Happy customers

93 – 31 May 2021

Key points

- The economic rebound triggered by the European reopening could be spectacular given strong consumer confidence and high cumulated excess saving. The European Central Bank (ECB) should look through it, but the debate on the post-PEPP stance has started in earnest. We take a good look at BdF Governor Villeroy de Galhau's latest speech. In the US, the debate on the appropriateness of Biden's economic policy continues. This week we focus on Adam Posen's critical view of his approach to trade.

Europe is re-opening. The summer of 2020 is probably going to be the point of reference to gauge the magnitude of the looming economic rebound. The "mechanical recovery" could be spectacular again this year (assuming no bad Covid news). Indeed, while there is less distance to cover from the winter recession, which has been shallower than during the first wave, key components of consumer confidence – intentions to make major purchases, labour market prospects – are better oriented today than in the summer of last year, while accumulated excess saving, mostly stored in the most liquid financial assets, is even larger than in Q3 2020.

Such sudden "liberation" of spending capacity – although it would not tell us much about the trajectory of the economy beyond 6 months – will probably draw even more attention to production bottlenecks and inflationary pressure. Still, we should refrain from being overly influenced by the American "overheating narrative" when looking at the European situation. We think a wide majority of the Governing Council – including most hawks – are convinced the risk of runaway inflation is close to zero on this side of the Atlantic. When they argue for "tapering" PEPP, they usually do it from the point of view of financial stability. The latest messages from the ECB make it very unlikely that the central bank would announce any reduction in the quantum of purchases at the June 10th meeting, but the policy conversation is only starting. We think it is already focusing on the looming battle on the calibration of the ECB's "ordinary QE" when PEPP is over. We take some time this week to dissect Banque de France Governor Villeroy de Galhau's latest policy speech, since in our opinion it lays the ground for what is likely to be the "doves" line of argumentation in this respect.

Meanwhile, in the US the latest dataflow is not helping the Fed's doves. In a context of mounting inflationary pressure, it is not surprising that the discission on the appropriateness of Biden's economic policy continues to heat up. This week we take a good look at Adam Posen's criticism of Biden's stance on international trade. What we find quite telling of the current intellectual mood in the US is that even when a prominent economist criticizes an element of Biden's economic policy on "orthodox grounds" – Summers' concern about the current overheating or Posen's defense of free trade – ultimately their recommendations go in the direction of more state intervention and higher taxation. The "Washington consensus" of the early 1990s is well and truly dead.

Households stop hibernating

As the European economies are gradually reopening, we should get ready for a spectacular rebound in spending. We have been there before, and Q3 2020 should be the point of reference when assessing its magnitude. True, there is less “automatic catch-up” potential since last winter’s recession has been quite shallow when compared with the complete collapse of the first half of 2020, but judging by available soft data, the rebound is still likely to be very steep. Business surveys in the all-important services sector have only just recovered to their level of late spring/early summer 2020, but some key components of consumer confidence are in a much better shape. Intentions to make major purchases in the next 12 months are already one standard deviation above their long-term average, while last summer they had barely returned to it. This may be a simple reflection of the fact that the vaccines offer a chance that the latest lockdown would be the last one, offering better visibility on the outlook, but in any case, it is consistent with the improvement in households’ perceptions of their labour market prospects (Exhibit 1).

This would suggest that the precautionary motive should not impair the decompression of the “saving bubble” too much. We made the point a month ago in Macrocast that in France in particular the potential for a very strong rebound in consumer spending was high since it is the European country where last summer the saving ratio came closest to full normalization. The sector accounts have just been released for Q1 2021 for France and Germany. Unsurprisingly, they show that the saving rate did not move much relative to the end of 2020, staying between 7 and 10 percentage points above their long-term average. Mechanically, this means that households have accumulated even more spending potential. Last summer, in both countries “cumulative excess saving”, i.e., the quantum of financial power which had been built in the first half of the year - which we proxy by cumulating the difference between the actual saving rate and its long-term average since the start of the pandemic - stood at less than 10% of disposable income. By the start of the spring of 2021, it had reached 35% (see Exhibit 2).

