War made the State

126 – 7 March 2022

Key points

- The consequences of the war in Ukraine will be unequal across social groups in Europe. Redistributive pressure will add to the fiscal drift triggered by the acceleration in the energy transition and the rise in military spending.
- The European Central Bank (ECB) is probably ready to slow down its policy normalization, but the direction of travel remains clear. It would be wrong to count on debt monetization to make this fiscal drift painless.

Major political economy shifts often coincide with wars or preparation of wars. They do not simply affect how resources are affected to defend against external threats. They also shape priorities on civil spending to maximize internal social cohesion. Building a comprehensive welfare state as a demonstration of the West's superiority against the Communist bloc was part and parcel of the cold war. Fighting Covid was a "near war experience" which has accelerated a pendulum shift towards interventionism again. In western societies, the awareness of deep divisions before the pandemic, reflected in the rise of populism, probably played a role. Without massive support to household income and job security, they may not have been able to withstand the degree of collective and individual constraints made necessary by the sanitary situation.

European economies and societies are going to be tested again by the Ukraine war. While polls suggest public opinion is ready to accept some economic sacrifice because of the sanctions against Russia, additional fiscal support is unavoidable. The distribution of the shock across social groups is likely to be highly unequal. The surge in inflation will be the most intense for energy and food, two items which stand for a high share of the consumption basket at the bottom of the income ladder. This "redistributive pressure" will add to the acceleration in the energy transition and the rise in military spending in a new fiscal drift.

A major difference with the pandemic is that the ECB is not in the same situation to help governments fund a new rise in public debt. This time, inflation is the first manifestation of the crisis in the economic realm, not a lagged effect. While this week we expect Christine Lagarde to communicate a slower pace of policy normalization than could have been expected after the February meeting, we think the general direction of travel has not changed. In uncertain times central bankers tend to react with two historical precedents in mind. One is the policy mistake of maintaining a too hawkish stance during the Great Depression of the 1930s. The other is the symmetric policy mistake of maintaining a too dovish stance during the 1970s. They have spent the last 14 years reading Bernanke's "Essays on the great depression". They might be dusting their Milton Friedman now. The fiscal drift is not going to be painless.

The new shape of war economics

"War made the state and the state made the war". We expect the scholar Charles Tilly's words to be used a lot in the public debate as Europe grapples with the war in Ukraine and a resurgent military threat on its border. Tilly's point was that major moments in the growth and transformation of particular states, and of the European state system as a whole, corresponded to war and preparation for war, as governments need to reorganize themselves to mobilize resources. This approach might be too narrow (it has been dubbed the "bello-centric" theory of state formation) but **it's easy to relate major historical shifts in the realm of political economy to changing geopolitical conditions**. **These conditions do not simply affect how resources are affected to defence against an *external* threat. They also shape priorities on civil spending to maximise *internal* social cohesion.**

The immediate source of the emergence of the interventionist state in Europe after the second world war was the need to rebuild the economy in a situation where domestic private capital was sorely missing. But it can also be understood as a reaction to the failure of traditional laissez-faire economics to deal with the Great Depression. Such failure had fuelled the attractiveness of totalitarian forces in the 1930s and ultimately powerfully contributed to the advent of war. Building a state cushioning citizens' welfare against the vagaries of the business cycle – and reducing the width of these cycles - was key to strengthen democracy. The need to demonstrate the West's superiority against the Communist block by providing the working class with a decent welfare state was part and parcel of the cold war. Instead of mutual eviction – the idea that democracies after 1945 had to choose between re-armament and developing social spending - welfare state building and high to decent military spending co-existed in the West from the 1950s to the late 1970s. It may not be a coincidence that the loss in attractiveness of Keynesian/redistributive economics occurred as the competition with the Eastern block faded.

It has become banal to paint the fight against Covid as a "near war experience", forcing a return to forms of "command and control" economics unseen in decades. **The economic war against Covid has already accelerated a pendulum shift towards interventionism again**. Mainstream governments during the pandemic implemented aggressive fiscal policies which they had shunned since the 1980s. The awareness that western societies were made very fragile by deep divisions probably played a role in this (re)conversion. Without massive support to household income and job security, western societies may not have been able to withstand the degree of collective and individual constraints made necessary by the sanitary situation. Before the pandemic, concerns over the hollowing out of the middle class formed during the 30 years which followed the end of WW2 had played in the hands of various populist streams which blamed the free-market, free-trade policies espoused since the 1980s, and reduced support for traditional government parties. However, mainstream parties and personalities regained their footing during the pandemic – illustrated for instance by Mario Draghi becoming Prime Minister in Italy. Their success owes a lot to their decision to borrow from the old economic toolkit.

