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In-Depth Review for the UNITED KINGDOM

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

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EXECUTIVE SUMMARY AND CONCLUSIONS

This in-depth review takes a broad view of the UK economy in order to identify actual or potential imbalances and the possible macroeconomic risks which they may entail. It should be acknowledged that the UK has embarked on an ambitious fiscal consolidation plan since June 2010 and many structural reforms have been implemented in recent years. However, macroeconomic risks from high private debt remain, fiscal consolidation is necessary but challenging and the effects of structural reforms, such as those linked to the planning system and the national infrastructure plan, have yet to materialise. The main observations from this review are:

- **The high levels of household debt cumulated over the past decade are linked closely to high house prices and represent an important imbalance in the UK economy.** Household debt has been increasing steadily over the past decade, though it has declined somewhat since its peak in 2009. Highly indebted households are vulnerable to rises in interest rates or in unemployment, with potentially destabilising effects – should household insolvencies be pervasive – on the economy at large, namely via the financial sector. The widespread use of variable-rate mortgages in the UK may amplify the financial risks of households as it heightens their sensitivity to interest rate rises. Household indebtedness may be further exacerbated if house prices increase again, especially in relation to disposable income. While there are currently few indications that housing demand or interest rates would surge in the near future, the insufficient and rigid supply of housing in the UK exposes the country to higher and volatile house prices. Households are now undergoing a deleveraging process and the government has published plans on how to increase the housing supply which should reduce risks going forward, especially if disposable income also recovers. As results are only likely to be observed in the medium term, close attention to developments in the short term is warranted and additional policy steps could already be considered to reduce the emergence of further risks.
- **The noticeable underperformance of the UK as regards external competitiveness and export developments also deserves attention, although its potential macroeconomic risks appear less pressing than those arising from internal developments.** Losses in global export market shares were driven, in particular, by both temporary and structural factors. Among the former are a rapid depreciation of sterling in 2008, which caused an immediate short-term decrease in export values, a marked drop in financial services exports in the wake of the financial crisis and the negative effects of a strong value of sterling in the decade to 2007. Given their temporary nature, and the fact that their effects have been fading, these factors do not imply per se significant risks of instability. Structural factors have, however, also caused UK export shares to decline. The emergence of strong new international competitors has meant a decrease in international market shares for most mature western European economies which, however, has been larger for the UK. In fact, UK manufacturing exports lag significantly behind services exports as well as global trends. Additionally, the UK has remained focused on slower-growing traditional export markets and unit labour costs have increased above euro area trends. While the cumulated negative effects of unit labour costs on competitiveness have been largely offset by the recent depreciation of sterling, a continuation of the on-going correction and rebalancing towards the external dimension of the economy and towards more dynamic

markets would contribute to further improve the UK current account. Overall, the external underperformance of the UK merits addressing by the authorities with a view to boosting productivity, particularly in the manufacturing sector, which desirably should outpace compensation growth.

- **The government deficit, although decreasing, remains elevated while government debt is high and increasing.** The UK is currently subject to the Excessive Deficit Procedure of the Stability and Growth Pact and to Council recommendations which frame the adjustment to be undertaken. The government has implemented a fiscal consolidation programme which they plan to continue until 2016-17. These developments are discussed in detail in the assessment of the UK Convergence Programme.

In this context, **the in-depth review concludes that the UK is experiencing macroeconomic imbalances, which are not excessive but need to be addressed.** In particular, macroeconomic developments in the areas of household debt and the housing market deserve attention, as do unfavourable but less pressing developments in external competitiveness, so as to reduce the risk of adverse effects on the functioning of the economy.

Possible areas for relevant policy responses include increasing housing supply, improving the functioning of the housing market and discouraging excessive and risky lending. The government is reforming the planning system with the aim of supporting an increase in housing supply, which should help to reduce house prices and with it the future level of associated mortgage debt. Sustained government commitment to effective implementation would ensure that the reforms announced in the housing strategy document and national infrastructure plan deliver positive results. Further simplifying the planning system or altering the property taxation system could improve the functioning of the housing market, contribute to stabilising house prices and budget revenues, and provide better incentives for labour mobility and efficient capital allocation. Fostering prudent lending, reducing incentives for households to take on excessive levels of debt, and improving their financial information and risk awareness, would lower the demand for mortgages at high loan-to-value ratios or high income multiples, which both raise house prices and leave households and the financial system most vulnerable. This can be partially achieved by improving credit frameworks, namely to better assess the financial soundness of mortgage applicants as recently proposed by the Financial Services Authority. As regards external competitiveness, the exporting sector could benefit from improved transport infrastructure given the UK's constraints in this area. Furthermore, improving training and education in order to equip more workers with high-quality vocational and technical skills could help boosting labour productivity growth in the industrial sector, which has been relatively weak in the past decade.

1. INTRODUCTION

On 14 February 2012, the European Commission presented its first Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device, helping to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth

reviews” should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists and what type of policy follow-up it will recommend to the Council.

