

# UK Monthly Economic Update

4<sup>th</sup> December 2008

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## Monetary Policy Committee (MPC) lowers the Bank Rate by 100bps to 2.00%

Comment from Stuart Porteous, Head of RBS Group Economics:

*“Business activity, employment, confidence – take your pick, the UK economy is steering dangerously close to a deep recession. The MPC clearly thinks interest rates are at the wrong level and is intent on bringing them down as quickly as possible. At this stage, the risks of doing too little dwarf the risks of doing too much. But as rates approach zero, let’s spare a thought for the 8 million or so net savers in the UK.”*

## New public enemy number one: deflation

**Although risks remain small, deflation can no longer be ruled out.** Deflation refers to a *sustained* fall in the *general* price level across the economy – not to be confused with the cyclical moderation in inflationary pressures now underway. Testifying before the Treasury Select Committee last week, Mervyn King, Governor of the Bank of England, said that the UK would see “deflation come to pass” if problems in the financial sector intensified. This is a significant change. As recently as September, Mr King wrote that “inflation is likely to remain markedly above the target until well into 2009.”

**This reflects the seismic shift in inflation expectations in just three months** (chart 1), driven predominantly by two factors. First, commodity prices have fallen even more quickly than they rose in the start of the year – a barrel of oil now costs \$45, down 70% in just five months (chart 2). Second, and equally importantly, the negative feedback loop from the crisis in financial markets to the wider economy has hit with a vengeance. Demand is weakening rapidly, keeping a cap on firms’ desire to raise prices. At the same time, unemployment is increasing, which will tame workers’ efforts to push for higher wages.

## Inflation can be bad, but deflation is much worse

**Deflation can turn a bad situation into something more serious.** A *sustained* decrease in the general price level depresses activity in two ways. Most obviously, it makes people postpone big-ticket purchases. After all, why would anyone shop today if they think that prices for goods and services will be lower tomorrow? While not buying makes sense from an individual’s perspective, the aggregate effect is to choke demand, prompting firms to lay off staff. In aggregate households lose more from higher unemployment than they gain from lower prices – this is what the renowned economist John Maynard Keynes called the ‘paradox of thrift’.

**The second negative effect is that it increases the burden of outstanding debt.** The amount of money that people owe, in real terms, *increases* over time when prices fall. Using a hypothetical example, if people borrow £100 for one year at zero interest, but prices drop by 50%, then the *real* cost of debt has doubled (as the £100 can now buy twice as many goods and services as a year earlier). Put differently, when prices and wages fall, it becomes tougher to service a given amount of nominal debt. With the real cost of debt increasing and repayments becoming more difficult, more loans go bad, dealing yet another blow to the financial system.

## The Monetary Policy Committee (MPC) will do whatever it takes

**Official interest rates could reach zero before they succeed in reflating the economy.** Lower policy rates aren’t translating smoothly into lower real borrowing costs for households and firms (chart 3). This means that the Base Rate has to fall by more than under more normal circumstances. Moreover, the widespread weakness in the wider economy puts further downward pressure on policy rates. These two factors together could drive the Base Rate towards zero, at which point conventional rate cuts have gone as far as they can.

**But that doesn’t mean policymakers are powerless.** When official interest rates approach zero, the Bank of England is likely to start using more creative measures to spur activity. One approach, already underway in the US, is to buy outstanding government and private sector debt using freshly printed money, explicitly targeting borrowing costs across the economy. While almost certain to avert deflation, running the printing press is not a one way bet – if sustained for too long, it could lead to galloping inflation further out. But faced with the gravity of the ‘deflation scenario’, inflation worries will likely have to wait for another day.

**Chart 1: market expectations for UK inflation over the next five years**

(in %)

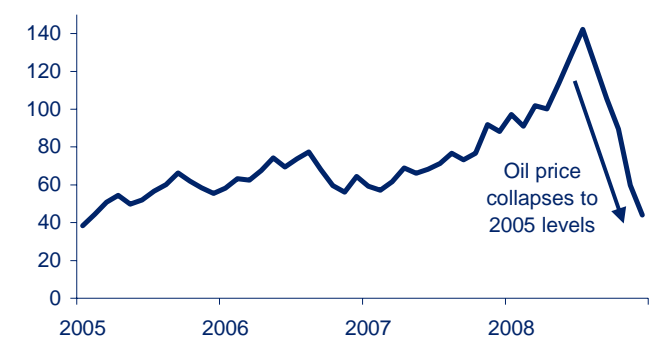
Source: Datastream



**Chart 2: oil prices have dropped significantly since the summer (like almost all commodities)**

(in \$)

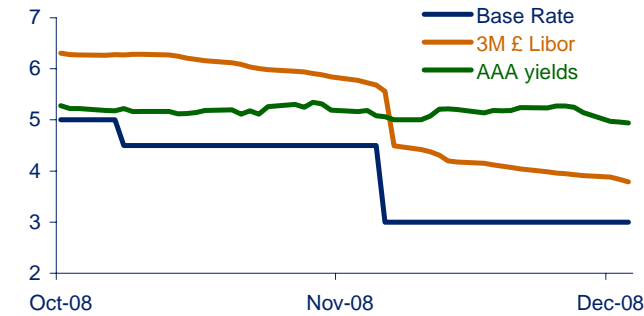
Source: Datastream



**Chart 3: market rates have not come down as much as the Base Rate**

(in %)

Source: Datastream



**Interest rate facts & figures**

Source: Bank of England, RBS Group

	Bank of England	RBS Group
<b>Current rate</b>	2.00%	2.00%
<b>Since</b>	4 <sup>th</sup> Dec 08	4 <sup>th</sup> Dec 08
<b>Month ago</b>	4.50%	4.50%
<b>Year ago</b>	5.75%	5.75%

Minutes of December MPC meeting released: 17<sup>th</sup> December 2008

Next MPC announcement: 8<sup>th</sup> January 2009

Next Inflation Report published: 11<sup>th</sup> February 2009

**Following the decision, The Royal Bank of Scotland, National Westminster Bank plc and Ulster Bank Ltd. lowered their Base Rate by 100bps to 2.00%**

All %s	Retail Price Index (includes mortgage payments)	Consumer Price Index
	RPI	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
	3.0	4.0
2009	1.0	3.1
	-0.1	1.9
	-1.2	0.8
	-0.5	1.0
2010	0.9	1.2
	1.5	1.6
	1.9	1.7
	2.2	1.7

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