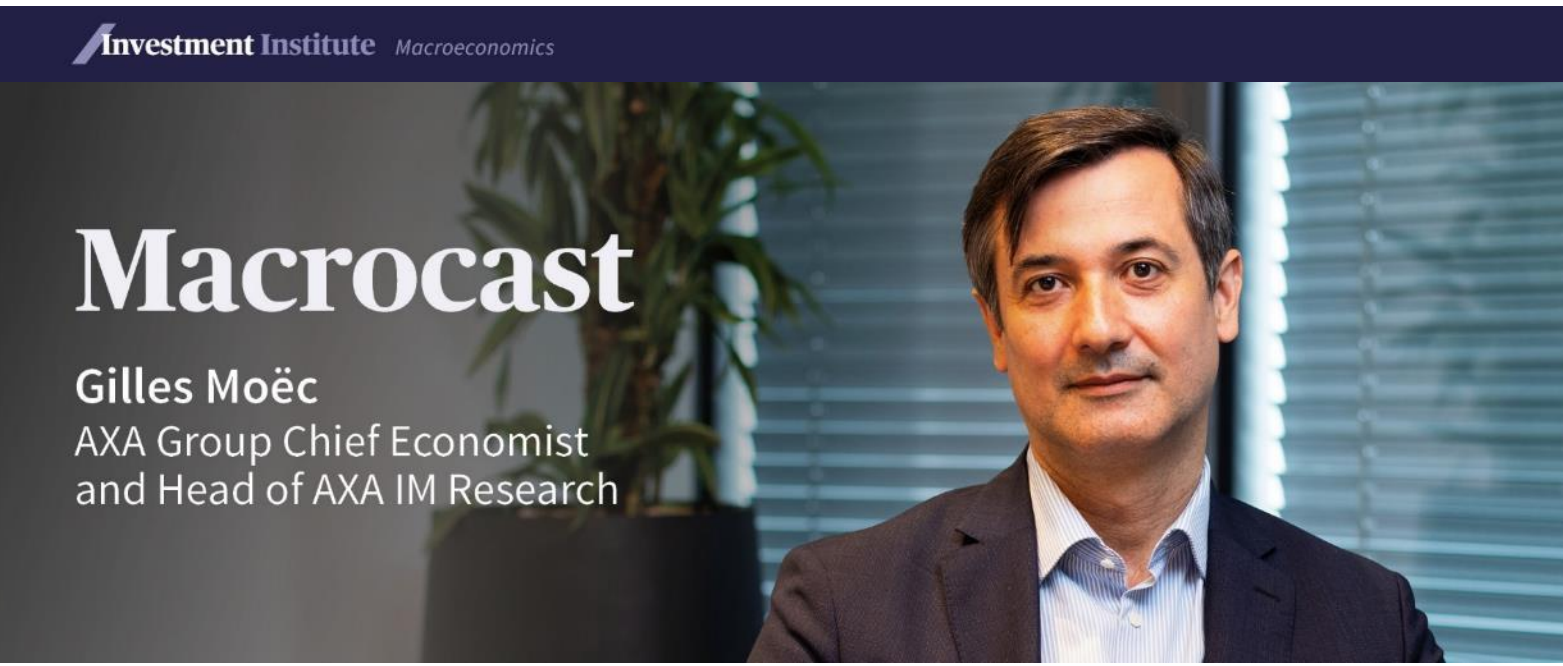


Unusual Suspects

- Strong domestically-driven inflation in the old "D-mark zone" - in contrast with the developments in the periphery – is a new form of divide in the Euro area with significant policy implications.
- Last week's dataflow was kind to the Fed: the "pause scenario" gained in likelihood.

ECB Governing Council members from the old "D-mark zone" continue to be quite vocal about the need to continue tightening monetary conditions in the Euro area. Conditions in their countries may explain some of this: services inflation – which is normally the most "idiosyncratic", domestically-driven component – is significantly above the average in Austria, Belgium, and the Netherlands, in clear contrast with the relative moderation seen in Southern Europe. This does not seem to reflect a specific situation of excess demand in the "North". Relative to their historical standards, labour market tightness is at least as prevalent in Italy and Spain. It may be the extreme "speed limit" on prices which was imposed on peripheral countries a decade ago to deal with the sovereign crisis which may have formed a "habitus" which is coming handy now, even if we should avoid seeing this as an eternal feature. Whatever the reasons, persistent inflation in the "North" may tilt the ECB into hiking on after this summer. This could create some political frictions.

