

The logo for ABFA (Association of Banks and Financial Institutions) is displayed in a white serif font. The letters 'A', 'B', and 'F' are connected by thin horizontal lines, and the 'A' and 'F' are also connected by a thin vertical line, creating a stylized, interconnected monogram.

ABFA

Economic Report

September 2010 / Issue No. 05 (2010Q1 - 2010Q2)



ABFA Economic Report September 2010

THE ABFA ECONOMIC REPORT

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EXECUTIVE SUMMARY

The world economy is expected to grow faster in 2010 than previously thought...In our last report there were signs of increased growth and greater confidence that the worst of the recession was over in the advanced economies. The Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) had upgraded their projections for GDP growth for 2010 and 2011. The projections have improved further for 2010, but doubts have returned for 2011. It is possible that there will be negative growth for some countries due to persistent unemployment and fiscal cuts, but exports, retail sales and corporate earnings are stronger, so the outlook is mixed.

...the UK and Irish economies have seen a return to positive GDP growth but recovery is likely to be slow and patchy. The Office for National Statistics recorded nominal annual GDP growth in the United Kingdom increased by 2.1% in the second quarter of 2010 up from an increase of 1.1% in the first quarter. But much of this is due to an increase in prices, as real output rose by 1.2% in 2010Q2. In Ireland, real GDP growth was 2.7% in the first quarter after eight consecutive quarters of negative real GDP growth. The recovery is driven mostly by business investment, while consumption and exports in the UK have fallen back. Significant public sector cuts, above-target levels of inflation and continued weakness in the financial sector will slow the recovery.

The asset based finance industry has seen advances grow over the year...Total advances by ABFA members to their clients have increased from £14.1bn in 2010Q1 to £14.6bn in 2010Q2. ABFA members are now advancing more than

they were at any time in the last year. The growth in total advances for this period was 3.4%, of which the largest component - pure invoice finance - grew by 4.2%, while advances against debt and other assets grew by 7.4%. The majority of advances - amounting to 82% or £12 billion out of the total of £14.6 billion are pure invoice finance advanced on debt. This is also the case for Ireland, where the advances were €1.4 billion against €3.4 billion of assets up 1% compared to figures in 2009Q2.

...while net borrowing and lending to small businesses has declined. The flow of net lending to UK businesses declined by £3.5 billion in June, which represents a fall of 8.1% on a year ago. Net lending has been falling continuously for the past nine months according to these Bank of England figures. Small business lending has also declined. The government's Enterprise Finance Guarantee Scheme fell by 60% in the last year, offering guarantees to £150 million in 2010Q2. But firms report access to finance has improved since the last quarter.

Firms have paid out less in protection payments and have kept down the number of days debt is left unpaid. Client protection payments for non-recourse debts have come down once again compared to 2009. The amount paid to clients over the last four quarters was £28.7 million. This confirms results from the Bank of England's Credit Conditions Survey of lenders' experience of defaults, which fell for all but small businesses in the last quarter. ABFA members have continued to keep the number of debtor days outstanding below the pre-crisis average.

GLOBAL ECONOMIC OVERVIEW

THE WORLD ECONOMY IS EXPECTED TO GROW FASTER IN 2010 THAN PREVIOUSLY THOUGHT...

When the previous economic report was written, we reported there were signs of increased growth and greater confidence that the worst of the recession was over in the advanced economies. The Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) had upgraded their projections for GDP growth for 2010 and 2011. The news continues to be positive, as the most recent projections reported in **Table 1** show a further improvement of GDP growth figures in 2010. World output, which fell by 0.6% year-on-year in 2009, is projected to rise by 4.6% in 2010 and by 4.3% in 2011. Advanced economies are expected to grow by about half this rate in 2010 and 2011, after a dismal 2009, while emerging markets and developing economies will see growth of 6.8% and 6.4% respectively. This is the good news.

... BUT DOUBTS RETURN FOR 2011, PARTICULARLY IN THE UNITED STATES...

With the exception of Russia and the United States, all economies are anticipated to see growth stall or decline in 2011. The most recent data from the United States suggests the stimulus has not had the effect of keeping output growing at or above a level consistent with the long-term potential of the economy, and many observers predict a return to negative growth.

Chart 1 illustrates that the growth of output in the major economies has recovered after the recession in 2008, but the level of GDP is lower than it was at the beginning of this period, and attention is now focused on the prospects for a return to negative growth that would reduce output further. The US Bureau of Economic Analysis has recently revised its official figures for GDP and components of expenditure attributable to households, firms and government (see **Table 2**). The data shows the US recession was much worse than the official data suggested before it was revised. The economy declined by 4.1% from peak to trough on the new data compared to 3.8% on the old data, making this the worst post-war recession for the US.

TABLE 1 Annualised nominal GDP growth projections and updates	Projections			Changes from April 2010	
	2009	2010	2011	2010	2011
World Output	-0.6	4.6	4.3	0.4	0
Advanced Economies	-3.2	2.6	2.4	0.3	0
United States	-2.4	3.3	2.9	0.2	0.3
Germany	-4.9	1.4	1.6	0.2	-0.1
Japan	-5.2	2.4	1.8	0.5	-0.2
Emerging Economies	2.5	6.8	6.4	0.5	-0.1
China	9.1	10.5	9.6	0.5	-0.3
Russia	-7.9	4.3	4.1	0.3	0.8
India	5.7	9.4	8.4	0.6	0.0
ASEAN-5	1.7	6.4	5.5	1	-0.1

Source IMF:WEO

What has worried many observers is that there has been a weaker contribution from the private sector reflected in lower consumer expenditure and private investment. The effect of the government stimulus - which it is now recognised takes time to spend and therefore time to influence economic growth - has had less effect through the recession than was first thought. Net exports has contributed to growth in a more positive way, but as the dollar strengthened in the second quarter this effect has diminished. The result is much talk of a double dip in output growth and if the United States has lower growth the prospects for other economies must be revised downwards.

...ONE REASON FOR THE PESSIMISM IS LITTLE CHANGE IN THE EMPLOYMENT FIGURES...

Chart 2 shows the seasonally adjusted non-farm employment figures for the United States. The columns show the level of employment fell almost every month from August to December 2009. After the turn of the year, the employment numbers picked up and there was steady growth for five months to May 2010. But in June and July the numbers surprised markets by dropping from their May peak. In reality the monthly percentage changes are quite small, as shown by the blue line on the same chart, but the result of these figures is that employment numbers since the economy emerged from recession look more similar to the slow recovery rates after the 1990 and 2001 recessions rather than the sharp recovery after the 1981 recession. As a rule of thumb for the US economy the worse the recession the steeper the recovery in employment, but this time the steepest recession in the post-war period has not produced a strong improvement in employment.

The key question is whether the recovery could continue without employment figures moving upwards once again. The Gallup Job Creation Index shows that US firms were creating more jobs than in 2009, and other survey evidence from Gallup shows that 'hirings' are higher and 'firings' lower in 2010 compared to the previous year.

