Economic Background 2009/10

(courtesy of Butlers)

Central banks continued to ease monetary policies in an attempt to reduce borrowing rates and hence alleviate some of the cost pressures being experienced by financial institutions and, in particular, the corporate and household sectors. These latter areas were faced with an increasing financial pressure, brought on initially by the monetary squeeze (courtesy of the credit crunch) and falling asset prices.

With official interest rates in the US already at close to zero at end-2008, the Bank of England was at the forefront of policy easing. Bank Rate was cut in successive monthly moves from 2% at the outset of the year to the historically low level of ½% in March 2009. Policy ease going forward would take the form of quantitative measures where the stock of money would be expanded via a mechanism of buying securities from investment institutions in exchange for cash. This so-called “quantitative easing” commenced in early March.

Aside from Bank of England assistance, the Government launched the second phase of its support operations for the banking industry during the second half of January. During the course of the quarter two major High Street banks needed substantial cash injections, action that led the public sector to assume substantial ownership. In addition to this a number of building societies were rescued through a combination of mergers and financial support.

Economic data confirmed that the UK was in recession. Mounting expectations of rapidly declining activity and projections of negative retail price inflation were seen as justifying the shift to a more aggressive approach to monetary policy.

The generally uncertain backdrop to the UK and the financial markets prevented a marked expansion in overall money market liquidity. While the situation did show some signs of improving as the quarter progressed, the margin between official interest rates and those quoted in the inter-bank market for periods longer that 1-month remained very wide.

Financial markets entered calmer waters in the Spring as fears of global depression subsided. However it was not until the Summer months that economic performances began to stage a welcome improvement. Fear of a collapse of another leading financial institution lessened markedly. The UK economy continued to post a mixed performance. The low point of the business cycle was passed during the third quarter (July to September 2009) of the year but the return to positive growth was not confirmed until the early part of 2010.

Industrial production was one of the buoyant areas of the economy, although this returned to a more erratic profile in the closing stages of the year. Consumer spending, by contrast, remained mixed throughout as consumers strived to reduce levels of personal debt. This, together with uncertainty in the employment situation served as further deterrents to spending.

The bias of the Bank of England decisions remained directed towards policy ease throughout the year. This policy approach, coupled with dwindling fears of financial collapse, created an environment in which money market rates eased to yet lower levels. In addition to this, the margin between LIBOR and LIBID rates returned to a somewhat more normal position. This was a sign that banks were more comfortable about transacting business between each other but the availability of credit to a wider cross-section of the economy remained problematic through to year-end.

Long-term interest rates rose sharply in January 2010 but the rising trend in yields did not continue. Long-term rates remained generally erratic, frequently registering large intra-day movements, although the fluctuation in yields was within a comparatively narrow range.