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Things are still bad but not disastrous

Friday, 24th July 2009

EDITOR'S LETTER

ALLISTER HEATH

WE will know this morning by how much the British economy shrank in the second quarter. The good news, if one can call it that, is that the official figures will confirm that after falling off a cliff in the first quarter, economic output fell by much less in the subsequent three months. And although today's backward looking stats won't show this, yesterday's strong retail sales numbers were further confirmation that the economy is now roughly stagnant, rather than collapsing.

Growth will return next year but it will be anaemic; an expansion of 0.5 per cent in 2010 is a good guess. The extreme pessimists, who convinced themselves after Lehman Brothers than we were set for another Great Depression, have been proved spectacularly wrong (as I have been arguing since January they would). The arch-optimists, who are convinced that strong growth is just around the corner, will also be bitterly disappointed.

There are several reasons why the worst has been averted. Perhaps most important of all, payments systems survived the crisis unscathed: cash did not stop flowing from ATMs, bank websites did not all collapse, records were not erased and catastrophe was avoided. For all the criticism that has been directed towards the banks, the prevention of this particular potential Armageddon was a great success.

The second reason was that the financial crisis was prevented from spiralling out of control. The stabilisation of the banking system was botched and conducted in an irrational, costly manner, but at least it helped stabilise the economy. It was right to allow Lehman to go bust; but with the benefit of hindsight, the bail-out of AIG and some other firms was a mistake. As a new Cato Institute paper points out, Fed vice chairman Donald Kohn told the Senate Banking Committee that all of AIG's derivatives counterparties could have withstood its default. But given the starting point, some of the policies were good; Libor soon started falling back; crucially, the money supply was prevented from declining (although its growth remains anaemic, when adjusted for distortions in the data). The need to keep money growing was a great lesson from the 1930s (the other, that Keynesian economics is bunkum, has been ignored over the past two years).

Perhaps most important of all, the liberal international economic order has largely survived. Nobody in any position of power, bar a few crazies, want to reintroduce trade barriers or capital controls. I remember having lunch with a top economist in Canary Wharf six months ago; we discussed whether large, globally integrated financial institutions would still be allowed or whether we would return to protectionist, small-scale banking within national borders. Fortunately, protectionism has been defeated, albeit by default. The debate between those who want to reform global banking – versus those who want to shut the whole thing down and move towards communist-style, state-owned utilities directing credit, has been won by the former camp.

Last but not least, the recession double-dippers have little to show for their forecasts. But they could still have the last laugh: China's recovery is largely bubble and liquidity led, and could end in tears. For the time being, however, the outlook is one of stagnation – bad, but much better than most were forecasting just nine months ago. allister.heath@cityam.com

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