

27. THE UNITED KINGDOM

Budget deficit and debt spiral as economy contracts

Domestic demand begins to fall

Economic activity in the first two quarters of 2008 slowed sharply compared to the previous year, reaching standstill in the second quarter, and contracted by 0.5% in the third. ⁽¹¹⁾ In 2007 annual growth had reached 3.0%, following 2.8% in 2006.

Notwithstanding the overall slowdown, growth continued to be supported mainly by private consumption in the first half of 2008, which however stagnated in the second quarter following a sharp increase in the first. Gross disposable income increased slightly in the first half of the year, with a notable rise in the second quarter. In the face of the high household spending, the saving ratio nonetheless turned negative (-0.6%) in the first half, compared to an already low 2.5% in 2007.

Fixed investment fell markedly in the first two quarters, subtracting on average 0.4 percentage points from quarterly growth. The weakening was broad-based, driven by a fall in both residential and business investment, although general government investment provided a small stimulus. General government consumption contributed positively to overall growth in the first half while the build-up of inventories dampened it slightly.

Net external demand provided a sizeable stimulus in the first two quarters on account of falls in imports and a slight improvement in exports. The current external balance showed marked swings in the first two quarters due to sharp changes in the income balance, leaving the current balance in deficit by 3.0% of GDP in the second quarter,

following a deficit of 3.8% in 2007.

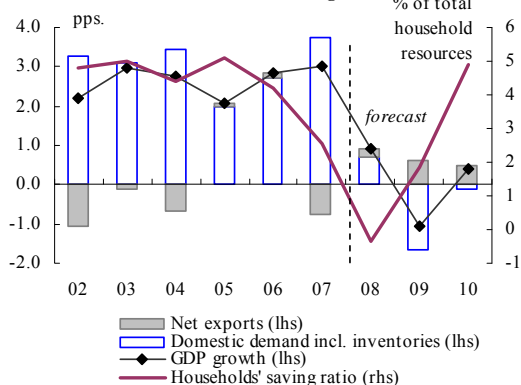
Financial market conditions proved both tense and volatile throughout the year, culminating in sharp rises in money market spreads and a pronounced weakening in equity markets. Following the nationalisation of the Northern Rock (NR) bank in February 2008, the UK government took ownership of Bradford & Bingley (B&B), another UK mortgage lender, in late September. In response to mounting pressures on the banking sector, the government announced a banking recapitalisation plan on 8 October, accompanied by a sovereign guarantee of certain types of new short- and medium-term corporate debt as well as an enhanced extension of the Bank of England's Special Liquidity Scheme.

Financial and housing markets depress outlook

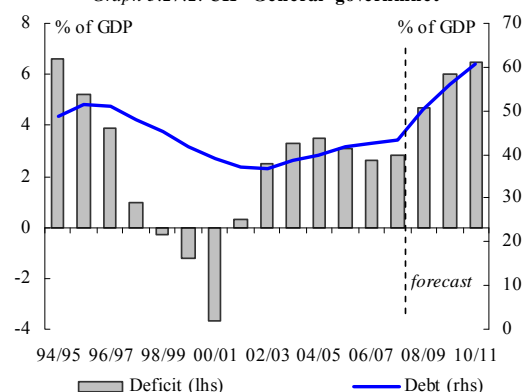
The economic outlook in the medium term is shaped by developments in the housing market and domestic credit conditions, both of which will weigh on domestic demand going forward. The historically large depreciation of the pound's nominal effective exchange rate since mid-2007 is likely to improve the price competitiveness of UK exports in the medium term.

The central outlook envisages a marked fall in private consumption in 2009 and 2010, driven by more restrictive borrowing conditions and lower household wealth. The Bank of England's October 2008 credit conditions survey showed that conditions for all types of lending to households and corporations tightened successively from the onset of the credit crunch through to the third

Graph 3.27.1: UK - GDP growth contributions and household savings



Graph 3.27.2: UK - General government



quarter 2008, and would be restricted further in the fourth. The expected continuation of the downward correction in house prices will also weaken the collateral value of housing for secured borrowing, thus compounding the ongoing tightening of credit conditions. Private consumption will be dampened further as household spending responds to falling employment, which depresses disposable income, as well as to falls in net housing and financial wealth. The heightened unemployment risk is also likely to prompt increases in savings from their currently very low level.

