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Economic healthcheck

A return to growth, but no recovery

GDP can't tell us everything about how an economy is performing. The UK might now have returned to growth, but underlying problems remain. Only by looking at a set of alternative economic indicators can we identify what these are, and how to move towards a secure, long term recovery.

The British economy appears to be returning to something approaching health. Consistent GDP growth has been welcomed by the Coalition Government as proof that its economic programme of austerity measures is now finally working. The long-delayed recovery is finally on track.

But as Chancellor George Osborne has himself admitted, this recovery bears little resemblence to the one he and the Coalition originally wanted.[1] In June 2010, the Office for Budget Responsibility (OBR) forecast an investment- and export-led recovery , where businesses significantly increased their spending to generate jobs and boost real wages. By 2013, they expected business investment to have risen 11%, and real earnings by 4%.

This hasn't happened. Investment is down 3.5% from this time last year, and median earnings have fallen for the longest period since official records began in 1964. GDP may be going up, but things are not going to plan.

GDP is an increasingly inadequate measure of progress. Over the last decade or more the presumed link between increasing GDP and rising living standards has broken down for most people, with real wages failing to rise with economic growth.[2]

So to discover what is really happening to our economy, we need to look beyond GDP. This paper sets out five indicators that allow us to better understand the short-term reality of the Coalition Government's recovery and what it means for our economy in the long term. All five are standard economic statistics, either publicly available, or based on official sources. They are

1. Unsecured borrowing by households
2. House prices vs. average earnings
3. Average real earnings
4. Output per hour worked
5. Investment as a share of GDP

George Osborne himself has acknowledged that the recovery is 'unbalanced' and 'not secure'. And looking beyond the single measure of

GDP we can see this is an understatement. The five alternative indicators above, taken together and backed up by some additional context, reveal serious underlying problems in the British economy that must be addressed.

What our economy is going through now is not so much a recovery as a *reversion.* We're going back to pre-2008 patterns of debt-led consumption growth masking low real earnings for most. But post-crash, with debt levels still high, these patterns are even more dangerous.

Unsecured borrowing by households

What is it: Unsecured lending is borrowing by households that is not attached to collateral. It excludes the biggest chunk of household borrowing – mortgages – but includes things like credit cards, loans from retailers, and (increasingly) other forms of consumer borrowing such as payday loans.

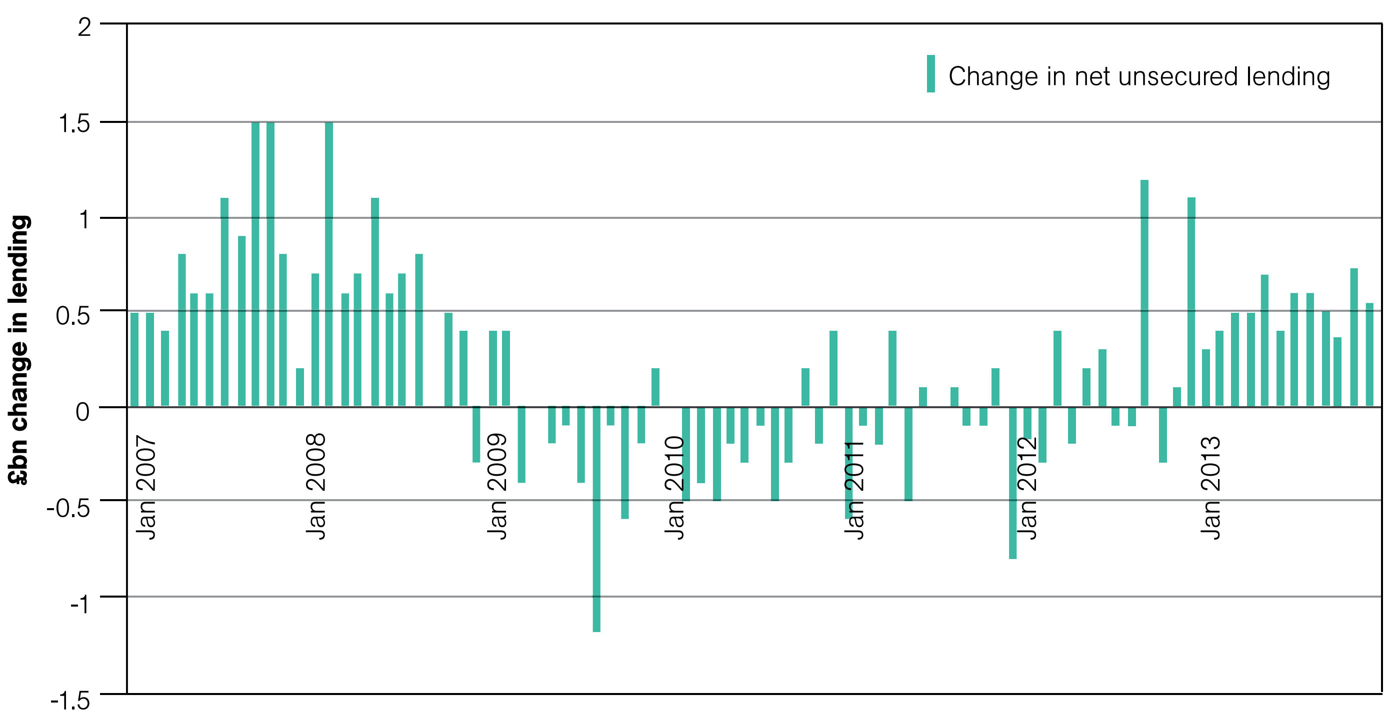
Why it matters: Unsecured lending can act as an early indicator of a return to unsustainable growth. If it is rising rapidly, it means that households are taking on more debt.

