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GLOBAL ECONOMIC HIGHLIGHTS

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Fed Chair Emphasizes Monetary Policy to Be Looser for Longer than in Prior Recovery; Mexico Cuts Policy Rate

UNITED STATES: In a February 10 speech, Federal Reserve Chair Jay Powell emphasized that the Fed will take a different, slower approach to normalizing monetary policy after the 2020 recession than they did after the 2008-09 recession. He first noted the huge gap between the current state of the economy and full employment: while the unemployment rate fell to 6.3% in January from nearly 15% last April, it would have been near ten percent in January if virtual schooling, "fear of the virus and the disappearance of employment opportunities" were not keeping potential workers out of the job market. Powell also emphasized that the Fed "will not tighten monetary policy solely in response to a strong labor market." In 2015, the Fed began raising the federal funds rate as the unemployment rate reached a 4-5% range, which was then believed to be the lowest that could be sustained without the economy overheating. However, inflation continued to average below the Fed's 2% target over the next five years as the unemployment rate not only held in the range they believed consistent with "maximum employment," but fell below it and reached a 50-year low. Reflecting on early 2020, Powell now says there was "every reason to expect that the labor market could have strengthened even further without causing a worrisome increase in inflation were it not for the onset of the pandemic." Going forward, not only will the labor market need to be strong for the Fed to raise interest rates, inflation must rise to their 2% target, and the Fed must expect "inflation moderately above 2 percent for some time." PNC forecasts for the Fed to not raise the federal funds target until 2024, and for quantitative easing to continue at the current monthly pace of around $120 billion throughout 2021.

Inflation continued to undershoot the Fed's target in the January consumer price index (CPI) report, which saw a smaller increase in prices than expected. The CPI rose 0.3% in January from December, largely due to a 7.3% increase in energy prices including 7.4% higher gasoline prices. The core index, excluding volatile food and energy prices, was unchanged in January. Food prices rose a modest 0.1% in January, while services prices excluding energy services were flat. On a year-ago basis, overall inflation was 1.4% in January, the same as in December. Year-over-year core inflation was also 1.4% in January, down from 1.6% in December.

Both overall and core inflation will accelerate to 2% or slightly higher on a year-ago basis over the next few months because of comparisons with the spring of 2020, when prices fell outright as the economy crashed. But inflation will then slow to below 2% year-over-year in the second half of 2021. Continued weak demand for many goods and services, excess capacity in wide swathes of the economy, and low wage pressures from elevated unemployment will all keep inflation low over the next couple of years, especially for services, which make up more than one half of consumer spending.

MEXICO: The Bank of Mexico cut its policy interbank rate a quarter percentage point to 4.0% at its February 11 monetary policy decision. Buoyant financial conditions and the Fed's commitment to keep U.S. interest rates near zero for an extended period created room for further easing in Mexico. The Bank of Mexico cited downside risks to economic growth, and expects "ample slack conditions … throughout the time frame in which monetary policy operates." The Bank sees the outlook for inflation as unchanged from their last round of forecasts issued in November's *Inflation Report*: Total inflation is likely to stay around their 3% target in 2021-22, and core inflation to average slightly below it. On a forward-looking basis, Mexico's real (inflation-adjusted) policy interest rate is 0.5%, versus a negative real rate of -2% in the United States.

EUROZONE: The European Commission's latest economic forecasts underscore that Eurozone interest rates are likely to stay negative for the foreseeable future. The European Commission's Winter 2021 Economic Forecast is for 3.8 percent real GDP growth in both 2021 and 2022 after a 6.8 percent contraction in 2020, returning real GDP to its pre-crisis level by late 2022; this forecast is close to the ECB's December 2020 economic projection, which also foresaw real GDP recovering to its pre-crisis level by late 2022. Both sets of economic projections expect HICP inflation of between 1.0 and 1.5 percent in 2021 and 2022, undershooting the ECB's target of below but near 2%. Similarly, the consensus of private sector forecasters is that inflation will undershoot the ECB's target throughout the forecastable time horizon, leaving no realistic prospect of the ECB raising its negative policy rate back to positive territory in the next few years.

CHINA: President Biden and Chinese Communist Party Chairman Xi Jinping had their first direct communication on February 10, in which President Biden raised U.S. concerns about China's "coercive and unfair" economic policies, as well as human rights and geopolitical issues. Biden and Xi also discussed potential areas of cooperation: The pandemic, climate change, and other geopolitical issues. The tensions that worsened between the U.S. and China during the Trump administration are likely to persist during the Biden administration.

