
# Second guessing the second-round effects

# 108 – 11 October 2021

## Key points

- We think the disappointing payroll data last week won't prevent the Fed from tapering in November
- We look into second-round effects on inflation from the current spike

We think the bar for the Fed NOT to announce a taper in November is high and has not been reached despite the disappointing payroll report for September. True, the US economy may not have added many jobs last month, but for a central bank still paying attention to the Phillips curve the faster-than expected decline in the unemployment rate combined with another acceleration in wages can hardly be ignored. Moreover, the "stop-gap" solution found in Congress on the debt ceiling, pushing the deadline to December, changes the Fed's tactical position: announcing a taper in November could incentivize lawmakers to finally "do the right thing" and provide full-year visibility on the matter, after having been made aware that counting on the Fed's magic money tree may be risky. Finally, outside the labour market the data flow has been more than decent lately.

The recent further drift in market-based expected inflation may also influence the Fed's decisions in November. Naturally, the accumulation and prolongation of exogenous price shocks – with the further rise in international gas prices drawing more attention – raise the question of "second round effects" which would turn the current spike into a problematic self-sustained upward spiral. While everywhere in the advanced world, the accumulation of excess savings may dampen the usual self-stabilization mechanisms which normally stop supply-driven price hikes from lasting too long, we continue to see more reasons for concern in the US than in Europe. There is no "consumption gap" left in the US – personal spending has come back to its trend level – while it remains deeply negative in the Euro area, suggesting that still comparatively weak demand is chasing the disrupted supply here. Probably more importantly, in the Euro area the current significant rise in hiring difficulties has merely brought them back to where they had been in the three to four years before the pandemic, without at the time triggering any significant acceleration in wages. In the US, conversely, unfilled vacancies have now hit their 20-year peak and are standing significantly above their 2019 level. Moreover, we find comfort in the fact that in Germany, where tensions on the labour market are the highest in the Euro area, the union movement is not seizing the opportunity to force a hard bargain.

We want to take a nuanced view, however. In the US, we think that the conditions for a wage/price spiral are dependent on the continuation of a rapid recovery in demand, which is less and less likely given Biden's difficulties passing the next steps of the fiscal stimulus. Symmetrically, in the Euro area hiring difficulties have become entrenched in some sectors for which attracting workers is increasingly problematic, which may call for some re-scaling of pay, but probably more as a gradual process than as a "sudden burst" in 2022.

## Enough for tapering

At first glance, the additional "miss" of the September US job numbers should caution the Federal Reserve (Fed) against any hasty tapering. The details of the release, however, together with the message from macro indicators outside the labour market, are in our view strong enough to convince a majority of the Federal Open Market Committee (FOMC) to announce a taper at the November 3rd meeting, with immediate implementation.

Of course, the headline number for the September payroll was weak (194k versus 500k expected). However, the August batch was revised significantly up, and a lot of the weakness came from government jobs, which – possibly counter-intuitively for European readers – tend to be very volatile. When we exclude from the count those jobs and those in the covid-sensitive hospitality sector (that still leaves 75% in the sample), **what we find striking is how steady the pace of recovery has been in US employment since the autumn of last year** (see Exhibit1). True, the rebound in private employment has been slower than GDP's, but as we noted before in Macrocast, at the same stage of the recovery in 2010, employment had improved much less than this time.

Besides, the unemployment rate – which is derived from another survey than payroll – fell more than expected to 4.8% (from 5.2%), hitting the Fed's median forecast for Q4 in September already. True, we are still left with unanswered questions on the post-pandemic behaviour of the US labour market – the participation rate fell again, although unemployment benefits have now been cut nationally – but crucially the decline in unemployment was accompanied by another acceleration in average wages (4.6%yoy from 4.0% in August). Given the Fed's usual focus on the Philips curve, for all its shortcomings, this is hard to ignore.

