

## Sunday Wrap

Happy Sunday,

To all you who worry that the present spell of global inflation will become a longer-lasting problem and therefore need to be addressed now by monetary tightening, if not even by higher interest rates, consider Friday's great US job numbers, while recalling that the US is leading the way in the OECD back towards recovery.

As I'm sure you saw, the US added (higher-than-expected) 531,000 new jobs in October, while the August and September numbers were both revised up substantially. And, to complete the picture, unemployment dropped to 4.6% while hourly earnings rose a strong 0.4% over September.

Precisely, the strong labor market and earnings growth are signs for many that inflation is on the horizon, but recall that, even after these great numbers, there are still 4.2 million fewer people employed in the US than when the pandemic struck in early 2020. This means that the recovery in US GDP to above its pre-pandemic level has been generated to a very large extent by productivity gains. And, as you know, wage growth is not inflationary if matched by productivity growth.

This is not to say that the US faces no risk of longer-term inflation pressure, but it does put the growth numbers – and the outlook for inflation - in perspective, and it justifies Jay Powell's statement this past week that "we can be patient" when it comes to raising interest rates. With the European recovery running 6-12 months behind that of the US, this is true to an even greater extent in the eurozone.

This – central bank communication and their likely policy changes – is not the only issue from this first week of November, which does not seem sufficiently appreciated by markets. There are two other such issues, if more fundamental and longer lasting ones.

**In today's note, I'll discuss the three key examples from this past week, which I don't think markets don't appreciate sufficiently, namely:**

- **The degree of trouble virtually all European central banks seem to have communicating their intended policy path from here – which stands in stark contrast to the Fed's clarity.**
- **The reality of COP-26: Vastly insufficient coordination of policy action, which suggests a highly uneven approach to climate change – with potentially substantial impact on trade.**
- **The striking difference between today's political climate in the US and UK vs Continental Europe. It is bound to have an impact on the quality of policies.**

### 1. Central bank communication: Trouble in Europe – in sharp contrast to the Fed.

In theory, central bank communication should be relatively straight-forward: Tell us your reaction function and what your forecast and risk profiles are, and markets should be able to do their job well. In reality, of course, things are more complicated, not least when the economy is going through big shocks, adding uncertainty, and central banks introduce – and now begin to remove – extraordinary measures.

But the task is not impossible, as demonstrated by the Fed. This past week it managed to deliver the tapering announcement (of the expected USD 15bn a month) without triggering any of the market tantrum long feared (if not even claimed) by the many who have argued that central banks cannot abandon their present super-accommodative policies. As noted by the FT's US financial markets commentator, Robert Armstrong, in his great "Unhedged" daily email, "Jay Powell's Fed is nothing if not transparent. It has said pretty clearly what it thinks and what it plans to do, and then it has done it. Such surprises as it has delivered are mostly the result of the market's swivel-eyes desperation for something resembling tradable information."

Yet, to various degrees, virtually all European central banks seem to struggle these days with communicating of their thinking and intentions.

Because of the uncertainties, but almost certainly also reflecting the increasing disagreement at the Governing Council, the ECB has pushed the decision whether to extend the PEPP beyond March to their December meeting, thereby cutting their normal (and advisable minimum) six-months forewarning of changes to QE to just three months (although Christine Lagarde seemed to confirm at the October press conference that they indeed intend to wind it down in March) – leaving markets wondering to what extent, and how, they'll neutralize the imbedded substantial tightening of monetary conditions that'll come with the end of PEPP.

And, as I discussed last Sunday, with Lagarde's "who am I to say?" reply to a question at the press conference whether markets were right to price in two rate hikes before the end of 2022, she left doubt not only about the ECB policy outlook, but about their carefully articulated reaction function, specifically about the sequencing of scaling back QE and rate hikes. The damage was partly repaired during the following days when a number of ECB folks tried to clarify matters; but only partly. As roughly one rate hike in 2022 was still priced in on Friday, Isabel Schnabel said what should have been said from the beginning: "The conditions that we have defined in our forward guidance for raising rates [i.e. after the inflation forecast is in line with the target and after net purchases have ended] are very unlikely to be satisfied next year". To me, this is clear, but let's see how long it'll take for traders and portfolio managers to get it.