European economies and societies are going to be tested again by the Ukraine war. The macro scenario we sketched out last week was based on oil hitting USD125/bbl and natural gas EUR125/Mwh. Current market pricing is still below this level for oil, but gas prices have gone much further, hitting EUR176/MWh on Friday morning. For Europe, Russian gas matters more than oil, because of its specific role in electricity price formation there. In addition, private operators tend to pre-empt a further tightening in sanctions – or simply don't want to take counterparty risks – by refusing to purchase or transport Russian commodities. This makes the scope of the potential supply-side disruption brought about by the war in Ukraine even wider, irrespective of the decisions Moscow could make on voluntarily switching off European access to natural gas. **Losing "only" 1 percentage of GDP growth in Europe over 2022-2023 now looks optimistic.**

For now, public opinion in Europe is clearly on the side of their governments' efforts to respond to the Russian challenge. In some cases, public opinion *forced* a more aggressive stance onto the government and may continue to do so soon. An Infratest poll conducted in Germany between 28 February and 2 March found that 53% of respondents consider the government's new stance as appropriate, and crucially the share of those thinking Olaf Scholz did not go far enough is almost twice as large as those who believe he went too far (27% against 13%). In France, an Opinion way poll published on 4 March suggests only 14% of the electorate considers the European Union (EU) should not support Ukraine, and we find interesting that in an Elabe poll conducted on 27-28 February (which means that some respondents could not have been aware of the toughening up of the sanctions that weekend) 60% of respondents were in favour of more sanctions (only 9% finding them too tough) although 72% expect a big economic impact at home. French households seem to be well aware of the transmission channels of the shock (92% expect a rise in the price of gas, 88% of petrol and 83% of food). **This suggests that there is now a readiness to accept some personal economic effect of the confrontation with Russia**. Yet, this a snapshot of public opinion today and such readiness may erode over time if – as it is unfortunately likely – the crisis lasts.

In addition, **the distribution of the shock across social groups is likely to be highly unequal.** The looming inflation shock is going to be particularly intense on energy and food prices, two items which stand for a significantly higher share of the consumption basket at the bottom of the income ladder. According to the ECB's household consumption and credit survey, spending on food and utilities absorb 55% of the median gross disposable income of the 20% poorest in the Euro area population, against only 11% for the top 10%. Moreover, the current crisis is likely to disproportionately hit the manufacturing sector, whose employees have been shouldering for decades the brunt of adapting to international competition, while the pandemic had hit the services sector more**. It had been an unwritten law of macro management during the pandemic that household income could not fall, and that businesses could not fail. While there might be some tolerance for an aggregate downward shock this time, public opinion may be expecting the blow to be cushioned for the most vulnerable.**

This "redistributive pressure" is not going to be the only source of fiscal drift facing European governments in the years ahead. A significant upgrade in military spending will also be needed (an additional 0.5% of GDP per annum in the EU just to get to the North Atlantic Treaty Organization (NATO) targets) while the investment effort needed for the energy transition will need to be accelerated to reduce dependence on Russian gas. The European Commission already estimated at EUR360bn per annum (c.2.5% of GDP) the additional investment needed to achieve the 2030 target. Not all of it will have to come from the public purse of course, and one of the effects of the current rise in prices is to make the return on investment in alternatives to gas more attractive to private investors. We made last week the point that at the current price of electricity, even hitherto expensive solutions such as European Pressurized Reactor (EPR) nuclear technologies become viable. Yet, the speed of the change needed will probably make government incentives and direct involvement necessary. Beyond these new sources of pressure, social spending will continue to be pushed upward by population ageing. **There is thus a lot on the plate of European finance ministers in this new configuration.**