Exhibit 1 – A very steady normalization

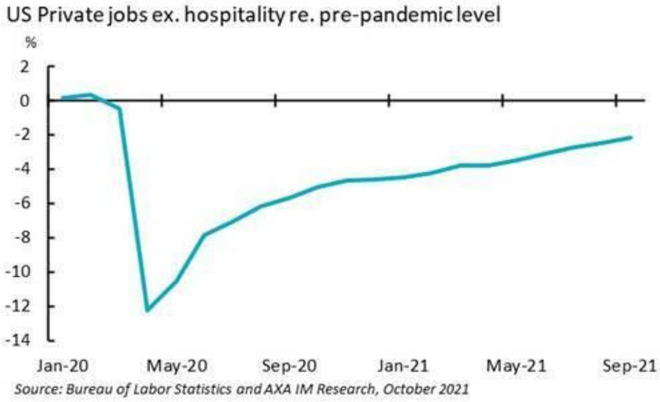


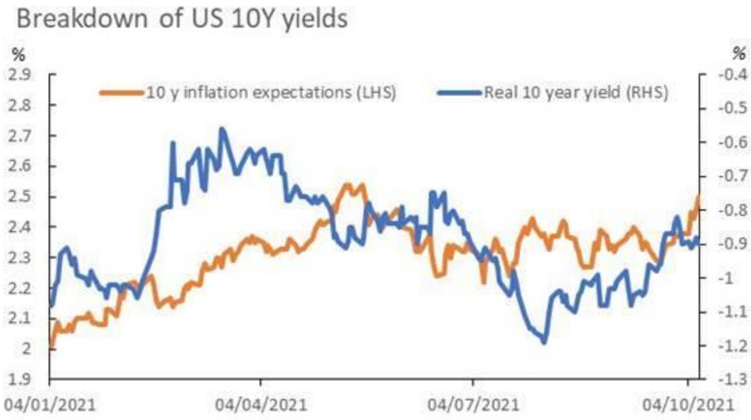

Exhibit 2 – US services had a good summer in the end


In addition, **beyond the labour market indicators the dataflow has been more than decent lately,** with for instance a strong ISM services in September (see Exhibit 2), at 61.9, up from 61.7 in August (the market was expecting a decline), with a particularly positive reading for the forward-looking "orders" component. Durable goods orders - a good predictor of business investment – also came out above expectations. It seems that the US economy is weathering the "delta variant" wave rather comfortably in the end.

**Another issue to consider in the timing of the Fed's decision is the "debt ceiling saga".** If the issuance limit had been hit around 18 October, as per Yellen's soft deadline, then markets could have been in free-fall just before the Fed's November 3rd meeting. As we discussed last week, it would be very difficult to announce a taper in that configuration, since purchases of defaulted bonds by the Fed could have been the only workable option to avoid a meltdown, would have been particularly difficult. The bipartisan deal struck last week is offering us only a short respite, until December, but this still changes the tactical position of the Fed. Starting the taper in November, and the accompanying rise in US market rates, can incentivize lawmakers to address the issue in a more meaningful manner. It would always be possible for the Fed to reverse course if no deal occurs, but at least in the meantime it will have demonstrated its independence and might have helped wean Congress off "magic money trees".

Finally, even if the role of inflation expectations is now hotly disputed (more on this later**), the Fed mustn't be very happy about the very recent developments in break-evens**. Over the last few days, expected inflation has rebounded (see Exhibit 3) and are now very close to the peak hit last spring (2.50% on Friday against 2.54% on 17 May). While we expect the Fed to stick to its view that the current inflation spike is transitory, hawks and doves at the FOMC can compromise on an early tapering "offset" by some patience on the rate lift-off. All in all, we thought before the release of the payroll numbers that the bar for the Fed not to taper in November was very high. We think this bar has not been reached and that they will proceed.

