Standard Life Investments

Weekly Economic Briefing
Global Overview

Jackson Hole letdown
26 August 2014

Investor hopes were high heading into the Federal Reserve Bank of Kansas City's Economic Symposium at Jackson Hole. Previous years had seen the previous Fed Chair Ben Bernanke signal that major changes in the path for monetary policy were coming and this year's symposium saw the current heads of the United States, Eurozone and Japanese central banks speaking at the same forum for the first time. The topic of the symposium was ostensibly "Re-evaluating Labor Market Dynamics" but what economists and market participants were most interested in was whether the leaders of the world's most important central banks would foreshadow any imminent shifts in the outlook for policy. For the most part those hopes were disappointed. Fed Chair Yellen spent much of her speech outlining how difficult it was to judge the amount of economic slack in the post-crisis economy while defending her core view that there was most likely enough slack to allow policy support to be withdrawn gradually. While she did acknowledge that faster progress towards the Fed's employment and inflation mandates would imply an earlier and faster rise in short-term interest rates that was really just central bank speak for policy being data dependent. We continue to expect the first rate hike to come in June 2015.

ECB President Draghi offered nothing new on the policy outlook. He did indicate that the Governing Council was ready to do more if inflation continued to undershoot its expectations, but that was just a reiteration of his previous statements. What was more newsworthy was his acceptance that fiscal policy could and should be doing more to support the recovery. It remains to be seen whether Eurozone governments heed his message. Bank of Japan Governor Kuroda talked a lot about how the long period of deflation had damaged the normal functioning of the labour market, going so far as to call for a more coordinated wage policy. However, he also fell short of pledging any expansion of the current quantitative easing programme in the near-term. Inflation dynamics hold the key to policy outlook and in both cases we do not think that existing initiatives will be enough to achieve price stability (see chart 1). As a consequence, we anticipate a new round of policy stimulus to be initiated in the first half of 2015.

