Augmenting the Bernanke Doctrine

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Key points

- The "Bernanke doctrine" on how central banks should deal with energy price shocks should be augmented by taking the fiscal stance in consideration.
- Such augmented Bernanke doctrine would be consistent with a very cautious European Central Bank (ECB). The central bank wants to be flexible, but the direction of travel is clear: they really want to normalize.

Ben Bernanke eloquently expressed the central banks dilemma when dealing with an exogenous price shock: "monetary policy cannot offset the recessionary or inflationary effects of increased oil prices at the same time". It must choose. He also proposed a qualitative criterion to inform the central bank's choice: how close the economy was to full capacity before the shock. Indeed, if overheating was an issue before oil prices rose, then risks of second round effects are higher and the economy can better afford the impact of the monetary tightening. Yet, a key factor Bernanke neglected was the fiscal stance. If a lot of the GDP loss triggered by the exogenous shock is likely to be mitigated by government spending, then the central bank can focus on fighting inflation. In the Euro area, this is made more complex by the fact that the quantum of fiscal support is partly dependent on the monetary stance. Given the structural "fragmentation risk", terminating Quantitative Easing (QE) can reduce the government's capacity to increase spending.

Looking at all the elements of this "augmented Bernanke doctrine", the ECB should proceed with extreme caution. There were no blatant signs of overheating before the start of the Ukraine war. Fiscal policy is pledging to help, but the European summit in Versailles has not produced tangible results on extending debt mutualization. Yet, although the ECB wants to be flexible and was more dovish than what could have been expected after the February meeting of the Governing Council, last week Christine Lagarde announced a faster pace of QE tapering than what was heralded in the forward guidance of December 2021. As we wrote last week the direction of travel is clear: the ECB really wants to normalize.

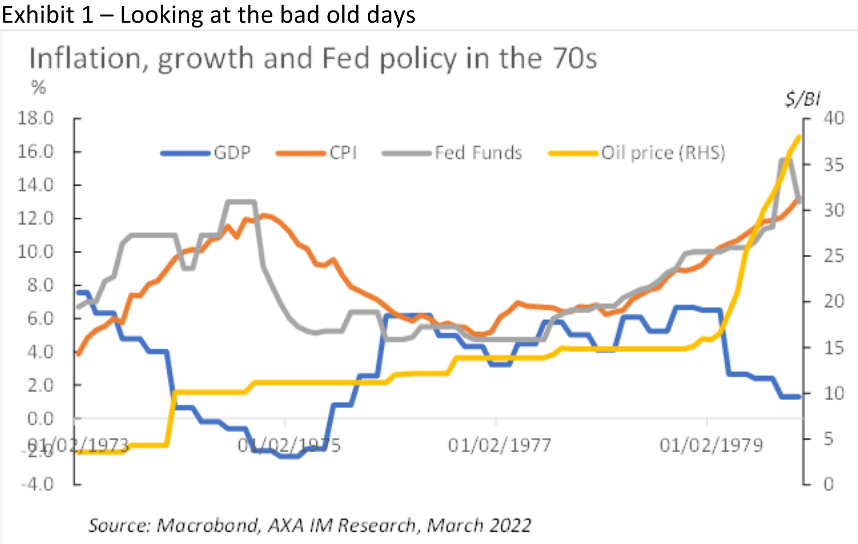
We continue to expect a first-rate hike by the ECB in December 2022. It is predicated on the peak of the economic fallout of the Ukraine war being reached in Q2/Q3. This itself is based on the idea that the two parties cannot sustain high-intensity warfare for more than a few months. It is a very uncertain baseline of course and we explore some possible bifurcations. Note also that we cannot fully ignore the latest pandemic developments. The lockdown in Shenzhen should act as a reminder that beyond the disruption triggered by the war in Ukraine on the European macro outlook, a China-centred new shock to supply lines cannot be discarded.

