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Bumping Along the Bottom: UK Economic Assessment at March 2010

By

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Introduction

Since the great crash of 2008/2009 there has been a partial but extremely weak recovery in most developed countries with growth rates ranging from 0.1% to 0.4%, but a somewhat stronger upturn in the emerging economies of China and India. This generally anaemic recovery has been due to massive government interventions designed to boost demand, since during the downturn both domestic consumption and business investment had collapsed (along with growth and trade). These types of interventions are now the standard operational procedure when there is a serious downturn in the economy. Injections of liquidity through monetary easing or fiscal activism (cutting interest rates, and taxes, as well as initiating public works programmes) is intended to fill the gap in demand which had been vacated by the private sector. However, this is an emergency measure and is by no means a long term panacea to the problems which global capitalism has run into.

The present global conjuncture is a massive area of discussion and analysis so I will attempt to restrict my commentary and prescriptions (if there are any viable prescriptions) to the UK and occasionally the US and EU.

Labour's Response to the Crisis

In order to contain the financial and banking crisis the Labour government has had to bail-out basket cases like Northern Rock, Royal Bank of Scotland, HBOS from their own short-sighted greed and financial myopia. But it should be understood that the banks would not have been able to carry on in this manner were it not for the active collusion of the monetary and Treasury authorities. In fact these banks became *de facto* nationalised industries insofar as the state now holds a majority shareholding. However, there has been no apparent *quid pro quo* as these banks have returned to their dissolute ways of lavish bonuses and risky trading. Moreover the suspicion remains that there are still considerable hidden toxic debts on their balance sheets.

In addition to the bail-outs the government, or rather the nominally independent Bank of England, reduced the base interest rate to 0.5% - an ultra-loose monetary policy which would – it was hoped – give a stimulus to borrowing by consumers and investors. Of course this didn't work since the monetary mechanism was caught in what Keynes' once called a 'liquidity trap'. This in essence meant that although the central bank made credit available it could not control the demand for cheap credit. After the crash, which was in fact largely caused by easy monetary policy, consumers were not overly keen to go further into debt; they were more concerned to pay down their existing liabilities. Similarly business investment took a nose-dive since viable investment outlets began to disappear, and in the deflationary conditions of industrial overcapacity there was no point in adding further capacity to existing capital stock. Moreover, banks began to restrict their lending – the great credit crunch – since they needed to rebalance their books after the losses that had been occasioned by their purchases of toxic debts – Collateralised Debt Obligations, (CDOs) and Mortgage Backed Securities (MBSs) and various other exotic debt instruments - and defaults on lending to sub-prime borrowers. And since nominal interest rates cannot be forced below zero then further monetary loosening through this method was essentially redundant.

Enter Quantitative Easing (QE). This is the new name for what used to be called 'Open Market Operations' and is another method whereby the Central Bank can attempt to control money supply. It is supposed to work like this. In practical terms, the central bank purchases financial assets including government and corporate bonds, from financial institutions (such as banks) using electronic money it has created out of thin air. This is supposed to increase liquidity (i.e., boost money in the economy) and result in an increase in the level of demand and economic activity generally. Of course this policy is not without its downside. The massive increase in the money supply means the government deficit is on course for a cool £163 billion by the end of the year. This is an unprecedented figure for peacetime and represents approx 12% of GDP – about the same as Greece 12.7%. The twin dangers here are (A) Inflation. Such a huge addition to the money supply is almost certain to have inflationary consequences in the near future. This is evidenced by the rise in both the CPI and RPI to 3.7% and 4% respectively.(1) (B) Related to this point is the reaction of the Ratings Agencies and the Bond markets. If there is one thing that bond markets hate it is inflation. Holding a government or corporate bond over a lengthy period with a fixed rate of interest does not sit well with sharp upward movements in price levels. If these markets get a sniff of inflation they will almost certainly demand higher premiums for their purchase of UK Government Gilts (Bonds). This will mean higher long term interest rates. Or, since bond prices and interest rates move in opposite directions a market sell-off of UK bonds, occasioned by a similar fall in investor confidence, will lead to an increase in long-term bond yields. In addition this eventuality could also be triggered by a downgrading of the UK's credit rating from its presently overvalued triple A status. Such a downgrade by one of the ratings agencies – Standard and Poor, Moody's or Fitch – would almost certainly spook the bond markets and lead to this outcome.

