Economic Outlook 2009

Picking up the pieces: prospects for the global and UK economies

January 2009

Key points

- The global economy is facing its biggest crisis since the 1930s. Savage deleveraging and financial system failures have caused a downturn on a par with the oil shocks of the mid 1970s and early 1980s. The task facing governments and policymakers is being made more difficult by the hoarding of cash and fears of deflation.

- Recession is now a reality for the UK for the first time since 1992. The heavily indebted consumer sector has been retrenching, and GDP growth has turned negative. Among the consequences that are now starting to emerge are rising unemployment and more business failures.

- The authorities have responded decisively and early in the cycle. Interest rates are at their lowest since 1951, sterling has hit an all-time low against the euro and fiscal policy has been loosened appreciably. These were the levers that worked in 1992 but their effectiveness during 2009 could be blunted by continuing problems in the financial sector.

- All industry sectors are showing signs of strain and the key surveys report confidence levels sinking across the board. All regions are therefore being affected. HM Treasury has predicted a short and shallow recession ('V' shaped) but it is more likely to be longer and deeper ('U' shaped).

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The world's local bank

The global economy: from boom to bust

The past five years have been a period of robust growth for the world economy. Between 2003 and 2007, global economic output increased by about a quarter, with annual growth reaching around 5% in 2004, 2006, and 2007. That golden age has come to an end with a shattering crash. The collapse of Lehman Brothers in September unleashed a bewildering sequence of events that is still reverberating around the financial system. There has been a widespread loss of trust among those involved in the financial markets, amid a savage process of deleveraging. Investors are shunning all but the safest assets. Households and companies, meanwhile, are looking to reduce their indebtedness to help them survive in a world where obtaining the necessary funds is no longer easy or automatic, and where the economic climate is turning nasty.

Until September, the prevailing wisdom was that the credit crunch which took hold in the advanced economies in August 2007 would turn out to be a localised problem. This belief was reflected in the continuing surge in oil and commodity prices, buoyed up by the expectation of further demand growth from the large emerging economies.

Coping with the fallout

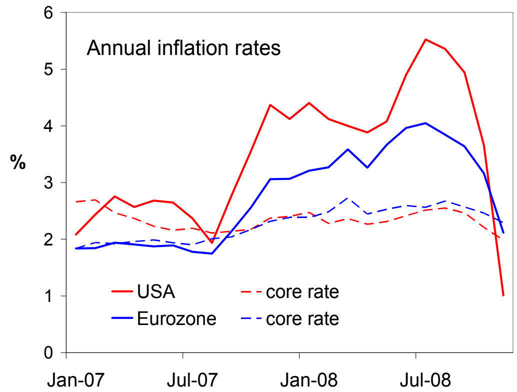
Despite hefty interest rate cuts, fiscal stimulus packages and IMF rescues, the fallout from the banking crisis is now wreaking havoc on the real economy. Although the US Government has unveiled plans to support ailing car manufacturers (with similar moves being considered by some European governments), the sector is facing a major shake-up: this will affect suppliers of materials, components and services, and will have implications for overseas subsidiary businesses. Big cuts in output are also being forced upon steel-makers and mining companies, while the downturn in international trade is hitting suppliers of transport and logistics services.

Japan is already in recession (defined as two or more successive quarters of falling GDP). Within the euro area, recessions have also taken hold in Germany, Italy and Ireland, with Spain a near-certainty to follow suit. In the USA and the UK, output contracted in the third quarter, and with conditions having worsened markedly since then, both countries will be in recession once fourth-quarter data are available in January.

For 2008 as a whole, growth in the advanced economies is estimated at just 1%. This year, output in these countries is expected to contract by the same amount, the worst performance since 1945. Growth in emerging and developing economies, meanwhile, is projected to slow to around 3% (compared to nearly double that rate in 2008). The upshot is that global growth is expected to come in at barely 1% in 2009, making it a more severe slowdown than that which followed the dotcom crash, and putting it on a par with the oil-induced episodes of the mid-1970s and early 1980s.

Just a few months ago, policymakers in advanced economies were still fixated on inflation. But now it is the threat of deflation and an associated economic depression that is keeping them awake at night: annual inflation rates are expected to be negative in both the US and the UK by the middle of 2009. The risk is especially pertinent for economies where households and businesses are laden with a heavy burden of debt (Britain and America both fit the bill). Negative inflation imposes a high real rate of interest, while gearing increases as nominal incomes and turnover fall. Japan's long malaise stands as a testament to the perils of this so-called 'debt deflation'.

