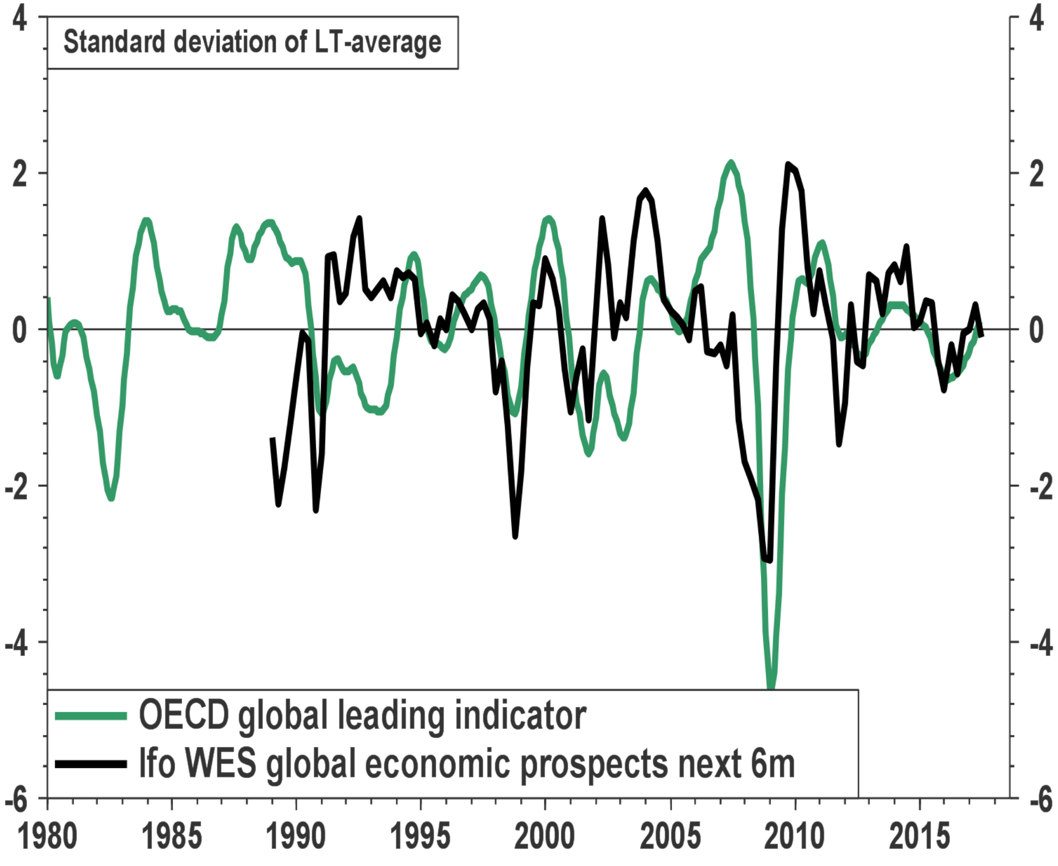
# *What's next for central bank policy ?*

21 August 2017

Hans Bevers – Chief Economist

# Global backdrop in a nutshell

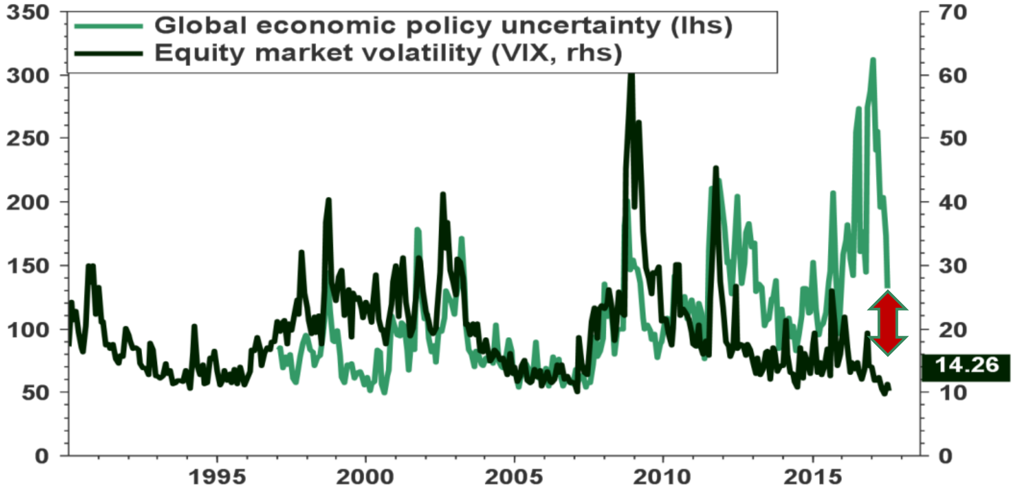
# Global economic activity doing fine from cyclical point of view

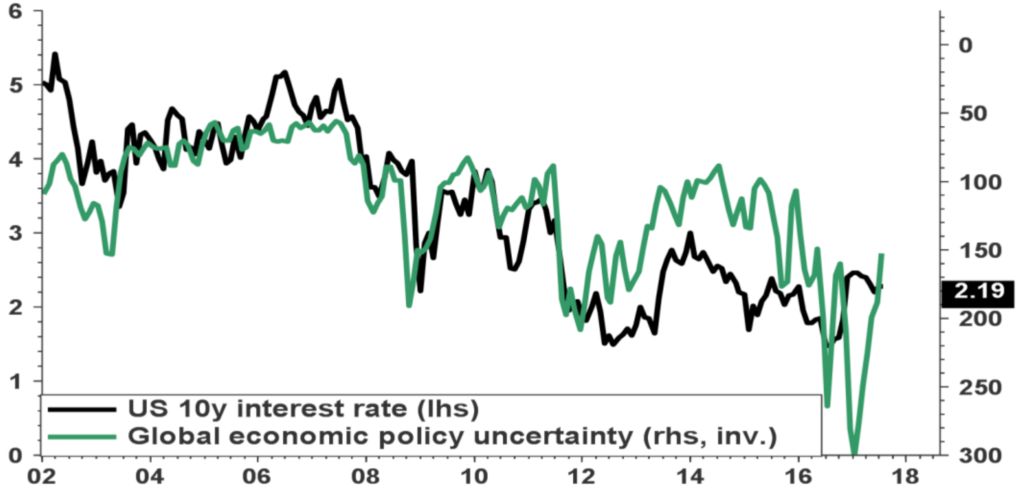



Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Global confidence hovering around LT-average
- ✓ Global GDP growing at around 3% in yoy terms
- ✓ Global trade showing signs of improvement
- ✓ Fiscal policy stance fairly neutral
- ✓ Inflation figures still coming in below target
- ✓ Monetary policy conditions remain loose for now

# Narrowing gap between economic policy uncertainty and volatility



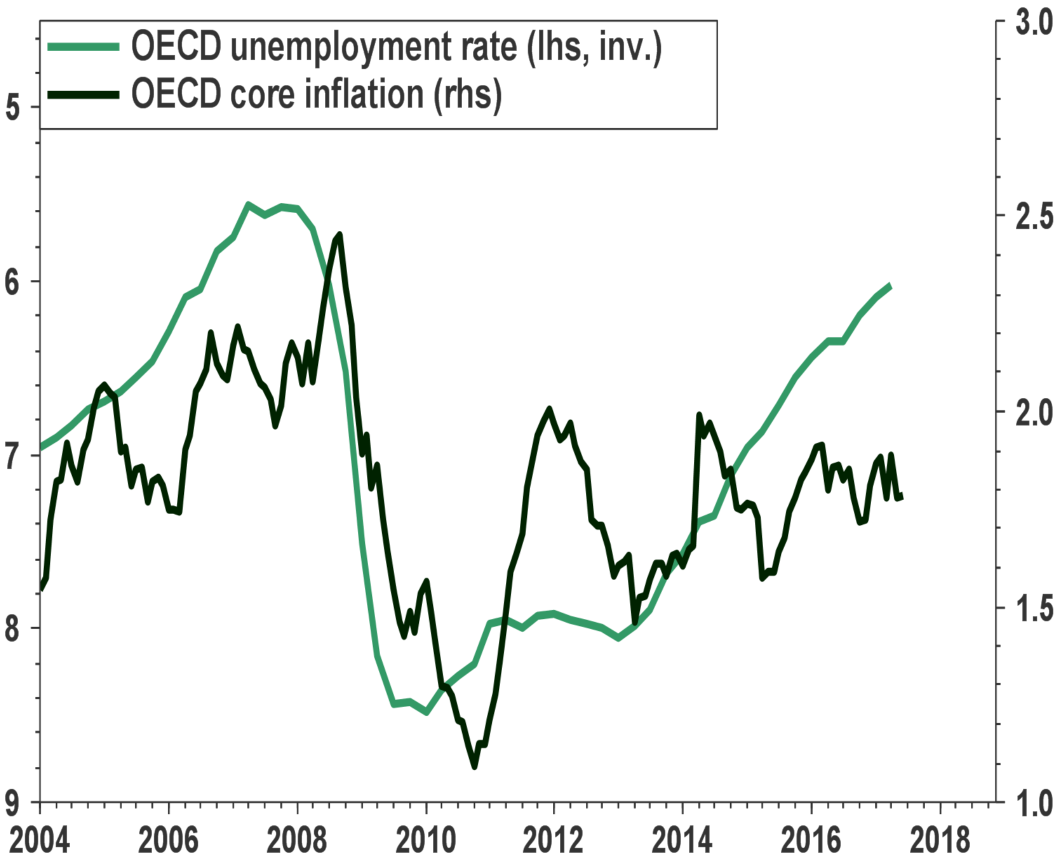

Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Economic policy uncertainty is still high in LT-perspective…
- ✓ …but has been falling lately
- ✓ Equity market volatility is still very low in LT-perspective…
- ✓ …but has been creeping up lately
- ✓ Less policy uncertainty would help lift interest rates…
- ✓ …while keeping volatility in check as central banks step up their efforts to gradually tighten monetary policy

# Challenging and confusing times

- ✓ Disappointing productivity growth
- ✓ Promising technological breakthroughs/ ongoing digitization
- ✓ Ageing of the population
- ✓ Inequality of income and wealth
- ✓ Global debt overhang/excessive leverage in China
- ✓ Possible pockets of overheating *(e.g. Canada housing market, US equity market,…)*
- ✓ Populism and geopolitical uncertainty *(N. Korea, Middle East,…)*

