

G3 Monetary Policy: Where Do We Go From Here?

With the possibility of coordinated tightening among the US, European and Japanese central banks on the horizon, monetary policy is at the forefront of market concerns. We discuss the outlook for monetary policy and the implications for global asset markets, particularly the risky markets that have recently been under pressure.

Sandra Lawson (Moderator): With the possibility of coordinated tightening among the three major central banks on the horizon, monetary policy is at the forefront of market concerns. We'd like to discuss the outlook for monetary policy and the implications for global asset markets, particularly the risky markets that have been under pressure in recent weeks. Tetsu, why don't you start by discussing the Bank of Japan's decision last week to end quantitative easing?

Tetsufumi Yamakawa (Japan): The BoJ's new policy has two features which may look incompatible. On the one hand, the end of quantitative easing is obviously a tightening measure. On the other hand, policy is easing in the near term because the BoJ has made clear that it plans to keep policy rates in the neighbourhood of zero. This means that as Japan emerges from a depression, it will have negative real rates, and financial conditions—which are already quite easy compared to other major countries—should ease further, at least unless the yen strengthens significantly.

Negative real rates will have an enormous impact, and not just in boosting nominal GDP growth. Easier financial conditions will boost the money supply, which will encourage banks to accelerate lending to the corporate sector. Easy financial conditions will also boost equity and property prices, and this in turn will push consumption higher.

In this way the BoJ's policy of staying behind the curve is something of a double-edged sword. A prolonged period of near-zero policy rates could ultimately create a bubble like the one Japan experienced in the late 1980s.

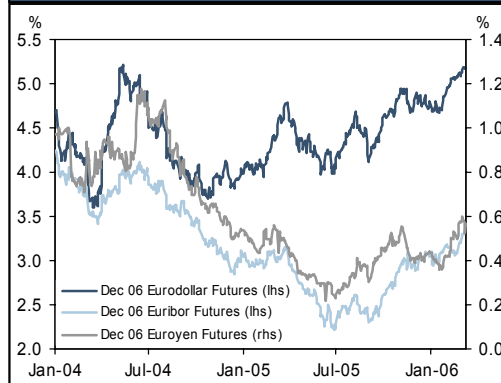
The fact that the BoJ introduced a form of inflation targeting also creates a further potential dilemma. This isn't really inflation targeting, it's more an inflation reference range, of 0%-2% with a midpoint of 1%. Although this wide band does give the BoJ flexibility in conducting policy, we could

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Roundtable Participants

- Jim O'Neill**, Head of Global Economic Research
- Francesco Garzarelli**, Co-Director of Global Macro & Markets Research
- Jan Hatzius**, Chief US Economist
- Erik Nielsen**, Chief European Economist
- Dominic Wilson**, Co-Director of Global Macro & Markets Research
- Tetsu Yamakawa**, Co-Director of Asia Economic Research
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Implied Rate Expectations on the Rise Across the G3



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imagine a situation in which property prices started increasing sharply, while core CPI stayed stable and under 1%. In that case, the BoJ would need to act, and it might raise rates at a much faster pace than the market is pricing in.

The BoJ appears to be focused on eliminating all sources of potential risks to the recovery. As far as I understand, this policy has a lot of similarities with US monetary policy from 2002-2004, when the Fed tried to keep policy rates as low and as stable as possible.

SL: Turning to the US, what parallels would you draw between the BoJ's position and the Fed's situation a few years ago, when its own easing policy began to fuel asset price growth? Can the BoJ take lessons from the Fed in how to avoid the risks of a bubble?

Jan Hatzius (US): Historically, of all of the G3 central banks, the Fed has put the least weight on bubble issues for their own sake. The Fed does put a lot of weight on asset prices in the transmission of monetary policy, which is why we stress the importance of financial conditions. But the Fed takes, in some ways, the most pragmatic attitude in focusing on the near-term implications of asset markets for the growth and inflation outlook. It does not spend much time agonising over what might happen three, four or five years down the road with potential asset price overshoot.

