Centre for Policy Studies

Pointmaker

THERE IS A COST OF LIVING CRISIS

…AND NO ROOM FOR COMPLACENCY

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SUMMARY

- Despite the recovery in the economy there is no room for complacency and the rehabilitation of Britain's economic performance remains a work in progress.
- Though Britain has returned to growth, the fundamental problem is that the economy remains incapable of delivering expansion without adding to a debt mountain.
- This is reflected in a rapid deterioration in the current account, where the deficit is already at a dangerous and unsustainable level. The balance between income and outgoings from interest and dividends has lurched alarmingly into the red, and is not sustainable.
- Government needs to address the imbalance in the current account if capital flight, currency weakness and upwards pressure on interest rates are to be averted.
- Although the reduction in unemployment and the attainment of record numbers in work are welcome, wage growth remains depressed.
- Because wages have lagged both CPI inflation and the cost of household essentials, there is a "cost of living crisis", though this problem long predates the Coalition administration.
- The objective of any future Government should be a transition to a higher-skilled, higher-paid, and higher productivity economy – in which consumer spending is driven by incomes, not by borrowing.
- Government policy should focus on freeing small businesses from tax and regulation.
- To this end, Government needs to toughen competition policy, and reduce a regulatory burden which imposes proportionately greater handicaps on small businesses than on large corporates.
- At the same time, the burden of business rates needs to be reduced as a matter of urgency, with smaller businesses exempted altogether from this counter-entrepreneurial tax.

1. INTRODUCTION

The British economy is still fragile. Despite the restoration of economic growth, and the reduction in unemployment to pre-crisis levels, any temptation to complacency would be gravely mistaken, and could prove extremely costly.

In short, the Coalition has made welcome but limited progress in tackling a disastrous economic legacy. Economic policies in the years before the 2008 recession crippled the economy's capacity to generate sustained growth and even now, six years later, GDP has only just surpassed its pre-recession peak. The Coalition has reduced the deficit, but public borrowing remains far too high whilst debt continues to increase. Expansion in public expenditure has been stemmed, but reductions in overall spending have been limited. Most seriously of all, the economy remains imbalanced, and incapable of generating growth by means other than borrowing, whilst the rapid deterioration in the current account poses real forward dangers.

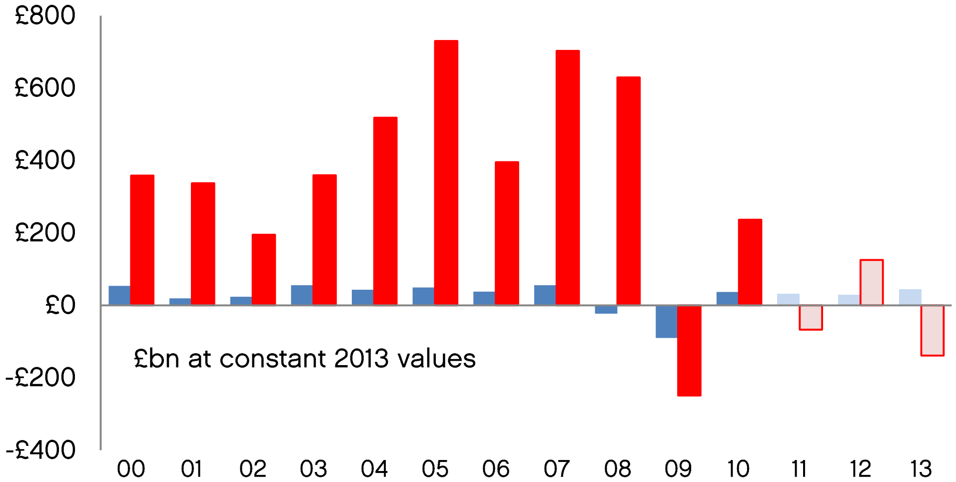
Unemployment has fallen and the number of people in work is at record levels, but wages continue to lag far behind headline inflation, let alone the cost of consumer essentials. In this sense, Labour's accusation of a "cost of living crisis" has demonstrable validity, and could yet be a pivotal economic issue at the election.

All political parties need to acknowledge and discuss how there has been a deterioration in median living standards. It should be understood that the restoration of the economy remains a work in progress, and new strategies are required to improve living standards whilst creating non-borrowed growth. Above all, it should be made clear that the objective of future governments should be a high-wage, entrepreneurial economy, not a low-wage, corporatist system.

