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ideas with impact

More mirage than miracle

Assessing the UK's economic performance

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How often have we heard this story? For the past 15 years, Britain has enjoyed unprecedented economic growth. More than 60 consecutive quarters of growth coincided with low interest rates, low inflation and high employment. While other economies around the world faltered at one point or another during this period, Britain kept steaming ahead, achieving strong and sustained growth.

The British economy has expanded in every single quarter since the 1992 recession - the period we are examining in this research note. That is indeed a remarkable performance. However, the picture is less impressive when we look behind the headline figures. UK growth was built partly on unsustainable foundations. Even worse, a rising tide of regulations and higher taxes threatens to erode some of the pillars of UK growth.

Overall GDP growth figures only give a part of the picture. This is not because GDP is the wrong indicator for the overall economy (we believe it is), but because it is not the only indicator that matters. But even if we look merely at GDP and not at, say, life expectancy and education, the UK record may not be that spectacular. It very much depends on the countries with which we compare ourselves. The UK has grown by less than all other industrialised English-speaking economies.

Our growth was built on a number of factors - factors which we believe cannot continue for much longer. The exceptionally buoyant housing market had a number of side effects. First it eroded our savings culture as bricks and mortar seemed to offer a better investment. Second, as we needed higher mortgages, we became ever more reliant on private debt.

The growing private indebtedness was mirrored by an increase in public debt. Despite strong economic growth, the public debt continued to expand, more than doubling in real terms over this period. The expansion of the public sector artificially inflates the GDP growth data. And it cannot continue much longer. Judging by the fiscal deficit trend, the UK is now in worse fiscal shape than almost any other major Western country.

It is also worth differentiating between GDP and per capita growth. The UK population has increased substantially since 1992, adding another three million people to the economy as consumers. The working age population grew even faster than the overall population. Part of our economic growth is due to this. Whether we can continue to rely on a strong inflow of well-qualified immigrants is an open question. As Poland gets richer, more Poles may want to stay at home.

The purpose of this note is twofold. First, to highlight some key factors behind the economic growth of the past 15 years. House prices, personal debt, public debt and population growth. But more importantly, we want to draw attention to our over-reliance on these factors. Growth can be boosted for a while by fast rising house prices and massive increases in personal and public debt. But such factors are not sustainable in the long run. We only need to look at the recent trouble in financial markets for evidence of this.

Other European economies have recently embarked on a process of economic modernisation. However, the UK's tax, spending and regulation policies have gone in the other direction. We need to find more sustainable foundations for our future economic prosperity than house prices and debt.

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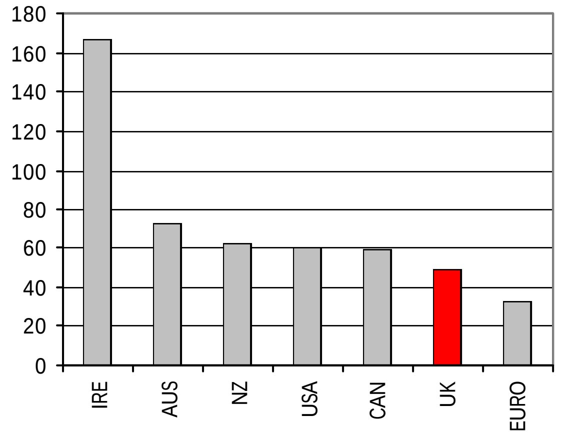


Real GDP growth between 1992 and 2006 in Anglosphere OECD economies and the Eurozone

