March 22, 2011

Economics Group

WELLS FARGO SECURITIES

Special Commentary

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The Outlook for Central Bank Policy Rates

Executive Summary

The developed economies of the world are faring very differently in the wake of the global recession. The economies of Australia and Canada are firmly in expansion territory, while economies in the Eurozone and the United Kingdom are still striving to get output back to pre-recession levels. The U.S. economy is somewhere in between, having just recently surpassed its pre-recession peak in real GDP. The already fragile recovery in Japan was dealt a serious blow by the recent earthquake and the still-unfolding developments related to that tragedy.

We believe that some major foreign central banks are about to tighten monetary policy, with the Bank of Japan (BoJ) and the Federal Reserve being two notable exceptions. The BoJ will likely remain on hold for the foreseeable future to combat deflation and as it tries to come to terms with the extent of the devastation from the Tōhoku earthquake and tsunami. We project that the Fed will not begin to hike rates until next year. In this report, we discuss the outlook for the key lending rates in each of these economies, while considering the economic outlook as well as the respective mandates for each of the central banks.

Figure 1

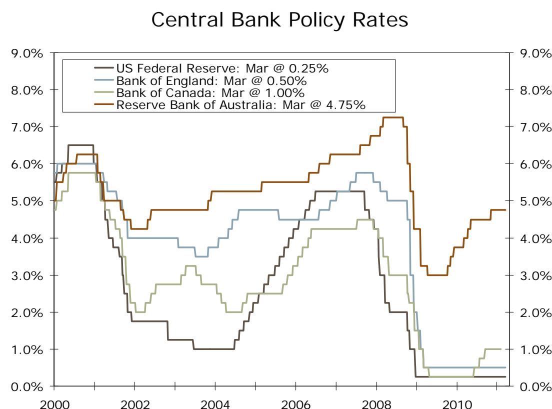
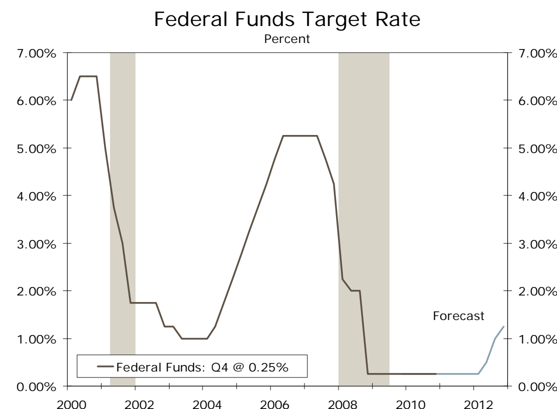


Figure 2



Source: IHS Global Insight and Wells Fargo Securities, LLC

Central Banks in Australia and Canada Are Set to Resume Tightening

In terms of developed economies, Australia and Canada are the standout examples of foreign central banks that have been at the forefront of monetary policy tightening in this cycle. In the 13-month span between October 2009 and November 2010, the Reserve Bank of Australia (RBA) raised rates seven times taking its cash overnight rate to 4.75 percent from 3.00 percent. Similarly, the Bank of Canada (BoC) hiked its key policy rate three times in as many months in the summer of last year lifting the overnight rate to 1.00 percent by September from 0.25 percent in June. While both banks have been on hold since the autumn of 2010, there is a growing

expectation that the tightening campaigns are set to resume soon, although the unfolding situation in Japan could have implications for monetary policy decisions all over the world. This is particularly true Down Under, because Japan remains Australia's largest export market.

The rate hikes undertaken by the BoC and the RBA over the past year may seem somewhat out of step with other central banks that have been content to keep rates at historical lows. In fact, the U.S. Federal Reserve is still engaged in quantitative easing measures, which effectively ease policy even further. What is so different about the Australian and Canadian economies that justified monetary policy tightening earlier in this cycle, and what is potentially driving their respective central banks back to policy tightening in the coming months?

For starters, the recessions were not as bad in these economies as they were in most other advanced countries. In fact, Australia never really had a recession at all. Real GDP in Australia contracted at an annualized rate of 3.7 percent in the final quarter of 2008 (Figure 3). But the Australian economy returned to expansion in the very next quarter and never looked back. As of the fourth quarter of 2010, total economic output in Australia was 4.4 percent higher than it had been prior to the fourth quarter of 2008—the sole quarter of contraction in the current cycle.

While Canada did endure a recession, the fallout was not as bad as other large, developed economies (Figure 4). The peak-to-trough decline in Canadian real GDP was 3.3 percent, not as severe as the more than 4 percent decline in the United States and a far cry from the 6.4 percent decline in the United Kingdom. The Canadian economy also bounced back quickly. While many developed economies are still in recovery (which is to say that GDP has yet to return to pre-recession levels), total output in Canada crested above its pre-recession peak in the second quarter of 2010 and has been in expansion territory ever since.

