Volcker- Skelter

137 – 30 May 2022

Key points

- The ongoing debates at the Federal Reserve (Fed) get us to explore the "Volcker tightening" of 1980.
- Messages from the European Central Bank (ECB) continue to get more hawkish.
- The United Kingdom (UK) to spend more on mitigating the income shock from energy prices. This will push the Bank of England (BoE) to hike more.
- Going after the "big corporate beasts" will not necessarily work against inflation.

The Fed is now talking about the possibility to bring its policy stance in restrictive territory – and not just neutral – to tackle inflation. This is not a unanimous approach, as evidenced by Raphael Bostic's call for a pause in September but these discussions about a painful tightening in monetary policy against a background of stubbornly high energy prices bring us back to Paul Volcker's 1980 "inflation killing journey". One of the features of US inflation in the early 1980s is that its correction was essentially driven by its core components, with limited help from lower energy prices. The early 1980s show "it can be done", but the macro price to pay was huge (it took a doubling of the unemployment rate). Of course, we are not in 1980 and it may be possible to put the inflation genie back into its bottle at a much lower cost to the real economy: inflation expectations are better anchored today than at the end of the 1970s, and the labour market is now much less rigid. Yet, we suspect that "killing inflation" will take more than a "few ticks on the unemployment rate", to quote Powell.

While the debate seems to open at the Fed, at the ECB the "hawkish drift" continues, with the possibility to start the lift-off in July with a 50 basis points hike now on the table. We continue to expect 25 basis points in July (with another one to zero in September). We note that some "de-pricing" of the Fed hikes has lifted the euro a bit, and the exchange rate seems to be a key variable for the Governing Council at this stage.

The UK announced a significant upgrade in its support package for consumers partly funded by an exceptional levy on the profits of energy companies. This fits well with our expectation that governments, irrespective of their political leaning, are still responding to "infinite social demand" despite the deterioration in their policy space. We think the Bank of England will consider that with higher fiscal support, it can afford to tighten further and help anchor inflation expectations without being too nervous about the state of the economy.

Finally, we look into Larry Summers' critic of the current focus on anti-trust policies as a tool against inflation. We think he has a point. Yes, large companies can capture rents, maintain inordinate profits, and impair the adjustment of relative prices, but they can also benefit aggregate productivity. We note that the 1980s disinflation coincided with a rise in firms' profit margins.

No "smoking gun"

You can't fault Jay Powell for his sense of timing. He acknowledged that some pain could be felt for the ongoing Fed tightening just before the United States (US) dataflow started weakening. Nothing too steep at this stage, but the combination of lower-than-expected Purchasing Manager's Index (PMI) business confidence surveys, home sales and durable goods orders in a matter of days suggest that the US overheating phase might be closing. There is still long way though between these "cracks" appearing and the Fed changing course.

Still, market pricing duly reacted – US 10-year yields gave back 20 basis points in a week – as the auto-pilot trajectory towards "neutral rate" is now put under scrutiny. Raphael Bostic also has a good sense of timing. While Neel Kashkari two weeks ago was the first at the Federal Open Market Committee (FOMC) to openly contemplate recession risks in the US, **Bostic was the first to call for a pause in September before hiking again**. Yet, against these first warnings, the minutes of the last FOMC meeting still conveyed a sense of "stern hawkishness", with the notion that the Fed may have to exceed its neutral rate and turn truly restrictive. Down the road, the central bank is driven by inflation developments, and there was no real news in the release last week of the consumption deflator data – the Fed's favourite measure of inflation – for April. True, a mere absence of acceleration probably counts as a source of relief these days, but the slowdown in the core Personal Consumption Expenditures price index (PCE) (to 4.9%yoy from 5.2% in March) simply confirmed what we knew since the Consumer Price Index (CPI) had come out two weeks ago.

An issue which will weigh on the Fed's internal conversations is the resilience in consumption. While the second estimate of GDP for Q1 2022 painted an even less rosy picture than the preliminary reading (it was revised from -1.4% annualized to -1.5%), consumption was revised up (from +2.7% to +3.1%), and personal spending in real terms started Q2 on the front foot with a 0.9% gain month-on-month in April.

