Long and winding road

Ten years on and still feeling the effects

Trevor Williams considers the UK economy ten years after the financial crisis

AUTHOR

Trevor Williams is a Visiting Professor at Derby University & Chairman of the IEA Shadow Monetary Policy Committee

It was ten years ago this September that Northern Rock failed, triggering in the following year the rescue of Royal Bank of Scotland and Lloyds Bank after it had in turn rescued HBOS. Those once-in-one-hundred-years events epitomised the gravity of the situation facing the UK economy and, more broadly, the risks to the global financial system.

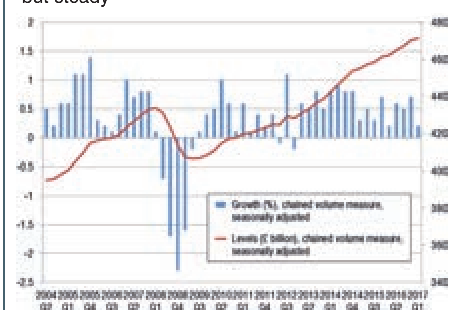
On the tenth anniversary of those seismic events, what has happened to the UK economy?

Growth recovery

Starting with the broadest measure of economic activity, GDP, there has been a recovery – albeit unspectacular compared with that from previous downturns. The economy is 8.7% bigger than it was at the peak level of output in quarter one in 2008 before the onset of the recession in 2009 (**see Chart 1**). It could be said, however, that since that peak was ten years ago, an average pace of 0.9% economic growth per annum is hardly stellar.

Since 2007, and to a greater extent than previously, the biggest contribution to UK economic growth has come from services,

Chart 1: UK economic recovery has been weak but steady



while manufacturing and construction lag and struggle to match their pre-crisis levels. Total growth is up 8.7% since 2008, but services output is up by 14%. Manufacturing output is 4.6% below its 2008 peak, and construction output is 5.6% ahead of its 2008 pre-crisis high.

However, the pace of the recovery has been slowing since 2015, and according to recent forecasts from the Organisation for Economic Corporation and Development (OECD) and the International Monetary Fund (IMF), the UK will be the slowest growing of the Group of 7 (G7) economies this year and next. Indeed, the OECD projects that UK growth could be as low as 1% in 2017 from whatever pace is registered this year, which ironically would almost bring it bang in line with the average since the crisis.

Admittedly, they do not have a terrific record of forecasting the UK economy's path correctly, but their arguments will nonetheless get a hearing. Their view seems to be that policy uncertainty about Brexit will hit investment, deter productivity gains and, via a weak exchange rate, hit real earnings and so slow economic activity. Nonetheless, the main point is that the UK's economic recovery has been sluggish by historical standards as it's been held back by certain factors including some the OECD has mentioned.

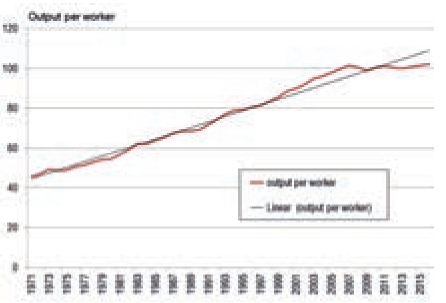
Employment has been the success story

Now, you may be asking yourself how, if the economy has only grown at around 1% a year since 2008, it is that the rate of unemployment has fallen so much? The answer, of course, is that productivity has been non-existent, meaning that growth has come from employment. If productivity growth had been stronger and real wages higher, perhaps the rate of employment would not have been great and the fall in the rate of unemployment not as pronounced. Of course, we will never know the answer to that question, but the evidence is that productivity has been weak.

Chart 2 shows that UK productivity has not increased since 2007 – moving sideways at best – and is well below the long run trend, by 18% in fact. Why should this be?