CHART 1: Actual and projected path GDP growth

Source IMF

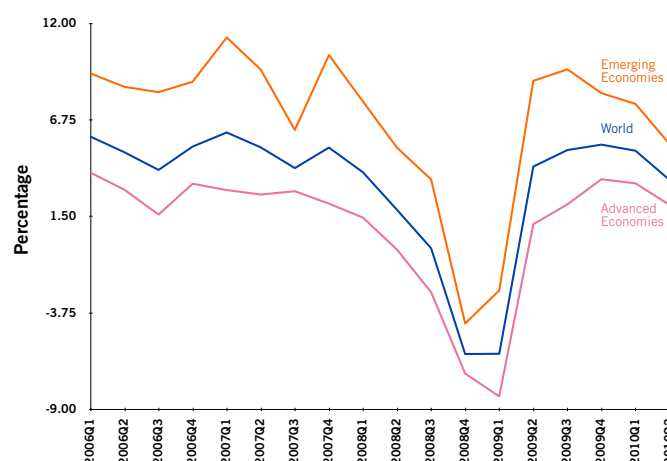


CHART 2: US Non-farm Employment (LHS) and change (RHS)

Source BLS

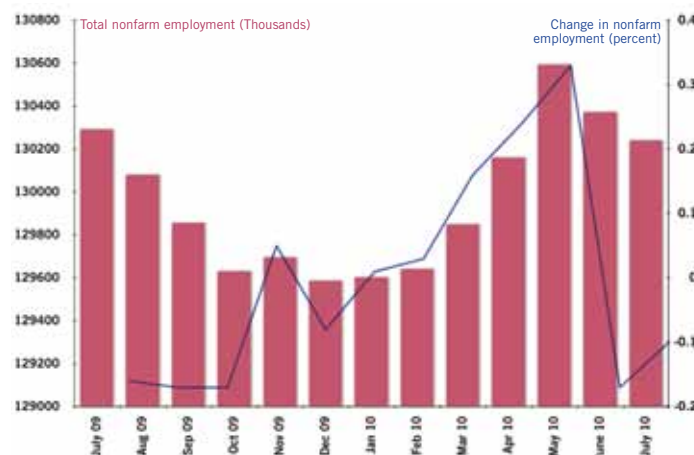


TABLE 2 Revisions to US GDP and Components of GDP	Billions of dollars								
	Revised estimates			Revisions to previously published estimates			Revisions as a percentage of previously published estimates		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Gross domestic product (GDP)	14061.8	14369.1	14119.0	-15.8	-72.3	-137.3	-0.1	-0.5	-1.0
Personal consumption expenditures	9806.3	10104.5	10001.3	-20.1	-25.4	-87.8	-0.2	-0.3	-0.9
Goods	3357.7	3379.5	3230.7	-7.3	-23.7	-24.5	-0.2	-0.7	-0.8
Services	6448.6	6725.0	6770.6	-12.8	-1.8	-63.3	-0.2	0.0	-0.9
Gross private domestic investment	2295.2	2096.7	1589.2	6.7	-39.4	-39.6	0.3	-1.8	-2.4
Fixed investment	2266.1	2137.8	1716.4	-3.0	-33.0	-33.3	-0.1	-1.5	-1.9
Residential	628.6	472.5	352.1	-0.4	-4.7	-8.9	-0.1	-1.0	-2.5
Change in private inventories	29.1	-41.1	-127.2	9.7	-6.3	-6.3
Net exports of goods and services	-714	-710.4	-386.4	-0.2	-2.6	6.0
Exports	1661.7	1843.4	1578.4	5.8	12.3	14.2	0.4	0.7	0.9
Imports	2375.7	2553.8	1964.7	6.0	14.9	8.1	0.3	0.6	0.4
Government consumption expenditures and gross investment	2674.2	2878.3	2914.9	-2.3	-4.9	-15.8	-0.1	-0.2	-0.5
Federal	976.3	1079.9	1139.6	-0.4	-2.7	-5.2	0.0	-0.2	-0.5
State and local	1697.9	1798.5	1775.3	-1.9	-2.1	-10.6	-0.1	-0.1	-0.6

Firms have managed to deal with increases in output as the economy exited the recession by working existing employees harder, as shown by the five consecutive quarters of productivity growth, but this is not likely to be sustainable. Firms increased the hours worked by employees in April and June 2010 and may subsequently hire new workers. But confidence has diminished with the poor GDP figure in Q2, so the improvement in employment may take a little longer to appear in the data. For this reason many economists are pessimistic about the prospects for the US economy.

... BUT THERE IS A MORE OPTIMISTIC OUTLOOK REFLECTED IN OTHER DATA.

The improvement in productivity growth, and the opportunity that the recession has given firms to contain costs has resulted in strong corporate earnings. It is not clear that a de-coupling can continue for long between the strong results for corporate earnings and the weak results for consumption and investment expenditure. If the effect of the stimulus continues to work through the economy then there will be further reason to think that GDP growth will improve.

Another reason to be more optimistic about US prospects for growth is that retail sales and exports are all above the levels at the beginning of 2007. **Charts 3 and 4** show

that advanced economies have seen retail sales grow by 5% since January 2007, and exports have grown by 10%. The emerging economies have continued to see strong growth as **Table 1** has demonstrated, despite the efforts of the authorities in China to curb the excessive growth earlier in the year. China is expected to see double digit growth at 10.5% in 2010. As the Chinese currency appreciates against the US dollar US exports will be cheaper for the growing domestic market, creating opportunities for an export-led phase to the recovery.

Many European countries have benefitted from growing export markets in China. Germany, which has a strong export sector, is heavily dependent on its sales of high quality cars and machinery in this market. This has been the main driver of its exceptional GDP growth figure of 2.2% in the second quarter, along with the effects of the construction sector and government stimulus. Other European countries have also seen strong export growth contribute to the recovery, as euro-area exports have recovered in India, Latin America and Australia. The data for the euro area as a whole saw exports surge in April as the euro weakened, but the performance has reversed slightly as the currency has strengthened in recent months.

MONETARY POLICY CONTINUES TO ACCOMMODATE THE RECOVERY...

Monetary policy conditions continue to be loose, and there is little prospect of tightening in the advanced economies until 2011. The ample spare capacity in the advanced economies and unemployment rates above their 10 year averages are judged to exert downward pressure on wage and price inflation. Central banks have sought to encourage recovery by keeping short-term interest rates at historic lows, while also committing to keep rates low for the foreseeable future. The Federal Reserve in the United States has pledged to hold interest rates at 'exceptionally low' levels for an 'extended period', using this language to make commitments about future short term interest rates. The US central bank recently committed itself to buy Treasury Bills with proceeds from the sale of mortgage backed securities and to set a \$2.05 trillion floor on its holdings of government bonds and mortgage backed securities. It is hoped that this will keep the recovery on track while avoiding medium term inflationary worries if it were to extend quantitative easing measures.

The European Central Bank maintained its refinancing rate at 1% in its most recent meeting, and is scaling down the size of the emergency operations in government bond purchases that began in May. Next month the central bank will determine how to reign in the unlimited loans that they have extended to banks during the financial crisis. The record growth of GDP in Germany in 2010Q2 will pose a problem for policy makers in the eurozone since some other countries have seen anaemic growth or contractions in output. Many of the peripheral economies have fragile economies and weak financial systems. They would find any tightening of interest rates in present circumstances difficult to accept.

The Bank of Japan faces a different dilemma. Some policy makers have suggested that the Bank of Japan should have an inflation target in order to ensure it has a transparent objective. At present it does not have a mandate to target inflation, but balances the risks of inflation, deflation and stagnation. In its most recent policy decision it maintained its view that the economy will continue to expand, but it expressed concern over the recent appreciation of the yen versus the US dollar that reached a 15 year peak. It is facing calls to use its powers to intervene in foreign exchange markets to weaken the currency, and improve conditions for Japanese exporters.

