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BRIEFING

THE BITTERSWEET RECOVERY

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NEW IDEAS
for CHANGE

THE BITTERSWEET RECOVERY

Despite a recent spate of good news, there is still plenty of cause for alarm about the UK economy. Strong growth in the short term does not mean that the structural weaknesses that became evident during the 'Great Recession' have been eliminated. Unless we move to adopt a new economic model, the nascent recovery will prove unsustainable and bittersweet, because many will not benefit from it before it is extinguished.

The UK economy is doing better now than at any time in the last three years. Real GDP – the total output of the economy – increased at an annual rate of 3 per cent in the middle two quarters of 2013, and forecasters have been forced to revise up their estimates for growth in 2013 and 2014. At the time of the March budget, the Office for Budget Responsibility (OBR) was forecasting that real GDP would increase by 0.6 per cent in 2013, followed by 1.8 per cent in 2014. However, in its latest forecast released alongside the Autumn statement,[1] these estimates were revised up to 1.4 per cent and 2.4 per cent respectively. Recent survey evidence suggests there could well be further upward revisions to the 2014 figure in the coming months.

At the same time, employment growth has outstripped even the most optimistic projections. Over the last year the number of people in employment in the UK has increased by 485,000,[2] as the private sector has proved more than able to create enough new jobs to offset those that are being lost in the public sector. As a result, the unemployment rate has fallen to 7.4 per cent, its lowest level since early 2009.

This is good news indeed, but it needs to be seen in context. The recession of 2008 and 2009 was the deepest in the UK since the 1920s, and the recovery from it is the slowest in living memory. Real GDP in the third quarter of 2013 was still 2.5 per cent below the peak that was reached five and a half years earlier, in the first quarter of 2008. If real GDP had continued to grow in line with its pre-recession trend over this period, real GDP would now be some 15 per cent higher than it actually is – and we would all be substantially better off as a result.

The UK has also fared poorly relative to other major economies: only in Italy and Japan was the peak-to-trough fall in real GDP bigger, and only in Italy is real GDP currently further below its peak, than in the UK.[3] Furthermore, the UK's population is growing faster than those of other countries; when this is taken into account the comparison on a GDP-per-capita basis looks even worse.

Table 1.1
Real GDP in the major seven economies

	Pre-recession peak-to-trough fall (%)	Current level relative to pre-recession peak (%)
Canada	-4.2	+6.2
US	-4.3	+5.5
Germany	-6.8	+2.6
Japan	-9.2	+0.1
France	-4.4	-0.3
UK	-7.2	-2.5
Italy	-9.1	-9.1

Source: http://www.oecd-ilibrary.org/economics/data/oecd-national-accounts-statistics/quarterly-national-accounts_data-00017-en?isPartOf=/content/datacollection/na-data-en

1 http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2013/
2 Figure for August–October 2013, compared to a year earlier. http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/december-2013/statistical-bulletin.html
3 In fact, Italy's real GDP in the third quarter of 2013 was at its lowest level since the pre-recession peak.

The good news on employment is also not quite all that it seems. There are still 2,388,000 people unemployed in the UK – 770,000 more than in the first quarter of 2008, just before the recession began. Over the same period, long-term unemployment has increased by 470,000 to 866,000, and youth unemployment has risen by 254,000 to 941,000. Furthermore, there are 1,472,000 people working part-time in the UK because they cannot find a full-time job, and 593,000 people in temporary employment because they cannot find permanent work.[4] There is therefore a high degree of 'underemployment' in the UK, alongside a worrying level of unemployment.

The time it has taken the UK economy to recover and the persistence of high levels of both unemployment and underemployment suggest there is something fundamentally wrong with the UK's economic model. The unbalanced nature of the economic recovery only serves to confirm this impression.

In his March 2011 budget, George Osborne promised a 'march of the makers' – an economic recovery led by the manufacturing industry boosting exports and investment spending. His efforts to cut government borrowing would, he said, give industry the confidence that it needed to invest, while cuts in corporation tax and sustained low interest rates made it cheaper to do so. When there appeared to be a problem with blockages in credit lines holding back investment, Osborne introduced the Funding for Lending scheme to pep-up business lending.

