International Economics Monthly

December 2015

[redacted], ID; [redacted]
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Understanding policy divergence

Main message: *Data on inflationary pressures across the US, UK and euro area are consistent with market expectations that monetary policy will be relatively looser in the euro area, where inflationary pressure looks weakest. Comparing inflationary pressure across the three economies raises two questions: first, given the similarity in the conjuncture, why do markets expect the MPC to raise rates so much later than the FOMC; and second, while the outlook warrants a looser stance, there is a question about what has changed in the last six months to persuade the ECB to start easing policy again? On the first, the differing stance of fiscal policy is the clearest candidate to explain the UK's later expected tightening. On the second, a revision of their forecast reflecting a weaker outlook for EMEs is probably the main factor explaining why the ECB has shifted towards loosening policy. But strategy considerations may also play a role: while the ECB are more concerned about the risks of below target inflation, the Fed is more concerned with the risks of getting behind the curve and triggering market volatility by subsequently having to raise rates quite sharply. A box summarises the main data and policy developments over the month.*

Introduction

Central banks are centre stage in December: the FOMC have signalled they are likely to tighten policy; while further ECB easing is widely expected.[1] Currently, expectations for policy implied from financial markets suggest that: the FOMC will probably raise rates for the first time in December, with rates reaching 1½ - 1¾% by 2018Q4, the MPC will raise rates for the first time in Q1 2017, with rates reaching around 1¼% by end 2018, whilst policy rates in the euro area are expected to remain negative in three years' time. Charts 1 and 2 show recent developments in interest rates and exchange rates.

In this month's IEM we review the macroeconomic outlook driving those key policy decisions, and compare them to the UK. The next section compares measures of slack and inflationary pressure.

Chart 1: 3y spot OIS rates

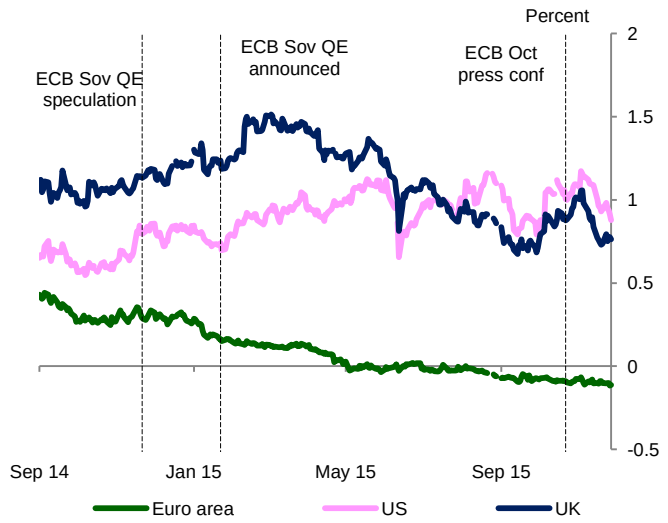
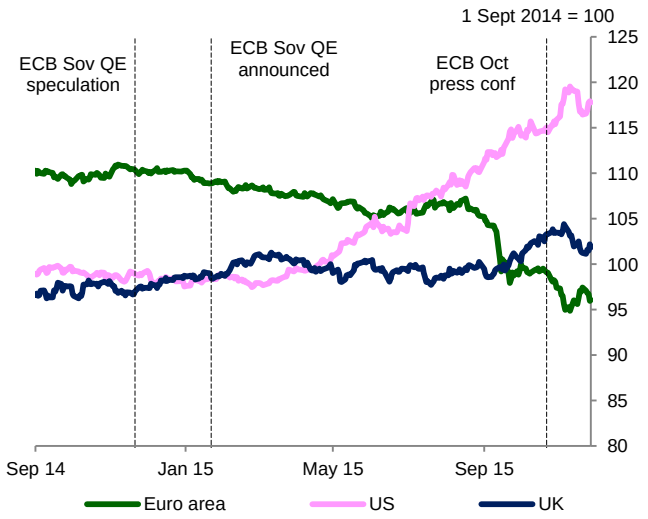


Chart 2: Exchange Rate indices



[1] For a preview of the ECB decision, [redacted]. A preview of the FOMC decision is forthcoming.

