

The background of the entire page is a close-up photograph of several coins of different denominations and colors, including copper, silver, and gold. The coins are scattered and overlapping, with some in sharp focus and others blurred in the background. The lighting is dramatic, highlighting the metallic textures and intricate designs on the coins.

ABFA

## Economic Report

March 2010 / Issue No. 04 (2009Q3 - 2009Q4)

ABFA Economic Report March 2010

# THE ABFA ECONOMIC REPORT

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Disclaimer: The views are those of the author and not necessarily those of the Centre for Finance and Credit Markets or the University of Nottingham.

## EXECUTIVE SUMMARY

### **There are signs of improvement globally, but growth is variable**

...Both the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) upgraded their projections for GDP growth for 2010, and have done so again in early 2010. Emerging economies have seen a larger increase in GDP growth than the advanced economies, but substantial differences exist between countries. The US is expected to grow faster than Europe, while Russia lags China, India and Brazil, which are likely to grow rapidly.

**...the UK and Irish economies have reached the bottom of the recession and will recover slowly.** The UK and Irish economies appear to have reached the bottom of the recession. Compared to previous recessions in 1980-1 and 1990-1 the decline in output has been steeper, and more prolonged, but unemployment, which started from a lower point than in previous recessions, has not reached heights seen previously. Demand remains weak. The financial sector is recovering, and although it faces new challenges, the financial system is now stable. Central banks have ceased asset purchases, and are focusing now on inflation pressures and the large budget deficits relative to GDP.

**Turnover in the asset based finance industry fell along with advances reflecting economic conditions...** ABFA statistics report the asset based finance industry in the UK advanced £14.1 billion at the end of December 2009, against invoices, stock, property and other trading assets worth £29.0 billion.

This represents a slight reduction in advances compared to the previous quarter. In Ireland, the advances at €1.3 billion, against €3.2 billion of assets, were down from the previous quarter'. The downward trend in asset based finance reflects two general trends: the weakness in activity in the UK and Irish economies, seen in falling clients' sales, and a tendency for firms to reduce net borrowing compared to a year ago.

**...and net borrowing declined, but asset based lending to larger firms increased.** The reduction in the growth of total M4 lending is due to the decline in net lending that has occurred as firms repay previous loans and restructure their debt. The composition of corporate finance is changing as firms raise more debt, and fewer loans, and this is also seen in the growth of asset based lending to larger firms through 2009. More generally, advances declined in 2009, levelled out in the last two quarters and are expected to improve in 2010.

**Firms face less financial distress.** Client protection payments for non-recourse debts have risen for the year as a whole, but they have turned down in the last half of the year. Similarly, insolvencies reported by the UK Department for Justice have risen in 2009, but again these figures have declined in the last two quarters. Together these indicators suggest firms are over the worst of the recession. The time taken on average for ABFA members' clients to receive payments has also returned to pre-recession levels in 2009Q4.

## GLOBAL ECONOMIC OVERVIEW

### THE SIGNS OF GLOBAL IMPROVEMENT ARE BEING REFLECTED IN ECONOMIC ACTIVITY AND CONFIDENCE...

In the previous economic report we reported that there were signs that positive growth would return in 2010. During 2009 the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) upgraded their projections for GDP growth for 2010, and have done so again in early 2010. The most recent statistics show the IMF revised the output growth of the advanced economies up by 0.8% compared to 2009 projections, and IMF revised the output growth of the emerging economies up by 0.9%. **Chart 1** illustrates our point. It shows the steep decline in output growth in the crisis and the sharp increase in output growth in the first half of 2009 on average. Other indicators confirm the signal that the global economy is recovering. The volume of goods exported and the levels of industrial production have risen, confidence has also improved in the last quarter, and some countries - most notably the United States - report that firms are once again replenishing their inventories, which suggests that they anticipate greater demand in the coming quarters.

Emerging economies have seen a larger increase in GDP growth than the advanced economies, and this is expected to overshoot the sustainable level of growth over the next two years. But substantial differences exist between countries among the advanced and emerging economies, as can be seen in **Table 1**. According to the IMF the United States is expected to grow faster than the Euro Area in 2010 and 2011, and the UK will be slower to emerge from recession than most European countries, with slower growth in 2009, but faster growth in 2010 and 2011. Among the emerging markets, China, India

and Brazil will grow fast, while Russia is expected to lag behind to some degree, having experienced substantial negative growth in 2009. These differences between advanced and emerging economies results in what the IMF labels 'multispeed growth' rather than a steady improvement in all parts of the world.

### ...MOST OF THE IMPROVEMENT IN GROWTH CAN BE TRACED TO THE MONETARY AND FISCAL STIMULUS.

Monetary policy conditions are exceptionally loose by historic standards, with interest rates currently below 1% in most countries. These measures will have encouraged consumer spending and investment and discouraged saving relative to what we would have expected without low interest rates. **Table 2** reports the actual and projected spending in three major economies, which are broken down into components reflecting private consumption, government spending and fixed investment by firms. The figures of 2009 show that year on year growth in private consumer spending and investment spending in the US, the Euro area and Japan were all negative, with the largest contraction being seen in investment in fixed capital. These contributed to a negative final demand growth for goods and services in these economies which was only offset to a degree by positive government spending growth. Projections for 2010 see all components of spending growing relative to 2009 in the United States, but it will take several years of growth from the low levels of spending in 2009 to cause output to recover the levels seen before the financial crisis. In the Euro area and Japan the growth is slower, with little net improvement in the Euro area, and mild improvement in Japan. The situation improves for all economies in 2011, but as these figures are forecasts, and they are more uncertain the further out the projections are made.

We conclude that monetary and fiscal policy has been highly accommodating. Private sector and government spending have

TABLE 1 Country GDP growth rates (percent) Country growth rates from world growth				Projections	
	2007	2008	2009	2010	2011
World output	5.1	3	-0.8	3.9	4.3
Euro Area	2.6	0.6	-3.9	1	1.6
United States	2	0.4	-2.5	2.7	2.4
Germany	2.5	1.2	-4.8	1.5	1.9
France	2.2	0.3	-2.3	1.4	1.7
Japan	2.3	-1.2	-5.3	1.7	2.2
United Kingdom	2.6	0.5	-4.8	1.3	2.7
Russia	8.1	5.6	-9	3.6	3.4
China	13	9.6	8.7	10	9.7
India	9.4	7.3	5.6	7.7	7.8
Brazil	5.7	5.1	-0.4	4.7	3.7

Source IMF:WEO

driven up demand domestically and demand has spilled over into other economies. Without the stimulus from monetary and fiscal policy the recession would have been deeper and possibly also longer.

#### THERE IS LITTLE EVIDENCE THAT INFLATIONARY PRESSURES WILL RETURN IMMEDIATELY...

The OECD expects interest rates to remain on hold for the rest of 2010, as inflation is not expected to increase significantly in the major economies, and then interest rates are expected to show a steady increase from the end of 2010 to the end of 2011. **Charts 2 and 3** illustrate the projected paths. These projections are consistent with the assumptions that are priced into fixed income securities by financial markets, which also expect interest rates to remain low in 2010 and then increase. US Federal Reserve chairman, Ben Bernanke, has signalled that US interest rates will remain low for 'an extended period'.

