Research & Strategy Insights

The Draghi Effect to live On

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Key points

- The political status quo in Italy is good news, even if the majority may become more difficult to steer towards swift implementation of the structural reforms which are part of the Next Generation EU (NGEU) framework. Costa's electoral victory in Portugal will also help in the conversation with Berlin on the next steps of the European Union (EU)'s economic integration.
- The Federal Reserve (Fed) "means business" on curbing excess demand quickly, while the European Central Bank (ECB) this Thursday is likely to re-affirm it is in observation mode. The January inflation print for the Euro area will colour Lagarde's press conference.

Political stability is going to be a precious asset as the world economy normalizes and economic policy needs to break from "all-out" accommodation. The status quo which has prevailed in Italy, with Mattarella remaining President of the Republic and Mario Draghi Prime Minister is the best possible outcome as the ECB's support to the bond market is about to fade. Italy's economic performance in 2021 has been encouraging with the Next Generation EU framework acting as a catalyst for much-needed structural reforms and catch-up on investment. The country will need to stay the course though, and the internal conflicts in the baroque parliamentary majority supporting Draghi may make the next steps more difficult. The intrinsic shortcomings of the Italian institutional setup are still there. Yet, in the meantime the alliance between Paris and Rome to reform the Stability and Growth Pact – and possibly to turn the NGEU into a permanent feature – is holding up. Moreover, the clear victory of incumbent Portuguese Prime Minister Costa in a snap general election now equips him with an absolute majority which should allow him to pursue an economic policy which can keep the populists at bay while keeping the market on board. Avoiding crisis and delivering good macro results is what is needed – although it may not be sufficient – to convince Berlin that peripheral countries can be trusted to do their part of the job if the EU moves even further into a system of mutualized liabilities.

"Peace and quiet" on the political front – for now - is one concern less for European investors as they deal with contagion from the US. Last week's press conference by Jay Powell has confirmed that the Fed "means business" and is not ready to soothe the market. Curbing excess demand quickly is the central bank's new motto, and Raphael Bostic's point on the possibility to start the lift-off with a 50-bps hike was "interesting". Still, while the direction of travel for the Fed in the first half of 2022 is becoming even clearer, we note that the market's expectation for the total number of hikes in the whole tightening phase has not changed much. The "Fed overkill" thesis is still prevalent.

The ECB's Governing Council meets this week. They have given themselves quite some time to remain in observation mode and we expect Lagarde to "lower the temperature" after the series of statements from hawks. The January inflation print – to be released the day before - is likely to colour the press conference.

Welcome status quo

Political instability in Italy ranked high on our list of worries for 2022. Questions on the policy stance in the periphery is the last thing the Euro area needs now that the ECB's support to the bond market is fading. Fortunately, the status quo emerging last weekend from the presidential election's saga is clearly the best outcome from a market perspective. President Mattarella accepted to stay after the "great electors" (mostly parliamentarians) failed to produce any other solution which would have been consistent with a continuation of the current baroque majority supporting Mario Draghi, who stays as Prime Minister.

For now, **the "Draghi effect" is preserved. The success of the experiment is not only vital for Italy. It is also a condition for the recent institutional progress seen in the European macroeconomic management to outlive the pandemic**. Yet, the inability of the parties in the majority to control their own parliamentary groups in what has been a very messy process can be a sign of difficulties ahead, as the implementation of the "reforms against funding" deal with the EU could get bogged down. Italy is fortunate enough it can rely on the combination of "two men of good will" (Mattarella and Draghi), to borrow the words from Massimo Giannini in La Stampa on Sunday, who happen to possess strong tactical acumen. Yet, fundamentally, the limits of Italy's institutional setup are still there.

Draghi's strategy for Italy is a clear break from the economic policy model which had become dominant there since the early 1990s, where success on fiscal austerity – reflected in years of large primary surpluses – ultimately reduced the policy space to deal with the country's structural weaknesses, since no significant financial accompaniment of the transitorily adverse effects of much-needed reforms could be provided. This was the root of the failure of another "Great European Technocrat" propelled to the Italian Prime Ministership (Mario Monti) at the beginning of the sovereign crisis of the last decade. In his "Rimini speech" just before becoming Prime Minister, Draghi focused on a distinction between "good" and "bad" debt, the former being issued to fund public investment which could lift the country's potential growth and thus ultimately improve debt sustainability. This is the very premise of the EU's Next Generation plan, and Italy has been the only large country taking advantage of both the transfers (which do not raise the recipient's debt) and the loans components to the tune of 10.7% of its GDP (EUR 191bn).