Of course, the ECB's light fumble is nothing compared with what we got from the Bank of England this past week – which in turn was modest compared with the confusion created by the Polish and Czech central banks also this past week.

As you know, the Bank of England surprised markets (but not UniCredit Research, if I may say...) by refraining from hiking rates on Thursday. The roughly 15bp rate hike, which was priced in, was very much the product of Andrew Bailey's statement in October that the MPC would "have to act" to stem inflation. To confuse even further, they stated now that rates will have to rise "over coming months".

With quite dramatic market moves in rates and sterling right afterwards, Bailey defended himself by saying that it's not his job to steer markets on interest rates day by day or week by week. This is, of course, true but at the same time, a central bank certainly needs to recognize that the longer it allows mispricing by markets of their intentions to remain in place, the more damage to the real economy because of the tightening of monetary conditions imposed by (misguided) markets' pricing, and the more disruptive will be the correction when it comes.

Granted, it's not easy to be a relatively small central bank with a floating exchange rate when global conditions start to change (for the BoE, the task is further complicated by Brexit and the government's shambolic handling of it, but alleviated by its relative size), but if the BoE fumbled its communication this past week, the Polish and Czech central banks were outright clumsy.

On Wednesday, the Polish National Bank caught markets off guard when it hiked rates by 75bp after having indicated that its October hike was a one-off. Then late on Thursday, NBP President Glapinski said that further tightening (after another likely hike on December 8) won't be needed since they expect inflation to peak in January. As pointed out by my colleague, our CEE Chief Economist, Dan Bucsa, this is likely to be just another strong commitment which the NBP may have to backtrack on when inflation remains above target in 2022.

Still worse, on Thursday, the Czech National Bank hiked rates by a whopping 125bp – after some MPC members had suggested to market participants that they would likely do 50-100bp, thereby surprising markets for a second month in a row. In a press conference, the CNB denied the wide-spread belief that the misguidance/surprise was partly driven by a hope to strengthen the exchange rate as part of their inflation fight, but as Dan has argued, the surprise move has fueled market expectations for significant further tightening (FRAs are now pricing 1.2pp more hikes within three months than just one month ago). If they don't deliver on that, the Czech crown will likely surrender its recent gains, leaving the central bank with the unfortunate record of having caused sizable FX volatility and eliminating hope of getting help on the inflation front from the FX.

To paraphrase the FT's Armstrong, central banks across Europe (and the world for that matter) should focus on saying what they think and what they plan to do - and then do it! Mispricing and volatility are not good for the real economy.

## 2. The reality of COP-26: Insufficient coordination of policy action, which suggests a highly uneven approach to climate change – with substantial impact on future trade.

We are half way through the COP-26 meetings in Glasgow, and the political and business leaders have (private-?)-jetted back to their daily life, leaving negotiating teams to squeeze a few more agreements out of the process.

I'm a pessimist when it comes to the fight against climate change and nothing I have seen this past week has alleviated my worries.

Yes, a good chunk of policy and business measures will be agreed on, but the challenge is too great for the political reality of this deeply divided world of ours. As a result, I think the next years (and decades) will be marked by a fair amount of policy measures, but they'll be too heavily geared towards regulation (although probably not against private space journeys for fun), rather than the necessary hard-hitting financial incentives. And they'll be predominantly focused on national (or small group) efforts, rather than globally coordinated efforts among the major powers, and this will trigger trade barriers. The sum of it all will not be sufficient to markedly limit the increase in global temperatures, which means years of increasingly frequent natural disasters, and more economic waste and distortions than needed. Looking at relative prices across sectors and regions, I don't think global equity markets have fully understood this.

