QUARTERLY

STATE OF THE TYNE & WEAR ECONOMY REPORT Spring 2010

Job changes covering Jan to Mar 2010
Local News to May
Bank Lending Latest BoE Report May

Ref:SOER10/1

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KEY POINTS

UK Economic Overview

For the second successive quarter, the **UK economy continued to grow in Q1, but at about half its normal pace.** ONS' revised estimate (25/6) of GDP growth is 0.3%, which follows 0.4% in Q4; Note: UK output remains about 5 ½% below its peak, and about 11% below its pre-recession trajectory.

UK economic **growth in 2010** is now **forecast to be 1.2%** –Independent forecasts (compilation by HM Treasury of April 2010 forecasts). This is shaved down by 0.2 percentage points from 3 months ago. They are now consistent with CBI forecasts of 1.2% in 2010. Caution: these forecasts pre-date the euro crisis in May; this can be expected to shave growth down again, particularly due to slower growth of exports.

The new UK govt. has **begun to cut** the **budget deficit** which was over 11% of GDP in 2009/10. The £6bn of in-year cuts announced on May 24th are a start worth about 0.4% of GDP. The aggregate size of the main cuts is due to be announced in the "emergency" budget on June 22nd. If they are around £60bn (or 4% of GDP), compared with last year, this would be nearly a tenth of public spending. If the deficit is not convincingly controlled, however, interest rates on govt. debt will rise, possibly very sharply; a combination of the big public debt and higher interest rates could push the UK into a public debt trap. [The context for this risk is outlined in the feature on the 'Public Debt Trap' in §7.]

Annual inflation has **surged again** (in December CPI was 2.9% even before the VAT rise), with CPI reaching 3.7% in April. Inflation has been above and the target range (2% +/1pp) band since January. **RPI and RPIX both broke through 5% in April.**
Important note: The Bank of England expects inflation to subside in 2010's second half; if this does not happen, base rate could be forced up**.**

Unemployment

ONS' estimate of **UK unemployment** (the **official definition from LFS**) rose to 2.51m in the 3 months to March. This is the highest level since 1994, and a rate of 8.0%. Caution: these LFS ests. can be volatile.

Conversely, **UK unemployment has continued to fall** since **the autumn** months (except around January)**: Claimant unemployment *fell* 27,100 in April** on the seasonally adjusted series. The same variable had also now fallen nearly 100,000 since Nov (1.630m) to 1.52m.

In **Tyne & Wear, claimant unemployment** has fallen in most months since October and in April was **lower by over 1,600 from a year earlier** at under 37,000 It had broadly stabilised since April 2009. Caution: the TW series is *not* seasonally adjusted.

TW's fall in claimant unemployment in the year to April was **led by Sunderland**, **with a fall of over 1,400 (-12.9%).** Newcastle rose a bit (+111, +1.3%). All other Districts have had falls, down over 300 in South Tyneside, with negligible falls (under 25) in both Gateshead (-12) and North Tyneside (-24).
Caution: there is no seasonally adjusted (SA) series by ONS for TW claimant unemployment count.

Claimant unemployment is forecast to rise modestly, by about a further 0.15m by end-2010 to 1.72m. (Est. from HM Treasury compilation of independent May 2010 forecasts). (This suggests *pro rata* for Tyne & Wear's employment base, a rise of about 3,000).

Global Context

Euro countries faced a **major crisis**, as interest rates on their govt debt rose sharply in April and the first week of May. They eventually countered it with a huge €750bn set of guarantees (9/5). The **Greek Govt has unsustainable debts and will have to default at some point**; Greece may have to leave the euro. The other southern members of the euro imposed spending cuts to try to improve confidence in their govt debt. This 'sovereign debt crisis' in the eurozone countries will slow growth across the EU. The NE (like the UK), unfortunately, exports half as much again to the EU as to the whole of the rest of the world. **Global economic growth accelerated** to a forecast for 2010 of over 4½%pa –IMF.

The NE's goods exports in Q4 **jumped 17% on the previous quarter (up £392m) (double the 8% rise in Q3)**. Exports soared to emerging markets **up 25% to Asia**, up 83% to Sub-Saharan Africa and **up 136% to Eastern Europe**. NE exports were up 8% on a year before. Raising NE and UK exports looks essential for a stronger recovery; which probably means much more focus on Asia.

Local Job Gains

Clipper Windpower is creating a blade-manufacturing plant in Newcastle, by late 2010, which it expects to employ **500 by 2020**.

