Sunday Wrap

Happy Sunday from my favourite cafe here in my small village on the Danish coast. The sea outside the window is calm, and incredibly beautiful this morning - but I'm not sure that's the right metaphor for what's on my mind.

Rather, it's been a wobbly week in markets. In Europe, the week was partly dominated by the renewed confusion about the Italian government's fiscal intentions, causing quite a selloff in the sovereign debt. But while Rome surely makes confusing and contradicting statements, few policy makers can match Trump when it comes to random and unconstructive messages. So, not surprisingly, as I have discussed before, with Trump in the White House, the risk of an abrupt end to decent economic growth is non-trivial.

Of course, in a week that on Thursday will take us to the 75th anniversary of D-day one should contemplate the much broader risk Trump is imposing on what really is a beautiful friendship between the US and Europe; a friendly anchored in Europe's immense gratitude to what Tom Brokaw in his 1998 book called "The Greatest Generation" of Americans.

But let me stay in my reservation of economics and markets this morning and note that Trump's latest outbursts caused global markets to have a bit of a panic attack this past week, with old-fashioned flight from equities and other risky assets towards fixed income assets. As a result, additional maturities of "safe assets" moved into negative yield territory, and inflation expectations dropped to near new lows. This, in turn, raised - again - the critical issue of what the big central banks should, and can, do about these types of purely man-made economic trouble.

Here are my views on the three key issues of the week:

- **The latest disagreement between Italy and the Commission**
- **This weekend's change-over at the ECB, and what it may mean for policies down the road ...**
- **... and, more immediately, what lies in store for Thursday's ECB meeting.**

Erik F. Nielsen
Global Head of CIB Research
Group Chief Economist
(UniCredit Bank, London)
+44 207 826-1765
erik.nielsen@unicredit.eu

Bloomberg: UCGR, UCFR
Internet: www.unicreditresearch.eu

1. The latest disagreement between Italy and the Commission

This past Wednesday, the European Commission sent a formal letter to the Italian government to inform it that the government has not made sufficient progress towards compliance with the debt criterion in 2018, therefore asking for information to assess if the Stability Program for this year can be finalized.

The government replied late on Friday that the non-compliance with the required fiscal effort in 2018 was mainly due to the sudden deterioration in macroeconomic conditions, rather than to a discretionary relaxation of the fiscal stance. The government noted that the increase in the debt-to-GDP ratio in 2018 (by almost 1pp to 132.2%) was partially explained by the need to increase treasury balances in anticipation of sizeable bond redemptions in early 2019. More generally, the government invited the Commission to make a more comprehensive assessment, not only of 2018, but also of the budget for this year and the next three, as outlined in the Stability Program. Rome is convinced that the adjustment in the structural budget this year will prove to be compliant with EU rules, while for 2020 the letter highlights that the Italian Parliament endorsed the budgetary projections in the Stability Program that envisages compliance with the required structural adjustment - while calling on the government to take action to avoid an increase in indirect taxes.

In its assessment (likely to be released on Wednesday), the Commission will evaluate any significant difference between the government's macroeconomic and fiscal projections and the Commission's spring forecasts, in order to identify any actual (or risk of future) non-compliance with the adjustment required under the preventive arm of the Stability and Growth Pact, which could – ultimately - lead the Commission to suggest the opening of excessive deficit procedures (EDP).

According to the Commission's Spring forecasts, Italy's structural budget balance is set to deteriorate by (a rather miniscule) 0.1pp in 2018, from -2.1% to -2.2% of GDP, and by another (modest) 0.2pp to -2.3% this year. With the lower-than-assumed GDP last year, the Commission is likely to say there was a deviation of 0.4% of GDP from the required adjustment (the government says it was 0.3% of GDP).

Importantly, the government agreed with the Commission in December, and confirmed its intention in the 2019 Stability Program to guarantee compliance with EU fiscal rules this year. But given where we are now, the government estimates that the required adjustment for this year should be 0.25% of GDP, while the Commission is likely to argue that it should be 0.6% of GDP. If you want the details of this budget battle, please do reach out to my colleague, our Chief Italian Economist Loredana Federico.

I'll make three brief observations on this renewed disagreement:

First, in terms of actual diversion in Italy from the fiscal plan so far, the numbers are really rather small and hardly worth a lot of drama. In a rapidly changing economic environment, including the unanticipated slowdown in Europe on the back of a near-collapse in global trade during 2018 H2 (which this spring led the Commission to revise down its 2019 GDP growth forecast for Italy to 0.1% from 1.2% estimated just this past autumn), it's really hard to get excited about a deviation from the fiscal plans by a quarter of a percentage point, if you ask me.

