Bretton Woods 2.2?

119 – 17 January 2022

Key points

- After the December inflation print, a March lift-off for the Federal Reserve (Fed) Funds has become our central scenario.
- There are hopes the return of large current account surpluses in China could dampen the rise in US yields, in a "Bretton Woods 2.2" model. We are not convinced.
- Isabel Schnabel opens the debate at the European Central Bank (ECB) on the impact of the green transition on monetary policy.

Given the number of Fed speakers arguing for an early lift-off for rates amid more bad news on US consumer prices, we have brought forward our expectation of the first hike to March. That the Fed is increasingly ready to act fast to "nip inflation in the bud" is clear. However, calibrating the appropriate quantum of hikes which will be needed to bring inflation back to target is going to be tough for the central bank. Some of the current excess demand will probably spontaneously disappear given the change in the US fiscal stance, but the extent to which some of the past stimulus currently stored in the households' savings overhang will ultimately support spending is impossible to predict. Meanwhile, some of the supply-side constraints will recede. Central banks always operate under uncertainty, but the lack of visibility is still unusual for the beginning of a tightening phase. This will trigger volatility.

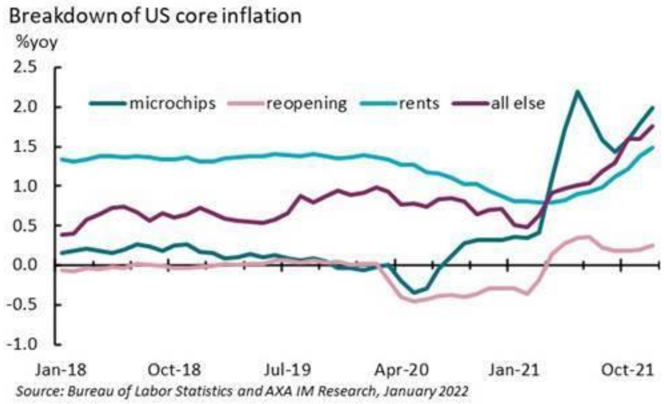
As higher long-term interest rates are also part of the Fed's arsenal given their insistence on the reduction of its balance sheet, it's tempting to look for factors which could counteract the impact of the monetary policy stance on the bond market. A resumption of the old "Bretton Woods 2.0" model is mentioned, with re-emerging large current account surpluses in China being recycled into purchases of Treasuries. We are not convinced. We think the policy agenda in Beijing is inconsistent with a large structural surplus in the medium-term. We also believe the Chinese official sector will continue to try to diversify away from dollar-denominated assets. Finally, Chinese financial flows have changed. The official sector is intermediating a smaller share of "excess dollars" in China. Private entities are playing a larger role, and they will probably behave like any other profit-seeking investor and wait to see if US yields have sufficiently risen before moving their currently massive deposits into bonds.

While the European bond market is affected by some contagion from the US, at least the monetary policy status quo prevails. This week we explore the discussion of the impact of the green transition on monetary policy by ECB board member Isabel Schnabel. We don't share her optimism of the capacity of fiscal policy to redistribute a lot of the transition costs – which has a strong bearing on the ultimate impact on inflation and monetary policy - but she opened a key debate with her speech. However, this question is not for immediate consumption, which is consistent with quite a lot of "wait and see" at the ECB this year.

Navigating with limited visibility

The Fed's increasingly hawkish communication is being fuelled by the dataflow: the inflation print for December came out – again – above expectations. We have updated our usual breakdown of core inflation, which paints a depressing picture. All components are moving in the same – bad – direction (see Exhibit 1). The "microchip" bucket, which had seen some deceleration last autumn is accelerating again, as well as the "reopening" bucket – albeit to a lesser extent. Rents – both actual ones and owner-occupied rent equivalents – are also gaining further strength. Perhaps even more concerning, t**he continuing upward slope of the "everything else" component signals a widening of inflationary pressure across all sectors**.

