QUESTION OF LEADERSHIP

There is a good chance that Jerome Powell, chairman of the Federal Reserve, decided to take the latest book by 89-year-old Henri Kissinger, which is totally focused on leadership[1] analysis, with him under his beach umbrella this summer. The doubts, insinuated by the media in recent months, about his determination to lead the world's most important central bank will have tainted him. And on the journey from the sea to the mountains, to the picturesque valley of Jackson Hole in the state of Wyoming, where the planet's[2] leading monetary and economic policymakers are invited each year, the former business lawyer's reflections were consolidated into the vision recounted by Kissinger, former Secretary of State under President Nixon and now, despite his age, perhaps the most listened-to expert on international relations.

For Kissinger, every society is perpetually in transit between a past that forms its memory and a vision of the future that inspires its evolution. On this journey, leadership is indispensable to help people reach, from where they are, places where they may not have even imagined going. Without strong women and men, institutions and nations are heading for disaster. The leader must be able to balance what he has learned from history with what he intuits about the future, which is inherently conjunctural and uncertain. The vital attributes of a leader are courage and character: courage to decide direction amidst the multiplicity of options, which requires a willingness to transcend routine; and strength of character to continue to stand by decisions made whose benefits and dangers can only be glimpsed. Leadership is essential during periods of transition, when values and institution lose weight and the lineaments of the future are controversial. In his strategy, the leader is obliged to move on a razor's edge, in narrow margins suspended between the relative certainties of the past and the ambiguities of the future. The strategist faces an

[1] Henry Kissinger, *Leadership, Six Studies in World Strategy*, Pinguin Press, New York, 2022, 416 p.

[2] This year the meeting took place from Thursday, August 25 to Saturday, August 27.

inherent paradox: in circumstances that call for action, the space for decision making is often most important when relevant information is scarce. As much data becomes available, the room for maneuver tends to shrink. In such a heavy context, there is a strong temptation to look at emerging phenomena as transient or manageable according to established standards. But by the time the threat can no longer be denied or minimized, the scope for action is narrow and the cost of addressing the problem has become exorbitant.

Kissinger's analysis is calibrated on great heads of state and government who helped shape the 19th and part of the 20th century: Konrad Adenauer, Charles de Gaulle, Richard Nixon, Anwar Sadat, Lee Kuan Yew and Margaret Thatcher. But the role of central bankers over the past three decades has gone far beyond that of the senior official. A well-delineated political framework in the post-Cold War era has limited politicians in acting at the planetary level, while central bank executives have found themselves capable of directing global financial flows, the sap of the commercially open world. This was an enormous responsibility, which they were able to assume within a very specific framework: globalization, delocalization and digitization were the deflationary assumptions of their models. Of course it took leadership to speak to markets. But the historical task of a central banker, fighting inflation and seeking monetary stability, was made easier. The macroeconomic problems to be solved were about how to stimulate demand to support consumption and employment. The eventual mistakes, as Jerome Powell later admitted, were to overestimate inflation risks and thus to maintain monetary policy tighter than necessary at the cost of unnecessary unemployment. To avoid that mistake, the Fed adopted a new strategy in 2020 that pledged to combat "the employment gap." In practice, this meant a more accommodative policy that took more risks with inflation in favor of higher employment. Imprisoned in this view, it is therefore not surprising that the Federal Reserve chairman took too long to realize that inflation is not "transitory," as he kept insistently saying until not long ago. This delay represents a blow to his leadership, which, in Jackon Hole, he has decided to make up for. "Restoring price stability," he said in his speech, "will take some time and the use of vigorous tools to better balance supply and demand. Reducing inflation is likely to require a sustained period of below-trend growth. In addition, there will likely be an easing in labor market conditions. While high interest rates, slowing growth, and softer labor market conditions will bring down inflation, they will bring hardship to households and business. These are the unfortunate costs of reducing inflation. But a failure to restore price stability means much greater pain." [3]