The boom of the 2000s was driven by exceptional increases in borrowing by households. UK consumers hit the crash with the highest level of debt, relative to disposable income, of any large developed economy, holding debt equivalent to just over 100% of GDP.

Since the crash, many reined in their spending to try and pay off or at least stabilise this enormous burden. The saving ratio, which shows what proportion of their income households are saving, had been falling since 1992, but suddenly rebounded. As households stopped spending, the economy was pushed into recession. While it made sense for individual households to cut their expenditures, for the economy as a whole it meant less was being sold overall, driving the recession. Government austerity plans reinforced this effect, tempered slightly by the "automatic stabilisers" of non-discretionary expenditure like benefits.Austerity – attempted savings by government – had exactly the same impact.

Households are finally spending again. But this rise in consumption over the last year has been bought through a fall in savings, with consumption spending rising at the highest

Figure 1. Unsecured lending to UK households 2007–2014



Source: Bank of England

rate since the first three months of 2008. Over the last year, the household savings ratio has dropped – from 7.2% in 2012 to 5.3% during the first three quarters of 2013.[3] And with the fall in savings, have come the first indicators of a return to unsustainable debt-fuelled consumption. This can be seen directly in the figures for household unsecured lending, released monthly by the Bank of England. 'Unsecured lending' is borrowing by households that is not attached to collateral – so it excludes the biggest chunk of household borrowing, mortgages, but includes things like credit cards, loans from retailers, and (increasingly) other forms of consumer borrowing such as payday loans.[4]

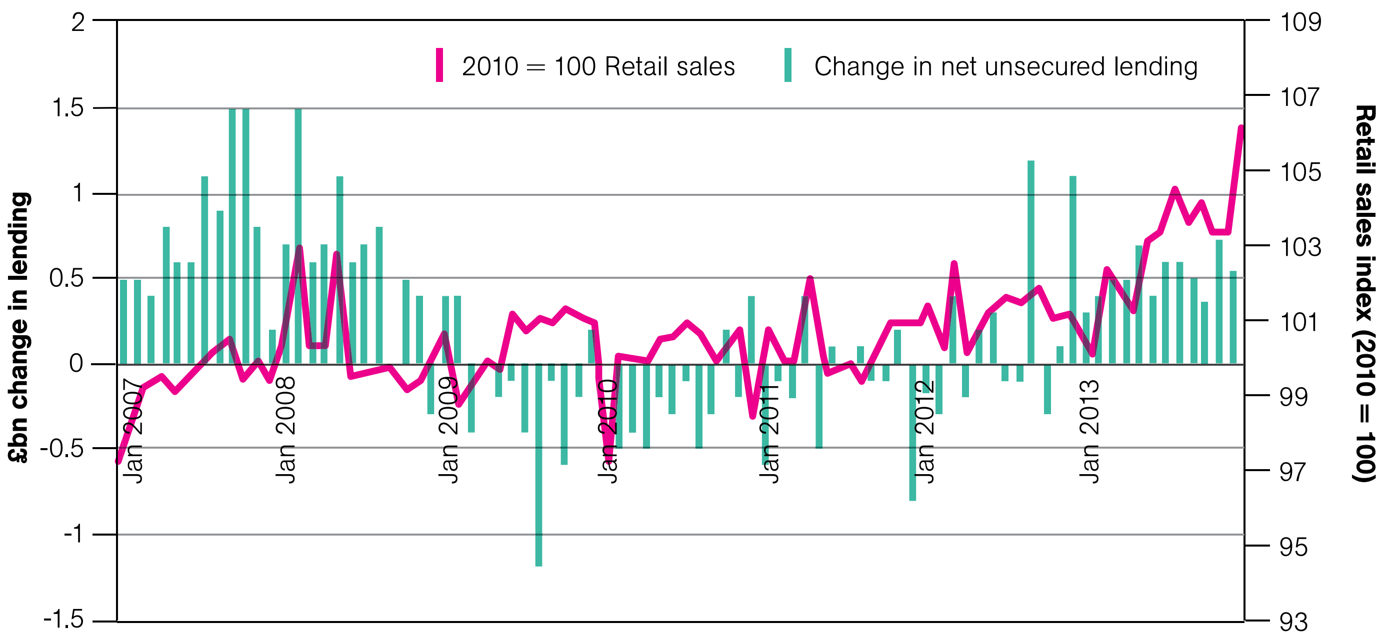
As figure 1 shows, there is a close relationship between wider economic growth and unsecured lending. Prior to the crash in 2008, households were borrowing in large and increasing volumes. But once the crash hit, unsecured lending fell consistently, with households borrowing less and less each month. Only at the start of last year, from early 2013 onwards, did household borrowing begin to pick up once more.

