Philippe Waechter
Chief Economist
Instagram @Economic_Dynamics

Ostrum ASSET MANAGEMENT

Keys of the week

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- This week: GDP Growth in China 2022

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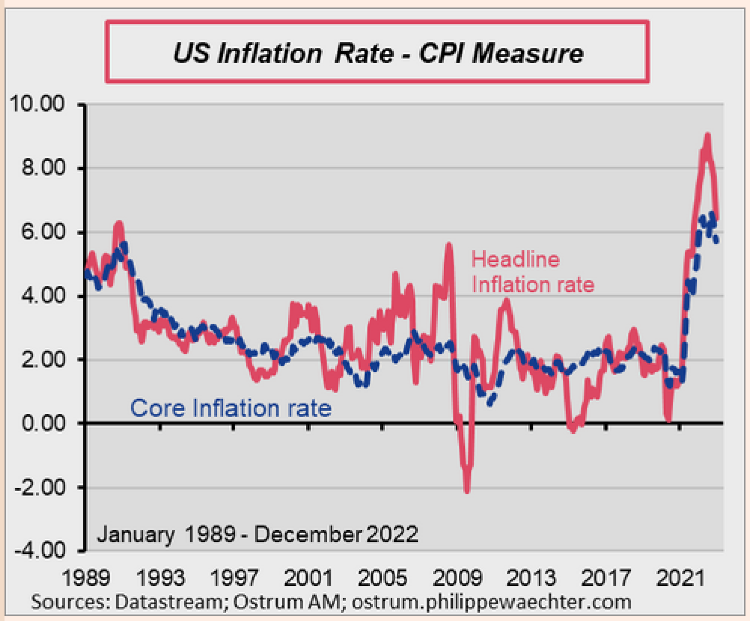
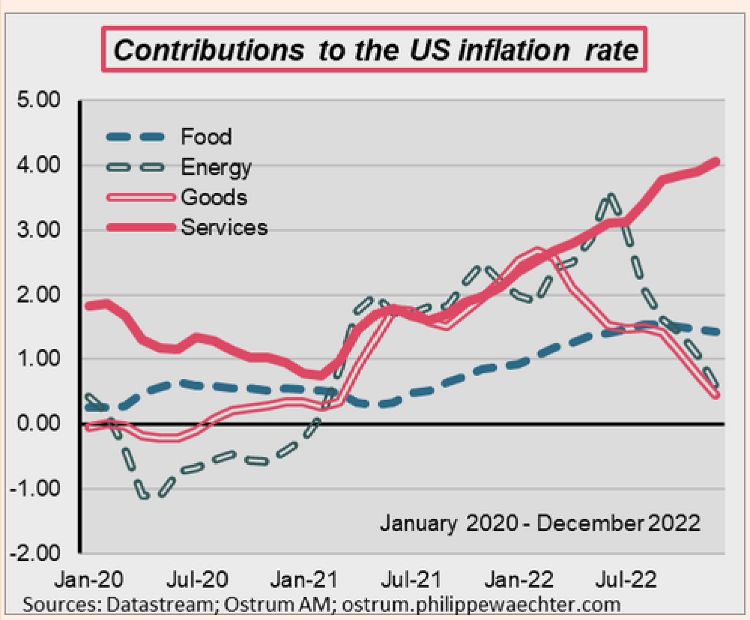
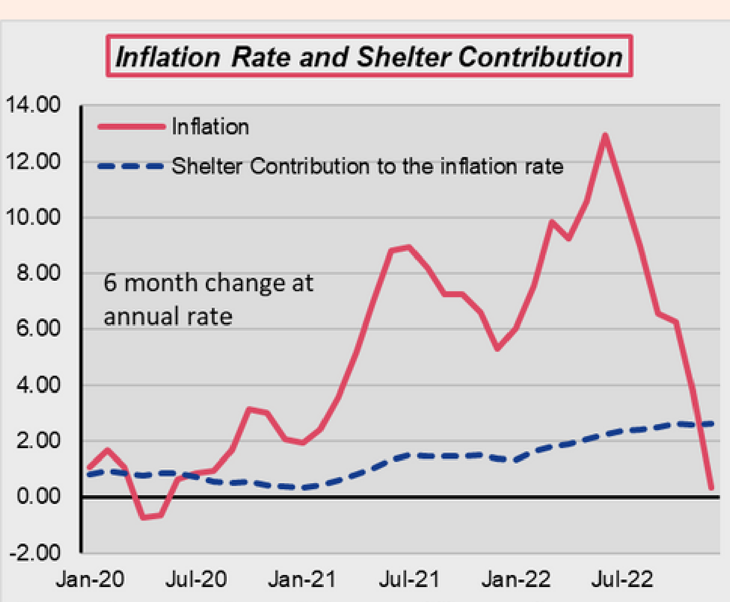
Is US inflation disappearing?







