Change of focus

114 – 29 November 2021

Key points

- The Omicron variant may change the policy conversation as we wait for answers on its aggressiveness.
- We explore the implications of the German coalition agreement for the macro-management of the Euro area.
- The adverse effects of the loose Turkish monetary policy are so obvious a U-turn should have already happened.

For a few months now the pandemic has been considered as sufficiently manageable for the debate to focus on the effects of the "decompression" of our economies upon reopening and ponder the risks of persistent inflation and, as a corollary, discuss policy normalization. The deterioration on the sanitary front in the East and North of Europe due to the delta wave was a hindrance, but generally seen as unlikely to trigger more than a short-term wobble. The detection of a potentially aggressive variant in South Africa – already found in several locations across the globe – changes the conversation. It may take some weeks before we have answers to the three key questions: i) is the Omicron variant more susceptible to trigger severe forms of the disease; ii) is it resistant to existing vaccines and iii) does it spread faster than "old" versions : if it does, even if it is not more lethal nor resistant it would still call for an acceleration of the vaccination programmes and possibly some short lockdowns where a significant catch-up is needed. While we wait for this, policymakers will have to be very cautious when making key decisions given the need to contemplate the possibility "hard", growth-busting sanitary measures may have to be re-instated. It is not too much of a problem for the Federal Reserve (Fed), which upon starting its tapering has retained wide optionality. It's going to be more complicated for the European Central Bank (ECB) which has a crucial rendez-vous with the market on 16 December. We argue that the "prudence" advocated by ECB board member Panetta in his speech last week should indeed prevail.

We also review the implications of the German coalition agreement for the economic management of the Euro area. The best we expected was "constructive silence". We had a bit more than that, with some openness to discuss a reform of the Stability and Growth Pact. However, it does not seem Berlin is about to break with the Merkelian era's reactive, rather than pro-active approach to the European economic agenda. Another issue is that the coalition may not have enough bandwidth to engage much on this topic, between a tough domestic agenda and an external platform which could trigger some tension with China, Russia, and the Eastern members of the European Union (EU).

Finally, we take another look at Turkey. There is no doubt for us that the adverse effects of the current loose monetary policy are already massive and should have already triggered a turnaround. We are concerned Ankara could instead choose economic and financial repression (e.g. capital controls and price controls).

A new known unknown

As Europe is already grappling with a delta-variant flare-up, the emergence of a potentially aggressive new version of Covid in South Africa forces us, once again, to contemplate the possibility that the ongoing global recovery could be significantly impaired by mobility restrictions.

The World Health Organization has swiftly classified the Omicron variant originally found in South-Africa "variant of concern" given the high number and nature of its mutations. The total number of cases in South Africa has increased ten-fold in about 10 days, and the variant was detected in a high proportion (70%) of the samples collected in the Gauteng area between 14 and 23 November, the main contributor to the -re-acceleration of the pandemic at the country level. The first statements from South Africa's National Health Laboratory point to no empirical evidence so far of the variant's capacity to escape immunity, and the number of hospitalizations remains low (18 on Saturday against 2858 new cases) but it's early days. We'll know more from the specific hospital surveillance system the country has just put in place. While South Africa's vaccination rate is relatively low (28% of the population), it has recorded a total of 3 million positive cases since the start of the pandemic for a population of 60 million which, given the fairly low testing, suggests many people had acquired natural immunity. What will be crucial in the next few days and weeks will be to get a sense of (i) whether the variant triggers severe forms of the disease more often than the "old" versions, (ii) to what extent immunity from either previous infection or vaccination provides protection against these severe forms associated with the variant.

Even if the empirical evidence gathered in South Africa were to point to weak protection from the current vaccines, Pfizer stated that it could adapt its product to an "escape variant" within 6 weeks and reach industrial production stage within 3 months, and Moderna has communicated a similar message over the weekend. Yet, **another piece of information which is going to be key is the speed of dissemination of the variant relative to old versions**. The latter is key to understand the implications in terms of healthcare capacity: **even if the variant is not more dangerous nor resilient, if it spreads much faster it could hit a larger fraction of the population before the ongoing "booster programmes" reach them**. This is why pre-emptive restrictive measures can be tempting. Ultimately, restricting mobility is unlikely to "stop the variant in its tracks" – there is already evidence of local contamination in Europe – but it can slow down its progression to preserve healthcare capacity while either the new vaccines are produced or the current vaccination programmes can be stepped up.

