E-mail sent to supporters of Tim Congdon's bid for the leadership of the UK Independence Party, on 1st October 2010

This e-mail is sent to you because I have been informed - or have good reason to believe - that you are a supporter of my bid to become leader of UKIP. **If you do not want to receive e-mails from me, perhaps you would let me know. The leadership campaign rules are intended to encourage discussion and debate, but also to prevent spamming.**

....

Dear friends and supporters,

Today has been very busy with various odds and ends, and I have needed to look after the clients of an internet-based research business, called International Monetary Research Ltd., which I set up in early 2009. I write an weekly e-mail on a topical economic or financial theme, and send it to about 450 actual or potential subscribers.

The material can be quite technical, but I thought you might be interested in today's note. I have also included a note I prepared about a fortnight ago on the current problems in the Eurozone.

If I become Leader of the UK Independence Party, one of my aims would be for the party to have a high-quality research team in London able to comment authoritatively on a wide range of public policy issues, particularly of course as these relate to our membership of the European Union. The two notes are the sort of material we must be able to write, at speed, in response to events. Building up this kind of research team - and of course financing it - would take a few years. It would be a formidable organizational challenge for anyone, but we need to win the intellectual battles.

With best wishes,

Tim Congdon

Note I

Weekly e-mail from Tim Congdon of International Monetary Research Ltd. – 1st October, 2010

Will another QE money injection be needed in the UK?

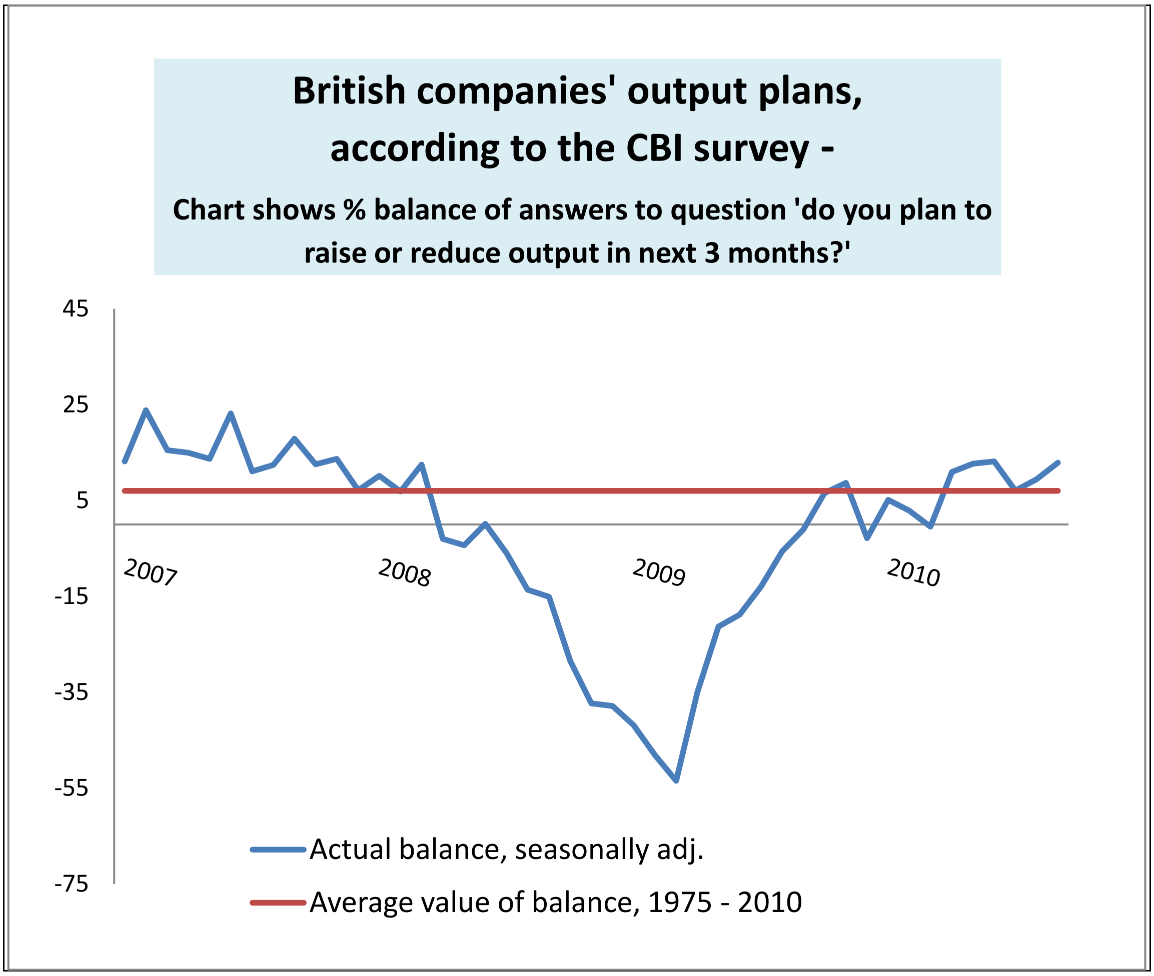
....

