WEEKLY ANALYSIS

Number 787, July 25, 2022

PRIVREDNA BANKA ZAGREB

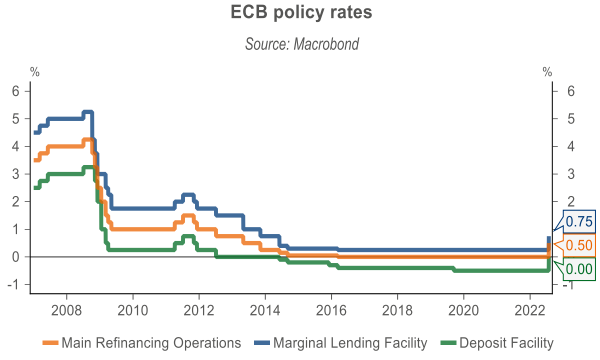
Bank of INTESA SANPAOLO

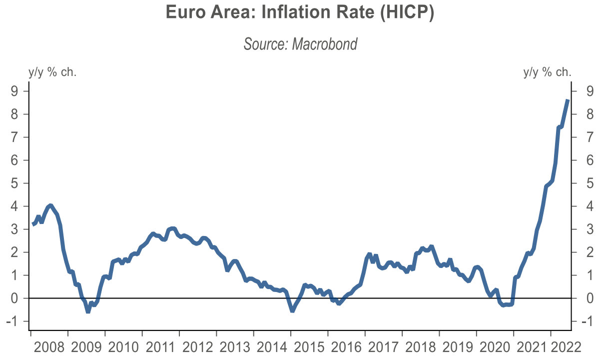
Decisive tightening of the ECB's monetary policy

The European Central Bank's July meeting was eagerly awaited. Although a 25 b.p. increase in key interest rates was announced in June, the possibility of a 50 b.p. hike was not excluded, which would continue to be in line with the current forward guidance against the backdrop of more persistent inflationary pressures. The eurozone inflation rate (HICP) reached 8.6% year-on-year in June (an average of 5.4% in the last twelve months), and pressures (energy, food) come not only from external factors, but also from rising domestic demand after the opening, which is among other things the result of significant accumulated savings over the past two years. To illustrate the latter, we can look at the contributions of Recreation and culture and Hotels and restaurants to year-to-year growth of prices where we see that the contribution of the first item increased from -0.05 p.p. in June 2021 to 0.34 p.p. in June 2022, and the contribution of the second category from 0.00 p.p. to 0.64 p.p.

To alleviate inflationary pressures, the ECB ultimately decided to raise interest rates by 50 b.p. and now all three key rates are out of negative territory (although negative in real terms), and forward guidance has been abandoned, with the ECB announcing that decision on interest rates will be taken from one meeting to another, taking into account recent data. From July 27, the deposit facility rate will thus be 0.00%, the rate on main refinancing operations 0.50%, and marginal lending facility rate will be 0.75%. This more decisive than expected move by the ECB is certainly supported by the establishment of a new Transmission Protection Instrument (TPI) aimed at preventing market fragmentation. The volume of TPI purchases will depend on the severity of the risks facing monetary policy transmission, and the TPI will primarily serve to buy public sector securities, namely those with a remaining maturity of one to ten years. The instrument will be activated in situations where market developments deviate significantly from the fundamentals (Lagarde stated that activation will be decided upon if indicators point to "unwarranted, disorderly market dynamics"), i.e., in the case of a significant widening of spreads and fluctuations in yields that exacerbate the financing conditions of a particular country. The activation of the instrument is also conditional on the conduct of a sustainable economic policy (in particular fiscal policy) and compliance with EU rules (Lagarde stated that all eurozone member states meet the requirements). Lagarde also noted that the ECB would rather not activate the TPI, but if necessary, it would not hesitate to use it.

Autumn ahead of us brings uncertainty about the pace of further interest rate hikes, and what is expected is a much faster convergence towards a neutral level (to the question which one would that be Lagarde responded cautiously stating that she does not know at this time), implying several waves of increases by the end of the year. Ahead of the next meeting in September, the question arises whether the ECB will opt for a hike of 25 b.p. (replacing the dynamics between July and September), 50 b.p. (as expected after the June meeting) or even 75 b.p. (if the inflationary pressures do not weaken, as is now expected). The Governing Council will be guided by data on HICP movements (and certainly the energy situation) when deliberating, and in September the ECB will also publish updated macroeconomic forecasts.



