Economic Theme

Central Banks

Global rate cuts: will they help?

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At a glance

- On Wednesday, Major central banks, including the US Federal Reserve, the European Central Bank (ECB) and the Bank of England (BoE) announced coordinated, surprise half a percentage point, cuts in their respective main policy rates.
- With the interbank credit markets clogged up, however, there is doubt about the efficacy interest rate reductions can have at this juncture.
- The fact that we saw, for the first time since the beginning of the crisis more than a year ago an, internationally coordinated action can be seen as positive because it signals more global action in the future.
- But more action and results will take time, which is a negative in our view.
- Overall investors should remain cautious in this environment.

Seven major central banks – the Fed, the European Central Bank, the Bank of England, the Bank of Canada, the Swiss National Bank, the Swedish Riksbank and the People's Bank of China – decided in a coordinated action to cut their respective interest rates.

The move was highly anticipated and even demanded by the markets. In fact, in our view, the negative reaction of stock markets on Monday and Tuesday can be partially attributed to the disappointment that the coordinated cuts didn't come earlier. And with almost all European markets closing down between 5% and 7% on Wednesday, it appears we did not see the typical impact of a coordinated rate cut of this scale. The question that now comes to mind is "Was it too little too late?" But this is not the right question to ask. Far more important is to ask: "Was it the right thing to do anyway? There is a rational and an irrational, let's say more symbolic, answer to this question.

Rationally: It doesn't matter
The main problem financial markets and the economies are currently facing—especially in the US but more and more in Europe as well— is a severe credit crunch, which after having affected the consumer has spread now to the short term borrowing of firms. This short term borrowing in the form of commercial paper or credit lines at financial intermediaries has been under a tremendous stress lately, leaving more and more sound firms with liquidity problems. The creation of a special investment vehicle on Tuesday through which the Fed would buy commercial paper has certainly mitigated the problem in this market, but the interbank market (i.e., the one in which financial institution lend and borrow money from each other) is still dried out. As long as banks are not lending to each other, it is safe to assume that they will not lend to anyone else either, therefore the interbank money market is a clear indicator of the stress on the credit market.

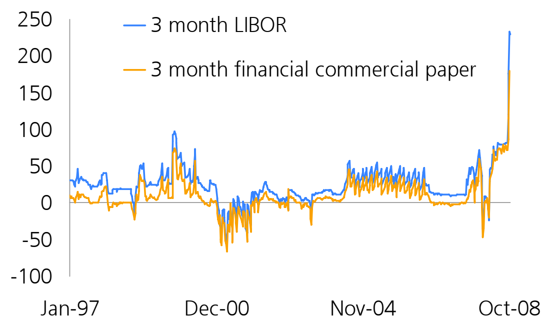
One can see the stress on the interbank and commercial paper market in chart 1, which plots the spread between the 3 month LIBOR in USD (one of the key interest rates in the interbank market), against the 3 month commercial paper rate and the Fed fund target rate. On Wednesday the USD LIBOR was fixed at 4.52%, i.e. 252 basis points

Where do the major central banks stay?

Central bank	Move	in points	new rate
Fed	cut	-50	1.50
ECB	cut	-50	3.75
BoE	cut	-50	4.50
BOC	cut	-50	2.50
SNB	cut	-25	2.50
Riksbank	cut	-50	4.25
PBoC	cut	-27	6.93
BoJ	unchanged	0	0.50

Source: Bloomberg, as of 8 October 2008

Chart 1: spreads against Fed fund target
In basis points



Source: Bloomberg, Federal Reserve, UBS WMR as of 8 October 2008 above the Fed fund target of 2% (before the rate cut announcement). If we don't see this spread coming down significantly over the next couples of days, then, in our view, the whole concerted action was not a success. And frankly there is no rational reason at this stage to forecast that the concerted action of the central banks alone will unfreeze the interbank market.

Symbolically: It matters a lot
From a rational perspective there is therefore no reason to cheer up, however markets are not only driven by pure rational thinking; there is also a symbolic dimension. The coordinated move of the central banks around the globe was the first truly global try to address the financial crisis, which until recently was seen as a US crisis.

We have stressed in several previous reports that one of the main points to solve the crisis is international coordination. It has now gained some traction. On October 10, the G7 finance ministers and central bankers will meet in Washington to decide on the next steps.

Conclusion
We recommend in this environment to remain cautious. Rate cuts won't do much immediately, but the symbolic meaning of the fact that they have been taken in international coordination can be seen as a promising step in the right direction.

