AXA Investment Managers

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Investment Institute Macroeconomics

Summers' Blues

- Fed to "stay put" for now, ECB to hike by 25bps, but all eyes on "soft forward guidance".
- Larry Summers has painted a bleak picture of the US long-term fiscal challenges. We use it as a starter to discuss Europe.

This week is of course going to be defined by the central banks. We expect the Fed to "stay put" for now, but the focus will be on the future trajectory. We expect the prepared statement to stick to the line laid out in May and maintain a "soft directional" bias, but we acknowledge that the US data flow will have to deteriorate further on the growth side – as in our baseline - to avoid another hike in July, while the May inflation print to be released this week could be crucial. Just like everyone else we expect the ECB to hike by 25 bps this Thursday while maintaining a tightening bias for the future, but without firm guidance. We continue to think July will be the peak of the ECB's tightening, but we also think that the Governing Council has not reached a consensus as to what to do after the summer break. September remains in play, despite the Euro area's fall in "technical recession."

Now, while we have been discussing monetary policy a lot since the end of the pandemic, we think fiscal policy is going to be more in focus in the coming years. We listened carefully to Larry Summers' speech at the Peterson Institute on 1 June. It's not for the faint-hearted, as he painted a quite bleak picture of the structural forces shaping US public finances. His main point seems to be that Americans need to accept a significant rise in taxation across the board, implicitly towards European levels. This is of course a politically challenging proposal in the current environment, both for the right and the left since he believes that the "populist solution" (taxing the wealthiest only) would not be commensurate with the magnitude of the revenue shortfall on trend.

Europe's starting point is more favourable (the deficit and debt ratios are lower in the Euro area as a whole than in the US, "consent to taxation" is higher, the fiscal process is less ideologically charged), but thorny issues abound on the horizon. We add to the mix the cost of the green transition, drawing on Jean Pisani-Ferry and Selma Mahfouz's report. While the debate usually focuses on more debt and more tax, we also take a quick look at episodes of spending restraint.

Fed: a hawkish hold?

Philadelphia Fed President Harker had provided a very straightforward "statement of intent" on 1 June*: "It's time to at least hit the stop button for one meeting and see how it goes*" while adding *"we have to be ready that we might have to do more*". This would get the Federal Reserve (Fed) in a "directional pause mode" this week: the tightening bias would remain, but with some openness to the possibility that enough has already been done. **Our baseline is that indeed, the peak of monetary tightening has been hit**, as we expect more tangible signs of an economic slowdown to materialise by the time the Fed meets again in July, but the market is pricing one last hike in 6 weeks after a 70% probability of the Fed keeping rates unchanged this Wednesday.

The Fed merely "skipping" a meeting rather than having already brought policy rates to their peak would fit well with the recent "global mood" as the Reserve Bank of Australia and the Bank of Canada have resumed hiking last week. However, **we think that the US dataflow is not unequivocally calling for more policy action**. True, there is some Beckettian quality in the current wait for a recession which in the United States (US) has stubbornly refused to materialise so far, but we note that the non-manufacturing ISM index came out in May barely in expansion territory at 50.3 (lower readings have been seen only in recession times). Combined with some stabilisation in wage growth – at least according to the payroll numbers – and good news on ex-housing service prices in the recent Consumer Price Index (CPI) prints, we think there is already a good – however not an overwhelming one – case for the Fed to consider that its job is done.

We acknowledge it is a close call. As we discussed last week, the labour market is very difficult to read at the moment with conflicting data sources. We may get some clarity on the Fed's intentions this week, with two main conduits: the Federal Open Market Committee (FOMC) members "dot plot" and the wording of the prepared statement. **One more hike could be easily telegraphed by simply adding one in the members' forecasts for end 2023, and it would be quite straightforward for the Fed to come back to the "old" wording for the soft forward guidance**. In May, the less committal *"determining the extent to which additional firming may be appropriate"* replaced the more directional *"the Committee anticipates some additional firming may be appropriate*" of March. Reverting to the latter would surprise us however, precisely because **we fail to see in the current dataflow enough evidence that it's possible today to make a clear determination for where monetary policy should be even at only a 6-week horizon.** Keeping options opened – in practice maintaining the statement as it was – is in our opinion the most appropriate course of action. There is no reason to believe the FOMC sees better through the current "data fog" than anyone else.

