



review of the UK economy

Q4 2015

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The UK economy in Q4 2015

By Economists for Rational Economic Policies (EREP)

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Fiscal Policy: It's the Same Old Story

John Weeks

For almost two years each successive ONS quarterly report on the UK economy brings much the same news 1) the Treasury fails to achieve the target for the overall fiscal balance set way back in the summer of 2010; and 2) the recovery from the Great Financial Crisis, always predicted at last to be robust and sustainable, shows continued vulnerability.

Much like a fire started with damp wood, the recovery flickers, belches smoke, but fails to ignite. The preliminary estimate of the Office of National Statistics for GDP came in at [0.5% higher than for the fourth quarter](#), an increase from 0.4% for quarters two and three (statistically non-significant and very much in the eye of the bean counters). This modest expansion calculates to an annual increase of 1.9%, bringing the Osborne-managed economy to 6.6% higher than the pre-crisis peak of 2008Q1 (see further discussion of GDP performance by Graham Gudgin).

Weak fiscal performance both reflects and anticipates the sluggish output growth. Actual economies grow in market ("current") prices, with "real output" the result of a statistical adjustment. The table below measures fiscal variables and GDP as they come to the Treasury, in market prices. Statistical analysis strongly suggests that the revenue generated in the current quarter is closely linked to the GDP increase of the previous, reflecting in part the time gap between income generation and tax flows from PAYE employees.

I presented calculations in the EREP 2015 review of the economy implying that fiscal policy had a slightly negative impact over the 12 months December 2014 through November 2015. The table below shows that the deflationary effect of fiscal policy for the third quarter of 2015 was minus £3.9 billion as revenues far exceeded increases in expenditure. For the fourth quarter the negative fiscal impact is less even though expenditure tightened by considerably more, +0.7 billion increase compared to +2.2 billion for the third quarter.

Change in fiscal variables and GDP, 2015Q2-Q4

(Current pounds sterling)

Time period:	Change in (£bn)	
	<u>2015Q2-3</u>	<u>2015Q3-4</u>
Revenue	6.2	3.0
Expenditure	2.2	0.7
Net Fiscal Impact	-3.9	-2.3
GDP	+19.5	+17.1
% Change in GDP growth:		- 0.1

Source: [ONS](#).

We should not attribute the smaller deflationary effect in the fourth quarter to the Chancellor momentarily moderating his austerity agenda. While the lower quarterly change in public expenditure (£1.5 bn less) itself reduced aggregate demand, revenue generation fell by over half, by £3 bn compared to 6.2 bn for the previous quarter. This drop of 3.2 bn in revenue generation resulted from the slightly slower current price GDP growth (minus 0.1 percentage points, in contrast to the +0.1 for price deflated GDP).

To put it simply, the smaller revenue increase reflects the UK tax structure operating as a counter-cyclical buffer to weakening aggregate demand. On the surface, this appears a positive outcome – between the second and third quarters £100 of GDP generated £32 of revenue, falling to 17.7 for the last quarter (meaning a larger non-tax increase). As a result GDP and household income increased more than would have been the case had the tax bite been larger.

On reflection we should curb our enthusiasm. While pleased with the people-friendly operation of the automatic stabilizer to soften the blows from the Chancellor's policies, it comes as part of an interactive process of slow output expansion and stagnant incomes for the vast majority of households. Each quarter brings a new constraint on fiscal expenditure; lower tax revenue reduces but does not negate, much less reverse, the impact of the constrained fiscal expenditure.

The UK economy is deep into a Tory-dug fiscal trap – each budget tightens the spending belt, which in the next quarter means that the resulting counter-cyclical fall in public revenue means the Chancellor fails to meet his self-imposed fiscal target. That failure becomes a justification to reduce spending further. The Chancellor has peddled this dysfunction process for over five years as a strategy of recovery. This is not strategy, it is fiscal failure.

