Rosa & Roubini
ASSOCIATES

# MAKING SENSE OF *THIS* WORLD

***17 January 2022***


***R&R Weekly Column***
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## The Unwinding of Central Banks' Policy Coordination Does Not Imply Fiscal Dominance

When the Covid-19 pandemic began, many countries had been in the process of unwinding some of the extraordinary measures they had introduced years before to counter the effects of the global financial crisis and the ensuing Great Recession of 2007-2009. Central banks had taken the lead in the policy response to the crises of 2007-2009, as some governments, especially in Europe, had mistakenly reacted with a mix of fiscal austerity and structural reforms, policies which deepened a recession which was eminently being driven by the (lack of) demand side of the macroeconomic equation.

Central banks meanwhile introduced ultra-long term repo operations (extended to 3-4 years maturity) against wider collateral, large-scale asset purchases (LSAPs), credit-easing facilities, forward guidance on rates and asset purchases, and negative policy rates. This arsenal was deployed in various forms and at various points in time throughout the 2010s. Some governments admittedly introduced forms of fiscal support, and certainly they indemnified central banks (whether directly or indirectly) for taking additional risks on their balance sheets, especially credit and liquidity risks, together with a massive increase in reputational risk. But both central banks and governments were keen to emphasise how these decisions were taken independently of one another, so as not to compromise their respective areas of autonomy and independence.

In early 2020 most central banks had been in the process of winding down the policies created ten years before, but then had to quickly reverse their course of action in order to respond to the pandemic. Central banks had to re-implement those measures they had been unwinding, to some extent on an even larger scale than had been the case pre-pandemic. This time around however governments realised that they too needed to react with large fiscal stimuli, causing fiscal deficits to reach double digit figures in many countries. In this case, the policy response was "coordinated" with central banks, which were asked to directly or indirectly monetise these large deficits. Investors praised this monetary-fiscal coordination, which represented the main policy innovation of this crisis.

As the economy normalises, and as central banks start focusing on inflation developments more than on supporting economic activity, it seems that this coordination with fiscal authorities is becoming less pronounced. Central banks are re-focusing their policy actions toward fighting inflation, after decades of dis-inflation and of inflation targets undershooting and the fear that if central banks continue to provide a backstop to the bonds of highly indebted countries, it may eventually lead to some form of "fiscal dominance."

But this may hardly prove to be the case in the short run. Governments extended large amounts of fiscal support to their populations knowing, or assuming, that central banks would effectively monetise the debts they incurred to do so – this prevented debt-issuing and debt-financing costs from spiralling out of control. Policy and short-term and long-term market rates actually fell to new lows during this period. But things seem to have changed recently. As central banks announced the end of their extraordinary measures, market rates increased, as the banks' moves were not announced in coordination with their respective governments.

In fact, central banks seem to fear that, if they continue coordinating with governments, they will become subject to some form of "fiscal dominance," de-facto losing their independence. While the risk exists that central banks will eventually fall back within the sphere of influence of their respective Treasuries over the medium term, in the short term coordinating with their governments to exit from the policies they implemented in the last few years would simply be common sense. In fighting inflation central banks will necessarily exhibit independent decision-making processes. Ensuring that the cost of borrowing for governments remains tolerable in the short term will not endanger central bank independence.

***Our Recent Publications***

- Long Covid: The Long-Term Economic, Social and Political Impact of the Pandemic, *by Marco Lucchin and Brunello Rosa, 14 January 2022*
- MACRO PICTURE: ASEAN Countries Divided On AUKUS Agreement, *by Mirko Giordani, 7 January 2022*
- *Travel Notes: Italy All Eyes on The Upcoming Presidential Election*, *by Brunello Rosa, 5 January 2022*
- **GEOPOLITICAL CORNER:** After The Failure Of Merkellism To Perpetuate Itself, The CDU Rediscovers Its Soul, *by John Hulsman, 11 January 2022*

## *Looking Ahead*

### *The Week Ahead: Inflation Set to Increases In UK and EZ; BoJ To Maintain Rates Unchanged*

***In EZ,*** in December, the final inflation reading is likely to be confirmed at 5.0% y-o-y (*p:* 4.9%) and core consumer prices are expected to increase to 2.6% y-o-y (*p:* 2.6%). On a monthly basis, CPI is expected to stay unchanged at 0.4% (*p:* 0.4%).

***In the UK***, headline inflation is expected to rise to 5.2% in December (p: 5.1%) with core inflation remaining at 4.0% y-o-y.

***In Japan,*** BoJ is expected to leave its policy stance, and in particular its short-term interest rate, unchanged at -0.1% (*p:* -0.1) in January.