A major difference with the pandemic is that the European Central Bank is not in the same situation to help governments fund this new rise in public debt. The inflation backlash of the pandemic occurred when the economy had reopened, *after* the peak in fiscal stimulus. When the emergency monetary stimulus was launched and the ECB was openly talking about coordination with fiscal policy (a big taboo for the first 20 years of monetary union), there was no conflict of objective: inflation was significantly below target. **This time, inflation is the *first* manifestation of the crisis in the economic realm.**

This is where the parallel with the "bad old 1970s" becomes uncomfortable. We have already mentioned in Macrocast how the inflation wave of the 1970s can be traced back to the conflict between the Johnson administration and the Federal Reserve (Fed) in the late 1960s on the funding of both the Vietnam war and the extension of the social safety nets. By the early 1970s, it was getting increasingly clear that the cost of leading the West *militarily* was eroding the United States (US) capacity for *economic* leadership, and this was spectacularly illustrated by Nixon's decision to abandon the gold standard, which probably further contributed to the generalization of inflation in the developed world. Yet, the US continued to compete with the Union of Soviet Socialist Republics (USSR) on military spending, sometimes by taking significant risk in terms of economic balance. The rise in defence expenditure was a key factor behind the significant increase in US fiscal deficits in the early 1980s which by then had stopped being accommodated by the Fed, embarked at the time in Paul Volcker's successful fight against inflation. Yet, the "last thrust" in outspending the USSR was possible despite positive real interest rates because the US public debt at the beginning of Reagan's first mandate stood at only 40% of GDP. By the time the cold war was won, in 1990 it had reached 68% of GDP. The Euro area's public debt stood at 100% of GDP in 2021, up from 85% before the pandemic.

Even the proponents of Modern Monetary Theory accept that inflation should be the limit to a central bank-enabled public spending free. Indeed, in their fiscally centred approach, monetary policy is essentially inefficient to control aggregate demand. Its only viable transmission channel is via government spending, which it can cover with debt monetization. Public expenditure should be allowed to rise in this fashion until there is no capacity under-utilization to plug, and the emergence of inflation would signal that there is no under-utilization left.

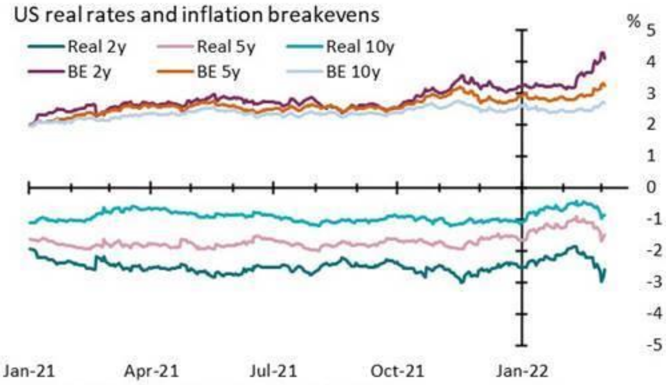
What makes the current European inflation issue particularly thorny is that it is the result of a succession of supply-side shocks, not the reflection of underlying overheating. The ECB hawks position though is that monetary policy could no longer ignore the inflation spike because price expectations are at risk of being de-anchored. Before the war in Ukraine, our view was that this risk was negligible because (i) with still some amount of capacity under-utilization a lot of the exogenous price shock would spontaneously recede and (ii) fiscal policy would start gradually tightening from 2023 onward. If the expected fiscal tightening is postponed and scaled down by the need to counteract the impact of the Ukraine war in the short run and the twin re-armament/energy transition project in the medium-run, then the hawks would find themselves in a better position. **The ECB may well – and should in our opinion – decide to be accommodative in the short-run and delay its expected normalization to avoid intra-euro area fragmentation, but we think it is illusory to believe it will be able to eternally postpone the lift-off.**

In a nutshell, we don't think it is realistic to expect the ECB to fund the combination of (i) active demand management (ii) rising military spending and (iii) the energy transition. **An issue though is that public opinion may have got used to the idea that the magic money tree can bear fruit in any season.** Governments will be walking a tightrope. We think this will probably call for a mixture of reforming some of the existing social transfers programmes – e.g. the pension systems where there is still some space to raise retirement age – and accelerated debt mutualization as we discussed last week – e.g. through an extension in scope and size of the Next Generation EU programmes – to protect the sovereigns with already shaky debt sustainability conditions, since long-term interest rates would rise. Higher taxation, either direct or via various forms of carbon taxes, has also become likelier once the brunt of the impact of the Ukraine war is absorbed. All this could jeopardize social cohesion in Europe, to come back to our first point, but so would either (i) allowing inflation to roam freely on trend or (ii) taking the risk of another sovereign crisis in the Euro area and/or finally (iii) forcing the central bank into a sudden stop "a la Volcker" after years of complacency.

