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# GLOBAL ECONOMIC HIGHLIGHTS


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## EMERGING MARKETS FOLLOW THE FED IN RAISING POLICY RATES; OTHER G7 CENTRAL BANKS ON HOLD IN DECEMBER

**UNITED STATES:** As expected, the Federal Open Market Committee raised the federal funds rate by one-quarter of a percentage point to a range of 1.25 to 1.50 percent on December 13, the third increase in the fed funds rate in 2017, and the fifth increase since the current tightening cycle began in late 2015. The language of the press release announcing the decision was little changed from the prior announcement November 1: Economic and job growth are "solid," inflation is undershooting the FOMC's 2 percent goal, and slowed in 2017. Monetary policy remains "accommodative," thus "supporting strong labor market conditions and a return to 2 percent inflation." The Fed expects to make "gradual" fed funds rate increases in 2018; PNC Economics forecasts three 0.25 percentage point federal funds target hikes in 2018, the same as in 2017. The midpoint of the Fed's December projections for economic growth and inflation (a.k.a. the "dot plot") forecasts the tax cut to raise real GDP growth to 2.5 percent in 2018; the September dot plot forecasted growth of 2.1 percent. The Fed's long-run projection for GDP growth remained at 1.8 percent. FOMC members' median projection for the unemployment rate over the next few years fell slightly: The rate is projected at 3.9 percent at the end of both 2018 and 2019, down from 4.1 percent for both years in the September projections. The long-run median of the unemployment rate remained unchanged at 4.6 percent. The median value of the projected fed funds rate is 2.1 percent at the end of 2018, implying three fed funds rate increases next year; this is unchanged from the September projections. Not raising the rate again until June of 2018 would give the FOMC some breathing room for inflation to pick up. It would also allow incoming Fed Chair Powell (assuming he is confirmed as expected and takes the reins in early 2018) the opportunity to get his feet wet before raising the funds rate. However, financial markets are pricing in a faster rate of increases than this: The fed funds futures market is pricing virtually no probability of a rate increase at the FOMC's next meeting in January, but a 76 percent probability of at least one increase by the meeting after that in mid-March, and a 42 percent probability of at least two hikes by June. There is both upside risk and downside risk to PNC's fed funds rate outlook. If inflation does not pick up as expected and instead stubbornly undershoots the FOMC's target, they could be reluctant to raise rates. Alternatively, numerous changes to the makeup of the FOMC could lead to a more aggressive pace of rate hikes in 2018. Fiscal stimulus during a tight labor market could also spur faster inflation in 2018. Longer-term rates are also expected to rise over the next couple of years, but more slowly, so PNC is forecasting a flatter yield curve in 2018 and then again in 2019, though not an outright inversion.

**CHINA:** The People's Bank of China (PBoC) raised key policy rates a small 5 basis points (0.05 percentage points) on December 14$^{th}$, the day after the Federal Reserve raised the federal funds target range 25 basis points. The PBoC raised the 7-day and 28-day reverse repurchase operation rates (similar to the Fed's interest on excess reserves rate) to 2.50 percent from 2.45 percent and 2.80 percent from 2.75 percent, respectively, and also raised the one-year medium-term lending facility rate from 3.20 percent to 3.25 percent. The PBoC, like the Fed, raised benchmark interest rates three times in 2017, in February, March, and December, but raised rates only 0.25 percentage points in total, a third of the federal funds target's 0.75 percentage point increase in 2017. Chinese monetary policy independently manages both the price and quantity of money, and money supply growth has slowed more than interest rates have risen: Aggregate financing to the nonfinancial sector grew 12.4 percent in year-ago terms in November, close to its slowest since 2006, and the broad M2 money supply grew 9.1 percent, only slightly above the slowest since at least

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1997. Fiscal policy also tightened into year-end: Central government expenditures fell 7.3 percent on the year in October and November after growing 11.7 percent in the January to September period. Little surprise that November's activity indicators show China's expansion moderating: Value added of industry grew 6.1 percent from a year earlier, down a hair from 6.2 percent in October, and investment in fixed assets rose 7.2 percent on the year in the first eleven months of 2017, down from 7.3 percent in the first ten months. Retail sales grew 10.2 percent on the year in November after 10.0 percent in October. The Chinese economy grew more in the first three quarters of 2017 than Chinese policymakers think is necessary to keep corporate balance sheets well-funded and the labor force employed, so they are throttling back on monetary and fiscal policy into year-end – this is consistent with the irregularly-reported survey-based unemployment rate, which was 4.90 percent in November 2017 versus 4.95 percent in December 2016 (neither seasonally-adjusted). With Chinese inflation benign (CPI inflation just 1.7 percent in year-ago terms in November), global growth broadening, and interest rates relatively low, China's small interest rate hike in December poses little risk to the country's expansion. Over time, higher interest rates could crimp cash flow for highly leveraged businesses, but that risk seems small at present: In the most recent release for October, Chinese industrial enterprises' operating revenues rose 12.4 percent in the year-to-date from the same period in 2016. China seems headed toward moderate economic growth in 2018 despite tighter monetary policy.