# Falling unemployment versus low and broadly stable core inflation

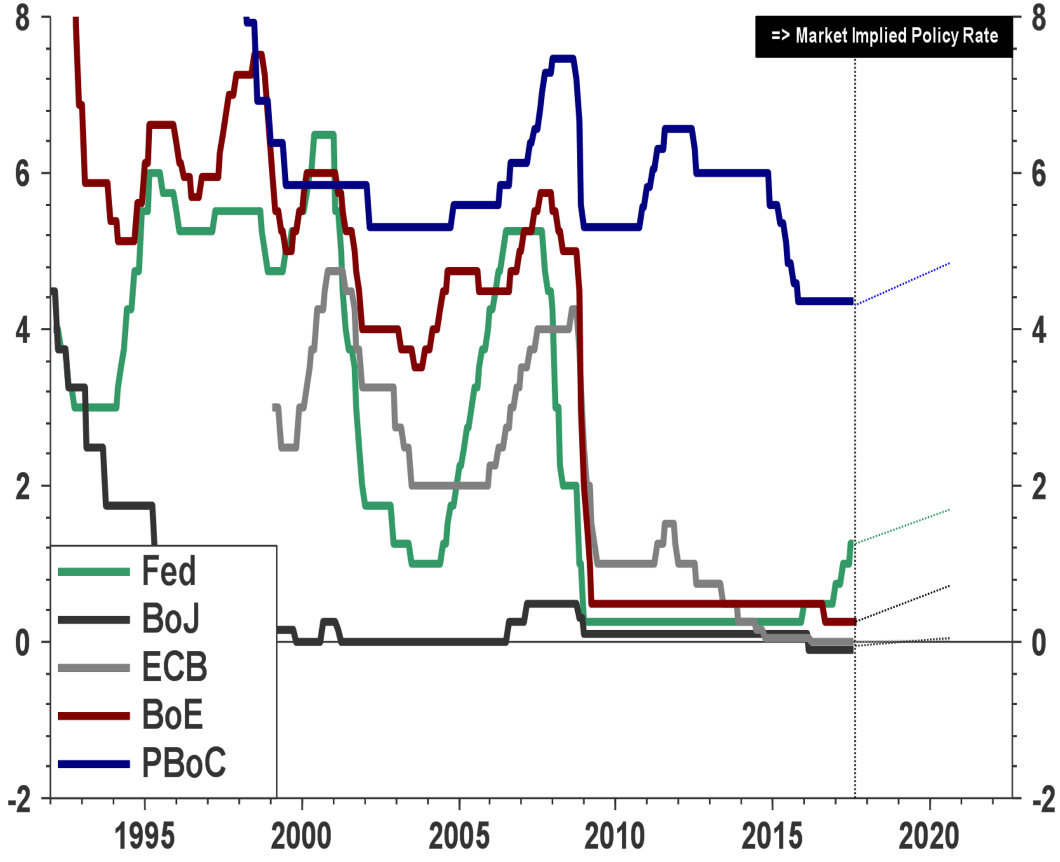



Source: Thomson Reuters Datastream, Degroof Petercam

***A combination of different factors at work:***

- ✓ Globalization
- ✓ Technological change and digitization
- ✓ Presence of shadow labor market slack
- ✓ Ageing of the population *(~higher paid workers in retirement)*
- ✓ Weakening labor union power
- ✓ Lower anchored inflation expectations
- ✓ Sluggish productivity growth *(~wage growth)*

# Markets expect policy rates to rise only very gradually



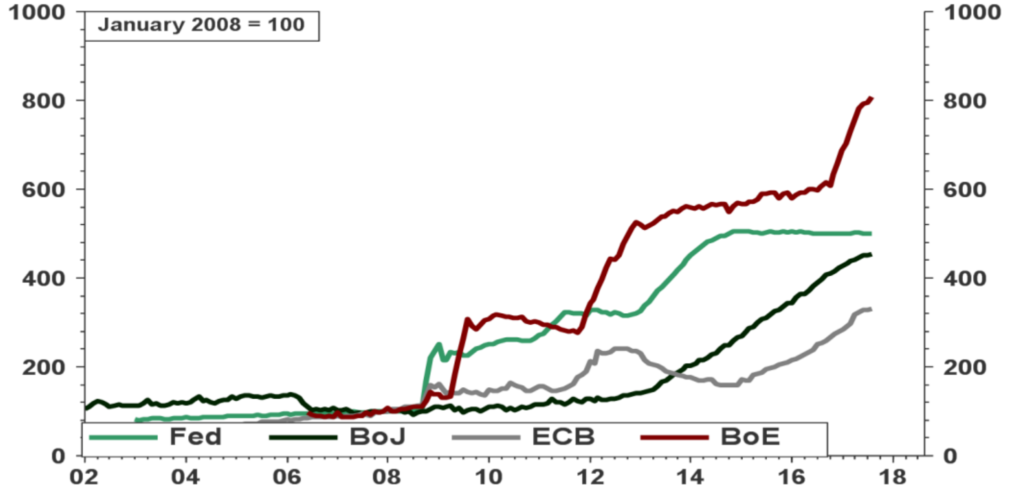
Source: Thomson Reuters Datastream, Degroof Petercam

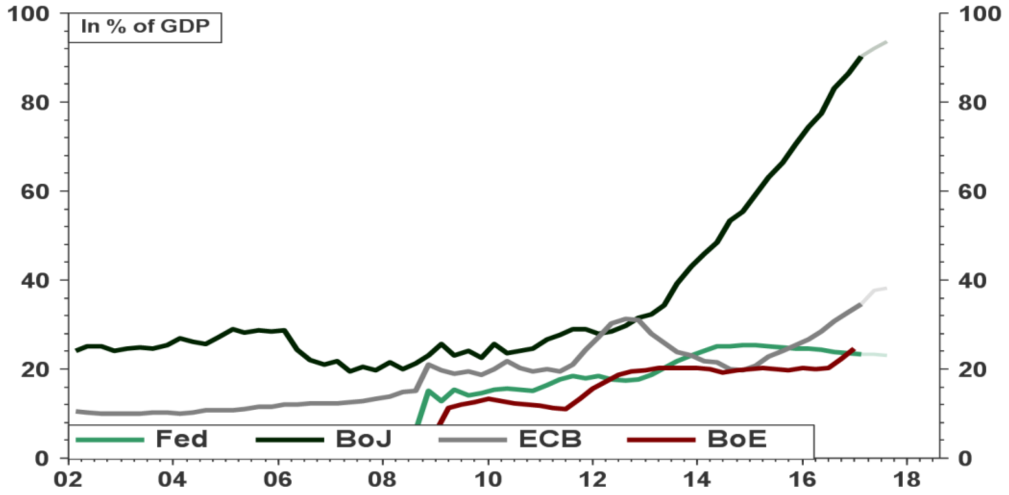
✓ From here until fall 2019, markets are pricing in:
- About 2 more rate hikes in the US
- About 1 rate hike in the UK
- About 1 rate hike in the Eurozone
- No rate hike in Japan

✓ We agree with markets that interest rates will move up rather gradually as to strike the right balance between growth and inflation. These two factors will ultimately drive the outcome

✓ On the margin, however, taking into account central banks' willingness to move away from the zero interest rate environment, we think that risks are skewed to the upside

# How fast will central banks unwind unconventional policy?

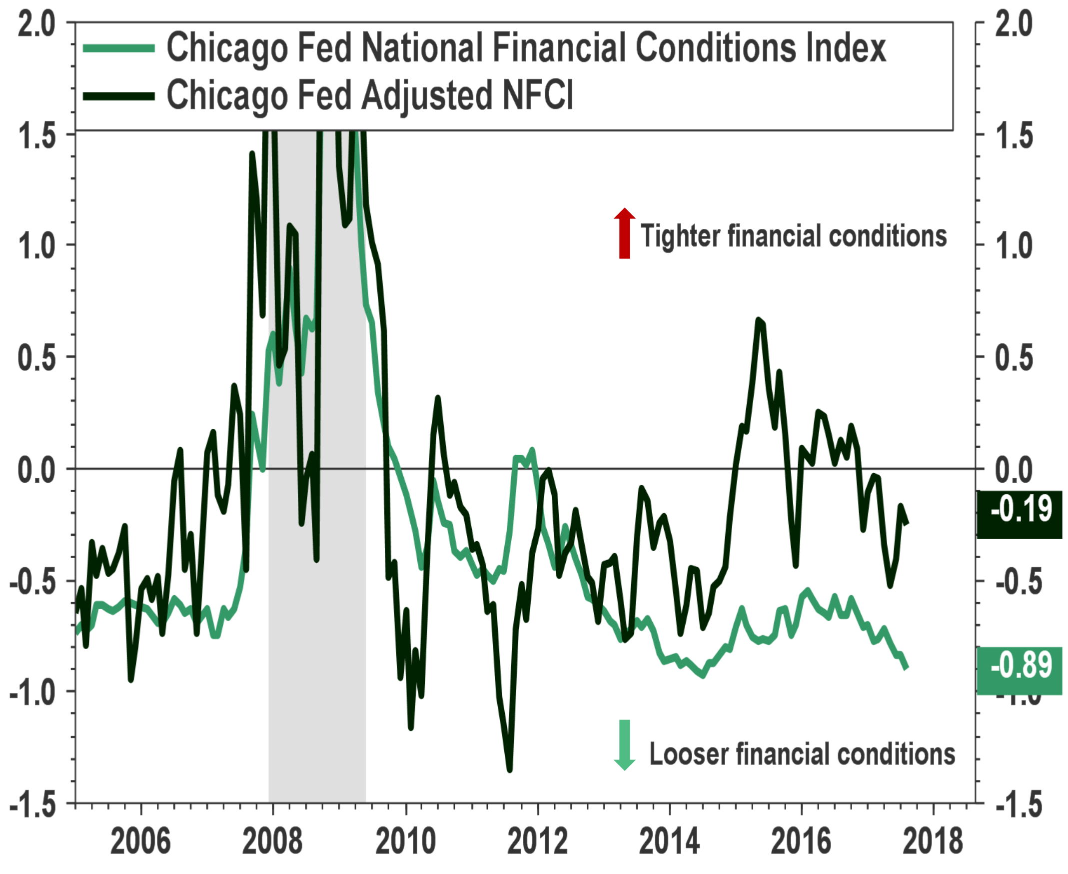



Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ There's no preset course, this is unchartered territory
- ✓ Financial market volatility is likely to show up again from time to time, perhaps significantly
- ✓ Relatively easy process from a technical point of view, very difficult to factor in market psychology
- ✓ The only thing we can be pretty sure of is that the process:
  - will be communicated very clearly and in advance
  - central banks will leave all options on the table
  - will be introduced very gradually
  - central bank balance sheet levels will not shrink to the levels seen before 2008

