March 2015 Investment Publications Highlights

European Economics: Core of the Matter

Christel Aranda-Hassel, Mirco Bulega, Neville Hill, Sonali Punhani, and Giovanni Zanni, Credit Suisse, February 27, 2015

European inflation has consistently disappointed since mid-2013. Credit Suisse believes the Eurozone is not experiencing deflation given the decline in prices is not broad-based, inflation expectations are picking up, and the European Central Bank (ECB) is committed to continuing quantitative easing until the path of inflation is consistent with reaching the ECB's 2% target.

Falling food prices dragged down inflation in the first half of 2014 and, during the second half, headline inflation followed oil prices down. Food and energy together subtracted an average 30 bps from headline inflation over 2014. Yet the share of the basket in negative inflation was just 26%, on average, implying the decline in prices is not broad-based. If oil prices (based on Brent crude) continue to stay somewhat stable around $60, Credit Suisse believes Eurozone headline inflation likely troughed in January at -0.6% year-over-year.

Core inflation, which strips out items like food and energy that experience volatile price movements, is not yet negative, though it is weak, having fallen to 0.6% year-over-year in January 2015, its lowest value on record and well below average core inflation of 1.5% year-over-year. In 2014, core inflation was 70 bps below its average. Flagging demand is responsible for part of the weakness coming from demand-sensitive components of core inflation; other weak components are sensitive to oil prices. Some rebalancing within the Eurozone may be taking place as well—Germany, which had experienced low inflation in the first decade of the monetary union, has recently seen inflation hold up, whereas countries like Italy and Spain, which heated up in the Eurozone's first decade, are now showing core inflation well below historical averages.

Credit Suisse notes that the output gap (lagged by one year) explains core inflation, and the growing output gap in 2014 will likely depress core inflation in 2015. However, core inflation should increase from 0.7% in 2015 to 1.1% in 2016 through the combined effects of euro depreciation and quantitative easing, among other factors. Though higher, this level is still below the ECB's inflation target of 2%, suggesting that the ECB's quantitative easing could go on beyond the current target end date.

Escaping the Stagnation Trap: Policy Options for the Euro Area and Japan

OECD, January 2015

Global economies, particularly those in the Eurozone, continue to grow at low speeds in an environment of increasing risk for persistent stagnation. The OECD argues that in addition to accommodative monetary and fiscal policy, developed economies must also enact structural reforms to improve growth and reduce income inequality.

The world economy continues to struggle in the wake of the global financial crisis. Growth rates in OECD countries, at just 1.5% to 2% over 2011–14, are lower than before the crisis. Global trade volumes are only moving in line with economic activity, rather than at twice the level of GDP as they did pre-crisis. This low growth persists despite many central banks having pushed nominal interest rates to near zero, low volatility, and low credit risk premiums. Several factors have likely combined to contribute to the global economy's inability "to leave behind the legacies of the crisis": (1) central banks' limited ability to stimulate demand, (2) business investment becoming less responsive to changes in interest rates, and (3) weak supply-side factors like a decline in the pace of technology progress and a stagnant labor force. The OECD report sees evidence of persistent stagnation in Japan and the Eurozone, particularly in the so-called periphery.

A comprehensive package of reforms would include monetary and fiscal policy. With interest rates near zero, central banks have to use (and have used) unconventional monetary tools like quantitative easing to stimulate growth, but these have their limits and there is evidence that QE can result in excessive risk-taking that leads to financial instability. Fiscal stimulus is also appropriate, and should target investments with a large impact on growth, specifically infrastructure.

Beyond monetary and fiscal policy, the OECD argues that structural policy reforms that boost potential growth are necessary to increase the effectiveness of stimulus measures, and reforms with an immediate positive effect on demand are priorities given the limits of the other two pieces to do much to change demand. The OECD's report makes the case for reforms in four areas.

First, stimulating private investment that will help increase demand. This can be done through reviving investment in infrastructure via public-private partnerships or other measures, such as credit and revenue guarantees, that increase returns for private investors; completing efforts at financial reform; liberalizing international investment restrictions and better coordinating tax policy across countries; and ensuring that laws do not favor share buybacks over other uses of cash.

Second, policymakers should focus on reducing barriers to entrepreneurship as start-up rates have declined in many OECD member countries, particularly in peripheral Europe. Actions here would include improving access to financing, reforming bankruptcy laws, and ensuring the government is otherwise facilitating business creation. The third area for reform is trade, where countries need to improve both imports and exports by making customs procedures more efficient, and by developing more bilateral or regional trade agreements. Finally, creating jobs and reducing unemployment will also help stimulate demand. Policymakers should examine tax policy to make sure it does not penalize additional earners and should put in place measures to address skill gaps in the unemployed.

While these reforms are needed in many member countries, the OECD report advises specific additional reforms for the Eurozone and Japan. In the Eurozone, policies must be enacted or expanded to improve the business and investment environment, reduce trade barriers and harmonize regulations, encourage more risk-taking, and increase employment. Some developments are helpful in this regard, including the "Investment Plan for Europe" announced by the European Commission in November 2014, which is one measure that could stimulate investment in EU companies. The European Fund for Strategic Investment called for in this plan hopes to raise €315 billion for funding projects with public guarantees of €21 billion. The European Capital Markets Union portion of the plan seeks to reduce regulatory bottlenecks.

In Japan, the OECD report notes the importance of achieving the "third arrow," particularly given that the second, fiscal policy, is limited by Japan's sovereign debt levels. Specific reforms advised include implementing product market reforms, particularly for the service sector; negotiating additional regional trade agreements; creating a better climate for inflows of foreign direct investment; and addressing the disconnect between the formal and informal labor markets.

Using a model based on past studies, the OECD estimates that enacting these reforms could result in an increase of 2% to 2.5% in the growth rates of the Eurozone and Japan over a five-year period. ■

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