### *The Quarter Ahead: Court Blocks Biden COVID Mandate; NATO-Russia Council Amid Ukraine Tensions; Situation in Kazakhstan*

***U.S. Supreme Court blocks US President Biden COVID vaccine mandate for large employers.*** The mandate would have required 84m workers at large companies with at least 100 employees to get vaccinated or get tested weekly at their own expense. The rule would have also made masks indoors compulsory for unvaccinated workers.

***NATO-Russia Council met in Brussels on 12 January to discuss the situation in Ukraine and East European security.*** In past few months, Kiev has warned that Russia had amassed 106K troops and 1.5K tanks near the border. Following the meeting, U.S. representatives and NATO members univocally rejected Moscow's demands for new European security architecture, whilst they remain open to more diplomacy. On the other hand, Russia described the talks as "unsuccessful" and repeated its demand that the military alliance will not expand eastwards.

***The situation eases in Kazakhstan, while Russia-led block starts pulling troops.*** Massive protests began on 2 January 2022, following the unexpected surge in liquefied gas prices, as the government lifted price caps. Protests over fuel morphed into general dissatisfaction with the government and socio-economic problems. A state of emergency was declared. Kazakh authorities have now detained about 12K people for their alleged participation in anti-government protests. Social unrest in OPEC+ member Kazakhstan has increased oil prices, as investors worry about supply chain disruptions.

***CBs turn hawkish.*** Federal Reserve Chairman Jerome Powell announced rate hikes and tighter monetary policy, to control inflation, which hits a close to a 40-year high. Other CBs will also reduce monetary accommodation in coming months.

## *Last Week's Review*

### *Real Economy: Consumer Prices Increase In The US, While Falling in China; UK GDP Accelerates*

***In US,*** December's annual inflation accelerated to 7% (*p:* 6.8% *c:* 7.0%), marking the fastest pace since 1982, while monthly inflation slowed down to 0.5% m-o-m (*c:* 0.4% *p:* 0.8%).

***In China,*** inflation fell to 1.5% y-o-y (*c:* 1.8% *p:* 2.3%) and -0.3% m-o-m (*c:* 0.2% *p:* 0.4%) respectively.

***In UK***, in November GDP rose by 8.0% y-o-y (*c:* 7.5% *p:* 5.1%) and 0.9% m-o-m (*c:* 0.4% *p:* 0.2%).

### *Financial Markets: US and EZ Stocks Fall; Bond Yields Rise; Dollar Weakens*

***Market drivers:*** investor sentiment weakened, as *i)* price pressures increase; *ii)* U.S. retail sales fell more than expected; *iii)* further escalation in Russia-NATO relations is probable; *iv)* Powell reported in his confirmation hearing that Fed will likely end net asset purchases in March; and *v)* JPMorgan Chase and Citigroup released lower profits in the fourth quarter.

***Global equities*** rose slightly w-o-w (MSCI ACWI, +0.2%, to 744). The US S&P 500 Index fell (-0.3% w-o-w, to 4,663) since increasing bond yields made tech stocks less attractive and thus caused sharp losses. In the EZ, shares also decreased compared to last week (Eurostoxx 50, -0.8% w-o-w, to 4,272), as concerns over the impact of tighter policy weigh on European stocks. In EMs, following a slump in the safe-haven dollar, equities rose (MSCI EMs, +2.6%, to 1,257), considering that investors shifted towards emerging markets' stocks. On the other hand, Chinese stocks decreased (Shanghai Comp., -1.6%, to 3,521), as Beijing reports the first local Omicron case and default risks in China's real estate sector add to worries. Volatility rose to 19.7 (VIX S&P 500, 52w avg.: 20.6; 10y avg.: 17.8).

***Fixed Income:*** UST yields rose and reached a two-year high (+2.8 bps, to 1.79%), as investors remain focused on Fed hawkish comments. German 10-year bonds declined compared to last week (-1.1 bps, to -0.04%), but on 10 January reached its highest level since May 2019 and remains near the threshold of 0%.

***FX:*** w-o-w, the US Dollar Index decreased (DXY, -0.6%, to 95.17; EUR/USD +0.5%, to 1.142), despite Fed Chair Powell announced the future rate hikes. Investors seem to accept that Fed hawkish comments are priced in and that the euro has a potential to offer higher returns. In EMs, currencies increased against the USD (MSCI EM Currency Index, +0.6% w-o-w, to 1,742).

***Commodities:*** w-o-w, oil prices increased as output from OPEC falls behind (Brent, 5.6% to 86.4 USD/b). w-o-w, gold prices rose (+1.1% to 1,817 USD/Oz).