2. ECONOMIC MISMANAGEMENT

The poor state of today's economy is in large part due to an extreme imbalance between borrowing and GDP growth in the recent past. In 2002, for example, and expressed at constant 2013 values, the economy grew by £24bn but debt increased by £122bn. In 2003, growth of £56bn came at a cost of £148bn in

Figure 1: GDP growth and net borrowing, 2000 – 2013



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Increase in GDP	£54	£20	£24	£56	£43	£50	£38	£56	-£23	-£90	£37	£32	£30	£45
Increase in debt	£359	£337	£195	£359	£518	£730	£395	£702	£629	-£24	£237	-£67	£125	-£13

*Chart shows annual changes in GDP, and in combined government and private debt, expressed in constant 2013 £bn additional borrowing. In 2004, £43bn of growth was accompanied by borrowing of £168bn.

The overall picture is stark. Between the end of 2000 and the end of 2008, the real value of GDP increased by £263bn, from £1.31 trillion to £1.58 trillion. Over the same period, aggregate debt grew by £3.9 trillion, meaning that £14.68 of new debt had been added for each £1 of growth. Figure 1 shows how, in every single year after 2000, additional borrowing far exceeded annual growth in the economy, whilst Figure 2 shows how dramatically the total of government, household, business and banking debt out-grew much more pedestrian expansion in the economy.

The adverse consequence of such excessive borrowing was that Britain became by far the most indebted of the world's major economies. When the Coalition took office in 2010, Britain's total debt exceeded 500% of GDP, and indebtedness remains close to this level.

Under the previous Labour Government, there were two drivers of the economy. One of these was borrowing, notably by consumers, and the other was the escalation in public spending. Between 2000 and 2008, and expressed in real terms, non-public debt doubled, from £3.6 trillion to £7.2 trillion. Meanwhile, and again at constant values, public expenditures increased by 53% between 2000-01 and 2009-10.

These trends introduced massive distortion into the economy. Borrowing by consumers, most of which was channelled through property lending, saw the aggregate output of the construction, real estate and finance industries expand by 46% between 2000 and 2008. Over the same period, the output of state-dominated health, education and public administration sectors grew by 31%. Retailing too prospered on the back of debt-fuelled consumer spending, whilst manufacturing output decreased by 19%.

Reflecting this, the economy's dependency on borrowed private and public spending skewed the economy to the point where construction, real estate and finance accounted for 39% of output, health, education and public administration contributed 18% and the inclusion of retailing and distribution lifted the total to 68%. Less than one-third of the economy, then, remained capable of growth

Figure 2: GDP and debt, 2000 – 2013

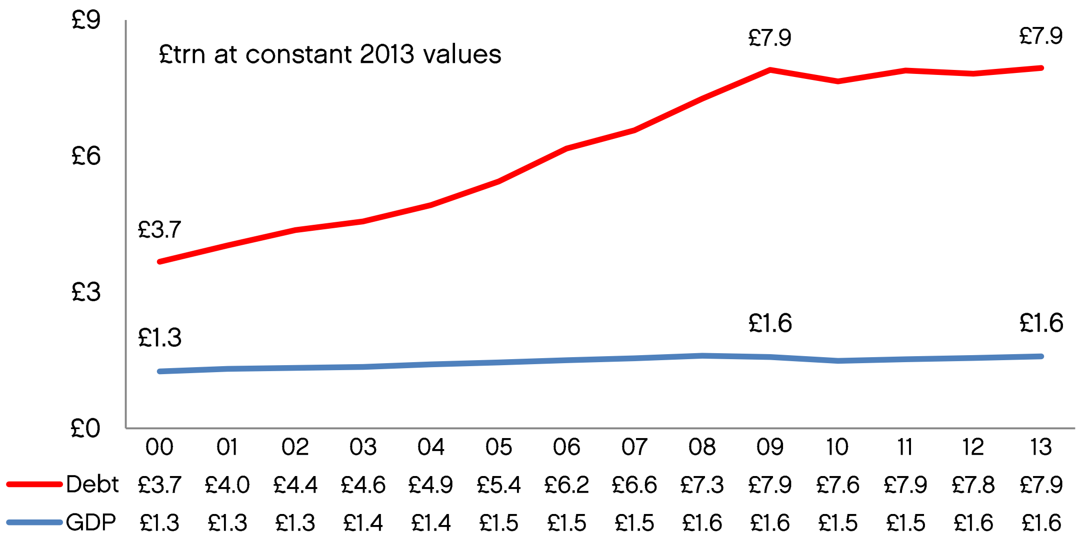


*Chart shows GDP, and combined government and private debt, expressed in constant 2013 £bn once further borrowing and further expansion in public spending ceased to be viable options.

