The west is (trying to be) back

95 – 14 June 2021

Key points

- The conclusions of the G7 summit, albeit not immediately actionable, can be read as a "West is back" manifesto. Still, for this "Cornwall consensus" – heavy on active economic policy – to thrive, central banks must refrain from pulling the brakes. We look hard at the latest US inflation figures and still consider the Fed can remain patient, just like the European Central Bank (ECB) was patient last week.

The G7 last week truly turned the page on the populistic "Trump era". Observers were quick to criticize the lack of ambition in terms of concrete commitments, but even successful G7 meetings merely set the tone and give general policy directions rather than produce immediately implementable action. The flavor from Cornwall was definitely of the "liberal/progressive" variety. Beyond the obvious focus on the pandemic, fighting climate change, free and fair trade and inclusive growth were the common leaders 'priorities beyond their political diversity. On economic policy, the "Keynesian conversion" looks complete. The West is more unified and can more easily project its values on the international stage through renewed multilateralism. Still, many policy directions agreed last week will need to pass the "G20 test". From this point of view, China is the "elephant in the room". The tone on China was "firm" but very vague on any concrete follow-up. While Biden has managed to narrow the gap with Europe on this issue, nuances still abound. Maybe more fundamentally, while the West may be back "ideologically", the crucial question is whether it will have the financial resources to win the argument at the global level. The G7 countries are exiting from the pandemic with high levels of debt and lots of internal grievances to tend to, while China is emerging with much of its fiscal and monetary capacity intact.

The "Cornwall consensus" can thrive only if central banks are not forced to pull the brakes. Reassuringly, the market is remarkably non-plussed by the further spectacular acceleration in US inflation. What helps may be the fact that it is still straightforward to attribute the spike in consumer prices to contingent, sector-specific causes which are not "generalized overheating" material. For the time being, the Fed can fairly comfortably maintain its patient stance. In the months ahead we will focus on any sign of "contagion" to a wider array of consumption items, but our baseline has not changed: while inflation is unlikely to return to its sub-par pre-pandemic pace (which would be a good thing), we see little reason to shift away from the "transitory shock" narrative.

The ECB chose to be patient as well last week, refraining from signaling a deceleration in the pace of purchases, as we expected. We don't see the forecast upgrade as sending a hawkish policy message. What remains crucial is that the central bank still expects core inflation at the policy-relevant horizon to be significantly lower than the already sub-par pace they were forecasting before the pandemic.

G7 summit: who to be multilateral with?

The world is getting – a bit – more normal. That the G7 summit took place at all this year was not a done deal (it had to be cancelled in 2020 because of the pandemic), but more interestingly it produced a substantial, 25 pages final statement, in contrast with the one-pager which had been etched out in 2019 after the failure of the 2018 summit to even produce common conclusions (on climate change and energy the final communique of the Quebec summit presented the position of the US separately from that of the other members..). Donald Trump's four years of unilateralism have been cast aside for now, and many of the intentions packed in this year's statement read as a liberal/progressive manifesto. Beyond the Covid emergency and the need to speed up the global vaccination process, the fight against climate change, free and fair trade, social, ethnic and gender inclusion all rank high in the leaders' common preoccupations. This gives the G7 "club" a sense of purpose and unity which it had lost, despite the "Brexit legacy issues" which may have been prominent in the side-discussions but did not prevent the leaders from converging on a common narrative.

The statement does not however constitute a return to "business as usual" after the Trump era. This would have brazenly ignored how the foundations of the liberal order have been shaken in the last few years and will probably continue to be internally and externally challenged. **What we detect throughout the text is a strong conviction that active economic policy – beyond the current support made necessary by the pandemic – is key to mend the fabric of democratic societies.** There is a nearly explicit criticism of the common restrictive policy stance adopted immediately after the Great Financial Crisis in the last sentence of the following quote: *"We will continue to support our economies for as long as is necessary, shifting the focus of our support from crisis response to promoting growth into the future, with plans that create jobs, invest in infrastructure, drive innovation, support people, and level up so that no place or person, irrespective of age, ethnicity or gender is left behind. <u>This has not been the case with past global crises, and we are determined that this time it will be different</u>".* **The "full-Keynesian" conversion of the developed nations in response to the pandemic is manifest**, and this transcends the diverse political orientations of the leaders. We had already commented on the deal at the G7 finance ministers' level on international corporate taxation.

