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## Interest rates

### Combating the recession

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#### The base rate falls to an all-time low in the battle against the downturn

Eyevine



THE decision made history. On January 8th the Bank of England cut the base rate from 2% to 1.5%, the lowest since the central bank was founded in 1694. The Bank of England's mission then was to provide war finance. Its task now is to fight a recession that looks increasingly likely to be the worst since the second world war.

The bank's latest move means that the base rate has now fallen by an extraordinary 3.5 percentage points since the start of October (see chart). It followed a clutch of closely watched business surveys of purchasing managers that painted a dismal picture of the economy in December. Manufacturing was mired in the deepest downturn since the survey started in 1992. Construction activity plumbed new depths. And activity in private services stayed close to its record low in November.

The findings, together with earlier surveys, confirm that the recession intensified towards the end of last year. Official figures published in late December showed that GDP fell in the third quarter by 0.6%—rather than the original estimate of 0.5%—from its level in the spring. It now looks as if GDP declined by a further 1% or so in the last three months of 2008, according to Capital Economics, a consultancy.

The outlook for 2009 is dispiriting. Despite the fillip from the

temporary reduction in value-added tax, consumer spending will fall sharply. Households will retrench as unemployment rises and those with jobs fear they may lose them. Spending will be hit, too, by weak stockmarkets and shrinking housing wealth. House prices fell by 15.9% in the year to December, according to Nationwide Building Society.

The economy will also be clobbered by cuts in capital spending. Since the prices of homes still have a long way to fall, housing investment will remain depressed. Businesses are already cutting their capital programmes, with more to come in the year ahead. Capital Economics is predicting that GDP will fall by 2.5% in 2009, the biggest annual decline in the past 60 years.

A common cause of these downward pressures on the economy is the banking malaise, which has undermined equity and property markets and curtailed the routine provision of finance to business.

That makes it all the more ominous that banks are expecting to restrict credit still further. A survey by the Bank of England published on January 2nd found that lenders had reduced the availability of credit to both households and companies in the three months to mid-December and expected to curb it still further in the first quarter of 2009.

Banks' reluctance to lend as they strive to repair their overstretched balance-sheets is impairing the effectiveness of monetary policy. But the sheer scale of rate cuts over the past three months is helping many indebted households. About half of mortgage borrowers have variable-rate loans and are therefore generally benefiting from the reduced cost of servicing their debt. Savers are grumbling about the sharp fall in interest rates on their deposits and the Conservative opposition has pledged tax concessions to help them. Yet, however unfair it may seem to the thrifty, rate cuts are needed to boost the overall economy.

Another way in which monetary policy retains some of its clout is through the exchange rate. Ahead of the Bank of England's decision, the pound clambered back from near parity against the euro at the end of last year to €1.11 on January 7th as gathering gloom about the euro area's prospects led foreign-exchange dealers to factor in an early cut in European interest rates. But the hefty depreciation of around a quarter in sterling's trade-weighted value since mid-2007 will still bolster the economy by making British producers of tradable goods and services more competitive both in foreign markets and at home.

The fall in sterling will also blunt deflationary pressures that might otherwise exacerbate the credit crisis, since when prices start falling the burden of debt rises in real terms. As consumer-price inflation was still 4.1% in the year to November, deflation might seem a remote prospect. But inflation will tumble in the coming months because of lower oil prices and the recession.

Despite this help for the economy from looser monetary policy, the worry is that the Bank of England is running out of ammunition as the base rate heads towards zero. And in any case the conventional strategy of lower rates may not be strong enough as long as banks continue to restrict credit. One solution would be to force-feed them with even more capital, but Gordon Brown said on January 4th that this was not a front-runner among possible new measures. Nor is "quantitative easing"—printing money to buy assets. However, the government is planning a package of further help to support bank lending in the battle against recession.

