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Investment Institute Macroeconomics

Resilience of the West

- One of the conditions for the transatlantic relationship to thrive is that Europe is convinced the US is not a spent economic force. It's easier today than 10 or 20 years ago.
- If PM Sunak manages to push through his deal with the EU on the Northern Irish protocol, for the first time since 2016 the extreme Brexiters will have failed to impose their view on the UK government.

This week we want to take a step back from assessing cyclical conditions and second-guessing central bankers to take a look at the transatlantic relationship, spurred by a view "from the outside", a long essay by Ding Gang, senior editor at China Daily, who highlights how the Ukraine war makes Europe more united and at the same time more reliant on the US, generally pointing at a more resilient than expected "West".

One of the conditions for Atlanticism to thrive is that Europe convinces itself that the US is not in economic decline. It is easier today than 10 or 20 years ago. Since the 1990s, the US had been increasingly seen as a "spent force" in terms of its capacity to compete with both the rest the "old world" and the emerging nations. GDP continued to grow faster than in Europe, but this came at the price of a rising current account deficit, proof that the US was living "above its means" and had less and less to sell to the rest of the world. Today, even if the US current account deficit is still significant, it is at half of its pre-GFC peak. Sustainability conditions are better achieved while the US can still exert significant traction on European exporters. Meanwhile, foreign holdings of US federal debt have been "westernised". The share of China has been declining and roughly 60% of foreign holders of treasuries now come from strong allies of the US, linked by free-trade agreements or military treaties. The "macro-financial West" still exists and this reality, in our view, shapes the EU's pathway. The solution to the challenge created by the IRA lies more in the EU's capacity to respond with its own industrial ambition than with confrontation at the WTO.

Brexit has been a thorn in the solidity of the "West" since 2016. We want to be cautious, and we are convinced that the next steps will be very slow to come, but if Prime Minister Sunak manages to push through his deal with the EU on the Northern Irish protocol this week, this will be the first time since the referendum that the extreme Brexiters will have failed to impose their view on the British government.

News from Atlantis

In a very recent long piece, Ding Gang, senior editor at China Daily, often considered as a non-official spokesperson for Beijing, drew some early conclusions from the war in Ukraine, highlighting how it has made Europe at the same time more united against the Russian threat and more dependent on the United States (US). Overall, the article could be read as an acknowledgement that the US-dominated post-war international order, from which China was de facto excluded because of its weakness at the end of World War 2 (WW2), is more resilient that maybe commonly thought. While it was unclear what practical consequences this would have for China – Ding Gang seemed to simultaneously recommend a better articulation of the alternative offered by Beijing and some acceptance that for now China needs to "live with" the current order – **this "view from outside" confirms the resilience of the transatlantic construct.**

Yet, many conditions are needed for Atlanticism to thrive. One is that Europe convinces itself that the US is not in economic decline**. Since the 1990s, the US had been increasingly seen as a "spent force" in terms of its capacity to compete with both the rest the "old world" and the emerging nations.** Your humble servant has to confess having written quite a few pages in the early 2000s about the US decline as an industrial producer. Yes, GDP continued to grow faster than in Europe, but this came at the price of a rising current account deficit, proof that the US was living "above its means" and had less and less to sell to the rest of the world. The structure of its trade with China was that of an "old style" developing nation, exporting primary products (food and energy), and importing manufactured goods, which may be fine for Australia but not necessarily a recipe for long-term success for a leading industrial power. In contrast, although Europe was also under significant competitive pressure from China, at least it managed to build a much more balanced trade relation. The only "nut" that Europe had not managed to crack was the US advance in the field of new digital technologies, but this was a rare oasis in an increasingly desertified manufacturing landscape which could not on its own suffice to rebalance the US books. **With the exception of hi-tech, this left Europe without the need to stress and fret about a "second competitive front" from the West…**. **but equally convinced that the US market could not eternally be the source of demand it had been in the post-war decades.**

The ambivalence of the European Union (EU) reaction to the US Inflation Reduction Act (IRA) – which illustrates a readiness from Washington to take bold action to retain its technological and economic leadership – is interesting from this point of view: concerns abound over the consequences for European competitiveness, but also, deep down, there might be some relief now that the US is reacting. This could explain the refusal by some of the most Atlanticist members of the EU, such as the Netherlands, to openly criticize the IRA. It seems that some of the structural developments in the US over the last few years – from energy independence to a re-appraisal of industrial policy – are forcing Europe to positively re-assess its main strategic partner.

