The UK economic and fiscal outlook

Report for StepChange Debt Charity

December 2014

Cebr

Contents

Executive Summary

- Although the UK economy is expanding at its **fastest pace in seven years** in 2014 (the labour market is strengthening, leading to rapid job creation and a drop in the unemployment rate), **for many households the outlook remains challenging.**

- While unemployment is dropping, ***underemployment*** persists; a significant chunk of the UK workforce is working fewer hours than they would like or being employed on zero-hours contracts. This persistent spare capacity is causing **wage growth to remain slow** although it is expected to gradually pick up.

- However, households face other major challenges: **interest rates will rise** from record lows and the UK government will further reduce public spending in the next Parliament; further welfare reform will act to constrain income growth.

- Since the financial crisis in general households have been able to **reduce their debt to income ratios** but **households on higher incomes have been more able to do this than lower earners.**

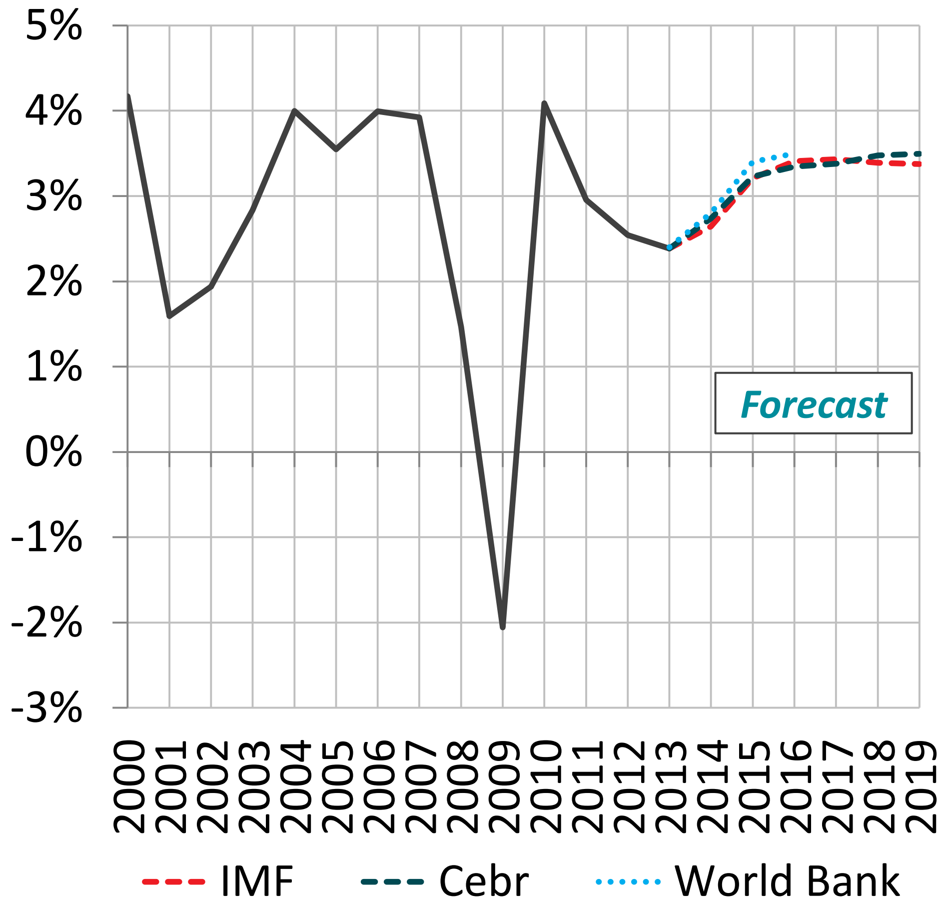
- We expect **unsecured debt to start increasing again** as consumer confidence and willingness to spend increases faster than real incomes; however, the **regulatory regime will prevent credit from growing as quickly as in the 2000s**.

The global economic outlook

Global economic prospects brightening; growth expected to pick up

- After a slowdown through 2011 to 2013, the global economy is expected to gather momentum in 2014 and beyond.
- Growth is expected to return to the vicinity of 3.5% for the medium term – slightly below the 4% pace seen in the years immediately before the global financial crisis.
- The Eurozone is expected to expand only modestly over the next two years; further out it will accelerate and contribute more to global growth.
- In the near term global growth will be driven by robust US expansion and a stimulus from cheap energy.
- However, growth is expected to soften in China over the medium term, preventing the world economy from expanding at higher speeds.

Global real annual GDP growth forecasts

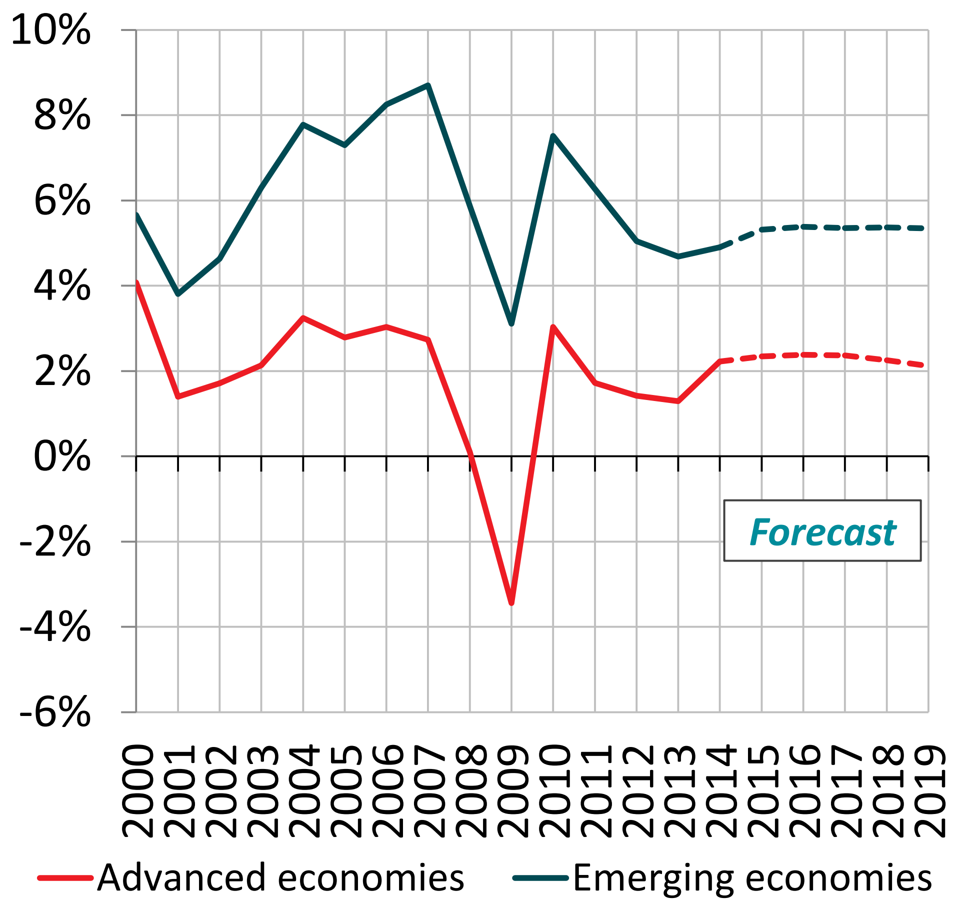


Source: Cebr analysis

Despite China slowdown, economic growth to be much faster in developing nations

- Growth in the 'emerging' economies is expected to accelerate further above the rate attained by advanced economies. An acceleration in India's expansion will contribute to this.
- With this boost offsetting a slowdown in China, growth is projected to be more than twice as fast in the emerging economies in 2014 than in the developed nations. This is projected to rise to almost two and a half times faster by 2015.
- With such rapid growth in the emerging economies, these areas are projected to contribute more to total global GDP growth than the advanced economies.

Annual GDP growth by economy type

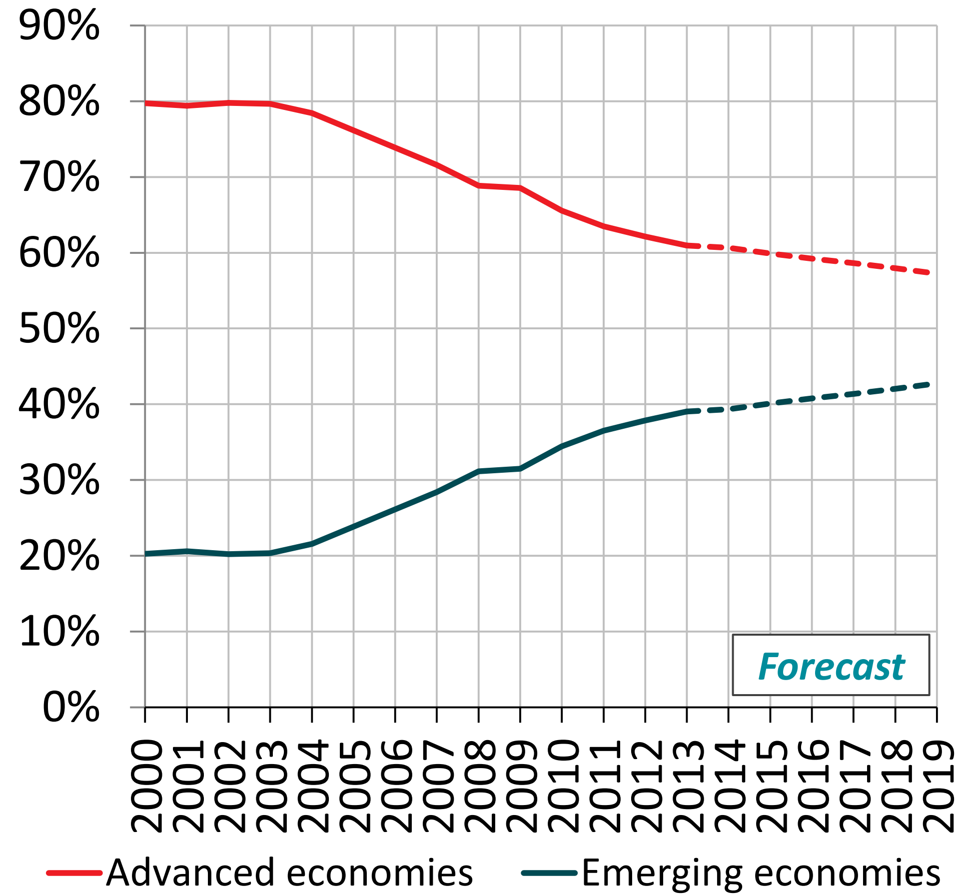


Source: IMF World Economic Outlook

Rapidly growing emerging nations heading towards comprising half of the global economy

- With growth in emerging economies far outpacing that of the advanced nations, it follows that they will comprise a larger share of the total global economy.
- This share is projected to reach 43% by 2019, well up from the 20% seen twenty years before.
- If this trend continues, emerging economies will produce more than half of global output by 2040.
- This highlights the shift in the centre of global economic power. As the emerging economies become more advanced, they will become more competitive in the sectors in which the West has traditionally been the leading supplier – such as business or financial services.
- This shift in competitiveness will weigh down on the long-term growth prospects for countries such as the UK.

