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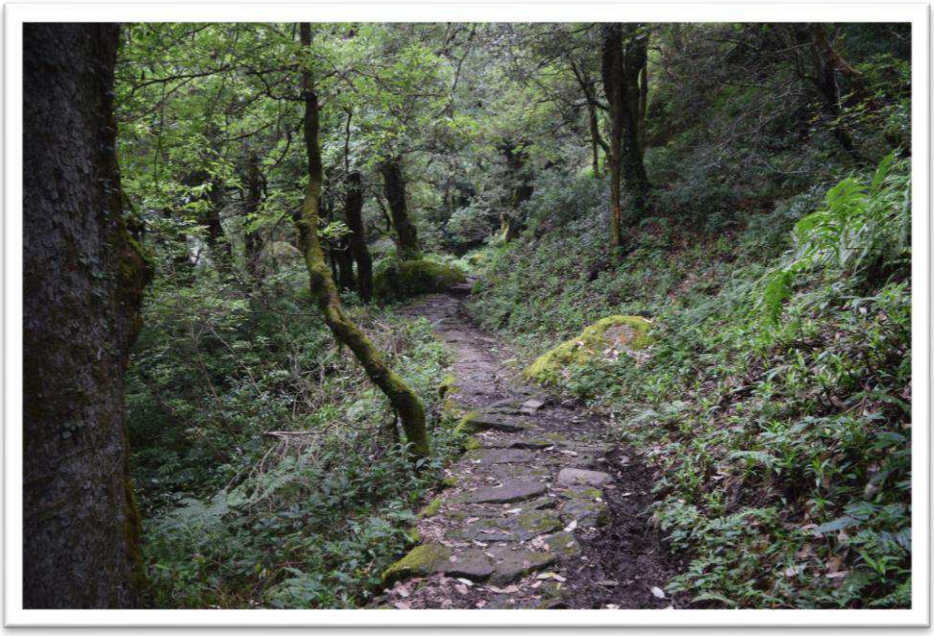
# Economic Bulletin

# NOT OUT OF THE WOODS YET



- UK economic growth and labour market performance remain strong.
- Rising household debt and poor productivity performance remain weaknesses.
- Slower global growth in China and Europe will constrain UK growth potential.
- Seven steps the Government should take at the Spending Review.

## 1. INTRODUCTION

Turmoil in financial markets across the world has shone a spotlight on the vulnerability of the UK to external shocks. In recent years, the UK economy has performed strongly in comparison to other developed economies; net employment has increased by more than every other Eurozone country put together. However, despite this labour market success and sustained economic growth, external factors ranging from the slowdown in China to persistent Eurozone weakness endanger what is, so far, a fairly resilient domestic situation.

Alongside this, the UK faces two key challenges; eliminating the still large budget deficit and raising underlying productivity growth. The Chancellor should use the Spending Review on the

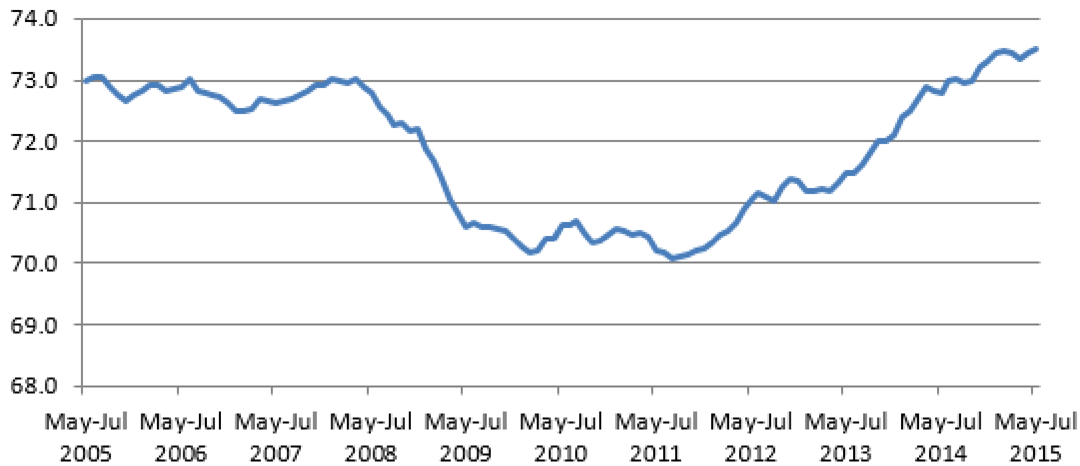
25th November not only to outline departmental spending cuts but also a series of measures which will contribute to improving the UK's poor productivity performance.

