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CFM TALKS TO... MEGAN GREENE

Introduction

Megan is a Senior Fellow at the Mossavar-Rahmani Center for Business and Government at Harvard Kennedy School. She is also the Global Chief Economist at Kroll, the US-based risk consulting firm, and serves on the board of various organisations including the National Association for Business Economists, and the Parliamentary Budget Office in Ireland. She previously held the posts of Global Chief Economist at John Hancock, Head of European Economics at Roubini Global Economics and was the Euro Crisis Expert at the Economist Intelligence Unit. Apart from regularly consulting with central banks and governments, she also writes a fortnightly column for the Financial Times and is a regular contributor on major TV and radio outlets. Megan is a member of the Council on Foreign Relations and holds a B.A. from Princeton and an MSc. from Oxford.

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CFM Talks To ... Megan Greene

CFM: We must start with the Russian invasion of Ukraine. In short, how do you see this crisis reverberating through the global economy? What do you consider as the key negative spillover effect(s)?

MG: Clearly, the most obvious consequence is rising energy costs. This will be a drag on growth, even for a country like the US, which is a net exporter of oil. While demand has recovered in the US and elsewhere, supply can't magically be turned on to meet it. The US has been in an energy crunch even before Russia invaded Ukraine owing to chronic underinvestment in fossil fuels since 2014. Nor has much institutional money flowed into the oil patch – this partly because of ESG-related pressure. On balance, though, higher energy prices will disproportionally hit Europe, simply because of its reliance on natural gas from Russia.

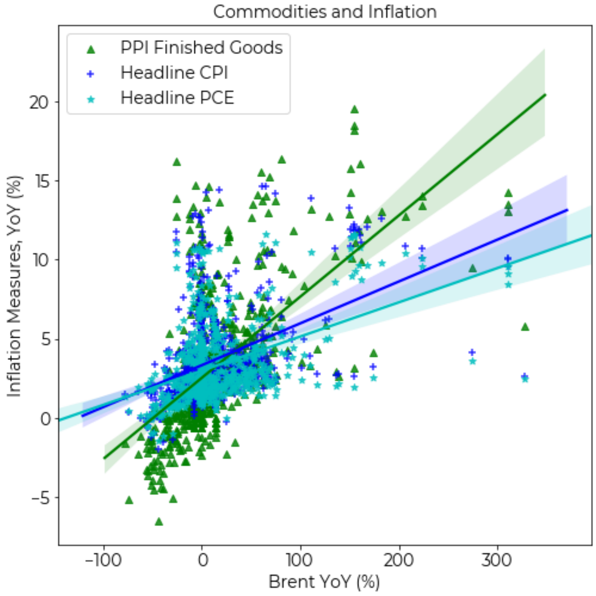
This supply shock is coming at a time when major central banks are already wrestling with high inflation. So, all this leaves policy makers in a tough spot because energy costs will be driven even higher, as will the cost of any goods that require energy as an input – which is most goods. At the same time, consumers are being hit by higher prices – it's more expensive to heat your house, to fill your car, etc. This is likely to sap demand and drag on growth. This evokes the nightmare scenario of stagflation: sideways growth and persistently high inflation – which is increasingly looking more likely, especially for Europe. Central banks don't have good tools to address this. They can either choose to boost growth (more accommodation), or lean against high inflation (less accommodation), which will act as a drag on growth. And I think the ECB is about to land there.

> **"Mainstream economics assumes very simple characters in a complex system, whereas agent-based modelling assumes very complex characters in a simple system. I think the latter has yielded much better forecasting results.**

The other major issue has been the stubbornly persistent disruption of supply chains. Many economists have argued it would be mitigated by the end of this year. I no longer support this view. Russia, in addition to oil and gas and its derivatives, is also a major exporter of other key commodities, wheat and fertiliser being the most obvious. Come spring, food prices will have risen, and that will cause major issues, especially in the Middle East. Russia is also a major exporter of key metals, an input into a vast number of goods. Semiconductor chips being one, which will only intensify many existing shortages.