It would probably take an upside surprise in the inflation data for May to be released on Tuesday to tilt the FOMC in this direction. Actually, a very strong reading could be the trigger for hiking again in June without "skipping" – Harker mentioned that two pieces of data could still change his mind, the payroll release, and the CPI print. Given the low probability of such move in the current market pricing and the Fed's attention "not to rock the boats" recently, we would expect some warning to come via a "friendly article" in the Wall Street Journal in the coming days, if such was the FOMC's determination.

ECB: the big debate is still ahead

As much as we believe the Euro area's "technical recession" over Q4 2022-Q1 2023 reflects proper weakness beyond the one-offs – e.g., the wide gyrations in Irish GDP which are truly becoming an issue for any immediate readings of aggregate national accounts at the region's level – **we do not think this is enough to sway the European Central Bank (ECB) at this juncture**. We have been arguing for some months that central banks, faced with the kind of persistent inflation shocks they are dealing with now, probably consider that GDP contractions may well be the price to pay to deliver on their mandate. We would add that institutional differences across the Atlantic, e.g., the fact that wage bargaining is more centralized in the Euro area than in the US, may make the ECB less ready to "gamble" on a swift response of labour costs to cyclical changes.

There is very little suspense around the fact that the ECB is likely to hike its policy rates on Thursday, so the market is going to focus on what may lie ahead. Keeping the prepared statement unchanged is the best way for the ECB to signal that June is very unlikely to mark the peak of its tightening without triggering too much tension within the Council. The May version more than hints at more hikes: *"our future decisions will ensure that the policy rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target."* Yet, if, as we expect, this is followed by the same points on "data dependence," this would probably form the basis of an acceptable consensus at the ECB around the notion that they are" not there yet" without pre-committing to any precise number of additional moves. Indeed, we believe the battle lines are drawn around whether July could be the "peak," or if a continuation well into the second half of 2023 will be necessary.

The forecasts could also convey a sense of "compromise." Indeed, given the latest dataflow it would be surprising to see the ECB not taking its GDP projections down, for 2023 and probably 2024 given the carry-over effects. On the inflation side, the projections could be lowered for 2025 for headline inflation from the March above-target 2.1%, reflecting lower oil prices and the lagged effect of a stronger euro, while core inflation could be kept above target (it was 2.2% in the March batch), reflecting strong domestic pressure, notably from the labour market, in a nod to the hawks.

Our baseline is still that the ECB hits its tightening peak in July but, as we have been discussing over the last few weeks, we also see a significant risk that we will need to wait until September to get there. We don't think that this week's meeting will bring much clarity to this particular debate: the dataflow will determine this. Habitual readers of Macrocast may remember that **we think the German labour market holds the key**. Based on the historical relationship between GDP growth and the unemployment rate, Germany is now very close to an "inflexion point" which may change the terms of the current wage bargaining process. The issue of course is that by September, the ECB will only have the Q2 data for negotiated wages. It is shaping up to be a fierce debate, within a persistent "data fog."

We have dedicated an inordinate number of words to discussing monetary policy in Macrocast for the last 18 months. This is only to some extent the product of your humble servant's personal history with central banking. The "sea change" in monetary policy in response to the abrupt transition from "deflation risk" to "persistent inflation" has been truly remarkable and has shaped to a large extent macro and financial developments since the end of the pandemic. Yet, while we may argue for hours on the exact timing of the monetary policy peak, it is probably only a matter of months. We increasingly believe that fiscal policy is going to be critical, from a macro, financial and political point of view in the years ahead. So, dear reader, after having put up with months of monetary rumination, you may have to brace yourself for a large dollop of fiscal hair-splitting ahead.