## 2. UK ECONOMY

The UK domestic economy appears to be continuing on a positive trajectory in contrast to more troubling trends in the global economy. Economic growth in Q2 this year was 0.7% and the latest OECD forecast confirms that the UK can expect 2.4% growth this year and 2.3% in 2016; which would be a relatively strong performance. Inflation, which is currently at zero, remains low and stable as a result of falling commodity and energy price pressures. Whilst there is still the possibility of a lapse into a malign deflationary spiral, this is still highly unlikely given that core inflation is positive and measures of demand are still robust.

GfK's UK consumer confidence index is surging and small businesses are reporting rising optimism with firms expecting to see strong growth in their turnover over the next year. Retail sales in August were sluggish but this appears to be partly because of a higher number of families taking holidays abroad. The latest ONS labour market figures also show continued improvements on that front with another record employment rate at 73.5% and 413,000 more people in work than last year. Total pay grew by 2.9% over the year and by 3.4% in the private sector with retailers, services and construction seeing the largest growth in pay.

**Chart 1: UK employment rate since 2005**

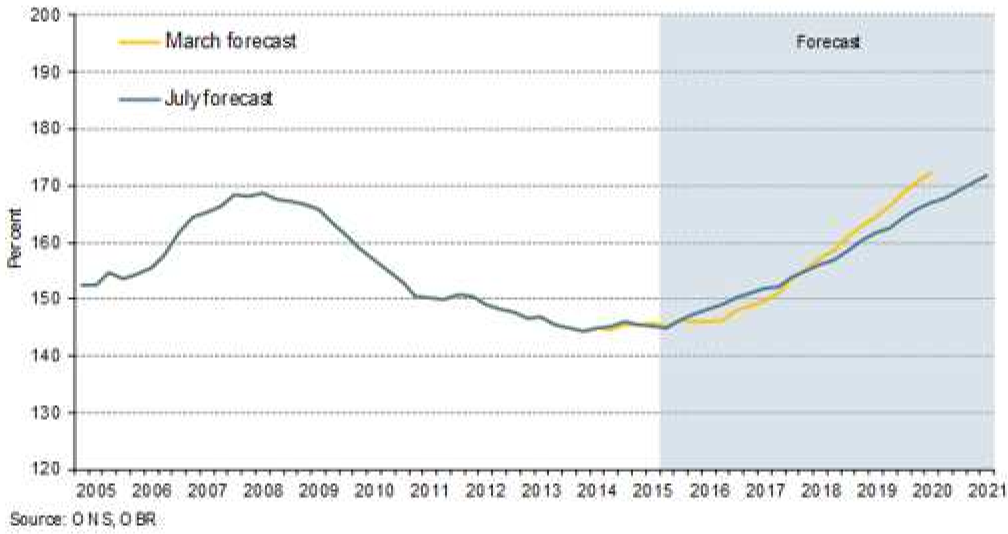



There are of course still some weaknesses across the UK economy. Whilst, households have undergone significant deleveraging since the onset of the financial crisis, the OBR now expects household debt to grow significantly in the coming years; from 146% of income currently to 170% by 2020 which would be even higher than the pre-crisis peak. This greater vulnerability of households to interest rate rises also raises concerns over the strength of medium term consumption growth.

Such concerns will be exacerbated if productivity fails to grow sufficiently and places downward pressure on real wages. The most recent data shows a 20 percentage point gap between UK output per hour and the average of the other G7 economies; the widest gap since 1991. The current account position is still precarious with the trade deficit in goods and services growing again in July to reach £3.4 billion. Goods exports fell to £22.8 billion in July which was the lowest export figure since September 2010.

