TUC

Economic Report

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Introduction

This is the first in a new series of TUC Economic Reports, which will provide ongoing analysis of the state of the UK's economy. In this first edition, we examine how the economy has changed since the Government set out its economic strategy in June 2010 (including developments in domestic demand, business investment and trade), consider the role that the ongoing crisis in the Eurozone has had for growth and outline our future prospects.
Our conclusions are that:

- Since the Government first set out its plans a £65bn growth gap has opened up.
- As a result cumulative borrowing is set to increase by £123bn.
- Over the next four years £83bn of spending cuts & £29bn of tax rises will only cut the deficit by £56bn
- The real problem over the past 18 months has been a collapse in domestic demand not the Eurozone's troubles.
- The Eurozone economy has grown faster than the UK over the past year and analysis by the OECD suggests that the UK slowdown preceded the Eurozone slowdown.
- With domestic demand depressed and the international picture getting darker the prospects for the UK economy look grim.

Key economic data

Annual growth in the UK economy has been weak, 1.5 percentage points below pre-recession trend. Inflation remains high and average earnings are rising significantly more slowly, leading to a persistent squeeze on living standards. While trade has performed better than expected, business investment is still well below its pre-recession level.

Indicator	Latest
GDP Growth (yoy)	0.5% (Q3 2011)
RPI Inflation	5.4% (Oct 2011)
CPI Inflation	5.0% (Oct 2011)
Average earnings Growth (Regular Pay)	1.7% (Oct 2011)
Claimant Count	1,598,400 (Sep 2011)
ILO Unemployment Rate	8.3% (Sep 2011)
Industrial production (yoy)	-0.7% (Sep 2011)
Manufacturing Production (yoy)	2.0% (Sep 2011)
Trade in Goods & Services Quarterly Balance	-£9.5bn (Q3 2011)
Business investment (yoy)	3.40% (Q2 2011)

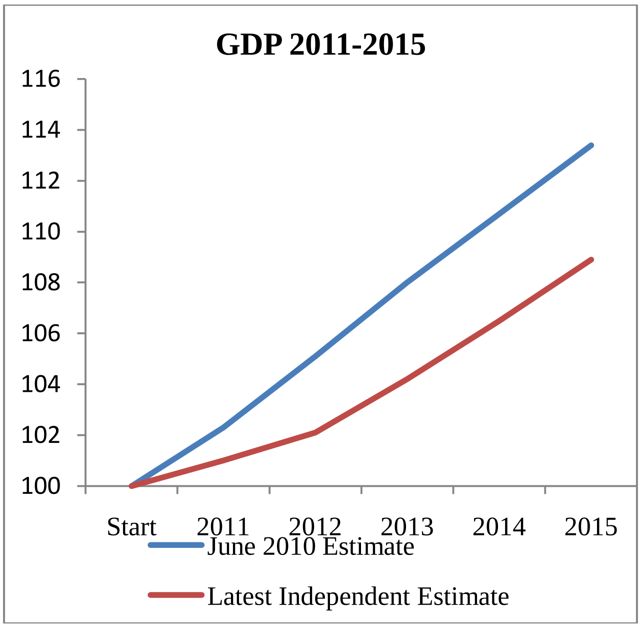
The Economy since June 2010

In June 2010 the Chancellor set out his fiscal plans at an 'emergency budget' – a fiscal consolidation of £128bn by 2015/16 comprised of £99bn of discretionary spending cuts and £29bn of tax rises. The aim was to eliminate the structural deficit and achieve a falling ratio of government debt to GDP by 2015/16[1]. These plans were based on growth projections from the newly created Office of Budget Responsibility (OBR) which assessed that they had a greater than 50% chance of success. 18 months later the growth outlook for the UK economy has changed significantly and yet the government is sticking to a plan based on growth forecasts which the vast majority of independent economists assess are unrealistic and unachievable. Whilst the OBR is expected to make further large downward revisions to its growth forecasts at the Autumn Statement the Chancellor is expected to stick to his plans.

