Hawks Aplenty

122 – 7 February 2022

Key points

- Lagarde sent the European Central Bank (ECB) on a course consistent with a rate lift-off this year. We expect it in December, but it could come as early as September.
- The memory of the "Greenspan put" probably makes the Federal Reserve (Fed) ready to look through quite a lot of market pain. For the ECB, fragmentation, as always, would be the problem. As the monetary mood changes in Europe, progress on the fiscal framework must accelerate.

Christine Lagarde's refusal last week to repeat the point she made in December about a rate hike this year being unlikely, while mentioning a "unanimous concern" about inflation in the Governing Council, is a big shift. The ECB is now ready to follow the Fed with a first hike with only a 6 to 9-month lag – we now expect the lift-off in December. Yet, the Fed "bared its teeth" only when wage data made it absolutely clear the US inflation process had turned endogenous. The ECB is changing its stance before wage acceleration appears in the Euro area. Of course, the January print for consumer prices was hard to ignore, but the ECB's pre-emptive stance suggests a sensitivity to inflation risks at odds with the cultural change imposed by Draghi during his tenure.

Financial markets are currently bombarded by a steady flow of hawkish signals from all major central banks. On top of the Fed's and now the ECB's tougher rhetoric, the Bank of England, upon delivering another 25 basis points hike last week, revealed that 4 members of its Monetary Policy Committee voted for 50 basis points. A key issue is whether the market reaction could ultimately "stay the hand" of the central banks. At the Fed, the memory of the "Greenspan put" and its fateful consequences are probably vivid enough to make the Federal Open Market Committee (FOMC) look through quite a lot of pain on the markets. Asset prices developments would have to significantly affect the real economy before the Fed changes course, especially in a situation where there is enough excess demand for the central bank to take risks with the magnitude of its tightening.

The "feedback loop" works differently in the Euro area. the central bank could not completely ignore a widening in sovereign spreads which would bring back existential questions on the functioning of the Euro area. Fortunately, positive political developments in Italy and Portugal provide a buffer against too brutal a market reaction. Still, If the ECB normalizes faster, the evolution of the fiscal institutions of the European Union (EU) should also go faster, and deeper. The French Presidency of the EU convened a special European Council on 10-11 March to kickstart discussion on a new model for the Stability and Growth Pact. The proposal by Giavazzi and Weymuller (economic advisors to Draghi and Macron) we discussed here a few weeks ago is becoming an even more appealing option given the new monetary mood. Draghi's legacy at the ECB may be in question, but his capacity to shape the debate in Europe remains high.

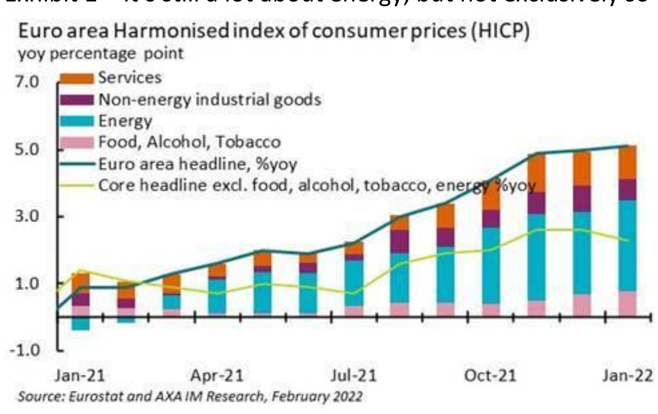
The 2011 trauma is overcome?

While the market was expecting the US labour market to take a breather in January because of the Omicron wave, almost half a million new jobs were added, only marginally below the robust pace observed since Q3 2021. Average earnings also surprised to the upside at 5.7%yoy. True, the unemployment rate marginally rose to 4% from 3.9% in December, as labour participation edged up by 0.3 percentage points, but **there is more than enough momentum to justify Powell's assertion, which we commented last week, that there is such ample excess demand to cut through in the US that a pre-emptive monetary tightening can be implemented** as early as in March while still leaving the economy with a decent growth rate. We note at the same time that the latest Institute for Supply Management (ISM) surveys suggest supply tension continues to ease and we have our concerns over the second half of the year, but for now, the dataflow supports the Fed's hawkish turn. The release this week of another strong inflation print for January (the market is expecting 7.3%yoy for headline and 5.9% for core) will likely trigger more calls for strong, pre-emptive action, even if the most recent Fed speak took some distance from some very hawkish statements earlier (such as Raphael Bostic's mention of the possibility to start the lift-off with a 50 basis points hike).