This suggests that, for now, the self-stabilization forces of inflation are not showing up, as US households accept to plough into the excess savings, they accumulated during the pandemic to continue spending despite the bite from diminishing real wages. This comes out clearly in Exhibit 1: real income is falling in year-on-year terms, as the impact of the fiscal push disappears and inflation erodes purchasing power, but the savings' rate has now fallen below the pre-pandemic level. Within consumption, the rebalancing from goods to services continues – and spending on goods has been flat on the whole for the last year or so – but it might be too late to reap of the disinflationary effect of this turnaround. Indeed, as long as the bulk of the inflation spike was attributable to the disruption in supply lines, reducing demand for goods would help contain prices. Demand for services is rising at a moment when nominal wages are accelerating, which is likely to further fuel price pressure in this sector. There is still no "smoking gun" in the dataflow which would for sure stay the Fed's hand. Things need to go significantly worse – and we think they will – for underlying price pressure to abate.

Exhibit 1 – US savings rate now below pre-pandemic level

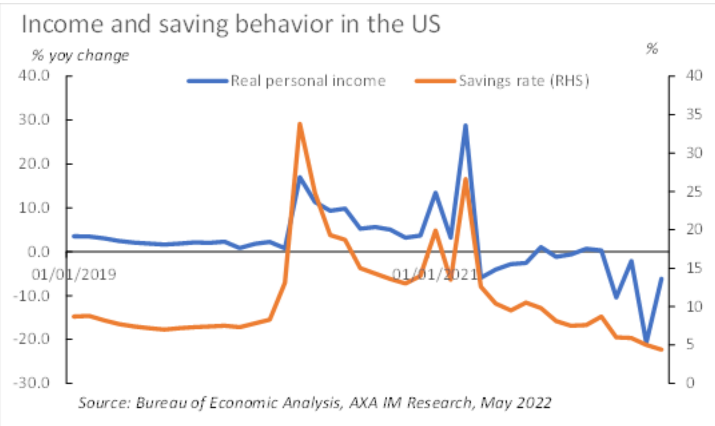
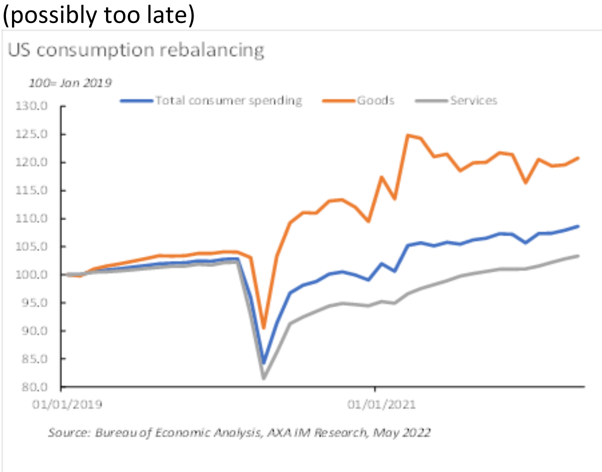


Exhibit 2 – The goods/services rebalancing is happening (possibly too late)



"Doing a Volcker"?

Talking about the possibility to bring policy rates in truly restrictive territory against a background of high energy prices brings us to the historical reference everyone – including your humble servant – has in mind for the current policy configuration: the decision by Paul Volcker to "kill inflation at the cost of a recession" in 1980.

One point to remember about the 1980 turnaround is that **the contribution from the "supply component" of inflation to the ultimate success of Volcker's policy was very small**. Exhibit 3 illustrates the fact that the decline in headline and core inflation was highly correlated. Oil prices stopped rising, but their correction was very gradual – despite the contraction in demand which the Volker hikes triggered – bringing only a small negative contribution to headline inflation in the US from 1981 onward. In 3 years, core inflation was divided by 3 in the US, driven by a significant deterioration of the labour market. The unemployment rate shot up from 5.6% at trough in May 1979 to exceed 10% from September 1982 to July 1983. Killing demand-led inflation is what did the trick, and it took a lot of resolve. The "helter-skelter" analogy probably works it goes down, fast, and it's very scary on the way down.

