Sunday Wrap

Happy Sunday,

this is Marco Valli from Milan, the UniCredit Chief European Economist. Erik is off this weekend and he asked me to step in to share with you my thoughts on our annual CEE winter conference held in Vienna this past week, as well as on the upcoming review of ECB strategy and the implications of the US-China trade deal.

This is my agenda for today:

- **EM investors in Vienna predict stronger growth for the CEE region than we do, largely reflecting more positive assumptions about the global business cycle.**
- **The ECB policy review is about to start: the risk that it might signal higher tolerance for suboptimally low inflation should not be underestimated.**
- **US-China trade deal: temporary truce, but no breakthrough.**

1. How EM investors attending our winter conference see the CEE region in 2020

This past week, the 21st edition of our annual UniCredit CEE winter conference took place in Vienna. Our conference has increasingly established itself as the best-in-class for EM investors from around the world seeking a great opportunity to meet and exchange views with policymakers and policy advisors from the CEE region and the euro area. But this was also a good occasion to think beyond macro and markets and look at broader geopolitical themes. In her panel, Constanze Stelzenmüller, Senior Fellow at Brookings, wanted us to reflect on the challenges and opportunities for Europe as the US retreats from its traditional role of safeguarding the international order – a trend that will continue after Trump. As usual, our Chief CEE Economist Dan Bucsa, his team and all the UniCredit staff involved did a great job with the preparation of it all.

This year, the mood among investors was generally constructive after the good performance achieved in 2019. Most of them challenged our global outlook, having a more positive view of US growth and global trade. While some believe that a US slowdown will materialize (albeit somewhat later than we expect), others think that the US economy will continue to grow at an annualized pace close to 2% and global trade will recover gradually. Prevailing expectations are for one or two rate cuts by the Fed and a moderate weakening of the USD.

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Reflecting their relatively benign expectations for global growth, investors have a better economic outlook for Central European exporters than UniCredit does, with our forecasts seeing average growth falling below 3% this year in EU-CEE before a slight recovery in 2021. Our estimates for global and EU-CEE growth are seen at the bottom of the consensus range.

At the same time, the range of growth forecasts is narrow for Russia and Turkey, with the former seen expanding less than 2% per year, while the recovery in Turkey is expected to continue with growth exceeding 2% this year (which is still well below the country's potential).

Most investors regard the current spike in inflation throughout Central Europe as temporary and they expect headline inflation to trend lower later this year and in 2021. However, higher core inflation remains a concern due to tight labor markets and fiscal spending. We believe that both labor shortages and fiscal impulses have peaked last year throughout CEE, with inflationary pressure set to decline gradually. Most investors believe that inflation will struggle to return to target in Russia, a view we share and the CBR opposes. At the same time, many of them questioned the scope for further disinflation in Turkey.

Investors expect rate cuts in Russia and Turkey, a consensus call we agree with, while seeing Central European central banks on hold. They also believe, as we do, that it is probably too late to hike rates in Central Europe and that even the hawkish CNB may have to forego tightening. Supply shocks explain a big part of the current inflation spike and central bank officials see very small second-round effects in headline inflation from these shocks.

Investors believe that CEE offers a few improving macroeconomic stories, probably more than other EM regions. The fiscal adjustment in Romania and additional reforms in Ukraine emerged as the top stories for those attending the conference. Both face challenges but the potential for improvement is significant if policies are implemented as suggested. The same holds true, to some extent, for Serbia and North Macedonia. Solid fiscal positions in Czechia, Hungary, Poland and Russia bode well for financing needs and future yield trends.

Overall, most investors seem to expect high single-digit returns for EM hard-currency bonds. Potential for a bit of Fed easing and a moderately weaker USD should also support the performance of local-currency bonds.

2. The risk that the ECB's commitment to higher inflation might weaken

The schedule of our winter conference also included a panel on eurozone monetary policy, where I had the pleasure to discuss the ECB's future challenges with Ewald Nowotny, former governor of Austria's central bank and member of the ECB Governing Council (GC). With the strategic review scheduled to last until towards the end of the year, my view of a high bar for any policy action in 2020 was confirmed. And while Lagarde's consensus-seeking leadership style already implies a somewhat less dovish ECB, the review adds to the risk that the central bank's commitment to pushing inflation towards 2% might weaken.