Last week's dataflow has been kind to the Fed, supporting a pause. Core inflation as a whole only decelerated by 10bps in April, but the crucial "services excluding rents" component continues to decline markedly. The Senior Loan Officer survey pointed to only a minor additional tightening in lending standards – probably a surprise in the context of the banking turmoil – but it also signalled a significant drop in credit demand by businesses. This suggests that irrespective of the change in the banks' appetite to lend, the Fed tightening is working its way through the economy.

We think the Bank of England has joined the Fed in hinting at a pause after one last hike last week. Governor Bailey's mention of having "no bias" matters, and the BOE's insistence on how policy transmission may be slower than before is consistent with some patience at the MPC. Still, given the upward revision in the Bank's growth and inflation forecasts, we have pushed our first rate cut to February 2024 instead of the end of this year.

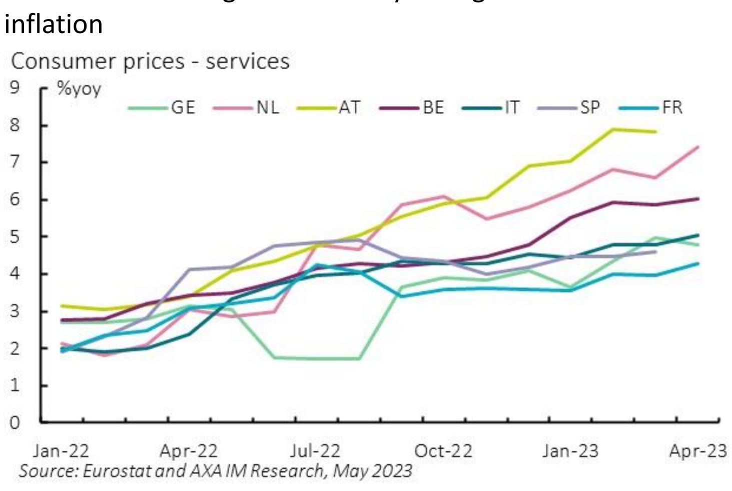
The old “D-mark zone” is misbehaving

A big positive of the last three years is that, despite the number of shocks the Euro area has had to deal with, at least the usual questions on the solidity of the monetary union never came to the fore. We may be tempted to take this for granted, but it’s testament to the institutional progress seen since the sovereign crisis of 2010-2012 that at least we did not have to deal with what could have been an immense source of distraction. The last institutional taboo – mutualized debt at issuance – broke with the Next Generation EU programme. The memory of the bad old days of the early 2010s prompted the European Central Bank (ECB) to set up, as a precaution, the Transmission Protection Instrument, to reassure the markets on the capacity of even the most fragile national bond markets to cope with the normalization of monetary policy.

Still, what we have inherited from the sovereign crisis of the previous decade is a tendency to focus on the periphery as a source of risk while considering that the core of the Euro area will always “behave well”, especially the former “D-mark zone”, formed of Germany’s neighbouring countries which had attached their monetary policy firmly to the Bundesbank as early as in the late 1970s. The dispersion of the national reactions to the ongoing inflationary shock may however challenge this traditional view.

When looking at the latest batch of headline consumer prices, no easily identifiable “clubs” of countries emerge, possibly because the impact of common shocks – gyrations in energy and food prices – dominates, with some idiosyncratic transmission quirks depending for instance on each country’s energy mix. But in Exhibit 1, we focus on services prices, the component of the index which should be the most affected by *domestic* conditions (non-energy goods prices tend to be heavily affected by *global* conditions). By this metric, the smaller countries of the “D-mark” zone (Austria, Belgium, the Netherlands) are exhibiting strong price growth, while Italy and Spain are only slightly exceeding the pace seen in France, the region’s “best behaved” country when focusing on this measure. The divergence started in the autumn of 2022 for Austria and the Netherlands and in early 2023 for Belgium.

