From cold war to stagflation, are we BACK TO THE FUTURE ?

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Threaths

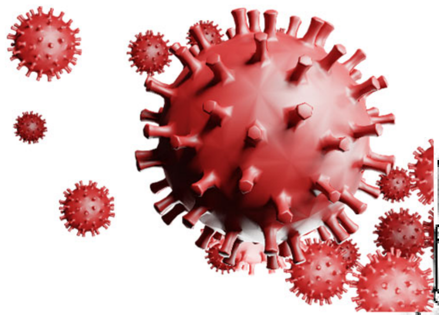

Chart 2

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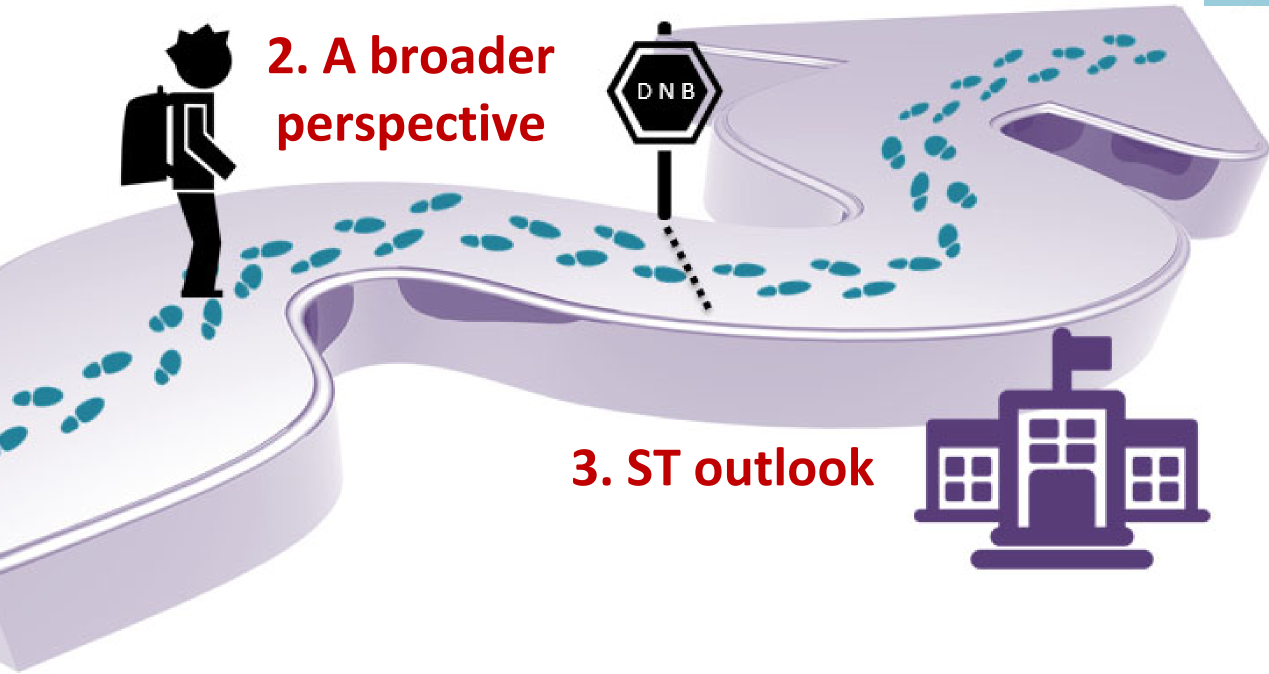
Content

1. Environment



2. A broader perspective

3. ST outlook

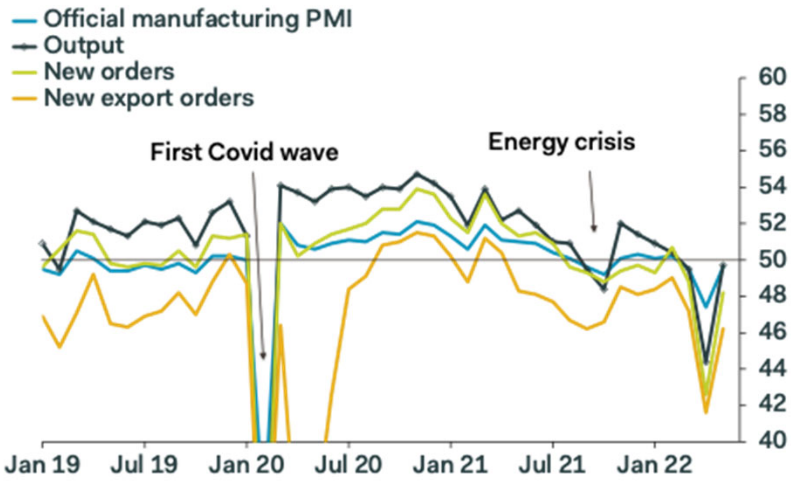
4. Financial conditions

1. Environment

(1) Pandemics – getting used to it

- Still with us
- Especially in China
- With impact on
    * supply
    * sentiment
- But clearly receding

PMI, China



Source : Pantheon, May 31, 2022

(2) Russia – nobody knows

- No economic rationale => impossible to predict
- Bad news
    * More uncertainty for longer
    * Risk of face-saving behavior
- Good news
    * Unity within the EU, with changing roles
        Germany under economic pressure
        Tension between Germany and Eastern EU countries
        EU integration (additional EU debt issuance)
    * Weakness of Russian army
    * Deterrence Taiwan

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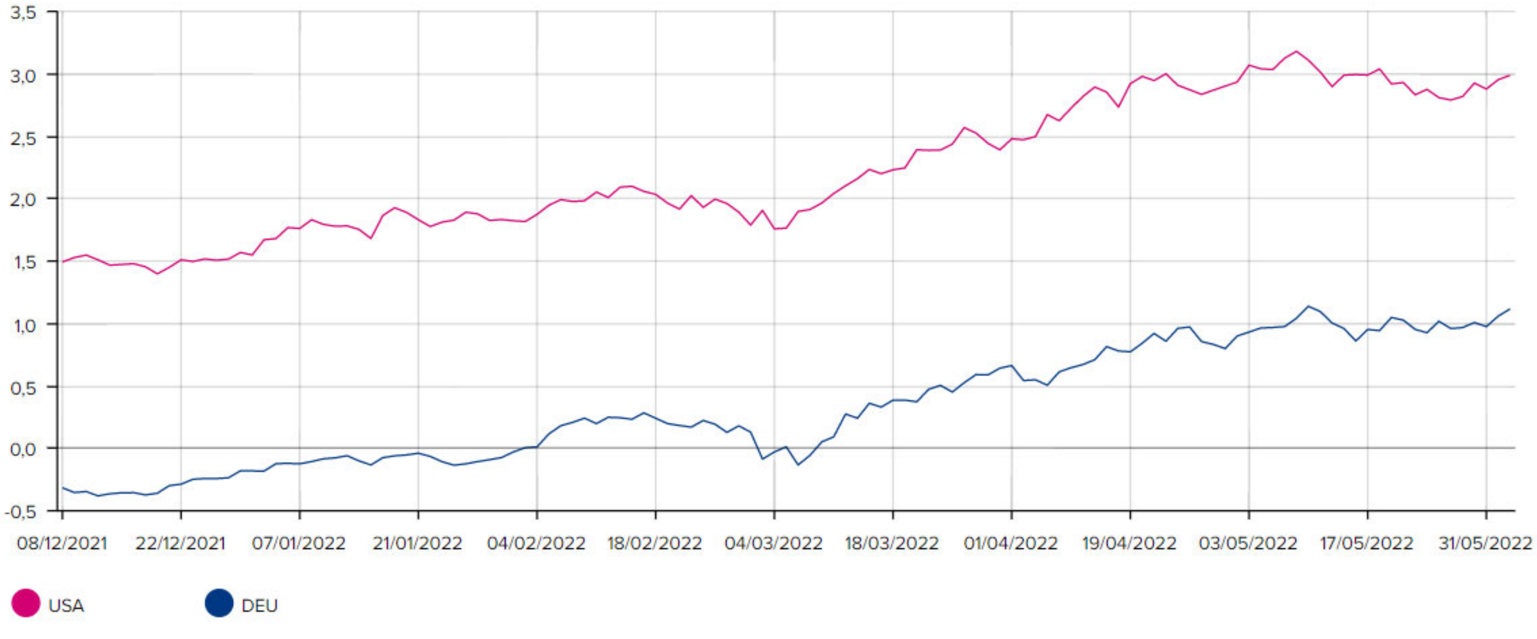
(3) Inflation – everybody knows

