Will the recession damage UK long-term growth prospects?

Key points

- Over the last economic cycle between 1997H1 and 2006H2 the UK grew at an average rate of 2.9% a year, a marked improvement on the 2.4% a year it averaged over the previous cycle from 1986Q2.
- From a supply side perspective, this success was founded on the combination of several exceptional factors. Strong net immigration was supported by an increase in the employment rate, as the Thatcher labour market reforms continued to push down the NAIRU. Meanwhile, robust business investment and a movement towards high value added sectors, such as financial services, underpinned a stronger contribution from productivity growth.
- However, the recession will dampen potential output growth over the current cycle. Poor employment prospects and a narrowing of relative wage differentials will exacerbate the recent slowdown in migration from A8 countries. And other European countries bringing their rules on A8 migrants into line with the UK is likely to further dampen in-migration from 2011. The long-term ONS migration projections are based upon an extrapolation of a trend which includes the EU expansion and, as a result, they look unrealistic. We expect net migration to slow to 90,000 a year from 2013, compared with official projections of 190,000, resulting in a cumulative population shortfall of 1.09 million by 2018.
- A sharp and prolonged rise in unemployment will cause an erosion of skills amongst those who have lost their jobs and, when demand recovers, employers are likely to prefer to bid up the wages of existing workers rather than hire the unemployed workers who have lost their skills. We therefore expect the NAIRU to rise to 6.5% over the next two years, which is consistent with a long run employment rate of 80.5%. Therefore employment will act as a drag on economic growth, reducing potential output by 0.1% a year, in contrast to the +0.4% contribution it made in each of the last two cycles.
- As the credit crunch has intensified, access to credit has tightened significantly and, with the major industrialised countries in a deepening recession, business confidence has plummeted. Therefore, we expect firms to make large cuts in capital spending across the economy over the next two years, significantly dampening the contribution of capital deepening to potential GDP growth. Meanwhile, the turmoil in the banking sector is likely to result in greater regulation and a lower appetite for risk, ensuring that financial services – one of the fastest growing sectors of the previous cycle – will grow at a slower pace in the future. Lower investment and the damage to high value added sectors will mean that output per hour worked contributes 2.1% a year to potential output, compared with 2.3% over the last cycle.
- Our forecast shows potential output growing by just 2.1% a year between 2006H2 and 2018H2, a much poorer performance than in the previous cycle and far lower than the Treasury's assumption of 2.75%. This points to further fiscal problems, with tax revenues likely to significantly undershoot the Treasury's projections, necessitating higher taxes. It also has implications for Regional Development Agency growth targets, while our weaker migration assumptions suggest a lower requirement for new house building.

Introduction

The UK economy recovered strongly from the recession of the early 1990s to record its longest period of unbroken economic growth – 63 quarters to 2008Q2. The period saw significant structural change, with services forging ahead of a dwindling manufacturing sector, while the Thatcher labour market reforms underpinned rapid growth in employment and a marked decline in unemployment, without a pick-up in wage inflation.

However, the UK economy has fallen into a deep recession which we expect to last at least a year, with the recovery phase likely to be more gradual than in previous downturns. It is also possible that over the longer term growth will not return to the heights of the past decade, given the damage that the recession will do to the factors which have underpinned the recent strong performance. This article looks at the factors underpinning potential output growth to assess the prospects for the UK economy over the next ten years.

Rapid expansion in the labour supply underpinned the strong growth of the last cycle

HM Treasury has now dated the last economic cycle as being between 1997H1 and 2006H2[1]. Over this period the UK economy grew at an average rate of 2.9% a year, a marked improvement on the 2.4% a year it averaged over the previous cycle from 1986Q2.

In order to gain a clearer picture of the underlying reasons for the acceleration in output in the last cycle we can decompose the drivers of potential output[2] growth. Potential output is a function of the resources available and the way in which they are utilised, so varies according to changes in the working age population, employment rate, average hours worked and output per hour worked, i.e. productivity.

