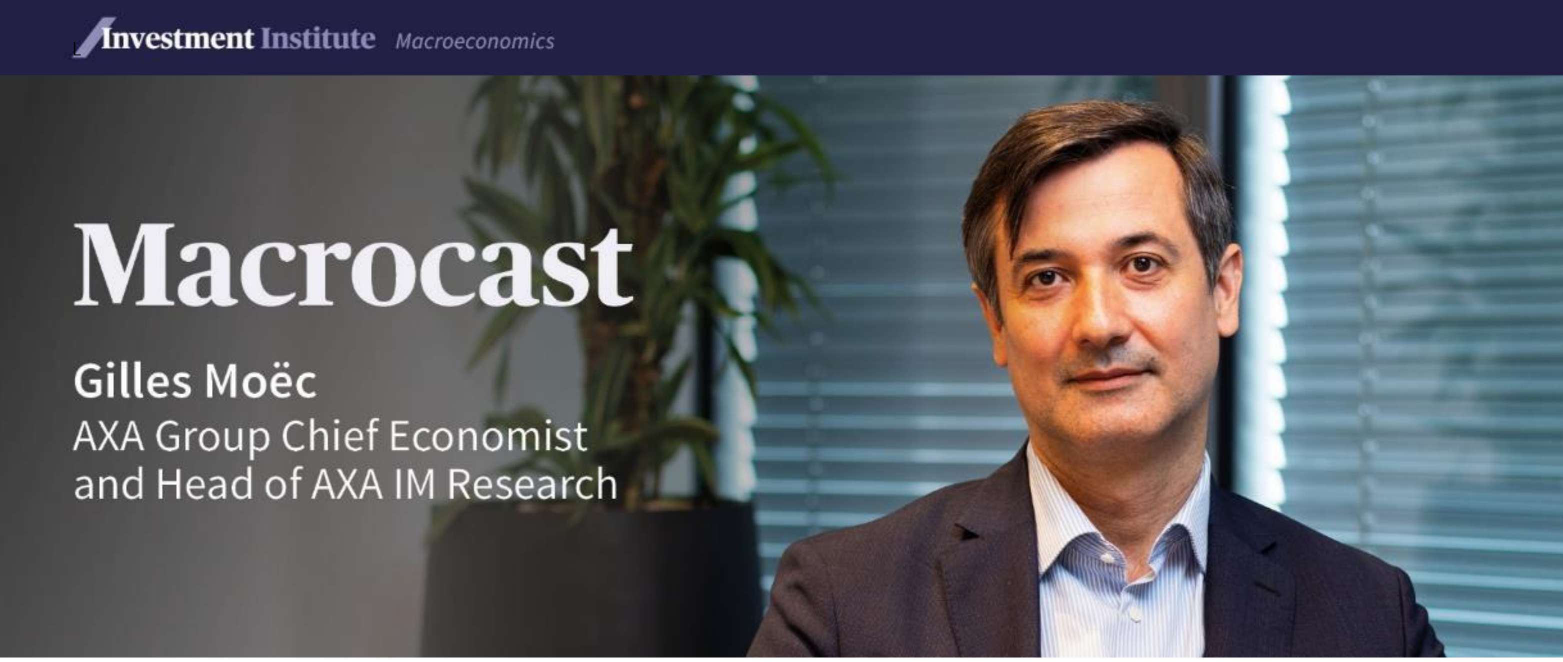
215 – 26 February 2024



Draghi Captures the Zeitgeist

- Mario Draghi's latest speech offers a vade mecum to policy makers in the Post Covid world.
- It would take some convincing in Germany though, even if a shift towards more fiscal activism and a more "muscular" approach to international trade relations may gradually become more tempting in Berlin as well.

Mario Draghi's meeting last Saturday with the EU finance ministers, as he is drafting his report on the Union's competitiveness, is a reminder of his influence. In the speech he gave in Washington two weeks ago, he offered a sweeping vade mecum for policy-making in the post-Covid world. He managed to combine a critique of globalisation under the 1990s operating system – ending on a call for a more muscular approach to international trade relations – with the need for cooperation between governments and central banks in which monetary policy would "provide space" for the former to invest – and thus raise potential growth – and deal with a higher frequency of adverse supply-side shocks which is likely to be a consequence of deglobalisation. Taken in isolation, these elements are not necessarily innovative, but by articulating them in a coherent framework, Mario Draghi has captured the Zeitgeist.

