

United Kingdom: The Labour heritage

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Even as growth has resumed in the United States and the euro zone starting in third quarter 2009, the United Kingdom is still in recession. Contrary to what was seen in past cyclical swings, the UK services sector has been a major contributor to the current crisis. The difference this time is due to the nature of the crisis itself as well as to far-reaching changes in the British economy in recent decades¹. In twenty years, with the liberalisation of markets and the consequent growth of financial activity, services have increased markedly as a proportion of economy-wide value added. They now contribute nearly 80% of the total, compared with less than 70% in 1990. (Chart. 1 and Chart. 2)

State of the economy

The current crisis began in an overheated property market to which the financial sector was heavily exposed and propagated from there to the entire economy. According to the International Monetary Fund, a recession associated with a financial crisis lasts six quarters on average, as opposed to three quarters for an ordinary recession. Weak domestic demand largely explains the severity of the current crisis. At more than 400%, the ratio of housing prices to household income is still well above its long-term average (Chart. 3). Even so, and despite a recent uptick, the steep decline in residential property prices – in Q3, prices were down more than 10% from their highs in Q3 2007 – is forcing households to shore up their financial positions. Furthermore, rising unemployment in 2010 will depress residential spending and investment and could compromise the durability of the rebound in property prices. On top of this, the current crisis is worldwide – another unfavourable factor for the British economy, which is quite open to foreign trade. In these

circumstances, depreciation of sterling has been of little help. This recession has gone on for six quarters and is already the longest since the Second World War. For comparison, the 1973-74 recession lasted three quarters; the 1980 and 1990 recessions lasted five. Moreover, fiscal stimulus measures have entailed rapid deterioration in public finances, much of it attributable to the effect of automatic stabilisers (see below). The necessary budget consolidation will have a lasting impact on growth, keeping it well below the potential growth rate for some time.

Standard & Poor's (S&P) and Fitch, the rating agencies, have consequently put the United Kingdom on credit watch with the possibility of a downgrade of its triple-A rating. In May 2009, S&P announced that it was putting a "negative outlook" on its assessment of the health of UK public finances based on the likelihood that the next government would fail to rein in the deficit. In November, Fitch advised that any further stimulus measures would cause the United Kingdom to lose its AAA rating. If this were to happen, only the United States, Germany and France would still be rated AAA, and the United Kingdom would join the ranks of the four other countries downgraded in 2009, namely Ireland, Greece, Spain and Portugal.

GDP declined by 0.3% q/q in the third quarter, falling for the sixth consecutive quarter. It had fallen by 0.6% in the second quarter. Year over year, GDP contracted by 5.1%, after being down 5.5% in the second quarter – the sharpest drop since 1955. It is now 5.8% below its pre-crisis peak in first quarter 2008. The contraction in activity struck across all sectors. In construction, output was down 1.1% q/q, after falling by 0.8% in second quarter 2009. In manufacturing, activity declined by 0.1% q/q, as it had done in the second quarter. This trend is consistent with a gradual winding down of the destocking cycle. In agriculture, output contracted by 2.5% q/q, after shrinking 2.9% q/q in the second quarter (Chart. 4).

The unpleasant surprise came from the services sector, where activity was off 0.1% q/q in the third quarter when the surveys had given reason to expect a slight rise (Chart. 5). The overall drop occurred despite stabilisation of demand for services to business and financial services (which together represent 40% of activity in the sector).

All components of domestic demand excluding inventories contributed to the decline in GDP in the third quarter (Chart. 6), excepting public sector expenditure. Household consumption was unchanged in the third quarter, the first time in six quarters that it did not fall. Economic uncertainties and financing difficulties continued to weigh on business investment, which was down 3% after plummeting 10.2% in second quarter 2009, the sharpest fall since third quarter 2005. The Confederation of British Industry's quarterly survey indicates that access to credit remains the leading factor² cited by businesses as restraining their investment spending. The relevant index stood at 14, well above its long-term average (Chart. 7) even after the recent decline. Changes in stocks, after contributing positively (0.3 point) to GDP growth in the previous quarter, had no impact on growth in the third quarter. Lastly, a slight rise in exports (up 0.5%), the first in five quarters, was offset by a faster increase in imports (up 1.3%), whereas imports had been declining steadily since the start of 2008. On balance, foreign trade clipped off 0.2 percentage point of GDP growth.

Households

Faced with the deteriorating outlook for the labour market and, more generally, with the economic difficulties besetting the United Kingdom, households have taken a cautious posture by paying down debt and rebuilding their savings. According to recent Flows of Funds data, the savings rate posted a spectacular rise in second quarter 2009, climbing from 3.9% in the first quarter to 5.9%, its highest level since fourth quarter 2003. In previous recoveries, the savings rate had had a tendency to fall. This time, however, we expect a decline in household consumption for full-year 2009, despite a probable rebound in the fourth quarter in anticipation of the scheduled 2.5-point hike in the VAT rate (from the current 15% to 17.5%) in January 2010. After that, consumers are likely to remain relatively uninclined to spend, in expectation not only of a rise in interest rates that will raise their expenses but also of the foreseeable

rise in taxes. In these circumstances, private consumption is unlikely to pick up significantly before 2011.

Households will have to keep savings at a high level in order to provide for retirement income. As it is, the public pension system offers limited coverage, and the ageing of the population puts it on a shaky footing. According to projections by the Office for National Statistics (ONS), pensioners will make up 21% of the population in 2020, up from less than 19% in 2006, despite the gradual rise in the minimum retirement age³. An increase in individual contributions thus seems inevitable if the system is to be kept in balance without adding a significant burden onto government spending.

