



Policy tectonic plates shifting

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Key points

- Massive demand for policy action is meeting a policy vacuum now that central banks move away from fiscal dominance
- In the Euro area, upside risks to inflation are materializing while Q1 GDP partly contradicts the positive message from the business surveys. The ECB is likely to focus more on the first point.

We expect the Federal Reserve (Fed) to hike by 50bps this week, and the European Central Bank (ECB)'s rhetoric is getting increasingly hawkish to the point that a July lift-off cannot be excluded. This is more than mere "normalization". The whole policy-mix is changing. We need to brace ourselves for "instant nostalgia" for the brief era of unlimited policy support – and fiscal dominance – which the pandemic had ushered in. The West is faced with a potential policy vacuum at a time when demand for action is massive: tolerance for income inequality has ebbed, demographic challenges push for a structural drift in public spending, and citizens want decisive intervention to fight climate change together with a minimization of the impact the energy transition will have on their income.

We see three ways to resolve the tension between unlimited demand for policy action and a depleted arsenal. First, governments could decide to "call the monetary policy bluff" and maintain an extremely accommodative fiscal stance, counting on central banks to recoil at the political and economic consequences of massive policy divergence and ultimately neglect price stability to accept fiscal dominance again. Turning the clock back on central bank independence would be an extreme form of this approach. We would ascribe a low probability to this, given the huge transition costs for fiscal authorities themselves. Second, we could see a "self-limitation" of economic policy which would give up on reacting to every twist and turn of the cycle – in short a return to the 1990s. Politics are much more hystericized though and it's unclear if our already polarized western democracies would cope well with allowing unmitigated patches of rising unemployment and declining real income. Third, governments could be tempted to harness the financial capacity of the corporate sector to achieve their goals. This could take an aggressive form – e.g. windfall taxes or regulatory pressure – or a cooperative one – e.g. incentivizing businesses to deal with global warming and the demographic challenges. A "combo" mixing these different approaches is likely to emerge, but in any case, redefining the scope of economic policy is likely to strain our democracies.

Moving away from this "high level" discussion, we look into more details in the current ECB debate in the light of the latest, contrasting dataflow: more inflation risks are materializing, while the print for Q1 GDP dampens the positivity of the message sent by the recent businesses surveys. Given the mood at the ECB, it is however likely that more weight is going to be put on the former than on the latter.

Limited policy space meets unlimited demand for policy action

Before we discuss the timing of the European Central Bank (ECB)'s lift-off in the light of the recent dataflow in the next section, we want to "pause and reflect" on what we think is a profound change in the policy-mix. The pandemic ushered in a brief era of unlimited policy support, at least in the developed nations. The tools used – e.g., open-ended, unconditional quantitative easing – were not new. They were honed during the response to the Great Financial Crisis (GFC) of 2008-2009, but what was new was their combination with a level of fiscal spending which itself was unprecedented in peace time. Truly exceptional conditions were necessary to their advent, and the very fact that the war in Ukraine is very unlikely to trigger another instalment in QE, despite a plausible case for ensuring the ongoing fiscal action is financially manageable, suggests that this could not be a permanent fixture. Yet, we should brace ourselves for "instant nostalgia" for the fiscal dominance combo, as we learn to live again with grey, complicated, unsatisfying, and heavily constrained policies. Demand for policy action, against all risks – the traditional, social ones but also increasingly environmental ones – has possibly never been higher in the West, colliding with a very depleted policy arsenal.

Fiscal policy has been revived by the pandemic crisis. In the intellectual realm, its rehabilitation had started in the years immediately following the GFC of 2008-2009, but as a counterfactual. The now famous recognition by the International Monetary Fund (IMF) – under the steering of its then Chief Economist Olivier Blanchard – that it was the collective and ill-timed conversion to fiscal austerity which had prolonged the pain of the Great GFC laid the ground for more active fiscal support in adverse times for the real economy, but this was not tested in real conditions before 2020. From the 1980s to the GFC, the dominant model viewed fiscal policy as a cumbersome "also ran" to deal with macroeconomic instability (even if it could focus on structural issues), while monetary policy reigned supreme. As soon as the credibility of the central banks was anchored, around a generalized belief in its capacity to deliver 2% inflation in the medium run, there could be no conflict between cyclical smoothing and price stability. In adverse cyclical conditions, inflation would fall below target and interest rates could be safely cut to trigger a rebound in the economy. Symmetrically, overheating (excess demand) would lift inflation above target, calling for rate hikes. And so on and so forth. Deviations from trend, for both inflation and growth could be kept to a minimum. To quote former British Prime Minister Gordon Brown, who in his role as Chancellor of the Exchequer probably embodied the best the neo-Keynesian consensus the "*era of boom and busts*" had come to an end.

