177 – 24 April 2023

What you know and what you must guess

- A debate is heating up on Central Bank Digital Currencies. We can easily see political and technical arguments stall their widespread adoption
- We explore what the Fed and the ECB "know", and they must "guess". The balance of signals is more supportive of an imminent pause in the US than in the Euro area.

Central banks' digital currencies are usually seen as a non-contentious "compromise" providing the technical benefits of cryptos without their financial stability risks. The central bank community has been working positively, albeit prudently, on these issues, but some key players are clearly hesitant. Fed Governor Bowman produced last week a long list of arguments against CBDCs – even if she safely concluded her speech by a mere call for "more research". Those who support CBDCs for their policy potential – the capacity to deal efficiently with the lower bound of central bank rates – may well underestimate the political and technical pitfalls. The risk that unlimited CBDCs would create for the banking system is recognized by most of their own advocates. This argument has probably gained in traction with the recent banking turmoil.

April has been quiet for the Fed and the ECB but as the market prepares for a much busier May we explore what the two central banks now "know" – the message sent by tangible data – and what they must "guess" – what they infer from recent developments. The balance of signals is different for the two central banks in our opinion. In the US, price data suggest core inflation is slowing down and the impact of the banking turmoil – although under control from a financial stability point of view – is already plain to see. It does not take "interpretative overreach" to conclude that a pause will be appropriate after "one last" hike in May. In the Euro area, it takes microscopes to detect a deceleration in core prices, while key indicators suggest the real economy is holding up well, potentially fuelling demand-led inflation. Credit data tell us that the monetary tightening is working its way, but "guesswork" is needed to substantiate an impact from the banking turmoil. Finally, while observed aggregate wages remain tame, recent industry-based pay deals (e.g., the very generous proposal in the German public sector) can be interpreted as signs that wages will soon replace profit margins as key inflation drivers. The idea that there is "more ground to cover" – and more than one rate hike left in this cycle – is easier to sustain in the Euro area than in the US.

Objecting to Central Banks' Digital Currencies (CBDCs)

Late last year, the debate in academic and policy circles on the future of digital currencies was converging towards some measure of consensus. The coincidence of the rebound in interest rates and generalisation of quantitative tightening with the free-fall of many private digital currencies supported the conclusion that those new instruments were more the expression of a speculative wave fuelled by idle liquidity rather than a proper, sustainable form of financial innovation. At the same time, some of the technical benefits of digital currencies - such as the speed of transaction or the capacity to combine payment with contract execution - were widely praised. **Establishing digital currencies controlled and operated by central bank often appeared as the optimal solution,** a natural and technologically exciting extension of bank notes. However, the banking turmoil of the last few weeks may have played in the hands of those calling for some "pause for thought".

We were intrigued by a speech by Michelle Bowman, member of the Federal Reserve Board of Governors, last week (link here) which provides a subtle but still quite clear list of reasons NOT to embrace CBDCs. Her starting point is to discuss which would be the problem a CBDC would solve. We won't review all her objections but to start with, she does not seem to think that CBDCs are uniquely appropriate to deal with the lack of efficiency of the payment system. She praised instead the upcoming FedNow system - which does not use ledger technology - which is due to be available to depository institutions later this year and is designed to provide swift transactions, 365 days, around the clock. She also gives short shift to the inclusion argument - the fact that CBDCs could act as a free and easy to use substitute to a bank account for financially vulnerable people - by stating that three quarters of the 4.5% of US households who do not have a bank account have no interest in having one, and musing that since "lack of trust" is one of the reasons behind this, it's unlikely that those having no confidence in banks would necessarily wish to bank with the government instead.

