

The State of the UK Economy as it enters its Third Slump

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The UK is in the midst of what even the most mainstream economists are now calling its most severe recession since the 1930s. Bank of England Deputy Governor John Gieve said during a speech to London School of Economics on 19 February 2009 that policy makers are fighting to protect Britain from the threat of a decade long depression similar to that suffered by Japan in the 1990s. This reflects a general crisis of the capitalist economic and financial system rather than just a “credit crunch” as has been popularised by the media as the reason for all our woes.

In the article we will examine, with the aid of statistics, the current state of the UK economy which has technically entered a recession – two successive quarters of negative gross domestic product (GDP) growth. We will use classical economic measures such as GDP, rate of profit, inflation, unemployment, manufacturing production and utilisation of manufacturing capacity to determine what lies behind this recession. In addition we will take a look at the levels of personal debt and the state of the housing market and relate them to the economic cycle which is depicted by the classical measures. Finally, we will assemble a picture of the structure of the UK economy and see how this structure will determine the likely future performance of the UK economy to the global recession.

UK Enters Recession

The UK “officially” entered a recession at the end of 2008. We had predicted this in January of that year¹. But on closer examination of the data the date of entry was only down to a rounding error. Using the revised seasonally adjusted data from the office of national statistics, GDP shrank from quarter one to quarter two in 2008 as chart one below shows. So technically the UK actually entered recession at the end of third quarter of 2008. Despite claims of a strong UK economy prior to the “credit crunch” by Gordon Brown, average quarterly growth was 0.6% for the new millennium compared to nearly 1% for the last fifty years of the last century.

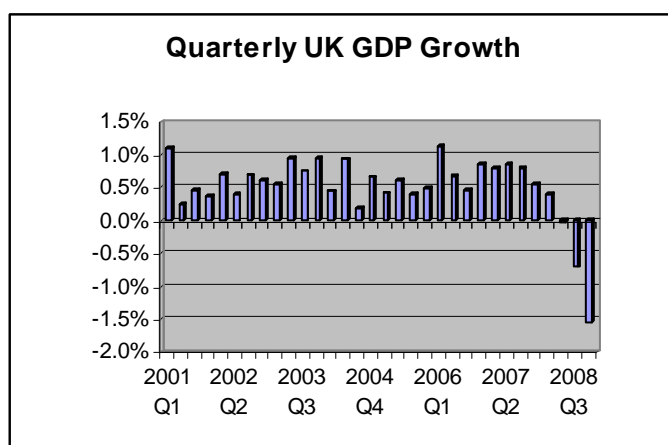


Chart 1: Office of National Statistics

One can see from the chart that GDP growth started to slow dramatically from the third quarter of 2007. This ties in with the “credit crunch” breaking in August of 2007. That is the start of the tightening of credit to consumers. Table two below shows for 2007 and 2008 monthly new consumer credit secured on property and other forms of credit mainly credit cards.

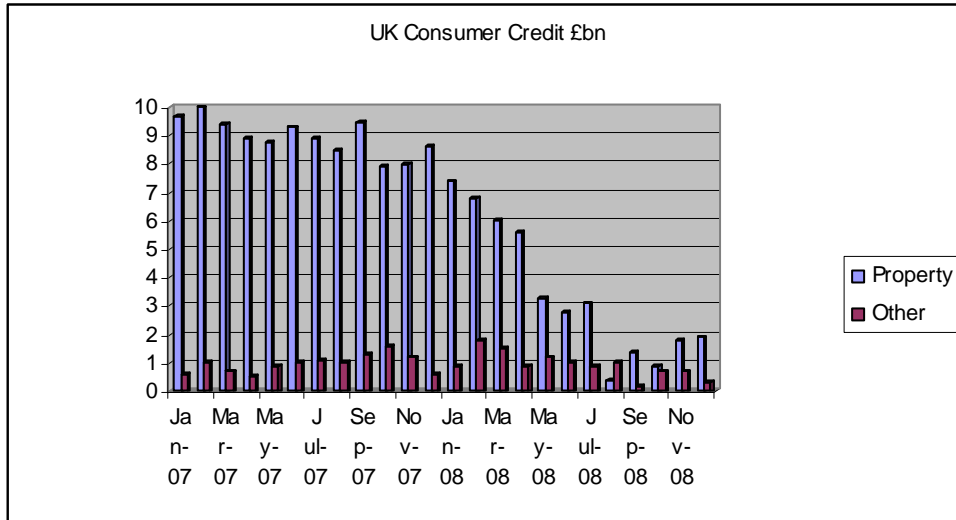
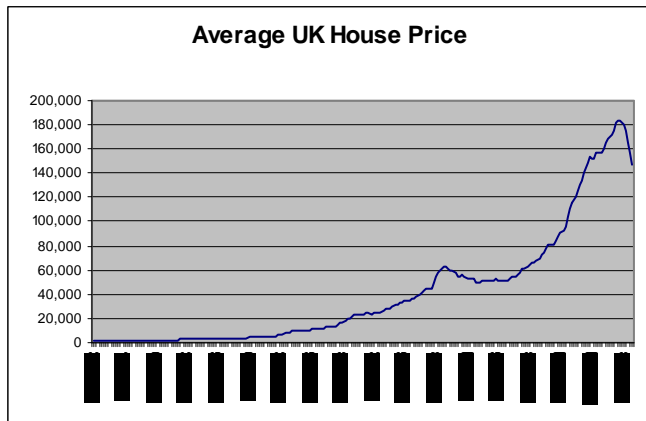


