Standard Life Investments

Weekly Economic Briefing
Global Overview

Loosen up
26 May 2015

23 major central banks have either cut their policy rates or expanded their balance sheets this year. Others have informally loosened monetary policy by guiding markets towards a lower future path for policy (see Chart 1). This global stimulus has been justified by widespread drops in inflation, as well as the failure of global economic activity to accelerate as expected in the first months of 2015. The world economy effectively has a sizeable negative output gap; extremely accommodative monetary policy is required to close it, particularly when fiscal policy is either tightening or neutral in most of the large economies.

The critical question now is whether central banks have done enough, or whether further easing measures will be necessary. This is a country by country proposition. In the US, the market anticipates that the lift-off for policy will be delayed until December. We still expect September, though that is conditional on the recent weakness in growth and inflation indicators proving transitory. The first UK rate hike is rightly not expected until 2016 because inflation is even lower than in the US and fiscal policy is likely to be tightened substantially over the next 12 months. In the Eurozone, we do not expect any additional policy measures until it is clearer whether inflation is tracking back towards target. However, ECB officials will continue to be quick to quash any speculation that it will end its asset purchase programme early. Meanwhile, Japanese policymakers will come under significant pressure to do more in the coming months if underlying inflation remains stuck at zero; trust in the Bank of Japan's commitment to its 2% inflation target will last only so long. Emerging markets also face complicated choices. Aggregate growth has fallen to its lowest pace level since 2009, inflation has moderated in most countries and low interest rates are necessary to keep debt servicing burdens low while structural adjustments take place. Nowhere is this clearer than in China. The trick the authorities must pull off is to ease policy just enough, and in just the right places, to prevent a genuine hard landing from taking place, but not so much, or in the wrong places, such that the country's economic imbalances get worse. The fate of more than just the Chinese economy is resting on the success of this juggling act.

Chart 1: Guiding rates down

Contributors

Authors:
Jeremy Lawson
James McCann
Govinda Finn
Alex Wolf

Editors:
Jeremy Lawson
Stephanie Kelly

Chart Editor:
Craig Hoyda

Contact:
Jeremy Lawson,
Chief Economist
jeremy_lawson@standardlife.com

Parsing Janet

There are seventeen members of the Federal Open Market Committee (FOMC), with nine voting in any given year as the regional Federal Reserve (Fed) presidents rotate in and out. However, there is little doubt that there is one vote that matters more than the others - that of the Committee Chair, Janet Yellen. For that reason **we paid much more attention to Yellen's speech to the Providence Chamber of Commerce in Rhode Island this week, than to the minutes from the April FOMC meeting,** which give equal weighting to all participants regardless of their actual sway over decisions.

Cautious optimism was the speech's dominant theme. When discussing the labour market, she noted that the economy had not yet reached full employment as "a significant number are not seeking work because they still perceive a lack of good job opportunities" and "an unusually large number of people report that they are working part-time because they cannot find full-time jobs". Moreover, indicators of wage growth remain well below their historical norms. Yet, she also noted that the job opening and job quit rates have increased, suggesting that firms and employees alike are becoming more confident in the outlook. **It was evident then, that Yellen remains confident that labour market slack will be eroded over the course of the next two years, despite the data disappointments of the last few months.** Like most economists, the Fed Chair is attributing most of that weakness to transient factors, including residual seasonality. We have some sympathy for that view. Real household disposable income growth remains strong, which should lead to stronger consumer spending as the year goes on. Moreover, our own analysis shows that first quarter GDP growth since the financial crisis has been much weaker than other quarters because of a systematic tendency for estimated non-residential structures investment and net-exports to be very weak at the start of the year (see Chart 2). However, if we, the consensus and the Fed are wrong, the timing of the first rate hike will probably be pushed back into 2016. The most important downside risk is emanating from the rest of the world, where, as Yellen observed, weak growth is "denting exports", though she still expects easier monetary policy to boost global growth over the coming quarters.

