PRESS RELEASE 8 May 2009

HSBC ECONOMIST SPEAKS TO LOCAL BUSINESSES ABOUT CREATING A SECURE ECONOMY

On 22 April, Dennis Turner, HSBC economist spoke to Bedford Breakfast Club at Stagsden Golf Club about how the credit crunch and recession came about, where we are now, and the key role of businesses in the UK's recovery. Over 100 business people, from throughout Bedfordshire and Buckinghamshire, invited by sponsors HSBC, Mazars and Woodfines Solicitors, turned up to listen to what he had to say.

"We were so privileged to have such a high-profile speaker, all the way from Canary Wharf, on the day of the annual budget," said Sarah Black, Head of Commercial, at HSBC in Bedford.

Dennis gave a down-to-earth view saying that the credit crunch had not caused the economic slowdown but that it would hinder the pace of recovery, and a correction was almost four years overdue. He explained how the government managed the financial environment's stability, through a trilogy of interest base rates, inflation and exchange rates and let national consumer and business market forces drive the economy itself.

The audience was reminded of how the government used the same levers, as it is doing today, to catapult the UK out of the recession in 1992. Since then, Britain has enjoyed 63 consecutive quarters of economic growth, the longest period since records began in 1870.

"Economists generally consider a safe, natural rate of growth to be around 2.5%. Dennis compared Britain's 52% growth over 16 years with Europe's 29%. In the absence of a population explosion, this poses risks comparable to reckless driving," said David Birch, partner at Mazars in Bedford and Milton Keynes.

In short, the UK population's spending outstripped income, which only rose by 2% per annum, and led to unprecedented borrowing. Consumers made up two-thirds of the rapid rises in GDP which could not be

sustained and was destined for bust. Now consumer debt is larger than the national economy and spending has tailed off.

For 16 years, inflation has hovered around 3%. Previously business people used double-digit inflation to increase prices as the risk of market rejection was much lower. As inflation rises, businesses will increase their prices once again, rather than continuing to cut costs thus jeopardising output quality.

He also highlighted how, historically, personal and corporate debts have been paid off more rapidly in higher inflation environments. This is largely because earnings were pushed upwards as inflation fuelled rising prices.

Substantial inflation hikes will lead interest rates upwards. Since 1992, UK borrowers have enjoyed the lowest interest rates since 1955. To put this in context, in 1977 the average was 12% and the lowest under Thatcher's government was 7.5%, and this only lasted for four months. In November 2006, borrowers considered 5% to be high, which reflects the mentality produced by such a long economic boom.

Today's record low interest rates will help relaunch spending and investment as the returns on savings are negligible.

Looking back over 50 years, the exchange rate took a tumble, devaluing the pound by around 75% in 1995. Although it suppressed import costs and interest rates, which benefited most of the population, selling overseas became difficult and manufacturing took the hit. In January, sterling hit an all-time low against the dollar and a 25-year low against the euro. These boost the appeal of UK exports and if the pound remains weak, we could see the return of large-scale manufacturing in Britain which would benefit regional cash flow, direct employment and local service industries.

Attracting large manufacturers to Britain, so that they can use it as a springboard into Europe, would dramatically strengthen and help rebalance the economy. To date, few have mentioned post-recession planning, but Dennis emphasised that this was the time to do it, and appealing to manufacturers appears to be the most appropriate buoyancy aid.

When consumers appeared to be running out of steam, the government injected cash from surplus funds. At around the time of the dot-com bust, tax receipts weakened, creating a deficit, so the government started borrowing. Growth was driven by consumer and government spending and borrowing, while investments and exports did not make a full contribution, creating an imbalanced economy.

Correction should have come in 2005 but the government artificially suppressed inflation by telling the Bank of England not to include rising house prices in its calculation. The absence of a timely, controlled adjustment has now caused economic crash. But things are about to get better.

Consumers' diminishing disposable income gives businesses the opportunity to invest at the lowest point in the economic cycle. Although they entered the recession in good shape, a recent government survey of purchasing managers suggests that businesses are not yet keen.

British recessions typically last between four and six quarters, but if the recession officially ends in December 2009, it may not return to business as usual. Such an ending is officially defined as when GDP increase is no longer negative, but this means that it could be 0%, so directors should plan further ahead.

Dennis suspects that things are not going to get worse. Private sector profitability, growth and employment will pick up, although public sector finances have been seriously damaged by bridging the spending gap in 2008 in an attempt to boost commerce. Increasing inflation and tax while cutting spending is the government's only route to repaying debt and covering increased unemployment costs. Although this sounds negative, it is likely to boost earnings.

The funding gap responsible for the credit crunch came when some banks lent more than they received from deposits. Dennis warned that only banks that covered lending with their deposits could offer security.

The funding gap worsened when banks turned to the wholesale money market to enable them to lend. As a result, the government is now using quantitative easing to reduce long-term interest rates and close the gap. This is where the Bank of England gives money to the banks, while maintaining a low base

rate to secure the business case which compels bankers to lend. £150 billion has been earmarked to be injected in two tranches. Although this will cause interest rates and inflation to rise, the risks of short-term deflation are much greater than long-term inflation.

This strategy works slowly, but positive indications are already starting to appear. The economy will recover and the banking system that will emerge will focus on risk rather than market share. It will be smaller and safer, but what they lose in business volume will be compensated for by higher prices. This is not a sign of inefficiency, rather stability.

"I have recently led a university student discussion group. They had three key questions: Where did all the money go? How am I going to repay the £30,000 that I owe the government? Is borrowing money on a student loan a good idea? They are the next generation of consumers, business people and politicians. They are concerned about the economy, their long term personal finances and believe that such levels of debt are unacceptable," commented David.

"I am sure the guests at Bedford Breakfast Club appreciated such an understandable analysis of the UK's economic situation. Having direct access to such a senior bank economist is relatively rare and we were delighted to be able to co-host the event," concluded Ian Melville, Licensed Conveyanser of Woodfines Solicitors in Bedford.

If you would like to attend or find out more about future events at the Bedford Breakfast Club, please visit www.bedfordbreakfastclub.co.uk.

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