The UK Economy 2007-2017

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Contents

Chapter 1

GDP: Boom, Bust and Recovery

Introduction

The story of UK GDP growth between 2007 and 2017 is complex. The 'NICE' decade of Non-Inflationary Continuous Expansion ended with the credit crisis of 2007 and was followed by the recession of 2008-09. In the years since, the UK economy has returned to growth with output rising and unemployment falling alongside low inflation, but new threats to stability and prosperity are emerging.

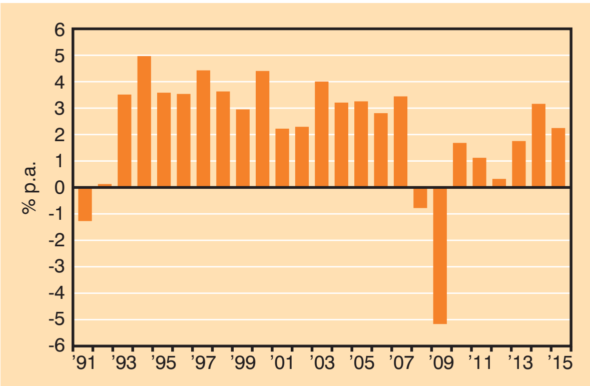
Knowledge: Economic growth

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

Figure 1.1: UK real GDP growth



Source: HM Treasury

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 2008-09. In addition, the UK economy was initially believed to have re-entered recession in late 2011 and early 2012 but later revisions of the data showed this was narrowly avoided. 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 in 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.

Question

1. Using Figure 1.1, give examples of each of the following: boom, slowdown, recession, recovery.

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.

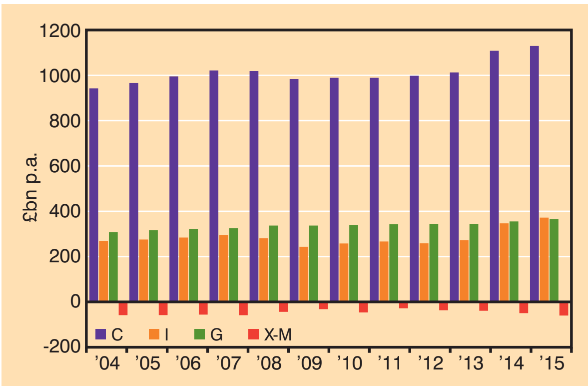
When investigating the story of the UK in recent years, economic growth is a key indicator of the health and potential of the UK macroeconomy.

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

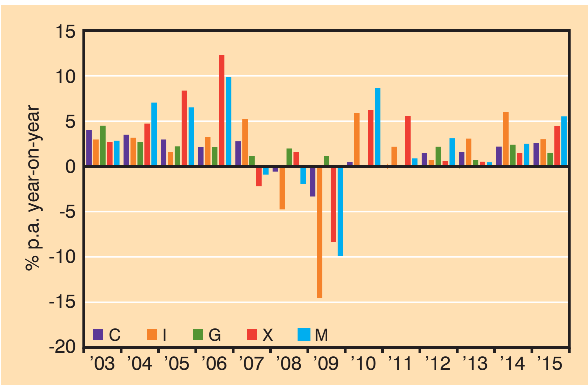
Figure 1.2: UK GDP by component



Source: HM Treasury

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

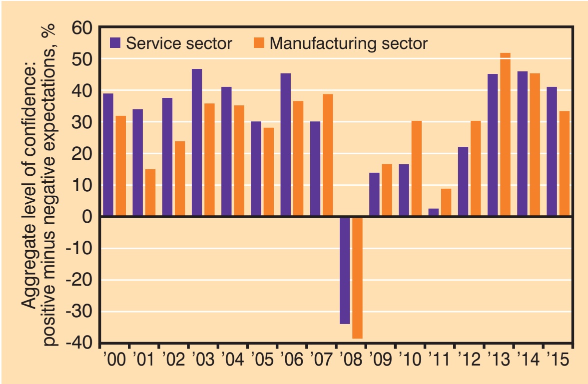


Source: HM Treasury

Figure 1.3 shows how each of these components changed over the same period.

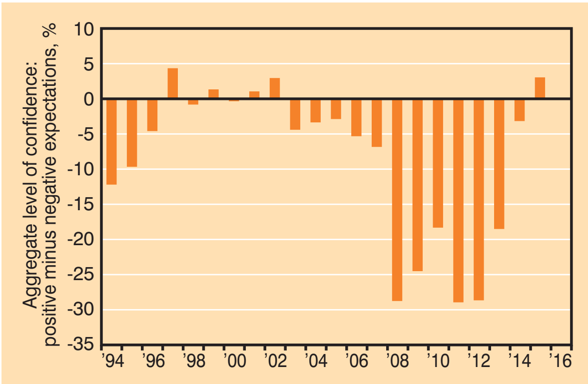
Analysis: Explaining fluctuations in real GDP growth

Figure 1.4: UK business confidence in the service and manufacturing sector



Source: HM Treasury

Figure 1.5: UK consumer confidence



Source: HM Treasury

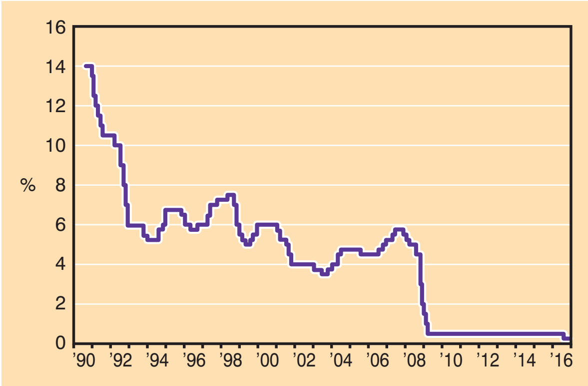
1991-1997: Recession and export-led growth

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 1992-97 saw recovery from recession. The weaker value of sterling helped to boost exports, particularly to other European countries, and there was growth in the service sector and the UK economy began to emerge as a modern, service-based consumer economy.

