2019 UK GENERAL ELECTION BRIEFING:
THE ECONOMIC BACKDROP

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OVERVIEW

This briefing focuses on:

- The state of the UK economy and UK-wide living standards going into the election.
- The causes of slow growth and the need for supply-side reforms.

KEY TAKEAWAYS

- The **global economy** has experienced a **trade-related slowdown** since the middle of 2018 when tariffs on **bilateral trade** between the US and China were increased.
- The UK economy has been suffering from a '**slow puncture'** since the EU referendum in June 2016, made worse by faltering demand from the rest of the world. Growth has continued at a positive rate, but has been at a slow pace on account of significant political and economic uncertainty.
- **Employment** is at record levels and **unemployment** is at its lowest point since 1970. There is some evidence that businesses have preferred to take on more workers than invest in capital because of uncertainty about the future relationship with the EU. Public sector employment has started to expand again as austerity is relaxed.
- Slow **productivity growth** has meant that **living standards** have not improved much in recent years. **Real wages** are little higher than they were at the time of the financial crisis more than ten years ago.
- Aggregate **saving** remains low and much of the finance for investment has been sourced from abroad via a **current account deficit of over 4 per cent of GDP**.
- Slow **productivity** growth and low **saving** do not bode well for growth in **living standards** in the future.
- These issues can be addressed by government **policies** to foster **productivity growth** and increase **national saving**. The type of policies that can help are well understood but have not been pursued methodically within a coherent growth strategy.

The state of the UK economy going into the election

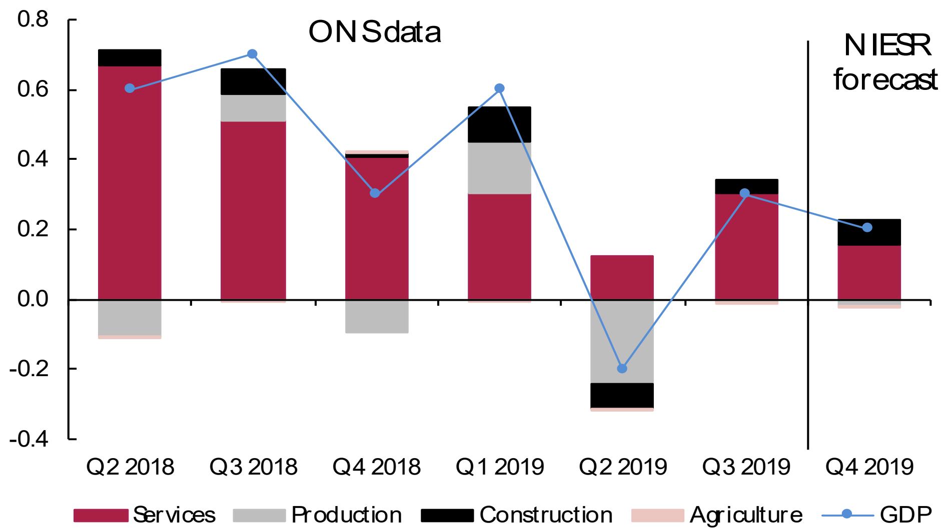
- The **global economy** has experienced a trade-related slowdown since the middle of 2018 when tariffs on **bilateral trade** between the US and China were increased. **Growth** in the OECD economies has slowed from 2.7 per cent in 2017 to 2.3 per cent in 2018 and is forecast to slip back to 1.6 per cent in 2019. The reduction in growth has been focused in **industrial production** where the three-month annualised growth rate in the advanced economies has fallen from around 4 per cent in early 2018 to zero in the most recent data.

- Despite experiencing a 15 per cent depreciation of the **pound** in the wake of the EU referendum vote in June 2016, the UK economy has since grown more slowly than the average of other advanced economies. After growing at 2 per cent in 2016, the same average rate as other OECD economies, UK growth was 1.9 per cent in 2017, 1.4 per cent in 2018, and is likely to be around the same rate again in 2019. This suggests that the level of UK GDP has fallen by about 2 per cent relative to other OECD economies since the 2016 referendum.

