IoD Pulse

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UK economic outlook

The Topsy-Turvy Economy

In the world of Mr Men children's books, Mr. Topsy-Turvy does everything the wrong way around. He lives in an upside-down, outside-in world where everything is backwards or the wrong way up. This edition of *Pulse* applies the topsy-turvy analogy to the UK economic outlook in 2012.

MR TOPSY-TURVY

In the previous edition of Pulse, entitled *'This Sucker is Going Down'* I wrote about the structural gaps at the heart of the euro and why some form of collapse was inevitable at some stage in the future – probably sooner rather than later. However, the timing of any break-up is uncertain and there is a scenario whereby the euro zone crisis struggles on without intensifying this year – so-called 'back door' quantitative easing works. In such circumstances the outlook for the UK economy in 2012-13 is far better than many expect. So let's look at the circumstances in which a more optimistic scenario might come to pass:

GDP GROWTH PAUSE

The 0.2 per cent (qtr-on-qtr) decline in GDP in the final quarter of 2011 led to a media storm and speculation that the economy was sliding back into recession. However, a 0.2 per cent decline is equivalent to the margin of error in the figures and so the GDP numbers could be saying output was flat (obviously output could have fallen 0.4 per cent, but we're concentrating on the more optimistic argument here), which is not a bad result given the intensity of the euro-crisis and likely postponed business investment and recruitment towards the end of 2011.

Obviously in a normal cyclical upturn the quarterly growth rate should probably be accelerating, not declining (or decelerating), but this is no ordinary recovery, in the wake of the financial crisis. As we have long argued, the L shaped recovery always meant that the gap between recession and recovery was much narrower in this cycle and hiccups along the road to recovery were to be expected.

With this in mind, it is plausible to argue that companies were always likely to delay any final decision on new business investment plans and recruitment much longer than in previous cycles.

Our sense, from our members, is that many business investment and recruitment plans were beginning to be dusted down in the first half of 2011, only to be put back on the shelf in the second half of the year as the euro crisis exploded.

Graeme Leach: Chief Economist and Director of Policy

Snapshot

This edition of *Pulse* highlights:

- UK economic performance is topsy-turvy. At this stage in a normal cyclical recovery we should be expecting acceleration in quarterly GDP growth, broad money supply and inflation. In reality the opposite has happened.
- Regardless of the euro zone crisis, the latest GDP and broad money supply numbers justify a further extension in quantitative easing.
- Sharp potential falls in the CPI should remove any constraint – from inflation well above target – on a further large extension in QE.
- If QE2 reaches £200 billion it could raise the level of GDP by up to 2 per cent – ten times the 2011Q4 loss of output.
- QE2 works. In this topsy-turvy economy the UK outlook in the second half of 2012 could be better than expected – if (a big if) the euro-zone crisis stabilises.
- Business investment and recruitment plans which were postponed in the second half of 2011 could be implemented in the second half of 2012 – a lost year due to the crisis.

If these plans are filed as 'postponed' and not 'cancelled', any stabilisation in the euro-crisis, which is believed to be durable, could result in the plans becoming operational in the second half of this year.

In a sense we would have lost a year due to the crisis. What should have happened in the second half of 2011 eventually happens in the second half of 2012.

