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Britain's Inflationary Debt Spiral as Bank of England Keeps Expanding Quantitative Easing

By Nadeem Walayat
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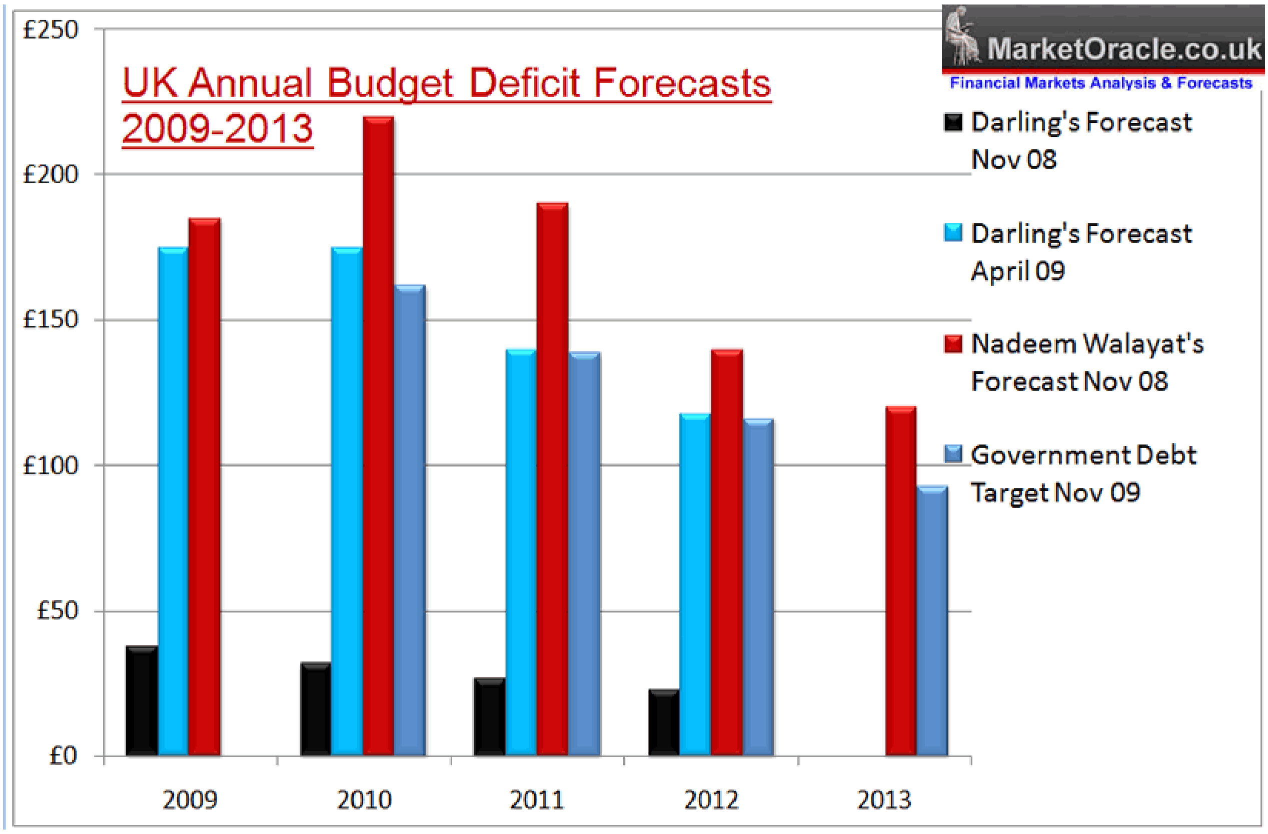
Over the coming years we will witness the systematic destruction of the British currency as witnessed through the inflation and commodity / asset price data as the Inflation Mega-trend starts to unfold following the asset price destruction induced Deflation of 2008 into early 2009.