Unsecured lending to households rose consistently throughout the last year as people began to borrow more. This consistent rise in borrowing, in turn, has helped fuel consumer spending, as indicated by the index of retail sales shown here for comparison. Much of this borrowing is coming from non-traditional sources, outside the conventional banking system. For instance, the rise in car sales has been sustained by record levels of credit being offered directly to consumers by car manufacturers. 75% of cars sold during 2013 had a financing deal attached – compared to pre-crash levels of just 50%.[5] Some of the increase in spending may also be due to the one-off compensation from Payment Protection Insurance mis-selling, amounting to £12bn over the last 18 months.

SUMMARY

Unsecured lending is helping to drive consumer spending. We are returning to the unsustainable economic conditions of the 2000s.

Figure 2. Unsecured lending and retail sales 2007–2013



Source: Bank of England, ONS

House prices vs. average incomes

What it is: The ratio of house prices to what people earn on average.

Why it matters: Rising house prices alone don't tell us much about the strength of the economy; it's whether people can afford them that counts. Comparing house prices to earnings gives us a sense of how sustainable any house prices rises are. If they rise significantly above earnings, it's a clue that households are having to borrow more – taking on larger and larger mortgages that they risk not being able to pay back. This was exactly what happened in the run up to the financial crisis of 2008/9.

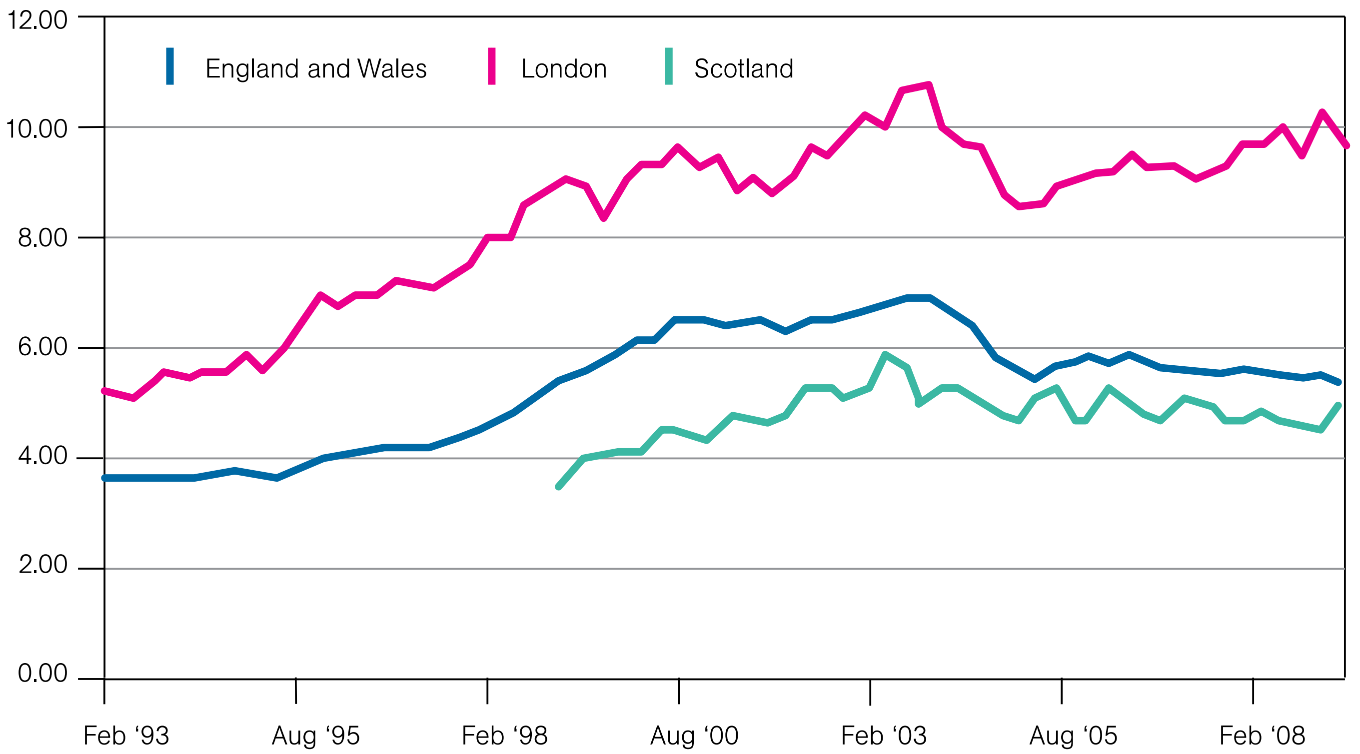
The trends

Rising household debt was sustained, prior to the crash, on the basis of rising house prices. As houses became more expensive, larger mortgages were needed to purchase them; whilst at the same time, the improvement in net wealth that rising house prices represented, allowed households to borrow on top of their mortgages. Rising house prices can promote additional borrowing as individuals may utilise their property value either directly, as collateral for borrowing, or indirectly, through increased access to credit in other forms. Or, they may simply feel more prosperous and secure. This relationship between house prices and the wider economy, via borrowing, appears to have grown stronger over time.[6]

The crash of 2008 dragged house prices downwards sharply. The average price of a UK house fell by 16.3% during the course of the year - the biggest annual drop on record.[7] Since then, prices appear to have recovered, rising 5.5% over the last year.

