Message in a bottleneck?

90 – 10 May 2021

Key points

- The disappointing US labour market data last week are read in the wider context of supply-side bottlenecks, which could fuel the debate on tapering. Bottlenecks can be found in the Euro area too, with probably even less immediate bearing on the ECB stance, but on this side of the Atlantic as well the tapering debate has started.

Economic recoveries rarely follow a straight line, and it's perfectly possible that last week's disappointing US employment data are a mere statistical accident. Still, it is fueling the already heated debate on the right dosage of the policy stimulus. Indeed, the mediocre pace of job creation in April seems to reflect labor supply issues – while employers hiring intentions were still improving. The generosity of the federal top-ups to the unemployment benefits may make it possible for some individuals to delay their return to employment. Janet Yellen was more focused on childcare issues in her own analysis, since a lot of US schools remain partly closed. Whichever reason is the right one, the supply-side bottlenecks are likely to ease as the sanitary situation continues to normalize and the end of the boost to unemployment benefits looms. An issue though is how much of the additional impact on inflation expectations it may have could be permanent.

In the short run, the April payroll release will help Jay Powell and a majority of the FOMC to keep the "tapering issue" in the icebox, but the debate is likely to continue in the background. Central bankers everywhere will probably follow closely how the market and the economy at large react to the decision by the Bank of Canada and last week the Bank of England to reduce their quantum of purchases.

Bottlenecks have also emerged in the Euro area. Their impact on inflation should be lower than in the US though, given the difference in demand conditions, but the "tapering debate" is also rearing its head at the ECB Governing Council, with one member last week mentioning the possibility to reduce the pace of buying at the June meeting. This is an even more sensitive issue in the Euro area given the memory of the sovereign crisis and the impact QE is having on the supply and demand of government bonds. We note however that the ECB doves are not silent. Olli Rehn is proposing to adopt the Fed's average inflation targeting which would call for a robust "ordinary QE" programme well after the end of PEPP. The ultimate stance of the ECB remains uncertain at this stage, even if we think that a PEPP deceleration in June already would come too early.

In any case, these "normalization policy" discussions are conditional on dealing with the pandemic first. From this point of view, the latest US developments on the vaccination programme are getting even more concerning, with another significant deceleration last week.

It’s rarely a straight line, but still….

Last week ended on a cautionary note with very disappointing employment data in the US for April. The US private sector added only 218,000 jobs on the month, while the market was expecting another whopping report near 1 million. March was revised down as well, albeit to a still very strong 708,000. **This leaves employment 5.4% below its pre-Covid level.** Payroll reports are notoriously volatile and prone to significant revisions – which may help explain why the market took it in its stride on Friday – but **the release is fuelling an interesting debate around the current policy stance in Washington DC.**

Indeed, the Biden administration can see there some support for its all-out approach to fiscal stimulus: if the labour market normalization is hesitant, then one cannot yet expect the “spontaneous” rebound of the economy to plug the output gap quickly. Incidentally, lingering unemployment would justify his administration’s decision to prolong the federal top-up to preserve aggregate income. Yet, on the other side of the fence, **those of a less fiscally dovish disposition are already arguing that the weakness in job creation is a symptom of supply-side bottlenecks which the stimulus exacerbates.**

Exhibit 1 – Labour demand still improving in services

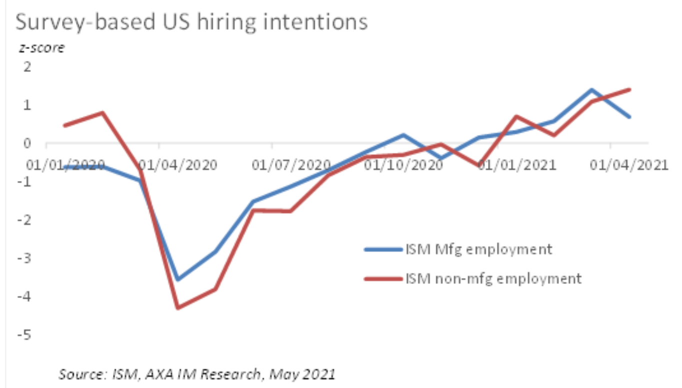


Exhibit 2 – Production bottlenecks are real

Indeed, labour demand (i.e., employers’ hiring intentions) continued to improve in April (Exhibit 1) in the crucial services sector, standing at 1.4 standard deviations above its long-term average in the Institute of Supply Managers survey (ISM), which would **suggest it is labour supply – individuals’ willingness to work – which is the source of the problem**. We have already covered in Macrocast the point that the federal top-ups were so generous that for about half of the recipients, their income would actually rise relative to what they earn in work. If one adds unavoidable expenses if every adult in the family works – childcare is expensive in the US – it makes the “opportunity cost” of returning to work quite problematic. Perfectly rational “tactical behaviours” could also be at play. If people outside employment anticipate a further rise in labour demand in the coming months, while they can afford to wait because their benefits are decent and/or they have been able to save a large share of the latest government cash transfers, then it makes sense to “scan the market” for now and be more selective in the job they will eventually take, especially if wages start accelerating, which the data batch on Friday also suggested.

