wrong questions give wrong answers

the need to re-think the British economy

Further confirmation of economic flat-lining should prompt three questions. Why are official forecasts so wrong, so often? Why is the economy showing no real growth at all? And are there policy alternatives which do *not* involve higher borrowing? We investigate.

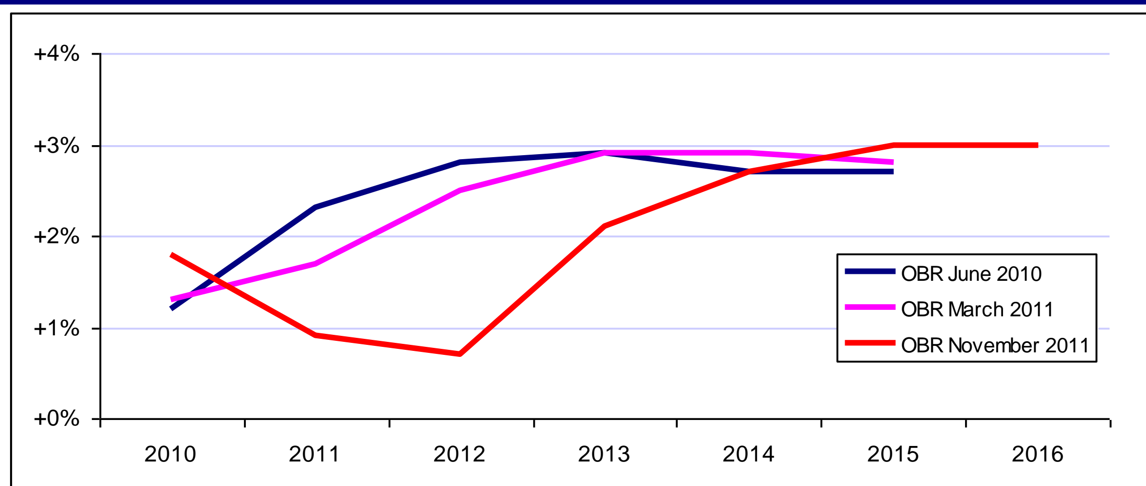
The latest set of economic numbers – showing a 0.2% decline in British GDP in the final quarter of 2011 – prompted wholly predictable responses from government and opposition alike. Unfortunately, these responses, far from providing answers, fail even to address the right *questions*.

These right questions are as follows:

- Why have official forecasts been so wrong, so often?
- Why is the UK economy continuing to flat-line at best?
- Are there untried policy options which could kick-start growth?

In the lead-up to the GDP announcement, there was extensive media debate about whether the published number would be a tiny positive or, as it turned out, an equally tiny negative. For the record, first release GDP numbers tend to be subject to subsequent revision of +/-0.25% anyway, so we could yet discover that growth was fractionally positive in the quarter, or that GDP shrank by as much as 0.5%. Neither, in our opinion, makes much difference. To all intents and purposes, the economy is flat-lining. More pertinently, we see no reason for a return to significant growth any time soon.

Fig. 1: Always jam tomorrow? – official growth forecasts*



*Source: Office for Budget Responsibility

Fig. 2: How realistic? – official growth forecasts*

	2010	2011	2012	2013	2014	2015	2016
OBR June 2010	+1.2%	+2.3%	+2.8%	+2.9%	+2.7%	+2.7%	
OBR March 2011	+1.3%	+1.7%	+2.5%	+2.9%	+2.9%	+2.8%	
OBR November 2011	**+1.8%**	**+0.9%**	**+0.7%**	**+2.1%**	**+2.7%**	**+3.0%**	**+3.0%**
of which:							
Household consumption	+1.1%	-1.1%	+0.2%	+1.2%	+2.2%	+2.7%	+2.9%
Business investment	+0.8%	-0.8%	+7.7%	+8.9%	+9.4%	+12.6%	+12.4%
Government consumption	+1.5%	+2.2%	-0.1%	-1.6%	-2.3%	-3.2%	-3.5%
Government investment	+2.8%	-6.8%	-9.4%	-4.2%	-0.1%	-1.1%	-2.3%
Net trade	-0.8%	+1.2%	+0.3%	+0.6%	+0.3%	+0.2%	+0.1%

*Source: Office for Budget Responsibility

For its part, the government argues that the poor numbers reflect an adverse external environment, an environment dominated by the slow-motion car crash that the Eurozone (EZ) is fast becoming.

There are at least three snags with this stance.

First, blaming economic woes on foreigners is a shift for which the current administration rightly castigated Gordon Brown during the latter days of his hapless government.

Second, the EZ problem, whilst undoubtedly it *will* impact the UK economy, hasn't really done so *yet*. It is clear that domestic demand is the striking weakness in the current situation.

Third, the government and the Office for Budget Responsibility (OBR) must surely have known about global economic weaknesses when they were telling us, until quite recently, that the nirvana of 2%+ growth was just around the corner.

