TRICKLE-DOWN EFFECT WITH FISCAL LEVERAGE

On financial markets, the summer fears have subsided. The S&P, the world's leading index, is close to its historical highs reached on July 16th (+17% since the beginning of the year). In Europe, the Eurostoxx50 (+10%) has recovered more than 11% from the low of August 5th and is not far from the March and July highs: it needs to rise another 10% to reach the absolute peak touched in 2000. The usually cautious Swiss SMI index (+12% since January), which struggled in the first half to keep pace with the more capitalized and diversified Western indices, managed to surpass the July peak and is just a step away from the record of March 2022. Even Japan, the epicenter of the summer earthquake (losing 12% in a single session on August 5th), has recovered two-thirds of the losses. The global MSCI World index has even broken the resistance set by historical highs.

The spark for the recovery was ignited by Federal Reserve Chairman Jerome Powell at the annual central bankers' meeting in Jackson Hole. His victory lap on inflation, but also on growth, warmed up the markets. "Four and a half years after the arrival of COVID-19 - Powell said -, the worst economic distortions linked to the pandemic are fading. Inflation has decreased significantly. The labor market is no longer overheated, and conditions are now less tight than they were before the pandemic. Supply constraints have normalized. And the balance of risks for our two mandates has changed. Our goal has been to restore price stability while maintaining a strong labor market, avoiding the sharp increases in unemployment that have characterized previous disinflation episodes when inflation expectations were less well anchored. Although the task is not complete, we have made significant progress towards that outcome."[1] The explicit acknowledgment of these advances led markets to consider a first

[1] Jerome H. Powell, "Reassessing the Effectiveness and Transmission of Monetary Policy", Jackson Hole, Wyoming, August 23, 2024. https://www.federalreserve.gov/newsevents/speech/powell20240823a.htm.

interest rate cut at the upcoming September 15-18 meeting as almost certain, between 0.25% and 0.5%. The emphasis on the change in the "balance of risks of our two mandates" between inflation and unemployment has led markets to imagine that Powell will focus more on job preservation, thus shifting towards more growth-friendly monetary policies in a scenario that is already shaping up to be a soft landing. In practice, the American economy is managing to bring inflation towards 2% while avoiding a recession, with the statistical probability of such being generally recognized between 25% and 30%.

The Fed's charge is part of the increasingly widespread movement of monetary easing. In August, for the first time since April 2022, the number of central banks that cut interest rates (56%) exceeded those that raised them (44%): among these, the European Central Bank (ECB), the Swiss National Bank (SNB), and the Bank of England. The money supply (M2) of the world's major financial centers has instead remained stable at the maximum levels it has been fluctuating within since March 2022.[2] Nevertheless, inflation in OECD countries in the second quarter stood around 2.7%. In many of the more developed economies, it continues to slow down, as in Italy and Canada, where it fell to 1.6% and 2.5% respectively in July, and in the United States, where the PCE, the Fed's preferred price indicator, is at 2.5%. Signals of a possible acceleration seem limited now: nominal wages, while being at levels higher than the pre-pandemic period in G10 countries, continue to decline relative to the current annual increase of 4%. In OECD countries, this occurs with growth consistently around 1.8%, an unemployment rate around 5% (albeit slightly up this year), and a labor force participation rate at an all-time high. Not to mention corporate earnings, which despite a fair level of skepticism, grew by over 10% year on year in the second quarter.

The combination of these data indirectly confirms Jerome Powell's proud optimism. Few economists would have bet on such success just a few months ago. How could - many wondered - modern, complex economies grow in a context of high rates?

[2] https://en.macromicro.me/central_bank/overview.

Attempts at answers abound. Service economies, increasingly digitized, need less of the strong capital injections that characterized heavy industry and construction. Years of low rates have led many to borrow at medium-to-long-term fixed rates, while returns on current accounts have turned positive, containing the erosion of savings accumulated during the pandemic.