Local Job Losses

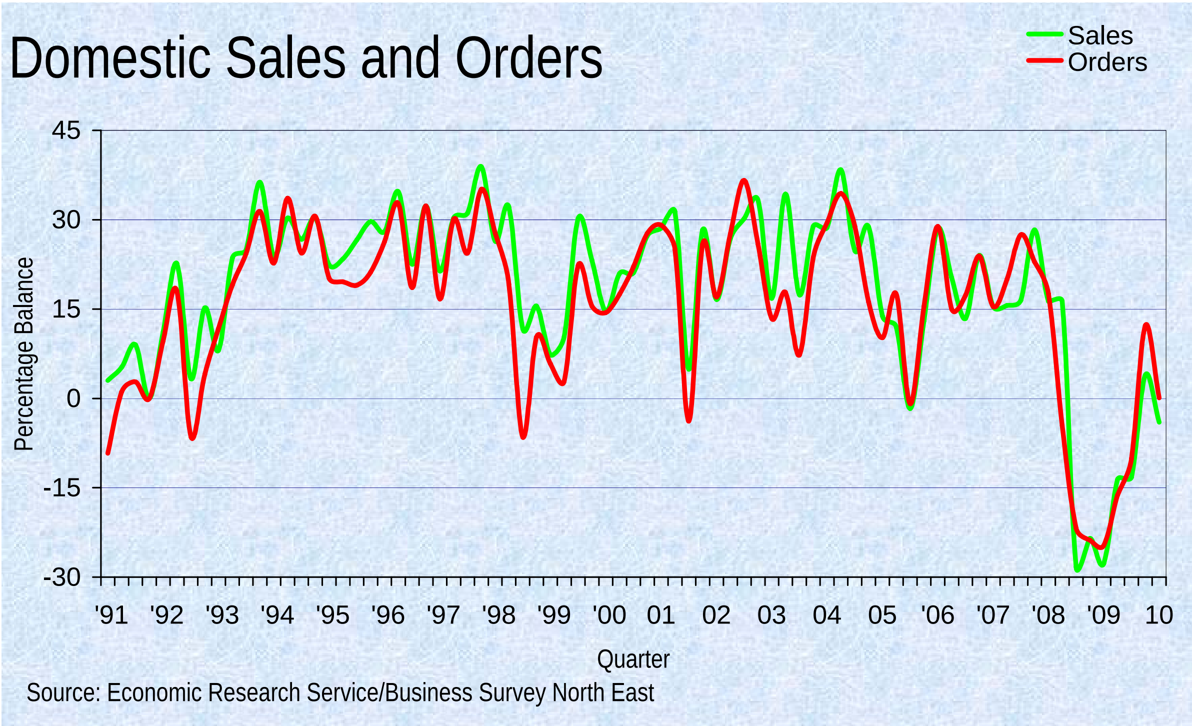
Littlewoods Shop Direct closed (900). **Wellstream** (200) and **BAE Systems** (270) each shed around two-fifths of their jobs.

Date: 4th June 2010

TYNE & WEAR ECONOMY

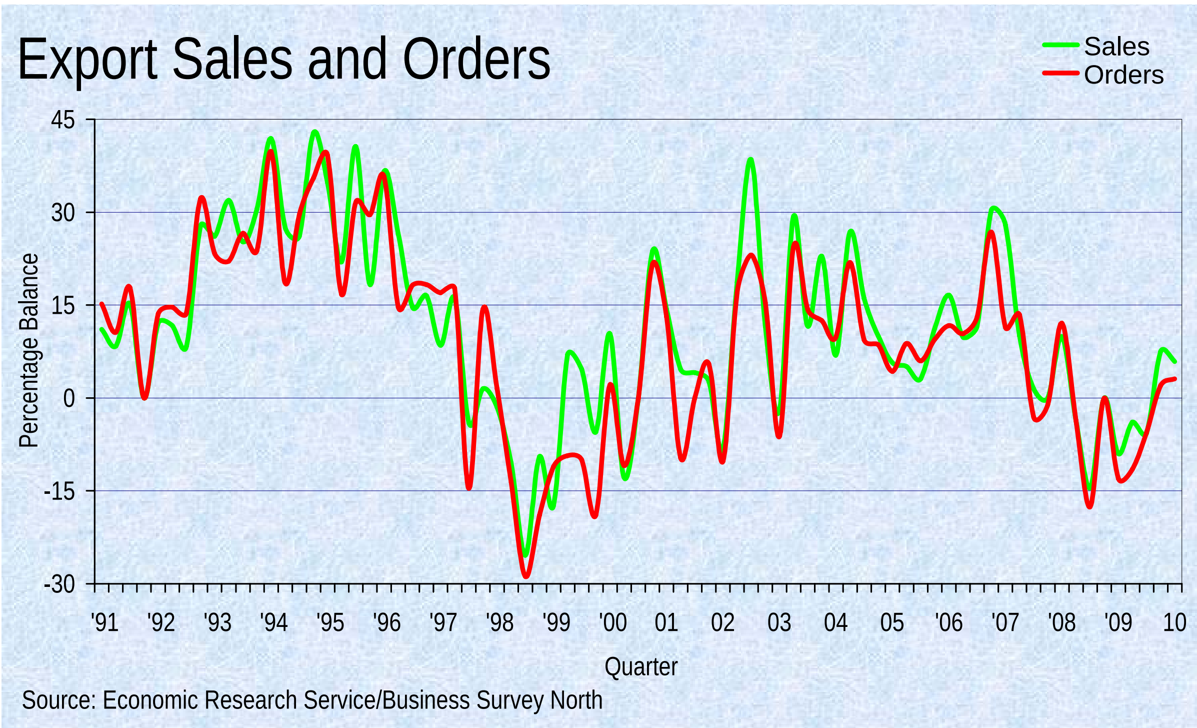
1. Indicators of Demand:

In the first quarter of 2010, TW firms reported domestic demand (UK customers) growth slipped back to almost zero, after slight growth in Q4 (from a net balance under 4%). Growth of orders was zero (after a balance of 12% in Q4). Caution: these TW indicators are weaker than UK GDP growth indicates.



