

4. The UK economic outlook

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Summary

- The UK recovery finally gathered pace in 2013, led by the consumer and the housing market. We expect quarterly growth rates to slow a little through 2014, as the economy makes the transition towards more balanced growth, but our forecast shows growth averaging 2.6% over the year as a whole. The contribution of the consumer is expected to ease, given that there is little scope for households to reduce their savings any further and that the recovery in real incomes is likely to be steady rather than spectacular. But the outlook for both business investment and exports is likely to improve from this year, as the global recovery strengthens.
- We judge that there is currently a significant amount of spare capacity in the UK economy, with the output gap estimated to have averaged 5% of potential output in 2013. The financial crisis is likely to have caused substantial permanent damage to potential output, though our estimates for the scale of this damage are smaller than those of most other forecasters, including the Office for Budget Responsibility (OBR). Such a large output gap will provide the conditions for the recovery to gain momentum over the medium term, with GDP growth expected to average 2.6% a year from 2014 to 2018. Our forecasts are not dissimilar to the OBR's, but are above the market consensus over the longer term.
- The risks around our forecast are more balanced now than they have been since the financial crisis. Domestically, the main uncertainties surround the housing market and the high level of consumer indebtedness. Externally, the most likely upside scenario would involve stronger recoveries in the US and Eurozone, which would boost UK export growth. On the downside, the biggest threat would be if the Eurozone were to slide into deflation; such a scenario could force Greece out of the Eurozone, with the UK's close trade and financial linkages with the Eurozone meaning that the UK recovery would slow sharply.

4.1 Introduction

After several false starts, 2013 finally saw the UK recovery gather momentum, with growth steadily accelerating through the year. Indeed, the combination of upward revisions to the historical data and a stronger-than-expected pickup in activity through the year meant that the forecast we presented in last year's Green Budget – which at the time was at the more optimistic end of the market consensus – ultimately proved to be too pessimistic. However, thus far the recovery has been narrowly focused on the consumer and the housing market, with little support coming from business investment or exports. In this chapter, we discuss the outlook for the UK economy, beginning in Section 4.2 with short-term prospects, where we assess whether the recent strength of the recovery can be maintained and look at whether it is likely to broaden out into business investment and exports.

Moving our focus beyond the short term, we consider prospects for the 2014–18 period as a whole. As part of this, we analyse the amount of spare capacity in the economy by considering the degree to which the economy has suffered permanent damage to

potential output growth, before moving on to discuss the extent to which potential output will recover over the next five years (Section 4.3). Having set out our baseline forecast, we then assess how this compares with the most recent forecast from the Office for Budget Responsibility (OBR) and those of other independent forecasters (Section 4.4).

Section 4.5 analyses the risks around the baseline forecast and looks in detail at the potential impact of alternative global scenarios on the UK economy, including an upside scenario ‘Golden Age’ and a downside scenario involving the Eurozone sliding into deflation. Section 4.6 concludes.

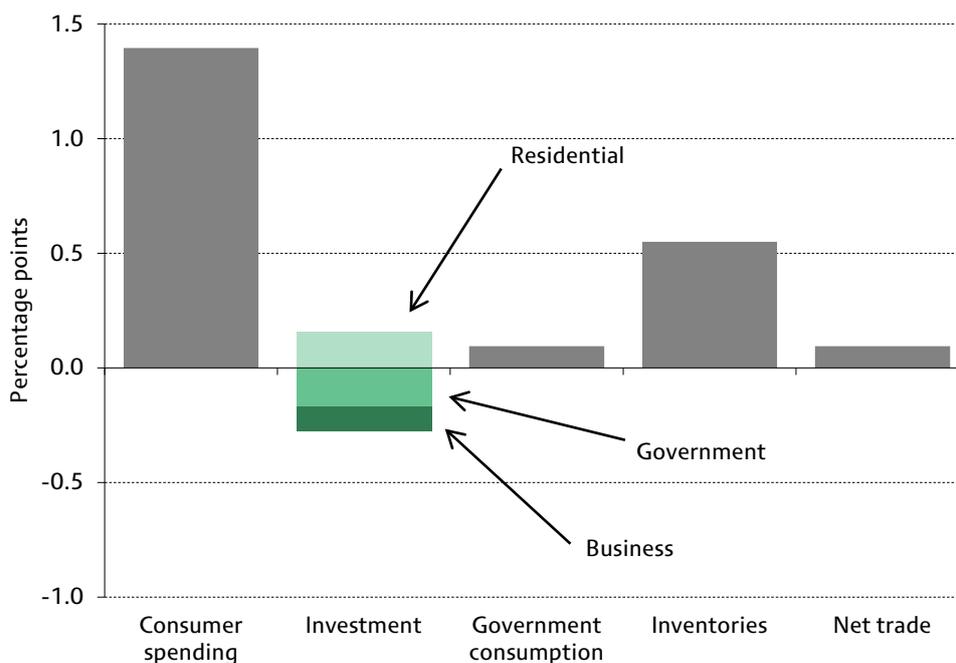
4.2 Will the recovery maintain its momentum in 2014 and 2015?

2013 – the year that the recovery finally took hold

The UK recovery finally got underway in earnest in 2013. The economy grew by 0.8% in both Q2 and Q3 and by 0.7% in the final quarter. This took GDP growth for 2013 to 1.9%, which represented the strongest performance of the UK economy since 2007.

The consumer has provided the drive behind the acceleration in activity, with private consumption accounting for 1.4 percentage points (ppts) of total GDP growth for 2013. The pickup in consumer spending occurred despite a small real-terms contraction in personal incomes, with households having financed additional expenditure through a sharp reduction in their rates of saving; the savings ratio is estimated to have fallen from 7.2% in 2012 to just 4.9% in 2013. This switch to a lower rate of saving reflected a strengthening in consumer confidence over the course of the year, which was underpinned by falling unemployment and which induced consumers to lower levels of precautionary saving. It was also a function of a steady decline in deposit rates, acting to reduce incentives to save and encouraging people to spend more.

Figure 4.1. Contributions to UK GDP growth in 2013



Source: Haver Analytics, Oxford Economics.

A further key contributor to the heightened levels of confidence was the strong recovery in the housing sector, particularly during the second half of 2013. At the height of the financial crisis, a lack of mortgage availability had left housing transactions at just a third of pre-crisis levels. However, following intervention from both the Bank of England and the government, there was a resurgence in transactions last year, with gross mortgage lending up more than 20%. In addition to the confidence channel, this also supported consumer spending through traditional wealth effects, as well as more directly through the sales of white goods and furniture.

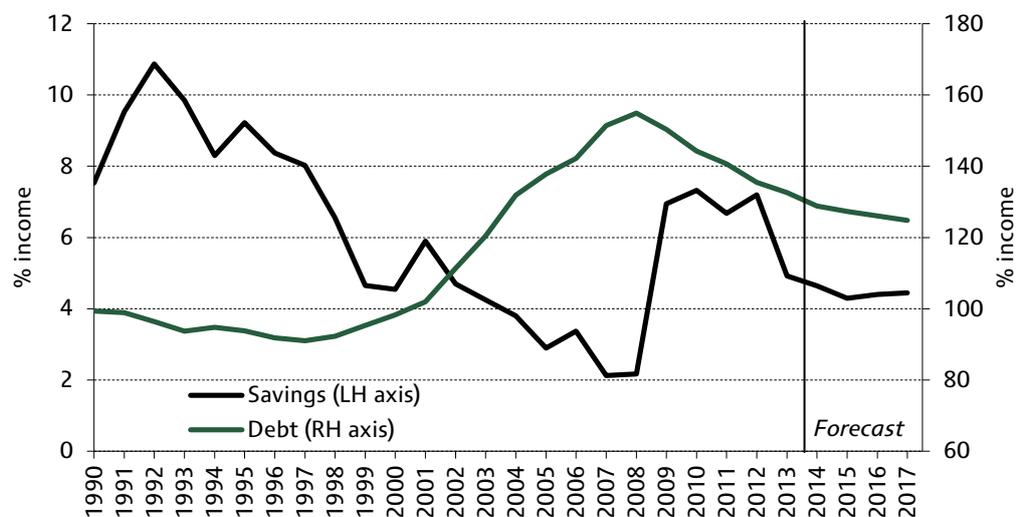
However, beyond the consumer and housing there was precious little support to the recovery; business investment was again a drag on growth, while the contribution of net trade was negligible (see Figure 4.1). The contribution of inventories looks suspiciously high, which is likely to reflect the Office for National Statistics (ONS) having problems reconciling the output and expenditure approaches to GDP; some of this is likely to be reassigned to other components over time, but even so it is unlikely to alter the perception of a very narrow-based recovery in 2013.

Consumer spending growth is set to cool ...

As we have already established, the 2013 rebound in consumer spending was funded by lower rates of saving rather than real income growth. But given the extent to which the savings ratio has fallen, and the expectation that households will continue to deleverage over the short term in anticipation for when interest rates start rising, the scope for households to further reduce savings is somewhat limited (see Figure 4.2). Indeed, many high-frequency consumer indicators – most notably retail sales growth – weakened towards the end of last year, following sharp improvements in early 2013, indicating that the process of equalisation may have already started.

As the household savings ratio levels out, consumer spending is expected to realign and more closely follow the evolution of income growth over the next two years. Real household disposable incomes stagnated in 2013 and, at below 1% on an excluding-bonuses basis, wage growth remains anaemic. But the prospects for real income growth are a little brighter going into 2014.

Figure 4.2. Personal debt and savings ratio



Source: Haver Analytics, Oxford Economics.

The pace of improvement in the labour market has stepped up a notch in recent months. Labour Force Survey data for the three months to November showed that the level of employment increased by 280,000 on the quarter, the strongest net job creation on record, while over the same period the unemployment rate fell by 0.5ppts to 7.1%. The entire rise in employment has come from an increase in the number of full-time workers, highlighting the underlying strength of the labour market. Unemployment will continue to fall in line with the stronger performance of the economy, although with a record number of part-time employees looking to work on a full-time basis, the pace of deceleration should decline as businesses increasingly accommodate this slack.

With the much improved outlook for the labour market, the wage bargaining position of workers will also strengthen, and indeed a number of sectors are already reporting an emergence of skills shortages, most notably in construction. However, while private sector pay growth is likely to improve, the public sector pay squeeze will remain somewhat of a drag in the short term. We expect earnings growth to pick up to 2.6% this year, before accelerating to 3.2% in 2015.

Alongside this pickup in wage growth, we are due to see another above-inflation increase in the income tax personal allowance in April, which will provide an additional boost to incomes, although this boost will be partially offset by the government's decision to either freeze or limit the indexation of many social payments.

