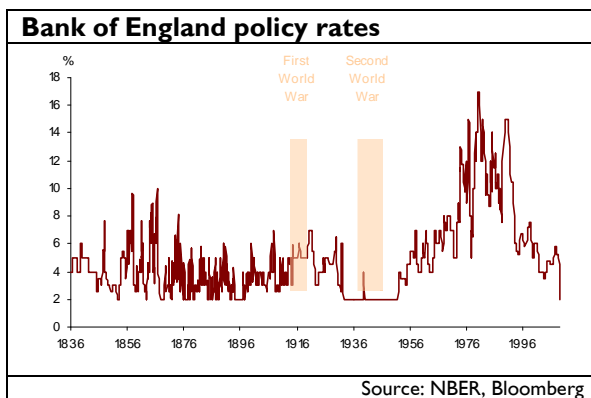


Zero bound

Today, the Bank of England is set to cut rates again by at least 50 basis points (bps), with a good chance that rates will be cut by 100 bps, to just 1%. Rates have never been below 2% since the Bank was founded in 1694. We expect them to fall further in the coming months, hitting 0.5% in the second quarter and staying there for the balance of 2009 before rising very slowly.



Economic theory tells us that, in the face of deflation, a central bank should get rates down quickly to zero and keep them there for as long as necessary. That argues for a repeat of last month's 100 bp cut. But, in the messier real world, there may be political arguments for continuing to slow the pace of rate cuts. November saw rates cut 250 bps, December 100 bps, and January may see the pace of rate cuts slow to 50 bps.

Why slow the pace of rate cuts?

As rates get closer to zero, any further cuts become increasingly symbolic in a world where banks aren't keen to lend and prefer to rebuild their margins. From here on, the heavy lifting in terms of monetary policy is likely to be done via quantitative easing – printing money to buy assets –

rather than base rate cuts. And, recently, the Bank of England's Deputy Governor, Charlie Bean, has spoken of the Bank purchasing debt – both sovereign and corporate – and equities as a possible course of action once base rate cuts have been exhausted.

However, the Bank and HM Treasury are involved in a tussle over how quantitative easing should be carried out – whether by the two organisations working together, or by the Bank within a yet to be agreed framework. The Bank prefers the latter option and may be willing to slow the pace of rate cuts and not cut all the way to zero. That would be a sop to the government, which is finding low interest rates increasingly unpopular with the sizeable number of voters who are pensioners. In reality, protecting pensioners' incomes would be better handled via the tax and benefit systems, rather than by halting the decline of interest rates, which affect the wider economy.

Some may see this tussle as the Bank fighting to maintain its independence. At times like these, however – as we have seen over recent months in the US – the distinction between monetary policy and fiscal policy and between a central bank and a treasury start to blur in the heat of the battle against de-leveraging and deflation.

Rates have further to fall

The Monetary Policy Committee is set to cut rates to as low as it thinks they can feasibly go. What's more, we expect rates to stay low. For now, we have pencilled in that rates fall to 0.5% in the second quarter and stay there for the rest of the year before rising very slowly. In the current environment, however, we would stress the uncertainty surrounding our forecasts, particularly those further out.

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