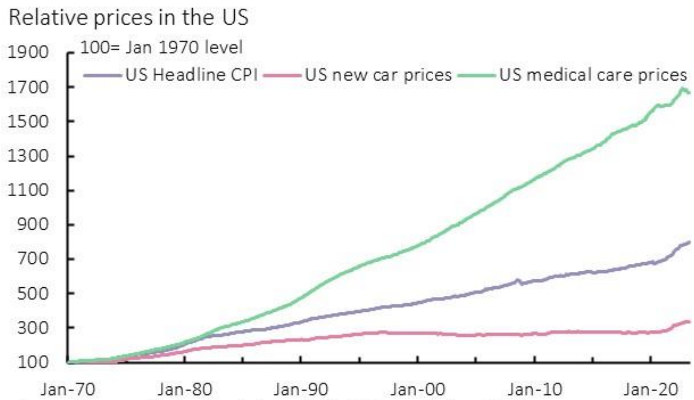
Larry Summers' scary computations

The folk-singer Loudon Wainwright wrote a Blues song about Nobel Prize winner Paul Krugman, mocking his doom-mongering on US media (see the link here for those interested in academic comedy). **Blues may however not be sad enough to fit Larry Summers' latest speech on fiscal issues at the Peterson Institute** (link here). We were in Nick Cave territory, or Bruce Springsteen in "Nebraska" mood. Those who like to start their week on a sunny disposition may want to skip this section of Macrocast. You've been warned.

Summers starts from the Congressional Budget Office (CBO)'s latest projections, which have the fiscal deficit at 7.3% of GDP at a 10-year horizon under a no policy change assumption, with a debt to GDP ratio of 119%. He however sees 4 reasons why this may well be too optimistic. The interest rate assumption (2.3% on average over the coming 10 years for the 3-month rate) is too low, failing to take on board the legacy of the current inflation shock – and the Fed reaction to it. The CBO assumed defence spending to gradually fall as a share of GDP, which is at odds with the current geopolitical situation, between the war in Ukraine and the relentless rivalry with China. Summers notes that defence spending in the CBO's baseline would fall below the levels seen in the 1990s when the US was an unrivalled hegemon. Third, the CBO does not take enough note of the relative price drift between what is paid by the government and what is paid by the private sector (the price of healthcare typically rises faster than that of the average consumer's basket, as we illustrate in Exhibit 1). Fourth, the CBO may be over-optimistic on tax receipts, in particular because by construction it posits that the non-permanent tax cuts granted by President Trump will fade, which is politically "brave". **The accumulation of these four factors would bring the deficit well above 10% of GDP – coupled with an explosive trajectory for public debt.** Of course, one can dispute some of Summers' assumptions. For instance, the CBO's interest rate forecast is slightly lower but not that far away from the Fed's own estimate of the long-run value of its policy rate (2.5%), while Summers' 4% is at the upper end of the distribution. But the more structural aspects of his speech are much harder to refute.

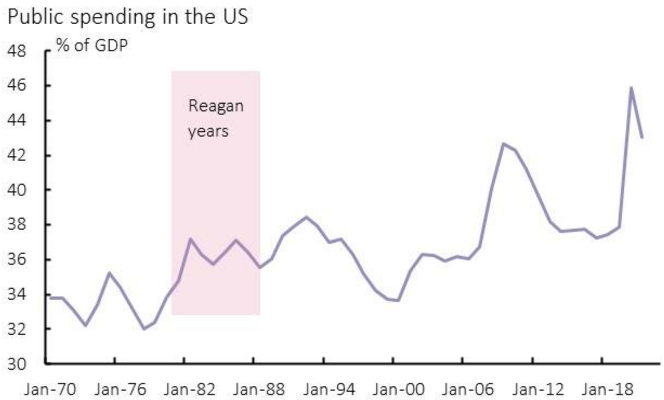
Summers made it plain in his talk that such scenario is valid only at "constant values", in other words that collective preference for (more) spending and (lower) tax would be unchanged, but he opined that **even an ideological shift of the magnitude of the one which seized the US at the beginning of the 1980s under Ronald Reagan would not bring about enough change in public spending.** Indeed, when we look at government expenditure in the US in the 1970s and 1980s, "Reaganomics" did not coincide with a regime change (see Exhibit 2). Spending was understandably volatile around the two oil shocks, but the trend was upward well into the 1980s. Perhaps counter-intuitively, public spending did not fall convincingly before the Clinton era – and only for a relatively short time.

