Sunday Wrap

Happy Sunday - and Happy May Day weekend, if you celebrate it,

I had the pleasure of joining Joumanna Nasr Bercetche and Juliana Tatelbaum on CNBC's Street Signs Friday morning to discuss the release of European Q1 GDP numbers, the challenges facing European companies in this increasingly fragmented world as well as ECB and Fed policies.

Eurozone growth disappointed with meager 0.1% (qoq) growth in Q1, but the real story was the remarkable difference between the zero growth reported in Germany and the strong 0.5% qoq growth in Italy (or 2.0% annualized, as the US would have called it.) Those numbers triggered this pertinent question from Bercetche: "Is Germany becoming the sick man of Europe?"

That is indeed the number one question which German economic policymakers should ask themselves. While underlying German balance sheets remain comfortable, the German export-dependent business model needs to be adjusted to boost domestic demand in the medium term. To engineer such a shift, something better than the present accounting-based fiscal policy approach (to both German and European fiscal policy) will be needed in Berlin. In this context, the impressive Italian GDP number didn't come out of thin air. Instead, it bears witness to the benefits of smart and aggressive fiscal policies, as put in place in Rome – with the help of EU money – during Covid.

We also discussed the monetary policy responses to high inflation. As I have argued for the past 12-18 months, the ECB is very likely to overdo the tightening, while the Fed is much closer to the mark. On Wednesday, the Fed is likely to hike rates by 25bp – and say that this probably is it for now. A day later, on Thursday, the ECB will raise interest rates by another 25bp (or maybe even by 50bp) while sending a message that further hikes are in the pipeline.

In today's note, I'll explain why I think the ECB is getting it wrong. Three brief sections:

- **A super-brief summary of the ECB narrative, with a few comments.**
- **A simple macro double-check, which suggests that the ECB is not right.**
- **A question why they are doing it, and what the consequences may be.**

1. A super-brief summary of the ECB narrative with a few comments.

The message from across the ECB's Governing Council of continuously tighter monetary policies has been clear for the past year or so. Indeed, until the last meeting, the clarity of intentions was borderline pre-announcements.

In their narrative, what started as a supply shock some 18 months ago has somehow developed into a mixture of supply and demand shock. How that's possible is a bit of a mystery to me because the (undisputed) initial supply-shock eroded real income to a very significant degree, including a 8% drop in real wages. How this enormous erosion of real income then becomes a story of too strong real demand escapes me. The excess savings could have triggered it, but they haven't been reduced to any measurable extent in Europe (which is different from the US.)

The ECB's "excess demand" narrative began to gain ground sometime last year. Recently, in his lecture in Dublin on 6 March, Philip Lane argued that roughly 40% of inflation is now generated by excess demand, about 50% by supply shocks, while some 10% is ambivalent. It's an extremely read-worthy piece, including the analysis of the breakdown between the sources of inflation, which is elegantly done separately for goods and services. It's here: Underlying inflation - Lecture by Philip R. Lane, Member of the Executive Board of the ECB, Trinity College Dublin.

At the last ECB press conference, the policy statement started and ended with this observation: “Inflation is projected to remain too high for too long” and Lagarde added as part of her answer to the very first question, “We know that if the baseline as we have it was confirmed and was to persist, we would have more ground to cover” (beyond the 50bp rate hikes announced on that day.) In her interview with Politico on 24 April, Isabel Schnabel seemed to add the often-heard additional argument for further rate hikes, namely present core inflation: “We need to see a sustained decline in core inflation that gives us confidence that our measures are starting to work”.

The reference to present inflation as an argument for policy changes is tough to relate to as an economist. Present inflation is not even “present” but backward-looking, and we know that monetary policy is working with a lag. Milton Friedman famously compared the focus on present inflation with someone in a shower, who is impatiently waiting for the hot water to arrive and therefore keeps turning up the hot water tap. In the end, of course, he’ll get burned once it comes in full flow, and he’ll then feverishly try to reverse the situation (h/t to Silvana Tenreyro for reminding me of this great illustration.)

2. A simple macro double-check, which suggests that the ECB is not right in claiming any material role for demand in the excess inflation.

