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DAILY GLOBAL
COMMENTARY

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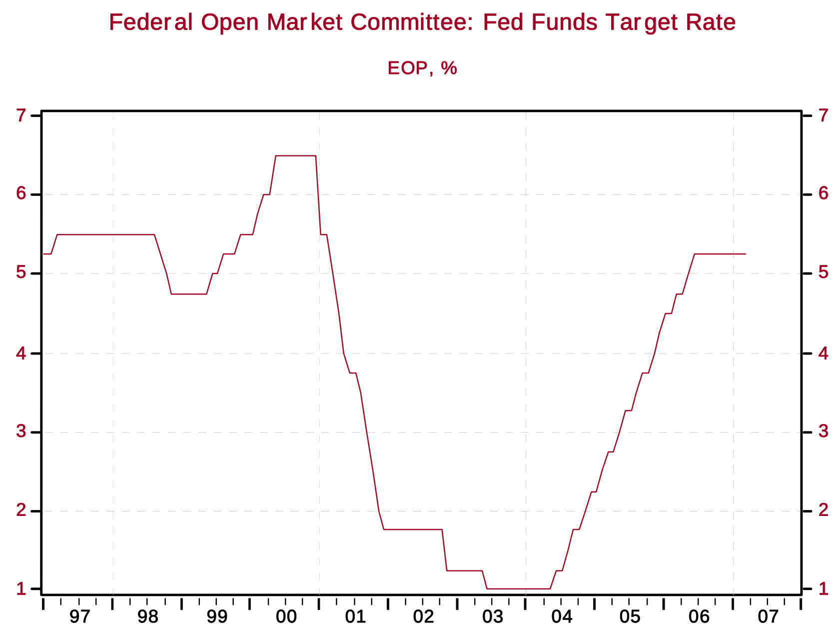
March FOMC Meeting: Inching *Toward* Neutral

March 21, 2007

The FOMC abandoned the tightening bias of the January policy statement which said that "additional policy firming" is possible and replaced it with "future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." At the same time, that "the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected." Adjustment in the housing market is seen as underway now vs. the observation in January that "some tentative signs of stabilization have appeared in the housing market." Although the FOMC is watching closely the housing market adjustments and the spillover effects of this adjustment, the concern about inflation from rising resource utilization was also noted in the statement. In other words, the FOMC is not neutral yet, but it remains concerned about inflation and growth. Essentially, the inflation worry has moved down a few notches in the priority list with the anxiety about growth moving up a few notches.



There is an implicit expectation that the Fed will move from a tightening bias to a neutral stance before adopting an easing bias. It is important to note that this step-by-step approach did not prevail in the November 2000 – January 2001 period. The Fed's policy statement at the close of the November 15, 2000 meeting noted that "the risks continue to be weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future." There was a complete change in judgment at the close of the December 19, 2000 FOMC meeting, with the policy statement reading as: "The Committee consequently believes that the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future." The Fed surprised financial markets with a 50 basis point cut in the federal funds rate on January 3, 2001, which was carried out without a scheduled FOMC meeting. Will the Bernanke Fed repeat this procedure? This possibility cannot be ruled out. Given that the Fed now indicates that economic conditions are mixed vs. the observation in January that "firmer growth" is emerging, the FOMC is inching towards neutrality. The FOMC needs additional weak economic data to lower the federal funds rate. History suggests that the FOMC could respond to economic weakness without officially changing the bias. Moreover, with no tightening bias in place, room has been made for a lower federal funds rate.

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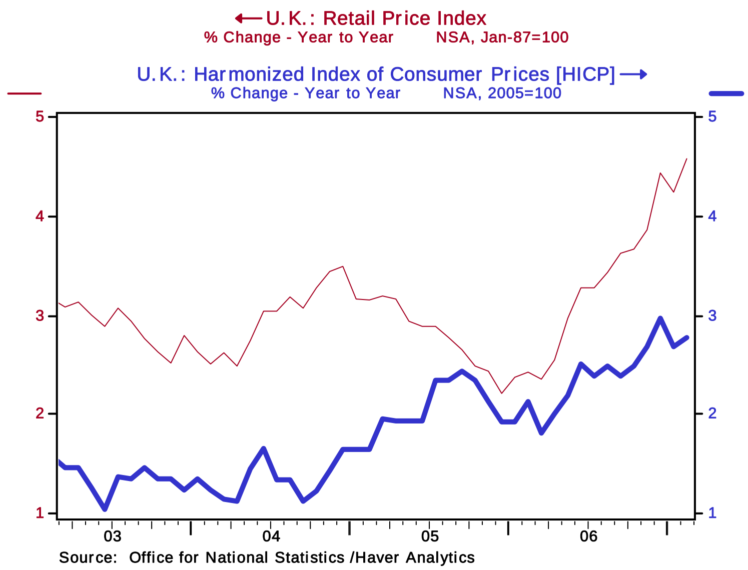
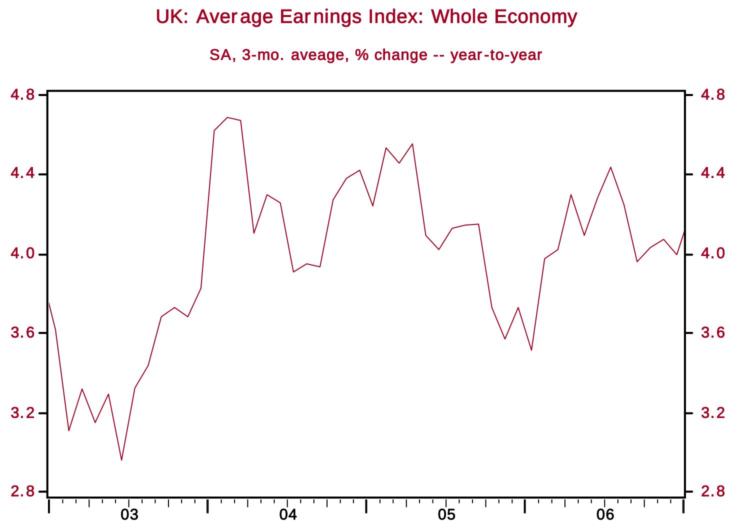
UK: Rate Hike Expectations Ease But Don't Rule Out Further Tightening

