ECONOMIC VIEWPOINT

Is the Reflation Trend Strong and Widespread?

An Issue for Future Monetary Policy Evolution and Movement by the Major Currencies

Inflation rates have been coming up around the world in the last few months. The financial markets tend to read this as a signal that monetary policies will soon become less accommodating, as is happening in the United States. That being said, the recent rebound by inflation primarily reflects the rise in oil prices. To judge how strong and widespread the reflation cycle is, we must examine several variables.

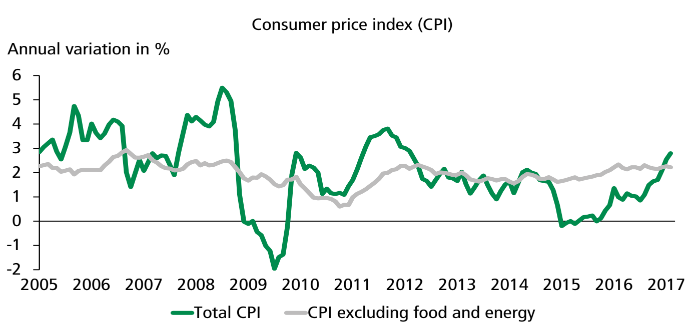
This *Economic Viewpoint* analyzes the inflation situation in the major advanced economies. We find that the rise by inflation seems more durable in the United States, suggesting that U.S. monetary policy will continue to tighten, and the greenback will keep going up. In Canada and the United Kingdom, although inflation is close to the targets, not all the conditions are in place for kicking off monetary firming. Due to Brexit, uncertainty remains especially high in the United Kingdom. We will likely have to wait until 2018 to see less accommodative monetary policy in the euro zone, and later still in Japan.

United States: Well into the Economic Cycle

The 2014 drop in oil prices played a big role in bringing down the total inflation rate in the United States and several other countries. The reverse is happening now, with crude prices up substantially from where they were at the start of 2016—US$30 a barrel. This positive effect should dissipate in the next few months, meaning that, in the United States, total inflation should not stay above 2.5% very long. A more stable inflation metric, which excludes energy and food prices, still points to the presence of a strong underlying trend for price growth, at just above 2.0% since 2016 (graph 1).

The U.S. economy has been growing since the 2008–2009 recession. This has gradually reduced the surplus production capacity generated at that time. The gap between real GDP and potential is now around -1.0%[1] (graph 2 on page 2). This is quite a small gap and it should almost disappear in 2017, if economic growth hits 2.5% as projected. Inflationary pressure should therefore increase.

GRAPH 1
Inflation in the United States



Sources: Datastream and Desjardins, Economic Studies

Another sign that inflation should remain sustained is the decrease in the ranks of the unemployed (graph 3 on page 2). At 4.7%, the U.S. jobless rate is now close to the 4.4% low point reached prior to the last recession. Acceleration by wages is still deemed moderate, which suggests that the job market has not overheated enough to generate high inflation. The situation

[1] For uniformity's sake, all the output gap metrics used in this *Economic Viewpoint* come from the Organisation for Economic Co-operation and Development (OECD). Other organizations publish this type of metric, and values may diverge slightly.

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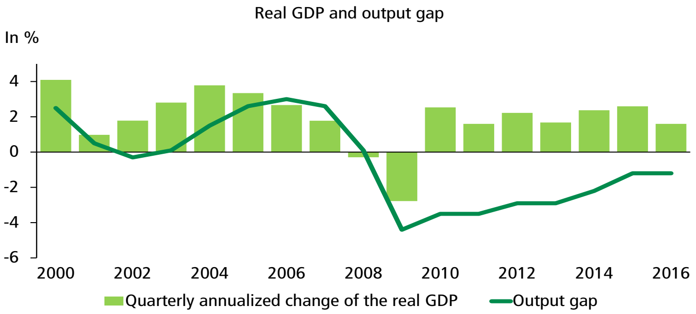
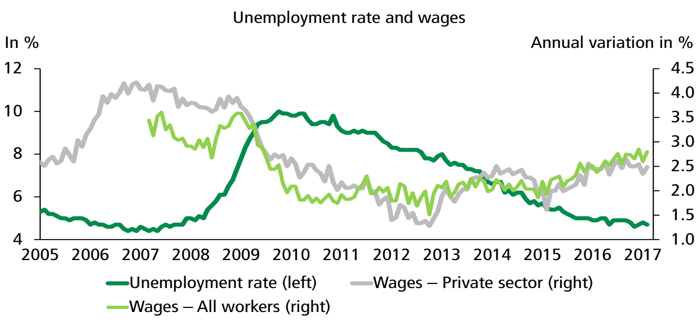
GRAPH 2
U.S. economic cycle