Exhibit 1 – Perkier than last summer

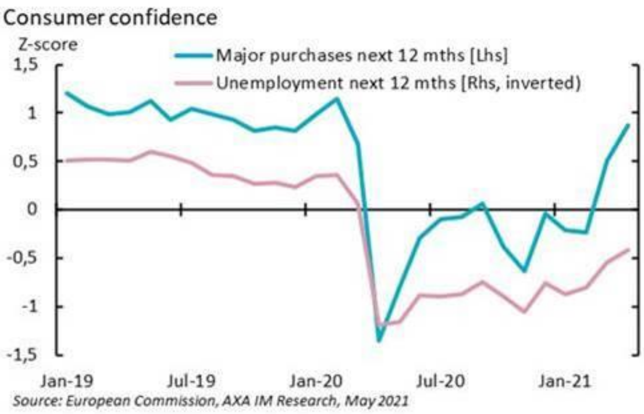
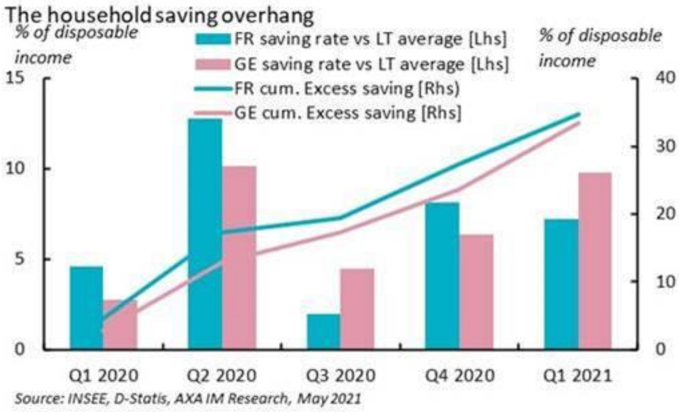


Exhibit 2 – Lots of money ready to be spent….



Financial accounts are not yet available for Q1 2021, but we have data for bank deposits from the ECB**: As of March 2021, the preference for liquid assets has not abated and overnight deposit have passed the bar of EUR 5trn**, 15% above their pre-pandemic level (a jump equivalent to 5.8% of annual GDP) and 8% above June of last year. Many ingredients are there for a summer splurge. Some of it will probably materialize in Q2 already, so that we will need to look at Q2 and Q3 together to measure the “mechanical” part of the recovery, but we are now bracing for some bumper figures, assuming of course that no bad news emerges on the pandemic front.

ECB: preparing for the summer break?

Significant injection of dormant deposits into the economy will probably exacerbate the “bottlenecks”, adding to some underlying price pressure. Still, **we think that we should refrain from being overly influenced by the American “overheating narrative” when looking at the European situation**. INSEE revised down French Q1 GDP by 0.5% back into marginally negative territory at -0.1%qoq (this was due to new information about lower-than-expected activity in construction). France was the only big member state which was thought to have experienced positive growth in Q1. Before taking on board this revision, the gap relative to the pre-pandemic GDP level was already at 5.5% in the Euro area, against less than 1% in the US. The fiscal stance is not as supportive, and none of the features of the US policy packages which may be contributing to the pressure on supply at the moment – in particular over-generous unemployment benefits – can be found in Europe.

While in the US consumers are definitely showing signs of acute "inflation anxiety", there is little sign the same is happening in the Euro area. We cannot directly compare survey-based inflation expectations in the household sector across the Atlantic. The University of Michigan asks respondents to provide a precise, numerical inflation forecast up to 5 year ahead, while the European Commission only provides a balance of opinion on the general direction of consumers prices. Still, while the former is now 2 standard deviation above its long-term average, the latter has barely normalized (see Exhibit 3).

Exhibit 3 – Not bothered (at least not yet)

This will need to be closely monitored in the months ahead of course – base effects will materialize in European prices as well and this may impress consumers - but even the most hawkish members of the ECB Governing Council are relaxed about inflation prospects on their side of the Atlantic, but interestingly the debate in Frankfurt looks eerily close to the policy discussion at the Fed's FOMC.

Two weeks ago, in Macrocast we expressed our scepticism towards Goldman Sachs call for the ECB to "taper" at the June 10 meeting. GS's position remained quite isolated, but generic concerns around the central bank' resolve were mounting, contributing to the further drift upward in market interest rates. This has partly reversed last week after Christine Lagarde came out clearly against any hasty decisions, a position backed by several Council members in the following days. Among last week's plentiful "ECB speak", **we would single out Banque de France Governor Villeroy de Galhau's speech on May 25th, which provided a comprehensive review of the ECB strategy which in our view nicely encapsulates – from a "dovish angle – what is likely to be the discussion at the Governing Council.**

Beyond the short-term message to bond investors ("*let me be crystal-clear: any hypothesis of a reduction of purchases partly for Q3 or the following quarters is purely speculative"*), Villeroy de Galhau's speech starts from the basics: what should the ECB's objective be. He repeats a point he has made several times before: the central bank needs to address the ambiguity of its definition of price stability – "below but close to 2%" – to make it clear it is properly symmetric. Such symmetry would allow for some inflation overshooting, necessary to re-anchor long-term inflation expectations towards 2%: *"it is even more important to stress that we are ready to accept inflation moderately higher than 2% for some time to anchor fully medium-term inflation expectations"*. This is very close to the Fed's "Average Inflation targeting" framework.