US inflation stood at **6.5%** in December after 7.1% in November. In 2022, the **average inflation rate was 8%** (for comparison, it was 8.4% in the eurozone).

The **underlying inflation rate** slowed to **5.7%** compared to almost 6% in November. The average rate is 6.15% for all of 2022.

The contributions' analysis is fascinating. **Three of the four major contributions still decline in December** (the sum of the four contributions is inflation).

The **good price contribution** which had been strong and essential in the impulse of inflation and in its propagation because of the tensions on the productive apparatus with shortages and rationing, **is melting away.**

The **energy price contribution**, which peaked at more than 3.5% in June 2022, **is now less than 1%, approaching 0.5%.**

Food price contribution has been **declining since August** 2022. This **movement will continue** due to the stabilization of US fertilizer prices.

The last interesting point is the rate of inflation. **Over 6 months, the inflation rate is zero.** The peak was hit in June, but since then it has been a stampede.

If it were not for the housing component, which still contributes strongly to inflation, the 6-month change in inflation would be downwards negative beyond -2%.

This **housing component will, by construction, still weigh on inflation** for a few months but **basically, inflation is disappearing.**

This is the novelty of the end of the year which suggests that US inflation will have been temporary.

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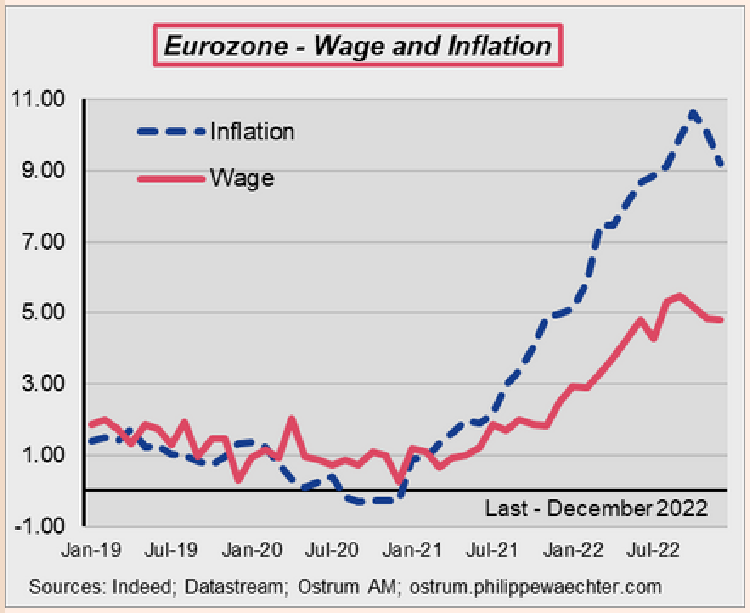
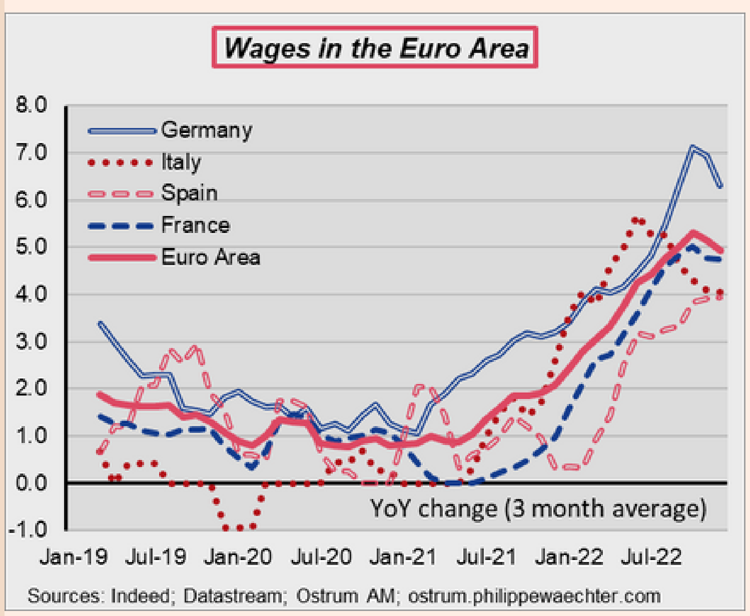
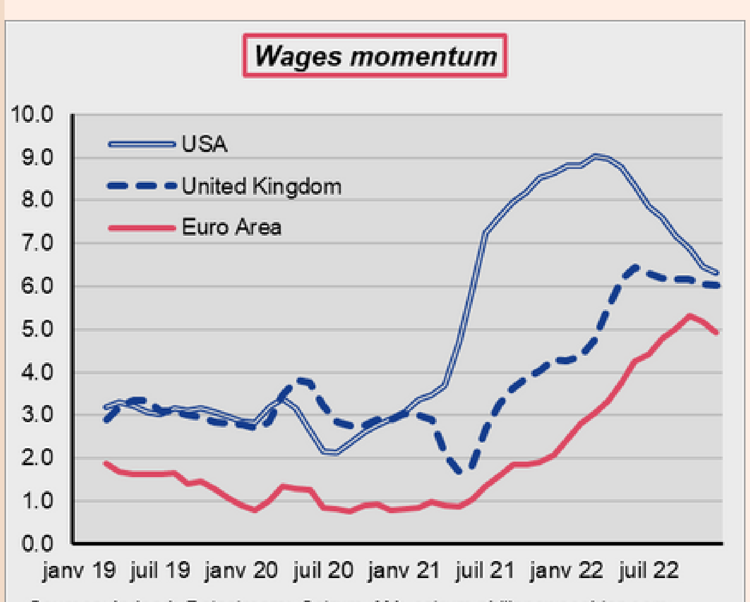
Wages are slowing down in the euro area







The **wage dynamics** has been changing since last fall in the Eurozone if we follow the measure resulting from Indeed's research.

In **December** the increase was **4.8%** after a high in September at 5.5%. On average over 3 months, the increase in the wage rate was 4.9% against 5.2% in November and 5.3% in October.

(The job search site captures the wages of job postings. This is therefore the salary of new contracts, not the stock of old contracts).

Two remarks
The **adjustment of wages to inflation is far from unitary**. There is **no European-wide indexation rule** or **price/wage loop** that would suggest a persistent dynamic.
For the different countries of the Eurozone, the pace is substantially similar to that of the whole.
A **slower momentum** are observed in **France and Germany**. In Italy, the peak has been seen in spring and it is in Spain that catching up continues.

Indeed does the same type of survey for the US and the UK.
It is clear that the **change in trend is earlier in the US and the United Kingdom than in the Eurozone.**
These differentiated trajectories show the cyclical differences between the three countries. The **slowdown has been dramatic in the US** since early spring 2022.

What does the ECB say on wages ?

