Letter n°49

Economic Outlook 2022.

"That little time is enough to change all things" Victor Hugo in Tristesse d'Olympio

2020, an unprecedented global crisis, 2021, a strong recovery that gives credence to Victor Hugo's word in the opening. This year, in the world, the path of growth will have to and should overcome two pitfalls, the permanence of the virus and the resurgence, temporary or lasting, of inflation and thus growth, except in China, will again exceed the average rate of recent years.

- ***The brake represented by the virus*** : the Omicron variant is contagious, economic activity is moderately impacted to date but the speed of its spread, with half of the European population to be infected within two months according to the WHO, should make it possible to progress towards herd immunity. After 9 billion doses of vaccines distributed in 2021, this should reach 25 billion by mid-2022, emerging countries should finally be covered and Covid should, if not disappear, at least be controlled. At the same time, we should welcome the development of a malaria vaccine in 2021 whose dissemination will be useful in Africa.

- ***The threat of inflation***, even if temporary, is a brake on growth because it reduces purchasing power and forces central banks to adopt more restrictive monetary policies. At the time of the crisis, governments had done everything to prevent massive unemployment and social crises, but the collateral damage of record monetary injections is inflation. Today, we must hope that bottlenecks will be resolved before a price-wage spiral is triggered.

- ***Growth potential*** : the IMF and the OECD will revise their forecasts for the global economy in 2022 slightly downwards, currently at 4.9% and 4.5% respectively, but growth will remain strong and that is the key. Expansion in OECD countries will be driven mainly by consumption, by sector-specific reduction of bottlenecks, for example in semiconductor production, secondarily by continued investment in the energy transition and marginally by some relocations, such as new semiconductor plants in the United States and Europe.

I. The evolution of growth :

If the financial crisis of 2008 left a lasting impression on people’s minds, the crisis of 2020 was incommensurate. In 2008, world growth had stagnated, but in 2020, it fell by 3.5%, marking the worst performance since the war.

Thanks to the diligence of governments and the vigilance of the central banks, the rebound in 2021 was fast and strong with a growth of 6% and 2022 should allow to see an expansion of 4.5%.

The Omicron variant, particularly in China, is disrupting supply chains but, for the time being, the activity is not too badly penalized. Liquidity remains abundant and there is no increase in the number of bankruptcies.

The outlook for the United States :

- *From a political perspective* :

American democracy has often been a theater of confrontation, but since the assault on the Capitol a year ago, everyone is measuring the extent of the rifts between Republicans and Democrats. The major issues are inequality, at its highest level since 1945, access to voting rights and racial violence.

In the Democratic camp, disappointments are surfacing because Biden has abandoned some promised reforms such as drug prices, taxation, the minimum wage and he communicates less with the people than his predecessors. Therefore, the Democrats should be unable to pass the "Build Back Better" plan and avoid a setback in the midterm elections in fall.

- *From an economic perspective* :

As a result of the generous stimulus packages, $4 trillion, the federal public debt has risen from 80% of GDP in 2019 to 100% in 2021, but this has allowed the economy to record exceptional growth and be rich in jobs, 6.4 million created in 2021 which works out to a monthly average of 550,000 and the highest pace since 1940. It is extraordinary to have reduced the unemployment rate from 14.7% to 3.9% in just over 18 months.

These stimulus packages have also lifted more than 11 million people out of poverty and of debt.

Admittedly, the number of people employed is 2.9 million fewer than in 2019 and the number of people who have opted for early retirement amounts to 2.4 million. Certainly, the participation rate, 61.9% in December, corresponding to a working-age population of 162 million, remains lower than before the crisis, 63.4%, but this year, job creation will remain high and will allow us to return to the pre-crisis level of unemployment, i.e. 3.5%.

The upward pressure on wages, +4.7% in December over one year, will persist because many employees, 4.5 million in November, have resigned from low-skilled service jobs to find better conditions and even more, 11 million, have unfulfilled job offers.

Job creation, wage growth, and the historically low cost of debt servicing (9% of gross disposable income, compared with nearly 13% at the end of 2007), combined with the $2.5 trillion saved, are all reasons for optimism this year, as well as for confidence in consumption.

In 2021, Americans accounted for 9/10ths of the additional global demand for durable goods. This year, consumption will lead to a further widening of the trade deficit, which is historically high at $80 billion.

