

27. THE UNITED KINGDOM

The pause in growth risks becoming prolonged

Growth slows as external events increase uncertainty

After a promising start to 2010, the UK economic outlook has deteriorated significantly since the turn of the year. Output in the second quarter of 2011 was just 0.6% higher than in the same quarter of 2010. Quarterly output did not grow at all in the three quarters to the second quarter of 2011, remaining 4.4% below its pre-crisis peak. This puts the UK's recovery performance well behind its major peers.

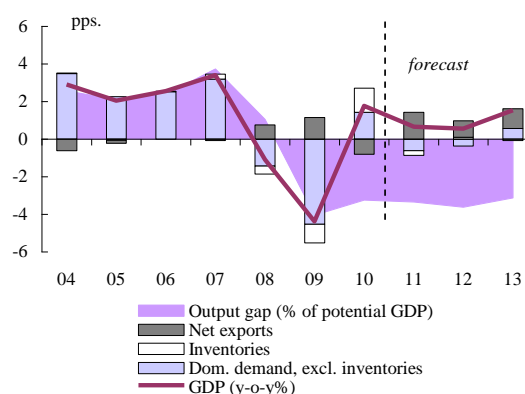
Much of this weakness can be traced back to household consumption, which has contracted for four successive quarters. Households spent 6.4% less in the second quarter of 2011 than at the pre-crisis peak in the fourth quarter of 2007. Survey indicators suggest that this weakness will continue, with consumer confidence as measured by the Commission's Business and Consumer survey having fallen sharply since May 2011 to below its average for 2008 and 2009, although still well above its January 2009 trough. Overall economic sentiment, as measured by the Economic Sentiment Indicator, has also declined sharply since May, having risen above its long-term average in the early part of the year.

On the output side, while the manufacturing sector's strong recovery has faltered recently, services sector performance has strengthened during 2011, growing 0.7% and 0.2% in the first two quarters respectively. Without the growth contribution from services, the economy would have contracted in both quarters. However, it seems unlikely that this stronger services performance will be maintained. Confidence in the sector appears to have declined even more sharply than in the rest of the economy over recent months. Domestic consumption and financial services exports, the two main sources of demand for services, also appear likely to remain subdued.

Net exports and corporate investment remain the best hopes for a return to stronger growth although the prospects for both are mixed. On the export side, the Bank of England's announcement in October that it would increase the size of its quantitative easing programme should help prevent any substantial appreciation in sterling, protecting exporters' price competitiveness. Weak domestic

demand should also hold back import growth. However, the external sector's growth contribution has remained volatile; it contributed 1.4 pps. q-o-q in the first quarter of 2011 but subtracted 0.3 pp. in the second quarter. Weakness in the euro area, the UK's main export market, will hold back external demand at least in the short term. As regards corporate investment, the sector's large financial surplus, the government's announcement that it will explore options to use its own balance sheet to support corporate debt issuance and highly expansionary monetary policy all provide reasons for optimism. However, weak demand prospects are likely to make firms cautious about investing and ongoing stress in the banking sector will continue to hamper credit availability.

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



In all, this yields an uncertain outlook. The slowdown which began at the end of 2010 now looks more like a prolonged soft patch than a simple weather-related blip. Risks from the euro-area sovereign-debt markets and the banking sector heighten this uncertainty. As such a contraction in GDP in at least one of the next few quarters cannot be ruled out. However, the outlook for corporate investment and net exports still appears positive enough to justify a forecast of modest positive growth with the economy expanding by 0.7% in 2011, 0.6% in 2012 and 1.5% in 2013. The substantial downward revision from the spring forecast is explained mainly by the bleaker outlook for household consumption, corporate investment and exports, offset partially by slower expected import growth.

Is the net exports rebound finally with us?

Hopes of an imminent growth impetus from the external sector have been a feature of many UK economy forecasts ever since world trade started to recover with sterling remaining well below pre-crisis exchange rates. Recent data revisions suggest that the external sector has made a more significant contribution to UK growth than first thought. However, strong data on export orders suggest the export rebound may still have further to go. The surge in import growth which accompanied the UK's exit from recession has evaporated with imports falling in both the first two quarters of 2011. Weak consumption growth and the ending of the acceleration in stock building are likely to keep import growth weak or negative throughout the forecast period.