Figure 3

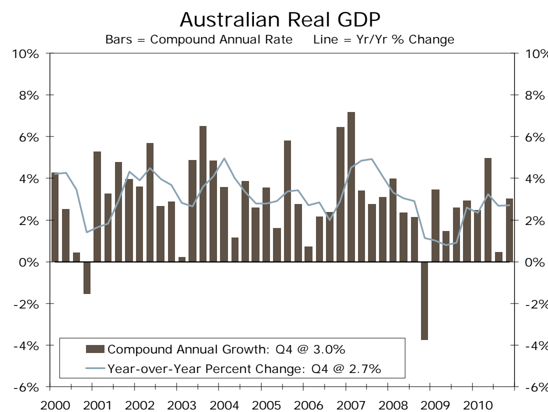
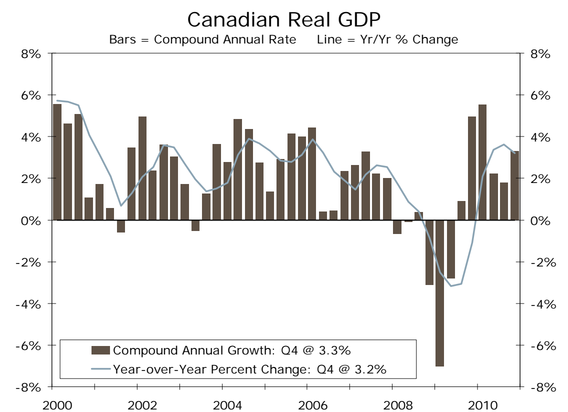


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

There are a number of explanatory factors that can shed some light on the relative outperformance of these economies including a less-leveraged consumer and rapid implementation of government stimulus programs. Still, the attribute that perhaps goes the furthest toward explaining the difference is that Australia and Canada are rich in natural resources and exports of raw materials are important for both economies. The fast pace of growth in developing economies over the past few years, especially in China, has increased demand for raw materials and that has helped boost economic growth in Australia and Canada. Due to the strength of recoveries in these respective economies, the BoC and the RBA have cover to concentrate on maintaining a stable price environment, with an eye on the global recovery.

Moreover, both central banks have explicit inflation targets. The RBA is charged with keeping consumer inflation between 2 and 3 percent while maintaining financial stability. The BoC has the sole mandate of keeping consumer price growth between 1 and 3 percent and as close as possible to the 2 percent midpoint. Although overall CPI inflation rates in both countries are currently close to their respective targets, both central banks want to keep future inflation rates within the

target ranges. Because economic growth is humming along fairly reliably in both countries, we would expect to see the RBA and BoC hike rates further by the middle part of this year. That said, the implementation of monetary policy tightening in Australia may be delayed as the RBA endeavors to gauge what effect the Tōhoku earthquake and tsunami in Japan will have on the Australian economy. Japan is one of Australia's largest trading partners, and the natural disasters in Japan will have a negative effect on Australian exports, at least in the near term.

Central Banks in Europe Ready to Throw Their Hats into the Ring

Although the conversation about central bank activity in Australia and Canada is focused on when the current tightening cycle will *resume*, discussion about European monetary policy is a question of when rate hikes will *begin*. Both the European Central Bank (ECB) and the Bank of England (BoE) began cutting rates aggressively in October 2008 when the financial crisis rattled markets around the world. By the time the dust settled in the spring of 2009, the ECB had cut the refinancing rate to 1.00 percent and the BoE had reduced its official bank rate to 0.50 percent, and both central banks have subsequently remained on hold. Consequently, rates have stayed at historically low levels concurrently for almost two full years—the longest period without a major central bank move in Europe since the 1940s.

Unlike the situation in Canada and Australia where strong economic growth prompted rate hikes last year, central banks in Europe are confronted with a different challenge: rising rates of CPI inflation despite the fact that incipient economic recoveries are not completely self-sustaining yet. Although the British economy has expanded four out of the past five quarters, real GDP remains 4.6 percent below its pre-recession peak (Figure 5). In addition, the fact that real GDP contracted at a 2.3 percent annualized rate in the final quarter of 2010 raises doubts about the sustainability of the recovery in the United Kingdom.

