

## 27. THE UNITED KINGDOM

### Fragile recovery in the face of headwinds

#### Assessing the fallout from the recession

After more than a decade of stable output growth, the UK economy passed through its most challenging year in 2009. As financial market stress mounted from autumn 2007 and negative feedback loops began to weaken balance sheets, restrict lending and reduce demand, output falls accelerated in early 2009 to their fastest rate in post-war history. Although the contraction is estimated to have bottomed out in the third quarter with modest growth in the fourth, the annual GDP contraction hit almost 5%.

While unemployment rises have been smaller than expected for such a large contraction, the number unemployed has increased by half since the start of the crisis and 800,000 workforce jobs have been lost. One of the greatest challenges for the UK economy will be to redeploy spare capacity, reverse the fall in aggregate supply and improve employment prospects. Restoring the UK public finances is a central task, as they have been greatly weakened, by a combination of the severe downturn, its impact on previously tax-rich income and expenditure, the operation of automatic stabilisers and the fiscal stimulus.

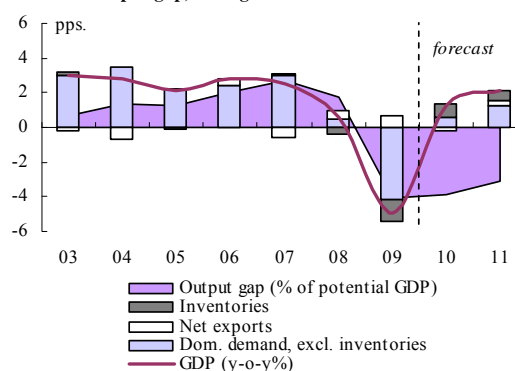
#### A slow start to a protracted recovery

Economic output passed through its lowpoint in the second half of 2009, with 0.4% quarterly growth in the fourth quarter, the first quarterly growth since the start of 2008. GDP expanded at a somewhat slower rate in the first quarter of 2010, at least partly reflecting a negative impetus from poor weather and the re-increase in VAT.<sup>(79)</sup> Output is expected to pick up gradually over the forecast horizon as the corporate and – to a lesser extent – the household sector begin to increase their investment and (for households) consumption expenditure. Overall, GDP growth of 1¼% is expected for 2010, followed by 2% the year after.

Domestic demand, the weakness of which was the principal driver of the UK recession, is set to return to growth in 2010. By contrast, net external demand will provide a small negative contribution

due to a negative carryover from the relatively stronger rebound in imports than in exports in the second half of 2009, but on a quarterly basis net trade is expected to already make a positive contribution during the course of 2010 as export volumes rebound from still-depressed levels. Nonetheless, sterling's depreciation has not yet been reflected in more competitive terms of trade. An important growth stimulus will come from the turning of the stockbuilding cycle, which will add ¾ pp. to GDP growth in both forecast years.

Graph II.27.1: The United Kingdom -  
Output gap, GDP growth and contributions



The outlook for private consumption, the biggest GDP component, remains muted. Consumer spending increased slightly in the fourth quarter of 2009, but this is likely to have included some expenditure brought forward by households to avoid the re-increase of VAT to 17% in January 2010. While consumer sentiment has improved since the start of 2010 and points towards continuing household spending growth in the short term, the strength of the spending recovery will be limited by negative real average earnings growth in 2010 and very limited job creation over the forecast horizon. The latter reflects the fact that during 2009 companies reduced employment by far less than the fall in output, which led to a marked fall in labour productivity. Coupled with positive earnings growth, this resulted in a considerable rise in unit wage costs, which is likely to reduce the demand for additional labour. Furthermore, households' expectations of weak job prospects and the adverse impact of future interest rate rises on debt servicing costs are likely to encourage continued saving, keeping the household saving ratio at 6½% of household resources. (see Graph II.27.2)

<sup>(79)</sup> GDP data published on 23 April, after the forecast cut-off date, showed slightly weaker output growth in Q1 2010 than incorporated in the forecast, thus increasing downside risks to the forecast.