Moreover, with interest rates having been stuck at 0.5% since March 2009 and further Quantitative Easing likely to have little positive effect, there is virtually no scope for looser monetary policy. At the same time, the budget deficit is still at an elevated 3.7% of GDP and further spending cuts are still necessary and feasible in order to reach a balanced budget by 2018/19. As a result, counter-cyclical policy will be severely constrained if consumption and investment weaken in the coming years. This makes the case for bolder, supply-side policies more urgent to help raise productivity and UK growth potential.

**Chart 2: Household gross debt to income**

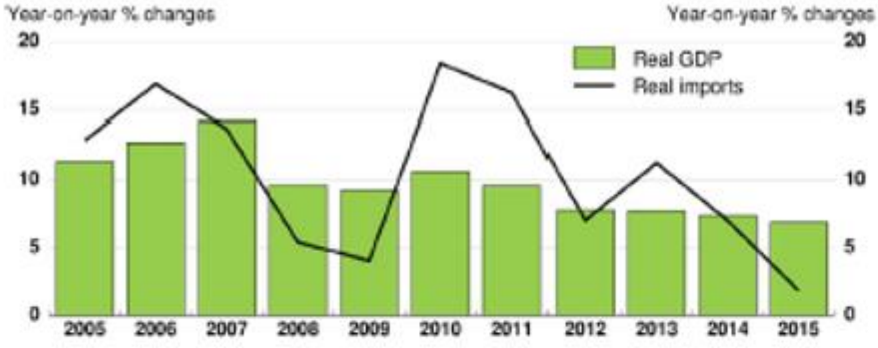



## 3. GLOBAL ECONOMY

Economic growth globally in 2015 is likely to disappoint largely as a result of the slowdown in China. Official Purchasing Managers' Index (PMI) data on factory activity shows that the country is on the verge of a contraction in manufacturing and other PMI data focussing on SMEs had a reading of 47.1; suggesting a sharp fall in output. China is currently seeing falling exports, weakening fixed investment and collapsing factory gate prices. OECD data shows that weakening annual GDP growth has come alongside a much sharper fall in import growth.

The inevitable result will be a reduction in Chinese demand for British produced goods and services. China is the UK's sixth biggest export market which reflects approximately 5% of export volumes. Whilst this in itself may not be a significant component of aggregate demand, heightened financial market volatility as a result of a potential hard landing in China may damage investment intentions and lead to falling growth in other export markets. A positive side-effect of the current Chinese malaise is that demand side pressures on commodities have eased which will keep prices lower for longer.

**Chart 3: Chinese GDP and import volumes**




Also of concern is that in the first half of 2015, world trade underwent its largest fall since 2009. Even with the benefits of lower oil prices, lower longer term interest rates and a depreciated Euro, the economies of the Eurozone will still struggle to see particularly strong growth this year. The OECD is expecting Japanese growth to reach only 0.6% this year and 1.2% next year, whilst Brazil is currently facing a recession with output falling by 2.8% and 0.7 this year and next. US economic and employment growth remains strong but it seems that global demand weakness will lead the Federal Reserve to delay its expected tightening of monetary policy. Altogether, it is clear that the UK cannot rely on strong external demand to sustain our own economic recovery.

## 4. PROPOSALS

The Budget and the Productivity Plan announced over the summer contained some measures which should help to remove barriers to private sector productivity growth. Planned reductions in corporation tax and national insurance alongside easing planning restrictions on brownfield sites, reforming fracking planning applications and a focus on apprenticeships are to be welcomed. However, there is still much more that can be done. Below are a collection of proposals which could help to deliver stronger productivity growth.

### 4.1 Roll out property owner Business Improvement Districts across the UK

Business Improvement Districts (BIDs) are business-led and business-funded bodies set up to improve commercial areas at little or no cost to taxpayers. The success of London's 41 BIDs during the downturn shows that they can be effective in encouraging business expansion. Firms operating in BID areas saw turnover grow by 4% between 2005 and 2012 compared to negligible growth in other areas. Employment also performed more favourably in BID areas. However, BIDs outside London cannot receive funding from property owners unlike in London which reduces the potential for long term improvements to local areas. Property Owner BIDs should therefore be rolled out across the rest of the UK. This can be done with secondary legislation and will contribute to localism and regeneration.

