# Economic Update

JUL 2017

## Global Economy: Hawkish doves

Evidence continues to mount that the era of extraordinary central bank policy accommodation is at an end. This comes as a growing number of monetary policymakers consider following the US Federal Reserve's (FED) lead to 'normalise' policy settings. However, there remains considerable disparity between the so-called hawks and doves – or perhaps more accurately, the hawkish-doves and the more cautious policymakers.

Prominent amongst the former are the Fed who are already raising rates and now also the Bank of Canada (BoC) who have taken the first tentative step. Then there is the Bank of England (BoE), which remains the most hawkish bank yet to raise rates, while definitely considering doing so. The more dovish set are those that now see significantly diminished risks of further policy easing and are at least considering a potentially tighter stance in future. This group consists of the European Central Bank (ECB), Norges Bank, and Reserve Bank of New Zealand (RBNZ). The Reserve Bank of Australia (RBA) also seems, at this stage at least, to be content to be in this group. It has adopted a "glass half full" narrative with regard to the economy, but sees no justification to warrant a shift in tone. And lastly the Bank of Japan, which is broadly expected to stay on its accommodative course.

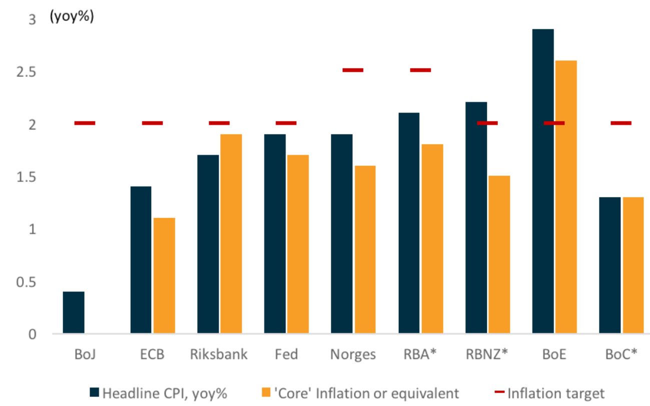
Assisting central banks in this policy shift is arguably a somewhat softer view of their key policy mandate – that is inflation targeting. Very few central banks are hitting formal targets and inflation outlooks are not at all certain. Instead, there is seemingly more attention being placed on managing the cycle. At this point, if growth is solid enough for the output gap to be narrowing and unemployment to drift towards full employment, then this is an environment that warrants an adjustment of ultra-accommodative policy. The expectation of accelerating inflation towards central bank targets, with limited threat of deflation, is seemingly now enough to at least consider withdrawing some policy stimulus.

Current cyclical dynamics aside, in which the Phillips curve is either broken or shifted lower, there are also the medium to long-term disinflationary impacts of technological advances and automation to consider. This may see global central banks becoming accustomed and attuned to inflation hovering around the lower ranges of their respective target bands – or in time could even see them consider lowering their targets outright.

A further concern is financial stability and the future risks that household debt accumulation may present. These risks are only exacerbated by having interest rates too low for too long – a mistake that has arguably been made before in the US.

**Global: Inflation rates**

*Most central banks have inflation below target*




Source: IFM Investors, Various central banks, Bloomberg
*Midpoint of +/1.0% band

It should also be noted that this coincidental rather than coordinated shift in monetary policy merely represents steps towards a gradual removal of what are ultra-accommodative policy settings. It in no way represents moving convincingly towards settings that would be considered as contractionary policy, and slightly tighter policy settings are therefore unlikely to materially curb the gradual acceleration of inflation.

We would also assert that with potential growth rates in most developed economies lower now than before the global financial crisis, central banks will be feeling their way to what are clearly lower neutral policy rates for an extended period of time. This mix of lower neutral policy rates, lower inflation and lower potential growth rates all support the notion that bond yields, rising gradually, will remain lower for longer. Consequently, the reflation thematic, although intact, will only gradually gather momentum.

