

UK Interest Rates

Rates cut to record low, justified by weak economic data, but further measures are likely to be needed to prevent steep downturn in 2009

- **The Bank of England cut its base rate to a record low of 1.5% in January, but poor credit availability and low demand for loans will limit the impact of rate cuts.**

Base rates cut to record low

Today saw the Bank of England reduce its base rate from 2.00% to 1.50%, the lowest seen in the 314-year history of the Bank.

The need for the cut was attributed to the unusually steep global economic downturn and weak business survey data in recent weeks, which suggests that output is set to contract sharply in the first part of this year. As a result, the Monetary Policy Committee members judged that, despite the past easings in monetary and fiscal policy, plus the recent fall in sterling, there remained a "significant risk" of inflation undershooting the 2% target.

The weak business survey data are typified by the PMI surveys, which pointed to a marked acceleration in the economic downturn in Q4 2008 and were consistent with GDP contracting at an annual rate of 1.1% in December. This will leave GDP in Q4 as a whole some 0.7% lower than a year ago (see our research note published 8 January). Such a rate of decline has not been seen since late 1991.

Fig 1: GDP contracting at rate of 1.1%

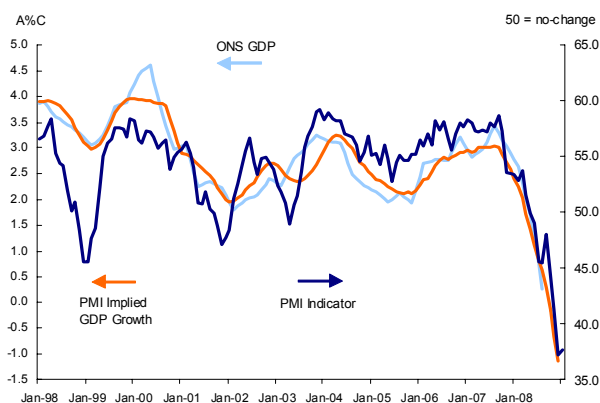
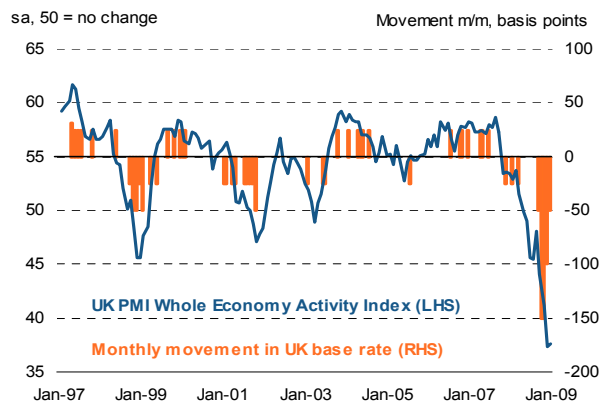


Fig 2: Composite PMI and Bank of England base rate

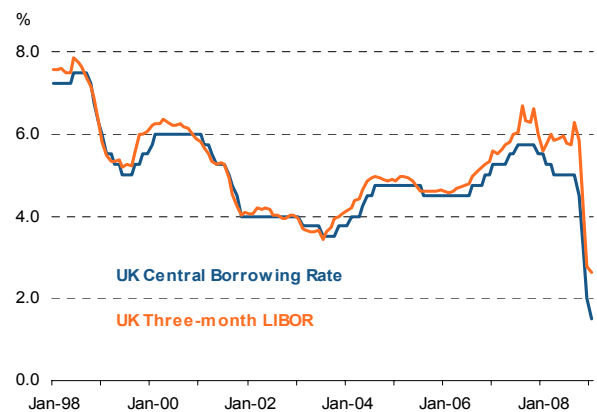


Source: Markit Economics, Bank of England

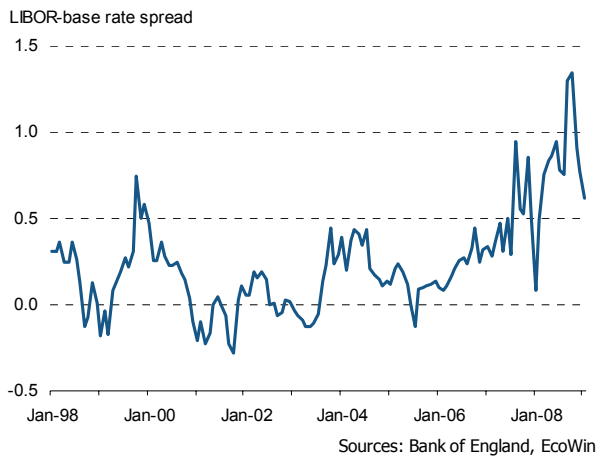
Interbank rates also at record low

The impact of the rate cut will depend in part on whether it is passed on to borrowers. Here there are encouraging signs. Even before the latest cut, interbank lending rates had fallen to a record low (LIBOR was 2.61% in early January, which was the lowest since records began in 1978). At 0.61%, the spread between LIBOR and the base rate remained elevated compared to the historical long-run average of 0.25%, but has come down sharply from the peaks in excess of 1.3% seen last October.

Fig 3: LIBOR and base rate (end of period)



Sources: Bank of England, EcoWin

Fig 4: LIBOR-base rate spread (end of period)

However, it is not just the cost of credit which is important. Credit availability and the desire for borrowers – both households and business – to take up credit will be key determinants of the impact of recent monetary policy easing.

In this respect, banks appear to remain unwilling to lend

and, even if they were, it is likely that demand for credit will remain subdued as unemployment rises and businesses retrench in the face of weak global demand.

This suggests that further measures beyond traditional monetary policy will be needed to stimulate the economy, but a painful year ahead looks inevitable even if rates are cut further in coming months.

To illustrate, even if in 2009 the composite PMI recovered all of the ground that it lost during 2008 – which would require an unprecedented gain of nearly 16 index points from its current level – as growth is stimulated by the interest rate cuts, lower inflation and the boost to exports from sterling's depreciation, the UK economy would still contract by around 1.25%.

A more modest (and more likely) upturn in the composite PMI of around half of the ground lost in the past year would be consistent with GDP contracting by around 2.0% in 2009 (see our research note published 8 January).

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