景順 Invesco

Economic Insights
Annual Economic Outlook for 2015

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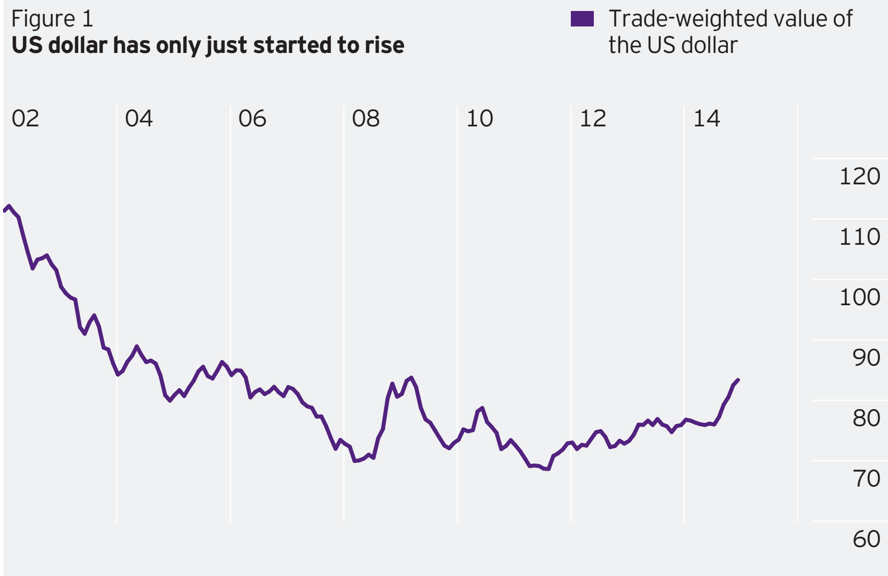
Introduction

Balance sheet repair and growth
US GDP growth is returning to past norms of 3.0-3.5% thanks to the near-completion of balance sheet repair by the household and financial sectors. The UK is following the US, but with much less balance sheet repair accomplished, especially in the financial sector. Growth is not yet self-sustaining as in the US and remains vulnerable to the continuing problems of the Eurozone. The Eurozone has only seen balance sheet repair in the periphery (notably Spain and Ireland) but these improvements are outweighed by the lack of deleveraging in France and Italy. Growth will continue to "bump along the bottom"; there are no indicators – monetary, fiscal or structural – that point to the start of a genuine business cycle upturn. In Japan the combination of "Abenomics" and "QQE" (quantitative and qualitative easing) from the Bank of Japan (BoJ) has failed to generate balance sheet expansion for the commercial banks, while on the fiscal side the consumption tax increase in April has once again seriously damaged personal consumption expenditure as it did in 1997. Consequently, Japan's real GDP growth in 2015 will reach only 1.3%, according to consensus estimates. Growth in China will continue to slow in 2015 as the economy gradually shifts away from investment- and export-led growth.

Currencies
I expect the US dollar to continue to strengthen in 2015, partly on expectations that the US Federal Reserve (Fed) will raise short-term interest rates ahead of other central banks in the second half of 2015, and partly based on the relative strength of the US current account (see Figure 1). This is the first recovery in more than two decades when the current account has not deteriorated as a percentage of GDP and in which industrial production growth has kept pace with GDP, suggesting that US manufacturing is maintaining its competitiveness. I expect the euro and Japanese yen to weaken further, while the British pound is likely to weaken against the US dollar but strengthen modestly against the euro.

Monetary policy
A striking feature of the next year or two will be the marked divergence in the monetary stance of central banks in the US and the UK on the one hand and Japan and the Eurozone on the other. Whereas the Fed and the Bank of England (BoE) are both likely to be raising interest rates from the second half of 2015, the European Central Bank (ECB) and the BoJ are expected to continue with asset purchases and zero interest rates. However, we should be careful to distinguish between rising rates because economies are returning to normal and tighter monetary policy. If commercial banks expand bank credit more rapidly, then rising rates may not mean tight money.

Figure 1
US dollar has only just started to rise



Source: Thomson Reuters Datastream, as at 15 December 2014.

Inflation
Most analysts expect inflation to pick up as growth returns to normal. This is based on the output gap theory of inflation, i.e. as GDP returns towards trend and the output gap closes, inflationary pressures will resume. However, this view is almost certainly mistaken. The normal historical experience is for inflation to fall in the first two years of a recovery as rising output absorbs any excess purchasing power. If we add the observation that monetary and credit growth remain abnormally low, it is inconceivable that core measures of inflation could rise, other than temporarily, in most developed economies in 2015. Even where there is abrupt currency devaluation, inflation is unlikely to be sustained if money and credit growth rates remain very low. In the Eurozone it is highly likely that 2015 will witness the emergence of some months of deflation as money and credit growth remain too low for long-term price stability, while Japan will only just avoid the re-emergence of deflation.