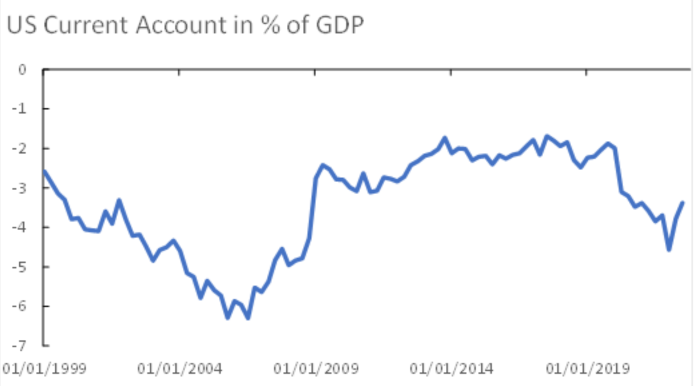
It is not the first time Europe is faced with a challenge from the US on international trade, but the IRA's nature is different from the usual defensive action from Washington DC. European capitals were -rightly- worried about the ease with which the US can decide to slap custom duties when it is unhappy about a bilateral commercial relationship, and European producers were often collateral damage in the various "trade wars" the US has been waging over the years. Yet, **a difference with the Trump era approach is that with the IRA, barriers to trade for foreign suppliers are matched by significant additional funding for a catch-up in investment in the US, including on some of the products on which the EU was expecting to gain an advantage**. For instance, the IRA's spending on converting to Electric Vehicles (EVs) – which will have to be produced in the US with a minimum domestic content – can trigger a catch-up of the US car industry which could then compete with European producers.

The impact of the IRA on the US current account – e.g., by substituting domestic production over imports - is unlikely to show up before several years, if at all (the positive impact on US demand could offset the competitiveness effect) but in any case, the US imbalances have significantly shrunk since the late 2000s. Before the Great Financial Crisis (GFC) of 2008, the current account deficit peaked at 6% of GDP, when the "global imbalances" theme was all the rage (see Exhibit 1). After the Great Recession "reset", It hovered in a range of 2 to 3% of GDP until the pandemic, when the consumption shift from services to goods coupled with massive stimulus deepened the deficit (4.6% of GDP in Q1 2022). Yet, the latest data point to some improvement again (3.4% in Q3 2022). We explored in previous issues of

Macrocast how the energy independence secured since 2019 has changed the picture for the US, shrinking its overall current account deficit while protecting against massive terms of trade shocks.

Yet, even if its current account deficit is not as massive as it used to be, the US remains a massive source of traction for suppliers' countries. In Exhibit 2, we calculate the direct contribution to German GDP growth from German exports to the US and China. Since the mid-2000s the two countries have roughly produced the same traction on the German economy – China compensating its lower share in German exports with stronger demand growth. Unsurprisingly given the differing reaction to the pandemic, in 2022 the US contribution has significantly exceeded that of China. This is likely to be attenuated in the quarters ahead, but while a few years ago the consensus view was that on trend China would overtake the US as a source of direct traction for the European countries, the long-term picture is now more ambiguous, given the reduction in the expected demand gap between the two biggest economies of the world.

