APPENDIX 3

Prospects for interest rates 2009/10 (Sterling Consultancy Services)

The credit crunch, combined with a sharp rise in commodity prices, has pushed the UK and other major economies into recession. Consumers, businesses, politicians and economic policymakers have had to come to terms with tighter credit conditions and the distinct probability of a protracted recession.

Despite the warning signs of a potentially sharp contraction in economic activity, the Monetary Policy Committee (MPC) were slow to respond, initially more concerned about the upside risks to inflation from last years surge in food and oil prices. Bank Rate remained at 5.0% until October, when it was reduced as part of co-ordinated central bank action, a move designed to restore confidence in the battered banking sector. The Committee has now cut Bank Rate by 3.5% since October to the current level of 1.5%.

Recent Bank of England publications and decisions have painted a worrying picture for the UK economy in 2009. The annual GDP growth rate is forecast at around –2.0% by the end of the first quarter 2009, and remains negative although improving throughout the year and then recovers quickly in 2010. With oil prices having fallen around 65% compared to record levels in July 2008, CPI is expected to drop sharply and has given the MPC room to manoeuvre to attempt to stimulate demand. Inflation is forecast to fall from November's level of 4.1% to under 2% by the middle of 2009. From this point the CPI rate falls further below the target level, with a small chance of deflation.

The MPC will assess a number of factors when deciding whether further monetary stimulus is needed. Upside risks to growth include the fiscal stimulus of major countries including the UK and US. Commodity prices have also declined steeply and the weaker value of sterling may benefit UK manufacturing and service sector exports. However, downside risks to growth, and so inflation, remain. Diminishing consumer sentiment, as house prices fall and unemployment rises, could pull back consumer spending. Meanwhile tight credit conditions have constrained both residential and business investment and made it difficult to refinance debt. The current pressure on companies is illustrated by the many well-known high street names entering administration. There is also a question mark about whether looser monetary policy is the right tool in order to combat the current problems. This is illustrated by growing support for more drastic action, such as increasing the amount of cash in circulation, so-called quantitative easing.

Despite an argument for holding rates at the current level, the MPC is likely to take further action due to the significant risk of CPI undershooting the 2% target in the medium term. However, with a diminishing benefit from each reduction and the view that rate cuts by themselves are not the answer to easing credit conditions, we see the bottom of the current policy cycle as 1.0%. It is likely to remain at this level for a considerable length of time in order to rebuild confidence, restart bank lending and stimulate economic activity. From mid-2010 as the economy recovers, Bank Rate will rise steadily to combat re-emerging inflationary pressure. Throughout this period, wholesale money market interest rates are likely to remain above Bank Rate, although the process of normalisation will continue as the credit risk margin diminishes. The UK authorities are hoping the combined fiscal and monetary stimulus will ensure a short, sharp recession, but the risk of prolonged economic deterioration remains. Therefore a downside risk exists to our central forecast for Bank Rate throughout the coming years.

Sterling Consultancy Services Central Forecast – January 2009

	Bank Rate	1 month LIBOR	3 month LIBOR	12 month LIBOR	25 year PWLB	50 year PWLB
Current	1.50	1.77	2.38	2.71	4.23	4.12
Q1 2009	1.00	1.20	1.70	1.90	4.20	4.10
Q2 2009	1.00	1.20	1.60	1.80	4.50	4.30
Q3 2009	1.00	1.10	1.50	1.70	4.70	4.50
Q4 2009	1.00	1.10	1.50	1.70	4.80	4.50
H1 2010	1.50	1.75	2.00	2.50	4.90	4.60
H2 2010	2.00	2.35	2.75	3.10	5.20	4.90
H1 2011	3.50	3.80	4.25	4.75	5.50	5.20
H2 2011	5.00	5.10	5.25	5.40	5.70	5.40

HM Treasury survey of forecasts

Bank Rate Forecasts	Actual (%)	Bank Rate (%) Q4 2009*	Average Bank Rate (%)**		
			2010	2011	2012
Median	2.00	1.00	3.11	3.97	4.49
Highest	2.00	4.00	4.70	5.00	5.25
Lowest	2.00	0.50	1.00	2.25	3.00

* HM Treasury Forecasts for the UK Economy - December 2008
** HM Treasury Forecasts for the UK Economy - November 2008