The AMR suggested the need to look more closely at whether the UK is suffering from macroeconomic imbalances of an internal and external nature. The AMR noted that, on the internal side, the high level of private debt is a concern, also in a context of a weak public finance situation with high and increasing government debt. The high value of private debt largely reflects household mortgages in a context of high accumulated increases in house prices. While both the levels of real household debt and real house prices have reduced, they still remain comparatively high which suggests that their unwinding has further to go where the speed of adjustment is an important aspect. On the external side, the UK lost export market share over the last decade, although some stabilisation can be noted in recent years. This loss of market shares took place despite a substantial depreciation of sterling between 2007 and 2009. At the same time and since 1997, the UK recorded small but significant current account deficits albeit below the indicative threshold.¹

The purpose of the present in-depth review is to investigate the findings presented in the AMR and to ascertain whether macroeconomic imbalances of either an internal or external nature effectively exist in the UK and, if so, whether they are excessive in the meaning of Regulation no. 1176/2011.

Sections 2 and 3 of this review analyse the existence and nature of potential macroeconomic imbalances in the UK. Section 2 takes a broad perspective of the UK economy, while section 3 focuses on two potential areas of concern for the UK: household debt and the housing market on the one hand, and external competitiveness on the other hand. Section 4 presents possible policy considerations.

2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

2.1. Macroeconomic scene setter

The run-up to the international economic and financial crisis in the late-2000s saw very dynamic developments in income and domestic demand in the UK, which fed an overheating housing market. House price-to-income ratios reached historical highs as loose credit policies and frameworks, as well as buyer competition for a rigid supply of housing, drove house prices rapidly upwards and contributed to the accumulation of high levels of mortgage debt. Excluding financial corporations, total gross **private debt** stood at 212% of GDP by year-end 2010. Households found themselves overleveraged once declining income streams, house prices and expectations took their toll.

The crisis hit the UK particularly badly. UK **public finances**, which had appeared relatively stable during the pre-crisis years, deteriorated quickly. The UK authorities

¹ The United Kingdom exceeded the indicative thresholds in four out of ten AMR scoreboard indicators in 2010. As regards external imbalances and competitiveness, the UK was flagged given a 3-year change of -19.7% in the real effective exchange rate and a 5-year change in export market shares of -24.3% (the lower bounds set in the AMR were -11% and -6%, respectively). As concerns internal imbalances, the UK exceeded the debt indicators of both the private sector (212% of GDP versus a threshold of 160%) and the public sector (80% of GDP versus a threshold 60%).

had to intervene extensively in the large, open and highly leveraged financial sector through nationalisations, capital injections and guarantees which, alongside lower tax revenues and the operation of automatic stabilisers elicited by the economic downturn, quickly raised government debt as a percentage of GDP from 44% in 2007 to 80% in 2010².

On the **external side**, the UK has experienced a secular trend of small but significant current account deficits averaging 2.2% in the decade to 2010 which had built up to a negative international investment position (IIP) of 23.8% of GDP by the end of that year. Although most EU Member States have lost international market shares due to fierce competition from emerging economies, the UK fared particularly badly with a drop of 24% in the five years to 2010. The reasons for the external underperformance of the UK are more diverse than those explaining its internal developments. UK goods export growth has lagged behind world trends since the late 1990s, while UK service exports have been more dynamic. Additionally, rising unit labour costs (ULCs) and a strong pound in the decade to 2007 contributed negatively to external competitiveness. However, these developments were partly offset by the nominal depreciation of sterling which took place during 2008 and 2009, and which drove the real effective exchange rate (REER) downwards by about 20 pps. In fact, nominal depreciation had an immediate negative price effect on relative export values while the ensuing positive effect on export volumes has been slower to materialise.

The **labour market** experienced a significant shock in the wake of the crisis with the unemployment rate moving from 5.4% in 2006 to 8% in 2011 and youth unemployment reaching historical highs (22%).³ However, the labour market performance of the UK remained somewhat more resilient than that of the EU as a whole due to a low number of business insolvencies, labour hoarding by British firms and the high degree of flexibility of the UK labour market which facilitated transfers from full-time to part-time employment. The counterpart to a resilient labour market in a context of negative growth has been a sharp drop in productivity, which largely accounts for the gap with respect to potential growth.

Overall, the UK is considered to have a generally **flexible economy** when compared with international peers. Flexible labour markets allow for the adjustment of labour costs as a possible path to regaining competitiveness. Monetary policy remains a possible instrument, although the inflation targeting mandate of the monetary authority severely restricts its discretionary use.

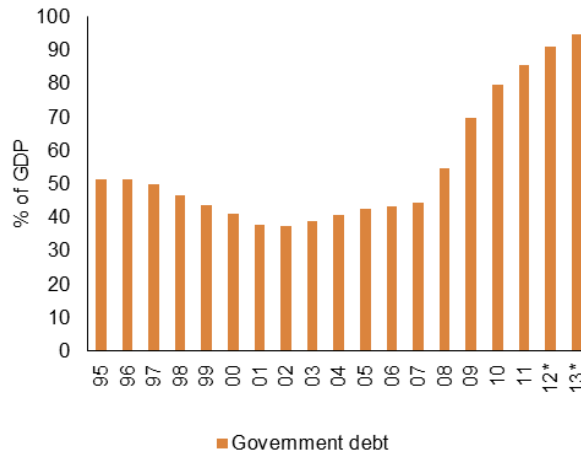
2.2. Government indebtedness

The MIP scoreboard highlights both private sector and government debt as areas of concern in the UK economy.