Chart 2: Source Bank of England

One can see from the chart that the bulk of new consumer credit comes from the re-mortgaging of property and this has been dropping off sharply along with other forms of credit since the start of the “credit crunch” in August 2007 with an acceleration in this decline in May 2008. This decline in credit is tied to the housing market which itself linked to the tightening of credit. The UK average house price is displayed in chart 3 below and it shows that a large bubble in housing prices has burst reaching a peak in October 2007 and falling 20.6% from this peak by the end of February 2009. We have written about this bubble previously² in April 2008. We predicted then that house prices in the UK, if growth was to return to pre-bubble levels of the last millennium, would need to fall by 40% from their peak so there is still some way to go for house price declines.



It was this credit linked to the housing bubble which was propping up the capitalist economy in the UK. The tightening of the credit markets and the corresponding fall in the housing market and reduction of property linked consumer credit has led to a big reduction in demand for goods and services, a decline in GDP and the recession we are now in. As Marx said many times in Capital ‘the ultimate reason for all real crises always remain the poverty and restricted consumption of the masses, as opposed to the drive of capitalist production to develop the productive forces as though the absolute consuming power of society constituted their limit’.

Profitability of UK Industry

We can take a look at the profitability of UK companies’ rate of profit. Chart four below shows the rate of post tax profits for manufacturing and service companies in the UK for 1989 to 2008.

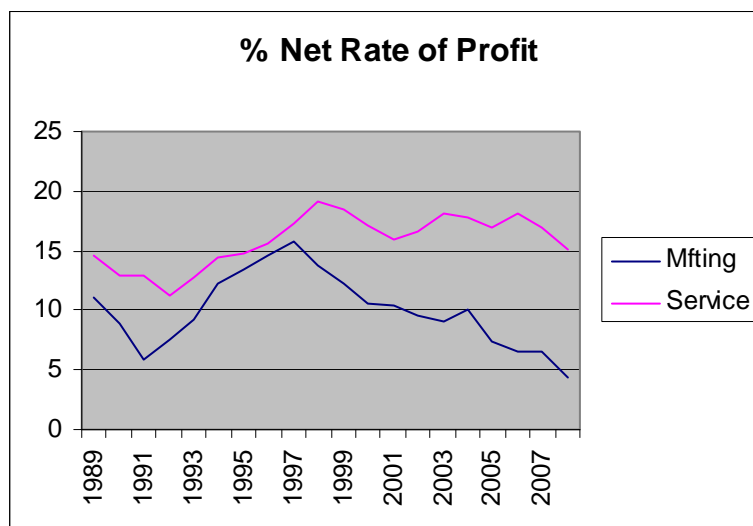


Chart 4: Source Office of National Statistics

The chart shows that for both segments of UK industry the rate of profit has declined from the peaks of the late 1990s. This indicates a build up of automation and consequently machinery including computers and telecommunications. Classically Marxists economists would say living (humans) labour is being replaced by dead (machinery etc) labour to maintain profits and reduce costs. However, this also reduces the rate of profit as the human contribution to the creation of goods or services is where the capitalist makes their profit. This effect is more profound in manufacturing where the process is more mature and more machinery is used. In the service sector there is less automation and it is more human labour intensive. There is also, a much larger reserve army of labour for this sector of unskilled and semi-skilled workers particularly with the free movement of people across the EU states. The difference in the rate of profits between the service sector and the manufacturing sector also partly explains the diminishing size of the manufacturing sector. Capital has flowed to the more profitable sector.

