Is there life after PEPP?

109 – 18 October 2021

Key points

- Biden may arrive quite "empty handed" at COP26
- Exploring US inflation dynamics – again
- Villeroy de Galhau's latest speech offers some insight into a "post-PEPP bond market

The European Central Bank (ECB) governing council is busy preparing the next phase of its monetary policy when, in all likelihood, announcing in December that Pandemic Emergency Purchase Programme (PEPP) will not survive the winter. We have been intrigued by press reports these last two weeks suggesting the central bank is mulling a "third programme", between the Pandemic Emergency Purchase Programme (PEPP) and the Asset Purchase Programme (APP), which would address bond market disruptions – read "peripheral spreads widening" – as PEPP is terminated, through discretionary interventions on selected national markets. We are very circumspect about such a concept, reminiscent of the ill-fated Securities Markets Programme (SMP) in 2010. This would make the ECB far too powerful if it could on its own extend or withdraw bond market support to member states without a clear "conditionality contract". Ultimately, the ECB would be torn between accusations of intervening too late if it did not approve of the policy course of a member state, or symmetrically of being too complacent with adventurous governments if it felt compelled to intervene anyway to stop contagion. We think that the proposals made by Banque de France Governor Villeroy de Galhau in a speech last week to extend to APP some of the flexibility of PEPP would deal with a potential post-PEPP "withdrawal syndrome" much more efficiently.

But before turning to European monetary policy and with COP26 looming, we look at the headwinds blowing against the US administration's determination to advance concretely on decarbonization. A key plank of Biden's platform is the Clean Electricity Payment Programme (CEPP), which is under direct threat given the opposition of West Virginia Democratic Senator Joe Manchin. We think the alternatives – boosting and prolonging the tax credit for renewables – are sub-optimal primarily because CEPP was the closest possible substitute to proper carbon pricing in the US.

We also continue to explore inflation dynamics in the US. The September batch brought fodder for doves and hawks alike, between the deceleration in the price of the items affected by the microchip shortage and the reopening, and signs that the shock is spreading to a wider array of sectors. We continue to think that the impact of base effects is under-stated.

Coping (or not) with COP26

The success of the world's decarbonisation between now and 2050 essentially hinges on two key contributors, the US and China. Last week, press reports were becoming insistent that Xi Jinping would not be present in Glasgow. **Joe Biden has confirmed his presence, but there is a significant risk he may arrive at the conference quite empty handed in terms of concrete policy announcements.**

So far in Macrocast, we have focused on the aggregate, macro impact of the various stimulus packages pushed by the US administration, basically "counting the billions" to gauge their net effect on economic growth and public finances. Yet, as Congress is forcing the President to shrink the next programmes, "what" is cut is becoming as crucial as "how much". On Friday, the New York Times reported that Joe Manchin, the Democratic Senator of the coal-dependent state of West Virginia – who has the power to block anything in the Senate given his party's rather thin majority – continues to oppose the USD150bn "Clean Electricity Payment Programme" (CEPP). CEPP would set to power companies an annual minimum target for the "clean component" of their mix. It is a complex system involving several thresholds, but basically, the megawatt-hours (MWhs) produced above said target would elicit a payment from the federal government, and conversely, MWhs below would elicit a penalty. The targets would be tailored according to the starting point for each company, but gradually, on aggregate the threshold would be pushed to 80% in 2030. In other words, by 2030 80% of all electricity produced in the United States would come from low-emission sources, against 38% today according to the Massachusetts Institute of Technology Review.

Your humble servant is a long-time subscriber of "The Economist" but in our opinion the esteemed weekly erred when concluding in its latest issue that there are equivalent alternative options, such as boosting and prolonging the existing tax credits for investing in solar and wind power, in case CEPP needs to be carved out of the USD3.5tn social and environmental package currently stuck between the House and the Senate. These options are in our opinion sub-optimal.

