NORMAL SERVICE WILL BE RESUMED AS SOON AS POSSIBLE...

William De Vijlder considers the likelihood of an imminent return to the days of predictable inflation, wage rises and interest rate hikes

Following the agreement with its creditors, Greece is now in the headlines a little less. This is a relief. It raises the hope that the fallout from weeks of intense uncertainty about its position in the eurozone and, more generally, about how the eurozone deals with these situations will be limited – outside Greece, that is.

Looking at the recent dataflow, there has been some impact on the rest of Europe, with a softer reading of the purchasing manager indices for July, though the German IFO index has surprised on the upside. In Greece, however, the impact has already made itself strongly felt, with detrimental consequences in terms of debt/GDP dynamics. This serves as a reminder that Greece will move higher up the agenda in the autumn and that the negotiations about a debt reduction, which the IMF is insisting on and which European Central Bank President Mario Draghi has described as “uncontroversial”, will be tense.

In the meantime, attention is shifting towards the Federal Reserve. “To hike or not to hike?” is not the question. The economy has been growing since the summer of 2009, the unemployment rate is getting closer and closer to a level which should see an acceleration of inflation but… the official interest rate is still virtually zero after all these years. So, the need to hike is clear. It is not even a question of timing. We think it will be December 2015, although about half the respondents in a recent Bloomberg survey expected a move in September. September or December won’t make much of a difference for markets but for the Fed it does, because it’s a matter of how confident it is about the impact of its actions. The Fed is truly between a rock and a hard place.

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Waiting could push up asset prices (equities and bonds), thereby increasing their sensitivity to the shock if it turns out that it has waited too long; act too quickly and there is the risk of a negative confidence shock in the economy.

Faced with this dilemma, the US central bank is confronted with an asymmetric payoff: stepping up the pace of rate hikes when it turns out that inflation and wages are picking up too strongly is easier than trying to boost an economy which didn’t digest a tightening that ended up being premature. In the latter case, with rates still close to zero, the Fed would be forced to embark on a quantitative easing programme... again. In view of this asymmetry, we think it will err on the side of caution and wait until December.

This same dilemma will influence the pace of tightening. This is the question. It’s not so much about what happens in 2015, but what Janet Yellen and her colleagues at the Fed will do in 2016. They have made countless efforts to convey their thinking to households, corporates and the market. Publishing the projections of the Fed funds rate provided by board members and regional Fed presidents has been a key communication tool, but the audience doesn’t believe the message: the market-implied path of interest rates remains well below the one put forward by the central bank. If the former converged to the latter, meaning faster rate increases, it could be destabilising.

A potential external influence is China. Given its weight in the world economy, directly and indirectly via its impact on developing economies and commodity exporters, a turn for the worse could push the Fed to adopt a wait-and-see attitude and delay tightening. Following the big drop in the Chinese stock market, which came on the back of the build-up of a bubble, visibility has declined greatly: what is the extent of speculative leverage? What will be the consequences for the real economy? Will there be more intervention to stabilise the market and will it be more effective this time around? The recent surprise devaluation of the yuan makes it even more difficult to answer these questions. Reduced visibility means increased uncertainty means greater caution. This may also impact the eurozone. In 2014 close to seven per cent of its exports went to China, so an unexpected slowdown there would hit the growth outlook in Europe. However, the list of factors underpinning the growth outlook in the eurozone remains long: low oil prices, the delayed effects of the weakening of the euro, a neutral stance on fiscal policy, low rates, improved bank lending conditions, a pick-up in loan demand, an improving labour market, and the prospect of an increase in capital expenditures.

**William De Vijlder**

is Group Chief Economist of BNP Paribas. Before this he was Vice-Chairman of BNP Paribas Investment Partners. He has a PhD in Economics from Ghent University, Belgium, where he has been teaching since 1991.