How to stop a house fire

113 – 22 November 2021

Key points

- US "excess demand for goods" played a key role in the emergence of global bottlenecks
- Even cut in half, Joe Biden's green and social package will have a noticeable impact on the deficit next year
- Some at the ECB are looking at house prices through monetary policy lens. Focusing on the French example, we think it still makes sense to allow macro-prudential measures to work their way first.

At the peak of the pandemic the shift in household consumption towards goods often supplied via long and tortuous global value chains, to the detriment of services, has been a key driver of the emergence of bottlenecks and the ongoing inflation spike. We think we need to be more granular though. In Europe or In Japan, while the share of goods in household spending has indeed risen, the volume of this form of consumption did not increase relative to the pre-pandemic level. The US, conversely, has seen the steepest rise in consumption of goods ever recorded in the national accounts since they have been made available in 1947, standing in the third quarter (Q3 2021) at 15% above the Q4 2019 level. Given the still dominant role US consumption plays (30% of the world's consumer spending in nominal US dollars), this has been a key source of tension on global capacity. The latest developments on this front are reassuring: US consumption in goods has started to recede.

The House of Representatives has finally passed the shrunk version of Joe Biden's green and social package, which still needs to clear the Senate hurdle. Headlines reporting on the Crogressional Budget Office (CBO) assessment were misleading. While over 10 years its impact on the deficit would be very small, in the first few years it will be noticeable (0.7% of GDP for 2022). True, even combined with the investment programme passed earlier this year it is a much smaller stimulus than the packages of the last two years. However, a lot of the 2020 and early 2021 stimulus has been stored in the form of excess household saving, which constitutes an interesting "reserve of demand" ahead.

Fast-rising house prices seem to be ranking high in the European Central Bank (ECB)'s preoccupations. We were intrigued by Isabel Schnabel's statement on the possibility it could affect the central bank's reaction function. We estimated a simple model of French house prices to explore the issue. Our conclusion is that the ECB should start by giving time to macro-prudential measures before using the blunt tools of monetary policy to try to curb house prices. The direct contribution of interest rates to the further rise of the last few years has been modest. The steps taken by Banque de France to stop the lengthening of mortgage terms and cap the share of disposable income which can be spent on mortgage servicing seem to start having some dampening effect.

US demand and global bottlenecks

While commentators – including your humble servant – spend a lot of energy on analysing the developments in global supply in the aftermaths of the Covid crisis, this week we want to turn our gaze to the specific role US demand has been playing in the emergence of massive global bottlenecks, and hence global inflation.

We have already commented in Macrocast on the shift in consumption patterns away from "experiences" (mostly services) towards "stuff" (i.e. goods) as sanitary restrictions peaked. "Stuff" can and is internationally traded along sometimes tortuous value chains, while experiences – with the notable exception of foreign tourism – cannot. More spending on goods than on services would then make global production bottlenecks more likely. However, this should not be an issue if only the share of goods in total consumption rises while the overall volume of goods consumption doesn't increase. This is where the US is in a very specific situation.

Exhibit 1 – Still a bit under the weather…

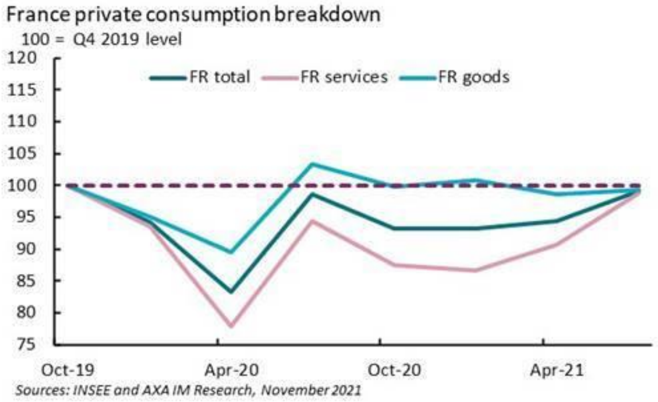
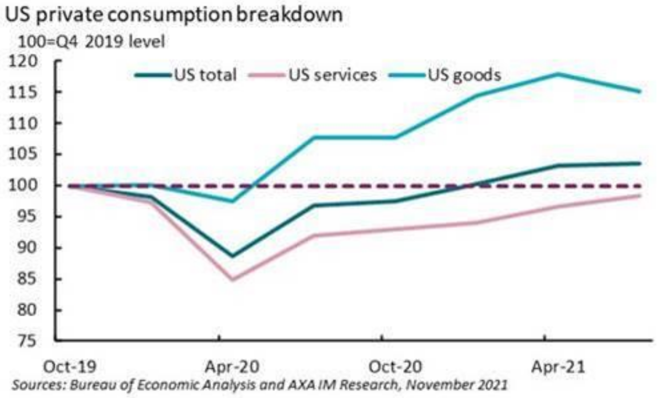


