AXA Investment Managers

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Investment Institute Macroeconomics


# Targeting the Target

- Very good news on US inflation, but the rebound of real wages will help the hawks
- More voices are calling for raising the central banks' inflation target.
- China needs a stimulus, but the policy space is probably less wide than commonly thought

There was not much to dislike in the US inflation print for June, with all the main components of core going in the right direction. This keeps our hope alive that the Fed's July hike will be the last one. Real wages need to be monitored though: US employees have been gaining purchasing power again since May. This could re-start consumption, and make the "last mile" of disinflation, down to 2%, more difficult. This is the type of issues which are likely to keep the debate on the post-July trajectory live at the FOMC.

It's unlikely that inflation can completely normalize without a tangible contraction in aggregate demand, and a crucial issue is how deep such contraction needs to go, and whether central banks should tolerate a higher inflation regime, given the potential cost of going all the way to 2%, and lift their target. O. Blanchard had reopened this debate last October, and we hear more voices supporting such a shift. As much as there may be a theoretical case for lifting the inflation target, we think the ramifications for long-term interest rates can be so adverse that it could become counter-productive, e.g., by making the cost of the green transition – one of the forces possibly pushing inflation up – even higher. We are also concerned by the long-term competitiveness impact.

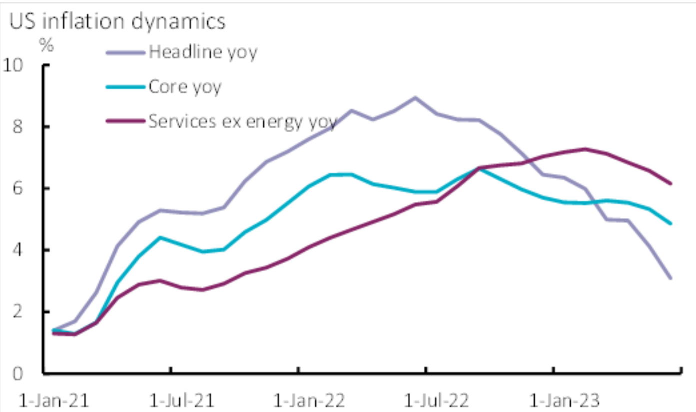
While the West is debating whether 3% inflation would be acceptable, China is dealing with a real deflation trap risk. A stimulus is needed to deal with the current aggregate demand deficit, and the central bank has been operating with much caution so far. Focus is turning to fiscal policy, and expectations are building around announcements which could be made at a Politburo meeting later this month. There are only difficult choices though. The plight of the Local Governments Financing Vehicles is drawing attention to the fact that the policy space is probably less wide than often thought. In any case, China should probably distance itself from its usual approach to stimulus – pouring more capex in the economy – and focus on consumption.

## More good news on US inflation

Last week we discussed how the payroll data for June, despite softening more than expected, still failed to produce the "smoking gun" we need to be certain the United States (US) economy is finally landing, and inflationary pressure can abate more decisively. Well, while we suspect it will take more than one Consumer Price Index (CPI) print for the Federal Open Market Committee (FOMC) to shift from its current hawkish tone, **last week's release of a below-expectation 4.8%yoy core inflation in June is a decisive step in the right direction**, keeping our hope alive that July will be the peak in the Federal Reserve (Fed)'s tightening cycle.

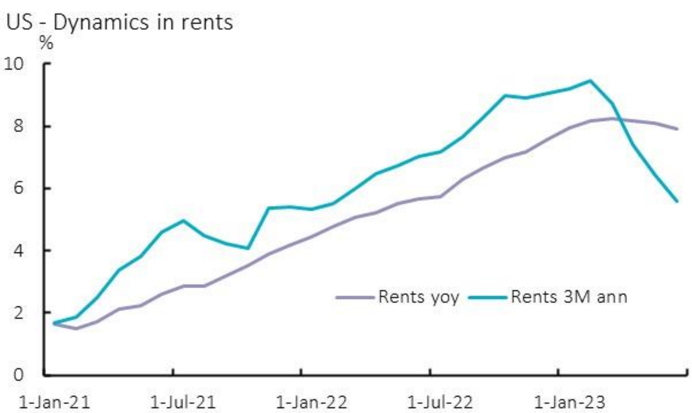
There's not much to dislike in this release – a pleasant change from a flurry of ambiguous data recently. Headline inflation fell back to 3% year-on-year (3.1% expected) for the first time since March 2021, down from 4.0% in May, and core fell below 5%yoy (4.8%, 5.0% expected) for the first time since October 2021. Grumpy minds – we accept this often applies to ourselves – would highlight that some of the deceleration in core inflation is driven by the notoriously volatile "used car" component, but **the improvement is in fact broad-based**. Inflation in the services sector continues to abate (see Exhibit 1). What's more, within services rents are also starting to slow down (see Exhibit 2), albeit from a very high pace. This confirms the usual pattern of rents following house prices with a lag. Given their significant share in the basket (c.40% of core), no proper inflation landing can occur without the materialisation of such mechanism. Further up the inflation pipeline, last week brought more good news with another deceleration in producer prices, which fell to 2.4%yoy excluding food and energy in June, down from 2.8% in May.