... despite lower inflation promising a return to real wage growth

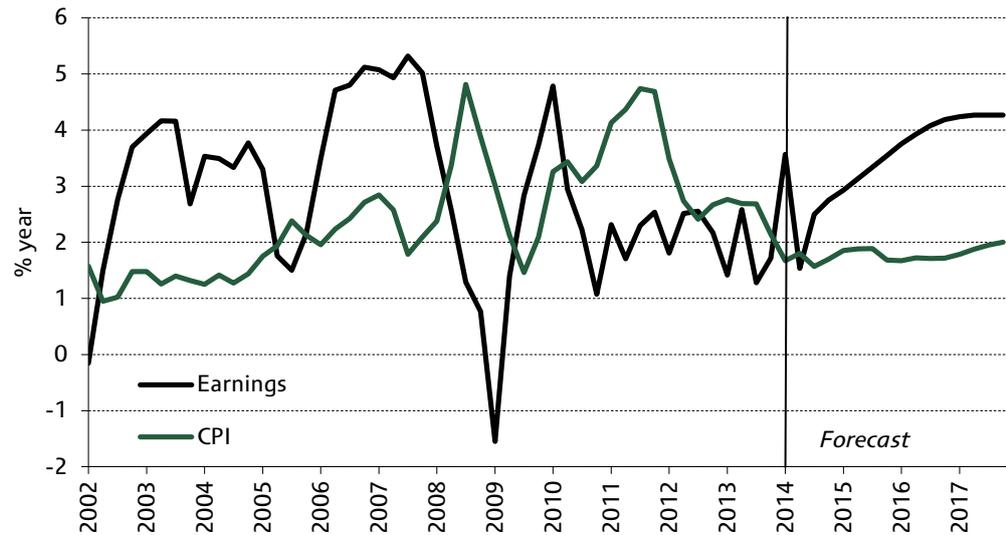
The UK economy has faced an unusual situation in recent times, with inflation remaining above target for the last four years despite the poor growth performance. But inflationary pressures cooled towards the end of last year, with CPI inflation falling to 2% in December. This provides some vindication of the Monetary Policy Committee (MPC)'s argument that inflation would fall back towards the target once the effects of several temporary factors had subsided.

Indeed, the slowdown in inflation has largely been a result of base effects falling away; big rises in food prices in the autumn of 2012 were not repeated last year as world commodity prices fell, and increases in domestic energy bills, while still very large, were also lower than in the previous year. In addition, the impact of higher university tuition fees was much reduced in 2013, further contributing to the slowdown in inflation.

There has also been a slowdown in underlying or 'core' inflation, with December's reading of 1.7% for CPI excluding food, energy, alcohol and tobacco being the lowest for more than four years. We attribute this to the combination of a large output gap, which continues to put pressure on profit margins and keep wage growth constrained, and the influence of a stronger pound, which has reduced the price of imported commodities.

We expect the slowdown in inflation to continue over the short term. There is no indication of pressures building up in the supply chain, with producer output price inflation slowing to less than 1% towards the back-end of 2013. Similarly, oil prices have been trading at a little under \$110 per barrel recently, in line with the average for 2013 as a whole in dollar terms but, because of the appreciation of sterling, around 4% lower in sterling terms. The benefits are being seen at the pumps, with retail petrol prices currently around 3 pence per litre lower than over 2013 as a whole. We expect oil prices to slip back through 2014 as supply increases strongly, particularly through non-conventional output from North America, and while the pound is likely to weaken against the dollar as the US economy accelerates, we still expect petrol prices to be broadly flat

Figure 4.3. Inflation and earnings growth



Source: Haver Analytics, Oxford Economics.

through 2014. Furthermore, government intervention in domestic energy markets at the end of 2013 should act to ease the pace of energy price increases over the short term.

Underlying inflationary pressures are also likely to remain weak as the persistence of the large output gap will continue to bear down on operating margins and wages. Such weak underlying pressures should push inflation below the 2% target during the early months of 2014, where it is expected to remain throughout the year. Our forecast shows CPI inflation dropping from 2.6% last year to average 1.7% in 2014 and 1.8% in 2015.

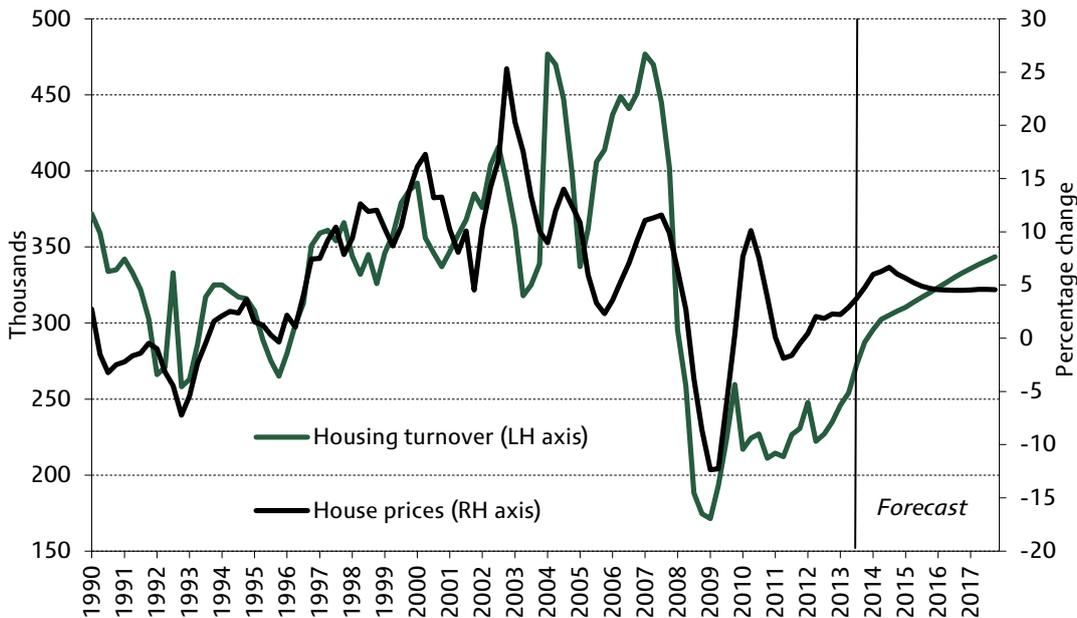
This combination of strengthening earnings growth and low inflation should be sufficient to ensure that real wages begin to increase again by the middle of this year (see Figure 4.3). This will provide households with a welcome improvement in their spending power, although this will be a gradual process and, with the savings ratio unlikely to fall much further, this suggests that the pace of consumer spending growth will cool a little in the near term. Our forecast shows consumer spending averaging 2.2% in both 2014 and 2015 – a significant improvement on recent years, but still well short of the 3.7% a year average over the decade prior to the financial crisis.

A buoyant housing market will provide strong support

House prices and activity exhibited strong growth through 2013 (see Figure 4.4). This was partly due to the more favourable macroeconomic backdrop, but was mainly a function of policy targeted at increasing mortgage lending. The Bank of England's Funding for Lending Scheme (FLS) was particularly effective at increasing the flow of mortgage credit and reducing its cost and this was supported by the first leg of the government's Help to Buy (HTB) policy, which provided equity loans for new-build properties and underpinned a strong pickup in demand for these properties. As a consequence, house price inflation accelerated above 5% towards the end of 2013.

This rapid recovery in the housing market, plus the launch of the second leg of HTB, which provides lenders with guarantees on high loan-to-value mortgages, has raised some concerns among commentators that the UK is once again in the early stages of a housing market bubble. Indeed, the Bank of England demonstrated its sensitivity to such

Figure 4.4. House prices and transactions



Source: Haver Analytics, Oxford Economics.

concerns in November by removing the mortgage lending incentive from the FLS. Given that mortgage interest rates have fallen since the launch of FLS, this move could cause them to rise once more. However, we expect the impact to be relatively minor, particularly given that many banks had been making less use of the scheme in the second half of last year. What the move has done, however, is send a clear signal that the Bank of England is willing to intervene in the housing market if necessary.

The latest survey data from the Royal Institution of Chartered Surveyors (RICS), indicating strong growth in new buyer enquiries, suggests growth in both activity and prices will remain firm in the short term. Indeed, our forecast sees housing activity accelerating further, as the impact of the second phase of HTB begins to filter through and the wider improvement in household incomes and employment provides further support.

However, there is little evidence that the market is overheating. Prices – as measured by the ONS – have only recently returned to pre-crisis levels in nominal terms but are still 15% lower in real terms, while affordability and indebtedness measures are far less stressed than they were during the financial crisis. It is a similar story when reviewing the level of activity. There has indeed been a firm acceleration in transactions, but in a similar vein to prices, the rebound started from a very low base. As such, transactions are still one-third below peak levels, while mortgage approvals and gross lending both remain over 50% lower.

Key to avoiding a bubble in the future will be ensuring that housing supply keeps pace with demand. Early evidence suggests that the stronger market has encouraged a robust pickup in residential construction, with new orders up 40% on a year ago. But housebuilding has averaged just over 150,000 a year for the past five years, some way short of the previous government's estimate of 240,000 as the number of new homes needed every year just to keep pace with demographic developments, which suggests that construction needs a period of catchup if the stock is going to return to a more sustainable level.

Our forecast sees housing investment continuing to recover, but only overtaking its 2006 peak in 2018. This should be sufficient to keep a lid on price growth, which is expected to average just over 6% a year in 2014–15, and would suggest that further intervention in the housing market will prove unnecessary. This forecast suggests an increase in the direct contribution of housing investment to GDP growth as well as indirect benefits of an increase in activity and prices on consumer spending through confidence and wealth effects.

A further discussion of trends in the UK housing market, and recent housing policies, can be found in Chapter 5.

Interest rates to remain low despite an improving labour market

We are fast approaching the point at which the Monetary Policy Committee will have to make a decision about the future of its much-maligned forward guidance policy. The policy, introduced back in August following the appointment of Mark Carney as Governor of the Bank of England, had been intended to bolster consumer and business confidence by providing reassurance that the bank rate would remain at 0.5% for a prolonged period of time. However, the economy, and in particular the labour market, has improved so rapidly that we expect the unemployment rate to hit the 7% threshold in the next few months, more than two years earlier than the Bank had initially forecast.

This provides a headache for the MPC, which continues to emphasise that 7% is a threshold not a trigger and reaffirm its intentions to keep rates on hold for as long as possible. Indeed, recent comments by Mark Carney have suggested that the Bank intends to make greater use of macroprudential tools in the future and that those are likely to be employed before interest rates are increased.