While exports also fell in the second quarter, this followed four consecutive quarters of expansion. The outlook for exports is clouded by uncertainty in the global economy and particularly in the euro area. Given the worsening external conditions, forecast export growth has been revised down significantly since the spring forecast. However, with the exchange rate likely to remain competitive following the Bank of England's decision to undertake more quantitative easing firms should have a continuing incentive to explore new foreign markets. With hindsight it is not surprising that an increase in the resources devoted to export markets has been slow to materialise given economic uncertainty and restricted credit availability, but the longer the exchange rate remains at its current level, the greater should be firms' confidence that a sudden appreciation is not imminent. As such, the forecast is for modest export growth to exceed weak import growth, with the external sector contributing positively in all three years of the forecast.

Consumption and investment yield weaker outlook for domestic demand

It has been clear for some time that domestic demand growth in the coming years would be weak. With government consumption falling, consumers struggling with falling real incomes and the stock cycle having peaked, the only bright spot on the horizon was business investment which is overdue a rebound after its unprecedented collapse during the recession.

The surprise has been the degree of weakness in household consumption, which was 1.7% lower in

the second quarter of 2011 than in the same period in 2010. During 2010, as the household saving rate fell steadily from its crisis peak it appeared that households were eschewing additional saving in favour of maintaining reservation levels of consumption as falling real wages pushed down their disposable incomes. However, this trend now appears to be going into reverse. Households could be becoming more cautious as the risk of unemployment heightens. The partial reversal of the 2010 housing market recovery could also have discouraged households from relying on house price rises as a means to increase net worth. Finally, while household debt has fallen as a percentage of GDP since 2009, it remains well above the EU average, implying a continuing incentive for households to deleverage. The increasing certainty that interest rates will remain at record lows for a significant period is the only compensating factor. Given that these conditions are likely to persist, consumption is forecast to remain very subdued with a strong possibility of further quarterly contractions around the turn of the year. With real wages forecast to return to at least modest growth, this implies a continuing increase in the household saving rate.

This leaves business investment likely to be the only significant support to domestic demand. With investment as a share of GDP having fallen to around 14% of GDP in the aftermath of the crisis, compared to a long-run average of 17%, a significant recovery seems likely at some point if only to keep up with depreciation. What remains uncertain is the timing. The sharp fall in investment in the first quarter of 2011 is likely to push its annual growth rate into negative territory, barring a significant rebound in the last two quarters. Whether this represents a one-off reverse or a more persistent malaise is as yet unclear. On the one hand, low real and nominal interest rates (which should go even lower once credit easing and increased quantitative easing are implemented), the huge corporate sector surplus and the need for further investment to maintain the existing capital stock should all push investment higher. However, on the other hand, continued problems with access to credit for some firms, uncertain prospects for domestic and external demand and lower capacity utilisation seem to offer a strong incentive to firms to wait and see before committing to large scale capital spending. On balance, this yields a forecast of moderate investment growth with the level remaining well below pre-crisis peaks.

Employment: can private sector growth offset public sector cuts?

The most concrete signal that the slowdown in the recovery had begun to impact the labour market came through data showing that unemployment increased from 7.7% over the period March-May 2011 to 8.1% for June-August. This was its highest level since 1996. Over the past year, the labour market has been characterised by strong falls in public sector employment offset by modest private sector growth. Because it accounts for 80% of employment, a small percentage growth rate in the private sector can offset a much bigger percentage fall in public sector employment. However, it appears that in the three months to August, private sector growth was insufficient to achieve this.