Chart 1: ECB and BoJ must do better

Contributors

Authors:
Jeremy Lawson
James McCann
Govinda Finn

Editors:
Jeremy Lawson
Stephanie Kelly

Chart Editor:
Craig Hoyda

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

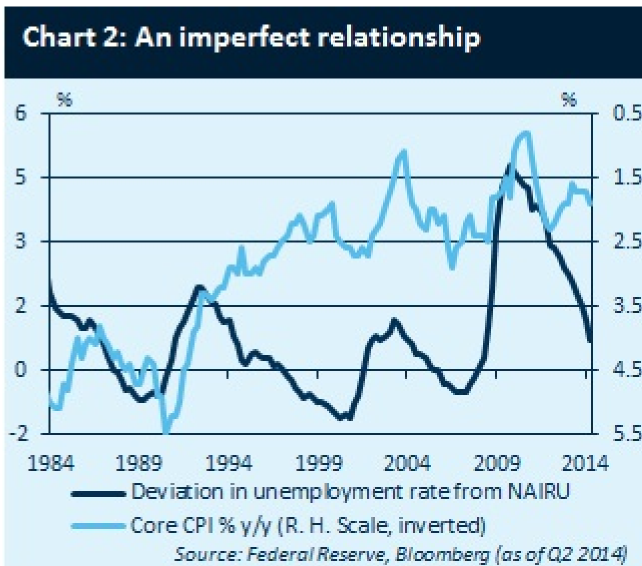
US

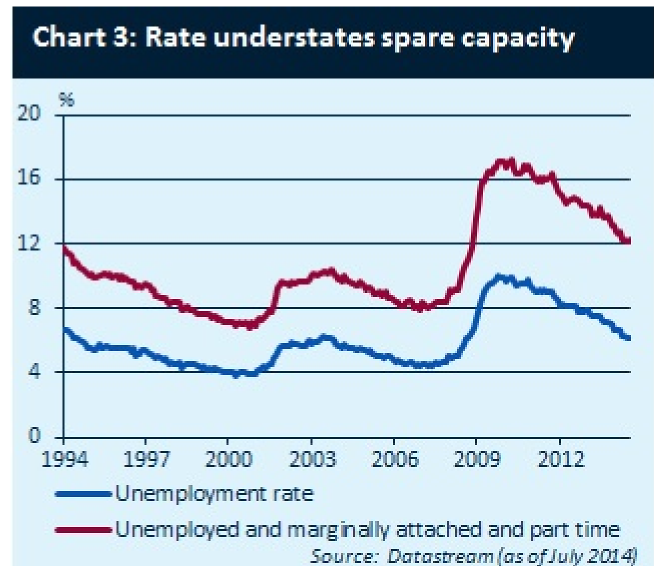
On track for June

The minutes of Federal Open Market Committee (FOMC) meetings often read more hawkishly than the earlier policy statements and press conferences. The FOMC currently has 17 members with a wide range of views on the appropriate path for policy and **the hawks on the Committee have a stronger voice in the minutes than they do in actual policy decisions.** The Fed's July meeting fit this pattern well. The statement itself had been fairly dovish; a growing acceptance that inflation risks were becoming more balanced was offset by the downplaying of the unemployment rate as the best measure of labour market slack. The minutes on the other hand gave full voice to the hawks' view that policy accommodation should be reduced promptly "to avoid overshooting the Committee's unemployment and inflation objectives over the medium term", as "the guidance suggested a later initial increase in the target federal funds rate as well as lower future levels of the funds rate than they judged likely to be appropriate". The short end of the yield curve sold off, despite the comments coming from outside the Committee's dovish core.

The minutes provided an interesting lead-in to this year's Jackson Hole Economic Symposium. Would Janet Yellen use her speech on labour market dynamics to depart from the dovish message she had been giving for much of the year? The answer was not really. Instead she used her speech as an opportunity to walk the public through the hard to interpret and sometimes conflicting evidence on how much slack remained in the economy. She talked about how labour market developments that appeared at first glance to be structural, such as increased early retirement and use of disability support, could themselves be related to cyclical weakness. At the same time, she outlined how a substantial proportion of the decline in the participation rate was related to demographics and even acknowledged that some of the increase in part-time work for supposedly economic reasons could be structural rather than cyclical. Yellen also discussed how wage and inflation developments could give a misleading signal about the optimal path for policy, particularly in a world where the amount of slack was of limited use in predicting underlying inflation trends (see chart 2). **Overall though, the main message from the speech was consistent with her long-held view that the decline in unemployment in recent years likely overstates the progress in the labour market and substantial slack remains (see chart 3).**

One small aspect of the speech did elicit some market reaction. Yellen restated the message from the minutes that if progress towards full employment and the inflation target continues to exceed expecations, policy accommodation will also be removed earlier and more quickly. On the one hand, this was a simple acknowledgement of the data dependence of policy. On the other, **it does seem to be indicative of a growing confidence within the core of the FOMC that the economy will soon be able to cope with higher short-term interest rates.** Our own central view remains that **June 2015 is the most likely timing for the first rate hike.** The Fed will want the first increase to coincide with a press conference and a move as soon as March would require a fairly substantial surprise to key labour market and inflation indicators.





