

Stumbling and Mumbling

An extremist, not a fanatic

February 05, 2009

Silly interest rate arguments

Alex Singleton claims that today's cut in Bank rate will prolong the recession. I think he's confused.

If the primary aspect of the financial crisis is the quantity of lending, focusing on cutting the price of credit and, thereby, making lending less profitable is exactly the wrong policy.

But Bank rate is not the price at which banks lend. It's the price at which they can borrow from the Bank of England. A low Bank rate therefore cuts the cost of funds to banks - especially because it drags down overnight Libor - which increases the profitability of lending.

You can complain about government demands that banks pass on the cut in full - as this won't restore their profits - but you can't complain about the cut in Bank rate in itself.

Why should we bother to save for no reward (given inflation) when we can eat, drink and be merry?

But if we do this, consumer spending will rise, helping lift the economy out of recession.

Now, by all means argue that these two mechanisms are weak; I think the pure substitution effect of interest rates upon spending is teeny. Or argue that they will be overwhelmed by the strength of recessionary forces. Or if you're being more adventurous, you could argue that a cut in Bank rate might worsen the recession by signalling ([pdf](#)) to agents that things are even worse than previously thought, which in turn leads people to cut spending.

But Mr Singleton's arguments, I'm afraid, are just wrong.

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"But Bank rate is not the price at which banks lend. It's the price at which they can borrow from the Bank of England."

Yeah, even I know that. In fact, you'd have thought just about everyone whose ever used a bank would know that. What a howler. Who's Alex Singleton anyway?

Posted by: [Shuggy](#) | [February 05, 2009 at 02:31 PM](#)



His comment that as a businessman he would far prefer to have funds available to borrow, than customers buying his product, is so bad that it is almost as if he wants to provide a living example of the sort of 1920's thinker that needed the Paradox of Thrift explained to him over and over again.

thanks for the pointer, Chris.

Posted by: [Giles](#) | [February 05, 2009 at 03:02 PM](#)



There is no point making borrowing cheaper when no one has any collateral. The average house has dropped 15k in the last 3 months. That is 15k I can't borrow from the bank regardless of how cheap the interest rate is!

You obviously have no idea of the real purpose of interest rates. They are not designed for governments to use as a switch. They are a legitimate tool to calculate the correct premium to cover the cost of risk, inflation and alternative investments.

If the government were not nailing the rate down, the open market rate would be well over 20% - which is what happens when your economy is allowed to boil over for too long!

The current situation is going to see stagflation for the next 4-5 years - minimum!

Posted by: [Foul](#) | [February 05, 2009 at 04:31 PM](#)



Singleton is right for the wrong reasons. Libor is the rate at which banks borrow from each other, the clue is in the 'interbank' part of the name.

They are not doing this anymore, so why care about LIBOR. It has lost its meaning. The BOE has lost control of monetary policy.

I don't think moving the bank rate has any effect now. Ok, so people can overpay their mortgages a little. That is not the solution to our problems

Posted by: [Cityunslicker](#) | [February 05, 2009 at 05:10 PM](#)



Good old Gordon! Good old Alistair! I've got a few hundred different currencies under my mattress so when they print more money and the pound goes to 500 to the ryal, the dollar and the euro, I'll be rich! What will they do next? Must figure it out. Anyway at this rate, I'll be able to buy Vyella, Wedgwood, Woolies and the House of Commons from the administrators with my euros. Nobody will be able to outbid me! Whoopee!

Posted by: [john problem](#) | [February 05, 2009 at 05:26 PM](#)



Alex Singleton has lost his mind. Lets have much higher rates so nobody could buy homes, cars or appliances that would surly help end our economic problems a lot quicker.

Posted by: [FX](#) | [February 05, 2009 at 05:51 PM](#)



Foul

They are not setting those interest rates. They are setting the risk free rate, which competes against Libor for money. The open market rate is still being set in a largely open and free market and is at broadly the right level - check out the BBA.

And your claim to have some understanding of rates is somewhat weakened by your statement that 'the' open market rate should be at 20 pc, without specifying who the borrower is, what the term is, and so forth. If you will post a link to someone willingly offering to borrow at that rate, i will be clicking very quickly.