This is the next in a series of articles as part of my inflation mega-trend scenario that I am in the process of writing up to complete before the end of December and to finally publish as an ebook that I will make available for free. Ensureyou are subscribed to my always free newsletter to get the latest analysis in your email box and check my most recent articles on the inflation mega-trend at http://www.walayatstreet.com

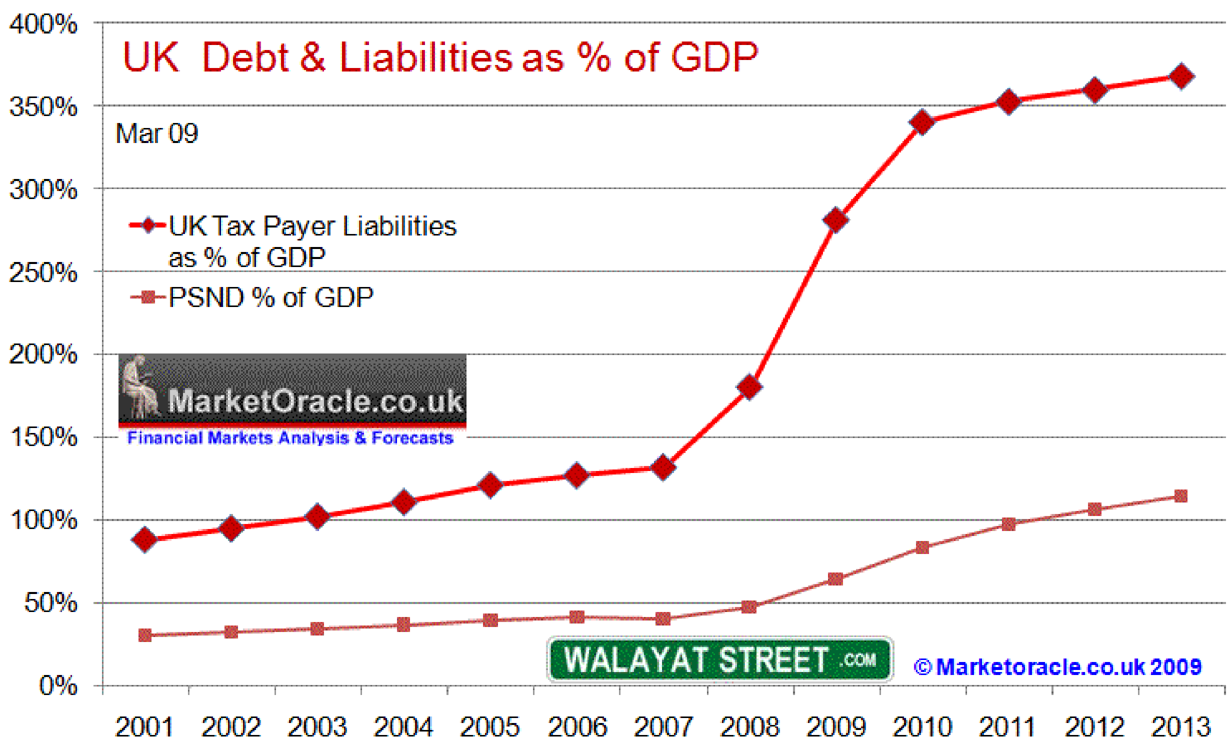
UK Debt Crisis Deepens as Government Plans to Borrow Another £510 billion

The Labour government announced in the recent Queens speech with much fanfare a LAW to halve the public sector net deficit over the next 4 years. Lets leave aside for the moment that the Labour party is confusing calling an objective a law for purely political electioneering purposes in an attempt to place a burden around the next Conservative governments neck. The objective of the Law is to halve the deficit and NOT to pay down the total accumulating debt. What this amounts to is that the annual budget deficit of approx £185 billion for 2009/10 being halved to an annual deficit of approx £93 billion by 2013/14 which suggests Britians National debt is expected to increase by a further £510 billion to an approximate total of £1,300 trillion or 100% of GDP by 2013/14.