The table below compares the contributions to potential output growth across the past two cycles:

Contributions to potential output growth
per cent per annum

	1986Q2-1997H1	1997H1-2006H2
Trend output per hour worked	2.0	2.3
Trend in average hours worked	-0.2	-0.4
Trend employment rate	0.4	0.4
Population	0.2	0.6
Potential output	2.5	2.9

Using this framework, it is clear that rapid improvement in labour-related factors was a significant factor behind the strong performance of potential output over the past decade. During the late 1990s a continuing decline in the NAIRU[3], reflecting the impact of the Thatcher labour market reforms of the 1980s in increasing labour market flexibility, helped to push up employment rates. We estimate that the NAIRU has fallen from almost 10% in the early 1990s to about 5% now. In addition, the effective labour supply was boosted by a

[1] This article uses HM Treasury's cycle dates for ease of comparison. However, our model suggests that the last cycle did not end until 2008Q2 and that in 2006H2 – when the Treasury estimates that the cycle ended – actual output was around 0.3% above potential output

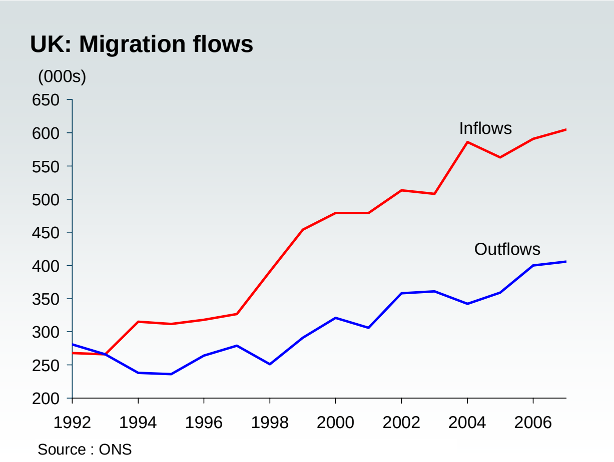
[2] Potential output is the level of output the economy would produce if labour and all other resources were fully and efficiently employed

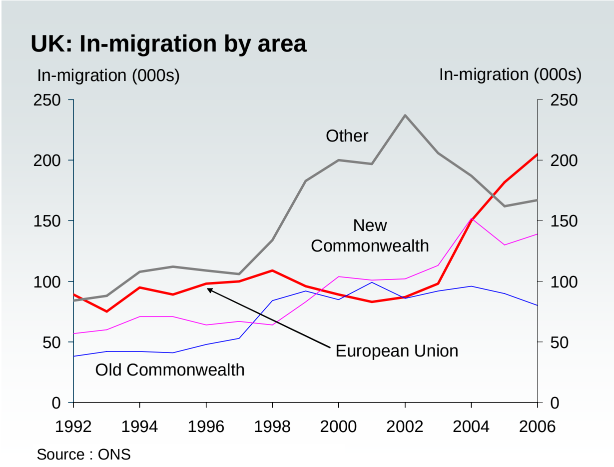
[3] NAIRU - Non-Accelerating Inflation Rate of Unemployment. This represents the rate of unemployment at which the utilisation of resources is such that the inflation rate tends to remain stable, assuming there are no exogenous shocks

pick-up in the rate of participation. Older workers delayed their retirement, while pensioners returned to part-time work. This may reflect the variety of part-time jobs on offer and the new-found willingness of employers to take older people on. But it was also a response to the pension crisis and the consequent deterioration of retirement prospects. These factors underpinned a continuation of the rise in the employment rate which had started in the latter part of the previous cycle.

Much of the recent success has been built on strong net migration

More recently, the effective labour supply has been boosted by robust net international migration, which has generated much stronger growth in the working age population. Inward migration doubled between 1993 and 2004, with a large increase in arrivals from the EU, 'New Commonwealth' – particularly the Indian subcontinent – and the Rest of the World (mainly non-Commonwealth parts of Africa, Asia, and Oceania). Net migration peaked in 2004, when the expansion of the European Union to include the A8[4] countries caused inflows from the European Union to double. The government estimates that 1.1 million of the 2.7 million jobs created since it came to power in 1997 have been taken by migrant workers.





