Macro Comment 12/40

Shahin Kamalodin

UK: Opening the monetary spigots, again

The UK monetary authorities have come up with new credit easing and quantitative easing measures to jump-start the ailing economy. We continue to remain unconvinced that these measures will materially alter the economic outlook.

In a desperate attempt to jump-start the ailing UK economy, the Chancellor George Osborne and Bank of England (BoE) Governor Mervyn King announced a two-pronged approach to reducing the price and increasing the quantity of credit to the private sector. First, to improve banks' liquidity, the BoE "*will start holding auctions of sterling liquidity with a maturity of six months*" in tranches of no less than GBP 5bn a month. Second, a 'funding for lending' scheme would provide funding to banks for an extended period of several years, at rates below current market rates. According to Mr. King, this scheme will involve the BoE lending "*against a much greater value of collateral comprising loans to the real economy*". The Treasury indicated that the programme is expected to reach around GBP 80bn in size (±5% of GDP). Details of the plan will be announced within a few weeks.

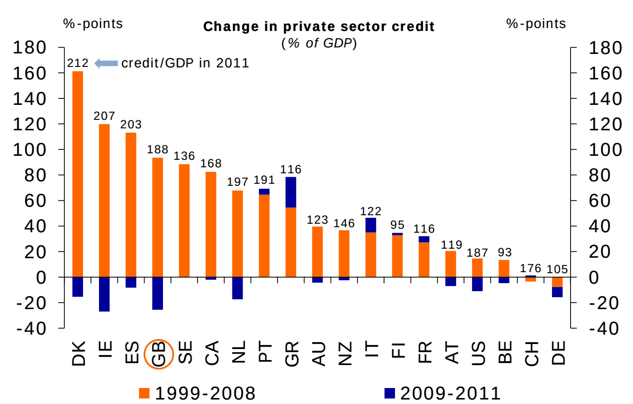
Mind the supply and demand constraints

There are good reasons to be sceptical about the success of the credit easing measures. For one, the deteriorating economic outlook may force banks to not borrow any money from this scheme even with the carrot of cheaper funding. Besides, the slew of bank downgrades carried out by Moody's on 21 June together with mounting financial market stress arising from the euro crisis means long-term funding conditions will remain challenging going forward. As for the demand for credit, there is no guarantee that households and firms will borrow more even if banks are willing to lend. Figure 1 shows that private sector deleveraging process, which began in earnest in 2009, is likely to go on for some time given that UK's credit/GDP is still relatively high when compared to most other advanced countries. Finally, tighter credit conditions is not the only deterrent for private sector borrowing. Households and firms may simply postpone borrowing decisions until economic visibility improves.

QE1+QE2+QE3 = recovery?

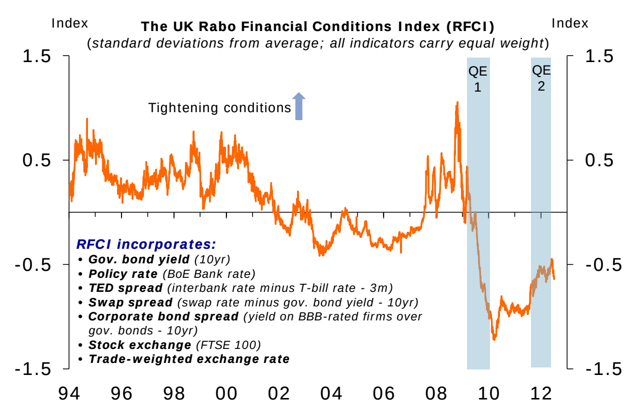
Given the limitations of the credit easing measures, the worsening economic backdrop and tensions in the financial markets, the BoE has announced another GBP 50bn tranche of quantitative easing (QE) at the July policy meeting, in line with our expectations. The market have well anticipated the move

Figure 1: Who wants more credit?



Source: IMF, Rabobank

Figure 2: Will QE3 be as "successful" as QE2?



Source: Reuters EcoWin, Rabobank

following the recent statement of the Governor that "*further monetary easing and attempts to lower bank funding costs are not alternatives. We can do both.*" Of course, the question once again is whether QE3 will work? The failure of its predecessor (QE2) to loosen financial conditions (see figure 2) and thereby buoy growth gives us cause for caution. Naturally, some of this can be blamed on the market turmoil amid escalation of the euro crisis. What's more, the 'shock and awe' factor that resulted in the success of QE1 was absent in QE2. All in all, if the failure of QE2 is anything to go by, one cannot expect QE3 to be significantly more successful in giving the economy a much-needed shot in the arm. That said, we can never know how bad things may get if the BoE sits on the side-lines and does nothing.

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Rabobank

Rabobank Economic Research Department

		Tel.	E-mail:
Chief economist	+31 30 21		
Wim Boonstra		66617	W.W.Boonstra@rn.rabobank.nl
International Economic Research			
Allard Bruinshoofd*		63272	W.A.Bruinshoofd@rn.rabobank.nl
Macro			
Shahin Kamalodin		31106	S.A.Kamalodin@rn.rabobank.nl
Tim Legierse		62677	T.Legierse@rn.rabobank.nl
Michiel Verduijn		30522	M.P.Verduijn@rn.rabobank.nl
Country Risk			
Erwin Blaauw		62648	E.R.Blaauw@rn.rabobank.nl
Fabian Briegel		64053	F.Briegel@rn.rabobank.nl
Jeroen van IJzerloo*		62406	J.IJzerloo@rn.rabobank.nl
Herwin Loman		31105	H.Loman@rn.rabobank.nl
Reintje Maasdam		31403	R.Maasdam@rn.rabobank.nl
Ashwin Matabadal		61601	A.R.K.Matabadal@rn.rabobank.nl
Reinier Meijer		31568	R.Meijer@rn.rabobank.nl
Anouk Ruhaak		64860	A.N.Ruhaak@rn.rabobank.nl
National Economic Research			
Hans Stegeman*		31407	H.W.Stegeman@rn.rabobank.nl
Macro			
Ruth van de Belt		60143	R.Belt@rn.rabobank.nl
Maarten van der Molen		64490	M.T.Molen@rn.rabobank.nl
Danijela Piljic		31104	D.Piljic@rn.rabobank.nl
Anke Struijs		31408	A.C.A.Struijs@rn.rabobank.nl
Theo Smid		67599	T.H.Smid@rn.rabobank.nl
Paul de Vries		30172	Vries.P@rn.rabobank.nl
Regional			
Rogier Aalders		31393	R.Aalders@rn.rabobank.nl
Cynthia Briesen		31411	C.C.Briesen@rn.rabobank.nl
Frits Oevering		64439	F.J.Oevering@rn.rabobank.nl
Anouk Smeltink-Mensen		66404	A.H.H.M.Smeltink@rn.rabobank.nl
Willem van der Velden*		62478	W.Velden@rn.rabobank.nl
Financial Sector Research			
Yvette Jörissen		64931	Y.M.Jorissen@rn.rabobank.nl
Dick Scherjon		31405	D.P.Scherjon@rn.rabobank.nl
August Sjauw-Koen-Fa		31406	A.R.Sjauw@rn.rabobank.nl
Nicole Smolders		79108	N.M.P.Smolders@rn.rabobank.nl
Leontine Treur		67084	L.Treur@rn.rabobank.nl
Bouke de Vries*		61195	Y.B.Vries@rn.rabobank.nl

**Head*