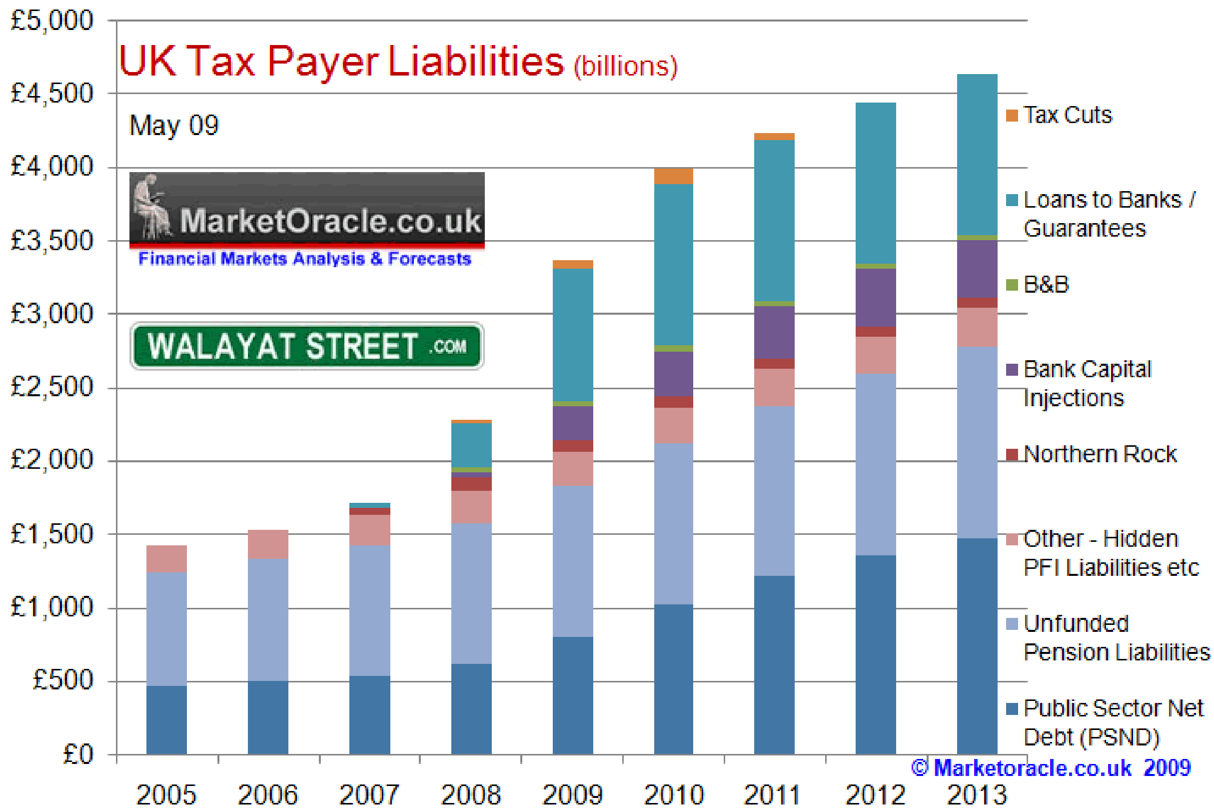
The below graph illustrates the updated Government projection for the annual Public Sector Net annual deficit against Alistair Darlings November 08 and April 09 targets, as well as my original estimate of November 2008 (Bankrupt Britain Trending Towards Hyper-Inflation?) that remain unchanged.



The target PSND of £1,300 trillion would approximately equate to 100% of GDP by 2013/14. This is against my original target as of November 2008 of £1.48 trillion by the end of 2003/14 at a projected 114% of GDP.



Therefore there is nothing announced in the governments targets nor any change in economic circumstances that warrants amending the total liabilities target of £4.75 trillion by the end of 2013/14, which confirms that Britain remains firmly on the path of a probable decade of economic stagnation coupled with high inflation i.e. stagflation.



However the problem for Britain is that whilst the British economy stagnates, many of the other world economies will not stagnate but grow thus forcing up the price of commodities, goods and services and hence result in higher inflationary pressures. Which therefore implies that the budget deficit will be widen further as public spending will need to be higher in an attempt to counter loss of purchasing power of the currency. A higher budget deficit would require higher interest rates and therefore more monetization of government debt which confirms the vicious inflationary debt spiral cycle. The only true answer to escape this viscous inflationary cycle is to get a firm grip on the budget deficit in the immediate future, the longer we leave the debt to grow the more difficult it will become to deal with.

Setting a target of halving the budget deficit over the next 4 years is not going save the economy from stagflation as by the end of this period Britain will still owe far more than it does today so actually be in a far worse budgetary and probable economic state in real-terms.

Quantitative Easing Necessary to Monetize Debt

The Bank of England embarked upon a programme of printing money or Quantitative Easing during March 2009 with an initial print run of £75 billion of a total set at £150 billion in an attempt to wave the central bank magic wand to increase the supply of credit. However as I warned at the time (5th March 2009: Bank of England Ignites Quantitative Inflation) that once started the Bank of England would continue printing money right into the May 2010 General Election targeting an print run of as much as £450 billion and therefore igniting Quantitative Inflation during 2010.

Virtually all of the mainstream press swallowed the Bank of England's hints and winks that Quantitative Easing had ended at £125 billion during the summer months, which at the time I stated was not possible (8th July 2009: Irrelevant UK Base Interest Rate on Hold as Real Rates have Already Begun to Rise)

This confirms my view that the Bank of England will continue printing money into year end to beyond the current arrangement of £150 billion and probably as high as £250 billion.

