

2. The UK economic outlook

Andrew Goodwin (Oxford Economics)

Summary

- The UK likely re-entered recession at the end of 2011. Near-term prospects are bleak with a number of headwinds hampering the recovery. In particular, falling demand from continental Europe, continuing fiscal retrenchment and weak consumer and business confidence will keep GDP growth down to only 0.3% in 2012. Unemployment is projected to rise to close to 9% by the end of this year.
- But growth should gather pace in the later part of 2012 and average 1.9% in 2013. Key to this pick-up in activity is an expected fall in inflation that ends the squeeze on consumers' purchasing power. In addition, assuming that business confidence improves, sound balance sheets mean that companies can accelerate investment spending.
- We judge that there is currently a significant amount of spare capacity in the UK economy. However, growth in the capacity of the UK economy is likely to be relatively slow in the short term, constrained by tight credit conditions. We expect potential output growth to average only 1.6% over the period to 2016. GDP, however, is expected to grow on average by 2.1% a year over the next five years as the output gap gradually closes.
- Our short-term forecast is somewhat weaker than both the Office for Budget Responsibility (OBR) forecast and the market consensus, although in our view this discrepancy is largely a question of timing, with other forecasters – including the OBR – likely to downgrade their forecasts in the next few months.
- While our baseline forecast may appear to be rather gloomy, particularly in the short term, the risks remain heavily skewed to the downside. The most serious threat comes from the prospect of an escalation of the Eurozone sovereign debt crisis, with a series of defaults and exits from the Eurozone having the potential to cause another deep recession in the UK.

2.1 Introduction

2011 was a particularly challenging year for the UK economy, with most forecasters forced to make substantial downgrades to their forecasts as the year progressed. The Office for Budget Responsibility (OBR) cut its forecasts for gross domestic product (GDP) growth for the 2011–13 period to 1.2% a year in November 2011 from 2.4% a year previously. However, subsequent events raise questions about whether even these revisions went far enough, with the failure to bring the Eurozone crisis to an end meaning that the short-term outlook has continued to worsen. In this chapter, we discuss the outlook for the UK economy, beginning in Section 2.2 with short-term prospects, where we assess the likelihood that the UK will endure a double-dip recession. We then explain why we think that growth will recover next year (Section 2.3).

Moving our focus beyond the short term, we consider prospects for the 2012–16 period as a whole. As part of this, we analyse indicators of the degree of spare capacity in the economy and discuss the prospects for growth in potential output over that period (Section 2.4). Having set out our baseline forecast, we then assess how this compares with the most recent forecast from the OBR and those of other independent forecasters (Section 2.5).

Section 2.6 analyses the potential impact of alternative global scenarios on the UK economy, including an upside scenario ‘corporate reawakening’ and a severe downside scenario involving a break-up of the Eurozone. Section 2.7 concludes.

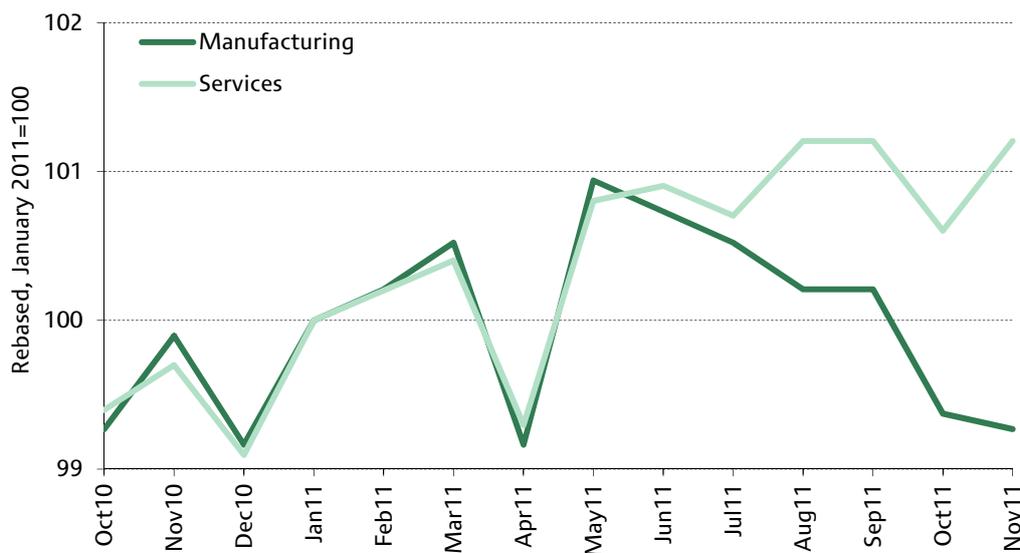
2.2 Double dip in 2012?

The UK enters 2012 from a weak position

The preliminary estimate for GDP growth in 2011Q4 showed that output contracted by 0.2% at the end of last year. Official monthly output estimates had shown manufacturing activity drifting down through the summer, but greater resilience in the services sector. However, the escalation of the Eurozone crisis from late July caused a sharp decline and increased volatility in equity prices, which in turn damaged sentiment amongst both businesses and consumers. This was reflected in a steep downturn across a number of the key business surveys in the autumn, but the damage to the real economy was most apparent in October’s official monthly output estimates, with the manufacturing and services sectors having seen month-on-month declines of 0.9% and 0.6% respectively (Figure 2.1). December’s Purchasing Managers’ Index (PMI) surveys were less weak than in preceding months, but activity balances remained well below the levels reached in early 2011 and the new orders pipeline remained weak. We are forecasting that the UK economy will endure a technical recession in 2011Q4 and 2012Q1.

The descent back into recession was caused by a range of international and domestic factors. The global economy slowed sharply during 2011, firstly because of a soft patch in

Figure 2.1. Official monthly output estimates



Source: Haver Analytics.

the US and latterly as a result of the escalation of the Eurozone sovereign debt crisis. This has been particularly damaging for the UK because of its heavy reliance on the Eurozone for its exports (see Chapter 1). We estimate that growth in world trade, weighted by UK export shares, slowed from 13.4% in 2010 to 6.4% in 2011.

The uncertainty over the future of the Eurozone has also had a negative effect on domestic demand in the UK. Surveys of business and consumer sentiment have dropped back to levels last seen during the recession of 2008–09, and this has translated into a reluctance to spend until the uncertainty clears.

Furthermore, though weaker global growth has been reflected in lower prices across a range of commodities, including food and metals, oil prices have remained at historically high levels. Social and political tensions in the Middle East have increased concerns about supply disruptions, raising the risk premiums. As a result, retail petrol prices have barely fallen from their April 2011 peaks. And, with domestic energy bills also increasing by more than 10% in Autumn 2011, households' finances have remained under severe pressure.

Domestically, the austerity programme has been a significant drag on growth in recent quarters. The increase in the main rate of VAT in January 2011 added around 1 percentage point to inflation in 2011, exacerbating the squeeze on consumers. Moreover, government investment has been cut sharply. We estimate that it reduced GDP growth by 0.3 percentage points in 2011. The austerity programme has also dampened net job creation. The pace of job losses in the public sector has been considerably faster than the OBR had originally forecast and, with economic growth faltering, the private sector found it increasingly difficult to create sufficient jobs to offset the drag from the public sector. The subsequent increase in unemployment has reinforced the pressure on households and further damaged confidence.

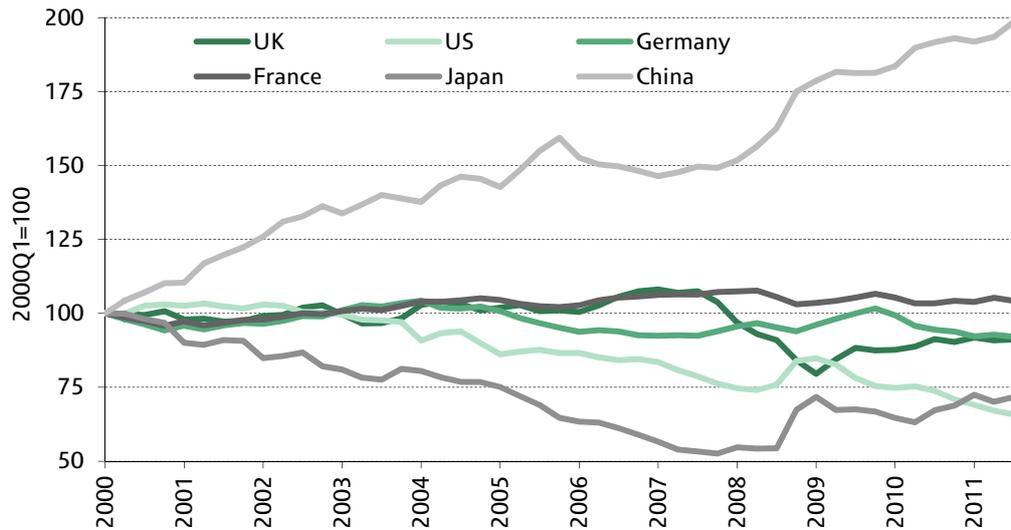
In addition, credit conditions still remain tight relative to historical norms. Small and medium-sized firms, in particular, continue to find it difficult to access the credit they require, which is constraining their ability to invest and to expand production. Furthermore, although UK banks have not implemented the type of credit tightening seen in the Eurozone, there were signs towards the end of 2011 that higher interbank rates were beginning to increase the cost of credit, particularly for firms.

Export environment expected to remain adverse this year

UK exports rebounded strongly in the early stages of the recovery, benefiting from the recovery in world trade and a substantial improvement in competitiveness (Figure 2.2), caused by the sharp depreciation of the pound. Measured in terms of relative unit labour costs, the UK's cost competitiveness has improved by 14% since 2007. However, export momentum faltered as 2011 progressed and global growth slowed.