The speed of the reduction in public sector jobs has been surprising. Excluding the impact of the state-owned banks, it fell by 228 000, or 3.8%, in the year to June 2011. This already equates to around half the total job cuts which the Office for Budget Responsibility (OBR) estimated would be necessary to deliver the government's spending reduction targets over the period to 2014-15.⁽⁷³⁾ To the extent that this represents an unexpected frontloading of the planned job cuts, it should improve the employment outlook since fewer cuts can be expected later on. However, it could also imply that government departments are implementing a higher-than-expected share of the cuts through job losses rather than cuts to other spending. In that case, the employment outlook could be worse than previously thought. Both explanations probably have some validity. However, once falling private sector employment intentions are also taken into account the overall employment outlook does appear markedly worse. As such, unemployment is forecast to rise to 8.7% in 2012 before falling back to 8.6% in 2013.

Stronger monetary stimulus but credit growth remains weak

In spite of the extraordinary monetary stimulus provided by the Bank of England (interest rates at 0.5% and quantitative easing increased from GBP 200 bn to GBP 275 bn, or 19% of GDP), net lending to business has remained mainly negative. Some positive signs may be starting to emerge. Net lending by UK banks to UK businesses was positive in August, only the fourth positive month

since January 2009, although three-month and annual net lending remained negative. Furthermore, data suggest that in the first half of the year UK banks met their targets for increased lending to businesses agreed under the Project Merlin initiative. The government's plans for credit easing should further support net lending. However, if this does represent the start of a recovery in net lending it will be severely tested in its early days. A peak in maturities of UK banks' debt in the fourth quarter of 2011, coupled with heightened risk aversion and tighter liquidity conditions as a result of the distress in some euro area sovereign debt markets will test banks' already fragile will to lend. As such, any recovery in business lending seems likely to be reliant on a degree of government support.

Inflation: still high but still likely to fall

The short-term outlook for inflation has worsened somewhat over recent months, with household energy prices pushing the annual rate to 5.2% in September. However, while the upward shock to inflation, driven by VAT rises, commodity price increases and sterling depreciation, has lasted long enough to stretch the definition of "temporary" right to its limit, the case for believing that inflation will fall sharply in 2012 remains as strong as ever. While average earnings growth ticked up in the three months to July 2011, it fell back again sharply in August, in line with the generally weaker labour market picture, continuing to show an absence of second round effects from the price shock. Furthermore, the circumstances which have driven inflation so high over the past eighteen months look unlikely to be repeated. While sterling may weaken slightly in response to looser monetary policy, a further fall on the scale seen in 2008 and 2009 seems highly unlikely. Weakness in the global economy makes any sharp increases in world commodity prices improbable and all of the announced VAT rises have now been implemented. Inflation is therefore forecast to fall to 2.9% in 2012 and 2.0% in 2013.

Continuing commitment to fiscal consolidation

Despite the downturn in both the global economy and the outlook for the UK, the government has maintained its strong commitment to fiscal consolidation. Recently published outturn data for 2010/11 produced a positive surprise with the deficit estimated at 9.6%, below the 9.9% forecast in the March 2011 budget. The main sources of the

⁽⁷³⁾ Here and throughout 20xx/xx refers to the UK financial year which runs from 1 April to 31 March.

lower-than-expected deficit were methodological changes and upward revisions to GDP.

Recent data have shown government revenues to be slightly below their forecast levels. However government consumption has been lower than expected leaving overall borrowing lower than forecast by the OBR in March 2011. Significant improvements in the structural deficit have already been delivered, as it fell to 8.3% of GDP in 2010/11 from 9.8% of GDP in 2009/10. The consolidation is forecast to slow slightly in 2011/12 before picking up again through 2012/13 and 2013/14. The worsening growth outlook implies clear downward risks to the latest UK official fiscal forecasts published in March. However, given that the UK's own fiscal targets are assessed in cyclically-adjusted terms, there will be flexibility to accommodate a nominal overshoot in the deficit to the extent that the OBR judges the overshoot to have been driven by cyclical rather than structural weakness. The higher deficit forecast does imply some risk to the 2014/15 Excessive Deficit Procedure deadline for reducing the deficit below 3% of GDP. However, given the uncertainty around current growth forecasts it is preferable to focus on the structural budget which is still forecast to show a strong improvement.

