Central Bank update: RBA and US Fed

Economic research note

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- The RBA Governor has signalled that even though domestic price pressures alone would support the need for higher interest rates, the uncertainty in global markets suggest that Australian interest rates will now remain on hold well into 2012.
- While the global economic outlook looks to have deteriorated, the Governor reminded us all that Australia's macro-economic fundamentals are sound and that the country is at a good starting point to withstand global uncertainty.
- In the US, Fed Chairman Bernanke stopped well short of announcing any specific further policy stimulus.
- The Chairman did reiterate the view that the Fed will keep interest rates at very low levels until mid-2013 and that the Fed possesses additional tools to ease policy further if needed.
- The Chairman also made the point that monetary policy alone could not support the economy and that there was a need for a better focus on fiscal policy, as well as policies on housing, taxes, trade, education, regulation, investment and technology.

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RBA to remain in sidelines

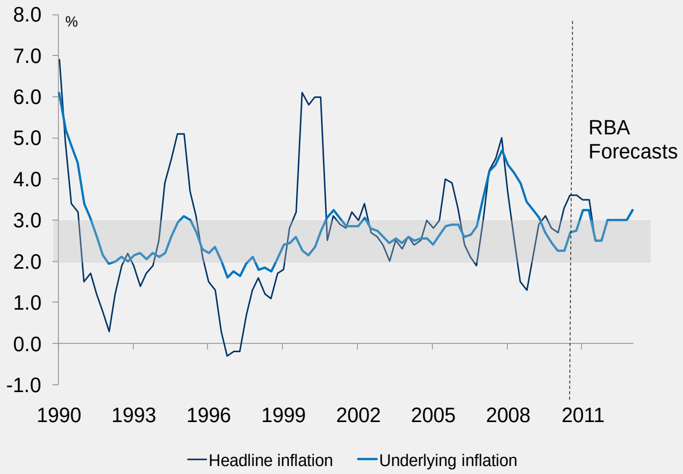
On Friday, the RBA Governor delivered his semi-annual Parliamentary testimony. Usually the testimony follows closely the view detailed in the August *Statement on Monetary Policy*. However, given the extreme volatility in global markets since then and downward revisions to global growth expectations, the Governor took the opportunity to update the RBA's views.

What seems clear from the testimony is that the RBA is now balancing two major forces on the inflation outlook. Global growth expectations are being revised down and this, combined with increased consumer and business caution as a result of the volatility in markets, is likely to put downward pressure on inflation. Offsetting this is the ongoing upward trend of Australia's terms of trade and the solid upswing in capital spending and low unemployment rate that it is supporting.

While the RBA had previously signalled that it was close to raising interest rates further, a move that would be justified by the higher-than-expected Q2 11 CPI reading, the clear signal from the Governor's testimony is that monetary policy should now be expected to be on hold for a number of months, likely well into 2012.

What the Governor did not do was ratify market expectation of an imminent and substantial easing of monetary policy in Australia.

Australian inflation. Actual and outlook



Source: ABS and RBA forecasts

In attempting to convey the RBA's delicate balancing act, the Governor highlighted a number of key factors the Bank is looking at. In asking themselves the question, will "recent events have a bearing on the medium-term inflation outlook" the RBA is looking at both confidence and structural issues.

The Governor noted that "it would be reasonable to anticipate that the decline in confidence arising from recent events internationally may well dampen demand somewhat compared to the outlook set out in the *Statement on Monetary Policy*."

This factor, "in addition to the increased visibility of structural change in the economy may also condition wage bargaining and price setting." Note: here the Governor is clearly pointing to recent company profit reporting and announced job losses in some sectors of the economy.

Signalling that the RBA will be watching these developments closely the Governor stated that "if these forces persist, they may act to lessen the upward trend in inflation pressures that appear to be in prospect."

On the other side of the inflation debate, the Governor made two key points. Firstly, "significant rises in a range of administered prices are still set to occur", the implication being that these higher costs (ie. for electricity) could be factored into wage setting negotiations.

Secondly, the risk of higher inflation was being exacerbated by "the fairly poor performance of multi-factor productivity growth over recent years" that this was leading to "unit costs…rising quite quickly." This is another issue that has been observed in the recent company profit season, especially from the mining sector.

It is worthwhile noting, however, that even with the increased volatility in global markets and uncertainty over the economic outlook, the Governor ended his testimony on a positive note – sending a signal that expectations of aggressive monetary policy easing were unlikely to be fulfilled.

In this regard the Governor made a few key points:

- Australia's "terms of trade remain at record highs",
- The "unemployment rate remains low",
- "Inflation bears watching, but we can keep it under control",
- Australia's banks are "strong",
- The Australian dollar "is sound",
- Our "sovereign credit position is in the international top tier", and
- "Consumer caution, while making life hard for the retail sector, is also building resilience in household balance sheets."

As a result of these positive factors the Governor also stated that "if we are entering another period of weaker international conditions, this is a pretty good starting point from which to do so."

Fed Chairman: It's not just about monetary policy

The US Federal Reserve Chairman, Ben Bernanke, stuck to the anticipated script in his Jackson Hole speech on Friday (titled "The near and longer-term prospects for the US economy").