First, CEPP would be a step toward a proper federal cap and trade carbon pricing system such as the European Emissions Trading System (ETS) which in the US has only been established to an extent or another in 13 states. Rather than setting a global emission budget to the electricity generation industry and let the individual companies trade their allowance, generating a market price for carbon (that's how the ETS works), CEPP would set a penalty price for "dirty" electricity which would become the *de facto* price of carbon (for power generation). Tax credits to invest in renewables create a "pull" – or a "carrot". What would be missing without a carbon pricing mechanism, or at least CEPP, is "push" – or a stick. So far in the US, the "stick" has usually taken the form of mandatory changes in the carbon emissions of power companies implemented in states such as California, but at the federal level this option is probably closed in Congress. Since it does not have any budgetary implications, this could not make its way to a "reconciliation" process requiring simple majority in the Senate.

Second, while tax credits would continue helping with the developments in renewables, CEPP would also support nuclear power. Out of the 38% of low-emission power generation, 20% come from nuclear energy. We have already highlighted in Macrocast last May that while most comments on the International Energy Agency (IEA)'s "net zero by 2050 report" focused on the fate of fossil fuels, another striking feature for us was that the IEA's scenario was conditional on a near-doubling of the contribution of nuclear energy to power generation over the next 30 years. We are far from this In 2019, 5.5 gigawatts (GW) of additional nuclear have been added globally, while 9.4GW were permanently shut down: overall, nuclear capacity is declining.

COP26 will take place amid a significant rise in the price of fossil fuels – one of the channels through which decarbonization will occur – but also the widespread realization of some shortcomings of renewables. The UK, hosting COP26, has been forced to re-start some of its coal-fired power stations to deal with the lack of wind. Interestingly, this is triggering in the UK an acceleration in nuclear power projects, and it seems to be a common theme in advanced nations. Small-scale nuclear reactors were one of the items of the French government innovation spending plan for 2030 unveiled last week. Japan's new Economy and Trade minister stated on 5 October that he would like to *"promote the maximum adoption of renewable energy, thorough energy conservation and the re-start of nuclear power plants with the highest priority on safety".* Actually, Japan has already re-started a nuclear reactor last June for the first time since 2018.

If the legislative avenue is closing for Biden on CEPP, it is very likely he will try to pursue his green agenda through the regulatory agencies under his direct control. In the realm of finance, we have already commented in Macrocast on the change of attitude of the Securities and Exchange Commission (SEC) on environmental issues. Now, as much as the global financial industry is taking its participation to the fight against climate change very seriously, some key decisions still need to be made by governments, in particular in terms of energy choices. **The role of finance is to allocate capital. It would allocate it more efficiently if it had some clearer visibility on a trajectory for the price of carbon**.

Monitoring inflation - again

Exogenous inflationary shocks continue to pile up. While the US market is for now shielded from the steep increase in gas prices observed in Europe and in Asia, the continuing rise in oil prices is an issue for all. This will drive headline inflation further up. Last week, we focused on the scope for “second round effects”, stemming in particular from the labour market, but with new monthly consumer price data becoming available in the US, we want to explore again the dynamics already at play.

Doves and hawks can equally find support for their line of reasoning in the September batch. While headline inflation rose again, from 5.3% in August to 5.4% year-on-year (yoy), core inflation stabilised at 4.0%, below the peak at 4.5% hit in May. We have updated our usual breakdown of the core consumer prices index (Exhibit 1). The doves will probably want to focus on the fact that the contribution from the items most affected by the shortage in microchips, as well as from those driven by a “catch up” behaviour, continues to edge down. The yoy change in the price of used cars, which at peak had contributed a staggering 1.6 percentage point to total core inflation, has now halved, bringing a contribution of “only” 0.8 percentage point. The hawks will probably insist on the acceleration in the price of the “other components”, which in September has for the first time hit a higher yoy growth rate than before the pandemic started. This would suggest that inflationary pressure is spreading.

