Bank of england

Finance, Banking

The 2007-8, credit crunch in the UK was a result of a sharp increase in the number of defaults on housing mortgages. Mainly these mortgages were in America, however the effects of the decline of funds spread across the whole world. As Ishikawa notes (2009) the UK has also been hit hard with the current credit crunch, the banks are not lendingmoneyand the number of defaulters is increasing. The question being asked is what blame should be attached to the Bank of England for the impact of the 2007-08 Credit Crunch on the UK economy?

To answer this question, we shall begin by defining credit crunch, looking at its impacts and then finally analyzing the blame that should be put on Bank of England (BoE) What is credit crunch? Some financial disasters, such as the stock market collapse of 1987, came up unexpectedly. While, others such as the 2001 crash of the dot. com stocks, resulted from culmination of pricing bubble that had been broadly, though not globally expected to burst.

The current credit crunch certainly falls under the second type, because it has resulted mainly due to two factors, which are, exaggerated house prices and two, over-extended credit in the financial institutions. Brummer (2008) adds that, credit crunch could also be explained as sudden deficiency of finances for leading resulting to an ensuing decline in funds available for loaning. Credit crunch could occur for a number of reasons, including: 1. Sudden raise in interest rates for instance what happen in 1992, in UK when government raised rates to 15%. 2. Direct control of money by the government

3. Drying up of money in the investment market (Shiller, 2008) The genesis of credit crunch Shiller (2008) explains that, the current credit crunch started

in the U. S in 2007, at the moment when lending financial institutions' exposure to billions of dollars in terms of bad debt mortgages started to spiral. Anxietyregarding the feasibility of sup-prime mortgage lending spread along the financial systems, this undermined the capacity of banks as well as building agencies to borrow enough funds or continue feeling confident enough to lend to their customers.

All over the world in less than 15 months, there was a chain reaction of the happening in the U. S as it slowly became apparent that in a financial system that is globalized, bad debts had spread out to many national as well international banks without clarity on where the risks were (Shiller, 2008). The UK credit crunch: issues and impacts • The mortgage lenders in UK did not loan out a lot of bad mortgages. However mortgage lenders became much more relaxed in their lending over the past recent years. However, compared to U.

S the UK mortgage lenders, still had several regulations in place. • Nonetheless, this lending caused an extremely serious difficulty for the Northern Rock. Apparently, Northern Rock had the highest risk loans at 96%. At the same time most pf these loans were financed by reselling in the capital markets. The moment the sub-prime crisis began, Northern Rock was not able to raise sufficient funds in the normal capital market. Northern Rock was left with a deficit and ultimately it had to take an embarrassing action of requesting the Bank of England to give it emergency money.

Since Northern Rock has asked for emergency money or funds, its clients got worried and they started to with draw their savings, even though they were not directly affected. • Due to the credit crunch in the UK, its mortgage market has turned to be highly expensive. As a result risky mortgage schemes such as 125% mortgage have been taken away (squeezed) from the market • The UK banks such as HBOS are struggling tofinancetheir balance sheets, HBOS just like Northern rock it financed increased loaning through borrowing.

Now, de to the credit crunch, money markets have dried up and these banks can not raise sufficient funds to keep their liquidity. • Declining house prices: Since the mortgages are hard to obtain, the market for houses have fallen. Thus, the price for houses has declined. Cheap house prices, implies that a lot of people have negative equity. Consequently, mortgage defaults presently are costing banks a lot more since the banks can not even get back their initial loan (Shiller, 2008). What blame should be attached to the Bank of England?

In this current financial crisis times, it is important that we take time, and reflect on why the world and particularly the UK is going through these bad times. What in commonly agreed upon is that the main root cause of the current credit crunch is the financial system in which the financial institutions were much more interested in how much credit they provided, instead of judging the quality of loans being taken. However, Payne (2008) asserts that, the Bank of England being the central bank and the lender of last resort can be blamed for not doing much to regulate advice or assist the financial systems.

In the past the UK applied various methods of limiting the amount of money created by the banks. For instance in 19th century, gold was used to limit the flow of money, and from post world war to 1970s direct regulations on lending was used. However, with increasing opening up of global financial markets, the regulation measures being used became less effective and instead of the Bank of England modifying them it abandon these regulatory measures. From late 1970s to mid 1980s, there was continuous deregulation of the financial industry.