The high bar for additional accommodation mainly reflects the growing number of GC members thinking that incremental stimulus would be ineffective or even counterproductive, as well as the misguided (for an inflation targeter like the ECB) perception that inflation undershooting can be acceptable if the economy is not doing too badly. Their hawkish rhetoric after the September easing package, recently compounded by signs of stabilization in economic activity and moderate reacceleration in core inflation, has convinced markets to price out any further interest rate cuts and start betting that the next move will be a hike. Therefore, market expectations have progressively started to challenge the signal of the

ECB's forward guidance, which envisages policy rates at "their present or lower levels" until the inflation recovery gains momentum and sustainability.

The "self-inflicted" part of this repricing looks paradoxical, because the ECB's decision to introduce a tiered system for excess reserves was mainly intended to lower the effective lower bound for the policy rates, hence making more credible in the eyes of investors the narrative that their toolbox is not empty amid high (legal) uncertainty on how much more assets the ECB can buy. Given the split in the GC, in case an adverse shock hits the real economy and inflation expectations before the strategic review helps them assess their residual firepower, there is a big risk that the policy response might prove too slow and timid.

The upcoming review of ECB policy was obviously a big theme of our conversation, with Lagarde widely expected to announce its beginning after Thursday's GC meeting. We already learned from her that the definition of price stability will be the main topic of discussion, as the ECB will have to gauge whether targeting inflation rates "below, but close to, 2% over the medium term" remains appropriate given the structural changes in the domestic and global economies since the last review was held in 2003. These changes are mainly related to trends in variables such as demography, technology and globalization.

The debate will be watched closely by financial markets and I think it will develop along two opposite lines of thinking. The dovish faction of the GC will probably want to push the inflation target up slightly to 2% and make it explicitly symmetric, where symmetry implies that the ECB should react with the same determination regardless of whether inflation is above or below target. The second faction, more hawkish, is likely to push for a revision of the goal that increases ECB tolerance for inflation outcomes below 2%; here I think the main proposal could be a 1.5-2.5% target range. Of course, a compromise could emerge in which the definition of price stability remains unchanged at slightly below 2%.

If the option of a tolerance band were to prevail, markets would (rightly) think that the ECB has lost faith in its ability to push inflation towards 2% and would thus regard the low end of the range as the new target. This would be troublesome, especially when considering that the Fed (which is also holding its policy review) is likely to strengthen its commitment to achieving its inflation goal – possibly by adopting a regime of average inflation targeting, where the central bank wants to compensate for past inflation misses with above-target inflation in the future.

If the ECB does switch to a 1.5-2.5% target range and growth proves to be decent, markets would swiftly price in some policy normalization, with a real risk of unwarranted currency appreciation and wider credit spreads. It is not clear whether inflation expectations will get hit immediately after the announcement of such a target range (I suspect they will); if not, they would probably start coming under downward pressure once financial conditions tighten. And if the ECB does bring the deposit rate back to zero when projected inflation is only about 1.5% (given their mean-reverting features, the ECB's models would almost always predict headline inflation of at least 1.5% at the three-year-long forecast horizon, even starting from a position of high spare capacity and low core inflation), the risk of ending up with a very flat Bund curve at or just above zero percent would be real. In this environment, banks' maturity-transformation business would be severely tested.

3. The US China phase-one agreement

This past Wednesday, US and China signed a phase-one trade agreement, 22 months after the onset of the trade war. The deal was announced back in mid-December 2019 and, at the time, markets rallied. Only now have the full details of the agreement been made public.

The 86-page agreement covers eight chapters. The first five (on intellectual property, technology transfer, trade in food and agriculture products, and financial services) aim to improve access of US firms to the Chinese market. For example, China has pledged to end its long-standing practice of forcing US firms to transfer their technology to Chinese firms as a condition for receiving regulatory approvals and market access; and low-risk food products from the US shall no longer require Chinese certification. In a chapter entitled “Expanding trade”, China has committed to make vast additional purchases of US goods and services. In return, the US will marginally lower tariffs on imports of Chinese goods. And, as is usual for any trade agreement, there is a chapter on dispute resolution.

