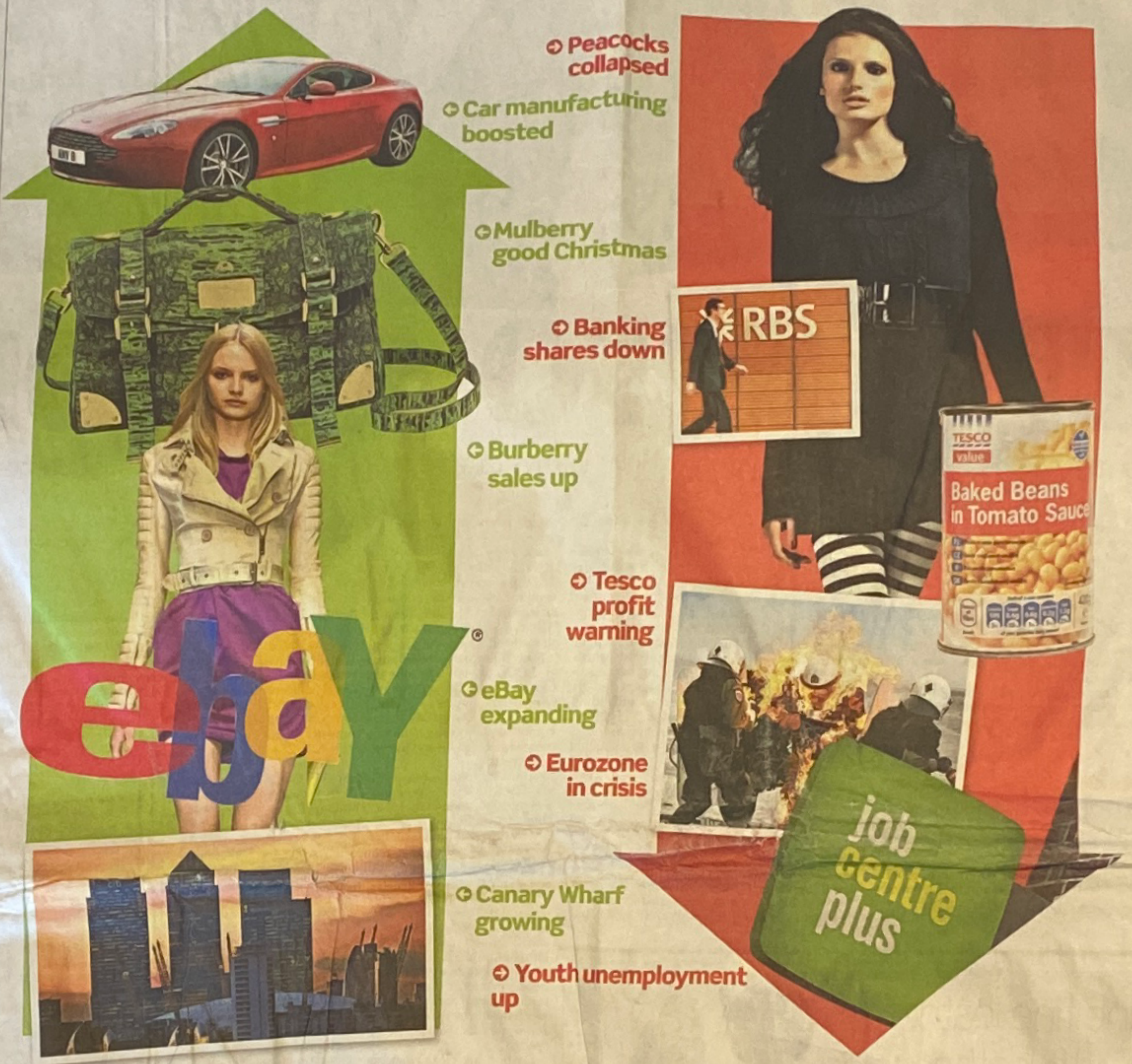
# UP OR DOWN?