3. RECOVERY – SLOW AND PATCHY

The Coalition has dragged Britain away from some of the worst excesses of the past. Years of unaffordable real growth in state spending have given way to austerity, though the continued escalation in the cost of servicing existing debt has blunted the drive towards lowering total expenditures. Despite the austerity agenda, public debt has continued to increase, and the annual deficit remains at close to £100bn.

Meanwhile, little has been done to sever the link between economic activity and private borrowing. Programmes such as Funding for Lending and Help to Buy have contributed to a resumption in mortgage borrowing, and Britain's standing as the fastest-growing of the G7 economies needs to be seen in a context in which additions to debt continue to exceed incremental growth by a substantial margin. Between 2010 and 2013, when the economy grew by £107bn at constant values, the government alone borrowed £232bn. This year, nominal GDP may grow by £80bn, but this is likely to be far exceeded by increases in private and public borrowing. In short, the Coalition has yet to sever the link between borrowing and growth, and urgent consideration must be given to policies which can restore debt-free expansion to the economy.

At the same time, there has been comparatively little rebalancing of the economy. Progress in manufacturing has been tepid, despite the signal contribution delivered by foreign-owned motor manufacturers. With house prices rising, it is likely that the real estate and finance sectors' share of economic output is increasing again.

Borrowing money to inflate house prices, and then channelling the increase in notional equity into consumption, is not a viable formula for economic prosperity.

4. THE COMING RISK

High levels of debt – which total about 480% of GDP – pose a threat to the economy, because any material rise in interest rates could have serious consequences. Though a minority on the Bank of England's Monetary Policy

Figure 3: Structural distortion, 2000 – 2008

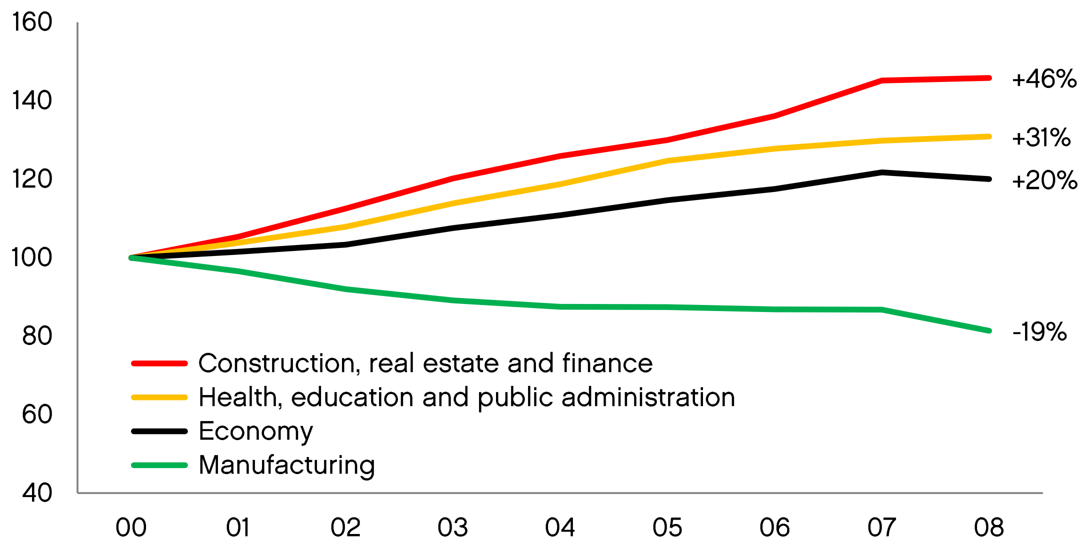


*Chart shows GVA contributions at constant value, indexed to 2000 = 100

Committee (MPC) now advocates modest increases in the base rate from its historic low of 0.5%, no one seriously suggests that rates should rise to a point at which savers earn real returns above inflation, which is in the range of 1.5% to 2.0%. In short, Britain needs to remain in an environment of negative real interest rates. This is bad for capital formation and it also makes it imperative that control of interest rates should remain firmly in the hands of the Bank of England.

