Why we will have a recession, and it may be a big one

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The world is obsessed with politics as I write but I have a very strong suspicion that economics will, at the end of the day, still dictate the terms of what happens next. That is because I have little doubt at all that the UK is now heading for recession, and that it could be prolonged and deep. To explain why requires a little bit of economic theory.

What a recession means is that there is a sustained downturn in national income, which is also called GDP, which stands for gross domestic product.

GDP is made up of four parts. The first, and biggest component, is household consumption. This covers most domestic spending, except on new housing.

The second element is investment which represents expenditure on new equipment by business and household spending on new housing. I stress, this is not a financial activity: investment in this context means spending on real things and not putting money aside in savings accounts like pension funds or buying shares.

The next component is net exports i.e. the difference between exports and imports. If exports exceeded imports then they contribute to national income, and vice versa, if imports exceed exports that reduces national income. Once more, finance is not the issue here: trade in real goods and services is.

Last, there is government spending. Once more there is a caveat: this does not include what it described as transfers, which include pensions and social security expenditure because these turn up again in consumption and the formula must not double count. So, what counts as government spending is, in effect, the discretionary element of its spend that, in particular, is either investment or does not turn up in consumption e.g. some defence spending.

There are, of course, lots of nuances to all of these items which are sufficient to let an economics professor spend their whole life discussing the finer detail of these issues but in reality the above is sufficient information to explain why a recession is likely now that the UK has voted Leave.

There are two pretty certain consequences of that Leave vote. The first, and most likely of all trends, is that business will now invest substantially less in the UK. This does not just mean that overseas businesses will invest less here, but UK ones will as well. This is because for the next two or three years it seems very unlikely that the UK's terms of trade with the rest the world will be known with any certainty. As a consequence no business can be sure what the potential return on its investment in this country might be and their rational response will, in many cases, be to simply stop investment spending. This will have an immediate, and downward, impact upon GDP.

Businesses will not be alone, however, in suffering this uncertainty. So will households. One reason for that is that if businesses stop investing there will be less employment in the UK economy, more uncertainty as to future prospects, less chance of wage increases, and a higher probability of people being made unemployed. All of those circumstances create a situation where people are much more inclined to save than to spend, if they have that option (which of course, not everybody does). Whilst accepting that some people spend absolutely everything they earn every month, whatever happens, there are sufficient who exercise discretion to ensure that it is very likely that people will be saving more over the next two or three years than they do now. This will, then, reduce consumption expenditure. And for those who cannot save, there is the risk that their earnings will fall because of a reduced demand for people to work because investment will suffer a downturn. This, also, is likely to reduce consumption expenditure.

I think these two trends are extremely likely to happen. What is less certain is what the impact of the Leave vote will be on net exports (or rather, as we have in the case of the UK, net imports). Some argue that the devaluation of the pound that we have already suffered is advantageous to exporters and, therefore, our international position should improve. Unfortunately, this assumes that whilst the rest of the world will buy more of what we have to offer because it will now be cheaper we will at the same time be in a position to substitute a UK made product for what we have previously imported, which will now be more expensive. If we cannot do that because there is no UK alternative then the benefit resulting from increased exports is completely wiped out by the increase in the price of imports, and even exaggerated because we have, for some time, imported more than we export. Given that the unfortunate fact is that there is little evidence that we are able to produce alternative domestic goods and services to those we import, partly because of the very nature of globalisation and also because we simply do not have the manufacturing base that we once enjoyed, I am not at all confident that we will actually benefit from a fall in the value of the pound, and might actually suffer from it. At best it would seem wise to presume that there is no net overall effect for the time being.

This then means that with falling consumption, falling investment and at best a neutral position on net imports/exports whether or not we have a recession depends entirely upon the reaction of whatever government we might have to the situation in which we find ourselves. There are, very broadly speaking, two possible responses although I would entirely accept that there would be plenty of ground for nuance between them.

The first response would be that which we would expect from a Johnson government. If this is composed of those around the Leave campaign, made up of those that many would think from the hard right of UK politics, with a significant representation for organisations like the Taxpayers' Alliance that has persistently demanded large-scale cuts in government spending and a balanced budget coupled with significant tax rises for the well-off, then it is very likely that there will be significant cuts in government spending as a result of the UK voting Leave. If that were to happen then all the other trends noted above would be significantly exacerbated and the UK could suffer a substantial fall in GDP, with government debt rising significantly at the same time because the collapse in government income.

Alternatively, if there were to be a left of centre government that believed that, in Keynesian style, it had to spend counter-cyclically to compensate for the uncertainties in the marketplace and so increased government spending at this point in time then the impact of falling consumption and investment would at least be partly addressed. Whether any government would be brave enough to entirely reverse that trend, and spends sufficiently to promote growth is a good question and the answer is as yet unknown, and so whether recession could be avoided at all is again, also unknown. What is beyond doubt is that it is within the power of government to ameliorate any such downturn, and that there is a real political choice to be made on this.

Until such a choice is, however, made, the economic trend will be substantial, and significant, and I think indisputable: all the economic indicators suggest that we are heading for a recession. And, unless, against all recent political trends, we get a government that is willing to counter that trend by incurring significant new expenditure, so severe are the potential reductions in consumption and investment that the recession could be deep, long-lasting, and profoundly difficult.

Voting Leave has established the economic environment for the UK for the next decade. The political choices that are made will determine how bad things turn out to be.