GREEN SHOOTS? WHAT GREEN SHOOTS?

Ideal growing conditions so far this year: lots of sun and lots of rain. Add to that the copious quantities of plant food that my wife has been ladling onto our garden, and it's no surprise that it looks the very picture of rude - not to say obscene – good health. Positively bursting with growth and fertility. Fecund is the word, I believe.

The same cannot be said of the economy. Equity markets and most commentators appear to believe that the worst is behind us and we are now on a path to recovery. Green shoots are everywhere – except in official data. The data suggest it's a wasteland out there.

Q2 saw UK GDP contract by 0.8%, (down 5.6% on a year earlier) – much worse than most economists were expecting. The recession has now been running for five consecutive quarters, and shows no signs of letting up in the short term. Policy measures to stimulate growth do not appear to be working.

We are currently one year into what is probably the most aggressive macroeconomic policy loosening in UK history. Bank rate is down by 500 basis points, and the structural fiscal position has deteriorated by 10% of GDP. And, since March this year, the Bank of England has embarked on Quantitative Easing (QE) worth £125 billion so far. Even without QE, we have not seen a policy loosening on this scale for at least three decades – as the table below makes clear.

	Fiscal stimulus *	Monetary stimulus **	Total
1980s	-1.8	-2.0	-3.8
1990s	-5.2	-4.0	-9.1
Early 2000s	-5.0	-4.3	-9.3
2008/09	-7.3	-3.3	-10.6

* change in cyclically adjusted government net lending as a % of GDP, OECD estimates

** change in the short real interest rate

Most macroeconomic models would suggest that, in normal times, a 1% point cut in real interest rates is 'worth' about the same as a 1% point of GDP loosening of fiscal policy, in terms of their impact on GDP growth, each adding around 0.5% to GDP growth one year later (in the range 0.2% to 1%, depending on the model).

Taking QE into account, and the substantial depreciation of sterling along the way, policy stimuli should be adding around 5% points to GDP growth – but GDP contracted by 5.6% in Q2 in spite of that.

And the structure of GDP growth (in terms of its output components) has also changed for the worse. Output of the service industries contracted faster in Q2 than that of manufacturing industries, for the first time in this recession. Given that the service sector accounts for 76% of UK GDP, that shift bodes ill for growth going forward. Moreover, transport services - which we would expect to pick up if a sustained recovery were imminent, as goods and people are moved around to meet expected demand - fell by 2.1% on the quarter. Finally, since all output components contracted in a quarter when retail sales growth was positive and net trade probably made a positive contribution, it seems likely that the widely expected bounce in inventories after the massive de-stocking in Q1 did not materialise. Firms are not building up their stocks, presumably because they do not yet expect a sustained increase in demand.

It's not just that there are no green shoots as yet: the roots are dead, and the soil is infertile. The policy measures will have some effect, but it could be a long time before that translates into significant growth.

In that context, it is surprising that many commentators are of the view that QE should and will be halted when the MPC meet in August. It is far from clear what the Bank is hoping to achieve with QE – whether the aim is to reduce gilt yields, corporate bond yields, or to boost broad money growth, inflation or nominal demand growth. But the clearest statement of its purpose was in a speech by Charles Bean (Deputy Governor) in May of this year. He said that the aim was to bring the growth in nominal demand (GDP measured in current prices) to a rate consistent with sustainable real growth and target inflation. That would imply nominal GDP growth of around 4.5% to 5% per year. Given that nominal GDP probably contracted in the second quarter by 4.3% compared to a year earlier, that leaves a mere 9% points or so to be achieved!

Of course, the economy will not go on contracting at its current rate forever, whatever happens to economic policy. But to assume that we're going to get 5% nominal demand growth without any further policy loosening seems very optimistic.

To pursue the gardening analogy, the sanguine view is like expecting a patch of rubble to turn into a flourishing garden in a few weeks, in a drought, having been treated with DDT, if we just leave it alone. It's not going to happen. Unfortunately, we have run out of monetary and fiscal measures to get things going again – all that remains is the 'miracle-grow' QE that we found at the back of the shed, decades old. We have no idea whether it will work, but we should keep on using it nevertheless.

Words: 872

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