Economic Report

Number 3 August 2012

- **By 2008 the UK economy had become unbalanced in four key ways – by expenditure, by sector, by region and by wage share.**
- **In the past two years there has been little progress on rebalancing by any measure.**
- **The investment and net exports share of the UK economy is not rising.**
- **The financial sector is growing faster than the rest of the economy.**
- **Regional imbalances are persisting.**
- **The share of the economy going to low to middle income households is still falling.**

Introduction

The current government came into office will three primary economic aims – secure the recovery, eliminate the structural deficit and 'rebalance' the economy. Against the first two objectives it has so far failed. The economy is now smaller than when the government came to power with the UK experiencing its longest double dip recession since records began and (as a result of slow growth) eliminating the structural deficit will no longer be achieved in one Parliament.

Recently there has been less discussion of 'rebalancing', the overriding need to get the economy moving again has focused minds and attention on how to get any growth at all. Partially the problem is that 'rebalancing' is a nebulous term – unlike growth or deficit reduction there is no widely accepted definition and so no benchmarks for success.

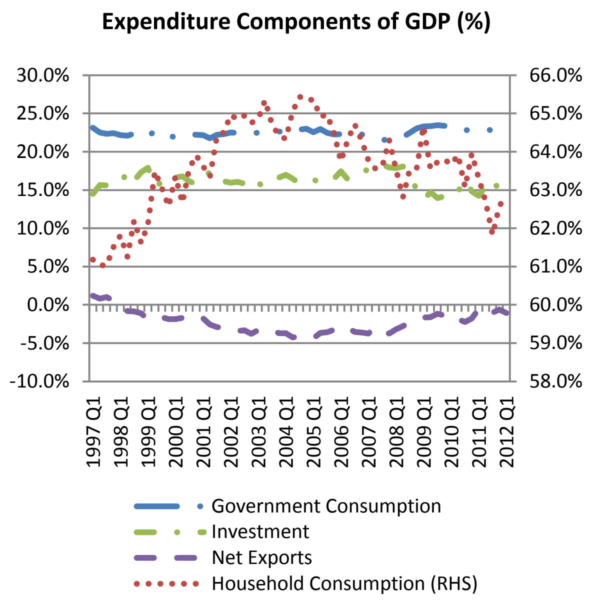
This Economic Report therefore attempts to define 'rebalancing' and so provide some benchmarks against which future economic performance can be measured. It identifies four ways in which the economy before the crash had become 'unbalanced' – by expenditure, by sector, by region and by the wage share and shows that in the last two years there has been little progress on rebalancing by any measure.

While the case against the Government's deficit reduction target continues to build, as austerity increasingly chokes off the recovery the Chancellor purports to seek, Government recognition of the need to rebalance the UK economy is welcome. Rebalancing is vital to the UK's long-term economic performance, as without some significant shifts in the way our economy looks we risk slower long-term growth and an increased risk of further steep recessions. The aim of policy cannot therefore simply be to return the economy to where it was before the recession, instead we need a new model of growth – one that is more sustainable, more resilient and that works for ordinary people.

Expenditure

Background
One measure of how 'unbalanced' the UK has become, and one that George Osborne was keen to press in opposition, is the expenditure breakdown of GDP. GDP can be broken down into household consumption, government consumption, net exports (i.e. exports minus imports) and investment.

The graph below shows the breakdown of GDP by expenditure since 1997 (consumption on the right hand scale).



Prior to the recession in 2008, the changes in the expenditure share of GDP were relatively minor. The share of net exports fell, moving from a small positive factor in 1997 to become a negative drag on GDP in 1998. Government consumption was broadly flat whilst household consumption rose gradually from around 61% in 1997 to around 65% by 2006/07. Investment remained locked in range from 15-18%.

How much of a problem is this?

The historically low share of investment in UK GDP has long been recognised as a problem. Since 1980 the UK has ranked either 6th or 7th of the G7 advanced economies by this measure. As the TUC's previous Economic Report has argued[1], raising the share of GDP going into investment would be beneficial not just in the short term but in the long term too.

Equally the growth of the UK's trade deficit in the period from 1998 has been recognised as sign of 'unbalance' by several analysts. Whilst running a small trade deficit is not always a major problem, running a consistent deficit over a decade may be an indication of wider underlying problems. If an economy is running a persistent trade deficit it suggests a shortage of national savings and may be an indication of an international loss of competiveness.

