Sunday Wrap

Happy Sunday,

Summer is over and I'm back to my Sunday morning routine of pondering the world over a cup (or two) of coffee.

I'll pick up where I left off before my summer break because important things have begun to evolve: The effects of Trump's misguided trade policy, and of the Brexit mess, are starting to appear in terms of weaker growth and increased market volatility, which in turn is raising the urgency of policy action. And while the ECB is about to deliver a substantial package on Thursday, the real debate is about its limited effectiveness, if not outright counter-productive impact.

So, here is the agenda for today:

- **To be sure we start on the same page, I'll first – very briefly – remind you of my "big picture" from where today's story is going to flow.**

- **Brexit is not the most important determinant for European and global growth, but it is the most extreme example of the implosion of politics in the aftermath of nativist governance. This past week, UK politics took an important turn. I'll summarize why that has significantly lowered the risk of a no-deal-Brexit on October 31, and substantially increased (to near certainty) the probability of early elections, the outcome of which is impossible to predict, however.**

- **I'll summarize the ECB's journey from Sintra to the upcoming package on Thursday, I'll question the effectiveness of the planned measures - and I'll encourage you to note how the advocacy for truly extraordinary policy measures have now jumped from "out-of-the-box academia" to some of the world's most respected former policymakers. Watch this space!**

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1. My "big picture" background to today's story.

As you'll recall, I have long argued that the post-crisis European policy mix was severely, and sub-optimally, skewed toward too tight fiscal and (therefore – to achieve the inflation target) extremely easy monetary policy. In the generally low-inflation environment, this led to negative rates and forward guidance to flatten the curve. In spite of the ECB compensating for the inflicted pain on bank profitability with TLTROs, QE, etc., European bank profitability has been squeezed for years (in spite of cost cutting that saw 25% of all branches closed and a 17% cut in employment during the past ten years) to an extent where some 80% of European banks have failed to generate a return on equity that matches their cost of capital during this past decade. This is obviously not sustainable, so the only question was – and is - whether the system could function on this life-support long enough until normality is restored.

But normality would require a good period of decent growth. Unfortunately, the US' and the UK's descent into nativist policies, and particularly Trump's attack on global trade, and thereby on global GDP growth, got in the way (and the shift in European fiscal policy from restrictive to accommodative came too slowly and too modestly). Admittedly, the negative effect on global growth of Trump's disruptive policies has come later than I originally thought (partly because of the massive US fiscal stimulus), and markets have held up better than I had guessed.

But maybe not for much longer. Things seem to be turning now, and possibly faster than is generally appreciated, partly as the accumulation of the Trump-madness hits sentiment and hence investment, partly as the trade-war has now expanded in scope and beyond selected tariffs. Most importantly, the US has labelled China a currency manipulator, and the 4% drop in USD/CNY in August was the biggest move for the CNY in some 25 years. I often hear the suggestion that Trump will scale it all back, if not reverse the trade war, when the election campaign gets under way next year, but that's wishful thinking. "China-bashing" seems to play well in the US swing states.

And the negative impact on markets and global growth is now there to be seen:

Since May, we have seen a doubling of intra-day market volatility in equities and tweets fly around. This reflects the uncertainty imposed by this lunacy, which also hits growth. On Friday there was a lot of focus on the poor German industrial production numbers (-0.6% month-on-month in July, driven by a 4.8% drop in car production) and the disappointing job numbers out of the US (130k even including the temporary 25k for the Census). But what you really need to focus on now is global trade, which in Q2 shrank for only the third time in more than 25 years (on a year-on-year basis) – and if you need reminding, the previous two times were after the Lehman collapse and following the bursting of the high-tech bubble at the beginning of the 2000s. This is worrisome!

Not surprisingly, therefore, there has been increasing calls for a European policy response, primarily via fiscal easing. But with no clear sign that governments (particularly in Berlin) are listening, we are now heading towards further attempted easing by the ECB. Nevertheless, it's widely appreciated that the effectiveness of what the ECB has left in its arsenal is not going to be significant, maybe apart from preventing a euro appreciation.

In other words, there is an urgent need for a different medicine – which I'll come back to. But first a brief note on the latest misery here in London:

2. Latest on Brexit and what it means.

I assume you are familiar with the latest twists in the Brexit farce, including the new legislation (set to be signed into law tomorrow) which will force PM Boris Johnson to request a three-month extension of Article 50 to January 31, 2020 if he has not managed to get a withdrawal agreement through the House of Commons by October 19. The legislation also says that if the EU-27 agrees to this three-month extension then the UK government must automatically accept it, and (rather exceptionally) if the EU-27 were to offer an extension of a different length, then the UK government must also accept it unless it gets the consent of MPs to do otherwise.