There are limits to his narrative. We think that pushed to its logic it would probably require an upward revision in the inflation target which we think would entail significant risks. We suspect Draghi wants to avoid raising too many red flags since several governments – and particularly Germany – are probably more than hesitant. Beyond the current political difficulties in Berlin which make a strategy re-think difficult, we also remember that Germany has been a clear winner of "all out" globalisation. Changing models is always difficult when the current one has been so obviously successful. Still, between China's less stellar domestic demand and its capacity to compete directly with German products, as well as with the prospect of an even more protectionist US government if Donald Trump wins, accepting a shift towards more mutualised investment spending in the EU and a more "tolerant" central bank should gradually become more tempting for Berlin. We also think that Berlin, once it removes its opposition to a change of model, could play a key role in insisting for moderation in the way a shift to Draghinomics could be executed in Europe. As much as the 1990s approach was flawed, we are also worried that the new-found general enthusiasm for curbing free trade and lifting state intervention could lead to some policy mistakes.

"A fundamental weakness"

Sometimes, one single speech manages to embody the economic Zeitgeist. The lecture given by Mario Draghi in Washington two weeks ago at the National Association of Business Economists may be one of those. The relatively short text combining a more sceptical approach to globalisation to a call for cooperation between central banks and more activist fiscal authorities may be read as a vade mecum to policymakers in the post Covid world.

Mario Draghi did not part with the intellectual consensus of the last 200 years or so as he did not embark on a theoretical critique of free trade as a major source of progress in the world economy. It is more that he sees its execution as flawed. Indeed, he takes on board the view that the "rules of the game" of free trade have not been complied with by emerging nations and has no qualms about singling out China there. But **his point on globalisation goes far beyond denouncing the limits of World Trade Organization (WTO). The crux of his argument is that for international trade to be collectively welfare-enhancing, domestic demand should not be rationed**. Too many emerging nations chose to accumulate current account surpluses – in part to protect their financial stability after the traumatic episode of the Asian crisis in the late 1990s – leaving little space to imports from mature exporters.

Moreover, such "savings glut" depicted by Bernanke as early as 2005, combined with the positive supply shock triggered by the irruption of cheap labour in the world economy, ushered in a long phase of low interest rates/near deflation which crippled the normal operation of monetary policy. Meanwhile, far from strengthening the liberal consensus, such flawed globalisation triggered a rise in populist movements in the mature economies as real wages stagnated or even declined for those directly hit by the competition from emerging producers. These populist movements are the reflection of a massive demand for government protection in the economic realm.

Draghi's conclusions for policymakers are clear. He supports what we would summarise as a muscular approach to international trade. His view there is nicely encapsulated in a straightforward statement: *"countries that want to keep exporting goods may have to be more willing to import other goods, or services, to earn that right – or they will face increasing retaliatory measures"*. Since the President of the European Commission has tasked Draghi with drafting a report on the EU's competitiveness, his musings carry particular weight. He espouses industrial policy, with powerful action by governments, to spur investment – notably in the field of digitalisation and energy transition. This "government comeback" will probably coincide with the persistence of large deficits, and this is where Draghi's call for cooperation between governments and the central bank takes centre-stage. Central banks should be ready not to react too harshly to the effects of activist fiscal policy as long as the latter would be beneficial to supply capacity rather than focusing on stimulating demand. With such tolerance from monetary policy, capital costs could be kept low, making the public-driven investment push sustainable.

We find this whole framework very resemblant to the Biden project in the US. Breaking with the "unfettered globalisation" approach of the Democratic party under Clinton – and largely Obama too – and a return to its old "economically activist" roots from the Rooseveltian to the Johnsonian eras is probably the most obvious characteristic of Bidenomics. **Draghi just like Biden is clearly looking for a response to the current surge in populism in the West**. Rather than defending the orthodoxy of the 1990s version of the international liberal order mainstream policymakers should recognize its flaws to save what is essential, such as the rule of law and the market economy as the main principle of resource allocation, even if it must be complemented by a resurgent state. **In short, borrowing from the populists "just enough" to preserve the principles of liberalism.**

There is something cyclical in those ideological shifts within the liberal camp. Between the two world wars, faced with the mounting competition of revolutionary economic ideas on both the far-right and the far-left, and accepting the failure of the orthodox monetary and fiscal policy recipes applied in the 1920s, many mainstream policymakers accepted to stray from the old principles even before Keynes had provided them with a theoretical backing. The conversion was spectacular in France, where until World War I the staunch defenders of "classical liberalism" in economic matters were largely dominant even within the then leading party of the centre left. By the end of the 1930s, classical liberals had been increasingly marginalised in the parties of government.