Exhibit 1 - The shock seems to be spreading…

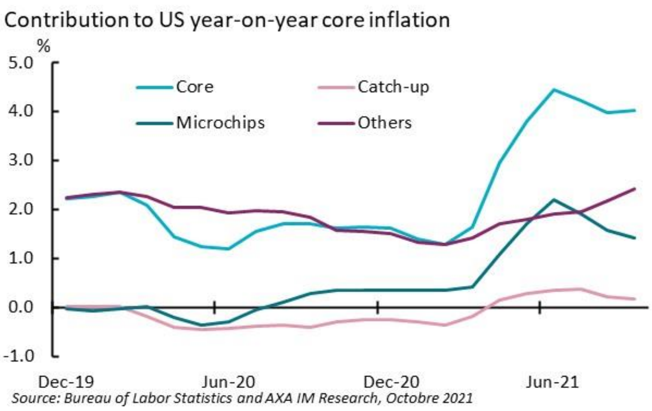
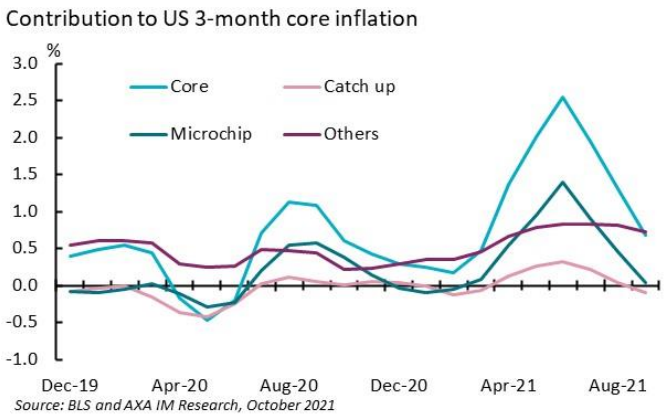


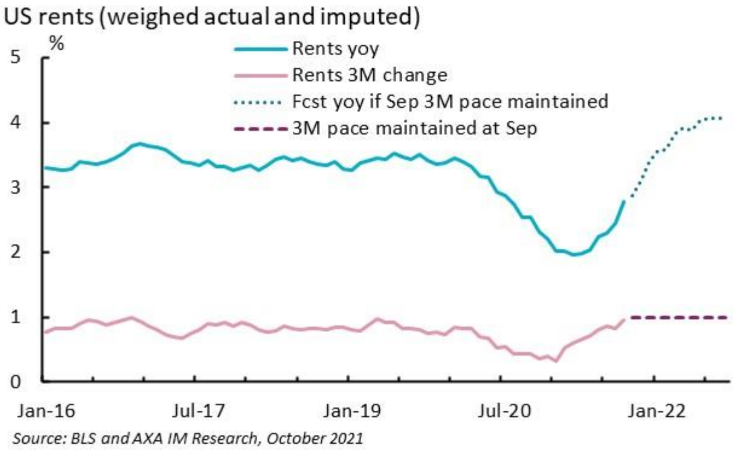
Exhibit 2 - …but it’s less clear when controlling for base effects



Still, we continue to think that **some of the concerns now commonly expressed about inflation are fuelled by the habit of looking at this variable in year-on-year changes.** Base effects are always a problem, but they are particularly acute now because we are in practice comparing current data with a period before the vaccines had become widely available and strict restrictions were implemented. To change a bit the perspective, in Exhibit 2 we look at the change over three months for the same “price buckets” (we make sure to use seasonally adjusted prices). Then, the inflexions for the two “special buckets” are much steeper, but crucially, even the “other components” have started to decelerate, albeit marginally. This would go against the notion that clear “diffusion effects” are at play.