Michelle Bowman then discusses the risks CBDCs would create. Her first point is about privacy and politicization of payment systems. We find it interesting that she uses the example of a fiscal measure, rather than a monetary policy one, in her discussion. Indeed, she mentioned the possibility that the government would use a CBDC to trigger a targeted fiscal push by giving consumers a time-limited credit (the value of the transfer would disappear after a certain time). She makes no mystery of her dislike for these options: "*Enabling this type of limit through a CBDC would stand in stark contrast to the flexibility and freedom embedded in physical currency or bank deposits and could serve to control or even harm consumers and businesses".*

When the policy aspects of CBDCs are discussed, it's usually in the context of negative interest rates. It's what Willem Buiter has just done in his latest column for Project Syndicate (see the link here). He projects himself in a situation in which after the ongoing inflationary shock, the world economy goes back to the pre-pandemic configuration of low equilibrium interest rates, drawing on the International Monetary Fund (IMF)'s key finding of its latest World Economic Forum. We have our doubts, and this would call for a lengthy discussion in its own right – and that's we will do in the next issue of Macrocast – but for now let's accept the premise. Buiter argues perfectly sensibly from a technical point of view that under such circumstances a central bank would have to frequently resort to unconventional policy with various degrees of efficiency to "break" the lower bound interest rate. Levying negative interest rates on CBDC holdings could be a better way to deal with the lower bound than resorting to quantitative easing.

Buiter only briefly discusses the political acceptability of his proposal to establish a *"well-designed wholesale and retail digital currency that is widely available to the general public…with a CBDC setting the policy rate at -5% could be as easy as setting it at 5%".* It seems he sees "*libertarian objections"* as trumped by the benefits of *"fighting tax evasion or money laundering"* which by the way goes against his own argument that his CBDC would be "anonymous" ("pseudonymous" to be precise). As an aside he is in favour of abolishing physical cash altogether. Michelle Bowman may well harbour such libertarian proclivities (she is a Republican) but we suspect her points are shared by many, including beyond her own political family and geography, and there would probably little difference in terms of public reception between a CBDC "tax" triggered by the government and one imposed by an independent central bank to try to speed up consumption and revive the economy.

Conceptually, there may not be any difference – from the point of view of consumers' real income - between keeping nominal interest rates below inflation, which central banks routinely do, and levying a negative interest rate on cash deposits. But people would probably see this quite differently, otherwise banks these last few years would have had no qualms in passing the European Central Bank (ECB)'s negative deposit rate to individuals, which they pointedly did not do. We note also that a very recent survey by Banque de France (link here) suggests that on this side of the Atlantic as well households value the anonymity of traditional cash (it's the first reason given for the preference for cash payments). In any case, Governor Bowman stated at the beginning of her speech that the Federal Reserve (Fed) would not establish a CBDC without an authorisation of Congress. Given its current configuration, this may take ages to come…

Still, beyond the political and psychological aspects, in our view a **more technical objection to CBDCs may be the most valid, at least to kill it as "policy instrument". Bowman makes the point that establishing a CBDC could harm banks' funding model** – by creating competition to the deposit base. This is a well-known issue, recognized by most of its advocates, but of course this takes a particular resonance now in the context of the deposit migration in the US. Bowman was explicitly appointed to the board as a representative of the community banks: she is naturally sensitive to the plight of small banks currently fighting for deposits. Palliative solutions can be considered. ECB board member Fabio Panetta suggested among other possibilities creating for each CBDC holder a "waterfall bank deposit account" to which CBDC holdings would be automatically transferred above a certain threshold, to avoid depriving banks from too much of their deposit base. If the amount of CBDCs allowed to each individual is limited – precisely to deal with the adverse consequences of the development of this new asset for the capacity of the banking sector to fund the economy – then negative rates imposed on these holdings would probably fail to move the needle from a macroeconomic point of view. Buiter's enthusiasm is technically appealing, but we can easily see how political and technical arguments are aligning to stall widespread adoption of CBDCs.

What do central banks know by now?

Central banks must make their decisions based on what they *know* – i.e., data describing the current state of the economy, which may not send a straightforward message – and what they must *guess*, i.e., what they can infer from recent developments, usually based on historical precedents which may or may not remain relevant. Our contention is that what the Fed already knows with a fair degree of certainty would normally encourage them to stop tightening soon, while the case for pausing requires more guesswork on the ECB side.