Daniel Vernazza, our Chief International Economist, does not regard this as a major breakthrough in US-China trade tensions and thinks that the risk of China non-compliance is high. He provides three main reasons for this assessment.

First, there is no significant rollback of tariffs and no plans for any either. The agreement is probably best described as a pause in tensions ahead of the US presidential election on 3 November.

Once the agreement takes effect in mid-February, average US tariffs on imports from China will fall just 1.7 percentage points, from 21% to 19.3%. This would leave tariffs six times higher than before the trade war began in 2018, when they averaged just 3.0%. The small 1.7pp. reduction comes from the US halving the 15% tariff on USD 120bn of Chinese imports imposed on 1 September 2019 (in mid-December the US also “suspended indefinitely” the tariffs on around USD 160bn of Chinese imports set to go into effect on 15 December 2019). The share of US imports from China affected by tariffs will be unchanged, at almost two-thirds. And the Chinese have not committed to removing any of the tariffs it has placed on US goods (although it will almost certainly have to do so on a temporary basis in order to meet its commitment to buy additional US products).

Second, there are rightly doubts whether the deal will prove durable.

The agreement text argues that the actions taken by China to open up its markets should lead to “significant increases in exports of goods and services to China by the United States”. But the agreement specifies minimum levels of China’s additional imports of US goods and services over the next two years (from 1 Jan 2020 through 31 Dec 2021) relative to 2017 levels, totaling USD 200bn. This is made up of sector-by-sector minimum additional purchases covering manufactured goods (USD 77.7bn over two years), agricultural goods (USD 32.0bn), energy products (USD 52.4bn), and services (USD 37.9bn). For example, for agricultural goods China has committed to buy at least an extra USD 12.5bn in 2020 and USD 19.5bn in 2021, relative to 2017 levels.

US Trade Representative Robert Lighthizer has said, “These numbers are realistic and they were arrived at together”. But how realistic are they really?

US exports to China were around USD 128bn in 2017, so exports would have to almost double. Agricultural purchases from the US would rise to USD 43.5bn by 2021, up from USD 24bn in 2017. It would surpass the record level of China’s purchases of US agricultural goods reached in 2013 by more than USD 10bn, and that was when prices were higher than today (meaning quantities would have to rise by even more unless prices rise). In addition, China’s demand for soybeans, one of the main agricultural imports from the US, is much diminished following the African swine fever.

China would almost certainly have to reduce its tariffs on US goods to generate the additional purchases, possibly to levels that would violate WTO rules that stipulate members must treat all other WTO members in a non-discriminatory way.

And the bulk of US tariffs that remain will make it hard for China to achieve the minimum purchases. US tariffs on China have targeted intermediate goods, which make it harder for US firms to integrate production chains with Chinese firms, and, hence, harder for China to meet its commitment to make huge additional purchases of US goods.

Third, the likelihood of the phase-one agreement opening the door to a phase-two agreement (that would potentially remove all tariffs) seems very remote.

The most intractable issues are not covered by the agreement, including China's vast subsidies to state-owned enterprises, cyber security and data. The idea that China would change its entire industrial strategy and "Made in China 2025" (a plan to produce higher value-added goods, particularly high-tech, and includes a goal to increase the Chinese-content of products to 40% by 2020 and 70% by 2025), and to do so within a few years, just to please the US, is unrealistic.

The agreement does not give a timeframe for further negotiations (phase-two). Bloomberg News, citing people familiar with the talks, reported that further tariff reductions will not take place at least until after a period of 10 months has passed during which time compliance with the phase-one agreement would be checked i.e. there will be no further tariff reductions until at least after the US election, and there is no hurry to start those negotiations.

That's not a big surprise given Donald Trump has built a reputation as the self-styled "Tariff Man". And the situation is unlikely to materially change if the Democratic candidate were to win the election.

Meanwhile, the threat of re-imposing tariffs and escalation remains. Either party may terminate the phase-one agreement 60 days after providing written notice to the other party. This is unlikely to provide the certainty that businesses need to boost investment and output growth.

Best

Marco

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