Other points relating to QE: much of the Bank of England (BoE) purchases went to overseas investors who now hold some 30% of UK gilts so that much of the increased money supply did not take place in the UK but leaked abroad. It should also be borne in mind that QE is a finite process, and, contrary to the conventional wisdom wealth (as opposed to paper money) cannot be conjured out of thin air.

It is now self-evident that the economy is in one of its worse fiscal positions on record. In the hole for 12% of GDP, with collapsing tax revenues, a deteriorating current account where exports have collapsed to a greater extent than imports: this in spite of the 20% devaluation of the pound against the euro and the dollar. (The weak currency enthusiasts, anti-euro school led by economic experts like Kaletsky in *The Times* and Elliott in *The Guardian* – have recently been noticably quiet in this respect).

This crisis of a twin-deficit will act as a significant restraint on future growth. This of course means rising unemployment, falling output and national income, as well as large scale bankruptcies. This will without question the case if QE is reversed and a recovery has not gained sufficient momentum to become self-sustaining.

Assessment of Labour's response.

There is little in the Labour government's response to the crisis (for once a correct description) to suggest that it has learned anything from the current financial and economic travails, and evidently there seems much that it does not even comprehend. It would appear that it is essentially relying on the same approach which was the norm in the period 1997-2007. This became known as the 'Greenspan put' after the then Chairman of the US central bank, the Federal Reserve Board, or more popularly 'The Fed'. At any hint of a downturn Alan Greenspan simply flooded the market with liqudity by keeping interest rates historically low for an excessive time period. It worked, up to a point. It was based on the creation of asset bubbles firstly in the dot.com boom and more latterly in the credit and property markets. Until it blew up in 2008 this bubblenomics became the template for economic policy in the UK, Spain, Ireland and Australia. Only now it is a busted flush. Humpty Dumpty has fallen off the wall and no amount of increasing the money supply is going to put him back together again. However, Labour seems to imagine that we can somehow get back to business as usual once the 'recovery' is in place. The strategy – if we can dignify it with such a term – is for further state support of the economy until a recovery begins to establish sufficient traction which will make it self-sustaining, at which point QE can be removed and the debts accrued by this policy can be paid down over a number of years.

The signs so far have not been encouraging. Unemployment has at best fluctuated but the general trend seems to be upward (2); the tax base has become seriously eroded, the balance of payments continues to deteriorate, one in four retailers are in trouble, the housing market seems to be stalling after a minor upturn. and there is no sign of private sector investment picking up.(3) In technical terms the massive credit bubble is deflating and companies as well as individuals are deleveraging – i.e., paying down their debts. Yet Labour's response seems little more than attempt to reflate the credit/property bubble. Nothing in its economic outlook seems to have changed: like the Bourbons it has learned nothing and forgotten nothing. It is determined at all costs to appear pro-business, market friendly, and to appease financial interests. New Labour is ideologically incapable of challenging a system to which it is signed up but which is systemically unstable. It is symptomatic in this resepct that the banks, having been saved by the taxpayers, have not changed any of their practises, nor are they being instructed to do so by the government. It seems abundantly clear, therefore, that the government has been subject to regulatory capture by the same banking and finance capital clique, aided and abetted by the Murdoch press – the Media Mogul before whom all Labour leaders cringe. This phenomenon is by no means restricted to the UK. It is much in evidence everywhere including the transatlantic collossus on the other side of the pond. Doug Noland explains.

> The markets' perception of "too big to fail" has for years been an integral facet of Bubble dynamics. And despite all the talk of trying to rid the marketplace of this notion, the markets remain more persuaded than ever: the unfolding global government finance Bubble is much too gigantic for policymakers to risk letting it come anywhere close to failing. Massive U.S. deficits and near-zero interest rates ensure a steady flow of finance (newly created as well as an ongoing exodus out of low-yielding instruments) to debt markets around the world. Confidence runs high that ultra-loose U.S. financial conditions will continue to underpin Credit expansions globally. Politicians may talk tough, and they do put on a good show. Meanwhile, markets function with reticent aplomb, knowing they've got policymakers right where they want them.(4)