CHART 3: Retail Sales

Source IMF

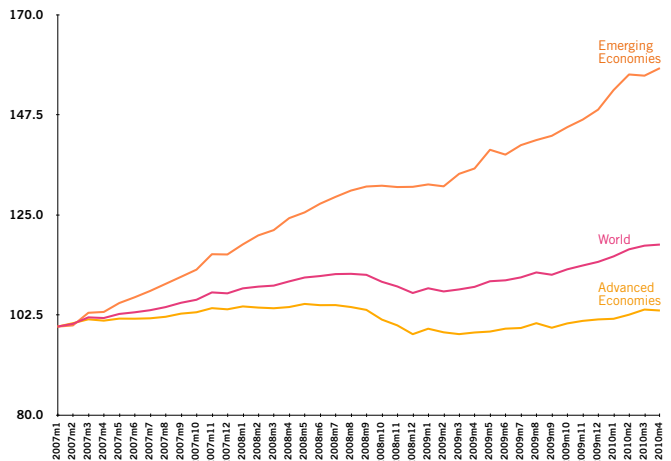


CHART 4: Merchandise Exports

Source IMF



CHART 5: Contributions of Real GDP and Inflation to UK Nominal GDP

Source OMS

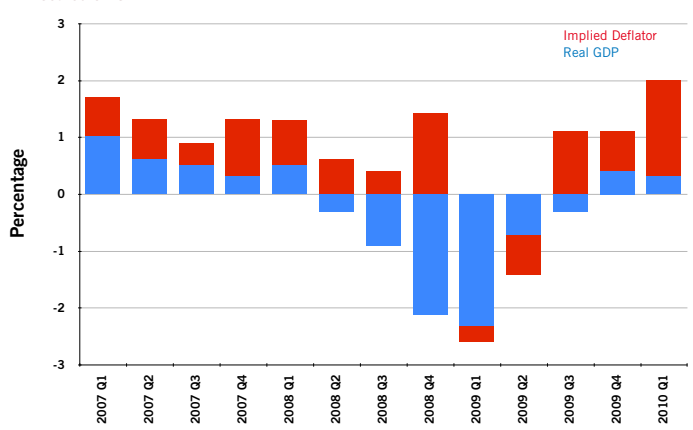


CHART 6: UK and Ireland Annualised Real GDP growth figures

Source ONS and CSO Ireland

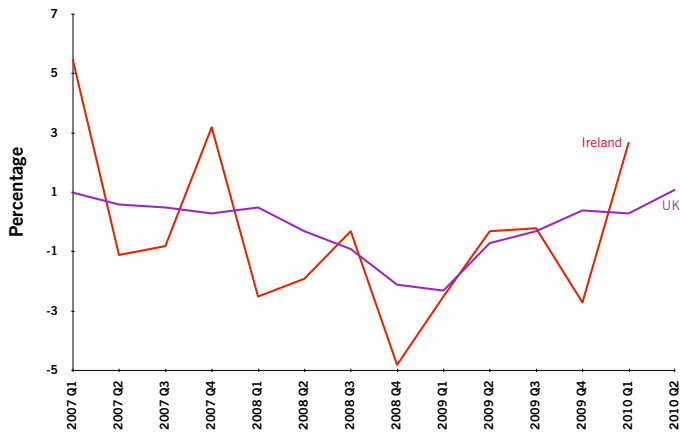


CHART 7: UK Business Investment growth

Source ONS

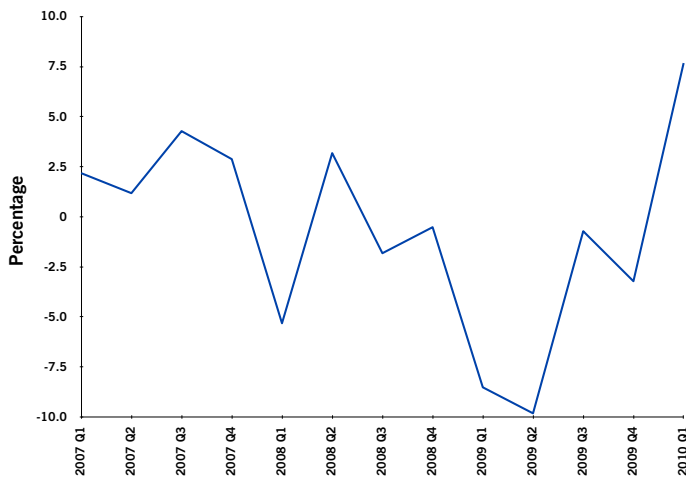
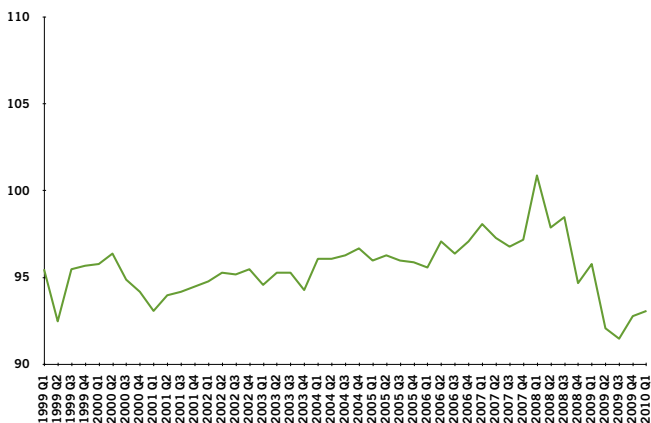


CHART 8: Share of Consumption out of UK Total Income

Source ONS



...BUT FISCAL POLICY MEASURES TO DEAL WITH SOVEREIGN DEBT WILL WEIGH HEAVILY ON GROWTH.

Those countries in Europe with high levels of government debt to GDP face the prospect that their borrowing will prove unsustainable, ratings agencies may downgrade their debt, and interest rates for present and future borrowing may rise. As a result many countries have chosen to take the step of cutting their spending and raise taxes despite the relatively weak recovery in advanced economies. Italy committed in May to cut its budget deficit by €24 billion by 2012, Spain plans to cut the deficit by €15 billion over the same period. After a €110bn bailout of Greece from the euro area countries and an additional EU-IMF package of €750bn, announced on May 10th, Greece will cut its budget by €30 billion over three years. Figures calculated by Barclays Capital suggest Greece's austerity measures are equivalent to 7% of GDP in 2010 and 4% in 2011 while Spain, Portugal and Ireland will cut their budgets by 2-3% of GDP in each of the next two years. The measures in Germany to reduce spending by around €80 billion by 2014, which mostly fall in 2013 and 2014, will nevertheless have a much greater impact on spending in the euro area.

The figures involved will reduce public spending dramatically, and through tax rises and benefit cuts may also reduce private sector spending. The net effect depends on the spillover effects of these changes on world spending, and on the timing of the measures in each country. The best case scenario is that reduced uncertainty associated with lower deficits will cause households to save less, but if they focus on the micro picture rather than the macroeconomic one, falling incomes will most likely cause them to cut spending to match.

TRENDS IN THE UNITED KINGDOM AND IRELAND

THE UK AND IRELAND ARE NOW SEEING THEIR ECONOMIES GROW.

The figures for the growth of nominal GDP growth from the UK Office for National Statistics record that annual GDP growth in the United Kingdom increased by 2.1% in 2010Q1, which gives further evidence that the UK is recovering from the recession which ended in the last quarter of 2009 (on revised figures). Nominal GDP growth is the percentage increase in the current value of goods and services. The value can rise for two reasons, either because the real goods and services produced increase, or because their prices increase. Improvements in the standard of living result from increases in real GDP. **Chart 5** shows the decomposition of the changes to nominal GDP growth in terms of real GDP and inflation. We see in the chart that the decline in nominal GDP in the period 2008Q3-2009Q1 was due predominantly to falls in real GDP. The standard of living fell because the UK produced fewer goods and services. The more recent episode has seen nominal GDP growth increase, and this has been predominantly due to an increase in the prices of goods and services. UK inflation has been persistently above the inflation target as we shall see later in the report, and this has been the element that has increased the growth in the nominal value of goods and services.

