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TRENDMACRO LIVE!

On ECB and BOE October Rate Decisions

Thursday, October 6, 2011

Lorcan Roche Kelly

Massive QE for the UK, and continued growth-killing rates for the Euro area.

Despite our out-of-consensus hope to the contrary (see "Europe Fails, US Stocks Flail" October 4, 2011), Jean-Claude Trichet did not use the occasion of his final monthly European Central Bank meeting as President to start the unwind of the ECB's catastrophic interest rate hikes in April and July (see "EUicide" April 7, 2011 and "On Europe's July Rate Decisions" July 7).

But it was not all bad news, as the ECB did announce some policy changes that should help ease pressures on European banks:

- There will be two 12-month Longer Term Refinancing Operations (LTROs) -- on October 25 and December 20 -- which will be fixed rate, full allotment operations. Thus the ECB is deepening its commitment to be a source of virtually infinite liquidity for bank funding.
- The normal 1-week Main Refinancing Operation (MRO) and the standard 1-month LTRO will remain on a fixed rate, full allotment basis until at least July 2012.
- There will be a new Covered Bond Purchase Programme (CBPP2) that will have the capacity to purchase €40 billion of covered bonds -- Europe's version of pooled mortgage-backed securities -- in both the primary and secondary market. The CBPP2 will start operation in November 2011 and continue until October 2012.

While these moves are welcome, they do nothing to directly address the problem of growth within the Euro area. The effectiveness of a rate cut in starting growth can be argued -- as the US Fed has learned. But it is certain that *not* having the rate cut will be no help at all, given that high rates directly penalize struggling homeowners, especially in peripheral nations, with variable-rate mortgages.

The CBPP2 is considerably smaller than the first covered bond program run by the ECB in 2009/2010, which totaled €60 billion. This smaller amount points to a theme Trichet stressed throughout the post-decision press conference: Emergency liquidity is one thing, but it is not up to the ECB to save the banking system in Europe -- it is up to governments to do that.

Update to strategic view

ECB, EUROPE MACRO, BOE: ECB President Trichet failed to use one of his last opportunities to unwind his catastrophic rate hike errors. But the ECB will continue to flood the banking system with liquidity. Rates must be cut, lest they continue to strangle growth -- but incoming president Draghi, as an Italian, will be in a difficult bargaining position with inflation-phobic northern colleagues. The BOE has extended its QE by £75 billion, the US equivalent of $780 billion.

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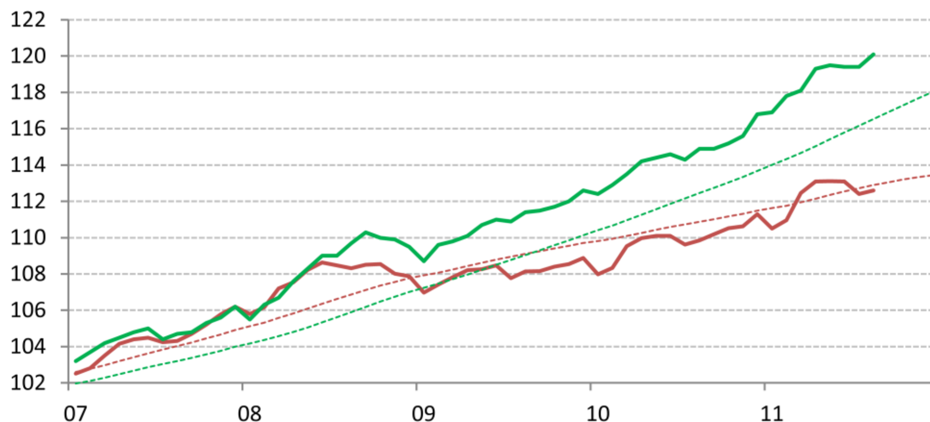
The instrument governments likely intend to use to recapitalize the banks is the European Financial Stability Facility (EFSF). So Trichet's comments on leveraging it were worthy of note, even if they were a little opaque. He said that it would not be appropriate for the ECB to leverage the EFSF -- as US Treasury secretary [Tim Geithner proposed last month](#) -- but that the "governments have the capacity to leverage" it.