We have no exactly comparable data for UK banks but if we use the net return on equity (ROE) number for banks the average ROE for 2000 to 2005 is 18.4% compared to 9.5% and 17.1% respectively for the manufacturing and service sector for the same time period. Clearly the high returns offered by banks attracted a lot of capital and contributed to their excessive high risk investment practices as they sought to maintain these returns and retain this new capital. But the striking point of note is that the decline in the rate of profit in the manufacturing and service sector pre-dated the “credit crunch” and the recession and led to more flows of hot capital to the banking sector which eventually led to the “credit crunch”.

Unemployment, Manufacturing Production and Capacity Utilisation

Unemployment in the UK had accelerated rapidly as chart 5 below which quarterly unemployment in the UK from Q1 2000 to Q4 2008.

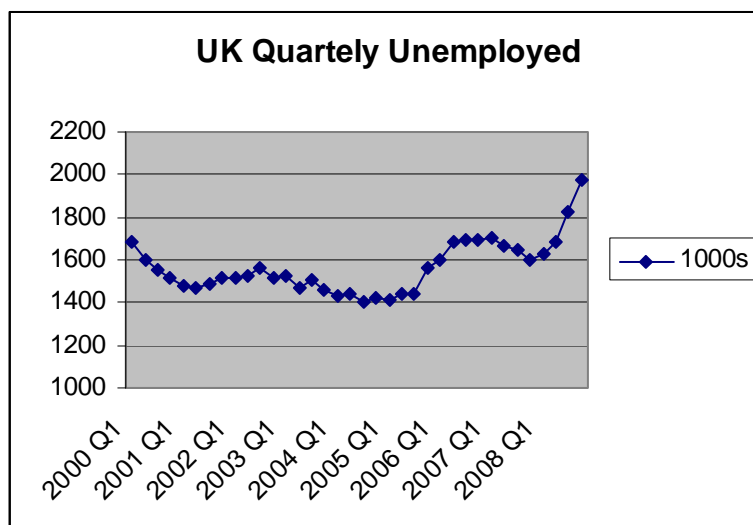


Chart 5: Source Office of National Statistics

There is normally a lag between an economy going into recession and unemployment rising. If this is the case then unemployment is likely to rise to well over three million by the end of the recession. The rise in unemployment is sharp given the drop in industrial production. By the end of last quarter of 2008 industrial production has fallen 9.5% so far from its peak, which was at the end of the second quarter of 2007, in this economic cycle. Given that the peak fall in the 1974/75 recession was 10.1% all the indications are that this recession will be much deeper than that. It also reflects a move of capital from a low returning segment of the UK economy to higher returning parts.

Chart six below shows the quarterly utilisation of industrial capacity from 2000 to the end 2008 – there is a one quarter lag in the numbers. It clearly shows that an excess capacity in industry built up in the UK from the second quarter of 2008. Clearly a crisis of over production of goods had set in as the demand for goods and services fell on the back of the drying up of consumer credit. This excess capacity will increase more in 2009 as the recession deepens.

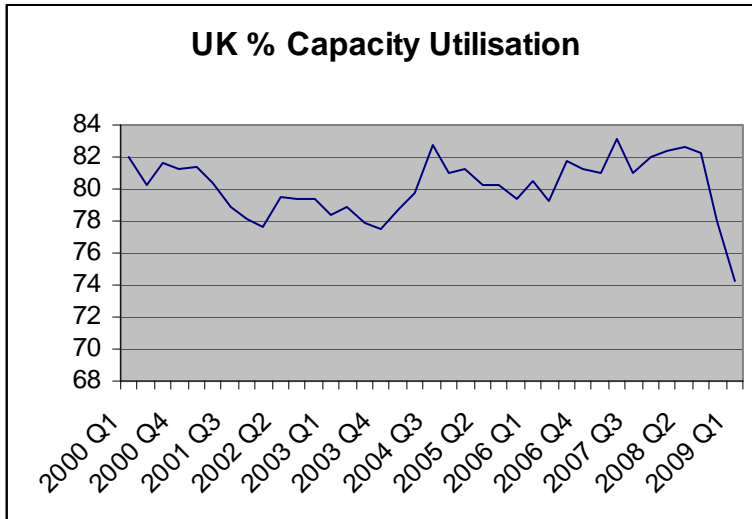


Chart 6: Source European Commission

Inflation

Chart 7 below shows the 12 month annualised rolling percentage rate for the different measures of inflation. The retail price index (RPI) is a broader and more representative measure of inflation and includes housing which the consumer price index (CPI) does not.