From a more technical point of view, **Draghi's call for cooperation between governments and central banks is also the product of his belief in the relative inefficiency of monetary policy in the new configuration**. Indeed, the post 1980s consensus held that monetary policy was the best suited instrument to deal with a cyclical shock as fiscal policy was not nimble enough to respond in a timely manner. During the "unfettered globalisation" era, demand shocks dominated, and were often the product of financial excesses which could be appropriately addressed by a swift response in terms of policy rates and liquidity management. At the time, supply constraints could always be alleviated by resorting to foreign producers. In the new configuration, supply-side shocks will become dominant – deriving for instance from disruptions in supply lines due to geopolitical conflicts. Fiscal policy is in principle better equipped to deal with them – e.g., by immediately mitigating the impact on consumer prices. Then again, fiscal policy will need more "space", which would call for a flexible approach by the central bank.

We think this is one of the limits of Draghi's framework. He calls for governments to produce a *"clear and credible fiscal path ahead that focuses on investment while preserving European social values"*, preferably with a large dose of mutualised funding, to reassure the European Central Bank (ECB). We understand the reference to the social values as a clear indication that, in his mind, investment funding would not come from significant cuts to the welfare programs. We also need to add to the mix the surging cost of defence. If, on top of what is already a daunting to-do-list, governments need to devote resources to deal with frequent supply-side shocks, central banks will have to be *very* tolerant, or very active, to keep public debt sustainable. Draghi advocates a monetary policy focused on inflation expectations, rather than on current price dynamics *"to delineate temporary upward price shock from risks of generalised inflation"*. Implicitly, this is a critique of the current approach by the ECB, which has tightened monetary policy very significantly in reaction to high observed inflation, although inflation expectations remained largely anchored. This however is a fine line, as the last two years have amply demonstrated.

We wonder if, ultimately, an upward revision of the central bank's inflation target would not be the unavoidable conclusion of Draghi's argument – although he chose to stay clear of that debate in his speech – in line with the position advocated by Olivier Blanchard for quite some time. Blanchard's view on accepting a "level shift" in public debt to deal with the mounting global challenges – such as global warming – beyond which the trajectory would stabilise again would also be a natural fit to Draghi's speech. Beyond the daunting consequences of revising the inflation target – we have covered them a few times in Macrocast - we suspect Draghi wants to avoid too many red flags. **He may have captured the Zeitgeist, but some segments of the EU are probably still more than hesitant to embrace his vision.** Convincing Berlin is a major hurdle. Pushing for radical solutions such as lifting the inflation target would make the debate even more difficult.

A very German problem

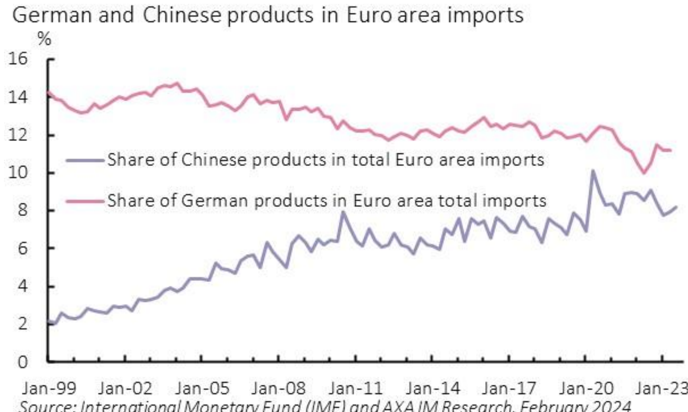
Olaf Scholz' Z*eitenwende* was seen as heralding a major shift in Germany under the pressure of the Ukraine war and the confirmation that the rivalry between the US and China, with its accompanying deglobalisation risks, was not a quirk of the Trump administration. Yet**, a profound and lasting re-orientation of macro policies towards fiscal activism would need to be supported by a political consensus which would need to extend beyond the boundaries of the current coalition** since a super-majority would be needed to reform the domestic "debt brake". It is currently out of reach. Even within the coalition, the gap is too wide between those who would probably be ready to embrace "Draghinomics" (the Greens in particular) and those who are existentially attached to the old orthodoxy (the Free Democrats). Germany has started a fiscal restriction effort of around 1% of GDP in 2024 although it finds itself in a situation of shallow recession. At the European level, none of the new initiatives pushed by Draghi – e.g., an extension of mutualised debt issuance to boost investment – are acceptable to Berlin in the current circumstances. We also suspect that Draghi's call for "cooperation" between governments and the central bank would fall on mostly deaf ears over there. The German members of the ECB board have so far espoused impeccable orthodox views.