Fixed investment spending by corporations and households fell sharply during the recession as demand expectations weakened and cash-flow pressures intensified. Tighter credit conditions further dampened investment spending. Spare capacity reduced the investment necessary to offset depreciation. This suggests that demand expectations and credit conditions will be key determinants of fixed investment spending. The expected resilience of corporate gross operating surpluses will allow for moderate rises in business investment, but – given the strong negative carryover from 2009 – annual growth will remain negative in 2010. Residential investment levels will be dictated mainly by the housing market, where following a slight recovery in transactions and prices during 2009 recent mortgage approvals data suggest more subdued housing demand, thus limiting housing investment growth.

Changes in inventories accounted for a considerable share of the 2009 output fall, driven partly by producers' desire to support their cash flow positions by running down large inventories built up in better times. With business surveys signalling increased new orders, changes in inventories are likely to turn positive towards the end of 2010, and to make positive contributions to growth throughout 2010 and 2011.

Government consumption expenditure grew on a quarterly basis throughout 2009, supporting domestic demand, especially in the final quarter. Looking ahead, the latest Budget projections imply falls in spending that create a drag on demand in financial years 2010/11 and 2011/12.

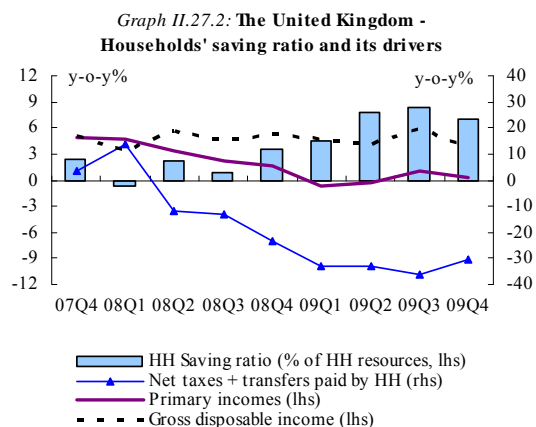
Net external demand supported growth in the early part of the recession, as imports fell further than exports. However, in the second half of 2009 imports grew more rapidly than exports, subtracting ¼ pp. from growth in each quarter. Sluggish export performance following sterling's depreciation of over 20% since mid-2007 is in part attributable to the relative stability of the UK's terms of trade. While some remaining pricing lags still delay an adjustment of export prices in the short term, the central scenario is for a moderate terms of trade deterioration over the forecast horizon. This should help increase export growth relative to that in imports enough to generate a moderate improvement in net external demand, thereby supporting growth in the medium term.

### Moderate job losses but higher inactivity

Since mid-2009 harmonized UK unemployment levels have remained relatively stable at around 2.5 million persons, with the narrower claimant count measure showing slight falls in 2010. However, the apparent stability of the unemployment rate at around 8% must be seen in its broader context. Notably, full-time employment levels have continued falling throughout 2009 but were largely offset by rising part-time employment. Growth in the working age population since early 2009 was outweighed by a 1 pp. rise in inactivity to 21.5%. While much of this increase is due to rising student numbers, inactivity may have also increased due to lower perceived employment prospects. Stemming rising inactivity and preserving full-time employment is an important challenge facing the UK labour market, with repercussions for tax revenues, benefit payments and household income.

### Households' finances supported by stabilisers

During 2009 aggregate household income was supported by rises in benefit payments and lower tax payments and social contributions. Real household gross disposable income continued to grow throughout the recession (Graph II.27.2). As private consumption spending fell during 2009, household gross saving increased to a ten-year high of 8.4% in the third quarter, moderating only slightly thereafter. Most of this rebalancing is attributable to increases in disposable income. However, transfer payments are unlikely to grow further given the stagnating UK labour market, and the (re-)increases in VAT and social contributions in 2010 will depress disposable income growth. This suggests that the current high saving rate cannot be maintained without significantly constraining household spending growth.



