

Will the UK recovery outpace other major economies?

Key points

- The crisis in the banking sector in the autumn of 2008 triggered a dramatic deterioration in conditions, with all of the major economies contracting sharply in 2008Q4 and 2009Q1. UK GDP fell by 4.2% between 2008Q3 and 2009Q1, with the initial decline largely due to aggressive destocking, latterly compounded by a significant reduction in investment spending.
- However, the past few months have seen the first signs that the pace of contraction is beginning to slow, both at home and abroad. In particular, surveys of confidence have improved markedly, especially in the manufacturing sector, and financial markets have been quick to seize upon these more positive signals, leading to a significant rally in global equity markets and a notable drop in financial stress levels.
- The recent improvement in the data is likely to reflect some of the early benefits of the unprecedented monetary policy loosening set in train last autumn, with interest rates cut to near zero and quantitative easing adopted. The Bank of England estimates that the maximum effect on output is observed 9-12 months after policy changes, suggesting the maximum impact is likely to be felt over the second half of this year and in early 2010.
- The UK consumer will benefit more than most from low interest rates, due to the popularity of variable rate mortgages and high levels of home ownership. However, these benefits will be offset by the need to rebuild balance sheets after significant wealth losses and the high levels of consumer debt.
- Many nations are also benefiting from fiscal stimulus packages, though the poor state of the public finances precluded a large giveaway in the UK and will ensure that the government sector remains a drag on the recovery.
- The weakness of sterling should help UK exporters to gain market share. Though goods exports are much less important to the UK than to the major Eurozone economies, the success of the UK services sector means that total exports account for a similar proportion of GDP as France and Italy.
- The biggest threat to the global recovery remains the slow thaw in lending. Though conditions in the financial sector are improving, progress is slow and levels of stress remain well above what might be considered to be 'normal'.
- Recessions brought about by a banking crisis are deeper and take longer to recover from than those caused by other factors and we expect this recession to be no different. The sheer size of the policy stimulus should mean that the US leads the global recovery. However, the UK's own aggressive monetary response and the weakness of sterling should ensure the UK follows close on the heels of the US and remains comfortably ahead of the major Eurozone nations, where the policy response has been considerably slower and more timid. Nevertheless, with a number of factors weighing on the key components of final demand – consumption and investment – the UK recovery is going to be gradual.

Introduction

Over the past year the world has endured its deepest recession since the Second World War but there are now signs that the bottom may have been reached. The UK recession has been particularly deep, with a dearth of credit forcing companies to conserve cash by running down stocks and slashing capital spending. GDP has fallen almost 5% from its 2008Q1 peak. However, green shoots have also begun to appear in the UK and it appears likely that GDP will fall by a much smaller amount in Q2 than the 2.4% decline in Q1.

This article looks at the factors which should provide the basis for recovery and assesses whether the UK recovery will be stronger than elsewhere.

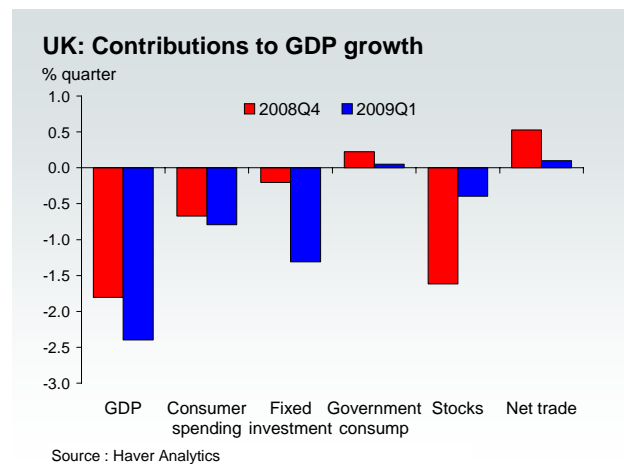
All major economies contracted sharply in Q4/Q1

The crisis in the banking sector in the autumn of 2008 triggered a dramatic deterioration in conditions, with all of the major economies contracting sharply in 2008Q4 and 2009Q1. Indeed research from Eichengreen and O'Rourke¹ suggests that the decline has closely tracked the drop in output recorded at the beginning of the last global financial crisis, the Great Depression of the 1930s. Then, as now, global industrial production fell around 14% in the first year of the crisis, with the declines in world trade and stock markets much worse now than before.

