

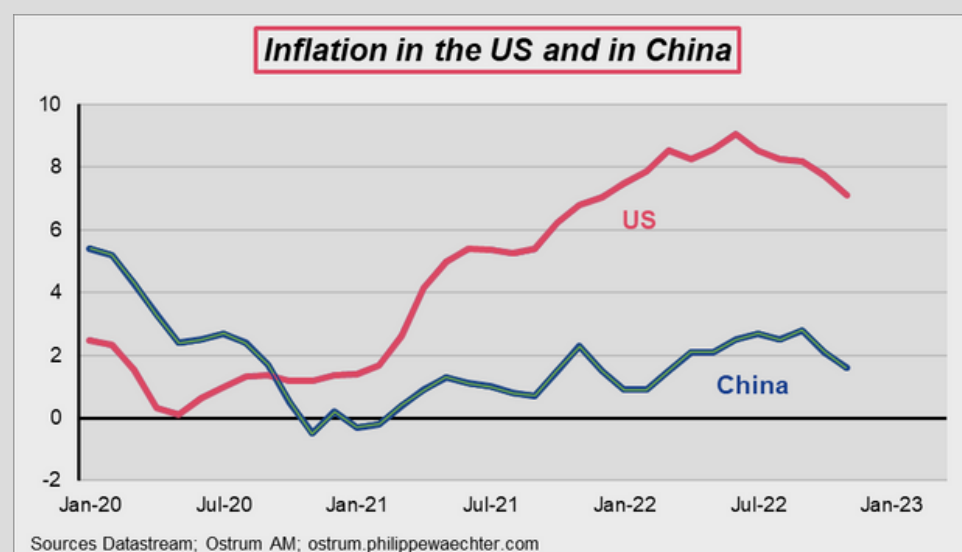
KEYS OF THE WEEK

The theme of the week

How was the energy shock shared?
The necessary definition of a new equilibrium
in the euro area

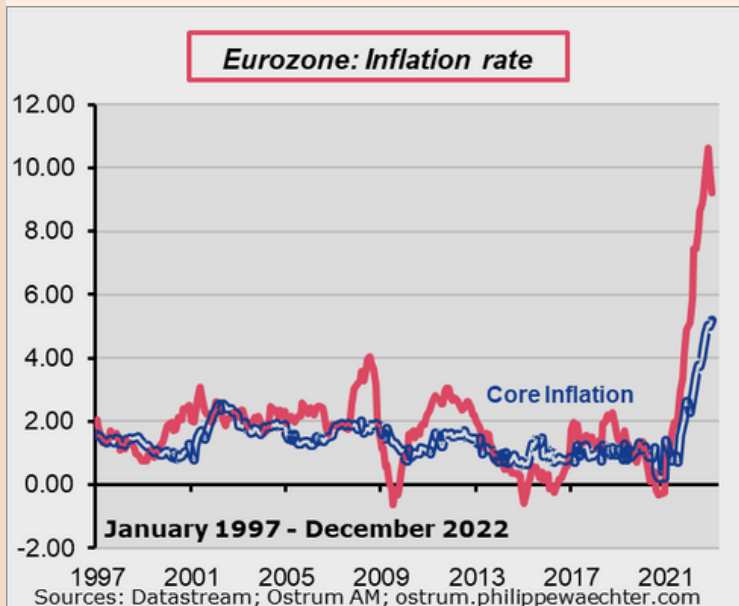


- **Inflation in the Eurozone - It starts slowing down (Page 2)**
- **ISM Index plummets in December (Page 3)**
- **Business Cycle, Households Confidence and US Wages (Page 4)**
- **Energy Shock, Real Income and Inflation (Page 5, 6, 7 and 8)**
- **This week: Inflation in the US and China for December 2022**