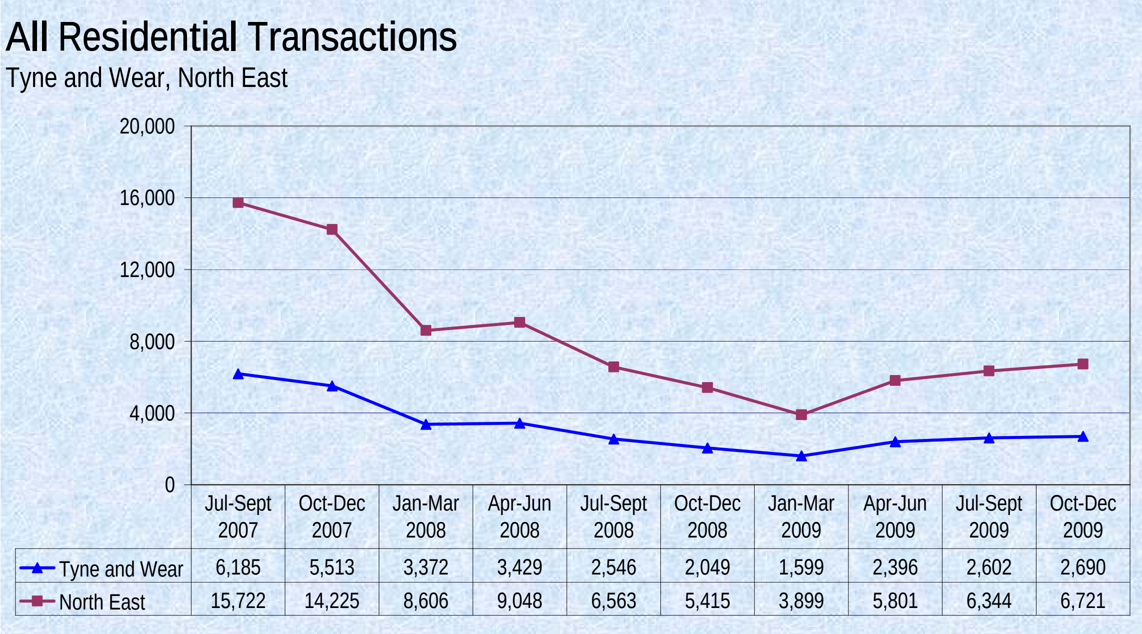
Note: these indicators of demand are from firms in Tyne & Wear (only).

Export demand remained positive in Q1, but growth of orders (balance 5%) was weaker than sales.



2. Housing Market

In Q4 'autumn' 2009, house sales ('All residential transactions', below) rose for the third successive quarter (TW up 3%, NE up 6%). Compared with a year earlier (the 'Lehman quarter'), in TW, house sales were about 31% (about 640) higher, rebounding faster than the NE (up 24% or about 1,300). Compared with 2 years earlier (in 2007)(chart below), however, sales were still down by about half (TW -51%, NE -53%). Caution: sales are highly seasonal, in 2007 TW sales rose in the spring.