Exhibit 1 – Growing cross-country divergence on “domestic” inflation



Source: Eurostat and AXA IM Research, May 2023

It’s hardly the first time inflation dynamics differ across the Euro area. After the sovereign crisis of the early 2010s inflation in the peripheral countries fell markedly below the zone’s average. The Spanish services sector even went through a phase of outright deflation in 2013-2014, while services inflation fell below 1% in Italy. This was the logical effect of the massive deterioration in cyclical conditions in these countries triggered by the fiscal austerity turn and the rise in long-term interest rates. More fundamentally, that Southern European countries went through a protracted period of below-average inflation was a crucial ingredient in their structural recovery, correcting the deterioration in competitiveness accumulated in the pre-crisis years reflected in the accumulation of current account deficits.

However, **this time, cyclical differences cannot easily explain the divergence in the inflation dynamics**. Measuring the degree of slack across countries is not straightforward. True, most of the "D-mark zone" countries have restored their GDP relative to the pre-pandemic level faster than the Southern European countries, but they are also routinely credited with a higher potential growth rate. In Exhibit 2, we offer a simple approach to assessing slack via the unemployment rate, as both a reflection of where various economies stand in the cycle and how much pressure is being exerted on wage dynamics and hence, ultimately, inflation. To get a sense of where the "structural" unemployment rate stands, we break down the observed unemployment rate between a trend and cyclical component using a Hodrick-Prescott (HP) filter. We take the "trend" value we obtain for Q4 2019 as a reference for the structural rate to avoid the disturbance of the pandemic period. We then calculate the gap between this "structural" rate and the observed value in Q4 2022. We expressed it both in "percentage points" as well as in proportion of the structural rate: having an observed unemployment rate 1 percentage point below trend should not have the same impact on inflation dynamics if trend is at 10% or 5%.

The gap is negative in all the countries in our sample – a clear indication that labour tightness is a shared condition across the Euro area now. Yet, interestingly, it tends to be more negative in the two Southern European countries than in the "D-mark zone" states. This would suggest that the current inflation gap cannot be explained by cyclical differences. Given how unemployment rates have fallen so deeply from their trend value in Italy and Spain, this is where we would expect the most intense pressure on wages and services inflation, not in the Northern states.

Exhibit 2 – Labour tightness everywhere…

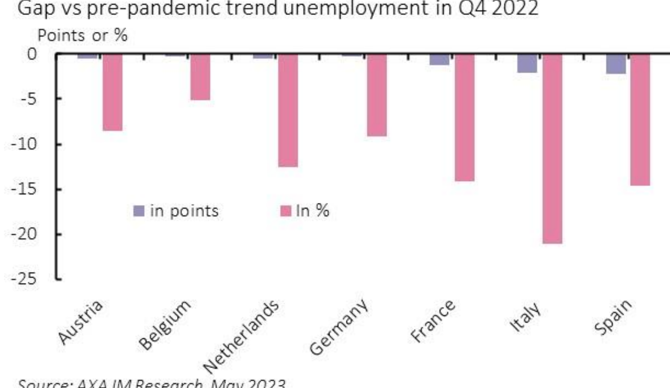
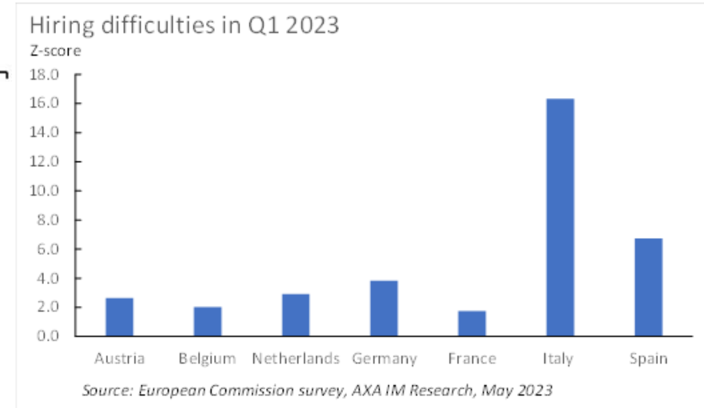