The recovery in the euro area has been slower compared to the US and the UK; growth has averaged 0.8% oya in the period since 2010, compared to around 2% in the UK and US. The level of GDP is just about back to its pre-crisis peak, whilst in the US and UK it is 9% and 7% higher respectively (**Chart 3**).

The starting level of spare capacity looks largest in the euro area...

At around 2% the euro-area output gap is currently 1.5pp larger than in the US and the UK (**Chart 4**), with slack in the labour market and slack within firms contributing. Other things equal, the slower recovery experienced by the euro area would imply a much larger output gap than the US or the UK. However, euro-area potential output growth seems to have been particularly subdued in the aftermath of the crisis. [2]

...but is very similar, and relatively limited, in the US and UK...

Meanwhile, our estimate of the UK output gap consistent with the Nov IR is around ½% in 2015 Q4, similar to the OBR estimate, and (on average) external forecasters. [3] This mainly reflects slack in average hours, with capacity utilisation slightly above potential.

Our estimate of the US output gap is also ½% in 2015Q4. [4] This is broadly consistent with the Fed's staff forecast, although it is smaller than the CBO estimate, which appears to be based on higher approximations of potential productivity, and is at -1.2%. For the US, slack is mostly in participation and hours, with a little within firms, and is partly offset by a positive unemployment gap. This is important because the Fed have indicated they put most weight on the unemployment gap as an indicator of inflationary pressure. As **Chart 4** shows, we expect output gaps to close at a similar pace in the three economies.

Chart 3: GDP levels

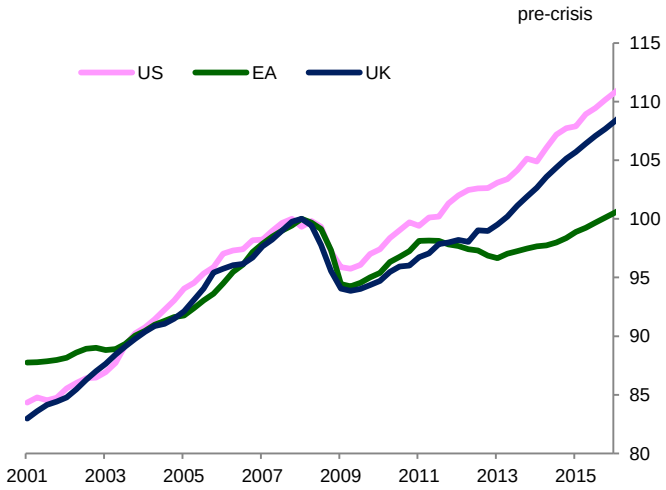
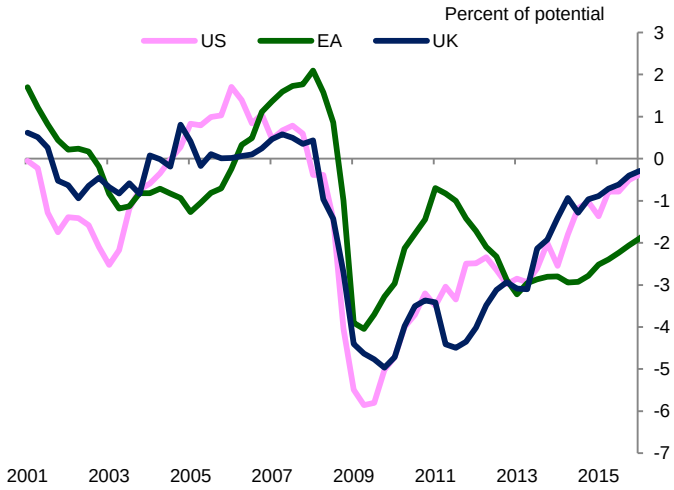


Chart 4: Output gaps



...and inflationary pressures also look the weakest in the euro area.

At 0.1% in the euro area, 0.2% in the US and -0.1% in the UK, headline inflation[5] remains well below target in all three economies. Core inflation has also been weak for some time, and currently stands at around 1% (**Chart 5**). While external factors can affect core as well, weak core could indicate a lack of domestically generated inflation.