Exhibit 3 – Market-based inflation expectations creeping up again



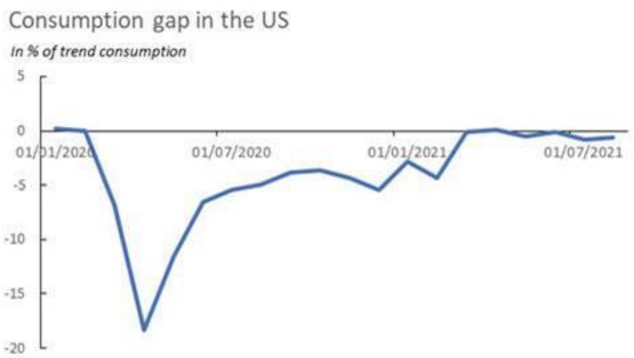

*Source: Macrobond, AXA IM Research, October 2021*

## Dissecting the exogenous price shock

The steep rise in gas prices – even if recent statements from Vladimir Putin have cooled down the market somewhat – is naturally fuelling concerns around a prolongation of the ongoing inflation spike, which could fan risks of "second round effects" turning what has remained so far an exogenous shock into a self-fulfilling upward shift in the inflation regime.

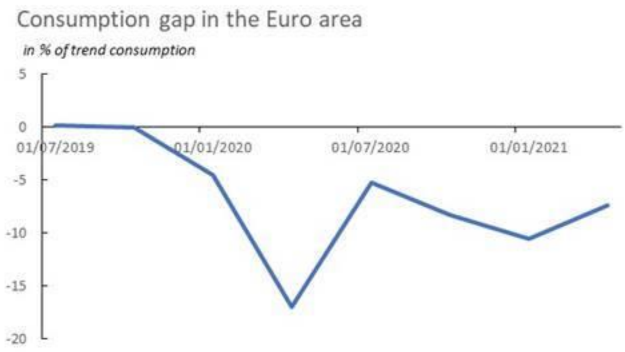
**A key variable here is the starting point for the "buoyancy" of consumption.** We measure this by comparing the actual level of consumer spending to the volume it would have reached had it constantly grown in line with its 2010-2019 trend. In the US, despite the rise in the savings ratio, the stimulus-fuelled massive growth in income has brought consumption back to its trend level last spring (see Exhibit 4). In the absence of any "consumption gap", demand pressure is hitting hard sectors faced with disrupted supply, making it tempting for producers to deal with the pressure from rising input costs by lifting their final prices.

Exhibit 4 – No more "consumption gap" in the US…




*Source: Bureau of Economic Analysis, AXA IM Research, October 2021*

Exhibit 5 – … but still a big one in Europe




*Source: Eurostat, AXA IM Research, October 2021*

**The situation is very different in the Euro area, where the consumption gap still stood at a staggering -7% in Q2 2021** (see Exhibit 5). True, the catch up continued at a fast clip in Q3, even if precise data is not yet available, but it is unlikely, given the differences in income dynamics relative to the US, that the gap has been fully bridged by now.

With consumption still far from having normalized, weak demand is chasing the available supply. **The room for manoeuvre for passing higher input prices to consumer prices is much more limited in the Euro area than in the US**. The difference in terms of consumption gaps may help explain why inflation has been quicker to accelerate in the US than in Europe.

**A crucial issue though is whether the point has been reached when the inflation spike in turn starts affecting the volume of consumption**. Under a textbook approach, exogenous price shocks spontaneously fade. Indeed, they tend to be recessionary – the point was made by the European Central Bank (ECB)'s chief economist Philip Lane last week - since they immediately depress purchasing power. The economy cools down fast enough to stop an adjustment in wages. It is tempting to ascribe to the ongoing price spike in the US the lack of further acceleration in consumer spending since last spring (it has fallen back marginally below its trend level this summer). Yet, since this coincides with the peak in the "delta variant" wave over there**, it is probably impossible to disentangle what would be the reaction to rising prices from self-restraint by worried individuals.** The next months of consumption data, now that the US pandemic wave is finally going in the right direction, will allow for better analysis.

