Not so great Britain

Britain's economy has been savaged by the downturn, but it could be worse.

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Alistair Darling, the chancellor of the exchequer, had the unenviable task on Wednesday April 22nd of delivering the grisliest budget in post-war history. The fall in national output in 2009 will be the biggest since 1945, and the budget deficit as a share of GDP both this financial year and next will be the largest since the second world war.

So much for the claims by the Labour government, led by Gordon Brown, of unparalleled economic stability and fiscal prudence. Instead Britons face a poorer future in which they pick up the tab for ballooning public debt. Despite sightings of green shoots, an early or robust global recovery remains unlikely. Whatever happens, the bill for taxpayers will be massive.

Britain's experience is a prime example of what is to come as economies are saddled with extra public debt. Contrary to earlier predictions, Britain's economy is no longer expected to be the worst-performing among its peers in the Group of Seven (G7) rich countries. That only makes the deterioration in Britain's public finances all the more extraordinary.

A year ago Mr Darling thought the economy had become particularly resilient to shocks. Even then such claims seemed implausible: since the financial crisis broke in 2007 the economy had looked especially shaky rather than resilient, not least after a run against Northern Rock, the first against a British bank since 1866.

Britain looked vulnerable on three counts. First, the economy was exposed to the credit crisis through its own big banks and London's salience as an international financial centre. Second, British households had run up the biggest debt, relative to disposable income, among the G7 countries. Third, British house prices had risen extremely fast during the bubble years.

Yet the economy has not turned out to be the fall-guy. Other big economies, notably Japan and Germany, have fallen further. Although they avoided the spending and borrowing excesses, their export-driven economies were particularly exposed to the global economic downturn. The IMF predicted on Wednesday that Britain's economy would contract by a grave 4.1% this year, but that was surpassed by three others in the G7, with drops of 6.2% and 5.6% predicted for Japan and Germany respectively.

Some see signs that the worst of the recession may soon be over in Britain. Business surveys of purchasing managers still point to continuing contraction but have picked up a bit. Activity in the dire housing market is now starting to recover slightly. Inventories have been run down fast, which suggests that the economy will benefit once companies meet more demand from new production.

But it would be foolish, all the same, to pin many hopes on an immediate or sturdy recovery. A lot of economic pain is still due. On Wednesday the unemployment rate rose to 6.7% in the three months to February, up from 5.2% a year earlier.

Even so, Britain does now look set to fare less poorly in comparative terms than once feared. An essential precondition has been the steps taken to prop up its banks. The Treasury this year guaranteed two of them, Royal Bank of Scotland and Lloyds Banking Group, against worst-case losses, through a scheme covering £585 billion ($855 billion) of their dodgy assets. Together with more provision of public capital, this appears to have stabilised the banking system.

Britain's limited dependence on manufacturing sector may turn out to be a benefit too. With plummeting demand for investment goods and big-ticket consumer items like cars, it has been the likes of Germany and Japan that have suffered the most. In Britain manufacturing makes up only 13% of the economy, and pharmaceuticals and aerospace, which are more recession proof, are especially important in Britain.

A decline of 27% in sterling's trade-weighted value between July 2007 and March 2009 has also given a comparative edge to British exporters. Although exports have fallen, the decline has been less pronounced than in many other countries. The weak pound also helps to make exports more profitable and helps domestic producers competing with imports. A weaker pound is also guarding against deflation, which could be lethal in an over-borrowed economy since it pushes up the real value of debt. Consumer prices, the measure used for the inflation target, increased by 2.9% in the year to March, still above the government's 2% goal.

The economy is now getting a big boost from monetary policy. The Bank of England hauled down the base rate from 5% in early October to 0.5% in March, smashing historical records. Then it promptly ordered a switch to quantitative easing, with the central bank buying £75 billion of assets, mainly gilts, over a period of three months with money it is creating.

By contrast, the British economy is getting a smaller fiscal stimulus than some over the next two years. But the use of automatic stabilisers, the fall in tax collection and rise in welfare spending that occur anyway during a downturn, suggest that budgetary loosening in Britain (and elsewhere in Europe) is rather similar to that in America.

All these measures together should cushion the fall in GDP compared with some other big economies. But the outcome will still be grim by historical yardsticks. And the public finances will be left in a dreadful state.

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