its biggest creditors.

Recent data showed China sold more US Treasuries in March than it has in any month over the past 2-1/2 years.

If that proves to be more than a one-month quirk, speculation will rise about where it is diverting those reserves, and the eurozone – the world's biggest trading bloc – tops the list of

likely spots.

On size alone, eurozone government bonds appear to provide a credible landing pad: outstanding securities are almost two-thirds of the overall Treasury market.

There are signs already of greater Chinese interest in Europe – bankers attribute record Asian demand for recent Spanish, French and Belgian debt sales to Beijing.

And China has stepped up buying debt from Europe's quasi-sovereign entities, bankers told Reuters, in particular the European Stability Mechanism (ESM) a eurozone-guaranteed AAA/A1-rated bailout fund.

Asian investors snapped up 33% of the ESM's recent 2bn-euro 10-year bond, data from International Financing Review shows.

Asian takeup for ESM's euro issues last year was 4%-5%. But for Chinese reserve managers to shift hundreds of billions of dollars from Treasuries to Europe's single currency, the euro bloc needs to address key shortcomings.

"I find it hard to square the circle how such a huge Treasury holding can be diversified away, given the landscape we are in," said Salman Ahmed, chief investment strategist at Lombard Odier Investment Managers.

"In the eurozone there is not a big risk-free market...Twenty years down the line it may be different."

For Ahmed, the main issue is that credit risk in the bloc is not uniform.

The 19 members each run their own fiscal policies, budget rules are too loosely policed to ensure adherence, and euro exit remains a theoretical possibility.

So wealthier members such as Germany remain net savers that run balanced budgets or even surpluses, while others, mostly in southern Europe, are dogged by high debt.

The resulting mix of credit and political risks make it harder to see the aggregate eurozone bond market as a true mirror of the US Treasury universe.

Ross Hutchison, a fund manager at Aberdeen Standard Investments, says it boils down to the fact the United States "has a federal nature that the euro area hasn't got yet".

Additionally, distortions stemming from years of bond buying stimulus by the European Central Bank mean available euro government bonds are far fewer than may appear.

While euro government debt outstanding is around \$9.5tn, the ECB is estimated to hold roughly a quarter.

And the kind of “safe” securities that reserve managers seek are even scarcer – AAA-rated debt from Germany, the Netherlands and Luxembourg totals around \$2.5tn, less if ECB holdings are discounted.

Debt from slightly lower-rated France, Belgium and Austria would add another \$3tn.

Italy on the other hand has the bloc’s biggest government bond market, worth \$2.3tn.

But its poor debt-to-GDP ratio, sluggish economy and populist policies make its bonds riskier and its credit rating is a notch or two above junk.

So in times of stress, investors clamour for German bonds, while in Italy, yields spike, threatening to undermine local banks that hold these securities.

Italian 10-year yields are at 2.5%, versus Germany’s minus 0.22%. Such risks have chipped away at the euro’s fortunes as a reserve currency – International Monetary Fund data shows it comprises 20% of global central bank holdings, from 26% in 2009.

The decline is linked to the 2011 Greek debt crisis that then ravaged Spain, Italy, Portugal and Ireland, highlighting risks of default by a member state and redenomination of euro debt into a new currency.

European officials are keen to counter the dollar’s hegemony, and at a conference last month they debated ways to win the euro a “stronger international role”. But they made no mention of the one measure that could resolve the issue at a stroke – joint debt issuance via common eurozone bonds.

Such securities would pool the bloc’s risks, and offer safer securities than those from most individual nations.

Olli Rehn, Bank of Finland governor and an ECB governing council member, said last week a safe asset would help enhance

the euro's international role, offering hope the issue will be on the agenda of the new European Commission later this year. A common bond "would be more significant than the creation of another TLTRO in boosting demand for euros globally and reserve managers would be part of that story," said David Owen, chief European economist at Jefferies. He was referring to the ECB's cheap multi-year loans. "Maybe there will be more focus on pushing forward this agenda and taking advantage of the US and China having this trade spat," Owen added. Others, however, note that wealthier states oppose any common bond programme, fearing they will end up footing the bill. Also, across Europe populist and anti-establishment movements are on the rise, with the agenda of slowing integration and returning power to national capitals. Such groups grabbed a greater share of the vote in EU parliamentary elections last month, albeit less than expected. "If anything, the trend is towards decentralisation of power," Ahmed said.

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## **Bank of England to Hold Rates as Clouds Gather Over Outlook**



Bank of England officials will probably keep policy on hold next week as they acknowledge that the economic outlook has worsened materially since May.

All but one of the 24 economists surveyed by Bloomberg predict a unanimous vote to maintain the benchmark rate at 0.75%. The risk of a no-deal departure from the European Union under new Prime Minister Boris Johnson and an increasingly gloomy global outlook suggest that policy makers will be cautious.

Officials have scaled back their rate-hike rhetoric and investors are increasingly pricing in rate cuts as the risk of a disorderly Brexit grows.

But with a falling pound and stronger wage growth threatening to fuel inflation, officials potentially face a dilemma. Governor Mark Carney is expected to address the trade-off between growth and prices after the BOE publishes its quarterly Inflation Report, alongside the monetary-policy decision, at noon on Thursday.

Economists are virtually unanimous in predicting the BOE will cut its 2019 growth forecast, with around half predicting a downgrade to the following two years. Officials are also widely expected to hike their inflation projections.



Policy makers have softened their language about the possibility of interest-rate increases. Michael Saunders, who led the charge for the BOE's last two rate hikes, has suggested he's in no rush to begin another push, telling Bloomberg the economy right now is "clearly not overheating."