Real GDP has seen some positive growth, however, as seen in **Chart 6**. The Office for National Statistics recorded real annual GDP growth in the United Kingdom increased by 1.2% in the second quarter of 2010 up from an increase of 0.3% in the first quarter. The growth was driven by an increase in construction, which rose by 6.6%. Construction is traditionally the first sector to feel the effects of a recession and the first to see the recovery, but in this quarter much of the growth is due to a subdued first quarter due to bad weather. Manufacturing grew by 1.6%, while business services and finance rose by 1.3%, and distribution, hotels and restaurants grew by 0.7%. Evidence of a recovery in these other sectors is an encouraging sign, but the strength of the recovery in some sectors such as manufacturing is partly a reflection of the severity of the recession for firms in those industries. In part the recovery is supported by the desire to increase inventories and also by the improvement in exports as sterling has weakened relative to the euro and the dollar. Real GDP has recovered in Ireland, where the Central Statistical Office has reported growth of 2.7% in the first quarter after eight consecutive quarters of negative real GDP growth.

UK FIRMS ARE EXPANDING INVESTMENT AND STOCKBUILDING...

Demand in the UK has picked up in the business sector. A large increase in spending has been seen in business investment, which up to now has been well below the level that has been experienced at this stage in previous recessions. Business investment grew by 8.0% in the first quarter of 2010, as can be seen in **Chart 7**, due to the increase in spending by private sector non-manufacturing firms, which is largely a reflection of the increase in construction (up 36.5%), transport and communications (up 30.4%), financial intermediation (up 18.9%), and real estate (up 13.1%). Other components of business investment have fallen, however, including education (down 13.7%) and manufacturing (down 0.3%). The level of business investment is still 7.7% down on a year ago, and 18% below its pre-recession level. The constraints on investment due to credit conditions remain tighter than they were before the recession, although fewer firms are now reporting that this is the main reason to withhold investment. Where investment is taking place it is partly for the domestic market, as some firms are sourcing from the home market rather than importing components, and to a larger extent for the export market. This reflects the impact of exchange rate movements on the relative price of imports and exports, which has tended to boost export demand and diminish import demand.

Firms are also building their inventories of raw materials, work in progress and finished goods. Stockbuilding has been on a rising trend for the past four quarters, and contributed 0.6 percentage points to GDP growth in 2010Q1. Firms had previously been de-stocking, but this episode has ended and firms are now replenishing inventories that had been allowed to decline while the economy was in recession.

The Bank of England's regional agents consider that the increase in business investment and inventory accumulation is consistent with a gradual improvement in demand, rather than a strong recovery. Plans discussed by companies typically involve efficiency savings and asset replacement, where some assets have been used through the recession beyond their normal replacement date, rather than capacity building. There is ample evidence that output is below capacity, although the capacity is being utilised to a greater extent as demand picks up in some sectors, and the ability to meet orders is falling in other industries where labour shedding has occurred.

CHART 9: UK Imports and Exports and Current Account

Source ONS

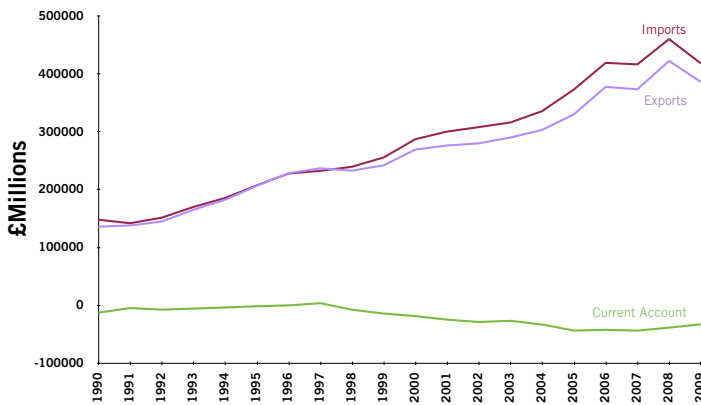


CHART 10: UK Current Account Balance with EU27 Countries

Source ONS

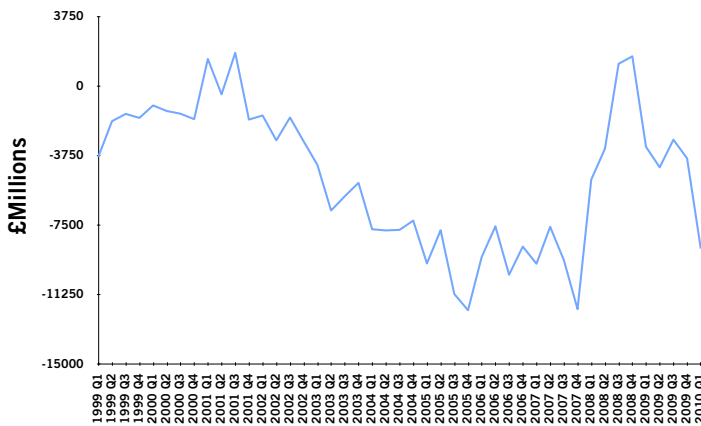
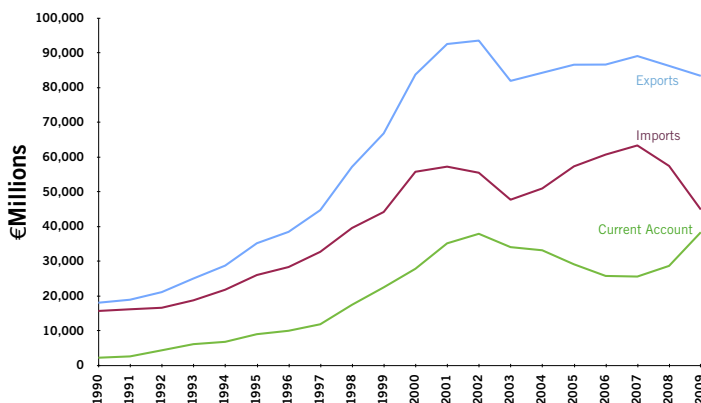


CHART 11: Irish Imports and Exports and Current Account

Source CSO



...BUT CONSUMERS ARE SPENDING LESS, AND EXPORT MARKETS ARE WEAK.

The positive results from the corporate sector are offset to some degree by the less positive outcomes in the household and external sectors. Households have responded to uncertainty about future expected net income, employment and prices by reducing the share of income devoted to consumption. **Chart 8** shows that between the years 2001-2003 the share of consumption out of disposable income was in the range 94-95%. From 2004-2007 there was an upward trend as the economy grew steadily, inflation was contained and credit was readily available; the share rose to 98%. In 2008 the share briefly peaked at over 100% as households maintained consumption while disposable incomes declined, but once the extent of the financial crisis and the recession was felt after the Bear Stearns rescue and the Lehman Brothers collapse, consumers reigned in their spending drastically. The share of consumption out of disposable income fell to 91.5%, below the previous trough in 2001 of 92.5%, and now stands at 93.1%. The Bank of England's regional agents have found that consumer spending has softened in 2010Q2, with growth in the volume of goods falling, and it is probable that the impact of public sector budget cuts will cause further dampening of consumer spending over the next few years. But retail sales for July beat expectations and consumer services have seen a slight increase in growth. Tourism in particular has seen an improvement as holidays taken in the UK rather than elsewhere have increased, perhaps due to changes in the exchange rate.