## Central Banks: Rising as one? Not quite

As noted above, it is the Fed that is clearly well out in front in reducing monetary policy stimulus. Its stance was demonstrated again in June as the FOMC (Federal Open Market Committee) increased the Federal Funds Rate by 25bp. As a result, the target rate rose to 1.00-1.25%, while the Committee noted that the "labor market has continued to strengthen and that economic activity has been rising moderately so far this year". Economists remain of the view that there will be one more rate hike this year, based on the data flow, particularly growth and solid labour market performance. The improved growth will come despite what are now increasing concerns, from economists and the Fed alike, that the softer pace of inflation may persist.

Also expected is an increasing focus on communication around when the gradual reduction of the Fed's balance sheet how and will take place.

Across the border the Bank of Canada (BoC) raised interest rates for the first time in seven years (September 2010) this month. The hike was in line with market expectations and saw the policy rate rise 25bp to 0.75%, in what was described as a "removal of stimulus". The move was driven by the BoC's confidence in its outlook for "above potential growth" for at least the remainder of 2017 and into 2018. Although equally it recognised the softness of inflation recently as it remains in the bottom of the target range. Yet this has been attributed to temporary factors and Governor Stephen Poloz noted that it takes 18 to 24 months for a monetary policy action to have its full effect on inflation. Poloz added that central banks must "target future inflation by anticipating future deviations from target". This view somewhat justifies the BoC's removal of stimulus before reaching its target, but it also shows its confidence that inflation will continue to accelerate – a confidence that could be misplaced given the uncertainty of the outlook. There was no strong commitment from the BoC for follow-up hike, suggesting it will be "guided by the incoming data".

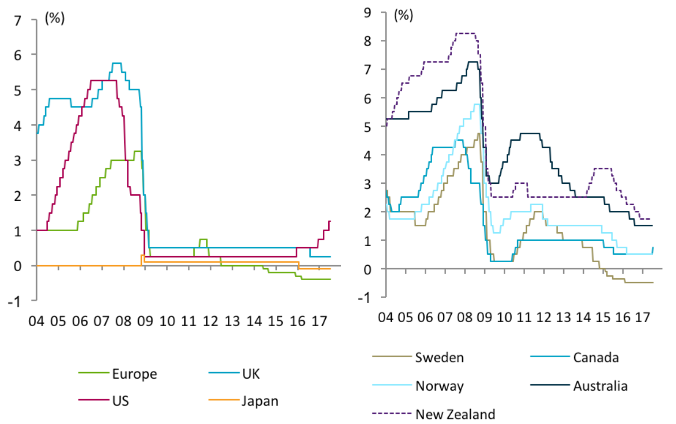
The move by the BoC is an interesting paradigm to examine policy in similar commodity-reliant economies that face almost identical conditions – Australia and New Zealand. If either the RBA and/or RBNZ look to follow Canada's example, rate hikes may be forthcoming earlier than markets currently expect – although for now that's a big 'If'.

There was only a passing reference to financial stability, the statement noting "financial system vulnerabilities" will also guide future policy. But again, central bankers in Australia and New Zealand will be keenly examining the impact of Canada's hike. Not only on its booming property market, but, as the BoC statement notes, the economy may be "more sensitive to higher interest rates than in the past, given the accumulation of household debt. We will need to gauge carefully the effects of higher interest rates on the economy." Exactly the same can be said for household sectors in Australia and New Zealand.

> ***"...the economy may be "more sensitive to higher interest rates than in the past, given the accumulation of household debt. We will need to gauge carefully the effects of higher interest rates on the economy."***

**Global: Central Bank policy rates**

*Unlikely to see any further policy accommodation*




Source: IFM Investors, various central banks, Bloomberg

Across the Atlantic, the BoE is seemingly in two minds about whether or not to raise policy rates. The Monetary Policy Committee (MPC) was divided at its June meeting, voting by a majority of 5-3 to maintain its policy rate at 0.25%. The three members of the MPC in favour of raising rates included, as it transpired, the BoE's Chief Economist – putting him somewhat at odds with a more measured view from Governor Mark Carney. Andrew Haladine's and others more hawkish tone came as inflation becomes an increasing concern, with the MPC's minutes noting it could rise above 3% by the autumn, "and is likely to remain above the target for an extended period" as sterling's depreciation continues.

This stance seems particularly hawkish given the still very elevated uncertainty around Brexit negotiations, and domestic politics more broadly. The BoE's challenge is that it must balance this clear downside risk with a circumstance in which the growth outlook is maintained or improves. As the latter would see further upside risk to inflation and would warrant, in the MPC's words "some removal of monetary stimulus".

