MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa

The Ongoing Challenge to Central Bank Independence

The independence of central banks from political influence is one of the pillars of the world order as we know it. Central bank independence started to be granted in many countries during the 1980s, when central banks began to be tasked with the goal of achieving price stability (fiscal policy, meanwhile, remained mostly in charge of supporting economic activity). Since then, the benefits deriving from central bank independence have been evident in the structurally lower inflation rate that has occurred at a global level, which has contributed to lower long-term interest rates. Nevertheless, in the same way that other pillars of the post-WWII world order, such as NATO, the EU, and even the role of the US as the hegemonic global super-power, are now being questioned, central bank independence is also being challenged. One could even say that central bank independence is "under attack." To a certain extent, the quantitative easing programs begun by the major global banks in 2008 were meant to blur the distinction between monetary and fiscal policies. The risk of "fiscal dominance" (i.e. the use of monetary policy to keep governments solvent) was contained solely by the fig leaf that those policies were "independently" adopted by central banks in order to pursue the banks' price-stability objectives (e.g. by minimizing deflation risks). Also, it was inevitable that after this golden era of the central bank *semi-gods* coming to the rescue of the world economy – since fiscal policy was still constrained by anti-Keynesian ideological approaches – their apparent unlimited power would come under more severe scrutiny by the political authorities. But here we are not simply talking about central bankers returning to their traditional roles, by giving up the exorbitant powers granted to them in the aftermath of the Global Financial Crisis. Rather, we are talking about the return of political interference in matters that have traditionally been decided by central bankers, such as the right of independently setting interest rates.

Examples of this new tendency are starting to become common. In Argentina, when the government increased the inflation target from the 8%-12% range to 15% at the end of last year, the central bank "found the space" (to use a euphemism) to cut rates at a time when inflation was not giving any sign of moderating. This upset international investors, who then sold the peso *en masse*, thereby forcing the government to go cap in hand to the IMF for a USD 50bn emergency loan. In Turkey, ahead of the elections that certified Tayyip Erdoğan's acquisition of new presidential super-powers, Erdoğan himself explicitly said that he would reduce central bank independence, thus causing a sharp sell-off of the Turkish lira. After the election the president granted himself the power to appoint the new central bank governor, after choosing his son-in-law as head of the new treasury and finance ministry. Unfortunately, even in developed markets central bank independence is also not as sacred as it used to be. Last week U.S. President Donald Trump criticised the Federal Reserve's recent decision to increase rates. Reportedly, Trump said: "I am not happy about it. But at the same time I'm letting them do what they feel is best […] So somebody would say, 'Oh, maybe you shouldn't say that as president. I *couldn't care less what they say*, because my views haven't changed. I don't like all of this work that we're putting into the economy and then I see rates going up." It is worth reminding Trump of the experience of Fed Chair Paul Volcker, who in the early 1980s engineered a recession in order to combat inflation, and eventually succeeded in achieving his goal. Given the considerations above, it is certainly a possibility, but definitely would not be a welcome one, that a lack of central bank independence will become, together with populism, nationalism and rising authoritarianism, yet another ingredient of the new world "dis-order" we seem to be heading for.

Our Recent Publications:

- *ECB Preview: Focus on Re-Investment Policy, by Brunello Rosa, 20 July 2018*
- *Iraq: Protests Will Be Contained, But Risk Of Further Unrest Remains, by Alessandro Magnoli Bocchi, Pablo Gallego Cuervo and Francisco Quintana, 18 July 2018*

The Week Ahead

In the US, Q2-2018 GDP is expected to accelerate (*c:* 4.2% q-o-q ann.; *p:* 2.0%).

In the EZ, the ECB will likely leave its monetary policy stance unchanged (*c:* 0.0%; *p:* 0.0%).

In Turkey, the CBT is expected to hike the policy rate. The hike is expected to be by 50-100bps (from the current 17.75%), following a deterioration of inflation expectations (*end-2018:* 13.9%, +160bps).

