Sunday Wrap

Happy Sunday,

The Omicron variant is now popping up across Europe and the US (and almost certainly everywhere else), triggering renewed restrictive measures, although so far mostly hitting the unvaccinated and therefore – maybe – with limited impact on economic activity. On the one hand, Omicron is said to be more infectious than previous strains and there are indications that the existing vaccines may be less effective. On the other hand, very early studies suggest that it may cause less severe illness. We'll need to wait at least another few weeks before more substantial evidence on these things emerge. Meanwhile, two things seem clear: Omicron adds uncertainty to the economic and inflation outlook – and it promises a less joyous holiday season than hoped for.

The additional uncertainty muddles the great inflation debate – "transitory" or "permanent" – and complicates, therefore, the decisions making by the big central banks, as richly demonstrated this past week.

During his congressional testimony early in the week, when Omicron had just been identified in South Africa, Fed chair, Jay Powell, announced his conversion from "Team Transitory" to "Team Permanent" when he said that "transitory" is no longer the right description of the inflation story. By implication, he seemed to pre-announce an acceleration in the pace of tapering. But when will they formally announce it? If they want to get done with their net purchases meaningfully earlier than June, then they can't wait much beyond their December 15 meeting. But are they really that convinced about the inflation outlook that they'll make an adjustment already next week in the midst of this intensified uncertainty? I wouldn't – but I think they will. Markets won't like it.

Meanwhile in the UK, card-carrying "Team Permanent" MPC member, Michael Saunders, who voted for a rate hike already at their last meeting, has gotten cold feet. In a speech on Friday, he said, "Given the new Omicron Covid variant … there could be particular advantages in waiting [with the rate hike] to see more evidence on its possible effects". Makes sense to me.

Christine Lagarde remains on "Team Transitory", although I continue to worry that the ECB may be creating a gap between words and action. I sure hope I'll be proven wrong, but consider this: On Friday, Lagarde said in an interview with Reuters that "we believe that we are now at the high level of the hump and that it will start declining". (I remind you that the ECB's – and our - forecast is for inflation to return to below the target within about a year.) Lagarde's conclusion must, therefore, be that any removal of monetary accommodation now would be inappropriate. I agree.

Yet, Lagarde also emphasized in her interview the need to provide "clarity because otherwise we just add uncertainty to uncertainty". To me, that sounds like a confirmation of her earlier virtual pre-announcement of the end of PEPP in March – even though that would imply a significant tightening of financial conditions, unless compensated for by other measures. But compensating fully for the end of PEPP with other instruments would be technically complicated, and it would create more uncertainty about the effects on the economy than by simply keeping the PEPP rolling for a bit longer. So, what's going on here?

I think the ECB is getting trapped in its own politics. The very idea of creating a health-related monetary policy instrument in the first place, instead of simply adjusting the APP, was a questionable choice, and one almost certainly driven more by politics than by economic analysis. (Note that no other central bank introduced new and special Covid-designed instruments.) That said, so far during the pandemic, the outcome of the ECB's (politics-driven) choice has been very good indeed.

But why would the ECB end its carefully labelled pandemic-specific program just as the Omicron variant injects additional uncertainty? Surely only if their policies are driven (again) more by politics than by economics. The push from the hawkish side of the Governing Council to curb overall asset purchases, as well as the PEPP-specific flexibility to deviate from the capital keys, has been intense ever since GDP started to recover – regardless of the inflation forecast – and gradually, Lagarde seemed to have given in.

If that's the politics that drives policies in Frankfurt these days (and I think it is), then let's hope something good comes out of it again. Two different QE programs never made sense, so a unification of the PEPP and APP, at the right level and with the necessary flexibility, could actually be a positive outcome. What the right level of 2022 QE will be to keep the inflation target in sight will be a function of many factors, including the pandemic and the fiscal policy response – and fiscal policy will largely be a function of politics in the major eurozone capitals, which are now entering some truly interesting months.

