

Section 2 Commentary



Chapter 1

Economic prospects and public expenditure

Introduction

These continue to be difficult times. National and international economic growth prospects remain limited, and the acute crises in some eurozone economies still have the potential to explode and further derail hopes for economic recovery across Europe as a whole (and beyond).

UK economic forecasts have continued to tumble, and not for the first time the government has had to acknowledge that even with the expenditure cuts it set out in 2010 it will take longer than planned to bring down levels of public borrowing.

The focus of this chapter is, first, on the latest prospects for the UK economy, and then on the measures announced by the government in the 2012 Autumn Statement.

Economic prospects

The revised lower forecasts for UK economic growth are set out in Table 2.1.1. The extent of their downward revision can be seen by comparing these figures with the forecast made at the time of the 2012 Budget as set out in Compendium Table 11.

While the more limited prospects for exports are a factor in the revised forecasts, more notable is the much greater reduction in levels of general government expenditure. Investment in private dwellings is now forecast to decline in 2013, ahead of an anticipated recovery now deferred to the following year, with the economy now expected to have grown far more slowly in 2012. By comparison with earlier projections, household consumption is also now forecast to expand far more slowly in the years from 2013.

It is already the case that the current economic downturn is more severe than both the 1980 and 1990 downturns (see Figure 2.1.1), and has already lasted nearly five years. In contrast, the two previous downturns lasted just three years. The latest forecasts from the Office for Budget Responsibility (OBR) effectively suggest it will be 2015 before the economy returns to its 2008 level: a year later than it previously predicted. On that basis the 2008 downturn will by then have lasted for more than twice as long as the 1980 and 1990 downturns.

Table 2.1.1 Office for Budget Responsibility Autumn Statement Economic Forecast

Percentage change on a year earlier (unless otherwise stated)

	2011 outturn	2012	2013	2014	2015	2016	2017
		forecasts					
Gross Domestic Product at constant prices	0.9	- 0.1	1.2	2.0	2.3	2.7	2.8
Expenditure components of GDP							
Domestic Demand	- 0.4	0.5	0.9	1.9	2.1	2.5	2.7
Household consumption ¹	- 0.9	0.5	0.9	1.6	1.8	2.4	2.9
General government consumption	0.2	2.4	- 0.7	- 1.4	- 1.2	- 2.1	- 3.0
Fixed Investment	- 2.4	1.0	2.1	8.1	8.5	8.7	8.7
Business	2.9	3.8	4.9	8.1	10.2	10.1	9.5
General government	- 20.4	- 9.2	- 2.5	4.8	- 3.0	- 2.6	0.7
Private dwellings	0.3	2.4	- 1.1	9.5	10.0	10.0	9.7
Exports of goods and services	4.5	0.1	3.1	4.5	5.1	5.5	5.4
Imports of goods and services	0.5	2.1	2.1	3.9	4.5	4.9	5.0
Inflation CPI Q4	4.5	2.8	2.5	2.2	2.0	2.0	2.0
Labour market							
Employment (millions)	29.2	29.5	29.6	29.7	29.9	30.2	30.4
Wages and salaries	2.5	3.3	2.7	3.2	4.5	4.8	4.9
Average earnings ²	2.2	2.7	2.2	2.8	3.7	4.0	4.0
ILO unemployment (percentage)	8.1	8.0	8.2	8.2	8.0	7.6	7.1
Claimant count (Q4 millions)	1.53	1.59	1.66	1.69	1.63	1.53	1.43
Household sector							
Real household disposable income	- 1.5	2.1	0.4	0.8	1.6	2.0	2.3
Savings ratio (level, percentage)	6.0	7.1	6.2	5.5	5.5	5.4	5.0
House prices	- 1.0	1.4	0.7	2.5	3.8	4.0	4.0
Fiscal aggregates (Percentage of GDP) ³							
Public sector net borrowing	7.9	5.1	6.1	5.2	4.2	2.6	1.6
Public sector net debt	66.4	74.7	76.8	79.0	79.9	79.2	77.3
General government net borrowing ⁴	7.7	5.2	6.2	5.3	4.3	2.8	1.8
General government gross debt ⁴	85.8	90.3	93.5	96.3	97.4	96.6	94.4

Source: Autumn Statement 2012, HM Treasury.