Exhibit 1 – All going in the right direction



*Source: Bureau of Labor Statistics and AXA IM Research, 12 July 2023*

Exhibit 2 – Even rents

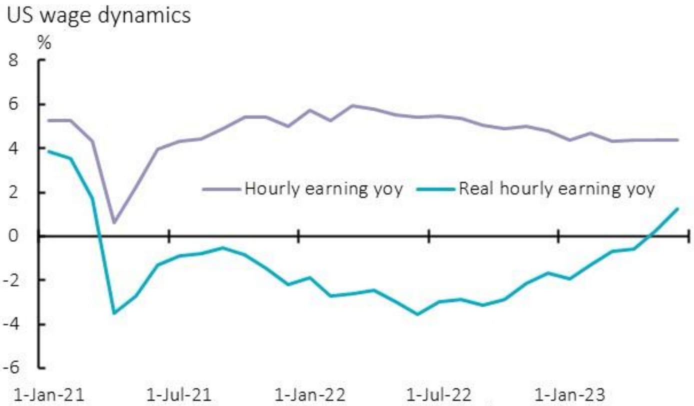


*Source: Bureau of Labor Statistics and AXA IM Research, 12 July 2023*

Of course, 4.8% is still a very high pace for core inflation relative to the Fed target and it can't be solely ascribed to last year's base effect (on a 3-month annualized basis, core inflation came out at a still chunky 4.1% in June). Yet, the return of headline inflation to less choppy waters is in itself a source of hope. Indeed, while core may be the central bank's focus, workers care about headline – this is in the end what they pay – and at 3%, they may demand less in wages to catch-up on their purchasing power. The July Michigan consumer survey was also released last week**. Households now expect inflation to stand at 3.4% next year. It's a volatile series, but it's still comfortably below the 5% territory which was common last year, and the 4% often hit so far in 2023.**

The inflation expectations/wages argument goes however both ways. Indeed, **real wages (here the payrolls' hourly earnings corrected for headline CPI) have rebounded in positive territory in May at 0.2%yoy and the acceleration in June was steep (1.3%)**, as can be seen in Exhibit 3. A continuous dampening of aggregate demand is needed to deliver a proper convergence of core inflation towards 2%. This is what in our view has been happening over the last few months, with consumption remaining broadly flat since February, notably thanks to the rebound in the savings rate. However, if real wages keep accelerating, as a combination of some inertia in nominal wage growth in a still tight labour market and further decline in energy, food and (often imported) manufactured goods' prices, then demand in the crucial services sector could recover, impeding a more comprehensive moderation of prices in this sector. In these circumstances, **we could then imagine a configuration in which the US would avoid a recession, thanks to decent consumption growth, but where core inflation would remain "stuck" somewhere between 3 and 4%.**

Exhibit 3 – Real wages growing again




*Source: Bureau of Labor Statistics and AXA IM Research, 12 July 2023*

**Why isn't this configuration our baseline? Mostly because we think the improvement in real wages is temporary,** as the full impact of the monetary tightening has not yet filtered through the labour market. But we can easily see how, despite the undeniable improvement on the inflation front, the overall dataflow in the US is still "too hot" to the taste of the hawks, or even the centrists at the FOMC. The hawks' camp is going to be depleted by the departure of James Bullard who is going to Academia, but Governor Waller is keeping the hawks' torch alight, re-starting his preference for two more rate hikes last week *after* the release of the inflation data.