Source: OECD

Putting the UK's economic growth into perspective

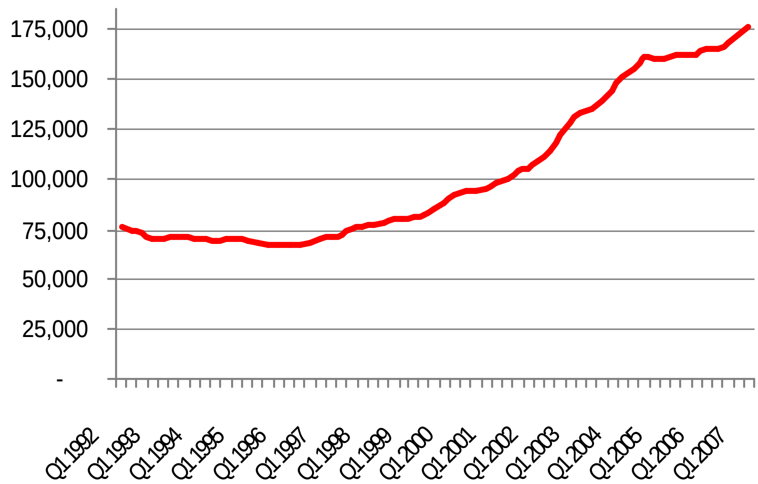
Between 1992 and 2006 the UK's economy grew by 49 per cent in real terms. At first sight, one might argue, we have been doing well, especially considering that the Eurozone only managed 33 per cent growth over the same period. Yet, there are two problems with this: first, the Eurozone's growth record was blighted by Germany's specific post-unification troubles. Second, other economies of comparable cultural backgrounds (i.e. those English-speaking countries within the OECD) have fared much better.

Canada achieved 59, the United States 60, New Zealand 62, Australia 73 and the Republic of Ireland a stunning 167 per cent real GDP growth between 1992 and 2006. So all other English-speaking OECD countries have done better than the UK over this period. In this sense, Britain's growth record is not exceptional. More importantly, it has been underpinned by numerous worrying developments.

The UK's housing boom

House prices have more than doubled in the 15 years since 1992 in real terms. The Nationwide house price index had the average UK property at £175,554 in the first quarter of 2007, while in early 1992 it stood at £76,408 (in 2006/07 prices).

There are a number of reasons behind this house price inflation, the most important being harsh planning restrictions, changing demographics, lower real interest rates and immigration. But whatever the reasons, house price inflation is unlikely to continue much longer at recent rates. The period of declining real interest rates, which made expensive houses affordable, is over. The current crisis in the US housing market illustrates the risks.



House prices 1992 - 2007 (2006/07 prices)

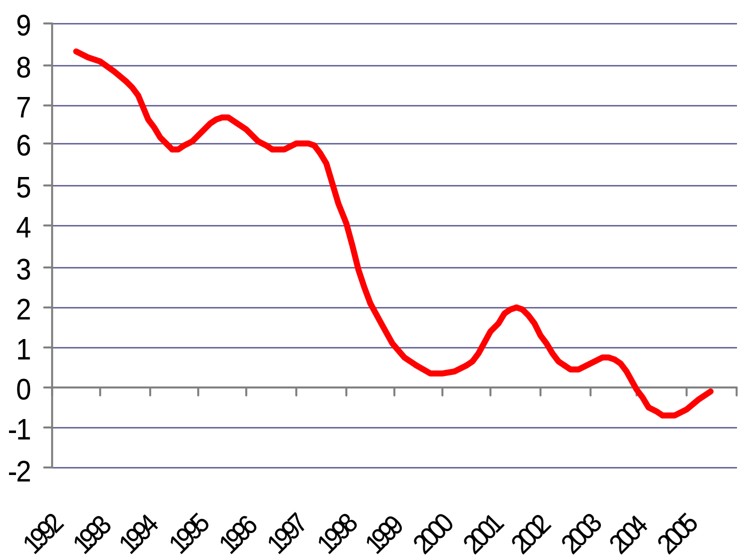
Source: Nationwide House Price Index (adjusted for inflation)

The decline of the UK's savings culture

Fifteen years ago, at the beginning of our current period of growth, UK households saved 8.3% of their disposable incomes (net savings). Partly due to the surge in house prices, the attitude to savings has changed dramatically, leading to negative net savings rates from 2004. UK households borrowed more than they saved.