Phillips curves can be useful in determining how much of the observed weakness in core inflation can be explained, and also in apportioning the undershooting of the inflation target to temporary and more persistent factors. Indeed, in a recent speech Fed Chair Yellen laid out her preferred Phillips curve specification. [6]

For the euro area, we can largely explain core inflation over the recent past. Given exchange rate movements, core inflation in the euro area is also probably being boosted relative to the US and UK. Of more concern though, the equation also suggests that expectations may be playing a role in low inflation. According to the equation, the fall

[2] For more detail
[3] For a range of estimates of the UK output gap .
[4] A forthcoming note on US inflation dynamics will discuss potential participation in more detail.
[5] For inflation, we refer to CPI measures in the UK and euro area, and PCE in the US.
[6] The equation specifies core inflation as a function of lagged inflation, labour market slack, long-run inflation expectations (constructed from estimates by the Survey of Professional Forecasters) and changes in the relative price of core imported goods.

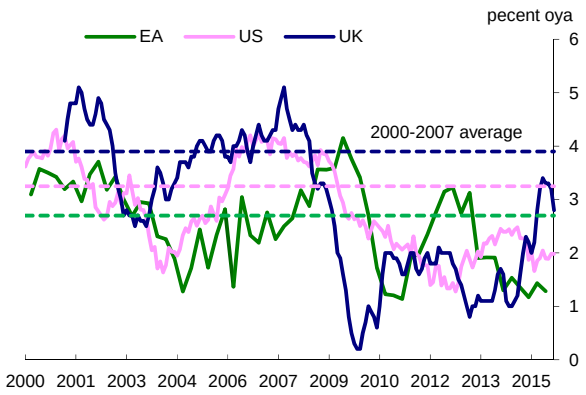
in professional forecasters' expectations over the past two years can explain around a 0.5pp fall in core inflation. So while low EA inflation can be explained, the factors we can explain it with – persistent underemployment and low inflation expectations (to the extent we place weight on the particular measure of expectations) – are troubling in themselves.

For the US the fitted values for core inflation are running slightly above the data. This can be explained by temporary factors that have been dragging down on US core inflation recently. Staff at the Fed thinks that the US dollar appreciation together with a temporary drag from healthcare costs are depressing core inflation by 0.5pp. After taking that factor into account, an adjusted measure of core inflation would be running significantly above the fitted values.

After adjusting for productivity, wage inflation remains below historic averages in the UK and euro area…

Nominal wages in all three economies have been sluggish in recent years, although UK wages have picked up recently as productivity has recovered (**Chart 6**). In part, wage weakness has been explained by the much slower pace of productivity growth observed post-crisis. But ULC growth still looks to be running below pre-crisis levels in the UK and euro area. In the latest quarter where data is available, ULC growth was 1.8% in the UK and 1.3% in the euro area, relative to pre-crisis averages of 2.7% and 1.4% respectively. However, US ULC growth has been slightly stronger, averaging 2.1%

Chart 6: Nominal wage growth



Note: Monthly -UK - Regular pay AWE, US – Private non-farm AHE Quarterly EA – quarterly compensation growth

In summary, inflation is weak in all three areas but weakest of all in the euro area. However, it is less obvious that that there is much difference between the UK and the US that justifies a different path for policy. Furthermore, conditions in the euro area have been less inflationary for some time; what has happened recently that convinced the ECB that more policy stimulus is necessary? We consider each question in turn.

Question 1: Why are rates in the UK expected to rise after the US?