Yellen was less impressed with the Fed's record on price stability, which she thought was holding down wage growth and inflating real debt burdens. Still, here too she ended on an optimistic note, arguing that inflation is likely to "move up to 2 percent as the economy strengthens further and as other temporary factors weighing on inflation recede." Indeed, **she went so far as to remind markets that it would be a mistake to leave monetary policy too loose for too long.** Yellen therefore remains of the view that the first rate hike will take place this year if labour market conditions and inflation indicators evolve as she expects. Part of the rationale for normalising policy is the growing recognition that not all of the weakness in wages can be attributed to demand factors. Productivity growth has been exceptionally weak by historical standards, in part because there has been little capital deepening but also because entrepreneurship is unusually subdued (see Chart 3). If this persists, policy rates will need to move higher in the short-term, though the terminal rate will be considerably lower than in the past.

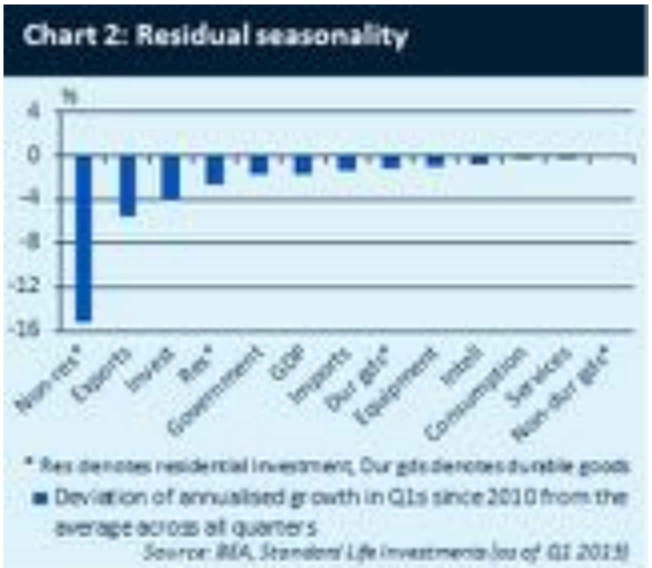


Chart 2: Residual seasonality

Chart 3: Depressed productivity

Curing contagion

The European Central Bank (ECB) struck a cautiously optimistic tone in the account of its mid-April meeting. **The Bank noted that the recovery is broadening and gaining momentum.** Nevertheless, there was a clear message that an upturn remains contingent on the full implementation of policy measures announced, pushing against any suspicion that the ECB will end Quantitative Easing (QE) early. The meeting occurred before the sell-off in government bonds, which saw German 10-year yields rocket from 8 to 72 basis points. Governing Council member Coeure recently commented that the ECB could vary the pace of QE purchases to ease distortions during period of low liquidity. This could simply reflect an effort to smooth the impact of purchases. Alternatively, it might signal some unease at the ECB about the impact of rising market interest rates.

The thorny issue of Greece was only mentioned once in the account. 'Financial turbulence' from stalled negotiations was flagged as just one downside risk. The Greek interior minister has warned that Greece will not be able to meet debt obligations in early June without a release of bailout funds (see Chart 6). Negotiations towards this disbursement continue in earnest and show signs of painfully slow progress. Even if Greece and its creditors are able to reach agreement, this will only provide a stop gap solution. Greece formally exits its bailout in late June and will need to agree on a new programme given financing needs over the second half of 2015. **We remain of the view that policymakers will be able to find the compromises required to keep Greece in the Eurozone.** Indeed, a large majority of Greeks support membership and it remains in the interests of other member states to keep Greece in the currency union. **However, the risks of exit are high and rising.** Moreover, the likelihood that capital controls are required is even larger. If things were to go wrong, what might we expect from the ECB?

The first thing to emphasise is that the Eurozone has become more resilient to this form of shock. A whole host of acronyms provide insulation against a Greek event – the European Stability Mechanism (ESM); Outright Monetary Transactions (OMT); the Single Resolution Mechanism (SRM). Indeed, the threat of OMT proved strong enough to calm markets in 2012 (see Chart 7). Despite these firewalls, we would expect a Greek exit to be felt in the periphery, although contagion is likely to be less pronounced than in the past. The ECB has the option to push against this through OMT purchases, with the European Court of Justice having approved the legality of this instrument. The OMT is applicable in countries that are currently in some form of ESM programme; either a bailout or credit line. This leaves Spain and Italy outside of this umbrella at present. QE provides another line of defence. There might be some flexibility to front-load purchases in the case of distress, while the ECB could signal that the programme will remain in place for longer. In order to justify a permanent increase in the size of monthly purchases, the ECB would have to argue that the shock has had a material impact on the aggregate Eurozone recovery. It would almost certainly find its hands tied with regards to the distribution of purchases between member states, which is dictated by the ECB's capital key. **Overall, the central bank could probably contain, rather than eliminate, the knock-on effects from a Greek exit.**

