

GLOBAL INFLATION WATCH

30th Aug. 2011



Global inflation set to fall

- The slowdown in global growth and recent falls in commodity prices will feed through to lower headline and core inflation in the coming months. Indeed, headline inflation is already at or near its peak in most major economies, while core inflation should also peak before year-end. With few signs of price pressures from labour markets or credit growth, inflation in advanced economies should drop back to very low levels by late 2012. (See pages 3-4.)
- This publication considers the outlook for inflation in the US, euro-zone, UK and Japan. It also briefly addresses prospects for China and other emerging markets.
- The slowdown in **global demand** since the beginning of the year looks set to persist during the rest of 2011 and 2012, as fiscal policy is tightened and the euro-zone crisis deepens. (See page 5.)
- Unemployment is stuck well above its pre-crisis level in the major economies and employment growth has slowed. As a result, real earnings are stagnant, suggesting the **labour market** will not provide any impetus to global inflation in the foreseeable future. (See page 6.)
- **Commodity prices**, which are already well below their peaks, are likely fall further as a result of faltering global demand and improved supply conditions for oil and agriculture. Even if they simply remain at current levels, energy and food prices will no longer push annual inflation higher in the remainder of this year, and they will have a significant downward impact in 2012. (See page 7.)
- Ultra-loose **monetary policy** has not generated a rise in private sector credit. Although there is little prospect of the Fed resorting to QE3 this year, it may do so in 2012. However, we doubt that further asset purchases would have much impact on credit, commodity prices or inflation. (See page 8.)
- Long term **inflation expectations** have been low and stable for several years. Moreover, household and bond market expectations of inflation in the short term, which spiked up earlier this year, have been scaled back during recent months. (See page 9.)
- Inflation is also at or near a peak in most **emerging economies**. The drop in commodity prices will have a bigger impact on headline inflation in these countries in 2012, although the strength of domestic demand will limit the degree to which inflation comes down in some cases. (See page 10.)

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Forecast Summary

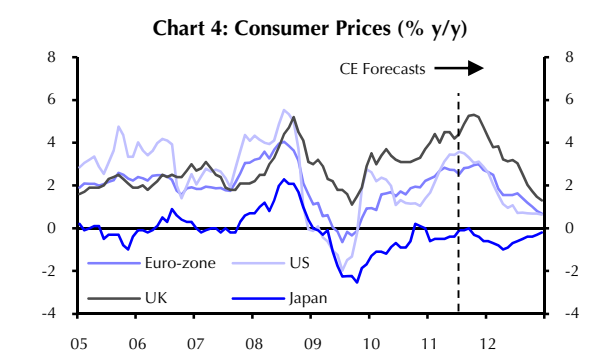
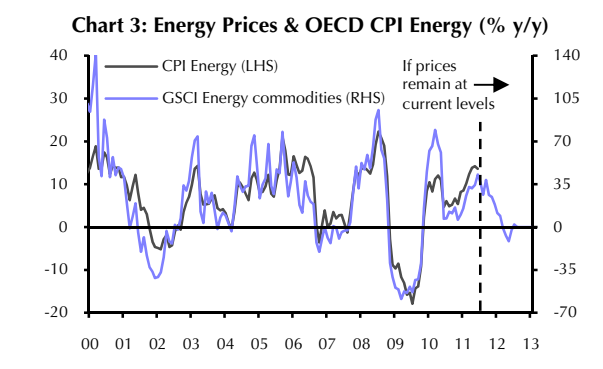
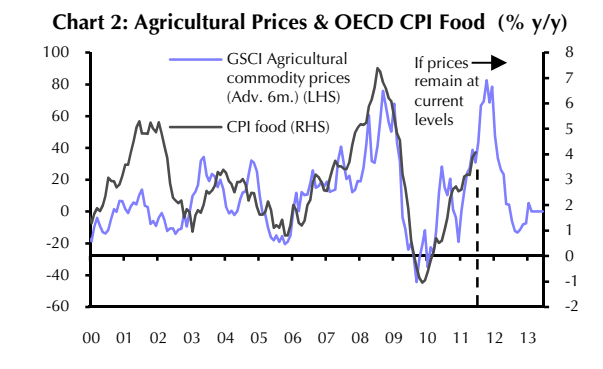
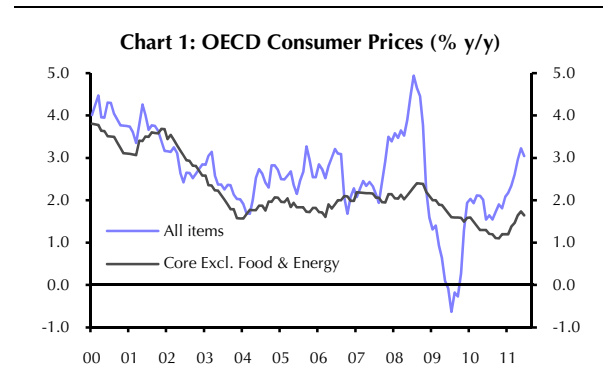
	Average					Forecasts		
	1990 - 2006	2007	2008	2009	2010	2011	2012	2013
CPI Inflation ⁽¹⁾								
World (PPP) ⁽²⁾	12.3	4.0	6.0	2.5	3.7	4.7	3.0	2.7
G7	2.4	2.2	3.2	-0.1	1.4	2.4	0.9	0.4
US	2.9	2.9	3.8	-0.3	1.6	2.9	1.2	1.0
Canada	2.3	2.1	2.4	0.3	1.8	3.1	2.3	2.0
Japan	0.6	0.0	1.0	1.4	-0.7	-0.4	-0.6	-0.5
Euro-zone	2.2	2.1	3.3	0.3	1.6	2.8	1.5	0.5
<i>of which</i>								
Germany	2.1	2.3	2.8	0.2	1.1	2.4	1.5	0.5
France	1.9	1.6	3.2	0.1	0.1	2.2	1.3	0.7
Italy	3.4	2.0	3.5	0.8	2.0	3.2	0.7	-0.2
UK	2.6	2.3	3.6	2.1	3.3	4.6	2.8	1.3
China	5.1	4.8	5.9	-0.7	3.3	5.5	3.0	3.5
Real GDP								
World (PPP) ⁽²⁾	3.3	5.3	2.9	-0.5	5.0	4.1	3.9	3.6
World (Market) ⁽³⁾	2.9	3.9	1.6	-2.1	3.9	2.7	2.5	2.2
G7	2.4	2.2	0.0	-3.7	2.8	1.6	1.7	1.5
US	3.0	1.9	0.0	-2.6	2.9	2.0	2.0	2.3
Canada	2.7	2.2	0.5	-2.5	3.2	2.7	1.5	1.0
Japan	1.5	2.4	-1.2	-6.3	4.0	-0.2	2.5	1.0
Euro-zone	1.9	2.7	0.5	-4.0	1.7	2.0	0.5	0.0
UK	2.4	2.7	-0.1	-4.9	1.4	1.0	1.5	2.0
China	10.0	14.2	9.6	9.1	10.3	9.3	9.0	7.5
Commodity Prices ⁽⁴⁾								
Oil (Brent \$ pb)	32	94	42	79	95	85	85	85
Gold (\$/oz)	456	834	880	1086	1375	2000	2000	2500
Exchange Rates ⁽⁴⁾								
US\$ / €	1.19	1.46	1.40	1.43	1.34	1.40	1.30	1.20
Yen / US\$	114	112	92	93	81	85	90	95
US\$ / £	1.66	1.99	1.46	1.62	1.56	1.60	1.55	1.50

