New Shocks, Old Debates

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Key points

- Food inflation poses a specific challenge for policymakers.
- The European Commission proposes to fund some of the investment effort needed to restore energy security by auctioning unused CO2 emission permits. We are not convinced it's the right signal to send.
- The "recession" word is back in the open discussions of the Fed members. For now, hawks and doves can agree on a substantial tightening given the signs of overheating. This will change.

After a short reprieve wheat prices have started spiking again. Food inflation poses a specific challenge for policymakers: it is both socially regressive (it specifically affects those at the bottom of the income distribution) and highly visible (it's a high frequency consumption). Food inflation thus fosters massive social demand for government action. Symmetrically, given its high visibility for households, protracted increases in food prices can push inflation expectations up, making central banks less than keen on easing the funding of such a fiscal mitigation. This is a variation on a theme which we have been exploring for some weeks now: the disappearance of policy space. Some of the current discussions eerily echo the debates which were rife at the dawn of economic science.

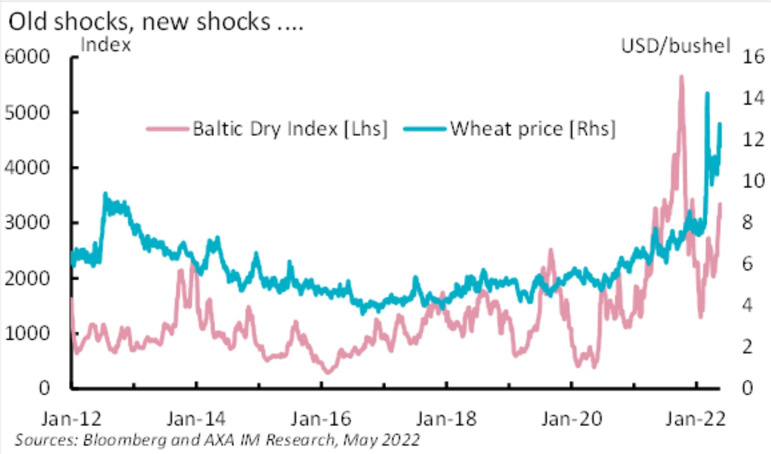
Yet, for now it's the pressure from energy prices which is the focus of governments' attention, and preparations continue to deal with the possibility of an embargo on Russian energy. Upon unveiling its "Repower EU" plan, the Commission has come up with an intriguing solution to fund the investment effort: sell some of the unused carbon emission allowance currently held in the Market Stability Reserve. We are not convinced. Corporates and financial institutions need a clear price signal to be able to accurately allocate capital towards decarbonization. Creating the impression that emission permits would be seen by public authorities more as a source of funding than as a way to create the right incentives for cleaner production could distort this price signal.

The coexistence of demand-led and supply-led inflation is a major difficulty for the Federal Reserve (Fed). The central bank ultimately must choose between two policy options: "run demand to the ground" – in clear trigger a significant recession - so that the part of inflation which is sensitive to cyclical conditions declines enough to offset the continuing positive contribution from the supply-side. Or allow some overshooting of headline inflation relative to its target once the demand-side component has been tamed. Unity at the Federal Open Market Committee (FOMC) may be temporary: as long as the signs of overheating are obvious, hawks and doves can easily agree on a substantial tightening. Disagreements are however likely to reappear when the positive output gap disappears.

New rises in food prices, (very) old economic debates

Addressing a parliamentary committee, the Bank of England (BoE)'s Governor Andrew Bailey deplored *"apocalyptical food price inflation*". That the United Kingdom (UK) would consider fuelling this particular fire by risking a trade war with the European Union (EU) over the Northern Irish Protocol would possibly merit a full Macrocast issue were it not for the intense Brexit fatigue afflicting your humble servant. Still, while Bailey's use of adjectives can be surprising for a central bank Governor whose unofficial role, after securing price stability, should be to instil confidence, the rise in food prices deserves attention at the global level. Indeed, **while wholesale energy prices have stabilized over the last few weeks, the cost of some key food staples such as wheat has started rising again after a brief reprieve**. This is another source of supply-side pressure, together with the return of disruption reflected in the recent rebound in shipping costs, with the Baltic Dry Index moving back above 3000 since 11 May (see Exhibit 1).