On the other side of the Atlantic, we had understood the ECB's announcements of December 2021 – consistent with a status quo on policy rates this year - as perfectly appropriate for an economy which has been lagging behind the US in the post-lockdown recovery and displays no sign of labour market overheating**. The clear takeaway from last week's press conference is however that the ECB is ready to alter its forward guidance next month already to open the door to a rate towards the end of this yea**r – December is our baseline but we think September is in play – after accelerating its pace of tapering. In clear, **the ECB is ready to emulate the Fed with only a 6 to 9 months delay.**

True, the Euro area GDP has returned to its pre-pandemic level in Q4 2021 only two quarters after the US. The unemployment rate in December 2021 fell further to stand 0.5 points below December 2019. The inflation print for January – which was expected to be an inflexion point with the disappearance of the German VAT base effect – came out *above* expectations and its message cannot be reduced to energy prices, even if they remain by far the main contributor to the ongoing spike (see Figure 1). Yet, **there is an ingredient missing in the comparison with the US: wage growth.** The Fed bared its teeth after months of strong wage prints, i.e. once it had become obvious that a domestic inflationary process was in the works. The ECB is not waiting for the evidence.

Exhibit 1 – It's still a lot about energy, but not exclusively so



This is getting us back to the "pre-Draghi" ECB and its hawkish bias, where the mere risk of inflation expectations being dis-anchored was enough to trigger pre-emptive action. Reading again the transcripts of the ECB's press conferences of 2011 – when it hiked twice before finally being forced to cut again in November – what we find striking is how the central bank was sending stark messages to price-setters – notably unions and employers – insisting on the need to avoid second round effects from the energy price push, when the *actual* growth in negotiated wages was then perfectly unremarkable (1.8%yoy in April 2011, when it hiked for the first time).

The trauma of 2011 helped in no small measure Mario Draghi to impose a complete "cultural shift" on the ECB and engage it on a U-turn in terms of risk sensitivity. While the pre-Draghi ECB was always ready to tighten fast at the earliest sign of inflationary pressure and was dismissive of deflation scenarios, under Draghi it was always ready to

loosen fast at the earliest sign of deflationary pressure and was dismissive of inflation risks. It's always risky to try to guess how Mario Draghi would have reacted to the current inflation spike, but we think it is likely he would have waited until wage growth had effectively picked up in the data before changing the rhetoric. **That the ECB is in no mood to take this risk today is strong evidence that the Draghi era has closed for good.**

Now, Christine Lagarde did not commit to hike in 2022. She "merely" refused to reiterate that hiking would be unlikely this year. There is still some room to backtrack, but in our view the "natural slope" is clear. The hawks have won the argument and baring a serious deterioration in the data flow in the months ahead, the ECB will hike in the second half of 2022. The change has been quite sudden though. The magnitude of last week's shift surprised us. Only two weeks ago, at a World Economic Forum panel Lagarde came across as quite relaxed on the risk that persistent inflation would settle in the Euro area.

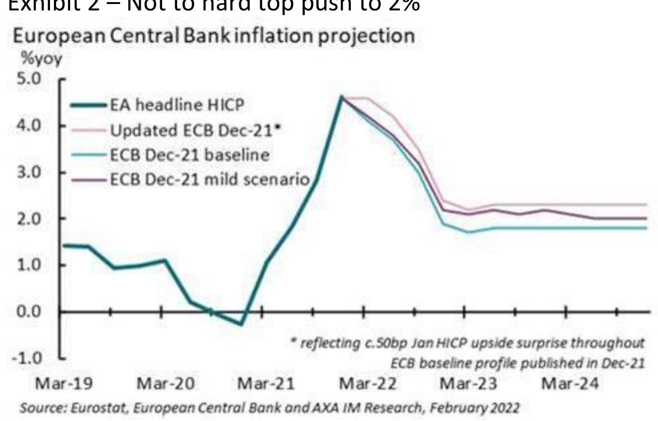
We think one of the reasons the doves have given up the fight (as reflected in Lagarde's mention of *"unanimous concern"* with inflation) is that even within that camp some Governing Council members have for long had misgivings about some aspects of the ECB's unconventional policy. Negative interest rates, in particular, is a feature of the Euro area economy which many members consider to be difficult to communicate to the wider public and intrinsically dangerous for financial stability. Many Governing Council members may consider that given how far the ECB has gone over the last 10 years, some quicker-than-expected normalization is easier to accept. Those issues have been with us for a long time though. The acceleration in the "mood change" in Frankfurt may quite simply boil down to the fact that even sophisticated observers can be swayed by one spectacular data point, and it's probably what happened with the January inflation print.

