# Sunday Wrap

Greetings from Clerkenwell in London,

The past roughly 18 months of record-breaking monetary policy tightening by the world's major central banks seems to have come to its end. Following the Fed's pause in September, the ECB decided on Thursday to pause as well. On Wednesday, the Fed will almost certainly leave its interest rates unchanged again.

At present, neither of the two central banks seems willing to even consider the day when they'll begin to reverse course, but that'll surely change during the next 6-12 months. The need will become clear when the economies get hit by the powerful combination of these past 12 months' huge policy tightening, the weight of the global slowdown and general uncertainties as well as recent months' market-imposed tightening of financial conditions on the back of the continuous vast fiscal deficits in the US.

I see lots of discussion these days of the possibility that maybe the power of monetary policy is not what it used to be, and we'll therefore come in for a beautiful soft landing. I don't buy it, particularly for Europe. The details of monetary transmission, including the lag, can be discussed, but to argue that the greatest monetary tightening we've ever seen, administered in reaction to a real-income-crushing shock in Europe, will not cause deep pain for the economy seems just too fanciful to me.

In today's note, I'll focus on the brake on the real economy from the monetary policy tightening already administered. In particular, I'll discuss the stunning similarity between the tightening done by the ECB and the Fed in spite of the very different drivers of inflation. I conclude that both central banks cannot be right – and that the odds are that the ECB has overtightened. If so, this could be the third example of a European policy mistake within the past 15 years driving an increasingly measurable wedge between US and European per capita income.

**I'll argue my case in the following three sections:**

- **The message from the ECB this past Thursday, and what we'll likely get on Wednesday from the Fed – as both central banks are ending their brutal monetary policy tightening.**
- **The ECB and the Fed have delivered amazingly similar policy reactions to very different shocks: I'll argue that the ECB and the Fed almost certainly cannot both have been right in their policy response. Either the ECB has overtightened or the Fed has not done enough - or a combination of the two!**
- **On balance, I conclude that it's the ECB which has overtightened. I suggest what may have driven the ECB to do so, and what it means going forward.**

## 1. The end of the hiking cycle.

This past Thursday, the ECB left interest rates unchanged, as expected. The end of the hiking cycle came after ten consecutive rate hikes of a record 450bp in just 15 months, taking the ECB's depo rate to 4.0%.

Or was it indeed the end of the hikes, or just a pause? Certainly, the ECB wanted us to know that the distribution of likely further rate decisions remains heavily skewed towards further hikes, but I – and my colleagues in UniCredit Research – think it's the peak. Inflation is coming down very nicely (wait for another beautiful decline on Tuesday!) and the economy is already flat on its back with a far from pretty outlook. In addition, further serious tightening of monetary conditions has been imported from the US in recent months. Therefore, we expect the ECB to change their mind in coming months, then change the message during the winter and spring, and - finally - begin to cut rates maybe around mid-2024.

Less expected (at least by me), and hugely positive, ECB President Lagarde said at the press conference on Thursday that the Governing Council had not discussed the rumbling worries among several of the Northern central banks about their balance sheets, specifically the PEPP reinvestments and banks' minimum reserve requirements. As I discussed last weekend, my fear was that these concerns might tip the ECB to accelerate its QT and hence switch to a mode of tightening-by-stealth. That would have been a mistake. The ECB has already reduced its balance sheet by about a trillion euros (that's more than 10%) in parallel with the rate hikes, adding the equivalent of maybe up to 200bp to the tightening, for a total tightening of some 650bp (recalling that the shadow rate came from a deeply negative territory due to past QE).

On Wednesday, the Fed will conclude its two-day meeting with – almost certainly – a decision to also leave the target range for the Fed fund rate unchanged at 5.25-5.50%. That'll be the second pause following 525bp tightening during the 16-month period to July.

They too will surely keep their tightening bias in their communication, but I – and my colleagues – think we are at the peak (although with a greater risk of one more hike in December than in Europe). With the continued positive surprises on the US data front, and the seemingly never-ending fiscal mega-expansion, I'm more uncertain about the Fed's path, including when they'll start to cut. Presently, markets price in a rate cut by June, but as my fellow Dane, Torsten Slok of Apollo, illustrated in his email on Friday, "The market is almost always wrong about what the Fed will do beyond the next FOMC meeting".

