3 – The UK economic recovery: Better balanced than you might think [1]

Key points

- UK economic growth since the financial crisis has been disappointing relative to past recoveries but not in relation to other G7 economies.
- The main reason for relatively weak growth has been sluggish consumer spending, particularly in the early phases of the recovery when consumers were hit by a "perfect storm" of rising VAT, high food and energy prices, and tough lending restrictions from banks. However, recent consumer spending growth has been stronger.
- Global headwinds do not seem to be responsible for subdued growth. The export contribution to UK growth has been broadly in line with historical trends and previous recoveries of a similar duration.
- Public spending "austerity" is not an obvious culprit for slower growth either. The contribution of government spending on goods and services to UK growth is small but broadly similar to the 1970s, 1980s and 1990s recoveries.
- Looking ahead, the key risk is that this relatively well balanced recovery does not last, particularly against the background of extremely low interest rates.

Introduction

The UK economic recovery – which started in the middle of 2009 – is now into its seventh year. In terms of GDP growth, it has been a relatively weak recovery, though this is not unique to the UK. In the past six and a half years, UK economic growth has averaged around 2%, significantly below the average of 3.4% for similar phases of previous post-war recoveries and also below the average trend rate of growth since 1970 (2.3%). Despite this disappointing growth, UK GDP has risen at the third fastest rate of all the G7 economies, behind Canada and the US, and our economy has rebounded more strongly than any other major European economy (Figure 3.1). The UK has also enjoyed a strong employment recovery, which has taken the employment rate to a new record high and brought the unemployment rate down to its lowest level for about a decade.

Alongside worries about the disappointing pace of recovery, there have also been concerns about its balance. Growth has been led by the services sector and manufacturing industry has lagged behind the pace of recovery in the rest of the economy – with output rising at around 1% per annum since 2009. As we discuss in Section 4 of this report, there has been a long-term decline in UK manufacturing employment, which is set to continue in the years ahead. We have not seen the "march of the makers" in the way that the Chancellor George Osborne suggested back in 2011.

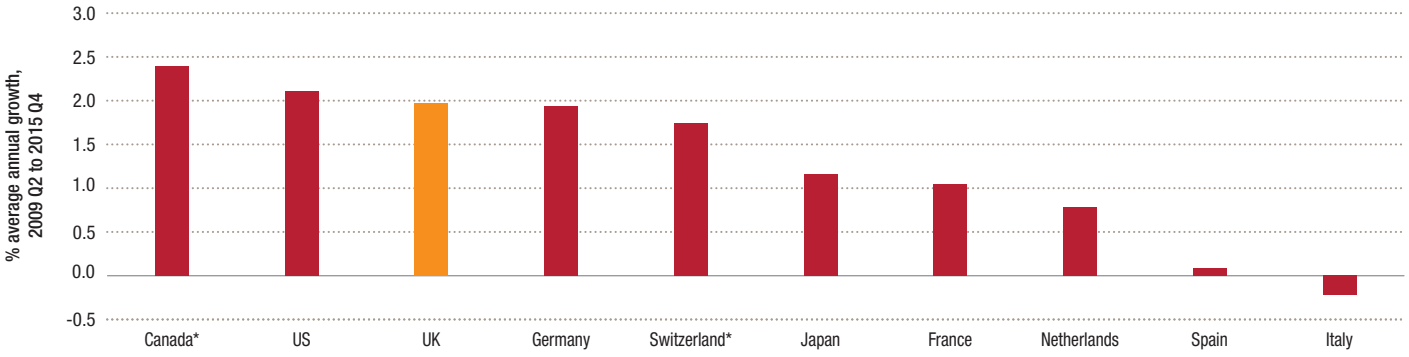
At the same time, economists have registered other concerns about the balance of the recovery. In its New Year review of economic forecasts the Financial Times found a widespread view that the UK recovery was unbalanced in some way. About half of the economists surveyed had concerns that growth was over-dependent on consumer spending or that the country's large balance of payments deficit was a significant problem.