Exhibit 3 – Oil did not help Volcker much

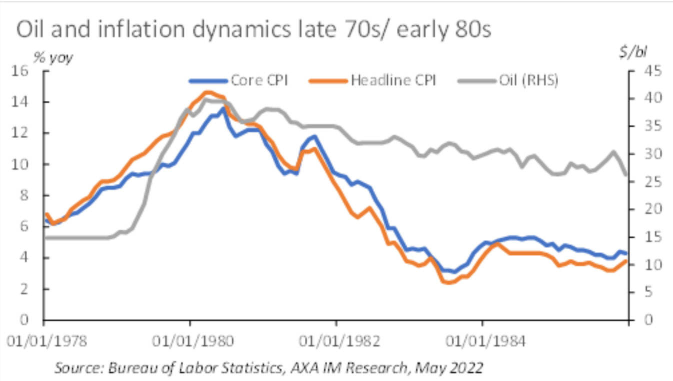
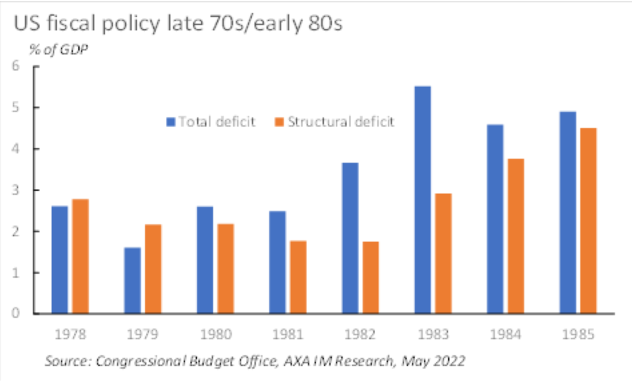


Exhibit 4 – Fiscal policy "picked up the pieces" 3 years later



The sequencing of the policy-mix also calls for attention. At the beginning of the Volker tightening, fiscal policy did not provide much support to the economy beyond the usual operation of automatic stabilizers. It's only in 1983 that fiscal policy became actively supportive, with the structural deficit rising (see Exhibit 4). With the benefit of hindsight, it may well have been the right thing to do from a domestic point of view, for all the criticism the Reagan administration got at the time. The "all out "restrictive stance of the policy mix in 1980-1982 effectively killed inflation. By 1983, the Fed could not easily lower its guard, since the reduction in inflation expectations was too fresh to be considered as fully anchored (the Michigan survey had US consumers expecting inflation to still stand at 5% on a five-year horizon at the end of 1983). That fiscal policy "did the mitigation" of the impact of the monetary tightening on the real economy after 2 years of "staying put" was probably a rational division of labour. Seen from the rest of the world, this was not a favourable configuration: the combination of highly positive real interest rates with an expansionary fiscal policy triggered a massive current account imbalance, but that's another story.

A question for the US policy mix today though is whether the same sequencing could be secured. For now, Biden has seemingly given up on the additional fiscal support measures he had in mind for 2022 while the perspective of the Democrats' losing their slim majority in Congress next November would make it very difficult to enact a support package for 2023. So, it's likely that fiscal policy will remain at best neutral while the Fed is doing its utmost to deal with inflation, just like 40 years ago. Yet, the space to "mend the economy" in two or three years from now with a fiscal package if indeed a protracted recession is what it will take to kill inflation is probably much tighter than in the early 1980s, if only because of the massive change in the level of public debt in between.

There are of course massive limits to reading the current macro situation through 1980 lenses. A major difference is that when Volcker embarked on his journey, inflation had been rife for more than 10 years. It took an inordinate quantum of tightening to bring price expectations down. Arguably, with the current spike being very new, and little sign that long-term consumers' inflation forecasts are off the grid (the 5-year ahead inflation expectations measured through the Michigan survey are currently less than half a standard deviation above their long-term level), it may be possible to put the inflation genie back into its bottle at a relatively low cost to the real economy. The steepness of the "Philips's curve" is also a source of uncertainty. With the rigid labour market of the 1970s and strong level of unionization at the time, it took a massive rise in unemployment to finally dampen wages. It may be easier this time. Yet, we suspect it may well take more than the "*few ticks*" on the unemployment rate which Powell mentioned. We think this uncertainty should be taken into consideration by the Fed, and habitual followers of Macrocast won't be surprised to read that your humble servant thinks Bostic has a point in arguing for a pause in September.