INFLATION IN THE EUROZONE - IT STARTS SLOWING DOWN



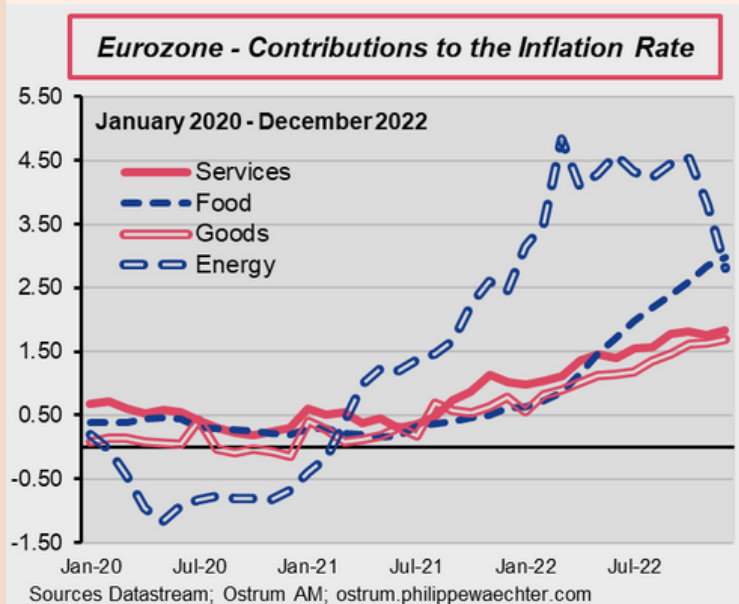
Euro-zone **inflation** fell to **9.2%** in December. The peak was at 10.6% in October. For 2022, **the average inflation rate is 8.4%** vs 2.6% in 2021.

The recent **slowdown** in price increases is due to the **lower contribution of energy** to the inflation rate.

The remarkable point is that **its contribution is now lower than that of food prices**.

On the social level this will result in important trade-offs for low income households. That is the major point to keep in mind as it deeply change the previous equilibrium.

Nevertheless, it is worth noted that **fertilizers' price is slowing down sharply**, which will **reverse the trend in food prices** in coming months.



The **core inflation rate** continues to rise. This reflects the diffusion effect of the energy shock on good and services prices.

Discussions around energy prices in SMEs/SMIs/ISEs reflect the risk of this propagation effect. This is the most worrying point as this **rise in underlying inflation makes the dynamics of consumer price increases more persistent**.

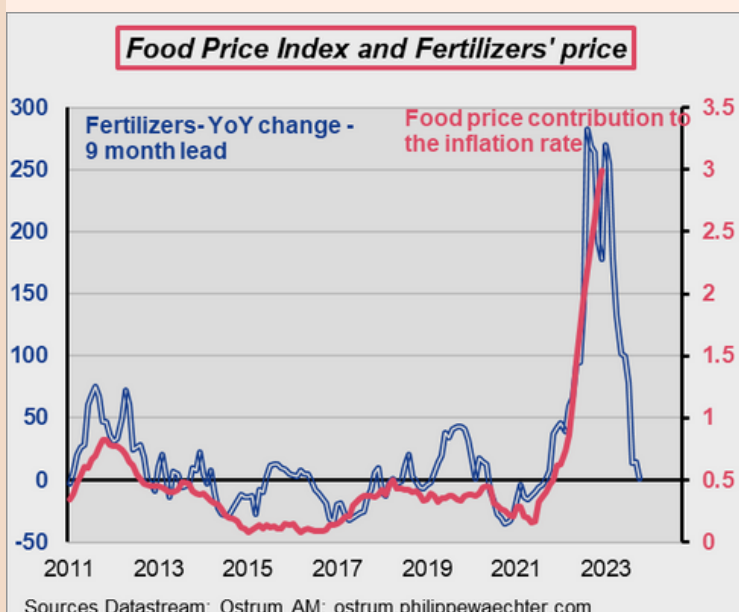
For the **next few months**

1- Keep an eye on **energy prices**. The price of gas is currently very low because the activity is limited, because the weather is favorable and Asian demand is reduced. That could change.

2- **Overall inflation will continue to fall** due to significant base effects.