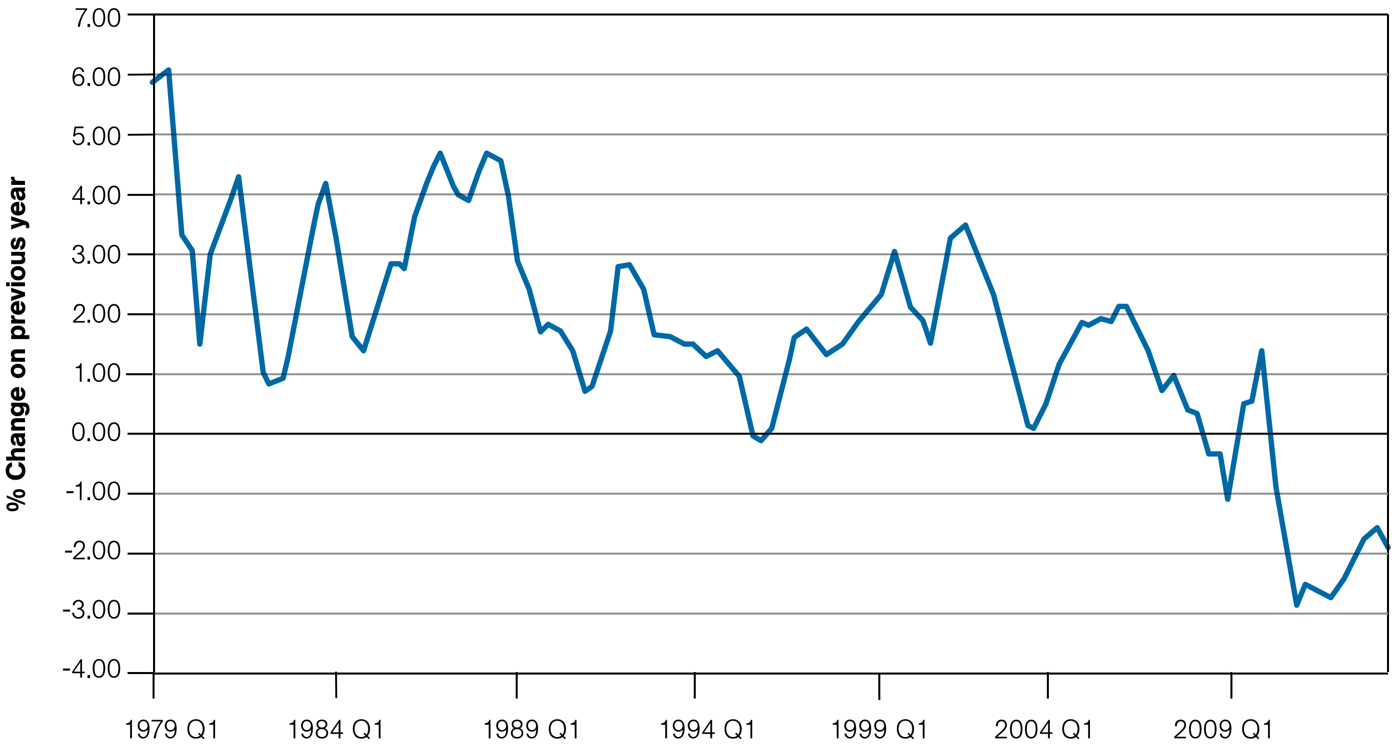
But house prices alone, may not tell us much. It is possible, at least theoretically, that the current extraordinary increase in house prices in places like London is driven by changes in actual earnings – people can spend more on houses because they are earning more. We need a measure that shows a relationship between

Figure 3. Average house prices:earnings, England and Wales, Scotland, and London, 1997-2013



Source: ONS, Land Registry

Figure 4. Average real earnings growth, 1979–2013



Source: ONS

house prices and earnings, since this would give us a better sense of the sustainability of the price rises. If prices are rising significantly above earnings, there is an implication that a greater mass of borrowing is being taken on by households – and larger and larger mortgages will be needed.

