24 August 2018
Opinion

Powell speaks on a changing economy

So what has changed about the economy? What will Powell talk about? For me, the biggest changes in the economy concern the consumption and production of virtual goods, and the flattening of the Philipps curve. Both suggest that central bank policy needs to adapt. But has it?

The economy has changed...

I don't think the world of finance and economics is ready for a complete re-think on monetary policy. But given the changes that have taken place in the economy in recent decades, a complete overhaul would not be a bad idea.

What changes? Ask yourself, what did you spend money on recently? Did you get a new app? Did you buy a new i-book? Or upload a movie onto a tablet to watch on a plane flight? More and more, what we buy is a mixture of pixels, photons and bytes. In short, it exists only in electronic form, not in "reality". Our consumption of these goods has no implication for the scarcity of factors of production, and therefore for inflation. The "platform economy" does not only deal in virtual goods but also delivers real consumables, food, services. It drives prices down by making instant price comparisons possible, and by massively broadening our choice options. It is like the world has moved from being a textbook one dominated by oligopoly, to near perfect competition, and in a very short time. We can spend and spend and spend, but prices will barely budge.

Throw in automation and AI, and there is also the beginnings of an explanation for the flattening relationship between labour market tightness, and wages growth. Running short of workers? Buy a box of electronic wizardry to do their job instead. Seriously, there are boxes out there writing economic data reports already. My working days are numbered (at least in their current form). What about yours?

...central banks should too

So how have central banks changed? The short, answer is, they haven't. Almost all of the major central banks still follow inflation targets. And that target is usually 2%. Given what I wrote in the previous paragraph, there is no reason why targeting a 2% inflation rate should deliver a rate of credit growth consistent with stable financial markets. In other words, following the current targets is a good way to build up excesses that will deliver the next financial crisis. Something much lower than 2% might be more appropriate. There may be times when a negative inflation target is appropriate - this is quite different from deflation by the way). Sometimes, the target should be much higher. And there is no reason why a central bank model where inflation outturns are wrapped around employment gap methodology should give you the right policy responses when the Philipps curve has shifted flatter.

Central banks have, for the most part, resisted calls to adopt policy rule frameworks beyond the simple inflation target. That is, in my opinion, a very, very good thing. When the economy changes - your models will give you the wrong answer. And there has been a lot of pressure for such adoption of rules based frameworks by some members of the current US administration.

Yet if you take a look at such rules (see image above), you find that Fed policy is exactly in line with them. A 2% inflation-target Taylor rule with inertia and a 4.3% unemployment target, delivers a 2.19% Taylor rule recommendation. The current effective Fed funds rate is 1.92% - after the

September rate hike, it will be 2.17% - a difference of only 2bp.

In short, unless Jay Powell announces the end of a static inflation target, and the incorporation of a credit growth target info the Fed's deliberations (only the ECB does this, sort of) then I shall be disappointed. I expect to be.

Back me or sack me - Turnbull waits for vote

The fate of Australian PM, Malcolm Turnbull hangs on whether the contender for his job, Peter Dutton, can get enough votes today. This is Australian politics as normal. Remember, Turnbull ousted former PM Tony Abbot in much the same way. This is survival of the fittest politics. Watch your back for knives.

While we wait on an outcome, the AUD is under weakening pressure. A resolution, almost any resolution, is likely to see the AUD rally. There are other reasons to expect some weakness in the AUD though. We aren't convinced that the economy is in as good shape as the popular view on Australia runs. An absence of RBA policy changes over recent years has allowed household debt to balloon. Meanwhile, the property market across almost the entire country is beginning to cool, and we doubt an about-face in lending standards by APRA will be sufficient, or fast enough to turn it round. So a bounce today, but then weaker.

Trade talks come to nothing - as expected.

China and the US have concluded their mid-level talks on trade, and they have agreed to nothing. Overnight, the US has imposed tariffs on an additional $16 billion of Chinese imports, and China has reciprocated in like manner.

China is saying it will not even resume talks until the November mid-terms are over, viewing much of the US stance on trade as having a political motivation. It probably does. Maybe China is also listening to chatter about a possible impeachment of President Trump. We wrote about this yesterday before the file crashed and lost everything before publication. But if that had saved, it would have pointed out that impeachment is very rare, needs to be passed by the House of Representatives, and then needs the subsequent trial to be decided by a two-thirds super-majority of the Senate to remove the President. In short, If I were Trump, I would not be worried.

Were the unlikely to happen though, the market reaction could well be an unexpected rally in stocks and decline in the dollar (as a winding back of trade wars was factored in) and bond yields would likely rise.

Asia Day ahead

In Singapore, industrial production year-on-year growth was 7.4% in June, and will likely stay about that rate in July when data is released at 13:00 local time. It might be perhaps a smidgen weaker. Recent activity data for Singapore has held up reasonably well, and though some statistical flip to the month-on-month figures is likely for July, it won't likely make a significant dent in the production trend. With data holding up a bit better over the last month, we are less inclined to forecast a much weaker SGD. As one of the better performing currencies since April, USD/SGD 1.38 might prove to be close to the recent peak, and we anticipate it at roughly the same level by the end of the year.

In Malaysia, the removal of Goods and Services Tax dented CPI inflation sharply in June. Data today for July due at noon local time is expected to show that the GST impact continues to linger. Our forecast of a slight uptick to 1% YoY from 0.8% in June results from low base effects, especially in the transport component. The replacement of GST with the Sales and Services Tax (SST) in September, is likely to be benign. After one-off rises in July, we expect inflation to decelerate below

1% in August and remain there over the rest of the year. This, and slowing GDP growth are reasons we expect no change to central bank (BNM) monetary policy over the remainder of the year.

In Thailand, we have revised our end-year USD/THB forecast to 33.5 from 35.0 on the back of recent THB outperformance and as the central bank (BoT) monetary policy committee has already started thinking about the timing of policy normalization. However, we aren't forecasting any change to the policy this year because growth has already started to ease and inflation is likely to slip below the policy target in coming months. We need to see a significant shift in consensus within the BoT policy board in favour of tightening, from the 6-1 vote for no change at the last meeting, before revising our policy view.

Robert Carnell
Chief Economist Head of Research, Asia-Pacific
+65 6232 6020
robert.carnell@asia.ing.com

Prakash Sakpal
Economist, Asia
+65 6232 6181
prakash.sakpal@asia.ing.com