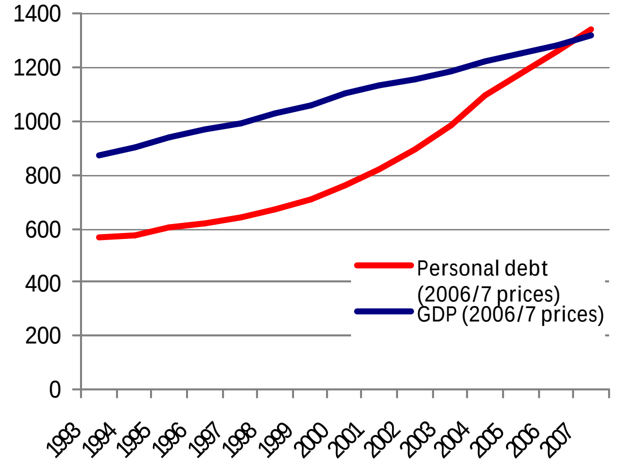
Rising house prices made savings look less and less like a good investment. The property market promised much better returns in comparison, especially since interest rates were low. On the other hand, it became more expensive to become a homeowner. Households could save less and had to borrow more. This reinforced the decline of the UK's savings rate.

While asset-backed debt may not be a problem in itself, fluctuations in asset prices can be dangerous. As Mervyn King once said: "House prices are a matter of opinion whereas debt is real."



UK household net savings rates as a percentage of disposable household income

Source: OECD



UK personal debt and GDP between 1993 and 2007 (in 2006/2007 prices)

Sources: Bank of England, HM Treasury

Rising personal debt

Between June 1993 and June 2007 inflation-adjusted personal debt increased by 137 per cent (or £777bn) to over £1,343bn. Personal debt in the UK is now greater than annual GDP. The driver behind most of the increase in private debt has been rising house prices. More than 80 per cent of all personal debt is secured lending against the value of private property.

As house prices surged, people began to withdraw more equity from their houses. From 2001 to 2006 a total of £256bn equity (in current prices) was extracted from UK property values in this way. On top of rising levels of unsecured credit, part of this Housing Equity Withdrawal helped to bolster private consumption.

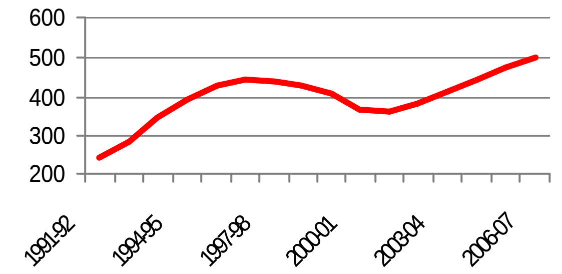
However, dependent as it is on rising house prices, Housing Equity Withdrawal cannot continue indefinitely to prop up our consumer spending at its current level. The amount of private debt leaves us vulnerable to future house price developments.

Rising public debt

While the UK economy has expanded continually since 1992, public finances recorded a surplus in only four of these years (between 1999 and 2002). In all other years, the government spent more than it raised in taxes. Consequently between 1992 and 2007 real public sector net debt more than doubled from £243bn to £500bn. This figure does not even account for future liabilities such as public sector pensions and PFI repayments.

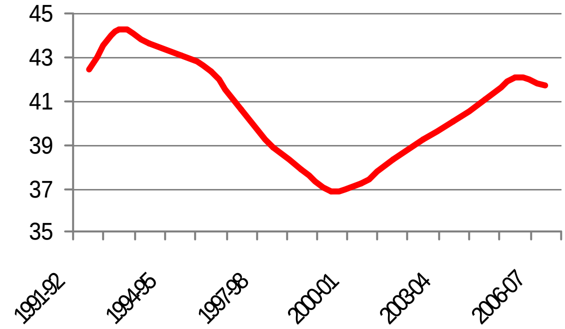
Another important measure is government expenditure as a percentage of GDP. This fell continually from 1991/92 to 1999/2000 since when it has risen each year apart from 2006/07 (and is projected to continue rising in 2007/08).

