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MAKING SENSE OF *THIS* WORLD

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When Complacency Abounds, Moral Hazard Reigns Supreme

The IMF's Spring Meetings took place in Washington, DC last week. This was the occasion for policymakers, academics, practitioners and market participants to meet after the financial instability episodes of the last few months, at a time when the fears of a global recession are not totally dissipated.

The atmosphere in DC was relatively relaxed, with policymakers taking a sigh of relief as they saw inflation start to abate, recession fears becoming severely diminished, and some potentially devastating financial crises having been averted. There was no sense of urgency, but rather a sense of suspension, with the knowledge that something unpleasant may happen down the line, but that this "something" has not materialized yet. This sense of suspension may however easily morph into complacency, given the downside risks that still affect the global economy. In our opinion, complacency abounded at these Spring Meetings. And here is why.

First, inflation may be going down, but it is unlikely to return consistently to 2% (apart from potentially undershooting the target for a period of time, due to base effects). More likely it will remain around 4-5% in the medium term, for structural reasons we have discussed several times.

Second, in terms of financial stability, it is true that potentially dangerous spillovers have been averted on both sides of the Atlantic, by containing the SVB and Credit Suisse crises. But at what costs? In the US there is a return of some form of blanket guarantee to all deposits; in Switzerland, there was a de-facto inversion of the pecking order, with AT1 bond-holders being bailed-in before shareholders were wiped out.

Third, the major economies may have escaped a full-fledged recession, but only because household consumption has been supported by reducing the excess savings deriving from generous monetary policy and profligate fiscal policy. Once these excess savings run out, and the full extent of the monetary policy tightening will be felt, the economy will remain prone to contraction.

This period resembles the early stages of the Global Financial Crisis (GFC). In November 2006, BNP announced that it would not allow the redemption of some funds. In February 2007, the first shakeup to the system let several institutions, including UK's Northern Rock and Germany's IKB, run into trouble. In September 2007, there was the bank run on Northern Rock, but it took more than one year for the collapse of Lehman Brothers to materialize. Until September 2008, it wasn't immediately clear that what was described as a localised banking crisis was about to become the Global Financial Crisis of 2007-09.

Banks around the world are all subject to a synchronized and abrupt increase in policy rates, whose effects, after "long and variable lags" will be felt by the real economy. Initially, higher interest rates are good for banks, as long-term rates rise, and the yield curve bear-steepens. But, after a threshold, higher interest rates may become problematic for banks, especially if badly run, as the yield curve inverts. The market has targeted the weakest links in a systematic way: SVB first, Credit Suisse afterwards, and then it tested the solidity of Deutsche Bank. Short-term fixes have been applied, but long-term solutions are far from being deployed. In the US, a blanket guarantee on all deposits is not fiscally sustainable. In Switzerland, a gigantic single institution has been created, with a balance sheet much larger than that of the state.

In Germany, there is a risk that a new attack on Deutsche Bank may result in the withdrawal of deposits, which may force a panicking government to promise a blanket guarantee on all deposit, and a suspension of the bail-in rules. This would re-activate the doom loop between banks and government bonds, with a potential fragmentation of the regulatory environment and of the transmission mechanism, and with amplified effects on the government bonds of the most indebted countries, Italy first and foremost.

So far, irresponsible bankers have learned that their mismanagement won't be punished, and that depositors will be backed by taxpayers' money. It is the return of the *moral hazard*, which regulators were believed to have dismantled in the aftermath of the GFC. It is sad to note that, so far, moral hazard has always paid off. Especially when regulators have been too complacent, and too slow in recognising emerging risks.

Our Recent Publications

- *The Evolving Dimensions of Japan's Indo-Pacific Strategy, by Mirko Giordani, 13 April 2023*
- *Israeli Democracy and Security at Risk? A Briefer on Recent Developments in Israel, by London Politica, 12 April 2023*
- *The Saudi-Iranian Diplomatic Deal and Intra-GCC Relations, by Gulf State Analytics, 6 April 2023*
- *Evasion Tactics: How Russia Is Using Other Countries To Circumvent U.S. Sanctions, by London Politica, 5 April 2023*

Looking Ahead

The Week Ahead: EZ Headline Inflation To Fall, While Core Rises; UK Inflation To Cool; Composite PMIs To Increase In EZ And UK

In the US, according to flash estimates, Manufacturing and Services PMI are expected to fall to 49.1 (*p:* 49.2) and 51.5 (*p:* 52.6).

