Perspectives by Ruth Lea

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The recession deepens: time for further measures

The year 2008 will go down in history. It is difficult to recall that in the first half of September there were actually some modest and tentative signs that the credit crunch may be easing. LIBOR rates were, for example, modestly ticking down. Such optimism was blown away on 15 September with the collapse of Lehman Brothers and the following financial crisis, which profoundly undermined consumer and business confidence.[1]

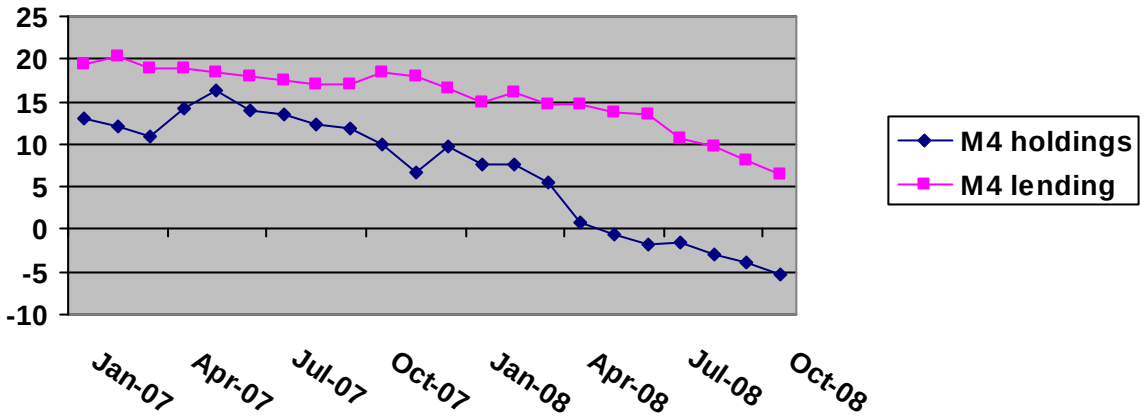
In the weeks after the Lehmans crisis it seemed that key players in the international financial scene were competing with each other to produce the most apocalyptic phrases to describe the turn of events. In the first half of October IMF managing director Dominique Strauss-Kahn warned that the world financial system was teetering on the "brink of systemic meltdown". Later in the month Alan Greenspan, the former chairman of the Fed, called the turmoil in the financial markets a "once in a century credit tsunami" and events had left him in "a state of shocked disbelief". And Bank of England Governor Mervyn King noted, slightly more prosaically but nevertheless dramatically, that "not since the beginning of the First World War has our banking system been so close to collapse" and he said that, following the collapse in Lehmans, "an extraordinary, almost unimaginable, sequence of events began".

Weak bank lending

Hyperbole and drama apart, it is clear that the distress in the financial markets is having increasingly severe effects on the real economy. Credit availability is tight despite the cuts in interest rates and the bank rescue package announced on 8 October.[2]

Chart 1 below shows the dramatic slowdown in the growth in M4 bank lending to private non-financial corporations (PNFCs). Annual growth rates of around 20% were recorded in the first half of 2007, but by September 2008 the rate had decreased to 8.2% and by October to 6.5%. M4 holdings, mainly deposits, by the PNFCs are now falling on a year-on-year basis.[3]

Chart 1: Private non-financial corporations (PNFCs): M4 holdings of and M4 lending to, 12-month growth rates (%): January 2007 to October 2008

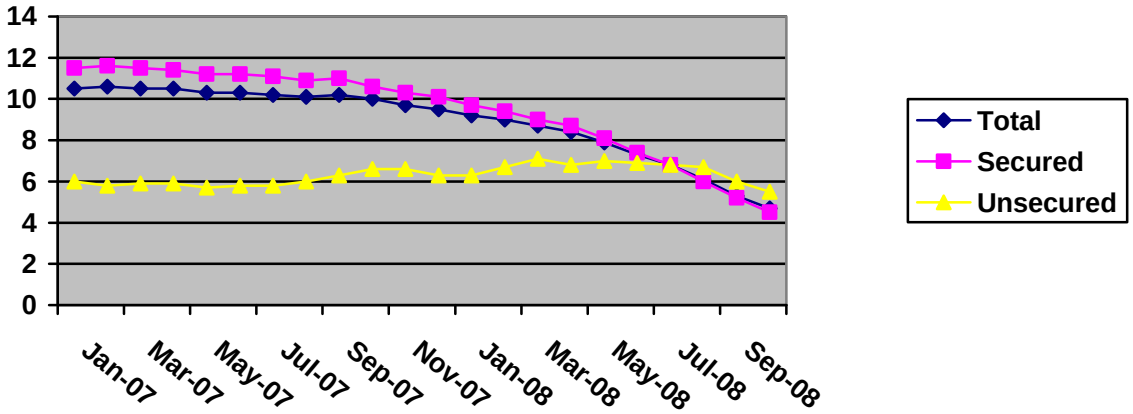


Source: Bank of England, *Sectoral breakdown of aggregate M4 and M4 lending: October 2008*, 1 December 2008.