UK Economy – Wilting Expectations

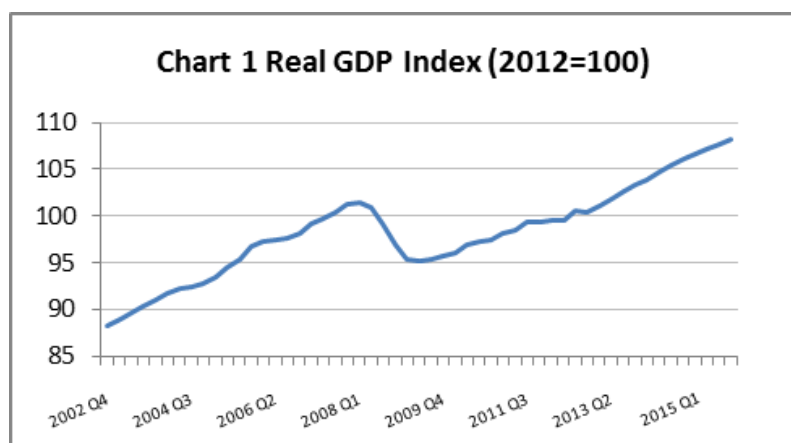
Graham Gudgin and Ken Coutts

As we had expected, the recent ONS estimates for the growth of GDP in the 4th quarter of 2015 confirm a marked slowdown in 2015 compared with the previous year. The first estimates of GDP by the ONS are frequently revised upwards and we expect that growth in 2015 may eventually be shown to have been a little higher than the provisional estimate of 2.2%, but still well below the 2.9% of 2014, despite the boost given to consumer demand from higher North sea oil output and from low oil prices towards the end of the year. The pre-election mini-boom underpinned by the Chancellor's measures to stimulate the housing market is now fading away. Official optimism has disappeared extra-ordinarily rapidly.

Only four weeks before Christmas the Chancellor's Autumn Statement, backed up by the OBR, painted a picture of good economic growth 'better than anywhere else in Europe'. On New Year's day, both the Daily Telegraph and The Times gave extensive coverage to the Centre for Economics and Business Research prediction that the UK will remain the fastest growing economy in Western Europe and will overtake Germany and Japan to become the world's 3rd largest economy by the 2030s. In January all of this changed. The Chancellor echoed Janet Yellen at the Fed in warning about tough times ahead. The Chancellor was clearly getting his retaliation in first, and laying in excuses for an anticipated failure to generate the growth he had foreseen only a few months earlier.

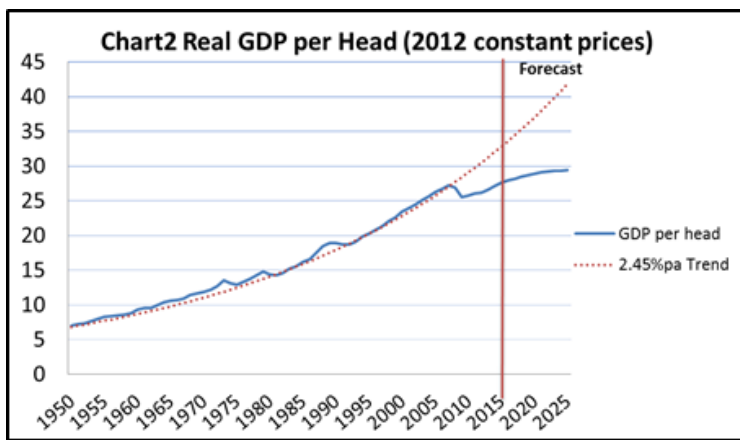
The bad start of the year in the world's largest stock markets appears to have spooked policy-makers, despite the generally poor correlation between stock markets and real economic performance. The new pessimism is however in line with our own macro-economic forecasts for the UK, of which more below.

Following a series of definitional changes in GDP, the UK is now judged by the ONS to be 7% above the pre-crisis peak of 2007. At first blush the recovery appears relatively steady and consistent (chart 1).



