AXA Investment Managers

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Investment Institute Macroeconomics

Another Money Magic Tree Dries Up

- We explore the risk of a protracted cut in Russian gas supply after the "maintenance period".
- Fed hawks bolstered by the latest labour market data.
- That inflation helps with public finance is not a "law of the universe". Europe is not experiencing "the right kind of price shock" from that point of view.

The beginning of a "maintenance period", which is stopping the flow of Russian gas to Europe via Nord stream for 10 days, is focusing attention on the risk of a more protracted Russian embargo which could tip in the Euro area into a recession. A key issue is whether a comprehensive European solidarity mechanism pooling scare gas resources could be conjured up to support Germany and Italy. The current system designed by the European Union (EU) rests on a series of bilateral agreements which would be insufficient. We could easily picture a complicated "give and take" negotiation to get a stronger framework across the line, with France and peripherals arguing that the natural "complement" to such solidarity in the realm of energy supply benefiting Germany would be another push towards debt mutualization – the second stage of Next Generation EU (NGEU) which has so far been elusive. This would not be an easy discussion.

"Gas stress" is in any case pushing prices further up, jeopardizing the gradual deceleration in headline inflation which base effects would provide. In the US, "persistent inflation" is more likely to come from a lack of sensitivity of the labour market to the economic slowdown. From that point of view, the stronger-than-expected job creations in June unveiled last week strengthened the case of those at the Federal Open Market Committee (FOMC) who argue for another 75-bps hike.

The only benefit of inflation is its capacity to help with reducing public deficit and debt, as long as real interest rates don't react too much. However, it is not a "law of the universe". Drawing on Agnes Benassy-Quéré's latest note we distinguish two cases. One when an economy is faced with overheating, and the GDP deflator rises in sync with consumer prices (close to the US current situation), and another where an exogenous shock dominates, and consumer prices rise much more than the GDP deflator (European situation). It is much harder to bring public debt back under control in the second case. While the current fiscal mitigation of the price shock is justified, it is not a "free lunch". Painful decisions will have to follow.

Scarcity sharing

When we discussed our revised forecasts two weeks ago, "persistent inflation" scenarios were those where full-blown recessions would plague both the United States (US) and the Euro area in 2023. However, the source of this persistence differed. For the US, it would come from a lack of sensitivity of wages to the deterioration in economic activity. In the Euro area, it would stem from a further rise in gas prices triggered by a Russian decision to cut supply. Unfortunately, the probability of materialisation of the latter is rising. The flow of gas from Russia to Germany through the North stream pipeline stops this Monday for 10 days for maintenance. The flow had already been cut by a 2.5 factor between May and June. Germany is now on high alert in case the flow does not resume on 22 July. Rationing measures, sometimes purposefully visible to grab citizens' attention and nudge them towards preserving energy, such as lowering the temperature of municipal swimming pools, are already being enacted.

Citi produced an interesting note in its latest "European Economics Weekly" last Friday, using current data on gas storage and historical consumption patterns, to estimate when Germany and Italy, the two big economies in the EU which are the most sensitive to Russian gas, could run out. Even with some contribution from Liquefied Natural Gas (LNG), in their calculations and despite storage ratios which have already moved up north of 60%, "crunch time" would come by January/February 2023 if Russia entirely turns the tap off. Other big economies are in a much better shape. Only 17% of French gas comes from Russia. The country would still be hit by the increase in prices which a Russian embargo would trigger, but it should be able to supply local consumption through next winter, barring an extreme weather episode.

A nagging issue though is whether Germany and Italy – together with the smaller countries from the East of the EU – would trigger European solidarity so that resources across the entire EU would be pooled (which would force some rationing including in countries without any direct pressure on gas). Since 2016 and a first alert on gas supply, the EU has equipped itself with such solidarity principle, with a priority towards key services and households – which means that gas-intensive industries would face the brunt of any rationing. However, no comprehensive system has been set up (see here for a more precise description). Instead, the framework is based on a series of bilateral agreements between neighbouring countries. The first one was signed between Germany and Denmark in December 2020. Five more deals have been agreed since then (Germany and Austria, Estonia and Latvia, Lithuania and Latvia, Italy and Slovenia, Finland, and Estonia).

Such network, in its existing form, would probably do little in practice to mitigate the shock. We could easily picture a complicated "give and take" negotiation to get a comprehensive system across the line, with France and peripherals arguing that **the natural "complement" to such solidarity in the realm of energy supply benefiting Germany would be another push towards debt mutualization** – the second stage of NGEU which has so far been elusive. This would not be an easy discussion though and significant tension could appear across member states, which is probably exactly what would be a key motive for Moscow to deliver such "sudden stop" in gas exports to Europe.