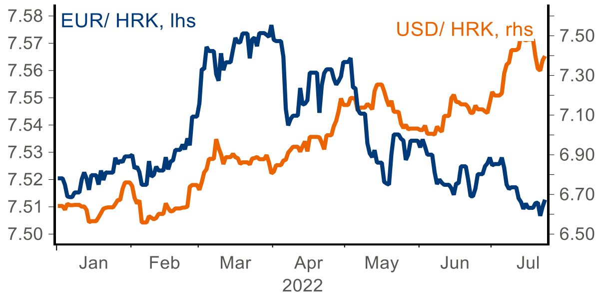


Weekly overview

- The year-to-year growth in consumer prices reached a new, record high of 12.1% in June, while in the first half of 2022 the average inflation rate reached 8.6% year-on-year due to rising food and energy prices.
- In the domestic foreign exchange market, the euro last week strengthened slightly against the kuna, mainly because of increased interest in buying the euro below the conversion rate level, and last week the ECB's interest rate hike further affected decision-making on increasing euro positions. On the other hand, we have increased seasonal inflows, usual for this time of the year. The mid-point EUR/HRK exchange rate almost stagnated on a weekly basis and stood at 7.5126 at the end of the week, while the trend of depreciation of the kuna against the dollar stopped, with the kuna strengthening by 1.1% to HRK 7.3979 per dollar. This week we see EUR/HRK trading in the range of 7.50-7.54.
- The Crobex Index closed last Friday at 1,963.49 points, up by 1.4% w-o-w, while Crobis stagnated at the same time at 98.86 points. As for sector indices, CROBEXindustry recorded a w-o-w increase of 0.9% (to 1,045.50 points), while CROBEXtourist and CROBEXconstruct declined by 0.1% and 3.7% respectively (3,484.36 and 379.46). Total ZSE turnover in the last week reached HRK 205.9 million, down by 6.6% w-o-w, owing to an 8.2% lower turnover in bonds (reaching HRK 168.5 million), while turnover in shares increased by 1.5% (HRK 37.4 million).