# Financial conditions still loose providing room for the FED to proceed




Source: Thomson Reuters Datastream, Degroof Petercam

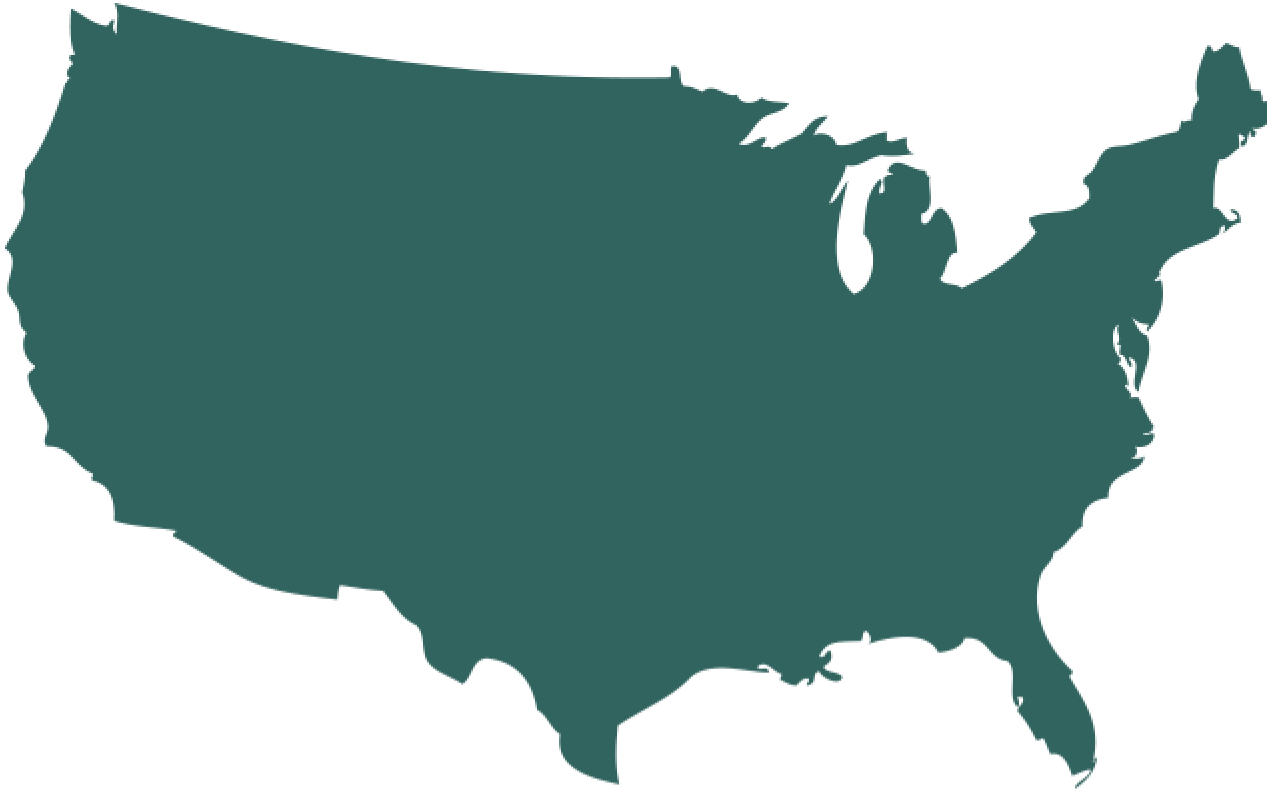
- ✓ Financial conditions traditionally stamp their mark on near-term economic activity and inflation

- ✓ The National Financial Conditions Index:
  - A comprehensive weighted measure of financial conditions based on…
  - money markets, debt and equity markets, banking system and currency
  - Positive values point to tighter than average financial conditions (and vice versa)

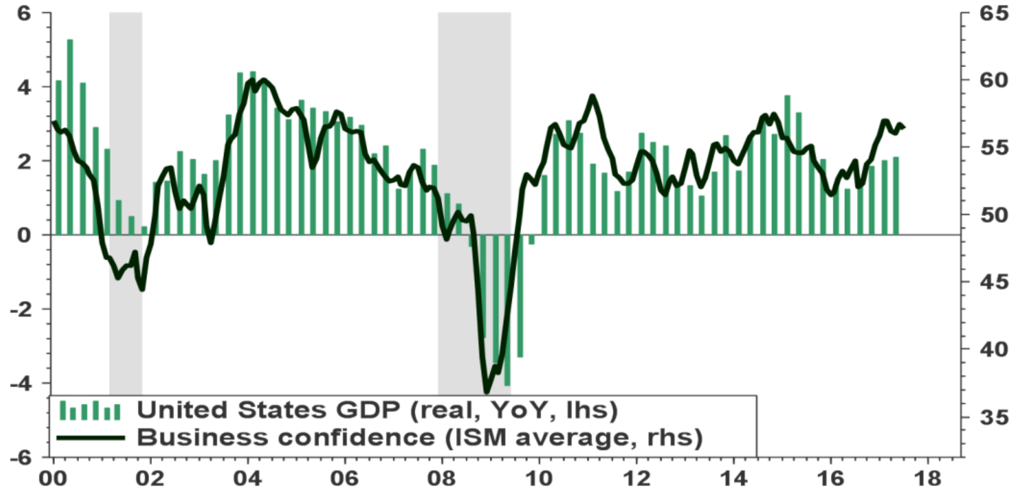
- ✓ The adjusted NFCI (ANFCI) also takes into account economic activity and inflation and so provides guidance on where financial conditions relate to current economic conditions

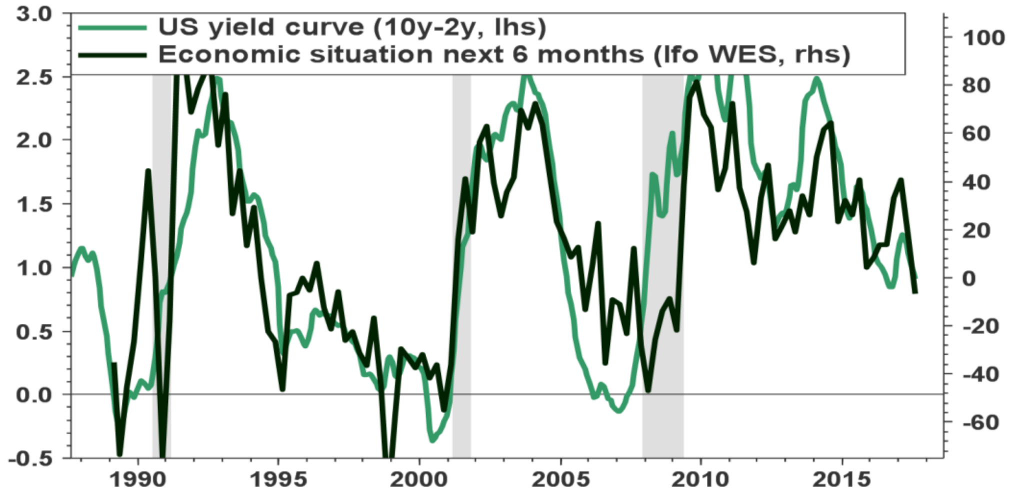
- ✓ The latter suggests that financial conditions are still relatively loose in comparison to economic conditions, providing room for the FED to gradually tighten monetary policy further

# United States Federal Reserve



# US economic activity: on the one hand, on the other…



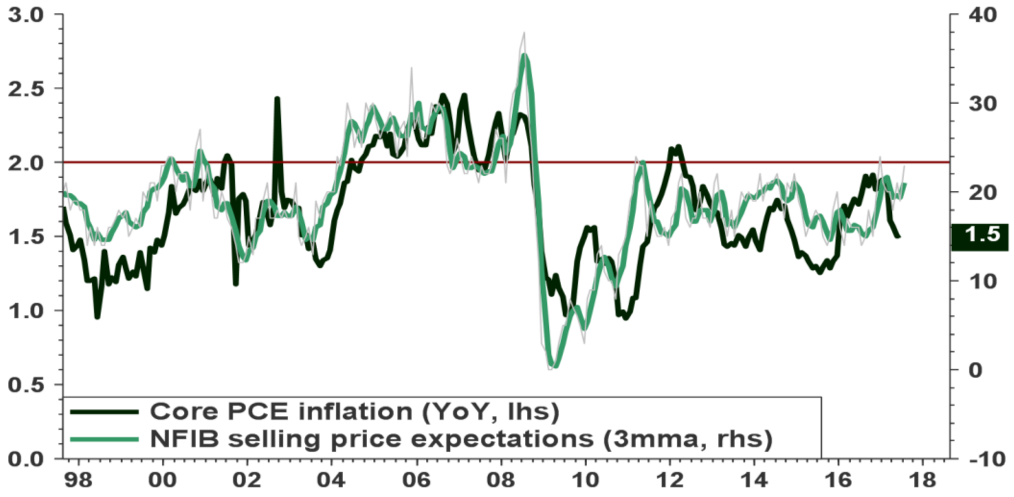



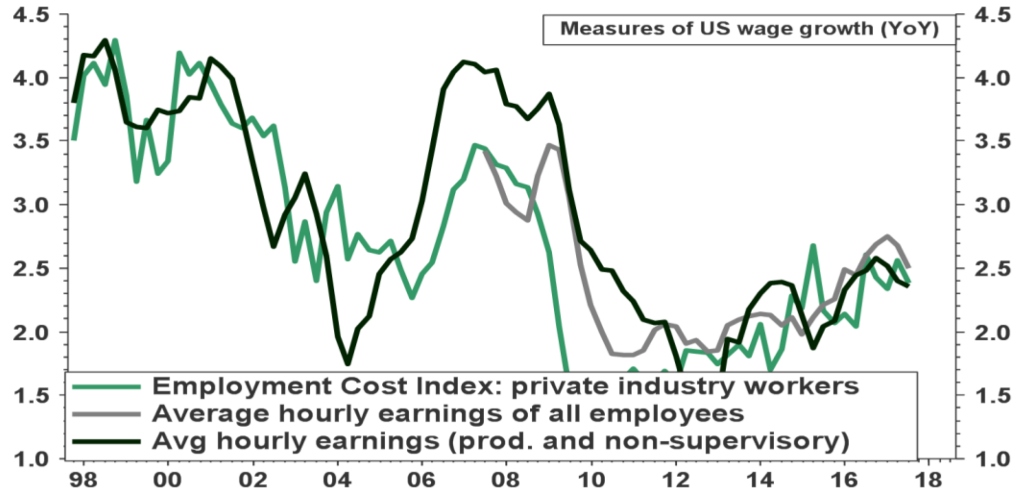

Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Confidence indicators pointing to solid momentum
- ✓ Other leading indicators point to softening outlook
- ✓ Consumption should hold up in H2 *(housing market, energy prices, job market)*
- ✓ Labor market continues to tighten
- ✓ Productivity growth remains very subdued
- ✓ Political uncertainty linked to Trump agenda