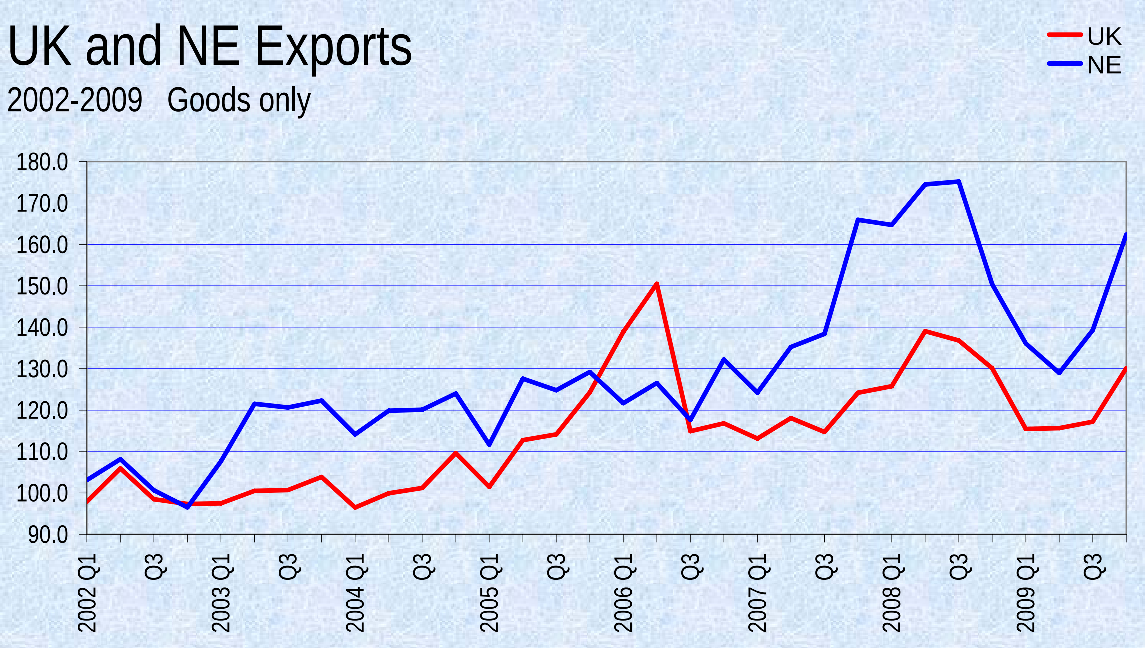


	Jul-Sept 2007	Oct-Dec 2007	Jan-Mar 2008	Apr-Jun 2008	Jul-Sept 2008	Oct-Dec 2008	Jan-Mar 2009	Apr-Jun 2009	Jul-Sept 2009	Oct-Dec 2009
Tyne and Wear	6,185	5,513	3,372	3,429	2,546	2,049	1,599	2,396	2,602	2,690
North East	15,722	14,225	8,606	9,048	6,563	5,415	3,899	5,801	6,344	6,721

Source: Land Registry Address file (compiled by TWRI). Caution: data are not seasonally adjusted.

3. Exports Note: exports may be critical to economic recovery in the medium-term (say 1-5 years).

NE[1] goods exports (by value) jumped 17% in Q4; to over £2.75bn. Emerging markets all took at least 25% more exports (Asia); exports to Africa jumped 83% and Eastern Europe by 136%. NE exports were up 8% on a year ago. Exports to EU markets (in 2009 57% of NE exports) grew 10% after only 3% in Q3. Machinery & Transport, TW's key exports (which includes vehicles) continued to recover jumping 41% (to £1.367bn) on top of 12% in Q3 and 22% in Q2; they were within 0.5% of Q1 2008 (pre-recession) level.



Source: HM Revenue & Customs

[1] HMRC Tyne & Wear data are not available to TWRI.

In Q4, NE exports were only 7% lower than in the peak quarter (Q3, 2008). Also, Machinery & Transport in Q4 accounted for *half* of all NE goods exports.

At last in Q4 NE exports showed renewed growth to Eastern Europe (exc. EU)[presumably mainly Russia] to a quarterly level of over £100m; in 2007 NE exports here had doubled to £603m (equivalent to about 1% of NE GDP). In the first three quarters of 2009, however, exports to Eastern Europe were down around three-quarters from 2007 levels (a loss of exports worth about £450m annually). E. European markets were known to have been constrained by a severe withdrawal of banking credit. The Russian car market had roughly halved from peak.

4. Aggregate Job Gains and Losses in TW (Jan-Mar 2010) – reported in the press:

There was a *reported* net job gain for TW again of about +700*, about half that in each of the previous two quarters, but more than the net gain of +500 in Q2. The improvement has been sustained from a net loss of -1,100 in Q1.

Summary of job gains and losses (announced in the press).

Jan 1st - Mar 31st 2010, for Tyne & Wear

District	Gain	Loss	Net
Gateshead	418	8	410
Newcastle	748	270	478
North Tyneside	75	20	55
South Tyneside	278	0	278
Sunderland	400	900	-500
Unallocated #	0	10	-10
Tyne and Wear	1,919	1,208	711

Unallocated gains and losses are usually estimates at County level of regional change.

Source: compiled by TWRI from the Journal and other local media.

Caution: press reports are very incomplete. In particular, they essentially omit construction job change, small job losses in retailers and other service firms. Historically they have omitted major growth in public service employment in health and education. Nevertheless, the reported job changes give a strong sense of overall employment change.

Claimant unemployment rose by about 15,000 in TW in the year to June 2009, stabilised in the second half of 2009 at around 38,000 and then falling to under 37,000 in April 2010. More details, including an itemised list of gains and losses, will be presented in the TWRI State of the Tyne & Wear Labour Market Report.

5. Structural Change in the TW economy:

- Clipper Windpower Marine is building a blade factory on the former Neptune factory site (in Walker). It is scheduled to open by the end of 2010. It could employ 500 by 2020.
- Go-Sustainable is to hugely expand, selling window panels. It plans to have 200 employees by 2013.
- Longbenton Foods has been re-expanding activity at the former Findus Foods factory (hit by a serious fire in January 2009). (Possibly 250 job gains over two years).
- Losses: Littlewoods Shop Direct closed with the loss of 900 jobs in January. This was the largest single job loss in Tyne & Wear since Nissan's retrenchment a year before.
- Wellstream shed 200 jobs, or nearly two-fifths of its employees, to 340 in February. The firm makes flexible piping for the offshore industry.
- BAE Systems in Newcastle shed 270 jobs, to about 380 (after it lost a major order to build trucks for the US Army).