Despite some earlier market expectations that the Fed Chairman may use this speech to announce specific new policies to support the economy, this was always unlikely to occur.

The Fed Chairman did reiterate that the Fed Funds target rate would be kept at its very low levels until at least mid-2013 and that the Fed "has a range of tools that could be used to provide additional monetary stimulus" if required.

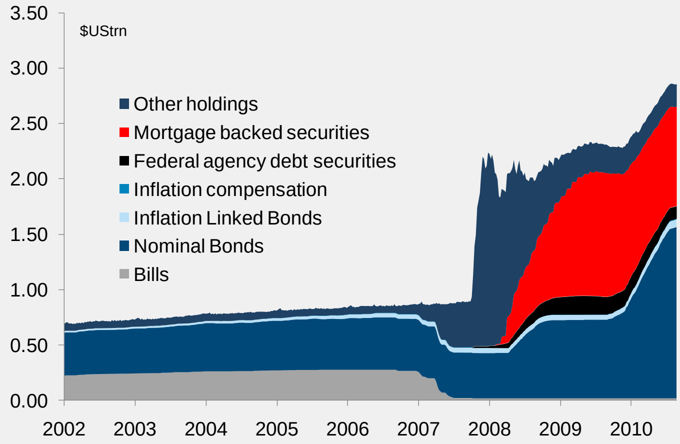
The Chairman confirmed that the decision to provide specific forward guidance on interest rates at the August meeting was based on the view that "recent data have indicated that economic growth during the first half of the year was considerable slower than the FOMC had been expecting" and that "temporary factors can account for only a portion of this economic weakness."

It terms of forward guidance the Fed Chairman simply stated that the FOMC "will continue to consider (the use of its additional tools) and other pertinent issues at our meeting in September." It is worth noting, however that the September FOMC will now be a two-day meeting (20th-21st) "to allow a fuller discussion."

In this regard, the option of further monetary policy easing does look to be a "live" debate for the two-day September meeting – given that no further policy change would likely have taken only one day (as originally scheduled) to discuss. The longer meeting should allow Bernanke time to debate the economic outlook with the three dissenters on the FOMC, who did not vote for the specific interest rate timeframe.

While the Fed Chairman did not discuss them in detail, some of the other policy "tools" open to the FOMC include increasing the maturity of their existing bond holdings, embarking on a third round of quantitative easing (QE3) and increasing the already substantial size of the Fed's balance sheet or lowering the interest rate on excess reserves.

Fed's balance sheet



Source: US Federal Reserve, data to 18 August

In discussing the US economy, the Chairman tried to paint a more positive medium-term picture, stating that he was “more optimistic” than some market participants/commentators.

He also made the point that “although important problems certainly exist, the growth fundamentals of the United States do not appear to have been permanently altered by the shocks of the past four years. It may take some time, but we can reasonably expect to see a return to growth rates and employment levels consistent with those underlying fundamentals.”

This is a very important point as it highlights the Fed Chairman’s view that the downturn in the US economy and current high unemployment rate is cyclical and not structural. The implication here is that the Fed can continue to support a return to trend growth rates and lower unemployment through ongoing monetary policy stimulus – both in the traditional sense and in more unconventional tools.

In terms of the very modest recovery to date for the US economy, the Chairman highlighted two features that had weighed on growth, the ongoing weakness of the housing market (due largely to the number of foreclosure sales and tighter credit conditions) and the elevated level of uncertainty in both the consumer and business sectors as a result of the financial crisis and political situation.

The Fed Chairman also made the point that there is only so much that monetary policy can do to support economic growth and that other policies – especially fiscal, were also important.

In terms of the US budget deficit, the Chairman stated clearly that the government needed to have a credible plan to reduce the medium-term accumulation of debt, but that this fiscal consolidation also needed to be done in a way that did not harm near-term growth prospects.

Venturing into political ground, the Fed Chairman stated that there is a need to put “US fiscal policy…on a sustainable path that ensures that debt relative to national income is at least stable or, preferably, declining over time”

However, he also added that “the country would be well served by a better process for making fiscal decisions”, as “the negotiations that took place over the summer disrupted financial markets and probably the economy as well.” He also noted that “similar events in the future could, over time, seriously jeopardize the willingness of investors around the world to hold US financial assets or to make direct investments in job-creating US businesses.”

The Chairman also highlighted the view that policies on housing, taxation, trade, the regulatory environment, population, education, health, investment in R&D and technology would also be critical to the long-term economic outlook for the US.

The Chairman also took the time to highlight the importance of combating the current high level of long-term unemployment, with the risk being that people who are unemployed for long periods of time can be left behind and their potential to add to the economic wellbeing of the nation (not to mention themselves and their families) seriously compromised through loss of skills.

It is this point, perhaps more than any other, which highlights the view that the Fed Chairman will continue to push monetary policy stimulatory measures into uncharted territory with the aim of reducing the unemployment rate, especially for the long-term unemployed.

It remains debatable, however, whether these unconventional monetary policy tools can correct the path of the US economy and encourage economic growth on its own. Fiscal policy, even in an environment of fiscal consolidation has a very large role to play. It is becoming clearer that a refocus on productivity enhancing policies and creating confidence in the political framework are what is needed to ensure a return of the US economy to its potential growth rate.

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