Inflation – falling sharply



Source: Thomson Datastream

The unprecedented nature of recent events makes it even more difficult than usual for economists to predict the severity and duration of the downturn. Despite the bold actions that have been taken by governments and central banks around the world, and the high degree of co-ordination, there can be no certainty that the measures will work. If asset prices continue to slide, and banks are forced to write down their assets still further, additional measures may be needed. Even if the action that has been taken has the desired effect, the coming months will bring a lot more bad news. The best that can be hoped for is that by the end of 2009 the major advanced economies will no longer be shrinking. But even under an optimistic scenario it will be 2011 until the global economy returns to anything that could be regarded as normal.

Unconventional warfare

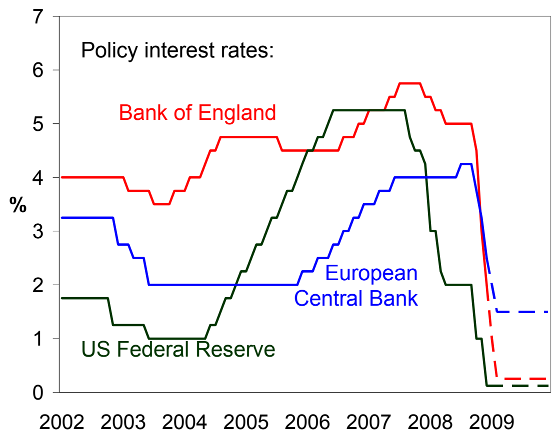
Given the trials and tribulations of the past year, it is a little surprising that the United States has so far managed to avoid a 'technical' recession. But in recent months things have gone from bad to much worse very quickly: the closely-watched Purchasing Managers' Index surveys (PMIs) are running at their lowest levels since the early 1980s; retail sales have contracted and car sales have plunged; the sharp fall in investment in residential construction has now spread to other areas of capital spending; and there is still no sign that the housing market has touched bottom.

Any lingering doubts about the seriousness of the situation were dispelled when it was reported that non-farm payrolls (a key measure of employment) fell by more than half a million in November, the biggest monthly drop since 1974. This meant that payrolls had been slashed by one and a quarter million in just three months. The likelihood is that GDP will contract by at least 1% in the final quarter of 2008 (which will be reported by US statisticians as an annualised decline of around 5%). The new Obama Administration is expected to launch a substantial fiscal package soon after January's inauguration, that could run to more than US$600 billion, and the economy should return to growth in the second or third quarters. Nonetheless, for 2009 as a whole, GDP is likely to be lower than in 2008, and the road to recovery could be long and painful. Unemployment is expected to continue rising, reaching a rate of close to 9% in 2010.

In December, the Federal Reserve's policy interest rate was reduced to a range of zero to 0.25%. This effectively means that all the conventional monetary policy ammunition has been used up. The Fed has also committed to keeping the policy rate at a very low level for some time (HSBC does not anticipate an increase until 2011), and proclaimed its willingness to resort to more unconventional means.

Apart from the fiscal assistance that the US Government is expected to provide, the Federal Reserve has already gone beyond standard credit operations (in which funds are offered in exchange for collateral) to making outright purchases of asset-backed securities. As a result, the Fed's balance sheet has more than doubled in just three months to over $2.3 trillion. The next step that is being considered is purchases of government debt. The aim is to sustain asset prices and depress yields, which will help to reduce financing costs for borrowers, including homeowners, students and those looking for finance to buy cars and consumer durables.

Policymakers take drastic action



Source: Bank of England, US Federal Reserve, European Central Bank

Feet of clay

Heavy burdens of household debt, accompanied by a slump in property prices, mean that the US, the UK, Spain, and Ireland, are the candidates for the most severe recessions. Yet it is surprising that the economy of the euro area has rolled over so easily, since it was supposedly less tainted by the ‘borrow and shop’ culture of Britain and America. But the eurozone is already in recession, albeit a milder variety than is likely to grip the UK and the USA. Spending by households has gone into reverse, and a severe industrial recession has taken hold. In October, the eurozone’s industrial output was more than 5% down from a year earlier, with Spain registering a decline of almost 13% as its construction sector reels from the ending of the housebuilding boom.

Although the labour market has still to turn in Germany, even here the industrial landscape now looks ugly. Industrial output is down by around 4% on an annual comparison, with the economy likely to contract by close to 1% in the final quarter of 2008. But the German government has resisted the sort of fiscal stimulus packages that have been announced in Britain, France, and Spain. While other governments are prepared to ratchet up their borrowing, Germany remains wedded to the nostrum of a balanced budget.

It is unclear whether the European Central Bank has the stomach to cut interest rates to close to zero and then deploy unconventional weaponry. So, while the initial plunge into recession may not be quite as vertiginous as in Britain and America, the euro area could find itself enduring a longer period of stagnation as politicians bicker about the merits and scale of fiscal stimuli and the central bank shies away from radical measures.