But beyond the demonstration of unity within the club, this year's statement reaches out to other global stakeholders, in a clear attempt to revive multilateralism. To some extent it may be read as a mere recognition of the G7's declining weight in the global economy (45% of world GDP last year, against 70% when it was founded), but also as a pragmatic realization that some of the world's most pressing problems – climate change in the first place – cannot be dealt without outside partners. The statement mentioned 19 times the G20 - which will meet next month - and the G7 club has joined forces in an "open societies" group with Australia, India, South Korea and South Africa.

The elephant in the room is obviously China, a key player in the G20. The language in the statement is "firm" but non-committal in terms of the actual measures which could follow suit, and the text oscillates between treating Beijing as a partner and an adversary. For instance, on trade, it reads "*with regard to China, and competition in the global economy, we will continue to consult on collective approaches to challenging non-market policies and practices which undermine the fair and transparent operation of the global economy".* On Human Rights, "*we will promote our values, including by calling on China to respect human rights and fundamental freedoms, especially in relation to Xinjiang and those rights, freedoms and high degree of autonomy for Hong Kong enshrined in the Sino-British Joint Declaration and the Basic Law"*. While China is not explicitly named, it is clearly "in scope" in the geopolitical part of the text: "*we underscore the importance of peace and stability across the Taiwan Strait, and encourage the peaceful resolution of cross-Strait issues. We remain seriously concerned about the situation in the East and South China Seas and strongly oppose any unilateral attempts to change the status quo and increase tensions"*. Asking the World Health Organization to perform a study in the origins of COVID can be put in the same bucket. However, the tone mellows when it gets to global warming, *"In the context of our respective responsibilities in the multilateral system, we will cooperate where it is in our mutual interest on shared global challenges, in particular addressing climate change and biodiversity loss in the context of COP26 and other multilateral discussions"*.

The key tenets of Biden's strategy clearly permeate the G7 position: a "muscular" attitude towards China when it comes to trade and the country's geopolitical influence, but less strident in tone than under the previous administration and recognizing China's crucial role in global affairs. The summit can probably be seen as another

demonstration of Biden's capacity to re-create a broad alliance to contain China – at the risk of seeing Beijing blocking the multilateral efforts at the G20 and other broader forums, but beyond the fact that even successful G7 summits merely "set the tone" and give general policy directions rather than produce immediately implementable action, the fact that the language on the practical consequences of the general stance towards China is vague probably reflect significant nuances across the members. We have already discussed in Macrocast that the interests of the US and the EU are not fully aligned when it comes to the trade relationship with China. In a press conference on June 10, French President Macron had offered what might be the "European angle", affirming the EU *"independence when it comes to our strategy towards China"*.

The G7 summit is followed by a short meeting of NATO. The security and economic matters are of course intertwined. Trump's incapacity to organize a coalition against China came partly from the fact that at the same time he was reducing the US support to allies faced with a more immediate strategic threat – Russia, in the European case – than China. The language at the G7 against Russia was also quite muscular, and this is key to Biden's equation. To enrol the transatlantic alliance in his roll-back strategy against China, he needs to lift doubts as to the US involvement in Europe which have been exacerbated under Trump's administration but which Obama's "pivot do the Pacific" had already sown.

This will add pressure on US resources. For now, the debate on governments' financial capacity has been frozen by the extreme monetary policy support provided since the beginning of the pandemic crisis. Yet, **an issue for the "West is back" narrative which this G7 summit wants to propel is the level of debt that this region will have to deal with in the years ahead, potentially impairing its capacity to properly shape international relations, in both the economic and the geopolitical realms,** while China so far has managed to emerge from the pandemic crisis with little damage to its fiscal and monetary firepower. As part of its support to the fight against Climate Change this G7 summit re-affirmed an intention to provide USD100bn a year from private and public sources to help developing nations in their own green transition. We will go into more details on the "transfer issues" surrounding the green agenda next week, but this funding goal – which is not new but so far failed to come to fruition – may be difficult to meet. Many observers on Sunday criticized the G7's lack of ambition on supporting the vaccination programmes in the developing nations beyond its pledge of 1bn doses, but more generally, this question of "capacity limits" is likely to increasingly come to the surface. It may take different forms across countries, for instance a reluctance in Germany to spend more on defence, or the UK's current controversial decision to scale down its international aid budget.

