Whisper it soft, but the worst may be over

Events in Greece and the eurozone could still derail recovery, but the economic outlook for Britain is improving

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Government statisticians announced yesterday that Britain returned to decent growth in the third quarter, after the near-recession that started almost immediately after George Osborne's austerity Budget. So is the worst over for the economy?

For David Cameron and the Tories, probably it is. This may sound surprising, given the worsening chaos in Europe and the failure to hit key budget targets that will almost certainly be revealed in Mr Osborne's autumn statement later this month. But behind these headlines there has been better news on both the international and the political fronts.

Recent statistics from the US and China suggest that the global economy suffered rather less damage than expected from the Libyan oil shock, the financial turmoil in the eurozone and July's political stand-off in Washington. The US appears to have avoided a double-dip recession, despite high unemployment, collapsing business and consumer confidence and the near-breakdown of its political system. In China, the Government is easing the credit squeeze imposed to curb inflation last year. These developments, which became apparent in October, triggered the biggest one-month stockmarket rally for almost 40 years.

Europe, of course, is a far more important market for Britain than the US or the emerging economies. But the broad improvement in the global economy and financial markets should help to prevent a recession in Europe, unless the euro actually disintegrates or eurozone banks suffer a Lehman-style meltdown. If such disasters can be avoided, the chaos in Europe will prove a political blessing for the Tories, providing Mr Osborne with an excuse for the British economy's disappointing performance.

Even more important is the improving outlook for monetary and budget management. Last month, the Bank of England finally began the quantitative easing that enlightened voices on the Monetary Policy Committee have been demanding for a year. Because of this excessive caution, credit conditions will not improve much until next year and the economy will be condemned to a period of near-recession that might have been avoided, but at least there is light at the end of the tunnel.

> Quantitative easing will keep interest rates down for years ahead

Quantitative easing through buying government bonds will push down long-term interest rates, as well as guaranteeing that short-term rates remain near zero for years ahead. Homeowners and other borrowers will thus have the chance to lock into low interest rates for the next two years and beyond. Over time, this policy of "free money" will almost certainly encourage more borrowing to finance business investment and consumer spending, even if banks continue to impose much tighter conditions for lending than in the past.

More surprisingly, fiscal policy is also improving. The Government is planning a number of worthy initiatives to ease credit, such as the small-business lending scheme, the green investment bank and a possible new infrastructure loan programme, although rearguard action by Treasury officials has limited their scale to the point where the impact will be negligible. More important are recent comments by the Chancellor that suggest a softening of fiscal targets.

Of course Mr Osborne will never openly admit that his election promise to eliminate the budget deficit by 2014 was misguided or unrealistic. But nobody in authority takes it very seriously any longer. The Treasury's deficit reduction plans have already fallen far behind schedule in their first year and there is no chance of a zero deficit by 2014.

In place of this simple objective, officials now emphasise the fine print in Mr Osborne's first Budget. This talked about eliminating the structural deficit by the end of the Parliament, while allowing government debt to keep growing if the economy has not returned to full employment by 2015. As official forecasts have been steadily revised downwards, the Chancellor has explained that he will allow the "full operation of automatic stabilisers", which means that the Government will keep borrowing to finance any extra spending or make up for smaller than expected tax revenues that can be attributed to shortfalls in growth.

> No one now expects the budget deficit to be eliminated by 2014

In short, the Government's budgetary policies may not, in the end, be very different from those planned by Gordon Brown and Alistair Darling — and the degree of fiscal austerity in Britain will not be anything like as extreme as that suffered in Mediterranean countries or the US.

So much for the good news — now for the uncertainty and ambiguity. Even if the statistics turn out to be right in suggesting that the economy reached its nadir in the spring and summer, the recovery may not feel like much of an improvement for several years. One reason is that unemployment, house prices and credit availability are all lagging indicators that often continue to deteriorate for months, if not years, after growth accelerates.

The more profound reason is that the post-2008 recession was so deep that it would take years of rapid growth just to return living standards and government revenues to their pre-recession levels. Even if growth accelerated to 3 or 4 per cent, instead of the paltry 2 per cent annualised rate reported for the third quarter, it would take the rest of this decade to make up the losses to both the Government and the private sector from the international credit crunch.

What are the chances of achieving such rapid growth? This brings me to the uncertainties inevitable in economics. The modest improvements in global conditions and British policies would be wiped out instantly by a Lehman-style collapse in the eurozone. The risks of that have been exacerbated by the failure of last week's EU summit and the call for a referendum in Greece.

We must not forget, however, that the natural condition of a global capitalist economy is one of fast growth — and that almost all of that growth now comes from rapidly developing countries far from Europe and largely unaffected by the problems of the eurozone. So on balance, it is more likely that world growth will surprise on the upside rather than the downside the next few years. And Britain, free of the fetters of the euro and now pursuing more sensible, pragmatic policies, will be better placed than its neighbours to take advantage of whatever opportunities the world presents.