In the EZ, in March, the headline inflation is likely to fall to 6.9% y-o-y (*p:* 8.5%), while core inflation is seen increasing to 5.7% y-o-y (*p:* 5.6%). Monthly Inflation is expected to edge up to 0.9% (*p:* 0.8%). April's Consumer Confidence is likely to shrink to -18.5 (*p:* -19.2). According to flash estimates, Manufacturing PMI is expected to rise to 48 (*p:* 47.3), while Services PMI is likely to edge down to 54.5 (*p:* 55). Composite PMI is seen increasing to 54 (*p:* 53.7).

In the UK, in February, unemployment rate is expected to stay the same at 3.7%. In March, the headline and core inflation rates are likely to ease off to 9.8% y-o-y (*p:* 10.4%) and 6.0% y-o-y (*p:* 6.2%). Monthly Inflation is seen rising to 1.1% (*p:* 0.5%). Still in March, retail sales are expected to contract by 3.1% y-o-y (*p:* -3.5%) and 0.5% m-o-m (*p*: 1.2%). According to flash estimates, Manufacturing and Services PMIs are expected to rise to 48.5 (*p:* 47.9) and 53 (*p:* 52.9) respectively. Composite PMI is seen rising to 52.6 (*p:* 52.2).

The Quarter Ahead: French Pension Reform Approved; German Foreign Minister Visited China; Macron's Controversial Remarks

The French Constitutional Court approved the key elements of Macron's controversial pension reform. The council passed the core of the reform, including raising the legal retirement age to 64, but removed six additional provisions, as had been expected. Among others, the council rejected the creation of a "senior index." A series of protest began in France in January against Macron's pension reform. Earlier in March, the government used a special constitutional power to force the reform through parliament without a vote.

The German foreign Minister Baerbock warned China against using force in Taiwan. During the strategic talks in Beijing, she also urged China to pressure Russia to end the war in Ukraine. Baerbock said she also expressed concerns about human right issues and escalating tensions with Taiwan.

Macron suggested Europe should not be a vassal of the US on Taiwan. The president said that the EU should become a "third pole" independent of both Washington and Beijing. Macron stood by his comment, insisting that Europe should not be a "follower."

Last Week's Review

Real Economy: US Headline Inflation Fell, While Core Inflation Increased; Retail Sales Decelerated In US And Contracted In EZ

In the US, in March, the headline inflation rate eased off to 5.0% y-o-y (c: 5.1%; p: 6.0%), while core inflation increased to 5.6% y-o-y (*p:* 5.5%) as expected. On a monthly basis, inflation fell to 0.1% (*c:* 0.2%; *p:* 0.4%). Retail sales decelerated to 2.9% y-o-y (*p:* 5.9%) and shrank by 1.0% m-o-m (*c:* -0.4%; *p*: -0.2%). In April, according to a preliminary estimate, Michigan Consumer Sentiment edged up to 63.5 (*c:* 62; *p*: 62). Michigan Consumer Expectations rose to 60.3 (*c*: 60; *p*: 59.2).

In the EZ, in February, retail sales shrank by 3.0% y-o-y (*c:* -3.5%; *p*: -1.8%) and 0.8% m-o-m (*c:* -0.8%; *p:* 0.8%). Still in February, IP increased by 2.0% y-o-y (*c:* 1.5%; *p:* 0.9%).

In the UK, in February, IP contracted by 3.1% (*c:* -3.7%; *p:* -3.1%).

Financial Markets: Stock Prices And Bond Yields Increased; Dollar Index Fell, While Oil And Gold Prices Edged Up

Market Drivers: In the US, stocks rose due to positive inflation report. In Europe, stocks climbed as investors bet central banks could soon reach a peak in their rate-hiking cycle. Yields rose as investors expect further tightening.

Global Equities: Increased *w-o-w* (MSCI ACWI, +1.4%, to 665.04). The US S&P 500 index edged up (+0.8% w-o-w, to 4,137.64). In the EZ, share prices were up (Eurostoxx 50, +1.9% w-o-w, to 4,390.75). In EMs, equity prices moved up (MSCI EMs, +1.0%, to 997.03). Volatility decreased to 18.20 (VIX S&P 500, 52w avg.: 26.1; 10y avg.: 18.5).

Fixed Income: *w-o-w*, the 10-year US treasury yields were up (+10 bps to 3.52%). The 2-year US Treasury yields increased (+11 bps to 34.1%). The German 10-year bund yield edged up (+25 bps to 2.43%).

FX: *w-o-w,* the US Dollar Index fell (DXY, -0.4%, to 101.3; EUR/USD +0.9%, to 1.1). In EMs, currencies increased (MSCI EM Currency Index, +0.5% w-o-w, to 1,696.81).

Commodities: *w-o-w,* oil prices increased (Brent, +1.8% to 86.63 USD/b). Gold prices rose w-o-w (+0.3% to 2,017.70 USD/Oz).

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*