

## Novus Capital Markets Research

### Bread, butter and (small) beer

20 July 2011

**When will interest rates go up?** Without answering that question, I set down some markers on where, I think, the MPC is coming from. I argue that the MPC is effectively targeting the real economy and that it will not raise interest rates until it is confident that the recovery is strong enough to take not just one 25bp hike. Odd as it sounds, inflation is the main factor holding back spending in real terms so it won't be until inflation is well past the 5% peak that is likely in the coming months before the MPC is willing to hike. Next month's *Inflation Report* will produce the usual increase in the inflation forecast and growth downgrade. An element in the calculation, which is more prominent in the July Minutes, is productivity. The MPC is asking precisely how much comfort they can take from subdued earnings growth; the hawks are wondering whether the rate of earnings growth consistent with inflation returning to the 2% target might be lower than in the past. There is not an issue in the UK economy – inflation, the public finances, looking after the baby-boomers – that does not come back to our 'puzzlingly' low level of productivity.

**Small beer:** I don't often part company with David Smith but I disagree with his argument that the main drag on the economy is not fiscal (the reduction in the budget deficit) but monetary (a shortage of bank lending). He notes in particular that small and medium-sized enterprises (SMEs) are finding it difficult to access credit and that this is holding back growth in that sector. I don't doubt that; nor do I dispute the importance of the SMEs to the medium-term growth dynamic. But surely it is the squeeze on household budgets and the unwillingness of heavily indebted households to take on more credit that is holding back consumer spending. And large companies are cash-rich and/or have access to credit through various channels so I would not ascribe any shortfall in investment there to a lack of credit. Overall I reckon that, relative to all the other pressures on the economy, a lack of credit (supply) is small beer.

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## **When will interest rates go up?**

I have had a lot of fun over the last two weeks writing about the pressures on the economy and the public finances from an ageing population, but it is back to bread-and-butter issues this week. Bank Rate has been 0.5% since March 2009. At the start of the year markets were looking for the first hike to have occurred by now. Today they expect no change until well into 2012. So, without answering my own question, here are some thoughts.

### **1. The MPC is predisposed to raising rates**

When Bank Rate was cut to 0.5%, it was an extreme response to a major financial crisis – abnormal economic conditions required an abnormal monetary response. By any standards Bank Rate of 0.5%, which equates to a real rate of -4% or thereabouts, represents extreme monetary accommodation. A rate hike would signal that the period of abnormality is drawing to a close and that extreme monetary accommodation is no longer necessary. In any case Bank Rate of 0.5% is too low for a 2% inflation target over the medium term. It is a question of when (even if the answer is still many months away) rates rise not if.

### **2. The MPC is targeting the real economy not inflation**

The MPC always couches its decisions in terms of the outlook for inflation but when a pick-up in CPI inflation to 4.5% and the Bank's own forecast that inflation peaks at 5% is not enough to produce a rate hike, it is right to be sceptical. For most of the last two years successive forecasts from the MPC have featured a stronger inflation profile and a downgrade of similar magnitude to the real economy. The increase in inflation has been treated as water under the bridge and the downgrade to the real economy has been the driver of the rate decision. OK, weakness in the economy today (a larger output gap) should produce lower inflation on the two-year timescale that the MPC typically addresses but the risk is that high inflation today breeds high inflation tomorrow. Against that the risks to the real economy, and hence, the MPC can argue, to inflation further out, are to the downside.

### **3. The MPC will not risk derailing the recovery**

Its successive forecasts for inflation and the real economy having proved over-optimistic, the MPC has become very risk-averse with regard to the real economy. Growth over the last three quarters has been anaemic in the extreme and shows no sign of upping a gear. The MPC, having presided over the worst

recession of modern times, is not going to risk throwing what is already a fragile recovery into reverse. The MPC recognises that the bulk of the planned fiscal tightening is still to come and that monetary policy needs to remain accommodating to offset the effects of the cuts in public spending which are getting under way. For this reason the MPC is in no hurry to enact the first hike.

#### **4. The MPC welcomes the fall in the exchange rate**

Rebalancing the economy away from debt-financed consumption towards investment and exports is seen as both necessary and vital to the health of the economy over the medium term. Although the fall in sterling (25% since the onset of the financial crisis) has made life difficult for the MPC in terms of the inflation target, the MPC is comfortable with the stability of the pound at its lower level. It may be disappointed that exports have so far done rather little in response to the weaker pound and surprised at the resilience of imports but this is all the more reason why sterling should stay at these lower levels until a stronger response from net trade is evident.

#### **5. The MPC will not raise rates until inflation is falling**

I have noted the way successive forecasts have raised inflation and downgraded growth. This is cause and effect: in the near term higher inflation is strongly deflationary since it squeezes real incomes and holds back spending. The weakness of consumer spending is directly attributable to the impact of rising prices (especially, food and utilities) on household budgets. Odd as it sounds, the MPC will not raise rates while inflation is still heading upwards. Only when inflation starts coming down, and household budgets are under less pressure and spending will increase, will it think about raising rates. Ironically, falling inflation is a necessary condition in the current conjuncture for higher interest rates. That implies no change in rates for the next few months at least.

