

Section 2 Commentary



Chapter 1

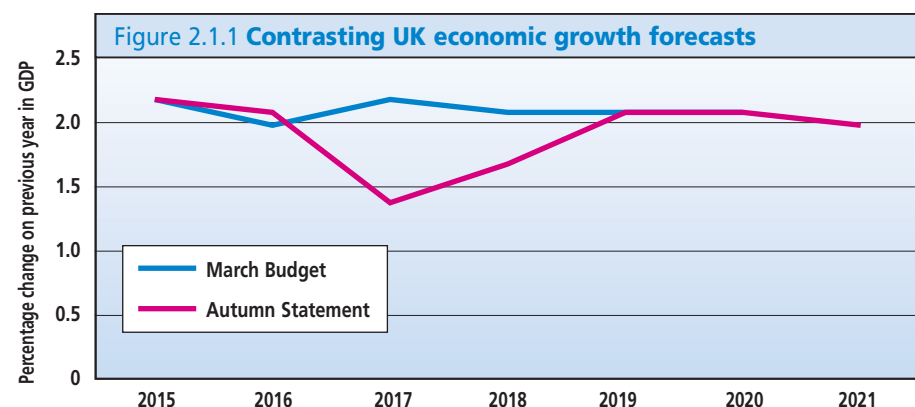
Economic prospects and public expenditure

Last year we reported that the economic recovery had been firmly established, and that the Spending Review and anticipated further fiscal consolidation marked a post-crisis policy shift towards a permanent reduction in the role of the state. Since then the outcome of the referendum on membership of the European Union and the consequent change of government have created a new environment, the dominant feature of which is uncertainty. Whilst the immediate effect of the vote to leave the EU has not been as drastic as some (notably the Treasury) predicted, it has led to a deterioration in economic prospects and a devaluation of the pound. It has also elicited monetary and fiscal policy responses, the latter including the adoption of new fiscal rules.

Summary of Developments

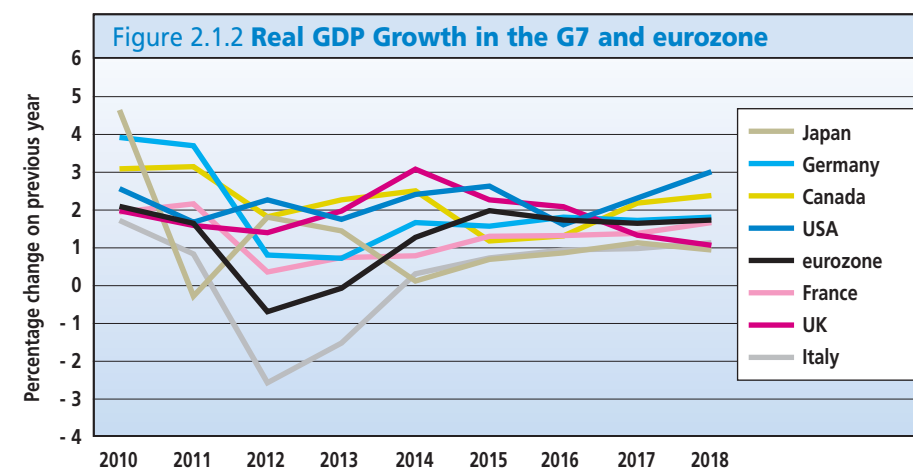
Growth

The economic recovery continued in 2016, with its performance described by the Treasury as being 'solid'. Although the outturn forecast for 2016 was upgraded slightly between the March Budget and the Autumn Statement, this marks a slower rate of growth than was recorded in 2015. The anticipated impact of the referendum is to lower the growth forecast for 2017 and 2018 before returning to the rate that had been anticipated previously (see Figure 2.1.1). The forecast reduction in growth suggests that the economy will be almost 1.3 percentage points smaller by the end of 2020 than it would have been had the referendum result been different.



Source: OBR in Budget Report, Table 1.1; Autumn Statement (2016), Table 1.1.
Note: 2015 (outturn); 2016-2021 (forecast).

In recent years, the UK's real growth rate has been among the highest in the major economies in the G7 (see Figure 2.1.2). From 2013-16 the UK's growth rate has been (or is expected to be) either the highest or second highest among these countries. However, in 2017 the UK is expected to slip to fifth place and in 2018 to sixth. The overall pattern, however, is one of fragile growth. The eurozone and Japan have not recorded a real growth rate of two per cent or above since 2010. France and Germany have not attained growth rates of two per cent or more since 2011 and are not expected to do so in the forecast period. Canada and the United States are expected to record the strongest growth rates in 2017 and 2018.



