

Monthly economic commentary

January 2009

Banking on recovery

This month, the MPC took another half-point off UK Bank Rate, taking it down to 1.5%, the lowest since the Bank of England was founded 314 years ago. In the past few weeks, sterling reached a record low against the euro and the Chancellor has loosened fiscal policy to such an extent that even on his (very optimistic) forecasts, borrowing in the 2009-10 fiscal year will reach a record £118 billion. All the actions that the John Major government took successfully to end recession once the UK had left the ERM in September 1992 have been taken in the past few months, even more decisively and earlier in the cycle.

Of the policy initiatives, the interest rate reductions will potentially offer the biggest boost to spending this year, and therefore the quickest route to ending recession. The recent Bank Rate reductions from 4.5% to 1.5% have been worth about £100 a month to anyone with a £50,000 debt. Since the average mortgage is around £100,000, the rate cuts represent a substantial benefit to the borrower. The tax and spending changes, and the weaker currency, are rather more indirect in their effects.

The maximum impact from lower interest rates will, of course, only occur if the reductions are passed on in full, and this is where the picture gets a bit murky. The media have had a field day castigating banks for failing to match the rate cuts but many institutions can justifiably claim that cutting rates to borrowers will be counter-productive. To be in a position to lend, the banks need to attract savings but, as rates get lower, savers will inevitably look elsewhere. This will force banks to the interbank market, where funds are scarce and, consequently, more expensive. Interest rates are probably close to the point where further cuts have very little effect. For many businesses and households, having access to the necessary funds is more important at the moment than the price.

The problems in the financial sector, therefore, could blunt the impact of the looser monetary policy. A weaker currency will make British exports cheaper, but if the world economy is slowing, it will be difficult to sell even at lower prices. And the changes to fiscal policy will take time to work through the system. Lower interest rates should be the most effective weapon but the so-called credit crunch is aggravating the economic slowdown and will probably delay the timing and the strength of recovery.

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Having played all the traditional cards to counter an economic downturn, the government may well be considering the 'nuclear option' of quantitative easing. In effect this means pumping money into the system, freeing up the credit markets so the funds are available to borrow and spend. There is more than one way this could be done and the Treasury will want to get the maximum bang for its buck. High on the list of sectors to get a boost from extra funding must be the housing market, with schemes targeted particularly at first-time buyers. With loan-to-values ratios in some cases falling below 70%, the difficulty first-time buyers have of getting mortgages has brought the market to a virtual standstill and created a mindset in which prices are expected to fall. No bank will want to be the first to break this logjam, but if the government can engineer a change, there will be a scramble to be the second.

The issue then will be to track inflationary pressures and to ensure that the policy response is timely. This implies interest rates turning, and starting to move up again. This problem is still some way off as households and businesses brace themselves for what is expected to be a tough 2009. But the recession will end because recessions always end, although when is still a moot point. Since 1945, there have been three major downturns (apart from the very short dips in activity in 1956 and 1961). On average, the three lasted around two years, although there were quarters of flat or even increasing growth (a 'W' shape). In terms of consecutive quarters of falling output, 1973-75 was the shortest, measured by the peak-trough fall in output, 1990-92 was the mildest, while the longest recovery period was from the 1979-81 recession.

It is this last consideration which will soon bother the authorities. The economy may stop shrinking by Q4 this year, which will mark the end of recession. But it is a long way back to the 0.6% per quarter trend growth the UK needs to stop unemployment rising. Getting back to this point may stretch beyond 2010.

This is the problem after next for the policymakers, but a crucial one. If the UK wants or has to get away from its past dependence on retailing, financial services, and property and construction, something else will have to fill the gap. The challenge of getting Britain to pay its way in a global economy in the 21st century may be an even bigger one than persuading people to start spending again in 2009.

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