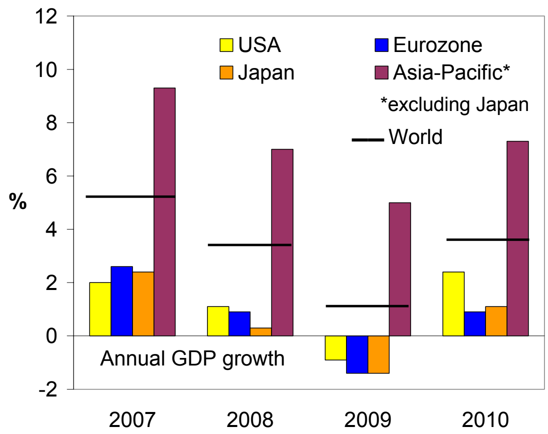
No escape

Hopes that the big emerging economies could ride out the storm unscathed have been dashed. Their problems include falling demand for their exports, plunging prices for oil and other commodities, and a flight of capital as international investors have run for cover. These countries are in a much better position to withstand a global financial storm than was the case after the Asian crisis of 1997, with several boasting foreign exchange reserves running into hundreds of billions of dollars.

But this hasn’t afforded complete protection. As investors have piled into cash and US Treasuries, many emerging market currencies have fallen sharply; and those deemed especially vulnerable on account of high levels of external debt or large current account deficits, have found their room for manoeuvre tightly constrained. While the likes of China, India, Korea, and Taiwan, have implemented aggressive interest rate cuts, some countries, like Turkey, have had to keep rates high, and others, such as Hungary and Russia, have had to put rates up to defend their currencies. Since October, the IMF has agreed support packages for Iceland, Hungary, Ukraine, Belarus, Serbia, and Pakistan, with Turkey expected to follow suit early in 2009.

In China, the authorities are scrambling to avoid the downturn becoming too severe. Exports have tumbled, while house and car sales are falling. Having announced a massive pump-priming package valued at RMB 4 trillion (nearly $600 billion) the Government then announced measures to increase the availability of credit, setting a target for money supply growth of 17% in 2009. This comes on top of an aggressive rate

A sharp slowdown



Source: Thomson Datastream, HSBC

cut of 108 basis points by the Peoples Bank of China on 26th November. But despite these measures China's growth rate for the whole of 2009 is still expected to be slightly under 8%, the slowest for seven years.

The slackening tide of globalisation

One of the enduring legacies of the global banking crisis of 2008 will be another shift in the political-economic landscape. The free markets consensus that has held sway since the collapse of Communism in the late 1980s has turned out to be flawed. In particular, it now seems that the recent wave of globalisation, the hallmarks of which included the rush to offshore production and outsource services, also came with a dark side: the economic integration that was hailed as a benefit to all has turned out to be the means for the faster transmission of contagion.

With governments around the world desperate to avoid a repeat of Japan's malaise of the 1990s, or worse still, a re-run of the Great Depression, there is no longer any thought of 'letting the market work'. Notions of liberal globalisation have been blown away in a few short months, with the right-wing Bush Administration in the United States committing large sums of taxpayers' money to keep the banking system and the economy afloat.

With taxpayers in advanced countries now having to pick up the tab for the financial sector's exuberance – a burden that they will probably have to carry for the best part of a generation – the *quid pro quo* is that governments are likely to impose new regulatory frameworks. This could extend to a more fundamental reshaping of the relationships between governments and business, and even between employers and employees. The days of governments and workers in developed economies quietly accepting the loss of jobs to emerging economies could be numbered.

This has already been hinted at by the election of Barack Obama as President of the United States, where employment growth is clearly a priority for the new Administration. The Democrats have traditionally adopted a more protectionist stance, which is likely to be reflected in a tougher US position on trade liberalisation. The slackening of the impulse towards globalisation will also be evident in diminished flows of foreign direct investment to emerging economies, and stagnation in the volume of international trade. In its latest forecasts, the World Bank predicts that the volume of trade in goods will shrink by over 2% in 2009, the first decline since 1982.

It has been a mantra of mainstream economics that globalisation has been the key to delivering faster economic growth. If less globalisation means greater sustainability and stability – albeit at the price of slower growth – then, after the experience of the past 18 months, many people in the advanced economies may settle for that.

