UK economy after the recession

> The era of soaring borrowing and the associated boom in finance is over. The government should indeed act as borrower of last resort at this traumatic time. But the aim cannot be to tide the economy over until households start borrowing madly again. For the same reason, attempts to pump up the mortgage market, however understandable, are largely misguided. No sane person would borrow to buy houses whose prices are so likely to fall. Even if the government does get away with its heroic gamble, the longer-term path of the economy must be quite different from that of recent years. Do the government or the British people understand the implications of such a shift? I doubt it.[1]

When this recession comes to an end what kind of shape will the UK economy be in? While we cannot answer this question exactly, there have been some significant trends in recent years which will limit some possibilities and encourage some others. Some of these trends are economic and some are political.

What kind of crisis is this? As Phil Mullan[2] and others have pointed out, the current crisis hinges on the changed balance of global production. The decline of manufacturing in the west relative to the east has created a disequilibrium which underlies the global credit crisis. How this disequilibrium is resolved and over what period is impossible to predict. However, it seems unlikely that we will return to the status quo ante. Politics is concentrated economics and the changed nature of global production and the production of wealth has to cause changes in the distribution of world power.

If we wanted to summarise what has happened to the UK economy in the past ten years it would be as follows.

1. Investment and growth have remained relatively subdued, compared with previous periods and with more dynamic growth areas, while at the same time being fairly stable.

2. The UK has benefited from high levels of foreign direct investment.

3 The finance sector became more important to the UK in both an absolute and a relative sense, and both domestically and in relation to the world economy, while manufacturing continued its long term decline.

4. Household wealth grew mainly as a result of the housing bubble and the rise in the stock market, which along with easy credit and cheap imports led to a boom in retail consumption.

5. Total employment grew mainly as a result of the growth of the public sector, funded partly from the growth of the finance sector and partly from government borrowing.

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[1] Martin Wolf Financial Times 24 November 2008

[2] http://www.spiked-online.com/index.php?/site/article/4244/

Looked at like this we can see that the crisis has taken a form that presents almost the worst of all possible worlds for the UK. The recession has hit Britain hardest in its most exposed parts.

1. The crisis began in the financial sector, the most dynamic part of the UK economy, leading to a knock on process through the rest of the economy.

2. The crisis has become a crisis of credit, thus affecting the ability of businesses, homebuyers and individual consumers to continue to borrow.

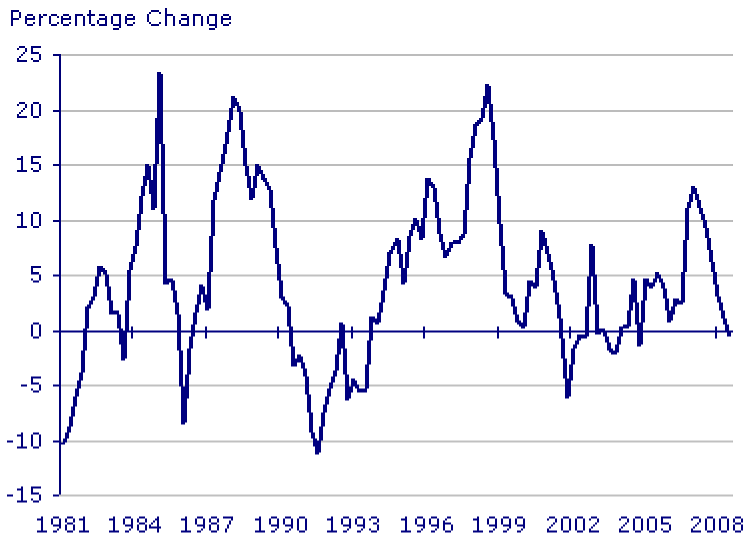
3. Public finances were already deep in the red, limiting the ability of the UK government to use fiscal policy to combat the crisis.

Before we look at each of these points in detail it should also be noted that the political response to the crisis has been shaped by the political culture of the past ten years as well, both from the point of view of governments and from the public. In many ways this recession has been a crisis of politics as much as of the economy. We shall return to this in the conclusion.

