ECONOMIC POLICY VIEWPOINT

NO. 2 - APRIL 2014

The UK's debt-led recovery is unsustainable

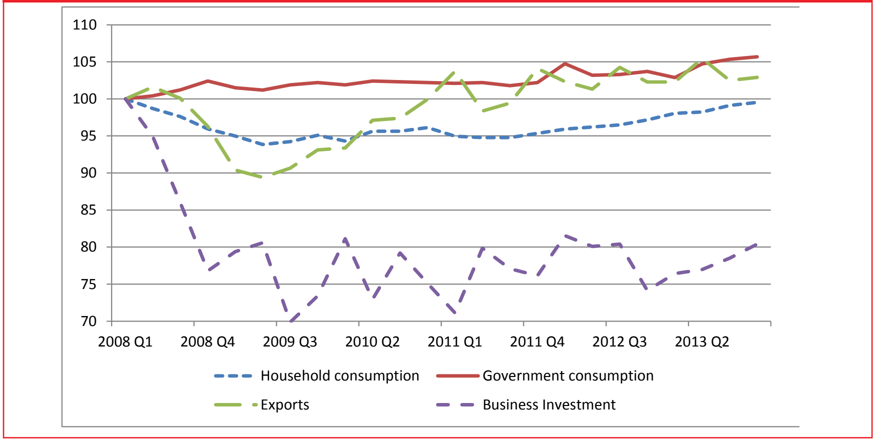
Written by JO MICHELL,
LECTURER IN ECONOMICS, UNIVERSITY OF THE WEST OF ENGLAND

With GDP growth in the UK back above 2.5 per cent, economic recovery is widely regarded as being finally back on course. UK GDP growth is currently higher than that of any other large European nation. Last year, real GDP finally exceeded its pre-crisis peak. Is this not vindication of the government's austerity policies and the superiority of Anglo-Saxon labour market flexibility over the European social model?

This Economic Policy Viewpoint examines the sources of demand underlying this ostensibly robust economic recovery and shows that the recent upturn in GDP is the result of a recovery in consumption demand, underpinned by resurgence in the expansion of credit to households. Using projections generated by the Cambridge Alphametrics macroeconomic policy model (CAM), it is demonstrated that this growth strategy cannot be sustained.

In UK Chancellor George Osborne's 2014 budget speech, he claimed, "We're putting Britain right."[1] It is hard to reconcile this claim with the macroeconomic data. In a more illuminating comment, he noted that the British "still don't invest enough, export enough or save enough." This is confirmed by Figure 1, which shows the main expenditure components of UK GDP (rebased to a common index at the first quarter of 2008). By late 2009, the volume of business investment had fallen by nearly a third and, despite a recovery during 2013, is still twenty per cent below pre-crisis levels. Over the same period, household consumption fell by only around five per cent and has since recovered to almost pre-crisis levels. Exports are slightly up on 2008 levels, but this improvement is much weaker than might have been hoped, given the substantial devaluation of the pound that has taken place. Government current spending continues to rise [figure 1].[2]

FIGURE 1 - COMPONENTS OF UK GDP EXPENDITURE, REBASED



Source: UK Office of National Statistics and author's calculation

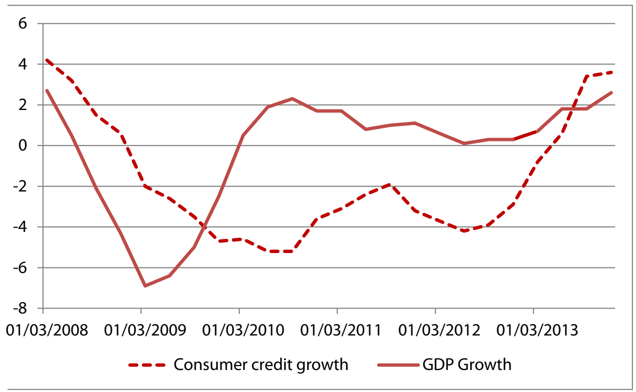
The spectacular collapse in investment since the start of the 2008 crisis is part of a longer-term trend of falling investment in the United Kingdom: private investment peaked at 19 per cent of GDP in 1989 before falling to a low of 12 per cent of GDP in 2011. Under such circumstances, stagnation can only be avoided in one of three ways: by running a significant net export surplus; through government deficit spending; or through the extension of credit to the private sector in order to maintain consumption demand. Over the past decades, the UK chose the final option of reliance private debt-led aggregate demand (despite the current government's highly misleading yet endlessly repeated claims that excessive government spending was at fault).

