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GLOBAL ECONOMIC HIGHLIGHTS

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China Cuts Reserve Requirement Ratio; ECB Strategic Review Opens a Door for More Dovish Guidance at July 22 Decision

CHINA: The People's Bank of China (PBoC) reduced the reserve requirement ratio ("RRR") for Chinese commercial banks by 0.5 percentage point on July 9; the RRR cut allows commercial banks to turn more of their customers' deposits into loans rather than holding them at the central bank as reserves. The PBoC estimates that the RRR cut will increase banks' lending capacity by ¥1 trillion yuan, about 1% of China's $16.4 trillion U.S. dollar GDP. The cut came after aggregate financing to nonfinancial borrowers grew 11.0% in year-ago terms in June, matching May for the slowest growth since the pre-pandemic period.

The PBoC explained that they do not view the cut as a change in monetary policy; rather, it is a necessary adjustment to maintain stable monetary conditions. Even if that were convincing, the timing of the RRR cut hints that real GDP likely disappointed in the second quarter—Chinese policymakers get a preview of the data prior to its public release, the night of July 14 in U.S. time zones. Prior to the RRR cut, the consensus expected real GDP growth of about 1.5% in quarterly un-annualized terms, or 8% in year-ago terms for the second quarter; the RRR cut suggests a meaningful undershoot. The disappointment is likely coming from exports of consumer goods and manufacturing activity; as Western economies reopen, their consumers are shifting spending toward domestically-produced services, sapping demand for goods exported by China.

EUROZONE: As expected, the ECB made mostly dovish changes to its monetary policy framework in the 2021 strategic review, whose conclusion they announced July 8. The ECB raised their inflation target to 2%; previously it had been "below but near 2%." The ECB emphasizes that the new inflation target is symmetric. This is actually not a change, since the ECB announced their prior target was symmetric in 2019. The ECB will expand their preferred measure of inflation to include owner-occupied housing costs: The Eurozone's statistical agency Eurostat (separate from the ECB) will broaden the basket of prices included in the Harmonized Index of Consumer Prices (HICP) to include owner-occupied housing costs, but this will be "a multi-year project." Until Eurostat makes the change, HICP will remain the ECB's primary inflation measure, with measures of owner-occupied housing costs used to supplement HICP. The ECB's new framework affirms that they will take "especially forceful or persistent monetary policy measures" when the economy is near the lower bound, meaning a situation in which realized inflation and expected inflation are both weak despite monetary policy nearly as loose as possible. In addition, the ECB will incorporate climate change risks explicitly into monetary policy, prudential supervision, and the criteria for their QE programs' purchases of private assets.

President Lagarde was tight-lipped about how the new framework changes the outlook for monetary policy, but it clearly points to the ECB tightening monetary policy less in 2022 than the Federal Reserve. The Eurozone economy is near the lower bound, which justifies "especially forceful or persistent monetary policy measures" in the new framework: The ECB's deposit rate is -0.5%; its quantitative easing program is extremely expansionary both in quantity of purchases and in the scope of public and private assets purchased; and yet core HICP inflation was 0.9% in year-ago terms in June, with financial markets pricing inflation averaging just 1.3% over the next 10 years. The ECB will want the Eurozone economy to run hotter than before the pre-crisis period before reducing their non-crisis asset purchases or raising interest rates. The ECB will likely taper its temporary, crisis-era Pandemic Emergency Purchase Programme (PEPP) in the fourth quarter of 2021 if the pandemic continues to come under control, and end the program by mid-2022.

But as they wind down PEPP, the ECB is likely to increase open-ended asset purchases made by their pre-crisis QE facility from the current €20 billion monthly pace, to prevent the end of PEPP from tightening Eurozone financial conditions. There is no rate hike in sight for the Eurozone. It is easy to imagine euro interest rates staying negative through 2030. Separately, the ECB released the Account (minutes) of the June 9 and 10 Governing Council on July 9, showing the same old fights between doves and hawks continue over the appropriate response to the recovery. The hawks argued that "the better outlook for growth and inflation" justified that "asset purchases should be scaled back somewhat." The doves argued that the weak inflation outlook—the ECB's staff economists project HICP inflation of just 1.4% in 2023—means "even an increase in asset purchases as the main monetary policy instrument could be justified." President Lagarde told Bloomberg News in a July 11 interview that the ECB's July 22 decision, the first following the strategic review, will be "an important meeting." Lagarde's statement implies the ECB is likely to incorporate the shifts in monetary policy outlined above into its forward guidance at the decision.

The Eurozone's economic data flow continues to point to a strong recovery underway as pandemic restrictions are lifted. The June flash release of HICP inflation showed a 1.9% year-ago increase after 2.0% in May, with core HICP excluding food, energy, alcohol and tobacco up 0.9% after 1.0% a month earlier. The unemployment rate fell to 7.9% in May from an upwardly-revised 8.1% in April (it had been 8.0% in the prior release). Retail sales rose 4.6% in May from April after a downwardly-revised 3.9% contraction in April (revised from 3.1%); the ZEW survey of investors' expectations for economic growth fell to 61.2 in July from 81.3 in June but was still buoyant, higher than any pre-pandemic reading since 2015.