Growth of regions and major economies
(annual % change in real GDP)

	2007	2008	2009	2010
World	5.2	3.4	1.1	3.6
Canada	2.7	0.6	-0.8	2.5
United States	2.0	1.1	-0.9	2.4
Latin America	4.8	3.8	0.7	2.7
Brazil	5.7	5.5	2.0	3.6
Mexico	3.2	1.7	-0.7	1.8
Euro Area	2.6	0.9	-1.4	0.9
Germany	2.6	1.2	-1.5	0.9
France	2.1	0.8	-0.8	1.0
Italy	1.4	-0.5	-1.8	0.5
Spain	3.7	1.1	-1.3	1.4
UK	3.0	0.7	-2.5	0.5
Emerging Europe	7.1	5.1	-0.5	3.0
Russia	8.1	5.4	-2.0	2.0
Turkey	4.6	1.1	-1.4	4.3
Asia-Pacific	5.7	3.7	2.0	4.4
Japan	2.4	0.3	-1.4	1.1
China	11.9	9.2	7.8	8.9
India	9.3	7.7	5.9	7.6
Korea	5.0	2.7	-0.6	4.6
Africa	6.1	5.0	2.5	3.5
Middle East	6.0	5.0	3.5	4.5

Source: HSBC

The UK economy: recession is here

The 0.6% fall in GDP in Q3 2008 was the first decline in economic activity for over 16 years. Although a recession is defined as two successive quarters of negative growth, nobody doubts that the UK is now in recession. A slowdown was expected, and has been long delayed, but what should have been a correction or an adjustment has turned into something more serious. The turmoil in financial markets is adding to the severity of the downturn.

As 2009 dawns, the key questions are about the length and depth of the recession. Policymakers believe that the economy went into the slowdown in better shape than at the start of previous recessions. As a result, they have been able to take more decisive fiscal and monetary steps which should ensure the UK emerges from a shallower recession much sooner.

Consumers lead the economy down

The 16-year period of unbroken growth was overly reliant on spending and borrowing by households and by government. A slowdown was long overdue and it will be more severe because it has been delayed. Because of the overhang of debt, moreover, particularly in the household sector, there is no quick fix and constraints on consumers will continue into 2010.

Total debt in the personal sector has reached £1.4 trillion, equivalent to 160% of annual earnings. Over the ten years to 2007, mortgage equity withdrawal amounted to £319 billion, which effectively added 4% to disposable income each year. Meanwhile, unsecured personal borrowing rose 2.3 times.

Payback time

It is now payback time. Over the last two years, consumer confidence has been dented by higher debt servicing charges on a record level of debt, a steady rise in the tax burden, slow growth in earnings and, in 2008, a spike in consumer price inflation. With the collapse in the housing market and a rise in unemployment, the household sector is in retreat.

Corporate Britain has shown no inclination to fill the gap. Despite several years of robust financial performance, business investment growth has been slowing and started to turn down. Although exports of goods and services held up well in 2008, so too did imports, and so the deficit remains uncomfortably high.

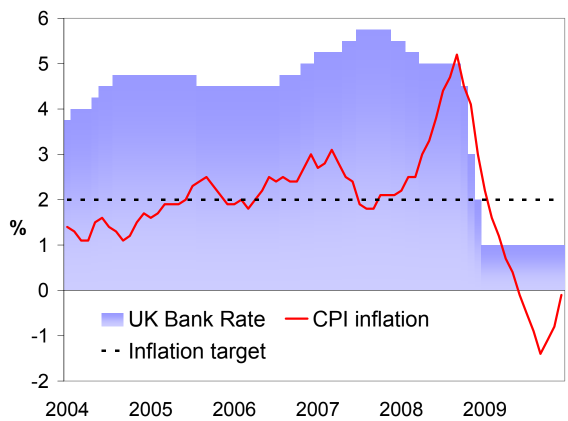
Policy response

While a slowdown was generally predicted, the speed at which events moved in the final quarter of 2008 was the major surprise. This was almost certainly a reflection of the turmoil in financial markets, which began to spill over into the real economy. Until then, the so-called 'credit crunch' appeared to be about banking, problems associated with individual banks or banks' relationships with each other. It now seems that events have moved on.

The authorities have not been slow to respond to the slowdown in economic activity, and both monetary and fiscal policies have been loosened quite markedly. Going into 2009, the priority is to encourage spending. The old adage that everybody's expenditure is somebody else's income is the key message.

The MPC, confident that inflation was set to fall from 5.2% in September 2008 back towards the target 2% in 2009, reduced interest rates at record speeds. From 5% at the start of October,

Inflation – yesterday's story



Source: ONS, Bank of England, HSBC

UK Bank Rate fell to 2% by the December meeting, with the likelihood of more cuts to come. If passed on in full, this 60% reduction in Bank Rate would be worth £90 a month to the disposable income for every £50,000 of debt.

Chancellor Darling's November Pre-Budget Report was in effect an emergency budget and it was intended through a series of measures to boost spending by £20 billion over two fiscal years. Despite the obvious charges of fiscal profligacy levelled against Mr Darling, he is more open to criticism for the relative modesty of his measures given the scale of the slowdown and for the precise tax proposals.