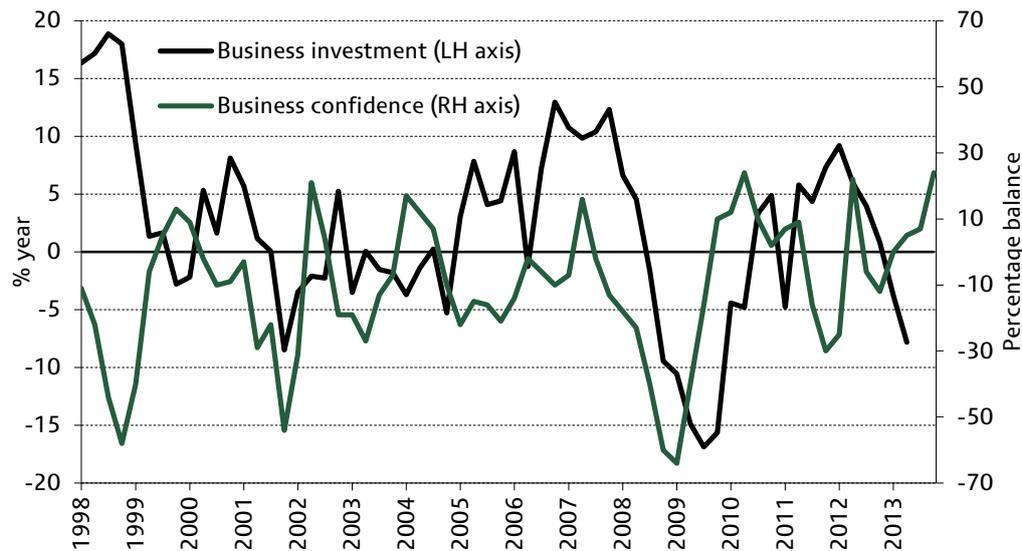
We therefore expect the bank rate to remain at 0.5% throughout 2014, even after the 7% unemployment threshold is breached, with the first rate rise not expected before the second half of 2015. This would provide additional breathing space to ensure that the recovery has sufficient momentum before having to weather tighter policy. The Bank could lower the threshold for unemployment, most probably to 6.5%, or abandon it altogether and switch to guidance that is not so tightly linked to a particular outcome. There are increasing signs that the Bank is leaning towards the latter option, which, given the teething problems experienced so far, is probably for the best.

Business is set to play a stronger part in the recovery

The performance of the corporate sector has been particularly disappointing, with the anticipated pickup in business investment still yet to materialise. We estimate that business investment fell by 3.9% in 2013 and remains well over 20% short of its pre-crisis peak, although we are very suspicious about the quality of the official business investment data following the methodological changes last summer that brought about substantial downward revisions right back to 1997.

Taking the investment figures at face value, the performance has been particularly disappointing given the relative strength of corporate finances. Non-financial corporations continued to run sizeable surpluses throughout 2013 and have now accumulated cash deposits equal to 30% of GDP, some 7ppts higher than the average of the decade prior to the financial crisis. In addition, although smaller firms continue to report problems in accessing funding, larger firms, which dominate investment spending in the UK, retain good access to bank finance.

Figure 4.5. Business confidence and investment growth



Source: Haver Analytics.

The dearth of capital spending over the past couple of years appears, therefore, to be largely a function of low corporate confidence, reflecting the earlier poor domestic growth performance and heightened uncertainty which increased concerns over the likely return on investment (see Figure 4.5). This uncertainty led firms to employ their cash reserves in other ways, rather than committing to large and irreversible investment projects in the UK.

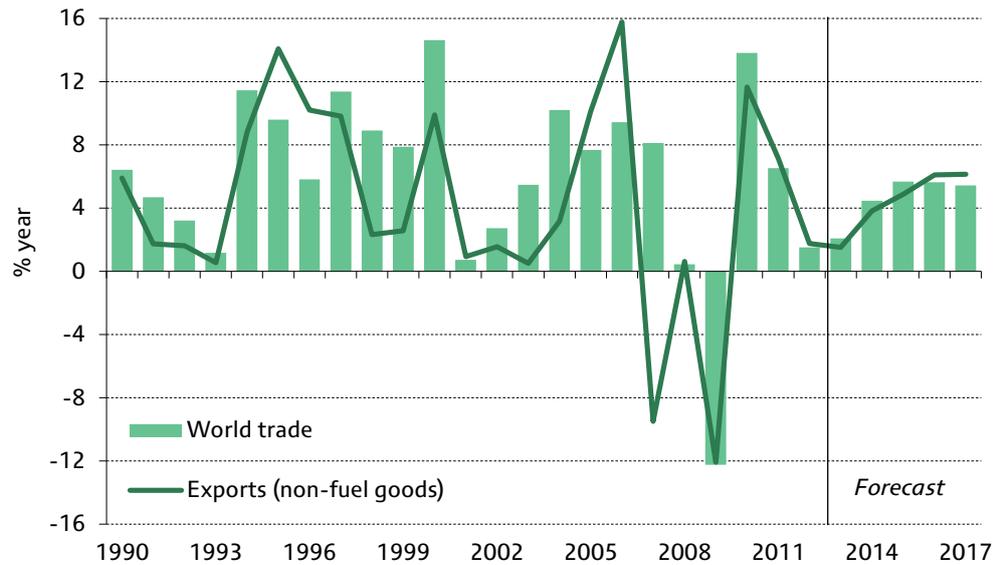
However, with the economy having moved onto a much firmer footing, the corporate sector is now well placed to start supporting the recovery. Corporate confidence is much improved in recent months, reflecting not just the enhanced growth outlook but also reduced downside risks, and business surveys are reporting much stronger investment intentions. The depressed levels of investment in recent years suggest a sizeable level of pent-up demand, and we expect this to be released as confidence continues to improve, encouraging firms to spend their accumulated cash surpluses. We are forecasting business investment to increase by 5.4% in 2014 and 7% in 2015, but these growth rates remain modest considering the strength of corporate balance sheets and when compared to the standards set in previous recoveries. As such, there is a good chance that the company sector could surprise on the upside, especially if the encouraging performance of the UK continues.

Export growth is also forecast to pick up

A key component underpinning the improving levels of corporate confidence in the UK is the strengthening export outlook, although this is yet to be seen in the official data. Business surveys reported a clear improvement in export demand throughout 2013 but, after promising signs in 2013H1, official data for the second half of the year were very disappointing.

Indeed, the UK's export performance since 2008 has been disappointing, especially when considering the sharp depreciation of sterling during 2008-09. This largely reflects sluggish demand in key export markets, with an over-reliance on poorly-performing developed economies, and the relative unresponsiveness of services exports to price movements. But it is also indicative of structural failings within the domestic economy,

Figure 4.6. Exports and world trade growth



Source: Haver Analytics, Oxford Economics.

which damage the non-price competitiveness and hamper export growth. A recent report from the EY ITEM Club¹ found evidence that exporters' efficiency has been hampered by factors such as red tape, the poor access of small and medium-sized enterprises (SMEs) to trade finance and a prolonged period of underinvestment in the transport and communications infrastructure networks. These problems have slowed the UK's pace of expansion into fast-growing emerging markets and limited the ability of exporters to capitalise on an increase in external demand.

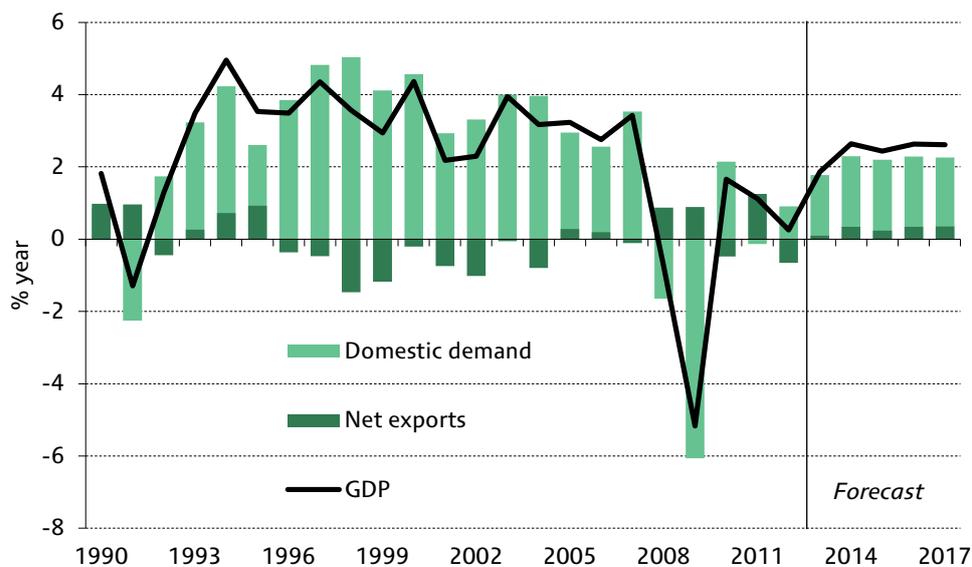
We are nevertheless optimistic that the stronger survey results will soon become noticeable in official statistics. The US recovery looks well entrenched and growth in emerging markets is expected to remain robust, if not spectacular. The Eurozone, meanwhile, has pulled out of recession and a stronger pickup in growth, particularly in Germany and the periphery, should help to strengthen UK export demand going forward. World trade, weighted by UK export shares, is expected to grow by 4.5% this year, up from 2.1% in 2013, before accelerating to 5.7% in 2015 (see Figure 4.6). Although these rates are unspectacular, and the pound is expected to appreciate modestly on a trade-weighted basis, this pickup in demand should be sufficient to underpin a steady acceleration in export growth. We expect export volumes to grow by 3.1% in 2014 and 4.0% in 2015. Import growth should be more subdued, given that consumer spending is unlikely to accelerate. As such, we expect net trade to make modest positive contributions to GDP growth moving forwards and the large current account deficit, estimated to have averaged 3.6% of GDP in 2013, will steadily shrink.

Recovery set to become entrenched and more balanced

Drawing these strands together, our forecast points to slightly weaker growth in the near term as consumer spending growth cools, with quarterly growth rates stepping down

¹ EY ITEM Club Special Report on UK Export Performance, November 2013, [http://www.ey.com/Publication/vwLUAssets/ITEM_Club_special_report_12_2013_-_Exports_-_full_report/\\$FILE/EY-ITEM-Exports-special-report-December-2013-full-report.pdf](http://www.ey.com/Publication/vwLUAssets/ITEM_Club_special_report_12_2013_-_Exports_-_full_report/$FILE/EY-ITEM-Exports-special-report-December-2013-full-report.pdf).

Figure 4.7. Contributions to GDP growth



Source: Haver Analytics, Oxford Economics.

from 0.7–0.8% to nearer 0.6%. But as the recovery broadens out, with the contributions of business investment and exports improving, then the recovery will achieve the ‘escape velocity’ that Mark Carney is desperately seeking. Our forecast shows GDP growing by 2.6% in 2014, which would be the strongest growth for seven years, and 2.4% in 2015 (see Figure 4.7).

4.3 Medium-term recovery slower than usual

Over the medium term, we expect a steady 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 damage has the financial crisis done to potential output?

The question of the size of the output gap and forecasts for growth in potential output is crucially important to both fiscal and monetary policy. With regards to monetary policy, the MPC’s apparent contentment to leave interest rates at their current level for a prolonged period is partly due to its belief that the UK has sufficient spare capacity to ensure that underlying inflationary pressures remain subdued. In terms of fiscal policy, these estimates 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 the 2013 Autumn Statement, when the OBR judged that the stronger economic performance through 2013 was cyclical in nature, so despite borrowing coming in lower than anticipated, the underlying fiscal position was little changed and the Chancellor had no additional room for manoeuvre against his fiscal targets.

