



Perspectives by Ruth Lea

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The economic background to the Budget: weaker growth, higher inflation

Introduction

The Monetary Policy Committee's next interest rate announcement will be on Thursday, 10 March 2011. It seems most unlikely that the Bank would move rates 2 weeks ahead of the Budget (23 March). But more to the point there is little evidence from the February MPC minutes that a majority of the members are ready to vote for a rise at this stage – even though attitudes are hardening and three of the 9-strong committee voted for a rise in February.¹ The Governor himself takes the view that an early move would be a “self-defeating gesture.”² His stance are in sharp contrast to ECB President Trichet's recent comments that suggest a rate rise in April - probably from 1% to 1.25%.³

Weaker growth and higher inflation

Over the last 3 months the economic outlook has worsened, as the Bank acknowledged in the February *Inflation Report*. Their GDP growth projection was revised downwards and their CPI inflation projection was revised upwards.⁴ When the OBR revises its forecasts for the upcoming Budget, a similar pattern of revisions can be expected.

There were expectations that the ONS, in its first revision of 2010Q4 GDP, would revise the preliminary estimate in a favourable direction. But the opposite happened and Government statisticians now estimate that GDP fell by 0.6% in the quarter.⁵ Within the components, household consumption and fixed capital formation both slipped back – both affected by the bad weather. But it is of note that growth for household consumption was less than 1% in 2010 as a whole, as consumers' real incomes were squeezed by prices inflation outstripping earnings growth and higher taxes. Government consumption was the most buoyant component in the final quarter, but this is set to reverse as fiscal retrenchment begins to squeeze the public sector this year. Net exports continued to disappoint in the quarter (and indeed for the year 2010). Exports growth was commendable, but was outstripped by imports growth. On present form, it is hard to see quite how this component of demand will deliver the contribution to GDP growth over the next few years that the OBR expected in its November forecast.⁶

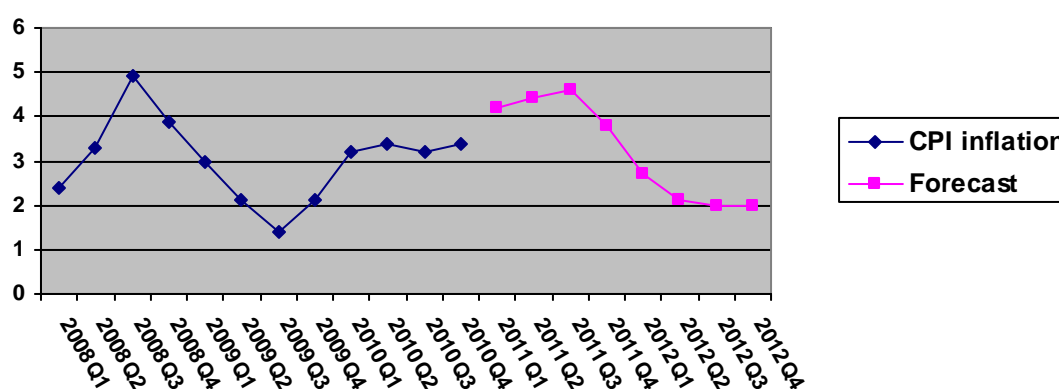
Indicators so far available suggest that there was some bounce-back in activity in January and February. But how much this is “noise” and how much an improvement in underlying activity is impossible to say at the present. Retail sales were 1.9% higher in the month after December's fall and the latest Markit PMI surveys indicated continuing growth, especially in manufacturing and construction, but there was a disappointing slowdown in the services sector.⁷ There are other less positive signs. Unemployment is rising (it was some 44,000 higher in 2010Q4 than in Q3) and consumer confidence indices are depressed (both Nationwide's and GfK NOP's). The housing market is “treading water” according to Nationwide, whilst the Halifax house price index fell by 0.9% in February. Bank lending to

both individuals and businesses remains weak as the after-effects of the financial crisis continue to drag on growth.

