

27. THE UNITED KINGDOM

Path to recovery complicated by remaining imbalances

Abrupt end to decade of growth and stability

The UK entered its deepest post-war recession in the second half of 2008, after a decade of strong and continuous expansion, falling unemployment and steep rises in asset prices. As in many other countries, the recession undid much of the output, employment and financial gains built up in previous years: GDP at the end of the second quarter 2009 stood at the level of late 2005, while the unemployment rate surged by 2.5 pps. to around 8% in the year to mid-2009. In addition, a number of imbalances had been mounting in the UK economy over the last decade - notably in the housing market and public finances - that compounded the impact.

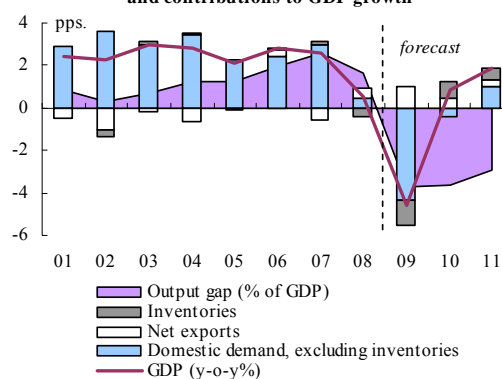
Policy intervention since the onset of the crisis has aimed at stemming systemic failure and restoring financial stability through a range of operations to improve banks' liquidity and solvency, as well as increasing the flow of credit to the private sector and supporting domestic demand through radical monetary easing and fiscal policy measures. Partly in response to the change in the monetary stance, which as well as historically low interest rates included the exceptional use of quantitative easing mainly through the purchases of UK government bonds, the exchange rate weakened substantially. While the success of some of these measures intended to support broad money growth and spending cannot yet be adequately gauged, financial market conditions are gradually returning to normality, although credit growth remains low.

Exiting recession with weak domestic demand and some support from the external sector

Following the sharpest quarterly loss of GDP in over fifty years in the first quarter of 2009, the speed of contraction moderated in the following quarter.⁽⁸⁹⁾ Positive growth is expected in the second half of the year, though this reflects a number of temporary factors, such as high government spending, a rebound in the inventories cycle and the re-increase of the VAT rate in 2010. Notwithstanding this positive development, GDP in 2009 as a whole is expected to contract by 4½%,

before returning to very modest growth of around 1% in 2010 and 1¾% in 2011.

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



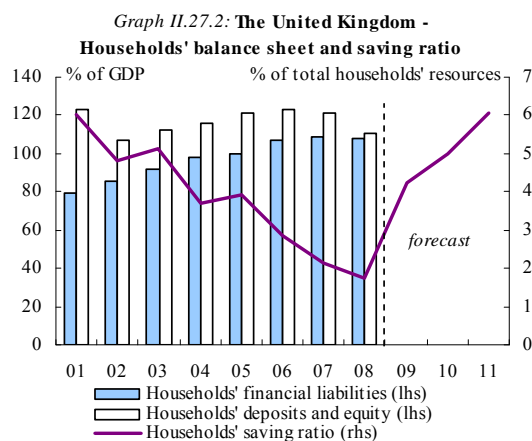
Throughout the recession, falling domestic demand has dominated the overall picture, as fixed investment fell by around 17% between the first quarter of 2008 and the second quarter of 2009, and private consumption contracted by close to 4% over the same period. Looking ahead, domestic demand is not expected to improve in 2010, although it is likely to do so in 2011, albeit modestly.

The outlook for private consumption, which accounts for around 60% of domestic demand, is marked by weak household income throughout most of the forecast period, as additional expected falls in employment in 2009 and 2010 depress labour income and impact on consumer confidence and spending intentions. This will be compounded by weaker earnings growth, as inflation moderates and rising unemployment keeps wage pressures in check. On the other hand, higher transfer payments to households will temper the labour market's negative impact on gross disposable income in 2010, as was already the case throughout 2008 and the first half of 2009. As employment is expected to begin to rise in 2011 and earnings growth to recover somewhat, disposable income would then rise again in both nominal and real terms.