1. A low growth,low investment economy

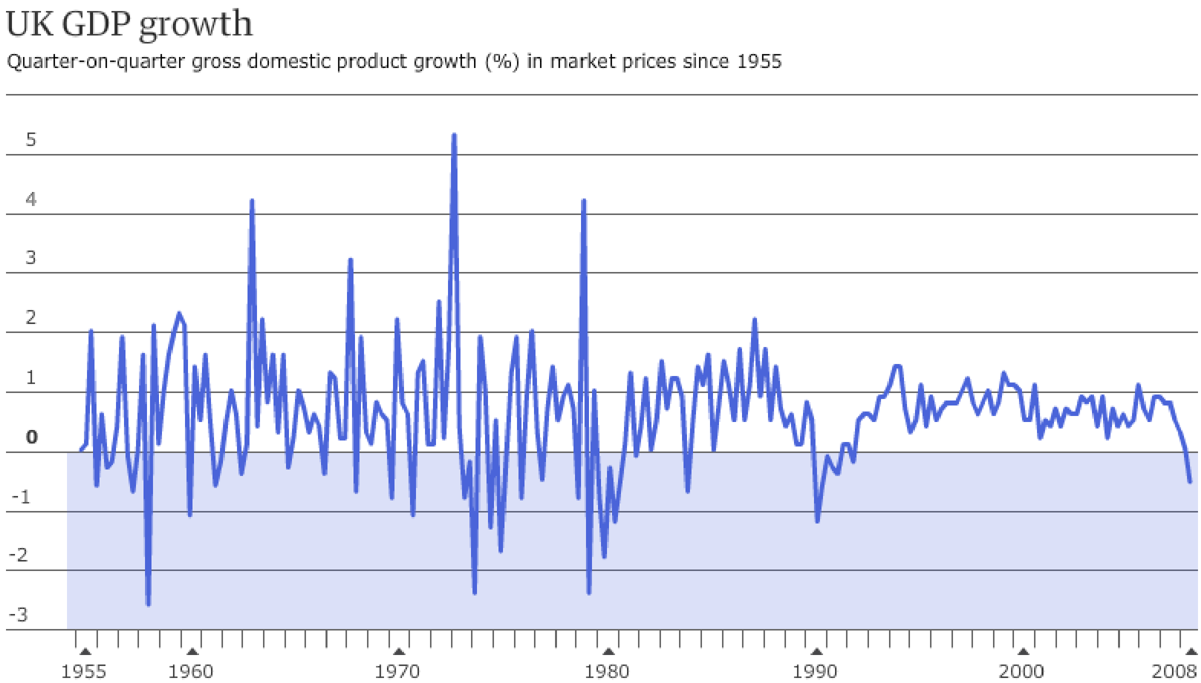
As can be seen from the graph below, business investment growth in the UK has reached a lower plateau in the past ten years compared with the previous 20 years. [3]

Total Business Investment percentage change, quarter on corresponding quarter of previous year