George Osborne is braced for difficult fourth-quarter GDP figures this week. **Angela Monaghan** reveals divergent views on whether it will be good or bad news for the Chancellor



If the doomsayers are correct, the Chancellor of the Exchequer could be facing a pretty gloomy few days. With GDP figures due this week, there have been countless warnings of an imminent recession, a looming credit crunch and potential euro break-up.

If the cheeries are correct, George Osborne could be allowed the hint of a smile. Car production figures are up, inflation is down, Britain has avoided a downgrade and there have been some good corporate results from the likes of, among others, Burberry.

The key question is, which is it? Up or down? Economists are divided on just how bad it is likely to get for the UK in the coming months, revealing a growing divergence of opinion on the type of 2012 Britain will enjoy.

There is plenty of intellectual muscle on either side, from Gerard Lyons, chief economist at Standard Chartered, to Simon Ward, chief economist at Henderson Global Investors.

Lyons believes the economy is already back in recession, and will contract by a decisive 1.3pc this year. Ward thinks his peers underestimate the underlying strength of the economy, which he says is likely to grow by about 1.25pc-1.5pc this year, supported by strength in the US and emerging economies.

Both men are respected City economists but have strongly opposing views. So who is right?

The first clue may come on Wednesday, when we must look back to the fourth quarter in order to move forward. The clearest indication of where we are now will be provided by the Office for National Statistics (ONS), when it delivers its initial verdict on how the economy performed in the final three months of 2011.

The consensus among City economists is that the economy slipped back into negative territory, contracting by 0.1pc.

Lyons is forecasting a far sharper fall in gross domestic product of 0.7pc, citing a weak manufacturing sector and a struggling domestic and external environment.

He thinks GDP will fall by 0.9pc in the first quarter of 2012, followed by a fall of 0.5pc in the second quarter, before returning to growth of 0.2pc in the third.

Standard Chartered got it right with a bullish forecast in the third quarter, predicting correctly the surprise 0.5pc growth revealed in the ONS's first estimate (subsequently revised up to 0.6pc).

"We were correct there but while one tries to get the figures right sometimes we tend to overanalyse the detail," Lyons says, suggesting too much emphasis can be placed on one number.

That is one thing that Ward does agree with, and he will not be drawn on a specific number for the fourth quarter. He indicates, however, that even if the ONS does announce negative growth, his viewpoint will still stand, given the ONS tends to revise its numbers even years after the event, once it has gathered all the relevant data.

"Whatever number they pull out of the bag next week, in three years' time the ONS will probably be saying there was growth in the fourth quarter. I think growth this year will be stronger than the consensus thinks, driven by the US and emerging economies," he says.

The hard data for the fourth quarter so far have shown a manufacturing sector in decline, and a weak start to the period for the services sector. Some of the business surveys, including the highly respected Markit/CIPS PMIs, have told a more positive story, but are not included within the official numbers.

"The evidence is consistent with the economy having eked out some marginal growth in the fourth quarter," says Ward, with a nod to the PMI surveys and the labour market, which he says shows stable employment. "I'm not laiming last year was a good ear by any means but I on't think it was as bad as any think."

He says the picture in 2011 as distorted by certain actors including the isruption to North Sea Oil roduction, largely because of aintenance work. He also tes a record low number of orking days last year, ecause of the extra bank oliday given for the royal edding and the way eekends fell.

For his part, Osborne has vested time over the past w days on managing pectations ahead of the NS estimate.

While in private he may nk the odd fraction of a rcentage point here or re does not make a huge ference in real economic ms, he knows it is crucial on the political battleground and in the public psyche.

"You don't have to tell me that the economic environment is very difficult for Britain and indeed for the whole world," he told the FBC.

> I think growth will be stronger, driven by the US and emerging economies
> **Simon Ward,** Henderson

"When you look at the GDP numbers from Britain, they are very similar to the GDP numbers of France, Germany and other Western countries. I don't know what next week's GDP number is going to be. Our independent forecaster, the OBR [Office for Budget Responsibility], has warned us that it may well be a negative number. That was their forecast in November, but they didn't forecast a recession."

