

## **Economic Background**

### **Introduction**

1. The credit crunch storm of August 2007 eventually fed through to the near collapse of the world banking system in September 2008. This then pushed most of the major economies of the world into a very sharp recession in 2009 accompanied by a dearth of lending from banks anxious to rebuild their weakened balance sheets. Many governments were forced to recapitalise and rescue their major banks and central banks precipitately cut their central bank rates to 0.10 – 1.00% in order to counter the recession.
2. The long awaited start of growth eventually came in quarter 3 2009 in the US and the EU. However, there was disappointment that the UK failed to emerge from recession in quarter 3.
3. Inflation has plunged in most major economies and is currently not seen as being a problem for at least the next two years due to the large output gaps and high unemployment putting a lid on wage growth. In many countries there have been widespread pay freezes in 2009 and these are likely to be persistent for some time.
4. Deflation could become a threat in some economies if they were to go into a significant double dip recession.
5. Asian countries, especially China, are buoying world demand through their own stimulus measures.
6. There still needs to be a radical world rebalancing of excess savings rates by cash rich Asian and oil based economies and excess consumption rates in Western economies if the world financial system is not to avoid a potential rerun of this major financial crisis in years to come.
7. Most major economies have resorted to a huge expansion of fiscal stimulus packages in order to encourage a fast exit from recession. This, together with expenditure on direct support provided to ailing banks, has led to a drastic expansion in government debt levels which will take many years to eliminate and to restore the previous health of national finances.

### **Two growth scenarios**

8. The current big issue is 'how quickly will the major world economies recover?' There is a sharp division of opinion on this question as set out below. The knock on effects on forecasts for interest rates can be seen in Annex D – UBS strong recovery, Capital Economics – weak recovery.

### **Scenario 1: Strong recovery**

9. This is a normal cyclical recovery which will be strong in the major world economies. The US still has potential to add further fiscal stimulus in 2010 to ensure that strong recovery continues after the current round of stimulus measures end. Growth in the EU is likely to be strong in 2010 and not require such help.

### **The UK:**

10. GDP growth will almost get back to the long term average of about 2.5% in 2011 but is likely to peak in the first half of the year as inventory rebuilding and stimulus measures fade and fiscal contraction kicks in later in the year.
11. The economy will rebalance with strong growth in exports and import substitution helped by strong recovery in the EU and the rest of the world.
12. Sterling has depreciated by 25% since the peak in 2007 and is likely to stay weak.
13. Consumer spending – only a mediocre recovery is expected due to a steady increase in the savings ratio from +5.6% in 2009 to about 8% in 2011 as consumers pay down debt or build cash balances. Consumer incomes will be held down by wage freezes and increases in taxation.
14. House price recovery is expected to persist helped by a low Bank Rate for a prolonged period; the peak to trough fall in house prices is now expected to be no more than 20%. House prices to rise by about 6% in 2010, and 3% in 2011; mortgage approvals will rise back to the level of 75 - 80,000 per month needed to ensure a continuation of a trend of rising house prices.
15. CPI inflation to peak @ 2.5% in early 2010 after the rise in VAT in January but then to fall to a trough near 1.5% in early 2011 and to stay below 2% for the rest of 2011.
16. The current MPC attitude is one of hang on as long as possible before increasing Bank Rate. The aim of this would be to try to ensure that growth gets going at a decent rate and that Bank Rate gets back to 4 – 5% before the next recession and that all assets purchased through QE have been sold off by then. The first Bank Rate increase is expected in Q3 2009.
17. If there is a change of Government in 2010 with a more aggressive fiscal approach then this could delay the timing of Bank Rate starting to go up.