The £65bn Growth Gap & the deficit

The OBR's forecasts of June 2010 showed growth of 2.3% in 2011, 2.8% in 2012, 2.9% in 2013, 2.7% in 2014 and 2.7% in 2015[2]. With growth in both 2011 and 2012 now expected by independent forecasters (and the Bank of England[3]) to be around 1%[4] these numbers are clearly far too optimistic.

Comparing the initial OBR forecasts, on which the government's fiscal plans are based, to the latest estimates of independent economists shows that by 2015 the economy will be around 4.5% smaller than the OBR thought 18 months ago. This is a 'growth gap' of around £65bn.



As the economy will be around £65bn smaller than the Chancellor expected by 2015 his deficit reduction targets will be much more difficult to achieve. This growth gap means lower than expected tax revenues and higher than expected welfare spending over the coming years. It means that it is increasingly unlikely that the Chancellor will be able to achieve his targets. The real risk is that by 2015 the UK will still has a large budget deficit but has also experienced weaker growth and higher unemployment than would have been the case if the Chancellor had adopted a longer-term and less severe deficit reduction plan.

This can clearly be seen by comparing the latest estimates of independent economists for the size of the deficit to the OBR's numbers.

The latest forecasts show that economists expect borrowing to be a cumulative £123.4bn higher than the OBR expected when the Chancellor set out his plans last Summer between 2011/12 and 2014/15[5].

1 Budget June 2010

2 OBR Economic & Fiscal Outlook, June Budget 2010.

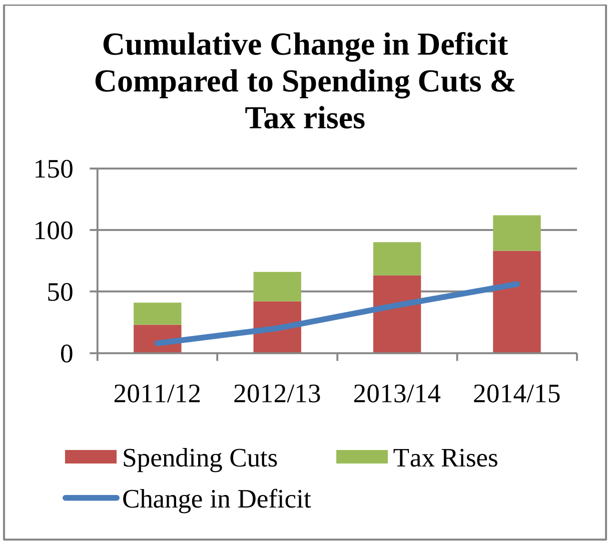
3 Inflation Report, November 2011

4 Forecasts for the UK Economy: a comparison of independent forecast, HM Treasury, November 2011

5 Forecasts for the UK Economy: a comparison of independent forecast, HM Treasury, November 2011

Public Sector net Borrowing (£bn)	2011/12	2012/13	2013/14	2014/15
Latest Independent Estimates	129.1	117.0	98.2	81.1
OBR March 2011 Forecast	122.0	101.0	70.0	45.0
OBR June 2011 Forecast	116.0	89.0	60.0	37.0

The self defeating nature of the government's plans is best illustrated by the chart below, which compares the most recent forecasts for deficit reduction from independent economists to the Chancellor's planned cuts in public spending and tax rises. Over the next four years £83bn of spending cuts and £29bn of tax rises, a cumulative fiscal tightening of £112bn[6] are only expected to cut the deficit by £56bn. This will mean that while the quality of our public services falls, the amount invested in education for young people is reduced and the social security system becomes even meaner, slower growth (leading reduced tax revenues and increased benefit claims) will lead to poorer living standards and the deficit will remain unpaid.