(1) Year average (2) Weighted by PPP exchange rates (3) Weighted by market exchange rates (4) End-year including forecasts

Inflation Outlook

Inflation at a peak in advanced economies

- In advanced economies as a whole, both headline and core inflation continued to rise in the past few months. The latest data show average inflation in the OECD was just above 3% in June, still below its previous high in 2008. (See Chart 1.) However, headline inflation is probably now around its peak. Core inflation, which remains comfortably below 2%, is likely to peak a little later than headline measures, but before the end of the year.
- The lagged effect of rising commodity prices has been the main source of upward pressure on inflation since the 2008/09 crisis, but this upward pressure has now come to an end. Admittedly, higher global agricultural prices will exert upward pressure on food prices for some months yet, as they affect retail prices with a lag. (See Chart 2.) But this will be offset by the fall in global energy prices, which has a more immediate impact. (See Chart 3.) By early 2012 the combined impact of global commodity prices on inflation should be unequivocally negative, and will substantially reduce headline inflation.
- The pace and profile of disinflation will vary between countries. In the US, headline inflation probably peaked at 3.6% in July and is likely to fall to around 3% by December, as the reduction in energy prices will more than offset a further rise in food prices. By contrast, euro-zone inflation is unlikely to fall significantly until in 2012, and UK inflation may rise to around 5% later this year as energy companies are committed to raising prices. However, by early 2012 headline inflation will be on a firm downward trend in all the major western economies. (See Chart 4.) During 2012, markets could again be concerned about the risk of deflation.