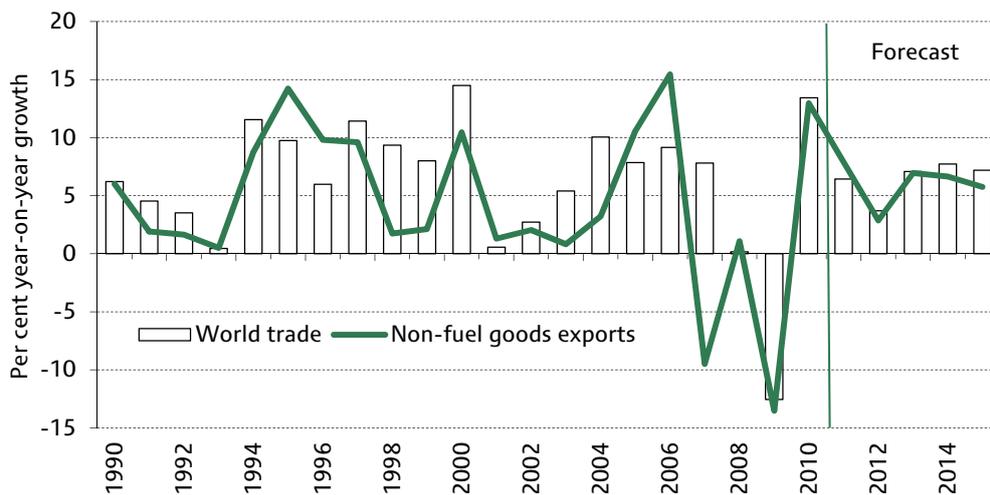
The export environment is likely to remain tough this year, with global growth expected to be slower than in 2011. Our forecast is for a mild recession, at best, in the Eurozone, the UK's main export destination. Exports to Eurozone markets will be further hampered by a weaker euro, with the recent depreciation of the currency likely to persist while uncertainty remains heightened. While the outlook for emerging markets is more robust, the UK has only had limited success in exporting to these countries. We expect growth in world trade, weighted by UK export shares, of just 3.7% in 2012, only half its long-term average (Figure 2.3).

Figure 2.2. Relative unit labour costs



Source: Haver Analytics, Oxford Economics.

Figure 2.3. UK exports and world trade



Source: Haver Analytics, Oxford Economics.

As a result, our forecast shows export growth slowing from 4.8% in 2011 to 1.9% this year. The poor consumer outlook should ensure that imports remain weak, but the contribution of net trade to GDP growth is still likely to drop back from 1.0 percentage point last year to just 0.1 percentage points in 2012.

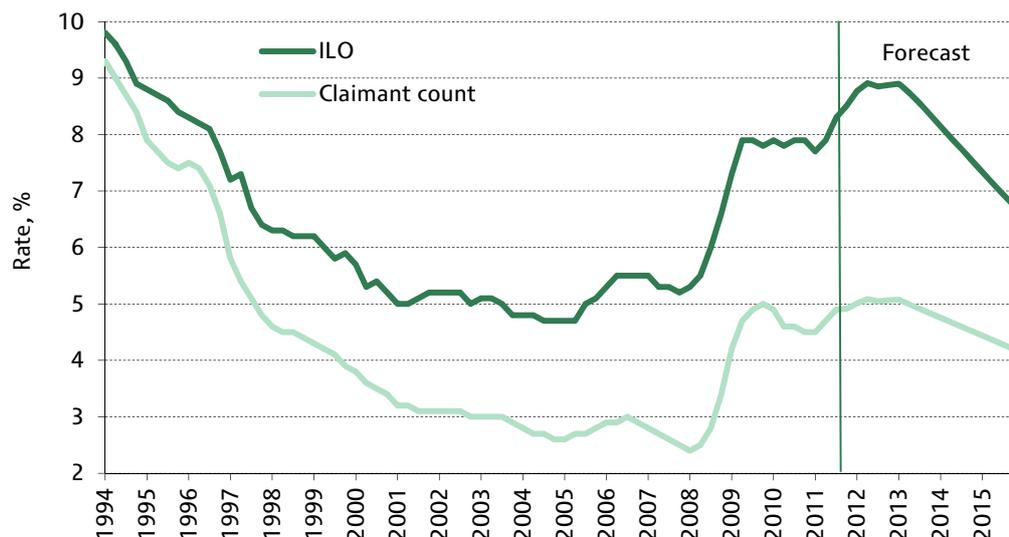
Domestic economy not yet able to offset external weakness

It is unlikely that the domestic economy will be able to offset weaker net trade performance in 2012. The corporate sector should be a bright spot, given the strength of company finances, but business confidence is unlikely to improve significantly so cash surpluses will not be used in the near future. Instead, until the outlook improves, firms are likely to continue to invest primarily on a 'care and maintenance' basis and to use surplus funds to pay down debts instead.

There is also likely to be some renewed tightening in credit conditions. Eurozone banks have already begun to restrict lending, reducing one source of funding for UK firms. And while UK banks generally appear to have a stronger financial position than their Eurozone counterparts, further tightening in domestic credit availability is also possible, particularly if the Eurozone crisis escalates, threatening to raise levels of bad debt. At the very least, firms will have to contend with higher costs of credit, as banks pass on increases in interbank lending rates.

Moreover, further job cuts are in the pipeline, putting a cap on pay settlements and hence households' income growth. It could be argued that the first year of the austerity programme was always likely to see the largest shake-out of public sector jobs, as the new plans were put into action. However, there is unlikely to be much let-up in the pace of job cuts this year given the scale of the savings required. And the poor growth performance is making it increasingly difficult for the private sector to create sufficient jobs to offset the drag from the public sector. We expect unemployment to increase sharply this year, to close to 9% on the International Labour Organisation (ILO) measure by the end of the year (Figure 2.4). Poor employment prospects will also restrict the bargaining power of workers and bear down on earnings growth. Thus, while the real wage squeeze is likely to ease compared with 2011, the recovery in real household disposable incomes is expected to be gradual.

Figure 2.4. Unemployment rates



Source: Haver Analytics, Oxford Economics.

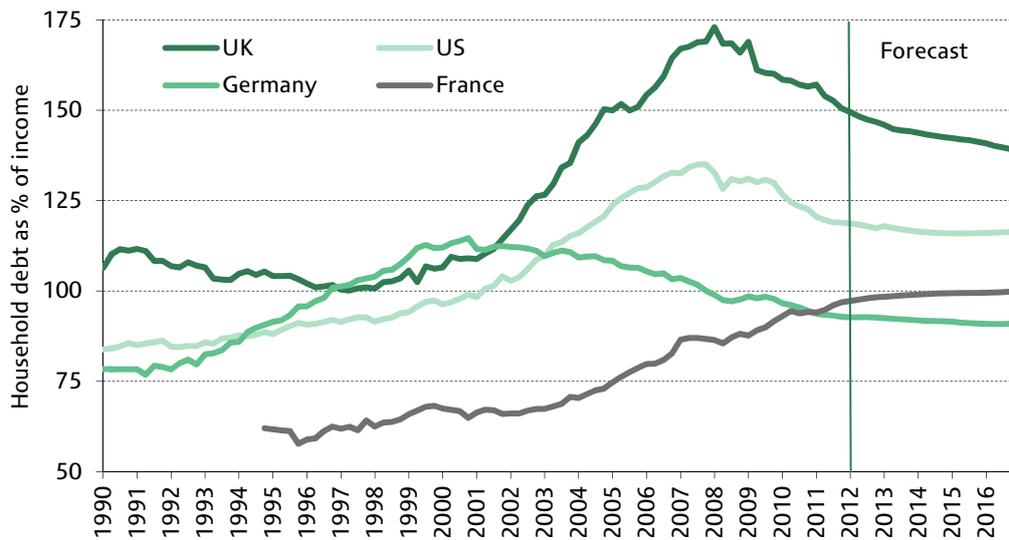
We are also gloomy about the short-term prospects for the UK housing market. Much of the recent resilience in prices has been founded upon a gradual improvement in mortgage availability, but this would be undermined by a renewed tightening in credit conditions and the deterioration in wider prospects. High rates of home ownership mean that the housing market plays a central role in the UK economy, particularly in terms of the consumer outlook, so the possibility that prices have further to fall will further undermine households' willingness to spend.

In addition, the period since the onset of the financial crisis has seen the private sector engaged in a process of deleveraging and we expect this to continue this year. While the household debt-to-income ratio has fallen over the last three years, it remains around 150%, significantly higher than those of our main European counterparts and the US

(Figure 2.5). The medium-term level of household debt is hard to judge, but both historical averages and international comparators suggest that UK households may reduce debt further. Debt reduction will be an additional factor weighing on consumer spending.

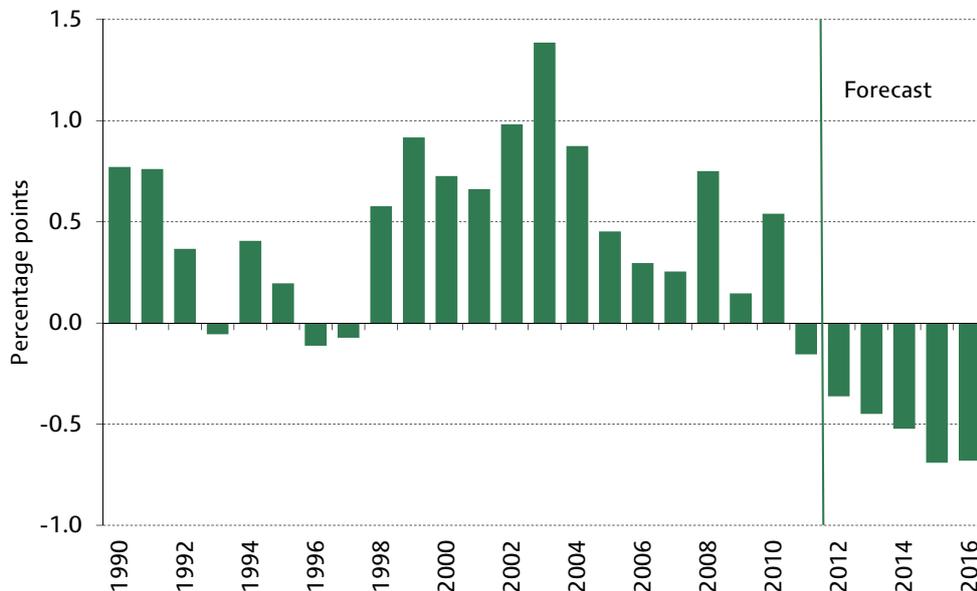
It is not only the private sector which is under pressure to deleverage. The vast majority of the planned cuts to public spending are yet to come into effect (see Chapter 3). We estimate that, taken together, general government consumption and investment reduced GDP growth by 0.2 percentage points in 2011 (Figure 2.6). However, the increasing

Figure 2.5. Household debt-to-income ratios



Source: Haver Analytics, Oxford Economics.

Figure 2.6. Direct contribution of general government to GDP growth



Note: General government = Government consumption + Government investment.

Source: Haver Analytics, Oxford Economics.

intensity of the austerity programme means that this drag is likely to rise to 0.4 percentage points this year and intensify further in the medium term.¹

2.3 More favourable factors to help recovery next year

We expect growth to pick up in the latter part of 2012 as some supportive factors start to outweigh the short-term constraints discussed in the previous section.

Monetary policy is likely to remain supportive ...

One factor supportive to growth will be monetary policy, which is expected to remain very accommodative with the possibility of even further easing from the Bank of England (BoE).

Figure 2.7. Bank of England interest rate



Source: Haver Analytics, Oxford Economics.