**I'll do three things here today: I'll remind you of the scale of the challenge; I'll outline the first-best policy response; and I'll point to what I think will be the direction of travel.**

**First, the scale of the challenge is immense:**

Science is clear that the increase in global temperatures will need to be restricted to 1.5C over pre-industrial levels in order to avoid catastrophic climate change. For that to happen, we'll need to bring the present roughly 50bn tons of global annual greenhouse gas emission to net zero by 2050. According to Bill Gates' book "How to avoid a climate disaster", published earlier this year, of the roughly 50bn tons, some 16bn tons come from the production of various building materials, including steel and cement, some 14bn tons come from the production of electricity, 10bn tons from stuff we grow to eat, including the production of fertilizer, 8bn tons from the mobility of people and goods, including by cars, trucks, ships, trains and planes, and 3bn tons from heating and cooling of housing, offices and factories.

As Gates discusses in his book, we already have the technology to eliminate a good chunk of the 50bn tons, but it'll take time – and massive investment by both the public and private sectors - to make the transition. Bruegel, the Brussels based think tank, has estimated that Europe alone would need to boost investment by about 2% of GDP each year, of which almost half would have to be public investment. On present policy, such a boost to investment is made impossible by the combination of the EU's fiscal rules and the political reality of not wanting to raise taxes or cut other expenditure in sufficient amounts. (Mindbogglingly, borrowing at zero or negative rates to save the planet continues to be a no-go for parts of the European political leadership.)

A further challenge is that large parts of the existing technology that would get us towards net zero emission come with serious practical and political obstacles, including nuclear power and the storage of radioactive waste, and the heavy lobbying of the coal industry which has kept, e.g., the US and China from signing on to the COP-26's pledge to end coal-generated electricity.

Finally, if we can overcome all these practical and political obstacles, and use all the existing technologies, we may reduce the 50bn tons in annual emission to maybe 10-20bn tons. To get the rest of the way down to zero we'll then need to invent new technologies over the next 10-30 years, but what's the prospect of that if we keep limiting spending on education to some 4%-5% of GDP and only a very small fraction of that on research? – and if consultancy, law firms, finance and the exploitation industries keep offering substantially better starting salaries for young PhDs than academia and hardcore research in the most needed fields?

**Second, I'll turn to what would surely be the first-best solution.**

The "clean economics" (pun intended) first-best way of addressing the challenge of climate change was spelled out, and illustrated, beautifully by former IMF chief economist and Indian central bank chief, professor Raghuram Rajan, in Wednesday's FT:

Rajan points out that the world has an obviously common interest in reducing emission in order to limit the increase in global temperatures, but that countries have differentiated responsibilities, given past sins. For example, Uganda emits 0.1 tons per capita of carbon per year, and must therefore have less responsibility for global climate change than, e.g., the EU, which emits 6.4 tons per capita per year, or the US, which emits a record 15 tons per capita per year. (In absolute terms, as opposed to per capita, China is the world's biggest emitter of greenhouse gasses, surpassing the combined emission of the US, EU, Japan and Canada.)

Rajan equates emission rights with property rights (held against the planet and hence future generations), noting that the weaker a country's commitment to reduce emissions, the more rights it claims for itself against the world's future generations.

On this basis, Rajan proposes a global system, which will "distribute emission rights fairly, while improving incentives to do more". Specifically, the system would require "every country that emits more than the global average of around five tons per capita pay annually into a global fund. The amount paid would be the excess emissions per capita multiplied by the population and further multiplied by a dollar amount called the Global Carbon Incentive" (the GCI). As illustration, if the GCI begins at \$10 per ton, the US would pay around \$33bn each year. "Meanwhile, countries below the global average would receive a commensurate payout based on how much they emit below the average."

In this example, to begin with, "every country would then face an effective loss of \$10 per capita for every additional ton that it emits, regardless of whether it starts at a high, low or average level". Over time, the GCI would be raised to drive emission to net zero.

As Rajan concludes, "The scheme is simple and self-financing. Low emitters, often the poorest countries and the ones most vulnerable to climatic changes they did not cause, would receive a payment that could help their people adapt. Conversely, the responsibility for payments would appropriately lie with big rich emitters, who are also in the best position to pay. Countries would be free to choose their own domestic path to emission reduction. Instead of levying a politically unpopular carbon tax, one country might impose regulations on coal, another might incentivize renewables."