UK ECONOMY

6. UK Economic Context:

The **central challenge** for UK economic policy-makers is to rein in the deficit (to prevent a substantial rise in interest rates) whilst also ensuring that economic growth continues at a reasonable rate. That balance has shifted in favour of tightening, according to Business Secretary Vince Cable (on R4 AQ, 28/5), following the Greek and eurozone crisis.

UK economic **growth** has been **slow and quite steady**, but the crisis in the countries using the euro means – at the very least - expanding exports to them will be more difficult. Growth continued in the UK economy in the Jan-Mar quarter of 2010 with 0.3% following 0.4% in Q4; slow at half the UK long-term average growth rate, but the VAT-rise did not stall economic growth.

In early May, **southern**[2] **Eurozone countries found serious difficulties** in raising finance from abroad (with sharply rising interest rates demanded). This was a spreading (or 'contagion') of the Greek crisis. It led to a huge package of guarantees and loans up to €750bn announced on May 9th. This has been followed by rapid budget cuts in Portugal, Spain and Italy - of around €20bn each in the latter two cases (or very roughly 2% and 1½% of GDP). The eurozone's economic growth is expected to be only 1.2% this year and 1.8% next (source: OECD 26/5, quoted in the Guardian). These cuts reduce incomes and thus reduce the prospective growth of UK exports to these countries.

The **"emergency" UK Budget** is due on June 22nd. The OECD has forecast growth accelerating in 2011 to 2.5%, and private consumption growing by 2.2%. This seems surprisingly strong to TWRI, given the scale of public spending cuts expected starting in 2011 (perhaps taking about 1½% of total demand out of the economy each year[3] for a couple of years). The budget can be expected to set out the following;

a) The scale of the cuts in public spending, perhaps as much as £60bn or nearly a tenth (but it could be reduced by tax rises instead),

b) The period over which the cuts are to be introduced, e.g. progressively over three years,

c) The forecast growth rates of the UK economy for each of the next few years (from the new Office of Budget Responsibility),

The OECD expects the UK economy to grow about twice as fast in 2011 (2½%) as in **recent quarters**. Crucially, the OECD expects private consumption growth to resume in 2010 (at 0.3%) and almost return to normal in 2011 at 2.2% (following the big drop -3.2% in 2009). For private consumption to grow like this in 2011, presumably the OECD expects private sector employment growth to offset public losses and that households will be able to raise their borrowings significantly[4]. Its forecast certainly assumes that inflation[5] subsides markedly, halving from 3% in 2010 to 1.5% in 2011.

The OECD has indicated UK base rate should rise over the next year, to 3½% by end of 2011 (OECD country report, as reported by R4 26/5). It also says the base rate rises should start in the next six months[6]. It warns that 'If bond yields rise faster than expected or inflation expectations stray further from the Bank of England's [2%] target, fiscal and monetary policy may have to tighten faster to maintain credibility.' The **OECD expects unemployment to peak in 2010**, falling by 0.2pp to 7.9% in 2011.

Private sector growth strong **enough to expand employment** is **now crucial**. Without it living standards[7] seem likely to fall, at least for a year or two. In any case, since about December, inflation has been running ahead of earnings growth – so living standards are falling. Consequently, TWRI

2 Greece, Portugal and Spain.

3 The OECD expects the UK govt budget deficit to fall by 1.2 percentage points of GDP in 2011 to 10.3 from 11.5% in 2010.

4 Though perhaps around one percentage point could be due to employment growth, and real earnings could grow a bit if inflation falls as low as they expect.

5 CPI inflation (which hit 3.7% in April).

6 Second half of 2010.

7 Real disposable incomes per head.

cautions consumer spending growth may well weaken in the second half of 2010 (perhaps back down close to zero[8], after a fall of -3% in 2009).
Some economists, however, warn UK economic growth will slow further under the impact of major cuts in public spending, which are expected from April 2011. David Blanchflower[9], in particular, has warned of what he calls a "death spiral". He is concerned that only when the recovery is well established should major cuts are implemented, because he sees a real danger of ending economic growth.

Growth of investment is needed for the recovery to broaden from growth of exports. The OECD expects investment to fall -2.3% this year, with [private] non-residential investment down -6.6%. This is now perhaps a bit pessimistic, as in Q1 business investment grew by 6%.

Bank lending growth is **too weak** to **ensure satisfactory economic growth**. The banks have losses est. at £50bn on their loans on commercial property (FoF, R4, Feb.). Independent economist Roger Bootle said, to ensure sufficient lending, the **Govt will have to** do at least one of a) **recapitalise the banks** (a third time) **and/or** b) tell/**order the banks to lend**.

