ECONOMIC OUTLOOK: SHORT-TERM OPTIMISM, MEDIUM-TERM VULNERABILITY, LONG-TERM CHALLENGES

David T Llewellyn

Professor of Money & Banking: Loughborough University
Centre for European Policy Studies, Brussels
ResPublica, London
Kellogg College, Oxford University

Chair, Banking Stakeholder Group, European Banking Authority

CIPFA Treasury Management Forum, Dunblane
27th February, 2014

AGENDA

(1) Short-term UK economic outlook

(2) Medium-term vulnerability:

* hysteresis
* debt-fuelled consumers expenditure
* debt-overhang
* savings ratio
* low investment
* real wages
* house prices: bubble?
* unsustainable external deficit
* housing market bubble
* rise in interest rates

(3) Long-term adjustment:

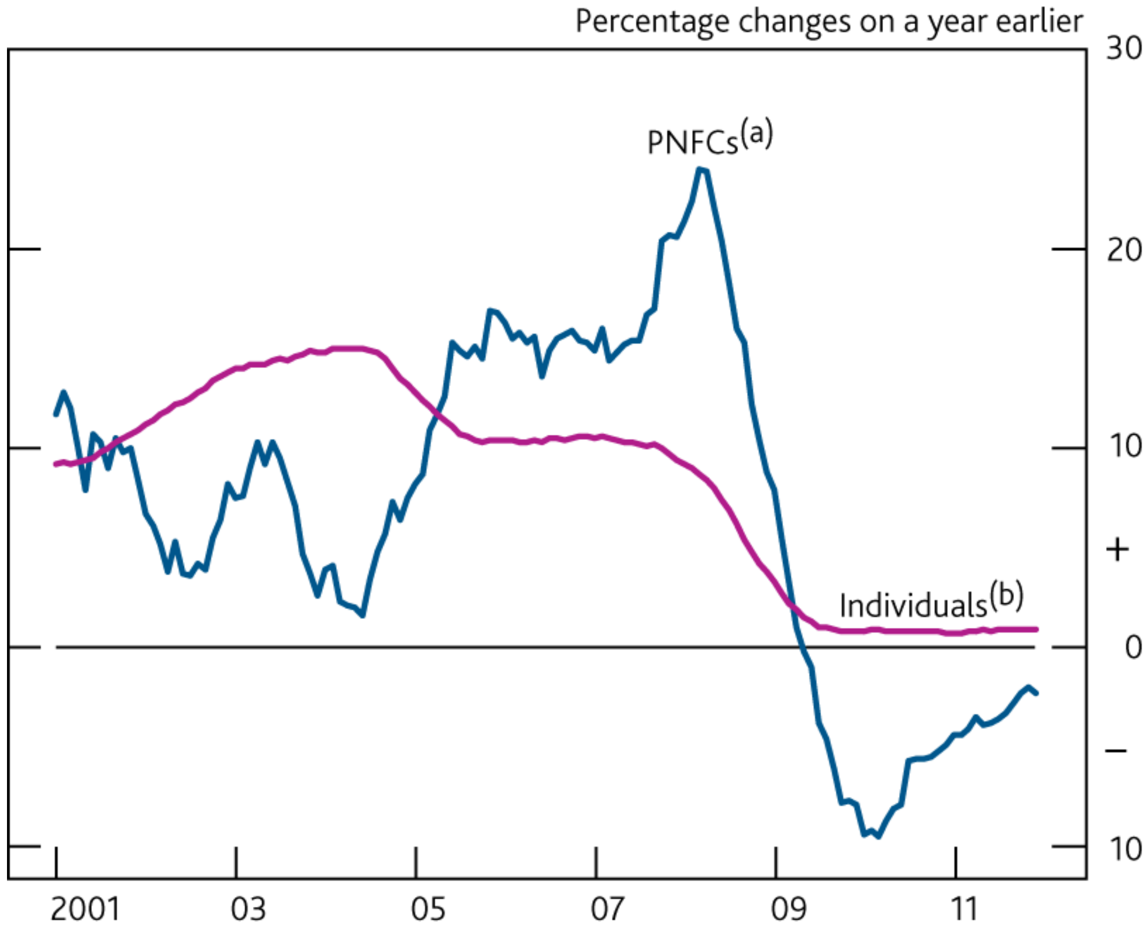
* the Lucky Generation: unsustainable/un-repeatable outcomes
* public finances: fiscal retrenchment
* demographics
* inter-generation transfers
* external deficit
* structure of the world economy
* global shift in real income from labour to capital

(1) THE SHORT TERM: Optimism

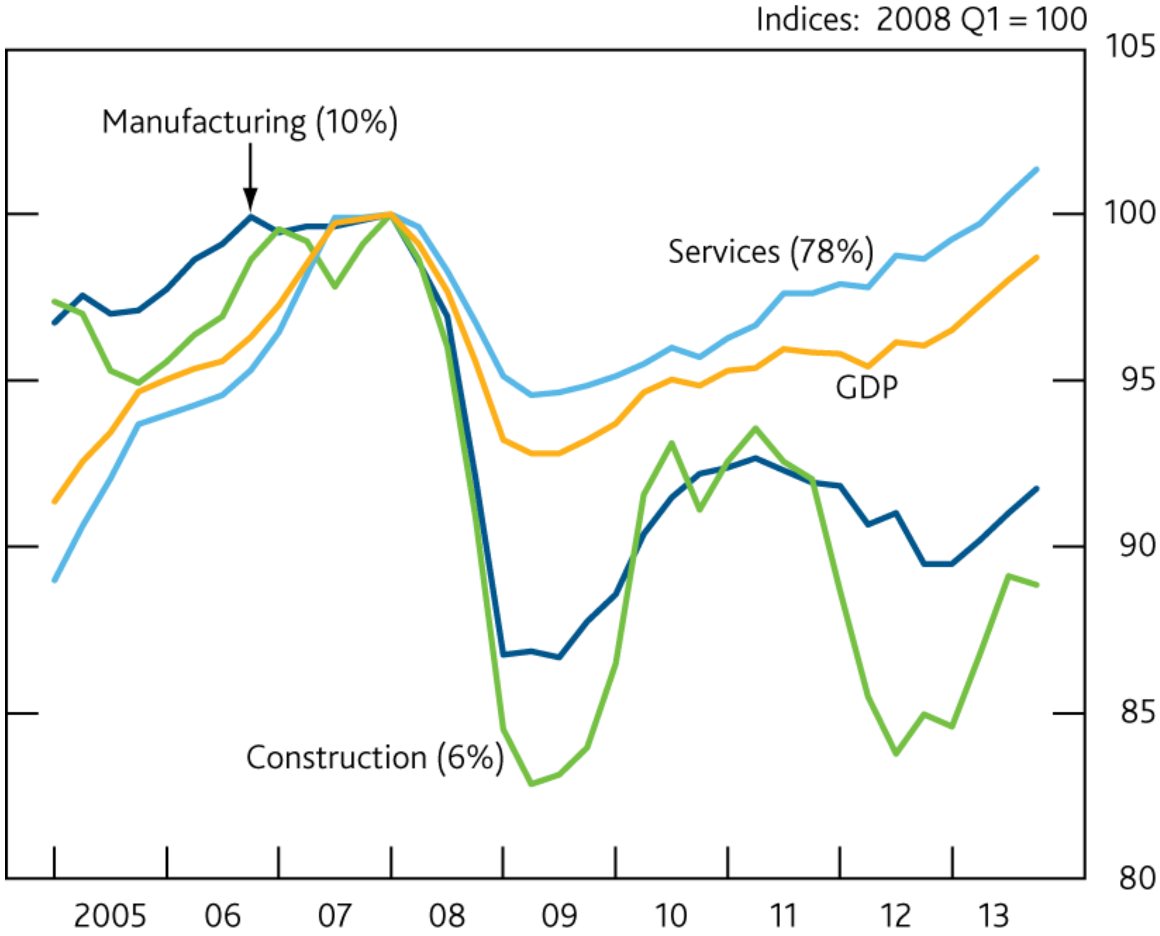
REVIVAL

- Natural cycle
- Confidence and lower uncertainty
- Lower inflation
- Debt overhang moderated
- Lower savings ratio
- Monetary policy
- Credit availability and conditions
- Housing market
- Sterling exchange rate

LOANS TO INDIVIDUALS & PNFCs

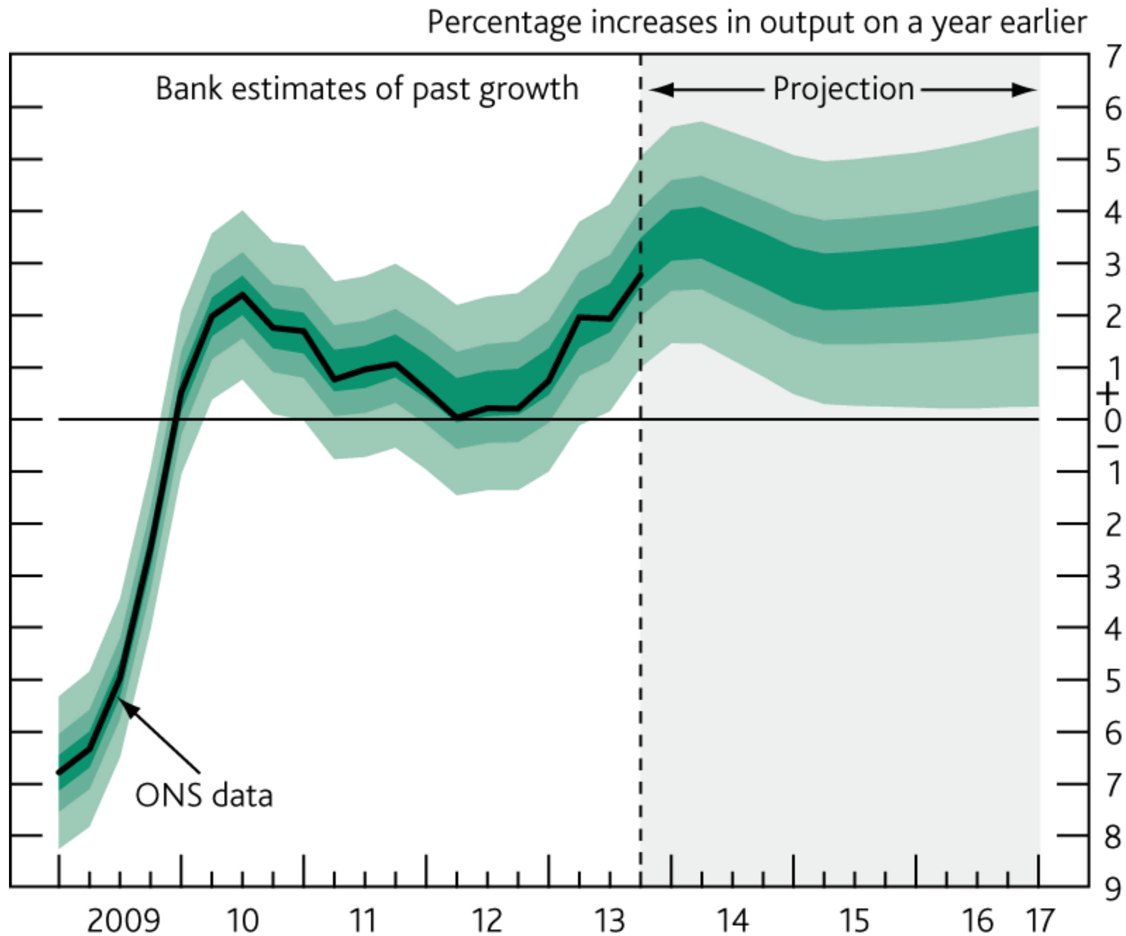


GDP and sectoral output(a)