What triggered the unexpected comeback of fiscal policy? Essentially, the decline in the equilibrium interest rate. Indeed, with the equilibrium rate getting closer and closer to zero, the capacity of monetary policy to provide the necessary amount of stimulus in adverse cyclical conditions fell dramatically, with quantitative easing acting as an imperfect substitute for rate cuts once rates are negative. Fiscal policy filled the vacuum, while quantitative easing (QE) dealt with one of the main drawbacks of fiscal activism: the tightening in financial conditions triggered by higher long-term interest rates.

Inflation is putting an end to this love story between active fiscal policy and unconventional monetary policy through two channels. First – and this applies largely to the United States – it's highly likely that fiscal support went too far in the recent phase, with Republicans under Trump and Democrats under Biden piling up stimulus packages exceeding the impact of the pandemic, sending the American economy in a state of overheating which ushered in demand-driven inflation. The Fed, after being an enabler of the spendthrift US administrations, is now forced to mop up excess demand. It's highly likely that the lesson will serve for future episodes of fiscal activism: next time, the Fed will apply the brakes earlier. Second – and this applies more to Europe – the emergence of supply-driven inflation shocks changes the equation for monetary policy, especially if this supply-side inflation becomes a structural fixture, for instance if the transition to carbon neutrality entails a constant drift in prices. We would encourage our readers to delve into the work of Arnaud Mares, Chief European economist at Citi, on this issue. Central banks are ill-equipped to deal with this, and their natural response might be to focus on medium-term inflation expectations rather than on how current cyclical conditions could impact inflation in the short-run. At least that seems to be the ECB's attitude today.

Now that quantitative easing can no longer work its magic and central banks retreat, the West is faced with a potential policy vacuum at a time when demand for action is massive. Collective tolerance for inequality has

significantly declined over the last 20 years, maybe as a natural pendulum shift after the rise in inequality which coincided with globalization (establishing causality is another story). That is quite trivial. But what is perhaps more intriguing is the fact that social pressure is mostly exerted on governments, from which decisive corrective action is requested, than on the corporate sector. At least for now – this may change if inflation truly turns persistent – focus is on public expenditure and tax fairness rather than on wage behaviour. In addition, beyond the push for income equality, demographic change is a structural factor behind a structural increase in public spending, at least in the countries where health is socialized, and pay-as-you-go pension systems are developed. Finally, the climate emergency is adding another dimension. Public opinion demand decisive action against global warming, while also requesting protection against any impact on their real income from the energy transition.

We see three potential outlets for this tension. In the first one, governments undertake to fully respond to the continued push for more fiscal activism in the hope central banks will relent and accept to be diverted from pursuing price stability to embrace “fiscal dominance” again. In an extreme version of this scenario, governments would attempt to turn the clocks back and formally put central banks under control. We would not ascribe a high probability to it because the “transition cost” and side-effects would be massive for the fiscal authorities themselves. Indeed, if the central bank starts with a fight, adjusting for the additional fiscal stimulus by tightening monetary policy, the very purpose of the fiscal response would be defeated. If conversely the central bank gives up quickly, investors will immediately add an inflation risk-premium to government bonds and it’s highly likely the stimulus would also be drowned in a market-led tightening in financial conditions. In practice, governments could not stop at eroding central bank independence. They would also have to “turn the clock back” on the entirety of the liberalization of financial markets of the last 40 years. There is no “half-way house”.