Emerging economies
Private estimates of China's growth have continued to fall as exports have disappointed and fixed capital investments have slowed. At the same time the authorities had been reluctant to ease monetary policy until mid-September when the People's Bank (China's central bank) injected 500 billion yuan (about US$85 billion) and then cut interest rates marginally in November. Elsewhere in the emerging markets (EM) arena, growth has remained weak, most notably in the larger economies of Brazil, India and Russia, which have all witnessed a slowdown in growth, especially of exports. Most EM economies are waiting for recoveries in the US and the Euro-area to revive their export-led growth, but they are likely to be disappointed.

Inflation and growth forecasts

Consensus Economics	2014 estimate Real GDP (%)	2014 estimate CPI inflation (%)	2015 Consensus forecast (Invesco forecast) Real GDP (%)		2015 Consensus forecast (Invesco forecast) CPI inflation (%)	
US	2.2	1.7	3.0	(3.1)	1.6	(1.5)
EU-18	0.8	0.5	1.1	(0.6)	0.9	(0.3)
UK	3.0	1.6	2.6	(2.8)	1.6	(1.8)
Japan	1.0	2.8	1.3	(0.8)	1.9	(1.6)
Australia	3.1	2.6	2.9	(3.2)	2.4	(2.5)
Canada	2.3	1.9	2.5	(2.3)	1.7	(1.7)
China	7.4	2.1	7.1	(6.5)	2.4	(2.0)
India	5.6	7.3	6.3	(6.0)	6.5	(6.8)

Source: Consensus Economics, Survey date: 10 November 2014. Eurozone became 18 members on 1 January 2014.

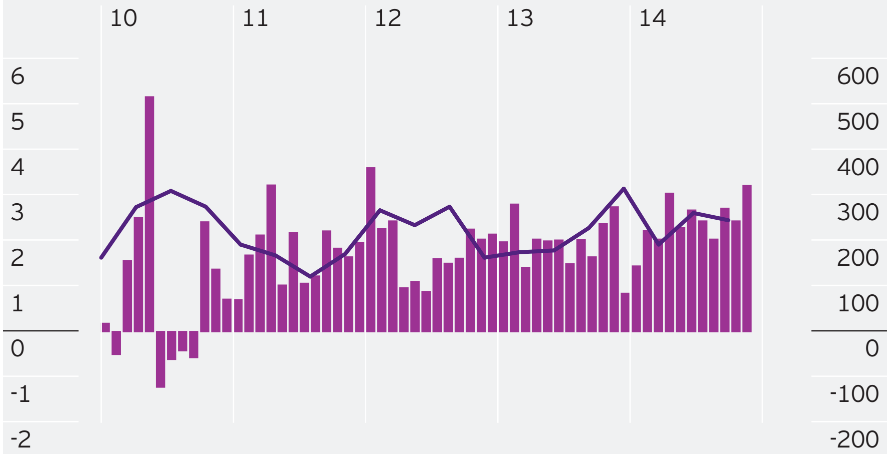
Commodities
My long-standing forecasts of sub-par economic growth and lower-than-expected inflation (especially in the developed world) remain intact, although gradual balance sheet repair in the US is expected to create a meaningful upswing of exports for those economies which export substantial amounts to the US. Even so, expectations for weakness in Europe and a slowdown in China have been reflected in weak basic industrial commodity prices, especially for iron ore, coking coal and oil, and sharply weaker prices for grain, corn and soya beans. In addition, record US harvests and the shale gas revolution have increased supplies of critical commodities. I do not expect any strong recovery of commodities in 2015.

World trade
One symptom of the sub-par performance of the global economy, both developed and emerging, is the stagnation of world trade over the past three years. This has primarily reflected weak domestic demand in the US and Europe but it has also had serious consequences for the export-led economies of the emerging world, particularly China. With low nominal GDP growth persisting across most major economies, I expect only a slow improvement in 2015.

United States
With the gradual healing of private sector balance sheets, US growth is at last returning to normality after several years of balance sheet-constrained weakness. The weather-induced downturn of -2.1% in Q1 2014 was followed by a bounce-back of 4.6% in Q2, and vigorous growth in Q3 of 3.9%. Although for the year as a whole the end-result is likely to be only just over 2%, due to the difficulty of making up the ground lost in Q1, the underlying growth rate appears to have resumed its more normal 3%.