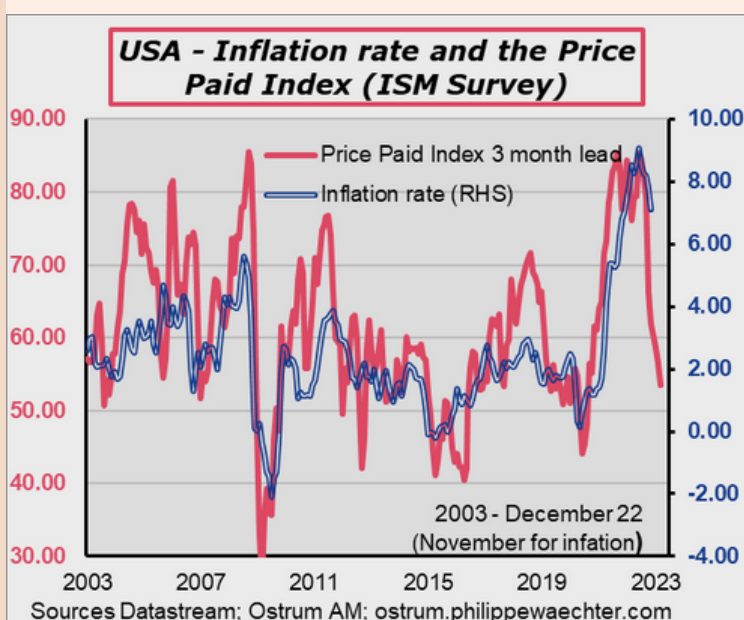
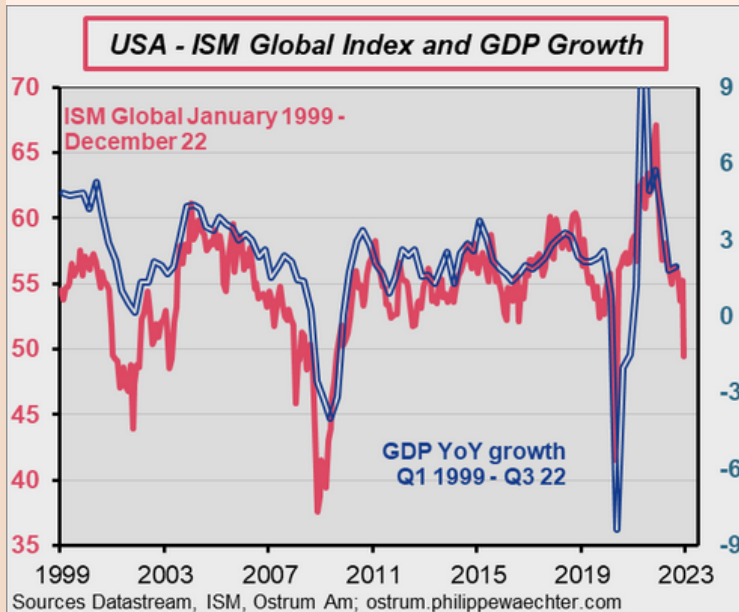
3- **The price level for energy and food will remain high** even if the price change slows down. This will lead to significant arbitrage in household budgets, especially those with the lowest incomes. That is why energy **subsidies must be targeted**.

4- The **ECB will not change its monetary stance** until contagion effects are controlled.





ISM INDEX PLUMMETS IN DECEMBER



For the first time since May 2020, the **Global ISM Index** fell **below the 50 threshold** in December. This is a strong signal of a **slowdown in the U.S. economy**.

(The Global ISM index is the employment-weighted average of the two composite indicators for manufacturing and services. An index below 50 indicates a slowdown in the economy)

The graph shows the **good correlation** of this indicator with the **GDP trend**. Both follow a similar cyclical dynamic.

Both components of the Global Index are in the negative territory. The **manufacturing ISM** registered at **48.4** after 49 in November. The **services index** stood at **49.6** from 56.5 in November.

To visualize the sources of the slowdown, we note the **significant decline in manufacturing new orders** in December.

In the **services** sector, the **decline in demand is still insufficient to characterize a recession** situation for the economy as a whole.

The **first explanation** for this inflection in demand is the **end of the momentum from Biden's recovery plan**, this is very visible in the goods sector, **the second** is the impact of the **restrictive monetary policy** led by the Federal Reserve.

