Perspectives by Ruth Lea

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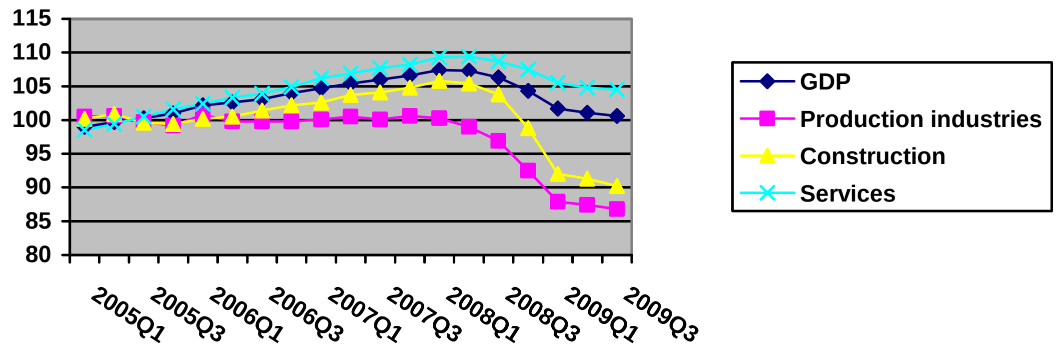
Risks to global recovery risk a British recovery

Introduction

There was much consternation when the third quarter GDP data for the UK were released recently.[1] They showed a quarterly fall of 0.4%. This was well short of City expectations of a rise of 0.1%, or even 0.2%, and the “end of recession”. Within the total, the production industries and construction showed falls though services, especially distribution, were also weak and made a major contribution to the quarterly decrease.

GDP and components, 2005Q1 to 2009Q3, index, 2005=100



Source: ONS database, www.gov.uk

One of the “explanations” for the ONS figure being out of line with City expectations is that the ONS may significantly revise the GDP figure upwards and thus the City will be vindicated. Whilst it is certainly true that the ONS revises its data, after all the preliminary estimates are based on relatively few hard figures, it cannot be guaranteed the revisions will be that significant or even in the “right” direction. According to one analysis when the revisions to preliminary growth estimates are analysed for, say, the past 15 years, the initial figure has turned out to be too low when it showed expansion of 0.3% or more over the quarter. But when initial growth estimates are weaker than this, revisions have often been downward.[2] So helpful ONS revisions cannot be relied on to save the City’s face.

Another explanation is that forecasters partly rely on business surveys in order to make their forward estimates of GDP. These surveys are, quite simply, different in nature from the methods the ONS uses. Such surveys include the CBI's business conditions survey and the Markit/CIPS purchasing managers' index (PMI) survey. Other contenders include the BCC and the ICAEW - which proclaimed back in August that, according to their latest survey, GDP would grow by 0.5%in the third quarter.

Care should always be taken when converting business survey information into indicators of growth because such surveys have at least three intrinsic shortcomings. The first is that they are subjective and difficult to standardise over time. The second is that they do not provide direct and quantifiable estimates of changes in economic activity. They tend to ask questions along the lines of whether matters have "improved" or "deteriorated" or "stayed the same". They do not ask how much output has gone up or down. A survey result could be interpreted in positive terms if 60% of respondents reported that output had improved and only 40% reported that output had deteriorated. But, if the average increase of the 60% positive respondents was a miserly 1% whilst the average fall of the 40% negative respondents was 10%, then clearly it would not be a positive outcome at all. In contrast the ONS deals in hard quantitative information. Finally, their coverage is limited.

Britain as the laggard

Britain's third quarter GDP data were given considerable coverage not merely because they were worse than expected, but also because Britain seems to be lagging other major economies in recovering from recession. France and Germany both grew by 0.3% in the second quarter and are expected to show similar increases in the third quarter. But how well-established and robust these recoveries will prove to be is questionable. Germany's scrappage scheme ended in September and lay-offs still have further to play out, particularly once temporary job-supporting fiscal measures start to fade. France's scrappage scheme will be wound down next year.

The US third quarter figures, showing an annualised 3.5% increase for the third quarter, looked very positive. But again qualifications should be made about the robustness of the recovery. Private consumption was the mainstay of 3rd quarter GDP growth, with more than half of this contribution coming from durables purchases. This clearly reflects a "cash for clunkers" effect which is likely to reverse in Q4 and leave consumer spending struggling to grow. Residential investment rose for the first time in 3 years as prices stabilised with the help of a temporary homebuyer tax credit. This, again, may not be sustainable.

More fundamentally America's households are deeply in debt and are, moreover, facing weak growth in real personal disposable income (RPDI). Indeed in the 3rd quarter, real disposable incomes fell 3.4% (annualised) and only by reducing their savings rate from 4.9% (Q2) to 3.3% (Q3) could America's consumers finance the pick-up in consumer spending. This is not sustainable.