It is my contention that inflation in Europe remains predominantly a supply shock and not one driven by excess demand. If so, the implication for monetary policy should be a moderate approach, aimed at just anchoring inflation expectations and thereby wage developments (which all remain very well behaved, given the shock), rather than engineering the greatest tightening of financial conditions in decades.

In my assessment, the higher core and food price inflation reflects two phenomena: A number of relative price changes in the aftermath of the greatest shock in modern history, namely the Covid lockdowns and fiscal stimulus, which shifted demand massively towards goods consumption and now back again towards services, as well as a simple transmission of the initial commodity price shock into other goods and services items: Shops and producers raise their output prices to compensate for some of their shock to input prices. Think of the baker who needs to raise the price of bread because of the additional cost of heating the oven. These types of core, or food, price increases only serve to further squeeze real income and undermine growth. They are not signs of excess demand.

Indeed, after stressing about price increases in services, food prices now seem to have become a specific area of concern for the ECB, highlighted, e.g., in Lane’s 6 March lecture. But note the earnings reports out this past week, which tell a potentially troublesome story. Admittedly, only roughly 35% of STOXX 600 Europe companies have reported so far, but the consumer staples sector is one of only three sectors having disappointed (along with basic materials and telecom), while discretionary consumer goods (which includes luxury goods) outperformed, benefitting from the bounce-back in China and the US. An underperforming consumer staples sector does not rhyme with the idea that the higher prices for food and other fundamental consumer items should be driven by excessive demand. On the contrary, it’s the squeeze from higher energy prices transmitting through the system. (H/t to my colleague Stefan Kolek for having pointed this out to me.)

My point is this: There is an unusual amount of noise in individual and sector-related data during this aftermath of the multiple shocks to the economy, causing big relative price changes and severe distributional effects, but that only goes to highlight the need to think about inflation and monetary policy at the macro level (“look at the forest”), while resisting the temptation to venture into the undergrowth of the forest to take measure of individual scrubs and branches and then try to add them up to get a macro picture.

Thus, here’s the picture of “the forest”, which challenges the claim that demand is any measurable (if any, at all) part of the explanation for the present excess inflation:

If the presently elevated inflation is caused by excess demand at the aggregate level (which is what matters to the central bank), as claimed by the ECB and many others, then – by definition - aggregate demand must be greater than potential output. Put differently, we must, therefore, be experiencing a positive output gap.

While we can’t measure the output gap directly, a positive output gap seems extremely unlikely to be at work in the eurozone at this time for the following reasons:

First, HICP inflation, which is what the ECB is targeting, measures the changes over time in the prices of consumer goods and services acquired by households. So, if excess demand (the positive output gap) is part of the explanation for the elevated HICP, one would expect personal consumption to be quite buoyant. Yet, eurozone personal consumption in real terms remains a stunning 0.8% below its level in 2019 Q4, i.e., just before Covid struck. In other words, eurozone consumers are still spending – in real terms – less than they did more than two years ago, which really isn't such a surprise, given the erosion in their real income. By way of comparison, US personal consumption is 7.5% above its end 2019 level (in the UK, it remains a whopping 2.3% below 2019 Q4).

Granted, total GDP is doing better than personal consumption on account of mostly exports and government spending. Following Friday's Q1 GDP releases, eurozone GDP is now 2.5% above its 2019 Q4 level – but even so, it remains 2.0% below where it would have been had it not been for Covid and all that, i.e., it remains this spring 2% below its trend line. (The US has reached its trend line).

If this level of overall activity in an economy (2% below its trend line) is inflationary, then it means that potential output has fallen by even more since 2019. Yet, if potential output has declined during these past 3-4 years, then it would have to be on account of either a decline in labor input and/or a decline in productivity – there really isn't any other way for potential output to decline.

Yet, we know that one of the great success stories in the eurozone post-Covid is the exact opposite: Labor input has actually increased in the eurozone since 2019, not fallen. Total employment is now 2.3% higher than in late 2019 (and unemployment is near a record low), while the total number of hours worked in the eurozone has increased by 0.6%. In comparison, the US labor market is still struggling to attract folks back to employment.

