AXA Investment Managers

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Investment Institute Macroeconomics

Note to readers: Macrocast is taking a break on 10 April. Next issue on 17 April.

The Pitfalls of the Inflation Blame Game

- We fail to see the upside for the ECB in focusing on profit margins as a key factor behind inflation persistence.
- Deposit migration is a normal feature – but non-banks cannot take up all the “funding slack” left by banks.

Core inflation accelerated again in March in the Euro area, while the decline energy prices, which is helping to push headline inflation down, could be jeopardized by the latest supply cut announced over the weekend by OPEC. The ECB’s frustration is understandable, but we are concerned by their focus on resilient profit margins as the main factor behind inflation persistence. Such line of communication could strengthen the position of those who argue for a very large catch-up in wages. This would weaken the ECB’s message of caution to the stakeholders in the wage bargaining process. More fundamentally, we fail to see the upside for the central bank in insisting on corporate pricing behaviour, which, unlike wage bargaining, is completely decentralized. While unions may internalize in their reaction function the adverse consequences for job creation that large interest rate hikes would have if wages accelerated too much, there is no organized “pricing coordination” system in the corporate sector – nor should there be, as per the EU’s very own pro-competition stance. Where there is no obstacle to competition, excess profit margins usually reflect lingering pockets of excess demand – otherwise, by construction firms could not sustain higher markups. It’s up to the central bank to determine whether more hikes are needed to deal with these pockets.

Market indicators suggest some measure of calm has come back in the banking industry, and the Fed’s latest data show that small banks stopped losing deposits. However, the deposit base continues to erode in the aggregate US banking sector. We look at the last 40 years to show that deposit migrations towards non-banks – or at least towards more expensive resources for banks - are not exceptional but are a regular reaction to monetary tightening. We however cast a doubt at the idea that non-banks could take up all the “credit slack” left by banks. Risks aversion is rife, and disintermediated funding may favour governments over private actors, as the recent developments in US money market funds suggest.

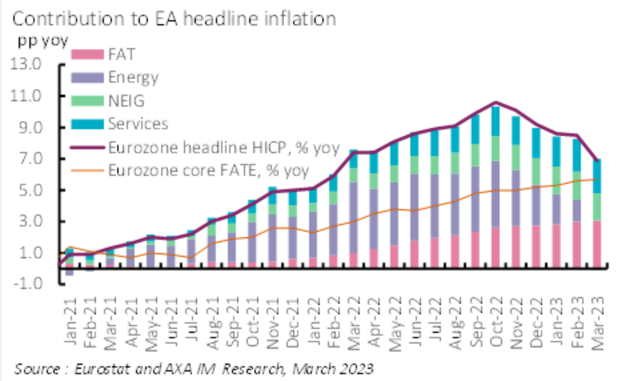
Apportioning inflation guilt

It's always uncomfortable to call the market "wrong" but on monetary policy pricing this has often been our case over the last few months. We disputed the market's contention that the banking stress would trigger a quick turnaround in the central banks' stance, especially in the European Central Bank (ECB)'s case. We are therefore more comfortable with the current pricing, with almost two more hikes (of 25bps) to nearly 3.50% now priced in (our terminal rate is still a bit higher, at 3.75%). This probably reflects some relief at the lack of additional bad news on the banking front, but also the recognition that inflationary pressure is far from going away.

Headline inflation fell again in March in the Euro area, and this time by more than what the market was expecting (6.9% year-on-year instead of 7.1%), down from 8.5% in February. As often, the difficulty in gauging the magnitude of the gyrations in energy prices was the main source of divergence from consensus. The good news is that this component is no longer providing any contribution to overall inflation (see Exhibit 1). The base effect from February 2022 is now out of the calculation. Yet, the surprise announcement on Sunday of a coordinated production cut by Organization of the Petroleum Exporting Countries (OPEC) reminds us that we should still brace ourselves for some potential reversal before the end of the year.

