Investment Managers

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Investment Institute Macroeconomics

Macrocast

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Changing of the Guards

- Macro management principles holding firm since the 1980s/1990s are coming under criticism, including within mainstream political forces. Paradoxically though, doubts on the role of central banks are emerging while they are on the cusp of winning their war against inflation.
- We continue to monitor the political developments in France. Finding the path towards a stable government may take more time.

Understandably, the French elections and the US presidential race have focused attention on the potential for radical policy experimentation. We think attention should also be drawn to how even mainstream political forces can be affected by a new approach to macroeconomic management straying away from the main principles which have been guiding policymakers since the 1980s. A circumspect attitude towards the role of fiscal policy in cyclical fine-tuning, the primacy of monetary policy and a distrust for direct state intervention in capital allocation are giving way to enthusiasm for activist fiscal policy, a critical view of the capacity of monetary policy alone to deal with inflation shocks and some appetite for price controls. We review a paper by Van Klooster and Weber which in our view encapsulates very well the new Zeitgeist. While we agree that without determined government action during Covid and the energy price shock triggered by the Ukraine war, a painful recession could not have been avoided, there is a risk that what was emergency management turns into a structural shift.

Paradoxically, central banks are coming under heavy criticism when they are on the cusp of a victory on the inflation shock. We do not expect any hard decision this week, but the ECB Governing Council meeting should be the occasion to make it clearer that the June cut was only the start of a process, and we expect the next 25bps cut coming in September. In the US, the June print for the CPI probably sealed the deal for a first cut in September.

We continue to monitor the latest political developments in France. The President has made it plain he would wait for compromises across political families to emerge before appointing a new Prime Minister. This process could still take some time. We draw attention to the fact that beyond the budget bill for 2025, a new government will have to produce a credible medium-term plan to allow the EU to grant France extra time to bring its deficit to 3%. This will take more than just cobbling up together a non-committal budget.

The times, they are a-changing…

Even for politics junkies such as your humble servant, comes a time when saturation sets in. Since the French President of the Republic has in effect called for a "pause", by conditioning the nomination of a new Prime Minister (PM) on some still elusive compromises across political families, we yield to summer's invitation to more contemplative endeavours to start this weeks' Macrocast (we will explore the political chessboard only in the last section). Looking beyond the tumult of the recent European and French elections, and zooming out for a while from the looming political battle in the US, how can we characterize the ongoing tectonic shift in macroeconomic management in the West?

We are all to some extent prisoners of our generation, and for those who were trained in the late 1980s/early 1990s, sound macroeconomic management revolved around three main principles.

First, **fiscal policy should be largely unplugged from active cyclical adjustment**. This does not mean at all that "laissez faire" and an absolute retreat of government from the economic sphere is necessarily warranted. Tax rates could be modulated to incentivise resource allocation in certain directions – for instance R&D – and nothing prevented government from setting up social protection nets which could be more less extensive depending on local political preferences – but public finances were deemed to be ill-equipped to deal with cyclical shocks beyond their automatic operation. In clear, the safety nets – unemployment insurance in particular – may mitigate a shock (the so-called "automatic stabilisers", but discretionary changes would likely always come too late and only distract tax and public spending policies from their long-term objectives – social cohesion and lifting potential growth.

Second – and that is of course a corollary of the first point – **the onus is on monetary policy to "do the cyclical stabilisation"**. Central banks are nimble enough to detect quickly enough changes in cyclical condition, respond to it by adjusting rates and eventually reversing their stance equally swiftly.

Third**, policies work best by allowing decentralized decisions to respond to stimuli.** Public finances can contribute to achieving long-term collective goals – e.g., promoting innovation – by tweaking tax rates, or directing public spending to sound infrastructures, incentivising private economic agents to alter their behaviour – but direct government intervention into capital allocation is often counterproductive. The same applies to monetary policy. Far away from the minute, sectorial and quantitative approaches of the 1960s/1970s, modern monetary policy revolved around a general interest rate signal, to which the financial system and non-financial agents choose to respond independently.

