World growth remains strong

Doubts over direction of investment cycle

Trevor Greetham in London

The Federal Reserve is embarking on a monetary tightening cycle for the first time since 2006. Assessment of three possible scenarios, taking account of the present economic cycle, leads to the conclusion that gradual and drawn out tightening is most likely, with stock markets continuing to do well for the time being. A more synchronised and inflationary upturn would trigger more concerted rate rises and an increase in financial market volatility.

There are some confusing messages about what may happen after the US starts to normalise interest rates. The 'investment clock' model, linking the global business cycle to the performance of different assets, shows an indeterminate picture.

Falling unemployment in the major economies indicates that the period of above-trend growth that began in 2009 is intact. Yet confidence surveys relating to the global manufacturing sector are weak. While the global inflation trend has been downwards since China started to slow and commodity prices peaked in 2012, base effects suggest a rise in measured inflation rates heading into 2016.

The notion that the coming Fed rate hike will be 'one and done' is misplaced. Consumer strength is driving the US unemployment rate lower and consumers are benefiting from lower energy prices. But, among major central banks, the Fed is a lone hiker, pushing the dollar still higher but with tightening moves gradual enough to keep stock markets on a positive trend.

Meanwhile, euro area growth could surprise positively, with the monetary base and credit measures expanding rapidly even before the European Central Bank extended its stimulus. Even China could see better activity as monetary and fiscal easing measures take effect. In this scenario a series of Fed rate hikes and increased financial markets volatility seem likely. ■

Call for solidarity rebounds on Berlin

Refugee flood poses problems for Merkel

Stefan Bielmeier in Frankfurt

The flood of refugees into Europe and Germany seems to be growing. The figure for Germany for 2015 is estimated at above 1m. Germany's local authorities are reaching capacity limits. The initially very positive sentiment of the German population is ebbing, with fears and worries growing.

For many governments in Europe, the issue is a welcome opportunity to postpone necessary reforms and to forego budget consolidation.

The discussion has become far more strident. Although the media shows still widespread sympathy for refugees, extremist voices are rising, uttering controversial opinions that are deliberately fuelling the population's fears. After some hesitation, the German government has decided to carry out rapid deportation of economic migrants, freeing capacity urgently needed for war refugees.

There is a lack of necessary structures for implementing these decisions on the borders. It is doubtful whether politicians can find effective solutions in the near future.

The debate has far-reaching political implications. Chancellor Angela Merkel and her Christian Democrats have lost electoral favour. If this trend continues Merkel's decision-making capacity will be diminished. At the EU level, the German government is calling for European solidarity. While fully justified, this weakens Germany's negotiating position in other areas – at a time when Berlin's standing has been damaged by the Volkswagen diesel scandal.

In the last few years during the debt crisis, faced with other countries' calls for further-reaching solidarity, Germany has generally been able to get its own way, seen in its resistance to stimulus for hard-hit economies. So it is not surprising that Germany's call for collective action over refugees is falling upon deaf ears. ■

New central banking model

Changes will lead to greater public oversight

Linda Yueh in Oxford

The past year has emphasised the changes in central banks' remits since the financial crisis. The era of pure inflation-targeting is over, as central banks begin to play more of a role in liquidity management and macroprudential regulation.

The European Central Bank is moving towards a more active role in stimulating European demand through attempting to attract greater private sector investment in European infrastructure. This strays closer towards assuming a fiscal policy role – opposed by many central bankers.

The Fed's dual mandate, geared to price stability as well as unemployment, looks more appealing as the world's main central banks move in different directions in considering increasing interest rates (the US and the UK) or undertaking more quantitative easing (the euro area and Japan). The Bank of England is at the forefront of this expanded central banking model, with a financial policy committee operating alongside the monetary policy committee. The challenge is to define 'financial stability' as well as to identify the tools to reach that target.

China and other emerging markets offer some lessons. For countries that peg their currencies, intervening to influence the money supply is essential when interest and exchange rates move in step. Emerging markets' measures such as reserve ratios, macroprudential steps and countercyclical interventions may become more familiar in the West. If such methods of greater financial market control become more prevalent in coming years, improving oversight over the technocrats responsible for implementing them will become a pressing task. ■