The rate of growth of households' employment income has slowed sharply since the start of the crisis, from 3.5% year-on-year in fourth quarter 2008 to 1.8% in third quarter 2009 (Chart. 8). This is largely a reflection of increased wage flexibility as well as the way businesses are adjusting to the sharp rise in their costs of production as sterling has depreciated. By the same token, the slower pace of wage growth partly explains why employment has held up relatively well, slipping by just 0.1% q/q in third quarter 2009 after falling by 0.6% in the second (see below).

According to the latest Flows of Funds data, households' income from capital were also heading downwards in the second quarter, although less so than in the quarter before (down 3% q/q, after falling by 17.2% in Q1 2009), as companies were cutting dividend payouts. The decline of more than a half in interest income, on the other hand, was entirely offset by the decline in interest payments, particularly on mortgage loans. In contrast, payments on life insurance contracts increased sharply (up 12% q/q). All told, household disposable income grew by 1.6% (0.9% in real terms). Households' financial positions improved on the strength of the rebound in equity markets, with the FT100 index up 13% q/q in Q2 and up 20% q/q in Q3. The value of shares and other equity portfolio holdings thus grew by 11%, whereas the value of all assets held increased by 3% q/q.

According to an article by Oxford Economics⁴, UK households' capital losses since the start of the crisis amount to 90% of GDP. In the OECD countries, only US households have suffered greater losses. On the liability side, households have reduced their short-term debt by GBP 4.6 billion, even as their long-term debt was increasing by GBP 1.6 billion.

Breakdown of main economic sectors in 1990

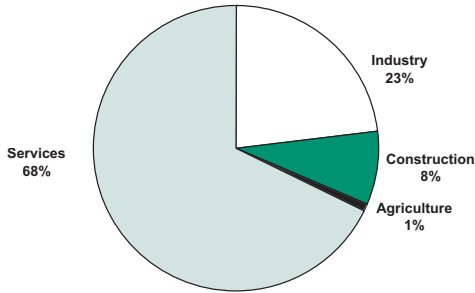


Chart 1

Source: ONS

Breakdown of main economic sectors in 2009

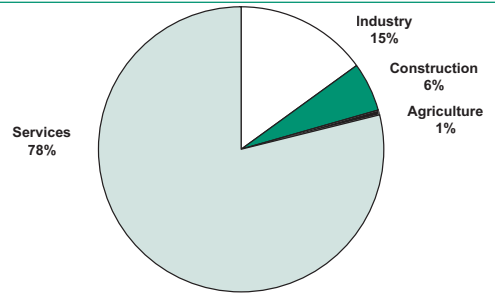


Chart 2

Source: ONS

Ratio of housing prices to household disposable income

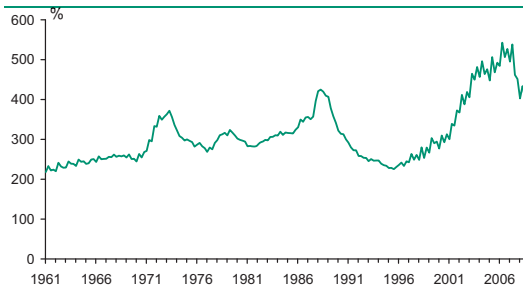


Chart 3

Sources: ONS, Nationwide Building Society, BNP Paribas calculation

Breakdown of the Added Value by economic sectors

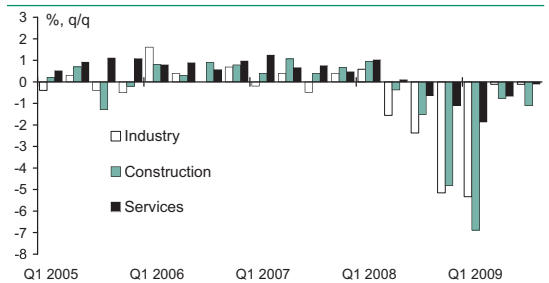


Chart 4

Source: ONS

Breakdown in the services Added Value

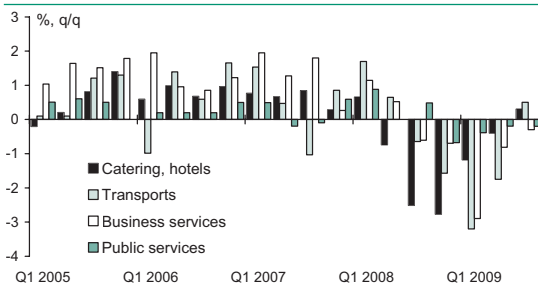


Chart 5

Source: ONS

Breakdown in GDP (Expenditure Approach)

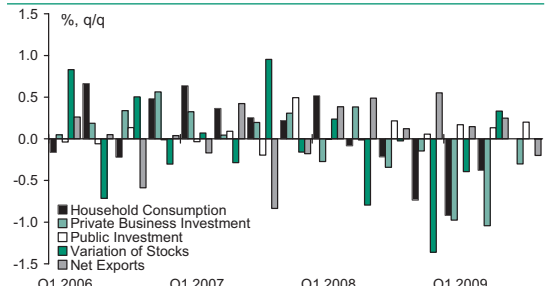


Chart 6

Source: ONS

The exceptionally low level of mortgage interest rates probably explains this increase. In all, aggregate financial liabilities of the sector declined to 131% of gross disposable income, down from 142% in the first quarter. However, households hold significant financial assets which, on a net basis, amounted to 175% of their disposable income in second quarter 2009.

Labour market

Despite the substantial deterioration in economic conditions over the past eighteen months, the number of people in work has decreased by only 721 thousand since the start of the recession, a decline of about 2.5%. This contraction is far less than during previous episodes (see Table 1) and has resulted in a more pronounced decline in productivity per worker. The Bank of England's regional agents have noted both a decrease in the number of hours worked and an increase in the use of part-time workers. The limited decline in employment during the current recessionary episode is explained in part by the fact that employees accepted lower wages for fear of losing their jobs. The Bank of England's regional agents report that some businesses, after consulting with their employees, have put through general wage decreases to preserve jobs at their production site.