The Quarter Ahead

Global growth and inflation will likely decelerate. After a cyclical acceleration in 2017 and Q1-2018, global growth and inflation started decelerating in Q2-2018; the trend will likely continue in 2019. According to the IMF, the global expansion that began in 2017 has plateaued. Global GDP projections remain unchanged (*2018:* 3.9%; *2019:* 3.9%), but the downside risks have increased.

The US economy will continue to grow. June retail sales growth (*a:* 6.6% y-o-y; *p:* 6.5%) show support for future growth.

Trade tensions will remain high, but will likely not lead to a trade-war. Last week: *a)* the US filed complaints with WTO against retaliatory tariffs imposed by China, the EU, Canada, Mexico and Turkey; *b)* President Trump announced he is ready to impose tariffs on all USD 505bn of Chinese goods imported to the US; and *c)* the EU announced it is considering retaliatory measures in case the US increases tariffs on EU car imports from 2.5 to 20%. Furthermore, the EU and Japan signed a trade deal, showing that two of the world's largest economies reject protectionism.

In the UK, the likelihood of a "no deal" Brexit will increase. Under PM May's proposal to the EU: *a)* a free trade area for goods will be established; *b)* free movement of people will end; and *c)* UK will no longer be under ECJ's jurisdiction. The EU considers the plan unacceptable, as it would weaken the single market and create burdens for businesses.

In China, GDP growth will continue to moderate. In Q2 2018, GDP grew at 6.7% y-o-y (*c:* 6.7%; *p:* 6.8%), above the government's target of "*about 6.5%*". Growth prospects will be hit by trade tensions, which caused the CNY to depreciate against the USD, to USD/CNY 6.770 (+1.2% w-o-w).

EMs will remain vulnerable to outflows in Q3 due to: *a)* declining USD liquidity; *b)* rising US interest rates; *c)* a stronger USD; and *d)* trade war fears. EM currencies will likely depreciate further (MSCI EM currency index: -0.9% w-o-w).

Turkey's relations with the EU and the US will stay frosty, despite the removal of the state of emergency—in place since the attempted *coup d'état* in July 2016.

The economic recovery in the MENA region will likely be stronger than anticipated. The GCC is set to benefit from rising oil outputs and fiscal stimuli. In 2018 the IMF expects for the MENA region a growth of 3.5% (*2017:* 2.2%).

We expect Brent oil prices to remain above 70 USD/b. Brent prices declined by 2.9% w-o-w, to 73.1 USD/b due to: *a)* trade war concerns; and *b)* US crude oil production hitting 11 mb/d for the first time in history. However, the risk of output shortages remains elevated: Opec has only 2.1m b/d of spare capacity (in KSA, Kuwait and the UAE), which will be further reduced if KSA delivers on its promise to increase its output to 11mb/d.

Last Week's Review

In the US, a good start of the Q2-earnings season was hampered by trade war concerns. With data published for 17% of the S&P500 firms, 89% reported a positive EPS surprise, with a blended earnings rate of 20.8%. However, concerns about China's retaliatory tariffs hindered stock performance, increased volatility and provided support to fixed income: *a)* the S&P500 remained flat w-o-w; *b)* the VIX index rose by 1 point to 13, below its long-term trend of 22; and *c)* the 10y UST yield rose to 2.89% (+6bps w-o-w). After a bullish testimony of Fed's Chairman Powell to the US Senate Banking Committee, President Trump broke with a 25-year tradition and criticized the Fed "*for raising interest rates*". The USD depreciated against a basket of currencies (DXY -0.3% w-o-w), and against the EUR (EUR/USD 1.172, +0.5 w-o-w).

In the EZ, June CPI inflation came in line with expectations (*a:* 2.0% y-o-y; *c:* 2.0%; *p:* 1.9%), with core CPI inflation slightly decreasing (*a:* 0.9% y-o-y; *c:* 1.0%; *p:* 1.0%).