Macroeconomic conditions in the UK are not too bad. Since mid-2009 output has been growing at about the trend rate, while business surveys suggest continued advance at a similar pace in the next few months. But in one key respect talk about "the recovery" is misplaced. Output may be growing, but it is not growing at an above-trend rate and unemployment remains stuck at just under 8% of the labour force (measured on the Labour Force Survey method). The 8% figure is roughly 3% higher than the typical level during the NICE years until mid-2007. (NICE = non-inflationary, consistently expansionary.) This difference of 3% in unemployment from the NICE period is consistent with national output being perhaps 3% - 5% beneath its trend path (i.e., with a so-called "negative output gap" of that size) and implies that downward pressure on underlying inflation continues. British companies have been able to raise prices in recent quarters, because of the continuing leeway from the pound's big devaluation from its mid-2008 level. But – if the effect of the planned VAT increase is taken out – consumer price inflation in 2011 ought to be in line with or beneath target.

The main point of this note is that – without an upturn in broad money growth in the near future – 2012 could see recurrent undershooting on the inflation target. 2011 would need to be a boom year, with output growth of 5% or so, to eliminate the negative output gap and re-establish serious upward pressures on underlying inflation. There is no sign of that. Sure, inflation numbers in 2012 of 0% - 2% would not be a disaster. Factors of production will price themselves back into employment. Demand and output will recover, with *any* positive rate of money growth, no matter how low (even zero) as long as the money growth is fairly stable. However, another key policy objective at present is to halt the expansion of government debt. That argues for a bias towards ease in monetary policy and hence for the re-activation of quantitative easing.

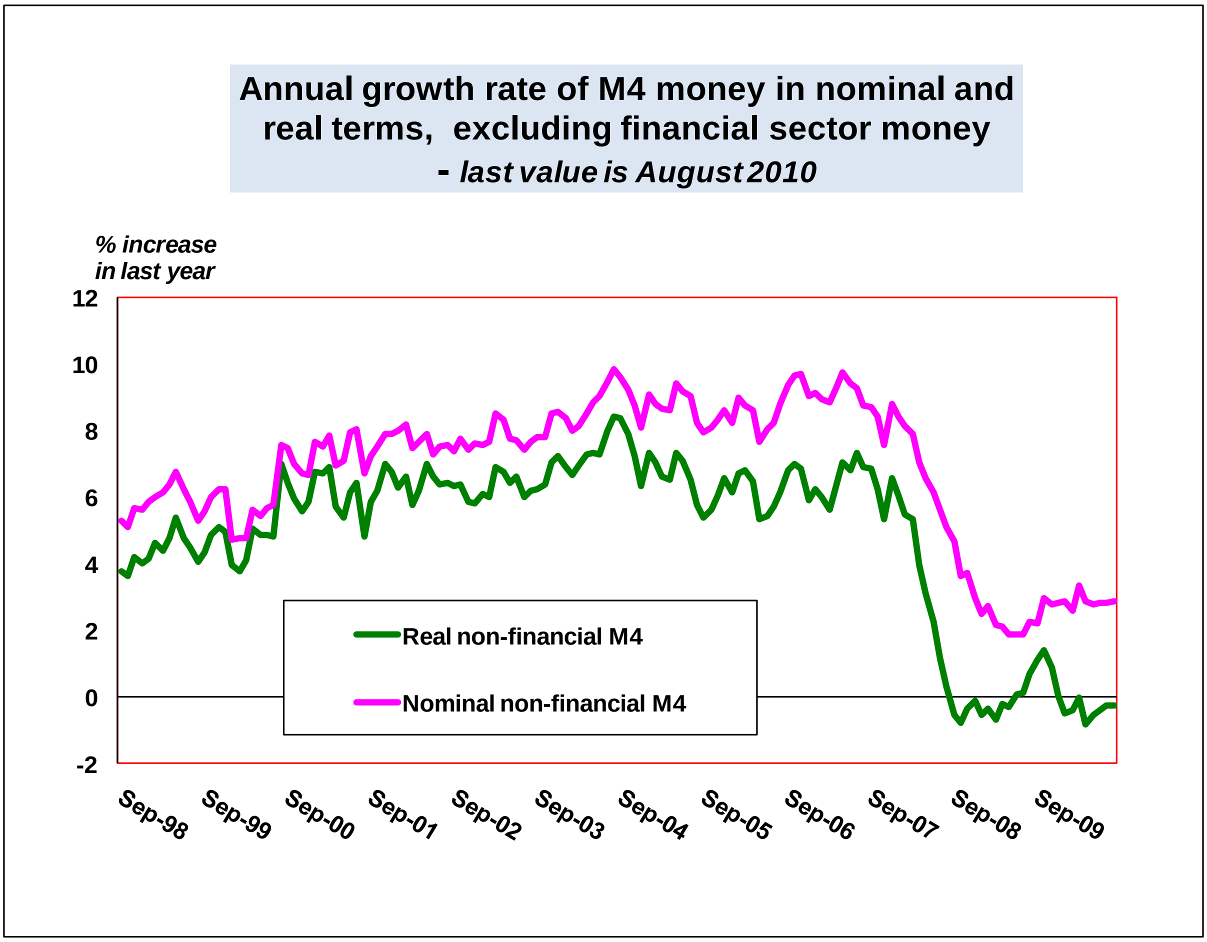
What do the data say about the UK economy in the next few quarters?