It is this consideration which makes the alarming deterioration in the current account deficit particularly dangerous. In 2011, the deficit on the current account was £22.5bn. But this widened to £59.7bn in 2012 and £72.8bn in 2013. The latter was equivalent to 4.5% of GDP, and recent figures suggest that the deficit is now running at about 5.5%.

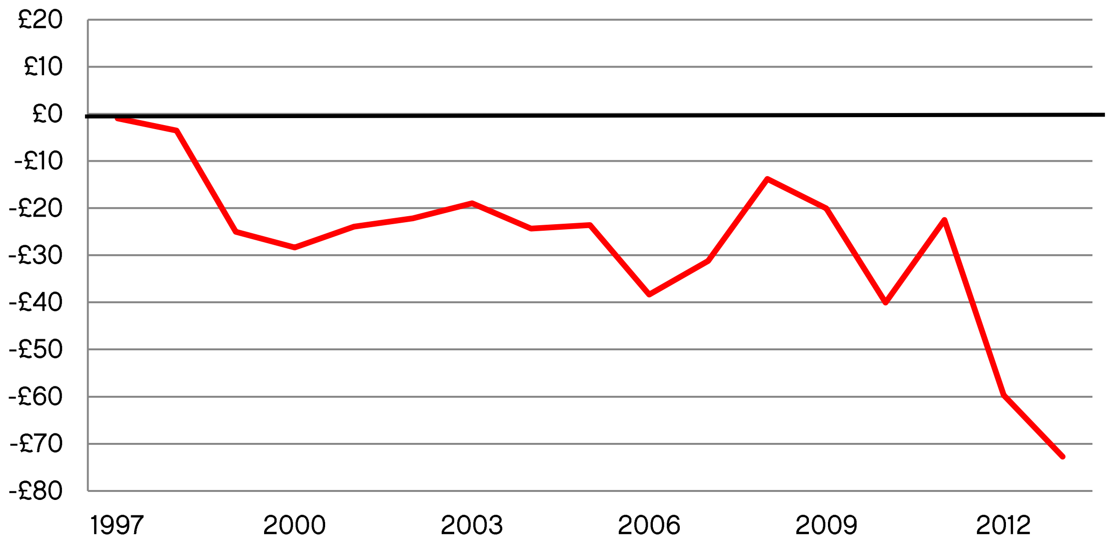
The current account is a broader (and a more important) measure than the balance of trade in goods and services. Last year the trade deficit was £28.5bn, which remains well below the level in 2007, when a debt-fuelled economy's appetite for imported goods created a trade shortfall of £36.7bn.

Disturbingly, however, there has been a sharp reversal in the non-trade component of the current account. This consists primarily of flows of interest and dividends. In 2011, Britain enjoyed a small (£0.8bn) surplus on these financial flows, but this has since lurched into deficits of £26.7bn in 2012 and £54.9bn in 2013. Essentially, Britain is now paying out more interest than it receives, whilst profits remitted from foreign-owned companies in Britain now exceed profits remitted back by British-owned companies overseas.

The sustainability of a severe current account deficit is limited by a country's Net International Investment Position (NIIP), which in Britain's case currently stands at zero. Optimists (including, apparently, HM Treasury) believe that marking investments to market would improve Britain's NIIP to as much as 30% of GDP, but, even if valid, this would limit to less than five years the country's ability to sustain current account deficits of greater than 5% of GDP.

The items which balance out current account deficits are positive capital flows in the form of asset sales and borrowing from overseas – but

Figure 4: The UK current account, 1997 – 2013



*Source: Office for National Statistics. Figures in £bn past asset sales, and the scale of existing borrowings, impose clear limits on these expedients.

In short, the impending (but seemingly little-noticed) danger is that global markets take fright at Britain's current account imbalance. Such an event could create capital flight and could drive sterling downwards whilst creating severe upwards pressure on interest rates. In the worst analysis, sovereign borrowing rates could be driven upwards by a flight from gilts whilst downwards pressure on sterling might force the Bank of England to increase rates. The slump in the current account is illustrated in Figure 4, and the anatomy of this slump is shown in Figure 5.