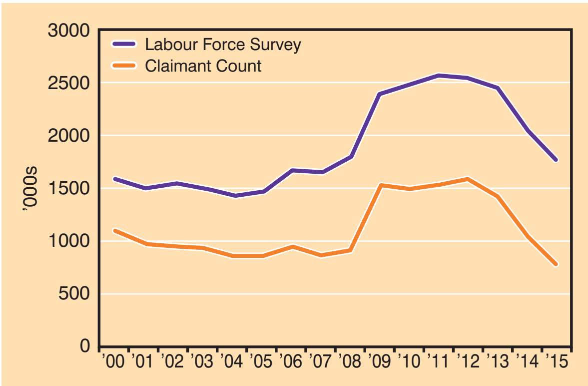
Spending by households on consumer goods such as clothes is the most important element of UK GDP.

Figure 1.6: UK base rate of interest



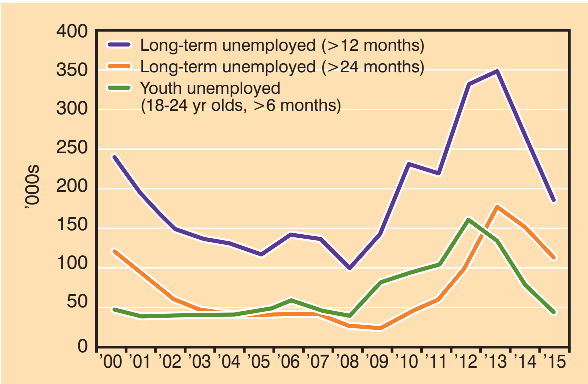
Source: Bank of England

Figure 1.7: UK unemployment



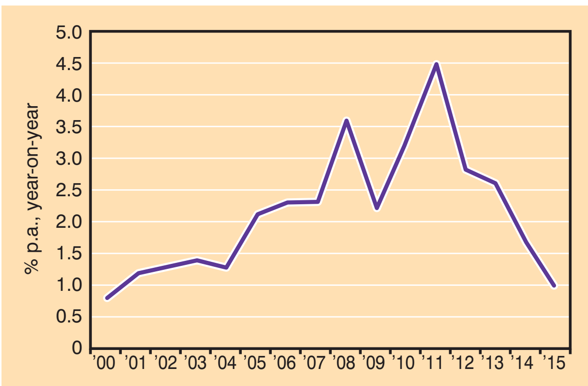
Source: HM Treasury

Figure 1.8: Long-term and youth unemployment in the UK



Source: HM Treasury

Figure 1.9: UK inflation, Consumer Price Index



Source: HM Treasury

1997-2000: Early days of New Labour

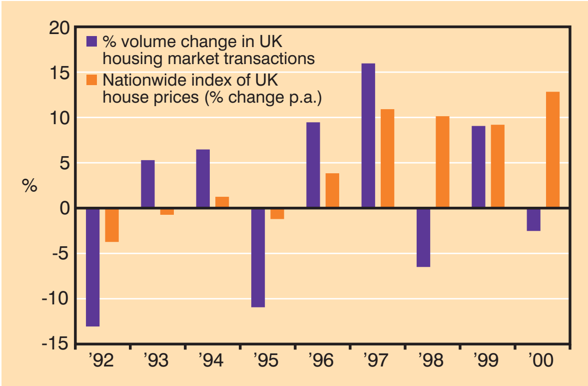
With a New Labour government in place with an emphasis on growth and economic stability, the UK economy began a period of significant expansion. The control of monetary policy and the setting of interest rates was handed to the newly-independent Bank of England and the intention of significant public 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 1990-2016 are shown on Figure 1.6).
- unemployment continued to fall, in particular long-term and youth unemployment.
- low and falling inflationary pressure.
- 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).

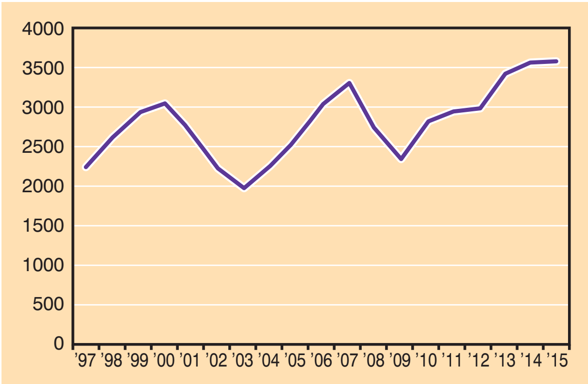
During the years 1997-2000 the housing market experienced its strongest growth since the early 1990s.

Figure 1.10: UK housing market indicators



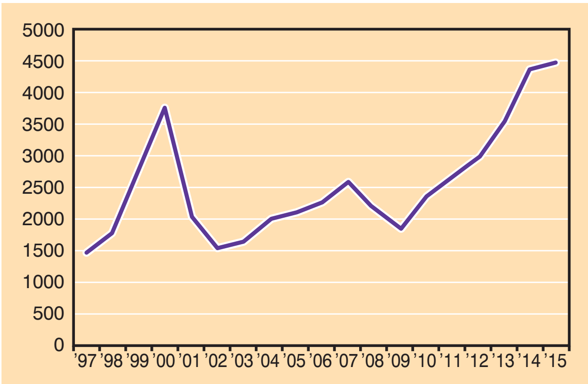
Source: HM Treasury

Figure 1.11: FTSE All Share Index, annual average



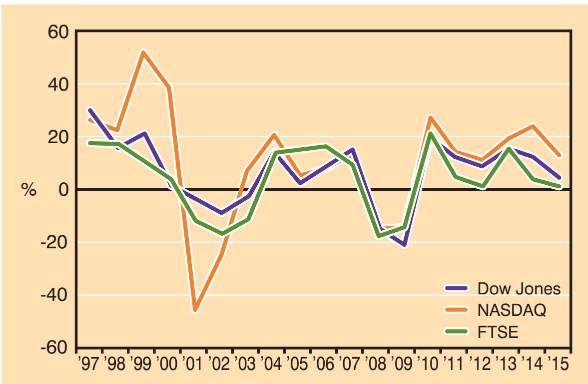
Source: HM Treasury

Figure 1.12: NASDAQ Composite Index, annual average



Source: HM Treasury

Figure 1.13: Annual change in selected stock market indices



Source: HM Treasury

2000-2003: Turbulent times

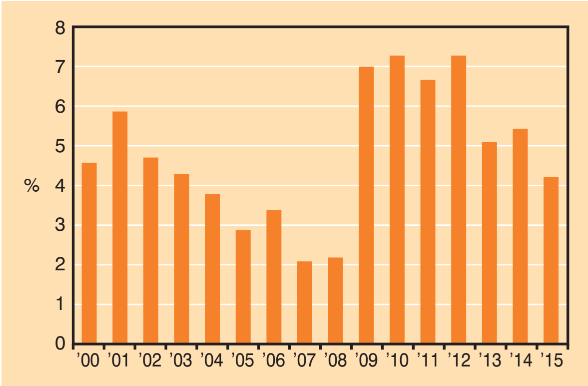
By the turn of the millennium, it was clear the 'mini-boom' of 1997-2000 was coming to an end. The FTSE index increased by less than 5% over 2000 compared to double-digit growth in 1996-99 (see Figure 1.11). Even before the terrorist attacks in New York in September 2001, the US economy had faltered 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 1997 and 2015.