All in all, we are more comfortable with our call that July will be the last Fed hike in this cycle, but we want to remain cautious. Together with more good news on inflation in the July and August prints, more tangible signs the labour market is definitely landing is what could seal the deal for an "unchanged rates" decision in September.

## Moving the target?

Our discussion of the behaviour of real wages and aggregate demand gets us back to a theme which has been gaining traction lately: an upward revision in the central banks' 2% inflation target. We noted in Macrocast last week the point made by the French Finance Minister on this subject, and we can hear more voices – on top of Olivier Blanchard who (re)stated his proposal in the Financial Times last October – calling for such a change.

It is a delicate matter, and we think this calls for some precise dissection of what is at stake here. We can see two different arguments for this. One has more to do with short-term demand management, which is at the centre of Blanchard's argument – and another is more focused on long-term issues, such as the need to accommodate the cost of the energy transition which could bring about simultaneously higher inflation and a higher investment effort – that's more the point made by Patrick Artus.

Let's start with short-term demand management. The "sacrifice ratio" is the issue here: **how much of an economic downturn are developed economies ready to accept to get through the "last mile" and bring inflation back to 2%** now that the exogenous forces, such as global commodity prices, have abated. This is a particularly thorny issue for the Federal Reserve which is supposed to pursue a dual objective, price stability and full employment, even if the latter has been clearly playing second fiddle for decades. Given how far wage growth has gone recently, it could be argued that only a very high unemployment level could bring it back to a pace more consistent with productivity growth and hence a return to the pre-pandemic inflation pattern. It would then be very tempting to stop the monetary tightening early once an *acceptable* inflation rate is hit, even if it's still above 2%. **How to determine what would count as "acceptable"? Blanchard proposes to use the notion of "salience": observations suggest that there is no major difference in terms of consumers' perceptions between 2 and 3% inflation**. It's only above this threshold that the rise in prices start affecting decisions. In other words, settling at 3% rather than 2% would not trigger a proper regime shift with inflation expectations continuously rising.

This would probably be more of a temptation in the US – where the Fed until 2012 had no official quantitative target for inflation – than in the Euro area. Yet, we also suspect that some members of the European Central Bank (ECB) Governing Council would get increasingly restless if, despite having spent several quarters in GDP contraction and then rising unemployment, inflation, while still above 2%, were to settle around 3%. There may be country by country specificities considerations to take on board. Inflation in Germany is currently three times higher than in Spain. **We could see some heated discussions in the Council emerge around the need to start loosening monetary policy if the average Euro area inflation remains above 2% but with a disproportionate contribution from only a few, high wages/persistent inflation member states.** The low-inflation countries could get increasingly frustrated by their facing rising real interest rates – coming with a higher probability of severe recession - to fight persistent inflation in a few core countries.

**The prediction of a high sacrifice ratio is however based on the assumption that the slope of the Philips curve would remain unchanged from the pre-pandemic period,** when even large changes in the unemployment rate only had a weak impact of wages and, ultimately, inflation. Governor Waller (among others) claimed last year that maybe only a limited reduction in vacancies – which need not be accompanied by significant job destructions – may be enough to curb wage growth. Moreover, margin behaviour may also do the trick. A moderate rather than steep contraction in demand may convince businesses to absorb the rise in labour costs by lowering their mark-up.

**In any case, at this stage it is still a mostly theoretical debate: the labour market has not really started to deteriorate, and it's impossible to know now how inflation will respond once it starts happening**. That central banks ultimately accept to tolerate inflation at 3% rather than 2% to avoid a catastrophic decline in employment is thus a plausible scenario, but it is by no means a certain one. It would still be a risky approach. The "salience argument" is powerful, but even if consumers' inflation expectations could be reined in, we find it unlikely that investors would not realise that a new monetary policy regime has settled in. This would normally be factored in long-term interest rates in the form of a higher inflation premium. Nominal short-term interest rates could be lower than under the current regime, but this would be offset by higher nominal long-term yields. It would still be a gamble to believe that *real* long-term yields would not rise investors could start suspecting that if central banks now tolerate a 3% inflation, it is only the prelude to the target moving even higher. One can consider that this is an acceptable price to pay to avoid a severe recession in the short-run, and central banks could later on gradually shift back to the "old" 2% objective, but we doubt it would be a fully free lunch. Central bank communication would need to be extraordinarily precise, explaining that the current situation calls for tolerance, but that price stability would still be preserved in the long run.