5. THE COST OF LIVING CRISIS

The above should illustrate that, behind solid headline growth numbers, the restoration of the British economy remains a work in progress. The same applies to the related issues of employment and real incomes.

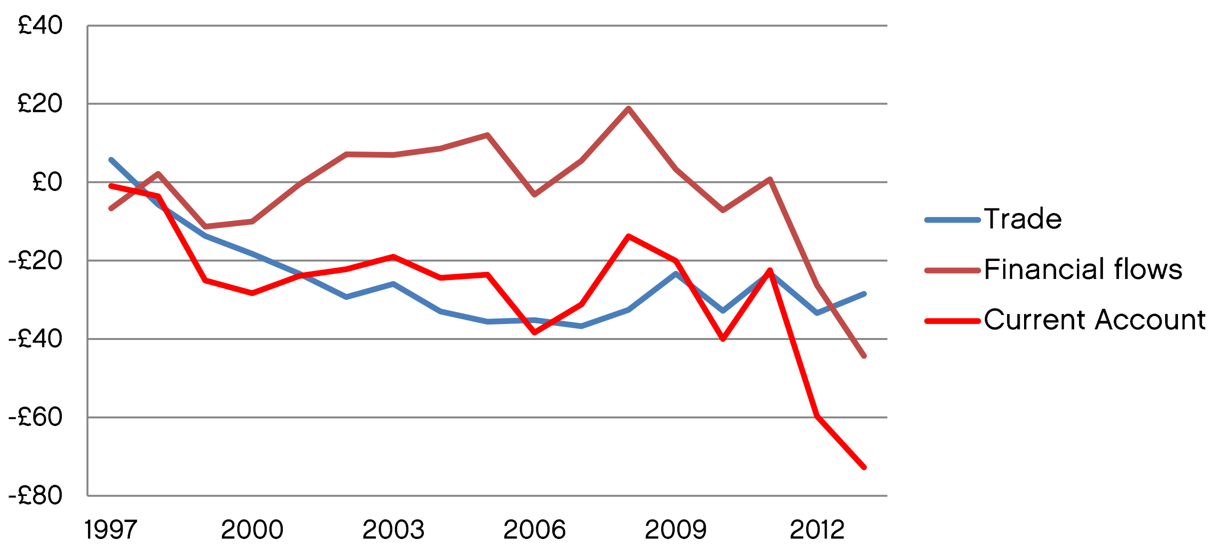
The Coalition has rightly taken credit for the decline in unemployment to pre-crisis levels and the achievement of record numbers of people employed. Unfortunately, this has not been reflected in earnings, which continue to lag increases not just in inflation but also, and perhaps more tellingly, in the cost of household essentials.

Between 2010 and 2013, average wages increased by 4.8%, significantly less than the 9.4% rise in official inflation as measured by the Consumer Price Index (CPI). Over the same period, the cost of household essentials, as measured by the TM UK Essentials Index[1] rose by 12.8%. On this basis, then, the average worker has become worse off by 4% relative to CPI, and by 7% relative to the cost of essentials. These figures are based on annual averages, but latest data for annual wage growth (0.6%) and consumer inflation (1.5%) confirm that these trends are continuing.

There is, then, a "cost of living crisis", and it would be counter-productive for the Government to deny that this is the case.

[1] The TM UK Essentials index includes: food; alcohol & tobacco; council tax & rates; water & other charges; dwelling insurance; fuel & light; petrol & oil; vehicle tax & insurance; fares & other travel costs. For further information see Appendix.

Figure 5: Components of the UK current account, 1997 – 2013



*Source: Office for National Statistics. Figures in £bn

On the other hand, it would be disingenuous to blame this "cost of living crisis" on the Coalition, since the decline in real living standards clearly began earlier. Between 2007 and 2010, for example, average wages (+5.8%) grew by less than CPI inflation (+10%), let alone the cost of household essentials (+19.6%). The "cost of living crisis" was inherited by the Coalition, not created by it.

The relationships between wages and the cost of living are set out in Figures 6 and 7. Figure 6 shows how wages outperformed CPI, but fell ever further adrift of the cost of essentials, throughout the period from 2000 – 2013, whilst Figure 7 emphasises the underperformance of wages on all measures since 2007. Obviously, wages did outperform costs during the earlier (2000 – 2007) part of the period, but any apparent benefits were more than wiped out by the rapid escalation in household indebtedness during the same period.