The *real estate sector* is benefiting from the economic upturn, as evidenced by the record amount of real estate mortgages issued in 2021, $1.61 trillion, an amount higher than the peak of 2005 at $1.5 trillion. Also, a record number of home sales and a 19% year-on-year price increase in October. House price inflation could continue as inventories are low.

In *industry*, the same confidence is evident as the level of inventories is low, investment is strong and margins are high.

There are three caveats to this picture :

Firstly, the recent rise in the 30-year mortgage rate to 3.45%, far from the 2.65% recorded a year ago, is likely to penalize the activity of the real estate sector in 2022.

On the other hand, following the Omicron variant, there has been a temporary slowdown in activity in services and a decrease in retail sales of 1.9% in December compared to November. These are all obstacles to growth because consumption represents 69% of GDP. Expectations for the first quarter have thus been lowered to 3% against 4.2% three months ago.

Finally, perhaps temporary, the trend of the population, an increase of only 0.1% in 2020 which is the lowest level recorded in decades, following a decline in the birth rate (3.5 million against 4 million in 2015), an increase in mortality (3.4 million against 2.7 million in 2015) and low immigration.

Europe :

- *From a political perspective* :

The new coalition in power in Germany is more pro-European than Merkel and therefore more in line with Emmanuel Macron's proposals for further integration. Among the possible advances, the banking union with the possible implementation of a European deposit guarantee scheme, foreign policy with the appointment of a Foreign Minister of the EU and, where appropriate, the change from a unanimous vote to a qualified majority vote.

- *From an economic perspective* :

After a 6.5% decline in GDP in 2020, the recovery was rapid, growth reached 5% in 2021 and, this year, the average growth of the EU should reach 4.3% according to the Brussels Commission.

In 2021, France's growth was 6.5%, Italy's 6.3% and Germany's only 2.7%. This year, growth will remain above potential growth, again more in France (17% of European GDP) than in Germany (25% of European GDP).

As a result of this growth, budget deficits are lower and public debt/GDP ratios are improving. In 2021, the French deficit, initially expected at 9%, was 7%, and in Germany it was only 4.3%.

Another consequence of this growth is that the European unemployment rate, at 8.6% at the peak of the pandemic, has already fallen to 7.2% in November and should continue to decline in the coming months. Unlike the United States, the participation rate, 64.3%, is only 0.6 points below the level at the end of 2019 and Europe is not facing wage inflation.

Great Britain :

Growth was only 1.1% in the 3rd quarter and GDP is still 4% below the pre-crisis peak. According to the Office for Budget, Brexit will cost 4 points of growth in the coming years.

The economy should be well oriented this year but with more constraints than elsewhere : port activity is struggling, whereas it has increased by 50% in the Republic of Ireland. Foreign trade, in relative terms, has been affected by more than 10% compared to other major countries and this will persist because more than 50% of trade is with the EU. Customs formalities with the EU have been tightened since January and this means increased delays and reduced trade.

The shortage of goods is aggravating inflation and penalizing purchasing power. Household wealth compared to 2020 and to that of the US is only slightly up 3.3% to £11.2 trillion, compared to 20% in the United States.

In addition to these obstacles, the shortage of workers estimated at one million and the low unemployment rate at 4.1% push the minimum wage to a level higher than that in France (€11.3/hour in April against €10.5 in France) and affect the competitiveness of companies.

All these factors are likely to weaken an already contested Boris Johnson.

Japan :

GDP is still close to 3% below the pre-pandemic level as the long low vaccination rate has risen to nearly 80% in recent months.

Another advantage for the country is the absence of inflationary pressures, a rarity in today's world, and thus both fiscal and monetary policy can remain accommodative.

Asian countries :

Since 1st January, they have benefited from the entry into force of the RCEP, a trade agreement between 15 Asian countries (China, South Korea, Japan, Australia, New Zealand...), 2.2 billion people against 450 million for the EU, 30% of world GDP, 27% of world trade with 90% of duty-free trade. The only drawbacks are that India is not a member and non-tariff standards are not included. Recall that this treaty was originally an Obama initiative but Trump withdrew the United States from the agreement and allowed China to take its place.

China: an opportunity or a risk?