Figure 5

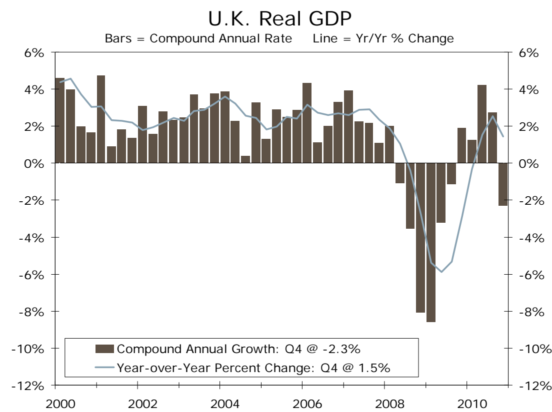
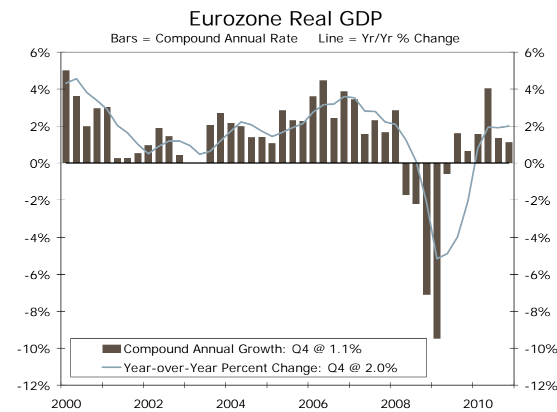


Figure 6



Source: IHS Global Insight and Wells Fargo Securities, LLC

The Eurozone economy has posted six back-to-back quarters of positive economic growth (Figure 6). Yet even after a year-and-a-half of growth, Eurozone GDP is still roughly 3 percent below its pre-recession peak. Like the United Kingdom, the Eurozone is still in recovery mode and total economic output will probably not crest above pre-recession levels until well into 2012. The Eurozone also has the additional challenge of the sovereign debt situation. We do not look for the Eurozone to slip back into recession, but fiscal consolidation in many countries over the next few years should exert headwinds on the overall rate of GDP growth in the euro area. Despite the challenges to economic growth in the United Kingdom and the euro area, there is a growing likelihood that the BoE and the ECB will begin hiking rates soon due to rising CPI inflation.

The BoE's sole monetary policy objective is to maintain price stability. Toward that end, the BoE is given a specific annual inflation target (presently 2 percent) each year by the Chancellor of the Exchequer in the annual budget statement. Some deviation from the target is considered

acceptable, but if the government's target is missed by more than 1 percentage point on either side (that is, if CPI inflation is more than 3 percent or less than 1 percent on a year-over-year basis), the BoE Governor must write an open letter to the Chancellor offering an explanation as to why inflation has breached the target to such an extent and what the bank proposes to do to ensure inflation comes back to the target. Considering the fact that CPI inflation has been 3 percent or higher since January 2010, BoE Governor Mervyn King has written a number of letters.

British CPI inflation has been above 3 percent for more than a year. Initially, most members of the Monetary Policy Committee (MPC) expected that sluggish economic growth would eventually bring inflation back within the target range. However, inflation has failed to recede as widely expected, and the recent run-up in food and commodity prices makes it appear increasingly likely that the overall rate of CPI inflation may not be retreating anytime soon. In our view, the BoE will choose to maintain credibility by raising rates in order to bring inflation back in line with its 2 percent target.

In the Eurozone, the goal of monetary policy is codified by the Maastricht Treaty (the treaty that created European Monetary Union with the euro as its common currency). Article 3a, section 2 of that treaty lays the groundwork for monetary policy by establishing that the primary goal of the ECB is to "maintain price stability." Although the ECB does not have a formal inflation target like the Bank of England does, the ECB has elected to define "price stability" as "inflation rates of below, but close to, 2 percent over the medium term."

At its most recent meeting, the ECB left rates unchanged but ECB President Jean-Claude Trichet made clear the intention to begin raising rates, citing the need for "strong vigilance" with respect to containing inflation. Consumer prices rose 2.4 percent on a year-over-year basis in February. Given the aforementioned price pressure in commodities, particularly crude oil, there is plenty of evidence of building inflationary pressure. Given the terms of the ECB's mandate and our inflation outlook for the Eurozone, we believe the ECB will raise its policy rates by 25 bps at the April 7 meeting, its first rate hike in three years.

So Why Is the Fed Dragging Its Feet?

So if Australia and Canada are both firmly in expansion mode while the Eurozone and the United Kingdom economies are still plodding along in slow recoveries, where does the United States—the world's largest economy—fit into the context of the broader global economic story? The level of U.S. GDP growth in the fourth quarter of 2010 surpassed its previous high water mark set in Q4 2007, a distinction that shifts the U.S. economy from recovery to expansion. We look for a fairly steady, if not overwhelming expansion over the next couple of years with top-line growth on the order of 2.5 percent to 3 percent for 2011 and 2012. On that basis alone, one might expect that the Fed would be poised to join the other central banks of the developed world in policy tightening. However, we think the Fed will remain on hold until next year.