*(Fiscal stimulus expected to be modest at best and unlikely to boost economic activity)*

# Inflation set to pick up only modestly



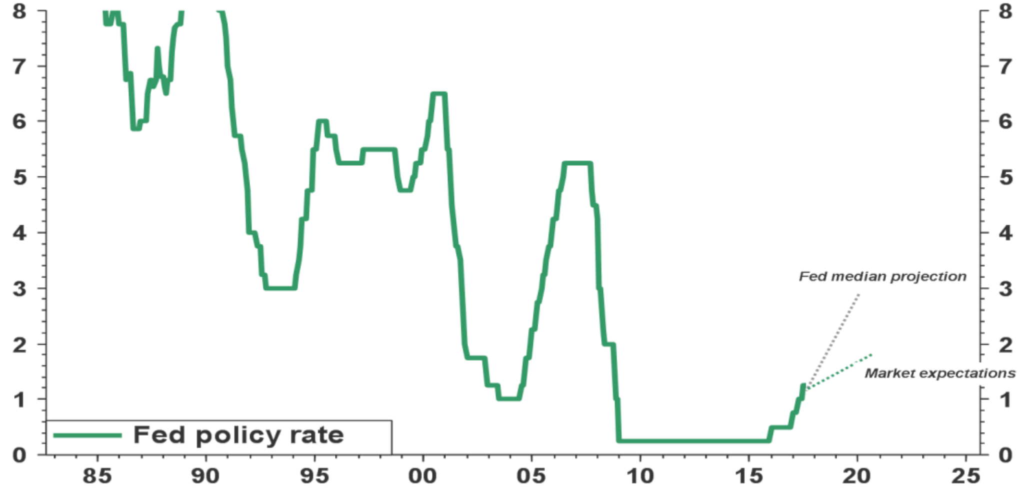



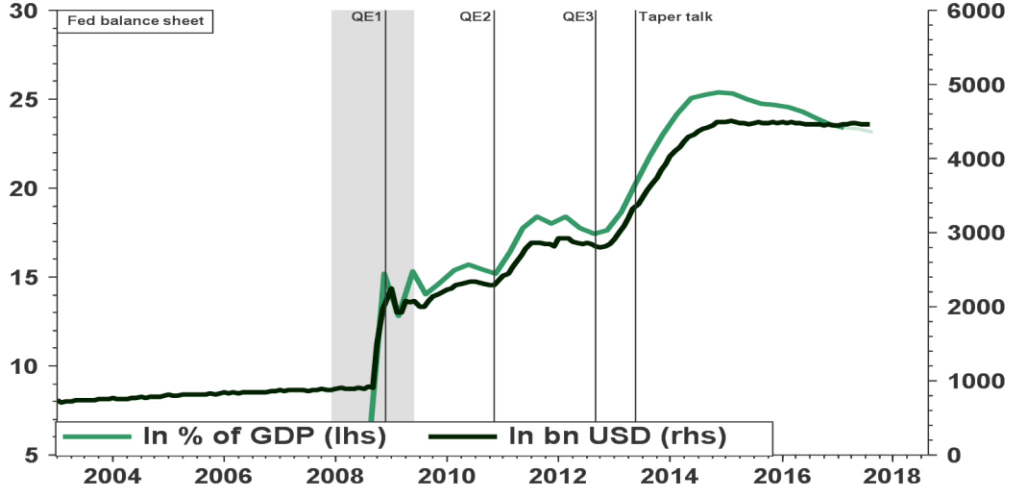

Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Temporary setback in inflation *(telecommunication, airfares, lodging)*
- ✓ Price expectations point to renewed but modest pick-up
- ✓ Recent USD depreciation should help somewhat
- ✓ Labor market tightness should gradually lead to higer wages
- ✓ That said, recent experience warrants caution

*(for possible explanations see page 6)*

# Fed in gradual tightening mode




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Fed in gradual tightening mode

  *(with actual pace determined by financial market volatility, economic activity and inflation)*

- ✓ Markets expect rates to rise slower than median of Fed participants' forecasts

- ✓ Split views on the future evolution of price levels

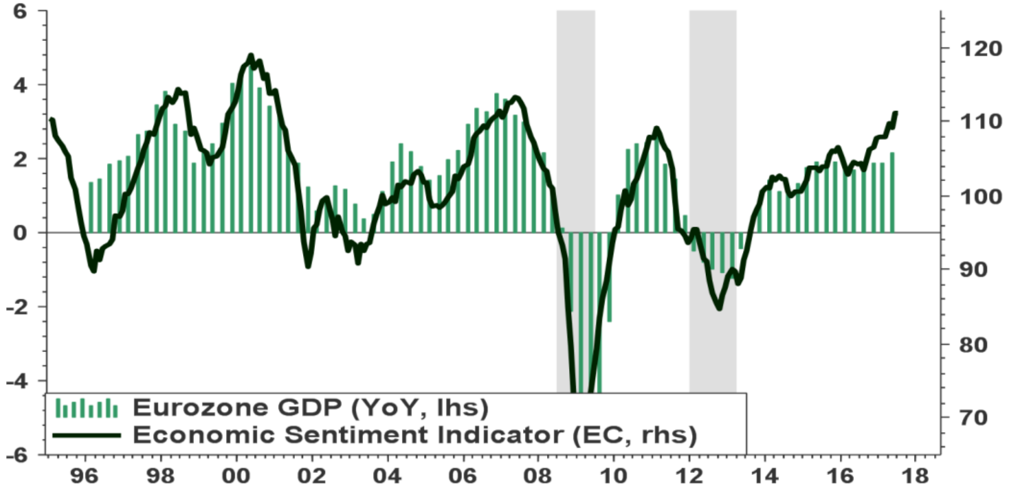
  *(although most still think the Phillips curve relationship between economic slack and inflation is valid)*

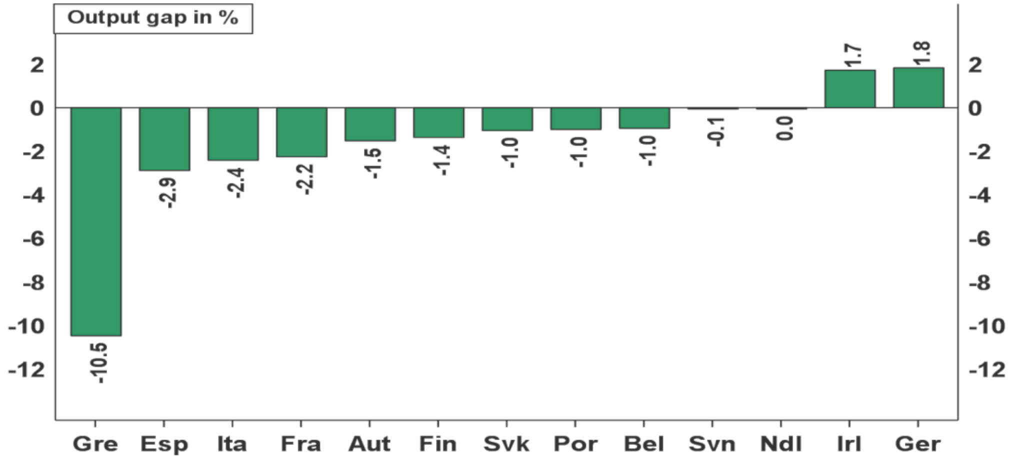
- ✓ As things stand, we expect the Fed:
  - to announce start of balance sheet rundown in its September meeting
  - to proceed with a fifth rate hike in December
  - to hike interest rates 2-3 times in 2018