Chief Economist Andy Haldane, also considered among the more hawkish members of the Monetary Policy Committee, said in a speech this week that the case for keeping policy unchanged is strong and the group should proceed with caution on any loosening.

Carney has also warned that damage to the global economy from rising protectionism could be significant and require a major policy response.

While one economist sees a dissenter on the nine-member rate setting committee calling for an immediate cut, most recent comments point to unanimity.

Officials may try to address the discrepancy between their official forecasts and market expectations. Carney has said they will explore "how best to illustrate" the market "sensitivities."

Source: Bloomberg

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**France aims for US digital tax deal by late August – minister**



France wants to reach a deal with the US on taxing tech giants by a G7 meeting in late August, Economy Minister Bruno Le Maire said Saturday.

He was responding to US President Donald Trump, who on Friday vowed “substantial” retaliation against France for a law passed this month on taxing digital companies even if their headquarters are elsewhere.

The law would affect US-based global giants like Google, Apple, Facebook and Amazon, among others.

### **‘Foolish’ Emmanuel Macron**

Trump denounced French President Emmanuel Macron’s “foolishness”, though they discussed the issue by phone on Friday, according to the White House.

Le Maire told a news conference Saturday: “We wish to work closely with our American friends on a universal tax on digital activities.

Inspired by”We hope between now and the end of August – the G7 heads of state meeting in Biarritz – to reach an agreement.”

Leaders of the Group of Seven highly industrialised countries are to meet in the southwestern French city on August 24-26.

Le Maire emphasised that “there is no desire to specifically target American companies,” since the three-percent tax would be levied on revenues generated from services to French consumers by all of the world’s largest tech firms, including Chinese and European ones.

The law aims to plug a taxation gap that has seen some internet heavyweights paying next to nothing in European countries where they make huge profits as their legal base is in smaller EU states.

### **Raising a glass**

In a move that’s rattling the industry, President Trump responded to the French plans by threatening to raise tariffs on French wine. French vintners sold 1.6 billion euros worth of wine last year to American consumers.

Trump derided French wines in a tweet, and later said he might hit them with retaliatory tariffs to French. He made a similar threat last year.

About 20% of French wine is sold in the US, and the Federation of French Wine and Spirits Exports on Saturday expressed concern about tariffs that could hurt “French players in this market, but also their clients and American consumers.”

The federation urged French and American authorities to pursue dialogue on the tax issue, expressing hope “that they can quickly find a path to follow to prevent these threats from materialising.”

Le Maire said the US “should not mix the two issues,” and noted that European wines already face tariffs in the US as do American wines in Europe.

Trump insisted Friday that he has a good relationship with

Macron and had just spoken with him.

After initially befriending the US president despite their starkly different worldviews, Macron has increasingly stood up to the impulsive, America-first Trump on trade, climate change and Iran's nuclear program.

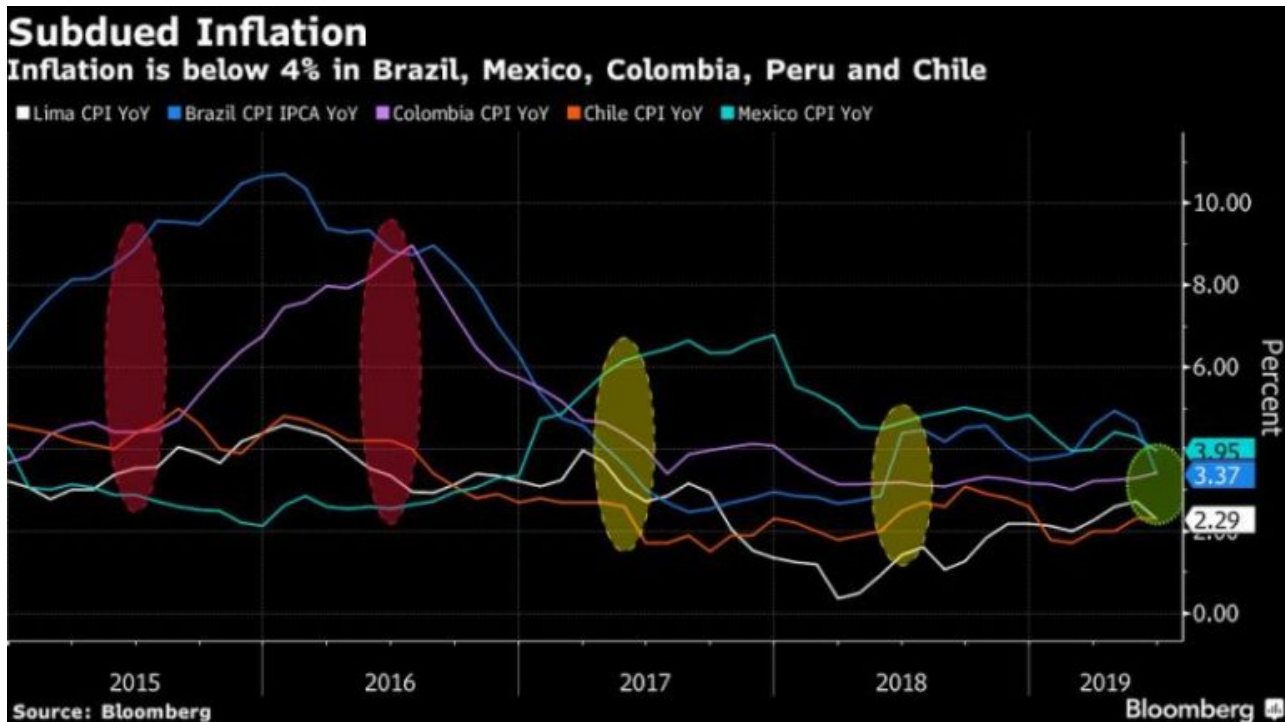
The tech tax is just their latest battleground, and will be a key tension point when the two men meet at a Group of Seven summit in France next month.

