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Economic Bulletin

APOCALYPSE SOON?

The Danger of Further Loosening Monetary Policy

- Plans to relax the UK's deficit reduction programme open up the risk of monetary policy being used to deal with UK debt by inflation.
- The UK has already been through unprecedentedly loose monetary policy with record low interest rates for 83 consecutive months and a £375bn QE programme.
- Risks of persistent loose monetary policy are clear. Asset price inflation, increasing consumer debt, rising inflation and sustaining zombie firms are major risks.
- Government borrowing costs have fallen since Brexit, but counter-intuitively costs to insure against government defaults have increased. Additional risk of investor flight if holders of 0.38 per cent yielding debt may soon face a 2.5 to 3 per cent inflation environment (as currently forecasted).
- Abandonment of deficit targets, political instability and inappropriate monetary policy response could lead to potential recession risk.

1. THE UK'S SOFTENING FISCAL CONSOLIDATION PROGRAMME

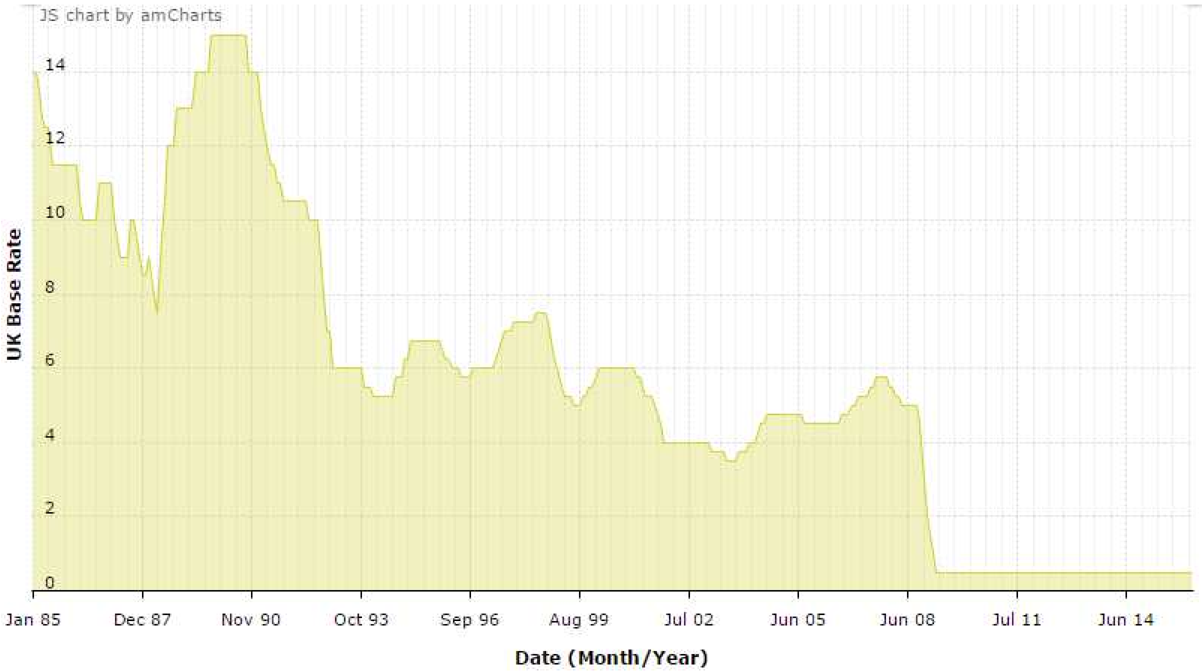
According to the Budget 2016, public sector net borrowing in the UK is around 3.8% of GDP in 2015-16, which is down from a peak of 10.3% in 2009-10. Although this shows steady progress in reducing the UK Government's borrowing, the Chancellor of the Exchequer has failed to meet his budget deficit targets.

In 2010, George Osborne pledged to eliminate the budget deficit by the end of the 2010 – 2015 parliamentary term. After failing this, he pledged to achieve a budget surplus by the financial year 2019-20. He has, however, abandoned this target, citing the uncertainty created by the EU referendum. Indeed, the threat of lower growth, or even the Treasury threatened post-Brexit recession, may hamper the Government's deficit reduction plan.

The UK's softening fiscal stance opens up the very real risk of a further loosening of monetary policy, whereby inflation is used as a way of dealing with the Government's debts.

2. UK'S LOOSE MONETARY POLICY

Figure 1: Bank of England Base Rates (1985 to 2016)



Source: Property Investment Project *link*

Table 1: Bank of England's Asset Purchase Programme (Quantitative Easing)

November 2009	£200bn
October 2011	£75bn
February 2012	£50bn
July 2012	£50bn
TOTAL	**£375bn**

Source: Bank of England link

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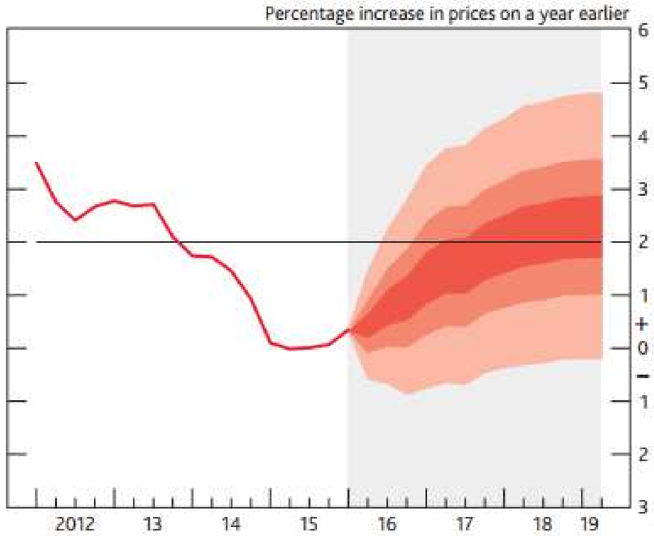
The UK has been through a period of unprecedentedly loose monetary policy. As shown in Figure 1, the UK's base interest rates have remained at a record low of 0.5% for 83 consecutive months. In addition to this, the Bank of England has purchased £375bn of assets by the creation of central banking reserves (known as Quantitative Easing). All £375bn has been used to purchase UK Government gilts.