There is little evidence that government consumption rose as a share of GDP in the ten years before the crash, and a consistent share of GDP of under 25% is well below that of many other advanced economies. However the rising share of household consumption could be seen as a problem – as is discussed later in this report if household are reliant upon debt to boost their spending this can cause wider economic problems.

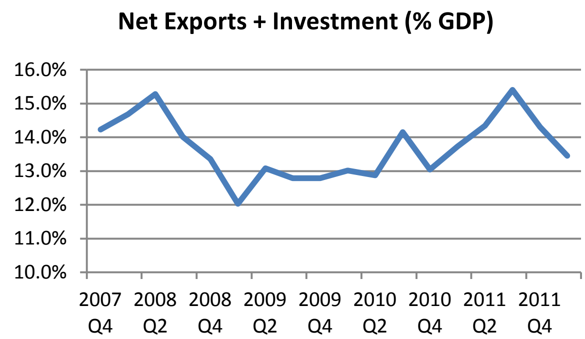
Measure of Success

Measuring how far we have come in rebalancing by expenditure is relatively straight forward. In February 2010 the then Shadow Chancellor George Osborne argued that: "We will increase saving, business investment and exports as a share of GDP."

This seems as good a measure as any other. If the economy successfully rebalanced by expenditure the share of net exports and investment in GDP would rise. Of course there is an important caveat to this, as this form of rebalancing could be achieved via a recession which hit consumer and government spending harder than net exports or investment. If consumption and government spending collapsed whilst exports and investment only fell by a smaller amount, their share of GDP would rise whilst GDP itself would be smaller. It would be hard to argue that this would constitute a 'success'. What is required is for investment and net exports to grow quicker than the other components of GDP against a backdrop of a growing economy.

Outturn so far

Over the past two years there has been little evidence of any rebalancing by expenditure.



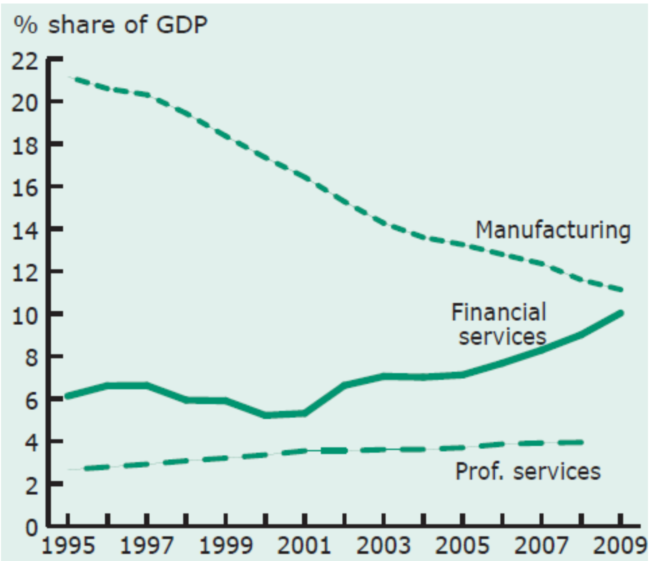
To put it mildly, both net trade and investment growth have been somewhat patchy. There is no evidence in the last two years that net exports and investment have been the major drivers of growth they would to be to achieve rebalancing and the combined share of net exports and investment in GDP remains below its 2007 level. In addition household consumption has been a drag on growth as overall has it has fallen.

Sectors

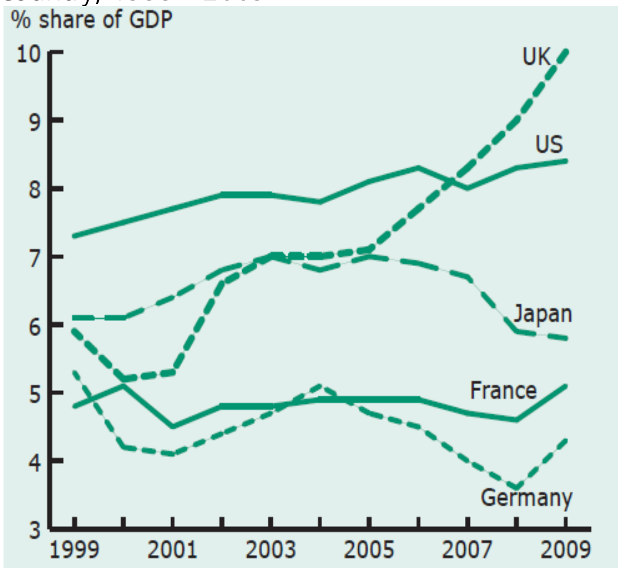
Background
The notion that the UK economy has become too dependent on a few key sectors at the expense of other activities perhaps the most widely used meaning of the term 'rebalancing'. At a simple level there has been a wide spread concern amongst many observers that the UK economy, prior to 2008, became too dependent on banking at the expense of traditional industries such as manufacturing.

