

## G5 Interest Rates After the Surprise

Market developments drove a number of central banks to announce interest rate cuts outside of their regularly scheduled policy meetings earlier today. The rate cuts injected extra volatility into the markets but did not ease market anxiety. The anxiety is being fed by a four-fold concern: (1) reducing illiquid and distressed assets. (2) recapitalizing the banks. (3) preventing a more serious economic downturn. (4) rekindling animal spirits (risk taking). The central banking community will have to do more on the rate cut front (along with liquidity injections and measures to try and recapitalize the banking system).

The **Federal Reserve's** 50bp cut in the Fed funds and discount rates does not rule out another cut at the October 29th meeting. There is precedent for a rate cut at a regularly scheduled meeting following an inter-meeting move. The Fed may lower the target rate another 50bp to 1.0% which is where the market is already expecting it to be at year end. The Federal Reserve may also move the discount rate to the Fed funds target as another way to reinforce its extremely accommodative stance.

Since **European Central Bank** and Bank of England rates are the highest in the G7, there is more room for them to cut rates than the Fed. The question is how much. In the previous monetary easing cycle, euro zone rates reached a low of 2% (in June 2003, for over two years). This would represent a reasonable target of where the refi rate will move over the medium-term. This coordinated rate cut does not preclude a rate cut before the end of the year.

It is a similar argument for the **Bank of England**. There will be a need for an aggressive monetary policy response from the Bank of England – especially as the room for maneuver seems rather limited on the fiscal policy front. UK base rates reached a low of 3.5% in the previous easing cycle (in December 2003) but given the current circumstances, we could see rates falling below that level to the 3% mark by the end of 2009 with another 50bp cut likely to be delivered before year-end.

The **Bank of Japan** did not participate in the coordinated rate cuts. With the official rate already at a low 0.5%, a cut looks unlikely in the near term. However, renewed deflationary forces are threatening. Japan may choose to take action to counter these deflationary forces. Intervention to smooth out the yen's appreciation cannot be ruled out at some point

The **Bank of Canada** meets before the Federal Reserve's October 29th meeting and another Canadian rate cut cannot be ruled out. Canada is likely to elect a minority government in mid-October, a negative for the Canadian dollar. The risk is that the Bank of Canada is influenced by the Monetary Conditions Index and will see the weakness of the Canadian dollar as part of an ease limiting the rate cut at the October 21st meeting to 25bp.

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