



Weekly Economic Briefing Global Overview

Inflation decoupling 16 September 2014

There has been a notable divergence in global inflation trends over the past year. Among the twenty large economies that we monitor, ten have seen an increase in consumer price inflation, while the other ten saw a decline. Among the countries where inflation has moderated, the majority are in the Eurozone, where inflation was forced down by euro appreciation, weak domestic demand and relative cost adjustments (see chart 1). The currency's more recent reversal will put some upward pressure on inflation over the coming year, but declining commodity prices, a weak economy and further relative price changes will work in the other direction. If the ECB wants to lift inflation out of the danger zone, it will have to follow Japan's lead sooner rather than later. India and Indonesia are the only large emerging economies where inflation has declined significantly over the period. Unlike Europe though, weaker inflation is a positive development that will relieve pressure on their central banks and make it easier to push through needed reforms. The recent plunge in oil and agricultural commodity prices will lower inflation further in the coming months, as energy and food prices make up more than 50% of their price baskets.

The countries where headline inflation has increased since mid-2013 fall into two main camps. In the first camp are Brazil, Russia and Turkey. All are plagued by the structurally high inflation that results from poorly designed product and labour market regulations, entrenched high inflation expectations and central banks that have paid insufficient attention to their inflation targets. Turkey will benefit from the recent falls in commodities, but it is a mixed blessing for Brazil and Russia. While they will likely enjoy some moderation in headline inflation, both are net exporters of commodities and the resultant deterioration in their terms of trade will weigh on their already very weak domestic economies. Meanwhile, inflation is likely on a long upward trajectory in the US and Japan. In the US, domestic inflation pressures are gradually building as labour market slack continues to erode. In Japan, the jump in inflation has been triggered by the April sales tax hike and the Bank of Japan's massive policy stimulus, which has led to a 28% depreciation of the exchange rate over the past two years and a tightening in the labour market.



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No alarm bells yet

The trajectory of consumer price inflation over the next two years will be pivotal in determining when, and how quickly, the Federal Reserve (Fed) withdraws monetary accommodation. We normally examine the outlook for inflation through the prism of the labour market, specifically, how quickly economic slack is being eliminated. On that front, **we have generally concluded that slack is not being eroded quickly enough to force the Fed into an aggressive policy tightening cycle.** Another, complementary approach is to analyse inflation developments from the bottom up. In particular, we want to identify which components of the consumer price index (CPI) have accelerated the most over the past year, and most importantly, whether those trends will continue.

The first thing we observe is that **headline consumer price inflation has increased more than core inflation over the past year.** A year ago, headline consumer prices were growing at a six-month annualised rate of 1.7%; now they are growing at 2.5%. In comparison, core inflation has risen a more modest 0.5 percentage points (ppts), from 1.6% to 2.1%. The reason for that divergence is that both food and energy price inflation picked up rapidly. Energy price inflation increased from 2.8% to 3.7%, driven by a jump in gasoline prices. Meanwhile, food price inflation rose even faster, from 1.2% to 3.9%. Both of these trends should reverse over the next few months (see chart 2). Brent oil prices have declined from around \$115/barrel in June to just over \$97 today. That 18% fall alone will shave 1 ppt from headline inflation. At the same time, the Goldman Sachs Agricultural Commodity Index is down almost 16% over the past three months, some of which will be passed through to consumers. Falling commodity prices are, of course, very positive for the economy; they improve the real purchasing power of consumers and lower input prices for firms. If the lower prices persist, the economy will benefit.

Although movements in headline inflation obviously have important implications for the economy, core inflation is the more important variable for the Fed. And there, the drivers of the pick up will not be ringing alarm bells just yet. **Core CPI inflation is running a little above the 2% target but this is mostly due to high owners' equivalent rent (OER) inflation.** OER is the implicit rental cost of owning one's own home and is imputed by the Bureau of Labor Statistics from private rental data. It also makes up almost a quarter of the CPI basket. When food, energy and OER are excluded from the CPI, inflation is currently running at just 1.5%. Indeed, the lower weight of imputed rents in the personal consumption expenditure (PCE) deflator is one of the major reasons why core PCE inflation is still much lower than core CPI inflation (see chart 3). The aforementioned decline in food and energy prices will modestly subtract from core inflation as well. For example, fuel prices are an important determinant of public transportation prices, which have a 1.5% weight in the core CPI. Another factor that will help keep a lid on core inflation is the appreciating exchange rate. On a trade-weighted basis, the US dollar has risen by 4 % since July, which will flow through into lower clothing, new vehicle, and appliance and computer prices.