Furthermore, the contraction in employment is already abating. Several surveys of hiring intentions signal that the contraction is easing. Also, the CIPS-Markit index for the manufacturing sector indicates that businesses are still cutting staff, but not as sharply as before. The related index has stayed below 50 for eighteen months straight as of October 2009. It has, however, been rising steadily since the start of the year, when it hit an all-time low. The story is the same in services. Given the relative flexibility of the UK labour market, the lag between economic upturn and improvement on the jobs front should be relatively short (less than six months). The unemployment rate could consequently stop rising next year and stabilise around 8%⁵. It was 7.8% in August 2009 (latest available Charture), compared with 5.5% at the beginning of the crisis. For comparison, in the United States, where the labour market is just as flexible as in United Kingdom, the unemployment rate has risen from 5.6% to 10.2% in October. In contrast, the rise in unemployment in the euro zone has been less pronounced: from 7.4% in June 2008 to 9.7% in September 2009 (Chart. 9).

Factors likely to limit capital expenditure authorisations

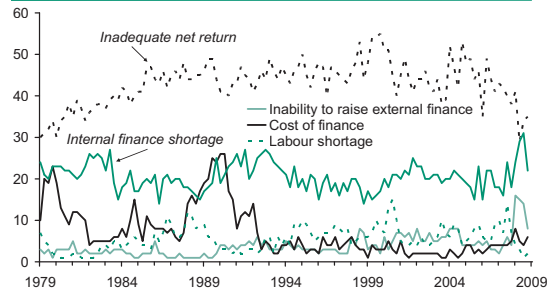


Chart 7 Sources: CBI, quarterly survey

Private sector wages

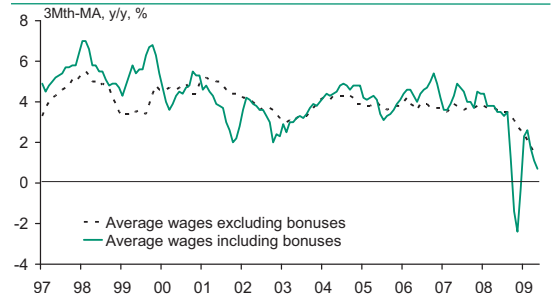


Chart 8 Source: ONS

Comparison of the jobless rate in the US, the UK and the Euro zone

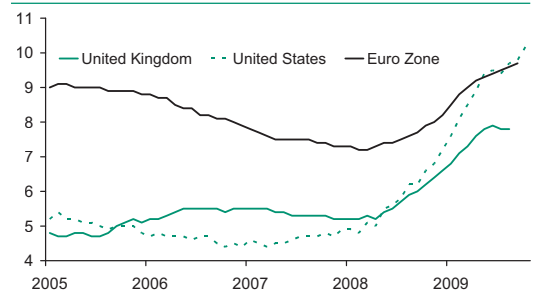


Chart 9 Sources: ONS, BLS, Eurostat

Output, employment, average working hours during past economic recessions in the 1980's, 1990's and the current crisis

Year-on-year variation, five quarters after the beginning of the recession¹

	1980	1990	Current crisis ²
GDP ³	-4.7	-2.5	-5.5
Employment ⁴	-2.4	-3.4	-2.2
Average working hours ⁵	-3.0	-1.9	-1.3

Table 1

Source : Bank of England, ONS and BNP Paribas

1: A recession corresponds to two consecutive quarters of contraction in GDP (constant market prices)

2: BNP Paribas calculations on Q2 data concerning employment and average working hours

3: GDP in volume measure, market chained prices

4: Employment measured in the Labour Force Survey

5: Average working hours are calculated as the ratio between weekly working hours to employment

The recent rise in unemployment among those aged 15 to 24 years is still worrisome, though. According to a recent OECD report⁶, the UK unemployment rate for this age bracket stood at 14.4% in 2007, well above the average of OECD countries and close to the level in the euro zone. In comparison with the unemployment rate for those aged 25 or over, joblessness in the 15-24 age bracket has risen faster than in other countries. For non-graduates in this age bracket, the situation has deteriorated rapidly. According to the OECD, the opening of the labour market to new migrants from the East (Poland, Lithuania, Slovakia, Czech Republic and Hungary) and the introduction of a minimum wage in 1999⁷ partly explains this development.

Business

During the second quarter, businesses continued to adjust inventory levels to demand, which was still heading down. This enabled them to trim their financing requirements. The rate of destocking moderated in the second quarter, adding 0.3 point to GDP growth, but there was no contribution from this source in the third quarter. From the fourth quarter on, businesses are likely to be gradually rebuilding their stocks, such that the change will again contribute positively to GDP growth.

However, the uncertain prospects for world demand and the still-high levels of excess capacity have required businesses to be cautious. For one thing, they have hoarded considerable amounts of cash. Their liquidity ratio (liquid assets divided by short-term liabilities), although down from the quarter before, was still above

87% in the second quarter (most recent Flows of Funds data). For another, their investment spending has decreased by 3% q/q in the third quarter, after plunging more than 10% in the second quarter.

Of all the components of internal demand, private non-residential investment was the one most affected by the crisis, above all because of tighter financing conditions but also because of lower capacity utilisation rates, actual and expected. In third quarter 2009, capacity utilisation reached 72.4, its lowest level since the series began in 1985 (Chart. 10). In March 2008, it had stood at 82.6. The steep decline in production reduced capital spending requirements, and with domestic demand weak, the outlook is improving only very gradually.

