

European Interest Rates

Rates slashed again in December

Key findings

- **Base rates slashed again in response to signs of deepening recession.**
- **But past cuts have done little to brighten the outlook...**
- **... as fears of default hit new highs.**

Base rates slashed again

Today saw the Bank of England reduce its base rate from 3.00% to 2.00%, the lowest level since 1951. UK base rates have not been lower than 2% in the 314-year history of the Bank of England.

The European Central Bank also cut its policy rate from 3.25% to 2.50%, the lowest rate since March 2006 and the largest single reduction in rates in the history of the ECB.

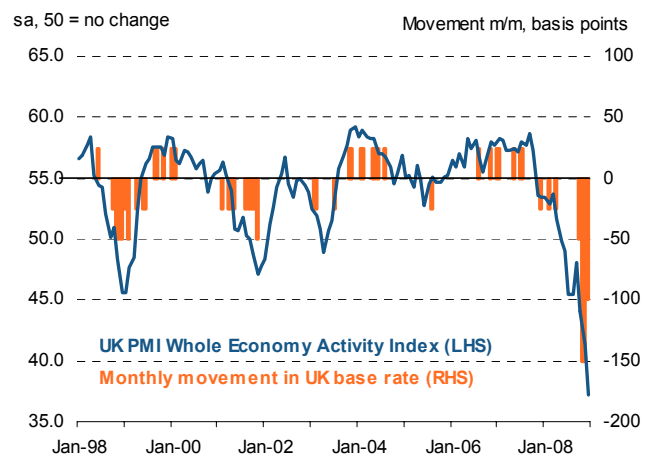
The latest cuts are a further step in the aggressive easing of European monetary policy, following 50bp cuts by both banks in early October, and cuts of 150bp and 50bp by the Bank of England and ECB respectively in early-November.

Recession deepens

This aggressive easing reflects both a much faster and deeper economic downturn than had been anticipated earlier in the year and a concomitant faster and greater than anticipated easing of inflationary pressures.

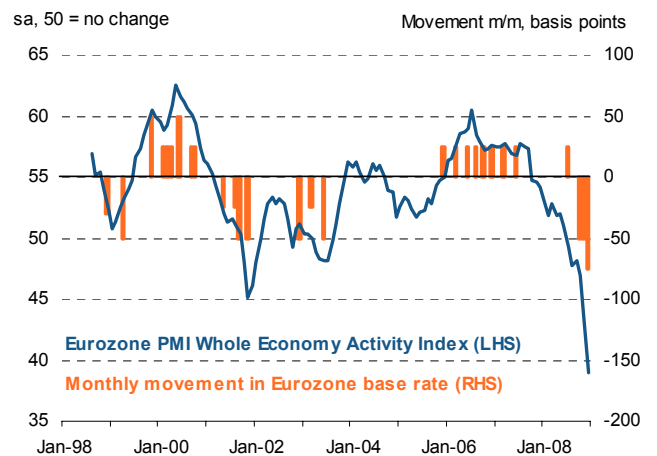
The inflationary pressures that had built up earlier in the year had led to rates being held higher than economic growth data alone would have justified, even prompting the ECB to raise rates by 25bp in July, when the Eurozone economy was already technically in recession. As the charts to the right show, economic growth, and especially the composite PMIs, had typically been a good advance indicator of interest rate decisions. The recent aggressive cuts by both central banks are clearly justified by signals sent by the PMI data.

UK Composite PMI and Bank of England base rate



Source: Markit Economics, Bank of England

Eurozone Composite PMI and ECB base rate



Source: Markit Economics, ECB

Interbank rates have fallen but spreads remain elevated

The extent to which lower rates are passed on by banks will be crucial in determining the effectiveness of the easing in monetary policy. In this respect, interbank lending rates have indeed come down in line with recent base rate reductions, but the spread between interbank rates and the base rate remains elevated by historical standards (see charts on page 3), suggesting past rate

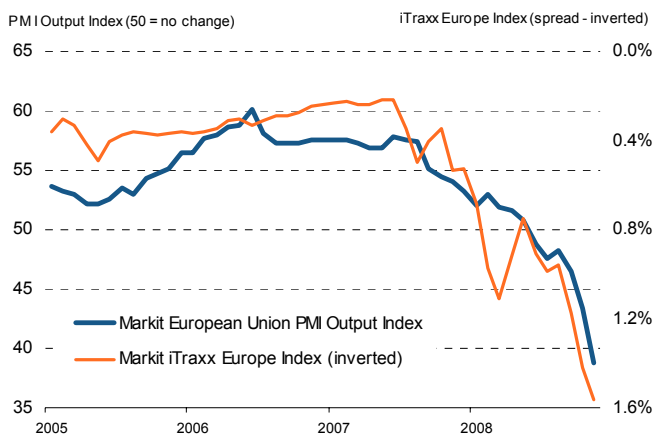
cuts have so far done little to improve sentiment about the economic outlook.