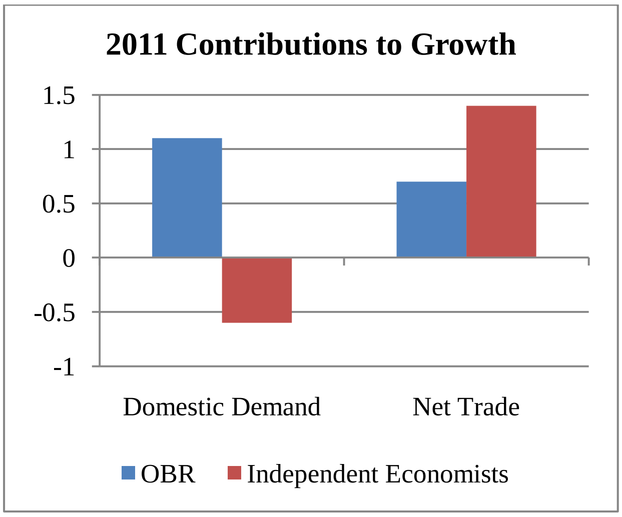


The Collapse in Domestic Demand is the Real Problem

Despite the Government's recent insistence that Britain's current economic woes can be blamed on the ongoing Eurozone crisis the real problems have been home grown. Of course developments in Europe have the potential to have a severe impact on the UK economy in the period ahead but over the past year the real problem has been a lack of domestic demand. Back in March 2011 the OBR expected the UK economy to grow by 1.7% in 2011 (9 months previously it had been expecting growth of 2.3%), independent economists now expect growth of only 1%[7] (an especially weak performance when one considers that the economy contracted because of 'temporary factors' at the end of 2010 and a bounce back from this added to grow in Q1 2011).
The composition of the expected 1% growth for 2011 is very different to that of the OBR's expected 1.7% growth, as is shown in the chart below.

6 Budget June 2010

7 Forecasts for the UK Economy: a comparison of independent forecast, HM Treasury, November 2011

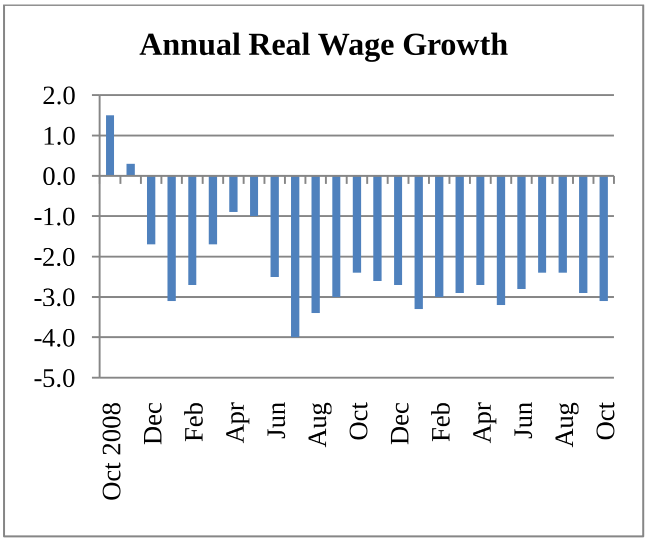


As can be seen the impact of net trade (exports minus imports) on growth for 2011 is actually expected to be significantly stronger than the OBR expected back in March, however this is more than offset by a sharp contraction in domestic demand. Given that trade is the economic indicator most likely to be significantly affected by developments in the Eurozone this is provides important evidence that our economic problems have originated at home not abroad.

The OBR had expected domestic demand to contribute 1.1% to 2011 growth (two thirds of the total), whilst independent forecasters now expect it to subtract 0.6% from GDP growth. As the Bank of England has noted this fall in domestic demand can be blamed on three factors:

"*Domestic demand over the past year has been hampered by falling real household incomes, tight credit conditions, and the effects of the ongoing fiscal consolidation".*[8]

One major driver of this has been falling real wages (the 'real' value of pay increases once inflation has been taken into account). Real wages have been falling throughout the recovery and, in recent months, the downwards trend appears to have accelerated.



The OBR forecast that real wages would fall throughout 2011[9] but expected that faced with falling real incomes households would borrow to increase their consumption. They expected the household savings rate (the amount of post tax income saved rather than spent) would fall to just 3.5%.