² Eurostat-validated data.

³ Eurostat data (Labour Force Survey).

Graph 1: UK government debt



Source: Commission services' (incl. forecasts)
* Forecast

While government debt has been increasing at a fast pace from 44% of GDP in 2007 to 86% in 2011⁴ (Graph 1), the situation is expected to improve with the government taking steps to reduce the deficit and debt by introducing new fiscal rules. However, performance against the fiscal objectives, including those of the excessive deficit procedure, has been affected by poor growth prospects. The debt ratio grew as a result of increases in government expenditure from the early 2000s, public interventions in the financial sector from 2008, along with a general economic weakness and the 2008 and 2009 recessions reducing tax revenues in recent years. The government adopted strong consolidation plans in 2009, which were accelerated further by the new government in 2010. The latter also set up two new fiscal rules in order to deal with the problems in the public finances. The 'fiscal mandate' requires that the cyclically-adjusted current budget (i.e. excluding investment expenditure) be on track to be in balance by the end of a rolling 5-year forecast period, currently ending in 2016-17.⁵ Furthermore, this is supplemented by a debt sustainability target which currently requires that public sector net debt target as a percentage of GDP be falling by the fixed date of 2015-16. The government has indicated that it will consider a more stringent debt target once it has made progress with the current fiscal consolidation.

After a deficit of 8.4% in 2011-12, the Commission services' Spring Forecast estimates the deficit to be 6.1% in 2012-13 and 6.5% in 2013-14, with government debt forecast at 91.8% in 2012-13 and 94.7% in 2013-14. The government has continued with its fiscal consolidation plan and introduced measures in the Autumn Statement 2011 in order to adhere to its fiscal mandate and debt target. This did not change the size of the existing consolidation package but altered the timing and composition of them. Furthermore, the 2012 Budget was fiscally neutral.

The EDP deadline for the UK is 2014-15 but this year has not been included in the Commission services' forecast. Nevertheless, the current estimate from the Office for

⁴ Eurostat-validated data.

⁵ Here and throughout, 20xx-xx refers to the UK fiscal year which begins on 1 April and ends on 31 March.

Budget Responsibility (OBR) is that the UK will miss their target by one year. Although the government has so far stuck to its fiscal consolidation plans, which initially appeared sufficient to correct the excessive deficit, poorer than expected growth prospects have affected the fiscal outlook. The OBR forecast the deficit at 4.4% of GDP in 2014-15 and 2.9% in 2015-16, and the debt at 92.7% of GDP and 91.4%, respectively. Further details on government debt and deficit dynamics are examined in the assessment of the Stability and Convergence Programme⁶ in the Commission Staff Working Document (2012).

2.3. Private sector indebtedness

Private sector debt⁷ as a share of UK GDP increased steadily and significantly, by 84 pps. since 1995, to reach 212% in 2010. This was well above the AMR threshold of 160% and the tenth highest among the EU-27. The ratio can be disaggregated into household debt of 100% and debt of non-financial corporations at 112%, as depicted in Graph 2.

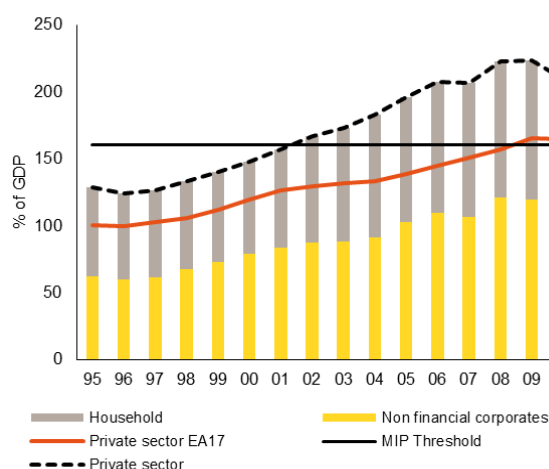
Corporate balance sheets remain strong despite increased leverage

The degree of leverage of UK non-financial corporations (NFCs) increased in the pre-crisis period and is moderately higher than for euro area counterparts. The increasing trend evidenced in Graph 3 can also be observed in other EU countries and the euro area. At 112% of GDP in 2010, the unconsolidated debt of UK NFCs was somewhat higher than the euro area figure (100%). The corporate debt-to-equity ratio increased rapidly in the early 2000s due to the burst of the international dot-com bubble and a fall in the UK stock market. It remained stable at higher levels during the pre-crisis years as the economy recovered and companies took on more debt. Debt-to-equity spiked in 2008 due to temporary valuation effects from a drop in the stock market. By contrast, the NFC debt-to-financial-assets ratio has remained broadly stable since 1995.