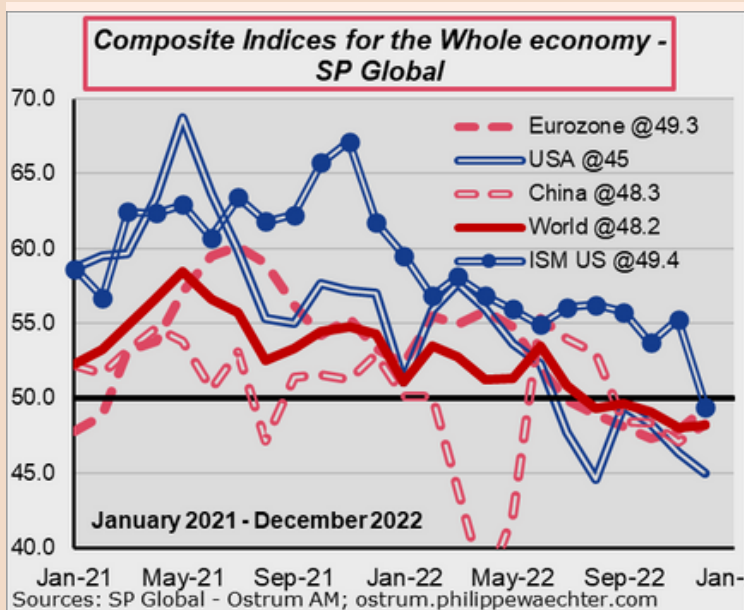
One effect of this slowdown in activity is the **downward trend in the prices paid index**. Its profile is quite well correlated with that of US inflation.

This price paid index suggests a **coming strong slowdown in US inflation**, perhaps faster than is generally expected.

This does not mean that the Fed will quickly change its monetary strategy.



BUSINESS CYCLE, HOUSEHOLDS CONFIDENCE AND US WAGES

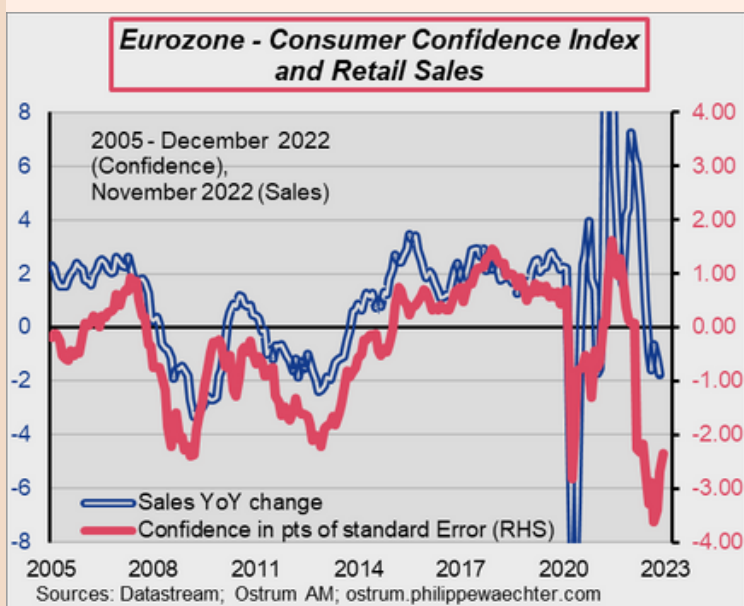


The **December surveys** indicate a **slowdown in activity** in the major countries.

The world index is slowing, China is still slowing and the Eurozone has been below this threshold since July. The global ISM Index also converges below this 50 threshold.

The European decline is linked to the price of energy, that observed in the US is more the result of the policy implemented by the Fed.