The central banker's anguish

In 1979, 18 months after leaving the chairmanship of the Federal Reserve (Fed) Board, Arthur Burns gave a lecture in Belgrade titled "the anguish of central banking" (full text here) in which he reflected on the Fed's (and other central banks') inability to control inflation throughout the decade. Burns did not try to deflect his own responsibility, but also blamed the dominant intellectual mood of the day for this repeated failure. His main point is in a nutshell that the post-WW2 social settlement – which we discussed last week – had created an allergy to the kind of decline in growth and income which seriously tackling inflation in a context of massive exogenous price shocks would have entailed. It is somewhat ironic that Burns gave this lecture just a year before his second successor Paul Volcker chose to take this risk and was ultimately successful, at the cost of a significant recession.

The Fed's failure in the 1970s did not stem from a refusal to tighten monetary policy when inflation accelerated. The central bank hiked aggressively in 1973 in response to the oil shock, although it was plainly apparent that the economy was taking a hit. **It failed because it did not have the nerve, or the political capital, to maintain the adequate pace of tightening for long enough**, given the persistent cost to GDP growth. The Fed "cracked" in the spring of 1975 in the face of a deep decline in GDP and cut rates aggressively despite a still intense inflation pace (see Exhibit 1). Real rates fell quickly in negative territory, and as the economy rebounded, inflation remained above 5% even as oil prices had stabilized. Consumer prices started accelerating again, exceeding 10% year-on-year *before* the second oil shock of 1979. This "central banker's anguish" was nicely summarized by Ben Bernanke in a famous 2004 lecture (see full text here), when he was already a member of the Fed's board, stating that *"monetary policy cannot offset the recessionary or inflationary effects of increased oil prices at the same time".* It must choose, often with very little visibility, both on the duration of the exogenous shock and on the magnitude – or even existence – of second round effects on endogenous inflation.

Exhibit 1 – Looking at the bad old days



Still, Bernanke proposed a qualitative criterion to inform the central bank's choice: how close the economy was to full capacity before the shock. Indeed, if overheating was an issue before oil prices rose, then (i) risks of second round effects are higher and (ii) the economy can better afford the impact of the monetary tightening. This is easier said than done, because it's difficult in real time to get a precise sense of where the economy is standing relative to potential. Burns in his Belgrade lecture described the Fed's incapacity to spot that their estimate of where structural unemployment stood was too low, which got them to stimulate the economy too much. Still, for all its limits, the Fed is currently clearly following the Bernanke's doctrine. They were enough signs before the pandemic that the US economy was growing too fast and inflationary pressure had become self-sustained. It makes sense to hike during the current energy shock, and we expect the first 25 bps hike to be announced this week.

What we find striking in Bernanke's 6,000 words lecture, is that the term "fiscal" does not appear even once. This is a very "early noughties" characteristic. Fiscal policy was seen as very cumbersome and unable in practice to fine tune the cycle – contrary to monetary policy which, before the "Great Recession" of 2008-2009 was clearly seen as the senior partner in the policy-mix. There has been a complete shift in the hierarchy since then to the point that central banks have been mere auxiliaries of government spending in the fight against the pandemic. Equally in dealing with the fallout of the Ukraine war, fiscal policy is playing a key role – exemplified again this weekend by the announcement of a EUR 0.15/l rebate on petrol at the point of consumption by the French government. **We could then add to Bernanke's doctrine another element: the central bank's response to the exogenous shock should be driven by the level of over or under capacity in the economy and by the quantum of fiscal support.** If a lot of the GDP loss triggered by the exogenous shock is mitigated by government spending, then the central bank can focus on fighting inflation. We note that Volcker's inflation killing "super tightening" of 1980-1981 may not have been tenable without the expansionary fiscal policy which Reagan launched at the same time.

So, what would this "augmented Bernanke doctrine" tell the ECB to do right now? Well, it's not clear. The unemployment rate has fallen below the pre-pandemic level in the Euro area and surveys point to hiring difficulties, although wages have not started to accelerate which would be sure sign that overheating is with us. Fiscal policy is showing signs that it's going to help, but we are not (yet?) talking about the sort of "blanket support" provided during the pandemic. **Still, the ECB can argue that the starting point of its policy stance also matters.** Given its long-held belief that when it comes to Quantitative Easing, the stock (what's been bought so far) matters more than the flow (what is being bought every month), announcing (with a caveat) that the net purchases would stop at the end of Q2 2022 would mean that the central bank would merely stop adding stimulus – thus would refrain from fanning the flames on inflation – but this would not constitute a proper tightening in monetary policy. This would come only when the ECB starts hiking rate – which has been somewhat detached from the horizon of QE – and reduces the size of its balance sheet.