Sources: Datastream, Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

GRAPH 3
U.S. job market



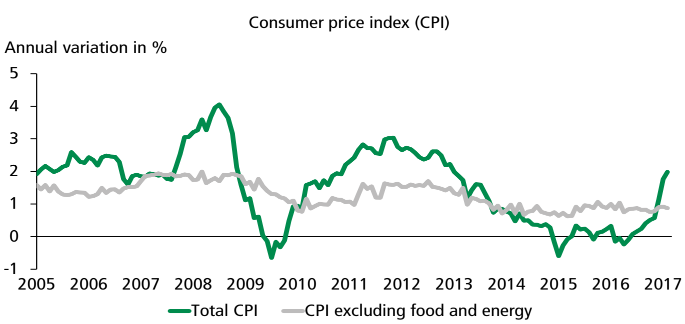
Sources: Datastream and Desjardins, Economic Studies

could change quickly, however, and it could be risky to slow U.S. monetary firming just because of overly weak wage growth.

Euro Zone: Lagging Behind the U.S. Cycle

The picture in the euro zone is very different from the United States. While total inflation recently rebounded there as well, core inflation excluding energy and food prices is much lower, at just under 1.0% (graph 4).

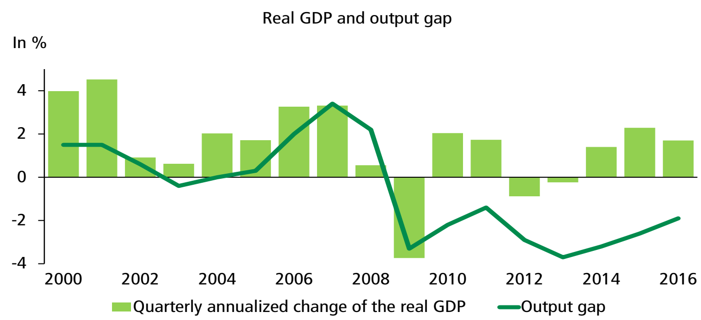
GRAPH 4
Inflation in the euro zone



Sources: Datastream and Desjardins, Economic Studies

This difference exists because the euro zone is lagging behind the U.S. economic cycle. After the 2008–2009 financial crisis, the euro zone was hit with another shock in 2012 when the sovereign debt crisis affected several nations in the region and threatened to break the monetary union. The euro zone still has a gap of about 2.0% between its real GDP and potential (graph 5). With an expected 1.6% economic growth in 2017, the output gap will remain large. The European Central Bank (ECB) is showing a little more optimism with a growth forecast of 1.8%. However, that will not be enough to catch up with the U.S. cycle. More evidence of the existence of excess production capacity in the euro zone is that the unemployment rate remains far from the 7.2% low set in 2008 (graph 6). At 1.4%, wage growth is also very weak; it was close to 3.5% at the start of 2008.

GRAPH 5
Economic cycle in the zone euro



Sources: Datastream, Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

GRAPH 6
Job market in the euro zone

Sources: Datastream and Desjardins, Economic Studies

Another challenge lies in the fact that some zone countries remain on shaky ground financially. The ECB's current policy provides some stability there. Economic and financial conditions would likely have to improve rapidly in 2017 to prompt the ECB to change course. Moreover, before it starts to consider firming, the ECB will first have to stop buying securities; for now, the program is scheduled to run until the end of the year. It would be surprising for the ECB to raise its key rates before it wraps up its securities purchasing program.

United Kingdom: Brexit changed the situation

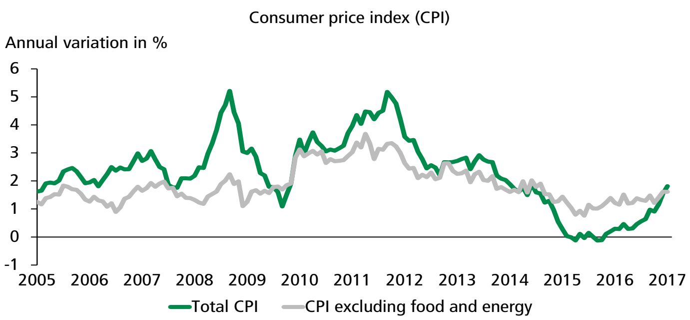
Britain's economic numbers are similar to the United States'. Price growth is a little weaker, with total inflation at 1.8% and inflation excluding food and energy at 1.6%, but it is trending up (graph 7). Moreover, the economy has been growing since the 2008–2009 crisis and the gap between real GDP and potential has almost closed (graph 8). At 4.7%, the unemployment rate is close to levels observed before the last crisis (graph 9). As in the United States, wage growth remains moderate.