To be fair, the move away from austerity during the pandemic – in contrast with the choice made during the previous phase of synchronized global recession at the time of the Great Financial Crisis of 2008-2009, when Italy provided much less support to domestic demand than France and Germany – pre-dates Draghi. It had been embraced by his predecessor Conte, but Draghi made this palatable to the markets and Italy's European peers thanks to his ECB credentials and ability to push for effective structural reforms despite a fractious majority. The results are plain to see. Italy's GDP performance through the pandemic has been in the "middle of the pack" but **the resilience in investment has been impressive (see Exhibit 1) amid an unusually high level of consumer confidence both relative to Italy's long-term average and to the other large European economies (see Exhibit 2).**

Exhibit 1 – The investment engine finally switched on

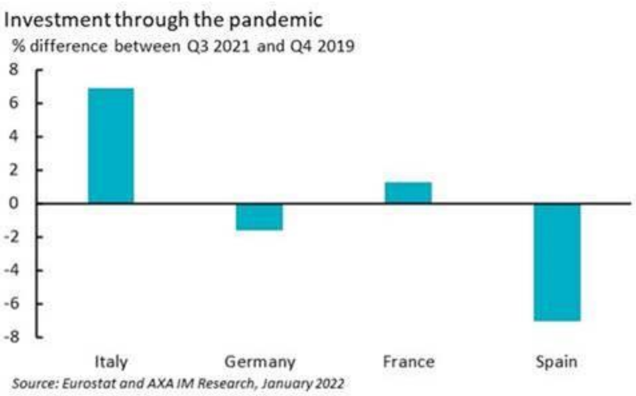
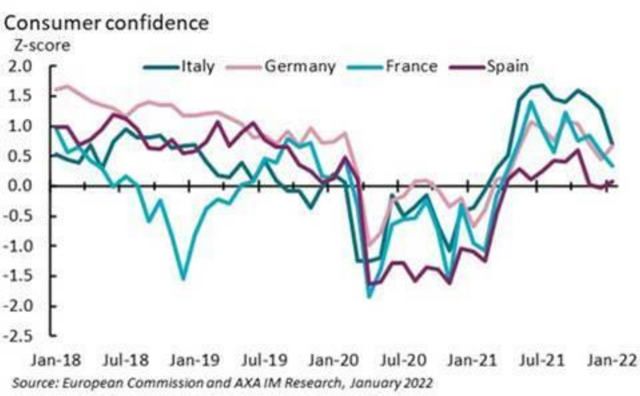


Exhibit 2 – Unusually high consumer confidence



Progress on structural issues is tangible. The Next Generation EU framework is based on delivering on several milestones negotiated with the European Commission in exchange for the disbursement of the funds and we now have the first concrete examples of how it effectively works. According to the request sent to the Commission by the Italian government for the first tranche of EUR 21bn (half of it in loans), 51 of said milestones have been achieved. The level of granularity on those is quite high, with some decrees already taken towards, for instance, reforming public procurement in information technology or vocational training. The whole project is a catalyst for a "catch-up" in the Italian economy after years of stagnation. The impact of the Next Generation EU funds is already reflected in business and consumer confidence before the funds are effectively disbursed.