Exhibit 3 – …but more so in the South by historical standards



There are gigatons of econometric literature on the measurement of structural unemployment, and we would perfectly understand if our readers considered our simple statistical approach as far too rudimentary to be conclusive. However, the results of the HP filter are consistent with the message from the European Commission's quarterly surveys in the services sector. The survey asks businesses whether a lack of labour supply impedes production, which is routinely used as proxy for hiring difficulties. In Exhibit 3, we look at the z-score of this component (with the long-term average and the standard deviation in each country calculated over 2013-2019 to avoid both the disruptions from the sovereign crisis and those from the pandemic). **Hiring difficulties, by each country's own historical standards, appear as much more intense in Italy and Spain than in the D-mark countries.** True, one could argue that z-scores are misleading if slack has been so wide in the South for decades that even an increase in hiring difficulties by several standard deviations is meaningless. We would however retort that the *absolute* net percentage of firms reporting hiring difficulties in the last European Commission survey is now slightly higher in Italy (36.9%) than in Austria (34.8%) and significantly higher than in Belgium (24.7%).

If differences in the degree of labour market tightness cannot be invoked, what then can explain this divergence in price dynamics? We don't have any definite answer, but we **suspect this may reflect a sort of "long memory" of price moderation in the countries which went through the hardship of the sovereign crisis a decade ago.** The divergence in inflation after 2012 was long-lasting and profound, as can be seen in Exhibit 4, where we look at the services price level

between 2012 and 2019 (we use non-seasonally adjusted series which explains the regular “waves” in some countries). The accumulated “price deficit” in the Southern countries was massive – more than 20% between Spain and Italy on the one hand and Austria on the other, more than 10% vis-à-vis the Netherlands, and had not corrected much by the end of the period. **This long period of price moderation may have formed an “habitus” in price setting which, even in the recent, disrupted period, may have convinced producers and retailers to proceed cautiously with the transmission in input costs to final prices.**

Exhibit 4 – The legacy of the post-Sovereign crisis: “Southern moderation”

Services consumer prices 2012-2019

100 = level in Jan 2012

Source: Eurostat, AXA IM Research, May 2023

It’s likely that the divergence comes more from the margin behaviour of businesses – something the ECB has been keen to insist on lately for the Euro area as whole – than wages. Indeed, when looking at compensation per employee data which is now available until Q4 2022, there is no clear contrast between North and South – the only country widely off the mark with wage growth above 7% year-on-year is Belgium, where automatic indexation of wages on past inflation continues to be implemented.

None of this should be cause for complacency in the Southern countries though. If it’s merely “habitus” which explains the better performance on domestic prices, this won’t necessarily be eternal, especially since consumers’ inflation expectations for the next 12 months and the next 3 years, unveiled last week in the ECB’s latest consumers survey, are as concerning in Spain and Italy as in Belgium and the Netherlands. There is a significant risk that in a second stage of the inflation process, the labour movement in the South gets more demanding and take advantage of the steep decline in unemployment and hiring difficulties to push for a strong acceleration in wages. On 1 May, the two main Spanish unions called on the opening of a negotiation with the employers’ federation around triggering the “inflation revision clause”.

Yet, for now, domestic inflation forces look less under control in the North than in the South, with a significant impact on the debate at the ECB in our view. These developments help to understand why the Governors of the national central banks of Austria – who according to Reuters supported a 50bps hike two weeks ago at the Governing Council – Belgium and the Netherlands have been even more vocal than what their usual hawkish proclivities would suggest. They can also count on the support of the small Eastern members of the Euro area, such as Latvia and Estonia where inflation is still in 2-digit territory. **Together, these countries stand for less than 20% of the Euro area GDP, but with the principle of “one Governor, one vote” and the general hawkish attitude of the Bundesbank, they can still tilt the central bank towards a continuation of rate hikes beyond the summer.**