The lingering effects of the crisis are often cited. Perhaps it is owing to the uncertainty created by the crisis, resulting in a lack of business investment growth. Or it could be a lack of finance for firms due to damaged balance sheets of lenders, reluctance by borrowers to invest due to worries about their gearing levels, or too high survival rates for poor performing companies so that they reduce profits for solvent businesses and lower their investment. Also, could it be that companies would rather employ people with the flexibility of cutting back if demand for their products falters than invest in expensive plant and machinery that could leave them vulnerable if the cycle turned against them?

Chart 2: UK productivity has stagnated

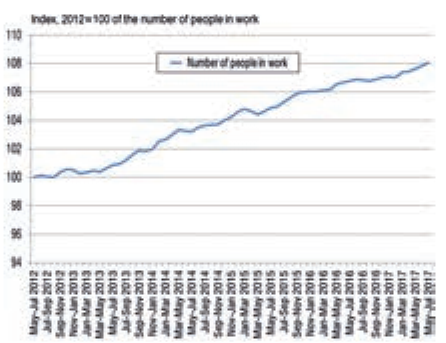


> "It is a dilemma for the Bank of England. On the one hand, a rise would unwind the unnecessary cut from last year, but on the other hand, frustratingly, they could be doing it just as the economy requires a relaxed stance."

But at the expense of reduced productivity and weak wage inflation

It is likely that a host of factors such as these, or combinations thereof, are at play, but the evidence is clear: productivity, the lifeblood of growth, real pay increases and higher living standards, has been very weak since 2007. UK growth has primarily come from greater numbers in employment (**see Chart 3**) and not from their productivity. Employment is currently at the highest level ever, at some 32.2 million, with the employment rate of 75.3% the highest since 1971 when records were first compiled on this basis. One thing is certain; these employment numbers do not suggest that the 'rise of the robots' is hitting job growth.

Chart 3: Sharp rise in the number of people in work



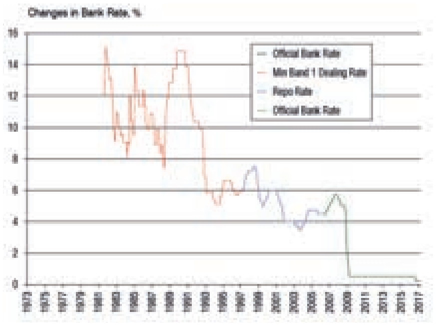
Indeed, some argue that full employment is dangerous for productivity, as when the economy approaches full employment the last people to be hired will have the lowest marginal productivity. Over the same period, though, real and nominal pay has declined, in line with what one would expect if there were no gains in productivity. **Chart 4** shows that adjusted for inflation actual pay is once again falling, after dropping continually between July 2008 and October 2014.

Chart 4: UK real pay is falling

Interest rates still at record lows – for now

The evidence of pay and falling unemployment without any rise in price inflation that can be attributed to it puts questions marks on what happens to policy rates in the months ahead. Since 2008, interest rates have tumbled. **Chart 5** shows that bank rate, instead of rising as the crisis fades, has fallen further. With the economy on the cusp of a slowdown, talk of the first rate increase since July 2007 may be premature. Although the cut in rates last August was to calm fears after the result in the referendum to leave the EU, economic conditions since then have deteriorated.

Chart 5: UK bank rate still at record lows



Economic growth this year looks like it might be a little less than it was in 2016, which in turn was slower than in 2015. Next year, growth looks like it will be even weaker, as the world economy accelerates. It is argued that price inflation of 2.9% for the year to September is so far above the 2% target that it justifies a rate response. But all of the rises can be attributed to the fall in the exchange rate since last year. Next year, as the exchange rate effect drops out of the annual comparison, price inflation will fall back, just in time for the economic slowdown.

It is a dilemma for the Bank of England. On the one hand, a rise would unwind the unnecessary cut from last year, but on the other hand, frustratingly, they could be doing it just as the economy requires a relaxed stance. Ten years on, the effects of the financial and economic crisis do not seem to have yet faded away completely.