The recovery in the US economy has been hugely assisted by the Fed's prolonged supportive monetary policy over the past five years. While the third phase of quantitative easing (QE) ended in October 2014, commercial banks appear willing and capable of continuing to expand credit now without the Fed's assistance. As at 4th December, total bank credit, which includes all commercial bank loans and bank holdings of securities, grew by 7.3% year-on-year. This could be enough, if sustained, to support nominal GDP growth of a similar magnitude. In addition, recent labour market data have continued to be buoyant with non-farm payrolls increasing by 321,000 in November, unemployment holding steady at 5.8% and average weekly hours worked rising to 34.6, the highest since May 2008. Furthermore, average hourly earnings of private employees increased by 9 cents or 0.4% in November, the highest since June 2013, although this was up only 2.1% over the previous year. Moreover, the labour force participation ratio increased only marginally from 62.7% in September (a 36-year low) to 62.8% in November (see Figure 2).

Figure 2
US: Solid employment growth positive for GDP outlook



Source: Thomson Reuters Datastream, as at 15 December 2014.

Output and investment data have also shown gathering strength. Industrial production increased by 4.0% year-on-year in October, slightly ahead of real GDP, suggesting that in contrast to the two previous cycles, the US is maintaining its competitiveness in manufacturing without the need to outsource. Similarly, durable goods orders rose by 5.4% year-on-year in October, while non-residential investment maintained a healthy average growth of 8.4% (quarter-on-quarter annualised) in Q2 and Q3. In summary, this adds up to a recovery that is now self-sustaining even without Fed asset purchases, although it is unlikely to become exuberant any time soon.

One area where investment has not been so active is the housing market where new single family home sales have averaged 455,000 per month between August and October, far below the pre-crisis levels of over one million per month. Existing (or pre-owned) home sales are also running well below past peaks, while house prices and condo-prices have slowed from double-digit growth rates in 2013 to just 4%-5% year-on-year in recent months. Mortgage rates have fallen but mortgage applications for home purchase have not increased since 2010 due to the cautiousness of the banks. All these data suggest an economy that is gradually returning to normal. For 2015 I expect 3.1% real GDP growth.

On the inflation front the official figures have continued to surprise most forecasters on the downside. This is partly because most forecasters pay excessive attention to economic models that feature the output gap. This means that they rely on a theory that predicts rising inflation as soon as the gap between actual output and potential output is closed. In the view of conventional Wall Street economists, the return to near 3% growth and the steady falls in the unemployment rate imply an economy with only modest headroom for expansion. In their view, the output gap is near to closure. Similarly they presume that when unemployment hits some level, such as 5.3%, wage inflation will begin to rise steeply.

My own view has been very different. First, it is a well-established fact that inflation tends to fall in the first two years of a recovery. In one sense the economy has of course been recovering for longer than two years but in another sense the recovery is only just beginning. Most of the fuel for recovery so far has been provided by the Fed, not by the commercial banks, so the standard linkages have not been operating. Second, even when the commercial banks do start expanding at a more normal pace, it will take two years before faster money and credit growth feed through to inflation. Against a background of abnormally low growth of money and credit, I have long been forecasting lower than consensus rates of inflation. For 2015 as a whole I expect 1.5% consumer price inflation in the US.

In response to the improved economic backdrop, members of the Fed's policy-making committee (FOMC) have moved to a less dovish stance. Although the Fed statement in October continued to claim that it "would be appropriate to maintain the 0 to 0.25 percent target range for the federal funds rate for a considerable time following the end of its asset purchase program", FOMC and market estimates of the date when the fed funds rate would be raised have been brought forward to July or September 2015.

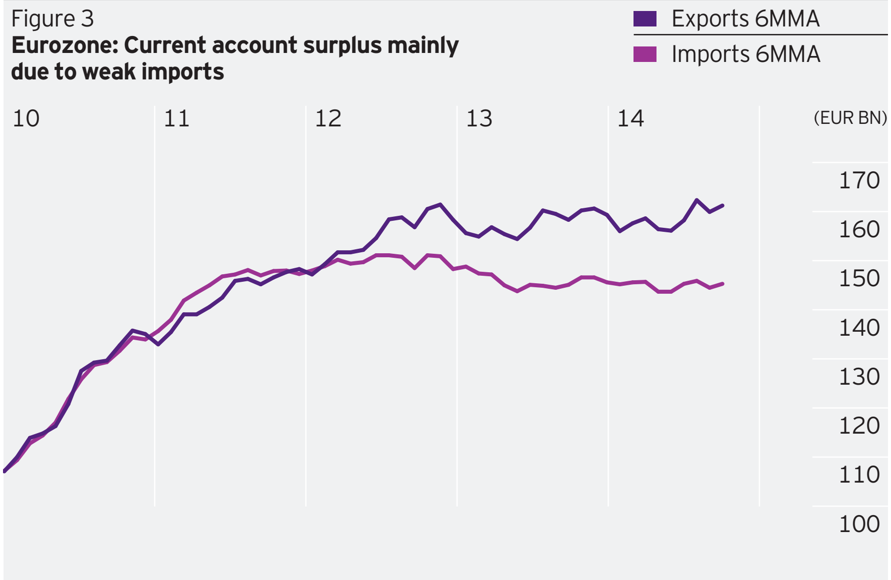
It will be important to remember that even though the Fed may be hiking rates in the second half of 2015, this does not itself signify a tightening of monetary policy. After all, the main problem in recent years has been the lack of money and credit growth. If, over the next two years, money and credit growth accelerate, it is likely that the economy will adjust to rate normalisation smoothly. Even so, it is unavoidable that market expectations of impending rate hikes are likely to intensify whenever strong economic data points are reported, potentially leading to more volatile financial market conditions in the months ahead. Nevertheless, with the economy now on a stable trajectory of steady-paced recovery, it seems unlikely that the Fed or other policymakers will need to act precipitately.