Sources – Thomson Datastream, Capital Economics

Inflation Outlook (continued)

....sharp disinflation likely in 2012

- Although it is still rising, core inflation is likely to stay well below 3% in most western economies this year. In the US, core CPI inflation reached a nineteen-month high of 1.8% in July, largely due to the higher cost of rent and clothing. It may reach around 2.5% by December, before subsiding again in 2012. By contrast, euro-zone core inflation is likely to stay comfortably below 2% this year, and to fall further in 2012. Only UK core inflation has risen significantly. (See Chart 5.)
- Unlike the other advanced economies, Japan continues to struggle with falling prices. Indeed, recent revisions to its consumer price index reveal that Japan has experienced persistent deflation since the 2009. (See Chart 6.) Despite planned fiscal expansion, and a rapid bounce-back from the earthquake, overall demand conditions are sure to be very weak this year and next. The Bank of Japan may only be able to contain deflation by resorting to significant further QE.
- We also expect inflation to peak in the major emerging economies before the end of this year and to fall significantly in 2012. (See Chart 7.) Subsiding food price inflation will be the major source of disinflation in these economies. In addition, tighter monetary policy is helping to reduce inflationary pressure in many countries, though some are still at risk of over-heating.
- The recent rise in Chinese inflation is almost entirely due to higher food prices, and particularly a spike in the price of pork. (See Chart 8.) A recovery in the pig population will bring down headline inflation by year-end. But more importantly, there is little evidence of rising underlying inflationary pressure. Core inflation remains below 3%.

Chart 5: CPI Excl. Food & Energy (% y/y)

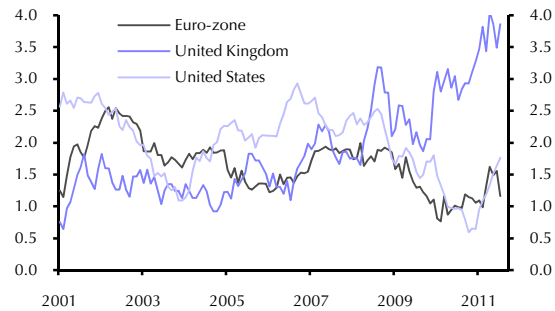


Chart 6: Japan CPI (% y/y)

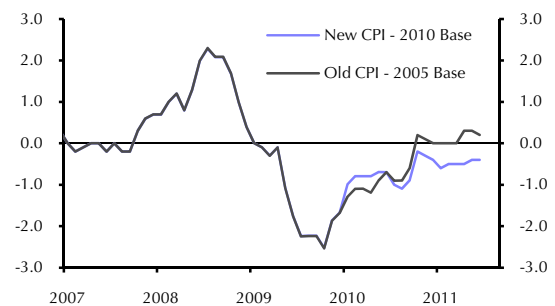


Chart 7: Emerging Market CPI (% y/y)

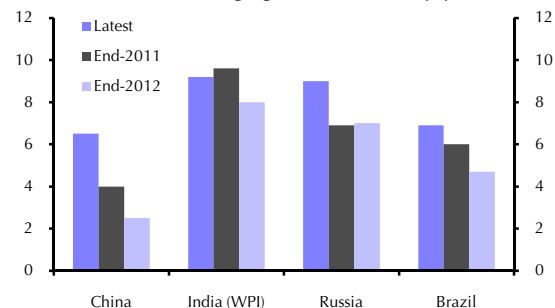
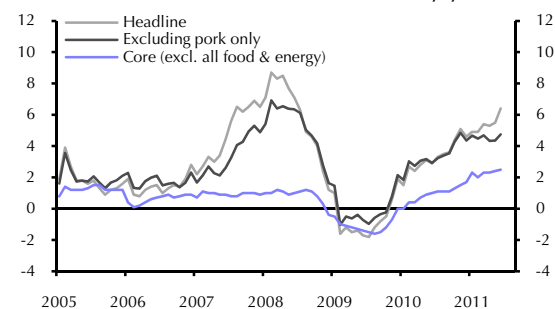


Chart 8: China Consumer Prices (% y/y)



Sources –Thomson Datastream, Capital Economics

Demand and Capacity

Shortage of global demand

- The global recovery has now stalled. We estimate that world GDP rose by 2½ percent during the second quarter of the year, only half the pace recorded twelve months ago. (See Chart 1.) Moreover, business surveys for July and August indicate that, rather than a bounce-back in the third quarter, growth is likely to remain sluggish. This is clearly not just a result of transitory factors, such as the Japanese earthquake, but a reflection of underlying fragility in the economy and in confidence.
- The downturn has affected all major economies in recent months, with the steepest decline being in the euro-zone. (See Chart 2.) Germany's export-led recovery appears to have fizzled out.
- Three factors will keep global growth very low in advanced economies next year. Fiscal policy will be restrictive in all major economies, including the US for the first time since the 2008/09 crisis. (See Chart 3.) The euro-zone crisis also looks certain to flare up again and probably intensify, as the second bail-out for Greece has failed to turn sentiment around. And finally, the prospect of more turmoil in equity markets will further dampen consumer and business confidence.
- The euro-zone may come perilously close to a renewed recession in 2012. However, we expect the US to avoid another recession, partly because lower energy costs should offset the negative effect of the recent sharp fall in equity prices.
- The outlook for emerging economies remains brighter. However, even in these countries growth is likely to weaken, partly because their exports to the rest of the world have stagnated as world trade has slowed. (See Chart 4.)