Over the course of 2001, the NASDAQ lost almost half of its value, with significant losses also recorded on the Dow Jones and FTSE indices (Figure 1.13).

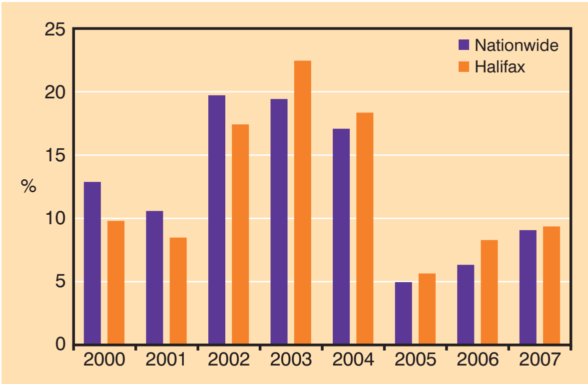
These problems in the US economy were compounded by the tragic events in New York on the 9th September 2001, and the economic impact in the UK was one of shaken confidence and fears for future growth. The saving ratio for UK households, which had fallen steadily since the early 1990s recorded a small increase in 2001 (see Figure 1.14), 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).

Figure 1.14: UK saving ratio



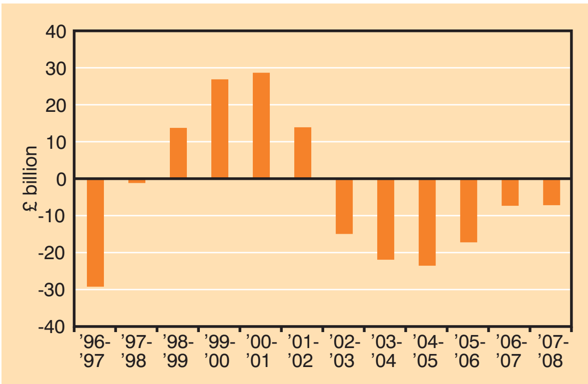
Source: HM Treasury

Figure 1.15: UK housing market inflation



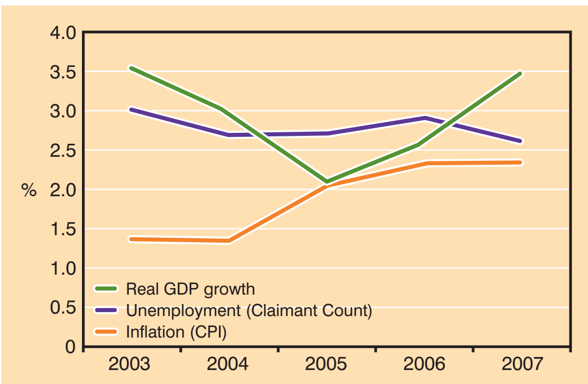
Source: HM Treasury

Figure 1.16: UK budget position at constant 2010-11 prices



Source: HM Treasury

Figure 1.17: UK economic data



Source: HM Treasury

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) and were viewed by Chancellor Gordon Brown as being available to fund significant public sector investment.

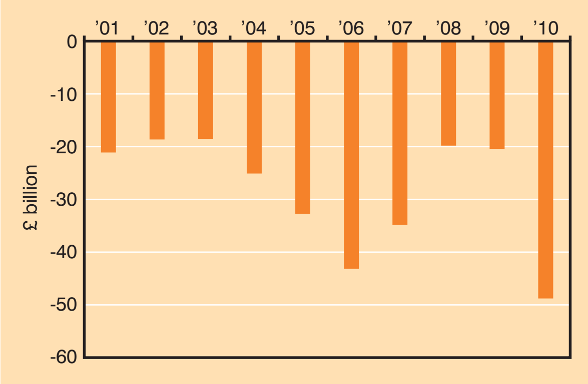
2003-2007: Steady, stable growth

The period 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 2000-01.

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.

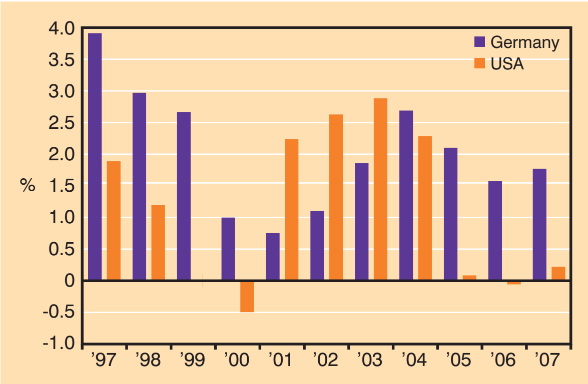
The base rate was increased steadily from 3.50% in July 2003 to 5.75% in July 2007 (see Figure 1.6). Interest rates – a flagship independent policy of the New Labour government – played a significant role in the story of the UK economy at that time; this is discussed in greater detail in Chapter 9. Interest 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

Figure 1.18: UK current account position



Source: HM Treasury

Figure 1.19: UK interest rate (LIBOR) differential with interest rates in Germany and USA (UK minus foreign rate)



Source: HM Treasury

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

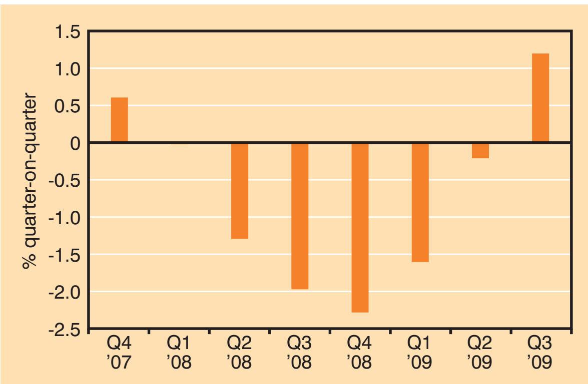
2. Using the ideas from this chapter so far, identify the factors which might contribute to strong economic growth in an economy.

