MAKING SENSE OF *THIS* WORLD 7 February 2022

R&R Weekly Column
By Brunello Rosa

Central Banks Are Getting Ready For A New Inflation Era

The 1970s were characterised by structurally high inflation. A number of events contributed to that environment. In 1971, US President Richard Nixon announced the end of the USD convertibility into gold, causing the collapse of the Bretton Woods agreements between 1971 and 1973. This meant the end of the fixed-exchange regimes that had regulated the international financial environment since the end of WWII. Central banks had to switch their “nominal anchor” from the exchange rate to the inflation rate, and they were unprepared to do so. The two oil shocks of 1973 (following the Yom Kippur war) and 1979 (following the Iranian revolution) meanwhile contributed to global inflation rates reaching double-digit territory. And the indexation mechanisms of salaries and pensions induced a price-wage spiral, which underpinned the high inflation rates of that decade and of the 1980s.

Gradually, during the 1980s and 1990s, central banks gained operational independence from their government, to set interest rates, and by the end of the 1990s were able to reign in inflation. Meanwhile, globalisation, which also started in the 1970s with Nixon's trip to China in 1972 and the opening up of the Chinese economy to capitalism under Deng Xiaoping, also induced a rapid deflation in the price of manufactured and technological goods. Overall, one may consider the period between 1985 and 2020 as the “great dis-inflation” era, with inflation rates well below the established targets for the past 10 years or so, during which time central banks have been struggling to make inflation return to target.

The 2020-22 pandemic has radically changed this dynamic. Supply bottlenecks, high energy prices, labour shortages following “the great resignation” phenomenon have induced a short-term increase that has clearly caught global central banks by surprise. They thought these phenomena would be “temporary”, “transitory”, or “transient”, but have instead had to realise that inflation deriving from such a large negative supply shock and positive fiscal stimulus has proved to be higher and more persistent than they had initially anticipated.

As we discussed in previous columns, even once this short-term inflation has subsided, a more persistent inflationary environment will emerge as a result of the technological and ecological transition the world is now going through, as well as a result of the more equal distribution of income between capital and labour that is about to happen and is badly needed, and the balkanisation of global supply chains deriving from incipient de-globalisation. After the inflationary era of 1970-1985 and the deflationary era of 1985-2020, a new inflation era is about to start.

Central banks are getting ready for this new inflation era. In the last few weeks, the world’s major central banks have clearly changed tack. The Fed confirmed that QE tapering will end in March and that the first rate increase will also occur in March, opening the road to four if not five rate hikes in 2022. The Bank of England increased its policy rate on back-to-back occasions after its December hike, for the first time since 2004, and almost half of the Policy Committee wanted a 50bps increase instead of the standard 25bps that was in fact adopted. Finally, the ECB also hinted at an imminent policy shift that is likely to materialise in March, when the new staff macroeconomic projections will be released. Of the four major central banks, only the Bank of Japan so far has remained in the old era of the deflationary environment – but this is because inflation rates remain close to zero in Japan. For now.

Our Recent Publications

Flash Review: ECB Signals A Policy Shift To Occur In March, *by Brunello Rosa, 3 February 2022*

Flash Review: BoE Delivers Back-to-Back Hike And Signals More Rate Rises, *by Brunello Rosa and Nato Balavaze, 3 February 2022*

Looking Ahead

The Week Ahead: Inflation To Rise In The US; GDP To Fall In The UK

In the US, in January headline inflation and core inflation are seen rising to 7.3% y-o-y (*p:* 7%) and 5.9% y-o-y (*p:* 5.5%) respectively.

In the UK, Q4 GDP growth rate y-o-y is expected to slow down to 6.5% (*p:* 6.8%), while Q4 GDP growth rate q-o-q is expected to remain unchanged at 1.1%.

In Sweden, the Riksbank is expected to leave its repo rate unchanged at 05%.