So, the agenda for the rest of the note is:

- **A summary of where I think we are heading in European politics. I'll argue that we may well be in for a rather profound "watershed moment", with significant (positive) implications for policies.**
- **What this means more concretely for fiscal policy in 2022 and beyond – and hence the room for ECB policies, as we approach the big December 16 decision.**

1. European politics: The prospect of a watershed moment unfolding.

This past week saw a host of important political events throughout Europe, including the farewell to Angela Merkel in Berlin ahead of this coming week's inauguration of the Scholz-led Ampel-coalition, as well as the emergence of two additional candidates for the French presidential election next year, namely the extreme-right Eric Zemmour, who announced his candidacy in a tragic-comic (yet possibly effective) 10 minute video, and Valerie Pecresse, who clinched the center-right's (Les Republicains), nomination when she beat her right-wing opponent, Eric Ciotti, in yesterday's second round run-off.

Pecresse is a center candidate who resembles Macron on several policies. Indeed, her clearest attack on him so far has been a claim that he zigzags. She has described herself as "two thirds Angela Merkel and one third Margaret Thatcher". On the latest opinion polls, she'll come fourth in the first round of presidential elections (behind Macron, Le Pen and Zemmour), but this can change in coming months, of course. Still, her most obvious hurdle will be to come in at least second in the first round on April 10. If she manages to get through to the second round on April 24, she would be a serious contender against the favorite (still undeclared) Macron.

As someone who is convinced of the importance that the political center holds, it was good to see her beat Ciotti. That said, her victory increases the likelihood that non-extreme voters may split their votes between her and Macron, raising somewhat the still very low risk of a run-off between two extreme candidates. More likely, still, is that Le Pen and Zemmour will split the extreme votes, delivering a second-round election between Macron and Pecress. Much more on this as we get closer to the elections…

Also of importance, this past week saw the sudden departure from politics of former Wunderkind of the right, Austrian Sebastian Kurz (who, in his departure note, felt compelled to clarify that he is neither a saint nor a criminal) and the (second) arrival of Magdalena Andersson as Swedish prime minister. Andersson, a Social Democrat, opened her tenure with the withdrawal of Sweden's long-held opposition to the proposed EU-wide minimum wage and with a statement of strong support for Belarusian opposition leader Svetlana Tikhanovskaya, thereby echoing the incoming German government. Her government's program will focus on an acceleration of green transformation and on domestic social reforms. Meanwhile in Rome, the behind-the-scene maneuverings to line up support for the candidates to become the next president continued.

I'll focus on the outlook for the next German government and the prospect of Mario Draghi becoming president of Italy next year, as opposed to staying on as prime minister for another 12-18 months.

First Germany and what the new government is likely to mean for Europe:

I have already written quite a lot about Angela Merkel and her 16 years in power, but I can't let her go without tipping my hat, one more time, for her appeal in her farewell speech that "everywhere where scientific facts are denied, conspiracy theories and smear campaigns are spread, resistance must be loud". On Wednesday, after the Green party has formally approved the coalition agreement in a vote tomorrow (SPD's is done and FDP approves today), she'll be gone and Germany will be led by Olaf Scholz and his Ampel-coalition.

The new German government will bring in significant reforms in Germany, if less headline-grabbing and straight-forward then desirable – and it will, very likely, also facilitate reforms in Europe, assuming France stays away from the extremist candidates in next year's elections, as indicated by opinion polls, and particularly if Macron is re-elected, and assuming the Italian political fabric remains anchored in pro-EU policies.

The FT's Martin Sandbu argued this past week that "what is happening in Germany … may be nothing less than the end of 20th-century politics", with which he means a break not only from the "general Washington consensus type of economic thinking that has dominated international discussion (including in Europe) [for the past decades, but also from the] old leftwing views of state control". Instead, Sandbu argues, there is a clear resemblance "between the new German government's approach and the economic theory set out by US President Joe Biden's administration: a progressive supply-side economics. In both Washington and Berlin, smart government interventions in the form of strong investment and active regulation are seen as instruments to make the private sector stronger — not as substitutes for it (as per the old left)".

While one may wonder if the US stays this course after next year's mid-term elections and after the 2024 presidential elections, I have little doubt about this new direction of policies in Germany and in Europe – although the extent may turn out a bit less impressive than suggested by Sandbu's big call. After all, and in spite of these past 18 months, Scholz is a fiscal conservative at his core.