The defeat of the government led Boris Johnson to (de facto) expel 21 conservative MPs from the party, including some of the most senior and distinguished members, who had voted with the opposition. Others have since departed, including the PM's younger brother (who said he could no longer reconcile family loyalty with the interest of the country) and, yesterday, Works and Pensions minister Amber Rudd.

Having repeatedly stated that under no circumstances will he seek an extension of Article 50, Boris Johnson then called for early election before October 19, but this was voted down on Friday by a majority of the House - leaving the PM between a rock and a hard place.

In yesterday's FT's "Editor's Choice", Lionel Barber summarized it all as follows: "The prime minister, stripped of his parliamentary majority and his authority, is in office but not in power. The Conservative Party is splitting at the seams; a radical Labour opposition is waiting in the wings. A general election is now certain, most likely in October or November. Only a fool or a knave would pretend to guess the outcome."

So, what now?

Having stated that he'll rather be "dead in a ditch" than delay Brexit beyond October 31, Boris Johnson now basically faces the following four options, as summarized by my colleague Daniel Vernazza:

First, Boris Johnson's (stated) preferred option is to secure a deal at the European Council meeting on October 17-18. In his usual unsubstantiated bragging ways, he says he'll achieve this by his power of persuasion. But since the EU will not be willing to change its stance (for both real economic, practical and political reasons), this will mean Johnson will have to sign on to what is de facto Theresa May's deal, including the Irish border backstop (with just a few face-saving commas, etc., changed in the political declaration). He'll then have to face down the hardline Brexiteers in his party with whom he has surrounded himself. The FT quotes unnamed allies of the PM saying that he'll purge them, if needed, i.e. treat them the same way he did with the 21 rebels this past week … this could leave him with a very small Conservative Party!

Second, Johnson could stick to his word (not something he is particularly used to) and refuse to ask for the extension, and therefore resign. This seems highly unlikely, not least as it surely would end his political career. But if he did, it would lead to a caretaker-government, led either by another conservative MP or by Corbyn, who would then ask for the extension of Art 50 until after a general election would have taken place – an extension subject to approval by EU-27, an issue I'll come back to in the fourth option below.

Third, Johnson could defy the law and refuse to ask for the extension. Stunningly, and absurd as it sounds, today's Sunday Times leads with a story that this is indeed what Johnson wants to do; to "force an explosive showdown at the Supreme Court that would risk see him risk a jail sentence". Personally, I can't see him pursue this course, but if I'm wrong, I think you would have to start to think of the UK as a sort of Third-World country…

Fourth, Boris Johnson could swallow whatever pride he has and ask for a three-month extension of Article 50, as the law will say tomorrow that he must to by October 19, and then call elections, for e.g. mid-November. Of course, an actual extension would require unanimous agreement of the EU27 leaders, which would be a lot less straight-forward than it used to be, although – at the end of the day – they might just grant it to be sure the entire blame for this misery remains in London, where it belongs, rather than in one of the European capitals. But make no mistake about the growing pity (and in some quarters resentment) across Europe towards the UK. It's clear that Europe is getting seriously fed-up with Brexit – and, as one policymaker put it to me a couple of weeks ago, despite the impressive demonstrations in the UK, it's far from clear that an extension would resolve anything. There just isn't a clear pro-European majority in the UK to either bring in a pro-EU parliamentary majority, or to reverse the outcome of the Brexit referendum in a second vote.

So, only one thing is almost certain, namely that the UK will hold early elections within the next 2-3 months – and because of the degree of absurd political theatre now at play, and the UK's electoral system of "first-by-the-post", the outcome is impossible to predict, as noted by Lionel Barber. A YouGov poll published this morning gives the Conservatives a sizable lead with 35% of the votes, followed by Labour at 21%, the Lib Dems at 19% and the new Brexit Party at 12%. But again, because of the "first-by-the-post" system, you can't translate these numbers into seats.

Indeed, the election could deliver a majority to this new nationalist Conservative Party dominated by Boris Johnson (possibly in alliance with the new Brexit party), and the UK will be out of the EU within five months without a deal. Or an election could make the Lib Dems kingmaker, leading to another referendum (with an uncertain outcome) – or to nothing more than continued chaos.

But one thing is clear: Boris Johnson and his government have been gearing up for early elections, touring the country for photo-ops, pledging additional money to everyone who asks.

So, as a neat bridge to my next section on markets, let me say that, despite the weaker pound since the referendum, I'm amazed how sanguine investors have been – and continue to be – about the collapse of governance in the UK and the quite likely prospect of a long-lasting economic decline. And I am equally amazed by the virtual silence, let alone lack of rating action, by the rating agencies as this otherwise beautiful country has descended into political chaos (which – always – comes with economic consequences).