**A source of added complexity is the fate of the excess savings accumulated since the start of the pandemic everywhere in the developed world.** They constitute spending reserves which should sustain consumption *despite* the dampening effect of inflation on purchasing power, thus "blocking" the self-stabilization mechanism which normally stops exogenous inflation shocks from developing dangerous second-round effects. In theory, the inflation spike should accelerate the liberation of excess savings. Rationally, especially with negative interest rates, individuals would maximize their welfare by converting their savings into consumption as soon as possible before the purchasing power of those savings is eroded. **This creates a risk that, with consumer spending more resilient to the inflation shock, the latter persists longer than usual.**

Yet, even if the inflation shock takes longer to fade, for all the discomfort it would bring to central bankers**, it would not necessarily mean that a proper upward shift in the inflation regime. For this to happen, wages need to respond to the shock.**

## Are we on the brink of a catch-up in wages?

Much intellectual energy is now being spent lately on dissecting the rise in hiring difficulties in advanced economies, and true, the percentage of firms reporting labour shortages is rising significantly. However, at least in the Euro area, the current shift reflects more the return to a pre-pandemic situation which was already tense than the emergence of a new, potentially scary covid-related phenomenon.

**First, there are "mechanical" reasons why the number of businesses reporting hiring difficulties should rise sharply in the current rebound.** Just consider the simple fact that every year in France about 600,000 people retire (that's 5% of the entire workforce) and leave the labour market for good. In normal circumstances, they would be replaced gradually across the year. In the context of lockdown/heightened uncertainty, this "churning" process has stalled. As the economy reopens, all firms will be trying to replace those departed employees over the last year and a half *at the same time*. Even if there is no "real" shortage of potential candidates (i.e. that the quantum of workers with the matching skill-sets and preferences in terms of working conditions – including wages - is large enough), the sudden release of many hiring opportunities would slow down the recruitment processes, generating a rise in reported hiring difficulties. Beyond the replacement of retirees, it is likely that many recruitment plans have been simply put on ice during the pandemic and are being reactivated at the same time.

Second, and that is more fundamental in our view, **the level of hiring difficulties was already high before the pandemic struck** (see Exhibit 6). We focus here on the dominant services sector. A rising trend had been observed in Germany just after the Great Financial Crisis of 2008-2009 but another acceleration occurred circa 2016. Although reported hiring difficulties in France never quite matched the level seen in Germany, they had also risen significantly between 2016 and 2019. In the three biggest economies of the Euro area, hiring difficulties are higher where the participation rate is also elevated. In theory, a low participation rate would be consistent with difficulties finding staff given a low overall pool of workers relative to the size of the population. But Germany has the highest participation rate and the highest percentage of businesses reporting a shortage of labour (see Exhibit 7). **What this data reflects is how "intense" the labour market has become in Germany, with most of the potential resources already used, making any skills, or working conditions mismatches difficult to accommodate**. This contrasts with Italy, a "low intensity" labour market, where the low participation rate is probably as much the product of supply-side rigidities as the accumulation over thirty years of very low *demand* for labour amid a stagnating economy. France sits between the two. Note that in all three countries, participation has been rising over the last 10 years, to the extent the rate now stands higher in the Euro area on average (73.7%) than in the US (73.1%)