In the UK, the GBP depreciated to GBP/USD 1.313 (-0.7% w-o-w), as an expected 25bps policy rate hike at the BoE MPC August meeting was put in doubt by: *a)* a standstill in UK inflation (June CPI, *a:* 2.4% y-o-y; *c:* 2.6%; *p:* 2.4%); and *b)* retail sales growth missing expectations (*a:* 2.9%; *c:* 3.9%; *p:* 4.1%).

Pablo Gallego Cuervo *and* ***Josiane C. Zhang*** *contributed to this Viewsletter.*

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Abbreviations, Acronyms and Definitions

a	Actual	*k*	thousand
AKP	Justice and Development Party, Turkey	*KSA*	Kingdom of Saudi Arabia
ann.	annualized	*LN*	Northern League, Italy
ARS	Argentinian Peso	*M5S*	Five Star Movement, Italy
bn	Billion	*m-o-m*	Month-on-month
BoC	Bank of Canada	*mb*	Million barrels
BoE	Bank of England	*mb/d*	Million barrels per day
BoJ	Bank of Japan	*MENA*	Middle East and North Africa
bpd	Barrels per day	*MHP*	Nationalist Movement Party, Turkey
bps	Basis points	*mn*	Million
BS	Balance sheet	*NAFTA*	North-American Free Trade Agreement
c	Consensus	*NATO*	North Atlantic Treaty Organization
C/A	Current account	*OECD*	Organization for Economic Cooperation and Development
CB	Central bank	*Opec*	Organization of Petroleum Exporting Countries
CBK	Central Bank of Kuwait	*p*	Previous
CBR	Central Bank of Russia	*PBoC*	People's Bank of China
CBT	Central Bank of the Republic of Turkey	*PCE*	Personal Consumption Expenditures
CDU	Christian Democratic Union, Germany	*PE*	Price to earnings ratio
CNY	Chinese Yuan	*PM*	Prime minister
CPI	Consumer Price Index	*PMI*	Purchasing managers' index
DJIA	Dow Jones Industrial Average Index	*pps*	Percentage points
d-o-d	Day-on-day	*pw*	Previous week
DXY	US Dollar Index	*QCB*	Qatar Central Bank
EC	European Council	*QAR*	Qatari Riyal
ECB	European Central Bank	*QE*	Quantitative easing
ECJ	European Court of Justice	*q-o-q*	Quarter-on-quarter
EIA	US Energy Information Agency	*RBA*	Reserve Bank of Australia
EM	Emerging Markets	*RRR*	Reserve Requirement Ratio
EP	European Parliament	*RUB*	Russian Rouble
EPS	Earnings per share	*SHCOMP*	Shanghai Stock Exchange Composite Index
EU	European Union	*tb/d*	Thousand barrels per day
EUR	Euro	*tn*	Trillion
EZ	Eurozone	*TPP*	Trans Pacific Partnership
Fed	US Federal Reserve	*TRY*	Turkish Lira
FM	Future Movement	*UAE*	United Arab Emirates
FOMC	US Federal Open Market Committee	*UK*	United Kingdom
FRB	US Federal Reserve Board	*US*	United States
FX	Foreign exchange	*USD*	United States Dollar
FY	Fiscal Year	*USD/b*	USD per barrel
GCC	Gulf Cooperation Council	*UST*	US Treasury bills/bonds
GBP	British pound	*VAT*	Value added tax
GDP	Gross domestic product	*VIX*	Chicago Board Options Exchange Volatility Index
GOP	Grand Old Party (US Republican Party)	*WTI*	West Texas Intermediate
IMF	International Monetary Fund	*w-o-w*	Week-on-week
INR	Indian Rupee	*y-o-y*	Year-on-year
IPO	Initial public offering	*y-t-d*	Year-to-date
IS	Islamic State	*2y; 10y*	2-year; 10-year
JPY	Japanese yen		