Italy needs to stay the course though, and the peak in disbursements is scheduled to come in 2024 only, *after* the next elections (they must be organized by 1 June, 2023 at the latest). Implementation discipline is needed, but it may become more difficult to deliver the necessary votes in parliament to get to the relevant "milestones". It took seven rounds of voting to land on the "Mattarella 2.0 " option, and when the leadership of the centre-right (which normally enjoyed a numerical advantage among great electors) attempted to push its own candidates, it was unable to even come close to the theoretical number of votes it controls. Five-Star appeared bitterly divided between a Di Maio and a Conte faction (plus numerous parliamentarians whose attachment to the party looks now purely nominal), with Conte trying until the last moment to scupper a deal around Mattarella. Centre-Left PD possibly comes out of this relatively unscathed, but its isolation within the majority is plain to see. The conflict/competition within the right between Lega (inside the coalition) and Fratelli d'Italia (outside) is wide open. As the 2023 elections get closer, the various components of the loose majority will probably need to differentiate themselves, making it more difficult to get votes through. There will also be questions about the role that Mario Draghi will want to play in those elections. One of Mario Monti's mistakes probably was to enter politics directly and become a competitor to the parties which had supported him as long as he was purely a "technical Prime Minister".

A solution of course would be that Mattarella resigns before the end of his mandate, to be replaced by Mario Draghi who would remain a force in Italian politics, exerting his influence to ensure continuity on the reforms and compliance with the Next Generation EU framework, but without the need to enter the electoral race and align himself with a specific party (Monti created his own). This is not necessarily obvious though**. In the Italian constitutional order, the President of the Republic's role can be major to deal with acute institutional crises, but it never was intended as a "guide", however indirect, of the government's policy.**

On these matters, it's worse remembering the fate of Matteo Renzi, another predecessor to Draghi. Despite some early success – his was also an attempt to break away from the "austerity now, reforms later" model – he concluded that the Italian institutional setup was intrinsically incompatible with the economic overhaul the country needs and embarked on a constitutional reform which was rejected in a referendum which he failed to win and ultimately triggered his demise. True, here we would be talking about a subtle change in the role of the President brought in by the *practice* of Draghi in office, rather than about an explicit and polarizing constitutional change, but Renzi's referendum defeat (although focused on the balance of power between the parliament and the PM rather than on the presidency's role) suggests that there may still be in Italian public opinion a distaste for too strong an executive power. For all his popularity, Mario Draghi is a "technical" Prime Minister who has never contested an election. The fact that the President of the Republic is not directly elected by citizens is another limit to how far his scope could be widened.

These considerations are not for immediate consumption though. For now, the market is reassured, and the explicit alliance between E. Macron and M. Draghi on the reform of the Stability and Growth Pact – which we think is crucial for the definition of the policy stance next year – is bolstered by Mattarella's re-election. Avoiding crisis and delivering good macro results is what is needed – although it may not be sufficient – to convince Berlin that peripheral countries can be trusted to do their part of the job if the mutualized liability system which the Next Generation framework created is to be made permanent, or more simply for the fiscal surveillance system to allow more leeway once its suspension expires at the end of this year.

Portugal: stability made easier

Socialist Portuguese Prime Minister Antonio Costa had managed for 6 years to maintain an economic policy which has kept the market on board despite being dependent on the outside support from two hard-left parties. This tightrope finally snapped at the end of last year when these parties sided with the centre-right to reject Costa's latest budget bill, triggering a snap election last Sunday**. The Socialists have won an absolute majority,** securing 117 seats (+9) out of 226 seats declared with 4 still pending as we write. The hard left was a clear loser of the election night, with Bloque de Esquerda down 14 (from 20) and CDU down 6 (from 12). Centre-right PSD lost 8 seats. Right-wing populists Chega became Portugal's third largest political force, but their 7.2% of the votes is significantly below their score in last year's presidential elections (11.2%). **Costa finds himself in a very strong position, which he is likely to use to secure a smooth disbursement of the NGEU funding (transfers only in Portugal's case), to the tune of a total of EUR16.6bn (7.8% of GDP).**

What's next for the Fed?

The Fed means business. Jay Powell had an occasion last week to soothe the market after two difficult weeks and chose not to, in line with our point that the central bank is actively seeking a tightening in financial conditions even before it moves on its policy instruments. When asked about the reaction to the Fed's hawkish messages, he merely commented that the *"communication channels between the Fed and the market work well"*, mentioning explicitly in this context the expectation of the reduction in the central bank's balance sheet this year already, albeit with the customary addendum about "*no decision being made yet*".