To me, this seems economic policy-wise as close to the perfect model – and yet, politically utterly unrealistic to imagine, of course. So:

### **Third, what I think we are likely to get instead:**

If you have followed the news from Glasgow this past week, I suspect you (like me) are rather underwhelmed – if not outright disappointed – with what has been achieved so far. The agreement to cut coal had to be divided into two levels of commitment, and even so, the world's biggest polluters, the US and China, didn't sign up. There is an agreement to cut methane emission (many times worse than CO<sub>2</sub>), but China, Russia and India didn't join. And while there is progress on deforestation it comes with virtually no details.

The picture is clear: The Paris Accord gained wide support, but it was all intentions and few commitments. In Glasgow, when the rubber meets the road, the political leaders are rushing for the door on every issue that includes any measurable adjustment in their own country – if they were even in the room to begin with. The Chinese and Russian presidents didn't come at all, as you know.

To me, the single most telling agreement in Glasgow was the EU-US deal on steel and aluminum "to negotiate for the first time a global arrangement to address carbon intensity and global overcapacity" in the sector. The two sides put past disputes aside and the US will allow duty-free imports of steel and aluminum from the EU while the EU will suspend its existing tariffs on US imports. The deal will be open to all countries which will comply with the aim "to defend [US and EU] workers, industries and communities from overcapacity and climate change, including through a new arrangement to discourage trade in high-carbon steel and aluminum ... from other countries and ensure that domestic policies support lowering the carbon intensity in these industries."

If you need translation of this, here it is: Handed the overarching policy objective of battling climate change, the EU and the US have buried their hatchets and agreed to create a EU-US market for steel and aluminum, protected by import duties (and maybe other restrictions) – aka CBAM, the controversial, but highly appropriate, Carbon Border Adjustment Mechanism. Not surprisingly, China went ballistic, and I suspect others will too when they realize what's happening here. Make no mistake about

this, it's a big deal for global steel and aluminum! As a reminder, the biggest external provider of steel and aluminum to the EU is Russia (selling roughly USD 8bn worth of it per year before COVID), followed by China (USD 7bn), Turkey (USD 5.5bn) and Ukraine (USD 3.5bn). For a discussion of this, see my colleague, Edoardo Campanella's Chart of the Week, published on Friday.

My contention is that this is only the first of several such sectorial agreements among high-cost producers in the OECD. As a result, trade barriers will start to emerge to a greater extent under the guise of climate change considerations. Depending on how effective the domestic policies are in terms of turning those domestic industries into (semi) green industries, this will surely be helpful for the global environment, but it'll fall far short of what should be done because it'll leave EM countries behind – and almost certainly lead to an escalation of trade restrictions.

We shall see.

### **3. The striking difference between today's political climate in the US and UK vs. Continental Europe – and that's important for the quality of policies.**

My finally example from this past week of events not sufficiently appreciated by markets is the display of the sharp difference between the political climate in the US and UK vs. Continental Europe. Without a doubt, cooperative and transparent policymaking, based on the best available information, analysis and values will deliver better policies and therefore better growth – and value creation for investors.

In the US, we had a number of state and local elections this past week. The outcome probably provides little insight into next year's mid-term elections or the 2024 presidential election, but it leaves me with the following three suggestions:

First, with Joe Biden being 82 years old in 2024, the Democrats have long been looking to Vice President Kamala Harris as the likely candidate, but where is she? Maybe I'm blinded by other issues, but as far as I can see, she has done virtually nothing to build her profile so far and she wasn't exactly out campaigning for the Democrat candidates. That the GOP has lost its soul is clear, but it looks as if the Democrats have a pretty serious problem too.

Second, the campaigns were way too focused on such issues like mask wearing, teaching of "Critical Race Theory" and tax cuts (in the middle of the biggest fiscal expansion in peacetime history), rather than on, e.g., climate change, teaching of science, etc. The culture war was at full display, and it doesn't look to me like the right folks are winning it these days.