Let's start with the United States (US). We have at our disposal near-real time indicators of the behaviour of banks there. It is clear the "acute" phase of the banking turmoil is behind us. It started in early March, and the Fed data on banks' assets and liabilities show that the brutal changes in terms of borrowing, cash hoarding and deposit migration peaked in mid-March (see Exhibit 1) with much more contained movements since then. Yet, **when comparing last week's snapshot of banks' balance sheet to what it was at the end of February, the shock remains significant**. We can look at it as a "z-score" – i.e., in terms of number of standard deviations relative to the long-term average - based on the history of these series since the 1970s (see Exhibit 2). Banks have experienced since early March a two-standard deviation decline in their deposit base, and even if the knock-on effect on credit origination has been more muted, the decline there has still been a non-trivial one-standard deviation. **The Fed has thus tangible information to consider that serious macroeconomic ramifications are likely to emerge from the banking turmoil**. Gauging now their *magnitude* would take a lot of guesswork, but the *existence* of an adverse impact is already plain to see. Besides, the Fed knows that core inflation has been declining, albeit too slowly for its taste. There were some encouraging signals in the latest batch of consumer prices, which we discuss last week, between the steep deceleration on a 3-month basis of core services prices excluding rents, as well as in the latest Producer Price Index.

Exhibit 1 – Bank turmoil peaked in mid-March

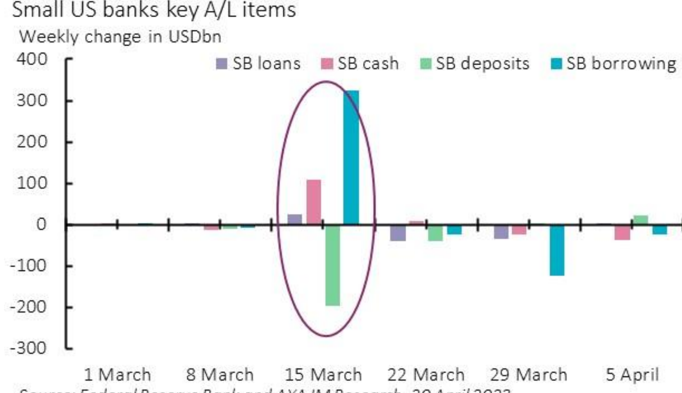
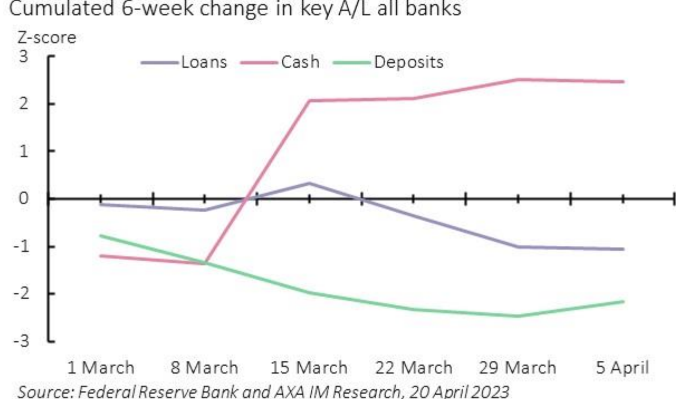