Is there a chart really needed?

(4) Interest rates

Look at the US first – 10 Y sovereign rate, US vs. Germany



Source : Boursorama
https://www.boursorama.com/bourse/taux/

(5) Social cohesion

- *It is worth remembering that the chant going into Tahrir Square in the Arab Spring was "Bread, Freedom, Dignity."*
  (Jeremy Grantham, GMO, April 2022)

- *Public-opinion polls have shown that inflation (or something like inflation) has often been viewed as the most important national problem.*
  (Robert Shiller (1997), quoted by Agarwal & Kimball, How Costly Is Inflation ?, IMF, March 20)

2. A broader perspective

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Crises are the normality !

- 2008 – 2009	Great Financial crisis
- 2010 – 2012+	EU Sovereign debt crisis
- 2020 – 2022	Sanitary crisis
- 2022 – …	Geopolitical crisis
- 2022 – …	Inflation crisis

Main lessons :

- “so far so good”
- procrastination

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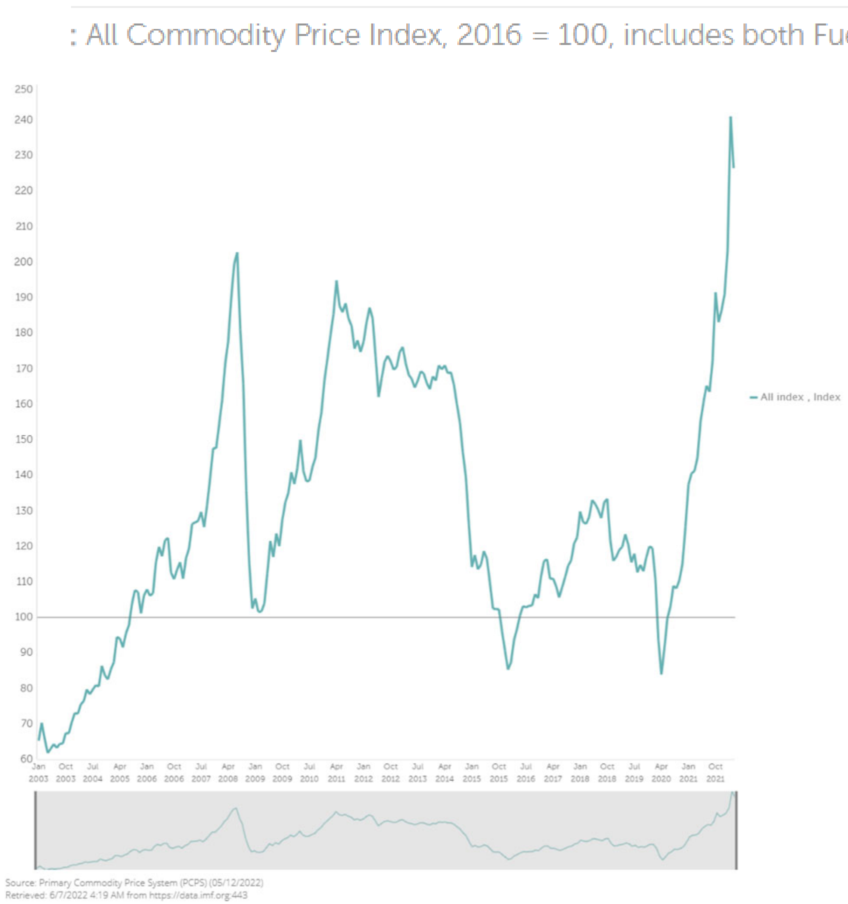
Commodity prices : something big



Source : IMF, IMF Data, Primary Commodity Price System
https://data.imf.org/?sk=471DDDF8-D8A7-499A-81BA-5B332C01F8B9&sId=1547558078595

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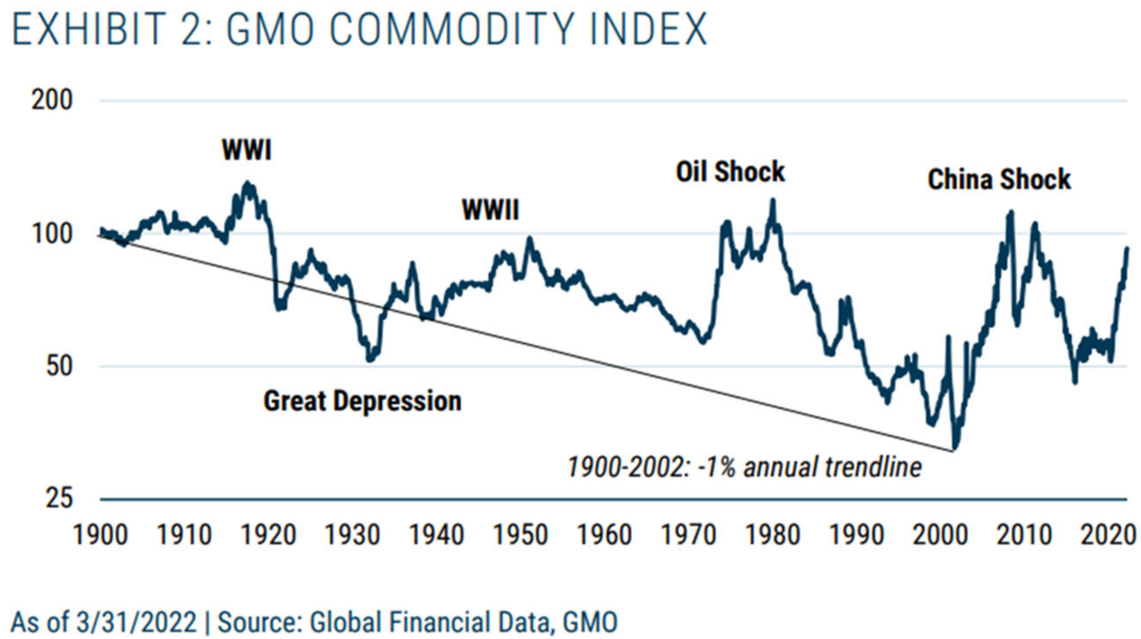
Commodity prices : something new?