These three principles are today under scrutiny. The post-Great Financial Crisis experience paradoxically revived interest in cyclically active fiscal policies. Indeed, the massive cost in terms of growth and employment of the decision, across the G20, to reduce public deficits very quickly after the 2009 recession suggested that fiscal multipliers were larger than thought in 1980s/1990s. Symmetrically, if cutting spending too fast comes at a cost, then policymakers would be forgiven for thinking that allowing spending to expand could lift GDP growth nicely. The Covid and then Ukraine war emergencies, coupled with growing concern about Chinese competitiveness, ushered in a revival of direct government intervention in the economy. Central bank's difficulties in reining in the latest global inflation shock triggered some re-thinking of the capacity of monetary policy to deliver price stability.

A recent paper commissioned by the European parliament in our view encapsulates the current "state of thinking". **Van Klooster and Weber ("*Closing the EU's Inflation Governance Gap*", see link here) focus on the limits to the capacity of central banks' to respond to supply-side inflation shocks** affecting systemically important components, such as food or energy, which have deep ramifications for the rest of the economy, because they profoundly affect consumers' expectations, hence ultimately wages and/or firms' profit behaviour and/or disrupt production processes. Raising the policy rate to deal with such "shockflation" to use their expression can be very costly in terms of welfare loss, which would call for a multi-faceted approach which goes far beyond monetary policy.

This is not necessarily new. The two authors recall the experience of post-unification Germany to show how even a very credible central bank such as the Bundesbank in those days did not deal with the 1990s inflation shock alone but was supported by a political mobilisation – enlisting the labour movement – which brought about wage moderation. We agree with this view, **as episodes of correction from high inflation regimes usually entailed more than pure monetary tightening**. Paul Volcker did a lot to severely wound the inflation beast in 1980, but the final killing probably came courtesy of the transformation of the US labour. In France, abolishing the automatic indexation of wages on inflation also played a major role in the 1980s.

Yet, the authors argue that "shockflation" has changed in nature. They highlight in particular "greedflation" which saw profit margins expand when food and energy prices accelerated in the wake of the Ukraine war. **They advocate the possibility for national governments, in coordination with the European Union (EU), to intervene – if need be – in price formation** to nip these inflation waves in the bud. Some of this intervention would be "pro-market", using the instruments of competition policies more readily, but Van Klooster and Weber also explicitly mention direct intervention by setting up public supply buffers – in the image of the US oil strategic reserves for instance – but also by using *"selective price controls to correct the overshooting of prices in response to shocks that induce endogenous price uncertainty*". They mention the European gas price cap as an example. In addition, the authors praise industrial policies, with their large dollops of state aids, to the extent that they could have a disinflationary effect by removing production bottlenecks. All this would ultimately be **the opposite approach to the one pursued in the late 1970s/early 1980s, or in Germany in the early 1990s: at the time, disinflation was brought about by "more market". Today, it would be quelled by "less market".**

Some of Van Klooster and Weber's recommendations are perfectly reasonable. Your humble servant praised in Macrocast the action of European governments when they introduced de facto subsidies to mitigate the transmission of wholesale energy costs to consumers' purchasing power. We believe that without such action, an even larger drift in wage growth would have occurred, as workers would have more readily turned to their employers to protect their purchasing power. We are however concerned about **the risk that what was exceptional would become run of the mill policies**. Van Klooster and Weber come with a very long list of potential "shockflation" triggers, including the cost of the transition to net zero, which we think are of a structural nature, and propose to embed "price monitoring" in the European macroeconomic framework.

Isabelle Weber had come under heavy fire from the economic profession at the end of 2021 when she already argued for price control in an OpEd in the Guardian. Objections became less vitriolic when the inflation shock proved more persistent than expected and mainstream institutions such as the European Central Bank (ECB) started documenting "greedflation" themselves, delving deep into corporate margin behaviour. **We think that at this stage this paper reflects well the "economic Zeitgeist",** at least in policy circles – the academic community is more circumspect.