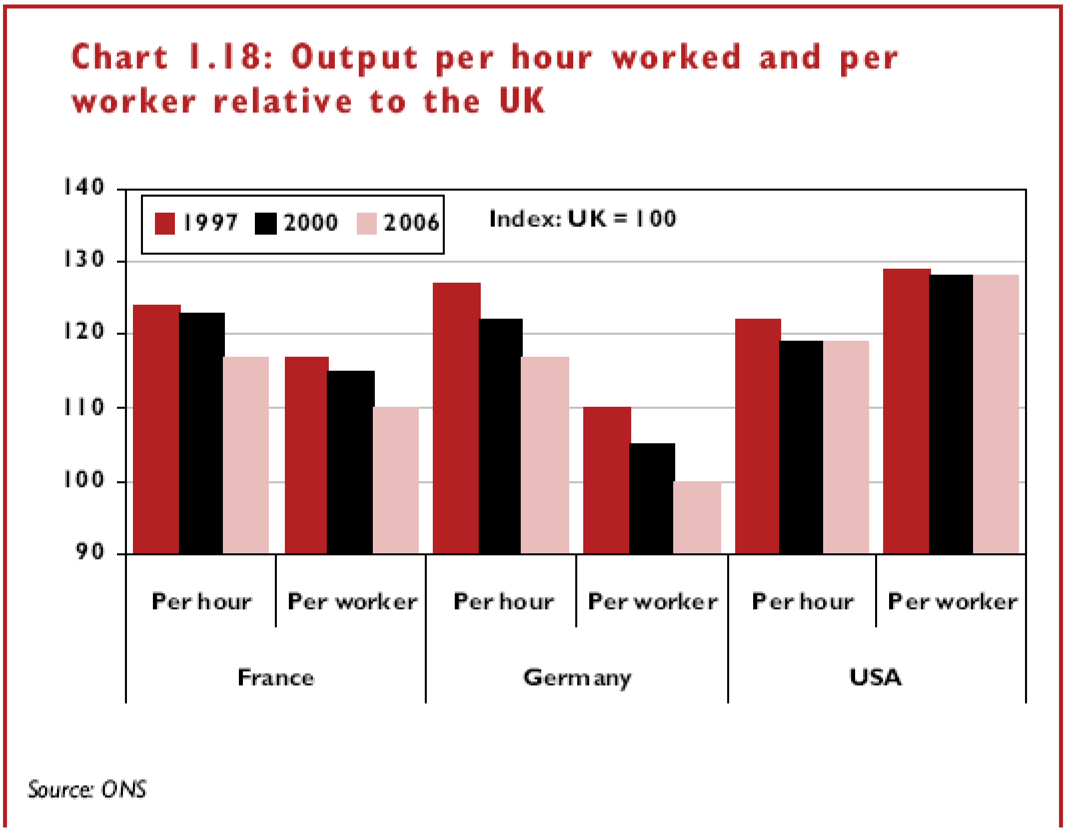


The UK economy grew for 63 quarters prior to the third quarter of 2008. GDP grew at this time at an average of 3%. While this may look a respectable growth rate the growth has been in largely unproductive sectors of the economy. Also bear in mind that the current *fall* of GDP growth to 7.5% in China is considered a potential crisis.

[3] http://www.statistics.gov.uk/CCI/nugget.asp?ID=258



Productivity has improved against western based competitors but remains at a lower rate.



[4]

[4] The UK economy, analysis of long-term performance and strategic challenges march 2008 HM Treasury p5

2.Foreign Direct Investment

The UK is the second largest recipient for foreign direct investment in the world, behind the US. In the last year it was $224b.[5]A recent survey by KPMG predicts that the UK will be second preference for financial services investment, first for property and first for transport. It listed the factors involved in making these decisions in descending order as follows.[6]

Access to new Customers
Political stability
Impartial rule of law
Infrastructure
Regulatory climate
Tax regime
Quality of labour

In the past year investment in UK technology, media and telecoms rose, mainly from the US, by three times to £12.6b due to low valuations. This compares to £40b at the height of the dot com boom in 2000.

3.The service economy and the financial sector's key role in GDP

> 'It is true that the reputation of both UK-based and US finance houses have been seriously affected by recognition of the processes leading up to the crunch, and inadequacies of the regulatory system in managing both the problems in the wholesale market and more general lending behaviour.'[7]

1. The main long term trend in the UK economy has been a shift away from manufacturing towards services. Services in total now make up 75% of the output (GDP) of the UK. In 1975 it was 55%.

[5] FT 25 September 2008
[6] http://www.kpmg.com/Global/PressRoom/PressReleases/Pages/NewKPMGInternationalsurvey.aspx

[7] London's place In The UK economy LSE October 2008

Manufacturing is down to 13% from 21% since 1996.[8]

Table 2.1: Changes in sector shares of output – broad industry sectors

	Output (GVA) share (%)		Ppt change in share of output
	2006	1996	1996–2006
Real estate, renting and business services	24.8	19.1	5.7
Manufacturing	13.2	21.1	-7.9
Wholesale and retail trade	12.1	11.6	0.5
Financial intermediation (excl. FISIM)	9.4	6.5	2.9
FISIM	5.0	3.3	1.7
Health and social work	7.3	6.4	0.9
Transport, storage and communications	7.2	7.8	-0.6
Construction	5.7	5.1	0.6
Education	5.6	5.4	0.2
Other social and personal services	5.4	4.3	1.1
Public administration and defence	5.1	5.8	-0.7
Hotels and restaurants	3.1	2.7	0.4
Mining and quarrying	2.4	2.9	-0.4
Electricity, gas and water	2.7	2.3	0.4
Agriculture, forestry and fishing	0.9	1.8	-0.8

Source: ONS Blue Book (including experimental output statistics). Note: FISIM = Financial intermediation services, independently measured.