The picture created by the British data could argue for monetary firming. However, the June 2016 referendum on Britain leaving the European Union (Brexit) changed the situation. Although the economy has been very resilient so far, we can assume the situation will deteriorate once formal negotiations begin or Brexit becomes official. The Bank of England should therefore remain cautious in its future monetary policy decisions. We must also consider that some of inflation's recent acceleration is associated with the pound's plunge. This effect should eventually evaporate, but could be delayed by ongoing pound depreciation.

Japan: Hard to Make Inflation Grow Faster

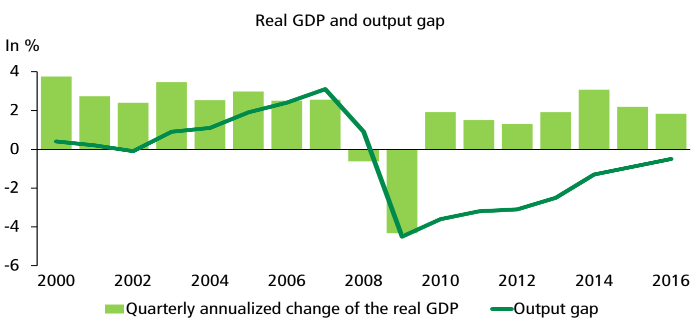
In Japan, inflation has been struggling to stay in positive territory (graph 10), yet there does not seem to be any substantial surplus production capacity. The gap between real GDP and potential is close to 0%, which should normally come with inflationary pressure (graph 11). The job market also seems to have tightened up in the last few years; the jobless rate is close

GRAPH 7
Inflation in the United Kingdom



Sources: Datastream and Desjardins, Economic Studies

GRAPH 8
U.K. economic cycle

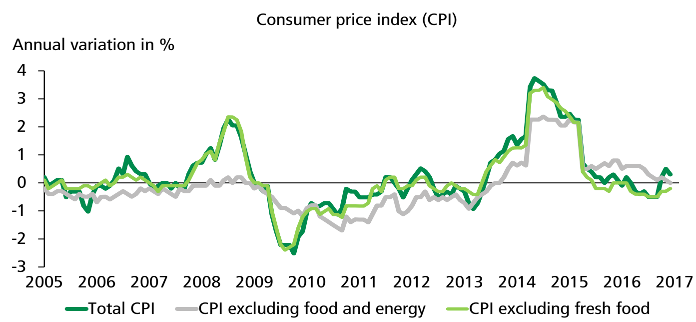


Sources: Datastream, Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

GRAPH 9
U.K. job market

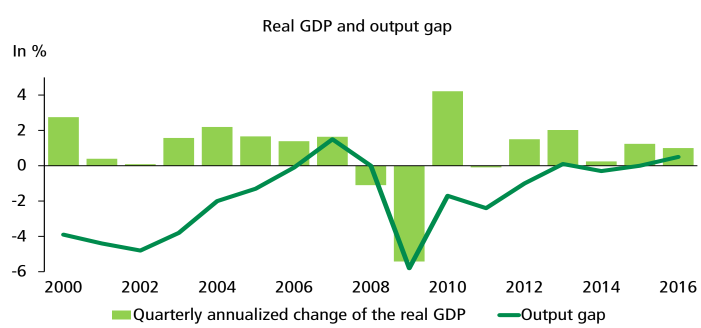
Sources: Datastream and Desjardins, Economic Studies

GRAPH 10
Inflation in Japan



Sources: Datastream and Desjardins, Economic Studies

GRAPH 11
Economic cycle in Japan



Sources: Datastream, Organisation for Economic Co-operation and Development and Desjardins, Economic Studies to 3.0% (graph 12). However, wage growth remains very weak, at around 1.0%.

GRAPH 12
Job market in Japan

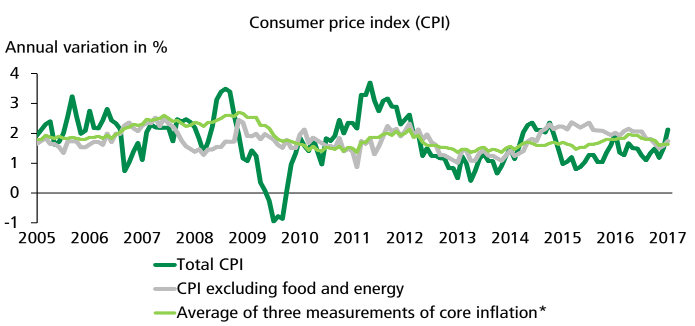
Sources: Datastream and Desjardins, Economic Studies

Japan is a special case. The Bank of Japan (BoJ) seems to be unable to get inflation expectations up on a lasting basis despite highly accommodative monetary policy and the adoption of an average inflation target of 2%. The target came into effect last fall; it means that the more inflation stays below 2%, the more tolerant the BoJ will be when inflation goes above that mark. The onset of Japanese firming therefore seems quite remote. Moreover, even if inflation finally goes up, the potential for economic growth is weak due to the ageing of Japan's population, which greatly reduces the leeway for raising interest rates.

