Central Bank update: Further easing in the UK and EU

Economic research note

7 October 2011

- Both the Bank of England and European Central Bank decided to leave interest rates on hold overnight, but announced a further easing of monetary policy via ‘unconventional measures’.
- This once again shows that much of the heavy lifting in policy making in developed economies is being left to the central banks and follows the decision by the US Fed to implement ‘Operation Twist’, given indecision by other policy makers.
- In all three circumstances these central banks have eased monetary policy despite elevated inflation, preferring to focus on avoiding further market dislocation and the deteriorating economic outlook.
- The measures announced by both the ECB and the BoE are positive for markets, but should be viewed in the context of a very challenging economic environment, and appear to be preparing the European banking system for an eventual default by Greece.

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Further ‘unconventional’ easing from BoE and ECB

Both the Bank of England (BoE) and European Central Bank (ECB) decided to hold interest rates steady at 0.5% and 1.5% respectively overnight, but both central banks have announced a further easing of monetary policy via ‘unconventional’ means.

While inflation remains above-target in both the UK and euro-area (EU), the central banks have acknowledged the significant downside risks to economic growth. In addition, both central banks, especially in the case of the ECB, have acted to ensure the supply of liquidity to the banking system is plentiful.

Markets have responded positively to the policy easing measures (see below for full details), and the willingness of the central banks to provide additional support to the economy and banking system is a welcome development. Although it does highlight that much of the heavy lifting in policy making is being left to central banks and that inflation mandates are a secondary concern to preventing market dislocation at this time.

It does, however, remain clear that the economic outlook for the UK and Europe (as well as the US) is deteriorating and that this will weigh on markets in the months ahead.

In addition, while the ECB has acted to provide liquidity to the banking system, the question over the ability of some sovereigns to confront their massive debt burdens remains.

In this sense it appears that the ECB and other European authorities are now acting in a way to prepare the EU banking system from an eventual default by Greece – an event that is appearing more inevitable as the weeks and months drag on.

Markets still, therefore, will have this event to deal with in the months ahead and will likely remain very cautious as these developments unfold and as the EU authorities continue to attempt to limit the contagion risk across the region.

The Bank of England

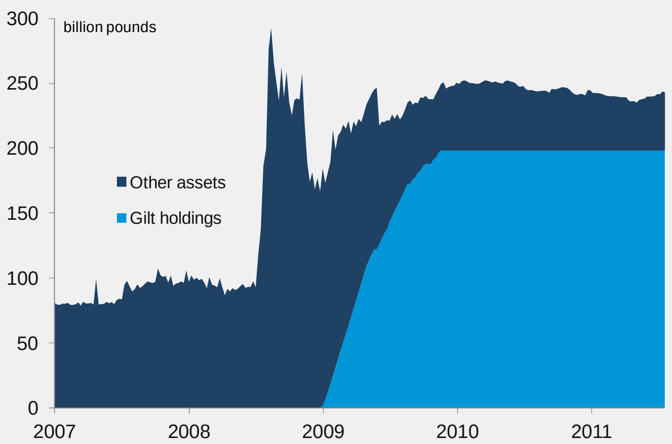
While keeping the official interest rate at a low 0.5%, the BoE has announced a further round of quantitative easing (QE2). Starting as early as next week, the BoE will begin purchasing a further £75bn of UK government bonds (gilts), taking the BoE's total gilt holdings to £275bn (an estimated 25% of total gilts outstanding).

The £75bn QE2 program was larger than market expectations and has had a positive impact on market sentiment, with equities rallying and bonds selling off.

The BoE has stated that they plan to make these purchases evenly across three maturity buckets; 3-10 years, 10-15 years and over 25 years, with purchases of £1.7bn for each maturity sector at each purchasing operation. The full £75bn of gilt purchases is expected to take 4 months to complete.

This is a relatively quick turnaround by the BoE with market expectations early in 2011 pointing to a rate hike given elevated inflation. However high bank funding costs and a challenged economic outlook, as well as global uncertainty, saw first a neutral stance adopted and now further unconventional measures announced.

Bank of England balance sheet (£bn)



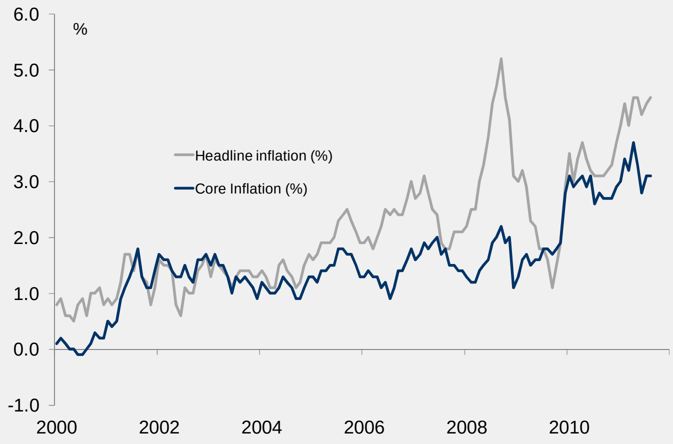
Source: Bank of England

In announcing this new phase of quantitative easing, the BoE stated that "the pace of global expansion has slackened, especially in the UK's main export markets. Vulnerabilities associated with the indebtedness of some euro-area sovereigns and banks have resulted in severe strains in bank funding markets and financial markets more generally. These tensions in the world economy threaten the UK recovery."

