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OUTLOOK FOR THE UK ECONOMY:

Green Shoots but Shallow Roots

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Contents:

INTRODUCTION 9

THE GLOBAL CONTEXT 9

THE UK BUDGET FORECASTS 11

UK ECONOMY FORECASTS 12

SUMMARY 16

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INTRODUCTION

At the time of preparing this paper, May 2009, I am absolutely confident that, in economic terms, the worst is behind us in the sense that the biggest decline in output experienced in this recession can now be spoken of in the past tense. In contrast, I delivered a similar paper at the Clydesdale Bank in Glasgow in the middle of 2008 and when I finished the presentation, which was extremely negative about the outlook for the UK economy, most people were busy trying to prise open the window to hurl themselves upon the pavement below.

I am absolutely confident we can talk about the worst in the past tense. What I intend to look at is whether we have got green shoots; and I will focus on the roots of the shoots in order to judge whether the recovery will be sustainable and durable through looking at

- The global context
- The Chancellor's budget forecasts, and
- The view of the National Australia Bank on the UK economy and how it might develop.

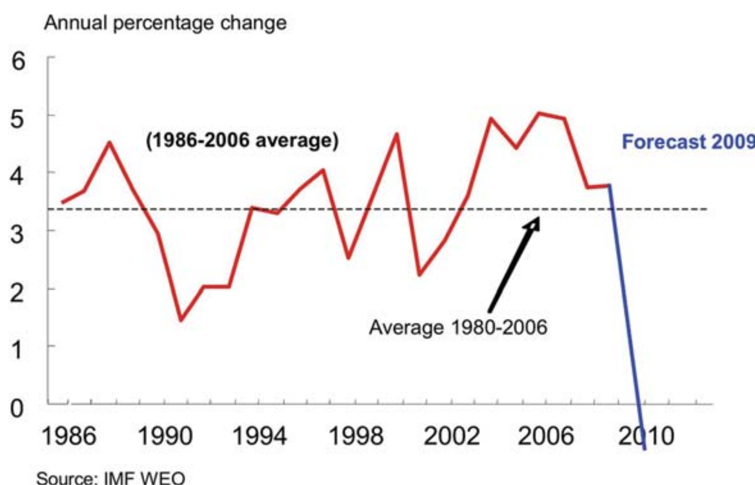
The Global Context

The average rate of growth for the global economy, or at least the 31 countries that make up the OECD area, has averaged, over the last 20/25 years, just under 5%, the golden period of the post war age.

This is our forecast for this year, a synchronised decline where every major industrial block moves into recession simultaneously.

In terms of numbers, "growth" in the UK economy, and for the first time in 2 years we agree with forecasts made by Alistair Darling, is forecast to be minus 3.5 for this year. The Euro-zone fares worst. We have just revised down our Japanese numbers from – 3.4. Only China and India are expected to show growth this year, were it not for that the "World" forecast would be lower. To put the numbers in context although the 2009 growth rate of China is halved it is easy to forget that an economy that

Global economic growth is set to collapse in 2009



- Business surveys and output data released since last September's financial crisis reveal an output decline of unprecedented speed, scale and regional synchronisation for the post-war period.
- Industrial output declined by over 10% through the last few months of 2008 and the business surveys show that reduction in output continuing into 2009.
- Synchronized downturns across OECD and emerging market economies.

Sharp G10 slowdown, so global growth now only from India and China

Annual average	2006	2007	2008	2009(f)	2010(f)
US	2.8	2.0	1.4	-2.0	1.9
Japan	2.4	2.0	-0.3	-3.4	1.5
UK	2.9	3.1	0.8	-3.5	0.8
eurozone	2.9	2.6	1.1	-3.8	0.4
Canada	3.1	2.7	0.8	-1.3	0.6
Australia	2.5	4.2	2.3	-0.2	1.0
New Zealand	2.0	3.2	0.0	-0.9	2.3
China	10.7	11.4	9.5	6.2	6.9
India	9.8	9.3	7.7	5.4	5.7
World	*5.1*	*4.9*	*3.5*	*-0.6*	*2.4*
Emerging E Asia	5.4	5.5	4.3	-3.6	2.6
Latin America	5.1	5.3	4.5	-0.3	1.8