From mood change to actual policy changes

We had noted that the outcome of the strategy review – with the unusual precision on how inflation settling at 2% on a sustainable basis in the "mid-point" of its projection horizon – made the ECB's policy trajectory very dependent on the next batches of forecasts. To anchor a rate hike in 2022 already, the ECB needs to revise its inflation projections next month.

That part should not be too difficult. The ECB produces around its baseline a mild and severe COVID scenario. **The December 2021 version of the "mild scenario" (see Exhibit 2) already had inflation at 2.1% in 2023 and 2.0% in 2024** (against 1.8% for both years in the baseline). It would be easy for the ECB to argue that the most recent news flow on the pandemic front should shift the baseline towards the mild scenario. The ECB staff will also need to consider the impact of the stronger-than-expected recent inflation prints on the starting point of its new forecast. In Exhibit 2 we created an illustrative "updated forecast" by keeping the upside surprise of January 2022 constant over the full horizon. It's highly speculative of course, but it shows how a "spooked ECB" could quite significantly revise its forecasts next month by merely extrapolating on the most recent developments.

Exhibit 2 – Not to hard top push to 2%



Shifting the forecast allows the ECB to signal a rate hike would put the ECB in line some aspects of its forward guidance while telegraphing a rate hike this year: *"In support of its symmetric 2% inflation target and in line with its monetary policy strategy, the Governing Council expects the key ECB interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realized progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilizing at 2% over the medium term".* Note however that the current wording also contains as a proviso that *"this may also imply a transitory period in which inflation is moderately above target."* There was always an element of judgment there, and the ECB can argue that the recent overshooting has exhausted its margin of tolerance. That bit could be modified next month, together with the notion that rates could go lower, to signal the ECB's change of approach.

There remains a problem with the timeline implied by the current forward guidance. Indeed, the Asset Purchase Programme (APP) is intended to continue until October 2022 at least, and the ECB would normally wait until net purchases are over before hiking. **In this configuration, the earliest they could technically hike would be December, which we now consider as our base case (instead of early-2023). The ECB sounded so worried that a move in September cannot be ruled out.** However, this would in principle force them to accelerate their tapering and stop APP in June or July. While we do expect a revision of the profile to be announced in March, with a smaller quantum of purchases, we think that a complete stop of the purchases by the summer would be very brutal in altering underlying demand on the bond market and would likely push peripheral spreads wider. True, the seasonal issuance pattern side could limit the shock, but this may be a risk the ECB would rather not take.

The other option to go in September already would be to disconnect APP from movements on the policy rates, but it would be seriously at odds with previous communication and would create a conundrum for the central bank. Indeed, APP was always presented as the natural complement to conventional monetary policy when interest rates had hit the lower bound and price stability was still not achieved. Its stated purpose never was to shore up sovereigns struggling with market pressure. Continuing net purchases while hiking rates would send the blatant message that APP is a "spread contraction" tool, detached from the overall purpose of monetary policy. That would push "fiscal dominance" too far in our view.

The exact timing is probably still data dependent. What should we watch out before the next ECB meeting on 10 March? Inflation data should be the first on the list. The full details of the January inflation print will be released on 23 February, which may help understand better the causes of the unexpected spike. The flash February Harmonised Index of Consumer Prices (HICP) print will also be released before the next meeting. We also noted in the press conference that consumer demand was seen as a potential downside risk, and the ECB may want to know how much consumption withstands the purchasing power shock. Consumer confidence, and actual consumer data (retail sales, consumer goods) should thus be closely monitored.