The chancellor has, however, been proven wrong, because companies have been reluctant to oblige. Investment spending, which the OBR in its June 2010 forecast predicted would increase by 22 per cent between 2010 and 2013,[5] is likely to have fallen by 4 per cent over this period;[6] it remains 24 per cent below where it was at the end of 2007. Meanwhile, although exports have fared better (despite the economic turmoil in the eurozone, which is still our main overseas market), import growth has almost kept pace. As a result, net trade has added just 0.4 percentage points to growth over the last three years, and has been negative in each of the last two.[7]

This failure of businesses to deliver the economic recovery that the chancellor hoped for helps to explain why he has reverted to pumping up a fresh housing bubble with the Help to Buy scheme, which encourages households to borrow more.[8] According to the Nationwide Building Society, house prices are now increasing faster than at any time since July 2010. Across the UK as a whole they rose by 6.5 per cent over the last year, and in London growth reached double digits.[9] There may still be some who see large increases in house prices as a positive sign – particularly those hoping to release some equity from their current home to help finance their retirement. However, there is a growing recognition that in some parts of the country – including, but not just, London – house prices have become detached from the reality of incomes. This makes it extremely difficult for young people to purchase their first home, even when they only have to find a 5 per cent deposit under Help to Buy.

4 These groups are not mutually exclusive: some people may be in part-time, temporary employment when they want to be in full-time, permanent employment. Source for all statistics in this paragraph: http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/december-2013/statistical-bulletin.html

5 http://budgetresponsibility.org.uk/budget-2010/

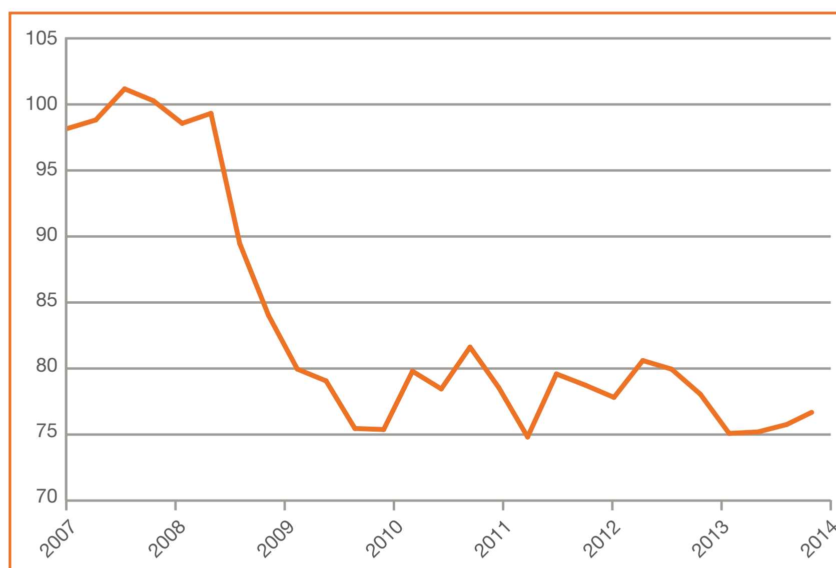
6 http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2013/

7 http://www.ons.gov.uk/ons/rel/naa2/second-estimate-of-gdp/q3-2013/stb-second-estimate-of-gdp--q3-2013.html

8 Anyone wanting to buy a home costing up to £600,000 can now do so with a 5 per cent deposit, a 75 per cent mortgage and a 20 per cent loan from the government.

9 http://www.nationwide.co.uk/hpi/default.htm

Figure 1.1
Real investment spending, Q1 2007–Q3 2013 (Q4 2007 = 100)



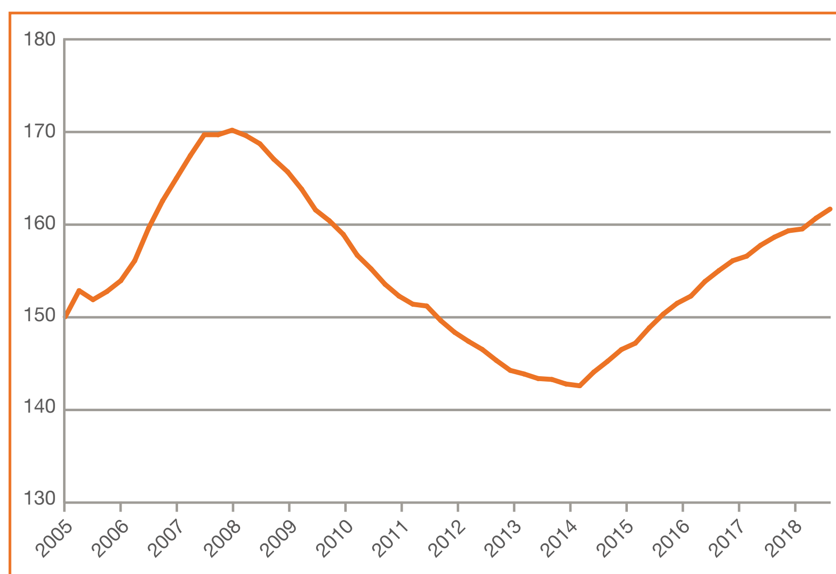
Sources: http://www.ons.gov.uk/ons/rel/naa2/second-estimate-of-gdp/q3-2013/stb-second-estimate-of-gdp--q3-2013.html, and author's calculations.

