UNITED KINGDOM

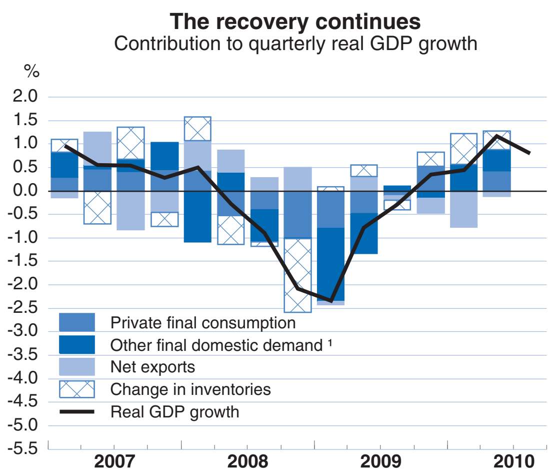
The economy is recovering from the recession, supported by both growing domestic demand and rising exports. The substantial but necessary fiscal tightening and weak real income growth create headwinds and growth is projected to remain subdued in 2011. The recovery will gain a bit more momentum in 2012 when exports are expected to increase further and business investment to grow more robustly. Unemployment is set to fall gradually. Inflation will remain above the 2% target through 2011 due to an initial boost from the rise in VAT, but is projected to fall below the target in 2012 when the effects of the increase in the VAT rate wane. Underlying inflation, excluding effects from changes in VAT, remains low due to significant economic slack.

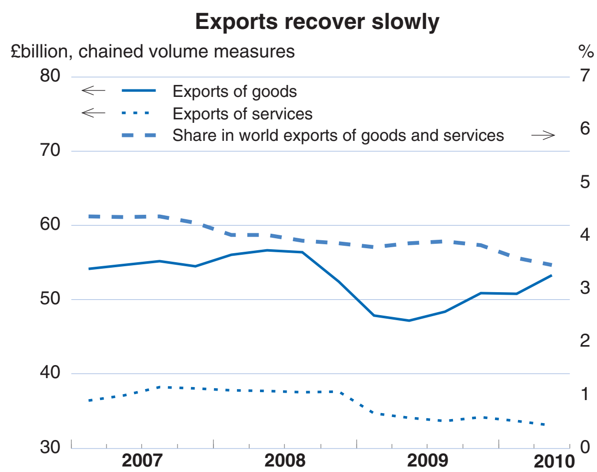
Fiscal consolidation is underway with detailed plans set out in the Spending Review. The government's ambitious medium-term plan has significantly reduced fiscal risks and could, in combination with efficiency improvements in health spending and structural reforms, support growth in the longer term. While monetary policy will need to remain expansionary over the forecast period against the background of a significantly tighter fiscal stance, the process of normalisation of interest rates will have to start in earnest during 2012 as underlying inflation starts to increase.

The pace of growth is robust but is set to slow

The economy is recovering from the deepest recession since the 1930s. GDP growth in the first three quarters of 2010 was robust, reflecting broad-based growth in domestic demand, including from a needed rebuilding of inventories. The pace is set to slow, however, as contributions from stockbuilding fade and fiscal consolidation creates increasing headwinds. Although deleveraging pressures on households have eased as house prices and overall wealth positions have picked up and saving rates risen, the modest rise in real incomes will contain household consumption going forward. Exports have risen significantly but continue to underperform relative to other OECD countries as

United Kingdom





1. Consists of gross fixed capital investment, government consumption and statistical discrepancy.

Source: OECD Economic Outlook 88 database, Office for National Statistics.

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United Kingdom: **Employment, income and inflation**

Percentage changes

	2008	2009	2010	2011	2012
Employment	0.7	-1.6	0.0	0.3	0.5
Unemployment rate[1]	5.7	7.6	7.9	7.8	7.6
Compensation of employees	2.3	0.2	2.8	2.5	3.3
Unit labour cost	2.3	5.5	1.0	0.8	1.4
Household disposable income	5.4	2.6	3.5	3.4	3.8
GDP deflator	3.0	1.4	3.3	2.0	1.3
Harmonised index of consumer prices[2]	3.6	2.2	3.1	2.6	1.6
Core harmonised index of consumer prices[3]	1.6	1.7	2.6	2.6	1.6
Private consumption deflator	3.1	1.3	4.4	3.0	1.8

1. As a percentage of labour force.
2. The HICP is known as the Consumer Price Index in the United Kingdom.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.

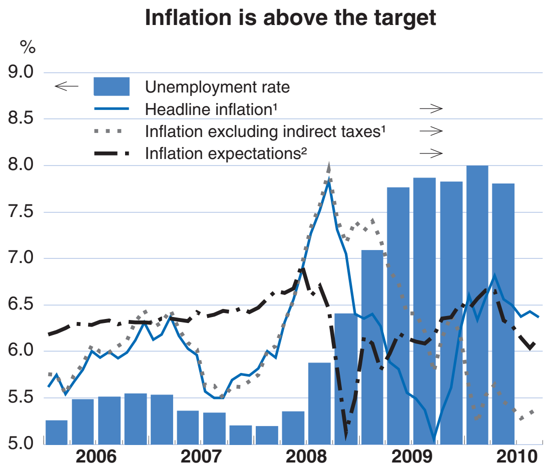
Source: OECD Economic Outlook 88 database.