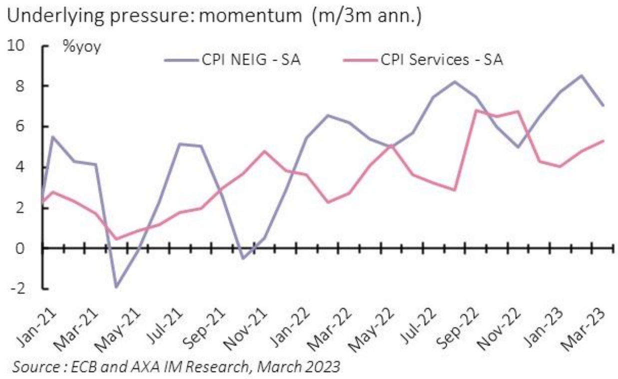
In any case, the crucial piece of bad news in the March batch, beyond the continued acceleration in food prices, is that **core inflation continues to move up,** reaching 5.7%yoy against 5.6% in February. No relief can be had from base effects: on a 3-month annualised basis, no declining trend can be noticed, services and non-energy industrial prices merely alternating from one month to another to push core higher (see Exhibit 2). The – modest – decline in core inflation seen in the United States (US) (confirmed in the Personal Consumption Expenditures price index (PCE) data for February released last week) continues to escape the Euro area, fuelling visible frustration at the ECB. This transatlantic divergence is indeed counter-intuitive: excess demand was much more obvious in the US than in the Euro area when both economies exited the pandemic, and even if Europe is only flirting with recession, aggregate demand continues to do significantly better in the US.

Exhibit 1 – Energy helps, but core inflation still up



Source : Eurostat and AXA IM Research, March 2023

Exhibit 2 – No relief to be found in varying base effects



Source : ECB and AXA IM Research, March 2023

In this context, the notion that inflation is currently driven by corporate profits refusing to fall, or even rising, is becoming very popular. The ECB dedicated its last blog post to this issue – already mentioned by Christine Lagarde - and Fabio Panetta focused his interview on this over the weekend. The general message from the data itself is undeniable: we have at the same time strong growth in retail prices and an improvement in corporate profits, and the latter contributed more to inflation at the end of last year than the upward drift in wage costs. Yet, we are concerned with the side-effects this discussion may have in the coming months and quarters**. In a nutshell, we don't think it is wise for the ECB to engage in this "blame game" on the roots of inflation.**

The ECB's focus on rising corporate margins will strengthen the position of those within organized labour who are trying to frame their current claims for a significant wage catch-up within the more general theme of "burden sharing", using the recent improvement in profit margins to argue that there are "reserves of purchasing power" which could be tapped. While for now, the contribution from labour costs to core inflation is lower than that of profits, a further acceleration in wages could very easily change this in the coming months or quarters, at a time when Germany – where inflation remains higher than the Euro area average – is dealing with strikes targeting 2-digit wage hikes.

More fundamentally, **we think there is nothing to gain for the ECB in getting embroiled in a discussion on corporate behaviour because its capacity to alter it is close to nil**. True, it's not uncommon for central banks to opine on the wage bargaining process, so it may seem obvious that this should also apply to the "profit policy" of companies, but there is a key difference between the two: in Europe, the wage bargaining process is often "institutionalized" – with in most countries a precise protocol for negotiations at the industry level between unions and employers' federations, allowing for deviations at the company level, while firms' approach to pricing, with a few sectorial exceptions, remains – fortunately – decentralized.

It makes sense for the ECB to warn unions against the ultimate consequences of excess wage growth – faster rate hikes, triggering a cyclical downturn which will destroy jobs – because the unions can internalize those warnings within their own reaction function, pushing their members into restraint. The shift to wage moderation since the 1990s, in many European countries, entailed the active participation of organized labour. One could argue that sectorial wage-setting can be "welfare enhancing" – as long as participants effectively consider the macro consequences of the negotiation - despite breaking with the canonical "one to one" approach to wage negotiation advocated by classical economic theory. Conversely, **corporate price behaviour is fully decentralized for very solid reasons: anything different would seriously stifle competition and attempts at "price coordination" would collide with EU regulations.** The central bank can of course choose to warn businesses in general against inflating their mark-ups but there would not be any collective mechanism to respond to this and alter price behaviour – and there probably should not. Actually, margins remaining "too high" could reflect a lack of competition in some sectors calling for some attention by the EU authorities (this point was made by ECB board member Fabio Panetta in his interview). But **where there is no evidence of anti-competitive behaviour, we are concerned that the debate on "excess margins" paves the way for more direct government intervention in price setting**.