Labour, meanwhile, has yet to gain public credibility on the economy. The fact that too many of the opposition's front bench team were part of Gordon Brown's government doesn't help, of course, but the real problem is that the public simply will not buy the idea that you can borrow your way out of a debt problem. Both sides of the political debate have promised the public, times without number, that they would back away from ya-boo politics. But each new set of economic stats seems to turn the Commons into a bear pit of accusations and counter-accusations, none of which moves the debate onwards in any constructive way.

Official forecasts – so often so wrong

Let's look instead at the first of our three critical questions – why have official forecasts been too optimistic too often? In figs. 1 and 2, we summarise the truly lamentable track record of the official forecasters. As recently as March last year, the OBR thought that the UK economy would grow by 1.7% in 2011, and by 2.5% in 2012. In less than a year, both of these forecasts proved to be embarrassingly off-target. The economy actually grew by 0.9% in 2011 – a number that we expected back in May - and the latest official estimate for this year (0.7%) still looks optimistic (for the record, our current assumption is 0.3%).

Fig. 2 also helps to show why official forecasts have been so inaccurate. Even on the sober basis of its humbled November projections, the OBR still looks guilty of over-optimism. Its projections for consumption and capital investment by government can hardly be faulted, since public spending plans are a matter of record. But the OBR remains defiantly optimistic both about private consumption and about business investment.

We see no particular reason for optimism on either. To be sure, inflation is now declining, and will fall further as the VAT hike drops out of the numbers, but wage stagnation has taken a big bite out of consumer disposable incomes, and the rising prices of essentials (such as utility, fuel and travel costs) continue to squeeze spending power. Corporates may have plenty of cash, but they need to be given far better reasons for investment than have been vouchsafed so far. They, at least, recognise that we are in the midst of a **deleveraging** recession, quite different both in character and duration from the *destocking* recessions of recent history.

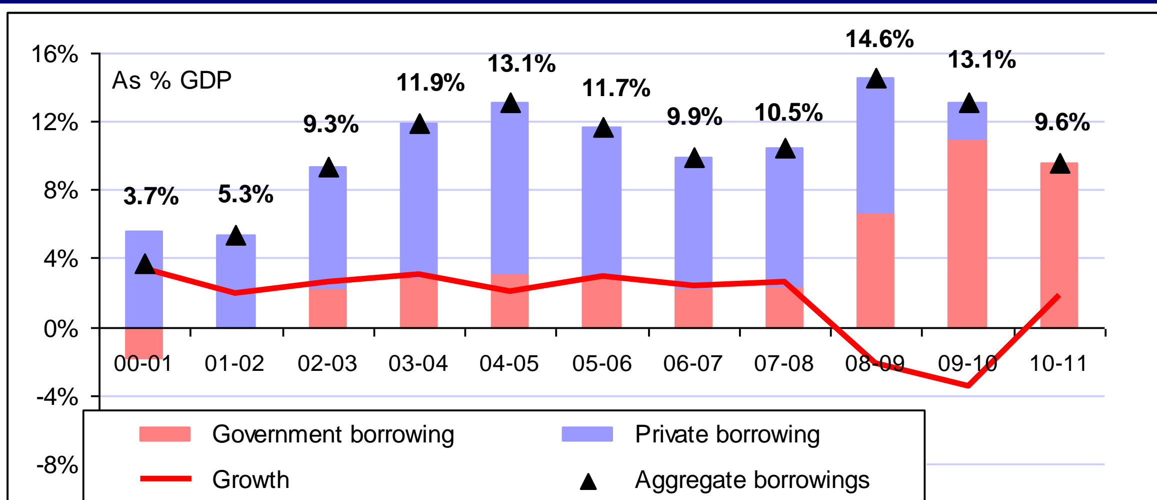
Despite its past forecasting failures, the OBR continues to believe that growth will pick up sharply after 2012, reaching 2.1% next year and 3% by 2015. This looks to us like so much wishful thinking, unless and until the real underlying problems with the economy are addressed.

The real problem – life after debt

Instead of assembling over-optimistic assumptions for consumer spending and business investment, it makes far more sense to look at the economy in terms of segmental performance and funds flow trends. The conclusions that can be drawn from such an analysis are as follows:

From a funds flow perspective, Britain became a debt-driven economy in the years before the financial crisis. Between 2003-04 and 2007-08, individual and government net borrowings averaged 11% of GDP, whereas growth averaged just 2.6% (see fig. 3). In other words, Britain became a debt-dependent economy, and a low-returns one at that, and most of the "growth" of that period was actually nothing more than the proceeds of borrowing.

Fig. 3: Driven by debt*



*Source: Tullett Prebon analysis based on official data

- Reflecting this, strong growth was enjoyed both by the debt-driven CREF (construction, real estate and finance) sectors and by government-funded HEPA (health, education and public administration) activities, whilst the rest of the economy deteriorated (fig. 4). Between 2000 and 2007, manufacturing output slumped by 14% in real terms.
- As a direct result of the preponderance of debt and public spending, the composition of the economy is massively skewed towards the CREF and HEPA sectors. Add in the troubled retail sector as well and a huge proportion of the economy should now be considered ex-growth.