Instead, the Commission's concern is – almost certainly – based much more on recent rhetoric rather than on actual numbers for 2018, and here, they have plenty of good reasons to worry. Maybe partly related to the European Union elections, the rhetoric out of Rome towards European rules and commitment to fiscal agreements, including the effective commitment to raise the VAT in order to reduce the deficit and the public debt next year, certainly justifies concern in Brussels and beyond.

Second and related, the Italian government (and their advisors) should note that it's not only Brussels who is worried, but also investors, including Italian pension funds, insurance companies, etc., who have recently lowered their holding of Italian sovereign debt as concerns about the government's fiscal commitments have intensified. As a result, the 10Y BTP/Bund spread has widened beyond 280bp and 10Y BTP yields are trading 190bp higher than 10Y SPGB yields andonly 40bp below 10Y GGB yields.

Third and more broadly, the Commission's reliance for their policy views on structural balances is indeed troublesome. The structural balance is calculated on the basis of the estimation of the output gap, but that's a highly uncertain entity, as can be observed by both the frequent changes in the Commission's estimates and the great differences in estimates of the size of output gaps for any one country between different institutions, including the Commission, the OECD and the IMF.

For example, the Commission's estimate of Italy's output gap in 2017 has changed from an estimate in the spring of 2016 of -0.4% of potential GDP (negative means that actual GDP is smaller than potential), to -0.8% in the spring of 2017, on to -1.2% in the spring of last year, and now, in their latest report, back to -0.5% - again, all estimates for the Italian output gap for the same year (2017).

And while the government and the OECD broadly agree that the Italian output gap is about -1.8% this year, the IMF's estimate is a good deal smaller. And it's certainly not only for Italy that such confusion exists. For Spain, the Commission now estimates the output gap to be +1.6% (i.e. overheating), while the OECD thinks the gap has only just closed. But my favorite is Greece (admittedly a difficult case to estimate), where the Commission estimates a -4% gap, while the OECD thinks it's a whopping -10%. It would make for some very interesting policy discussions between the two if both were to recommend fiscal policy measures for Athens based on their output gap and structural deficit estimates…

But most importantly and in spite of such technicalities, it seems to me that the Italian government spends too much time blaming (if not even attacking) Brussels, rather than addressing (with a consistent and constructive policy message) the community which they'll have to rely on to continue to finance the budget.

Hence, just as investors' anxiety was on high alert this past week, a further significant widening in Italian spreads was triggered on Friday morning by the news of a vote in the lower house on a motion to accelerate the payment of public arrears using alternative methods of payment, including the possibility of issuing government bonds (mini-BOTs). Again, because of past confusing communication that messed up these (potentially reasonable) ideas of securitizing the arrears with the voodoo idea of a parallel currency, and no coherent message Friday morning, near-panic spread for a few hours, only to settle later in the afternoon as people started to understand what was going on.

Still, the yield surge on Friday is a reminder that further volatility probably lies ahead for Italy, at least until all the issues (related to the budget and the commitment to the EU) are resolved. I highly recommend this note from my colleagues Luca Cazzulani and Chiara Cremonesi, on how to navigate the pressure in the next few months: BTPs: How to navigate the pressure in the next few months

2. ECB: change of guard at the chief economist's office

This weekend there is a change of the guard at the ECB's chief economist's office. On Friday, Peter Praet packed his bags after eight distinguished years at the ECB, most recently as the chief economist, and tomorrow morning, Irish central bank Governor Philip Lane moves in. Meanwhile, in Dublin they are waiting for incoming Governor Gabriel Makhkouf to arrive from New Zealand, where he has been chief of the treasury department and the government's chief economic and financial advisor. He is scheduled to take over in September, so Ireland – and the ECB's Governing Council – will have to do with a stand-in for the time being.

The shift from Praet to Lane is significant because it represents an important step in the large turnover presently under way at the top of the ECB, which started with the replacement of Vice-President Vitor Constancio with Luis de Guindos in June last year, culminating at the end of October with Draghi's replacement, and to be completed (for this round) with Benoit Coeure's departure at the end of the year.

Peter Praet's broad career before arriving in Frankfurt (including as an IMF economist, an economics professor teaching money and banking, as chief economist at a commercial bank, chief of staff to the Belgian finance minister and as a central banker) served him well as a top European monetary policymaker. He has been one of market participants' favorites at the ECB because of his clear and consistent (and usually elaborate) communication, which - almost without fail - turned out to be good guidance. (We'll miss you, Peter!)

