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R&R Weekly Column
By Brunello Rosa

Neither Permanent, Nor Temporary, But “Persistently” Low Inflation

In a column of a few months ago, Nouriel Roubini discussed the potential factors behind what he called “the mystery of the missing inflation”, i.e. the fact that inflation was undershooting central banks’ objective in most areas of the advanced world, including those in which the output gap is closed, or very narrow, such as the US. In particular, he referred to the various persistent supply- side phenomena that can lead to a prolonged period of low inflation, including technological advancement, globalisation, new forms of labour organisation (and associated weakness of the unions and flatness of the so-called Phillips curve, which supposedly links unemployment and inflation rates).

A week later, Fed Chair Janet Yellen also used the same term (“mystery”) to acknowledge that inflation have been undershooting the Fed’s 2% target for quite some time, while attributing this phenomenon to a series of temporary supply factors, such as reduced mobile phone bills and medical insurance premia, the long-lasting effects of lower oil prices, etc. Given their temporary nature, the Fed could look through those factors, and continue its monetary policy normalisation cycle, as in fact it did with the additional 25-bps rate increase delivered in December 2017. But before that, Yellen herself started to express some doubt on the temporary nature of this inflation under-shoot, when in a discussion at NYU, she declared: “We expect [inflation] to move back up over the next year or two, but I will say I’m very uncertain about this.” It is too early to say that the Fed will make a U-turn on this issue, but at least the debate in openly on the table.

In our recent 2018 Global Economic Outlook, we made a further step in our analysis of this phenomenon, when we argued that we don’t think that inflation is low either for a series of temporary factors, or due to the presence of permanent phenomena, such as the “death of the Phillips curve.” Rather, we think that inflation is low for a series of “persistent” supply- side (and some demand-side) phenomena, that conjure to keep inflation low for a long period of time, but unlikely forever. We believe that the global and technological factors that have kept inflation low so far are somewhat persistent and that these global factors matter for traded goods inflation but less so for non-traded goods inflation. Thus, in the debate between those at the Fed who believe that the supply-side shocks were mostly temporary and those who believe that they are mostly permanent, we argue that reality is in between, the shocks are neither permanent or temporary but “persistent” over time. As a result, in spite of stronger growth, inflation may rise only gradually rather than surprise to the upside in 2018, and the Fed may thus hike less than signalled by the “dot plot” but more than market participants currently expect.

Our Recent Publications

- *Travel Notes: Will Macron Succeed in Reforming France?*
  by Nouriel Roubini and Brunello Rosa, 3 January 2018

The Week Ahead

US - December y-o-y CPI (*c*: 2.2%; *p*: 2.2%) and m-o-m retail sales (*c*: 0.4%; *p*: 0.8%) will be released.

China - trade numbers (imports, *p:* 17.7%; exports *p:* 12.3%) and CPI (*p*: 1.7%) for December will be released.

Iran - Street protests are likely to gradually lose momentum. Demonstrators are complaining about rising prices, lack of jobs, political corruption and the country's involvement in foreign conflicts. Estimates indicate that 20 people might have been killed and 450 arrested. Protests, initially triggered by the conservative opposition, focused initially on the reformist government but quickly extended to the religious leadership.

The Quarter Ahead

In the US, growth is expected to accelerate. The December ISM manufacturing index rose to 59.7 (c: 58.1 p: 58.2), close to a 13-year high. Strong data increased the likelihood of a hike in March to 67.5%, according to Fedwatch.

The EZ's economic recovery will likely last: strong PMIs support the optimist outlook: in December, the composite PMI rose to 58.1 (c: 58.0; p: 58.0). Inflation will remain below the 2% ECB target, allowing policy to remain expansionary. The March 4 elections in Italy, where support for the Eurosceptic opposition is on the rise, pose political risks. In the UK, Brexit-led uncertainty will weigh on growth and the GBP/USD, which is hovering within the 1.31-1.36 range.