Teflon bond market

Month after month US inflation surprises to the upside, and the bond market remains remarkably non-plussed. What helps – beyond the Fed's remarkable communication consistency – may be the fact **that it is still straightforward to attribute the spike in consumer prices to causes which are not "generalized overheating" material**. We refine a bit the sectoral approach we developed when the April CPI came out to better understand the further acceleration in core inflation observed in May (from 3.0% to 3.8%). We isolate two different sources of contingent price pressure: a "reopening/catch-up" bucket, items whose prices fared particularly poorly at the height of the pandemic crisis and are now mechanically rebounding as the economy reopens (hotels and airline tickets) and a "micro-chip" bucket, items whose prices are strongly affected by the global shortage of micro-chips (new, used and rental cars, car insurance, household appliances). It is an imperfect classification (e.g., the price of rental cars is affected by both factors), but it helps shed a light on the potential for further prices hikes.

Between March and May 2021, core inflation rose from 1.7% to 3.8%. **60% of this acceleration can be attributed to the "microchip bucket" (+1.31%) and almost one quarter to the "catch-up" items** (+0.52%). A bit less of 85% of the of the spike can thus be explained by transitory phenomenon affecting items standing for only 12% of the core inflation index (see Exhibit 1).

Exhibit 1 – Breaking down the US inflation spike

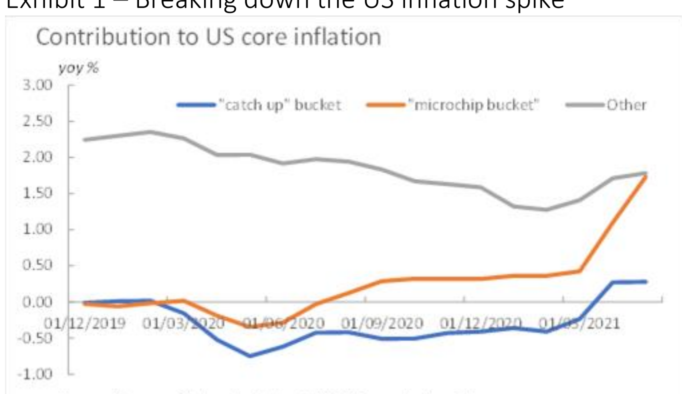
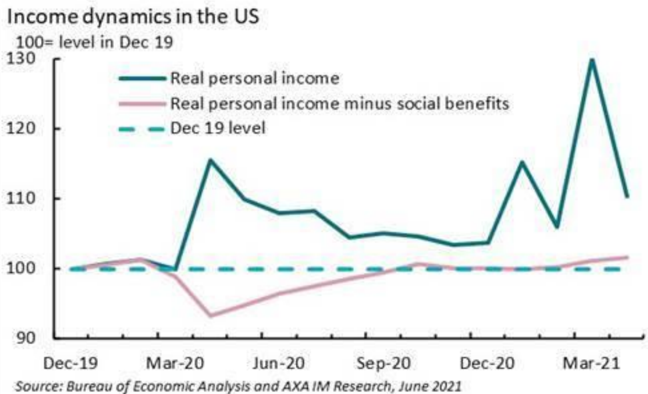


Exhibit 2 – A very specific income pattern



What is the capacity of the "catch up bucket" to continue pushing inflation up in the coming months? Much of price loss has already been recouped for hotels (now only 3.7% below December 2019 – in seasonally adjusted terms, against -11.7% in March), and wile airline fares in May are still 11.8% below their pre-pandemic level, taking the weighted average of these two items together, almost 2 thirds of the convergence back to the starting level has already been achieved. Of course, other services could "mechanically" react to the reopening later than the two items we have focused on, but we note that a natural candidate for that, the price of admissions to recreation activities (e.g., cinema, theatre, sport events etc.…) had already recovered above its pre-pandemic level. **We could thus expect some further pressure in the coming months, but we think it is plausible that this source of inflationary drift fades by the end of the summer**. By construction a catch-up process triggers either a steep acceleration for a short time or a small impact over a longer period. Note that in any case, in the months ahead, the base effects will continue to make it very difficult to assess price dynamics when focusing on year-on-year change. Indeed, even if we could "freeze" all prices at their May level, core inflation would still stand at 3.5%yoy in June.