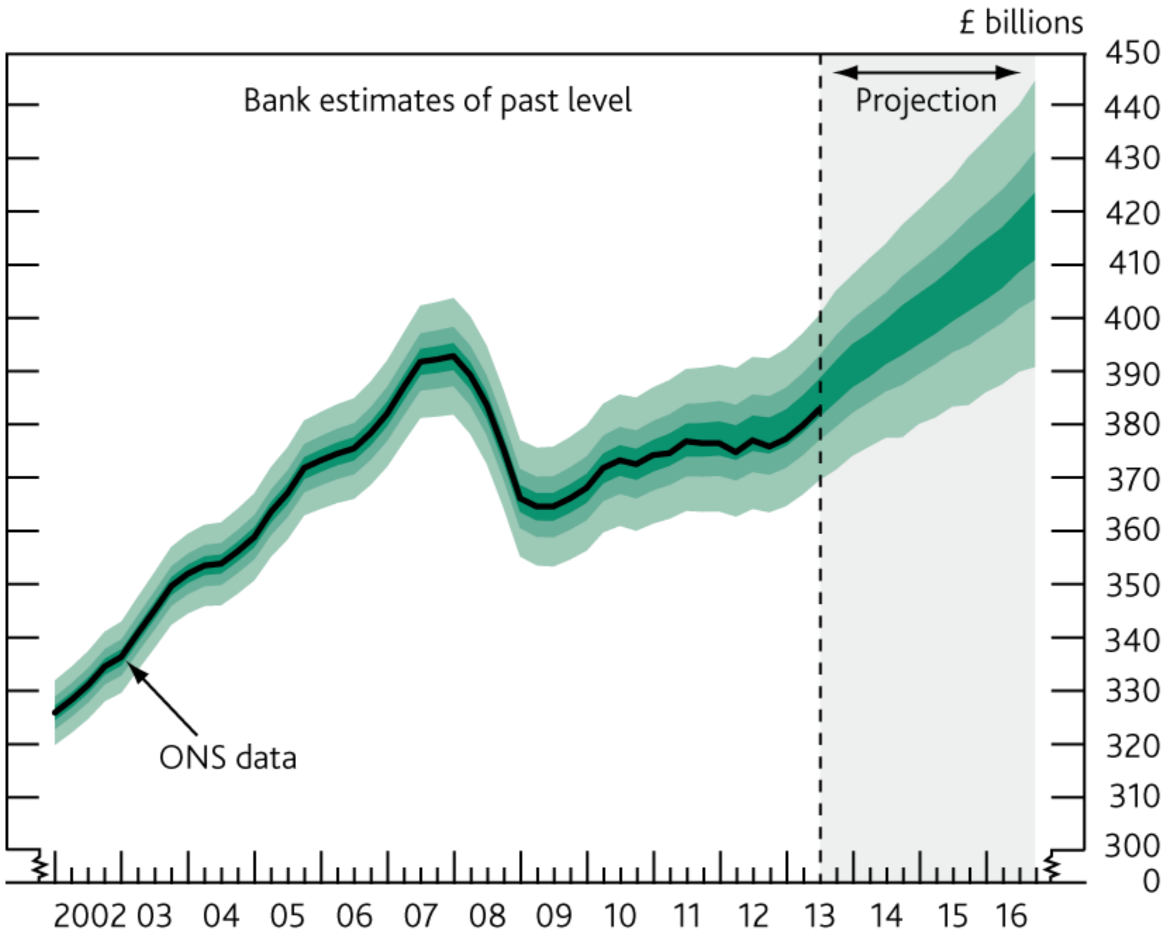
(a) Chained-volume measures. GDP is at market prices. Indices of sectoral output are at basic prices. The figures in parentheses show 2010 weights in gross value added.

GDP projection based on market interest rate expectations and £375 billion purchased assets



The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. To the left of the vertical dashed line, the distribution reflects the likelihood of revisions to the data over the past; to the right, it reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP growth would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter green areas on 30 occasions. In any particular quarter of the forecast period, GDP growth is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP growth can fall anywhere outside the green area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents.

Projection of the level of GDP based on market interest rate expectations and £375 billion asset purchases

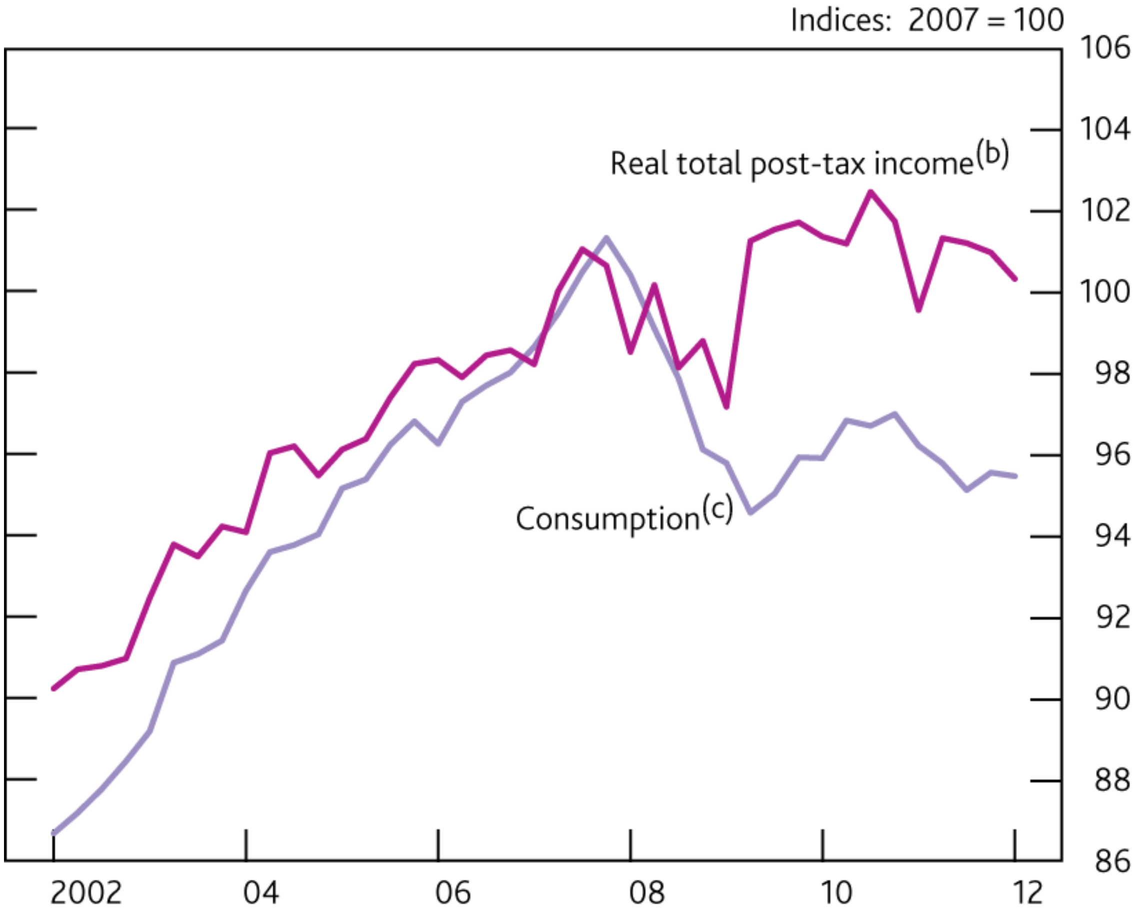


Chained-volume measure (reference year 2010). See the footnote to **Chart 5.1** for details of the assumptions underlying the projection for GDP growth. The width of this fan over the past has been calibrated to be consistent with the four-quarter growth fan chart, under the assumption that revisions to quarterly growth are independent of the revisions to previous quarters. Over the forecast, the mean and modal paths for the level of GDP are consistent with **Chart 5.1**. So the skews for the level fan chart have been constructed from the skews in the four-quarter growth fan chart at the one, two and three-year horizons. This calibration also takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to GDP growth in one quarter will continue to have some effect on GDP growth in successive quarters. This assumption of path dependency serves to widen the fan chart.