2007-2017: 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).

Figure 1.20: UK GDP – the recession of 2008-09



Source: HM Treasury

Analysis: Causes of the UK recession, 2008-2009

The economic conditions of 2007-09 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 per barrel between early 2007 and July 2008).

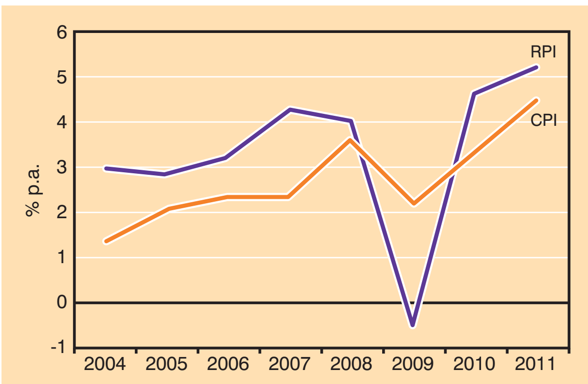
As aggregate demand (total spending in the economy; the sum of consumption, investment, government expenditure and net exports) fell, further problems were created.

Analysis: Impacts of the UK recession, 2008-2009

The credit crisis and consequent 'Great Recession' at the end of the 2000s created a sharper contraction in economic activity in the UK than any time since the second world war, with output falling more than at the beginning of the 1990s.

- 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 discussed 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, and 0.25% from August 2016.
- 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 £375bn).
- 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):

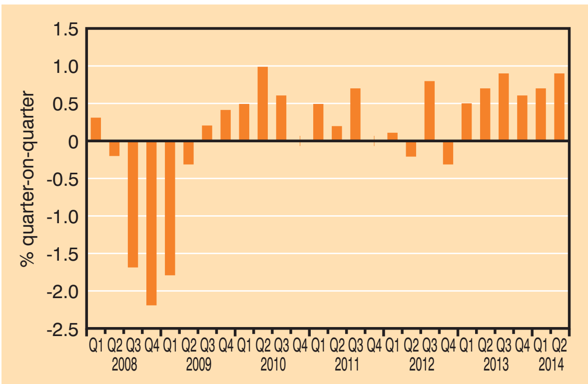
- cuts in tax rates, such as the temporary reduction in VAT from 17.5% to 15% in December 2008.
- increases in other taxes, such as the introduction of a top rate of income tax of 50% on earnings over £150,000 per annum and a reduction of tax relief on pensions for high earners.
- higher government spending 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.
- the scope for fiscal expansion has been limited due to the government's focus on closing the budget deficit ('austerity' policies) rather than to stimulate GDP growth to trigger automatic stabilisers.

Question

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

Evaluation: The impact of austerity

Figure 1.22: UK GDP, quarter-on-quarter growth (%)



Source: HM Treasury

Figure 1.22 shows the quarterly growth data for the UK economy.

UK GDP returned to its pre-crisis level in Q2 of 2014 as the economy grew at an annualised rate of 3.1%. Relevant economic indicators will be explored in the chapters ahead, but even with the shock result of the EU referendum result and arising uncertainty of the future trading position with the EU, the economy has continued to record positive quarterly growth into 2017.

There are several arguments explaining the story of GDP growth since 2009, including:

- Austerity measures have boosted confidence and innovation in the private sector of the economy, creating a 'crowding-in' dynamic and sustainable job creation and output.
- Austerity has slowed down the recovery: fiscal stimulus, rather than fiscal contraction, would have returned the economy to growth more quickly, reducing unemployment (and associated benefits) and generating tax revenue earlier.

- 'Austerity' is a myth: the Coalition government made pledges to cut the size of the government and national debt, but in reality the economy remained reliant on government spending to maintain recovery. Phillip Hammond, the new Chancellor under Theresa May, announced a programme of infrastructure spending in the Autumn Statement in November 2016 which looks surprisingly 'Keynesian' in its fiscal stance!
- Recovery continues to look unbalanced (regionally, and in terms of income levels) and dependent on cheap credit, fuelling another consumption and housing boom despite increasing levels of job insecurity in some sectors and uncertainty regarding the UK's trading relationship with the EU.

Question

4. Has austerity helped or hindered economic recovery in the UK?

The result of the referendum in June 2016 on whether the UK should remain in the European Union will be an important factor determining the future level and pattern of growth in the years ahead. The shape and timing of 'Brexit' will be discussed throughout this book. The shape and timing of 'Brexit' will be discussed throughout this book; it is likely to have a more significant influence on both the level and pattern of economic growth than any other event in recent economic history.

Evaluation: Gain and pain in a recession

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

Extension Question

5. What might be the likely effects of 'Brexit' on the UK economy in the years ahead?

Chapter 2

Consumer Spending, Saving and Credit

In this chapter we consider in detail how household expenditure in the UK has moved and discuss the factors which explain differences in the growth rate of this spending.

Knowledge: Consumption, saving, credit and income

The concepts of consumer spending, saving and credit are intrinsically linked. **Consumer spending**, also known as **consumption**, is spending by households on goods and services. The most obvious determinant of the consumption level in an economy is **income**. However, households can fund spending from income in different time periods.

- **Past income** – households can draw on **savings** (income previously earned and not consumed) to fund consumption now.
- **Current income** – the most obvious source of funds for consumer spending, but most households will usually try to save some of their income to plan for the future or prepare for contingencies.
- **Future income** – effectively, households can spend future income streams by taking out **credit** and borrowing. Debt repayments will, of course, reduce future consumption levels, and will be influenced by interest rates in credit markets.

To quote John Maynard Keynes, *"the importance of money flows from it being a link between the present and the future."*

Knowledge: Economic theories of consumption

The link between income levels and consumption levels is disputed by economists.

- **Absolute income hypothesis**

John Maynard Keynes argued that national income is the key determinant of consumption. Thus when income levels rise, as in a boom, households will spend more money on goods and services. During a recession, consumption will fall. However, the proportion of income used for consumption may differ. Keynes identified the average propensity to consume (APC) and marginal propensity to consume (MPC) as important features of macroeconomics. The Keynesian model also distinguishes between **autonomous consumption** (spending on necessities) and **induced** or **discretionary consumption** (spending on non-essentials). Only discretionary consumption, in this model, is directly related to income.

