Lessons from the past

HOW FAR DOES THIS RECESSION HAVE TO GO, AND WHAT SHOULD DOMINATE THE UK'S POST-RECESSION AGENDA? HSBC ECONOMIST DENNIS TURNER WAS IN OPTIMISTIC MOOD WHEN HE RECENTLY SET OUT HIS THOUGHTS, REPORTS **GRAHAM BUCK.**

Executive summary

- **Labour had avoided the boom/bust economic cycle over much of the last 12 years, but credit-fuelled growth ended this prolonged period of stability. Dennis Turner sees a long slow climb back to prosperity in 2010, with either public spending cuts or higher taxes inevitable, and a boost to manufacturing vital. As the election looms, the main parties must set out their stalls.**

How should the government be judged on its economic record? With the economy plunging into recession and the public sector borrowing requirement ballooning, the verdict on 12 years under Labour could be harsh.

But Dennis Turner, veteran chief economist at HSBC, believes that, based on the economy's "holy trinity" of inflation, the base rate and the exchange rate, the Brown administration's record scores fairly respectable marks. As he noted, the main bellwether of the UK economy's health was traditionally the country's balance of payments, until the focus began to shift to the money supply and, more recently, moved again to the inflation rate.

Turner was speaking to delegates at a workshop at the Association of Insurance and Risk Managers' annual conference in Bournemouth. His relatively positive assessment of the Blair-Brown era is due partly to the fact that a whole generation has not experienced an economic downturn. He cited sterling's ejection from the ERM in September 1992 as a turning point for the UK. Since that traumatic event, governments have followed a simple agenda of meeting business demands for an end to boom-bust economic policies. Until recently, it seemed this was being achieved with a prolonged period of stability.

On inflation, the UK has shed its long-held reputation as a high inflation economy thanks to its exit from the ERM. Since 1992, the mechanism of interest rates has switched from a means of controlling the value of sterling to a means of managing the British economy and inflation. The former policy inflicted on Britain the longest and deepest recession since the war. The change of focus has resulted in 16 years of comparatively low inflation, which has forced companies to focus on improving productivity and weeding out inefficiencies rather than "cheating" by pushing through price hikes.

A structural shift on interest rate policy dates back to the same time. Over a 30 year period from the early 1960s to the early 1990s, the lowest point touched was 5% and this only for a combined period of 13 months. Under Margaret Thatcher's premiership, they never went below 7.5% and even this level was only held for a brief period in 1988. By contrast, the past 16 years has demonstrated that low interest rates go hand in hand with low and stable inflation.

On currency, the record is more mixed. Sterling depreciated steadily against major currencies like the deutschmark in the years preceding the UK's brief ERM membership. It slid further after September 1992 and only began to rally when UK economic recovery was evidently under way in the mid 1990s. Since Labour regained office in 1997, a strong pound for most of the period has made imports cheap but created problems for exporters; a situation that only improved with the pound's sharp depreciation against the euro and dollar last year.

Turner points out that Labour can also boast of sustained economic growth. The rate of 0.4% recorded for the first quarter of 2008 was the 63rd consecutive quarter in which the figure was positive. Nor was there any repetition of the Thatcher-Lawson boom of the late 1980s, which was marked by economic growth of 6% in 1988 accompanied by a rise in inflation to 10% and a jump from 7.5% to 15% in the Bank of England's base rate.

In all, 16 years of growth from 1992 saw the British economy expand by 52% over the period, while living standards rose significantly without any acceleration in inflation.

WRONG SORT OF GROWTH So why has this sunny vista been so suddenly replaced with black clouds? In part it is due to UK economic growth being the "wrong sort" of growth, says Turner. In 2008 the UK national income totalled £1,400bn, of which £900bn was contributed by consumer spending, which was achieving annual growth of 3% helped by high confidence levels. Spending levels rose faster than income, with consumers able to borrow more and banks ready and willing to lend. By the end of 2008, consumers owed £1.5 trillion, a debt load exceeding the size of the UK economy. The average Briton owed 19 months' pay – the most indebted consumer in the western world.The debt to income ratio stood at 150% and, with CPI inflation still above 2%, will take a long time to unwind.

Since the start of the decade, growth in the public sector has also consistently outpaced the economy. As Chancellor, Gordon Brown was able to rely on a fiscal surplus at the outset that more recently has been supplanted by a steadily growing deficit.

The current situation, with the government's finances steadily weakening due to excessive spending and borrowing and with both investment and exports under pressure, contrasts with the period 1994 to 1998 when all parts of the economy made a positive contribution; these being household spending, government spending, investment and net trade.

From 2002 to 2008, the position slowly deteriorated, but the boom was extended due to the 2005 election when a timely opportunity was wasted to rebalance the economy. Brown announced in 2003 that the main inflation measure would switch from the retail price index (RPI) to the consumer price index (CPI), a measure at the time mistakenly interpreted as the prelude to UK membership of the European single currency. This removed the influence of an overheating property market from the main measure of inflation and meant that interest rate increases, which would have responded to a rising RPI measure, were withheld.

The boom was maintained in 2005 and beyond, with the result that in 2009 the consumer sector is hampered by:

- excessive debt;
- a rising tax burden, which would matter less if earnings growth was keeping pace;
- inflation, which is adding to the pressure due to double-digit percentage increases in food and fuel costs;
- a squeeze on discretionary spending, which has hit companies in the catering, holiday and leisure sectors;
- negative media stories and rising unemployment, which are sapping consumer confidence.