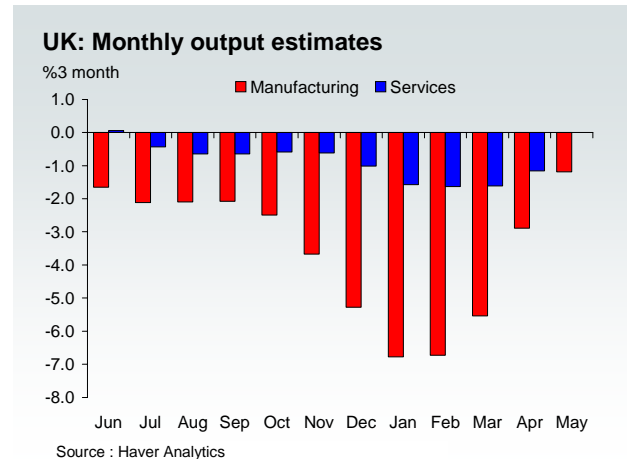
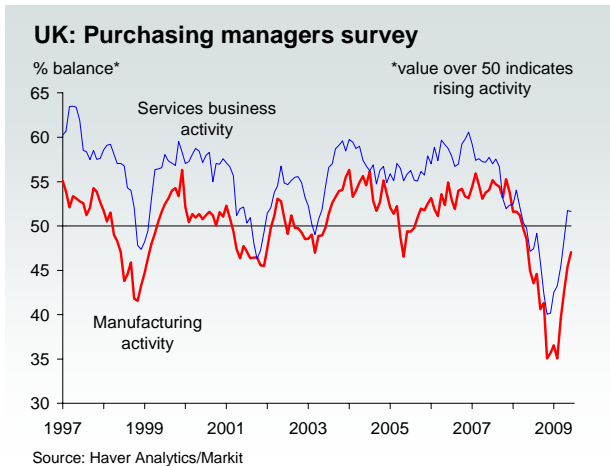
In common with other major economies, output has plummeted in the UK. GDP fell by 4.2% between 2008Q3 and 2009Q1, with the initial decline largely due to aggressive destocking, latterly compounded by a significant reduction in investment spending. The severe restrictions on credit availability have forced firms to conserve cash and decimated confidence. The consumer retrenchment has been relatively mild thus far, though Q1 saw the largest quarterly fall since 1980 and a deteriorating labour market outlook will weigh on prospects going forwards.

However, the past few months have seen the first signs that the pace of contraction is beginning to slow, both at home and abroad. In particular, surveys of confidence have improved markedly, especially in the manufacturing sector, and financial markets have been quick to seize upon these more positive signals, leading to a significant rally in global equity markets and a notable drop in financial stress levels.

In the UK the CIPS/Markit Purchasing Managers Surveys have strengthened significantly. The composite PMI for manufacturing has risen from a record low of 35.1 in February to 47.0 in June, while the output balance rose above the no change mark of 50 for the first time in fifteen months. Meanwhile the services activity balance has now been in expansionary territory for two successive months. There has been a similarly marked improvement in official data, with monthly output estimates showing much shallower declines in recent months. Regressions using the more timely survey data to extend the monthly official outturns suggest that GDP is likely to have fallen by 0.4% in Q2, compared with -2.4% in Q1. Some of this improvement reflects an easing in the pace of destocking, which is likely to contribute positively to GDP growth in Q2, but it also suggests a wider stabilisation in conditions.