Unsurprisingly Janet Yellen rejects the “benefit generosity” hypothesis and made the point that job creation was livelier than the average in some low-paying industries, such as hospitality which added 330,000 jobs in April (in other words, without the contribution of hospitality, the US would have experienced net job destruction last month). She also mentioned that average working time has increased and the number of employees reporting “unvoluntary part-time” work has declined, which would suggest employers are responding to the increase in demand by first using more intensively their existing workforce. Finally, Yellen focused on temporary child-care issues: with many schools in the US only partly open, childcaring parents are postponing their return to the labour market. If she is right, the ongoing sanitary normalization would spontaneously release labour supply.

Still, that the US economy is experiencing bottlenecks is beyond doubt. Supply difficulties in the manufacturing sector are well-known – in particular because of a global shortage of micro-chips – but this is also affecting services. In the latest ISM survey, the balance between businesses reporting slower delivery times and those

reporting an acceleration has rebounded to nearly 4 standard deviations above its long-term average in April (see Exhibit 2), although mobility restrictions continued to be lifted in the US.

The issue there is whether the ongoing "race" between supply normalization and price upgrades can have a lasting impact on the inflation trajectory. The current bottlenecks will fuel an acceleration in inflation which was going to happen anyway because of base effects, amid strong policy-support for aggregate demand. By the end of the year, with further sanitary normalization combined with the scheduled disappearance of the federal top-up to unemployment benefits, price pressure should abate. The question mark lies on whether this transitory shock can lift businesses and households' inflation expectations "for good". If this coincides with additional fiscal spending – as per Biden's plans – and maintained dovishness from the Federal Reserves (Fed), the risk is real.

The Canadian-British experiment

It has been a very busy week for Janet Yellen, who also had to deal with the fallout of her statement on the possibility of rate hikes. In our view, this was the monetary policy equivalent of saying that *if* grey clouds accumulate you should not be surprised if it ends up raining at some point, but the magnitude of the market reaction to a statement from a *former* Fed chief is a great illustration of how reliant investors have become on the Fed's dovish stance. What we find striking though is what we think is **an excessive focus on the timing of the first-rate hike, while the biggest and much more immediate issue ahead of us – and not just in the US – is the tapering of emergency quantitative easing programmes**. Indeed, if central banks have hit the effective lower bound of their policy rate, it is the unconventional component of their policy which defines their stance. Investors may have priced in the Fed's tapering, but there remains some uncertainty on its timing and its speed.

While Jay Powell made clear the Federal Open Market Committee (FOMC) was not even "thinking about discussing" tapering yet, for his part Dallas Fed President Robert Kaplan is clearly thinking hard about it, and he is more than ready to discuss it, stating in an interview that *"it will make sense to at least discussing how we would go about adjusting these purchases…sooner rather than later*". True, Kaplan stands at the "hawkish extreme" of the FOMC (he expects the first-rate hike next year already) and he is not a voter in the committee this year, but his comments still strike a chord given the Fed's release of its semi-annual financial stability report in which it warned against *"elevated valuations relative to historical norms, even when using measures that account for treasury yields".* Of course, the (dovish) majority at the FOMC can argue that "asset price exuberance" calls for macro-prudential measures rather than a change in monetary policy, but this line may be increasingly hard to maintain. We made the point when the Fed shifted to "Average Inflation Targeting" that what may sway the Fed into tightening early would not necessarily be the magnitude of an inflation overshoot, but rather financial stability considerations if leveraging and asset prices became too frothy for too long.

