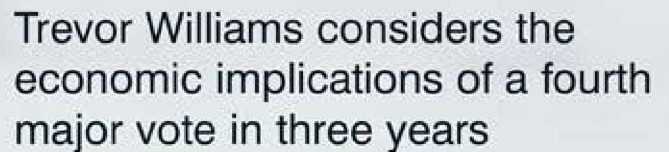
Beating uncertainty
Here we go again



Trevor Williams considers the economic implications of a fourth major vote in three years

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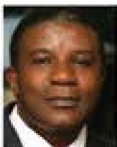

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Uncertainty is often said to be damaging for the pace of economic activity, and what can be more uncertain than the outcome of close-run elections? In the last three years, the UK has had: the Scottish referendum in 2014, the General Election in 2015 and the Brexit referendum in 2016, Now, we will have a fourth vote after the snap General Election called by Prime Minister Theresa May for 8 June. The worry is that this may lead to a period of weaker economic growth as people wait to see what happens in the election, even though the expectation at present is a convincing victory for the Conservative party.

Evidence suggests that the pace of growth in the UK economy has not been damaged by the number of times the electorate has been called on to vote since 2014. That year the economy

grew by 2.3%, in 2015 it rose by 2.0%, and in 2016 it expanded by 1.8%. For 2017, the consensus forecast is that the UK economy will be 2% bigger than the previous year.

This is the best period of expansion since before the financial crisis in 2008. Not bad for an economy that many expected to have been exhibiting signs of a drag on economic growth as a result of the uncertainty generated by the number of times the UK electorate has had to vote over the last few years. Perhaps it could be argued that, had it not been for these events, the economy would have grown even faster, but we will never know whether this would have been the case.

Little negativity

What we can say is that there appeared to be little negative feedback to the real economy from these elections. Take the Brexit referendum in 2016. The fear was that there would be a recession or significantly slower growth following a vote to leave. If anything, the economy accelerated after the referendum in June of last year rather than weakened, as evidenced by the quarterly growth profile since 2012. Not surprisingly, the IMF has just raised its forecast for this year, to 2%. Updated forecasts in April make it the third time the IMF has raised its forecast for the UK economy's rate of growth for 2017, after slashing them last year to 1% immediately after the vote to leave the EU.

Something seems to have happened to the channels by which greater uncertainty normally leads to weaker real economic growth. Looking at some of these will illustrate the current state of the UK economy and the prospects for growth this year and next, as Brexit negotiations get under way in earnest no matter what happens on 8 June.

We can think of two main channels through which uncertainty is supposed to impact the real economy: companies and households. The first is the investment route. The second is the consumer spending path.

Companies abhor uncertainty about the future, as it affects their decisions about the expected real return on investment in future output from expenditure on plant and machinery and people made today. Inflation might be higher as a result of loose monetary and fiscal policy from political outcomes today. That would erode real returns, perhaps below some threshold they target, and thus put off investment spending.

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On the one hand, if monetary policy is loose it may mean lower rates in the short term, and that might encourage investment spending. On the other hand, it may also be that companies look beyond the period of lower rates to when they have to be raised by the authorities to choke off higher inflation. Higher long-term interest rate expectations imply a steeper yield curve as higher expected future inflation raises longer-term interest rates relative to short-term ones. This would increase the cost of borrowing for companies and so deter investment.