Household spending growth will be tempered by a number of factors over the forecast period, notably households' desire to increase savings in response to a higher risk of unemployment and the sizeable falls in households' net wealth brought about by sharp asset price falls since the onset of the crisis. Households may also wish to provide for future

⁽⁸⁹⁾ GDP data published after the forecast cut-off date show weaker-than-expected activity in Q3, which increases downside risks to the forecast.

interest rate rises that would increase their debt servicing costs appreciably, following sharp increases in household indebtedness in the last ten years. Furthermore, those intending to buy residential property are now faced with a significantly higher deposit requirement, while households with negative housing equity intending to move home are also likely to increase their saving. Overall, this supports an outlook for consumption that involves a fall in 2009 and a bottoming-out in 2010 before rising moderately in 2011. As a result, the household saving rate is expected to rise over the forecast horizon, reaching levels last seen at the beginning of the decade.



Fixed investment was more affected by the crisis than other demand components, not least due to its greater dependence on credit financing and its link to both expected and actual capacity utilisation. The latter fell sharply during the crisis as production cuts reduced the stock of active capital, which in turn reduced the amount of gross investment required to offset depreciation of active capital. The outlook for investment spending shows little improvement as weak demand growth limits the need for net new capacity: fixed investment stabilises in early 2010, but grows at low rates thereafter, especially for machinery and equipment. Investment in housing, which was badly affected by the fall in mortgage lending during the crisis, is assumed to perform slightly better on account of improved credit conditions.

Changes in inventories throughout the recession were comparatively large and showed sizeable variation over time, as stockbuilding turned sharply negative in the final quarter of 2008, particularly in the retail and motor trade industries. The rate of destocking slowed after the first quarter 2009 and is expected to continue doing so until the

second half of 2010, when replenishment of depleted stock levels is expected to start. Overall, inventories are likely to subtract 1¼ pps. from GDP growth in 2009, but will add ¼ pp. and ½ pp. respectively in 2010 and 2011.

Government consumption expenditure continued growing throughout the recession, although at relatively modest levels, thereby providing only a minor stimulus to domestic demand in the first half of 2009, although transfer payments to households and lower tax receipts supported disposable income growth. Current budget plans imply that government spending growth should pick up throughout the remainder of the financial year 2009/10, before fiscal plans for the following financial year dictate reductions in expenditure that will dampen domestic demand.

Net external demand for goods and services, by contrast, recorded a positive contribution to output growth in 2008 and the first half of 2009, driven by import falls that outstripped the reduction in exports, which benefitted from the weaker pound. The supporting effect from net foreign demand is likely to peak in 2009, but will continue over the forecast horizon, by around ½ pp. in each year.

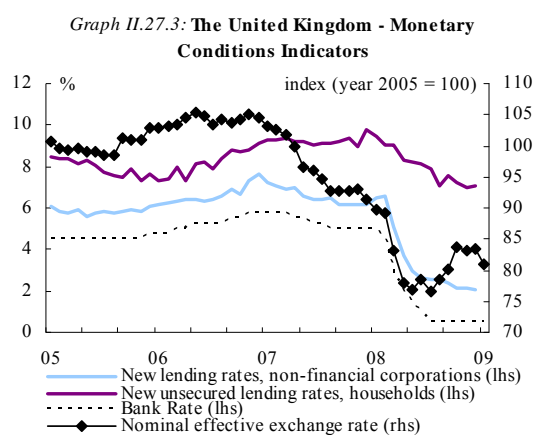
Unemployment still rising

Developments on the labour market throughout the crisis have reflected the severity of the output contraction in falling employment and rising unemployment levels, particularly for full-time employment. The unemployment rate in the second quarter of 2009 reached 7.9%, from 5.3% one year earlier. Employers' employment intentions in the third quarter continue to signal further employment losses, albeit at a lower rate, and the number of vacancies remains historically low, suggesting further unemployment rises in the near term. Given the UK's relatively flexible labour market, the lag between output losses and employment response should be short, so that the unemployment rate is expected to peak in the second quarter of 2010. The rate of net job creation thereafter is expected to be moderate, in line with expectations for a relatively muted recovery in domestic demand.