Notes: 1. Includes households and non-profit institutions serving households.

2. Wages and salaries divided by employees.

3. Fiscal aggregates are for the financial year (i.e. 2011 is 2011/12).

4. General government borrowing and debt measures on a Maastricht basis.

Moreover, it should be noted that the latest OBR forecast recognises that:¹

'The euro area remains a major risk to our forecast. Policy action during the summer, including the ECB's new bond purchase facility, appears to have reduced some of the immediate pressures in euro area financial markets. However, the underlying situation remains very fragile...'

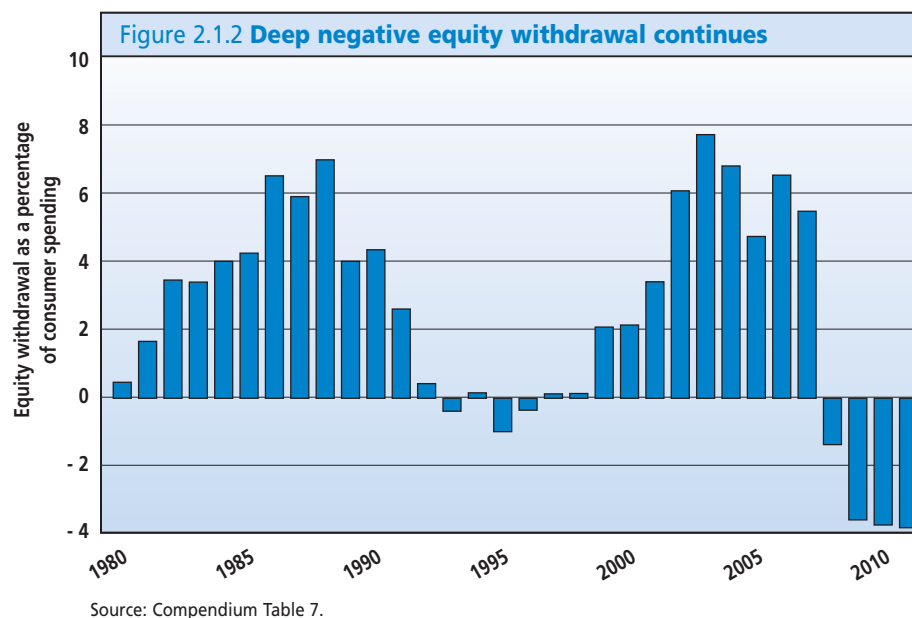
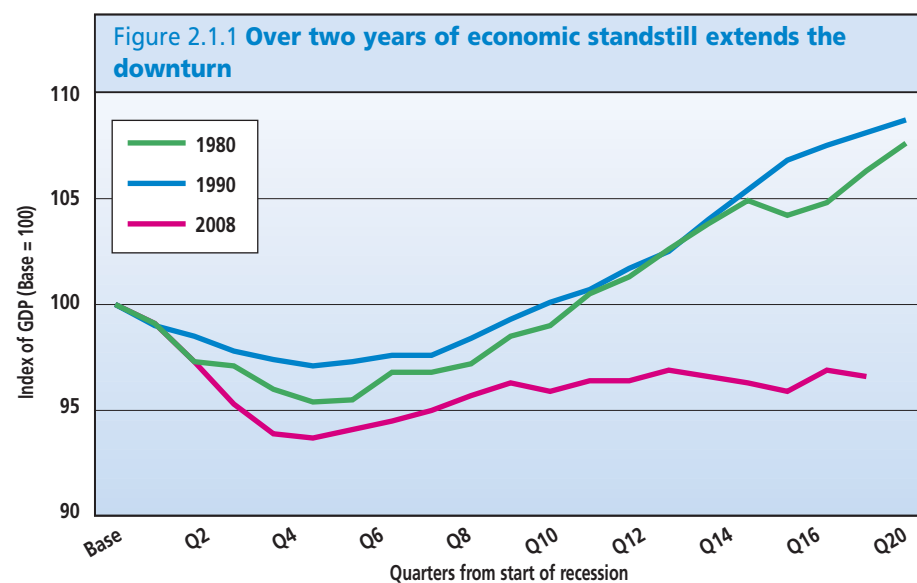
But as noted above there are domestic as well as international factors at play in the slower than hoped for rate of UK economic recovery. The government's expectations of private sector growth to offset the cutbacks in the public sector have been dampened both by the reduced prospects for exports and the downgraded forecasts for household consumption and the housing market.