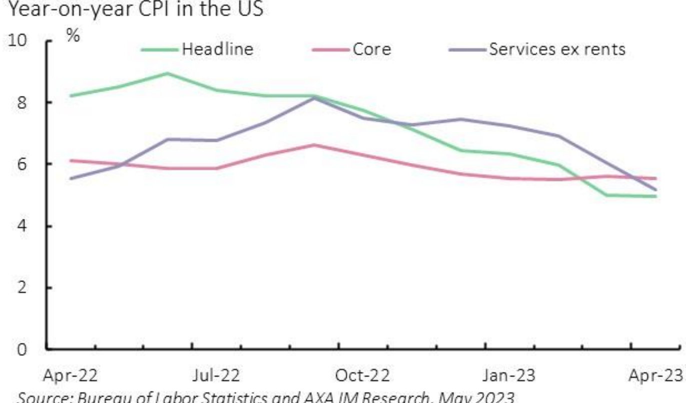
A nagging issue is that it’s the Southern European countries which would come under the heaviest pressure from the ECB continuing to hike rates and proceed more swiftly with Quantitative Tightening. For now, sovereign spreads have remained remarkably resilient, but **we could see political complications arising if the South starts seeing itself as a victim of persistent inflation in the North.** An interesting reversal of fortunes.

These political considerations may also reach the fiscal arena. While the ECB targets the Euro area's average inflation, national authorities are not deprived of tools to deal with idiosyncratic price developments, and the fiscal stance can be a key ingredient here. One would expect countries faced with the most intense "domestic inflation" issues to proceed more forcefully to an austerity turn than the others. As countries send their updated "stability programmes" to the European Commission as part of the fiscal surveillance framework, this is not what emerges. For next year, almost everyone is pledging a fiscal effort – embedded in the planned reduction in the structural deficits, i.e., the fiscal balances corrected for cyclical conditions – comprised between 0.5% and 1% of GDP. The Dutch government is communicating on an effort of 0.7% of GDP, Belgium 0.8%, not that much higher than Spain (0.5%) and in line with Italy (0.8%). This is another piece to add to the already complicated debate around the renegotiation of the fiscal surveillance framework.

Data coming the Fed's way

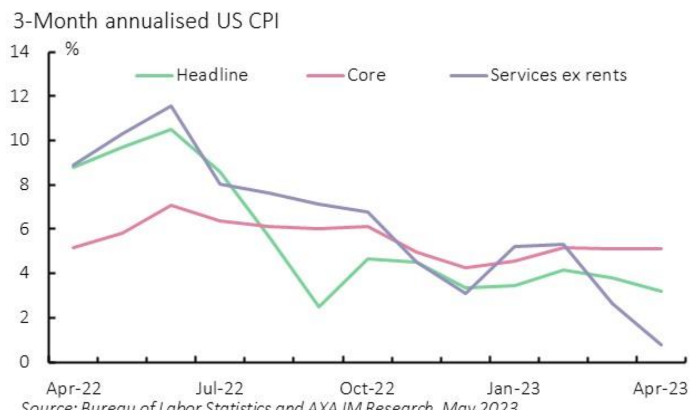
While the release of the consumers expectations survey played into the hands of the ECB hawks, **Jay Powell must be relieved by last week's dataflow in the US.** Indeed, even if the Federal Open Market Committee (FOMC) took every precaution not to oversell a likely pause – after all, a tightening bias is still there – a "bad reading" on April inflation would have come at a particularly inopportune moment. The Consumer Price Index (CPI) batch came out broadly in line with expectations. True, headline inflation did not decelerate, and a 5% pace remains obviously very far from the Fed's comfort zone, but there was another small downshift in the core inflation reading, from 5.6% to 5.5% (see Exhibit 5). More importantly, **the price of services excluding rents – a key "variable of interest" for the Federal Reserve (Fed) - continues to slow down quite forcefully**. The 3-month annualized change in particular is sending a very positive signal to the Fed: it has now fallen below 1% (see Exhibit 6). Since the United States (US) housing market is continuing to correct, a deceleration in rents should become tangible in the coming months, if one trusts historical regularities, which would then help get the whole of core inflation gently if slowly towards the Fed's target, allowing monetary conditions to stabilize for the remainder of the year.