Forward indicators of economic activity are satisfactory, although rather mixed. The fall in the pound since mid-2008 has given particular help to the trade-ables sectors (i.e., exporters or domestic producers subject to import competition), but has been unfavourable for domestic consumption. So manufacturing is chirpy, while retailers remain gloomy. Indeed, the manufacturing sector is relatively buoyant by long-run standards. As the chart below shows, the latest monthly survey from the Confederation of British Industry reports a higher-than-average net balance of companies with positive output plans. That is consistent with somewhat *above-trend* growth in manufacturing until early 2011. On the other hand, the housing market – often the key to discretionary consumer spending – is dull, with mortgage approvals held back by the funding constraints on building societies. Although the recent take-up of London office space has been impressively strong, the London-based international financial service industries are worried about the long-term viability of their activities in the risk-averse, over-regulated European Union. With housing weak and office development at a low ebb, construction activity is still heavily down on its 2007 levels. In short, the immediate prospect is for trend growth at best. Unemployment will remain high and downward pressures on underlying inflation will persist next year.



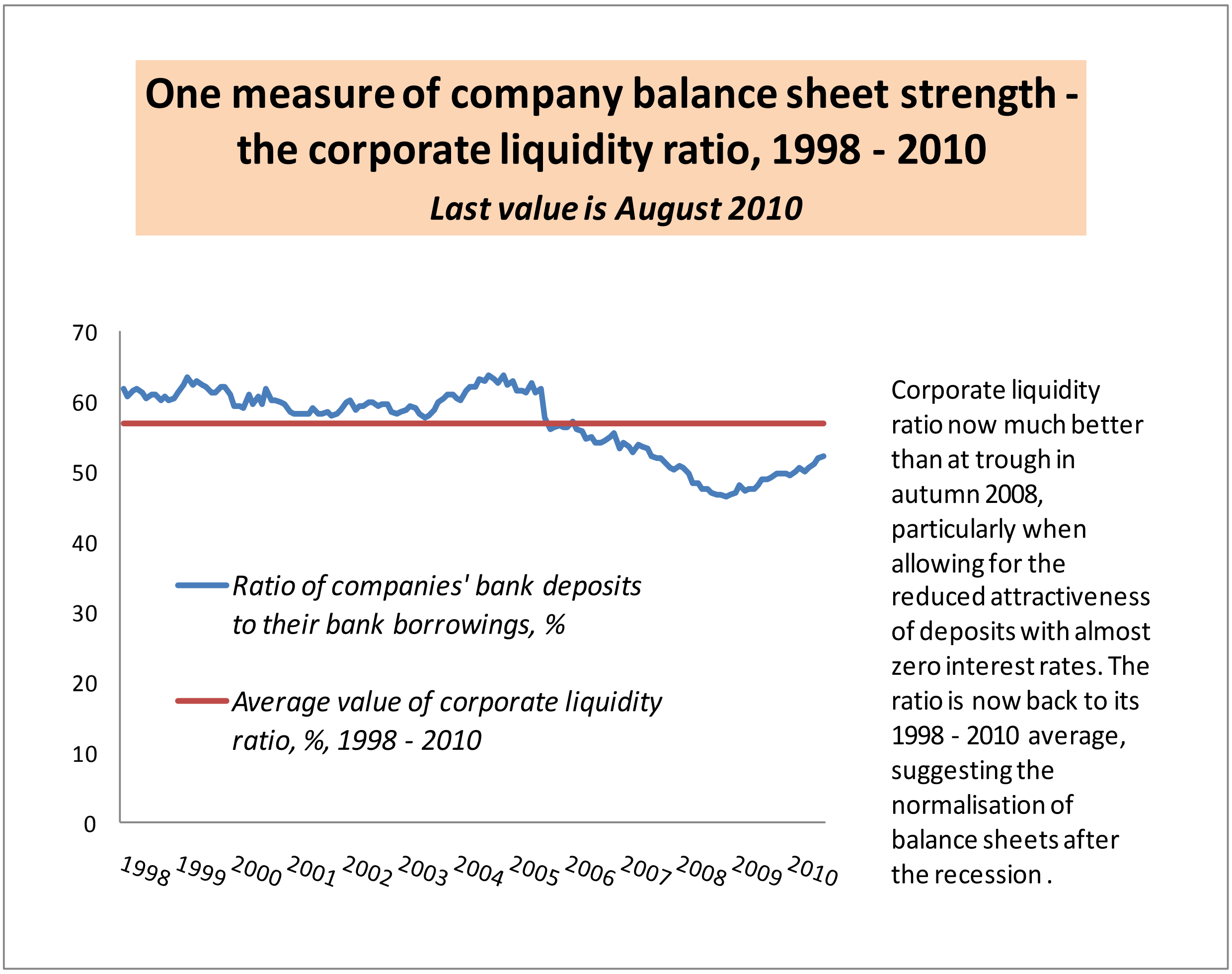
And what about money trends?