However, the size of the output gap and the strength of potential output growth cannot be measured. As such, most commentators agree that the best approach is to use a range of different indicators to try to proxy the level of spare capacity. But these indicators do not

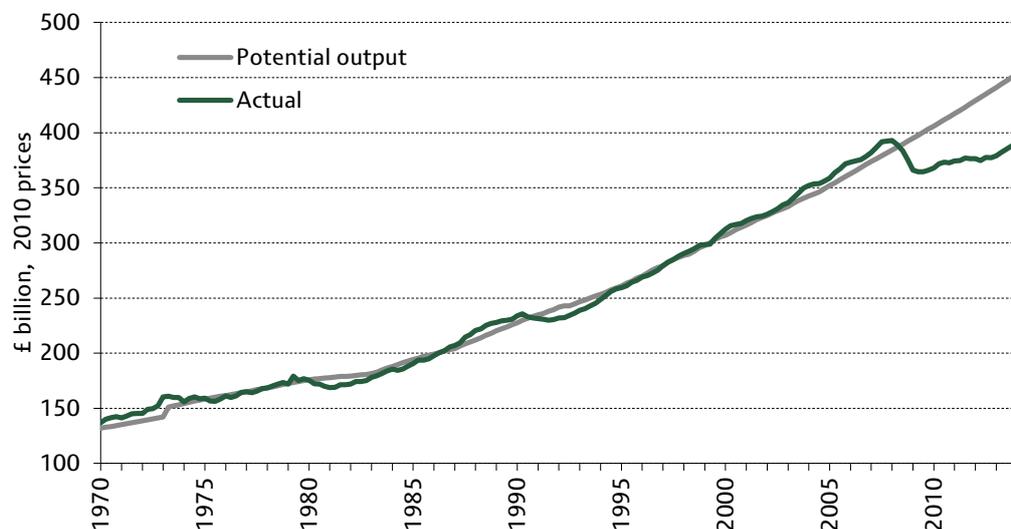
always corroborate one another. For example, labour market data suggest that the UK has a sizeable amount of spare capacity, with the unemployment rate around 2ppts higher than pre-recession levels and earnings growth very muted despite inflation having been persistently above the 2% target. Yet business survey results tell a markedly different story, with respondents reporting levels of capacity utilisation in the production industries that are above long-term average.

Therefore, a high degree of judgement is often required on behalf of the forecaster. Furthermore, economic data can often be subject to revision for many years after the event, which makes 'real-time' estimates of the output gap particularly difficult. Indeed, a working paper from the External MPC unit of the Bank of England² found that estimates of the output gap have become progressively more prone to revision and 'unreliable' over time, with the authors citing the difficulty of separating the trend from the cycle in economic data as being the main cause of this. This presents a significant challenge for policymakers.

The depth of the recession and the slow pace of the subsequent recovery make estimating the size of the output gap even harder at the current time. GDP fell by 7.2% from peak to trough during the recession and remains around 1¼% short of previous peaks. Were we to assume that potential output has continued to grow at historic rates since 2007, it would suggest an output gap of around 15% (see Figure 4.8). This experience is by no means uncommon and a number of the advanced economies would have double-digit output gaps if this were the case.

However, as commentators analyse the causes of the financial crisis and its implications, the general conclusion has been that it has inflicted structural damage to potential output

Figure 4.8. GDP relative to potential output



Note: Potential output series shows OE estimates from 1970 to 2006. Potential output is then grown in line with the long-term average (2.8% a year) from 2007 to 2013.

Source: Haver Analytics, Oxford Economics.

² A. Chiu and T. Wieladek, 'Did output gap measurement improve over time?', Bank of England, External MPC Unit, Discussion Paper 36, 2012, <http://www.bankofengland.co.uk/research/Pages/externalmpcpapers/discussionpaper36.aspx>.

which will never be reversed, implying much smaller output gaps. There is a substantial literature on previous crises and while the evidence generally leans in favour of this argument, the estimates of the degree to which potential output has been affected tend to vary widely across crises. The main findings of four prominent studies are summarised in Table 4.1.

Table 4.1. Selected literature on the impact of financial crises on potential output

Authors	Countries / Crises covered	Dates covered	Results
Reinhart and Rogoff (2008) ^a	18	1977–1995	The average drop in real output per capita is over 2% and it takes two years to return to trend. For the five most catastrophic cases, the drop in annual output growth from peak to trough was over 5% and growth remained well below the pre-crisis trend after three years.
NIESR – Barrell, Davis, Karim and Liadze (2010) ^b	13	1980–2008	On average, banking crises reduce the level of potential output by 2.5%. But crises that were ‘systemic’ in nature were associated with a 4% decline in potential output. Some crises did not affect trend output and some – e.g. Canada in the early 1980s – were not even associated with a subsequent recession.
OECD – Furceri and Mourougane (2009) ^c	30	1960–2009	On average, banking crises reduce the level of potential output by 2.4% and it takes five years for the full effects to be felt. But for ‘severe’ crises, the average effect was 3.8%. The 99% confidence intervals were very wide – from just under 1% to just under 5% for average crises and from just under 1% to over 7% for a severe crisis.
IMF – Balakrishnan, Brooks, Leigh, Tytell and Abiad (2009) ^d	88	1970–2002	On average, banking crises reduce the level of potential output by 10%, with the maximum impact being felt after four to five years. The impact varies across countries depending upon their demand and supply structures.

^a C. Reinhart and K. Rogoff, ‘Is the 2007 U.S. sub-prime financial crisis so different? An international historical comparison’, *American Economic Review*, 2008, 98, 339–44.

^b R. Barrell, E.P. Davis, D. Karim and I. Liadze, ‘The effects of banking crises on potential output in OECD countries’, National Institute of Economic and Social Research (NIESR), Discussion Paper 358, 2010, <http://niesr.ac.uk/sites/default/files/publications/dp358.pdf>.

^c D. Furceri and A. Mourougane, ‘The effect of financial crises on potential output: new empirical evidence from OECD countries’, OECD Economics Department, Working Paper 699, 2009, http://www.oecd-ilibrary.org/economics/the-effect-of-financial-crises-on-potential-output_224126122024.

^d R. Balakrishnan, P. Brooks, D. Leigh, I. Tytell and A. Abiad, ‘What’s the damage? Medium-term output dynamics after financial crises’, chapter 4 of IMF, *World Economic Outlook: Sustaining the Recovery*, October 2009, <http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/text.pdf>.

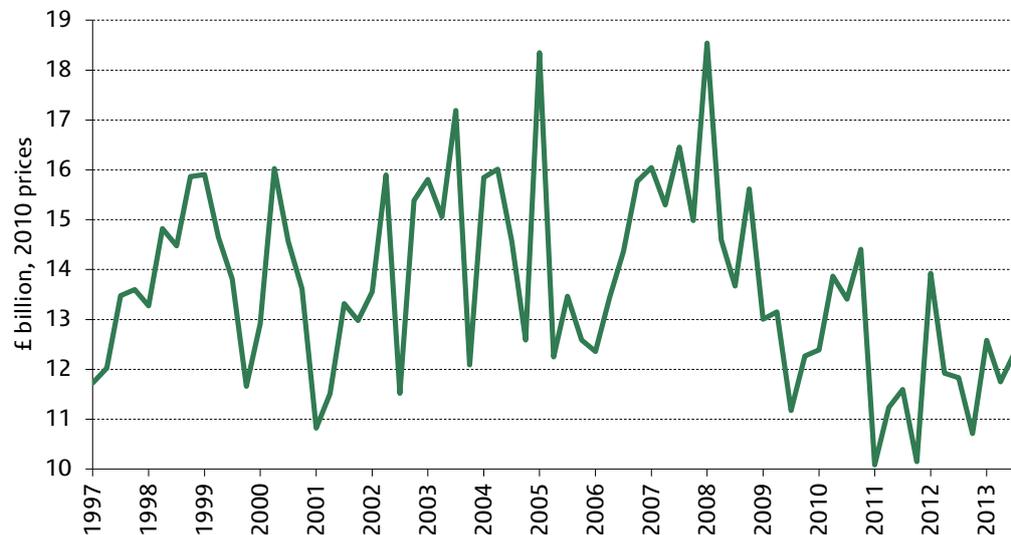
There is a range of views on how best to estimate potential output. We use a production function approach,³ which provides a framework that relates the level of potential output to contributions from factor inputs – labour and capital – and the efficiency with which those inputs are used (so-called ‘total factor productivity’). It also provides a consistent method for forecasting future growth in potential output, taking into account important changes such as demographic trends. For the economy to have suffered a permanent loss of potential output, the financial crisis and subsequent recession would have to have wreaked permanent damage to one, or more, of the size of the labour force, the level of capital it has to work with and total factor productivity.

Capital stock

The collapse in business investment during the recession could be a potential cause of a permanent loss. From the early-2008 peak, business investment fell by 30% due to a need to conserve cash, a shortage of external funding and a reassessment of how attractive the UK was as a place to produce. In effect, firms were forced to invest only on a ‘care and maintenance’ basis, with little investment in new capital equipment; investment in machinery and equipment fell by around 21% in 2008–09 and has fallen further since then (see Figure 4.9).

Verifying this argument is challenging for two reasons. First, the ONS usually only publishes estimates of the size of the capital stock after a lengthy lag, but in recent years it has decided not to publish estimates of the capital stock at all because of concerns over data quality. Second, the ONS introduced a number of methodological changes in mid-2013, which has resulted in the business investment series becoming incredibly volatile, and a number of commentators, including Bank of England Governor Mark Carney,⁴ have expressed concerns about their accuracy.

Figure 4.9. Investment in machinery and equipment



Source: Haver Analytics.

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: $\ln(Y^*) = \ln(A) + 0.65\ln(L) + 0.35\ln(K)$.

⁴ ‘Mark Carney hits back at critics of forward guidance on rates’, *Financial Times*, 26 November 2013, <http://www.ft.com/cms/s/0/e34ce498-568f-11e3-ab12-00144feabdc0.html?siteedition=uk#axzz2qCKxOrOI>.

We can apply data on business investment to those data on the capital stock that have been published, in order to try to estimate the likely impact on the capital stock, albeit subject to substantial caveats because of the aforementioned data availability and quality problems. This suggests that the period since the beginning of the financial crisis has seen the capital stock contribute around 1ppt a year to potential output growth, down slightly from the 1.2ppt a year over the period from 1996 to 2006.