- **Life cycle hypothesis**

Franco Modigliani argued that households smooth out their spending over their lifetimes. At the beginning of people's careers consumption exceeds income as households take out credit to pay for housing and consumer durables. This is known as **dissaving**, or negative saving. In their middle years, workers pay off debt (e.g. mortgages) and begin to save for old age (positive saving). Later in life, these savings can be used to fund consumption in retirement.

- **Permanent income hypothesis**

Milton Friedman argued that households have a 'permanent income': a rate of return based on ownership of assets (physical assets such as property, and financial assets such as stocks and bonds) and human wealth (skills, education and experience). Short-run shocks, such as redundancy, will not have a major impact on consumption as workers will expect to be re-employed in the future. Only changes to assets and human wealth will affect the permanent income. This is linked to the 'rational expectations' model, where

economic agents take all available information into account and their behaviour is not easily influenced by short-run fluctuations in income or changes in government policy.

- **Confidence hypothesis**

The role of confidence and expectations are important in economics. Both terms imply an opinion or outlook on the future. In periods when consumer confidence is high, households might choose to consume more and save less as a proportion of their income. When confidence is low, households may increase their saving ratio in preparation for possible falls in income.

- **Relative income hypothesis**

James Duesenberry argued that consumer spending is determined by cultural as well as economic factors. Households base spending decisions on previous levels (in particular, past 'peak income') and in comparison with other households. Thus low income households consume a higher proportion of their income (and save a lower proportion) to maintain a standard of living similar to that of richer households. This theory helps explain why households may continue to spend even when income has fallen drastically, such as during a period of unemployment in a recession or after retirement.

- **Behavioural models**

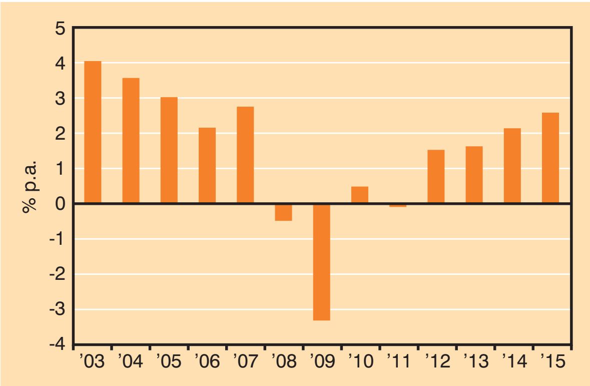
Behavioural economics is a relatively new branch of economics which is concerned with why economic agents might sometimes behave irrationally and make decisions which appear to be less than optimal. Such economists might argue that consumption levels will fluctuate according to the ability of households to defer gratification, which might give important insight into why some people are prone to indebtedness. Other research has suggested that households treat different sources of income in different ways ('mental accounting'). For example, a large 'windfall' income (such as an unexpected bonus or a lottery win) will increase consumption, whereas a small windfall may be saved.

Question

1. What reasons do each of these models suggest for a less than perfect link between consumer spending and income levels?

Application and Analysis: Explaining changes in consumer spending and saving in the UK

Figure 2.1: Growth in UK households' consumer spending



Source: HM Treasury

Figure 2.1 shows the trend in consumer spending growth year on year from 2003 to 2015. Clearly, the impact of recession in 2008 and 2009 can be seen on the chart, as can the drop in confidence when the recovery stalled in 2011. Between 2012 and 2015 growing confidence contributed to economic recovery.

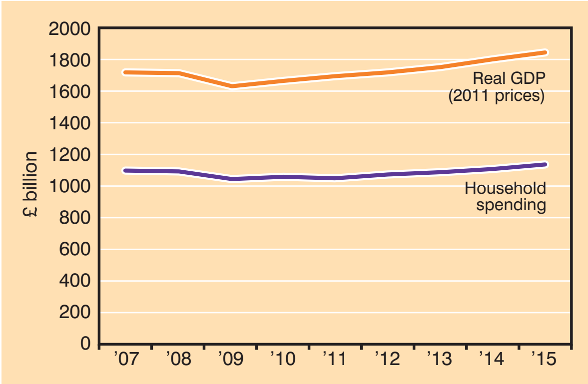
Consumer spending growth has remained strong despite the 'headwinds' of austerity and the uncertainty created by the surprise 'Leave' result in the EU referendum.

The factors which are most likely to explain recent trends in consumer spending are explored below.

1. Rising real disposable incomes

Figure 2.2 shows consumer spending against real GDP since 2007. There is a clear correlation between these two trends, suggesting that national income has a strong influence on household spending.

Figure 2.2: UK real GDP versus household expenditure



Source: HM Treasury

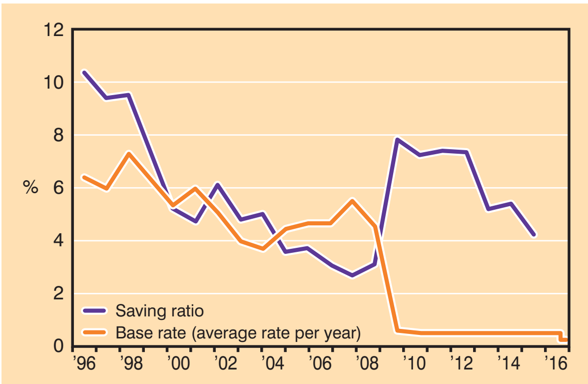
It should also be noted that consumption growth has played a significant role in fuelling the boom (and bust) in the UK economy in recent years. To suggest that higher consumption led to rising national income, which in turn increased consumption, is a circular argument. It is therefore important to consider other factors which have affected both consumer spending and national income in this period.

2. Interest rates

Interest rates are a cornerstone of monetary policy (see Chapter 9) and they are used by central banks to influence consumption, investment and export performance. Interest rates affect both the incentive to save and the cost of borrowing, and thus should have a strong impact on household's spending decisions.

Put simply, higher interest rates increase the reward to savers and increase the cost of borrowing. This should increase the saving ratio and reduce consumption on goods more likely to be purchased using credit (housing, and consumer durables such as furniture and cars). Falling interest rates should boost consumer spending by reducing the incentive to save and reducing debt repayments.

Figure 2.3: UK base rate and saving ratio



Source: HM Treasury

The link between the base rate and saving ratio is shown in Figure 2.3. In theory, the data should show a positive correlation, but this is not the case. Even with the base rate at a historic low of 0.5% since 2009, the saving ratio has increased considerably from 3% to over 7% during this period. Also, the general upward trend in the base rate between 2003 and 2007 saw the saving ratio almost halve from 5% to less than 3%. It is too early to tell if the further cut in the base rate to 0.25% in August 2016 will reduce saving even further.