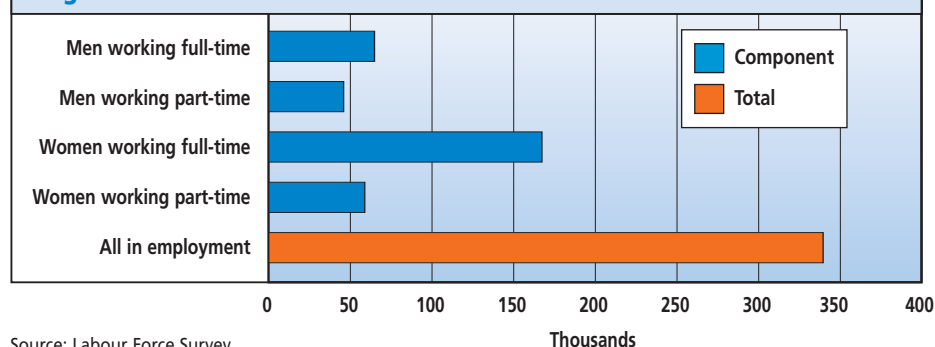
Source: OECD (2016) Real GDP forecast (indicator) doi: 10.1787/1f8410b-en.

Labour market

The UK labour market continued to grow in 2016. Unemployment as measured by the Labour Force Survey (LFS) fell to 4.8 per cent of the economically active population (its lowest since 2005). The male rate at 4.9 per cent was the lowest since 1979; the female rate at 4.7 per cent was the lowest since 2005. On this measure unemployment continued to fall post-referendum (July-September), although this is a three-month measure so could disguise a rise in the later part of the period. The claimant count fell from a peak of 4.9 per cent in 2009 to a low of 2.2 per cent in March 2016. It began to rise post-referendum and was 2.3 per cent in November 2016.¹

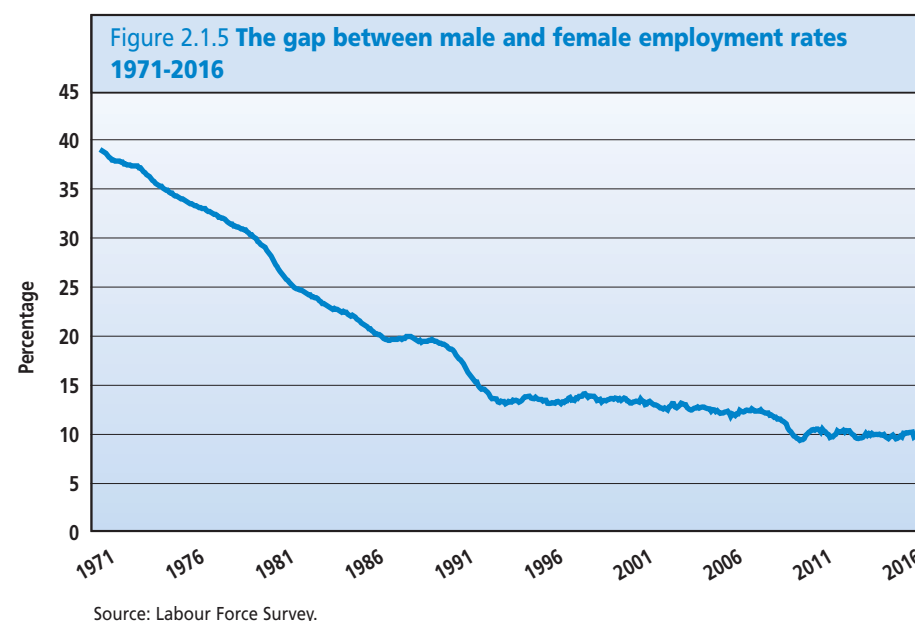
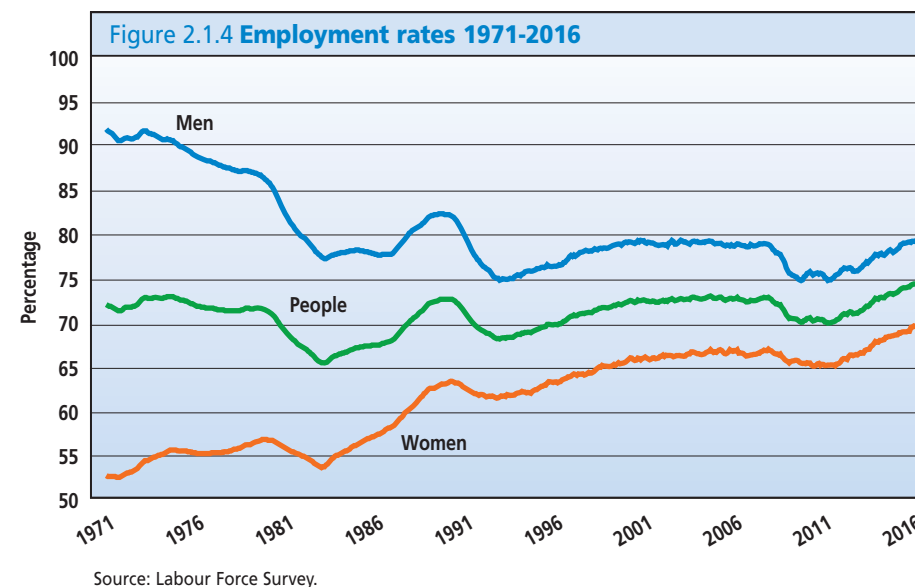
There were more than 342,000 more people in work in the three-month period August-October 2016 compared with a year earlier. Two-thirds (235,000) of the rise was accounted for by full-time jobs, but around half as many of these were obtained by men compared to women. However, the bulk (72 per cent) of the growth in part-time employment was accounted for by women (see Figure 2.1.3).