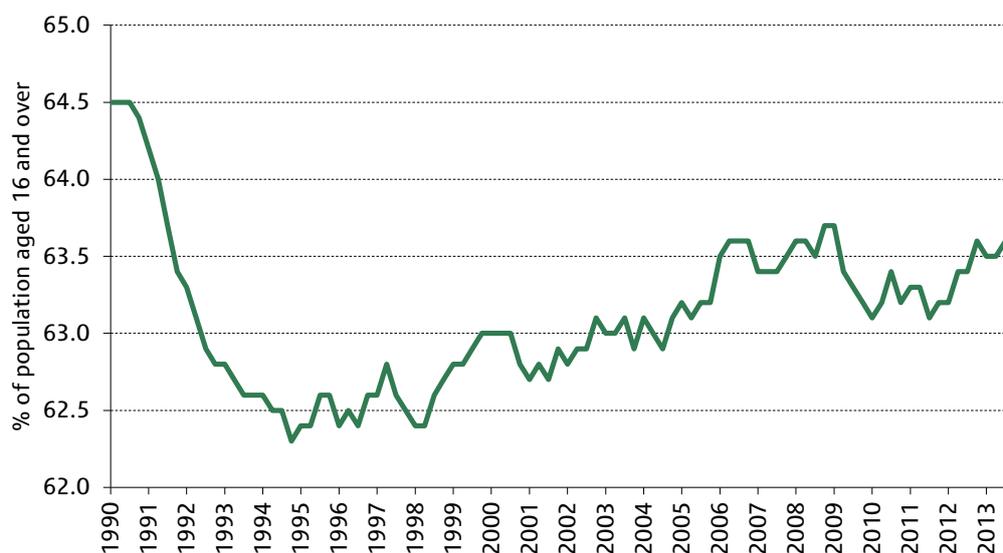
Labour supply

The contribution of the labour supply to potential output is dependent upon three factors: growth in the population of working age, participation rates and the level of the NAIRU.⁵ We find that there is little evidence to suggest that the financial crisis has caused significant damage to any of these.

The strength of inward migration flows has been a constant source of surprise given the depth of the UK recession and the extent to which unemployment increased. Migrants typically tend to be of working age, so relative employment prospects are a key driver of migration flows, yet the UK has remained a popular destination in recent years; net inflows have averaged just over 200,000 a year since the financial crisis, well above long-term averages. This has ensured that the period since the beginning of the financial crisis has actually seen faster growth in the working-age population than the decade before.

Labour market participation fell back in the aftermath of the crisis (see Figure 4.10), though to a much lesser extent than in previous cycles. This is because the downward pressures from poorer employment prospects have been offset by a series of longer-term structural shifts. These include greater female participation, as well as both older workers delaying their retirement and pensioners returning to part-time work, in reaction to poor retirement prospects caused by low levels of pension saving. Over the past couple of years, the combination of strong employment growth and the staged increase in the state pension age for women has helped to encourage a recovery in participation rates and they have returned to their pre-crisis levels.

Figure 4.10. Economic activity rates



Source: Haver Analytics, Oxford Economics.

⁵ 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.

Empirical evidence – notably Blanchard and Summers (1986)⁶ and Ball (2009)⁷ – suggests that significant shifts in aggregate demand can lead to changes in the NAIRU through hysteresis. 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. Ball 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 protracted period of weak or negative growth in the UK is a cause for concern. It is very difficult to measure the NAIRU in real time, but we think it unlikely that the UK has seen any significant impact through this channel thus far given the need for a period of time to pass in order for these unemployed workers to become detached from the labour market. However, the longer that demand remains low and unemployment rates stay elevated, the larger and more long-lasting these effects are likely to be, and we would expect to observe some hysteresis effects on the NAIRU over the next few years.

Total factor productivity

The OBR's analysis of the UK economy⁸ has consistently identified total factor productivity as being the most important source of any permanent loss of potential output, an argument that is also advanced by Dicks (2010).⁹ The arguments in favour of this theory generally centre on lower levels of innovation and research & development (R&D). This is generally caused by a lack of bank funding, resulting from a reduction of risk appetite or from forbearance on outstanding lending which prevents the reallocation of capital to more productive activities. Balakrishnan et al. (2009)¹⁰ suggest that there is some evidence that the biggest effects are felt in those countries with a greater degree of financial development prior to the crisis.

The nature of total factor productivity makes this assertion virtually impossible to verify for the current cycle, but for countries such as the UK, which exhibits a high degree of financial development and where a significant proportion of the banking sector collapsed, there would appear to be a strong argument for some permanent damage to total factor productivity. There is certainly strong evidence that there was a funding crisis, with lending to the corporate sector having collapsed over the past five years (see Figure 4.11).

The other way that the contribution of productivity growth could have been damaged would be if there had been a shift in employment towards low-productivity sectors. Those arguing that this has occurred¹¹ cite the deep decline in output per worker as

⁶ O.J. Blanchard and L.H. Summers, 'Hysteresis and the European unemployment problem', in S. Fischer (ed.), *NBER Macroeconomics Annual*, Volume 1, 1986, <http://www.nber.org/chapters/c4245.pdf>.

⁷ L.M. Ball, 'Hysteresis in unemployment: old and new evidence', National Bureau of Economic Research (NBER), Working Paper 14818, 1989, <http://www.nber.org/papers/w14818>.

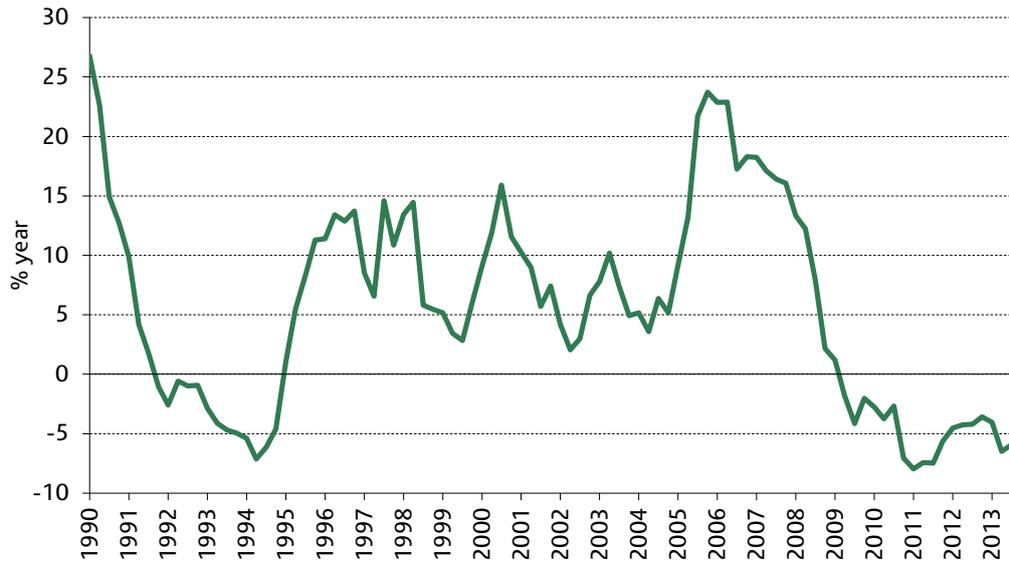
⁸ See, for example, Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2012*, <http://budgetresponsibility.org.uk/economic-and-fiscal-outlook-december-2012/>.

⁹ M. Dicks, 'The UK's productive capacity: surveying the damage', in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, <http://www.ifs.org.uk/budgets/gb2010/10chap1.pdf>.

¹⁰ R. Balakrishnan, P. Brooks, D. Leigh, I. Tytell and A. Abiad, 'What's the damage? Medium-term output dynamics after financial crises', chapter 4 of IMF, *World Economic Outlook: Sustaining the Recovery*, October 2009, <http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/text.pdf>.

¹¹ See, for example: HM Treasury, *Budget 2010: Securing the Recovery*, March 2010, <http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/budget2010.htm>; S. Dale, 'Productivity and monetary policy', speech given at the South

Figure 4.11. M4 lending to private non-financial corporations

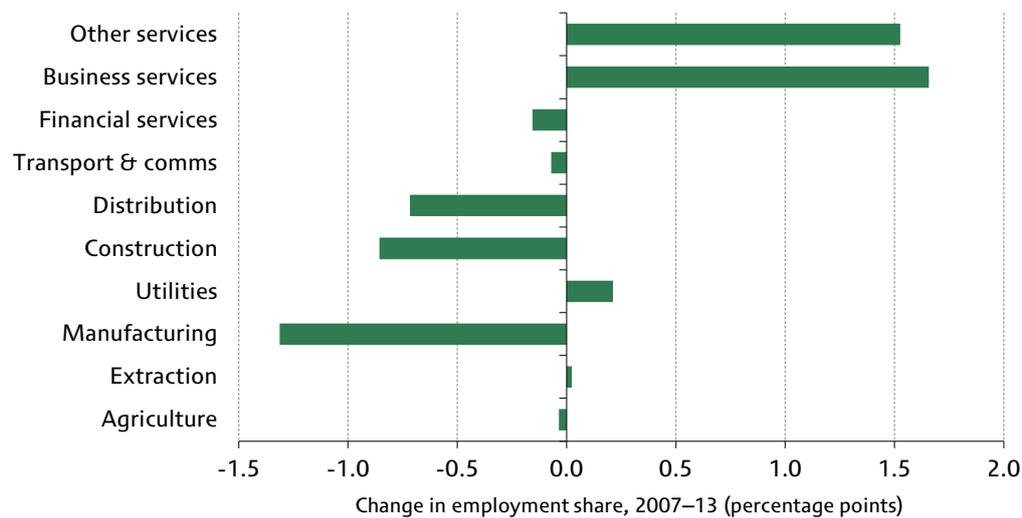


Source: Haver Analytics.

evidence of this phenomenon and point to the fact that several ‘high-productivity’ sectors – in particular, oil extraction and financial services – experienced large declines in activity in the aftermath of the crisis.

There is some evidence in favour of this view, but a sectoral shift would appear to have had a relatively small effect on the UK (see Figure 4.12). There has not been a discernible shift in the share of total employment accounted for by financial services. There has been a loss of share of manufacturing – a high-productivity sector – with gains for other (mainly public) services – a low-productivity sector – but the sectoral shifts appear

Figure 4.12. Change in share of total employment, 2007–13



Source: Haver Analytics.

Tyneside Manufacturing Forum, Bank of England, 21 September 2011, <http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech519.pdf>.

relatively minor. Indeed, Martin and Rowthorn (2012)¹² estimate that just a tenth of the UK productivity shortfall can be attributed to these shifts.

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. 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, though the unusually low rate of bankruptcies suggests that this allowance should be fairly small.

The output gap is likely to be very large

Drawing all of the various components of potential output together, we find that there is likely to have been a permanent loss of output in the UK, largely because of the systemic banking crisis which has hindered credit availability and damaged the contribution of total factor productivity. We also find that the magnitude of the damage to potential output is likely to be towards the higher end of the scale of those seen in previous financial crises because of the severity of this crisis.

This would imply an output gap averaging in the region of 5% of potential GDP in 2013. This implies a somewhat greater degree of spare capacity than that estimated by either the OBR (-2.3% of potential output) or the consensus of independent forecasters (-2.9% of potential output).¹³ Some forecasters believe the output gap to be lower than 1% of potential output, but such a small output gap would imply permanent damage to potential output in the region of 13–14%, far in excess of those identified by the literature on past financial crises.

There is clearly a large discrepancy between our estimate of the output gap and those of other forecasters. In order to validate our assumptions, we have used our Global Economic Model to quantify the factors that explain why actual GDP has lagged behind potential output. We identify three key factors that explain the relatively weak recovery of the UK economy over the past five years: the pace of fiscal tightening, tight credit conditions and weak demand from the Eurozone. Table 4.2 shows the relative size of the factors explaining why UK GDP in 2013 is below its long-run trend.