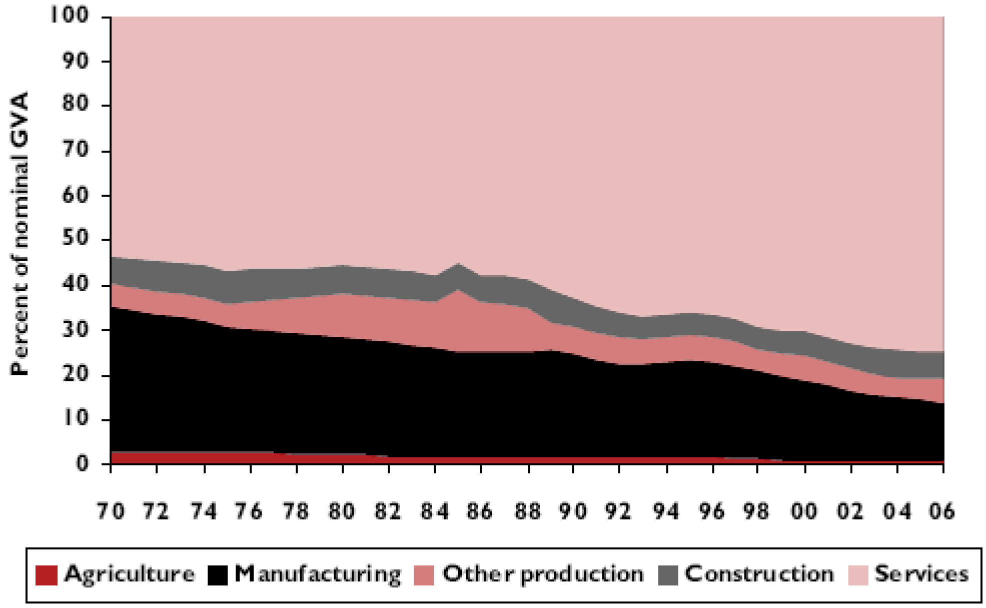
2. Within the services sector there has been an increase in the weight of financial and business services. Between 1996 and 2006 business services and financial services together rose from 25% to 34% of GDP. Within the services sector financial services now represent 10% of GDP, up from 6% in 1996.[9]

3. Net exports of financial services have grown from £3b in 1991 to £23b in 2006 to become the largest part of services exports.[10] The UK is the global leader in the export of financial services, having 24.4% of the total.[11]

4. London holds the top spot as the world's most important international financial centre, ahead of New York City. In all segments, including cross border lending, foreign equities turn over, foreign exchange turnover, exchange traded derivatives turnover, over-the-counter derivatives turnover, marine insurance net premium income, international bonds, fund management, hedge funds, private equity and IPO, London holds the largest share.[12]

[8] UK economy, analysis of long-term performance and strategic challenges march 2008 HM Treasury p5
[9] Globalisation and the Changing UK Economy BERR February 2008 p14
[10] The UK economy, analysis of long-term performance and strategic challenges march 2008 HM Treasury p47
[11] Globalisation and the Changing UK Economy BERR February 2008 p16
[12] http://www.financialexpress.com/news/uks-financial-services-share-rises-to-9.4-of-gdp-in-06/256893/

Chart 1.10: The changing structure of the UK economy



Source: ONS

<u>The London effect</u>

London depends heavily on the success of financial and business services, and the UK depends heavily on London, although Edinburgh, Glasgow, Leeds, Manchester, Birmingham and Bristol are also emerging as important financial centres.

1. London's role as a financial hub for world finance is reflected in the weight it has within the UK economy. London has 12% of the UK population but produces 19% of GDP and 15% of UK jobs. London is a net contributor to the UK economy by around £15bn per annum and contributes 18% of all tax revenues.[13]

2. However the economy of London is heavily dependent on the health of the financial and business services sector. These services make up a third of all jobs in London, while all forms of manufacturing represent only 9%.The rest of London's jobs are in different forms of support and personal services or in the public sector.[14]

<u>What shape will the financial sector be in after the recession</u>?