These are undoubtedly important aspects. But it is probably the fiscal policies decided by governments that are fueling aggregate demand. The measures adopted in the urgency of the pandemic now show all their electoral value. It is difficult to remove them in societies where the gap between rich and poor has widened over the past twenty years. The United States is the country where this contrast has stood out to the point of producing presidential candidates who embody the extreme values of their respective factions but do not intend to address debt problems. On the contrary, Washington will replicate this year a deficit equal to 7% of GDP (Gross Domestic Product), while the average overruns are around 4.4% in the richest countries. Old economists would say it is strange to maintain strong fiscal leverage when unemployment is contained.

But there is a fundamental aspect to consider. Years of economies based on Quantitative Easing (QE), i.e., the strong production of liquidity as demonstrated by central banks' balance sheets, have only moderately succeeded in creating wealth in the real economy. The idea of the trickle-down effect, of liquidity dripping from the financial economy to the real one, has not worked much, although it has allowed the system to be sustained: the real economy has not developed as much as the financial one in the last fifteen years. Inflation seemed a relic of the past, while deflation was a constant threat precisely because there were no excesses of liquidity in the productive system: it remained stuck in the financial one. Even before the pandemic, it was understood that liquidity needed to be directed directly into the real world. With COVID, it even came to putting money directly into consumers' pockets.

Powell found himself having to manage this duality: maintaining QE, albeit reduced, in a context of states that spend. At first, he assessed inflation risks as “transitory.” But when price increases proved persistent, he raised rates above 5%, ready to accept a feared recession. But this did not materialize precisely because, in parallel, fiscal policies kept demand alive. It is in this dual context that the transmission from the financial to the real productive economy found a raison d'être that went far beyond the trickle-down effect. Instead of discouraging demand and productivity, inflation served to stimulate the search for investments in the real economy.

The war in Ukraine certainly played a role. Putin hoped to destroy Western economies through inflation driven by energy and raw materials. He faced the determination of the Federal Reserve and Biden, who worked to keep oil prices low, also favoring the much-maligned fracking that even candidate Kamala Harris does not intend to ban or even limit. The American administration was also helped by China, which chose not to implement the powerful stimulus measures needed by its economy to overcome the transformation it is experiencing.

The boom in Artificial Intelligence (AI), instead of remaining anchored to the financial economy as happened with the dot-com bubble at the beginning of the millennium, precisely because of investments from the private economy and government entities operating in a wartime context, has outpaced the trickle-down effect, directly impacting the real economy. In the first phase, the attention of investors was especially drawn to the seven large companies directly involved in the new technological evolution. But now, with the prospect of rates falling without first facing a severe recession, other stocks also reflect the prospect of increasing profits and thus facing new investments in the inevitable dynamics of Artificial Intelligence.

Were the fears that the markets exhibited in August completely misplaced? Simply dictated by summer speculative games. Probably not. The markets signaled how a structural imbalance between a country, Japan, which is destined to raise rates, while others, especially the United States, lower them, could contaminate the entire Western financial system: if Japan stops investing in American public debt, strengthening the Yen, the American financial structure will suffer heavily. But geopolitics has its weight: Tokyo has not failed to indicate that its rate hikes will be very moderate. The second aspect concerns inflation itself. If markets were to become convinced that Powell's optimism is exaggerated and that the fight against inflation takes a back seat, perhaps for strictly political reasons, the scenario would change quickly. In a careful historical analysis, Christina and David Romer identify two channels of success in the fight against inflation: reducing expected inflation and avoiding premature easing of monetary policy.[3] The markets will be very attentive to these two aspects after Powell's words.

The stock markets enter a difficult seasonality that could mark some setbacks between September and October. The new form of the trickle-down effect will continue to support them, at least until the issue of public debts, especially the American one, takes precedence.

Translated with ww.DeepL.com/Translator/CSM

[3] Christina D. Romer, David H. Romer, *Lessons from History for Successful Disinflation*, Working Paper 32666, National Bureau of Economic Research, July 2024, p. 2.