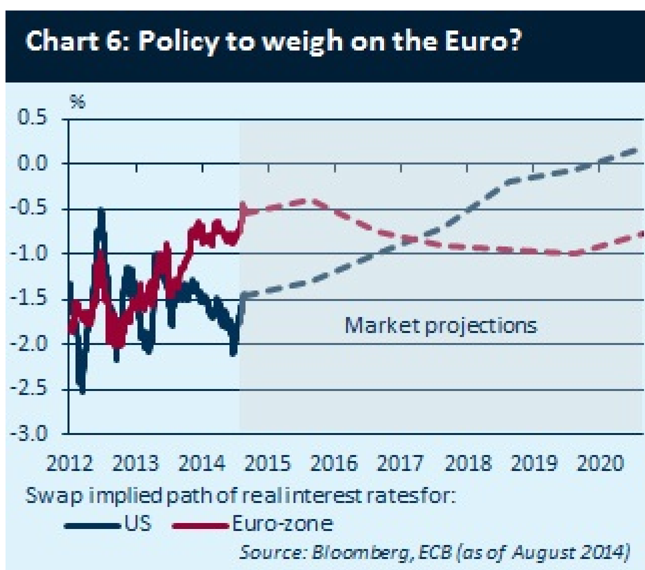
Europe

Rallying call

Another month, another fall in Eurozone inflation. The harmonised measure of consumer prices for the currency union slowed again in July to just 0.4% year-on-year (y/y) according to Eurostat's final estimate - the weakest rate of price growth since late 2009. There are temporary factors weighing on inflation at present. Volatile energy and food prices are currently subtracting 0.4 percentage points from the index and there could be further disinflationary pressure coming through this channel. Indeed, Brent oil prices have fallen by close to 15% since the middle of June, in spite of escalating geopolitical tensions. Exchange rate effects have also played a role. The appreciation of the euro since mid-2012 has weighed on import prices although this has started to reverse. ECB President Draghi pushed the currency lower again last week, noting that a divergence in the respective monetary policies of the US and Eurozone should weigh on the euro (see chart 6). Energy and currency effects aside, the underlying trend in domestically generated inflation remains weak while services inflation is running close to record lows at 1.3% y/y.

The risk is that the 'temporary' weakness in inflation proves more lasting. If expectations of future inflation among firms and households fall then Europe could find itself stuck in an environment of persistently low inflation. Mario Draghi used his Jackson Hole speech to sound a warning on this front. Inflation expectations as measured by breakeven rates have fallen notably in the Eurozone alongside the decline in spot inflation. While shorter-term expectations typically move closely with current inflation, medium-term expectations should be less responsive. Draghi therefore was justifiably concerned with the recent declines in these longer term measures (see chart 7). This should not be a complete surprise since the central bank itself has forecast that it will not hit its inflation target until 2017. It should, however, provide a wake-up call for the ECB. Indeed, the Japanese experience of deflation suggests that it is much more difficult to reverse once the downward spiral in prices has started.

Mario Draghi used his Jackson Hole speech to issue a rallying cry to Eurozone policymakers as they return from summer holidays. In particular, Draghi emphasised the important role governments could play in supporting growth through structural reform and fiscal stimulus. **While the emphasis on reform is not new, the call for demand-boosting stimulus represents a clear change in direction.** Draghi acknowledged the constraints of high debt and legal agreements but emphasised a number of options to better calibrate fiscal policy. These include using flexibility within the current budgetary rules, a more growth-friendly composition for fiscal tightening and more support at the overall Eurozone level. On the monetary policy front signals were more subtle. Draghi continued to point to the coming targeted long-term lending operations and asset backed security purchases as evidence that more stimulus is on the way. A larger asset purchase plan including government bonds remains likely, although the ECB will probably look to assess the impact of other stimulus measures before taking this controversial step. Overall, the best response to the current crisis would be a coordinated package of quantitative easing, targeted fiscal stimulus and structural reform. It remains to be seen if policymakers are up to the task of delivering.