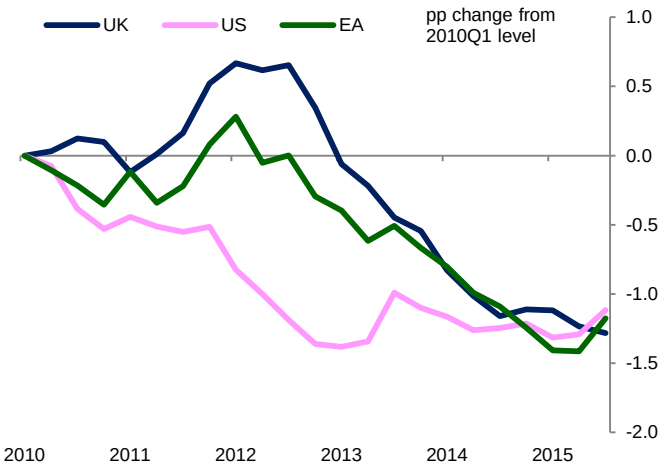
The output gap is determined by the path for policy but also by the fundamental shocks that are hitting an economy. A steeper yield curve may be warranted in one country relative to another even if spare capacity and inflation are the same, because policy is responding to a different set of shocks. If the headwinds to growth that are pushing down on the warranted interest rate ease faster in some economies than others, then policy is likely to diverge even if output gaps are currently very similar.

With this in mind, we compare UK and US credit and fiscal conditions. Credit conditions normalised more quickly in the US than in the UK (**Chart 7**), which help to explain why the US might be closer than the UK in raising rates. It is difficult to compare the level of credit spreads across countries on a like-for-like basis and to know exactly how long it takes for credit conditions influence the economy. However, a quicker normalisation of credit conditions should allow monetary policy to normalise more quickly as well.

Fiscal policy has tightened in all three economies over the past five years. Structural deficits have fallen across the board (see **Chart 8**). Although there are problems with such simple measures of the fiscal impulse, we expect fiscal

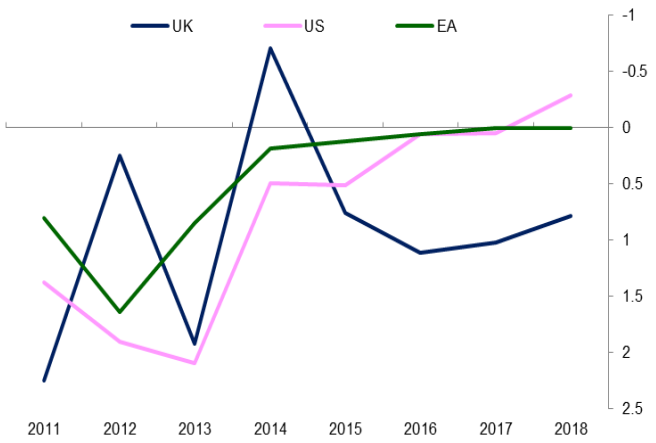
UK structural deficit will contract by 2.9ppt between 2015 and 2018,[7] compared to a slight fiscal loosening in the US (and broadly flat profile for the euro area[8]). Using our standard approach,[9] fiscal policy in the UK is currently contributing -0.4ppt to the output gap. Over the forecast, this grows to -0.7%. In contrast, the flat profile for the fiscal position over the forecast in the EA and US means that fiscal policy should not be a drag on growth. So, fiscal policy might be delaying policy normalisation somewhat more in the UK than in the US.

Chart 7: Credit spreads



Source: Bank of England, Datastream, ECB St Louis Fed and Bank calculations.

Chart 8: Change in structural fiscal balance (IMF measure[10])



Source: WEO

This difference in headwinds from credit and fiscal conditions provides a tentative explanation for the later lift off in the UK and the slightly slower path of rate rises thereafter. In addition, the low level of interest rates in the euro-area will tend to pull down on the appropriate level of interest rates than the MPC may want to set by more in the UK – a smaller, more open economy more closely integrated to Europe.

Question 2: What has changed to make the ECB want to ease policy?

Comparing inflationary pressures in the euro area with the other two economies suggests that a looser stance for policy makes sense. However, this has been the case for some time – why is the ECB now looking to ease policy.

The euro area is most exposed to the EME shock….

An important factor feeding into the ECB policy decision relates to EMEs. Both the EA and the UK are much more open economies than the US. But while exports to EMEs account for a relatively small part of UK exports, they make up a much larger proportion of EA exports (**Table 1**). This might make the euro area more exposed to the slowdown in EMEs, and has been a key reason why the ECB has recently downgraded their growth forecasts.

