January 29, 2019

GLOBAL ECONOMIC HIGHLIGHTS

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **William Adams** Senior Economist | **Kurt Rankin** Economist | **Abbey Omodunbi** Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

CHINA EASES CREDIT POLICIES; ECB SEES DOWNSIDE RISK TO GROWTH; BANK OF JAPAN CUTS GROWTH OUTLOOK

CHINA: The People's Bank of China on January 24 announced a credit easing program that will use central bank funds to inject capital into commercial bank balance sheets, allowing banks to grow loan books and stimulate investment and other economic activity. The Central Bank is launching a swap facility that will exchange central bank bills for perpetual bonds issued by Chinese commercial banks and owned by participants in China's interbank money markets. The swaps will be conducted as fixed rate full allotment operations, meaning participants can swap out as much as their entire holdings of commercial bank perpetual bonds with the central bank at face value. The swap participants will continue to receive interest payments on the perpetual bonds, and must pay the central bank the 4.5 percent coupon of the central bank bills, which are three-year risk-free bonds. Financial institutions that participate in the swaps can then use the central bank bills as collateral to borrow from the central bank's other liquidity facilities. This means that the swap program creates a channel for Chinese financial institutions to buy perpetual bonds issued by commercial banks, using the central bank's money. Since Chinese bank regulation considers perpetual bonds to be part of commercial banks' capital base, the swaps indirectly increase commercial banks' ability to recognize and write down nonperforming loans, make new loans, or buy corporate bonds. In essence, the swaps are a form of fiscal policy support to the banking sector, but one conducted by the central bank instead of the Ministry of Finance. In that respect, they are similar to commercial bank recapitalizations in the first decade of the 21st century in which China's sovereign wealth fund injected capital into banks' balance sheets before their IPOs. Broadly speaking, the policy is another tool Chinese policymakers are using to avoid an excessively sharp slowdown in 2019.

EUROZONE: The European Central Bank sees growth risks tilted to the downside, but a rate hike is still on the table in the fall of 2019 if headwinds abate. As virtually assured, the ECB's Governing Council held the monetary policy stance unchanged at their January 24 decision. The benchmark negative deposit rate is -0.4 percent, and the Governing Council holds unchanged their forward guidance on interest rates. The conditions for a rate hike are both time and state contingent: On timing, they will not consider raising interest rates until at least the summer of 2019. On the state of the economy, they pledge to hold interest rates unchanged as long as necessary to ensure inflation rises to their target of below but near 2 percent over the "medium term," meaning 1.5 to 2.5 years in the future. Also as virtually assured and following the end of their QE program in December, they are maintaining unchanged the size of the ECB balance sheet by reinvesting all maturing securities. The Governing Council commits to three conditions that must be met before they would consider reducing the balance sheet. They will wait until (1) after they begin raising interest rates, AND for as long as necessary to maintain (2) favorable liquidity conditions and (3) ample monetary accommodation. The Governing Council is divided as to whether they expect the Eurozone's economy to improve enough to justify a rate hike in 2019. According to President Draghi's description of the Governing Council's debate, its members unanimously agree that the Eurozone economy's slowdown in 2018 and into early 2019 was due to uncertainty about trade protectionism, threats to the world's multilateral political institutions, Brexit, political turbulence in some Eurozone countries (unspoken, Italy and France), China's slowdown, the US' fading fiscal stimulus, and German auto industry disruptions. They unanimously see risks to growth as tilted to the downside, and also unanimously see the risk of a Eurozone recession in 2019 as low. But Governing Council members disagree about whether growth headwinds will persist. If growth stays weak, as some pessimistic members expect, President Draghi thinks financial markets are justified in expecting an initial interest rate hike to be delayed until 2020. On the other hand, if headwinds abate or are offset by fiscal stimulus announced for France, Italy, the UK, and potentially Germany, as expected by the Governing Council's optimists, a rate hike in the fall of 2019 is still possible. PNC forecasts for the expectations of less pessimistic Governing Council members to be realized. If the US and China reach a trade détente, Brexit is reversed or fudged, and fiscal stimulus comes through in Europe, Eurozone growth should pick up by mid-2019 and justify a 0.1 percentage point ECB deposit rate hike to -0.3 percent in September. PNC forecasts a substantial recovery of the euro vis-à-vis the dollar in 2019, from $1.14 per euro in January to $1.18 by end-June and $1.23 by year-end, as financial markets pull forward expectations for ECB rate hikes (perhaps aided by the announcement of a less dovish successor to Draghi, whose term ends in October), and as slowing US growth, large US fiscal and trade deficits, and the end of the Fed's rate hike cycle take the luster off the dollar's 2018 shine. President Draghi mentioned that "several" Governing Council members raised the possibility of another round of fixed-rate four-year loans by the ECB to Eurozone commercial banks, issued at the ECB's deposit rate – a.k.a. Targeted Longer Term Refinancing Operations or TLTROs. The ECB issued TLTRO loans in 2016 and 2017, and so another round in 2019 or 2020 would more or less amount to allowing banks to roll loans over. The impact of another round of TLTROs on the Eurozone economy and exchange rate would likely be limited. More broadly, discussion of TLTROs emphasizes that the ECB will move very gradually to drain liquidity from the Eurozone's financial system.

