Rate cuts fail to spur global economy

By Madhavi Acharya-Tom Yew
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Borrowing got cheaper from Beijing to Brussels after central banks in China and Europe cut their respective interest rates Thursday in an attempt to rev up their flagging economies.

Will the fuel injection do any good?

Economists are skeptical.

David Madani, Canada Economist at Capital Economics, expects the cuts to have a "modest" effect.

"And I'm being generous. It's only going to buffer the slowdown in the global economy," Madani said. "Already central banks have pulled out a lot of the stops to support the global recovery over the last four years and here we are struggling."

More signs of the struggle may be evident with Friday's release of June labour market figures for Canada and the U.S.

China cuts its key lending rate for the second time in a month to prevent a further slump in manufacturing. Interest on a one-year loan falls to 6 per cent from 6.31 per cent, the central bank said.

In a separate move, the European Central Bank cut its benchmark rate to 0.75 per cent from 1 per cent, as the latest unemployment figures showed the highest number of jobless people in the region's history.

Europe is now firmly in recession, the region's sovereign debt crisis is unresolved, (though the urgency has been dialed back), China's economy is slowing, and the U.S. continues to sputter (see the latest tepid retail sales report).

That means interest rate cuts, particularly when rates are already so close to zero, are likely to have little impact, economists say.

Interest rate reductions are meant to stimulate the economy by making it cheaper for consumers to borrow. For instance, it may prompt them to buy clothes or a fridge, take a vacation, or buy a home. That in turn means businesses may sell more of their products or services.

But when consumers are worried about their jobs, or when they're already so indebted they can't spend anymore, a small cut to rates is unlikely to get them to open their wallets.

Similarly, businesses concerned a recession may be on the horizon are unlikely to hire employees or expand their operations.

Banks would be reluctant to lend for fear of bad loans.

Central banks around the world have slashed interest rates repeatedly since the 2008 global financial crisis and the recession that followed.

In Canada, the overnight lending rate is holding steady at 1 per cent is may not change until mid-2013. The U.S. Federal Reserve's target rate is holding steady at a miniscule 0.25 per cent.

"When rates are effectively at the zero band to begin with, the effect of each additional rate cut is lower," said David Onyett-Jeffries, economist at RBC Economics Research.

Ultimately, it means governments have one less lever to pull as they try to get the economy moving.

"You do get to the point where there's not a lot more you can do on the rate side," Onyett-Jeffries said.

Hence, the latest move by the Bank of England, which left its base interest rate unchanged at 0.5 per cent, but announced an injection of 50 billion pounds into its bond-buying program, bringing the total for the quantitative easing initiative up to 375 billion pounds.

Markets rallied briefly after the rate cuts, but then sank back as investors remained fretful about the state of the global economy.

The "ECB interest rate cut does little to alter the bleak economic outlook," said Jennifer McKeown, analyst at Capital Economics.

Capital Economics expects economic growth in Canada to come in at 2 per cent this year and 1.5 per cent in 2013. (That's well below the consensus view.)

"We do think the situation in Europe will be prolonged. We see an ongoing recession in that area. We see some slowing in China, but not a hard landing. The U.S. economy we see scraping by with sluggish growth around 2 or 2.5 per cent," Madani said.

"Against that backdrop we do expect further declines in commodity prices, particularly oil."

On the other hand, the U.S. recovery could gain unexpected traction. If the euro continues to limp along, rather than implode, and the Chinese economy picks up speed, that would be positive for commodity prices and, by extension, Canada.

"It's plan for the worst and hope for the best. It could go either way and I think that's what weighing on confidence around the world and on Canadian businesses," Madani said.

U.S. retail sales rose 2.5 per cent in June. That's the third consecutive month of weak growth and well below the 7.7 per cent increase for June, 2011.

As for the June labour market report, Madani expects it will show modest growth with no major change in the jobless rate.

By contrast, RBC estimates that the Canadian economy added about 16,000 jobs in June, a sign that the labour market is fairly solid and will support future growth.