The major route out of recession for the UK is **export-led growth (plus business investment)**[10]**; in this** in this the NE is well–placed still with a larger manufacturing base than most UK regions, bigger firm size and much higher export-orientation. In this restructuring of the national economy, the UK now needs significantly bigger exports. The UK's 2008 goods exports of nearly £250bn (one fifth of the UK economy) need to grow as quickly as possible by £30bn or so to close the trade gap. If the NE is to deliver 5% of this putative target, it would add £1.5bn or 13% to NE goods exports (from 2008) to reach about £12.8bn. In 2009 they dipped to £9.6bn. This gives a measure of **the challenge**; to **grow NE exports from their partially-recovered 2009 base by a third** as soon as possible. Given that NE exports to the EU were still 57% of the NE total (in Q3), the growth of demand in EU markets still remains crucial to NE export opportunities. The opportunities for big rapid growth of NE exports now mainly lie outside the EU, notably broadly in Asia, North America and the Middle East. These are the global regions with economies with significantly faster long-term economic growth than in the UK and the EU. The NE needs to get much better connected to them, and develop deep long-lasting large-scale trading relationships.

7. £6bn First Cuts Package:

The new government's £6.2bn package of first cuts (24/5) applies to the current year (2010/11) and includes the following:

- £1.7bn from delaying or stopping major projects; no new applications are being taken for the Future Jobs Fund (which originally aimed to provide 150,000 places nationally; it could have provided 3,000 in TW).
- £1.1bn from the DCLG (Communities Dept.); could be around £20m from TW Local Authorities.
- £1.15bn from consultants, advertising and travel.
- £836m from the Business Dept. Nissan still hopes it will receive its £20m grant towards the Leaf electric car.
- £670m from education although schools, Sure Start and 16-19 education are protected.
- £320m from ending the Child Trust Funds (from August for 7 year olds).
- £270m from RDAs. TWRI estimates this at close to a 10% cut. One NE said this should be manageable.

Note: £500m will be recycled into programmes for jobs and skills.

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[8] It was flat in 1991, the last year the UK had a big recession.

[9] A leading labour market economist and former member of the Bank of England MPC, now economics professor at Greenwich College in the USA.

[10] If the OECD's forecast of renewed near-normal growth of consumer spending in 2011 does happen, and provided it is not substantially driven by household borrowing, it could well effectively consolidate the UK recovery.

The IFS said that the cuts are 1.2% off departmental spending on top of the 0.5% real terms reduction in public spending this financial year from the Labour Govt.. The IFS said unprotected areas will face estimated cuts of 3.7% on top of Labour's plans to give an average 8.4% reduction compared with last year. Departmental cuts are particularly large for Defra (10%) and DCLG (27% real terms cut).

The major cuts programme being talked about before the election was of around £60bn or ten times the above package. The Labour Govt had announced measures which included £38bn of cuts, but these were largely unspecific "efficiency savings", i.e. without specifying which departments would bear them. The Spending Review in the autumn is expected to specify the budgets for each department and major programme.

The feature, below, was written in December 2009 and explains the context. Also we now know it took only about four months from Greece making its first significant cuts (in December), to being unable to finance its debts at reasonable interest rates (in April).

WHY THE UK GOVT. NEEDS TO CUT THE BUDGET DEFICIT; AVOIDING THE PUBLIC 'DEBT TRAP'.

1. The dangers: 'Loss of confidence' could occur amongst those who lend money to the UK govt.. [11]

a) at any point over the next five years or so, possibly within months;
b) meaning that interest rates on UK govt bonds would rise, perhaps substantially, displacing other public spending and
c) tends not to be a gradual process, but a sudden event.

2. The effects, if confidence were to fall in this way;
The sterling exchange rate would fall, perhaps markedly.
Inflation could, subsequently, rise – although if there is substantial unused capacity in the economy this will be damped.

Any govt.'s top priority in economic policy in current circumstances must be to restore and sustain economic growth.
Its second priority, however, is to cut the budget deficit, so as to avoid any substantial risk of falling into a public 'debt trap'.

3. Assessment of the Risk;

a) Size: The UK is running a budget deficit of around 12% of GDP (£175bn pa) this financial year, and a higher % of GDP in the year starting in April (2010). The public debt (or the 'national debt') is on course to roughly double to about 100% of GDP by 2014 (IMF)[12].

b) Speed of Rise: The cost of servicing the public debt will rise by 2½ times by 2014 (from 2008), other things being equal. Economic growth will help to pay that interest (mainly by lifting tax revenues, but also by cutting govt social benefits).

Unfortunately, the interest rate on national debt is in some danger of rising in the next year or two, if the UK govt.'s credit rating falls. At present, the UK has the highest credit-rating possible; 'triple-A' (AAA). Ireland lost its AAA in the current crisis, but has substantially larger public debts relative to GDP, and has had roughly twice as deep a recession (denting revenue and constraining its ability to introduce new taxes).

From cases of other rich countries with rising levels of public debt (in the last couple of decades) we can see that the ratings agencies withdrew the triple-A rating for Canada in the 1990s; this important decision was taken by the agencies when its public debt rose to be close to 100% of GDP. So the UK can expect to lose it before 2014. Greece, in December 2009, has a public debt of over 110% of GDP and rising; it has been forced to make big budget cuts (of about 10% in aggregate).

By 2014, on Treasury projections, the UK's national debt is heading for over £1,500 billion (about 2½ times its 2008 level); a one percentage point on a debt of this size would cost £15bn annually. This is equivalent to around 2% of total public spending (in 2009).

