

Daily Note

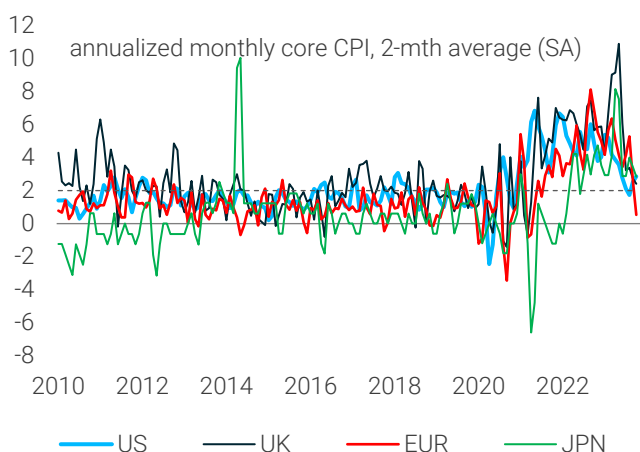
FED OPTIMISM VERSUS EUROPEAN DEFEATISM

Dario Perkins

- The Fed wants to take the win on plunging inflation and cement the soft landing.
- But European policymakers are gripped by supply pessimism and policy defeatism.
- Falling behind the curve once is understandable, but doing it twice in the same cycle?

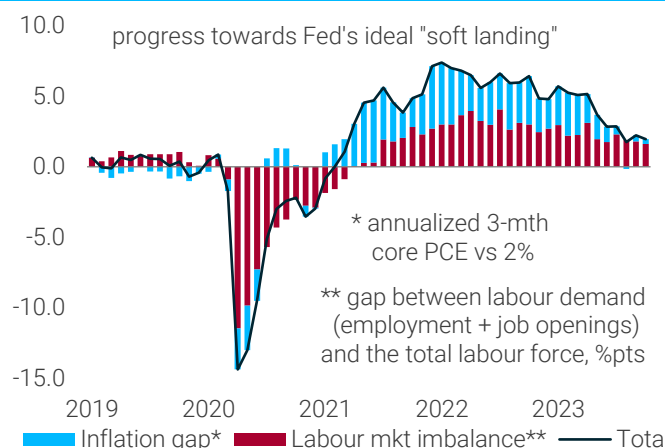
The big “surprise” of 2023 was that we didn’t need a recession to get inflation back to tolerable levels. (I say ‘surprise’ but I spent the entire year telling anyone who would listen – and some who wouldn’t – that this was not a normal business cycle and that this meant “immaculate” disinflation was a totally plausible endgame. Not to say “I told you so”, of course...). Immaculate disinflation is now a concrete reality in the US, where sequential CPI rates are basically back to the Fed’s target, even without any serious destruction in the labour market. And Fed officials have acknowledged as much, which is why rate cuts are no longer such a distant prospect. Jay Powell and his colleagues can see the opportunity for a historic soft landing – a remarkable turnaround from the calamity they thought they were facing 18 months ago. They want to grasp it with both hands. But you can’t say the same about policymakers in Europe. Even with underlying price trends improving (because they have followed the US), European central banks seem determined to snatch defeat from the jaws of victory. But why the gloom? What is it about their economy that has put the European authorities into a self-fulfilling spiral of pessimism and policy defeatism?

Chart 1: Inflation is SO over!



Source: National sources, TS Lombard

Chart 2: The Fed is 75% of the way there!

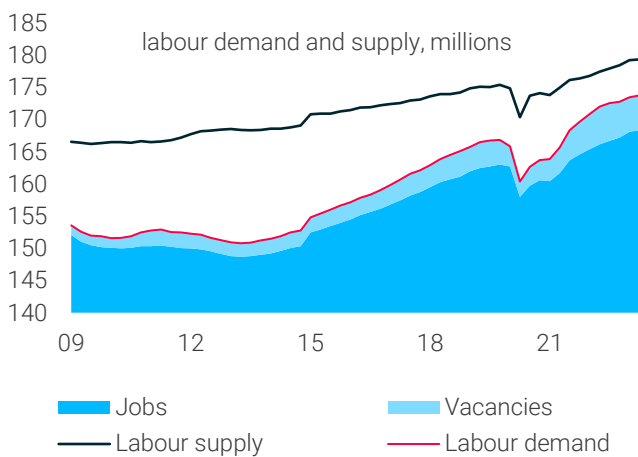


Source: TS Lombard, * Core PCE vs 2% ** Demand as per cent of supply

Let’s recall our three conditions for a soft landing: (i) inflation back at tolerable levels (not necessarily below 2%); (ii) a rebalancing of the labour market, without putting people out of work (ideally from a reduction in job vacancies and a recovery in the labour force); and (iii) evidence that the economy can tolerate higher interest rates (or, if the economy cannot, that central banks