But how justified are these fears? Consumer spending has not been particularly strong over this recovery. Household expenditure has risen on average by 1.7% a year, slower than overall GDP growth and considerably slower than the long-term rate of consumer spending growth of 2.7% per annum since 1970. Even though consumer spending has picked up in the past three years, its average growth rate since 2013 has still been below the long-term historical trend.

To understand better the drivers of this recovery and the question of the balance of growth, this article sets out a new framework for analysing the contribution of different sources of demand. The basis for this approach is set out in Section 3.1 below. Section 3.2 then uses this framework to look at the recent drivers of growth, comparing the balance between different elements to previous recoveries and long-term historical trends. Section 3.3 discusses the implications of this analysis for the issue of the balance of growth and for the sustainability and durability of the economic recovery. Section 3.4 summarises conclusions from the analysis.

1 This article was written by Andrew Sentance, Senior Economic Adviser at PwC.

Figure 3.1 – Recovery in G7 and major European economies



Source: OECD Quarterly National Accounts

*Growth to 2015 Q3

3.1 - Analysing the demand drivers of economic growth

The conventional analysis of GDP growth starts from a decomposition of GDP into domestic demand and net trade – exports less imports. This decomposition can then be used to account for the contribution of the different components of domestic spending – consumption, investment and government spending – with net trade making either a positive or negative contribution, depending on whether the growth of exports exceeds imports (positive) or import growth exceeds exports, which creates a drag on GDP growth.

As a piece of accounting this is mathematically correct, but there are a number of ways it does not capture very well the key features of a modern economy like the UK and the way it is affected by international trade. First, the contribution of net trade to GDP growth – which normally appears relatively small in this conventional GDP accounting - does not reflect the very important influence that trade has on economic growth, both in the short-term and the long-term.

In the short-term, big swings in demand in the UK economy can have very significant implications for growth, as we saw in the global financial crisis. Yet this does not show up clearly in the conventional accounting because imports often move in the same direction as exports in a recession or a boom. As a result the net trade contribution does not capture the full impact of swings in trade. Indeed, if imports and exports move broadly in line with each other, then the net trade contribution to growth will always be zero, even though the underlying level of economic activity could change. And if imports fall more sharply than exports in a recession (which is what happened in the UK in the 2008/9 recession), there can appear to be a positive net trade contribution, even though the economy has been hit by a large negative international shock.

In the long-term, globalisation and the growth of international trade are very powerful drivers of economic growth. But because exports and imports tend to grow together as world trade expands, this is not captured by the movement in net trade, which only reflects the difference between export and import growth. So over longer periods, conventional GDP accounting does not reflect the very powerful contribution of world trade to economic growth.

A second weakness of this net trade accounting approach is that it effectively counts the full weight of import growth against one component of demand – exports – whereas imports are generated by all the components of demand. Consumer spending and investment have a relatively high contribution to import growth, but this is not apparent in the accounting framework based on a net trade contribution to GDP. To understand the drivers of growth properly, we need a framework which reflects the way in which both domestic demand and exports affect import growth.

A third weakness of using net trade in the accounting framework for GDP is that it does not capture how businesses operate within the real economy. Businesses sell their output to customers at home and abroad. In terms of its impact on demand, the value of a sale to a UK customer should be seen as equivalent to the value of a sale of the same magnitude to an overseas customer. So we should be looking for a framework which treats UK and overseas customers in a broadly equivalent way in terms of their contribution to demand. On the import side there are other ways in which the net trade approach does not reflect reality. For many businesses, imports are an input into their processes, either in the form of raw materials and components or – in the case of retailers and distributors – as finished goods. The alternative to importing would be to source goods or services in the UK, so we should see imports and UK GDP as competing ways of meeting a given amount of spending on goods and services, which is driven by demand conditions.