It's still a delicate calculation for Russia though. Indeed, a complete cessation of the gas supply to the EU would result in a painful loss of access to critical hard currency (the pipeline system does not allow to send to China much of the gas normally sent to Europe). The best course of action for Moscow may well be to maximize its revenue and political pressure on the West by reducing its supply but keeping it positive, so that prices go markedly up – adding to the inflation spike and hurting European consumers – but with maintained gas receipts for Russia. While Putin may hope that a complete embargo would eventually turn public opinion in Europe against their governments' support for Ukraine, he could not completely discard the opposite reaction: that military support in form of heavier weaponry would be boosted to "punish Russia".

In any case, keeping the "West on its toes" on the gas issue may be starting to have some positive political benefits for Russia. On Sunday, **the Canadian government announced it was granting an exception to the Russia sanction regime to allow turbines for Nord stream – which had been sent for repairs in Montreal – to return to Germany**, explicitly mentioning the economic risks to Germany from a Russian gas embargo. This drew immediate criticism from Ukraine.

This may however push Moscow into the "reduce, don't cut" option. The same calculation by Citi would suggest that Germany and Italy could go through the winter without resorting to rationing if Russia cut its supply by another 50%, again assuming no extreme weather event occurs this winter. This would minimize the impact on European supply – industries would not have to stop producing – but the further rise in energy prices would still reduce European growth.

Fed in Saint Thomas' mode

We have entered this strange phase of the cycle when "good news are bad news", i.e., where signals of deterioration in the real economy can boost the valuation of risky assets because investors expect the central bank's tightening to be stopped in its tracks. As we discussed at length in the last two issues of Macrocast, the decline in the Purchasing Managers' Index (PMI) combined with the drop in US consumer spending in May triggered such reaction. Yet, the labour market remains the crux of the matter, since wage growth will decide whether inflation persists or not. Softening hiring intentions, according to the business surveys, combined with some normalisation in jobless claims, could make us expect the beginning of a deceleration in job creation which would ultimately significantly dampen wages. However, **June payroll numbers came out stronger** than expected (372k versus a market consensus at 265k). True, this is significantly slower than in Q1 on average (375k in Q2 against a whopping 540k in Q1), but still consistent with decent underlying economic activity, and thanks to another drop in the participation rate, the unemployment was unchanged over the month at 3.6%.

Exhibit 1 – Wages are not decelerating fast enough

Source: Bureau of Labor Statistics and AXA IM Research, July 2022

True**, there are signs that wages are decelerating**, even if one controls for base effects (which we do by looking at hourly earnings on a year-on-year basis and a 3-month annualized basis - see Exhibit 1) **but it is probably still too tentative for the Federal Reserve (Fed).** While our baseline remains that the Fed will ultimately choose to hike by 50 basis points only in July, this strengthens the position of those like Governor Waller who openly call for another 75-basis points hike. We suspect that the Consumer Price Index for June, released this week, is going to be crucial. The market is expecting a further acceleration to 8.8%yoy from 8.6% in May for headline. Core is seen as decelerating (from 6% to 5.7%) but as usual the deceleration would have to be broad-based to address the Fed's concerns. If it continues to be dominated by the normalization of the used cars component, the FOMC is likely to disregard the signal.

The latest minutes of the FOMC debates suggest that it will take a significant *observed* deceleration of consumer prices to affect the Fed's rhetoric, rather than just a change in the "likely outlook". The points on the respective role of demand and supply are quite illuminating. FOMC members seem to be quite sceptical about the chances of seeing supply-side pressure abate and accept the logical conclusion when controlling inflation is paramount: demand must decelerate enough to adjust to the lower level of supply. That's another, indirect way for the Fed to communicate its tolerance for a recession.

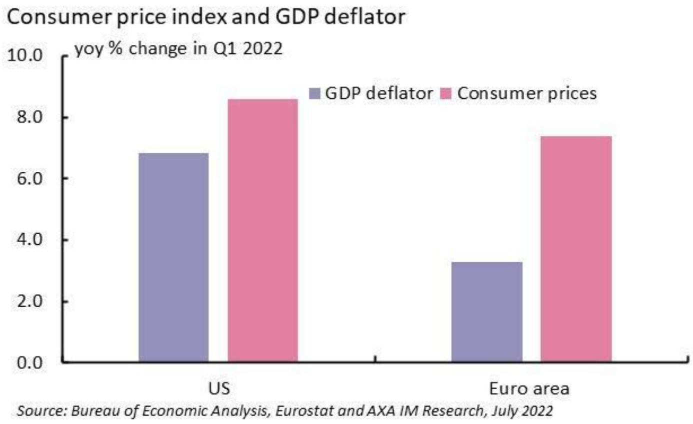
Even when inflation could help, it doesn't