⁶ The main aspects relating to Member States' public finances are covered extensively by specific EU procedures and legislation (namely, the Stability and Growth Pact and the Excessive Deficit Procedure). The UK Convergence program can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm.

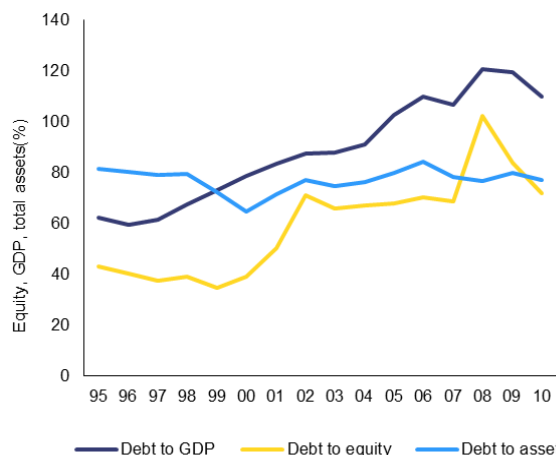
⁷ The AMR indicator on private sector debt comprises gross non-consolidated debt of households and non-profit institutions serving households, and the corporate sector, excluding financial corporations.

Graph 2: Private sector debt dynamics



Source: Commission services

Graph 3: Leverage indicators of UK non-financial corporations



Source: Commission services

The fact that UK NFCs appear more leveraged than euro area companies can be explained by a number of structural features of the UK economy. UK corporations are larger on average and include an important share of multinationals. These characteristics tend to be associated with higher degrees of leverage. Additionally, UK bond markets are comparatively well-developed, with companies relying more strongly on wholesale debt markets than in other countries. Finally, it should be noted that corporate debt figures are unconsolidated.⁸ As the corporate sector in the UK is likely to be more integrated (e.g. involving more use of inter-company loans), unconsolidated debt figures are bound to be higher.

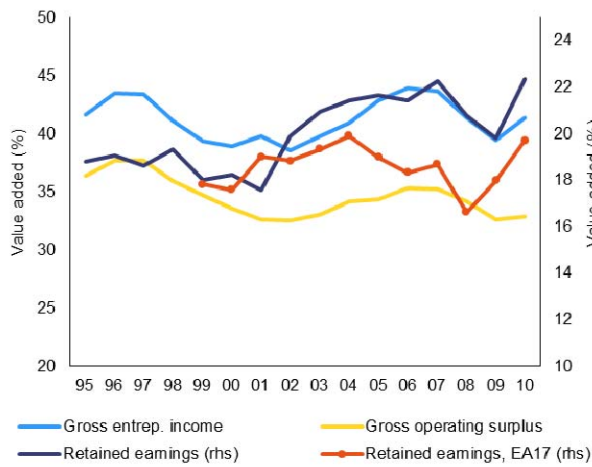
UK companies started actively deleveraging in the wake of the financial crisis. The debt-to-GDP ratio peaked in the recession years of 2008 and 2009, partly due to the 'denominator' effect of a GDP contraction. It has improved since 2008 as can be observed in Graph 4, decreasing by about 5.5%. In fact, NFC credit growth turned negative in 2009 as firms paid down their debts.

UK NFCs have accumulated significant surpluses in the past decade and the balance sheet of the corporate sector as a whole does not appear to have fed imbalances in the economy. As evidenced in Graph 4, corporate savings in the UK (as measured by the ratio of retained earnings to value added by NFCs) have decoupled from euro area averages since 2002 and have remained significantly above the euro area ratio, as well as above the ratios of other large EU economies such as Germany, France and Italy. In fact, the UK corporate sector has been in a net lending position since 2002, as can be seen in Graph 5.⁹

⁸ Consolidated debt figures from national accounts are not available for the UK.

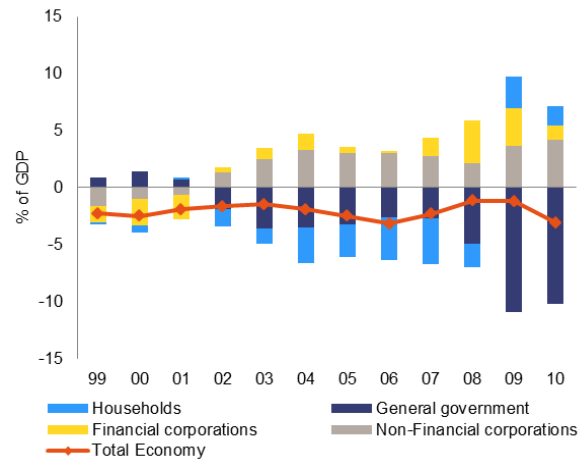
⁹ Notwithstanding the comparative strength of the UK corporate sector as a whole, the balance sheet of some specific subsectors, and in particular commercial real estate, show signs of weakness in the wake of the current crisis.