Exhibit 6 – Higher…but it was already high

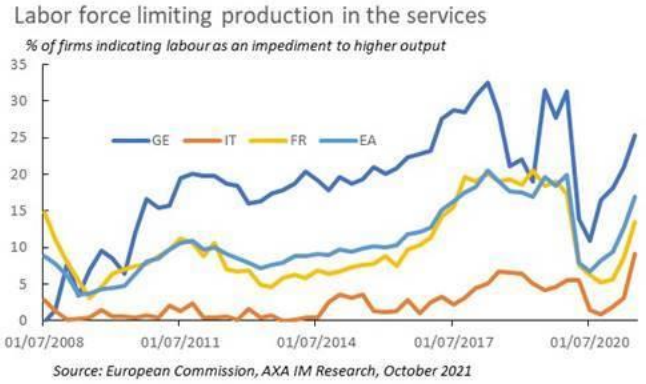
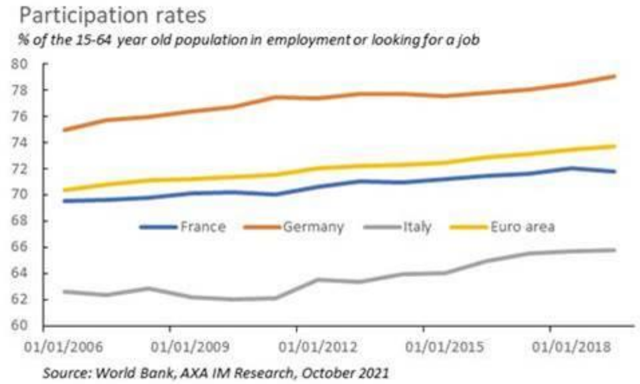



Exhibit 7 – Participation rates have been rising on trend




So, beyond the level differences across countries, **labour markets were already under unusual pressure for some years before the pandemic while no acceleration in wages was observed**. Logically, if no major wage drift was observed then, why would hiring difficulties today trigger a wage response? Arguably, the missing ingredient then might have been an exogenous inflation shock. A shift in wages would only occur thanks to the *combination* of a random price shock and labour market tension. However, **for the time being it is very clear that unions in Germany – where the highest level of labour market pressure is observed - do not want to seize this opportunity to drive a hard bargain.** Verdi, the public service union, made the news a few weeks ago by demanding a 5% rise, but this is a lower opening gambit than in 2019 (they started at 6%). In Spain, where the labour ministry has been maintaining a monthly series of wages agreed in collective bargaining rounds, the latest data points to the slowest nominal gain (1.5%yoy in August) since inflation had actually been negative in Spain between 2014 and 2016.

True, given the deep structural changes in the labour market institutions, **we may be in a situation where wage growth is less the product of centralized negotiations between unions and employers but more the result of a myriad of individual decisions.** In a recent much-commented paper which we found as stimulative as infuriating, Fed economist Jeremy Rudd made the point that one of the reasons why *expected* inflation has less of an impact on wages and hence *realized* inflation than in most theoretical models is that in normal circumstances, individual workers pay little attention to inflation because, at least over the last 25 years, it has been relatively stable and low. He posits that there would be a point beyond which observed inflation will erode real wages enough so that workers will start looking for a better-paying job (given the loss of influence of unions they could not count on pay rises in their current jobs). Rudd's policy recommendations is that central banks should not necessarily take comfort in the fact that surveys so far have not reflected any dis-anchoring of long-term inflation expectations, because a large *realized* hike in prices such as the one currently underway could suffice to push wages higher and hence trigger second round effects.

Rudd's hypothesis is intriguing, but we are not convinced. **While it is true that people quitting low-paying jobs in droves for better-paying ones would *statistically* lift aggregate pay, from a macroeconomic point of view this is not at all certain this would become self-perpetuating.** Indeed, even accounting for frictions, if more people are offering their services to high-paying businesses, wages in these firms will end up moderating. What matters down the road for inflation are unit labour costs, i.e. how wages grow relative to productivity. High-paying jobs are normally higher-productivity ones as well. If pay can rise slower in those efficient sectors thanks to a large inflow of candidates, unit labour costs will fall. **It is only if low-paying businesses manage to retain their workforce by paying them more, beyond the level normally allowed by their own productivity conditions, that unit labour costs will rise.**

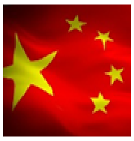
This sort of mechanism can help explain the ongoing acceleration in aggregate wages and subsequent inflation in the US amid strong stimulus-fuelled demand. With the economy returning to a more usual growth rate post peak-stimulus this will likely become less powerful. Europe has opted from the start for a less spectacular stimulus than the US and the conditions for such a configuration are even less likely to be met.