We also find it interesting that he explicitly analysed the weakness in inflation – which pre-dates the pandemic – as partly the result of a "demand deficit". He vigorously defended the "Phillips curve" in his speech. This matters for the future discussion at the Governing Council. Indeed, the lower inflation is seen as the product of "structural forces", the easier it will be for hawks to argue there are limits to what the central bank can do to restore it to its target. If however demand still needs some support to become consistent with a 2% inflation rate, then there is still space for monetary stimulus.

These are far from purely theoretical points. If we retain the view that the objective of the Pandemic Emergency Purchase Programme (PEPP) is "*not to bring inflation fully back to 2% (but) to counter the downward impact of the pandemic on the projected path of inflation*", to borrow words from Isabel Schnabel's interview last week, then the real big issue is what to do with the ECB's ordinary quantitative programme when PEPP stops. If Villeroy's line prevails, then the additional phase of sub-par inflation triggered by the pandemic should not be forgotten. This is how we understand his point that *"we assess inflation performance over a long enough period, looking forward, but <u>also not ignoring the past</u>"*. Although the Governor did not make the point explicitly in his speech, **this new focus on symmetry, and a belief in the efficiency of monetary policy to lift inflation through action on demand, would be consistent with upgrading the pace of APP upon dismantling PEPP**.

In practice, the June 10th meeting should not be the occasion for too much pyrotechnics. It is not entirely 100% guaranteed that the ECB will be able to enjoy a quiet summer break though. Indeed, although "tapering" is for now off the cards, the ECB still has allowed yields to rise these last few months, and it is not clear if "skipping June" on the calibration of PEPP will be enough to keep the benefits of last week's bond rally, especially if positive surprises on key inflation data, however transitory they may be, fuel some market unease (this week's May inflation numbers may be of interest from that point of view). Communication from the ECB is going to be crucial. Isabel Schnabel, although she implicitly endorsed the notion that no tapering would be announced in June, said last week that "rising *yields are a natural development at a turning point in the recovery: investors become more optimistic, inflation expectations rise and, as a result, nominal yields go up. This is precisely what we would expect and what we want to see"*. While this assessment came with a lot of qualifiers later in the interview, an issue is that distinguishing in real time what is a natural upgrading of yields due to an improved outlook from a potentially harmful tightening in financial conditions can be tricky.

Fundamentally, focus should move away from the gyrations of PEPP to the "strategy review". Villeroy de Galhau has made his positions in this debate clear. Let's see what comes next from the hawks, but for four part, a central banker who manages to quote Voltaire in a speech about monetary policy cannot be entirely wrong. Still, even if the strategy review is supposed to provide guidance for the long-term, its conclusions may be impacted by the cyclical conditions prevailing at the time of the debate. If we are right and the Euro area goes through several months of very strong consumer demand, it can play in the hawks' hands, even if such a rebound would not tell us much about where the economy would go next year.