Chart 2 shows the equally dramatic tightening in lending to individuals secured on property. Annual growth rates of around 12% were recorded during the first half of 2007 but by September 2008 this had fallen to 5.2% and by October down to 4.5%. Such data confirm other information (both quantitative and qualitative) of a sharp drop in activity in the housing market, against the backdrop of deflating house prices. Of the approvals secured on dwellings, over half is currently for re-mortgaging and only one quarter for house purchase.

The growth in unsecured lending to individuals (consumer credit) had been buoyant until August – if anything it had accelerated. But the figures for September and October were weaker as the realities of recession started to bite.

Chart 2: Lending to individuals, 12-month growth rates (%): January 2007 to October 2008



Source: Bank of England, *Lending to individuals: October 2008*, 1 December 2008.

This weakness in lending is now, arguably, the most pressing problem for the British economy as recession takes grip. But despite the afore-mentioned rescue package, aggressive cuts in interest rates and vigorous exhortations from the Government to the banks to lend, it is not surprising that banks feel in a poor position to lend generously or indeed pass on all the cuts in Bank Rate to their customers.

As discussed in a previous Perspective[4] British banks are faced with a huge "funding gap" - the surplus of lending over deposits which had been funded mainly by borrowing from the international wholesale markets. Such borrowing is not currently possible because of the dysfunctional wholesale markets. According to the Bank of England, seven years ago, major UK banks funded lending almost entirely out of customer deposits, so the funding gap was negligible. But by the first half of 2008, they had a funding gap of some £740bn.[5]

Added to which banks have recorded, are recording and will continue to record (as the recession deepens) losses. They need, therefore, to restore profitability despite the tighter capital requirements they are being asked to implement. Banks are, moreover, aware that, if they are to attract deposits to maintain current levels and replace the lost wholesale funds, they must be prepared to pay a reasonable return to savers. They cannot, therefore, just pass on all the cuts in Bank Rate to borrowers.

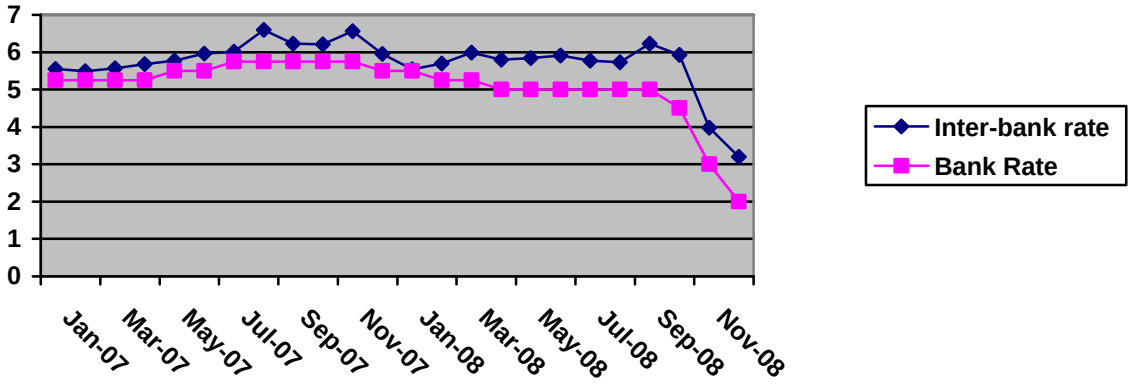
The recession deepens

The real economy has deteriorated significantly recently. Specifically, NIESR's latest GDP estimate for the three months to November suggested a contraction of 1% over the previous three months (to August).[6] This compared with a contraction of 0.8% in the three months to October. At this stage it is reasonable to estimate that GDP will fall by 1% in the final quarter of 2008, which would represent a significant worsening over the third quarter, when activity fell by a (much worse than expected) 0.5%. Later this week (17 December) the next set of labour market data will be released with the expectation that the claimant count will have risen by 45,000 in November.

There is, moreover, little doubt that the economy will continue to deteriorate in the first half of next year, despite the action so far taken by the Authorities – including the bank rescue plan, the Pre-Budget Report's fiscal package and the aggressive cuts in interest rates – as well as the significant fall in sterling. Sterling has dropped 13% against the euro in the last couple of months since the Bank began cutting interest rates aggressively, though it should be noted that the beneficial effect on exports will be muted because of recession in Britain's major markets. This recession is marked by two very insidious features: the first being the extreme distress in the financial markets and the second being the global nature of the downturn.