Importantly, the incoming German government seems to have a better and more constructive understanding of Europe and what it takes for a currency union to remain sustainable and deliver all the benefits to the citizens that it's meant to do, than the outgoing coalition, let alone the previous one with a then virtually all-powerful Wolfgang Schäuble as finance minister.

I never had any doubt about Merkel's commitment to Europe, but I have at times doubted whether she fully understands what it takes for it to work – or, at least, whether she was willing to spend the necessary political capital to drive the European agenda, particularly during the years with Schäuble as finance minister (with the critically important exception of her rescue of Greece, and indeed of the entire European project, when – stunningly - Schäuble advocated a Greek exit). In contrast, Scholz seems clearer on the need for further European integration. Outgoing state secretary, Jörg Kukies, has said that it was Scholz' commitment to the need for further European financial integration, expressed in a series of bilateral conversations, that persuaded him to join the finance ministry in 2018.

That the Green party are committed Europeans has always been clear, but it was translated into a concrete commitment again this past week when incoming foreign minister, Annalena Baerbock, said in an interview with TAZ that the security aspects of the controversial Nord Stream 2 pipeline will have to be discussed jointly with Germany's European partners.

And the FDP seems to be moving in the same direction, with incoming finance minister, Christian Lindner, distancing himself from Schäuble's understanding of Europe. In a ZDF interview the week before last, he said that Germany, "as the EU's strongest economy, has a responsibility to ensure that this currency area [the euro area] stays together, that other countries also invest, and that there is overall political stability. This means that our country cannot act like a smaller Nordic country. But we also cannot unilaterally side with those who want to undermine the economic and monetary union and its rules". I hope someone will tape this quote on the walls in every office in the BMF – and in the paternosters too – as a daily reminder to staff.

To be clear, this does not mean that a fiscal union is just around the corner (and neither should it be so long as there is no parallel political union), or that a completed banking and capital markets union is now in sight. But the door seems open to e.g. a refined and adjusted second-generation NGEU (for climate change), more public investment in general (e.g. for digitalization) and for progress on banking and capital markets union, even if a common deposit insurance remains unlikely (it's not the most important part, anyway.)

On fiscal policy – in Germany and as it translates to the European fiscal rules – I'll make the following two predictions:

In Germany, we'll get a substantial increase in green (and other) investment per year, while (nominally) living with the German debt brake. Following the coalition agreement, the door is now wide open to fiscal expansion – although, as my colleague, our chief German economist, Andreas Rees, puts it: "the politicians still have to go through it." My guess is that they'll square the circle between the political commitment to invest and the debt brake via four routes: (i) The government will borrow additionally next year, while the debt brake rules remain suspended, to build a serious money tank for the following years; (ii) they'll introduce more realistic estimates of potential growth, which will lead to a bit more space within the budget going forward, still under the debt brake (h/t to Philippa Sigl-Glöckner and her colleagues at Dezernat Zukunft for being the first to translate the widely held frustration with Europe's use for policy making of troublesome potential growth estimates into policy relevant proposals, and then driving the campaign to educate the policymakers); (iii) they'll boost the lending capacity of KfW; and (iv) they'll add capital to a number of state-owned companies, including Deutsche Bahn, with instruction to leverage it and invest. The two latter routes are versions of extra-budgetary means, not that different from what most other countries do, but certainly not first-best in the context of common and transparent European rules.

In spite of Germany muddling the picture for future fiscal rules, Europe, we'll get - with German blessing - some small revisions to the fiscal rules, including a change to the requirement of an annual 1/20th reductions in debt/GDP until it gets to 60%. More importantly, I'm convinced that there'll be special provisions outside the existing rules for additional green investment of maybe 1%-1.5% of GDP per year. Those special provisions could include spending on the social costs stemming from the green transition, i.e. money to shelter the poorest part of the population hit the most by the necessary green measures.

It's too early to guess the details and exact magnitudes of all this, but it could be modelled on, e.g., Bruegel's proposal to ring-fence green investment (which I have discussed before), or – maybe - one could imagine a future sizable common European fiscal capacity to finance the green transition, allowing for a more limited adjustment of the national fiscal rules, as highlighted by Eurasiagroup's Mujtaba Rahman. There is a lot of positive thing to be said, should we end up coming down this path.