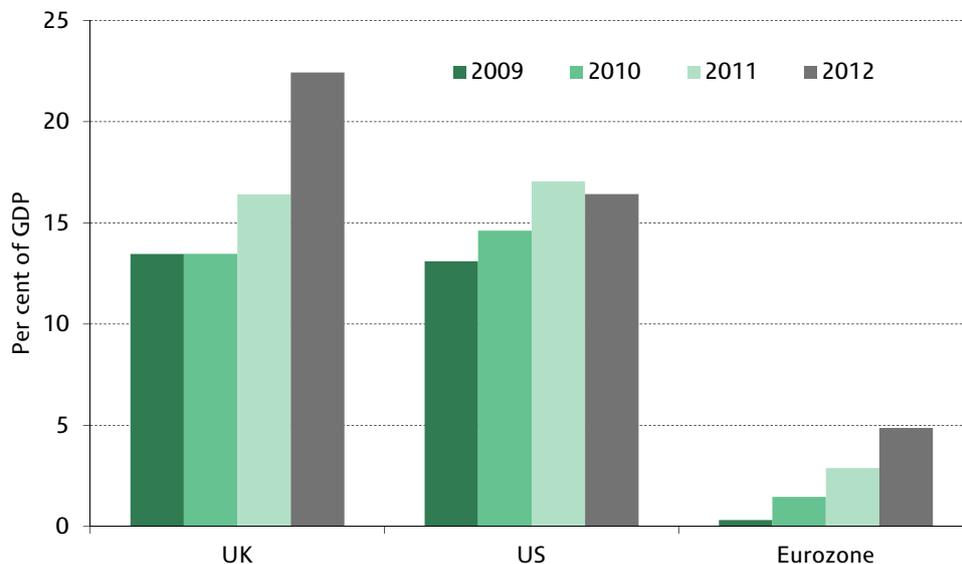
We expect the BoE's interest rates to remain on hold, at 0.5%, until the end of 2013, with only gradual increases thereafter (Figure 2.7). Moreover, it appears likely that the Monetary Policy Committee (MPC) will announce a further round of quantitative easing (QE) when the current round has been completed in early February 2012. Indeed, the November Inflation Report showed a forecast where inflation was well below the 2% target at the two-year horizon, based on the current level of asset purchases, suggesting that further stimulus would be needed for the Bank to fulfil its inflation targeting remit.

We expect the MPC to authorise a further £75 billion of asset purchases at its February meeting, to be completed over the following three months. By then, the BoE will have purchased £350 billion worth of assets under its successive QE programmes. This amounts to more than 22% of GDP. By comparison, we estimate that the US Federal

¹ These calculations cover the direct impact of the cuts to government consumption and government investment on GDP growth. However, this is likely to be offset by stronger contributions from the private sector because, for example, monetary policy is likely to be looser than would have been the case if government spending were not being cut.

Reserve has purchased assets worth around 17% of US GDP (Figure 2.8). The European Central Bank meanwhile has had a much more limited programme, worth less than 4% of GDP so far.

Figure 2.8. Quantitative easing



Source: Haver Analytics, Oxford Economics.

... as will low bond yields

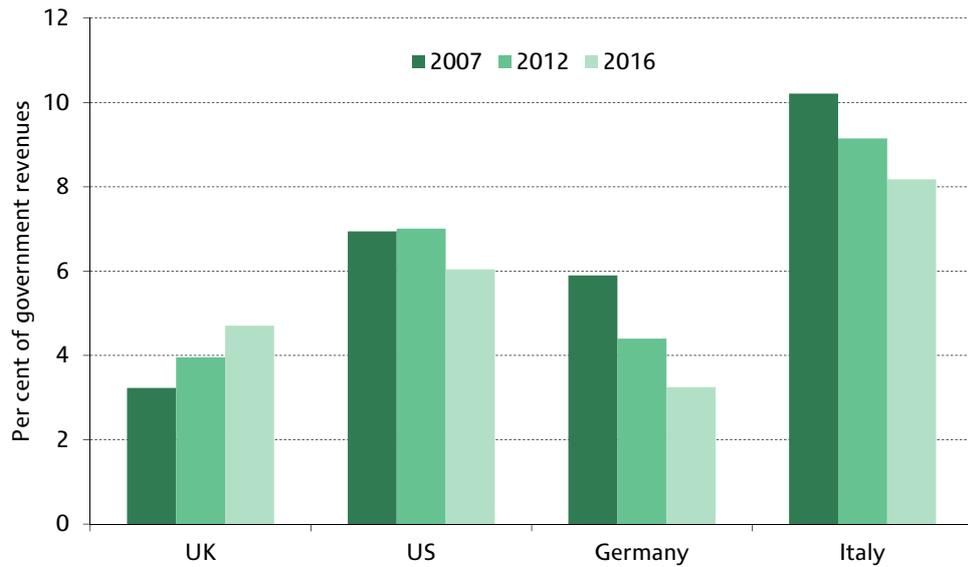
Our research suggests that quantitative easing has a significant impact on longer-term interest rates. We estimate that QE equivalent to 10% of GDP depresses 10-year government bond yields by around 1 percentage point (100 basis points). The BoE's programme has therefore been a key factor contributing to the significant fall in 10-year UK gilt yields, to below 2% in January 2012. As the QE programme remains active, bond yields should stay low.

In addition, UK gilts are benefiting from a safe haven status, as investors move away from riskier government bond markets, in particular in some Eurozone countries. With uncertainty about the resolution to the Eurozone crisis, or indeed the future of the Eurozone, likely to be high throughout the year, UK bond markets should remain very attractive.

Our forecast shows yields on 10-year UK gilt yields remaining below 3% until next year, before gradually rising as investors become more confident about the recovery.

In turn, low bond yields help to hold the government's debt interest payments at low levels. In 2012, we estimate that net interest payments on public debt will amount to 4% of government revenues (Figure 2.9). This is only slightly higher than before the global crisis, despite rising public debt (3.2% in 2007). And it compares favourably with other countries. For instance, the US government spends 7% of its revenues on interest. In Europe, some countries are spending close to, or even more than, 10% of their revenues on debt interest. We expect the share of revenues used up by debt interest payments in the UK to rise, to around 4.7% by 2016 as public debt increases and bond yields edge up. But this will remain easily affordable. It means that the government is not constrained on its fiscal policy by unsustainable spending on debt repayments.

Figure 2.9. Government debt interest payments



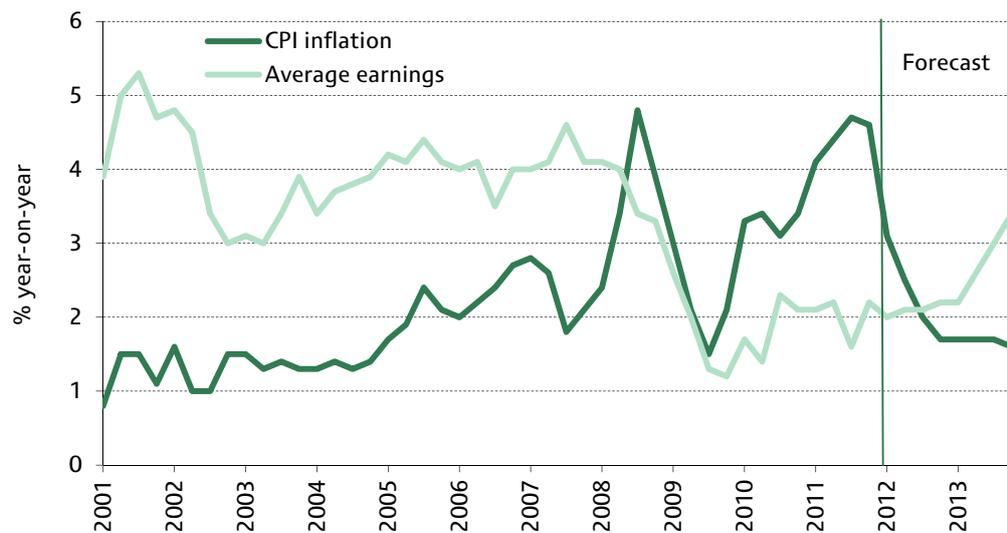
Source: Haver Analytics, Oxford Economics.

Inflation to fall sharply ...

Another support to growth is expected to come from a sharp fall in inflation, which has already begun. The bulk of the rise in inflation to over 5% during 2011 can be attributed to one-off or temporary factors, such as higher VAT or food and energy prices. As those increases fall out of the year-on-year calculation, inflation is set to fall under 2% (Figure 2.10). The most significant drop in inflation rates is likely to come in early 2012, as the impact of the increase in the main rate of VAT in January 2011 falls out.

In addition, we expect further falls in oil prices this year, which will also contribute to lower inflation. Assuming that concerns over oil supply abate, slowing demand should pull Brent prices down towards \$100 per barrel by the end of 2012. Non-oil commodity prices are also forecast to fall this year, on the back of weaker global demand.

Figure 2.10. Inflation and average earnings



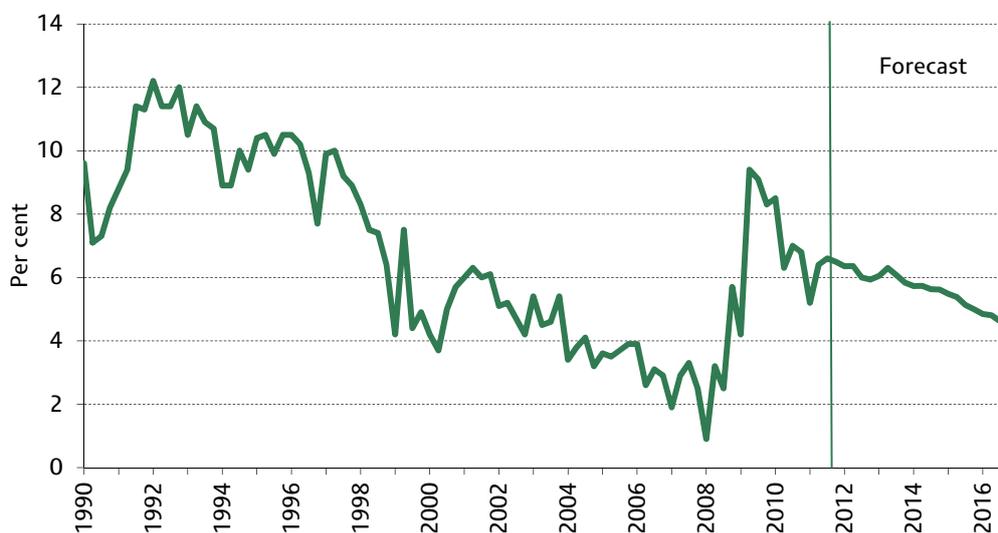
Source: Haver Analytics, Oxford Economics.