Besides, quitting one's job, even for a better paying one, entails adjustment costs as well as heightened uncertainty. This is not a decision that is taken lightly and realized inflation and observed deteriorated purchasing power may not be a sufficient reason if workers believe the price increase is a one-off. **We would be surprised to see massive reallocations occur without surveys reflecting a drift in expected inflation**, which so far, they have done only moderately.

**To be clear, for all our doubts on the impact of many of the "inflation boosters" currently debated, we are not arguing that the "status quo ante" will prevail on wage growth.** Some ingredients are undoubtedly there in the US. Beyond the disappearance of the "consumption gap", contrary to Europe, some indicators suggest that labour market tensions there are more acute than before the pandemic. Surveys are not designed in exactly the same way across the Atlantic so we cannot directly compare the European Commission's questions on "output impeded by labour shortage" with anything in the US, but unfilled vacancies – a key indicator of labour market tension over there - are much higher than at any point in the 20 year history of the series. In the US the current level of hiring difficulties does not merely reflect a return to pre-pandemic conditions.

**We continue to be less concerned about Europe in the short run, even if we think that some structural upward pressure – rather than a sudden "burst" in 2022 in response to the current inflation spike – is likely to materialize in the years ahead.** The Research department of the French Ministry of Labour has just released a very topical paper examining, profession by profession the causes of hiring difficulties. In the largest group of sectors/skills under tension (a third of them), the main difficulty is the lack of trained professionals (e.g. skilled workers in mechanical industry, construction, or IT). In a second group (a quarter), the dominant factor is the lack of attractiveness of the jobs because of problematic working conditions (e.g. unskilled workers in industry, restaurant workers). In a third one (a fifth) the two issues (skill shortage and attractiveness) combine (e.g. for skilled workers in the food industry). **The conclusion of the paper is that, while improving vocational and university training is a clear priority, *"some re-scaling of wages"* in some sectors would be needed, to overcome their lack of attractiveness.**

Again, this did not happen in the years preceding the pandemic and there is absolutely no certainty it will happen after it, but some gradual wage catch-up in some sectors looks more likely than not. In most cases, they are not directly exposed to international competition, which would make some pass-through of the wage hikes into final prices swifter. **This would chime with our general view that, as much as we continue not to believe in "run-away" inflation in Europe, the return to the weak pre-pandemic inflation trend is unlikely**. This would be a good thing: exiting from below-target inflation on a sustained basis is precisely what central banks need to be able to normalize their monetary policy.