18. The fiscal deficit is 6.4% of GDP, about £90bn, which is expected to fall at £11bn p.a. over eight years at currently planned rates. This is similar to the peak deficit of 7% in 1990s which was remedied to a surplus of 1.6% in the space of 6 years helped by strong, steady economic growth of 3% p.a. supported by loose monetary policy that compensated for the fiscal squeeze.
19. Gilt yields, especially longer term ones, are currently artificially low due to the Bank of England's Quantitative Easing operations. £200bn of gilts, commercial bonds and paper are being purchased under this scheme which has inflated prices and depressed yields. Once this campaign ends, yields will inevitably rise but will also rise due to the huge level of issuance of new gilts to finance the fiscal deficit. Long gilt yields are therefore forecast to reach 6% during 2011.
20. Gilt yields could rise higher if there was a hung Parliament in 2010 or if the fiscal situation deteriorates further.
21. The major risk to this scenario would be a lack of supply of bank credit. However, it is felt that the Bank of England is on alert to ensure that this does not happen and would continue various measures to assist the expansion of credit.

## **Scenario 2 - Weak recovery**

22. The current economic cycle is not a normal business cycle but a balance sheet driven cycle. Over borrowed banks, corporates and consumers are focused on shrinking their levels of borrowing to more viable and affordable levels and this balance sheet adjustment will take several years to be effected. Repayment of debt will therefore act as a major head wind to the required increase in demand in the economy. Consequently there will only be weak economic recovery over the next few years after the initial sharp inventory rebuilding rebound fades. GDP growth is forecast to reach only +1.5% in 2011.
23. Fiscal contraction will further dampen economic recovery driven by a strong political agenda to accelerate cuts in expenditure and increases in taxation after the general election in 2010.
24. The consumer savings ratio will rise so as to eliminate over borrowing and to insure against people losing their jobs during this downturn. This will depress consumer expenditure, the main driver of the UK economy.
25. Growth will also be hampered by a reduced supply of credit from weakened banks compounded by weak demand for credit.

26. The eventual reversal of Quantitative Easing will take cash out of the economy and reduce demand in the economy.
27. Unemployment is likely to rise to near to 3m in 2010 and take years to subside due to weak growth. High unemployment will reduce tax income and increase expenditure on benefits and the costs of local authority services.
28. Inflation will not be a threat for several years as the current 6% output gap will take until 2014 to be eliminated. However, deflation is a major danger for some years: the major falls in manufacturing prices over the last 12 -18 months have still to feed through to the economy and then to impact wage deflation.
29. CPI inflation will blip up over 2% in early 2010 but will then be on a strong downward trend to about -1% in 2011.
30. There is no need for the MPC to change Bank Rate from 0.5% in 2010 or 2011 and possibly for 5 years as they will need to counter the fiscal contraction which will dampen demand in the economy.
31. Long PWLB rates will FALL from current levels to near 4% in 2010 due to weak economic recovery and minimal inflation so that the real rate of return (net of inflation) on long gilts is healthy at these low levels

#### **Treasury Management Advisers - Sector Treasury Service's view**

32. Sector Treasury Services recognises that at the current time it is difficult to have confidence as to exactly how strong the UK economic recovery will prove to be. Both the above scenarios are founded on major assumptions and research which could or could not turn out to be correct. Sector Treasury Services has adopted a more moderate view between these two scenarios outlined above i.e. a moderate return to growth.
33. It is felt that the risks that long term gilt yields and PWLB rates will rise markedly are high.
34. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas: -
  - i. degree of speed and severity of fiscal contraction after the general election
  - ii. timing and amounts of the reversal of Quantitative Easing,
  - iii. speed of recovery of banks' profitability and balance sheet imbalances
  - iv. changes in the consumer savings ratio
  - v. rebalancing of the UK economy towards exporting and substituting imports

35. The overall balance of risks is weighted to the downside i.e. the pace of economic growth disappoints and Bank Rate increases are delayed and/or lower.
  
36. There is an identifiable risk of a double dip recession and deleveraging creating a downward spiral of falling demand, falling jobs and falling prices and wages leading to deflation but this is considered to be a small risk and an extreme view at the current time on the basis of current evidence