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UK:Expansionary fiscal austerity is a myth

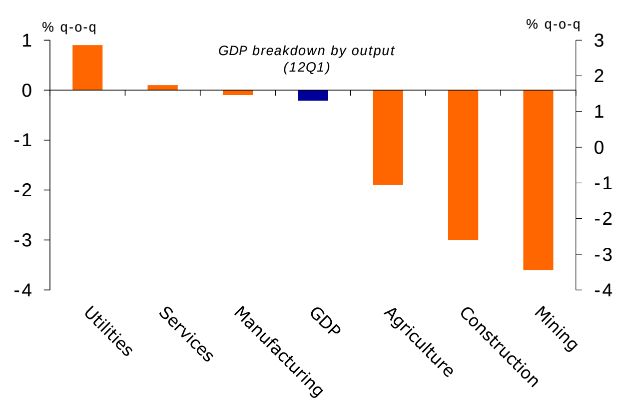
Rabobank

The recent GDP release suggests that the UK has also joined the recessionary club. However, reliable leading indicators point to a high chance of output being eventually revised upwards. But barring a very large revision, the big picture is that the economy remains exceptionally weak and this due to the government's harsh austerity drive. In our view, the coalition should slow down the pace of fiscal adjustment in order to effectively respond to the country's economic woes. Since we deem the probability of such a policy change as extremely low, we have decided to lower our GDP forecast for the current year to 0.5% from 1% previously.

The UK's recent GDP release for 12Q1 was simply disappointing. The economy shrank for the second quarter in a row by 0.2% q-o-q suggesting that a technical recession, which most (ourselves included) were not expecting, has become reality. Admittedly, the fall in GDP was driven by a 3% quarterly drop in the highly volatile construction output and there are doubts over the reliability of these numbers. The statistical office has stated that there is a tendency for construction output to be revised up by 1-2%. Then again, GDP would have done no better than stagnate if construction would not have knocked 0.2%-point off the headline growth figure. Overall, we should remind ourselves that over the past 20 years, the average revision to the initial estimate of UK quarterly GDP growth has been +0.2%. This is because the preliminary estimate of GDP is based on less than 50% of actual output data. So we shouldn't be surprised if the growth figure would be revised upwards to show that a recession was avoided after all. (We will not know for sure until the publication of the *Blue Book* that will be released somewhere in 2014). In fact, the weakness in output is difficult to reconcile with other indicators of activity. For one, the PMI surveys, which have been strong predictors of post-revision GDP data, were undeniably encouraging in the recent months (especially in the last month of Q1 were coverage of the hard data has been very patchy). The main balances of the manufacturing, construction and services indices point to quarterly GDP growth of around 0.5%.

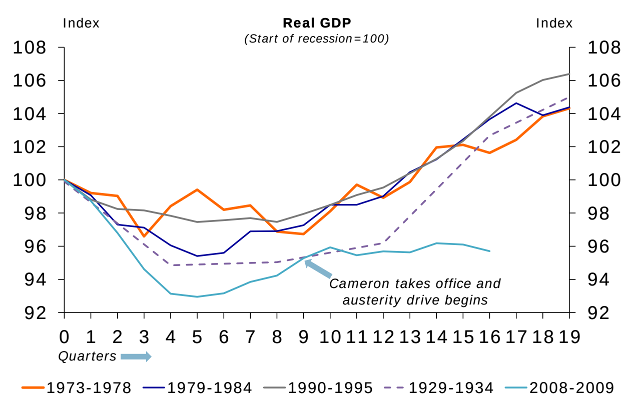
But barring a very large revision, the big picture is that the economy remains exceptionally weak. The stuttering nature of growth following the recession means that the economy is now weaker relative to its pre-recession peak than at the corresponding stage of the depression in the early 1930s (see figure 2). This does not come as a surprise to us. We have been saying from the start that the government's harsh austerity drive was going to be harmful for growth (e.g. see our Special Report – UK Budget: good politics, bad economics?, June 2010). UK's GDP has stagnated since David Cameron, the prime minister, took office (May 2010) and is now 4.3% below its peak of four years ago. From the G7 economies, only

Figure 1: Real GDP (production approach)



