



Perspectives by Ruth Lea

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We're definitely in recession: and another necessary bank bailout

There are several ways of defining recession. But taking the most usual definition of two consecutive quarters of falling GDP, then Friday, 23 January 2009, should be the day when the British economy is officially proclaimed as being in recession.

On Friday the 4th quarter GDP preliminary estimate will be released by the Office of National Statistics. It is expected that it will show a substantial fall compared with the third quarter. The National Institute of Economic and Social Research (NIESR) has already published its estimate for the quarter, which shows a drop in GDP of 1.5%, after a revised estimate of a 1.1% fall for 3 months to November (compared with the previous three months). Since 1955 when quarterly figures were first produced there have been only 5 quarters in which output has fallen more sharply.¹

The NIESR data look eminently reasonable. At this stage of the statistical compilation cycle for quarterly national accounts data, there are very few official estimates available for the components. But the ones that are available have looked very weak. The latest manufacturing data, for example, showed a fall of nearly 3% in the month of November, to be nearly 7½% lower than a year earlier.² These are sharp falls by any standards and significantly worse than expected. Granted monthly data can be volatile but it is clear that Britain's traded goods sector is suffering badly, despite the weaker pound, as the global recession translates into lower demand for their products. Economies heavily reliant on the exports of goods, including Germany and China, are especially vulnerable to the current global slowdown.

But even if the NIESR estimate proves too gloomy, the ONS is expected to release an estimate for the 4th quarter fall in GDP of at least 1%. This figure, coming after the 0.6% estimated for the decline in GDP for the 3rd quarter, puts the economy officially in recession.

GDP forecasts set to be downgraded

The British economy is now shrinking faster than even the most pessimistic forecasters expected just three months ago. GDP forecasts for Britain are being consistently downgraded, as is also the case for all the major economies. Prediction is indeed very difficult, especially when it is about the future.⁴

Forecasting during this recession is especially problematic because most economic models (and hence forecasts) have an inbuilt assumption that the banking sector functions effectively and efficiently, lubricating the economy with the necessary credit. In the current recession, this crucial assumption has been spectacularly and uniquely (certainly post World War Two) violated. The British banking system is malfunctioning.

The table below compares “consensus” forecasts for the five major western economies over the last nine months.

Consensus forecasts for GDP growth (%) for the major western economies

	US	Japan	Germany	France	UK
<u>For 2008, forecasts made in:</u>					
April 2008	1.3	1.3	1.7	1.5	1.6
July 2008	1.5	1.4	2.2	1.6	1.5
October 2008	1.4	0.7	1.7	0.9	1.1
January 2009	1.2	0	1.3	0.8	0.8
<u>For 2009, forecasts made in:</u>					
April 2008	2.1	1.7	1.9	1.7	1.7
July 2008	1.5	1.3	1.2	1.3	1.0
October 2008	0	0.5	0.3	0.5	-0.2
January 2009	-1.8	-1.7	-2.0	-1.0	-2.2
<u>For 2010, forecasts made in:</u>					
January 2009	2.3	1.1	0.8	0.9	0.6

Source: Consensus forecasts, Consensus Economics, survey dates 14 April 2007, 14 July 2008, 13 October 2008, 12 January 2009 (the first report to include 2010).

Three observations can be made about these figures. Firstly, the deteriorations in growth prospects between April 2008 and January 2009 for the UK are not hugely out of line with those for the US, Japan, Germany or even France. Secondly, we expect the growth projections for these economies to worsen over the next few months.

And thirdly it should have been clear to the Chancellor at the time of his Pre-Budget Report (24 November 2008) that his forecast of a GDP decline of only 1% in 2009 (followed by growth of 1¾% growth in 2010) was wildly unrealistic at the time.⁵ He has recently acknowledged this to be the case, with dreadful knock-on effects for the projections for the public finances. It will be interesting to see the Chancellor’s Budget forecasts, which should be due in the first half of March.

Latest forecast

Our latest central case forecast for GDP is shown in the table below.

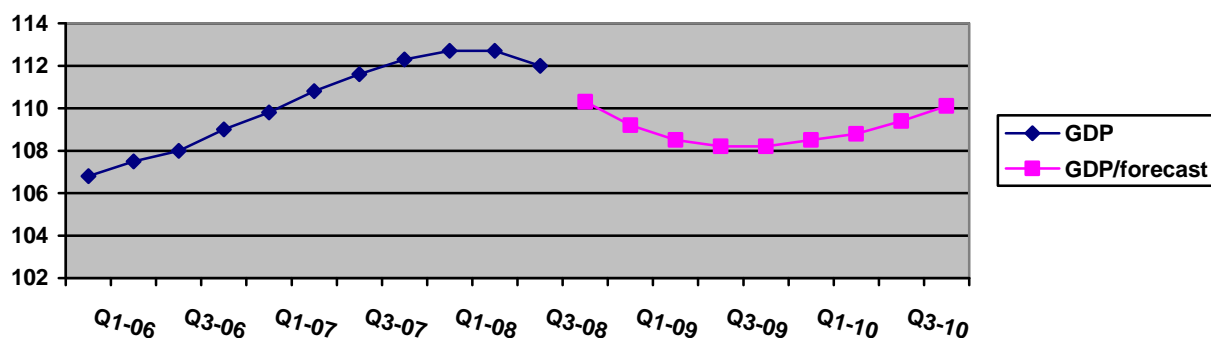
Central case forecast for GDP: quarterly data, growth rates (%)

	2008					2009					2010				
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
<u>GDP:</u>															
QOQ growth	0.4	0	-	-	Na	-	-	-	0	Na	0.3	0.3	0.5	0.7	Na
YOY growth	2.6	1.7	0.4	-	0.8	-	-	-	-	-3.1	-	0.3	1.1	1.8	0.6
				1.8		3.1	3.7	3.4	1.9		0.6				

The forecast takes the NIESR estimate for the 4th quarter (which may or may not prove to be an erratically bad figure). It projects a deceleration in the rate of decline for much of this year and some growth next year, as the lower interest rates and weaker pound stimulate the economy. It assumes some improvement in global conditions, not least of all in the US. But most crucially of all it assumes some improvement in credit availability in Britain. The brutal truth is that the economy will not recover unless the financial sector returns to health and the availability of credit improves.⁶ The improvement in credit availability should, however, be seen as a necessary rather than a sufficient condition for economic recovery.