Not surprisingly, sterling has weakened against both the dollar and the euro. Given that the UK needs to rebalance economic activity, any stimulus to exports is welcome. In a global market that is clearly slowing, weaker sterling will give UK companies a price edge, which should offset the inflationary impact of more expensive imports.

All the steps that were taken by the Major government in September 1992 to boost the economy were repeated in 2008, but earlier in the cycle and much more decisively. If the economy was the only problem, the downturn need not be too deep or last too long, but the credit crunch now needs to be factored in.

Prospects for 2009

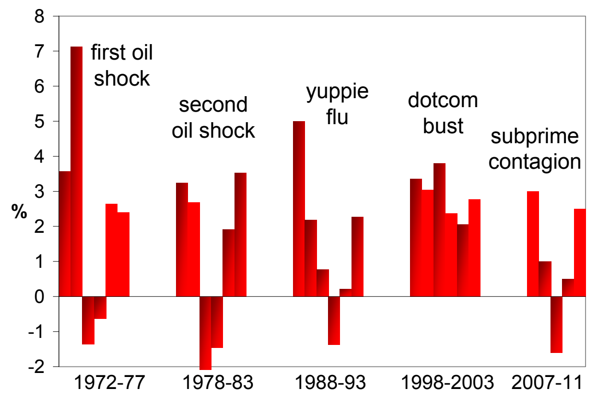
The outlook for the economy in the coming year is clouded by the uncertainties in financial markets. Although the government has taken steps to try to stabilise the system (and has probably done enough to ward off the threat of an institutional failure), the interbank market is still blocked. Lending between banks is expensive and in short supply and this could act as a brake on activity and prevent the cuts in Bank Rate from being passed on in full.

Survey and anecdotal evidence suggest that in the small- and medium-sized business sector access to finance rather than the price is the issue. It is a similar story in the mortgage market. Sharp falls in house prices and interest rates have improved affordability, while the household formation rate is currently more than twice as high as housing starts. A supply of mortgage finance is the key to reviving activity.

Despite various monetary and fiscal initiatives, consumer spending growth is expected to be negative throughout 2009, falling by around 2.5% in the year, only returning to positive territory in the second half of 2010. A fall in business investment is also likely this year, leaving just government spending showing real growth. A decline of 2.5% is forecast for GDP in 2009, with a slow recovery starting in 2010.

Consequently, unemployment will rise, probably exceeding two million (on the ILO measure) before recovery gets underway. Meanwhile, inflation will edge down and be under the 2% target by Q3. Although at 2% Bank Rate is the lowest since 1951, weak activity levels and falling inflation means a rate of below 1% rate is likely in the early months of 2009, the lowest-ever rate since the Bank of England was formed in 1694. More might still be needed. This could take the form of even lower rates, even more government spending (and bigger deficits) or, as a last resort, what is now called 'quantitative easing' (in effect, printing money). As the Governor of the Bank of England has hinted, this could be on the agenda during 2009.

A historical perspective –GDP growth



Source: ONS, HSBC

UK industry - the pain is shared

The slowdown in activity, which turned negative in the third quarter of 2008, has affected virtually all the major sectors of industry. Outside the public sector, the only modest exception is agriculture, which in 2008 was recovering from the previous year's decline in output. For some industries, such as manufacturing, the recent fall is part of a much longer-term decline, while for others (such as construction, distribution, and financial and business services) the current slowdown followed on from what were record levels of output.

Service industries dependent on consumer spending, and discretionary spending in particular, are clearly very vulnerable. But the speed with which the slowdown has taken hold indicates that no region or industry has been immune. Those dependent on exports or investment are now being squeezed as global growth weakens and businesses cut back on capital expenditure. There are few industrial safe havens in the private sector.

A healthy starting point

Corporate Britain has benefited hugely from the stability and growth of the last few years. Official statistics show that all private non-financial corporations achieved record net rates of return in 2007. The 14.2% (13.0% excluding energy-related businesses) was higher even than in the Lawson boom years of the late 1980s. Not surprisingly, services companies led the way (19.1% net return in 2007), while manufacturing continued to drift downward.

There were signs that these numbers were starting to soften in the second quarter of 2008 (the latest available). Even so, much of UK industry goes into the recession in better financial shape than in 1989-90. This is reflected in both the trends in employment (which hit new highs in 2007) and in business investment. In 2007, investment spending rose in real terms by over 8%, with services again the key. Even in the first half of 2008, these trends were holding up. It is however the speed with which events have turned that has been surprising. Going into 2009, the output, employment and investment data will all weaken which will impact on financial performance. The prospects for industries, however, do vary widely by sector.