Chart 1: World GDP and Global Composite PMI

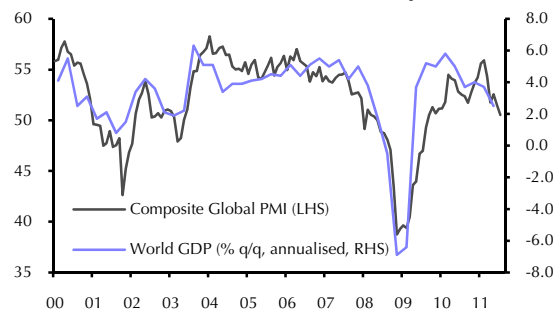


Chart 2: Composite PMIs

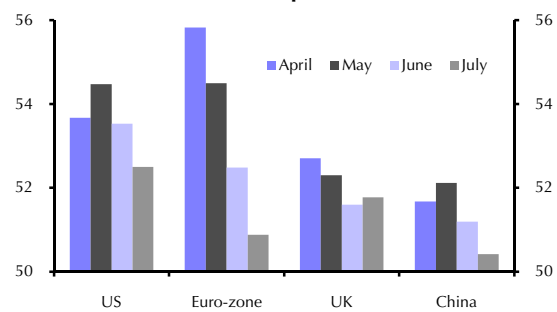


Chart 3: IMF Projections of Fiscal Stimulus (% GDP)

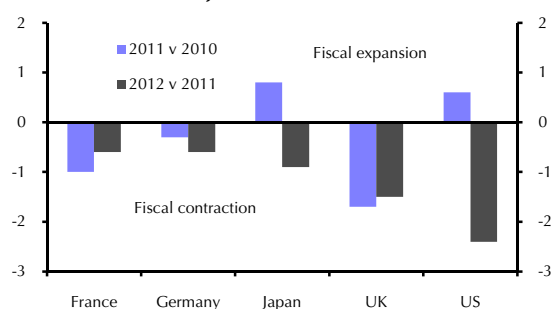
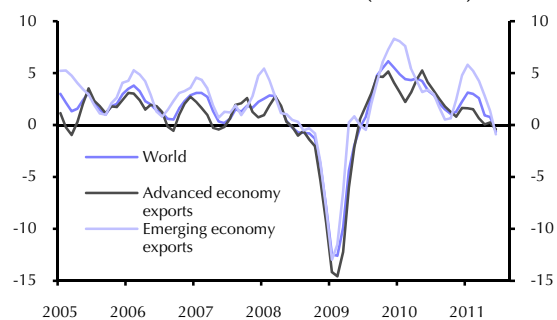


Chart 4: Global Trade Volume (3m/3m %)

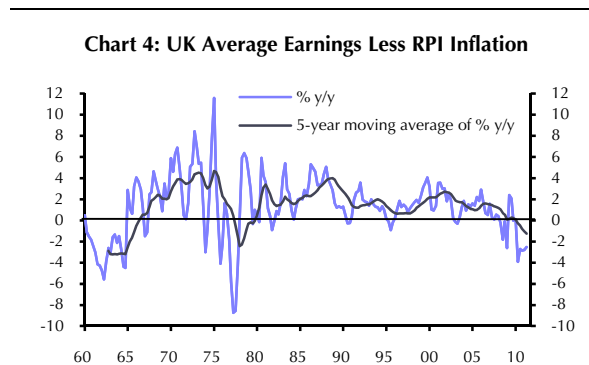
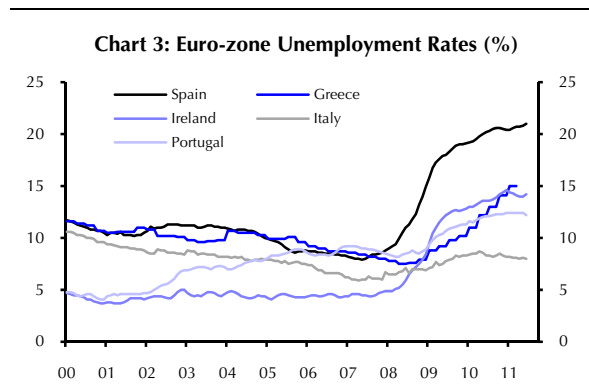
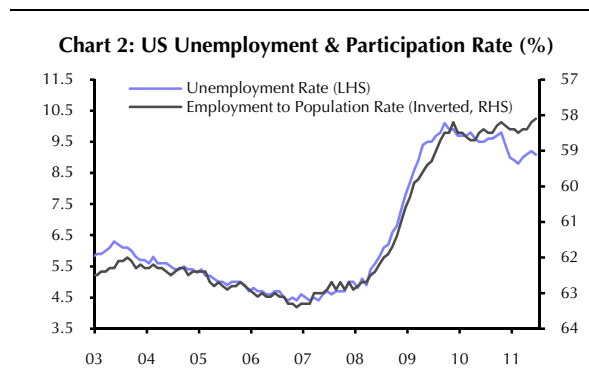
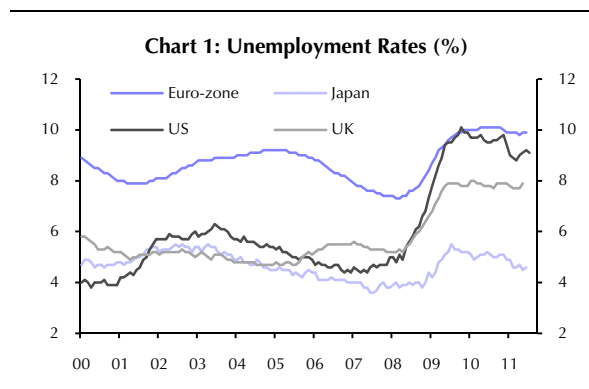