It is true that China, according to the IMF, achieved 20% of global growth in 2021 with a GDP expansion of 8% but, against the trend of the world's major powers, growth has slowed and disappointed over the quarters (18.3% in the first quarter but 4% in the fourth quarter).

The vaccine is less effective, forcing health authorities to take stricter and more massive isolation measures than in developed countries.

Exports, $3.35 trillion and the equivalent of German GDP, +30% in 2021, +21% again in December over one year, benefited from the global recovery and were the main engine of growth, increasing the trade surplus by more than 50% to a record $676 billion, including $400 billion with the United States (+25%).

But none of this is sustainable as Western governments expand their local production, impose taxes on Chinese imports and will again allocate less to the purchase of durable goods and more to services.

China had not participated in the fiscal and monetary stimulus led by OECD countries, credit growth, which was above 20% in 2016 and 10% in 2020, fell to 7% in 2021, and infrastructure investment fell by 3.5% in 2021.

Industrial production in December rose by only 4.3% year-on-year, retail sales by only 1.7% year-on-year and the unemployment rate rose to 5.1%.

The South China Morning Post points to an increase in small business bankruptcy filings, 4.3 million over 11 months and worse, a decrease in business start-ups, 1.3 million in 11 months compared to 6.1 million in 2020 and 13.7 million in 2019, as a result of raw material cost inflation.

China has just started to lower reserve requirement rates, injected $180 billion in liquidity and the Caixin manufacturing PMI improved in December to 50.9 and the services PMI to 53.1. But growth this year is not expected to exceed 5%.

A topical example is the automotive market. A rebound is expected, a little more than 5% to 27.5 million according to the optimistic estimate of the China Association of Automobile Manufacturers, but it will remain far from the record 29 million registrations recorded in 2017.

Another example of deterioration is real estate and construction. Yesterday, it was a source of 30% of Chinese GDP growth, today, it is a source of concern with a decline in real estate prices and a 9% contraction in housing starts in 2021.

Evergrande's $300 billion in debt is equivalent to 2% of China's GDP. The group lost nearly 90% of its market capitalization in 2021 and today 120,000 jobs are at risk. The company has requested help from the Guangdong Provincial Government, and restructuring is underway. The tribulations of Evergrande are unfortunately not an isolated case. Several smaller operators – Sinic, Fantasia, Modern Land, Fortune Land Development, Kaisa, China Aoyuan Group, Yango Group – have also either defaulted on $ debts or are having difficulty restructuring their debts.

The real estate crisis is having a negative impact on household confidence and consumption because real estate represents 40% of their assets, because many have real estate debts to repay and, in view of the high stocks of unsold properties amounting to 70 million homes, are worried about a bursting of the bubble and further price falls.

This Chinese slowdown raises several concerns :

Gone, structurally, are the three decades of 10%/year on average. Even if, we can underline the confidence of foreign companies to temper this pessimism. Even if, according to UNCTAD statistics, they invested $180 billion in 2021, i.e. 20% more than in 2020, the country's capacity to move from the category of middle-income country to that of a developed country is now doubtful.

A second concern for the country is that the population is aging and, despite the incentive to have 2 or 3 children, the number of children/women has fallen to 1.3x in 2020, a lower level than Japan’s 1.34x.

The third concern, or more precisely a question, is the chances of winning the technological challenge set out in the "China 2025" program if the government persists in sanctioning tech managers and corseting society. Certainly, according to PE Data's estimates, investment in technology remains strong, $165 billion in the first nine months of 2021, mainly in the hardware segments advocated by the government and in enterprise software, with the aim of reducing dependence on foreign electronic chips. In contrast, investment in consumer Internet-related businesses has fallen.

The inflection is similar in Vietnam, with growth of 2.5% in 2021, after years of growth above 7%/year.

The slowdown in China will affect Japan as China accounts for more than 20% of its exports.

Emerging countries :

The crisis has been more severe and long-lasting than in developed countries as GDP is approximately 5% lower than before the crisis.

The aid packages were more modest than in OECD countries because many of these countries were already indebted.

Countries led by populists such as Erdogan, Bolsonaro, Duterte and Orban have been willing to spend but in return have to deal with inflation.

Food inflation is eroding purchasing power and igniting social protest, as in the recent example of Kazakhstan.

To hope for, ***Brazil***, an electoral defeat of Bolsonaro this year as it would be a victory for democracies against populism. Growth was only 4.5% in 2021 because the country was in recession in the second and third quarters and it should be less than 1% in 2022 because the country is forced into a restrictive monetary policy.