Exhibit 5 – Small deceleration in yoy core



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

Exhibit 6 – Strong recent deceleration in services ex rents



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

In our "preview" of the Fed meeting we had mentioned that the FOMC would already have had access to a preliminary version of the latest Senior Loan Officer survey (SLO). It was made public last week. It may have come as surprise to many observers – your humble servant included – that it was not even worse given the recent banking turmoil (banks received the questionnaire on 27 March and had to respond by 7 April). The net percentage of banks tightening lending standards to medium and large firms rose only slightly from 45% in January to 46% (see Exhibit 7). However, we note that **among the reasons behind the change in lending standards, banks' liquidity issues were mentioned much more frequently than in January (53% versus 31%)** and reached their highest level since that particular question was added to the survey in 2008, while the banks' assessment of macroeconomic conditions has barely moved (see Exhibit 8). Also interestingly, the net percentage of banks reporting an increase in the interest rate spread on loans over banks' own funding cost rose by nearly 20 points.

It's not straightforward to derive indications from the SLO for economic activity since it is a qualitative survey. Banks tell us if they tighten "somewhat" or "considerably" but it is only a crude measure of intensity (for this we would need to know how many credit applications are effectively rejected). Yet, historically it has been predictive of key cyclical inflexions. The net percentage of banks tightening lending standards observed in April remains markedly below the levels seen during the Great Financial Crisis (at peak more than 80% of banks were reporting a tightening) but in line with the 2001 "mini recession". This strengthens our baseline view that the US is moving towards a mild contraction in GDP.

Exhibit 7 – Steep decline in business credit demand

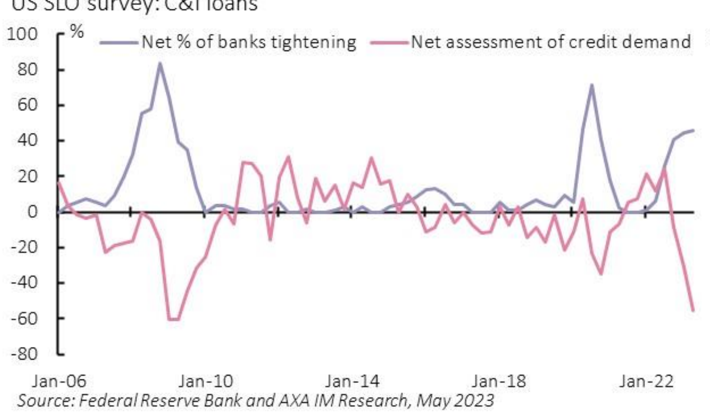
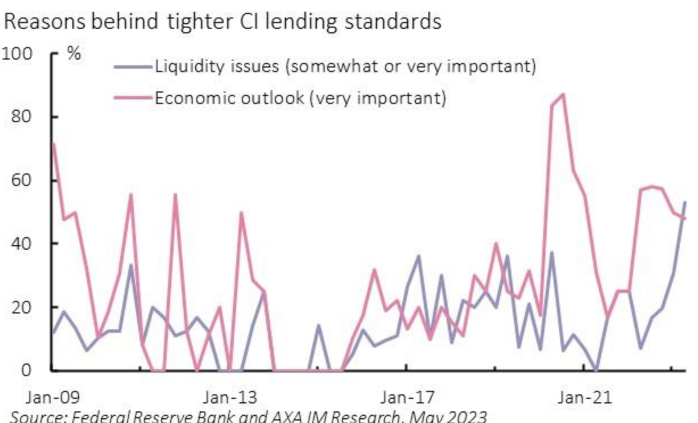


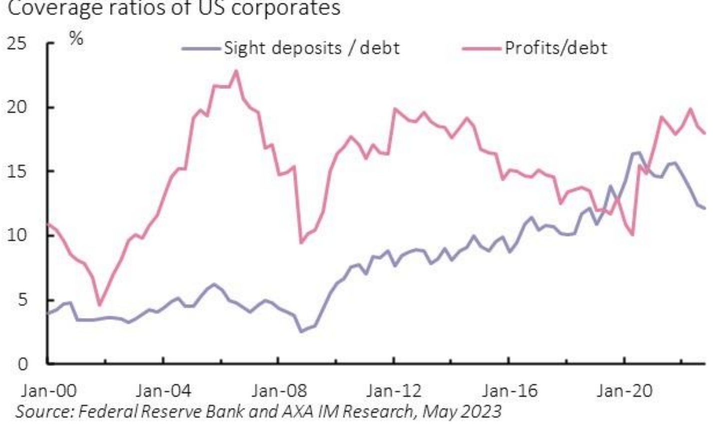
Exhibit 8 – Liquidity drives tightening in lending standards