#### **6. The MPC will downgrade the growth forecast next month**

When the MPC publishes its next forecast on 10 August, inflation will be revised up from a peak of just below 5% to a little above 5%. As before, this will translate into yet another growth disappointment. In May the MPC estimated that y/y GDP growth was 2.1% in 11q1 (the ONS preliminary estimate was 1.8% subsequently revised to 1.6%) and forecast that growth would fall to 1.4% in 11q2, before rising to 1.7% in Q3. As far as I can tell from the backcast the MPC agrees with the ONS q/q profile for 2010. If that is correct, the May forecast implied q/q growth of 0.6% in Q1 (the ONS estimate is 0.5%) followed by 0.4%

in Q2 and as much as 1% in Q3 (a 0.3pp increase in annual growth running off a 0.7% q/q increase in 10q3). On the basis of my current estimate for Q2 (0.3% q/q, 1% y/y) and early indicators for Q3, the MPC's forecast is once again on the high side. Another growth downgrade puts back the timing of the first hike.

#### **7. The MPC will raise rates when the real economy can cope with (not just one) 25bp hike**

Bank Rate has stayed at 0.5% far longer than almost anyone would originally have expected because in the judgment of (the majority of) the MPC the economy has not been robust enough to withstand a hike. When they eventually do raise rates, they will proceed in gentle (25bp) steps. At that stage the market will be pricing in a series of rate hikes (as it is now) and the MPC will want to be as certain as it can be that the recovery is robust enough to withstand not just one 25bp hike but several. Although in theory any rate hike can be quickly reversed, the MPC will expect the process of monetary normalisation, once started, to continue at least for several months. All of this effectively delays the first hike. Arguments that delaying a rate hike risks rates eventually having to go further cut no ice – the MPC would like rates to get back to a 'normal' level eventually and this gives it plenty of upside.

#### **The July Minutes**

None of these arguments is materially affected by today's Minutes, though I did pick up on a couple of points on productivity, where the MPC is showing the first sign of rethinking its 'normal service will be resumed' assumption. The behaviour of productivity is now described as 'puzzling'. For Spencer Dale and Martin Weale, earnings growth might have to be lower than in the past if productivity growth did not recover to its previous trend. (It remained unclear how much comfort to draw from recent labour market developments, given the puzzling behaviour of productivity over the recent past ... It was not clear how much comfort could be drawn from subdued earnings data: it was possible that the rate of wage growth consistent with inflation returning to the 2% target would be lower than in the past, as a result of the continued weakness in productivity growth and the likelihood that businesses would seek to rebuild their profit margins.)

### **Is a shortage of lending holding back the economy?**

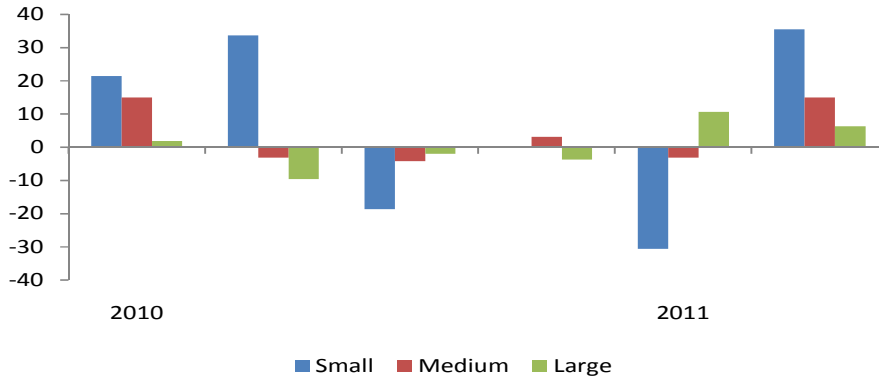
In his Sunday Times column this weekend, David Smith returns to a theme he first advanced in June and argues that the main drag on the economy is not the Government's fiscal austerity measures but a shortage of bank lending. The problem is most acute with small and medium-sized enterprises (SMEs), where bank lending has been falling for the last two years, but is also evident in other parts of the economy most obviously the housing market.

M4 Lending (excluding intermediate OFCs) fell in both April and May and is virtually unchanged (+0.2%) over the last year. Lending to private non-financial companies (PNFCs) on an underlying basis (excluding securitisation) is down 2.1% y/y. Lending to individuals is rising (+0.6% y/y) but with inflation at 4.2% (CPI) it is falling in real terms. For SMEs, Smith suggests, the drop in lending is around 6% over the last year.

There is no doubt that credit growth is sluggish but that does not mean that it is the weakness of bank lending that is holding back the recovery. Credit growth reflects both supply and demand. Demand may be weak because, for a variety of reasons, companies or individuals may not want to borrow. Or supply may not be forthcoming because the banks, again for a variety of reasons, are unwilling to lend. David Smith argues that it is primarily the unwillingness of the banks to lend to the SMEs that is holding back growth and investment in this part of the economy. To the counter-claims of the Treasury and the banks that demand from SMEs is not there, he argues that the SMEs would wish to take on more bank borrowing but are wary of approaching their banks in the current climate.