To watch, ***Argentina,*** because the country is unable to repay this year's $19 billion installment on the $44 billion loan granted in 2018 and is seeking payment facilities.

To follow, ***India.*** Growth was above 8% in 2021 as the country benefited from deconfliction but will be lower this year as the government will have to start raising rates around mid-year.

To avoid, ***Turkey,*** because, unsurprisingly, after the imposed rate cut to 14%, the Turkish Lira depreciated by 45% in 2021, inflation soared to 36% in December and the producer price index rose to +80%. With the need to increase low wages, there is a risk of an uncontrolled wage-price spiral.

II. The evolution of interest rates :

In all countries except China and Japan, monetary policies are becoming less accommodative. Nevertheless, between the Fed, eager to reduce its balance sheet, and the ECB, still buying every month until the end of the year, policies differ.

Evolution of inflation :

At the beginning of 2021, Larry Summers was right when he predicted an acceleration of demand-side inflation in the US because, in view of the fall in incomes, he judged the aid plans to be disproportionate. But let us not be too quick to blame the governments as the fear at the time was of a deep recession and the risk of social problems had to be averted at all costs.

As a result of this surge in demand, supply shortages in some sectors will continue to be a problem in the coming months.

To absorb the impact of these supply shocks, companies are investing in capacity and in the United States, Biden intends to fight against oligopolies because, according to the BEA, the abuse of dominant positions in sectors such as cars and oil, and the exaggerated use of pricing power explain three of the seven inflation points.

To this sudden increase in demand and this shortage of supply in certain industries, we can add a third inflationary factor, the exits from the labor market and the labor shortages in certain sectors, thus the beginning of wage inflation, currently confined to a few service sectors but whose generalization will have to be monitored.

The evolution of interest rates will depend on inflation. At the moment, central banks want to delay as much as possible because in a few years' time, technological progress, robotization such as digital and 5G, the rapid increase in production capacities, and aging will overcome inflation.

This is not a cause for concern but a wage-price spiral should not be allowed to develop, as inflation could then become structural.

In the coming months, the energy component will play less of a role in inflation, but the rise in food prices and industrial products will have an upward impact on the price index. In Germany, for example, manufacturers consider shortages, and thus bottlenecks, and therefore price pressures to be lasting.

As a result of the pressure on interest rate, the amount of negative-rate debt outstanding in the world has fallen back to below $10 trillion from $18 trillion a few months ago.

Evolution of monetary policies :

Emerging markets were the first to have to raise their rates as they accumulated inflationary and currency pressures.

Of all the major emerging countries, the worst remains Argentina with inflation of 51% in 2021 after 36% in 2020 and 54% in 2019. Then there is Turkey, which has already been mentioned, followed by Brazil, which will be forced to raise its rates by 7.2 points to 9.25% in 2021 because inflation exceeds 10%. Also, Russia increased its rates by 4.2 points, Hungary by 1.8 points, Poland by 1.6 points and Mexico by 1.2 points. And, these increases will persist this year.

Among the ***developed countries,*** only two, Norway and Great Britain, have started to raise rates and Canada, because of an inflation rate of 4.8%, should follow.

In the ***United States,*** December's inflation rate of 7%, with the rate excluding energy and food at 5.5%, a record since 1982 and above the 2% target, is forcing the FED to halt liquidity injections. The 10-year rate, 1.83%, is thus above the high reached in the first quarter of 2021.

The difference between the two sides of the Atlantic is that in Europe, inflation is mainly due to energy, while in the United States it is more due to the increase in salaries and food prices (+12%). Inflation therefore seems more cyclical and temporary in Europe.

A few months ago, the FED was buying up to 40% of new debt and its balance sheet was increased to almost $9 trillion, i.e. 35% of GDP, but the liquidity injections by the FED ($1.5 trillion in March and April 2020 and then $120 billion/month until today) will be completed in March.

There will be four 0.25% rate hikes over the year, in each quarter, and possibly three more in 2023 to bring official rates to 1.75%. In the meantime, the aim is to reduce the FED's balance sheet to 20% of GDP.

Based on past experience, this tighter monetary policy should not cause a market reversal as there is still more than $4 trillion of liquidity in money market funds.