Share of total global economy



Source: IMF World Economic Outlook December 2014

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The UK economic outlook

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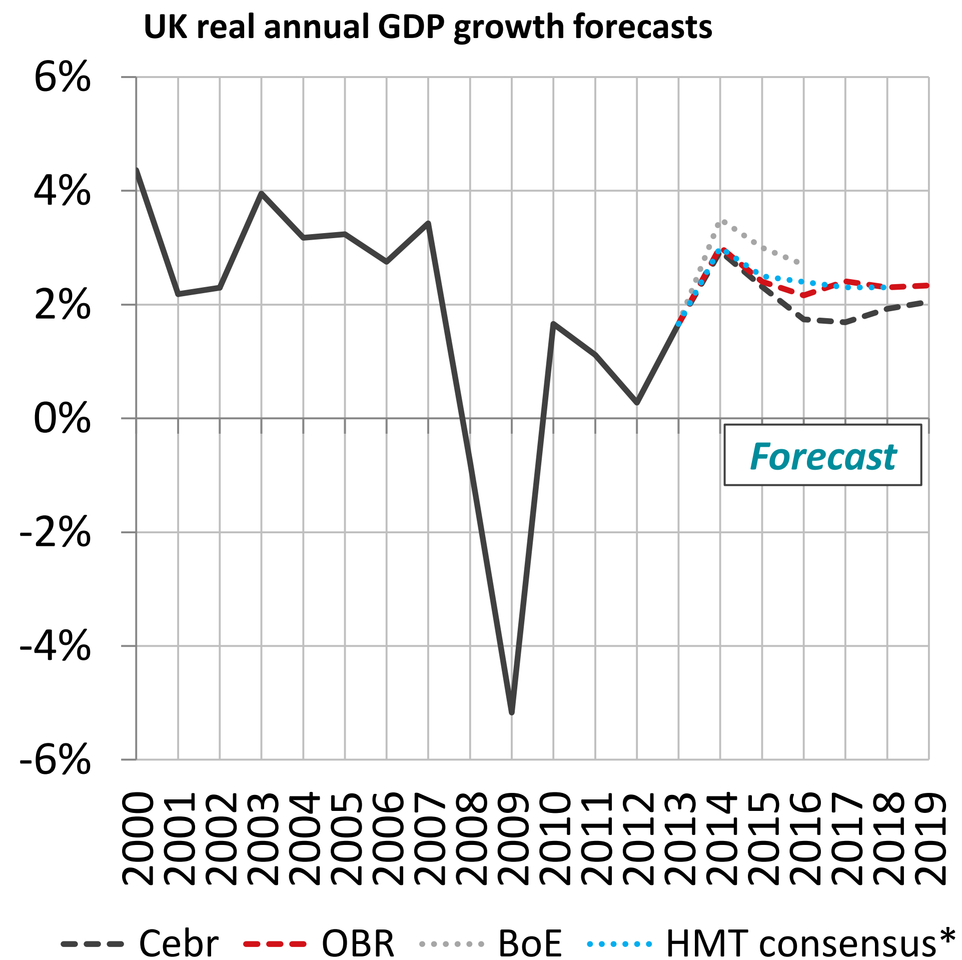
UK growth accelerating in 2014, but this will fall back to a steady state in 2015 and beyond

- The UK is seeing rapid year-on-year growth in 2014, thanks to a solid bounce back from the weaker growth in early 2013 and before. Growth is projected by Cebr, the IMF and the Bank of England to slow in 2015 and 2016.
- Weak wage growth means that household spending will slow. Rising house prices have supported household consumption so far, but this growth is slowing.
- In addition, as the recovery gains momentum, the Bank of England will be required to tighten monetary policy from the crisis levels of a 0.5% base rate. This will feed through into higher housing costs for mortgage holders and also potentially translate into higher rents in the private rented sector.
- Growth is expected over the medium term by most forecasters to remain beneath the 1990-2007 average of 3.0%.



Source: Cebr analysis, HM Treasury, OBR, Bank of England (BoE)
* This is the median of the HM Treasury consensus of independent forecasters

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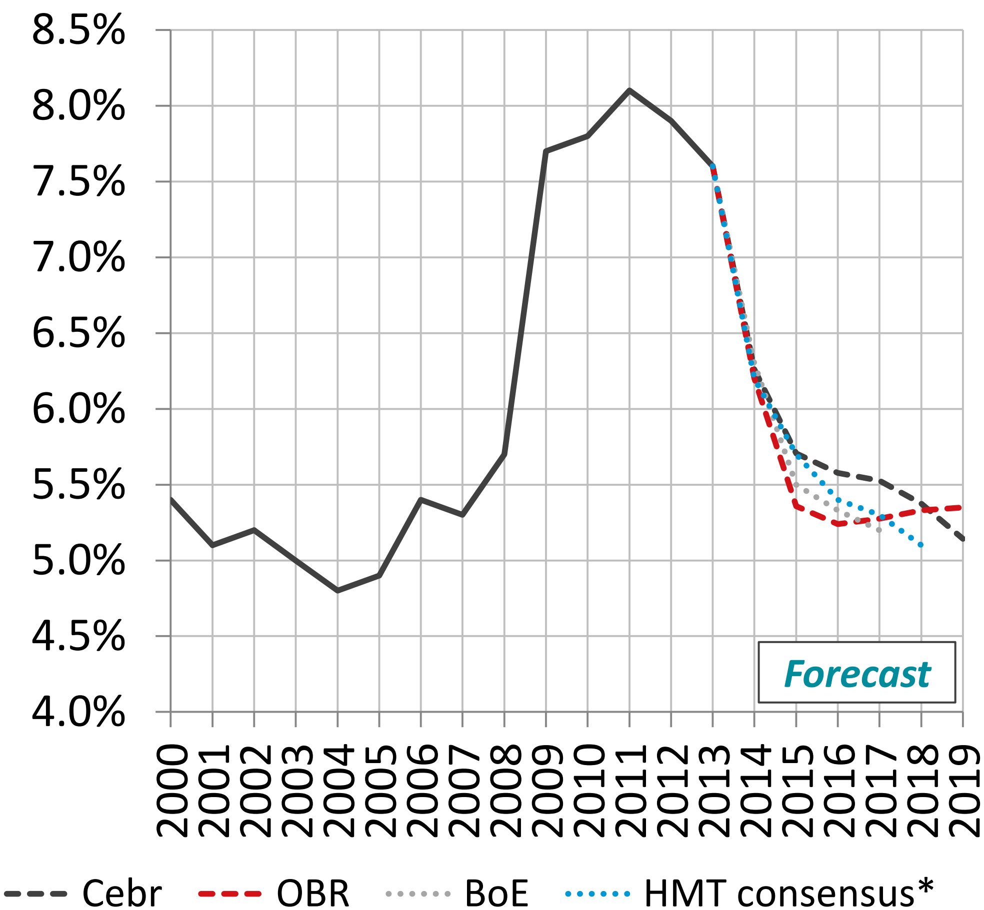
UK unemployment heading back toward pre-crisis levels

- The effects of economic recovery are also feeding through into the UK labour market, as the unemployment rate is now falling back sharply after remaining elevated for much of the past five years.
- Most economists expect the rate to fall below the 5.5% mark that essentially marks the general upper bound of pre financial crisis unemployment during 2015 and lower still through 2016-19.
- While the labour market recovery has certainly gathered strength through 2013-14 there are lingering concerns.
- In particular, *wage* growth has failed to rise significantly even as spare capacity in the labour market has been steadily eroded away.

