



# Perspectives by Ruth Lea

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### **Belt-tightening all round – except in the public sector**

#### *Credit conditions are still tightening*

The credit statistics released last week made for difficult reading. Despite the aggressive cuts in official rates and the Government's support for the banking sector, the Bank of England's latest *Credit Conditions Survey* for the 2008Q4 showed a further deterioration in credit availability.<sup>1</sup>

Concerning supply, lenders reported that they had reduced the availability of secured credit to households during the fourth quarter and, moreover, the tightening had been tougher than they had anticipated three months ago. Negative expectations for house prices and concerns over the economic outlook were cited as explanatory factors. Similarly, credit availability for corporate customers had also declined more than expected. Only with unsecured credit availability had the tightening been much as expected. Significantly, lenders expected further falls in credit availability over the next three months – and across the board.

On the demand side, the picture was more varied. Demand for secured lending for house purchase and re-mortgaging had been broadly stable over that past three months. But the demand for credit by private non-financial corporations (PNFCs) had declined further and, moreover, was expected to fall further. Reduced PNFC demand continued to reflect a poor outlook for capital investment, mergers and acquisitions, and commercial real estate.

The report also said that with economic conditions worsening, more borrowers (whether household or PNFC) were defaulting on their loans and the default rate was expected to worsen. Overall spreads on secured lending to households and on corporate lending had widened and there was some expectation that the spreads would continue to widen on corporate lending – though not on secured lending to households.

The findings of the Bank's latest *Credit Conditions Survey* came as no real surprise. And neither did the latest recorded data from the Bank on lending to private non-financial corporations and individuals.

Borrowing from banks by private non-financial corporations slowed very sharply last year. In November 2008 it grew by just 4.9% (year-on-year), compared with over 17% in November 2007. On the other side of the balance sheet, deposits at banks by the non-financial companies have fallen every month since May 2008. Deposits were over 6% lower in November 2008 in than the previous year. Non-financial companies, many of which are struggling to survive, are facing a cash crunch, trapped between dwindling reserves and a weakened ability to borrow.

And, if the Bank's latest *Credit Conditions Survey* turns out to be at all accurate, the ability of these businesses to borrow will deteriorate further.

Turning to the latest data on lending to individuals, approved loans for house purchase fell to just 27,000 in November compared with October's 31,000.<sup>3</sup> This is but one piece of recent evidence for a continuing, sharp decline in the housing market. The Halifax reported last week that house prices were 16.2% lower in 2008Q4 than in 2007Q4. This was the fastest pace of decline since the Halifax began keeping records in 1983 - faster even than during the recession and housing bust of the early 1990s.

#### *Another Bank Rate cut?*

The evidence on the continuing deterioration in credit conditions, despite the Government's rescue plan and the very aggressive cuts in Bank Rate from 5% in April 2008 to 2% in December (3-month LIBOR was just over 2.5% on 2 January 2009), begs the question as to whether there is any point in the Bank cutting interest rates further. It is clear that the banks are increasingly reluctant to pass on the cuts in Bank Rate, not least of all because they are trying to deliver reasonable savings rates for their depositors.

However, cutting the Bank Rate does reduce the cost of money for banks from other sources, not least of all from the Bank itself, so in these desperate times there is a case for further cuts in the Bank Rate - down to 1.5% or even 1%. The markets have already factored in another 0.5% cut and this is probably the judicious move for the MPC to make at next Thursday's MPC meeting (8 January 2009). Given the current fragility of sterling, a 1% cut in January could unnecessarily undermine the currency. In addition to a further cut, there are increasingly persuasive reasons for other measures to stimulate lending.<sup>4</sup>

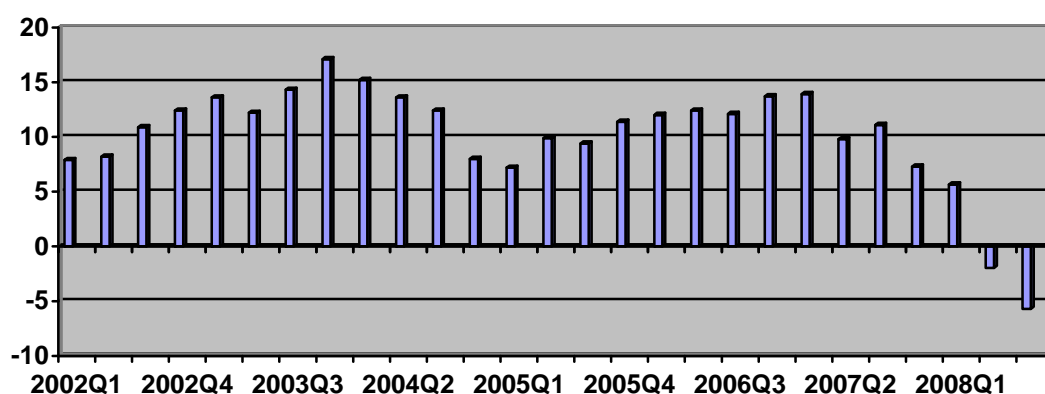
#### *The private sector tightens its belt*

The private sector is now tightening its communal belt and significantly at that. Many companies are downsizing, shedding labour, and generally cutting back on costs. And many companies are closing their doors. Already several High Street names have gone - expect many more by the end of the year.