In Europe, the Mifid II directive - introduced on January 3, 2017 - ***will bring profound changes to the banking and asset management industries.***

EMs - Russia and Brazil are expected to continue their ongoing recovery. China likely to further increase capital controls. *In Russia*, interest rates are likely to be cut further ahead of the March 18 presidential election, as the RUB remains stable. *In Brazil*, industrial production will continue to improve: November's 0.2% m-o-m (p: 0.3%) rise was the third consecutive monthly expansion. *In China,* further moves to increase capital controls are likely, following the measures adopted in the past two weeks to curb credit card payments abroad.

GCC - The outlook for sukuks in 2018 remains mildly negative. In Q4 2017, the Emirates NBD Markit IBoxx USD Sukuk index fell nearly 2% (in price terms) following the Fed's rate hike, which are expected to continue in 2018, putting further pressure on the price of existing sukuks. Saudi Arabia and Iran's foreign policy will continue to strain the region, although military conflict is unlikely.

Last Week's Review

US - The minutes of the 'FOMC December meeting' reaffirmed the Fed's expectation of three hikes in 2018. Trump's tax cuts were cited as a reason for upgrading the GDP growth forecast for 2018 to 2.5% (c: 2.5; p: 2.1).

Europe - EUR/USD appreciated to 1.21, a 3-year high and the EUR/JPY reached a 27-month high. The rally represents an acceleration of the previous positive momentum, and was 1) prompted by the record high PMI figures (manufacturing, services and composite) released during the week, and 2) supported by Germany's 5.5% unemployment rate (c: 5.6; p: 5.5), a record low.

Turkey - Inflation eased slightly at 11.9% in December (c: 11.0; p: 13.0) after reaching a 14-year high in November, prompting a 1.1% appreciation of the USD/TRY to 3.748.

China - Data were consistent with the ongoing soft deceleration of the economy, as: a) manufacturing PMI edged down to 51.6 in December (c: 51.6; p: 51.8); and b) growth of industrial profits slowed to 14.9% y-o-y in November (p: 25.1).

GCC - Saudi Arabia and the UAE introduced a VAT of 5%, to boost non-oil income. In compensation, Saudi Arabia ordered a monthly payment of 1,000 riyals (USD 267) to state employees over the next year.

Iran protests and oil prices - Brent crude rose amid concerns about possible supply disruptions, following the unrest in Iran. Brent for delivery in March ended the Thursday 4 session at 68.1 USD/bbl, the highest price since December 2014.
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Abbreviations, Acronyms and Definitions

bn	*Billion*	*GBP*	*British Pound*
BoE	*Bank of England*	*GOP*	Grand Old Party (US Republican Party)
BoJ	*Bank of Japan*	*IMF*	International Monetary Fund
bps	*Basis points*	*IPO*	Initial public offering
c	*Consensus*	*JPY*	Japanese yen
CB	*Central bank*	*k*	thousand
CBK	*Central Bank of Kuwait*	*m-o-m*	Month-on-month
CBR	*Central Bank of the Russian Federation*	*M5S*	Five Star Movement
CBT	*Central Bank of the Republic of Turkey*	*OECD*	The Organization for Economic Co-operation and Develop.
CPI	*Consumer Price Index*	*Opec*	Organization of Petroleum Exporting Countries
DFMGI	*Dubai Financial Market General Index*	*p*	Previous
DJIA	*Dow Jones Industrial Average Index*	*PM*	Prime minister
d-o-d	*Day-on-day*	*PMI*	Purchasing managers' index
DXY	*US Dollar Index*	*pps*	Percentage points
EC	*European Council*	*QE*	Quantitative easing
ECB	*European Central Bank*	*q-o-q*	Quarter on quarter
EM	*Emerging Markets*	*tn*	Trillion
EP	*European Parliament*	*TRY*	Turkish Lira
EUR	*Euro*	*UAE*	United Arab Emirates
EZ	*Eurozone*	*UK*	United Kingdom
Fed	*US Federal Reserve*	*US*	United States
FOMC	*US Federal Open Market Committee*	*USD*	United States Dollar
FRB	*US Federal Reserve Board*	*USD/bbl.*	USD per barrel
FX	*Foreign exchange*	*VAT*	Value added tax
GCC	*Gulf Cooperation Council*	*w-o-w*	Week-on-week
GBP	*British Pound*	*y-o-y*	Year-on-year
GDP	*Gross domestic product*	*y-t-d*	Year-to-date