These figures are expressed in terms of real wages in Figures 8 and 9. Again, wages deteriorated in relation not just to CPI but (and even more strikingly) to the cost of essentials after 2007, before which year gradual improvements in real wages were accompanied by escalating household indebtedness.

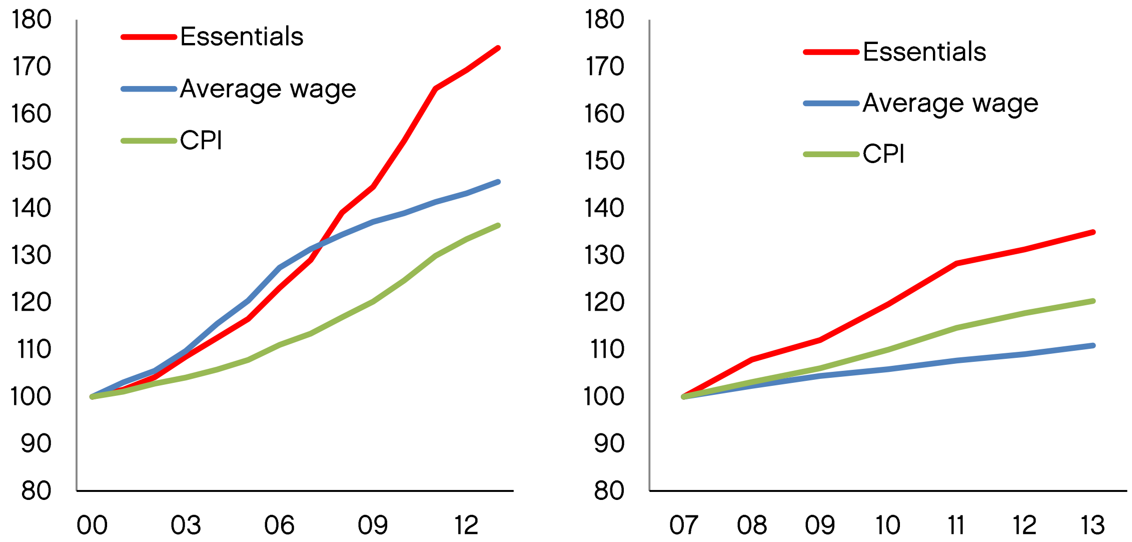
6. CONCLUSIONS AND RECOMMENDATIONS

Since Britain is now the fastest-growing G7 economy, and since both unemployment and interest rates are at low levels, it would be understandable if politicians were to take a complacent view of the economy. This would be a grave mistake.

Given the track record of the British economy between 2000 and 2007, when "growth" was purchased using an escalation of debt whilst public spending soared to unaffordable levels – it is clear that the reckless economic policies of the period must not be repeated. If any party is to assume power they must find an answer to the "cost of living crisis". No answer will be found in denial of the deterioration in real wages, since it is abundantly clear that such deterioration has indeed occurred.

From a policy perspective, the Government needs to accept that it has not thus far severed the link between growth and borrowing, and that some new growth dynamic

Figures 6 & 7: Wages and costs, 2000 – 2013



*Source: Office for National Statistics and TM UK Essentials Index needs to be found for an economy which all too often has relied on the injection of debt into consumer spending via the conduit of an inflated property market.

Nearer term, the Government needs, as a matter of urgency, to address the dangerous deterioration in the current account, since this deterioration poses the clearest and most pressing danger to the economy.

These objectives might in part be met by changing the balance of economic power between large corporations on the one hand and small businesses on the other.

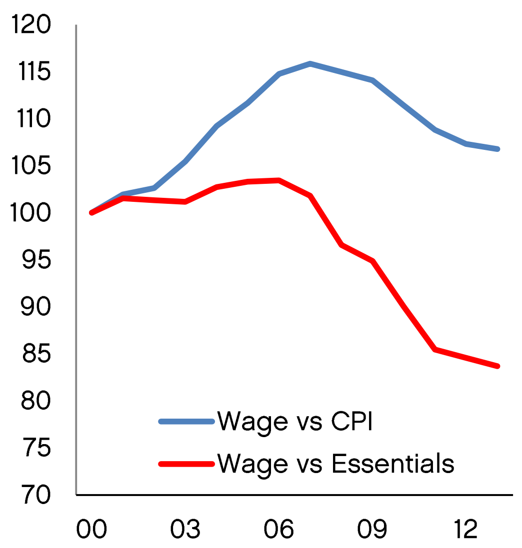
The regulatory burden, which has a proportionately far worse effect on small businesses than on large corporates needs to be reduced as a matter of urgency.

