

UK Interest Rates

No surprise in rate decision, but Bank likely to make greater use of unorthodox policy going forward.

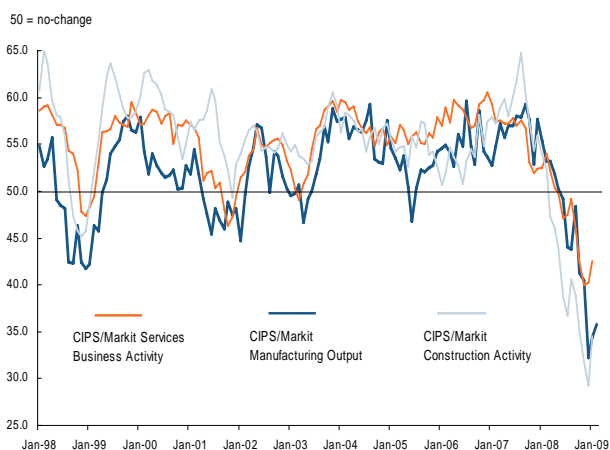
As widely expected, the Bank of England today cut its main base rate by a further 50 basis points to a new historic low of just 1.0 percent. It was the fifth successive meeting in which rates have been cut and takes the cumulative reduction since October to 400 basis points.

The latest cut largely reflects the MPC's response to further sharp reductions in output during Q4 and into the New Year, as well as the ongoing constraints in credit availability.

However, the BoE are now set to be faced with a delicate balancing act, and opinions on the MPC are likely to be divided as to how much stimulus the economy needs following aggressive rate cuts, the government's fiscal packages and a weak pound.

On the one hand, the MPC may be encouraged by the recent upticks in the closely-watched CIPS/Markit surveys of purchasing managers, which have risen following the record contractions signalled last November. The Composite UK PMI, which combines the output/activity balances from the construction, manufacturing and services sectors, has gained 2.7 points over the past two months, reaching a three-month-high at the start of the year.

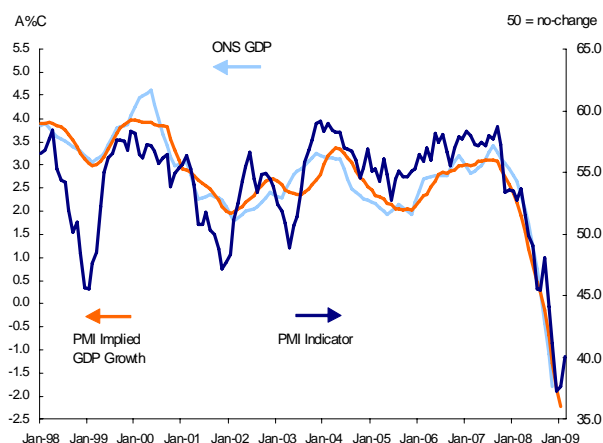
Chart 1: Output still contracting severely



While providing tentative signs that the deep point of the recession may have passed, it would seem to be dangerous to herald any recovery on just two months of improvement, especially given the severe declines seen in the index between August and November (cumulative fall of over ten points). Anecdotal evidence from the January CIPS/Markit surveys suggests that market conditions remain extremely poor, especially in manufacturing, where companies continue to struggle in the face of rapid falls in demand from both domestic and foreign sources.

Moreover, the current trends in the composite index are consistent with rapid declines in private sector output and, according to our updated models, point to an annual fall in GDP of over 2% in January (see graph below). Even allowing for continued steady improvements in the PMI during the coming months, annual declines in GDP of nearly 3.0% are likely by mid-year.

Chart 2: GDP contracting by around 2.2% year-on-year



Sources: ONS, Markit Economics

Falls in GDP of this magnitude will inevitably continue to rapidly increase the UK output gap (i.e. the difference between actual and potential output) and, not allowing

for the upward impact that weak sterling is likely to have on imported goods costs, bear down on overall prices and raise the spectre of deflation.

The CIPS surveys have been highlighting increasing spare capacity in the private sector economy for a number of months, with backlogs of work declining at a series record clip in manufacturing and at a severe rate in the service sector during January. Companies are responding to excess resources at their plants/units by reducing payrolls at unprecedented rates, further undermining consumer confidence and potential spending levels.

The possibility of seriously undershooting the inflation target and having to deal with a vicious deflationary spiral on balance calls for further aggressive action by policymakers in a bid to restore confidence and

stimulate growth (not just in the UK, but also from global trading partners in continued co-ordinated policy actions).

Given how low the base rate already is and the (although improved) impairment of the transmission mechanism of monetary policy the increased use of unorthodox action from the UK central bank may be required in the months ahead.

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