

Opinion

Sex and extreme female youth — a disturbing mix

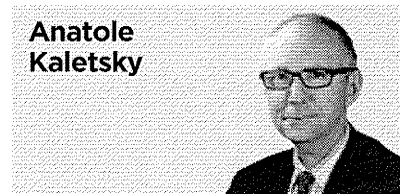
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Why the irresistible financial force will prevail

Economic paralysis seems like an immovable object. But dramatic interest rate cuts and other measures can shift it

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At noon today, the Bank of England is expected to reduce its benchmark bank rate to 2 per cent, the lowest since the Old Lady of Threadneedle Street was founded in 1694. And in the months ahead, the rate will almost certainly be cut farther — maybe to zero, as Mervyn King, the Bank's Governor, clearly suggested last month.

In this way, as in so many others, economic history is being made before our eyes. But will the lowest interest rates in British history overcome "the greatest financial crisis in human history"? — as Charles Bean, the Bank's Deputy Governor, has described the near-collapse of every leading bank in the US, Britain and Europe that was triggered by the US Treasury's decision to bankrupt Lehman Brothers and wipe out the shareholders of Fannie Mae and AIG.

The honest answer is that nobody knows. For a slightly more informative answer, consider the question beloved of argumentative children: "What happens if an irresistible force hits an immovable object?" The answer is that there is no answer. As infinite force and infinite inertia don't really exist, the outcome depends on whether the force is more enormous than the object, or the other way round.

In the world economy today, the immovable object is a paralysed

financial system crushing consumer spending, investment and property and stockmarket prices all over the world. But in trying to gauge the effects of this unprecedented credit squeeze, we must not forget that equally unprecedented forces are pushing the other way: around the world we see unprecedented monetary stimulus, with central banks reducing interest rates to zero or near-zero in Japan, the US, Switzerland and now Britain.

We also see unprecedented fiscal stimulus, with governments spending and borrowing like there is no tomorrow, to stop the recession degenerating into a prolonged slump. Finally, there is unprecedented financial intervention, with regulators and politicians in every big country supporting their banking systems with unlimited guarantees, that allow regulators to seize control of banks and take over their lending decisions.

Normally any one of these policy experiments would be enough to stimulate recovery. All three together would be likely to trigger a huge boom and serious global inflation. But circumstances are far from normal, which brings us back to the immovable object confronting these irresistible forces of stimulus.

There are two broad reasons to believe that the forces of policy stimulus will begin to prevail in the year ahead. The first is timing. Much of the impact of credit contraction is already being felt, but the benefits of policy stimulus are several months ahead. Usually there is a lag of between six and twelve months between a cut in interest rates or taxes and its impact on the economy. With the banking system broken, these lags may be longer. But the

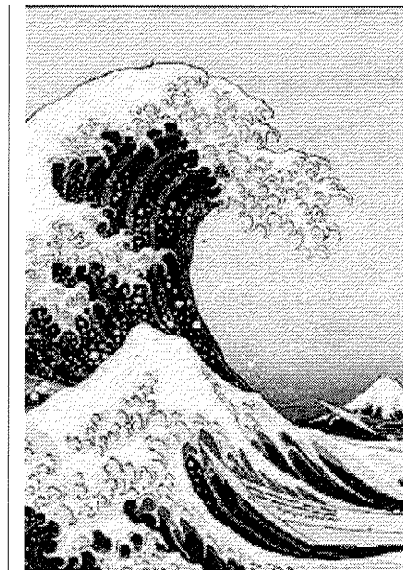
idea that monetary and fiscal policy simply will not work is implausible — and certainly unjustified so far.

Those who say that rate cuts and tax reductions have been tried and proved ineffective are talking nonsense. The huge policy stimulus now being implemented, not only in Britain but also in the US and, to a lesser extent, China and Europe, is like an earthquake in the depths of the Pacific. It will cause an economic tsunami, but this tidal wave of money will take time to arrive. Until it hits, the credit crunch will seem immovable, but once the wave makes landfall, the most immovable objects are likely to be swept away.

Until the tsunami of policy stimulus makes landfall, the financial world will worry about a 1930s-style depression. But paradoxically, that investors and policymakers are so preoccupied with deflation is the second reason for believing that the stimulus will work — and may trigger a spiral of rising, not falling, prices.

As long as everybody believes that the world is threatened by falling prices, central banks will continue to enjoy a totally unprecedented freedom to cut rates and print money — and as long as they are free to print money, governments will be free to continue spending, borrowing and guaranteeing banking systems without any of the limits normally imposed by political tradition or prudential financial rules (such as the self-imposed fiscal framework that Gordon Brown abandoned last week).

The fear of deflation gives governments this freedom because investors and savers want to keep all their money in cash or government-guaranteed bonds. As a result, governments can borrow without



Hokusai's *The Wave*: the tsunami of fiscal stimulus will take time to work

limit, secure that they will always find willing buyers for their bonds. Investors will buy these bonds not because they trust governments or approve of their borrowing and spending, but because all other assets — shares, properties or commodities — seem too risky, and their money must go somewhere.

Similarly, governments have little to fear from currency markets. Investors may believe that the British and US governments are profligate in their borrowing and spending, but will sell the pound or dollar only if they can find a government with a better fiscal record — and in a deflationary global environment, none seems to offer a better bet.

And even if investors get nervous about future inflation and reluctant

to tie up savings in bonds for ten years, governments can still go on spending and borrowing. All they have to do is instruct central banks to print money. If taken to excess, such resort to the printing press would stoke fears of Zimbabwean-style inflation. But if consumers delay purchases while investors favour paper money over inflation-protected assets, it implies that, whatever they may say about fearing inflation, their behaviour reveals the opposite concern. If they are not spending or investing in real assets it is probably because they believe that prices will fall. Under these circumstances, central banks can safely print money and are right to do so.

As Sir Samuel Brittan, the doyen of British economic commentators, noted a few weeks ago, in today's deflationary environment Treasury ministers have a simple answer to the perennial question: "Where will the money come from?" The answer, according to Sir Samuel, is simple: "From the Bank of England's printing works in Debden."

But what happens when savers do regain enough confidence to start investing in real assets? Then the reallocation of capital from "risk-free" paper guaranteed by government to genuinely productive, but risky, economic assets will mean that the dangers of a prolonged depression are on the wane.

Then it will be extremely important for central banks to stop printing money and start raising interest rates to avoid global overheating and an inflationary crisis. At present, however, that is a problem the world's politicians, as well as its businessmen and investors, would love to have.