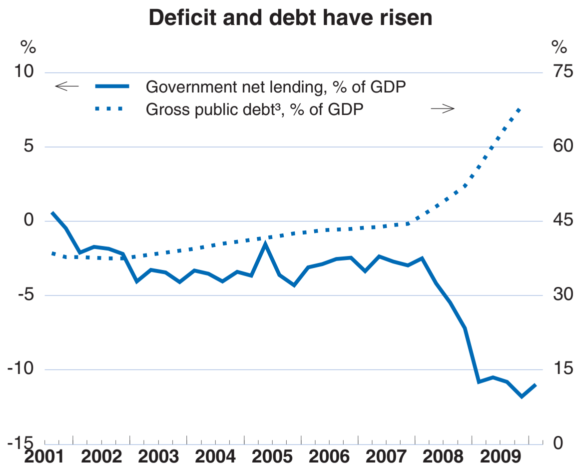
StatLink http://dx.doi.org/10.1787/888932347180

financial service exports have not started to recover from the sharp fall in 2009.

Financial conditions are improving slowly. However, lending is subdued, reflecting both weak demand and continued deleveraging in the banking sector, which constrains credit supply to small firms and households. Large firms are cash rich and able to access sources of non-bank financing. The unemployment rate has remained stable since mid–2009, while employment has started to recover. Wage growth remains subdued. Headline inflation has fallen gradually in 2010 but remains

United Kingdom





1. Year-on-year percentage change.
2. Implied by yield differentials between 10-year government benchmark bonds and inflation-indexed bonds.
3. Maastricht definition.

Source: OECD Economic Outlook 88 database, Bank of England and Office for National Statistics.

StatLink http://dx.doi.org/10.1787/888932345565

United Kingdom: **Financial indicators**

	2008	2009	2010	2011	2012
Household saving ratio[1]	2.0	6.3	4.4	3.5	3.4
General government financial balance[2]	-4.8	-11.0	-9.6	-8.1	-6.5
Current account balance[2]	-1.6	-1.3	-2.2	-1.6	-1.2
Short-term interest rate[3]	5.5	1.2	0.7	0.9	1.8
Long-term interest rate[4]	4.6	3.6	3.5	3.6	4.5

1. As a percentage of disposable income.
2. As a percentage of GDP.
3. 3-month interbank rate.
4. 10-year government bonds.

Source: OECD Economic Outlook 88 database.

StatLink http://dx.doi.org/10.1787/888932347199

above 3%, largely reflecting the end of the temporary cut in the VAT rate in January. However, stripped of tax adjustments, inflation has remained stable and significantly below the 2% target. Bond yields and inflation expectations have edged down, influenced by falling headline inflation and the improving fiscal outlook.

Fiscal austerity is here to stay

The government has stepped up the pace of consolidation and has set out plans to achieve a cyclically-adjusted current balance by the end of the budget year 2015-16. As a result, fiscal headwinds are set to strengthen, as the projection assumes that the fiscal consolidation

United Kingdom: **Demand and output**

	2009	2010	2011	2012	Fourth quarter 2010	Fourth quarter 2011	Fourth quarter 2012
	Current prices £ billion	Percentage changes from previous year, volume (2006 prices)					
Private consumption	908.5	1.2	1.7	1.8	1.8	1.3	1.9
Government consumption	327.4	1.9	-1.1	-1.7	1.8	-2.1	-1.5
Gross fixed investment	204.3	2.0	2.3	4.3	5.1	2.7	5.1
Public[1]	41.6	-4.9	-17.0	-5.2	-20.2	-11.0	-1.7
Residential	41.3	7.9	8.6	3.3	12.6	3.3	3.4
Non-residential	121.4	2.3	6.1	7.0	12.3	6.4	7.4
Final domestic demand	1 440.2	1.5	1.2	1.4	2.3	0.8	1.7
Stockbuilding[2]	- 14.5	1.2	0.1	0.0			
Total domestic demand	1 425.7	2.7	1.3	1.4	3.4	0.8	1.7
Exports of goods and services	386.2	4.4	5.0	6.4	3.2	5.6	6.6
Imports of goods and services	419.3	7.5	3.1	4.0	5.1	3.5	4.1
Net exports[2]	- 33.1	-1.0	0.4	0.5			
GDP at market prices	1 392.6	1.8	1.7	2.0	2.9	1.3	2.3

Note: Detailed quarterly projections are reported for the major seven countries, the euro area and the total OECD in the Statistical Annex.
1. Including nationalised industries and public corporations.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook 88 database.