On the continent, the ECB became somewhat more optimistic, both during its press conference after its recent monetary policy decision and at an ECB Central Bank conference in Sintra, Portugal. ECB President Mario Draghi was broadly upbeat, if not hawkish, when suggesting that the threat of deflation are gone and "reflationary forces" are at play as the region's economic recovery continues. He did try to subsequently soften his remarks, but it nonetheless remains clear that further interest rates cuts are now unlikely. Draghi refused to be drawn on the issue of tapering asset purchases, noting the ECB will be in the market "for a long time". Indeed, he noted purchases could be increased should the economy soften. As it stands, there is an expectation that the ECB will communicate a tapering of this program towards the end of the year.

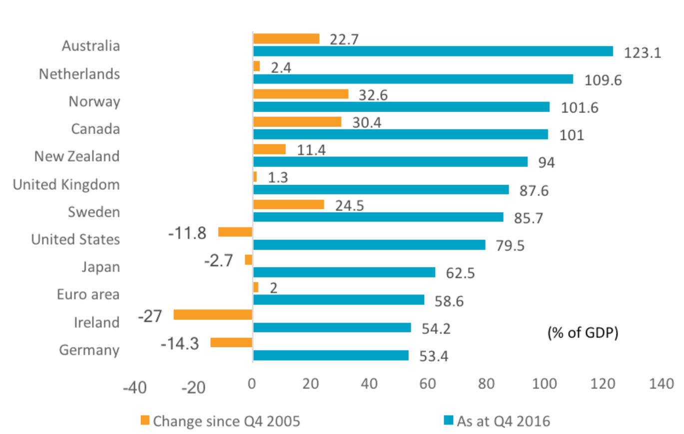
The Bank of Japan is the laggard of the major central banks, displaying no current desire to relax its policy of accommodation. Governor Haruhiko Kuroda refused to be drawn recently on any specific discussion of an exit strategy, and its policy stance will therefore remain unchanged. Negative interest rates and its ongoing commitment to keep the 10-year bond rate at 0% will remain for the foreseeable future (despite some speculation that this target may rise in line with global yields). This is as GDP growth is around potential, but the inflation pulse is unambiguously weak. As such policy will likely continue to be set “with a view to maintaining the momentum toward achieving the price stability target”.

## Scandinavians soften easing biases

Of the key Scandinavian central banks, Norges Bank (NB) removed its easing bias, recently noting that “the balance of risks suggests that the key policy rate will remain at today’s level in the period ahead”. This is again despite inflation being lower than expected, recently sitting on a core measure at 1.6%yoy (well under the 2.5% target). Similar to Australia, financial stability concerns are also factoring into NB’s reaction function. The bank noted: “Persistently low interest rates [currently at 0.5%] lead to financial system vulnerabilities. By taking into account the risk associated with very low interest rates, monetary policy can promote long-term economic stability.”

In Sweden the Riksbank struck a slightly more cautious tone seeking to soften what still seems to be a mild ‘easing’ bias. In its early July policy statement it noted that stronger than expected inflation and reduced downside risks had made any further interest rate cuts less likely. But it remains of the view that the current rate of -0.5% should be viewed as appropriate. Like Norges Bank, it too warned of the increasing risks that “high and rising household indebtedness” were presenting.

**Global: Household debt to GDP ratio and changes**
*Financial stability concerns are well founded*




Source: IFM Investors, various central banks, Bloomberg

## Antipodean ambivalence

The Antipodean central banks are equally neutral and face similar challenges. Both the RBNZ and RBA have relatively high policy rates, at 1.75% and 1.5% respectively, and any premature shift to a more hawkish tone would result in unproductive appreciations of the AUD and NZD. This alone suggests that ideally both would wait for as long as possible before switching to a more positive tone. Such a stance would let other central banks either begin or continue to tighten, and push the Australian and New Zealand dollars lower – still desirable outcomes for the RBA and RBNZ alike.