Modern Monetary Theory (MMT) came up with a beautiful "magic money tree". Its premise was simple: as long as the economy has spare capacity, fiscal policy can embark on massive stimulus which are made financially sustainable by equally massive purchases of government bonds by the central bank. The limits of MMT lie precisely in its premise: it works only if the economy displays a negative output gap. In a way**, MMT was so successful that it brought about a degree of overheating – in the US at least – which has triggered home-grown inflation**. While the MMT's magic tree has dried up, another one seems to be in full blow. It relies on the notion that since inflation naturally erodes public debt" as ex post real interest rates remain negative, governments could fully mitigate the impact of the spike in prices on real income without jeopardizing their medium-term trajectory. We are afraid the fruits of that second magic tree could end up tasting quite bitter.

When thinking about any macroeconomic problem, a good idea is often to start by checking what Agnes Bénassy-Quéré has to say about it. In general, she has identified the issue earlier than most, dissected it, looked at it from all possible angles and produced a crystal-clear analysis on it in less time than it takes your humble servant to open Excel. Her latest note on the – less favourable than usually thought – effect of inflation on public finances is a must read (it's here, the English version is coming out soon). Here we will focus and hopefully expand on one of the points she made: the fact that **public spending tends to move in sync with the consumer price index, while the GDP deflator is more relevant for government receipts**. Your humble servant can easily picture the immediate drop in attention the last sentence might have triggered for even the most battle-hardened habitual readers of Macrocast, whose patience with national accounts intricacies might be – understandably – limited. But bear with us for a bit longer. It's actually a big issue.

Just like GDP is the sum of the net output of all the sectors of the economy, the GDP deflator captures the change in the prices of all the factors, labour, and capital, contributing to the growth of all the components of GDP (including exports) while the consumer price index measures the price of, well, consumption alone. And here we find again the distinction between an endogenous and an exogenous inflation shock. When an economy is in overheating, the price of all production factors usually rises. When a country deals with an exogenous inflation shock, consumer prices react quickly but it can take a long time for the impact to work its way through the economy. These two different positions should be reflected in the spread between the GDP deflator and consumer prices.

Exhibit 2 – Gap in Europe, not so much in the US



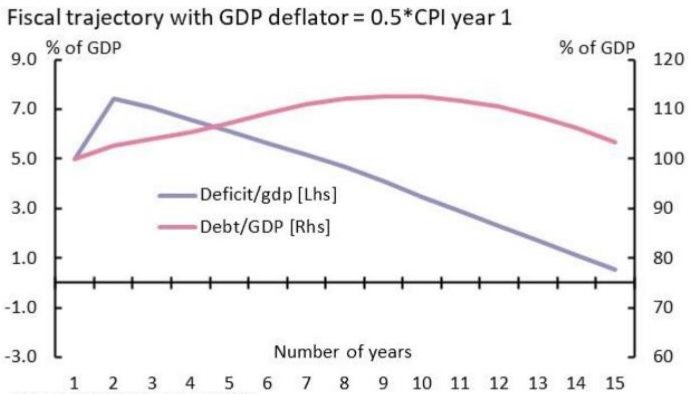
Source: Bureau of Economic Analysis, Eurostat and AXA IM Research, July 2022

As Exhibit 2 illustrates, in the US, even if it is obviously faced with the exogenous shock of high oil prices, excess demand is present as well, so that as of Q1 2022 – last available data – the GDP deflator is below the CPI but not massively so. Meanwhile, in the Euro area, where there was no sign of excess demand as we exited the pandemic, the year-on-year change in the GDP deflator is about *half* of the one observed for the consumer price index.