Fiscal tightening

The UK was both quick to begin its austerity programme and aggressive in its implementation. Data from the International Monetary Fund (IMF) imply that the UK began to tighten fiscal policy in 2010, with policy having been tightened by in excess of 5% of GDP between 2010 and 2013.

Moreover, the UK's austerity programme has been heavily geared towards cutting investment spending, which typically has larger multipliers than either tax rises or cuts to current spending; this has arguably increased the damaging effects on output relative to tightening that was more evenly spread across the three areas. Using the IMF's estimates of the degree of fiscal tightening and the OBR's estimates of the size of the fiscal

¹² B. Martin and R. Rowthorn, 'Is the British economy supply constrained II? A renewed critique of productivity pessimism', Centre for Business Research, University of Cambridge, 2012, http://www.cbr.cam.ac.uk/pdf/BM_Report3.pdf.

¹³ HM Treasury, *Forecasts for the UK Economy: A Comparison of Independent Forecasts, December 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/266744/201312forecomp.pdf.

multipliers, we estimate that fiscal retrenchment has reduced the level of GDP by 3.7% compared with what would have happened had there been no fiscal tightening.

Tight credit conditions

The most damaging effects of deteriorating credit conditions were felt in 2008–09, when a lack of credit availability forced corporates to slash inventories and investment spending in an attempt to improve liquidity. Nevertheless, the financial crisis has clearly left a legacy which has continued to damage growth in the recovery phase. The Oxford Economics model includes a measure of credit conditions, based upon work by Aron and Muellbauer (2006),¹⁴ that seeks to proxy changes in credit conditions not reflected in the interest rate, so we can use this to quantify the impact of tight credit conditions on the recovery.

Given that credit conditions are generally acknowledged to have been too loose in the period immediately prior to the financial crisis, it would not be realistic to run a counterfactual scenario where credit conditions were set to 2007 levels. Therefore, in our scenario, we set credit conditions equal to where they were in 2005, prior to the last – and most damaging – leg of the credit boom. The results of our scenario suggest that tight credit conditions have reduced the pace of the recovery by 1.2ppts between 2010 and 2013, with the impact having receded over time, reflecting the notion that credit conditions have begun to gradually recover over the past two years.

Weak Eurozone demand

The export recovery has generally been disappointing and, with the Eurozone taking just under half of UK exports, the sovereign debt crisis and the Eurozone’s subsequent slump back into recession in 2012 is typically cited as being the main cause of the UK’s export slowdown.

Table 4.2. Decomposing why UK GDP in 2013 is below its long-run trend (%)

	%
Degree to which GDP is below the long-term trend	15
<i>Impact of the financial crisis on potential output</i>	
Impact on the capital stock	1
Impact on growth in the labour supply	0
Impact on total factor productivity	5
<i>Why are we below capacity?</i>	
Fiscal tightening	4
Tight credit conditions	1
Weak Eurozone demand	1
Residual, which is likely to include factors such as the under-recording of the current level of GDP and slow adjustment	3

Note: Figures may not sum exactly due to rounding.

Source: Oxford Economics.

¹⁴ J. Aron and J. Muellbauer, ‘Housing wealth, credit conditions and consumption’, Centre for the Study of African Economies (CSAE), Working Paper WPS/2006-08, 2006, <http://www.csae.ox.ac.uk/workingpapers/pdfs/2006-08text.pdf>.

We used our model to construct a counterfactual scenario where the Eurozone is assumed to have grown at a pace equivalent to its long-term average over the past three years. The results of this scenario suggest that the level of UK GDP would have been around 0.7ppts higher in 2013 had Eurozone growth been faster. It is quite possible that the full impact of the Eurozone crisis might be a little larger, as this scenario does not allow for any impact on business confidence and, therefore, investment, but such effects are very difficult to quantify.

Reconciling these results

Aggregating these effects, we estimate that these three factors have reduced the level of GDP by 5.7ppts between 2010 and 2013, accounting for around two-fifths of the shortfall in GDP relative to pre-crisis trends. As such, this analysis confirms that there are grounds to believe that there is a sizeable amount of spare capacity. Indeed, given that this analysis suggests that around two-fifths of the gap to the pre-crisis trend can be explained by factors that have weakened demand, and that a similar amount of the shortfall can be attributed to permanent damage to potential output caused by the financial crisis, there is still a portion of the gap that remains unaccounted for. We believe that a comparison of the GDP data with other evidence on the health of the economy suggests the level of GDP might be under-reported.

Potential output growth to accelerate 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. To do this, we again use the production function approach to consider how the contributions of the various factor inputs are likely to evolve.

Capital stock

Our forecast shows a steady recovery in business investment, as diminishing downside risks and stronger economic growth underpin a strengthening in confidence and encourage firms to begin to release their accumulated cash surpluses. Furthermore, firms that have got through the past five years by patching up old machinery will increasingly come under pressure to replace it with new equipment and will also need to invest to expand capacity. This means that the contribution of the capital stock to potential output growth is expected to accelerate through the forecast period, from 0.6ppts in 2013 to 1ppt by 2018. However, this is not sufficient to regain levels consistent with the pre-recession trend.

Labour supply

Migration flows have slowed over the past two years, with the latest data, for the year to June 2013, reporting inward migration of 182,000. This followed a change to visa rules which means that foreign students cannot work on their student visas during or after their studies. The OBR's forecast adopts the low migration variant of the ONS population projections, which assumes a steady reduction in inward migration from 150,000 in the year to mid-2014 to 123,000 in the year to mid-2018. The forecasts look a little low for the current year, in light of the latest data, but otherwise look reasonable. Given that the bulk of migrants tend to be of working age, this implies a modest slowdown in the growth of the working-age population.

However, while growth in the working-age population may slow, we expect participation to increase. Improving employment prospects should steadily encourage some of the

inactive to seek work, while the continued increase in the state pension age (SPA) for women will continue to have an effect. However, some of this boost will be dampened by the fact that the population itself is ageing, and labour market participation is still substantially lower amongst those close to the SPA than amongst younger individuals.

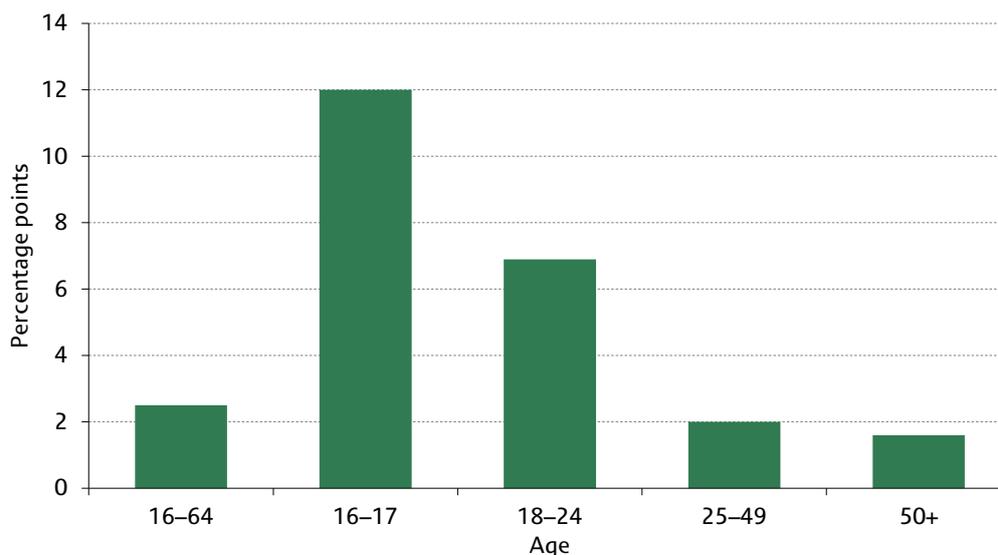
As we have established previously, there is empirical evidence to suggest that a prolonged period of weak activity can drive up the NAIRU through hysteresis. As a result, we assume that the NAIRU rises to around 6% throughout the forecast period, up from 5% ahead of the recession.

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. This means that the pool of available and suitably-skilled workers is reduced. This process could be exacerbated by the shift in employment from the public to the private sector, which could lead to a mismatch between skills and opportunities as the likelihood is that the regional pattern of public sector job losses – and private sector opportunities – will be very uneven.

Previous cycles may not provide a good guide for the likely movements in the NAIRU because, this time around, the increase in unemployment has been much more highly concentrated on the younger age groups (see Figure 4.13). Some argue that this may mean that the young miss out on the essential formative years of their career when they pick up many of their skills. However, we take the view that this should mean that the impact of a rising NAIRU is less marked than in previous cycles because we would expect that the younger unemployed would be better placed to retrain and re-enter the workforce than those from older age groups.

Bringing together our forecasts for population growth, participation and the NAIRU, we find that the contribution of the labour supply to potential output growth should pick-up from 0.1ppts a year over the period 2007–13 to 0.5ppts a year for 2014–18. However, this is down on the average contribution of 0.7ppts a year over 1996–2006, reflecting much lower levels of inward migration.

Figure 4.13. Increase in ILO unemployment rate by age, 2008Q1–2013Q3



Note: ILO is the International Labour Organisation.
Source: Haver Analytics.

Total factor productivity

As we have already established, the financial crisis is likely to have caused permanent damage to total factor productivity because of its impact on credit availability and the efficient allocation of resources. However, the literature would suggest that we have already seen the bulk of any permanent damage. As such, we assume that the contribution of total factor productivity to potential output growth moves back towards historical norms over a relatively short time period. Over the 2014–18 period as a whole, we assume that total factor productivity contributes 0.8ppts per year to potential output growth.

A forecast of potential output and the output gap

Bringing these factors together, we expect growth in potential output to accelerate through the forecast horizon. Our forecast shows potential output growing by 2.1% a year in 2014–18 (Table 4.3), with GDP growth during that period averaging 2.6%. Ordinarily, we might expect such a large output gap to foster stronger GDP growth; however, there are several important factors likely to limit GDP growth through the forecast horizon, which means it will take longer for the output gap to close. In our view, there is no reason why an output gap should have to close within a particular time frame, and in this case the headwinds to growth provide good reason to expect it to close at a slower pace than in previous cycles.