One analysis of the period 2003 to 2007 is that interest rates were relatively high but historically low (see Figure 1.19 in Chapter 1). The impact of interest rates on other macroeconomic variables needs to be considered, for example on the exchange rate and the housing market as these will also have influenced household spending.

3. The effect of wealth

Theories such as the Keynesian absolute income hypothesis stress the importance of current income as a determinant of consumption. However, household finances are influenced by wealth as well as income.

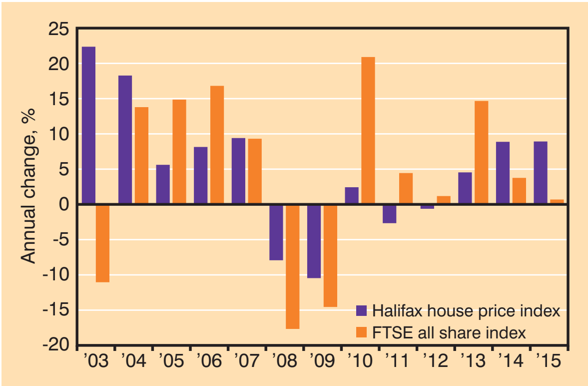
- Income is a **flow** concept: it represents earnings over a given period of time, for example an annual salary for a worker or a monthly rent for a landlord.
- Wealth is a **stock** concept: it represents a value of financial worth at a period of time, for example the value of a property or a share in a company.

Wealth can be affected by increases in asset values, most typically resulting from a boom in the housing market or stock market.

2003 saw massive house price inflation as we noted in Chapter 1. Figure 1.15 showed 22.4% on the Halifax index and 19.4% on the Nationwide index. This large increase represented a significant boost to perceived household wealth. The UK housing market was also experiencing a buy-to-let boom, with many people choosing to divert savings from more traditional financial assets (savings accounts and pension funds) and into second homes, which would then provide an income stream (rent) in addition to an increase in value.

2003 saw a more difficult year for the stock market. The FTSE index fell by over 10% as oil prices increased and concerns grew surrounding conflict in the Middle East and tension in North Korea. However, even as the UK housing market cooled, the FTSE bounced back and recorded double-digit gains until the recession of 2008-09.

Figure 2.4: Halifax house price index and FTSE all share index



Source: HM Treasury

The housing market has a particularly powerful effect on the economy in the UK. Unlike other countries in Europe, the UK has a high proportion of owner occupied homes, with at least 50% of homes owner occupied in all regions. This makes consumption more responsive to changes in interest rates (via the impact on mortgage repayments) and to changes in house prices (via wealth effects – positive when house prices rise, but negative when house prices fall).

The debate over the influence of house prices on the wider economy is controversial. If house prices fall, this reduces the wealth of home owners, but it will also reduce the cost of borrowing for first time buyers which in theory leaves more disposable income for other areas of spending. In addition, lower house prices represent a lower cost to landlords in the buy-to-let sector, which according to market theory should reduce the cost of renting and again increase consumption on non-housing goods.

A final consideration is that of mortgage **equity withdrawal**. A homeowner experiencing positive equity (where the market price of their home is greater than the value of mortgage debt outstanding) can, in theory, remortgage their house to free up funds for spending. This can be used for consumption or the purchase of another property for own use or to lease for rental income.

During the NICE decade, the concept of the housing market as a source of extra income and a means of saving for retirement became widespread. This was exacerbated by various factors:

- High house price inflation, outstripping returns from more traditional savings.
- Price inelastic supply of housing in urban areas.
- Demographic changes, increasing the proportion of one-person households.
- A severe decline in confidence in pension schemes after high-profile scandals such as Mirror Group (1991) and Equitable Life (2004).
- A significant increase in global money supply which led to easy credit terms, banks' acceptance of rising loan-to-value ratios, and low interest rates which discouraged saving and reduced borrowing rates.
- Income elastic demand for housing as it is seen as a superior alternative to the 'inferior' good of renting a home.

4. Other factors

The impact of globalisation on the UK economy was an important factor during the NICE decade and beyond. Related issues including migration, greater interconnectedness of international trade and the continued rise of the multinational corporation all played their part in shaping opportunities and threats for UK households, firms and the government.

Key impacts of globalisation have been:

- Cheaper money in world credit markets due to higher saving ratios in emerging economies such as China.
- Falling prices of consumer durables due to lower labour and land costs for growing businesses in Newly Industrialising Countries (NICs), and lower costs for UK-based firms engaging in *off-shoring* (moving business functions to cheaper countries) and *outsourcing* (contracting business functions to be supplied by a cheaper, foreign supplier).
- Greater migration, both into (immigration) and out of (emigration) the UK; this has helped to fill skills gaps in the UK labour market and to offer opportunities for some UK workers to move abroad.

As of late 2016, the future of globalisation itself looks uncertain, as democratic decisions in the UK and USA throw into question the assumption that free trade can, and is accepted to, increase the prosperity of all citizens in developed economies.

Government policy can also influence consumption levels in the economy. Monetary policy clearly influences the key decision whether to spend or save for households and firms, but fiscal policy also affects the incentives to work, earn, save and invest through marginal rates of income tax, tax relief on pension saving, and corporation tax and tax breaks for firms.

Question

2. Using the data given above, which model – or combination of models – provides the most accurate theory of what factors influence consumer spending in the economy?

Analysis: The 'Great Recession': why did consumer spending collapse in 2008-2009?

As noted in Chapter 1 consumer spending is the single largest component of GDP, and it is therefore no surprise that the fall in GDP experienced during the recession of 2008-09 can be largely explained by a drop in consumption. The relationship between consumption, GDP and investment can be analysed by two effects: the multiplier and the accelerator. When economic growth begins to slow, this influences both consumer and business confidence and households and firms change their expectations of future income levels. Investment – capital spending by firms – often responds more quickly and more drastically. Firms do not need to invest; supermarket chains expecting tougher trading conditions can call a halt to expansion, and manufacturers and construction firms will reduce output in anticipation of lower demand. This is called the **accelerator effect**, and is often a key indicator that an economy is heading into recession even before consumers and governments change their behaviour.