The behaviour of long-term rates would be even more crucial if a de facto or explicit shift in the inflation target was justified by the need to address long-term challenges. Here, rather than the notion of employment/inflation trade-off, the key issue is the nature of the price shock. Patrick Artus developed this point in an Op Ed in Le Monde last Saturday. **There are reasons to believe that inflationary pressure is going to rise structurally** because of the green transition – which is forcing the adoption of cleaner but more expensive technologies - and deglobalisation – which will limit the capacity of offsetting domestic price growth by a more intensive recourse to cheaper imports. **If in this context central banks stick to their current approach and try at all cost to keep overall inflation at 2% despite these structural forces, they will precipitate the economy in a sustained low-demand regime.**

What would happen however if central banks accept the emergence of these structural forces and move their inflation target upward? The same as what we described in our previous discussion, long-term interest rates will rise, this time in a more durable way, since we fail to see how central banks could ever become credible again if they announced a return to the “old” 2% target. The whole strategy would become self-defeating, since it could end up making the cost of the green transition, which success is conditional on a massive investment effort, even higher by lifting ex ante real interest rates. A way to solve the equation would be that central banks engage in continuous Quantitative Easing to control the long end of the curve. It’s already quite a stretch to believe that central banks would be ready to move in a permanent manner to a higher inflation target. Adding a permanent recourse to unconventional policy is an even bigger challenge.

Patrick Artus mentions another way to solve the equation: **engaging in supply-side reforms which would raise the economy’s potential growth, thus making the higher long-term yields sustainable, or would even completely offsetting the impact of the structural inflationary forces.** Pushing this line of reasoning further, we could imagine a “division of labour” between the central bank raising its inflation target and governments reforming. This is theoretically impeccable, but this would still leave us with a “commitment asymmetry”: the central bank would have to accept a shift in its strategy *now* against pledges of structural reforms from national governments which may or may not bear fruit in the future.

Finally, **the implications of a permanent upward shift in the inflation target for competitiveness should not be ignored**. Not all regions of the world may make the same choice. In the configuration where only the West would let the inflation regime move up but where emerging nations would “stay as they are”, we could expect a constant deterioration of the West’s trade balance. This would be one of the channels through which de-globalization could turn into a self-reinforcing phenomenon. The deterioration in the trade balance would feed more protectionist tendencies in the higher inflation regions as their industrial base would become increasingly challenged, in turn fuelling a deterioration in overall growth prospects and productivity.

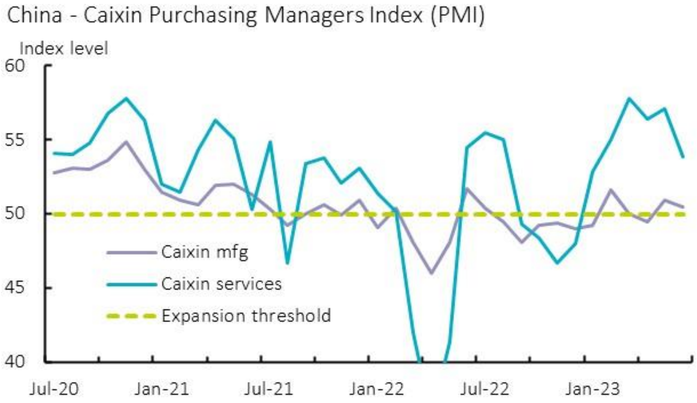
## China’s uncomfortable choices

Inflation differentials across the world’s main economic regions should warrant more attention already today. **While the West is debating whether it would make sense to lift its inflation target, China is increasingly at risk of falling into a deflationary trap**. The June print for the consumer price index came out at 0% year-on-year - which, given the measurement error margin, suggests that prices may already be falling – after an already meagre 0.2% in May. What is in the pipeline does not look better, with the producer price index declining by 5.4%yoy, after an already deeply negative reading at -4.6% in May.