Source: NAB Economics

- Synchronized downturns across OECD and emerging market economies.
- China and India still expanding but growth slower and depends on policy stimulus. There are also downside risks in 2010.
- Continued growth in India and China has, however, limited the damage to global growth; without their contribution the world economy would be contracting by over 1% this year.

Spending sums are roughly similar around the world

Table 4. G-20 Countries: Estimated Cost of Discretionary Measures, 2008–10
(In percent of GDP)

	2008	2009	2010
Argentina	0.0	1.3	...
Australia 1/	0.7	2.1	1.7
Brazil	0.0	0.4	0.2
Canada	0.0	1.5	1.3
China	0.4	2.0	2.0
France	0.0	0.7	0.7
Germany	0.0	1.5	2.0
India 1/	0.0	0.5	...
Indonesia	0.0	1.3	0.6
Italy	0.0	0.2	0.1
Japan	0.4	1.4	0.4
Korea	1.0	1.5	0.3
Mexico	0.0	1.5	...
Russia 2/	0.0	1.7	...
Saudi Arabia	2.4	3.3	3.5
South Africa 1/ 3/	1.7	1.8	-0.6
Spain 4/	1.9	2.3	...
Turkey	0.0	0.0	...
United Kingdom	0.2	1.4	-0.1
United States 5/	1.1	2.0	1.8
Total (PPP weighted average)	0.5	1.5	1.1

Source: IMF staff estimates.

grows 6% per year is an economy that will double in size in twelve years.

Globally to tackle the downturn interest rates have been cut.

Governments are actively relating economies at tremendous cost.

The UK Budget Forecasts

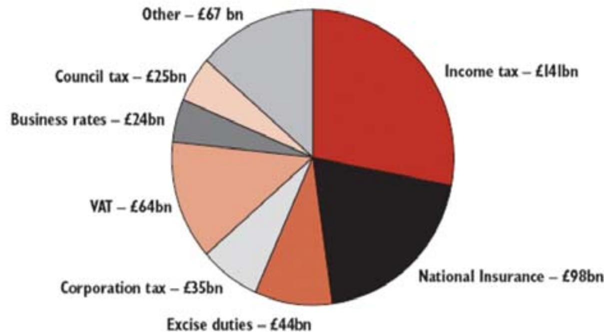
It is against that background that the Chancellor put together his forecasts for the UK budget of a few weeks ago.

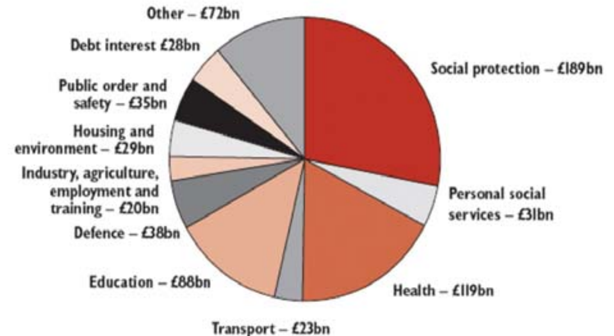
We agree with his assumption that the UK economy will shrink 3.5% this year but regard his 1.25% growth forecast for 2010 as a bit optimistic. Then he assumes a 2011 growth figure of 3.5% and I intend to show that these growth figures are hopelessly unrealistic.

The Chancellor is forecasting that this year the UK will need to borrow £175 billion whereas just a year ago he was forecasting £38 billion, albeit revised in the December 2008 PBR (Pre-Budget Report) to £118 billion. this time at the depths of this recession £175 billion is the forecast. Bearing in mind that all Chancellors forecast a declining borrowing path he has managed to shave £2 billion off the 2010/11 number, then down to £140 billion, then £118 billion and even at the end of this forecast period he is still forecasting the thick end of £100 billion of public borrowing.