Exhibit 1 – Massive relative price drift



Source: Bureau of Labor Statistics and AXA IM Research, June 2023

Exhibit 2 – Even Reagan did not roll back public spending



Source: OECD and AXA IM Research, June 2023

Summer's underlying message – which makes sense given his own political preferences – is that, rather than counting on action on the expenditure side which historically has never been possible on a sustained basis, **the US should focus on raising tax receipts**. But he did this while also crushing some illusions on the Democratic side: even when considering the fact that a larger share of total income is now concentrated among the wealthiest, focusing the tax effort on the upper brackets would not move the dial enough to bring public finances on a sounder footing. The income of the "top 1%" stands at 10% of GDP, of which 3.5% is currently extracted as tax. Summers calculates that even bringing the marginal tax rate to the 70% to 90% historical peak would raise tax receipts by a maximum of 2% of GDP, less than a fifth of what he expects the "trend deficit" to be. In short, "taxing the rich" is no panacea. So, **Summers' ultimate message seems to be** – although he did not spell it out as clearly – **that the US needs to raise government income "across the board," with a larger base and not just more progressivity, we suspect very much in line with the current European standards.**

And what about Europe?

This gets us naturally to Europe. We discussed two weeks ago how – except for Italy – the biggest member states all posited a rosy scenario for the gap between nominal GDP growth and the government's refinancing rate in their most recent stability programs, which flatters their debt trajectory a bit too much to our liking. But more fundamentally, some of the structural forces at work in the US will also push public expenditure up in Europe, not least because the cost of ageing tends to be more socialized on this side of the pond. The war in Ukraine has also operated as a "wake-up call" on Defence spending on a continent where – with a few exceptions – governments had been milking "peace dividends" since the end of the cold war.

Still, when looking at where public finances stand today, Europe probably looks more balanced than the US. To start with, public debt is expected in 2023 to be lower in the Euro area than in the US (90.8% of GDP according to the European Commission against 98.2% according to CBO), and the expected 2023 deficit is also smaller (3.2% of GDP against 5.6%). Most governments are pledging to return deficits below 3% of GDP by 2024 or 2025, and maybe more fundamentally the budgetary process on this side of the pond is not as much a hostage to intractable ideological conflict as in the US. But a lot of this positivity can be traced back to the fact that, **unlike in the US, by and large, public opinion in Europe has so far accepted that their desired level of public service must be matched with large tax receipts**.

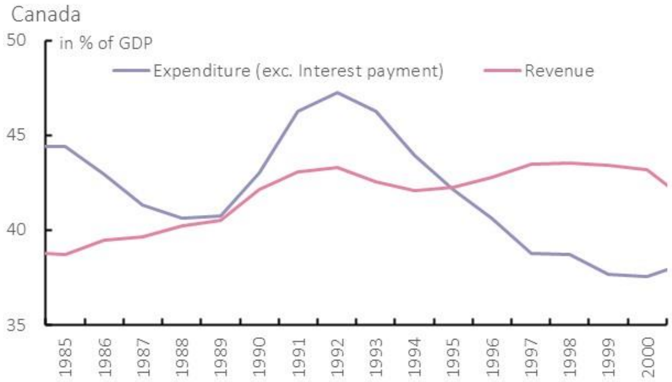
However, with tax receipts very close to 50% of GDP in many member states, **the remaining margin of manoeuvre on that front is probably extremely thin.** It is an over-simplification of course, but while the US has a clear "tax deficit" to fill, Europe's problem is more firmly located on the spending side. **In addition, the fight against global warming must be introduced as a new variable in this already complicated equation**. The US Inflation Reduction Act (IRA) may be grabbing headlines now, to the detriment of the European Union (EU)'s often less straightforward initiatives, but the EU's resolve on hitting "net zero" is much clearer than the US. If there's a continent politically ready to change its policies in a way that is consistent with a proper decarbonisation, it's Europe. Now, **it seems that there is less and less naivety about the fiscal cost this will entail.**

The report coordinated by Jean Pisani-Ferry and Selma Mahfouz for France Strategie spells it all remarkably clearly. What your humble servant enjoyed most in reading it was its capacity to connect the most mundane aspects of the fight against climate change, such as the insulation of homes, the replacement of heating devices and the shift to electric cars, to the thorniest economic policy issues. Pisani-Ferry and Mahfouz calculated the cost of these three items for various income brackets in France. For the bottom 20% of the income ladder, the overall effort (spread over the lifetime of the new equipment) would stand at 22% of disposable income. This leaves us under no doubt that given how socially regressive the cost of fighting global warming can be, it's highly likely it will have to be largely socialized by the government. We note as well that the redistribution effort would quickly meet some difficulties, since the middle class would also face a significant effort (13% of disposable income for the fourth and fifth decile of the income distribution). Summers' warning about the limits of using tax rises on the wealthiest to fill the gap may well apply on Europe as well as in the US.