***Nato Balavadze*** *contributed to this Viewsletter.*

## Abbreviations, Acronyms and Definitions

| | | | |
|---|---|---|---|
| *a* | *Actual* | *LN* | *Northern League, Italy* |
| *AKP* | *Justice and Development Party, Turkey* | *M5S* | *Five Star Movement, Italy* |
| *ann.* | *annualized* | *m-o-m* | *Month-on-month* |
| *ARS* | *Argentinian Peso* | *mb* | *Million barrels* |
| *avg.* | *Average* | *mb/d* | *Million barrels per day* |
| *bn* | *Billion* | *MENA* | *Middle East and North Africa* |
| *BoC* | *Bank of Canada* | *MHP* | *Nationalist Movement Party, Turkey* |
| *BoE* | *Bank of England* | *mn* | *Million* |
| *BoJ* | *Bank of Japan* | *MPC* | *Monetary Policy Committee* |
| *bpd* | *Barrels per day* | *NAFTA* | *North-American Free Trade Agreement* |
| *bps* | *Basis points* | *NATO* | *North Atlantic Treaty Organization* |
| *BS* | *Balance sheet* | *OECD* | *Organization for Economic Cooperation and Development* |
| *c* | *Consensus* | *Opec* | *Organization of Petroleum Exporting Countries* |
| *C/A* | *Current account* | *p* | *Previous* |
| *CB* | *Central bank* | *P2P* | *Peer-to-peer* |
| *CBB* | *Central Bank of Bahrain* | *PBoC* | *People's Bank of China* |
| *CBK* | *Central Bank of Kuwait* | *PCE* | *Personal Consumption Expenditures* |
| *CBT* | *Central Bank of Turkey* | *PE* | *Price to earnings ratio* |
| *CDU* | *Christian Democratic Union, Germany* | *PM* | *Prime minister* |
| *CNY* | *Chinese Yuan* | *PMI* | *Purchasing managers' index* |
| *CPI* | *Consumer Price Index* | *pps* | *Percentage points* |
| *DJIA* | *Dow Jones Industrial Average Index* | *pw* | *Previous week* |
| *DJEM* | *Dow Jones Emerging Markets Index* | *QCB* | *Qatar Central Bank* |
| *d-o-d* | *Day-on-day* | *QAR* | *Qatari Riyal* |
| *DXY* | *US Dollar Index* | *QE* | *Quantitative easing* |
| *EC* | *European Commission* | *q-o-q* | *Quarter-on-quarter* |
| *ECB* | *European Central Bank* | *RE* | *Real estate* |
| *ECJ* | *European Court of Justice* | *RBA* | *Reserve Bank of Australia* |
| *EIA* | *US Energy Information Agency* | *RRR* | *Reserve Requirement Ratio* |
| *EM* | *Emerging Markets* | *RUB* | *Russian Rouble* |
| *EP* | *European Parliament* | *SWF* | *Sovereign Wealth Fund* |
| *EPS* | *Earnings per share* | *tn* | *Trillion* |
| *EU* | *European Union* | *TRY* | *Turkish Lira* |
| *EUR* | *Euro* | *UAE* | *United Arab Emirates* |
| *EZ* | *Eurozone* | *UK* | *United Kingdom* |
| *Fed* | *US Federal Reserve* | *US* | *United States* |
| *FOMC* | *US Federal Open Market Committee* | *USD* | *United States Dollar* |
| *FRB* | *US Federal Reserve Board* | *USD/b* | *USD per barrel* |
| *FX* | *Foreign exchange* | *UST* | *US Treasury bills/bonds* |
| *FY* | *Fiscal Year* | *VAT* | *Value added tax* |
| *GCC* | *Gulf Cooperation Council* | *VIX* | *Chicago Board Options Exchange Volatility Index* |
| *GBP* | *British pound* | *WTI* | *West Texas Intermediate* |
| *GDP* | *Gross domestic product* | *WTO* | *World Trade Organisation* |
| *IMF* | *International Monetary Fund* | *w* | *Week* |
| *INR* | *Indian Rupee* | *w-o-w* | *Week-on-week* |
| *IPO* | *Initial public offering* | *y* | *Year* |
| *IRR* | *Iranian Rial* | *y-o-y* | *Year-on-year* |
| *JPY* | *Japanese yen* | *y-t-d* | *Year-to-date* |
| *k* | thousand | *ZAR* | *South African Rand* |
| *KSA* | *Kingdom of Saudi Arabia* | *2y; 10y* | *2-year; 10-year* |