Geopolitical risk, of course, is yet a further cause for concern. The rest of the world is watching closely, China especially, for how the West and its allies are responding in Ukraine. Their response could have enormous implications for any escalating tensions between China and Taiwan. I have long held the opinion that Russia invading Ukraine was a 'high probability, but low impact' event, whereas China invading Taiwan is a 'low probability, but high impact' event. How we respond to Russia will impact the calculus for China.

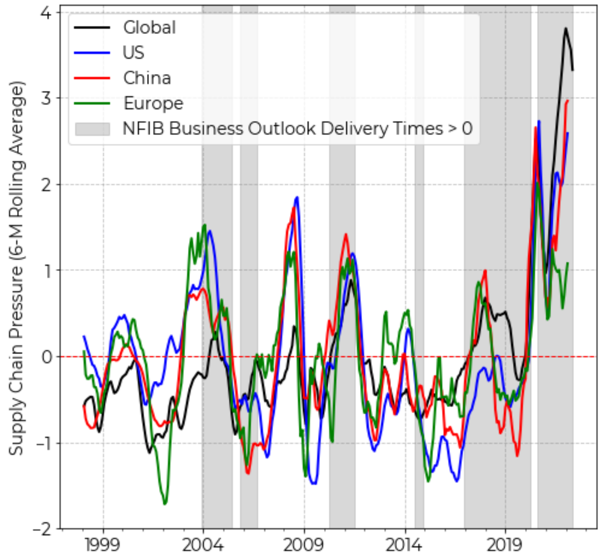
Inflation and Energy



Source: Bloomberg, GFD, CFM

A scatter plot showing the correlation between the YoY percentage changes in the price of Oil (in this case, the benchmark Brent contract) and various measures of inflation using data since 1960. There is a positive correlation between energy and measure of consumer inflation – although slightly more for headline than CPI than for PCE, simply because PCE strips out the more volatile energy component. There is, however, a much stronger correlation with especially PPI Goods – i.e., the input cost of manufacturers of the various products in the economy. It can serve as a leading indicator for CPI, depending on the willingness or need of producers to pass on the higher costs to the end consumer, which in turn trickle down into the CPI.

Supply Chain Pressure



Source: Bloomberg, CFM

The Federal Reserve Bank of New York compiles a 'Supply Chain Pressure Index' of various countries, as well as a global equivalent using a selection of metrics that track changes in freight volumes and prices. The plot shows the rolling 6-month average of each index for selected countries with data as of end of May 2022. Overlaid is the periods where the Philly Fed's Delivery Time diffusion index, on a rolling 6-month basis, exceeds 0, i.e. the reported change in delivery time compared to the previous month for reporting manufacturing firms has increased. Historically, the supply chain pressure index was a good leading indicator for increased delivery waiting times in the US. The index has also reached a record level, and even if, as suggested, supply chain pressure eases, historically it has taken between 6-12 months to recede to 0 from a prior peak

CFM: What might the implications be of any further energy trade embargoes? How much worse could it get?

MG: It was clear to me that the US would do this, it is less clear whether Europe will follow suit, and/or to what extent. For Europe, an oil embargo would be much less disruptive than a natural gas embargo. A general energy embargo, however, would be disastrous for Europe.

The case for the US is more ambiguous. While the US is a net exporter of oil, there is a question of how much more shale fields could provide. We tend to think of shale as inexhaustible and unlimited in the US, even though no goods are inexhaustible. But we know that the first 55% of a shale field is more productive than the last 45%, and we are in the last 45% of many of these fields.

I think it is clear that Europe and the US will be trying to secure additional supplies from elsewhere, but this won't be enough to offset what would be lost from Russia in the short term. Net-net, prices will go higher, irrespective of any trade embargoes.

CFM: Given the gravity of the Russian invasion, one could argue that the Chinese response has been pretty mum. How do you think China will respond?

MG: First, I think there has probably been, officially or not, coordination between Russia and China. China, like Russia, has no interest living in a unipolar world with the US as the global authority, and they have likely coordinated to launch the US from that seat. You can see that, for example, Russia only invaded after the Winter Olympics in Beijing concluded, and Chinese jets flew into Taiwanese airspace as soon as Russia started amassing troops on the Ukrainian border. The Russian central bank has quite a lot of gold, and crucially, renminbi, and China has not imposed a blanket ban on the Russian central bank. China has also agreed to buy more Russian commodities.