However**, there is one key component for which *both* the year-on-year and the 3-month changes have accelerated recently: rents.** They stand for an inordinate size of the Consumer Price Index (CPI) basket in the US (30% of headline and 40% of core) since in the US, the Bureau of Labour Statistics takes into account “owner occupiers’ rent equivalent”, i.e. what those landlords would have to pay if they rented their current home rather than owning it. They also tend to be “sticky”: once they’ve set on a certain trajectory, they usually stay on it for a long while. These two factors explain why the Fed is probably paying a lot of attention to these new developments. The ongoing acceleration however still looks a lot like another form of post-pandemic "catch-up" after landlords accepted a *decline* in the purchasing power of their rental income (Exhibit 3) between the last months of 2020 and the beginning of 2021. But **even if the latest, strong 3-month growth rate in rents was maintained over the next 12 months, this would push the year-on-year change only 0.5% above the pre-pandemic by September 2022, which itself would translate into a 0.2 upward shift in core inflation, everything else kept equal.** Remember that the inflation pace before the pandemic was sub-par, i.e., too low relative to the Fed's target. This leaves quite some room for manoeuvre.

Exhibit 3 - Rents need to be monitored – but it looks like a catch-up



Besides, that the "other components" in our core inflation breakdown (which include rents) managed to marginally decelerate in the three months to September despite the acceleration in rents would suggest that even in the US, there is for now no generalised shift upward in the inflation regime. Finally, what is reassuring is that consumer surveys still do not point to a dis-anchoring of long-term price expectations. True, in the Michigan survey for October unveiled last week the one-year ahead inflation forecast of polled households rose again, to 4.8% from 4.6% – which is actually below the latest five prints for realized headline CPI – but the five-year ahead forecast fell back to 2.8% from 3.0%, bang in line with the pre-pandemic 20-year average. In these circumstances, we reiterate our view that the Fed can afford to follow a "median path", with a fairly quick taper announced next month but with also some time before a rate hike (we continue to expect the first one in 2023 only).

"Size" versus "flexibility"?

The ECB hawks have been quite vocal for a while, while the doves have made themselves scarce in external communication. **This makes freshly-reappointed Banque de France Governor Villeroy de Galhau's particularly topical**. He has been sitting as a "moderate dove" since the beginning of his tenure, and we are tempted to read his speech as a possible manifesto for that wing of the Governing Council in the months ahead.

He made four points on monetary policy tools: (i) "*it could be worth examining if and how at least some elements of this Pandemic Emergency Purchasing Programme (PEPP) flexibility should be kept in our virtual toolbox. Their mere existence, the theoretical possibility of their use, would mean that we would probably not have to actually use them*"; (ii) " *The Asset Purchase Programme (APP) might benefit, still more than from increased fixed volumes, from adding some forms of flexibility of purchases over time";* (iii) on the exemption of part of banks' excess reserves from the negative deposit rate, he "*would support a more rule-based approach to set the level of the multiplier, as a function of the change in excess liquidity*" and (iv) while he is in favour of keeping the Targeted Long-Term Refinancing Operations (TLTROs) as a "*liquidity backstop for the future*", its "*generous pricing... up to 50 basis points below the average deposit facility rate since April 2020 – is no longer justified"*.

In our view, points 3 and 4 combine to send a subtle but forceful message on a "technical" reason why the ECB could take its time before raising its policy rate. When insisting on how generous TLTROs are, Villeroy de Galhau conveys the message that the deposit rate no longer is the actual "minimum policy rate" since banks can obtain, under conditions, long-term liquidity at much more advantageous conditions. **Keeping TLTROs as a potential permanent**

tool, but with less of a spread below the deposit rate, would allow for some "tighter" monetary policy signalling without touching the policy rate itself. In a similar fashion, that the ECB would intend to keep its deposit rate for long in negative territory would get further substance by adapting the "two-tier" system which exempts part of the banks' excess cash from the "tax" which the deposit rate creates: if it needs adapting – given the massive rise in liquidity triggered by Quantitative Easing (QE) – it implies it would be there to stay for long. At a time when the market has been busy bringing forward its pricing of the ECB rates lift-off, sending such a message could be handy.