Flexible Inflation targeting

Headline inflation in the UK is currently running at 1.6% year-on-year (y/y), just a shade below the Bank of England's (BoE) 2% target. Price growth has hovered between 1.5-2.0% over the course of this year, providing little cause for concern at present. This relative stability comes after a long period of less well-behaved inflation. Indeed, inflation peaked at 5.2% after the crisis and averaged almost 4% during 2010 and 2011. Volatile inflation has not only been a feature of the post-crisis environment. Headline inflation averaged just 1.3% between 2000 and 2005, bottoming out at 0.5% y/y at the start of the decade. In the lead up to the financial crisis, inflation accelerated markedly to more than 5%. Encouragingly, we have not seen any of these over or undershoots weaken confidence in the BoE's inflation target, mostly because they have proven transitory.

Much of the volatility in price growth has been driven by developments in goods prices (see chart 4). In the early 2000s, supply-side shocks from the emerging world helped to dampen goods prices, which account for just over half of the CPI index. In the lead-up to the global financial crisis, a commodity price boom reversed this effect, with goods prices contributing to a marked overshoot in inflation. In the years since, goods prices have been very volatile, partly due to swings in commodity prices but also as a result of large moves in sterling exchange rates. At present, subdued international growth and favourable supply dynamics are serving to dampen commodity prices, which is helping to deliver lower inflation in the UK.

The trend in services prices has been more stable over time, but no less interesting. Services sector inflation has averaged 3.6% y/y over the last 15 years – almost double the Bank's target. This has led some to question if the UK has an inflation problem in its services sector, concealed by the volatility in goods prices. While changes in indirect taxation have distorted matters somewhat, there has been a slowdown in services inflation since the crisis; currently, it remains above target at 2.5%, although well below the long-term average. Productivity weakness has prevented a steeper decline, driving unit labour costs higher in spite of soft wage growth (see chart 5). The BoE expect a slow improvement in productivity to cushion the effect of higher wages in 2015, keeping inflation close to, but below, target.

The BoE has something of a mixed record when dealing with under or overshoots in inflation. It took the view that surges in inflation in the aftermath of the crisis were temporary and continued to offer extraordinary stimulus to the economy. This proved to be the correct interpretation of flexible inflation targeting, although the Bank took severe criticism from some quarters. However, the BoE's pre-crisis record looks less favourable. The Bank did not look through imported disinflation in the early 2000s in the same way. Policy was too loose for domestic conditions, exacerbating an overheating economic expansion and generating risks to financial stability. In future, the Bank should be mindful of the damage that this sort of misdiagnosis can cause and put more weight on domestically-driven inflation.

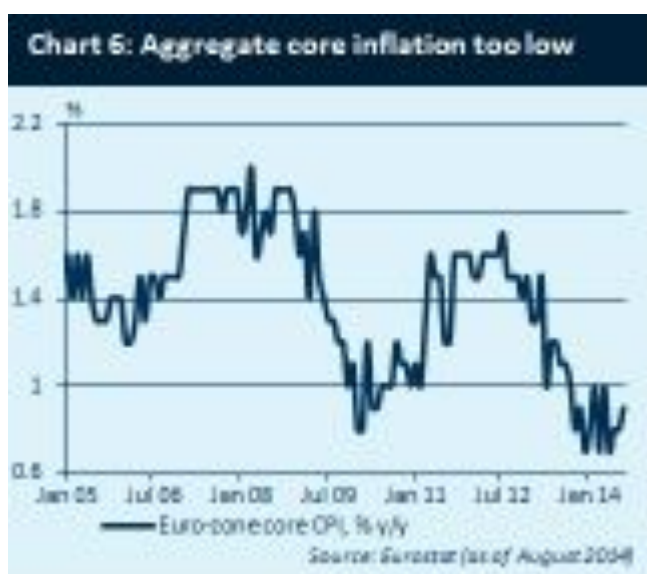


Trying to boost inflation

We have watched the Eurozone inflation rate track inexorably lower over recent years. In late 2011, price growth was running at 3% year-on-year (y/y), but has since slowed to just 0.3% in August this year. Part of this decline reflects the effect of temporary drivers such as falling international commodity and food prices. Exchange rate fluctuations have exacerbated this disinflationary trend. The euro appreciated by around 10% in trade-weighted terms following Draghi's promise to do "whatever it takes" to save the Eurozone in 2012. The European Central Bank (ECB) has estimated that a 10% appreciation in the currency lowers inflation by 40-50 basis points. These two effects are set to move in different directions over coming months. International commodity prices have fallen further which will add to disinflationary pressure through the food and energy channels. This should, however, be softened by a 4% depreciation in the euro since the spring. Headline inflation is expected to have troughed and should rise very slowly from current lows, helped in part by base effects from 2013.