- Recent evidence from international business surveys also points to a weaker outlook in the UK than among its peers. For example, the EU-collected **UK services confidence indicator** remained in negative territory for the twelfth consecutive month in October, posting -21.4, around 25 points below its long-run average. This represents the longest negative run in the indicator history since the global financial crisis. Service sector confidence in the UK is substantially lower than in the EU as a whole where the level of the index was 3.7 in October, only 6 points below its long-run average.

- Figure 1 shows how the **quarterly growth rate of the UK economy** has changed over the past two years. The main point to note is the gradually reducing contribution of the **service sector** as the 'slow puncture' takes effect.

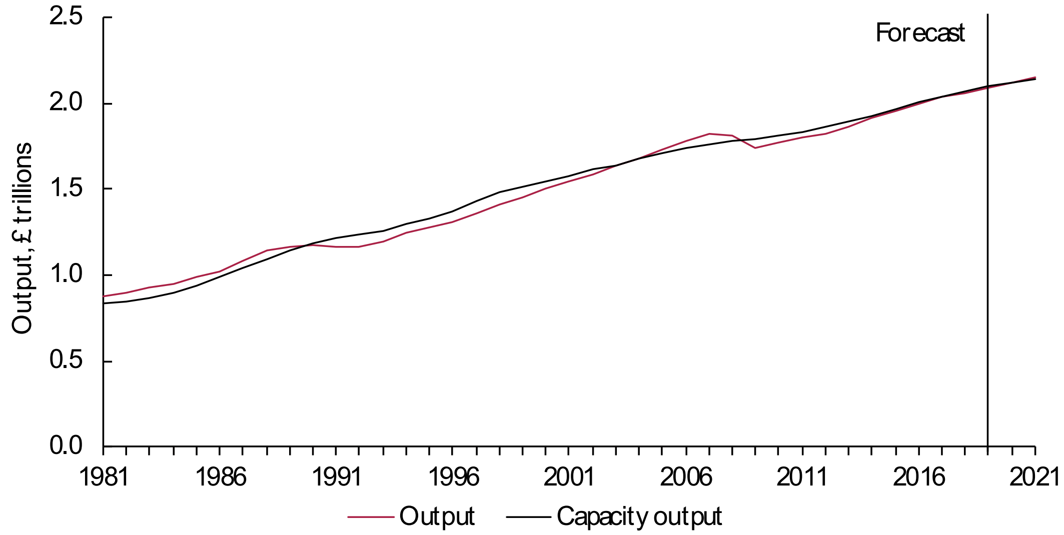
Figure 1. Contributions to quarterly GDP growth (percentage points)



Source: ONS, NIESR GDP Tracker.

- For some time now it has appeared that there is little slack in the economy. Figure 2 shows estimates of the level of **UK output** and NIESR estimates of **potential output,** the amount that can be produced with available resources. With little slack, economic growth must come from an expansion in potential output, determined by the availability of **labour, capital** and the **efficiency** with which they are used in production.