While the commentariat is now focusing on the most spectacular versions of non-mainstream policies, espoused by radical movements, we sense that more central political forces also are yielding to this new macro paradigm. We already covered in Macrocast how a more "muscular" approach to international trade was getting tempting, including within European political families normally allergic to these trends. The recent history of the European state aid regime is in our view quite telling. The European regulation was initially suspended to accommodate the Ukraine war shock. The changes have now been made permanent. **Historically, significant shifts in macro management did not come from a single political force becoming dominant but the argument was won by becoming the consensus position.** In the US, Keynesian management in the 1960s was supported by both the Republicans – e.g., by a figure such as Nelson Rockefeller – and the Democrats. Symmetrically, the Clinton era brought to power teams which were essentially in agreement with the Republicans' free market approach under President Bush Senior. In Europe, the triad of principles for macro-management we mentioned earlier was largely shared across the political spectrum. Symmetrically, it is plausible that **"central political forces" try to respond to the strong social demand for more government protection – in a more active way – which is today reflected in the surge of populist movements by espousing themselves a sort of reasonable version of dirigiste macro-management.** A crucial issue in our view is how much of this activist push will be offset by more dedication to economic flexibility – e.g., in the form of red-tape cutting or labour market reform. Given the current political mood, maintaining this balance will be difficult.

The state of public finance is of course a natural limit to this shift. State aid can be expensive. The EU keeps a "scorecard" every year on the various schemes in each member state. In 2022, the total stood at 1.4% of GDP in the EU. Half of this came from crisis-related schemes (the pandemic and the reaction to Ukraine war), leaving 0.7% of GDP to "run of the mill" operations. The calculation of the cost-benefit balance from the point of view of public debt sustainability is not straightforward. Indeed, without the emergency government support of the last few years, Europe would not have avoided a deep recession with some immediate impact on tax receipts as well as lingering adverse effects on trend GDP growth due to the mothballing of investment projects. Yet, maintaining such effort in the current configuration is less easy to justify. True, the state-aid financial bill – which comes on top of funding the operations of the welfare state – should naturally decline as emergencies fade, but the sense that the current race with competing economic blocks, China in the first place but also increasingly the US, with or without a Trump victory in November, could easily trigger additional aid. Emergency spending would be replaced by structural expenditure.

If the state of public finances in a context of positive real interest rates makes it impossible to fulfil all these ambitions, we believe governments will be increasingly tempted to resort to more and more regulatory intervention in the private sector. In other words, **if states cannot demonstrate to their public opinion that they are spending more to act in the economic sphere, they may try to intervene more in price formation.**

ECB: the waiting game

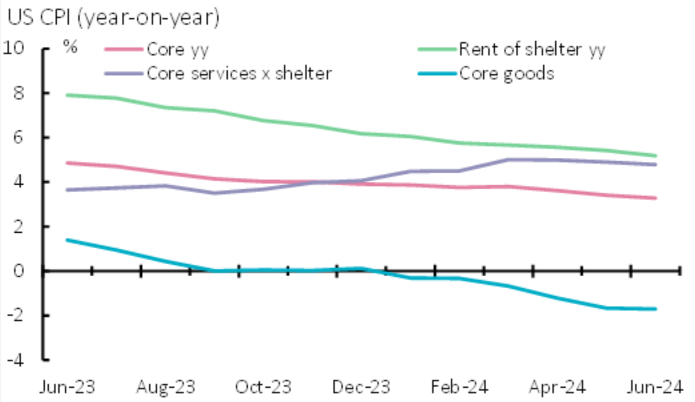
Paradoxically, **the questioning of the leading role of monetary policy is taking place while central banks are on the cusp of being able to declare victory on inflation at a manageable cost to the real economy**. Indeed, the ECB started to cut interest rates in June before obvious signals of recession started accumulating. We think it is going to be tight, but there is indeed a chance that the ECB will remove monetary restriction quickly enough so that a recession phase could be avoided. We are not expecting an emergency cut at this week's meeting – we think there would have been clear signs to this effect at the annual conference in Sintra. There is less than 1 basis point of a cut for this week priced in. The preference of the Governing Council – at least for now – seems to be to timing the rate cuts with the release of new forecasts, and the next one comes in September. The market is now pricing an 87% probability of a cut then, and we would put it even higher. True, disinflation is on a plateau, but the surveys converge to paint a sufficiently tame picture of underlying price pressure for the ECB not to wait too long. In June, Christine Lagarde has strenuously avoided embarking on a discussion of what would be a "restriction removal trajectory". We would expect more openness this week, largely validating current market pricing.