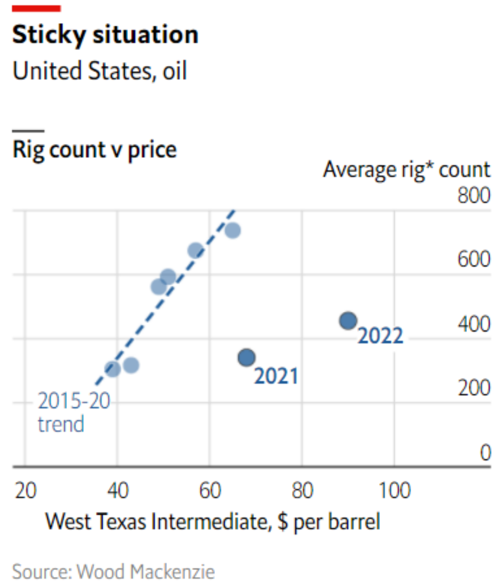


Source : Putin's Invasion Reminds Us That We Live In A Finite World, GMO, April 2022

Why a reversal? (1/3)

For commodities : partly explained by environmental transition

- New needs (transport, heating, …)
- Regulation
- Polluter pays tax principle
- Fear of **stranded assets** => lowering of supply
- Lower yields (impact of climate and of less polluting inputs on yields)
- Social concerns (labor conditions)
- Growing demand from emerging countries
- …



Source : The Economist, March 28, 2022

Why a reversal? (2/3)

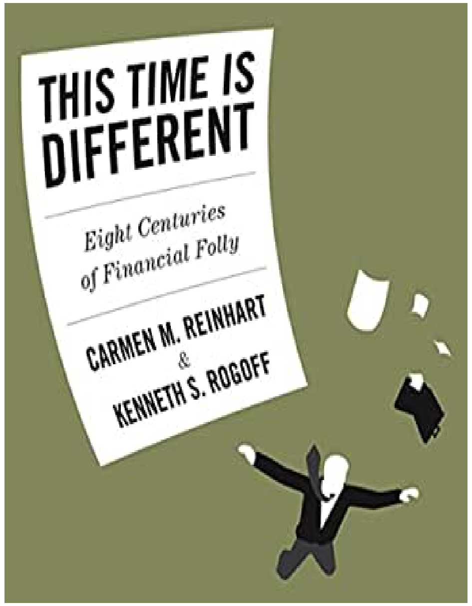
Inflation at large:

- Emerging markets no longer emerging / higher wages
- Re-shoring / friendly shoring / end of globalization
- Demographics + Great resignation = Labor shortage
- Mismatch supply vs. demand
  - on the labor market
  - on the goods and services market
- Higher taxes

Why a reversal? (3/3)

Be careful!

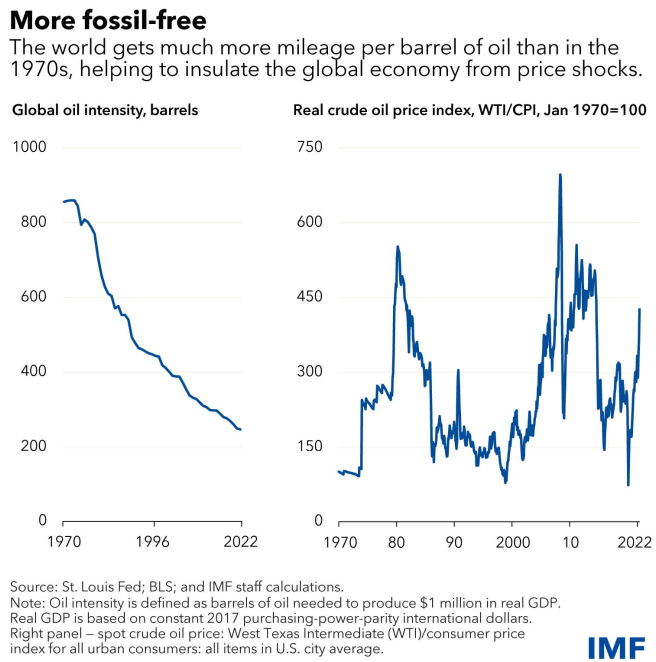
- This time is different? Unlikely, as times are rarely that different !!!
- Higher prices => Higher supply
  + Substitution
  + Innovation
  => self-correcting process



Stagflation is back?

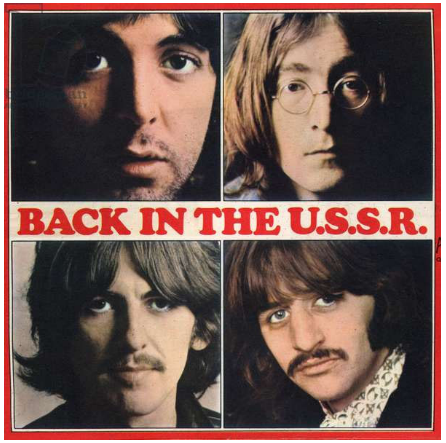
Mind the difference

- Lower growth + higher inflation	YES
- Back to the 70s ?	NO
* inflation then	much higher
* inflation anchoring then	absent
* growth then	much lower
* unemployment then	much higher and rising
* oil/GDP then	much higher
* wage indexation then	much more frequent



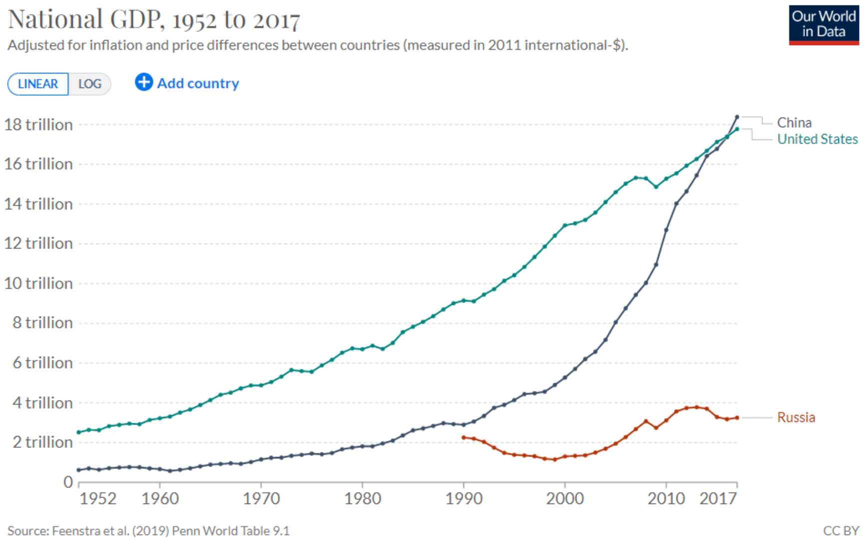
Source : Nico Valckx, Lower Oil Reliance Insulates World From 1970s-Style Crude Shock, IMF Blog, May 2022

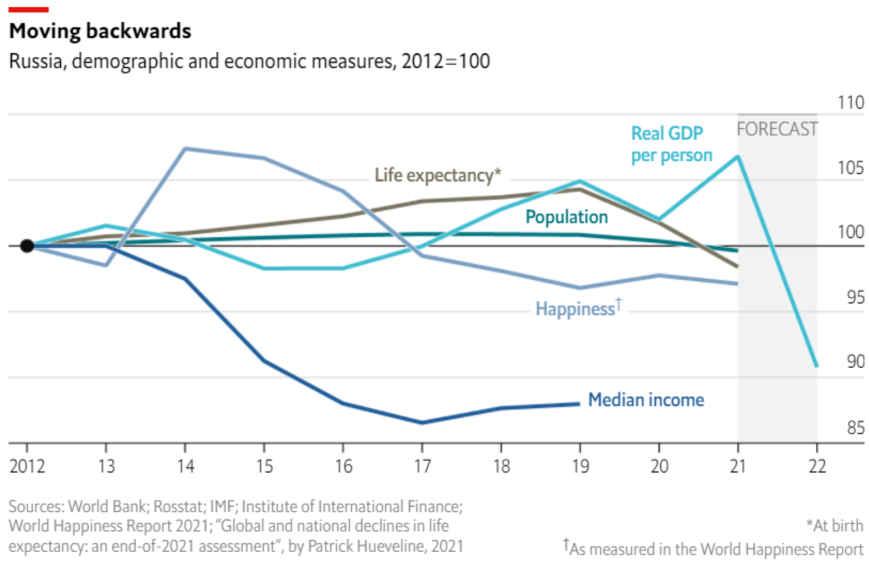
USSR is back?