The risks of persistent loose monetary policy are well established. These include:

- The Quantitative Easing programme leading to asset price inflation: By inflating asset prices, the increase in the value of households' financial wealth has been skewed towards the richest – given that the top 5% of households hold 40% of the assets, according to analysis from the Bank of England.
- Low rates leading to an unsustainable rise in consumer debt: The Office for Budget Responsibility expects the ratio of total debt to income to rise by 26 percentage points from the start of 2015 to start of 2021.
- It can also undermine the process of creative destruction, which is an essential component of a successful capitalist economy. Ultra-low interest rates are partially responsible for the estimated 103,000 UK businesses deemed 'zombie firms' – those that continue to operate in spite of being insolvent or on the brink of bankruptcy. This is leading to diminishing productivity, which is worsening the growth prospects of the UK economy.
- Persistently loose monetary policy leaves little room for the Bank of England to react to potential future shocks.
- The risk of rapidly escalating inflation (see next section).

3. PROSPECT OF RAPIDLY CLIMBING INFLATION

Figure 2: Projected inflation under current policy (May 2016)



Source: Bank of England link. Note: These projections were set out in May 2016 (i.e before the EU referendum).

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Assuming that interest rates and quantitative easing remain at current levels, CPI inflation is projected to pick up over the next year or so. In the Bank of England's central projection, under the path implied by market interest rates, domestic cost pressures are projected to return inflation to the 2% target by 2018. There is therefore a very high likelihood of the Bank of England overshooting its inflation target over the next couple of years. If monetary policy is further loosened, the risk of inflation overshooting the Bank of England's target becomes even more likely. Furthermore, given the sharp rise in the cost of imported goods following Sterling's relative weakness after the Brexit vote, these Bank of England estimates will likely be revised upwards.

4. WELCOME FALL IN GOVERNMENT BORROWING COSTS

In its analysis "the immediate economic impact of leaving the EU", the Treasury warned that 10 year government bond yields would increase by between 40 and 100 basis points. This would, in effect, increase the cost of servicing the government's borrowing costs.

In reality, the reverse has actually happened. Last week, the UK held its first government bond sale since voting to leave the EU, issuing £2.5bn of debt that attracted robust demand from global investors. Bids exceeded the amount on sale by 1.8 times according to Reuters data, enabling the five year bonds to be sold at a record low yield of 0.38 per cent. Ten-year gilts, which started the year trading at interest rates of 1.96 per cent, fell to 0.78 per cent on Tuesday.

5. BUT TRENDS IN SOVEREIGN CREDIT DEFAULT SWAPS ARE A CONCERN

Sovereign credit default swaps function as insurance contracts that allow investors to buy protections against the event that a sovereign defaults on or restructures its debt. Although the reduction in Government bond yields suggests a high degree of confidence in the government, trends in sovereign credit default swaps are a concern. The cost to insure against a British default has jumped to the highest level since the Eurozone crisis of 2012 as investors attempt to protect themselves from further turmoil (see Figure 3). This leads to a concern that government bond yields could rise substantially in the near future at a time when inflation picks up. It would make little sense for investors to continue holding 0.38 per cent yielding debt in a 3 per cent inflation environment, leading to the potential risk of investor flight.

Figure 3: Costs to insure against UK Government

Source: Financial Times link

6. LOOSER MONETARY POLICY ADDED TO THE UNCERTAINTY OF BREXIT COULD:

1. Result in foreign holders of Sterling assets losing confidence in the continuing value of Sterling. This would lead to an increase in Government bond yields thereby increasing the cost of Government borrowing (and the difficulty of "balancing the books").

2. That would feed through to capital losses on gilt holdings as prices drop as required yields rise. Pension funds, which account for around 26% of gilt holdings, would suffer a serious loss in the value of their gilt holdings.

3. While the Bank of England can control base rates, it is less able to control other interest rates. LIBOR, which is a benchmark rate that some banks charge each other for short-term loans, could separate from the base rate, and longer rates would rise considerably as investors demand a proper return for watching inflation and currency weakness.

4. Confidence rarely changes in a slow and orderly way. It may well be that rapid interest rate rises could occur in the near future with serious effects on business and consumer confidence, potentially adversely impacting the UK economy.

7. CONCLUSION

The UK economy faces a number of concerns at the current time. The abandonment of the balanced budget target, the political instability arising from Brexit and the risk of inappropriate monetary policy responses could all prove damaging for the UK economy.

Thankfully, political instability is likely to be significantly reduced after the events of the past few days. It is now critical that other sources of uncertainty are also eliminated, particularly the problems associated with senior figures 'talking down the economy'. Furthermore, the Bank of England should avoid reducing interest rates or increasing the asset purchase programme.

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