Market *View*

Feb/March 2008

The UK economy is in the midst of a peculiar phase, as is the US and the eurozone, where economic data has sometimes appeared perplexing. These three economies are facing loosely similar conditions presently, where interest rates have been/may be cut to combat weaker economic growth despite inflation running at, or expected to rise to, higher than comfortable levels. Thus far, central bank reactions have differed significantly and, over the course of time, we will see how effective they have been.

In the US, the ongoing housing market collapse and growing fears of recession prompted the Federal Open Market Committee (FOMC) to slash 125 basis points (bp) from interest rates over a two week period at the end of January. The drastic action arrived in two tranches. The first cut (75bp) was unexpected both in size and timing – it did not follow a scheduled FOMC meeting – and had quite an impact, albeit fairly short-lived. Rumour that similar action would follow in the UK and eurozone, which ultimately did not materialise, raised expectation of deeper interest rate cuts and financial markets reacted accordingly.

The Fed Funds Rate now stands at 3.00% but this is likely to reduce further at the next meeting of the FOMC in March. A recent Reuters' survey revealed Wall Street economists unanimously predict further easing, but opinions differ over the size of the rate cut (between 0.25% and 0.50%). Looking further ahead, the same survey shows a 60:40 split as to whether April's FOMC will ease or hold respectively.

Interest rates were held at 4.00% at the February meeting of the European Central Bank (ECB) but there was an apparent change in outlook for the eurozone. As recently as January the ECB had warned that it would consider a pre-emptive interest rate increase to curb inflationary pressure: eurozone inflation is running at a 14-year high of 3.2%, a considerable distance over the target of "below but close to 2.00%". Now, however, it seems likely that the ECB will lower interest rates in the near term.

Though this is not yet guaranteed, acceptance by the ECB of the gloomier economic prospects in the region and the probability that this will eventually lead the central bank to downgrade growth forecasts have heightened anticipation. Furthermore, Jean-Claude Trichet (ECB president) did not dispute financial market expectations of a 25bp cut in interest rates by April. According to economists there is a 66% chance that interest rates will be cut by mid-2008.

The Bank of England's Monetary Policy Committee (MPC) decided to cut Base Rate by 25bp to 5.25% in February. The vote to cut was unanimous albeit one MPC member (David Blanchflower) stood out from the crowd by voting for a 50bp cut.

In the weeks leading up to the meeting we saw further evidence of the housing market decline as house prices fell for the 6th consecutive month in January and mortgage approvals continued to fall. Following the meeting Mervyn King (Bank of England governor) forecast that the economy may well come close to a halt in the next few months and declared that a technical recession (two successive quarters of economic contraction) was "not very far off our central projection". The challenge facing the MPC became apparent when Mr King announced that, even though the economy will probably contract over the short-term, at the same time it would be no surprise if another letter to the chancellor, explaining why the consumer price index (CPI) had risen above 3.0%, is required. CPI rose to 2.2% in January from 2.1% a month earlier and, while this was lower than expected (economic consensus was 2.3%), there is real concern that inflation will rise to dangerous levels before too long.

So, the MPC is left with the difficult juggling act of rousing a flagging economy whilst ensuring inflation does not spiral out of control. Its own projections currently suggest Base Rate of 4.75% to 5.00% would bring CPI to around the 2.00% target within an acceptable timescale. This is reflected by economic consensus, according to a recent survey by Reuters, which predicts Base Rate will fall to 5.00% by June and possibly to 4.75% by September. Of course, projections and predictions are based on data living up to expectations but the MPC have acknowledged that looming jumps in energy, food and import prices are outside of its control. The warning signs are there: the economic outlook is becoming bleak and Mr King believes we should all prepare to accept a period of lower living standards.

Interest rate cuts are expected in the US, eurozone and in the UK but the respective central banks will all be mindful of the potential inflationary impact. If they cut too deep now a long and painful remedy may ultimately be necessary.

Ian Wooldridge
Manager, Corporate Treasury Sales
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Interest rates valid at time of writing.