The impact of the – dominant – "microchip" bucket is likely to last longer. Microchip production capacity was tight even before the pandemic struck, since investment has been lagging sales for several years. The shift in global consumption from services to physical products as social distancing was rife, in particular towards those intense in microchips, exacerbated the issue (consumption of information processing equipment rose by 40% in volume between December 2019 and April 2021 in the US only). Car manufacturers – another major user of microchips – cut orders at the trough in production last year, "missing the boat" of the recovery. A spokesperson for Acer last week predicted the shortage could last until Q2 2022, when the additional capex at SMC, Samsung and Intel starts lifting production.

In clear, this all means that core inflation will remain elevated. To gauge the possibility an endogenous inflation process emerges behind the base effects and the direct impact of the microchips shortage, **in the months ahead we will focus on signs of "contagion", checking month after month whether a wider array of goods and services start contributing to the spike.** Fortunately, for now, the two "juggernauts" of US core inflation, rents – including owner-occupiers implied rents – which stand for 41% of the core inflation weights and healthcare (both prescription drugs and medical services) which account for another 11% - remain tame. In May rents were growing by 2,2%yoy, accelerating a bit from the second half of 2020 but still markedly below their 3%+ pace on which they had settled between 2017 and 2019. Healthcare inflation is very volatile, but the latest prints are reassuring (1.5%yoy in May).

So far, we have focused on core inflation – it's what matters for the Fed – but in terms of purchasing power, of course the even stronger pace of headline consumer prices is paramount. For now, the current inflation spike looks small when compared with the massive rise in US personal income: as of April 2021 (last available data), corrected for inflation it was still 10.4% above its December 2019 level. Yet, this is essentially the product of fiscal support. Excluding social benefits, real personal income is only 1.7% above its pre-pandemic level (see Exhibit 2). Of course, there is a self-stabilizing mechanism at play here: as the economy continues to normalize, labour income should gradually replace social transfers (in particular unemployment benefits), but some elements of fiscal stimulus were

one-offs anyway (e.g., the "cheque" to households). If – as is plausible – the inflation spike continues for several months, many consumers will have to draw from their accumulated savings to maintain their volume of spending to offset the price rise. Those accumulated savings are plentiful, but real income dynamics may still make the ongoing economic recovery less spectacular than experienced so far, dampening in turn the risk of a "proper" inflationary process taking shape.

We will of course also continue to take a hard look at inflation expectations, especially in the "real economy". From this point of view, and even if we have to keep in mind that it is a widely volatile series, **we see it as reassuring that US consumers according to the June Michigan survey released last week have scaled back their 5-year inflation forecast from 3.0% in May (highest since 2011) to 2.8%.**

All in all, despite the spectacular nature of the latest inflation print, the general dataflow should help the FOMC to keep a steady hand at its meeting on Wednesday. The Fed is committed to expand its balance sheet at the current pace until "*substantial further progress*" has been made in achieving the Fed's goals. The Fed believes such progress will take "*some time".* We expect the Fed to remove the "some time" guidance at the July's FOMC meeting rather than this week, even if hawks are clearly getting restless. The summer will be busy. If as we expect the Fed announces it taper purchases in December, they will have to set the scene several months earlier given the assurance they gave they would give the market ample warning. September could be the right moment for this but the Jackson Hole conference at the end of August could also be in play.

ECB: is there some "forecasting signalling"?

