



Perspectives by Ruth Lea

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Memo to the Bank: there's no point in further interest rate cuts

The global economic outlook continues to deteriorate. The IMF recently downgraded its forecasts, yet again, and significantly. The sheer scale of the revisions indicates that in the current circumstances economic forecasters and their models, which tend to assume a normally functioning financial system, are flying blind. Despite the press headlines emphasising that the UK will have the worst growth performance of all the major economies this year, caution should be exercised in interpreting the figures.

IMF forecasts for GDP, annual change (%)

	January 2009 projections		Difference from November 2008 projections	
	2009	2010	2009	2010
World output	0.5	3.0	-1.7	-0.8
US	-1.6	1.6	-0.9	0.1
Euro area:	-2.0	0.2	-1.5	-0.7
Germany	-2.5	0.1	-1.7	-0.4
Japan	-2.6	0.6	-2.4	-0.5
UK	-2.8	0.2	-1.5	-0.9
China	6.7	8.0	-1.8	-1.5

Source: www.imf.org

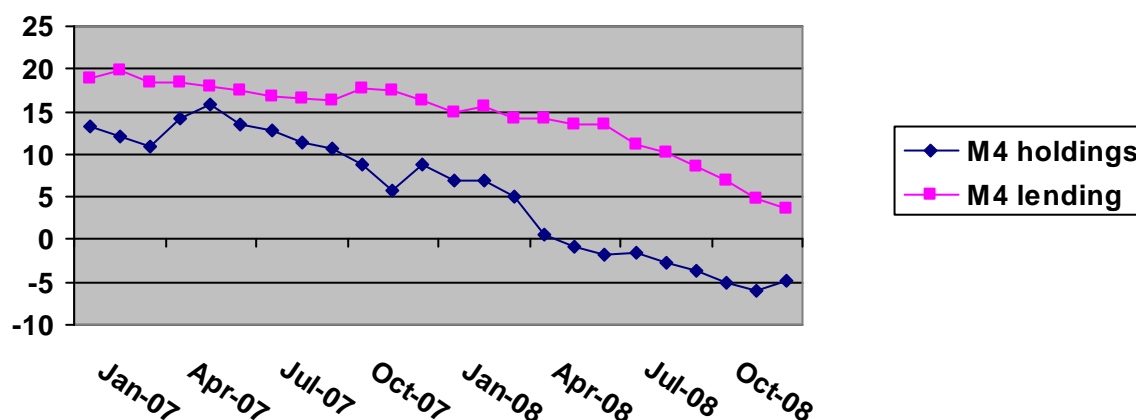
But we can be sure about one thing. All the western economies are set to have a torrid 2009. Confidence in both the US and Japan took a tumble last week as the US unveiled a GDP fall of 3.8% (annualised) for the fourth quarter of 2008, indicating a deepening recession, whilst industrial production in Japan plunged by nearly 10 percent in the month of December, a record drop. Japanese exports, as are Germany's, are being ravaged by the global recession. And here in the UK recessionary forces are increasing their grip.

Lending to the non-bank economy still weakening

As we have discussed in earlier Perspectives, the key to stabilizing the British economy is the financial sector and the recovery of credit availability to the non-bank real economy. The first priority is to fix the banking system, so that it can resume its normal lending function.¹ But the latest Bank of England data show that lending is still weakening. The growth in loans to non-financial companies and households slowed to 0.5% in 2008Q4 (QOQ), the slowest since the first quarter of 1993. Of course, the Bank's figures do not distinguish between demand and supply factors, and it is likely both factors are at work.

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 December 2008 the rate had fallen below 5%.

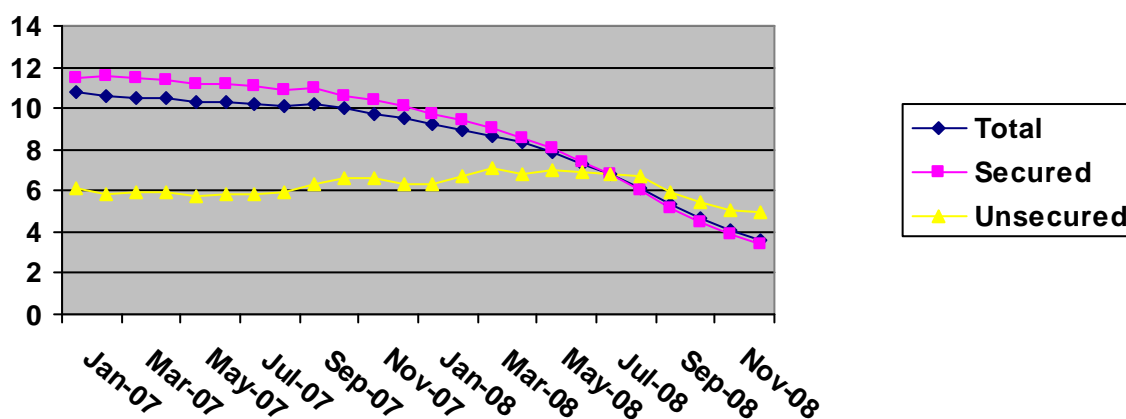
Chart 1: Private non-financial corporations (PNFCs): M4 holdings of and M4 lending to, 12-month growth rates (%): January 2007 to December 2008



Source: Bank of England, *Sectoral breakdown of aggregate M4 and M4 lending: December 2008*, 30 January 2009.