Exhibit 1 – Rebound in shipping costs and wheat prices



[The latest bi-annual report of the World Bank on commodity markets] released last April makes for sobering reading. Taken together, Ukraine and Russia stand for only 10% of total wheat production, but 25% of world wheat exports (10% for Ukraine alone). Many countries' wheat output is saturated by internal consumption, with only a handful of suppliers in capacity to ship significant surpluses to third countries. Of course, the war in Ukraine has triggered an increase in planned production in other locations with exporting capacity, but adverse weather conditions are impairing production in Europe, Canada, and the US. Wheat is not the only impacted foodstuff – Ukraine is also the largest supplier of sunflower oil in the world (46%) – but it is one of the least substitutable, at least in the short run (while edible oil users can easily shift from one source to another. Note that the disruption from Ukraine is not only an issue for the short-term supplies: if the war continues well into the second half of the year, winter wheat will be affected (it is planted in September and October).

In addition, **the rise in energy prices triggered by the war pushes agricultural prices up, both because farming is energy-intensive** (e.g., via fertilizers, which require large quantities of natural gas in Russia and coal in China) **and because the proportion of arable land used for bio-ethanol production rises**. True, some countries are now forcing caps on such conversion, but the US has authorized for this summer a rise in the proportion of ethanol in "flex fuel" from 10% to 15%. In any case, by construction, the lower the additional supply of bioethanol (equivalent to 1.9% of total oil output as of 2020), the more pressure there will be on oil production and hence on its price.

Concerns over sheer availability of wheat can then trigger policy decisions which, if generalized globally, would exacerbate price pressure. India is a case in point. The country has had five good crops in a row and was forecasting exports of 12 million tons of wheat in 2022/2023 (as a reference Ukraine was expected to ship 20 million tons this season before the war started). However, owing to the heatwave which has affected central India (hottest March in 122 years), production expectations were revised down by 6%. The combination of strong overseas demand with lower domestic production triggered a rise in wheat price in India above the fixed price the government uses to purchase wheat for distribution at subsidized costs via welfare programmes, pushing producers to sell on the free market. **The reaction from the Indian government came last week with the decision to ban wheat exports.** The choice was between (i) adjusting the procurement price of the Food Corporation of India (FCI), the state body in charge of the welfare programmes without raising the retail subsidized price, and thus raking more debt (its deficit was close to 0.7% of GDP last year), or (ii) take the risk of massive social pain and political stress by allowing the rise in wholesale prices. The announcement on 14 May was followed by another rise in wholesale wheat prices, exceeding 12 dollars per bushel on the US market for the first time since early March. **The political and social case for India's choice is of course easily understandable, but the generalization of such approach could ultimately contribute to maintaining high wholesale prices at the global level.**

Grain trade has been a key battleground for economists, between free-marketers and interventionists. Our Anglo-Saxon readers are familiar with the debate on the abolition of the corn laws in the 19th Century in which David Ricardo illustrated himself, possibly less so with the "flour wars" in the 1770s in France. Two schools of thoughts clashed bitterly at the time. The reformist physiocrats – who later inspired the moderate Republicans during the revolution - pushed for a liberalization of grain trade within the French borders to allow regions in surplus to export to hard-up areas, thus reducing price pressure, while traditional royalists - and the radical revolutionaries - favoured a heavily regulated framework and price control. We cannot resist quoting this excerpt from the "Letter on the grain trade" by Condorcet, supporter of the free-trade approach, published a few years before the French Revolution. "*When bread is expensive, people do not blame nature, do not say there is no wheat. People say that no one wants to sell any, claim monopolies are responsible for this state of affairs, implore government support. And if the government seems to listen for a moment, traders take fright, trading stops and violent action is brought in, even if they have no other effect than intensifying and prolonging scarcity*" (the original version is available in full here). As bread prices rose through 1792 and 1793, Robespierre's radical government reinstituted price control. Condorcet died in jail. You must admit economic debates have become safer these days….