Exhibit 1 – Up, wherever you look



The number of Federal Open Market Committee (FOMC) members openly calling for the Fed Funds lift-off to start in March is rising, and although Jay Powell has refused so far to commit to this timeline, it has now become our central expectation. In a somewhat reassuring view, the quicker the tightening starts, the easier it may be to limit the total quantum of rate hikes and hence the impact on the economy. Indeed, bringing forward the hikes would help anchor inflation expectations, thus reducing the risk of a self-perpetuating inflationary spiral settling in. However, we are not in normal times and what we find striking at the moment is **the discrepancy between the spectacular rise in observed consumer prices and the muted reaction of inflation expectations**. This is true for market-based ones as well as for household surveys. The five-year inflation expected by consumers according to the Michigan survey stood at 3.1% in the January batch, still close to the long-term average and slightly below the peak value observed in early 2011, the last time a significant but ultimately wrong "inflation alert" emerged in the US.

If there is an "endogenous inflation engine" to kill right now, it's more on the actual level of demand, clearly exceeding supply, that the Fed may want to focus, rather than on expectations. In other words**, the monetary tightening would have to be significant enough to effectively lower demand, as there is not much the Fed can do about the current constraints weighing on supply.** It's however going to be difficult for the Fed to calibrate the appropriate quantum of tightening. Indeed, some of the current excess demand is by nature temporary, the result of past fiscal stimulus – while the next phases of fiscal support have become more elusive with Biden's legislative difficulties. True, there is still a lot of the past federal profligacy which is stored in the households' savings overhang, but predicting at what speed will find its way again towards actual spending – especially since some of this reserve of consumption is being eroded by inflation – is next to impossible. Monetary policy operates with lags, and by the time the imminent tightening starts to make a difference, demand is likely to have started decelerating spontaneously.

Meanwhile, on the supply-side, some constraints may ease. We have already covered last week the fact that delivery time and order backlogs are starting to recede in the Institute of Supply Managers survey for now both manufacturing and services. Another element to consider is that according to the federal government**, 4% of the schools are currently completely closed in the US because of the pandemic**. These childcare issues may be still having a significant effect on the decline in labour market participation, which has dropped for prime age women.

If Omicron is the "last big wave", then the normalization of the school system could finally trigger some improvement in the labour market shortage in the course of the year.

So while it seems that the Fed does not want to take any risk and is ready to act quickly, we don't think the FOMC will have that much of visibility in the first half of the year on the total number of hikes it will have to provide to bring inflation back to target. Of course, central banks are used to operating under uncertainty, but at this particular juncture, we think the fog is thicker than what is customary at the beginning of a tightening phase. **This is likely to trigger significant volatility in the months ahead.** The general direction of travel – towards moderately higher yields – is clear to us, but as we opined last week, we don't think this will happen in a straight line.

Is there space for Bretton Woods 2.2?

The Fed's readiness to reduce its balance sheet faster than expected, and faster than last time, is another aspect of their reluctance to take any risk and their willingness to "nip inflation in the bud". Quite naturally, it is worth considering whether developments outside the realm of monetary policy could counter-act the Fed's stance. **There is some speculation as to whether a resumption of large purchases of US Treasuries from China, as it recycles its re-emerging massive current account surplus, could stop the rebound in US yields in its tracks** (see for instance this piece in the Financial Times on 5 January). **We are not convinced**.

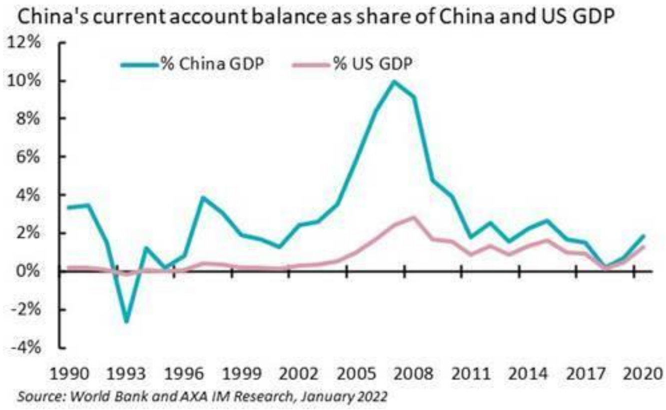
The FT piece gets us back to **the old "Bretton Woods 2.0" model** coined by Folkerts-Landau and Garber in 2004. At a time when most of the economic profession – including your humble servant – was concerned by the growing and seemingly intractable current account deficit of the United States, which would end up in either a sharp recession in the US and/or a massive depreciation of the dollar, the two authors countered that some stability could still be achieved. In their narrative, as countries churning out structural current account surpluses – China in particular – would have no other practical choice, given their reluctance to let their currency appreciate, than to recycle said surpluses into official reserves held in dollar-denominated assets, the value of the US currency could be maintained and US long-term interest rates could remain low despite obvious signs of domestic overheating. The model could not be fully disproved. The crisis finally came in 2008, but its epicentre was the US real estate sector. This had been fostered by the abnormally low level of rates for years, but there was no direct contribution from a brutal current account adjustment.

