

Monthly economic commentary

March 2009

Going for the nuclear option

The official UK interest rate has been cut again (to an all-time low of 0.5%), further steps have been taken to bolster the flagging banking system and sterling remains weak. Yet for all the actions taken by the authorities to counter the recession, unemployment continues to rise, the housing market is still sinking and businesses are failing in increasing numbers. Confidence levels in the personal and corporate sectors continue to slide.

In many ways, the bad news is to be expected and the fact that the policy stimuli have yet to take effect is no surprise. The lead times for initiatives such as interest rate reductions or fiscal easing to kick in is usually measured in months rather than weeks and to have expected a response so soon is unreasonable. But there is a feeling that this recession is different and still more needs to be done. So the MPC has announced that the nuclear option of ‘quantitative easing’ (QE) will be tried in the UK for the first time.

If this recession is different from the mid 1970s, the late 1970s and the early 1990s, it is because of the banking system. The credit crunch might not have caused the economic downturn but it will certainly have a major impact on the pace and strength of any recovery. While the usual fiscal and monetary weapons have been used to tackle the economic slowdown, extra measures are needed to address the problems in the banking system and the flow of credit to households and businesses.

It is for this reason the Bank of England has been given the go-ahead by the Chancellor to create £150 billion with a flash of its electronic pen. Initially, the Bank will use £75 billion of this over the next three months to buy financial assets – mainly in the form of medium-term and long-term gilts and corporate bonds – from banks and other financial institutions. The other half will be kept in reserve in case the first strike is ineffective. As the crisis has developed, we have been inundated with large monetary statistics – billions here, trillions there – to the extent that we are now becoming inured to them. A useful benchmark to bear in mind is that £150 billion is equal to about a tenth of what the UK economy produces in any given year. It is, therefore, a considerable boost.

What does the Bank want to achieve? Well, for one thing, buying these assets should push their price up and, therefore, their yield down. And if it does, that will ease conditions in credit markets. Not only will it be cheaper for the Government and, more importantly, companies to issue further debt, it should also be easier given the squeeze on the supply of existing assets. And if corporate yields can be reduced relative to gilt yields, that would provide an extra benefit. Yet, whether companies are convinced that this is a route they wish to take, of course, is less clear and is one of the big unknowns in deciding whether QE will be successful.

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More importantly, perhaps, the Bank hopes that the scheme will increase the flow of bank lending to companies and households. If the Bank of England buys directly from a commercial bank, for instance, that bank will see its reserves at the central bank expand. Given that the rate of return on this extra cash will be extremely low, the hope is that the bank would then use the funds to increase its lending. Any loans would then be spent and deposited elsewhere in the banking system, so providing the basis for another round of lending – in economic jargon, the so-called ‘money multiplier’. If the Bank buys from a non-bank financial institution such as an insurance company, that institution may buy a further asset or leave the money on deposit with a bank but it does provide the basis for the money multiplier to work its magic.

It is clear, however, that there are two major risks to all this. The first is that it simply doesn’t work because the recipients of the cash, in each instance, hang on to it rather than risk lending it on. A small reward in terms of interest received might be deemed preferable to lending it out and not getting it back. The second is that it works far too well, bank lending grows too quickly and far from moving into a deflationary world, inflation takes off again.

The trick, therefore, for the Bank of England is to keep the process going until it does work – there is no limit to the amount of money it can create – but also to know when to stop and, more importantly, when to reverse the process. Knowing when to sell back the assets it has required will require the Wisdom of Solomon. Over the past decade, the Bank of England has by and large been successful in weighing all the evidence when setting interest rates. The coming months will see that ability stretched to the limit.

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