The emergence of the variant may tilt the countries which were already considering forms of lockdown because of the strength of the delta variant flare-up amid low vaccination rates (Germany from this point of view is key), if only to "pause" while they catch-up on vaccinations. A simple heuristic is that in a typical European country, a week of lockdown reduces quarterly GDP by roughly half a point. A three-week lockdown in Austria would barely register on the Euro area GDP, given the small share of the country. The same lockdown in Germany would shave 0.3% off Euro area growth. Beyond the effect of potential lockdowns on the short-term outlook economy-wide, the emergence of this new variant will add to woes of the international transport and tourism industry. Indeed, the return of flight disruptions could incentivize leisure travellers to find solutions closer to home or – in the case of business travel – stick to virtual contacts. As we type, three countries – Israel, Morocco, and the UK – have to varying degrees already re-instituted *general* limitations to international travel.

The Omicron variant is emerging at a critical time for policymaking in the advanced world, even if the room for manoeuvre differs for central banks across constituencies. We mentioned last week that we believed the Fed had retained maximum optionality. The most hawkish members of the Federal Open Market Committee (FOMC) are openly discussing a *faster* pace of tapering, a possibility open by the committee's latest decisions (in their wisdom, they had committed to a 15bn taper only for the first two months). Symmetrically, even if the bar is probably high for this given the US general attitude to the sanitary risk since start of the pandemic, they could decide to slow down the pace of tapering if the macro outlook gets cloudier and/or if market conditions get tense. The same flexibility holds for interest rates: Jay Powell must feel pleased with his absolute refusal to get dragged into a discussion of the likely timing for the lift-off. The market was pricing a move next summer, but the Fed would not lose face nor credibility if it nudged towards a 2023 pricing.

Things are more binary for the ECB since it is expected to tell us at the next Governing Council meeting on 16 December if and when the Pandemic Emergency Purchase Programme (PEPP) is terminated, and if and when the Asset Purchase Programme (APP) is recalibrated. An update on the forward guidance – on the link between the timing of the termination of APP and the first-rate hike – is also due. Decisions were always going to be difficult in a very divided council. The uncertainty created by the new variant adds another layer of complexity.

The new forecast batch was going to be crucial as an underpinning of their decisions. If the South-African variant were to force significant growth-busting mobility restrictions, then their new projections could be "dead on arrival" (the severity of the delta wave in the East and North of the Euro area was already a source of uncertainty). Beyond the questions on the response of the real economy, the emergence of the variant has already triggered a significant decline in the price of oil, with Brent at long last falling markedly below USD80/bbl. on Friday. Another issue for the ECB is that the euro depreciation could be stopped as the market re-assesses its anticipations of the Fed's trajectory. **Both developments can seriously take Euro area inflation down**.

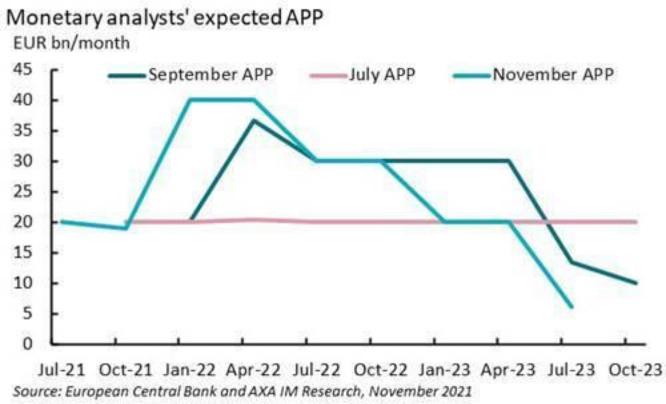
Habitual readers will know that your humble servant believes domestic inflation dynamics are radically different in the Euro area and in the US. In the latter, there are some signs that "endogenous" price pressure is already underway, especially in the form of wage acceleration. None of this is tangible in the Euro area. If external sources of inflation are removed from the equation more quickly than expected, then the chances inflation would re-anchor below 2% are significant once the current price spike is absorbed.

We may get more certainty on the sanitary side by 16 December, but in our opinion the emergence of the variant is another reason for the ECB to try to build up some "flexibility buffers" for 2022, rather than committing too hard to a given trajectory for PEPP and APP.

More for shorter?