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United Kingdom: **External indicators**

	2008	2009	2010	2011	2012
			$ billion		
Goods and services exports	781.8	604.1	649.8	706	761
Goods and services imports	853.2	655.8	721.3	779	827
Foreign balance	- 71.3	- 51.7	- 71.4	- 72	- 66
Invisibles, net	28.3	24.6	22.1	34	35
Current account balance	- 43.1	- 27.1	- 49.4	- 38	- 30
			Percentage changes		
Goods and services export volumes	1.0	- 11.1	4.4	5.0	6.4
Goods and services import volumes	- 1.2	- 12.3	7.5	3.1	4.0
Export performance[1]	- 1.3	0.3	- 5.5	- 2.5	- 0.8
Terms of trade	0.0	- 1.0	0.7	- 1.1	- 0.8

1. Ratio between export volume and export market of total goods and services.
Source: OECD Economic Outlook 88 database.

StatLink http://dx.doi.org/10.1787/888932347237

announced in the June budget and the Spending Review will be fully implemented. The implied fiscal deficit is projected to fall to 6.5% of GDP, and gross public debt to reach almost 95% of GDP, in 2012. Altogether, the fiscal contraction, measured in terms of the cyclically-adjusted primary balance, amounts annually to roughly 1.7% of GDP between 2009 and 2012 and will hamper growth. Tax increases, including higher social security contributions and a hike in the VAT rate in 2011, contribute significantly. However, expenditure cuts and restraints will appropriately account for the major part of consolidation. The Spending Review set out how the expenditure cuts will be delivered, supporting the credibility of the government's fiscal plans. Most spending areas, with exceptions for ring-fenced health spending and overseas aid, will be affected and significant falls in government investment, consumption and transfers are envisaged over the next few years.

Monetary policy needs to remain highly expansionary

With the Bank of England's policy rate close to zero and quantitative easing amounting to £200 billion (14% of GDP), monetary policy remains highly expansionary. This is appropriate as the large output gap and sluggish unit labour costs are expected to reduce inflation to below the 2% target during 2012, once the effect of the VAT increase fades. If the recovery proceeds as projected, first steps towards more normal settings of monetary policy should be taken during the second part of 2011 and withdrawal of stimulus should proceed in 2012 as the recovery gathers pace.

The recovery remains modest and gains strength only in 2012

Growth is projected to remain modest during 2011 as public consumption and public investment are set to fall significantly, while household consumption is expected to remain subdued, reflecting slow real income growth and stagnant asset prices. Further increases in exports, supported by rising global demand, the weak exchange rate and the fading drag from financial services exports, will eventually underpin a somewhat stronger recovery in 2012. Business investment has fallen to low levels and is also expected to gather pace in 2012 in response to rising exports. With weak domestic demand, imports will grow slowly and the current account position is expected to improve slightly, though remaining negative through 2012.

The labour market is slowly recovering

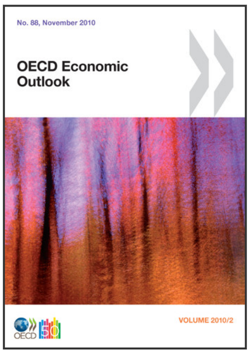
Employment has started to pick up, but will be sluggish as public employment is set to fall and firms can initially meet rising demand through productivity gains and increases in average working hours. As activity picks up during 2012, more substantial improvements in the labour market are expected and unemployment should start to fall gradually. Wage increases will remain subdued, reflecting significant economic slack.

Risks are tilted towards the downside

Substantial risks surround these projections and are more to the downside. The squeeze on households' disposable incomes from fiscal consolidation may bear down more than projected on household consumption, especially if access to credit remains constrained and the housing market weakens again. Similarly, renewed price falls on commercial property could trigger further losses in the banking sector. On the other hand, diminished uncertainty and improved confidence could encourage companies to deploy their strong cash positions to increase investment more than expected. Risks to the export outlook are significant on both sides. Whilst the weak performance of service exports, especially in financial services, remains a downside risk, a swifter recovery in exports in response to the weak pound cannot be ruled out.

Health sector reforms could lessen the impact of consolidation

By stepping up the speed of consolidation the government has significantly damped fiscal risks, contributing to lower bond yield spreads and diminished uncertainty. While fiscal adjustment will be challenging, such measures are necessary to rein in deficits and slow the build-up of debt. Further enhancing the medium-term fiscal framework would support the consolidation process. The setting up of the Office for Budget Responsibility is an important development and its credibility will depend crucially on its ability to make independent judgements. Given the scale of the fiscal effort, structural reforms to improve the efficiency of public service provision and overall productivity are more critical than ever. For example, further productivity-enhancing reforms in the health sector would leave room for significant spending cuts in this area while maintaining service delivery, thus allowing greater protection of infrastructure spending which is under pressure. Moving swiftly on financial sector reforms, by setting up a functional macroprudential framework and dealing with issues related to "too big to fail" banks, would improve financial stability.



From:
OECD Economic Outlook, Volume 2010 Issue 2

Access the complete publication at:
https://doi.org/10.1787/eco_outlook-v2010-2-en

Please cite this chapter as:

OECD (2010), “United Kingdom”, in *OECD Economic Outlook, Volume 2010 Issue 2*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_outlook-v2010-2-10-en