G3 Monetary Policy – United States, Japan and the Euro Area

In the early years of this decade, the central banks of various economies introduced more flexible monetary policies as a way of avoiding consolidation of deflationary environments and/or offsetting the impacts of adverse shocks. Monetary activism, coupled with fiscal incentives in many economies, has driven private consumption, international trade and rising international raw material prices since that time. Continued expansion of international liquidity has contributed to consistent improvement in the economic fundamentals of the emerging countries, while allowing corporations to restructure their finances, following the disinflation of the so-called technological bubble in 2000 in the United States. Consequently there was a generalized and consistent reduction in corporate credit market spreads and financing costs for final borrowers. Another factor to be added to this scenario is the wealth effect of sustained upward movement in security and real estate assets as of 2002-2003, which became an additional factor driving the world economy.

Despite this, the inflation trajectory remains relatively benign in global terms, while perceptions of a progressive reversal in the cycle of ample international liquidity have been strengthened. In this sense, the concerns expressed by various monetary authorities regarding the impacts of the persistent rise in the prices of oil and commodities on price trajectories have played an important role in preparing the way for adoption of a generally more conservative central bank stance. Since last March, international financial markets have had to adapt to a generalized shift in expectations regarding interest rate trajectories, resulting from the expected synchronism of more restrictive monetary policies in the world's three major economies: the United States, Japan and the Euro Area, which form the so-called G3.

Monetary policy in the United States

In the second quarter of 2004, given the consistency of renewed economic activity and elimination of the risk of deflation, the volatility of international financial markets increased as a result of official warnings that United States monetary policy would shift from its then rather flexible stance to a more neutral type of management. Market uncertainties were revealed in the accentuated high registered in government bond yields in the central economies, increased stock market volatility and rising sovereign risk indicators in the emerging economies.

Elimination of the monetary incentive, terminating the period of the lowest basic interest rates in 25 years, began in June 2004. Since that time, the United States Federal Reserve (Fed) has introduced 16 consecutive increases into its annual basic interest rate target (Fed Funds), rising from 1% to 5% at the very moderate pace of 0.25 p.p. at each meeting of the Federal Open Market Committee (FOMC). In this sense, the strong productivity gains achieved by the economy attenuated inflationary pressures and contributed to the smooth interest-rate transition.

Recently, however, the Fed has signaled that termination of the cycle of a more restrictive monetary policy will depend on a certain cooling of the pace of economic activity and the return of consumer price inflation to a level considered more comfortable by the monetary authority[1]. In this sense, increases in energy prices and higher mortgage rates have contributed to the slowdown in consumption.

Two aspects should be stressed: i) the impacts, albeit limited, of increased energy and commodity costs already perceptible in price indices; and ii) the Fed warned that raw material price volatility tends to have a negative impact on the inflation outlook. The Fed suggests that the persistence of this scenario could result in prolonging its restrictive monetary policy,

1/ The Personal Consumption Expenditures Index (PCE) accumulated 2.9% growth in twelve months through April, which is above what analysts consider to be the ceiling for the Federal Reserve: 2%.

though the gradualist approach to the adjustment will be maintained. The Fed explained that it will monitor the conditions surrounding convergence of the activity level to a less intense pace.

Monetary policy in Japan

In order to reverse the deflationary environment, at the end of the 1990s, the Central Bank of Japan (BoJ) introduced the so-called zero interest rate monetary policy (overnight call rate). In March 2001, a new framework was introduced: the quantitative monetary easing policy, in which: i) the operational targets would be the balance of current account deposits maintained at the BoJ[2] by financial institutions; and ii) the monetary authority would provide liquidity at a level much higher than that required by reserve requirements. In summary, with an abundant supply of liquidity, the new framework would result in nominal basic interest rates in the range of zero. At that time, the BoJ determined that the necessary but not sufficient condition for reducing excess liquidity would be maintenance of the twelve-month consumer inflation core at a level equal to or greater than zero in a sustained manner[3].

Given BoJ's confidence in the sustainability of the process of renewed economic growth and the recent trajectory of consumer price inflation, the BoJ recently determined that the macroeconomic scenario justifies transition to a progressively more restrictive monetary policy. Consequently, in March 2006 the institution introduced new alterations into its conducting of monetary policy: whereby the basic interest rate once again became the operational target and excess current account liquidity was gradually reduced.