The reason for this approach is the collapse in the tax take. The forecast for the current year is that income tax and national insurance should contribute almost £230 billion. Originally it was estimated that the two would contribute about £300 billion, thus the scale and depth of the recession has shaved £70 billion pounds off receipts. Also the decline in the housing market and falling retail sales growth leads to declines in Excise Duty, VAT receipts, stamp duty and all the rest of it. Hence the increase in borrowing has nothing at all to do with an increase in spending, as there is virtually no planned increase in spending. Revenues have collapsed to the extent that borrowing this year will reach £175 billion and cumulative borrowing over the next 5 years will add

HMT forecasts for government spending and receipts 2009-10





- 28% of all government revenues come from income tax, with 20% from National Insurance
- Tax revenues from all sources are expected to be lower as a direct result of the recession.

Now this is not a party political point but it is the case that every Chancellor in post war history in delivering the budget has said that borrowing will be lower in 3, 4 and 5 years time. There has never been a Chancellor, of any party, who has said borrowing will be higher in 4 years time as this would invite the obvious repost, "Well what are you going to do about it?"

Furthermore this is going to be the first time ever that future borrowing is predicted in three figures. In the depths of the 1991 recession borrowing was £51 billion, up to £703 billion. If you go back to when financial records began, the middle of the 17th century, and add up all the accumulated debt we have in this country, it amounts to less than £500 billion.

Therefore 450 years of history have taken us up to £500 billion; now the plan is to add another £703 billion to that over the next 5 years. This is an enormous amount of central government borrowing.

Forecast Public Sector Net Borrowing (PSNB) expressed as a percentage of GDP shows a trend of declining

borrowing. Borrowing is predicted to fall as a percentage of GDP. The current year figure is 12.4%. Some readers may remember that back in the early 1990s, when the introduction of a single European currency was under discussion, one of the qualifying criteria was that public sector debt could not exceed 3% in any year; one of the Maastricht criteria enshrined in the Maastricht Treaty. Yet this Budget predicts 12.4%, 11.9%, 9.1%, and 7.2% before reducing to 5.5% in 2013/14; even then almost double the Maastricht criteria.

I am confident that these figures will not be met. We will not get down as low as 5.5% in 2013 mainly because of the growth projections upon which they are based.

The underlying economic assumptions for the public finance projections assume a reduction of output in the current year followed by growth in the following year and then 3 consecutive years of $3\frac{1}{4}$% growth. However remember that even at the height of the recent boom the best year over year rate that we ever got was 3.6% and yet the forecast for recovery is $3\frac{1}{4}$% for 3 consecutive years. It is generally accepted that if you look at the UK economy, its trend rate of growth, [the trend rate is the rate of growth which will absorb all demographic change, not lead to any increase in unemployment, whilst at the same time not putting any upward pressure on inflation] is about $2\frac{3}{4}$%. In other words, if the economy grows at $2\frac{3}{4}$% per year over year there will be no increase in inflation or unemployment.

But the Chancellor is assuming that the trend rate of growth has been completely unaffected by the financial crisis of the last 18 months. Now you know, as individuals, as homeowners, as householders, speaking from business, from running the accounts of your own organisations, you know that is not the case. You know that most people and organisations are, in fact, trying to save more, spend less, and keep more cash to one side. Therefore I believe that it is fanciful to believe that current financial difficulties will not affect the trend rate of growth. Our view is that the trend rate of growth has been reduced by the financial crisis. And yet the Chancellor is assuming that not only will the trend rate of growth be unchanged as a result of the last 18 months, but for 3 consecutive years we are going to grow half a percent above that unchanged trend rate of growth. It is fanciful numbers.