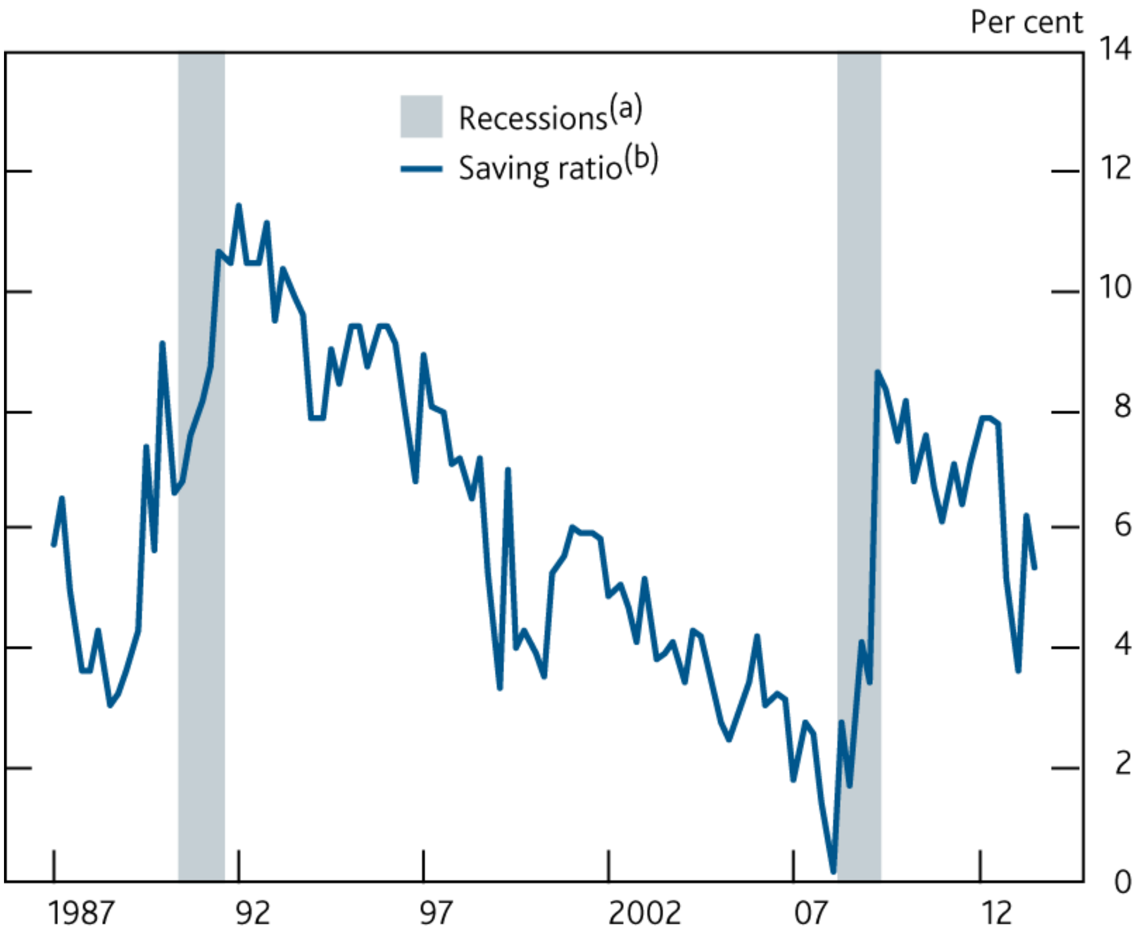
GROWTH FORECASTS
% growth in GDP

	2010	2011	2012	2013	2014	2015
World	5.2	4.0	4.2	2.7	3.4	3.7
United States	2.4	1.8	2.2	1.9	3.0	3.0
Japan	4.7	-0.5	1.9	2.0	1.8	1.5
China	10.4	9.3	7.9	7.7	7.5	8.2
Euro area	1.9	1.5	-0.5	-0.4	1.0	1.5
Germany	4.0	3.1	0.9	0.5	1.5	1.4
UK	1.7	1.1	0.2	1.8	2.1	1.8

HOUSEHOLD REAL INCOME & CONSUMPTION

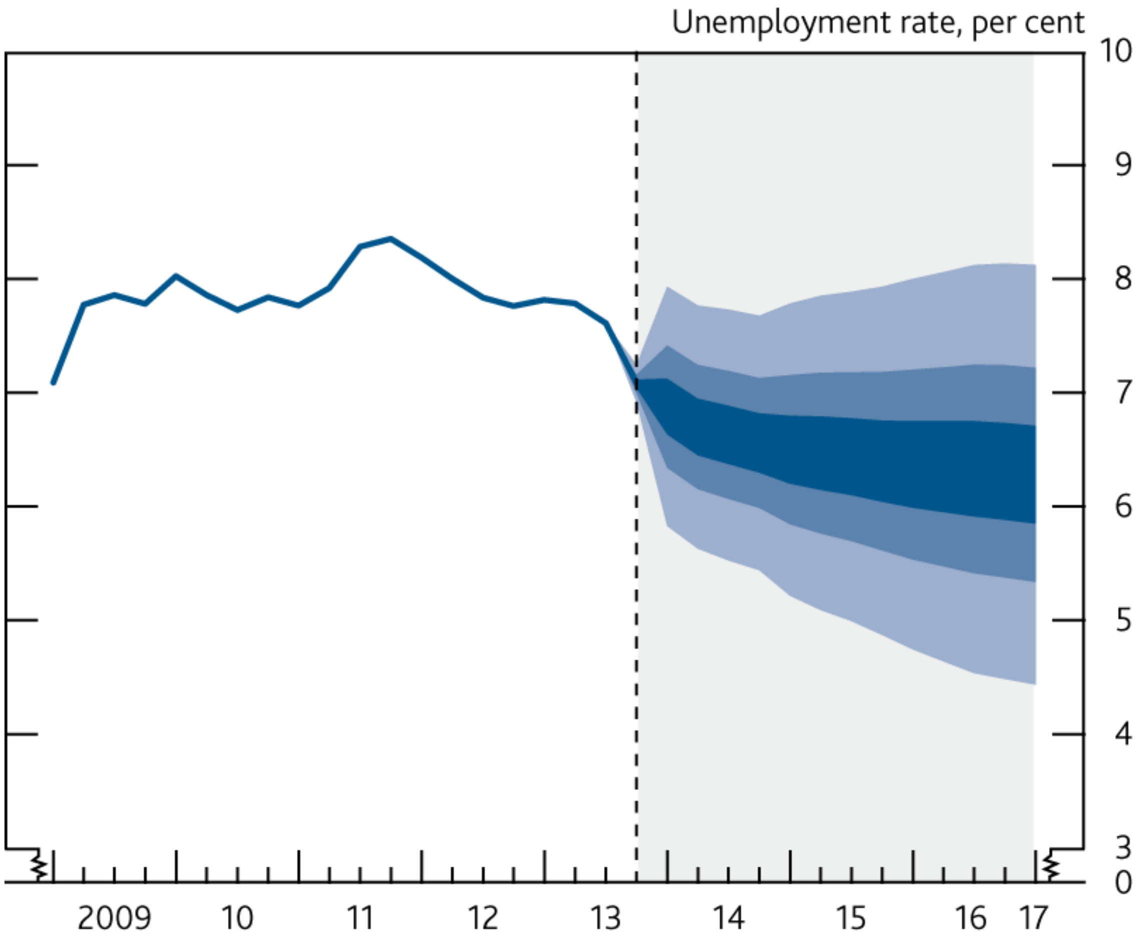


Household saving ratio



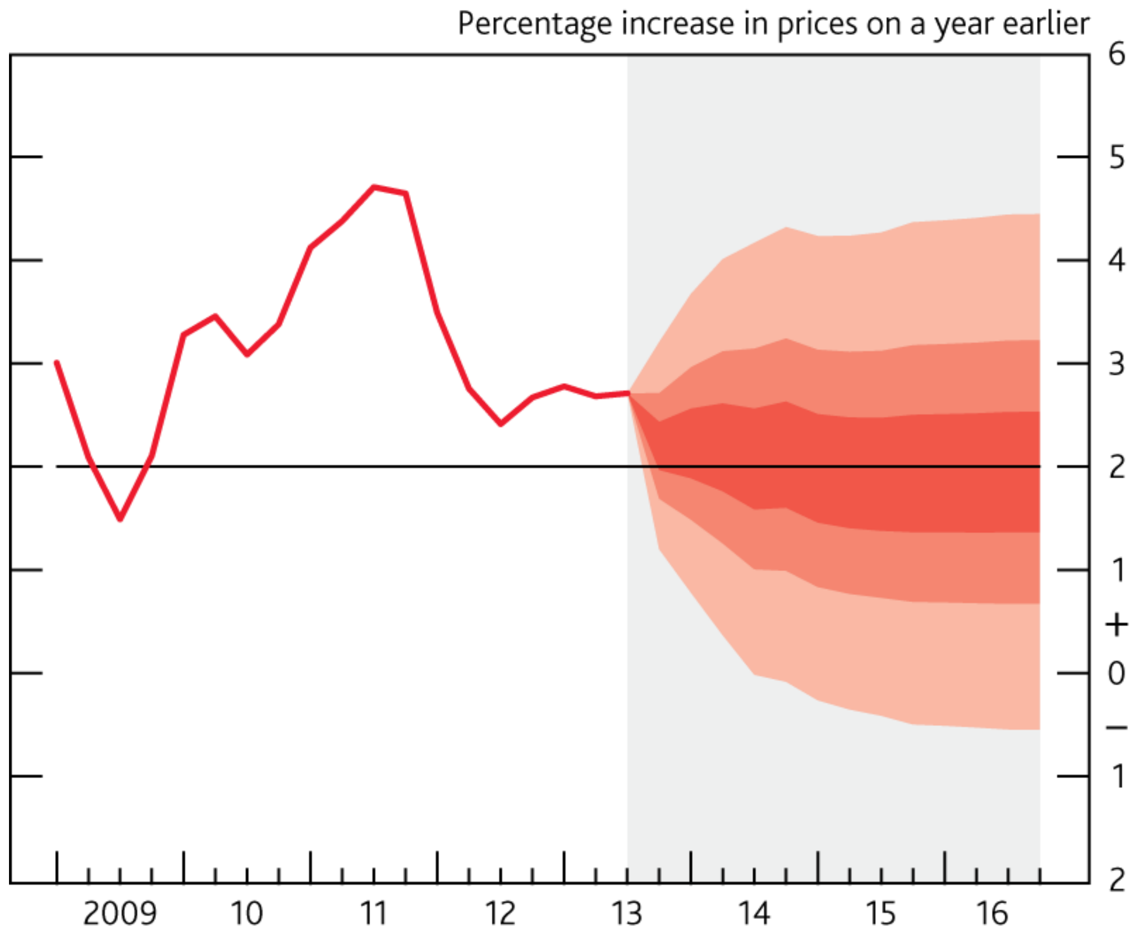
(a) Recessions are defined as at least two consecutive quarters of falling output (at constant market prices) estimated using the latest data. The recessions are assumed to have ended once output began to rise.
(b) Percentage of household post-tax income.

Unemployment projection based on market interest rate expectations and £375 billion purchased assets



The fan chart depicts the probability of various outcomes for LFS unemployment. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of unemployment would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter blue areas on 30 occasions. In any particular quarter of the forecast period, unemployment is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions unemployment can fall anywhere outside the blue area of the fan chart. Over the forecast period, this has been depicted by the light grey background. The calibration of this fan chart takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to unemployment in one quarter will continue to have some effect on unemployment in successive quarters. The fan begins in 2013 Q4, a quarter earlier than the fan for CPI inflation. That is because Q4 is a staff projection for the unemployment rate, based in part on data for October and November. The unemployment rate was 7.1% in the three months to November, and is projected to remain at 7.1% in Q4 as a whole.