Moreover, ample amounts of slack in the economy (see Section 2.4) will continue to put downward pressure on profit mark-ups and prices. The impact of renewed recession is also beginning to be felt. There is a wealth of anecdotal evidence that suggests that retailers are being forced to discount heavily in an attempt to maintain sales. Meanwhile, a fragile labour market and rising unemployment will continue to push down on pay settlements.

... and boost incomes and confidence

Lower inflation will contribute to stabilising and then raising consumer purchasing power, after two consecutive years of falls in real incomes. We expect household real disposable income to rise by 0.5% in 2012 and 1.5% in 2013, having fallen by 1.5% in 2011. This in turn will underpin a slow acceleration in consumer spending growth to 1.5% in 2013 from just 0.4% in 2012 and a fall of 0.7% in 2011. Ongoing deleveraging will prevent a more significant revival in consumer spending, with the savings ratio remaining close to 6% over the next two years (Figure 2.11).

Figure 2.11. Savings ratio



Source: Haver Analytics, Oxford Economics.

Sentiment should be further supported by a gradual strengthening in the housing market. As credit conditions begin to loosen and mortgage availability improves, housing activity is likely to strengthen. Activity and prices are closely correlated, so this should then translate into a pickup in prices. The rebound in activity and prices could be particularly strong if banks also relax their lending criteria, thus freeing up the lower end of the market which has been constrained in recent years by banks insisting on lower loan-to-value ratios and lower income multiples.

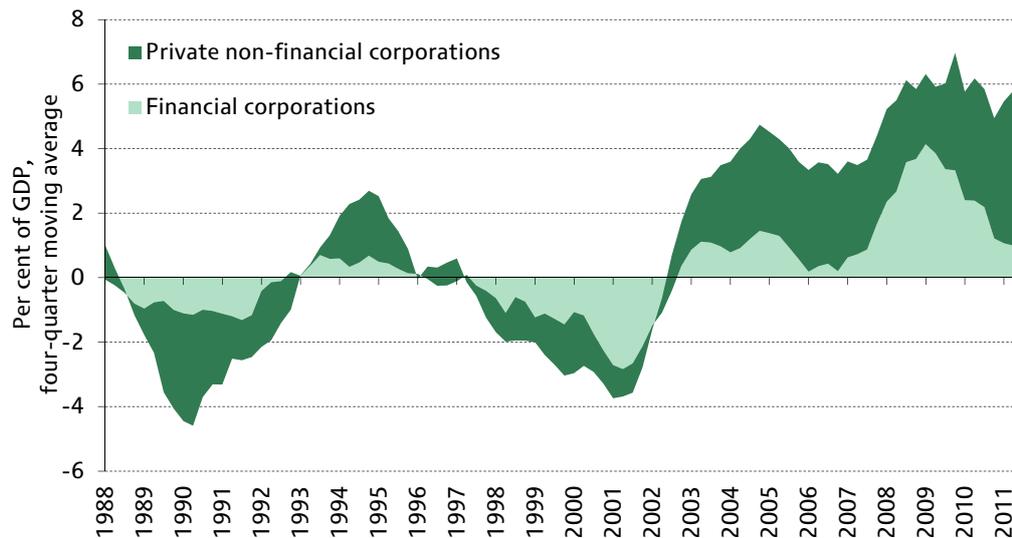
Businesses have the means to support growth

We also expect business investment to strengthen next year, assuming that confidence is restored during 2012. This presumes, in particular, that the Eurozone sovereign debt crisis is managed and that significant additional turmoil is avoided.

In that environment, companies should be able to use large profits and cash balances to finance investment spending. Corporate profits have not fallen sharply as a share of GDP

in this cycle, in marked contrast to the recession of the early 1990s and in 2000–02. Moreover, non-financial companies have accumulated further cash balances worth 4.3% of GDP in 2011 (Figure 2.12). While the company sector financial surplus last year was not as large as its peak in 2009, it is still very high by historical standards. With cost competitiveness very favourable, we would expect the UK to benefit once companies have the confidence to start to invest these funds. We therefore expect business investment to rise by close to 5% in 2013, having risen just 1.1% in 2011 and 1.6% in 2012. Even so, our forecast implies that the level of business investment will not return to its pre-crisis peak before 2014.

Figure 2.12. Corporate sector financial balance



Source: Haver Analytics, Oxford Economics.

Investment in dwellings is also likely to pick up strongly, from current very low levels. A recovery in housing activity and prices will be the prime motivation, but further public sector support is also likely given the need to substantially increase rates of house building to keep pace with demographics. Though government investment will continue to fall, as part of the government's austerity programme, the strength of business and housing investment is expected to drive an acceleration in total investment growth to 3.5% in 2013, after declines of 2.7% in 2011 and 0.2% in 2012.

2.4 Medium-term recovery slower than usual

Over the medium term, we expect a gradual economic recovery to continue. The combination of estimates of the output gap that currently exists and of potential growth going forwards drives our forecast for medium-term GDP growth.

How much spare capacity is there in the UK economy?

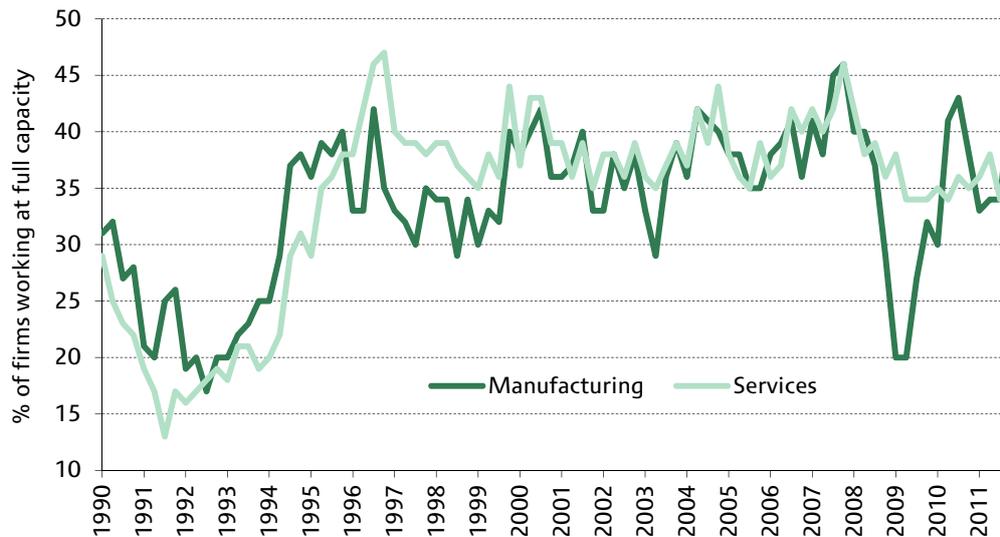
The question of the size of the output gap and forecasts for growth in potential output, have taken on added importance since the Chancellor adopted a cyclically-adjusted target for the public finances. Indeed, the importance of these estimates was demonstrated in November by the OBR's decision to revise its estimate of the size of the output gap. These revisions required the Chancellor to announce further fiscal tightening in order for the

OBR to judge that the government was still complying with its fiscal mandate (see Chapter 3 for further discussion).

Assessing the size of the output gap is far from a precise science and requires a high degree of judgement on behalf of the forecaster. As such, it is no surprise that there is a broad range of views amongst economists as to how much spare capacity there currently is. Most commentators agree that the best approach is to use a range of indicators.

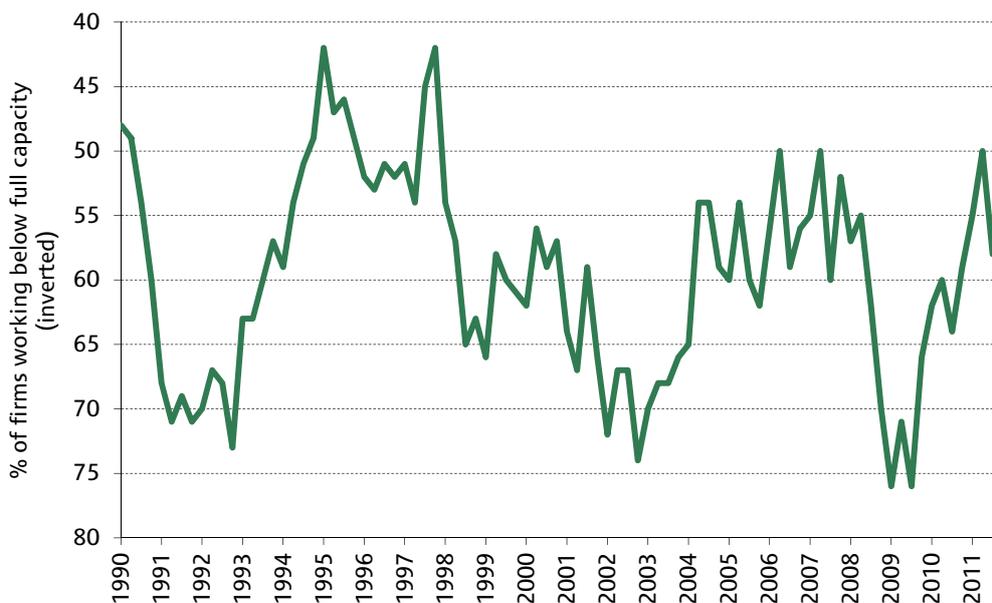
Analysis of the current size of the output gap is complicated by the fact that business surveys and labour market indicators are offering widely contrasting signals. The business surveys suggest that there is relatively little spare capacity, particularly in the manufacturing sector. Both the British Chambers of Commerce (BCC) survey and the

Figure 2.13. BCC survey – capacity utilisation



Source: British Chambers of Commerce.

Figure 2.14. CBI Industrial Trends Survey – capacity utilisation



Source: CBI.

Confederation of British Industry (CBI) Industrial Trends Survey reported sharp increases in utilisation rates in manufacturing last year (see Figures 2.13 and 2.14 respectively). The BCC survey even pointed to above-average utilisation. These responses come as somewhat of a surprise given the extent to which output fell during the recession – manufacturing output fell by 14% from peak-to-trough and still remains 8.7% below its January 2008 peak. But with the Bank of England’s survey of regional agents telling a similar story, we are inclined to give them some credence.

In the services sector, survey results generally point to more ample spare capacity. The BCC survey reports that levels of capacity utilisation are merely in line with the long-run average, while the Bank of England agents’ survey reported that they are slightly below. However, the results are markedly stronger than they were at a similar stage during the last recession and are consistent with the notion that there is not a significant degree of spare capacity at present.