The introduction of the Help to Buy scheme in October 2013 looks to have been remarkably badly timed, because the evidence suggests that the housing market is not short of finance. Figures from the Council of Mortgage Lenders show that mortgage lending in the third quarter was £49.3 billion – up 32 per cent on a year earlier, and at its highest level for five years.[10] Meanwhile, labour market statistics show that the number of jobs in the real estate sector increased by 16 per cent in the last year, outstripping the growth of any other sector of the economy.[11] Lastly, the latest set of national accounts show that the household saving ratio in the first half of 2013 was at its lowest level since before the recession.[12]

A massive build-up of household debt before 2008 contributed to the depth of the recession in the UK. According to OECD figures, UK household debt relative to income was the highest among the major seven economies in 2007.[13] Between 2007 and 2012, this debt ratio fell, but only because income increased. Unlike households in other countries with high levels of debt, households in the UK have not, in aggregate, reduced their nominal debt. The OBR now expects debt to start increasing again – not just in nominal terms, but also in relation to incomes. Although it is not expected to return to its previous peak within the next five years, by 2018 the OBR thinks the debt ratio will be back up to 160 per cent (see figure 1.2).

10 http://www.cml.org.uk/cml/media/press/3711
11 http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/november-2013/statistical-bulletin.html
12 http://www.ons.gov.uk/ons/rel/naa2/quarterly-national-accounts/q2-2013/stb-quarterly-national-accounts--q2-2013.html
13 http://www.oecd-ilibrary.org/economics/household-wealth-and-indebtedness_2074384x-table18

Figure 1.2
Household-debt-to-income ratio (%), Q1 2005–Q4 2018 (forecast from Q4 2013 onwards)



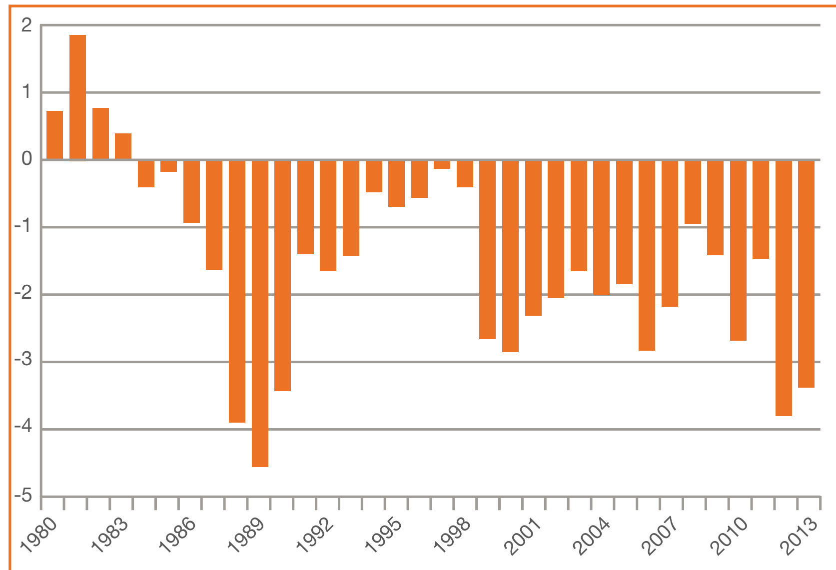
Source: http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2013/

As a short-term measure to boost growth while it continues to cut public spending, it might be politically expedient for the government to adopt this approach. However, it is not a sustainable strategy for the British economy. George Osborne was right when he said that we can no longer rely on ever-higher levels of debt for growth. It is an indictment of the failure of his attempts to boost business investment spending that, rather than encouraging a rebalancing of the economy, he now has to resort to policies that will increase its imbalances.

The flip-side of the government's efforts to boost the housing market, consumer debt and spending is its failure to facilitate an export-led recovery. On this front it has been unlucky in that demand in the UK's main export market – the eurozone – has disappointed (although sympathy should be tempered by the realisation that this is in no small part because countries in the eurozone have been following the same mistaken fiscal policy as the chancellor has been implementing in the UK). But the UK's poor trade performance is not new. Over the last three decades it has been demonstrated to be a serious structural weakness – one that will have to be tackled if the economy is ever to experience sustainable growth in the future.

2013 will be the 30th straight year in which the UK has recorded a deficit on its current account balance. Throughout this period, only in the mid-1990s – when trade performance was boosted by the fall in the value of sterling after the pound was ejected from the European exchange rate mechanism – has there been an export-led improvement in the current account balance (as opposed to one caused by import weakness when the UK economy was in recession). However, while the fall in sterling's value in 2007 and 2008 was slightly greater than the fall in 1992, it has failed to have an impact on the current account: in fact, the deficits have grown bigger. This is disappointing even after allowing for recent developments in the eurozone. It might suggest that another large fall in the value of sterling is required to turn around Britain's trade performance, or that the UK does not have the capacity in the right industries to take advantage of the increased competitiveness that results from a fall in sterling.