Why do we make this historical digression? Simply because **food inflation is both socially regressive (it specifically affects those at the bottom of the income distribution) and highly visible (it's a high frequency consumption)**. Food inflation thus fosters massive social demand for government action. In developed countries, this is likely to transmit less via direct price controls than via targeted income support, but pressure on public finance is likely to continue. **This is one of the reasons we are very sceptical about the extent to which the current bout of inflation will erode public debt.** True, in principle, inflation is "good" for public finances as long as it does not trigger a rise in real interest rates, since government income is largely mechanically indexed on prices (e.g., VAT receipts rise when selling prices go up) while there is more leeway on government spending. Still, **given the nature of the current inflation spike, it is highly likely that significant chunks of government expenditure will have to be "indexed by hand" to reduce social and political pressure**. Symmetrically, given its high visibility for households, protracted increases in food prices can push inflation expectations up, making central banks less than keen on easing the funding of such a fiscal mitigation. This is a variation on a theme which we have been exploring for some weeks now: the disappearance of policy space.

Wrong incentives in the pipeline for carbon prices

Yet, for now it's the pressure from energy prices which is the focus of governments' attention, and preparations continue to deal with the possibility of an embargo on Russian energy. The "Repower EU" framework, integrating the decoupling from Russian sources into the overall green transition, has been made public by the European Commission last week (see a summary here). The cost of such turnaround is of course a key issue, and **Brussels offered as an additional source the proceeds of the sale of some of the carbon emission allowances which had been "stored" in the Market Stability Reserve (MSR) set up in 2019 over the last year to regulate the EU's Emissions Trading System (ETS).**

The ETS is based on a regularly dwindling quantum of permits to emit CO2. However, over time less permits were sold than what this diminishing target would have allowed. Instead of rolling these unused permits over indefinitely in auctions, the idea was that the MSR – which received the existing surplus allowances at the time of its creation - could be used to smooth volatility in carbon prices, following an automatic rule for the build-up or release of these allowances depending on the volume of surplus on the market. However, **until recently, carbon prices determined by the market had been significantly lower than the levels seen as consistent with proper decarbonization. It's only just before the war started in Ukraine, that the price of carbon finally came close to the 100 EUR/ton which is often seen as the right threshold** – possibly thanks to the EU's shift to more ambitious targets and announcement of a further acceleration in the reduction of the emission permits. The war triggered a sharp drop in March 2022, operators probably betting on a relaxation of the EU's climate policy to focus on energy security. There has been some recovery since then, but market prices remain below their pre-war level, and we cannot help but think that it is the expectation of the release of some of permits held in the MSR the allowance reserve which triggered the decline last week (from 91EUR/t on 17 May to 80 EUR/t on 20 May). The Financial Times had been writing about this in the days before the "Repower" strategy was released.

Exhibit 2 – Moving back from the right threshold

In a joint Op Ed with Bertrand Badré in Project Syndicate a few weeks ago we made the point that while the imperative of taking on board energy security concerns could justify some short-term drift in carbon emissions – e.g., because Liquefied Natural Gas emits more GreenHouse Gas (GHG) per calorie than ordinary natural gas – any strategy to wean the EU off Russian energy had to preserve the long-term imperative to get to "net zero in 2050". In clear, the short-term drift would have to be offset by less emissions than initially expected in the medium term. **Releasing unused emission permits would send the wrong signal, because lower carbon price today affects carbon emissions tomorrow**. Corporates and financial institutions need a clear price signal to be able to accurately allocate capital towards decarbonization. An instrument to reduce its volatility – more signal, less noise – as the MSR will help, and it may become at times necessary to stop carbon pricing to overshoot the equilibrium level consistent with net zero by 2050. A too high price of carbon could end up being so immediately crippling for energy companies that their financial capacity to invest in the transition could be curtailed. **But creating the impression that emission permits would be seen by public authorities more as a source of funding than as a way to create the right incentives for cleaner production could distort this price signal.**

True, the MSR solution may well have garnered support for lack of easy alternatives. **In a recent interview, Germany's Finance Minister Christian Lindner made it plain that he was opposed to any extension of debt mutualization schemes.** The Next Generation package would thus be a "one off" if he has his way. While he acknowledged the EU decision to prolong into 2023 the suspension of the fiscal surveillance rules, he still urged countries to do more to rein in their debt. His more combative stance may be influenced by the elections results last week in North Rhineland Westphalia. Commentators focused on the very weak performance of the Social-Democrats – to the benefit of the Greens – but Christian Lindner's Liberal Democrats halved their votes and feel close to the representation threshold in the Landtag. This may incentivize the party to distance itself more from its centre-left coalition partners and focus again on its traditional fiscally hawkish preferences.