The Eurozone

Eurozone growth has remained weak and deflation risks have continued to intensify. Real GDP again grew by a slow 0.2% quarter-on-quarter in Q3 2014, following the upwardly revised 0.1% growth in Q2. On 4th December the ECB released its latest forecasts for 2015 and 2016, which were again reduced in line with earlier downgraded forecasts by the European Commission. Compared with an expected growth rate of 0.8% in 2014, the ECB expects a small pick-up to 1.0% in 2015 with a further upturn to 1.5% in 2016. However, these modest upturns assume no renewed crisis in the financial system and broadly ignore the risk of vulnerability to real shocks, such as a shut-off of energy from Russia.

From its high of 54.1 in April, Markit's composite Purchasing Managers' Index (PMI) for the Eurozone slowed further to 51.1 in November, the lowest level in 2014, with France declining to 47.9. Both Italy (51.2) and Germany (51.7) avoided contractions but the overall level of activity in the Eurozone remains disappointing. The German Ifo index of business conditions has fallen from 111.2 in February to 104.7 in November, declining for six consecutive months from May to October. In contrast to the US or UK, Eurozone unemployment has failed to decline and remained at 11.5% in October.

Figure 3
Eurozone: Current account surplus mainly due to weak imports



Source: Thomson Reuters Datastream, as at 15 September 2014.

The gradual weakening of the euro from a peak of US$1.39 in March to US$1.23 has not yet contributed to any significant strengthening of export activity from the Euro-area (see Figure 3). The main explanation is that without volume growth abroad, price changes alone will do little to boost demand in Europe. Consequently, Eurozone exports, in line with the sluggish performance of global trade in recent years, have been essentially static since 2012. Meantime the current account has shifted to a surplus of 2.4% of GDP, mainly due to weak imports and rising financial receipts. Adjusted to a "full employment equilibrium" balance, the current account surplus would be substantially lower, or possibly even in deficit.

In addition to these cyclical problems, the Eurozone is failing to reduce its indebtedness, either on an absolute basis or relative to GDP. While Germany did not engage in the leveraging up seen in many bubble economies during the early 2000s and therefore has not needed to de-leverage, the same cannot be said for other Eurozone economies. The large economies of France and Italy, in particular, have failed to show any de-leveraging in either the private or public sector. The result is that the relatively modest balance sheet repairs achieved by periphery countries like Spain and Ireland have been swamped by the high levels of debt that remain outstanding in the core.

To assist with balance sheet repair one of the best contributions policymakers could offer would be to expand domestic demand, i.e. spending on consumption, investment and inventories. However, the ECB did not make any change in policy in either its November or December meetings, instead relying on the measures announced in June and September. These were targeted longer-term refinancing operations (TLTROs) and purchases of asset-backed securities (ABS) and covered bonds. Given the disappointing initial take-up of TLTROs, ECB President Mario Draghi has been gradually preparing the ground for the Governing Council to adopt more effective measures such as purchases of sovereign bonds, but there remains some opposition to these proposals. It seems likely, therefore, that the Governing Council will only be persuaded to act after the Eurozone as a whole has fallen into deflation, an event I expect in early 2015.