While lamenting the lack of direction from German policymakers is becoming a cottage industry in the European commentariat – which routinely oscillates between disapproving of Berlin's lack of ambition in Europe and expressing concerns every time Berlin tables some ideas – **we need to recognize that changing models is always more difficult when the current one has been very successful**. In his speech, Mario Draghi includes Germany's economic strategy of the last 20 years, with its relentless accumulation of current account surpluses, among the contributors to the "fundamental weakness" in globalisation. The sovereign crisis of 2010-2012 forced the rest of the Euro area to convert to the model – in the periphery via a collapse in domestic demand – but there it was never a first preference. In the German case, the large support for the model was not only the expression of a "cultural disposition" – your humble servant confesses having issues with this sort of explanations – but also quite simply the recognition by public opinion that **Germany was one of the winners of globalisation as it had been unfolding since the 1990s.**

In a mercantilist model, in which national players do not believe international trade is a positive sum game, governments will be tempted to look at their competitive position versus another country across three dimensions. (i) The degree to which this foreign competitor jeopardises the national producers on their own domestic market ,which in the case of an EU member state should extend to the entirety of the single market; (ii) the degree to which national producers can gain from exporting to this foreign competitor, which depends among other parameters on its growth prospects and openness to trade; (iii) how much of the threat this foreign competitor can be to national producers in third countries. In a very simplified version, the US problem is that the Chinese penetration of its own domestic market has been massive, while US exports to China remain comparatively small. Washington until recently could afford to ignore competition from Chinese products on third country markets as there was only limited overlapping of US and Chinese product specialisation. Things started to change when China moved closer to the technological frontier and started to represent a threat on high tech which remains one of the – rare – strong spots for US players. With pressure on these three dimensions, that China has become a national obsession in the US is not surprising.

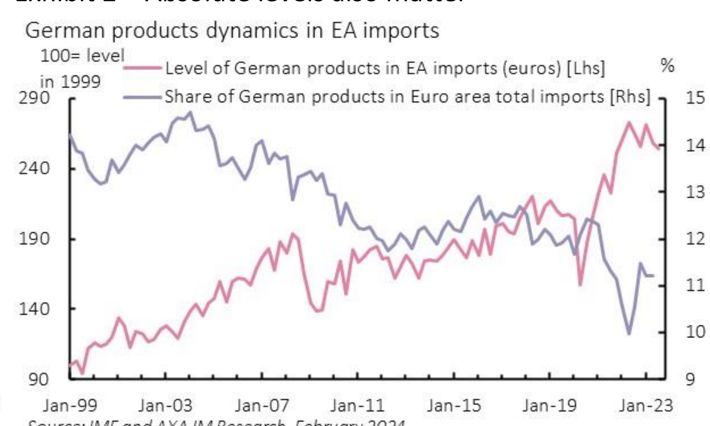
On these dimensions, Germany has been in a much better position. Let us start with Germany's "backyard market". While the share of German products in Euro area total imports has been slowly falling on trend (see Exhibit 1), the decline has been small (c.3 percentage points since the beginning of monetary union) compared with the surge in the penetration of Chinese products (c.6 percentage points). The picture also needs to be complemented by looking at the absolute level of German exports to the Euro area: even if their *share* has fallen, they have continued rising, and benefited massively from the shift in demand towards manufactured goods during Covid (see Exhibit 2). **So far, German producers have been handling the irruption of Chinese products on the European market well.**