Core inflation excludes more volatile components and provides a better gauge of domestically generated inflation. This measure edged higher to 0.9% y/y in August, but remains low from a historical standpoint, reflecting sluggish demand across the currency union, weak pricing power and slowing wage growth. Recent research from the ECB finds that core inflation typically starts to accelerate approximately a year after the output gap starts to narrow. This would imply some increase in domestically generated inflation in the Eurozone over the second half of this year if growth quickens as forecast. However, there is a risk that if the anaemic growth seen in the Eurozone in recent quarters continues, the output gap will not narrow. Furthermore, this relationship may have changed; structural reform, particularly in labour markets, can make prices more responsive to spare capacity. Monetary policy in the Eurozone has been consistently too tight over the course of the crisis, impeding the recovery in the currency union. The ECB will finally start to expand its balance sheet over Q4, through liquidity operations and the purchase of asset backed securities. While it will take time to gauge the impact of these measures, the central bank should be ready to increase the scale of this stimulus through government bond purchases if we do not see a marked improvement.

Only Austria is achieving inflation at the ECB's target of close to but below 2%. Otherwise inflation remains alarmingly low across the currency union (see chart 7). There is some divergence; German inflation is running at 0.8% y/y while prices are falling in Spain by 0.4% y/y. This implies a small relative cost adjustment, although the pace of this is insufficient to address the underlying competitiveness gulf between the core and periphery. Clearly, this process would be quicker if German inflation were higher. Indeed, while structural reform reduces rigidities, it is still likely to be difficult to engineer large reductions in nominal earnings. Germany is one of the few economies in the Eurozone with the fiscal fire power to engineer a large-scale stimulus package. This would support growth within the Eurozone and raise German wages relative to Eurozone peers. Finally, if the package is directed towards productivity boosting investment in infrastructure it could raise Germany's potential growth rate.



Still short of target

To foreigners, Japan has long been identified in several simplistic ways – the courtesy of its citizens, the excellence of its cuisine, the speed of its trains and for continually falling prices. Truth be told, **when one looks at the CPI index, the main takeaway is how flat it has been overall since 1993**, with short uptrends in 1997, 2008 and 2014, interrupted by long periods of slowly declining prices. Only now are the authorities making a decisive effort to break out of this deflationary trap. One of the key targets of Abenomics has been to raise the rate of inflation to 2% annualised by 2016. Despite some initial success, it is clear that inflation expectations have not yet altered sufficiently to achieve that target (see chart 8). A recent Bank of Japan survey showed that companies expect annual inflation to peak at 1.7% in three years time, while market expectations are even lower. Headline inflation is currently running at 3.4%, but this above-target performance is entirely due to April's three percentage point increase in the sales tax. Once all the one-off effects are taken away, the "core core" rate (which excludes both food and energy) is only rising at a 1% annualised pace. Hence, the speculation that either Japan must benefit from a pronounced acceleration in global growth in the coming months or the Bank of Japan will need to undertake more QE to ensure the yen remains on its downward path. Of the two, we think the latter is far more likely. Of course, relying on currency depreciation is not a sustainable way of permanently raising inflation – that would require a structural change in wage and price setting behaviour.

The impact of the sales tax increase is still rippling through the Japanese economy, making it difficult to gauge the true state of the business cycle. Many economists (including ourselves) have lowered their forecasts for economic growth in 2014 to around 1%. This is mostly because the economy was much weaker than anticipated in the first half of the year. GDP growth in Q2 was revised down to an annualised decline of -7.1% from a preliminary reading of -6.8%, more than reversing the 6.0% jump in the first quarter. Adding to the gloom, the economy has failed to recover from Q2's tax-induced decline as quickly as had been hoped. Despite continued employment growth, real household spending eased 0.2% in July, although poor weather that month may have played a part. One piece of good news for the central bank is that money supply growth has been stable over the summer. M2 growth, for example, is running about 3.0% a year, although this is down from 4.3% at the turn of the year, when cars and other durables were purchased ahead of the sales tax increase.

