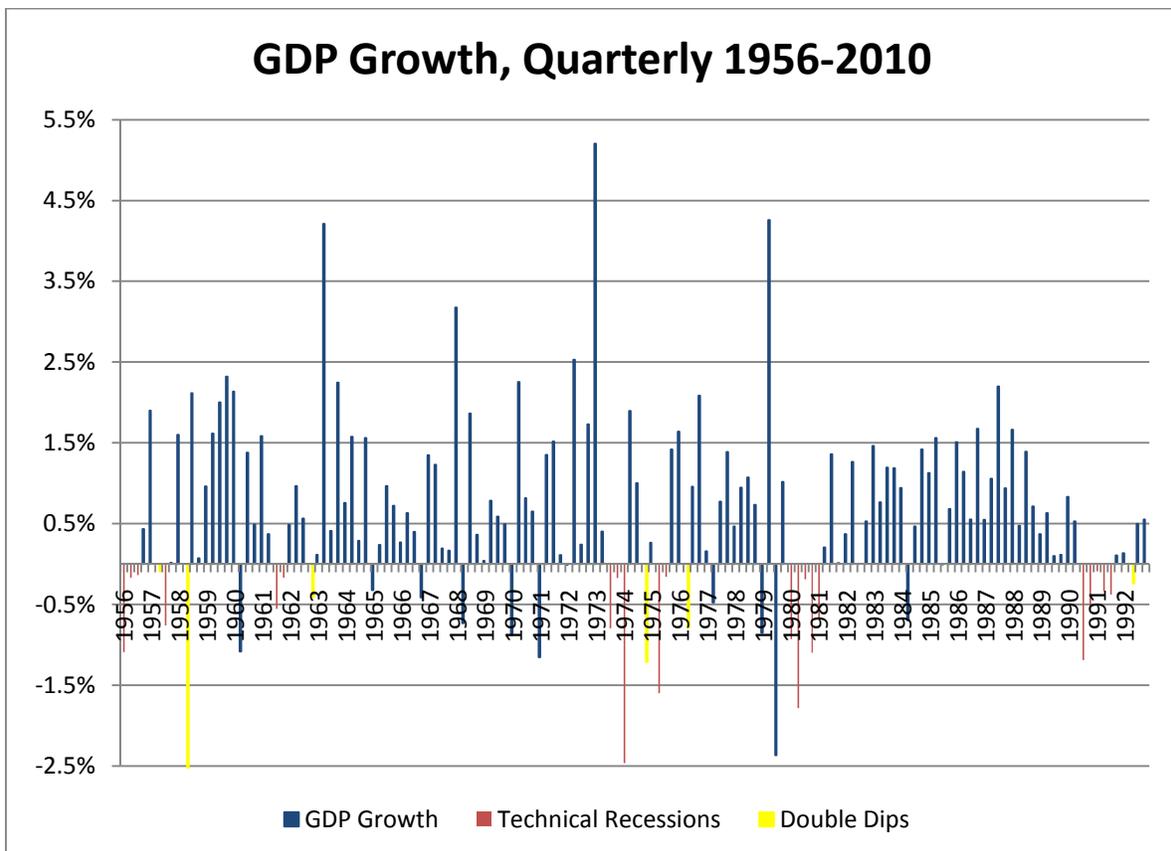


Five politically relevant things about where we are on the economy

Andrew Lilico

1) Double dips are not uncommon, and I expect there to be one this time.

Chris Huhne suggested recently that double dip recessions are rare and that talk of one occurring this time is Labour scaremongering. I'm afraid he is certainly wrong on the first; whether I am a Labour scaremonger I shall leave to others to judge.