In comparison, Philip Lane, while widely seen as a broadly like-for-like dove, is a relative unknown in terms of the details of his policy views. Probably reflecting his distinguished career in academia, Lane has never been shy of trying to communicate complex ideas (latest as an advocate of the ESBies, i.e. the attempt to create a euro-denominated safe asset via an intricate derivative, underwritten and enhanced in value by pooled sovereign debt and regulatory preference) while being relatively more reluctant to express applied policy views - at least during the last couple of years (which may, of course, just reflect one of the unfortunate requirements of being appointed to the ECB these days…).

A change at the Executive Board is always important, but this one is potentially particularly so because it comes between the appointment of the new vice-president from the political world (rather than from the economics field, let alone monetary policy area) and the still unknown replacement of Draghi as president. If you are a worrier, you'll fear that the selection of the next ECB president gets muddled in the grander horse-trading now going on for the many top European appointments, leading to the appointment of someone without the same extensive experience in monetary policy matters as past ECB presidents, or top central bankers in other major central banks around the world for that matter. If that were to be the case, the role of the chief economist could become rather outsized in importance.

Such an unusual set-up (of, e.g., a future generalist president and vice president and an academic chief economist) would come at a time when the ECB – like most other central banks – is facing particularly challenging times with an increasingly depleted tool box to fight the continued low inflation environment and now, the latest nose-dive in market measures of inflation expectations.

So this leads me to the bigger issue of where monetary policy may be going from here, and the possible need for a broader review of policy options (ideally in the context of fiscal policy having played a different tune).

As you know, the Fed is in the midst of a major review of its monetary policy strategy, tools and communications practices – although not of their mandate of "maximum employment and price stability", nor (probably) of their interpretation of price stability as being inflation running close to 2%.

So far, the Fed has conducted several town-hall events (labelled "Fed listens") with business, labor and community leaders, and on Tuesday-Wednesday, the Chicago Fed will sponsor a major research conference on these issues, where they'll hear mostly from academics, adding to the already quite rich academic debate on the various issues surrounding monetary policies.

A substantial part of the US academic community (including former Fed Chair Ben Bernanke) and several current Fed officials (including Vice Chairs John Williams and Richard Clarida, as well as Atlanta Fed President Rafael Bostic) are either explicitly advocating or sympathetic to a shift to a "price level" target instead of the inflation-targeting system. That would imply that a number of years of inflation below target would have to be followed by a period of inflation above target to make up for the lost ground. This would send a clearly dovish signal given the recent undershooting of inflation, should it happen. But it's still too early to conclude where they'll come down on this issue. They'll publish their conclusions during the first half of next year.

Maybe inspired by the Fed, late last year, Finnish governor, and one of the frequently mentioned candidates for Draghi's job, Olli Rehn, suggested a broadly similar review of ECB policies. My understanding is that the ECB brass is not enthusiastic, mostly because they fear that it'll unleash a series of communications and proposals that will muddy their carefully crafted forward guidance – not to mention the timing of raising the issue of persistent past inflation misses when current inflation and inflation expectations are low, and the solution is not known - and, indeed, may not exist in the monetary policy space alone.

Personally, however, I think a review would be highly valuable, not least following a period of extensive use of previously untested instruments, and the persistent undershooting of the inflation target. But also, and more broadly, for the simple reason that everything in life needs to be reviewed occasionally, not least in a fast-changing world.

To remind you, while low inflation is helpful for a period of time because it helps support real income at a time when nominal wage growth has been compressed, longer term it is undesirable because (with many prices sticky on the downside) it'll slow down the relative price changes you want in a dynamic economy. Also, purely intuitively, knowing the dangers of deflation, nobody would choose to cruise along a path very close to that edge.

Therefore, without a doubt, 2% inflation is better than 1%. Indeed, to avoid periods of 0%-1% altogether, you could well argue that aiming for 4%-5% inflation would be preferable. And there is, indeed, no evidence available that suggests that 4% inflation causes less real growth than 2%.

To be sure, the inflation targeting system has served the world well during the past almost 30 years (pioneered in New Zealand in 1990). The idea was – and is – that by successfully targeting price stability, typically defined as a 2% annual increase in a general consumer price index, the objective becomes partly self-fulfilling through the impact on inflation expectations.

In the case of the ECB, this was certainly the case during the first ten years of existence, but both the stability in actual inflation as well as in inflation expectations took a severe beating during the two recessions between 2008 and 2013, and the past five years have seen a consistent undershooting of the target.