Jean Pisani-Ferry quipped that the choice was between more tax or more debt. **If the taxation avenue is politically fraught, raising more debt has become economically dangerous in our opinion**. Your humble servant proposed in 2019 to "front load" the funding of the green transition through a massive issuance of mutualized debt in the EU at the time long-term interest rates were negative. This train has however left the station for now.

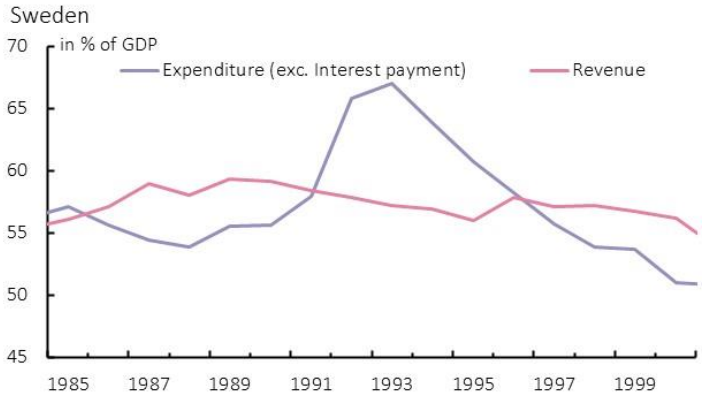
Then, logically the last remaining avenue to explore is: how prepared are European countries to "make space" for additional redistributive expenditure – plus the necessary investment effort, for instance in electricity grid – by curbing "ordinary" spending? While – maybe counter-intuitively – the US has not necessarily been particularly efficient at curbing government spending, **we can find examples of countries sharing at least some of Europe's current collective preferences which in the past have managed to cut their spending to GDP ratio**. Canada and Sweden in the 1990s are the two canonical examples of materialisation of an explicit public finance reform strategy in "socially-minded" nations. In both cases, while government spending rose in response to the recession of the early 1990s, by the end of the decade, public sector expenditure had fallen by around 5 percentage points relative to the pre-recession level, which is large relative to the additional investment effort needed to bring about the energy transition (2% of GDP annually according to the European Commission). We note however that **these remarkable turnarounds occurred *before* the impact of ageing on public finances was acute, and at a time political life was not as polarized as today.**

Exhibit 3 – Canada did it…



Source: OECD and AXA IM Research, June 2023

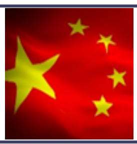
Exhibit 4 – …Sweden as well



Source: OECD and AXA IM Research, June 2023

Of course, these are not the only examples of decline in public spending seen in socially advanced countries, but the more recent ones fall in the "adjustment under duress" category. Portugal for instance has managed to reduce primary government expenditure by almost 10% of GDP between 2010 and the beginning of the pandemic and as much as Lisbon's impressive turnaround must be lauded, the programmes set in motion under the auspices of the European Commission and the International Monetary Fund (IMF) can hardly represent a desirable model. Symmetrically, of course, a positive exogenous growth shock, for instance the advent of a clean, cheap, and scalable energy source would change the entire picture but making policy plans on such an assumption is adventurous.