Among all the changes brought about by the Great Financial Crisis (GFC), the transformation of China's growth model was probably the most significant when it comes to "global imbalances". Indeed, the country started as an aggressive "substitute producer", winning market shares on manufactured goods, with domestic consumption lagging behind – consistent with growing current account surpluses. As a percentage of domestic GDP, the peak in the Chinese surplus was hit in mid-2008 (see Exhibit 2). But in late 2008 and in 2009 Beijing chose to stimulate massively its domestic demand to act as the global "consumer of last resort" while the world economy was contracting. Eventually, in the years that followed the immediate response to the GFC, China shifted its long=term growth strategy towards promoting consumption, which naturally coincided with a reduction, on trend, of its current account surplus, generating less reserves to invest in US Treasuries**. The volume of US government bonds held by the Chinese official sector peaked in 2012 and fell gently after that.**

The impact of the change in the Chinese external accounts on US long-term yields was largely hidden by the US ultra-loose monetary policy, with quantitative easing (QE) maintained long after the end of the GFC, while stubbornly low inflation combined with a downward revision in potential growth conspired to take the US equilibrium rate down.

Symmetrically, the return of the inflation threat in the US and the potential quick tightening by the Fed coincides with another rise in China's current account surplus, as the country has so far refrained from stimulating domestic demand to the same extent as the more mature economies. China has been operating since the start of the pandemic as the world's "producer of last resort", as the dependence on Chinese supply, which normalised very fast after the first pandemic wave, has increased in most regions. True, as a percentage of Chinese GDP the current account surplus remains only a fraction of what it was before the GFC, but what matters in terms of "global imbalances" is the size of this excess Chinese saving relative to the US funding needs, and as a percentage of *US* GDP, the Chinese surplus is now only marginally lower than in 2008 – a reflection of the massive reduction in the GDP gap between the two countries. This would make a "Bretton Woods 2.2" model possible, if these surpluses would again be recycled into holdings of US treasuries, dampening the rise in US long-term interest rates.

Exhibit 2 – China's surplus smaller relative to Chinese GDP, but much less so in % of US GDP



This optimistic view – in terms of funding costs for the US government – in our view ignores three key elements:

First, China's current status as the world's producer of last resort and "re-conversion" to current account surpluses is temporary. Some of the additional gains in market shares made by Chinese exporters since 2020 will probably remain, but the gradual normalisation of supply across the world once the pandemic is finally put under control will reduce the global dependence on Chinese products. Moreover, and perhaps more fundamentally, **the Chinese authorities want to continue rebalancing their economy in the years ahead**. The "common prosperity" agenda and its focus on reducing income inequality is normally inconsistent with structural current account surpluses, which implies to some degree of consumption rationing.

True, for the time being the crackdown on the real estate sector and areas of "conspicuous consumption" may weigh on aggregate expenditure, but **in the medium term, the reduction in inequalities agenda is likely to trigger a decline in the household saving rate**, especially if socialized insurance is expanded – which would reduce the need to maintain high personal precautionary savings - and the tax system is reformed. Indeed, contrary to what is observed in the more mature economies, tax revenues in China are skewed towards indirect levies: tax on personal income stands at only 5% of the total tax receipts of the government, against 30% for the various forms of value added tax (see there for precise OECD data). The current structure is thus socially regressive. Any proper crackdown on income inequality will entail a rebalancing of the tax framework which will hurt more the "big savers" (those at the upper- end of the income ladder) and benefit those whose propensity to spend is highest.