In policy terms, the only change of note since the spring forecast has been the decision that central government will fund the extension to 2013 of a freeze in the Council Tax collected by local authorities. This is estimated to cost GBP 800 million (0.06% of GDP) and will be funded through efficiency savings in other areas.

Gross debt for 2010/11 was revised up by 3.9 pps. to 80.6% of GDP, following the inclusion of Eurostat's amendments on the treatment of financial sector interventions. It is projected to rise throughout the forecast period although the rise will slow significantly in 2013/14, reflecting the lower forecast deficit.

Table II.27.1:

General government projections on a financial year basis					
	2009/10	2010/11	2011/12	2012/13	2013/14
	Actual		Forecast		
General government balance	-11.7	-9.6	-8.6	-7.3	-5.2
Structural budget balance	-9.8	-8.3	-7.2	-5.8	-4.0
General government gross debt	72.6	80.6	83.3	87.7	89.7

Table II.27.2:

Main features of country forecast - THE UNITED KINGDOM

	2010			92-07	Annual percentage change					
	bn GBP	Curr. prices	% GDP		2008	2009	2010	2011	2012	2013
GDP	1458.5	100.0	100.0	3.0	-1.1	-4.4	1.8	0.7	0.6	1.5
Private consumption	937.9	64.3	64.3	3.3	-1.5	-3.5	1.1	-1.1	-0.5	0.8
Public consumption	338.1	23.2	23.2	1.9	1.6	-0.1	1.5	1.5	-1.0	-1.6
Gross fixed capital formation	217.1	14.9	14.9	4.1	-4.8	-13.4	2.6	-1.6	1.1	2.9
of which: equipment	76.5	5.2	5.2	5.5	-5.2	-22.0	8.6	-5.7	3.4	6.1
Exports (goods and services)	429.0	29.4	29.4	5.6	1.3	-9.5	6.2	5.1	3.4	4.8
Imports (goods and services)	478.0	32.8	32.8	6.4	-1.2	-12.2	8.5	0.2	0.5	1.4
GNI (GDP deflator)	1481.3	101.6	101.6	3.2	-0.6	-4.8	1.8	-0.1	1.0	1.1
Contribution to GDP growth:		Domestic demand		3.2	-1.4	-4.5	1.5	-0.6	-0.4	0.6
		Inventories		0.1	-0.4	-1.0	1.3	-0.2	0.1	-0.1
		Net exports		-0.3	0.8	1.1	-0.8	1.4	0.9	1.1
Employment				0.7	0.7	-1.6	0.2	0.9	0.5	0.5
Unemployment rate (a)				6.6	5.6	7.6	7.8	7.9	8.6	8.5
Compensation of employees/head				4.3	1.7	2.7	3.3	2.0	2.5	3.0
Unit labour costs whole economy				2.0	3.6	5.7	1.7	2.2	2.5	2.0
Real unit labour costs				-0.4	0.5	4.0	-1.1	-0.7	-0.6	-0.2
Saving rate of households (b)				6.8	2.0	6.0	5.3	7.7	7.3	7.6
GDP deflator				2.4	3.1	1.7	2.8	2.9	3.1	2.2
Harmonised index of consumer prices				2.0	3.6	2.2	3.3	4.3	2.9	2.0
Terms of trade of goods				0.0	-0.6	0.1	0.6	-0.9	-0.6	-0.5
Merchandise trade balance (c)				-3.4	-6.6	-5.9	-6.8	-6.3	-5.6	-5.0
Current-account balance (c)				-1.8	-1.8	-1.4	-2.5	-2.5	-0.9	-0.2
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-1.7	-1.5	-1.2	-2.3	-2.3	-0.7	0.0
General government balance (c)				-2.8	-5.0	-11.5	-10.3	-9.4	-7.8	-5.8
Cyclically-adjusted budget balance (c)				-3.2	-5.5	-9.7	-8.9	-8.0	-6.3	-4.5
Structural budget balance (c)				-	-5.0	-9.5	-8.9	-8.0	-6.3	-4.5
General government gross debt (c)				43.7	54.8	69.6	79.9	84.0	88.8	85.9

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