The recession will dampen short-term migration flows

The government's latest projections assume that the integration of Bulgaria and Romania, in addition to ongoing immigration from the A8 countries, will raise net migration to 230,000 a year on average over the period 2008-10 – only just short of 2004's record high. However, there is already evidence that migration from the A8 countries is slowing, with approved applications for the Worker Registration Scheme falling below 35,000 in 2008Q3, a drop of 39% compared with a year earlier and the lowest level since the scheme was introduced in 2004.

In-migration will be further dampened by the recession. There is strong evidence of a link between migration and employment growth, with the UK experiencing a period of net out-migration during the recession of the early 1990s which was then rapidly reversed as the economy recovered. Near-term prospects for sectors which employ significant proportions of migrant workers are poor, with the housing market and commercial property crashes triggering widespread job losses in construction, and the consumer slowdown dampening prospects for the retail and hospitality sectors. Furthermore, net in-migration associated with well-paid financial services jobs, particularly in London, is likely to drop sharply with employment in the sector expected to decline by more than 10% over the next two years.

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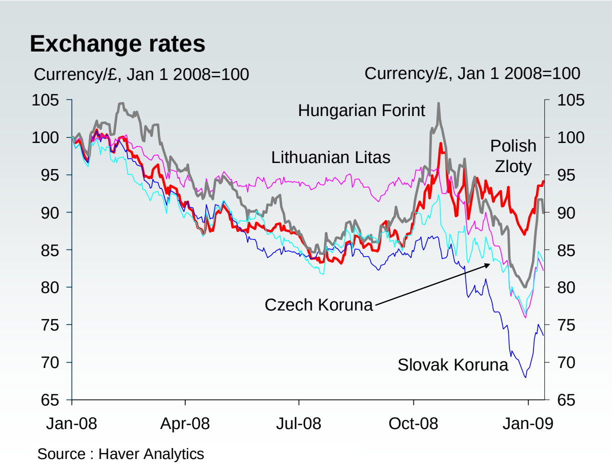
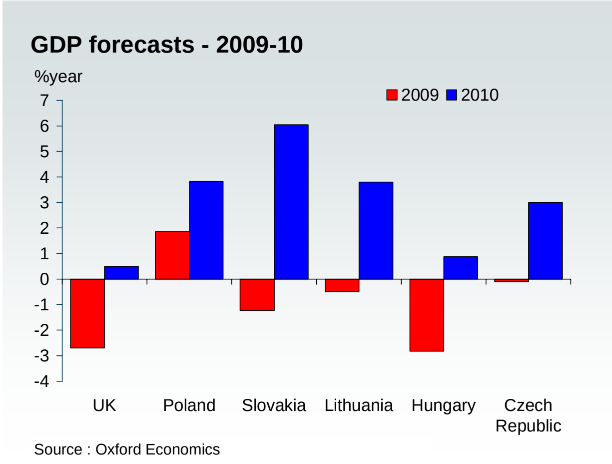
[4] *A8 countries are Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia*

Poorer UK job prospects and the stronger relative performance of many of the A8 economies will discourage potential migrants from moving to the UK and draw earlier migrants back home. This effect is compounded by the weakness of sterling – which has declined on average by 20% against the currencies of the larger A8 countries since the beginning of 2008, causing a narrowing of relative wage differentials – and the rapid improvement in living standards in the A8 countries, which further reduces the attractiveness of migrating to the UK.