Exhibit 1 – Sharing the European market



Source: International Monetary Fund (IMF) and AXA IM Research, February 2024

Exhibit 2 – Absolute levels also matter

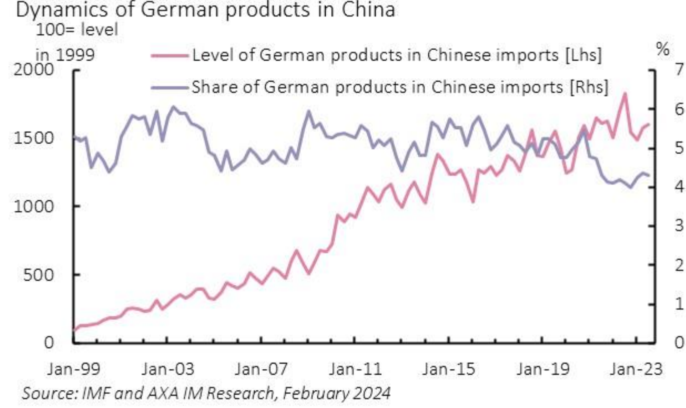


Source: IMF and AXA IM Research, February 2024

On the second dimension of bilateral competitiveness, Germany has also found itself in a quite favourable position in China. Its market share there – computed in Exhibit 3 as the share of German products in total Chinese imports – has been stable for the last 25 years around a very respectable 5%. But this mere stability meant that **German producers have been able to fully benefit from the huge increase in Chinese demand over the last 25 year**s, multiplying their shipments by more than 15.

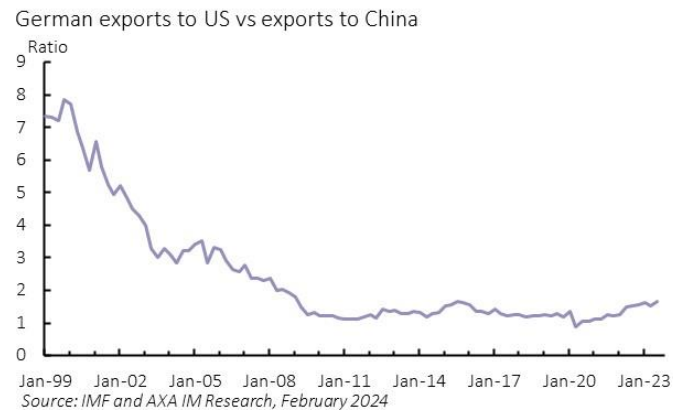
Germany's strategy was fully understandable when looking at the respective dynamics of its exporters in the US and China (see Exhibit 4). While at the beginning of the century Germany exported 7 times more to the US than to China, by the time of the Great Financial crisis the ratio had fallen to 1.5. German exporters did not lose market share in the `US (it has been standing at around 5% as well over the last 25 years), bringing evidence that across the "third dimension" of competitiveness (competition in third country markets) Germany has withstood the emergence of China well. **The decline in the relative share of the US in German exports was simply the reflection that US demand – although more dynamic over there than in Europe – simply could not keep up with the stellar Chinese performance.**

Exhibit 3 – Illustrating the Chinese traction



Source: IMF and AXA IM Research, February 2024

Exhibit 4 – China versus the US



Source: IMF and AXA IM Research, February 2024

Given this impressive list of strengths, German leaders could be forgiven for trying to hold up to their economic model and take a sceptical view to the "muscular approach" to international trade. Olaf Scholtz' decision to visit China on his own last year, while initially pushing for progress on the stalled EU-China Comprehensive Agreement on Investment (CAI) rather than accompanying in their joint visit Emmanuel Macron and Ursula Van der Leyen, who take a dimmer view on the CAI, was a clear illustration of Berlin's attachment to the "old" globalisation compact.