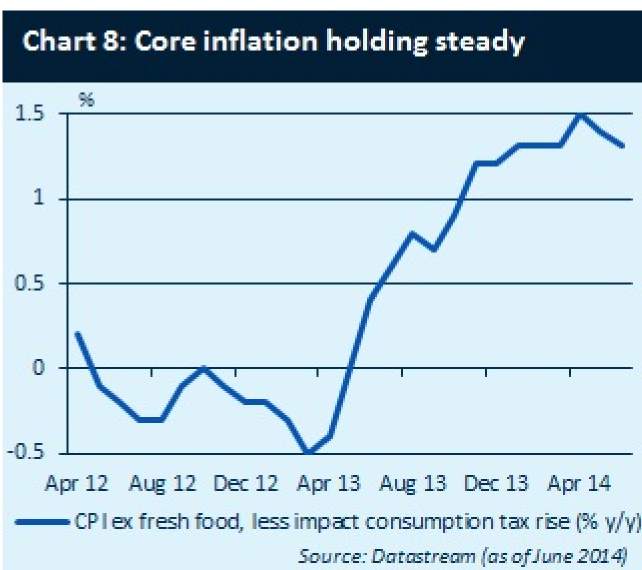


The tactics of distraction

Governor Kuroda had plenty to share with his central banking peers at the Jackson Hole conference. Japan has not only had to face up to the structural challenges currently facing other developed nation workforces – ageing, globalisation and skills mismatches – it has also lived through a post-credit bubble balance sheet adjustment and a prolonged period of deflation. However, for all the lessons he sought to impart regarding Japan's history of wage deflation and declining aggregate demand, **there was remarkably little comment on the progress, or otherwise, of the efforts to tackle Japan's current problems.** In case one has forgotten, the Bank of Japan is part way through an unprecedented policy experiment which, despite the initial success in driving core inflation higher in 2013, has been displaying signs of running out of steam, with core CPI trending sideways in 2014 at a level significantly below the Bank's stated target of 2% (see chart 8). Perhaps more worryingly, a key contributor to higher prices has been a surge in energy prices, accounting for nearly half of the 1.3% year-on-year rise in inflation in June. This is largely the result of a weaker currency and a shutdown in the country's nuclear power plants. These factors are likely to drop out of the picture in the coming months, challenging Kuroda's statement at his most recent press conference that CPI would not fall below 1%.

The question that needs to be answered then is how prepared the Governor is to respond to a further deterioration in the data. Despite his frequent proclamations that there may be more stimulus to come, **the answer appears to be that the Bank is somewhat reluctant to alter is current policy settings.** There could be a number of motivations to explain this. Firstly, the Bank is well aware that demand-side stimulus can only provide a temporary boost to the economy, with meaningful structural reforms needed to compliment the monetary efforts. So far, the government's third arrow has disappointed investors, and there is no reason why the BoJ should be any more impressed. Secondly, the Bank may have on eye on the government's efforts to come up with a credible plan to meet its fiscal consolidation target. The moral hazard issues associated with QE have been well flagged and, given Japan's considerable spending burden as a result of its ageing population, the Bank may be wary of being seen to be explicitly funding the fiscal deficit.

Of course, Kuroda would prefer us to believe that this is simply a case of the Bank's policy taking time to work its way through the system. He highlights the fact that, since the late 1990s, wage growth has fallen below CPI, illustrating that efforts to drive expectations higher through the wage channel have been sluggish (see chart 9). **To tackle this 'delay', he recommends a more proactive role for government in terms of determining wage growth # a return of the 'visible hand'.** This would allow both firms and households to come to an agreement more swiftly regarding the appropriate level of wage increases given the relevant economic conditions.



The opinions expressed are those of Standard Life Investments as of 08/2014 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.

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL.
Standard Life Investments Limited is authorised and regulated by the Financial Conduct Authority.
Standard Life Investments (Hong Kong) Limited is licensed with and regulated by the Securities and Futures Commission in Hong Kong and is a wholly-owned subsidiary of Standard Life Investments Limited.
Standard Life Investments Limited (ABN 36 142 665 227) is incorporated in Scotland (No. SC123321) and is exempt from the requirement to hold an Australian financial services licence under paragraph 911A(2)(l) of the Corporations Act 2001 (Cth) (the 'Act') in respect of the provision of financial services as defined in Schedule A of the relief instrument no.10/0264 dated 9 April 2010 issued to Standard Life Investments Limited by the Australian Securities and Investments Commission. These financial services are provided only to wholesale clients as defined in subsection 761G(7) of the Act. Standard Life Investments Limited is authorised and regulated in the United Kingdom by the Financial Conduct Authority under the laws of the United Kingdom, which differ from Australian laws.
Standard Life Investments Limited, a company registered in Ireland (904256) 90 St Stephen's Green Dublin 2 and is authorised and regulated in the UK by the Financial Conduct Authority.
Standard Life Investments (USA) Limited, registered as an Investment Adviser with the US Securities and Exchange Commission.
Standard Life Investments Inc., with offices in Calgary, Montréal and Toronto, is a wholly owned subsidiary of Standard Life Investments Limited.
Calls may be monitored and/or recorded to protect both you and us and help with our training.
www.standardlifeinvestments.com © 2014 Standard Life, images reproduced under licence