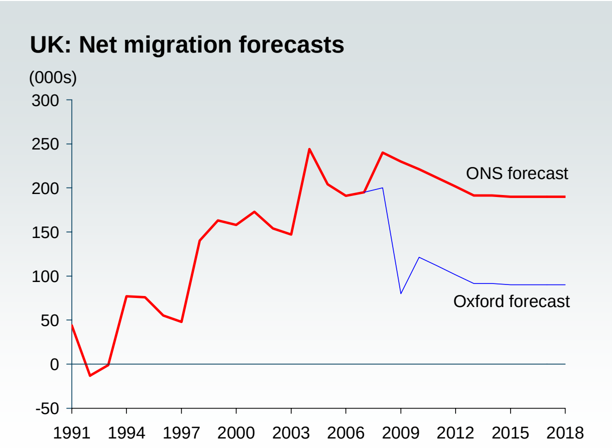
There appears to be no appetite to compensate for falling levels of A8 migrants by allowing higher migration from elsewhere. The government has recently renewed restrictions on unskilled workers from Bulgaria and Romania, permitting only a small increase in the number of migrants allowed to work here as part of the seasonal agricultural workers scheme. The introduction of a new points-based system for migrants from outside of the European Union represents a further constraint, tightening entry requirements for all but the most highly skilled. These effects are likely to offset by a modest decline in "retiring" out-migration, with the property slump making it more difficult for pensioners to sell their houses and move abroad.

Overall we expect net migration to slow sharply over the next two years. Our forecast shows it declining to 80,000 this year at the height of the recession, just a third of the recent peak but still significantly higher than the comparable point of the 1990s recession. By the time that GDP growth has returned to trend – and employment has started to grow once more – in 2011, our forecasts show a cumulative in-migration shortfall of 390,000 compared with the official projections.

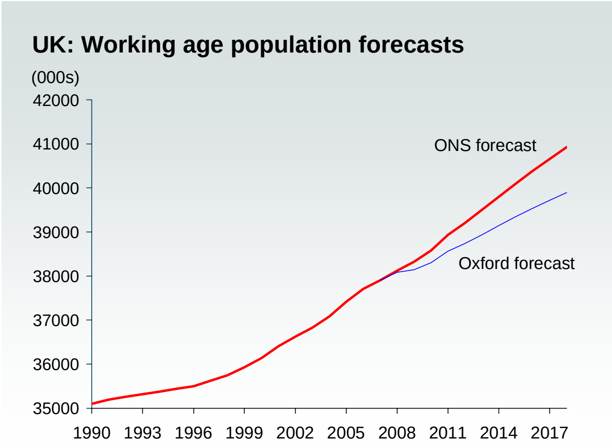
The ONS long-term migration assumptions also look much too strong

The official population projections assume that net migration will average 190,000 a year over the longer term, but this also looks far too strong. This assumption is based upon the extrapolation of a trend derived from a period of exceptional growth in migration, encompassing the enlargement of the European Union in 2004 and a period of robust growth in the UK economy. However, even prior to the recession there was evidence that the flow of migrants was slowing, with net migration totalling 198,000 in 2007 compared with 240,000 in 2004, and over the longer term we would expect these flows to continue to ease as living standards in Eastern Europe continue to catch up with the west. This trend is likely to accelerate from 2011 when other European countries relax their employment rules for migrants from the A8 countries, bringing them into line with the UK. With countries such as Germany and France closer to home for A8 migrant workers and more similar in terms of culture and language, the attractiveness of the UK as a destination is likely to diminish.

We therefore expect net migration to slow to 90,000 a year from 2013, resulting in a population shortfall of 1.09 million by 2018 compared with official projections. On average 95% of migrants are of working age, so this shortfall will have significant implications for the size of the workforce. We estimate that the working age population will be 39.9 million in 2018, more than 1 million lower than the ONS projections. This will mean that population growth will contribute 0.5% a year to potential GDP growth in the current cycle – a little lower than the previous cycle (0.6%) but well below the Treasury's assumption (0.8%).