UK unemployment rate, annual average

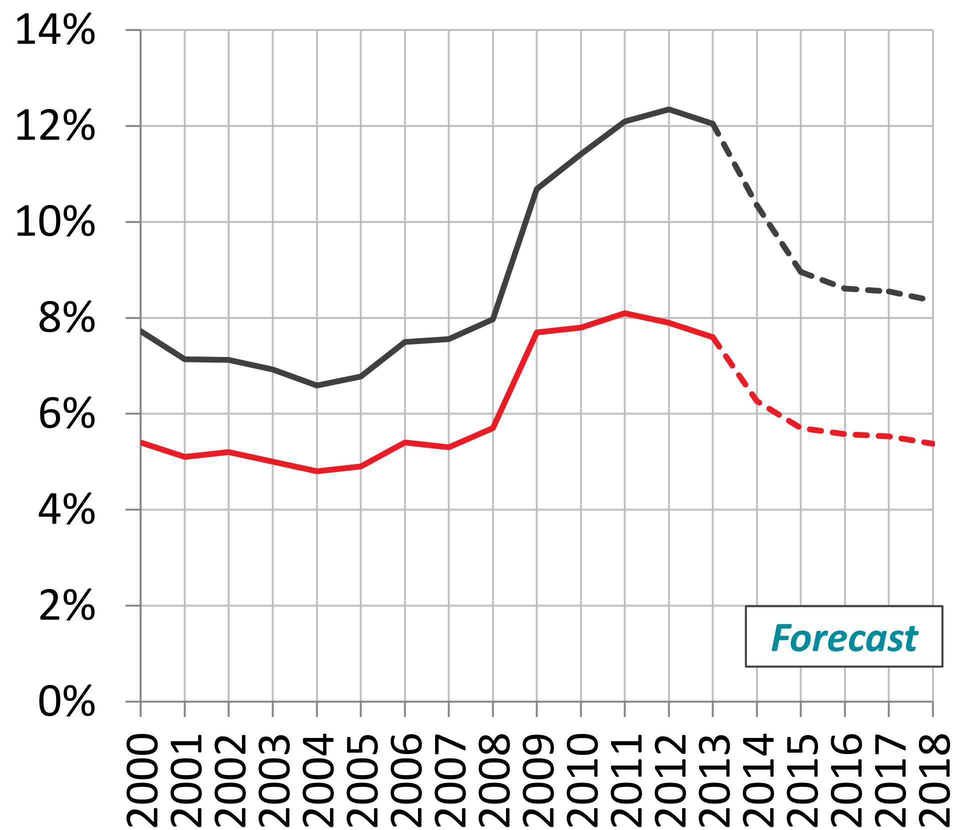


Source: Cebr analysis, HM Treasury, OBR, Bank of England (BoE)
* This is the average of the HM Treasury consensus of independent forecasters

Despite sharp fall in unemployment, *under*employment likely to remain elevated for coming years

- While Cebr expects a sharp reduction in the unemployment rate to result from the sustained expansion of the economy, this must be understood in a wider context.
- The share of workers that are only working part time because they cannot find full time employment – i.e. ***involuntary part-time employment*** – is projected to remain above pre-crisis levels until through the next 4 years.
- This means that *under*employment – i.e. all those unemployed *plus* those that are working less hours than they would like as a proportion of all economically active people – is expected to persist. Underemployment is really a better reflection of spare capacity and notably, the underemployment rate is expected to fall back towards pre crisis levels less quickly than the unemployment rate.
- This suggests employers are meeting demand by hiring more staff, but demand is not high enough to support full hours for every worker, which acts to constrain the pace of pay growth.

UK unemployment and underemployment* rates as a proportion of all economically active

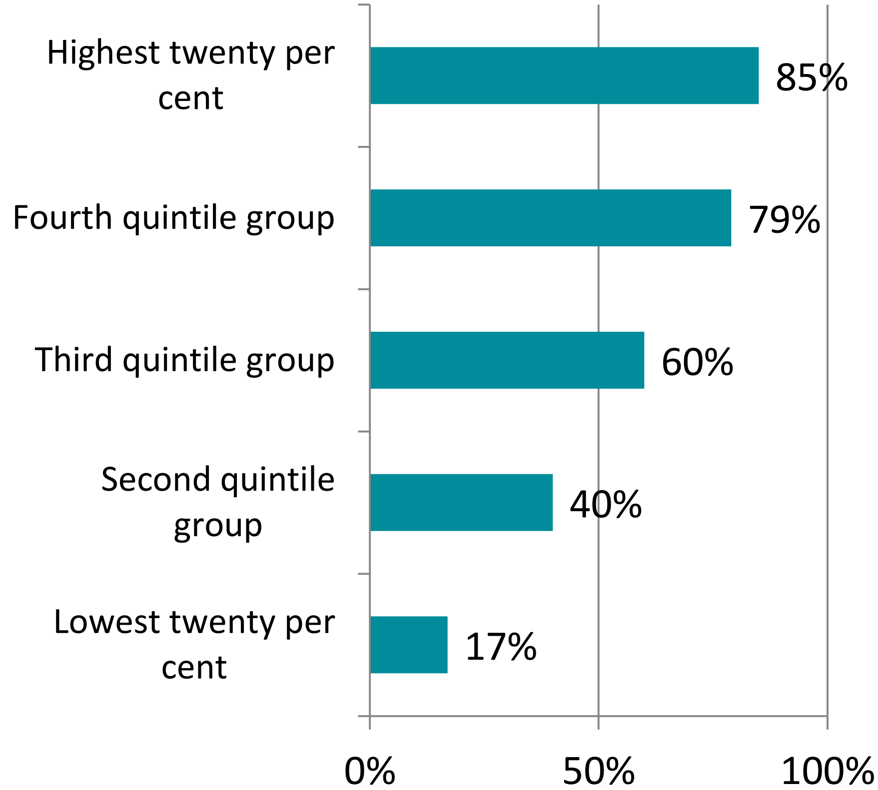


* People working part time that wish to work full time + unemployed people
Source: Cebr analysis, ONS

Pick up in earnings growth will have a greatest proportionate impact on middle to high earners' finances

- The increase in income growth resulting from improvements in the labour market will have notably different effects across the income distribution.
- The highest earners are most 'geared' to faster income growth; hence, as the economy picks up and income earned from employment accelerates, this will have a greater proportionate impact on higher earners.
- Those who have been in a job for longer than a year are seeing significantly higher wage growth than those in casual or temporary employment.
- In contrast, the poorest groups are the least dependent on earned income – with the lowest twenty per cent of households gleaning just 17% of their total income from wages / salaries and self employment. This is up from 12% a year before, in part reflecting falling unemployment.
- However, with growth in working age benefits remaining constrained by government policy, incomes at the bottom end of the spectrum are likely to be held back more over the forecast period than households with higher incomes.

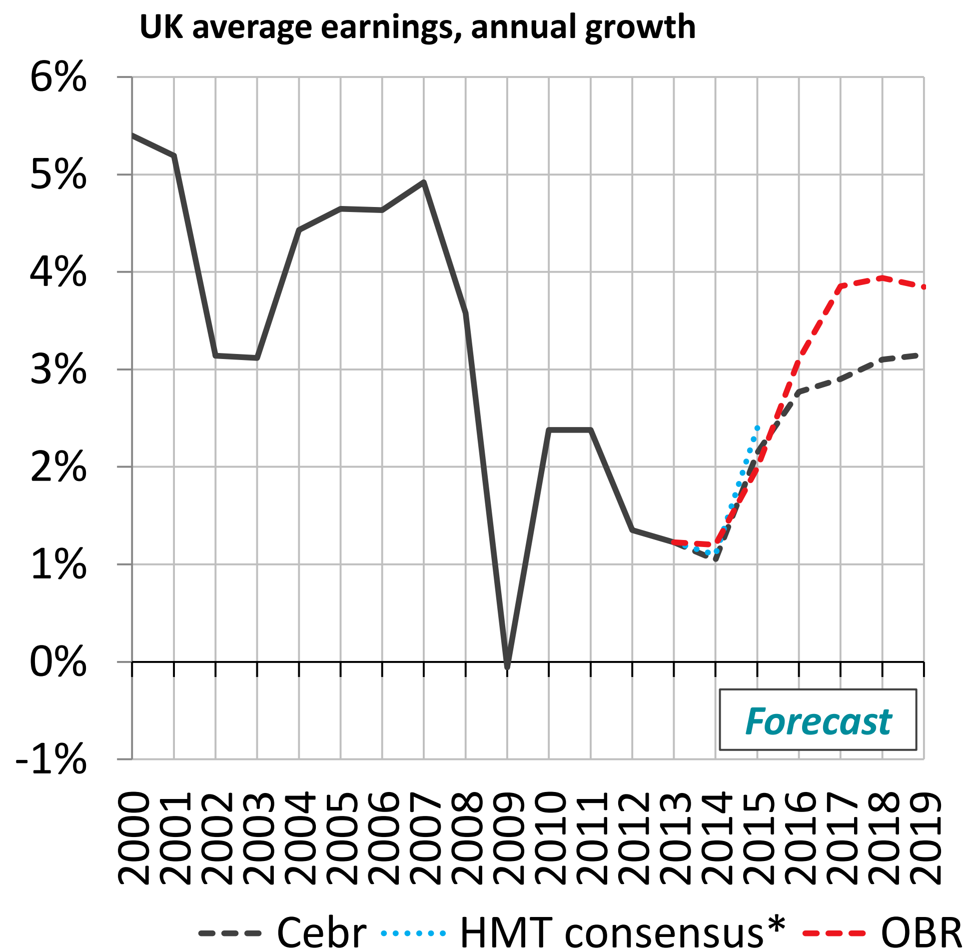
Percentage share of income from employment across income quintiles in the UK, 2013



Source: Cebr analysis, ONS Living Costs and Food Survey

Productivity growth feeds through into wage growth: expected to pick up but remain below pre-crisis rates

- Falling unemployment does increase the wage bargaining power of employees, particularly at a time of emerging skills shortage in some sectors.
- This means that wage growth is projected to accelerate during 2015.
- However, with productivity growth expected by Cebr to remain well below the rates of growth seen before the financial crisis, wage growth is also likely to remain lower.
- This contrasts with the OBR's view of faster wage growth – again, reflecting its faster view for productivity increases.