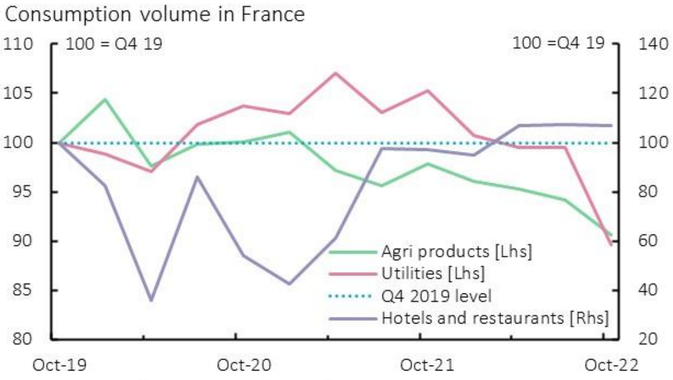
In some specific cases, direct price intervention makes sense if it corrects an institutional flaw. We have already discussed in Macrocast the price-setting system for wholesale electricity in the European Union (EU): the average price is in effect driven by the production cost of the marginal supplier, in practice, gas-fired power plants. Wholesale prices were thus drastically higher than the production costs of most suppliers, whose profit margins mechanically rose without any adverse impact on their sales. With gas prices falling, the wedge between average producer prices and average wholesale prices should disappear. We are however worried that there is now an "ingrained habit" in government's meddling with price-setting across the board, in response to public opinion pressure, much in the same vein as the recent multiplication of "windfall taxes". It is a slippery slope. **Excess wage rigidity was a characteristic of the 1970s, the last episode of persistent inflation in the West, but it was a decade also replete with all sorts of direct government intervention in price-setting, with adverse effects on economic efficiency and productivity.**

Margins rising amid strong inflation is not a very surprising phenomenon. Consumers faced with a generalized and significant upward price shock which comes "out of the blue" after decades of very low inflation may be less discerning on how specific products, or brands offering the same product, move their prices. When inflation in general hits 2-digit territory, it becomes easier for some suppliers to "squeeze in" an extra 1 or 2% in mark-ups without losing too much volume. **The question which should arise is: how is it that *aggregate* volume does not fall?**

Indeed, it becomes a negative-sum game if the aggregate behaviour of suppliers triggers a decline in purchasing power which reduces the overall volume being sold. There are already some examples of this on some forms of "high-frequency" spending for which price elasticity is normally low. Food consumption has fallen in real terms in both France and Germany, and so did spending on utilities (see Exhibits 3 and 4), on account of the rise in energy prices and governments' recommendations to reduce electricity consumption to deal with the supply disruptions last winter. Logically, we should also see the usual mechanisms of supply of solvent demand play their role in curbing margins in other sectors and bring about disinflation.

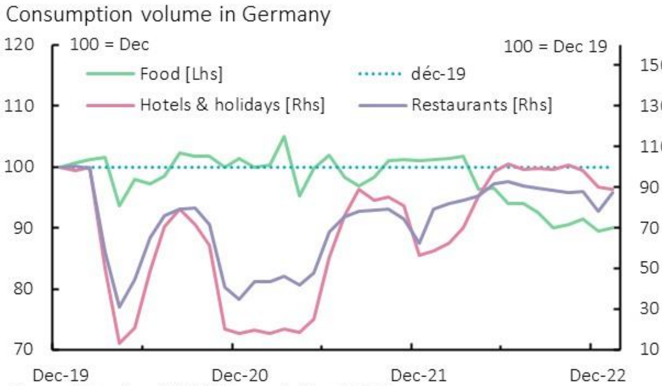
The ECB figures suggest that margins have improved significantly in some key services, which can be explained by the ongoing catch-up in spending since the post-pandemic reopening. There was simply so much pent-up demand that businesses could afford to raise their profits. The volume of consumption in hotels and restaurants remains above its pre-pandemic level in France (see Exhibit3). Germany displayed a similar pattern but is already beyond peak consumption on those items (see Exhibit 4). The ECB's impatience is understandable, but given the reaction of demand already at work, we should begin to see a change in margin behaviour soon.

Exhibit 3 – Pent-up demand blurs the picture…



Source: INSEE and AXA IM Research, March 2023

Exhibit 4 – …but spending volumes are reacting



Source: D-Statis and AXA IM Research, March 2023

This gets us back to a very simple point: central banks affect inflation through their action on aggregate demand. Unless blatant anti-competitive behaviour can be substantiated**, rising margins in some sectors point to lingering pockets of excess demand**. The ECB has two options, as always: either it considers that its monetary tightening has gone far enough and it's now only a matter of time before the deceleration in demand forces businesses to revise down their mark-ups, or it considers that sticky margins, reflecting persistent excess demand, calls for even more monetary tightening. But **the ECB cannot deflect its responsibilities on the behaviour of private agents, or worse being seen as calling for more direct government intervention in price setting**. The central bank is not there to say who's doing the "right" or the "wrong" thing. It's there to react with the tools at its disposal to whatever behaviour is observed.