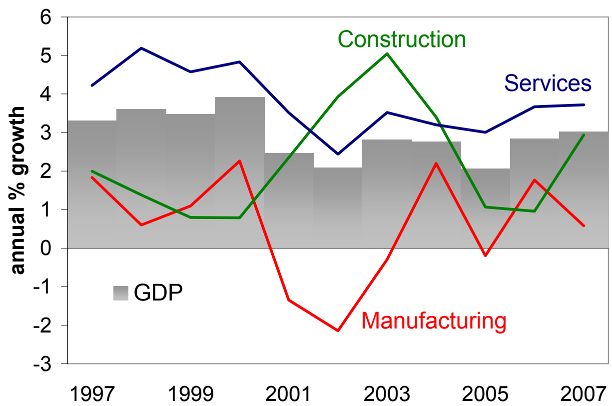
Manufacturing

Manufacturing is the most internationally exposed activity, a fact which is both a strength and a weakness. It is a weakness because the exposure to overseas competition has contributed to the long-term decline of some subsectors and the restructuring of others. The strength is the fact that manufacturing is the most export intensive industry and has opportunities to offset a domestic slowdown by selling overseas.

Over the last decade, manufacturing output's slow decline seems to have been arrested and at the end of 2007 was about 4% higher than when this government came to office in 1997. But any improvement in output stalled in mid-2008, and output and employment are now falling. In a very pessimistic survey, the CBI reported in November that the outlook is the weakest for nearly 30 years. Chemicals is one of the few bright spots.

Hopes of an export-led boost have faded, despite the weaker currency, largely because of the slowdown in key markets such as the EU and the USA. The most positive note is a sharp slowdown in the costs of materials and fuels that were rising at an annual rate of 30% earlier in the year.

Sector performance relative to GDP



Source: Thomson Datastream

Despite this easing of the pressure on margins, the CBI reports that the total order book is the weakest for five years and stocks are at their highest level since 2001. The much-watched PMI survey supports this view. The November figure of 34 not only implies further contraction but was the fastest monthly fall on record and the lowest level since the series began in the early 1990s.

Construction

Construction benefited enormously from the stability that followed the early 1990s recession. By the end of 2007, the industry had recorded 12 consecutive years of growth which amounted to 30% in real terms. The key subsectors of new build were commercial (36% of the total) and the public sector (20%).

This growth now looks to be slowing sharply as new housebuilding, commercial (dominated by retail and financial services) and industrial (factories for manufacturing and warehouses for distribution) all go into reverse. Only the public sector (including infrastructure spending) will maintain positive growth in 2009. New building work as a whole is likely to fall by 5%.

With house prices still falling, private sector housing starts will drop to under 100,000 this year for the first time since 1980. When housing demand recovers, a shortage of supply is likely again to put serious pressure on prices. On the other hand, a substantial supply overhang will constrain retail building while difficulties in financial services will dampen new office building. A record low PMI survey result in November of 31.8 summarises the poor outlook for construction, despite the Chancellor's increased spending announced in the PBR.

Services

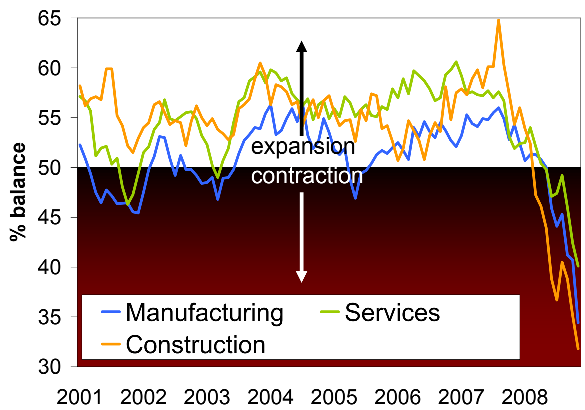
In an economy fuelled by primarily by consumer spending, services have been the key sectoral driver of growth. Every year between 1997 and 2007, services outpaced GDP growth and overall grew 40% faster than the economy as a whole. Yet in Q3 2008, growth in services was negative, and not just in one or two specific subsectors.

Activities such as retailing are already in the midst of a storm and a necessary shakeout is already underway on the high street with some well-publicised failures. The growing popularity of on-line shopping will add a further downward twist to retailers' difficulties. Not far behind are subsectors such as hotels, tour operators, restaurants, which are dependent on discretionary spending. Even education will not be immune as private schools have to balance rising costs with a squeeze on revenues and falling numbers.