A more radical and appropriate response to the crisis would include outright nationalisation of some, if not all, the banks with no compensation – they have had enough compensation already. Secondly there should be a strict demarcation between retail banking and investment banking. Retail banking should be treated as a public utility with a remit to serve households and business with credit at reasonable rates of interest. Interest rates should be such as to incentivize households to save – since such saving forms the basis of investment capital for mortgages and business (particularly small business investment). Under no circumstances should retail banks be allowed to trade in financial markets in currencies, derivatives, shares, bonds and any other securities. These activities should be left to investment banks and there should be no bail-outs if such speculative activities result in bankruptcies or big write downs. We don't bail out Ladbrokes so why should we bail out these City high-rollers. This is in essence a return to the Glass-Steagall Act which was passed by the Roosevelt administration in the 1930s in the US, and repealed by Clinton in the 1990s.

Secondly, more control on capital movements, particularly speculative capital and short term credits ('hot money') by means of measures such as the Tobin tax and the possible reintroduction of exchange rate controls. This would need agreement at least at a regional level, but ultimately at a global level. Thirdly there must be a system to replace the exchange rate mayhem and currency manipulation which is giving rise to competitive devaluations. This would need to be on the scale of a new Bretton Woods system. The current world imbalance between surplus and deficit countries cannot and will not be allowed to continue. There must be a system of exchange rates which is fixed but with some flexibility for the weaker currencies to make adjustments.

As far as the UK is concerned its propensity to devalue – Wilson, 1967, the pound in your pocket - has been the source of weakness not strength. It must be definitively decided whether we integrate further into the EU or simply become confirmed as a leading US client state, which is precisely what the right in this country have always wanted. This is a crucial question and the whole future of the UK is dependent on the outcome. It needs a separate discussion which is why I restricted my contribution to a passing comment.

Fourthly, the pivotal role of housing and house prices in the UK has been parasitic on the real economy. Investment capital which might have gone to upgrade industry and manufacturing has sought easy pickings in the (illusory) notion that ‘bricks and mortar’ were the most worthwhile and safest investment. Similarly the house price bubble was responsible for the present levels of indebtedness since it was believed that the value of property would always rise thus obviating the need for savings and a reasonable pension.

Fifthly, there must be a comprehensive reindustrialisation of the UK. Specialising in Financial services (becoming a one-crop economy) left us vulnerable to any downturn in that sector. We now have the opportunity to invest in green technology and a high value added manufacturing sector. It is a matter of political will and of facing down the same financial interests which have brought us to the brink of disaster. The policies of the Thatcher/Blair governments have been tilted towards these same financial interests and ignored the manufacturing sector and this has resulted in the UK suffering from structural balance of payments problems. Clearly this lunacy has to end – the sooner the better.

It is difficult to know with any precision what the detail of such policies to deal with the crisis might be, since we are not aware of how deep and acute the situation will become. One thing is for sure, however, the days of borrow and spend are over. But if we are to have austerity, then there is no reason why this should not be an opportunity to transform our country into something approaching a popular social-democratic dispensation. It has always been my belief that there is a natural social-democratic majority in the UK; unfortunately it has never had a voice, at least not since the mid 70s. There is no reason why this should not be so. The main obstacles are political. Given the outlines of the above emergency programme for dealing with the end of the neo-liberal epoch, what chance of the Labour party adopting such policies? Absolutely zero. This means in effect the majority of the population are effectively disenfranchised. You can either vote for a neo-liberal, neo-imperialist, centre-right business party, or you can vote Tory. Such is the state of democracy in the UK circa 2010. However, since the rise of the Liberal-Democrats the political situation has become more fluid. What this might mean for economic developments is too early to judge at this stage.

So for the time being at least it seems that a series of non-solutions will be applied to the current and future situations. Prepare to bump along the bottom for a while yet.