The nagging issue for the ECB is however that the quantum of fiscal support is not independent from the central bank's stance on the flows of quantitative easing. Indeed, without the support of a non-profit seeking, "long-only" buyer of its bonds, governments may choose to proceed carefully with their fiscal action. This is why, specifically for the Euro area plagued by the "fragmentation risk", we may need a "feedback-loop augmented Bernanke doctrine": to decide whether or not to accommodate an exogenous inflation shock, a central bank should consider the level of pre-existing tension in the economy, the level of fiscal support pledged by governments *and* the effect a monetary tightening would have on the continuation of such a fiscal support.

ECB: optionality, but with a hawkish bias

When assessing last week's ECB Governing Council, a difficulty lies in finding the right reference. Relative to what could have been the outcome based on the stern warnings of the February meeting, Christine Lagarde came up with a few dovish nuggets, reflecting the uncertainty brought about by the Ukraine war. But relative to the forward guidance set last December, the hawkish turn is still significant.

As widely expected, – and consistent with the December message – Pandemic Emergency Purchase Programme (PEPP)'s termination was confirmed. However, **the ECB has now decided to reduce its Asset Purchase Programme (APP) pace on a monthly basis *within Q2* to €20bn in June, which could be the last month of net purchases** (instead of €30bn per month for the entire Q3, and EUR20bn, in an open-ended fashion, from October onward). We were expecting the purchases to be terminated at the end of September. Relative to our call, this would remove c.€120bn worth of assets bought by the ECB.

However, in line with our expectation, and "softening the blow" from the early termination of APP, the ECB loosened the link between APP and rates indicating that rates would now be lifted "some time" after the end of net APP purchases (in the December forward guidance net purchases were intended to stop "shortly before" the rate lift-off). We suspect there will be intense debates on exactly how long "some time" is. During the press conference, President Lagarde mentioned this was to replace time dependency with data dependency. In clear, the message is not so much that the ECB would necessarily wait longer than under the previous forward guidance to hike, but that there won't be any automaticity and that the central bank will take a hard look at macro conditions before making up its mind on hiking rates. Note that the policy statement also indicated that pace of hikes will be *gradual*, although missed to specify whether that applies to the pace of tightening and/or to the magnitude of each hike.

This is not the only element of "optionality" – it seems Francois Villeroy de Galhau's recent speech at the London School of Economics (LSE) which we had commented in Macrocast has been widely read – which can be found in the ECB's communication last week. Indeed, the end of APP by the end of Q2 will occur *"if the incoming data support the expectation that the medium-term inflation outlook will not weaken even after the end of our net asset purchases*". Another trace of this flexibility can be found there*: "if the medium term inflation outlook changes and if financing conditions become inconsistent with further progress towards our two per cent target, we stand ready to revise our schedule for net asset purchases in terms of size and/or duration*." President Lagarde kept options open, repeating several times ECB GC "*data dependency" [...], "assessing step by step progress"* during the press conference.

What does this mean in practice**? The central bank implicitly wants to give itself an "exit door" from its planned tightening** if the fallout of the Ukraine war is so significant for the Euro area economy that the labour market would deteriorate to the point that wage dynamics would completely stop any second round effects from the rise in energy prices. In such configuration, once oil and gas prices normalize, the Euro area could be left with a sub-2% medium term inflation trajectory (again). We also suspect that an episode of acute fragmentation – read significant widening in peripheral spreads – would force the ECB to reconsider the end of APP, even if this programme, more rigid than PEPP, would not be as efficient to keep spreads in check. The optionality probably also reflects deep divisions within the Governing Council. Christine Lagarde was quite candid on this point, disclosing during the press conference that *"some wanted to move ahead with no conditionality, while others wanted to do nothing".*

