



# Perspectives by Ruth Lea

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### **Cut Bank Rate by 0.5%: inflation is not the problem, recession is**



The economic prospects and perceptions for Britain have deteriorated significantly over the past month as a new and vicious twist has developed in the credit crunch. It can be said, with little fear of exaggerating, that the current global financial situation is the most severe since the late 1920s and early 1930s.

The collapse in confidence and the freezing-up of the credit market call for radical policy responses. And US Treasury Secretary Paulson has been right to vigorously promote his proposed \$700bn bail-out (TARP (Troubled Asset Relief Program)) for the US banking system, whatever its shortcomings. Piecemeal fire-fighting was no longer an option for the US and, quite simply, the banking system has a uniquely important function in any economy and cannot be allowed to collapse. Time will tell whether, and to what degree, TARP will “normalize” the credit markets. But there may still be a need for the authorities to take more drastic moves, including directly injecting capital into the banking system.

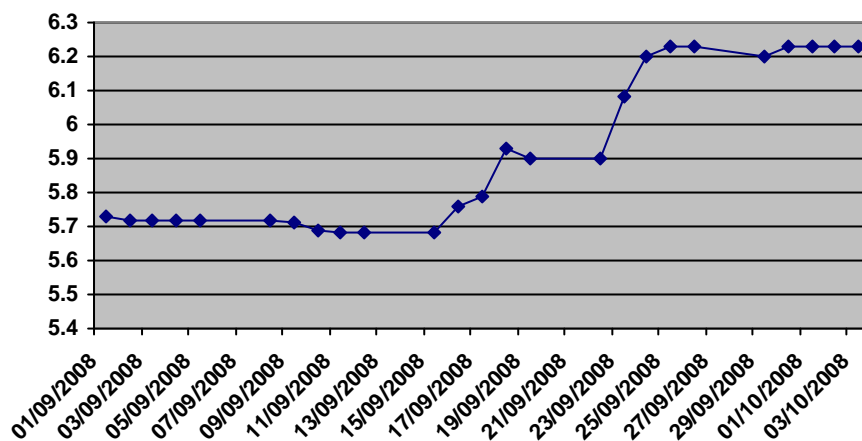
In the UK activity by the authorities to combat the worst aspects of the financial crisis has focused on nationalizing failed banks, injections of liquidity of increasing magnitudes into the credit markets and raising the level of state guaranteed deposits from £35,000 to £50,000. But the large infusions of funds have not yet stabilized the system and it is increasingly clear that the current liquidity crisis has a more fundamental cause than mere shortages of liquidity and funding. And that is the lending institutions’ fear of insolvency of their counter-parties. Re-capitalisation of the banking system is, therefore, a priority. The possibility that such capital injections (in the form of equity stakes) may be provided by the public sector, if conditions became sufficiently dire, cannot be ruled out. Plans for this should be made.

As the credit crisis deepens in the UK other policy proposals are being promoted for unfreezing the markets including a TARP-style operation for the UK, suspension of the mark-to-market rules, unlimited state guarantees for depositors and, last but not least, cutting interest rates.

### *Credit conditions tighten*

Inter-bank rates (and associated rise in the cost and availability of credit to business and households) have increased significantly since the onset of the current phase of the financial crisis on 15 September, when the collapse of Lehman Brothers was announced. In early September the 3-month inter-bank rate was about 70 basis points above Bank Rate. By early October it was over 120 basis points above Bank Rate. This rise in rates has more than reversed the recent, albeit modest, easing in the UK seen in August and early September by a very significant margin. (Some mortgage rates were beginning to ease.) At the very minimum, this tightening should be reversed. As the economy heads for recession, tighter monetary policy in the form of higher inter-bank rates with all their implications for lending rates is entirely inappropriate.

### **Daily Sterling inter-bank lending rate, 3 month, mean, LIBID/LIBOR (%)**



Source: Bank of England, [www.bankofengland.co.uk](http://www.bankofengland.co.uk)

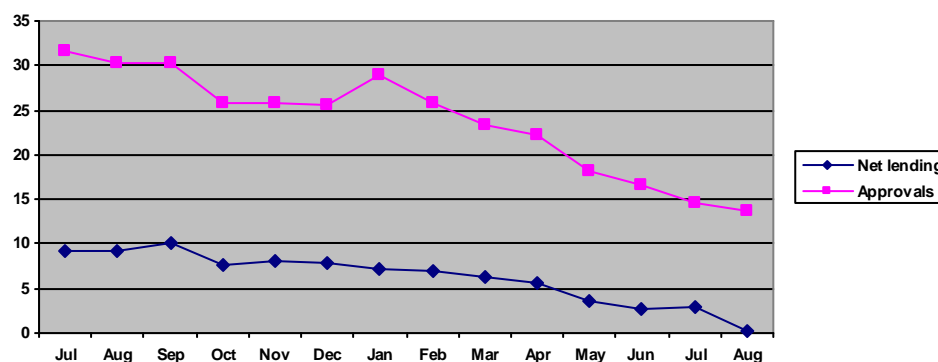
Putting aside the increase in inter-bank rates over the past three weeks, the Bank of England's latest *Credit Conditions Survey* for the third quarter of 2008, showed a consistent picture of tightening in credit conditions.<sup>1</sup>