When trying to peer into the future, the usefulness of leading indicators and business survey information is limited to the next three to nine months. Beyond about six months out money trends become a vital input and cross-check. If real money growth is weak and the banking system is likely not to want to grow its balance sheet at any time in the foreseeable future, that justifies a cautious view on demand growth prospects up to a year or more away.



As clients of International Monetary Research have been warned many times, the money balances of the financial sector are extraordinarily volatile. They are buffeted around by institutional upheaval and changes in the relative attractiveness of money compared with other assets, and can give a misleading guide to the economic outlook. In the above chart I have therefore concentrated on money balances held by households and non-financial companies, as the evidence suggests the resulting aggregate – of non-financial M4 broad money – has a closer relationship with national income and expenditure than total M4 (i.e., inclusive of financial sector money). The chart speaks volumes about the blunders in monetary policy and banking regulation in 2007 and 2008, with the abrupt plunge in annual *nominal* non-financial money growth from about 8% - 9% in 2006 and 2007 to 2% - 3% in autumn 2008.

Fortunately, the plunge in money growth stopped in late 2008 and early 2009. As is well-known, the introduction of "quantitative easing" in March 2009 went a long way to offset the adverse impact of tighter capital regulation on the size of banks' balance sheets and so on the quantity of broad money. The annual rate of change in nominal non-financial M4 has been chugging along at about 2% - 3% for 18 months or so now, and has been quite stable. Although the lowest growth rate of this sort of money since modern records started in 1963, the money squeeze has in fact become less severe over the period. As the chart below shows, the ratio of companies' money holdings to their bank borrowings – which could be called "the corporate liquidity ratio" and identifies cash strains in company balance sheets – has improved since mid-2008, despite the very low rate of money growth overall. In fact, this ratio now stands at about 52% compared with 46% at the most severe phase of the squeeze in mid-2008. It is still below the average value over the last decade of about 57%, but an important caveat has to be entered here. Money balances at present pay almost nothing, because base rates are at ½%. So money is an unappealing asset to hold and the desired ratio of corporate money to corporate borrowing may have gone down from 57% to, say, 54% or 55%. (Who knows?) On that basis, roughly two years from the nadir company balance-sheet strength – as measured in this way – have more or less returned to normality.