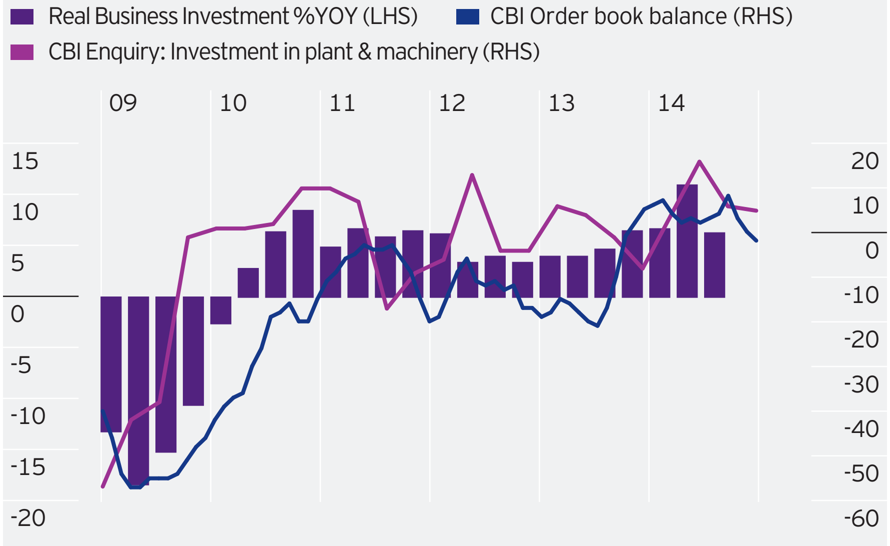
One key problem for the ECB to overcome is the failure of its new measures to reach the household and non-financial corporate sectors. The reason is that in conducting its operations the ECB focuses almost entirely on the banks as counterparties. This is in clear contrast to the asset purchases conducted by either the Fed or the BoE where securities were purchased from non-bank entities. The effect was to place new deposits in the hands of the non-bank public, enhancing the liquidity of their balance sheets, adding to the money supply and effectively compelling these private sector players to buy other riskier, longer term assets. In the case of the ECB's transactions, LTROs provided Euro-area banks with cheaper funds, enabling them to reduce their borrowing from other sources but there was no assurance that they would either add to their loan or securities portfolios. The new TLTROs are designed to impose additional lending obligations on the banks but the purchases of ABS or covered bonds will again be largely from the banks, limiting the transmission effects on non-banks.

If the ECB's new measures are not successful the risk of deflation in the Eurozone remains acute. To avoid deflation the ECB must encourage much more currency depreciation, and/or ensure much faster growth of money and credit. I forecast the inflation rate of the Eurozone as a whole will move into negative territory on a year-on-year basis during 2015, unless there is a very sharp depreciation of the euro in the meantime.

United Kingdom

The recovery of the UK economy continued in 2014 but slowed modestly from the strong pace seen earlier in the year. On a quarter-on-quarter basis, growth accelerated to 0.9% in Q2 2014, or 3.2% year-on-year, well ahead of any other leading developed economy, before slowing to 0.7% and 3.0% respectively in Q3. For example, the composite PMI index (which includes manufacturing and services but not construction) remained in the range 57-61 throughout the year until October when it fell to briefly to 56.2 before recovering to 57.6 in November. Perhaps the most encouraging aspect of the recovery so far has been the strength of investment spending by businesses, demonstrating that the upswing is more than simply a consumption-led recovery.

Figure 4
UK: Business investment contributing to recovery



Source: Thomson Reuters Datastream, as at 15 November 2014.

Retail sales volumes (ex-automotive fuel) averaged just over 4.0% year-on-year between January and October, showing the strength of consumer spending. The year-on-year growth of final consumption expenditure, a wider definition taken from the GDP statistics that includes spending on utilities, insurance premiums and other services, has been a more modest 2.4% for the July-September quarter. The key to stronger consumer spending has been the gradual upturn in wages, which increased by 1.3% year-on-year in September, combined with the rapid growth of employment. For example, using the Labour Force Survey data, the number of people in employment increased in the year to July-September by 695,000, while the number of jobs (including part-time jobs) increased by over 1.12 million. Together these figures account for the increased purchasing power shown by UK consumers over the year, though further falls in energy prices could also boost consumer spending.

Elsewhere investment spending by businesses has been growing steadily and order books have been mostly strong (Figure 4). The lower level of sterling over the period 2010-13 has also aided export-oriented companies to maintain market share. Reflecting the growth in the number of households and population as well as the shortage of new supplies coming on to the market, house prices have been rising across the board, according to the official regional house price indices. The renewed surge in housing prices has been led by increases in London and the south-east, areas where prices have out-paced increases in the rest of the country. This is despite the slowdown in mortgage lending approvals since the start of the year, a trend enhanced by the introduction of tighter lending standards from April onwards by the BoE.

Looking ahead the pace of economic growth is unlikely to accelerate much from here but a range of surveys and indicators suggest that growth will be maintained at close to 3.0%. Low rates of money and credit growth over the past two years combined with the strength of sterling over the past few months will ensure that import prices continue to fall and that inflation remains low through 2015.

Turning to monetary policy, the BoE's once clear forward guidance has been overtaken by a series of mixed messages not only from MPC members, including two members voting for early rate increases, but also from the Governor himself. After abandoning the 7% unemployment threshold for considering interest rate hikes in February (in favour of a set of eighteen indicators) but promising that rates would stay low for an extended period, the surprising strength of the economy has required a shift to a more pragmatic stance. In June, Governor Carney advised that rates could rise by yearend but by December the market had shifted to expecting a rate hike only in the second half of 2015.