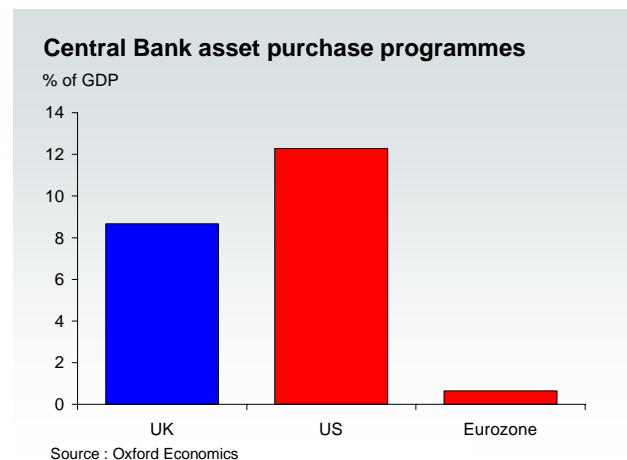
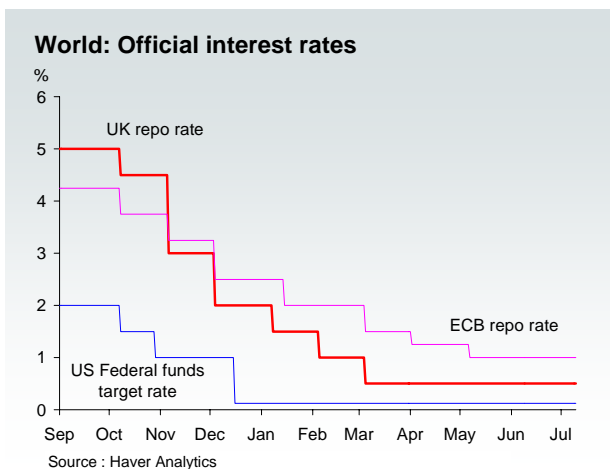
¹ Eichengreen, B. and K.H. O'Rourke. 2009. "A Tale of Two Depressions."



Unprecedented monetary loosening will provide basis for recovery...

The recent improvement in the data is likely to reflect some of the early benefits of the unprecedented monetary policy loosening set in train last autumn. With the benefit of hindsight it is clear that policymakers were behind the game for the first half of 2008, with the Monetary Policy Committee (MPC) even considering rate rises to control accelerating inflation at the very point at which the economy entered recession. However, the response in the aftermath of the collapse of Lehman Brothers was aggressive, with central banks across the world slashing interest rates. The MPC cut rates from 5% in early October to a record low of just 0.5% in March, a much more aggressive stance than that taken by the ECB and only a little behind that of the Federal Reserve.

The MPC has also been quick to implement quantitative easing. The Bank of England is committed to buying £125bn (8.7% of GDP) of private sector assets between March and July – with a further £25bn available if required – in an attempt to expand the money supply and stimulate nominal spending, while also pushing down borrowing costs. As with interest rates the stimulus is far larger than that provided by the ECB and only a little short of the Federal Reserve’s programme. We expect the Bank to seek permission from the Treasury to extend asset purchases into the autumn so ultimately the UK stimulus may even be as large as that undertaken in the US.

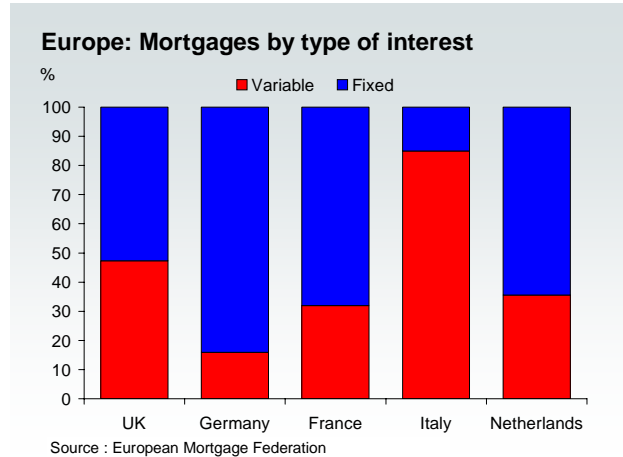


The precise feed through of monetary policy changes is always uncertain, particularly so when the transmission mechanism is impaired as it is now. The Bank of England estimates that the maximum effect on output is observed a between 9-12 months after policy changes, so it is likely that we are now starting to enjoy the benefits of last autumn’s deep rate cuts with the maximum impact likely to be felt over the second

half of this year and in early 2010.