Source: Cebr analysis, HM Treasury, OBR

* This is the average of the HM Treasury consensus of independent forecasters

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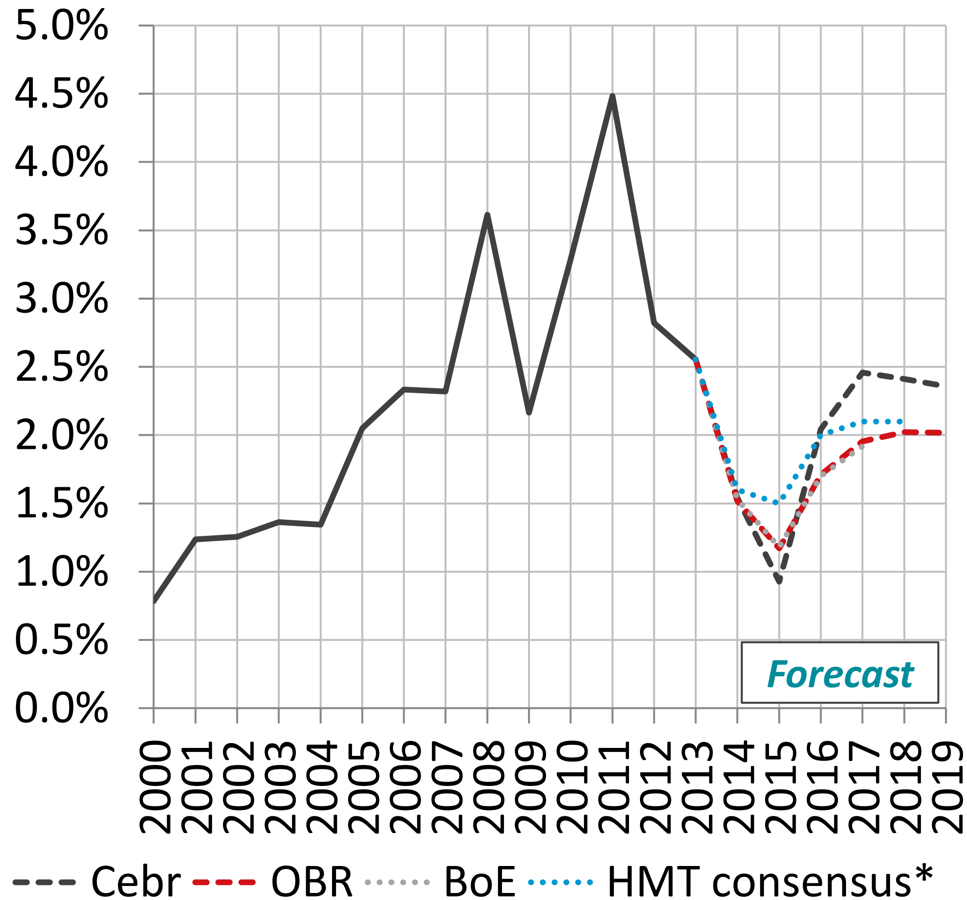
Inflation reaches lowest rate in ten years in 2014 on more benign external environment

- The inflation rate has fallen substantially in 2014, as growth in commodity supplies significantly outstripped growth in demand. In particular, oil prices fell to levels not seen since 2009.
- With oil supply still increasing and demand growth slowing compared to earlier years, consumer price inflation is expected to drop to near 1% during 2015 as a whole.
- Though wages are expected to pick up, this is expected to exert only mild upward pressure on the inflation rate.
- Private rental prices often follow base rate increases and as such, upward pressure on inflation is expected to come from housing costs once the Bank of England tightens monetary policy in late 2015.
- The pound is expected to remain strong against most other currencies. Two major currencies – euro and yen – will weaken as their central banks continue loose monetary policy.

UK consumer price inflation, annual average

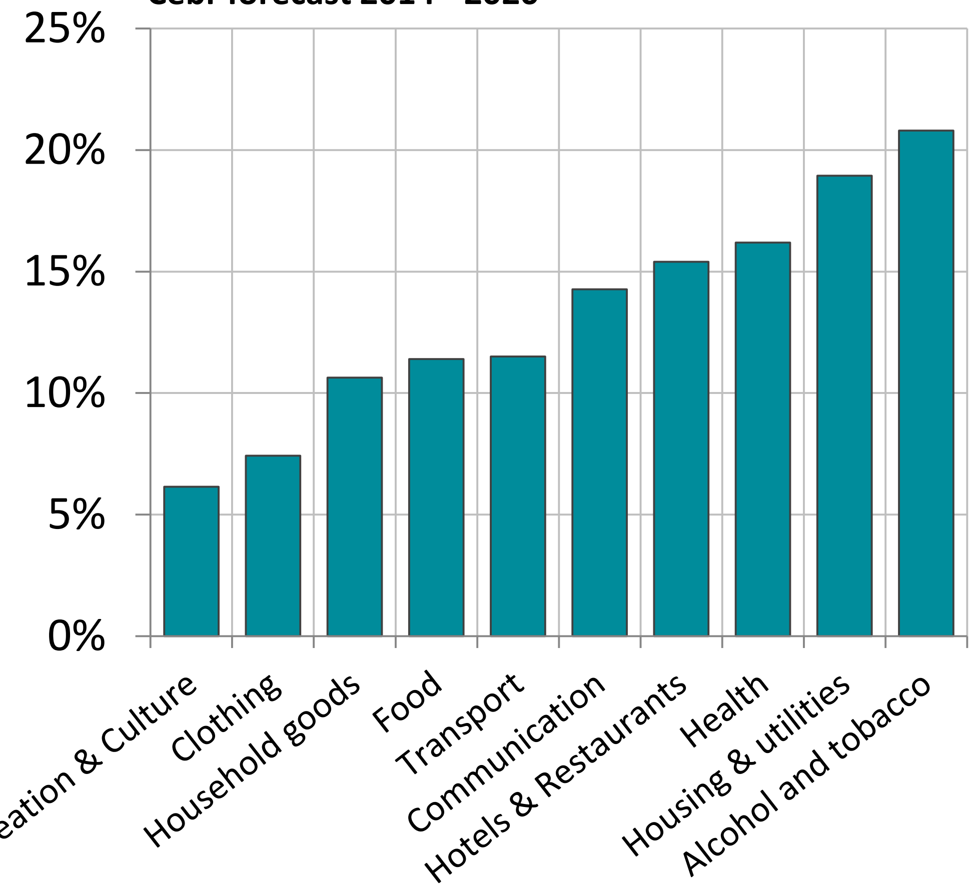


Source: Cebr analysis, HM Treasury, OBR, Bank of England (BoE)
* This is the median of the HM Treasury consensus of independent forecasters

Housing costs and utility prices to be a key driver of rising cost of living over next five years

- Alcohol and tobacco are expected to see rapid price inflation over the medium term thanks to duty escalators. However, these are a relatively minor expenditure.
- Housing & utilities are one of the largest expenditure categories for many households, the cost of which is expected to rise by almost a fifth by 2020.
- This is driven by housing shortages continuing to push up rent prices.
- Food prices are projected to rise by around 11% by 2020, assuming no weather-based disruption to supply.
- Clothing prices meanwhile are forecast to increase by just 7%. However, this is a turnaround from the price deflation seen over the past decades, as the cost of production rises in line with economic development in South and East Asia.

UK consumer price inflation by product type, Cebr forecast 2014 - 2020

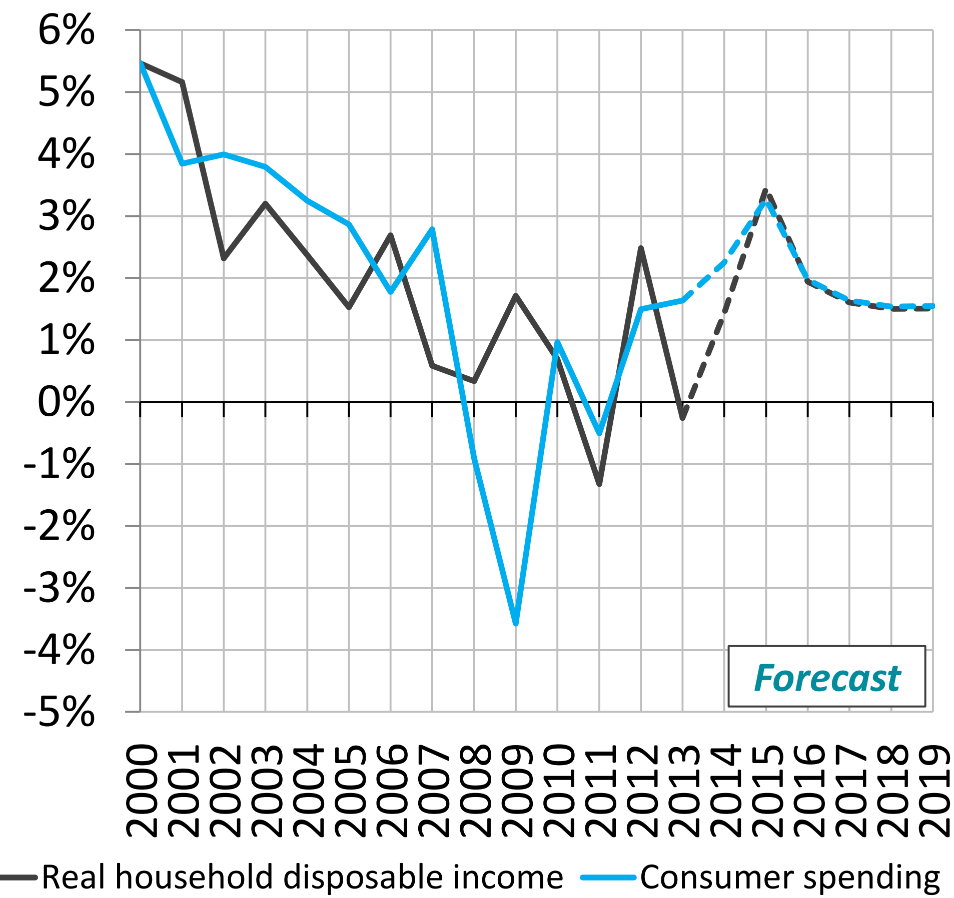


Source: Cebr analysis

Income growth to keep pace with consumer spending after 2015

- In the run up to the financial crisis, consumer spending outpaced income growth, as households leveraged up.
- This trend reversed in the downturn as spending was cut back, but is now returning.
- Households are winding down their savings ratios and starting to take on more credit, to finance spending at a time when confidence is high but income growth has yet to catch up. Low inflation is expected to provide a boost to consumers in 2015.
- However, consumer spending is expected to normalise in 2016 and beyond, as this bounce-back effect wears off.
- From 2017 to 2019, Cebr expects income and spending growth to generally move in line with each other as households avoid taking the excessive amounts of debt that helped contribute to the financial crash in the first place.