Consider this beyond the Brexit debate: During the four months to end-July, the government's net borrowing has increased by 60% [sic], compared to the same period last year, admittedly from a very low base, as expenditures have soared and revenues taper off with lower growth. On top of this, you are – de facto – staring at one of two scenarios:

Either the UK will be run by the present government, which has pledged additional spending of close to 1% of GDP, which – if implemented – would take next year's net issuance to about 2.5% of GDP. Is that a lot? You decide, but let me remind you that it's broadly the same as Italy's – a country with a proper (pro-EU) government with a program of fiscal prudence. Or the UK will be run by a Corbyn-led government, which is campaigning on a long list of highly questionable pledges, including nationalization of several industries.

And still, Mr. Market, you presently charge the UK government only half the yield of what you charge Italy. Just saying … and yes, Italy has plenty of issues, but as I have been arguing before, the UK has long gotten a big discount in markets (and by the rating agencies) for being … well, the UK. I wonder how long that will last.

3. The ECB's journey from Sintra to this coming Thursday, the problems with that package – and the latest migration of "big policy thinking" from the fringes to the core of highly respected former policymakers.

As I have discussed on a number of occasions, central bankers and other policymakers (and economists more broadly) understand the danger to global growth from the arrival of nationalism in some of the major OECD countries, and particularly from Trump's attack on the multilateral world order. But opinions about the magnitude of this risk (including the hope of a reversal, i.e. the delusion that Trump might come to his senses), the impact on growth, and of the appropriate monetary policy reaction differ significantly among policymakers.

Draghi's speech in Sintra in June was a clear sign that he (rightly) worries a lot about this risk and that he believes that more monetary policy easing will help (more questionable). So, he signaled that he wanted to deliver a measurable pre-emptive strike against this risk – and before his term is up. (The argument that he should leave it for Lagarde is absurd in my view, both because any delay of a policy measure, otherwise deemed appropriate, would only add to the need for even bigger measures, but also because the very idea of leaving it for his successor would imply an acceptance of being a lame duck.)

Hence, the only question in Sintra was whether he could pull the Governing Council with him. Looking back now, there is little doubt that markets gradually became convinced of both the need for a major package, and about Draghi's ability to deliver it. Only this past week has seen some pull-back in markets as 5-6 GC members started to speak out against a comprehensive package, particularly questioning the assumed QE component.

Where we exactly land on Thursday, I obviously don't know, but it is now very late indeed in the game if the ECB wanted to dial back expectations. Therefore, I think we'll get something close to what Marco Valli has argued for quite a while, namely: (i) a 10bp cut in the deposit rate; (ii) a framework to mitigate the impact of negative rates on banks' profitability, (iii) a twist in rate guidance, and (iv) a new round of asset purchases.

As Marco has argued, the rate cut seems a done deal, and the only real uncertainty is the size. We think they'll do 10bp, but 20bp wouldn't surprise us. This will hurt banks, so they'll do something to try to mitigate the effect, maybe via the terms of the TLTRO, maybe via tiering, or – they'll argue – via more QE.

We also expect them to change their forward guidance on interest rates, probably by scrapping the calendar-based part of the guidance (to the extent that'll be successful in anchoring the long end of the curve, the need for offsetting measures for banks will further increase.) They might also formally introduce "symmetry" of the inflation target, as hinted by Draghi in Sintra.

The planned QE component is the most controversial part of the package, with a number of GC members having launched a rather coordinated attack on this part of the plan. But, as far as I can see, Draghi will still command a reasonable majority on Thursday to restart QE, so our guess remains that asset purchases will indeed be part of the package. In terms of size, we are in low end of expectations, namely – as a guess - some EUR 300-400bn over nine months, comprising both public and private assets.

But will such a package have a material impact on growth and inflation? – or will it add further complexity to the already existing up-side-down world of European banking, and hence the transmission mechanism? Depending on the details, I'm doubtful that we are still heading in the right direction. In particular, I worry about the effects of negative rates and about the ECB's ability to mitigate the effects on banks (and the transmission mechanism) via their already tested measures.

As you know, I have long had (intuitive and practical) reservations about negative interest rates, and recently, a number of heavy-weight academics have added more research-based indications that negative rates are indeed counter-productive.

Timed for the Jackson Hole conference in late August, Larry Summers and Anna Stansbury argued in a Project Syndicate piece that “central bankers’ ingenuity in loosening monetary policy is exactly what is not needed. What is needed are admissions of impotence, in order to spur efforts by governments to promote demand through fiscal policies and other means”. It’s well worth reading, if you haven’t done so already: Whither Central Banking?