The UK economy depended on the growth of financial and business services for its dynamism in the past 10 years. Other sectors of the economy, particularly retail, benefited directly and indirectly

[13] London's place in the UK economy Oxford Economics2007
[14] London's place In The UK economy LSE October 2008

from this. The UK government got deeper into debt on the strength of assuming that growth would continue indefinitely (no more boom or bust). Most of the extra jobs created in this period were business or financial services or in the public sector.

This means that a permanent decline in the importance of financial and business services would have a disproportionately hard impact on the UK economy. Bluntly, if growth in this sector goes backwards there is no other sector of the UK economy which could pick up the baton in terms of growth.

A former Deputy Governor of the Bank of England summed up the City's position as follows,

London benefits from English as an international language of commerce, and from its time zone, which means the working day overlaps with Asia in the morning and America in the afternoon. London also has well established financial infrastructure and telecommunication networks.
Many of those surveyed point to the regulatory and legal environment. This is partly a matter of the regulatory style – the "risk based and proportionate" approach that the Financial Services Authority has adopted based on general principles where possible. It is partly the simplicity of dealing with a single regulator.
English law, which is also the basis for financial services law in the United States, prevails here, with the added advantage that practitioners are less likely actually to invoke the legal system. And what has been called the Wimbledonisation of the UK financial markets – the sale of nearly all the British merchant banks and stockbrokers and the dominance of foreign players – gives confidence to prospective market participants that the competitive environment is genuinely open to all comers.
London is also a growing centre for Islamic banking. Finally, London may be benefiting from measures elsewhere; certainly in the years since the Enron and WorldCom scandals, commentators have suggested that the application of the Sarbanes-Oxley legislation to foreign firms listing in New York may have encouraged some firms to list here instead.
But the single most important factor is the first one suggested by economists: London's comparative advantage lies in its skilled labour and financial know-how both in the financial firms and in the professions which support them.
The free movement of labour within the European Union, and relative openness to immigration by those with specific expertise from outside it, has also meant that employers in the financial sector can access the world labour market. And the relative flexibility of the labour market here in the UK compared to others in Europe may also be a factor.
That concentration of skilled labour has spurred competition and innovation. We have seen a very striking illustration of this in the last few years with the rapid growth of hedge fund management and private equity firms in London. Many have been established and are staffed by people who acquired their skills and earned their capital at the more established investment banks and fund management firms of the City. Being at the heart of world markets helped them spot the opportunities and assess the competition. Once they struck out on their own, they could draw on a network of former colleagues and contacts for staff, information and expertise.[15]

Some debate about London's role as a financial sector has begun.[16]At this stage it is too soon to know to what extent the financial sector in London will recover. However in the short to medium term it is contracting and this will have a deleterious impact on the London economy in particular.

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[15] SIR JOHN GIEVE DEPUTY GOVERNOR, BANK OF ENGLAND
The City's Growth: The Crest of a Wave or Swimming with the Stream?
26 March 2007

[16] For a fascinating discussion of this in relation to LIBOR see Donald Mackenzie London Review of Books 25 September 2008

4. Consumption and the credit crisis

> I believe that new net mortgage lending is very likely to fall below zero in 2009 (compared to around £40 billion this year and £108 billion in 2007) with only a modest recovery likely in 2010. No new net mortgage lending across a full calendar year would be unprecedented and is likely to be associated with further weakness in consumer spending and an increase in unemployment. In the housing market it is difficult to see why this would not also involve further house price falls and fewer housing starts.[17]

The bubble in house prices has been unwinding over the past year. How important was it in the prosperity of the past ten years?

The value of residential housing as a percentage of total UK non financial asset values rose from 50% to 61% between 1999 and 2007.[18] Over the past 2 years home owners have been withdrawing equity at a rate equivalent to about 5% of post tax income, or around £42b per annum, in order to spend on other things. In the second quarter of 2008 this had reversed and homeowners paid back into their mortgages or paid for housing by cash to the tune of £2.8b, thus reducing their spending power.[19]

Household saving fell from 10% of income in 1997 to 2% in 2007[20] while personal debt in the UK, comprised of mortgages, loans and credit cards rose to 1.444 trillion by 2008. This compares with household wealth of 3.7 trillion of housing assets and over 4 trillion of financial assets.[21]

Household debt represents more than one year's total GDP rising at a faster rate than GDP, by 7.3% compared to 5.1% for GDP.[22]We would all have to work for more than a whole year without consuming anything to clear the debt.