Source : ONS / Oxford Economics



Source : ONS / Oxford Economics

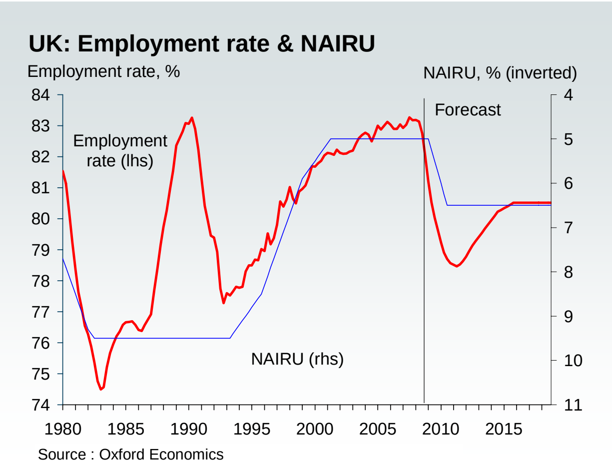
Our forecast assumes a small rise in the NAIRU

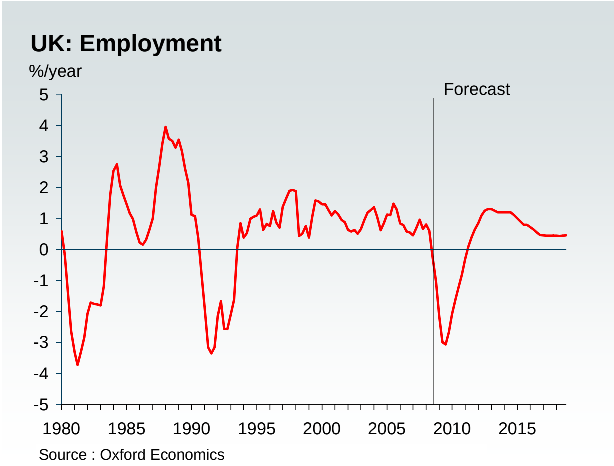
As stated previously, the continuing sharp decline in the NAIRU in the last economic cycle was a significant factor behind the rapid growth in potential output. However, with the UK entering a deep recession we expect the NAIRU to rise over the next two years, reflecting our forecast of a sharp and prolonged rise in unemployment. This will cause an erosion of skills amongst those who have lost their jobs and, when demand recovers, employers are likely to prefer to bid up the wages of existing workers rather than hire the unemployed workers who have lost their skills. Lower net migration will also make it harder to fill the type of low paid jobs that migrants have taken up over the past decade. However, at 6.5% the NAIRU will remain well below the levels of the 1980s, reflecting the ongoing rise in participation rates as older people work more, especially as the female pension age increases, and the introduction of stricter rules governing unemployment benefits. We expect the NAIRU to fall back to 5% over the longer term as workers retrain and the economy restructures.

We expect the recession to result in more than 1.3 million job losses from peak-to-trough, taking the employment rate[5] below 79% by early 2011 from an average of just under 83% in 2008. As the economy gradually recovers employment growth will follow and – assuming that rates of inactivity remain broadly flat – our NAIRU assumption for the next decade implies a long-run employment rate of 80.5%, a little lower than the average over the past decade. This means that over the period from the end of the last cycle in 2006H2 to the end of 2018, changes in the employment rate will act as a drag on economic growth, reducing potential output by 0.1% a year, in contrast to the +0.4% contribution it made in each of the last two cycles.

A persistent decline in average hours worked has acted as a drag on growth prospects in each of the last two cycles, reflecting the movement from full-time to part-time working. The pace of decline peaked in the first half of the last cycle but has slowed in the period since and we concur with the Treasury's assumption that hours worked will continue to fall at this slower pace over the current cycle. This will mean that it reduces potential growth by 0.3% a year, compared with 0.4% a year over the last cycle.

