Essentials of the Monetary Policy

Desjardins Economic Studies
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April 10, 2008

BANK OF ENGLAND

Another 25 basis point cut to the key rate

ACCORDING TO THE BANK OF ENGLAND (BoE)

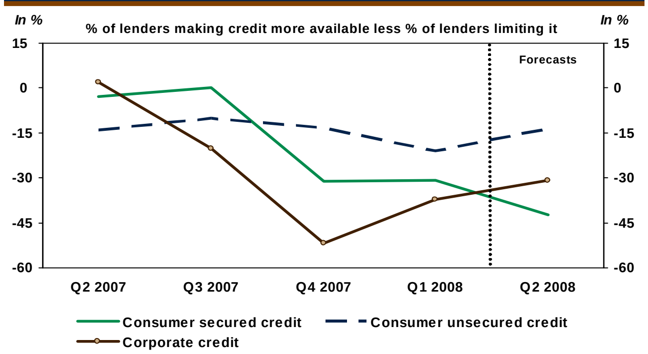
- Inflation rose to 2.5% in February and should accelerate further this year, given the increase in energy and food prices, as well as the pound sterling's deterioration. However, even if commodity prices remain at their current high levels, inflation should subsequently slow.
- The BoE needs to balance two risks. On one hand, elevated inflation could drive up inflation expectations. On the other, the disruption in financial markets could lead to a slowdown in the economy that was sufficiently sharp to pull inflation below its target.
- Credit conditions have tightened, and the availability of credit appears to be worsening. The business surveys suggest that economic growth has started to moderate and that a margin of spare capacity should emerge during the year. This should help keep domestic inflation pressures under control.
- Against that background, the BoE decided to lower its key rate by one quarter of a point to 5%.

COMMENTS

The 25 basis point cut to the BoE's key rate had been anticipated by the vast majority of analysts. The latest statistics show that credit conditions are continuing to tighten in the United Kingdom (Graph 1), and problems in the housing market are getting worse (Graph 2). Everything is in place for British households to slow consumption, which would rein in economic growth substantially. Despite the pound's deterioration, foreign trade should not provide any major support, given that economic activity is also slowing for the U.K.'s main trading partners.

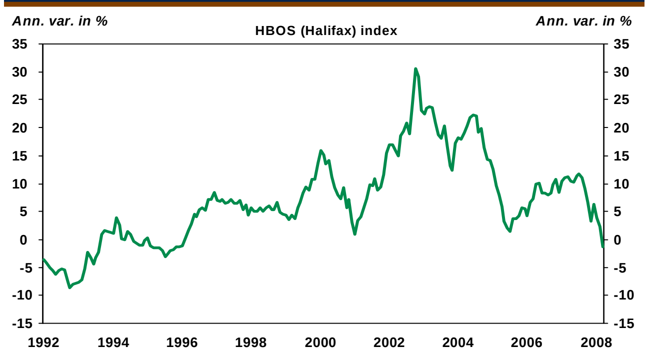
The BoE cannot completely overlook inflation's acceleration, and it is still concerned about a lasting increase in inflation expectations. We should even expect annual inflation to close in on 3% in the next few months in the United Kingdom. However, the inflation pressures are essentially coming from external factors, and the main risk to Britain's economy is still an overly sharp economic slowdown. The BoE should thus lower its key rate by another 25 basis points at its May meeting. After that, it could take a break to reassess the situation. If real estate market conditions deteriorate further, it could be forced to ease its monetary policy again in the second half of 2008.

Graph 1 – Most lenders continue to tighten credit



Sources: Bank of England and Desjardins, Economic Studies

Graph 2 – Prices on British homes slide for the first time since 1995



Sources: Halifax Bank of Scotland and Desjardins, Economic Studies

Mathieu D'Anjou
Senior Economist

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Director and Deputy Chief Economist

Mathieu D'Anjou
Senior Economist

Martin Lefebvre
Senior Economist

Hendrix Vachon
Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

EXCERPT FROM THE BANK OF ENGLAND PRESS RELEASE APRIL 10, 2008

BANK OF ENGLAND

The Bank of England's Monetary Policy Committee today voted to reduce the official Bank Rate paid on commercial bank reserves by 0.25 percentage points to 5.0%.