Exhibit 1 – Still a deficit, but peak was c.20 years ago



Source: Bureau of Economic Analysis, AXA IM Research, February 2023

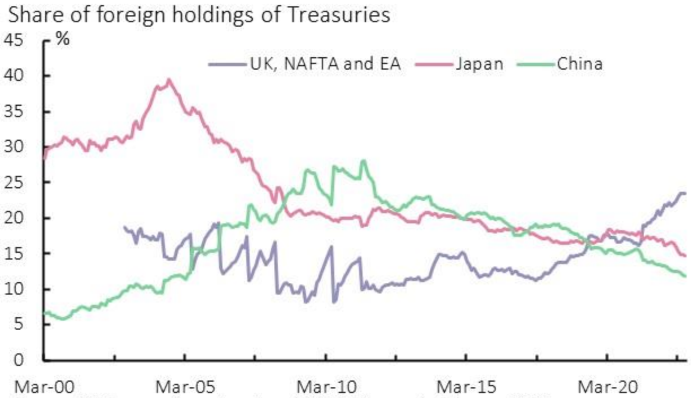
Exhibit 2 – Significant traction for Germany lately

Source: Deustche Bundesbank, AXA IM Research, February 2023

Another aspect of the generally pessimistic view of the US in the late 1990s/early 2000s was the country's increasing reliance on savings from emerging countries – China in particular – to fund its current account deficit. A general concern was that it would put the US at risk of political pressure (China brutally "dumping" its holdings of US securities was a "risk scenario" regularly explored). The expression "Bretton Woods 2.0" was coined to describe the informal system under which the US current account deficit could be funded without triggering a significant rise in US interest rates as China – and other emerging countries – would recycle their growing surpluses into US assets, in particular US treasury securities. The peak of such recycling came in 2010, when China accounted for more than a quarter of foreign holdings of US treasuries (see Exhibit 3) at the time when the US government debt market had reached the peak of its reliance on non-resident investors, who were holding half of US federal debt (see Exhibit 4).

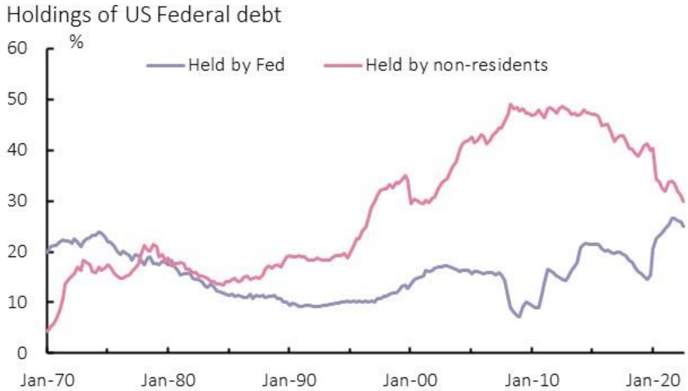
Conversely, the past 12 years have been characterized by the twin decline in the overall share of foreigners in holdings of US federal debt (from 50% to 30%) and that of the share of China in this (from 25% to 15%). Non-residents have been replaced by the Federal Reserve (Fed) – through the Quantitative Easing (QE) operations – and "ordinary" resident investors. Within what remains of the foreign holdings, the most striking development – and under-discussed in our opinion – has been the steep rise of Western countries. If we bundle together Canada, Mexico, the United Kingdom (UK) and the Euro area, these Western nations now stand for nearly a quarter of total foreign holdings of US debt, twice as much as in 2017. If one adds Japan to this group – although its share has been falling over the last few years – as well as South Korea, Taiwan and Singapore, **close allies of the US, via North American Free Trade Agreement (NAFTA), North Atlantic Treaty Organization (NATO), or bilateral security agreements, stand for almost 60% of the foreign holdings of US federal debt.**

Exhibit 3 – The “westernization” of US debt



Source: US Treasury Department and AXA IM Research, February 2023

Exhibit 4 – US federal debt less reliant on non-residents



Source: US Treasury Department and AXA IM Research, February 2023

When it comes to its government funding, the US now finds itself in a much more secure position from a political standpoint than at the time of the Great Financial crisis. Note that the dominance of “intra Western financial flows” is also true when looking at the equity market. As of December 2022, European, Canadian, and Japanese investors stood for 52% of foreign holdings of US corporate stocks, against only 2.3% for their Chinese counterparts.