The OBR argued:

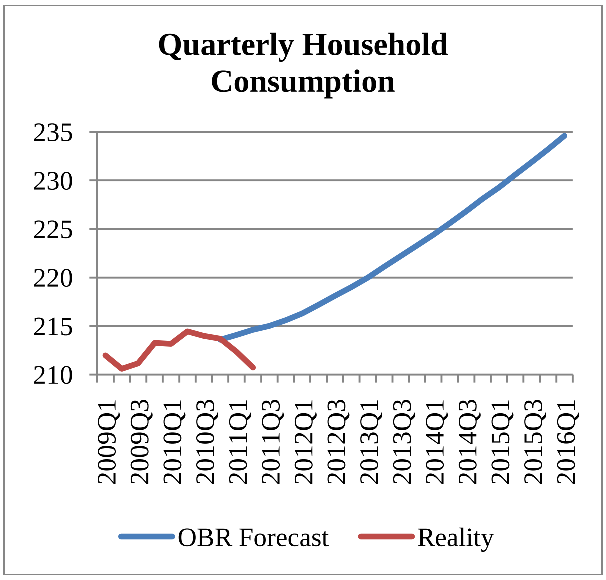
"large but temporary shocks to the economy (such as a fiscal consolidation) may be consistent with households reducing their saving for an extended period, until incomes recover"[10]

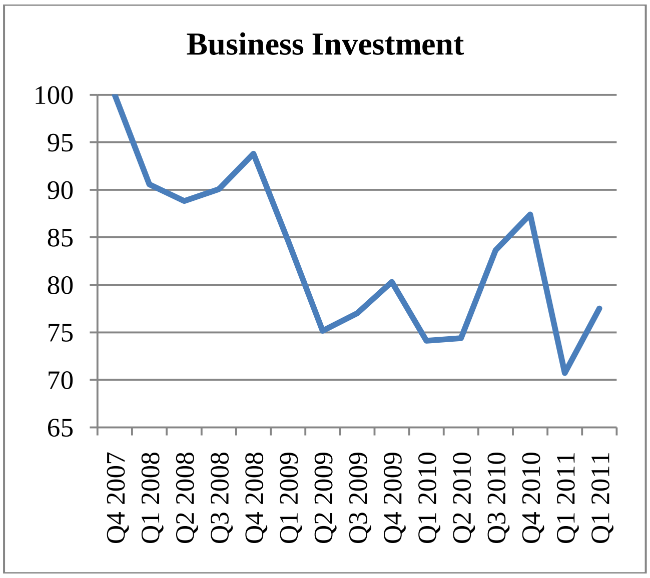
However this does not appear to have happened. Faced with falls in their income caused by higher inflation, less benefits and higher taxation households have not borrowed to maintain their spending.
Household consumption has fallen for four successive quarters and the OBR's forecasts have been badly missed, as the chart below shows.

8 Inflation Report, November 2011

9 They have actually been falling at a slightly greater rate than the OBR expected due to higher than expected inflation.

10 Briefing paper No. 3: Forecasting the Economy, OBR





Despite the Government's emphasis on 'export and investment led growth', consumption by households remains hugely important to the OBR's growth forecasts. Their forecast increase in consumption represents 58% of all growth to 2015[11]. As consumption is currently actually falling this is a very large problem for the Government's economic plans.

The dual impact of the squeeze on household incomes (partially caused by the VAT rise) and government spending cuts has been a large fall in domestic demand which has led to sluggish growth overall and more than offset the positive contribution of net trade. The impacts of the Eurozone crisis will soon start to impact on UK economic data: but to date growth has stagnated because of a sharp fall in domestic consumption.

Investment & Exports

Despite bounce back in the second quarter business investment remains depressed.

It remains over 20% below its pre-recession levels[12].

As of the second quarter it was growing at an annual rate 3.8% against an OBR forecast of full year growth 6.7% of 2011.

With domestic demand depressed and external challenges growing it seems unlikely that firms will decide to rapidly increase investment in the near future. At the current annual growth rate it will be late 2015 before business investment returns to 2007 levels. By contrast the current OBR forecast is for it to surpass these levels by mid 2013. This is another area where the OBR's March forecast now looks extremely optimistic.