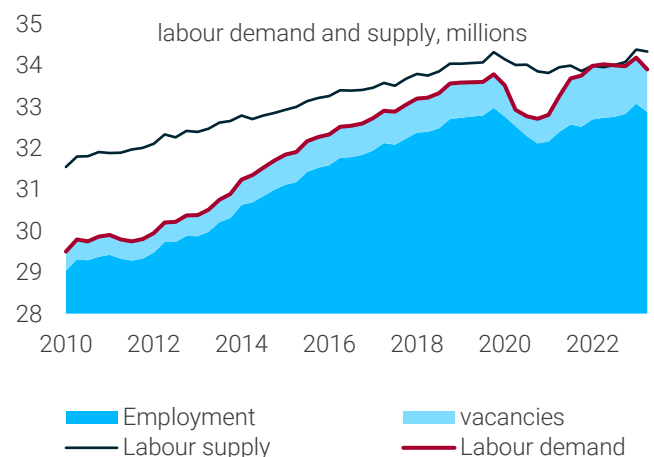
are willing to reverse course before they genuinely break something). As far as the first condition goes, Europe is now making good progress. Headline inflation is down significantly and there is clear evidence that core inflation has peaked. Contrary to what ECB officials say, there is nothing “remarkable” about this. Most of the rise in the core CPI was just a lagged response to the various cost shocks associated with the pandemic, compounded by the passthrough from food and energy prices after Russia had invaded Ukraine. Now that those costs shocks have been absorbed, inflation is returning to normal. Like in the US, the entire distribution of the CPI is shifting back down – a trend that will continue regardless of what the ECB and the BoE do next.

Chart 3: Euro area job market not exactly tight



Source: Eurostat, TS Lombard

Chart 4: Supply problems in UK labour market



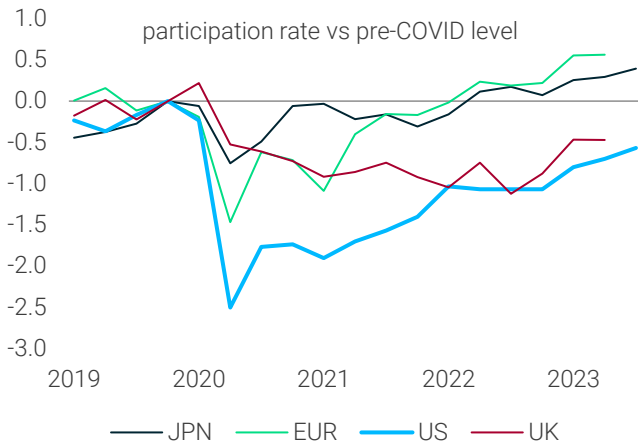
Source: ONS, Eurostat

The more interesting contrast between the US and Europe is to be found in the soft-landing conditions (ii) and (iii) – i.e., labour market developments and the impact of higher interest rates. In previous analysis, we showed that the European central banks – both the ECB and the BoE – have engineered a bigger monetary squeeze than the Fed. Not only were European credit markets more sensitive to higher interest rates, but initial macroeconomic conditions in Europe were more fragile, largely because there had been no discernible post-pandemic boom (and far less fiscal stimulus). Here I want to focus on labour markets. The Fed, which has an explicit employment mandate, has always put a great deal of emphasis on rebalancing the job market. Owing to their obsession with the Phillips curve, Fed officials were never going to feel relaxed about the medium-term inflation trajectory as long as the number of job openings vastly outnumbered the unemployed and wages were growing “too fast” relative to productivity. At one point, Powell described this as the “fundamental imbalance” in the US economy and the main rationale for monetary tightening.