The “macro-financial West” still exists. It comes with significant vulnerabilities of course – in particular the US regular temptations to opt for an isolationist course but this reality, in our view, shapes the EU’s pathway. Military, energy, macroeconomic and financial links make it difficult to engage in a confrontation with the US on industrial policy, for instance via the World Trade Organization (WTO). The solution lies more in the EU’s capacity to respond to the IRA with its own industrial ambition. A complementary, positive sum game, rather than confrontational approach.

A ray of light on the “delivering Brexit” saga

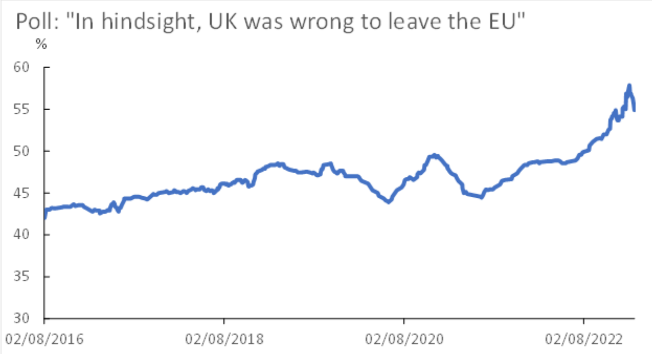
Brexit is obviously a sign that “not all is well” in the Western construct. It is a negative sum game in terms of Western solidity since the UK has not been able so far to offset the damage to its relationship with Europe with a tighter relationship with the US (even Donald Trump did not show any pressing desire to negotiate a swift free-trade agreement with post-Brexit Britain). It is also a source of distraction, with the entire British political personnel busy dealing with the aftermath of a decision made seven years ago – without much conclusive success so far. Finally, the UK’s economic weakening limits its capacity to lead in international affairs, even if it has taken a very clear approach to the Ukraine war. We do not frequently comment on the UK in Macrocast – although it is your humble servant’s base – possibly to avoid repeating depressing conclusions. There might however be a ray of hope at the moment. **If the Prime Minister (PM) manages to cut a deal with the EU on the “Northern Irish protocol” this week without too much damage to his domestic political standing, it will be the first time since 2016 that the most extreme Brexiteers will have failed to ultimately impose their view on the government.**

When exploring the consequences of the demise of “Trussanomics” last year, our conclusion was that there is no viable path for the UK which would not entail a rapprochement with the EU. Trussanomics was an almost pure version of the libertarian leg of the Brexit movement – “shedding the shackles” of an overly interventionist EU to move to the sunny uplands of low tax and deregulation. Its collision with the market last autumn has closed the option. The other one is the populist version of Brexit, which quite the opposite embraces state interventionism and redistribution. It would collide as well with the reality of a much-deteriorated fiscal position… and with Rishi Sunak’s own “small state” convictions. If growth cannot be obtained by decree, we are back to the fastidious approach of all middle-of-the-road governments across the world: focusing on fostering the best possible conditions for the private sector to thrive, and in the current state of affairs in the UK, this means mending some of the bridges with its neighbouring market.

Not a lot of details are available on the content of the potential deal, but the British press is remarkably convergent on a number of key features, most notably: (i) the separation of exports from Britain to Northern Ireland in two "streams", one directed to the local market only – with minimal controls – and the other to re-export to the EU; (ii) some reduction in the role of the European Court of Justice in adjudicating disputes on the implementation of the protocol; (iii) some possibility for the Northern Irish institutions to be consulted in case of changes in EU rules applied to this territory. The EU clearly made some important concessions.