Graph 4: Profit margins of UK non-financial corporations



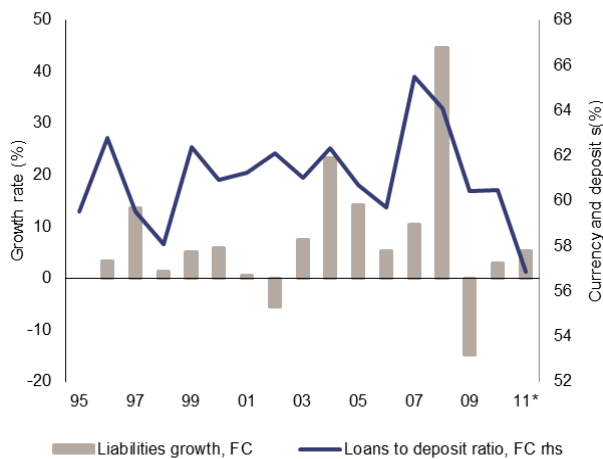
Source: Commission services

Graph 5: Net lending/borrowing by sector



Source: Commission services

Graph 6: Financial corporations leverage indicators



Source: Commission services

* Estimated

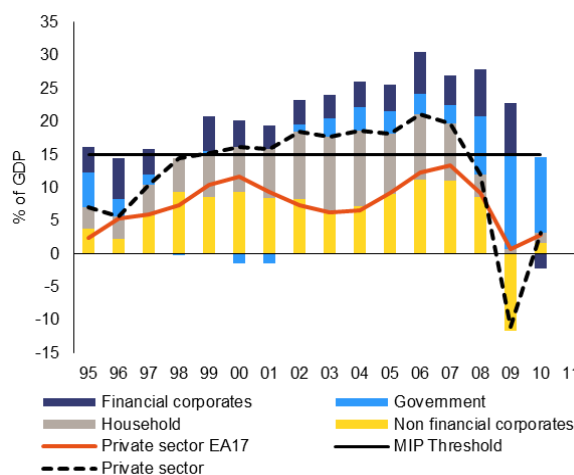
Corporate investment has so far failed to deliver its full potential as an engine of recovery in the present context of subdued private and public consumption. In fact, investment rates have remained among the lowest in the EU-27. This is due not only to the structural features of the UK economy but also to the combined effects of an uncertain and unfavourable economic environment and difficulties in accessing finance (mainly on the part of small and medium enterprises). In fact, credit conditions became tighter and spreads increased in the wake of the crisis, even though official rates dropped to historical lows and UK NFCs benefit from the high creditworthiness of the UK sovereign. Difficulties in accessing credit have, in particular, motivated a country-specific recommendation by the ECOFIN Council¹⁰ to promote the availability of financing for the corporate sector.

¹⁰ Council recommendation of 12 July 2011 (2011/C 217/04).

Looking at financial corporations, their unconsolidated debt is exceptionally high, reflecting the role of the UK as a global financial hub, as well as the large size and high degree of integration of the UK financial sector. Although not included in the definition of private sector debt, the unconsolidated debt of the financial sector amounted to 357% of GDP by year-end 2010. After a period of turmoil in the wake of the 2008 crisis, which required large government interventions to guarantee the liquidity and solvency of several UK banks, the banking sector has stabilised. Credit default swap rates of UK banks remain contained at low levels and the solvency ratios of UK financial institutions were not identified as requiring further strengthening in the 2011 stress test and temporary bank recapitalisation exercises coordinated by the European Banking Authority.¹¹ In fact, the exposure of UK banks to sovereigns of EU countries under market stress is low (although the exposure to their private sector is more pronounced). Moreover, UK domestic banks face a comparatively low percentage of doubtful and non-performing loans and benefit from the creditworthiness of the UK sovereign, which retains a AAA rating from the three leading credit rating agencies. A process of deleveraging and credit retrenchment is noticeable since 2008, as banks started shrinking their loans-to-deposits ratio (Graph 6).

Household debt increased rapidly driven by mortgage lending

Graph 7: Decomposition of credit flows



Source: Commission services

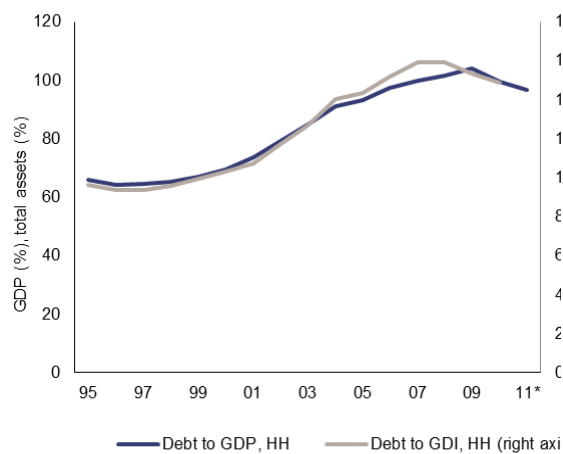
Of greater concern in the UK is the level of household debt which has risen quickly in the past decade from 69% of GDP in 2000 to a peak of 104% in 2009, though it has since fallen somewhat. UK household debt stood at 100% of GDP in 2010 against an EU average of 70%. In fact, the flow of credit to UK households in the pre-crisis years was abundant, averaging 8.7% of GDP per annum in the decade to 2007 compared to just 3.8% for the euro area (see Graph 7). This, combined with the similarly-sized credit flows of NFCs, which averaged 8.9% in the same period, led the UK to exceed the 15% MIP threshold for private sector credit flows every year in the pre-crisis period. A process of household deleveraging has become apparent since 2009, with the credit flow to the household sector almost coming to a halt. The loans-