The depressed housing market is, of course, one of the contributors to the downturn in household consumption. The limited level of borrowing for new investment in private housing, as well as accelerated mortgage repayments by

existing owners, saw substantial 'negative equity withdrawal' (i.e. positive net investment) continue into 2011, at the equivalent of 3.8 per cent of GDP (see Figure 2.1.2.). This contrasts with positive levels of equity withdrawal of 6.6 per cent just five years ago.

In other words there has been a ten per cent swing in households' housing equity withdrawal/investment over the period – a huge retraction of economic stimulus, and clearly one of the major factors that has dampened levels of spending on household consumption.

More generally, the disappointing levels of private sector economic activity, which have struggled to compensate for the cutbacks in public spending, have raised questions about the economic efficacy of the government's strategy in seeking to reduce public spending so rapidly at this time. Those doubts have been reinforced by an International Monetary Fund analysis of the multiplier effects of government fiscal cutbacks.



The assumption the IMF had previously made was that fiscal cutbacks only had a 0.5 (i.e. 50 per cent) net negative economic impact on fiscal balances, and this was borne out by evidence from advanced economies over the previous three decades. In other words the net reduction in government borrowing was only typically half of the gross level of expenditure cuts.

However, when they looked at the impacts of fiscal cutbacks in 2010/11 they found that the multipliers were far higher – ranging from 0.9 to 1.7. They conclude that the multiplier effects of fiscal cutbacks will vary depending on the international economic context. In particular they argue that their results are consistent with other research evidence that:²

‘...in today’s environment of substantial economic slack, monetary policy constrained by the zero lower bound, and synchronised fiscal adjustment across numerous economies, multipliers may be well above 1.’

In other words, in the current context fiscal cutbacks result, at best, in negligible net reductions in government borrowing, and may well be counter-productive.

The extended downturn into 2012 has obliged the government to defer its ambitions for reducing the deficit, but without making any fundamental change to its stance on public expenditure cutbacks. Indeed, the 2012 Autumn Statement is presented as being ‘fiscally neutral over the Parliament to 2015/16’. It also states the intention that Total Managed Expenditure (TME) will continue on its downward trajectory in the years to 2017/18, following on from the years covered by the current Spending Review.

However, within that fiscally neutral stance the government has made provision for a reduction in the main corporation tax rate, from 22 to 21 per cent, and a £5.5 billions capital package for infrastructure investment for programmes such as new roads, science infrastructure and free schools and free academies. While this will not involve any new money for housing investment, in itself, it will include funding to accelerate the delivery of large housing sites, ‘de-risking’