The major economies in the OECD have seen inflation rise with the increase in commodity prices, especially energy prices, but core inflation appears to be stable at a low level. Given the risks of a return to negative growth from a premature and poorly calculated exit strategy, monetary policymakers are likely to keep conventional monetary policy instruments at low levels. The situation in non-OECD countries is quite different, however, since inflation is primarily driven in these countries by increases in food prices and to a lesser extent by energy prices. Although these countries have had more modest increases in headline inflation than developed countries, their core inflation has risen more rapidly. Data on the annualised growth of prices shows developed countries shows stable core inflation around 1.1%, while developing countries face core inflation of 2.3%, up nearly 1.25% since September 2009.

#### ...BUT INFLATION IS LIKELY TO BE MORE VOLATILE FOR SOME TIME.

Inflation is likely to be highly volatile by comparison with the period before the financial crisis. Over the past three years GDP weighted average CPI inflation in developed countries has reached a maximum of over 4%, compared to a target of approximately 2%, and a minimum of under -1%. The inflation rate currently stands at 2%. In emerging economies over the same period, inflation has peaked at 9% and reached a minimum of 1%, standing at 5% currently. Large variations in inflation will occur if interest differentials emerge and

CHART 1: Actual and projected path GDP growth

Source IMF

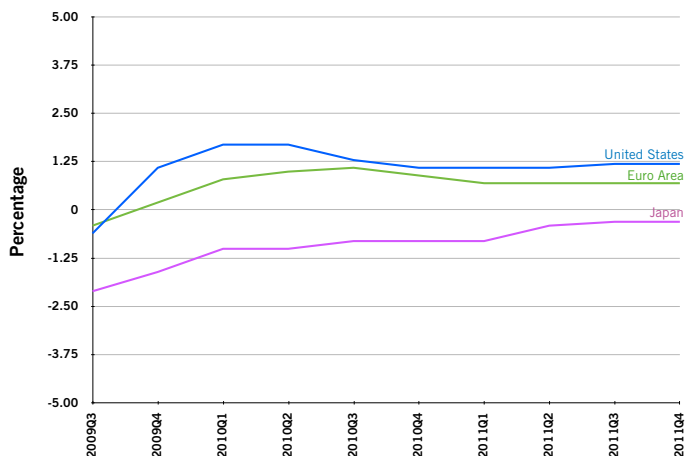


TABLE 2 Components of Demand	2009 actual	2010 forecast	2011 forecast
United States			
Private consumption	-0.6	1.3	2.4
Government spending	2.0	1.8	0.4
Gross fixed investment	-14.3	2.1	7.8
Final demand	-3.4	2.5	3.0
Euro Area			
Private consumption	-1.0	0.0	1.1
Government spending	2.3	1.1	0.8
Gross fixed investment	-10.6	-1.0	2.3
Final demand	-2.5	0.0	1.3
Japan			
Private consumption	-0.7	1.2	1.2
Government spending	1.1	2.3	2.3
Gross fixed investment	-12.8	-0.8	4.4
Final demand	-3.2	1.0	2.1

Source OECD

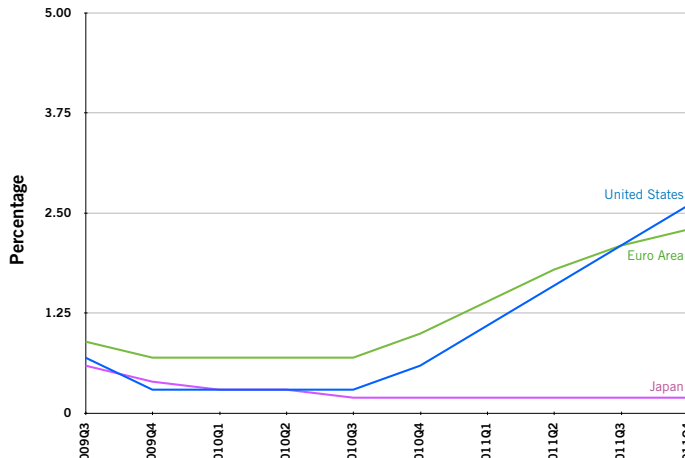
**CHART 2: Inflation Rates**

Source OECD



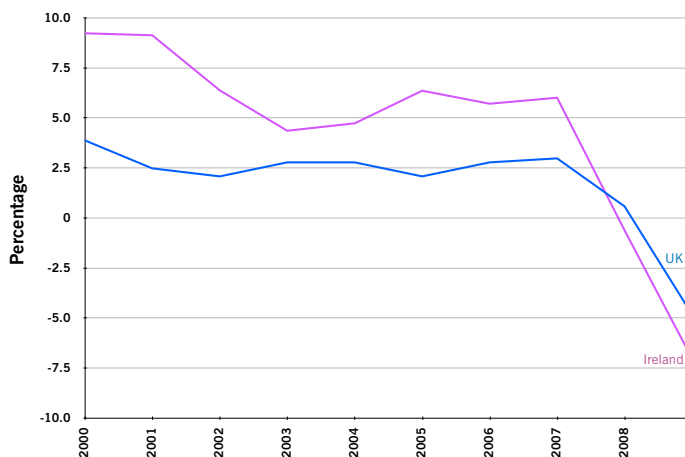
**CHART 3: Short term Interest Rates**

Source OECD



**CHART 4: UK and Ireland Annual GDP growth figures**

Source ONS and CSO Ireland



exchange rate movements result. It is therefore important that policymakers co-ordinate their interest rate responses to inflation to avoid excessive volatility.

**WITHDRAWAL FROM EXCEPTIONAL MONETARY AND FISCAL POLICY MEASURES NEEDS TO BE CAREFULLY JUDGED.**

While there are encouraging signs that the recovery is underway in many economies to a greater or lesser extent, all economies are prone to great uncertainty about the future path of policy. Growth could quickly be reversed if policy stimulus measures are withdrawn too quickly, and at the same time if they are introduced quickly in some countries and less quickly in others they could destabilise financial markets and introduce volatility into exchange rates. Policymakers will need to focus on communication strategies to avoid both outcomes. Interest rates have been increased by central banks in Australia, Israel and Norway, while China and India have raised bank's reserve requirements. In major economies the central banks have begun to eliminate the emergency measures required during the financial crisis, but interest rates remain very low for now. Few central banks would wish to implement the suggestion of IMF chief economist, Olivier Blanchard, to raise inflation targets to 4% for fear that this will raise inflation expectations, long term interest rates and erode hard-earned credibility.

The scale of government's budget deficits will also need careful management as the scale of the debt to GDP threatens to undermine confidence in the sustainability of government finances, the credibility of exchange rate systems, and the low default risk on sovereign bonds. Fiscal stimulus cannot be withdrawn too quickly, and in the US, Japan and Germany, fiscal measures will continue to expand. But for many countries fiscal restraint will be necessary to avoid public debt to GDP ratios expanding to levels unheard of among developed nations. Bringing them down again will take many years.