¹¹ The results of the stress tests coordinated by the European Banking Authority support similar results of the Financial Services Authority, the UK supervisor.

to-disposable income ratio peaked at in 2008 (Graph 8) and had come down to 140% by the third quarter of 2011, a value close to 2005 levels.¹²

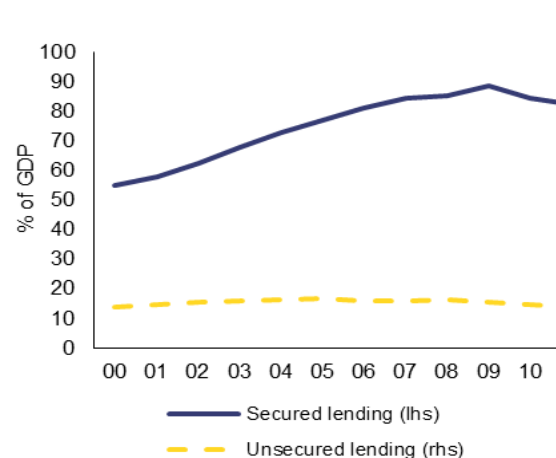
The steep increase of household debt in the pre-crisis period is mainly attributable to lending secured on dwellings, where its ratio peaked at 89% of GDP in 2009. This is shown in Graph 9. By year-end 2011, mortgages still represented about 86% of all household debt, equating to 83% of annual GDP. Unsecured lending (i.e. consumer credit) does not appear to pose a threat to macroeconomic stability as it grew modestly during the boom to reach a peak of 17% of GDP in 2005, and has now fallen to less than 14%. This is likely to be linked in part to an increase in the household saving rate, which more than doubled to 7.5% in 2010 when compared with the historically low levels of 2004-2008, when it averaged just 3.2%.

Graph 8: Household leverage indicators



Source: Commission services
* Estimated

Graph 9: Lending to the household sector



Source: Bank of England

2.4. Housing market developments

The main issue regarding private sector debt in the UK stems from the high value of household mortgage debt. This implies that there is a fundamental link between UK private debt and the UK housing market. In fact, in the years preceding the 2008 financial crisis, the increase in household debt followed *pari passu* that of house prices, as households took on increasingly larger mortgage loans to finance the acquisition of increasingly expensive properties. In particular, the Eurostat house price index¹³ rose continuously in real terms from a trough in 1995 to a peak in 2007, appreciating more than 150% during this period. A heating-up period is especially noticeable between 1998 and 2007 when real UK house prices rose on average 9.4% per year. A correction phase can be observed since 2008 when house prices started decreasing, although they have since stabilised. Graph 10 illustrates the recent

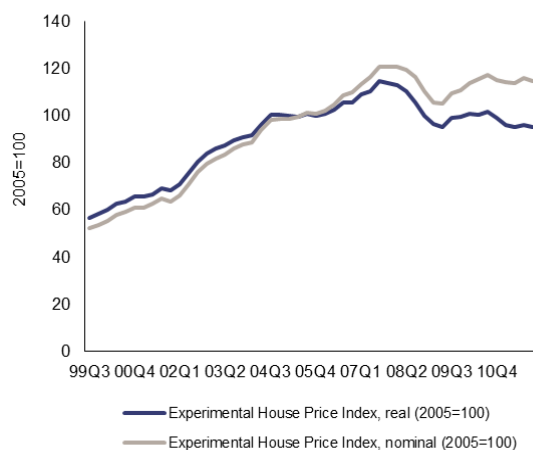
¹² European Central Bank data.

¹³ The house price index was obtained from Eurostat and complemented with OECD data for missing years. The real house price index was obtained by deflating nominal house prices with the household final consumption deflator.

evolution of UK real and nominal house prices based on the Eurostat house price index.

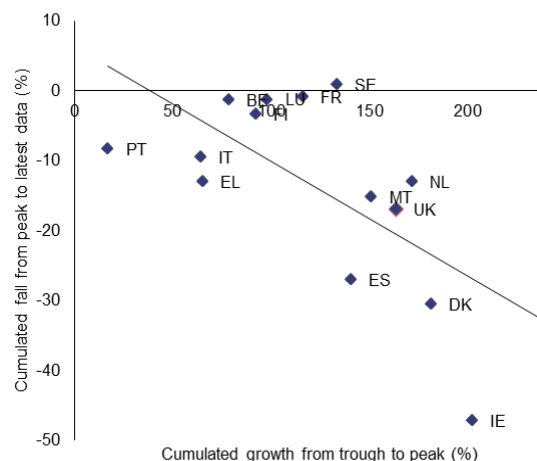
The UK appears to have undergone an adjustment in real house prices similar to that of most European countries which experienced a housing bubble, though with less of an impact on the external accounts. As shown in Graph 11, the upswing in the UK house price cycle was one of the most pronounced of all EU Member States, whereas the recent correction appears to be in line with other EU Member States experiencing housing market issues. By contrast, as can also be observed from Graph 12, housing market developments in the UK did not correlate strongly with the current account which, while negative, did not deteriorate markedly during the heating-up period. This differs from the experience of some other European countries where a housing bubble went hand-in-hand with a deteriorating current account.

