

UK economy special

Measuring the fallout

November 2008

Summary

- *The UK is likely to experience a recession of similar depth and magnitude to that of the early 1990s.*
- *Interest rates will be cut further, reaching 2% early next year.*
- *As banks bring lending more into line with deposits, credit will remain tight into the medium term.*

The spate of rescue packages announced in Britain and many other countries has finally brought a modicum of stability, although wholesale money markets remain extremely dislocated. Attention has now turned to gauging the fallout on the real economy.

The UK economy was already shrinking before September's crisis struck. The preliminary estimate of third-quarter GDP showed the first contraction in 16 years, and the largest since the recession of the early 1980s. The events of the past two months will only make matters worse, at least in the short term.

There is an important silver lining. Since the summer, the price of crude oil has more than halved, adding weight to the view that inflation is now yesterday's story. This has opened the way for aggressive interest rate cuts by the Bank of England, with Bank Rate expected to fall to 2% during the first quarter of 2009.

Fiscal policy will also be employed. Over and above the assistance to the banking sector, the Government has made it plain that it intends to provide a fiscal boost to help the economy through the recession.

Yet these policy measures will have only a limited impact. As banks bring their lending more into line with their deposits, credit is likely to remain in restricted supply into the medium term.

The economy is expected to remain in recession until the end of next year, and may not be growing at its trend (long-term average) rate again until 2011.

There is, fortunately, one further silver lining. The British economy has entered this difficult period in better shape than in the mid-1970s, the late-1970s, or the late-1980s. Sixteen years of unbroken growth and a decade of full employment will count for something.

This report was prepared based on information available at 6 November 2008. Further information from: Mark Berrisford-Smith, Business Economics, HSBC Bank plc. Telephone: 020 7991 8565.

The dust settles

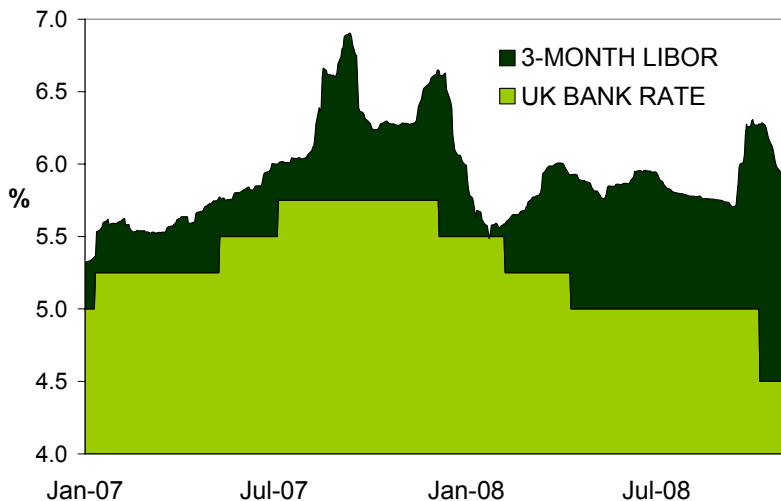
The various rescue packages announced in Britain and many other countries in the past few weeks have finally brought a modicum of stability to the banking system, averting the spectre of mass panics and further failures. It is too soon to be sure that these radical measures will work, albeit that there has been some thawing of the wholesale money markets. The difference between the Bank of England's base rate and three-month LIBOR (London Inter-Bank Offered Rate), which had climbed to nearly 1.8 percentage points around the time of the announcement of the UK Government's rescue package, narrowed to around 1.2 percentage points in the first week of November.

Attention has now shifted to gauging the fallout on the real economy of spending, growth, and jobs. Financial markets have suffered continued turmoil, with share prices plunging, and sometimes rebounding, amid extremely volatile trading conditions as investors wake up to the economic realities of a prolonged credit squeeze. In particular, the commodities bubble has been well and truly popped. Hopes that America, Britain, the euro area, and Japan could escape recession now seem overly optimistic, as does the notion that the big emerging economies could weather the storm largely unscathed.

In this latest phase of the crisis, it isn't banks that now need help but countries, with the International Monetary Fund being called upon to provide assistance to Iceland, Ukraine, and Hungary, with others likely to follow. International investors are moving their money to safe havens, so that some currencies have tumbled (including sterling) and others collapsed (such as the Korean won, the Argentine peso, and the Hungarian forint), while the US dollar and the Japanese yen have surged.