- It is not at all clear what "capacity" Trichet is referring to. All the leverage ideas we have heard somehow involved the ECB, directly or indirectly. It would seem now that whatever form leverage takes, it will not be *directly* through the ECB. But it is useful that at least Trichet has implicitly endorsed the notion of leverage *in general.*

Meanwhile, the Bank of England surprised today, but again not with a rate change. It announced an extension of its quantitative easing program to allow for another £75 billion of purchases over the next four months, bringing the total of purchases to £275 billion. The bank pointed to moderation of the underlying rate of growth in the UK economy as justification for the purchases.

The BOE's £75 billion QE operation is approximately equivalent to a $780 billion package for the US, taking the size of each economy into account. However, the ECB €40 billion CBPP is vanishingly small compared to the Euro area economy. And is not even true quantitative easing, as it does not purchase sovereign debt. The ECB instead refers to it as "credit easing," as Ben Bernanke does with respect to the Fed's purchases of MBS.

CPI, year-over-year — Euro area --- 10-yr trend — UK --- 10-yr trend



Source: Eurostat, ONS, TrendMacro calculations

The BOE and the ECB are pursuing very different tactics in addressing similar problems (please see the chart above). The BOE's base rate is currently at 0.5%, with the latest CPI reading for the UK at 4.5% year-over-year -- against a 2% target -- and sluggish growth in the economy. Not overly perturbed by inflation, the BOE has chosen QE as the solution to both growth and banking system stability. The ECB, on the other hand,

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with rates at 1.5% and latest inflation estimate at 3% -- also with a 2% target -- has decided that providing limitless liquidity will be enough to stave off the problems within the banking sector. But the ECB does not seem to be concerned about growth at all -- hewing entirely, obsessively, to its single mandate to target inflation.

The only other interesting thing about today's ECB meeting was that the decision on interest rates was not unanimous. It has been a tradition of the ECB governing council that all rate decisions are unanimous, so this apparent discord may point to the needed rate cut sooner rather than later. It could also be an institutional response to last month's resignation of Juergen Stark -- within the tradition of unanimity, a dissenter has no choice but to resign (see "Too Few Good Men" September 9, 2011).

This will put the incoming ECB president -- Mario Draghi -- in an uncomfortable position. He may have to cut rates at his first meeting as President of the ECB, a move unlikely to endear the Italian to the inflation-phobic northern members of the ECB.

There is an alternative, though -- one which we consider unlikely, but worthy of mention nevertheless. Trichet does have one more governing council meeting as President of the ECB, on October 20 in Frankfurt. While it would be extremely unusual for a rate decision at a meeting other than the first meeting of each month, there is nothing stopping the ECB changing rates whenever it wants. We only highlight this because a rate cut on October 20 would have several positive effects:

- It would allow Draghi to start his tenure as President without the ghost of Trichet's past policy mistakes -- this year's rate increases -- hanging over him.
- It would coordinate very well with the meeting of the European heads of state on the October 18, where we are now looking for decisive action on Greece and other European fiscal problems.
- Full Eurostat inflation data will be out by then, and if it comes in below the 3% flash estimate, it may give the ECB room to act that it does not have at the moment.

We do not see a rate cut at the October 20 meeting as likely, but in these unusual times, it would make sense for the ECB to do it. Given the ECB's poor track record for making sense, we expect to be disappointed.

Bottom line

ECB President Trichet failed to use one of his last opportunities to unwind his catastrophic rate hike errors. But the ECB will continue to flood the banking system with liquidity. Rates must be cut, lest they continue to strangle growth -- but incoming president Draghi, as an Italian, will be in a difficult bargaining position with inflation-phobic northern colleagues. The BOE has decided to extend its QE by £75 billion, the US equivalent of $780 billion.