Figure 2.1.3 Changes in people in employment, August-October 2015 to August-October 2016



Male and female employment (74.4 per cent) now exceeds the levels recorded before the credit crunch. Male employment remains almost ten percentage points (79.1 per cent) higher than female employment (69.8 per cent). However, whereas female employment is at record levels, male employment is still considerably below the rates of 90 per cent that preceded the era of rapid deindustrialisation that began in the mid-1970s. The gender gap has therefore narrowed considerably since the early 1970s when it was almost 40 percentage points. Although the gap closed most rapidly in the period up to the early 1990s, the growth in the rate of female employment has picked up over the last four years (see Figures 2.1.4 and 2.1.5).

The Office of Budget Responsibility (OBR) forecasts for employment and unemployment did not change very much between the Budget and Autumn Statement. Employment is forecast to continue to grow up to the end of the forecast period in 2021 (by one million compared to 2015). LFS unemployment is forecast to be about 0.1 percentage point higher in 2018, 2019 and 2020.

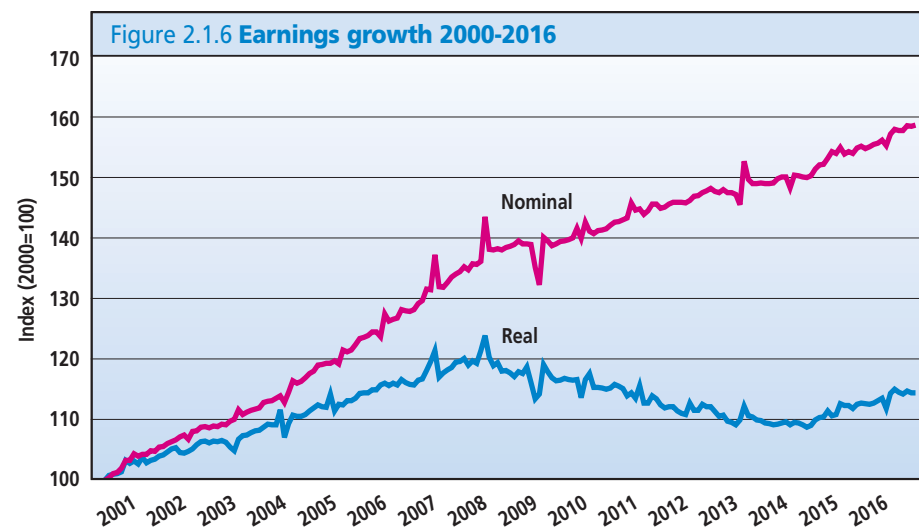


EU and Non-EU employment

With the number of non-UK nationals working in the UK having been one of the central issues in the EU referendum, we note that there are now 2.3 million EU nationals and 1.2 million non-EU nationals working in the country compared to fewer than one million in total in 1997. The numbers of EU nationals working in the UK caught up with the number of non-EU nationals in 2007 when there were about one million of each. Thereafter the numbers of non-EU nationals levelled off, but the number of EU nationals continued to rise (for further discussion, see Contemporary Issues Chapter 1).²