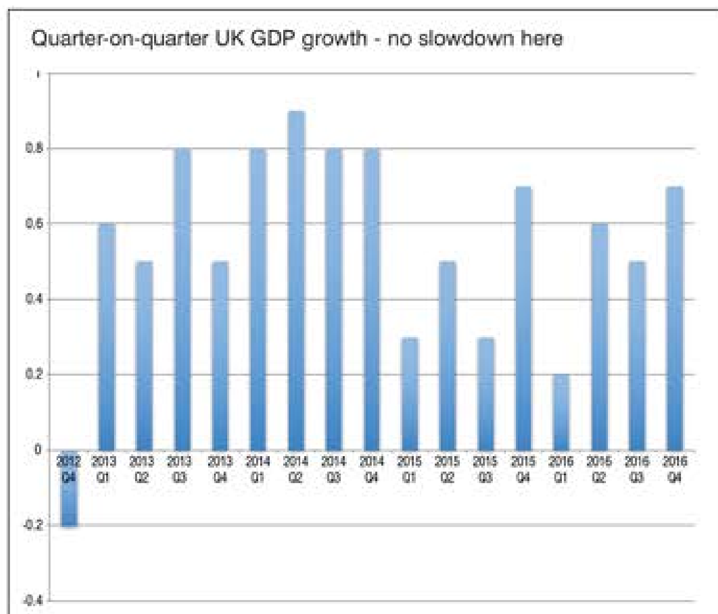
In the current environment of low global price inflation, this may be less of an issue perhaps for households and businesses than concern about policy uncertainty. This is more likely to be reflected in financial market volatility, in various asset classes such as currencies, exchange rates, gold, bonds and so on. Over the last few years, however, long-term interest rates in the UK have fallen further, and the stock market has boomed. Although the exchange rate has dropped, this has not prevented the fall in long-term rates. Indeed, the weaker currency has mainly boosted the equity markets, on the basis that it has made UK firms more competitive overseas. In other words, the cost of equity funding for companies has fallen over the past year, not risen.

For households, the fall in long-term rates and lower short-term interest rates since August 2016 have boosted borrowing by lowering interest costs and freeing up income for spending, as the cost of servicing existing debt declines. Since consumer spending accounts for some two-thirds of the expenditure of the economy, this has provided a significant boost. With the lowest unemployment rate since 1975 – just 4.7% in March 2017– and the highest employment rate since records began on the current basis, it is no wonder that consumer-spending growth has remained robust.

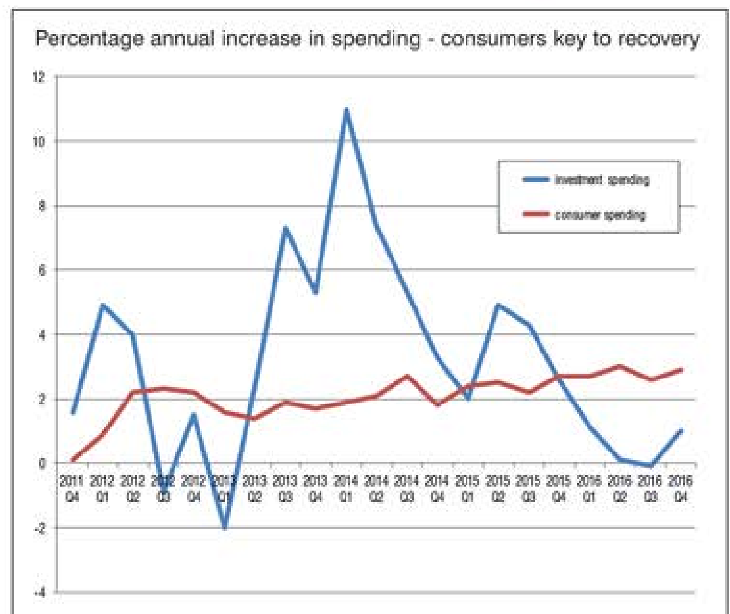
Slowing growth

The big question for the rest of 2017 is whether the recent pace of consumer spending growth can be maintained. In my view it seems that it can, though the pace of expansion may decelerate. Real earnings (nominal earnings minus consumer price inflation) is falling towards zero and likely to turn negative as inflation rises further. But employment remains high and interest rates – long and short – are at very low levels. It is probable, nonetheless, that the pace of growth will slow further into 2018, perhaps towards 1 to 1.5% at an annual rate. In this environment, the Bank of England is likely to keep interest rates at just 0.25%, even as consumer price inflation peaks close to 3%.

Additionally, with Brexit negotiations ongoing, and the fiscal policy backdrop to be determined by the upcoming General Election, there seems to be significant policy risk and uncertainty. However, the economy has been able to shrug off a slew of these over the last few years. Who's to say it will not continue to do so over the next few years as well? ■



Quarter-on-quarter UK GDP growth - no slowdown here



Percentage annual increase in spending - consumers key to recovery