But it's probably points 1 and 2 which will probably draw more immediate attention given the market's current focus on the future of QE once PEPP stops, presumably in March 2022. We interpret Villeroy de Galhau's call for some "transfer of flexibility" from PEPP to APP in the light of, and as an alternative to, some exploration, at the ECB, of a new programme, somewhere between the APP and PEPP recently reported in the press, which could be used in a discretionary fashion to deal with a potential spread widening after PEPP stops.

We are circumspect about the creation of an ad-hoc programme designed to deal with potential bond market disruptions. Of course, there would be a monetary policy justification for this – the ECB has since the sovereign crisis used the "monetary union fragmentation" argument extensively – and there is even a precedent for such tool, the Securities and Market Programme (SMP) of 2010, but **the political economy of such an instrument is problematic in our view.** When Mario Draghi set out to deal forcefully with the peripheral crisis, he made it clear to make any specific intervention in support of an individual member state dependent on a "conditionality contract", involving the European Commission and preferably the International Monetary Fund (IMF). This was the rationale behind the Outright Monetary Transactions programme (OMT) which, without being used in practice, was so efficient in bringing the crisis to an end.

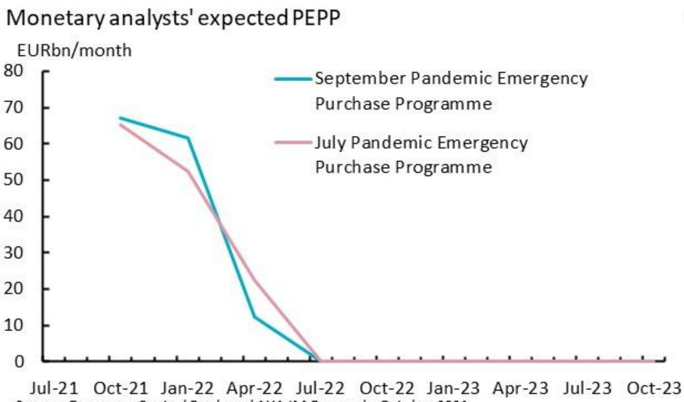
Ostensibly, the big operational issue of SMP was the ECB's insistence on retaining a senior creditor status – something which was dropped from OMT – but deep down it was doomed by its political implications: the power it gave to the central bank to offer or withdraw its support on a discretionary basis, without any role for democratically accountable EU bodies. **This created two symmetric risks: from the doves' point of view, that the ECB would tolerate far too much disruption before finally intervening, and from the hawks' that the ECB would feel compelled to intervene irrespective of the policy course adopted in the member state under market attack**. Of course, the current conditions in the EU are very different from 2010. For 2022 the EU's fiscal surveillance system is suspended and there is much more convergence on economic policy across member states than 10 years ago, but principles matter. Axel Weber might have resigned from the Bundesbank under any configuration for bond buying, but it's SMP and not OMT which was the ECB's policy at the time of his resignation. Symmetrically, Italian populists have long argued that the ECB had exceeded its role by using SMP to extract policy concessions from the Berlusconi government. The problem with OMT though remains its extremely cumbersome nature, even if over time the European institutions have developed lighter forms of "contracts". It can hardly be a "fine-tuning" instrument dealing with sudden and temporary market tensions.

Rather than a politically fraught ad hoc programme, or the "old OMT", **transferring to APP some of the flexible features of the PEPP would probably in practice buy "peace and quiet" on a bond market dealing with the termination of PEPP**. Two elements, mentioned in Villeroy de Galhau's speech, would be crucial: "*flexibility across jurisdictions"*, i.e. the possibility to take liberties with the "capital key" when apportioning the purchases, and *"flexibility across time"*, referring to the PEPP's definition as a global envelope to be spent over an indicative period of time, leaving much leeway on the actual monthly purchases. Investors willing to "test" the sovereign spreads would never know when, where and by how much the ECB would focus its next purchases.