The Bank's quarterly Credit Conditions Survey shows a significant increase in credit demand from small companies in the second quarter, though only after a significant reduction in demand in Q1. For medium-sized companies demand also rebounded strongly in Q2 after a modest decline in Q1. For large companies demand is rising this year where it was falling for much of 2010 (Chart 1). According to the lenders, the demand was primarily for working capital purposes and that for small companies proactive marketing strategies and seasonal factors were also important. Demand for credit to finance capital investment by contrast was reported to have been negative.

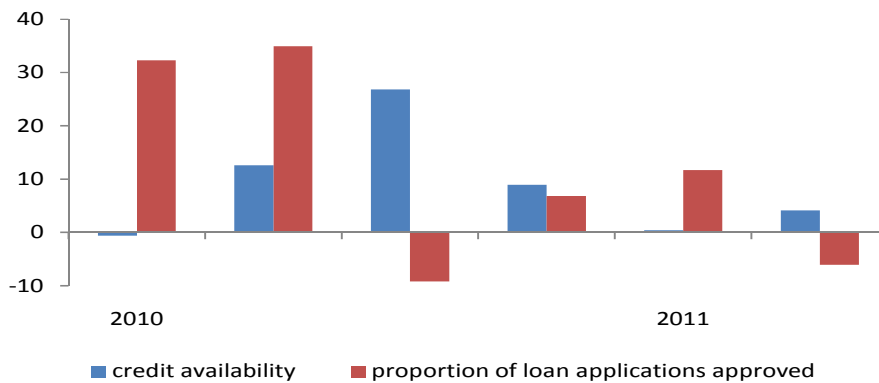
**Chart 1: Change in demand for lending by size of company**



Source: BoE

On the supply side lenders reported that the amount of lending made available to the corporate sector was broadly unchanged in 11q2 for businesses of all sizes. For small companies there was a modest increase but, with demand up significantly, there was a reduction in the number of loan applications that were approved (Chart 2).

**Chart 2: Lending to small companies**

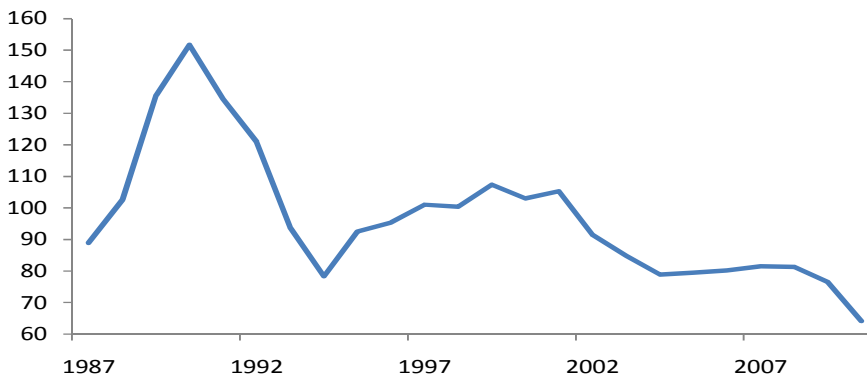


Source: BoE

From this it would appear that there has been an increase in credit demand by the corporate sector, particularly small companies, and that the banks have been unwilling to meet the demand in full. In the small company sector at least it would appear that a dearth of lending is holding back expansion (though not, if the lenders are correct, investment, since most of the demand for credit was for other purposes).

While the importance of SMEs to economic growth in the long run is not in doubt, I am still rather sceptical about their impact on growth in the near term. There is an old statistic which says something like 80% of investment is accounted for by the largest 20% of companies and these, according to the ONS, are flush with funds. The PNFCs as a whole had a surplus in 2010 of £62.8bn on top of a £56.7bn surplus in 2009. The sector has now been in surplus every year since 2002 in which time it has racked up surpluses totalling nearly £300bn. In this period investment has been falling steadily as a share of gross disposable income, dropping to only 64% in 2010. At the height of the late 1980s boom PNFCs' investment spending was larger than their incomes (Chart 3).

**Chart 3: PNFC investment as % of gross disposable income**



Source: ONS

While I do not understand why the PNFCs have opted to build up their cash surpluses and to invest proportionately less of their income, I am in no doubt about the weakness of consumer spending, where the squeeze on household budgets remains intense. Even with the help from a falling saving ratio, household consumption has contracted in each of the last two quarters (and may well be down again in 11q2). The availability or otherwise of mortgage credit is not going to alter the fundamental arithmetic of household budgets.

So all in all, I am unsympathetic to David Smith's arguments. In the first instance it is income that drives spending and it is cash-constrained companies and consumers that seek to augment their spending by borrowing. Today, although consumers are heavily cash-constrained, they are also heavily indebted and may not be interested in taking on extra debt. Large companies by and large are cash-rich. It is only the SMEs that are cash-poor. So yes, at the margin, the unwillingness of the banks to advance credit to some (small and medium-sized) companies is holding back growth. In the long run, were it to persist, that would be bad news since the SMEs are behind a lot of the growth dynamic. But in the short term, given all the other pressures on the economy, the weakness of credit growth appears to me to be pretty small beer.

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