The Cuban Missile Crisis
Cartoon published in the United States, 1962

Beware strength … beware weakness





Source : Our World in Data, https://ourworldindata.org/grapher/national-gdp?country=CHN~RUS~USA

Source : The Economist, April 1, 2022

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Beware warnings (1/2)

https://www.washingtonpost.com/opinions/henry-kissinger-to-settle-the-ukraine-crisis-start-at-the-end/2014/03/05/46dad868-a496-11e3-8466-d34c451760b9_story.html

Henry Kissinger: To settle the Ukraine crisis, start at the end

By **Henry A. Kissinger**
March 5, 2014

THE 7 FROM The Washington Post

Beware warnings (2/2)

"Does Europe simply say that if Russia is the cheapest provider of gas, then we should buy from Russia regardless of the implications for its security…?"

(Joseph Stiglitz, Making Globalization Work, 2006)

Inflation, my friend

Cons

- Losers and winners, with adverse social impact
- Uncertainty => less activity / higher risk premium

Pros

- Good for indebted authorities … and therefore for macroeconomic & financial stability
- Penalty on cautious savings => higher consumption and/or more risk-taking
- Creative destruction; reallocation of resources (labor & demand for goods) ; higher productivity
- Away from the « zero lower bound » limit / good for monetary policy
- Push for anti-trust policies

3. Short-term outlook

Six months ago

Consumption

- Sustained income
- High savings
- No fear of unemployment

Capex

- Technology
- Climate transition
- ESG
- Low interest rates

Budgetary policy

- Low interest rates

Monetary policy

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Six months later

Consumption

- Sustained income **… but inflation**
- High savings
- No fear of unemployment **… but war**

Capex

- Technology
- Climate transition
- ESG
- Low interest rates

Budgetary policy

- Low interest rates **… but rising**

Monetary policy
???

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Ukraine, an overview of economic impact

The war in Ukraine is likely to worsen Europe's economic problems

Short- and long-term implications of the Russia-Ukraine war for the European Union

	Short-term effects (1–2 years)	Long-term effects (3–5 years)
Trade and foreign direct investment	Collapse of exports to Russia. Reduced capital for EU firms.	Restructuring of supply chains and foreign direct investment flows away from Russia.
Refugees and reconstruction	Large inflows of refugees to EU states lead to additional fiscal costs.	No lasting effect. Most refugees are likely to return to Ukraine or enter the EU workforce. Contribution to the rebuilding of Ukraine.
Defense	Added costs of weapons and military support for Ukraine weigh on defense budgets.	Increases to EU defense budgets.
Efficiency	No short-term effect.	EU firms to reconsider their reliance on extended supply chains and just-in-time delivery schemes, causing further deglobalization and reduced efficiency.
Food	Higher food prices as Ukrainian and Russian crop yields fall, reducing global supply and damaging fragile developing economies.	No lasting effect.
Energy	Higher energy bills. Reduced efficiency from temporary reliance on outdated energy sources. Possible supply disruptions. Added costs from alternative sourcing.	New energy sourcing. More energy integration at the EU level. Accelerated transition to renewables.
Uncertainty	More precautionary saving.	Possible drive towards closer EU policy integration.

PIIE **Source:** Adapted from Olivier Blanchard and Jean Pisani-Ferry's Policy Brief, *Fiscal support and monetary vigilance: Economic policy implications of the Russia-Ukraine war for the European Union.*

Source : Olivier Blanchard and Jean Pisani-Ferry, The war in Ukraine is likely to worsen Europe's economic problems, PIIE, May 9, 2022

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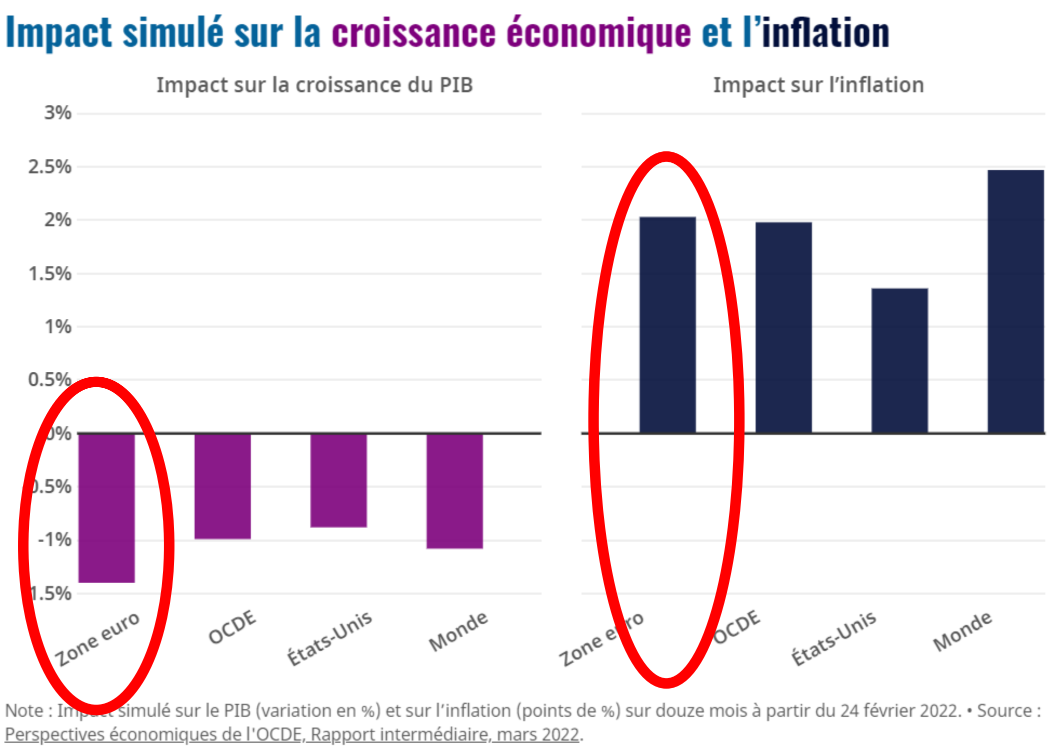
Identified risks

- Bottlenecks
- Loss of purchasing power from wages and from savings
- Loss of confidence
- Bankruptcies
- Monetary tightening
- Loss of budgetary room for maneuver
  (less growth military spending + refugees + reconstruction + higher interest rates)