...with interest rates particularly important to the UK consumer

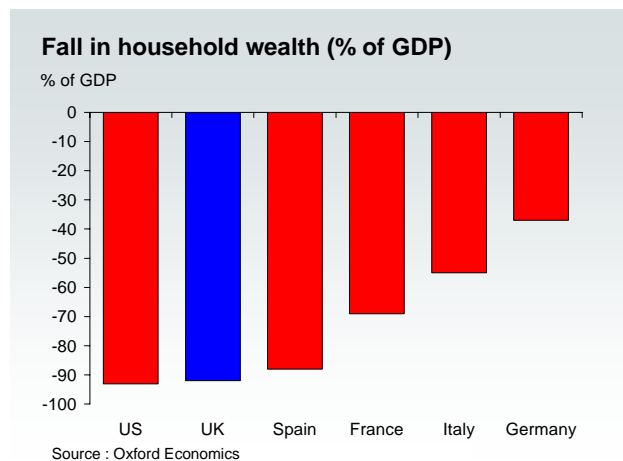
The UK consumer will benefit from lower interest rates by more than most of their European counterparts. The UK has seen a modest shift towards fixed rate mortgages over the past decade, as the more stable economic environment reduced interest rate risk and allowed lenders to price fixed rate deals more competitively. However, the proportion of borrowers with variable rate mortgages is still significantly higher in the UK than in Germany or France. Owner occupation is also far higher in the UK than in most other European countries, so at the macro level lower interest rates will provide a much larger boost to disposable income for UK consumers than in the other major European economies.



Wealth losses will encourage the consumer to retrench....

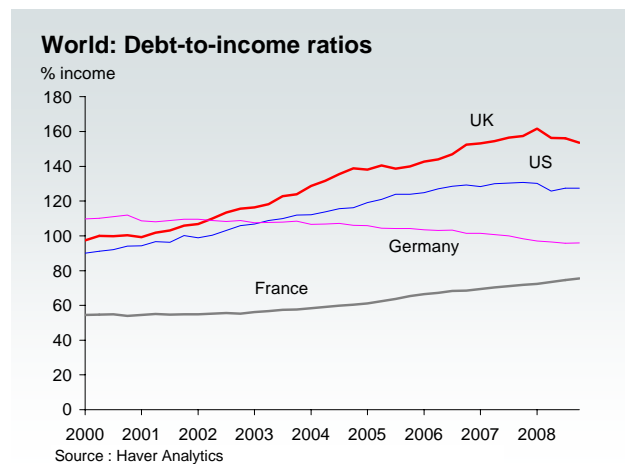
With consumer spending accounting for more than 60% of the economy it will be difficult to sustain a recovery without a contribution from the household sector. While low interest rates and low inflation will support spending power, the UK consumer faces strong headwinds and the outlook is particularly uncertain. In particular falling employment levels and subdued earnings growth is dampening income growth, while the threat of unemployment is driving up precautionary saving.

The desire to retrench will be strengthened by a need to rebuild household balance sheets. Consumers across the world have suffered from the sharp declines in housing and equity prices over the past eighteen months, but worst hit have been those nations who had enjoyed housing market booms in the first half of the decade and where owner occupation is at its highest. We estimate that UK households have endured wealth losses equal to 90% of GDP, with only the US suffering greater losses. Though UK wealth levels still compare favourably with elsewhere, based on current valuations of the housing stock, the prospect of a prolonged period of weakness in the housing market will encourage households to make moves to rebuild balance sheets.