France failed to persuade EU partners to impose a Europe-wide tax on tech giants, but is now pushing for an international deal on it with the G7 and the 34 countries of the Organisation for Economic Cooperation and Development.

France has said it would withdraw the tax if an international agreement was reached, and Paris hopes to include all of the OECD countries by the end of 2020.

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## **The world economy's biggest week of 2019 as Fed prepares cut**



There will be no chance of a summer break for investors or policy makers in coming days as they brace for what might be the busiest week for the world economy this year.

The highlight is Wednesday's decision by the Federal Reserve with markets and economists virtually united in predicting Chairman Jerome Powell and colleagues will cut interest rates for the first time in more than a decade.

## What's Likely to Happen?

Some Fed watchers predict officials will cut their benchmark by half a percentage point, but the signal is that they will eschew a bigger move in favor of a quarter point reduction. They will likely also leave open the possibility of further action down the road as they seek to sustain the record-long U.S. expansion and kick start inflation.

*"While the Fed cutting rates by a quarter point will hardly be a surprise to financial market participants – as it has been well advertised and is priced in with a relatively high probability – the broader question will be how the Fed telegraphs its intentions regarding additional easing," said Carl Riccadonna, chief U.S. economist at Bloomberg Economics. "Policy makers are keen to avoid getting 'bullied' by the*

*markets into more than 50 to 75 basis points of rate reductions.”*

The Fed isn't the only event with the ability to shape the outlook for the global economy this year.

On Monday, U.S. Trade Representative Robert Lighthizer and Treasury Secretary Steven Mnuchin are set to travel to China for for the first high-level, face-to-face trade negotiations between the world's two biggest economies since talks broke down in May.

Then on Friday, the monthly payrolls report will shed light on whether the Fed's move was necessary. Economists surveyed by Bloomberg predict a 166,000 gain in non-farm jobs in July, slower than the 224,000 of June.

If that's not enough, Bank of Japan policy makers meet on Tuesday amid calls to reinforce their commitment to low rates and Brazil's central bank may cut rates on Wednesday. Thursday sees the release of global manufacturing data amid concerns many industries are already suffering recession.

Here's our weekly rundown of other key economic events:

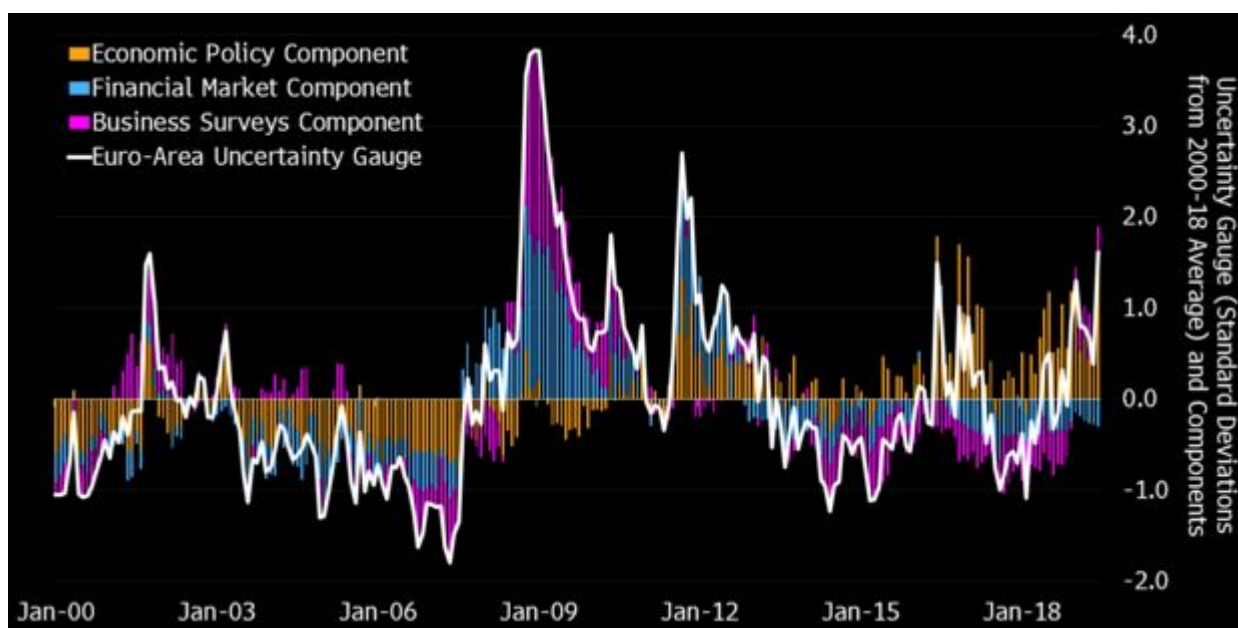
## **U.S.**

As Fed officials begin their discussions on Tuesday they will have some more data with which to assess the economy. Personal income, pending home sales and consumer confidence statistics are all due that morning. Then on Thursday, the ISM manufacturing report is expected to show industry is stabilizing and continuing to expand. Friday's trade data will be pored over for evidence that the skirmish with China is having an effect. Also next week, the Treasury will say on Wednesday how much money it needs to borrow amid rising budget deficits.