The exchange rate has boosted exports and encouraged substitution away from imported goods. Bank agents report that goods manufacturers are seeing an increase in orders from the Far East, the Middle East and Russia. But many exporters have taken the opportunity to boost their margins, which had been squeezed by economic conditions in the previous two years, rather than expand market share. The UK economy has run a persistent current account deficit with the rest of the world for most of the years since 1990 as shown in **Chart 9**. The EU, which is the major UK export market, still imports more goods and services to the UK than it purchases from the UK. **Chart 10** shows that the current account balance between exports

and imports with the EU 27 countries, had returned to surplus briefly in 2008Q3 and Q4, but has now reversed, and is now reflecting a deficit comparable in size to pre-recession levels. The net contribution from the external sector is unlikely therefore to provide much contribution to the GDP growth figures. The contribution of net trade to GDP growth in 2010Q1 was -0.9% on a quarter earlier.

The implication of the recession for unemployment has been significant. The UK has had a settled rate of unemployment of 5-6 percent for a decade, but in recent quarters has seen unemployment rise to 8 percent, and remain there.

IN IRELAND, CONSUMPTION GROWTH HAS BEEN PERSISTENTLY NEGATIVE, BUT NET EXPORTS ARE POSITIVE.

The Irish economy similarly has seen a cut in consumer spending. In volume terms consumer spending was 0.8 per cent lower for 2010Q1 compared with 2009Q1. Consumer spending growth, which had grown between 8-10% per year in 2005, 2006 and 2007 had variable growth in 2008, and negative growth of -10% in 2009. The growth for the first quarter of 2010 was -4.6%

Unlike the United Kingdom, the Republic of Ireland has run a consistent trade surplus, exporting more than it imports, for many years. This contributes strongly to GDP growth. **Chart 11** shows the exports and imports for Ireland from 1990-2009, which illustrates that the current account surplus has grown through the period, even in the last year when exports and imports both fell. An analysis of trends between the first four months of 2009 and 2010 show exports decreased again, by 6% to €28,069m, while imports decreased by 6% to €15,185m, but this caused the surplus to increase.

In Ireland the unemployment rate had been below 5 percent for the last decade, but the unemployment rate has now reached 13%. In Ireland unemployment can be expected to fall gradually in 2010 and 2011, although the tightening of spending in the public sector will increase unemployment arising from that sector.

THERE HAS BEEN A SUBSTANTIAL SHIFT IN PUBLIC POLICY...

During recessions government spending automatically increases as more people claim benefits and the tax take from income declines when people lose their jobs or work fewer hours. The scale of the UK government's net borrowing requirements to finance the difference between spending and revenues peaked at 11% of GDP. Since coming to power the coalition government

has committed to reducing the deficit and bringing government spending back in line with its revenue. In the June budget the Chancellor reviewed the public sector net borrowing, set up a new Office for Budget Responsibility and initiated a comprehensive spending review set to outline cuts in government spending in October 2010. **Chart 12** shows the revisions to the net borrowing in the light of the June budget. The blue columns show the projected net borrowing to 2014 based on HM Treasury figures in the March budget. The red columns show the new figures from HM Treasury after the June budget to 2015. The comparison reflects the desire of the government to ensure a faster reduction in the deficit which would essentially be complete within the lifetime of this Parliament. This will be achieved through welfare cuts worth £11 billion by 2014-15. Over 50% of these cuts will be achieved by allowing benefits to rise by the CPI rather than the RPI inflation rate. CPI inflation tends to be lower and less volatile than RPI, and on average will reduce the indexation of benefits for welfare recipients. The remaining cuts will be found from working-age benefits and tax credits, and although some red lines have been drawn to prevent cuts in some areas, in principle all taxes and benefits are under review. In terms of spending the public services, with the exception of the NHS and overseas aid, will need to find savings of 25% in real terms before 2015. This is the largest spending cut since the Second World War. The government will also increase the VAT rate to 20% from January 2011.

The likely effects of this sharp reduction in government spending is to directly reduce GDP growth, and indirectly dampen consumer spending and business investment, but it will also reduce the likelihood of a ratings downgrade for British government debt, and lower the risk premium associated with UK government bonds, reducing the cost to the taxpayer of financing the deficit. The distributional impact of the budget is likely to be somewhat regressive, since welfare reductions, slower pensions growth and VAT increases tend to affect lower income households more than they affect the better off. Poorer households are more likely to claim benefits, and they spend a larger fraction of their income so they pay more VAT than richer households. But until the comprehensive spending review is complete it is difficult to assess the total effect of the spending cuts on households with different levels of income.

...AND THE FOCUS OF CENTRAL BANKS IS STILL ON PROMOTING THE RECOVERY BUT INFLATION IS STUBBORNLY HIGH ...

Since the beginning of the recession inflation has proved more volatile than in the previous few years. **Chart 13** shows that the headline consumer price index (CPI) and the retail price index (RPI). The Bank of England is mandated to focus on keeping CPI inflation at 2%, but RPI is relevant to many pay settlements and to welfare increases. After peaking, as commodity prices spiked, at 5.0 and 5.2 percent respectively in September 2008, RPI and CPI dipped in 2009. RPI turned negative as oil prices fell and the cost of mortgage interest payments declined. CPI excludes mortgage interest payments so it did not fall to the same extent as RPI, but from the third quarter of 2009 both inflation rates have been increasing once again. This has nothing to do with the changes in the rate of interest - there have been no changes to rates since the sharp decline in rates in late 2008-09 - but has much more to do with rising oil prices, the return to a 17.5% VAT rate and the weakness of sterling, which increased import prices. Oil prices have increased in the first quarter of 2010, as there was strong demand for energy in the far east, and these costs have been passed on to the consumer through higher prices. Increases in the wholesale price of gas contributed to retail gas prices and electricity prices, pushing up inflation further. The VAT rate increase to 17.5% from 15% similarly contributed to inflation by raising the retail price consumers pay for goods and services. The UK Office for National Statistics calculated that the impact of the VAT increase alone contributed 1.47% to the monthly change in inflation. Finally, the weakness of sterling in the first half of 2010 resulted in an increase in imported inflation, which is 27% higher in 2010 than it was in 2005. At the end of a recession, when margins have typically been squeezed, producers and retailers have little option but to increase prices in line with cost increases. One area where there is relatively little pressure on prices is the labour market. There is still downward pressure on earnings as demand is weak and capacity is under-utilised.

FUTURE INFLATION IS PROJECTED TO REMAIN PERSISTENTLY ABOVE TARGET...

The headline rate of inflation in consumer prices reached 3.2% in July 2010 and the rate has been above the Bank of England's target for seven months running.

The Governor Mervyn King will write his first letter to the Chancellor of the Exchequer, George Osborne, in accordance with the Bank of England (1998) Act. The forecast for inflation remains above target, based on the projections of the Monetary Policy Committee, until the end of 2011, but it is expected to dip below the target thereafter. This projection, in the August Inflation Report, considers high inflation to be more persistent than the projection in the May Report, but there is considerable uncertainty around that projection and inflation is likely to be volatile for some time. The balance of risks has shifted in the intervening three months and the factors that influence the projection are clouded with uncertainty.

On the demand side the members of the Monetary Policy Committee are uncertain how much weakness in consumer spending and exports will affect growth, and eventually inflation. If households aim to save a larger proportion of their income, as they have done recently, then there will be less pressure on prices from excess demand. Export growth will depend on movements in the exchange rate, which are likely to depend on the timing and speed of interest rate tightening vis-à-vis other countries, and the prospects for 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. Business investment has rebounded but it is not creating additional capacity for the economy to grow. There is a great deal of uncertainty about how capacity in the UK economy will develop. Some firms have responded to the recession by curtailing production, laying off staff and postponing investment, effectively lowering their capacity. Others in export-intensive sectors have expanded and if sterling continues to give these firms a competitive advantage, will need to expand capacity. Excess capacity creates a buffer against price increases. Taken together these effects offer an uncertain picture for future GDP growth, which is reflected in the Bank of England's assessment of economic growth between 2010/12. Another effect of excess capacity can be seen on wage growth. The level of unemployment in the UK continues to exert downward pressure on wages, which helps contain wage costs for companies and lessen the likelihood that they will raise prices.