As the following two graphs (from the financial services trade body The City UK[2]) UK make clear, the contribution of the financial sector to the economy rose rapidly in the 2000s. The share of financial services in GDP is also higher in the UK than in many other major economies. However, it is worth noting that manufacturing still has a larger share of the economy than financial services (albeit in decline).

Percentage share of GDP by sector, 1995 – 2009, UK



Financial services' percentage share of GDP by country, 1999 - 2009



How much of a problem is this?
A strong case can be made that the UK was over reliant on financial services on two basic grounds – sustainability and wider economic resilience. Several prominent economists have questioned how sustainable the growth in financial services actually was. In an especially important intervention the Bank of England's Andrew Haldane has argued that much of the growth in financial services productivity that boosted GDP in the run-up to the crisis was a 'mirage' rather than a 'miracle' driven by excessive risk-taking.[3] This analysis suggests that an unreformed financial sector of a comparable size to that we saw before the crash would pose an inherent risk to the UK economy, regardless of how much value it created in the short-term.

Secondly there is a question of resilience. The OBR has acknowledged that the primary reason why the UK's fiscal deficit opened up so widely in 2008/09 was a rapid collapse in tax revenues from property and finance. As the OBR argued in July 2011 the overdependence on finance and property related revenues was "one of the primary drivers of the severe deterioration in the UK public finances in recent years, exposing the risks to sustainability of reliance on revenue from these sectors".[4] Their assessment suggests that an economy with a better balance between sectors would be better place to withstand significant economic shocks of the type we have recently experienced.

Rebalancing away from financial services (although not necessarily only towards manufacturing) would therefore be desirable. Financial services will always be a key part of the UK's economy, especially in terms of their contribution to the balance of payments, but a strong case can be made that in the years leading up to 2008 the UK became too dependent on the sector.

Successful sector rebalancing is not simply a case of growing the manufacturing sector but also would require a shift in the balance of the service sector away from low wage, low skilled activities.

Measure of Success
Success in this case, at its narrowest level, is best defined as the share of financial services in GDP falling over time as other sectors grow faster than finance. More specifically, a there is an argument that the share in manufacturing in GDP should rise given that manufacturing is associated with exports, investment and research and development spending.

Outturn so far
By this measure the UK economy has become more unbalanced sectorally over the past two years, and especially over the past year.

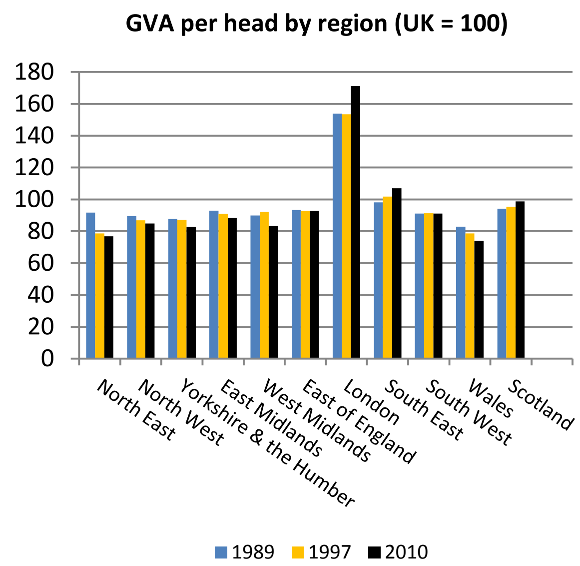
According to the most recent GDP figures (Q2 2012) the output of business and financial services rose by 2.4% in the two years to June 2012, while over the same period GDP as a whole only rose by 0.4%, suggesting the share of the economy accounted for by business and financial services is rising rather than falling. While manufacturing output grew by 1.8% in the two years to June 2012, also faster than GDP, this rate of increase was slower than for business and financial services.

