What are central banks doing?

Contact:
Madan Sabnavis
Chief Economist
madan.sabnavis@careratings.com
91-22-6754489

Dr. Rucha Ranadive
Associate Economist
rucha.ranadive@careratings.com
91-22-67543531

Mradul Mishra (Media Contact)
mradul.mishra@careratings.com
91-22-67543515

Four major central banks have taken a call in the last week or so on interest rates based on their perception of the way in which their economies are shaping as well as their expectations on both growth and inflation in the coming years. Three of the four central banks left interest rates unchanged, while the Bank of England (BoE) has increased lending rates. The European Central Bank (ECB) promises to be accommodative until such time that the economy is in a takeoff state, while the Federal Reserve is ready to increase rates only when required. Bank of Japan on the other hand also has indicated that accommodation is the way forward.

A. Status quo by Federal Reserve

The basic premise is that the labor market has continued to strengthen and economic activity has been rising at a solid pace despite hurricane-related disruptions. Although the hurricanes caused a drop in payroll employment in September, the unemployment rate declined further. Add to this, household spending has been expanding at a moderate rate, which is positive for the economy. Finally, growth in business fixed investment has picked up in recent quarters.

On inflation the view is that gasoline prices have risen in the aftermath of the hurricanes boosting overall inflation in September. However, inflation for items other than food and energy remained soft. On a 12-month basis, both inflation measures have declined this year and are running below 2%.

It is believed that hurricane-related disruptions and rebuilding will continue to affect economic activity, employment, and inflation in the near term, but not alter the course of the national economy over the medium term. Therefore, it is expected that with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will strengthen somewhat further.

The Federal Open Market Committee (FOMC) decided to maintain the target range for the federal funds rate at 1 to 1-1/4%. The stance of monetary policy would continue to be accommodative, thereby, supporting some further strengthening in labor market conditions and a sustained return to 2% inflation.

B. How about the ECB?

The view taken is to keep the key ECB interest rates at their present levels for an extended period of time and well past the horizon of the net asset purchase programme. The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25% and -0.40% respectively.

Additionally,
- The non-standard monetary policy measures would be persevered with. Purchases under the asset purchase programme (APP) will continue at the current monthly pace of €60 billion until the end of December 2017. From January 2018 the net asset purchases are intended to continue at a monthly pace of €30 billion until the end of September 2018, or beyond, if necessary.
- In case the outlook becomes less favourable the ECB will increase the APP in terms of size and/or duration.
- The Euro system will reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of its net asset purchases, and in any case for as long as necessary. This will contribute both to favourable liquidity conditions and to an appropriate monetary policy stance. Such a rollover will also mean that the support will be from existing funds and hence not entail creation of fresh currency.

C. Bank of Japan: Not really different

The Bank of Japan will continue to apply a negative interest rate of minus 0.1% percent to the Policy-Rate Balances in current accounts held by financial institutions at the Bank. Some other noteworthy takeaways:
- The Bank will purchase Japanese government bonds (JGBs) so that 10-year JGB yields will remain at around zero percent.
- The Bank will conduct purchases at more or less the current pace - an annual increase in the amount outstanding of its JGB holdings of about 80 trillion yen which will help to achieve the target level of the long-term interest rate specified by the guideline.

How about asset purchases other than JGB purchases?
- The Bank will purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase at annual paces of about 6 trillion yen and about 90 billion yen respectively.
- As for commercial paper (CP) and corporate bonds, the Bank will maintain their amounts outstanding at about 2.2 trillion yen and about 3.2 trillion yen respectively.

D. Bank of England- it is different here

The MPC of Bank of England voted to increase Bank Rate by 0.25% to 0.5%. Additionally, the Bank decided to maintain:
- The stock of sterling non-financial investment-grade corporate bond purchases financed by the issuance of central bank reserves at £ 10 billion.
- The stock of UK government bond purchases financed by the issuance of central bank reserves at £ 435 billion.

The view on the economy is as follows.
- GDP grows modestly over the next few years at a pace just above its reduced rate of potential.
- Consumption growth remains sluggish in the near term before rising in line with household incomes.
- Net trade is bolstered by the strong global expansion and the past depreciation of sterling.

- Business investment will be affected by uncertainties around Brexit but will grow at a moderate pace supported by strong global demand, high profitability, low cost of capital and limited spare capacity.

What about inflation?

Inflation will peak above 3% in October, as the past depreciation of sterling and recent increases in energy prices continue to pass through to consumer prices. The effects of rising import prices on inflation diminish over the next few years, and domestic inflationary pressures gradually pick up as spare capacity is absorbed and wage growth recovers. On balance, inflation is expected to fall back over the next year and, conditioned on the gently rising path of Bank Rate implied by current market yields, to approach the 2% target by the end of the forecast period. Therefore, the Bank expects inflation to shift from being a cost-push phenomenon to a demand pull one once consumption and investment pick up.

How do these economies look?

The table below provides some data on various economic indicators of these 4 economies.

%	USA	Euro region	Japan	UK
GDP	2.2	2.1	1.5	1.5
Unemployment	4.2	9.1	2.8	4.3
Inflation	2.0	1.5	0.5	2.7
Fiscal deficit	-3.4	-1.3	-4.5	-3.3
CAD	-2.5	3.1	3.6	-3.6
10-years rate	2.41	0.48	0.07	1.35

Source: Economist
Forecasts are for GDP, inflation, fiscal, CAD for2017, Unemployment, 10 year GSec prices are latest

In terms of growth all the countries appear to be on course to recovery albeit at differing pace. Unemployment is high in the euro area which is more country-specific in nature. The 2% inflation mark will be observed closely by the Fed as well as BOE as the target rates are ingredients in monetary policy formulation. Budgetary deficits are on the higher side for all countries except the euro region, where several countries had to go in for fiscal austerity in the aftermath of the sovereign debt crisis post 2010.

Does this matter for India?

Monetary policy in India will be driven by domestic inflationary considerations, which the MPC is monitoring and analyzing on a real time basis. Therefore, the basic thrust factor would be outside the perimeter of these actions by global central banks. This said, such developments are important in terms of:

- Affecting global currencies and hence the rupee-dollar rate. This in turn will have an impact on the trade balance as well as imported inflation especially if oil prices continue to increase.
- Higher interest rates overseas tend to skew investment decisions of FPIs which could impact such flows and hence balance of payments.
- Higher global rates would also make overseas borrowing less attractive; and as it goes with currency depreciation, will increase forward cover too.

- At a very macro level, higher interest rates in the US or UK would also indicate that there is an economic recovery, which will augur well for exports.