Exhibit 2 – Massive re-composition of US consumption



Let's first consider the case of France (the only large Euro area countries for which we have details for GDP components up to Q3 2021). There, the share of goods in total household consumption duly rose from 46% in Q4 2019 to 50% at the peak of the lockdown, but crucially, the volume of private consumption in goods in the summer of 2021 was (slightly) below its pre-pandemic level (Exhibit 1). The same was observed in Japan. There, as of Q3 2021, private consumption in goods there was still *lower* than before the pandemic started. The US stands out, with a level of consumption of goods in Q3 2021 15% higher than in Q4 2019 (Exhibit 2). To put this in perspective, **the pandemic explosion in US consumption of goods is the steepest seven quarter gain ever seen since the data became available in 1947** (Exhibit 3). The last time it had been almost as buoyant was in the late-1990s.

Exhibit 3 – The rise in consumption in goods since the pandemic is the steepest on record in the US

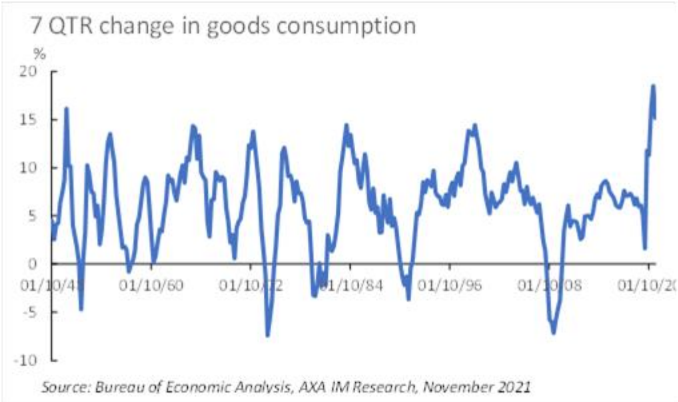
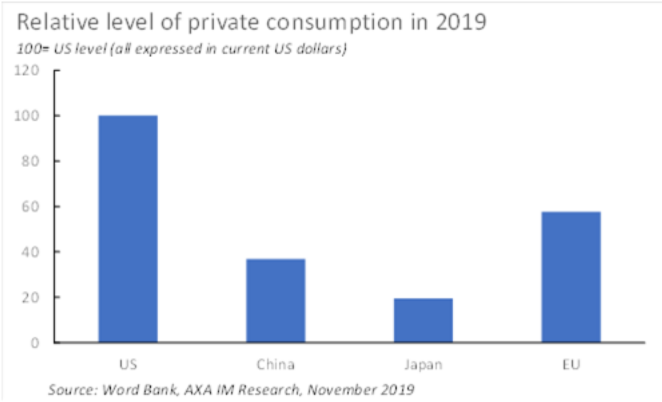


Exhibit 4 – US consumption is still dominant



Still, one could argue that such an explosion in US tradable consumption could not have had a massive impact on global supply given the trend decline in the relative size of the US economy. This would be neglecting an important fact: while the US share in world output, or GDP, is no longer dominant, it is still massive when it comes to global consumption.