Just as private households have been living beyond their means, so has the state. This is particularly worrying as public debt and expenditure rose at a time of strong economic growth in which the government should normally have reduced its debt to be ready for a rainy day. In the event of an economic downturn, the UK now has little leeway for a financial stimulus.



Real public sector net debt (£bn; 2006/07 prices)

Source: HM Treasury



Total managed expenditure (percentage of GDP)

Source: HM Treasury

Population growth

While the UK's real GDP grew by 49 per cent between 1992 and 2006, a part of this growth is down to the fact that the UK population has also grown. While our GDP today is bigger than before, it has also been produced by more people.

Ultimately, GDP per capita is more important, reflecting people's actual experience of economic well-being rather than an aggregate national figure. While GDP grew by 49.3 per cent in real terms, GDP per capita only increased by 41.9 per cent.

Year	Population (thousands)	Working age population (thousands)
1992	57,585	34,882
2006	60,587	37,296

Sources: ONS, DWP

Inward migration is largely a sign of economic strength. It has important knock-on effects for the economy. While the influx of migrants has been useful in curbing wage inflation (thereby helping maintain lower interest rates), it has added further pressure to house prices. Both effects have helped to boost the economy in the short run. In the long run, however, the UK cannot rely on such a wave of well-qualified immigrants. Other countries are following suit, opening their labour markets to migrants. Also, as Poland and other EU newcomers get richer, their people may stay at home. The extraordinary supply of mostly well-qualified immigrants from these countries may dry up.

Keeping Britain competitive

As we have seen, the UK's economic performance over the past 15 years was boosted artificially by some exceptional circumstances. How long these conditions will last is difficult to tell. But it would be unwise to rely on them any further. House prices cannot increase in double figures for much longer. Without a buoyant real estate market, households will need to borrow more carefully again. The recent jitters in financial markets, culminating in the first run on a UK bank since Victorian times, and the strained state of public finances suggest that growth could slow down soon.

The UK economy needs a new foundation for sustainable growth. The question then becomes: what should be done? Or, in other words, in which areas does the UK lag behind its competitors? Where could we do better?

When the World Bank analysed the conditions of doing business in countries around the globe, the UK came out as the best place to do business in only one respect: the ease of getting credit. In other respects the UK fared less well. For example, the UK came only 54th in the category of dealing with licences, a clear indicator that there is room for improvement. According to the British Chambers of Commerce, the cost of regulation to business for the past decade has been above £50bn.

Earlier we saw that other Anglosphere economies in the OECD had a better growth record than the UK. It is worth noting that in these economies the ratio of public expenditure to GDP was significantly lower than in the UK. In 2005, 45.1 per cent of the UK's GDP was spent by government. This compares unfavourably with state spending in Ireland (34.6%), Australia (34.9%), the US (36.6%), Canada (39.3%) and New Zealand (40.6%). Although unsurprising, it is also worrying that the UK's high public expenditure has coincided with a rising tax burden. It has already gone up from 34.8 to 37.3% of GDP in the last decade. UK business leaders frequently point to the level (and complexity) of taxation as one of their top concerns.

Although the UK government has increased its overall spending substantially, our infrastructure still lags far behind our competitors. In terms of the public capital stock per person, the UK had only accumulated about half the OECD average in 2006. Consequently, in the competitiveness report published by the World Economic Forum the overall quality of the UK's infrastructure ranked far behind countries like the US, Germany and Japan as well as the OECD average.

All this presents UK economic policy with a challenge: to improve our infrastructure while reducing tax and regulatory burdens. This would increase the UK's still disappointing productivity. In the long run, this is the key to economic growth. **An economy built on lower taxes, lighter regulation and better infrastructure will be more sustainable than one built partly on rising house prices and extra debt.**

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