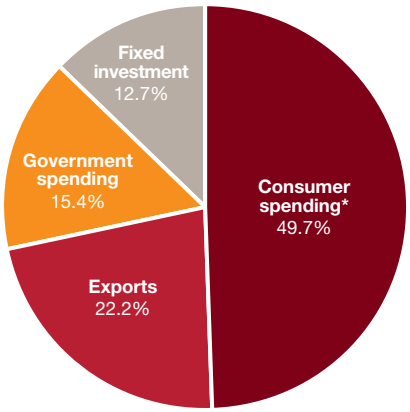
A very detailed input-output analysis of the transactions in the economy would capture these characteristics of the real economy, but it would be very complex. However, there is an alternative framework available based on the measure of Total Final Expenditure (TFE), which is the total value-added of goods and services either sold or produced in the UK.

Total Final Expenditure is made up of four main components which comprise the demand for the goods and services which the economy produces. The first is consumer spending – which is the largest component in the UK and other major economies. The second is capital investment, which is mainly undertaken by businesses, including the construction of houses and other buildings. The government also contributes to investment, for example through building transport infrastructure. The third source of demand is from overseas – exports of both goods and services. And the fourth element is the spending undertaken by the government in providing goods and services, like education and health. This is not the whole total of government spending, because the government also transfers money to households in the form of benefit payments and pensions. But these "transfer payments" only add to growth when the money is spent by consumers. So their contribution to demand is measured indirectly through consumer spending, not directly.

These four elements are the main components of final expenditure on goods and services, which drive GDP growth (when both are measured in real terms) and Figure 3.2 shows their relative contributions to TFE over the past decade. In the short-term, fluctuations in the level of stocks of materials, components and unsold goods can also play a part in influencing the level of economic activity. But, over longer periods, these fluctuations in the level of stocks do not have a significant influence on the growth of the economy. Stockbuilding is sometimes treated as a component of capital spending – i.e. investment in working capital – though more commonly it is discussed as a separate element of demand (which is the treatment used in this article).

Figure 3.2 – Composition of UK Total Final Expenditure

% of Total Final Expenditure in real terms, 2005-15



Source: ONS

Note: *Consumer spending includes non-profit sector.

The demand generated by higher spending, however, does not just boost the demand for goods and services produced in the UK. It also adds to imports from overseas – both when imported goods are part of the supply chain and when products bought by UK firms and households have been made overseas. So when Gross Domestic Product (GDP) is calculated, the value of imports has to be subtracted from total final expenditure. The key equations for understanding the growth of the economy from the demand side are therefore:

1) TFE = C + I +X + G + Stockbuilding

(TFE = Total final expenditure,
C = Consumer spending,
I = Capital investment,
X = Exports, and
G= Government spending on goods and services) and

2) GDP = TFE – Imports

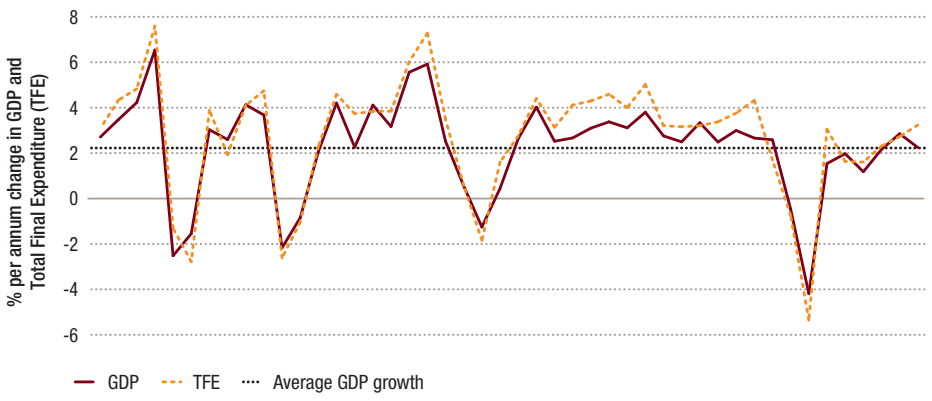
If final expenditure and imports grow at the same rate, then GDP growth will be in line with TFE growth. But if imports grow faster than spending, then GDP growth will be below the rate of growth of TFE – which has normally been the case for the UK economy. Figure 3.3 shows how GDP and TFE growth have moved closely together in the UK economy since 1970.

