Schroders

Quickview

Economic update
8 October 2008

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- **UK government announces plans to recapitalise the banking sector**
- **UK approach has, historically, proven more successful than that proposed by the US**
- **We are now entering a global recession**

The UK government has today announced that it is planning an injection of capital into the UK banking sector that will effectively result in a partial nationalisation of the country's major banks. There will also be conditions for these banks in terms of how they act, how they lend, and their dividend and compensation policies.

The UK approach to shoring up its financial sector is somewhat different to the action already taken in the US. The $700 billion Troubled Assets Relief Program (TARP) that has been approved by US Congress is using government money to buy 'toxic' assets such as mortgage-backed securities from ailing banks. What the UK government has proposed by contrast is a more direct recapitalisation of the sector. In previous financial crises, this approach has been more successful in restoring market confidence.

Twice as long, and twice as deep

The International Monetary Fund (IMF) has released a study on financial crises that examines their frequency, their duration and how they have affected economic growth in the past. According to their research, since 1970 there have been 42 financial crises in 37 countries – so, these events are more common than one might think!

The study does, however, acknowledge that the crisis we are seeing today is on a bigger scale than previous events. The cumulative loss of GDP following a financial crisis has been circa 4% on average - in "normal" recessions it has been about half of this. A typical recession lasts between 12 and 18 months whereas analysis of past crisis suggests that the current downturn could last for more than two years.

Monetary policy isn't working

The key problem for the economy at the moment is that the monetary transmission mechanism has effectively broken down. The financial sector has become so risk averse that banks are unwilling to lend, even to one another. This seize-up in the credit system means that the benefits of interest rate cuts are not feeding through into the real economy.

Spreads on credit for the inter-bank lending market have reached extraordinarily high levels – between 300 and 350 basis points. This is a key indicator of the level of distrust that exists amongst the banks and, until we see these spreads come down, the cost of capital in the real economy will remain high.

So, what now?

We've had a glimpse this morning of the future face of the UK

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Continued…

banking sector. The sector itself will be smaller, government borrowing will rise, private sector borrowing will fall and we should, consequently, see a reduction in both corporate and household debt. However, we may be in for a bumpy ride before we arrive at this point. We would expect that the journey will be turbulent and that the consumer will be negatively affected by this sharp shake-up in the banking system.

We are now expecting a widespread global downturn. This means that we should anticipate sharp and rapid interest rate cuts as central banks attempt to resuscitate growth. We had thought that the Bank of England may cut interest rates by as much as 50 basis points tomorrow – at the time of writing, it was announced that the Bank of England has taken the decision today to cut interest rates to 4.5%. It has also been announced that the US Federal Reserve has cut US interest rates by 50 basis points to 1.5%, and the European Central Bank (ECB) has trimmed interest rates from 4.25% to 3.75%.