DAVID HALE GLOBAL ECONOMICS

Has Growth Returned?

By David Hale

As appeared in Prospect Magazine on May 25th, 2013

The British economy has been in the doldrums for nearly 18 months. It has been the United Kingdom's longest period of sluggish growth since the early 19th century and its performance has lagged behind all other G7 countries, except for Italy.

There was relief at the Treasury in April when official figures showed that the economy grew by 0.3 per cent in the first three months of 2013 and avoided the danger of a "triple dip"—a third period of recession. In May the Confederation of British Industry discerned signs of recovery. But these are only faint sources of encouragement. It's worth asking why Britain has found recovery quite so hard, whether George Osborne or his predecessors are to blame, and whether growth is now finally returning.

Let's start with the bald figures, which spell out just how painful this period has been for the UK. The downturn was the worst since the Second World War for many countries, but for the UK it was the worst since 1830. The economic crisis caused UK GDP to fall by 6 per cent compared to 9 per cent in Japan, 8 per cent in Italy, 7 per cent in Germany, 5 per cent in the United States and 4 per cent in France.

Robust upturns often follow severe downturns, but not this time. Britain technically emerged from recession in 2009 but output is still 2.9 per cent below its previous peak. It has grown by about half the rate of Germany, Japan and the US since then, although it has done better than Italy and Spain, which have been in recession for the past two years—France slipped back into that state in May.

There are many intertwined reasons why the UK has struggled. Some do lie in the last few years—Osborne, in pursuing his austerity programme, failed to produce policies which would offset its effect plus that of the eurocrisis and global slowdown. In April, the International Monetary Fund lectured him that "near-term flexibility in the fiscal adjustment path might be needed."

But many reasons stretch back more than a decade. One straightforward answer is that households entered the downturn with record levels of debt which they are now having to pay off, and are not spending. In turn, businesses have hoarded their money—just like households, they have stopped spending. In the third quarter of 2012, they were holding reserves of £671bn, equal to 46 per cent of GDP (twice as much as the share in 2002). They have not invested precisely because UK consumers are spending less, and they have found little relief through exports because of recession in the Europe Union and modest growth elsewhere.

Putting it all together, households are not spending, businesses are not spending and Osborne has restricted government spending. The economy lacks a locomotive to drive its growth.

The roots of the problem lie in the policies that caused such an expansion of borrowing. There was a far more reckless expansion of private borrowing in Britain during the governments of Tony Blair and Gordon Brown, in the years before the 2008-09 downturn, than during any previous post-war business cycle. Between 1997 and 2007, private debt rose by nearly three and a half times the growth in the economy.

That was far greater than in the US and similar to the growth of debt in Spain, which occurred after that country joined the European Monetary Union, enabling it to borrow at lower rates. If the UK had joined the monetary union and enjoyed

similar interest rate levels, it might have experienced a property boom and bust comparable to those in Spain and Ireland. The Treasury might then have had to rescue not just RBS but all the banks.

However, even if Britain escaped that fate, its own borrowing boom had effects on people's behaviour throughout the economy. Rising house prices inspired confidence—people spent more and saved less. The savings rate plummeted from over 8 per cent in 1997 to below 2 per cent in 2007 and tax revenues from the property market made the Labour government more willing to increase public spending. As with all booms, the momentum from increased borrowing had self-reinforcing effects on prices, retail spending and tax receipts.

The economy's recent weakness reflects the effects of this process going into reverse as households pay down their debt. There are some sources of comfort in this picture; it might not seem that way in some regions outside the southeast, but the UK had comparatively modest job losses during the downturn. It lost 2.5 per cent of its jobs—more than the 2 per cent lost in Germany and France, but far less than the US, which lost over 6 per cent. UK unemployment is now 7.9 per cent, compared with a current rate of 7.5 per cent in the US, around 11 per cent in both France and Italy and over 27 per cent in Spain.

However, even for those in work, inflation has restrained the desire to spend as people find the price of things they want to buy outstripping their resources. Recent wage growth has been only 2 per cent while inflation has fluctuated between 2.5 to 5.5 per cent.

Inflation is not at the moment the spectre that it was in the 1970s, but it has become a new factor in people's calculations, after years when it had disappeared from the picture. The Bank of England has not been able to restrain inflation because its priority has been to encourage economic recovery by

lowering interest rates to [0.5 per cent], and injecting £375bn of money into the economy through "quantitative easing."