Exhibit 2 – Still a big shock by historical standards

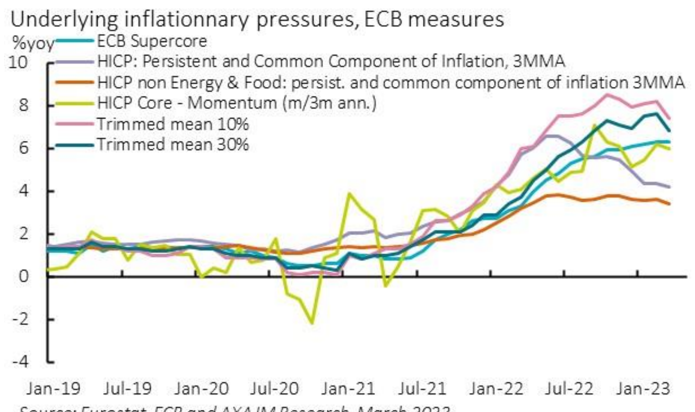


At least, **there can be no denying that the monetary tightening accumulated since last year is really working its way through the US economy** and we treat the banking turmoil as a too spectacular and precipitated version of what would have happened anyway in terms of financial conditions. Fed Funds are already roughly twice as high as the Fed's own estimate of the neutral rate. The real debate of the next months – after probably delivering a last, "precautionary" 25 bps hike next week – will probably focus on how long the stance will need to be maintained but determining this now would be entirely dependent on "guesswork". There is not much in the current data which can help answer this question at this stage. Models based on experience can help – and we think they would call for not lowering the guard too quickly, but with as usual a limited level of confidence. More immediately, the Fed would need to decide whether to make a pause after May explicit – i.e., pre-committing, at least loosely, not to hike again - or more simply "playing it by ear" and simply stating it will remain data dependent. For our part, we think that keeping an "open" outlook to the trajectory of monetary policy post-May – i.e., not committing to any particular steps nor timeline – would probably be the most appropriate approach given the circumstances.

Let's now turn to the Euro area. What does the ECB know? Two important things in our opinion. First, core inflation remains far too elevated. Second, the real economy is still doing very well. What do they have to guess? Two equally important things in our opinion. First, whether the Euro area will also be hit – from a macroeconomic point of view – by the banking turmoil. Second, whether wages will bring a "second helping" of excess core inflation after the corporate margins behaviour we discussed two weeks ago.

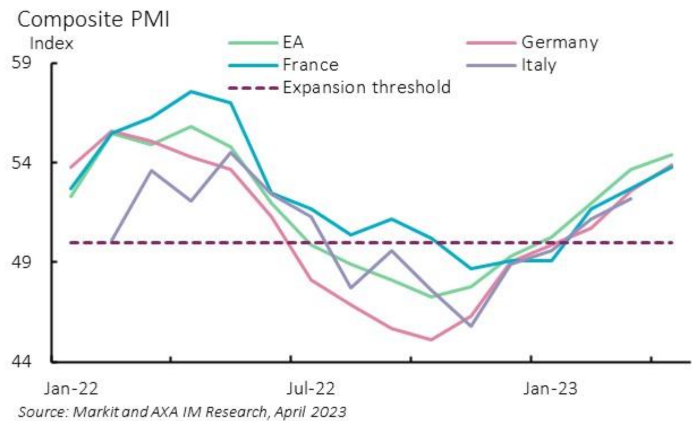
The "basic" version of core inflation – all-items excluding food and energy - surprised to the upside again in March, but over the years, the ECB has developed a whole arsenal of alternative measures of core (see Exhibit 3). Using some of these "microscopes", a sense that the peak has just been passed could emerge. This is true for the "trimmed" approach – where the components displaying the most extreme variations are taken off from the calculation. The model-based "persistent-common component" has been decelerating for much longer. However, **the "supercore" measure, which is normally reactive to changes in demand conditions, continues to accelerate**, hitting 6.3%yoy in March. We are tempted to connect this to ECB board member Isabel Schnabel's latest speech, in which she argued that demand was starting to overtake supply as the main driver of inflation in the Euro area. This is key. Since the ECB has much more capacity to affect demand than supply, then a demand-led inflation would call for more monetary policy action. So, **what would be the overall verdict when it comes to tangible – i.e., already observed – inflation data? Probably that there is not yet enough evidence to consider that inflation is getting back under control.**

Exhibit 3 – Is core inflation peaking? Have your pick!



Source: Eurostat, ECB and AXA IM Research, March 2023

Exhibit 4 – Recession, what recession?