The case for another QE injection

Business survey evidence, leading indicators and money trends suggest that over the next two or three quarters, the UK should enjoy more or less trend growth. That may sound encouraging, but it must be remembered that unemployment is 3% higher than in the mid-noughties and that output may be 4% - 5% beneath its trend. Factors of production (capital equipment, office space, skilled and unskilled labour) do eventually price themselves back into work in every business cycle. So above-trend growth will return at some point in the next two or three years, even if annual money growth remains stuck in the low single digits. However, somewhat above-trend growth would now be desirable - and not only for its own sake. Early above-trend growth would also lead to a speedier return to a balanced budget and hence a lower long-run debt interest burden. The Gordon Brown fiscal extravaganza of the late noughties will have added 30% - 50% to the ratio of debt to national income (and corresponding numbers for debt interest and extra tax), whatever the pace of the fiscal improvement from here on. But it would be better if the rise in the debt/income ratio could be kept towards 30% and not exceed 50%.

One part of the argument for another QE money injection is that it would be a pre-emptive strike against the forces that might cause another dip – a double dip – in the economy. But the evidence is against the UK suffering from a double dip in the foreseeable future. Another type of argument for a QE injection is that it might accelerate the return to a few months of roughly 5% broad money growth, which would further the recovery and help towards an earlier improvement in the public finances. My own view is that deliberate action by the state (i.e., the central bank and the finance ministry, the Bank of England and HM Treasury, working together) to boost broad money by, say, £25b. - £50b. over the next six months would be a Good Idea. As I continue to emphasize, the simplest method would be for the government to borrow directly from the commercial banks and to bypass the Bank of England balance sheet. Whether the relevant individuals in the Bank and Treasury understand the argument is very doubtful. Anyhow another QE injection is back on the agenda and that is a positive for the UK economic outlook over the next two or three quarters.

1st October, 2010

Note II

Weekly e-mail from Tim Congdon of International Monetary Research Ltd. – 17th September, 2010

ECB has <u>increased</u> *lending to PIGS' banks in 2010*

……………………

An ECB priority in early 2010 was to reduce the size of its own balance sheet. In particular, it wanted to withdraw the very large credit lines it had extended to Eurozone banks during crisis conditions in late 2007 and 2008. As is well-known, banks in the PIGS countries (Portugal, Ireland, Greece and Spain) had cash problems because they could not roll over inter-bank funding and seemed to have become too reliant on ECB credit as a substitute. The expression used by, for example, Trichet and Stark was that the ECB should try to "exit from non-standard measures". The main point of this note is that in 2010 ECB lending to banks in the PIGS countries has *increased*, not fallen. As far as these countries are concerned, the ECB exposure to possible bad loans has *risen* in recent months.

It is true that total Eurozone-wide ECB lending to banks has declined, which the ECB might claim is a sign of the success of its strategy; it is also true that the proportion of this lending taking long-term form has dropped sharply. But these aggregate numbers are misleading. The ECB's lending to the PIGS' banking systems is more than 100b. euros higher now than it was at end-2009; it now constitutes about 60% of its lending to *all* Eurozone banking systems, even though the PIGS account for under 20% of the Eurozone's GDP. This imbalance is bound to be of interest in the impending case before the German Federal Constitutional Court, in which five German professors are challenging the legality of the EU/Eurozone package for Greece. Unless the judges can ignore, twist, bend, mangle, torture or in some other way overcome the clear meaning of words, they must find that Greek support package breached the "no bail-out" provision of the 1992 Maastricht Treaty. (Another point likely to be brought in evidence is that the ECB is now sitting on losses on the Greek government bonds it bought in May.) The Eurozone remains in deep trouble.