Figure 2. UK output and potential output

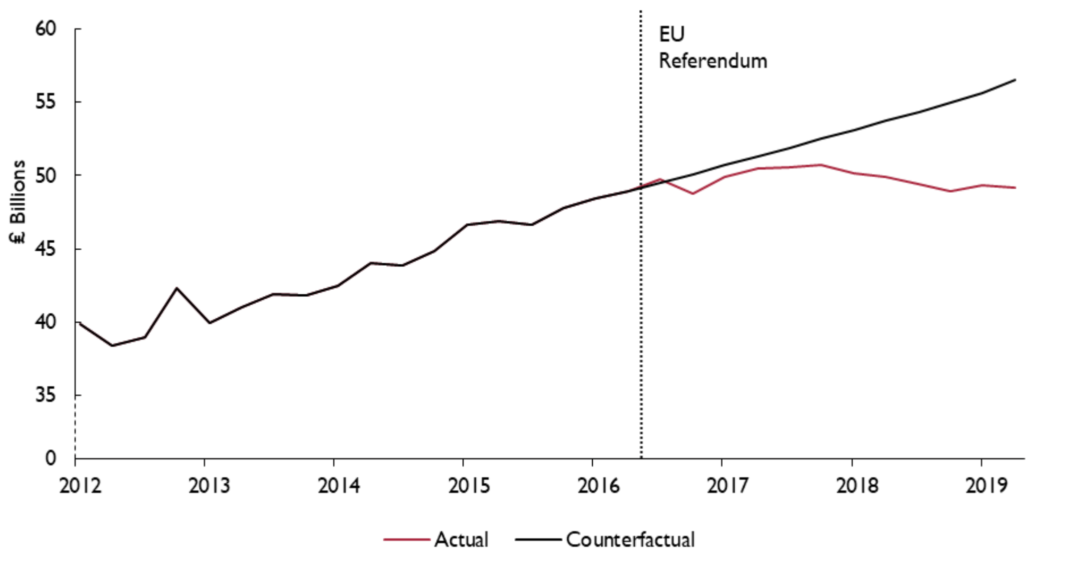


Source: ONS, NIESR estimates.

- The primary cause of the '**slow puncture**' is the uncertainty surrounding future trade relations with the EU. The main channel by which this has affected the economy is through lower **business investment**. It is also likely to have affected the dynamism of the UK economy, what it can produce and the amount of income it generates.

- **Business investment** is estimated to be **around 15 per cent lower** than it would have been had it not been for the 2016 Brexit vote (figure 3). This is due to the uncertainty that the decision to leave the EU has created. This uncertainty has led businesses to postpone investment until they know more about the new relationship with the EU.[i]

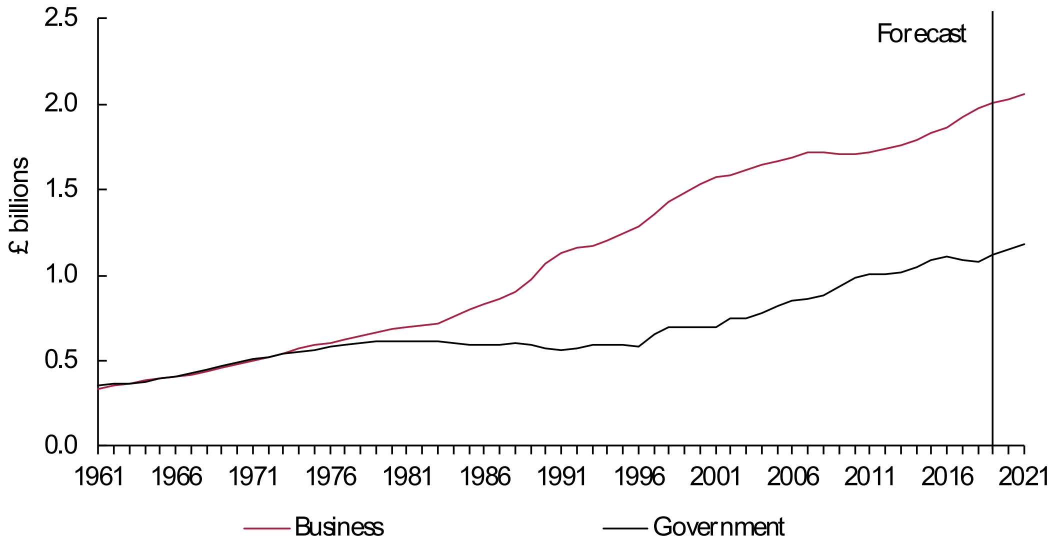
Figure 3. Business investment: actual and counterfactual



Source: ONS, NIESR estimates.

- Subdued **business investment** has contributed to a slower pace of **capital accumulation** than in the run-up to the financial crisis. Since 2009 the **measured business sector capital stock** has risen by 17 per cent compared with growth of 26 per cent in the ten years leading up to 2007.