The reserve requirements were removed, limitation over the application of the whole sale markets were also removed, and building societies were regarded as banks. Credit that had initially been controlled was all freed, and a person could borrow any amounts of money. This seemed to be an approach to solve the problems of 1980s (Payne, 2008). However, it did not come as a surprise that these measures resulted in a big expansion of money supply and a credit-based property boom resulting in a recession of 1990s (Payne, 2008).

Similarly the Bank of England acknowledged that deregulating the financial markets had ended credit control but resulted in inflationary boom. Sadly for some unexplained reasons these occurrences were soon forgotten. Monetary policies by the Bank of England continued to be focused on " freedom to borrow and to own" (Payne, 2008). The inflation rate was to be maintained at 2%, something the Bank of England was claimed was doing. But, the Bankfailureto learn from the past experiences on what happens in situations where credit is over-provided.

Instead it chose to depend on its prestige of keeping inflation at the set rates, which had proved to be completely ineffective in sustaining the economy. On other hand, Payne (2008) explains that, the banks were merely doing their duty in a political strategy that believed that promoting the desire to own property was the greatest thing. Thus, this where the Bank of England should be blamed, past financial crisis tells us that, giving banks freedom to give out loans without any restrictions is a recipe for financial problems.

The mere fact that the Bank of England understood this aspect very well, and yet we are facing credit crunch is a clear indication of its failure. Poor handling of Northern Rock crisis Montia (2008) explains that according to the Treasury select committee, that was appointed to examine the Northern Rock crisis together with other issues surrounding the current credit crunch, has blamed the Bank of England as well as Financial Services Authority (FSA), for their failure in ensuring that financial institutions tackled serious risk in their businesses.

Though the committee agrees that the Bank of England tried to warn the businesses concerning the impacts of a decline in the lending market, the committee concluded that the structure of giving warnings of possible financial problems is weak and ought to be strengthened. The bank was slow in reacting to the crisis Conway (2008) quotes David Blanchflower, a member of the bank of England as admitting that the BoE was slow in reacting to the financial crisis. He explains that the Bank failure to act quickly enough in cutting the rates and this might now mean that the country will experience a long lasting and painful financial recession.

According to David Blanchflower, the BoE was not anticipative enough and should have realized the extent of the financial crisis earlier. This acknowledgement comes in the middle of confirmation that the country is indeed facing financial crisis. As Conway (2008) states that, extraordinary situations call for extraordinary measures. Thus, the current financial crisis required that the bank take extraordinary measures like drastically cutting interest rates. However, the bank reaction was slow and even if they have reduced interest rates, their timing was not perfect (Edmund Conway, 2008).

In addition Conway (2008) explains that, the Bank of England is not being blamed for not supplying enough money the moment the credit crunch set in, however it is being blamed for allowing inflation momentum to continue. Accordingly the bank's measures on reducing interest rates are seen as unpopular action. Interest rate cut the decision by the Bank of include to reduce the interest rates to 1. 0%, the lowest in recent history might have been expected but it has attracted a lot of negative comment . Interest rates have been reduced five months consecutively and are currently as states at the lowest rate in the history of the bank.

However, according to economist Rose Altman, the bank is making another policy mistake, (Brummer (2008). Brummer (2008) quoting Altman say that, more panic reductions does not answer the economic crisis. Though the bank policy makers are frantically attempting to boost the crumpling economy and promote more spending, however, Brummer (2008) notes that lowering interest rates is an extremely primitive weapon. Accordingly he point out that this is a way of punishing those who have money and want to spend whilst benefiting the same groups (specifically banks) whose acts resulted in the present financial crisis in the first place.

Indeed, thisobservationis supported by Montia (2008) who notes that, lowering the rates is hurting. He adds that, it is punishing those who save, since lowering the rates is affecting their earning, while its impact on improving the economy is not being felt. Even if this observation is not entirely correct, the truth is cutting the interest alone is does not provide an answer to the current economic crisis, and people are blaming the bank of this. They point out that the bank should do much more to make the banks start lending once more. Quantitative easing

Experts point out the bank of England has declined to undertake quantitative easing measures and instead have opted for lowering the interest rates. According Payne (2008) quantitative easing are approaches used to boost economy after the normal monetary policy measures like interest rates reductions have been failed. Quantitative easing requires that the central banks floods the banking industry with lots of money, much more than it is required to maintain the official interest rates at a lower rate or even at zero. This then is able to overflow the banking system and boost lending.

The central banks normally carry out these processes by buying up huge quantities of assets owned by the banks. Werdigier (2007) points out that this method was used by Bank of Japan (the central bank of Japan) in 2001 when the economy went down due to the busting of the dot-com bubble and remained down. A lot of experts and a number of Bank of Japan policy makers, at first were cynical of if that policy could revive the economy. However, a lot of them agreed that the measure was able to restrict deflation and prevent more severe banking crisis.