It's getting hard to follow

While the debate seems to have opened a bit at the Fed, the ECB continues with its constant toughening up of its rhetoric which at times is getting confusing. The Governing Council – thanks to a lengthy "blogpost" by Christine Lagarde - had seemingly converged to a pre-set course for at least July and September, with 25 basis points hikes each, with a somewhat fuzzier but in fact unusually explicit path towards a neutral rate after that – the speed of normalization being still subject to data dependence. Yet, markets had started looking into tougher options, such as starting with a 50 basis points hike in July. Christine Lagarde did not explicitly reject this possibility in her interview with Bloomberg in Davos last week, and the Austrian Governor Holzmann stated that his was his preference. Klas Knot also seems to be open to this suggestion. Francois Villeroy de Galhau stated that this option was not the Governing Council "consensus", but the genie is out of the bottle.

The next meeting on 9 June could be an occasion for clarification, but we doubt the ECB will want to tie its hands. This will make the global and European dataflow for June crucial. On balance, we don't think the ECB will do more than 25 basis points in July and will wait until September to bring the deposit rate to zero. A key input for us is precisely the new doubts arising on the Fed's trajectory. The depreciation in the euro seemed to be a growing issue for the Governing Council. With some "de-pricing" of the total quantum of Fed hikes in the pipeline, the euro should regain some strength.

More news from the "UK Lab"

We expect hard-pressed governments, dealing with less generous central banks, to go for the corporate sector for financial resources to mitigate the impact of the ongoing inflation spike for households, in particular those at the bottom of the income ladder. We were thus not surprised last week that the **UK's Chancellor of the Exchequer, despite rumblings within the Tory party, announced a significant upgrade in its support package for consumers partly funded by an exceptional levy on the profits of energy companies**. According to the computations of the Institute for Fiscal Studies, the programmes taken together – direct checks to households, skewed towards the poorest, cut in the local tax etc.... - will allow workers at the median wage to see his or her real income stabilize between 2021 and 2022. In other words, for this "belly" of the British population, the government has just completely offset the acceleration in consumer prices. **This fits well with our general expectation that governments, irrespective of their political leaning, are still responding to "infinite social demand" despite the deterioration in their policy space.**

Interestingly, only GBP 5bn out of the additional 15bn announced are expected to be covered by the exceptional levy. Since the Chancellor has not explained what resources would be channelled to meet the remaining 10bn, we must assume that it will come from additional borrowing. There is a lively discussion in the UK as to whether this new fiscal stance will fuel inflation and hence push the Bank of England into more action. **We think the central bank will indeed react,** not necessarily because observed inflation would end up being even higher than expected, but possibly more crucially because the Bank will consider that with fiscal support, it can afford to tighten further and help anchor inflation expectations without being too nervous about the state of the economy.

We had previously expected the BoE to hike in June and August leaving rates at 1.5%. We now expect the BoE to hike again in September, and pencil in an additional hike in November bringing rates to 2.00% - now in line with market expectations for November. However, where the market now prices the BoE to continue lifting rates to 2.5% in H1 2023, we think that the Bank of England will pause at this level. Moreover, with growth below trend and an expectation of inflation falling fast over the course of 2023, we believe that risks will grow across 2023 for rate cuts rather than any further hikes, although for now our forecast is for policy to remain unchanged at 2.00%.

