

5 March 2009

Bank of England cuts interest rates to 0.5%



The Bank of England slashed interest rates to another record low of 0.5% today and launched an economic salvage bid with billions in newly-created money.

Official borrowing costs have fallen for the sixth month in a row, but the Bank will now tackle recession with so-called quantitative easing (QE) - effectively printing money - to ease credit conditions.

The Bank will also create £75 billion to pump into the economy over the next three months.

Anxious banks are still reluctant to lend despite rates at all-time lows, so the Bank is resorting to increasing the money supply - which is uncharted territory for the MPC.

Bank of England Governor Mervyn King has asked Chancellor Alistair Darling for permission to create up to £150 billion to pump into the economy.

The MPC is worried rate cuts alone will not be enough to make a difference due to "depressed confidence and the persistent problems in international credit markets".

"Accordingly, the committee also resolved to undertake further monetary actions, with the aim of boosting the supply of money and credit," the Bank said.

Liberal Democrat Treasury spokesman Vince Cable said the Government should be wary of stoking up inflationary pressures for the future.

He said: "Today's rate cut means the Bank of England has now run out of conventional weapons to fight this recession."

"With interest rates now close to zero and the real threat of prolonged deflation and recession, the Bank's decision to start quantitative easing is understandable.

"Even with interest rates at a record low, the banking system is still in chaos with many families struggling to make ends meet.

"Directly increasing the amount of money flowing into the economy is now the only clear option.

"However, the Government must be careful that this kind of radical action doesn't quickly turn deflation into high inflation."

Mr King wrote to the Chancellor: "In these highly uncertain times, there are merits to stimulating the economy through a variety of different channels."

Ian McCafferty, the CBI business group's chief economist, welcomed the cut but said QE would have more impact.

He said: "The conventional rate cutting tool is becoming less and less effective as a means of stimulating the economy.

"A swift move towards quantitative easing as a way of boosting money supply and lending directly is now the MPC's best bet for supporting the economy and getting credit flowing again."

The Bank will create the money to buy Government and corporate bonds through its Asset Purchase Facility (APF).

The APF has bought up £820 million in corporate bonds - like company IOUs - in a bid to ease conditions in credit markets, but has so far been funded by £50 billion from the Treasury rather than "new" money.

Most of the £75 billion will be used initially to buy Government bonds. The MPC will now vote each month on what purchases are required as well as the level of official interest rates.

QE will only be used by the Bank of England to the extent necessary to hit its 2% inflation target.

Official inflation is currently well above target at 3.1%, but expected to plunge rapidly as recession grips and the Bank hopes boosting the money supply will ward off a prolonged slide into deflation.

Whether QE will work, however, depends on the extent to which struggling banks pass on the extra funds created by the Bank of England.

Today's move from the Bank comes against the grim backdrop of a deepening recession. Its own forecasts published last month predicted a year-on-year fall in output of almost 4% - although deputy Governor Charles Bean said the chances of an even heavier decline were odds-on.

This week has seen a fresh slew of downbeat data from manufacturing, services and construction sectors - while house prices are falling at a record annual rate of 17.7%, mortgage lender Halifax said today.

Royal Bank of Scotland underlined the problems in the ailing banking sector with a UK record £24.1 billion loss last week.

Meanwhile, around four million homeowners could see their monthly mortgage repayments drop as a result of the cut.

Roughly a third of mortgage customers have tracker loans, the majority of which will automatically move down in line with the Bank of England base rate.

But for those on other deals tied to standard variable rates, banks and building societies have argued that they are no longer able to pass on reductions in full as they have to balance the needs of their savers against those of their borrowers.

IHS Global Insight economist Howard Archer said the latest reduction to 0.5% was likely to see an end to rate cuts to ease pressure on bank profits.

He said: "Quantitative easing is clearly now going to be at the forefront in the Bank of England's ongoing efforts to stimulate the economy.

"Indeed, while we would not rule out a further cut ... we suspect that 0.5% will mark the floor, given the MPC's concerns about the negative repercussions that even lower interest rates might have on the banking sector."

Graeme Leach, chief economist at the Institute of Directors, said: "We strongly support quantitative easing and think it will be most effective if the Bank is aggressive in its use.

"Markets need to see a shock and awe approach over the coming months but even then there is no guarantee of success."

Neil Young, CEO – Young Group, believes the greatest impact of today's cut will be to broaden the divide between the mortgage 'have' and 'have nots'.

He said: "Those with existing mortgage loans will see a benefit but first time buyers or those looking to secure a new mortgage still face hurdles that are not helped by a reduction in base rate.

"The fall in interest rates is good news for those who already have a mortgage in place but is adding to inertia in the market. Lower base rates are no incentive for first time buyers, nor those seeking new mortgages, as tough lending criteria mean they remain out of reach to all but those with significant deposits or equity.

"The current low interest rate regime is widening the gap between those with and without mortgages as increasing numbers of mortgage holders continue to benefit from unprecedentedly low rates.

"As more and more existing borrowers come to the end of fixed rate deals and transfer onto lenders' low standard variable rates, they will join those on tracker deals in paying less in mortgage interest.

"By way of example, borrowers who took out 2 year fixed rate deals two years ago - and are at the end of their deal - are benefiting from standard variable rates that are lower than the fixed rate they had been paying.

"Our research shows that in transferring from a fixed rate onto standard variable rate, these borrowers are achieving savings of around 40% on their mortgage outgoings; good news for owner occupiers and great news for investors who see an immediate increase in cashflow.

"The economy is crying out for liquidity but successive cuts in base rate have not made an appreciable impact on lenders' willingness to provide credit."

Meanwhile, angry demonstrators descended on the Bank of England today to protest about how cuts in interest rates are crippling savers.

Protesters waving placards and banners convened outside the looming bulk of one of England's most venerable institutions demanding a better deal for savers.

Savers have found themselves increasingly affected as the credit crunch tightens its grip on the economy.

Interest rates have repeatedly fallen with the latest figures from the Bank of England showing that saving rates plunged to a record low during January, with notice accounts now paying an average of just 0.29%.

Protester Ian Dixon was made redundant in December as the hydraulics firm he worked for struggled to cope in the face of the recession.

The 45-year-old, from Whitby, North Yorkshire, said the prospect of finding another job was bleak.

Mr Dixon, brandishing a National Savers and Pensioners Union (NSPU) placard, said: "I can't remember a situation as bad as this before, either in the 1980s or 1990s.

"There's a lot of people struggling and a lot more will go the same way.

"I found there's lots of people chasing a tiny handful of jobs."

Mr Dixon said he was lucky he owned his own home but warned that those who relied on their savings were being clobbered.

He added: "It's the savers who are bearing the brunt of this.

"There's just no return on savings any more and many work pensions are worthless.

"Pensioners who rely on their savings are really struggling.

"And it seems the bankers who've done all the damage seem to be the ones who are being rewarded for it."