[5] *Employment rate is defined here as total employment (workforce jobs measure) as a proportion of the working age population*

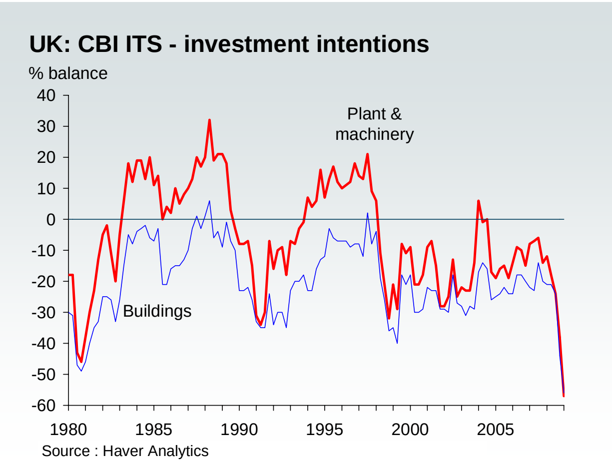


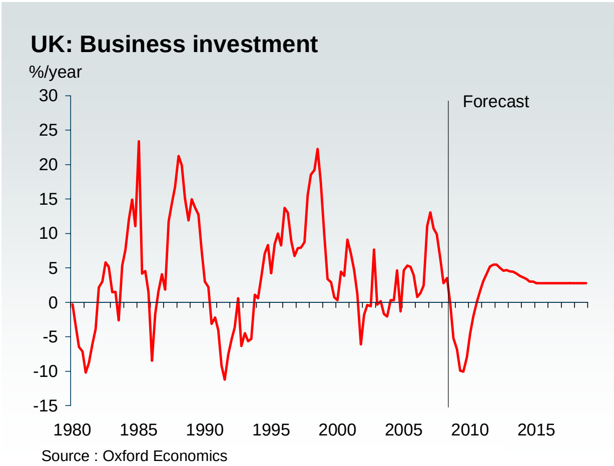


Falling business investment will slow growth in the capital stock

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 4.7% a year between 1997H1 and 2006H2. However, the UK is now in the midst of a deep investment downturn; by 2008Q3 business investment had already fallen by 2.3% from its late-2007 peak, while the January *CBI Industrial Trends Survey* reported the weakest investment intentions in the 50-year history of the survey for both plant & machinery and buildings. As the credit crunch has intensified, access to credit has tightened significantly and, with the major industrialised countries in a deepening recession, business confidence has plummeted. We therefore expect firms to make significant cuts in capital spending across the economy.

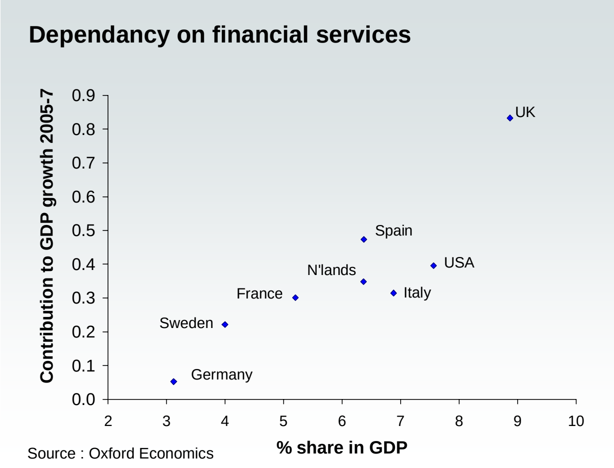
Our forecast shows UK business investment declining by 10% over the next two years. Though we do expect capital spending to recover strongly as the economy enters the recovery phase, the deep decline in the short-term will significantly dampen the contribution of capital deepening to potential GDP growth over the current cycle.