There is, however, a further complication. Increases in London house prices have been truly remarkable, with the average value of a house, across the whole city, increasing by 12.5% in 2013. But across the country as a whole, while there are some notable hotspots, the pattern is less dramatic. Indeed, in the north east, prices actually fell a little. The rise across the UK, excluding London, is 3.1%.[8]

In addition to showing the ratio of average prices to average earnings, therefore, we should also aim to show the regional differences. The graph below attempts this, separating out London from England and Wales jointly, and Scotland.

It is clear that the London property market, at least, is functioning rather differently to the rest of the country. The average house price in London is now over ten times average earnings – a level very close to that seen at the peak of the property market, prior to the crash. Indeed, while house prices fell in London, as they did across the rest of the country, they recovered with astonishing speed.

Aside from the implications for living costs in the capital, most obviously for those unable to buy a house, this concentrated inflation of house prices has consequences for the shape of the recovery. This is because recovery is tied closely to a rise, not in real earnings, but in consumer spending - fuelled by falling savings and a steady return to borrowing – which is why changes in wealth held by individuals are decisive.

If house price increases are located only in one area, then the boost to the economy will be concentrated solely in one area too. Early indications suggest that this is precisely what is happening. Since 2010, 79% of new private sector jobs created have been created in London. The next five largest urban areas account for just 10% of jobs between them.[9] Over the last year, for every four new jobs created in London and the greater south-east, just one was created in the rest of the country. The UK is already the most geographically unequal country in the EU; whilst central London is the wealthiest single area on the continent, parts of England and Wales are comparable in per capita income terms, to recent EU accession countries such as Bulgaria and Romania.

SUMMARY

House price rises are helping fuel GDP growth, as in the 2000s. But the effects are now more unevenly spread now, meaning growth is also extremely uneven.

Average real earnings

What is it: The amount earned by the average individual once inflation has been accounted for.

Why it matters: This is the figure that perhaps has the most immediate impact on most people's standard of living. If median earnings are not keeping up with inflation, it is likely most people are suffering a real decline in living standards.

The trends

The pressure on households' living standards has contributed to intense debate between the two main political parties, especially in relation to how best to measure real earnings accurately – that is, earnings after taking account of inflation.

It is helpful, however, to place the issue in an historical context. This is the longest sustained decline in living standards for most people since official records began, in 1964. The graph below illustrates just how unusual the period is, showing year-on-year changes in average real earnings.[10] While average income growth has moved up and down with the economy, the period since 2008 appears to be a clear break with the past. Real earnings fell sharply in that year, recovered somewhat over 2009, and then fell very sharply in 2010. They have, since 2010, fallen year-on-year.

Understanding the causes of this exceptional slide in most people's standard of living is complex. We argue that there are two main parts to the story. First, that the response of employers as the crash hit in 2008 was to make use of a 'flexible' labour market to limit total redundancies, while pushing for reduced overall hours. Redundancies were somewhat compensated for by an increase in part-time work from 25% to 27.5% of the workforce, over 2008-9. Unemployment, while rising (particularly for the young), did not rise as high as might have been expected in a severe recession. Average hours worked fell 14% in 2009, but hourly wages remained fairly stable.

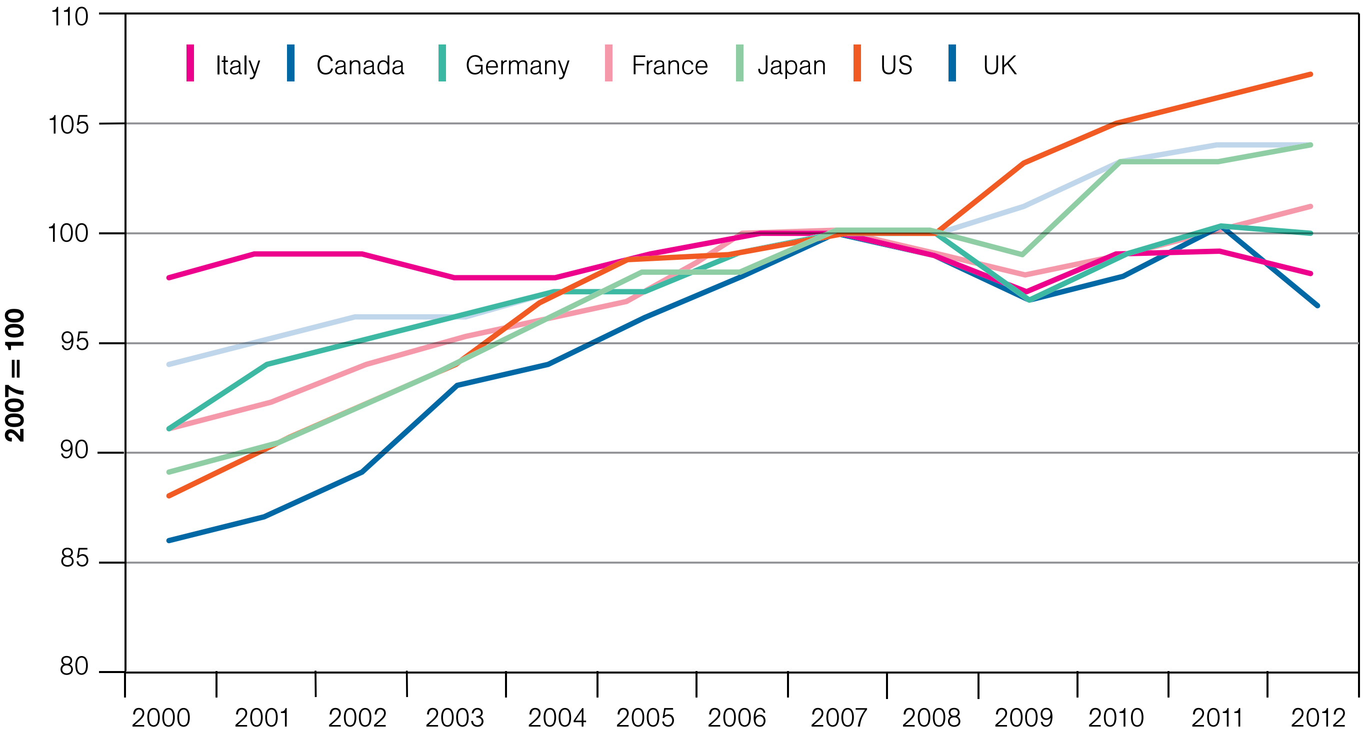
However, there is a second part to the story. As markets shrank in the recession, firms sold less of their output. Productivity, measured as output sold per hour worked, declined sharply. This applied significant pressure on firms to cut costs, and during 2010, real pay per hour fell by nearly 2%. This decline was compensated for in part, by an increase in hours worked. Between 2010 and the end of 2012, hours worked increased by 11%. Unemployment has since fallen, but real earnings have fallen faster. Despite the increase in hours worked, the number of people reporting that they are underemployed (working fewer hours than they would wish) has risen to record levels. Meanwhile, jobs are being created consistently in lower-paid and more insecure sectors of the economy, with four out of five jobs created since 2010 where the average hourly wage is less than one-quarter of average earnings.[11]