When using the nominal dollars measure, before the pandemic US consumption was already larger than the EU's and China's taken together (Exhibit 4), standing at 30% of total world consumption according to the World Bank data. Here we do not use the purchasing parity measure, which takes into account local price level conditions, which is useful to assess the relative development of an economy but also tends to under-state the traction of the most developed nations on international trade. Indeed, countries import and export goods expressed in "hard dollars", not in "purchasing parity units". A disproportionate share of the world's output is already dedicated to service US demand in normal circumstances. Since the pandemic struck – and while world output was still impaired by sanitary restriction – this already dominant market has gone through its fastest ever growth in its demand for goods**. The US exuberance on tradable spending in the last 1.5 years has played a decisive role in stoking the global inflationary pressure.**

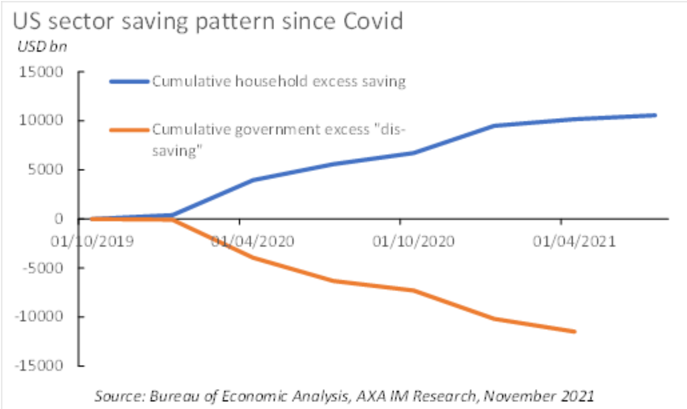
The recent dataflow is on the whole reassuring on the additional pressure global supply should get from US demand. The consumption pattern is normalizing. **Spending on goods by US households fell by 2.4% in Q3 2021** while aggregate consumption continued to rise. Yet, even after this decline the share of goods in total consumption was still high last summer, at 40.2%, against 36.1% in Q4 2019, which points to further contractions in the quarters ahead. This should reduce the need to import from the rest of the world and hence curb the pressure on global supply. Interestingly, **just when goods consumption fell, Q3 2021 was the first quarter imports of goods declined on a quarter-on-quarter basis in the US since Q2 2020**. It was still a tiny drop (-0.1%), as the impact of the decline in consumption was almost entirely offset by a positive contribution from import-intensive inventories to GDP, possibly as an attempt by US producers and retailers to protect themselves against further supply disruptions. All in all, even if US consumer spending on aggregate is likely to remain healthy looking ahead – more on the fiscal determinants of this in the next section – **we think the worst of the pressure exerted by the explosion in demand for "stuff" by American households is behind us.**

Where is US fiscal policy heading?

The House of Representatives has just endorsed the latest version of Joe Biden's social and green USD1.75tn package. Although it has already been cut in half relative to the initial project, this may be shrunk further through the Senate process. So far, the press has been focusing on the CBO's estimate of the total increase in the federal deficit triggered by this package of USD367bn over 10 years, which may look small (that would be 0.1/0.2% of GDP per year). However, such approach is misleading since this estimate takes on board a net reduction in the deficit from 2027 onward, as the tax measures would yield their full effect later than the spending ones. Net expenditure (i.e. the deficit) would rise by USD155bn in 2022 and 161bn in 2023 (roughly 0.7% of GDP each year). When focusing on the impact on demand, most of the tax hikes will hit either wealthy individuals or big corporations, i.e. triggering little immediate impact on spending, while the boost in government expenditure will disproportionately support the income of those at the lower end of the income ladder with a high propensity to spend. **In other words, combined with the beginning of the infrastructure programme, this new Biden package – as it stands today – will make the fiscal stance in 2022 very accommodative**.

True, when compared with the last two years, these latest instalments of fiscal stimulus are quite small, but one should keep in mind the fact **that a large part of the fiscal pushes of 2020 and 2021 is still "stored" in the form of excess savings by households, creating an important "reserve of demand" for the years ahead**. We illustrate this in Exhibit 5. We compare there the excess savings accumulated by US households (by difference with the savings rate before the pandemic) with the excess "dis-saving" by the US government (federal and local government taken together), in a nutshell the cumulative difference with the pre-pandemic level of the fiscal deficit. The similarity of the two is striking. While the saving ratio of the US households has fallen significantly relative to peak Covid, it is still about 1 percentage point above the 2019 average. On average, US households have been able to increase their spending without digging into the cash windfalls of the last two years.

Exhibit 5 – We know where the money went….