In recent research, the ECB looks at the wage dynamics.

What has been retained is the beginning of the last paragraph which indicates that **wages should increase rapidly** in the coming months.
A hasty conclusion since in the second part of this last paragraph, the **authors moderate their remarks**, leaving the **reader in some inconclusive confusion.**

Let us return to the various points raised by the ECB.

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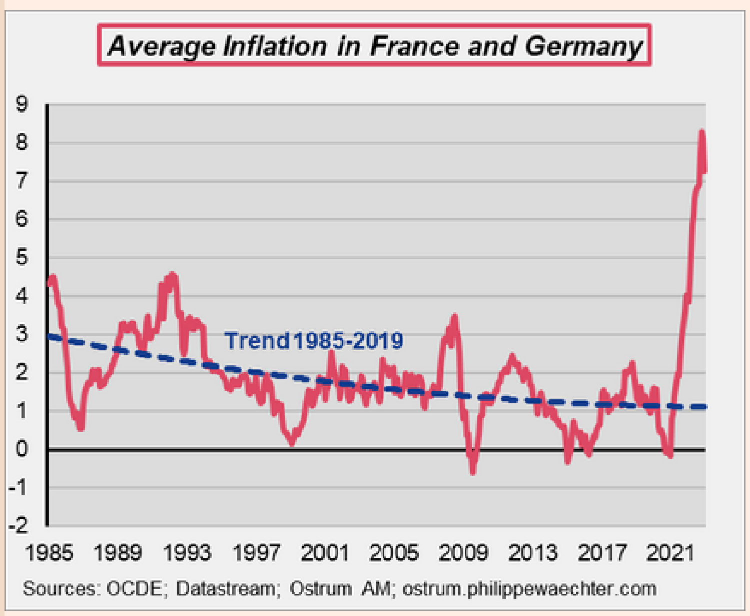
Discussion on wages

The problem of prices and wages

The issue of **wages** is at the heart of the **ECB management of its monetary policy**. A **persistent rise in wages is a major factor that can lead to persistent higher inflation than expected.** From this point of view, it is necessary to distinguish between indexation rules, as in the 1970's in several developed countries including France, and an increase in wages resulting from productivity gains. In the first case, the rule can create the conditions for permanent inflation above the desired target, not the second.



For a long time, the **sensitivity of wages to inflation has been greatly reduced**. One reason for this is the stability of inflation. The rise in prices was limited and moving in reduced margins, only penalized by temporary shocks on the price of oil.

Inflation reversed its trend quickly after a shock.
That's what the graph suggests.
As a result, price dynamics were of little relevance for understanding wage dynamics. And making the hypothesis that she would leave it permanently was risky (see box on the Fed of Saint Louis).

The recent breaks

Inflation is now higher. Thus, **the relationship between wages and inflation changes in nature since inflation does not spontaneously reverse its long-term trend**. Pre-COVID modelling is no longer as relevant as it was.

Moreover, as the ECB points out, governments interventions on the labor market have clouded the issue. While such intervention was desirable for obvious reasons related to the rigidity of the labor market, it **frozen the productive structure and limited adjustments as the economy changed** during and after the health crisis.

This is probably an explanation for the continuing tensions on the euro area labor market with a historically high level of employment and very high vacancy rates

The **ECB** concludes its discussion on wages by saying that the **usual models have lost their relevance** due to the inflationary shock. But his observation of the labor market suggests that the strength of this latter, the lag of wages on inflation and increases in minimum wages should push wages on the upside. That is what we observed until the fall. **Recent wage data are, however, less optimistic**, as suggested by the Indeed database.
The effect of catching up on activity is fading and will affect the labor market.

Philippe Waechter
Chief Economist
@Economic_Dynamics

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Box on Inflation Persistence

The **Federal Reserve Bank of Saint Louis** has recently questioned the **future of inflation and its persistence.**
For this it has divided recent American history into two sub-periods: one from 1960 to 1983 and the other since 1983 corresponding to what economists call the period of great moderation during which fluctuations in prices and activity have been much less volatile than in the previous period.