A specific feature of this shift in the labour market has been the expansion in self-employment. There has been a decline of 434,000 employees since 2008, but a rise in self-employment of 367,000 over the same period of time. Of that increase, 60% has been since 2011.[12] This is not a spontaneous blossoming of the entrepreneurial spirit. Average earnings from self-employment have fallen from £15,000 before the crash, to £10,400 by 2011.[13] The evidence points to a rising rate of self-exploitation by the self-employed, desperate to find work, however ill-paid. This is the 'flexible' labour market in operation.

SUMMARY

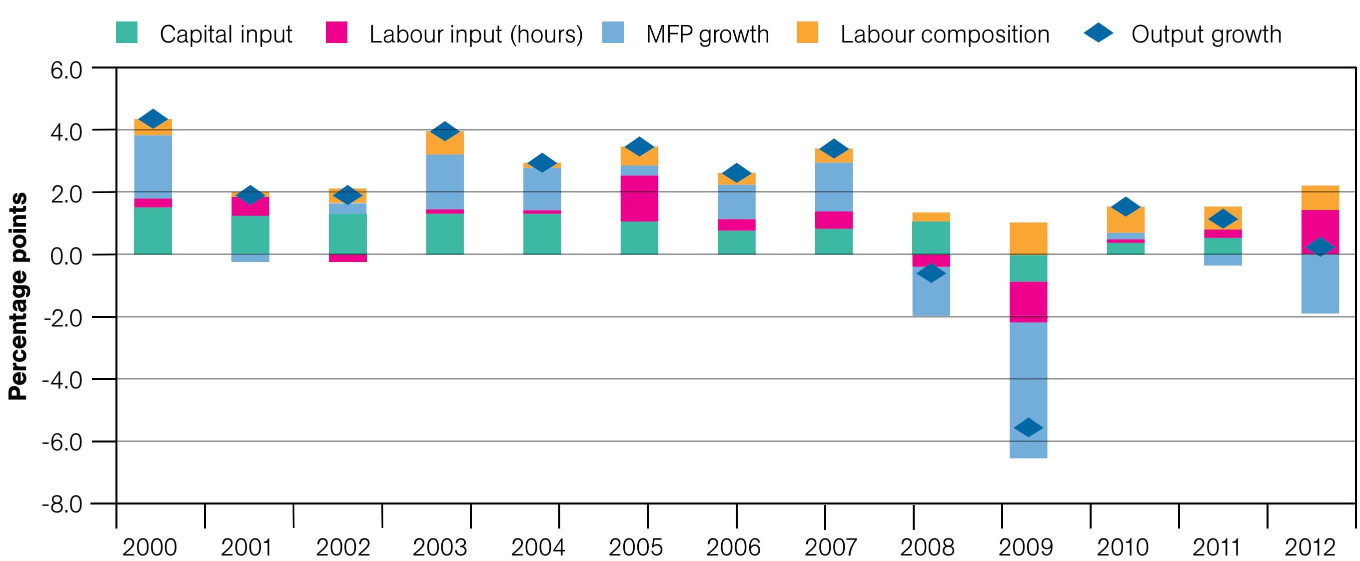
Real earnings are still declining, squeezed by employers looking for ways to cut costs. The labour market has provided little security. Rising debts and falling earnings will present a major risk in the future.