Chart 2 shows the equally dramatic deceleration in lending to individuals. Annual growth rates in secured lending of around 12% were recorded during the first half of 2007 but by December 2008 this had fallen to 3½%. The growth in unsecured lending, having picked up in the first half of 2008 as consumers sought to maintain their spending levels, is also now falling and showed an annual growth rate of just 5% in December. Households are tightening their belts.

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



Source: Bank of England, *Lending to individuals: December 2008*, 30 January 2009.

The latest bank package

The bare facts of the bank package announced on 19 January are listed in the annex to this Perspective. The package covered some valuable developments including the Asset Protection Scheme, an insurance alternative to a “Bad Bank” for toxic debt, encouraging state-backed banks to increase lending and the Asset Purchase Facility (APF).

The APF provides the Bank of England with new powers to lend up to £50bn directly to businesses by buying high quality corporate assets. The APF is the first scheme to allow the Bank to provide liquidity support for non-financial companies. It became operational on 2 February and under the APF the Bank purchases the corporate assets with Treasury Bills. These Bills are, in turn, funded by private sector investors. Under these circumstances, the money supply does not increase and, in itself, the APF does not facilitate “Quantitative Easing” (QE, i.e. creating money).

But the APF provides a framework for QE, as a monetary policy instrument, should that be considered necessary by the Monetary Policy Committee. The key difference between QE and the APF is that in QE the money used to buy the commercial assets would be created by the Bank at the stroke of a computer key, rather than by the government by selling Treasury Bills.

The package received a mixed reception but it should help the necessary de-leveraging of the financial system whilst reducing the impact on the non-financial parts of the economy. (It was in the financial system that the really dramatic increase in debt burdens took place in recent years though there was a build up of debt in the non-bank sectors.) In principle this de-leveraging of the financial system could be achieved by simply netting out the transactions among the financial sector, with very little impact among the non-financial parts of the economy, but in practice this has clearly not been the case so far. It is now vital that the continuing de-leveraging of the financial system should be undertaken with as little damage to the non-bank economy as possible.

As Lord Adair Turner said in a recent speech, which is one of the most insightful so far on the development of the credit crunch: ²

“The huge growth of intra-financial system leverage has a relevance to the urgent issue of short-term macro economic management. The more that we can ensure that bank de-leveraging takes the form of stripping out of inter-trader complexity, and the less it takes the form of leveraging (sic) vis-à-vis the non-bank real economy, the better.”

This week’s MPC meeting: what should it do?

It is widely expected that the Monetary Policy Committee will cut Bank Rate again this week – from 1.5% to 1%. But there seems to be increasingly little point in cutting official rates. Banks and Building Societies are increasingly reluctant to pass all the reduction in official rates on to their borrowers. Indeed it can be argued that further cuts could be of no benefit to borrowers, and could even do them harm, by reducing the flow of savings that lenders rely on. Further reductions in Bank Rate can only have a limited further stimulatory effect in activity.

Under these circumstances Quantitative Easing, the direct expansion of the money supply, looks to be an increasingly attractive option. In a recent speech Bank Governor Mervyn King said: ³

“The disruption to the banking system has impaired the effectiveness of our conventional interest rate instrument. ...the MPC (should) prepare for the possibility that it may need to move beyond the conventional instrument of the Bank Rate and consider a range of unconventional measures. They would take the form of purchases by the Bank of England of a range of financial assets in order to expand the amount of reserves held by commercial banks and to increase the availability of credit to companies. That should encourage the banking system to expand the supply of broad money by lending to the private sector and also help companies to raise finances from capital markets.”

Mr. King then outlined two approaches to such “unconventional measures”:

- The “conventional” approach by buying assets, such as government securities or gilts, to boost the supply of money. It should be noted that 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. When there is “under-funding”, the Bank of England effectively funds some borrowing at the stroke of a computer key. The issue of under-funding is one for the Treasury.
- The “unconventional” approach. When certain credit markets are dysfunctional targeted purchases by the Bank of England of certain assets may improve liquidity in the markets for those credit instruments. As discussed above, the Asset Purchase Facility authorizes the Bank to buy corporate assets, financed by the issue of Treasury Bills. But the MPC has the option of converting the APF into an instrument of monetary policy by recommending that the money used to buy the commercial assets would be created by the Bank at the stroke of a computer key, rather than by the government by selling Treasury Bills.