Table 1: Exports to Emerging Markets

	Exports to EMEs, % of GDP	June forecast for 2015 growth	September forecast for 2015 growth	Change to forecast of 2017 GDPlevel
UK*	7%	2.8%	2.7%	-0.2%
Euro Area	14%	1.5%	1.4%	-0.5%
US	5%	1.9%	2.1%	-0.1%

*UK forecasts are from August and November IRs. The euro area numbers are for extra euro-area exports. for more detail.

[7] The OBR expect a slightly faster degree of fiscal tightening over the forecast horizon, as measured by the change in the structural deficit. Compared to the IMF, the OBR have around 0.3% of potential GDP more in fiscal tightening by 2018-19 relative to 2015-16. for details of the latest Autumn Statement and the OBR forecast.

[8] The IMF only publish a forecast for EA structural fiscal balance out to 2016, but it is unlikely policy will tighten to anything like the extent as in the UK.

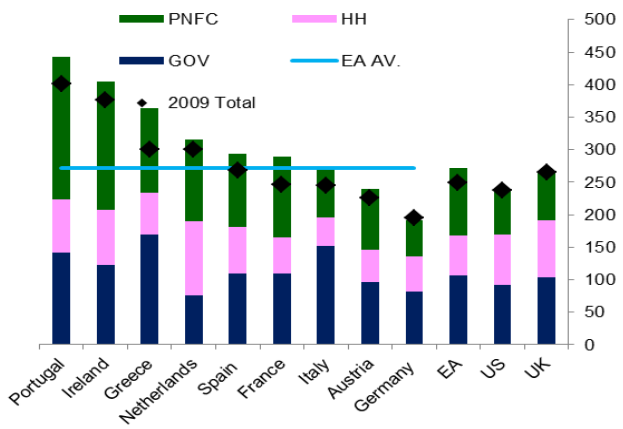
[9] This uses the policy rule in COMPASS, where fiscal policy responds to changes in potential supply – any additional tightening over this is treated as discretionary, and therefore a shock which can explain movements in GDP and other endogenous variables.

[10] In our analysis and the forecast, we use the IFS "action-based" measure of discretionary changes in fiscal policy, rather than changes in the cyclical adjusted fiscal deficit. The former has generally superseded the latter in the literature, and suggests a notably more stable path of fiscal tightening in recent years, along with a slightly more moderate pace of tightening ahead. We use the IMF measure for comparability.

….and that seems to be driving policy.

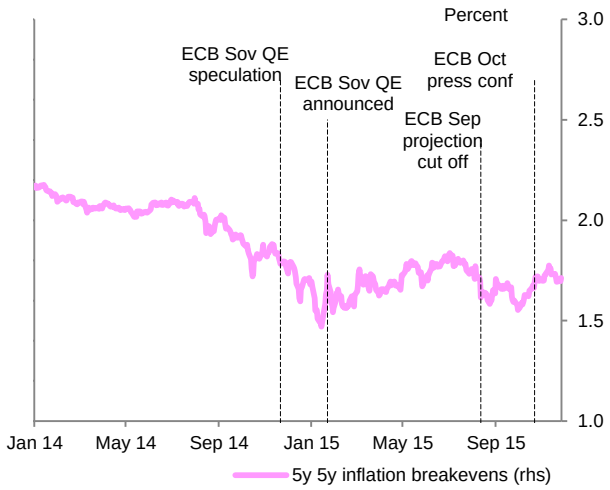
While exposure to the EME slowdown, and the associated downgrade to its central forecast, explains why the ECB is looking to ease policy further, it is also possible that the ECB is responding to a shift in the distribution of outcomes. President Draghi has talked about the continuing fragility of the euro area and the risks of continued low inflation (*'In making our assessment of the risks to price stability, we will not ignore the fact that inflation has already been low for some time'…. 'putting the whole picture together, we have a situation where we cannot yet say with confidence that the process of economic repair in the euro area is complete'*). This suggests that, as well as a weaker central case, the ECB, or at least some members of the Governing Council, may be concerned with the risk that this shock interacts with existing fragilities in the euro area. The weakness in some long-term measures of inflation expectations through much of 2015 may be of particular concern (**Chart 10**). While greater sensitivity to the risks could be interpreted as a change in the ECB's reaction function, as noted in the Policy Preview we think significant additional stimulus can be explained by the weaker September forecasts. Why might the euro area be less resilient to shocks than the US? One reason is that debt burdens are not evenly distributed across EA countries (**Chart 9**). If inflation expectations de-anchor and nominal growth stalls, the rising real burden of debt could place some countries in serious difficulty. The absence of fiscal union makes this a particular problem for the EA. Although this is not a new development, the ECB may be more concerned than the Fed or BoE about how the worsening in global conditions interacts with existing vulnerabilities.