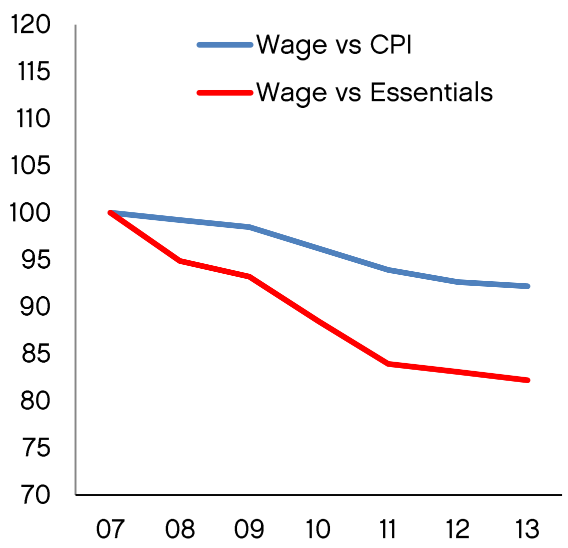
At the same time Government should seek to impose a minimum tax floor on large corporates, pursue a much more aggressive stance on the promotion of competition and productivity and set as its primary fiscal objective the reduction of business rates. The priority with business rates should be exemption for small businesses, since business rates, as a tax unrelated to profitability, does more than any other tax or regulation to stifle entrepreneurship.

Where the cost of living is concerned, it is wrong to assume that low wage rates are good for the economy. Low wages may, in purely microeconomic terms, appear to boost business profitability, but the macroeconomic effect is to depress demand. When Henry Ford famously paid his workers far more than was necessary in strictly market terms, he was advocating a high-wage economy in which workers were able to afford to purchase his products.

The objective for Britain should be a high-skilled, high-paid, and high productivity, workforce within a higher wage economy in which consumer spending is driven by incomes and not, as hitherto, by borrowing. At the same time, redressing the balance between large corporates and small businesses should be a priority.

Figures 8 & 9: Real wages, 2000 – 2013





*Source: Office for National Statistics and TM UK Essentials Index

APPENDIX

THE TM UK ESSENTIALS INDEX

The TM UK Essentials Index was developed by Tim Morgan in his role as head of research at Tullett Prebon.

The aim of the Index is to measure changes in the cost of household essentials. Trends in the cost of these essentials are very important, not least in identifying the scope which exists for discretionary spending by individuals and households. The Essentials Index, when set against trends in average wages, provides a useful alternative benchmark for real incomes, and can also put mortgage and rent affordability into context.

It is thus a useful resource for analysts, policymakers and journalists.

The index measures weighted changes in the cost of the following:

- food;
- alcohol and tobacco;
- council tax and rates;
- water and other charges;
- dwelling insurance;
- fuel and light;
- petrol and oil;
- vehicle tax and insurance;
- fares and other travel costs.

Housing costs are excluded because households tend to fall either into the rented or the mortgage-paying sector, but not both, though subsidiary indices reflecting these two categories may be developed in the future.

The TM UK Essentials Index has revealed that the cost of household essentials has increased far more rapidly than broad inflation as reported in the official CPI (Consumer Price Index) and RPI (Retail Price Index) measures, and has also grown more rapidly than average wages.

Between 2002 and 2013, the cost of essentials increased by 69%, a far greater increase than either CPI (+32%) or average wages (+36%). Between 2007 and 2013, the increase in the Essentials Index (of 39%) was, again, far greater than the 20% rise in the CPI or the 10% increase in average wages.

For more information, please email Tim Morgan at tim@vvmodel.com.

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Tim Morgan was global head of research at Tullett Prebon plc from 2009 – 2013, and is author of *Life After Growth* (Harriman House, 2013), and numerous influential papers published by the Centre for Policy Studies including *A Shower, not a Hurricane: the Modest Nature of the Proposed Cuts* (2010) and *Five Fiscal Fallacies* (2011) and *The Quest for Ideology How to fill the centre-right ideology gap* (2012) and *Oil, Finance and Pensions: Why Scots Should Say No* (2014).

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