Beyond the timing issue, the ECB needs to make up its mind on the quantum of tightening. The market is currently pricing the ECB's normalizing by increments of 10 bps, in symmetry with how it proceeded on the way down. President Lagarde sounded so worried on inflation last week **that we find worth considering the normalization would go in bigger steps than that, e.g. in two hikes of 25 basis points to reach zero for the deposit rate in March 2023**. It would make sense for the ECB to go fast while the Fed is itself hiking fast, to avoid an overreaction of the euro exchange rate. The next question is how far the ECB would go once the deposit rate is back to zero. A pause of several months is likely, since the doves concerned with the financial stability consequences of negative rates would be reassured and pushing for more hikes would become more difficult in terms of political balance within the Council. The answer to this question will probably ultimately depend on where broad financial conditions stand by then relative to aggregate demand. It is difficult to argue that there is any excess demand to curb in the Euro area at the moment. There may be even less demand left by the middle of 2023, especially in the periphery, if market interest rates continue to rise in response to the ECB's new stance.

The "Greenspan precedent" and the market/policy loop

Financial markets are currently bombarded by a steady flow of hawkish signals from all major central banks. On top of the Fed's and now the ECB's tougher rhetoric, the Bank of England, upon delivering another 25 basis points hike last week, revealed that 4 members of its Monetary Policy Committee voted for 50 basis points. A key issue is whether the market reaction could ultimately "stay the hand" of the central banks.

Institutions often proceed along an error-correction path. We mentioned earlier in this note the 2011 precedent which had for nearly 10 years influenced the ECB. **In the Fed's case, the precedent of interest at the current juncture may get us back to before the Great Financial Crisis (GFC) , to the "Greenspan's put".**

Former Governor of the Reserve Bank of India and International Monetary Fund (IMF) Chief Economist Raghuram Rajan in a recent column for Project Syndicate recalled how in 1995 Greenspan stated at a Congressional Hearing that the Fed could not prevent *" the inevitable economic hangover"* from an asset-price boom, but it could "*mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion".* Rajan's eloquent summary of this approach is that the Fed gave the market the assurance that it would not limit the upside but would limit the downside. The Greenspan put encouraged cumulative risk-taking to the point at which the Great Financial Crisis triggered a shock to the real economy which no amount of monetary stimulus could completely contain.

To be clear, we are not arguing here that the current market configuration can be compared to the pre-GFC one. Yet, **the memory of the "Greenspan put" is probably still vivid enough at the Fed to make them look through quite a significant amount of market pain before re-considering their stance**. We noted in last week's Macrocast how Powell at his last press conference chose not to soothe the market when asked about the reaction to his hawkish rhetoric, simply indicating that this proved the communication lines between the Fed and the market work well. The limit to this approach, in the Fed's case, is that the gyrations in asset prices tend to have a significant impact on the real economy. If the correction in equity price – which so far has been contained outside high tech – starts impacting consumption, then the Fed would have to take the market development in consideration. Clearly, we are not there.

The ECB is in a different position. The direct effect of market developments on the real economy tends to be lower than in the US, but the central bank could not completely ignore a widening in sovereign spreads which would bring back existential questions on the functioning of the Euro area. Fortunately, positive political developments in Italy and Portugal provide a buffer against too brutal a market reaction to the possibility of an early end of quantitative easing (QE) and a faster normalization of the ECB's policy rates. Still, the bond market "took notice" last week. Having run the entire policy show since the GFC – to the point that Governing Council members were openly talking about the necessary cooperation between monetary and fiscal policy, **the ECB normalizing monetary policy early will put additional pressure on governments while discussions about the future of the Stability and Growth Pact rules are just starting.**