Second, irrespective of the overall state of China's current account, the Chinese authorities are probably less keen on significantly raising their investment in US Treasuries. Beijing has been increasingly vocal in its criticism of the centricity of the US dollar in the international monetary system, and concerns over the possible "weaponization" by the US of their liabilities vis-a-vis China. While Beijing has not released data on the currency breakdown of its reserves since 2014, recycling into US denominated assets is probably less attractive. The discrepancy between the change in Chinese official reserves and the volume of US Treasury bonds held by the Chinese official sector these last few years is a good indication of this lack of attractiveness (see Exhibit 3).

In any case, **the US authorities themselves would indirectly discourage a resumption of massive purchases of US treasuries by the Chinese official sector**. Indeed, a significant share of the purchases were the product of China's exchange rate policy and its reluctance to allow the Yuan to appreciate. While the Yuan's exchange rate is still "managed", currency interventions are much less systematic, which has the benefit of undermining the accusations of currency manipulation against China, a key argument in the trade wars. **Washington can either benefit from** large financial inflows from China keeping its long-term interest rates low or limit the undervaluation of the yuan. It can't have both.

Exhibit 3 – Less allocation to USTs in Chinese reserves

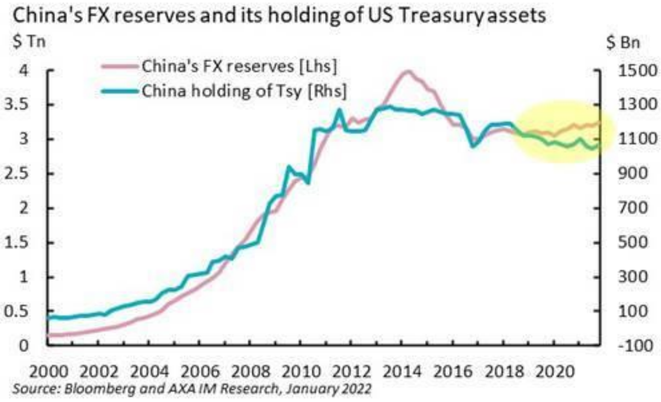
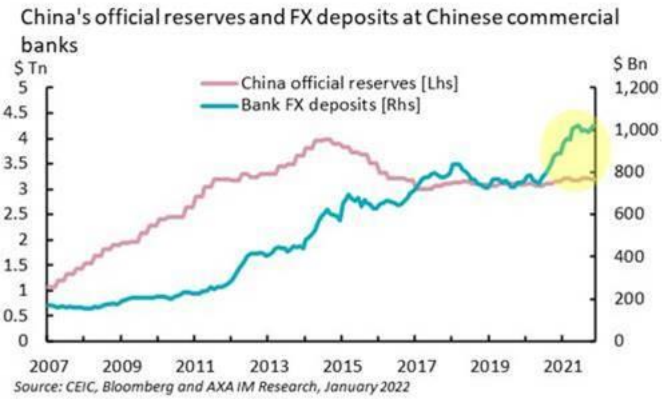


Exhibit 4 – More dollars are held by private Chinese entities



Third, and as a corollary of the change in the Chinese foreign exchange policy, much of China's current account surplus is not "intermediated" by a build-up in official reserves by the State Administration of Foreign Exchange (SAFE). Increasingly, the dollar-denominated Chinese external assets are held by the private sector. At the moment, a lot of the financial account counterpart of the Chinese current account surplus is recycled in the form of foreign currency cash deposits held by Chinese banks (see Exhibit 4). **Chinese private entities will probably behave just like any other profit-seeking investor: they would probably wait to be convinced US yields have risen enough to move out of deposits and invest in bonds.** The US has probably kept much of its capacity to attract international investors for a comparatively low return (it's still the biggest, most liquid financial market on earth) but some of this "exorbitant privilege" has probably eroded as the regular flows of investment by the non-profit seeking Chinese official sector have probably gone for good.