Chart 9: debt/GDP ratios for the non-financial sector



Source: BIS total credit statistics

Chart 10: euro area inflation expectations



Source: Thomson Reuters Datastream and Bank calculations

The Fed may also be mindful of risk management issues. However, they appear to be more focused on the risk of getting behind the curve and needing to tighten quickly, and the volatility in markets that this could lead to. The logical implication of gradualism is that rates should start to rise early, but do so slowly[11].

Conclusions

The euro area inflation outlook looks weaker than in the US or UK, and this explains why policy is expected to be relatively looser. Headwinds from credit and, particularly, fiscal point towards a later expected lift-off in the UK relative to the US. But the euro area has faced a weaker inflation environment for some time. Our view is that the greater exposure to an EME slowdown, and associated downgrade to the central forecast, explains why the ECB is looking to ease policy further. However, it is possible that the ECB also believes there has been a shift in the distribution of outcomes, and this might also be playing some role.

In the light of the data and likely headwinds, the current expectations of a divergence in policy probably make sense. However, if developments turn out differently, policy could diverge even more sharply. For instance, if the US recovery proves more resilient to rising rates, whilst the euro area faces further falls in inflation expectations which start to make highly indebted countries look vulnerable again, then a wider gulf between policy stances could emerge.

[11] "If the FOMC were to delay the start of the policy normalization process for too long, we would likely end up having to tighten policy relatively abruptly….. Such an abrupt tightening would risk disrupting financial markets and perhaps even inadvertently push the economy into recession." Janet Yellen, 24 Sept.

Assessment of data and policy news on the month

By

Region	Judgement on the month	GDP growth forecasts*		Dec MPC	Nov MPC
Euro area	*Q3 GDP came out at 0.3% qoq, slightly below the Nov IR forecast of 0.4%. Near-term indicators have picked up a bit in Q4, and headline inflation rose to 0.1% in October. Market expectations of further ECB policy loosening in December have strengthened.*	**EA**	Q3	0.3%	0.4%
			Q4	0.4%	0.4%
			Q1	0.4%	0.4%
US	*Q3 GDP growth was 0.5% qoq, 0.1pp higher than at November pre-MPC reflecting a smaller drag from inventories. Our nowcast for Q4 is 0.4%. The strong October labour market report leaves the likelihood of policy tightening in December very high.*	**US**	Q3	0.5%	0.4%
			Q4	0.4%	0.6%
			Q1	0.6%	0.6%
RoW	*In China, the Q4 nowcast points to growth of 1.6% qoq, in line with the Nov IR. Industrial activity appears weak, in particular, IP growth came in lower than expected at 5.6% oya in October, although retail sales rose to 11% oya.*	**China**	Q3	1.6%	1.6%
			Q4	1.6%	1.6%
			Q1	1.5%	1.5%
Commodities	*The US dollar appreciation has added downward pressure on commodity prices. Oil prices have fallen 8.8% since November pre-MPC to around $43pb. Metal prices and agricultural prices have fallen 8.4% and 3.4%, respectively.*	**Data in yellow*			
World activity	*The JPM global output PMI points to 0.9% oqa PPP-wtd world GDP growth in both Q3 and Q4, slightly stronger than the Nov IR (but has over-predicted world growth recently). CPB world trade growth fell to 1.1% 3m-on-3m in September from 1.8%, mainly driven by weaker EME imports, but CPB world IP picked up a little in September to 0.4% 3m-on-3m from 0.3%.*				