We wrote two weeks ago that despite the accumulation of positive signals in the Euro area economy, the ECB would still refrain from "rocking the boat" amid a still uncertain summer. Last week, the Governing Council opted for continuity, pledging to maintain net Pandemic Emergency Purchase Programme (PEPP) purchases at a *"significantly higher pace than during the first months of the year"*, thus keeping the language unchanged since March. We noted last week that this was the option which would give them the widest leeway, while still sending the signal the increasingly vocal hawks are being kept in check. Indeed, buying significantly more than in Q1 2021 – when it fell to a trough at EUR53bn per month in January – does not necessarily mean the ECB could not dial down a bit if market conditions are supportive. In any case, to fully use the EUR1,850bn envelope by the soft deadline of March 2022, a monthly average pace of EUR 75bn is required, just a tad below the current pace (80bn, see Exhibit 3). We do not read too much into the "net" PEPP purchases addition in the June monetary policy statement - we see it as clarification in case redemptions heavily fluctuate in the coming months.

Exhibit 3 – Dialling down very gently will do the trick

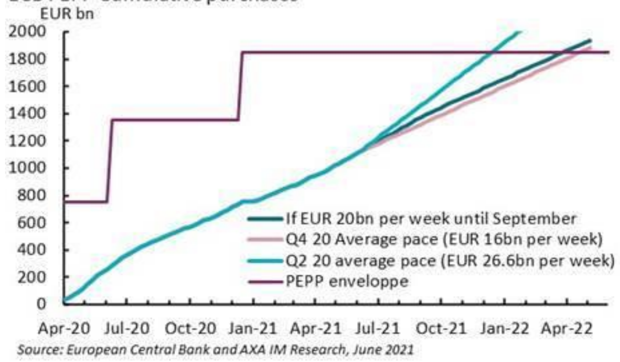


Exhibit 4 – Still a lot of work ahead for the ECB

Maintaining the "significantly higher" pace of PEPP purchases over the summer makes sense in our view in terms of risks management. Indeed, we see at least three reasons justifying a "wait and see" attitude before potentially altering the current course: (i) how the market deals with a complicated summer for the Fed, as we discussed in the previous section, (ii) gauge the strength of the consumer rebound and (iii) developments on the pandemic front (vaccination vs. variants race still ongoing).

Questions on the pace of PEPP, tapering discussions, and inflation outlook dominated the press conference. Although President Lagarde emphasized there was unanimity on the introductory statement, she acknowledged that there was a debate on the pace of PEPP purchases, the balance of risks and inflation assessment. Internal divergence within the Governing Council is not new and will likely intensify ahead of the conclusion of the strategy review. It is not 100% sure yet that the outcome will be unveiled at the 9 September meeting (Lagarde mentioned H2 21). As habitual readers of Macrocast know, we think the central bank needs to address the ambiguity of its definition of price stability – "below but close to 2%" – to make it clear it is properly symmetric. Such symmetry would allow for some inflation overshooting, necessary to re-anchor long-term inflation expectations towards 2%. But we are a bit worried about the timing. Even if the strategy review is supposed to provide guidance for the long-term, its conclusions may be impacted by the cyclical conditions prevailing at the time of the debate. Activity data and surging confidence point to strong consumer demand in the months ahead and solid recovery, while inflation pressure concerns are unlikely to abate, so it could play in the hawks' hands.

Beyond the policy decisions and informing them, the new forecasts were the main point of attention in last week's Governing Council meeting. We were surprised by the magnitude of the growth upgrade: 0.6pp to both 2021 and 2022, with the risk assessment being shifted to balanced. It was justified by faster progress of the vaccination campaign/ reopening, the incorporation of NGEU fiscal support and spill overs from US fiscal policy packages. While we have revised up our near-term forecast to 4.4%yoy in 2021 (0.4% above the ECB), taking stock of the steep improvement in soft data, we remain more cautious on 2022 (3.7%yoy, a full percentage point below the ECB) as we see slower reabsorption of unused labour, corporate fragility and persistent households' precautionary savings.

There was much debate among ECB observers about the possibility that the higher inflation forecasts could send a policy signal. We disagree. True, 2021 headline inflation was upgraded to 1.9% on the back of oil prices, supply disruptions and base effect from German VAT reversal, but what we think is crucial is core inflation at the end of the policy horizon and it has been lifted up by just 0.1pp to 1.4%yoy in 2023 (see Exhibit 4) as ample labour market slack is expected to keep a lid on wages growth, despite the upgraded GDP recovery. This gets us back to a point we have been making ad nauseam: the inflation trajectory expected by the ECB before the pandemic struck was already inconsistent with its definition of price stability, and this was the justification for the ECB re-starting quantitative easing. Unless by the end of PEPP – so probably in March 2022 – the ECB brings back its inflation forecasts to where it was in December 2019, purchases under the APP would normally have to rise further, even when ignoring the additional "price level gap" accumulated since the beginning of the pandemic.