The latest Chartered Institute of Personal and Development (CIPD) report suggested that 600,000 jobs could be lost this year, making 2009 the worst year for job losses in two decades. Overall, the CIPD believes that job losses from this recession could top one million with unemployment rising to 3 million in 2010. In addition, the CIPD's latest survey found that pay expectations among employees had slumped, with many expecting pay freezes - if not pay cuts.<sup>5</sup>

Households are now reining in too. Two relevant indicators relate to housing equity withdrawal (HEW) and the saving ratio.<sup>6,7</sup> The first chart below shows that the large positive readings for HEW between 2002 and 2007 were, in no small part, contributors to the unsustainable credit-driven consumer boom of that period. The rapid reversal in 2008Q2 and 2008Q3 shows a radical change in behaviour as households paid off existing mortgages at a faster rate than they took out new ones. Households injected more equity into the housing market in 2008Q3 than at any time since records began in 1970.

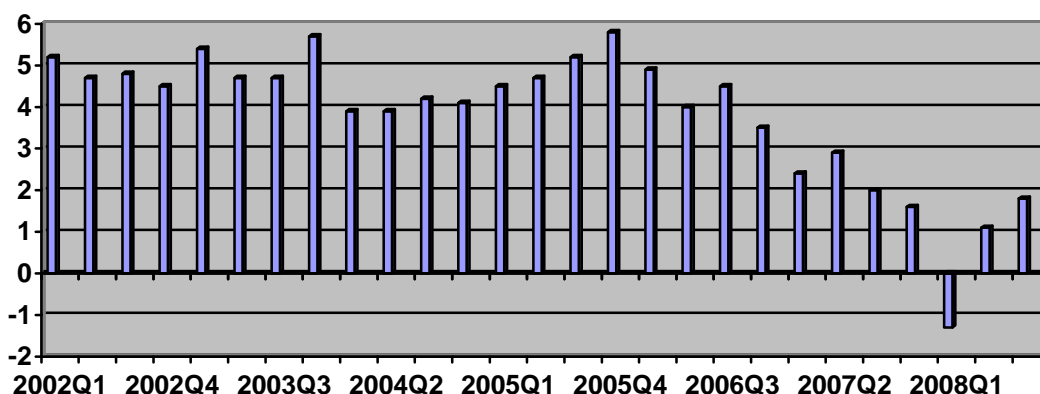
### Housing Equity Withdrawal, seasonally adjusted, 2002Q1 to 2008Q3, £bn



Source: Bank of England statistical database, [www.bankofengland.co.uk](http://www.bankofengland.co.uk).

The next chart shows how the saving ratio collapsed in late 2007, actually turning negative in 2008Q1. This was clearly unsustainable and households are now seeking to repair their balance sheets, which will inevitably depress consumption. But this should be seen as a necessary adjustment to more sustainable behaviour, after the years of a consumer-led binge.

### Saving Ratio, seasonally adjusted, 2002Q1 to 2008Q3, (%)



Source: ONS, "Quarterly national accounts: 3<sup>rd</sup> quarter 2008", 22 December 2008.

### *The public sector*

There is, of course, one part of the British economy which shows no sign of contraction and which continues to spend energetically. And that is the public sector. Indeed it is Government policy that it should continue to do so – even though the public borrowing figures are appalling and the productivity record in the public sector is frankly disgraceful, thus dragging down the overall performance of the economy.<sup>8</sup>

In 2008Q3 public sector employment rose by 14,000, compared with a fall of 128,000 in the private sector.<sup>9</sup> Given the substantial increase in public sector employment since 1997 (it was 5.2 million in 1997 and is currently nearly 5.8 million), there should surely be room for cost savings and belt-tightening, which could help finance tax cuts and stimulate the wealth-producing private sector.

## References

1. Bank of England, *Credit Conditions Survey, Survey results, 2008Q4*, 2 January 2009. The survey was conducted between 24 November and 15 December – which straddled the Bank's decision to cut Bank Rate from 3% to 2%.
2. Bank of England, "Sectoral breakdown of aggregate M4 and M4 lending: November 2008", 2 January 2009.
3. Bank of England, "Lending to individuals: November 2008", 2 January 2009.
4. Ruth Lea, "The recession deepens: time for further measures", Arbuthnot Banking Group, 15 December 2008.
5. Christine Buckley, "Stark numbers add up to worst year for employment in Britain for 20 years", *Times*, 29 December 2008.
6. Housing equity withdrawal (HEW) is new borrowing secured on dwellings that is not invested in the housing market (e.g. not used for house purchase or home improvements), so it represents additional funds available for reinvestment or to finance consumption spending. Source: Bank of England.
7. The saving ratio is defined as "households' saving as a % of total available households' resources". Source: ONS.
8. Ruth Lea, "The public finances: time for a radical reappraisal", Arbuthnot Banking Group, 1 December 2008.
9. ONS, "Public Sector Employment: 2008Q3", 17 December 2008.

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