Accepting a higher degree of cyclical volatility would be the second possible outlet. In this configuration, governments and central banks would accept not to mitigate every “bad patch” in economic data, recognizing limits to both fiscal and monetary policy. Fiscal efforts would focus more on long-term issues – e.g., investing in the decarbonization of the productive system – rather than respond to every twist and turn of the cycle. This would get us back to the policy-mix of the 1990s, when central banks and governments showed restraint in the stimulus they offered in the face of cyclical shocks (e.g., during the first gulf war). There are obvious limits to this approach though. Politics are much more hysterical than in the 1990s and it’s unclear if our already polarized western democracies would cope well with allowing unmitigated patches of rising unemployment and declining real income.

Exhibit 1 – Margins are plentiful – but it’s mostly a mechanical rebound



Harnessing the private sector’s financial capacity would be the third outlet. We mentioned earlier the intriguing fact that so far most of the debate on purchasing power has focused on what governments could do. We sense a growing temptation in governments to “shift the burden” to the private sector by encouraging an acceleration in wages. We expect economic comments in the next few months to focus on margin behaviour. Indeed, a striking feature of the current macro configuration is that the rise in input prices is passed quite easily to final users, so that margins remain significant. This “pot of money” could prove irresistible to governments, and beyond “regulatory persuasion”, windfall taxes could soon become a common staple of the policy mix. This is one of the reasons which

make us suspicious of the current level of corporate profits and hence of the future resilience of the equity market, beyond the impact of higher interest rates.

This “third way” – deflecting demand for policy action to the private sector – is not without risk though. The currently favourable level of margins is mostly a “payback” for the contraction seen during the pandemic, as can be seen in Exhibit 1, comparing the GDP deflator – i.e., aggregate output prices in the overall economy – and unit labour costs in the Euro area. We have already discussed in Macrocast how accommodating the current spike in energy prices via wages rather than fiscal measures raises the risk of wage overshooting – and hence persistent inflation.

Harnessing the financial capacity of the financial sector could be done in a cooperative manner, e.g., by incentivizing businesses to do more to decarbonize or respond to the demographic challenges, rather than taxing rapidly evaporating profits. Combined with debt mutualization at the European level, this would make monetary support less crucial, while helping to deal faster with the adverse, long-term supply-side shocks which could plague our economies in the decades ahead. This would however still leave open the question of mitigating cyclical volatility.

Economic policy never follows a “pure model” and the developed nations are likely to follow a “combo” in which these different approaches will co-exist. Finding the right balance is unlikely to be straightforward though, and this will strain our already tense democracies.

Summer fever in the works

In a frank interview with Bloomberg last week, the ECB’s chief economist and board member Philip Lane made it plain that *“the story is not ‘are we going to move away from -0.5% for the deposit rate’ [but] the big issue, which we do have to still be data-dependent about, is the scale and the timing of interest rate normalization”*. We harboured little doubt as to the “direction of travel” of the ECB, but this statement, coming from one of the “identified doves” at the board confirms that the internal fight has decisively moved to the intensity of tightening, not on its principle. ECB Vice-President de Guindos in another interview also mentioned the need to be “data dependent” but chose not to dismiss the possibility of a rate hike in July already, conditional on the June forecasts. The dataflow ahead of the summer is thus going to be crucial. The releases last week painted a contrasted picture: upside risks to inflation are materializing, but GDP for Q1 came out below expectations in several countries. Our impression though is that the ECB’s current mood would be consistent with downplaying the adverse signals on the real economy to focus on the inflation trajectory.

Inflation continues to accelerate. Eurozone Preliminary Harmonized Index of Consumer Prices (HICP) for April came at 7.5%yoy, in line with consensus and up by 0.1 percentage point from the previous month. As expected, energy inflation declined after the rebate on oil prices at the pump in most countries, the retreat in wholesale oil prices and some easing on gas spot prices. Unfortunately, this was offset by an acceleration in food prices, which added 1.4 percentage points to reach 6.4%yoy, a new record pace. Still, the ECB – and the market – is likely to essentially focus on the fact that core inflation momentum continues to build up (3.5%yoy from 2.9% in March), mainly driven by an acceleration in services (3.3%yoy, +0.6ppt) while prices in non-energy industrial goods also continue to accelerate (3.8%yoy, +0.4 ppt). There are now convincing signs that the European inflation spike is widening and may not remain essentially exogenous, thus calling for a quick reaction from the central bank.