For 2015 I now expect 2.8% real GDP growth and 1.8% CPI inflation.

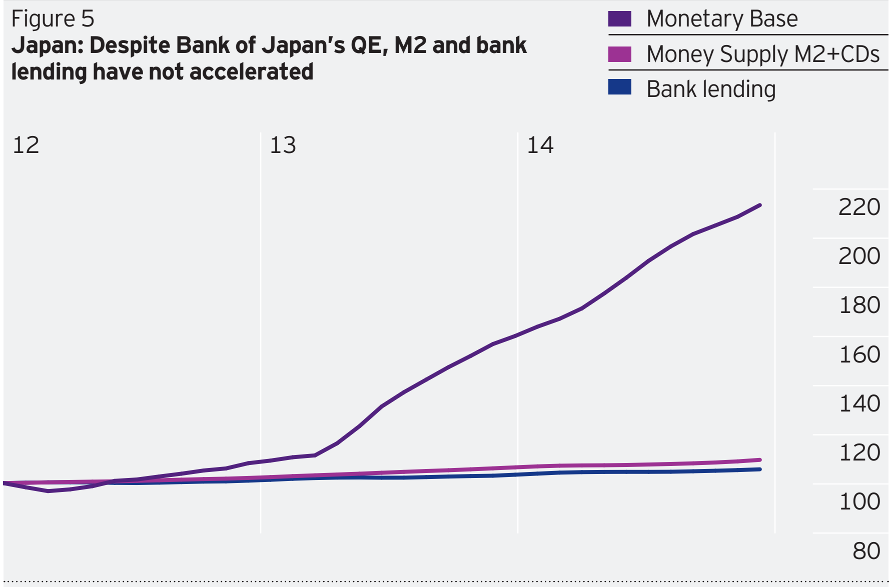
Japan

When Shinzo Abe became Prime Minister of Japan for the second time in December 2012 he announced a bold plan to revive the economy consisting of three 'arrows' or three components: a stimulative monetary policy, a boost to fiscal spending and a series of structural reforms.

During the past year doubts have grown about all three 'arrows' of 'Abenomics'. First, on the monetary front, although the BoJ is vigorously expanding its balance sheet and recently announced (31st October) a further increase in the pace of its asset purchases, the commercial banks are not expanding their balance sheets. At the end of October, Japan's money supply (M2+CDs) had increased by only 3.1% year-on-year, while bank lending had increased by 2.4% (Figure 5). Total bank credit, which includes bank holdings of securities, has actually declined since March 2013 when Governor Kuroda took over at the Bank of Japan.

The second 'arrow' of Abenomics, fiscal policy, turned restrictive this year when a 3% increase in the consumption tax was imposed from 1st April. Household spending, which had surged ahead of the tax, plunged and has still not recovered. In a low growth economy like Japan the effect of a 3% tax hike has not just been temporary. As I have previously predicted, without strong income growth the new permanent tax hike has led to a sustained decline in consumer spending, which could last for a prolonged period. In October nominal retail sales increased by 1.4%, well below the rate of CPI inflation at 2.5% for the same month. Consensus estimates forecast year-on-year declines in real consumer spending until 2015 Q2.

Figure 5
Japan: Despite Bank of Japan's QE, M2 and bank lending have not accelerated



Source: Thomson Reuters Datastream, as at 15 November 2014.

The decline in consumer spending was so great in the April-June quarter that overall real GDP declined at a (revised) 6.7% annual rate as consumers stayed away from department stores and supermarkets. The general decline continued into the third quarter with an unexpected fall in annualised real GDP of -1.9% as the impact spread to the productive sectors. Industrial production declined 1.0% year-on-year in October, with vehicle output falling 6.3% year-on-year. Consensus estimates of overall real GDP suggest growth rates of 1.0% only in 2014 and 1.3% in 2015. For 2015 I expect 0.8% real GDP growth.

The third 'arrow', structural reform, consists of a long list of some 240 initiatives proposed by PM Abe's closest advisers as well as by government departments. Very little of substance has yet been implemented. The problem is that vested interests such as farmers, truckers or certain other groups of professionals have built strong political lobbies and the PM has not felt able to confront them. It is largely for this reason that he called a new election of Japan's lower House of Representatives for 14th December to give himself a new mandate to govern.

On the external front, the deterioration of the trade and current accounts is continuing to act as a drag on growth. This is due mainly to increased imports of oil and gas to replace the power lost from Japan's nuclear energy providers, whose plants were closed down following the tsunami damage to the plant at Fukushima. Despite the yen's near-50% depreciation against the US dollar (from 80 to around 120), the current account switched from a surplus of 4% of GDP in 2010 to deficits in late 2013 and 2014 of 1% of GDP, although there has recently been some recovery to small surpluses. Meanwhile the trade balance has also switched to large and persistent deficits.