Posen versus Biden

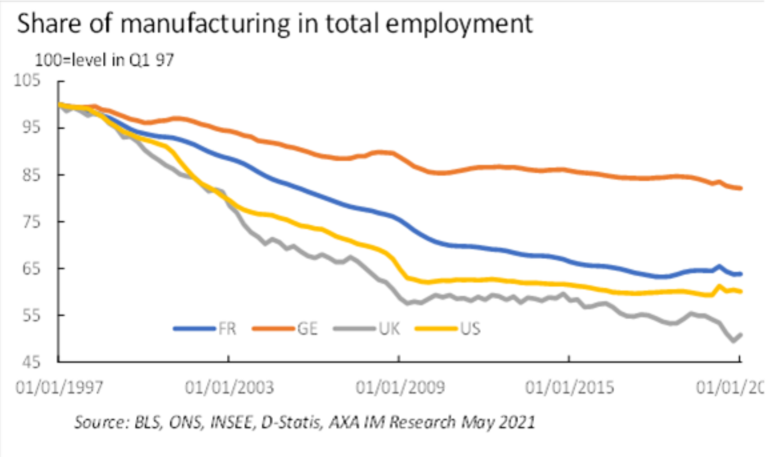
Last week's US data flow did not help the local doves. The April Personal Consumption Deflator print did not reveal much more than what we already knew from the consumer price index (it's going up sharply, but price pressure is not widespread across sectors), but the second estimate of the May Michigan survey confirmed the strength of US households' inflation forecasts: the 5-year ahead one was only marginally revised down to 3.0% from 3.1% in the initial release, still around 2 standard deviations above its long-term average and noticeably higher than before the pandemic struck. Fed's Vice-Chair Clarida on May 25th made it plain that the exact timeline of the beginning of the discussion on tapering, which he expects for "*upcoming meetings*" (don't miss the "s" at the end), would be data dependent. This puts this coming Friday's payroll number for May crucial – the market expects a healthy rebound to 600K from the disappointing 266K in April. While the majority of the FOMC around Jay Powell continue to stick to the "transitory inflation" narrative, we think it's fair to say that they are not fully comfortable with the speed to which the rebound in consumer prices is materializing.

In this context, it is not surprising that the discission on the appropriateness of Biden's economic policy continues to heat up, including within Democratic/Keynesian circles. Larry Summers opened the salvo at the beginning of the year, criticizing Biden for getting the sequence between demand stimulus and infrastructure investment wrong. More recently, **Adam Posen, head of the Peterson Institute and former member of the Bank of England Monetary Policy Committee, came out with a fierce criticism of Biden's trade policy** in a piece for "Foreign Affairs" two weeks ago, titled "the price of nostalgia".

Posen starts from the “Foreign Policy for the Middle Class” report which we commented in our first Macrocast of the new year, which constitutes the backbone of “Bidenism” when it comes to trade policy. This approach marks a U-turn from the “Clintonian era” of the early 1990s when the Democrats embraced free trade without much reservation. International trade, in particular with China, is now seen as having jeopardized the US manufacturing base, which in turn can explain the shift to populism of blue collars. While not as blatantly protectionist as the “Trumpian strategy”, such approach would call for a muscular attitude towards trade.

There are two pillars to Posen’s criticism**. First, the US is one of the developed nations which has opened to trade the least in the last 20 years, judging by the share of exports and imports in GDP.** For all the clamouring about losing out to foreign producers, Posen highlights the fact that “*since 2000, the U.S. government has brought into force deals with a number of extremely small economies, primarily for foreign policy, rather than economic, reasons (…) In the last 20 years, only the 2012 U.S.-Korea Free Trade Agreement, a deal with South Korea, has required any measurable liberalization, and even it included greater protections for U.S. manufacturers of light trucks*”. His point is that various lobbying groups have been very effective in protecting large chunks of the US economy from international, competition even if the end result in terms of staving off deindustrialization has been very limited. Actually, countries such as Germany which have embraced international trade with far more gusto, have been able to protect manufacturing employment much better than the US even if the relative disappearance of manufacturing jobs is a trend observable across the whole developed world (see Exhibit 4).

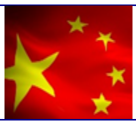
Exhibit 4 – De-industrialisation trends



The second pillar is more of a political nature. **Posen considers that the obsession with protecting manufacturing jobs** – which reveals a nostalgia for the 1950s and 1960s when industry could provide well-paying, stable jobs to the non-college educated part of the US population – is ultimately a misallocation of policy energy as it would unfairly help one demographic group against others. Posen’s point is that white males are over-represented in manufacturing, while the development of low-paying precarious jobs in the services, in which women and men from ethnic minorities are over-represented, should deserve more attention.

In a nutshell, Posen dusts off the old left-of-centre argument in favour of free trade, that tariffs and protecting sectoral rents ultimately hurts the most disadvantaged part of the society. Given his angle, it is not surprising that, when it comes to policy recommendations, Posen ends up arguing in favour of European-style “social-democratic” solutions: *“what is needed are universal benefits that protect individuals and families, rather than jobs and places”.*

We can’t do full justice to Posen’s carefully crafted argument here, but **what we find quite telling of the current intellectual mood in the US is that even when a prominent economist criticizes an element of Biden’s economic policy on “orthodox grounds”** – Summers’ concern the current overheating will force an early monetary policy tightening which will jeopardize the whole experiment, Posen’s defence of free trade – **ultimately their recommendations go in the direction of more state intervention and higher taxation. The “Washington consensus” of the early 1990s is well and truly dead.**