As we expected, Powell presented a simple case for Fed action, which boils down to the existence of excess demand: "*there are many millions of more job openings than there are unemployed people. So, you ask whether we can raise rates and move to a less accommodative and even tight financial conditions without hurting the labour market. I think there's quite a bit of room to raise interest rates without threatening the labour market"*. The Fed does not believe that hiking rates won't have any impact on jobs, but that there is simply enough "overheating" to take out while still leaving actual employment close to its sustainable maximum.

The Fed boss has been unusually clear about the timeline. Saying that the Federal Open Market Committee (FOMC) is "*of the mind*" to raise rates in March is a strong message. The Fed made it plain that they would wait until the rates lift-off to start the reduction of its balance sheet, but mentioning that "a few meetings" would suffice to craft the relevant strategy on this aspect of their arsenal suggests that June would be the likeliest moment for this.

What's left then for the Fed to announce in the next few months? First, while its timing is now clear, the quantum of the first hike is now a question of interest after Atlanta Fed President Raphael Bostic expressed his support to a fifty-basis point move "if the data warrants it". Second, beyond the timing for the beginning of the balance sheet reduction, its speed will be a key variable of interest for the market. Even if the Fed will of course retain the possibility to fine tune this as the process is being implemented, allowing to take market and macro conditions into considerations, the "starting pace" will matter. **What the Fed will have more difficulties providing visibility on is the *total* quantum of rate increase which will be needed.** Jay Powell used the expression "humble and nimble" and we don't think it's a rhetorical escape clause. The current cyclical position of the US economy is very specific given the pandemic shock, and Powell continues to acknowledge the role of supply-side constraints in inflation dynamics. Calibrating the exact quantum of "excess demand removal" which will be needed while supply-side conditions will likely continue to improve is going to be tricky. While Powell was unusually specific in his comments last week, his refusal to get into any conversation on the trajectory beyond the lift-off reflects a genuine openness on what could be needed. We also find it interesting that Bostic, beyond his readiness to start the lift-off with a "bang" also stuck to only three hikes in 2022.

Beyond the likely confirmation of the rate lift-off, **a key aspect of the March meeting will be the release of a new "dot plot" providing some guidance on the Fed's expected trajectory.** It's never a commitment. In September 2018, while preparing to deliver what was going to be their last rate hike of that cycle, judging by the dot plot of the time, the FOMC wanted to continue tightening by another 100 basis points within the coming two years. Still, while focus might be on the number of hikes for 2022, we will be more interested in the message the Fed will want to send for 2023.

Exhibit 3 – Expected hikes are more front-loaded…

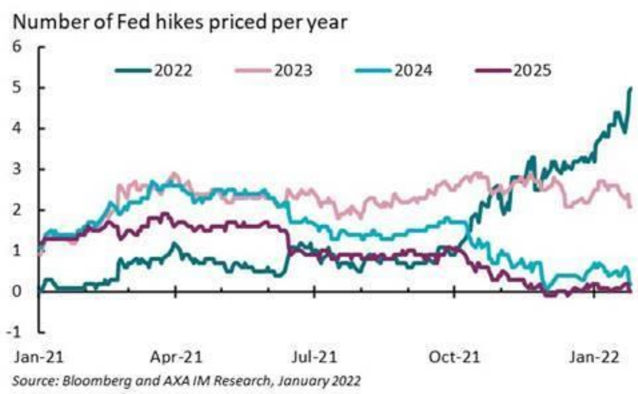
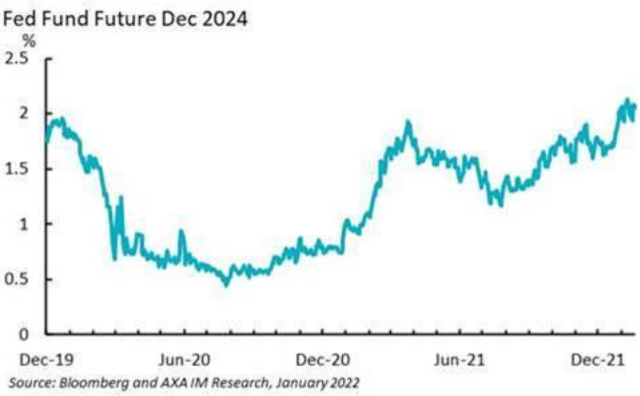


Exhibit 4 - …but landing level has been quite stable



For now, we note that while the market has evolved a lot in its assessment of the likely pace of the Fed's tightening since the beginning of last year (see Exhibit 3), **the total number of hikes between now and 2025 has moved much less and has been anchored around 7**, thus pushing the level of the Fed Funds' rate to 1.75/2.0% at the end of the current tightening phase (see Exhibit 4). This remains below the FOMC's median estimate of the long-term level of Fed Funds (2.5%) and of the 2024 level (2.2%), as per the December dot plot. The market does not even believe the Fed will need to bring its policy rate to the same peak level as during the previous tightening cycle (2.5%).