This may be a big ask, however. While we think a consensus can be relatively easily found on extending APP to Greece (it is covered by PEPP) and some limited flexibility across the capital key, finding a majority in favour of a large overall envelope to be distributed according to market conditions may be difficult. To the hawks, this may look a bit too much like "PEPP forever" in practice. A compromise solution for APP 2.0 might be a dual framework combining a time-limited monthly pace of buying purchases combined with a larger overall envelope on which to draw if need be. However, given the ECB's history, we worry that this could "end up" being the final arrangement, but hawks may be successful in resisting its adoption immediately at the December meeting. The central bank usually does the right thing in the end, but not necessarily at the first attempt.

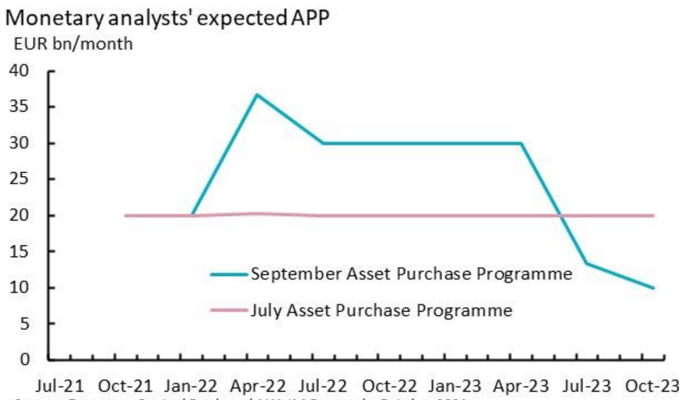
These discussions cannot be reduced to the kind of central banking "hair-splitting" which your humble servant confesses to relish. The monetary analysts survey, which the ECB conducts ahead of its Governing Council to get a sense of ECB watchers' expectations, is sending a strong signal that very few observers expect a continuation of PEPP beyond March 2022 (Exhibit 4). Through the summer, between the July and September batches, the shift upward in the expected pace of APP from the second quarter (Q2) 2022 onward suggests that the idea that the ECB would "recalibrate" APP to deal with any cliff effect from the end of PEPP – an old obsession of ours – has become consensual. But **we are surprised by the fairly low amount of monthly purchases being forecasted** (EUR30bn per month from Q3 2022 onward, see Exhibit 5, our baseline is EUR40bn). True, the decline in public deficits next year will make the gross supply much less abundant than in 2021, but with 30bn per month, net supply would still probably rise quite significantly. More fundamentally, between the last trickle of PEPP and a recalibrated APP, the median forecast in the September survey stood at only EUR577bn of additional buying between Q1 2022 and Q4 2023. Compared with previous estimates by the ECB of the quantum of QE needed to lift inflation, this is at the low end of what would be needed to bring inflation from 1.5% (the current ECB inflation forecast for 2023) and 2%.

Exhibit 4 – R.I.P. PEPP



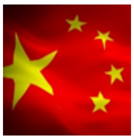
Source: European Central Bank and AXA IM Research, October 2021