According to the most recent Flows of Funds data, EBIT of businesses in the private non-financial sector continued to contract in the second quarter, although compared with the previous quarter the contraction slowed: it shrank by 1% q/q, after shrinking 8% in first quarter 2009. Businesses' free cash flow decreased by more than 7% after increasing strongly in the previous quarter. Overall, the business sector's net creditor position⁸ declined slightly to GBP 14.4 billion, down from a four-year high of GBP 15.7 billion. Businesses essentially used their funds to pay down debt. Borrowings outstanding declined further in the second quarter, contracting by nearly GBP 45 billion after having shrunk by GBP 43 billion in the first quarter. Even so, the debt ratio (short-term and long-term debt divided by EBIT) remains particularly high, at 475% in the second quarter (but nevertheless lower than in Q4 2008). For comparison, the sector's debt ratio was

below 400% in 2006. The sector's consolidated assets likewise contracted by about GBP 30 billion during the quarter. In particular, businesses repatriated funds from their subsidiaries abroad. Loans associated with direct foreign investment declined by GBP 15.5 billion after falling by GBP 23 billion during the previous quarter.

Foreign trade

Since the beginning of the crisis, net foreign trade had been a source of support for UK economic activity, but only because imports had been falling faster than exports. Exports picked up again in the third quarter (up 0.5% q/q), but not enough to offset the rise in imports (up 1.3% q/q) (Chart. 11). From fourth quarter 2009 on, the sterling depreciation that has already occurred, coupled with stronger world demand, should boost exports and help to shift the balance among drivers of growth in favour of foreign trade (Chart. 12).

Some high-value-added industrial sectors such as aerospace, pharmaceuticals and biotech stand to benefit from the improved price-competitiveness of British products. The United Kingdom successfully specialises in these advanced sectors. In this regard, the latest available survey by the Confederation of British Industry (November 2009) indicates that the improved order volume in these sectors comes mainly from foreign markets. The related index hit a low in June 2009 but has been climbing ever since. There seems to be little prospect of a rise in manufactured goods' share of UK exports, however. They now account for less than half of total exports of goods and services, compared with more than 60% at the beginning of the 1990s. The decline is due mainly to the rise in the share of services⁹. Lastly, higher import prices (reflecting past sterling depreciation), coupled with weak domestic demand, are likely to hold down imports.

Inflation

Since March 2009, inflation as measured by the retail prices index (RPI) has been below zero for the first time since a brief period in the late 1950s (Chart. 13). In October it stood at -0.8%, after -1.4% in September. The negative rate of inflation is a result of falling house prices (-13% y/y in Q3) and declining mortgage interest payments¹⁰ (down 45% y/y, in line with the decline in the Bank rate from 5% in October 2008 to 0.5% one year later). As house prices and mortgage interest rates have now stabilised, they should cease to be a factor driving down the retail prices index.

Capacity utilisation rate and business investment

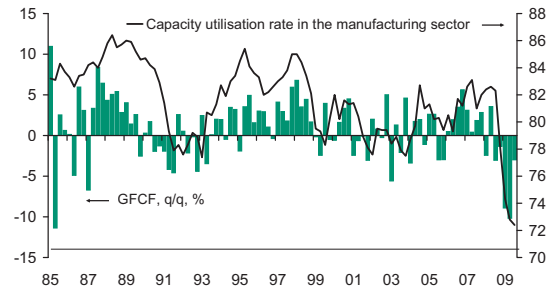


Chart 10

Sources: ONS, OECD

Net trade contribution to GDP growth

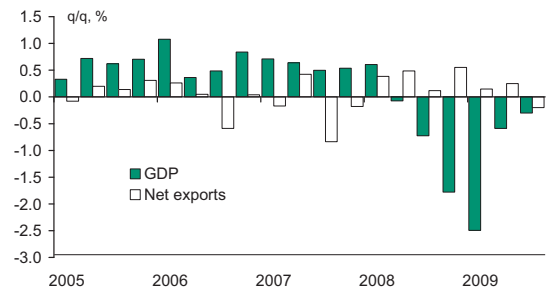


Chart 11

Source: ONS

Effective exchange rate and exports

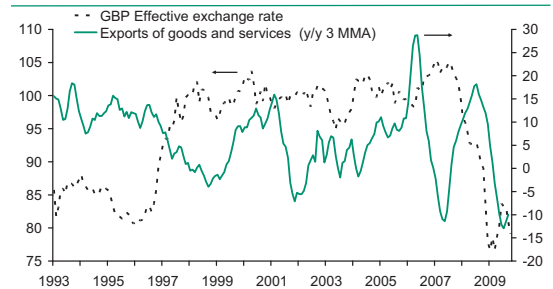


Chart 12

Sources: ONS, BoE

The RPIX sub-index, which excludes mortgage interest payments, has also declined sharply in recent months, but it has stayed well above zero. After falling to 1% year-on-year in June, its lowest level since the series began in 1975, it had risen back to 1.9% y/y in October. The Office for National Statistics (ONS), which compiles the index, wants to change the base interest rate used in the calculation of the mortgage interest component in order to reduce the volatility in this component and in the overall index (see Annex).

As for inflation as measured by the harmonised consumer price index, for which the Bank of England has set 2% as a medium-term (2-year) target, it has declined steadily over the past twelve months, from 5.2% in September 2008 to 1.5% year-on-year in October 2009, after reaching a four-year low of 1.1% in the preceding month (Chart. 14). Inflation is now set to begin edging up, however. The recent rise in oil prices, the past depreciation of sterling¹¹ and the hike in the VAT rate in January will all be having an upward effect on the price level in the months ahead. In its most recent Inflation Report, published in November, the Bank of England even anticipates that, with unchanged monetary policy, the rise in the price level will easily exceed the 2% target in the next six months before declining again under the effect of persistent excess capacity.