UK real household disposable income and total consumer spending, annual change – Cebr forecast

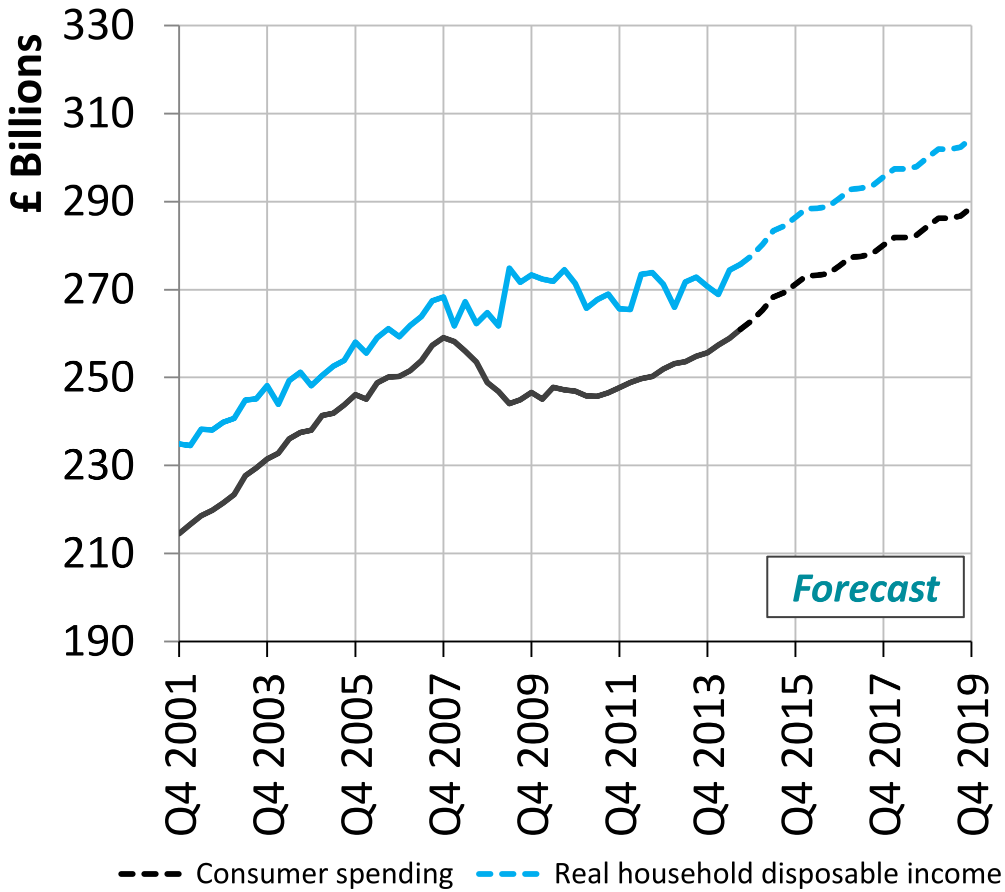


Source: ONS, Cebr analysis

Households building up consumer credit despite incomes exceeding expenditure, as consumers spend and save

- The consumer credit that households built up during the 2000s came despite the fact that total incomes were higher than consumer spending.
- This means that households were saving even as they took on more consumer credit.
- The household savings ratio dropped to its lowest point at Q1 2008 at near zero, before climbing sharply following recession.
- Over the next five years, the growth in real consumer spending previously illustrated is forecast to be part funded by increases in real disposable incomes, and part funded by upticks in consumer credit and a lower savings ratio.

UK real household disposable income and total consumer spending, levels (2010 prices)



Source: ONS, Cebr analysis

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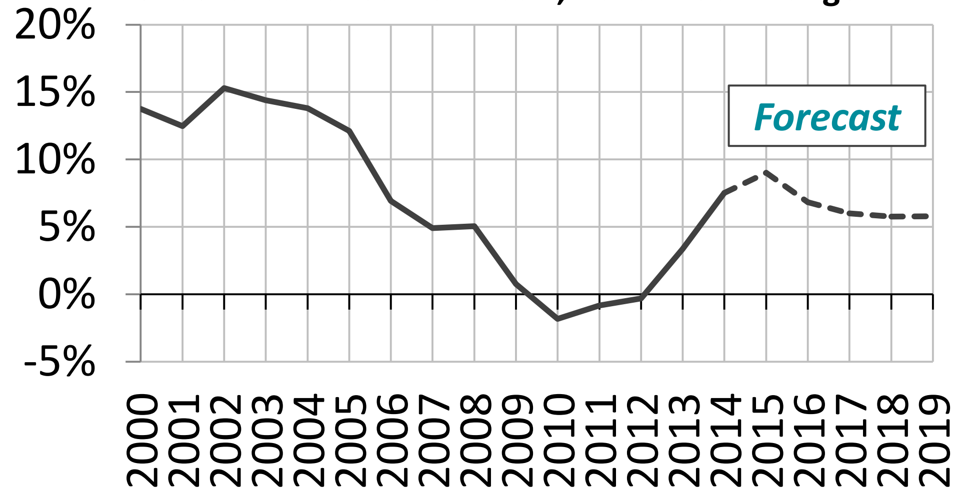
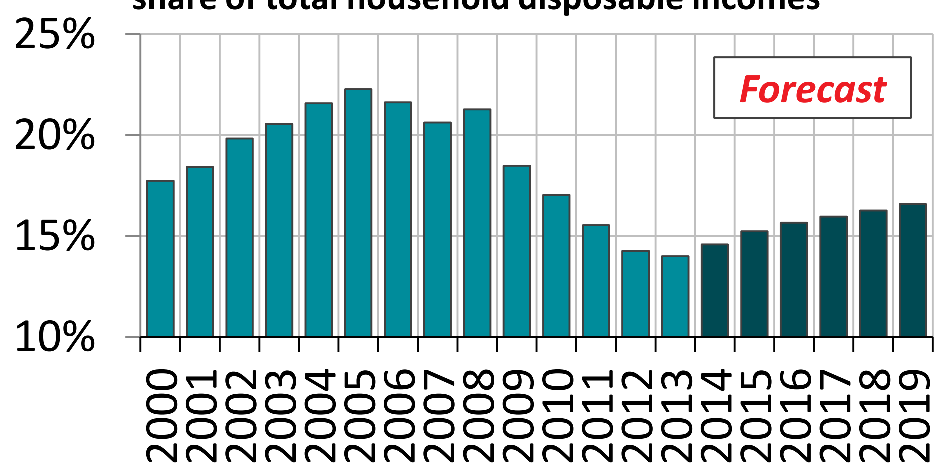
Consumer credit growth to remain well below pre financial crisis highs

- Consumer credit saw huge gains in the decade before the financial crisis, pushing up the ratio between total outstanding unsecured debt and total nominal household disposable incomes.
- In contrast, households paid off more unsecured credit than they took out in the 2010 to 2012 period. Credit growth returned to positive territory in 2013 but this upward trend is expected to peak in 2015. After that, a likely increase in base rates will also serve to reduce the attractiveness of taking on credit.
- Moreover, the regulatory regime is expected to act as a constraint on the rapid growth in credit; in secured lending we have seen the Mortgage Market Review and the Bank of England has announced caps on loan to income ratios. Hence, in the base case for unsecured lending we see the regulatory regime acting to cap consumer credit growth.

Unsecured consumer credit, net annual change



Total outstanding unsecured consumer credit, share of total household disposable incomes



Source: Bank of England, Cebr analysis

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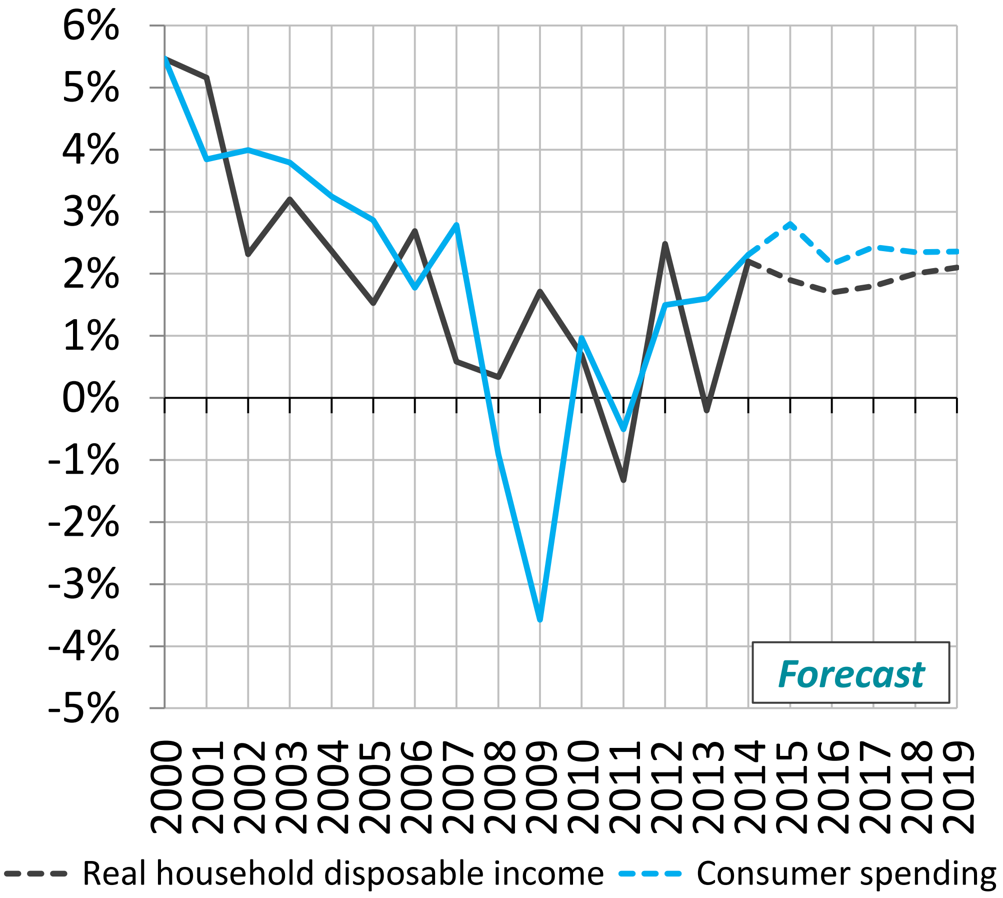
OBR expects consumer spending to outpace income growth for much of the forecast period

- The OBR expects consumer spending growth to outpace increase in disposable incomes for every year of the forecast period.
- Partly this is due to a winding down of the household savings ratio. The OBR expects this to fall to 4.8% in 2019 from 6.6% in 2014.
- In addition, the OBR expects a pick up in total household debt as a share of income. Partly this will be due to increasing mortgage holdings, but likely also due to increased unsecured debt.
- This wedge between income and spending growth provides the offset to the government's fiscal consolidation – in effect, moving debt from the public sector to the private sector.