Concerning supply, lenders reported that they had reduced the availability of secured credit to households more than expected in the previous survey and, moreover, expected a further decline in secured credit availability over the next three months. The survey results for unsecured lending to households and corporate lending showed a similar pattern. On the demand side the survey found that the demand for secured lending for house purchase and for remortgaging and for credit by private non-financial corporations (PNFCs) had declined and, moreover, was expected to fall further. Reduced PNFC demand related to capital investment, mergers and acquisitions, and commercial real estate. The report also said that with economic conditions worsening, more borrowers (whether household or PNFC) were defaulting on their loans and the defaults were expected to increase.

The main pressures behind this tightening of credit availability were identified as the elevated cost and difficulty of accessing funding by the banks, the adverse impact on bank assets (such as residential mortgages) of the weaker economic prospects and lenders' re-pricing risk. In addition de-leveraging pressures on banks and other financial institutions had continued. In seeking to reduce the scale of their borrowing relative to their capital base, banks had both reduced the scale of lending to households and companies as well as raising new capital.<sup>2</sup>

Credit availability is of crucial significance and closely correlated with the medium-term path of nominal spending growth of both the household and corporate sectors. The growth rates of money and credit have declined sharply in recent months and the impact on the real economy of these developments is intensifying. Lending secured on dwellings, for a combination of supply and demand factors, has spectacularly declined.

### **Lending secured on dwellings: July 2007 to August 2008, £bn, seasonally adjusted**



Source:

Bank of England, [www.bankofengland.co.uk](http://www.bankofengland.co.uk)

#### *The real economy: recession is the risk not inflation*

The real economy is now weakening fast. The downward revision to the second quarter GDP figure, from the preliminary estimate of a rise of 0.2% in the quarter to no growth at all, changed perceptions. Current GDP data show that domestic expenditure on goods and services actually slipped back 0.1% in the second quarter reflecting a fall of nearly 3% in gross fixed capital formation. A fall in net imports (imports minus exports) offset this slippage in domestic demand. Reflecting the weakening economic activity, the labour market is also now weakening. Unemployment is rising - the claimant count rose over 32,000 in August to over 900,000 - and job vacancies are falling.

But the second quarter is a long time ago. Subsequently surveys have suggested that business conditions have worsened since then. The September survey by the Chartered Institute of Purchasing and Supply (CIPS) for manufacturing industry, for example, indicates a sharply deteriorating situation. Moreover, the erosion of real incomes associated with higher inflation, together with the pronounced credit squeeze, will restrain spending of both households and the corporate sector. GDP probably fell in the third quarter of this year and will

probably fall further in the fourth. A recession, in the strict definition of the word, is now highly likely. The question is now just how prolonged and just how deep the recession will be.

Of course, CPI inflation is still rising, not least of all because of the increases in gas and electricity prices in our chronically vulnerable energy sector. The fall in the pound against the dollar adds to inflationary pressures. But commodity prices, especially oil prices, have now fallen and there are few signs that a “wage-price” spiral is emerging. A weakening labour market will surely control any serious possibility that such a spiral should develop. CPI inflation should peak over the next 2-3 months (at around 5%) and then fall quite rapidly in 2009. Moreover, Mervyn King has made it abundantly clear that the “MPC is aiming to return inflation to the 2% target within its normal forecast horizon of around two years”.<sup>3</sup> The MPC has time to achieve their target without losing credibility.

The threat to the economy is now recession, not rip-roaring inflation. And this has been exacerbated by the current exceptional events in the financial markets, which has pushed inter-bank rates sharply higher, as discussed already in this note. The financial crisis is unlikely to be resolved quickly and market rates will probably stay well above Bank Rate for some time. Higher inter-bank rates and tightening credit conditions, as shown in the BoE’s latest *Credit Conditions Survey* (discussed above), can only increase the probability of a severe recession, when inflationary pressures are fading.

#### *The MPC should cut Bank Rate by 0.5%*

Under these circumstances it is clear that Bank Rate should be cut – and be cut by 0.5%. Further cuts should be in the pipeline. A 0.5% cut would help to guide down inter-bank rates and soften the economic impact of the financial crisis. A cut in rates will not solve the crisis in the credit markets and it will not cure any problems in the banking sector. But it would help curb the upward moves in market interest rates and support the fast-eroding business and consumer sentiment.

#### **References**

1. Bank of England, *Credit Conditions Survey, Survey results, 2008Q3*, 2 October 2008. The survey was conducted between 26 August and 17 September - in other words, mainly before the onset of the current financial crisis.
2. Bank of England, *Inflation report*, August 2008.
3. Letter from the Governor of the Bank of England to the Chancellor of the Exchequer, 16 June 2008.

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