Graph 10: Developments in UK house prices



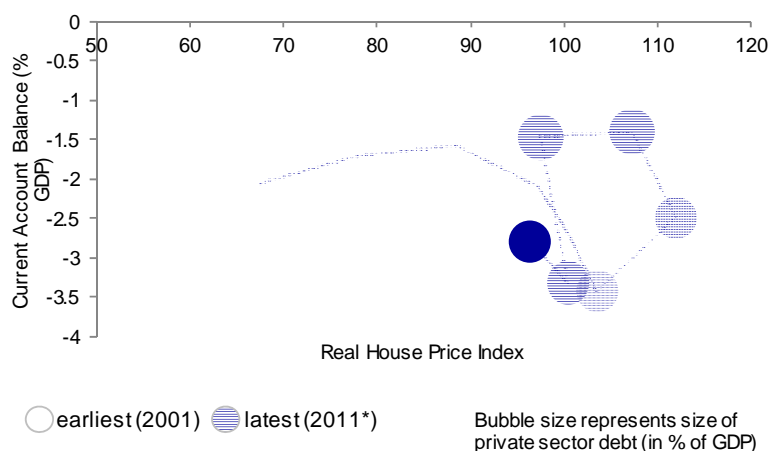
Source: Commission services, ECB, OECD

Graph 11: House price cycles (% growth of real house price index)



Source: Commission services, OECD and own calculations

Graph 12: Current account, house prices and private debt



Source: Commission services, OECD and own calculations
* Estimated

The marked appreciation in UK house prices was a result of the interplay between a rigid housing supply and a buoyant demand. The latter was fuelled by easy access to finance, loose credit frameworks, expectations of continued increases in house prices and incomes, government incentives for home ownership and government subsidies to renters. The housing supply shortage, however, played the most crucial role in driving up prices. Graph 13 shows the evolution of building permits and residential investment as a percentage of UK GDP. The latter variable averaged 3.4% between 1997 and 2011, broadly half of the euro-area figure for the same period (6.2%).

Unlike many EU countries that were subject to a housing bubble, the UK does not face an overgrown construction sector. On the contrary, strict planning laws in the UK have significantly constrained the ability of the housing supply to meet an expanding housing demand. In fact, the UK population grew 5.8% in the decade to 2011, a figure above EU and euro area averages.¹⁴ Although building permits increased from 2001 to 2006, they did so from a comparatively low basis and have since reverted to historically low levels.

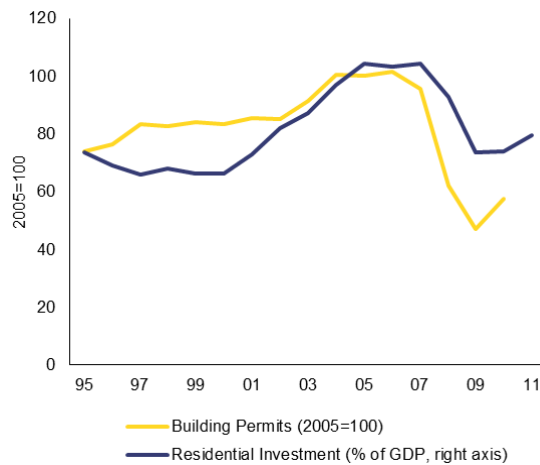
The structural features of the UK housing market reflect some unfavourable characteristics. As shown in Graph 14, while the owner occupancy rate of high income households is similar to the EU's, that of low income households is lower, reflecting the difficulties of low earners and younger households getting onto the "housing ladder" in the UK. The owner overburden rate¹⁵ is significantly higher in the UK (12%) when compared with EU or euro-area figures (8.7% and 7.1%, respectively), reflecting the high levels of mortgage debt in the UK. It should be noted that the exceptionally low levels of official interest rates currently flatter the owner overburden rate in the UK by decreasing the amount of household interest payments.

The private rental market is growing but does not appear to represent a solution to affordability problems. As shown in Graph 26 in section 3.1.2 the proportion of households in private rented accommodation has risen significantly, from 9% in 2000 to 17% in 2010. However, as set out in the next section, a growing proportion of households, more than 10%, are currently renting but aspire to own their own home. This suggests that private renting is still not seen as an attractive long term option in the UK, probably in part because most private rental contracts are short term and insecure. Social renting is concentrated among lower income households that cannot afford to buy a house and private renting among younger households who cannot fund the deposit required to take up a mortgage. Furthermore, as shown in Graph 14 the tenant overburden rate is more than 40% in the UK, much higher than the EU average. The high overburden rate appears to reflect the generally high cost of housing in the UK rather than any structural problems with the rental market since, as shown in Graph 24, rental yields are still significantly below their long term average and rents have been broadly stable relative to incomes. There is however scope to improve the functioning of UK housing rental markets. Rental subsidies provided through housing benefit have acted to increase effective demand and helped to bid up both private rental and sale prices of housing in high demand locations. Restrictions in and subsidies for social housing are barriers to labour mobility.