Figure 5. Output per hour in G7 countries, 2000–2012



Source: ONS

Figure 6. Components of output growth, 2000–2012



Source: ONS

Productivity

What is it: output per hour worked.

Why it matters: Productivity matters because it sets the boundaries for wage and salary increases. If output per hour rises, increases in real earnings can be paid more easily by firms. If productivity is not increasing, wages and salaries can only rise consistently with a redistribution of income away from capital and towards labour.

The trends

The decline in real earnings hinges on productivity. As is typical in a recession, measured productivity declined over 2008-9, with less output being sold but a delayed response in employment. However, while every other major developed economy has seen a rebound in their productivity,[14] in the UK it is still flat or even declining.[15] This has given rise to the so-called 'productivity puzzle': why is productivity in the UK so weak?

The more benign part of this answer is 'labour hoarding'. Firms do not necessarily adjust their demand for labour when faced with falling demand for their products. Prior to company closure, and rather than enforcing redundancies, firms may 'hoard' their workforce, holding on to workers until the good (or at least better) times return. This is not an act of kindness; there are well-known advantages to retaining a workforce, even when it is costly to do so. People learn on the job; they have valuable skills and experience that would be expensive to reproduce if laid off. Much of this knowledge will be firm- or site-specific, making it harder to reproduce. Alternatively, a firm may decide to hold on to labour, in the face of what it believes to be a temporary disruption to its markets, to avoid the additional costs of redundancy and rehiring.

In either case, there is the potential for a comparatively benign outcome: workers keep their jobs, the firm keeps trained workers, and earnings in the whole economy are sustained. The argument has been made that government should actively seek to support 'excess' employment of this type, given the wider benefits. Recent German policy has attempted to do just this, as has the Welsh Assembly (on a smaller scale).[16]

However, while this benign effect may account for a little of apparent robustness of the labour market, it doesn't account for very much. It is not clear why firms in the UK's flexible labour market would want to hoard labour, given the comparative ease with which workers can be hired or fired.. Earlier work by the Bank of England suggested that labour hoarding in the UK was declining with increasingly flexible working practices, as appears to be indicated by the rise in self-employment.[17] The rise in employment is evidence against labour hoarding: if firms were hoarding labour, they would not need to take on additional work. Indeed, since the work being created is generally in low-paid sectors, where we would expect the benefits of hoarding to be minimal, the presence of much hoarding seems highly unlikely.

Further, we can show how total growth in output is driven by different factors. Breaking up the headline growth figure into different components, we can begin to see the whole story: a contribution from labour, a contribution from capital, and 'multi-factor productivity' (MFP). This last is intended to capture productivity gains made that arise from improvements in overall efficiency – not just by applying more of any particular input. It is, however, a difficult measure to rely on, since it is calculated as the difference between the contributions of other inputs, and overall growth. In other words, it is a residual measure, capturing efficiency improvements and everything else not properly recorded.

The dramatic impact of the crash can be seen very clearly in Figure 6. MFP falls through the floor, as firms' output falls but their use of inputs remains much the same: labour in 2009 was being hoarded. However, in subsequent years – especially 2012 – something peculiar happens. As the number of hours worked increases, it makes a positive contribution to growth. MFP, however, becomes negative, pulling down overall growth. This cannot be the result labour hoarding by firms, since labour is working more hours. It is an early indicator that something more fundamental may be happening – measured productivity growth will now, potentially, be permanently lower, or at least restrained for the foreseeable future.

SUMMARY

Weak, or even falling, productivity has meant employers are looking to cut costs, which has appeared as falling real earnings.

Investment as a share of GDP

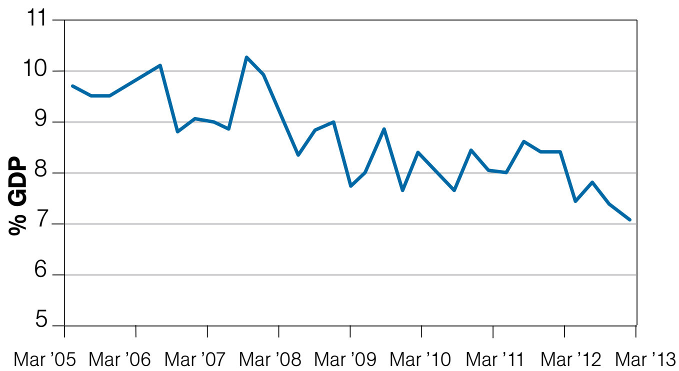
What is it: the amount that companies are spending on investment – installing new equipment, or building new premises, for example – relative to the size of the whole economy.

Why it matters: Rising investment boosts demand (and therefore employment) in the short-term. In the long run, investment should lead to rising productivity and potentially improvements in real earnings.