However, data from the labour market tell a very different story. At 8.4%, the unemployment rate is at its highest for almost 18 years, well above most estimates of the NAIRU.² Levels of inactivity have also increased, with a significant proportion of people who are not counted as unemployed (or employed) still wanting to work if the conditions were right. Other indicators also point to a significant amount of spare capacity in the labour market. The total number of hours worked has risen modestly during the recovery (Figure 2.15), but it remains more than 3% below the early-2008 peak, with many workers still on shortened working weeks or having been forced to switch to part-time employment because of a lack of full-time opportunities. The degree of slack is further demonstrated by how weak wage growth has been, with a lack of bargaining power leading workers to accept pay rises averaging around 2.3% last year, despite inflation rates of 4.5–5%.

Figure 2.15. Total hours worked per week



Source: Haver Analytics.

² NAIRU – non-accelerating inflation rate of unemployment. Even when the economy is operating at its long-run potential, there will still be some level of frictional unemployment – this is known as the NAIRU.

On balance, we place a slightly greater emphasis on the indicators of the labour market, which can generally be measured more accurately and which better fit with the anecdotal evidence. Based upon these data, we estimate that the output gap was around –3.2% of potential output at the end of 2011. That compares with a peak in the output gap of –6.1%, reflecting very slow growth in productive potential in the last few years as investment has fallen and the NAIRU has risen. But it does imply somewhat more spare capacity than estimated by OBR (–2.5% of potential output in 2011Q3).

Muted potential growth over the next five years

Having estimated how much spare capacity we believe there is in the UK economy at present, we must make a judgement on how potential output will evolve, in order to determine the scope for actual GDP growth to recover.

There are a range of views on how best to estimate potential output. We use a production function approach,³ which provides a framework that relates the level of potential output to contributions from factor inputs – labour and capital – and the efficiency with which those inputs are used (so-called ‘total factor productivity’). It provides a consistent method for forecasting future growth in potential output, taking into account important changes such as demographic trends.

Using this approach, we can quantify the contributions to potential growth over the two previous cycles from its key drivers (Table 2.1). This analysis shows that the significant improvement in performance in the last cycle was mostly due to a much stronger contribution from the labour supply – particularly reflecting growth in the population of working age as migration increased and a fall in the NAIRU – with some support from an improved contribution from the capital stock, underpinned by robust business investment growth.

Table 2.1. Contributions to potential output growth (percentage points per annum)

	1986Q2–1997H1	1997H1–2006H2
Employment at the NAIRU	0.2	0.7
Capital stock	0.9	1.2
Total factor productivity	1.3	1.2
Potential output	2.4	3.2

Note: Columns may not sum exactly due to rounding.

Source: Oxford Economics.

Applying this framework to the current economic cycle, we can assess how potential growth is likely to develop.

Growth in the labour supply

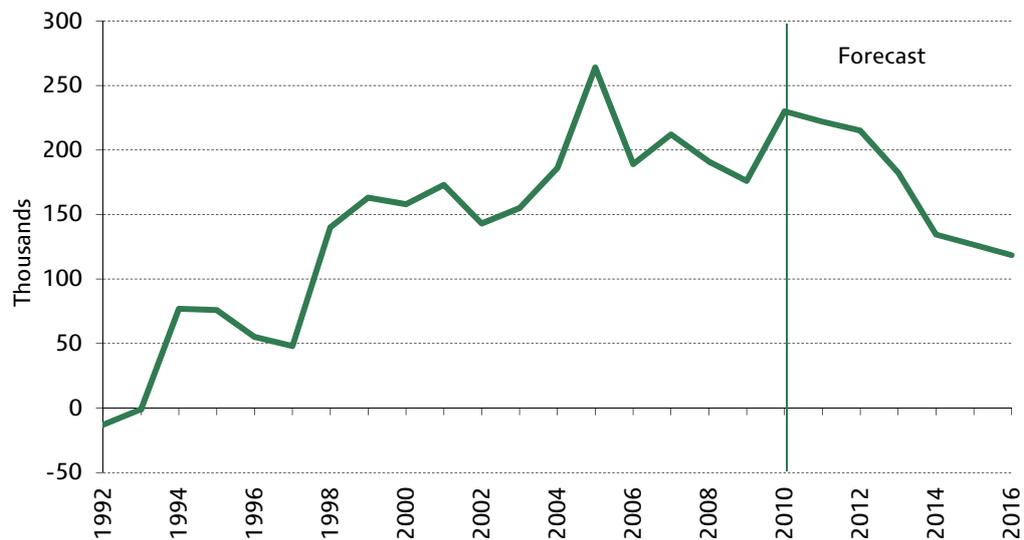
The most recent (2010-based) set of official population projections features an increase in the assumption for net in-migration flows. Migration is now projected to slow from the most recent figure of 230,000 in the year to mid-2010, to 200,000 by 2016–17; previously the ONS had adopted a medium-term assumption of 180,000 per year. Despite

³ In the Oxford Economics UK Model, we use a Cobb–Douglas production function, $Y^* = A + L^\alpha + K^{(1-\alpha)}$, where: Y^* is potential output; L is potential labour supply, which is equal to the labour supply at the NAIRU; K is the capital stock; and A is total factor productivity (TFP). This is rewritten in natural logs, with α equal to 0.65: $\ln(Y^*) = \ln(A) + 0.65\ln(L) + 0.35\ln(K)$.

the slowdown from current levels, this would still represent a prolonged period of in-migration at a level that the UK economy has never previously experienced over an extended period.

The OBR's forecast takes a different view, adopting the ONS low migration assumption of 140,000 per year. However, we would argue in favour of an assumption that is even lower still. Given that migrants are typically of working age, employment prospects tend to be the key driver of migration flows. As explained in the previous sections, for the UK, these are particularly weak: our forecast shows employment only regaining its pre-recession peak in 2015. This deterioration in employment prospects has already resulted in much lower flows of migrants from the European Union (EU), a trend which we expect to continue. Moreover, the government has made it clear that it will actively seek to restrict the flow of migrants from outside the EU. Data from the International Passenger Survey suggest that the bulk of long-term non-EU migrants are coming to the UK to study, with numbers having almost doubled over the past five years. Funding pressures for universities would imply a motivation to maintain these flows of overseas students, but the government has already suggested that the number of student visas approved will fall.

Figure 2.16. UK net in-migration



Source: Office for National Statistics, Oxford Economics.

We therefore expect net migration to drift downwards from current levels, eventually reaching 110,000 a year over the medium term (Figure 2.16). If we assume that, on average, 90% of migrants are of working age, this shortfall will have significant implications for the size of the workforce. We estimate that this assumption would reduce potential output growth by 0.1 percentage points per year over the 2012–16 period, relative to the OBR forecast.

Estimates of the NAIKU

There is empirical evidence – notably Blanchard & Summers (1986)⁴ and Ball (2009)⁵ – that links changes in the NAIKU to shifts in aggregate demand through hysteresis.⁶ While

⁴ O.J. Blanchard & L.H. Summers, 'Hysteresis and the European unemployment problem', *NBER Macroeconomics Annual 1986, Volume 1*, 1986.

⁵ L.M. Ball, 'Hysteresis in unemployment: old and new evidence', NBER Working Paper 14818, 2009.

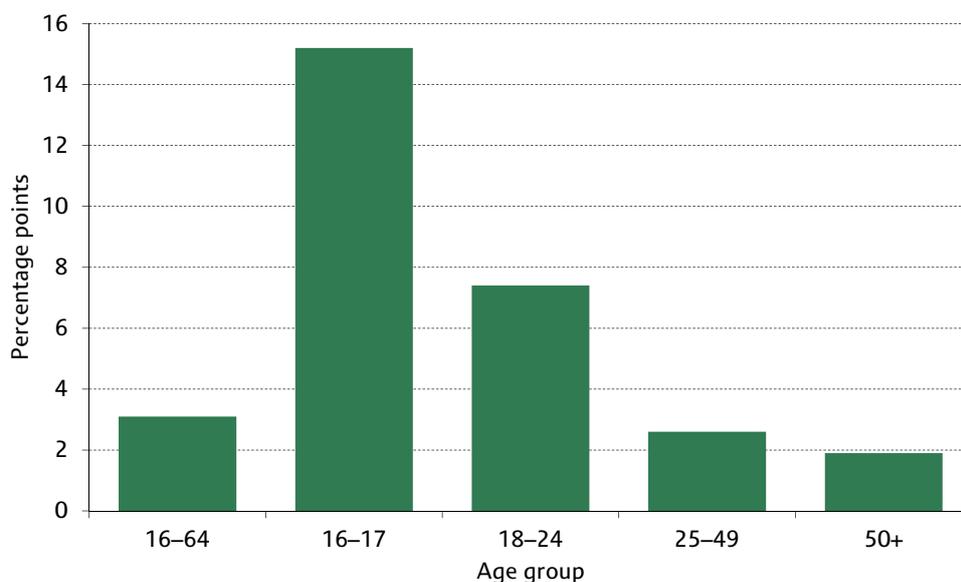
a period of steep declines in joblessness dragged the NAIRU down towards the actual unemployment rate over the last cycle, we expect the deep recession of 2008–09 and the increase in unemployment since then to push up the NAIRU.

Ball (2009) argues that the degree to which hysteresis occurs is a function of the time it takes for output to return to its previous trend, with longer periods of weak growth in aggregate demand yielding larger increases in the NAIRU. In this context, the current protracted period of weak or negative growth is a concern. As of 2011Q3, output was still 3.6% below its pre-recession peak and much further below its previous trend. As a result, we expect this to cause a shift upwards in the NAIRU to around 6% throughout the forecast period, up from 5% ahead of the recession.

High levels of long-term unemployment are likely to cause a rise in the NAIRU as those out of work for a prolonged period may see the value of their skills eroded and become detached from the labour market. The impact in this cycle may not be as marked as in previous cycles, however, because the increase in unemployment has been highly concentrated on the younger age groups (Figure 2.17). In general, we would expect that younger unemployed are better placed to retrain and re-enter the workforce than those from older age groups, particularly if schemes such as the ‘Youth Contract’⁷ are successful.

However, the shift in employment from the public to the private sector could lead to a mismatch between skills and opportunities. For example, a 2011 survey⁸ by the Financial

Figure 2.17. Increase in ILO unemployment rate by age, 2008Q1–2011Q3



Source: Haver Analytics, Oxford Economics.

⁶ Hysteresis is when changes have long-lasting effects. In this case, increases in the unemployment rate may lead to increases in the NAIRU in the future as the short-term unemployed lose skills, for example, and become long-term unemployed.

⁷ The ‘Youth Contract’ encompasses a range of initiatives announced in the November 2011 Autumn Statement, including the government funding wage incentives for 160,000 young people to make it easier for private sector employers to take them on and at least 40,000 incentive payments for small firms to offer apprenticeships.