Since the Fed needs to see "further substantial progress" towards full employment and price stability in the *actual* data - not just in forecasts – last week's payroll release will help keep the issue in the icebox for now, but the debate will continue raging behind the scenes, and **the market and macroeconomic reaction to the Bank of England's announcements last week may provide an interesting "natural experiment".** I

Indeed, **the Bank of England (BoE) is reducing its quantitative easing (QE) pace from GBP4.4bn to 3.4bn per week, which is what was needed for the whole envelope to last until the end of 2021.** In that sense, it is a "mechanical" decision and Governor Bailey made clear the BoE does not consider it as a change in the policy stance. Habitual readers of Macrocast may consider that your humble servant displays an annoying fondness for splitting hairs when it comes to monetary policy, but we think the BoE's decision is still an interesting monetary policy signal. Indeed, **if the BoE is reducing its pace now, it means that they have no intention to prolong QE beyond its current deadline.** From that point of view, the BoE has differed from the US and European central banks since the start of the current crisis. The Fed has engaged in an open-ended programme – there is no hard nor soft deadline – while the European Central Bank (ECB) has designed Pandemic Emergency Purchase Programme (PEPP) as providing a conditional flooring to the economy – the envelope is supposed to run until March 2022 but the Governing Council explicitly reserves the right to extend it in size and time if need be.

The BoE is the second major central bank to reduce its quantum of purchases. The Bank of Canada came first on 21 April and went even further by bringing forward its expected timing for the first-rate hike, a tantalizing close "at some point in the second half of 2022".

What we find striking is that these two central banks are ready to take a risk by "breaking ranks" on the current level of policy accommodation despite their sensitivity to exchange rate developments. Indeed, the UK and Canada are much more extrovert economies than the US, and a "less dovish than everyone else" policy stance could trigger a currency appreciation which would ultimately jeopardize the normalisation of inflation. While Sterling has barely moved after the BoE's announcements, the Canadian dollar has appreciated by 3.1% vis-à-vis the US dollar since 21 April, adding to the upward pressure observed since last autumn triggered by expected rising demand for raw materials amid a global recovery. If the two countries' economic performance is satisfactory in the remainder of 2021, we would expect the FOMC hawks to take notice.

Pressure conditions in Europe

The discussion on tapering takes a specific light in the Euro area, since the growth in the ECB's balance sheet in this crisis has been particularly steep (Exhibit 3), with a rise of 27% of GDP against 20% for the Fed and 13% for the BoE, from an already elevated level. The gap is likely to widen, based on our forecast of the likely stance of these central banks into 2022. Still, beyond the impressive headline numbers, **the ECB has removed from the market a bit less public debt than its two counterparts during this crisis** (see Exhibit 4, where we look at the proportion of the current level of public debt which has been purchased by the central bank since the beginning of 2020). This reflects the ECB's skew towards long-term liquidity for banks and purchases of corporate bonds. Still, given the Euro area's recent past – the memory of the 2011-2012 sovereign crisis is fresh – supply and demand conditions on government bond markets remains a "variable of interest" for the ECB beyond the immediate need to deal with the pandemic.

The case of Italy of course jumps to mind. Based on the data from the *Banca d'Italia*, the Eurosytem held 21.6% of Italian public debt in February 2021. Assuming the entirety of the PEPP envelope is spent and the ECB sticks to the capital key to apportion the purchases (which it has broadly done so far), this will have risen to 27% in March 2022. This is a significant share but based on the Italian government's own forecast of a total public debt of EUR 2,895bn in 2022, the debt to GDP ratio which will still have to be covered by private investors would stand at 113% of GDP (the loans from the EU, as part of the Next Generation Pact, would not change the picture much, since only EUR20bn would be disbursed by the end of 2022 to Italy).

Exhibit 3 – ECB ahead

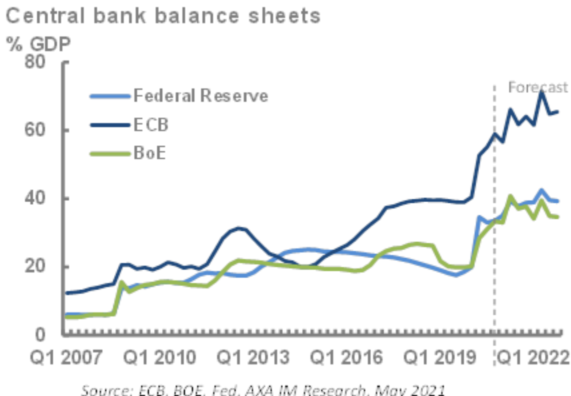
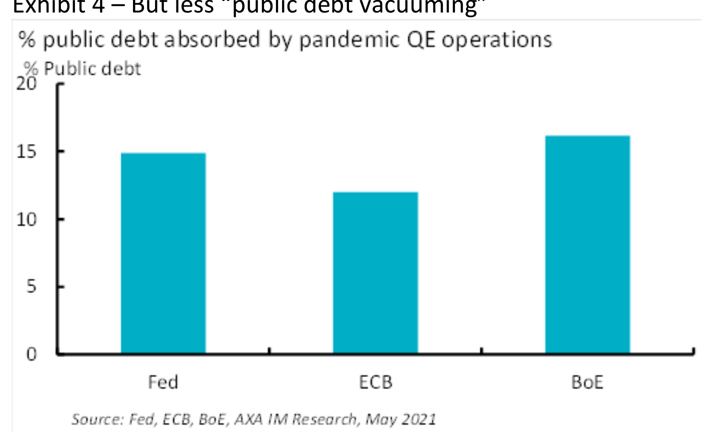