#### 4.2 Extend Right to Buy to commercial tenants

The investment estate of councils, which in 2012/13 was worth £9.5 billion, contains properties which are rented out competitively, including to small businesses. Allowing tenants to buy public sector owned non-residential properties at a discount would drive business expansion and drive public sector efficiencies. Businesses would have much greater freedom to customise their properties for their own needs and would be able, more easily, to borrow against the property to fund further investment. Local authorities would see a significant increase in receipts from sales and a reduction in their maintenance costs.

#### 4.3 Simplify and consolidate planning laws

Annual house building starts in England reached 140,500 over the last year whilst completions reached 125,110; growth of 5% and 11% respectively. Nevertheless, to meet rising demand, the supply of new houses needs to grow by more than 250,000 every year. The planning system needs to be lighter and more streamlined to encourage more building and the Government can do this by introducing "Pink Zones" which cut the existing red tape. These Pink Zones would increase development and new construction by bringing together councils, residents and developers to achieve consensus. The key delivery mechanism would be a Special Purpose Vehicle through which various planning regulations could be bypassed and design standards could be improved.

#### 4.4 Reform the North Sea fiscal regime

Oil and gas supplies more than 70% of the UK's total primary energy and Britain's industry remains an important contributor to GDP and employment. However, domestic production and revenues have collapsed alongside a rising cost base, a sharp decline in prices and a burdensome fiscal regime. Whilst the North Sea fields appear to be in long term decline, the death of the sector is not inevitable. The Government should reduce the tax burden on the sector to help reinvigorate production and investment. It can do this by abolishing the Supplementary Charge on profits from domestic oil and gas production at little dynamic cost. Alongside this needs to be more effective information sharing in areas such as well reviews and the planning of decommissioning projects.

#### 4.5 Expand water industry competition

The water market has been operating as a series of regional monopolies almost entirely devoid of any competition. The success of water sector competition in Scotland shows that opening the market can help to deliver higher service quality and reduced costs for customers. It is welcome that retail sector competition is due to begin in the UK in April 2017 for non-households including public sector bodies, business and charities. However, the Government should seek rapidly to expand this consumer choice and competition to households as well. The Government should also ensure that retail market exit is permitted as removing barriers to entry and exit is necessary for a properly functioning market. The Government should also quickly implement reforms to the abstraction licensing system to allow the development of water trading.

#### 4.6 Improve public education information

Greater emphasis on apprenticeships is to be welcomed but measuring performance and quality remains a problem. The Government should introduce more formal ways to measure the performance of an apprentice and introduce a standardised grading system equivalent to a university degree classification. Giving more and better information on the relative performance of different aspects of an apprenticeship will help to raise standards. In addition, schools should publish information on the employment rates and average earnings of their alumni in school league tables. This would increase parental choice and give schools a stronger incentive to ensure that their pupils are equipped with the skills necessary to succeed in employment

### 4.7 Reform visa applications

Simplifying visa requirements for business travel will cut the cost of business and help to increase trade. The Government should extend the Super Priority Visa Service, which processes visa applications in one day, to new countries beyond India and China. The Government should also extend the Gulf visa free scheme to other Gulf and Middle Eastern countries as it reduces the administration times and the financial costs of travelling and investing in the UK. Introducing a free visa waiver scheme for Chinese investors and entrepreneurs would make business travel to the UK much easier. It would also mean that Chinese businesses would not have to travel to Beijing, Shanghai or Guangzhou to have their applications processed as they do currently.

## 5. CONCLUSION

Weak demand in the Eurozone, China and elsewhere alongside weak productivity are negatively influencing UK economic growth. The Government should use the opportunity of the Spending Review to implement further supply side reforms to help raise medium term growth rates alongside continued deficit reduction measures.

## 6. MUST BE READ

- Why we need to improve economic ties with China – William Sternberg
- Progress on Eurozone structural reforms – Madeleine Thornton

## 7. MUST BE READ ON CAPX

- The Eurozone remains stuck in the slow lane – Philippe Legraine
- Why the free market right abandoned Tony Abbott – Patrick Hannaford

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