It seems that key members of the ECB board and Governing Council have taken to talk to each other via speeches and statements to the press rather than behind closed doors. Depending who has been the latest to take to the wires, market pricing oscillates between a dovish and hawkish timeline for the rate lift-off**. Last week, Fabio Panetta made the case for the doves**. As a disclaimer, your humble servant might be biased since Fabio Panetta was kind enough to reference Macrocast in his speech, but even without this bout of vanity we would have probably agreed with his main point: given the nature of the inflation shock in Europe, the ECB should be patient and refrain from early tightening. Panetta made sure not to focus on the rate lift-off and more on the fate of quantitative easing (QE): *"an inappropriate, sharp reduction of purchases would be tantamount to a tightening of the policy stance (…). They need to be calibrated to help ensure we reach our target, avoiding an undesirable, premature increase in long-term interest rates".*

Exhibit 1 – Quicker taper expected for the ECB



There is quite a bit for the ECB to row back from on that front. The central bank's latest "survey of monetary analysts" suggests the market is now expecting a bigger upside recalibration in APP by the time PEPP terminates in

March 2022 than in September, up to the EUR40bn euros per month we have been forecasting for a while. But this upgrade is also anticipated to be very short, with a steeper tapering pace very quickly by the end of spring 2022 (see Exhibit 1). "More for shorter" in a nutshell. Our own view is that the central bank will maintain EUR40bn pace for longer – actually for the entirety of 2022. We think Panetta's call for "flexibility" at the end of his speech – which echoes the earlier words by Villeroy de Galhau – could take the form of (i) keeping the open-ended nature of the programme and (ii) allowing some protection against the possibility of flare-ups on some national bond markets amid still shaky macro conditions.

APP for now is fully open-ended*: "run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates"*. We know that the last segment of that sentence is likely to be significantly revised in December, to sever the condition of a short lag between the end of QE and the first-rate hike. **But the most important debate in our view might be around the possibility that an explicit deadline is set for APP at the December meeting**, which is likely to be a temptation for the hawks. Given the renewed uncertainty, it probably would be a mistake. If the probability of significant sanitary measures rises, so should the expected level of public deficits next year, since some of the exceptional fiscal support schemes put in place to cushion the shock might have to be re-instated. As we have repeatedly argued in 2020, making fiscal expansion financially possible has been monetary policy's most efficient transmission channel since the start of the crisis.

To retain optionality on QE, the ECB should maintain the focus on state-dependent – the outlook and actual developments in growth and inflation – rather than time-dependent forward guidance. The "best of both worlds" would be to instil a sense of direction to the market by using a hybrid formulation, e.g. along the lines of "at least until late 2022 and in any case as long as the Governing Council deems it necessary to reinforce the accommodative effect of policy rates".

Protection against bond market flare-ups would ideally entail injecting in APP post-March 2022 some aspects of the PEPP – notably in terms of deviations from the capital key for apportioning the purchases across markets. Note that such **flexibility could be obtained by using the PEPP's reinvestments rather than changing the rules of engagement for APP itself.**

The German coalition opens some doors, but there's a lot on the plate

The December meeting will be the last one with Jens Weidmann. The lengthy coalition agreement sealed in Berlin was silent on his replacement. Even though the hawkish FDP leader Christian Lindner obtained the finance ministry, we think that a measure of "checks and balance" will apply and that he won't have a free hand in the choice of the next Buba boss, which would keep the door open to more consensual personalities on monetary matters, such as Joerg Kukies or Joachim Nagel (the same would apply if Isabel Schnabel were to leave the ECB board to join Buba – Germany would still need to appoint her successor).

Beyond the "personnel" issues, the agreement sends several messages which we find generally positive for the next steps of European policies but with very limited granularity. There will be a lot of "learning by doing" it seems, and it does not seem Berlin is about to break with the Merkelian era's reactive, rather than pro-active approach to the European economic agenda. Domestically, as we expected, the agreement finds a compromise between respecting the principles of the national "debt brake" and carving out some off-balance sheet solutions to provide support for the private sector's investment needs. Moreover, the impact of the "corona debt" on Germany's fiscal room for manoeuvre is going to be diluted by spreading its correction over a longer period. This is not heralding a revolutionary public investment programme, but at least it's consistent with supportive German demand in the years ahead. Germany would not find itself in a position to lecture the other member states on their own fiscal stance.

In a way, the best we could expect from a coalition bringing together fiscal hawks and doves is "constructive silence" on the thorniest issues. We had a bit more than that. For instance, while the text lauds the European fiscal surveillance framework as *"flexible enough"* – which could be construed as making it unnecessary to reform – this was followed by "*the evolution of fiscal rules should focus on fostering growth, debt sustainability and climate-friendly long-term investment*" which by definition accepts the possibility of change, while the final sentence *"in any case the Stability and Growth Pact should be simpler and more transparent*", which we find interesting since a lot of reform propositions from the French side – notably by Agnes Benassy-Quere and jean Pisani-Ferry – precisely focused on simplicity. No offer from Berlin, but at least a willingness to talk. "Constructive silence" can be detected when discussing the EU's next generation programme. The coalition agreement describes it as a "one off" but does not elaborate to explicitly reject the possibility to create another mutualized programme. There again, it's unlikely the initiative would come from Berlin, but there is no rejection by default of a proposition from another member state.