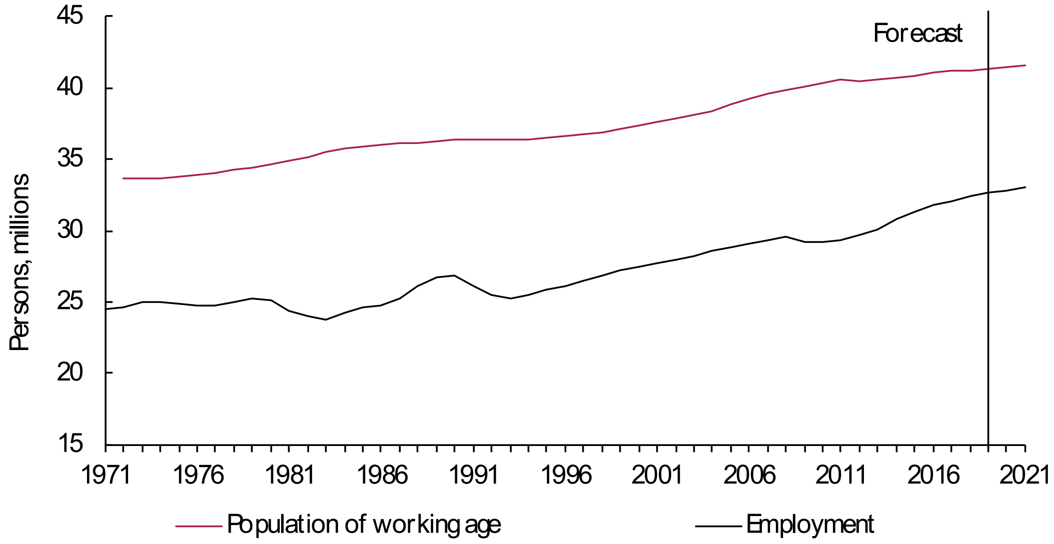
Figure 4. Business and government sector capital stock



Source: ONS, NIESR estimates.

- **Employment** has grown by 3.3 million since the financial crisis began in 2007, almost double the rise of 1.8 million in the **population of working age** over the same period (figure 5). **Net migration** continues to add to labour supply, though at a slower pace. Immigration for work-related reasons has fallen since the year ending June 2016 and can largely be accounted for by a decrease in EU citizens moving to the UK for work. Following a peak of 190,000 in the year ending June 2016, the number of EU citizens arriving for work has fallen to 90,000, the lowest level since 2012.

Figure 5. Employment and Population of working age

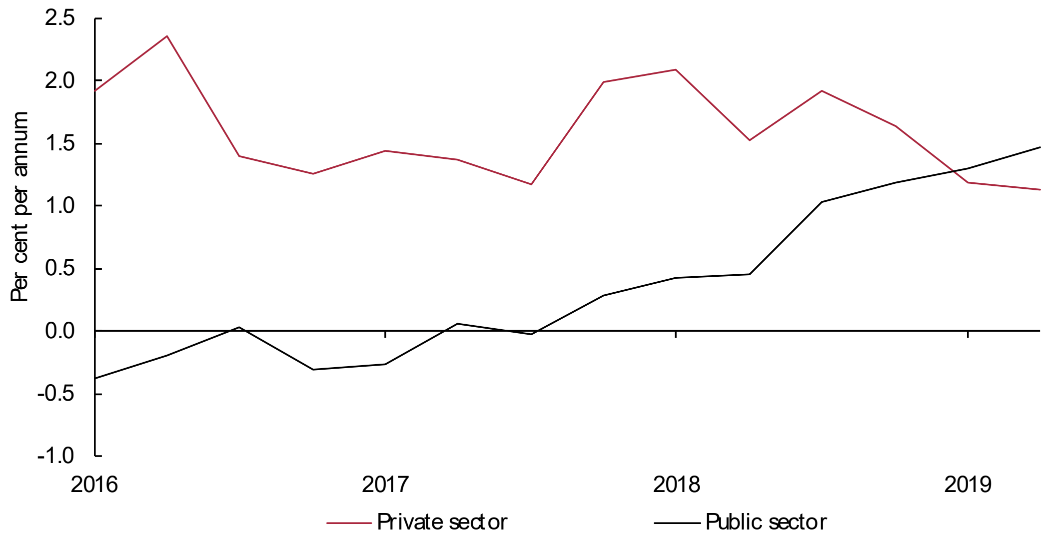


Source: ONS, NIESR estimates.

