HAPPY EVER AFTER?

By Dennis Turner, Chief Economist, HSBC Bank

When the recession finally comes to an end, it will usher in a new set of problems that could prove even more challenging for the UK economy.

How deep and how long the recession will be continues to dominate the debate among economists and policymakers. Opinions about how it will play out range from short and sharp (V shaped) to slightly longer (U shaped) and on to prolonged (L shaped). But at a time when forecasts are even more uncertain and tentative than usual, the most confident prediction we can make about the recession is that it will eventually end.

But the end of the recession is not the same thing as getting back to normal. There is a big difference. The recession will technically be over when the economy stops shrinking, or when the quarterly GDP figure stops being negative. A growth rate of zero per cent will be enough to declare the recession at an end. Given the extent to which policy has been loosened recently (interest rates at a 314-year low, record levels of government borrowing, and a much weaker currency), not to mention quantitative easing and the measures designed to bolster the banking system, this could happen by Q4 of this year. It would, therefore, be a five-quarter recession, pretty much in line with the average of the previous three.

But this will not be enough to stop unemployment rising, nor will it generate the tax revenues the government needs to stop its deficit continuing to escalate. For this, we need to return to our trend or sustainable growth rate, thought by most economists to be an annual rate of around 2.5 per cent, or 0.6-0.7 per cent a quarter. From the technical end of recession to the trend rate of growth is quite a big jump, and it could take most of 2010 to get there.

Goodbye stability

What sort of economy emerges from the recession is not an issue that yet features on the policymakers' radar. With the constant media glare and political attention on the housing market – and using activity on the high street as a weather vane – it seems the authorities are trying to kick-start growth by triggering the mechanisms that got us into trouble in the first place. The quick-fix out of recession may be to persuade consumers to start spending again, and to see house prices and transactions start to move upwards, but it is also a sure-fire route to the next downturn. Welcome back boom and bust.

Some idea of the extent of the economy's problems can be gauged by looking at the industrial composition between 2001 to 2007, when GDP rose by 16.5 per cent. The largest contribution to growth in those years came from property and business services. This sector, which accounts for 24 per cent of GDP, contributed 39 per cent of the increase in output. The second largest share (20 per cent) was from distribution (wholesale and retail, plus hotels and catering), which represents 15 per cent of the economy. The biggest mismatch between the share of activity and contribution to growth, however, was in financial services. Despite contributing to three per cent of GDP, it was responsible for 17 per cent of the rise in the size of the economy.

The unbalanced nature of the growth in industry terms is very clear and it mirrors the imbalances viewed from a spending perspective. A little over three quarters of the jump in GDP between 2001 and 2007 came from three industries, which together accounted for 42 per cent of the economy. The remaining 58 per cent added just 24 per cent, with the contribution from industrial production actually negative.

What makes this particularly worrying as far as future growth is concerned is that the three industries that were at the heart of robust growth have fallen furthest in this recession. As they are likely to remain in the doldrums long after GDP growth stops being negative, the UK will need faster growth from other sectors to get back to trend growth.

Manufacturing still matters

Rebalancing the economy in spending terms means less consumption and more exports and investment, which clearly has implications in industrial terms. The UK needs to be more internationally focused to ensure it pays its way in the globalised economy. One industry that is traditionally export-intensive and needs to invest is, of course, manufacturing. After years of being on the sidelines, manufacturing could move to centre stage once again.

For years, the UK has experienced the phenomenon common to most advanced economies of de-industrialisation. This has seen manufacturing's share of GDP fall from 32.5 per cent in 1970 to just 12.6 per cent in 2007. But the decline was relative rather than absolute, since the value of manufacturing was at an all-time high in 2007 and fell in only five of those 37 years. Any growth, however, paled in comparison with other sectors and so manufacturing's share declined.

There is no point in the UK going head-to-head with China in many product markets because, in terms of price, we will always come second. But there are areas in which the UK could have an important comparative advantage globally – areas where competition is about being smart not cheap. For example, pharmaceuticals rather than basic chemicals and aerospace rather than old-fashioned metal bashing. There are also parts of services, such as education, financial services and tourism, that can step up their sales to overseas customers.

The government has a role in this process, but as an enabler rather than a producer. Improved communications (broadband), better infrastructure links, competitive rates of corporate tax, less regulation, freer labour markets and the availability of educated, trained and motivated staff are the sort of supply side issues within the government's remit that would restore the UK's reputation as a good place to do business. If the major firms in the key industries are not already in the UK, we must persuade them that they should be. It might be a long haul, but building something sustainable will take time.

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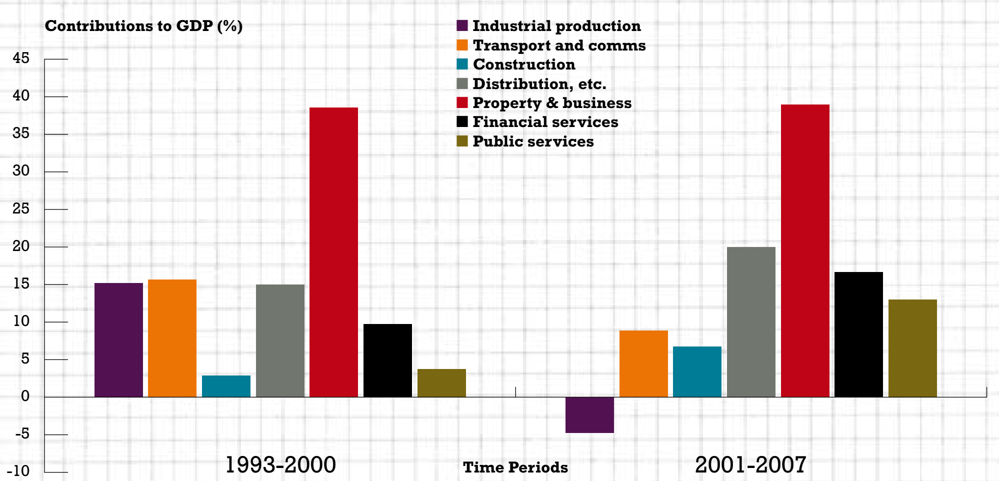
Restoring the balance



The industries that contributed most to growth in the UK economy are the very ones to have fallen furthest in the downturn. Other sectors will need to take up the slack.

Source: ONS

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