**TRENDS IN THE UNITED KINGDOM AND IRELAND**

**THE UK AND IRELAND APPEAR TO HAVE REACHED THE BOTTOM OF THE RECESSION ...**

Figures for the growth of nominal GDP from the UK Office for National Statistics record that annual GDP growth in the United Kingdom increased by 0.3% in the final quarter of 2009 revised up from the first release figure of 0.1%. Technically this brings the recession - which began in 2008Q2 - to an end after six quarters of negative growth. As **Chart 4** shows, UK GDP growth rates were in the range 3-4% per annum for most years in the last decade, but output for 2009 was between 6-7 percentage points below this range. The prospects for 2010 are more positive, however, and the Bank of England - whose Monetary Policy Committee makes projections in order to determine the stance for interest rates - judges that GDP growth will approach 1% growth in 2010 and converge on the average for the previous decade in 2011-12. While the projections that the Bank of England has made recently have been more optimistic than

the actual growth rates, the consensus view of other forecasters is 1-2% for 2010 and 2-3% for 2011-12. The view of the Bank's regional Agents is that few firms are reporting intentions to cut investment, output or jobs in 2010, but equally few are looking to expand on a permanent basis. Any improvement in demand will be met from the employment of temporary staff and normalization of average hours for permanent staff that had previously been cut in the recession. The Irish economy similarly has seen a sharp cut in GDP growth from 5-7% growth in the period 2003-2007 to a negative growth rate of 7% in 2009. There have been signs that the decline is moderating, and output is anticipated to rise to 1% growth in 2010.

The implication of the recession for unemployment has been significant. The UK has had a settled rate of unemployment of 5-6% for a decade, as **Chart 5** indicates while in Ireland the unemployment rate had fallen below 5% and remained at this level over the same period. But recent events have seen UK unemployment rise to 8.1% towards the end of 2009, a figure last seen in September 1996, while in Ireland, the unemployment rate has reached 11.9% for the first time in 14 years. Unemployment is a lagging indicator and will continue to show the effects of the recession on the labour market for some time after the economy begins to grow again, although it is expected to fall gradually in 2010 and 2011.

#### ...AND THE IMPACT OF THIS RECESSION CAN BE COMPARED WITH PREVIOUS DECADES.

**Charts 6 and 7** show the impact of the decline in GDP growth and the rise in unemployment relative to previous recessions in 1980-1 and 1990-1 for the UK. The two previous recessions were shorter, lasting five quarters compared to a seven quarter recession in 2008-9. There is still the possibility that the UK economy could return to negative growth in 2010Q1 if weak output growth is adversely affected by lower demand due to the poor weather in January and attempts by households to bring forward spending before the re-introduction of VAT at 17.5%. Subsequent quarters are likely to pull the economy out of negative growth, but the projected path is likely to be quite shallow, not returning the level of GDP to its pre-recession value until 2012. In **Chart 6** this would mean the index of output growth would not rise above 100 until at least 15 quarters after the start of the current recession.

Comparing the experience of unemployment in the UK with previous recessions in **Chart 7**, the unemployment rate has risen much faster than in 1980-1 or 1990-1, but since it started from a lower level of 5.2%, compared to 5.6% in 1980 and 7% in 1990, the unemployment rate has not yet reached the same scale as it did after six quarters in previous recessions. In both 1980-1 and 1990-1 the unemployment rate after six quarters was around 9.5% of the workforce. There is considerable evidence to suggest that flexibility between employees and employers has ensured that workers have been able to retain their jobs by taking lower wages or cutting hours, and this has reduced the unemployment rate and avoided the costs to employers of cutting skilled workers in the recession. It should also make it easier for firms to incrementally raise output as

demand returns by increasing hours for existing staff on reduced working arrangements.

#### OUTPUT HAS DECLINED IN MOST SECTORS...

The scale of the reduction in productive output is seen in **Chart 8**. Relative to the pre-recession level of production, which was approximately equal to a value of 100, productive output in the UK had declined to a level some 12-15% below this level by early 2009, where it has remained. The low level of production reflects a deficiency in demand, short order books and variable demand in the face of uncertainty about the recovery. While manufacturers are beginning to detect signs of improvement relative to mid-2009, other sectors such as construction, agriculture, forestry and fishing have experienced declines. Business and financial services also have seen weak growth, although their output has been static rather than falling, and some sectors that have benefitted from stimulus from the government, most notably the motor trades and health sectors. The combined effect of these changes to output was just 0.1% in the final quarter of 2009. Surveys of sentiment in different industries by the Confederation of British Industry and the manufacturer's organization the EEF confirm these trends.

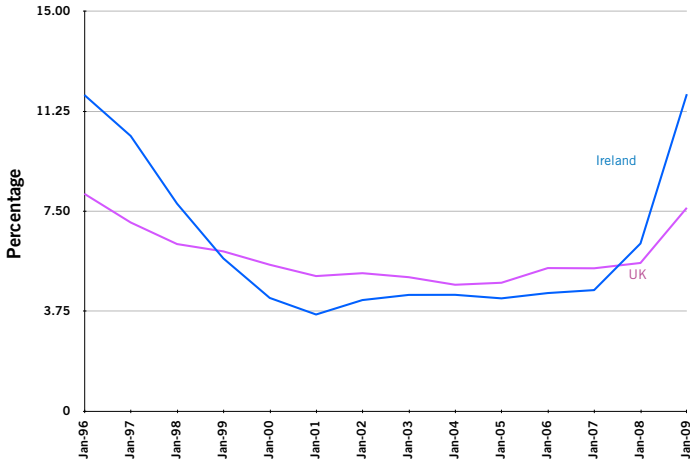
#### ...AND DOMESTIC DEMAND CONTINUES BE WEAK FROM MOST QUARTERS EXCEPT THE PUBLIC SECTOR.

The Office for National Statistics and the Central Statistical Office Ireland report the contributions to real GDP growth broken down into their expenditure components. These reveal the level of spending by different sectors of the UK and Irish economy. Figures in **Table 3** report the percentage changes on the previous quarter for the UK and the percentage change on a year earlier for the Irish Republic. The table shows that spending by UK households has been continually falling since 2008Q2 when the recession began, and investment by UK firms has been falling every quarter by even larger amounts. The government has increased spending in every quarter since the start of the recession to counter the negative effects of private sector demand, but total domestic expenditure still fell in each quarter before 2009Q3. Final expenditure adds the percentage change in the demand for exports to the percentage change in domestic demand, and since export demand has been falling through the recession, the percentage change in the final expenditure has been negative. The result of falling demand from these expenditure components has been a negative real GDP growth rate in each quarter. Only in 2009Q3 did these figures begin to turn, with a slight increase in the level of household consumption compared to a quarter earlier and an increase in investment by 2.2%. In 2009Q3 total domestic spending and final expenditure rose relative to the previous quarter for the first time since 2008Q2, and in 2009Q4 these figures were stronger still causing real GDP growth to rise to 0.3%.