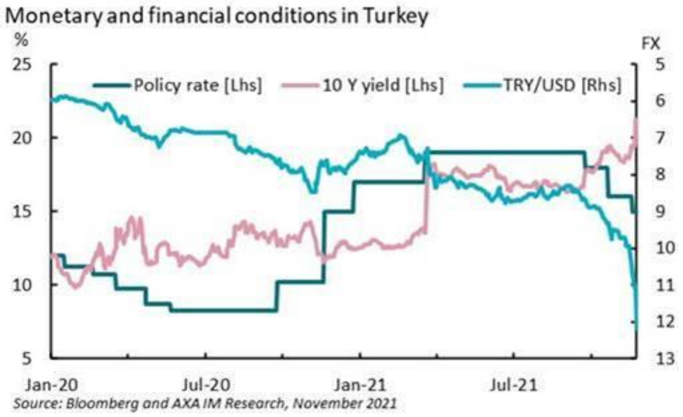
There will be several delicate balances to maintain in this coalition. Domestically, a conflict could easily arise between Green Economy Minister Robert Habeck and Christian Lindner, while on the European matters observers will focus on differences in the approach of Lindner and Scholtz. Note that after the numerous episodes of "robustly worded nuances" of opinion between Wolfgang Schaueble and Angela Merkel, this would not be new nor necessarily dramatic**. A key unknown though is the bandwidth which the new German government will have to deal with purely economic European issues**. Domestically, beyond the fact that the coalition will take power amid a nasty Covid wave, the climate transition agenda will be tough to push through. On the external side, the Greens (now controlling the Foreign Office) want to pursue a muscular approach to China and Russia, while the coalition text is a trove of potential conflicts with the Eastern EU members (between the "rule of law" points and their support to an extension of majority voting at the European council).

Incidentally, the coalition text should not be comfortable reading for the British government. When it comes to Brexit *"we insist on full compliance with the agreements, in particular when it comes to the Irish protocol and the Easter agreement. In case of non-compliance we count on a systematic implementation of all agreed measures and countermeasures"*. It does not seem Boris Johnson should count on much goodwill from Chancellor Scholtz in his ongoing spat with France….

Turkey: what's the reaction function?

We have been monitoring Turkey quite often in Macrocast, as one of the most problematic cases of macro-management among large emerging economies. The latest weeks have been quite dramatic for the country, after another rate cut triggered another steep fall in the currency, while pushing the risk premium on long-term yield to another high (see Exhibit 2). The depreciation in the currency magnifies the impact of elevated key international prices and inflation had reached 19.9% in October which the additional bout of Lira weakness will probably push further up in the next few months.

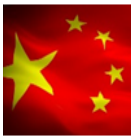
Exhibit 2 – Another cut, another wave of currency depreciation



In a "benign" scenario, we would simply be dealing with the replication of a sequence already observed in Turkey, with the government, after months of adventurous experimenting, ultimately allowing the central bank to tighten financial conditions enough to stabilize the currency. Indeed, the pressure on the Turkish economy is piling up. While the current account position has improved, with August and September in surplus, **consumer confidence has fallen to a new low as inflation erodes purchasing power**. The currency mismatch is mechanically getting deeper, and with corporate debt in foreign currency reaching 44% of GDP, questions on sustainability – at least in the most fragile segments – will get louder.

"Crawling dollarization" – where economic agents seek to substitute holdings in foreign currency to holdings in national currency (more than half of total deposits in Turkey are already held in foreign currency) – by contrast with "institutional dollarization" – where the government of a country makes a foreign currency legal tender in domestic transactions - **is a bad recipe for political stability.** Tax continues to be collected in a devaluing currency, and so is government spending. Those who cannot access euros or dollars and are dependent on government expenditure are the main losers. If in addition the government faces positive real funding costs (the 10-year yield was 1.5% above inflation last Friday) and is facing its own currency mismatch (public debt denominated in foreign currency stood at 19% of GDP in October according to HSBC, and has mechanically risen higher this month), it soon runs out of options.