3.2 - The drivers of UK recoveries – past and present

This accounting framework provides an alternative and arguably more realistic way of decomposing GDP growth. Instead of using net trade, the contribution of exports and imports can be assessed separately. The way in which they feed into the growth accounting calculation is different, however. Exports add directly to demand, but it is only if imports grow faster than total spending (TFE) that they detract from growth. If imports grow more slowly than TFE, then their contribution to economic growth will be positive because that allows GDP to rise faster than total demand measured by TFE.

To set the context for analysing the current recovery, it helps first to look at the historical pattern of growth and the contribution of the different drivers identified by our framework. Table 3.1 shows two sets of benchmarks that we can use for our analysis. The first is the long-term historical trend, which is measured from 1970. The second is the experience of previous UK recoveries – measured, where possible, over the first six-and-a-half years of growth – which is the current length of the recovery we have experienced so far since mid-2009.[2]

Figure 3.3 – UK economic growth since 1970



Source: PwC analysis, ONS

Table 3.1: Contributions to UK growth: past trend and previous recoveries

	Contribution to TFE growth: % points per annum					TFE (% p.a.)	Imports (% p.a.)	GDP (% p.a.)
	Consumer	Investment	Exports	Gov't	Stocks			
1970-2015	**1.34**	**0.28**	**0.73**	**0.32**	**0.07**	**2.74**	**-0.46**	**2.28**
Recoveries								
1948-55	1.45	1.12	0.54	0.96	-0.33	3.74	-0.07	3.67
1975-79	1.18	0.87	0.90	0.26	0.60	3.81	-0.25	3.56
1981-87	2.02	1.01	0.74	0.18	0.33	4.26	-0.65	3.61
1991-97	1.72	0.27	1.22	0.13	0.28	3.62	-0.88	2.74
Average	**1.59**	**0.82**	**0.85**	**0.38**	**0.22**	**3.86**	**-0.47**	**3.39**

Source: PwC analysis of ONS data

Not surprisingly, consumer spending is still the largest single contributor to growth, accounting for nearly half of TFE growth since 1970 and just over 40% of demand growth in previous recoveries. Exports are the second most important contributor to the growth of demand both in the long-term and in recoveries. Investment makes a big contribution during recoveries, but a smaller contribution to trend growth as it is highly cyclical – falling sharply in downturns and then bouncing back as economic confidence recovers.

Government spending, however, is normally the smallest contributor of the major demand components in recoveries. This is an important point to bear in mind when considering the view that "austerity" in public spending plans is responsible for slow growth in this recovery. It would be surprising if the smallest major contributor of demand to economic growth in a recovery could exercise so much leverage on the path of the economy in this recovery.

2 See earlier UK Economic Outlook articles by Andrew Sentance on services productivity here: http://www.pwc.co.uk/assets/pdf/ukeo-jul2015.pdf and on the contribution of services to regional growth here: http://www.pwc.co.uk/services/economics-policy/insights/uk-economic-outlook/ukeo-nov2014-getting-the-balance-right-in-the-uk-regions.html

So how does the pattern of growth over this recovery compare with past historical experience? As we noted earlier, there have been two different phases to the current recovery. Until the end of 2012, GDP growth was relatively sluggish, averaging around 1.5% per annum. Since then, it has averaged around 2.5% - above the long-run trend and closer to the growth we have seen in previous recoveries. Table 3.2 shows both phases and the contributions to the average growth rate of 2% since 2009, which is then compared to the long-run historical trend and the average experience of previous recoveries.