In Ireland, a similar situation has been observed in the annual data provided by the Irish Central Statistical Office. Household consumption, investment and exports have all fallen in 2007 and 2008 relative to a year earlier. The figures are expected to be larger than those reported for the UK because they reflect

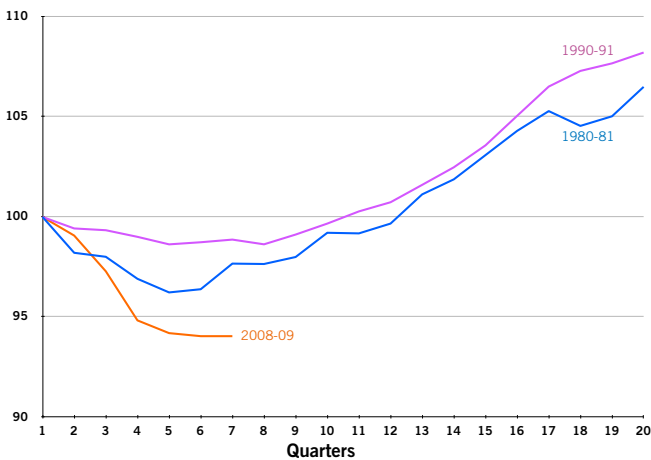
**CHART 5: Unemployment Rates for UK and Ireland**

Source ONS



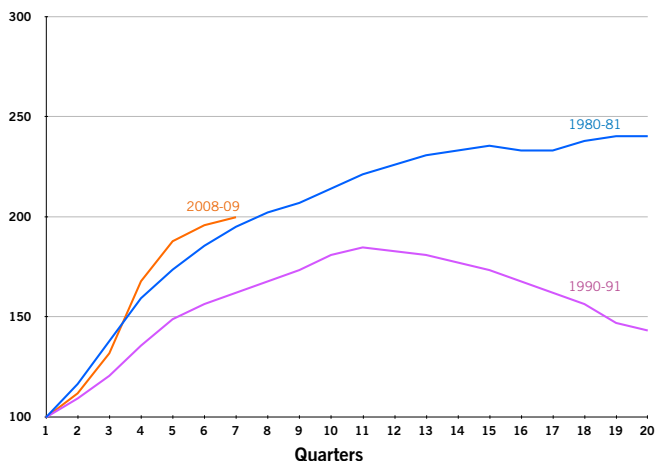
**CHART 6: Output paths in previous UK recessions**

Source ONS



**CHART 7: Unemployment paths in previous UK recessions**

Source ONS



percentage changes versus four quarters earlier, but even allowing for this difference, the Irish Republic has seen investment fall by more than the UK, and real GDP growth dropped by 7 percent points in 2008. The figures for 2009, based to some extent on forecasts, reflect a slight improvement in demand, but real GDP is still expected to be negative, partly due to government cuts in spending.

**THE FINANCIAL SECTOR FACES NEW CHALLENGES...**

In the previous economic report the scale of the bad debts remaining on the balance sheets of the larger UK banks were reported as a continuing concern that would hamper the chances of banks resuming lending to the private sector. Default rates on corporate loans have worsened in the last quarter, and the UK banks have continued exposure to commercial property, but defaults on loans to households have stabilised. In 2009, according to figures published by the Bank of England, the major UK banks have increased their capital ratios from an average of 6% in the years 2001-8 to 10% in 2009. This reflects attempts by Lloyds, HBOS and RBS to raise capital from the UK government's asset protection scheme or the private sector. The increase in stock markets since March 2009 has also contributed to an improvement in the major bank's balance sheets. Balance sheet concerns have begun to recede and the major issues now concern the regulation of bank's capital ratios and their funding of future lending.

It is expected that the Basel Committee that determines the capital banks are required to hold will impose higher capital ratios in the future. This may explain to some degree why banks have begun to hold more capital compared to previous years. The impact of this decision on bank lending is uncertain, and the debate about how to regulate the activities of banks is ongoing. The former chairman of the Federal Reserve, Paul Volcker, has suggested that banks should be restricted to prevent them speculating with their own capital, others have proposed that banks be limited in size or scope. No consensus has yet emerged but banks are likely to be more restricted than in the recent past.

A second issue for UK banks has been their looming funding requirements. These banks have a substantial quantity of funding that is due to mature in the next 2-3 years, some of which is short-term marketable debt and the bulk of the remainder is funded by official schemes such as the Bank of England's special liquidity scheme and the government's credit guarantee scheme. Banks have resorted to seeking funds from retail depositors by offering fixed rate deposits for up to five years as alternative funding options have been relatively more expensive.

**QUANTITATIVE EASING HAS CEASED FOR THE TIME BEING...**

By the end of the fourth quarter 2009 the Bank of England had purchased £190bn of government bonds, corporate bonds and commercial paper through its asset purchase facility. The vast majority of the assets were in the form of government bonds due to the comparatively small volumes of high quality commercial

TABLE 3 Expenditure Components of Demand (UK)	UK % Changes on a Quarter Earlier							Ireland % Changes on a Year Earlier		
	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2007	2008	2009
Household Consumption	-0.1	-0.2	-1.2	-1.5	-0.8	0.1	0.4	-0.2	-7.5	-3
Government Consumption	0.4	1.0	1.1	0.0	0.7	0.4	1.2	2.9	-1.0	-3.0
Investment	-5.3	-2.4	-2.4	-7.5	-5.9	1.6	-3.4	-18.4	-30.5	-18.4
<b>Total Domestic expenditure at market prices</b>	-0.3	-0.4	-2.3	-2.2	-1.3	0.4	0.5	-4.5	-13.0	-4.7
Exports	-0.5	-0.3	-4.3	-7.0	-2.2	0.1	3.7	1.2	-2.5	1.4
<b>Final expenditure</b>	-0.3	-0.4	-2.3	-2.4	-0.9	0.1	1.1	-1.8	-7.9	-1.5
Imports	-1.4	0.1	-5.9	-6.7	-3.3	1.3	4.1	-3.0	-9.1	-2.2
<b>Gross domestic product at market prices</b>	0.0	-0.5	-1.8	-2.5	-0.7	-0.3	0.3	-1.0	-7.0	-1

Source ONS and Irish CSO

paper and corporate bonds available in the UK. The purpose of this facility is to lower the spreads on corporate bonds and encourage issuance in these markets. Market data shows that spreads over risk free rates on investment grade non-financial commercial bonds have fallen by 200 basis since the start of the scheme and issuance of bonds by non-financial companies has doubled compared to the average issuance prior to the financial crisis. Although, as we will discuss later, there is less evidence that credit markets have normalised, the Bank of England has suspended any further purchases of assets for the time being.

In the euro area the European Central Bank has purchased €36.7bn of covered bonds since the inception of its asset purchase scheme by February 2010, and will continue 'well into 2010', which is understood to require it to purchase further bonds up to the €60bn ceiling by June 2010. All central banks are normalizing their monetary operations by winding down the emergency measures implemented during the financial crisis, but this does not mean monetary tightening will occur immediately.