- ✓ All this is subject to both downward and upward risks

# European Central Bank

# Economic confidence points to strong growth

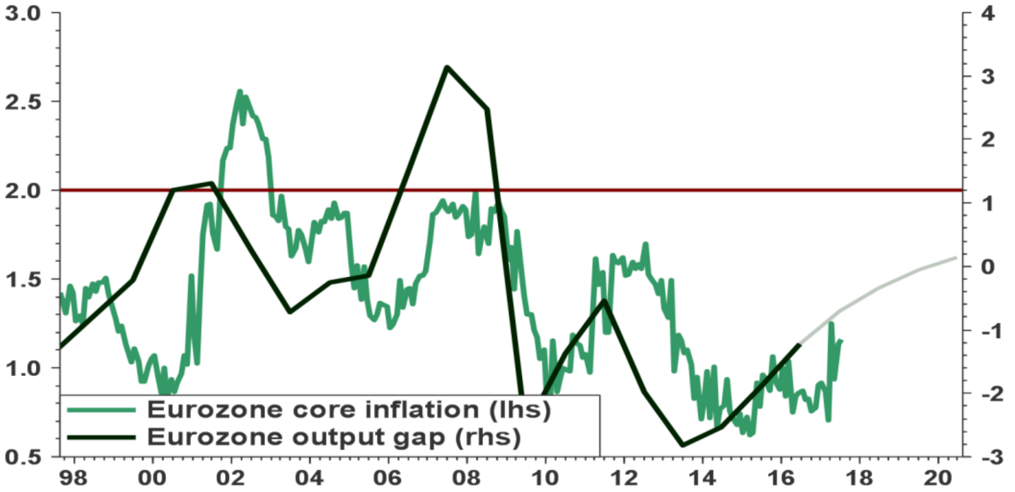


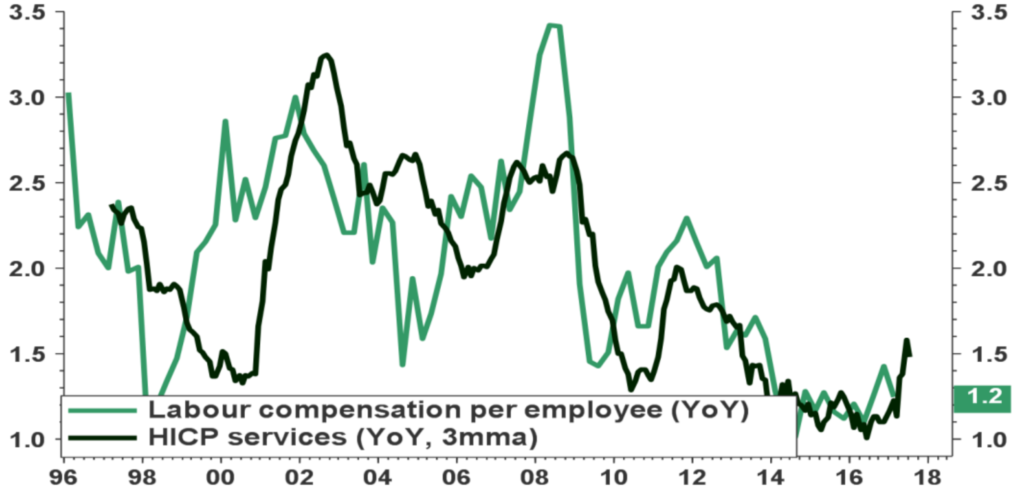




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Economic activity firing on all cylinders *(from cyclical point of view)*
- ✓ Fast economic growth is absorbing economic slack
- ✓ Broad-based recovery across actors, sectors and countries
- ✓ Unemployment continues to decrease throughout the region
- ✓ Differences in unemployment and economic slack remain
- ✓ Political uncertainty surrounding Brexit
- ✓ Longer term political and institutional risks persist

# Inflation unlikely to reach target anytime soon

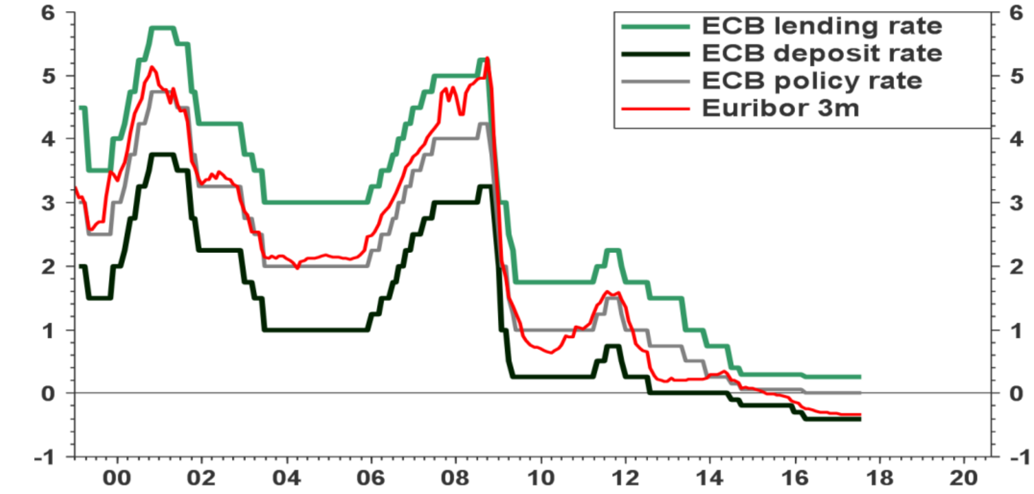


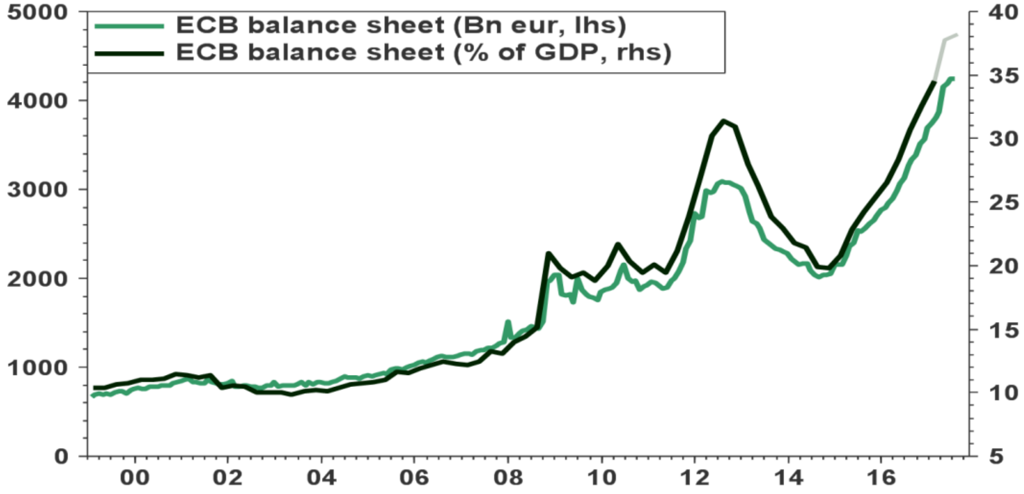




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Economic slack suggests that inflation will remain subdued
- ✓ Most likely core inflation will rise only very gradually
- ✓ Wage growth is a crucial factor in this respect
- ✓ Although unemployment is coming down:
  - There are still a lot of part-timers looking for a full-time job
  - There are still many discouraged people that will decide to enter the labor market one day
- ✓ Wage growth likely to remain sluggish for the time being

# ECB to focus on tapering and exchange rate




Source: Thomson Reuters Datastream, Degroof Petercam

✓ Monetary policy set to remain loose

✓ ECB in no hurry to hike interest rates

✓ Too much EUR apprecation would not be welcome:

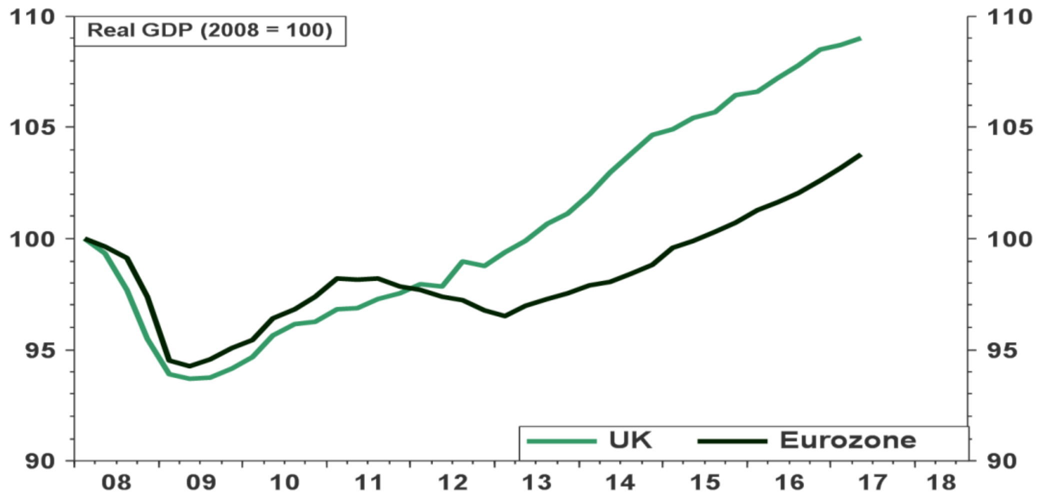
- As it would make the 2% inflation target more difficult to attain
- As it could ultimately weigh on export competitiveness

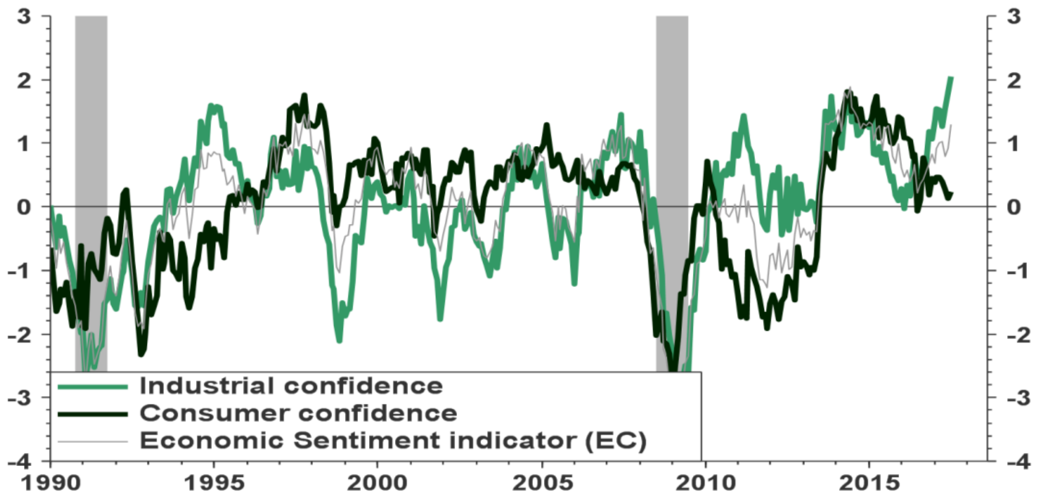
✓ At this stage, we expect the ECB:

- To announce at its October meeting QE tapering from the start of 2018 onwards
- which implies the ECB will buy gradually less government and corporate bonds
- To reduce its buyings from eur 60bn to zero over a period of 6-12 months
- To put more emphasis on the stock effects of QE *(rather than the flow)*
- To raise interest rates for the first time towards the summer of 2019