Property market

After advancing at a very rapid pace between 1997 and 2007 (prices tripled), the residential property market collapsed in late 2007 (Chart 15). Its fall by nearly 20% between the end of 2007 and the start of this year was exacerbated by the effects of the international financial crisis. Since then, property prices have begun to rise again, according to indices published by lenders Halifax and Nationwide. Activity in this sector has picked up, although the number of transactions is still less than two-thirds of its average over the past ten years. The price rebound is partly attributable to renewed risk appetite (which also explains the recent rise on stock and bond markets). It is also a sign of imbalance between supply and demand in a market which remains relatively illiquid. The latest available RICS survey shows that the index of requests for information by potential buyers (a reliable indicator of demand) is higher than the index of new listings of properties for sale (a reliable indicator of supply). A situation like this tends to push prices up. In this past, this measure of tension in the property market has moved in concert

with the RICS price index. The outlook for the property market, however, also depends on the supply of mortgage credit. In these circumstances and in the absence of ready access to refinancing of maturing mortgage loans, which could mean further defaults are in store, another downturn in property prices cannot be ruled out. Moreover, demand for housing is closely linked to the outlook for household disposable income, which remains constrained by the continuing deterioration of the labour market.

National measures of inflation

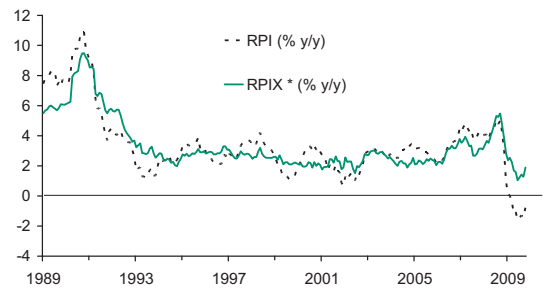


Chart 13

Source: ONS, * ex mortgage interest payments

Harmonized measures of inflation

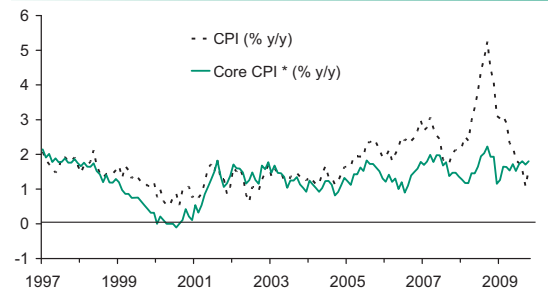


Chart 14

Source: ONS, * ex energy, food, alcohol & tobacco

Equity and housing markets

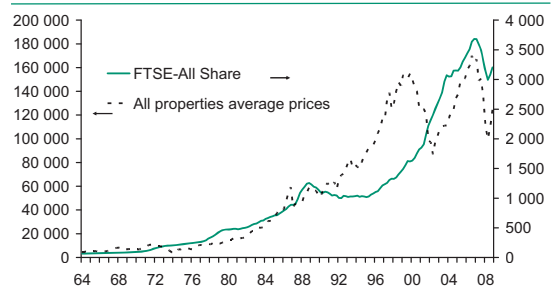


Chart 15

Sources: Reuters, Nationwide

Annex

Recommendation to change the methodology of calculating inflation as measured by the retail prices index

Source: Bank of England

The Office for National Statistics is seeking to change the method by which changes in mortgage interest payments are reflected in the retail price index. It is recommending that the standard variable rate (the SVR applied in place of the previous variable or fixed rate on a mortgage loan that has reached its term) no longer be used. It proposes instead to use the average effective rate (AER) across SVR, tracker and fixed-rate loans. As it is, SVR loans make up only 10% of all mortgage loans. This is a recommendation of the ONS at this point. The ONS will be conducting a consultation with the public, the Treasury and the Bank of England until 22 January 2010. A change of methodology could be adopted starting in March 2010. The historical RPI series would not be revised.

Currently, the year-on-year decline in the SVR is 45%, whereas the AER is down only 38%. In the long term, this change in methodology is likely to limit variations in the RPI. As it is, 56% of the mortgage loans held by UK households are fixed-rate. The AER will consequently be less volatile than the SVR, as it has been over the course of previous cyclical rises and falls in interest rates. The AER will be calculated from data collected from mortgage lenders.

Hue and cry over the liberal credo

In dealing with the economic and financial crisis that struck the United Kingdom so hard, the British authorities have shown themselves to be pragmatic. They have come to the rescue of threatened financial institutions and have taken unprecedented fiscal and monetary measures to support the economy.

Rescuing the banking system

To contain systemic risk and restore financial stability, the measures taken needed to improve banks' liquidity and solvency and at the same time increase the amount of credit available to the private sector in order to sustain domestic demand. In the financial sphere, the authorities took action along several lines: stabilising the banking system and protecting the savings of British depositors; cleaning up banks' balance sheets to ensure continued financing of economic activity; taking part in the remodelling of international bank supervisory standards; maintaining competitiveness in the banking sector.

The British government set up several new bodies. The Bank Recapitalisation Fund, established in November 2008, enabled the government to put GBP 37 billion of fresh capital into the banking system, starting with the *de facto* nationalisation of the Northern Rock bank. In November 2009, a further GBP 37 billion was

injected into two other banks hit hard by the crisis, Lloyds and Royal Bank of Scotland (RBS). The first of these operations took place simultaneously with a capital increase of GBP 13.5 billion, to which the government subscribed in the amount of GBP 5.6 billion, thereby keeping its equity interest unchanged at 43.5%. In the RBS operation, on the other hand, the government's stake rose from 75% to 84% on the injection of an additional GBP 33.5 billion. By setting up the Asset Protection Scheme, a public fund to insure banks' toxic assets, in January 2009, the government put in place a system to cover losses on uncollectible loans in excess of an "initial loss" of roughly 10% of the asset holder's own capital. The banking institutions concerned would have to set aside reserves to cover that initial loss.

All in all, the British banking system is gradually recovering from the severe crisis that it went through in 2008. The recent trend in the property market is removing the immediate threat of further potential losses. The survey on credit conditions for third quarter 2009 shows that payment defaults on loans were less than anticipated in second quarter 2009.

