WestLB

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# Economic News

MONETARY POLICY

## Coordinated key rate cuts

**In a concerted action, leading central banks have cut their key rates. The Fed, the ECB, the Bank of England and the Sveriges Riksbank have each cut their key rates by 50bp, while the Swiss National Bank has lowered its rates by 25bp. Nevertheless, this still does not resolve the core problem of the seized up refinancing market. We believe that state guarantees for the issuance of new bank debt are necessary to break out of this vicious circle.**

- Following the further escalation of the financial market crisis in the last few days, leading **central banks have acted in concert to cut their key rates**. Bailout packages for the banking sector, the nationalisation of individual institutions, increasingly greater cash injections and most recently also the direct purchase of securities in the US have not sufficed to restore the severely dented confidence in the financial markets. Many central banks have so far refrained from easing their key rates, even though the downside risks to growth have grown considerably of late. Only yesterday, Fed Chairman Ben Bernanke was still deliberating whether the Fed should reconsider the appropriateness of its monetary policy stance. After consultations with other central banks the Fed has readjusted its position.

- However, whether **today's joint action** will suffice to **restore the severely damaged confidence within the financial sector is questionable**. Rate cuts such as those coordinated today by the Fed, the ECB, the BoE and other national monetary institutes will ensure that the banking system has additional liquidity, but these measures are not a real alternative to a functioning and liquid interbank monetary market. This is all the more true as experience in recent months has shown that banks have hoarded this additional liquidity, but have not sufficiently utilised it for further lending on the money markets or other areas.

- We believe this financing problem cannot be resolved using the classic and also the newly created instruments of monetary policy (TAF, TSLF and UP). The crisis of confidence has limited the banks' lending ability as they are currently unable to refinance their loans. This credit crunch therefore represents a major risk for the future performance of both the real economy and the financial markets. In order to break the vicious circle of dried-up liquidity in the money market and further crises in the banking sector, we feel a **new source of funding will have to be made available to the banks**. This financing could be achieved by issuing a new category of bank bond that comes with a fee-based state guarantee. This fee should be levied from the issuing bank depending on the term and the issue volume (25 to 50bp are conceivable figures, in our view). In addition, the maximum guarantee should also depend on the capital structure of the issuing institution (based on a tier 1 capital stock ratio) and the term of the guarantee bond.

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- As the British Prime Minister Gorden Brown also put it today, this means that **governments**, particularly in Europe, **are called upon to act**. Nevertheless, the central banks have signalled with their actions that they will utilise all of the options at their disposal. The downbeat economic prospects in the EMU and the UK suggest there will be further rate cuts to come. Despite their already low level, further cuts in interest rates cannot be ruled out in the US either over the next few weeks and months.
- **Stock markets:** The central banks' concerted action will initially ease the situation for the equity markets, which is dominated by great uncertainty. In particular, the fact that the various interventions at the national level have now been followed by joint action should nourish the hope that the dried-up liquidity situation could be alleviated by further coordinated interventions. This is because the rate cuts in themselves should be primarily regarded as reassurance to calm the hyper-nervous markets, as they are hardly likely to have any directly positive impact on the extremely strained liquidity situation. To bring about a sustained stabilisation of the markets would require further synchronised global measures, like the above state guarantees for corporate bonds, which would revitalise the money and bond markets. The central banks' actions would therefore still need to be backed up by further coordinated steps.
- At the **sector level,** we expect to see emotional rotation. Besides the banking sector, the winners should include in particular raw materials, but also cyclical industries like chemicals, construction and industrials. The defensive sectors may well only benefit less than average from the recovery of the market, if at all.
- In addition, **euro corporate bonds** are likely to profit in the short term from the joint action taken by the major central banks. In the past two weeks, spreads have risen by more than 100 basis points in the investment grade segment, and by close to 500 bp for high yields. We do expect this situation to return to normal, but this may well be initially driven by an increase in government bond yields. In the medium term, however, the high level of risk aversion will only normalise when confidence in the banking sector is also backed by government action.
- **US dollar:** The dollar has reacted initially by hardly losing any ground against the euro. Since the joint action has not changed the relative interest rate differential between the US and Europe, we do not believe the greenback will weaken significantly. Setbacks in the near term are certainly likely, but we think the trend still points towards a firmer dollar.

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