In reality it has been unprecedentedly weak. Because UK population has grown by 6% since 2007, largely through immigration, per capita GDP is only 1% above its 2007 peak after six years of 'recovery'. Until 2007 real per capita GDP had grown at close to 2.5% per annum ever since modern records began in 1948. Growth had in fact been faster in the 'corporate' era prior to 1980, but even in the 'free-market' era since 1980 it was not far below the 2.5% p.a. trend.

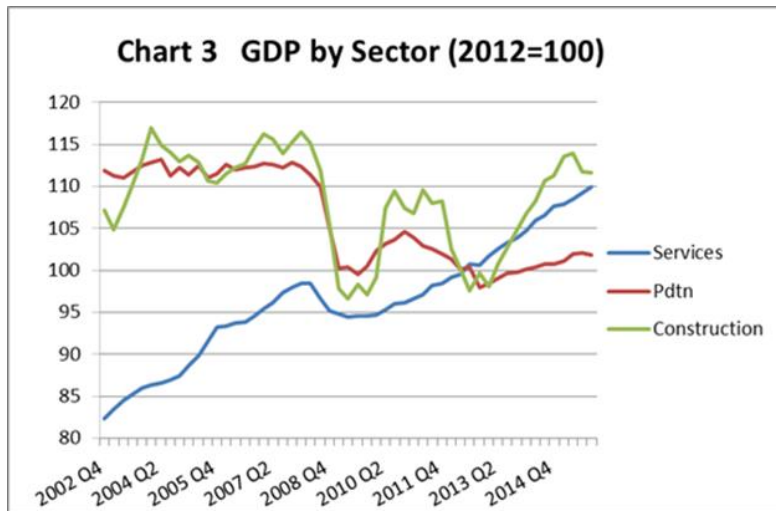
The deep recession of 2008-9 took per capita GDP well below the pre-2008 trend and GDP has not subsequently converged on that trend. Even after the above-trend growth of 2014, GDP per head remains 15% below the pre-2008 trend. The forecast values in chart 2, generated by the forecast model described below, predict that GDP will move ever further from the trend.



Even with a reasonably optimistic outlook for world trade, our view is that the austerity planned by the present government will depress growth in GDP well below 2.5% per annum and take per capita GDP ever further below the pre-2008 trend. These forecasts are much less optimistic than the OBR's current projections, based on supply-side optimism, which forecast GDP growing annually at 2.4% throughout this parliament (and essentially forever).

Manufacturing has continued to disappoint, with output falling slightly last year. Real GDP in manufacturing remains hardly above its recessionary nadir in 2009 despite the boost from a 23% depreciation in the sterling effective exchange rate in 2008-9 (half reversed by a renewed appreciation of sterling since 2013). There is no sign that the Chancellor's ambition to rebalance the economy towards the 'makers' has even begun to be achieved. As so often with policy-makers, too much faith has been placed in what are essentially small and peripheral measures to help entrepreneurs, in the hope that new manufacturing firms will appear.

It is not though, manufacturing, or other production sectors, which are primarily responsible for holding back the recovery. These sectors are too small at only 15% of GDP to have much influence. Even if GDP in the production sectors had returned to pre-crisis levels it would only have added 1.5% to total GDP by 2015. Despite 15% growth since the recession (chart 3), it is services which have underperformed.



For the economy to have converged back to the previous trend, as has happened in all previous post-war recessions, the services sector would need to have grown many times faster than it actually did. In part public services have held back recovery with growth in GDP between 2009-15 of only 5.5%. Private services did much better, expanding by 19% over this period, but at only 2.9% per annum, this was much too slow for the economy to converge back to the pre-2008 trend. Credit conditions are partly responsible. The amount of consumer debt outstanding fell after the recession until 2013. Since then it grew 3% in 2014 and 7% in 2015, helping the pre-election mini-boom.

Another problem has been construction. After a rapid recovery since 2009, construction output fell back in the second half of 2015 (see chart 3).