The turmoil in financial and business services, which account for over a third of all services, has barely yet registered in the numbers but will probably have the biggest impact on the overall level of services activity. The collapse of the housing market has obviously affected estate agents, solicitors, surveyors, etc but the impact of the woes of the banking industry has yet to be felt. It will be significant and stretch past 2009.

Without the positive contribution from the still-expanding public sector, the outlook for services would look even bleaker. The November 2007 PMI survey result of 40.1 was the lowest since the series began in 1996. The fact it was over 50 (implying expansion) as recently as March shows how quickly things have turned.

PMI surveys point to contraction



Source: CIPS/Markit Research

The household sector: spent out

Consumers led the way

Over the last decade consumer spending has been the main economic driver in the UK, accounting for nearly 80% of overall GDP growth. In seven of the past ten years, consumer spending has grown by 3% or more with the average growth rate hitting 3.2%.

Yet real income growth has been just 2.4% a year and it is a huge rise in borrowing which has allowed spending to grow at a consistently robust rate. The stock of unsecured debt (personal loans and credit cards) more than doubled in the last decade while house owners were able to use the strength of the housing market to take on extra secured debt which could be used to subsidise day-to-day living rather than be invested in property. That amounted to £319 billion over the ten years adding the equivalent of 4% of nominal disposable income per year to spending power.

Stresses emerging

Now the household sector has come under severe pressure and the spending spree to an end. This was initially because of the accumulated debt, the weight of which began to be felt as long ago as 2006 and 2007 when interest rates were raised to slow and rebalance the economy so making debt servicing more onerous.

Then, during 2008, a number of extra pressures began to bear on households. The most visible signs of the effect of the credit crunch have been seen in the housing market where the supply of finance has been reduced to a trickle, leading to sharp falls in house prices. Approvals for house purchase in the latter half of 2008 were running at just over 30,000 a month, a third of their level a year earlier. At the same time, the fall in house prices has moved into double figures.

That has not only made householders feel less well off, hitting consumer confidence, but more tangibly has persuaded people to refrain from borrowing against their housing equity, even if the banking sector could be persuaded to let them have the funds in the first place. By the second quarter of 2008, according to Bank of England statistics, households were putting their own money into the housing market rather than taking equity out.

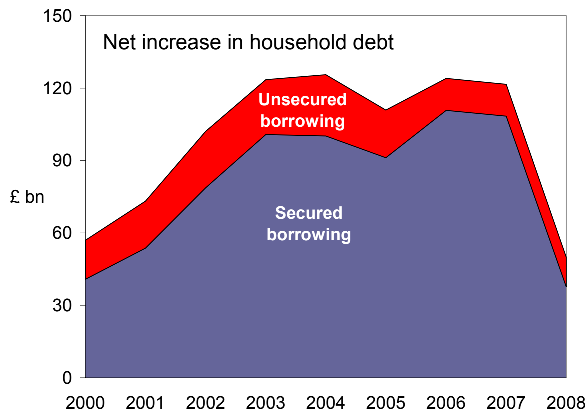
At the same time earnings growth fell below the rate of inflation during 2008 and is likely to remain so until the New Year at least. And just to add to the Yuletide cheer, unemployment has also been rising and employment levels falling.

It is not surprising, therefore, that consumer spending has weakened. In both Q2 and Q3, consumer spending dropped in real terms while retail sales figures suggest a further fall in Q4, probably taking the annual rate into negative territory for the first time since Q1 1992. Overall consumer spending growth is estimated at less than 2% in 2008, compared with 3% in 2007.

Fiscal and monetary help

The authorities' response has been threefold. Firstly, the MPC has cut interest rates by three percentage points, in effect transferring money from savers (who by definition are less likely to spend) to borrowers (who are more likely to). At the same time, there should be an increased incentive to borrow. The HSBC view is that Bank Rate will fall below 1% in early 2009, a totally new experience for borrowers, savers and banks alike.

Credit is squeezed



Source: Bank of England

Secondly, the Government's loosening of the public purse strings in Alistair Darling's Pre-Budget Report (PBR) in November amounted to £20 billion over two fiscal years, financed by borrowing. The sum was relatively modest given the scale of the problems and the measures spread thinly across the economy. But, having opened the public purse once, the Chancellor could have another go should the situation warrant it.

The third arm of the revival strategy is to get the banking sector back into lending mode. To that end, the Government and Bank of England have been busy providing funds to rebuild bank capital (with part/full nationalisation as a by product) and help to restructure balance sheets and facilitate lending between banks. That should work but persuading banks to pick up their lending at a time of the economic cycle when their inclination would be to move carefully and avoid risk might well take time.

In order to lend, moreover, banks need deposits. The wholesale money markets are still not functioning properly which will hamper progress. It is in this context, the 'nuclear option' of quantitative easing or printing more money has to be considered if funding remains constrained.