A Treasury spokesman reiterated the OBR's fourth quarter forecast, emphasising external factors.

"This is the result of last year's high inflation and the continued uncertainty in the eurozone. The global economic outlook is certainly challenging but there are reasons to be optimistic: inflation is coming down, business surveys show the service and construction sectors strengthening, and the Government's credible fiscal plan is helping keep UK interest rates at record lows," he said.

Whatever the number is, the Chancellor will be safe in the knowledge that the fourth quarter is, at least, historic. The trouble is that the immediate outlook is not exactly sunfilled. The eurozone crisis remains the biggest single threat, but the economy has entered 2012 against a domestic backdrop of a depressed consumer environment, deteriorating business confidence and a potential bank funding crisis.

Sir Mervyn King, the Governor of the Bank of England armed with a greater responsibility for financial services regulation thanks to George Osborne, has repeatedly warned that the last - driven by the renewed credit crisis plaguing European banks - should be closely monitored and not underestimated. The last global credit crisis resulted in the collapse of US investment bank Lehman Brothers and triggered a global recession.

With the Budget just two months away, it is very difficult to see what, if any, giveaways the Chancellor will be able to offer in order to ease the burden on the British people and businesses. If by then it looks almost certain that the country will slip back into recession at the end of the first quarter, his challenge will be all the greater.

The markets have become well accustomed to "shocks" from the eurozone over recent months – repeated concerns that Greece is going to default; failed bond auctions; soaring Italian bond yields and credit downgrades.

Markets remain edgy but just about shrugged off Standard & Poor's decision to strip France of its AAA credit rating. As the crisis rumbles on with no resolution in sight, the risk of a collapse of the eurozone in its current form still cannot be ruled out.

Jonathan Loynes, chief European economist at Capital Economics, said that a limited break-up of the eurozone beginning this year could knock between 3pc-4pc off UK gross domestic product by the end of 2013.

"A bigger, more disorderly, break-up could have much more damaging effects," he adds, ominously.

> Inflation should ease off and help the recovery in the second half of the year
> **Gerard Lyons,** Standard Chartered

Capital Economics is forecasting a limited break-up this year, with a Greek exit followed by the departure of smaller countries – probably Portugal and Ireland – in 2013.

"Even a limited break-up will have serious adverse effects on the eurozone economy. We expect eurozone GDP to contract by around 5pc in 2012 and 2013 together, similar to the drop seen during the global recession of 2008-09.

"This will hit the UK economy through a number of different channels. Exports to the eurozone could drop by around 10pc, enough on its own to knock some 1.5pc off UK GDP. This would be distinctly unhelpful at a time when the UK's economic plans rely on a boost from net trade. But the direct trade impact could be overwhelmed by the financial ramifications and the negative effects on wealth and confidence."

Most economists are agreed that the one bright spot for the UK economy this year is likely to be inflation, which is expected to fall sharply from a high of 5.2pc in September 2011 to closer to the 2pc target.

That trend was reflected in the latest data published last week, which showed annual inflation slowed to 4.2pc in December from 4.8pc in November. It is likely to accelerate from there, as the Coalition's January 2011 VAT hike drops out of the annual comparisons.

Ward says: "The more favourable background [in the US and emerging economies] is important in terms of confidence and on top of that you've got inflation coming down. I think you'll see some real consumer spending growth."

But while Lyons is willing to concede that lower inflation is "good news", he seems to suggest that really it is rather a case of less bad news.

"The good news has been inflation, but the falls reflect a working through of a past spike and the fact that retailers do not have much pricing power. Overall the picture is one of a soft economy," he says.

"Inflation should ease off and help the recovery in the second half of the year but lower inflation doesn't automatically translate into higher consumer spending."

Consumer confidence is back at recession levels, as unemployment continues to rise, wage growth remains weak and the effects of lower inflation have yet to be felt.

"It's a fragile West and resilient East, with a steady but not spectacular recovery in the US, a deep recession in the eurozone and the UK getting caught up in it all."

He says his pessimistic view is backed up by key criteria for the outlook: one – the fundamentals do not look good; two – there is not much room for manoeuvre on policy; and three – confidence is fragile.