US: exactly the right inflation print!

We wrote last week that it is becoming now even easier for the ECB to continue cutting because the signals from the US point to the Federal Reserve (Fed) being in position to cut soon as well. Last week's dataflow has provided even more support to this view, and **the market is now pricing a 93% probability of a Fed cut in September (we concur). The Consumer Price Index (CPI) print for June helped a lot.**

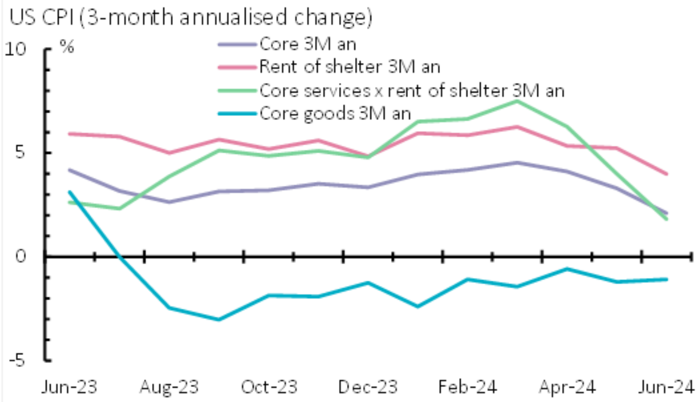
Headline CPI fell by 0.1%mom in June, 0.2 percentage point below market expectations, hitting at 3.0% its lowest year-on-year change since March 2021. Core CPI rose 0.1% on the month but that was also less than expected (0.2%) and at 3.3%, the year-on-year change also hit a more than 3-year low. On a year-on-year basis, the deceleration was driven by still negative prints of core goods and progress on rents, while core services excluding rents, the Fed's main point of focus, did not budge (see Exhibit 1). The short-term momentum, which helps control for base effects, tells a different story: core services excluding rents have been decelerating quite sharply over the last few months (see Exhibit 2).

Exhibit 1 – Steadily down



Source: Bureau of Labor Statistics and AXA IM Research, July 2024

Exhibit 2 – More dramatic disinflation on a 3-month basis



Source: Bureau of Labor Statistics and AXA IM Research, July 2024

The June CPI print has triggered a string of positive comments from Federal Open Market Committee (FOMC) members, and what is striking is how **the balance is now shifting across the two targets of the Fed: with signs accumulating that inflation is getting back under control, Fedspeak is turning to the labour marke**t, and the risk that it would deteriorate too far if the current level of monetary restriction is maintained for too long is increasingly mentioned. Jay Powell in is latest Congressional hearing still call the labour market "strong" – albeit no longer overheating – but his readiness to contemplate downside risks there is obvious. A September cut is indeed very, very probable at this stage. Technically, the Fed could move at its late July meeting already, but we think the bar for this remains high: it would probably take a truly horrendous GDP print for Q2 – to be released on 25 July – to get the Fed in that mood.

France: the trappings of summer

In those uncertain times for France, we put our faith in two things: the Constitution and arithmetic. The combination of the two provides a good guide out of the current maze.

In a public letter, the President of the Republic made it plain last week that he would take his time to appoint a new Prime Minister, calling on parties to find the compromises needed to build a majority. He initially refused Gabriel Attal's resignation. This means that, constitutionally, the French government can exercise the full scope of its role. The French Constitution makes a clear distinction between "regulatory power" – what government can do by decree, without parliamentary intervention – and "legislative power" which requires parliamentary approval. At the moment, Gabriel Attal is in full control of regulatory power. The President hinted at accepting Attal's resignation in the next few days, which will turn the government into a more restricted "current affairs" cabinet – which incidentally will allow ministers to take their seat in parliament – but there is no time limit to such state of affairs. In practice though, **a full-scope government will be needed to elaborate a budget for 2025 and steer it through the parliamentary process. The current "limbo" cannot thus extend too far into August**.