The likely cause was regulatory changes in June 2014 making the process of getting mortgages more difficult and bureaucratic. The number of new mortgages for house purchase rose rapidly in 2013 and 2014 but stalled suddenly in early 2015. Since mid-2015, growth in the number of loans has been relatively rapid, but the number of loans remains 30% below the pre-recession peak. If growth in real GDP is to remain much above 1% per annum, a further rapid expansion in both mortgage and consumer credit is required to offset the negative impact of government austerity.

A Dismal Future

Our forecasts for the UK economy are generated by the new CBR econometric model. This is described in detail in WP472 which can be [downloaded here](#) . They differ significantly from those of the Bank of England or the OBR, which are based on highly optimistic assumptions and essentially embody the supply-side optimism which asserts that the private sector will always quickly fill any gap left by public sector austerity. Both the OBR and BoE pin their faith on unprecedentedly sustained period of high growth in business investment.

The forecasts in table 1 show that we expect growth in GDP to slow throughout much of the remainder of this parliament as cuts in government expenditure become more severe. We have used the Government's own plans for tax rates and for current and capital spending on public services in nominal terms. The OBR estimates what real

government spending will be, based on these nominal-terms plans, but we find their assumed deflators erratic and unrealistic and have instead used our own estimates. Our forecasts using these deflators indicate no growth in real government services in 2018 and 2019.

Table 1: Economic Forecasts for the UK Economy

% per annum (unless otherwise stated)	2015	2016	2017	2018	2019	2020
GDP	2.4	2.1	1.5	2.0	1.6	1.6
Household consumption	4.1	3.8	3.1	2.7	2.3	1.8
General government consumption	-0.1	1.6	1.8	0.0	0.0	1.6
Business investment	3.9	4.7	-3.8	0.6	1.4	3.2
General government investment	3.1	0.6	0.6	-1.6	1.9	2.0
Household investment	8.3	8.1	2.9	2.9	-1.2	-1.3
Exports	2.7	0.9	2.1	3.9	4.3	4.2
Imports	4.7	5.0	3.4	3.6	3.4	4.1
CPI	0.2	0.6	1.3	1.8	2.4	2.8
Employment	1.8	0.8	0.2	0.0	-0.1	0.2
Average earnings	3.8	4.4	3.1	2.3	1.6	0.8
LFS unemployment (% of labour force)	5.1	4.7	5.0	5.4	5.7	5.8

The puzzle of large-scale private sector job creation since 2010, combined with flat labour productivity, is in our view, due to a combination of low real wages, bargain-basement interest rates and a low level of business investment (which means less substitution of capital for labour than usual). The reversal of these factors from now onwards means that we forecast jobs growth slowing to zero by 2018. A direct consequence is that unemployment is projected to begin rising once more from 2017 as long as net immigration remains at close to 300,000 per annum as we predict.

A further consequence of slow economic growth is that the Chancellor is forecast to miss his target of a zero fiscal deficit by 2019-20. Instead we project that the deficit will stabilise at close to 2% of GDP and that public sector net debt will remain close to 80% of GDP.

The eternal UK problem – our current account

Jo Michell

If there is one perennial British economic problem, it is our inability to reach 'equilibrium' with the rest of the world: we have run a deficit on current account – borrowed from the rest of the world – for the whole of the last three decades. Yet this issue receives far less discussion than the 'other' deficit – that of the government budget.