Source: Reuters EcoWin

Figure 2: Recovery has been worse than the 1930s



Source: Reuters EcoWin, Rabobank

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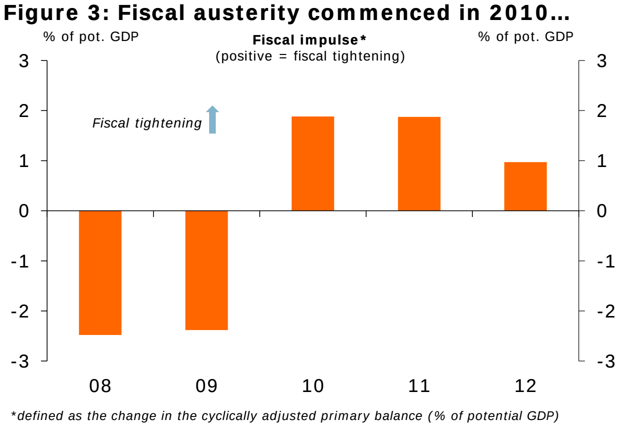
Italy seems to be fairing worse. What is important to realise is that this economic stagnation has been purely “made in Downing Street”. Figure 3 clearly illustrates that the coalition’s ambitions to tighten their belts (see figure 3) while the private sector was also in a deleveraging mode exactly matches the period that UK’s GDP started moving sideways. It’s worth mentioning that the highly disappointing economic performance is yet another proof that expansionary fiscal contraction was nothing but a myth. The belief that highly indebted consumers facing numerous headwinds such as high inflation and unemployment would in some magical way step in to fill in the gap left open by the government was wishful thinking if not plain absurd. Monetary policymakers could not make much of a difference given that interest rates were stuck at the zero bound and quantitative easing was unhelpful amid deleveraging in the banking sector. And as for the export sector, no one could have expected them to come to the rescue while the country’s major trading partner, the eurozone, is mired in a debt crisis.

So does the government plan to respond to this undesirable situation? Not at all! Following the release of the GDP data, Mr. Osborne said that “*the one thing that would make the situation even worse would be to abandon our credible plan*”. In other words, the coalition still maintains the view that fiscal austerity in the coming years is the right answer to the country’s macroeconomic woes. This is why they will be embarking on one of the harshest fiscal consolidation plans in the industrialised world going forward (see figure 4). With the exception of Ireland, all the troubled eurozone periphery countries will be going for a slower fiscal adjustment than the UK, according to the IMF’s recently published Fiscal Monitor. Adding more fiscal austerity while households and firms are still busy cleaning their balance sheets only leads to further economic pain down the road. Therefore, we continue to believe that a slower pace of fiscal adjustment and even short-term stimulus is a better medicine for UK’s economy than the current policy prescription of the coalition.

Implications for forecast:

Since we do not believe the government to make such a U-turn, we decided to lower our forecast for the UK economy from 1% to 0.5% in 2012. Mind you that GDP may contract once again in 12Q2 due to the extra bank holiday. However, growth is likely to bounce back in the third quarter, perhaps strongly thanks to the Olympic games in London.

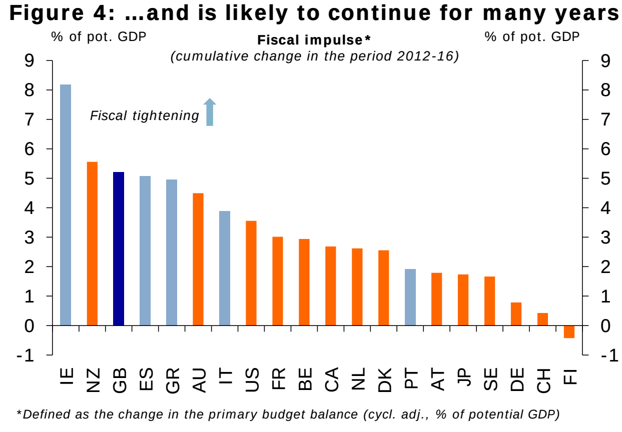
Figure 3: Fiscal austerity commenced in 2010…



*defined as the change in the cyclically adjusted primary balance (% of potential GDP)

Source: IMF, Rabobank

Figure 4: …and is likely to continue for many years



*Defined as the change in the primary budget balance (cycl. adj., % of potential GDP)

Source: IMF, Rabobank

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