Earnings

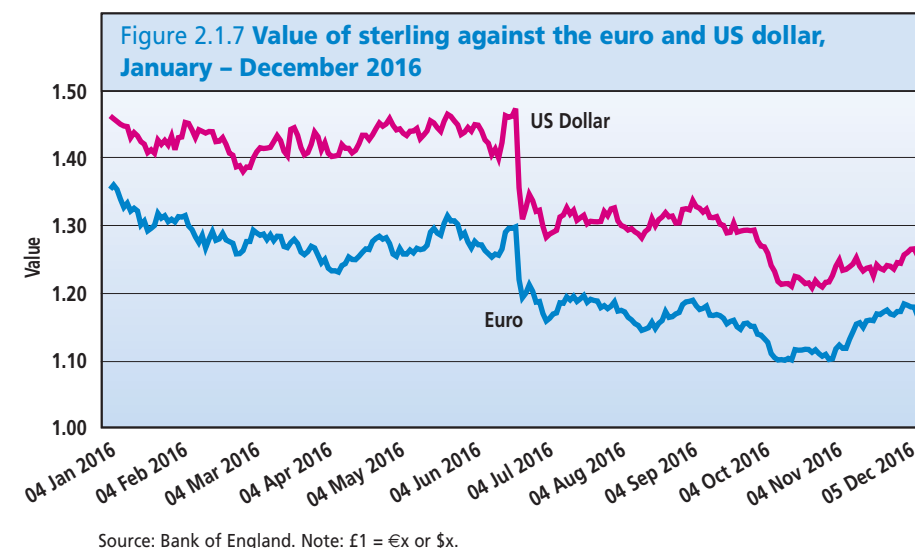
In marked contrast to employment, earnings growth has been very weak. Real earnings peaked at 124.1 in February 2008 (where 2000 = 100), and fell to a low of 109.2 in August 2014 (see Figure 2.1.6). The recovery since then has been slow and real earnings in September 2016 were just 114.6, a level first reached more than a decade earlier in September 2005, and almost ten percentage points below the 2008 peak. The IFS points out that real earnings will not return to their 2008 peak until 2021.³



Source: ONS Monthly Wages and Salaries Survey (MWSS).

Devaluation

A clear effect of the referendum was to reduce the value of sterling, which ended the year some 13 per cent lower against the euro and 14 per cent lower against the US dollar. The OBR used a sterling value 13 per cent lower in its forecasts for the Autumn Statement compared to those prepared for the Budget in March. Figure 2.1.7 shows how the pound rose in value on the day of the referendum, reflecting the erroneous expectation of a 'remain' vote. From this point sterling fell to a low of €1.10 and US\$1.22 in October, before recovering somewhat to €1.19 and US\$1.24 in December 2016.



Inflation

Inflation remains at historically low levels, but the Bank of England Monetary Policy Committee (MPC) expects it to be higher than previously forecast largely as a consequence of the depreciation of sterling. The OBR refers to a rule of thumb whereby 'around 80 per cent of movements in sterling feed through to import prices and around 20 per cent of changes in import prices feed through to CPI inflation. This implies that sterling's fall will add around 2.0 per cent to the level of the CPI in the medium term.'⁴

A second reason for these expectations is the Bank's judgement that it should accommodate a period of above-target inflation in order to limit the deleterious impact of higher interest rates on the real economy. In its November Inflation Report, its modal projections for CPI inflation are for it to rise from 1.3 per cent in Q4 2016 to 2.7 in 2017 and 2018, and 2.5 per cent in 2019.⁵

Monetary policy response

The MPC responded to the anticipated economic effects of the outcome of the referendum with a stimulus package. The Bank Rate was reduced to 0.25 per cent in August, having been held at 0.5 per cent since March 2009. Both these rates represented the lowest levels in the Bank's history going back to 1694. Alongside the cut in Bank Rate, the Bank introduced a term funding scheme under which it supplies funds to banks and building societies at rates close to the Bank Rate, and is intended to encourage these institutions to pass on the cut to customers. Certainly, by November the interest rate on outstanding mortgages had fallen by 24 basis points (floating rate) and ten basis points (five-year fixed rate) since May. The interest rate on new mortgages fell by 33 basis points over the same period (two-year 90 per cent loan-to-value ratio).⁶ Interestingly, the Bank noted the long-term reduction in world interest rates, suggesting that this might be attributable to a shift towards more risk-averse behaviour by investors. In other words, the low interest rate environment is not solely the result of monetary policy.