Scenario – OECD

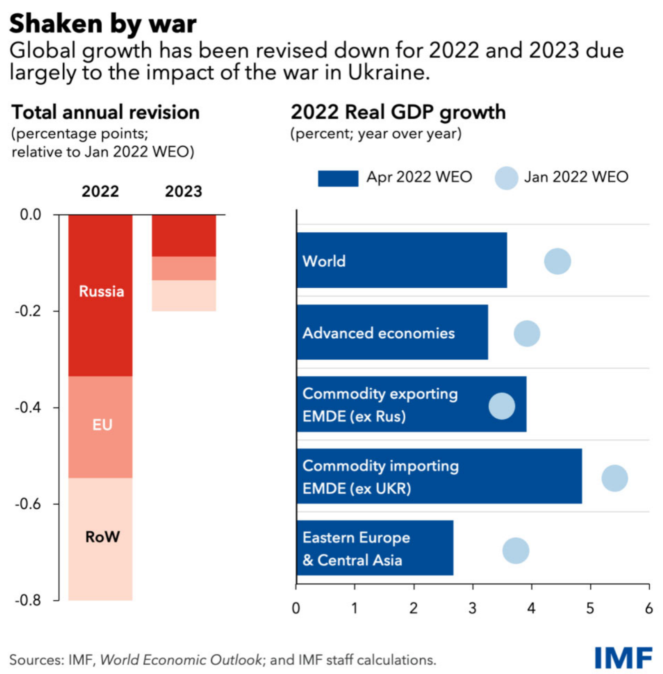


Source : OECD, March 2022

Scenario – IMF (1/2)

Source : IMF, April 22, 2022

Scenario – IMF (2/2)



(real GDP, annual percent change)	2021	PROJECTIONS 2022	2023
World Output	**6.1**	**3.6**	**3.6**
Advanced Economies	**5.2**	**3.3**	**2.4**
United States	5.7	3.7	2.3
Euro Area	5.3	2.8	2.3
Germany	2.8	2.1	2.7
France	7.0	2.9	1.4
Italy	6.6	2.3	1.7
Spain	5.1	4.8	3.3
Japan	1.6	2.4	2.3
United Kingdom	7.4	3.7	1.2
Canada	4.6	3.9	2.8
Other Advanced Economies	5.0	3.1	3.0
Emerging Market and Developing Economies	**6.8**	**3.8**	**4.4**
Emerging and Developing Asia	7.3	5.4	5.6
China	8.1	4.4	5.1

Source : IMF, April 19, 2022

Dilemma

Support needed : war financing, popular discontent, environmental transition

Inflation has to be fought against (adverse impact on social cohesion, on States, and on financial stability

Loss of purchasing power, a reality

Real wage and earnings growth, March 2022–2022Q1	1-year percent change	Percent difference from pre-pandemic level	Percent difference from pre-pandemic trend
ECI, all civilian workers	-3.6	-2.6	-5.0
Average hourly earnings, total private	-2.7	0.1	-2.9
Nonfarm business sector, hourly compensation	-1.4	4.6	0.7
Median usual weekly earnings	-3.0	-0.1	-3.7

Note: ECI is Employment Cost Index for wages and salaries. Pre-pandemic level is December 2019 for ECI, February 2020 for average hourly earnings, and 2019Q4 for hourly compensation and median usual weekly earnings. Pre-pandemic trend based on log-linear time trend for 2018 and 2019. Nominal wage measures deflated by Consumer Price Index for All Urban Consumers (CPI-U).
Sources: Bureau of Labor Statistics via Macrobond; authors' calculations.

Source: Jason Furman and Wilson Powell III, The US labor market could be cooling down, PIIE, May 6, 2022

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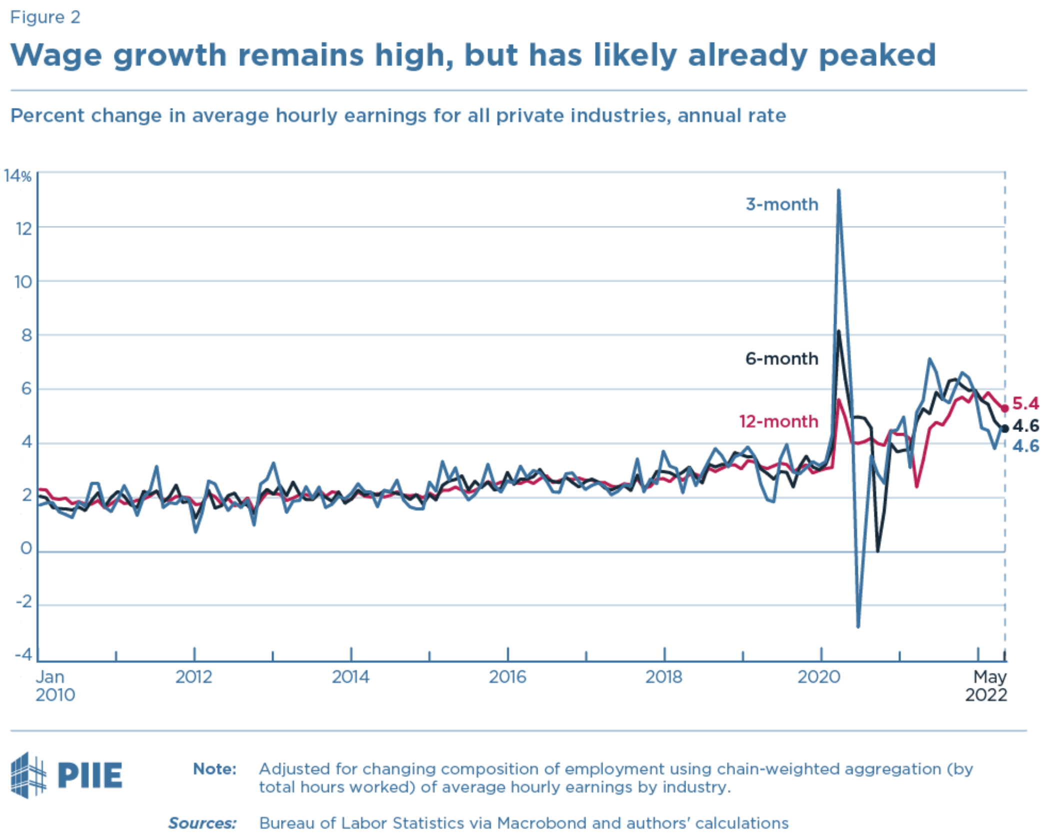
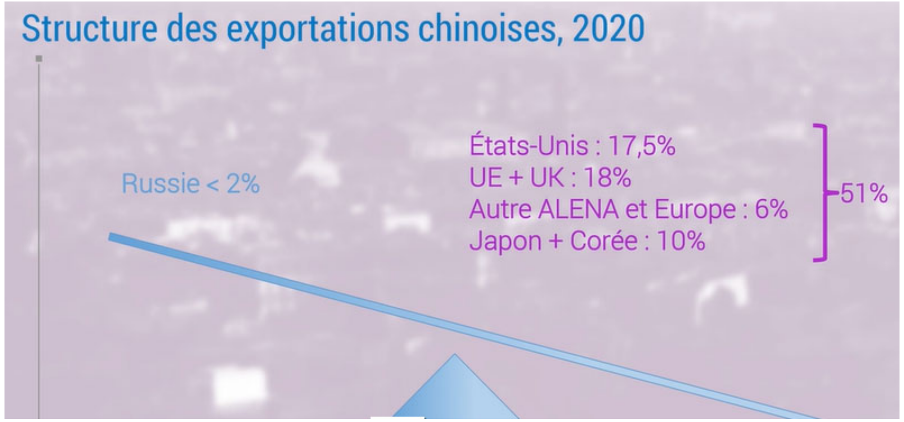
Some comfort – no wage/price vicious circle