Uncertainty is rife in the current economic climate and Howard Archer, chief UK and European economist at IHS Global Insight, is among those who believe Britain's fourth-quarter performance is too close to call.

"There is major uncertainty over whether or not the economy managed to avoid contraction in the fourth quarter of 2011. We estimate flat activity but acknowledge that there is a very real risk that GDP fell modestly, which would put one foot back through the recession door.

"Whether or not the economy contracted at the end of 2011, it clearly faces a daunting start to 2012 and we expect this to be reflected in January survey evidence on retail sales and on manufacturing activity. This is clearly of concern to the Bank of England and we expect the minutes of the January Monetary Policy Committee (MPC) to open the door wide to more quantitative easing in February."

Those minutes will be published on Wednesday, and although they are likely to show the MPC was unanimous in its decision to leave policy on hold earlier this month, they will no doubt emphasise the committee's ability to do more should members deem it necessary next month.

The Bank does still hold some cards in the form of QE, and is expected to pump more stimulus into the ailing economy from next month, with an extra £50bn-£75bn of QE. At that point, it will have completed the latest round of £75bn of additional asset purchases, taking the total QE spend to £275bn.

But economists say there is evidence from gilt yields that this latest round is having less of a positive effect on the economy than it did the first time around, when a total of £200bn of stimulus was pumped in through QE.

Senior bank officials have cautioned as much themselves, and any further QE could be as much about boosting confidence as anything else. Such a move would [illegible] Britain has in its armoury something the individual eurozone countries do not: autonomous and more flexible monetary policy.

While further QE may support the economy, not least by providing that boost to confidence, it is unlikely to provide the silver bullet.

Nor is the Chancellor likely to be able to pull any rabbits out of his red Budget box come March, but he will have to navigate the choppy seas of the eurozone crisis nonetheless.

He will be hoping that Ward's more optimistic view is proven correct.

## THE THUMB INDEX: THE UK'S UPS, DOWNS AND IN-BETWEENS

**INFLATION**

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KEY NUMBER: **2pc**

Most economists agree this could be the one bright spot for the economy in 2012, falling from a high of 5.2pc in September 2011 to close to the 2pc target. A weaker economy, lack of a VAT rise and moderating global commodity prices are all expected to weigh down on inflation. It would be a source of great relief for the Bank of England, which has been criticised for its persistent failure to hit the target in recent months.

**PMIs**

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KEY NUMBER: **50**

There were mixed messages from the December PMIs, published at the beginning of January. The surveys for the services and construction sectors remained above the 50, indicating expansion. But the manufacturing PMI came in below 50 and economists said there were some worrying indications in all three surveys, which are not included within the official growth data. British exports in particular look under threat from a deteriorating situation in the eurozone – the UK's biggest trading partner.

**UNEMPLOYMENT**

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KEY NUMBER: **3 MILLION**

Unemployment rose more slowly than expected during the initial phase of the financial crisis that took hold in 2008. However, it is once again on the rise, and hit a 17-year high of 2.69m in November in the latest available statistics. Economists are forecasting that it will creep closer to the 3m mark into next year, with jobs both in the public and private sectors at risk.

**QUANTITATIVE EASING**

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KEY NUMBER: **£325BN**

The Bank of England's asset-purchasing scheme has been an economic barometer of sorts since its introduction in March 2009 at the height of the crisis. It was subsequently put on hold, and then restarted in October 2011 when eurozone concerns accelerated. So while quantitative easing is designed to stimulate the economy, it is also an indication of weakness. A further £50bn injection is likely in February, taking the total to £375bn.

**RETAIL SALES**

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KEY NUMBER: **1.1PC**

Official retail sales showed that British consumers flocked to the shops in the run-up to Christmas after a weak November, much to the relief of the sector. Looking at the fourth quarter overall, economists say the data point to a 1.1pc rise. Further ahead the outlook is more uncertain. Fears remain that embattled consumers will put away their purses post-Christmas, though lower inflation could ease the squeeze on households.