By a “double dip” I mean a situation in which, following a recession, after a period of growth but before the previous trend level of output, there is a further period of contraction. Such events are by no means

uncommon. For example, there were double dip recessions in 1992 (output contracted in 1992Q2 after two quarters of growth), 1976 (output contracted in 1976Q2 after two quarters of growth), 1974 (output contracted in 1974Q4 after two quarters of growth), 1962 (output contracted in 1962Q4 after three quarters of growth), 1958 (output contracted in 1958Q2 after two quarters of growth) and 1957 (output contracted in 1957Q2 after two quarters of growth). Indeed, the only technical recession in the UK since records began that did not involve a double dip was that of the early 1980s — with the early 1980s recession escaping only on the technicality that the initial period of contracting before the second dip from 1980Q1 on involved two quarters of contraction (1979Q1 and 1979Q3) interrupted by a quarter of growth (1979Q2).

Thus double dips are essentially the uniform experience of the UK when there are recessions (and note that the one-time spending plans were materially cut back in the midst of recession – in the early 1980s – was the one time a double dip was averted, so double dips historically have occurred quite independently of fiscal consolidation), and I have always expected there to be one on this occasion, also.

2) A double dip recession will make it more important to cut spending early, not less important.

If/when there is a double dip, many commentators will presumably urge that the Coalition's fierce fiscal consolidation plans should be abandoned. That would be a bad mistake. With a double dip recession, tax revenues are liable to fall below forecast and expected future debt levels relative to GDP will rise. In other words, the risk that financial markets will lose appetite for UK government bonds, triggering an upwards spike in interest rates and the serious further slump that would entail, will rise materially. With a double dip recession, markets will be more demanding of urgent action, not less, and any sniff that the Coalition is losing the political will to carry its programme through could be disastrous.

3) A double dip recession would be quite compatible with a boom thereafter.

If the US and UK monetary authorities respond to the double dip as they should (and I expect they will) — namely by printing more money — and if the Coalition stays the course on cutting spending, then I expect growth through most of 2011 to be the strongest seen in the UK since the late 1980s (cf the recent experience of Germany). I believe that this will be the combined result of natural recovery-driven growth and massive and unsustainable investment driven by huge monetary growth. The model I have in mind is the early 1970s. Output in 1973Q1 was 10% higher than in 1972Q1; capital formation rose over that period by 25%. I'm not expecting growth in output or investment to be quite that rapid in 2011, but I do believe that this is an indicator of what enormous monetary stimulus can result in, if left in the system (which it

ought to be, and I believe will be, on this occasion — I don't believe the Bank of England will raise rates above 2% before late 2011 after a double dip, even if quarterly growth is exceeding 1.5% by then).

4) Once the economy gets growing sustainably, there will be a huge expansion in the money supply, which will lead to inflation.

In the UK, the monetary base (the narrowest concept of how much money there is) has quadrupled during the crisis (most of this increase has been what is called "quantitative easing" or, more loosely, "printing money"). Under normal circumstances, one would expect the result of such a huge expansion in the monetary base to be a similar expansion in the broader money supply, and consequently a large rise in the price level (if it were all to occur in one year — which it wouldn't — we'd be talking 300% inflation). Obviously these aren't normal circumstances, so the increase in the monetary base (the extra money printed) has actually served to prevent what would otherwise have been a sharp fall in the broad money supply — which is why I favoured it, and favour doing more still; for now the big risk remains, as it has been since 2008, that we will see significant deflation, nominal wages would fall, and people would default on their mortgages. We need to print more money now to limit that risk.

But once the economy starts growing properly again, more normal times will be restored, the banks will cease to fear imminent collapse, lending will expand (particularly lending for investment, rather than consumption — household balance sheets are still highly over-extended) and the money supply will grow rapidly. There will then be "too much money chasing too few goods" and as well as rapid growth in late 2011 and into early 2012, we will see rapidly rising inflation.

Of course, once inflation rises, interest rates will rise rapidly as well. Since interest rate rises will raise mortgage rates, the initial effect will be even more inflation. In the early 1990s RPI inflation went above 10% off the back of rapid interest rate rises. I expect a similar level of inflation in 2012 (that would imply CPI inflation exceeding 6%, vs its recent peak of 5.2% in September 2008 — thus what I'm proposing is only a slightly larger overshoot of inflation than that only two years ago). If we see no more than one year of inflation of above 10%, and no year of deflation of more than 5%, I shall consider the Bank of England's policy to have been a resounding and surprising success.