Fears of default hit new highs

This wide spread reflects the continued fear of default on corporate debt and concerns over financial institution and corporate solvency. These fears are reflected in the widening of credit spreads, as measured by the Markit iTraxx indices, which hit record wide levels in early-December.

Until credit spreads narrow, monetary policy is likely to remain limited in its effectiveness in boosting economic growth, and the fear is that the aggressive easing by central banks may itself stoke further concerns over corporate health, causing spreads to widen again and interbank lending spreads to remain elevated.

European credit markets and economic growth



Source: Markit.

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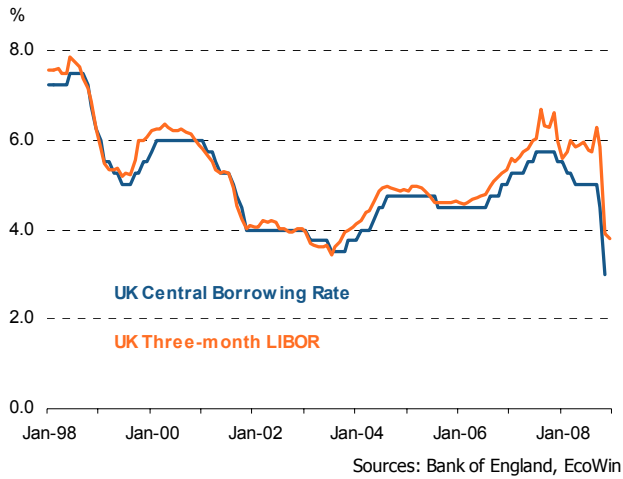
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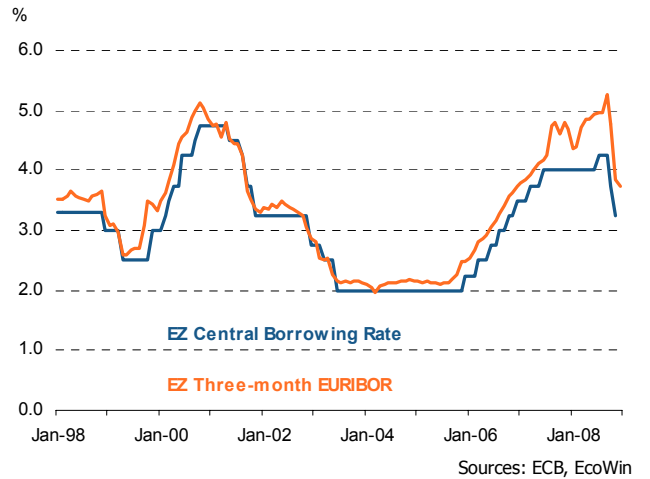
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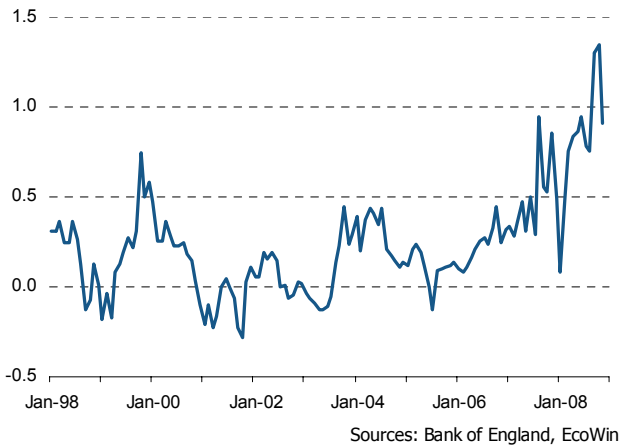
United Kingdom interest rates



Eurozone interest rates



LIBOR-base rate spread



EURIBOR-base rate spread