Households tend to react more slowly to changes in economic circumstance. The various economic theories of consumption explained in the section at the beginning of this chapter show that the correlation between income, and income expectations, and consumer spending is not perfect. However, a drop in investment (or a fall in other injections into the circular flow, such as government spending or net exports) reduces GDP, in turn affecting household's abilities to afford to maintain existing standards of living. The recession of 2008-09 was in many ways a casebook in how recession leads to falling consumer spending, with the addition of some other factors which compounded the problems already facing households.

- **Falling disposable incomes**

However imperfect, the link between spending and earnings is nonetheless important. Recession led to rising unemployment, directly reducing average earnings, and even workers who remained in employment often faced wage freezes and lower bonuses and commission than had been available during the previous

boom. In addition, CPI inflation remained stubbornly high despite negative growth, eroding the real value of incomes as prices increased faster than average earnings.

- **Negative wealth effects**

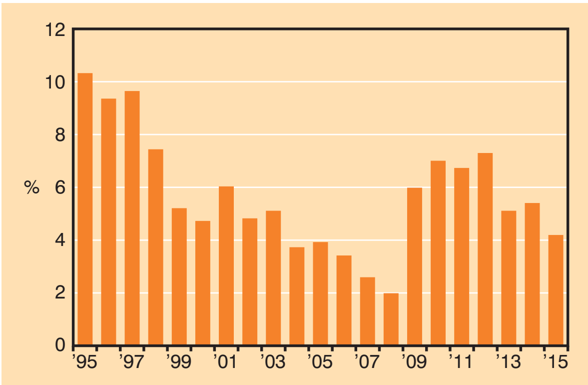
The housing market experienced dramatic 'corrections' as the bubble burst. Despite unprecedented reductions in the base rate of interest, which reduced the burden of debt on owner-occupiers with variable mortgage repayments, households experienced a reduction in wealth as the market value of their homes fell. This was exacerbated by the inflow of funds into the buy-to-let market during 'the NICE decade', and was matched by losses in stock market values which further reduced the wealth and confidence of households.

- **Tougher credit conditions**

Despite reductions in the base rate of interest by the Bank of England, the actual costs of financing credit cards and mortgages rose. Banks became less willing to lend as they attempted to address the bad debts on their books, and when lending was available the risk premium was often increased to reflect the difficult trading conditions in the financial sector. This disconnection between the base rate and market rates of interest was known as '**decoupling**', and raises serious questions about the effectiveness of monetary policy in managing demand during a credit crisis.

- **Higher saving ratio**

Figure 2.5: UK saving ratio



Source: HM Treasury

Despite falling incomes, downturn and recession is often accompanied by an increase in the saving ratio as households increase precautionary balances in case of job losses, and also to try to bring down debt levels if they predict negative equity on their home. Figure 2.5 shows this effect clearly. The problem is further compounded as consumers reduce their discretionary spending (purchasing of non-essential goods and services), leading to lower demand and job losses for suppliers of these 'luxury' goods.

- **Commodity price rises**

Prices of oil and food products increased in 2008, reducing the ability of households to buy other goods and services. Low income households in particular are affected significantly by higher food and energy prices. More recently, the price of foods and energy had fallen globally, but the drastic depreciation in sterling since June 2016 is likely to put upward pressure on prices of imported goods in the UK.

Question

3. What is meant by the terms 'food poverty' and 'fuel poverty' in an economy such as the UK? Why are these problems of greater significance during recession?

Application and Analysis: Explaining changes in the pattern of saving in the UK

Perhaps counter-intuitively, between 1995 and 2008 (except for a few minor increases) UK households saved a falling proportion of incomes. However, once the economy entered recession, the ratio increased by 250%, from 2% to 7% by 2010. Clearly, the concept of a stable **average propensity** or **marginal propensity to save** is highly dubious.

The different reasons for saving are important to explore at this stage.

Households save to defer present consumption and fund future consumption (e.g. saving for a future holiday or to buy high-price consumer durables, or when waiting for prices to fall), to prepare for retirement (e.g. saving in a pension fund), and as a means of avoiding future drops in consumption if income expectations are uncertain (precautionary saving). It is this latter factor which best explains the UK saving ratio over the last 15 years.

In times of strong economic growth, and when households expect such growth to continue, households may save a lower proportion of income as the need to build up precautionary balances declines. In essence, households believe they are less likely to be jobless, and thus feel free to spend a higher proportion of what they earn.

Other factors also reduced the saving ratio up to 2007:

- Historically low interest rates encouraged borrowing and discouraged saving in the UK.
- Relatively high interest rates pushed up the value of sterling and pushed down the prices of imported goods, helping to fuel a consumer boom.
- Rising house prices increased positive equity in property, reducing the need for households to save income to build up wealth levels.

During the 'Great Recession' of 2008-09 the rise in the saving ratio can perhaps be best explained by the precautionary saving model.

- Low consumer and business confidence and a weak labour market made households wary of spending and more inclined to save due to the threat of unemployment. Despite very low rates of return, saving has increased as a proportion of income.
- Households with high levels of indebtedness (most significantly where large loans were taken out to buy housing at peak prices in 2007) may seek to pay down debt levels to reduce their exposure to negative equity. This is known as a '**balance sheet recession**', or '**debt hangover**': even where positive income growth has resumed, economic agents feel a negative wealth effect through property and other asset prices remaining below their previous peak.

Knowledge: The paradox of thrift – should more saving be encouraged?

John Maynard Keynes popularised the concept of the **paradox of thrift**; that every decision to save, rather than spend, reduces demand in the economy and therefore causes demand-deficient unemployment. This is encapsulated by the quote, 'Whenever you save five shillings, you put a man out of work for a day.'

However, the then Governor of the Bank of England, Mervyn King, said in 2009 that, 'the United Kingdom faces… fundamental long-run challenge(s)… to rebalance the economy, with more resources allocated to business investment and net exports and fewer to consumption. That is consistent with the need – now widely accepted – to eliminate the large structural fiscal deficit and to raise the national saving rate.'[1]

The paradox of thrift appears to suggest that higher saving will reduce demand and reduce economic growth further. However, this assumes that higher savings create only lower demand, and are not used to create extra borrowing, which in turn stimulates purchases of consumer durables and business investment. The efficiency of the financial industry in creating credit is therefore an important factor in determining whether the higher saving ratio in recent years has been harmful or not. In the same speech quoted above, Mervyn King proposed the second challenge facing the UK was to reform the structure and regulation of the banking sector. He later made calls for banks to lend more money to smaller businesses, providing essential credit for firms to expand and create jobs and profit.