JAPAN: As all but assured, the Bank of Japan held its monetary stance unchanged at its January 23 Policy Board decision: The short term policy rate stays at -0.1 percent, the 10-year government bond yield target is unchanged at "around zero percent" (in practice, a range of -0.2 to 0.2 percent), and QE purchases of government bonds, exchange traded funds, and real estate investment trusts continue at unchanged paces. The BoJ downgraded its forecast for real GDP growth in the 2018 fiscal year, running April 2018 to March 2019, to 0.9 percent from their prior forecast of 1.4 percent, and kept forecasts for the 2019 and 2020 fiscal years mostly unchanged. The BoJ downwardly revised its forecast for CPI inflation in fiscal 2019, reflecting the drop in oil prices between their prior round of forecasts in October 2018 and January 2019. PNC forecasts for the BoJ to maintain its monetary stance unchanged throughout 2019 and likely 2020 as well.

UNITED STATES: The five-week government shutdown that ended January 25 slowed economic growth. The Congressional Budget Office predicts that the shutdown will subtract 0.4 percent from annualized real GDP growth in the first quarter of 2019, but add 1.0 percentage points to growth in the second quarter as the government catches up on expenditures delayed by the shutdown. PNC forecasts for the advance estimate of GDP for the fourth quarter of 2018 to be 2.9 percent, down from 3.4 percent in the third estimate; this report scheduled for Wednesday January 30 could be delayed by the government shutdown. PNC also forecasts for the employment cost index to rise 0.8 percent in the fourth quarter from the third and 3.1 percent from a year earlier, up from 2.8 percent in the third quarter to the highest since the first quarter of 2008. The February 1 release of the January employment situation summary will likely show a 160,000 gain in nonfarm payrolls from December with the unemployment rate edging lower to 3.8 percent from 3.9 percent, but the shutdown means the report should be taken with a big grain of salt. Labor market data in hand are still solid: Initial claims for unemployment insurance fell to a 49-year low of 199,000 during the week of January 19, and the four-week moving average fell to 215,000. But The Conference Board's Consumer Confidence Index® fell in January for a third consecutive month, to its lowest since July 2017.

UNITED KINGDOM: Prime Minister Theresa May and her Tory Party spent the week of January 22 floating improbable alternatives to the Withdrawal Agreement, mostly a sign that they are preparing to argue that they left no stones unturned and that the Withdrawal Agreement is, as argued by the government and the European Union, the only potential Brexit deal that would comply with the UK and EU's red lines.

MEXICO: Monthly GDP rose 0.4 percent in November from October but just 1.8 percent from a year earlier, and would have been even weaker without a surge in primary sector activity. Secondary or industrial activity fell 0.6 percent on the month and 0.8 percent on the year, while services activity rose 0.4 percent on the month and 2.9 percent on the year.