So if the Fed faced a similar situation to Japan—where there seems to be a lot of slack and inflation is still very low, but where concerns are emerging about a bubble in some asset markets—the Fed would err on the

Our Forecasts Are Slightly Below Market Views Across the G3							
3mth Rates	Current*	3-Month Horizon		6-Month Horizon		12-Month Horizon	
		Forward	Forecast	Forward	Forecast	Forward	Forecast
Euroland	2.7	3.0	3.0	3.2	3.2	3.4	3.2
USA	4.9	5.1	5.1	5.2	5.0	5.0	4.5
Japan	0.1	0.2	0.2	0.4	0.2	0.9	0.5

*Close 14 March 2006.

side of staying behind the curve for a fairly long period before worrying about the longer-term issues.

Francesco Garzarelli (Global Markets): I am puzzled as to why we should be reading the end of quantitative easing as a bearish signal for asset markets. After all, the BoJ is acknowledging that strong growth is sustainable and that deflationary pressures are coming to an end. And the fact that it has moved from targeting a *quantity* of money to targeting a *price* of money suggests that there will be more uncertainty and volatility than before. This should require a higher premium, and I would expect to see it reflected in the intermediate- to long-ends of yield curves internationally.

TY: The impact on the market is likely to be mixed. The BoJ is reassuring the market that it will remain near zero for a considerable period. But it is also trying to encourage the market to accept higher inflation in the future. I think there is a tug of war situation here, as the steepening bias induced by the negative real rates is in conflict with the ultimate flattening implied by the long-term normalization.

Jim O'Neill (Head of Global Economics): I agree with Tetsu more than with Francesco on the implications for the yield curve. However, going from a quantity target to a price target does add an element of uncertainty that the BoJ itself can't really know about. It will take some

time to digest, because how do they know what's going to be required to keep zero rates?

One of the more subtle issues relates to the reason why it's an inflation range rather than an inflation target. This, I guess, is because they have no confidence in the size of the output gap. One of the great complications could be that the output potential hasn't in fact changed much. If that were true, and if inflation started to rise more than we are forecasting, that might lead to a mini panic.

TY: That's possible. Many people still expect that the momentum in CPI will fade in the second half, and so our forecasts are already higher than the market's. But the risk of higher inflation definitely exists. With so much liquidity already in the system, the output gap might in fact be much smaller than the BoJ estimates. Conventional estimates suggest that a sizeable output gap still exists, but some measures of labor and capacity do already imply shortage rather than excess.

Is Risky Asset Outperformance Coming to an End?

SL: Risky assets have been under a lot of pressure in recent days, and the 'easy' carry trades that have fuelled a lot of this investment are not looking so easy any more. Is the BoJ's move the end of the story for some of these trades?

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Dominic Wilson (Global Macro): Obviously the Japan issue is crystallising some of these concerns. The broader fear outside fixed income markets is whether tightening—perhaps co-ordinated tightening across the major regions—will change the environment for a lot of the risky asset trends that have been in place.

We know that co-ordinated tightening is pretty unusual—except for a month or two in 2000, you have to go back to the early 1980s to see it. Generally, we think the market is overly concerned about the outlook today. I see three reasons to think that risky trades can continue to perform.

The first is that real rates will remain pretty low, and we don't expect simultaneous tightening by the G3 central banks. Instead we see a hand-off from the US to Japan and Europe. This may be a big story for FX markets, but it probably isn't for global financial conditions.

The second reason is that activity trumps liquidity in a lot of markets. Rates are rising largely as a consequence of good growth, and that is pretty normal. You generally see rates rise and yields rise when the cycle picks up and you generally see risky assets outperform at the same time. I think markets are probably underestimating how the strong growth is underpinning these performance trends.

Finally, it looks as if the deeper structural stories and the adjustment and imbalances that need to be resolved over the next couple of years still point to outperformance, particularly in emerging market equities and currencies. It seems the market is going to need to digest these policy shifts, and that will remain a feature of the volatility of some of these risky asset trades over the next 12-18 months. We're pretty firmly in the camp that says that a lot of the risky asset trades are going to remain intact.

