Standard Life Investments

Weekly Economic Briefing
Global Overview

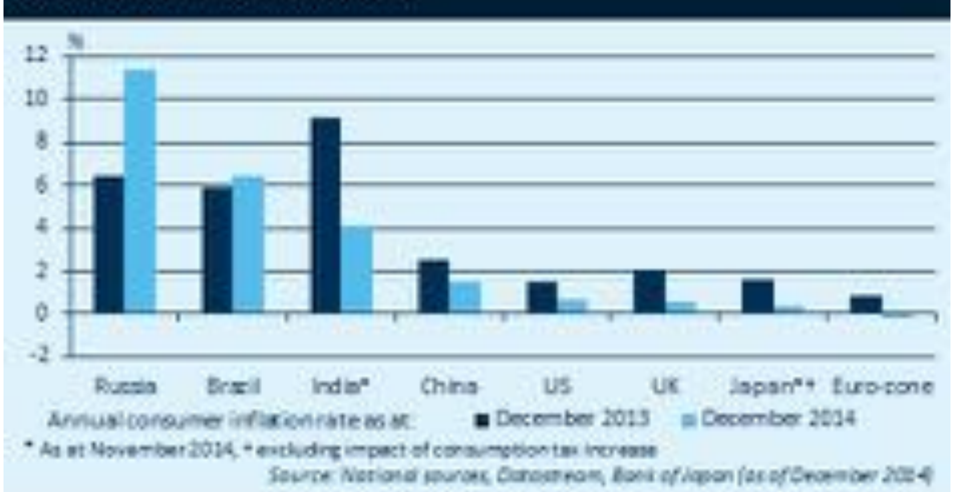
One size fits oil?

20 January 2015

In the wake of a positive supply shock to the oil price, economic textbooks suggest that central banks in net oil importing countries should look through the negative first-round effects on headline inflation by keeping nominal short-term interest rates steady and allowing real interest rates to rise. That is because the decline in oil prices raises the productive potential of the economy, as well as the equilibrium real interest rate. In practice, however, the appropriate policy response depends on the macroeconomic conditions prevailing in the country at the time.

We can divide central banks' responses to the more than 50% drop in oil prices into four main camps. The first is comprised of institutions, such as the ECB and the BoJ, which were dealing with inflation rates that were already too low before oil prices began falling, carrying a greater risk that excessively low inflation expectations become entrenched. The BoJ used the fall in oil prices to justify why it was expanding its quantitative easing programme in October and we expect the ECB to follow suit this week by announcing its own sovereign bond purchase programme. The second is made up of central banks taking advantage of the fall in oil prices and headline inflation to opportunistically lower interest rates from previously very high levels. India is a prime example, where the RBI surprised markets last week by cutting interest rates for the first time in two years as headline inflation has declined from just under 10% to 5% (see Chart 1). We expect the Turkish central bank to follow suit sooner rather than later. The third includes central banks such as Brazil, Venezuela and Russia that have had to tighten policy despite falling activity because inflation is too high and lower interest rates could trigger destabilising capital outflows. The final group incorporates central banks, like the BoE and the Fed, that do not intend to ease monetary policy further, but where lower headline inflation may delay rate hikes even though labour market conditions are tightening. The BoE has already signalled that it is in no hurry to tighten policy as headline inflation has fallen below 1% for the first time since 2002. Fed officials have been more resolute, but if headline inflation turns negative over the coming months and wage pressures remain muted, the first rate hike could be delayed past June.

Chart 1: Not a common shock



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Pick your target

Downside surprises to retail sales and core inflation in December have left the Fed with some thinking to do at its January meeting next week. A modest drop in aggregate retail sales was to be expected because vehicle sales edged down in the month, while the big fall in gasoline prices depressed nominal spending at gas stations. What was not expected was that core retail sales (excluding auto sales, gasoline sales, sales of building materials and food) would also decline for the first time since January last year. This took the three-month annualised growth down to 2.4% - the slowest pace since March, when the numbers were still being dragged down by the unusually cold weather last winter (see Chart 2).

What should we take away from this disappointing report? Most immediately, it lowers tracking estimates for Q4 GDP by around 0.2 percentage points (ppts) to just over 3%. It also raises questions about just how large the pass through from lower oil prices into goods consumption will be. Our assumption has been that real non-gasoline spending will be boosted by the drop in oil prices. That expectation now seems less supported by the data. That said, we would exercise caution about over-interpreting the data. Monthly data is volatile and subject to large revisions. The underlying trend also remains healthy - even with the December decline, core sales were up 3.7% annualised in Q4 as a whole and the Michigan Consumer Sentiment Index hit its highest level in a decade in January. Meanwhile, the majority of aggregate consumer spending is on services, which are not included in this report. **For now then, we retain our view that lower oil prices will boost real private consumption growth through 2015**.