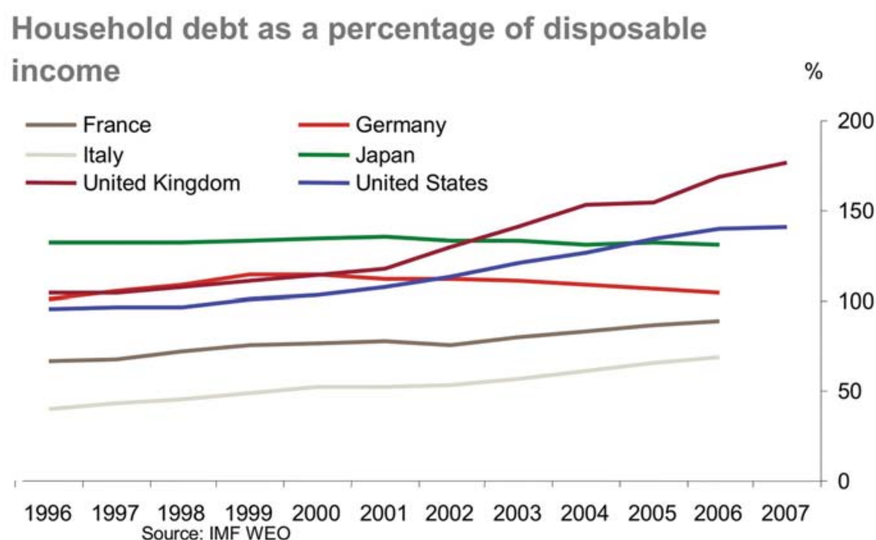
We believe the reason for doing this is to achieve the political imperative showing declining public sector borrowing as a percentage of GDP. Question; how do you reduce public sector borrowing as a percentage of GDP? Answer; put in some silly GDP numbers and come up with $3\frac{1}{4}$% growth for 3 consecutive years.

National Australia Bank forecasts for the UK economy in 2009 and 2010

The defining feature of the UK economy is the debt position of UK households.

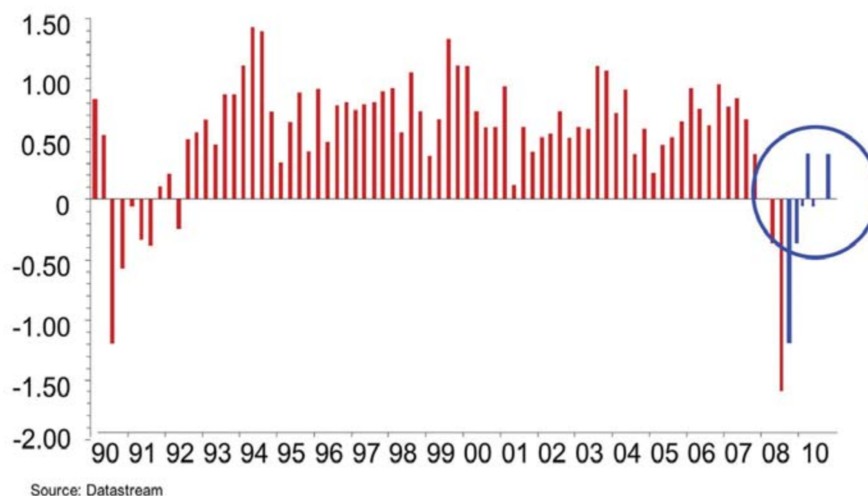
To produce this graph we aggregate all the debt of all the households in the country and then express that as a percentage of average household income. I will focus on the UK household debt, the dark red line. Back in 1996, a dozen years ago, UK household borrowing levels were much in line with the international averages. Over the

UK Household debt is the highest in the world



- UK household debt is highest in the world and also the highest in history
- Debt to income ratio is more than double Italy's and more than 50% higher than France and Germany

We look for a similarly patchy recovery this time around.