Two non-mutually exclusive explanations can be found for the state of affairs. First, that the market believes the Fed is tightening too quickly in the face of an intrinsically fragile economy once the fiscal boost is gone. Second, that the ongoing spike in consumer prices will have no effect whatsoever on trend inflation so that the US would return relatively quickly to the pre-pandemic below 2% regime.

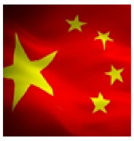
We find the second point difficult to support. While we do not believe in the emergence of a price spiral in the US which would bring inflation markedly above 2% in a persistent manner once the current exogenous shock is absorbed, equally **the current episode is likely to be the ingredient which had been missing for years to prompt consumers and producers to re-think their estimate of long-term inflation**. Surveys suggest households are not overly worried about consumer prices over a five-year horizon, but at least their forecasts have stopped wallowing below their long-term average as they had been doing for years after the Great Financial Crisis. **The new configuration is more supportive of a permanent inflation regime at 2.0/2.5% than the old 1.5/2.0%.** The first point unfortunately deserves some attention. We have already explored several times in Macrocast the possibility that the Fed is in "overkill mode". The current dataflow is not straightforward to interpret. Only last week the release of the stronger-than-expect GDP growth in Q4 suggests the US economy is indeed in rude health, but **the disappointing data for personal spending in December (-0.6%mom) after a downward revision for November may reflect the beginning of a significant dampening impact of high inflation on consumption.** The Q4 print for the Employment Cost Index confirms the strong performance of wages, but the quarter-on-quarter change was less spectacular than in Q3.

All in all, we remain comfortable with our 2% call for US 10-year yield at 2% at the end of 2022, amid 4 hikes in the Fed Funds (100 basis points in all) and the beginning of a balance sheet reduction in June, but we expect significant volatility in the meantime as the market – and the Fed – get pulled in different directions by a dataflow which we think will remain ambiguous in the coming months.

Meanwhile, at the ECB….

The ECB's Governing council meets next week. We have been arguing that the central bank has given itself quite a bit of cover to remain in "monitoring mode" late into 2022, given its forward guidance which already provides strong visibility on its action at least until October on quantitative easing while pushing the discussion on rate hikes for later. Hawks have been quite vocal however, and **we expect Christine Lagarde to "lower the temperature"** and repeat that it's unlikely that the ECB will hike this year. **The tone of the press conference may however depend on the inflation print for January, which will come out the day before.**