Of course, the ECB needs to balance this flow of bad news on the current inflation front with the state of the real economy. Philip Lane made the case in his interview that the deterioration in purchasing power triggered by the inflation shock could ultimately erect a barrier to persistent core inflation (by reducing the capacity of retailers to continue to pass the rise in upstream prices to final consumers). Yet, we discussed last week how the available surveys for the beginning of Q2 – in particular the Purchasing Managers Index (PMI) – suggested a strong resilience of the Euro area economy to the fallout of the war in Ukraine, possibly thanks to the tailwind of the economy’s reopening and the strength of the fiscal support schemes designed to mitigate the increase in energy prices. The doves may however find some succour in the disappointing GDP numbers in some key countries released last week, but they are fighting an uphill battle.

Euro area "flash" GDP growth slowed down to 0.2% quarter-on-quarter in Q1, down from 0.3% in Q4 2021. The prints came below expectations in France (stagnation, against a market consensus of 0.3%) and Spain (+0.3% against 0.6%). Although there is no subcomponent breakdown by Eurostat for the Euro area as whole, we gather from detailed releases in France and Spain that the Q1 slowdown mainly came from private consumption, while high level qualitative comments by German and Italian statistical agencies highlight a negative trade contribution. While the deterioration in real income and spending was well captured by household confidence surveys, there was little sign in the business surveys that this had transmitted to the services sector. It might be that businesses are ready to "look through" what they see as a transitory drop in demand, but for now we fail to see a fully convincing way to explain the discrepancy between soft and hard data. Given the inflation news flow, we would bet on the ECB to be quite dismissive of the lacklustre Q1 GDP print, possibly ascribing it to technical factors.

We maintain our baseline of subdued growth outlook, projecting flat sequential growth in Q2-Q3 before reaccelerating from Q4 22 onwards. Headwinds continue to blow against consumer spending and will ultimately affect business confidence. Concerns about the Chinese growth outlook adds to the uncertain and worrying picture, especially for Germany. All in all, while we acknowledge some upside risks against our Q2 forecast (-0.1%qoq) – if only as a mechanical offset for Q1 in some countries – we remain comfortable with our below consensus projecting euro area growth to average 2.1%/1.2% this year and next (consensus: 2.8%/2.4%).

Still, against this background, we think Euro area inflation is unlikely to recede quickly. We forecast headline inflation will remain above 6.5%yoy until the end of Q3. The contribution from energy should be gradually replaced by increased pressure from food prices. On core inflation, for the next few months, China-related supply bottlenecks are likely to disrupt goods production again, so prices are likely to go up. We continue to see no sign of significant acceleration in wages, but the resilience in job creation may cushion the decline in consumption, thus allowing some pass-through from input prices to final prices. In addition, the further weakness in the euro exchange rate may add to imported inflation.

What does this all mean for the ECB? In a cautious approach, the Governing Council should probably choose to take stock of the reaction of the markets and the fundamentals to the end of Quantitative Easing, which we expect to be announced in June, effective in July, before moving to hiking rates, especially given the dark clouds gathering from China. Our baseline call remains for a first depo hike in December, while we acknowledged that a September lift-off is a distinct possibility. Still, in view of the latest inflation figure and rhetoric from Governing Council members, we cannot rule out a first hike in July, although we think the real economy dataflow will have to be stronger than we expect in the next two months for this to materialize.