The ECB has wanted to cut its lending to the Eurozone

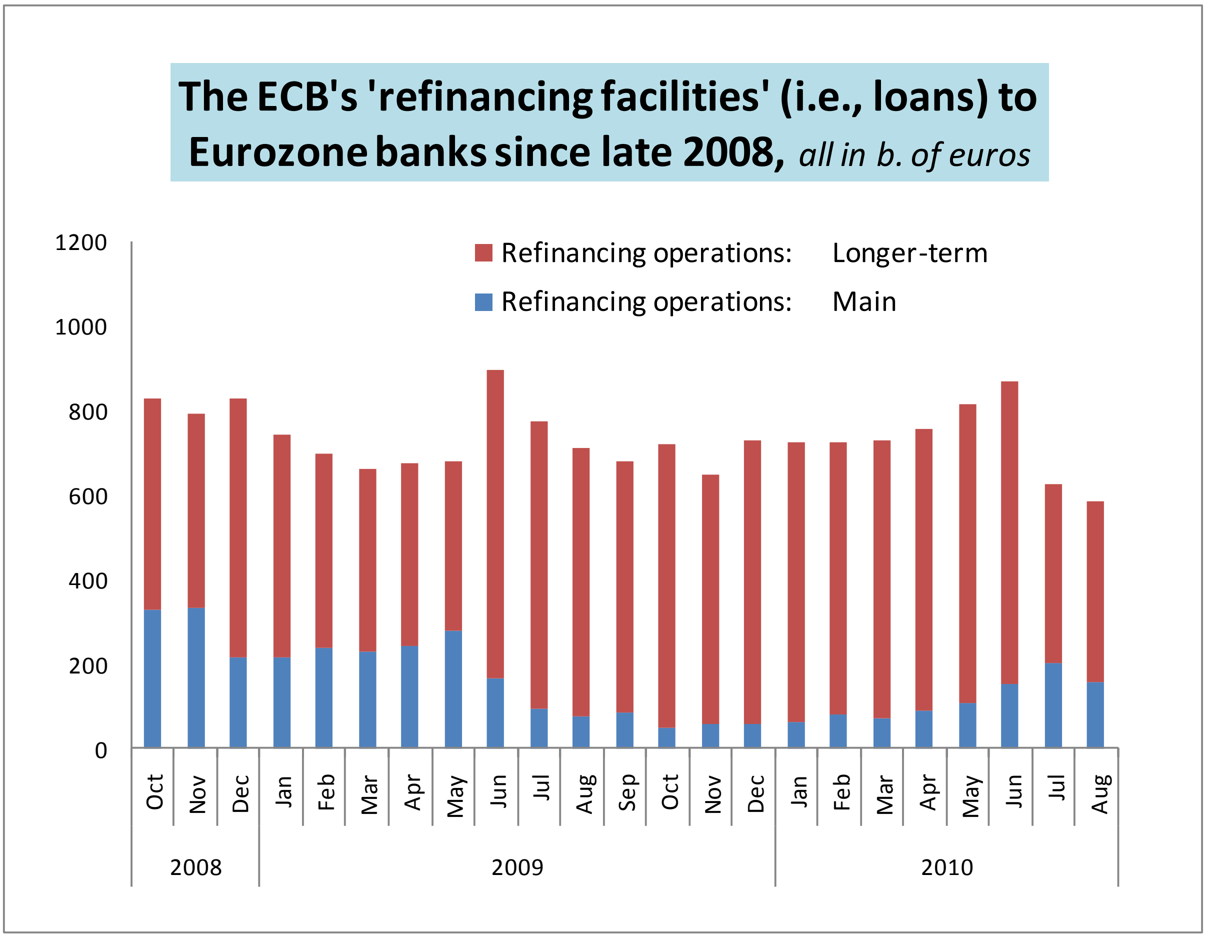
In early 2010 the ECB's top brass made clear that they wanted Eurozone banks to repay a significant part of the loans that the ECB been extended to them in crisis conditions in late 2007 and 2008. According to Jurgen Stark in a speech to the European Parliament on 16th March, the expansion of the ECB's balance sheet was potentially inflationary. So it had become necessary to withdraw "the non-standard measures". That was also the message of an interview given by Jean-Claude Trichet to *Le Point* the next day. I regarded the Stark and Trichet remarks as "inflation nuttiness" of an extreme kind, and said so in an e-mail of 19th March. In the conditions then prevailing – and still prevailing now – commercial banks were/are unlikely to respond to the increase in the monetary base by expanding their loan portfolios. There was in fact an upward blip in money growth *in Germany* in the second quarter, but nowhere else. In August Eurozone M3 stagnated again.

Anyhow the ECB has persisted with the Trichet/Stark plans to unwind the non-standard measures. The key withdrawal measures came in late June/early July. To give the ECB its due, the sky didn't fall in. Very tight conditions in the Eurozone money market were seen over periods of several weeks in July and August, with upward pressure on inter-bank rates, but many Eurozone banks were able to settle their obligations to other banks without difficulty. The unwinding of the non-standard measures is evidenced on the ECB balance sheet in two ways,

i. by the fall in the total amount of "lending to euro area credit institutions in euro", and
ii. by a fall in the proportion of that total represented by "longer-term refinancing operations".

The EC's longer-term refinancing facilities to all the Eurozone banking systems were 718.2b. euros at 25th June. At 27th August they had tumbled to 150.3b. euros. On the face of it, the ECB has gone a long way to eliminating the "non-standard measures".