Inflation has also deteriorated, reflecting rising global commodity prices and the effects of increases in indirect taxes, factors outside the Bank's direct control. CPI inflation was 4% in January and the Bank's February forecasts suggest that it could rise towards 5% in forthcoming months.⁸ The worry is, of course, whether higher prices inflation lifts wage settlements, triggering a "wage-price" spiral. Earnings growth has remained subdued, but recent surveys suggest that pay settlements are now picking up. Income Data Services (IDS) reported recently that median private sector pay settlements were 2.8% in the 3 months to January, compared with 2.2% in 2010Q4. IDS estimated that the median was set to edge up to 3%. Even though we do not expect a significant "wage-price spiral" to materialise in the foreseeable future, given the current economic uncertainties and rising unemployment, the Bank cannot ignore rising pay settlements.⁹

The Bank is caught in the dilemma of rising inflation and concerns over lost anti-inflationary credibility if no action is taken, and signs of a weakening economy, which would be exacerbated by higher interest rates. The Governor has clearly taken the view, rightly in our opinion, that the preferred course of action is to ride out the current pick-up in CPI inflation, trust that it will fall back to the 2% target next year and continue with the ultra-accommodative monetary policy.¹⁰ As chart 1 shows, the expectation is that CPI inflation will continue to rise into the middle of this year, driven by the effects of higher commodity prices and higher indirect taxes, before subsiding in the second half of the year, as these factors fall out of the annual calculation.

Chart 1 Quarterly data for CPI annual inflation rate (%)



Source: ONS database, Arbuthnot forecasts from 2011Q1

Oil prices and higher inflation

The big "if" in this scenario is, of course, the future path of commodity prices. This is especially true about oil prices where the current turmoil in North Africa and the Middle East¹¹ has pushed up crude prices by about 25% since the middle of December. The main concern in the oil markets currently focuses on the conflict in Libya.

The impact of higher oil prices on Britain's inflation rates will crucially depend on how the Libyan conflict is resolved and/or whether it spreads to other oil-producing states. If the conflict is confined to Libya, even if relatively protracted, global oil consumption should be met and oil price rises contained. The International Energy Agency has 1.6bn barrels of reserves if needed.¹² And OPEC's spare capacity stood at about 4.7m b/d. until the oil market was hit by the current crisis.¹³ Saudi Arabia, OPEC's main "swing producer", has spare capacity of over 3m b/d, as shown in the table below. If, however, there is contagion from Libya to other oil producers, the impact on Britain can only be speculated about at this stage. If the unrest spreads to Saudi Arabia, the situation would clearly be very serious indeed.

Current crude oil production, spare capacity, millions barrels per day (b/d)

	Current production	crude	Spare capacity
Saudi Arabia	>9		<3.1
Iran	3.66		
Iraq	2.66		
UAE	2.37		0.33
Kuwait	2.32		0.23
Nigeria	2.24		
Algeria	1.27		
Oman	0.89		
Qatar	0.82		0.18
Egypt	0.74		
Libya+	0.60, 1.6 (January)		
Syria	0.37		
Yemen	0.26		
Footnote: global daily consumption	87		

Source: "Investors grapple with new crude shock", *FT*, 5 March 2011.

Bank lending: constrained by demand factors not just supply

As we have already noted, bank lending remains remarkably weak. Bank lending to both individuals, for both secured and unsecured credit, and to businesses collapsed in 2008 and has barely shown any recovery since. The quarterly data since 2007Q1 are shown in charts 2a and 2b.

Chart 2a: M4 lending to households and PNFCs, 2007Q1 to 2010Q4, seasonally adjusted data, £bn