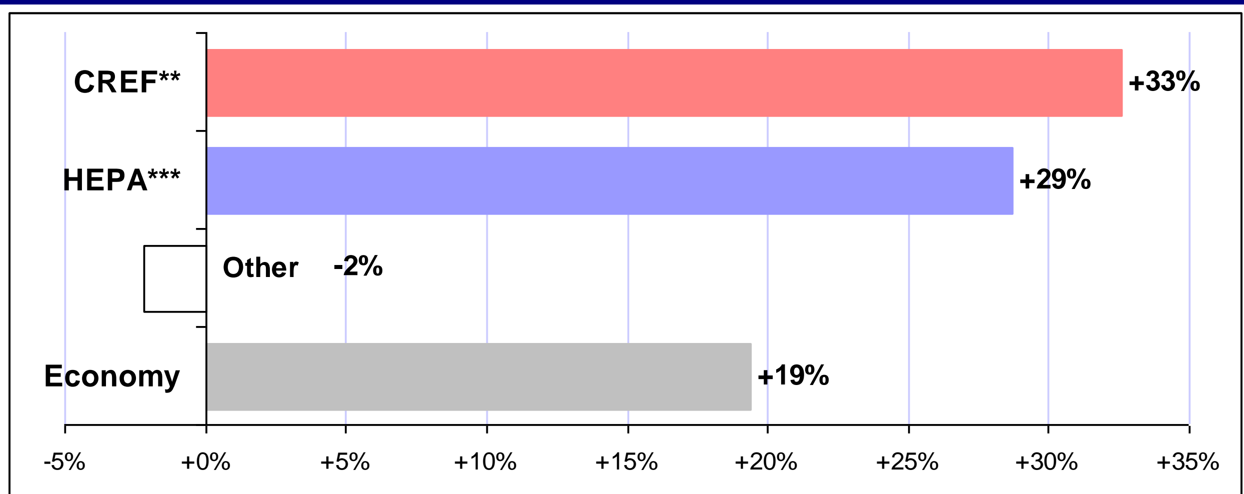
This segmental and funds-flow analysis surely makes a compelling case for realignment, and for freeing up small and medium enterprises (SMEs) to create jobs and drive growth.

We should be in no doubt that **both of the erstwhile drivers of the economy are dead in the water**. Individuals, far from going on another borrowing spree, are doing everything they can to retrench. Despite the siren calls of those who would like Britain to borrow her way out of a debt crisis, the fiscal situation gives no scope for ramping up public spending. The exposure of mortgage payers to even the most modest of rises in interest rates should underline the imperative need to get the deficit under control.

Let's be very clear about the fundamental problem, as it affects not just the UK but the rest of the developed world as well. That problem is **a deleveraging downturn, not a destocking one**.

Though the immediate pre-crisis years were punctuated by a rash of bubbles – in property, in tech equities, in commodities, in property again – the underlying dynamic was **a credit super-cycle**. Individuals, businesses – and, latterly, governments as well - lived far beyond their means, and allowed faith in the supposed certainty of uninterrupted growth to make them unduly relaxed about taking on ever greater amounts of debt. *The so-called "great moderation" of the decade before the crisis was, in fact, "the great delusion".*

Fig. 4: The skewed economy, 2000-07*



*Source: Tullett Prebon analysis based on official data **Construction, Real Estate and Finance *** Health, Education and Public Administration

Can *any* policy work?

Government and opposition may disagree on most issues, but neither has been prepared to come clean with the public on one key issue – every traditional economic policy lever has been tried, and has failed.

First, **interest rates** have not proved to be the magic bullet. Government has cut policy rates to the bone – leaving no scope for further reduction – but almost three years of near-zero rates have failed to deliver growth. Given that **we are in a deleveraging rather than a destocking recession**, this is hardly surprising – individuals and businesses are far more concerned with reducing their debt exposure than with borrowing still more, however cheap money may become.

Second, **devaluation** hasn't worked either, partly because potential export markets have their own problems, and partly because an economy skewed towards property and public services doesn't actually have that much to export anyway.

Neither has **stimulus** delivered recovery. Over four fiscal years, governments of both parties have run deficits equivalent to 33% of current GDP, but the economy is flat-lining.

Finally, **quantitative easing** (QE), which is the current euphemism for printing money, has been tried to the tune of £275bn, again without kick-starting the economy (though we can be pretty sure that there is more to come).

In an earlier series of reports, we argued for the radical alternative of cutting the tax burden on low- and middle-income working people, funding this by taking spending cuts further than has been contemplated thus far. Given that the spending reductions would take time – whilst the tax cuts should be implemented immediately – this would amount to a loosening of the fiscal reins.

This, we think, might be **the one form of fiscal loosening that could be sold to the bond markets**. Relaxing the deficit reduction plan in order to spend more would not convince the markets, but doing so in order to cut taxes and boost growth would get a much better reception.

Ultimately, though, most monetary and fiscal policy options have been exhausted. This exhaustion of macroeconomic policy levers means that **microeconomic reform is the only game in town**. Government now needs to start reducing the legislative and regulatory burdens on businesses. This would involve tough choices, notably in the field of labour laws.

Is the UK capable of taking tough decisions in the face of well-meaning (but misplaced) opposition? The real issue now is one of choosing pragmatism over sentiment.

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