Euro area

Q3 GDP came out at 0.3% qoq, slightly below the Nov IR forecast of 0.4% with downside news in Italy and some of the smaller EA economies. IP fell 0.3% oma and retail sales by 0.1% oma in September. Near-term indicators have picked up somewhat in Q4. The composite PMI and consumer confidence have both increased. The final release of HICP inflation in October was 0.1%, up 0.2pp on September. Core inflation also rose by 0.2pp, to 1.1%. We now expect HICP inflation to pick up to 0.3% in November, before rising further in December and January. The ECB minutes and comments by Governing Council members have strengthened market expectations of further policy loosening at the December meeting. A deposit rate cut and an increase in the size of the asset purchase programme are seen as likely, but there are a range of views about the scale of any action.

It is too early to say if the macroeconomic consequences of the tragic events in Paris are likely to be significant. In the past, the impact of such events has tended to limited and short-lived. So, as long as the Paris attacks are not the start of something more long lasting, past evidence suggests the macroeconomic consequences may be short lived.

US

The second release of Q3 US GDP was revised up by 0.1pp to 0.5% qoq, but our underlying view of the economy remains unchanged. The increase was due to an upward revision to private inventories (+0.2pp) partly offset by small downward revisions to net exports (-0.05pp). The stocks correction is now likely to extend into this quarter, with inventories once again dragging on headline growth. Our nowcast for Q4 is 0.4% qoq. This is somewhat lower than the Nov IR and in part reflects weaker consumption data in October. This weakness is not expected to persist, with real personal disposable income growing at a healthy rate recently, increasing by 0.4% oma (3.9% oya). However, a range of monthly survey indicators have fallen on the month, flagging a downside risk to the near-term forecast.

The October employment report painted a significantly brighter picture of the labour market, following two disappointing months. Non-farm payrolls increased by 271k, the highest monthly figure since December 2014. The unemployment rate fell from 5.1% to 5.0% and the U6 unemployment rate fell by 0.2pp to 9.8%. The October FOMC minutes indicated weaker labour market data was a key reason for keeping rates unchanged. Barring a major data surprise, the FOMC is now widely expected to raise the federal funds rate in December, with the market implied probability around 75%. Inflation, however, remains weak: headline CPI increased by 0.2pp to 0.2% oya in October, the same level as PCE (flat at 0.2%). Core CPI was unchanged at 1.9% oya, and core PCE was also unchanged, but at 1.3% stands at a much lower level.

China and EMEs

In China, the Q4 nowcast points to growth of 1.6% qoq, in line with the Nov IR. Industrial activity appears weak: IP growth came in lower than expected at 5.6% oya in October, while the principal component measure points to a risk of an even faster deceleration. In contrast, official retail sales growth continues to expand, rising 11% oya in October. And official FX reserves increased unexpectedly by $11bn, perhaps reflecting the record trade surplus. SAFE's October spot FX settlement data showed banks sold a net $30bn to clients (vs $128bn in Sept.), also suggesting capital outflows have slowed. However, contacts suggest intervention may still be taking place using FX forwards. The PBoC cut rates on its Standing Lending Facility (overnight to 2.75% (-175bp); 7-day to 3.25% (-225bp)), thought to be aimed at creating an interest rate ceiling, given they have now fully liberalised interest rates. The PMI also pointed to a stabilisation in other EMs. Our composite PMI for the main non-China EMs increased by 0.1 to 49.5 in October.

But Brazilian GDP again came in weaker than expected at -1.7% qoq in Q3 (-4.5% yoy).

Commodities

The recent appreciation of the US dollar has led to a significant fall in commodity prices. Brent oil prices have fallen 8.8% since November pre-MPC, with the futures curve 7.2% lower. Recent falls in oil prices has also been driven by resilient oil supply. A global oil supply glut is expected to continue throughout 2016, mainly reflecting high inventories and the expectation of Iranian oil coming on to the market. But the recent escalation of the conflict in Syria has increased upside risks to oil prices. Industrial metal prices have fallen 8.4% since pre-MPC, reflecting weak Chinese demand. Agricultural prices have fallen 3.4% over the same period.