House prices: it's not all about interest rates

Fast-rising house prices seem to rank high in the ECB's preoccupations at the moment. Board member Isabel Schnabel devoted a large share of her recent speech on "monetary policy and inequality" on this issue which could illustrate a key adverse effect of unconventional monetary policy: a difficulty for the younger and the poorer to step on the property ladder, with a potentially negative effect on potential growth since it would impair workers' geographical re-allocation, *"exacerbating labour shortages in major cities".* In his pre-presentation of the ECB's latest financial stability report, Luis de Guindos also highlighted developments in the housing sector as an area of concern.

A crucial issue here is to determine how much this issue is directly relevant to monetary policy, or if this still lies resolutely in the realm of macro-prudential policies. Isabel Schnabel clearly believes the former. She insisted on the inclusion of house prices in the measure of inflation by the ECB, and explicitly acknowledged in her speech that this would have a bearing on the ECB reaction function: *"in the second quarter of this year, owner-occupied housing would have contributed between 0.4 and 0.5 percentage points to a new, augmented Harmonised Index of Consumer Prices (HICP). Should we judge that differences of this magnitude are likely to persist over the medium term, they then become relevant for the appropriate calibration of our monetary policy stance".* This would mean that the ECB would choose to focus on the demand-side of the equation. To reduce house prices and, ultimately, to keep this new "extended" version of consumer prices in check, a rise in interest rates would be warranted (probably first by terminating quantitative easing, and if it's not enough by hiking policy rates). Beyond the fact that we fail to see how it would help those with limited means to get on the property ladder – the resulting rise in mortgage payments would likely exclude them as surely as mounting prices – there might be less spectacular manners to dampen house prices, focusing on loan supply.

To explore this, we estimated a simplified model of French house prices over the last 15 years. There are three reasons why we focus on France. First, because housing developments in this country were highlighted by Schnabel as calling for attention. Second, because Banque de France is experimenting with a macro-prudential approach which could curb the rise in house prices without requiring the intervention of monetary policy. Third, because the French statistical apparatus offers good quality data in this field, which is not always the case across the whole Euro area.

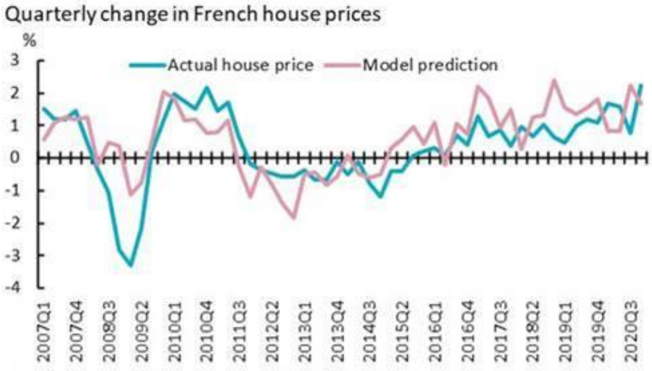
We seek to explain the quarterly change in house prices in France (INSEE source) using first the most traditional drivers: changes in household gross disposable income and mortgage rates (Banque de France source). We add the unemployment gap (difference between the current unemployment rate and its trend value) as a proxy of uncertainty households may face when taking long-term financial obligations, and finally a supply-side indicator: the balance of opinion on credit standards on lending for house purchase in the Banque de France Bank Lending Survey. We also inject in this equation the residual of the (robust) long-term relationship between the level of house prices and the level of disposable income (situations of prices/income divergence force a "correction" in the following quarters). The details of the estimates are in Exhibit 6. The model does a good job of predicting the key inflexions in French house prices (Exhibit 7), even though it failed to capture the full depth of the correction during the Great Financial crisis of 2008/2009.

Exhibit 6 – A simple model for French house prices…

Explained variable: quarterly % change in house prices	
Explanatory variables:	**Coefficient**
Qtr % change in gross disposable income	0.99***
Unemployment gap	-0.72 ***
2 qtr lagged change in mortgage interest rate	-2.4**
3 qtr lagged change in credit standards for house lending	-0.03 **
Residual from LT income/house price level equation	-8.5 **
R2=0.5 Mean error: 1.1 Sample: 2004Q1/2020Q4	
***: 1% confidence, **: 5%	