# United Kingdom

# UK growth softens amid political uncertainty

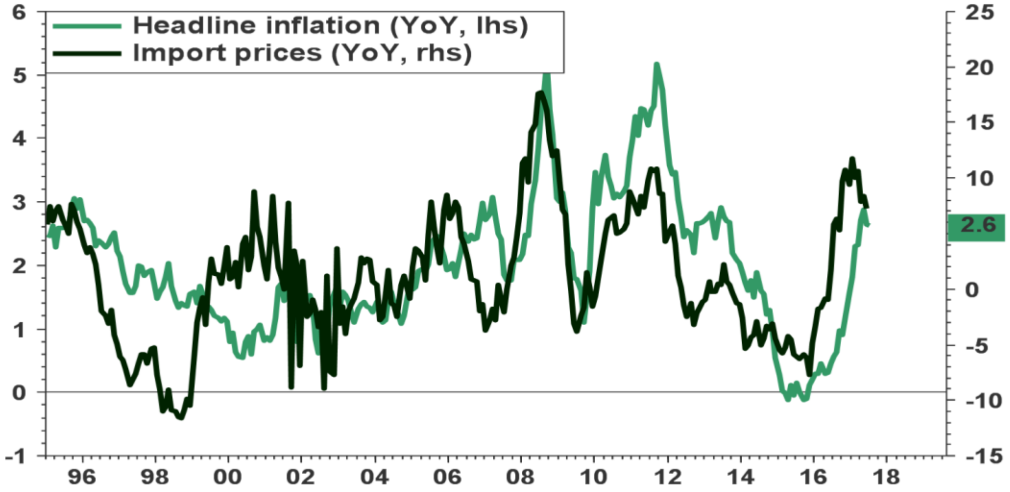


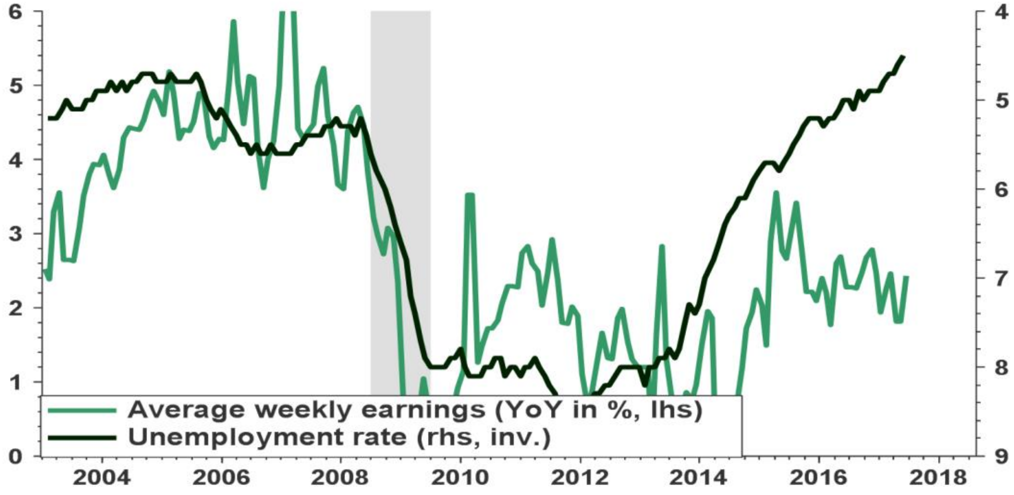




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ UK economic activity on a softer patch
- ✓ Industrial confidence up on lower GBP and better international trade picture
- ✓ GBP depreciation is squeezing consumers’ spending power
- ✓ As a result, consumer confidence has taken a significant hit
- ✓ Growth is likely to remain subdued on Brexit uncertainty

# UK inflation spikes on lower £ and base effects

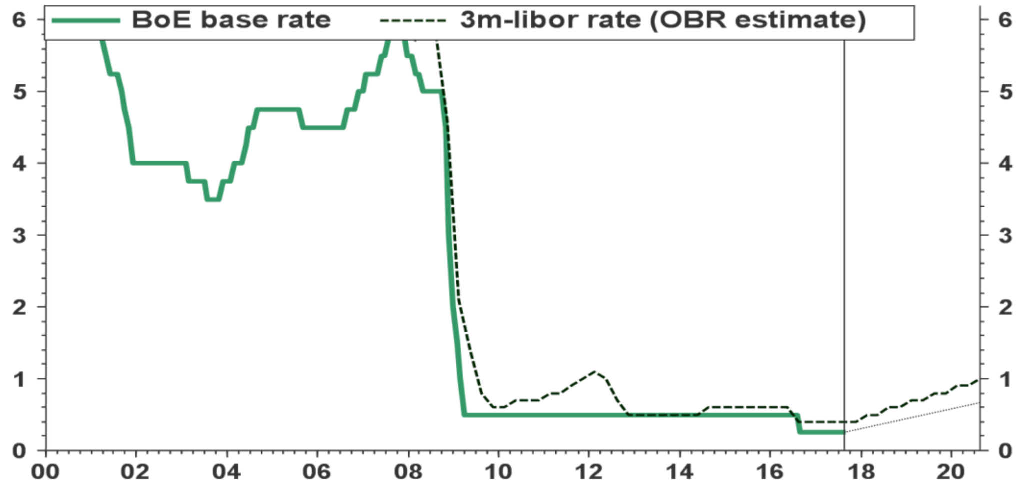


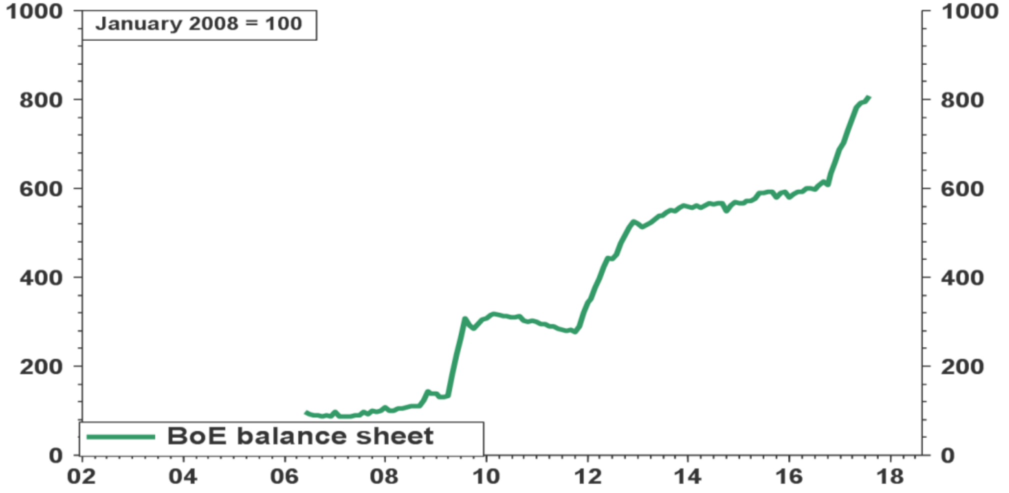




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ UK inflation is peaking on the back of :
  - GBP depreciation
  - Base effects linked to commodity price evolution
- ✓ Therefore, inflation is likely to ease over the next year
- ✓ Wage growth remains subdued despite low unemployment
- ✓ Theoretically, this suggests wage growth should accelerate
- ✓ However, the prospect of below-trend growth and broader forces linked to technological change and globalization raise concern this will not happen anytime soon

# BoE finds itself in difficult stance




Source: Thomson Reuters Datastream, Degroof Petercam

✓ BoE finds itself in a rather uncomfortable position:

- Brexit might create a lot of political and economic uncertainty
- A further fall in the GBP would continue to erode consumer spending power

✓ For now, there is much uncertainty about monetary policy

✓ The BoE believes that:

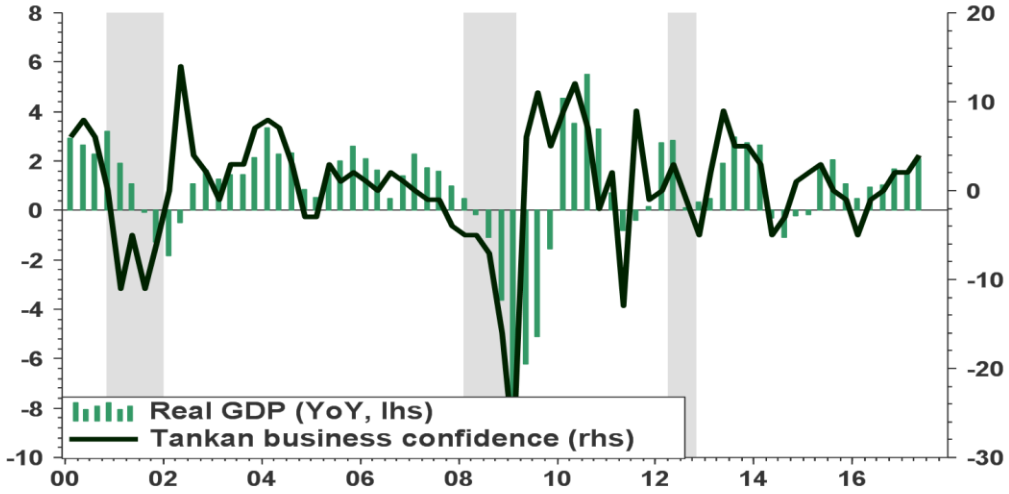
- growth in real income and consumption will remain subdued
- high profitability among firms, low cost of capital and limited spare capacity will support investment
- inflation will stay above the 2% target for the foreseeable future

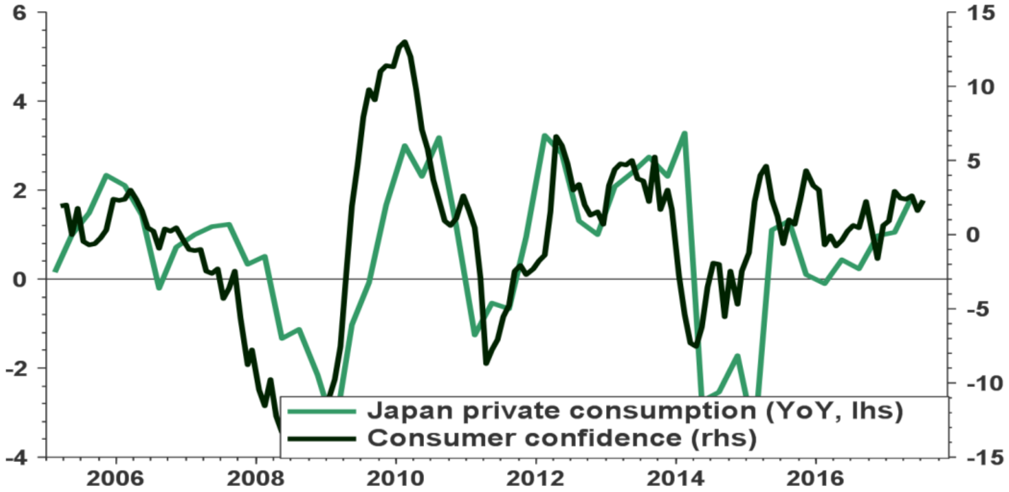
✓ As things stand, we expect the BoE:

- to run its QE and corporate bond program (£ 435bnand £ 10bn respectively) until Feb 2018
- to end the Term Funding Scheme in Feb 2018
- to start hiking its policy rate towards next summer

# Japan

# Japan's economy performing quite nicely

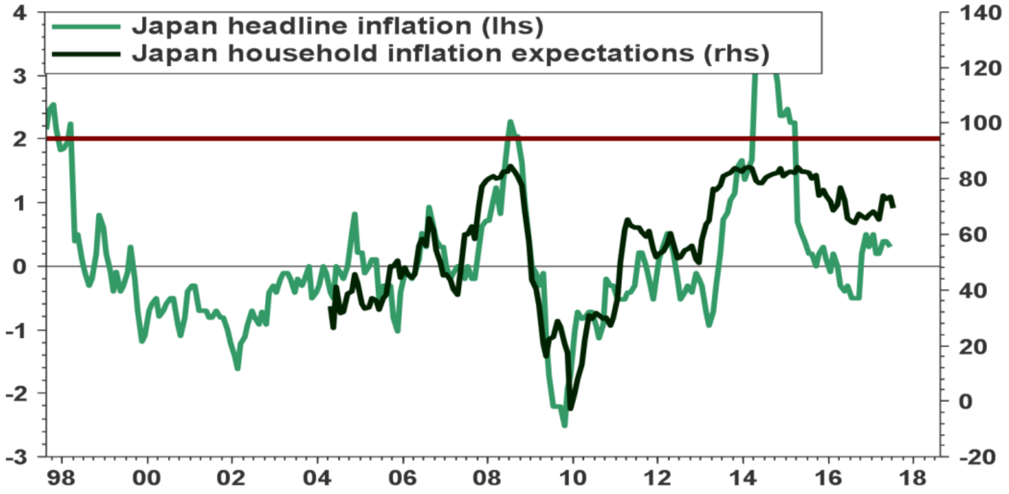


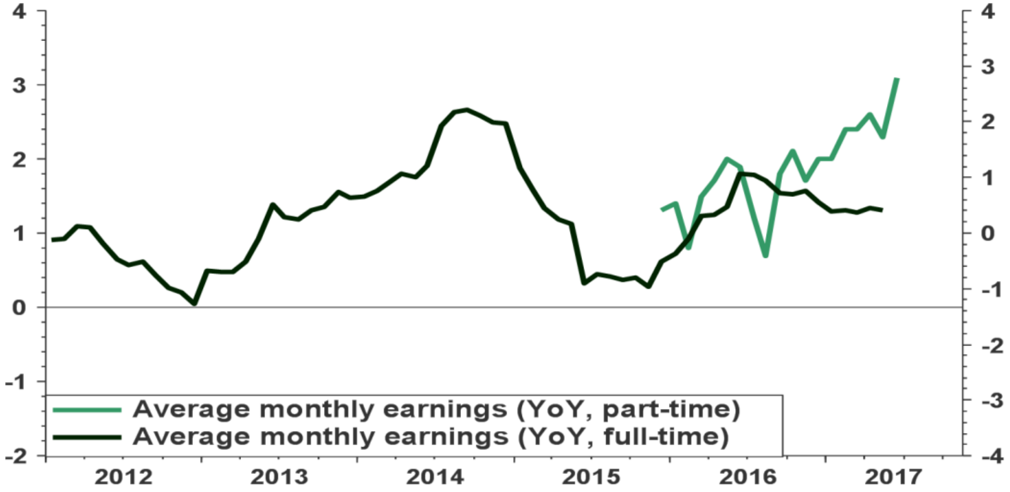




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ The japanese economy has been performing strongly recently
- ✓ Manufacturing activity is doing well on the back of:
  - improving global trade conditions
  - JPY weakening since last summer
- ✓ Both business and household confidence remains upbeat
- ✓ This suggests growth should hold up well quite nicely for now
- ✓ The risk of a renewed economic slowdown in China warrants some caution

# Inflation nowhere near the BoJ's target




Source: Thomson Reuters Datastream, Degroof Petercam

✓ Incoming inflation prints remain soft

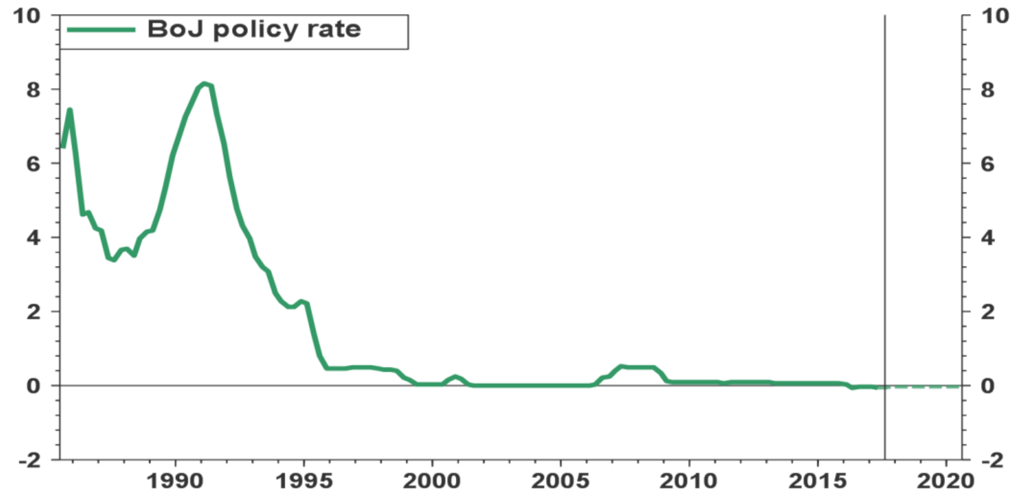
✓ The same goes for household inflation expectations

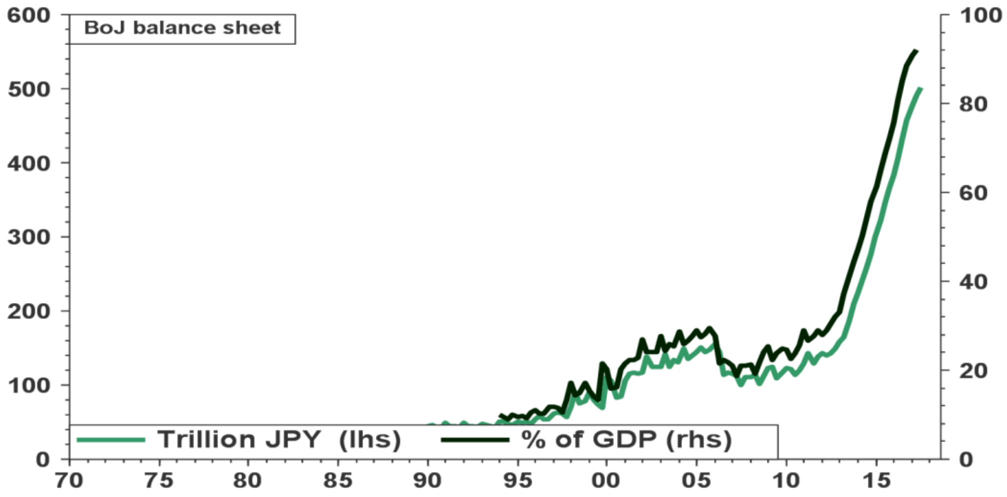
✓ BoJ inflation target unlikely to be hit anytime soon

✓ The labor market is becoming increasingly tight:
- The unemployment rate has fallen to a 25-year low
- Survey evidence reveals a lack of skilled labor
- The ratio of job-openings to applicants is close to an all-time high

✓ Some signs of stronger wage pressures *(particularly for part-time workers)*

# BoJ set to continue its ultra-loose policy into 2018




✓ Monetary policy tightening is not on the cards for now

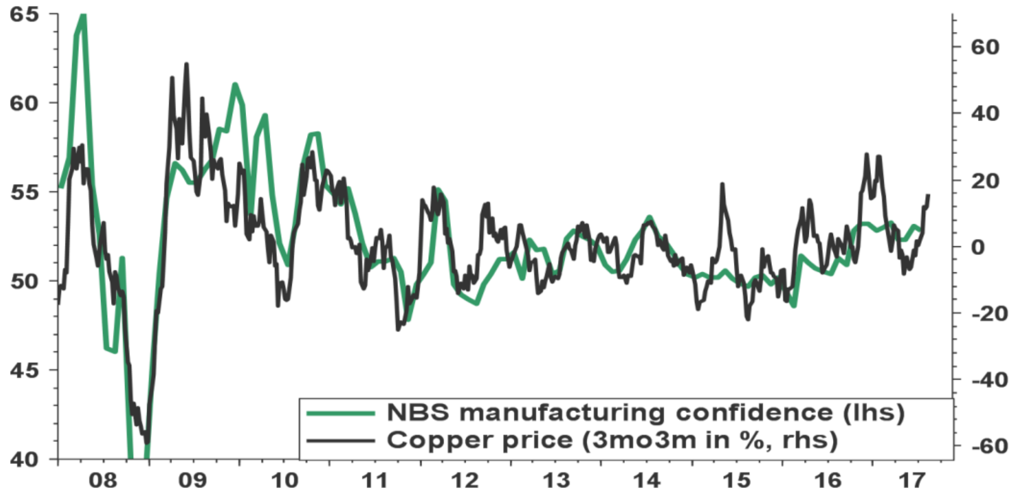
✓ The BoJ's pledge to continue its QE efforts until inflation has settled comfortably above its 2% target remains intact *(inflation overshooting target)*