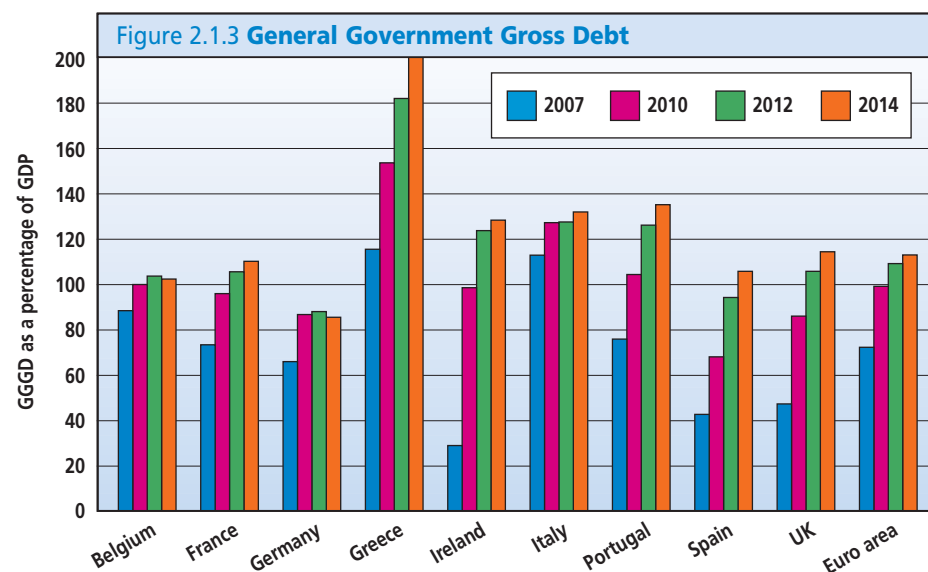
public sector land and enabling the quicker disposal of surplus sites for new homes. Previously announced measures to support new investment in private housing are discussed in Commentary Chapter 3.

The cost of these measures is to be met in part by annual uprating of most working-age benefits and tax credits by just one per cent for the three years from April 2013. This will clearly lead to a real terms reduction in the values of those benefits, and will set the levels for the start of universal credit (discussed further in Contemporary Issues Chapter 4). While the savings from these cutbacks will be cumulative, it is anticipated that the infrastructure investment will provide a more immediate boost to spending in 2013/14.

In overall terms, this approach reaffirms the government’s commitment to reduce the levels of public sector net borrowing (albeit now over a slightly longer timescale), with a view to maintaining the international financial confidence in the UK that underpins the low costs of UK government borrowing.

The government can rightly claim that the UK’s ‘AAA’ credit rating, and access to low-cost borrowing, has been maintained in stark contrast to the much higher costs of borrowing facing Greece, Italy and other southern European countries. However the limited effectiveness of its fiscal and economic policies has now raised question marks about whether it will continue to be afforded this much-prized rating, albeit without being at significant risk of seeing a major rise in the costs of borrowing even if the AAA rating is lost.

As can be seen in Figure 2.1.3, UK general government gross debt is set to slightly exceed the average level for the eurozone countries by 2014, and after a small increase in 2015 (to 97.4 per cent of GDP) is then forecast to start declining (see Table 2.1.1). This compares with the much higher debt levels of Ireland, Italy and Portugal where by 2012 debt levels are forecast to exceed 120 per cent of GDP. The unique difficulties for Greece, with its projected debt figure of 195 per cent of GDP are also apparent, albeit that this is still lower than the 230 per cent of GDP debt level forecast for Japan by 2014.



Source: OECD Economic Outlook 2012. Note: Maastricht definition of GGGD

This comparison also implicitly makes the point that market concerns about the security of lending to different countries reflect a view not just on the absolute levels of debt, but also the future financial risks to which countries are exposed, and their capacity to manage their way out of their financial difficulties. There are, for example, much greater international concerns about the financial position in Spain compared to the UK, despite their slightly lower levels of debt.

It is also to be noted that international comparisons of government debt are typically based on measures of 'general government' debt, and not the measures of public sector debt that are the unique pre-occupation of UK governments. Public sector debt includes the debt of 'public corporations' (i.e. government-owned trading bodies), as well as the debts associated with the provision of central and local government services.

Although the UK public sector net debt figure (PSND) is thus wider in its sectoral scope than the general government gross debt (GGGD), it is also a net rather than a gross debt measure. Moreover, the UK government decided to exclude the debts

associated with the purchase of its interest in the beleaguered banks from its public sector borrowing and debt measures, taking the view that these were only temporary arrangements. That approach does not, however, accord with international accounting conventions, and those debts are *included* in the international GGGD measure. For both those reasons the GGGD levels shown in Table 2.1.1 are higher than the PSND levels.

