Group Economics

UK Monthly Economic Update

6th November 2008

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Group Economics Internet

Monetary Policy Committee (MPC) lowers the Bank Rate by 150bps to 3.00%

Comment from Stuart Porteous, Head of RBS Group Economics:

"Extraordinary times require extraordinary actions. Today's rate cut is unprecedented in the history of the MPC. Markets were crying out for something bold and the MPC has delivered. The slowdown in the real economy is accelerating and I expect rates to fall towards 2%. It now looks like we'll get there sooner rather than later."

UK interest rates will come down further

The market expects UK policy rates to fall towards 2%. Interest rate derivates ('swaps') are the best available gauge of investors' beliefs about the course of the UK Bank Rate. And the shift in expectations since the summer has been decisive (Chart 1). As recently as June, investors believed that rates would go up by the middle of 2009 – largely a reflection of the then relentless ascent in inflation. Despite the already significant 200bps easing in the past month, markets expect rates to fall further. Rates are already at their lowest level since the 1950s (Chart 2). The causes are unsurprising – the UK economy shrank by 0.5% in Q3 and leading indicators suggests the slowdown is accelerating.

Growth and inflation determine the Bank Rate

Receding inflation worries and tumbling growth join forces in pushing the MPC to trim rates. There is widespread consensus that the MPC, like most other central bankers, follow rough 'rules of thumb' when deciding on the appropriate level of interest rates. The best known of these rules is the 'Taylor rule', named after John Taylor, an American economist at Stanford University. The rule says that only two variables matter for interest rate decisions: deviation of growth from its trend level and deviations of inflation from target. The UK's trend growth rate is slightly above 2.5%, while we expect the UK economy to shrink by something close to 1% next year (Chart 3). Inflation is likely to fall back to the target zone of around 2% in 2009, driven by sharply falling food and commodity prices, eliminating pressure to hike rates. Combining both factors, the 'Taylor rule' suggests that the Bank Rate should fall to around 3.5%. Why is it, then, that the Bank of England has cut so aggressively and investors expect more to come?

The reason – the monetary transmission mechanism is not working effectively

The Bank Rate has stopped tracking actual borrowing costs. One of the main reasons why lower interest rates stimulate economic activity is that they make it cheaper to borrow and finance existing debt. This helps support demand via investment and consumer spending. **The problem** is the true cost of borrowing is no longer tracking the official Bank Rate. **The reason** is that, since the onset of the financial market turmoil last year, banks' funding costs have increased relative to the Bank Rate. Interbank rates (LIBOR) are the rates banks charge to lend to each other, and are a good measure of marginal costs of funding for the financial system. The spread between 3-month LIBOR and market expectations of where the Bank Rate will be in three months is more than 200bps (for comparison, this spread used to hover around 10bps pre-August 2007). In normal times, lending between banks acts as an efficient way of distributing funds within the banking system – banks with surpluses lend to banks with shortfalls. However, slower deposit growth and a reduction in the availability of wholesale funds mean that banks have fewer funds than they would like. Banks therefore require a higher compensation to induce them to lend to another bank.

The implication is that the Bank Rate has to work harder (i.e. fall further) to achieve the desired level of real borrowing costs – hence investors' expectation of more aggressive cuts. Although interbank spreads are elevated, the Bank of England can still influence the cost of borrowing by lowering the base. 3-month LIBOR has fallen by c.70bps since the globally-coordinated rate cut last month. But this lurch downward was less than the reduction in investors' expectations of where policy rates will be in three months time, which dropped by 100bps over the same period. Only when funding pressures dissipate will changes in the Bank Rate feed through fully to the wider economy. The measures taken by policy makers give us hope that this could happen over the course of next year.

Chart 1: market expectations for the UK Bank Rate in April 2009

(in %)

Source: Bloomberg

Chart 2: the UK Bank Rate has not fallen below 3% since the 1950s

(in %)

Source: Datastream

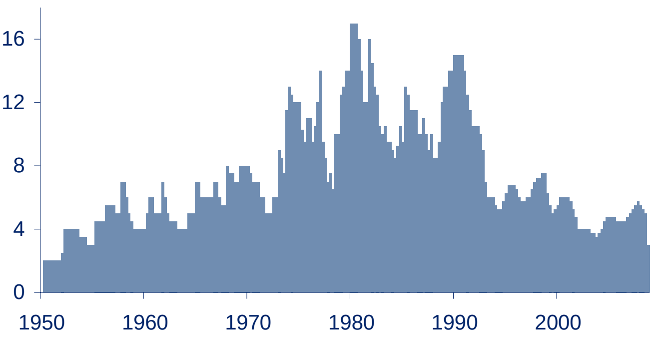
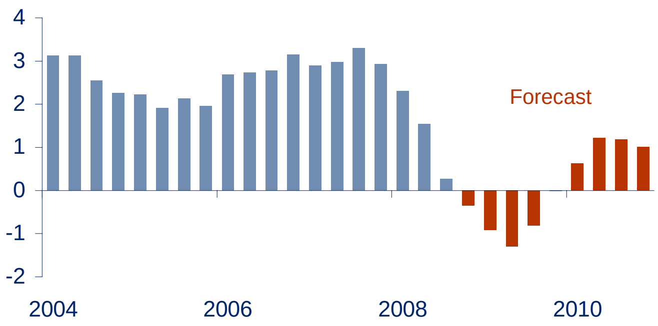


Chart 3: GDP is set to shrink by about 1% next year (y/y GDP growth)

(in %)

Source: Datastream, RBS Group Economics



Interest rate facts & figures

Source: Bank of England, RBS Group

	Bank of England	RBS Group
Current rate	3.00%	3.00%
Since	6th Nov 08	6th Nov 08
Month ago	5.00%	5.00%
Year ago	5.75%	5.75%

Minutes of November MPC meeting released: 19th November 2008
Next MPC announcement: 4th December 2008
Next Inflation Report published: 12th November 2008

Following the decision, The Royal Bank of Scotland, National Westminster Bank plc and Ulster Bank Ltd. lowered their Base Rate by 150bps to 3.00%

All %s	Retail Price Index (all items) *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
	4.2	4.6
2009	3.2	4.0
	2.3	3.1
	1.4	2.2
	1.4	2.0
2010	1.9	2.1
	2.3	2.1
	2.4	2.1
	2.5	2.1

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