The challenge facing economic forecasters is that these recent unprecedented events render their crystal balls even more fallible than usual. Nonetheless, it was known right from the onset of the credit crunch in August 2007 that a failure to unclog the arteries of the financial system quickly would eventually lead to serious collateral damage for the real economy. A cure was not found, and the situation did indeed become very much worse. The grim assessment by Mervyn King, Governor of the Bank of England, in a speech delivered in Leeds on 21st October, is that the UK's financial system came closer to systemic collapse on October 6th and 7th than at any time since the First World War.

Money market interest rates – signs of a thaw?



Source: Thomson Datastream

Learning from the past

The lessons of history should always be treated with caution, as no two sets of circumstances are entirely the same. But what is abundantly clear is that cyclical downturns become very much worse if accompanied by a banking crisis. The good news is that governments and policymakers have learnt an awful lot since the Great Depression of the 1930s and Japan's experience in the 1990s. In particular, they know that speedy and decisive action is imperative.

What is worryingly different about the present crisis is that it is the first that has been truly global in scope. Moreover, there can be no guarantee that the actions taken so far will be enough. The gnawing uncertainty that still more measures might be necessary will persist until the world's major economies have returned to reasonable health and asset prices have embarked on a sustained recovery.

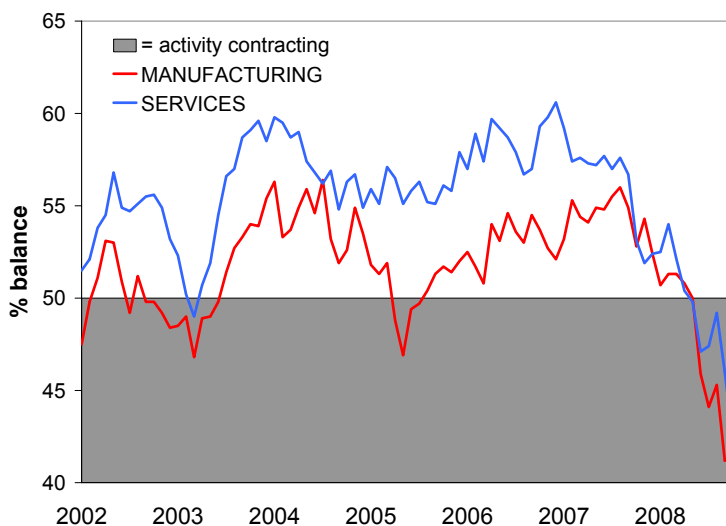
Heading into recession

As it turned out, the British economy was already shrinking before September's crisis struck. Growth had been faltering since the final quarter of last year, under the dual impact of interest rate rises (in late 2006 and early 2007) and the progressive tightening of credit, especially for lending secured on residential and commercial property. The preliminary estimate of economic growth in the third quarter showed a decline in Gross Domestic Product (GDP) of 0.5%. This was the first contraction since 1992, and the largest since the recession of the early 1980s.

While the technical definition of a recession as employed by many economists requires a second quarter of decline, which won't be confirmed until late January, this is splitting hairs. What matters is that economic activity probably started to shrink in June, and that the tumultuous events that have unfolded since mid-September will only make matters worse, at least in the coming months.

The slide into recession is also evident from the monthly Purchasing Managers' Index (PMI) surveys. The index for the manufacturing sector slipped below 50 (the boundary between expansion and contraction) in May, and has now been in negative territory for six months. In September it reached the lowest level since the survey began in 1992. For the services sector, activity began to contract in July, with the index reaching its lowest-ever level (since 1996) in October.

Business surveys – turning sour



Source: CIPS/Markit

Other tell-tale signs of the economy's rapid deterioration include: a rise of 164,000 in unemployment in the three months from June to August, the biggest quarterly increase since the early 1990s; house prices falling by 5% in the third quarter, the steepest decline since the regular tracking surveys began more than two decades ago; residential property transactions running at less than a third of their level a year ago; annual growth of spending at non-food retailers slowing from more than 4% in mid-2008 to barely 1% now; and an annual fall of more than 20% in new car registrations in September and October.