Article 8 of the Constitution makes it clear that the President can freely appoint any Prime Minister of his choosing. The limit of course is that, once parliament reconvenes, opposition groups can table a motion of no confidence which would force a resignation of the newly appointed Prime Minister if it is actively supported by the absolute majority of the lower House (289 seats). This is where arithmetic matters. There is still some uncertainty around the precise breakdown of the National Assembly across political groups since all deputies have not yet declared their affiliation, but Exhibit 3 below, based on counting by French newspaper Le Monde, is probably not far off the mark.

Exhibit 3 – Breakdown of the French National Assembly

French National Assembly breakdown (preliminary count)										
	LFI	PS	Greens	PC	Div left	Ensemble	Div Centre	Centre-right (LT+Div)	RN an allies	Others
Seats per group	*73*	*63*	*35*	*11*	13	168	6	60	143	5
Electoral blocks			182			168			143	
Coalition A							234			
Coalition B				*296*						
Coalition C					*356*					

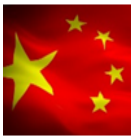
Sources: Le Monde, AXA IM Research, as of 14 July 2024

The different groups making up the left Alliance Nouveau Front Populaire are – so far unsuccessfully – negotiating to determine who they would propose as Prime Minister to the President. Again, the President is absolutely not bound by any proposal, but more importantly, it is highly likely that a PM supported by NFP alone would be immediately defeated by a motion of no confidence. It might be that the whole “intra-left” discussion is essentially a way for the various groups to prepare their electorate to a split in the alliance: the impossibility to agree on a name would allow all factions to take up their freedom. Within the main party within the Ensemble centrist alliance, Renaissance, tensions are flaring on whether a coalition should be symmetric – i.e., encompassing the centre-left and the centre-right – or if it should be skewed towards the centre right. Numerically, the clearest path to building a stable coalition comfortably above the absolute majority threshold would indeed consist in a symmetric deal. Now, there may be nuances around this. The main centre-right party, Les Republicains (LR), rejects the idea of participating to a coalition government, but also expressed some openness to a “legislative pact” offering support to a government on a case-by-case basis. This would be close to the British notion of “confidence and supply”, where a party does not participate to a government but commits – at certain conditions – to support a budget and abstains from voting of motion of no confidence.

Given the numerical and political constraints – presidential elections will take place in 3 years and the new legislature could end abruptly in one year once the President has the possibility to dissolve the National Assembly again – this sort of arrangements may also become attractive to some groups on the left as well. Parties embarked in a confidence and supply pact could pledge that they are doing their patriotic duty to help “unblock” the country, while maintaining enough political differentiation to retain their chances in the next elections.

Now, before such solution is reached, more “politicking” may have to take place. The election of the Chair of the National Assembly this week will provide some early indication of the level of convergence across political families. We have been arguing since the beginning of this political phase that the budget is the real deadline. While the services of the finance ministry are probably busy readying the technical aspects of the budget bill, they obviously cannot finalise anything without political instructions coming from a “full scope” government. The bill must be transmitted to parliament on 1 October. Around the same time, the French administration must transmit to the European Commission its medium-term fiscal adjustment plan by 20 September, with possibly some flexibility around the date. This matters a lot because a purely minimalist budget bill for 2025 would not suffice. Indeed, it is on the basis of the medium-term plan that the European authorities can decide whether to grant France 7 years, and not just 4, to bring its deficit back to 3%. However, in principle such extension – which would help minimise the adverse effect of the fiscal consolidation on aggregate demand – would be conditional on commitments on reforms and public investment. This suggests that the conversation needs to move rapidly from “intra-family” discussions to proper, granular cross-party negotiations on what could be concretely form the basis of the country’s macroeconomic strategy.