Deleveraging and banking sector uncertainties

These projections are clouded with considerable risks and uncertainties. The prospects for a return to strong and sustainable growth will depend in

part on when and how imbalances in the government and household sectors are unwound. An important trade-off in this respect will be the rebalancing speed, which will determine the extent to which adjustment in the household and government sector takes a toll on economy-wide expenditure in the short term. However, an excessively protracted adjustment could be at the expense of domestic and external confidence, and might thereby fail to strengthen resilience to future shocks. Furthermore, the expected recovery in domestic demand is heavily contingent on credit demand rising and on credit provision being improved on price and quantity terms. The extent to which loan default rates rise from their current level will be one important determinant of the latter, together with future developments in wholesale funding conditions and the potentially large further losses by UK banks.



Housing market stabilisation not yet solidified

The previously buoyant UK residential property market succumbed to its own exuberance in late 2007, with the impact of the financial crisis compounding the effects. Following a tripling of average house prices between 1997 and late 2007, these fell thereafter by 20% up to early 2009, with moderate price growth resuming thereafter. The number of transactions slumped, and in the third quarter of 2009 remained well below average. Available evidence points towards the recent price recovery being in large part due to a shortage of properties for sale. As price rises are expected to attract more sellers and forced sales rise with unemployment, supply pressures should ease, thus dampening price growth in the near term. Housing demand is expected to remain depressed, as labour market conditions will affect disposable income.

Inflation surprisingly sticky, to ease further

Despite the large rise in economy-wide spare productive capacity and oil prices having halved compared to their previous year's level, annual HICP inflation moderated only gradually throughout 2009 to 1.1% in September. This was driven to a large extent by the sharp nominal effective depreciation of sterling compared to the previous year (-10%, Q3 average). In view of the weakness of economic activity relative to potential, disinflationary pressures should continue to bear down on inflation throughout the forecast period, although in January 2010 the reversal of the 2.5 pps. VAT reduction is likely to lift inflation temporarily. Average earnings growth slowed noticeably throughout 2009 to around 2%, and should continue to slow further in 2010.

Competitiveness gain through depreciation

As markets' perception of risks in the UK financial sector turned increasingly pessimistic throughout the crisis, sterling depreciated substantially. This is expected to help rebalance the economy and generate a positive growth contribution from net external trade throughout the forecast period. The merchandise trade deficit has widened since the late 1990s, only partly financed by a rising surplus in services trade and investment income. An improvement in the trade balance is likely over the forecast horizon, driven by a recovery in exports of goods and services in 2010 as world trade activity resumes following its partly trade-finance-induced collapse in early 2009. The UK is in a good position to consolidate its strong services trade surplus in the medium term, and could further capitalise on its science and technology base by raising skill levels and private R&D spending. Imports are expected to lag the expected export recovery, as domestic demand stays weak and higher import prices gradually lead to a substitution for domestically produced output.

Extraordinary deterioration in public finances

The public finances are expected to remain in a very weak position throughout the forecast period. The high level of the structural government deficit before the outbreak of the present economic crisis limited the government's capacity to pursue a looser fiscal stance without compromising budgetary sustainability. The recent financial sector rescue operations have helped to shore up the banking sector, but have also generated large new contingent liabilities. The government deficit

in 2009/10 is estimated to increase to over 13% of GDP from 6.9% in the preceding financial year (running from April to March). Three-fifths of the forecast deterioration in 2009/10 is due to a drop in the revenue ratio that is largely a result of two interconnected factors: first, the sharp contraction in economic activity; and secondly, the additional losses in tax revenue from two hitherto major sources: the financial sector and the housing market. The expenditure ratio is also forecast to rise sharply, primarily reflecting the planned increase in non-cyclical primary and investment expenditure, higher social security expenditure and the front-loading of expenditure from 2010/11.

Table 2.27.2:

General government projections on a financial year basis					
	2007/08	2008/09	2009/10	2010/11	2011/12
Budget balance ¹	-2.8	-6.9	-13.0	-12.5	-10.7
Structural budget balance	-3.8	-6.3	-11.4	-11.0	-9.6
Debt	43.3	55.2	71.8	82.0	89.1

¹ Data adjusted for the consistent recording of UMTS licence proceeds.