The minutes of the March 8 meeting of the Bank of England's (BoE) Monetary Policy Committee (MPC) have caught the markets by surprise, with an unexpectedly-dovish 8-1 vote to leave rates on hold, and the one dissenter a vote for a rate cut. The members noted that "the upside risk to inflation from wage growth might have started to diminish," and "financial market volatility added to the case for holding rates." So, can we assume that the current 5.25% repo rate is the peak? Not yet.

Yesterday came the news that the EU-harmonized rate of inflation , HICP, hit 2.8% in February, up from 2.7% in January – still far above the BoE's 2.0% medium-term target. The Retail Prices Index (RPI), the basis for most wage negotiations, climbed to a 16-year high of 4.6%. Last week, the BoE's quarterly inflation survey found that expectations for the rate of inflation over the coming year were unchanged from the November survey, at 2.7%. While this remains well above the BoE's 2.0% target, the stabilization of expectations is likely to be comforting to the members of the MPC. However, with the RPI at a 16-year high, there is still a risk to inflation expectations.



Last week's report on average earnings showed the fastest three-month rate of growth since the summer, with November-January earnings up an annual 4.2% (4.0% in October-December). However, excluding bonuses, which were concentrated in the booming financial services industry, earnings growth eased from 3.7% to 3.6% – suggesting that the closely-watched January pay round was relatively benign.



The British Bankers' Association reported a fall in the growth of credit card debt in February, marking seven straight months of lower consumer borrowing. On the other hand, the housing market continues to show a surprising level of resilience despite three rate hikes since last August. Underlying net mortgage lending rose by a still-robust £5.2 billion in February, down only slightly from £5.4 billion in January. Still, this did mark three successive months in which lending rose by slightly less than the month before, suggesting that we may be seeing the start of a moderating trend. However, data from the Building Societies' Association showed that mortgage approvals, a forward looking indicator of housing demand, rose a seasonally adjusted £5.4 billion last month, down only slightly from the record-high £5.8 billion seen in January, and the highest level on record for the month of February. And, money supply growth remains strong, climbing an annual 12.8% in February (12.9% in January). All told, it is too soon to call the end of the current housing cycle recovery.

Over on the fiscal side of the policy equation, Chancellor (and PM-in-waiting) Brown today delivered his eleventh consecutive annual budget (making him the longest-serving Chancellor since the 1820s). It clearly was designed to win back support for the Labour Party ahead of PM Blair's retirement (expected within the next six months) without totally undermining Brown's reputation for relative fiscal prudence. The Chancellor announced headline-catching cuts in the basic rate of income tax and in the corporation tax, but also tweaked some other tax margins such that the overall impact of fiscal policy should be broadly neutral. However, Brown's forecast of a gradually-narrowing fiscal deficit looks overly optimistic. It is based on the assumption that GDP growth will climb as high as 3.25% this year and 3.00% in 2008. With this year's growth likely to be closer to the 2.74% seen in 2006, tax revenue is likely to fall short of the projection.

So, where does all this lead interest rates? The prospect of one more rate hike in April or May has dimmed a little but not disappeared. In its February Inflation Report the BoE concluded that inflation would be slightly above the 2.0% target in two years time if the repo rate stayed at 5.25%. And while the MPC seems to be feeling more sanguine – even the two most hawkish members voted to stay on hold this month – they are not yet ready to rule out the need for additional tightening. The minutes note that most members felt that risks to inflation in the medium-term remain "on the upside" due to capacity constraints, strong price intentions among businesses and strong money supply growth. Key reports due before the April 5 MPC meeting include February retail sales (March 22), and BoE consumer credit and mortgage lending for February, due on March 29.