...and high debt levels will also dampen spending

The debt overhang will also weigh on the outlook for consumer spending. UK household debt has risen from 100% of income in 2000 to 157% in 2008, significantly higher than any of our main competitors. Much of this increase reflects greater mortgage borrowing in the housing boom and has been matched by a build up in assets. However, while the cost of servicing these debts is very low at present, it will rise sharply when interest rates return to a neutral level and it is unlikely that consumers will want to continue to add to this burden in the way they did prior to the recession.

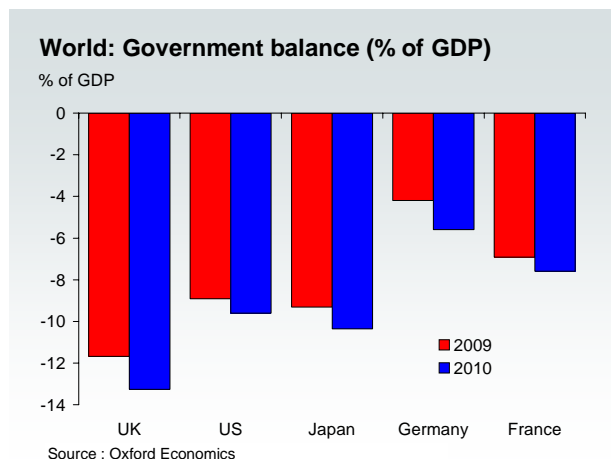
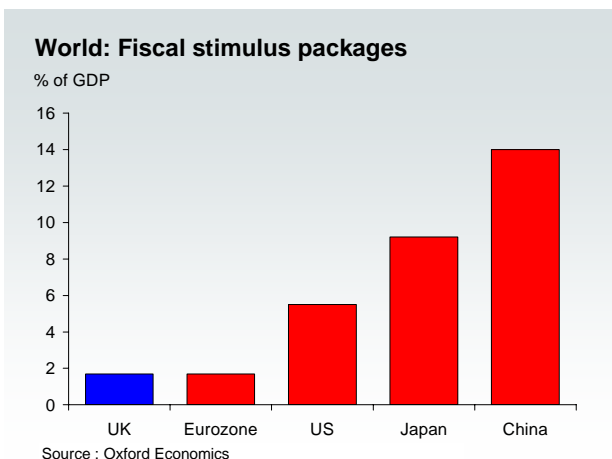


Despite record low interest rates, we expect the UK consumer to continue to retrench over the course of the next two years. Consumer spending is set to fall by 3.4% this year and a further 0.4% next, a much weaker performance than in the US or Eurozone. The profile is likely to be bumpy too, with the reversal of the temporary VAT cut likely to encourage consumers to bring forward spending to Q4, with offsetting weakness expected in 2010Q1. This consumption forecast is consistent with an increase in the savings ratio to just below 6% by the end of next year, but this represents a smaller correction than in previous recessions so the risk of a more significant retrenchment remains.

UK fiscal policy is less supportive

While the UK monetary policy response has been extremely supportive, the stimulus from fiscal policy has been more muted. This is largely a reflection of the poor state of the public finances, with the government running large deficits prior to the recession which have since ballooned as the automatic stabilisers kicked in. The government has implemented a stimulus totalling just £25bn (1.7% of GDP) across the Pre-Budget Report and Budget, consisting of a temporary VAT cut, bringing forward capital spending and some minor changes to personal tax allowances and capital allowances.