Exhibit 4 – But less "public debt vacuuming"



Given the "sovereign issue", one would expect the ECB to tread very carefully when it comes to even mentioning tapering, and mostly it has, but cracks are appearing. We were intrigued by a statement by Martins Kazaks, Governor of the Latvian national central bank, hinting at the **possibility to reduce the pace of purchases at the June meeting already**, depending on the new batch of forecasts, and that the ECB may not have to spend the entirety of its PEPP envelope.

Despite the acceleration in the purchases announced in March, GDP-weighted market interest rates have not come off in the Euro area (a point we made last week). **If the central bank chooses to go back to the previous pace, this would be another illustration that the Governing Council is willing to tolerate a further rise in yields,** another step away from the "absolutist" position held by Panetta and others, according to whom anchoring financial conditions as they were at the end of last year is paramount. The defence by the hawks is that allowing some further drift upward in yields is manageable if it comes along an improvement in the macroeconomic outlook. This is another key difference with the Fed's approach: the FOMC wants to see an actual substantial improvement in the data, not in the forecasts, to make decisions on QE. Apparently, the burden of proof would be lower for some members of the ECB Governing Council.

Exhibit 5 – Significant supply-side hurdles in the EA…

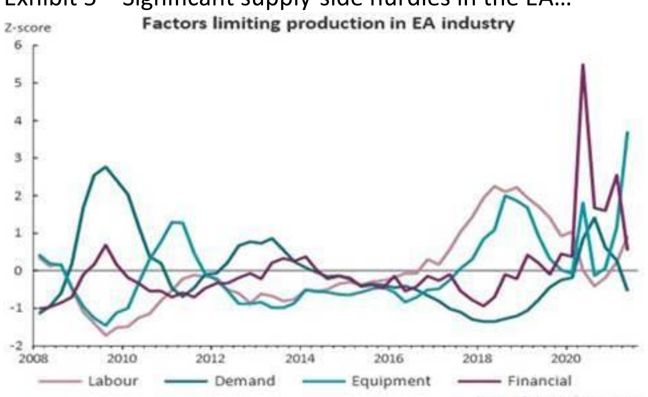
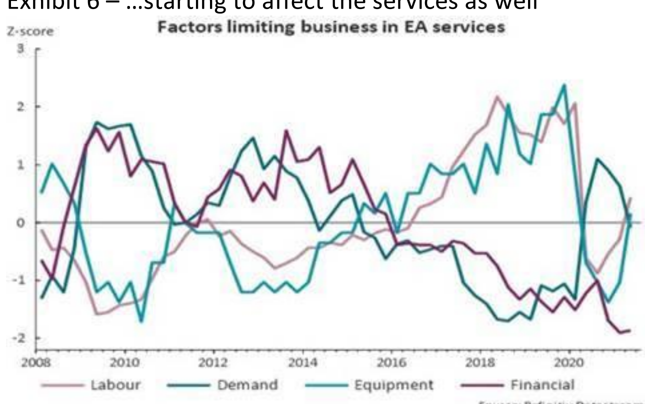


Exhibit 6 – …starting to affect the services as well



Discussions on bottlenecks fuelling the rebound in inflation could make their way to the ECB Governing Council, but in our view the risk of a lasting impact on the price dynamics is much lower than in the US. True, the European Commission surveys suggest that the manufacturing sector in the Euro area too is facing significant supply-side difficulties, much steeper than upon rebounding from the Great Financial crisis (Exhibit 5) and this now starting to affect the services sector as well (Exhibit 6). Yet, a big difference with the US is that demand is much less robust, given the absence of a massive fiscal stimulus. Faced with supply issues, businesses in Europe are more likely to respond by merely delaying output rather than pushing prices up. At this stage, we think a majority of the Governing council will opt to keep the pace of purchases at its new level.

