

What next for central banks?

- **Some central banks – including the Fed – have reached the end of the easing cycle**
- **ECB, BoE still likely to ease policy somehow**
- **BoJ new policy based on misconception but may succeed thanks to weak yen**

Last week the RBA, the ECB and the Bank of England all left monetary policy unchanged (although the ECB promised to keep monetary policy easy for as long as necessary). Next week the Riksbank and the Bank of Canada are likely to do the same. The FOMC meets at the end of the month, but is equally unlikely to change anything. The only major central bank to have shifted policy – and substantially so – is the Bank of Japan. At the same time, the largest world economies are beginning to diverge. The US is firmly set on a recovery path, if un-even and with below-par strength. By contrast, the euro area, despite brave words to the contrary, is still mired in crises and the overall growth outlook remains dismal. Diverging economic developments should eventually result in diverging monetary policies. This Comment is a quick overview of where some central banks are likely to head next – and when.

| <u>Central bank</u> | <u>Move</u> | <u>Time</u> | <u>Comment</u> |
|---------------------|-------------|-------------|---|
| Federal Reserve | Taper QE | 2013 | Depending |
| Federal Reserve | Hike | 2014 | Depending |
| ECB | Cut | 2013 | End of cycle |
| Bank of England | Extend APP? | 2013 | After Carney comes |
| PBoC | Tighten | 2013 | Raise RRR more likely than rate hike |
| BoJ | Ease | 2013 | Less effective short-term than expected |
| BoC | Hike | 2014 | Year-end |
| RBA | Hike | 2014 | Year-end |
| Riksbank | Hike | 2014 | Year-end |

One problem when attempting to forecast policy is of course the difference between what *should* be done and what *will* be done – not helped by the fact that both of these are ultimately subjective. This is particularly true in the case of the Federal Reserve. The outlook for the US economy is reasonably benign. While recent data have shown some weakness, the American economy should grow near trend in H1 2012 and possibly at an above-trend rate in H2 and into 2014. On this basis, the Fed's markers for policy change (chiefly an unemployment rate of 6½%) should be achieved by mid-2014, subject to how quickly previously discouraged workers return to the labour force. In turn, this should mean a tapering off of QE3 this year, with a first interest rate increase next year. However, as noted in several recent Comments, the dovish composition of the FOMC next year may mean that both QE and current interest rate are maintained for longer. Judging by recent speeches by different FOMC members and regional Fed Presidents, as well as by the latest FOMC Minutes, what we will see is most likely QE3 being discontinued in late 2013 (possibly early 2014); while interest rates remain unchanged into 2015. That would risk inflating – or perhaps better, prolonging – a bond bubble.

By contrast, the ECB seems relatively straightforward. There may be another repo rate cut, most likely if output growth is much weaker than the Bank forecasts (which admittedly is almost a given). But that

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would mean the end of the interest-rate cutting cycle, not only because there wouldn't be much room left to cut interest rates. The ECB, as other central banks, is finding that ultra-low interest rates begin to lose their power when extended indefinitely. One possibility may be some form of measure to boost lending, notably to SMEs. But, apart from the fact that concentrating on credit rather than money is a conceptual mistake – and even more so in a debt-induced downturn – the experience of similar programmes elsewhere (eg, the Bank of England's Funding for Lending Scheme) shows that it is marginal at best. Another is some attempt to compress the spread in bank interest rates between different EA countries.

Talk of changing the Bank of England's mandate (eg, to nominal GDP targeting) has temporarily ceased after the March Budget. However, it may well restart once Mark Carney has replaced Sir Mervyn King as Governor on 1st July. If the Bank extends its Asset Purchase Program (an issue which Sir Mervyn favours but on which he has been outvoted twice), that would probably also take place after the change of Governor and in conjunction with other changes, such as the introduction of a Fed-style forward guidance. Like the ECB, the BoE is still closer to easing further before the cycle ends.

The three 'smaller' economies in the table – Canada, Sweden and Australia – have different issues. All three weathered the Great Recession relatively well. All three have issues with high and rising household debt. All three also have strong currencies, underpinned by policy interest rates on the high side by current standards: 3% in Australia, 1% in both Canada and Sweden. The only one of the three where there has been any hints of a tighter monetary policy is the Bank of Canada. But these hints – made repeatedly over the autumn and winter – have since receded, not least because of fears of what this would do to the housing market. The Riksbank has two pronounced doves on its board who will resist any repo rate hike; and in Australia the talk over recent months has been more about cuts than about hikes in the cash rate. Nevertheless, based on recent data and on the improving global outlook, all three are likely to have reached the end of the cycle, meaning that the next move in interest rates should be up. However, that move will not come until 2014, perhaps only by the end of the year.