Sources: AXA IM Research, 19 November 2021

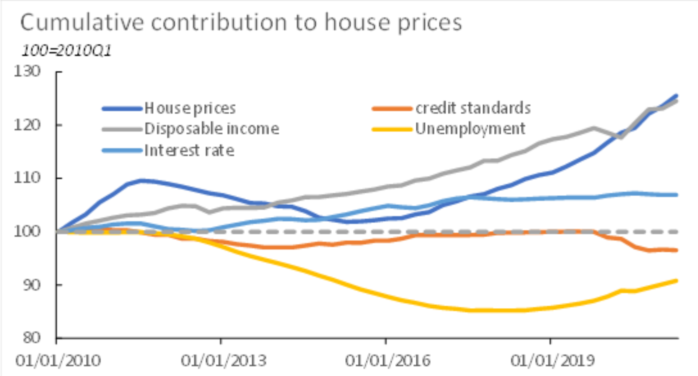
Exhibit 7 – …does a decent job



Sources: INSEE and AXA IM Research, November 2021

We used our model to compute the cumulative contributions of each factor to the rise in house prices over the last 10 years (Exhibit 8). The results are quite reassuring in the sense that **the largest contribution over the full period by far came from the growth in disposable income** (note that the sum of the contributions is not exactly equal to the overall rise in house prices since we took out the contribution from the constant and the residuals to keep the graph as readable as possible). **The contribution from interest rates has been flat since 2017**, reflecting the limited variance in mortgage rates since then (they marginally fell from the already historically low 1.4% on average in Q1 2017 to 1.1% in Q3 2021). Interestingly though, according to our model, the decent quantum of reduction in mortgage rates between 2010 and 2017 (250 basis points) only had a limited impact on house prices (c.6% cumulatively). Note as well that its effect at the time was more than offset by the rise in the unemployment rate to keep French house prices broadly in check. But our focus lies elsewhere. **The introduction of the banks' lending standards in our model allows us to substantiate the impact macro-prudential measures could have on curbing any additional rise in house prices.**

Exhibit 8 – It's less about interest rates than you would think

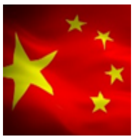


Source: INSEE, Banque de France, AXA IM Research, November 2021

In the absence of regulatory intervention, credit standards evolve in line with banks' assessment of the risk they take when extending credit, which is dependent on their macroeconomic outlook and the valuation of the assets they finance, together with the banks' own financial position (credit standards tightened during the Great Financial crisis and the Euro area sovereign crisis when banks were facing actual or potential difficulties to access wholesale funding). Naturally, that banks would initially react to the pandemic crisis by tightening their credit standards makes a lot of sense. This has brought a small but visible negative contribution to French house prices since the end of last year according to our model. **What is surprising in the French case is that after loosening them in late 2020 and early 2021, the latest instalment of the Bank Lending Survey revealed another steep tightening in credit standards on mortgage origination**, although macroeconomic conditions eased noticeably in France at the time. No such move was seen in Germany for instance, and no "funding crunch" occurred on the wholesale money market.

We are tempted to ascribe this tightening to the messages on mortgage origination from Banque de France via the High Council for Financial Stability. They started as non-binding recommendations to banks not to extend loans beyond 25 years – the lengthening in mortgage terms had been relentless over the last two decades, allowing to keep monthly capital repayments small enough to accommodate rising house prices – while keeping the mortgage servicing costs at below 35% of the borrower income. In September 2021, a decision was made to make this mandatory to French banks from January 2022 onward, but the origination of non-conforming loans had already started to contract earlier this year. Note that given the lags in our model, we would not expect the tightening in credit standards to have a material impact on house prices before next year. Yet, there are already some tentative signs of a slowdown in some of the frothiest segments of the French market, e.g. in Paris.