Following the deposits trail

The absence over several days of additional bad news is sometimes all that it takes to stop a confidence crisis, even if underlying issues have not yet been addressed. This may well be true of the "banking stress" episode. Some nervousness clearly lingers – the banking and asset management conglomerate Charles Schwab came under pressure last week – but by and large market indicators improved. This is supported by the new weekly data on banks' assets and liabilities released by the Federal Reserve (Fed) on Friday evening: **deposits at small banks were broadly stable in the week to 22 March** (see Exhibit 5), after the massive 197bn decline reported for the week before (which incidentally has been very significantly revised up against a first estimate at -120bn which we discussed last week). Borrowing and cash hoarding also moderated drastically.

Not everything is back to normal though. Deposits fell by USD90bn at large banks (see Exhibit 6), more than offsetting the smaller net positive inflows of the previous week. In other words, **the deposit base of the aggregate banking sector keeps on eroding**, with the competition from money market funds continuing. It's even possible that the growing attention to this phenomenon in the US press in the last 10 days may start magnifying the migration. More people are aware today of the significant spread between the remuneration of their bank deposits and what they could get by shifting their liquidity to money market funds.

Exhibit 5 – Deposit flight halted in small banks…

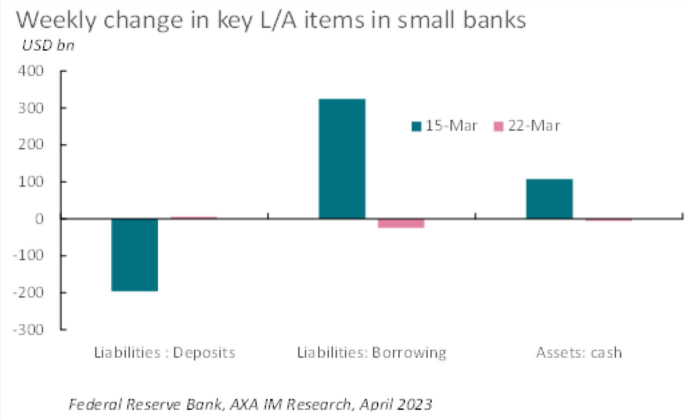
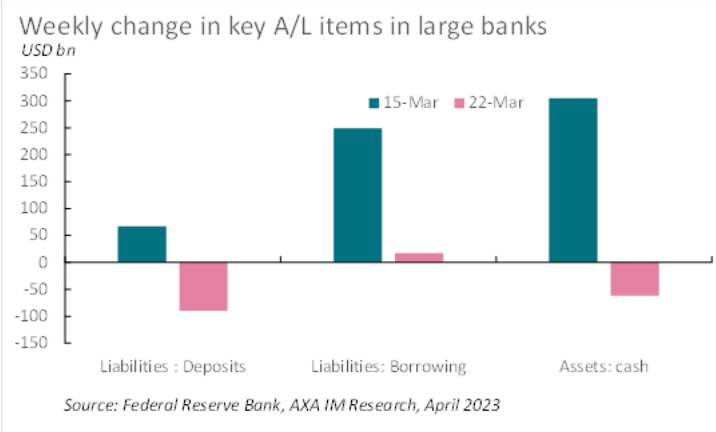
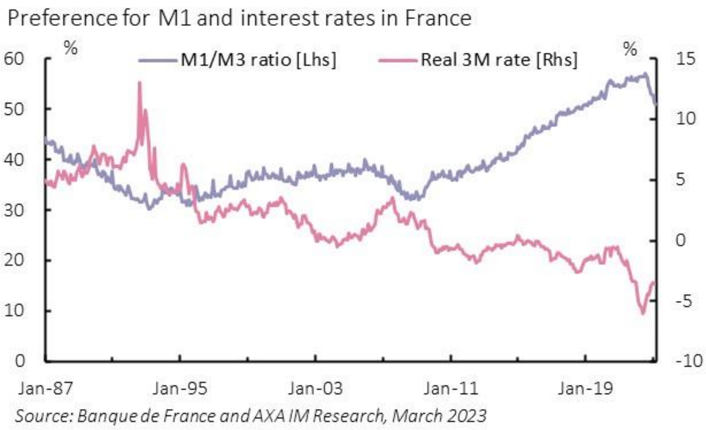


