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Fed decision: two expected, one surprise

- **Fed decision to taper and to move the unemployment goalposts were broadly expected**
- **Eric Rosengren's dissent was not and is potentially significant**
- **Diverging broad money growth meant diverging activity in 2013; more of this in 2014**

Yesterday's FOMC decision and statement contained two expected developments; and one surprise. The expected developments were the decision to begin to taper QE from January 2014; and the notice that interest rates would remain unchanged even after unemployment has fallen below the previous 6½% threshold. The fact that no new unemployment threshold was given, can be due to two factors: First, to give the Fed increased flexibility instead of tying policy to a number – a (welcome) retreat from ever-more detailed and thus ever-more confusing forward guidance. Second, it probably also indicates uncertainty and an internal Fed debate about exactly where the US natural rate of unemployment currently is.

The surprise was the dissent by Eric Rosengren, President of the Federal Reserve Bank of Boston, who felt that the decision to taper was premature. The surprise was not so much Mr Rosengren's views, which are well-known; but, rather that this was the first time since December 2011 that a dove has dissented from the majority. The implication is that there remains substantial opposition within the FOMC to the taper decision. It is a signal that markets cannot take for granted that QE taper now is a one-way street. Economic developments argue that it should be; but the Fed clearly remains prepared to reverse QE cuts if data so argue.

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The rest of this comment is an end-year round-up and analysis of broad money trends in the key world economies and what they mean for 2014.

The performance of the major world economies diverged substantially in the second half of 2013. US and UK output growth was stronger than expected. By contrast, the Eurozone's performance disappointed. In China, the 7.5% growth target for the year looks like being within reach; while Japanese activity has been less strong than expected, if better than in 2012.

Diverging growth was signalled earlier on by diverging broad money trends. In turn, these were partly the result of different monetary policies. The Federal Reserve maintained and the Bank of Japan expanded their respective versions of quantitative easing. The Bank of England's equivalent, the Asset Purchase Program, came to an end but the Bank tried to reassure markets through its new forward guidance policy. The ECB finally moved to further easing; while the Peoples' Bank of China tried, with limited success to dampen the growth of broad money.

Recent broad money developments imply that this divergence will not only continue but widen in 2014. That also points to monetary policy actions diverging for the first time in years.

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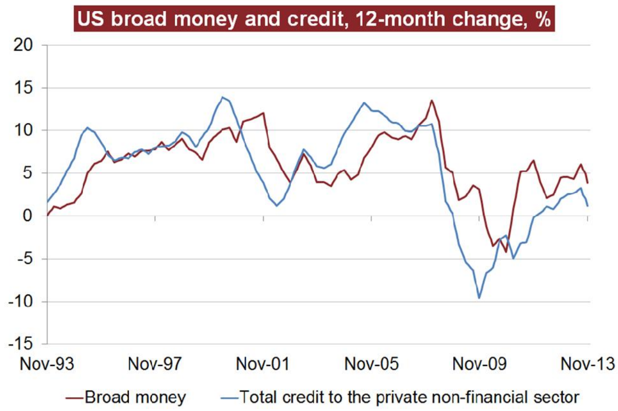
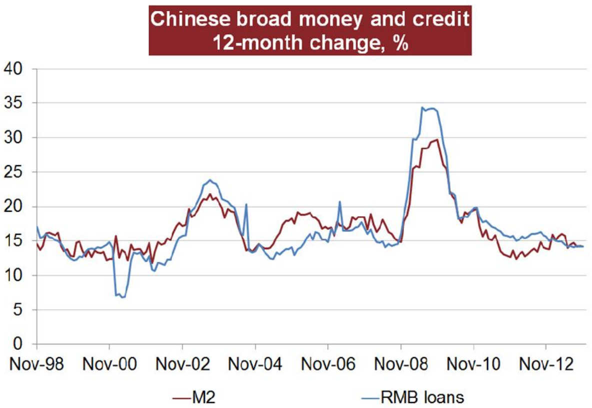
US broad money growth has held up reasonably well over the past year, generally oscillating around 5%.[1] Assuming a US trend real growth rate of 2-2½%, an inflation target of 2% and a long-term decline in the velocity of money of somewhat more than ½%, 5% annual broad money growth is barely consistent with medium-term trend rate GDP growth. Over the longer term, broad money growth should ideally be stable at between – say – 4% and 6%. However, the US economy is still exiting from a deep crisis; in Q3 the level of real GDP was 5.5% above its Q4 2007 pre-crisis peak. If GDP had grown at 2½% every quarter since (arguably, still a below-trend rate, given that trend growth in the early 2000s was estimated at 2½-3%), it would today be 15% above its level in Q4 2007 and close to 9% above its current level. It would therefore be better if US broad money growth were stronger than 5%, perhaps in the 7-10% range for the next six to twelve months.