Table 3.2: Contributions to UK growth: the current recovery in context

	Contribution to TFE growth: % points per annum					TFE (% p.a.)	Imports (% p.a.)	GDP (% p.a.)
	Consumer	Investment	Exports	Gov't	Stocks			
2009-12	0.47	0.39	0.72	0.12	0.33	2.04	-0.52	1.52
2013-15	1.24	0.60	0.73	0.27	0.06	2.91	-0.39	2.52
2009-15	**0.84**	**0.49**	**0.72**	**0.20**	**0.19**	**2.42**	**-0.44**	**1.98**
Differences of 09-15 from:								
1970-15	-0.50	0.21	0.00	-0.13	0.13	-0.30	0.00	-0.30
Previous recoveries	-0.75	-0.33	-0.13	-0.19	-0.02	-1.41	0.01	-1.42

Source: PwC analysis of ONS data

The most striking feature of the analysis in Table 3.2 is that the weakness of consumer spending is the main difference between the pattern of demand in this recovery and previous experience. Despite all the concern about the weakness of the world economy – often referred to as global headwinds – the contribution of exports to growth since 2009 has been similar to previous recoveries and historical trends. It is worth recalling that UK recoveries in the 1980s and 1990s also took place against a turbulent global economic background. In the 1980s there was a major debt crisis in Latin America, and in the 1990s Europe went into recession in 1993 just as the UK recovery was getting underway. European growth was sluggish through the 1990s as Germany grappled with the challenges of unification, just as it has been disappointing over much of this recovery. Yet exports made a very strong contribution to growth in the 1990s recovery, as Table 3.1 shows.

The weakness of consumer spending was particularly noticeable in the early years of the current UK recovery. Household spending was squeezed over this period by a combination of sluggish wage growth and high inflation. As inflation fell from a peak of over 5% in late 2011 to 2% by the end of 2013, the pressures on household expenditure eased. In the past three years, consumer spending has made a more normal contribution to the recovery. Another component of demand which has been making a stronger contribution since 2013 has been investment. However, this is less to do with business investment, which has grown fairly consistently since the financial crisis. Investment has been boosted since 2013 by a bounce-back in housing construction, helped by government initiatives like Help-to-Buy and Help-to-Build. The squeeze on government investment has also eased over the past few years.

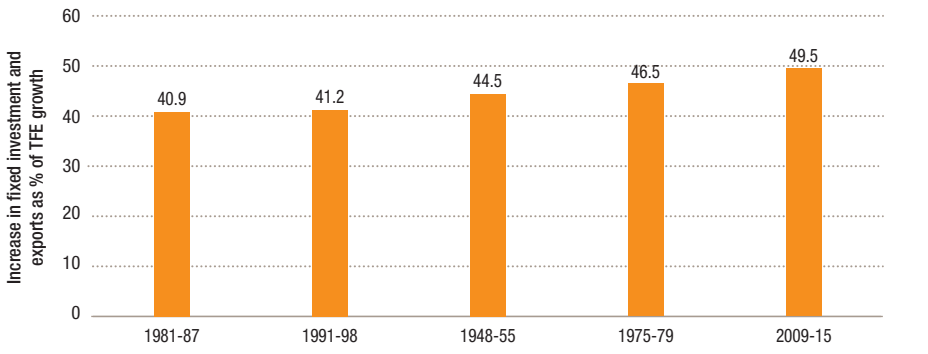
What has been the contribution of "austerity" to the pattern of weaker growth of this recovery compared to the past? The contribution of government spending – adding about 0.2 percentage points to TFE growth over the recovery – has been very similar to the growth contribution made by public spending in the 1970s, 1980s and 1990s recoveries. Probably the main impact of government fiscal plans were felt in 2010 and 2011 when the VAT rate was increased from a reduced rate of 15% to 20% in the space of two years. This added to the squeeze on households in the early phase of the recovery and contributed to the weakness of consumer spending. But there were other powerful factors adding to this consumer squeeze as well, including the impact of high energy and food prices from 2010 to 2012 and restricted access to finance for borrowers following the financial crisis.