UK real household disposable income and total consumer spending, annual change – OBR forecast



Source: OBR Economic and Fiscal Outlook December 2014

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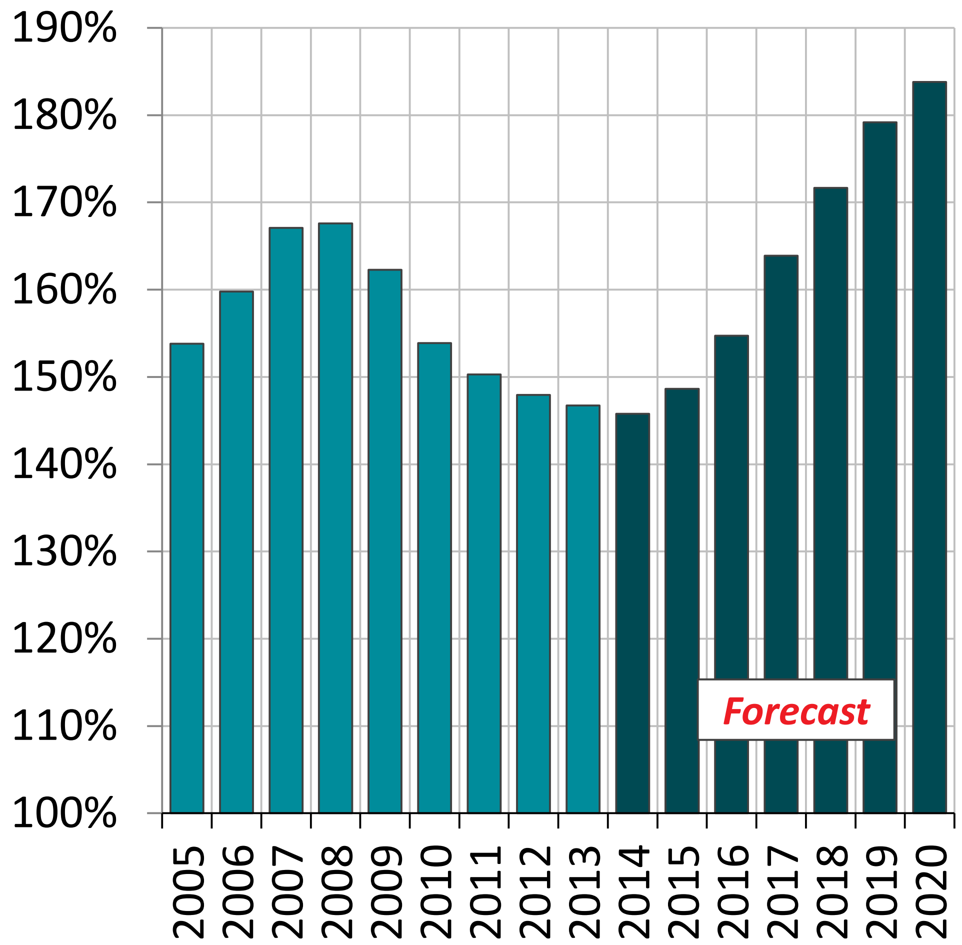
The OBR expects significantly greater household indebtedness to come

- As illustrated on the previous page, the OBR's economic forecasts are built partly on consumer spending outpacing household income growth over the medium term.
- This is partly due to a winding down of the saving ratio, but also due to a marked uptick in household indebtedness.
- As the figure opposite shows, the OBR expects average household gross debts to reach 184% of incomes by 2020, up from 146% in 2014 and a previous peak of 168% in 2009.
- Rising average house prices at a time of fairly stagnant incomes is a significant contributor to this increase in indebtedness.
- However, the share of unsecured debt in total debt is expected to reach back to levels seen before the financial crisis. And as total debt is expected to be higher, this suggests significantly higher unsecured debt levels as well.

Household gross total debt to income



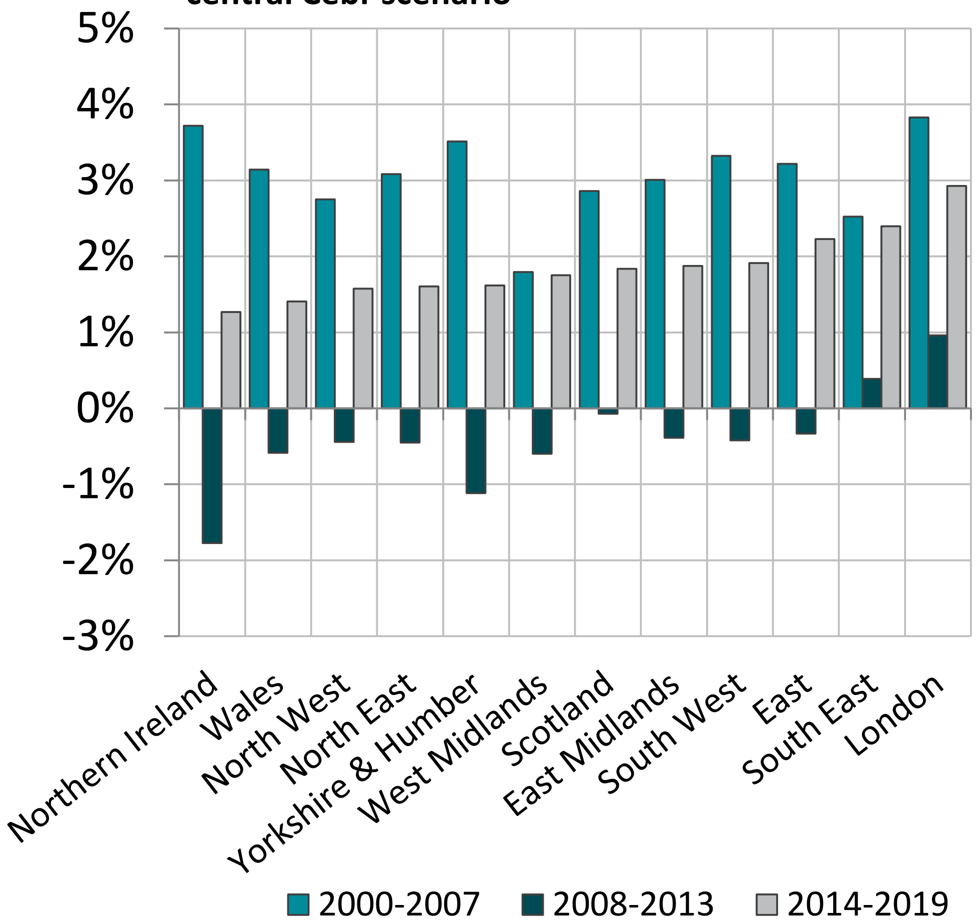
Source: OBR Economic and Fiscal Outlook December 2014

The UK regional economic outlook

UK economic growth to be driven largely by the south of England over the next five years

- Although economic growth is picking up in the UK and expected to remain buoyant over the coming years, recovery is not coming to all regions equally.
- London, the South East and the East of England are projected by Cebr to be the quickest-growing regions over the five years to 2019.
- This follows a generally better performance between 2008 and 2013 for these regions.
- Other areas of the UK are expected to be held back by a greater dependence on the public sector for spending in the local economy.
- Northern Ireland is expected to be particularly harshly constrained. This compares to the 2000-2007 period, which was boosted in no small part by the construction sector.

Average annual economic growth by region, central Cebr scenario



Source: ONS, Cebr analysis

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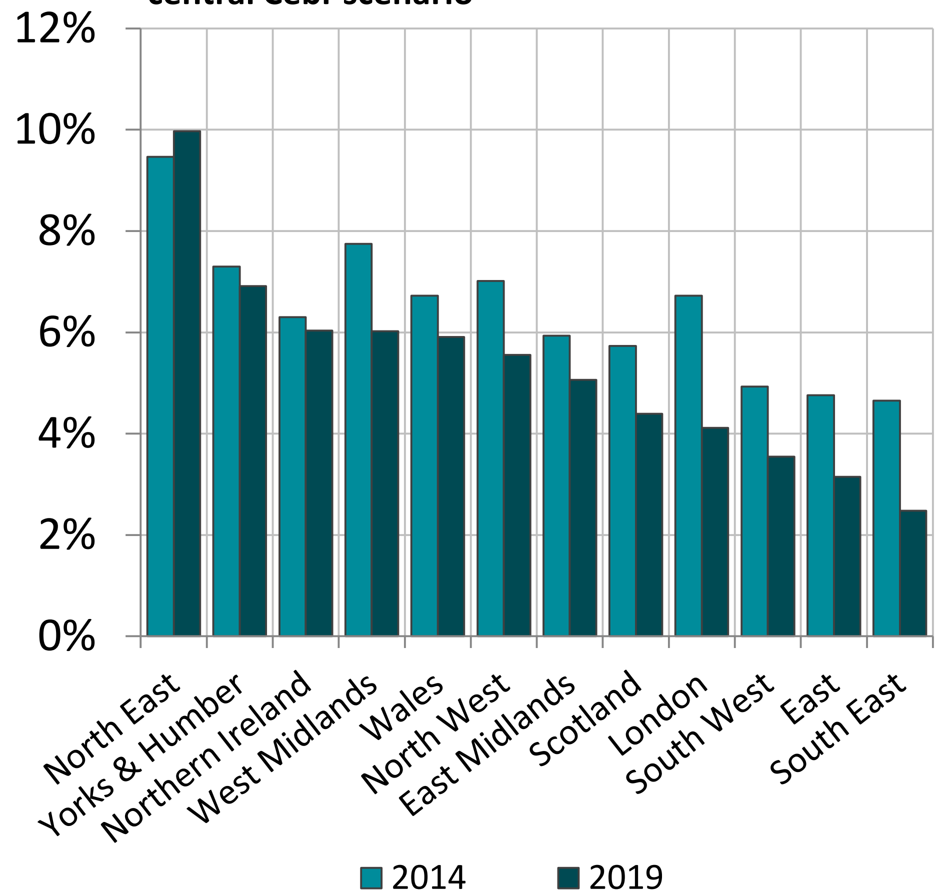
North / South unemployment rate divide to remain in place in years to 2019