The Bank also resumed its quantitative easing programme, first introduced in response to the credit crunch, by signalling the purchase of up to £10 billion of corporate bonds and £60 billion of government bonds funded by issuing reserves. This will bring the total value of stocks of asset purchases to £435 billion.

Fiscal policy

Rules

Budgetary rules have played a role in UK economic policy since the late 1990s when Gordon Brown introduced the 'golden rule' (allowing borrowing for investment only over the cycle) and the 'sustainable investment rule' (to limit the deficit to 40 per cent of GDP over the cycle). Even before the credit crunch, these rules attracted much cynicism as the Treasury could decide what period constituted

the economic cycle, and the coalition government established the Office for Budget Responsibility to remove the suspicion of political interference.

The majority Conservative government has itself adopted and then amended its own fiscal rules. In 2015, these were to target for fiscal surplus by the end of 2019/20 (i.e. the end of the parliament) and to reduce Public Sector Net Debt as a share of GDP up until then. The government also committed to target for surplus in Public Sector Net Borrowing once a headline surplus had been recorded. This rule was to prevail 'in normal times', but could be adjusted in the event of economic shocks.⁷

These rules survived for less than 18 months. With the uncertainty caused by the referendum result leading to growth forecasts being reduced, the government abandoned its rule to seek a budget surplus within this parliament, but rather to seek a balance 'at the earliest possible date in the next parliament.' It also commits to have net debt falling as a share of GDP by 2020/21.⁸ A greater margin is also allowed for the welfare cap.

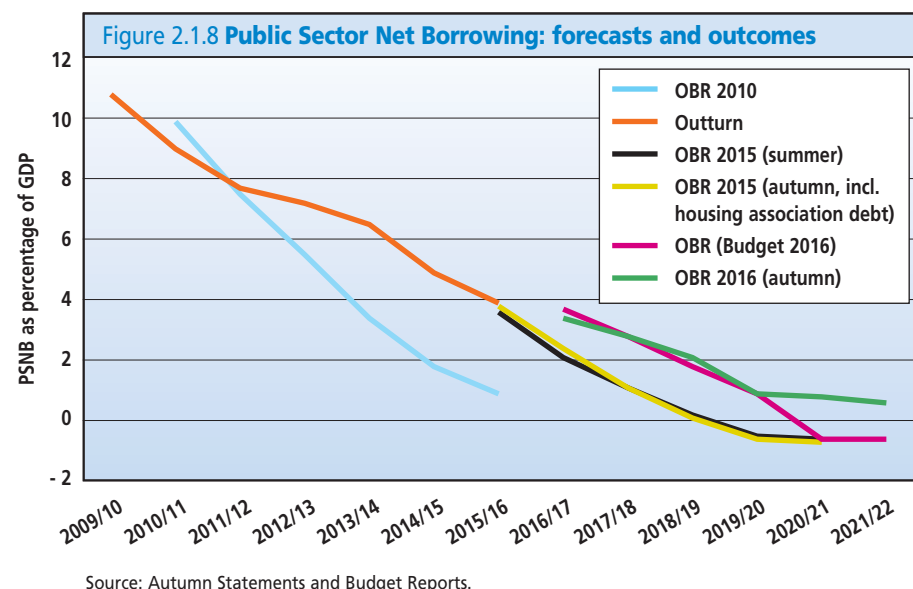
The persistent changing of fiscal rules is in marked contrast to the stability of regime afforded by the MPC, where adjustments have been for non-expedient reasons (such as the switch from RPI to CPI). The reason for such 'hand-tying' rules is to establish credibility in the markets. One must doubt whether fiscal rules retain this effect even if they ever had it.