According to Bloomberg, the market expects headline inflation to slow down to 4.4% year-on-year from 5.0% in December, with core inflation decelerating even more markedly from 2.6% to 1.8%. The volatile wholesale energy prices in January and the complexity of their transmission to final consumers in most Euro area countries create are a source of uncertainty on headline, but on the downside, the base effect of the normalization of the VAT rate in Germany should bring a negative contribution of 0.5%yoy to the aggregate Euro area print. We will focus on trying to look through all these volatile effects to get a sense of the underlying trend for core inflation. Of course, a higher than expected figure would put Lagarde in a less comfortable position on Thursday, but the real big issue for the ECB is going to be the next batch of forecasts out in March.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC meeting, no change in FFR; accelerated taper continues to finish QE in March. Press conference hawkish: signalled March hike, QT from June, prospect of faster tightening • US written response to Russia's demand on Ukraine. Talks continue, hopes fade • GDP (Q4, p) beat expectations at 6.9% (saar) – inventory rise much higher than expected • Employment cost index (Q4) slowed to 1.0% • PCE inflation (Dec) rose to 5.8%, core 4.9%	• Ongoing developments with Russia/Ukraine • Payrolls (Jan) – some surveys suggest soft headline. HH survey employment for retracement in line with payrolls. Pay growth • ISM manu & serv (Jan) watch for Omicron impact • COVID cases appear past peak, look for drop • Vehicle sales (Jan) – rise on weak December • ULC/Productivity (Q4,p) – normalisation after volatile Q3, ULC to guide inflation outlook
	• Fr, Spa flash Q4 21 GDP beat consensus, growing 0.7%qoq and 2.0%qoq respectively. Germany contracted by 0.7%qoq • EA business confidence (Jan) edged down, though still displaying decent momentum in early 2022	• It Presidential elections; Pt snap elections • ECB GC meeting: We expect no change to monetary policy stance • Euro area "flash" Q4 GDP expected by consensus at 0.3%qoq • Euro area Jan "flash" HICP expected to edge down (Jan)
	• Gray report delayed as police investigate Downing Street parties • PM Johnson refuses to commit to NI tax hike • Flash PMIs (Jan) softer than expected, reflecting the Omicron slowdown • PSNB (Dec) £12.9bn below forecast FY to date	• MPC meeting, markets pricing 90% chance of hike. We forecast MPC delaying hike • Monetary Policy Report near-term forecasts to show slower growth and higher inflation • Gray Report expected after delays this week • BRC shop price index (Jan) – clues for inflation
	• PMI flash (Jan) pointed to strong Mfg output and lower time delivery but services was down sharply in contraction territory at 46.6 (-5.5p) • CPI Tokyo (Jan) eased to 0.5%yoy (-0.3pp)	• Omicron: 2/3 of the country is under quasi-emergency measures but pressure is growing for further restrictions • Dec IP should ease after Nov rebound: 7%mom • Consumer confidence (Jan) to ease further
	• Mainland COVID cases continue to fall, allowing mobility metrics to recover. HK imposes strict restrictions to battle against Omicron	• Manufacturing sector should continue its mild expansion, but services activity may be hit by the recent outbreak
	• CB: Chile hiked +150 bps to 5.5%, Hungary +50 bps to 2.9% & South Africa +25 bps to 4.0%. Nigeria kept its rate stable at 11.5% • Inflation (Dec yoy %) picked up in Singapore to 4.0%. It decelerated in Malaysia to 3.2% • GDP (Q4 qoq%) gained steam in Taiwan (11.1%), Korea (1.1%) and Philippines (3.1%)	• CB: Brazil is expected to hike +150 bps to 10.75%. Egypt likely to stay on hold (8.25%) • GDP figures (Q4) for Mexico & Ukraine • Inflation (Jan) should decelerate in Korea, Philippines & Peru. It is expected to quicken in Indonesia, Thailand & Turkey • PMI numbers across EMs

Upcoming events	US :	Mon: Chicago PMI (Jan); Tue: Mfg PMI (Jan), ISM Mfg indx (Jan), JOLTS survey (Dec); Wed: ADP survey (Jan); Thu: Weekly jobless claims, Productivity (Q4,p), ULC (Q4,p), Services PMI (Jan), ISM non-Mfg indx (Jan), Factory orders (Dec); Fri: Payrolls report (Jan)
	Euro Area:	Mon: EU19 & It GDP (Q4,p), Ge HICP (Jan,p); Tue: Manu PMIs (Jan), EU19 & Ge unemp (Dec), Fr HICP (Jan,p); Wed: EU19 CPI (Jan,p), It HICP (Jan,p); Thu: EU19 Composite PMI (Jan), Services PMI (Jan), EU19 PPI (Dec), ECB announcement; Fri: EU19 Retail Sales (Dec), Ge New Mfg Orders (Dec), Fr Ind prod (Dec)
	UK:	Tue: Mfg PMI (Jan), BoE lending data (Dec); Wed: BRC Shop Price indx (Jan); Thu: Services PMI (Jan), MPC announcement & Monetary Policy Report; Fri: New car reg (Jan), Construction PMI (Jan)
	Japan:	Sun: Ind prod (Dec,p)
	China:	Sun: Official PMI (Jan), Caixin Mfg PMI (Jan); Mon: Chinese New Year

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