That Sunak prevails in this battle is not a done deal, and he will have to count with the overt opposition from a still influential Boris Johnson. who continues to push for the possibility for the UK to unilaterally stop implementing the protocol, bu**t it seems that even some arch-Brexiters, possibly worried by the electorate fatigue with the whole issue, are open to a deal**. Polls suggest that a fairly clear majority of British voters now consider leaving the EU was a mistake, with an uptick coinciding with the brief Truss experiment (see Exhibit 5). But possibly even more concerning for the Conservative party, now almost entirely "purged" of its most vocal Remainers, polls also suggest that up to 70% of respondents consider the government is not "handling Brexit well". A reformed Northern Irish protocol would only scrap the surface of the economic cost triggered by Brexit, but it would still materialise a new, more cooperative, pragmatic mood between the UK and the EU. This much would be progress, even if we don't hold our breath for major breakthroughs in the years ahead. The Labour party – the clear polls' favourite for next year's general elections - is still taking great pains at not being painted as a "remain party". The willingness to reopen some key issues – for instance the conclusion of a custom union with the EU – is for now extremely low.

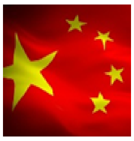
Exhibit 5 – Buyer's remorse



Source: National Centre of Social Research, AXA IM Research, Februaryt 2023

Still, the UK could do with a bit of good news. True, like the rest of Europe, judging by the latest Purchasing Managers Index (PMI) readings, the UK may have been granted a reprieve and might – just – avoid a GDP contraction in Q1. But this creates the same headache for the Bank of England (BoE) as for the European Central Bank (ECB), and the Fed on the other side of the pond: should this warrant even more monetary tightening? Among the three central banks, the BoE has been the most hesitant – at least in its communication. It felt that it resorted to rate hikes rather half-heartedly, just waiting for a largely spontaneous recession to further its anti-inflation agenda. It's one of the very few central banks in this particular tightening phase which has explicitly suggested the market was too hawkish in its pricing of the trajectory for policy rates. The BoE's hesitancy may have a lot to do with the fact that monetary policy transmission may well be swifter in the UK than in the US or in the Euro area, because of the dominance of revisable mortgage rates.