What are the implications? When an economy overheats, more people make more money, consume, and get taxed, filling the government coffers. The inflation shock can easily come with a reduction in the deficit, adding to the usual "reverse snow balling" effect of higher inflation on accumulated debt, as long as real interest rates don't follow suit. Conversely, **when an economy is hit by an exogenous inflation shock, tax receipts may rise by less than spending, boosted by higher consumer prices, triggering a rise in the government deficit.**

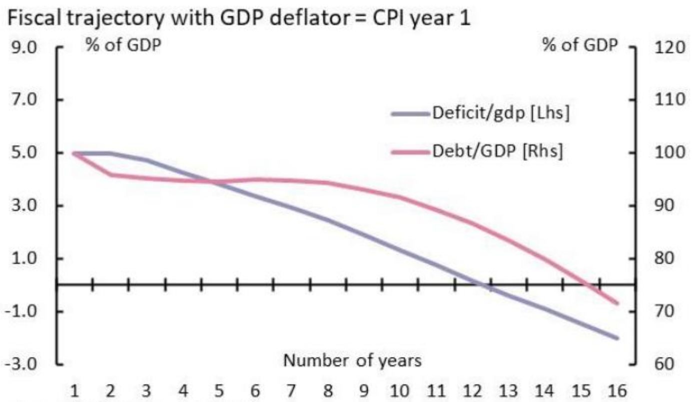
We illustrate the massive impact this phenomenon can have on the deficit and debt trajectory in Exhibits 3 and 4. We start from the situation of a "representative country" before the current inflation spike. Public debt is at 100% of GDP, and the primary deficit is at 3.5% of GDP as a legacy of the pandemic stimulus. Interest payments are at 1.5% of GDP and we make the average interest rate on debt move from 1.5% to 2.5% in 8 years (a lot of Euro area countries have an average debt maturity of about 8 years). We make public spending move in line with Consumer Price Index (CPI) inflation, and public receipts move in line with nominal GDP. We perform the shock in year 1. CPI inflation shoots up to 10%. Real GDP is flat that year (near-recession). From year 2 inflation converges gently to 2% (completed by year 5) while real GDP grows in line with the consensus estimate of potential GDP in the Euro area (1.3%). The *only* difference between trajectory 1 and 2 is that in the first, the GDP deflator in year 1 grows at half the pace of the CPI (exogenous shock) before re-converging by year 2. In the second, the GDP deflator grows in line with CPI (overheating configuration). This difference in initial conditions is enough to create vastly different trajectories.

Exhibit 3 – What a difference a change…



Source: AXA IM Research, July 2022

Exhibit 4 – …in an obscure parameter made



Source: AXA IM Research, July 2022

Of course, t**hese are ultra-simplified assumptions, purposefully so to illustrate the point. In reality, things are much more complicated, but not necessarily in a reassuring manner.** Of course, our assumption that public spending grows as much as inflation may sound like an extreme assumption – cases of automatic indexation have become rare - but in practice we don't think it is. To take a concrete example, the French government is currently trying to raise public spending by a bit less than what the CPI inflation shock would entail but faces an uphill struggle to so. For instance, base pay in the public sector will rise by 3.5% in July 2022. This is on paper less than inflation (which, albeit lower than the Euro area average, should be close to 6% this year). However, this does not take into consideration the fact that the wage scale in public administration works on a seniority basis. Since the average age of public workers rises on trend, the overall payroll cost routinely exceeds the rise in basic pay. But there also exists a statutory guarantee: if over 4 years, between the rise in basic pay and individual promotions, a public sector worker's pay rises less than inflation, the spread is offset. This is only one of the various mechanisms through which it's very difficult for the government to engineer any significant drift between consumer price inflation and its expenditure.

Beyond this, there are cyclical and structural other issues to consider. On the former, **governments faced with a massive exogenous price shock without experiencing overheating may feel compelled to offset a significant share of the real income loss incurred by consumers**. This could make public spending grow by more than what de jure or de facto indexation would imply. This is exactly what is being done right now in most Euro area countries, where governments increase transfers to households, either via direct payments or by forfeiting some tax receipts. Concerning structural issues, in our illustrative trajectories, public spending as a share of GDP falls on trend (that's why the initial shock ends up being absorbed, albeit at a widely varying speed across the two scenarios), since it is barely maintained in real terms but does not grow in line with GDP. There are strong forces that will push real expenditure in positive territory. Population ageing is the most obvious one.

Finally, both our trajectories are quite rosy on their interest rate assumptions. Indeed, they would remain for two decades only 50 basis points above inflation, at 2.5%, but below nominal GDP growth. At least in some member states it is a strong assumption. Our illustrative trajectories can of course be submitted to different interest rates scenarios, with the most reasonable ones consistent with a further drift in public debt.