CPI inflation projection based on market interest rate expectations and £375 billion asset purchases



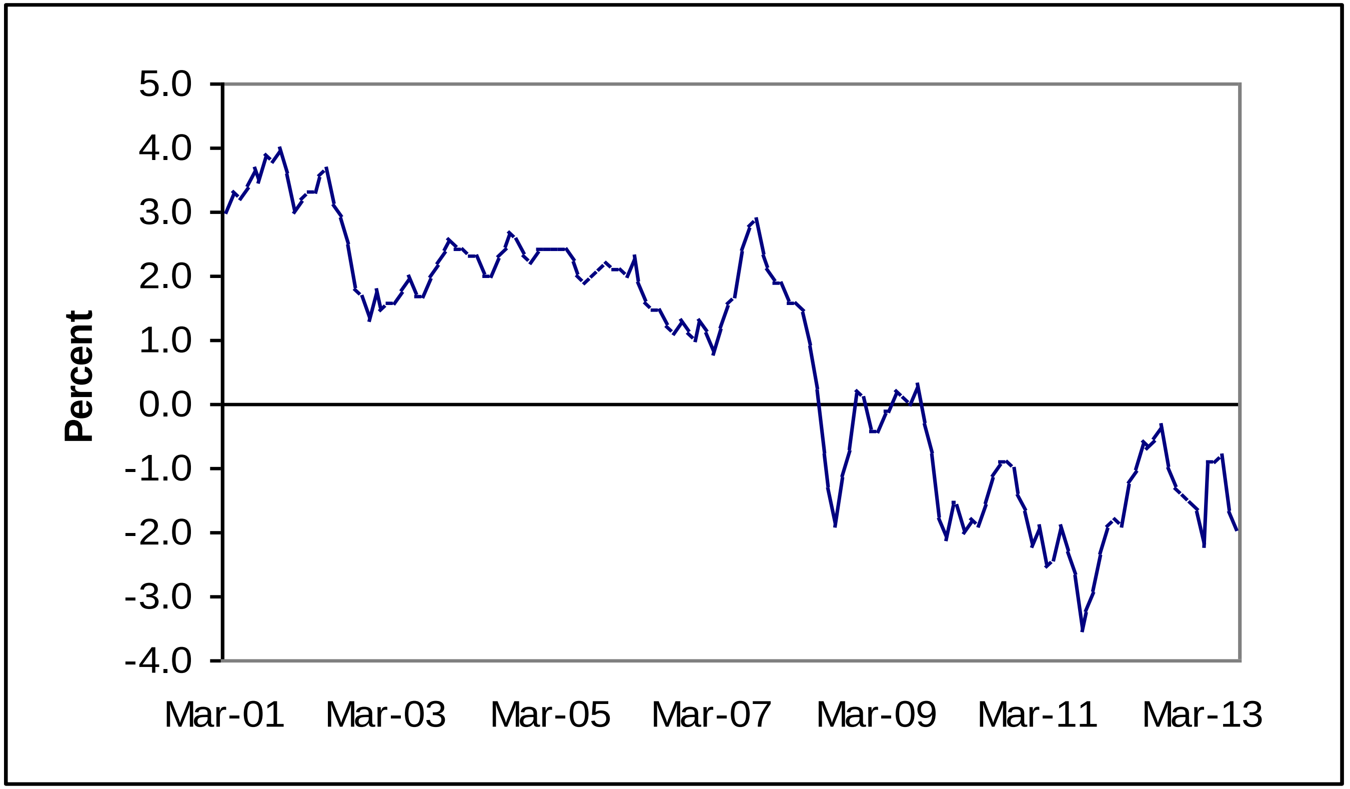
The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

PERSPECTIVE ON THE STANDARD OF LIVING

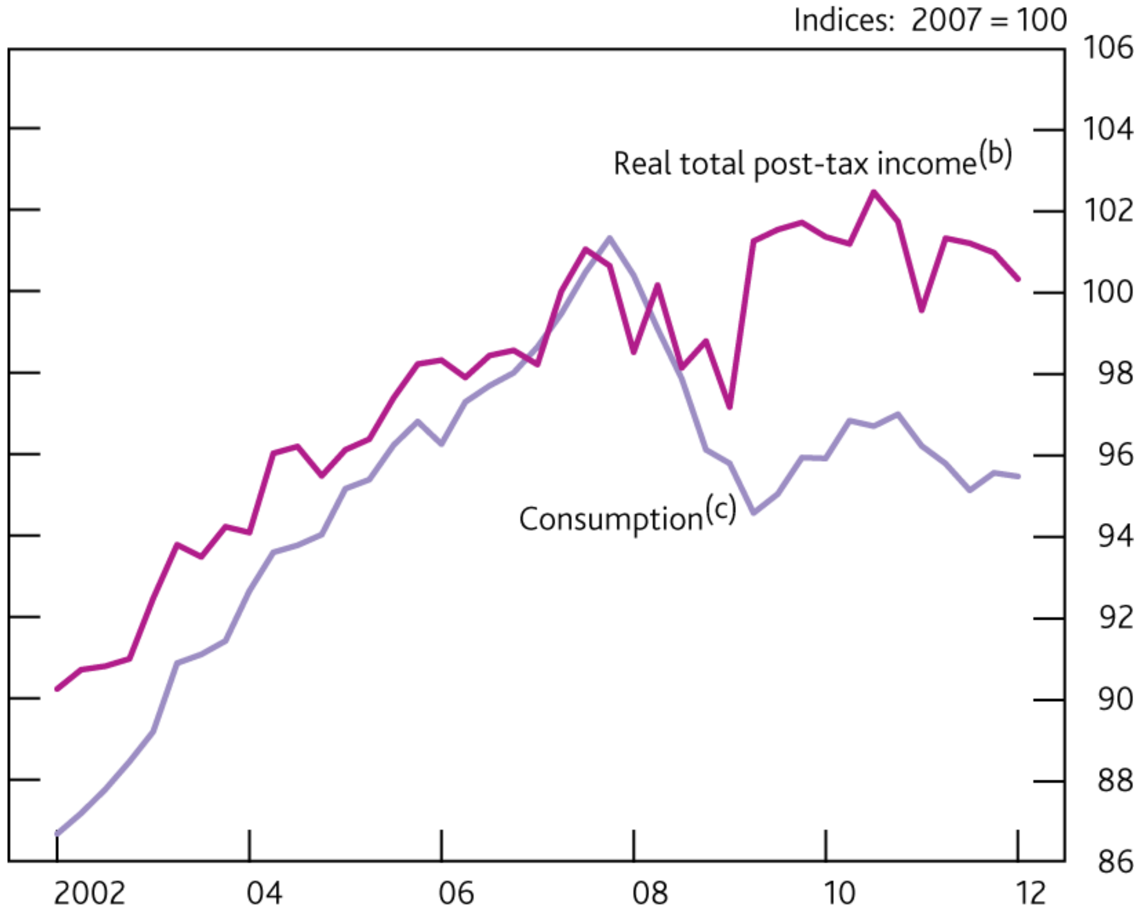
- Fall in standard of living 41/42 last months
- GDP now 6% higher than the trough but real wages (W/P) is 6% lower
- (W/P) 9% lower than in 2007
- Longest sustained fall in (W/P) on record
- Real average earnings £1967 lower than in May 07
- 1997-2007: wages rose by 4% pa and prices by 2%
- Minimum (W/P) now at 2004 level
- Since 2002/3 no year when rise in median real incomes >1% [1.7% average over previous 4 years]
- Therefore: not only due to the recession: partly structural

REAL EARNINGS GROWTH 2001-2013

(% CHANGE PA)



HOUSEHOLD REAL INCOME & CONSUMPTION



WHY (W/P) HAS FALLEN

SHARE OF WAGES IN NATIONAL INCOME HAS DECLINED

- Inflation
- Exchange rate and commodity prices: EGI
- Trade union power has declined
- Input prices to companies: resist wage rises
- Employers contributions to pension funds: reduce deficits
- Labour market flexibility has increased
- Rise in female employment
- Weakness in productivity trends
- Technology and returns to capital
- Immigration
- Trade and Global labour market trends in a globalised world economy

2. THE MEDIUM TERM: vulnerabilities

GOLDILOCKS ECONOMY BUT…..
MEDIUM TERM VULNERABILITY

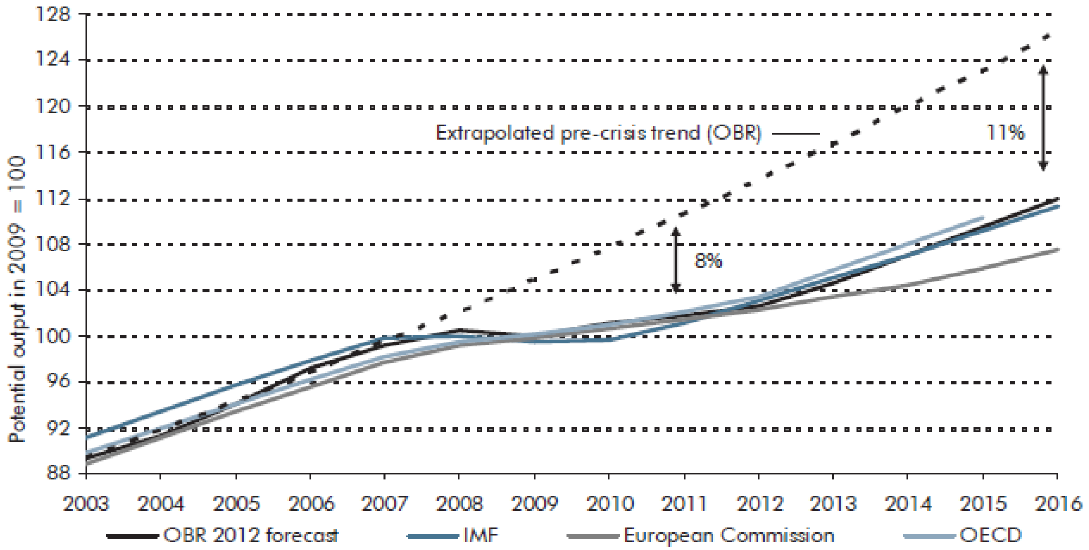
- Hysteresis
- Debt-fuelled consumers expenditure
- Debt overhang
- Savings ratio
- Exports
- Low investment: but cash balances of companies
- Real wages remain low
- Balance of payments deficit: E>Y
- Housing market bubble? [not only in UK]
- Rise in interest rates

HYSTERESIS

Long-term growth trend not independent of cyclical position: recession causes long-term damage that is not reversed in the subsequent recovery

OBR PROJECTIONS OF POTENTIAL OUTPUT

Chart 3.4: Projections of potential output[5,6]

