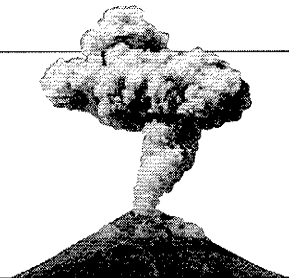


Opinion

After New Orleans
– five cities you
wouldn't move to

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Falling pound means that the only way is up

Despite the Government's modest and ineffective 'rescue package', the outlook is looking brighter for Britain's economy

Anatole
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How can you stabilise a market worth £4,000 billion by spending £1 billion? The answer is that you can't.

If the Government had been serious about supporting the housing market, it would have focused on lenders rather than housebuilders and first-time buyers, extending to new loans the Bank of England funding now available on old mortgages. By offering the Bank of England as a backstop to new mortgage lending, the Government would have brought Britain into line with the more generous central banking policies in the US and the eurozone, potentially unblocking the supply of new loans.

While British banks and building societies lobbied vigorously for this relatively low-cost technical change, the Bank of England opposed it, and the Government opted instead for more "eye-catching" initiatives — a small reduction in stamp duty, some modestly increased support for homeowners facing repossession and a supposedly free loan scheme for up to 10,000 first-time buyers.

There was nothing wrong with any of this in principle. But on closer inspection, the stamp-duty cut would apply to far fewer transactions than initially suggested by the Treasury. Meanwhile, the loans for first-time buyers, far from being "free of

charge", will probably end up costing more than normal commercial mortgages if and when the housing market recovers. Moreover, confining them to newly built houses will reduce the number of first-time buyers looking for existing homes.

Therefore, to the extent that it works, the measure will exacerbate weakness at the bottom of the market, and this will damage the entire market by making it harder to complete housing chains, which often depend on first-time buyers.

So far so bad, but now for two items of good news that had nothing to do with the Brown package but will prove far more important to the British economy.

First, there is more and more evidence that the housing slump will do less damage to the British economy than is expected at present. Secondly, Britain is in generally better shape to deal with a mortgage and housing crisis than any other important European economy.

These two observations obviously fly in the face of Alistair Darling's apocalyptic pronouncement about the worst economic crisis in 60 years and the grim Organisation for Economic Co-operation and Development (OECD) forecasts published on Tuesday. The shock-horror headlines generated by these figures completely overwhelmed the luckless Gordon Brown's attempted relaunch by suggesting that Britain was the only G7 country likely to suffer a recession — defined as two consecutive quarters of falling national output — this year. If the OECD, with its armies of economists, says that Britain will be the worst afflicted of the big economies, how can I possibly argue the opposite?

The answer is simply by looking at the OECD's figures and reflecting on what they actually mean. While it is true that the OECD predicts that Britain's GDP will decline in the third and fourth quarters this year, these declines are so tiny — just 0.1 per cent — as to be almost irrelevant, especially in a forecast where the margin of error is huge.

All the other big European economies have suffered, in the second quarter of this year, GDP declines four or five times bigger than the ones predicted for Britain. The only reason why the German, French and Italian governments were not facing headlines about a "technical recession" is that the OECD pencilled in growth projections microscopically above zero — 0.01 per cent for Germany — for the second half of this year.

What matters is that the broad picture presented by all recent figures, including the OECD's, is totally at odds with the impression created by most media and financial comment. The most surprising, and important, aspect of this is that America, the country generally believed to be most vulnerable to the housing and credit crises, has done better than any other important economy — and much better than expected. Not only has the US thus far managed to avoid a recession, but the OECD's growth forecast for 2008 as a whole has also been substantially upgraded, from 1.2 per cent to 1.8 per cent. Meanwhile, the outlook for every other G7 country has been drastically cut back.

Consider now what the US economy's strong performance may mean for Britain. First, it suggests that the impact of falling house prices and



Good news: the pound has fallen by 20 per cent against the euro

a mortgage famine on highly leveraged economies are not necessarily as crippling as widely believed. In the long run, consumers will rein in some spending if their homes start losing value, but the US experience suggests that this slowdown in consumption growth will probably be spread over a long period and will not be sufficiently dramatic to trigger a slump. This is also suggested by recent British high street sales figures.

Secondly, American experience points up clearly the built-in stabilisers that exist in a well-managed market economy to mitigate the deflationary impact of a housing slump and credit crunch. The US economy has avoided a recession because it has experienced

a boom in exports and a reduction in imports. The huge improvement in trade — and the jobs created or maintained by it — has been responsible for almost all the growth in the US economy in the past year.

A second stabilising factor, whose effects will become increasingly apparent from next year onwards, has been the steep reduction in interest rates by the Federal Reserve.

Now consider how Britain compares with other European countries. Since the credit crunch started, the pound has fallen by 20 per cent against the euro and by 16 per cent on its trade-weighted index. This is already equal to sterling's plunge after the ERM fiasco, which was followed by a powerful export boom. US experience strongly suggests that this devaluation, combined with the cautious mood of consumers, will soon trigger strong export growth in Britain as well.

Moreover, the Bank of England should become more willing to cut interest rates, now that oil and commodity prices are in decline. In other words, the British economy can use a freely floating exchange rate and independent proactive monetary policy to stabilise its economy, much as the US has. Continental countries, by contrast, will remain trapped by the single-currency straitjacket and the monetarist dogmas of the European Central Bank.

The upshot is that whatever happens in the housing market, the British economic cycle is probably nearing its low point, as the US did at the end of last year. The outlook should gradually improve from the start of next year. For the rest of Europe, by contrast, the economic troubles have only just started.