Central Bank update: US Fed, ECB & RBA

Economic research note

4 November 2011

- The US Fed held interest rates steady this week and maintained Operation Twist. New economic forecasts imply interest rates near zero into 2014, while momentum within the FOMC seems to be shifting towards QE3.
- The ECB surprised some market participants with a 25bp rate cut to 1.25%. The move by the new ECB President can easily be justified by the weakness in the EU economy stemming from the ongoing sovereign debt crisis.
- Despite currently elevated inflation, a further easing in monetary policy should be expected by the ECB in December as the outlook for inflation improves.
- The ECB also indicated its commitment to intervening in the sovereign bond markets, but highlighted that this was both temporary and limited and the ECB could not act as a lender of last resort to EU nations.
- The RBA also eased policy this week by 25bp, to 4.5%. In today's SMP the RBA has reiterated the desire to return monetary policy to a 'more neutral' policy setting. This is supported by revised inflation forecasts within the 2%-3% target band out to end-2013.

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Central Bank update

The US Federal Reserve (Fed), the European Central Bank (ECB) and the Reserve Bank of Australia (RBA) all had meetings this week which resulted in important changes in policy and signals for markets.

In the US, while the Fed held monetary policy steady, their revised economic forecasts imply a long-period ahead of highly stimulatory monetary policy. Indeed, at this point a third round of quantitative easing (QE3) looks likely, perhaps taking the form of purchases of MBS.

In Europe, the new President of the ECB, Mario Draghi, announced a 25bp rate cut in the repo rate to 1.25%, reversing half of the tightening that took place over April and July. We would expect the repo rate to return to 1.0% at the next ECB meeting on 8 December.

In announcing the policy easing, the ECB President stated that "owing to their unfavourable effects on financing conditions and confidence, the ongoing tensions in financial markets are likely to dampen the pace of economic growth in the euro area in the second half of this year and beyond."

In Australia, the RBA eased monetary policy by 25bp to 4.5%, stating clearly that global and local conditions warranted a return to a "more neutral" setting of monetary policy, rather than the "mildly restrictive" setting that had previously prevailed. (Please see our note of 1 November *RBA heading back to neutral* for further details).

Today the RBA released the *Statement on Monetary Policy*, noting that at the November meeting "the Board judged that a more neutral stance of monetary policy was now appropriate given that, over the period ahead, inflation was likely to be consistent with the medium-term target and that economic growth remained moderate."

In addition the RBA has revised its economic forecasts, with a lower growth profile out to the end of 2013. Inflation forecasts have also been reduced meaningfully, with the underlying inflation rate now forecast at 2.5% to mid-2013 and 2.5%-3.0% at year-end 2013.

Given these forecasts and the ongoing uncertainty in the global economy, we would expect a further 25bp easing from the RBA In the months ahead – perhaps as early as the 6 December meeting.

The US Fed

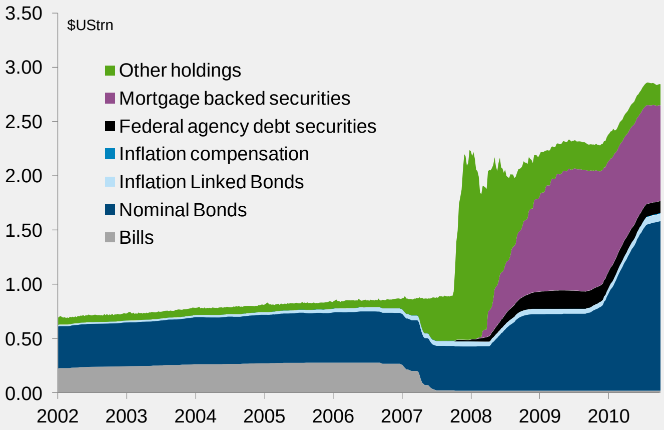
The Fed held monetary policy unchanged at its meeting this week, committing to "continue its program to extend the average maturity of its holdings of securities as announced in September" – also known as Operation Twist.