Given that Britain's level of investment is already low compared to international peers this is doubly worrying – a lack of business investment not only depresses domestic demand in the short run, it also harms the long run productive potential of the economy and may lead to slower growth in the future.

By contrast (as noted above) the UK's net trade position has generally developed well in 2011. The most recent figures show that the trade gap

11 OBR Economic & Fiscal Outlook, March 2011

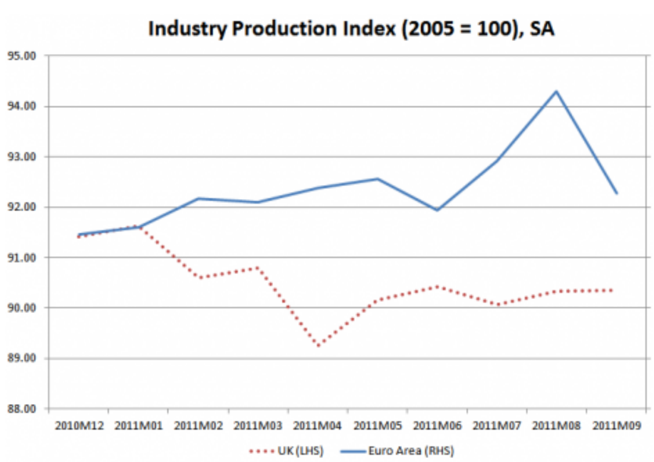
12 Business Investment, Q2 2011, ONS

has narrowed by 16% in Q3 2011 compared to Q3 2010. Exports in the most recent quarter are up by 9.4% whilst imports have risen by 7.4%. Strikingly exports to the Eurozone are up by 17.3% year on year[13].

Blaming the Eurozone for poor growth in 2011

The ongoing crisis is the Eurozone has the potential to cause severe economic headwinds for UK growth in 2012. Around 50% of UK exports go to the Eurozone and the most recent European Commission forecast is for Eurozone growth in 2012 to be just 0.5% in 2012, revised down from 1.6% just a few months ago[14]. A rapid slow down in European growth will surely impact UK exports and hence net trade – the one positive factor driving growth in 2011. However to blame the European crisis for the UK's weak economic growth in 2011 is to misdiagnose the problem. As noted above net trade has actually performed better than the OBR expected and the weakness is to be found in domestic demand.

The chart below clearly demonstrates that UK industrial production peaked well before Eurozone industrial production.



Moreover in the past year whilst the UK economy has grown by just 0.5%, the Eurozone has grown by 1.6%, more than three times as fast.[15] Given that the Eurozone economy has performed considerably better than the UK economy over the past year it seems disingenuous to blame problem in the Eurozone for Britain's slow growth.

The OECD's leading indicators[16]highlight that the slowdown in the UK economy began in mid 2010 whilst Eurozone economic activity peaked in early 2011. The UK's problems clearly predate serious problems in Europe.

Conclusions

Over the past year the effects of fiscal tightening and a squeeze on real wages and incomes have caused a collapse in UK domestic demand, only the strong contribution of net trade to growth has prevented a double dip recession.

The ongoing weakness in domestic demand coupled with a more difficult international environment has led independent economists to heavily downgrade their forecasts for growth in each year to 2015. As a result of this 'growth gap' the government's plan to close the deficit are looking unachievable.

The Government seems intent on pressing ahead with an economic plan based on projections which are now deeply out of date. The economic outlook has changed drastically over the past 18 months since the June 2010 Budget, the Chancellor should use the Autumn Statement to acknowledge this and change is plans accordingly. The economy now needs an immediate stimulus: increased austerity simply risks prolonging our economic pain while failing to deal with the deficit.

13 UK Foreign Trade, September 2011, ONS

14 European Economic Forecast, Autumn 2011, EC

15 GDP release, Q3 2011, Eurostat.

16 OECD leading Indicators, October 2011