The bar "not to proceed" with the new timeline for the termination of APP looks quite high to us though. Judging by its new forecasts, the ECB seems to be very far from a "panic mode". The outlook for GDP remains robust in their baseline, as growth was only revised down by 0.5p to 3.7% in 2022 while the 2023 figure was only marginally altered (-0.1p). During the press conference, Christine Lagarde reiterated that some headwinds were waning such as supply bottlenecks inherited from the pandemic and restrictions while strong labour market and well targeted fiscal measures should alleviate the impact of such crisis. The ECB however – mirroring the optionality on policy - also produced an "adverse" and a "severe" scenario for its forecasts. We are closer to these two alternative "storylines", since they take on board a stronger impact from the current conflict on sentiment, different kind of supply disruption and higher energy prices than the USD 93/bl for 2022 kept in the baseline. In the ECB's adverse scenario, GDP growth would decelerate further to 2.5% in 2022 and 2.7% in 2023 (and 2.3% for each in the severe scenario). What is striking is that in all three scenarios, inflation in 2023 would exceed 2% (see exhibit 2). The ECB is clearly not even contemplating a situation where, past the immediate energy price shock, core inflation would slow down markedly amid a mediocre performance of the economy.

Exhibit 2 – Inflation ahoy!

ECB's Growth and inflation projections for the euro area

(annual percentage changes)

	March 2022 projections				Adverse scenario				Severe scenario			
	2021	2022	2023	2024	2021	2022	2023	2024	2021	2022	2023	2024
Real GDP	5.4	3.7	2.8	1.6	5.4	2.5	2.7	2.1	5.4	2.3	2.3	1.9
HICP inflation	2.6	5.1	2.1	1.9	2.6	5.9	2.0	1.6	2.6	7.1	2.7	1.9

Notes: Real GDP figures refer to seasonally and working day-adjusted data. Historical data may differ from the latest Eurostat publications due to data releases after the cut-off date for the projections.

Source: ECB

While Christine Lagarde explicitly called on more fiscal action from governments, we note that she did not make any mention of a new facility that could be "replacing" PEPP should need be, but instead pointed to PEPP and APP reinvestments and reasserted that *the "Governing Council stands ready to adjust all of its instruments, as appropriate, to ensure that inflation stabilises at its 2% target over the medium term."* That is flimsy for those who were expecting a commitment by the ECB to stop a peripheral spread widening in its track.

So, ultimately, what do we expect? Barring a significantly bigger shock to growth than we expect, we think that conditions for a deposit rate lift off in December are likely to be met, leaving six months from the end of APP net purchases in June – which we think is consistent with the revised forward guidance loosening the link between APP end and the beginning of rate hikes. We then expect the deposit rate to reach zero in March 2023, then a pause until another hike in December 2023, as we think it's going to become more difficult to argue for a quick sequence of tightening once the deposit rate has been brought back to zero. Indeed, even some doves have always been uncomfortable with negative rates. They may be harder to convince once this anomaly is corrected.

The loneliness of the long-distance forecaster at the time of choosing a baseline

Our call for a late 2002 lift-off is underpinned by the fact that Q2 and Q3 may mark the peak of the economic impact of the conflict on the Euro area. Our latest simulation with higher energy prices leaves GDP growth at 2.1% in 2022 – below the ECB's severe scenario and 1.8 pp below our pre-war forecast – but the strong carry-over from last year's reopening arithmetically boosts the annual average. With oil at USD 125/bl and gas at EUR200/MWh, plus the impact of a collapse in Russian demand for European products and an adverse confidence shock, GDP growth could be transitorily in negative territory around Q2/Q3. Our baseline though is that by Q4 the economy could start improving again.

Uncertainty is of course massive, but the first 2 weeks of conflict suggest the Russian army can hardly take control of Ukraine and crush its army quickly. However, the two parties have little capacity to maintain high-intensity warfare beyond 2022. For lack of resources in the case of Ukraine (even with military supplies from North Atlantic Treaty Organization (NATO)), and because of the growing impact the collapse in the economy triggered by the sanctions will have on Russian military capability (the steep depreciation in the ruble and supply difficulties in Russia will engineer a massive acceleration in inflation, eroding purchasing power and consumption and impairing production outside the energy sector, resulting in a 2-digit recession).