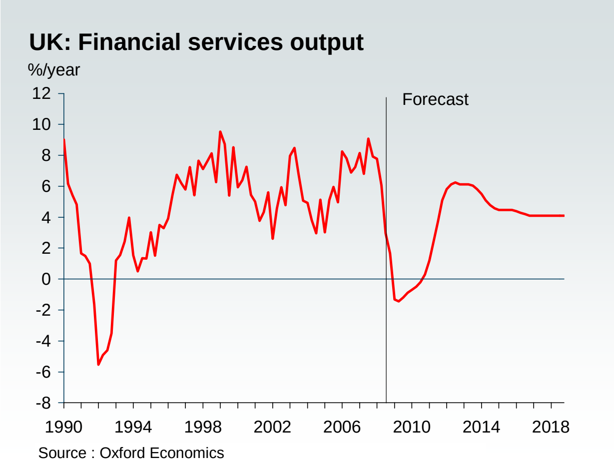


Structural changes are likely to dampen growth potential

The sectoral focus of the recession also has the potential to damage productivity growth. The strong performance over the last cycle was driven in significant part by the financial services sector, which achieved output growth of 6.1% a year – more than double that of the economy as a whole – and supported by the growth of a range of associated professional service sectors (e.g. legal, accountancy and consultancy). Financial liberalisation and the rapid expansion of credit markets underpinned significant structural change as the UK economy shifted towards financial and business services, while moving away from manufacturing. This trend accelerated in the years immediately ahead of the credit crunch and by 2007 financial services accounted for a much larger share of GDP in the UK (9%) than in any other major industrial nation, with the City of London Corporation's *Global Financial Centres Index* ranking London as the top financial centre in the world.



The financial crisis and its ramifications mean that medium-term prospects for the financial services sector are likely to be much less strong than generally assumed ahead of the credit crunch. Much of the expansion of recent years has been driven by an increased appetite for risk, but the current problems are likely to reverse this, particularly now that two of the UK's largest banks are partly state-owned. In future lending growth will be slower, as a result of tighter borrowing criteria and funding issues, and there will be a need to restructure their activities. There have also been moves towards greater regulation, with restrictions on dividend payments and remuneration being made a condition of the bank recapitalisation in October 2008. Political considerations make further regulation likely – the bank recapitalisation package, in particular, was unpopular amongst the electorate so there will be moves to put in place a system which will prevent these problems recurring. Though firms in other major industrialised countries are likely to be subject to similar constraints, the UK will remain under challenge from emerging financial centres and we expect the financial services sector to grow at a much slower pace in the future. Our forecast shows output growth in the sector averaging 4% a year over the current cycle, compared with 6.1% in the last cycle. This is particularly important given that output per job in the financial services sector is more than double the whole economy average.

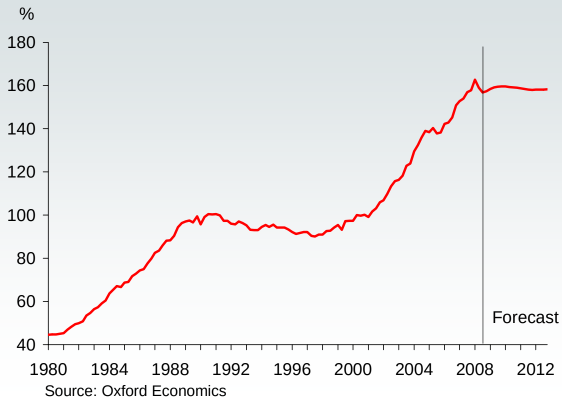


There will also be important spillover effects into other sectors with strong links to financial services. Business services, in particular, has been one of the fastest growing sectors over recent years, but the prospects for areas such as legal and accountancy – which have a high degree of dependence on financial services – will be dampened by the problems in the financial sector. With the recession permanently damaging these high value added sectors it will limit the ability of the economy to raise productivity growth to offset the weaker contribution from rising population and drag from lower employment. We expect output per hour worked to contribute 2.1% a year to potential output, compared with 2.3% over the last cycle.

Therefore we expect potential output growth to be much slower in this cycle…

Several exceptional factors combined to generate output growth of 2.9% a year over last economic cycle. However, prospects for the current cycle have been undermined by the descent into deep recession, which has damaged the most successful sectors of the last cycle, reducing the expected contributions of productivity and population growth to potential output growth and meaning that a lower long-run employment rate is a drag on prospects. Though we expect the UK economy to gradually recover from the current downturn, our forecast shows potential output growing by just 2.1% a year between 2006H2 and 2018H2.

In addition to these supply-side factors, the demand-side also points to much slower growth in the future. The bedrock of the UK economy over the last cycle was the consumer, underpinned by rapid expansion in credit and the boost to wealth from surging house prices. The household-debt-to-income ratio rose from 92% in 1997 to 163% at the beginning of 2008, aided by low interest rates and wider availability of credit. At the same time, savings rates sank to historical lows, resulting in a decade-long consumer boom, with spending growth averaging 3.4% a year.