If you ask for a single reason why UK output has lagged behind the US, it is this: the low level of retail spending. Some of that is due to differences between Britain and the US in whether people are allowed to default on debts. American households have reduced their debt by nearly $1.3 trillion since 2009, but significantly, two-thirds of the decline has come from defaults on mortgages. Many American households have home loans that allow them to send their house keys back to the bank (so-called "jingle mail," in the laconic phrase of the lenders) and just walk away. In the UK, banks have the legal right to pursue the income and other assets of those who default. There has been discussion in the UK about rules that would let householders simply write off mortgage debts, but as yet there are no proposals.

If the roots of the problem lie in the debt encouraged by previous Labour governments' policies, have Osborne's policies cut growth more than expected? But it is hard to say that cut sare not needed. The problem has been a lack of clarity on the useful means to offset austerity, such as airport expansion, or clarity of the tax code to encourage foreign investment. After 2010, the new Chancellor announced an "austerity" programme. At its core was a plan for the government to get its annual expenditure below its income within five years—to eliminate the budget deficit. The aim was to cut the sums that Britain had to spend each year in paying interest on its national debt, and to reassure the financial markets that it still deserved the highest credit rating—which influences how cheaply it can borrow money.

Osborne hoped at that point that rising business confidence would boost employment and investment. The government projected then that growth would rise from 1.2 per cent in 2010 to 2.3 per cent the following year and 3 per cent

the year after that. Critics have confronted the government with that early expression of optimism ever since.

The government has now abandoned those plans, although it has, as Osborne is at pains to point out, made some progress. The deficit has been cut by one-third during the past three years and the government now projects a deficit of 7.4 per cent of GDP this year, reducing to 2.2 per cent in 2017-18.

The problem is that a weak economy yields weak tax receipts while, despite the austerity programme and contrary to public perception, government spending is still increasing. So although the deficit is being reduced and the government is decreasing the amount by which it overspends each year, it still overspends and to do so it borrows from international money markets.

The eurozone crisis was a further blow, outside the UK government's control. Europe takes about half of UK exports. Sales to Germany have been resilient but those to France, Italy and Ireland all declined. UK export orders fell for the 15th consecutive month during March as a result of weak demand in Europe and strong competition in markets such as North America. Last year, British exports to Europe fell by around £8bn.

Osborne has, more than publicly perceived, significantly amended his original policies, although he cannot announce this for fear of being accused of a U-turn. The Chancellor has abandoned his initial fiscal targets and has accepted a deficit of nearly 6 per cent of GDP in the year of the next election. (He might have tried to hit the original targets with new tax increases or spending cuts, but this would have driven the UK back into recession). So far, his gamble has been accepted by the markets; although two ratings agencies have downgraded UKdebt, the government can still borrow cheaply. The markets appear not to care that deficit reduction will occur more slowly than the government promised in 2010.

However, in terms of trying to get more growth, all Osborne has room to offer is less spending restraint, not a genuine spending stimulus.

The results of this much greater emphasis on the pursuit of growth—but also the constraints on him—were reflected in the Budget in March. Osborne offered a reduction of corporate tax to 20 per cent in 2015, the lowest in the G7; a £2,000 rebate for companies on their national insurance contributions; and a £3bn increase in infrastructure investment in 2015. He also endorsed a new stance for the Bank of England—a flexible inflation target, in which inflation can on occasion be tolerated in the interests of economic recovery. The new Governor, the Canadian Mark Carney, is likely to inject more money after he takes over in July, although there are good questions about whether he is really the secret weapon that Osborne seems to believe.

Will these policies work? Yes, but more slowly than the Chancellor intended, and they carry risks of their own. The most novel feature of the budget—and the riskiest—was the proposal to stimulate the housing market by creating a larger subprime mortgage market in the UK. Banks currently require homebuyers to make a 25 per cent down payment when they buy a home. Many cannot afford this, so the number of housing transactions in England and Wales has fallen from over 1.2m in 2006 to just over 600,000. Osborne has offered to help homebuyers who can only afford a 5 per cent deposit by loaning them 20 per cent of the home value in order to qualify for a loan. He is prepared to help create £130bn of new mortgages with this proposal, an amount equal to more than 10 per cent of the value of existing mortgages. Before the collapse of the mortgage-backed bond market in 2007, banks offered mortgages worth more than 90 per cent of the value of a home. Such lending came to an end in 2008 and has never recovered because banks now want protection from falling house prices.

As the UK has such strict planning restrictions, Osborne's plans could inflate house prices—they will also create a large debt for which the Treasury will be liable, but the plan will not increase public spending. It sounds like a neat idea; the worry is that it replicates what Fannie Mae did in the US mortgage market seven years ago by putting government money behind bank lending. That arrangement did not end well.