Note: A credible cuts programme (or 'fiscal consolidation') is not one which is the biggest but one which
a) does not snuff out economic growth (so cuts of 4% of GDP would need to be over two or more years).
b) minimises damage to long-term growth, so education and infrastructure need to be sustained, and
c) will be substantially implemented (i.e. is politically acceptable to parliament and public).

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11 Specifically in the market for UK govt bonds (known as 'gilts'). If a loss of confidence in one market is sudden it often triggers volatile and large movements in other financial markets; markets for corporate bonds, foreign exchange (sterling) and shares are obvious related markets. Mortgage rates would be affected through the bond markets, which set interest rates for mortgage lenders' wholesale funds.

12 Cited in Economist Newspaper, feature 26th Sept. 2009.

8. Prospects:

Future UK Economic Prospects are for slow growth in 2010. Tyne & Wear's economic prospects (for at least the next year or so) are determined largely by the UK trajectory.
Local factors also apply; One big one is that NE (and especially TW) exports tend to be investment-type goods (vehicles and machinery) and demand for these are more sensitive to the rate of growth of real incomes than are average exports; the prospect of TW exports to the EU growing strongly has been hit by the debt crisis in the euro-zone, cuts there and consequent slower growth of incomes. [A guess might be that the eurozone crisis cuts between 1 and 3% from TW exports to the EU, although it may be towards the low end as NE exports are mainly to northern Europe].

	2010	2011	Comments
Economic Growth	+1.2%	+2.2%	Growth strengthens substantially to close to normal in 2011. In 2010, however, the upturn is still weak. (Growth slightly slower, 0.2pp, than forecast four months ago.)
Claimant Unemployment	1.72m by Q4 2010	1.69m by Q4 2010	Claimant unemployment to rise very slightly in 2010, and then fall even less (about 30,000) in 2011.
CPI inflation (Q4 in each year)	2.3% and RPI inflation to 3.2%	1.8% and RPI inflation to 3.0%	The acceleration in inflation in early 2010 is temporary, but does not return to target until after the end of 2010. RPI inflation is faster presumably as mortgage costs rise in 2010 and 2011.
Govt Borrowing (PSNB)	£163.8bn (2010/11)	£139.4bn (2011/12)	Govt net borrowing is forecast to fall by over £24bn, or about 1.6% of GDP.

Source: average latest revised UK forecasts from HM Treasury's survey of independent forecasts (May. 2010).

As stated in the two previous editions of this report (in October and February), three global regions appear critical to Tyne & Wear's sustained economic growth:
"TW's ability to achieve a higher [economic growth] trajectory than the UK will, to an important degree, depend on its ability to raise exports,

- especially to fast-growing developing country markets (notably in Asia).
- Faster economic growth in the Euro-zone than in the UK would also be helpful to TW's economy (relative to the UK), because TW is (probably) more oriented to exports than is the UK, and this is the dominant export market.
- A recovery in demand from other markets, notably eastern Europe (excluding the EU), mainly Russia, would also be helpful. "

[Now we can see eurozone economic growth is actually much weaker than in the UK, but growth in other export markets has been very strong boosting NE exports starting with Asia in Q2 and finally Eastern Europe in Q4- Ed.]

As in February, we can add that the Govt needs to ensure that bank lending grows more rapidly, so as to support economic activity across the UK – and particularly to ensure small and medium-sized firms can grow to meet demand when it grows.

There is now a risk of a much bigger crisis in the euro-zone, where there is both a renewed banking crisis and a peeling away from using the euro. One or more countries may be forced by events to replace the euro with a new independent currency.

SOME EURO-ZONE COUNTRIES FACE DEFAULT, AND MAY LEAVE

The €750bn package of guarantees announced on May 9th greatly improves *liquidity* for govts of euro-zone countries which are having difficulty borrowing money[13]; it does not, however, settle two big underlying problems (essentially in southern Europe):

a) Insolvency (or near insolvency) of some countries.

b) An overvalued and fixed exchange rate (which make achieving sufficient economic growth impossible).

Danger 1. Insolvency leading to default:

a) The Greek govt has unsustainably large debts on which it will have to default. This is the view of a number of economists e.g. Prof. Doug McWilliams[14] (R4T 1/6) and Derek Scott [15]wb 17/5). McWilliams said it could happen with days or weeks. Greece has a public debt of about 120% of GDP.

b) Portugal has a public debt around 80% of GDP. Portugal appears next in line after Greece. Its debts are only about 2/3 the size but it relies even more heavily on external (foreign) borrowing. Also, its growth prospects are low, making it hard to service the debt.

c) Spain has a smaller public debt, around 65% of GDP. It has had a big property bubble which has burst. Losses on loans for this property will have to be taken largely by the Spanish banking system.

If Greece were to default, the losses would increasingly fall on the ECB since it has essentially been the only buyer of Greek bonds since early May.

Danger 2. Countries replace the euro with a national currency,

The point would be to achieve a devaluation. Greece may choose this option, to stimulate growth via a lower exchange rate. The burden in terms of increasing the size of Greece's debt in local currency terms, however, would be crippling (a one-third devaluation could raise the debt to around 180% of GDP). Such a devaluation decision would make default inevitable.