Chart 6: Debt payments looming

Chart 7: OMT bazooka

China's high wire act

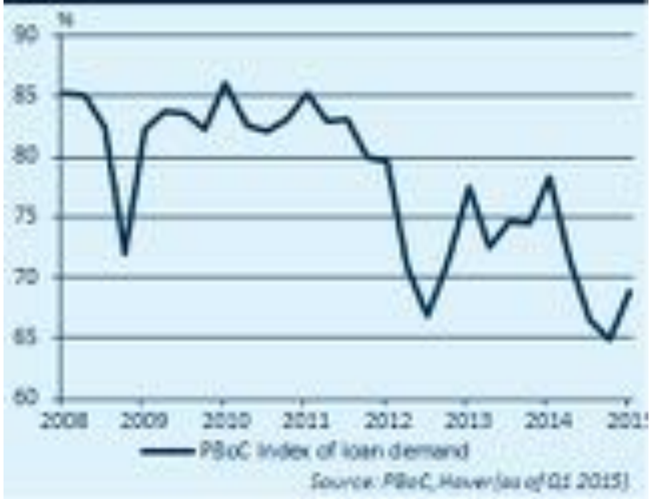
The Chinese government responded to very weak first quarter data with a combination of monetary easing and expansionary fiscal policy to stem the downturn and support growth in the near term. Across a variety of indicators, it appeared growth slowed sharply in the first quarter; proxies such as railway freight, electricity production, trade data, and fixed asset investment produced their weakest numbers since the global financial crisis (see Chart 10). Authorities responded by cutting the benchmark lending and deposit rates and lowering the reserve requirement ratio by 100 basis points. However, with real interest rates remaining stubbornly high, policymakers have stepped in to push the three-month Shanghai Interbank Offered Rate (SHIBOR) down nearly 2 percent since April, and the seven-day repo rate from an average of above 4.5% in March down to 2.1% this month.

These moves were partly an effort to lower borrowing costs and to dampen the slowdown in the broader economy but also to ensure successful local government bond sales. **The government plans to swap high yielding local government debt with longer-maturity, low-yielding local government bonds.** However, the efforts got off to a shaky start as AAA-rated Jiangsu province cancelled their planned issuance due to lack of investor interest (apparently Chinese commercial banks balked at the low yields on offer). To ensure success, authorities aggressively pushed down market interest rates to guarantee that provincial yields appeared attractive. This resulted in last week's first local government bond swaps; both Jiangsu and Xinjiang successfully sold three-year bonds yielding less than 3%, just slightly above sovereign yields and much less than the average borrowing rate. The debt to bond swap will reduce some systemic risks - it improves the maturity structure of local government debt and reduces borrowing costs. According to results from the 2013 local government audit, approximately Rmb 1.8 trillion of local government debt would mature by the end of 2015. Swapping this amount by year end will significantly lower local government's financing costs.

In addition to monetary easing and debt swaps, policymakers are also expanding fiscal spending to offset the slowdown. Worried that monetary easing may not be enough due to weak credit demand (see Chart 11), authorities partially reversed the fiscal reform process by relaxing constraints on funding local government finance vehicles (LGFVs). Tight restrictions imposed last year capped borrowing through LGFVs and reduced local governments' ability to expand spending on infrastructure. New decrees ordered banks to continue funding projects under construction and to continue lending to borrowers suffering from '"temporary liquidity problems'. Additionally, rules preventing LGFVs from issuing bonds were relaxed. These measures will boost local government investment spending but imply that Beijing is prioritizing short-term growth at the expense of reform. Beijing's strategy is now emerging: reduce risks from the existing debt stock through debt swaps and reduced borrowing costs, and ensure there is enough state-led investment through increased fiscal spending. **The government is using old tools of directed lending to support growth in order to prevent a deeper and more prolonged downturn, while also pledging to proceed with reforms.** It will be a difficult balancing act; the policies appear mostly sensible but the process will not be easy.

Chart 10: Slower than expected

Chart 11: Weak credit demand



The opinions expressed are those of Standard Life Investments as of 05/2015 and are subject to change at any time due to changes in market or economic conditions. This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any strategy.