High-intensity warfare could continue for several months, without resolving with a formal armistice but morphing by the end of the year into a "frozen", low intensity conflict between Ukraine and Russia wherever the "front" will have settled by then (similar to the situation which has been prevailing in the Donbass since 2014). Note that Moscow's inability to snatch a quick victory in Ukraine reduces the risk of a pivot to confronting other non-NATO neighbouring countries (e.g. Moldova) and even more to Eastern NATO members.

In this configuration, the absence of formal resolution would be consistent with **sanctions continuing to apply into next year. Crucially, we assume Russia would maintain its exports of gas to the EU.** Its central bank has lost access to the bulk of its hard currency reserves, making the gas-related revenue from Europe even more vital. Russia has been raising its energy exports to China since 2019, but there are technical limits and they must take a discount relative to world prices when diversifying their client base. On the demand side, we assume that the Europeans would not decide to stop importing Russian gas before being reasonably confident it could be done without significant disruptions forcing energy rationing. Still, we would expect regular rhetorical "flare-ups" on this issue, from both sides, in the months ahead. In this scenario, energy markets would start improving by the end of 2022 thanks to the decline in the risk of further escalation, but without a return to the status quo ante, given the lingering tail-risk of a severance of Russian gas shipments.

There are many possible bifurcations on this path. One avenue would be an escalation of the sanctions from the West either in reaction to more domestic public opinion pressure in the face of a humanitarian crisis in Ukraine or in case of repeated Russian military action too close to the border of NATO countries. Another would be a scenario of rapid deterioration of political stability in Russia in response to repeated military failures – for instance because of forcing more intense recourse to conscripts. Note that while this would likely loosen the pressure on Ukraine and significantly degrade Russia's capacity to threaten NATO, a new period of instability in Russia would create other geopolitical challenges in its own right (e.g. instability in central Asia or in Syria). Another possible scenario is that Beijing imposes a diplomatic solution onto Russia relatively quickly. We made the point that Beijing is clearly the senior partner in the relationship with Moscow. China could consider very quickly that after having secured more energy supply from Russia, it may be advantageous to force it to compromise in Ukraine to maximize the chances of political stability in Moscow – so as not to lose this precious new ally – as well as minimize the fallout for the world economy – at a time Chinese could do with more foreign traction – and avoid the Atlantic relationship to tighten further at the expense of Chinese geopolitical interests.

Beyond the wide uncertainty stemming from the geopolitical situation, we will pay close attention to two interconnected developments in Europe: the quantum of actual fiscal mitigation of the shock, and progress on debt mutualization. On the latter front, the European summit in Paris has not yielded any concrete results. We may hear more about this at the Eurogroup meeting this week though.

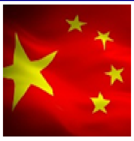
Adding to the mix Covid disruptions

The war in Ukraine has saturated the news. Yet**, it is probably wrong to consider that the pandemic is over**. In our list of risks for 2022, beyond a conflict in Ukraine a resurgence of the pandemic in China forcing strict sanitary measures which could add to the disruption in global supply ranked high. Unfortunately, this is a possibility which we need to consider again.

The number of new Covid cases in the 7 days to 12 March stood at 428 in China. It's of course a tiny fraction of what is routinely seen in the west, but it is still the highest level since the end of February 2020 and the number rose dramatically again this weekend. It seems the main source of those new infections is Hong Kong, which is facing a steep flare-up in the pandemic with 24,000 new cases per day in the 7 days to 12 march for a population of 7 million, with also a rise in mortality to very high levels at 37 casualties/million in the same period (to give an order of magnitude, in Germany the peak through all the waves stood at 21/million).

These last few weeks there seemed to be an hesitation in China on the response, with some signs that the country was moving away from its "zero Covid policy" which entailed severe clampdowns on entire cities to deal with even a handful of cases. Yet on **Sunday the decision to close all businesses except for those providing essential goods in Shenzhen (17.5 million inhabitants and home to Huawei) could signal a return to tougher action**, with potentially significant economic consequences.

Pressure from energy and food prices has been the main driver of inflation worldwide and the conflict in Ukraine is exacerbating this. The last thing the world economy needs right now is to see pressure of manufactured prices as well. China is the world's "manufacturing lung".