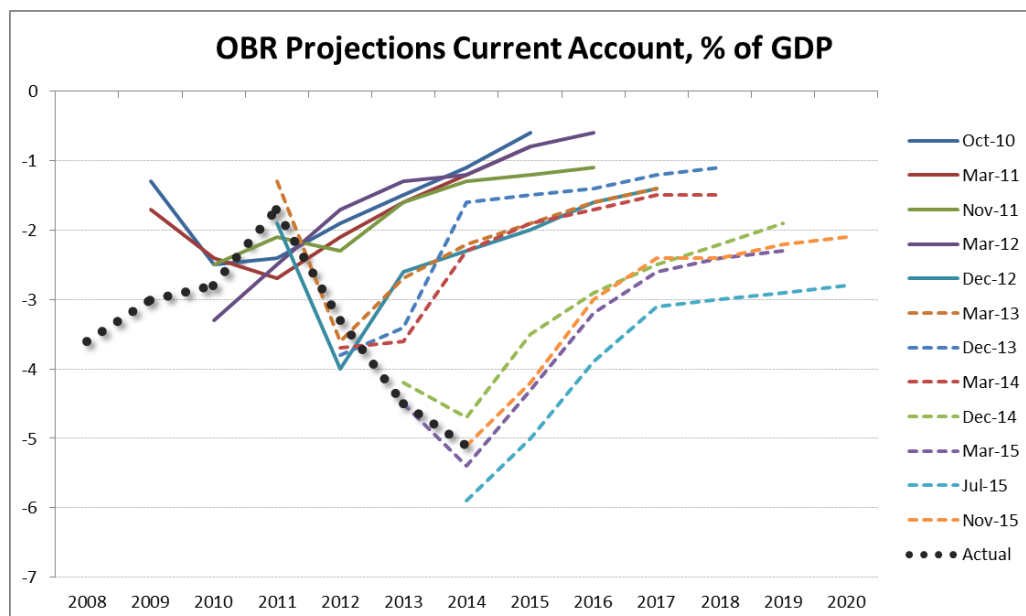
The most recent estimate of the 2015 current account deficit was, at 5.1 per cent of GDP, the highest as a share of national income since the early 19th century. Preliminary estimates of foreign investment income (one of the major components of the current account) suggest the final figure will be slightly lower, at around 4.5 per cent of GDP. This will still be the largest deficit on record.

One way to think of the current account deficit is as a hole through which spending leaks out of the economy. Much like trying to inflate a bicycle tyre with a hole in it, trying to reflate the British economy in the aftermath of the 2008 financial crisis is made more difficult when, instead of stimulating domestic income and employment, spending leaks out of the economy to the rest of the world.

What is the cause of this imbalance? Firstly, the UK has a chronic trade deficit – it imports more than it exports. This deficit, however, has remained relatively stable in recent years at around two per cent of GDP. The widening current account deficit is largely driven by a deterioration of the foreign direct investment (FDI) position. Until around 2012, net income from long-term UK investments held abroad was sufficient to offset the trade deficit.

For the last three years, however, net foreign investment income has disappeared. It is open to question whether this is a transitory effect – which will fade as the economies of the European Union and other sources of investment income recover – or whether it instead represents a structural shift.

The OBR takes the former view and is optimistic that FDI income will return, the trade balance will narrow and the current account deficit will close to around 2.5 per cent of GDP over the next five years. Their forecasting record is not without blemishes, however. The figure below shows OBR current account forecasts produced over the last five years.



The OBR forecasts appear to be predicated on both supply-side optimism about the UK economy and an assumption that the global economic recovery will continue to gather pace. This looks an increasingly uncertain prospect as the Chinese economy slows and indicators suggest that the US recovery is running out of steam. If, as we believe to be the case, the UK's recent mini-boom is now coming to an end in the broader context of a more generalised global slowdown, these forecasts for a rebound in foreign income look optimistic.

On the other hand, it might be expected that as UK demand contracts, the trade deficit will narrow as UK import demand falls. Recent experience is not encouraging on this front. In the period following the 2008 crisis, neither the current account nor the trade deficit contracted much despite the experience of a major recession followed by a period in which the pound devalued against other major currencies. That devaluation has now reversed and the pound regained much of its strength – something which will only serve to worsen the problem of the external deficit.

What accounts for the weakness of the UK's trade performance? It is often asserted that the UK's comparative advantage lies in the services sector, particularly financial services. While it is true that manufacturing as a share of GDP is now only around ten per cent of GDP – among the lowest of the advanced nations – manufactured goods make up over 40 per cent of our exports. Given that manufacturing has yet to recover to pre-2008 levels, it is therefore not entirely surprising that our revenues from exports are not sufficient to cover our spending on goods produced abroad.

