Bank of England cuts interest rates, turns to "quantitative easing"

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The Bank of England's decision Thursday to cut interest rates to another historic low and begin the process of "quantitative easing" won it plaudits as an audacious and pioneering move.

The BoE agreed to reduce interest rates to 0.5 percent, the lowest since its founding in 1694. But in an exchange of letters to the Treasury, Bank Director Mervyn King said that the monetary policy committee had agreed that further rate cuts "might not be enough to bring inflation in line" with the Bank's 2 percent rate. The BoE and the Treasury had therefore agreed to pump tens of billions of pounds of new money into the economy in another attempt to stimulate it.

In his letter King stated that a "maximum of £150 billon" is to be set aside to buy government bonds (gilts) and corporate debt over the next months. He also made clear that £50 billon of this could help finance the previously agreed Asset Purchase Facility, targeted at freeing up corporate borrowing.

The BoE and the Treasury were at pains to make clear that the plan had been given due consideration. Newspaper reports stated that it was the outcome of three months of study and consultation, involving leading economic advisors and Prime Minister Gordon Brown himself. They had studied the experiences of Japan and Sweden and had also consulted with the United States, where the Federal Reserve is implementing its own version of the process, buying billions of dollars worth of assets.

The Conservative opposition and much of the media broadly supported the move. The BoE's decision would act as an example elsewhere, it was claimed. It had "broken the dam for everyone else," Graham Turner, head of consultancy at GFC Economics said.

On Thursday, the European Central Bank had followed the BoE, cutting interest rates by half a percentage point to 1.5 percent, the lowest since the formation of the Eurozone in 1999.

The *Financial Times* said it was far "too little" in the face of a serious recession and called on the ECB to follow the BoE example and "face the crisis".

But there was no disguising that many regard the BoE move as the last throw of the dice. In January Chancellor Alistair Darling had rejected claims that the government was planning to "print money" to prevent deflation and revive the economy. "Nobody is talking about printing money", he said. "There's a debate to be had about what you do to support the economy as interest rates approach zero, as they are in the US. But for us that is an entirely hypothetical debate".

Less than two months later, Darling has now agreed to "print" some £75 billon—5 percent of national income—over the next three months. According to analysts from Barclays Capital, this is one-and-a-half times the entire stock of notes and coins in the economy.

Tim Sutcliffe, of advisers Pi Financial, said, "The Bank of England is fast running out of options—with only one more 0.5% rate cut to fall back on, they are going to have to start looking for another battle plan".

Larry Elliot in the *Guardian* concurred that the BoE had made "a bold move". "Let no one accuse Threadneedle Street of being behind the curve: it is going to create electronically (rather than physically print) up to £75 billion in three months in an attempt to get the UK moving again".

However, it was "definitely the endgame", he continued, as it meant that traditional methods of controlling the economy had failed. In theory the BoE could end up buying the entire £700 billion stock of government gilts.

"Had the government announced this scheme a year ago, the financial markets would have said the lunatics had taken over the asylum", he said.

The difference now is that all bets that the economy could avoid a crash landing are off.

The government's latest moves have increased concerns in Britain's ruling circles that sterling could face a Zimbabwean-style collapse, having already lost a quarter of its value over the last year.

Even as Brown had sought to portray himself during his visit to Washington Wednesday as a man with a grand plan to deal with the recession, the government's recent economic measures in the UK were rapidly coming unstuck. Hundreds of billions of pounds have been handed over to the banks in the last months. Apart from lining the pockets of the wealthy few, this has done nothing to stop the economic melt-down, with catastrophic consequences for millions of working people and their families.

UK GDP fell by 1.5 percent in the last quarter of 2008, following a 0.7 percent drop in the third quarter. New mortgage approvals are down 55 percent compared with January last year, car sales fell by 22 percent in February and unemployment has passed the two million mark.

Yet on Friday, it was revealed that the Treasury is involved in a fresh bank rescue plan—this time aimed at the Lloyds' Banking Group, whose government-backed takeover of the failing Halifax Bank of Scotland (HBOS) was meant to have stabilised the financial system. With losses in its HBOS subsidiary estimated at some £11 billion, Lloyds' shares have fallen by 80 percent since last autumn.

According to reports, the Treasury has agreed an outline deal to insure the bank's toxic assets for £258 billon, and the government increasing its stake in the bank from 43 percent to 70 percent.

Last week, the Royal Bank of Scotland (RBS), now 80 percent owned by the government, announced it would place £325 billion of assets into the government's insurance scheme. The scheme involves the bank agreeing to pay a "first loss" on bad loans, with the taxpayer underwriting 90 percent of the remainder.

At the same time, Europe's largest bank, HSBC, announced it is seeking to raise £12.5 billion from shareholders through a rights issue in the UK. The move by HSBC, which has not received government monies and had claimed it was fundamentally sound, came after it reported a 62 percent decline in pre-tax profits for 2008.

Writing in the *Financial Times* March 5, Martin Wolf opined that the "UK government looks increasingly like a python that has swallowed a hippopotamus. In acting as insurer of last resort to the British-based banking system, it is taking on huge risks on behalf of taxpayers. If this turned out to be a global depression, with huge losses for British-based banks, fiscal solvency might even come into question. Can this make sense? I doubt it".

At the end of 2008 British-based banking assets stood at £7,919 billion or 5.5 times GDP, Wolf said. This had "increased by £956 billion between the end of 2007 and the end of 2008 and by £4,493 billion, or by 130 percent, between the end of 2001 and the end of 2008".

RBS alone accounted for 45 percent of the last amount, he continued. It had held the largest assets of any British bank, at 166 percent of GDP. Today, its market capitalisation "is a mere £9 billion. Even this is only because the Treasury has not wiped out private shareholders".

The government is now likely to guarantee a minimum of £600 billion of toxic assets from RBS and Lloyds. An International Monetary Fund forecast that the total cost of UK banking support amounted to 13 percent of GDP, or £200 billion, was "too optimistic". In addition to the recession, it was now likely that the ratio of public sector debt to GDP would rise by 50 percentage points, "similar to the fiscal costs of a war".

"I am no populist. Yet when I think of the sums earned by those responsible for dumping this mess on to the UK taxpayer, even my blood boils", Wolf wrote.