Our point here is that **while there has been quite a bit of Schadenfreude in Europe when the US were wallowing in their toxic budgetary process a few weeks ago with the "debt ceiling drama," Europe is going to face some very thorny choices** in the coming decade which may affect their very social fabric. Negative interest rates have been a powerful anaesthetic. It is being removed exactly at the time governments seize the magnitude of the global warming challenge, which adds to an already full plate of daunting issues for socialized spending. This won't be an easy ride.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• ISM non-mfg (May) fell to 50.3 from 51.9, index only lower in recessions, new orders 52.9 from 56.1 • BoC surprise +0.25% to 4.75% contributed upside risk fears to Fed outlook in absence of Fed commentary • Jobless claims jumped to 261k, highest in 18 months. Memorial Day seasonals create uncertainty • Trade deficit (Apr) rose to $74.6bn from $60.6bn, will dampen Q2 GDP, which we est c 1% (saar) • Govt begins rebuild of cash account at Fed (TGA)	• FOMC announcement. Expect "skip", FFR unch at 5.25%. SEP projections published – dots watched for July hike signal. We do not expect this, but close • CPI inflation (May) headline expected to fall on gas and base effects to around 4%, core should also fall • Retail sales (May) should soften after solid Apr. • Empire & Philly Fed surveys (Jun) both hovering around recession territory • Michigan Uni 5-10y inflation expectations (Jun, p)
	• IP came below expectations in most countries: It (-1.9%mom after -0.6%), Ge (+0.3%mom after -3.4% in March) • April Eurozone retail sales was flat (0%mom). Carry over for Q2 remains largely negative • Final euro area GDP was revised lower at -0.1%qoq, now officially in "mild" recession. Employment remains extremely resilient, progressing +0.6qoq (Q1) • Producer prices decline again by 3.2%mom	• ECB meeting. We anticipate a consensual rate hike of 25bps and a communication oriented towards at least another hike in July then "data dependant" • Final inflation figures and details for EMU countries (May) • ZEW surveys for Germany • Euro area IP (Apr) • EMU Labour cost (Q1)
	• BRC Retail sales monitor (May) indicates retail sales remained subdued despite bank holiday boost • RICS Housing (May) suggests demand stabilising but does not reflect recent rise in mortgage rates • Sunak and Biden unveil 'Atlantic Declaration' to strengthen economic ties but falling short of trade deal	• Labour market data (Apr/May) employment to be watched closely to see if 182k payrolls fall confirmed in LFS, further easing in wages expected • GDP (Apr) expected 0.3%mom following May drop • Trade balance (Apr) should continue to narrow from -16.4bn on lower oil prices
	• GDP(Q1) revised up to 0.7%qoq from 0.4% driven by capex as indicated in recent MoF corporate survey • Wage data (Apr) up 1%yoy disappoints vs expectation of 1.8% not yet reflecting strong FY23 Shunto, but upward pressure on wages building	• BoJ meeting. We expect all policy tools to remain unchanged. Ueda's press conf to be closely watched for signal inflation is overshooting its forecasts • Trade balance (May) • Chain store sales (May)
	• CPI (May) edged higher to 0.2%, but still very soft • PPI (May) fell to -4.6% from -3.6%, add deflation worry • Exports (May) fell by sharp 7.5%yoy ($ terms) • Caixin services PMI (May) rose to 57.1 from 56.4	• Agg financing (May) expt'd to rise from soft April • 1yr lending rate expected unchanged, vols to rise • May's monthly data releases, inc industrial production, retail sales, fixed invest and jobless
	• CB: India (6.50%), Peru (7.75%), Poland (6.75%) & Russia (7.50%) kept policy rates unchanged • April CPI eased in Brazil (3.9%), Colombia (12.4%), Chile (8.7%), Indonesia (4.0%), Mexico (5.8%), Philippines (6.1%), Thailand (0.5%) & Turkey (39.6%) • Q1 GDP grew 0.1%qoq in Romania & 0.4%qoq in South Africa	• CB: Taiwan (1.875%) is expected to stay on hold • ECJ meeting for Poland • CPI (May): India & Czechia • Industrial production (April): Colombia & India • Q1 GDP data in Russia • Economic activity index (Apr): Brazil & Peru

Upcoming events	US:	Tue: CPI (May), NFIB small business optimism (May); Wed: FOMC announcement, PPI (May); Thu: Retail sales (May), Weekly jobless claims (10 Jun), Philadelphia Fed index (June), Empire State manufacturing survey (Jun), Ind prod (May), Business inventories (Apr), Long-term investment flows (Apr); Fri: Michigan consumer sentiment (Jun)
	Euro Area:	Tue: Ge & Sp HICP (May), GE ZEW survey (Jun), Ge Current account (Apr); Wed: EU20 Ind prod (Apr); Thu: ECB Meeting, EU20 Trade balance (Apr), FR HICP (May); Fri: EU20 CPI (May), It HICP (May)
	UK:	Tue: Labour Market data (Apr); Wed: GDP (Apr), Trade balance (Apr)
	Japan:	Thu: Trade balance (May), Private 'core' machinery orders (Apr); Fri: BoJ policy announcement
	China:	Mon: Caixin services PMI (May); Wed: Exports, Imports & Trade balance (May), Foreign exchange reserves (May); Fri CPI (May), M2 (May), New yuan loans (May)

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