- Brexit uncertainty may have led to more labour demand since 2016 than otherwise, with businesses meeting demand by employing more workers rather than investing in capital goods as investments cannot easily be reversed.

- The strength of **employment** is one of the recent success stories of the British economies. But in the recent data, there is evidence that employment and wage growth are stabilising amidst global and domestic uncertainties. While labour demand is cooling in sectors engaged in international trade, domestically focused service sectors continue to face tight labour market conditions and additional demand is expected to come from the public sector in the near term. Public sector hiring activity has accelerated since turning positive in 2018 and following 8 years of staff level reductions (figure 6).

Figure 6. Employment growth



Source: ONS.

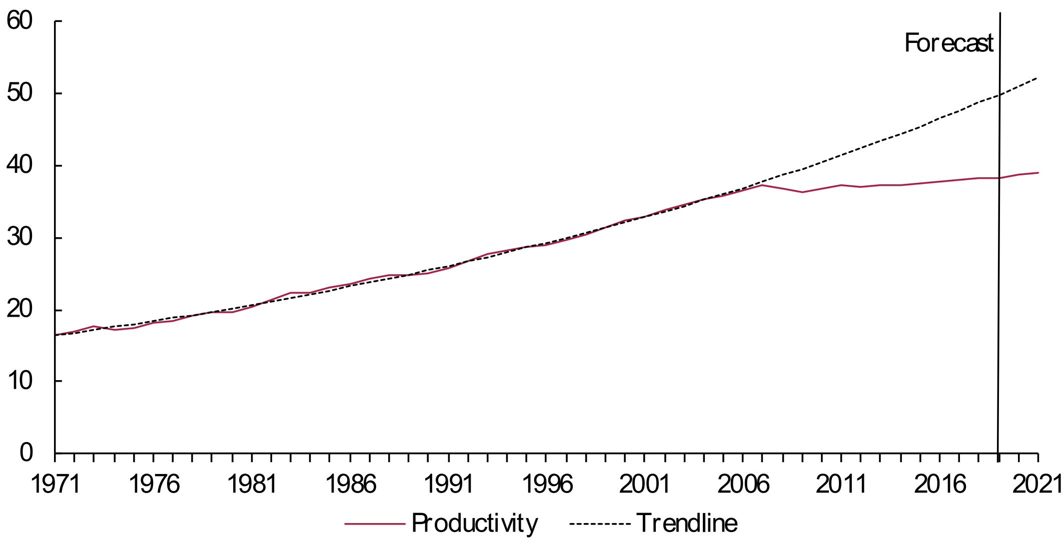
- With **employment** rising faster than the population of working age, **unemployment** has fallen and stabilised at 3.8 per cent of the labour force in the three months to September, slightly lower than the 4 per cent it reached a year ago.

Figure 7. Unemployment and proportion of population of working age not working

Source: ONS, NIESR calculations.

- **Productivity** growth has been very subdued since the financial crisis began in 2007. Some of the reasons for this were explored in out 2017 General Election briefing (Chadha, 2017). Output per hour in 2019 is only 2.9 per cent higher than at its 2007 peak. This is 23 per cent lower than a continuation of its pre-financial crisis trend (figure 8).

Figure 8. Output per hour (£, 2016 prices)