Werdigier (2007) explains that, the extra money cushion implied that banks that were burdened with huge nonperforming loans evaded a liquidity crisis and were thus able to undertake bolder measures streamlining their loan portfolios. Rather than, depending on traditional monetary polices of cutting interest, the Bank of Japan set a specific target of money it forceful fed into the financial system. This worked. Accordingly the Bank of England is being blamed for not taking this approach (that is currently being used by the U.

S Federal Reserve) earlier instead of focusing on cutting interest rates. Delayed in bailing out financial institutions The Bank of England also has been criticized by other financial institutions like the Citi financial, for its optimistic approach regarding the current credit crunch. According to observers, the meltdown is causing loss of jobs, and all sectors are bound to be affected. Indeed the Bank of England was also blamed for not bailing of the troubled financial institutions on time.

As Cooper (2008) explains, individuals as well as companies go for loans to get money to finance their expenses on buying of goods or services. But, if banks fail to lend out money, people and companies will not expend. It is generally accepted that if banks fail to loan the economy will be not develop. However, this is not the major aspect. Cooper (2008) asserts that a bank loan results in a bank deposit, the deposit is not destroyed if an individual spends that money. It only goes to the supplier of the goods or services or the person selling them. Money can only be passed around.

Thus Cooper (2008) explains that supposing, money and economy are varied in their adjustment, then, the econmy has to adjust the money. However, he asserts that this continuing aspect, that is very essential, is not broadly appreciated by the Bank of England. He points out that in 2007 when the credit crunch began, the biggest threat was the decrease in banks lending that resulted in deficient monetary growth. Supposing the Bank of England would have steeped in immediately, Cooper (2008) concludes that the crisis would not have been this severe. Conclusion

The current credit crunch can be attributed to various factors including previous monetary policies undertaken by the Bank of England the deregulated the financial institutions and encouraged borrowing without putting any limitations. The U. S credit crunch has also had very strong ripple effects on the UK economy and also it has contributed a lot to the crisis in the UK. In addition the fall in Mortgage backed securities (MBS) was another critical issue in causing the current financial crisis. Though, it might have been hard to prevent the credit crunch, the Bank of England is blamed for various misdeeds.

Among them is that, the bank's response was slow, its policy of reducing interest rates seems to be ineffective, it did not take quantitative easing measure quickly, it failed to effectively handle the Northern rock crisis, and more so its bailing of financial institutions in crisis was late. In worlds of Payne (2008) the mere fact that the Bank of England understood that, deregulating the financial system and allowing people to borrow money as they want is aspect very well, and yet we are facing credit crunch is a clear indication of its failure

Reference: Brummer, A: (2008): The Crunch: The Scandal of Northern Rock and the Escalating Credit Crisis; Random House Business Books Conway, E (2008): Bank of England member David Blanchflower admits bank was slow to act on rates: Retrieved on, 13/3/2009, from: http://www. telegraph. co. uk/finance/economics/3280664/Bank-of-England-member-David-Blanchflower-admits-bank-was-slow-to-act-on-rates. html Cooper, G (2008):

The Origin of Financial Crises (1st edition): Central banks, credit bubbles and the efficient market fallacy: Harriman House Publishing;

Ishikawa, T (2009): How I Caused the Credit Crunch: Icon Books Ltd Montia G (2008) Failures of Bank of England: Retrieved on, 13/3/2009, from: http://www. bankingtimes. co. uk/03032008-mps-report-on-credit-crunch-failures-of-boe-and-fsa/Mps Payne C (2008): Shame on the Bank of England: Retrieved on, 13/3/2009, from: http://www. guardian. co. uk/commentisfree/2008/oct/10/creditcrunch-bankofenglandgovernor Shiller, R (2008): The Sub-prime Solution: How Today's Global Financial Crisis Happened, and What to Do About It: Princeton University Press

Turner, G (2008): The Credit Crunch: Housing Bubbles, Globalizationand the Worldwide Economic Crisis: Pluto Press Werdigier, J (2007) Bank of England, in about-face, injects cash into money markets: Retrieved on, 13/3/2009, from: http://www. iht. com/articles/2007/09/19/business/boe. php Appendix: The credit crunch that hit the UK banking industry 2007 had a direct impact on the UK’s property Market Retrieved from: www. creditcrunch. co. uk/graphs/