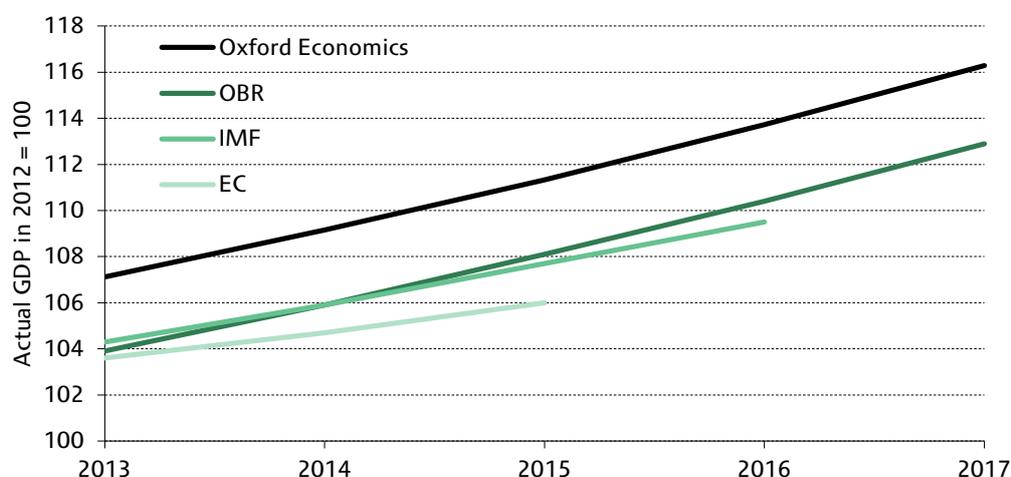
Table 4.3. Contributions to potential output growth (ppts per annum)

	1996–2006	2007–13	2014–18
Employment at the NAIRU	0.7	0.1	0.5
Capital stock	1.2	1.0	0.8
Total factor productivity	1.1	0.3	0.8
Potential output	3.0	1.4	2.1
Actual GDP	3.3	0.3	2.6

Note: Columns may not sum exactly due to rounding.

Source: Oxford Economics.

Figure 4.14. Forecasts of potential output



Note: Forecasts for OBR, IMF and EC calculated using data quoted in OBR, *Economic and Fiscal Outlook: December 2013*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2013/>.

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

Our forecast is similar to that of the OBR for this period. However, because we estimate that the permanent damage to potential output during the financial crisis was smaller, our forecast starts from a point where the level of potential output is higher than that of the OBR. As such, by 2018 our estimate of the level of potential output is around 3ppts higher than that of the OBR (see Figure 4.14). Given the uncertain nature of forecasting potential output, it is perhaps no surprise that there is a wide range of views across forecasters. Our forecast is at the top end of the range, ahead of the OBR. The European Commission (EC) is markedly more downbeat, assuming that potential output will grow by just 1.2% a year from 2013 to 2015. This means that by 2015 the EC estimates imply a level of potential GDP that is 5% lower than our forecast.

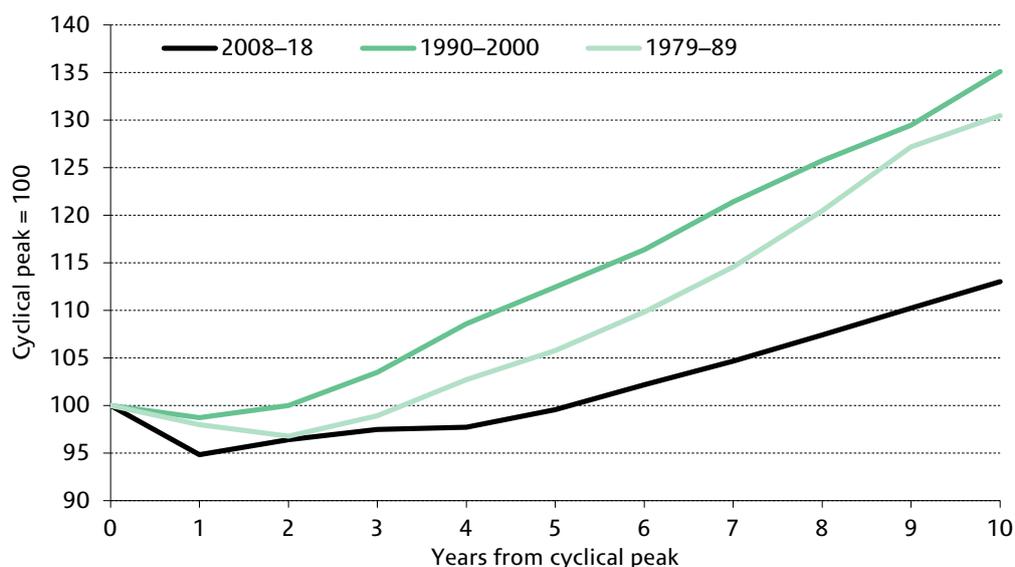
Recovery to remain firm over medium term but still weaker than previous upturns

The existence of such a large output gap should keep inflation low and create the conditions for growth to remain firm over the medium term. GDP growth is expected to average 2.6% a year over 2014–18.

Our expectations for the recovery phase are significantly weaker than previous recoveries, but this partly reflects the poor performance to date. As of end-2013, GDP was still around 1¼% below its 2008Q1 peak, which means that it is a long way behind where it was at the corresponding point of either of the previous two cycles (see Figure 4.15). Following the recession of the early 1990s, GDP was 12% above its previous peak by this stage, while the recovery of the early 1980s saw GDP around 6% above its previous peak by this stage. Our forecast (Table 4.4) suggests that, this time around, GDP will not regain its previous peak until mid-2014, a total of more than six years.

Even though growth accelerated during 2013, we estimate that the output gap narrowed only very marginally from 5.1% of potential output to 5%. With growth set to accelerate further this year, the output gap should start to narrow more rapidly and by the end of 2018 we expect it to have fallen to around 2¾% of potential GDP (see Figure 4.16). This forecast points to subdued inflationary pressures over the next few years, meaning that

Figure 4.15. Comparison of UK economic cycles



Source: Haver Analytics, Oxford Economics.

Table 4.4. Oxford Economics UK forecast (annual % change unless stated)

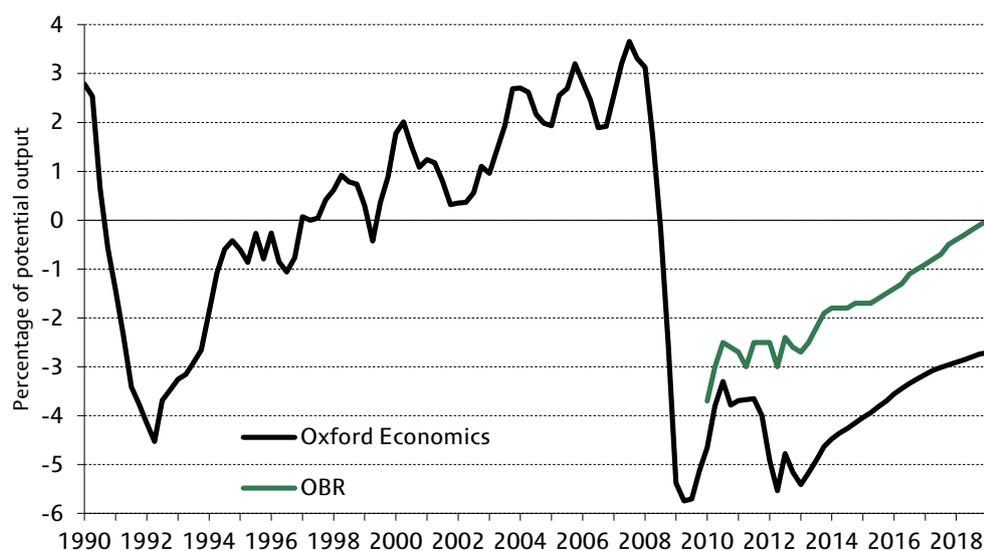
	2012	2013	2014	2015	2016	2017	2018
Domestic demand	1.2	1.8	2.2	2.2	2.3	2.2	2.2
Private consumption	1.5	2.2	2.2	2.2	2.3	2.5	2.6
Fixed investment	0.7	-2.2	6.5	6.3	6.5	5.9	4.3
Stockbuilding (% of GDP)	0.3	0.9	0.6	0.5	0.5	0.5	0.5
Government consumption	1.6	0.4	0.8	-0.3	-0.9	-1.5	-0.7
Exports of goods and services	1.1	1.1	3.1	4.0	5.2	5.3	4.6
Imports of goods and services	3.1	0.8	1.9	3.1	4.0	4.2	3.7
GDP	0.3	1.9	2.6	2.4	2.6	2.6	2.5
Industrial production	-2.5	0.1	2.8	1.7	1.6	1.5	1.3
CPI	2.8	2.6	1.7	1.8	1.7	1.9	2.0
Current balance (% of GDP)	-3.7	-3.6	-2.9	-2.3	-1.8	-1.5	-1.2
Short-term interest rates (%)	0.84	0.50	0.53	0.66	1.57	2.61	3.65
Long-term interest rates (%)	1.91	2.44	3.11	3.30	3.59	4.01	4.48
Exchange rate (US\$ per £)	1.59	1.56	1.57	1.53	1.55	1.53	1.52
Exchange rate (euro per £)	1.23	1.18	1.21	1.23	1.27	1.27	1.27

Source: Oxford Economics.

the Bank of England will have plenty of scope to keep the bank rate at 0.5% until well into next year, even if the forward guidance threshold is breached before then, and will be able to tighten policy at a very measured pace beyond that point.

Our forecast shows a larger output gap than that of the OBR in 2013, to the tune of around 2¾ppts. This gap narrows only very slightly through the forecast horizon and is still more than 2½ppts by 2018. That our estimate for the size of the output gap is much larger than that of the OBR implies a smaller structural deficit and that the degree to which fiscal policy needs to be tightened may not be as great as the OBR suggests.

Figure 4.16. UK output gap

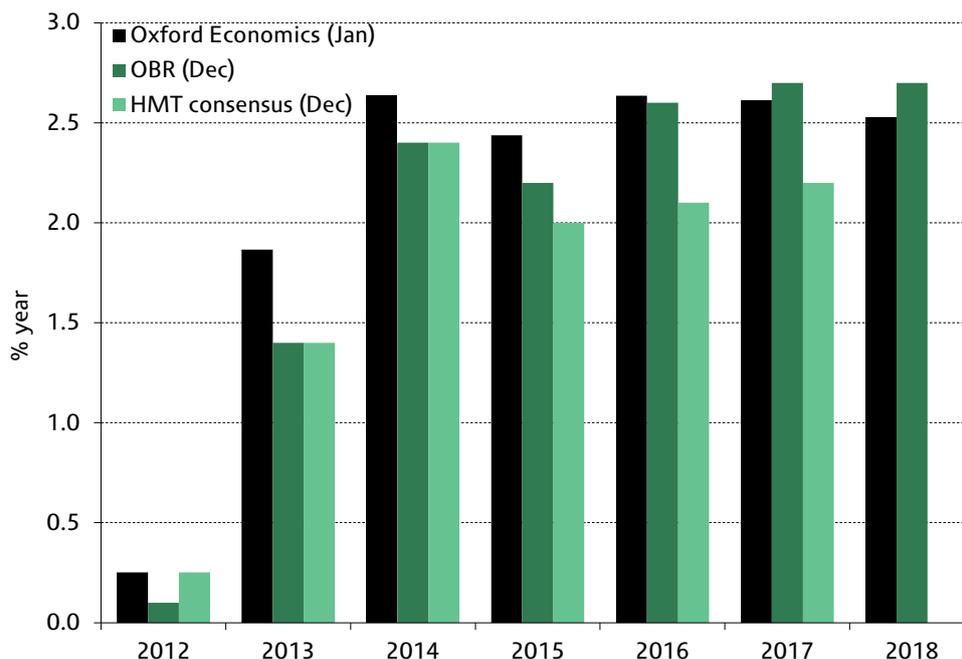


Source: Oxford Economics, OBR.