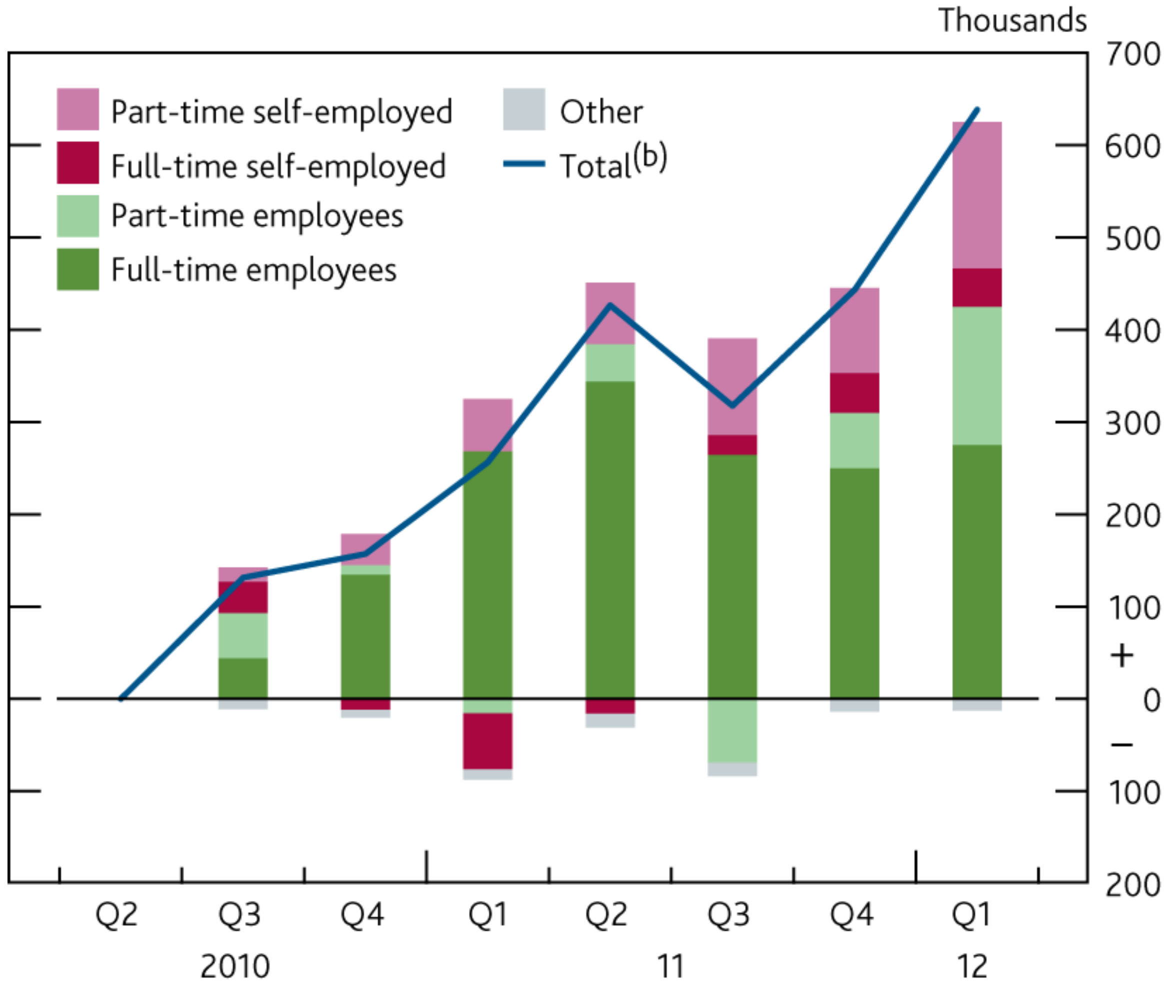


Source: OBR; IMF *World Economic Outlook*, September 2011;European Commission *European Economic Forecast*, Autumn 2011;OECD *Economic Outlook No.90*, November 2011.

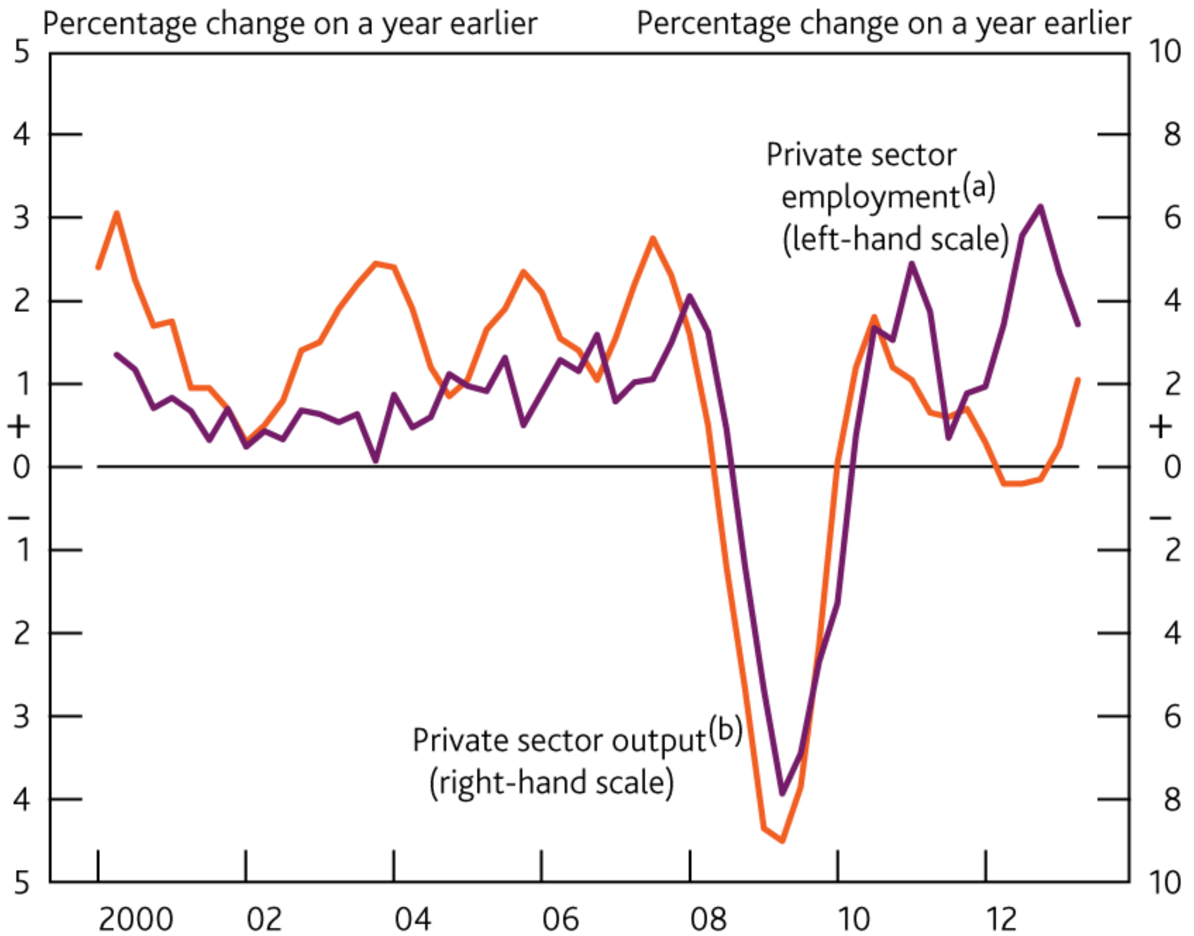
PRODUCTIVITY WILL RISE

- Hoarding of labour declines
- Investment
- Capital and labour shifts to more productive companies and projects
- Adoption of backlog of innovation and technological advances

CUMULATIVE CHANGES IN PRIVATE SECTOR EMPLOYMENT



Private sector output and employment

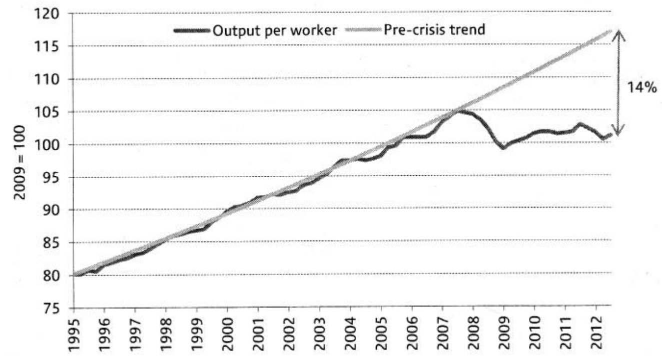


Sources: ONS (including the Labour Force Survey) and Bank calculations.

(a) LFS private sector employment. Calculated as the difference between LFS whole-economy employment and total public sector employment excluding publicly owned English further education corporations and sixth-form college corporations from the ONS's public sector employment release, adjusted to be on a calendar-quarter basis. Data start in 2000 Q2.
(b) Market sector gross value added. Chained-volume measure at market prices.

OUTPUT PER WORKER

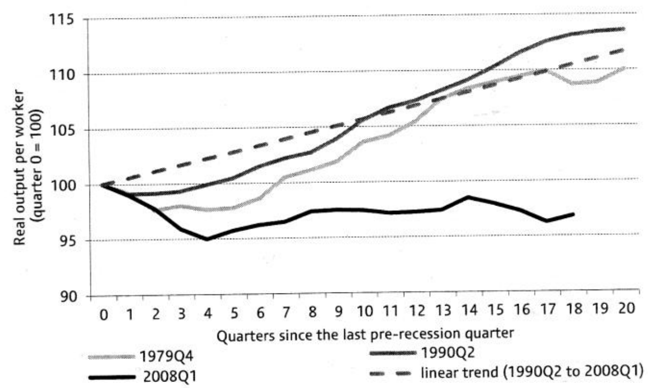
Figure 2.5. Output per worker



Note: The pre-crisis trend was calculated over the period 1995–2007 and was calculated to be 2.2% a year.
Source: Haver Analytics, Oxford Economics.