The question is the **more or less rapid return to previous inflation trend**, depending on the period used.
The Fed of Saint Louis indicates that whatever the indicator chosen (the two price indicators (CPI and PCE) and their underlying component) the persistence of the inflationary shock is much more marked over the period 1960 to 1983.
Over the period of great moderation, the shock is eliminated much more quickly.

The question is therefore about the framework in which the **economy will evolve in the near future.**
Is the sudden resurgence of inflation since spring 2021 a temporary phenomenon with the return to moderate developments rapidly?
or has the shock transformed the relationships within the economy resulting in a reduction in the predictability of economic data?
For the monetary policy management, the equation to be solved is not the same according to the framework chosen.

On the **question of wages** mentioned above, this dimension is important.

If the 2021 **shock** is only a **temporary** one, then the models used in the past can be used again.

If, on the other hand, **the economy is changing** because the **price of energy** is perceived as sustainably high, because the economy is being **profoundly transformed** in the context of the energy transition or because the **economy is** then **verticalizing** the **bargaining relationships will change in depth** and affect the wage profile.

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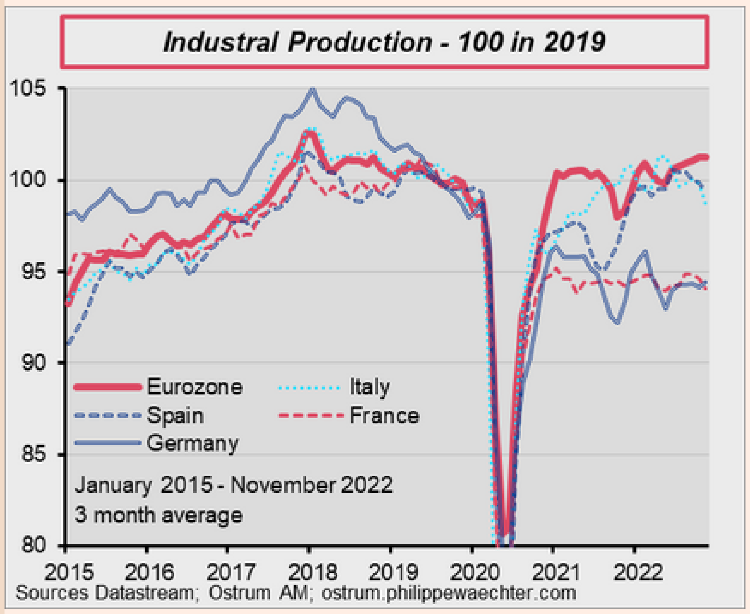
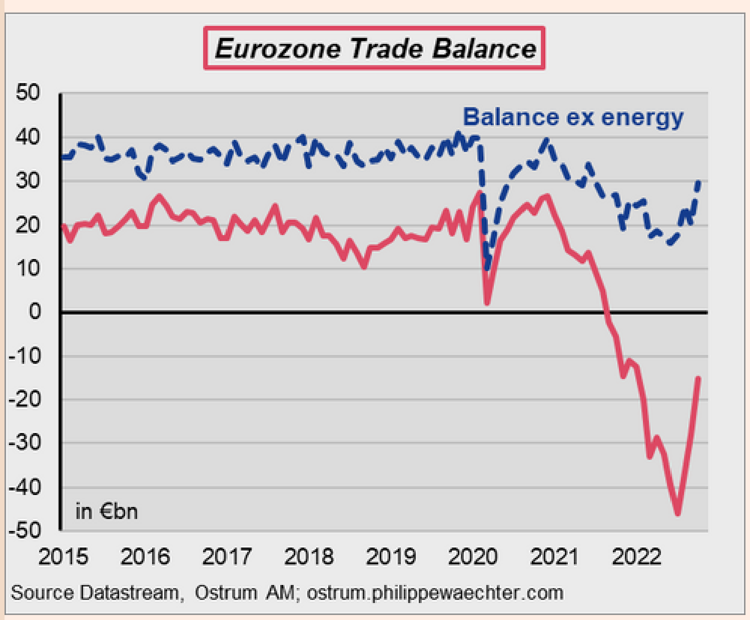
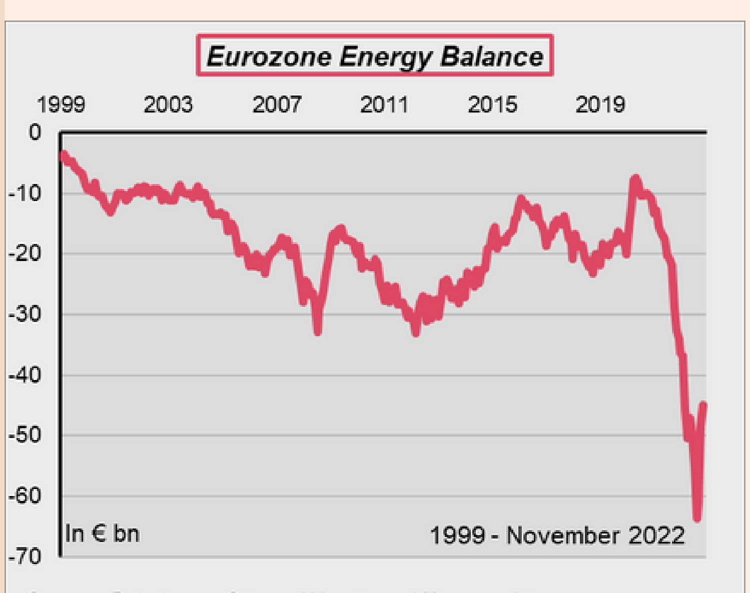
Industrial Producton and external trade for the Eurozone