### From quantitative easing to lending growth

Since the Bank of England's March 2009 decision to begin purchasing assets financed by the creation of reserves, GBP 200 bn (14% of GDP) worth of mainly UK government bonds have been purchased. The policy pursued multiple objectives, amongst these an increase in nominal spending and greater credit provision by banks to the private sector. The purchases to date have raised the monetary base by the amount of the purchases, but annual growth in broad money supply (M4, i.e. including lending) has slowed to almost zero. Bank lending to private non-financial companies contracted during 2009, and lending to households stagnated, partly due to the weak housing market. The Bank of England's credit conditions surveys suggests that after a tightening of the price and availability of credit in 2009, conditions for households had stabilised and improved for corporations in the first quarter of 2010. A further easing in lending conditions would support domestic demand without necessarily jeopardising the longer-term household sector deleveraging.

### Inflation story: VAT, sterling and spare capacity

Data released since the autumn have shown a strong increase in inflation in the final months of the year, in part due to base effects from 2008 energy price falls and the December 2008 VAT reduction. However, a significant part of the rise in inflation seems due to an unexpectedly long-lagged effect of sterling's depreciation since mid-2007. Given a higher price level than previously expected, this implies year-on-year inflation for much of 2010 will be higher as well, even on a broadly unchanged view of monthly price movements. The temporary effects should soon give way to deflationary pressures from significant spare capacity, particularly in the labour market. This is likely to bear down on factor costs, particularly average earnings growth, leading to inflation of around 1½% in 2011.

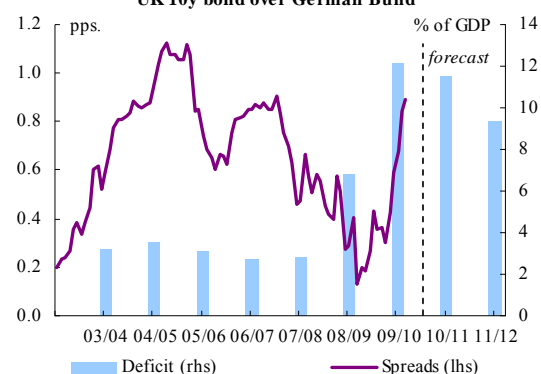
### From stimulus to limited consolidation in public finances

After a significant stimulus in 2009, the government has initiated a fiscal consolidation in 2010 with the deficit expected to fall from 12.2% of GDP in 2009/10 to just under 9½% of GDP by 2011/12, though most of the fiscal effort is backloaded to the end of the forecast period. The reduction in the deficit by 2011/12 primarily reflects the combined effects of better economic

conditions and unprecedented restraint in discretionary expenditure. However, the government's plans for non-cyclical primary expenditure in 2011/12, which the forecast assumes will be adhered to, are not yet backed by detailed departmental spending limits. In addition, government financial sector interventions undertaken during the crisis have generated large contingent liabilities.

The deficit in financial year 2009/10 is estimated at 12.2% of GDP, around ¾ pp. lower than projected by the Commission services in autumn 2009, primarily due to a weaker contraction in revenue growth. In 2010/11 the primary deficit is expected to fall by 1½% of GDP, though the reduction in the total deficit – at ¾% of GDP – will be smaller as a result of higher debt servicing costs. The reduction in the deficit is driven by an increase in revenue by 6⅓% in nominal terms, around one-thirds of which is due to the increase in the VAT rate to its pre-stimulus level. Expenditure is projected to continue growing at a slower rate, up by around 4% over the preceding year, in part reflecting a deceleration in cyclical expenditure. Front-loading of capital expenditure to 2008 and 2009 should also contribute to lower investment spending in 2010/11 by almost 1% of GDP. The spring 2010 deficit forecast for 2010/11 is 0.2 pp. higher than that projected in the 2010 Budget, primarily reflecting the projection of slightly lower economic growth and weaker tax elasticities.

Graph II.27.3: The United Kingdom - Spread of UK 10y bond over German Bund



Overall, the discretionary measures that will come into effect in 2010/11 will reduce the deficit by around 1% of GDP. The structural budget deficit, however, is estimated to decline only slightly from 2009/10, reflecting low revenue elasticity as a result of continued weak activity in the financial and housing markets, each of which had hitherto been major sources of revenue.

Table II.27.2:

General government projections on a financial year basis					
	2007/08	2008/09	2009/10	2010/11	2011/12
General government balance <sup>1</sup>	-2.8	-6.8	-12.2	-11.5	-9.4
Structural budget balance	-3.8	-6.2	-10.2	-10.0	-8.2
General government gross debt	43.7	55.8	71.4	80.9	87.9

<sup>1</sup> Data adjusted for the consistent recording of UMTS licence proceeds.