As shown in the chart below, the Fed's balance sheet is holding at around $US2.8 trillion, after increasing substantially through late 2010 and to mid-2011 via QE2.

It is interesting to note that the lone dissenter from the FOMC wanted "additional policy accommodation at this time." The dissenter, Charles Evans from Chicago, had previously stated that he was looking for the Fed to undertake a purchase program of mortgage backed securities (MBS) in an effort to further reduce the cost of home loans.

Any move to QE3 in the future, which should be expected, is likely therefore to involve the purchase of MBS.

US Fed balance sheet



Source: Bloomberg, data to 26 October 2011

In addition, on interest rates the Fed restated the view that "economic conditions – including low rates of resource utilisation and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."

Perhaps more significantly, when quizzed about the implication of the revised economic forecasts, see below, Fed Chairman Bernanke emphasised that the commitment was to keep rates low "at least" through mid-2013 and that this meant they could be held low until well into 2014.

Given the unemployment rate is expected to remain around 8% by year-end 2013, an environment of a 0%-0.25% Fed Funds rate for at least another 2 or 3 years and further quantitative easing is looking increasingly likely.

Revised US forecasts

As is traditionally the case, the November FOMC meeting included a full revision to the Fed's economic forecasts.

As shown in the table below, the Fed has substantially downgraded growth expectations and raised the forecasts for the unemployment rate.

For 2011 growth is now expected to centre around 1.65%, down from the previous forecast of 2.8%, while growth for 2012 is estimated at 2.7% (down from 3.5%). For 2013 and 2014 some acceleration to 3.25% and then 3.4% is forecast.

As a result of the low growth environment, the unemployment rate is expected to be just on 9% for 2011 and down marginally to 8.6% for 2012. Some improvement to 8.0% is expected in 2013 and then down to 7.25% in 2014.

After a rate just below 2.0% in 2011, the core PCE (the Fed's preferred measure of inflation) is expected to range 1.5%-2.0% for most of the period out to 2014.

As stated, based on these forecasts, it is hard to see the Fed tightening monetary policy in a meaningful way well into 2014 – rather than the mid-2013 current timeframe for retaining the Fed Funds target rate near zero.

Revised Fed forecasts, as at November (and June)

%/yr	2011	2012	2013	2014	Longer run
Real GDP	1.6-1.7	2.5-2.9	3.0-3.5	3.0-3.9	2.4-2.7
Forecasts as at June 2011	(2.7-2.9)	(3.3-3.7)	(3.5-4.2)	--	(2.5-2.8)
Unemployment rate	9.0-9.1	8.5-8.7	7.8-8.2	6.8-7.7	5.2-6.0
Forecasts as at June 2011	(8.6-8.9)	(7.8-8.2)	(7.0-7.5)	--	(5.2-5.6)
Core PCE inflation	1.8-1.9	1.5-2.0	1.4-1.9	1.5-2.0	1.7-2.0
Forecasts as at June 2011	(1.5-1.8)	(1.4-2.0)	(1.4-2.0)	--	(1.4-2.0)

Source: US Federal Reserve

European Central Bank

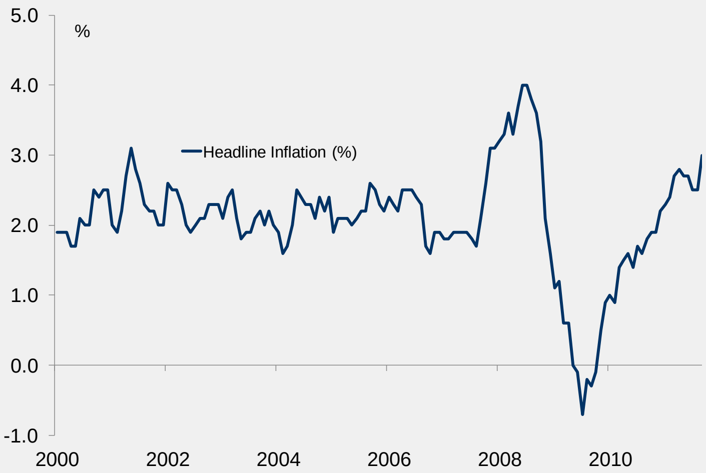
For the ECB, the 25bp easing in monetary policy to 1.25% clearly signals increased concerns that the ongoing financial market instability from the sovereign debt crisis is having a meaningful impact on economic activity. The expected economic slowdown is also likely to bring inflation down from its current elevated level of 3% to the 2% "target" in the year ahead.