In part, this was because the pace of business liquidations¹² was less rapid than during the recession of the 1990s. During that recession, business bankruptcies increased by an average of more than 60% year on year. In contrast, the increase during the recent downturn in activity has been less than 35% year on

year (Chart. 16). Furthermore, current payment arrears are well below the previous peaks reached in the early 1990s (Table 2). Banks have continued to bolster their capital. According to the central bank, the consolidated banking system's core capital (Tier 1) ratio was close to 7.4% in first half 2009, compared with an average of 6% between 2003 and 2008. Even so, the system is still vulnerable to a further rise in losses. The residential property market in particular remains fragile.

Conditions have improved markedly for banks' short-term refinancing. Spreads between 3-month Libor and OIS¹³ have come down internationally. Spreads on sterling have returned to their pre-crisis levels, and futures prices suggest that these spreads should remain low. Interbank lending volume remains low, but supply at the longer maturities has improved. Unsecured issues of senior debt (bank debt issued to finance leveraged acquisitions) have continued, and the average maturity of them is slightly longer than in 2005-2007, according to the central bank. More generally, despite these convincing signs of improvement, financing conditions for banks remain tight. The main British banks will have to refinance a large proportion of the borrowings that will reach maturity in the next few years, not to mention repayment of the public aid provided to the sector during the crisis. Lastly, banks must also take into account the more stringent regulatory requirements to come, which are likely to raise the cost of bank liquidity.

Supporting the economy

Two successive fiscal stimulus plans were adopted to support domestic demand: the first in November 2008, on the occasion of the preliminary budget report, and the second in April 2009, on the occasion of the 2009/10 budget. The measures that drew the most attention were the temporary 2.5-point cut in the VAT rate effective 1 December 2008 and the accelerated schedule of public investment projects. The effect of the lowered VAT rate was not immediately significant. It did not prevent household consumption from declining in first half 2009 after an initial jolt in January.

Business insolvencies and economic cycles

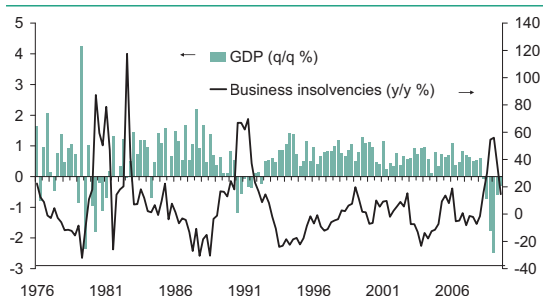


Chart 16

Source: ONS

Arrears of payments and seizure of housing mortgages

	Peak of the series	2007		2008		2009	
		H2	H1	H2	Q1	Q2	
Arrears of payments *							
From 3 to 6 months	1,82 (1994 H1)	0.60	0.73	1.01	1.11	1.05	
From 6 to 12 months	2,07 (1992 H2)	0.34	0.41	0.62	0.82	0.85	
More than 12 months	1,58 (1993 H1)	0.13	0.15	0.25	0.46	0.54	
Seizure of housing mortgages **	0,40 (1991 H2)	0.11	0.16	0.18	0.21	0.22	

Table 2

Source : Council of Mortgage Lenders

*: Arrears of payments in % of mortgage outstanding

** : Seizure in % of mortgage outstanding

Since then, retail sales have once again been rising at a relatively brisk pace (1.1% q/q in the third quarter) (Chart. 17). In January 2010, however, the VAT rate will go back to its previous level. The shot of oxygen from the VAT cut will have been brief and probably insufficient to provide any lasting impetus to private consumption.

The government has also put in place a Working Capital Scheme for small and medium-sized businesses. This scheme is funded at GBP 20 billion and will cover 50% of the risk on working capital. In addition, the Enterprise Finance Guarantee will provide GBP 1 billion of guarantees to back a GBP 1.3 billion volume of bank credit (in unit amounts of up to GBP 1 million) for a period of at most ten years. This guarantee fund is for companies with annual turnover of no more than GBP 25 million. Lastly, a special programme for the automobile industry has also been announced, with the goal of providing GBP 2.3 billion for car loans.

Taken together, these economic stimulus measures represent an outlay of about GBP 20 billion, or 1.6% of GDP, in the 2009/10 fiscal year. They are consequently not the sole cause of the swift deterioration in the public finances. The main causes are in fact the steep decline in tax receipts and the rise in recession-related expenditure (unemployment benefits, etc.). In particular, the decline in corporation tax revenue from the property and financial sectors explains three-quarters of the decrease in total tax receipts, and only one-quarter is attributable to the reduction in the VAT rate. The deficit is on track to exceed 13% of GDP in 2009/10, nearly twice its level over the previous recessionary episode in the early 1990s (6.3% in 1991) and the highest level since the Second World War (Table 3).

In October the Labour government announced that it would freeze public spending in real terms between 2011/2012 and 2013/2014. For comparison, real public spending increased by 4.5% a year between 1999/2000 and 2009/2010. In addition, it would also sell off assets. Among the assets to be sold, for a total of GBP 3 billion, are High Speed One, the rail line used by Eurostar; 33% of Urenco, the uranium enrichment company; Tote, the bookmakers company; and a student loan institution. A further GBP 12 billion would be raised by selling properties and other assets held by local authorities.

The government also announced its intention to sell a large proportion of its equity interests in Lloyds and Royal Bank of Scotland, with the aim of reducing its presence and restoring competition in the retail banking sector, which bore the brunt of the financial crisis (Table 4).