A positive to offset these factors is subdued earnings growth, helped by imported labour from Eastern Europe that has been able to plug any gaps caused by skill shortages and keep the lid on wage inflation.

However, the situation could be much worse, adds Turner. A slowing economy and an intensifying credit crunch are two separate and distinct factors that have so far demonstrated little interaction. The government has effectively added a detour line by rescuing the banks and pumping money into the economy. This should be enough to avoid the "train crash" that would result from the two interacting, although some "collateral damage" can still be anticipated.

Brown is keen to encourage an investment-led recovery and typically companies that invest at the bottom of an economic cycle do well. But while UK firms are entering the recession in generally better shape than in previous downturns, business surveys suggest that most are in negative mood and reluctant to invest.

WHEN WILL IT ALL END? Last year's question of whether a recession would occur has given way to queries on how long it will endure and how deep it will prove. Historically, recessions last for between four and six quarters. HSBC's view is that the current one will follow the typical U shape, with the UK economy emerging from five successive quarters of negative growth in late 2009.

Why will it not endure longer? Because this time around "all the (economic) levers that could be pulled have been pulled," suggests Turner. There will be a slow climb back towards a "business as usual" quarterly growth rate of 0.6% sometime in 2010.

Meanwhile, the massive hole created in the private sector by consumers in retreat and companies retrenching will be offset by pumping more money into the public sector.

Alistair Darling has been handed a dreadful inheritance by his predecessor, says Turner. At the outset of his chancellorship, Brown insisted the government would only borrow to invest. These rules changed as the government's budget surplus turned to deficit and the annual shortfall of £50bn is now set to soar to £175bn, or 12% of GDP. The deficit can be reduced only by slashing public spending or raising taxes. Other than the token gesture of slapping a 50% rate of tax on salaries of £150,000-plus, the government has yet to choose either option and a dividing line is forming for the next election on how the incoming government goes about cutting the debt load.

Another Brown target, of keeping public spending at 40% of GDP – which he even reduced to 29% at one point – is being abandoned as the figure will reach 75% by 2013. However, given that it is already 68% for Germany and 90% for the US, it looks less alarming, and the cost of taking action, although heavy, is better than doing nothing.

REASONS TO BE CHEERFUL Are there any grounds for optimism? Turner believes so. The tone of economic debate has shifted from unmitigated pessimism to cautious optimism. Performance of Manufacturing Index surveys are picking up readings back over 50 which indicate expansion, and there are signs of inflation returning, which indicates people are spending again.

TURNER DESCRIBES EUROPE AS "A DECLINING REGIONAL ECONOMY THAT IS FAR TOO INWARD-LOOKING", SET TO BE INCREASINGLY ECLIPSED BY THE BRIC ECONOMIES OF BRAZIL, RUSSIA, INDIA AND CHINA.

Interest rate rises are being pencilled in for 2010 and the UK looks likely to emerge from recession ahead of Europe and around the same time as the US. This points to sterling regaining ground, cutting short the opportunity offered to exporters by a weaker exchange rate.

Turner believes Europe is still way behind in its policy response, and needs to undergo a painful restructuring of its economies similar to the UK in the 1980s. He describes Europe as "a declining regional economy that is far too inward-looking", set to be increasingly eclipsed by the BRIC economies of Brazil, Russia, India and China.

The UK's own post-recession agenda must be to avoid returning to a consumer boom and a resurgent property market. However, the boom saw 80% of growth derived from three sectors; distribution, financial services and property/construction – none of which is likely to bounce back dramatically.

So growth will depend on becoming more competitive internationally, which principally means paying greater attention to manufacturing.

How does the UK revive its manufacturing sector? Possibly by resurrecting the agenda pioneered by Michael Heseltine as trade secretary during the Major years, suggests Turner. He took the view that the UK should attract multinationals in key industries to its shores, staking its claim to be their main European base through advantages such as lower corporation tax and a more flexible labour force. This could work again. The UK has a small but high quality manufacturing base in sectors such as pharmaceuticals and aerospace, which would benefit from foreign companies expanding their operations here.

The coming election will offer stark options for debt reduction and taxation. Turner says the Conservatives will opt for spending cuts, while Labour will maintain spending and hike taxes, despite the view that this proves counterproductive – and the Thatcher government's policy evidencing that tax cuts can create investment and jobs.

But David Cameron's reluctance to commit himself to a definite policy in advance is frustrating, says Turner, who would like the Opposition to present a coherent picture. This would be best achieved by setting up a commission to review government spending and allocating projects to three groups; those that are essential; those that are important but which the private sector could possibly do better; and those that should simply be junked.

Lifting the lid off inflation as a deliberate means of reducing debt is no longer an option however. The UK is "not a hermetically sealed unit" but part of a global economy, so cannot afford to run an inflation rate persistently higher than the rest of the world.

And what Mervyn King memorably dubbed the 'NICE' decade – of Non-Inflationary Consistently Expansionary economic activity – was sustained by cheap imports. While domestically generated inflation was nearer 3.5%, CPI inflation could be targeted at only 2% thanks to low-cost Chinese goods. This era too is drawing to a close, and interest rates will inevitably rise to offset the rate of inflation creeping higher.

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