The "R" word is out, and it's not rhetorical

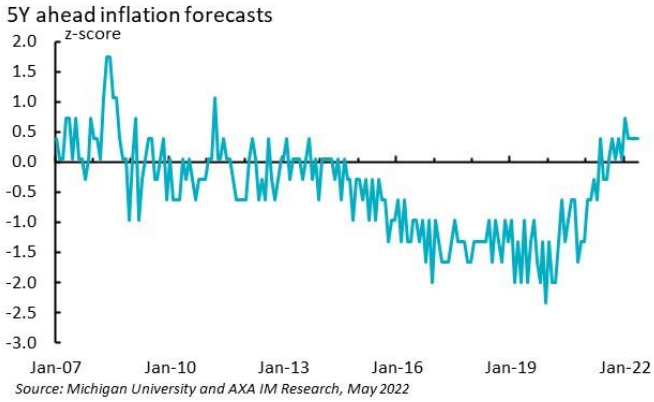
While the supply-side pressure continues to mount, the Fed's confidence in its capacity to engineer a "painless tightening" is rapidly eroding. After downgrading the expected soft landing into a "*soft-ish*" landing, Jay Powell was candid enough to concede that the unemployment rate may have to *"move up by a few ticks*" but Neel Kashkari was more blunt – and in our view more realistic – when he put forward the key question *"if we really have to bring demand down to get inflation in check, is that going to put the economy into recession? And we don't know*". He is not a voting FOMC member this year, but his readiness to utter the "r" word is probably telling of the general attitude at the Fed. At this stage, it seems quite a lot of members are ready to take that risk, and the generalization of statements supporting the possibility to bring the policy rate above the neutral rate – endorsed by Powell himself last Tuesday – suggest that **the need to re-take control of inflation trumps any other consideration.** We expect this week's release on the FOMC minutes to confirm this.

Still, there is always a difference though between entertaining the notion a recession may happen and live through an actual one. US inflation's hybrid nature is a problem for the Fed. While the demand-side component can be affected by a policy tightening, there is nothing the central bank can do about the supply-side component, at least in a first-round (this has been quite eloquently put by BoE Governor Bailey when he conceded that *"there is not much we can do*" about food prices. **The Fed ultimately must choose between two policy options: "run demand to the ground"** so that the part of inflation which is sensitive to cyclical conditions declines enough to *offset* the continuing positive contribution from the supply-side. **Or allow some overshooting of headline inflation** relative to its target once the demand-side component has been tamed. While in practice distinguishing between the two components in real time can be tricky, in principle the choice between the two options should be driven by inflation expectations. If they are de-anchoring, tough action is needed. Overshooting should however be allowed if expectations remain unaffected.

Determining what the right indicator for inflation expectations becomes crucial. In the US case, the message from the usual sources is not very clear though. The flagship market indicator on these matters - the "5-year inflation in 5 years" swaps - has been moving up quite steadily from its trough on the onset of the pandemic, but these last few days it was hovering only marginally above 2.5% (2.55% last Friday), which is consistent with the Fed's inflation target when considering the usual differential between the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE). Actually, it's more for the European Central Bank (ECB) that the message from the market-based indicators is concerning, with 5 year forward swaps above 2%, even if some downward correction has been seen in the last few days as well (see Exhibit 3). US households' 5 year ahead inflation forecasts have also been rising, but they currently stand less than half a standard deviation above their 1992/2022 average.

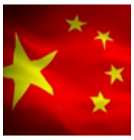
Exhibit 3 – More an issue for the ECB than for the Fed

Exhibit 4 – Households' expected inflation still under control



Central banks also need to consider the demand/supply feedback loops. Indeed, a supply-side shock (e.g., higher oil prices), if sustained, reduces real income and thus affect in time demand conditions to the point unemployment rises and wages slow down. This is what happened in 1991 with the fallout of the first Gulf war. Symmetrically, a tightening in monetary policy which dampens US demand could down the road exert an adverse effect on oil prices. The exchange rate provides another transmission channel. In general, non-US oil producers sell in dollars but buy in other currencies (they source their imports from elsewhere than the US for the most part). A hawkish Fed, by pushing the dollar higher, supports the purchasing power of oil producers and can make them more amenable to limiting the price of oil.