We now have bigger fiscal deficits colliding with higher policy rates. This is the recipe for some damage on the long end of the curve. In general, we are confident that long-term yields will end 2022 lower than today, as investors focus more on the challenged growth environment than on inflation, but **one risk to our call is precisely if governments do not take into consideration the change in**

monetary stance and continue to pile up new liabilities. For now, we think the risk-taking is acceptable in the UK case. The measures are supposed to be "one offs" so should disappear once energy prices correct – even though this sort of fiscal gifts have a habit of surviving much longer than the shock which originally triggered their implementation – and there was some room for manoeuvre. Indeed, in March the Chancellor's forecasts left some space for additional borrowing with a GBP 31.6bn margin between the forecast current budget and meeting his target of balancing books by the third year. Yet, we are "exploring the margins" here, and if the decisions in the UK were taken as an encouragement to go further into fiscal stimulus in 2022-2023 in other countries, we would be worried.

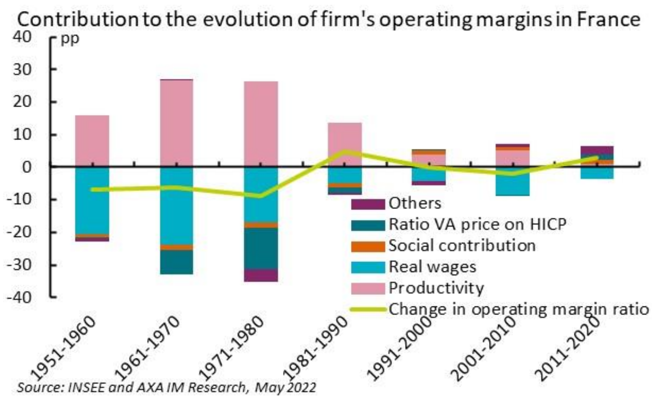
Could "running after the big beasts" backfire?

Larry Summers hath spoken again and his words matter. He is always a very interesting and eloquent analyst and policymaker, but his credibility has been further enhanced as of late with his correct forecast that the US fiscal push would trigger inflation and force the Fed into a policy turnaround. Last week he went after another tenet of Joe Biden's macroeconomic agenda: the notion that anti-trust policies had to play a role in the fight against inflation, on the premise that large corporations are currently exploiting rents and impair the normal adjustment of relative prices. His point – expressed in a short twitter thread - is that you should be careful what you wish for, as their contribution to aggregate productivity gains can be significant. Indeed, large companies are needed to generate economies of scale, which ultimately support a decline in prices. Moreover, what can be seen as undue exploitation of rents may merely reflect the fact that innovative firms often reap a "temporary monopoly" on new products and services. He adds a geopolitical concern to his list: *"Breaking large companies up increases domestic competition but decreases global competitiveness. Large state controlled Chinese companies have a very low cost of capital. Small American companies can't finance with the same relative competitiveness"*.

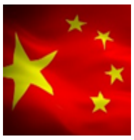
In 2020, a very thorough paper – confirming the findings of Thomas Philippon – concluded that since 1980 in the US, the mark-up rate (the difference between selling price and the firms' marginal costs) had increased in general, but with a significant skew towards a few companies. In other words, most firms did not experience a rise in their mark-ups, but some of them did by a large margin. This would be consistent with the notion that a few businesses – e.g., high tech firms – are "capturing" a disproportionate share of profits. This would weaken Summer's argument.

However, a key issue in the current debate is to understand whether such skew in corporate profits actually fuelled inflation. It would take a proper model to check this, but we would start with a simple observation: **the increase in mark-ups, or firms' profitability, occurred precisely at the time inflation fell** (in the 1980s). This is not solely a US feature. We looked at French data – France has the advantage of maintaining very long and detailed national accounts data. The improvement in profit margins also started in the 1980s, at a time when French inflation fell (see Exhibit 5). What drives the inflation trend at the corporate level usually is the balance between productivity gains and wages. It's when real wages growth exceeded productivity growth in the 1970s that inflation shot up. The disinflation of the 1980s took a transitory phase (in France) when real wage growth fell markedly below productivity. We would argue that at the current juncture, it's the outcome of the wage negotiations, rather than the competitive behaviour of firms, which should be the main area of concern.