An extraordinary EU Council on 11 March will kickstart the formal discussions on this topic. Our hope is that they will go further than "simply" allowing for a more manageable fiscal consolidation from 2023 onward than what the current rules would imply. We discussed in Macrocast the proposals by Giavazzi and Weymueller to transfer to an institution such as the European Stability Mechanism the "Covid debt" currently held by the ECB and prolong the debt mutualization permitted by the Next Generation EU. If the ECB normalizes faster, the evolution of the fiscal institutions of the EU should also go faster, and deeper.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Payrolls (Jan) up 467k, upward revisions to previous. Participation up, unemp up to 4.0% • Talks with Russia, inc offer of verification of missile sites; Senate progress on sanctions bill • Several Fed commenters dismiss +0.50% for now, George & Daly suggest "gradual path" • ISM (Jan) sees sharp fall in backlogs • Vehicle sales (Dec) up sharply – easing supply pressure, feeding into lower used car prices • Productivity/ULC (Q4, p) ease inflation outlook • Raft of Fed nominees to fill vacant Governor positions	• CPI (Jan) headline and core both expected to rise further to 7.3% and 5.9% • U MIch cons sent (Feb, p) – rebound post-Omicron from lowest since 2011. 5-10yr inflation expectations watched at 3.1% • Trade (Dec) continued worsening of US external balance as spending/inventory rebuild continues • NFIB small business survey (Jan) – further affected by energy and COVID headwinds
	• ECB President Lagarde hawkish tone during the press conference was a significant surprise. We have brought forward our expectation for policy normalisation • Euro area January HICP inflation materially surprised to the upside inching up to 5.1%yoy	• German January final HICP (Jan), including the new 2022 weights for pan German CPI measure
	• MPC increased rates by 25bps to 0.5%; 4 voted for +50bps, CPBS to be unwound also • MPR report inflation to peak at 7.25% in Apr. • OFGEM price cap set to increase by 54% in April. Gov set out plans to mitigate the impact • Update on Gray report published	• GDP (Dec/Q4) – We expect contraction mom due to omicron -0.4% (cons) and Q4 GDP at 0.9% (1.1% cons) • BRC shop price index (Jan) – clues for inflation • RICS House Price balance – expect minor slippage as interest rate rises weigh on prices
	• Cons confidence (Jan) fell to 36.7 from 39.1 • Final Mfg PMI (Jan) p to 55.4 from 54.6 (p) • Services PMI (Jan) shrinks at fastest pace in 5 months to 47.6 from 52.1 • BoJ's Kuroda vows to keep ultra-ease policy	• Households spending and current account (Dec) to refine Q4 GDP growth forecast • Corporate goods price (Jan) is likely to rise again on monthly basis, staying at record level (8.5%yoy)
	• Manufacturing and services activity both eased in January due to another virus resurgence	• High frequency data is expected to show tepid activity during the Lunar new Year holiday
	• CB: Brazil hiked +150bps to 10.75% & Czech Rep. +75bps to 3.5%, more than expected • Inflation (Dec yoy %) picked up in Indonesia (2.2%) & Turkey (50.9%); lost steam in Peru (5.7%) & Kenya (5.4%) • Mexico in technical recession as GDP contracted again in Q4 (-0.1%qoq) • PMIs weak in EM across the board in Jan	• CB: hikes expected in Mexico +50bps to 6.0%, Peru +50bps to 3.5%, Poland +50bps to 2.75%, Romania +25bps to 2.25% & Russia +75bps to 9.25%. Indonesia (3.5%), India (4.0%) & Thailand (0.5%) on hold • Q4 GDP accelerated in Indonesia & Malaysia • CPI figures across several EM countries

Upcoming events		
	US :	Tue: NFIB Small business optimism (Jan), Trade balance (Dec); Wed: Wholesale inventories (Dec); Thu: CPI (Jan), Weekly jobless claims; Fri: Michigan consumer sentiment (Feb,p)
	Euro Area:	Mon: ECB's Lagarde speaks, Ge Ind prod (Dec); Tue: Sp Ind prod (Dec); Wed: Ge Current account (Dec), Ge Trade balance (Dec), It Ind prod (Dec), Fri: Ge HICP & CPI (Jan)
	UK:	Mon: Halifax house price indx (Jan); Tue: BRC Retail sales (Jan); Wed: BoE's Pill speaks on monetary outlook; Thu: RICS Housing survey (Jan), BoE's Bailey speaks; Fri: GDP (Q4,p), Business investment (Q4,p), monthly GDP (Dec), Indx of services (Dec), Ind prod (Dec), construction output (Dec), Trade balance (Dec)
	Japan:	Mon: Leading indx (Dec,p), Trade balance (Dec), Current account balance (Dec); Tue: Economy watchers survey (Jan); Fri: Public holiday
	China:	Mon: Caixin services PMI (Jan), Forex reserves (Jan)

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