Third, I know that Americans have an infatuation with the idea that successful business people are better suited as political leaders than those who have – God forbid - studied public policy, formally or who have practical experience from other elected offices, and it shows. Virginia elected as governor a private equity guy, who got pushed out of his firm 18 months ago who has never held public office, or apparently displayed any interest in the broader issues of public policy. And four cities, including New York and Miami, elected mayors who have announced that they'll make their cities the crypto-capital of the world (!!), and to that end they announced that they'll take some of (early or partial) salaries in Bitcoin – only to then being informed that that's actually neither legally nor administratively possible. Looks to me as if a lot of newly elected US political leaders are finding themselves pretty far down on a fairly steep learning curve.

But it's not only in America that politics teeters on the absurd. In the UK, the Sunday Times leads this morning with: "New Tory sleaze row as donors who pay £3m get seats in Lords". (I remind you that the Lords is the – unelected – upper house which serves in the legislative process as a check and balance on new laws, as the paper notes.) An investigation by the Sunday Times and Open Democracy shows how big donors become treasurers for the conservative party, which has become the most ennobled job in Britain, ahead of the usual roster of former prime ministers and the heads of the country's key institutions.

And this comes after the government tried – but failed, thanks to the remaining strength of civil society – this past week to undermine the process of keeping parliamentarians accountable under the rules and laws; google Owen Paterson if you want the details of this deeply troublesome attempt by Boris Johnson to undermine parliament. Hardly unconnected, the UK government is now apparently actively planning to invoke within weeks Article 16 in the Brexit agreement, thereby almost certainly triggering a trade war, according to EurasiaGroup's Mujtaba Rahman, who is as well-wired on these issues as anyone.

Rahman tweeted that the government “will argue it's surgical ... but EU will (rightly) see it as nuclear”, and followed up this morning with tweets illustrating that Brussels is taking the threat seriously, getting ready to “fully socialise idea with UK so BJ [Boris Johnson] knows the consequences”.

Of course, the disaster of a trade war may still be averted, but it seems increasingly clear to me that the Boris Johnson government sees the EU (via Brexit) as a convenient external political opponent to pump up nationalist sentiment in the UK behind which they hope to hide a rather miserable economic and pandemic-related performance, while trying to chip away at the foundations of good governance. All combined, very problematic, in my opinion.

Now, in sharp contrast, if you haven't done so already, take a look at the videos this past week of Emmanuel Macron's and the French population's (in Beaune) goodbye to Angela Merkel – available on Macron's twitter @EmmanuelMacron. They are truly heart-warming.

You only need to be in your late 20s to have had the opportunity to have spoken (as an adult) with people who fought in the Second World War, so if you can't grasp the magnitude of those scenes in Beaune, you haven't informed yourself sufficiently about history. Not surprisingly, it's the most emotional I have ever seen Merkel, and that's towards Macron; they surely did not shy away from frustrating each other in the past, particularly during the early couple of years of his presidency.

In the greater global perspective, remind me of any other two countries outside Europe which have established a partnership even remotely as close as the French-German one, let alone after centuries of repeated warfare, and all within a couple of generations. For someone like me, a national of a small historically EU-reluctant country which is drifting further away from Europe and our European values under the present prime minister (details upon request!), it feels very good to be able to say I'm a European.

And on that note, I remind you that the 2021 survey by Ipsos of the world's best-regarded country, Germany retained its place as the world's most admired country for the fifth year in a row. Canada and Japan each moved up one slot to second and third, respectively, while Italy moved up by two slots to 4th, no doubt reflecting the arrival in Rome of Mario Draghi. The UK dropped back three places to 5th (I'm guessing on account of Boris Johnson and Brexit). The US improved two notches (post Trump!) and came in eighth place. China jumped four places to 31st (in spite of – or because of? – the increasingly intense crackdowns).

Each year, the survey asks 60,000 people around the world to rank 60 countries in six categories, including the population's perceived friendliness, tolerance, competence, quality of life and as a destination for tourism and investment. To be sure, these types of rankings remain rather meaningless, apart from being a fun opportunity to think about whether you agree or disagree.

On that note, and with my apologies for this unusually long Sunday note today, I wish you a good afternoon. I promise a shorter note next Sunday ...

Best

Erik

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