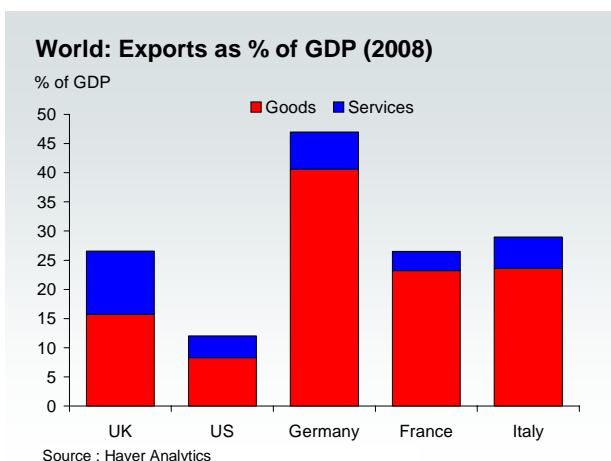
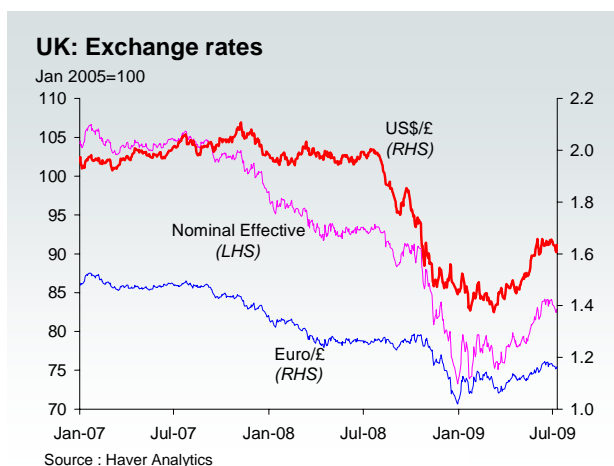
This package is unlikely to offer much support and is far less ambitious than President Obama's US package or those authorised by the larger Asian countries. Indeed not only will fiscal policy provide little support to the UK recovery, but it could in fact be a drag on prospects. The expectation of massive levels of gilt issuance has pushed up yields, despite the dampening effect of quantitative easing, thus driving up long term borrowing costs. We expect the UK to record the largest public deficit of the major industrialised nations over the next two years, while the costs of bailing out the banking sector have been higher than those of our major competitors, which implies a greater need to retrench in the recovery phase. The subsequent spending cuts and tax rises will prove to be a drag on growth as the economy recovers, but will also damage consumer and business confidence in the short-term.



Weak sterling will support a recovery in exports

With the consumer unlikely to offer much support, the main thrust of the UK's recovery is expected to come through trade. Sterling's trade-weighted index has spent much of the past ten years at a higher level than in the final year of the UK's participation in the ERM, resulting in a long period of poor export competitiveness. However, with the banking crisis causing capital inflows to dry up, sterling declined by around 30% between early-2007 and the beginning of 2009 and, despite a rally in the first half of this year, remains more than 20% below 2007 levels.

Having run large current account deficits over the past decade, exports are rarely viewed as being central to UK economic prospects. And in terms of goods exports the persistent strength of sterling has weighed heavily, with goods exports accounting for just 16% of UK GDP, well below comparable figures for the largest Eurozone nations. However, the UK's strength across the service sector means that total exports are of comparable importance to France and Italy at around 27% of GDP.



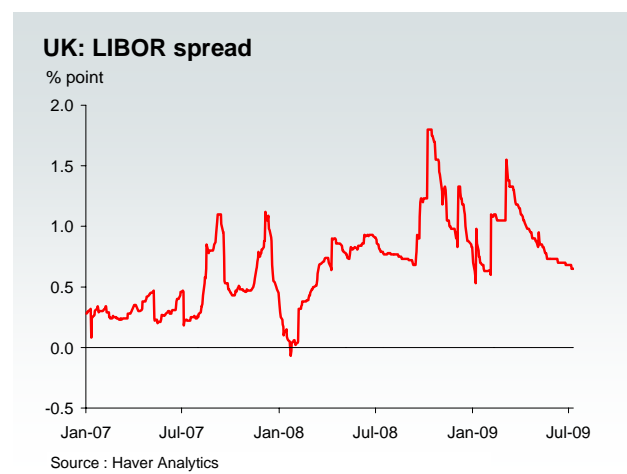
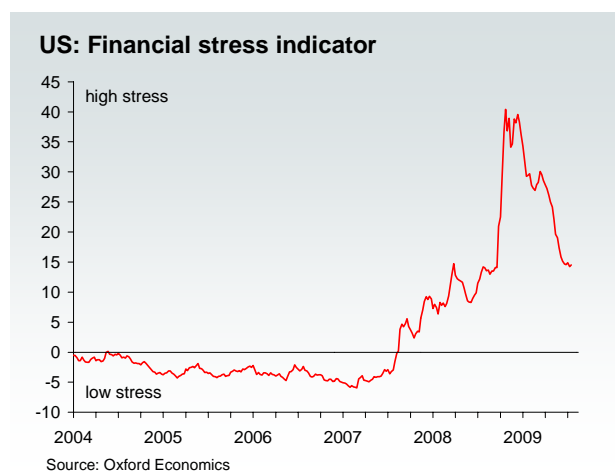
Markets appear to have already priced in the vulnerabilities of the UK to the banking crisis and are turning their attention to structural problems elsewhere. As the global recovery gathers strength – and investor confidence improves – the desire to invest in the dollar as a safe haven will also ease. With capital inflows slowly returning we expect to see sterling continue to gradually strengthen over the next couple of years, though competitiveness will remain significantly stronger than it has been over the past decade.