Significantly, the BoE noted that the current high inflation rate of 4.5% was likely to rise further to around 5% in the months ahead (due largely to higher utility prices), but that "measures of domestically generated inflation remain contained and inflation is likely to fall back sharply next year". They also state that "the deterioration in the outlook has made it more likely that inflation will undershoot the 2% target in the medium term."

The further easing from the BoE should be supportive for growth, but is unlikely to prove the catalyst for a substantial recovery in the UK economy given the ongoing challenges of slower global growth (especially in the EU and US), as well as the large fiscal austerity plans currently underway by the government.

UK annual inflation (%)



Source: Bloomberg. Data to 31 August 2011

The European Central Bank

At his last meeting as President of the ECB, Jean-Claude Trichet (he will be replaced by Mario Draghi from Italy at the end of this month) has held the official interest rate steady at 1.5% (after hiking rates in both April and June this year).

However the ECB announced a series of measures designed to ensure the supply of liquidity into the EU banking system. Importantly though, the ECB did discuss a cut to interest rates, but decided against this at this time. Much of the reason lies with elevated inflation which is discussed below.

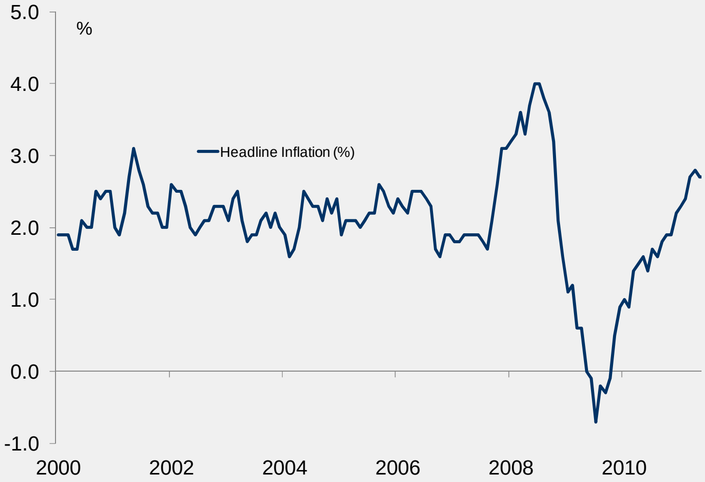
While an interest rate cut looks like it will have to wait until later in the year or in 2012, the commitment to maintaining the liquidity of the EU banking system is a welcome development for markets.

However, it seems that the motivation for this action is a strong desire to prepare the banking system for an eventual default by Greece on its sovereign bonds. While the ECB's action are a positive for markets, they should be viewed in the context of an environment that is likely to remain very challenging for a number of months to come – with significant challenges to deal with including the likely Greek default.

In discussing interest rates and the economic/inflation outlook, the ECB President noted that "ongoing tensions in financial markets and unfavourable effects on financing conditions are likely to dampen the pace of economic growth in the euro area in the second half of this year. The economic outlook remains subject to particularly high uncertainty and intensified downside risks."

The ECB noted inflation remains at elevated levels (where they have been since the end of 2010), driven by higher energy and other commodity prices. However the ECB believes that "inflation rates are likely to stay clearly above 2% over the coming months but to decline thereafter". Much of this is due to the more benign wages outlook. The ECB judges that inflation risks over the medium term are broadly balanced.

EU inflation



Source: Bloomberg. Data to 30 September 2011

In terms of the actual policy measures announced by the ECB, these were two-fold.

Firstly, the ECB has significantly stepped-up its liquidity provision to the banking system. The ECB will conduct two longer-term refinancing operations (LTROs) with maturities of around 12 and 13 months. This compliments its current shorter liquidity measures and ensures that the EU banking system will have all the liquidity it needs over the next 12 months to help deal with the sovereign debt challenges. The challenge, therefore, for policy makers outside the ECB remains the need for recapitalisation of the banking system. This remains an ongoing issue for markets.

Secondly, the ECB has acted to support European bank funding, particularly medium size and smaller European banks through a covered bond purchase program. Some European banks have relied extensively on covered bond issuance for financing requirements since 2009, but this market has been significantly curtailed in recent months.

Starting in November 2011 and continuing until October 2012, the ECB will purchase €40bn of covered bonds, which is only 4% of the outstanding EUR Benchmark covered bond market. These purchases will be made in both the primary and secondary market and will be carried out by “means of direct purchases.”

In other interesting comments, the ECB continues to call for particular attention to be paid to the banking system, to stop the interplay between sovereign risk issues and banks’ funding needs. The ECB is urging recapitalisation from both national governments and also from a possible future use of the European Financial Stability Facility (EFSF) to lend funds to governments to recapitalise banks.

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