Source : Karen Dynan and Wilson Powell III, Strong US jobs report for May should not change Fed plans, PIIE, June 3, 2022

Some comfort – support from China

- China knows where national interest are
  * Russia, a minor client
  * China, a net importer of energy
- China is facing other challenges
  * internal stability, top priority
  * real estate indebtedness
- Means available to boost the activity



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Some comfort – boycott : costly but bearable

What if? The economic effects for Germany of a stop of energy imports from Russia

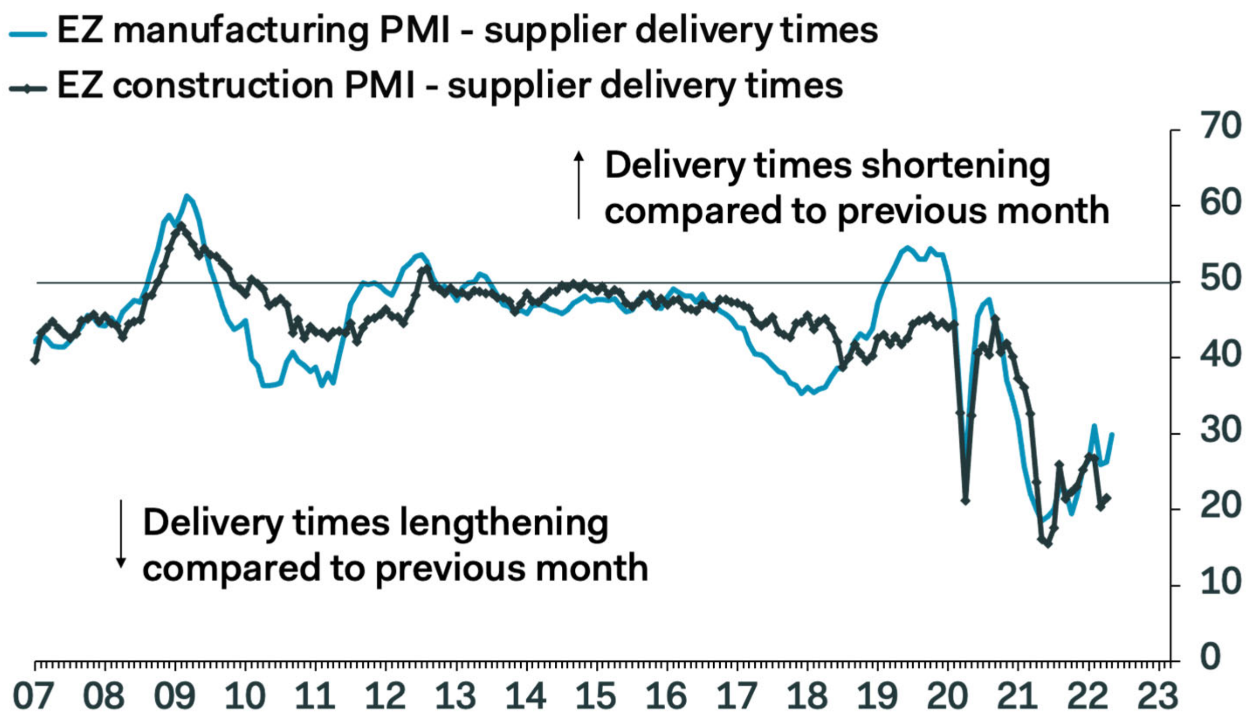
Rüdiger Bachmann, David Baqaee, Christian Bayer, Moritz Kuhn, Andreas Löschel, Benjamin Moll, Andreas Peichl, Karen Pittel, Moritz Schularick*

7 March 2022

This article discusses the economic effects of a potential cut-off of the German economy from Russian energy imports. We show that the effects are likely to be substantial but manageable. In the short run, a stop of Russian energy imports would lead to a GDP decline in range between 0.5% and 3% (cf. the GDP decline in 2020 during the pandemic was 4.5%).

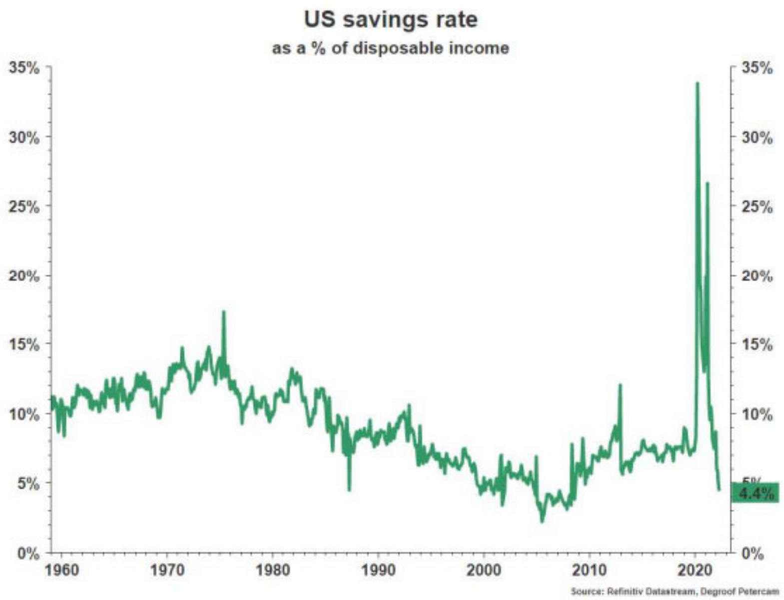
Source : https://www.econtribute.de/RePEc/ajk/ajkpbs/ECONtribute_PB_028_2022.pdf