But note that even on this relatively rosy scenario, we expect that GDP could fall by 3% this year and struggle to grow next year.

GDP index, market prices, 2003 prices, 2006Q1 to 2010Q4



Source: back data from ONS, First Release, Quarterly National Accounts – 3rd quarter 2008”, 23 December 2008.

Another bank bailout

There was little doubt that the October rescue package saved the banks from collapse. (The annex to this Perspective outlines the October package and more recent emergency measures.) But banks are still not lending as required. They are hoarding capital in readiness to absorb losses from existing bad loans and securities and in expectation of future losses as the recession progresses. There is clearly a need for the Government to do more.

The Government announced further measures to assist the banking sector early this morning. The measures include insurance to underwrite mortgage-backed debt and other “toxic” assets and reversing plans to shrink Northern Rock Plc’s lending. The Government also said that it will increase its stake in RBS as it converts £5bn of preferred shares it bought last year into ordinary stock. The Government will also authorise the Bank of England to set up a £50bn asset-purchase programme funded through the issue of Treasury bills. Starting on 2 February the central bank will buy assets including corporate bonds, commercial paper and syndicated loans.

These measures all have merit and in the current desperate times are probably necessary. The taxpayer will, of course, be picking up the bill. Taxpayers will, therefore, be paying for the failings of the Government and of the regulators, as well as the irresponsible behaviour of certain financiers. But the alternative is worse. It is prolonged recession, bordering on depression. The current financial crisis illustrates just how necessary it is for governments to pursue appropriate and responsible macroeconomic policies and for regulators to judiciously understand and regulate their markets so that business can flourish and the economy can thrive.

In addition to the policies that are expected today, we recommend that the following issues should be addressed:⁷

- The FSA has discretion over how banks are forced to value certain capital market assets on a prudential basis and could in certain circumstances help liberate lending if they were to use this discretion positively. They should do so.
- The Treasury and the FSA have the power to relax the rules that enforce “procyclicality”. Procyclicality is built into the Basel II international banking supervision agreement and dictates how much capital banks must hold against the risk of loans turning sour. As these risks rise in recession, then the banks have to hold more capital. The Treasury and the FSA should do more to exercise that discretion and relax the rules.

References

1. NIESR, "December 2008 Estimates of monthly GDP", 9 January 2009, available from www.niesr.ac.uk.
2. ONS, "Index of production, November 2008", 9 January 2009, available from www.statistics.gov.uk.
3. Ruth Lea, "Memo to the Bank: cut interest rates by 1.0%", Arbuthnot Banking Group Perspective, 3 November 2008, was well on the pessimistic side of consensus – forecasting a fall of 1.9% in GDP for 2009 - but not pessimistic enough.
4. "Prediction is very difficult, especially if it's about the future," attributed to Nils Bohr, Nobel laureate in Physics.
5. HM Treasury, *Pre-Budget Report, Facing global challenges: Supporting people through difficult times*, HM Treasury, Cm 7484, November 2008.
6. Bank of England, *Credit Conditions Survey, Survey results, 2008Q4*, 2 January 2009, showed that credit availability had tightened in the previous three months and was expected to tighten in the next three months.
7. Ruth Lea, "The recession deepens: time for further measures", Arbuthnot Banking Group Perspective, 15 December 2008, originally discussed these issues.

Annex
Emergency measures so far

Scheme, value, date	Basics of scheme, commentary
Special Liquidity Scheme (SLS) – up to £200bn (8 October 2008).	Designed to provide short-term liquidity; allows banks to swap illiquid assets for highly liquid gilts. Bankers say it has helped.
Credit Guarantee Scheme (CGS) – up to £250bn (8 October 2008).	Allows banks to issue bond finance backed by government. Was judged as pricy, although fee was trimmed as last month. Welcomed by banks, which issued £100bn of debt in 2008.
Bank Recapitalisation Plan - £37bn (8 October 2008).	Offer to underwrite £37bn recapitalisation of RBS, Lloyds TSB and HBOS. Ministers argue it saved banking system from collapse, but less effective in reviving lending.
Homeowner Mortgage Support Scheme – up to £1bn (3 December 2008).	Homeowners could have mortgage interest payments guaranteed for 2 years. The details are still being settled.
Working Capital Scheme for SMEs - £10bn (13 January 2009).	Guarantee for 50% of up to £20bn of short-term working capital loans, from 1 March 2009. It is unclear if it will push banks into new lending.
Enterprise Finance Guarantee - £1bn (13 January 2009).	Guarantee for 75% of loans to small businesses, until March 2010. Whether it works will depend on the banks, which still carry quarter of the risk.
Capital For Enterprise Fund - £50m (13 January 2009).	State is contributing £50m, the banks £25n to long-term finance fund for smaller companies. It is probably too small to make a real short-term difference, but could be expanded.

Source: Alex Barker, “What the government has done so far”, *FT*, 17 January 2009.