The main threat to a pickup in exports is the fragility of global demand. World trade has fallen by almost 20% over the past year and demand in the Eurozone – the UK's largest export market – remains particularly

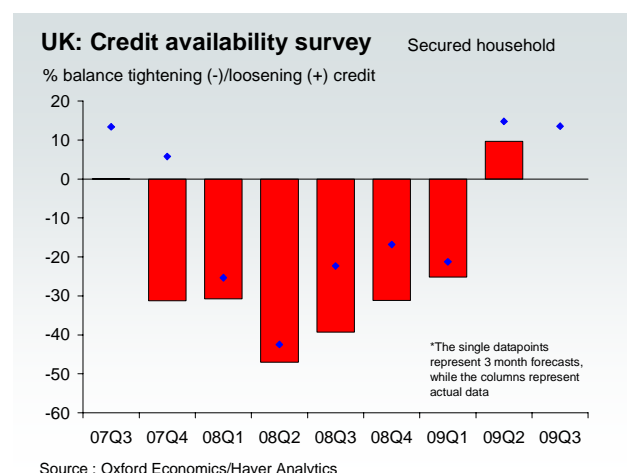
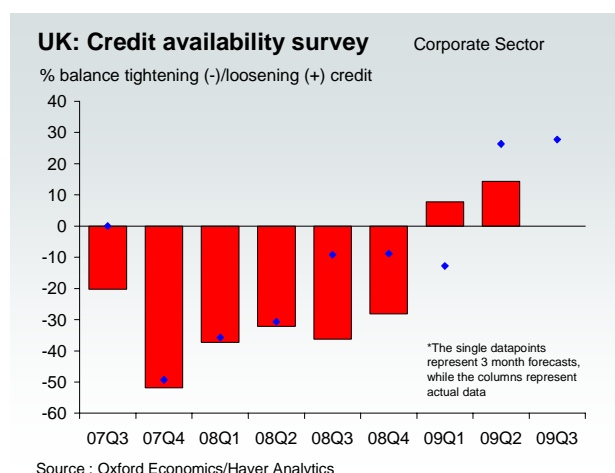
fragile. However, the boost to competitiveness should still enable UK exporters to gain market share, while higher import prices and the retrenching consumer will dampen demand for imports. As a result, we expect net trade to contribute positively to GDP growth over the next couple of years.

Slow resolution of lending problems remains a significant threat

The biggest barrier to the global recovery remains the slow thaw in lending. The past couple of months have provided plenty of signs that conditions in the financial sector are improving; for example, our own *Financial Stress Indicator* has fallen back to 15 in recent weeks, compared with a level of above 40 in the immediate aftermath of the Lehman Brothers collapse, while in the UK the spread of LIBOR over Bank Rate has continued to narrow, reaching 65bp having previously been as high as 180bp. However, while these indicators are moving in the right direction, progress is slow and levels of stress remain well above what might be considered to be 'normal'.