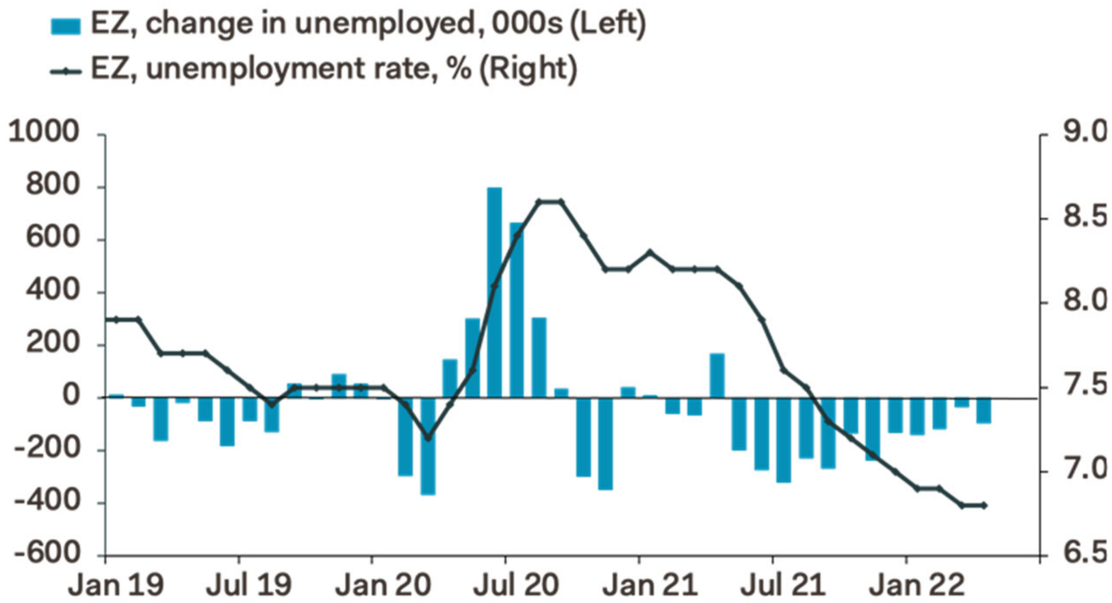
Some comfort – bottlenecks will go away



Source : Pantheon Macro, June 1, 2022

Some comfort – confidence will be back





Source : DegroofPetercam and Pantheon Macro, June 1, 2022

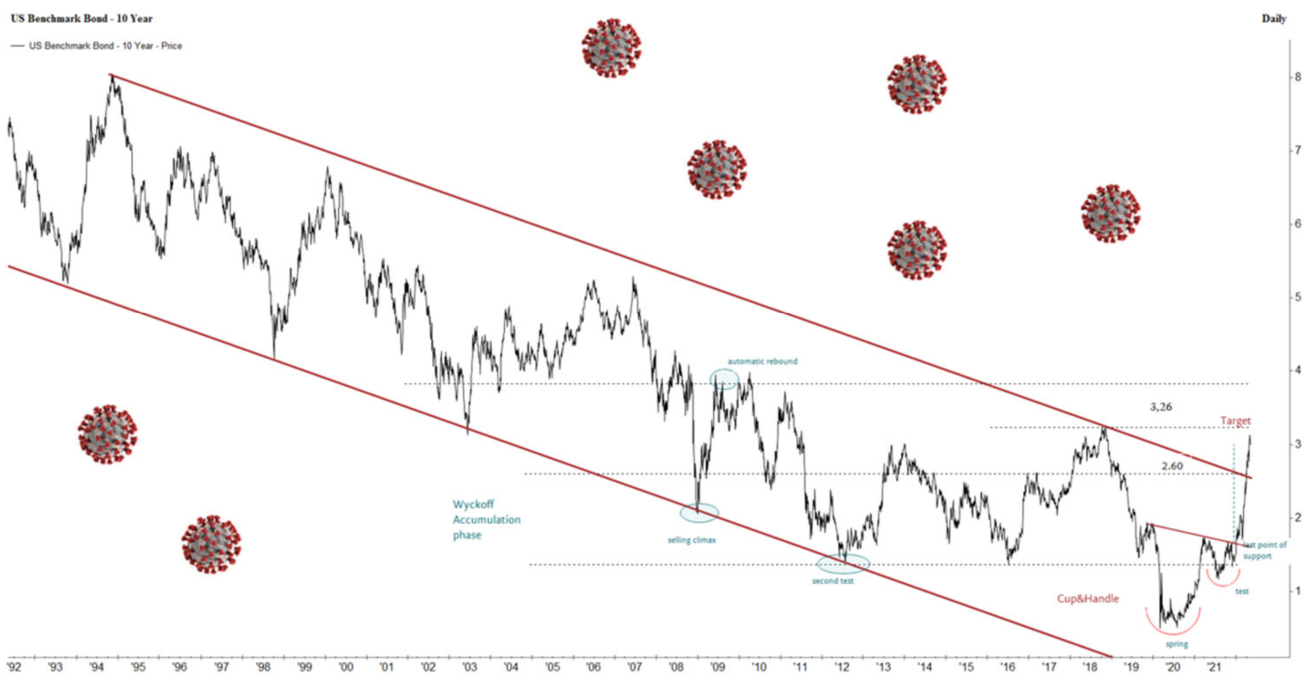
Some comfort – yesterday's supports are still largely at play

- Savings ratio
- Labor market
- Technology
- Environmental transition

4. Financial conditions

THE feature : not politics, but LT rates, and especially the real ones

US 10-year Treasury yield*



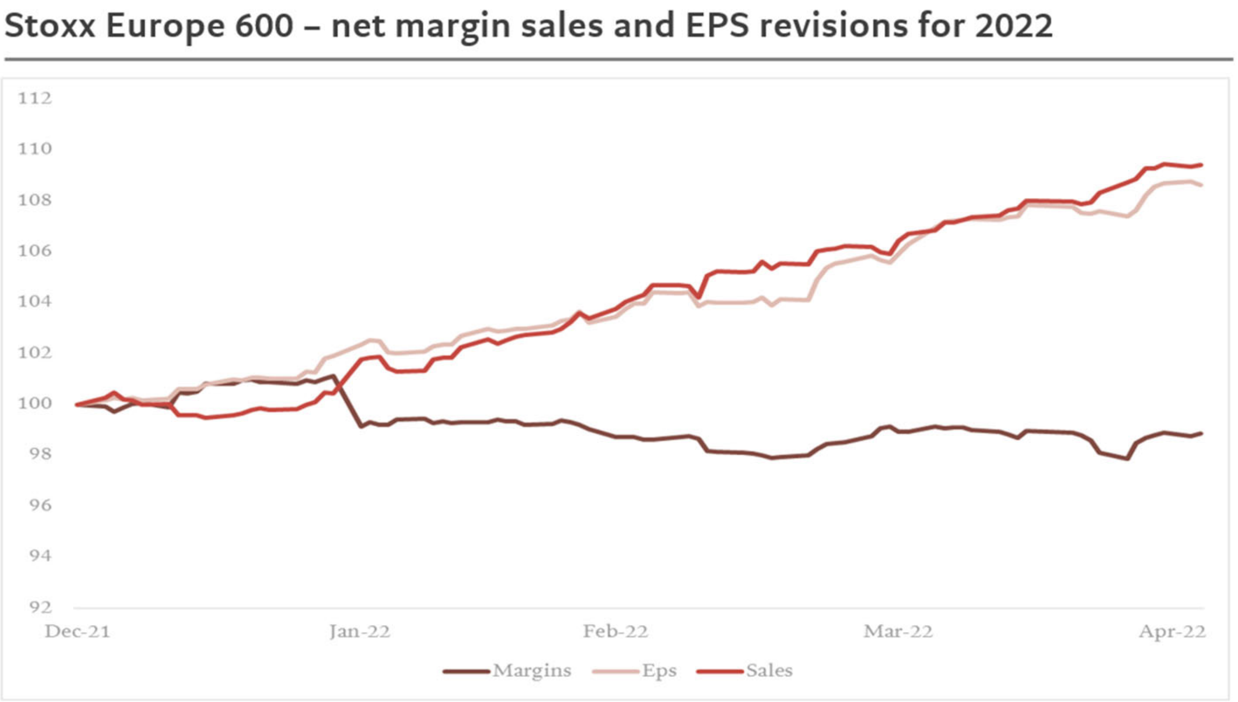
Source : Pictet, le 13/5/2022

[Pandemics + Ukraine + ↑inflation + ↑interest rates] = ???