It should be stressed that, following convergence of the current account balance to the level of required banking reserves; BoJ announced that it did not intend to introduce any immediate rise in basic interest rates[4]. Simultaneously, the Japanese

2/ Current account balances (CAB): encompasses the balance of total reserves held at BoJ by financial institutions independently of whether they are subject to reserve requirements on deposits.

3/ The target for the current account balance, initially set at ¥5 trillion was progressively raised into the range of ¥30 trillion to ¥35 trillion at the beginning of 2006.

4/ Between March and May 2006, BoJ reduced the current account balance from ¥33.1 trillion to ¥15.2 trillion, following the trajectory of convergence to the reserve requirement balance (¥6 trillion).

monetary Authority, with the objective of increasing transparency, announced what it understood as price stability: the range of 0% to 2% for changes in consumer core inflation. Considering the historical pattern of interest rates in Japan, this bracket is reasonably broad in such a way that it tends not to hamper a possible prolonging of the more flexible BoJ management, but does offer a parameter for the level of flexibility. In this scenario, expectations of a gradual rise in medium-term interest rates were strengthened, should the upturn in the pace of economic activity be confirmed and the rate of inflation remain at a positive level, as has occurred since November 2005.

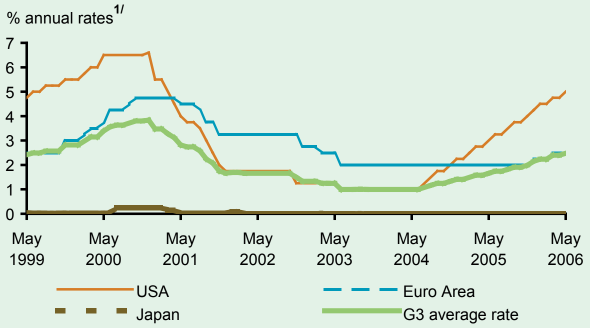
Monetary policy in the Euro Area

Between early 2000 and mid-2003, the Euro Area economy remained below its potential trajectory, with recession in several key economies. To reverse this situation, the European Central Bank adopted a monetary policy that assumed an expansionary character: the annual basic rate of interest (refi rate) was progressively reduced from 4.75% at the end of 2000 to 2% in mid-2003, remaining at that level for 30 months.

Recently, the ECB initiated a new cycle of a restrictive monetary policy since, given the upturn in the pace of activity in the region; it concluded that the current tendency to raise the Harmonized Consumer Price Index Core (IPCH) reflects a refiring of inflationary pressures. Considering that the formal objective is to maintain cumulative twelve-month growth in the IPCH at approximately 2% and that this index has remained above that level since mid-2005, the ECB estimates that consumer inflation tends to remain high in 2006 and 2007. In this context, the annual refi rate was raised from 2% to 2.25% in December 2005. In 2006, March and June increases of 0.25 p.p. raised the rate to 2.75%.

The Euro Area monetary authority also warned that the degree of monetary flexibility remains high, given the current tendency toward growth in M3 and the volume of credit. In this context, expectations of a continued restrictive monetary policy were strengthened, given the even more emphatic signals issued by the ECB regarding intensification: i) of the pass-through of oil price increases to consumer prices; and ii) the secondary effects of previous oil price highs.

Figure 1 – Official interest rates



Sources: Federal Reserve, ECB and Bank of Japan
1/ USA-target for fed funds, Euro Zone-refi rate, Japan-overnight call rate.

Summary

The abundant liquidity that has marked the last five years was a major factor underlying the longest and most rapid world growth cycle of the last 30 years. However, it did give rise to a variety of imbalances. Despite the volatility that may prevail on financial markets during the period of assimilation of new liquidity conditions, normalization of the monetary policies of the G3 nations tends to foster medium-term positive results, since it would favor: i) progressive reduction in balance of payments imbalances; ii) curtailment of inflationary pressures and expectations; and, iii) less exposure to risk. Though economic growth will tend to level off, it will remain at historically high levels in an environment of well-anchored inflationary expectations. In this context, the emerging economies that have improved their macroeconomic fundamentals, as Brazil has done, will tend to draw the greatest benefits.