AIB Group Treasury
Economic Services Unit

BoE Stays in Easing Mode

Any notion that the MPC's decision not to be as aggressive as the ECB and the Fed in September signalled a more hawkish stance from the Bank of England has proved wide of the mark. The minutes of both the September 18 and October 4 MPC meetings were exceptionally dovish. The vote in favour of rate cuts at the last two MPC meetings was unanimous. Those that did dissent were in favour of an even bigger 0.50% cuts.

To date, the MPC has put considerable emphasis on the impact of the weak external environment on the UK economy in its policy deliberations. This was very evident again at the September and October MPC meetings. In the statement accompanying the October rate cut, the MPC noted that the weaker world outlook and increased uncertainty in the wake of the terrorist attacks in the US have hurt UK business and consumer confidence, and may, for a time, restrain investment and household spending.

The BOE Governor went even further this week saying that "doing what we can to encourage domestic demand growth to compensate for the global economic weakness is certainly preferable to an unnecessary slowdown in the economy as a whole". He added that in the event of further weakness in final demand, the MPC "would not hesitate to ease monetary policy" again. Base rates are already at their lowest level in thirty seven years. However, with the global economy likely to weaken further over the balance of the year, another 0.25% reduction in base rates seems probable by the end of 2001.

One should not lose sight of the fact, though, that the UK economy has proved remarkably resilient year to date. Helped by aggressive monetary easing and a very expansionary fiscal policy, domestic demand has held up surprisingly well. Hence, despite a sharp weakening of exports, GDP rose by 0.6% and 0.4% in Q1 and Q2 respectively. There were strong increases, in particular, in consumer spending, government spending, service sector output and construction in the first half of the year.

Consumer spending remained strong in Q3 with retail sales growing by 1.5% in the quarter. The housing market remained buoyant, with house prices rising 14.6% y-o-y in September according to the Nationwide. Service sector output growth may have softened judging by PMI data. However, manufacturing output rebounded in August led by a surge in car production. As a result, the decline in manufacturing output in Q3 as a whole will be far less than the 2% fall recorded in Q2. Indeed, we would point out also that apart from the ICT (information and communication technology) sector, which has witnessed a 25% drop in output in the past year, UK manufacturing output has held up reasonably well. Overall, GDP growth in Q3 is likely to be close to the 0.4% increase registered in Q2.

The pace of economic activity is likely to weaken in the final quarter, though, as both exports and business investment decline in the wake of the Sept 11th terrorist attacks. Consumer spending may also lose some momentum on indications that unemployment has started to rise. In these circumstances, the balance of risk to the 0.25% rate cut expected by ourselves and the market lies on the downside. Rates may be cut to an even greater extent, especially as the MPC has been so pro-active this year.

Having said that, if the global economy swings upwards rates could snap back in 2002. Labour market conditions are very tight while consumer spending and the housing market are showing robust growth. Furthermore, fiscal policy will provide a considerable boost to domestic demand in 2002 as the Labour government strives to increase spending on public services. Thus, the MPC is unlikely to delay too long before tightening policy, once a global recovery gets underway. As Eddie George put it, the MPC will need to be vigilant in ensuring that domestic demand is reined back to accommodate any rebound in global demand.

Our view is, that given the exceptionally low level of interest rates, increasingly expansionary stance of fiscal policies, falling oil prices and rundown of inventory levels, the US and eurozone economies will return to trend growth or above by the second half of next year. In this situation, we could see the MPC increasing rates by quite sharply in H2 2002. Such has been the form of the MPC over the past four years.

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