Group Economics

# UK Monthly Economic Update

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## Monetary Policy Committee (MPC) lowers the Bank Rate by 50bps to 0.5%

Comment from Stuart Porteous, Head of RBS Group Economics:

*"Savers lose out again as the Bank of England opts to cut rates and inject more adrenaline into the ailing economy. But with rates on hold until well into 2010, and the economy requiring more life support, rates will soon be yesterday's news. The focus is on the next stage as the Bank takes UK policy into uncharted territory - printing money."*

## Interest rate cuts are not doing their job

**The downturn continues unabated.** The UK economy contracted by a hefty 1.5% q/q in Q4 2008 – the worst outturn since 1980 Forward-looking indicators point to a similar decline in Q1 (chart 1). Most forecasters (ourselves included) expect activity to fall throughout 2009. This bleak outlook may seem hard to square with the fact that the Bank of England has displayed unprecedented aggressiveness, bringing down the Bank Rate to an all time low of 0.5%. Part of the explanation is that it takes 12 to 18 months for rate cuts to have their full stimulative impact. But this is not the whole story – rate cuts just aren't feeding through in the usual way.

**Lower interest rates normally boost the supply of money**. We can tell that monetary policy is not working normally when ultra-low interest rates fail to provide a boost to the amount of money in circulation. A lower Bank Rate means that it is cheaper for commercial banks to borrow from the Bank of England. As commercial banks pass these lower costs of borrowing on to their customers, the demand for credit rises, and the money supply increases. In due course, this pushes up overall demand for goods and services. **But money supply growth is slowing** (chart 2). Households and firms have less appetite for borrowing, while banks remain cautious. Bank of England Governor, Mervyn King, seems determined to reverse this trend, saying that future policy measures would be "aimed at increasing the supply of money in order to stimulate the economy". The umbrella term for these measures is "quantitative easing".

## "Quantitative easing" to the rescue?

**"Quantitative easing" essentially means creating new money.** The Bank of England is the only institution in the UK that has the right to create new money directly. Under 'quantitative easing', the Bank would make extensive use of this privilege, issuing new money to buy a variety of assets. Rather than physically printing notes, the central bank purchases assets from commercial banks, crediting the accounts each bank has at the Bank of England. These new funds are called 'excess reserves' and can be used for new lending. However, boosting 'excess reserves' does not ensure a rise in commercial bank lending. US experience shows that banks sometimes hoard additional liquidity and the supply of money outside the banking sector may not rise as much as the Bank of England would like.

**Quantitative easing has the potential to deliver a boost through two channels.** Buying assets not only increases the supply of money as outlined above, it can also drive down the cost of credit for households and firms in the process, depending on which assets the Bank of England chooses to purchase. For example, purchasing corporate bonds would push down the yield (interest rate) on these instruments, lowering borrowing costs for firms. However, the Bank of England is only one player in financial markets - its purchases may fail to move asset prices (hence borrowing costs) decisively if investors sell assets at an even faster rate. Although in an extreme case, the Bank could even lend directly to companies, filling a role normally left to private banks.

By purchasing assets and taking on these risks, the Bank of England could incur losses. That is why any move under 'quantitative easing' has to be agreed with, and underwritten by, the Treasury. This is uncharted territory – hence calibrating the correct amount of Quantitative Easing will be tricky.

## Exiting 'Quantitative easing' will bring fresh challenges

The money injected into the economy will have to be drained when recovery comes, otherwise inflation will start to rise (with too much money chasing too few goods). But if 'quantitative easing' is reversed too early, it could send the economy back into recession. Moreover, taking money out of the economy requires the Bank to sell the previously acquired assets, which could depress prices, leading to a sharp rise in the cost of credit.

**Chart 1: Leading indicators of activity, remain deep in contractionary territory**

*(Purchasing Managers' Indices > 50 = expansion)*

*Source: Datastream*

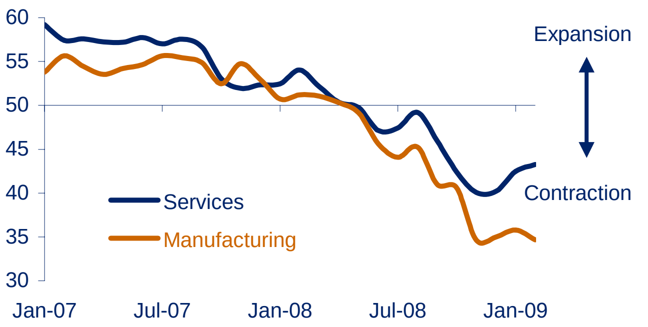



**Chart 2: Money supply growth is slowing sharply (households and non-financial companies)**

*(y/y)*

*Source: Bank of England*

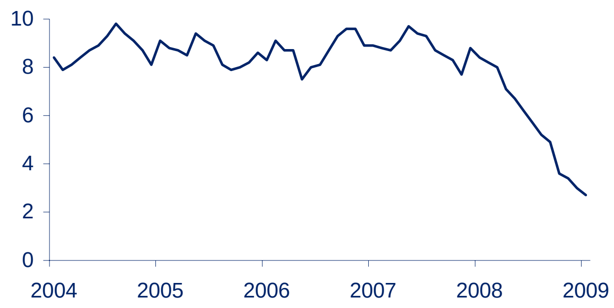
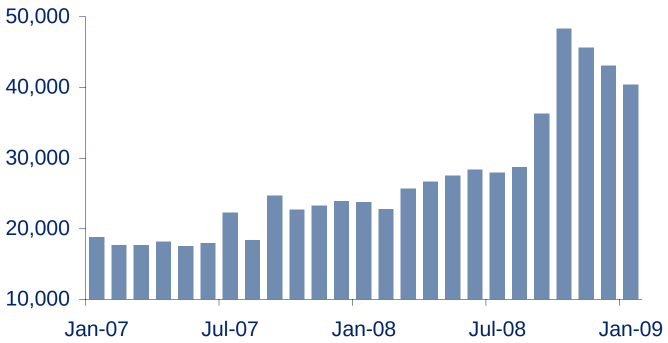



**Chart 3: 'Excess reserves' have been rising even before the announcement of quantitative easing**

*(in million)*

*Source: Bank of England*




**Interest rate facts & figures**

*Source: Bank of England, RBS Group*

| | Bank of England | RBS Group |
|---|---|---|
| **Current rate** | 0.5% | 0.5% |
| **Since** | 5th Feb 09 | 5th Feb 09 |
| **Month ago** | 1.00% | 1.00% |
| **Year ago** | 5.25% | 5.25% |

*Minutes of December MPC meeting released: 18th March 2009*
*Next MPC announcement: 9th April 2009*
*Next Inflation Report published: 13th May 2009*

**Following the decision, The Royal Bank of Scotland, National Westminster Bank plc and Ulster Bank Ltd. lowered their Base Rate by 50bps to 0.5%**

| *All in %* | Retail Price Index (includes mortgage payments) *RPI* | Consumer Price Index *CPI* |
|---|---|---|
| 2007 | 4.5 | 2.9 |
| | 4.4 | 2.6 |
| | 3.9 | 1.8 |
| | 4.2 | 2.1 |
| 2008 | 4.0 | 2.4 |
| | 4.4 | 3.4 |
| | 4.9 | 4.8 |
| | 2.7 | 3.9 |
| 2009 | -0.3 | 2.2 |
| | -1.3 | 1.1 |
| | -2.4 | -0.5 |
| | -1.8 | -0.5 |
| 2010 | 0.8 | 0.8 |
| | 1.5 | 0.8 |
| | 1.7 | 1.0 |
| | 1.8 | 1.0 |

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