Which route Europe takes, and how far down the path it goes, will all depend on the politics throughout Europe (and the economic climate), particularly in the big-three, specifically, on (i) the relative power in Berlin between Lindner and incoming economics, energy and climate minister Robert Habeck (which, in turn, may depend on which way Olaf Scholz leans in the debate), (ii) the outcome of next year's French elections (a Macron victory would be clearly positive, a victory by Pecresse almost certainly okay too, but a victory by Le Pen of Zemmour an utter disaster – for France and for Europe), and on the role of Draghi and/or other prominent Italians with European clout as president and the next prime minister, and therefore the broader question of the future direction of Italian politics.

For now, the number one political question about Italy relates to Mario Draghi:

The issue is whether Draghi will stay on as prime minister for the next 12-18 months until the next elections, no later than June 1, 2023, thereby giving him a direct hand in Italian and European policies during the critically important 2022, or whether he is elected president early next year, which would elevate him away from active policymaking in 2022 and for the next seven years, in return for the important position of guiding Italian political life more broadly in the longer term. As my colleague, our chief Italian economist, Loredana Federico, has argued, it's a close call which one it'll be, but more clarity is likely to emerge in January. (Early elections seems highly unlikely).

With no political party being strong enough to impose its own candidate for president, a number of behind-the-scene negotiations are now under way in Rome to try to identify candidates who will command the necessary majority in parliament.

To remind you, the Italian president is elected by secret ballot by a two-thirds majority in the two chambers of parliament plus regional delegates (adding up to 1009 electors), although if nobody reaches the required two-thirds majority during the first three rounds, it'll be decided by an absolute majority in the fourth round. To illustrate the fragmentation, and hence unpredictability of the ongoing negotiations, Loredana has pointed out that even a coalition of the Democratic Party, the Five Star Movement, "Free and Equal", former PM Renzi's party, "Italy Alive", and the smaller center-oriented parties, only add up to about 465 votes, which is still short of the 500 votes needed for the absolute majority in the fourth round.

If Draghi should become president (a job I suspect he would prefer over the prime ministership), a round of consultations between him and all parties in parliament will take place with a view to identify a new government in the current legislature. My guess is that we'll then get another government of national unity, supported by a majority similar to the current one. The next prime minister could again be a technocrat rather than a politician.

As president, Draghi would guarantee the country's political stability and would ultimately guarantee Italy's adhesion to the European project. While he would not be directly involved in policies, through moral suasion and direction on any future government to ensure the fullest possible implementation of the RRP, his impact would remain very significant.

However, it is also possible that the present negotiations conclude with agreement on an alternative candidacy for president. The key (non-Draghi) candidates include Ministers of Justice Marta Cartabia and Pier Ferdinando Casini, as well as European Commissioner Gentiloni. In this scenario, Draghi would almost certainly remain prime minister until elections in 2023, thereby securing Italy an unprecedented influence on key European policies next year while, possibly, leaving Italian politics somewhat less anchored over the longer term.

2. From politics to fiscal policy to monetary policy, and specifically to the ECB decision on December 16.

While the ECB hates any suggestion that they are engaged in yield curve control, nobody would deny that the levels of the curves (I intentionally use the plural here!) play a very significant role in determining financing conditions, which they – rightly - care so much about in their attempt to get inflation to the target over the medium term. With equity and credit markets showing signs of weakness, the importance of avoiding higher yields – and hence tougher financing conditions - at a time when the inflation outlook remains below the target is particularly important, although the weaker euro will help some. (Remember that it's the trade-weighted euro, which has depreciated considerably less than EUR/USD the past 6-12 month, that matters here.)

To guide the yield curves this past year, and hence to secure financing conditions consistent with the inflation target, the ECB bought sovereign securities (in the secondary markets) in excess of the sovereigns' net issuance. By doing so, the ECB encouraged – successfully - the desired move of private money away from the (supposedly) risk free sovereigns into riskier assets, including equities and credit. To remind you, this is how monetary policy is supposed to work, whether it can be achieved solely by interest rate policies or via QE.