Our view is that the ECB should allow time for macro-prudential measures to work their way through the residential real estate market before "jumping the gun" on using monetary policy to address the issue. Terminating quantitative easing early, or worse hiking policy rates quickly, to react to higher house prices are terribly blunt instruments. There are more "surgical" measures at the disposal of regulators.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CBO estimates Biden package to total $1.6tn spending, but $376bn deficit • President Biden & Xi summit – no sig outcomes • Retail sales (Oct) rise 1.7%mom, and 1.6% in 'control' – solid boost for Q4 GDP • Empire State and Philly Fed surveys (Nov) post marked gains – easing supply-constraints? • Industrial output (Oct) surges 1.6%mom (1.2%) • Business inventories gain strongly (Sep) 0.7% • Housing starts and building permits (Sep) easing	• President Biden suggested Fed Chair decision by Thanksgiving - expect Powell for 2nd term • House passing Biden's $1.6trn spending bill, look to amendment from the Senate • Revisions and details Q3 GDP, including aggregate corporate profit report • FOMC meeting minutes (Oct) • New and existing home sales (Oct), signs of softening demand • Post-Thanksgiving sales reports
	• New covid outbreak, lockdown in Austria, strict restrictions returned elsewhere • Q3 employment figures improved to reach 0.5% below pre-pandemic level • Oct car registration remains very volatile and declined everywhere after a rebound in Sept • Oct Ge producer price surged to 18.4%yoy	• Worsening COVID outbreak / Worth watching government response especially in Germany • Nov Flash consumer confid is expected to ease but do not take into account covid outbreak • Nov Mfg and Svcs Flash PMI in Ge/Fr/EMU • IFO/business surveys in Ge/Fr/It • Oct loans to households/non-fin
	• Inflation beat expectations reaching 10y high of 4.2%yoy in Oct. Prices set to rise further • Unemp (Sep) fell to 4.3% and Oct payrolls suggested no adverse post-furlough effect • Retail sales (Oct) +0.8% m/m and 1.6% ex fuel sales – the first month of growth since April • UK renews Art 16 threat of NI Protocol • BoE announces consultation on CBDC- Britcoin	• UK flash PMIs (Oct) – supply chain pressures and staff shortages likely to limit further gains • Nationwide HPI and mortgage approvals (Nov) – expect further softening amidst rate increases and income squeeze • BoE's Haskell to speak on Tues
	• Prelim GDP figures (Q3) was disappointed (-0.8%qoq). Priv cons, capex and exports fell • Gov unveils a ¥56tn spending package (10% of GDP) with cash handouts, subsidies to covid-hit firms but details lack for the remainder	• Further details on supp budget should be unveiled. We believe figures are inflated by loans, guarantees and reserves • Nov Flash Mfg PMI and business activity survey should point to robust activity
	• Industrial output growth recovers as power shortages abate and mining activity surges • Consumer spending beats in nominal terms, but remains depressed after price adjustment	• Policy fine-tuning has started; more incremental measures could be forthcoming
	• Rate hikes in Hungary (+30bps to 2.10%), South Africa (+25bps to 3.75%). Indonesia and Philippines stood on hold at 3.5% and 2.0%, respectively. Turkey cut 100bps to 15% • Q3 GDP slowed in Colombia (13.2%), Chile (17.2%), Hungary (6.1%), Romania (7.2%) and Russia (4.3%). It fell in Thailand (-0.3%) • Inflation (Oct)	• Reaction to the presidential and legislative elections in Chile (Sunday) • Industrial production will likely rebound strongly in Singapore and moderate in Taiwan • Korea should hike its policy rate +25bp to 1.0% • Peru Q3 GDP should slow to 10.8% (Q2: 41.9%) • Inflation (Oct) should pick up in Singapore

Upcoming events		
	US :	Mon: Existing home sales (Oct); Tue: PMI (Nov,p); Wed: GDP (Q3,p), Durable goods orders (Oct), trade (goods) (Oct), Weekly jobless claims, personal income & spending (Oct), Michigan consumer sentiment (Nov), New home sales (Oct); Thu: Thanksgiving
	Euro Area:	Mon: EU19 Consumer confidence (Nov,p); Tue: EU19, Ge, & Fr PMI (Nov,p); Wed: IfO business climate indx (Nov), Fr Insee manufacturing confidence (Nov); Thu: Ge GDP (Q3), Sw Riksbank announcement; Fri: EU19 M3 (Oct), Fr Insee consumer confidence (Nov), It ISTAT business & consumer confidence (Nov)
	UK:	Mon: CBI Industrial Trends survey (Nov); Tue: PMI (Nov,p), BoE's Haskel speaks on inflation; Fri: CBI Distributive Trades survey (Nov)
	Japan:	Wed: Manufacturing PMI (Nov,p); Thu: Leading indx (Sep)
	China:	Mon: 1yr & 5yr loan rate

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