In the year to June 2012 the picture is more striking, GDP fell by 0.8% whilst manufacturing output fell by a far steeper 3.1%. In contrast, the output of business and financial services rose by 0.8%. While without this growth the fall in GDP would have been even steeper, this trend does raise worrying questions about the shape of our future economy. The economy is not rebalancing away from a dependence on financial services, if anything its share of GD is actually rising. The picture for manufacturing is more mixed with a solid performance in 2010/11 giving way to a fall in 2011/12. If this trend continues we are set to become even more unbalanced than was the case before the crash.

Regions

Background
Another measure of unbalance is the growth in inequalities between the regions and nations of the UK.

As the graph below shows gross value add per head by region over the past twenty years (each region is shown relative to the UK as a whole which is set at 100) has varied significantly.



As can be seen by 1989 there was already wide regional differentiation, and this had been growing since the 1970s. Over the past twenty years London has pulled further ahead whilst the Northern regions of England, the Midlands and Wales have slipped further behind.

How much of a problem is this?
In purely economic terms the weaker GVA performance in the regions outside of the South of England (and to an extent Scotland) is drag on wider UK economic performance. Their differing performances also leads to widely varied labour market performances. At the end of 2007, before the crash and following 15 years of

economic growth, the employment ratio in the South East of England was 77.2% whilst in the North East it was only 69.4% - a substantial improvement on the 63.8% at the beginning of 1992 but still well below the national average.

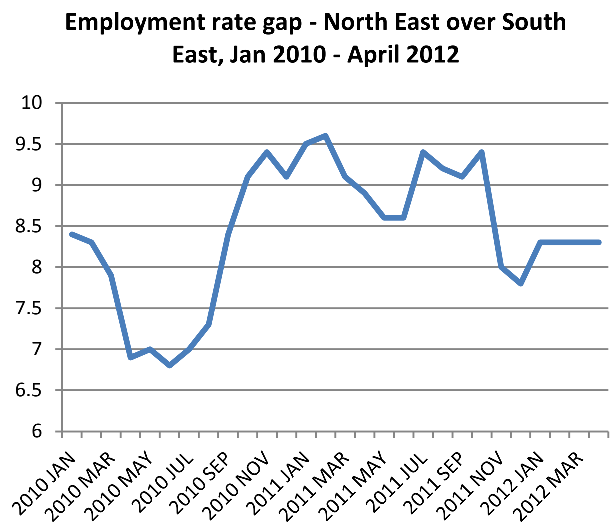
Weaker growth in the regions outside of the South has fed through into lower employment ratios and hence more pressure on public finances as a result of lower tax revenues and higher spending on social security benefits for those without work. Internal labour mobility in the UK was also depressed during the boom by more rapid rises in house prices in the South than in the North, making it harder for workers to relocate as a result of soaring Southern property costs.

To a large extent the rise of regional inequalities reflects the changing structure of the UK economy and the imbalance in sectors discussed in the previous sector. Whereas manufacturing was historically much more evenly spread throughout the UK, finance is far more concentrated in the South. The rise in finance and the decline in manufacturing over the past 30 years has therefore boosted growth in the South and reduced growth in the North. It is unlikely that the UK's regional imbalance can be corrected in absence of sectoral rebalancing.

Measure of Success
The best measure of success is the regional GVA per head data – if the UK is successfully regionally rebalancing then the wide differentials in performance should start to narrow. However as this data is not very timely (it comes out with a two year lag) a useful, although not perfect measure is regional labour market performances.

Outturn so far
Using labour market data as timely measure of success shows that there has been very little progress since the start of 2010.

The graph below shows the 'employment rate gap' between the North east of England and the South east since the beginning of 2010.



As can be seen the gap narrowed slightly in the early months of 2010 before widening in late 2010 and 2011. It has since narrowed slightly again is now back to roughly where it was in early 2010. In other words by this (albeit limited) measure there has been little progress.