#### ...AND THE FOCUS OF CENTRAL BANKS IS NOW ON INFLATION...

Since the beginning of the recession inflation has proved more volatile than in the previous few years. **Chart 9** shows that the headline consumer price index (CPI) peaked at 5.2% in September 2008 as commodity prices spiked, but then steadily declined with lower global demand to a low of 1.1% in September 2009. In the last four months inflation has reignited, jumping to 3.5% in January 2010, prompting the Governor Mervyn King to write another letter to the Chancellor of the Exchequer, Alistair Darling. Much of the pressure for inflation to rise and then fall has come from goods price inflation, which exceeded the peak and the trough in headline CPI. The increase in VAT and energy prices were expected to cause inflation to rise in January, but the prospects for inflation in 2010 are thought to be below the 2% target.

#### ...AND GOVERNMENT BUDGET DEFICITS.

Government spending has increased significantly during the recession and at the same time tax receipts have fallen. To some degree this was expected in a recession, but the scale of the UK government's net borrowing requirements to finance the difference between spending and revenues is large.

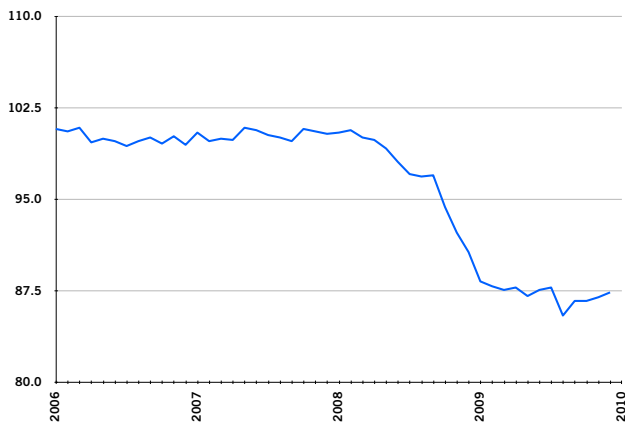
**Chart 10** shows the net borrowing requirements relative to GDP. The ratio rises to 12.6% of GDP, compared to 4.8% in the 1980-1 recession, and 7.7% following the 1990-1 recession. In order to reduce the deficit the government will need to reduce public sector spending and raise taxes as shares of GDP. Many other countries - most notably Portugal, Ireland, Greece and Spain (the so-called PIGS) - have faced similar harsh realities with estimated deficit to GDP ratios in 2009 of 12.3 (Greece), 12.0 (Ireland), 11.5 (Spain) and 8.0 (Portugal). The potential inflationary pressures arising from these deficits are also a concern for central banks in the medium term. In the euroarea these tensions have created pressure on the stability of the euro currency, and in the UK, where an election is due before June 2010, there is political tension over plans for deficit reduction.

#### THE DIRECTION OF FUTURE INFLATION IS HIGHLY UNCERTAIN.

The Bank of England projects that inflation will decline in the coming months, and undershoot the target of 2% in 2010 and 2011, but there is considerable uncertainty around that projection and inflation is likely to be volatile for some time. On the demand side it is uncertain how much spending can recover without some relaxation of credit conditions, and given the condition of banks and the uncertainties that they face going forward, there is no assurance that credit will ease. A fiscal contraction is likely to prompt households to save rather than spend, especially as future earning potential from income and assets is difficult to predict. Movements in the exchange rate are likely to depend on the timing and speed of interest rate tightening vis-à-vis other countries, and the prospects for

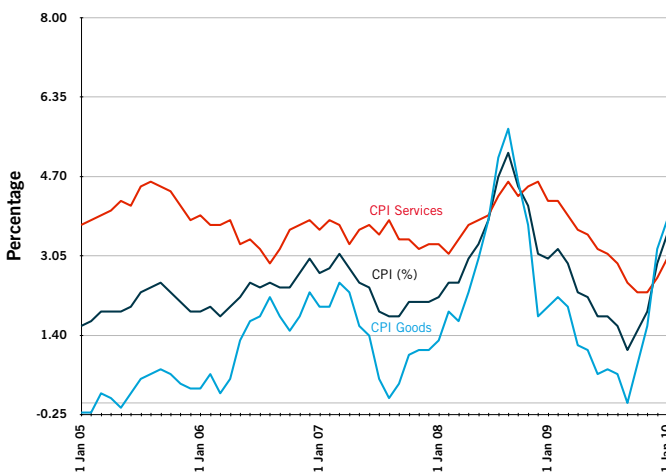
**CHART 8: Index of Production**

Source ONS



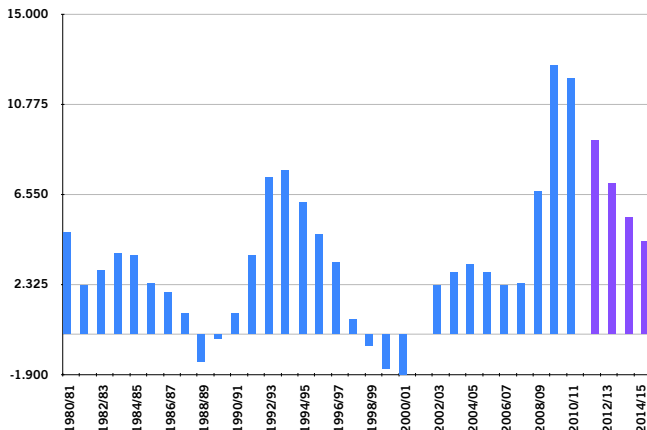
**CHART 9: CPI Inflation in the UK**

Source ONS



**CHART 10: UK Public Sector Net Borrowing to GDP**

Source HM Treasury



export-led improvements in demand are conditional on the direction of this movement. If world demand continues to pick up, particularly in emerging markets, demand for commodities and fuel are likely to increase pressure on inflation. Lastly, there is substantial excess capacity in the UK economy, which would tend to reduce inflationary pressures. The balance of these many factors influencing the inflation rate is hard to judge, but as different forces exert themselves, to a greater or lesser extent, inflation is likely to vary considerably.

## SUMMARY

The UK and Irish economies appear to have reached the bottom of the recession. Compared to previous recessions in 1980-1 and 1990-1 the decline in output has been steeper, and more prolonged, but unemployment, which started from a lower level has not reached levels seen previously. Demand remains weak, but the financial sector is recovering, and although it faces new challenges, the financial system is now stable. Central banks have ceased asset purchases, and are focusing now on inflation pressures and the large budget deficits relative to GDP.

## CREDIT CONDITIONS AND ASSET BASED FINANCE

ABFA statistics report asset based finance figures for the half year to December 2009 for the United Kingdom and Ireland. In the UK, the industry advanced £14.1 billion at the end of December 2009, against invoices, stock, property and other trading assets worth £29.0 billion. This represents a slight reduction in advances compared to the previous quarter. This is also the case for Ireland, where the advances were €1.3 billion against €3.2 billion of assets down from the previous quarter. The figures are down on a year ago because of the weakness in activity in the UK and Irish economies and a tendency for firms to reduce gross borrowing in general compared to a year ago. But from the lowest point for clients' sales in 2009Q1 there are signs that economic and financial conditions have improved, sales have increased, and there are some encouraging indications for advances through asset based finance providers for 2010.