| Country/Region | What we focused on last week | What we will focus on this week |
|---|---|---|
|  | • Senate agrees temporary \$480bn adj of debt ceiling, pushing deadline back to est early Dec<br>• Payrolls (Sep) underwhelmed again up just +194k (with +131k to previous month). Unemployment fell to 4.8%.<br>• Democrats lower ambition on spending bill to c \$2tn from \$3.5tn, less than expected<br>• Fed Vice Chair Clarida adds stock trading issues, complicates Powell renomination<br>• ISM servs (Sep), rise to 61.9, c. record highs | • FOMC minutes (Sep). Look for commitment to taper. We expect Nov announce after meeting<br>• CPI inflation (Sep) energy price pressure interrupts easing, import prices expt'd higher<br>• Retail sales (Sep), expected to be solid, but broader consumption expected c 1% Q3 and GDP outlook around 3% (saar)<br>• Empire State survey (Oct) to gauge continued scale of supply shortage impact<br>• JOLTS survey (Aug) to judge demand for labour |
|  | • The Greens and the FDP have exclusive discussion with the SPD to form a coalition<br>• Industrial output (Aug) dropped in Ge (-4.0%mom)/auto prod: -17.5%. Fr up by 1%mom<br>• Sep Svcs Flash PMIs Sep for It (55.5)/Sp (56,9)<br>• Aug EZ PPI inflation rose again by 1.1%mom | • German Oct ZEW economic sentiment should slightly fade<br>• Aug EMU IP is expected to fall after large drop in Germany. Auto sector still a burden for IP<br>• Final CPI figures for September |
|  | • Natural gas prices hit record highs pushing 10Y BE inflation above 4%. Markets now price Bank Rate rising to 75bps by end 2022<br>• Tory party conference, Sunak announced £500m fund to help people back into work<br>• Weakest new car registrations since 1998 semiconductor shortage weighs | • Monthly GDP (Aug) – we expect 0.7% firmer than consensus 0.5%, but Q3 at 1.3%<br>• Labour market releases (Aug/Sep) to point to impact of furlough unwind<br>• Wholesale gas prices, any further easing<br>• BRC sales (Sep), after surprising fall in Aug |
|  | • Election date schedule for 31 October<br>• Sep Tokyo CPI inflation rose by 0.3%yoy after drop in Aug<br>• Sept Svs PMI improved (47.8) but still below 50<br>• Sep Economy watchers poll up to 42.1 (+7.4p) | • Sept corporate goods price should increase again to approx. 6% after 5.5% in Aug, its highest level since 2008<br>• Aug machinery orders should remain sustained |
|  | • Spreading power shortages causing electricity rationing adds another risk to the economy<br>• Markets take a breath amidst ongoing Evergrande saga, but situation remains fluid | • Manufacturing activity should weaken due to power shortage, while the services PMI may improve as COVID impact fades |
|   | • CB: Poland surprised with a +40bps hike to 0.50%; Romania +25bps to 1.50%; Peru +50bps to 1.50%. India stood on hold (4.0%)<br>• Inflation (Sep) up in Turkey (19.6%), Brazil (10.25%), Russia (7.4%), Mexico (6.0%) and Taiwan (2.6%); Deceleration in Korea (2.5%)<br>• Brazil (Aug): contraction in retail sales and IP | • IP (Aug) figures for Malaysia, Mexico, India and Turkey<br>• CB: Korea to stay on hold at 0.75%; Chile should hike +75bps to 2.25%<br>• Preliminary Q3 GDP for Singapore<br>• Inflation (Sep) for India, Israel, Nigeria and Argentina |

| | | |
|---|---|---|
| Upcoming events | US : | Mon: Columbus day holiday; Tue: NFIB index (Sep), JOLTS survey (Aug); Wed: CPI inflation (Sep), FOMC minutes; Thu: PPI inflation (Sep), jobless claims (9 Oct), Fri: Retail sales (Sep), Empire State survey (Oct), Business inventories (Aug), Michigan consumer sentiment (Oct,p) |
| | Euro Area: | Mon: It ind prod (Aug); Tue: Ge ZEW survey (Oct); Wed: EU19 ind prod (Aug), Ge HICP & CPI (Sep,f); Thu: Sp HICP (Sep,f); Fri: Fr & It HICP (Sep,f) |
| | UK: | Tue: BRC retail sales monitor (Sep), labour market (Aug/Sep); Wed: GDP (Aug), Services (Aug), Ind prod (Aug) , construction output (Aug), Trade balance (Aug), Thu: RICS survey (Sep), BoE's credit conditions & bank liabilities survey (Q3) |
| | Japan: | Wed: Priv 'core' machinery orders (Aug); Thu: Indu production (Aug,f) |
| | China: | Mon: Evergrande next coupon payments due; Wed: Exports & Imports (Sep); Thu: CPI (Sep,f); Expected this week: Total social financing (Sep), New yuan loans (Sep), M2 (Sep) |

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