

Central bankers and the status quo

9th August 2010

Teenagers and central bankers see eye-to-eye on at least one issue – that doing nothing is not the same as inaction or indecision. With the recovery uncertain and the data mixed, policy makers have concluded that keeping rates loose remains the only sensible course to take.

The Bank of England's Monetary Policy Committee (MPC) left interest rates unchanged and kept their asset purchase program on hold at their August meeting last week. UK policy makers must tread a narrow path between a fragile recovery on the one side and the risk of higher inflation expectations on the other. As noted in last week's MPC minutes, in this scenario, "doing nothing is the best way of balancing risks." It has now been 18 months since the MPC cut the Bank rate to its historic low of 0.5%. Yet doing nothing can sometimes be a positive decision.

The UK Purchasing Managers Index (PMI), a lead indicator of economic activity, suggested that the strong rebound in output in Q2 might be softening. Although all three components of the PMI remain above the 50 point that separates expansion from contraction, July's figures for the service, manufacturing and construction sectors all weakened compared with June. Growth weakened in the service sector in particular. The index of private sector service companies dropped to 53.1 from 54.4 in June, with many business citing looming public sector cuts as a dark cloud depressing orders, proving the interdependency between the private and public sectors runs both ways.

The manufacturing sector is holding-up better. Increases in new orders helped UK manufacturers post a, still healthy, PMI reading of 57.3. In addition, job creation in the sector was robust, while manufacturers felt able to pass input price pressures onto customers – a reassuring indication that the sector is getting back on its feet. Outside the manufacturing sector, other production industries continued their decline in Q2 2010. Mining & quarrying, which is overwhelmingly oil & gas extraction, fell 6% compared to Q2 2009.

The equivalent Eurozone (EZ) services sector PMI rose to 55.8 in July, slightly higher than June's 55.5. The headline measure hides increasing polarisation within the monetary union, as rising expectations in the EZ's two largest economies, Germany and France, helped offset weakness in the periphery. Although it is encouraging that Q2's better-than-expected growth is continuing into Q3, it is too early to be optimistic. The strengthening euro could curb exports, while a two-speed recovery creates its own set of challenges.

The European Central Bank (ECB) agrees, as it also left the main policy rate for the Eurozone unchanged at 1% for the 15th month in a row. Despite welcome signs of improvement, the EZ's economy is still operating well below full capacity and, unlike the UK, inflation is set to remain below the 2% target ceiling. Without the need to keep at least half-an-eye on rising inflation expectations, we see little cause for the ECB to begin contemplating raising rates anytime soon.

Rates are also likely to remain on hold, at 0%-0.25%, when the Federal Open Market Committee (FOMC) meets on 10th August. The Fed's statement will probably re-iterate that it intends to keep rates "extremely low" for an "extended period". However, the FOMC may introduce a subtle shift in policy. The Fed appears to be considering re-investing the proceeds of the maturing mortgage bonds that it purchased as part of its asset purchase scheme to boost the economy. The funds would most likely be used to purchase Treasury securities, which would help keep down medium and longer-term interest rates, providing a modest additional stimulus.

Given US data continues to disappoint it's not hard to see why further policy easing is being considered. Weak US consumer spending and personal income data adds to growing evidence that the US economy will struggle in the second half of the year. Personal disposable income was flat in June, compared with a 0.4% average rise in the past three months. It is the first time that personal incomes have failed to rise month-on-month since September 2009. A slight fall in the wages and salaries earned by US workers was the culprit. Personal consumption also fell slightly m/m in June, by \$2.9 billion. Although this is less than 0.1%, its effects ripple large distances, as the US consumer remains the engine of global growth.

In addition, US labour market data continued to show a jobless recovery. July's widely watched non-farm payrolls release, reported that the number of jobs fell by 131,000 – double the losses anticipated, while revisions to last month's figures meant 221k jobs were lost in total in June.

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