Sources – Thomson Datastream, Markit, IMF, Capital Economics

The Labour Market

No sign of improvement in labour market

- Unemployment, which rose steeply during the 2008/09 crisis, appears to be stuck at a high level in most advanced economies. (See Chart 1.) This is keeping real earnings growth low or negative, meaning the labour market will not be a source of inflationary pressure.
- Two years after the end of the recession, the US labour market has still not recovered. Unemployment has actually risen since April and the share of the population in work fell to a 28-year low in July. (See Chart 2.) Earnings are falling in real terms. The latest data show average all-employee hourly earnings increased 2.3% y/y in July, compared to CPI inflation of 3.6%. Admittedly, there has been a slight upturn in earnings growth in the last few months, but this is unlikely to be sustained in light of the latest employment data.
- Unemployment has stabilised just below 10% in the euro-zone in recent months. But the divergence between countries has increased, as unemployment has continued to rise in many peripheral countries. (See Chart 3.) Euro-zone labour costs rose in the second quarter, although this may have been a lagged response to earlier falls in unemployment. With employment growth stalling, earnings growth is likely to slow.
- In the UK, employment has continued to rise, though more slowly in 2011 than last year. But this has not yet fed through to a reduction in unemployment because the workforce has also been rising. In this situation, average earnings have continued to decline in real terms. There is consequently little or no threat to inflation from wage pressures. (See Chart 4.)
- Finally, in Japan unemployment has trended down since the 2008/09 crisis. However, it remains high by Japanese standards, at around 4.5%, and earnings growth is weak.



Sources – CEIC, NSB, Capital Economics

Commodity Prices

Energy and food prices set to fall further

- Commodity prices have been the main driver of global inflation in the past two years but they have now fallen by around 15% from their peak in April (according to the S&P GSCI index). The price of all major commodity groups has dropped, with the exception of precious metals. (See Chart 1.) Looking forward, we expect most commodity prices to fall further during the remainder of this year and 2012. This will be a major source of disinflation in both advanced and emerging economies.
- Benchmark oil prices are likely to drop further for two main reasons. First, global oil demand is set to remain weak, particularly in the US, which still consumes twice as much oil as China. Secondly, supply should not be as tight as the markets expect. In particular, Libyan production could pick up fairly rapidly once the dust settles in Tripoli, potentially taking a further \$10 off the price of Brent. (See Chart 2.)
- Agricultural commodity prices are also likely to fall further by year-end. They tend to move in tandem with oil prices, partly because energy is an important component in food production. (See Chart 3.) Also, the number of weather-related supply shocks has fallen for some key agricultural commodities, including wheat.
- Industrial metal prices, which are very dependent on manufacturing demand, are also likely to fall further, in line with the recent decline in global manufacturing PMIs. (See Chart 4.) With 40% of world copper and aluminium being bought by China, the recent softening of Chinese growth will also affect industrial metal prices.
- The only commodities likely to rise much further are gold and silver, due to safe haven demand. But this would reflect fresh financial shocks rather than fears of higher inflation.