More rate cuts to come

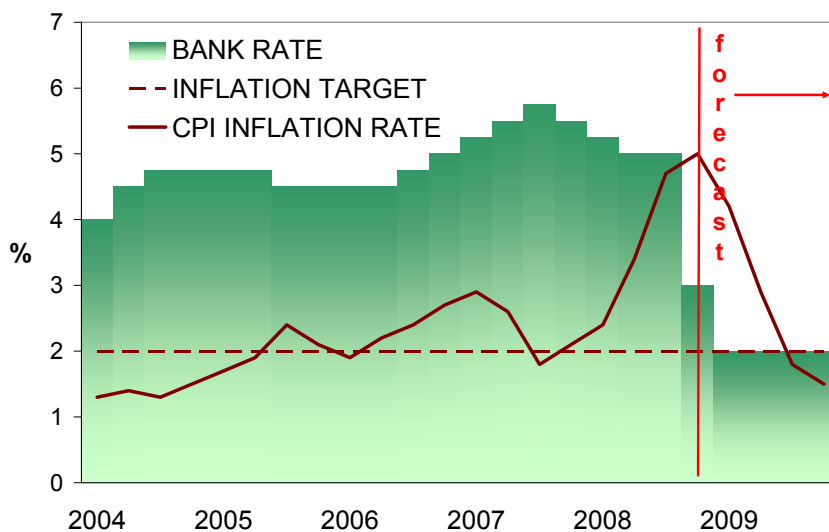
Amid the gloom, however, there is an important silver lining. Since the summer, the price of crude oil has more than halved, while the prices of many agricultural products and minerals have also fallen steeply. Petrol can now be had for well under £1 a litre again, and there is the hope that electricity and gas prices will eventually follow suit.

These developments have added weight to the view that inflation is now yesterday's story. The annual rate of consumer price inflation of 5.2% reported for September will mark the peak. With commodity prices soon to be subtracting from the overall index rather than adding to it, inflation will fall back sharply in the months ahead, and should be below the Government's 2% target by the middle of next year.

With the upside risks to inflation having evaporated, the Bank of England felt able to deliver a cut in Bank Rate of one and a half percentage points on November 6th. This was the biggest rate reduction since the Monetary Policy Committee was established in 1997, and was accompanied by a warning that the economy faces 'continued severe contraction in the near term'. In the light of this, the MPC took the view that unless they took bold action there was a significant risk that inflation would undershoot the 2% target.

Bank Rate is expected to be cut further in the months ahead, reaching a trough of 2% during the first quarter of 2009. But with the wholesale money markets still not functioning properly, and given the need for banks to attract and retain deposits, cuts in Bank Rate are unlikely to be reflected in a corresponding fall in the cost of obtaining bank finance.

Inflation – yesterday's story



Source: ONS, Bank of England, HSBC

Tearing up the rule book

In any case, it isn't just monetary policy that will be deployed. The Government has signalled that it is about to abandon Gordon Brown's much-vaunted fiscal framework. In one sense, this will be nothing more than a statement of the obvious, since the Sustainable Investment Rule, which holds that public sector debt should be kept to less than 40% of GDP, was shattered the day Northern Rock was nationalised in February.

In the first six months of the current fiscal year public sector net borrowing amounted to £37.6 billion, against a full-year forecast of £43 billion announced at the Budget in March. With tax receipts being undermined by the very low level of property transactions and lower Corporation Tax payments from the financial sector, the borrowing requirement for the whole of the 2008/09 fiscal year is likely to top £60 billion.

It should, of course, be borne in mind that recapitalising the banks isn't the same as ramping up current expenditure, as has been done during times of war. It is investment spending, rather than current spending, with the money being used to acquire assets (at what might turn out to be a very good price) from which a healthy income will be earned.

But over and above the assistance to the banking sector, the Government has made it plain that it intends to provide a fiscal boost to help the economy through the recession. How this will be done, and on what scale, should become apparent when Alistair Darling delivers the Pre-Budget Report in November. There has already been talk of bringing forward some of the Government's investment programmes, although whether this will prove feasible given the rigidities of the British planning system is open to some doubt.

With the fiscal stimulus coming on top of the £37 billion that has been earmarked to recapitalise some of the UK's largest banks, the Government's annual deficits and borrowing requirements are inevitably going to reach alarming levels in the next few years. Borrowing requirements of somewhere between £80 and £100 billion can be expected.

The new financial order

It is tempting to hope that with monetary and fiscal policy both pulling in the same direction the recession might be a short one. That is unlikely for several reasons. To begin with, the once-in-a-lifetime events of the past two months have dealt another blow to the already-frayed confidence of individuals and businesses. Second, the opportunities to side-step the recession in the UK by exporting or investing abroad now look to be curtailed as the global economy heads into a sharp cyclical slowdown. In particular, the large emerging economies are coming under some strain. In China, for example, residential property prices are now falling and the authorities have announced two interest rate cuts.