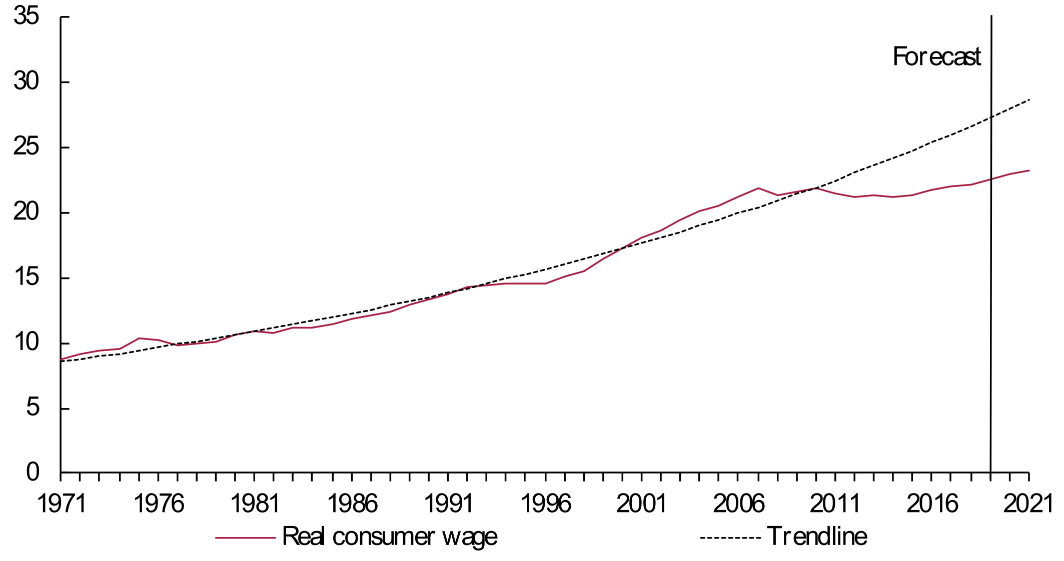


Source: ONS, NIESR calculations

- Brexit has also contributed to the **prolonged weakness in UK productivity growth**. Demand has increasingly been met by employing more workers rather than investing in capital goods as investments cannot easily be reversed. In addition, management time has been diverted towards no deal planning.[ii] Productivity has continued to be very subdued. Output per hour was 0.5 per cent lower in the second quarter of this year, compared with the same quarter a year ago.

- Despite low productivity growth, **real wages** are starting to pick up in response to a tight labour market and increases in public sector pay. Similar to employment growth, earnings growth has increasingly been supported by public sector pay. The NIESR Wage Tracker suggests that **annual nominal earnings growth** is stabilising at just below 4 per cent. This is half a percentage point more than a year ago. At the same time that nominal wage growth has risen, **consumer price inflation** has fallen to 1.5 per cent per annum in October. This suggests **real wages are currently growing at around 2½ per cent per annum**.

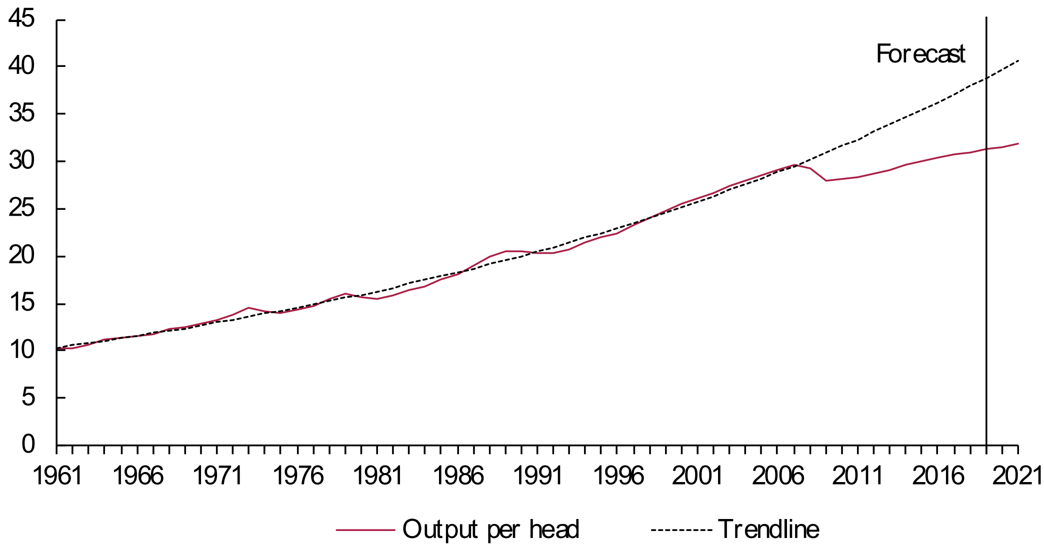
Figure 9. Real wages (£ per hour at 2016 consumer prices)



Source: ONS, NIESR calculations.

