The UK Economy
2003-2013

Nick Fyfe
Head of Economics, Dulwich College

Andrew Threadgold
Staff Tutor, Dulwich College
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Introduction

The UK economic story between 2003 and 2013 is a story of growth: initially, strong and positive; latterly, the quest for growth as the economy struggled to recover from two quick-fire recessions has become somewhat desperate. This chapter will set out key events, necessarily drawing on wider economic variables and serving as an introduction to the content of later sections. In addition, it is also important to note that economic performance during this period is best understood within the context of what has gone before. There will be a strong emphasis on the period 2003-2013, but data and events from the 1990s and even the 1980s are necessary for a full understanding of the trends and pressures in the UK macroeconomy.

Having noted the growth performance of the UK economy since 1990 we examine the movement of the components of GDP. We show the changes in the base rate of interest, the unemployment rate, rate of price inflation and stock market indices to reveal the unstable nature of the UK economy during the past two decades.

Knowledge: Economic growth

Economic growth – the increase in the productive capacity in an economy – is a fundamental measure of macroeconomic performance. The trend rate of economic growth for the UK economy has been assumed for several years to be between 2.5% and 2.75% per year. This implies that the total output of the economy, if all factors of production (land, labour, capital, enterprise) were fully utilised, would grow by this percentage each year.

However measuring productive capacity is very difficult, and thus economists focus on the more accessible measure of economic growth as the percentage change in Gross Domestic Product (GDP). GDP measures actual output: the total value of output in the whole economy over a given period of time.

Application: A brief history of UK growth

As Figure 1.1 shows, the actual growth rate of the UK economy has fluctuated significantly from year to year.

A recession occurs where real GDP growth is negative for at least two consecutive quarters. Over the period shown in Figure 1.1 the UK economy experienced two recessions: in the early 1990s and in 2008-2009. In addition, the UK economy re-entered recession in quarter 4 of 2011 and the first quarter of 2012 as real GDP shrank again. A boom is a period during which real GDP rises at a faster rate than assumed growth in productive capacity. The long boom of 1997-2007 can clearly be seen on Figure 1.1.

Recovery, or upturn, often marks the period between the end of a recession and the beginning of a boom. During this stage of the economic cycle, real GDP is positive, rising, but still below the long-run growth rate. On the other hand, a slowdown or downturn occurs when real GDP growth is positive but falling and is below the long-run growth rate.
Macroeconomic policies tend to focus on creating stable and sustainable economic growth. **Supply-side policies** aim to increase the long-run average, or trend level of growth which shows increases in productive capacity. This will be explored in greater detail in Chapter 6 when we examine productivity and competitiveness in greater detail. **Demand-management policies** such as fiscal and monetary measures are used to control actual GDP and take a shorter-term approach to macroeconomic stability. These policies are explored in greater depth in Chapters 9 and 10 respectively.

When investigating the story of the UK in recent years, economic growth is a key indicator of the health and potential of the UK macroeconomy.

### Application and Analysis: Components of UK GDP

GDP measures the total value of output, expenditure and incomes across the economy over a given period of time. Macroeconomists break down GDP into four key areas:

- **Consumption (C)**: Spending by households on consumer goods e.g. food, holidays, clothes
- **Investment (I)**: Spending by firms on capital goods e.g. machinery, vehicles, plant
- **Government Spending (G)**: Spending by the public sector e.g. infrastructure, public sector wages, NHS costs
- **Net Exports (X-M)**: Spending by foreigners on UK goods minus spending by the UK on foreign goods

**Figure 1.2: UK GDP by component**

Figure 1.2 shows the importance of consumer spending for the UK economy over the period shown. The effect of the recession in 2008-09 can be seen on both consumption and investment, along with the fall in net exports resulting from recession in the UK’s main trading partners.