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Feb) rose to 7.9% (6.4% core) – a 40-yr high, meeting expectation. Inflation broadening • Congress passes $1.5bn bill to fund government • US bans import of Russian oil and seeks to remove Russia's preferred trade status • Tsy Sec Yellen said Ukraine invasion would exacerbate inflation, but did not expect recession • JOLTS survey (Jan) reaches fresh high of 11.3m, showing ongoing strong labour market	• Fed meeting. Expect +0.25% increase in FFR, news on balance sheet in coming meetings. Key focus on 'dot plot' to gauge SR outlook • PPI inflation (Feb) expected to post further gains as war tensions rose • Retail sales (Feb) expected stable after a bumper Jan, likely drop in volumes • Empire and Philadelphia Fed surveys (Mar) • Existing home sales (Feb) – expected to fall from Jan surprise rise as mortgage apps decline
	• ECB Mar GC delivered a more hawkish tone than we expected. We expect additional tightening as a result • German IP started the year on a strong note • Euro area Q4 GDP and employment were confirmed, growing at 0.3%qoq and 0.5%qoq respectively	• Fiscal response from governments/EU to support the economy (including next EU Council 24-25 March) • Eurogroup meeting (Mon.) • Details of final euro area Feb inflation (Thur.) • Euro area Jan IP (consensus: 0.2%mom, Tues.)
	• GDP (Jan) rose 0.8%mom vs 0.1% (cons), we now expect Q1 22 at 0.9% up from 0.4% • Signs retail growth slowed as BRC sales (Feb) increased 2.3% on a like-for-like basis • RICS house price balance shows rise in Feb • BoE survey points to rising infl expectations	• BoE MPC meeting (Thur) we and markets expect 0.25% rise on concerns around inflation expectations • LFS employment (Jan) and payrolls data (Feb), unemployment expected to dip to 4% (cons) • Fuel price rises as petrol tops 160p/litre
	• Japan tightened sanctions against Russia • Q4 GDP has been revised down to 1.1%qoq (-0.2p) with lower priv consumption and capex • Feb Economy Watchers poll still stucked at low level (37.7 (-0.2p) from Jan)	• Tankan indices (Mar) should be mixed with expected decline in Mfg while non-mfg sector should benefit from the end of restrictions • CPI (Feb) should reach 0.6%. Keep in mind mechanical surge in Apr CPI (likely around 2%)
	• NPC sets an ambitious growth target and lays out a clear policy roadmap, but scepticism over its ability to hit that target remains	• Jan-Feb activity data to show a soft start to the year for the economy
	• CB: Peru hiked +50 bps to 4.0% & Poland +75 bps to 3.50% • Feb CPI (yoy%) picked up in Chile (7.8%), Colombia (8.0%), Hungary (8.3%), Korea (3.7%) & Russia (9.2%). It eased in Mexico (7.1%) & Taiwan (2.4%) • In a tight race, conservative Yoon Suk-yeol will become South Korea's next president	• CB: Brazil is expected to hike +100 bps to 11.75%. Indonesia (3.0%), Russia (20%), Taiwan (1.125%) & Turkey (14.0%) to stay on hold • Feb CPI (yoy%) to accelerate in Romania. It should ease in India, Nigeria & Poland • Industrial production numbers for Malaysia & India

Upcoming events	US :	Tue: PPI (Feb), Empire state mfg survey (Mar), TIC long-term investment flows (Jan); Wed: Retail sales (Feb), Business inventories (Jan), NAHB housing market index (Mar), FOMC announcement; Thu: Philadelphia Fed indx (Mar), jobless claims (12 Mar), Housing starts (Feb), Building permits (Feb), Industrial production (Feb); Fri: Existing home sales (Feb)
	Euro Area:	Mon: Eurogroup meeting; Tue: EU19 Industrial production (Jan), Ge ZEW survey (Mar), Fr HICP (Feb); Wed: It HICP (Feb); Thu: EU19 CPI (Feb)
	UK:	Tue: ILO Labour Market data (Jan); Thu: MPC announcement
	Japan:	Mon: Trade balance (Feb); Wed: Industrial production (Jan), Private 'core' machinery orders (Jan); Thu: CPI (Feb); Fri: Bank of Japan announcement
	China:	Mon: Industrial production (Feb), Retail sales (Feb), Fixed asset investment (Feb)

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