Chart 3 below shows the quite unprecedented cuts in Bank Rate to 3% in November and 2% in December. Sterling inter-bank rates have fallen dramatically too, with 3-month LIBOR down to 3.15-3.20% in the week beginning 8 December.

Chart 3: £ inter-bank lending rate (mean) and official Bank Rate, end-month, %: Janaury2007 to December 2008



Source: Bank of England statistical database. December 2008 figure relates to 12 December 2008.

Time for further measures

As the economy deteriorates, there is no shortage of advice from commentators for the Authorities in order to alleviate a Japanese-style 1990s deflation and a "lost decade" of growth.

Top of the list is further aggressive cuts in interest rates with Bank Rate down to 1% or even 0%. But there have to be reservations about this policy. The first is that even less of these cuts could be passed on to borrowers, than has been the case so far. As already commented, lenders must be prepared to pay a reasonable return to savers if they are to build (or even maintain) their deposit base and thus be able to lend. It could be that very little of the cuts would be passed on. The second reservation concerns the impact on sterling, which the Bank takes into account when judging the appropriate overall monetary stance. The Bank may take the view that sterling has fallen far enough and further aggressive cuts would needlessly undermine the currency. And the third reservation is that mere cuts in themselves would not encourage and/or enable the banks to increase their lending significantly. There is no point in having very cheap money if banks will not lend it! The interest rate lever, though not totally ineffective, is mal-functioning.

Under these circumstances it is reasonable to question when further aggressive cuts are the way forward. But even if they were, they would need to be accompanied by other policies to encourage the growth in the money supply and lending. The Bank stated in their announcement of the cut in Bank Rate to 2% in December that "despite the actions taken to raise bank capital, ease funding and improve liquidity, conditions in the money markets remain extremely difficult. The MPC noted that it was unlikely that a normal volume of lending would be restored without further measures".[7]

It is not entirely clear what "further measures" the MPC has in mind. But there are several weapons left in the armoury. The following proposals are amongst those that have merit:

- The Chancellor is apparently reviewing the £250bn credit guarantee scheme, which was part of the October bank rescue package. The fees demanded are arguably punitive and should be reduced.
- Schemes to guarantee corporate lending should be established.
- The Treasury's current policy, implemented through the Debt Management Office (DMO), is to "fully fund" public sector borrowing by insisting all borrowing is met by selling government debt. But selling government debt to the non-bank private sector reduces the money supply and hence lending. Under the current, potentially deflationary circumstances, government debt should not be fully funded but "under-funded" where the Bank of England funds some borrowing by, de facto, printing money.[8] This policy would be regarded as irresponsibly inflationary in normal times - but these are not normal times. This is an example of "quantitative easing".
- The FSA has discretion over how banks are forced to value certain capital market assets on a prudential basis and could in certain circumstances help liberate lending if they were to use this discretion positively. They should do so.
- The Treasury and the FSA have the power to relax the rules that enforce "procyclicality". Procyclicality is built into the Basel II international banking supervision agreement and dictates how much capital banks must hold against the risk of loans turning sour. As these risks rise in recession, then the banks have to hold more capital. The Treasury and the FSA should do more to exercise that discretion and relax the rules.

References

1. See John Authers, "Four strong contenders for mistake of the year", *FT*, 14 December 2008, who included the fall of Lehmans as one the contenders.
2. The rescue package as announced on 8 October comprised: (i) £50bn of new capital in order to re-capitalise banks (since revised to £37bn), (ii) £200bn, a doubling, available under the Special Liquidity Scheme which allows banks to swap their mortgage-backed securities and other illiquid assets for Treasury bills, (iii) £250bn Government guarantees for new short and medium-term debt issuance to help eligible institutions refinance maturing, wholesale funding issues as they fall due. So far it is estimated that £100bn has been used.
3. M4 holdings by PNFCs = notes & coin + retail & wholesale deposits.
4. Ruth Lea, "Memo to the Bank: cut interest rates by 1.0%", Arbuthnot Banking Group Perspective, 3 November 2008.
5. Bank of England, *Financial Stability Report*, October 2008.
6. National Institute of Social and Economic Research.
7. Bank of England News Release, "Bank of England reduced Bank Rate by 1.0 percentage point to 2.0%", 4 December 2008.
8. Gordon Pepper, *A confused and senseless policy*, Lombard Street Research, 5 December 2008.

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