There should not be much hesitation about the need to change course, an there would be some time to absorb the transitory cost to demand from rate hikes by the next general elections scheduled for 2023, but so far there is no indication of another turnaround. **An alternative to monetary tightening could be for Turkey to resort to financial and economic repression,** i.e. implementing an array of current account controls and domestic price controls. This would be a *very* slippery slope, which would take the country further away from mainstream economics.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Powell renominated as Fed Chair, Brainard becomes Vice Chair • COVID cases rise again, Mid West focus • FOMC minutes repeat that taper pace is flexible, could change with economic circumstances • Q3 GDP revised to 2.1% (saar) from 2.0% (p) • PCE inflation (Oct) reaches 5.0% (core rate at 4.1%) - highest since start of 1990s • Online Thanksgiving sales estimated at $5bn • Weekly jobless claims 199k, lowest since 1969	• Extension of government spending expires 3 Dec, shutdown without further action • Employment report (Nov), solid payrolls expected (500k) and dip in unemployment (4.5%), we will watch for rise in participation • ISM manu and serv indices (Nov) expected to remain elevated • Tsy Sec Yellen and Fed Chair Powell testify before Senate Banking Committee • Fed publishes latest Beige Book assessment
	• Tightening COVID restrictions with rising cases • The SPD/Greens/FDP announced coalition deal • Nov Mfg and Svcs Flash PMI surprised on the upside in Ge/Fr/EMU. Robust business climate in Fr (Nov), IFO slightly declined in Ge (Nov) • Ge GFk cons confidence softened to -1.6 (Dec) its weakest since June • Loans to households/non-fin (Oct)	• HICP Flash (Nov) in EMU-4 and aggregated euro area. We expect an increase from already high figures in Oct • EC sentiment surveys (Nov) • Eurozone retail sales (Oct) • Final Svcs PMI may be revised down from recent covid restrictions
	• MPC comments ahead of Dec meeting • Bulb largest energy supplier to collapse 1.7m clients, taxpayer bailout of £1.7bn • Flash Mfg PMI (Nov) at 58.2, economy sees solid momentum, despite high input prices • Migrant deaths add to tensions with France	• Nationwide HPI and mortgage approvals (Nov) – expect further softening • Final PMIs (Nov) – solid growth in prelims, pace of price growth may weigh on figures • BoE's Saunders speak on inflation • BoE Governor Bailey speaks
	• Flash Business activity (Nov) rose to 51.1 from 50.7 • Flash Mfg PMI (Nov) expands to 54.2 • Companies mentioned strong production and demand despite rising prices	• We should have a rebound in Retail sales (Oct), Consumer confidence (Nov) and Services PMI (Nov) as economic activity is normalising • Industrial production (Oct) should progress with higher auto prod than in Sept
	• Q3 monetary policy report sends subtle signals that the PBoC is turning more growth supportive	• Manufacturing may have improved slightly in November due to fading power shortages
	• Rate hikes in Hungary (+40bps to 2.9%) and Korea (+25bps to 1.0%). TRY on freefall • Peru Q3 GDP slowed to 11.4%yoy (Q2:41.9%) • Singapore IP (Oct) grew 16.9% y/y (Sep: -2.2%) • In line with polls, left-wing Gabriel Boric and right-wing Jose Kast will be in the Chilean presidential runoff on Dec 19	• CPI (Oct) figures for Indonesia, Korea, India and Peru (Nov) • Q3 GDP numbers for Brazil, Taiwan, India and the Czech Republic • Unemployment figures across LatAm countries

Upcoming events	US :	Mon: Pending home sales (Oct); Tue: Case-Shiller & FHFA HPI (Sep), Chicago PMI (Nov), Conf bd cons conf (Nov); Wed: ADP payrolls (Nov), Mfg PMI & ISM (Nov), Fed Beige Book; Thu: jobless claims; Fri: Non-farm payrolls (Nov), Servs PMI & ISM non-mfg (Nov), Factory orders (Oct)
	Euro Area:	Mon: EU19 Business confidence (Nov), Ge HICP (Nov,p); Tue: EU19 CPI (Nov,p), Ge Unemp (Nov), Fr & It GDP (Q3), Fr & It HICP (Nov,p), Fr cons spend (Oct); Wed: Mfg PMI (Nov); Thu: EU19 PPI (Oct), EU19 Unemp (Oct); Fri: EU19 Servs PMI (Nov), EU19 Retail sales (oct), Fr Ind prod (Oct)
	UK:	Mon: BoE bank lending data (Oct); Wed: BRC Shop Price indx (Nov), Mfg PMI (Nov); Fri: Services PMI (Nov), BoE's Saunders speaks; Nationwide house price indx (Nov) (during week)
	Japan:	Sun: Ind Profits (Oct); Tue: PMI (Nov); Wed: Caixin Mfg PMI (Nov); Fri: Caixing services PMI (Nov)
	China:	Mon: Unemployment (Oct), Ind prod (Oct,p)

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