### LOWER CLIENTS' SALES REFLECT WEAK ACTIVITY...

Previous sections have documented economic conditions, reflecting the weakness at the national level and sluggish improvement at the global level with much unevenness. The weakness has reduced clients' sales in the asset based finance industry, and reduced the volume of invoices on which business is based. **Chart 11** shows that total clients' sales fell steeply from £53bn in 2008Q4 to £45.7bn in 2009Q1, but sales have steadily improved through 2009, although they have not yet returned to the level seen at the end of 2008. They currently stand at £50.3bn. Despite the reduction in clients' sales compared to a year ago, product shares of business have not altered very much as shown in **Chart 12**. The majority share - 85% of business - is due to domestic invoice discounting,

a further 9% is domestic factoring, with an additional 6%, due mostly to export invoice discounting, making up the remainder. These shares have varied very little despite a drop in overall volume, which suggests that changes to the volume of asset based finance business was due to the reduction in the level of activity by firms that continued to use these facilities, and not so much due to a reduction in the net number of clients.

At any point in time there will be an inflow and outflow of firms that switch between asset based finance and other financing options, and during a recession there will be casualties among the industry's clients. The net reduction in client numbers in the UK in 2009Q4 was 4432 or 9% of the total in 2008. If these clients had been of average size with average sales volumes, then we would expect to see a 9% reduction in sales, but the reduction was only 5% because the majority of these firms had a turnover less than £5mn. Members report that they have been able to avoid client losses by being flexible and supportive in their financing when other providers were unable to offer similar assistance.

In Ireland, the reduction in clients' sales was greater in percentage terms, falling by 19% from 2008Q4 to 2009Q4. Members in the Republic of Ireland had a net loss of 113 clients in the last year, but the reduction in numbers was spread more evenly over different sized firms. Of the 113 net clients lost in 2009, 60 had a turnover below €5mn and 53 had turnover above that figure. But clearly the reduction in the volume of business, which was much larger than the decline in client numbers in Ireland, was mostly a reflection of lower activity.

#### ...AND THE TENDENCY FOR FIRMS TO REDUCE THE LEVEL OF BORROWING.

Many firms have made net repayments of loans in 2009. According to the Bank of England's most recent Trends in Lending reports large firms have been borrowing on financial markets and repaying loans to banks. The cumulative issuance of corporate bonds in 2009 rose to £20bn, twice the average for the period before the financial crisis. This may be traced back to the efforts of the Bank of England to support corporate debt markets through the financial crisis, although a similar increase in equity issues can be seen in 2009, and no Bank support was offered in that case. Large firms have been observed in 2009 to have changed the composition of their finances, and

as we will see below, some of the restructuring has included asset based lending.

The UK Department for Business, Innovation and Skills noted net repayments by SMEs in its 2009 assessment of credit conditions for smaller businesses. These firms do not have access to equity and bond markets, but their net borrowing has also declined. Net borrowing for the Private Non-Financial Corporations sector as a whole from banks was negative at the end of 2009, and even allowing for funds raised on financial markets, total net borrowing was still negative.

**Chart 13** shows that the growth in M4 money balances and lending by M4 deposit taking institutions in the UK economy have been on a downward trend since the end of 2006: the figures for both M4 and M4L at the end of 2009 hovered just above zero. As we noted in an earlier report these figures reflect the prevailing economic conditions - weak demand, low investment spending, fewer acquisitions and the nature of credit supply conditions.

#### ADVANCES BY ABFA MEMBERS SHOW LARGER FIRMS OBTAINED MORE FINANCE...

Total advances by ABFA members to their clients have declined marginally over 2009 from £15.1bn to £14.1bn as shown in **Table 4**. It would be surprising, given the abrupt decline in clients' sales at the start of 2009 and the weakness of the UK economy to find otherwise, but there are indications that asset based finance has increased in certain quarters. The figures in **Table 4** show that asset based lending secured against a variety of assets has increased through 2009. The total of advances against debt, stock, plant and machinery, and other assets increased over the year, while other types of asset based finance based on invoice financing declined. As a percentage of the total advances **Table 5** shows that asset based lending rose from 14.2% of total advances at the start of the year to 17.8% of total advances by 2009Q4.

The industry has reassured borrowers that this source of funding is secure and that the provider is prepared to offer flexibility and support in challenging times.

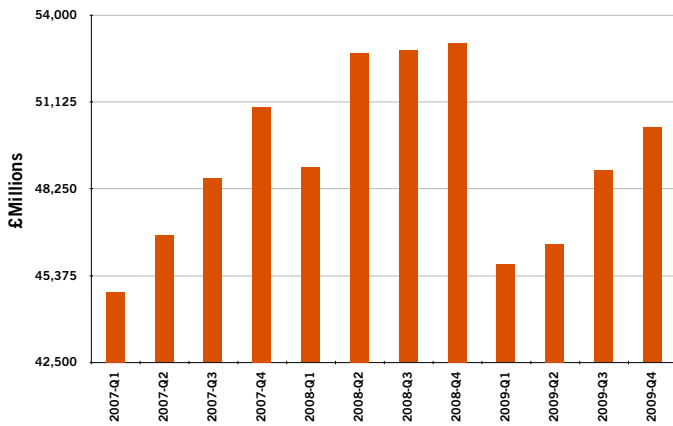
Asset based lending is typically extended to financially mature, and often multinational companies, which are by their nature large with high turnover. These companies have increased their financing from all sources except bank lending in 2009.

TABLE 4 Advances in 2009	Pure invoice finance - advances against debt	Invoice finance plus - advances against debt plus other assets	ABL - advances against debt	ABL - advances against stock	ABL - advances against plant and machinery	ABL - advances against property	ABL - advances against other assets	Other commitments	Total Advances
	£M	£M	£M	£M	£M	£M	£M	£M	£M
2009 Q1	12,404	525	1,295	288	38	228	89	208	15,075
2009 Q2	11,256	470	1,618	341	57	257	125	183	14,307
2009 Q3	11,364	417	1,754	370	52	254	125	166	14,502
2009 Q4	11,314	380	1,561	310	61	225	115	168	14,134