On a more positive note, the corporate sector is in better shape. Despite fiscal consolidation, the underlying trend for investment, excluding residential and other structures, hit a record high in Q2, while profits only fell -2.8%. Looking ahead, the business survey index examining the conditions of large companies bounced back from -14.6 in Q2 to +11.1 in Q3, similar to 2013 averages. Respondents also remain upbeat about the outlook for the next two quarters. If the historical relationship between confidence and GDP growth holds, the economy could expand at a 1% pace in Q3, although it must be remembered that the survey has been a poor predictor of growth over the past year (see chart 9).



Emerging Markets

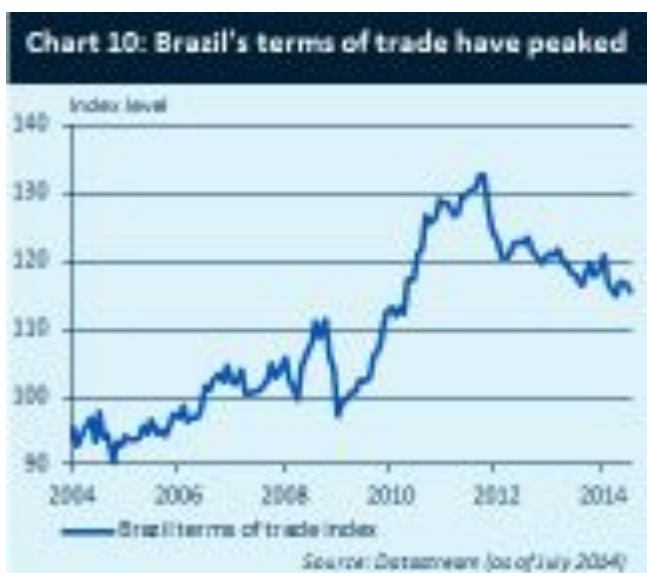
Profiting from lower commodities

If the recent fall in energy, food and bulk commodity prices persists, it will have a bigger impact on consumer price inflation in emerging and frontier markets than in developed economies because **expenditure on commodities tends to make up a much higher proportion of total consumer spending in emerging and frontier markets**. For example, food and energy comprise more than 40% of the total CPI in China, India, Indonesia, Malaysia, Russia and Thailand, compared to a typical range of between 15 and 25% in the developed economies.

Declining commodity prices carry five main benefits for an emerging or frontier market. First, it significantly boosts the purchasing power of consumers, especially at the lower end of the income distribution. Second, it usually leads to looser monetary policy because emerging market central banks are not able to look through commodity shocks in the way that developed economy central banks are able to. Third, it is supportive of business investment and, hence, overall growth because industrial production tends to be much more energy intensive in emerging markets than developed economies. Fourth, for those countries that are net importers of food and energy, declining prices boost their terms of trade. Among the large emerging markets, India, Turkey and South Korea derive the biggest gains through this channel. Finally, **lower commodity prices help promote social stability**; many past political crises in emerging markets followed large spikes in agricultural prices.

That is not to say that the impacts are all positive; many emerging and frontier markets are net exporters of energy, food and bulk commodities. The OPEC countries are, of course, heavily reliant on oil revenues, and falling prices damage both their terms of trade as well as the sustainability of their public finances. Brazil, Argentina and many sub-saharan African countries depend heavily on exports of agricultural commodities. Meanwhile, Brazil, Chile and Peru are major exporters of metals such as iron ore and copper. Brazil is the second largest exporter of iron ore (behind Australia) in the world, so the 40% decline in prices this year is quite damaging and is reinforcing the structural weaknesses that have pushed the economy into recession (see chart 10).

China would normally be considered to be a country that would benefit from falling commodity prices and certainly the declines in food and oil prices will be helpful. However, **the plunge in iron ore and coal prices this year is itself partly due to the deteriorating Chinese property market**. Industrial production slowed to 6.9% year on year (y/y) in August, which was the weakest outturn since the beginning of 2009 when the global economy was in recession (see chart 11). Property sales have fallen more than 10% over the past year, while housing starts are also depressed by historical standards. This deterioration in the data has once again prompted calls for looser policy. While this may well happen, authorities should exercise caution; fiscal policy is currently very loose, credit is still growing faster than GDP and there is a significant over-supply of housing. Sooner or later, the government will need to accept the inevitability of sub-7% growth.



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