Exhibit 5 – Higher, but not that much



Source: European Central Bank and AXA IM Research, October 2021

There is a feedback loop at work here: the survey informs the ECB of the market expectations, which helps the council to calibrate its decisions, but the survey reacts to the tone of the ECB communication. The current state of the survey may convince the ECB that EUR30bn would be well received by the market as it would fit its own central expectation. But the 30bn quantum may simply reflect the fact that ECB watchers are pre-empting the Governing Council's reluctance to provide "all that would be needed". For our part, beyond the monthly quantum, we believe that indeed, there is a case for maintaining the spirit of PEPP's flexibility into the APP.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Sep) rose to 5.4%, with energy prices and rents threatening more persistence • FOMC minutes appeared to confirm a taper announcement in Nov to conclude mid-2022 • JOLTS labour survey (Aug) fell sharply – although remains extremely elevated • Retail sales (Sep) surprised rising 0.7% on the month, ex autos up by 0.8%. • Empire State survey (Oct) fell to 19.8, but continues to point to solid growth into Q4	• Philly Fed survey (Oct), expected to echo Empire – lower, but solid • Industrial production (Sep) expected to post gains, despite ongoing supply-chain issues • Fed's Beige Book published • Housing market activity in housing starts, NAHB survey and existing home sales figures. • Weekly consumer confidence measure posted 6th fall and sharpest reversal since Mar 2020 • Manu and services PMI indices (Oct, p)
	• Industrial output (Aug) dropped in Ge (-4.0% mom)/auto prod: -17.5%. Fr up by 1%mom • Oct Ge ZEW economic sentiment faded more than expected, curr conditions and expectations are down • Aug EMU IP dropped by 1.6%mom. Auto sector still a burden for IP, rising energy prices threaten some industries	• Mfg and Svcs Flash PMIs in Fr, Ge and euro area should fade. In mfg, headwinds are supply shortages and worrying about energy prices while services sector doesn't have any longer the reopening effect. • Energy prices should impact emu cons confid
	• Labour market releases signalled a continued rebound. Payrolls reached pre-pandemic levels and vacancies increased further to 1.2mn • UK GDP rose 0.4% in August, softer than expected, with July revised lower to -0.1% from 0%. Annual forecast for 2021 is now 6.9	• CPI inflation (Sep), expect dip after EOHO base effect passes, but buoyed by energy. • BoE Gov Bailey speech clues on rate outlook • Retail sales (Sep), rebound after surprise Aug decline in danger due to petrol shortages. • Flash PMIs (Oct) on Thurs
	• Sept corporate goods price increased again to reach 6.3% after 5.5% in Aug, its highest level since 2008. • Aug IP has been revised down to -3.6%mom • IPSOS consumer sentiment rose again	• Sept trade balance should improve with larger decline in imports than exports • Sept CPI should rise on the back of strong energy contribution • Oct Mfg flash PMI should fade with shortages
	• Export growth surprises on the upside due to frontloading demand before shopping season • PPI rises further to a multi-year high from higher commodity prices, while CPI remains muted amid weak food prices	• GDP growth might have stalled in Q3 due to COVID resurgence, property curbs and power shortage
	• CB: Singapore tightened by raising the slope of its currency band. Chile delivered its biggest hike in 20 years (+125bps to 2.75%). Korea stood on hold (0.75%) • Singapore Q3 GDP grew at a slower pace of 6.5%yoy (Q2:15.2%) • Inflation (Sep) in India slowed to 4.4%yoy	• CB: Russia should hike +25bps to 7.0% and Hungary +15bps to 1.8%. Indonesia to stay on hold (3.5%). Turkey might deliver another cut. • Inflation (Sep) figures for Malaysia and South Africa • Retail sales for Mexico (Aug) and Poland (Sep)

Upcoming events		
	US:	Mon: Ind prod (Sep), NAHB housing indx (Oct), TIC report (Aug); Tue: Housing starts (Sep), Building permits (Sep); Wed: Fed Beige Book; Thu: Philly Fed indx (Oct), Weekly jobless claims (16 Oct), Existing home sales (Sep), Leading indx (Sep)
	Euro Area:	Wed: EU19 CPI (Sep,f), Ge PPI inflation (Sep); Thu: EU19 cons conf (Oct,p), EU27 Council meeting, Fr manufactoring conf (Oct); Fri: EU19, Ge & Fr PMI (Oct,p)
	UK:	Tue: BoE's Governor Bailey, Wed: CPI & PPI inflation (Sep); Thu: public finances (Sep), CBI ind trends survey (Q3); Fri: GfK cons conf (Oct), retail sales (Sep), PMI (Oct,p)
	Japan:	Wed: Trade balance (Sep); Fri: CPI inflation (Sep), PMI (Oct,p)
	China:	Mon: GDP (Q3), Ind prod (Sep), Retail sales (Sep), Fixed asset investment (Sep); Wed: 1y loan prime rate

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