## Europe, Middle East and Africa

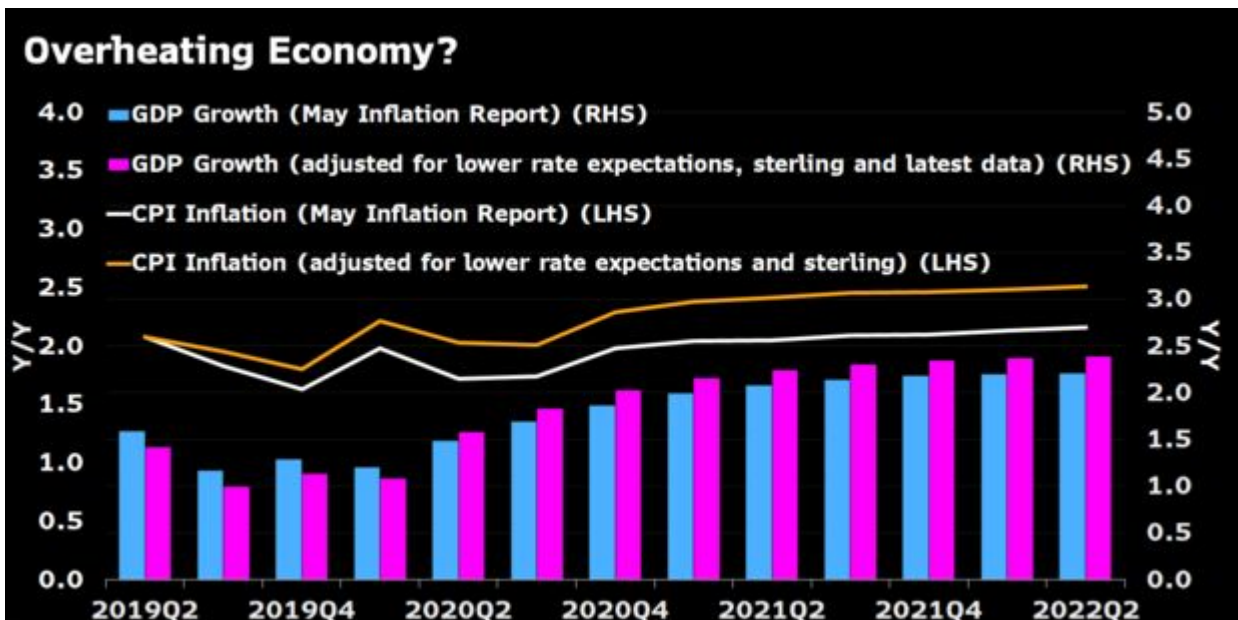
It's a big week for data after European Central Bank President Mario Draghi last week paved the way to cut interest rates in September and perhaps relaunch bond-buying. Tuesday is set to witness another decline in euro-area confidence while the following day is likely to confirm that the economy slowed in the second quarter to half the pace of the 0.4% of the prior three months. Inflation data the same day is expected to show consumer price growth languishing well below the ECB's target of just below 2%. Thursday sees the release of purchasing managers indexes.

## New Uncertainty Gauge Shows Damage to Euro-Area Economy



Source: Bloomberg Economics

In the U.K., the Bank of England publishes its latest forecasts on Thursday with Bloomberg Economics reckoning it will turn more dovish as the Oct. 31 Brexit deadline nears. The Czech central bank is predicted to leave its benchmark unchanged at 2% on Thursday.

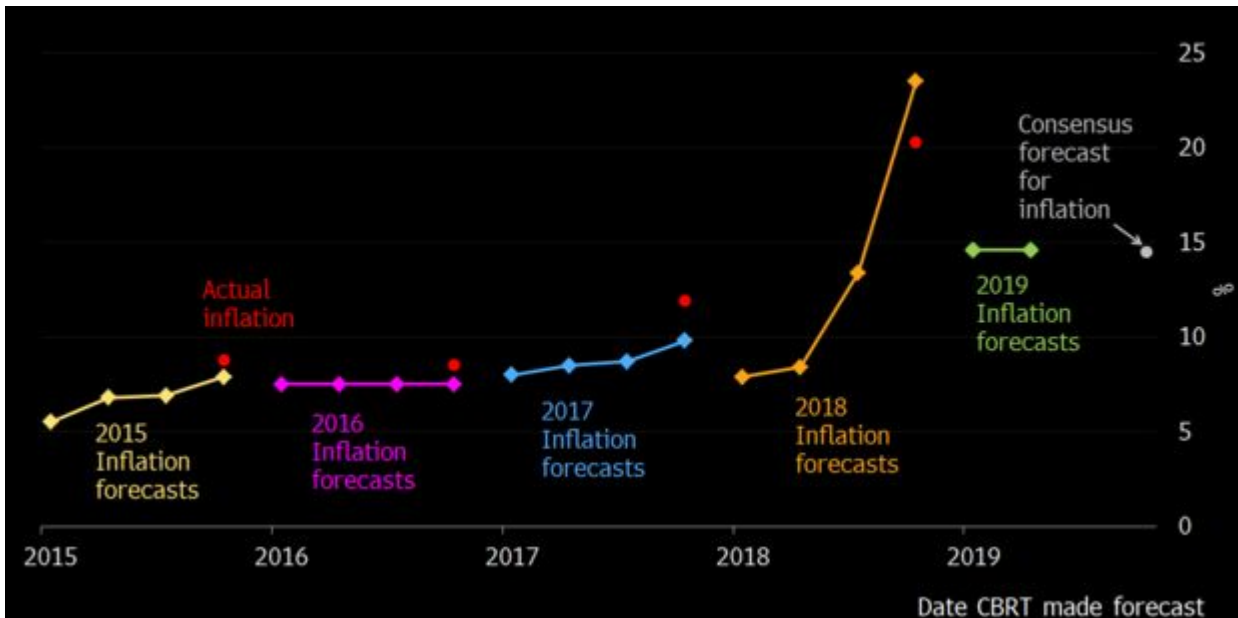


Source: Bank of England, Bloomberg Economics

Turkey's new Central Bank Governor Murat Uysal will face public questioning for the first time on Wednesday when he presents the quarterly inflation report. The lira was relatively unscathed after a 425-basis-point interest-rate cut at his first meeting, the largest in recent Turkish history, investors will be curious as to whether he shares President Recep Tayyip Erdogan's unconventional belief that high interest rates cause inflation. Banks across the Persian Gulf region will probably move to ease if the Fed cuts as expected.