JO'N: A lot of people are approaching asset class risk as though the experience of the past 25 years is the only guide—and that it's a reliable guide. I think that's just wrong. Even if all three major central banks do tighten at the same time, it's not necessarily bearish for a number of asset classes, particularly BRICS-related emerging markets. Not least because these countries are accumulating massive current account surpluses, which accounts for much of the global liquidity sloshing around. And it's clear that asset allocation from elsewhere into emerging markets is taking place.

Erik Nielsen (Europe): The fact that a few days of serious downdraft in the Turkish stock market was reversed by the news out of Japan tells me, at least, that the driving forces behind these trades are not dedicated emerging markets investors. These are global investors.

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FG: One of the peculiar features of this equity market rally, since the trough, has been the lack of compression in the equity risk premium. At the same time, we have seen the outperformance of everything that has yield value rather than growth value. This has been the case in numerous asset classes, whether FX or equities or bonds, etc.

Now, as global monetary policies start to shift, two things may happen. First, people will recognize that the BoJ and ECB are moving because growth is in place, and that higher rates are a symptom of the greater confidence in the expansion. The high ERP will underpin stocks. And second, assets that have outperformed, mostly because of their running yield, will start to suffer from the competition of higher risk-free rates. We should see more differentiation between trades that have a carry allure and trades that instead have a globalization tilt.

DW: I agree and I think the point about differentiation is important. The issue that the market sometimes skips over, because we've become so used to this environment of very low real rates, is that there's nothing particularly odd in seeing risky assets outperform in an up cycle. As long as the rate cycles are being driven by signs of stronger-than-expected growth, rather than by fear of inflation, that's still a pretty constructive environment to be in.

FG: The risk then would be an inflation shock, perhaps out of Asia, perhaps due to Japan's lack of output gap. Evidence of this might make people fearful that central banks had waited too long, were too far behind

the curve and would need to engineer a big shock to rein in inflation.

JH: Yes, that would be a risk in the US. Let's say you had a big decline in the unemployment rate; the economy stayed stronger than we expect for a few more quarters; the unemployment rate went to 4%; the wage inflation and maybe even core price inflation data deteriorated a lot; and the Fed did have to raise rates substantially beyond 5%, that would be the risk.

We're pretty comfortable with our forecasts, and we're not close to changing our 5% target for the Fed. We think the first-quarter strength is going to moderate as the year progresses, as we lose the rebound from Katrina and the boosts from the warm weather and the inventory cycle.

Even apart from the housing slowdown, there are a lot of reasons to think that the economy is going to look much less buoyant six or even four months from now. But if we did have stronger growth and a longer US rate cycle, then the world would be looking at something much closer to coordinated tightening.

JO'N: In some ways the big surprise of the year so far is the European data. We need to watch what's coming out of the ECB—if they plan to normalize, and quickly, that may be the most interesting aspect of G3 monetary policy issues going forward.

EN: European growth looks really robust, and that gives the ECB the chance of normalizing rates. It seems very clear that the hawks among the ECB have the upper hand, meaning that normalization is going to happen. In fact it may happen even if growth weakens from current levels. The

hawks have plenty of arguments to support their position: they are worried about money and credit growth, about abnormally low interest rates, about financial conditions. They can also take comfort in the fact that rates have risen elsewhere, including in the US, without having any real negative impact on the economy.

There are political issues about how to tighten if inflation is not really turning up in the data, but the hawks do feel they have sufficient arguments on their side. At the moment, I think the risk is certainly skewed more towards rates being higher than our 3% year-end forecast than to rates being lower.

JO'N: I'd echo Dominic's point on the global environment. Rising interest rates will mean different things depending on the circumstances of world growth. In virtually all regions of the world, with one or two modest exceptions, perhaps, it feels to us that the growth risks in the foreseeable future are on the upside. Tighter monetary policy is happening against the background of an extraordinarily strong world economy. If it weren't then I would have a lot more concerns myself. ■

Emerging Markets Tend to Outperform When Tightening Is Driven by Healthy Growth