Fixed investment is set to fall sharply in both 2008 and 2009 on account of a restrictive borrowing environment, as well due to a weak demand outlook in both the housing market and business sector. Faced with easing capacity pressures, business investment will fall until end-2009 before recovering, while housing investment will be cut in response to house price falls, low turnover and a weak and uncertain demand outlook. Government consumption will continue providing a moderate stimulus over the entire forecast period, with expenditure plans confirmed until 2010.

The growth contribution of net external demand is expected to continue to be weakly positive. Imports are expected to slow in 2009 in line with domestic demand growth, while exports will increase only moderately due to an appreciable softening of export markets and some absorption of a weaker exchange rate in UK exporters' profit margins. ⁽¹²⁾ Foreign income flows will be affected by writedowns of both UK assets and liabilities, but will continue to help finance the UK's substantial trade deficit and the external deficit is therefore likely to stabilise at slightly below 3% of GDP over the forecast period.

In summary, growth in the UK economy is expected to slow to 0.9% in 2008. In 2009, a negative carryover and the contraction in domestic demand through the year will lead to a contraction of around 1%, followed by a gradual recovery in 2010 to annual growth of around ½%. This scenario is subject to downside risks relating to the length and severity of financial market problems, which remain highly uncertain but are crucial in view of the scale of household indebtedness and the typically strong growth contribution of the UK's financial sector.

Employment falls and inflation drops sharply

The previously strong labour market showed early weakening, with employment starting to fall and unemployment rising markedly over the summer. Over the forecast period employment growth is expected to turn negative as a result of falling output. The supply of labour is also projected to increase at a slower pace, reflecting reduced immigration. As activity weakens the unemployment rate will rise by around 1½ percentage points over the forecast period. Average earnings growth remained stable at just below 4% in the first half of 2008, but is expected to moderate in 2009 due to labour market weakening. HICP inflation will remain high at above 4% in the final quarter of 2008, but will ease sharply in 2009 as economic activity and energy and commodity prices weaken.

Government deficit set to reach 6½% of GDP by 2010/11

In the 2008/09 financial year the general government deficit is forecast to rise to 4¼% of GDP.⁽¹³⁾ Thereafter, public finances are expected to continue deteriorating, with the deficit ratio forecast to reach 6% in 2009/10 and 6½% in 2010/11. The structural budget balance in 2008/09 is set to deteriorate substantially, the greater part of the deterioration due to the weakening of economic activities yielding high tax intakes.

Table: 3.27:

General government projections on a financial year basis				
	2007/08 ¹	2008/09	2009/10	2010/11
Budget balance	-2.8	-4.7	-6.0	-6.5
Cyclically-adjusted budget balance	-3.4	-4.9	-5.3	-5.4
Debt ²	43.2	50.4	55.9	60.8

¹ Actual data.

² In 2007 the Bank of England made a loan equivalent to 1.9% of GDP to Northern Rock (NR) bank in the context of a rescue operation. Eurostat has taken the provisional view that the lending should have the government as the principal party of the transaction in the national accounts framework. If the loan were to be treated in this way, the debt-to-GDP ratio would be 46.1% at end-2007 and 44.9% at end 2007/08. The lending to NR has no direct impact on the government deficit in 2007/08.

In 2008/09 the revenue ratio is forecast to drop by almost a three-quarter-percentage point. Revenue from corporate taxation, which accounted for a quarter of tax revenue increases over the past five years, is expected to decrease, primarily reflecting financial sector difficulties. An increase in corporate taxes as a result of higher profits from oil and gas extraction will be largely offset by lower profitability in the oil-consuming industries. Meanwhile, the sharp drop in property transactions and falling property prices will reduce stamp duty revenue. VAT revenues are also forecast to grow

at a lower rate than in 2007/08, due to an increase in the share of household expenditure on food and domestic energy, which are not subject to the standard VAT rate.

Subsequent to the March 2008 budget, which was fiscally neutral, the UK authorities announced for 2008/09 fiscal relaxation measures costing around ¼% of GDP in foregone revenue. On the expenditure side, the forecast assumes adherence to the envelope set in the government's 2007 Comprehensive Spending Review for the three years from April 2008, which foresees decelerating non-cyclical primary expenditure. By contrast, the sudden rise in inflation in 2008 will result in higher interest payments on index-linked gilts and sharply uprated social benefits in the near term.