Annex: the major central banks in detail
As part of a joint central bank effort to ease monetary conditions, the **US Federal Reserve** (Fed) cut its fed funds rate target by **50** basis points from 2% to 1.5%. Such a move was already widely expected for the next scheduled meeting on 29 October, and speculation that the Fed might cut before that was also widespread. In his latest speech on Tuesday, Fed Chairman Bernanke stressed the downside risk to growth and pointed to deterioration in the economic outlook due to the most recent financial market disarray. The most recent job and business climate data had also shown that economic weakness is spreading and deepening. We are reviewing our global economic forecasts and for now simply want to point out that further Fed easing seems very likely.

The **European Central Bank** (ECB) has lowered its minimum bid rate on the main refinancing operations by **50** basis points to 3.75%. The initial section of the ECB's statement, which is the same as that of all the other central banks involved, explains that the emergency rate cut reflects the intensification of the financial crisis, which has augmented the downside risks to growth. Interestingly, the only ECB-specific part of the statement says that, while upside inflation risks have eased "it remains imperative to avoid broad based second-round effects in price and wage setting." On the face of it, this might suggest that the Bank will be reluctant to cut rates much further. However, with the economic outlook weakening rapidly, we think that interest rates will have to be pared back further in coming months.

The **Bank of England** (BoE) has cut its Base Rate paid on bank reserves by **50** basis points to 4.5%. The fact that the Bank cut rates 24 hours ahead of a scheduled interest rate announcement underlines the seriousness of the situation. With consumer price inflation at 4.7% at present, the latest move may raise questions over whether the BoE is putting financial market stability ahead of its inflation targeting objective. However, the BoE stressed in the statement accompanying the move that the economic data released over the last month "indicate that the outlook for economic activity in the UK has deteriorated substantially, reflecting a sharp monetary contraction." Markets had expected the BoE to lower interest rates this month at the regular meeting and further rate reductions should be expected in the near future.

The **Bank of Canada** lowered its target for the overnight rate by **50** basis points to 2.5%. The central bank said that conditions in global financial markets have deteriorated sharply, the US economy has weakened further and commodity prices have fallen sharply. It added that as a result of these developments, credit conditions in Canada have tightened significantly, despite the relative health of the financial institutions. Weaker growth in the US will increase the drag on the Canadian economy although the recent depreciation of the CAD will help cushion the effects of the weaker global outlook on the domestic economy. Below-potential growth in aggregate demand through 2009, combined with a lower profile for commodity prices, will significantly ease inflation pressure in Canada, according to the central bank.

The **Swedish Riksbank** cut its target repo rate by **50** basis points to 4.25%. Over the past 2.5 years the Riksbank repeatedly prioritized fighting inflation by increasing interest rates from 1.50% in January 2006 to 4.75% in September 2008. The current move marks the first step in what will likely be an extended easing cycle with looser monetary conditions. Necessarily, the Riksbank justified the move by pointing out reduced inflationary pressures due to slowing growth. Additionally, the Riksbank emphasized that credit conditions have been artificially tightened by the financial crisis which has "led to higher interest rates for companies and households, lower capital wealth and increased uncertainty." The Riksbank will also be revising down its inflation and growth forecasts.

The **Swiss National Bank** (SNB) lowered the target range for the 3m Libor by **25** basis points to 2-3% aiming for the middle of the range at 2.5%. As the 3m Libor currently stands at almost 3.1% this effectively means that the SNB aims to ease conditions in the money market by almost 60 basis points. In the statement, the SNB argues that "the global financial crisis has intensified and is having a considerable impact on the international economy." As this will also affect the Swiss economy, the SNB now expects economic growth for 2009 to be weaker than forecasted at the last monetary policy assessment meeting in mid-September. And as the inflation outlook has improved on the back of slowing economic activity as well as lower oil prices, the SNB did see room for easing its monetary policy reins.

The **People's Bank of China** (PBoC) lowered its key one-year lending rate by **27** basis points to 6.93%. It is worth to notice that the PBoC participated in this coordinated move and shows that China is also taking its share of responsibility to solve the crisis despite the fact that the Chinese economy so far has been relatively immune to the recessionary tendencies in the US and Europe.

The **Bank of Japan** (BoJ) was the only major central bank leaving its rates **unchanged**. One has to bear in mind though that the central bank rates there at 0.50% do not leave much room for cutting. The BoJ nevertheless said in a statement that it supported the action.

The **Bank of Australia** (BoA) had already cut its overnight cash rate target in a surprise **100** basis points move to 6% on Tuesday, leaving market participants speculating that a coordinated rate cut move would be done sooner, rather than later, but they had to wait another 24 hours.

Appendix

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