But I don't think that Chinese banks will risk transacting with the Russian central bank for fear of retaliation from the US, in particular given that the dollar continues to be the global reserve currency. China has some tacit patience, but only so much.

CFM: And as for the impact more broadly on emerging markets?

MG: It's a fairly complex picture but dominated by two narratives.

Developed market central banks are desperate to tighten – that will increase borrowing costs for emerging markets. The Fed is much more likely to aggressively withdraw accommodation than the ECB, and to tighten policy even in the face of the Russian invasion – given it will affect the US economy less. The dollar should appreciate, borrowing costs for emerging markets should go up, which will make it more difficult to service debt in non-local currencies. It will also make imports more expensive, given that much of the world's trade is invoiced in US dollars. For importers, this will make it more expensive and a drag on growth. Emerging markets, broadly as an asset class, are retrenching, with capital flows to these countries on aggregate, ex. China, having been weak over the past couple of months according to data from the IIF. Emerging markets were generally overleveraged before the Covid pandemic, had to borrow to fund their response, and now face inflationary pressure themselves. This is a scary scenario for emerging markets, whereby you could see many getting entangled in debt distress.

The other scenario, though, suggests that external exposure of emerging markets is much better now than in the 1980s, their current account balances are healthier, they have higher levels of foreign exchange reserves, and, also, for those emerging markets that are commodity exporters, they stand to benefit from Russia invading Ukraine.

Both are valid arguments. However, I tend to favour the former.

CFM: The Fed is likely to tighten throughout the year, with the markets predicting the policy rate at just under 3.5% by the end of the year. Given the unfolding situation in Russia, and its impact – especially for energy as we've discussed – do you think the Fed might still surprise markets?

MG: It's worth pointing out that the Fed's estimate for the long-run neutral rate is 2.5% - and it is 1.5-1.75 per cent now. Real rates remain negative and there is room for the Fed to hike without impinging on growth dramatically. With inflation expectations jumping significantly in May, the Fed is concerned about them becoming unanchored. The Fed cannot do anything about supply issues stemming from global supply chain snarls, Russia invading Ukraine and China locking down areas because of Covid. All it can do is engage in aggregate demand management, which involves killing off demand. It will be difficult for the Fed to do this perfectly using the blunt tool of rate moves, which kick in with a lag. The Fed is aiming to engineer a soft landing, but it has only succeeded in doing so three times in history and unemployment was much higher at the beginning of each of those rate hiking cycles.

There is another type of supply issue the US is facing, which, unlike in Europe, is a supply of labour. The labour force participation rate has not recovered to its pre-pandemic levels, let alone its trend. The big question is what is happening to the American worker. Where did they go? I tend to think most of it is down to Covid: people are sick, or worried about getting sick, or dependents have gotten sick, etc. Now that the pandemic seems to be mostly behind us, those people should get back into the labour force. The reason many of these workers have been reticent of returning to the labour force is that the US provided much more direct financial stimulus than say in Europe, so there was a sizeable financial cushion for households. We know, by looking at anonymised bank account data, that it was low-income households that benefitted the most from stimulus cheques, but they also burned through them the fastest. Distribution matters a lot – if you consider how much low-income households tend to spend on average per month. This extra income, by some estimates, would be depleted before the end of this year. In which case, many workers would have to capitulate. I have argued before that many are overestimating how long workers are expected to remain on the side lines.