- While **real wages** have picked up in the recent data, they are only 2.9 per cent higher in 2019 than in 2007 and 17 per cent lower than a continuation of their pre-crisis trend. Slow growth in real wages is associated with little advance in **living standards** since the financial crisis. **Output per head of population** grew at an average annual rate of 0.5 per cent per annum between 2007 and 2019. This contrasts with average annual growth in output per head of 2.3 per cent between 1961 and 2007 (figure 10). **Output per head** is 20 per cent lower than a continuation of its pre-crisis trend.

Figure 10. Output per head



Source: ONS, NIESR calculations

The causes of slow growth and the need for supply-side reforms

- The slow pace of economic growth in the United Kingdom in the last couple of years has not been due to any weakness in overall demand but due to weakness of productivity growth.

- As described by Oulton (2018), there is not one UK productivity puzzle, but two. One puzzle is the lack of growth in productivity since 2007. The other is the low level of productivity in the UK relative to in other advanced countries. This has been observed since the 1960s with respect to France and Germany and relative to the United States since the early twentieth century.

- On the first productivity puzzle, concerning the stagnation in productivity since the financial crisis, the general conclusion from recent research is that it is an economy-wide phenomenon with stagnation widespread across detailed industry divisions (Riley, Rincon and Samek, 2019). One economy-wide factor that contributes to this weakness is capital shallowing, especially in the service sector, where the buoyancy of employment has not been sufficiently matched by investment. But the majority of the recent productivity weakness is accounted for by unusually slow growth of total factor productivity, the efficiency with which resources are used.

- The source of this weakness is not clear, but it is also apparent in other countries, albeit to a lesser extent. This points to the productivity weakness of the past decade having its roots in changes in the global economy affecting all countries to some extent. As a poorly-understood global phenomenon, there is not much the UK can do on its own to resolve this issue.

- The second productivity puzzle concerns the longstanding weakness of UK productivity relative to other countries. This is reasonably well understood and can be addressed by a combination of demand and supply-side policies affecting both the private and public sectors.

- The types of policies that are required include:
    - Fostering macroeconomic and policy stability to help businesses make long-term decisions without having to be concerned about major changes in their trading and investment environment.
    - Encouraging high productivity international businesses to locate in the UK so that local businesses can benefit from knowledge spillovers.
    - Improving the skills of the workforce so that technology can be used more effectively.
    - Ensuring that the physical and technological infrastructure are effective and not a source of congestion.
    - Allowing competition where appropriate to channel resources to where they can be used more effectively. Accepting that this will temporarily mean some institutions need to close and some jobs be lost.
    - Providing incentives to innovation.
- These sorts of policies can encourage productivity and so the amount that is produced in the UK. The uncertainty caused by the decision to leave the EU and the less open trading environment with the EU are both inimical to productivity growth.
- But the living standards of UK residents also depend on their claim over this output and the output of other countries that they have invested in. Low levels of saving have meant that the UK has run a current account deficit more or less continuously for the past twenty years, so that a significant proportion of the investment in the UK has been financed from abroad. This means that the claim of the UK over its own resources is diminished somewhat. At the end of 2018, the financial net worth of the UK was negative at -£224 billion, representing the UK's net financial position with the rest of the world.
- But to put this in context, the UK's overall net worth, its total cumulated saving, was £10.4 trillion in 2018, around 5 times annual GDP and an average of £156,000 per person. Around three-quarters of the measured net worth is in dwellings and land, the value of which has been affected by high house and land prices.
- A range of policies to increase national saving have been adopted in recent years, including reducing the taxation of saving and pension reform, including auto-enrolment. A more direct way to increase national saving is for government to save more and build up its balance sheet by running current budget surpluses when the state of the business cycle allows it.

[i] See NIESR's Prospects for the UK Economy, November 2019.
[ii] See also Bloom et al. (2019), The impact of Brexit on UK firms.

References

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