But of greater importance are the constraints of the new financial order that will emerge in the aftermath of the banking crisis. Even if the measures announced by the UK and other governments eventually succeed in restoring stability, especially to the wholesale money markets, things aren't going to return to anything approaching what passed for normal in recent years. In the post-credit crunch world, banks will make less use of wholesale markets and securitisations, not least because regulators are likely to impose new restrictions. This means that their capacity to lend will become more closely tied to their success in garnering deposits.

In its latest Financial Stability Report, the Bank of England has calculated that the customer funding gap (the difference between non-bank lending and deposits) of the UK's major banks increased from around zero in 2001 to over £700 billion at the end of June this year. Restoring this gap to where it was in 2003, at just short of £300 billion, during the coming year would imply a reduction in lending to customers, assuming that deposits continued to expand at the same rate as in recent years. Even if the adjustment takes three years, the Bank of England estimates that growth of customer lending would need to slow sharply in the short term to around 4%, down from around 15% earlier this year.

The process of bringing lending more into line with deposits implies that either more deposits must be attracted, or lending growth scaled back. In this context, the support measures announced by the Government should help to smooth this process. Nonetheless, the inescapable conclusion is that credit will continue to be in short supply into the medium term.

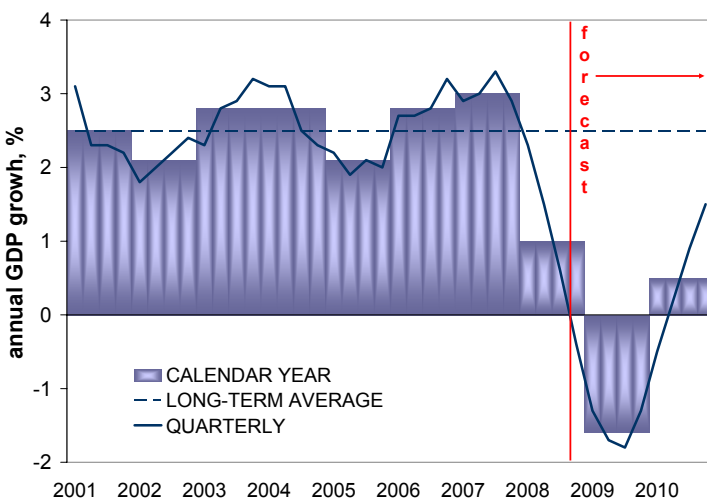
The shape of things to come

With households beset by steep falls in house prices and the growing threat of job insecurity, a period of marked retrenchment is inevitable. What were once regarded as outlandish forecasts of house price falls of 30% are now looking increasingly realistic. On top of this, the stockmarket has also fallen sharply, with the FTSE100 index down by more than a third from last year's peak. The upshot is that more than £2 trillion (or about a quarter) could be wiped off the collective wealth of UK households in the space of just two years. The Council of Mortgage Lenders has predicted that the number of home repossessions could reach 45,000 this year, up from 26,200 in 2007.

Meanwhile, the number of people out of work will continue to climb rapidly with a further 400,000 people likely to lose their jobs by the end of next year. Financial services and the distributive trades will bear the brunt of this, adding to the pain that has already been felt in the construction and real estate sectors.

From being the key driver of growth, the household sector will now act as a drag. Consumer spending, which expanded in real terms by a healthy 3% last year, is expected to contract by 2.5% in 2009. In fact, it is only the public sector that will provide any mitigation. Investment spending is already tumbling. Half-finished housing developments up and down the country bear testament to the slump in residential

Recession bites



Source: ONS, HSBC

fixed investment, with the picture being little different in the commercial sector. Added to that, many businesses which were contemplating expansion plans will be loath to proceed in the present climate, and may in any case find it more difficult to raise any finance that they need.

Finally, it might have been hoped that the recent slide in the value of sterling would bring some respite to exporters. This hasn't happened, thanks to the similarly difficult trading conditions being experienced in the economies of major trading partners. For all the talk about the enormous potential offered by large emerging economies, the bulk of Britain's exports of goods and services are still destined for western Europe and North America.