The market has revised its central banks views

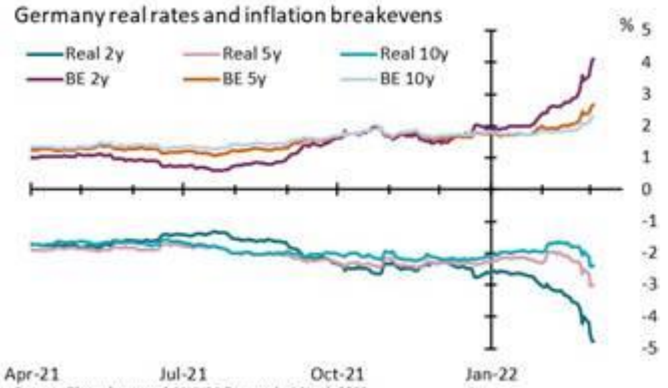
Still, for now markets seem to have a strong belief in the capacity of central banks to accommodate the shock. The Ukraine war has unsurprisingly triggered a significant rise in short-term inflation expectations, judging by the consumer price indexed government bond market (see exhibit 1 and 2). Given their specific sensitivity to Russian commodity prices it is not surprising that the rise in 2-year inflation expectations was steeper in the Euro area than in the US. What we find striking though is that while 10-year inflation expectations have been above the ECB's 2% target since 24 February in Germany, 10-year real rates have fallen by more than in the US. This reflects to some extent a flight to safety, but peripheral spreads help up well. This also suggests the market believes in an eternally dovish ECB.

Exhibit 1 – Higher inflation, lower real rates…



Source: Bloomberg and AXA IM Research, March 2022

Exhibit 2 - …in the US and the Euro area



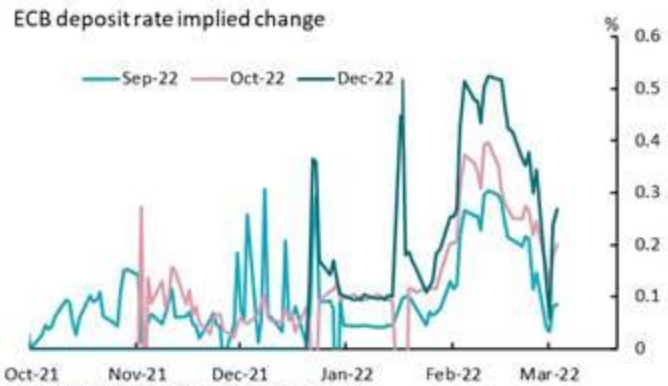
Source: Bloomberg and AXA IM Research, March 2022

The market has revised down its expectations of the policy rate lift-off for both the Fed (see Exhibit 3) and the ECB, although for the latter volatility has been significant these last few days (see Exhibit 4). As we expected, the uncertainty triggered by the war in Ukraine makes the uber-hawkish “Bullard view” less attractive now even though the direct impact on the US economy is limited. The payroll data released last week confirmed the US labour market continues to improve at a brisk pace, but doves may find comfort in the fact that earnings, for once, came out 0.8 pp below expectations at 5.1%yoy in February, from 5.5% in January and 0.8 pp. Real wages are now declining fast, which should down the road erode consumption. The setback on wages may be a blip but that would still reduce pressure for a very fast pace of tightening on top of the geopolitical risks. We remain comfortable with our call for 4 rate hikes of 25 basis points this year.