**Deflation is ordinarily the symptom of a deficit in aggregate demand.** On the domestic front, China continues to pay the price of its refusal to stimulate consumption when exiting from the pandemic, while the legacy of the downturn is still quite apparent on the labour market, with youth unemployment continuing to rise (20.8% in May from 20.4% in April), pointing at a difficulty of the economy to absorb the flow of new entrants. On the external front, China is dealing with the global slump in manufacturing activity after the whole world gorged on goods during the pandemic. Exports fell by 12.4% year-on-year in June. The current sluggishness of the Chinese economy is apparent in the surveys. The manufacturing Purchasing Managers’ Index (PMI) has been wallowing in or close to contraction territory for months, but the deterioration is now also obvious in services, albeit from a higher starting level (see Exhibit 4).

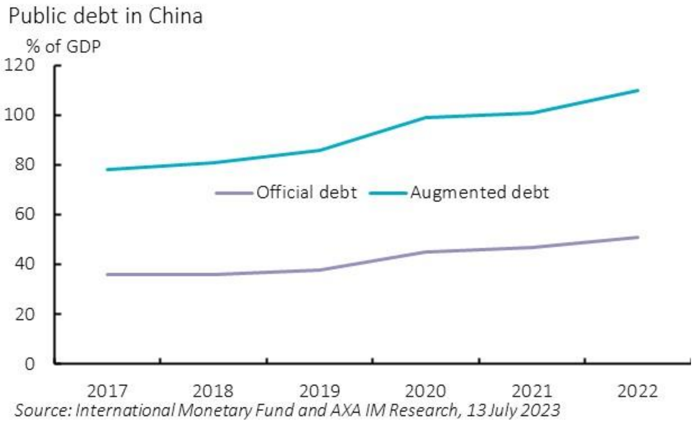
China needs a stimulus, but so far authorities have been very prudent. **The 10bps cut in the People’s Bank of China (PBOC)’s main policy rate in June was not decisive, and there is now a lot of focus on a Politburo meeting later this month widely touted to come up with a multi-faceted fiscal support package.** The usual approach, based on getting local authorities to raise their investment effort, is unlikely to be on offer this time. In its latest comprehensive review of the Chinese economy, the International Monetary Fund (IMF) corrected the official measure of public debt by producing an “augmented” version which includes the liabilities incurred by the Local Governments Financing Vehicles (LGFVs). This makes the general government debt ratio rise from 50% to 100% of GDP (see Exhibit 5).

Exhibit 4 – Rebound aborted




*Source: Macrobond and AXA IM Research, 13 July 2023*

Exhibit 5 – Less fiscal space than meets the eye

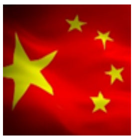



*Source: International Monetary Fund and AXA IM Research, 13 July 2023*

The status of these LGFVs is ambiguous. While some are nothing more than the operational arm of local governments in traditional public service areas, e.g., social housing, some – in a search for income diversification – have also invested in commercial property. While there is no explicit guarantee of the central government on the debt issued by the LGFVs, the level of implicit protection priced in by the market is higher for the first form of liabilities. Yet, through the whole asset class LGFVs have been facing an increase in their market risk premium recently. In those circumstances, **asking another spending effort from the local governments is probably impossible, or at least dangerous from a financial stability point of view.**

There is a more fundamental reason why the stimulus should move away from its traditional features. **In a situation of obvious demand deficit, reflecting a failure to fully shift the engine of the economy towards consumption, in what would be a normal step for an intermediate income country looking to mature, the last thing that is currently necessary is another dollop of capital expenditure**. However, directly stimulating consumption is not without its own challenges, since any action on income could ultimately end up being swallowed in the real estate sector which the authorities – for good reasons – may want to avoid spurring again. On this issue, the authorities' approach focuses on mitigating the damage by "asking" state-owned banks to engage in more forbearance and further delay the repayment of developers' loans.