## Turkish Central Bank's Inflation Forecast in Line With Consensus





Source: CBRT, Bloomberg

## Asia

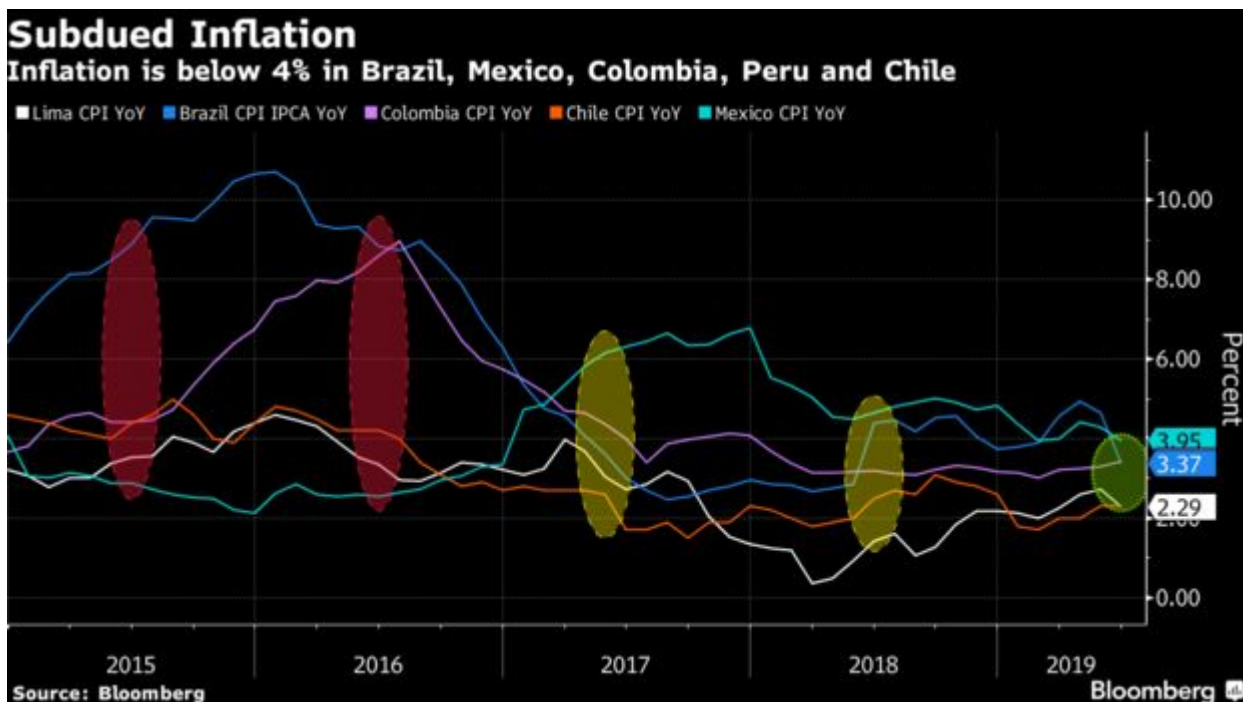
Bank of Japan policy makers finish a meeting on July 30. About a third of economists in a survey published last week said they expect policy makers to strengthen their pledge to maintain rock-bottom interest rates rather than do nothing and risk a sharp appreciation of the yen should the Fed cut rates. Still, some officials see little to be gained from such a tweak, according to people familiar with the matter. Data released on Tuesday is forecast to show industrial production shrank again in June amid weak external demand.

## Easy Does It

In China, Bloomberg Economics says purchasing managers' indexes will probably remain in contractionary territory as pressure on exporters persist. Elsewhere, a report on Thursday is set to show South Korean exports slid for an eighth straight month which will unnerve those already worried about global trade. Inflation data for Australia, Indonesia, South Korea and Thailand will help inform central bankers.

## Latin America

Brazil's central bank is widely expected to cut borrowing costs on Wednesday with economists and traders debating how deep it will go. The following day, July industry output data may shed light on whether Latin America's largest economy slipped into technical recession in the first half of the year. Mexico will learn if it was able to avoid a technical recession on Wednesday, when the national statistics bureau releases preliminary output data for the second quarter.



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**Halliburton second-quarter profit beats analysts' estimates**



(Reuters) – Halliburton Co (HAL.N) on Monday reported a second-quarter profit that beat analysts' estimates as its largest oil-well services unit exceeded expectations, sending shares to their biggest one-day gain in nearly three years.

The Houston-based oilfield company is the largest provider of hydraulic fracturing services in North America, a segment of the business that has been hard-hit by overcapacity, making it difficult to raise prices.

Halliburton Chief Executive Officer Jeff Miller said that market remains oversupplied and the company idled equipment during the quarter and will continue to do so. It has also taken steps to cut costs by reorganizing its North American business.

Halliburton shares, which have declined nearly 18.2% this year, closed up 9.15%, or \$1.99 a share, to \$23.74, marking the largest percentage gain since November 2016.

Revenues for the Completion and Production unit, which provides hydraulic fracturing services and tools to complete

oil and gas wells, rose 4% from the prior quarter to \$3.8 billion. Margins were boosted by cost-cutting and maximizing equipment usage, Miller said on a conference call.