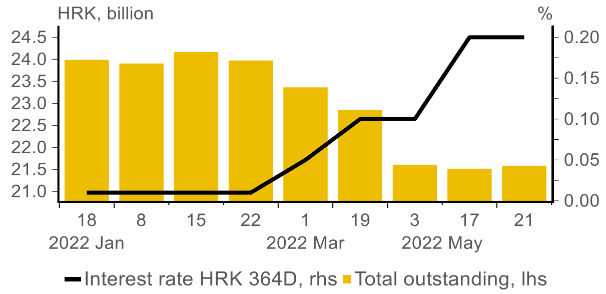
EUR/HRK and USD/HRK

Source: Macrobond



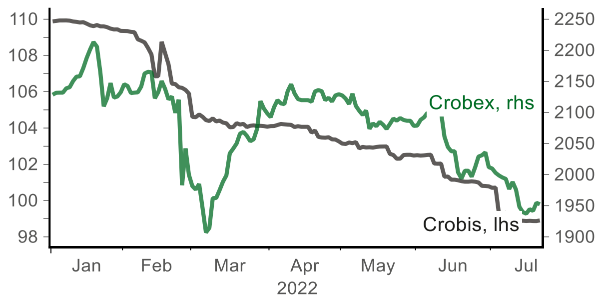
T-bills

Source: MoF



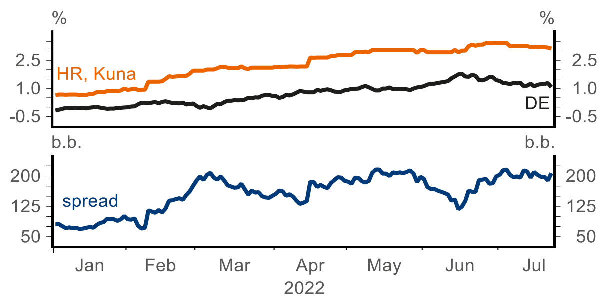
Crobex/Crobis

Source: Macrobond



10Y Government bond yield

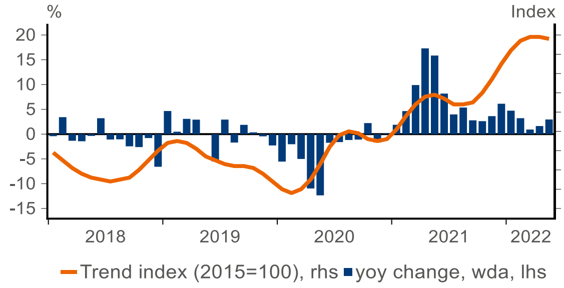
Source: Macrobond, Reuters



Statistics

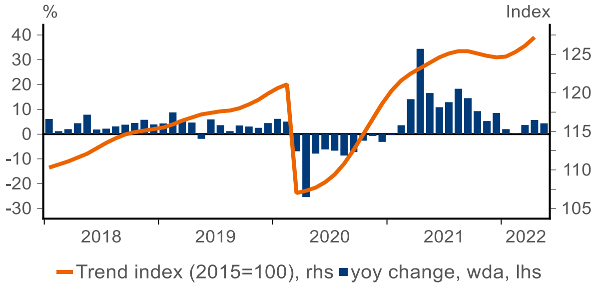
Industrial production

Source: Macrobond



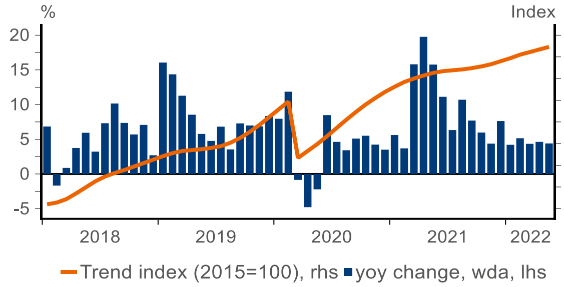
Retail trade, real

Source: Macrobond



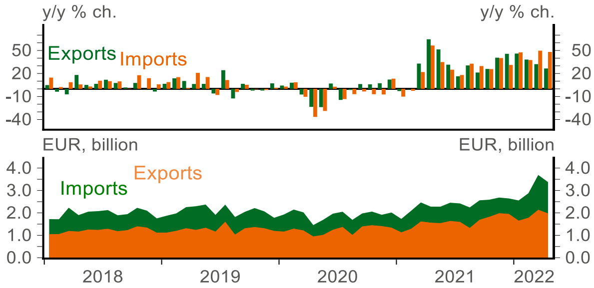
Construction works

Source: Macrobond



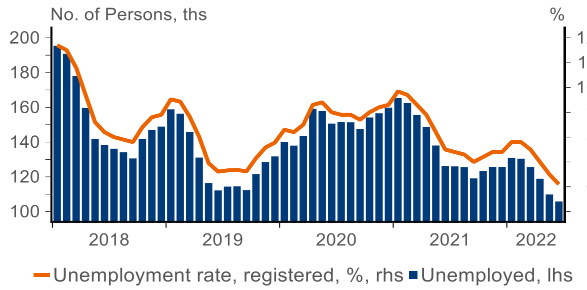
