Perspectives by Ruth Lea

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Memo to the Bank: cut interest rates by 1.0%

The third quarter GDP data were dire
The economic news over the last fortnight has been dire. The fall in the third quarter GDP figure, of 0.5%, was significantly worse than the expected 0.2% decline.[1] Most sectors of the economy contracted – with the exception of agriculture (despite the wet summer) and "Government and other services". The biggest fallers were "distribution, hotels and catering" (down 1.7%) and the production industries including manufacturing (down 1%). But declines were also recorded in the construction industry, hard hit by the difficulties in the housing market, "transport and communication" and "business services and finances". They all declined by around ½% in the quarter.

Given current surveys are indicating deteriorating business conditions, there can be little doubt that GDP will decline in the fourth quarter of the year and, using the conventional definition of recession being two consecutive quarters, few people believe that the economy will miss recession. It is worth noting that the Lehmans collapse, which triggered the latest vicious twist in the credit crunch crisis, happened towards the end of the third quarter and, therefore, the prospects for fourth quarter GDP are especially ominous.

As the HM Treasury prepares its forecasts for the Pre-Budget Report that is due later this month, the big questions that it faces will be how deep and how prolonged is the recession likely to be. Given the Bank of England's latest cheerless assessment of the financial situation, the overhang of indebtedness in the private sector and the poor state of the public finances, for which the Prime Minister still seems reluctant to accept any responsibility, the omens do not look good.

The Bank of England's Financial Stability Report
The Bank's latest Financial Stability Report (FSR),[2] made for gloomy reading and was more pessimistic than the previous one (released in April) by several degrees. For example, the Bank had dramatically revised up the mark-to-market losses on securitised credit instruments and unsecuritised corporate bonds.

Mark-to-market losses on selected financial assets

	Losses April FSR	Losses October FSR
UK (£bn)	62.7	122.6 (+95%)
US ($bn)	738.8	1577.3 (+113%)
Euro area (€bn)	344.1	784.6 (+128%)

Source: Bank of England, *Financial Stability Report (FSR)*, October 2008.

At current exchange rates the total losses amount to some $2.8trl. And, as the table shows, the outlook deteriorated faster in the US and, especially, the Euro area than it had in the UK. Of course, the mark-to-market estimates are, to a degree, notional estimates – not least of all because current exceptional market conditions are badly distorting the values. But the data do give one indication of how financial conditions have deteriorated over the past six months.

The Bank's FSR assessment of the major UK banks' customer "funding gap" – the surplus of lending over deposits which is funded mainly by borrowing from the international wholesale markets - is arguably of greater significance for economic policy. Seven years ago, major UK banks funded lending almost entirely out of customer deposits, so the funding gap was negligible. By the first half of 2008, they had a funding gap of some £740bn. The Bank does not expect this gap to close entirely, still believing there will be scope for wholesale funding in the long term, but it hinted that the gap needs to narrow to 2003 levels, which were about £265bn. The Bank estimated that major UK banks would have to shed a sixth of assets in order to return to 2003 leverage levels, despite the recapitalisation scheme. This is a far cry from trying to maintain last year's lending levels, as recently stated by the Government.

The deleveraging process would have been considerably more painful without the government's rescue package. But even so, it is now clear that there will be no return to the past rates of growth in bank lending and the consequent credit-fuelled expansion which has led to an economy living well beyond its sustainable means.

GDP forecasts

We are living in historic times and in uncharted waters. In the first half of October, before the full extent of the international bail-out of the banks was announced, IMF managing director Strauss-Kahn warned that the world's financial system was teetering on the "brink of systemic meltdown". 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 King stated in a speech to businesspeople in Leeds on 21 October, slightly more prosaically, that "not since the beginning of the First World War has our banking system been so close to collapse".[3]

These are indeed historic times and, given the collapse of the asset bubble and the consequent near-disintegration of the credit mechanism, the way this recession will evolve is entirely obscure. Compared with the early 1990s recession,[4] we have not recently experienced double-digit inflation rates, as was the case then, and we are not locked in the Exchange Rate Mechanism – which meant British interest rates were essentially determined by the Bundesbank which was coping with the post-unification inflationary boom in Germany. But this time the economy will be dragged down by the impact of the banking crisis and the lending squeeze that is part of the banks' deleveraging process, as discussed above. Such behaviour is especially difficult to model and forecast.