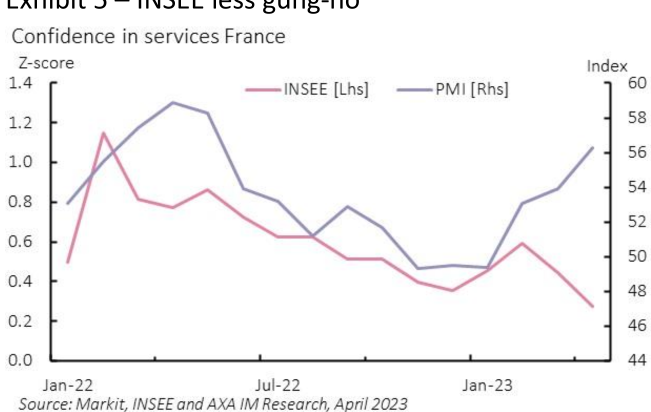


Source: Markit and AXA IM Research, April 2023

Meanwhile, the latest dataflow has been very reassuring about the state of the Euro area economy, with another consensus-trumping further rise in the composite Purchasing Manager's Index (PMI) for April, driven by services, with the added benefit that the improvement in cyclical conditions is widely shared across the various sub-regions of the Euro area (see Exhibit 4). This creates a significant upside risk to our expectation of only marginally positive GDP growth in Q1 and Q2**. It's not just that the PMI survey is firmly in expansion territory. It has reached levels consistent with slightly above trend growth**. In other words, slack may be already falling in the Euro area, which would fuel further demand-side inflation pressure.

We must be prudent. The swift re-acceleration in services is surprising given the downward pressure on consumers' purchasing power. In this sector, the message from the PMI is not entirely confirmed by national surveys. The divergence is particularly acute in France. In March already, the INSEE survey in the services sector was continuing to deteriorate, in contrast with the rebound in the PMI. The divergence has become more glaring in April (see Exhibit 5). The release of the European Commission surveys for the whole Euro area for April this week may provide more insight. **Yet, PMIs have become the "canonical" indicator of the cycle and the ECB is likely to focus on its message.**

Exhibit 5 – INSEE less gung-ho



Source: Markit, INSEE and AXA IM Research, April 2023

So, in total, based on what the ECB "knows" of the current situation, the terminal rate may well be some way away. But what can the ECB "guess" at this juncture? We have been arguing that contrary to what the hawks contend, there has been tangible evidence for some months now that the monetary tightening is starting to work its way through the economy. US commentators may have rediscovered the notion of "credit crunch" only a few weeks ago, but in the Euro area flows of new loans to the non-financial private sector have been falling since the end of 2022, while house prices – as captured by the ECB's own data – declined in Q4 2022. The next Bank Lending Survey – which will be released just ahead of the May Governing Council meeting - is likely to shed some light on whether the ramifications of the bank turmoil are triggering a further

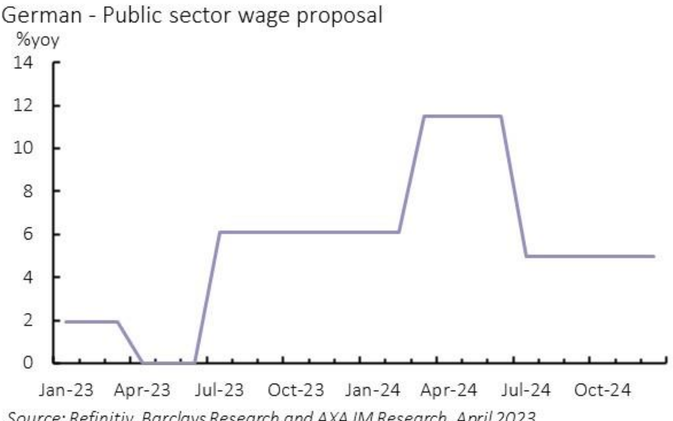
tightening in credit standards. Together with one more month worth of data on actual credit origination, this will – in our expectation – suggest an economic slowdown is on its way, despite the robust showing of the PMIs.

Yet, the ECB's guesswork can't be limited to gauging what's in the pipeline for the credit impulse. **There is another crucial area where observed data may well paint an obsolete picture of the underlying momentum, and that's wage growth. And there, reasons for concern abound**. In another contrast with the US, aggregate data on wage behaviour are scarce and take time to emerge in the Euro area. The ECB's index of negotiated wages in only available until Q4 2022 when it did not display anything spectacular (+2.9% year-on-year, same as in Q3) but the ECB is bracing for some significant acceleration in 2023 and beyond. The latest news from Germany on the arbitration council's proposal for public sector wages – the deal has been accepted by the union leadership, but the membership still need to be consulted – are unlikely to comfort the Governing Council.