By the end of 2005, UK banks were no longer financing lending from customer deposits but began to borrow from the wholesale markets. As The Sunday Times pointed out,

'Everything from mortgages to credit card debts to multi-billion loans given to private equity companies were packaged up into bonds and sold to hedge funds, pension funds and other large institutions.'[23]

Currently the amount owed by UK banks to global markets is around £740b.

5. Growth of the public sector

Between 1999 and 2007 manufacturing jobs in the UK fell from 4.5m to 3.3m. In the same period jobs in the financial and business services sector grew from 5.3m to 6.5 m, and jobs in the public sector grew from 8.4m to 9.9 m.[24]

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[17] Sir James Crosby: Mortgage Finance Markets HM Treasury November 2008
[18] The Blue Book 2008p243
[19] Bank of England statistics Housing Equity Withdrawal
[20] Blue Book 2008 p107
[21] The UK economy, analysis of long-term performance and strategic challenges March 2008 HM Treasury p4
[22] Daily Express 22 August 2008
[23] Sunday Times 30 November 2008 section 2 page 7

The Financial Times claims that around two thirds of jobs created since 1998 have been in the public sector. Most strikingly, within that figure, of the 1.07 m jobs created in the public sector,963,000 were taken by women in health, education, social care and social administration.[25]

There are at least 10 areas of the UK, all outside London, where 40% or more of those working are in the public sector.[26]

Flexibility

> Evidence suggests the UK is now more resilient to economic shocks..due to flexible product,labour and capital markets[27]

The UK government has claimed that the prosperity of the past ten years has been built upon three factors; flexible products, flexible labour market and flexible markets.[28] While a detailed examination of this claim is outside the scope of this article we should note the following.

Flexible products

The government claims that intervention in anti-competitiveness, as in the energy utilities, has helped free up UK economic activity and made it more competitive and innovative. In addition it claims to be reducing regulations which inhibit enterprise.

Yet research and development intensity is lower than the OECD average. Business research and development intensity has declined from 1.5% of GDP in the 1980s to 1.1% in 2006, way below the OECD average. The OECD attributes this to,[29]

'the structural characteristics of the British economy, with 75% of GDP produced in the services sector, and few large R and D intensive activities in key sectors such as motor vehicles, information technology and electronics.'

Flexible labour market

The government claims that flexible labour markets have contributed to prosperity. The main way in that this may be true is in the contribution of immigrants to the economy. They require less social spending, are more entrepreneurial and more flexible in what they will do. However, one of the first effects of the recession has been to reverse immigration and this has been endorsed by Phil Woolas. The positive effects of immigration may now be reversed, with a decline in working age people.

Flexible labour market is not so flexible because of regulations making it difficult for employers to sack people and leaving them open to claims of racial and sexual discrimination which can be very damaging.

Subdued wage demands may be largely attributed to the disappearance of an organised working class rather than being the product of government action.

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[24] The Blue Book 2008p103

[25] Financial times 24 November 2008 p3

[26] Sunday Times 30 November 2008

[27] The UK economy, analysis of long-term performance and strategic challenges march 2008 HM Treasury p37 passim p3

[28] The UK economy, analysis of long-term performance and strategic challenges march 2008 HM Treasury p37 passim

[29] OECD Science technology and Industry Outlook 2008

Conclusions

Government response

For a long period after the financial crisis began the government's only intervention was to bail out Northern Rock. There was no attempt to boost the economy through fiscal means, as the US government attempted via tax rebates in early 2008. Nor was there any recognition of the need to cut interest rates until the autumn of 2008. The predominant attitude was that the market should be allowed to sort itself out, thus continuing the managerial approach to the economy which has typified New Labour.