Industrial production in the Eurozone has a **robust trajectory** while the **surveys** are rather **negative** on the pace of this sector.

Eurozone production has returned to **its pre-pandemic level** of around 100 or above (on the graph). The same is true in **Italy** and **Spain** These movements are consistent with those observed before the pandemic.

On the other hand, in **France** and **Germany** the situation is **more critical.** The level of industrial production is about **5% lower than** it was **in 2019**. There is no catching up from the pre-pandemic level and the German pace is much less dynamic than during the period 2015-2019.

The **challenge** is now **Europe's ability** to face **American and/or Chinese challenges**. US competition will intensify through the Inflation Targeting Act (see Keys to the week of December 19). It will also be of a different nature because the higher **price of energy penalizes Europe**. We must adopt measures similar to those of the US in Europe. **I will come back to this point next week**.

In the **short term**, the relative stability of the indices suggests a **reduced risk of recession** in all European countries. **Economic policy dynamics** and the **recent decline in energy prices** explain this robustness.

This change of pace in energy prices can be seen in the profile of **European external trade**. The **energy balance is close to -45bn** compared to over 60bn in August.

The good point too is the **recovery of the balance excluding energy. Non-energy exports continue to grow** while non-energy imports stagnate. The internal market is not collapsing.

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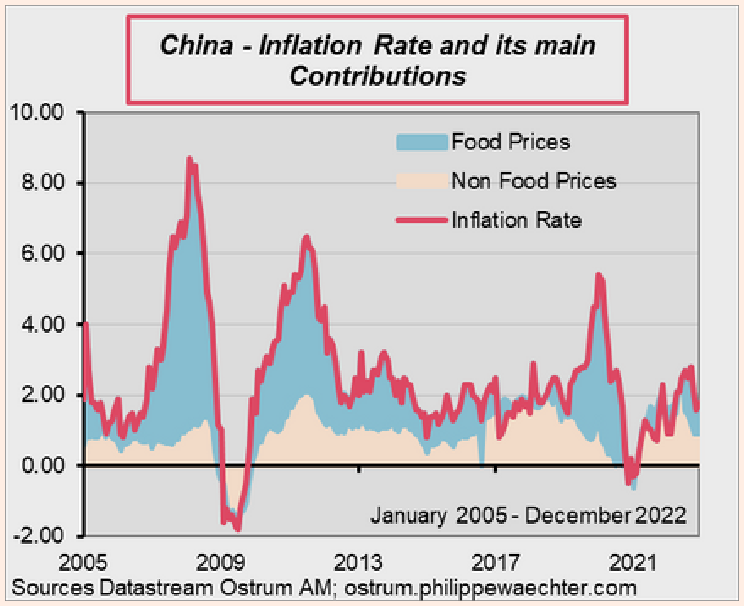
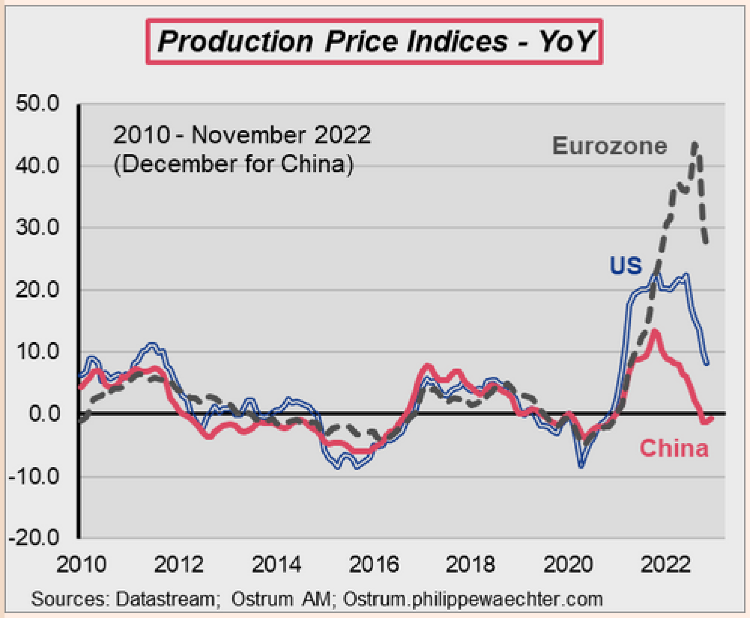
China – Inflation and waiting for the GDP