It follows from this that when the time comes for the UK government to dispose of its bank assets this will not only remove the anomaly in UK accounting conventions, but will substantially reduce the UK's debt on the GGGD measure. The extent of the reduction will obviously depend on the value of the banking assets at the time of sale, but the costs of the government's 'temporary' interventions are equivalent to some eight per cent of GDP, and even if the asset sales result in a net loss there is still scope for a significant reduction in GGGD that will almost certainly move the UK back to a position where its total debt falls some way below the eurozone average.

The *Review* has regularly made the case for the UK to adopt international fiscal measures based on general government, rather than including public corporations. This issue is revisited in Contemporary Issues Chapter 1, which more generally shows the potential for increased investment by English councils following the 2012 financial reforms.

Earnings and inflation

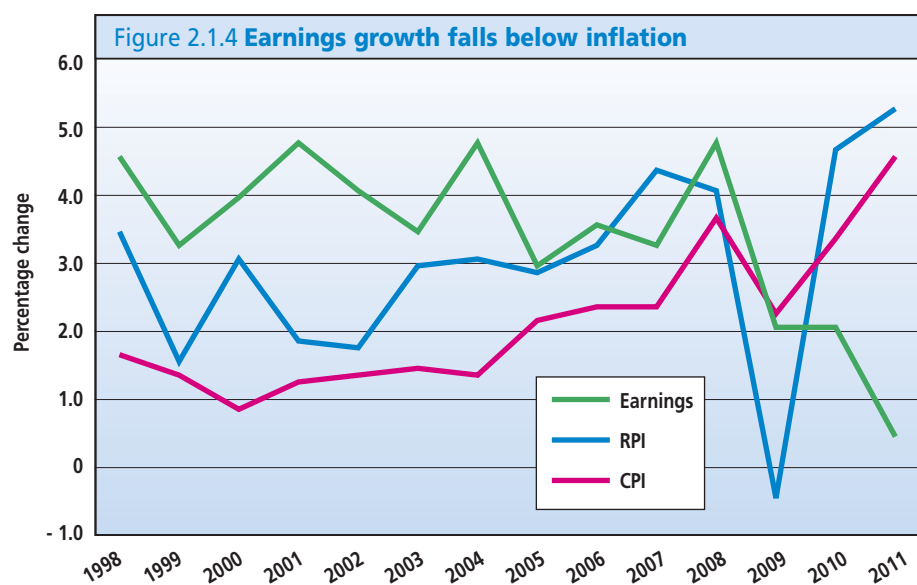
One of the more benign aspects of the extended downturn is that, so far at least, unemployment levels have not increased to the extent that might have been expected given the economic situation. In part this can be linked to a rise in levels of part-time employment, and a fall in the rate of earnings growth since 2008.

While both claimant and ILO unemployment measures have risen sharply since the beginning of the downturn, the claimant unemployment rate remains only about half the level experienced in the early 1990s (see Compendium Table 5). On the wider ILO measure, unemployment levels have risen to around eight per cent (for all those over 16 that are economically active), compared to ten per cent in the early 1990s.

There has though been a fall in the number of full-time jobs since the end of 2007 (by some 600,000 by the third quarter of 2012), while the number of part-time jobs has increased (by some 350,000). As a result part-time jobs now represent 27 per cent of all jobs (up from 25 per cent at the end of 2007).

A further factor has been the real-terms reductions in (full-time) earnings levels in the last two years, whether assessed against the RPI or CPI measures of inflation (see Figure 2.1.4). This fall in the level of real earnings, together with the rise in part-time employment, has softened the impact of the downturn on employment levels.

This fall in real earnings is one of the rationales given for the government's decision to uprate most working-age benefits by just one per cent over the next three years. This is an extension of the already ad hoc approach to uprating working-age benefits, following on from the switch from RPI to CPI as the primary inflation measure.



Source: Compendium Table 7.