Exhibit 6 – …but large banks are now losing deposits



We highlighted last week how it was going to be impossible – for lack of near-real time data – to gauge the emergence of a similar pattern in Europe. We would argue however that these reallocations are nothing new, and that we should consider them as "part and parcel" of the normal transmission of monetary policy. We look at French data, to get enough "historical depth" (data in the Euro area as a whole is incomplete before the late 1990s). In Exhibit 7, we have computed a very simple index of "liquidity preference" of non-financial agents by looking at the ratio of money supply contained in M1 – basically bank notes and basic sight-deposit accounts – to the broad measure of money supply (M3). Interest bearing accounts and money market funds will be found in M2-M1 and M3-M2. The negative correlation with the short-term interest rate corrected for observed inflation is plain to see.

Exhibit 7 – "Narrow" vs "broad" money and real interest rates



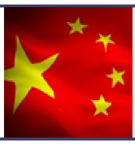
In the second half of the 1980s and early 1990s, Banque de France launched an aggressive monetary policy which significantly raised real interest rates. This was coupled to a deregulation of the banking industry and the emergence of new investment vehicles – including money market funds. The "regular" deposit base of the banking industry shrank – while inflation was falling. 1993 was the low point in French banks' intermediation margins. It's no surprise that the late1980s/early 1990s coincided with a massive concentration movement in the French banking industry and the onset of financial disintermediation – with a growing role for "non-banks" in the financing of the economy (for the readers interested in diving deeper into this period, follow this link). Once real rates stabilised, so did M1 as a share of the money supply. Conversely, the expansionary monetary policy adopted after the Great Financial Crisis of 2008-2009 ushered in a new phase of "liquefaction" of the money supply towards M1, which found its peak last year. Finally, and unsurprisingly, **the latest monetary tightening is now triggering a – timid – return towards the least liquid forms of money, pushing the M1 to M3 ratio down again**.

We took our readers through this historical detour to make a simple point: we should not be surprised by deposit reallocations – with all the unpleasant consequences for banks' appetite to lend. In a way, monetary policy would not work as swiftly without them, especially in the economies where intermediation remains dominant.

Of course, a shrinking deposit base, holding back banks' capacity to fund the economy at affordable rates can leave more space to other financial players – especially to those at the receiving end of the liquid assets non-financial investors no longer want to park at banks. We would however contend that even in countries such as the US where banks play a smaller role in the economy than in Europe, it is highly likely that **during episodes of deposit migration, risk aversion will limit the capacity of non-banks to completely pick up the slack**. The recent developments within the US money market funds (MMF) sector are quite telling from this point of view. Two major types of funds co-exist: "Prime" MMFs, which invest in short-duration private paper (e.g., commercial paper issued by non-financial corporations, or banks' certificate of deposits), and "Government" MMFs, which invest only in government debt. The latest available data (see this link for details) show that **in the second half of March, Prime MMF have lost USD20bn, while USD200bn have flocked to government MMFs.**

This gets us to a notion which has not been very popular over the last 10 years: "crowding out". When monetary policy was expansionary, especially under Quantitative Easing, there was not much competition between government and private funding. The rise in interest rates and Quantitative Tightening changes the equation in a situation where public finances benefit from risk aversion to the detriment of private issuers**. Irrespective of the change in the availability and cost of their resources, banks would probably have curtailed their funding to the private sector anyway**, estimating that rising interest rates would deteriorate the sustainability of their debt. **But aggregate investors' preference is unlikely to be very different.** In this configuration, governments can continue to fund their large funding needs without a too crippling rise in their debt servicing costs, but the private sector could be struggling more.