With a persistent current account deficit and a government which is attempting to close the public sector deficit, accounting tells us that the private sector must be in deficit. This is indeed the case. The UK saving ratio has fallen to its [lowest level on record](#), at just 4.4 per cent of income. Figures released on Monday by the [Bank of England](#) show consumer credit growing at the fastest pace since 2005.

As wage growth moderates and demand slackens, the chance of another rate rise is fading. Only a few months ago, Andy Haldane, Chief Economist at the Bank of England, was widely derided for raising the prospect of [negative interest rates](#). Yet an increasing number of [commentators](#) now suggest that the Bank's next move may be a cut not a raise in rates.

All of these trends – a current account deficit, slackening demand, cheap money and falling savings – point in the same direction. The British public will continue to borrow – from each other and from abroad. But the spending won't translate into high-quality jobs and rising wages – instead it will lead to higher debts, ever-less affordable housing and an increasing likelihood of financial instability.

The Labour Market Disappoints

Mary Robertson

Amidst an economic recovery that continues to disappoint, Britain's labour market has regularly been presented as a relative "good news story" in recent months. At 74% the employment rate is the highest since records began in 1971, while unemployment, at 5.2%, has returned to its local pre-crisis low. The table below summarises this performance. Furthermore, earlier concerns that jobs growth was being disproportionately driven by low paid, part-time, and self-employment began to be somewhat alleviated last summer when employment expansion began to encompass more full-time posts and pay rates began to turn upwards after several years of decline. In the year to November 2015, full-time jobs increased by 2% compared to a 1.8% increase in part-time jobs, while last summer wage growth reached 2.5% for the first time since the crisis.

However, those assuming that the labour market is now recovered and will help drive broader economic recovery through 2016 may find they have engaged in excessive hubris. The extent and depth of labour market recovery is frequently overstated, while a number of threats looming over 2016 are likely to make recovery more fragile still.

Summary of UK labour market statistics for September to November 2015, seasonally adjusted

	Headline Rate (%)	Change on Jun to Aug 2015	Change on Sep to Nov 2014
Employed	74.0	+0.5	+1.1
Unemployed	5.1	-0.3	-0.8
Inactive	21.9	-0.2	-0.5

Note:

Employment rate: number of employed people 16-64 divided by total population of that age range.

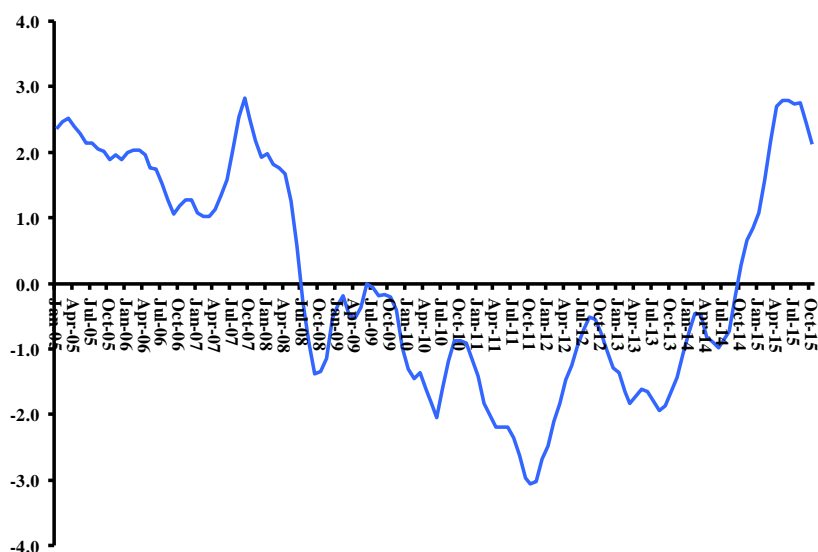
Unemployment rate: number unemployed divided by employed plus unemployed.