I'm more concerned about what the ECB may do. The central bank will end its bond buying programme at the end of June, leaving the eurozone with no feasible tools to address fragmentation. The last two hiking cycles involved the ECB hiking into higher inflation with disastrous effects. Even without Russia invading Ukraine, too much tightening by the ECB would be a huge mistake

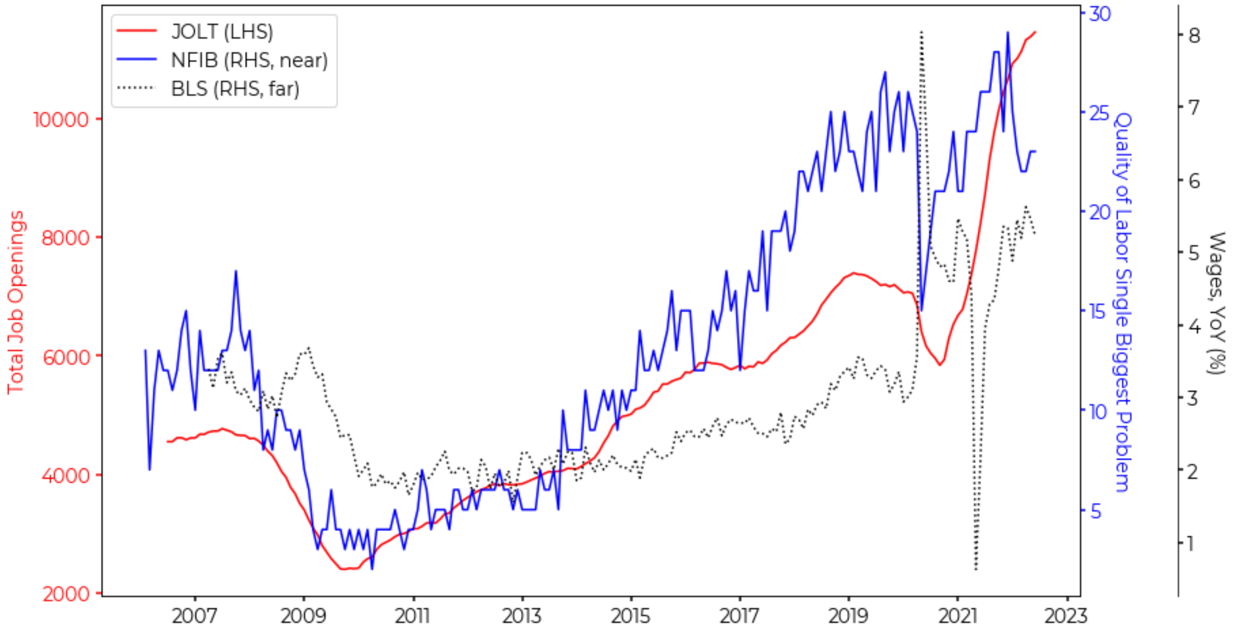
CFM: Teasing out what you mentioned about the US labour force, and your arguments for why American workers are likely to rejoin the labour market: what is the likelihood of continued wage pressure, and what specific data do you monitor to inform your view?

MG: Clearly, if many of the holdouts jump back into the labour force, wage pressure will moderate. There is still a concern about the inability to find labour. And sure, there will be mismatches between those who return, and the skills required. However, if you look at the NFIB survey data, the number one complaint in late 2019 was that businesses could not find skilled workers. But in spite of this, wage growth remained very much sclerotic. You can have this skill mismatch, but it needn't drive wages higher.

In terms of the wage-price spiral scenario – we also need to look at productivity growth in order to put wage increases into perspective. This often gets ignored by economists. We use wages as a rough and ready measure for unit labour costs, largely because productivity does not tend to change much from one quarter to the next. It has also been quite low for the developed world over the past decade. We are, however, seeing productivity growth accelerating – partly owing to the generally less productive hourly service workers who dropped out of the labour force – a 'compositional' effect. But we have also seen surveys, where companies accelerated their efforts to automate and digitize during the Covid lockdowns. If that is the case, that should feed into higher productivity growth. Companies, in these surveys, also overwhelmingly say that they plan to continue automating.

Moreover, investment in the US over the past fifteen years has been lacklustre, and borrowing costs are still very low – albeit rising. This all makes for an environment where we could see productivity growth. If that is the case, wages can go higher, but would be offset by companies squeezing more output from each worker, which won't necessitate companies having to pass on higher prices to end consumers. This, in my view, is at least one argument why we probably won't have this 'price-wage spiral' we had in the 1970s.