- The first three quarters of 2009 will all show negative growth.
- Q4 growth is based on assumption that VAT cut will be reversed at year-end
- Growth does not then resume until H2 2010

course of the last dozen years borrowing has gone up and up and up until now we have more debt than any other country in the world, and more debt per household than any other country in the history of the world. UK household debt as a percentage of household income is double that in Italy and 50% higher than France or Germany. If you thought Americans liked borrowing, on average, the UK has 20% more borrowing per household as a percentage of income than they have in the United States. We are an economy that has been floated on a sea of personal debt. This increase in debt did contribute to the longest consecutive increase in output of any country in the developed world when the UK had 63 consecutive quarters of growth.

This growth started in the third quarter of 1992, when we came out of the ERM, followed by the 63 consecutive quarters of growth that finished in the second quarter of last year. There were two phases to this extensive growth period. The first two thirds were based on a fairly old fashioned model, that essentially involved making, manufacturing and selling product to people who want to buy, old fashioned though it seems, an export and output led recovery. But the last 7 years of the growth period saw an economy whose growth was characterised by debt and property; a debt and property fuelled boom that ended spectacularly in the second quarter of last year.

Thinking forward to what the recovery might look like, take a look at the shape of the recession last time around, 1990/96. There were 5 consecutive quarters of no growth, and then a bit of a recovery, then we dipped down again before moving back into growth.

Our predictions are shown in blue on the right hand side of the graph, again fairly jagged in terms of profile. After 2 quarters of negative growth already experienced we show 3 quarters of further negative growth, one of recovery, one more of negative growth then back to growth again. The chances of getting the forecast for the next 6 quarters of GDP correct are not high, and we know that we are going to be wrong, but as an illustrative path, I think it tells a very, very plausible story.

In the first quarter of 2009, the UK economy shrank 1.9%, the worse outcome since 1980, an awful quarter. There are 2 items of good news.

- First we can talk about that desperately bad quarter in the past tense, because for the last 18 months we have been saying “it’s going to get worse” and it got worse.
- The second piece of good news is that from now on it is going to get worse, but more slowly.

In the second quarter of this year we think we will see another fall in output, about 0.4%. Then maybe flat or down 0.1% in the third quarter, and the fourth quarter is when we come out of this. We come out of this, or begin to come out of this for two separate but related reasons.

First we have all got more savings. For example if you are a borrower, a mortgagee, then you have more savings,

because, if you are on a tracker mortgage, or a standard variable rate (SVR) mortgage, or if you have just come off of a two year fixed mortgage and are about to take on a new 2 year fixed, on average, you are about £250 per month better off. Clearly due to the impact of the financial crisis you are not going to spend that and by the end of this year you will have accumulated £1,500 to £2,000. By Christmas you will be thinking about spending pushed along by a massive advertising campaign and the knowledge that at the end of this year the VAT reduction to 15% is going to be reversed back up to 17.5%.

When you come back from your summer holidays every time you open a newspaper, or every time you drive past a billboard, you will be told, “Buy now, before prices go up”. There will be a massive, and successful, campaign to encourage you to spend in the fourth quarter. So we will all spend more and the economy will come out of recession in the fourth quarter! But look at our first and second quarter numbers for next year, down 0.1% and flat. We are out of recession but it is not a return to growth.

When our predictions for recovery are compared with the experience of the last two recessions what we are arguing for here is quite sensible and reasonable. The graph replicates the current and last 2 recessions over 13 quarters, just over 3 years. The last recession began in June 1990 and is the red line. Here you can see that GDP went down, down, down and then went into growth in about the 6th quarter but then went down again before coming back up. December 1979 was a deeper recession and again it took us until the 6th quarter to come out of it only to dip negative again.