If you are into more heavy-duty research papers, I highly recommend Markus Brunnermeier and Yann Koby’s paper from January: “The Reversal Interest Rate”. They define the “reversal interest rate” as the rate at which accommodative monetary policy reverses and becomes contractionary for lending, a level determined by “1) banks’ fixed-income holdings, 2) the strictness of capital constraints, 3) the degree of pass-through to deposit rates, and 4) the initial capitalization of banks”, and since “over time the reversal interest rate creeps up since asset revaluation fades out as fixed-income holdings mature while net interest income stays low”, they make a strong argument that we are in trouble. Their paper is here: The Reversal Interest Rate

And I worry about the appropriateness, and effectiveness, of so-called mitigating measures. In particular, I doubt the logic of easier terms for the LTROs and of tiering. One of the single biggest problems in European banking is the continued over-banking, which persists – in spite of virtually unanimous agreement that it’s a problem – because banks are not allowed, it seems, to close down and disappear. Local, and national, political constraints stand in the way of bank closures, but the availability of cheap term money from the TLTROs surely helps keep a number of smaller banks afloat; banks which in a normal market economy probably would close down. And tiering? Let’s see what they come up with, but it’s a tricky issue. My colleague, Luca Cazzulani, explains it well in this brief note: Revisiting tiering in the Eurozone: The ECB will have to be creative!

With negative rates almost certainly being counter-productive and with big questions about the effectiveness of the existing mitigating measures, first best would be to bring rates back to zero. If that’s deemed impossible (the narrative would be difficult, no doubt), I would argue for a more aggressive action to compensate banks for the cost of negative rates and a flat curve. Not for the sake of the banks, but to preserve the transmission mechanism. My preferred option would be for the ECB to start buying bank debt (indices, not individual banks’ bonds, of course) as part of a QE program. (In return, I would advocate firm guidelines for banks’ cost ratios to force better cost/revenue ratios onto banks, e.g. modelled on the guidelines for NPL reduction.)

But let me end with a reference to a new, truly stunning, publication:

We all agree that the marginal effectiveness of monetary policy is now, at best, very limited - possibly zero, and maybe even negative. So, we need a different policy mix that will involve fiscal easing. But what if fiscal easing simply drives yields higher, e.g. due to concerns about debt sustainability? As you know, this debate helped bring the ideas of Modern Monetary Theory (MMT) back to life. MMT implies a number of very serious issues, which I truly struggle to reconcile with prudent governance, but I’ll leave that for now.

Then, in the quietness of the August break, some of the most respected former academics and policymakers threw their hat into the game with a detailed – and very constructive – twist to this debate, arguing for a new coordinated policy called “going direct”.

In a paper published by BlackRock Investment Institute, and later summarized by Philipp Hildebrand in an FT piece, no less than Stan Fischer, Philipp Hildebrand and others argue that we need a different, and properly coordinated, policy framework to be ready for the next recession. This, they argue, “would involve what might be termed “going direct”: policies that put central bank money into the hands of public and private sector spenders, rather than relying on the incentives of lower rates”. This “going direct” policy, they say, “should have the following elements. First, a clear definition of the circumstances that call for such unusual policy co-ordination. Second, an explicit inflation objective that fiscal and monetary authorities are jointly held accountable for achieving. Third, a mechanism that enables the prompt deployment of productive fiscal policy measures, without the negative monetary policy impact on inequality. … Finally, and critically, a clear exit strategy.”

Hildebrand’s summary in the FT is here: Central banks will need new tools to combat the next downturn

The full paper (note the term “BlackShock-report” – Touché!) is here; highly recommended: Dealing with the next downturn: From unconventional monetary policy to unprecedented policy coordination

I am sure we’ll be discussing this in much greater detail in the months to come, hopefully as it makes its way into the actual policy dialogue.

For now, I’m out of time so I’ll just end on this observation:

Christine Lagarde will arrive at the ECB in less than two months. The only area where she has expressed deviation from Draghi is with respect to the need for a policy review (or, to be more accurate, she says she supports it, while, to my knowledge, Draghi hasn’t said anything on this topic.) The Fischer-Hildebrand et al proposal goes well beyond an ECB review, but if Lagarde has one major advantage coming to the ECB, it is her standing with the heads of state and finance ministers. Let’s hope she puts it to good use, but to be successful in driving major changes to the policy framework, she’ll need help. Once we know who she’ll reach out to for help and guidance, we’ll get a good sense of whether she’ll be that transformational central bank governor – and policymaker – Europe needs for the years ahead (like Draghi was during the crisis), or whether she’ll be “just another” central bank governor.

To be continued …

And on that note, I wish you a continued good Sunday.

Erik

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