**MEXICO:** As expected, the Bank of Mexico followed the Federal Reserve and also raised its policy rate 0.25 percentage points to 7.25 percent on December 14. The central bank noted Mexico's decline in real GDP in the third quarter, which it attributes to recent earthquakes, weakness in the oil industry, weaker consumption, and stagnating investment; the Bank sees downside risks to the growth outlook, principally from the NAFTA renegotiation. CPI inflation in 2017 was boosted by a shift to higher market-determined consumer energy prices in January, and was 6.6 percent in year-ago terms in November, considerably above the central bank's 3 percent target. Inflation will plunge in 2018 as the January 2017 surge in energy prices drops out of the base comparison, leaving Mexico with one of the highest inflation-adjusted interest rates of any major economy early next year. Its central bank is keeping interest rates so high to support the peso amid NAFTA-related uncertainties; if it becomes clearer that NAFTA will remain status quo, the Central Bank is likely cut interest rates dramatically in the following year. On the other hand, if the result of Mexico's July 2018 general election scares financial markets, the central bank could be forced to raise interest rates even further to support the currency, amplifying headwinds to growth.

**EUROZONE:** Matching its October guidance for their monetary stance through September 2018, the ECB held policy rates unchanged at its December 14 decision and will continue to buy government and private assets at an unchanged rate of €60 billion euros per month. Their December macroeconomic projections raise the forecast for real GDP growth in 2018 to 2.3 percent from 1.8 percent in the September projections, but nevertheless forecast just 1.4 percent HICP inflation in 2018 (up from a forecast of 1.2 percent in September in reflection of higher oil prices), and 1.5 percent in 2019 (unchanged from the September forecasts). Despite solid job growth, an aging workforce and labor market liberalization are keeping wage growth in check and inflation tame. Employment grew 1.7 percent from a year earlier in the third quarter of 2017, up a hair from 1.6 percent in the second quarter. Real GDP grew 2.3 percent from a year earlier in the third quarter, and nominal GDP 4.8 percent, so GDP per person employed was up 0.6 percent in real terms and about 3.0 percent in nominal terms. With average hourly labor costs up 1.7 percent, real unit labor costs were roughly flat in year-ago terms in the third quarter of 2017. The ECB forecasts that unit labor cost inflation will accelerate to 1.8 percent by 2020, lifting HICP inflation toward target. If it doesn't, Eurozone short-term interest rates could stay negative into 2020.

**UNITED KINGDOM:** As expected, the Bank of England held the bank rate unchanged at 0.50 percent at its December 14 monetary policy decision. The Monetary Policy Committee's decision referred to Brexit as "the most significant influence on, and source of uncertainty about, the economic outlook" – a simpler but less diplomatic description for that is a "downside risk." The Bank of England will likely refrain from further rate hikes in 2018 as Brexit slows growth and the pass-through of the weaker pound to CPI inflation diminishes.

**CANADA:** Bank of Canada Governor Stephen Poloz's December 14 speech on things that keep him up at night unsurprisingly flagged the Canadian housing market and high household debt as a key risk to the

economy. The latest housing market data show the sector's downturn continues: The Teranet-National Bank National Composite House Price Index™ fell 0.5 percent in November from October, and is down a cumulative 2.2 percent from August. Home prices rose 9.3 percent in year-over-year terms in November according to the Canadian Real Estate Association (CREA), the slowest increase since February 2016. Home sales rose 3.9 percent in November from October according to the CREA, and rose 2.6 percent in year-over-year terms, but CREA President Andrew Peck attributed the pickup to buyers accelerating transactions to avoid tighter mortgage qualification rules that come into effect on January 1 and not an improvement in trend demand. The CREA reported new home listings up 3.5 percent in November from October, a larger increase than home sales'.

**BRAZIL:** The minutes of the Central Bank of Brazil's December 5 and 6 Monetary Policy Committee meeting name the possibility of a delayed implementation of economic reforms as the key downside risk to the outlook. The minutes warn that delayed reform could increase risk premia charged on Brazilian assets by financial markets, weaken the currency, and raise prices of imported goods and inflation. On this front, the news is negative: Brazil's House of Representatives decided on December 13 to delay a vote on pension reforms until February, narrowing the window in which the law can be passed – Brazil will hold a general election in October 2018, and the field seems open for critics of the unpopular pension reform proposal.

**JAPAN:** Very upbeat survey data: The Bank of Japan's Tankan manufacturing business conditions surveys covering large and small enterprises reached their highest levels since 2006 and 1991, respectively, in the fourth quarter of 2017. The nonmanufacturing indices for large and small businesses were at their strongest since 2015 and 1991, respectively. Industrial production rose 0.5 percent in October from September and 5.9 percent from a year earlier.

**AUSTRALIA:** Upbeat employment data will not do much to change the outlook for the Reserve Bank of Australia's monetary policy. The labor market roared back in November with a net gain of 61,600 jobs, well above the 19,000 consensus. This followed a paltry 7,800 increase in October. Full-time employment increased by 41,900 on the month and part-time employment rose by 19,700. The unemployment rate held steady at 5.4 percent for a third month in November even as the participation rate jumped 0.3 percentage points to 65.5 percent. This is the highest participation rate since September 2011 and indicates increasing confidence in the job market's trajectory. However, the good news of diminishing slack in the labor market is counterbalanced by disappointing data that showed consumer spending slowed in the third quarter as households coped with heavy debt burdens. Also, price competition in the retail industry could dampen inflation more than expected. PNC expects the RBA to cautiously wait until late-2018 to raise its policy rate.

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