Exhibit 5: Higher margins appeared when inflation fell



Source: INSEE and AXA IM Research, May 2022

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Q1 GDP revised lower to -1.5% saar (from -1.4%) • FOMC minutes showed “most” committed to 50bps hikes in coming meetings. Markets relieved at no further hawkishness • PCE inflation (Apr) retreated from its 40-year high of 6.6% in Mar to 6.3%, core dropped to 4.9% • Personal spending (Apr) rose by strong 0.9%, with Mar revised higher. Income rose by just 0.4% • New home sales (Apr) fell 16.6% (mom), pending sales -3.9% in further signs of housing slowdown	• Labour market report (May). Markets expect payroll at 329k, weaker econ suggests even lower. Unemp expected to reach 3.5% • House price inflation (FHFA&Case-Shiller, Mar) – signs of weakening price growth • ISM manu and services indices (May) watched for slowing in face of weaker Fed surveys • Vehicle sales (May) further increases expected despite weaker consumer – in part reflecting easing supply issues
	• May business confidence showed ongoing decent momentum mid-Q2 • Unconvincing Germany Q1 GDP details	• May European Commission survey • Flash May HICP in member states and euro area • EU Council meeting
	• Chancellor announced £15bn of additional cost of living support for households paid in part by a 25% ‘Energy Profits Levy’ • Flash PMIs (May) fell to 51.8 from 57.6, lowest level since Feb 2021 rising fears of slowdown • Rightmove house prices rose 2.1%mom	• Households lending data (Apr) to provide indication of household balance sheets • UK Nationwide House prices (May) likely to show continued cooling in housing market • Lloyds business barometer (May) • BRC shop price index yoy (May)
	• Tokyo CPI ex-fresh food (May) came in at 1.9% unchanged from April • Flash PMIs (May) strengthened in Services to 51.7, but marginally weakened in Mfg to 53.2 • Nationwide dept sales (Apr) rose 19%yoy	• Labour market data (Apr) jobless rate expected unchanged at 2.6% • Retail sales (Apr) to show signs of moderation 0.9%mom vs 2% in Mar • IP (Apr, p) expected -0.1%mom
	• State Council announced a raft of fiscal and monetary stimuli, including tax rebates, auto subsidies, a higher lending quota to SMEs and increased infrastructure bond issuance	• Manufacturing activity should improve sequentially after the sharp contraction in April. The improvement in the services sector may be smaller in comparison
	• CB: Korea hiked +25bp to 1.75%. Indonesia (3.50%) & Turkey (14.0%) stood on hold. Russia cut 300bp to 11.0% in an unscheduled meeting • Q1 GDP (%yoy) accelerated in Peru to 3.8% • April CPI (%yoy) rose in Malaysia (2.3%) and remained unchanged in Singapore (5.4%)	• Hungary expected to hike +75bp to 6.15% • May CPI figures across EM • Q1 GDP (%yoy) should slow in India & Turkey • Reaction to the presidential elections in Colombia (Sunday)

Upcoming events

US :	Tue: Case-Shiller & FHFA house price indx (Mar), Chicago PMI (May), Conference Board consumer confidence (May); Wed: Mfg PMI (May), ISM mfg indx (May), JOLTS job openings (Apr), Fed’s Beige Book; Thu: ADP employment change (May), Weekly jobless claims (28 May), Non-farm productivity (Q1), ULC (Q1), Durable goods orders (Apr), Factory orders (Apr); Fri: Non-farm payrolls (May), Employment data (May), Services PMI (May), ISM non-mfg indx (May)
Euro Area:	Mon: EU19 Business confidence (May); Ge & Sp HICP (May,p), Ge CPI (May,p); Tue: EU19 CPI (May,p), Ge Unemployment (May,p), Fr & It GDP (Q1), Fr & It HICP (May,p), Fr Consumer spending (Apr); Wed: EU19 Ge & Fr Mfg PMI (May), EU19 Unemployment (Apr), Ge Retail sales (Apr); Thu: EU19 Producer prices (Apr); Fri: EU19 Composite & services PMI (May), EU19 Retail sales (Apr), Fr Industrial production (Apr)
UK:	Tue: Lending data (Apr), Money supply- M4 (Apr); Wed: Mfg PMI (May)
Japan:	Tue: Industrial production (Apr,p)
China:	Tue: Official mfg & non-mfg PMI (May); Caixin mfg PMI (May)

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