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Between Northern Rock and a Hard Place

Northern Rock's travails and the Bank of England's response highlight a number of important points:

First, while the stress in short-term funding markets remains acute, there is a higher-than-usual risk that borrowers dependent on short-term finance – financial intermediaries, investors, or corporates – could face a business-threatening liquidity crisis. As Exhibit 1 shows, Northern Rock was vulnerable because its deposit base was relatively small compared with its loan book.

While the risks may be higher than usual, quantifying them is difficult. However, it's important to understand that while economic risks are centered on the US, credit dislocation is now global, so the risks are elevated in a range of markets.

Second, the Bank of England's response is justified by its role as guardian of the financial system, epitomized by its role of lender of last resort. While having a lender of last resort can create a degree of moral hazard, the Bank of England's approach – a targeted response to clear signs of distress, and charging a penalty rate – hardly seems likely to encourage renewed risk taking or prevent losses by investors for their poor investment decisions. This is no King put.

The Bank of England's response is consistent with the new emphasis by central banks on the distinction between their roles as bulwarks of the financial system and as macro-economic managers. This is a distinction that was blurred under the Greenspan Fed, which often used its principal macro-management tool – the Federal funds rate – to address what were essentially systemic threats (such as the Long-Term Capital Management collapse).

Exhibit 1

Northern Rock's Funding Problem

	Deposits	Total Assets	%	
Abbey	115	284	41%	
Barclays	339	997	34%	
HBOS	212	447	47%	
HSBC	897	1,746	51%	(dollars)
Lloyds	61.2	148	41%	
RBS	384	871	44%	
Northern Rock	**26.867**	**101.01**	**27%**	
Nationwide	80.9	120.6	67%	
Yorkshire BS	11.3	17.6	64%	
Bradford and Bingley	19.7	45.354	43%	

Data as at end-2006
Source: Company annual reports; Morgan Stanley Research

In my view, the Greenspan Fed compounded this inappropriate use of its macro tool for system-management tasks by keeping the funds rate too low for too long once the systemic problems had disappeared. In the case of the LTCM episode, for example, the funds rate wasn't returned to its pre-crisis level until November 1999, 14 months after the original easing.

Third, that Central Banks now seem eager to differentiate their systemic responsibilities from their macro-management responsibilities can be seen as a backlash against the Greenspan approach. It's clear that policy-makers want to minimize the moral hazard effect of protecting the financial system. No succor for suckers. This, in turn, reinforces the view that the policy-makers are not aiming to restore market pricing to pre-crisis levels; in fact, the events of the past two months confirm their view that risk had become seriously mis-priced through this cycle.

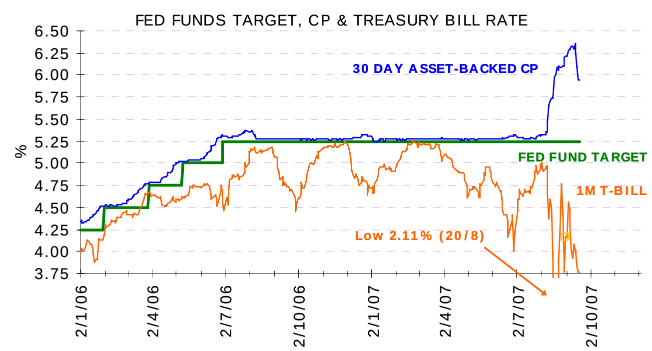
Fourth, the fact that Central Banks are not likely to ease to settle credit markets is a critical difference between now and both the 1998 crisis and the post-1987 equity market crash. The extended rallies that followed those market setbacks were given material support by monetary policy that, at least in hindsight, was clearly too loose. Today's central bankers are eager to avoid repeating that mistake. Importantly, that suggests that using the performance of risk markets in 1988 and 1999 onwards as a guide to how markets may perform through 2008 is, in my view, a mistake.

Fifth, the Federal Reserve is the only major central bank in the world now contemplating a shift to easier monetary policy – and that's because it is the only major central bank in the world managing an economy where the macro-economic risks have tipped towards below-trend growth. Elsewhere, macro conditions point to possible further tightening. In fact, last week saw rate increases announced in China, Chile, and Switzerland. My hunch is that if the problems in short-end credit markets are resolved quickly, the tightening campaign would resume in a number of economies.

In my view, the ongoing tightening of monetary policy outside the US represents a second important risk to the global growth outlook in 2008 – the other risk being that of a US recession. The combination of US slowdown and broad-based monetary tightening – and an uncertain degree of lender restraint – makes it increasingly likely that 2008 will be a year of global disappointment for growth and earnings. This is another reason to think that 2008 will not follow the 1988/1999 template for equity markets.

Finally, while I remain bearish on the outlook for next year, I'm impressed by the recent resilience of equity markets: After disappointing payroll data, disappointing sales data, and a run on a UK bank, the S&P 500 index is higher than it was two weeks ago. In a sense, that fits with my view that there will be one last rally, but such insouciance in the face of news that I considered fairly bearish has still surprised me. Calling short-term moves is not my forte, but this may be a repetition of the equity market's resilience in the face of credit distress through May-June – resilience that, as the bad news continued, could not be sustained. Having said that, the risks of a near-term equity market setback would be reduced if the tentative signs of improvement in short-term funding markets signal that the stresses there are past the worst (Exhibit 2).

Exhibit 2
Stress Starts to Ease



Source: Bloomberg, Morgan Stanley Research

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