The green transition and monetary policy: Schnabel opens the debate

We mentioned last week that beyond the usual contagion from the US bond market to Europe, long-term interest rates in core Euro area countries are unlikely to be moved by the ECB's policy until late in 2022 given the compromise between hawks and doves last December (the situation is different in the periphery given the central bank's "tapering" of QE). Still, we need to "closely monitor" the arguments of the two camps to get a sense of where the ECB could go after October (the "soft deadline" for the extension of the Asset Purchase Programme).

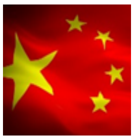
Isabel Schnabel's latest speech is intriguing since it introduces – at last – the "green transition" into the monetary policy debate. Indeed, so far, the ECB has been keener to discuss how it could contribute to the fight against climate change by changing its policy instruments, while we think the biggest challenge is on the monetary policy stance itself. Normally, an exogenous rise in energy prices – triggered for instance by carbon taxes – affects relative prices, but not necessarily aggregate prices. Indeed, over time, the decline in purchasing power triggered by the rise in energy costs would reduce the quantum of spending available on other items, reducing their price. Schnabel highlighted two mechanisms through which the ECB could deviate from the textbook approach. First, she explores what would happen if inflation *expectations* were to rise permanently in response to what is going to be seen as a long-term and gradual increase in the cost of carbon-intensive products. Second, she discussed the possibility that a policy-induced rise in the price of these carbon-intensive products differs in nature from the usual exogenous supply-side shocks.

The first channel is indeed unfortunately credible. Consumers may not understand the subtlety of relative versus aggregate price hikes and lift their inflation expectations immediately and in consequence demand a wage increase which would down the road fuel a self-perpetuating inflation spiral. The ECB would be expected to respond to such an acceleration in wages. **Note that the equilibrium all this would lead to would not be a great one**. Indeed, we would have to choose between inflation – if the ECB does not act – or permanently slower growth, if the ECB acts to reduce demand to stop the catch-up in wages, thus *permanently* locking in the decline in purchasing power triggered by the rise in the price of carbon.

The second one is trickier in our view. True, Isabel Schnabel is undoubtedly right to argue that **carbon taxes are different from the usual supply-side shocks affecting the price of energy since in the latter, some purchasing power is lost to the outside world** (e.g. when European households and businesses pay a higher price for their oil or their gas) **while in the former, the product of the tax can be recycled within the European economy.** For instance, if the fiscal authorities use all the product of the carbon tax to subsidize the most vulnerable consumers, or to invest in green projects which will lift the European aggregate demand, then there is no "leakage", total domestic spending capacity is unchanged and there is no reason to expect the rise in energy prices to be offset by lower prices elsewhere. Monetary policy would then be "wrong" to accommodate this type of shocks.

However**, we think that it is unrealistic to expect that the entirety of the "green transition" can be offset by fiscal policy and can thus be "growth neutral".** Indeed, a key problem of the transition is that low-carbon products are most of the time *inherently* more expensive than carbon-intensive ones (think for instance about the still significant price gap between electric and combustion engine cars). Nudging consumption towards low-carbon solutions can thus hardly be budget-neutral. Either governments accept to incur a permanent increase in debt to absorb the price difference, or they pass some of the price difference to final consumers in the form of higher aggregate tax. In the long-run, budget neutrality is possible only if the before-tax-and-subsidy price of the low-carbon alternatives falls sufficiently quickly. This assumption is a "brave one". Overall, we think some adverse impact on aggregate demand is unavoidable.