PRODUCTIVITY AFTER RECESSIONS

Figure 3.3. Real output per worker following recessions



THE CORE CONUNDRUM

1. Hoarding of labour

- Minimum level of employment
- Cost of recruiting when needed
- Retain skills
- Real wages

2. Composition of employment

- part-time
- Self-employed

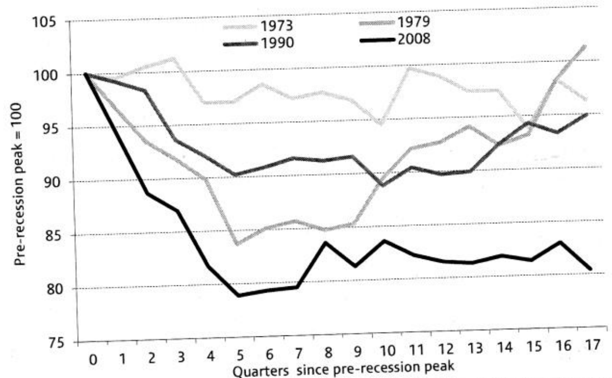
3. Productivity

- Slump in investment: lower capital stock
- Substitution of labour for capital
- Structural change: high to low productivity sectors
- Loss of skills
- less innovation
- Credit constraint:: problem for new companies
- Inefficient allocation of capital: lending to new/dynamic companies
- Forbearance – misallocation of capital

4. Illusion: statistics wrong

GROSS FIXED CAPITAL FORMATION

Figure 3.13. Gross fixed capital formation



Source: ONS National Accounts aggregates, gross fixed capital formation, chained-volume measure. Gross fixed capital formation includes information on investment and dwellings for business and government.

UK PRODUCTIVITY & GROSS FIXED INVESTMENT

(% pa)

	Productivity	Gross Fixed Investment
2008	-1.7	-6.9
2009	-2.4	-16.7
2010	1.6	2.8
2011	0.5	- 2.4
2012	-0.9	0.5
Average 1985-95	2.4	
Average 1996-07	2.2	
Average 2008-12	-0.7	

Self-employment share(a)

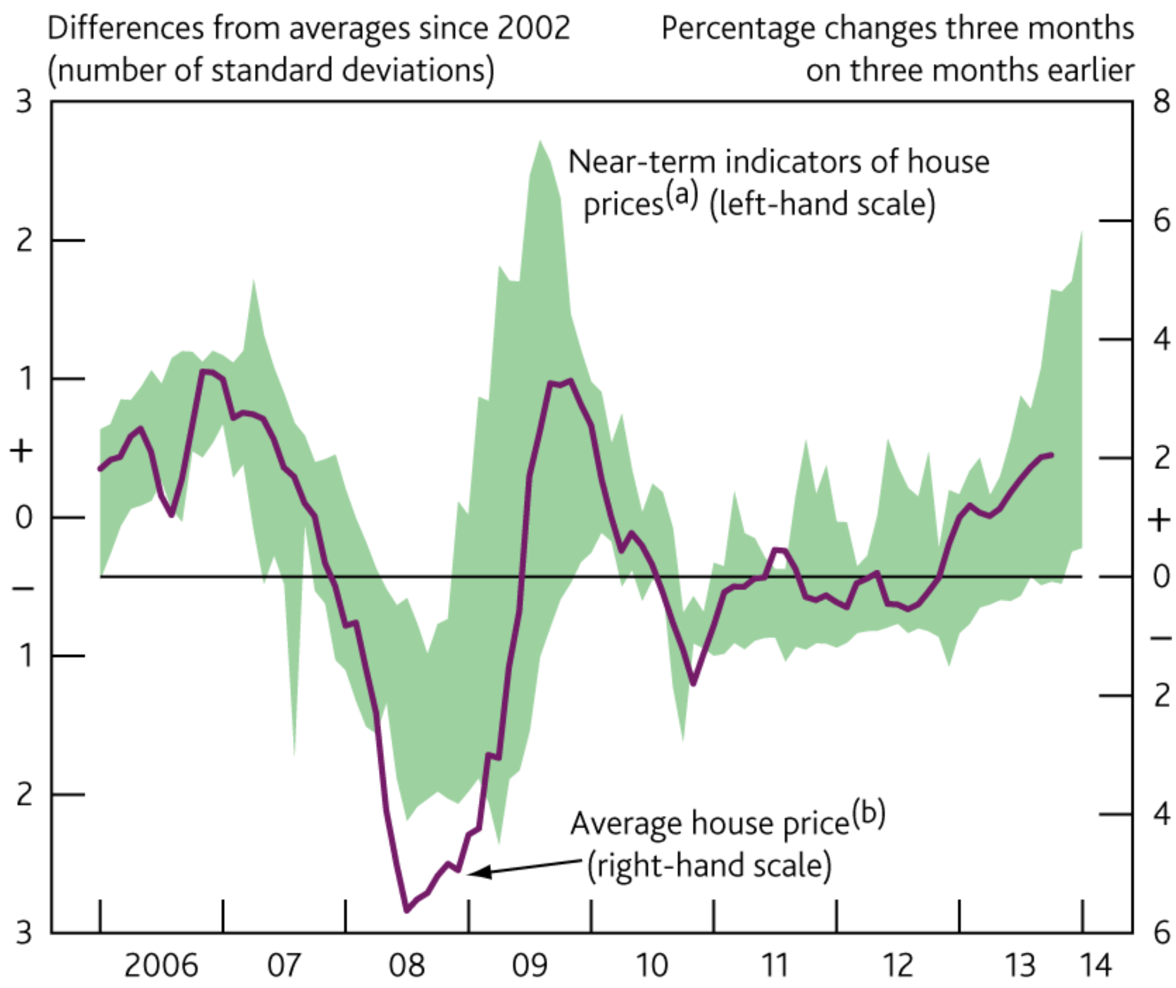
Source: Labour Force Survey.

(a) Percentage of LFS total employment. Rolling three-month measure. First data point is May 1992.

SERIOUS IMPLICATIONS

- Excess capacity will be lower at each level of output than in the past
- Standard of living will be lower and grow at a slower rate than in the past
- *Structural* budget deficit will be higher
- Capacity of economy to support particular levels of public spending is less than we thought
- *Austerity Trap* intensifies
- Austerity will last longer

House prices and near-term indicators of house prices

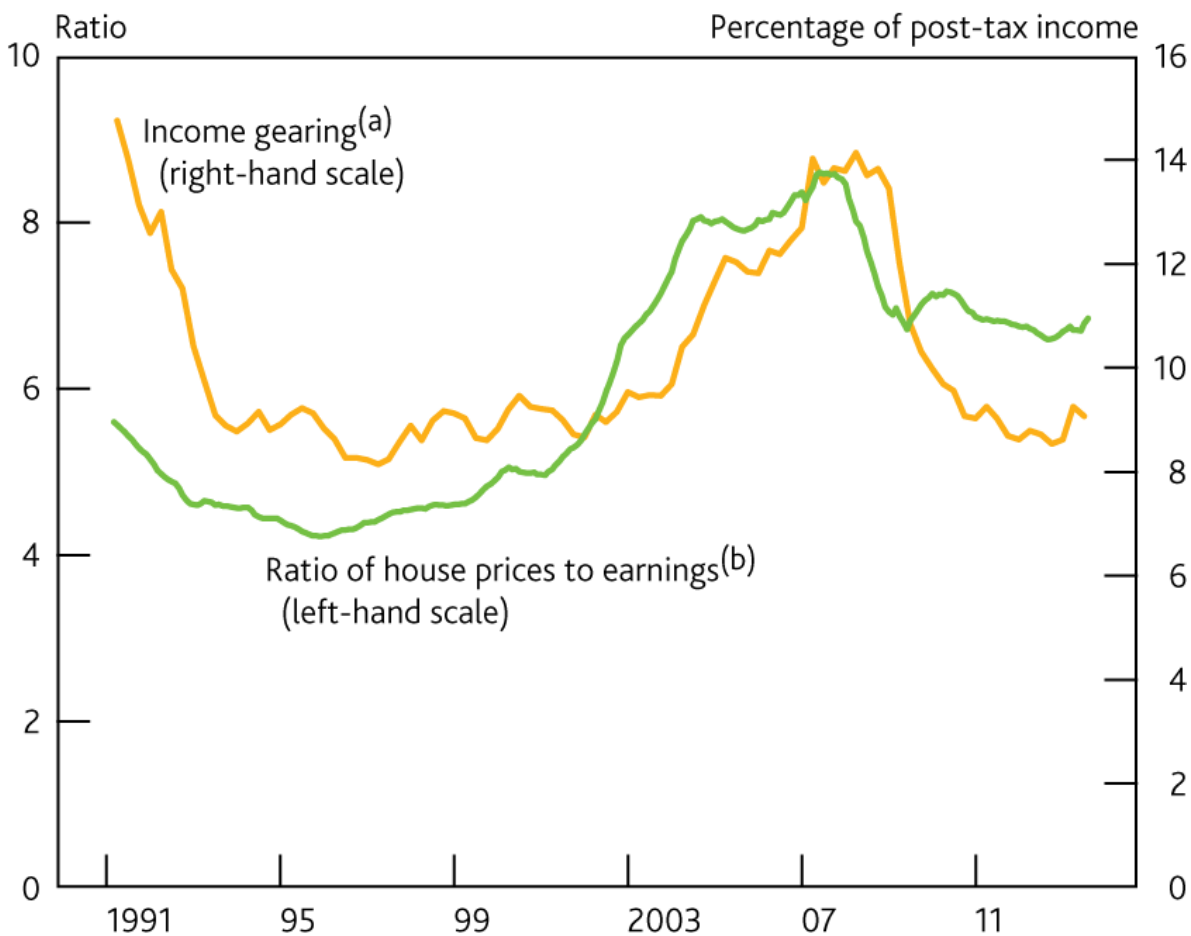


Sources: Halifax, Nationwide, RICS, Rightmove.co.uk and Bank calculations.

(a) Includes the RICS house prices three months ahead net balance, the RICS new buyer enquiries less instructions to sell net balances, the RICS sales to stock ratio and the Rightmove index for asking prices posted on the Rightmove website. All series have been moved forward by three months. The Rightmove index has been seasonally adjusted by Bank staff.

(b) Average of Halifax and Nationwide measures. Latest observation is for October 2013.

Indicators of housing affordability



Sources: Bank of England, Halifax, Nationwide, ONS and Bank calculations.