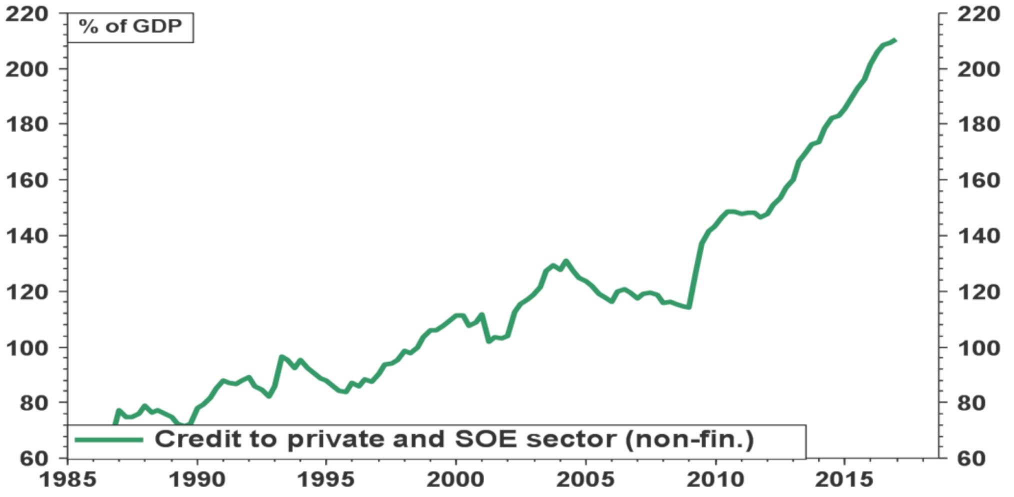
✓ As this is still a distant prospect, we expect the BoJ:

- to leave its policy rate of -0.1% unchanged until at least mid-2019
- to leave its 10y yield target at 0% until at least mid-2019
- to potentially drop its commitment to continue to buy JGB of ¥ 80trn annually

# People's Bank of China

# Economic activity set to slow in 2018

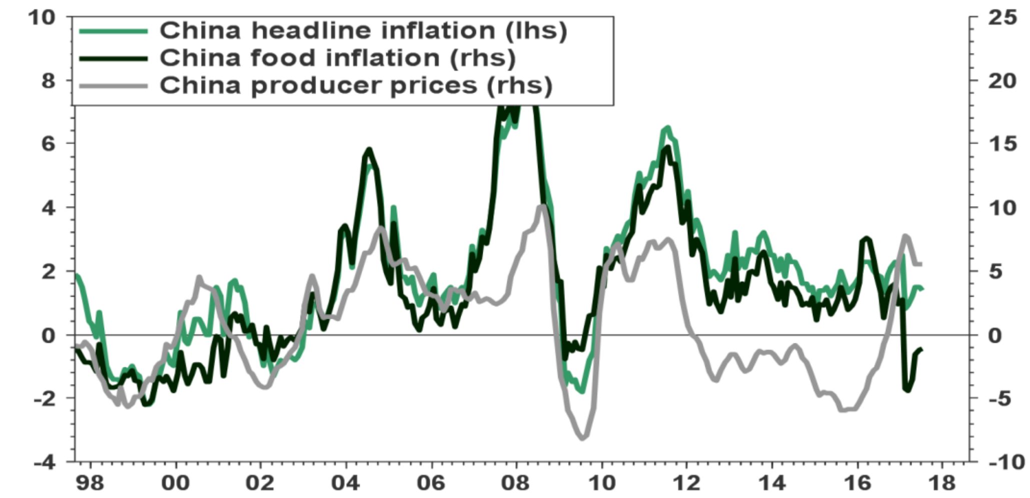


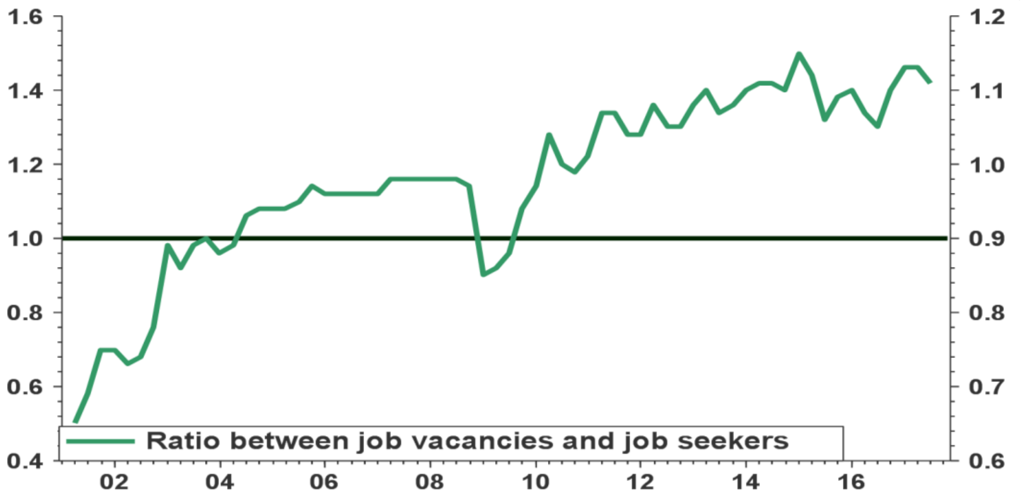




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Chinese economy in recovery mode since late 2015 following a year in which hard landing fears resurfaced *(a combination of significant monetary and budgetary stimulus kickstarted economic activity)*
- ✓ Confidence indicators and commodity prices suggest that economic activity is holding up well at this stage
- ✓ Chinese economic policy can still be labeled as stop-and-go government policy
- ✓ Even though credit expansion among SOE's has slowed recently, excessive leverage and financial risks are still a concern *(made explicit at the National Financial Work Conference held recently)*
- ✓ We expect growth to decelerate again before long

# Chinese inflation expected to ease gradually

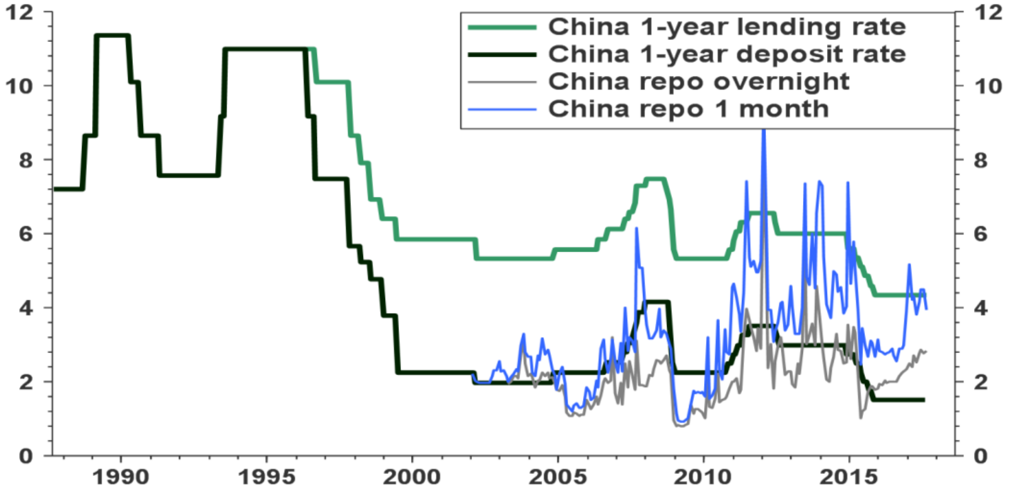


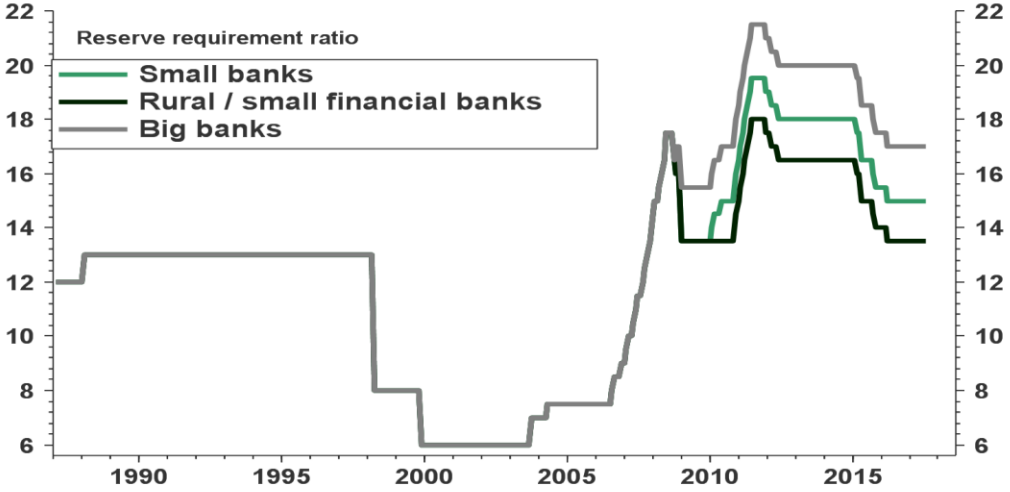




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ Base effects have started to drag down producer price inflation
- ✓ This effect has further to run over the next months
- ✓ Food inflation is still in negative territory but is set to pick up
- ✓ All in all, inflation is likely to remain below the 3% target
- ✓ China's labor market continues to perform well:
  - Survey evidence show concerns about unemployment are low
  - The ratio between job vancancies and job seekers remains high

# PBoC in stop-and-go mode




Source: Thomson Reuters Datastream, Degroof Petercam

- ✓ China's four largest state-owned banks set interbank lending rates which largely determines monetary policy across China
  - Monetary policy in tightening mode since last fall
  - This also corresponds with Xi's goal to tighten Beijing's grip on economic policy

- ✓ As things stand, we expect the PBoC:
  - to keep interbank lending rates relatively tight for the time being
  - to continue its monetary stop-and-go policy

- ✓ Should economic activity slow down too much in the eyes of Chinese policymakers and financial markets, there is still sufficient room to ease monetary conditions, to cushion FX depreciaton and tighten capital controls

- ✓ That said, China is on a slippery slope to keep economic growth high while keeping financial risks in check.

# In conclusion

- ✓ Global economic activity is performing solidly from a cyclical point of view, structural headwinds remain

- ✓ Inflation and wage growth remain subdued for the time being
  - Hidden economic slack arguably still is an important explaining factor
  - But structural factors also play a role and have been much discussed lately (see p. 6)

- ✓ Meanwhile, central banks are trying to gradually move away from the zero interest rate environment and unconventional policies in order to create space for manoeuvre further down the road

- ✓ Unsurprisingly, how fast central banks will act is largely dependent on economic activity, inflation and market volatility

- ✓ On balance, as things stand, we think that central banks will tighten policy slightly faster than what's currently priced in by markets.

# Contact

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