The stimulus measures of around 1½% of GDP that were announced by the government for 2009/10 are estimated to account for a quarter of the increase in the deficit ratio in that year. The reversal of those stimulus measures should contribute to an improvement in the primary balance in 2010/11, though the reduction in the total deficit will be more modest as a result of a surge in debt servicing costs. In 2011/12, fiscal

consolidation is set to accelerate, driven by a sharp deceleration in planned discretionary expenditure, especially through lower investment spending, and an increase in social security contribution rates. A temporary fiscal operating rule has been devised to apply after the end of the crisis, but it will impose only a relatively weak constraint in terms of minimum fiscal effort (0.5 pp. of GDP p.a.).

The decline in the share of domestic demand in economic activity will depress revenue growth in 2011/12 and beyond. Revenue from corporate taxation, which accounted for a quarter of the tax revenue increase during the five years to 2007/08, and income tax will be also affected by financial sector weakness. On the expenditure side, the spending plans announced in the 2009 Budget imply a freeze in real government expenditure from 2011/12 to 2013/14, compared to an annual increase of 4¼% between 1999/00 and 2010/11. These spending targets, however, are not yet backed by published departmental spending plans.

The UK's debt ratio in 2009/10 is estimated to increase by around 16 pps. of GDP, driven by the high primary deficit and, to a lesser extent, by debt-increasing financial sector interventions and a denominator effect from lower GDP. In 2011/12 the debt ratio, at around 90% of GDP, is set to overtake that of the European Union as a whole.

Table II.27.1:

Main features of country forecast - THE UNITED KINGDOM

	2008			Annual percentage change						
	bn GBP	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	1448.3	100.0	2.8	2.9	2.6	0.6	-4.6	0.9	1.9	
Private consumption	928.4	64.1	3.2	1.5	2.1	1.0	-3.3	-0.3	1.5	
Public consumption	313.3	21.6	1.8	1.6	1.2	2.5	2.9	1.4	-1.8	
Gross fixed capital formation	243.1	16.8	3.7	6.5	7.8	-3.3	-15.9	-3.8	3.0	
of which : equipment	83.8	5.8	5.0	4.5	11.5	-3.0	-26.8	-9.3	2.3	
Exports (goods and services)	422.2	29.2	5.6	11.3	-2.8	1.0	-11.5	1.8	4.6	
Imports (goods and services)	459.5	31.7	6.6	8.8	-0.7	-0.8	-13.7	0.1	3.0	
GNI (GDP deflator)	1474.7	101.8	3.0	1.8	3.3	1.0	-5.1	1.7	2.0	
Contribution to GDP growth :										
Domestic demand			3.1	2.4	3.0	0.5	-4.3	-0.4	1.0	
Stockbuilding			0.1	0.1	0.2	-0.4	-1.2	0.8	0.5	
Foreign balance			-0.3	0.4	-0.6	0.5	1.0	0.4	0.4	
Employment			0.7	0.9	0.7	0.7	-2.0	-0.9	1.3	
Unemployment rate (a)			6.8	5.4	5.3	5.6	7.8	8.7	8.0	
Compensation of employees/head			4.2	4.2	4.9	2.3	1.2	1.2	2.3	
Unit labour costs whole economy			2.1	2.2	3.0	2.5	4.0	-0.6	1.7	
Real unit labour costs			-0.4	-0.6	0.1	-0.4	2.9	-2.2	-0.3	
Savings rate of households (b)			-	-	2.2	1.5	4.3	5.0	6.1	
GDP deflator			2.5	2.8	2.9	2.9	1.1	1.7	2.0	
Harmonised index of consumer prices			1.9	2.3	2.3	3.6	2.0	1.4	1.6	
Terms of trade of goods			0.1	-0.1	0.6	0.3	-1.5	0.3	0.5	
Trade balance (c)			-3.1	-5.8	-6.4	-6.5	-5.8	-5.5	-5.2	
Current account balance (c)			-1.6	-3.3	-2.7	-1.6	-2.4	-1.6	-0.9	
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-1.5	-3.2	-2.5	-1.4	-2.2	-1.4	-0.7	
General government balance (c)			-2.8	-2.7	-2.7	-5.0	-12.1	-12.9	-11.1	
Cyclically-adjusted budget balance (c)			-2.8	-3.5	-3.8	-5.7	-10.5	-11.4	-9.9	
Structural budget balance (c)			-	-3.5	-3.8	-5.2	-10.3	-11.4	-9.9	
General government gross debt (c)			43.6	43.2	44.2	52.0	68.6	80.3	88.2	

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