Source ABFA

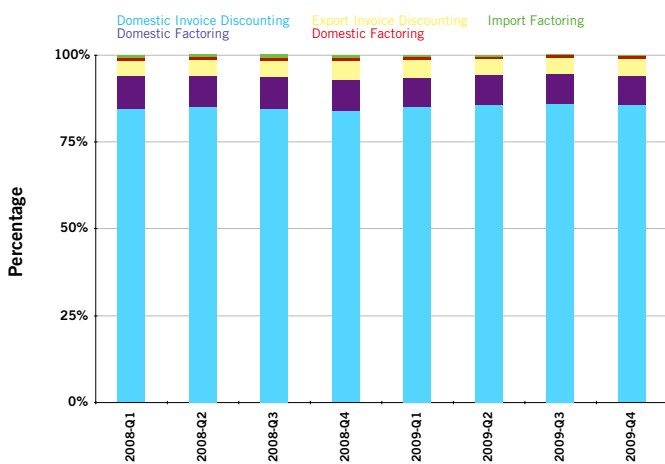
**CHART 11: ABFA Clients' Total Sales**

Source ABFA



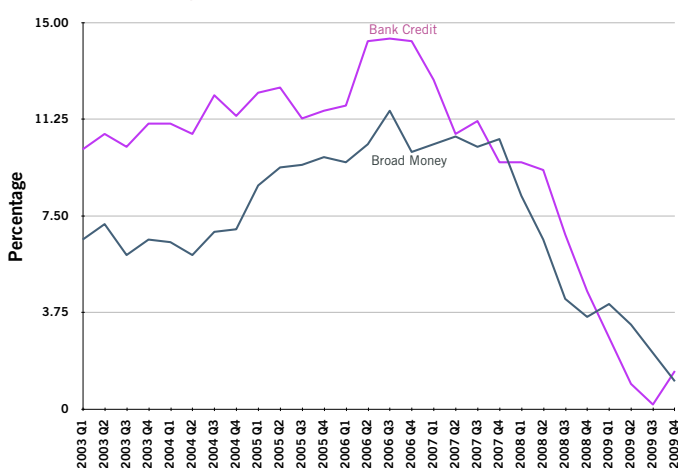
**CHART 12: Product Shares**

Source ABFA



**CHART 13: 12 Month Money and Lending Growth Figures**

Source Bank of England



**Chart 14** shows that lending to large firms with turnover in excess of £100mn rose by 6% in the final quarter of 2009 compared to the previous quarter, while the lending to all but the smallest SMEs fell back in Q4 after positive growth in Q3.

**ASSET BASED FINANCE FIGURES SHOW ADVANCES ARE NO LONGER FALLING, AND LARGE FIRMS' BORROWING DECLINED LESS THAN AVERAGE IN 2009...**

The majority of advances - over 80% of the total in the UK - are invoice finance, representing £11.7bn out of the total of £14.1bn raised against outstanding debts. For this reason advances in asset based lending did not outweigh the decline in other forms of asset based finance. **Chart 14** shows that the sum of these components has declined from the amounts offered in 2008Q3, but the decline that has occurred in advances took place in late 2008 and early 2009 and it has flattened off in the last two quarters. Although we might not see any increase in advances at this stage, we do not expect to see a further decline and there is tentative evidence of an increase expected in 2010.

**Chart 14** also shows the composition of advances to firms according to their turnover. The advances made to smaller firms with turnover below £5mn per annum are represented by the bottom two components. These make up a relatively small part of the total and they fell by 15% from their values a year ago. The figures for medium sized firms with turnover between £5-100mn shown by the next three components comprise more than half of the total advances. These components fell by more than the average since their advances fell by between 18-23% in the year. Larger firms saw a decline of only 11% which is well below the average. The general decline in advances reflects economic weakness as we have already indicated above, but the relatively small decline in advances to large companies reveals the growth in asset based lending to the very largest clients. We noted the growth of asset based lending as a share of total advances in the discussion above, and these figures for large firms include the growth in this component of advances. These firms may well have obtained finance from other sources, such as corporate bonds and syndicated loans, but asset based lending has also been part of that funding mix.

**ACCESS TO CREDIT HAS IMPROVED IN THE UNITED KINGDOM AND THE EUROAREA...**

Each quarter the Bank of England produces a Credit Conditions Survey. A number of indicators of supply and demand conditions from the latest issue for 2009Q4 are summarised in **Table 6**. Looking first at supply conditions, firms report improving availability of credit over the last three months compared to previous surveys and the net negative responses from lenders that were surveyed in 2008 have turned positive when asked what are the factors affecting credit availability in 2009. This means that these factors mentioned have turned from decreasing supply to increasing supply over the three months prior to the survey date. Hence, the economic outlook has improved compared to 2008, increasing the availability of supply, and similarly, the risks associated with economic sectors, capital market pressure and risk appetite have improved conditions,

**TABLE 5** Shares of Total Advances

	Pure invoice finance - advances against debt	Invoice finance plus - advances against debt plus other assets	ABL
2009-Q1	82.3	3.5	14.2
2009-Q2	78.7	3.3	18.0
2009-Q3	78.4	2.9	18.8
2009-Q4	80.0	2.7	17.3

Source ABFA

**TABLE 6** Summary of UK and Ireland Credit Conditions Surveys (past 3 months)

Net Percentage Balance	United Kingdom				Euro Area			
	Jun-08	Dec-08	Jun-09	Dec-09	Oct-09	Jan-09	Oct-09	Jan-10
Availability of credit	-32.1	-28.1	14.3	16.3	65	64	8	3
Factors affecting credit availability								
Economic outlook	-44.3	-44.8	-12.7	4.3	60.0	76.0	26.0	11.0
Sector risk	-29.2	-49.8	-2.3	16.5	58.0	70.0	38.0	21.0
Pressure from capital markets	-19.9	-21.6	2.2	5.6	22.0	29.0	-2.0	-1.0
Risk appetite	-39.9	-36.1	0.0	0.1	n/a	n/a	n/a	n/a
Cost/availability of funds	-29.6	-55.2	12.9	-7.6	16.0	26.0	7.0	9.0
Changes to demand								
	Jun-08	Dec-08	Jun-09	Dec-09	Oct-09	Jan-09	Oct-09	Jan-10
Mergers and acquisitions	6.7	-48.1	-9.4	-21.0	-32.0	-44.0	-33.0	-24.0
Capital investment	-16.4	-66.0	-40.7	-20.7	-36.0	-60.0	-52.0	-34.0
Inventory finance	9.6	11.4	-6.9	-12.7	1.0	-8.0	0.0	-1.0
Debt restructuring	2.4	24.0	37.4	-19.1	17.0	22.0	45.0	47.0
Commercial real estate	-23.2	-55.8	-53.4	9.5	n/a	n/a	n/a	n/a
Negative net balance indicates tighter credit availability/ highercost/terms compared to previous 3 months								

Source Bank of England, European Central Bank

while cost of funds has had a smaller negative effect on supply. Capital investment and commercial real estate activities have boosted demand as positive or small negative responses in 2009Q4 have replaced large negative responses in 2008Q4 and 2009Q2. Demand for credit for mergers and acquisitions and for inventory finance or debt restructuring have lessened, showing that demand is still weak. Many firms have intended to reduce their demand for net bank credit, as the Bank of England's Trends in Lending publication notes.

The euro area Bank Lending Survey conducted for January 2010 asked similar questions of 100 euroarea banks. These conditions are indicative of eurozone conditions as only five banks were located in the Irish Republic. Looking at **Table 6** once again we see that availability of credit improved considerably in late 2008 and early 2009, but it has not improved much since then. Similarly the risks associated with the euro zone economy and industrial sectors have moderated in their influence over credit

availability, and capital market pressure has intensified somewhat. Demand conditions are still very weak, as few banks report demand for merger and acquisition activity, capital investment or inventory finance, although there is demand for funding for debt restructuring.

