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Autor: Krista Hughes
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- * ECB policymakers debating how low to take main refi rate
- * Masks agreement to let market rates sink below benchmark
- * Two-tier message helps avoid charge of irresponsibility
- * 3-month interbank rates taking on new policy focus

By Krista Hughes

FRANKFURT, March 11 (Reuters) - When the European Central Bank was raising interest rates at a steady pace, it was often criticised for distilling its message to an over-simplistic set of code words signalling the timing of the next move.

Now, with euro zone interest rates at a record low and set to go even further, the ECB is pursuing a far-from-simple double-act in its communications policy with one message for the markets and another for the general public.

At one level, ECB policymakers differ publicly over how low to take the benchmark refinancing rate, which has been slashed by 2.75 percentage points to 1.5 percent but remains the highest among major developed economies.

Governing Council members including Athanasios Orphanides and Mario Draghi have said that fretting about cutting the main rate too close to zero cannot justify inaction. But President Jean-Claude Trichet has said zero rates would be "very inconvenient" and others, including Axel Weber, see 1.0 percent as the trough.

Another policymaker, Lorenzo Bini Smaghi, has warned against overshooting with rate cuts, although he says zero rates would be appropriate in the unlikely event of deflation.

But this exchange of views masks a consensus on letting short-term market rates fall well below the main policy rate -- potentially close to zero -- as the result of the ECB's own brand of credit easing. Economists have called this a zero interest rate policy by stealth.

(For report on this, double click on)

By flooding markets with liquidity, the ECB has pushed short-term market interest rates below the benchmark refi rate. The overnight deposit rate, which is one percentage point lower at 0.5 percent, is now acting as a floor for money markets.

This allows the ECB to argue that its policy is actually very expansionary and is helping the real economy, even though the refi rate remains well above equivalents in the United States, Japan and Britain.

"On the one hand, it looks like the ECB is not lowering rates quickly or by enough, but on the other this kind of refinancing is a unique ECB approach," Barclays Capital economist Julian Callow said.

"It's almost like you have a two-tier approach to satisfy both sides. The doves can be satisfied that their rate is going close to zero and the hawks can be satisfied that their rate is not going so close."

As well as helping to reconcile any internal differences, the two-pronged approach has other advantages.

Leaving the official benchmark rate relatively high while flooding markets with funds means the ECB can reverse some of the alchemy later without drawing the political criticism which usually accompanies official interest rate rises.

It also helps the ECB to avoid accusations that it is risking future bubbles by taking rates too low, too quickly -- as the U.S. Federal Reserve has experienced.

"It's a fine line they are walking right now," said Bank of America Merrill Lynch economist Gilles Moec. "Basically there's a message for the market and a message for the commentators: 'look at what we actually do'. And another message for public opinion: 'no, we won't get to zero because we don't want to feed the next bubble'."

CONSENSUS ON MARKET RATES

One of the drivers of the theoretical debate about the appropriate level for the refi rate is Orphanides, a former Fed economist with a long list of publications to his name.

In a speech on Jan. 28, he argued that it was a fallacy that monetary policy lost its punch when rates hit zero.

This goes against public statements from other policymakers, including Germany's Weber, who oppose zero rates. Weber said on Tuesday that he would not even like to see the overnight deposit rate at zero and this should stop at 0.5 percent.

Still, Weber said he was happy for market rates on loans for as long as six months to fall below the benchmark refi rate. This rate should now be seen more as a ceiling for money market rates than a floor, he told Reuters TV.

"With a main refinancing rate of 1 percent you will probably see the ceiling of money market rates at 1 percent. What will determine the floor for our rates is our deposit rate."

Bini Smaghi has also said he sees three-month and overnight market rates trading below the main refi rate.

Their comments gel with an argument put by Orphanides in a 1999 Fed research paper, despite the apparent surface differences between policymakers on the optimal rate level.

Orphanides and co-author Volker Wieland said a central bank which normally targets overnight rates may have to shift its focus to longer maturities if very short-term rates are already zero bound.

Some people in the money markets say the ECB's move to allow overnight market rate to hover close to the deposit rate means it has already moved its eye out along the yield curve.

"You could just as easily say the ECB has now switched to targeting three-month money rather than overnight money," one trader at a euro zone bank said.

The ECB's approach is working, as three-month Euribor, used as a benchmark for many mortgages and corporate loans, has hit record lows in recent weeks.

Markets at least are happy with the results behind the ECB's message. "The key thing is that three-month money is much more a point on the curve that gets out into the real European economy," the trader said.

"If you truly want to get your interest rate policies out to the economy, then tolerating a softness in overnight money has and is working for the ECB." (Additional reporting by Marc Jones; editing by David Stamp)