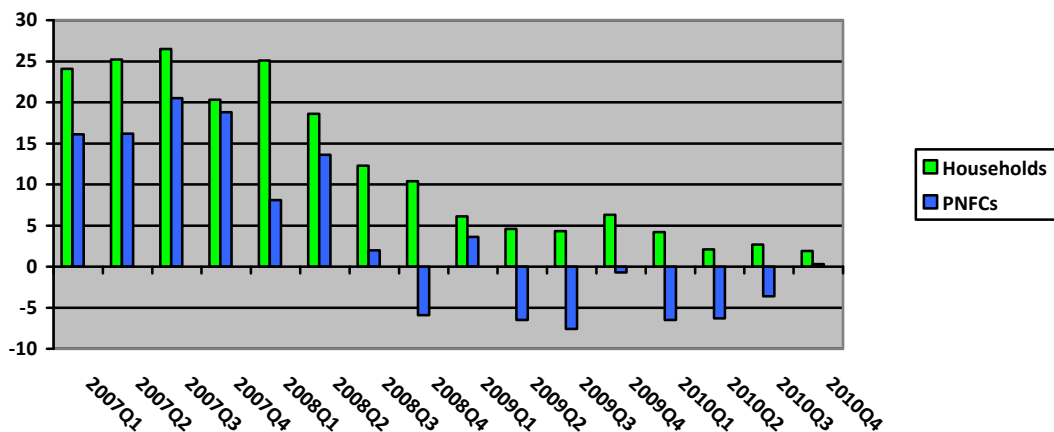
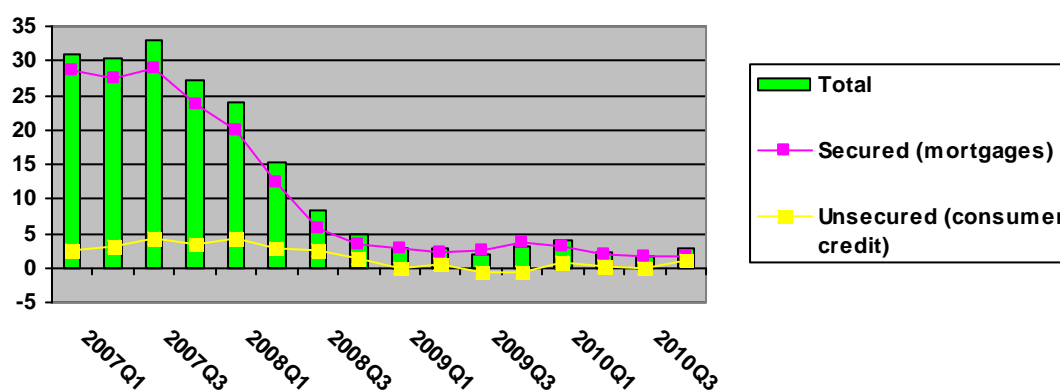


Chart 2b: Net lending to households (individuals), 2007Q1 to 2010Q4, seasonally adjusted data, £bn



Sources: Bank of England's database, on www.bankofengland.co.uk and press releases (i) "Sectoral breakdown of M4 and M4 lending, January 2011", 1 March 2011, (ii) "Lending to Individuals January 2011", 1 March 2011. The data exclude the effects of securitisations. PNFCs=private non-financial corporations

But, as the Bank noted in its latest *Trends in Lending*, the amount of lending and its price depend on the interaction of demand and supply factors.¹⁴ There are of course supply factors at work, banks are being asked to tighten their capital and liquidity requirements for example, but all too frequently the demand factors are ignored in the debate over lending.¹⁵ Disentangling the separate influences of changes in the supply of, and demand for, credit is notoriously difficult.

The results of the Bank's *Credit Conditions Surveys*, allied with their analysis of capital markets and information from their Agents, can however shed some light. Charts 3a and 3b show the changing fortunes of the lenders' assessments of the supply of, and the demand for, credit over the past three years.^{16,17} The telling feature of these two charts is that, even though supply has partly and steadily recovered since the collapse in 2008, any improvements in demand have been extraordinarily patchy.