I projected a Quantitative Easing total towards £250 billion by the end of 2009 with the current tally now standing at £200 billion of money printed which is to mainly buy government bonds issued as a consequence of the huge budget deficit that the Labour government will rack up by the end of this year that projects to £175 according to Alistair Darling which is up from his earlier projection of £38 billion in November 2008 as a consequence of the Labour Government's objective of aiming to both aiming to maximise the number of seats retained at the next General Election as well as to deliver a scorched earth economy to the next Conservative Government. Quantitative Easing is critical for the purpose of monetizing government debt for without it UK long dated interest rates would have to be much higher as a consequence of lack of demand for the huge amount of new debt issued.

The debt outlook for subsequent years remains bleak with budget deficits expected to continue for many years as Alistair Darling's own forecast for government net borrowing over the next 4 years has grown from a deficit of £120 billion in November 2008 to £608 billion as of the budget, which is still below my forecast total of £735 billion and therefore the expectation remains for further revisions to the upside over the coming years. This confirms my view that the Bank of England will just continue printing money regardless which on face value is both inflationary and supportive of the economic bounce in the immediate future, both coupled together i.e. economic bounce and money printing imply a surge in UK inflation is only just around the corner.

Britain's Debt Spiral Ensures Quantitative Easing Will Continue

Quantitative Easing now totals £200 billion which equates to about 15% of GDP which compares against U.S. Q.E. at approx 5% of GDP which illustrates that Britain is further on the path towards higher relative inflation than most major economies and therefore targeting a weaker exchange rate despite competitive devaluation.

The Bank of England will not stop printing money whilst huge budget deficits persist that will not be borne but he open market which would demand much higher interest rates. As the total national debt grows then so will the interest payments demanded to service this debt which means that the deficits will expand further which means even more money printing. Back in 2007 public sector net debt was about £534 billion which demanded interest payments of about £24 billion, now it is over £1 trillion demanding about £36 billion in annual interest payments. However as the government is eventually forced to raise interest rates by the market then so will the debt burden grow both as a consequence of the higher rates and higher next public debt that in 4 years time could demand annual interest payments as high as £100 billion per annum. Therefore Britain HAS entered into a vicious money printing cycle towards much higher inflation than we have experienced during the past 10 years where even if the economy grows increasing tax receipts will not be able to bridge the ever growing gap between income and expenditure including ever higher interest payments hence the perpetual debt spiral.

The implications of the debt spiral should be seen in the currency markets which does not bode well for a stable exchange rate, off course as mentioned earlier competitive devaluations as a consequence of other countries also to varying degrees immersed in their own debt spirals suggests that the real impact will be seen in inflation data and fiat currency alternatives such as GOLD.

Money Printing to Monetize Debt.

The Bank of England recently week announced that it would conjure another £25 billion out of thin air bringing the print run to a total of £200 billion that has a money supply multiplier effect through fractional reserve banking of approx £600 billion, normally this would be X20 to X40 but the Taxpayer bailed out bankrupt banks are just sitting on the cash hence the multiplier is much lower at this point in time, that and the fact that the bulk of the money is being used to monetize Government debt. In response to this Mervyn King has threatened negative short-term interest rates to force the banks to lend.

Money Printing Only Solution to Debt Financing

Without Quantitative Easing the Gilt auctions would fail as there is no way the market can swallow near £200 billion of new debt per annum or 15% of GDP, add to this maturing debt that needs to be rolled over which means that there is no end in sight to Bank of England money printing in ever escalating amounts to keep monetizing the debt. So again no matter what the Bank of England states about bringing Q.E. to an end, it is just not possible given the debt fundamentals to do so as we will see today's £200 billion extended to £250 billion then £300 billion onwards and upwards to eventually £500 billion or more than 40% of GDP.

Bankrupt Governments Following Bankrupt Banks into Debt Defaults and Bailouts

Last weeks major market event came late in the week whilst American's took the day off on Thursday for Thanksgiving, Dubai declared that it will be freezing repayments for at least 6 months on part of its approx $90 billion or so of visible debt at the state run Dubai World company ($20 billion). The ratings agencies responded by cutting the ratings on Dubai bonds to junk status.

