Tullett Prebon Research, a blog by Dr Tim Morgan

Why the British economy is nose-diving

by Tim Morgan on July 26, 2012

After yesterday's ONS figures showed a further sharp decline in the UK economy, political responses were all too predictable. Here is a much needed dose of reality on the current state of the British economy. I hope you find my latest strategy note "Tail Spin – why the British economy is nose-diving" enlightening.

You can read the full piece below.

It is surely axiomatic that, if a problem is to be solved, it must first be understood. The single most disturbing feature of the latest deterioration in the British economy is the seemingly wilful ignorance that both sides of the political divide have shown about what is really going wrong. If incorrect analysis always results in faulty policies, the economy is going to fall a lot further yet.

Preliminary estimates from the Office for National Statistics (ONS) shows that real GDP declined by a shocking 0.7% in the second quarter, following declines in the final quarter of 2011 and the first period of 2012.
Visibly shaken government spokesmen have sought to question the numbers, and to shift the blame to external factors such as the Eurozone debt crisis. Labour keeps repeating the tired mantra about government spending having been cut "too far, too fast", which would only be a valid criticism if spending had indeed been slashed which, of course, is not the case. Politicians of both persuasions persist in telling the public that they have policies to fix the problem, a line which is dishonest, in that all traditional fiscal and monetary policy levers have been pulled already, without success.

Let's be quite clear about five critical points:

- The UK economy is shrinking, and no amount of waffle about bank holidays, bad weather and similar anomalies (all of which are statistically tiny) can disguise this fact.
- No cocktail of traditional policy measures (such as deficit spending, devaluation, rate-lowering or quantitative easing) is going to turn things around.
- Help is not going to come from overseas.
- The fundamental causes of the British economic malaise are structural, requiring wholesale reform.
- In the absence of effective action, the economy is likely to go into a vortex.

There are two causative factors – one domestic, the other external – which have created an ex-growth economy. The domestic factor is that, in the decade before the banking crisis, the British economy was made a hostage to private borrowing and public spending. The external problem is that other countries made the same mistakes, even if few of them made those mistakes to quite the same extent.

Roads to ruin

In terms of causative factors, the indictments of the Labour and coalition governments are quite different. Either from a geographical or a historical perspective, it is difficult to find a parallel to the mismanagement of the British economy under Gordon Brown. The mistakes made by the coalition are of much smaller orders of magnitude, but the government is being hampered by an unwillingness to think sufficiently radically about the reforms that are required.

In an endeavour to 'out-Tory the Conservatives' on financial market liberalisation, Labour introduced a regulatory system which was not so much 'light touch' as 'asleep at the wheel'. Handing many of the Bank of England's traditional regulatory powers to the Treasury and the newly-created Financial Services Authority (FSA) under Brown's 'tripartite' system weakened regulation. Instructing the Bank to set monetary policy on the basis of consumer price inflation took asset price escalation out of the equation, with the predictable result that low rates fuelled a property price bubble.
Brown and his team should have spotted – but, of course, didn't – the following warning signs:

1. Property prices were overheating drastically, rising (in real terms) by 96% between 2000 and 2007, a factor which was socially adverse as well as economically highly dangerous.
2. Mortgage debt held by individuals was soaring, from £505bn in March 2000 to £1,200bn in March 2008.
3. Over the same period consumers, emboldened by the false comfort of inflated home equity, had increased their outstanding credit from £125bn to £230bn.
4. The funds which banks were pouring into the property bubble were being sourced from international short-term wholesale markets.
5. Banks were ramping up profits (and bonuses) at the cost of escalating balance sheet risk.

Far from recognising these risks and taking appropriate action, Brown bought into the belief that this bubble effect was 'real' growth which, very obviously, it wasn't. Between 1999-2000 and 2007-08, real GDP increased by £287bn (at today's prices), whereas individual debt had increased by £748bn. The real-terms output of debt-driven sectors – such as CREF (construction, real estate and finance) – increased by 43% between 2000 and 2007, whilst manufacturing output decreased by 13% over the same period.

Instead of curbing the debt-driven distortion, Brown chose to spend it. Public spending, expressed at today's values, increased by 50% (from £449bn to £673bn) between 1999-2000 and 2008-09. This, in turn, fuelled apparent 'growth' in areas such as health, education and public administration (HEPA), whose combined output (again at today's values) soared from £193bn in 2000 to £260bn in 2008.

The hostage economy
Together, these trends made the British economy hostage to private borrowing and public spending. By 2009, 58% of output was accounted for by the CREF (38%) and HEPA (20%) sectors, with the credit-influenced retail sector lifting the ex-growth proportion of the economy to 70%.
Both of the erstwhile drivers are dead in the water. Net borrowing by individuals collapsed from £114bn in 2007-08 to less than £1bn in 2009-10 (and has since turned negative). The strong uptrend in public spending was killed off, and not before time, by the emergence of the worst fiscal deficit of any major developed economy.
Some of the solutions proposed by policymakers are almost surreal, in that they aim to resurrect, Lazarus-like, the dead drivers of private borrowing and public spending. Labour spokesmen argue for higher public spending with all the originality of a parrot. The coalition

seems to hope that banks will increase lending to consumers, which ignores the fact that people are far too deeply in debt already.
The public, meanwhile, are assured that policymakers on both sides of the debate can sort this out, when the reality is that almost everything in the monetary and fiscal policy cupboard has already been tried, without effect. Over the course of four financial years, government has borrowed £519bn, equivalent to 34% of current GDP. A further 21% (£325bn) has been pumped in through QE. Policy rates have been kept at an all-time low for more than three years. Despite a recent recovery reflecting problems in the Eurozone, sterling remains far cheaper internationally than it was in 2007. In sum, everything but the kitchen sink has already been thrown into the pot, and nothing has worked.

What happens now?
Extrapolation into the future from the recent past can be dangerous, as the literate dachshund discovered[1]. Even so, current trends are extremely disturbing, not least because policymakers of all hues seem obsessed with ultra-short-term, media-friendly responses as substitutes for strategies based on fundamental analysis. The unnecessary dismantling the 2012 budget, undertaken in response to lobbying over charity giving, static caravans and pasties, exemplifies a chronic lack of longer-term policymaking.

When all macroeconomic options have failed, logic dictates that micro reforms should take centre stage. Most such reforms are cost-free, in that they require the dismantling of excessive state interference with businesses. One necessary reform which would carry a modest cost would be a reduction in business rates.

The government also needs to start a major programme of building social housing, incidentally profiting from depressed industry conditions to get desperately-needed homes built cost-effectively. This needs to be state-funded, urgent, and paid for out of reductions in current spending.

Even if fiscally neutral, a major house-building programme would have big spin-off benefits, and would start a long-overdue rebalancing of the economy from consumption to investment.

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