Not surprisingly, the market did not appreciate these remarks. The Nasdaq fell nearly 4%, as did the weekly balance of U.S. indices, which fell by the same amount. Fear also gripped the European and Asian stock markets. The message this time was very clear. The Federal Reserve will use all its tools to reduce inflation, because it is its definite responsibility. Of course, the rise in prices is a global phenomenon, and in the United States it is caused not only by the strength of demand but also by the reduction of supply. Although the Fed's macroeconomic tools work vis-à-vis demand and do not have much power in motivating supply, Powell is keen to emphasize that this cannot reduce the willingness to seek price stability. So "there is work to be done to moderate demand and bring it in line with supply." [4]

Restoring his leadership is therefore essential to the whole strategy. Although long-term inflation expectations seem well-anchored, Powell, referring to one of his important predecessors, Paul Volcker, knows that "inflation feeds on itself" and therefore one must undermine its expectations at the base. Still pointing to those who have occupied his post in the past, the current chairman also highlights the words of Alan Greenspan, for whom "price stability means that expected changes in the price level must be small enough and gradual enough so that they do not materially enter into the decisions of firms and households."

In support of his leadership and the difficult decisions he will have to make, Powell legitimizes himself in the historical groove of the institution he heads. His - now - firm position is also supported by other influential central bankers. Such as Isabel Schnabel, a member of the Executive

[3] *Speech by Jerome Powell at the Jackson Hole Symposium, August 26, 2022.*

[4] *Ibidem.*

Board of the European Central Bank (ECB), who reminded that "for the first time in forty years you have to show how determined you are to protect price stability." [5] For her, there is a tangible risk that the nature and persistence of the shocks affecting our economies will remain for a long time. And so the decisions that are made today against high inflation will determine the substance of the future, mitigating and limiting the negative impacts on prosperity and stability. Central banks must choose a very "robust" approach given the uncertainty about whether inflation will persist, the threat to central bank credibility, and the potential costs of acting late.

Clear guidance in monetary policies is therefore essential to overcome this difficult transition. The commitments declared at Jackson Hole oblige central bankers to bind themselves hand and foot to their words, or else there will be a total loss of credibility. So what is the near future for markets and risky assets? These will have to discount future earnings at higher rates and factor in a more ominous recessionary phase than expected so far. Stock markets may correct again to allow for recalculating multiples based on lower earnings growth and higher rates. Also, in the United States, the withdrawal of some of the immense amount of liquidity injected to counter the effects of the pandemic will take substance in the coming weeks (Quantative Tightening). The dollar, although it has traversed much of its bullish phase, will continue to be supported both as a haven and as an expression of a currency that is already ahead in monetary normalization. The euro may have a few moments of favor with the upcoming rate hike announcements - moving toward 1.02 against usd - but these will not be enough to encourage those still fearful of the historic future of a young currency and a region close to the important Ukrainian war hearth and with an energy policy to rebuild. The Swiss franc remains a safe haven currency (as do the three major stocks of the SMI). The Swiss National Bank (SNB) has already shown leadership, surprising markets with a 0.5% rise. It can now afford to be less severe by keeping an eye on the course of the euro, the dollar and rising

[5] Speech by Isabel Schnabel, “Monetary policy and the Great Volatility”, at the Jackson Hole Symposium, August 27, 2022.

prices, being able to at least partly calibrate how much inflation it will be willing to import. The S&P, the world's flagship index, after all the news priced in recent days, may well rebound in the early part of September. But structurally it will have to return toward 3,800 points. It will be the data, unemployment and inflation in the U.S. (the former needs to rise, perhaps toward 5%, and the latter needs to embark on a clear downward dynamic), that will determine whether the deterioration will be further substantial. In this context, China, which has lower inflation, and Japan (which continues with monetary easing) could be the pole of support for the entire world economy. But China continues with its lockdown policy and opens monetary easing with dropper drops to support its ailing economy. And without clear interventions from Xi Jimping's country, it will be difficult for Jerome Powell's leadership to be sufficient to enable a soft landing. China and the United States both have an interest in arriving in November with improving economies. Is this an assumption that could help motivate an easing of the war in Ukraine? If Powell and brethren can prove their leadership, the latter part of the year may well surprise us.

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