Deficit

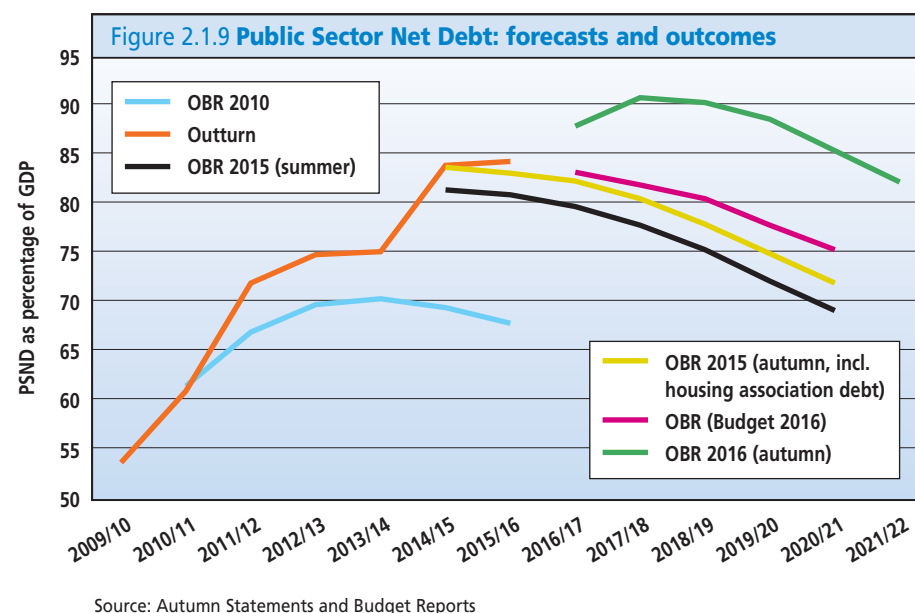
Since 2010, governments have attempted to reduce the current deficit of government revenue over expenditure from the post-1945 high of over ten per cent in the aftermath of the credit crunch.

Figure 2.1.8 shows how the government's ambitions have been repeatedly thwarted, most famously during the period of the coalition government when the pace of austerity was slowed in response to fears of another recession. However, since then forecasts have become less optimistic, too, the difference between the forecast at the time of the 2015 Autumn Statement and the 2016 Budget being one

example. Moreover, by the time of the 2016 Autumn Statement, the government's ambition to remove the deficit by the end of this parliament had been abandoned, principally due to the anticipated impact of the referendum result. Of course, running a fiscal deficit of one per cent rather than a small surplus is of no material consequence, and tends to detract from the fact that since 2010, the deficit has been much reduced and further tightening is a consequence of policy choice rather than economic necessity. Indeed the UK's deficit is lower than in four of the G7 countries.



The inevitable knock-on effect of additional net borrowing is for the level of outstanding government debt to continue to grow. By 2017/18 it is now expected to peak at 90 per cent of GDP (Figure 2.1.9), almost 40 percentage points higher than in 2010. This contrasts to the OBR's forecast in 2010 which anticipated the deficit peaking at 70 per cent in 2013/14. The impact of the reclassification of English housing associations as public sector bodies was discussed in the last edition of the *Review*. This year there is a smaller effect from the Scottish, Welsh and Northern Ireland associations having been reclassified in the same way.



Public spending

Despite speculation that a much more active fiscal policy would be adopted in response to the referendum result, the fiscal loosening announced in the Autumn Statement arises from the expected impact of 'automatic stabilisers' (such as social security benefits within the looser welfare cap), and by establishing a new National Productivity Investment Fund. This will facilitate an additional £23 billion of spending on transport, digital communications, R&D and housing between 2017/18 and 2021/22. Otherwise the government intends to stick broadly to the spending plans established in the 2015 Spending Review and Autumn Statement (set out in this chapter in last year's *Review* as Tables 2.1.3 and 2.1.4) with some additional cuts announced in the 2016 Budget.⁹

Conclusion

The main message of this year's *Review* is that the government is continuing to attempt to reduce the role of the state, amid an economic context whereby restored economic growth is leading to employment growth, but only weak real

earnings growth. The referendum has created additional uncertainty, and is the major contributor to the government having to abandon its only recently adopted fiscal rules. However, there has been no fundamental change in the direction of UK economic policy.

References

- 1 Office of National Statistics (2016) *UK Labour Market. Dec 2016*, Figure 12 and CLA01: Clamant Count (Experimental Statistics) (available at www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/latest#employment).
- 2 Office of National Statistics (2016) *op.cit.*, Figure 6a.
- 3 See www.ifs.org.uk/tools_and_resources/budget/514
- 4 Office of Budget Responsibility (2016) *Economic and Fiscal Outlook*, Cm 9346, November, p.61. London: OBR.
- 5 Bank of England (2016) *Inflation Report*, November (see www.bankofengland.co.uk/publications/Documents/inflationreport/2016/nov.pdf).
- 6 Bank of England (2016) *op.cit.*, Table 2.
- 7 HM Treasury (2015) *Charter for Budget Responsibility, Summer Budget update 2015*. London: HM Treasury.
- 8 HM Treasury (2016) *Autumn Statement*, p.11. London: HM Treasury.
- 9 HM Treasury (2016) *op.cit.*, p.13.