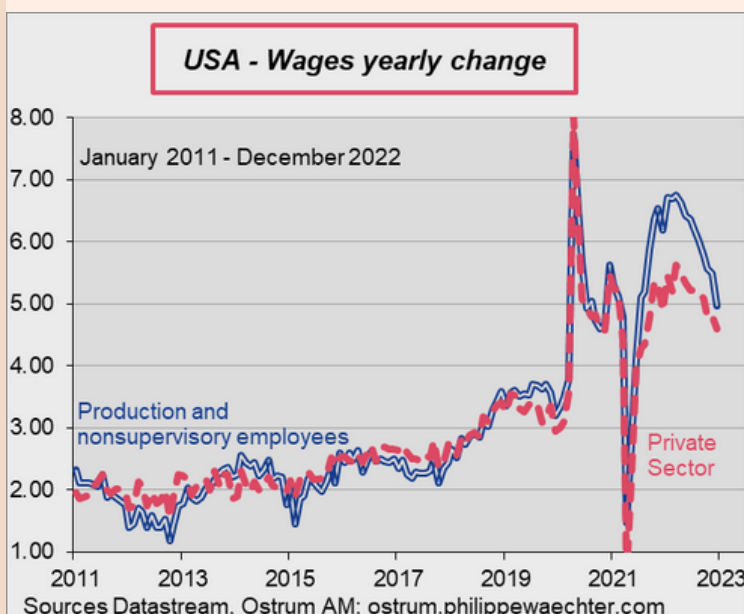
Cyclical dynamics are not directly comparable on both sides of the Atlantic.



Euro zone households confidence improved in December. However, it is still **far below its normal pace** (0 is the average of the index). It is barely above what was observed during the pandemic.

Inflation expectations are **back** to their **historical average** in December. Households are less worried about inflation. This is good news.

This concern about the environment is reflected in a **spending dynamic that remains weak**. The annual change in retail sales continues to decelerate even though the index rose over the month.



In the **US employment** report for December, the key point is the **sharp slowdown in wage growth**.

While the levels are still strong, the pace is slowing significantly **from the highs of spring 2022**.

This is an important indicator because the **Fed always scrutinizes it** with great interest.

Wage dynamics can be the cause of persistent inflation that central bankers do not like.



ENERGY SHOCK, REAL INCOME AND INFLATION

The risk of recession is in everyone's mind but especially not in economic statistics. This is somewhat what could be said in view of the high growth figures in the Eurozone, when the energy shock was considerable and potentially destabilizing.

From this point of view, the perception of this shock is out of proportion with the stopping point of the first oil shock in the mid-1970s. At the time, the economy had experienced a terrible rupture. None of this is observable today. The growth figure will be strong in 2022 and the slowdown expected in 2023 is not a break comparable to 1975.

Who absorbed the shock?

In a recent publication the French Treasury of the Ministry of Economy has showed how the measures taken by the government had transferred the burden related to the rise in the price of energy of households and partially of enterprises to the State. This is an important angle to understand behaviors. Yet it does not reflect the impact of the shock on the entire French economy.

The energy shock reflects a situation in which the rise in the price of its energy cannot be pass into the price of exports. The domestic part of the economy has to absorb this shock. Not being able to reverberate the shock via the price of exports, it is absorbed by domestic demand, consumption and investment.

What happened during the energy shock?

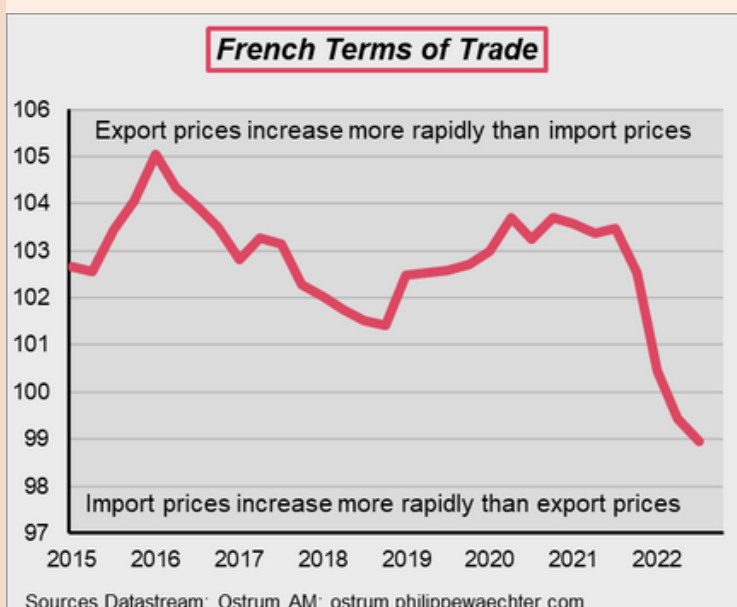
In the case of France, since exports are on average in the middle of the range in terms of quality, it is impossible to fully pass on the rise in import prices except to take the risk of seeing exports fall.