Chart 3a: Availability (supply) of credit, net % balances, since 2008Q1

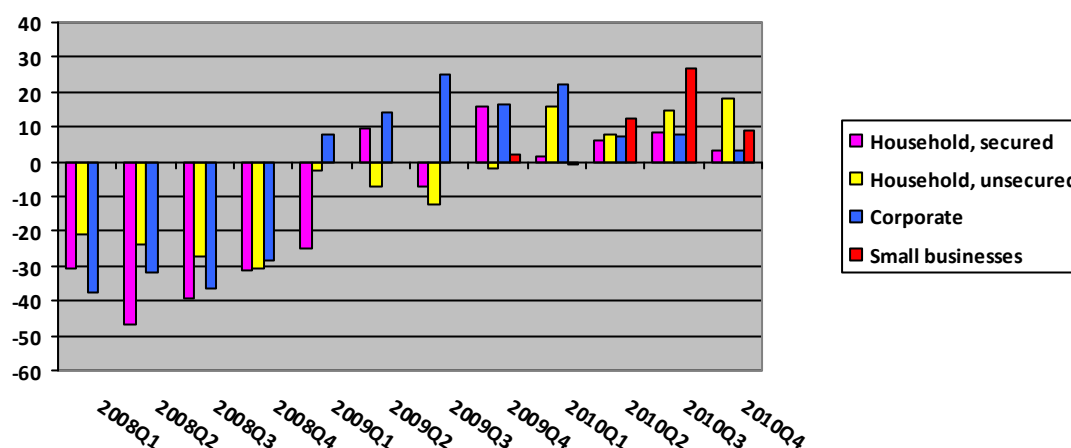
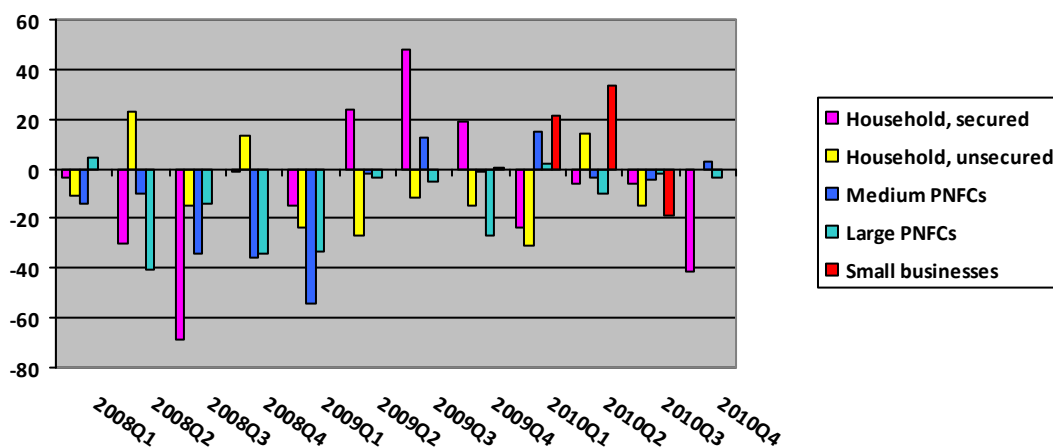


Chart 3b: Demand for credit, net % balances, since 2008Q1



Source: Bank of England, *Credit Conditions Survey, 2010Q4*, January 2010.

Concerning 2010Q4 the Bank concluded that both supply of and demand for credit were little changed. The main exception was the demand for secured lending for house purchase, which had fallen as the housing market weakened. In addition, it is worth noting that contacts of the Bank’s Agents had noted that credit conditions for smaller businesses remained tighter than for large corporates, though there were a few reports of a recent improvement in their access to credit. The Bank made two further observations relating to the very weak lending to businesses. Firstly, the Bank’s Agents reported that many small firms continued to be focused on repaying bank debt, rather than taking on extra debt. And, secondly, corporate gross lending had been lower than repayments. Large corporates had tended use the proceeds from capital market issuance to repay their bank debt.

No-one is doubting that bank lending is weak but it is clear from the Bank’s survey material that demand factors are at least as significant as supply factors, if not more so, in explaining the weakness.

Finally, there are two other factors which will bear down on net lending in the near-term. The first concerns bad debts. As chart 4a shows, banks wrote off £2.5bn in corporate bad debts in 2010Q4 – the biggest single write-off since the Bank began to keep records in 1993. Moreover, write-offs to individuals have tended to run higher than for corporates. The economic uncertainties ahead and the need for banks to minimise risk can only act as brakes on bank lending. Banks will remain cautious. The second concerns negative housing equity withdrawal (HEW), chart 4b, which depresses the net lending data for secured loans to individuals. Given the uncertainties ahead and continuing low interest rates (probably), HEW will probably continue for some quarters yet.

Chart 4a: Banks’ write-offs to individuals and the corporate sector, £bn, 2007Q1 to 2010Q4