The failure of political leadership has roots in the decline of politics. For example, an out of touch political establishment was afraid that inflation would provoke struggles for higher wages, thus leading to a delay in making interest rate cuts beyond what was necessary.

Since the onset of the recession proper in the last quarter of 2008 the public discussion has largely taken place around the issue of consumption rather than production, with the emphasis on stimulating consumption via public spending.

Neo- keynesianism

> The essential message can be summarised in three sentences: if an entire nation decides to cut spending and increase saving at the same time, the result is not an increase in saving but an increase in unemployment. This means that households can only increase their savings or reduce their debts if someone else spends and borrows more to keep the economy afloat - and in a recession that normally has to be government. And finally a government that spends and borrows in a recession can usually repay much of this borrowing without raising tax rates, because recovery automatically yields higher revenues and reduces spending on the unemployed. [30]

Now that the recession has become real, the government has been panicked into action on both the fiscal stimulus side and on interest rates. Almost overnight its rhetoric shifted from 'hands off' to a fully fledged neo-keynesianism.

Amidst a lot of talk about 'putting the fire out first' the government's explicit approach is to restore lending to 2007 levels and to try to pump up the housing market again. Critics of this approach, such as Tory leader David Cameron, have focused on the likelihood that this will lead to necessary cuts in public spending in the future.

More regulation

[30] Anatole Kaletsky the Times 20 October 2008

The Financial Services Authority will be beefed up in response to the credit crunch. It is planned to take on an extra 218 jobs giving it a total of 3000. It is clear that for the time being at least the message is that the finance sector needs to be both externally and internally policed more thoroughly,

'In terms of finding the new people the banking downturn has helped only a little since the worst hit sectors include traders and bankers and neither group is exactly what the regulator is looking for. Those it does want-risk managers, product controllers and compliance officers-are still needed by the banks. In fact, the FSA wrote to the industry earlier this year warning them against making any cutbacks in these areas.'[31]

It is already clear that attempts to move forward government spending on capital projects are limited by the extensive regime of planning agreements and consultations that have become an integral part of modern government.

Focus on the digital and creative industries

Stephen Carter has been appointed to oversee the development of digital development in the UK. The government sees this as a key part of the future development of the UK economy. The report Innovation Nation[32] and more recently the NESTA report, Attacking the Recession[33], attempt to develop a strategy for innovating the UK out of its current difficulties. Neither report deals with the risk averse and over regulated climate of low expectations in which makes a culture of innovation unlikely to develop.

Over consumptionist

Alongside the under consumptionist neo Keynesian response to the recession has been an over consumptionist one. Some politicians and sections of the middle class press in particular have been in the forefront of championing personal austerity as a response to the recession, arguing that the need for sustainability has been given a new imperative.

The balance of benefits for the continuation of the status quo is that while the discussion revolves round over or under consumption the fundamental problem of the lack of a productive economy remain unaddressed.

Public response

> The most alarming feature at present is the fatalistic public mood. The slump is being discussed as if it were a natural catastrophe like the arrival of the comet that destroyed the dinosaurs.[34]

The overwhelming public response so far to the recession has been passive acceptance. As long as this is the case then it is unlikely that public attention will turn to ways of avoiding recessions in the future.

This passivity has gone side by side with an outburst of hedonism and escapism, rates of sexually transmitted diseases shot up in Canary Wharf once the downturn set in.[35] Also the 118 telephone

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[31] FT December 1 2008

[32] http://www.dius.gov.uk/policy/annual_innovation_report.html

[33] http://www.nesta.org.uk/attacking-the-recession/

[34] Samual Brittan Financial Times January 2 2009

directory services reported that they had experienced 'a sharp increase in number requests for sex shops, lap dancing clubs and escort agencies'.[36]

<u>Green new deal</u>

> What about a "Global Green New Deal"?...The industrial and service sector-led growth "at any cost" may have hit its limits – in terms of job creation and in terms of its ecological footprint on the world's increasingly scarce nature-based assets. Gross domestic product as a measure of real wealth and as a bell-weather of economic success or failure may also have had its day in its current, narrow configuration.[37]

An emerging response to the recession is to call for a Green New Deal. This response has the advantage that it appears to offer a way out of the recession by encouraging a switch to investment in green technologies rather than a return to the credit based boom of the past decade.