**Figure 1.3: Economic growth in the UK by component**

Figure 1.3 shows how each of these components changed over the same period.
Analysis: Explaining fluctuations in real GDP growth

1991-1997: Recession and export-led growth

The UK experienced recession in the early 1990s. Stock markets crashed in 1987 in the USA and across Europe. The UK economy continued to grow until 1990 but as oil prices were pushed higher by the Gulf War, both consumer price inflation and the base rate reached double figures. Falling real incomes and the negative wealth effect from a struggling housing market pushed the UK into its deepest recession since the Second World War. In September 1992 the domestic currency, sterling, was forced out of the Exchange Rate Mechanism, which was the system used to ensure national currencies converged in preparation for the creation of the single European currency, the euro.

The period 1992-1997 saw recovery from recession. The weaker value of sterling helped to boost exports, particularly to other European countries, and although business and consumer confidence was not always high (the UK housing market was flat over this period, for example) there were signs of growth in the service sector and the UK economy began to emerge as a modern, service-based consumer economy.
1997-2000: Early days of New Labour

With a New Labour government in place with an emphasis on growth and economic stability, the UK economy began a period of significant expansion. The control of monetary policy and the setting of interest rates was handed to the newly-independent Bank of England, and although the new administration pledged to maintain Conservative spending plans for their first three years in power, the intention of significant public sector investment in education and healthcare was clear.

The ‘feel good factor’ returned to the UK economy:

- interest rates fell through 1998 and 1999 (from 7.25% in May 1998 to 5% by June 1999; figures for 1990-2012 are shown on Figure 1.6)
- unemployment continued to fall, in particular long-term and youth unemployment (Figures 1.7 and 1.8)
- low and falling inflationary pressure (Figure 1.9)
- the housing market experienced its strongest growth since the early 1990s, increasing household wealth through positive equity for homeowners (Figure 1.10)
- strong stock market performance, increasing household wealth for shareholders (Figure 1.11)

These factors combined to boost consumption and investment, and confidence also grew in expectation of an extensive programme of public sector investment.
2000-2003: Turbulent times

By the turn of the millennium, it was clear the ‘mini-boom’ of 1997-2000 was coming to an end. The FTSE index increased by less than 5% over 2000 compared to double-digit growth in 1996-99 (see Figure 1.11). Even before the terrorist attacks in New York in September 2001, the US economy had faltered as the dot-com boom (and associated economic expansion created by the growth of new technology spending and investment) came to an end.

On March 10, 2000 the NASDAQ (the second-largest stock exchange in the USA, which pioneered online trading and was the exchange of choice for the new technology firms associated with the internet boom of 1995-2000) Composite index reached its peak of 5,132.52. Figure 1.12 shows the average annual values of this index between 1995 and 2011.

Over the course of 2011, the NASDAQ lost almost half of its value, with significant losses also recorded on the Dow Jones and FTSE indices (Figure 1.13).

These problems in the US economy were compounded by the tragic events in New York on the 9th September 2001, and the economic impact in the UK was one of shaken confidence and fears for future growth. The saving ratio for UK households, which had fallen steadily since the early 1990s (see Figure 1.14), recorded a small increase in 2001, and house price growth dipped in 2000 and 2001, albeit still increasing above the rate of inflation (housing market transactions also continued to rise as shown in Figure 1.15).
The period 2000 to 2003 also marked a shift towards greater fiscal injection into the economy. The New Labour government elected in 1997 had stuck to Conservative spending plans for its first two years in office, but after a second election victory in May 2001 the budget surpluses built up in the years 1998-2001 (Figure 1.16) were viewed by Chancellor Gordon Brown as being available to fund significant public sector investment.


The story of the most recent decade of UK economic history begins with house price inflation of over 20% according to the Halifax index as shown in Figure 1.15. The second half of ‘the NICE decade’ (a period of Non-Inflationary Continuous Expansion) of 1997-2007 was a period of recovering economic growth after the problems of 2000-2001.

Real GDP growth began and ended this period above its trend rate of 2.5%, unemployment fell and inflation was under control. This stability allowed business and consumer confidence to recover in the UK; nonetheless, the current account position moved into a large deficit, most significantly as the imports of goods grew far more quickly than exports, as shown in Figure 1.18.