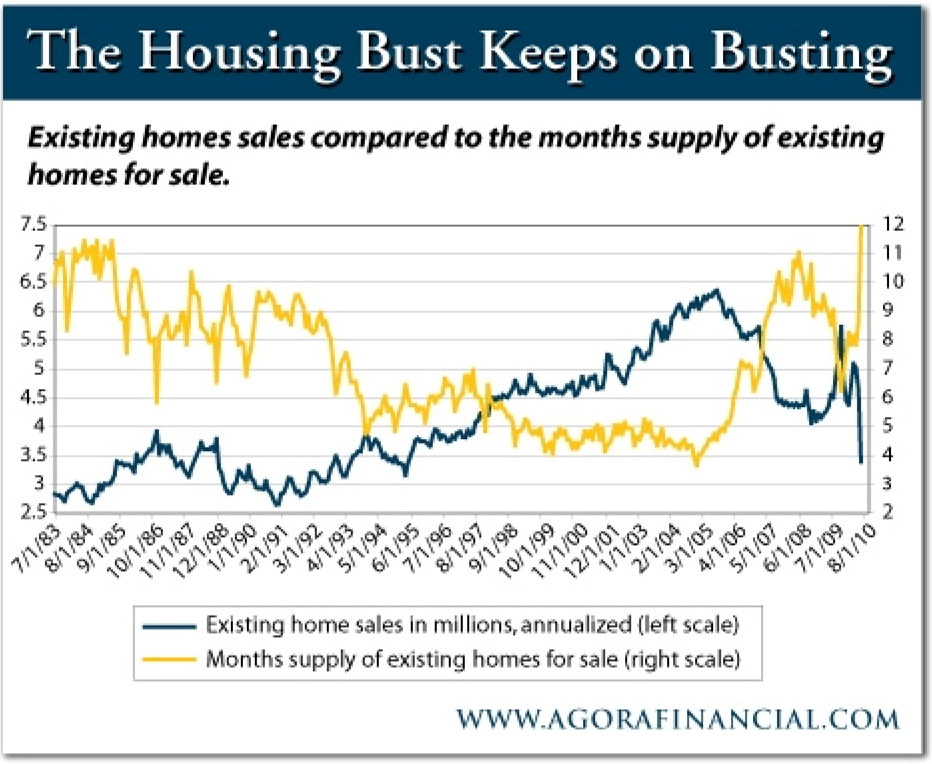
EPILOGUE: September 2010

Since I wrote the above assessment important political changes have taken place. In the May General Election the Tories received the largest share of the vote, but were unable to form a government without the support of the Liberal-Democrats. But this is a coalition in name only since the Lib-Dems have not had a noticeable impact upon policy making. Vince Cable's Damascene conversion to a *de facto* deflationary economic policy clearly indicates this. Brown has gone and Labour are in the process of electing a new leader. It is perhaps interesting to note, that with the exception of Abbott and Miliband minor, all the other candidates were part of the Blairite *Nomenklatura* 1997-2010. It is also significant that the candidates are lately distancing themselves from their compromised past in their attempt to not only clear their own political record, but to detoxify the Labour Party from its neo-liberal New Labour past.

As far as economic policy goes the coalition has opted for a drastic deficit-reduction programme involving unprecedented (for peace time) public spending cuts; this in order to reduce the present dangerously high level of sovereign debt. A present the deficit is around 11% of GDP not that far from the Greek level. The argument runs that such a deficit is unsustainable in the long run (which is generally correct) and the continuation of such a fiscal imbalance with result in a bond market strike where investors refuse to buy government bonds, or, will only buy such debts if the yield is raised (which is more problematic). This was certainly the Greek experience which led to the implementation of the austerity programme in that country. Without question this policy is deeply deflationary. It is pro-cyclical in the sense that it is going with the present economic current of deleveraging and consisting of public spending cutbacks leading to diminishing growth. It will certainly produce higher unemployment, slower or even negative growth, bankruptcies, poorer public services and a fall in national income.

The response from what might loosely be called the Keynesian school (see Krugman and Stiglitz) was that investors were in fact still buying bonds, particularly US Treasurys, and there was no sign of a strike by the so-called bond vigilantes (this was Krugman's argument). Now in normal times the bond vigilantes would be out in force to stymie any attempt at any government increasing the money supply and flirting with inflation. These are not normal times, however, and we have a situation where investors are piling into sovereign debt instruments as safe havens, this in spite of the huge increase in money supply which has taken place in the EU, East Asia and is still taking place in the US. This paradox being the case a window of opportunity may exist for nations to borrow on debt markets by issuing bonds at historically low yields of interest. The reflationists (inflationists?) argue that with sufficient stimulus of aggregate demand the economy can grow its way out of trouble and in doing so help pay down the deficit. The standard Keynesian response to cyclical crises (if this is a *cyclical* crisis as opposed to a structural one – the jury is still out on this one).