Retail sales

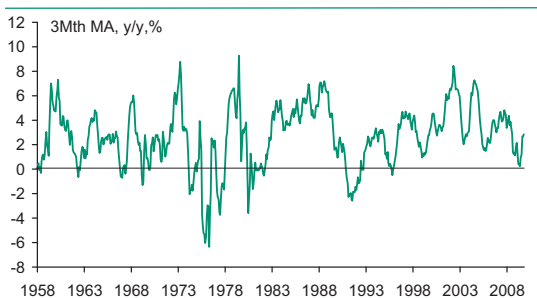


Chart 17

Source: ONS

Financial forecasts for budgetary years, in % of GDP

	2007/2008	200/2009	2009/2010	2010/2011	2011/2012
Budgetary deficit	-2.8	-6.9	-13.0	-12.5	-10.7
Structural deficit	-3.8	-6.3	-11.4	-11.0	-9.6
Public Det	43.3	55.2	71.8	82.0	89.1

Table 3

Source : European Commission

Public and semipublic banks

	Royal Bank of Scotland	Lloyds Banking Group	Northern Rock
UK branches	2 279	2 982	56
Staff	68 000	112 800	4 600
Government stake	84%	43%	100%
Mortgage lending market share	7.3%	30.3%	1.1%
What is it selling ?	-The RBS branch network in England and Wales ; - Natwest branches in Scotland ; - RBS insurance which includes Direct Line, Churchill & Greenflag; - RBS Sempra Commodities, the commodity trader	- 600 UK branches including all Lloyds TSB Scotland	-the « good » parts of the bank, including all its retail deposits and about £20bn worth of low-risk mortgages

Table 4

Source : Financial Times

The sale of the banking assets is scheduled to occur over the coming four years and is likely to draw interest from several large international banks, private equity companies and companies such as Virgin Money, which wants to expand in the British banking market. Taking the announced measures into account and assuming a rather favourable growth scenario, the government projects that the deficit will still be above 5% of GDP in 2013/14. This means that, one, the public deficit will certainly not come down to a sustainable level during the term of the next government, and probably not during the term of the government after that; and, two, the necessary adjustment in public finances will be a lasting drag on growth.

Intervention by the Bank of England

In April 2008 the Bank of England set up a Special Liquidity Scheme to enable banks, mortgage lending companies and other eligible financial institutions to receive UK Treasury bills from the Bank in exchange for the highest-rated asset-backed securities in their portfolios, for a period of up to one year. Initially intended to last for six months, the programme was extended through January 2009. The amount of the programme, initially set at GBP 50 billion, ultimately reached GBP 185 billion.

In September 2008, in concert with other central banks, the BoE signed a swap agreement in dollars with the Federal Reserve. In October 2008, this swap amounted to USD 70 billion. By the end of August 2009, the swap was down to USD 525 million, and it expired at the end of October 2009.

In January 2009, Britain's finance minister authorised the Bank of England to buy GBP 50 billion of high-quality assets from the private sector through the Asset Purchase Facility (APF). These purchases were financed by issues of Treasury bills. In March, the Bank announced an extension of the APF to UK government bonds (gilts) traded on the secondary market, made possible by an increase in its reserves. The list of eligible assets now includes commercial paper, corporate bonds, securities issued under the *Credit Guarantee Scheme*, syndicated loans and, under certain conditions, mortgage-backed securities. The ceiling on the APF has been raised several times, most recently in early November (by GBP 25 billion). It now stands at GBP 200 billion.

Limited impact of temporary measures, for now

At this time, the unconventional measures have had only limited effect. The Bank of England estimates that the economy reacts with a lag of between 9 and 12 months. Accordingly, the macroeconomic improvement should occur gradually between now and the end of first half 2010, *ceteris paribus*. For the moment, although numerous indicators and surveys show that recovery is imminent, they are also signalling that it is likely to be gradual. For one thing, the CIPS services indicator stood at 56.9 in October, its highest level since August 2007 and up from 55.3 in September. It is above 50 for the sixth consecutive month. For another, the recovery in the manufacturing sector is more chaotic. The CIPS manufacturing index was once again above 50 in

October, rising from 49.7 to 53.5 after fluctuating about that level during the third quarter (industrial production fell by 0.8% over the period, down for the seventh straight quarter).

Lastly, credit conditions have not eased significantly, and loan demand from non-financial agents has not yet turned up as they are still looking to reduce what they owe. In this regard, the trends in the monetary aggregates remain worrisome. M4 (which includes the monetary assets of non-financial agents such as households and non-financial companies) has been slowing since Q1 2009, whereas M4 ex OFCs (which excludes the monetary assets of other financial corporations) has only just stabilised. Although the easing that has occurred to date seems not to have brought about the expected rebound in the monetary aggregates (Chart. 18), those aggregates do nevertheless appear to have increased by more than the contraction in GDP would suggest. For comparison, M4 declined more sharply during the recession in the early 1990s (Chart. 19)

Cameron, the new providential man

The Conservative party led by David Cameron is far ahead in the latest polls (20-point lead in November) and is expected to win the election in May 2010. He has made responsible fiscal policy the central theme of his election campaign.

The main announced objective is reduction of the public deficit, which now stands at GBP 175 billion. A decrease in spending is consequently inevitable. George Osborne, expected to be the next Chancellor of the Exchequer, is calling for a spending reduction of GDP 7 billion, or just 4% of the deficit. Reform of the retirement age would be accelerated: men would retire at age 66 starting in 2016, women in 2020. Income tax breaks for the middle classes would be curtailed, and the highest marginal tax rate, set to rise to 50% in April 2010, would be kept at that level, at least initially. Family allowances would be cut for families earning more than EUR 55,000 a year. Salaries in the civil service would be frozen in 2011, except for the lowest-paid employees (those earning less than EUR 20,000 a year).