China's policy space may not be as wide as often seen, either because the real financial burden supported by the government – in various forms – is not necessarily that different from what would be seen in developed nations, or because of the difficulties to design a stimulus which would not end up making the domestic financial stability risks more acute.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • CPI inflation (Jun) fell to 3% and core inflation to 4.8%, both below expectation. Fuel, food, shelter and car prices all added to disinflation on the month.<br>• Fed Beige book reported expectations of slower growth, wage growth returning to pre-pandemic rate and increased reticence to increase prices<br>• NFIB survey (Jun) rose to 91.0 and 7-month high. Investment intentions rose, hiring intent fell | • Retail sales (Jun) expectations for modest uptick in spending, after softer May<br>• Existing home sales (Jun) to guide on overall housing market as starts (Jun) have been strong<br>• Empire and Philly Fed surveys (Jul), both have been volatile recently, soft but not recessionary<br>• Business inventories (May) guide to most erratic item of GDP, likely supportive of GDP in Q2 |
|  | • Final inflation figures in Ge, Fr and Sp unchanged. Details in Germany showed lower momentum in leisure prices (package holidays, restaurant & hotel). To be confirmed in July<br>• Euro area industrial production (May) rose by 0.2%mom | • EMU final HICP figures (June)<br>• Ge producer prices (Jun)<br>• Business climate (Fr)<br>• EMU Consumer confidence flash (July) |
|  | • Labour market (May) mixed. Employment slowed, unemp rose to 4.0%, wage growth still elevated.<br>• GDP (May) -0.1%, better than expected, suggest flat Q2<br>• RICS housing survey (Jun) sharp drop in new buyer enq<br>• BoE credit survey (Q2) reduced supply of secured credit, demand for lending falling across all sectors | • CPI inflation (Jun) fall anticipated in services CPI particularly – key to BoE outlook<br>• PPI inflation (Jun) more wholesale disinflation ahead<br>• Retail sales (Jun) and GfK consumer confidence (Jul) guide to household activity<br>• CBI Quarterly Survey (Jul) – gauge manufacturing |
|  | • Large and surprising fall in machinery orders (May) (-7.6%mom)<br>• USD/JPY eased to 138 (-4.5% week-on week) | • Trade data (June)<br>• Reuters Tankan Non-Mfg index (July)<br>• CPI (June) is likely to be key before BoJ meeting scheduled on 28 July |
|  | • CPI (Jun) (0.0%yoy, -0.2%mom), PPI (-5.4%yoy)<br>• New loans (Jun) (CNY 3,050bn, 8.5%yoy)<br>• Trade (Jun) slumped severely: exports -12.4%yoy, imports -6.8%yoy in (USD value) | • GDP (Q2) marked slowing from buoyant 2.2% (Q1)<br>• House price index (Jun)<br>• Monthly output data (Jun) expect further softening<br>• Loan Prime Rates, unlikely to cut, later Q3 possible<br>• To watch: potential fiscal stimulus packages in July |
|  | • CB: Korea (3.5%) & Peru (7.75%) stood on hold.<br>• Inflation (June) fell in Brazil (3.2%), Czechia (9.7%), Colombia (12.1%), India (4.8%) & Romania (10.3%). It picked up in Russia (3.3%)<br>• Industrial production (May) accelerated in Mexico (3.9%), Turkey (14.6%) & Malaysia (4.7%) | • CB: South Africa is expected to stay on hold (8.25%). Russia to hike +50bps to 8.5% & Turkey +150bps to 18.5%<br>• Economic activity index (May) in Brazil<br>• June industrial production in Poland<br>• June inflation in South Africa<br>• June trade data in Malaysia |

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|---|---|---|
| Upcoming events | US: | Mon: Empire State Survey (Jul); Tue: Retail sales (Jun), Industrial production (Jun), business inventories (May); Wed: Housing starts (Jun); Thu: jobless clm (10 Jul), Philly Fed business index (Jul), Existing home sales (Jun) |
| | Euro Area: | Mon: It consumer prices (Jun), It CPI (Jun), EU20 total reserve assets (Jun); Wed: EU20 HICP (Jun); Thu: Ge PPI (Jun), Fr mfg and overall business climate (Jul), EU20 consumer confidence (Jul) |
| | UK: | Wed: CPI (Jun), PPI input and output prices (Jun); Fri: GfK consumer confidence (Jul), Retail sales (Jun), public finances (Jun) |
| | Japan | Wed: Tankan non-manf business survey (Jul); Thu: Exports and imports (Jun), Trade balance (Jun): Fri: Headline & core CPI (Jun) |
| | China: | Mon: Industrial output (Jun), Retail sales (Jun), GDP (Q2); Thu: Loan prime rates 5Y & 1Y (Jul) |

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