We expect the consumer to retrench over the next two years as unemployment rises sharply, which should ensure that the debt-to-income ratio edges downwards, as it did in the aftermath of the 1990s recession. And once the economy enters the recovery phase it is unlikely that consumers will seek to keep adding to debt levels in the way that they have in the past, particularly with the housing market expected to sustain slower price growth than over the past decade. Furthermore, the government has already pre-announced increases in personal taxation from 2010/11, with further rises likely to be needed to plug a significant structural budget deficit. This will further squeeze personal incomes and contribute to weaker consumer spending growth over the coming decade. The recession could prove to be the catalyst for an overdue rebalancing of the UK economy, but unless either investment or trade step forward to offset the weaker consumer, demand growth is likely to be much slower over the current cycle.

…and much weaker than the Treasury predicts…

Our forecast is considerably lower than that of the Treasury, which assumes output growth of 2.75% from 2006H2 onwards, albeit with a 4% reduction in trend growth between mid-2007 and mid-2009 to take account of the impact of the credit crunch.

Contributions to potential output growth

per cent per annum

	Oxford Economics	HM Treasury
Trend output per hour worked	2.1	2.3
Trend in average hours worked	-0.3	-0.3
Trend employment rate	-0.3	-0.1
Population	0.5	0.8
Potential output	2.1	2.8

A decomposition of the forecasts shows three significant differences:

- The Treasury assumes that the pace of productivity gains will pick up in the current cycle, despite evidence of a significant deceleration over the second half of the last cycle. Our forecast shows output per hour contributing 0.2% a year less than the Treasury projections, which is broadly in line with the pace achieved in the second half of the last cycle and consistent with slower growth in high value added sectors such as financial services and weaker business investment.
- We expect the NAIRU to increase from 5% to 6.5% over the next two years, thus reducing the employment rate. The Treasury also forecast a lower employment rate, but this only reduces potential output growth by 0.1% a year, compared with our forecast of 0.3%.
- The Treasury forecast uses the 2006-based population projections but, as previously stated, we believe that these significantly over-estimate inflows of migrants due to the extrapolation of an exceptional period of in-migration. The official projections contribute 0.8% a year to potential growth, compared to 0.5% in our forecast.

…which has a number of implications for the economy

An undershoot in economic growth of the magnitude that we forecast will have a significant impact on a range of areas. Firstly, it is likely to cause a considerable shortfall in government revenues. Though the Treasury's fiscal projections adopt a more cautious view of trend output of 2.5% a year, this is still significantly higher than our forecast of 2.1% a year. The fiscal projections in the Pre-Budget Report show that real growth of 2.5% a year will generate growth in nominal current receipts of around 6.6% a year over the long-term, but our analysis points to much slower growth in receipts of roughly 5.5% a year. This would ensure that by 2015/16, when the Treasury expects the current budget deficit to be eliminated, there is a cumulative shortfall in tax revenues of £40 billion compared with the Treasury's projections. Therefore, we expect these overly optimistic growth assumptions to necessitate higher taxes and even greater government spending restraint in the future.

There will also be implications for bodies that have performance targets which are calibrated according to the government's long-term projections. Regional Development Agencies are assessed according to a range of targets but many of these are based upon the Treasury's long-term forecasts for the UK economy. This will be of importance to regions which are particularly dependent on migrant labour and our forecasts imply significantly lower population growth for areas such as London and the South East. This will also have implications for the new house building targets set by the Department for Communities and Local Government; our projections suggest that the UK population will be more than 1 million lower than official projections by 2018, suggesting a significantly lower level of new houses will be required in future.

Though the experience of past cycles often offers an insight into prospects for the current one, we expect this cycle to be very different from the last one. Less rapid productivity growth, a lower trend employment rate and slower growth in the working age population are likely to lead to significantly weaker potential output growth over the current cycle.