

# Weekly Perspectives

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## A Weekly View of Global Economies

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As expected, central banks are continuing to remove monetary accommodation and are being cautious in carrying out the task. We have not seen any examples of aggressive tightening. Policymakers are intent on carefully managing the process and achieving a gradual growth slowdown, in order to reduce inflationary pressures.

These are laudable aims, except that fine-tuning monetary policy is not an exact science. In most cases, the policy folks either overdo or under-do it and end up having to take corrective action later. Getting it just right requires a dose of good luck.

When Bernanke says that the Fed's actions are data-dependent he means that they are not confident of their forecasts and do not have a grand strategy in place. So, essentially, they monitor developments and react to the tone of economic data releases.

Well, last week's payroll data was weaker than expected, and appears to have convinced the markets that this was a good enough reason for the Fed to engage in a much anticipated pause in the rate-increase cycle. Writing just ahead of the FOMC (Federal Open Market Committee) meeting, the consensus is for the Fed to stay its hand at this week's gathering.

When the jobs report was released on Friday, the 4<sup>th</sup> of August, the equity market rallied on the news, but the cheerfulness soon dissipated when it was realised that it could also be signalling a slowdown - - and that's not too good for earnings growth. Meanwhile, the bond market has been reading the tea leaves more assiduously. Bonds have been rallying for a number of weeks, on slowdown expectations.

The problem for the Fed is that even if the job market is cooling, labour costs are not following suit. Other input costs are also on the rise, which doesn't bode well for a reversal in inflationary trends. Corporations are keen to raise prices to preserve their margins despite the positive influence of intense competition and productivity growth.

Looking across to China, the fast-growing economy has been a big factor in keeping a lid on global inflation. Modest labour costs, loose environmental standards, few worker safety nets, and a currency pegged at a low value, have all played a role. Much of the talk about the "productivity miracle" in the United States over the past decade fails to acknowledge the impact of China's industrial revolution on inflation trends in the US and elsewhere.

None of the above factors is about to change radically. However, there are indications that slow change is underway, and this will have an effect on global inflation over the medium term. Of course, some of the impact will be muted as other rapidly-industrialising

countries in the developing world take over the outsourcing role. In any case, the medium-term trends bear watching.

As for the short term, the Chinese authorities have rolled out all the monetary policy guns necessary to fight runaway growth. However, as we previously pointed out, they are just as cautious as the other central banks. So far, they have used the guns sparingly, with little effect on curbing the economy's rapid advance, which means that they have more work to do.

Recently, the European Central Bank hiked interest rates, which was hardly surprising since inflation is above its target rate, and it had clearly signalled the move. What's more, its accompanying statement had a hawkish tone. The Bank of England and the Reserve Bank of Australia have also raised rates.

The inflation trend in the G3 (US, Japan and the Eurozone) economies is on the rise, but monetary policy is not particularly restrictive in historical terms. A measure of excess liquidity, which takes account of money-supply growth as well as output growth and inflation, still points to an accommodative rather than a restrictive impact on the economy. That said, excess liquidity is taking a turn lower.

Directing our attention to the cost of borrowing, G3 real interest rates are rising, but they are doing so from a very low level. They are, even now, well below the average rate in the nineties. Essentially, this means that it is still cheap to borrow money.

Some global leading indicators point to moderating economic activity. The question for monetary policymakers is whether this is happening fast enough to curb inflation pressures. In the gradualist approach of the central banks, we have moved from a loose policy stance to one that is still accommodative.

This means that the authorities are likely to continue to normalise interest rates until growth moderates and there is evidence that inflation has been curbed. So even if the Fed selects the pause button at the current FOMC meeting this is unlikely to be the end of its rate-increase cycle. Several other central banks also have more work to do.

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