

ING Investment Weekly

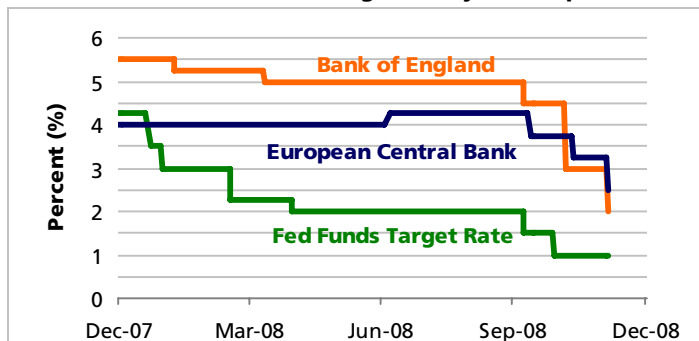
Global Base Rates Converge Towards Zero, Fiscal Stimulus Lags

by Martin Jansen, Senior Portfolio Manager

Until well into the third quarter of this year, central banks outside the U.S. were more concerned with the inflationary pressures in the wake of surging commodity and energy prices than with the worsening economic outlook as the crisis in the global financial markets began to affect economic activity. While the U.S. Federal Reserve began lowering rates in September 2007 from a high of 5.25%, and cut aggressively in the first quarter of 2008, the Europeans in particular maintained a tough monetary policy stance, actually raising their base rate to 4.25% as recently as July of this year. This past week, however, saw a second round of aggressive cuts in the United Kingdom and Europe in a belated move to offset an increasingly bleak economic outlook.

As Chart 1 shows, the major central banks finally coordinated their interest rate responses in October, when unrelenting pressure on the global financial system and increasingly recessionary conditions shifted the focus from price pressures to a possible deflation as consumer spending and industrial momentum turned suddenly negative.

Chart 1: The ECB and Bank of England Play Catch Up



Source: Federal Reserve, Bank of England, European Central Bank

In a mere two months the United Kingdom has slashed its base rate from 5% to 2%, with an unprecedented 150 bps cut in November followed by another 100 bps in early December. The continental cousins were somewhat less aggressive, easing by 50 bps in November and by 75 bps in early December. The other major player, the Bank of Japan, has pursued a near-zero interest rate policy since 1995, and reduced its target by 20 bps to 0.3% as a gesture of solidarity. Markets expect additional cuts, especially in the United Kingdom and Europe, resulting in an interest rate base converging swiftly on that of Japan.

While central banks everywhere have provided massive liquidity to stabilize the system, access to credit for even the most creditworthy of borrowers remains severely impaired. Widening credit spreads have resulted in no pass-through of lower credit costs for existing borrowers. The recent spate and scope of base rate cuts is therefore essential, as effective borrowing costs are finally starting to decline in an absolute sense. However, increasingly bleak employment prospects for all the major industrialized economies and the dramatic fall in household wealth has shattered consumer confidence. Business confidence likewise has tumbled in recent months. Aggressive and coordinated fiscal policies are required to prop up domestic consumption in all these economies.

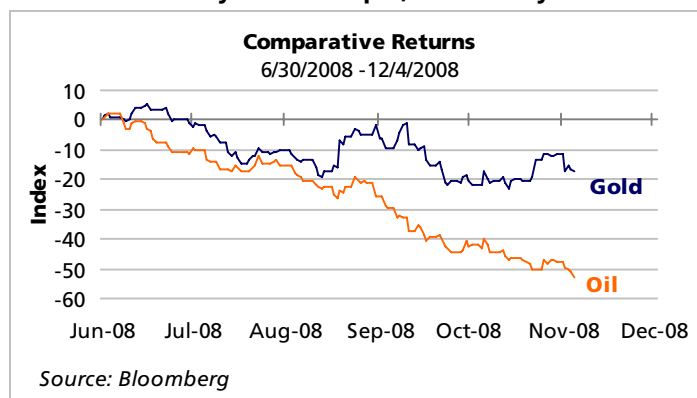
The U.S. is most advanced in this respect, but there is a lack of momentum pending the change in administration. The European response, to date, is an outright disappointment. Germany, Europe's largest economy, has announced a paltry 12 billion euro package. The expectations component of the IFO Institute for Economic Research business survey has fallen sharply to record low levels since the inception of the survey in 1991. Germany is already in a recession and the Bundesbank is

expecting it to be the worst since at least 1982. As the economic contraction bites, however, the stage is being set for a substantial fiscal boost in the first half of 2009.

On the positive side, the collapse of commodity prices, and in particular the price of oil, will alleviate some of the intense pressure on consumers and businesses. The CRB commodities index has collapsed from its lofty peak in June to the level of 2002, which too was a recessionary period. Combined with the coming fiscal stimuli, the hope is that demand will stabilize by the second half of next year. The decline of government bond yields across the maturity spectrum, induced by a flight to quality in a paranoid risk-averse climate, is an indication that governments must step up to the plate. While the market is not yet focusing on the longer term implications of what will be a huge increase in the government debt-to-GDP ratio, this could become an issue once economies do stabilize.

Interestingly, as Chart 2 depicts, the price of gold, which was strongly correlated to commodity prices generally when they surged, has appeared to have decoupled since mid-October and has held steady while the broader commodity index moved to a succession of new lows.

Chart 2: Commodity Prices Collapse, Gold Steady since October



This could prove to be a temporary anomaly, but it warrants monitoring as, depending on how policy evolves, we may be sowing the seeds of an inflationary spiral as we head into the next decade. ■