The company cut the number of North American employees by 8% in the second quarter, spokeswoman Emily Mir said on Monday.

Byron Pope, an oilfield analyst for Tudor, Pickering, Holt & Co, said, "The magnitude of the improvement in the Completions and Production margin performance" was encouraging, adding that it was good to hear the company publicly acknowledge that it has idled equipment.

Despite the improvements, CEO Miller warned investors that third-quarter activity would decline as producer customers continue to focus on reducing spending.

"We expect that activity in North America will be slightly down in the third quarter. We anticipate the slowdown to be more pronounced in the gassier basins due to persisting lower gas prices," he said.

Halliburton posted a strong increase in revenue from international markets, jumping more than 12% to \$2.60 billion, in contrast to the 13.2% decline in North America to \$3.33 billion.

"Momentum is building internationally and activity improvement should continue into 2020," Miller said in a statement.

Rival Schlumberger NV (SLB.N) on Friday reported a profit increase on demand from markets outside North America.

Net profit attributable to Halliburton fell 85% to \$75 million, or 9 cents per share, in the quarter, hurt by impairments and other charges.

Excluding one-time items, the company earned 35 cents per share, beating Wall Street's average estimate of 30 cents per share, according to IBES data from Refinitiv.

Revenue fell 3.5% to \$5.93 billion and missed estimates of \$5.97 billion.

Reporting by Nishara Karuvalli Pathikkal and Arathy S Nair in Bengaluru, and Liz Hampton in Houston; editing by Steve Orlofsky and Grant McCool  
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## A Reform Opportunity for the IMF



Jul 19, 2019 JOSÉ ANTONIO OCAMPO

The departure of Christine Lagarde from the helm of the International Monetary Fund represents a golden opportunity to put the institution on a path toward a more effective and inclusive future. What should her successor's priorities be?

NEW YORK – This month marks the 75th anniversary of the signing of the Bretton Woods agreement, which established the International Monetary Fund and the World Bank. For the IMF,

it also marks the start of the process of selecting a new managing director to succeed Christine Lagarde, who has resigned following her nomination to be European Central Bank president. There is no better moment to reconsider the IMF's global role.

The most positive role that the IMF has played throughout its history has been to provide crucial financial support to countries during balance-of-payments crises. But the conditionality attached to that support has often been controversial. In particular, the policies that the IMF demanded of Latin American countries in the 1980s and in Eastern Europe and East Asia in the 1990s saddled the Fund's programs with a stigma that triggers adverse reactions to this day.

It can be argued that the recessionary effects of IMF programs are less harmful than adjustments under the pre-Bretton Woods gold standard. Nonetheless, the IMF's next managing director should oversee the continued review and streamlining of conditionality, as occurred in 2002 and 2009.

The IMF has made another valuable contribution by helping to strengthen global macroeconomic cooperation. This has proved particularly important during periods of turmoil, including in the 1970s, following the abandonment of the Bretton Woods fixed-exchange-rate system, and in 2007-2009, during the global financial crisis. (The IMF also led the gold-demonetization process in the 1970s and 1980s.)

But, increasingly, the IMF has been relegated to a secondary role in macroeconomic cooperation, which has tended to be led by *ad hoc* groupings of major economies – the G10, the G7, and, more recently, the G20 – even as the Fund has provided indispensable support, including analyses of global macro conditions. The IMF, not just the “Gs,” should serve as a leading forum for international coordination of macroeconomic policies.

At the same time, the IMF should promote the creation of new mechanisms for monetary cooperation, including regional and inter-regional reserve funds. In fact, the IMF of the future should be the hub of a network of such funds. Such a network would underpin the “global financial safety net” that has increasingly featured in discussions of international monetary issues.

The IMF should also be credited for its prudent handling of international capital flows. The Bretton Woods agreement committed countries gradually to reduce controls on trade and other current-account payments, but not on capital flows. An attempt to force countries to liberalize their capital accounts was defeated in 1997. And, since the global financial crisis, the IMF has recommended the use of some capital-account regulations as a “macroprudential” tool to manage external-financing booms and busts.

Yet some IMF initiatives, though important, have not had the impact they should have had. Consider Special Drawing Rights, the only truly global currency, which was created in 1969. Although SDR allocations have played an important role in creating liquidity and supplementing member countries’ official reserves during major crises, including in 2009, the instrument has remained underused.

The IMF should rely on SDRs more actively, especially in terms of its own lending programs, treating unused SDRs as “deposits” that can be used to finance loans to countries. This would be particularly important when there is a significant increase in demand for its resources during crises, because it would effectively enable the IMF to “print money,” much like central banks do during crises, but at the international level.

This should be matched by the creation of new lending instruments – a process that ought to build on the reforms that were adopted in the wake of the global

financial crisis. As IMF staff have proposed – and as the G20 Eminent Persons Group on Global Financial Governance recommended last year – the Fund should establish a currency-swap arrangement for short-term lending during crises. Central banks from developed countries often enter into bilateral swap arrangements, but these arrangements generally marginalize emerging and developing economies.

Then there are the IMF initiatives that have failed altogether. Notably, in 2001-2003, attempts to agree on a sovereign debt-workout mechanism collapsed, due to opposition from the United States and some major emerging economies.

To be sure, the IMF has made important contributions with regard to sovereign debt crises, offering regular analysis of the capacity of countries in crisis to repay, and advising them to restructure debt that is unsustainable. But a debt-workout mechanism is still needed, and should be put back on the agenda.

Finally, the IMF needs ambitious governance reforms. Most important, building on reforms that were approved in 2010, but went into effect only in 2016, the Fund should ensure that quotas and voting power better reflect the growing influence of emerging and developing economies. To this end, the IMF must end its practice of appointing only European managing directors, just as the World Bank must start considering non-US citizens to be its president.