Consequently, since total labor input is up in the eurozone, the only way potential output can be down (as implicitly claimed) is if productivity has plummeted. Granted, productivity is difficult to measure, but there is no sign of a decline: Last year, productivity rose by a handsome 1.3%. ECB staff estimates it to grow by 0.2% this year, before it recovers to 1.2% again next year. Whether the 0.2% forecast for this year turns out to be accurate or not, it's important to recall that productivity usually declines for a period following big increases in employment, but never to an extent where potential output declines. More importantly, if productivity has declined, profit margins would have suffered. But that's not what we have seen so far. On the contrary, profit margins have been increasing beautifully since 2021 to a healthy 8.5% on the latest reading.

In conclusion, these simple macro identities illustrate that it's extremely unlikely that potential output has declined these past two years, and it may even have increased. As a result, it's very unlikely indeed that the output gap is positive – and if it is not, then one cannot really argue that, at the aggregate level which is what a central bank should care about, demand is excessive and causing inflation.

And if inflation is not demand driven, monetary policy shouldn't react beyond assuring well-anchored inflation expectations until the cost-push inflation comes back down by itself – as it will.

3. So why are they doing it? - And what are the consequences?

I claim no particular insight into the inner workings of GC members and the Council's dynamics, but here's a guess why we have gotten here:

First, we started from a ridiculously accommodative stance, which was beginning to distort the economy pretty badly. I'm referring primarily to the negative interest rates and the extent of QE. It therefore didn't take much inflation, whatever the source, for a majority of the GC to grab the opportunity to get this excessive policy stance corrected.

Second, once inflation shot up, an entirely legitimate concern about inflation expectations took hold. The ECB had to sound tough, and they sure did, particularly starting in early 2022. My contention is that the attention to inflation expectations then became excessive, maybe partly fueled by a poorly informed and destructive campaign by some tabloids. But, as I had the pleasure of discussing with a number of policymakers and academics at a panel at Sintra last year, chaired by Isabel Schnabel, policymakers began to pay too much attention – and respect - to all sorts of inflation expectations data, including from

professional forecasters and markets (flattering as that might feel to some.) To be sure, inflation expectations are important, not least as they may feed into wage growth. But as we know today, eurozone wage growth has remained extremely well behaved. It continues to undershoot the price shock, leaving everyone poorer. Hardly a setting for demand-driven inflation …

Here's my bottom line: The great easing of monetary policy during the Draghi-era was driven by a firm determination to bring inflation back up to the target of 2%, while minimizing the risk of deflation. But it came with undesirable side-effects. Likewise, the odds are that we are now witnessing a determined tightening of policies to bring inflation back down to the target of 2% "in a timely manner", while minimizing the risk of it spinning out of control. But "the timely manner" rests on the wrong diagnosis of the underlying inflation, so it'll most likely lead to an overshoot in the opposite direction, with costs to growth, income and employment – like Friedman's impatient man in the shower…

The UniCredit research forecast is for a peak rate of 3.75%, which I think sounds about right (although with more upside than downside risk). My guess is that this will be some 100-150bp higher than what would have been needed to contain inflation expectations. I'm basing that on e.g. the IMF's estimate of a long term real neutral rate of about zero (i.e. 2% nominal) - and on the lesson from years in the shower patiently waiting for the hot water to come and deliver just the right temperature …

After the Draghi-era, turbo-charged (appropriately) with the PEPP, it took the commodity price shock to reverse the policy stance. What it'll take for the ECB to reverse its present overly tight policy remains to be seen. My guess is that it'll take more, in terms of economic hardship, than markets anticipate. In other words, I doubt that the first rate cut will already come in 18 months.

Finally, if there is one important policy conclusion to take away from these past ten years it must be the questionable wisdom of a point-target for inflation. Draghi's ECB was challenge by the effects on inflation of globalization and years of excessively tight fiscal policies. Lagarde's ECB is challenged by the effects on inflation of deglobalization, including the war and disruptions to supply chains, as well as Covid-related fiscal policies. These are all factors completely outside the control of the central bank. To demand that monetary policies, nevertheless, deliver exactly 2% inflation through it all is not realistic, and the harder the central bank tries, the greater the risk is of suboptimal outcomes. A range target would be much preferable.

Best

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MR 22/3

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