Some environmentalists go even further,

Unless economic growth can be reconciled with unprecedented rates of decarbonisation, it is difficult to foresee anything other than a planned economic recession being compatible with stabilising the climate[38]

While it is unlikely that the call for more recession will achieve great resonance outside the ranks of hard core environmentalists, there will be resonance for seeing the recession as an opportunity to speed up green economics, which could end up with declines in growth rates and consequent reductions in living standards.

Lord Stern, who produced the Stern report for the UK government on the economics of climate change, explains it like this,

'We will have to pump up demand – by cutting taxes and increasing transfer payments and making investments that can take place quickly and are labour-intensive – all of those will matter. But we should be thinking about these things in a way that can start to drive forward a form of growth that is really well-founded and sustainable.'[39]

Currently in the UK what the treasury defines as Environmental goods and services grew from £16b to £25b between 2001-4, employing 400,000 people.[40] However Stern recommends that,

'it extends to new types of cars and other transport, new building materials and designs, energy transmission systems, new packaging for retailers, the redesign of manufacturing techniques, different farming methods, and a host of other developments in nearly all sectors of the economy.'

The struggle for democracy and for economic growth

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[35] http://www.timesonline.co.uk/tol/life_and_style/health/expert_advice/article4877055.ece

[36] http://www.guardian.co.uk/business/2008/nov/17/recession
Coupled with the government crackdown on trafficked foreign prostitutes this represents a no doubt welcome boost for UK born prostitutes

[37] http://www.ft.com/cms/s/0/bb03eaca-b9c0-11dd-99dc-0000779fd18c.html

[38] Tyndall Centre for Climate Change Control

[39] http://www.ft.com/cms/s/0/c5693d5e-b9c4-11dd-99dc-0000779fd18c.html

[40] The UK economy, analysis of long-term performance and strategic challenges march 2008 HM Treasury p33

Some countries, such as Britain, which has hitched its prosperity more completely to the wealth generated by the City of London, may wish that their economies were more 'real' in 2009. The idea that Britain's economy can rely solely on finance-exporting banks and importing goods-is surely dead. [41]

The UK has been living beyond its means. We have been consuming the product of somebody else's labour, in the form of loans from the more dynamic countries in the world. The relative over exposure of the UK to the global financial system means that within the current parameters the UK is over dependent on international developments. This is not sustainable in the longer term. The instinct of UK politicians is not to confront this problem but to put off the day of reckoning by finding ways to continue financing consumption. The issue of 'quantitative easing', however it is dressed up, is a short term attempt to stimulate the economy by printing money. This could have potentially dangerous long term consequences.

There is always scope for the economy to recover, for example the falling value of the pound may accelerate foreign direct investment. It is also the case that the compliance of British workers in pay freezes and wage cuts gives business more scope to recover. British capitalism will not collapse as a consequence of the recession. Economic activity will revive eventually. But the fundamental problem of the long of a dynamic economic engine will not go away.

The failures of the UK and other western governments to react effectively to this crisis are a product of the lack of real democracy and leadership in the west. The concept of TINA, There Is No Alternative to the market, has lulled politicians into the mistaken belief that the market always works and that governments need merely tinker with the economy. Unsurprisingly interest in politics has diminished. If, after all, economic activity is out of human control, what is the point in politics?

Even worse is the trend to interpret the many failures of the market as a reason to oppose economic growth. Even in the middle of this recession, when world trade is collapsing and capital flows between countries are drying up, with potentially disastrous consequences for the health and well being of the people of this planet, there are those who argue that falls in consumption are a good thing. We need to argue that continued economic growth is vital. If the market cannot deliver economic growth then we need to look at alternative ways of delivering it.

We should see this recession as an opportunity to develop arguments for democracy and for economic growth. The economy is the sum total of human activity. We made this mess and we can unmake it. But to do this requires a revolution in our attitude to politics and a renewed belief in our ability to change the course of human activity through conscious activity. The UK requires a political and cultural revolution in order for the economy to recover and thrive into the future. A more innovative economic environment cannot thrive in a generally risk averse culture and one which is wedded to welfarism, state intervention and regulation.

Rob Killick December 2008

[41] Financial Times editorial December 31 2009