UNITED STATES: The June jobs report was mostly better than expected, with 850,000 nonfarm payroll jobs added from May, more than the 600,000 consensus forecast. 343,000 of the net increase in employment was from leisure and hospitality jobs, which continue to recover rapidly as U.S. consumers return to pre-crisis spending patterns. However, the household survey (from which the unemployment rate is derived) was softer than the survey of employers—the unemployment rate rose to 5.9% from 5.8%, with employment down by 18,000 and the labor force up 151,000 as the recovering economy encouraged more people to actively search for jobs. Average hourly earnings rose 0.3% from May despite the large share of job growth coming from lower-paid leisure and hospitality jobs. Job openings rose to a new record high of 9.21 million in May from 9.19 million in April in the Job Openings and Labor Turnover Survey; with the factors constraining labor supply improving, job growth should stay very strong in the second half of 2021 and into 2022.

The ISM services PMI fell to 60.1% in June from 64.0% in May, thought it remained well above the 50% line that indicates expansion in service industries. The consensus expectation was for a smaller decline, to 63.5%. The last three months (March to May) were by far the three highest readings in the history of the index, back to 1997, so some retrenchment was inevitable. The June CPI report, to be released July 13, will likely show inflation slowing to 0.5% from 0.6% in May, with core inflation excluding food and energy slowing to 0.4% from 0.7%; some of the big one-off price increases which pushed inflation higher in May likely slowed or reversed in June.

MEXICO: Mexico's recovery continues, but a full recovery is still several quarters away. Monthly GDP fell a seasonally-adjusted 0.2% in April with primary activity down 2.9%, industrial activity down 0.2%, and services activity up 0.3%; monthly GDP in April was 2.3% below its January 2020 level. The unemployment rate fell to 4.1% in May from 4.6% in April, but this was on a big drop in the participation rate, to 58.3% from 59.0%; labor force participation is still well below the pre-crisis level, and the unemployment rate still well above it. The Markit manufacturing PMI for Mexico improved modestly in May, rising to 48.8 from 47.6 in April; while most survey components pointed to continued contraction, the expectations sub-index was in positive territory and the highest since January 2020. Over a quarter of Mexicans have received at least one dose of a coronavirus vaccine.

CANADA: Canada's labor market bounced back in June after two straight months of job losses in April and May. Employment rose 230,700 in June from May, a 1.2% increase—the same percentage increase in U.S. employment would create about 1.8 million jobs. June's increase was much better than consensus expectations for a gain of 175,000 jobs. The unemployment rate dropped to 7.8% from 8.2% in May; it was below 6% before the pandemic. Around 50,000 jobs were lost in the goods-producing sector, while the service sector added around 280,000 jobs. 33,200 full-time jobs were lost, the third straight month of full-time job losses, while 263,900 part-time jobs were added. The labor force increased by 169,900 and the labor force participation rate rose to 65.2% after declining for two straight months. With coronavirus cases falling and vaccination rates rising, the economic recovery should accelerate in the second half of the year as consumers get opportunities to spend the stimulus payments saved during the pandemic; Canadians saved C$212 billion last year, versus C$18 billion in 2019, according to Statistics Canada. Higher crude oil prices and a strong U.S. rebound will also contribute to Canada's economic growth prospects.

After a broad-based improvement in economic conditions in recent months, PNC Economics expects the Bank of Canada (BOC) to hold the benchmark policy rate unchanged at 0.25% and reduce the quantitative easing program to C$2 billion in weekly government bond purchases from C$3 billion at the BOC's July 14 meeting.

UNITED KINGDOM: Coronavirus cases in the UK have risen to the highest levels since January in July despite vaccination rates that are comparable to the United States; deaths have also increased since late June, but are still down 98% in the first ten days of July from the last ten days of January. The British government plans to lift most remaining coronavirus restrictions on July 19. The Markit services PMI was revised up to 62.4 in the June final release from 61.7 in the flash release, and the manufacturing PMI was revised down to 63.9 from 64.2. The construction PMI rose to 66.3 in June from 64.2 in May.

JAPAN: The Bank of Japan (BoJ) will announce details about its new facility to provide financing "to address climate change issues" at the conclusion of their July 15 and 16 Policy Board meeting, which will be the night of July 15 in U.S. time zones. The Bank announced the program at their June 18 decision but has not released details yet. Otherwise, the July BoJ meeting is not expected to make market-moving changes to the Japanese monetary policy stance.

INDIA: The service sector contracted for the second straight month in June as the pandemic continued to adversely impact India's economy. The Markit services PMI dropped to 41.2, an eleven-month low, from 46.4 in May.

BRAZIL: Consumer prices as measured by the IPCA index increased 0.5% in June from the prior month, slightly below consensus expectations for a 0.6% increase, and lower than May's 0.8% rise; prices were up 8.4% in June from twelve months earlier, the highest inflation since September 2016. IPCA inflation has overshot the upper limit of the central bank's target range for four straight months. Core inflation as measured by the trimmed mean index was 0.6% in June in monthly terms and 4.3% in year-ago terms. Core inflation has accelerated for four straight months; elevated inflation remains a challenge for Brazil's central bank. Brazil's service sector expanded for the first time in six months in June as the services PMI rose to 53.9, the highest level since January 2013, from 48.3 in May.