Country/Region	What we focused on last week	What we will focus on in next weeks
	<ul style="list-style-type: none"> US GDP -1.4% (saar), weaker than expected, volumes dropped sharply, but inventory softer, earlier. Reduces downside risk for coming qtrs. Dollar soared. Up 6% since Ukraine war, 16%yoy (DXY) – rising to highest levels since 2002. PCE inflation (Mar) rises by less than expected to 6.6%, core measures fall by more to 5.2% Personal spending (Mar) rose 1.1%, with Jan's rebound scaled back to 2.0% from 2.7%. Emp cost index (Q1) surges to 1.4% a record high 	<ul style="list-style-type: none"> Fed meeting. Expect 0.50% hike in FFR to May, suggestion of more to come. Announce QT, likely start in June. Fed Chair Powell press conf to focus on economic risks Labour market report (Apr), watch for more than modest slowdown in payrolls, also see downside risk to consensus unemp of 3.6%. ISM indices (Apr) likely still solid signal Vehicle sales (Apr) soft on supply or demand? Mort apps – have declined 18.5% in 3-months
	<ul style="list-style-type: none"> Euro area “flash” GDP slowed down 0.1pp to 0.2%qoq in Q1 22. Euro area “flash” April inflation inched up to 7.5%yoy in April driven up by core and food prices. 	<ul style="list-style-type: none"> Final PMIs, EC survey for April (Mon.). March retail sales, April car registrations. Germany, France March industrial production.
	<ul style="list-style-type: none"> UK public finances (Mar) PSNBx for FY21-22 at £151.8bn half the figures from FY20-21 Nationwide HPI (Apr) at 0.3%mom below expectations showing initial signs of slowing CBI survey (Apr) points to a slump in April retail sales as households faced higher bills 	<ul style="list-style-type: none"> MPC meeting and May MPR (Thurs). We expect a dovish hike (+25bps) to 1% with bank projections likely to show weaker GDP outlook UK Local elections and Northern Ireland Assembly elections (Thurs) BoE household lending data (Mar)
	<ul style="list-style-type: none"> CPI (Mar) up by 1.2%, Apr fig should cross 2%. The BoJ has been more dovish than initially expected, offering unlimited 10Y JGB purchase with fixed rate of 0.25% every business day. Prelim IP (Mar) was up (+0.3%mom), strong increase expected by companies in Apr: +5.8% 	<ul style="list-style-type: none"> Final PMIs and consumer confidence (Apr) Tokyo CPI (Apr), consensus on core inflation (exc. fresh food) expected at 1.8% from 0.8%, due largely to the end of neg contrib from mobile phone charges (CPI above 2%).
	<ul style="list-style-type: none"> COVID cases start to moderate, but remain high in absolute terms. Fears of COVID disruptions rout financial markets 	<ul style="list-style-type: none"> All eyes are still on the COVID situation, particularly if Beijing can avoid a Shanghai-style lockdown, and further easing of restrictions
	<ul style="list-style-type: none"> CB: Hungary hiked +100bps to 5.4%. Russia cut 300bps to 14% March CPI (%yoy) picked up in Poland (12.3%) & Singapore (5.4%). It remained stable in Malaysia at 2.2% Q1 GDP (%yoy) slowed in Korea (3.1%) & Taiwan (3.1%) 	<ul style="list-style-type: none"> CB: Brazil (11.75%) & Chile (7.0%) expected to hike +100bps. Poland +75bps to 5.25% April CPI in Colombia, Chile, Korea, Peru, Philippines, Taiwan, Thailand & Turkey PMI figures (April) across EM March IP data in Brazil & Hungary
Upcoming events	<p>US: Mon: Mfg PMI (Apr), ISM mfg indx (Apr); Tue: Durable goods & factory orders (Mar), JOLTS Job Openings (Mar); Wed: ADP employment change (Apr), Trade balance (Mar), Services PMI (Apr), ISM non-mfg indx (Apr), FOMC announcement; Thu: Weekly jobless claims (30 Apr), Non-farm productivity (Q1,p), ULC (Q1,p); Fri: Unemployment (Apr), Average earnings & weekly hours (Apr)</p> <p>Euro Area: Mon: EU19, Ge, Fr, & It mfg PMI (Apr); Tue: EU19 & Ge Unemployment (Apr), EU19 PPI (Mar); Wed: EU19 composite PMI (Apr), EU19, Ge, Fr, & It services PMI (Apr), EU19 retail sales (Mar), Ge trade balance (Mar); Thu: Ge new mfg orders (Mar), Fr ind prod (Mar); Ge & Sp ind prod (Mar)</p> <p>UK: Mon: Public holiday; Tue: Mfg PMI (Apr); Wed: Lending data (Mar), M4 (Mar); Thu: SMMT new car registrations (Apr), Composite & services PMI (Apr), MPC announcement, Local and NI Assembly elections; Fri: Halifax house price indx (Apr), Construction PMI (Apr)</p> <p>Japan: Tue: Public holiday; Wed: Public holiday; Thu: Public holiday</p> <p>China: Sat: Official mfg & non-mfg PMI (Apr), Caixin mfg PMI (Apr); Mon: Public holiday; Thu: Caixin services PMI (Apr)</p>	

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