But it is an awesome gamble; essentially a game of double or quits. Given the American experience of a fiscal stimulus of nearly US$1 trillion and a spurt in growth which is now petering out to a level not even high enough to prevent unemployment rising, the results don't appear encouraging. (See charts below, courtesy of *The Daily Reckoning* 24/08/10.) The US Central Bank as well as the Treasury Department have thrown everything but the kitchen sink at the downturn only for the economy to respond and then fall back again towards the dreaded double dip. Bernanke's solution is essentially more of the same. We cannot know whether it will succeed, but it seems doubtful.


The Housing Bust Keeps on Busting
Existing homes sales compared to the months supply of existing homes for sale.
7.5
7
6.5
6
5.5
5
4.5
4
3.5
3
2.5
12
11
10
9
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7/1/83 8/1/84 9/1/85 10/1/86 11/1/87 12/1/88 1/1/90 2/1/91 3/1/92 4/1/93 5/1/94 6/1/95 7/1/96 8/1/97 9/1/98 10/1/99 11/1/00 12/1/01 1/1/03 2/1/04 3/1/05 4/1/06 5/1/07 6/1/08 7/1/09 8/1/10
Existing home sales in millions, annualized (left scale)
Months supply of existing homes for sale (right scale)
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No Jobs, No Recovery
The percentage of the U.S. population that is employed.
66%
65%
64%
63%
62%
61%
60%
59%
58%
Dec'83 Oct'84 Aug'85 Jun'86 Apr'87 Feb'88 Dec'88 Oct'89 Aug'90 Jun'91 Apr'92 Feb'93 Dec'93 Oct'94 Aug'95 Jun'96 Apr'97 Feb'98 Dec'98 Oct'99 Aug'00 Jun'01 Apr'02 Feb'03 Dec'03 Oct'04 Aug'05 Jun'06 Apr'07 Feb'08 Dec'08 Oct'09
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Like the US authorities the UK Labour party, proposes a similar reflationary strategy based upon increased public spending - unlike the US authorities, however, it has the inestimable luxury of being in opposition - but the policy ignores major problems. Firstly expansionary fiscal policy means adding to a deficit which is already at historically high levels. This has the potential for significant inflationary pressures; pressures which the Bank of England has so far singularly failed to control. Secondly, although the bond markets are quiescent now, a sustained inflationary burst may well spook them into a panic sell-off. This will raise long term interest rates and kill off any recovery. Thirdly, and perhaps most importantly, businesses, consumers and investors are deleveraging; paying down their debts, cancelling investment projects, fleeing to what are perceived to be safe havens – like government bonds, gold and other commodities.

For the time being then the great market correction rolls on; attempts at holding it back have met with only a very limited and partial success. It looks like the best case scenario will be jobless growth (growth, but not at a high enough level to prevent a rise in unemployment), or worse case scenario, a dip back into negative growth and recession. This is to be expected from what has been the deepest economic global crisis since the 1930s. Solutions seem in short supply. Indeed there are those on the fringes – Marxist and Austrian schools – who argue that there is no solution; or rather that the problem (of crisis) *is* the solution. And given the gross excesses of the bubble years and the present massive debt overhang which resulted, they may well be right. The crisis in question consists of a fundamental restructuring process by which bad investment decisions, over or underinvestment, poor and mediocre management performance, massive market failure and resource misallocation results in a general destruction of capital values, a fall in prices and writing off of debts and businesses which should go bust but are kept alive by public infusions of capital (zombie businesses which account for up to 30% of all enterprise) all of which sets the scene for a new and higher round of capitalist accumulation. I'm agnostic on this. We shall wait and we shall see. This one could drag on for years.

Sources:

(1) UK Office of National Statistics – April 2010

(2) (Op.cit)

(3) (Op.cit)

(4) (Doug Noland – www.prudentbear.com. – March 2010)