1. http://www.bankofengland.co.uk/publications/Documents/speeches/2009/speech406.pdf

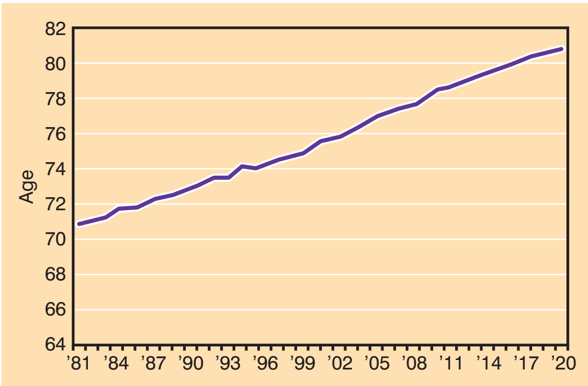
Question

4. Does it matter if the savings ratio of UK households continues to fall?

Analysis: The Pensions Crisis: an even bigger problem?

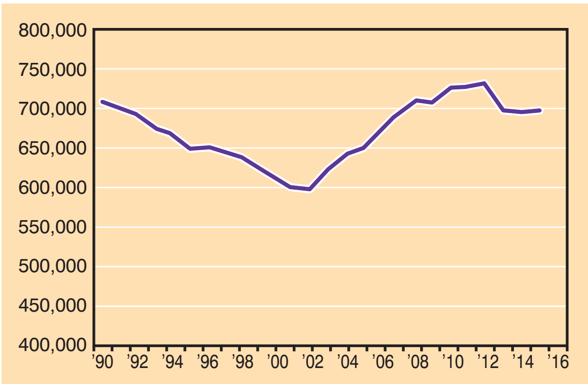
As important a role as savings play in the success of the macroeconomy, one area of concern in many highly developed economies is that of pension provision. A pension is a saving device to allow households to put money aside during their working years to fund retirement. Traditionally, workers would be employed by only a small number of firms (and often only one) over their working life, and powerful trade unions negotiated generous pensions based on final salary. The state pension – payments to old age pensioners, regardless of household income and wealth – was also an important element of the welfare state since 1945.

Figure 2.6: UK life expectancy at birth (2012-20 projections)



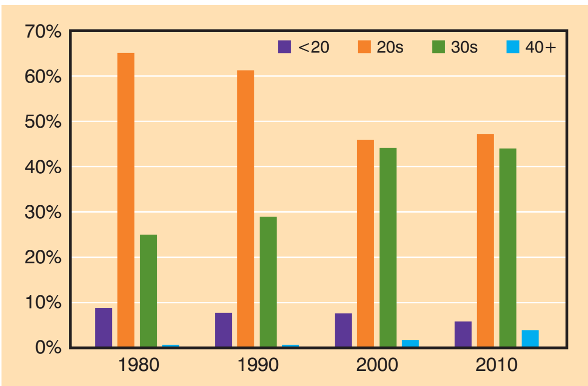
Source: ONS

Figure 2.7: UK births (p.a.)



Source: ONS

Figure 2.8: Births by age of mother (as % of births p.a.)



Source: ONS

Various factors have created a potential pension crisis for the UK:

- Increased life expectancy (Figure 2.6).
- For some years, the UK experienced a falling birth rate (Figure 2.7).
- Increased numbers of people extending their education past the compulsory school-leaving age, meaning later entry into the labour market.
- These two factors have also contributed to a shift towards families having children at a later age, leading to 'generational stretch' (Figure 2.8 shows the proportion of births to mothers over the age of 40 has risen four-fold since 1980).
- Greater labour market mobility and a breakdown of the 'job for life' culture has increased the likely number of employers in a worker's lifetime – reducing the ability of workers to build up a substantial pension saving.
- Loss of confidence in traditional pension schemes.
- Higher yields from other forms of 'saving', such as the buy-to-let market during the housing boom in the second half of the NICE decade.
- Lower interest rates for savers, especially since the drastic cuts in the base rate in 2009.

European countries where a 'pensions timebomb' is predicted to take place during the 21st century include the UK, Italy and Spain. A combination of high youth unemployment, high housing costs and a shift in culture away from 'traditional' family values may leave the economy short of workers (and therefore tax-payers) at a time when the cost of supporting an ageing population rises dramatically, given improvements in healthcare and rising life expectancies.

Figure 2.7 shows that, for the UK, the number of births has actually been rising since 2001. Some of this is due to greater immigration and higher birth rates in migrant families.

Policies which could be used to tackle the pensions timebomb problem include:

- Higher state pension retirement age (the age at which a state pension can be collected).
- Means-tested state pension (higher income households – typically those with significant private pensions – will no longer receive state pensions).
- Less generous state pension payments in real terms.
- Greater incentives to save for a pension, e.g. higher tax relief on employee and employer contributions.
- Extensive public information campaigns to alert young workers to the importance of preparing for retirement.
- Greater labour market flexibility to allow older workers to remain working, perhaps in part-time or flexible capacities.
- Compulsory employer pension contributions. In fact, by 2018 it will be compulsory for all employers to offer most workers a pension scheme.
- A minimum retirement age for private as well as state pension funds.
- A 'laissez-faire' approach, where older workers who have not saved sufficiently will have no choice but to continue working or depend on other benefits, e.g. disability or sickness payments.
- Compulsory individual pension tax (this has been introduced in Australia).

The pension issue is a very good example of how long-term problems which require long-term solutions are often ignored by governments of the day. **Public choice theory** suggests that governments do not, in reality, aim to maximise social welfare, but rather seek re-election by 'buying' votes with policies which appeal to their core electorate. The likely popularity of the policies listed above offers an insight into the likelihood of core reforms taking place before more drastic decisions have to be made.

One important point to consider is whether these projected increases in life expectancy will actually occur. Highly developed societies may actually see health outcomes worsen due to factors such as stress, sedentary lifestyles, and high-fat diets. However, the worse case scenario for the public finances would be an increase in healthcare costs for the obese and unhealthy, but a continued rise in life expectancy: people could stay sicker for longer while unable to work, with drastic negative impacts on NHS and care costs.

Extension Question

5. The Australian government introduced a compulsory 'pension tax' in the 1990s.
   Evaluate the case for and against such a policy in the UK.