Exhibit 3 – The “Bullard view” has lost traction

Source: Bloomberg and AXA IM Research, March 2022

Exhibit 4 – One rate hike left for 2022



Source: Bloomberg and AXA IM Research, March 2022

Christine Lagarde will have a difficult task on Thursday as assessing in real time the likely impact of the Ukraine war on the Euro area growth and inflation trajectory is tricky. Before the war in Ukraine, the ground had been laid out for an acceleration of the tapering, probably with an end to Asset Purchase Programme (APP) by the early summer. The debate was more around the timing of the rate lift-off. As we discussed two weeks ago we thought the doves were building a case for lengthening the transition time between the end of Quantitative Easing (QE) and the first rate hike to maintain optionality (in the current version of forward guidance a rate hike is supposed to occur “shortly” after the end of the net purchases). While this week we expect the ECB to downgrade its GDP forecasts – and the balance of risks around them – in reaction to the new geopolitical conditions, we don’t think the central bank is worried enough to postpone the termination of the Pandemic Emergency Purchase Programme (PEPP).

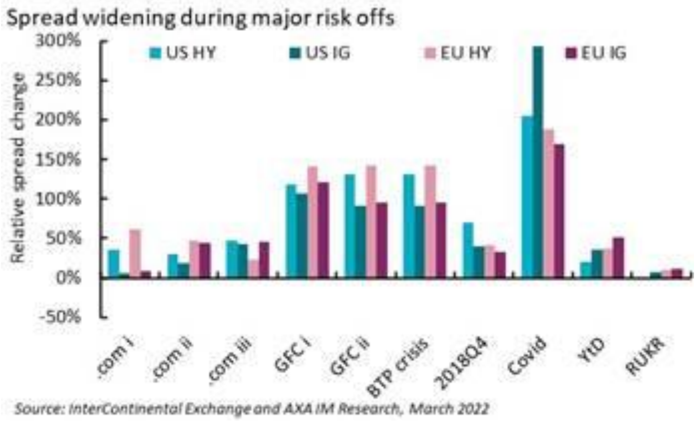
An option would be for the ECB to respond to the heightened uncertainty by merely keeping the current forward guidance – consistent with the possibility to maintain a trickle of APP into 2023 and thus providing lots of freedom on the timing of the rate lift-off while keeping the same definition of the QE-to-rate sequence. A problem though is that this would contradict the ECB’s expression of “unanimous concern” among the Governing Council over inflation in February, while consumer prices have accelerated further and exceeded expectations again since the last meeting. **A compromise could be found around an “expectation” (not an “intention”) to halt the APP in**

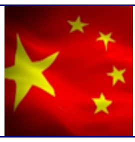
October (subject to a reassessment of economic conditions coinciding with the September forecasts) thus a "soft removal" of the current open-ended nature of the programme (as a nod to the hawks) tempered by the removal of the notion that the first rate hike would follow "shortly" (as a nod to the doves). The earliest a rate hike could happen would thus be December 2022 but possibly pushed back in 2023. Yet, we expect a lot of insistence by Lagarde around the ECB's intention to be "flexible" in the face of events so that the new forward guidance this week would in any case be (understandably) weak.

We think however that the focus this Thursday will be on contingency plans. Peripheral spreads have not reacted yet to the new events and we don't think the ECB feels under pressure to unveil any new "PEPP-like" programme "in case this becomes necessary", but the market will be attentive to any openness to such option. We think Christine Lagarde will mention the possibility to do so, although in an imprecise manner. Alluding to the possibility of more concrete steps would be a clear dovish signal.

In general, we think the debate at this stage at least is only on slowing down the pace of normalization, not about "doing more". In line with the first section of this note, **we think that in uncertain times central bankers tend to react with two historical precedents in mind.** One is the policy mistake of maintaining a too hawkish stance during the Great Depression of the 1930s – and this informed their approach during the Great Financial Crisis of 2008 and then during the pandemic. The other is the symmetric policy mistake of maintaining a too dovish stance during the 1970s. They have spent the last 14 years reading Bernanke's "essays on the great depression". They might be dusting their Milton Friedman at the moment. Yet, the market may have trouble adjusting to the change in mood. We would like to be sure that the amazing resilience in corporate bond spreads so far in this crisis (see Exhibit 5) is not the product of an exaggerated trust in the capacity and willingness of central banks to keep the show on the road.