The Fed has also been reducing its balance sheet (which is roughly the same size as a share of GDP as the ECB's) by a bit more than 10% - a trillion dollars or so - in parallel with its massive rate hikes, also adding maybe some 200bp to the increase in the "effective" rate.

As I'm sure you have noted, the parallel between the ECB's and Fed's policy decisions during these past 15-18 months is stunning, which – to me – really is a mystery given the profoundly different environments they have been – and are – operating in. I'll illustrate this in the next section:

## 2. A tale of two cities…

My central argument is that it's extremely unlikely that the virtually identical monetary policy reactions by the ECB and the Fed during the past 15-18 months to two so different underlying environments can both be right. The odds are – in my assessment – that the ECB has tightened too much, and that the Fed has been about right. If so, the size of the ECB's tightening may go down in history as the third European policy mistake during the past 15 years which is now further widening the gap between US and European real per capita income.

Consider this: For the decades leading up to the Great Financial Crisis in 2007-08, the US and the eurozone produced very similar per capita GDP growth rates on average. The stronger headline US GDP numbers everyone seems to know about were generated by stronger population growth, stemming from both higher birth rates and immigration in America. Productivity per person was similar – although better in Europe if measured per hour. But we Europeans squandered that by working fewer hours than Americans – or, as I prefer to think of it, we buy more of that wonderful commodity called free time.

The GFC 15 years ago brought an end to the similarity in US and European per capita growth rates because of two quite easily identifiable policy mistakes in Europe. First, following the crisis, Europe took much longer than the US to clean up its financial system (and, I would argue, the outcome still provides for less efficient capital allocation). Second, Europe then suffered its sovereign crisis (which, ultimately, reflected the incompleteness of the monetary union) which triggered a decade of fiscal austerity. The damage, or benefits, of the fiscal austerity per se can be debated, but the longer-term negative implications of what it let to in terms of cuts in public investment, education, etc., to make room for more immediate political priorities cannot be in doubt.

**Having fallen behind the US for the past 15 years, my worry is that we may now suffer another widening of the difference in per capita income due to a policy mistake.**

**But first some good news on European policymaking.** The pandemic in 2020-21 triggered massive fiscal and monetary responses in Europe which – along with the management of getting everyone (who wanted it) vaccinated – must go down in

history as one of the most impressive illustrations of what Europe and their institutions can do in times of crisis. (I count the German government's weaning off the country from Russian energy in 2022 as an achievement of the same order.) The US fiscal response to the pandemic seems excessive and too poorly targeted, particularly the American Rescue Plan in March 2021, as I'll come back to.

The fiscal policy responses to the commodity price increases during the latter part of 2021, turbo-charged in 2022 by Putin's war and the sanctions they triggered, followed the same playbook: Broadly appropriate in Europe, while widely excessive and poorly targeted in the US. (I suspect that other motives were behind the massive US fiscal expansion, including a hope to generate enough growth to prevent Trump from returning to power.)

The change in the general government's cyclically adjusted primary balance is considered the single best indicator of the magnitude of active fiscal management (although the exact calculation of those balances are compromised by more issues than you want to read about on a Sunday). On IMF estimates, that balance, as a share of GDP, not only expanded in the US by an impressive 5.3pp between 2019 and 2021; it landed on a whopping 9.0% of GDP. In the eurozone, the active fiscal stimulus was "just" 3.5pp between 2019 and 2021, and the structurally adjusted primary deficit reached a much more modest 2.8% of GDP (although the various guarantee schemes outside the budget were also helpful.)

Second, the commodity price shock hit the two economies very differently. The US is self-sufficient in energy while Europe is a big net importer. As a result, the US did not suffer any terms of trade loss (actually, it had a small gain, but a fair amount of internal relative changes between commodity producing and importing states), while the eurozone suffered a terms of trade loss of almost 5%. As part of this, natural gas prices quadrupled in Europe during the second half of 2022, hitting households' real income very hard indeed. In the US, they increased only marginally.