- On corporate earnings
  * impact on economic activity, globally
  * specific impact on some sectors / countries / regions
  * impact on margins
  * impact on taxation & other policies

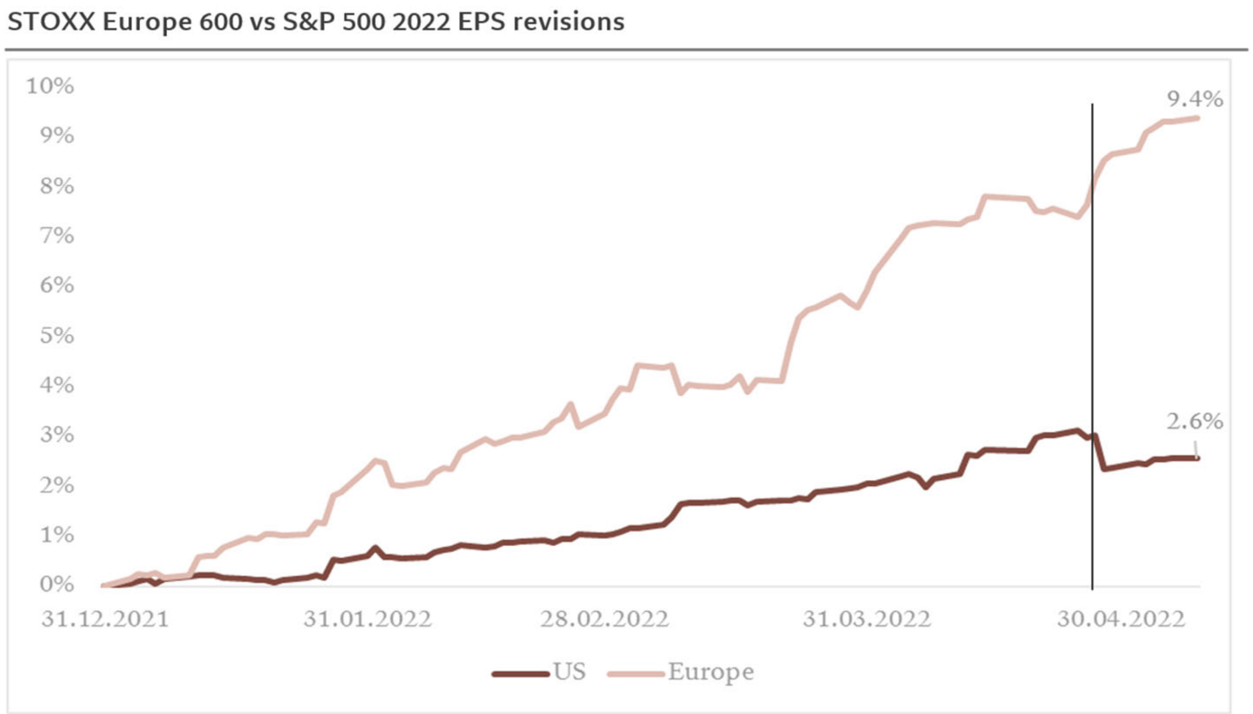
- On discounting
  * on risk-free rate
  * on risk premium

Corporate earnings – surprise #1 : revised upwards



Source : Pictet, May 5, 2022

Corporate earnings – surprise #2 : … and more so in Europe than in the US



Source : Pictet, May 23, 2022

Corporate earnings : at risk … but

- Inflation ?	Not a risk as long as limited inflation
- Higher wages ?	A cost factor … and a demand factor as well
- International taxes ?	Good for the « level playing field » and social cohesion
- Environmental regulations ?	Cost of non-action is much bigger
- Chinese slowdown ?	*Chi va piano va sano*

Higher interest rates ? Yes … but

- Inflation has peaked (base effect + no wage / price spiral

- Necessity knows no law

  States : heavily indebted, while facing ageing + social discontent

  + need to finance the environmental transition (regulations & taxes are way too unpopular)

  + financial stability requirement (within the Euro Area; financial sector as creditor)

- Interest rate expectations remain well anchored

- Higher rates not efficient to fight against supply-driven inflation

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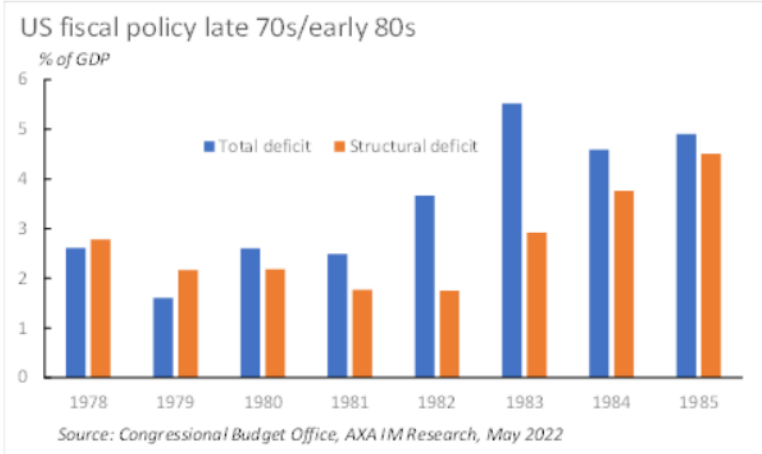
No “Volcker moment” this time

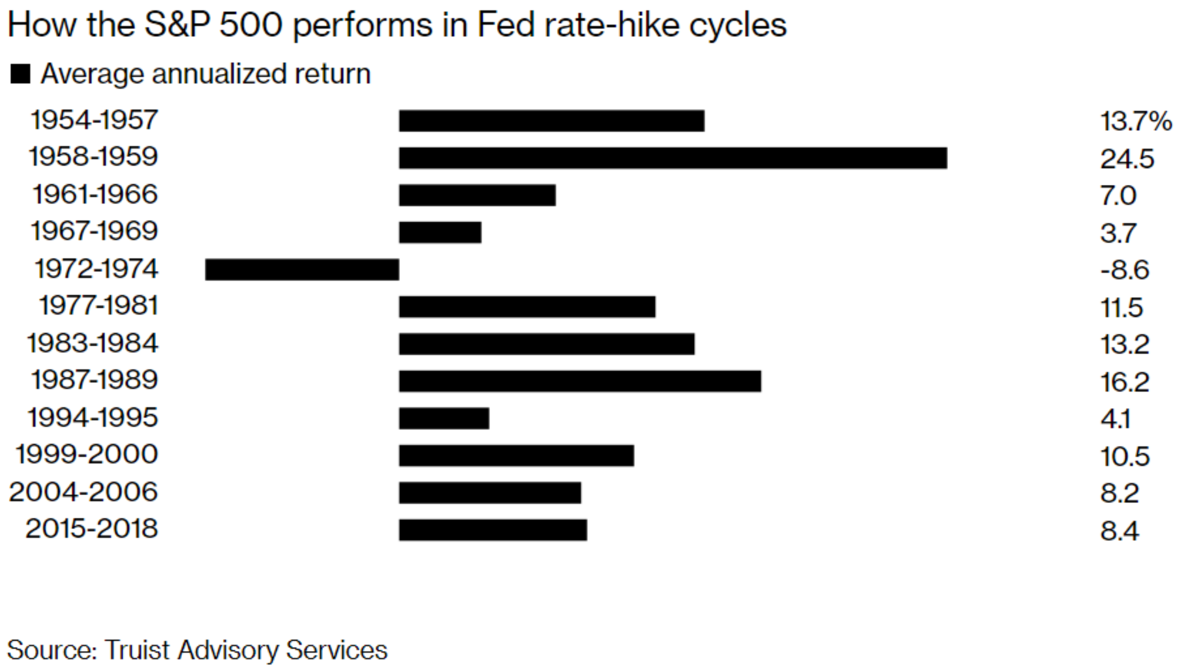
- No need
  (anchoring of expectations, no wage spiral, …)

- No possibility
  in 1983, US economy salvaged by fiscal expansion …
  today, public indebtedness is much higher

Exhibit 4 – Fiscal policy “picked up the pieces” 3 years later



No paranoid attitude : the Central Bank is my friend !



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