

# The monetary policy conundrum

Growth in the near future is likely to depend on domestic demand in the developing world, rather than on the traditional consuming western economies, argues **Peter Hensman**.

**M**arket chatter about exit strategies from the ultra-loose monetary policy continues to heighten. Nouriel Roubini, the market commentator known by the epithet of Dr. Doom, wrote in the *Financial Times* about the dangers of the current policy setting warning that “one day this bubble will burst, leading to the biggest coordinated bust ever”. Despite the Reserve Bank in Australia raising interest rates for a second month and this move being joined by the Norges Bank that set out a similar justification for normalisation of rates, the bias amongst policymakers is towards maintaining policy support.

This absence of any hurry to reverse policy conditions remains clearest in the US. Despite the apparent sop to the hawks as the Fed included the requirement that policy conditions will only remain loose if the inflation trend (core inflation) and inflation expectations remain low, the primary duty of the Fed is the maintenance of the maximum level of employment consistent with stable prices. The November policy statement also reiterated that the current low rates of resource utilisation were another factor behind the low Fed target rate. With unemployment breaching 10 per cent for the first time since 1983 and the more upbeat economy assessment in the Fed's Beige Book that “virtually every reference to improvement was qualified as either small or scattered”, there is unlikely to be a rush to tighten policy.

Two further factors could weigh on the Federal Reserve's decision. First is the pressure from politicians to reduce the range of responsibilities managed by the Fed. The Fed is unlikely to want to increase the ire of politicians by tightening policy so early in the economic recovery. Second, there is the fragility of the financial system and housing market. Concerns at the start of November that the tax credits available to first-time homebuyers might not be extended

contributed to a sharp drop in applications for home mortgages to the lowest level since 1997. If nothing else, this suggests that the stabilisation in the housing market over the summer months was heavily reliant on strong affordability. With mortgage spreads over Treasuries already at historic lows, anything that causes 30-year Treasury yields to rise can be expected to have a similar impact on mortgage rates. Allowing market interest rate expectations to build is unlikely to be helpful to the housing market. With Fannie Mae reporting its ninth consecutive quarterly loss in the third quarter and requiring a further US\$15 billion capital injection to prevent its net worth from falling below zero, the risks to tightening policy too soon seem substantial.

The case that central banks that tighten policy are going to remain the exception, rather than the norm, continues to mount. The Bank of Canada went so far as to suggest that the strength of the Canadian dollar was a reason to believe that future growth and inflation prospects were likely to be softer than would otherwise be the case and hence justified the low interest rate stance. The discomfort felt by those who are seeing local currencies appreciate is rising. The Bank of Israel that was first to increase interest rates in August announced that it had been intervening to prevent the shekel from rising in value too quickly, as capital has been attracted by the better performance of the economy and local markets. Similarly, Brazil reintroduced a tax on international inflows of foreign exchange and Taiwan has placed a ban on foreigners holding time deposits, both in an attempt to moderate some of the factors driving the currency higher. Even the new government in Japan has stepped back from the stance originally stated where it appeared unconcerned by yen strength.

These attempts by governments to avoid their economies being placed at too great a disadvantage in rounds of competitive

devaluations is arguably a factor behind the strength of gold in recent months. The attraction of gold as a store of value in an environment was perhaps underlined by the purchase of 200 tonnes of gold from the International Monetary Fund by India. According to the *Financial Times*, while India has held 20 per cent of currency reserves in gold, this percentage has fallen to below four per cent in recent times. In addition, the central bank in Sri Lanka bought a more modest amount of gold this month, but neatly justified the purchase on the grounds of the “huge currency volatility during the time of crisis” that contributed to a desire to “save in something more solid”.

Despite the rebound in US economic activity in the third quarter, GDP increased at a 3.5 per cent quarter-on-quarter annualised pace, the first rise in activity since the second quarter of 2008 and a positive indication from inventories where the pace of inventory reduction reduced. If this trend continues and companies return to rebuilding inventories, there will be the scope to make a positive contribution to activity for several quarters.

It is the developing world that continues to show a better response to the policy stimulus. One example is that the urban unemployment rate in Brazil is below the unemployment rate in the US for the first time since the 1980s – a marked contrast to the late 1990s, when the unemployment rate in Brazil was more than twice that in the US for long periods.<sup>1</sup> As similar examples are repeated across the world and policy struggles to gain traction in the developed world, it seems likely that growth will continue to rebalance away from its reliance on consumption economies like the US and the UK toward domestic demand in the developing world.

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