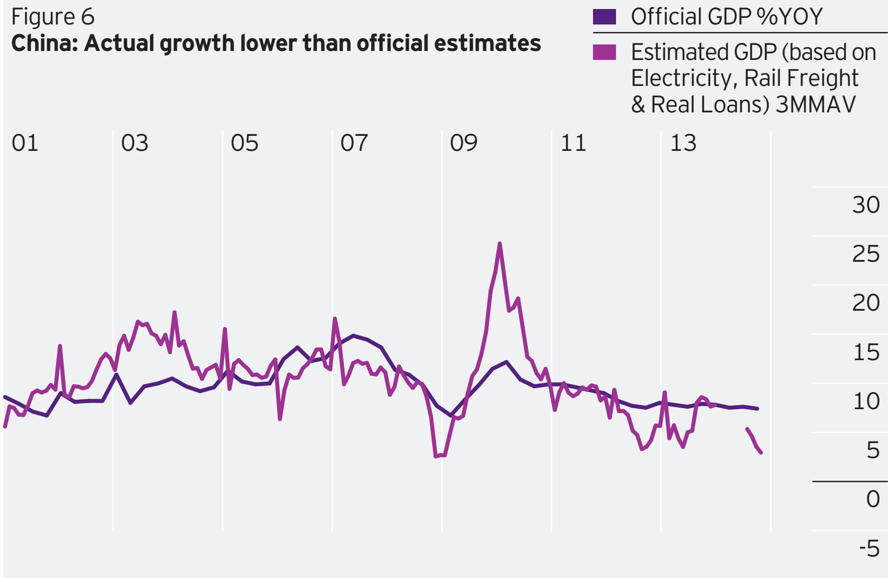
With wage growth sluggish and inflation temporarily elevated due to the depreciation of the currency and the imposition of the 3% hike in the consumption tax, consumer spending is likely to remain subdued. Until 'Abenomics' starts to show significantly better results the Japanese economy is likely to languish, though not necessarily in the somnolent state that it had fallen into before Mr Abe became PM.

China and non-Japan Asia

China's growth momentum has been subdued all year with weak trade growth and PMI data readings that have fluctuated in the narrow 49-53 range since January. In November the composite PMI slipped to 51.1 and the manufacturing PMI hit 50.0, which is the dividing point between expansion and contraction. The main problems have been the excessive build-up of debt in the domestic economy and the restraint this has forced on credit growth, and the slow growth of the international economy which has acted as a drag on China's export performance. For 2014, the official growth figures are expected to be 7.4%, according to Consensus Economics, although other private estimates of actual growth based on a range of key indicators would suggest lower growth rates closer to 6% (see Figure 6).

Note: Where there is a gap in estimated GDP in the chart, no data is available.

Figure 6
China: Actual growth lower than official estimates



Source: Thomson Reuters Datastream, as at 6 October 2014.

To counter the slowing of the economy the Chinese authorities have adopted a number of measures within a limited framework of easing. In short, they have not attempted the large scale credit expansion that they encouraged in 2008-09 and which has been the source of many of their recent problems. For example during September-October the People's Bank of China temporarily injected a total of 770 billion yuan (via three-month repos) into the larger banks and in November it reduced one-year lending and deposit rates at commercial banks by 0.25% and 0.4% to 6.0% and 2.75% respectively, while permitting more flexibility in rate setting by individual banks. With producer prices declining close to 2%, the real inflation-adjusted borrowing costs for large enterprises is higher than the nominal interest rate. For small- and medium-sized enterprises, borrowing costs in the Wenzhou money market are even higher at around 20% p.a. Separately the National Development and Reform Commission accelerated the approval of some 700 billion yuan of railway and airport infrastructure projects.

In the domestic economy fixed asset investment has been slowing from around 20% p.a. in 2012 to 15.7% in September 2014 as China shifts from an export-led growth model towards more a more consumer-led system. Housing construction slowed as new building projects were postponed and house prices fell 1.7% in the year to October. However, even retail sales have been affected by the restructuring, decelerating from 20% growth in 2010-11 to 11.5% year-on-year in October 2014. In effect, the Chinese authorities have not been able to contain the slowdown to specific sectors; it is becoming generalised.

In addition, the authorities deliberately allowed the currency to weaken from around 6.05 per US$ in January to 6.25 in early May and again in November from 6.11 to 6.18. Earlier Chinese exports had surged, recording annual growth rates in excess of 20% in 2010-11 as the emerging economies bounced back from the global downturn. However, the recent picture has been very different as exports slowed abruptly until April (falling 8.0% year-on-year) and have only recovered moderately since then, slowing to 10.4% year-on-year for the three month period of September-November 2014.