...THE FINANCIAL SECTOR IS IMPROVING BUT WILL TAKE TIME TO RETURN TO FULL STRENGTH.

Despite the fact that inflation is above the target it is unlikely that the Bank of England will raise interest rates in the near future. It is even less likely than it was at the time of the Bank's May Inflation Report. One important reason for this decision to keep rates on hold, apart from the patchiness of the recovery, is the continued weakness of the financial sector. The large provisions that they hold on their balance sheets for expected losses have diminished to some extent because the economic recovery has helped some borrowers to avoid default. Many banks have reported profits in the second quarter of 2010 and this will help to rebuild their balance sheets, but the process will take time. Since the previous report the stock market has lost ground, which has reduced the value of some assets held by the banks. 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.

Another important issue for UK banks has been their funding requirements. Many UK banks have a substantial quantity of funding that is due to mature in the next two 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 are increasingly seeking funds from retail depositors by offering fixed rate deposits but while this funding option is more stable it is more expensive and squeezes the banks margins.

SUMMARY

The UK and Irish economies are now growing, but the growth is patchy between different sectors. Consumer spending is weaker, while business investment is stronger. Government spending that has increased during the recession is scheduled to be scaled back. In the UK and Ireland these cuts will be painful, and are likely to cause output growth to slow, but not enough to create a 'double dip'. Central banks face inflationary pressures, but with a patchy recovery, and continued weakness in the financial sector, they are likely to keep interest rates on hold.

CHART 12: Revised UK Net Borrowing Projections following June Budget

Source HM Treasury

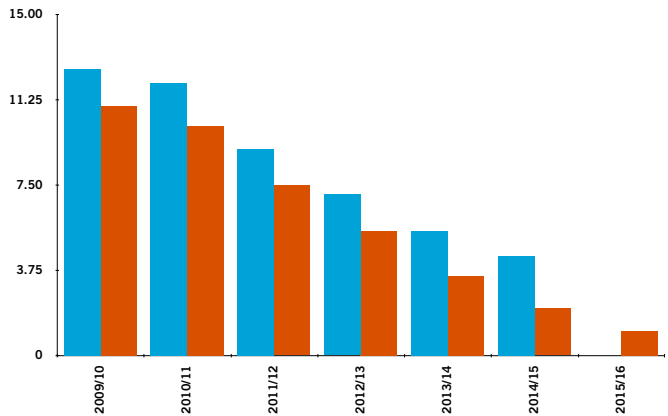
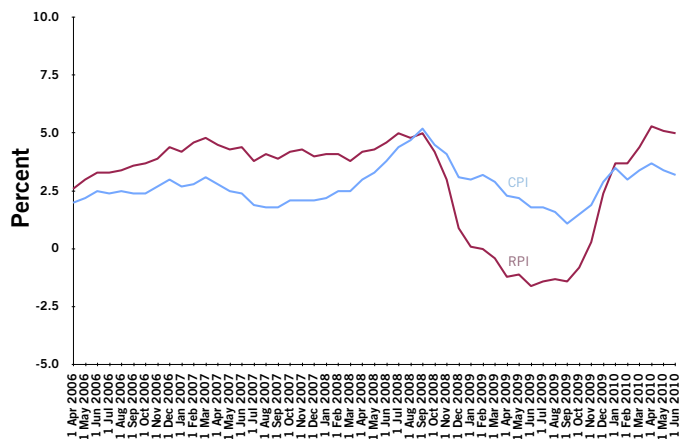


CHART 13: CPI and RPI Inflation in the UK

Source ONS



CREDIT CONDITIONS AND ASSET BASED FINANCE

ABFA statistics report asset based finance figures for the half year to June 2010 for the United Kingdom and Ireland. In the UK, the industry advanced £14.6 billion at the end of June 2010, against invoices, stock, property and other trading assets worth £30.5 billion. This represents an increase in advances of 2% over figures released a year ago demonstrating that not all lending to businesses is contracting. This is also the case for Ireland, where the advances were €1.4 billion against €3.4 billion of assets up 1% compared to figures in 2009Q2. Despite continued uncertainty about economic growth, asset based finance is growing in the UK and the Irish Republic, while net lending and net capital market finance are falling.

HIGHER CLIENTS' SALES REFLECT IMPROVEMENTS IN RETAIL SALES...

Previous sections have documented improving economic conditions, where there is exposure to the expansion in the emerging economies or domestic demand due to import substitution. This expansion in output and the growth in retail sales has contributed to growing clients' sales in the asset based finance industry through the increase in the value of sales, on which asset based finance is mostly based. **Chart 14** shows that total clients' sales increased this quarter from £49.4bn in 2010Q1 to £52.4bn in 2010Q2. Sales have improved steadily since the trough of 2009Q1 and have nearly

reached their previous peak seen at the end of 2008. They are now higher than they were before the crisis in mid 2007. A comparison of the clients' sales by product category compared to the previous quarter demonstrates where the additional business has been generated. Domestic factoring and domestic invoice discounting have grown by 5.6% and 6.5% respectively, while export factoring has grown by 7%. Export invoice discounting has grown much faster at 12% on a quarter ago, while import factoring has grown by just 4%. This reflects the effect of the weakness of the sterling exchange rate on export and imports over the first half of 2010. The increase in sales shows a similar tendency to retail sales figures in the UK, which grew faster than markets expected during July and have grown every quarter in the last 12 months.

... AND DESPITE A REDUCTION IN CLIENT NUMBERS, ADVANCES HAVE INCREASED.

These improvements in sales have been seen despite a net reduction in the number of clients - largely due to the recession. The net reduction in client numbers in the UK in 2009Q2 was 4533 or 10 percent of the total in 2009 Q2. The largest losses in clients have been in import factoring and asset based lending. Import factoring has declined as imports have fallen with the weakness of sterling, while asset based lending has fallen because fewer mergers and acquisitions have taken place in the last year, lowering the number of clients requiring this particular type of asset based finance.

TABLE 3 Advances to Clients by Product Category

£M	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
2009-Q1	11717	525	1783	346	58	294	145	208	15076
2009-Q2	11256	470	1618	341	57	257	125	183	14307
2009-Q3	11364	417	1754	370	52	254	125	166	14502
2009-Q4	11347	380	1562	310	61	225	115	168	14168
2010-Q1	11509	27	1662	326	63	237	115	179	14118
2010-Q2	11995	29	1668	334	70	213	121	166	14596
Growth rates on previous quarter									
2009-Q2	-3.9	-10.5	-9.3	-1.4	-1.7	-12.6	-13.8	-12.0	-5.1
2009-Q3	1.0	-11.3	8.4	8.5	-8.8	-1.2	0.0	-9.3	1.4
2009-Q4	-0.1	-8.9	-10.9	-16.2	17.3	-11.4	-8.0	1.2	-2.3
2010-Q1	1.4	-92.9	6.4	5.2	3.3	5.3	0.0	6.5	-0.4
2010-Q2	4.2	7.4	0.4	2.5	11.1	-10.1	5.2	-7.3	3.4

Source ABFA

In Ireland, the reduction in clients' sales was smaller in percentage terms, falling by 3 per cent from 2009Q2 to 2010Q2. Members in the Republic of Ireland had a net loss of 56 clients in the last year.