CPI inflation rose to 2.5% in February. The Committee expects inflation to rise further this year, reflecting the continuing impact of higher energy and food prices, as well as the recent depreciation of sterling on import costs. Such pressures are already evident in producer input costs and pricing intentions.

Even if commodity prices remain at their current high levels, inflation should fall back. But to ensure that inflation meets the 2% target in the medium term, the Committee needs to balance two risks. On the upside, above-target inflation this year could raise inflation expectations so that, in the absence of some margin of spare capacity, inflation would remain above the target. On the downside, the disruption in financial markets could lead to a slowdown in the economy that was sufficiently sharp to pull inflation below the target.

In the Committee's judgement, the balance of these risks to the inflation outlook in the medium term justifies a cut in Bank Rate this month. Credit conditions have tightened and the availability of credit appears to be worsening. While the recent depreciation in sterling will support net exports, the prospects for output growth abroad have deteriorated. In the United Kingdom, business surveys suggest that growth has begun to moderate and that a margin of spare capacity will emerge during this year. This should help to keep domestic inflationary pressures in check in the medium term. [...]

Table 1
Schedule and key rates

Date	*Central Bank*	*Decision*	*Rate*
January 2008			
22	U.S. Federal Reserve	-75 b.p.	3.50
17	Bank of Norway	s.q.	5.25
24	Reserve Bank of New Zealand	s.q.	8.25
30	Bank of Brazil	s.q.	11.25
30	U.S. Federal Reserve	-50 b.p.	3.00
February 2007			
4	Reserve Bank of Australia	+25 b.p.	7.00
7	European Central Bank	s.q.	4.00
7	Bank of England	-25 b.p.	5.25
13	Bank of Sweden	+25 b.p.	4.25
14	Bank of Japan	s.q.	0.50
15	Bank of Mexico	s.q.	7.50
March 2007			
3	Reserve Bank of Australia	+25 b.p.	7.25
4	Bank of Canada	-50 b.p.	3.50
5	Reserve Bank of New Zealand	s.q.	8.25
5	Bank of Brazil	s.q.	11.25
6	European Central Bank	s.q.	4.00
6	Bank of England	s.q.	5.25
6	Bank of Japan	s.q.	0.50
13	Bank of Norway	s.q.	5.25
13	Swiss National Bank	s.q.	2.75
14	Bank of Mexico	s.q.	7.50
18	U.S. Federal Reserve	-75 b.p.	2.25
10	Reserve Bank of Australia	*s.q.*	7.25
April 2008			
8	Bank of Japan	*s.q.*	0.50
10	European Central Bank	s.q.	4.00
10	Bank of England	-25 b.p.	5.00

s.q.: status quo; b.p. : basis points
Source: Desjardins, Economic Studies

Table 2
Coming soon

Date	*Central Bank*
April 2008	
16	Bank of Brazil
18	Bank of Mexico
22	Bank of Canada
23	Bank of Norway
23	Reserve Bank of New Zealand
23	Bank of Sweden
29	Bank of Japan
30	U.S. Federal Reserve
May 2008	
6	Reserve Bank of Australia
8	European Central Bank
8	Bank of England
16	Bank of Mexico
19	Bank of Japan
28	Bank of Norway
June 2008	
3	Reserve Bank of Australia
4	Reserve Bank of New Zealand
4	Bank of Brazil
5	European Central Bank
5	Bank of England
10	Bank of Canada
12	Bank of Japan
19	Swiss National Bank
20	Bank of Mexico
25	Bank of Norway
25	U.S. Federal Reserve
July 2008	
1	Reserve Bank of Australia
3	European Central Bank

Source: Desjardins, Economic Studies