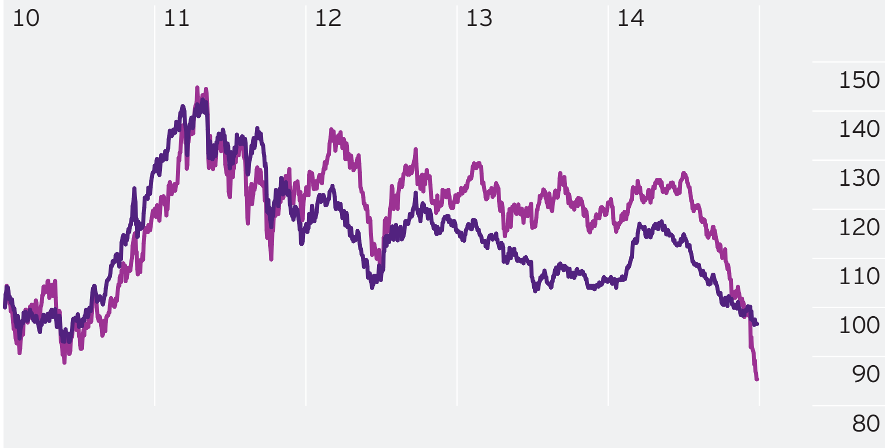
I expect China's official real GDP to continue to soften in 2015, slowing to 6.5% while CPI inflation will remain low, averaging 2.0% for the year.

The remainder of non-Japan Asia is suffering from the same broad weakness in world trade that has been holding back China's export engine. However, with only a few exceptions, such as India, Indonesia and possibly Korea, the regional economies do not have large enough domestic markets to provide a countervailing locomotive effect. Consequently the entire region is watching and waiting for progress in the developed economies, especially the US, to begin a more vigorous upturn.

Commodities

I have been bearish on the outlook for commodity prices over the past year. In recent months there have been further significant falls in most commodity markets. Most strikingly the oil price has fallen steeply with Brent crude dropping from US$115 per barrel in June to US$64 in mid-December as a result of weak demand in China, other emerging economies, and the Euro-area, as well as new supplies from US shale oil and gas suppliers, plus the decision of OPEC not to cut production. In addition, key industrial commodity prices such as imported fine iron ore in China have fallen from US$135 in January to US$71 per metric tonne in December, while Australian coking coal prices have also weakened. Moreover, prices for cereals such as corn, soya-beans and grain have fallen reflecting the bumper harvest in the US (see Figure 7).

Figure 7
Commodity price declines reflect weak demand and new energy supplies



Source: Thomson Reuters Datastream, as at 15 December 2014.

Finally, precious metal prices have been declining with the gold price falling from US$1,383 in March to US$1,217 per ounce in mid-December. This is all consistent with the relative softness of global demand resulting from the sub-par growth of major economies and the rebalancing of emerging economies away from export-led growth models. Looking forward, commodity markets are likely to stabilise over the next few months, but it is hard to envisage a strong upswing in 2015 so long as major economic areas such as the Eurozone remain weak and while inflation remains so low in so many economies.

Conclusion

In the financial markets there is a widespread misunderstanding about the stance of monetary policy. Most economists and analysts tend to judge monetary policy by the level or direction of interest rate changes. However, interest rates are not a good measure of the stance of monetary policy. If monetary policy i.e. monetary growth is eased, interest rates will fall initially but later, after the economy recovers and inflation rises, rates will rise. The longer term and more important effect (the 'Fisher effect') of easy money is higher rates not lower rates.

Conversely, if monetary policy is tightened interest rates will rise initially, but then after the economy has slowed and inflation has fallen, interest rates will fall. So the longer term and more important effect of tightening monetary policy is lower rates not higher rates. That is why interest rates today are highest in countries like Argentina and Venezuela and why interest rates are lowest in countries like Japan and the Eurozone.

It follows that what is needed to avoid deflation is faster growth of the quantity of money. It is not enough simply to lower interest rates to zero e.g. by following market rates downwards, especially if that means money growth remains anaemic, yet that is precisely what we are seeing in the Eurozone today. The low interest rates here and in Japan are the result of the second phase of a prolonged period of tight money policy – that is, slow money growth. It is hardly surprising that in these circumstances the Euro-area is struggling to avoid deflation, while Japan is also struggling to escape it.

More broadly, near-zero central bank interest rates have been temporarily effective in promoting equity and other risk asset prices but because broad money and credit have not yet accelerated to anything close to pre-crisis rates, the central banks' policies have not yet been effective in ensuring repair of private sector balance sheets or restoring normal growth. For that we need faster growth of money and credit. On this basis, I expect it will be several years before the business cycle and asset prices peak.

December 2014