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Harr's View

Global inflation may turn higher due to Fed and China

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Good evening all

Today, I discuss the global drivers of consumer price inflation and the implications for the Eurozone and Scandinavia. In my view, global monetary policy conditions are one of the most important drivers of global inflation as they influence inflation expectations, commodity prices and the global business cycle. Global monetary policy conditions tightened over the past year. Global liquidity growth collapsed due to the reduction in the Fed's balance sheet, the end of the ECB's quantitative easing and the slowdown in Bank of Japan's purchases of Japanese government bonds. In addition, broad money supply growth fell during 2018, while falling inflation expectations, higher real policy rates and slowing growth tightened global monetary conditions. **Hence, global monetary policy conditions dampened inflation last year and they are still not conducive to higher global inflation. However, the Fed's substantial dovish policy shift in December/January lifted marked-based inflation expectations in the US, which might help anchor global inflation expectations.** This month, the Fed may announce that quantitative tightening will end later this year, but its balance sheet will shrink further in coming months. We do not expect any change in forward guidance or the announcements of new policy instruments at the ECB meeting next week (see our preview *here*). The ECB is as usual not a 'leader' but a 'follower' in terms of global monetary policy and easing by the Fed and China may provide a helping hand.

We expect the oil price to rise over the course of 2019 supported by the policy shift from the Fed, a weaker US dollar and a recovery in global growth. As such, the oil price poses upside risks to headline inflation in our view. This week, we received the most decisive recovery signal yet from China, as February PMI Manufacturing rebounded supported by the monetary and credit easing by the Chinese authorities. A modest recovery in China also underpins metal prices. In my view, the US has the best chance of higher inflation among the largest economies. Fiscal policy will remain highly expansionary in 2019, which will further lift the positive output gap, although the boost to growth will be less significant this year than last year. The combination of high wage growth but relatively low labour productivity growth should lift core inflation in the US, but low survey-based inflation expectations and inflation inertia (lagged inflation) suggest that the process will be gradual. Higher US inflation has to happen sooner rather than later in my view. Otherwise, time will run out as slowing growth and fading fiscal stimulus set in.

What about the biggest driver of global growth, China? Over the past couple of years, China has moved from a big reflationary force to a deflationary force, which is another explanation for the muted global inflation over the past year. It has been visible, not least, in the drop in Chinese producer price inflation, which swung from a peak at 7.8% y/y in 2017 to 0.1% y/y currently. Tighter credit conditions, a weaker housing market and lower metal prices drove the shift. **China remains a deflationary force for global inflation, but there are early signs that it could turn soon.** The rise in bank lending growth and the fall in government bond yields should support a recovery in the housing market and a pick-up in metal prices.

What does this imply for inflation in the Eurozone? *Recent research* shows that global inflation primarily influences Eurozone inflation through global monetary policy and commodity prices. However, domestic price pressures in the Eurozone closely follow the business cycle in the common currency area. The dovish shift by the Fed and China support the global business cycle. A modest recovery in China will stabilise the European cycle, as I argued last week (*see here*). Higher wage growth should drive higher core inflation in the Eurozone in 2019 but it requires that the Eurozone recovers. As such, the rebound in China's PMI Manufacturing may be more important for Eurozone inflation than the slight downside surprise in Q4 German wage growth reported this week. High German wage growth and low labour productivity growth should drive higher core inflation in Germany in my view, if the economy recovers.

What is the impact on Scandi inflation? In Sweden, we believe that imported inflation accounts for around 30% of inflation through the global manufacturing cycle, commodity prices and the currency. Meanwhile, 70% of Swedish inflation is domestically driven, linked to domestic demand, service prices and wage growth. In recent months, the manufacturing part of the Swedish economy has held up surprisingly well, which was visible in this week's data. On the surface, Q4 GDP reported this week was much stronger than expected. However, domestic demand was very weak, which together with low wage growth will weigh on domestic inflation. **Hence, we are confident in our below consensus call for Swedish inflation even if global inflation rises.** I will discuss global inflation and implications for Swedish inflation with our Chief Economist in Sweden, Michael Grahn, on tomorrow's Macro Strategy View podcast.

That was all for today's comment. I wish you a great Sunday night and coming week, best regards, Thomas

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