US Labour Market



Source: Bloomberg, CFM

The plot shows the total number of job openings in the US (6-month rolling average, as per the JOLT Index compiled by the US Bureau of Labor Statistics – in red), as well as a proxy for the mismatch in available and sought skills (Quality of Labour Index derived from a survey by the NFIB – in blue). The plot also shows the YoY percentage increase in Average Hourly Earnings for all US workers – the dotted black line. While both job openings and a mismatch in labour skills increased significantly post-2014, the increase in hourly wages were less remarkable. There is an argument that the increased shortage of labour, in addition to households sitting on a large pile of cash – and therefore affords the luxury of remaining out of the labour force for longer – will keep upward pressure on prices. However, there are indications that greater job openings do not mechanically lead to much higher wages, nor is it clear how much of a financial cushion households, especially the bottom quartile, have in reserve.

CFM: In the past you argued that the use of sanctions has become a less useful tool in the diplomatic toolkit. Do you hold this line?

MG: It depends on what you want sanctions to achieve. What does success look like? If success in the current context is Putin changing course, then I don't think they will be successful. If success is the imposition of significant pain on the Russian economy, then I think the sanctions (and any additional future sanctions) will be a success.

In the Financial Times article where I put forth my arguments about sanctions, I noted that Russia was already a highly sanctioned economy, so more of the same probably wouldn't make a huge difference. What the West have done thus far, however, is not more of the same. Neither the US nor any of its allies have ever implemented an effective block on a major central bank. Russia is much more integrated into the global economy than Venezuela or Iran, the other two central banks that have suffered sanctions, and it will prove to be very crippling for Russia. Russia has worked hard to de-dollarise its economy since 2014 and has amassed a war chest of foreign reserves that have been rendered mostly useless. The impact of the sanctions on the Russian economy will be swift and severe. There is now also every chance of a sovereign default.

CFM: While Europe would want to wean itself off its dependence on Russian energy, they are also likely to double down on its renewable energy ambitions. Is there a worry about the fiscal position of Europe given that this would require significant spending, combined now with e.g., increased defense spending?

MG: If there is going to be some form of oil and/or natural gas embargo – the latter is not my base case – Europe's prices will soar in the short term. To help Europe pay for greater spending, I think the ECB should have continued its bond buying programme to keep borrowing costs low, particularly for peripheral countries like Italy, which has a lot of debt to roll over in the next year and is already facing higher bond yields. The ECB has argued that it can keep borrowing costs lower and avoid fragmentation by deploying the PEPP's investment scheme creatively, but there are political constraints to this; the Bundesbank will not want to buy a load of BTPs. Another option for reducing yields is the 'OMT' (Outright Monetary Transactions) scheme, but it comes with strict conditionality that countries would rather avoid.

There is another tool the ECB has to support greater European spending on the green transition but is being wound down: Targeted Longer-term Refinancing Operations (TLTROs). With this tool the ECB effectively introduced dual interest rates whereby banks could borrow at negative rates as long as they used it for a specific purpose, i.e., new lending. This constituted a subsidy that banks could pass on to end users. You could, for example, tweak the conditions to make the target green investment. Banks could borrow from the ECB at a deeply negative rate as long as it is used for this purpose. The ECB will, in such a setting, effectively subsidise green investment.

There would be losers with this approach, however, notably if you are a saver – you harvest lower and often negative rates. If you are a holder of long-term government bonds, or if you are in the fossil fuel industry, you are also going to lose out. But I don't think these are strong enough arguments not to subsidise green investment. Central banks are deeply uncomfortable about this idea, the Fed more than other central banks, simply because independent central banks don't want to be seen making decisions about asset allocation, they don't want to pick winners and losers. But everything a central bank does is essentially about picking winners and losers! Europe is facing this double whammy of an urgent need to finance the green transition, and to increase defence spending. Policy makers will need to get creative

CFM: Since we are on the topic, you are implicitly talking about central bank scope creep. There are strong views that central banks should not intervene, nor have the tools to address societal policy problems, with strong and opposite views that they should intervene, say especially in climate change related policy issues. Do you think central banks should play a role outside the scope of their immediate mandate(s)?