Monetary aggregates

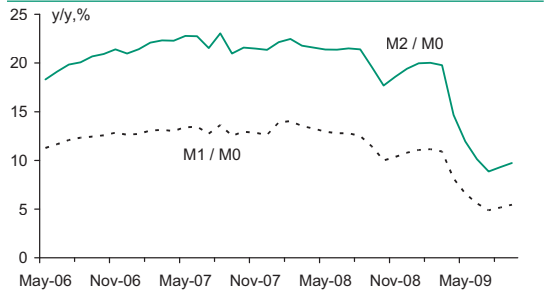


Chart 18

Source: Bank of England

M4 and economic cycles

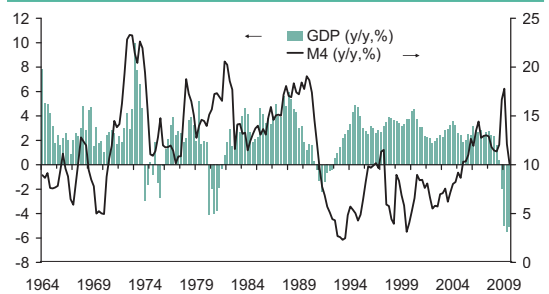


Chart 19

Sources: ONS, Bank of England

Average wages* in public and private sectors

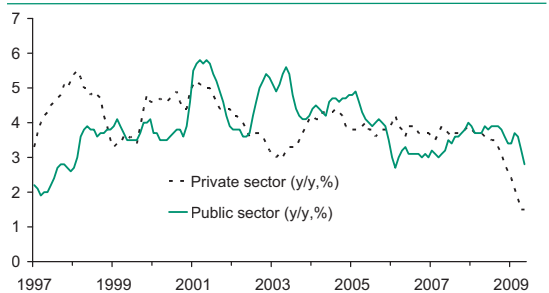


Chart 20

Source: ONS, *excluding bonuses

In this regard, we point out that pay growth in the public sector continues to be strong – up 3.4% year on year (June to August) and above 3% annually since June 2006. This compares with just 1.5% in the private sector (Chart. 20). The assessment required for participating in the Pathways to Work programme, aimed at bringing handicapped workers into the labour market, would also be applied to new benefit recipients starting in 2010. Ministers' salaries would be cut by 5%, the generous pension system for them would be remodelled, and the system would be closed to newly elected officials. Lastly, tax deductions on ministers' pensions would be capped, as is already the case in the private sector (limited to GBP 50,000 annually). As for the private sector pension system, the plan is to raise the minimum retirement age faster than provided for under current law (see above).

Mr Cameron's election campaign is being followed with interest as well as concern in the principal European capitals. His position on the European Union is based on a fierce defence of national sovereignty crossed with pragmatism. He rules out a UK referendum on the Lisbon Treaty. On the other hand, he wants to introduce the possibility of submitting any European treaty that could limit his country's sovereignty to a popular vote. He would also like to extend the British exception to EU legislation, which already applies to the labour market, the EU's social laws and domestic affairs.



The British economy is painfully emerging from its deepest economic and financial crisis of the post-war period. The set of fiscal measures taken by the Labour government has sent the country's public finances into an uncontrolled tailspin. A return to orthodoxy on the budget is the political and economic issue of the forthcoming election. And yet, if the next government wishes to keep Britain in the top rank of international competitors, there are certain expenditures for the future, such as education and communication infrastructure, that it must nevertheless find a way to afford.

30 November 2009

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NOTES

¹ *Within the services sector, financial services and services to business had in the past decade gradually expanded to represent the lion's share of the sector: in real terms, their output had been increasing at an average annual rate of 6.4% since 1997 – twice as fast as the UK economy as a whole. In 2006, the services sector accounted for 10% of gross value added in the United Kingdom, compared with 9% in the United States and 7% in the euro zone (source: most recent Blue Book).*

² *The other factors mentioned in the October industry survey were, in descending order of importance (measured by the size of the deviation from the long-term mean): internal finance shortage, uncertainty about demand, labour shortage, inadequate net return.*

³ *The retirement age for women will be raised from 60 to 65 years between 2010 and 2020. For both men and women, it will rise to 66 years between 2024 and 2026.*

⁴ *“Will the UK recovery outpace other major economies?”, Economic Outlook, Oxford Economics, July 2009*

⁵ *Data from the International Labour Organisation*

⁶ *Structural policies to promote sustainable long-term growth, OECD Economic Surveys 2009*

⁷ *There are currently three minimum wage levels in the UK: one for adults, one for persons between 18 and 21 years of age, and one for persons aged 16 or 17. The last two are respectively 80% and 60% of the first. They have also risen on average by more than 5% a year since they were introduced.*

⁸ *Private businesses have been net creditors since 2002*

⁹ *The share of manufactured goods as a proportion of all merchandise exports has been stable since the early 1990s at around 80%.*

¹⁰ *In 2008, according to the Bank of England, 56% of mortgage loans were at variable rates (these are the 'tracker loans' with interest rates indexed to the BoE's Bank rate or in some cases to LIBOR, with maturities of two to five years), and 44% were at fixed rates (87% of them with maturities between one and five years). When these variable-rate or fixed-rate loans reach maturity, the borrowers have the option to take out a new loan. If they elect not to, the loan will roll over to the standard variable rate (SVR). SVR loans account for 10% of UK mortgage loans*

¹¹ *The effective exchange rate of sterling fell by nearly 25% between August 2007, when it stood at a near-twenty-year high, and October 2009*

¹² *The limited increase in the number of business bankruptcies can be attributed in part to the facilities offered by HM Revenue and Customs for delaying payment of corporation tax, as well as to forbearance by some of the banks with regard to businesses that continued to pay interest on their borrowings, even if they were late in doing so.*

¹³ *The spread between Libor and the 3-month swap rate is an indicator of tensions in the interbank markets and one that was particularly widely followed during the 2008-2009 financial crisis.*

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Publisher: Michel Pébereau

Printed in France by: Ateliers J. Hiver SA – Dépôt légal : December 2009

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