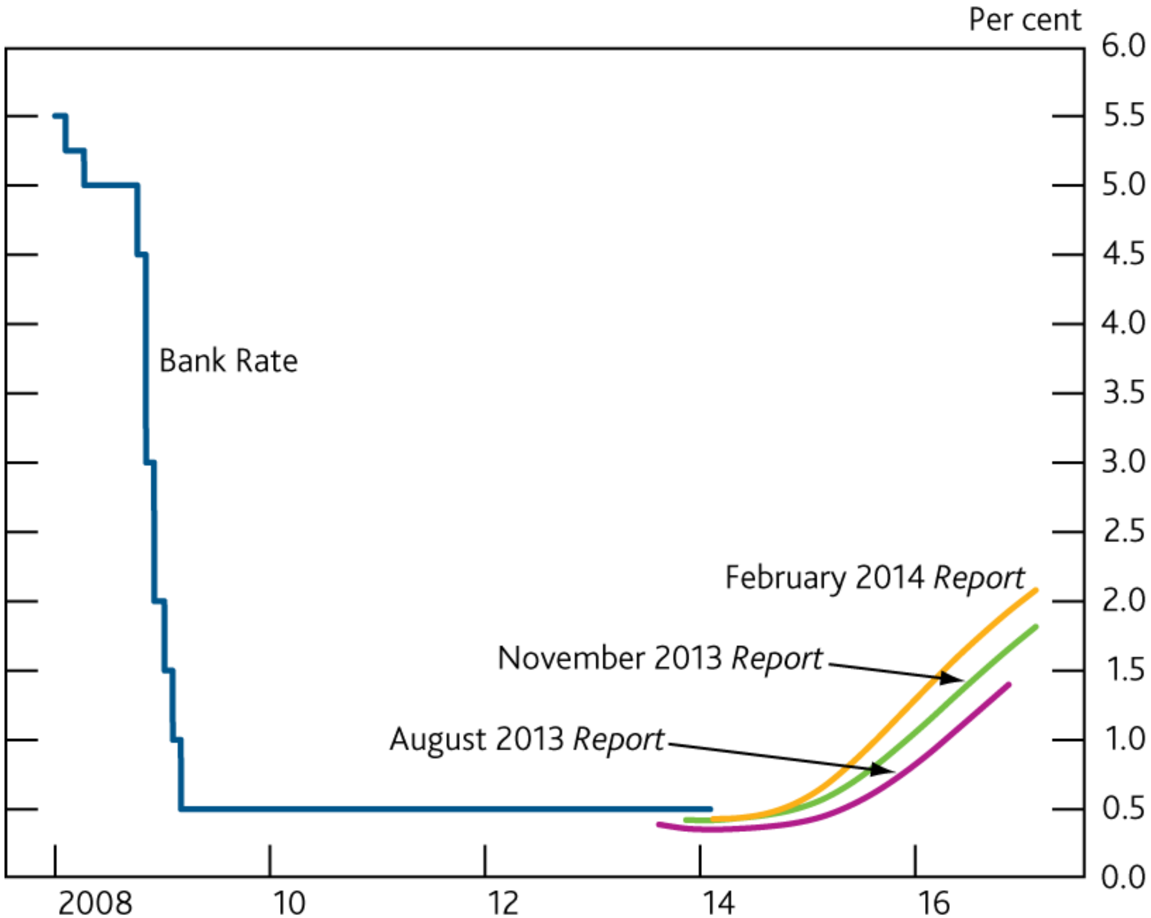
(a) National Accounts measure of household interest payments (which excludes the impact of Mortgage Interest Relief at Source) plus regular repayments of mortgage principal, as a percentage of nominal household post-tax income. Interest payments and income have been adjusted to take into account the effects of financial intermediation services indirectly measured. Repayments data are non seasonally adjusted. Excludes payments associated with endowment policies. Latest observation is 2013 Q2.

(b) Average of the Halifax and Nationwide measures of average house prices divided by average annual earnings, based on average weekly earnings from 2000 onwards and average earnings index prior to that. Data are three-month moving averages. Latest observation is for the three months to August 2013.

DANGER OF GOVERNMENT INTERVENTION

- House price bubble: at time of revival
- Parallel with pre-crisis trends
- Bloated sector of the economy
- Bank lending: too much absorbed by housing: structural weakness of the economy
- Who does it help?
- Increase debt overhang

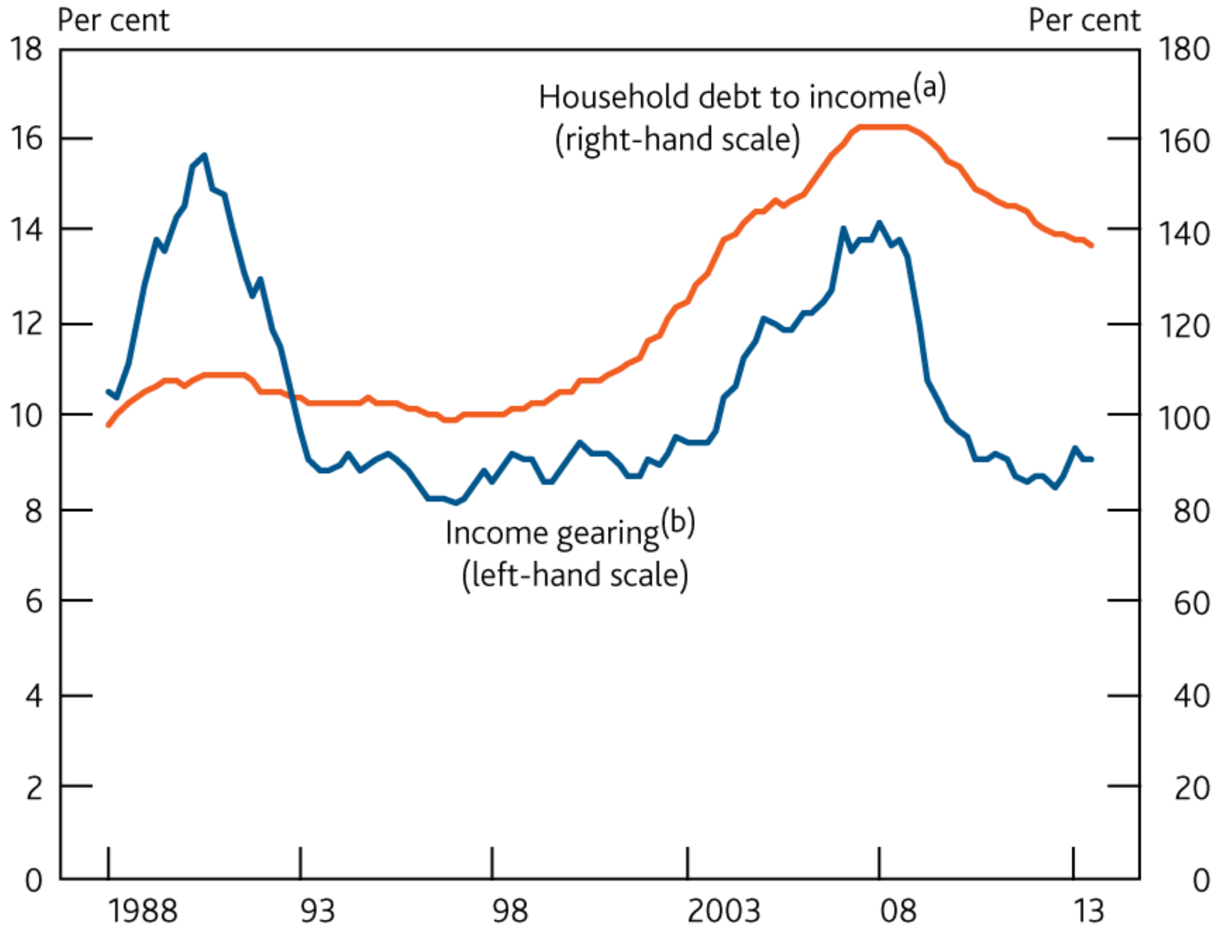
Bank Rate and forward market interest rates(a)



Sources: Bank of England and Bloomberg.

(a) The August 2013, November 2013 and February 2014 curves are estimated using overnight index swap rates in the fifteen working days to 31 July 2013, 6 November 2013 and
5 February 2014 respectively.

Household debt to income and income gearing ratios



(a) Household financial liabilities as a percentage of the four-quarter moving sum of post-tax income. Financial liabilities data are non seasonally adjusted.

(b) National Accounts measure of household interest payments (which excludes the impact of Mortgage Interest Relief at Source) plus regular repayments of mortgage principal, as a percentage of household post-tax income. Interest payments and income have been adjusted to take into account the effects of financial intermediation services indirectly measured. Repayments data are non seasonally adjusted. Excludes payments associated with endowment policies.

MPC VIEW ON INTEREST RATES

- Productivity will improve
- Excess capacity is available
- Delayed
- Slow rise
- Lower than past average
- No easing of QE until rise in interest rates

3. THE LONG TERM: structural challenges

LONG TERM CHALLENGES

- *Lucky Generation*
- Public finances
- Demographics
- Inter-generation transfers
- External deficit
- Structure of world economy

LUCKY GENERATION AND IGT

The Lucky Generation stole from their parents and are now stealing from their children