To maintain the balance of the economy, the volume of imports must be drastically reduced to compensate for the increase, or its real domestic income must be reduced because there is a deficit to finance.

Economists compare export and import prices by reporting the ratio of export to import prices. This ratio is called the terms of trade.

For the French economy but also for the Eurozone economy, higher energy prices have led to a rapid and deep deterioration of this ratio.

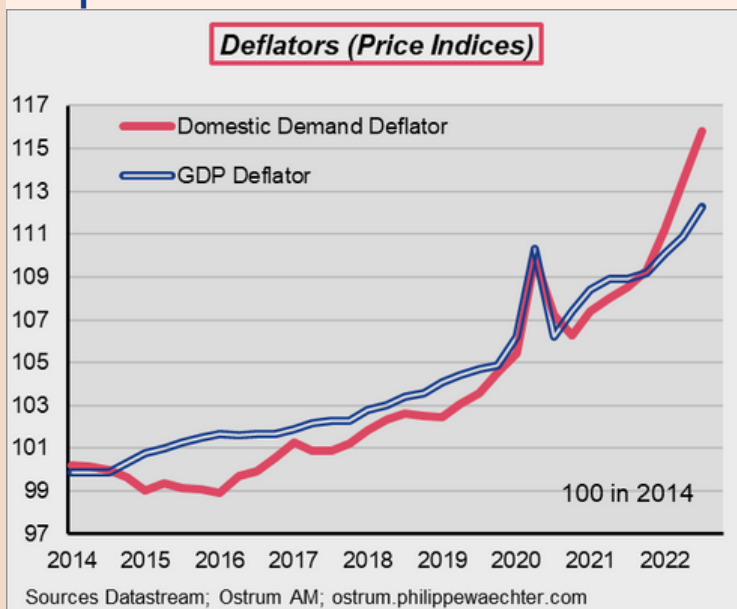
The drop is a measure of the way domestic demand has to adjust to these new conditions.



ENERGY SHOCK, REAL INCOME AND INFLATION

Real Domestic Income

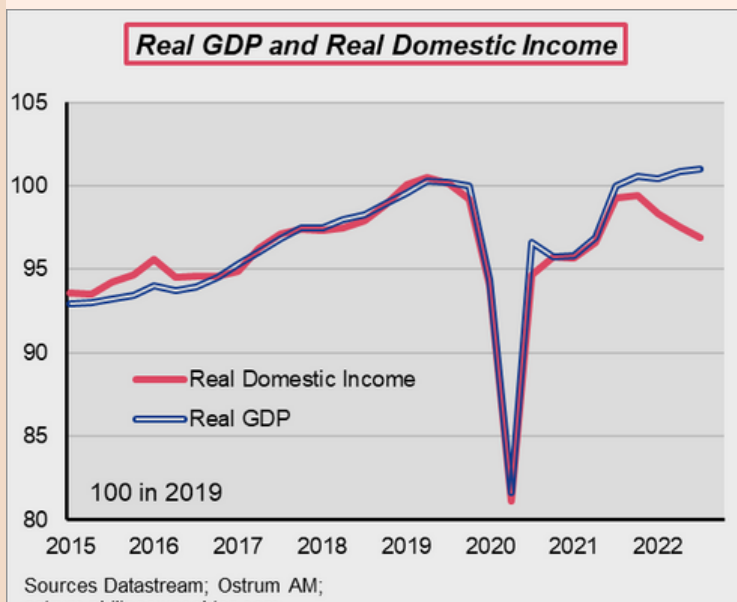
If import prices cannot be passed on to exports, this implies that they are reflected in the prices associated with domestic demand, namely consumption, investment and public expenditure.



I have constructed a price index of this domestic demand by weighting the price of each of these items by its weight in GDP. This is the deflator of domestic demand.

Its pace has recently been steeper than that of GDP prices. It is this divergent dynamic that should be taken into account in the measurement of the energy shock.

INSEE recommends deflating nominal GDP, GDP in value, not by the GDP deflator (GDP in volume terms) but by the deflator of domestic demand. Income is then measured in terms of domestic demand, not by a measure for the whole economy.