This elevated level of stress is reflected in the weak indicators of lending. UK net mortgage lending remains close to zero, with the number of mortgage approvals just a third of the level recorded two years ago. The Bank of England's Credit Conditions Survey did report an increase in the availability of secured credit and lending to businesses in Q2, with lenders expecting a further improvement in the next three months. However, this followed almost two years of continuous tightening of credit availability.



Some of the larger companies have taken advantage of recovering equity and bond markets and side-stepped the banking sector to access new funding, a facet of the US and UK systems which favour them over continental Europe where companies are more reliant on bank finance. However, the vast majority of UK

firms – and indeed homeowners – remain at the mercy of the banks and not only does credit remain in short supply, but it is becoming increasingly expensive as banks increase spreads. This will have implications for cashflow and will continue to weigh on the outlook for capital spending, pointing to further declines in business investment into next year.

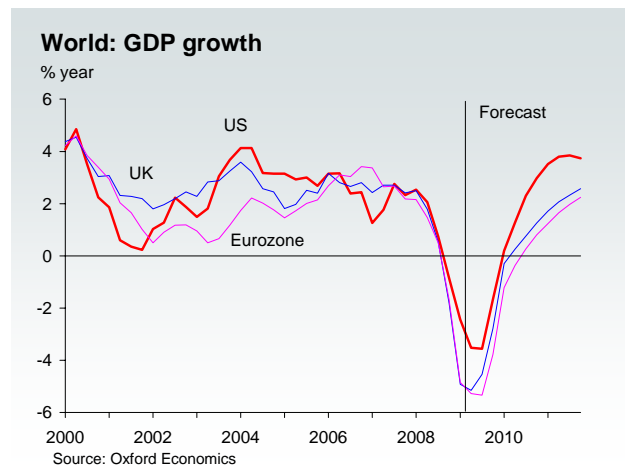
There is also a risk of a further credit shock. Rising unemployment across the world will push up household default rates, while corporate defaults will rise as weak demand squeezes profitability. Losses from these sources will further damage balance sheets and liquidity, providing banks with additional disincentive to lend.

Conclusion

Research by the IMF² suggests that recessions brought about by a banking crisis are deeper and take longer to recover from than those caused by other factors, such as monetary or fiscal policy tightening or an external demand shock. Despite globally co-ordinated policy intervention and unprecedented loosening of monetary and fiscal policy, we expect this recession to be no different.

The massive monetary and fiscal stimulus across the world provides a compelling case for recovery and, in conjunction with policy intervention in the banking sector, should help to ensure that the recession is ultimately less severe than the Great Depression of the 1930s. However, the origins of this crisis and the slow thaw in lending conditions will ensure that the recovery phase is slower and more prolonged than after the recessions of the 1980s and 1990s.

The sheer size of the policy stimulus should ensure that the US leads the global recovery. It appears that the UK economy is now close to the bottom, with the turn in the stock cycle likely to contribute to a much slower pace of contraction in Q2 and Q3, before the economy stabilises towards the end of the year. With the benefits of the aggressive monetary policy response continuing to feed through, and sterling remaining relatively weak, the UK should follow close on the heels of the US and remain comfortably ahead of the major Eurozone nations, where the policy response has been considerably slower and more timid.



Nevertheless, with a number of factors weighing on the key components of final demand – consumption and investment – the UK recovery is going to be gradual; our forecast shows the economy not returning to trend growth rates until the second half of 2011. The risks remain skewed to the downside, with a more significant retrenchment by consumers and businesses a possibility if the banking sector relapses. The colossal policy stimulus, while being the most important force for recovery, also raises question marks, notably in how – and when – it will be reversed. Policymakers have little experience in employing these tools and will have to be particularly careful not to choke off any recovery by tightening policy prematurely, while also being aware of the inflationary implications of leaving policy too loose for too long.

² IMF Economic Outlook – April 2009. Chapter 3: “From Recession to Recovery: How Soon and How Strong”