- Alongside strong economic growth, the East of England and the South East are expected to have the lowest unemployment rates in the UK by 2019.
- Despite London's rapid expansion, faster growth in the economically active population means that the unemployment rate remains relatively high.
- Meanwhile, reductions in public sector employment are expected to keep unemployment rates in the North of England, as well as Northern Ireland and Yorkshire & Humber elevated.
- Scotland is expected to perform relatively well over this period, as the well-developed business and financial services sector there gathers growth momentum.

Average annual unemployment rate by region, central Cebr scenario



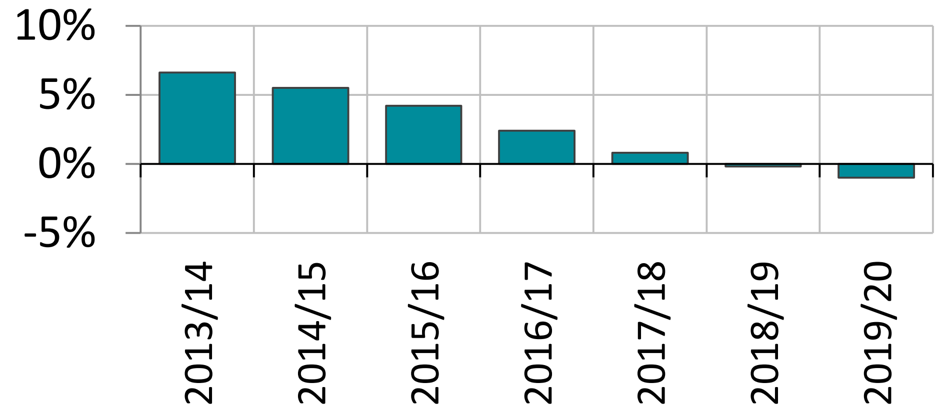
Source: ONS, Cebr analysis

The policy outlook

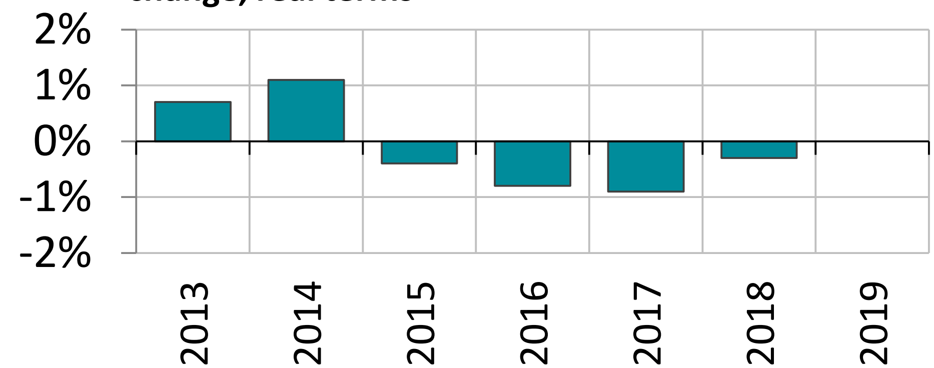
Significant public sector spending cuts necessary and likely in the next parliament

- The OBR's December 2014 Autumn Statement laid out its expected changes in government finances over the next five years. The deficit is expected to be trimmed to a marginal surplus by 2018/19.
- However, this cannot be done without significant cuts to spending. The OBR estimates that cuts will occur in real terms from 2015 until 2018, with the largest occurring in 2017.
- However, even the zero growth in real terms spending in 2019 is a cut on a per person basis, as the population continues to rise.
- These austerity measures are likely to continue to place pressure on household budgets, as social welfare spending remains constrained.

Public sector net borrowing (exc Royal Mail and Asset Purchase Facility transfers), % of GDP



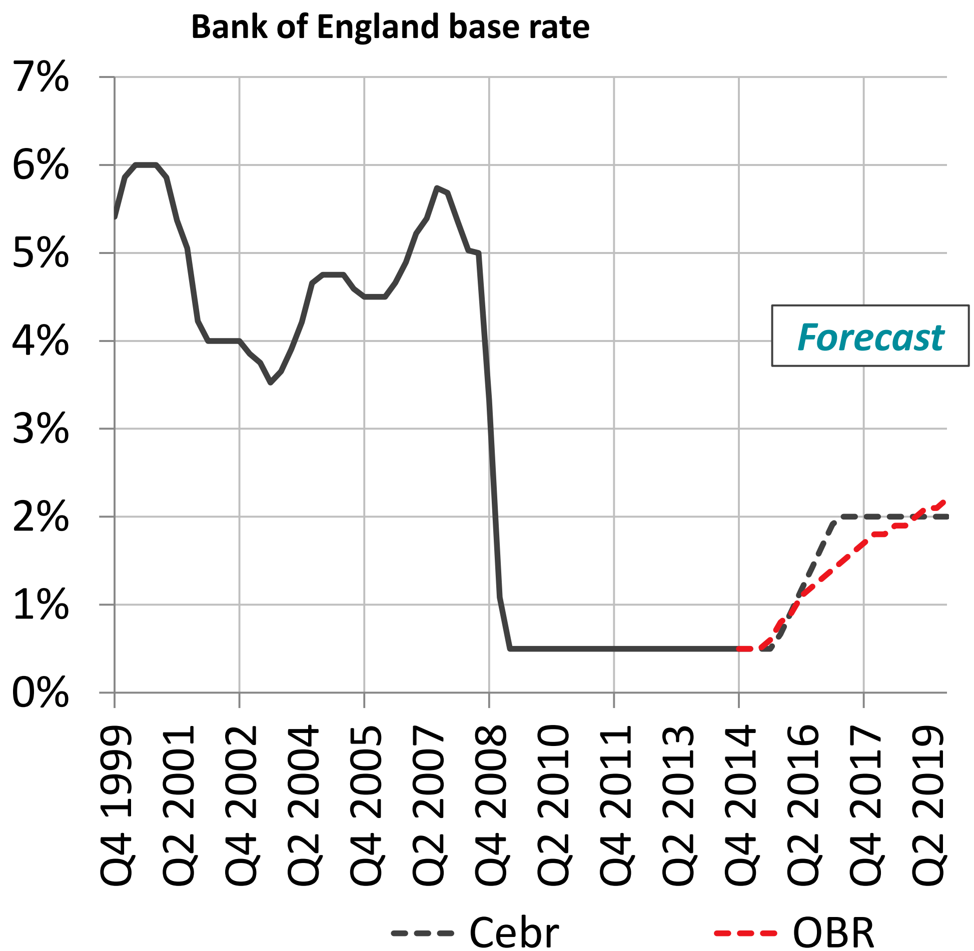
General government consumption, annual change, real terms



Source: OBR Economic and Fiscal Outlook December 2014

Base rate expected to start rising in 2015, but remain below pre-financial crisis levels

- The OBR uses market expectations of the base rate for its predictions. These show the base rate starting to rise gradually from mid-2015, reaching 2.2% by the end of 2019.
- Cebr expects a similar path of interest rates, except for a slightly later take-off from 0.5%: it expects lower inflation than the OBR does. Also, instead of continuing to rise the path is expected to halt at 2.0% for the medium term.
- This reflects Cebr's forecast of slower growth over the medium term than the OBR uses.
- Two members of the nine-strong monetary policy committee have voted for immediate rate rises at recent meetings.