Since 2015, the pace has been the same, there is no significant difference between real internal income and GDP.

In 2022, the energy shock caused a sharp divergence between the two profiles.

French economic income contracted in 2022 as GDP continued to grow.

Taking into account the energy shock changes one's perception of the economy. From a real income perspective, the economy is in a recession. The problem is identical in other European countries.

But then why such a limited feeling?

It is economic policy activism that changed the original interpretation of the energy shock. From this point of view, it contrasted strongly with the kind of passivity observed in the 1970s.

Economic policy has made it possible to pool risk and shock over time. The rise in public debt and its purchase by the ECB had the virtue of avoiding a brutal and destabilizing shock for the economy.

It is this management that has been beneficial. Nevertheless, in France, it is still partial. It affects households, small businesses but not really SMEs, which are the heart of the French economy.



ENERGY SHOCK, REAL INCOME AND INFLATION

Who finally pays the price?

The cost of pooling the energy shock will be largely paid for by future taxpayers. Rather than provoke a brutal adjustment, synonymous with recession and rupture now, European governments have preferred, in part, to postpone the cost for a period expected to be more favorable.

However, companies are paying a lot of the bill because they are directly affected by the rise in the price of energy. In France, for example, few of them benefit from regulated tariffs, which have been the intermediary between government measures and households. In Germany, the government has been more generous with companies in the development of the aid plan.

The choice that has been made often concerns the future consumer so as not to penalize the present. This arm wrestling exists everywhere because the energy shock upsets the balances of yesteryear. This can be seen on income with the notion of real domestic income, it can also be seen on inflation.

Energy shock alters the balance of power

In a recent discussion on Twitter, Olivier Blanchard, former IMF chief economist and famous MIT professor, discusses this sharing and the impact of the energy shock.

His initial tweet reads, "Inflation is fundamentally the result of a conflict between companies, employees and taxpayers. It only stops when the different actors are forced to accept the result "

This opens the door to a price/salary loop through the following mechanisms:

If, after a recovery plan, the economy is strong for everyone, then households and businesses want to be able to benefit from the tensions in the markets for goods and services but also in the labor market.

If the economy suffers an energy shock then no one wants to bear the burden. Businesses want to be able to pass on the rise in the price of the products they buy while households want to retain their purchasing power.

This is an uncomfortable situation for everyone. Government pooling can help to reduce stress on burden-sharing. But this is often not enough. This is why, in the final analysis, it is the central bank that by tightening the tone drastically reduces upward nominal pressures. Its restrictive monetary policy reduces inflation, but often at the cost of a recession.



ENERGY SHOCK, REAL INCOME AND INFLATION

Is a recession necessary?

The question raised by Blanchard and a few others relates to a form of determinism that makes recession the necessary transition to reduce inflation.

A recession always has a high cost. The potential growth rate of the economy is always somewhat lower after a recession.

The current cyclical pattern is unique: in Europe the labour market is very dynamic. Job creation is important. In the USA, low wages are growing faster than high wages. This is the first time that wage gaps of this type have been reduced.

A recession in Europe or in the US means taking the risk of putting an end to these particular dynamics that are beneficial to everyone.

Would it not be logical to find a solution that avoids such a rupture? A negotiating structure with the private sector so that the solution to the recession is not the only one available?

The definition of a new equilibrium

The energy shock is reshaping the situation in European countries in particular, since energy prices will remain persistently high.

First, there is the assumption of the associated cost. For the moment governments' strategies make it possible not to have a too important macro adjustments.

Then there is the dynamics of the balance of power on prices and wages which is modified by the nominal impact of the energetic shock. With an economy tending to become more vertical, the labor market is no longer as broad as in the recent past. Companies and governments no longer have the same desire to settle in China, for example, and productions could be relocated partly in developed countries. This would then translate into an additional dimension in terms of wage dynamics. The bargaining relationship could then change.

These two dimensions of the energy shock must find a solution so that the economy converges towards a new equilibrium that can be associated with a more autonomous economy. That is everyone's business and that is why dialogue between governments, the ECB, businesses and citizens must be effective. This is a terrible issue for the months ahead.