Weekly Perspectives

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A Weekly View of Global Economies

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Global equities demonstrated a dash of hesitation, at the beginning of the New Year, caused by worries about growth, inflation and central bank intentions. Meanwhile, bond markets are still pricing in a slowdown and commodities have undergone a correction.

The latest payroll report in the US indicates a tight labour market, as well as continuing wage acceleration. This is positive for consumer spending but adds to concerns about inflationary pressure. Given the Fed's data-dependent stance, there are few people now betting on interest-rate cuts, any time soon.

The Eurozone economy is performing quite well and confidence measures are relatively high. This has increased expectations that the economy may, to some extent, decouple from the United States. On the positive side, European consumer demand is a bit more robust, and a good deal of export growth is being driven by demand from Eastern Europe and Asia.

But stronger growth may also force the hands of the European Central Bank and cause it to raise interest rates. Furthermore, if growth and interest rate differentials favour Europe, relative to America, there could be upward pressure on the euro, hurting exports. On the other hand, a tightening of monetary conditions via the exchange rate would reduce the need for strong action by the ECB.

There are few signs that domestic demand is about to become the engine of growth for the Japanese economy. So, it looks like global growth will have to sustain economic activity in Japan. As for China, growth is still quite rapid and the authorities are continuing their efforts to tighten liquidity. They have again asked banks to increase reserve requirements.

Looking into the future, it is very difficult to say how things will evolve for riskier asset classes. The divide between risk factors and sentiment towards risk is as wide now, as it was last year. But this didn't stop the equity markets from staging a rally over the past six months. Evidently, the hunger-induced search for higher returns has not been curbed.

An index measuring risk appetite shows that investors are less euphoric than they were a month and a half ago, but still fairly ebullient. Examining a couple of the components, such as measures of bond and stock-market volatility, we note that there are no expectations of impending storms. As for spreads of emerging-market and high-yield bonds relative to treasuries, they remain pretty tight.

Central banks have been fretting a bit about possible inflationary pressures, but they are mostly waiting to see more evidence of where things are heading before they act. This is a smart strategy because their ability to forecast the economy is modest and lags between policy action and its impact on the economy are long and variable.

The world's major economies haven't sprung any major surprises in recent months, and this gives the impression that the central bankers are successfully fine-tuning the outcome by their policy actions. However, the relative stability of such economies has more to do with favourable structural features than with carefully-crafted policies.

Thus far, there has been no external shock or crisis to test the system. The central banker's job is an extraordinarily difficult one, and it is little wonder that many people are sceptical about policymakers' ability to achieve anything more than modest objectives.

There are broadly two schools of thought on the issue of inflation. On the one hand, some analysts argue that we are living in an era characterised by deflationary trends. The rise of China, with its impressive industrial efficiency is cited as one factor. But this argument can also be extended to include many of the countries in the emerging world.

Cheap labour, combined with imported technology affords the opportunity of extensive outsourcing of operations in low-cost centres. In conjunction with the openness of markets, this results in intense competition and downward pressure on prices, globally.

Tradable goods are the primary beneficiaries of these trends but, increasingly, services are also being targeted. Just to pick two examples, one notes the outsourcing of duties from Europe or America to highly-qualified financial analysts in India, or pharmaceutical researchers in China. In passing, we should note that any move towards protectionism will reduce the impact of deflationary trends caused by the forces of globalisation and an open trading system.

But another school of thought puts greater emphasis on credit creation and excess liquidity as a cause of inflation. These people trace their lineage through the Monetarists and the Austrians, all the way back to John Law and the Banque Royale in the early eighteenth century. Having a long history doesn't make you right, but who can deny that credit and the rate of interest play a crucial role in how the economy performs.

Their view is that monetary conditions are still relatively easy in a number of countries. They examine measures such as various definitions of the money supply, velocity of circulation and the real cost of borrowing. There is also an appreciation of the varying degrees of political pressure on central banks to furnish excess liquidity. Even those banks that are organisationally independent of the government are still considered to be susceptible to persuasion.

We don't want to sound like an undecided middle-of-the-roader, but there is truth in the views expressed by both schools. Currently, inflation in the major economies is of relatively modest dimension, but it may require a period of below-trend growth to remove the risk that it could become more resilient. Japan is something of an exception, with the core rate still in negative territory.

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