By contrast, the Chinese authorities are already in tightening mode. The Peoples' Bank of China has not moved officially yet, but every week seems to bring notification of another attempt to cool down the housing market with some form of restriction on mortgages, on second homes or in some other way. On the other hand, consumer price inflation is slowing and there is outright producer price deflation. The PBoC is therefore less likely to raise interest rates this year. Instead, it will probably raise the reserve requirements ratio. This is less effective than higher interest rates; but it is a preferred instrument of the authorities, and perceived by them to work better against asset price bubbles.

Which brings us to the one major central bank firmly in easing mode, the Bank of Japan. Under its new Governor, the BoJ has raised its inflation target to 2% and introduced a date – 2015 – for reaching it. Practically every day we read that the yen has fallen further towards 'parity' (ie, 100 yen per US dollar). The weak yen may – indeed should – help to boost activity and inflation. However, the main chosen method of the BoJ is to ramp up its quantitative easing by buying more government securities. Here, the outlook is clear. Like the Fed, the Bank of Japan concentrates on the monetary base. The theory is that if you stuff the banking system with cash, banks will eventually lend that out, which will create faster activity

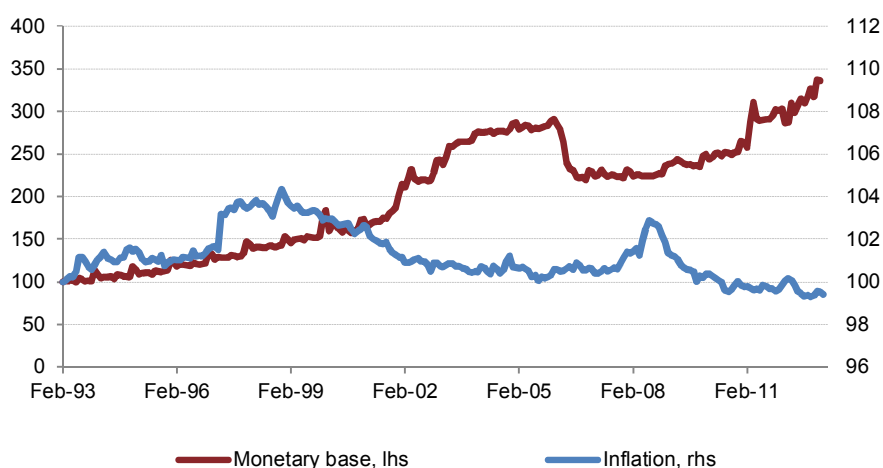
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and, ultimately, inflation. But that is not necessarily the case. Bank lending is not governed only by the amount of cash that banks hold. First, because banks do not need to hold money in order to lend it; banks *create money by the very act of lending!* When a bank lends money, it creates an asset on its balance sheet – the loan. It also creates a corresponding liability – the deposit of the lent sum. That deposit is money. Whether the bank had a sum in a deposit of its own with the central bank is not relevant. (This is also why the Fed’s obsession with banks’ reserves and with paying interest on them is misguided.) Banks’ willingness to lend is of course one factor determining the growth of money and credit; but other factors are the level of interest rates (already low in Japan, of course) and – most importantly – the willingness of non-banks to borrow. The latter is not high in Japan – although it must be said that if the BoJ’s policy des create a lasting shift in the mindset of non-banks, that could (hopefully would) change.

It is therefore not surprising to find that the relationship between changes in the monetary base and eventual inflation is not particularly good, neither in Japan, nor elsewhere. Over the past twenty years, the Japanese monetary base has multiplied 2.5 times; the level of prices over the same period has fallen. Inflation has accelerated when the monetary base had expanded; and had contracted; and *vice versa*.

Japanese monetary base and headline CPI, index Feb 1993=100



The BoJ is now firmly committed to its easier policy. It may succeed – but not in the way it thought it would. Inflation brought on by higher import prices is not as desirable as inflation caused by overheating domestic demand.

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