At face value, it is "only" a 5.5% pay rise but when working through the effect of the one-off hikes totalling EUR 3,000 added to the permanent rises, Barclays economists came up with an overall gain of more than 10% year-on-year by early 2024 (see Exhibit 6). It's in Germany and in surrounding countries (Austria, Belgium, the Netherlands) that the most generous pay deals can be seen now – which might be counter-intuitive and could trigger some "interesting conversations" later this year, if peripheral countries start resenting additional rate hikes fuelled by excess wage drift in the normally hawkish "core countries".

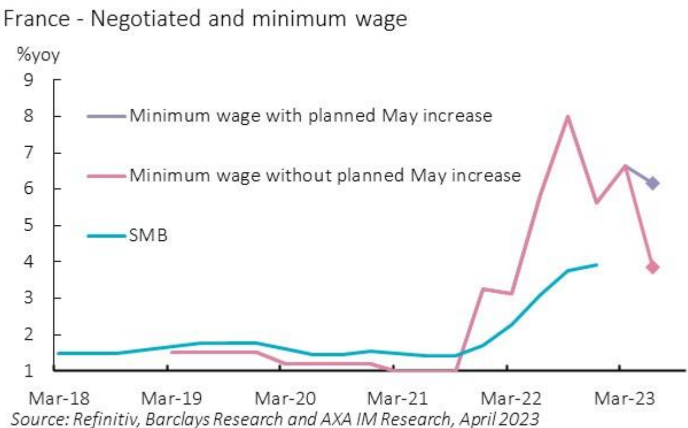
But in other countries, wage pressure is also mounting. In France for instance the indexation of the minimum wage on past inflation will trigger another hike in May pushing the year-on-year change to more than 6%. France is not the only member state with a minimum wage, but there the distance with the median wage is particularly small, which can trigger some significant second-round effects (more workers are "caught up" by the new level of the minimum wage).

Exhibit 6 – German public sector pushing hard



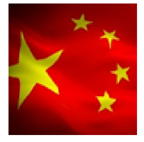
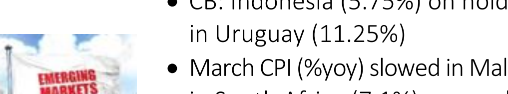
Source: Refinitiv, Barclays Research and AXA IM Research, April 2023