Third, in spite of the profoundly differently sized (and composed) shocks in 2022, the US kept its foot on the fiscal accelerator - if less so than during the pandemic and, importantly, now shifting from mostly cash hand-outs to households to structural programs for businesses to encourage investment in energy and climate change, as well as home-sourcing of national security related supply chains. In my view, the size and some of the details of their fiscal measures can be debated, but not the overall objective in this rapidly changing world. On the same IMF estimates, the US' cyclically adjusted primary deficit dropped to 4.1% of GDP last year but is set to increase again this year to 6.0% of GDP. In contrast, in the eurozone, and in spite of the much greater shock, and the same type of structural challenges to be addressed, the deficit (still cyclically adjusted primary) was reduced to 2.1% of GDP last year and is set to fall further to just 1.7% of GDP this year.

**So, in conclusion, this is clear:** The US economy has been impacted by a huge fiscal push for four years in a row while experiencing no terms-of-trade shock, while the eurozone economy saw a more modest fiscal support at the outbreak of Covid, followed by fiscal contraction (of 1.4pp since then, according to the IMF), despite the biggest-in-peacetime external shocks, causing a huge terms of trade loss.

Partly coincidental, partly reflecting the fact that both the US and Europe are open economies, we have seen amazingly similar inflation pictures in the two economies:

After having struggled below 2% for the better part of a decade, headline inflation broke through the magic 2% in both the US and Europe in the spring of 2021 and climbed very quickly to a peak of 9.1% in the US (in June 2022) and to 10.6% in Europe four months later, before then falling just as quickly back to 3.0% in June of this year in the US (since climbed back up to 3.7%) and to 4.3% in September in Europe (likely to drop further to 3.2% in October; to be released on Tuesday.)

Those headline inflation numbers triggered virtually identical monetary policy reactions, as described above. The Fed started its hikes three months earlier than the ECB, even though the ECB came into the inflation shock with lower – indeed negative – rates. But that doesn't make a big difference, apart from partially explaining why the decline in US inflation runs a bit ahead of European inflation. In her charming "Lunch with the FT" in this weekend edition of the paper, Christine Lagarde regrets the delay in their first hike and explains it with her commitment to stick with the already provided forward guidance of ending all QE before lifting rates. "I should have been bolder", she says. (This is music to my ears both because I have never been a fan of forward guidance, but also because that the same logic ought to apply as well to the present debate about lifting the inflation target a bit: Don't let existing policies stand in your way of doing the right thing. But that'll be for another day.)

What the right monetary policy reactions to the inflation shock should have been across the major economies was the topic of a great FT Webinar discussion this past week between Chris Giles, Martin Sandbu, Martin Arnold and Colby Smith, moderated by Claire Jones. Highly recommended.

## 3. Why – and what now?

It all leaves me wondering why the ECB followed the Fed so precisely (with a three-month lag) in spite of the very different circumstances driving the inflation story? And if I'm right that the ECB overtightened, what will be the consequences?

I can only guess what made the ECB change its narrative in early 2022, following the initial (correct) interpretation that this was a supply shock, although a multi-faceted and complex one, which would come to its end and automatically return inflation to its target. In other words, I am not fully persuaded by the official account - and I don't understand the logic behind the explicit inclusion of actual inflation in their revised reaction function, which serves as an unfortunate upgrade of this variable because it now gets double-counted. (Actual inflation is already, obviously, a key input for the forecast.)

**My guess is that a combination of the following four issues played the key roles in the U-turn last year:**

First, the commodity price shock from December 2021 to June 2022 came after a long and steady rise in prices from a very low level in April 2020, illustrated by the price of Brent oil having moved from USD 37 back then to more than USD100 in early 2022. As a result, the spillover from the earlier commodity price increase was beginning to make its way into core inflation (as it does pretty automatically over time). This, along with the supply chain issues and the massive shift in consumer preferences back from purchases of goods towards services, muddied the picture of inflation quite substantially.

Second, and related, a concern emerged that the higher inflation numbers would lead to a price-wage spiral via a resurgence of inflation expectations. The fact that labor markets remained strong (having GDP growth dropping to zero without an increase in unemployment is rather unusual, to say the least) muddied the water. In the end, long-term inflation expectations (which is what matters) remained well-anchored and wage growth has made only a minor dent in the erosion in households' real income. As I have argued before, I think the concern about inflation expectations was vastly overdramatized. Admittedly, it's a question we'll never fully know the answer to, but I'll come back to it in a second.