But there is also a problem in the retail deposit markets where banks will need to continue to offer a tempting rate if they are to attract sufficient funds. The upshot is that cuts in Bank Rate are unlikely to be reflected in a one for one fall in the cost of lending rates.

Still more bad news for housing

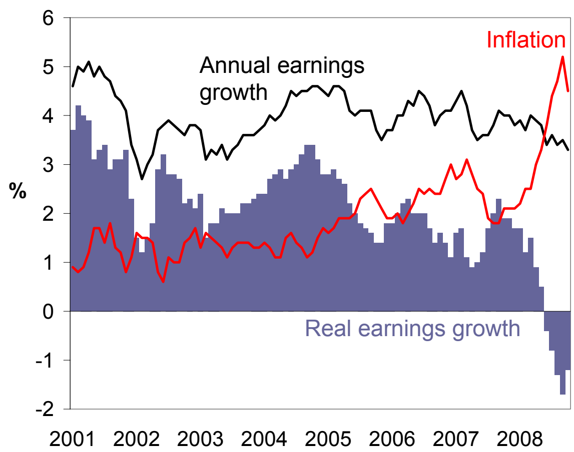
All this means that the housing market has some way to go before hitting bottom. House prices are already close to a fifth lower than their peak in 2007, with an overall drop of 25-30% generally expected. The worry is that by the time the credit crunch does end, any latent demand which does exist will have withered away.

There are two concerns. Firstly, as the economy turns down further, pushing unemployment even higher, demand for borrowing will fall away. The second is that more and more potential borrowers think that, by dragging their heels, they will get a better deal some months further down the line when prices are lower. This scenario can very quickly become self-fulfilling.

If all three policy initiatives work to their full potential, the UK might get away with a short, sharp recession. The danger is that one or more of the three will take time. HSBC's main case forecast, therefore, assumes that consumer spending falls by around 2.5% in 2009 and by a further 0.4% in 2010 after stripping out inflation.

Lower income, restricted borrowing, and a continuation of the weak housing market will ensure that consumer confidence and spending remains weak over the forecast period. As inflation tumbles in early 2009, average earnings growth in real terms should move back into the black. But with unemployment, a lagging indicator, rising through the next two years, fewer people are going to benefit from that shift. Unemployment, under the ILO measure, is expected to pass the 7% level during 2010 reaching 2.5 million by the end of the year compared with 1.8 million in the third quarter of 2008. As a result overall disposable income is likely to fall in real terms in both years and may even be lower in nominal terms in 2009.

Income is squeezed



Source: *Bank of England*

At a glance ...

WORLD ECONOMY

	GDP growth (%)				Inflation rate (%)			
	2007	2008	2009	2010	2007	2008	2009	2010
World	5.2	3.4	1.1	3.6	2.8	4.3	1.1	1.9
USA	2.0	1.1	-0.9	2.4	2.9	3.8	-1.2	1.0
Japan	2.4	0.3	-1.4	1.1	0.0	1.8	0.0	-0.4
Euro area	2.6	0.9	-1.4	0.9	2.1	3.3	1.1	1.7

	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09
Major currencies (end Q)						
Yen per US $	106	90	100	100	105	105
US $ per euro	1.40	1.40	1.45	1.45	1.50	1.50
US $ per £	1.78	1.50	1.58	1.58	1.61	1.61
£ per euro	0.79	0.93	0.92	0.92	0.93	0.93
3-month interest rates* (%)						
US	4.5	0.8	0.4	0.4	0.4	0.4
Eurozone	5.3	3.4	2.9	2.3	2.2	2.2
UK	6.3	3.3	2.0	1.7	1.6	1.5

** Note: due to the dislocation in money markets, these rates may not give a good indication of policy interest rates*

UK ECONOMY

(annual % changes, adjusted for inflation, unless otherwise indicated)

	2007	2008	2009	2010
Growth & output				
GDP	3.0	0.7	-2.5	0.5
Manufacturing output	0.6	-1.6	-2.8	1.7
Services output	3.6	1.3	-2.2	0.5
The personal sector				
Household expenditure	3.0	1.9	-2.4	-0.4
Retail sales	4.3	3.5	-2.0	-0.5
ILO unemployment (%)	5.3	5.7	7.7	8.6
House prices (Halifax index, Q4 on Q4)	5.6	-16.0	-10.0	5.0
Inflation & base rates				
Retail prices index (RPI)	4.3	4.0	-1.8	0.6
Consumer prices index (CPI)	2.3	3.6	0.4	0.9
Bank base rate (%, at year-end)	5.5	2.0	0.25	1.5

Forecasts are as at 31 December 2008

Sources: IMF, ONS, HSBC

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