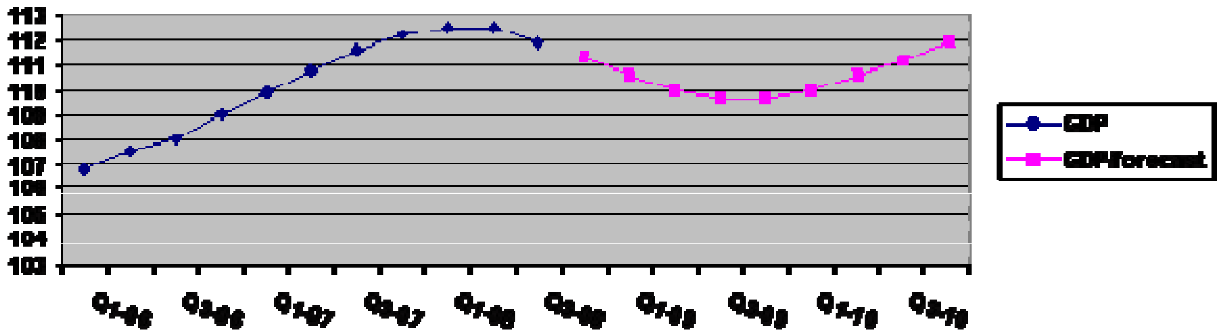
But, given the recessionary forces already at work in the economy, the considerable lagged effects of lower interest rates, the reversal of the effects of the credit-boom and the still correcting housing market, it is reasonable to assume that the recession, in terms of falling output, will last well into the middle of next year. Then the looser monetary policy (an easier pound as well as lower rates) should help the economy to recover. The automatic stabilisers, for example higher unemployment benefits, will help the economy but only add to the huge borrowing figures.[5]

On this basis, I would expect GDP to fall by around 2% next year and grow by about 1% in 2010, as shown in the table and chart below.

Central case forecast for GDP: quarterly data, growth rates (%)

	2008					2009					2010				
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
GDP:															
QOQ growth	0.3	0	-0.5	-0.5	Na	-0.6	-0.5	-0.3	0	Na	0.3	0.5	0.6	0.6	Na
YOY growth	2.4	1.5	0.3	-0.8	0.9	-1.7	-2.2	-2.0	-1.4	-1.9	-0.5	0.5	1.4	2.0	0.8

GDP index, market prices, 2003 prices, 2006Q1 to 2010Q4

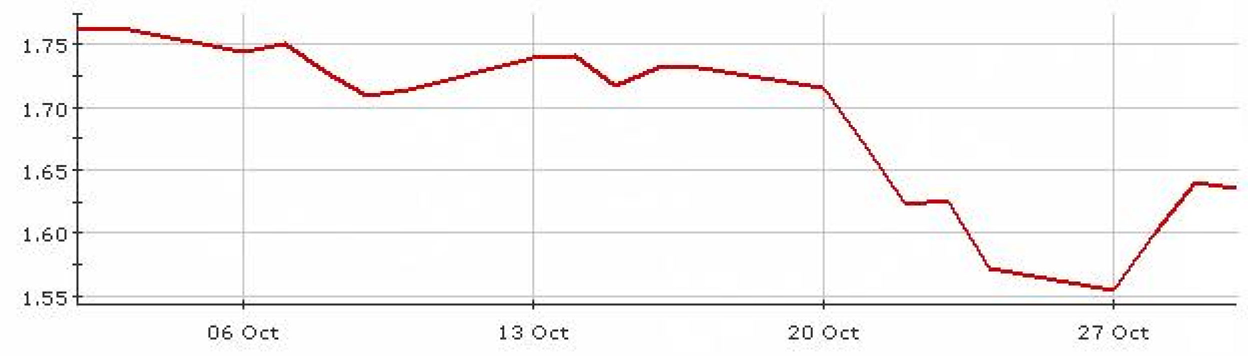


Source: back data from ONS, First Release, "Gross Domestic Product, preliminary estimate – 3rd quarter 2008", 24 October 2008.

Drastic times call for drastic measures. And, with 4.5% interest rates and inflationary pressures waning, the Bank should feel confident enough to cut interest rates by 1.0% to 3.5% on Thursday, 6 November. It is not that such a cut would significantly stimulate new lending, but it would ease the pressure on existing borrowers, as long as rate cuts by the Bank are passed on by lenders.

There are risks to the currency and the pound fell substantially after the Governor's afore-mentioned and rather gloomy speech of 21 October, as chart below shows. But the markets have almost certainly already factored in a sharp and nasty recession for the UK and further cuts in British interest rates.

Pound Sterling - United States Dollar



Source: BBC website. www.bbc.co.uk/news

References

1. ONS First Release, "Gross Domestic Product, preliminary estimate – 3rd quarter 2008", 24 October 2008.
2. Bank of England, *Financial Stability Report*, October 2008.
3. Speech available from the Bank's website: www.bankofengland.co.uk.
4. Ruth Lea, "Three British recessions compared", Arbuthnot Banking Group Perspective, 21 July 2008.
5. Ruth Lea, "The public finances: prepare for even worse figures", Arbuthnot Banking Group Perspective, 20 October 2008.

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