The UK can also pin some of its hopes for recovery on two factors from outside. The first is the revival occurring in one of the UK's growth areas of the 1970s and 1980s: North Sea oil. Oil and Gas UK, a trade body, says that investment in offshore oil and gas fields will reach record levels this year. The group expects UK oil output to rise from 1.5m barrels per day this year to 2m barrels per day by 2017. This is less than half the peak of 4.5m in 1999, but it is still an impressive gain.

But the question is whether these gains will flow to Britain to the extent they would have done in the past. Many of the large companies which drove growth 30 years ago have pulled out because of high costs and uncertainty about tax policy. In 2011, Osborne launched a £2bn tax raid on North Sea oil. He raised the effective tax rate on North Sea oil and gas development to 62 per cent and 81 per cent for some mature fields. He later softened the blow with new tax incentives, but his action confirmed what many oil industry executives suspected: that UK tax policy is unpredictable. The majors have been replaced by independent companies and some state-owned oil groups. The Abu Dhabi National Energy Company bought $1bn of assets from BP last year. China's Sinopec also invested.

As well as hopes of growth from oil, the UK can look to improving exports, particularly outside Europe. The UK has had success boosting exports to China, India and Brazil. Exports to China have doubled since 2008 while exports to Brazil have increased by 60 per cent. These gains are long overdue. In 2009,

the UK exported more to Ireland than to China, India, Russia and Brazil combined (although it should be noted that Ireland exported many of its imports from Britain to these very countries). Still, as Europe languishes, the UK must sell more directly to these emerging markets. The Prime Minister has been visiting China and India with business delegations to promote this objective. The biggest risk with the UK's international economic policy is Number 10's plan to hold a referendum on EU membership after 2015. Uncertainty about this issue could cause multinational firms to hold back from investing in the UK. American, Japanese, Korean and other foreign businesses regard Britain as an export base for the region and want Britain to remain in the EU.

At this stage of recovery, the politics of deciding economic policy are tortuous. Osborne is now part of a government in disagreement with itself. Some of his colleagues emphasise boosting small business lending while others want more public investment.

All the while a pervading sense of gloom works against him. Opinion polls reveal significant pessimism about the economic outlook. A survey by YouGov for the Resolution Foundation found that 46 per cent of people expected their living standards to be worse in 2015, while 28 per cent expected there to be no change; 36 per cent believed that the economy would fully recover within four to five years but 29 per cent expected it to take another six to 10 years. The pessimism is so entrenched that it's doubtful any change in policy would affect the mood. People have instinctively grasped that large fiscal deficits are a potential threat to their standard of living. While they may not like Osborne or openly endorse the "austerity" cuts, they recognise the need for a cut in the deficit.

So despite the gloom, the opposition is in no real position to make political capital. As well as this, Labour's plans would not reduce the deficit any quicker than the coalition's and the party must also take responsibility for the rise in

government share of GDP from 39.3 per cent to 49 per cent during its time in office. There is no doubt that if Gordon Brown had won the 2010 election, Labour would have had to cut spending.

But despite this, there are now signs of recovery. The Office of Budget Responsibility predicts that growth will be only 0.6 per cent this year but then 1.8 per cent in 2014, 2.3 per cent in 2015, 2.7 per cent in 2016 and 2.8 per cent in 2017. It has been projecting such an upturn since 2010—changing the timing of its forecasts, not the trajectory. It believes the UK has a potential growth rate close to 2.5 per cent.

These projections are beginning to be reflected in reality. The service sector, more than three-quarters of the economy, recently reported its largest gains in new activity since last August. Manufacturing benefited from increased orders to the US and the Middle East. It could rebound further if the IMF is correct that global growth will be 4 per cent next year. UK construction should improve next year as a result of government investment and the scheme to stimulate the housing market. If all three sectors improve during the next 12 months, the government may finally hit the OBR's 2014 target.

It is not an exciting story for a government whose popularity is suffering from austerity fatigue, but it could mark the start of a sustained upturn which will last through the life of the next parliament. Whoever wins the 2015 election will therefore have a good chance of winning in 2020 as well.

The writer is chairman of David Hale Global Economics. His website can be found at www.davidhaleweb.com

---

©2013 David Hale Global Economics, Inc.
All rights reserved. This document may not be quoted, forwarded, disseminated, distributed, or published without the express written consent of David Hale Global Economics, Inc.