Lagarde's departure represents a golden opportunity to put the IMF on the path toward a more effective and inclusive future. Seizing it means more than welcoming a new face at the top.





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35 Commentaries

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<https://www.project-syndicate.org/commentary/imf-lagarde-successor-institutional-reform-by-jose-antonio-ocampo-2019-07>

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**ECB rate-cut bets drive another big weekly fall in bond yields**



- \* ECB easing hopes bolster bond markets
- \* German Bund yield set for biggest fall in seven weeks
- \* Focus on ECB inflation target debate
- \* Markets ramp up bets on July ECB rate cut
- \* Euro zone periphery govt bond yields [tmsnrt.rs/2ii2Bqr](https://tmsnrt.rs/2ii2Bqr) (Updates prices, adds comment)

By Dhara Ranasinghe

LONDON, July 19 (Reuters) – Anticipation of ECB rate cuts put German yields on track for their biggest weekly drop in seven weeks on Friday, while Italian borrowing costs were set for a seventh week of declines despite rising off 3-year lows hit the previous day.

Euro zone debt has resumed its rally after last week's brief selloff, receiving fresh impetus after a report that European

Central Bank staff were studying a potential change of the inflation goal. That's added to expectations for prolonged policy easing.

"Last week, we did see a big selloff and when we entered this week it was a buying opportunity because central banks are expected to ease policy," said Pooja Kumra, European rates strategist at TD Securities in London. "And adding to that we've had further signals that we will get easing soon."

Comments by two Federal Reserve officials have also revived bets on a 50 basis-point U.S. interest rate cut this month, though 10-year Treasury yields inched higher on Friday after falling on Thursday .

With the exception of Italy, most 10-year euro area bond yields slipped, though they inched off session lows as U.S. yields rose.

Germany's 10-year yield fell 1.5 bps to minus 0.32% . It is down almost eight bps this week and set for its biggest weekly fall since the end of May.

In focus now is the ECB's July 25 meeting that is expected to flag a cut in deposit rates as early as September. Money markets suggest some investors expect a move as early as next week, pricing almost a 60% chance of a 10 bps cut, up from around 40% earlier this week.

Natixis fixed income strategist Cyril Regnat said it would make more sense to wait until September but added: "The big question is not about a rate cut but whether the ECB reopens asset purchases."

"This is what investors keep asking us about."

Bets on a deeper and longer rate-cutting cycle and the possibility of another bond-buying programme sent a key gauge of long-term euro zone inflation expectations, the five-year,

five-year forward, to the highest in almost two months at 1.32% .

## ITALY

Italian 10-year borrowing costs were the exception to the bullish mood, though analysts noted a seven bps rise came after yields fell to a new three-year low of 1.506% on Thursday.

Yields have fallen around 120 bps since mid-May, having outperformed euro zone peers thanks to the ECB easing speculation and relief that Rome avoided disciplinary action from the European Union over its fiscal position.

This week yields are down more than 10 bps.

But on Friday investors grew nervous as Deputy Prime Minister Matteo Salvini said he would meet coalition partner Luigi Di Maio amid speculation that the increasingly unwieldy government might collapse.

## ADVERTISEMENT

While investors might welcome an administration that excludes Di Maio's 5-Star movement, there needs to be a government in place in October to approve the 2020 budget.

Analysts at Eurasia Group said while pressure on Italian markets had lifted, they would remain volatile.

"The coalition remains inherently unstable and early elections remain likely, though probably not before early 2020," they told clients.

Reporting by Dhara Ranasinghe, additional reporting by Sujata Rao; editing by William Maclean, Larry King, Kirsten Donovan

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<https://www.reuters.com/article/eurozone-bonds/update-2-ecb-rate-cut-bets-drive-another-big-weekly-fall-in-bond-yields-idUSL8N24K2R8>

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## Will ECB walk or just talk as rate circus comes to Europe?



BRUSSELS (Reuters) – The global march towards lower interest rates reaches Europe this week with the European Central Bank expected at least to signal easier monetary policy, while Turkey’s new banking chief is seen taking an ax to the country’s rates.

Slowing global growth, increased protectionism and in some cases weak domestic data have persuaded major central banks to loosen monetary policy, with a rate cut more or less inked in for the U.S. Federal Reserve at the end of the month.

The ECB, whose Governing Council meets on Wednesday and Thursday, said last month that euro zone interest rates would remain at present levels at least through the first half of 2020 – an extension from previous period of until the end of 2019.

Two-thirds of economists polled by Reuters expect the ECB next week simply to change its guidance, such as for rates to be at “present or lower levels” ahead, with a cut of the deposit rate to an all-time low of -0.50% at its September meeting.

“I think for now, they’ll only get to point where they consider a rate cut is on the table and then do it later. The ECB has a long history of moving very slowly,” said Capital Economics’ senior Europe economist Jack Allen-Reynolds.

But some economists believe the ECB will have to do more.

Carsten Brzeski, chief economist for Germany at ING, says he thinks of the chances of just words as 51%, versus 49% for action.

“Draghi has surprised us more often in terms of being ahead of the curve, of over-delivering, but it’s very hard to say. I think there will be a tough discussion,” he said.

If the Fed starts cutting rates and the ECB does not send out an extremely dovish message, the euro could strengthen, although at Friday’s level of \$1.12 it is hardly near the pain barrier for EU exporters.

Commerzbank is one bank that predicts the ECB will act, cutting by 20 basis points

“Maybe they want to prevent an appreciation (of the euro) and, like the U.S., they want to prolong the upswing. The data though is not as bad as you might think,” said economist Bernd Weidensteiner.