In ***Europe,*** inflation was 5% in December and inflation excluding energy was 2.6%, but this is expected to fall as wage pressures are currently lower than in the US.

In Germany, the 10-year rate has just turned positive again for the first time since 2019, the minimum wage should be raised to €12/hour, which signals the end of mini-jobs, and the rise in producer prices, 9.8% in 2021, a record since 1974, should taper off in the coming months.

The concern is that long-term rates in the most indebted countries, Greece and Italy, will rise as some fear a solvency crisis.

That is why the ECB is exercising the utmost caution. The ECB's €1.85 trillion purchase programme will end in March, but unlike the US, the central bank will continue its purchases, albeit at a slower pace, €30 billion until October and €20 billion thereafter instead of €80 billion. Long-term interest rates are expected to come under pressure as European governments will continue to issue €1.2 trillion, but for the time being, the LTRO (long term refinancing operations), €2.2 trillion at -1% to help banks to lend, is continuing.

Outside the Eurozone, in Eastern Europe, inflation is more problematic, for example in Poland, with a rate of 7.8% in November.

The ***Bank of England*** has just started to raise rates and, given the inflationary pressures, 6% expected in the first half of the year after 5.4% at the end of 2021, it will raise them to 0.75% by the end of the year, i.e. to the pre-crisis level.

The ***Bank of China*** is the only one to go against the tide of the rate hike. Helped by the slowdown in producer prices to 10.3%, confronted with the economic slowdown and the difficulties of the real estate sector, it has just lowered its one-year rate from 2.95% to 2.85% and should continue in this direction over the next few months. However, the Chinese authorities are very cautious because the economy is already highly indebted and there is a lot of overcapacity.

In summary, central banks should not be allowed to lose their vigilance because, after the Fed's failure to forecast inflation (in the spring, it expected inflation to be between 1.3% and 4.3% for the year, but it turned out to be 7%), their credibility is at stake, even if rate hikes may not be the right response to current inflation.

Inflationary pressures will persist in emerging countries, persist for a few months in the United States and Great Britain, diminish in Europe, remain modest in Japan and contained in Southeast Asia.

Conclusion: "It isn't so much that hard times are coming; the change observed is mostly soft times going" Groucho Marx.

After an exceptional economic and stock market year, 3 points of confidence, 2 cyclical concerns, 3 structural concerns.

- ***Confidence in the economic growth*** of developed countries with the assumption of a growth rate higher than the average annual growth of the last two decades, unhindered by rising interest rates as real rates have never been so negative.

- ***Confidence in the strengthening of potential growth*** in the United States and Europe : the productivity gains recorded in 2020 have fizzled out by 2021, but the massive infrastructure investment, digitalization and energy transition plans initiated at the beginning of the crisis will have positive effects.

- ***Confidence in global consumption*** as it will be boosted by the recovery in employment and fuelled by some of the excess savings.

- ***Concern about inflation*** in the United States more than in Europe because of wage inflation.

- ***Concern about employment,*** as expressed by the ILO (International Labour Office) because if the employment situation improves everywhere, in 2023, the number of unemployed in the world would still be 203 million against 186 million in 2019. Even if the European unemployment rate is lower than the pre-pandemic rate, even if the American rate is not far off, the problem is in emerging countries and is the result of delays in vaccination.

  Another general trend is a 1.1-point decrease in the percentage of people of working age who want to work.

- ***Concern about a structural slowdown in Chinese growth,*** which could penalize global growth.

- ***Concern about global debt :*** 25 years ago, no country had a global debt greater than 3x GDP, today there are more than 25 countries, including the United States and China. So it is impossible for central banks to raise rates by more than 4 points as they used to do.

- ***Concern about ageing*** with a declining working population in more than 50 countries. Among the most characteristic examples, Italy with 1 million people lost between 2014 and 2020 and a population falling to 59 million. Also, in India, the birth rate has fallen below the replacement threshold at 2x/woman. Worse, in China, with a working population of 15-59 years down 5% in the last ten years; in the countryside, 34 million single men; in the cities, single graduate women; more separations in couples than marriages and thus births in 2021 down by 12% to 10.6 million (the lowest figure since 1949!), a shortage of labor and especially high-quality engineers. Even in the United States, for the first time, population growth fell to 0.1% between June 2020 and June 2021.

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