The Quarter Ahead: President Orban Meets Putin; US Disengaging From ME; Crunch In Global Supply Chain; Cryptos Destabilize EMs

Russian President Putin accused Western powers of not being concerned with Russian security. While Russia is perceiving the US involvement in the Ukrainian crisis as a geopolitical move to contain the development of Russia, the US and the UK are planning sanctions against President Putin's inner circle in case of an attack to Ukraine. To counter the Western countries bulwark, Russia has been seeking for supporters by meeting with Hungarian President Orban. This meeting is likely to increase distress and tensions among NATO allies, as there is no certainty on where the Hungarian ambivalence will tilt.

China fosters economic ties with Iraq, while the US ended the combat mission in Iraq and retreats from the Middle East. Beijing relies on the ME for energy imports, while Arab states are tapping into Chinese technology and trade relations. Iraq has become one of the biggest beneficiaries of the BRI and new deals are to be signed to sanction Chinese engagement in rebuilding airports, gas fields and powerplants.

Covid restrictions fuel bottlenecks in global supply chain. WTO warned that the crunch in global supply chains is likely to continue longer than expected. Ministers and trade experts will hold a summit in March to discuss how to ease frictions, especially for smaller companies.

Cryptocurrencies' price volatility is resulting in a destabilizing capital flow in emerging markets. Countries, as El Salvador, are recognizing cryptos as legal tenders and thus are putting financial stability and integrity at risks. The IMF has urged national and global regulators to establish a tight supervision over cryptocurrencies.

Last Week's Review

Real Economy: NFP Higher In The US; GDP Growth In The EZ; Higher Inflation In The EZ; Rising Base Rate In The UK

In the US, in January NFP rose by 467k (*c.* 150K, *p.*510K), beating expectations as employment growth continued in leisure and hospitality (151K), and in the accommodation industry (23K).

In the EZ, *i)* Q4 GDP growth rate slowed down to 0.3% q-o-q (*p:* 2.3%) as the Omicron variant continues spreading across the continent and restrictions hurt the services sector; *ii)* in December unemployment rate decreased more than expected to 7% (*p:* 7.2%); *iii)* in January headline inflation ended higher to a fresh record of 5.1% y-o-y (*p:* 5.0%) and core inflation fell less than expected to 2.3% y-o-y (*p:* 2.6%); *iv)* in December retail sales contracted much more than market forecasts by -3% m-o-m (p: 1.0%) amid the restrictions related to the pandemic.

In the UK, BoE increased its Base Rate to 0.5% from 0.25% and stopped reinvesting in government and corporate bonds.

Financial Markets: Wobbly Global Equities; Dollar Weakens; Oil And Gold Prices Rose Due to Geopolitical Tensions

Market drivers: Last week's main market movers that weighted on investors' sentiment were: *i)* fears that the US Federal Reserve might be lifting short-term interest rates from mid-March onwards; *ii)* announcement by the IMF that the global economic growth outlook is likely to scale back; *iii)* rising tensions due to the escalation of the Ukraine crisis.

Global equities increased w-o-w (MSCI ACWI, +1.93%, to 718). In the *US*, the S&P 500 ended higher (+1.55% w-o-w to 4,500). In the *EZ*, shares fell (Eurostoxx 50, -1.22% w-o-w, to 4,087). In *EMs*, equities gained (MSCI EMs, +2.52%, to 1,221), while the Chinese remained unchanged (Shanghai Comp. to 3,361). *Volatility* lost ground (VIX S&P 500, -8.58 pts to 23.16, *52w range.:* 14.1-37.51).

Fixed Income: US 10-year bond yield increased (+1bps, to 1.93%), as well as Germany's 10-year bond yield rose (+18bp, to 0.2%). The EMTX 7-10 RT decreased by -3.4pts, to 274.

FX: w-o-w, the US Dollar Index fell (DXY, -1.89%, to 95.43; EUR/USD gained by +2.81%, to 1.1457). In *EMs*, currencies strengthened against the USD (MSCI EM Currency Index, +0,15% w-o-w, to 1,739).

Commodities: Oil prices rose (Brent, +2.06 pts w-o-w, to 92.78 USD/b) pushed by geopolitical tensions in Eastern Europe and ME. Gold Futures (+11.4 pts w-o-w, to 1,810 USD/Oz) after the NFP report showed an unexpected strong gain in US employment.

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The picture in the front page comes from this website

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*