Now, while all this makes for a very interesting theoretical debate, what is clear to us is that it is not for immediate consumption. Actually, in an interview with Sueddeutsche Zeitung on Friday, Isabel Schnabel defended the policy "status quo". If board members of a "hawkish disposition" focus on medium-term issues such as the impact of the fight against climate change, 2022 could remain a relatively uneventful year at the ECB. However, both camps are clearly preparing their arguments for 2023.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Retail sales (Dec) fell by 1.9%. Q4 sales rose by 2%, weak after October and will struggle in Q1 • CPI inflation (Dec) rose to 7.0% - a 40 yr high – cars and rents main drivers. Likely around peak • PPI inflation (Dec) dipped to 9.7% from 9.8% annual rate, but to 0.2% from 1.0% on month • Fed Chair Powell said would prevent inflation becoming entrenched. Several members now talk about March hike. We change call to Mar hike • US-Russia talks no progress, but still talking	• Empire & Philly Fed surveys (Jan) – gauge net impact of omicron on supply chain issues • Housing starts/building permits and existing home sales (Dec) all watched for omicron impact and rising rate expectations after • Jobless claims, rose unexpectedly to 230k last week – seasonals or SR omicron effect? • President Biden to try to pass voting rights bill with Senate vote, but options after that fade
	• COVID cases continue to rise in Fr and Ge, but may have peaked in Sp and It. • Euro area industrial output (Nov) beat expectations rising by 2.3% on month • Euro area unemp (Nov) edged lower to 7.2% • Ge GDP (2021) recorded 2.7% for year as whole	• Eurozone consumer confidence (Jan, p) to gauge impact of omicron • GE ZEW survey (Jan), first bus survey of 2022 • Euro area CPI (Dec, f) at record high of 5.0% • Eurogroup meeting
	• GDP rose above pre-pandemic levels rising by 0.9% in Nov. GDP likely to contract in Dec & Jan due to Omicron • BRC sales monitor (Dec) suggests fall in sales • Omicron wave appears to be easing, cases begin to fall, hosp admissions <late Dec peak	• CPI inflation (Dec) expected to rise further to 5.2% (consensus) set to peak c. 6% in Q2 2022 • ILO employment (Nov) and HMRC payrolls data (Dec) – too early to gauge omicron impact • Retail sales (Dec) consensus estimates 0.6% fall, but we see risks to downside
	• PPI inflation (Dec) fell to 8.5% from 9.2% • Lead indicator (Nov,p) rose markedly, unwinding summer's COVID drop • Media report that BoJ considering longer-term prospects for raising policy rate	• BoJ meeting. Expect policy unchanged, Kuroda likely questioned to clarify forward guidance • CPI inflation (Dec) f'cast rise to pre-COVID rate • Core machine orders (Nov) add to Q4 bounce • Industrial production (Nov, f)
	• Inflation pressure eases as energy prices come off the boil and the official crackdown dampens coal prices	• Q4 GDP should improve sequentially from Q3 but full year growth unlikely prints above 8%
	• CB: Korea hiked +25bps to 1.25% & Romania +25bps to 2.0% • Inflation (Dec) picked up in India to 5.6%yoy, while it moderated in Brazil to 10.1%, marking the first deceleration since May '20 • IP (Nov) gained steam in Malaysia, Mexico & Turkey. It weakened in India	• CB: Several EMs are expected to keep their rates on hold: Malaysia (1.75%), Indonesia (3.50%) & Turkey (14.0%) • Inflation figures (Nov) for Malaysia, South Africa & Nigeria • Unemployment (Dec) numbers for Mexico & Peru

Upcoming events		
	US :	Tue: Empire State survey (Jan), NAHB housing indx (Jan), TIC Long-term investment flows (Nov); Wed: Housing starts & building permits (Dec); Thu: jobless claims (15 Jan), Philly Fed indx (Jan), Existing home sales (Dec); Fri: Leading indx (Dec)
	Euro Area:	Mon: Eurogroup meeting, IT HICP (Dec); Tue: Ge ZEW survey (Jan); Wed: Ge HICP (Dec, f); Thu: EU19 CPI (Dec, f), Ge PPI (Dec), FR Insee manu indx (Jan), Fri: EU19 Consumer confidence (Jan,p)
	UK:	Tue: Labour market(Nov/Dec); Wed: CPI & PPI inflation (Dec), BoE Financial Stability Report; Thu: RICS housing survey (Dec); Fri: GfK consumer confidence (Jan), Retail sales (Dec)
	Japan:	Mon : Private 'core' machinery orders (Nov); Tue: Ind prod (Nov), Bank of Japan decision; Wed: Trade balance (Dec); Thu: CPI inflation (Dec)
	China:	Mon: GDP (Q4), Ind prod (Dec), Retail sales (Dec), Fixed asset investing (Dec); Thu: 1y Loan prime rate

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