4.4 Comparison with other forecasts

Our short-term forecasts are a little higher than those of the OBR and the market consensus (Figure 4.17), which we attribute to our forecasts incorporating the revisions to National Accounts data published in late December, as well as the strong run of survey data over the past couple of months. Over the latter years of the forecast horizon, our forecast is similar to that of the OBR. The market consensus is much lower, 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.

Figure 4.17. Comparison of GDP forecasts



Source: Oxford Economics, OBR, HM Treasury.

4.5 Risks balanced: alternative scenarios for the UK economy

For much of the period since the financial crisis, the risks to our central forecast have been skewed heavily to the downside, reflecting several important international ‘event risks’, such as the threat of a Eurozone break-up or the US going over the ‘fiscal cliff’. However, over the past 18 months, these risks have either diminished substantially or gone away and have been replaced by a more normal – and more balanced – pattern of macroeconomic risks. We attach a probability of around 50% to an outcome similar to our baseline scenario and identify several areas of risk to the upside and downside.

Domestic risks

Domestically, several sources of upside risk have emerged. Companies have accumulated large amounts of cash on their balance sheets over recent years and could respond to the improved economic climate more aggressively than we anticipate. This scenario would be

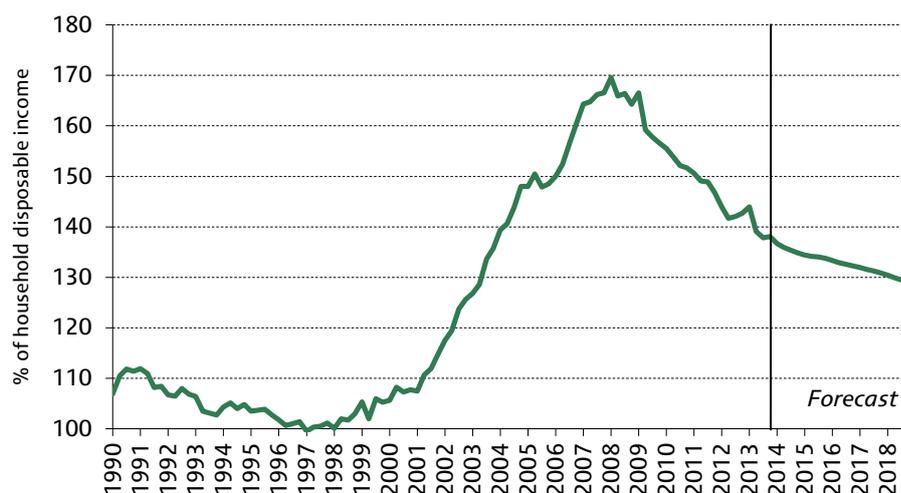
more likely to play out if there were a more significant improvement in credit availability for corporates, particularly SMEs.

The housing market is also a key source of risk. On one hand, the second phase of Help to Buy could underpin a stronger pickup in housing activity and prices, which in turn would be expected to boost economic growth through its impact on household wealth and confidence. However, while such a scenario might boost growth in the short term, it could store up problems later on, if it were to be accompanied by a renewed build-up of household debt and triggered earlier increases in interest rates.

Indeed, there remains a high degree of uncertainty surrounding the household sector. Households have been repairing their balance sheets over the past six years, but recently the pace of deleveraging has eased and the level of household debt remains high by historical standards (see Figure 4.18). Our forecast assumes that households continue to deleverage in a relatively orderly fashion, with the low interest rate environment giving them room to plot a path towards more sustainable debt levels. However, this outcome is far from certain; consumers may opt to use the anticipated acceleration in income growth to make more rapid inroads into their debts, or they may be forced into this action by earlier and more aggressive increases in interest rates. Such a scenario would dampen the pace of the UK recovery.

There is also considerable uncertainty surrounding future trends in productivity and, by extension, employment. Productivity has slumped in recent years and is now around 15% below where it would have been had the pre-recession trend continued. We assume that a portion of this decline is due to cyclical factors, which will unwind as economic growth recovers. However, some economists argue that almost all of the decline can be written off as being permanent and that the economy has moved to a new equilibrium some way below old levels. If this is the case, then the scope for job creation in the short term may be higher as the economy recovers, providing some upside for consumer spending. But on the flip side, if the level of productivity has shifted downwards and productivity continues to grow at slower rates, this would imply weaker potential output growth and, as such, poorer medium-term growth prospects.

Figure 4.18. Household debt-to-income ratio



Source: Haver Analytics, Oxford Economics.

External risks

As we established in Chapter 3, the risks to the global outlook are more evenly balanced than they have been for some time. In the rest of this section, we look at the two alternative scenarios for the global economy set out in Chapter 3 and consider how they might affect the UK economy.

Golden Age

The global economy could accelerate more swiftly than we currently envisage if a number of uncertain developments turn out positively in advanced economies. In particular, the US could benefit more than we currently forecast from its strong competitive position and fast pace of technological change. Moreover, the reform process currently underway in the Eurozone peripheral countries could yield larger benefits than we currently assume. And if the ‘third arrow’ of reforms by Japan’s Prime Minister, Abe, proves successful, our growth forecast for Japan could turn out to be too low.

This scenario would generate stronger growth in world trade and, given the relative importance of the US and Eurozone to UK exports, the UK would be ideally placed to take advantage. Similarly, a growing risk appetite would be expected to bolster corporate confidence and convince firms to implement capital spending plans more aggressively.

Under this scenario, we would expect the UK economy to grow by 3.3% this year and by 3.5% in 2015. The stronger recovery would prompt the Bank of England to start increasing interest rates from mid-2014, rather than mid-2015 in the baseline. We would attach a probability of around 15% to a scenario where the global economy surprises on the upside in this way.

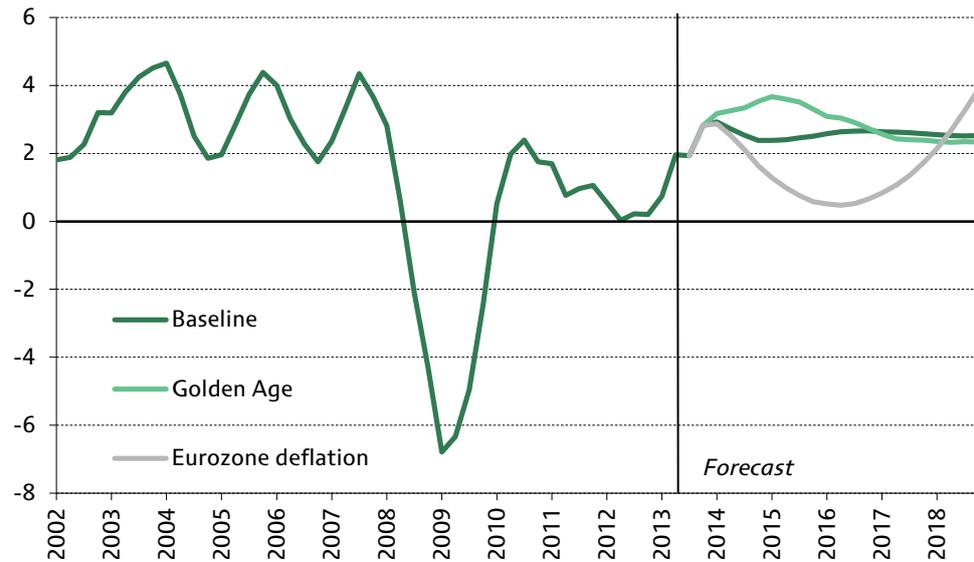
Eurozone slides into deflation

Inflation has reached strikingly low levels in the Eurozone and, with a significant output gap and only slow growth forecast, it could well fall further. The risk of deflation then becomes real. In a region characterised by high levels of public and private debt, a sustained fall in general prices would have devastating effects. In this scenario, a stronger euro and weaker growth combine to push the Eurozone into deflation in 2015–18. Weaker growth and deflation significantly raise the burden of public and private debt and peripheral countries in particular see debt increase as a proportion of GDP. Even for France, issues of debt sustainability become much more serious in this scenario. For Greece, deflation has the potential to trigger renewed doubts about the country’s viability in the Eurozone. Without additional debt relief on interest payments and possibly capital owed to other governments and EU institutions, Greece would most likely be pushed out of the Eurozone.

In such a scenario, the UK would be one of the countries hardest hit outside of the Eurozone because of its strong reliance on the Eurozone for exports and the likely negative impacts on consumer and business confidence. The strong financial linkages would also ensure that the UK is badly affected through financial contagion. GDP growth would slow sharply to just 0.9% in 2015 and 0.5% in 2016, compared with our baseline forecasts of 2.4% and 2.6% respectively. Inflation would slow sharply in this scenario, while the bank rate would remain at 0.5% throughout the five-year horizon. We would attach a probability of around 15% to this downside scenario.

Figure 4.19 shows GDP forecasts for the UK economy, based upon these alternative scenarios.

Figure 4.19. GDP forecasts for alternative scenarios for the UK economy



Source: Oxford Economics.

4.6 Conclusion

After a much better than expected 2013, the UK recovery appears to have finally become entrenched and we expect growth to remain firm over the coming five years. The main hurdle is ensuring that the recovery broadens out from its narrow focus on the consumer and the housing market towards business investment and exports; recent business survey data offer encouragement that this is beginning to happen and our forecast shows growth becoming more balanced as we move through the forecast horizon.

We think that there is currently a significant amount of spare capacity in the economy, with the output gap estimated to have averaged around 5% of potential output in 2013. Though the financial crisis is likely to have caused substantial permanent damage to potential output, our estimate of the scale of this damage is somewhat smaller than those of other forecasters, including the OBR, and we believe that the vast bulk of this damage has already occurred. Our forecast shows potential output growth averaging 2.1% a year over the period from 2014 to 2018. Such a large output gap will provide the conditions for the recovery to gain momentum over the medium term, with GDP growth expected to average 2.6% a year from 2014 to 2018.

The risks around our forecast are more balanced now than they have been for much of the period since the financial crisis. Domestically, the main areas of uncertainty are the housing market and the state of household balance sheets, with doubts around the extent to which house prices will rise in response to schemes such as Help to Buy and the impact that this will have on households' deleveraging. A further source of uncertainty is the labour market, where the collapse in productivity over the past six years makes future developments very uncertain. Externally, stronger recoveries in the US and Eurozone are a plausible alternative, a scenario which would be particularly beneficial to the UK given its strong trading links with those areas. The biggest downside risk is also related to the Eurozone; deflation is becoming an increasingly serious threat to the Eurozone because of its high levels of private and government indebtedness. Were the Eurozone to fall into deflation, it could lead to Greece being forced out of the Eurozone and set in train events that would cause the UK's recovery to slow sharply.