But the development which we found the most striking in this SLO batch was the magnitude of the decline in the demand for credit from the business sector reported by banks (also on exhibit 7). Nothing as drastic has emerged for the credit demand of the household sector, but the decline in business demand – something which has also observed in the ECB's Bank Lending Survey (BLS) two weeks ago – is another signal that, as interest rates rise, firms are re-thinking their spending decisions, irrespective of the tightening in lending standards which the banking turmoil may exacerbate.

However, the US corporate sector is still in a comfortable financial position overall. The peak in the capacity of liquid assets to cover accumulated debt was hit several quarters ago, but by historical standards, US businesses can still rely on an unusually high level of cash relative to their liabilities. Even if credit lines are harder to renew, this provides some significant protection. The overall level of corporate debt, relative to profits, is also still comparatively low (see Exhibit 9). "Peak profits" was probably reached last year (the latest data we have is for Q4 2022), but the starting point for margins remains historically high. This will help cushion the blow from the monetary tightening, consistent with a mild, rather than a steep recession.

Exhibit 9 – Past "peak buffers"?



The Bank of England joins the Fed

Although the Bank of England (BoE) revised up its growth and inflation forecasts upon hiking by 25bps last week – something which should normally leave more space for future policy action – Governor Bailey's insistence on having "no bias" struck the kind of neutral note which was also the main point of Jay Powell's own discussion of the future Fed trajectory. Also, the BoE dedicated some time to explain how policy transmission may take longer than usual, given the structural transformation of the mortgage market. Indeed, even if the British system of funding home acquisition remains very far from the proper, "fixed for the duration of the loan" approach dominant in many continental European countries and the US, the proportion of instantly revisable mortgages has fallen. Slower – but not weaker – transmission would be consistent with the central bank being more patient, counting on the lagged impact of its cumulative hikes to materialise rather than embarking on more hikes.

This makes us confident the Bank of England has reached the peak of its tightening cycle. However, with a balance of risks on inflation still tilted to the upside and a more confident macro-outlook, we don't think the Monetary Policy Committee (MPC) will be ready to change its stance as quickly as what we had projected so far. **We were expecting a first rate cut by year-end, ahead of the Fed and the ECB. We have pushed our call to February 2024** (for more details see this linked note by our colleagues Modupe Adegbembo and David Page).

Waiting for the dust to settle in Turkey

As we are writing these lines, even the state press agency which had reported that President Erdogan had secured more than 50% of the votes in the early count now has him in the lead but forced to concede a second round on 28 May. As we wait to know more about the direction Turkey will take, we invite our readers to look at this linked note by our colleague Irina Topa-Serry. The macroeconomic challenges facing Turkey are daunting, and there is no magical wand. The opposition has pledged to let the central bank operate freely. It is also quite likely that even another Erdogan-led administration would ultimately have to do so**. This would be consistent with a very significant rise in policy rates, which could reassure foreign investors who have deserted the Turkish bond market. But removing the financial repression framework could be very painful transitorily:** after the forced "lirafication" of the Turkish economy, local appetite for foreign currency is probably massive. A "re-dollarization" would trigger a further depreciation of the currency, with imported inflation impairing the price stabilization the central bank tightening would seek.