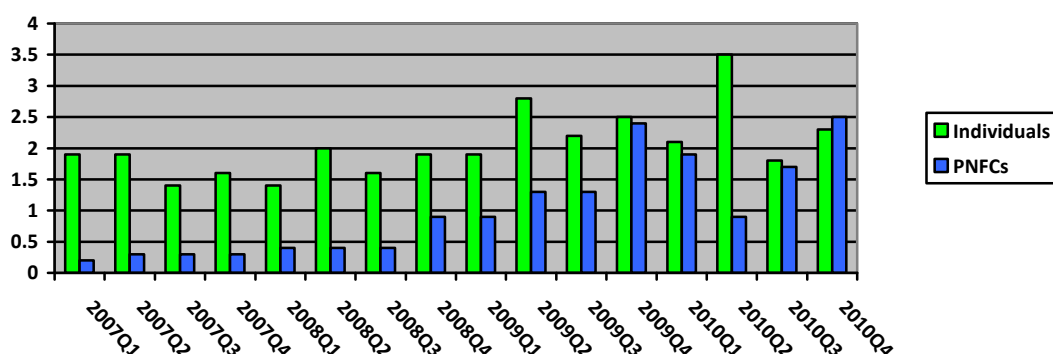
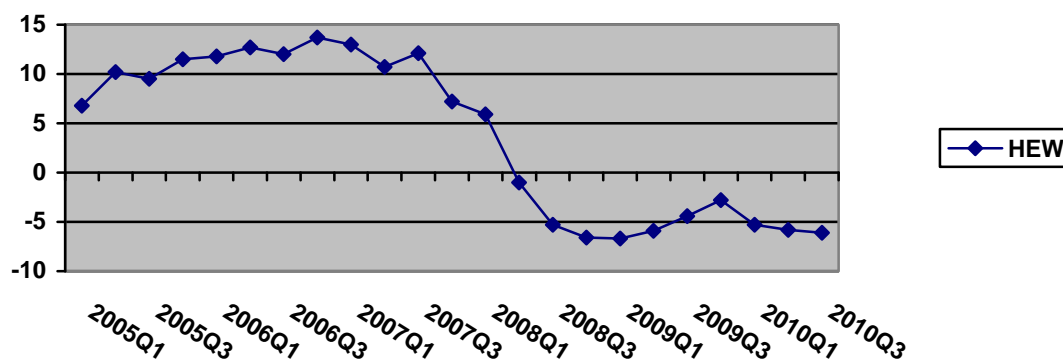


Chart 4b: Housing equity withdrawal (HEW), £bn, seasonally adjusted



Sources: Bank of England database and the press release "Housing Equity Withdrawal", 2010Q3, 29 December 2010.

Project Merlin

Of course the economy would grow faster if bank lending were higher, easier to obtain and cheaper, but as we showed above, lack of demand is a major factor behind the anaemic bank lending data. The Government has however endeavoured to encourage the banks to lend more through Project Merlin, agreed between the Government and the 4 big banks (HSBC, Barclays, RBS and Lloyds Banking Group), in February.^{18,19}

The deal included:

- The 4 big banks (and Santander) agreed to make £190bn of credit available to businesses in 2011, up from the £179bn they lent in 2010, if there was sufficient demand. Clearly the target may not be met if the demand is not there. Note also that the £190bn target related to gross lending (not net lending as in the Bank's statistics) and included loan facilities that may not be drawn on (whereas the Bank's data only include loans that are actually extended). Of this lending commitment, £76bn will be made available to smaller businesses. This was an increase of £10bn (or 15%) compared with 2010.
- In addition, the banks will also provide £200m to the Prime Minister's Big Society Bank, to finance community projects. And they will also provide an extra £1bn of equity capital over 3 years to the Business Growth Fund, which aims to help small business in hard-pressed parts of the UK.

In conclusion: interest rates

The Bank is caught between Scylla and Charybdis, caught between a weak real economy and above-target inflation. Our central view is that the Bank should start ticking-up interest rates fairly soon, not least of all to "normalise" them from the emergency 0.5% level agreed in March 2009. If the first quarter GDP figure (due end-April) suggests that growth has resumed then May looks an appropriate time to increase the Bank Rate to 0.75%. Our overall forecast for the Bank Rate remains:

- 2011Q2: increase from 0.5% to 0.75%.
- 2011Q4: increase from 0.75% to 1.0%.
- 2012Q2: increase from 1.0% to 1.5%.
- 2012Q4: increase from 1.5% to 2.0%.

References

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6. OBR, *Economic and fiscal outlook*, Cm7979, November 2010.
7. Economy watch, *Daily Mail*, 5 March 2011, reported that Markit had said that their surveys pointed towards a 0.5% increase in GDP in 2011Q1.
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16. Bank of England, *Credit Conditions Survey, 2010Q4*, January 2010.
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