Figure 1.3
UK current account balance (as a percentage of GDP), 1980–2013



Sources: http://www.ons.gov.uk/ons/rel/bop/balance-of-payments/q2-2013/stb-bop-q2-2013.html and http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2013/

As a nation, we have to finance current account deficits by selling assets to overseas buyers (or by borrowing from them). David Cameron's trips to China and India in 2013 were partly about trying to boost UK exports to large emerging economies, but also about trying to persuade them to invest – that is, buy assets – in the UK. The fact that the ownership of large swathes of UK industry has already passed into foreign hands is part of the same story. This is not always a bad thing – when overseas firms invest in new productive capacity, or rescue firms that appear destined for bankruptcy, they are creating or saving jobs. However, in other cases it is simply a switch in the ownership of a viable business. The government is fond of saying that we cannot live beyond our means when it refers to the necessity – as it sees it – of eliminating government borrowing. It should be making the same point about our external position. In the global economy we are truly living beyond our means, and have been doing so for three decades. This is a sign that there is a fundamental flaw in the UK's economic model.

If part of the reason that exports have not increased as much as expected, given sterling's decline in 2007 and 2008, is a lack of capacity in our export industries, this is associated with another structural weakness in the UK economy: its relatively low rate of investment. The UK's investment-to-GDP ratio has consistently been the lowest among the major seven economies throughout the last 30 years, and remains so now.

Table 1.2:
Investment-to-GDP ratio (%) in decades to 2009 and in 2010–2012

	1980s	1990s	2000s	2010	2011	2012
Canada	22.6	20.0	22.0	23.3	23.8	24.7
Japan	29.6	28.8	22.5	19.8	20.0	20.6
France	20.2	18.5	19.9	19.3	20.8	19.8
US	23.3	21.4	21.5	18.4	18.4	19.0
Italy	23.4	20.5	20.9	20.1	19.5	17.6
Germany	24.5	22.6	18.5	17.3	18.3	17.3
UK	18.5	17.4	16.9	15.0	14.9	14.7

Source: http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx

This is not due to lack of money: the UK corporate sector in aggregate has a huge cash surplus. Nor can it be blamed on the financing problems of small businesses in recent years. This is a longstanding problem that reflects the persistent short-termism of business in the UK – something that has grown even worse since the 'Big Bang' of deregulation in the City in 1986. The dominance of finance capitalists has led senior managers to focus ever more on quarterly results and the need to stave off potential acquisitions or mergers, to the detriment of investing for the long-term future of their businesses. For the economy as a whole, this is disastrous. A low rate of investment means a less productive economy in the future, as well as lower living standards and a lack of competitiveness.

There are other longstanding weaknesses in the UK economy.

In every year since 1975, unemployment has been higher than it was in every year between 1945 and 1975. This represents a huge waste of human potential, lower living standards for millions of people, and additional costs to be met by society. Locking in low inflation was supposed to deliver sustained growth and higher employment levels. Instead, the last 35 years have seen greater instability, with three deep recessions and unacceptably high unemployment.[14]

Regional imbalances have increased, with London and the South East faring far better than the rest of the country. Globalisation and technological change have led to the permanent loss of jobs in some parts of manufacturing and services, and in much of country the market economy has been unable to adjust rapidly enough to the pace of change. There has been a failure to invest in response, and the more successful or resilient parts of the private sector have not absorbed spare labour fast enough. This is a particular problem in areas where employment was concentrated in a few industries or occupations that are now in decline in this country.

And there are the well-documented – and related – problems of the plunge in productivity levels over the last five years, falling real median wages and the large percentage of the workforce that has few or no skills.

These longstanding problems tell us that, rather than being complacent about the recent improvement in the economic news, we should be asking what we need to do to improve the long-term performance of the economy, so that growth is sustainable rather than based on ever-rising household debt; so that exports are strong enough for the country to run a current account surplus; so that our regions are growing as strongly as London and the South East; so that unemployment is once again at the levels seen in the 30 years after the second world war, and so that the workforce is more productive and better paid as a result.

They should tell us that the 35-year experiment with free-market capitalism, which began in the late 1970s, has failed. The result has been increased instability, higher structural unemployment and increased inequalities that are undermining the stability of society. The coalition government is wrong to be content with an economic system that has provided a favourable outcome only for a small elite, and wrong to be trying to compensate for its flaws by backing another house price bubble. Instead, it is time for the UK to adopt a new economic model: one that will deliver better lives for the vast majority of the population, not one that favours an elite few.

14 http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/threecenturiesofdata.xls and http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/november-2013/statistical-bulletin.html