Total advances by ABFA members to their clients have increased from £14.1bn to £14.6bn as shown in **Table 3**. After a decline in advances for the last two quarters, ABFA members are now advancing more than they were at any time in the last year. The growth in total advances was 3.4%, of which the largest component - pure invoice finance - grew by 4.2%, while advances against debt and other assets grew by 7.4%. Growth in asset based lending of all types taken together was flat, although the advances against debt, stock, plant and machinery, and other assets behaved differently from each other. Much of this type of lending is 'event driven', being closely connected with mergers and acquisitions activity, but these events have occurred less often in the past year. Figures from the Office for National Statistics show that 99 mergers and acquisitions took place in 2008Q4 with a total value of £18 billion, compared to just 52 in 2010Q1 with a total value of £1 billion.

...BUT FIRMS HAVE BEEN BORROWING LESS FROM OTHER SOURCES.

According to the Bank of England's most recent Trends in Lending net funds from all forms of finance have fallen, with capital market finance falling considerably on a year ago. Larger firms have issued a lower volume of bonds than are maturing, resulting in a net reduction in bond finance. Equity finance has increased due to the activities of two sectors - mining/quarrying and utilities, but this increase is small, and is insufficient to offset the decline in bond finance and bank loans. All types of firms have been repaying loans to banks and the decline in net lending applied to all sectors in June 2010.

Chart 15 shows that firms have once again made net repayments of loans in the first half of 2010. The flow of net lending to businesses declined by £3.5 billion in June, which represents a fall of 8.1% on a year ago, the same rate of decline observed in the May figures. Net lending has been falling continuously for the past nine months according to these Bank of England figures. The underlying reason for this trend is unclear.

CHART 14: ABFA Clients' Total Sales

Source CSO

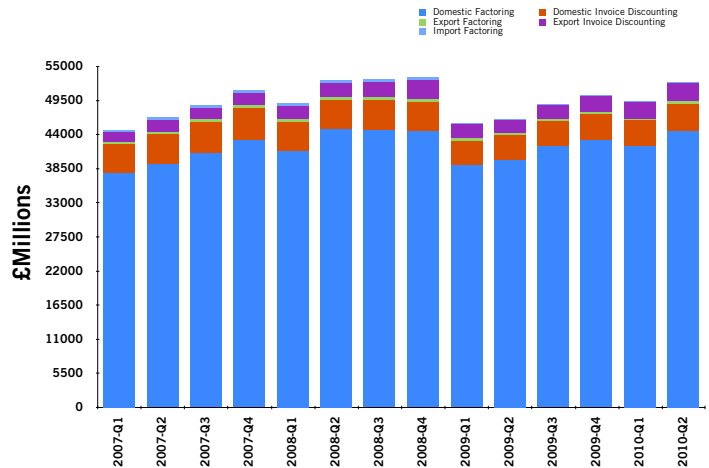


CHART 15: 12 Month Business Lending Growth Figures

Source HM Treasury

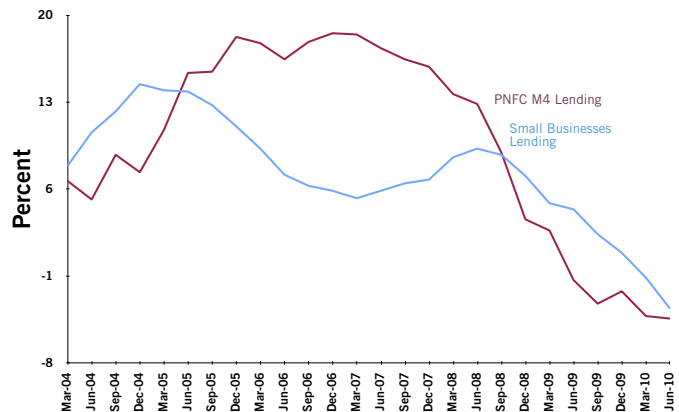
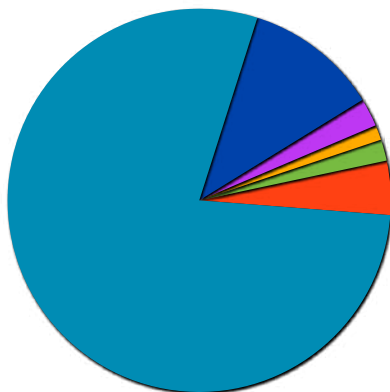


CHART 16: Shares of Advances by Product Type

Source ABFA

- Pure invoice finance - advances against debt
- ABL - advances against debt
- ABL - advances against stock
- Other ABL
- ABL - advances against property
- Other commitments

2009Q2



2010Q2

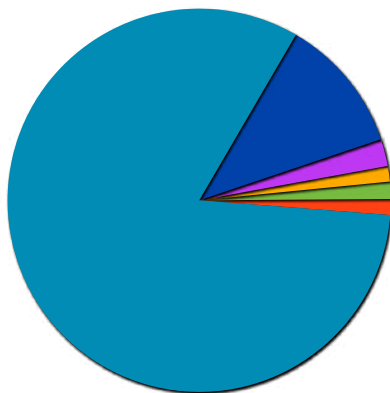
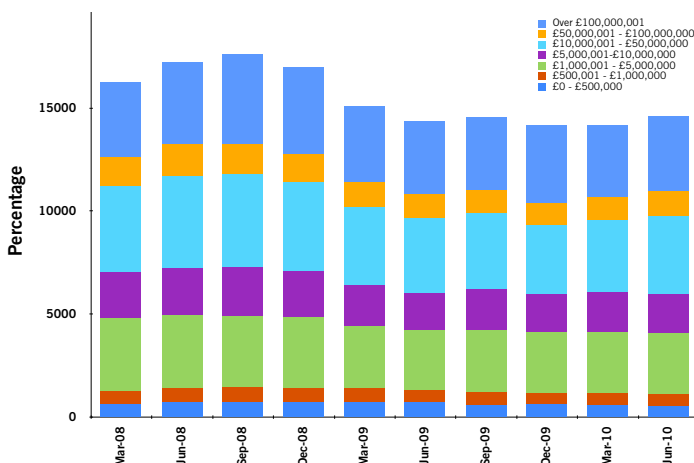


CHART 17: Quarterly Advances by Firm Turnover Size

Source ABFA



Surveys, such as the Bank of England's Credit Conditions Survey suggest that credit availability is still tight compared to before the crisis, although conditions have eased compared to the start of the year. Lenders on the other hand suggest that demand for loans is weak, which they surmise is due to the uncertainty surrounding the path of future demand.

The growth in the gross lending to small businesses, recorded by the British Banker's Association, shows a similar downward trend. Although the growth in lending to small businesses has only turned negative in the last two quarters, it has been on a downward trend since June 2008.

The UK government's Enterprise Finance Guarantee Scheme has been only partially successful in encouraging bank lending. More than £1 billion has been backed by the government's scheme, but the figures have been falling since the start of 2009. The amount guaranteed has fallen by 60% in the last year, and according to the Bank for International Settlements figures just £150 million was supported in 2010Q2. Once again this reflects weaker demand for loans, and possibly the fact that loans most suitable for guarantee were supported earlier in the scheme, and those that are being considered now are less appropriate for this form of funding.

ASSET BASED FINANCE FIGURES SHOW LARGER FIRMS' ADVANCES INCREASED TO A GREATER EXTENT...

The majority of advances - amounting to 82% or £12 billion out of the total of £14.6 billion are pure invoice finance advanced on debt. **Chart 16** shows the components in 2010Q2 compared to 2009Q2. Pure invoice finance and asset based lending on debt comprise 94% of all asset based lending in the most recent figures, compared to 90% in 2009Q2. The growth in the share of these components is due to the reduction in finance raised on other assets such as asset based lending on stock, property and other assets.

