BUSINESS

BANKING ON KNOWLEDGE

Divergent monetary policies on account of uneven economic recovery

By Dr R Seetharaman

The European Central Bank last week announced further measures to stimulate the eurozone economy after it revised downwards its inflation projections. It expects 1% in 2016 and 1.6% in 2017. Policymakers cut a key interest rate to a historic low of minus 0.3% and pledged to buy more assets with the proceeds of its existing bond purchases. The ECB pledged to continue its €60bn-a-month bond buying programme until March 2017 "or beyond". However the markets were generally disappointed by lack of more stimulus measures as they had hoped for deeper rate cuts and more monthly bond purchases.

US Federal Reserve Chairwoman, Janet Yellen stated last week that Fed interest rate increases will come slowly in the months ahead amid tepid growth overseas and divergent monetary policies between the US and other nations. She is ready to raise rates at the Fed's policy meeting this month as the domestic economy is improving, which is also affirmed by the latest job data. The US Department of Labor announced last Friday that the economy added 211,000 jobs in November, slightly better than expectations, with the unemployment rate remaining steady at 5%. The addition of 211,000 jobs likely paves the way for a rate hike later this month. Employers have added a robust average of 237,000 jobs a month over the past 12 months.

In November this year, the Bank of Japan (BoJ) reiterated its pledge to increase base money, at the central bank, at an annual pace of ¥80tn through purchases of government bonds and risky assets after Japan's gross domestic product shrank an annualised 0.8 % in the third quarter, following a revised 0.7 % decline in the second quarter. The BoJ has kept monetary policy steady since expanding stimulus in October last year, even as slumping oil prices and weak exports push inflation further away from its target. In October, inflation rose 0.3 %. Japan should keep stimulating its economy until it is overheated to a point that the inflation rate is higher than desired.

Banker's Take

The UK's inflation rate as measured by the Consumer Prices Index remained at -0.1% in October 2015. The Bank of England said earlier that the global economy was weakening, depressing inflation risks. The bank said that inflation was unlikely to rise to 1% until the second half of next year.

The Reserve Bank of India has kept the key repo rate unchanged at 6.75% in its fifth bi-monthly monetary policy review. The cash reserve ratio (CRR) has also been unchanged at 4%. India's consumer price inflation was at 5% in October.

In October, China stepped up monetary easing with its sixth interest-rate cut in a year to combat deflationary pressures and a slowing economy, moving ahead of anticipated fresh stimulus by central banks from Europe to Japan and possible tightening in the US.

The Central Bank of Brazil kept its key interest rate on hold for the third consecutive meeting at 14.25% last month, the highest in nine years, as policymakers struggle to curb rising inflation amid economic contraction. Brazil is experiencing its worst recession in decades and previous rate hikes have not prevented a rise in inflation, which in October reached a 12-year high of 9.93%.

The Bank of Russia left its key one-week repo rate on hold at 11% in October, saying the balance between inflation risks and weak growth remains unchanged. Yet, policymakers signalled they would lower rates in the next meetings if the inflation rate keeps slowing.

We have seen that the monetary easing by the ECB was below expectations and the indications are that rate hike by the Fed is going to happen in a phased manner, which could change depending on progress in economic developments. As Europe and Japan continue with their easing, after the Fed next may be the BoE to begin its monetary tightening.

The central banks in emerging economies will continue to watch the cross border flows on account of the actions of the central banks of advanced economies and factor them in their decision making. The financial markets have witnessed significant volatility in the last couple of days as we are going to witness diverging monetary policies between the Fed and ECB. The uneven economic recovery in advanced economies will further contribute to the divergence in monetary policies and hence financial markets should gear up for this.

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