Goods exports and imports

Source: Macrobond



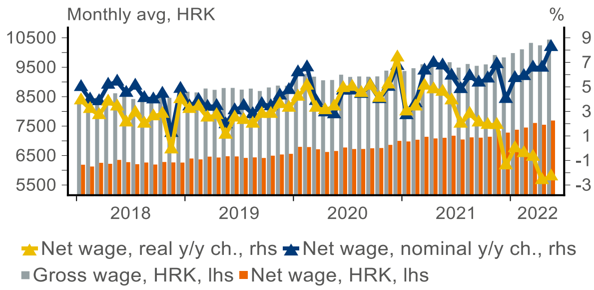
Unemployment

Source: Macrobond



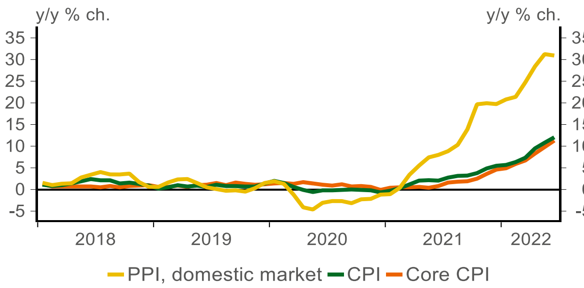
Wages

Source: Macrobond, CBS



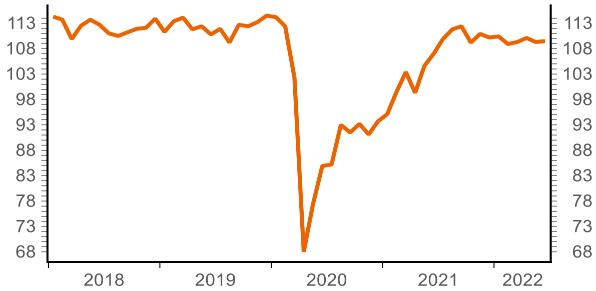
Prices

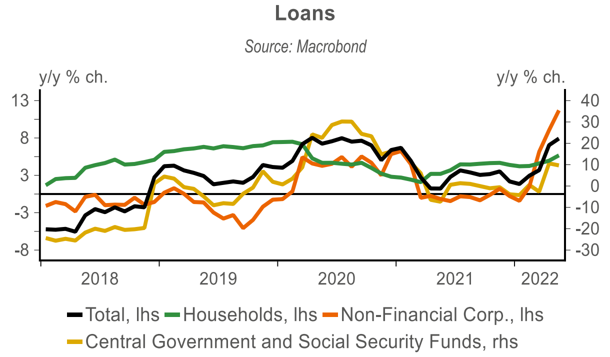
Source: Macrobond

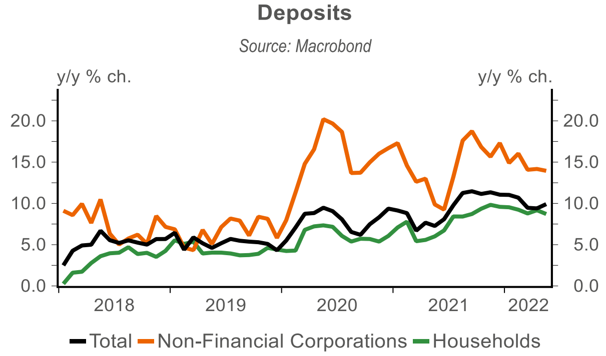


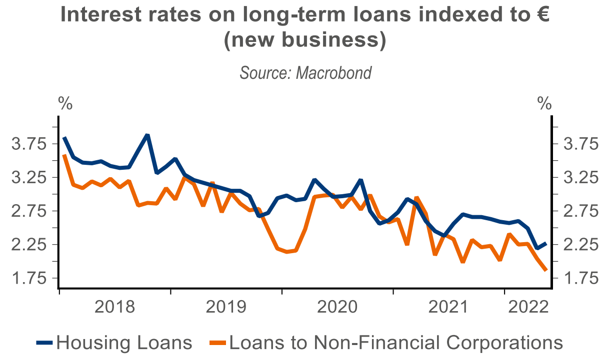
Economic Sentiment Indicator (ESI)

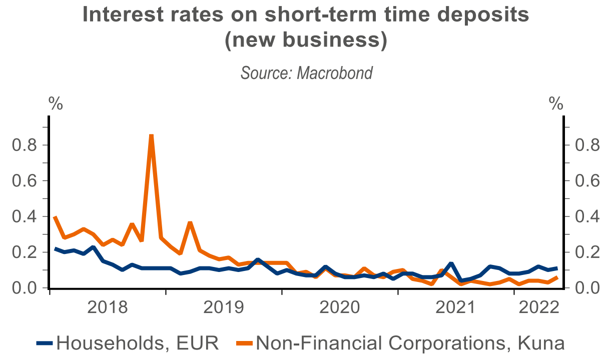
Source: Macrobond











RESEARCH OFFICE

Ivana Jović

Ana Lokin

Ivan Odrčić

TREASURY

Eugen Bulat

TRANSLATION

Ana Biloš

Jelena Marinović