MG: I do. Most central bankers are perfectly happy to admit that they have a role to play in so far you are talking about risk or supervision when it comes to climate change, or even inequality. I think climate change could be at the heart of their mandate. Inflation is well above most central banks' targets, driven largely by higher energy prices. If they want to keep inflation stable and at their target, then, addressing exposure to fossil fuels is arguably one way to do it.

I am sympathetic to the slippery slope argument. Say, central banks end up funding the green transition, then what else are they going to fund? Particularly in the US – what might the Fed fund next – a wall, depending on who is in the White House?!

I would highlight that the Fed effectively funded WWII, and central bankers' response? 'It was an existential threat!' But who would not argue that climate change is exactly that?!

CFM: Much noise was made about deglobalisation post-Covid, many of the arguments of which you dismiss. Now, given what is happening in Ukraine, do you think the deglobalisation argument has been given a fresh pair of legs?

MG: : I don't think so. Russia's economy is not considerable – its GDP is smaller than that of the State of New York. And Russia has already been fairly insular given its policy of de-dollarising its economy. There is, as such, a question about a 'global' Russia to begin with.

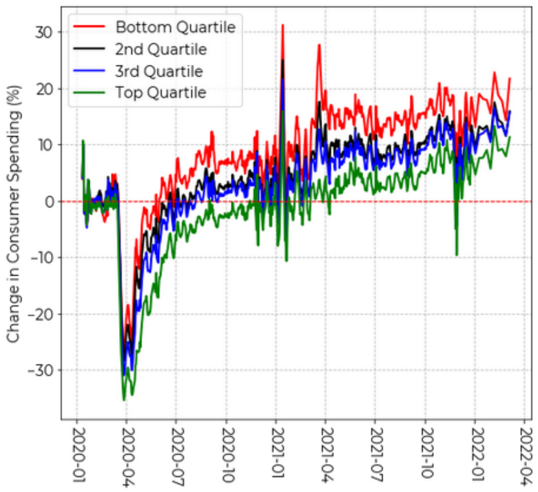
I myself put out the narrative at the onset of the pandemic that global supply chains were going to unravel, with a move to onshoring, or reshoring. How this would play out, over the longer term, is not, however, easy to measure. There is no magical index for globalisation, but there are proxies: world trade to GDP, gross value added to trade, hot money, capital flows, foreign direct investment, etc., and there is no indication in any of these metrics that globalisation is reversing. It certainly has slowed down, so we are globalising less quickly than before.

Most observers have been especially worried about de-globalisation between the US and China. American companies do business in China not just for access to sophisticated and high-quality supply chains, but also for access to a very large consumer market. There is no real indication that there is any reversal, and Russia invading Ukraine, I don't think, will move the needle.

CFM: Shifting to more philosophical questions. Is modelling of economic phenomena through the use of higher frequency economic data or proxies thereof something you have latched on to?

MG: Given how fast everything was happening, especially during the Covid pandemic, 'traditional' economic indicators were too slow, in addition to being mostly backward looking. Higher frequency data became crucial to get a timely handle on things, and I think its use will only increase. A valuable data set I'd like to highlight is by a colleague of mine at Harvard, Raj Chetty, who, along with others, is compiling data to monitor and track income distribution, spending patterns, and employment amongst others. The data allows you to track these, and many other, indicators at a more granular and in a more timely fashion – invaluable for assessing the state of the US economy.

US Consumer Spending

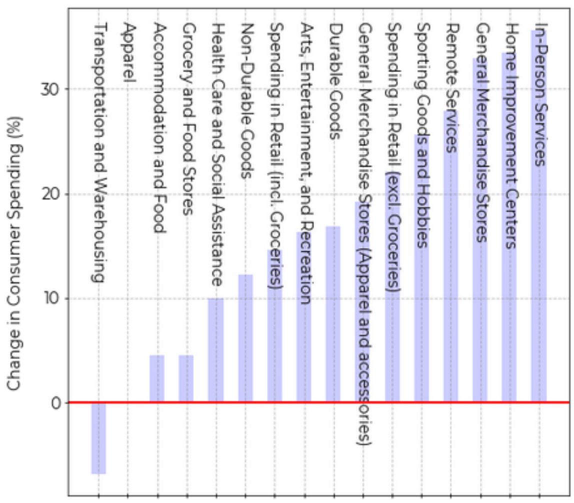


Source: Opportunity Insights, Harvard University.