Exhibit 5 – It takes a microscope (for now)



Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed Chair Powell's testimony to Congress, signalled +0.25% March, suggested front-loading • US payrolls (Feb) post strong 678k gain, unemp dropped to 3.8%. But pay growth slowed to 0.0%mom – weakest since 21 Jan • State of Union address focused on Russian invasion, reducing inflation and economic agenda to drive unity • Non-mfg ISM index fell to one-year low of 56.5, with employment index below 50	• CPI inflation (Feb) expected to rise to 7.9%. War now driving oil to result in higher peak • U MIch Sentiment (Mar, p) – confidence has dropped to 2011 low; longer-term inflation expectations still stable for now at 3.0% • JOLTS survey – still at record highs • NFIB survey to gauge employment issues and price / wage outlook • MBA mort apps – consistent and heavy falls across Feb suggest weaker residential investment
	• Euro area February flash inflation surprised again to the upside gaining 0.7ppt to 5.8%yoy • German Q4 21 GDP growth revised higher (+0.4pp) to -0.3%qoq • France flash HICP for February showed improved momentum in core inflation ECB minutes reflected GC hawkish shift at the start of the year	• ECB Mar GC meeting (Thur): Cautious hawkish tone • Flash Feb inflation: country releases ahead of euro area's on WedEU Heads of State meeting (Thur, Fri): Possibility of additional mutualised fiscal response in current crisis • Euro area and Germany labour market (Jan, Feb) Euro area final Q4 GDP & employment
	• Conflict and uncertainty over supply has pushed gas spot over 400p/therm • PMIs suggest broad-based rebound in Feb • Nationwide House prices (Feb) rose above expectations by 1.7%mom and 12.7%yoy • BoE's Saunders: 'prompt' tightening is needed	• UK GDP (Jan) expected flat on Omicron disruptions following Dec dip (cons, 0.1%) • BRC retail sales monitor data (Feb) expected strong with rising prices adding to reading • RICS house price balance (Feb) • BoE/Kantar UK inflation attitudes survey
	• January IP (prelim: -1.3%mom) confirms expected weakness at the beginning of Q1 • Feb consumer confidence declined further 35.3 (-1.4p) due to Omicron + rising prices • Covid hits Svcs sector, Urate rose to 2.8%	• Developments in Ukraine and response to energy prices • Feb Economy Watchers poll is expected to confirm consumer confidence fall • Q4 GDP may be revised up to 1.4%qoq (+0.1p)
	• Better PMIs suggest a modest improvement in manufacturing and services activities	• NPC to reinforce growth stabilisation is a priority and foreshadow more policy easing to come
	• CB: Russia hiked its key rate to 20% from 9.5%. Malaysia on hold at 1.75% • Feb CPI (yoy %) accelerated in Peru (6.1%), Thailand (5.3%) & Turkey (54.4%). It eased in Indonesia (2.1%) & Philippines (3.0%) • Q4 GDP (%yoy) lost steam in India (5.4%) & Peru (3.2%). It picked up in Turkey (9.1%) • Mfg PMIs in Asia reflect a decent momentum	• CB: Poland is expected to hike +50 bps to 3.25% & Peru +50 bps to 4.0% • Q4 GDP numbers in Romania & Israel • Feb CPI (yoy%) to accelerate in Chile, Colombia & Hungary. It should fall in Mexico, Taiwan & Russia • Jan Industrial production figures in Brazil, Malaysia, Mexico & Turkey

Upcoming events	US :	Tue: NFIB small business optimism (Feb), Trade balance (Jan); Wed: JOLTS Job openings (Jan); Thu: CPI (Feb), Weekly jobless claims (5 Mar); Fri: Michigan consumer sentiment (Mar,p)
	Euro Area:	Mon: Ge New mfg orders (Jan); Tue: EU19 GDP (Q4), Ge & Sp Ind prod (Jan); Wed: It Ind prod (Jan); Thu: ECB announcement; Fri: Ge & Sp HICP (Feb), Ge CPI (Feb)
	UK:	Mon: Halifax house price indx (Feb); Tue: BRC Retail sales monitor (Feb); Thu: RICS Housing survey (Feb); Fri: GDP (Jan), Indx of services (Jan), Ind prod (Jan), Mfg & construction output (Jan), Total trade balance (Jan), Trade in goods (Jan)
	Japan:	Mon: Trade balance (Jan), Current account balance (Jan); Tue: Economy watchers survey (Feb), GDP (Q4)
	China:	Mon: Trade Balance (Feb), CNY Exports and Imports (Feb), Forex reserves (Feb); Wed: CPI (Feb); Expected during the week: Total social financing (Feb), New yuan loans (Feb), M2 (Feb)

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