Chart 1: Global Commodity Prices (S&P GSCI Indices)

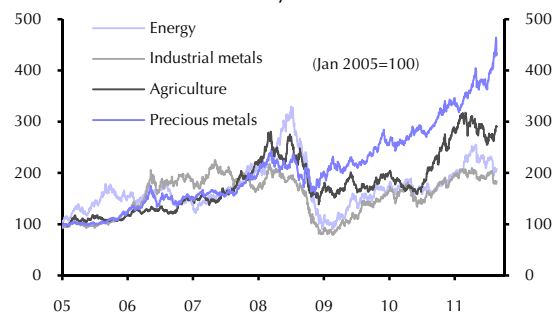


Chart 2: Crude Oil Prices (\$ per barrel)

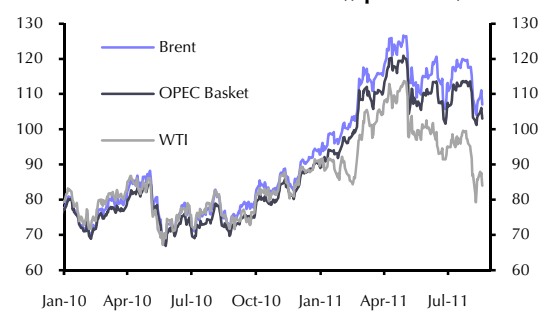


Chart 3: Oil and Agricultural Commodity Prices

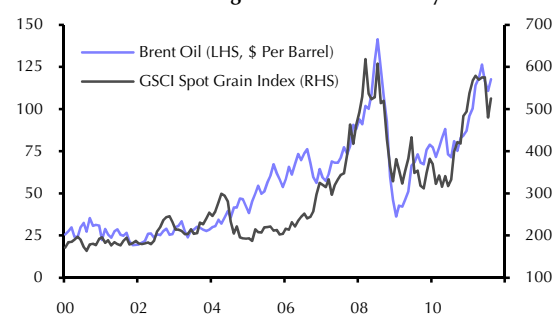
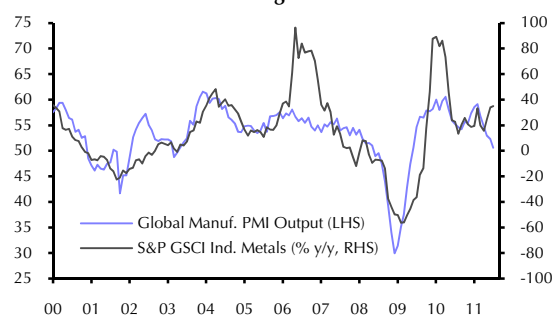


Chart 4: Global Manufacturing PMI & Industrial Metal Prices



Sources – Thomson Datastream, Capital Economics

Monetary Aggregates and Policy

Monetary policy looking increasingly impotent

- Despite the very loose monetary policy in advanced economies, broader measures of the money supply have continued to stagnate. (See Chart 1, in which we reproduce the US M3 series no longer published by the Fed.) Private sector households and companies are still reluctant to borrow even at very low interest rates, due to lack of confidence in the economy and their desire to reduce debt ratios. (See Chart 2.) This situation is likely to persist throughout 2012, as the global economy slows.
- There is now little central banks can do to boost credit growth. In the US, the Fed has now completed QE2 (see Chart 3) but with little impact on credit growth. Although unlikely to approve a further round of asset purchases this year, partly because core inflation is still rising, the Fed may do so in 2012. However, we doubt that a third round of QE would have much impact.
- In Europe, the monetary base has risen in recent months as ECB lending to the euro-zone has picked up. The central bank could well be forced to provide even more support to the banks next year. It is also possible that the ECB will reverse this year's rate hikes in 2012, though this would have little impact given the deepening sovereign debt crisis.
- Despite the rebound from the earthquake in the past few months, Japanese domestic credit is still shrinking. (See Chart 4.) Central bank intervention to limit appreciation of the yen has resulted in an expansion of the monetary base, and the Bank of Japan may ease further this year and in 2012. However, there is no prospect of a sustained upturn in credit growth. Even more than elsewhere, Japan's underlying problem is weak credit demand rather than tight monetary conditions.

Chart 1: Broad Monetary Aggregates (% y/y)

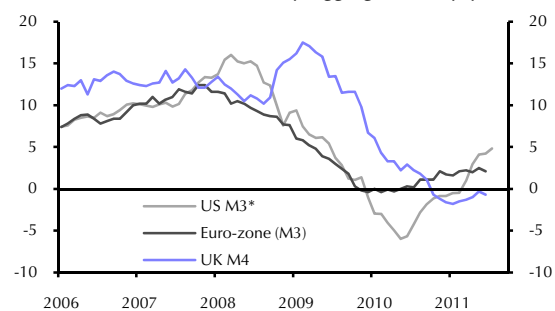


Chart 2: Credit to Private Sector (% y/y)

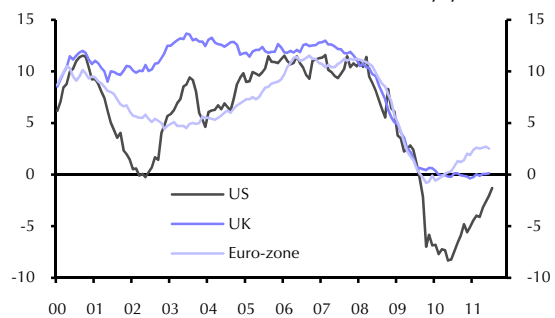


Chart 3: US Monetary Base (\$bn)