With unchanged policies, in 2011/12 the deficit is projected to drop by around 2 pps. from the previous year, while the structural deficit ratio is estimated to improve by 1¾ pps. The planned increase in social security contribution rates is expected to raise revenue by 0.4% of GDP, while an increase in tax rates on high incomes is expected to yield an additional 0.2% of GDP.

Current expenditure is planned to grow by 2¾% in 2011/12, or 1¼% in real terms, while investment spending is planned to be reduced by around ¾% of GDP.

The forecasts for interest payments in 2010/11 are based on an assumed increase in 10-year interest rates from an average of 3.4% in 2009 to 4.1% in 2010 and 4.5% in 2011.

The debt ratio in 2010/11 is estimated to increase by 9½ pps. of GDP, driven by the high primary deficit. In 2011/12 the debt ratio, at around 88% of GDP, is set to overtake the EU average.

Table II.27.1:

## Main features of country forecast - THE UNITED KINGDOM

	2008			92-05	Annual percentage change					
	bn GBP	Curr. prices	% GDP		2006	2007	2008	2009	2010	2011
GDP		1448.4	100.0	2.8	2.9	2.6	0.5	-4.9	1.2	2.1
Private consumption		928.5	64.1	3.2	1.5	2.1	0.9	-3.2	0.6	1.5
Public consumption		313.6	21.6	1.8	1.6	1.2	2.6	2.2	1.5	-1.5
Gross fixed capital formation		242.8	16.8	3.7	6.5	7.8	-3.5	-14.9	-0.9	4.4
of which : equipment		83.9	5.8	5.0	4.5	11.5	-3.2	-22.7	-3.9	6.3
Exports (goods and services)		422.4	29.2	5.6	11.3	-2.8	1.1	-10.6	5.2	5.4
Imports (goods and services)		460.6	31.8	6.6	8.8	-0.7	-0.5	-11.9	5.3	4.1
GNI (GDP deflator)		1478.7	102.1	3.0	1.8	3.3	1.2	-5.0	1.2	2.0
Contribution to GDP growth :										
Domestic demand				3.1	2.4	3.0	0.5	-4.2	0.6	1.3
Inventories				0.1	0.1	0.2	-0.4	-1.2	0.8	0.6
Net exports				-0.3	0.4	-0.6	0.4	0.7	-0.2	0.2
Employment				0.7	0.9	0.7	0.7	-1.6	-0.3	0.7
Unemployment rate (a)				6.8	5.4	5.3	5.6	7.6	7.8	7.4
Compensation of employees/head				4.2	4.2	4.9	2.6	1.4	1.4	1.6
Unit labour costs whole economy				2.1	2.2	3.0	2.7	4.9	-0.1	0.2
Real unit labour costs				-0.4	-0.6	0.1	-0.2	3.5	-2.5	-1.3
Savings rate of households (b)				-	-	2.2	1.5	7.1	6.5	6.3
GDP deflator				2.5	2.8	2.9	3.0	1.4	2.5	1.4
Harmonised index of consumer prices				1.9	2.3	2.3	3.6	2.2	2.4	1.4
Terms of trade of goods				0.1	-0.1	0.6	0.3	-0.3	-0.4	-1.2
Trade balance (c)				-3.1	-5.8	-6.4	-6.4	-5.9	-6.4	-6.7
Current account balance (c)				-1.6	-3.3	-2.7	-1.5	-1.3	-1.8	-2.0
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-1.5	-3.2	-2.5	-1.3	-1.1	-1.6	-1.7
General government balance (c)				-2.9	-2.7	-2.8	-4.9	-11.5	-12.0	-10.0
Cyclically-adjusted budget balance (c)				-2.8	-3.5	-3.9	-5.7	-9.7	-10.4	-8.7
Structural budget balance (c)				-	-3.5	-3.9	-5.2	-9.5	-10.4	-8.7
General government gross debt (c)				43.6	43.5	44.7	52.0	68.1	79.1	86.9

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.