Chart 17 shows how the advances to firms varied according to their turnover. The advances made to smaller firms with turnover below £5 million per annum are represented by the bottom two components. These make up a relatively small part of the total advances but they fell by the largest percentage, dropping 9.3% and 6% respectively. The figures for firms with turnover between £1 million and £10 million also fell, but by a small

amount below 2%. Larger firms with turnover between £10 million and £50 million saw their advances rise by 8%, and the largest companies with turnover above £100 million had increases of 7%. Firms in the top three categories by turnover receive over 50% of the advances from ABFA members.

...ACCESS TO CREDIT IS STILL TIGHT, DESPITE SOME IMPROVEMENT.

Each quarter the Bank of England produces a Credit Conditions Survey. Here we summarise a number of indicators of supply and demand conditions from the latest issue. Looking first at supply conditions, firms report continued improvement in the availability of credit over the last three months compared to previous periods. But a survey by the Institute of Chartered Accountants in England and Wales and Grant Thornton, found that 20% of firms still report that access to capital is a challenge. According to the Credit Conditions Survey, credit availability is expected to revert to lower levels once again in the next three months. Lenders surveyed indicated that fewer borrowers had sought funds than they had expected. This suggests that demand is weak, and the survey shows that demand for lending by firms had fallen among larger firms, but had risen among smaller firms. Since larger firms typically borrow greater amounts than smaller firms, this helps explain why the net demand for lending declined in the last three months. The costs of borrowing - in terms of the spreads charged over the cost of funds and the fees attached to loan applications - have declined for larger businesses, but have increased for smaller businesses. Lenders have been faced with an increase in the cost of funds as they have relied less on wholesale funding and more on funds from their deposit base. The costs of borrowing are expected to rise in the next three months.

Overall this information seems consistent with the improvement in the financial health reported by the UK banks, easing their willingness to lend; but the continued uncertainty in financial markets that has raised risk premiums, and the caution banks are now showing towards, risk means that loans are more expensive, and not all firms are finding these conditions provide them with access to credit.

The euro area Bank Lending Survey conducted for July 2010 asked similar questions of 100 euro area banks. These conditions refer to the entire eurozone not just the Irish Republic. The survey reports that the easing of credit standards on loans to enterprises has been reversed in the second quarter of 2010, largely due to more difficult conditions for the banks. Euro area financial institutions report that their own balance sheets

have deteriorated, particularly in terms of liquidity and access to wholesale funding. As a result they are less willing to lend, or at least wish to charge more for doing so. The situation of banks in Ireland is very much worse than the euro average. Governor of the Central Bank of Ireland, Patrick Honohan, assessed the cost of bailing out the Irish banks at €25 billion. The National Asset Management Agency that has been charged with dealing with the bad loans of the banks has acquired €16 billion of loans in the first purchase (Tranche I) and made preparations to acquire another €13 billion of loans in Tranche II. According to its business plan released in July, it hopes to return a net profit to the taxpayer of €1.0 billion, but the range of possibilities under different scenarios gives a range between a profit of €3.9 billion and a loss of €0.8 billion. The average discount being applied to the full portfolio of loans acquired is 50%, but some have been written down by as much as 90% and it states 'the percentage of loans which are "income producing" (i.e. loans which are at least paying the interest due on the monies borrowed) is...25%'. Against this background lending conditions are likely to be much harsher in Ireland than in the rest of the euro area.

FIRMS' CREDIT PROTECTION PAYMENTS HAVE STABILISED...

According to **Chart 18**, the amount of annual credit protection payments being made to clients in the UK before the crisis was approximately £23 million per annum. In 2009 that figure rose to £36.1 million. These payments are made by the asset based finance industry to their clients when non-recourse debts are defaulted upon by their clients' customers. The figures for 2010Q2 have come down once again compared to 2009, and the amount paid to clients over the last four quarters was £28.7 million. This figure is higher than the pre crisis average but somewhat lower than the 2009 average. It is expected to continue to fall as figures for the second half of 2010 are taken into consideration.

The Bank of England's Credit Conditions Survey asks lenders about defaults and losses given default for different types of firms. The net percentage of firms reporting higher defaults by small businesses has increased in 2010Q2, while those reporting defaults for medium and large businesses have fallen sharply. The losses given default for small businesses have fallen unexpectedly, while for medium and large businesses they were in line with expectations. The defaults are expected to fall for small and medium sized businesses in the next three months, and to rise slightly for larger companies; the losses given these defaults are expected to fall.

CHART 18: Quarterly Credit Protection Payments to Clients
Source ABFA

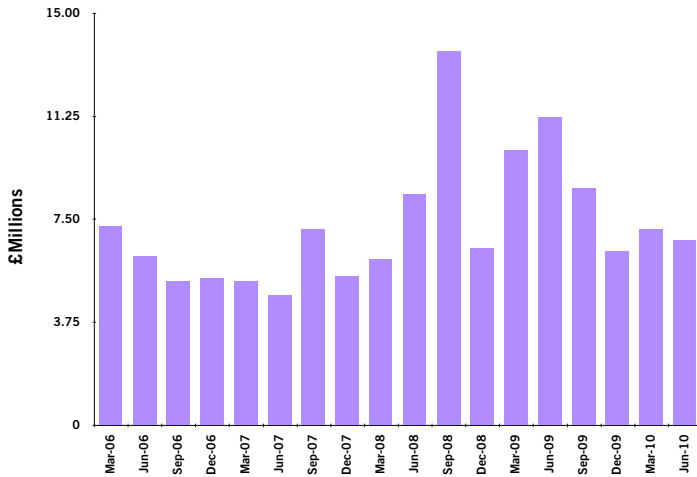
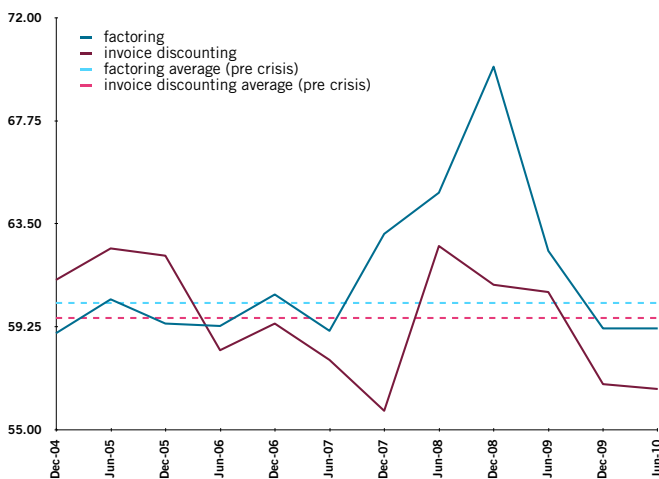


CHART 19: Debt Turn
Source ABFA



...AND THE NUMBER OF DAYS FOR DEBTS TO REMAIN UNPAID HAS ALSO LEVELLED OFF.

ABFA figures on the average number of debtor days outstanding are given in **Chart 19** 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 significantly above the pre-crisis average but ABFA members have pulled the debtor days back below the average. They now stand at 59.2 for factoring clients and 56.7 for invoice discounting clients. Businesses are therefore waiting the same number of days to receive payment on debts and sales invoices as two quarters ago.

SUMMARY

ABFA statistics for the United Kingdom and Ireland show that the industry advanced £14.6 billion at the end of June 2010, against invoices, stock, property and other trading assets worth £30.5 billion, and €1.4 billion against €3.4 billion of assets in Ireland. The figures are an improvement on figures released a year ago as retail sales have improved in the UK and Irish economies. The increase in advances to firms against debts outstanding contrasts markedly with reports of a decline in net lending and a reduction in market finance. Most of this increase is due to an expansion of pure invoice financing and asset based lending against debt. The situation is expected to improve further in the second half of 2010 despite the uncertainty surrounding economic growth.



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

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