Adding to concerns about the outlook for nominal growth, core CPI inflation was flat in December, bringing the annual rate down to 1.6%; its lowest rate since February last year. Although labour underutilisation rates continue to fall quickly, wage pressures remain very subdued. Incredibly, growth in average hourly earnings has actually been slowing in recent months, growth in the employment cost index is higher but still much lower than pre-crisis norms, while unit labour cost growth, the best predictor of underlying inflation, is only a little above 1% (see Chart 3). **With the drop in oil prices and the rise in the dollar still to fully pass through into consumer prices, underlying inflation is unlikely to rise above 2% until 2016**.

This leaves the Federal Open Market Committee with a difficult choice. The strength of economic and employment growth more than justifies initiating the first rate hike in June. The weak trend in labour costs, inflation and global activity provides members with an excuse to delay. Which way they go will depend on what the Committee is most worried about –undershooting its inflation target yet again, and potentially destabilising the rest of the world, or falling behind the policy curve and risking an inflation problem later on. **Recent speeches from regional Fed presidents Williams and Lockhart suggest that a mid-year hike is still on the table but that wage and inflation developments between now and then will be critical**. The Fed statement following next week's meeting might tell us more about which way the full Committee is leaning.

Chart 2: Retail sales trending down

Source: US Census Bureau, Datastream (as of December 2014)

Chart 3: Core inflation pressures subdued

Source: US BEA, BLS, Datastream (as of Q3 2014)

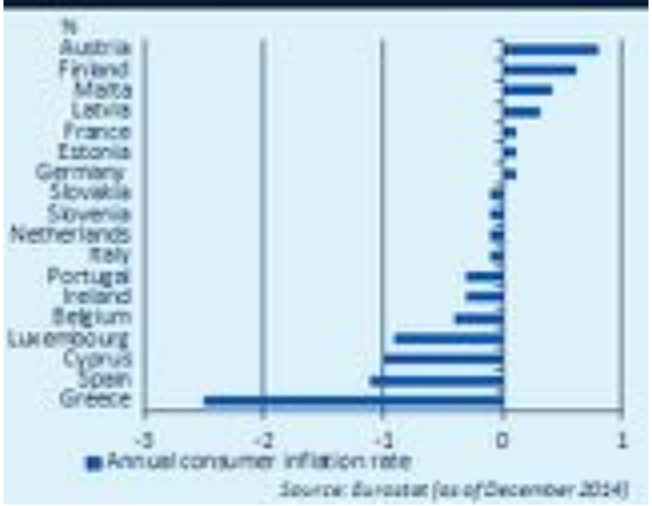
The ECB to the rescue

The collapse in oil prices has sent inflation falling in the Eurozone. The latest inflation figures tumbled to -0.2% year-on-year (y/y) in December, the weakest since 2009. Inflation is currently negative in 11 out of the 18 Eurozone member states, with the feed through from oil prices having been rapid and powerful (see Chart 6). Energy prices, which account for around 10% of the consumer price index, are currently falling 6.3% y/y. Price declines for individual product groups have been even sharper; heating oil prices are currently more than 20% lower than they were at the end of 2013. The effect is also being felt by motorists. Fuel is falling close to 11% in y/y terms, subtracting more than 0.5 percentage points from the headline inflation rate. The oil price effect is far from over. There will be a lag in the feed through of lower oil prices to consumers. Furthermore, prices continued to fall in January. Finally, there will be second-round effects as firms' input costs decline, allowing them to reduce prices (or raise their margins). Inflation is now expected to come in at -0.2% y/y in 2015; this decline could be larger if oil slips further or if the pass through from cheaper energy prices is more pronounced than we anticipate. **For a region that has been compared to Japan, this will not make for comfortable reading**.

The Eurozone is not in deflation. Genuine deflation can be defined as a broad based, sustained decline in the price level which has material effects on spending and investment decisions in an economy. A period of negative inflation caused by large declines in a narrow group of prices does not represent the sort of malaise that hit Japan. However, this should not provide cause for complacency. **There is a significant risk that the oil price shock could have more lasting consequences, particularly in the context of significant spare capacity and an anaemic recovery**. If inflation expectations continue to fall this could feed into broader price-setting behaviour (see Chart 7). This probably still couldn't push the region into outright deflation. A low inflation environment would, however, be extremely problematic and increase the probability of a slide into deflation in the case of an economic downturn.

Expectations have been growing that the ECB will finally deliver sovereign bond asset purchases (QE) at its meeting on Thursday. **Certainly, recent rhetoric from Governing Council members suggests that a consensus is forming**. QE alone cannot solve all the Eurozone's problems. It can, however, support activity and inflation, and is a necessary step for any recovery. Much will depend on the design and scale of the programme. International evidence over recent years suggests that a large, open-ended QE package is most powerful. The ECB should be mindful of this in order to get the most 'bang for its buck'. There has been speculation that the ECB will ask member states' national central banks to buy and hold bonds in the programme. This means that member states rather than the ECB would hold the credit risk of the bonds purchased. This does not have enormous implications for the economic impact of the package. However, the refusal to share risk does raise some worrying questions about confidence in the Eurozone project more generally.

Chart 6: Free falling



Source: Eurostat (as of December 2014)

Chart 7: Dropping anchor

Source: Bloomberg (as of 16 January 2015)

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