JAPAN: Real GDP grew an annualized 12.7 percent in the first preliminary estimate for the fourth quarter of 2020, better than the 10.1 percent consensus forecast. Unlike most other developed economies, Japan's growth in the fourth quarter was driven by exports and capital spending, not consumers: Real exports jumped 52.3 percent annualized in the quarter, much faster than the 17.3 percent annualized increase in real imports, and real gross fixed capital formation grew 13.2 percent annualized. By comparison, household consumption grew 9.0 percent annualized and private residential investment just 0.2 percent.

The fourth quarter's GDP growth was better than expected, a double-digit annualized increase despite the Jibun Bank manufacturing and services PMIs both averaging in contractionary territory (under 50) in the quarter. But even after that solid increase, real GDP in the fourth quarter of 2020 was still 2.9 percent below its pre-recession peak in the third quarter of 2019. Japan's recession started in October 2019 when its government raised the value-added tax, a kind of sales tax. Real GDP will likely recover much more slowly in 2021 and 2022, and only return to its pre-recession peak in 2023 or 2024.

UNITED KINGDOM: As expected, the Bank of England (BoE) held its monetary stance unchanged at its February 3 Monetary Policy Committee decision. Real GDP narrowly avoided a contraction in the first estimate for the fourth quarter of 2020, which showed a 1.0% increase (not annualized). However, the monthly GDP series fell sharply in November and only partially recovered in December; monthly GDP was 0.5% lower in December than in September. Real GDP in the fourth quarter of 2020 was boosted by 3.3% growth of manufacturing, including an 11.5% jump in transport equipment output as manufacturers front-ran Brexit. Manufacturing will not provide this boost in the first quarter of 2021: The Markit manufacturing PMI showed manufacturing growth slowed sharply in January on lower new orders and export orders. The BoE's economic projections, updated in February, anticipate a 1% drag on GDP (not annualized) in the first quarter of 2021 due to Brexit's new trade barriers. January's monthly GDP release will likely show a big drag from the national lockdown, as well as a hit to exports from Brexit.

Contrasting with this bad economic news is good news on the virus front: Despite the presence of a more contagious coronavirus strain in the past few weeks, new confirmed cases have fallen steadily in the UK since early January's peak, paralleling the decline in the U.S. The double-dip recession that the UK is likely suffering at the turn of the year still looks set to give way to solid growth in the spring and summer as vaccines start working.

CANADA: As in the U.S., housing continues to lead Canada's recovery. Housing starts jumped to 282,000 annualized units in January, according to the Canada Mortgage and Housing Corporation, up from 229,000 in December to the highest level since 2007.

BRAZIL: Consumer prices as measured by the benchmark IPCA index increased 4.6% in January from a year earlier, in line with consensus expectations and within the central bank's target range of 3.75% plus or minus 1.5%. Core inflation by the Central Bank of Brazil's trimmed mean index was 2.7% in January in the same terms. Retail sales fell 6.1% in December from November, much worse than consensus expectations for a 0.8% drop and the largest decline since the record 17.2% plunge in April. The IBC-BR Economic Activity index rose 0.6% in December from November, the slowest increase since the recovery began, following an upwardly-revised 0.7% increase in November.

Lawmakers in the lower house of Congress passed a bill to grant autonomy to the central bank and add “full employment” to the central bank’s policy mandate on February 10; the bill still needs to be approved by the Senate before it can be signed into law.

Brazil’s uneven recovery is trudging along but concerns about its fiscal health remain—public debt is around 90% of GDP and the budget deficit is just under 10% of GDP. Additional fiscal stimulus is likely to be passed in the next few months, although Brazil’s Congress is in theory constrained by a “spending cap rule” which limits growth of government spending to the previous year’s rate of inflation.

INDIA: CPI inflation slowed to a 16-month low of 4.1% in January in year-over-year terms, below consensus expectations for 4.4% inflation and down from 4.6% in December. Industrial output rose 1.0% in December from a year earlier, better than consensus expectations for a 0.1% decline, following a 2.1% decline in the same terms in November. India’s industrial sector should improve in 2021 thanks to an expansionary fiscal policy and a recovering global economy.