The base rate was increased steadily from 3.50% in July 2003 to 5.75% in July 2007 (see Figure 1.6). Interest rates – a flagship independent policy of the New Labour government – played a significant role in the story of the UK economy at that time. Interest rate changes influence the wider economy by influencing the consumer and business decision on whether to spend or save; they also directly influence the value of the domestic currency in foreign exchange markets through effects on the patterns of global saving and investment. Higher interest rates put upward pressure on the value of sterling, making exports more expensive and imports cheaper. However, consumer spending remained strong due to a structural movement towards lower saving across the economy. Despite higher consumption and
the added injection of a heavy public sector investment programme, inflation remained low, suppressed by falling import prices and the powerful force of globalisation. Thus UK interest rates were a dangerous combination of historically low but nevertheless relatively high compared with interest rates elsewhere. Figure 1.6 showed earlier in this chapter how the base rate was significantly higher in the early 1990s than a decade later. Figure 1.19 compares UK interest rates with those of Germany and the USA during the NICE decade. The differential in the UK interest rate with Germany was 1.5% or more in all but three years, and of the same size as compared with the USA in all but five years.

Question

2. Using the ideas from this chapter so far, identify the factors which might contribute to strong economic growth in an economy.

2007–2013: Recession, recovery, relapse?

Despite the false alarms of 2000-01, UK economic growth and related consumer indicators (most notably the housing market and stock exchange) recovered strongly up to the summer of 2007, when it became obvious that the longest period of positive economic growth since World War Two was coming to an end. The US housing market had peaked in early 2006, fuelled in part by the subprime lending market where banks were willing to issue mortgages to householders previously deemed too risky to lend to. As borrowers defaulted on loans, banks were forced to absorb these losses and in many cases required assistance from national governments to remain in business. Business and consumer confidence collapsed (see Figures 1.4 and 1.5) and public sector finances, already under strain as unemployment began to rise, had to be diverted to support financial institutions and avert a total collapse in the banking sector.

After 63 quarters of positive economic growth the UK economy entered recession, recording negative growth in the second quarter of 2008 of -1.3%. Growth remained negative until the third quarter of 2009 (see Figure 1.20).
Analysis: Causes of the UK recession, 2008-2009

The economic conditions of 2007-2009 are regarded by some economists as a ‘perfect storm’: a combination of factors which combined to drive the economy into recession. These factors are:

- A financial crisis which increased the costs of borrowing for firms and households as banks feared collapse due to their exposure to bad debts.
- A subsequent tightening of access to finance for both households and firms.
- Falling house prices (especially in the USA), exposing mortgage lenders to serious losses and reducing consumer confidence and household wealth.
- Significant losses on stock markets.
- High levels of household debt due to cheap, easy finance and a falling saving ratio in the NICE decade.
- Rising oil prices (an increase from $55 to $147 barrel between early 2007 and July 2008).

As aggregate demand (total spending in the economy; the sum of consumption, investment, government expenditure and net exports) fell, further problems were created.

Analysis: Impacts of the UK recession, 2008-2009

- Rising joblessness, particularly for long-term and youth unemployment.
- Fewer job vacancies as firms avoided recruitment due to uncertainty about the future.
- Falling living standards as average earnings fell (impact of higher unemployment bringing average earnings down, as well as pay freezes and below-inflation pay awards for those people still in work).
- Higher demand for higher education places as school-leavers (and graduates pursuing postgraduate courses) sought to remain in education.
- A fall in inflation on the RPI measure (Figure 1.21); the differences between CPI and RPI and therefore the explanation for the significant disparity between these measures in 2009 are given in Chapter 8.
- A depreciation in sterling (see Chapter 5).
- Pressure on the government’s budget position, as tax revenues fell (due to downward pressure on incomes, spending and wealth) and spending increased (due to the automatic stabiliser of more unemployment benefit claimants).

Figure 1.21: RPI and CPI in UK

Source: HM Treasury
Analysis: Anti-recession policies

The key policy instruments available to governments to control the level of aggregate demand in the economy are monetary and fiscal measures.