However, the outlook for US broad money growth is currently muddied by issues related to the Fed's tapering of its quantitative easing. On the one hand, recent credit data show that American households are taking on more debt, including some remortgaging loans to take advantage of higher house prices (ie, mortgage equity withdrawal, covered in a previous Comment). As against that, banks are being constrained by regulatory insistence on holding fewer risk assets. Banks have been able to expand their balance sheets (ie, grow credit and broad money) by amassing large amounts of cash. However, if the Federal Reserve begins to taper, that turns off the cash tap for banks. Which of these two forces is the strongest is the key to the outlook for the US economy in 2014. While this is difficult to judge, recent non-monetary data has generally been stronger than expected, implying that, although growth in the current quarter is likely to be weaker than it was in Q3, US economic activity should improve further in 2014.

In contrast with the US, the Chinese authorities have attempted to dampen broad money and credit growth in 2014. This has at best met with limited success. The Peoples' Bank of China has a 13% target

[1] Broad money refers to Stein Brothers' recreation of the broad money measure M3 that the Federal Reserve ceased to publish in March 2006.

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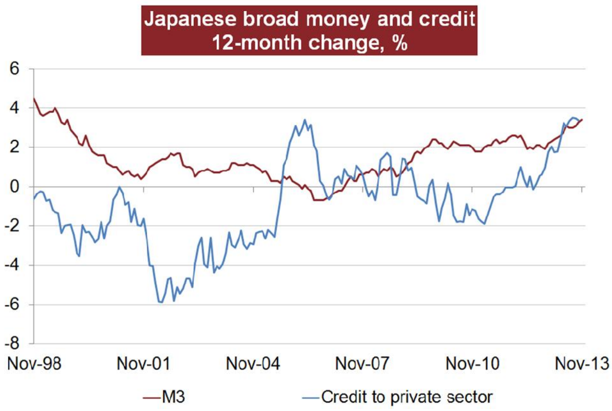
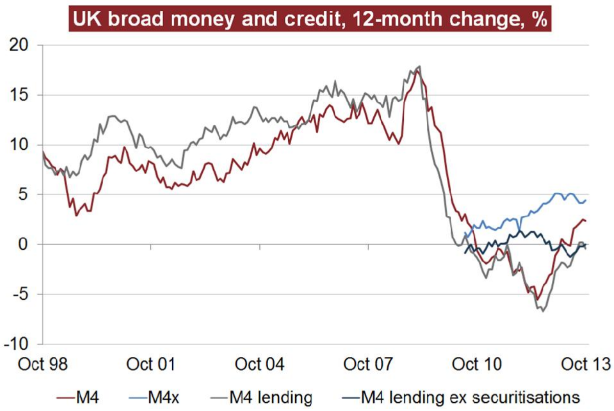
for M2 growth in 2013, down from 14% in 2012. In 2012, M2 growth averaged 13.5%, and ended the year at 13.8%. By contrast, in 2013, the average 12-month growth rate over the period January-November was 15%; while November M2 was up 14.2% on a year earlier. It therefore looks likely that broad money growth for the whole year will overshoot the central bank's target. The overshoot is not particularly large – around 1% – but what is significant is that it occurs at all and that money and credit growth accelerated in 2013 instead of the intended continued slight easing.

The current 13-15% broad money growth is slower than average of the pre-crisis 2000s, when it exceeded 16%. However, it is probably enough to be consistent with the likely 7% GDP growth target for 2014, which is also probably China's current trend growth rate. While China has a medium- and long-term growth issue related to the economic reforms the leadership is trying to implement, the near-term outlook is still looking relatively positive. In a recovering world economy, China too will benefit.





The UK and Japan both resemble the US more than China. That is to say, broad money growth is healthy but should ideally be somewhat stronger. Nevertheless, in both countries, broad money growth is ending 2013 on a reasonable note, implying that economic activity will strengthen in 2014.

Even though the main thrust of Japan's 'qualitative and quantitative easing' has been aimed at boosting the monetary base, broad money growth has benefited somewhat. M3 grew by 3.4% in the year to November, the fastest rate since August 1999, primarily sustained by credit growth. M3 growth has been above 3% since last May. This should be enough to power Japanese growth at trend (estimated at around 1%); the problem for Japan is that it needs growth above trend in order to ignite inflationary pressures. The downward revision of Q3 growth from 1.9% to 1.1% implies that the Japanese economy has yet to achieve 'escape velocity'. In the absence of stronger growth, the weak yen becomes crucial to achieving the Bank of Japan's 2% inflation target for 2015.