Canada: A Lot of Uncertainty Remains on the Horizon

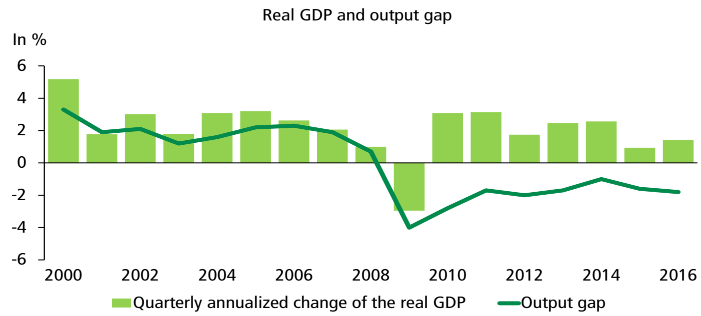
Canada's total inflation jumped above 2.0% in January. Core inflation measures are just under that and were trending down in the final months of 2016 (graph 13). Canada's economy has been pummeled by the drop in oil prices, which helped slow economic growth in 2015 and 2016. The gap between real GDP and potential also widened in those two years (graph 14).

GRAPH 13
Inflation in Canada



* The Bank of Canada now publishes three measures of core inflation.
Sources: Datastream and Desjardins, Economic Studies

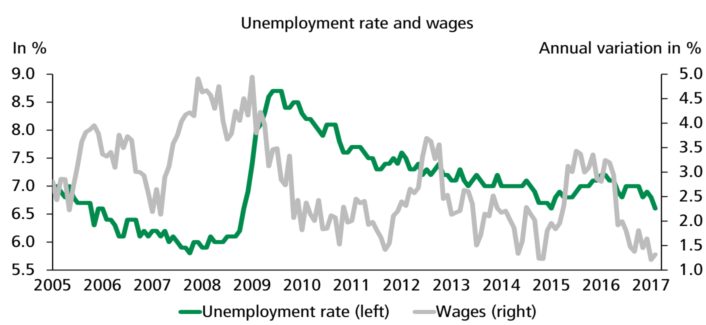
GRAPH 14
Economic cycle in Canada



Sources: Datastream, Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

There is reason for prudence in conducting Canada's monetary policy. The Bank of Canada (BoC) does not expect the economy to get back to full potential before mid-2018, which suggests that inflation pressures will remain subdued in the meanwhile. Although the job market has been performing well, the unemployment rate is still higher than it was prior to the 2008–2009 crisis, and wage growth is sluggish (graph 15).

GRAPH 15
Job market in Canada



Sources: Datastream and Desjardins, Economic Studies

New risks appeared recently with Donald Trump's win. Canadian businesses could be more cautious and put off some investments until the situation becomes clearer in terms of the future of the free trade agreement with the United States and potential adoption of protectionist or tax measures that would favour U.S. businesses. The rise by bond yields is also a new risk given that Canada's private sector has the highest rate of indebtedness among the G7 nations. For these reasons, it is hard to picture a Canadian key interest rate increase before the second half of 2018. Moreover, the eventual Canadian monetary firming will have to be very gradual, reflecting ongoing extensive prudence in an uncertain environment.

The Federal Reserve (Fed) will go it alone for some time to come

In closing, although total inflation has rebounded recently in several countries, we cannot say that this is a solid general trend. It is often enough to study other inflation metrics to see that inflationary pressure remains weak in some spots. Moreover, the major advanced nations are not all at the same point in their economic cycles and in the resorption of their excess production capacity.

The Fed should continue with monetary firming in 2017. Two additional interest rate increases should be ordered this year. The ECB and BoJ should pursue their securities purchasing programs, but the ECB's tone might start to change during the year, if only to aim for more neutral monetary policy. It will likely be late 2018 before we see real monetary firming in the euro zone. The wait promises to be much longer for Japan, as inflation expectations are still struggling to rise on a lasting basis. It could also be a long wait in the United Kingdom as the economy will likely erode when Brexit materializes. In Canada, despite fairly encouraging recent data, it still seems to be too early to raise key interest rates. Substantial excess production capacity persists and the future remains very uncertain.

In the context of monetary policy divergence, the U.S. dollar should remain strong against all of the other major currencies in 2017. However, the Canadian dollar and euro could do better in 2018 if the BoC and ECB kick off monetary firming as well. For the yen, the outlook remains weak for next year. As for the pound, a lot will depend on how Britain's economy evolves.

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