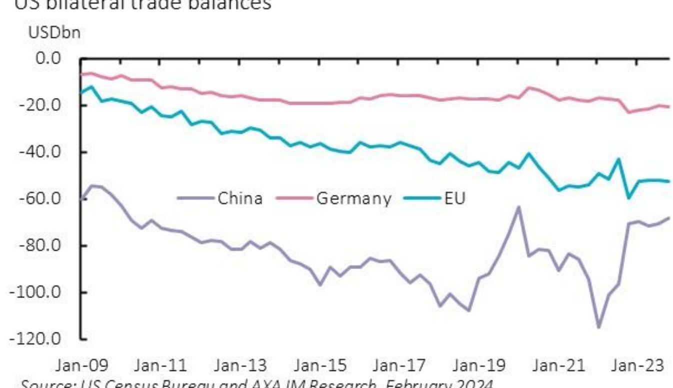
There are however signs that Germany has started to change its approach. The Federal government has issued in July 2023 its official "strategy on China" (see the link here) in which the country is explicitly labelled as a *"partner, competitor and systemic rival*", labels which we are now very close to the ones used by the US government and echoing the proposition from the European Commission in 2019. "De-risking" the German economy from a too tight economic relationship with China was also made explicit in the document: "*the Federal Government will promote the diversification of our economic relations so that we will continue to participate in China's economic development while reducing our dependence in critical sectors",* while a good measure of frustration on how China complies with the rules of the game was also expressed ("*our relations with China are characterised by numerous asymmetries"*). Separately, in the first national security strategy document issued by the German government (see link here) the following statement also clearly illustrates a change of attitude : "*China is trying in various ways to remould the existing rules-based international order, is asserting a regionally dominant position with ever more vigour, acting time and again counter to our interests and values*", even if a degree of cooperation and partnership with China is presented as unavoidable (but that is also explicitly recognized by Biden's National Security Advisor).

We suspect some of these changes were motivated by new threats appearing on the three dimensions of competitiveness we reviewed. Indeed, even if this has not yet clearly appeared in the data, Berlin is probably sensitive to the emergence of Chinese competition on products on which so far German producers were facing little challenge. The Chinese push in electric vehicles on the European market, combined to a decline in the position of German brands in this segment in China itself could not go un-noticed given the disproportionate weight of the car industry in the German economy.

Besides, it makes less sense to focus on China as a key export market if its growth prospects look significantly weaker in the years ahead than over the last two decades. Symmetrically, **the prospects of the US as a major source of traction for German products are strong.** Instantaneous nominal GDP growth is currently higher there than in China, and the promise of productivity-induced stronger real growth in the future makes it tempting for German companies to focus on America for their commercial strategy. In the context of persistent rivalry between the US and China, it will become increasingly difficult to maintain "economic neutrality" between the two.

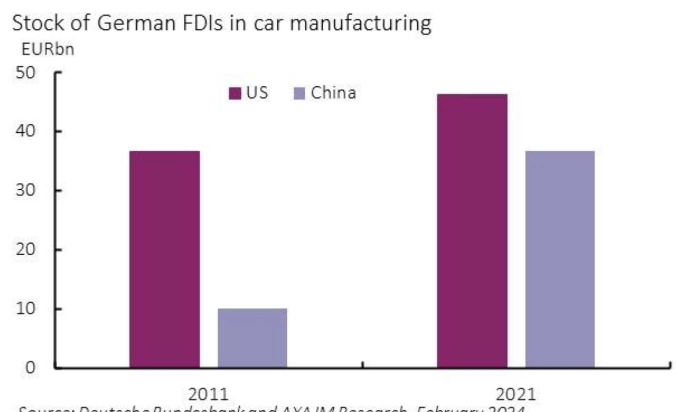
This comes with its own risks though. Donald Trump has publicly stated his intention, should he win the elections, to slap a 60% tariff on Chinese products…but also to raise tariffs on all imports to at least 10%. Whatever the doubts one may harbour on the true willingness of Donald Trump to effectively pursue this once in office – the inflationary impact and hence the welfare loss for US consumers would be large – the world has learned from his first term to take such threats seriously. A Trump administration would probably – again – focus on bilateral trade balances with the US, and from this point of view German products would be tempting targets (see Exhibit 5). We would expect the US to try to get commitments from its allies to shift production to the US to service local demand. Over the last 10 years the stock of German Foreign Direct Investment in the US in the car making industry has not increased massively – see Exhibit 6 – while German companies focusing on their Chinese operations. This may have to change.