Third, as headline inflation began to increase rapidly above 2%, public criticism of the ECB intensified and, in the case of some tabloids, became outright nasty and completely out of line! As the public pressure increased, attention began to focus on the ECB's staff's mistakes in terms of forecasting inflation – ignoring the fact that no models will accurately forecast the effects of massive shocks. Personally, I thought it was disappointing to see some economists (and some policymakers), who should have known better jumping on this wagon.

Fourth, while I rather suspect that most Governing Council members would have loved to show independence from the Fed, they probably had – deep down – a concern that if they didn't follow the Fed, EUR/USD would plummet, causing further inflation pressure.

**As a result, and given the considerable uncertainty, I suspect that the Governing Council's implicit incentive function became heavily skewed towards tightening rather too much than too little.** In many ways, if so, that would be understandable: Very few people would excuse them if they had stopped at interest rates of, e.g., 2%-3%, and inflation – for whatever reason – then were to linger for longer at, say, 5%-10%. In contrast, who'll raise concerns (apart from me …) if we end up with the level of GDP 2%-3% lower than we otherwise would have had, and inflation below 2% for a while because of the monetary tightening?

And yet, this latter scenario is not far-fetched. As a result of the shocks and the message of tightening – i.e., even before the full effect of the tightening hits the real sector - the eurozone economy has been flat on its back, showing zero growth for the past four quarters cumulatively. And if the latest PMI is a reliable indicator (and it usually is), GDP will be contracting during the present quarter. Meanwhile the US economy expanded by a whopping 2.9% during the past four quarters.

Granted, the US fiscal stimulus cannot go on forever and I have no squabbles with forecasts of a pretty hard landing in the US (although the timing is uncertain). But I'll buy you a beer if eurozone GDP catches up and closes the 2.9% shortfall (created in just 12 months!) to the US within the next 2-3 years - **because here is the key point:**

The US has enjoyed plenty of demand, stimulated by fiscal policy and not hampered by a terms-of-trade shock, so monetary policy has – rightly – been employed to cool the party. This leaves at least a chance of a soft landing. In contrast, Europe enjoyed no increase in demand because the pain from the terms-of-trade shock exceeded the benefits of the fiscal stimulus. If monetary tightening is justified in such an environment, it is – solely – because of a need to kill off the risk of inflation expectations spinning out of control, leading to a price-wage spiral. In other words, it is to prevent an even worse counterfactual to the base line. That may indeed be what justifies the ECB's massive tightening these past 15 months, but don't fool yourself and think it's not going to come at a cost to growth, relative to the US - or, with a pretty high probability, relative to a scenario of more modest tightening. (My view is that the ECB should have stopped the tightening much earlier, say at 2.5%-3.0%, and trusted its communication skills to persuade the population that inflation would come down, as indeed is happening now ahead of the full impact of the monetary tightening.)

Following the Great Financial Crisis, many Europeans were busy justifying the policy differences, the fiscal austerity, compared to the US, with the virtue of short-term pain for long-term gain. But so far, it's been 15 long years …. Let's hope we are not making the same mistake again.

**Finally, a post-script:**

As you'll have seen in my post-Marrakesh notes, I have been critical of the IMF's too general fiscal policy advice of (over-simplified) just cutting the deficit, while keep tightening monetary policy, including in Europe. In an outstanding opinion piece in this weekend edition of the FT, the IMF's First Deputy MD, Gita Gopinath, addresses my concerns about their rather un-nuanced fiscal policy advice. Succinctly, she tallies the virtually built-in fiscal needs going forward (a whopping 7% of GDP by 2030, on her estimate), and she outlines some of the ways that this money needs to be raised (as opposed to being borrowed). Bravo! – all forgiven…. It's here, and a must-read: The temptation to finance all spending through debt must be resisted.

Now I just hope that they'll apply the same degree of nuanced analysis to their monetary policy advice for Europe! The IMF Research Department presented an outstanding report in Sintra this past summer, outlining the differences between US and European inflation – although they pulled their punches when it came to the policy implications for the US vs Europe. What holds them back, I don't know!

And on that note, I'll enjoy this rainy Sunday afternoon in my couch watching football…

best

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This report was completed and first published on 29 October 2023 at 14:04.

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