Beyond this familiar dilemma, an issue for the UK at the current juncture is a general lack of strategic direction, while it suffers from some of the same structural headwinds as both the US and the Euro area. Just like the US, the UK needs to deal with a labour supply shortage which maintains a high level of pressure on the labour market. Indeed, the labour market participation rate in late 2022 still stood nearly 1 percentage point below the pre-pandemic level. Just like Europe it is suffering from a significant terms of trade shock in the context of the rise in energy price, compounded by the impact of the depreciation of sterling. Finding a new roadmap after years of quite simply piling up more cheap labour in the economy – at the cost of weak aggregate productivity – is still elusive.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC minutes (Feb) reiterated case for "ongoing increases", with "a few" favouring a 50bps rise. • PCE inflation (Jan) rose to 5.4% and 'core' to 4.7%, compounding fears of stickier inflation. • GDP (Q4) revised lower to 2.7% (saar), from 2.9% with consumption spending revised to 1.4% from 2.0%. • Personal spending (Jan) rose by strong 1.4%, in line with retail sales, he saving rate rose to 4.7% • US services PMI (Feb) rose to 50.5 from 46.8	• Survey evidence: Chicago PMI and ISM (Feb) to confirm still subdued manufacturing activity; ISM non-mfg (Feb) to reinforce January bounce. • Vehicle sales (Feb) to see if Jan's bounce one-off. • Conf Bd consumer confidence (Feb) for broader improvement in consumer trends as inflation slows. • Durable goods orders (Jan) to gauge strength of business investment activity • House price indices (Dec)
	• EMU February business confidence ("flash" PMIs, INSEE, IFO) are again in expansion territory, consistent with growing GDP at c. (+0.1/0.2%qoq) • EMU Jan final HICP headline and core were revised up by +0.1pp to 8.6%yoy and 5.3% respectively. German details showed increases in service prices are strong. • Q4 Ge GDP revised down to -0.4%qoq from -0.2% due to stronger decline in private consumption and capex	• February flash Inflation data : Belgium (Mon), Fr and Sp (Tue), Ge (Wed), EMU and It (Thu). Consensus expects the headline to decline to 8.1%yoy (-0.5p) and core at 5.3% (unchanged). • Loans to households and non-fin companies (Jan) • European Commission surveys (business climate, household confidence, selling price) (EMU, Feb) • Final PMIs (Feb), EMU producer prices (Jan)
	• Public finances (Jan) saw yearly borrowing £30bn lower than OBR forecasts – points to potential for near term stimulus. • Flash PMI (Feb) saw output rebound markedly with a recovery in services driving the uptick in output. • GfK cons conf (Feb) rose to highest since April 2022	• BoE household lending data (Jan) expected to reflect continued moderation in housing market • Nationwide house prices (Feb) expected to decline further though likely at a slower pace. • MPC members Bailey, Pill, Broadbent and Mann speak across the week
	• BoJ Gov nominee Ueda testified in the lower house: affirmed need for continued easing and suggested that there was still some distance to 2% inflation. • CPI inflation (Jan) rose to 4.3%yoy, with BoJ core (ex fresh food and energy) rising to 3.2% • Mfg PMI posted further declines to 47.4 from 48.9	• Industrial output (Jan) expected to decline -2.6%mom • Retail sales (Jan) forecast to rise 4% mom as the consumer recovery continues • Tokyo CPI (Feb) may show signs of price pressures beginning to ease as base effects weigh
	• PBoC injects liquidity via MLF, and keeps rates steady • President Xi pledges to support growth and continue to open the economy in a *Qiushi* article • Mobility metrics rise to above 2019 levels. House and auto sales improve last week but remain subdued. Industrial activity starts to pick up	• PMIs (Feb) to show continued momentum recovery • National People's Congress to kick off on Mar-5… • …where Beijing will announce the 2023 economic targets and policy focuses • A new Premier will be sworn in along with his economic team
	• Bank of Korea kept rate unchanged at 3.5% but took a hawkish tilt keeping the possibility of one more hike • Q4 GDP TH (1.4%yoy) TW moderated to -4%yoy. • Russia annual GDP at -2.1%yoy. • South Africa PPI declined on petroleum and coal sector. Release of 2023 budget	• December quarter GDP for India to remain largely supported by domestic demand • February export for Korea to see further weakening • CPI: Indonesia, Kenya, Turkey • GDP: Turkey, Poland and Peru

Upcoming events		
	US:	Mon: Durable goods (Jan), Pending home sales (Jan); Tue: Goods trade balance (Jan), C-S & FHFA HPI (Dec), Chicago PMI, Conference Board consumer conf. (Feb); Wed: Manf. PMI (Feb), ISM manf. indx (Feb); Thu: Weekly jobless claims (25 Feb); Fri: Composite PMI/Services (Feb), ISM non-manf. index (Feb)
	Euro Area:	Mon: EU20 M3 (Jan), Business conf./consumer (Feb), It ISTAT business/consumer conf. (Feb); Tue: Fr GDP (Q4), HICP (Feb), Consumer spending (Jan), Sp HICP (Feb); Wed: EU20, Ge, Fr, It, Sp Manf. PMI (Feb), Ge Unemployment (Feb), Ge HICP (Feb); Thu: EU20 HICP (Feb), EU20 Unemp. (Jan); ECB publish Feb meeting account, It HICP (Feb); Fri: EU20 Composite PMI/Services (Feb) & PPI (Jan), Ge, Fr It, Sp Services PMI (Feb), Fr Ind. prod. (Jan), It GDP (Q4)
	UK:	Wed: BRC Shop Price indx (Feb), Manf. PMI (Feb), Mortgage approvals (Jan), Net mortgage lending (Jan), Consumer credit (Jan), BoE Bailey speaks at cost-of-living crisis event; Fri: Composite PMI/Services (Feb)
	Japan	Mon: Ind. prod. (Jan); Thu: Consumer conf. (Feb)
	China:	Wed: Official manf./non-manf. PMI (Feb), Caixin manf. PMI (Feb); Fri : Caixin services PMI (Feb)

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Our Research is available online: www.axa-im.com/investment-institute

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