MONEY SUPPLY BAZOOKA

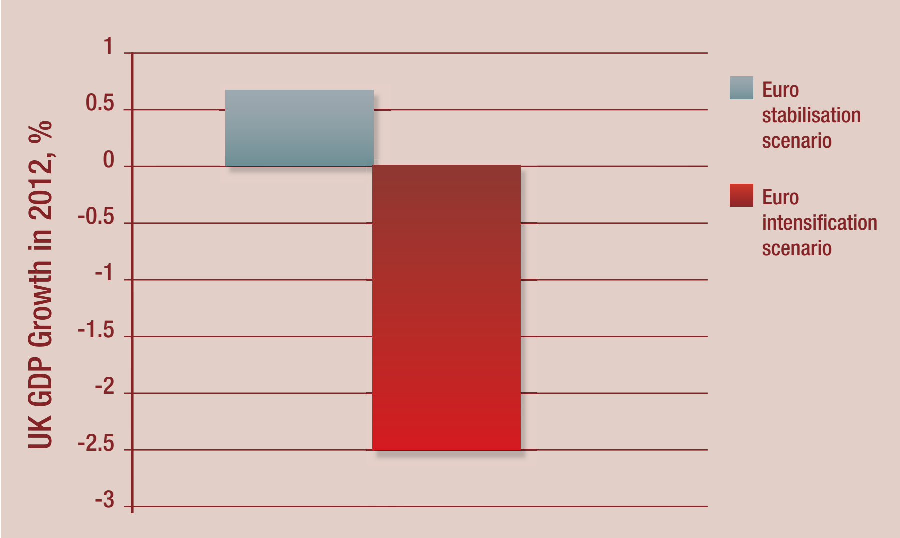
The Bank of England launched QE2 in late 2011 to inject a further £75 billion into the economy through the asset purchase programme. Despite this, overall broad money supply still contracted month-on-month in December and the key measure (excluding intermediate OFCs) rose by just 1.4 per cent (yr-on-yr). Broad money growth rates of this magnitude are incompatible with sustained economic recovery – we need to be up at 5-6 per cent plus growth rates on this measure. Consequently we expect the Bank of England to significantly extend QE in February or March.

The weakness of the UK money supply, together with the wider banking system difficulties on the continent, suggests that the next extension in QE could easily be £75 billion or more. Indeed QE2 could end-up being as great or greater than the £200 billion injection in the first round. These are big numbers and need to be seen in the context of the impact of the first round of QE.

The Bank of England estimates that the macroeconomic impact of the first round of quantitative easing was the equivalent of up to 300 basis points off the base rate – and shaved 100 basis points off gilt yields and boosted the level of GDP by up to 2 per cent.

Seen along side the relatively small 0.2 per cent GDP decline in 2011Q4, a 2 per cent increase in the GDP level over the next 12-18 months suggests the economic outlook may not be as bad as many fear. There is obviously no guarantee that QE will operate in the same way or to the same degree, as the first time around, but the broad orders of magnitude show that QE on this scale is not a spud gun, it's a bazooka.

Chart 1 – The UK and the euro – 2012 UK GDP scenarios



INFLATION AND REAL INCOMES

December's CPI figures brought good news on inflation, which is likely to continue in January, with last year's VAT increase falling out of the year-on-year index. Fairly chunky falls in the CPI can be expected over the coming year with the result that in the second half of 2012 incomes could finally be rising by more than inflation. The squeeze in real incomes over recent years – with inflation well above earnings growth - has clearly held back household consumption. Any real earnings[1] gains in the second half of 2012 are unlikely to be large, but will still represent a significant improvement in the growth of the core driver (real incomes) on the number one expenditure category (consumption) in GDP.

The danger here is that if the euro-crisis does intensify it will trigger a shake-out in the labour market, with rising unemployment and falling employment, which undermines any real income gains from falling inflation.

It all hinges on the euro-zone. If the situation stabilises, a flat UK GDP performance in the first half of this year could be followed by a pick-up in the second half. But if the crisis on the continent gets worse all the key drivers above could go into reverse. Investment and recruitment plans could be cancelled full-stop, and redundancy decisions accelerated. Deleveraging in the banking system could also put even greater downward pressure on the money supply, whilst rising unemployment reduces real incomes.

But this shouldn't be a surprise. Mr Topsy-Turvy designed the euro and its participants.

[1] Real earnings, refers to the difference between inflation and earnings growth. In other words it's an individual measure. Real income refers to real household disposable income growth, which is an aggregate of all incomes across the household sector, adjusted for inflation and taxation.