3.3 - The balance of the recovery

This analysis suggests that some of the commonly expressed concerns about the balance of the UK economic recovery are exaggerated and misplaced. Consumer spending has made a lower contribution to economic growth across this recovery than in the equivalent phase of any previous post-war recovery. Meanwhile, investment and exports contributed jointly around half of the demand growth we have seen since 2009 – the first time this has happened at this stage of any post-war UK recovery. Figure 3.4 shows that the ratio of investment and export growth to increased consumption has been the most favourable of any of the previous recoveries of this duration that we have experienced since the Second World War.

However, that still leaves us with some puzzles about the balance of the recovery. First, why has manufacturing been struggling so much when exports have been doing relatively well? The answer here lies in the success of the UK's services exports, which have been discussed in a number of recent articles in previous editions of this report.[3] Indeed, in the second half of last year, the UK exported more services than manufactures for the first time in its history. Given our comparative advantage in services exports – not just in the financial sector, but in business and professional services and a wide range of other creative and knowledge-intensive activities – this pattern is likely to continue into the future.

Figure 3.4 – Recovery driven by investment and exports



Source: PwC analysis of ONS data

A second puzzle relates to the balance of payments. The UK has a total balance of payments deficit which has averaged nearly 4% of GDP in the past couple of quarters. However, the relatively high deficit does not reflect a significant deterioration on the trade account. Our trade deficit has been around 2% of GDP or so for the past few years and, if anything, it has narrowed slightly in recent quarters. Rather, UK firms and investors are receiving less income from their activities overseas than we are paying out to foreign firms and investors. This may be a temporary phase linked to slow growth in Europe and other weak spots in the world economy. Or it may be the start of a longer term pattern. But the key point is that the balance of payments figures do not reflect poor UK trade performance. As this article has argued, the contribution of exports and imports to our growth over this recovery has been broadly in line with past trends.

There are, however, risks for the future which we need to be aware of. The household savings ratio has fallen quite sharply in recent years and one of the drivers of this shift has been a recovery in mortgage borrowing, which has also been associated with higher house price inflation – particularly in London and the South-East. So a well-balanced recovery so far could become less balanced in the future, and this is one of the risks of a prolonged period of low interest rates. Persistent delays in taking the first step to raise interest rates in the UK could be aggravating the prospect of excessive borrowing and other financial risks.

3 Quarterly data is only available from 1955 so the first post-war recovery period is measured using 7 years of annual data (1948-55). The late 70s recovery came to an end in 1979, so is measured over 4¼ years rather than 6½ years (1975Q3 to 1979Q4). The periods used for analysis of the other recoveries shown in Tables 3.1 and 3.1 are 1981Q1-1987Q3; 1991Q3-1998Q1; and 2009Q2-2015Q4.

3.4 - Conclusion

Every phase of economic growth is different, so there is no such thing as a typical recovery. This recovery has been characterised by weak consumer spending growth, particularly before 2013, and this has exerted a drag on the overall rate of expansion of the UK economy. In other respects, however, the pattern of growth does not look abnormal. Despite concerns about global headwinds and disappointing world growth, the contribution of UK exports and imports to our recovery has been much in line with previous experience. The role of public spending on goods and services has also been much in line with our experience from the 1970s, 1980s and 1990s, when the UK government was also trying to control deficit spending. From a macroeconomic perspective this has not been an unusual period of austerity in government spending. The main dampening influence on growth from fiscal policy has come from the effect of the two VAT rises earlier in the recovery on consumer spending – which are now behind us.

Concerns that this has been an excessively consumer-driven recovery so far are misplaced. Investment and exports have contributed about half of total growth, above their historical contribution, whereas consumer spending has contributed just about a third. The UK's balance of payments deficit reflects shifts on the income side of the account rather than poor trade performance. So far, this recovery has been better balanced than many economists recognise. The challenge looking ahead is to keep it that way.

Design Group 30431 (03/16)

www.pwc.co.uk/economics