

Richard Lambert, Letter to CBI Members

Tuesday, 14 October, 2008

The Government's decision to inject new capital into a number of major British banks is a bold and necessary step. By the end of last week, it had become clear that the global financial system faced systemic risks of a very serious nature. Here in the UK, it is fair to say that the collapse of the wholesale money markets had pushed some of our biggest banks dangerously close to the edge of a precipice.

Failure to act decisively to prevent a total breakdown in the credit markets would have had adverse consequences for the whole economy and for our society in general. In the face of these threats, the UK took a leadership role and other countries are now following.

The medicine seems to be working, at least so far. The overall stock market has rallied sharply, both here and around the world. Just as significantly, credit default swap rates on our major banks have fallen very sharply indeed in the past few days. A week ago, they were discounting something close to Armageddon. Now they are mostly below where they stood a month ago, although they remain well above the levels of this time last year.

It will take longer for the impact of the support package to flow through to the interbank lending market, because trust will take time to rebuild. Fifteen months ago, banks were willing to lend to each other for three months or more on an unsecured basis for a very narrow margin. It will be a long time before that degree of confidence is fully restored.

There are, thank goodness, very few precedents for a crisis on the scale that we have seen in recent weeks. Perhaps the nearest parallel is with the summer of 1914, when the credit markets collapsed in the run up to the First World War.

The stock exchange was closed, banks took a forced holiday, and queues formed outside the Bank of England to withdraw sovereigns.

It takes large scale intervention to check panic on such a scale, and this is certainly what we have seen in the past few days. The Government has built a mighty firewall around our major banks, designed to withstand the most severe economic downturn. We are by no means out of the woods, and significant risks remain. But it is reasonable to hope that a corner has been turned.

However this action is not cost free. Necessary though it is for the short term, it raises some serious issues that will have to be addressed over the longer term horizon.

First, it will have fiscal consequences. It is clear that the liabilities the taxpayer is taking on will be largely offset by the new assets that will be acquired at the same time. Indeed, it is possible that we might even make a profit out of these arrangements at some future date.

But the UK's public finances were already deteriorating before this shock took place. These new public investments will add a large and difficult-to-quantify load to the fiscal deficit on a scale which is bound to affect tax and spending decisions in the years ahead.

This fiscal stretch may be bigger for the UK than for other large European economies, given the relative size of our financial sector.

Second, the taxpayer will become a significant shareholder in a number of Britain's most important banks. The Government has very properly emphasised that it sees itself as a temporary investor, and that the banks concerned will be run on an arm's length basis.

But at the same time it is taking an interest in lending policy – as part of the deal, the banks involved will be obliged to maintain their lending on mortgages and to small and medium-sized enterprises over a three-year period. It is also overseeing compensation and dividend arrangements, and the appointment of non-executive directors.

The way it actually interprets its new role will be critically important to the economy so long as these arrangements last.

This direct public shareholding will inevitably lead to a fresh look at bank regulation in the coming months. Again, the outcome of this exercise will help to determine the way our economy works in the future.

Finally, it's very important not to allow what has happened in the global banking sector to undermine the belief in our broader market economy. For all its flaws and upsets, this has proved itself to be by far the most effective way there is of allocating resources and raising the prosperity of everyone. Of course, sound regulation has a vital role to play. But the CBI will continue to argue passionately for the merits of open markets and dynamic business enterprises in the years ahead.

The big unanswerable question now is about how all this will affect the real economy.

There is little doubt that the shock will have an impact on consumer confidence, which had already fallen to a point below that seen in the recession of the early 1990s. There is evidence, too, that businesses are reining back on their spending plans and looking to cut costs where it makes sense to do so.

It's important to remember that there are real forces for stability in our economy. Our flexible labour markets help us to adapt to changing economic

circumstances more readily than is possible in other European economies. And there is a further cushion in the pool of immigrant labour, as a number of central Europeans find it easier to get work back home.

The sharp fall in sterling should help to support the trade figures over the coming year.

And we believe there will be further room for cuts in the Bank Rate from the current 4.5 per cent. Inflation as measured by the Consumer Price Index hit 5.2 per cent last month, but this should be the peak or close to it. The coming slowdown will increase the degree of spare capacity in our economy, leaving room for the Bank Rate to be brought down further.

Despite all this, and the continuing strength of a number of important business sectors, there is little doubt that economic conditions are deteriorating. The CBI's surveys of our members point to a marked decline in expectations of future activity. And surveys also suggest that credit conditions are tightening, especially in the case of small and medium sized enterprises.

The taxpayers' support of the banking system has prevented what could otherwise have been a very serious economic recession. But 2009 will still be a very tough year for many of our member companies.

Yours faithfully,

Richard Lambert
CBI Director-General