Our purpose here is not to argue that European governments dealing with an exogenous price shock should refrain from mitigating the impact on real income. We have made the point before that from a medium-term point of view, the risks of an uncontrolled wage/inflation spirals would be better kept in check if one-off government hand-outs, rather than steep pay raises, are used. Our point is to show that, to borrow from the words of the Banque de France Governor, the current fiscal support is not costless. Spending today – which is entirely justified in our view – calls from fiscal restraint in the future. In these matters as in others, there is no free lunch.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Payrolls (Jun) surprised to the upside at 372k, unemployment was unch as expected at 3.6% and earnings rose +0.3%mom from upward revs'd 0.4% • FOMC minutes (Jun) Committee to decide between 50 and 75bps hike in July, keen to reach neutral • Fed's Waller and Bullard advocate 75bps rise • ISM servs (Jun) headline held up better at 55.3, but employment index fell to 47.4 • White House considering easing China tariffs	• CPI inflation (Jun) market expects further increase to 8.8%, we forecast softer. Core expected to fall • PPI inflation (Jun) expected to fall as oil drops • Fed releases Beige Book, watched for signs of broader deceleration in economy • Retail sales (Jun) key determinant for Q2 GDP, with other signs that momentum slipping quickly • Michigan 5-10yr inflation (Jul, p) the rise to 3.3% in June contributed to Fed 75bps hike, then revised
	• German and French May IP point to a contraction in Q2. Brighter situation in Spain and Italy • ECB June minutes showed clear hawkish tone bias. Meanwhile preparation of antifragmentation tool continue. No details have transpired yet	• Euro area May IP, and final June HICP • ECB speeches ahead of 21 July Governing Council meeting, especially on anti-fragmentation tool
	• PM Johnson steps down as leader of Conservatives after >50 MPs quit from government roles. He remains 'caretaker' PM util new leader is elected • UK PMIs (Jun F) composite measure revised upwards to 53.7 from 53.1 • REC Survey indicates slowing labour demand	• 1922 Ctte elections for leadership election rules/timelines. MPs to announce intention to run • UK monthly GDP (May) expected to rebound by 0.1% (cons) we see risks to downside • RICS House price balance (Jun) • Governor Bailey to speak at OMFIF event
	• ex-PM Shinzo Abe dies after being shot while campaigning for the LDP • Final Services PMI revised down marginally to 54 • Weak household spending data (May) signals weak Q2	• Upper House elections (Sun) PM Kashida's ruling coalition likely to maintain majority • Japan PPI (June) • Industrial Production (May F) • Tertiary Industry Index (May)
	• Small COVID flareups cause fears of Beijing backpedalling on re-opening. Additional policy support for infrastructure investment to keep growth momentum going	• COVID situation and potential tariffs cut will be the key focus before the release of Q2 GDP on Friday
	• CB: Malaysia hiked +25bp to 2.25%, Poland +50bp to 6.5%, Peru +50bp to 6.0% & Romania +100bp to 4.75% • Annual inflation accelerated in Colombia (9.7%) Indonesia (4.4%), Korea (6.0%), Philippines (6.1%), Thailand (7.7%), Taiwan (3.6%) & Turkey (78.6%)	• CB: Korea to hike +50bp to 2.25% and Chile +50bp to 9.5% • June CPI (yoy) in India and Romania • May IP figures in Colombia, India, Malaysia, Mexico and Turkey • Q2 GDP to accelerate in Singapore • May retail sales figures in Colombia and Brazil

Upcoming events		
	US:	Tue: NFIB index (Jun); Wed: CPI (Jun), Fed's Beige Book; Thu: Weekly jobless; Fri: Retail sales (Jun), Empire State survey (Jul), Ind prod (Jun), Business inventories (May), Michigan sentiment (Jul, p)
	Euro Area:	Mon: Eurogroup meeting; Tue: Ge ZEW survey (Jul); Wed: EU19 Ind prod (May), Ge HICP (Jun), CPI (Jun), Fr HICP (Jun), Sp HICP (Jun); Fri: It HICP (Jun), EU19 Trade in goods (May)
	UK:	Mon: Elections to 1922 Committee; Tue: BRC Retail Sales Monitor (Jun), BoE's Bailey speaks; Wed: Monthly GDP (May), Indx of services (May), Ind prod (May), Manufacturing & Construction output (May), Total trade balance (May), Trade in goods (May); Thu: RICS Housing Survey (Jun)
	Japan:	Mon: Private 'core' machinery orders (May); Thu: Ind prod (May)
	China:	Wed : Exports (Jun), Imports (Jun), Trade balance (Jun) ; Fri : GDP (Q2), Ind prod (Jun), Retail sales (Jun), Fixed asset Investment (Jun) ; Expected during the week : Total social financing (Jun), New yuan loans (Jun), M2 (Jun)

About AXA Investment Managers

At end of December 2021, AXA IM employs over 2,460 employees around the world, operates out of 23 offices across 18 countries and is part of the AXA Group, a worldwide leader in insurance and asset management.