In many respects, the UK labour market looks a lot like that of the US – only more imbalanced. Labour demand surged after the pandemic, with the number of vacancies rising well above pre-COVID levels. But the supply situation has looked worse in the UK, mainly thanks to lower immigration and a (larger) decline in labour-force participation. Yet, despite these supply-side problems, the UK economy has been following the US on its path to a soft landing. Vacancy rates have plunged as labour demand has eased, and this has happened with only a modest increase in unemployment. And now, there are even signs of a potential improvement in labour supply, thanks to some startling new immigration figures, which show the largest net inflow of migrants since records began (and when we are talking about the UK, those records go back a very long way – see Chart 6). Of course, there is no guarantee all these people will stay in the UK and find

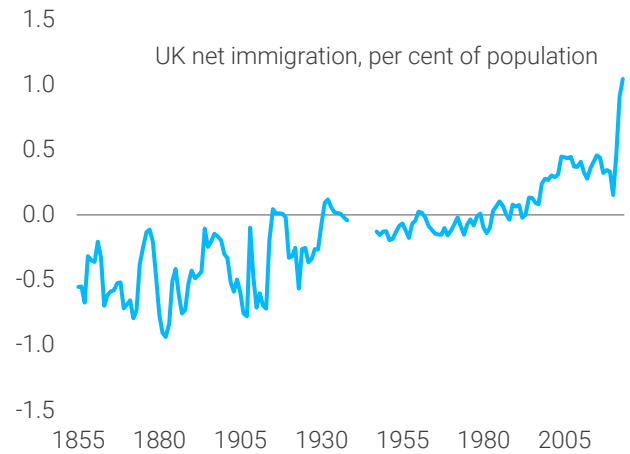
work (especially as a lot of them are from Ukraine and may return when the war eventually ends). But, together with the rebalancing of the labour market that has already happened, this does suggest Andrew Bailey was being overly dramatic when he described UK supply potential as “the worst I have ever seen in my career”. We are worried, too, as we explained in a Macro Picture earlier this year, but it is not clear an unnecessary recession is going to help the situation.

Chart 5: No euro labour-force problem post-COVID



Source: OECD, TS Lombard

Chart 6: A source of UK supply potential?



Source: ONS, TS Lombard

While we can criticize Andrew Bailey for being too gloomy about the UK economy’s supply potential, the position of the ECB is even more bizarre. In many respects, Europe now has the labour market it could only have dreamed about in 2019. Sure, it is tighter today than it was three years ago (when interest rates were NEGATIVE and everyone was worried about DEFLATION). And wage growth has accelerated somewhat. But we are still talking about a labour market in which there are twice as many unemployed people as job vacancies. And in contrast with the US and the UK, there has been no discernible reduction in the availability of workers. Participation rates have risen, and much of the increase in labour demand has already translated into actual jobs. ECB supply-side pessimism is rooted in something else – namely, the risk of future energy price shocks and the danger of “second-round” effects. While it is true that the global economy is probably facing a decade of volatile commodity prices and various supply shocks – as European officials routinely point out – this is not a good reason for being overly aggressive at a time when disinflation is clearly gaining traction and monetary policy is already too tight. We have to hope that the recent U-turn from ECB’s hawks sets the central bank on a new policy course, because Europe’s famously sclerotic labour market is now the only thing preventing a serious downturn.

From the vantage point of Europe, it is hard not to feel frustrated with the policy defeatism gripping policymakers. While the Fed wants to secure a famous soft landing, the Europeans are determined to fall behind the curve twice in the same cycle. To use a football analogy, it’s as if Liverpool were 3-0 down in “that” famous European cup final, came back to 3-3, and then lost after scoring an own goal in injury time. (As a Milan fan, I would have enjoyed that a lot more)

Table 1: The margins for a soft landing

	US	EUR	UK	JPN
Supply	1.3	2.3	0.1	0.0
Demand	3.2	3.9	0.3	-0.4
Labour market tightening	1.9	1.7	0.3	-0.4
-Unfilled vacancies	2.0	0.9	0.6	-0.1
-Employment	1.1	3.1	-0.3	-0.3
Margin for soft landing	1.1	0.8	2.0	N/A
(Vacancies/excess demand)				

Source: TS Lombard estimates

Shift in labour-market tightness since 2019 (everything as a per cent of the labour force)

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