#### FIRMS ARE FACING FEWER FINANCIAL DIFFICULTIES THAN THEY DID IN EARLY 2009...

According to **Chart 15**, the amount of annual credit protection payments being made to clients in the UK before the crisis was approximately £23mn per annum. In 2008 and 2009 that figure rose to £30.8mn and then to £36.1mn, representing a 37.5% increase in 2008 and a 17% increase in 2009. These payments are made by the asset based finance industry to their clients when their customers default on debt receivables where a non-recourse facility is in place. The figures increase as more businesses fail to settle debts and become insolvent.

Figures released by the UK Department of Justice, show that the total number of insolvencies has also increased in 2008 and 2009, and by far the largest contributor was debtor petitions, where the debtor initiated bankruptcy proceedings with the courts.

When we observe the quarterly figures, however, we see that debtor petitions decreased by 11% in 2009Q4 compared to a year ago, and fell by 16% on the previous quarter. Similarly, creditor petitions fell by 20% in 2009Q4 on a quarter ago and winding up orders fell by 14% versus 2009Q3. These figures indicate a turn around in the last two quarters that is not seen in the annual figures because insolvencies were relatively high in early 2009. ABFA figures in **Chart 15** also show that in the second half of 2009 credit protection payments fell back to levels more consistent with levels seen before the crisis. Although the annual credit protection payments rose to £36.1mn in 2009, the payments dropped to only £6.3mn in 2009Q4. These figures are an encouraging sign that the UK is pulling out of recession, and offers further indication that business conditions are not as harsh as they were even two quarters ago. It corroborates other mildly positive news such as the revision of GDP growth for 2009Q4 to 0.3 from 0.1%, growing exports, inventories and production levels

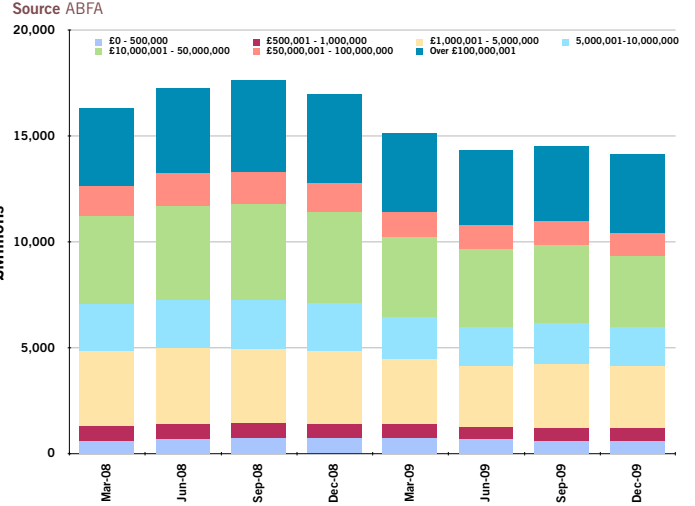
**...AND DEBTS REMAIN UNPAID FOR FEWER DAYS ON AVERAGE.**

ABFA figures on the average number days debts remain outstanding are given in **Chart 16** for factoring clients and invoice finance clients. The solid lines show the debtor days for each group recorded each half year, and the dashed lines represent the number of days on average in the period before the recession began. The period of the recession saw the debtor days for both groups rise above the pre-recession average but ABFA members have pulled the debtor days back below the average in 2009Q4. They now stand at 59.2 for factoring clients and 56.9 for invoice discounting clients. Businesses are therefore waiting fewer days to receive payment on debts and sales invoices.

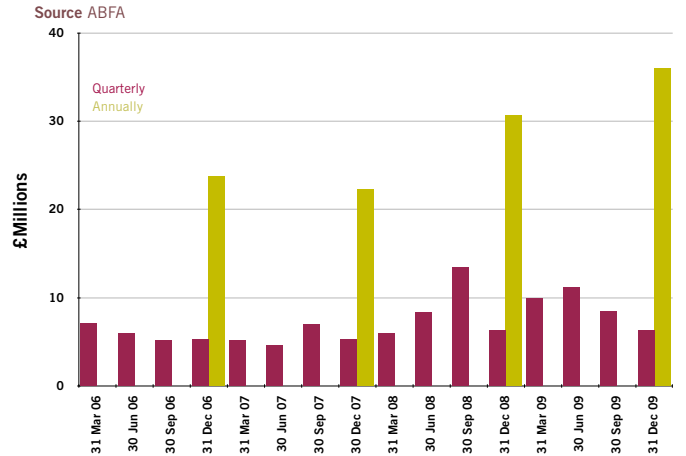
**SUMMARY**

ABFA statistics for the United Kingdom and Ireland show that the industry advanced £14.1 billion at the end of December 2009, against invoices, stock, property and other trading assets worth £29.0 billion, and €1.3 billion against €3.2 billion of assets in Ireland. The figures are down on a year ago because of the weakness in activity in the UK and Irish economies and a tendency for firms to reduce gross borrowing in general compared to a year ago but there are signs that economic and financial conditions have improved and clients' sales have increased. Advances are expected to improve in 2010.

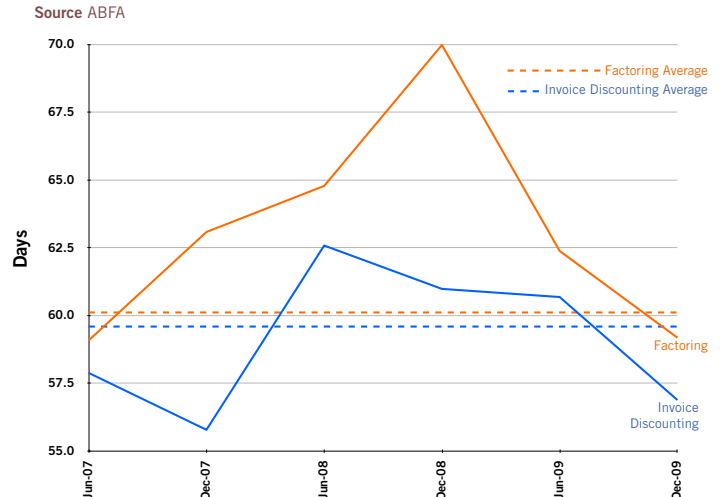
**CHART 14: Quarterly Advances by Firm Turnover Size**



**CHART 15: Annual/Quarterly Credit Protection Payments to Clients**



**CHART 16: Debt Turn**





The Asset Based Finance Association (ABFA) is the body that represents the interests of the asset based finance industry in the UK and Ireland. Members range from subsidiaries of major international banks to independent finance providers. The ABFA provides a variety of services to UK and Irish members, including on-line services, educational courses, lobbying, PR, and educational and networking events. The ABFA is a source of information and reference for those businesses looking to find out more about the products and services that this industry can offer.

For more information on the ABFA, or for more information on asset based finance in general, visit [www.abfa.org.uk](http://www.abfa.org.uk)

This economic report was commissioned by the ABFA, and was written by Professor Paul Mizen, Director of the Centre for Finance and Credit Markets, University of Nottingham.

Disclaimer: The views are those of the author and not necessarily those of the Centre for Finance and Credit Markets or the University of Nottingham.



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# Economic Report