Inactivity rate: population 16-64 neither employed nor unemployed divided by total population in that age range.

Source: ONS

The supposed recovery of real income growth last summer was limited, barely attaining pre-crisis rates of pay increase. Further, it has so far been short-lived, with wage growth falling to 2% in the three months to November 2015. The economy not only failed to make up for lost income growth over the eight years since the crisis, it has not returned pre-crisis levels. These points are demonstrated by the chart, which shows that real pay fell in every quarter but one from 2008 up until 2014, when real pay growth became positive again. Total real pay has yet to return to its pre-crisis peak.

Rate of change of Real Weekly Earnings, 2005-2015 (annualized 3 month moving average)



One likely reason for the recent, if modest, spurt in real wage growth is that low inflation, particularly for fuel and food, has helped to boost real incomes even though increases in money wages remain modest. Low food and fuel prices are expected to persist through 2016, but it is unlikely that this will continue to provide a boon to real incomes. Over time low inflation may feed into wages as employers factor inflation levels into wage negotiations and resist above-inflation pay increases.

The Recruitment and Employment Confederation predict that annual wage growth will remain low, between 1.5-2.5% this year. Real wage increases due to price deflation have the negative effect of increasing the burden of household debt. Further, as was recently seen in relation to the British steel industry, deflationary pressures have had adverse consequences for particular industries, with knock-on effects on employment and pay.

A number of commentators have also speculated that last summer's improvement in wage growth was a sign that Britain's strong employment performance was leading to reduced slack in the labour market. However, while employment remains at record levels, wage growth has since weakened, which together with the relatively low level of nominal wage growth seen in the summer, suggests that labour market slack remains.

In the early years of recovery, it was widely noted that jobs growth was driven by involuntary part-time, temporary and self-employment. As a result significant numbers of those recorded as in-work were in practice under-employed. Full time job creation increased in 2014, but this does not mean it has alleviated the slack accumulated since the crisis. There is no perfect measure of labour market slack, but evidence indicates very little change in the percentage of part-time workers that wanted but could not find a full time job and the percentage of temporary workers that wanted but could not find a permanent job. Both remain above their pre-crisis levels.

If Britain's superficially strong labour market performance continues, we may see it feed into wages over the next year. However, fragile GDP growth places a question mark over the robustness of that labour market performance. A graver consideration is whether low rates of income growth reflect changes in labour market composition; i.e., whether the crisis has accentuated a two-decade tendency towards low quality, poorly paid and insecure employment. ONS figures showing a fall in average hours worked per week over the last year may also be a sign of labour market slack.

Marginal productivity theory treats wages as determined by the contribution of labour to production at the margin or, put simply, that wages reflect the productivity of labour. While it is true that higher productivity increases the size of the pie from which wages are paid, whether workers receive the equivalent of their contribution to production depends on relative bargaining power. In practice, productivity, which has languished in Britain since 2006, may be both a cause and consequence of low pay increases. On the one hand, low productivity increases the incentive for employers to boost profits by squeezing wages. On the other hand, cheap labour discourages employers from making productivity-increasing investments.

The 1% cap on public sector pay increases puts continued downward pressure on wages, though this may be partially countered by the introduction of the National Living Wage. The implementation of the Trade Union bill this year will restrict workers' power in collective wage bargaining

Closer inspection of labour market statistics produces more pessimistic expectations than those suggested by recent headlines. We should be mindful of the implications for the broader economy. With public and private investment low, Britain's limited recovery has been driven by household spending. But that spending is being sustained by borrowing – at 3%, household spending is growing faster than average wages, and the savings rate is at an historic low of 4.4%.

Britain's unbalanced recovery leaves it caught between the twin threats of anaemic, fragile recovery and another damaging cycle of asset boom and bust. Robust and resilient labour market recovery is unlikely to occur without a large scale investment programme to boost productivity and create high-quality jobs. The chances of the private sector leading such a programme are currently remote.

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