Still, we think the ECB hawks are not focused on the short-term inflation risks. In our view, their reluctance in going too far into quantitative easing is more driven by financial stability and political economy concerns (e.g., blurring the lines between monetary and fiscal policy). We continue to think the real thorny debate is therefore not so much on the speed of purchases under PEPP, but more on the calibration of the ECB's ordinary QE programme (Asset Purchase Programme, APP) once PEPP is terminated. Since the ECB was not expecting to reach its inflation target by the end of its forecasting horizon even before the pandemic struck (1.6% in 2022 in the December 2019 batch), the continuation of APP itself after March 2022 is very likely, but the issue lies on its magnitude.

This is a question for the "strategy review" but **Bank of Finland Governor Olli Rehn last week has publicly pushed a solution which would normally go hand in hand with a robust and lasting APP: converting to the Fed's average inflation targeting,** explicitly tolerating a phase of inflation overshooting. Indeed, such approach would call for maintaining a high level of policy accommodation even once inflation has recovered.

The latest communication from the ECB suggests the Governing Council is very divided. While a consensus could be relatively easily found in the midst of the pandemic crisis, maintaining it during the normalization phase will be much more difficult. So far it seems that Christine Lagarde has been able to maintain her neutrality between the two factions. This will be more difficult after the summer. We suspect that the state of the data flow in the autumn will have a strong bearing on the outcome of the "strategy review". It may however still be difficult by that point to separate the signal from the noise if the Euro area at that moment is still going through the "mechanical part" of its post-Covid rebound.

Europe is catching up on vaccines – until when?

During his last press conference Jay Powell was asked whether the Fed would want to see some precise epidemiological targets being met on curbing the pandemic before making the next monetary policy decisions. Unsurprisingly he responded by saying this was not their field of expertise, but the question makes sense: even if the latest data on the pandemic in the US is very encouraging, it's unclear yet if "full normalization" will be within our grasp this year. **Last week we expressed concern about the slowdown in the pace of vaccination, which seems to reflect the resistance of some segments of the US population. Unfortunately, this has got worse** (Exhibit 7). The pace observed in the seven days to 5 May is consistent with having 75% of the population with at least one shot only around 5 September 5th, against around 8 July if maintaining the pace reached three weeks ago.

Exhibit 7 – It's slowing down

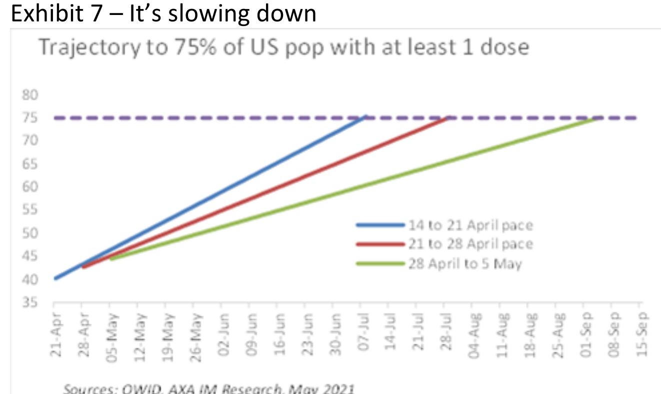
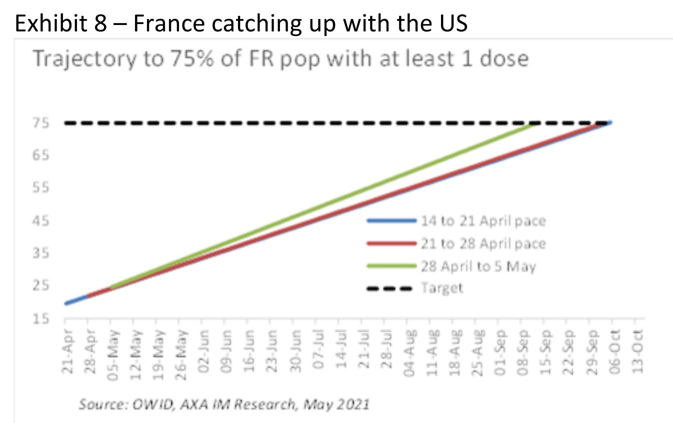


Exhibit 8 – France catching up with the US



Meanwhile, Europe is now making rapid progress. Germany continues to be in the lead but again using the vaccination pace in the seven days to 5 May France would reach the 75% threshold around 13 September. The difference with the US is now marginal. An issue for the European countries though is whether they will meet in the coming weeks and months the same difficulties as in the US to cover "the last mile" as resistance to vaccination will slow down the process. As much as your humble servant would love to delve deeper into "normalization economics", the road ahead on sanitary conditions is not yet clear.