Hence, going into 2022 with a medium-term inflation forecast still short of the target, the ECB will need to prevent any tightening in financing conditions, which mas that they'll need to continue to buy a bit more than the equivalent of the sovereigns' net issuance. The good news (for those who are – unnecessarily - worried about big central bank balance sheets) is that the financing needs of the eurozone sovereigns will decline sizably in 2022, compared with this year.

In gross terms, we estimate it to drop from roughly EUR 1.5tn this year (which is roughly the same as in 2020) to EUR 1.25tn in 2022. The bad news is that this is still about two-thirds higher than in a normal pre-pandemic year. The decline in eurozone gross financing needs reflects a substantial decline in the combined cash budget deficit across the eurozone, from EUR 820bn this year to roughly EUR 500bn in 2022, driven by the reversal of automatic stabilisers as GDP is recovering, the unwinding of some of the extra-ordinary discretionary measures, and – to a lesser degree - by the grant element from the NGEU funds, which are counted as revenue. Meanwhile, medium- and long-term redemptions will increase by about EUR 90bn.

The sharp decline in the cash deficits will come mostly from Germany (from EUR 249bn this year to about EUR 100bn in 2022), France (from EUR 205bn to EUR 150bn), Italy (from EUR 130bn to EUR 100bn), Spain (from EUR 80bn to EUR 65bn) and the Netherlands (from EUR 50bn to EUR 20bn). Needless to say, if Germany uses 2022 to "fill up the tank", as they should, before the debt brake returns, the German financing need will be larger.

The net supply of medium and long-term bonds will also decline substantially next year, from EUR 540bn this year to roughly EUR 380bn in 2022. With another roughly EUR 25bn in short-term issuance and EUR 15bn in state and agency issuance, total issuance which the ECB will face will be some EUR 420bn. To translate this into what the ECB will need to buy to prevent a tightening in financing conditions, you'll want to adjust these book values into face value of the securities (and make a few other minor adjustments). If you want the details, I recommend my colleagues, Chiara Cremonesi's and Francesco Di Bella's, "Rates Perspectives" note from this past week – or you may call them. Their note is here: Rates Perspectives: EGB gross issuance to decline in 2022 but remain above EUR 1tn

The bottom line is this: If politics dictates an end to the PEPP in March, then the APP will need to be roughly doubled to monthly purchases of EUR 40bn, starting in April, for the ECB's total QE just to match the sovereign issuance in 2022. To maintain broadly unchanged financing conditions from this year, as certainly called for with the present inflation forecast, the ECB would have to keep its 2021 policy of buying a larger amount than the net issuance also in 2022, e.g., by lifting the monthly APP purchases to EUR 45-50bn a month, starting in April. They'll also need to indicate that they'll remain committed to securing the desired financing conditions in all their constituencies and will, therefore, operate the APP with the necessary flexibility. Will they announce this on December 16? I sure hope so – but I doubt they will.

The politics of the Governing Council, including Lagarde's desire to lead more from the enter than Draghi did, seems to dictate a policy stance somewhat less than this, which will imply some reduction in monetary stimulus (along with some fiscal withdrawal as well, unfortunately), even though the message will likely not acknowledge this – but ending a pandemic-dedicated instrument just a new wave of that pandemic rolls in would never be an easy decision to explain to the general public.

One thing remains clear, however: A more forward looking and active fiscal policy across the eurozone will make life easier for the ECB down the road, and that will raise the probability of landing the inflation rate on the target one day. Ideally, this would happen via a common European strategy to fund the green transition (after all, pollution doesn't stop at the border…), anchored in a common political process to allocate and supervise the investment. If not common, room will have to be created in national budgets – for the sake of the desperately needed green transition, and for the sake of monetary policy.

But all said, with the new German government, the prospect for the French elections and Italy remaining unquestionably committed to Europe, I find myself more upbeat on Europe than I have been for a long time.

On that note, I wish you a continued good Sunday afternoon.

Erik

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

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k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511

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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

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

International Economics Research

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@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, 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 2 923-2192
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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