



R&R Weekly Column
By Brunello Rosa



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 evidently 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.

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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).



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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 Rial
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

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