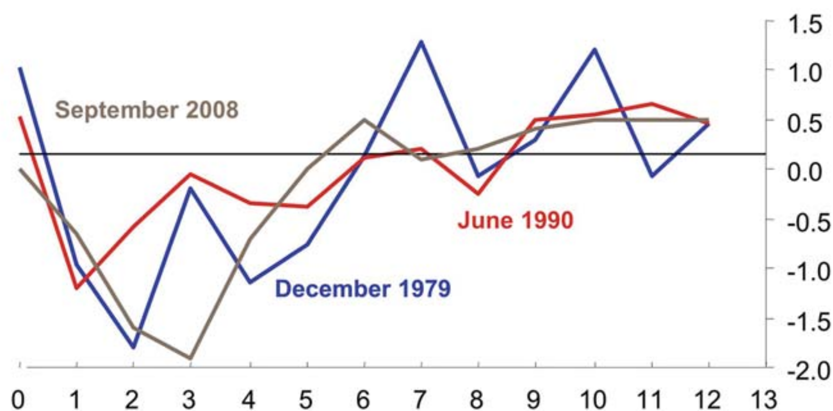
The experience of the last two recessions is we go into recession; we come out of it, and then mark time for about a year before returning to something resembling trend growth. Our prediction for 2009 is entirely consistent with previous recessions. The point I am making strongly to many of our business clients is to be cautious when you reach quarter 6 because no matter how bad and how long you feel the recession was, it may not yet be over. After 6 quarters of recession businesses are tempted to go ahead and invest, expand, borrow and gear up but it is not necessarily the best time to do it. Previously when we have come out of recession, both times, we have gone negative again. Do not run away with the idea is that the recession will show a simple “V” shape because in this country we have never seen a simple “V” shape recession and there are no reasons to believe that this time is going to be different.

This is because of the importance of the property market for the UK economy. Property comes and goes in cycles and even if you paid at the top of the last cycle in June 1989 you now feel it was not a bad investment as property is worth considerably more now than it was in June 1989.

But if you bought in June 1989 you had to wait until March 1998 to get your money back. It took a hundred and sixteen months to get your money back.

A comparison of the last three UK recessions

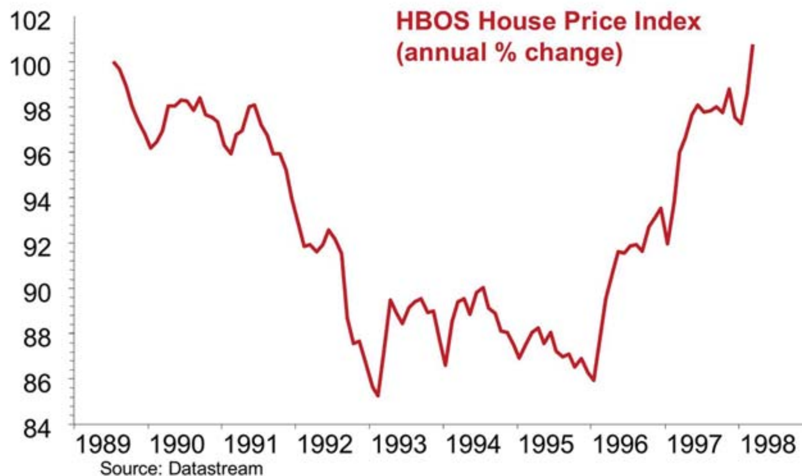
GDP growth on a quarter ago



Source: Datastream/NAB

- The latter stages of both previous recession have been characterised by a mix of positive and negative growth.
- In 1979-81, the last quarter of negative growth was almost 3 years after the start
- In 1990-92, growth twice moved negative after what looked like recovery

Recovery from the last house market decline took nearly 10 years



- House prices peaked in July 1989.
- Prices fell 14.2% over a 3 year period then began to recover strongly from 1996.
- By March 1998, prices had recovered all their prior losses: The process took 116 months.

Today we are down 18.8% from the peak that is our forecast for this year and the good news is that we are more than half way to the bottom of the recession and the rate of decrease is slowing. Thus it is still going to take some time before prices hit bottom and even longer before they recover. It took 10 years last time around but we are not going to have the same sort of boom this time that we had back in 1996.