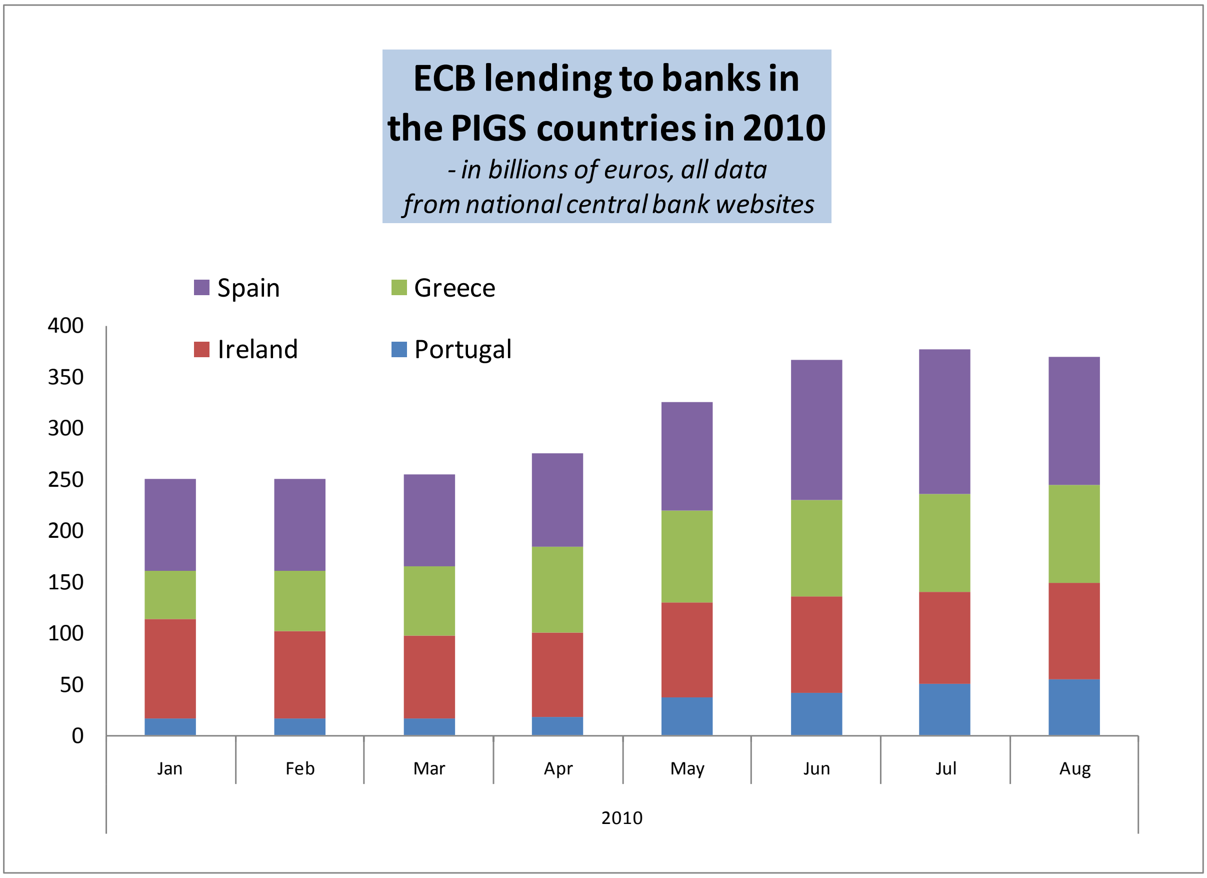
(Note that the longer-term facilities were not expensive and raised major issues about the subsidization by low-cost financing of different nations' banking systems. They were not at a penal rate, as central bank lending should normally be. Banks in other countries, notably the UK, complained about unfair competition. After all, in late 2007 the UK authorities had checked with the European Commission whether the support package for Northern Rock broke EU state aid rules. The Commission determined that, while the first Bank of England loan [i.e., the last-resort loan] was not state aid, the government guarantee on Northern Rock deposits was. Meanwhile Spanish banks – including Spanish banks buying UK ex-building societies – were being helped out of their cash problems by the low-cost longer-term refinancing facilities. The moral for the UK authorities is simple, "don't ask the European Commission its permission for anything and make sure that in the Council of Ministers the Chancellor of the Exchequer is prepared to be as aggressive a bully as any of his/her EU counterparts". In the immortal words of Sir John Major during the BSE crisis in 1996, the UK's European partners can be "a load of shits".)