Chinese inflation remained subdued at the end of 2022. It registered at **1.8%** after 1.6% in November. Over the year as a whole, the **average inflation rate is 2%** against 0.9% a year earlier.

As always the **food price** contribution is more volatile and drives up the price increase while for other goods, the contribution has been stable for 3 months.

The point to remember about the price dynamics in China is the **inflection in the decline of production prices.** This price index had fallen as industrial raw material prices fell. This is no longer the case. Commodity indexes are recovering and ex-factory prices are tending to stabilize.

This is a point to keep in mind because the **production prices** for December in the **US and in the Eurozone** that will be out later **follow the same profile** as that of China.

This change may reflect the anticipation of a resumption of activity in China after the lifting of the 0Covid policy in mid-December.

At the end of 2022, the **economic momentum** is **mediocre** with the decline in both imports, weak domestic demand and exports. Global demand for Chinese products is reduced.

Tuesday, January 17 will be published the **growth figure** for the last quarter of 2022 and we will then have the growth rate for the entire year.
In 2021, Chinese growth was 8.6% due to catching up after the fall in activity in the first quarter of 2020.
For 2022, **expectations** are in the neighborhood of **3%**, which is well below the 5.5% target set by the government.
By **2023**, the government should set a **target of 5%**, the economy benefiting from the recovery after the lifting of the 0Covid policy. The year should evolve in **two stages**: a first part penalized by the increase in contamination and then a **recovery from spring.**

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