Even though it is unlikely Quantitative Easing, in either of its forms, is imminent, the chances that it will be implemented are clearly rising. This seems sensible. But Quantitative Easing must come with an inflationary health warning. Any measures implemented to increase monetary growth directly would have to be rapidly unwound, once they had done their work by returning monetary growth to levels consistent with avoiding serious economic difficulties. Otherwise there is the danger of raising inflation expectations and triggering inflationary forces. The dangers are especially acute if the government starts creating money to finance its huge government debt. QE should be used to prevent inflation falling below the Bank’s target (for more than a temporary period) rather than in attempting to reflate the economy, with its dangerous inflationary implications.⁴

References

1. Ruth Lea, “The recession deepens: time for further measures”, Arbuthnot Banking Group Perspective, 15 December 2008, originally discussed these issues.
2. Lord Adair Turner, “The financial crisis and the future of financial regulation”, the Economist’s inaugural City lecture, 21 January 2009, www.fsa.gov.uk.
3. Speech by Mervyn King to the CBI, 20 January 2009, www.bankofengland.co.uk
4. Lombard Street Research, Shadow Monetary Policy Committee, “Keep Bank Rate at 1½% in February, but adopt Quantitative Easing”, 2 February 2009, www.iea.org.uk.

Annex: Emergency measures so far

Scheme, value, date announced	Basics of scheme, commentary
Special Liquidity Scheme (SLS) – up to £200bn (8 October 2008).	Designed to provide short-term liquidity; allows banks to swap illiquid assets for highly liquid gilts. Bankers say it has helped. The window closed on 30 January 2009.
Discount Window Facility (DWF) (October 2008).	On 2 February 2009, the Bank will permit drawings from the DWF with a term of 364 days, in addition to the standards option to draw for 30 days.
Credit Guarantee Scheme (CGS) – up to £250bn (8 October 2008).	Allows banks to issue bond finance backed by government. Was judged as pricy, although fee was trimmed was last month. Welcomed by banks, which issued £100bn of debt in 2008.
Bank Recapitalisation Plan - £37bn (8 October 2008).	Offer to underwrite £37bn recapitalisation of RBS, Lloyds TSB and HBOS. Ministers argue it saved banking system from collapse, but less effective in reviving lending.
Homeowner Mortgage Support Scheme – up to £1bn (3 December 2008).	Homeowners could have mortgage interest payments guaranteed for 2 years. The details are still being settled.
Working Capital Scheme for SMEs - £10bn (13 January 2009).	Guarantee for 50% of up to £20bn of short-term working capital loans, from 1 March 2009. It is unclear if it will push banks into new lending.
Enterprise Finance Guarantee - £1bn (13 January 2009).	Guarantee for 75% of loans to small businesses, until March 2010. Whether it works will depend on the banks, which still carry quarter of the risk.
Capital For Enterprise Fund - £50m (13 January 2009).	State is contributing £50m, the banks £25m to long-term finance fund for smaller companies. It is probably too small to make a real short-term difference, but could be expanded.
Asset protection scheme (APS) – about £200bn? (19 January 2009), insurance scheme.	The government will insure risky debt held by banks, which will be liable for an initial loss of about 10%. In other words, the banks will pay the government a flat fee (similar to an excess) and then the state will cover about 90% of the losses when there is a default.
Asset Purchase Facility (APF) - £50bn (19 January 2009).	New powers for the Bank to lend up to £50bn directly to businesses by buying high quality private sector assets. The APF provides a framework for “Quantitative Easing”. The MPC has the option to move to QE, by extending the scheme and paying for the assets by new money and not with Treasury Bills. The scheme came into effect on 2 February.
Guarantee scheme for asset backed securities (19 January 2009).	Guarantee scheme for asset-backed securities including mortgages, and corporate & consumer debt. The Crosby review (“Mortgage finance: final report and recommendations”, Nov. 2008, HM Treasury) said the government should underwrite £100bn of “mortgage-backed securities”. A step towards reviving the loans market. Will only work if fees are not too punitive. In itself will not force banks to lend more.
FSA capital rules clarified (19 January 2009).	FSA clarified capital rules for state-backed banks, stating minimum core tier-1 capital was 4%. The FSA had said at the time of the October bail-out they needed additional capital of 4% in the event of expected future losses.
State-backed and nationalised banks to lend more - £30bn (19 January 2009).	Northern Rock to stop actively encouraging its customers quit the bank when current mortgage deals expire. RBS to swap preference shares (at 12%) for ordinary shares (£5bn).
Car firms’ guarantee package - £2.3bn (27 January 2009).	The government will guarantee up to £1.3bn of auto industry loans from the European Investment Bank and guarantee a further £1bn of loans to back investments that are not eligible for support from the EIB.

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