As noted, a further 25bp easing to 1.0% should be expected when the ECB meets in early December.

In announcing the policy easing, ECB President Draghi stated that "the economic outlook continues to be subject to particularly high uncertainty and intensified downside risks. Some of these risks have been materialising, which makes a significant downward revision to forecasts and projections for average real GDP growth in 2012 very likely."

Perhaps also indicating that he is prepared to be more pre-emptive than his predecessor on monetary policy, Draghi also stated that "in such an environment, price, cost and wage pressures in the euro area should also moderate; today's decision takes this into account. Overall, it remains essential for monetary policy to maintain price stability over the medium term, thereby ensuring a firm anchoring of inflation expectations in the euro area in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Such anchoring is a prerequisite for monetary policy to make its contribution towards supporting economic growth and job creation in the euro area."

EU headline inflation



Source: Bloomberg. Data to 30 September 2011

In terms of the ECBs ongoing role in dealing with the sovereign debt crisis in the EU, the President indicated that the ECB would continue intervening in bond markets (via the SMP, securities market program) as and when required. He made the strong point, however, that the SMP had three key characteristics; it was "temporary, limited and justified in restoring the functioning of monetary transmission channels."

The President also made it clear, however, that it was not the ECBs role to act as a lender of last resort to sovereigns. Indeed he went so far as to ask the press the question "what makes you think that becoming the lender of last resort for governments is what you need to keep the euro region together? That is not really in the remit of the ECB. The remit of the ECB is maintaining price stability in the medium term."

In addition, in terms of financing for the banking system President Draghi stated that "the provision of liquidity and the allotment modes for refinancing operations will continue to ensure that euro area banks are not constrained on the liquidity side. All the non-standard monetary policy measures taken during the period of acute financial market tensions are, by construction, temporary in nature."

The RBA

As we noted earlier in the week, the RBA took a step towards returning monetary policy to a 'more neutral' policy setting this week by reducing the cash rate 25bp to 4.5%.

In announcing the easing the RBA noted that "with overall growth moderate, inflation now likely to be close to target and confidence subdued outside the resources sector, the Board concluded that a more neutral stance of monetary policy would now be consistent with achieving sustainable growth and 2%-3% inflation over time."

The big question is, therefore, what interest rate will constitute a "neutral" stance on monetary policy. It would be very unlikely for the RBA to consider that just one 25bp move was sufficient to achieve this goal and so a further 25bp easing to 4.25% should be expected in the months ahead – perhaps as early as the 6 December meeting.

Today the RBA released its quarterly *Statement on Monetary Policy*, noting that the outlook for the global economy had become much more uncertain, with risks to the downside, and that Australia's inflation outlook was now much more benign.

In terms of the global economy the RBA noted that the fiscal challenged being faced not just in the EU, but also in the US and Japan, "together with the ongoing consolidation of private-sector balance sheets following the financial crisis, mean that the outlook for growth in many advanced economies remains subdued."

In terms of the outlook for China, the RBA noted that "growth remains solid, although below the pace of 2010. This moderation in growth partly reflects a general tightening of macroeconomic policy over the past year or so in response to a pick-up in inflation in the region."

Importantly, the RBA's balance of risks seems to have tilted well to the downside, especially in relation to Europe, noting that "the Bank's central scenario for global growth over the next couple of years has been revised lower since the previous *Statement* to around 4 per cent. Around three-quarters of this growth is expected to come from the emerging and developing economies; in comparison, these economies accounted for less than half of global growth during the period from 1990 to 2005."