Source: Cebr analysis, OBR

The outlook for household finances

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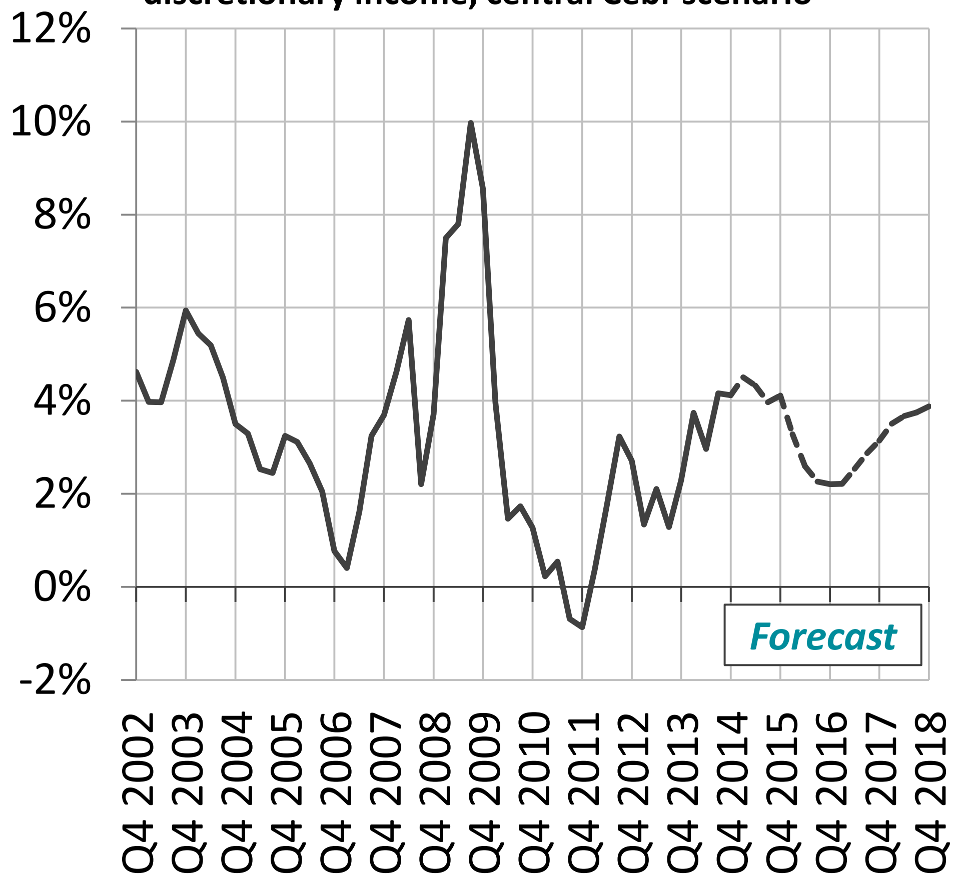
Household discretionary income growth expected to be strong in 2015, before being weighed down by tightening monetary policy

- Discretionary income is defined as gross income minus taxes and spending on essential items.
- The basket of essential items in the series opposite includes: food, housing, transport, housing (rent, utilities and mortgage interest), health, education, personal care and essential financial services.
- Discretionary income picked up sharply during 2009 as mortgage interest rates were cut. However, as wage growth slowed and inflation steadily rose, discretionary income fell into year-on-year decline.
- More recently, growth has been seen as unemployment has fallen sharply, and this is expected to accelerate as wage growth picks up.
- From late 2015 onwards though, increases in the base rate will push up mortgage costs, reducing growth in average discretionary income.

Annual change in average (mean) nominal household discretionary income, central Cebr scenario

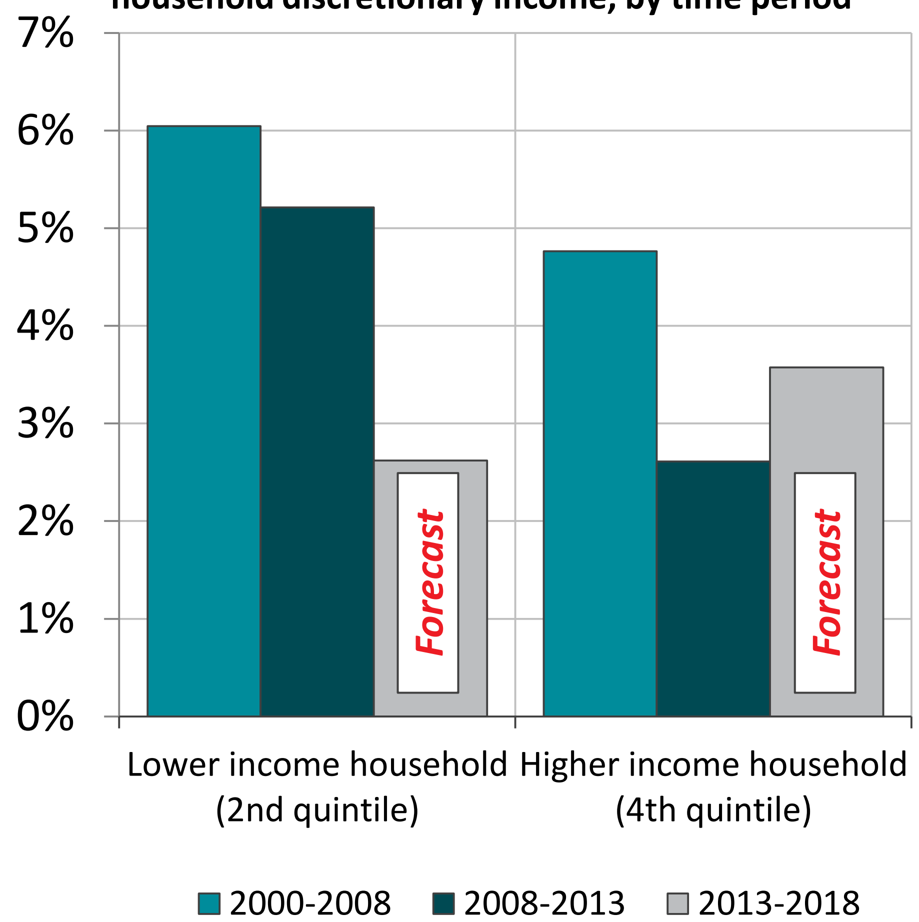


Source: Cebr analysis

Lower income households did better through financial crisis than higher income households, but will be left behind over next five years

- In the years before the financial crisis, average discretionary incomes were growing strongly at both lower income and higher income households. Discretionary incomes rose faster at lower income households in part due to the smaller level of spending power they have – meaning a given increase has a larger effect in percentage terms.
- However, once the financial crisis started, wage growth and employment both fell back, reducing the earning power of those on higher incomes in particular.
- Higher income households are typically more dependent on wages and salaries than lower income households. Benefits rose at a generous pace through the downturn, boosting the spending power of lower income households. In addition, increases to the income tax free personal allowance helped to strengthen the spending power of those on lower incomes in particular.
- In the next five years though, government policy has imposed a cap on growth in working-age benefits, limiting the increases in spending power that lower income households will see. At the same time, the labour market strengthens, boosting discretionary income for higher income households.

Average annual change in average nominal weekly household discretionary income, by time period



Source: Cebr analysis

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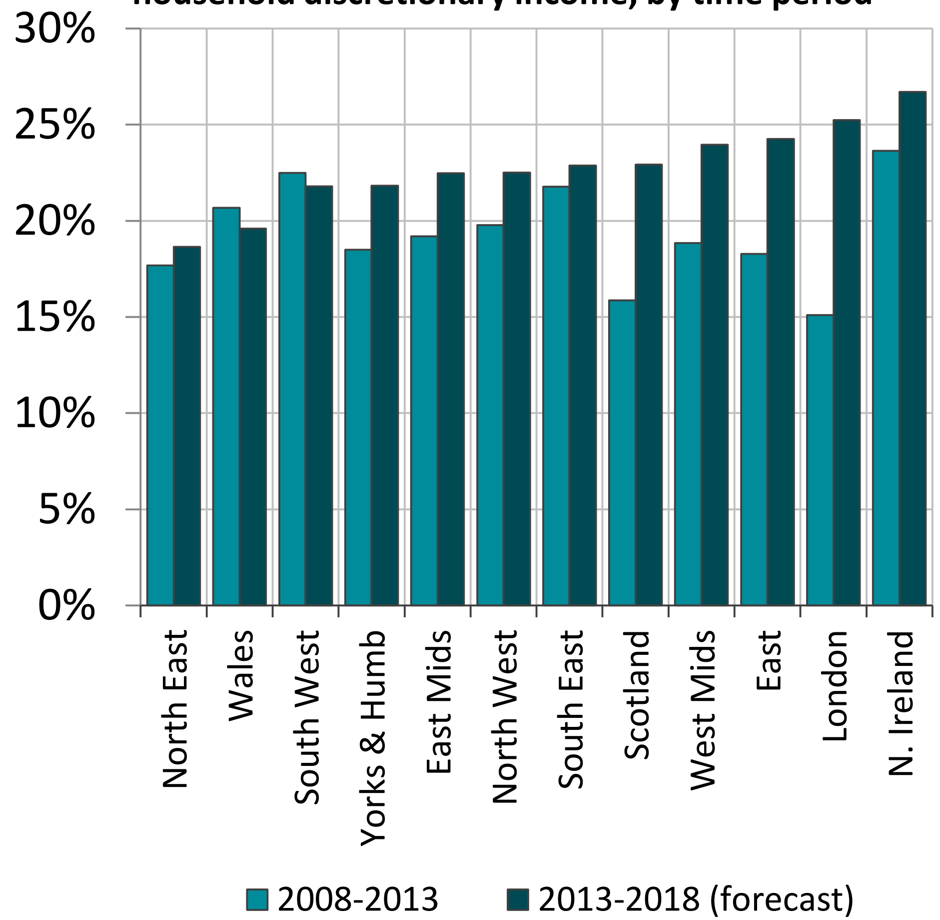
Discretionary income growth to be generally stronger across the South of England than elsewhere in the UK

- In the five years since 2008, regions that are generally more dependent upon social security benefits have seen household finances hold up better than in regions more dependent upon wages and salaries.
- For instance, discretionary incomes increased by 24% between 2008 and 2013 for the average household in Northern Ireland. Here, social security benefits make up roughly 17% of household income on average.
- This compares to an increase of just 15% in London, where benefits make up just 10% of the average household's income.
- However, over the coming five years, it is those regions more dependent on the private sector, such as London and the East of England, that are expected to see household incomes perform most robustly.
- However, discretionary incomes in Northern Ireland are very sensitive to growth in the cost of essential. As such, with very low inflation expected ahead, discretionary incomes in Northern Ireland are expected to rise relatively strongly in percentage terms, although remain much lower than the rest of the UK in absolute terms.

Overall change in average nominal weekly household discretionary income, by time period



Source: Cebr analysis

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Method notes

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Method notes

- The analysis in this report draws from Cebr's in-house macroeconomic forecasting, as well as from forecasts provided by the International Monetary Fund (IMF), Bank of England, HM Treasury and Office for Budget Responsibility (OBR).
- The analysis on household discretionary incomes draws on Cebr's work on the Asda Income Tracker, a monthly publication that follows developments in the spending power of average UK households.
- Figures on StepChange clients are drawn directly from StepChange's internal databases, with number crunching carried out at Cebr's end.

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