The Bank of England and European Central Bank opt for prudence

**According to the Bank of England and the European Central Bank:**

In the **United Kingdom**, the Bank of England is keeping its key rate at 5.75%.
- Disruption in asset-backed securities has spread to the money markets.
- Inflation should remain close to the 2% target and consumer and investment spending will slow.

In the **euro zone**, the European Central Bank keeps its key rate at 4.00%.
- Risks to price stability are still to the upside.
- Monetary policy remains accommodative.
- The volatility of financial markets and the revaluation of risks have led to a risk increase.

**Commentary:**

**Bank of England (BoE):** As expected, the BoE left its key rate at 5.75% at its September meeting, keeping it at its highest level in over six years. In its statement, unusual for a status quo, the BoE explained that strong concerns about asset-backed securities have led to some dysfunction in the planet’s money markets. According to the BoE, it is too early to properly assess the impact the crisis will have on household and business credit conditions, but this was enough to urge it to prudence.

Note that the economic situation allows the BoE to be patient. Earlier this summer, we were confident the BoE would tighten monetary policy one more time to bring the outlook for inflation into line with its target (2.0%) over the medium term. The Bank’s stance has now softened somewhat since the August *Inflation Report*. Production capacity is a little tight, but some indicators show that consumer spending is poised to slow and wage increases are tepid. The BoE should maintain the status quo over the next few months; its next move is likely to be down.

**European Central Bank (ECB):** The ECB kept its status quo at 4.00% this morning, in step with the central banks in the United Kingdom, Canada and Australia. Anything else would have been astounding, as tension in the credit market forced it to inject 42.2B euros earlier this morning to bring the overnight interbank rate into line with the ECB’s target.

The ECB is still torn between the risks of an economic slowdown in the United States and tightening credit conditions, on one hand, and, on the other, the domestic economy’s underlying inflation pressures. The jobless rate is at a low of 6.9%, growth by the money supply has not been this strong in twenty-five years, and oil prices are flirting with peaks. As a result, it is highly likely the ECB will want to move forward with monetary firming as soon as things settle down. Some production indexes have started to decline, indicating that interest rate normalization is drawing to a close, but we believe that, unless there is a major deterioration in the U.S. housing sector, at least one more rate hike is to be expected. Still, whether or not the hike will happen at the next meeting in October is unclear. The omission of the words “strong vigilance”, which have preceded all of the latest rate hikes, seems to be a clear signal that the ECB is now “dependent” on economic data. The U.S. Federal Reserve’s decision on September 18 will surely carry great weight.
**Excerpt from the Bank of England press release**

*September 6, 2007*

 [...] In its August *Inflation Report*, the Committee’s central projection was for inflation to remain close to the 2% target over the forecast period and for output growth to ease, reflecting a slowing in both consumer spending and business investment.

In recent weeks, heightened concerns about a variety of asset-backed securities have led to disruption around the world, not only in markets for those financial instruments but also in money markets more generally. The MPC’s mandate is to set interest rates to meet the Government’s 2% target for CPI inflation. So the Committee discussed these developments and other economic data in terms of their implications for the outlook for inflation.

CPI inflation fell back to 1.9% in July and may remain around, or a little below, the 2% target for the next few months. Pay pressures remain muted. There are tentative signs of a slowing in consumer spending. But the recent solid pace of output growth has been sustained and the margin of spare capacity appears limited. Indicators of pricing pressure remain somewhat elevated.

It is too soon to tell how far the disruption in financial markets will impair the availability of credit to companies and households. As stated in its August Report, the MPC is monitoring closely the evolution of both credit spreads and the quantities of credit extended, alongside all other data relevant to the outlook for inflation.

Against that background, the Committee judged that no change in Bank Rate was necessary at this meeting to keep inflation on track to meet the target in the medium term. [...]