The best explanation for the dichotomy between our expectations for the Fed relative to expectations for the other central banks of the world comes down to the issue of mandate. Like other central banks, the Fed has the mandate of promoting price stability. Unlike other banks, however, the Fed is additionally charged with promoting maximum employment. To best understand the rationale for its dual mandate, it is useful to consider how the mandate came about in the late 1970s and the prevailing mindset of the era. Price shocks stemming from the oil embargo in 1973 drove CPI inflation north of 12 percent the following year. The U.S. economy fell into recession in the fourth quarter of 1973 from which it did not emerge until the first quarter of 1975. The unemployment rate in that cycle topped out at 9.0 percent in May 1975. The current mandate is codified in section 2a of the Federal Reserve Act, which was legislated by acts of Congress in 1977 and 1978. Along with other subsequent amendments, section 2a explicitly spells out the Fed's charge to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Since long-term rate stability can only be achieved in an environment of macroeconomic stability, the implementation of monetary policy in practice seeks to foster an environment that fosters maximum employment and price stability.

Figure 7

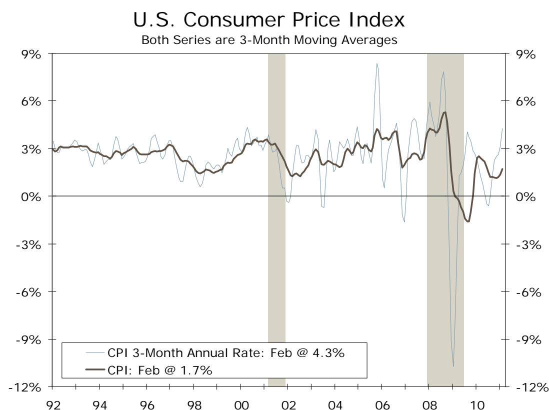
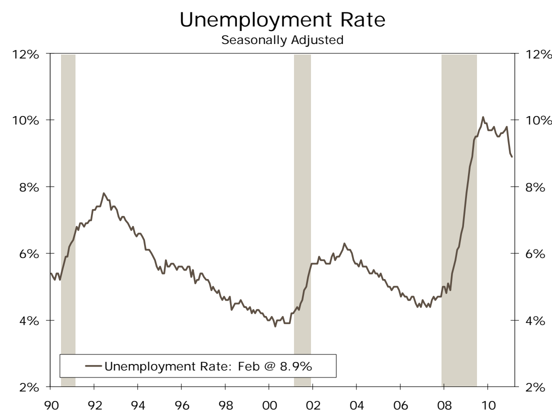


Figure 8



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

If the Fed's sole mandate were simply to promote price stability, our outlook for U.S. monetary policy would essentially be closer to our outlook for Canada or Australia. However, the unemployment rate in the United States has been above 8 percent for two years. Given the persistently high jobless rate, we would not expect the Fed to hike rates until the job market firms up substantially. Chairman Bernanke used his most recent appearance before Congress earlier this month to affirm the Fed's intention to continue purchasing Treasury securities through June. This quantitative easing activity is another tool used by the Federal Reserve to keep interest rates low. For the Fed to raise rates while this program is still in place or to begin hiking rates immediately after would be comparable to driving with one foot on the brakes and the other foot on the gas—not the sort of deliberate action one would expect from the Federal Reserve. Given our forecast for the unemployment rate to remain above 8 percent for the rest of this year, a rate hike in 2011 does not seem likely.

Conclusion

We are often asked whether or not central banks take cues from one another in the implementation of monetary policy changes. Insofar as various central banks are responding to the same data and indicators for the global economy, it certainly can appear that way. However, our view is that each of the central banks discussed in this report are acting independently and within the strict interpretations of its respective policy mandate(s).

Australia and Canada began tightening monetary policy when economic growth in those countries was outpacing most of the rest of the developed world. After pausing for several months, the RBA and the BoC are poised to resume monetary tightening in the next few months, as CPI inflation rates in both economies could begin to be approach the upper end of the target range. At the moment, rising prices around the world have commanded the attention of central banks—particularly those with a sole mandate of price stability. While economic growth is far from self-sustaining in the United Kingdom and the Eurozone, consumer inflation the BoE and the ECB are also set to begin raising rates as well.

The Bank of Japan and the Federal Reserve will be watching from the sidelines. The BoJ has a mandate to maintain price stability, but Japan has been grappling with a mild case of deflation for the past few years—a situation that will likely get worse as Japan struggles to rebuild. The Federal Reserve will simply be following its mandate as prescribed by Congress in the wake of the high unemployment and price shocks of the 1970s. The potential for higher inflation is certainly on the radar screen for the Fed, but at 2.1 percent at present, consumer inflation is not yet a serious problem. In addition, with unemployment so high at present, the Fed has cover to keep rates low in order to promote maximum employment—the other half of the dual mandate.

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