Country/Region	What we focused on last week	What we will focus on in next weeks
US	• US CPI inflation rose to 5.0% in May, core at 3.8% (the highest since 2008 and 1992 respectively) • Michigan university 5-10yr inflation expectations ease back to 2.8% - a previous 6-year high • US 10-yr Tsy yields fell to 1.44% – their lowest since early March • JOLTS survey (labour turnover) surges to record 9.2mn • Bipartisan talks on next spending bill breakdown; White House faces political difficulties in passing bill	• US FOMC meeting: Fed likely to raise IoER rate by 5bps to alleviate short-end pressure; might hint at dropping "some time" in July; could raise dot median in 2023 • Retail sales (May) expected broadly flat again, but we consider upside risks • Industrial output and business inventories (May) round out data for Q2 GDP, currently expecting ~8% (saar) • Empire and Philadelphia Fed surveys (Jun), still robust • Biden post G7 tour includes and EU (Tue)&Russia (Wed)
Euro Area	• ECB pledged to keep the pace of PEPP purchases significantly higher than in Q1 and despite solid growth revisions, lifted 2023 core inflation only marginally • IP dragged down by autos/supply disruptions • EU launched legal infringement action over German constitutional court's ECB ruling	• Light week for data, with only euro area IP, expected to be broadly flat • Lots of ECB speakers (Panetta, Schnabel, Villeroy) to give colour on ECB decision/ strategy review process
UK	• GDP Apr rises by 2.3%. Services rise sharply, IP and construction weigh, We up our Q2 GDP forecast to 5% and 2021 outlook to 6.8% • UK-EU dispute over NI protocol – UK appeals for "pragmatism" as EU insists UK does what it signed up to • BoE's Haldane says housing market "on fire"	• Decision on lifting restrictions on 21 June – we expect delay – up to one month discussed • Retail sales (May). BRC retail sales monitor suggests sales close to flat after +9% in Apr • Labour market (Apr) to record impact of re-opening • CPI inflation (May) expected to rise towards 2%
Japan	• Vaccination is ramping up (0.63% of the population is inoculated every day) • As expected, Q1 GDP has been revised on the upside to -1%qoq from -1.3% • May econ watchers poll fell to 38.1 from 39.1	• Robust worldwide demand has probably stimulated April machinery orders and May export/import data • The BoJ is holding its monetary policy meeting but we do not expect any changes
China	• PPI inflation surges to 9% on strong commodity price increases, while CPI only ticks up modestly to 1.3% • The transmission from PPI to CPI is limited by weak food prices and sluggish consumer demand	• May activity data to show a recovery in consumer spending and manufacturing investment, while industrial production growth should remain solid
EMERGING MARKETS	• Mexico mid-terms: Morena lost super majority, better footprint in local elections • Peru elected leftist Castillo as president • CB of Poland, Chile and Peru remained on hold, Russia CBR hiked rates by +50bps • India announced a fiscal package as free vaccine for all and free food allocation • Taiwan May export growth strong at 38.6%	• CB meetings: Indonesia, Taiwan, Turkey all to stay on hold, while Brazil to hike another 75bps • May CPI in India, Poland, Argentina • Q1 2021 GDP in Uruguay, Russia (detail)

Upcoming events		
	US :	Tue: Retail sales (May); Wed: FOMC meeting (unchg); Thu: Phili Fed Index (Jun), Jobless claims
	Euro Area:	Mon: EA IP (Apr); Tue: Ge, Fr, It HICP (final, May); Wed: EA HICP (final, May); Fri: Econfin meeting
	UK:	Tue: Unemployment (Apr); Wed: CPI (May); Fri: Retail sales (May)
	Japan:	Mon: IP (final, Apr); Wed: Private 'core' machinery orders (Apr); Fri: CPI (May)
	China:	Wed: Fixed asset investmemt (May), Retail sales (May)

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