Whilst the consequences of Dubai's debt fuelled real-estate boom and subsequent bust should not come as any surprise, however oil rich Abu Dhabi coming to its own inevitable shock realisation that it just cannot afford to keep footing bailout bill after bailout bill for their buddies just a few sand dunes away which triggered the market reaction as the consensus expectation had been that they would. However this is not September 2008 and Dubai Worlds debt freeze / default is not on anywhere near the scale to that of Lehman's bankruptcy so the perma-crash is coming NOW crowd were AGAIN disappointed, just as they have been on EVERY stocks correction during the past 9 months!

Analysts for the more mainstream agencies such as Reuters called the news out of Dubai a black swan event (A black swan in the desert), well to the mainstream press these days virtually everything is now a black swan! I assume Nassim Taleb never meant for events such as Dubai's debt freeze to be termed as a Black Swan? After all the whole point of the black swan theory is to suggest that black swan's are rare and totally unexpected events, i.e. along the likes of Arch Duke Ferdinand's assassination triggering World War 1, and not one of the the dozen or so in-debted teetering on the brink economies eventually going pop !

I mean there is a long trail of suspect economies dating back to September 2008 when Iceland first went pop, with a dozen or so contenders other than Dubai including Ireland, Venezuela, Argentina, Greece, Portugal, Spain, the whole eastern block and not forgetting Britain! Its only a matter of time before another country goes pop, which one could be next ? Well going by the credit default swap risk prices on sovereign debt, Venezuela tops the list, though closer to home I would definitely be wary of Greek stocks and bonds! the safest in terms of default risk are France and Germany which by and large missed out in the debt fuelled boom.

I specifically warned about Dubai back in March 2009 that the 22% drop in property values at the time where not even half way there, that projected to something along the lines of an average drop of 50%. Where are we today ? You guessed it average property prices in Dubai are now 50% lower than the peak! Which says a lot for the so called Dubai property experts back in March who were calling a bottom for Dubai property prices, though if one took an look under the bonnet one would see that these 'experts' had a vested interest in rising prices! Much as we saw with our very own soon to be bailed out mortgage banks in the UK such as HBOS which pumped out soft landing propaganda during 2007 and first half of 2008, which I repeatedly ridiculed as utter gobbledygook.

March 2008 – [UK House Prices Tumbling- Interest Rate Conundrum]

Britains biggest mortgage bank also gave a positive spin on UK House prices in March 08, the Halifax's Chief Economist continued to suggest that there will be no fall in UK house prices this year. – "strong underlying fundamentals will continue to support the market throughout 2008". "Over the past year, the average price of a home in the UK has increased by £4,390 to £196,649," he commented. "Whilst the housing market has slowed over the past six months, it is supported by sound economic fundamentals. Interest rate cuts by the Bank of England are also helping to underpin house prices,".

My earlier analysis of [February 2008] illustrated why it was impossible for UK house prices to avoid going negative in April 08, not only that but even if house prices stabilised and no longer fell, that the property market would still be heading for a sharp year on year fall for the quarter April to June 2008, which the media would eventually term as a mini-crash for the UK property market as the below table from the February article illustrates.

8th March 2009 – [Dubai Property Market Crash]

A warning to those investors being swayed, the Dubai property crash has only just begun which seeks to correct a 6 year property boom. The Dubai construction boom is expected to come to an imminent halt with many partially finished projects littering the landscape as investors walk away from the off plan deposits in the wake of the ongoing crash in property values. It remains to be seen how much of this excess supply will eventually be reclaimed by the desert as many foreign investors in off plan Spanish properties are painfully experiencing. My expectations are for an average 50% retracement in Dubai property prices from the peak, with many of the more over-leveraged high end properties possibly crashing by as much as 75%.

So where next for the Dubai property market? Well the crash is NOT over, we are in free fall territory towards a 75% drop! Maybe the worst case scenario may yet come true i.e of the desert reclaiming large chunks of abandoned developments?

The Dubai debt crisis gave plenty of skin deep copy text for deflationists to continue betting on another imminent Market Collapse, that FAILED to materialise Friday! However to interpret what is probably likely to follow one needs to peel away several layers than opt for the obvious i.e. debt deleveraging deflation, as I continue to develop the inflationary mega-trend over the coming weeks as a consequence of ever greater money printing in the face of escalating debt burdens that ensure INFLATION. Your money will be worth significantly LESS as a consequence of Money Printing! The Deflationists Advocate the WORST solution of cash being King. Stocks are Up more than 50% since March, Gold is up more than 25% over the past year, does this sound like cash is king to you?