The trends

Some of the lower output growth overall can be traced back to a longstanding British problem, and the final of our key indicators. Firms in the UK simply do not invest much, relative to other developed countries. Historically, this has been a factor in the British economy since at least the late nineteenth century. But with the crash of 2008, investment fell greatly in absolute terms, by around £40bn a year, and, with the recovery, continues to fall relative to consumption spending.

Figure 7. Investment spending by UK businesses 2005–2013



Source: ONS

Investment by firms should boost productivity because installing new equipment or building new premises, or whatever, generally means replacing old capital stocks with newer and better. Technological change is 'embodied' in real products, and these real products have to be purchased to enjoy the benefits of the new technology. If investment spending falls, this effect is clearly much reduced. The implication is that firms are relying on older equipment for longer. It is in this light that the decline in productivity can start to be understood: a failure to invest meant productivity in the UK declined.

Large firms certainly could invest: UK businesses are sitting on a cash pile of some £750bn, which they are failing to spend.[18] (Dividends to shareholders, meanwhile, have hit record levels in the last year, with some £65bn being distributed.) It is a different story for smaller companies without that ready cash: banks, notoriously, and despite some exhortations from the government, are still failing to lend to small businesses.

It is sometimes popular to ascribe companies' unwillingness to invest to a lack of 'confidence' – a mystical force that, once it takes hold of either consumers or companies, enables them overlook today's difficulties in favour of tomorrow's prospects. More prosaically, however, the weakness of investment spending by firms, seemingly awash with cash, is related to the burden of debt companies also built up during the boom. UK non-financial corporations' debt holdings peaked at 117% of GDP in 2009. Since then, they have been 'deleveraging', paying down debt, significantly more successfully than other parts of the economy. On the most recent figures, UK corporate debt is equivalent to 95% of GDP, or almost £1.5tr. This steady improvement in their balance sheets may well lead to a desire to increase investment spending, although the debt burden remains very substantial – way above the 1990s, pre-bubble average of 64% of GDP.

SUMMARY

Investment spending by firms is well down on pre-crash levels, and (as a share of GDP) is still falling. This has damaged productivity. Weak investment growth could continue for as long as firms carry heavy debts, despite their substantial holdings of cash.

The future and the alternatives

Without a sustained recovery in rates of investment by businesses, a recovery in productivity seems unlikely. Without a recovery in productivity, rising real earnings for most are unlikely – although of course it is possible that certain parts of the economy, with tight labour markets, may see an improvement whilst others do not, implying rising inequality. And without real earnings growth, rising debts will become rapidly unsustainable.

This creates a dilemma. It may well be the case that companies, at some point this year, have deleveraged sufficiently that investment can pick up. Domestic consumer spending will be needed to meet the output of that new investment, where it is not sold internationally; but without rising real earnings, that extra spending will only be possible if consumers also draw down savings and take on new debt. If government also continues to attempt to 'deleverage', via austerity – and this is, apparently, now permanent – the requirement for consumers to take on more debt to sustain economic activity can only be reinforced.

The scene is set, potentially, for a return to the conditions of the late mid-2000s, only this time in an economy that is barely recovered from the last crash. The imbalances highlighted here, combined (particularly) with the UK's chronic excess of imports, funded by borrowing, imply an economy that is geared to produce growth only at the expense of debt, and rising inequality. If low productivity continues to dog the economy, all of the problem features here – rising debt and low wages – will worsen steadily.

What, then, are the alternatives? One element could be to drive investment directly. UK firms are currently sitting on £750bn of cash deposits – savings, taken from their profits – that are not being reinvested. Despite cajoling from the government, including year-on-year cuts to corporation tax, firms have not budged. But rather than relying on firms, government could either invest directly itself, using ultra-low borrowing rates to do so, and driving the transition away from high-carbon, unsustainable economic activity as it did so. Demand for housing could be met through a serious and sustained expansion of council house building, opening up public housing to a new generation. Government could take a lead in shifting the balance of the economy out of the pressure-cooker of the south-east. Strategic or green quantitative easing is another option here.[19] Or government could start to apply a bit more pressure directly to firms, increasing taxes on dormant holdings of cash as an inducement to spend.

Second, the UK's collective debt – of which the government is a small and not the most important part – is an immense problem. Its external debt is the largest of any major developed economy, at 406% of GDP. The debt of its households is rising once more. Its financial sector, meanwhile, remains almost as bloated as it did pre-crash. Without consistent increases in real earnings, especially for households, this private sector debt simply will not be removed, and will constitute a permanent barrier to a broad-based recovery. Should incomes not recover, we may yet hit the point where large-scale write-offs are unavoidable.

Third, the weakness of the economy more generally is becoming manifest in a labour market that produces (on the best available figures) what is likely to be four poorly-paid, insecure job for every one that is better-paid. In addition, the bias of the economy is generating those jobs very largely in places where there is already an excess of activity, particularly in London. Greater protection at work, stronger trade unions and a compulsory minimum wage could help shift market power back in labour's favour; that, in turn, could help deliver a recovery in real incomes.

Endnotes

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