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TRENDMACRO LIVE!

On Central Bank Coordinated Action

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The BOE, PBOC and ECB show how far marginal returns on central bank action have fallen.

An extra [£50 billion QE from the Bank of England] (BOE), rate cuts from both the [People's Bank of China] (PBOC) and the [European Central Bank] (ECB) in what seems like coordinated action -- yet markets are nevertheless lower worldwide, with both European peripheral stocks and bonds particularly badly hit. The message would seem to be that central banks are facing strongly diminishing returns to policy actions. As the unenthusiastic reaction to the Fed's small extension of "Operation Twist" last month suggests (see ["On the June FOMC"] June 20, 2012), from here it will take truly grand gestures to make a difference.

- The PBOC move aside, much of what was announced today was not a surprise. The increase in the BOE's QE program was expected, and the 25 bp cut from the ECB -- which drops the deposit rate to 0% -- was the very minimum expected (see ["For Europe, It's the Politics, Stupid"] June 27, 2012).
- The BOE's deep foray into QE continues with Gilt purchases to total £375 billion once the £50 billion 4-month program announced today is completed. This will leave the BOE holding 37% of the *stock* of UK sovereign debt. This is the equivalent of the Federal Reserve doing $5.8 trillion of QE.
- While the BOE is willing to expand its balance sheet to counter what it calls the "margin of economic slack," the ECB remains unwilling to take meaningful action to stem Europe's crisis.
- The ECB cut in interest rates by 25 bp is significant only because it lowers the deposit rate to 0%, and reduces funding costs for banks using ECB monetary operations -- including the cost of the 3-year LTROs and ELA. This provides banks with higher margin possibility on loans not tracking ECB rates, and a greater incentive to lend funds they hold, as the risk premium between lending funds and leaving funds on deposit at the ECB is now the entire rate they can achieve for that lending.
- The ECB did not go as far as the Danish central bank though, who today [cut deposit rates to negative 0.20%] as its part in today's apparently coordinated action.

Update to strategic view

ECB, BOE, EUROPE MACRO: Seemingly coordinated ECB, BOE and PBOC action did nothing to improve sentiment, with central banks now having to make grand gestures to overcome diminishing returns on policy moves. For Europe, politics matters as much as monetary policy -- possible instability in German Chancellor Merkel's coalition is now the biggest risk factor.

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So why aren't markets happier? The key disappointment is that the ECB did not do more, especially in light of the progress made at the EU summit last week (see "No Senior Discount for Spain" July 2, 2012). There was no mention of the Securities Markets Programme (SMP) at the post-decision press conference, other than a reference by President Mario Draghi to the ECB still having "a full artillery" of both standard and non-standard monetary policy tools. Artillery not in the field is useless -- until the ECB is willing to bring out the big guns of outright QE, it will remain too tight for the extraordinary needs of Europe's crisis environment.

- It seems that the ECB has decided that there still needs to be more political movement before it can respond in a more meaningful way (again, see "For Europe, It's the Politics, Stupid").
- There is the chance that the ECB will never do any more for the sovereign debt market, instead leaving the solution completely up to the politicians. If this is the case, then at least we will not have to wait long before we get more clarification on how far those politicians are willing to go. The next Eurogroup meeting (meeting of euro area finance ministers) is due to be held on Monday.
- However we are already seeing the backlash in Germany to the perceived defeat of Chancellor Angela Merkel at last week's EU summit. Her coalition partner, the Bavarian CSU, has said that further country bailouts may lead them to pull out of government, and well known euroskeptic Hans-Werner Sinn has taken the opportunity to pile on the pressure.
- So the ECB seems to want more from the politicians, and the politicians seem to be coming to the end of what they do with relative ease. How this pinch-point plays out in the euro area in the coming months is going to be key for our long-term scenario in which Europe rescues itself, one crisis at a time, through ever-more substantive political and economic integration.
- Throughout the crisis, the dominant player has been Germany on the political side and the ECB on the monetary side. We don't want to overplay this based only on a few political emanations, but with the ECB unwilling to do more than the bare minimum and Germany at risk of being unable to provide the lead role it has to, the crisis could be entering a dangerous new phase.

Bottom line

Seemingly coordinated ECB, BOE and PBOC action did nothing to improve sentiment, with central banks now now having to make grand gestures to overcome diminishing returns on policy moves. For Europe, politics matters as much as monetary policy -- possible instability in German Chancellor Merkel's coalition is now the biggest risk factor.

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