But only the (relatively) strong banking systems repaid the ECB loans

However, what actually happened in late June and early July was very far from being a great success for ECB planning and organization. As we have seen, the aim was partly to eliminate a potential inflationary threat from banks' supposed excessive cash reserves and partly to wean the weaker banking systems in the PIGS countries off their dependence on ECB funding. But, since no inflation threat existed, it was only the second of these that really mattered. Examination of national central bank websites shows that the ECB has failed to cut back on its lending to the PIGS' banking systems. There has been a reduction in banks' borrowings from the ECB, from about 800b. euros in spring 2010 to about 550b. euros now, but that can be more than explained by repayments by the (relatively) strong banking systems of Germany, France, the Netherlands, Italy and so on. (Big banks in these countries have made a song and dance about how fully they meet certain "stress tests". The idea is that – because they pass the stress tests – they ought to have enough credibility to borrow to some extent in the inter-bank market. There has indeed been some resumption of inter-bank lending to these organizations. That – plus cutting back on assets – has enabled them to repay the lines from the ECB. The comparative ease with which they have repaid the lines implies that they were in fact subsidies by stealth, just as the UK banks and their regulatory authorities have alleged.)

But it is not the German, French and Italian banks which have really been in trouble in the inter-bank market. Instead since mid-2007 it is the banks in the PIGS countries which have been under most pressure to borrow from the ECB. The PIGS' banks did not have the credit-worthiness to roll over their lines in the inter-bank market in 2008 and 2009; they still do not have that credit-worthiness today. The chart below shows the extent of borrowing from the ECB by the banks in the PIGS from January to August this year. The central point is that – when the ECB withdrew most of its long-term refinancing facilities in late June/early July – these countries' total borrowings from the ECB did not go down at all. In fact, the ECB borrowings of Portugal's banks actually *rose* at exactly the same time that the "non-standard measures" were meant to be closed. (In qualification, Spanish banks were able to repay some of their ECB borrowings in August. Note that – for August – the chart below uses actual data from Spain, Ireland and Portugal, and an estimate for Greece. The point is unimportant.)



There is little doubt that – at present – total ECB lending to the PIGS' banking systems stands at over 350b. euros and is roughly 100b. euros higher than at the start of the year. For these banking systems – the banking systems about which commentators are most worried – the ECB has been unable to replace its funding by market-based finance. Sure enough, "longer-term" facilities have dropped "normal" lending risen sharply, but the underlying reality is unchanged. Banks in the PIGS – particularly in Greece, Ireland and Portugal – are more heavily dependent on ECB support than at any time since the start of the crisis.

The wider message

In May the ECB made large purchases of government bonds, particularly the government bonds of Greece, Portugal and Ireland. In the Greek case, the objective was to provide a breathing space for the negotiation of a package which would restore fiscal sustainability (and hence financial viability more generally) over the medium term. The purchases of Greek bonds must typically have been at yields of 9% or 10%, compared with a level of about 12% at the worst point in the crisis. If the measures taken by the EU authorities, the ECB and the IMF were working properly, yields on Greek government bonds ought now to be lower than after the ECB bond purchases in May. In fact, the Greek 10-year government bond yield at the time of writing is just over 11 ½%. Indeed, in the last few months the yields on Portuguese, Spanish and Irish government bonds have tended to remain very high relative to bund levels and – if anything – to increase while bund yields were falling. These yield rises have occurred despite market reports of further, rather small-scale ECB purchases of the bonds of the afflicted countries. The trends discussed in this note – which will not come as a surprise to large numbers of market participants – help to explain why the differentials relative to bund yields have been widening. To repeat, the PIGS' banking systems are more heavily reliant on the ECB for funding their assets than ever before. For these banking systems the crisis – far from being close to resolution – has been intensifying during 2010. The ECB's aggressiveness about the need to withdraw "non-standard measures" has in fact aggravated their problems.

Governments and banking systems are necessarily inter-twined. When a central bank lends on a large-scale to commercial banks, it usually needs an indemnity from the government against loss. The credit-worthiness of governments and their banking systems are not the same thing, but they are closely related. Two key facts emerging from this note are,

1. The PIGS' banking systems have not – so far – been able to repay their ECB borrowings. If the banking systems are eventually unable to repay the loans, the ECB will suffer a loss.
2. The ECB has already incurred losses on the bonds it bought in May, because of the adverse yield movements already noticed.

These issues are bound to be raised by the five German professors who are testing the legality of the May support package for Greece at the German Constitutional Court. The losses that the ECB is now taking on its interventions to help the PIGS undoubtedly constitute a breach of the no bailout clause of the 1992 Maastricht Treaty. If words have any definite meaning, the German Constitutional Court must deem the ECB's actions and the Greek rescue inconsistent with that treaty and therefore illegal. The Eurozone remains in great trouble.

17th September, 2010