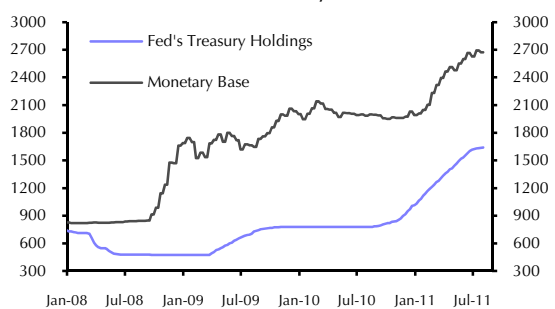
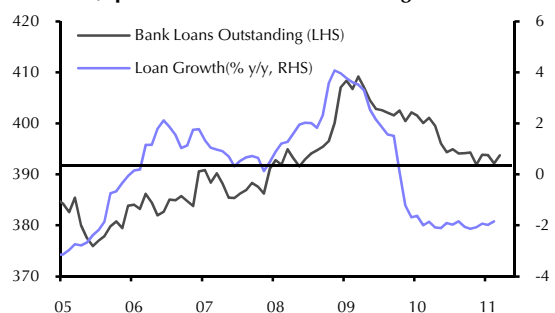


Chart 4: Japanese Bank Loans Outstanding (Yen Trillion)



Sources – Thomson Datastream, Capital Economics

Inflation Expectations

Inflation expectations dropping back

- There are no signs that inflation expectations are taking off. Long-term inflation expectations have been broadly stable in the US over the past decade, and recent survey data show a significant fall in expectations for inflation one year ahead, following a spike in the spring. (See Chart 1.) This fall reflects the recent drop in crude oil prices, which is already cutting the price of gasoline at the pump.
- Market measures of inflation expectations have also fallen in all major economies in the past few months. (See Chart 2.) Ten-year breakeven inflation rates in the US fell in August as a consequence of the deteriorating outlook for growth, and the drop in commodity prices. However, there are no fears yet of deflation comparable to those that emerged in 2008/09. (See Chart 2 again.) Indeed, the current economic slowdown is not likely to be as severe as that in the wake of the global financial crisis. Nonetheless, concerns about deflation may reappear next year.
- One factor which may have driven inflation expectations in the past two years is quantitative easing, as breakeven rates rose as both QE1 and QE2 got under way. (See Chart 3.) If the Federal Reserve ultimately embraces QE3 in 2012, this could raise inflation expectations, though probably less so the third time around.
- In Japan, household expectations of inflation jumped after the March earthquake, but have since levelled off at around 2%. (See Chart 4.) Given that these expectations tend to track actual inflation, albeit at a higher level, there is no reason to fear (or hope) that rising expectations will exert upward pressure on Japanese prices. On the contrary, deflation remains the major threat in Japan.

Chart 1: US University of Michigan Consumer Inflation Expectations (%)

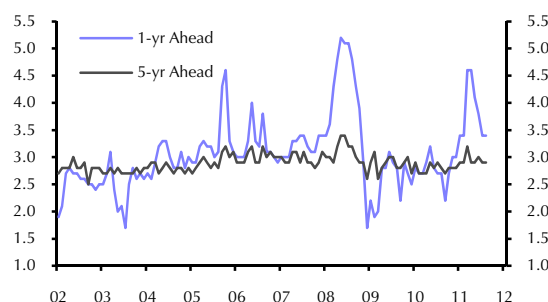


Chart 2: Ten-Year Breakeven Inflation Rates (%)

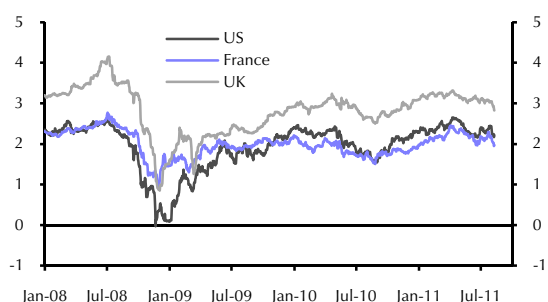


Chart 3: Ten-Year Breakeven Inflation (%)