In 2009/10 and 2010/11, the deceleration in corporate profits will weigh down on tax revenue, with no significant improvement in the contribution of the financial sector. Personal income tax receipts are also expected to slow sharply, mirroring lower employment and a deceleration in earnings, while the contraction in real consumption expenditure and low inflation depresses indirect tax revenue. Social transfers are forecast to continue growing at a high rate, in part

due to a weak labour market. Interest payments in 2010/11 are expected to increase by a third compared to 2007/08, mirroring a surge in government debt. The general government gross debt ratio is forecast to rise by more than 15 percentage points, to over 60% by 2010/11, driven by the primary deficits and government capital injections to the banking sector.

The deficit projections above could be subject to upside adjustment as a result of government decisions concerning the financial sector. The latter include the probable conversion into equity of debt owed by NR and the transfer of funds to Abbey following its takeover of B&B's retail deposits. The projections above do not include possible revenues and/or expenses from the government guarantee on interbank lending. The statistical implications of these operations are currently being examined by Eurostat.

⁽¹⁾ The preliminary Q3 GDP estimate published by the UK Office for National Statistics after the cut-off point for this forecast increases downside risks to our forecast.

⁽²⁾ The projections for export and import volumes exclude the impact of Missing Trader Intra-Community (MTIC) fraud.

⁽³⁾ The UK financial year runs from April to March.

Table 3.27.1:

Main features of country forecast - THE UNITED KINGDOM

	2007			Annual percentage change						
	bn GBP	Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at constant prices	1401.0	100.0		2.8	2.1	2.8	3.0	0.9	-1.0	0.4
Private consumption	893.4	63.8		3.3	1.9	2.1	3.0	1.8	-2.1	-1.1
Public consumption	296.9	21.2		1.8	1.7	1.6	1.8	2.0	1.3	2.0
Gross fixed capital formation	249.2	17.8		3.8	2.2	6.0	7.1	-3.3	-3.0	0.9
of which : equipment	84.2	6.0		5.3	1.7	4.0	9.0	-3.2	-2.5	-0.4
Exports (goods and services)	368.3	26.3		5.4	8.1	11.0	-4.5	1.6	1.3	2.7
Imports (goods and services)	415.8	29.7		6.6	7.0	9.6	-1.9	0.8	-0.9	0.9
GNI at constant prices (GDP deflator)	1408.0	100.5		3.1	2.3	1.8	2.8	1.9	-1.3	0.5
Contribution to GDP growth :										
Domestic demand				3.1	2.0	2.7	3.5	1.0	-1.6	-0.1
Stockbuilding				0.1	0.0	0.0	0.2	-0.3	-0.1	0.0
Foreign balance				-0.4	0.1	0.0	-0.7	0.2	0.6	0.5
Employment				0.7	1.0	0.9	0.7	0.5	-1.6	0.3
Unemployment rate (a)				6.9	4.8	5.4	5.3	5.7	7.1	6.9
Compensation of employees/head				4.3	3.7	4.6	3.7	2.8	2.7	2.8
Unit labour costs whole economy				2.1	2.7	2.6	1.3	2.4	2.1	2.7
Real unit labour costs				-0.4	0.4	0.0	-1.5	-0.8	-0.2	0.6
Savings rate of households (b)				-	-	4.2	2.6	-0.3	1.8	4.9
GDP deflator				2.6	2.2	2.6	2.9	3.3	2.3	2.0
Harmonised index of consumer prices				1.9	2.1	2.3	2.3	3.7	1.9	1.2
Terms of trade of goods				0.3	-2.3	-0.6	1.6	0.9	1.1	0.7
Trade balance (c)				-2.9	-5.5	-5.8	-6.4	-6.5	-6.1	-5.6
Current account balance (c)				-1.5	-2.6	-3.4	-3.8	-2.8	-2.6	-1.8
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-1.4	-2.5	-3.3	-3.6	-2.5	-2.4	-1.7
General government balance (c)				-2.8	-3.4	-2.7	-2.8	-4.2	-5.6	-6.5
Cyclically-adjusted budget balance (c)				-2.7	-3.6	-3.0	-3.5	-4.6	-5.0	-5.4
Structural budget balance (c)				-	-3.9	-3.0	-3.5	-4.6	-5.0	-5.4
General government gross debt (c)				43.7	42.3	43.4	44.2	50.1	55.1	60.3

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