The effects of a US recession on the UK

US economic troubles are clearly likely to have some affect on the UK's economy, but Roger Bootle of Capital Economics asks to what extent this will happen.

The news from the US continues to be pretty bad, and it now looks decidedly likely that the US will suffer a technical recession. More importantly, the chances are that this will be no short-term correction but the start of a long period of US adjustment after several years of boom. According to economic folklore, if the US sneezes we all catch cold. What ills might befall us, therefore, if the US were to catch the economic equivalent of pneumonia?

The closeness of the economic performance in the UK and the US is so much taken for granted that it is interesting to look at the facts afresh. There is no doubt that in broad terms the two economies do move closely together, with both booms and recessions occurring more or less simultaneously in both countries. However, when you focus on the gap between the two countries' growth rates, there are a number of occasions when both the severity of cyclical swings and the timing have been noticeably different in the two economies. And, in this regard, it is particularly noteworthy that the US has enjoyed a much more buoyant economy in the second half of the 1990s. In a crude way, this could be taken to suggest the imminence of a period when the US economy underperforms the UK.

Moreover, the extent of the closeness of the performance of the two economies has to be interpreted, rather than just accepted blindly. There is also a similarly impressive relationship between UK and OECD economic performance. In other words, a great deal of the apparent closeness of UK and US economic growth rates probably derives from a connection between the UK economy and the world, rather than from any particularly strong link with the US. This means that, to a large extent, how seriously the UK is affected by a US recession depends on how seriously the world as a whole is affected.

The effects on the UK could be felt though several different channels. Most obviously, there is the trade linkage. About 17% of UK exports of goods and services go to the US. But there could also be effects from a reduction in wealth and confidence following falls of the UK stock market, job losses and lower bonuses in the City of London, as well as reduced direct investment in the UK from the US.

How could it happen?

The upshot is clear. If all, or most, of these channels were operating, if the effects were close to the upper end of our estimates and if there were no offsetting influences – and in particular if a US slowdown spread to the UK's other trading partners – then a recession in the US would induce one in the UK. The various effects could readily add up to a reduction in GDP, compared with the pre-existing path, of some 4%.

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Therefore, if the economy had been on track for 3% growth, these effects would result in a fall in GDP of 1%.

But these are big ifs. Most importantly, if the slowdown were largely confined to the US then the effects on UK GDP would be reduced by about 1½%. In that case, on the assumptions described above, you would not quite get a recession in the UK.

Moreover, there surely would be offsetting influences. The monetary authorities would have to respond to any drop in aggregate demand by cuts in interest rates. In the UK, against the backdrop of low inflation, the MPC has great scope to reduce interest rates vigorously – and I think it will. Indeed, if you think that the impact of a US slowdown on the UK is greater than I have suggested, the result should not necessarily be that you see a weaker economy, but rather much lower interest rates.

And in these difficult times, we should all be well aware of the historical parallels. The 1930s offer a warning and a lesson. The warning is about the instability of the financial system and the possible failure of financial institutions. Fortunately, on the face of it at least, the UK's financial system is well capitalised, well managed and well regulated.

The lesson is that in such difficult global conditions it is invaluable to have an independent currency, with power over interest rates, and the possibility of currency depreciation. The scope for sterling to fall against the euro offers another way in which the UK may avoid the worst of the global slowdown. ■

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