BANK OF ENGLAND

The key rate at a historic low

ACCORDING TO THE BANK OF ENGLAND (BoE)

- The key rate has been lowered 50 basis points to 1.50%.
- The world’s economy appears to be undergoing an unusually sharp and synchronized downturn.
- In the United Kingdom, business surveys suggest that the pace of contraction in activity increased during the fourth quarter of 2008 and that output is likely to continue to fall sharply during the first part of 2009.
- The inflation rate fell to 4.1% in November and is expected to fall further, reflecting waning contributions from retail energy and food prices and the direct impact of the reduction in Value Added Tax.
- The recent easing in monetary and fiscal policy, the substantial fall in sterling and the prospective decline in inflation will provide considerable stimulus to the economy. There remains a significant risk that inflation will undershoot the 2.0% target in the medium term.

COMMENTS

As most analysts had expected, the BoE continued its monetary easing this morning, bringing its key rate down by 50 basis points. At 1.50%, the U.K.’s key rate is at its lowest level since the BoE was founded in 1694.

As the BoE remarks in its statement, the outlook for Britain’s economy is still deteriorating. Business and household confidence is very low and credit conditions are still tightening, promising some very difficult times for consumption and investment. Industrial output is off by more than 5.0% on an annual basis and the slide in home prices is accelerating.

To date, the drop in inflation has been less spectacular in the United Kingdom than in most other economies. However, the trend is well underway and it seems inevitable that year-over-year consumer price growth will quickly be back around the BoE’s 2.0% target. Given the deep recession that will affect the United Kingdom in 2009, soft commodity prices and the impact of the 2.5% cut to the sales tax, inflation could even fall well below the target.

Implications:

A very grim outlook for Britain’s economy and the sharp drop in inflation pressure fully justify ongoing monetary easing in the United Kingdom. Even though the BoE’s statement stresses the many stimuli that will benefit Britain’s economy in 2009, we think it will have to proceed with further rate cuts to ensure that it staves off deflation. The key rate should thus go to 1.00% in the next few months. If the situation keeps deteriorating subsequently, the BoE could make its monetary policy even more accommodative and start to look increasingly to quantitative measures, like the Federal Reserve.

Mathieu D’Anjou
Senior Economist
EXCERPT FROM THE BANK OF ENGLAND PRESS RELEASE

“ [...] The world economy appears to be undergoing an unusually sharp and synchronised downturn. Measures of business and consumer confidence have fallen markedly. World trade growth this year is likely to be the weakest for some considerable time [...] In the United Kingdom, business surveys suggest that the pace of contraction in activity increased during the fourth quarter of 2008 and that output is likely to continue to fall sharply during the first part of this year. Surveys of retailers and reports from the Bank’s regional Agents imply that consumer spending has weakened. The outlook for business and residential investment has deteriorated. And the availability of credit to both households and businesses has tightened further, pointing to the need for further measures to increase the flow of lending to the non-financial sector. But the substantial depreciation in sterling over recent months may help to moderate the impact on UK net exports of the slowdown in global growth [...] CPI inflation fell to 4.1% in November. Inflation is expected to fall further, reflecting waning contributions from retail energy and food prices and the direct impact of the temporary reduction in Value Added Tax. Measures of inflation expectations have come down. And pay growth remains subdued. But the depreciation in sterling will boost the cost of imports [...] At its January meeting, the Committee noted that the recent easing in monetary and fiscal policy, the substantial fall in sterling and the prospective decline in inflation would together provide a considerable stimulus to activity as the year progressed. Nevertheless, the Committee judged that, looking through the volatility in inflation associated with the movements in Value Added Tax, there remained a significant risk of undershooting the 2% CPI inflation target in the medium term at the existing level of Bank Rate. Accordingly, the Committee concluded that a further reduction in Bank Rate of 0.5 percentage points to 1.5% was necessary to meet the target in the medium term [...] The minutes of the meeting will be published at 9.30am on Wednesday 21 January. ”

**Table 1** Schedule and key rates

<table>
<thead>
<tr>
<th>Date</th>
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<th>Decision</th>
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s.q.: status quo; b.p.: basis points
Source: Desjardins, Economic Studies

**Table 2** Coming soon

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<td>February 2009</td>
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Source: Desjardins, Economic Studies