UK broad money growth is somewhat less positive than Japanese. Not because it is slower. In fact, it is faster, at around 4½%. However, where Japanese broad money growth is accelerating, the growth of

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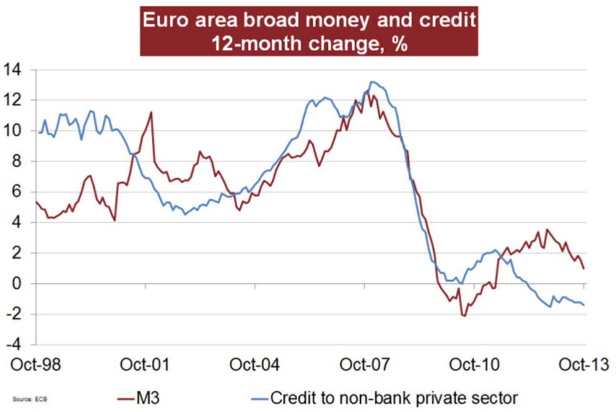
British broad money is has eased slightly in recent months, from around 5% per annum to between 4½% and 5%.

In contrast with the Japanese situation, British broad money growth – supported by a Bank of England policy specifically aimed at increasing the stock of M4 – has not been accompanied by stronger credit growth. Or, more correctly, credit has gone from contracting to being unchanged year on year. The weak credit growth is not necessarily surprising; as has been pointed out numerous times in previous Comments, central banks' myopic fixation on credit growth was always misguided. A debt-induced crisis cannot be solved by making the private sector take on more debt. However, as in the case of the United States, British broad money growth is probably enough to power trend rate growth in the medium term, assuming a trend growth rate in the 1¾-2¼% range and an inflation target of 2%, with a small fall in the velocity of money. In another parallel with the United States, recent data has confirmed that there is now a clear recovery, and that this is likely to accelerate somewhat in 2014.

So far, the countries covered are seeing broad money growth at rates which, if not stellar, are at least decent and indicative of activity around trend. This is most emphatically not the case with the last major world economy, the euro area. This issue has been extensively covered in previous Comments. What is deeply worrying in the euro area is the continued deceleration of twelve-month broad money growth, from above 3% at the end of 2012, to between 1% and 2% in the first half of 2013 and below 2% since then. In October, euro area M3 grew by 1% from a year earlier; November and December may well be down from late-2012; by the end of the year, we may find money supply contracting again.



This is partly due to euro area banks continuing to shrink their balance sheets, including for regulatory reasons. Difficulties in agreeing on a European banking union are likely to exacerbate this trend. The ECB has made it clear that some banks will be found to fail its impending asset quality review (AQR). It therefore makes sense for banks to shed bad loans and accelerate the building up of buffers. (A case in point is Spain, where the *Financial Times* on 18th December 2013 reported that private sector bankruptcies are increasing as banks foreclose on doubtful and bad loans in order to improve their balance sheets prior to the AQR.) But this means that broad money growth will be further constrained in 2014.

The euro area trend growth rate is likely to be around 1%. Given an inflation target of 2% and a slight long-term fall in the velocity of money, the broad money trend growth rate consistent with medium-term trend GDP growth is likely to be in the 4-6% range. As noted for the US, the UK and Japan above, in this phase in the cycle, it should ideally be considerably faster. The fact that it is not, implies that euro are growth is likely to disappoint in 2014 – as is also the message from recent data. The euro area recovery

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has already been weaker than the American. Where, as noted above, US GDP is 5.5% above its pre-crisis peak, euro area GDP remains 3% below its level in Q1 2008. (UK GDP is 2½% below its pre-crisis peak.)

Diverging monetary trends also mean that monetary policy is likely to diverge in 2014. The Federal Reserve will conclude the taper of its quantitative easing, although interest rates will now stay at current levels beyond the 6½% unemployment threshold. The Peoples' Bank of China is likely to continue its attempts to gently dampen M2 growth. Bank of England policy is likely to remain on hold, with the date for the first interest rate increase moving forward from 2016 to 2015 or possibly even late 2014. By contrast, the Bank of Japan will continue its monetary policy; and the ECB will attempt to ease policy further, whether by cutting interest rates to zero or by introducing negative interest rates of reserves or by other means.

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This is the last Stein Brothers Comment for 2013. The next Comment will be published in the week beginning 6th January 2014. I would like to take the opportunity to wish all readers a relaxing holiday season; and may 2014 be much better for us all than 2013!

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