Suffice to say, these economies are of supreme importance to Britain's economic prospects – especially if we are to achieve the much vaunted export-led growth. In 2008, the top destinations for British exports of goods and services were the USA (17% of the total), Germany (9½%), the Netherlands (7%, though distorted upwards by entrepôt trade), France (6½%) and Ireland (6½%).[3] Ireland's economic difficulties will inevitably depress Britain's exports to this very important market. It is, therefore, all the more important that the US, Germany and France prosper. It is true that key Asian economies are recovering well. But they are not, as yet, Britain's key export markets.

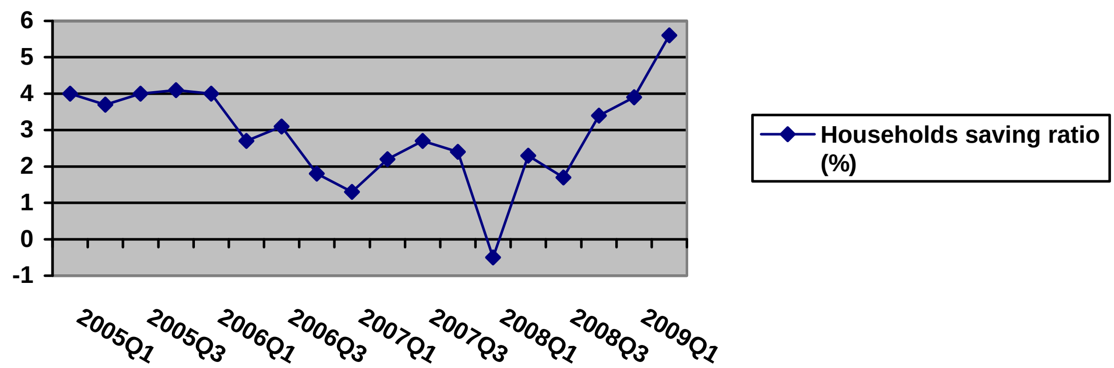
An export-led recovery?

As Britain emerges from recession, the key factor determining the nature of the recovery will be the performances of the drivers of growth. The major components of the GDP expenditure measure and, therefore, the potential drivers of growth are:

- Household final consumption and final consumption of non-profit institutions serving households (NPISH).
- General Government final consumption.
- Gross capital formation, including changes in inventories as well as fixed investment.
- Net exports.

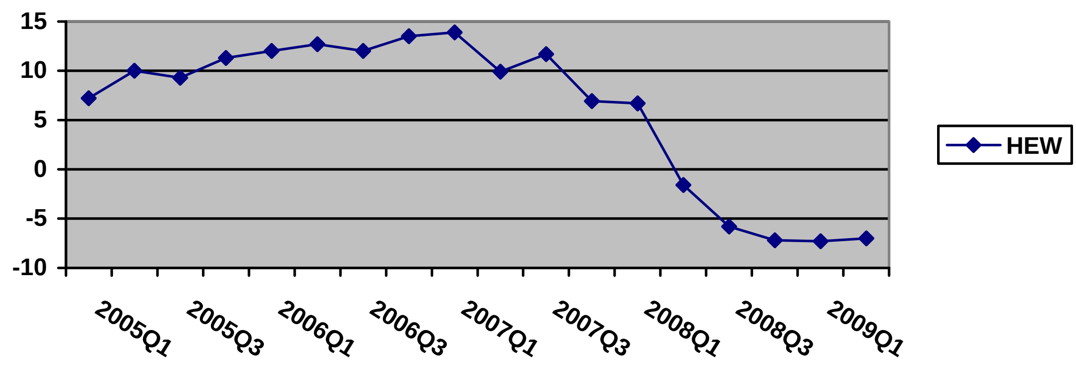
Starting with household final consumption, there are three key issues. Firstly, unemployment is still rising and will probably continue to do so into next year as it is a lagging indicator on general economic activity. (Note however that the ILO unemployment estimates for were marginally lower for the three months to August than for the three months to July.) Secondly, even for those in work, households are repairing their balance sheets after overextending them - as the banks are repairing theirs. The saving ratio turned negative in 2008Q1, but has since recovered and equity withdrawal has turned sharply negative, as the charts below show. These are quite unprecedented developments.

Households saving ratio (%)



Source: ONS database, www.gov.uk. The saving ratio is Households' saving as a % of total available households' resources.

Housing equity withdrawal, £bn, seasonally adjusted



Source: Bank of England, www.bankofengland.co.uk

And, thirdly higher taxes will depress people's disposable incomes. The rise in the standard VAT rate to 17.5% is pencilled in for January 2010. The top rate of income tax will rise from 40% to 50% in April 2010, accompanied by the withdrawal of personal allowances for those earning more than £100,000. More tax rises are almost certainly on the horizon.