It is a return to the debt-led and

consumption-driven growth path of the pre-crisis era that explains the recent improvement in UK GDP growth figures. This is illustrated in Figure 2, which shows annualised growth rates of real GDP and consumer credit. Alongside the return to growth that took place during 2013 was a dramatic turnaround in the trend of the deleveraging of the household sector. While in the autumn of 2012, consumer credit was contracting at a rate of around four per cent annually, one year later credit expansion had resumed, with positive credit growth of close to four per cent per annum. The ratio of UK household debt to disposable income peaked at 164 per cent in 2010, and has since declined to just over 140 per cent.[3] This trend will soon go into reverse if the government continues to rely on debt-driven consumer spending in order to maintain growth rates in the run up to the coming election.

The sustainability of the current situation is tested using macroeconomic projections generated by the CAM model. A scenario is examined in which austerity measures are maintained, in a continued attempt to reduce the government deficit. At the same time, it is assumed that sustained growth of around 2 per cent per annum on average over the period 2014 to 2020 is achieved through rising consumption expenditures, while private investment remains at historically low levels of below 14 per cent of GDP. The projected outcomes of such a scenario are shown in Table 1.

FIGURE 2 - GROWTH OF CONSUMER CREDIT (% PER ANNUM)



According to this projection, in order to maintain average growth of around 2 per cent per annum over the next seven years under conditions of government austerity and weak private investment, the share of consumption in GDP would have to rise to a record 69 per cent by 2020. At the same time, the net financial deficit of the private sector would exceed four per cent of GDP and the current account deficit would exceed seven per cent.

To summarise the implications of maintaining such a growth path until 2020, recall the famous warning issued by Wynne Godley in 1999 regarding the debt-led trajectory of the US economy:

> Moreover, if, *per impossibile*, the growth in net lending … were to continue for another eight years, the implied indebtedness of the private sector would then be so extremely large that a sensational day of reckoning could then be at hand.[4]

Godley concluded that "the present stance of policy is fundamentally out of kilter and will eventually have to be changed radically." In the case of the UK it seems this prediction is, so far, mistaken. The government appears determined to press ahead with a policy programme designed to reproduce and reinforce the imbalances which proved so deadly in 2008. But his reliance on the indebtedness of the household sector to maintain GDP growth rates is fundamentally unsustainable. One way or another, the current trajectory will come to an end.

TABLE 1 - CAM PROJECTIONS DEBT-LED GROWTH SCENARIO (% OF GDP PER ANNUM, AVERANGE FOR PERIOD)

	CONSUMPTION	PRIVATE SECTOR NET LENDING	CURRENT ACCOUNT
2001-2004	66	1.2	-0.9
2005-2008	64	1.7	-1.8
2009-2012	64	6.6	-2.7
2013-2016	67	-0.9	-6.3
2017-2020	69	-4.2	-7.5

Notes

1. 19 March 2014, https://www.gov.uk/government/speeches/chancellor-george-osbornes-budget-2014-speech.
2. Despite the UK Government's fanfare about getting the deficit under control, the majority of cuts have been in investment programmes, rather than to current expenditures.
3. UK Office of National Statistics and author's calculation.
4. http://www.levyinstitute.org/pubs/sr/sevenproc.pdf