"The risks to this central scenario continue to be tilted to the downside, with a very disruptive outcome in Europe still possible. If such an outcome did occur, the world economy would be considerably weaker than the central scenario, notwithstanding the ability of policymakers in Asia to respond to a slowdown in their own economies."

On the domestic economy the RBA states that "the Australian economy is growing at a moderate pace, with conditions varying significantly across sectors. The terms of trade in the September quarter are estimated to have been at their highest level in at least 140 years, and this is boosting both national income and investment. The mining-related parts of the economy are growing strongly and are expected to continue to do so, notwithstanding the recent decline in commodity prices."

"In contrast, in a number of other industries, the high exchange rate, the fading injections from the earlier fiscal stimulus and changes in household spending and borrowing behaviour are contributing to subdued conditions. Domestic demand continues to grow at around average pace, though an increased share of demand is being met by imports due to the high exchange rate and the import-intensive nature of the mining investment."

Importantly, on inflation the RBA states that "the recent CPI data indicate a moderation in underlying inflation in the September quarter, after it had picked up in the first half of 2011. While the quarter-to-quarter movements in inflation need to be interpreted with care, this moderation is consistent with the softer growth in the non-mining economy and liaison reports that many firms feel that they have limited pricing power."

Given this global and domestic outlook the RBA has made some meaningful changes to their growth and inflation forecasts.

As shown in the table below, GDP growth at the end of 2011 is now forecast at 2.75% (previously 3.25%), before accelerating to 4.0% in mid-2012. Much of this change in forecast centres around a slower-than-expected recovery in coal product ion and exports out of Queensland after this summer's severe weather.

Out to 2013 economic growth is now forecast in a 3.0%-3.5% and then 3.0%-4.0% range, rather than the previous point forecast of 3.75%.

Given both the lower starting point and weaker growth profile, the RBA's inflation forecasts have been reduced. Headline inflation (ex the carbon price) is now forecast to drop from 3.25% at the end of 2011 to 2.0% by mid-2012 and then around 2.5%-3.0% out to the end of 2013.

The underlying inflation rate forecast has also been reduced, from 3.0%-3.25% previously, to 2.5% all the way out to mid-2013 and 2.5%-3.0% at year-end 2013.

This within target band inflation forecast clearly justifies the move to a 'neural' monetary policy setting for Australia.

Revised Australian forecasts

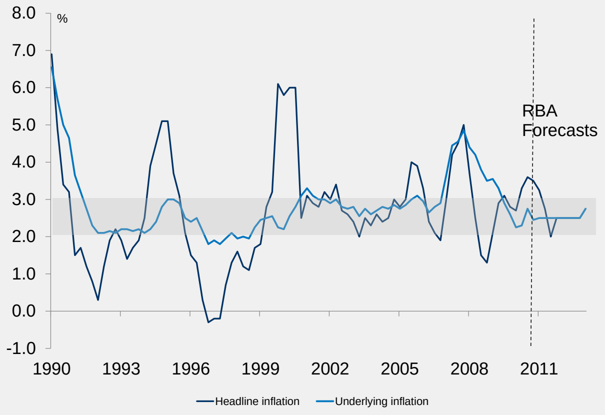
%/yr	Dec 11	June 12	Dec 12	June 13	Dec 13
GDP growth	2.75	4.0	3.0-3.5	3.0-3.5	3.0-4.0
Previous f/c	3.25	4.5	3.75	3.75	3.75
CPI inflation*	3.25	2.0	2.5	2.5	2.5-3.0
Previous f/c	3.5	2.5	3.0	3.0	3.25
Underlying inflation*	2.5	2.5	2.5	2.5	2.5-3.0
Previous f/c	3.25	3.0	3.0	3.0	3.25

*Excluding carbon price

Source: RBA November and August 2011 SMP

The following chart shows the past trend in inflation, both headline and underlying, as well as the new, within target, forecasts from the RBA.

Australian headline and underlying inflation



Source: ABS & RBA

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