Even if Recep Erdogan is ultimately re-elected, he will find himself in a weaker political position with less capacity to deal with the potential social consequences of a change in the policy stance. If the opposition wins, its heterogeneous nature may make it equally difficult to bring about the necessary policy change. Exiting from heterodox policies won't be a walk in the park.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Senior Loan Officers Survey (May) showed modest further tightening in credit conditions for corporates, more so for hholds. Demand for lending much lower • CPI inflation (Apr) eased to 4.9% from 5.0%, despite rising gasoline. Core to 5.5% from 5.6%. Cars boosted • PPI inflation (Apr) 2.3% (from 2.7%), core 3.2% (3.4%) • President Biden met Congressional leaders on debt ceiling. 2nd meeting delayed on better progress	• Retail sales (Apr), headline buoyed by auto boost and gasoline value rise. But control could be softer • Industrial output (Apr) exp'ted flat on weak surveys • Empire and Philly Fed surveys (May), divergent last month and Philly index was stronger than headline • Housing starts existing homes (Apr), recovering? • Jobless claims rose sharply last week (to 264k, 19-month high) – watch for persistence
	• ECB speeches have continued to come on the hawkish side comforting our view of upside risks to our 3.75% ECB terminal rate baseline reached in July • Marked falls in member states March industrial output bodes ill for Q2 GDP growth, consistent with business surveys painting a challenging situation	• Euro area March industrial production poised to fall markedly • Eurozone "flash" Q1 employment growth • Eurozone "final" April HICP to confirm headline at 7.0%yoy and core inflation at 5.6%yoy
	• MPC hiked by 25bp to 4.5% which we see as a peak • May MPR saw upgrade to growth outlook driven by improved assumptions and domestic factors. Large upsides skew in inflation forecasts remain • Q1 GDP rose 0.1%qoq driven by strong Jan growth as Mar output fell by 0.3%mom	• Labour market data (Mar/Apr) unemployment rate expected to remain at 3.8%, wages to be watched closely as key to further rate hikes • GfK cons conf (May) expected to improve progressively from -30
	• Apr BoJ Opinions showed growing divergence in opinions around inflation outlook • Sentiment picks up in Apr surveys. Economy Watchers index picks up 1.3pts • Fifth round of Shunto confirmed strong base pay rises; avg increase remains above 2%	• Q1 GDP expected to pick up 0.1% (cons) but risks tilted to the downside • Exports, Imports and Trade balance (Apr) • CPI inflation (Apr) expected to continue to moderate. Core CPI expected to continue to accelerate
	• CPI and PPI growth were weak with CPI inflation falling to 0.1%yoy led by lower food and gas prices. Core CPI, however, remained steady at 0.7%yoy. PPI contracted further to 3.6%yoy • Exports moderated to 8.5% from 14.8%	• China MLF • China April activities data (FAI, IP and retail sales) • Monetary policy report
	• CB: Peru (7.75%), Poland (6.75%) & Romania (7.0%) kept policy rates unchanged • Q1 GDP (%yoy) eased in Malaysia (5.6%) & the Philippines (6.4%) • CPI (April) fell in Chile (9.9%), Czechia (12.7%), Hungary (24%), Mexico (6.3%) & Romania (11.2%)	• CB: Mexico (11.25%) & Philippines (6.25%) to stay on hold • Reaction to general elections in Turkey & Thailand (Sunday) • Q1 GDP: Chile, Colombia, Hungary, Poland, Romania & Thailand

Upcoming events		
	US:	Mon: Empire State manf. survey (May), Long-term investment flows (TIC data) (Mar); Tue: Retail sales (Apr), Ind prod (Apr), Business inventories (Mar), NAHB housing market indx (May); Wed: Housing starts (Apr), Building permits (Apr); Thu: Weekly jobless claims (13 May), Philly Fed index (May), Leading index (Apr), Existing home sales (Apr)
	Euro Area:	Mon: EU20 Ind prod (Mar); Tue: EU20 GDP (Q1), Trade balance (Mar), Ge ZEW survey: current situation & economic expectations (May), It HICP (Apr); Wed: EU20 CPI (Apr), Fr ILO unemployment rate (Q1); Fri: Ge PPI (Apr)
	UK:	Tue: Unemployment (Mar), Average earnings (Mar); Thu: BoE Governor Bailey at Treasury Select Committee; Fri: GfK consumer confidence (May)
	Japan:	Wed: GDP (Q1), Ind prod (Mar); Thu: Trade balance (Apr); Fri: CPI (Apr)
	China:	Mon: PBoC 1Y MLF rate decision; Tue: Ind prod (Apr), Retail sales (Apr), Fixed asset investment (Apr)

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