On the other hand, to keep inflation down to only 10% for one year, the economy will have to be able to tolerate interest rates of perhaps 8% (note that interest rates were 7.5% in 1998, so the rates I am suggesting were very normal before the past ten years). But there is a risk that, between now and 2012, households will not take the opportunity to reduce their debts by enough, and so the economy will not be able to tolerate 8% interest rates without the mass defaulting on mortgages that we are trying to avoid. If

that is the case, then interest rates may have to be kept lower for an additional nine months and the consequence will be inflation peaking at 20% rather than 10%, as in the 1970s (when there were two years of inflation above 20%).

Thus I could well be wrong in all kinds of ways:

- we might not have a double dip, so they may raise interest rates materially in the second quarter of 2011 instead of holding them below 2% throughout the year as I expect
- we may have a double dip and they might lose control of deflation, with prices falling dramatically through 2011 and 2012 instead of rising
- inflation might go much higher than the sorts of numbers I've suggested

There are huge uncertainties in all direction – I'm only describing my central case. But my central case – of 10%+ RPI/6%+ CPI and interest rates of ~8% - is by no means extravagant historically. Inflation reached these levels in the early 1990s and interest rates were close to that level in 1998. The fact that scenarios such as mine are so little discussed in the press is, to my mind, an indication that in certain quarters city commentary and financial journalism have lost their sense of historical perspective and their appreciation of the challenges of policy. It is also disturbing in that households may not be planning sufficient reductions in their indebtedness over the next two years to cope with what is to come. Policymakers in the early 1990s did not want inflation to exceed 10% — they simply lost control of the situation and were unable to prevent it. Are we really so confident that there is no change of policymakers today losing control of events? Does the history of the last three years suggest they have the omnipotence over inflation rates that much standard commentary assumes?

5) The consequence of interest rate rises will be another recession in 2013 or 2014.

When pondering the political cycle, think of this: the Coalition arrives; there are big tax rises; then there are massive, unprecedented spending cuts, involving more than half a million public sector job losses; then inflation races away; then interest rates spike up; then, after all that, there is another recession in 2013/14.

And all of this is the optimistic case — what happens if the government gets policy right and its policies work. I shan't sketch you my pessimistic case.

Enjoy selling that one on the doorsteps at the next General Election...



The work of the Economics unit at Policy Exchange

Rebuilding the British economy - Even as we manage our way through the recession, we need to think about how to transform the British economy so that we are ready to face the future. Our research looks at how to restore financial stability, and also how to reform government spending and regulation. We believe that with radical reform of the budget, tax, welfare, and the supply side of the economy, Britain will be able to enjoy sustainable and faster growth in the future.

For more information on the work of the Economics unit, please contact Andrew Lilico, Chief Economist at info@policyexchange.org.uk

About Policy Exchange

Policy Exchange, an independent educational charity. Our mission is to develop and promote new policy ideas which will foster a free society based on strong communities, limited government, national self confidence and an enterprise culture. In contrast to many other think tanks Policy Exchange is committed to an evidence-based approach to policy development. Our impact speaks for itself: from housing to policing reform, education to the NHS, our proposals have been taken on board by the main political parties. Registered charity number 1096300.

For more information please contact us at: Clutha House, 10 Storey's Gate, London, SW1P 3AY. Alternatively we can be contacted on 020 7340 2650 and at info@policyexchange.org.uk

Trustees

Charles Moore (Chairman of the Board), Richard Ehrman (Deputy Chair), Theodore Agnew, Richard Briance, Camilla Cavendish, Robin Edwards, Virginia Fraser, George Robinson, Robert Rosenkranz, Andrew Sells, Tim Steel, Alice Thomson, Rachel Whetstone, Simon Wolfson