Monetary policy (This is discussed in detail in Chapter 9):
- drastic cuts in the base rate of interest (see Figure 1.6) culminating in a historically unprecedented base rate of 0.50% from March 2009
- a programme of quantitative easing beginning in March 2009: the purchase of government debt by the Bank of England (by February 2012, the Bank had authorised purchases of up to £325 bn)
- acceptance of a fall in the value of sterling, reducing the price of UK goods in international markets and stimulating export performance

Fiscal policy (This is discussed in detail in Chapter 10):
- cuts in tax rates, such as the temporary reduction in VAT from 17.5% to 15% in December 2008
- increases in other taxes, such as the introduction of a top rate of income tax of 50% on earnings over £150,000 per annum and a reduction of tax relief on pensions for high earners
- higher government spending on initiatives such as an extra £1.7bn on the job centre network, to support job seekers, and to help businesses during difficult trading conditions

Question

3. Which policies are likely to be most effective in reducing the severity of a recession?

Evaluation: Is the UK in good shape for recovery in 2013?

Economists classify recessions according to the pattern of economic growth.
- ‘V’ shaped recessions see a fall in economic growth followed by quick recovery and return to growth
- ‘U’ shaped recessions have a longer period of negative growth before recovery
- ‘W’ shaped recessions, or ‘double-dip’ recessions, are characterised by some recovery before the economy slips back into negative growth
- ‘L’ shaped recessions are the worst scenario: negative growth which persists, possibly for several years. Such a recession is sometimes called a depression

The experience of the UK since 2009 is shown in Figure 1.22, which extends the data period from Figure 1.20 above.

The UK economy has clearly experienced a double-dip recession. (Note that quarter 4 of 2010 and quarter 1 of 2011 do not count as recessions, as there were not two consecutive quarters of negative growth.)

According to a study by the National Institute for Economic and Social Research (NIESR), the economy is not predicted to return to the GDP level experienced at the peak of the previous boom until 2014.
Chancellor George Osborne’s Plan A of deficit reduction has not created the stimulus to private sector confidence and growth as he had desired in 2010. The consequences of more negative, or even low positive growth will be very serious for the UK economy, but it is important to remember that even during a time of recession there may be ‘winners’ as well as ‘losers’.

**Question**

4. To what extent does the government lack policy options in tackling new fears about economic growth in 2012 and beyond?

**Evaluation: Gain and pain in a recession**

<table>
<thead>
<tr>
<th>‘Winners’ in a recession</th>
<th>‘Losers’ in a recession</th>
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<tbody>
<tr>
<td><strong>Firms</strong></td>
<td></td>
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<tr>
<td>• Lower wage inflation</td>
<td>• Lower demand, especially for luxury goods</td>
</tr>
<tr>
<td>• Larger pool of available workers, some of whom may be highly skilled and desperate to work</td>
<td>• Negative equity as land and property prices decline</td>
</tr>
<tr>
<td>• Higher demand for inferior goods as consumers switch down to less expensive options</td>
<td>• Possible bankruptcy</td>
</tr>
<tr>
<td>• Higher domestic demand if currency depreciates, as exports become more expensive</td>
<td></td>
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<tr>
<td><strong>Households</strong></td>
<td></td>
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<tr>
<td>• Lower borrowing costs and mortgage repayments as base rate is cut</td>
<td>• Falling real income levels (especially if inflation remains relatively high)</td>
</tr>
<tr>
<td>• Lower income tax rates if government uses fiscal policy to stimulate the economy</td>
<td>• More expensive imports and foreign holidays due to weaker currency</td>
</tr>
<tr>
<td>• Cheaper goods and services as firms compete more aggressively for business</td>
<td>• Threat of unemployment and resulting poverty and hardship</td>
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</tbody>
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**Question Extension**

5. Why do economies experience an ‘economic cycle’ where periods of boom are followed by periods of recession?

Research theories of the economic cycle and evaluate which model is most applicable to the UK economy in 2007-09 and in 2012.