Back then unemployment was falling, more people were in work, and average earnings rose by 5% and the level of UK debt was in line with the rest of the world. Today there is a very different picture on employment, and average earnings, and the debt accumulated over the last dozen years is still there. Therefore today's circumstances are unlikely to be the starting point for another take off in the housing market. And the main reason is unemployment.

In April 2009, 57,000 people lost their jobs. In the month before it was 73,000, in February, 138,000 people lost their jobs; a total of 261,000 in the last three months. Our forecast for the rest of the year is shown in blue. The good news is fewer people losing their jobs as each month goes by but we do not think we will see any net job creation between now and the end of this year.

Another measure is the claimant count, ie of those who are unemployed and eligible to claim benefit. And if you lose your job and have more than £7,000 of savings you do not count in those figures. Neither do you count those who are unemployed and on job seekers allowance. We forecast a steady increase between now and the end of this year on the claimant count. Therefore on the unemployment benefit description, unemployment will have increased by 1.1 million in 2 years. This is the mirror image of the situation that helped cause the house price boom that started in early 1996.

Another factor is average earnings.

For the first time ever the average earnings index is negative. In 1995/1996 average earnings were growing by 5%. More people were in work; they were earning more and did not have a lot of debt. Now we have unemployment that has increased by a million and average earnings that are falling. For example my earnings fell 40% last year, but I am not asking for sympathy for a banker whose bonus was cut. The good news – for you – is that public sector earnings are up 3½% whereas private sector earnings are down 2.8%.

But beware there will be pressure to narrow that gap one way or another.

But the key point is that rising unemployment and with negative earnings growth there are fewer people in work and they are earning less and that is not the basis for a housing recovery. And housing recovery is needed in order to get the UK economy as a whole back to growth.

Conclusions

To begin to restore the status quo some reduction in the huge amount of debt is essential but debt reduction is a painful experience. Other than default, ie just refusing to pay it - not a recommended strategy - there are two ways to reduce debt.

- Cut expenditure, raise taxes and create structural surpluses.

  - De-leveraging in the banking system feeds through to households then corporates.
  - With tax revenues falling, government cuts expenditure leading to “debt deflation.”
- Decrease the real value of debt through hyper-inflation
  - The Weimar Republic and Zimbabwe show the cost of this.

The UK has experienced three major accumulations and run-downs of government debt in its history.

- From **1795 to 1882** debt peaked at 185% of GDP then down to 30% by 1914.
  - Sharp cuts in military expenditure combined with healthy growth helped generate surpluses.
- From **1913 to 1933** debt rose to 178% of GDP then down to 141% by 1938.
  - Debt reduction was slow and limited because growth was weak. Abandonment of Gold Standard allowed the pound to depreciate, reducing real interest rates through inflation spurring growth.
- From **1938 to 1946** debt rose to 252% of GDP then down to 43% by 1980.
  - Debt reduction was rapid due to austerity measures in 1950s and then inflation. But growth quality was poor

Summary

- In the UK the household sector is under considerable stress and a sharp retrenchment looks likely. The economy at best will shrink by around 3.5% in 2009.
- Official and survey data are showing the economy is deteriorating at a slower pace but this is not the same thing as a pick-up in activity.
- The worst quarter for GDP is now behind us but growth will not be seen until Q4 2009.
- The Bank of England will not cut interest rates further after the aggressive moves already seen. Monetary policy now focuses on the quantity, not the price of money.
- Government borrowing is set to increase by £703bn over the next 5 years.
- Economic recovery and massive public deficit will put upward pressure on interest rates and bond yields.
- The fall in sterling means that UK manufacturers have rapidly regained competitiveness, but an absence of overseas demand is still holding back output.
- The new trend of rate growth for the UK economy is likely to be 1.75-2.0%; almost a full percentage point lower than the average over the past decade

And Finally

I must end with the following statement that, in effect, says, “If I am wrong, it is not my fault”.

Nick Parsons