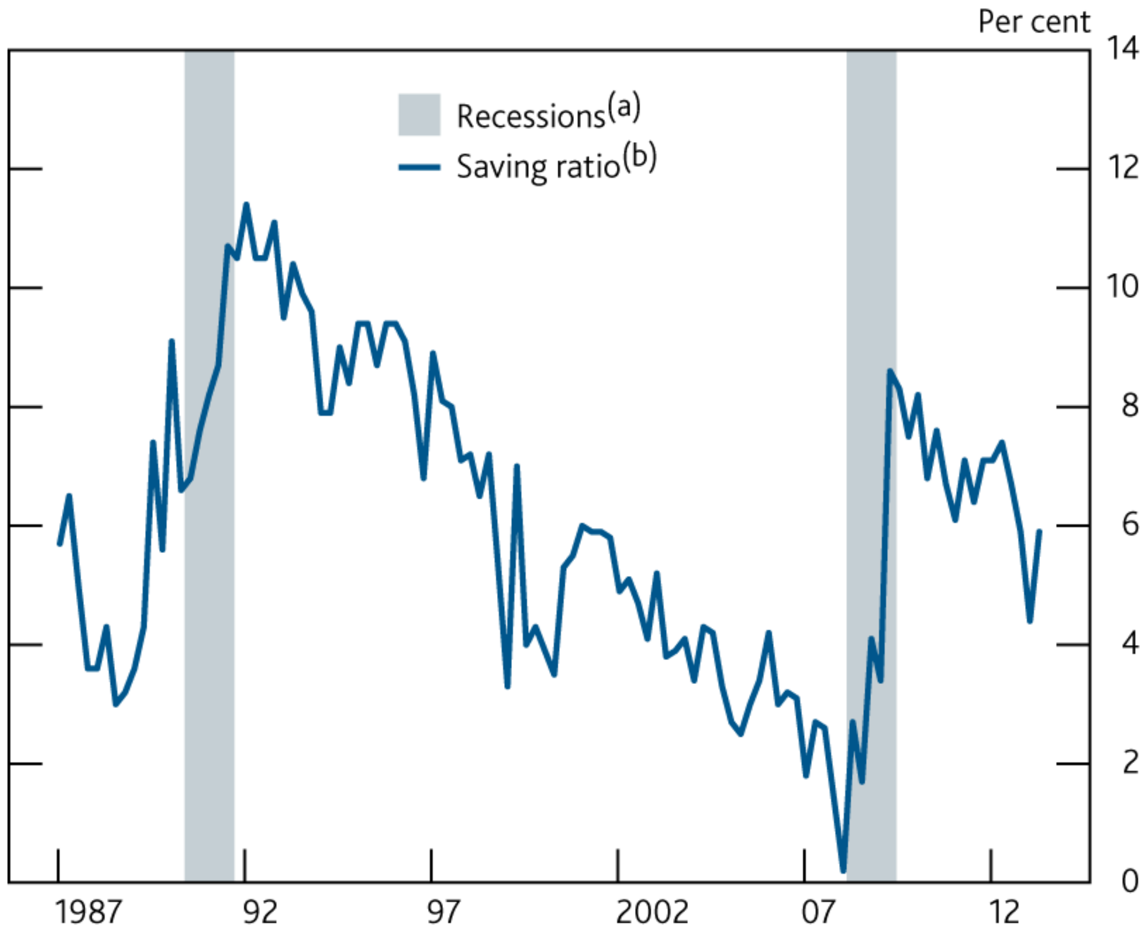
THE *LUCKY GENERATION*

- House prices: wealth effect
- Demograhics and state pensions
- Personal pensions tax advantages
- Defined-benefit pensions: LG receiving DB pensions paid for by current workers – top-ups
- Dental care
- University education
- Non-means tested benefits
- Budget deficits: Scandinavian welfare with US taxes
- Stock market
- Oil prices often low
- Utility prices
- NSO and gas
- Banks
- Oil and bank tax revenues
- Overvalued exchange rate
- Balance of payments deficit
- Access to credit: debt accumulation
- Council house purchases
- Child benefit
- Not pay full costs of pollution
- Public sector capital consumption: infrastructure

UNSUSTAINABLE LIVING STANDARDS

- Savings ratio
- Financial services: 6.6% (1997) to 8.7% (2008)
- Ageing population: Inter Generation Transfer
- NSO
- Low national savings: Savings < Investment
- Burgeoning current account deficit
- Public sector debt
- Household debt

Household saving ratio



(a) Recessions are defined as at least two consecutive quarters of falling output (at constant market prices) estimated using the latest data. The recessions are assumed to end once output began to rise.
(b) Percentage of household post-tax income.

The Wisdom of Marx: Groucho not Karl

"It isn't so much that the hard times are coming but that soft times are going"

(1962)

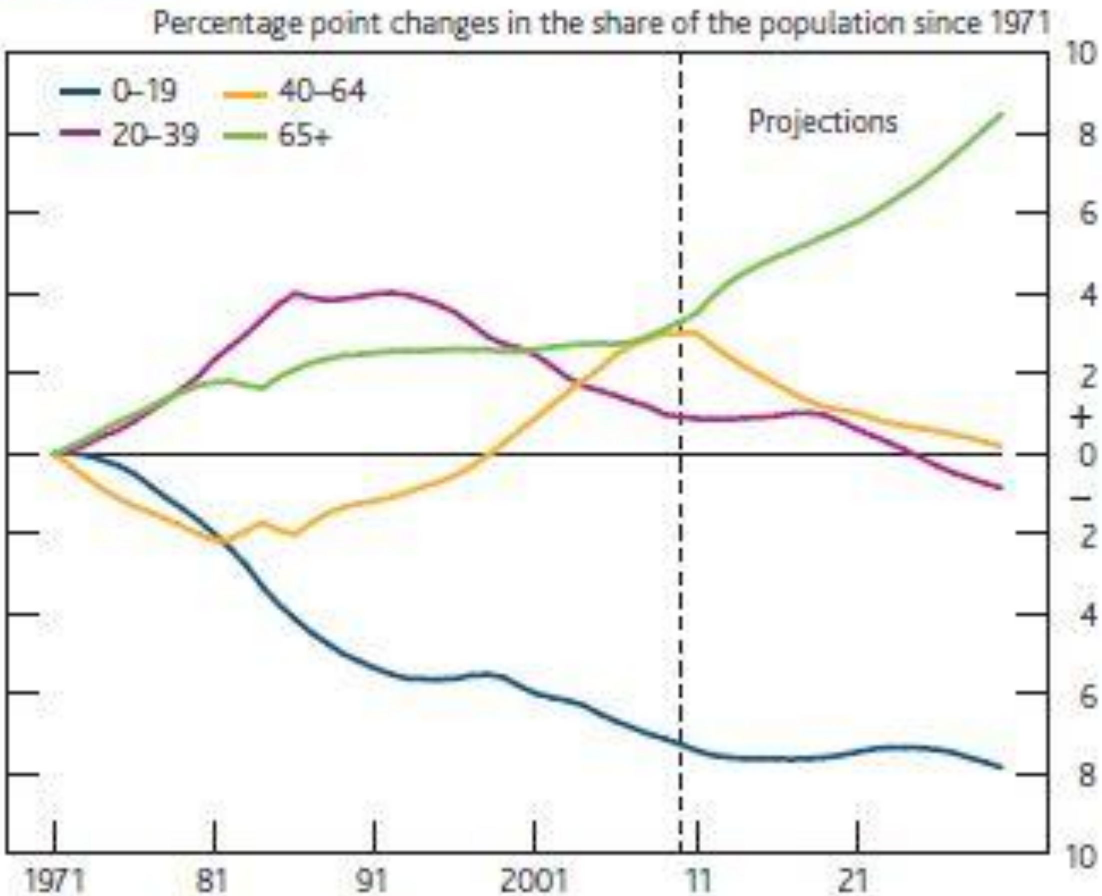
FISCAL POSITIONS (GENERAL GOVERNMENT)
Percent of GDP

	Budget Balance		Primary Balance		Gross Debt	
	2009	2013	2009	2013	2009	2013
France	-7.6	-4.0	-4.6	0.3	91	114
Germany	-3.1	-0.2	0.7	1.4	77	88
Greece	-15.6	-4.1	1.4	5.5	138	184
Ireland	-13.9	-7.5	-7.7	-0.5	71	129
Italy `	-5.4	-3.0	0.3	5.4	130	144
Japan	-8.8	-10.3	-7.0	-8.5	189	228
Spain	-11.2	-6.9	-8.1	0.3	63	98
US	-11.0	-5.4	-7.9	-3.1	89	109
UK	-10.8	-7.1	-7.6	-4.3	72	109

FISCAL ADJUSTMENT NEEDS
% points of nominal GDP

	Excl. ARS	Inc. ARS	Excl. ARS(1)	Incl. ARS(1)
Japan	13.3	14.9	17.9	19.6
Germany	0.6	3.4	0.6	3.3
France	3.6	5.4	3.3	5.2
Spain	7.8	10.4	3.7	7.3
United States	4.8	14.1	6.9	16.1
UK	7.4	13.2	8.5	14.0

Chart 3 Changes in UK population age structure[a]

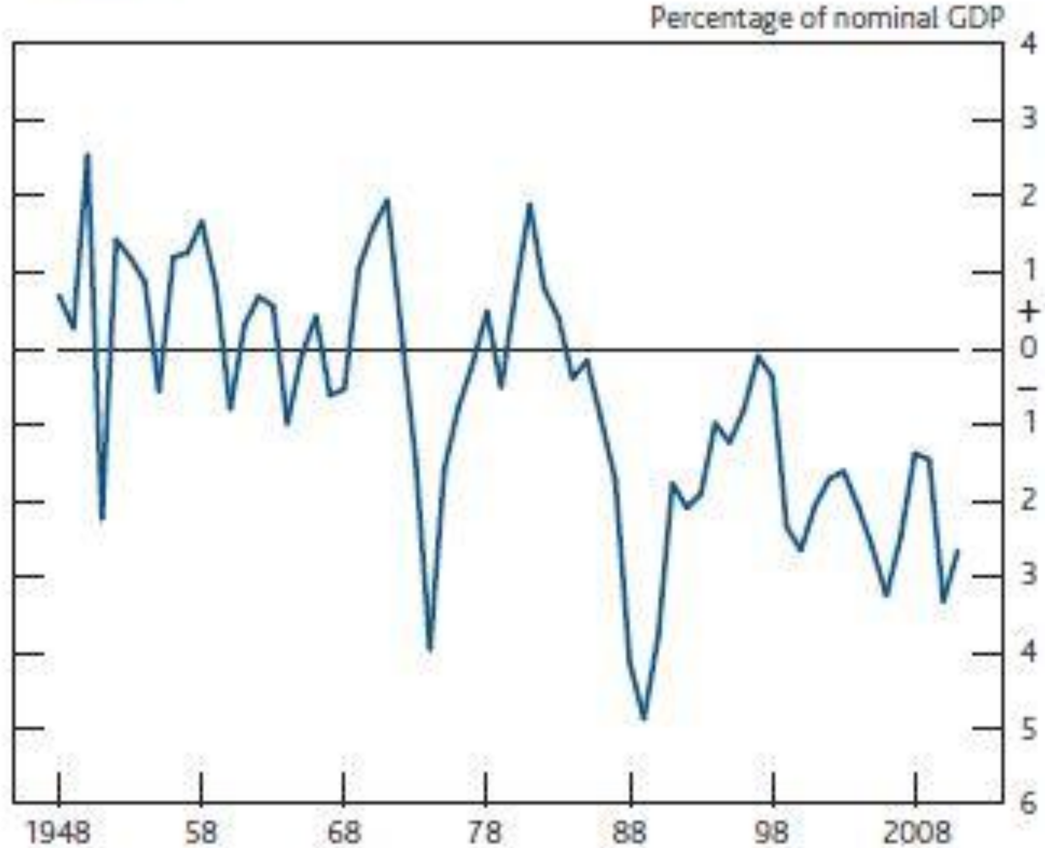


(a) Projections are the ONS 2010-based principal projections.

INTER-GENERATION TRANSFERS: children and their parents

- Critical ratio: workers v. consumers
- Withdrawal of windfalls and subsidies
- Parents more wealthy than their children will be
- Parents forcing children to pay more for homes: especially if interest rates rise
- Bank of Mum and Dad
- Early transfers

Chart 5 UK current account balance[a]



(a) Annual data. The data point for 2011 is based on the outturns for the first three quarters of the year.

TOP 3 DOMINANT ECONOMIES

% of world economy

1870	1973	2010	2030
UK (16)	US (19)	US (13)	China (18)
Germ (9)	Japan (8)	China (12)	US (10)
France (8)	Germ (8)	Japan (7)	India (6)

STRUCTURE OF WORLD GDP
% of total

	1990	2010	2020
Developed Economies	80	60	42
Emerging market economies	20	40	58