⁸ ‘Hiring blow for public sector jobless’, *Financial Times*, 20 February 2011 (<http://www.ft.com/cms/s/0/a41baaac-3d06-11e0-bbff-00144feabdc0.html#axzz1ju75PpE4>).

Times and Barclays Corporate found that 57% of private sector companies in the UK are not interested in hiring people who have lost their jobs in the public sector, because of a perception that these people lack the necessary skills for their business. This mismatch could be exacerbated by the likelihood that the regional pattern of public sector job losses – and private sector opportunities – will be very uneven. The share of total employment accounted for by the public sector varies widely across the UK regions, from 32% in the North East to 23% in Greater London.

In addition, participation rates are likely to continue to nudge downwards in the short term, as poor employment prospects discourage people from seeking work, but should pick up as the economy recovers. There are two conflicting long-term trends affecting participation. On one hand, people are working longer, partly perhaps because the state pension age (SPA) for women is increasing and partly because of low levels of pension saving. On the other, the population itself is ageing, and labour market participation amongst those close to the SPA is still substantially lower than amongst younger individuals.

Capital stock

The last cycle was characterised by an increased contribution to growth from the expansion of the capital stock – i.e. capital deepening – with business investment growing at a rate of 4.4% a year between 1997H1 and 2006H2. However, the financial crisis has had a significant impact on both the funding of, and incentives for, investment. As of 2011Q3, business investment remained 16% below its late-2007 peak (Figure 2.18).

Our forecast shows a recovery in business investment. Nevertheless, at 6% a year over the period 2012–16, it is significantly weaker than the OBR's forecast (in excess of 10% a year). This, in turn, means that our forecast features a much lower contribution to potential output from capital deepening. We expect it to contribute 0.8 percentage points a year to potential output growth over the 2012–16 period, down from 1.2 percentage points a year over the previous cycle.

Figure 2.18. Business investment



Source: Office for National Statistics.

Total factor productivity

By its very nature, total factor productivity is very difficult to forecast. However, several factors suggest that the contribution from total factor productivity will be considerably weaker than in previous cycles, particularly in the short term. The most important factor is the lack of credit availability, a legacy from the financial crisis, with small and medium-sized firms particularly badly affected. While some of the effects are catered for within estimates of the capital stock, this will not cover less easily quantifiable effects, such as the impact on research and development activities and on the ability of firms to reallocate capital to more productive activities.

The shift in the sectoral focus of activity also has the potential to damage productivity growth. The financial services sector played a significant role in the strong performance over the last cycle, achieving output growth of 5.7% a year – almost double that of the economy as a whole – and financial services was supported by the growth of a range of associated professional service sectors (for example, legal, accountancy and consultancy). However, financial services output remains almost 15% below previous peaks and the ramifications of the financial crisis, in terms of greater regulation and risk aversion, mean that the sector is likely to grow at a much slower rate in the future. This is particularly important given that output per job in the financial services sector is more than double the whole-economy average.

Finally, previous studies have suggested that recessions tend to coincide with a rise in premature capital scrapping, caused by an increase in the number of firms going out of business. However, the literature also suggests that these effects are not captured particularly well in official data on the capital stock, which means that we also need to make allowance for these effects within our estimates of total factor productivity.

Over the 2012–16 period as a whole, we assume that total factor productivity contributes 0.3 percentage points per year to potential output growth. However, this masks a significant acceleration through that period, as the legacy of the financial crisis fades.

A forecast of potential output and the output gap

Bringing these factors together, it is clear that growth in potential output is likely to be low, particularly in the short term. Our forecast shows potential output growing by 1.6% a year in 2012–16 (Table 2.2), with growth during that period accelerating from just 0.6% in 2012 to 2% a year in 2015–16, as some of the negative legacy effects of the financial crisis gradually fade.

Our forecast is around 0.4 percentage points a year lower than the OBR forecast, which means that by 2016 there is a cumulative shortfall of 2.3% of potential GDP.

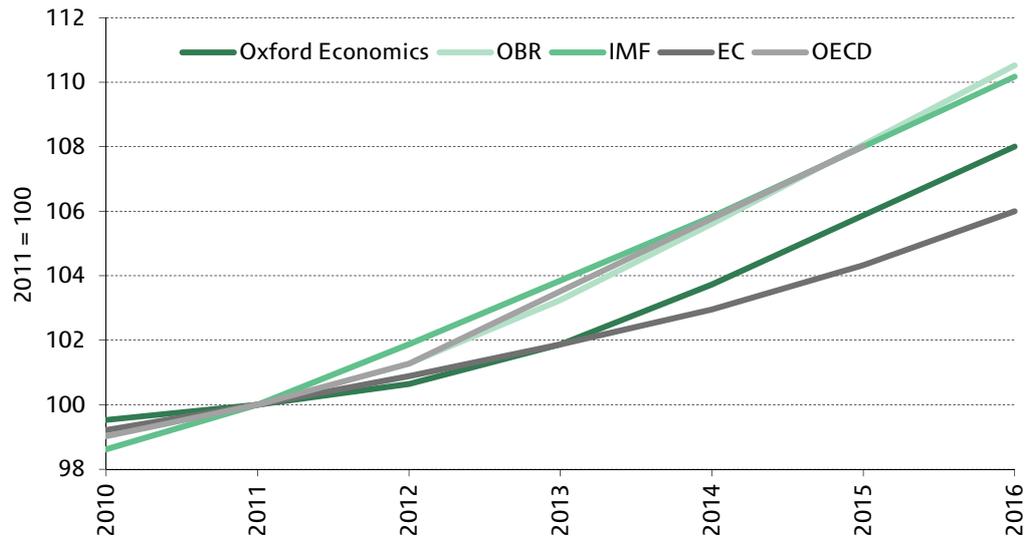
Table 2.2. Contributions to potential output growth (percentage points per annum)

	1997H1–2006H2	2006H2–2012	2012–2016
Employment at the NAIRU	0.7	–0.1	0.4
Capital stock	1.2	1.0	0.8
Total factor productivity	1.2	–0.2	0.3
Potential output	3.2	0.7	1.6

Note: Columns may not sum exactly due to rounding.

Source: Oxford Economics.

Figure 2.19. Forecasts of potential output



Note: Forecasts for OBR, IMF, EC and OECD calculated using data quoted in OBR, *Economic and Fiscal Outlook: November 2011*.

Source: Oxford Economics, OBR, IMF, European Commission, OECD.

Given the uncertain nature of forecasting potential output, it is perhaps no surprise that there is a wide range of views across forecasters (Figure 2.19). The OBR forecast is at the upper end of the range, though the IMF and OECD assume a similar rate of growth. However, the European Commission (EC) is markedly more downbeat, assuming that potential output will grow by just 1.2% a year. This means that by 2016 the EC estimates imply a cumulative shortfall of more than 4% of potential GDP compared with the OBR forecast.

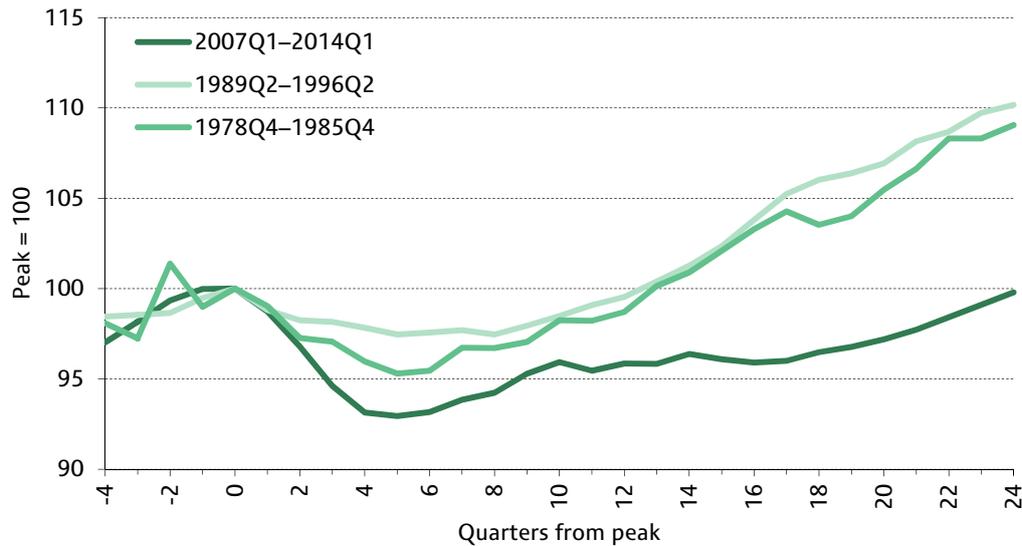
Weaker medium-term recovery than in previous upturns

As of 2011Q4, GDP was still 3.8% below its 2008Q1 peak even though the recovery had been underway for 15 quarters. Upward revisions to historical data over the past few months mean that this gap is smaller than we had previously thought it would be, but it is significantly wider than at the corresponding point of either of the previous two cycles (Figure 2.20). Following the recession of the early 1990s, GDP was 2.3% above its previous peak 15 quarters later, while the recovery of the early 1980s saw GDP 2.1% above its previous peak by this stage. Our forecast (Table 2.3) suggests that, this time around, GDP will not regain its previous peak until 2014Q1, a total of six years.

That the recovery has been particularly sluggish this time around is not surprising – recoveries that follow financial crises tend to be much slower than those that follow a more ‘normal’ recession caused, for example, by policy mistakes.⁹ However, it is notable that the UK recovery is also set to be significantly weaker than those of our peers (Figure 2.21). Of the G7 countries, only Japan and Italy report that GDP is further below its pre-crisis peak than the UK. In the case of Japan, the poorer relative performance is largely due to the impact of the tsunami in 2011 and we expect these positions to be reversed before the end of 2012.

⁹ See C.M. Reinhart and K.S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

Figure 2.20. Comparison of UK economic cycles



Source: Haver Analytics, Oxford Economics.