Part of the low inflation story is structural, part of it cyclical, which has contributed to a wide variety of suggestions as to what to do about it. At the extreme ends, you hear anything from a redefinition of what price stability actually means in terms of the inflation rate (i.e. the mandate can just as well be interpreted as 1% inflation) to, e.g., former ECB chief economist Otmar Issing (message: that things are fine so keep normalizing policies), to calls from mostly Anglo-Saxon economists, including PIIE director Adam Posen, to simply increase the inflation target to, e.g., 4%.

Importantly, however, a higher inflation target is credible only if it comes with a commitment to use a well-articulated set of tools, thereby lifting inflation expectations and then actual inflation. But, if you have those tools, why not just use them?

Most urgently, something has to be done about inflation expectations, which have plummeted to near all-time lows in recent months. The 5Y5Y inflation swap rate, which played a critical role in Draghi's argument for launching QE back in 2015, is now below the levels back then.

In his "exit interview" with the FT, Peter Praet acknowledged that one task remaining for the ECB is to challenge investors' skepticism on inflation, arguing that "there is still this perception in the market that we act asymmetrically — that we are more willing to tolerate low inflation than we are inflation that is above our goal of below but close to 2 per cent [so] …more can be done to clarify that we do act symmetrically and care an equal amount about being above or below our target."

A public sign-on by (at least a big majority of) the Government Council to Peter Praet's insistence on symmetry would be an important first step, but a marginal one in the grand scheme of things. Again, without lining up a set of credible tools in full display to get there, words can be risky. A full review would be a helpful process, I believe, but it'll be for next year, at the earliest, of course. For now, the ECB has more urgent matters to consider:

3. ECB meeting on Thursday

When the ECB's Governing Council meets on Thursday, they'll face a somewhat mixed set of growth numbers - and very low market measures of inflation expectations.

In terms of growth, we have decent hard data (Q1 GDP was stronger than the ECB had predicted in March but it was likely boosted by some temporary factors), while the soft data remain subdued, very much because of Trump and the trade tensions, as I discussed last week. Given that the new round of ECB projections to be published on Thursday probably will not yet take into account the effects of the latest round of US-China tariffs, my colleague, Marco Valli says that their baseline scenario will likely continue to envisage an acceleration in growth starting in the second half of the year. This should allow the ECB to keep its GDP forecasts throughout 2021 broadly unchanged.

But the ECB suffers the same apparent dilemma as many other central banks, OECD and IMF, namely that they pull their punches when it comes to numerical forecasts: They (almost) always project growth to move toward trend growth, because they don't want to take a clear stance on the damages in the pipeline from mad policies, like trade tensions, and they don't like to call the turning points, they forecast good growth but try to overpower it with discussions of downside risks. But this creates somewhat of a vacuum for what it all means for their reaction function.

Inflation and inflation expectations are equally troublesome as new lows are emerging on the horizon. The Governing Council is clearly concerned with the 5Y5Y gauge of inflation expectations - the single most important indicator driving the difficult road to QE - hovering around record-low levels.

The announcement of the details of TLTRO III on Thursday, especially the pricing, will play an important role in the future set-up of ECB monetary policy. The Governing Council will decide how appealing the facility should be, compared to market funding of similar maturity. As Marco wrote in his preview, if the benchmark is two-year funding via covered bonds and the ECB wants to secure a decent take-up, the spread on the MRO rate should be fixed in such way that the lowest rate on TLTRO III is allowed to decline into negative territory. If conditions are not sufficiently appealing and the take-up is low, the ECB's balance sheet would start shrinking in a year's time when the first TLTRO II expires - a clearly undesirable message to send at this time.

We think they'll decide to let the lowest possible rate of TLTRO III decline to zero or slightly below zero, to about -10/-15bp. This compares with -40bp for TLTRO II. Importantly, we expect the ECB to consider the pricing of TLTRO III (and potentially also the other conditions) as flexible tools, which can be revised if and when the outlook changes.

Of course, as Peter Praet insisted in his FT interview, their target is symmetric and they have a problem getting this across. If I were in their shoes, I would now try to shock the market back to believing in their ability to get inflation back toward 2%, which could (probably) be achieved by announcing a bold move on forward guidance along with very generous conditions for the TLTRO III to assure the market that they don't damage banks - the transmission mechanism, i.e. - in the process.

With substantial risks to the economic outlook and markets inverting the curves and sending inflation expectations scarily low, bold monetary action is needed. It's no time to be a shy policy maker!

And in that note, I shall initiate my 2019 swim season.

Best,

Erik

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Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: link

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UniCredit Research* Macro Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Daniel Vernazza, Ph.D.
Chief UK & Senior Global Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

US Economics Research

Dr. Harm Bandholz, CFA
Chief US Economist
+1 212 672-5957
harm.bandholz@unicredit.eu

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head of Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 9269-390
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu
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