The plot shows the percentage change in overall consumer spending as compared to January 2020.

Lower income households' expenditure accelerated more rapidly coming out of the nadir of the Covid pandemic and has tracked higher still in parallel with those of higher income households – this ostensibly thanks to the fiscal stimulus cheques distributed by the US government. As lower income households spend proportionally more on basic needs, such as shelter, food, energy, and transportation, it is reasonable to expect that, given prices for these have increased substantially, that lower household incomes will find it increasingly difficult to sustain this level of spending

US Consumer Spending (Per Category)



Source: Opportunity Insights, Harvard University.

The plot shows the total spending increase of all households per category. Perhaps unsurprisingly, the In-Person Service category has increased most – this coming off a lower base since these were the services most consumers were unwilling (or unable) to access owing to the Covid restrictions. As was widely reported, consumers spent proportionally more on home improvement related expenses, given the series of lockdowns. This, along with Durable Goods, however, has retraced recently as Covid restriction have eased. Tracking this data – compiled from credit card transactions – gives a timelier snapshot of consumer behaviour than survey data that is released with a lag, and allows policy makers to assess aggregate demand and changes near instantaneously

CFM: You mention income distribution. Does your research show whether income and wealth inequality worsened in the US during Covid?

MG: Yes. There are big structural drivers of inequality in the US, many of which are unique to the US. These are principally high market concentration, low worker power, and technological innovation – all of which have been turbocharged by the pandemic. Income and wealth inequality were already a big problem in the US pre-pandemic, and it is much more so coming out of it.

The theme I look at most closely is market concentration, which has arguably worsened during the Covid pandemic. Many mom-and-pop shops shut during the pandemic, whereas large multinationals, with access to deep and liquid capital markets did just fine over the course of the pandemic – tech and pharma are good examples of this. There are many other examples of heavily concentrated industries in the US that operate as monopsonies. This makes it very difficult for workers in those industries to negotiate better terms.

We are likely to grapple with this for years to come, how we regulate these industries or beef up antitrust has proven difficult. We don't have many good answers at this stage.

CFM: I've come to systematically ask our interviewees hailing from the economic sciences about their view of the profession, its epistemology, and the tools they use. As for Agent Based Modelling, where do you land in the debate?

MG: : I would say two things: First, mainstream economics assumes very simple characters in a complex system, whereas agent-based modelling assumes very complex characters in a simple system. I think the latter has yielded much better forecasting results.

Most forecasting models in economics are built on this fundamental belief in a single equilibrium. I've spent a lot of time through my contributions with NAEC (New Approaches to Economic Challenges) at the OECD, talking to researchers drawn from various sciences – and economics is the only field that still believes in a single equilibrium. Most other fields believe in multiple-equilibria which can move around, they view the system as more organic. Now, this is a terrifying prospect for a policy maker, who is trying to get an economy to potential growth. If there are many possible potential growths, and they move around, the job of a policy maker becomes much harder.

Nevertheless, I don't think we should ignore this vision of the world because it is complex or even messy, I think there has just been a lack of imagination within the economics community.

CFM: If you were in a position advising investors, where do you believe they could find global opportunities?

MG: The great news is that I am an academic now, and I don't have to give this advice, especially given all the uncertainty! But, for a long time I would have favoured Europe versus the US, because the US looked extremely overvalued, and Europe has teed up large capital outlays from Brussels, mostly via the Next Generation EU funds. I think that play is no longer attractive. And I'm rather bearish on emerging markets, which again leaves the US as the cleanest shirt in a dirty basket.

Megan Greene spoke with André Breedt, VP Research in the Paris office of CFM.

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