Cityunslicker, the BOE never did control LIBOR. It sets risk free rates, not LIBOR. it only ever influenced monetary conditions, rather than 'set' them. And if risk free rates were much higher, money would drain from the risk-economy (ie. the private economy) and go just towards financing the government. Which we don't want.

Cutting risk free rates is the right thing to do right now. There is nothing clever in what Alex wrote, no matter how hard you look.

Posted by: [Giles](#) | [February 05, 2009 at 05:53 PM](#)



The Nationwide complained that cutting base rates would discourage saving and so make lending more difficult.

What's to stop Nationwide offering a higher rate for savers so they can get the funds to lend out at an even higher rate? How does the BOE base rate stop this?

Posted by: [Dipper](#) | [February 05, 2009 at 09:49 PM](#)



This concept of a Risk Free Interest rate is mainly theoretical because it is based on the country setting these risks not defaulting. Is our economy really strong enough to ensure this is the case?

My suggestion of 20% was not a calculated figure, just an indication that interest rate naturally increase when an economy is running too hot - which the UK has been doing since 98-99.

I think my point is that the main flaw in our system is that it isn't a free market. The fact that we have a central bank seems to prove this. The BBA is just a glorified union working within a closed shop.

With the interest rates being forced down, the only outcome is a long period of stagflation.

The only way to get people spending again is to work out where the disposable income has gone. The answer is tax - both the obvious type, and the extra costs being introduced by the public sector through additional charges for services nobody asked for (green taxes etc)

Until we have a chancellor who has the understanding of how business actually works and has the bolox to go against the lobby groups that hound Westminster, we are in for a number of long dark years.

Posted by: foul | [February 06, 2009 at 12:05 AM](#)



Your argument -

"A low Bank rate cuts the cost of funds to banks...which increases the profitability of lending"

only proves that -

"A low Bank rate cuts the cost of funds to banks...which increases the profitability of lending".

It is *not* a proxy for anything else, including that cutting the bank rate results in a greater quantity of lending by banks, all other things considered, since you are not considering all other things.

For example, in a competitive banking market, the lower cost of funds will result in lower lending rates, mitigating the benefits to the banks of the lower bank rate.

A further consequence is that with the lower lending rates, the risk of borrowers default is not changed but the returns on lending are lowered. Exactly what is not required during a 'credit crunch'.

Also, where is the evidence that the elasticity of saving to changes in rates is greater than the elasticity of lending to the same changes? I doubt very much that that is true.

Lending involves risk that is reflected in the interest rate structure. The state should not tamper with this by manipulating rates to suit its own agenda.

Posted by: Andrew | [February 06, 2009 at 09:09 AM](#)



The mechanism of transferring BoE interest rate cut into cheaper credit or bigger spendings is questionable. But more and more I have feeling central banks around the world are just desperately trying to do "something" and have no idea what will be the real result. And that's not good...

Lorne

Posted by: [toronto insurance broker](#) | [February 06, 2009 at 02:39 PM](#)



I can't help but think that keeping the rate on hold for another month might have helped consumer confidence in the long run by making it look like things were starting to get under control. The average man in the street sees a cut in interest rates as a desperate measure

Posted by: [Business Protection](#) | [February 06, 2009 at 10:29 PM](#)



You ignore two large elements of bank income (1) from current accounts that pay almost zero interest and (2) from the payments clearing system where money "disappears" for a few days earning no interest.

The absolute level of rates determines how much banks make from the above two scams, they make much less with rates so low.

Posted by: russ | [February 11, 2009 at 11:10 AM](#)



awesome

Posted by: [waqa](#) | [February 18, 2009 at 06:01 PM](#)



This is just one idea, and perhaps displays no more than my limited imagination. If there are better ideas out there, that amount to more than "implement something called "market socialism" and then - alacazam! - full employment!" then I'd love to hear them.
<http://www.watchgy.com/> mostly bank deposits, fell by £143.2bn in Q1. And of course there's no guarantee such buying will continue.
<http://www.watchgy.com/tag-heuer-c-24.html>
<http://www.watchgy.com/rolex-submariner-c-8.html>

Posted by: [breitling watches](#) | [December 27, 2009 at 05:28 PM](#)

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