It is interesting to note that the massive expansion in consumer credit started to feed through into inflation from the start of 2005 as it began to creep up. This was one of the motives for the Bank of England monetary committee to start to raise interest rates in 2006 and 2007. A larger inflationary upsurge coincided with the out break of the “credit crunch” this time fuelled by increased demand from China and a speculative investment bubble. This meant that at the outbreak of the crisis in the financial system governments and their central banks were hesitant in cutting interest rates particularly outside the US. This undoubtedly hastened the onset of the recession and will mean that it will be much deeper as well.

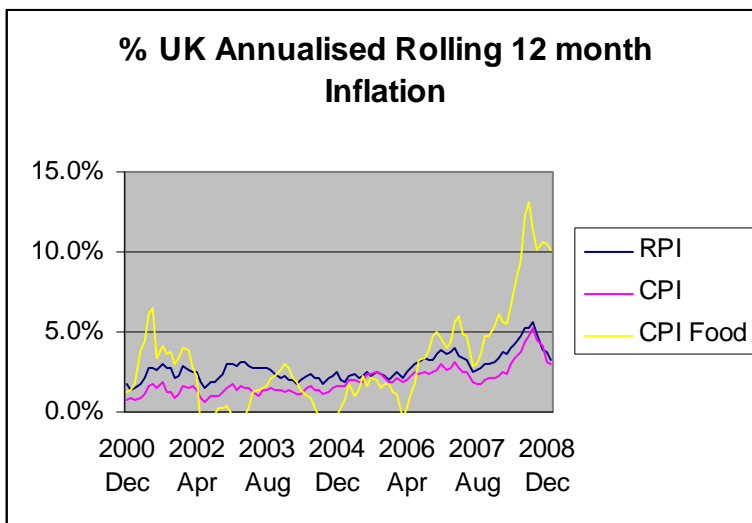


Chart 7: Office of National Statistics

Whether we will have the type of deflation that we had during the 1920/30s remains to be seen. The complete paralysis of the financial system and the banks unwillingness to lend to consumers because of their daily losses and future potential losses and the growing credit risk of consumers and other financial institutions that accompanies an acute recession means that consumer demand will remain weak. However, food inflation, which as we can see from the chart, remains stubbornly strong as climate change and demand from the growing Chinese middle-classes, keeps food products high. We are also big importers of food stuffs and with the weak pound this is helping support food prices.

Trade Deficit

The quarterly trade deficit is shown below in chart 8. It shows that this has been widening since the start of the new millennium. This reflects the UK's diminishing manufacturing base and the demand for consumer goods. The gap has flattened out as the demand for consumer goods decreases on the back of the drying up of consumer credit and rising unemployment. The weakness of the pound is keeping the deficit artificially high as the cost of buying goods from other countries increases.

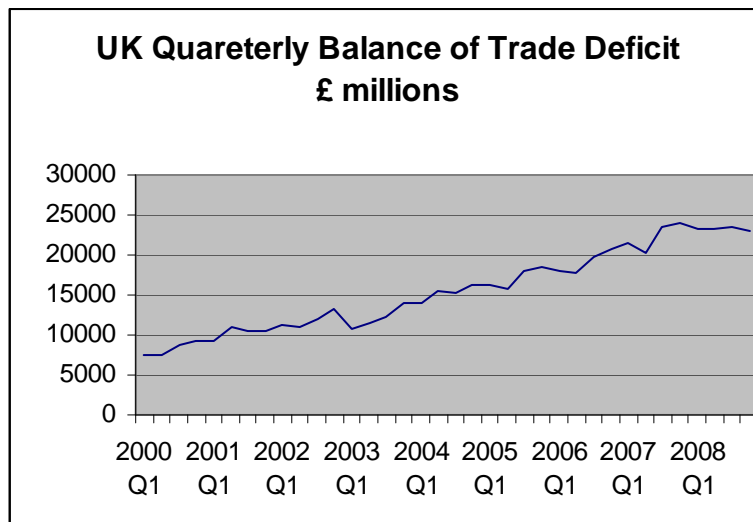


Chart 8: Source Office of National Statistics

Will the weak pound help our exports? Table 1 shows at the end of 2007 our main exporters and importers by country.