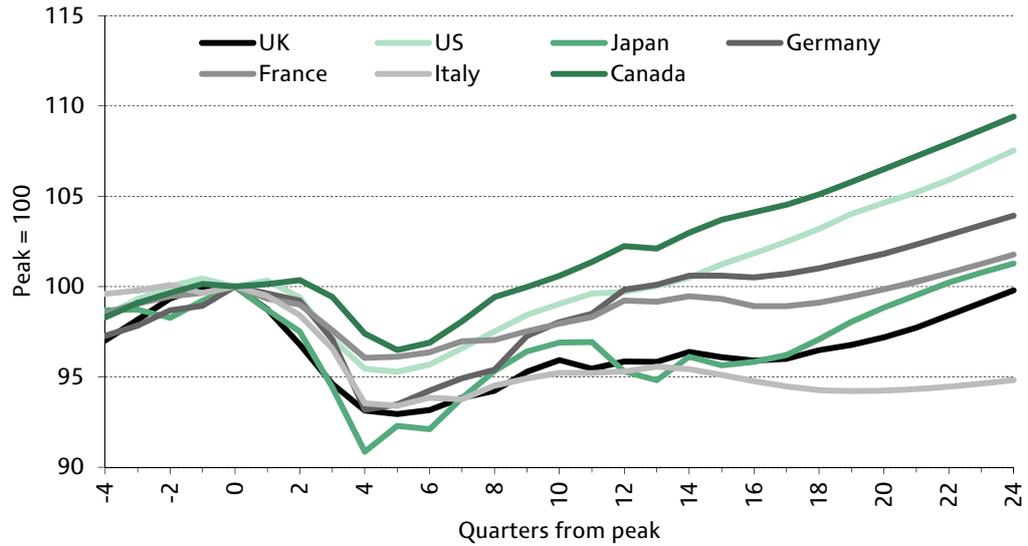
Table 2.3. Oxford Economics UK forecast (annual % change unless stated)

	2010	2011	2012	2013	2014	2015	2016
Domestic demand	2.9	-0.7	0.0	1.1	2.1	2.3	2.2
Private consumption	1.2	-0.7	0.4	1.5	2.6	2.9	3.1
Fixed investment	3.1	-2.7	-0.2	3.5	6.9	7.1	5.3
Stockbuilding (% of GDP)	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Government consumption	1.5	0.8	-0.6	-1.6	-2.3	-3.2	-3.3
Exports of goods and services	7.4	4.8	1.9	6.4	6.2	5.5	4.9
Imports of goods and services	8.6	1.4	1.5	3.8	4.1	4.0	3.7
GDP	2.1	0.9	0.3	1.9	2.8	2.8	2.7
Industrial production	1.9	-0.8	-0.6	0.8	1.4	1.0	0.8
CPI	3.3	4.5	2.3	1.7	1.8	1.9	2.0
Current balance (% of GDP)	-3.3	-2.5	-2.3	-1.9	-1.5	-1.1	-0.6
Short-term interest rates (%)	0.69	0.89	0.99	0.98	1.64	3.15	4.45
Long-term interest rates (%)	3.61	3.12	2.38	3.68	4.73	4.95	5.00
Exchange rate (US\$ per £)	1.55	1.60	1.55	1.56	1.57	1.57	1.57
Exchange rate (euro per £)	1.17	1.15	1.22	1.18	1.24	1.27	1.27

Source: Oxford Economics.

The poor relative performance of the UK can be attributed to several factors. The fact that the financial services sector accounts for a much higher proportion of output in the UK than elsewhere has meant that the poor performance of the sector in the aftermath of the financial crisis has caused greater damage to overall output in the UK. The increase in household indebtedness prior to the crisis was also much greater in the UK than in many other countries, which we expect to lead to more aggressive deleveraging than elsewhere. This is particularly important given that consumer spending accounts for a high share of GDP in the UK, relative to most other advanced economies. Finally, the UK plans a far larger fiscal adjustment than most of its peers over the next four years, having seen its budget deficit widen during the financial crisis to become one of the largest of the developed economies.

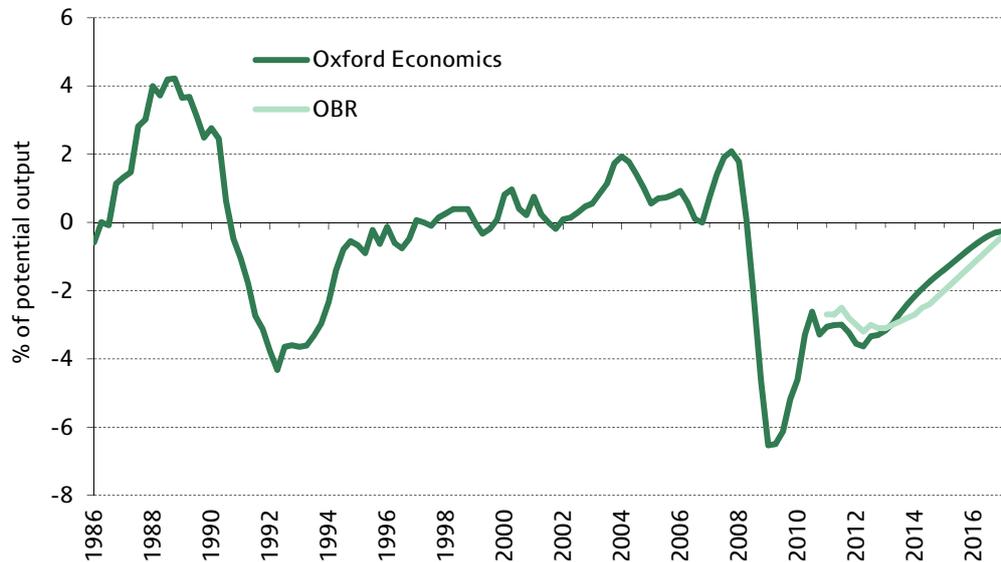
Figure 2.21. Comparison of current cycle across countries



Source: Haver Analytics, Oxford Economics.

The combination of our forecast for a slow recovery in GDP growth with weaker projected potential output growth means that our forecast for the output gap moves below that of the OBR during 2013 (Figure 2.22) and remains slightly smaller thereafter. By 2017Q1, the reference point for the fiscal mandate, our forecast shows an output gap of -0.3% , compared with the OBR forecast of -0.4% . However, our forecast shows a level of GDP that is almost 2.5% lower than that of the OBR.

Figure 2.22. Output gap



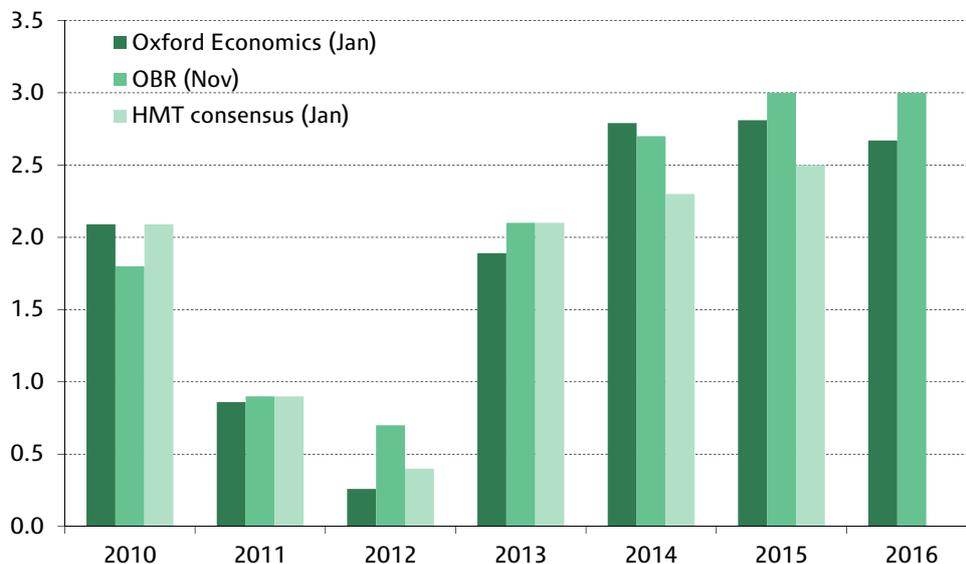
Source: Oxford Economics, OBR.

2.5 Comparison with other forecasts

Our short-term forecasts are somewhat weaker than those of the OBR and the market consensus (Figure 2.23). However, in our view, this is largely a question of timing: short-term prospects have worsened considerably in recent months and, in updating our forecast in January, we have had the opportunity to factor in these developments. We

would expect the OBR to make further downgrades to its short-term forecast when it publishes its next forecast in March, while the market consensus is also likely to drift downwards as other forecasters make revisions to their forecasts.

Figure 2.23. Comparison of GDP forecasts



Source: Oxford Economics, OBR, HM Treasury.

Over the latter years of the forecast horizon, our forecast is on average a little weaker than that of the OBR. This is because we have assumed lower growth in potential output over the next five years. The market consensus is lower still, although we consider the consensus forecast to be a less reliable indicator of longer-term forecasts, given that the sample size is considerably smaller than for the short-term forecasts.

Looking at the expenditure components, the key difference between our forecast and that of the OBR is that we are less optimistic about the prospects for business investment. Our forecast features a strong rebound in capital spending, underpinned by the strong financial position of UK firms and a gradual loosening in credit conditions. But it falls well below the OBR's forecast for business investment growth of nearly 11% a year between 2012 and 2016. Growth of this magnitude for such a prolonged period would be extremely rare in modern economic history¹⁰ and we are extremely sceptical that it could realistically be achieved.

2.6 Risks skewed to the downside: alternative scenarios for the UK economy

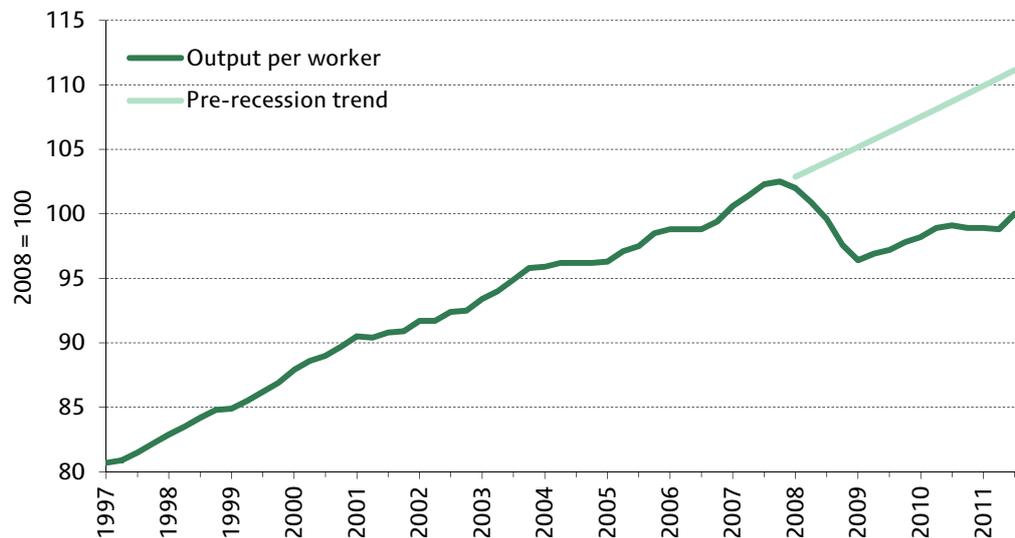
The level of uncertainty surrounding the forecast is almost without precedent. Indeed, we attach a probability of only 45% to an outcome similar to our baseline scenario. In normal circumstances, we might expect to assign a probability of at least 60% to our central forecast. Risks to the forecast have domestic and external origins.

