It’s raining monetary easing

The global economy is in transit through difficult times in the midst of an unresolved euro zone crisis that threatens to erupt frequently, resulting in volatility in markets. Low growth appears to be the expectation this year and emerging markets are not de-coupled from this development. What was earlier considered a euro problem is now global and governments and central banks are working hard to find a solution. The progress has been uneven so far and the quest to boost growth continues. Against this background, there has been some affirmative action taken by central banks in different countries.

Concerted action or similar thinking?

Three developments, apparently related, though independently crafted have raised hope in the global financial markets. The ECB lowered interest rates to all-time lows but did not introduce any unconventional moves to stimulate economic activity. The Bank of England held rates steady at 0.5% but agreed to back an additional £50 billion in asset purchases, raising its total to £375 billion. The People’s Bank of China also announced a rate cut. In fact elsewhere too, central banks in Kenya and Denmark also sought to ease credit conditions. Denmark's Nationalbanken took an unusual step by saying it would charge banks a 0.2% interest rate for funds that they leave on deposit with the central bank rather than lend out. What does all this mean?

The common fear

There is evidently a scare that the global economy is slowing down and all the components, i.e. countries are stressed; and one way out is to lower rates. The danger is that slackening demand in one country hits firms in another, leading to a self-reinforcing decline. American new export orders fell sharply due to slack demand in China and Europe. The Brazilian economy is heavily dependent on exporting commodities to China, so it is bound to be affected by a slowdown in industrial growth there. Germany too is vulnerable to Chinese slowdown which would hit its big exports of luxury cars and investment goods. China, it appears will be the fulcrum for future growth this year. Therefore, it does appear that all economies are being guided by an invisible hand to work together to revive global economic prospects.

ECB lowers rates

The ECB cut its main lending rate by a quarter of a percentage point to 0.75%. The ECB's belief is that the Euro zone was likely to show little or no growth in the second quarter of the year though is expected to recover somewhat by the end of the year. Falling inflation offered room for such action as it was not a risk (as is the case in India) and growth is the main target to be addressed to boost sentiment. The ECB also lowered two other key interest rates: the rate on a marginal lending facility was decreased to 1.5%, and interest rates on deposits were lowered to zero.

The quarter-point cut in its main refinancing rate will help banks in the ailing economies of southern Europe as it will feed into the rate they pay on the big three-year loans extended by the ECB in December and February which went basically to the peripheral countries. A similar reduction in the deposit rate, bringing it down from 0.25% to zero, will reduce money-market rates in the core countries like Germany where banks are flush with liquidity since these tend to hover a bit above the deposit rate, which acts as a floor.

These moves though considered necessary and widely expected, are regarded by critics to be insufficient to turn the euro zone economy around. Europe really needs a much stronger fiscal and political underpinning to buttress what will otherwise remain a rickety monetary union.

Were there other options?

ECB has other options such as the launch of its own government-bond-purchase program to push down long-term interest rates or expansion of its program of long-term loans to banks or lending to European rescue funds so they have more resources to directly support banks and indebted national governments. However, Mario Draghi has not made any indication that the ECB might consider a third long-term refinancing operation to funnel funds into European banks. The earlier LTRO finance did help reverse outflows of capital from the euro zone. But they were unable to increase lending around the euro zone.

Bank of England prefers quantitative easing

The Bank of England has not changed rates but will purchase bonds worth an extra £50 billion ($78 billion), taking the total to £375 billion. The Bank of England warned that recovery was at risk without a boost to its programme of quantitative easing after a flurry of economic surveys showed the double-dip recession could stretch into the autumn. The Central Bank had previously made purchases of £325 billion in two separate phases, the last of which ended as recently as early May 2012. Central bankers in many developed economies are however reluctant to push too hard on unfamiliar tools like the Bank of England's bond-buying program.

Chinese action

People’s Bank of China has cut interest rates, the second time in less than a month, to jumpstart a slowing economy. In June, the central bank responded to economic concerns by cutting interest rates for the first time since 2008. The bank also tried to spur growth in May by reducing the money banks are required to hold in reserves thus freeing up those funds in order to boost investment. The rate cuts follow disappointing economic data, causing concern about a slowdown in growth. Benchmark lending rates will be cut from 6.31% to 6%, while deposit rates will fall from 3.25% to 3%.

The impact will be monitored closely considering that China is now the world's second-largest economy after USA. Policymakers were concerned with June data and decided to take swift action. China's economy grew at an annual rate of 8.1% in the first quarter, the slowest pace in almost three years. China's export growth has been hit by a fall in demand from two of its biggest markets, the US and Europe, which are still struggling with the global debt crisis. The Chinese government, in its survey of purchasing managers, noted that there was a sharp drop in new export orders as weakness in other parts of the world affected the Chinese economy.

What about other countries?

Central banks in developing economies like China's are haunted by a fear of driving up inflation or causing another speculative bubble. That could limit their willingness to move more aggressively. The Fed will be meeting this month end and reviewing the situation. There are hopes that a QE3 could be possible, given that there is no room on the side of interest rates.

How will the RBI react?

The RBI has always maintained that monetary policy is dictated more by domestic conditions rather than 'by what other central banks are doing'. There was a convergence in goals during the financial crisis time, but then conditions were mimicked in domestic markets too. Presently inflation is the major concern and has been combated by the RBI for over 2 years. In the absence of this number coming down, it is unlikely to aggressively work towards monetary easing as is being done on other countries.

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