Exports	%	Imports	%
United States	14.7	Germany	14.3
Germany	11.1	United States	8.5
France	8.2	China	7.5
Ireland	8	Netherlands	7.3
Netherlands	6.8	France	7.1
Others	51.2	Others	55.3

Table 1: Source the Federation of International Trade Organizations

It shows that our exports are heavily dependent on three countries which have been badly hit by the recession – the United States, Germany and Ireland. This will likely more than offset any gains from our weak currency.

Public Sector Debt

Public sector net debt, expressed as a percentage of Gross Domestic Product (GDP), was 47.8% at the end of January 2009, compared with 42.2% at end of January 2008 and just over 35% before the Northern Rock crisis. Net debt was £703.4 billion at the end of January, compared with £607.8 billion a year earlier. This dramatic increase in public debt is almost solely down to the government's bailout of the banking system since the crisis of credit broke in August 2007. We also, have £1.5 trillion of liabilities on our balance sheet from the UK government's ownership of Northern Rock, RBS and Lloyds TSB/HBOS.

Ultimately this level of debt will become inflationary unless it can be financed by higher taxes or the issuance of more government debt. Higher taxes have to be put off until some sort of recovery begins but may have to be pursued as in Ireland because of the low credit rating given to its government's debt. Issuing more government debt also counters the so called "quantitative easing" solution where governments buy up debt to drive long term interest rates down and pump money into the markets.

What Do the Financial Markets Tells Us about Economy?

The credit default swaps market which is a market which insures country and corporate debt against bankruptcy rates the UK government's five year debt lower than Spain and Portugal's. As the 27 of February 2008 you would have had to pay a 1.52% insurance premium per year to insure five year government bonds against default. This was record high for such insurance and reflects the uncertainty about the liabilities that the UK tax payer is taking on.

Three month Sterling Libor, the rate that banks will lend to each other, remains one full one percent above the Bank of England base rate of 1%. This risk premium reflects the uncertainty that remain within the banking system of further bankruptcies and bailouts.

The pound has fallen 17.5% in value against a basket of major currencies over the last year from the end of February 2009. Sterling is in effect a share on UK plc and its fall reflects the lack of confidence in the UK economy by international investors. Its weakness is also a result of foreign investors selling UK assets and exchanging the money from the sale back into there own currency.

This sale of UK assets is shown in the decline in the stock market. The FTSE 100 closed on 27 February 2009 just over 43% down from its pre crash high in June 2007. If we were to see a depression of 1930s proportions the FTSE 100 would fall to around the 2,000 level.

Conclusion

The UK economy was starting to stall before the “credit crunch” broke. It was also starting to show declining profit rates even in the service sector and a widening trade deficit on a diminishing UK manufacturing sector and excess capacity. Only a huge mountain of consumer debt secured on the back of a housing bubble gave the illusion that all was well with UK plc. This large amount of debt was creating creeping inflation which threatened to turn into a gallop as Chinese demand and speculators pushed the price of resource commodities and foodstuffs up.

The “credit crunch” was in effect the bursting point of a huge wave of speculative investment driven by hot capital seeking higher returns than could be achieved in the manufacturing and service sectors. This led to a complete breakdown of the financial system and a drying up of credit to all. The dynamic of this process is still unfolding and could lead the world into its second great depression. The banking and financial system will continue to hemorrhage money as long as the recession and the decline in property prices continue.

The extent of the UK’s dependence on consumer credit has been starkly revealed as we enter what even most mainstream economists are recognising will be a long, deep recession. This gives socialists the first opportunity for a generation to explain the bankruptcy of the capitalist system and put forward a radical socialist alternative of running the economy; an economy run by the people, for the people and owned by the people.

It is an opportunity we should all go out and seize.

1 Money Market Madness, Scottish Socialist Voice 321.

2 What’s going on with the Housing Market? Scottish Socialist Voice 324.

Rafi de Santos was a former head of equity derivative research at Goldman Sachs International and an advisor to the Bank of England, London Stock Exchange, The London International Futures and Options Market and the Italian Ministry of Finance.