Again, these are probably unavoidable steps along any monetary tightening. As usual, the delicate job for central banks will consist in judging how much is more needed, but at the very least, they should now be satisfied that their signals are well transmitted through the entirety of the financial system.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US Fed emergency lending to bank fell in latest week ($15bn), US bank equity rose – a calmer week • GDP (Q4) revised to 2.6% (saar) from 2.7%, PCE lower • PCE inflation (Feb) fell to 5.0%yoy from 5.3%, core also fell but to 4.6% from 4.7% • Personal spending (Feb) +0.3%, from +2.0% in Jan • Housing data continues mixed: Jan house prices mixed from different providers, mortgage lending continues to increase and latest pending home sales rose again	• Labour market report (Mar) monitor slowing in employment growth; labour supply gains persist; and continued soft monthly pace of earnings • JOLTS survey (Feb) declines in level of vacancies • Vehicle sales (Mar) broader barometer of consumer sentiment • ISM indices (Mar) manu index suggested weakness, but services remained solid. Does this continue?
	• Euro area "flash" HICP dropped 1.6pp to 6.9%yoy while core edged up 0.1pp to 5.7%yoy in March • Eurozone February monetary aggregates showed continued bank lending weakness in line with monetary normalisation • EC survey showed slight decline in eurozone business sentiment across sectors in March	• Euro area "final" PMIs for March. "Flash" print suggested strong momentum in periphery • Euro area producer prices for February • February industrial production across member states
	• Humza Yousaf voted next leader of SNP • UK joins CPTPP in biggest trade deal since Brexit • GDP (Q4) revised up to 0.1% from 0% on higher consumption and lower imports, 2022 GDP now 4.1% • CA (Q4) deficit ex erratics narrows to 3.3% of GDP • Nationwide house prices (Mar) down -0.8%mom	• Final PMIs (Mar) Flash estimate suggest considerable momentum remains in services • Halifax house prices (Mar) • Total reserve assets (Mar)
	• Tokyo CPI (Mar) headline continues decline to 3.3% as domestic price pressures still rising, service PPI (Feb) up 1.8%mom from 1.6% prior • Ind output (Feb) up 4.5%mom above expectations • Nominal retail sales (Feb) up 1.4%mom • u/rate (Feb) rose unexpectedly to 2.6% from 2.4%	• Tankan survey (Q1) a deterioration in current conditions expected • Final PMIs (Mar) • Total cash earning (Feb) likely to continue rising • Household spending data (Feb)
	• NBS PMI survey came out stronger than expected in March with manufacturing slowing less than expected to 51.9 (Feb 52.6) and non-manufacturing higher at 58.2 (Feb 56.3), now at a 10-year high	• March Caixin PMI survey to be released – to compare to the strong NBS survey released last week
	• CB: +50bp hike in South Africa, +25bps hike in Thailand, Mexico & Colombia. Czech and Hungary on hold. Egypt +200bp hike • March CPI (%yoy) flash in Poland showing inflation rate slowing to 16.2% from 16.6%yoy • Ecuador's top court allows President Guillermo Lasso impeachment hearings to proceed	• CB: Chile (11.25%), Poland (6.75%) & Romania (7.0%) expected to stay on hold • March PMI surveys released across countries • March CPI: Colombia, Mexico, Indonesia, Korea, Peru, Thailand, Turkey & Czechia • Retail sales (Feb): Korea, Singapore, Czech & Hungary

Upcoming events	US:	Mon: ISM manf. indx (Mar), Manf PMI (Mar); Tue: Durable goods orders (Feb), Factory orders (Feb), JOLTS (Feb); Wed: ADP employment change (Mar), Trade balance (Feb), Services PMI (Mar), ISM non-manf. indx (Mar); Thu: Weekly jobless claims (1 Apr); Fri: Non-famr payrolls (Mar), Unemployment (Mar), Ave earnings (Mar), Ave weekly hours (Mar)
	Euro Area:	Mon: EU20, Ge, Fr, It & Sp Manf. PMI (Mar); Tue: EU20 PPI (Feb); Wed: EU20 Composite & Services PMI (Mar), Ge New manf. orders (Feb), Services PMI (Mar), Fr Ind prod (Feb), Services PMI (Mar), SP Ind prod (Feb), Services PMI (Mar); Thu: Ge Ind prod (Feb)
	UK:	Mon: Manf. PMI (Mar); Tue: BoE Huw Pill speech on inflation; Wed: SMMT new car regs (Mar), Services PMI (Mar); Thu: Halifax HPI (Mar), Construction PMI (Mar)
	Japan:	Mon: Tankan large manf. indx (Q1)
	China:	Mon: Caixin manf. PMI (Mar); Thu: Caixin services PMI (Mar); Fri: Foreign exchange reserves (Mar)

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