Exhibit 5 – Germany could be a target of Trump 2.0



Source: US Census Bureau and AXA IM Research, February 2024

Exhibit 6 – A shift in direct investment



Source: Deutsche Bundesbank and AXA IM Research, February 2024

If the US were to accelerate de-globalisation after November, Germany would have a strong incentive to move closer to Draghinomics. Indeed, reviving European demand will become more vital for the German industry. **Rather than bluntly opposing the policy shift, Berlin could play a key role in insisting for restraint in the way it could be executed**. Indeed, while we have sympathy for a surge in investment in Europe – three weeks ago we highlighted how the region may have "missed the train" on digital capex 10 years ago – we are also worried that an all-out departure from the 1990s orthodoxy would lead to some policy mistakes, for instance if state aid ended up strengthening monopolies and fostering "white elephants". Market fundamentalism in the 1990s had its obvious shortcomings, but one should not forget that it was not imposed by outside forces but came by democratic consent largely in reaction to the failure of dirigiste policies in the 1970s. Germany, after accepting the limitations of its current economic model could be a voice for moderation but we also recognise that in the current political configuration this may not be an easy proposition.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC minutes (Jan) suggest Fed concerned about cutting rates too soon • Existing home sales (Jan) was up to 4mn, showing signs of pick up in broader housing sector • PMIs (Feb, p) Mfg up to 51.5 from 50.7 in Jan, confirm continued growth; Services slowed to 51.3 • Initial jobless claims (17 Feb, w/e) down by 12k to 201k, continued signs of stability in jobs market	• GDP (Q4) revision, 3.3% (p), also includes GDI release • Personal spending (Jan), watch following weak retail sales, saving rate expt'd rise from 3.7% in Dec • PCE inflation (Jan) – core expt'd lower from 2.9% Dec • ISM survey (Feb), hold onto Jan's gains • Conf Bd Cons conf (Feb) watch further gains in expectations component
	• Business surveys for February suggested uninspiring euro area GDP growth momentum to continue • Final Jan HICPs unrevised. Momentum in services running at 3% annualised pace • A significant fall in German investment was mainly responsible for the unrevised -0.3%qoq in Q4 23.	• Last ECB speeches before quiet period starts, ahead of the meeting the following week. • Euro area flash HICP for February. We look headline/core to edge down to 2.5%yoy/2.9%yoy • Full details of EC survey for February
	• PMI mfg (Feb, p) edged up to 47.1 from 47.0 in Jan. Services held steady at 54.3 • GfK consumer confidence (Feb) fell back to -21 from the -19 in Jan, showing concerns among consumers after Q4 GDP • Jan achieved record fiscal surplus of £16.7bn, £9.2bn larger surplus than Jan 2023	• Nationwide HPI (Jan) ongoing price momentum • Mortgage approvals (Jan) signs of further gain? • BRC shop price index (Feb) first signs of underlying inflation trend • Mfg PMI (Feb, f) confirmation of 47.1 prel reading
	• Machinery orders surprised slightly to the upside growing by 2.7%mom in December • PMI flash composite edged down 1.2points to 50.3 in February. Services slowed but remained resilient	• CPI for Jan • Industrial production for Jan
	• 20 Feb: 25bps cut on 5Y LPR to 3.95%, marking the biggest cut in history, while 1Y LPR is unchanged, staying at 3.45%. • FDI (SAFE): China attracted a total of USD 33bn capital inflow in 2023, 82% lower than in 2022	• 1 Mar: NBS PMI mfg and non-mfg (Feb) • 1 Mar: Caixin PMI mfg (Feb)
	• CB: Korea (3.5%), Indonesia (6.0%) & Turkey (45%) kept rates unchanged as expected • Jan CPI (yoy): Malaysia (1.5%), Singapore (2.9%) & South Africa (5.3%) • Q4 GDP (yoy): Thailand (1.7%) & Peru (-0.4%)	• CB: Hungary is expected to cut -100bps to 9.0% • CPI (Feb): Indonesia, Peru & Thailand • Q4 GDP: Brazil, India, Taiwan & Turkey PMIs across EM countries

Upcoming events		
	US:	Mon: New home sales (Jan); Wed: Q4 GDP (Revision); Tues: Durable goods (Jan), conference board consumer confidence (Feb); Wed: GDP (Q4); Thurs: PCE prices (Jan)
	Euro Area:	Tues: EZ M3 (Feb); Wed: EC survey (Feb); Thurs: flash HICP in member states (Feb); Fri: EZ flash HICP (Feb)
	UK:	Wed: BRC shop price index (Feb); Thu: Mortgage approvals (Jan); Fri: Nationwide HPI (Jan), Mfg PMI (Feb, f)
	Japan	Tues: inflation (Jan); Wed: Industrial production (Jan)
	China:	Fri: NBS PMI mfg and non-mfg (Feb), Caixin PMI mfg (Feb)

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