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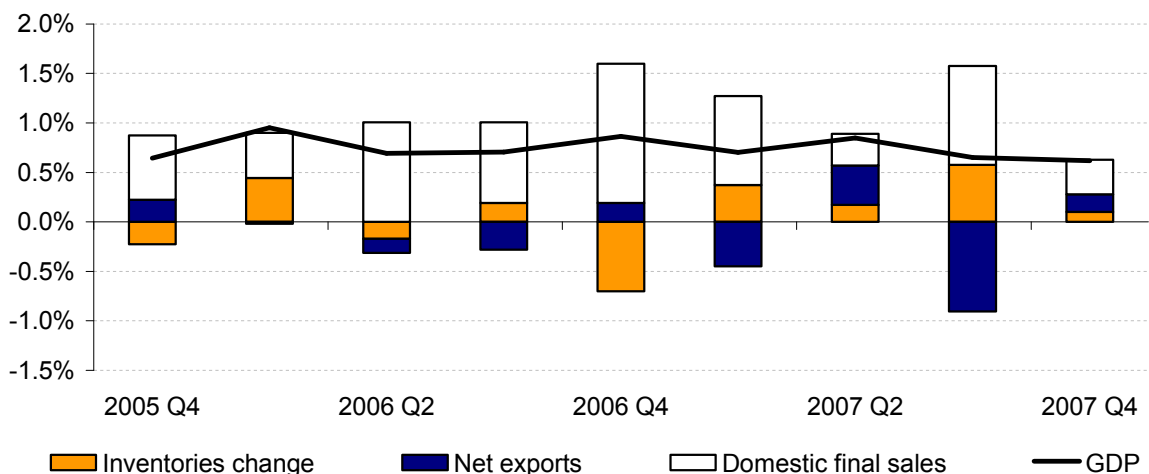
BoE has no control over credit crunch

WE SUGGEST: Bank Rate to stay unchanged in April

SUMMARY: The unravelling of securitisation caused a liquidity crunch, which has turned into a credit crunch. The BoE can ultimately provide as much liquidity as is needed, but the banks' constraint is inadequate capital. Aggressive Fed-style rate cuts are neither needed nor would help. If anything they could worsen the Bank's inflation problem in the medium term. We expect rates to bottom out at 4% in H1/09.

Aggressive Fed-style policy easing is a mistake that the Bank of England seems likely to avoid. The UK does not face the US's housing excesses and its domestic imbalances are smaller. Moreover, the needed re-balancing of the UK's open economy could be more easily achieved through weaker sterling. Today saw the final release of the fourth quarter GDP numbers, with output growth staying at 0.6%, i.e. at trend. Hence, the output gap – the difference between actual and potential output – remained positive. The economy continues to overheat and needs to slow. The problem for the BoE is to judge whether the ongoing credit crunch will plunge the UK in a deeper correction than necessary.

Contributions to quarterly UK real GDP growth

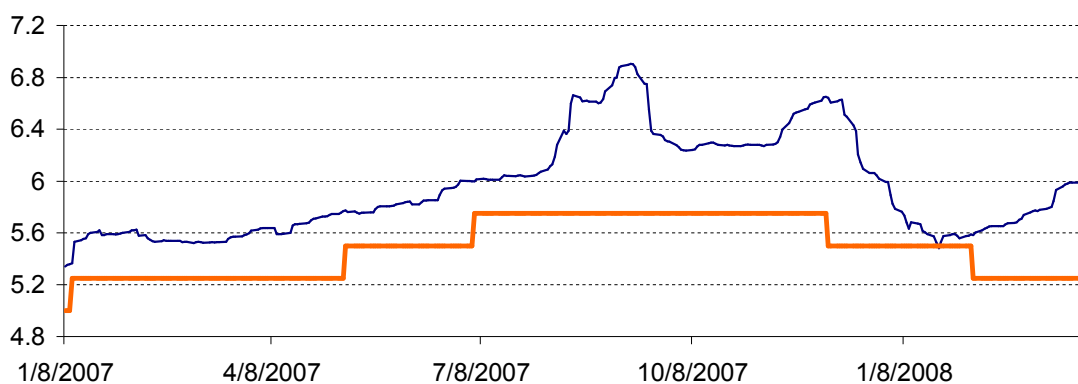


The real economy data so far this year have not been unequivocally bad. Housing-related data continue to worsen, but retail sales and the CBI distributive trades survey showed consumer spending staying fairly resilient in Q1. Importantly, inflation expectations continue to climb. With actual inflation set to accelerate sharply in coming months, the Bank will need to act tough to ensure that it anchors expectations and does not lose its credibility. Mervyn King maintained before the Treasury Select Committee on 26th of

March that the BoE was setting policy rates according to the outlook for inflation and economic activity, while leaving the impression that the problem of the fragile banking system should be addressed by other measures. In essence, he is right. Lower policy rates à la the Fed are unlikely to do much to restore the loss of confidence among the banks.

The global re-pricing of risk caused the unravelling of securitisation which triggered a liquidity crunch in the UK, Euroland and the US. Banks had to return the off-balance sheet ABS and CDO assets back on their balance as the money markets seized up. The Bank of England can ultimately provide all the liquidity that the banking system requires as it has the legal right to create money by the stroke of a pen. However, while the Bank has widened the eligible collateral that the Banks can use to borrow and announced “higher liquidity injections”, banks’ reserves with the BoE have not expanded. The gap between three-month interbank rates and policy rates has widened. Policy rate cuts will not solve the stalemate in the interbank markets.

Bank rate and three-month LIBOR rate, %



Neither will they alleviate the other constraint facing UK banks – capital. Looking at capital adequacy ratios UK banks are well capitalised. But the involuntary expansion of their balance sheets as securitisation unravelled has taken up capital. Moreover, unable anymore to shift the loans of their balance sheet, banks can give credit only to the extent that their capital would allow them. UK banks do not have the same loss potential as their US counterparts, but they will be looking to boost their margins and build up capital. In this context, it is no surprise that yesterday three banks announced they will charge more for loans. And with banks now keeping the risk, their lending standards have tightened. In these circumstances lower policy rates will be a lot less effective in stimulating bank lending. However, in contrast to the US situation, UK banks do not really face any major solvency problems. The credit crunch will ensure the UK economy slows down sharply, but it is unlikely to be so severe that it causes a major downswing.

All in all, expect a slower pace of monetary easing in coming months. A rate cut in May is more likely than in April. A trough of 4% for Bank Rate in the first half of 2009 should be enough to achieve an easy monetary stance, with further sterling weakness factored in.

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