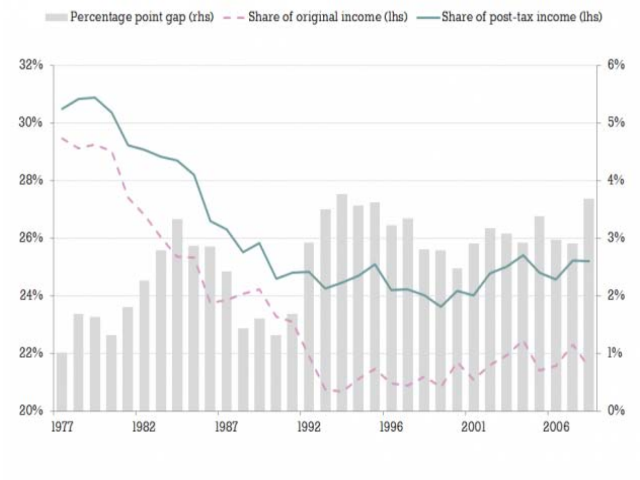
Wages

Background
The final measure of imbalance is that of wages and living standards. Whilst the unprecedented nature of the ongoing squeeze in living standards is firmly in the public debate this is not often linked to the question of rebalancing. However the two are intrinsically linked.

Two factors help explain the nature of the squeeze. First the share of the economy going into wages has fallen since the late 1970s and second the distribution of that share going to middle earners and those at the bottom has fallen whilst those at the top have taken an ever larger slice. This is a type of 'unbalance'.

The graph below, from the Resolution Foundation, shows the share of national income going to low-to-middle income households.[5]

Low to middle earners share of national Income, 1977-2009



As can be seen, even in post-tax terms, the share going to households in the middle fell from around 30% in 1977 to around 22% in 2008. This change is strongly related to the changing sector structure of the economy – the fall of the manufacturing share of the economy and the rise of finance has created far more high skill, very highly paid jobs (boosting the share of top-earners) whilst the UK has lost 'traditional' middle income jobs. But other factors are also at play. Earnings for those in lower and middle income jobs have risen more slowly than for those in higher occupational groups, partly as a result of the reduction in the scope of collective bargaining, and the UK's rules on corporate governance and pay setting at the very top have created a culture where excessive earnings for a significant minority of high earners has become the norm.

How much of a problem is this?
The economics profession is now waking up to the fact that rising inequality has serious economic, as well as social, implications. IMF economists Michael Kumhof and Romain Rancière have developed a model showing how growing inequality leads to rising debt and eventually a financial, followed by a real economy, crisis – something which happened in both 1920-1929 and 1980-2008.[6] As households find their incomes squeezed they resort to borrowing to maintain and grow their spending power. This pattern fits the UK data over the 2000s; median real wages stagnated from 2003 onwards whilst the ratio of household debt to income rose to the highest of any major economy. This left the UK very vulnerable to shocks resulting in a large recession in 2008/09 and an extremely weak recovery afterwards.

So without a rebalancing towards wages it is hard to see how any UK recovery can be sustained. Household consumption forms make a significant contribution towards overall GDP, and it can only be maintained in a sustainable way (without households becoming overly reliant upon debt) if income inequalities are reduced.

Measure of Success
The best measure of success would be for the share of national income going to middle to low earners as well as the overall wage share of the economy to begin to rising.

Outturn so far
So far there is little indication that this is happening. The OBR predicts that the share of national income going to labour will continue to fall until 2016. Average real wages fell in 2010 and 2011 and are expected to fall in 2012. Median real wages (a better measure given that the average is distorted by top earners) have performed even worse. So far there has been no progress in rebalancing towards wages.

Conclusion

Over the past two years the economy has stagnated and the government is set to miss its deficit reduction targets. It has also failed to achieve meaningful sort of rebalancing, whether measured by expenditure, sectors, regions or wages.

Growth alone is not enough; the UK economy needs the right kind of growth – higher investment, a better sectoral mix, a better regional balance and, above all, rising median wages. The TUC will continue to monitor progress with rebalancing against these four benchmarks. On the current consensus forecast the UK economy will be growing again by 2013, however all of the indicators are pointing to a return to an unbalanced economy rather than the sustainable growth we need for a stronger and more resilient economic future.

[1] TUC, Economic Report, February 2012 http://www.tuc.org.uk/economy/tuc-20717-f0.cfm

[2] The City UK, The Economic Contribution of Financial Services, 2010, January 2011

[3] Andrew Haldane, The Contribution of the Financial Sector, mirage or miracle?, July 2010 http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech442.pdf

[4] OBR, Fiscal Sustainability Report, July 2011 http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2011/

[5] Commission on Living Standards website, http://www.livingstandards.org/2011/10/the-share-of-pie-going-to-low-to-middle-income-households/

[6] Kumhof & Ranciere, Leverage, Inequality & the Crisis, 2010. http://www.imf.org/external/pubs/cat/longres.cfm?sk=24378.0