The upshot is that claimants will be denied the benefit of a temporary respite from the ever-widening gap between benefit levels and earned income levels, that has occurred over the last thirty years since benefit rates have been decoupled from earnings levels.

The switch from RPI to CPI was largely taken on cost grounds, on the basis that the CPI measure of inflation has typically (but not always) come up with a lower figure than the RPI measure. In part this is because the European-wide CPI measure involves a slightly differently weighted 'basket of goods'. But it is also because the traditional CPI measure has not included a component for the costs of owner-occupied housing.

However this is about to change since, from April 2013, ONS are to start publishing a new version of CPI (CPIH) that will include a measure of homeowners' housing costs.³ In time, it is anticipated that this will displace the current CPI measure, not least for the purpose of the inflation targets for the Bank of England.

That consideration has helped to determine the particular way that homeowners' housing costs are to be measured for the new CPIH measure. Essentially the measure will be based on the economic concept of the rental value of homeowners' dwellings, rather than the more direct measure of owners' mortgage costs that is included in the long-established RPI measure.

The inclusion of mortgage costs was seen to be problematic when interest rate policy was adopted as the primary means for managing inflation, as an increase in interest rates to choke off inflationary pressures has an initial impact in increasing RPI due to the inclusion of homeowners' mortgage costs. This harks back to the reasons for creating the RPI(X) measure that excludes mortgage costs.

This model does mean, however, that the CPIH measure will have a totally different approach to RPI in measuring homeowners' mortgage costs, and that these will therefore continue to have a different profile, especially at times when private rental values and mortgage rates are on divergent paths. The CPIH measure

is not, though, expected to be very different to the existing CPI metric despite owner-occupiers' housing costs comprising just over ten per cent of the CPIH basket of goods.⁴

The new CPIH measure will also mean a divergence between the UK and the rest of Europe, where the intention is to bring in a 'net acquisitions' housing cost component at some stage after 2015. While the rationale for the CPIH measure is clear it will nonetheless be something of a peculiar hybrid. It is essentially a European-wide measure, although it will differ from the current and future European measures. And while it accords with economic theory, and the requirements of the Bank of England, it is not a measure that will accord with homeowners' day-to-day experiences of the impact of inflation on their living standards.

Key Reading

HM Treasury (2012) *Budget 2012*. HC 1853. London: The Stationery Office.

HM Treasury (2012) *Autumn Statement 2012*. Cm 8480. London: The Stationery Office (see www.hm-treasury.gov.uk/as2012_index.htm.)

HM Treasury (2012) *Public Expenditure, Statistical Analyses 2012*. Cm 8376. London: The Stationery Office.

Office for Budget Responsibility (2012) *Economic and fiscal outlook*. Cm 8036. London: The Stationery Office.

OECD (2012) *Economic Outlook 92*. Paris: OECD (see www.oecd.org/economy/economicoutlookanalysisandforecasts/economicoutlook.htm).

A very substantial volume of economic and financial data, and related papers, can now be accessed from the Office for National Statistics website.

References

- 1 Office for Budget Responsibility (2012) *Economic and fiscal outlook*. Cm 8036. London: The Stationery Office.
- 2 International Monetary Fund (2012) *World Economic Outlook, October 2012: Coping with High Debt and Sluggish Growth*. Washington DC: International Monetary Fund (see www.imf.org/external/pubs/ft/weo/2012/02/index.htm).
- 3 ONS (2012) *Response to the consultation on: the recommended method of reflecting owner occupiers' housing costs in a new additional measure of consumer price inflation; and the strategy for Consumer Price statistics*. London: Office for National Statistics (see www.ons.gov.uk/ons/about-ons/user-engagement/consultations-and-surveys/archived-consultations/2012/owner-occupiers-housing-costs/index.html.)
- 4 ONS (2012) *Consultation on: the recommended method of reflecting owner occupiers' housing costs in a new additional measure of consumer price inflation; and the strategy for Consumer Price statistics*. London: Office for National Statistics.