

Factoring in the Central Bankers

We got a policy steer from all three leading central bank this week, with Alan Greenspan delivering testimony before the Senate Budget Committee, the ECB releasing its monthly bulletin and President Wim Duisenberg meeting with the European Parliament's Economic and Monetary Affairs Committee and the Bank of England releasing the minutes of its last monthly meeting.

The Fed....Greenspan Clarifies His Remarks

Alan Greenspan's comments in San Francisco on 11 January pushed long-term interest rates back down and deflated stock markets. The pessimistic tone of the speech caused markets to raise the odds of another rate cut at the Fed meeting on 29-30 January. Clearly this was not Mr. Greenspan's intention and he used last week's testimony as an opportunity to clarify his impression of the US economy. The change in tone was subtle. His belief that markets expectations of economic recovery are overdone "*created, unfortunately, phraseology which.... implied that I didn't think the economy was in the process of turning, and I tried to rectify that in today's remarks*". Despite this clarification, the rest of the message was unchanged. The economy still faces significant risks. The risks were clearly outlined.

1. The cessation of the inventory liquidation should have a significant impact on the economy. However, this impetus to activity will be short lived unless sustained growth of final demand kicks in.
2. Most recoveries from previous downturns received a boost from a rebound in demand for consumer durables and the housing market. Throughout most of last year's slowdown, the housing market and the consumer remained resilient. Therefore, while household spending could continue to trend upwards, the potential for significant acceleration is limited.
3. Low mortgage rates have provided considerable support to home building and have boosted sales of existing homes. Refinancing has also supported consumer spending. This impact has likely dropped following the back-up in long term interest rates that we have seen since November.
4. Consumer spending has been boosted by lower energy prices. To have a persistent effect on disposable income, energy prices will need to continue to fall. Future prices do not suggest such a decline is imminent.
5. Stock markets have retraced a portion of their earlier losses but the impact of the steep decline in values since March 2000 may not be fully in place.
6. The rate of job losses has abated but the unemployment rate could continue to rise for some time, dampening consumer spending. The extent of such restraint will depend on how much the rise in unemployment is the result of weakened demand and how much reflects strengthened productivity.
7. The retrenchment in capital spending over the past year was central to the sharp slowdown in the economy as a whole. These cutbacks interacted with, and were reinforced by, falling profits and equity prices. Profit margins are still under pressure.

If the recent evidence of more favourable economic conditions continues and gathers momentum, these uncertainties will diminish but it is still too early to say that the forces restraining growth have abated enough to allow a steady recovery to take hold. The chances of a rate cut this week have reduced significantly but the Fed will retain its easing bias and the option to cut again if conditions warrant it. To remove its easing bias now could result in a further increase in long-term rates, something the Fed will not want to do.



The ECB.....The Return of M3

We still believe that the ECB has scope to cut interest rates again but we may have to wait until Q2 before any change is made. The tone of Wim Duisenberg's address to the European Parliament's Economic and Monetary Affairs Committee and the central bank's latest monthly bulletin (released on 24 Jan) suggest, at best, that rates will remain on hold for some time to come.

After months of telling markets to ignore M3 money supply data because it was misleading, it is back now firmly back on the agenda. At an annual rate of 8.0% in November, growth in M3 is almost double the ECB's reference rate. According to the ECB, the recent build up of liquidity, if not reversed, will call for a thorough analysis of monetary developments, in particular when the eurozone economy recovers. The resurrection of M3 begs the question, is the ECB looking for reasons not to ease. Upcoming M3 figures, as well as euro changeover related increases in inflation are likely to argue for steady policy in February and again in March. However, there should still be room for maneuver thereafter. M3 is unlikely to fall back to the ECB's 4.5% reference rate any time soon but inflation should fall substantially below its current 2.1%, setting the stage for further easing.

The BoE.....Poised to Move in Either Direction.

The minutes of the last BoE policy meeting may have showed that the central bank was unanimous in its decision to keep the base rate at 4.0% but they also show a bank poised to move in either direction should conditions warrant it. The direction of policy will depend on the speed and extent of a recovery in the U.S. and on whether domestic demand will moderate and by how much. "There would be a case for a further reduction in interest rates if it was thought likely that consumption would slow before the world economy revived," said the minutes. Alternatively, it is "possible that consumption would not slow enough or sharply enough. In that case a rise in interest rates would be required to keep inflation on track." On balance, the MPC took the softer route, noting that there is a "reasonable prospect" that domestic consumption will moderate of its own accord broadly at the same time the world economy recovers.

The MPC said that there had been a number of "unexpectedly positive indicators from the U.S." in the period running up to the January meeting but the likelihood was that the first half of 2002 would see continued weak global activity. As a rapid recovery later in the year was not yet assured the BoE concluded that the best course of action was to do nothing in January. Waiting for more information on annual wage rounds and further analysis in the Quarterly Inflation Report due out in February would allow a more informed decision.

UK rates are likely to remain on hold for the coming months but once the global recovery takes hold the BoE should move on a tightening mode and the BoE is likely to be the first major central bank to raise rates. However, a combination of a below target inflation rate, a higher unemployment rate and a moderation in consumer spending (though not too rapid as lower interest rates continue to support the appetite for credit) should argue against overly aggressive tightening.

Geraldine Concagh
25 January 2002