Country/Region	What we focused on last week	What we will focus on in next weeks
	• PCE inflation Apr, 'core' measure expected to rise to 3.1%, nr 30-year high • Personal income and spending (Apr), expected to normalise (-13%, +0.5%) after stimulus boost in Mar • Q1 GDP unrevised at 6.4% (saar), but consumption revised higher to 11.3% from 10.7% • New home sales -5.9% (Apr), pending sales -4.4% and latest week's mortgage applications -4.2% • Durable goods (ex transport) rise by 1.0% (Apr)	• Non-farm payrolls report for May. April's 266k disappointed, markets expect 600k with unemployment dropping back to 5.9% - release will be key to set tone for Fed's meeting in June • ISM manufacturing and services reports (May), both are elevated above 60 and expected to remain so • Fed publishes its Beige Book, providing anecdotal summary of business conditions • Total vehicle sales (May), April soared to 18.5m
	• Survey data remained strong. Commission survey in May rose to 11.5 (from 10.9), Ge IfO rose to 102.9 – 2017 high, Fr business confidence reached 108 from 96 • Fr Q1 GDP revised to -0.1% q/q from +0.4% • Fr consumer spending -8.3% (Apr), after -0.3% (Mar), restriction easing to see May rebound	• Euro area CPI (May, p), further rise expected from April's 1.6% y/y (and key states) • Euro area unemployment (Apr), expected unchanged at 8.1% (and key states) • Final PMI estimates, 62.8 M & 55.1 S (May, p) • Euro area retail sales (Apr) • It Q1 GDP revisions, pre lest -0.4%qoq
	• Indian variant cases rise to 7.0k from 3.4k, third week with 100%+ growth rate • Public finances (Apr) rise to £31bn, from £25bn in Mar, but below deficit recorded one year ago • CBI retail survey suggested retail sales retraced after initial surge in April	• Wary of continued spread of Indian variant, monitoring hospitalisations • Final M & S PMIs (May), 66.1 and 61.8 (p) • BoE lending data (Apr), look to scale of ongoing support for housing market • Nationwide HPI (May), 7.1% (Apr) • G7 Finance Ministers meeting in London
	• Japan considers extension to State of Emerg, beyond 31 May deadline to mid-June • Unemp rate (Apr) rises to 2.8% from 2.6% • Tokyo CPI inflation (May) inches higher to -0.4%yoy from -0.6% in April	• Industrial production rises 4.0% in April prel releases, supports outlook for +ve GDP in Q2 • Retail sales (Apr) expected -1.0%, after +1.2% in March • Final PMI estimates
	• Industrial profit continues to grow at a solid pace due to strong demand and rising commodity prices	• The PMI to suggest that manufacturing activity continues to expand, but rising input costs and supply bottlenecks are two key concerns
	• Q1 GDP final release in Mexico better than expected – upside risks for FY2021 forecasts • CB in Indonesia (3.5%), Korea (0.5%), Hungary (0.6%) all on hold but hawkishness in Hungary with a first hike signalled in June • One of the four Turkish CB deputy governors removed	• RBI meeting in India (4%) expected on hold • May PMI survey released across the board • May CPI in Korea, Indo, Phil, Thailand, Peru • April IP in Korea, Thai, Turkey, Brazil, Uruguay • Q1 GDP in India, Turkey, Brazil • June 6 elections: mid-terms in Mexico (Morena expected to lose super majority), 2nd round in Peru presidential elections (tight polls)

Upcoming events	**US :**	Tue: ISM mfg index (May); Wed: Fed Beige Book; Thu: Jobless claims, ADP employment chg (May), ISM non-mfg index (May); Fri: Non-farm payrolls (May)
	Euro Area:	Mon: Ge, It, Sp HICP (prel., May); Tue: EA HICP 'flash' est. (May), EA, Ge unemp (May), It, Sp mfg PMI (May); Wed: EA PPI (Apr); Thu: EA Comp PMI (final, May), Ge, It, Sp Serv PMI (May)
	UK:	Tue: Mfg PMI (final); Wed: Mortgage approvals (Apr); Thu: Comp&Serv PMI (final, May); Fri: SMMT new car reg (May), Construction PMI (May)
	Japan:	Mon: Consume confidence (May), Housing starts (Apr)
	China:	Mon: Official mfg&non-mfg PMI (May); Tue: Caixin mfg PMI (May); Thu: Caixin serv PMI (May)

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