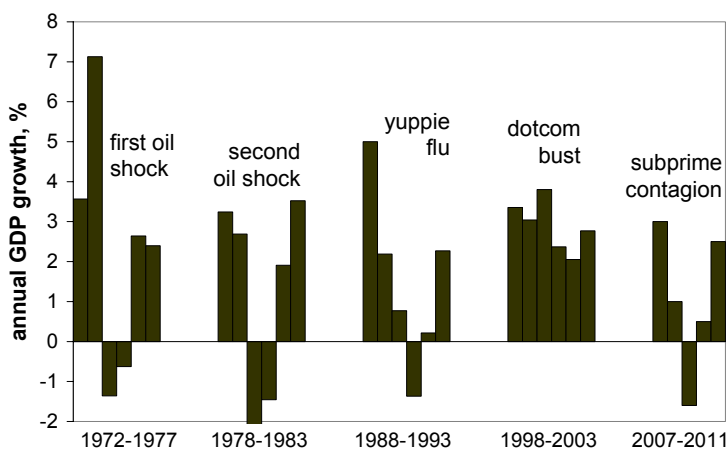
The pound's weakness, meanwhile, is likely to pose a considerable headache for importers, especially those buying goods from countries whose currencies are linked to the dollar. During September and October the pound fell by around a tenth against both the US dollar and the Chinese yuan. Retailers in particular will find themselves squeezed between higher prices for imported goods and the reduced spending appetite of shoppers.

The upshot is that the economy is expected to remain in recession until the end of next year, and may not be growing at its trend (long-term average) rate again until 2011. GDP growth, which was a healthy 3% last year, will slow to under 1% for the whole of 2008, and is then expected to fall by 1.6% next year. This would make 2009 the worst year for the British economy since 1980.

On the Richter scale of UK recessions how is this one likely to compare to previous episodes? GDP is projected to fall by a little more than 2% over the course of five quarters. If this prognosis is roughly correct, then it would make it as long a recession as both those of the early 1980s and the early 1990s. The fall in output would be close to that seen in the early 1990s, but it would be much less severe than the contraction of more than 4.5% endured a decade earlier.

There is, fortunately, one further silver lining. The next few years will undoubtedly be very tough for many businesses and households, and the banking crisis will have a lasting impact on confidence, the availability of credit, and the public finances. But it should also be remembered that the British economy is entering this difficult period in better shape than was the case in the mid 1970s, the late 1970s, or the late 1980s. Companies, in particular, have earned healthy profits in the past few years. Sixteen years of unbroken growth and a decade of full employment will help to cushion the blows.

Historical perspective



Source: ONS

UK ECONOMIC FORECAST

Annual percentage changes, adjusted for inflation, unless otherwise indicated

	2007	2008	2009	2010
Economic Growth				
GDP	3.0	1.0	-1.6	0.5
Domestic demand	3.6	0.6	-1.9	0.5
Output Trends				
Services	3.7	1.3	-1.7	0.5
Manufacturing	0.7	-0.9	-1.6	-0.2
Construction	2.9	1.2	-4.9	-0.8
The Personal Sector				
Disposable income	0.1	-0.3	-1.7	-0.8
Household expenditure	3.0	1.7	-2.5	-0.4
Retail sales	4.3	3.4	-0.9	0.2
ILO unemployment (millions)	1.65	1.75	2.10	2.20
Unemployment rate (% of workforce)	5.4	5.6	6.8	7.0
House prices (Halifax survey, q4 on q4)	5.4	-15.0	-10.0	5.0
Property transactions: Eng. & Wales	-2.7	-40.0	-10.0	30.0
The Business Sector				
Net rate of return - manufacturing (%)	6.3	4.5	4.0	4.0
Net rate of return - services (%)	19.1	16.0	11.0	10.5
Company insolvencies (Eng. & Wales)	-4.8	16.0	25.0	2.5
International Trade				
Trade in goods balance £bn	-89.3	-95.0	-90.0	-92.0
Current account balance £bn	-52.6	-38.0	-36.0	-37.0
US\$ / £ (at year-end)	1.99	1.70	1.65	1.65
£ / euro (at year-end)	0.73	0.80	0.78	0.78
Inflation and base rates				
Retail Prices Index	4.3	4.4	1.3	2.0
Consumer Prices Index	2.3	3.8	2.3	1.5
Bank Rate (at year-end)	5.50	3.50	2.00	4.00

Note: 1. Data are subject to revision

2. HSBC forecasts are as at 5 November 2008

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