¹⁰ The OBR forecasts that business investment will grow by 10.8% a year between 2012 and 2016. The ONS time series for business investment goes as far back as 1965 and on only one occasion has there been a four-year period where growth has been that strong (1994–98: 11.3% a year). The average annual growth rate over the period from 1965 to 2010 was 2.8% a year.

While the UK corporate sector is in relatively good financial health, the same cannot be said of UK households. The consumer continues to be hobbled by declining real incomes, rising unemployment, high debt levels that are still around 150% of disposable income, and house and equity prices that are, at best, moving sideways. Each of these factors could weigh on consumption by more than expected, leading the household sector to drag the UK into a deeper recession:

- Inflation has surprised on the upside and may continue to do so. Given wage inflation is likely to remain very modest with unemployment at high levels, this would squeeze back real income growth. This risk is compounded by current tensions between the US and Iran that could see a spike in oil prices which would also feed into UK inflation, cutting households' purchasing power.
- Although unemployment is expected to rise to almost 3 million, the level of employment is still very high given the level of output – output per worker is well below pre-recession levels (Figure 2.24). This could lead to employers significantly scaling back their labour force if the outlook looks set to worsen or the financial position of corporates starts to deteriorate.

Figure 2.24. Output per worker



Source: Haver Analytics, Oxford Economics.

- Household debt in the UK is higher than that in most other major economies (Figure 2.5 earlier) and UK households may decide – or be forced by tighter credit conditions – to deleverage faster than currently assumed, leading to lower spending and pushing the savings ratio higher.
- Asset prices – housing and equity – are vulnerable to changing economic sentiment and a sharp fall in these prices would have significant wealth and confidence impacts on the UK consumer.

UK households are therefore much more likely to be a significant drag on growth in 2012 than a driver of recovery and could even pull the UK into a deeper recession than we currently forecast. It is unlikely that further quantitative easing could be implemented quickly enough to prevent such consumer weakness from generating an even deeper double-dip recession this year.

The greatest threats to the outlook for the UK economy, though, come from abroad. In the rest of this section, we take the three alternative scenarios set out in Chapter 1 and consider how they might affect the UK economy.

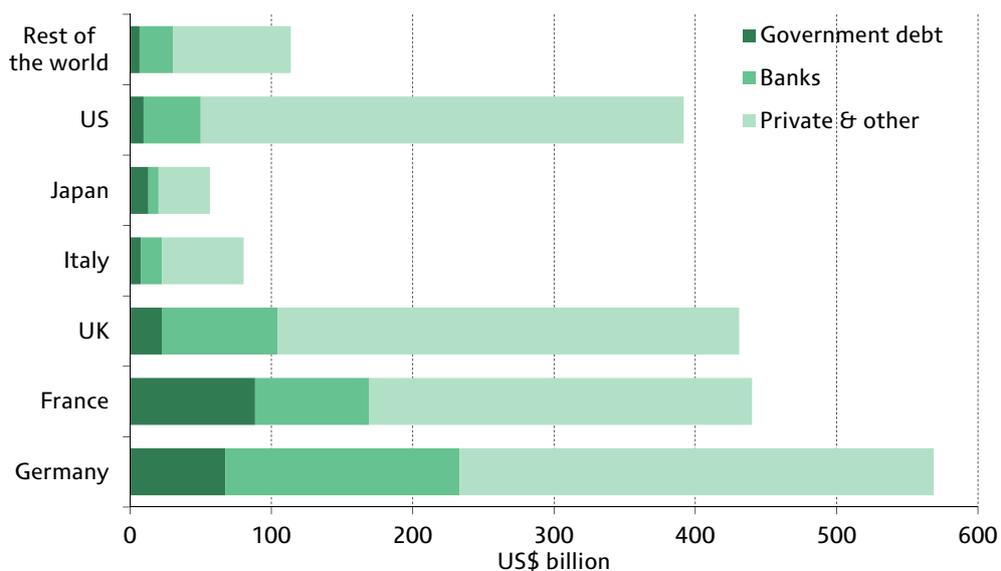
Disorderly defaults in the Eurozone

The escalation of the Eurozone sovereign debt crisis has already had a damaging effect on UK growth prospects, through the weakening in export demand and the dampening effect on business sentiment and, therefore, investment intentions. Our baseline forecast assumes that these pressures ease this year, as policymakers establish a solution that contains the financial crisis.

However, the UK would be particularly vulnerable to any escalation of the crisis and we estimate there to be a 30% probability that there will be one or more ‘disorderly’ defaults, including a potential for the Eurozone to fracture. In such a scenario, the UK would be one of the countries hardest hit outside of the Eurozone. This is partly because of its strong reliance on the Eurozone for exports and likely negative impacts on consumer and business confidence.

However, the strongest transmission would be through financial contagion and the credit crunch conditions that would ensue. While UK banks appear to be stronger than their European counterparts, having made significant efforts to recapitalise post-Lehmans, the close links mean that UK banks will not be immune to spillovers from increased stress in the European banking sector. As Figure 2.25 shows, the UK’s exposure to government debt of the Peripheral-4 (Greece, Spain, Portugal and Ireland) is relatively limited, especially compared with Germany and France, and the UK should withstand any orderly sovereign default of one or more of these countries relatively well. However, the UK’s exposure to bank and other private sector debt is much greater and a disorderly sovereign default in the periphery would lead to defaults in other sectors of the economy, as well as other parts of the Eurozone, which would hit the UK banking sector hard.

Figure 2.25. Bank exposure to peripheral debt



Source: BIS.

In a scenario where the Eurozone breaks up, we would expect the UK to endure a second deep recession, albeit not as dramatic as the 2008–09 recession because there is less scope for businesses to cut spending on inventories or business investment this time around. GDP would decline by 1.7% in 2012 and by a further 0.9% in 2013, with unemployment rising to a peak of 10.7% on the ILO measure.

China hard landing

Our ‘China hard landing’ scenario involves a more significant slowdown in Chinese growth triggered by problems in the local banking sector. Such a scenario would cause a slowdown in global economic growth which, in turn, would dampen demand for UK exports. However, the direct effects on the UK economy would be limited by its relative lack of exposure to the Asian economies, with just 2% of UK exports going to China. It is a similar story in terms of financial spillovers, with modest financial contagion spreading across the globe but the UK suffering less in relative terms because of its relatively weak links with Asia. In addition, the UK is likely to benefit from the drop in the oil price seen in this scenario, with a significant easing in the pressures on household finances.

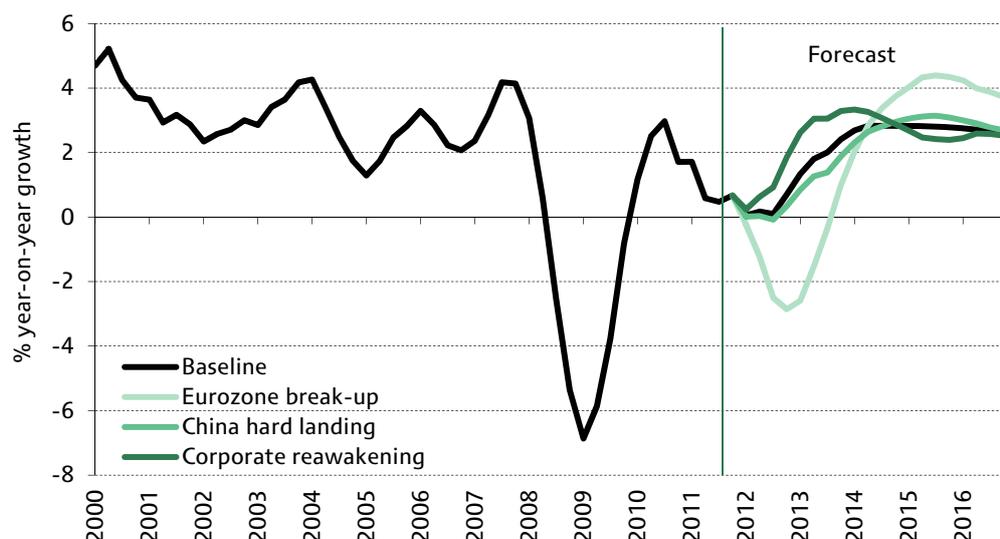
Under this scenario, we would expect UK GDP to grow by 0.1% this year and by 1.3% in 2013, modest downgrades on the baseline forecasts of 0.3% and 1.9% respectively. A lower oil price and looser monetary conditions would then see a degree of catch-up, relative to baseline, in later years.

Corporate reawakening

In addition to the downside risks, we do see some, limited, upside risks. One possible upside scenario might be generated by the development of credible plans to deal with fiscal problems and the financial crisis in the Eurozone and an easing of tensions in the Middle East which leads to oil prices falling back.

The UK would be at the forefront of such a scenario, given the extent to which UK firms have built up cash surpluses over the past four years. This scenario would see confidence restored, encouraging the corporate sector to use these large surpluses to invest and

Figure 2.26. GDP forecasts for alternative scenarios for the UK economy



Source: Oxford Economics.

boost its workforce. The drop in the oil price would ease pressures on the purchasing power of households which, combined with improved employment prospects and stronger sentiment, would generate a firmer contribution from the consumer sector, albeit this would remain constrained by the high levels of indebtedness. Under this scenario, we would expect the UK economy to grow by 0.9% this year and by 3.0% in 2013, somewhat stronger than the OBR forecast.

Figure 2.26 shows GDP forecasts for the UK economy, based upon these three alternative scenarios.

2.7 Conclusions

The escalation of the Eurozone sovereign debt crisis has caused short-term growth prospects to deteriorate significantly in recent months. Though the OBR slashed its forecasts for the 2011–13 period in November, these now look optimistic. We expect the UK economy to endure a short and mild recession from 2011Q4 to 2012Q1 before recovering, but growth is expected to reach just 0.3% this year and 1.9% in 2013. These forecasts are a little weaker than those of the OBR and the market consensus, though we expect these to move down over the next few months as forecasters adjust their forecasts to take account of the latest events.

We think that there is currently a significant amount of spare capacity in the economy. We expect potential output growth to average only 1.6% over the period to 2016, constrained by tight credit conditions and weak business investment. GDP, however, is expected to grow on average by 2.1% a year over the next five years as the output gap gradually closes.

While our baseline forecast may appear to be rather gloomy, particularly in the short term, we would stress that the risks remain heavily skewed to the downside. The most serious threat comes from the prospect of an escalation of the Eurozone sovereign debt crisis, with a series of defaults and exits from the Eurozone having the potential to cause another deep recession in the UK.