Unemployment in the euro zone is, at 7.5%, at its lowest level

since July 2008, while industrial production and exports improved in May, albeit after declines in April.

In the United States, the case for a rate cut is ostensibly even thinner, with strong labor markets despite U.S.-China trade tensions and factory activity strong – at a year high in the mid-Atlantic region.

Yet markets were by Thursday expecting a half percentage point cut in U.S. rates at the end of July, double the reduction they expected just a day earlier. The action has been sold as insurance against any negative development. U.S. economic growth is expected to have cooled in the second quarter, set to be confirmed in a first GDP estimate on Friday.

## **TURKISH AX, NEW BRITISH PM**

In Turkey, the case for action is more clear-cut given a recession-hit economy. Economists polled by Reuters expect the central bank under new governor Murat Uysal to reduce the current 24% interest rate by an average 250 basis points.

It will follow Indonesian and South Korean rate cuts on Thursday and the Reserve Bank of Australia, which reduced interest rates in both June and July.

The trend leaves only the Bank of Canada, buoyed by higher oil exports and consumer spending, and the Bank of England as outliers, though the latter could change.

Arch-Brexiteer Boris Johnson is expected to be named as Britain's next Prime Minister on Tuesday, raising the chances of a 'no deal' Brexit and potentially lowering growth forecasts.

Only 27 of 76 economists polled now expect an increase to British interest rates before the end of next year, compared to 36 of 69 last month. On the flip side, nine of 76 were expecting a cut by end-2020 compared to five of 69 in June.

“We don’t necessarily share the view that the UK economy will see a substantial pick-up in growth even in a smooth Brexit,” Royal Bank of Canada, a primary dealer of British government bonds, said.

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## The ECB Needs to Explain Itself



Ambiguity is hampering effective policymaking by the European Central Bank and leaving market participants wondering what to expect. A review of the ECB’s policy framework would help to eliminate such ambiguity – and place the Bank on much sounder footing for a new era of leadership.

ZURICH – Finland’s central bank governor, Olli Rehn, has reiterated his call for the European Central Bank to conduct a long-overdue review of its policy framework. The upcoming



change of leadership at the institution – with Christine Lagarde, the International Monetary Fund’s managing director since 2011, likely to succeed Mario Draghi as president – offers an important opportunity to heed that call.

When the ECB was established 20 years ago, central banks were generally not too clear about the details of their policy frameworks. At that time, some ambiguity may have been helpful, because of the flexibility it offered when the ECB started operating. Furthermore, it allowed central bankers with different experiences and perspectives to agree on a framework, even though they may not have agreed on its precise details.

But the world has changed considerably since then, and the public is now demanding far more clarity. How can the ECB offer that, 16 years after the last review of its monetary-policy framework?

Since that review, conducted in 2003, the global financial crisis, and the ensuing European debt crisis, prompted the ECB to adopt a plethora of new policy instruments. These crisis measures – which have been deeply unpopular, particularly in Germany – can be justified only to the extent that they have been effective, and this must be evaluated. Moreover, as Rehn, who sits on the ECB’s governing council, has noted, long-run structural trends – such as population aging, lower long-term interest rates, and climate change – must be considered.

The effectiveness of ECB policy requires the members of the governing council to be singing from the same song sheet. They need a shared understanding of Europe’s long-term goals and the strengths and weaknesses of various policy instruments. And, in order to strengthen accountability and support smart decision-making, they need to be able to spell out the details of their monetary-policy strategies in ways that the public can understand.

As it stands, such clarity is at times hard to find, even when it comes to some of the most fundamental elements of the ECB's policy strategy. Price stability – the ECB's primary objective – is currently expressed as “inflation below, but close to, 2%.” Does 1% inflation meet that condition, or is it too low, demanding more monetary-policy accommodation? Different members of the ECB's governing council may well have different answers to this question, and thus support different policies.

The same goes for the questions of whether the ECB's inflation target is symmetric – with the authorities intervening as vigorously when inflation is too low as they do when inflation is too high – and whether inflation should be measured over time or at a given moment. If, over some period, the inflation rate ranges from 0% to 4%, but averages to “below, but close to, 2%,” has the objective been achieved?

The answer has major policy implications. If inflation is measured over time, the ECB could accept, or perhaps even aim for, a somewhat higher inflation rate in the medium term, to compensate for the excessively low inflation of recent years. If the public came to believe that a period of above-target inflation was likely, the expected real interest rate would fall, giving a jolt to the economy.

Of course, Draghi has established in speeches and press conferences that, in his view, the inflation target is symmetric; 1% inflation is too low; and the inflation rate should be measured over the “medium term.” But it is not clear whether this view is broadly shared within the ECB's governing council.

Inflation targeting is hardly the only area where ambiguity is hampering effective policymaking and leaving market participants wondering what to expect. The ECB's outright monetary transactions (OMT) scheme – whereby the ECB promises to purchase bonds issued by eurozone member states on secondary sovereign-bond markets – is also generating

significant uncertainty.

OMT, Draghi's chosen tool for fulfilling his 2012 vow to do "whatever it takes to preserve the euro," was controversial from the moment it was announced, with Bundesbank President Jens Weidmann – one of Lagarde's main rivals for the ECB presidency – arguing fiercely against it in public. But that was seven years ago, and OMT has never actually been used. Is the governing council still committed to it? Or have the events – and council membership changes – of the last few years rendered that commitment obsolete?

With public debt in Greece and Italy still far too high, the eurozone still at risk of slipping into a recession that would significantly worsen both countries' fiscal positions, and Italian politics as volatile as ever, it would pay to know. A review of the kind Rehn demands would provide the needed answers – and put the ECB on much sounder footing for a new era of leadership.



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