Exhibit 7 – Indexation effects



Source: Refinitiv, Barclays Research and AXA IM Research, April 2023

What central banks know is not necessarily superior to what they are left to guess. Relying too much on what's already been observed is akin to driving with one's gaze fixated on the rear-view mirror. Yet, at the current juncture, the "balance of the signals" still probably favours the hawks. The only thing the doves can do for now is probably to push for smaller increments – 25 bps – against temptations for maintaining a 50bps pace, and for a thorough discussion at each meeting on whether an additional hike is necessary rather than pre-committing to a string of further hikes.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed emergency lending to banks edged higher in latest week (+$4.5bn), but has broadly stabilised • FOMC members last comments ahead of May's purdah period suggested hike in May • Empire and Philly Fed surveys (Apr) – divergent trends, although deep drop in Philly at odds with components • Debt ceiling timing with April tax receipts determining X date and House Reps proposing plan to raise ceiling	• GDP (Q1) Atlanta now tracker suggest 2.5% (saar) ahead of consensus 2.0%, but inventory poses downside risks. Will watch for impact on Q2 • PCE inflation (Mar) expected to drop to 4.1% from 5.0%, 'core' to fall by less to 4.5% from 4.6% • ECI (Q1) expected around stable at 1.1% from 1.0% in Q4 – cleanest measure of wages, but still too firm • PCE income and spending (Mar), spending should fall after retail sales. Saving rate in focus
	• EMU Final HICP (Mar) unchanged at 6.9%yoy and 5.7% for core. Ge PPI (Mar) decelerated further at 7.5%yoy • Services sector is boosting EMU GDP growth as highlighted by strong EMU Flash Svcs PMI (Apr) reaching 56.6. Mfg flash PMI is easing (45.5) but partially biased by supply chain easing. Overall, new orders and employment up, prices expectations down • EMU Flash cons confidence (Apr) remains below pre-energy crisis at -17.5 but is still recovering	• EC surveys (Apr) and German Ifo to match PMIs • GDP preliminary estimates (Q1) across euro area. Latest data in March point to possibly large upside surprise to our +0.1%qoq baseline (Consensus: +0.1%). Key to monitor growth composition • Inflation data (Apr) in Ge, Fr and Sp. Another headline decline is expected in Ge and Fr but not in Spain as huge energy base effect that occurred in Mar 22 will partially disappear
	• Labour market data (Feb) strengthens our call for May hike as private sector wages reaccelerated • CPI inflation (Mar) eased to 10.1% driven by energy, but rises in food kept prices elevated 30bp above cons • Retail sales (Mar) down -0.9%mom • GfK cons conf (Mar) rose to -30, highest since Feb 22	• Public finances (Mar) to complete outturn for FY22. OBR expected £152bn deficit in March EFO • Nationwide house prices (April) further slowing in prices expected • MPC members Mann and Tenreyro to speak (Wed and Thur)
	• CPI inflation (Mar) headline eased as expected to 3.2% but underlying measure continue to rise core (ex fresh food and energy) rose to 3.8% and services to 1.5% • Flash PMIs (Apr) Mfg edged up to 49.5 and services remains solidly in expansion territory • Trade bal (Mar) narrows as exports stabilize	• BoJ MPM (Apr) first meeting with new Gov Kazuo Ueda at helm. We expect no change to YCC and other policy tools • Tokyo CPI (Apr) • Labour market data (Mar)
	• Q1 2023 GDP stronger at 4.5%yoy – upside risks to 2023FY consensus expectations • March macro data showed strong retail sales momentum, slow recovery in IP, still weak FAI particularly in the infrastructure/RE sectors • PBoC kept 1Y LPR unchanged (3.65%)	• No major macro data publication
	• CB: Indonesia (5.75%) on hold, unexpected 25bp cut in Uruguay (11.25%) • March CPI (%yoy) slowed in Malaysia (3.4%) – accelerated in South Africa (7.1%) – overall sticky core inflation • Weaker IP (Feb) in Brazil, retail sales (Feb) in Mexico, econ. activity index (Feb) in Colombia • Consumer confidence (Apr) jumped in Turkey	• CB: Turkey (8.5%), Russia (7.5%), Colombia (13%) to stay on hold. Hungary (13%) signalling monetary policy normalisation • CPI (Apr) prelim.: Poland, Mexico, Brazil • IP (Mar): Taiwan, Korea, Singapore, Poland, Russia • GDP (Q1 2023): Korea, Taiwan, Mexico

Upcoming events		
	US:	Tue: Case-Shiller HPI (Feb), FHFA HPI (Feb), Conference Board consumer conf. (Apr), New home sales (Mar); Wed: Durable goods orders (Mar), Goods trade balance (Mar), Wholesale inventories (Mar); Thu: GDP (Q1), Domestic final sales (Q1), Core PCE price index (Q1), Weekly jobless claims (22 Apr), Pending home sales (Mar); Fri: PCE and Core PCE (Mar), ECI (Q1), Personal & spending income (Mar), Chicago PMI (Apr), Michigan consumer sentiment (Apr)
	Euro Area:	Mon: Ge Ifo business climate indx (Apr); Wed: Fr Insee consumer conf. (Apr); Thu: EU20 Business conf. (Apr), It ISTAT business & consumer conf. (Apr), Sp Unemployment (Q1); Fri: EU20, Ge, Fr, It & SP GDP (Q1), Ge Unemployment (Apr), CPI (Apr), HICP (Apr), Fr Consumer spending (Mar), HICP (Apr), Sp HICP (Apr)
	UK:	Tue: PSNB (Mar), CBI Industrial Trends survey (Apr); Wed: CBI Distributive Trades survey (Apr)
	Japan:	Thu: Leading indx (Feb); Fri: Unemployment (Mar), Ind prod (Mar), Housing starts (Mar), BoJ policy announcement
	China:	Thu: Industrial profits (Mar)

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