Yet, for now the voices calling for prudence at the Fed are very faint, even non-existent. This may merely reflect a sequencing issue though. Hawks and doves agree that there is in any case a "demand-side inflation" which needs to be tamed, and this calls for a tighter monetary policy. We expect debates to re-appear on the interpretation of the signs which would indicate that this is being achieved. What quantum of unemployment spike would qualify for instance? But we are not there yet. For now, the Fed is united, and the "hawkish festival" lives on.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Retail sales (Apr) posted solid 0.9% rise, but Mar revised materially higher to 1.4% from 0.5% • Industrial output (Apr) rose 1.1% • Empire and Philly Fed surveys (May) fell sharply to -11.6 and 2.6, both lower than expected • Existing home sales, housing starts and building permits (Apr) all <-2% than Mar first estimates • Jobless claims rose to 218k – highest since Jan • Fed Chair Powell wants “clear & convincing” evidence of price deceleration before slowing	• FOMC minutes (4 May) gauging commitment to 50bps hikes and looking for any doubters • New home sales (Apr) expected to follow rest of housing data lower • GDP (Q1) first revisions • Personal spending and focus on any rebalance of goods vs services expenditure • PCE deflator (Apr) headline and core expected lower • Jobless claims
	• Eurozone Q1 GDP was revised 0.1pp higher to 0.3%qoq. Employment grew 0.5% in Q1 22 • Final HICP was revised slightly down to 7.4%yoy	• May business surveys (IFO, INSEE, PMIs) • Detailed German Q1 GDP release
	• CPI inflation (Apr) rose to 9% - a 40yr high. Utility price rises driving most of the rise • LFS (Mar) showed further tightening in labour market, unemployment fell to 3.8%-a 50yr low • Retail sales (Apr) rose unexpectedly 1.4%mom • Gfk Cons confidence falls to record low (-40)	• UK public finances (Apr) expected to show continued improvement in PSNB • Flash PMIs (May) weakening orders likely to show subdued output 56.5 (cons) down from 58.2. But pass through may be delayed • Nationwide House Price Index (May)
	• PPI (Apr) rose above expectations to 10%yoy and CPI rose to 2.5% • Q1 GDP(p) fell less than expected -0.2%qoq • Tankan indices (May) point to slowdown in recovery due to concerns about rising costs	• Tokyo CPI ex-fresh food (May) expected to rise to 2% from 1.9% in April • Flash PMIs (May) likely to reflect slowdown in Tankan indices • Nationwide dept sales (Apr)
	• April data shows the economy was paralyzed by the COVID-induced lockdowns, with IP and retail sales falling, investment softening and the unemployment rate rising sharply	• COVID case numbers should continue to fall, allowing Shanghai to gradually reopen and economic activity to continue to normalise
	• CB: South Africa hiked +50bp to 4.75% & Philippines lift off +25bp to 2.25% • Q1 GDP strong in CEE and Colombia. A contraction reported in Chile, slowdown for yoy GDP growth in Russia suggests small fall • April CPI (%yoy) rose in Israel (4.0%) & Nigeria (16.8%). It remained unchanged in S. Africa	• CB: Korea expected to hike +25bp to 1.75%. Turkey (14.0%) to stay on hold, risk for Indonesia (3.50%) lift off • Q1 GDP (%yoy) should pick up in Peru and remain stable in Taiwan • April CPI (%yoy) to accelerate in Malaysia & Singapore

Upcoming events		
	US :	Tue: Mfg & services PMI (May,p), New home sales (Apr); Wed: Durable goods orders (Apr,p), FOMC meeting minutes (4 May); Thu: GDP (Q1), Core PCE (Q1), Weekly jobless claims (21 May), Pending home sales (Apr); Fri: PCE (Apr), Personal income & spending (Apr), Goods trade balance (Apr), Wholesale inventories (Apr,p), Michigan consumer sentiment (May)
	Euro Area:	Mon: EU19 Eurogroup meeting, Ge IfO business climate indx (May); Tue: EU19 Composite, mfg, & services PMI (May,p), Ge and Fr mfg & services PMI (May,p), Fr Insee mfg confidence (May); Wed: Ge GDP (Q1), Fr Insee consumer confidence (May); Thu: It ISTAT business & consumer confidence (May); Fri: EU19 M3 (Apr)
	UK:	Tue: PSNB (Apr), Composite, mfg, & services PMI (May,p), CBI distributive trades survey (May); Expected during the week: Nationwide house price indx
	Japan:	Tue: Mfg PMI (May,p); Wed: Leading indx (Mar);
	China:	Fri: Industrial profits (Apr)

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