233 – 15 July 2024

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Democrat concerns about President's Biden's fitness to run • Fed Chair semi annual testimony. Q&A said labour market "cooling", economy not "overheated" • CPI inflation (Jun) headline and core fell to 3-yr lows, below expectations • PPI inflation (Jun) rose by 0.2%mom, 0.4% (core) • Jobless claims, broke increasing run	• Republican Convention should see Trump pick VP, might distract from Democrats' Biden concerns • Retail sales (Jun) weaker auto spend and soft credit card reports suggest a weaker report • Empire and Philly Fed surveys (Jul) both subdued • Housing starts (Jun) pick up from sharp may fall • Fed's Beige Book signs of any concerns in lbr mkt • Fed Chair Powell at Economic Club, Washington
	• Fr elections (2d rd) leftist alliance finished 1st, Ensemble 2nd and RN a surprise 3rd. Uncertain how France will form government from here, with early October budget a critical deadline • Sp inflation (Jun, f) headline inflation edged higher to 3.6% at 2nd estimate	• ECB rate announcement (Jul) no policy change expected with several speakers clear no follow up in July. Sept still looks likely for next ease • Ez IP (May) sharp drop expt'd mom following Ge fall • Ez inflation (Jun, f) headline and core expt'd unch • Ge ZEW survey (Jul) expectation have improved in recent months
	• BRC total sales -0.5% in Jun, from 0.4% in May • Monthly GDP rose a firmer 0.4%mom in May, raises Q2 GDP outlook. Construction jumps 1.9%mom, but IP, mfg ans services all rise • RICS house price balance held broadly steady at -17%, new buyer and seller enqs both rise	• CPI inflation likely unch at 2.0% in Jun, in line with BoE expectations • Unemp rate unch at 4.4%. AWE ex. bonuses likely dropped to around 5.7% in May, from 6% • Retail sales likely down by 0.1%mom in June • GfK cons. conf. should continue to recover
	• Yen jumps on suspected MOF intervention • Cash earnings up 2.7%yoy on common-sample basis in May • PPI inflation (Jun) up 0.2%mom, 3.0%yoy • Industrial prod (May, f) rev'd up to 3.6% (2.8%)	• Trade bal. incl. exports for June • CPI inflation likely unch at 2.8% in Jun, core rate to edge down to 2.4%, from 2.5%. Ex. food and energy to fall to 2%, from 2.1%
	• CPI (Jun): 0.2%yoy; PPI: -0.8% (May: 0.3%; -1.4%) • Exports (Jun): 8.6%yoy; Imports: -2.3% (May: 7.6%; +1.8%) • M2 supply (Jun): 6.2% (May: 7.0%); New loans growth (Jun): 2.13tn RMB (-30.2%yoy) • Total social financing (Jun): 3.3tn RMB (-21.9%yoy) • FDI (Jun): -29.1% ytd yoy (May: -28.2%)	• 15 Jul: Q2 GDP • 15 Jul: June monthly output (industrial production; retail sales, fix asset investment, house prices)
	• CB: Korea (3.5%), Malaysia (3.0%) & Peru (5.50%) stood on hold • June CPI (%yoy): Brazil (4.2%), Colombia (7.2%), Czechia (2.0%), Hungary (3.7%), Mexico (5.0%), Romania (4.9%) & Russia (8.6%)	• CB: Indonesia (6.25%) & South Africa (8.25%) are expected to stay on hold • May economic activity index in Brazil, Colombia & Peru • June trade data in Indonesia & Malaysia

Upcoming events		
	US:	Mon: Empire state survey (Jul), Fed Chair Powell at Economic Club, Washington, Republican National Convention (Mon-Wed); Tue: Retail sales (Jun), Business inventories (May), NAHB housing index (Jul); Wed: Housing starts (Jun), IP (Jun), Fed's Beige Book; Thu: jobless claims (Jul), Philadelphia Fed index (Jul)
	Euro Area:	Mon: EU20 IP (May); Tue: ZEW survey (Jul), It HICP (Jun); Wed: EU20 CPI (Jun); Thu: ECB announcement; Fri: Ge PPI (Jun)
	UK:	Wed: CPI (Jun), PPI (Jun), Kings speech; Thu: Labour market (May/Jun); Fri: GfK consumer confidence (Jul), PSNB (Jun), Retail sales (Jun)
	Japan:	Thu: Trade balance (Jun); Fri: CPI (Jun)
	China:	Mon: GDP (Q2), IP (Jun), Retail sales (Jun), 1y MLF rate announcement, China's Third Plenum (Mon to Thu)

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