My good Deflationist buddy, Mike Shedlock questioned my inflationary logic earlier in the week to which I replied here –[Mike Shedlock, a Deflationist Lashing Out at Nouveau

Inflationists?

Don't get me wrong, to be of a deflationary mind set from mid 2008 and into March 2009 was correct, but being stuck there for the past 9 months is tantamount to giving up Most of not ALL of any gains for being right during the DEFLATIONARY downdraft, which my analysis has concluded was a temporary corrective wave in a ocean of inflation. Will we have more deflationary corrections ? Off course we will (great buying opportunities!), Will they be as severe as 2008/09? No Chance! How will one protect ones wealth and make money ? By gearing towards accumulating towards higher overall inflation and its consequences which I will continue to elaborate upon during the coming weeks.

Britain at the Core of the Dubai Property Bubble

Out of the $80 billion or so of Dubai debt at risk of default, some $50 billion of that is with UK banks or near 66%! Why ? Because it is symptom of the spread of the British disease of blowing property bubbles that eventually burst. As UK house prices reached to the stratosphere during 2005 to 2007, British speculators of all sizes spread their wings further a field across Europe (East and West), across the Atlantic (Florida) and Across the Middle East into Dubai, where the smaller the local market and less regulated the greater the subsequent boom and hence the greater the subsequent bust. What does this mean ? It means as property induced bubbles continue to explode right across the world, the impact of them will be even greater on Britain than the local economies, as the UK government will once more have to step forward to bailout bankrupting UK banks, failing that to provide teetering on the brink banks with ever greater amounts of liquidity in an attempt to kick start lending.

Higher UK Interest Rates Are Inevitable

Regardless of the objective of the Bank of England to KEEP UK interest rates at ZERO for the foreseeable future, the fact is that the growing government debt issuance and despite monetization of the debt via money printing which has the effect of driving sterling lower is that the market will eventually FORCE the Bank of England to RAISE interest rates, i.e. gradually we will see the Government losing control over the levers of power as the market will not stand to watch losses mount on government bonds as inflation statistics respond to the real world increase in commodity prices. My interest rate forecast for 2010 will expand on this, ensure you are subscribed to my newsletter to get this in your email box.

Declaration of War on Savers

The people of Britain are being hoodwinked by the politicians and inept mainstream media into thinking that money printing is a free lunch, there is no such thing as a free lunch, printing hundreds of billions out of thin air is akin to running a fiat currency ponzi scheme, the price of which is paid by the holders of existing currency i.e. investors, bond holders and savers who are hit by the double whammy of –

a. Artificially low interest rates of 0.5% which results in NEGATIVE REAL INTEREST Rates, increasingly so as I expect inflation to rise considerably as part of the inflation mega-trend.

b. The devaluing currency as the money supply increases well beyond that of the average of the past 10 years. Again don't be fooled by the British Pound holding steady against other fiat currencies as all of the worlds central banks are engaged in their own ponzi schemes aimed at defrauding exiting currency holders of their real value.

Ever escalating money printing is a silent declaration of war on the value of every British citizens hard earned current wage and accumulated savings. All prudent savers are suffering in terms of the loss of quality of life as interest rates have been slashed in many cases to less than 0.5%, making life time accrued savings of more than £100,000 worthless in terms of income generation with worse to come as money printing seeks to stealthily destroy the capital value as well.

Inflationary Consequences of Escalating Debt and Money Printing

The consequences are INFLATIONARY, inflation means RISING CONSUMER PRICES which in the UK means rising RPI and CPI indices. Inflation rises as more fiat currency chases a limited supply of commodities, goods and services, more so in a stagnating economy which over time sees diminishing output, it is only that at the present that the consequences of debt deleveraging is MASKING the building inflationary forces that will let rip with a vengeance which we are already witnessing in the commodities markets as many markets such as gold and crude oil have doubled from the Post September 2008 lows.

Nadeem Walayat has over 20 years experience of trading derivatives, portfolio management and analysing the financial markets, including one of few who both anticipated and Beat the 1987 Crash. Nadeem's forward looking analysis specialises on the housing market and interest rates. Nadeem is the Editor of The Market Oracle, a FREEDaily Financial Markets Analysis & Forecasting online publication. We present in-depth analysis from over 400 experienced analysts on a range of views of the probable direction of the financial markets. Thus enabling our readers to arrive at an informed opinion on future market direction. http://www.marketoracle.co.uk

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