Currently there is no mechanism within the Maastricht Treaty for any euro-zone country to leave. This does not mean a country might not do this; perhaps it could close its markets (or at a weekend), then announce that all deposits in its banking system will be converted to the national currency. Notes and coins could remain in circulation for a time (as euros), but be replaced by the national currency.

3. A renewed Banking Crisis;

a) If creditors default, banks which hold the debt must take corresponding losses. The €750bn package was largely intended to prevent large-scale bank losses across the eurozone. Banks hold perhaps €500bn worth of southern European govts' debt.

b) Thus the key risks in the Euro-zone, say over the next 12 months are;

   Greece defaults – causing losses for banks, and a banking crisis (like Lehman in 2008); but this risk transfers to the ECB with time.
   Portugal becomes unable to finance its debts, drawing on the EU facility.
   Spain, given its much bigger size, would be much more disruptive to the euro-zone. If it were to suffer or face large-scale bank failures, it might choose to leave the euro.

For now these risks are postponed. The €750bn package included €60bn made available to needy govts to borrow effectively in the name of the EU.

Since April, stock markets have fallen by about a tenth. The euro is around a 4-year low against the dollar. As the Economist noted (29/5), 'The reason is that the risks of a far worse outcome have risen, and those risks lie mainly with governments. The place with the wobbliest policy is Europe. For the euro to survive, Europeans need to be prepared not just for painful fiscal adjustment but for profound structural reform as well….[in] their labour and product markets. Countries that are running current-account surpluses, mainly in the north, must help, by avoiding overzealous belt-tightening and introducing reforms to encourage private spending. And the European Central Bank (ECB) should counter the fiscal austerity with a looser monetary policy.'

[13] The countries most exposed are; Greece, Portugal, Spain and Ireland – the so-called "PIGS".
[14] Former Chief Economist for the CBI.
[15] Former Economic Adviser to PM Blair.

9. Credit Crunch – recent developments

- **Bank lending to businesses** has continued to be **negative** in Q1 2010 after every quarter in 2009 (**this means businesses, overall, repaid loans to the banks**)*.
- Moreover, the decline each quarter (as a monthly average) rose from -£0.6bn in Q1, -£5.2bn in Q2, -£6.9bn in Q3, but slowed to -£2.4bn in Q4.
- Importantly, this weak **lending to business is *probably one of*** *the* ***major explanatory factors*** for **the UK's weak economic growth**, in Q4 and Q1.
- Bank net lending to business grew at over 20% in 2007, slowed to over 10% in 2008, but turned negative in 2009. By March 2010, the **12-month 'growth' rate was -9.1%.**

Source: The Bank of England's monthly now called 'Trends in Lending'. This is largely based upon a survey of the Big Six lenders; caution: it omits foreign lenders.

The May report states;

- The flow of **net lending**[16] to **companies** was **negative** in March at -£3.2bn 'close to the average net monthly reduction seen in 2009'.
- The BoE however, in effect, notes **potential difficulties ahead**; a) **lending on commercial real estate** and b) loans from **foreign lenders**. [Note: Lending for commercial property was being protected by the banks in 2009[17]] Now 'Lenders noted that **conditions in the real estate sector** – which accounts for **nearly 50% of the total stock of business loans – remained fragile**….More generally, the major UK lenders noted the large amount of refinancing required in the next couple of years. Some lenders reiterated that as long as cash flows were secure, they would expect to refinance their loans, even if some loan covenants had been breached. Around a third of the stock of UK-resident bank lending to real estate companies, and to business overall, is accounted for by foreign lenders…[which]..has slowed particularly sharply since the financial crisis began.'
- 'The industrial breakdown of corporate lending indicated that in 2010 Q1, **for the first time** in four quarters, the **stock of lending did not fall across all sectors** of the economy. These data – which are not seasonally adjusted – indicated that the stock of lending was broadly unchanged for a number of sectors, including real estate, wholesale and retail trade and manufacturing.'
- 'Contacts of the Bank's network of Agents continued to report some easing in loan availability, though experiences varied depending on the size of business, sector and lenders' perceptions of risk.'

Quantitative Easing (QE)

The Bank of England's MPC decided in March to suspend its QE programme once its planned £200bn (of creation of new money) is reached. Alongside the spending cuts, 'The OECD also said the Bank should simultaneously start to withdraw the £200bn of quantitative easing' (Guardian, 26/5; Economics Editor, referring to the OECD's Country Report on the UK, May 2010).

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16 Official data covering lending by all banks and building societies.

17 In February's report; '…the stock of **real estate lending** – which accounts for **nearly 50% of the total stock of business loans** – was **broadly unchanged in 2009 Q4 on a year earlier**, in contrast to the decline in the stock of loans to the ret of the corporate sector over that period.' This implies that the rate of decline of the stock of **lending to *businesses other than real estate*** over the 12 months to December 2009 **fell twice as rapidly (around -16%)** as overall (-8%).