Government consumption and capital formation are the next two components of GDP. As we have discussed in previous Perspectives, government spending is likely to be severely curtailed over the next few years, as future governments get to grip with the public borrowing chasm.[4] All the major political parties are now pondering how they would close the fiscal deficit. But they must plan too for the UK economy being too weak to bear serious cuts in public spending for some time, thus presenting them with a very nasty policy dilemma. Concerning investment (including changes in inventories), some rebalancing in stock levels after the precipitous drop seen at the end of last year and in the first half of this year may be expected and this will support some growth. But private sector fixed investment tends to lag recovery and public sector fixed investment will almost certainly be severely cut back over the next few years.

In summary, the outlooks for household consumption, government consumption and capital formation as drivers of growth look fairly negative.

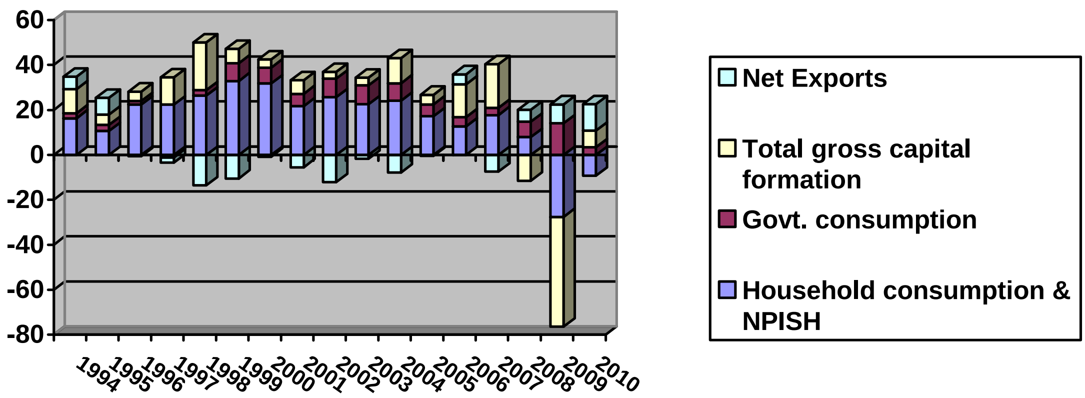
So, finally, will net exports drive growth and drive the recovery? The fall in sterling should help exporters but much foreign demand is sickly and brittle. As we have already pointed out, the economic recoveries in the US, Germany and France may falter as stimulus programmes are withdrawn. Without resilient growth in our key export markets it is difficult to see the much desired "export-led recovery" becoming solidly and buoyantly established. Risks to growth in these economies, risks our recovery. And the jury is out.

Precedents for export-led growth

There are "semi-precedents" for export-led growth. As the chart below shows net exports contributed to GDP growth in 1994 and 1995, after the depreciation of sterling following sterling's exit from the ERM in September 1992. It is perhaps too strong to say these were years of "export-led growth", because other components were also contributing – but the export performance was certainly very positive.

Since then net exports have been strongly negative on the whole, pulling down overall activity. (Improvement was, however, recorded in 2008.) And over the period from the mid-late 1990s growth was primarily driven by household consumption and General Government consumption, with a positive contribution from capital formation.

Contribution of GDP components to GDP growth, £bn, 2005 prices



Sources: back data from ONS databank. Forecasts for 2009 and 2010 from NIESR, *National Institute Economic Review*, July 2009. NPISH stands for non-profit institutions serving households.

We have added a forecast for 2009 (part-estimated) and 2010 to the chart. In 2009 there is forecast to be a dramatic fall both in household consumption and total capital formation, the latter reflecting a collapse in inventory levels as well as tumbling fixed investment. The "recovery" of investment in 2010 is solely due to a turn-round in inventories, with fixed investment continuing to decline. The forecast incorporates a positive view of the contribution of net exports reflecting both stronger exports and weak imports. Assuming some recovery in our export markets, we could be seeing the beginning of the development of a more balanced economy, one that saves and exports more, after 15 years of a consumer binge, allied with an over-expansionary public sector. This could be the makings of a "golden scenario" of a recovery.

More Quantitative Easing?

The release of the 3rd quarter GDP figure led to much speculation that the Monetary Policy Committee (MPC) would sanction another tranche of Quantitative Easing, beyond the £175bn of assets already purchased through the Asset Purchase Facility (APF), at their meeting this week (4-5 November). Weak money supply data added to the speculation. The headline measure of broad money supply rose by 0.8% in September. But the measure the Bank prefers, which excludes flows to non-bank financial intermediaries, fell by 0.9% during the month. The Bank's data also showed that lending to businesses fell by 0.1% in September taking the annual decline to 3.4%.[5]

In addition the Governor and two of his colleagues voted for £200bn of purchases through the APF in August. The Governor was clearly in expansionary mode.

All in all, this makes an increase in the APF very possible at this week's MPC meeting, though it should not be regarded as a foregone conclusion as there are large lags operating in monetary policy. An increase of £25bn to £200bn, at the very minimum, is a very possible outcome.

References

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