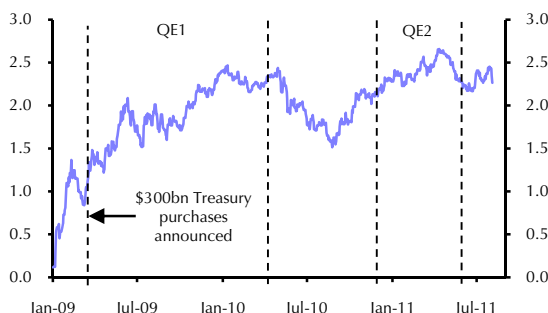
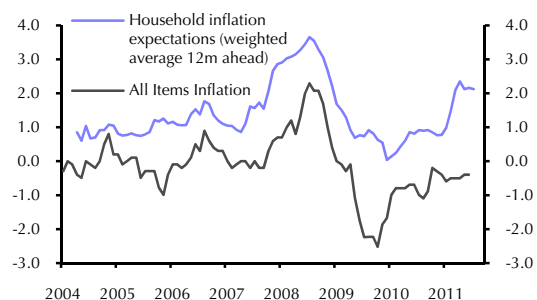


Chart 4: Japan Inflation & Inflation Expectations (%)



Sources – Thomson Datastream, Capital Economics

Emerging Markets

Falling commodity prices to have big impact on inflation

- Just as in advanced economies, inflation is at or approaching a peak in many emerging economies, and primed to fall during 2012. For example, it has probably already peaked in China, Russia and Brazil, and is very near doing so in India. (See Chart 1.)
- Falling commodity prices will pull down on headline inflation in emerging markets quite sharply during 2012, as the combined share of food and energy in consumer price indices is much higher in these economies. (See Chart 2.)
- However, in contrast to advanced economies, the strength of domestic demand in many emerging economies will limit the extent of disinflation. Indeed, in some cases there remains a risk of overheating, including Turkey and possibly Brazil. Also, it may be some months before inflation peaks in some countries as higher agricultural prices are still feeding through to the shops. (See Chart 3.)
- In contrast to advanced economies, central banks in emerging markets have been tightening policy, but they are mostly at or near the end of their tightening cycles. As headline inflation declines during 2012, they will gradually loosen monetary policy. However, in general, interest rates unlikely to be cut until the second half of the year, particularly in countries where core inflation is sticky or there are other signs of overheating.
- In China this year, there is little or no evidence that underlying inflationary pressure is rising, despite the unexpected strength of headline inflation. Core inflation is still around 3%. Even though domestic prices have risen, the price of Chinese exports has fallen in RMB terms, and risen only moderately in US dollar terms. (See Chart 4.) China is not therefore exporting inflation to the rest of the world.

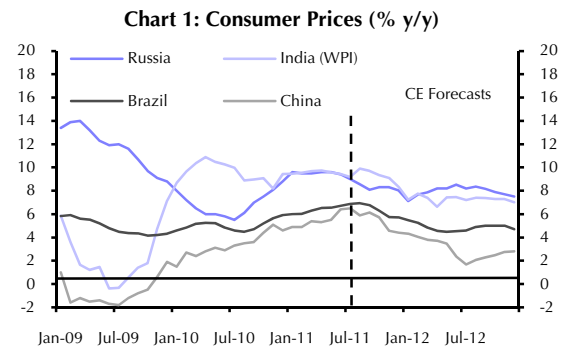


Chart 2: Weight of Food and Energy in CPI Basket (%)

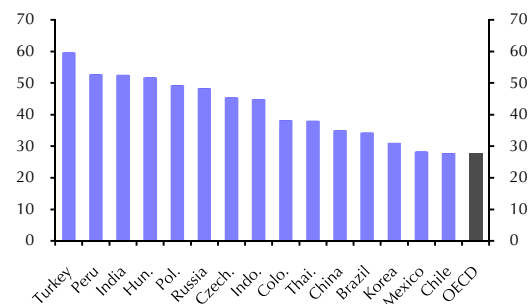


Chart 3: Latin America Food Inflation & GSCI Agri. Index

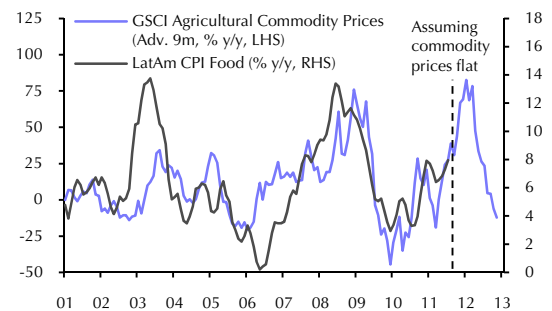
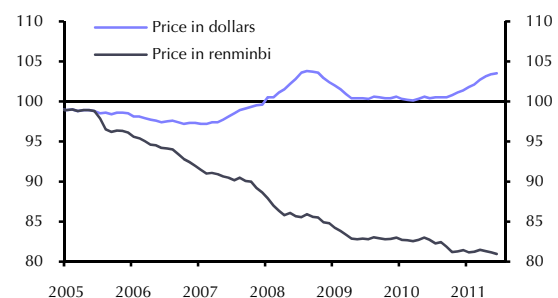


Chart 4: Price of US Imports from China (2003 = 100)



Sources – Thomson Datastream, Bloomberg, CEIC.