

UK Monthly Economic Update

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Monetary Policy Committee (MPC) lowers the Bank Rate by 50bps to 4.50%

Comment from Stuart Porteous, Head of RBS Group Economics:

"Investors have been crying out for a bold and coordinated policy response – this is it. Policymakers are determined to get ahead of the curve. Rate cuts across the board provide precisely the injection of confidence and the boost to demand that the real economy needs."

Aggressive policy action will help reduce the risk of a prolonged recession

This week, the UK Treasury unveiled extensive plans to support the banking sector, while the Bank of England joined a co-ordinated effort that saw key central banks around the world lower policy rates by 50bps. The Treasury's package addresses the pressure points in the financial sector head on by easing short-term liquidity and medium-term funding squeezes, and bolstering banks' capital positions. This will help mitigate against destructive de-leveraging that the economy was facing, where normally creditworthy businesses and households face restricted access to loans. The co-ordinated cut in interest rates, on the other hand, provides an important stimulus to global demand. While these measures together will help to avoid the worst case scenario of a prolonged recession, they are unlikely to cure all the economy's ills. The UK is still facing a difficult adjustment as we move towards a sustainable growth path, but the adjustment will be less painful than it would have been without this policy response.

Markets are now turning their attention to the real economy

September will go down as the month when problems in financial markets unambiguously hit the real economy. The UK Purchasing Managers' Index (PMI) tumbled to 44.6, the lowest level since the series began in 1998 (chart 1). Any reading below 50 indicates contracting levels of activity. More worryingly still, 'new orders', the key forward-looking subcomponent of the index, plunged to 43.6 from 46.2 previously. This reading alone is enough to eliminate the slim chance of a swift rebound in demand in the near future. While in the past there was hope that a cheaper pound would boost exports enough to prevent an outright contraction, the global manufacturing PMI readings dealt a heavy blow to this scenario. In September, this global index fell from 49 (a whisker away from stall speed) to 42 (comfortably in recession territory). The extent of the decline and absolute level of weakness is on a par with the immediate aftermath of September 11th. These numbers are pointing to a significant deceleration in what, until recently, has been only a modest contraction in global industrial activity.

Two tailwinds remain nevertheless

First, fighting inflation is 'yesterday's war'. It now looks highly probable that the Bank has embarked on a prolonged easing cycle – previous episodes of asset bubbles bursting have usually been followed by significant rate reductions (chart 2). As a result, borrowing costs for the private sector are expected to come down from their elevated levels. For example, many loans are linked to the rate at which banks lend to each other for three months (LIBOR). This rate has increased by almost half a percentage point since April even though policy rates remained unchanged until yesterday (chart 3). The fact that inflationary pressures are about to subside gives the Bank the necessary breathing space. Even after accounting for adverse movements in exchange rates, the sterling price of oil is still 35% cheaper now than it was July. These falls will take significant pressure off inflation, and provide some welcome relief for households and business in the run up to Christmas.

Second, falling imports will soften the impact from weaker consumer spending. What matters for domestic GDP growth is net trade (the difference between exports and imports). While exports are unlikely to grow much, imports are expected to fall significantly on the back of slowing consumer spending. Consumers' displayed a large appetite for imported goods over the last three years, leading to import growth outpacing overall consumption growth by more than two percentage points. As consumer spending slows, this pattern is likely to reverse with consumers cutting back most on imported goods. This leaves a bigger share to be spent on domestically produced goods. Technically, this 'import compression' has already contributed 0.4 percentage points to GDP growth in the last two quarters, offsetting weakness elsewhere.

Chart 1: The UK PMI tumbled in September

Source: Datastream

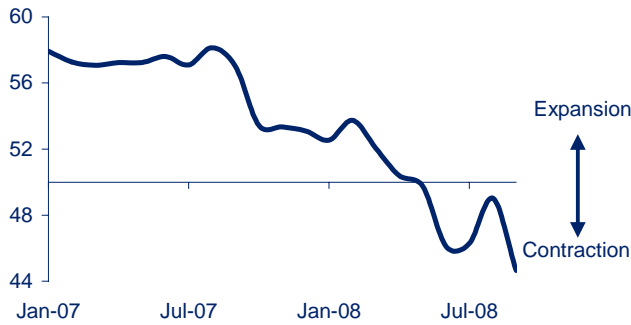


Chart 2: Policy-makers have reacted aggressively in the face of bursting bubbles

(in %)

Source: Datastream

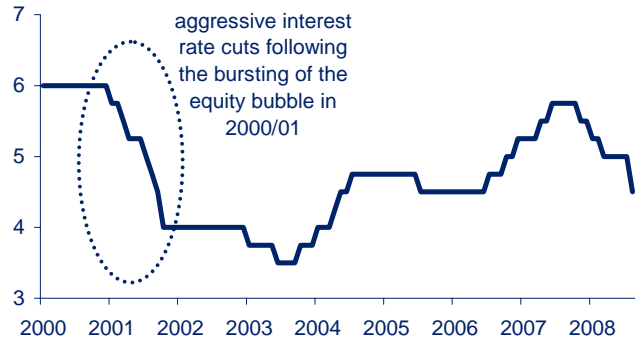
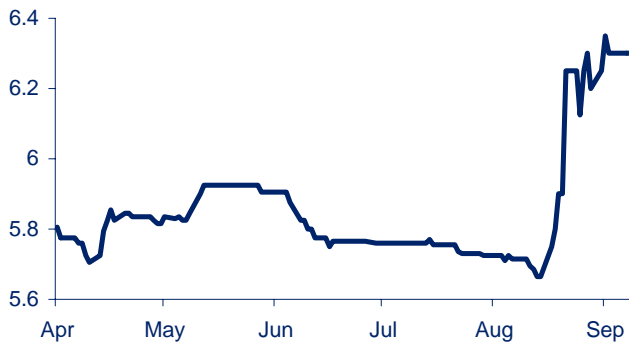


Chart 3: Increase in 3-month LIBOR signals stress in interbank funding markets

(in %)

Source: Datastream



Interest rate facts & figures

Source: Bank of England, RBS Group

	Bank of England	RBS Group
Current rate	4.50%	4.50%
Since	8 th October 08	8 th October 08
Month ago	5.00%	5.00%
Year ago	5.75%	5.75%

Minutes of July MPC meeting released: 22nd October 2008
 Next MPC announcement: 6th November 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 50bps to 4.50%

All %s	Retail Price Index (all items)	Consumer Price Index
	RPI	CPI
2006	2.4	1.9
	3.0	2.2
	3.4	2.4
	4.0	2.7
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
	5.0	4.7
	5.0	4.9
2009	4.6	4.5
	3.6	3.6
	2.6	2.6
	1.9	2.2

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