Country/Region	What we focused on last week	What we will focus on in this week
US	• Payrolls disappointed consensus and ADP survey, up just 266k (1mn expected), with unemp up to 6.1% • Jobless claims fell <500k for first time since March 2020, but continuing claims rose • New virus cases in US continue to fall, but now at a slower pace and positivity rates are rising • ISM indices slipped, but both remain >60 • Fed Fin Stability Report highlights elevated valuations	• CPI and PPI inflation reports (Apr). CPI expected to rise to 3.6% and fastest rate since 2011 as supply disruption combines with base effects for "transitory" pick-up • Retail sales (Apr) expected to rise by more modest 1.2%, following 9.7% surge in March • Manufacturing and industrial output (Apr) expected strong gains despite chip shortage weighing on autos • Uni of Michigan survey (May, p) of 5-10yr inflation expectations, rose to 2.7% in April
Euro Area	• Final April PMIs confirmed manufacturing at record high and better confidence in services • EA retail sales rose by 2.6%mom, supported by strong German data on March reopening • German factory orders jumped by 3%mom in March, but IP disappointed at +0.7%mom, likely dragged down by supply-bottlenecks	• Light data week, with just German ZEW, likely to edge higher and EA IP to post modest gains following disappointing manufacturing prints in Germany and France • ECB minutes unlikely to bring guidance on where consensus is going ahead of June • EC to publish its Spring Forecasts
UK	• BoE leaves Bank Rate and QE tgt unch, but slows QE purchases. Upgrades GDP outlook to 7¼% (from 5%) and sees CPI overshoot in 21 • Hartlepool by-election: first Tory win in 50y • Pro-independence parties won a majority in the Scottish parliament. Referendum timeline still very uncertain though – and expect political-legal complications with London. • UK-India agree Enhanced Trade Partnership	• Q1 GDP. We forecast -1.7% q/q in line with consensus, upside risk to our 5.3% for 2021 • Sectoral output data for March • BRC retail sales monitor (Apr) – gauge scale of boost for Q2, despite Easter distortion • RICS housing survey – impending Stamp Duty break expiry meets easing mortgage conditions
Japan	• The government is likely to announce the extension of restrictions until end of May • April Services PMI remains in contraction territory but rose to 49.5 from 48.3 • Total cash earnings rose to 0.2%yoy, the first positive print since the beginning of the crisis	• April bank lending should be useful to assess the level of support that is still needed • May IPSOS consumer sentiment index should decline after the renewed state of emergency
China	• Golden-week holiday spending points to continued consumption recovery • Mixed PMIs suggest moderating growth momentum, although price pressures are clearly on the rise	• China's virus control is tested by increasing imported cases from India. Next week will be key to see any spill over to local transmission
Emerging Markets	• Thailand, Malaysia, Poland, Turkey on hold while Brazil hiked +75bp (more signalled) • Indonesia Q1 2021 GDP +6.2%qoq -0.7%yoy recovery expected to continue albeit gradually • PMI mostly increased across EM suggesting robust manufacturing activity (PH TK worst)	• CB meeting: Mexico (4%), Chile (0.5%), Peru (0.25%), Philippines, all expected on hold • April CPI in India, Hungary, Peru, Argentina • Q1 2021 GDP in Philippines, Malaysia, Poland, Colombia, Ukraine • March IP in Mexico, Colombia, Turkey, SA

Upcoming events		
	US:	Tue: NFIB small busi opt. (Apr); Wed: CPI (Apr); Fri: Retail sales (Apr), Industrial Production (Apr), Michigan consumer sentiment (prel., May)_
	Euro Area:	Tue: Ge ZWE survey current situation (May), It IP (Mar); Wed: EA IP (Mar), Ge CPI, HICP (final, Apr), Fr HICP (final, Apr); Fri: Sp HICP (final, Apr)
	UK:	Mon: Halifax house price index (Apr); Tue: BRC Retail Sales Monitor (Apr); Wed: GDP (prel., Q1), Monthly GDP (Mar), IP, Total trade balance (Mar); Thu: RICS Housing Survey (Apr)
	Japan:	Wed: Leading index (prel., Mar); Thu: CA balance (Mar), Trade balance (Mar)
	China:	Tue: CPI (Apr)

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