The RBA and RBNZ also have financial stability concerns as household debt levels rise ever higher. Having interest rates too low for too long only exacerbates the financial stability and indeed macro-economic risk that this build-up of debt may present. Both central banks have had at least some assistance in this regard from the application of macro-prudential measures, and in New Zealand’s case government tax policy (introducing a capital gains tax on investor property). However, these measures are only curbing a problem that has already developed. Unless more macro-prudential measures are taken debt levels will continue to rise (in a positive move the RBNZ has published a consulting paper examining potential limits on debt to income ratios). This limits the ability of both the RBA and RBNZ to ease policy further if economic outlooks were to deteriorate.

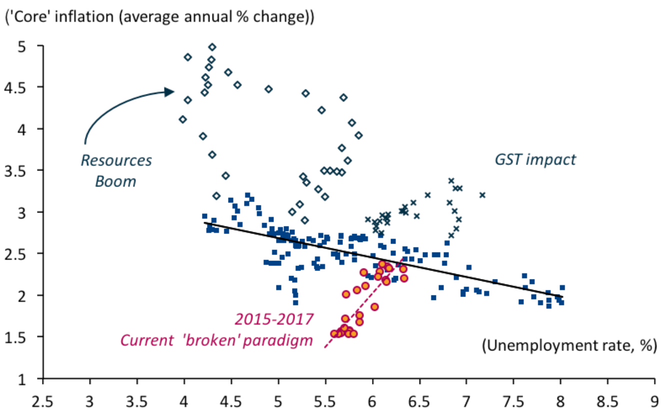
For now the RBNZ is adopting a wait-and-see approach to policy and leaving its options open and its stance neutral. “Monetary policy will remain accommodative for a considerable period,” it noted. “Numerous uncertainties remain and policy may need to adjust accordingly.” This sentiment is reflected in its Monetary Policy Statement (MPS) from May, with its own policy interest rate forecasts not rising until mid-2019.

The RBA also remains on hold with a cautiously neutral stance. This has been maintained up until its July meeting, at least, despite some speculation that it may start to share the slightly more hawkish sentiment of global central banks. Speculation was fuelled by comments made by long-serving former Board member John Edwards (his term ended July 2016) who suggested with regard to interest rate increases that “the time is coming to get back to normal”, and adding: “It’s possible the tightening could start earlier.” He went further still to suggest that if the RBA’s forecast were to come to pass then eight 0.25 percentage point tightenings over the course of 2018 and 2019 were “distinctly possible”.

These relatively hawkish comments before the RBA’s July meeting were tempered by relatively new board member Ian Harper (his term started in July 2016) after it. His much more measured comments are likely more reflective of the RBA's current stance. "We're on target," Harper said, "but to be blunt there is also plenty of evidence that you wouldn't want to rush this [raising rates]". He further noted two economic factors – "plenty" of unemployment, and a lack of a clear inflationary increase – to support the RBA holding off on any shift in bias. This is despite the economy "recovering nicely". Harper also confirmed again that it is the RBA's view that a lower Australian dollar would "help us along our way," in terms of ongoing recovery. His reasoning is why the RBA likely desires on economic grounds to keep rates on hold for longer still. To shift prematurely would likely promote an undue appreciation of the exchange rate that it continues to note would "complicate" the recovery of the economy.

**Australia: Phillips Curve**

*Low unemployment without inflation has broken the Phillips curve*




Source: IFM Investors, ABS, RBA

Indeed if the prudential regulator's efforts (which ideally will not only continue but intensify) to stem growth in household borrowing are successful this would allow the RBA to keep rates on hold for an extended period without exacerbating risks. This would benefit the Australian recovery as other central banks remove accommodation, by putting downward pressure on the exchange rate – especially true as the threat of a demand-pull inflation break out is relatively low. On the supply side, energy costs may boost inflation but like other countries wages growth has so far been elusive and the traditional Phillips curve relationship has been broken for some time.

For now the Bank's official comments continue to note that holding the stance of monetary policy unchanged at this meeting would be consistent with "sustainable growth in the economy and achieving the inflation target over time". And it is reasonable to expect this will remain unchanged for some time as it balances still soft economic growth, a coming downturn in residential construction, a solid but uncertain labour market, 'core' inflation below its target on the downside, and still rising dwelling prices and household debt on the upside.

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