¹⁴ Euro-area and EU population expanded 5.2% and 3.9% in the same period, respectively.

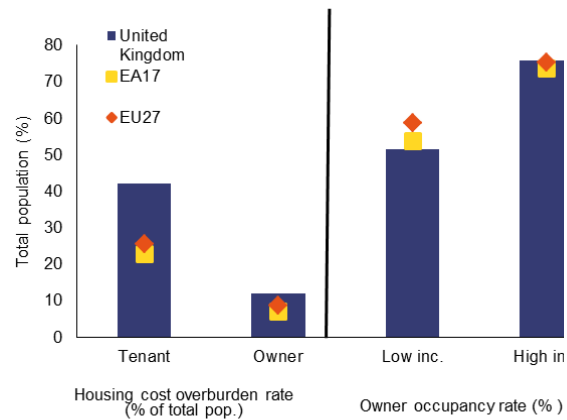
¹⁵ The housing cost overburden rate is the percentage of the population living in households where the total housing costs (net of housing allowances) represent more than 40 % of disposable income (net of allowances).

Graph 13: UK residential construction



Source: Commission services, own calculations

Graph 14: Structural features of the housing market



Source: Commission services

2.5. Competitiveness and export performance

Losses in export market shares have been a persistent feature of the UK economy and reached a particularly high level in 2007 and 2008. As evidenced in Graph 15, UK nominal market shares dropped markedly in 2007 (-8.3%) and 2008 (-10.1%), the cumulative change being flagged in the AMR scoreboard¹⁶ as breaching the -6% indicative threshold for a change over a 5-year period.

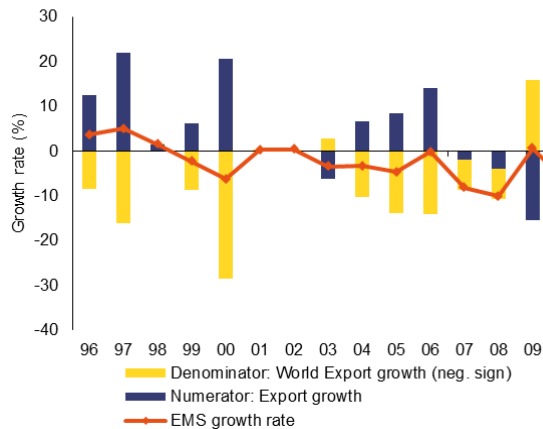
The drop in UK market shares is explained by a number of structural and conjunctural factors. Foremost among the structural factors is the fierce competition from emerging economies, a goods export sector that lags behind a more dynamic services sector and a significant increase in unit labour costs (ULCs) in the pre-crisis upturn.

In fact, the underlying loss in export market share experienced by the UK during the last decade is a feature common to most EU economies, in particular to EU-15 countries, although the UK's loss was particularly significant. Fast-growing and competitive emerging economies have quickly increased their exports and claimed global market shares, which translated into rapid world export growth and a strongly negative 'denominator' effect, as depicted in Graph 15.

Additionally, the UK has experienced a structural shift in its export mix since 1997, the last year that the current account was broadly balanced, as illustrated in Graph 16. Since then, the UK trade balance in goods has become increasingly negative while trade in services produced increasingly higher surpluses. However, the more dynamic services sector has been unable to fully compensate for a goods export sector which has lagged behind world growth trends. Besides driving a loss in export market shares, sluggish developments in goods exports have meant a negative trade balance in goods and contributed significantly to the UK trade deficit, which hovered between -2.5% and -3.5% during the 2000s.

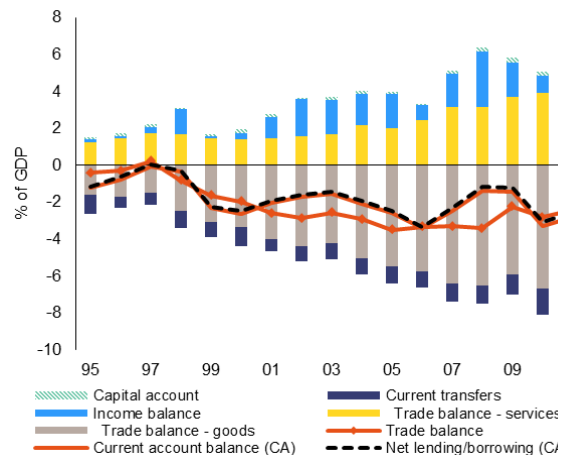
¹⁶ The AMR indicator on export market shares is calculated as total national exports divided by total world exports. Both figures are taken in value terms and converted to a common currency.

Graph 15: UK export market share growth



Source: Commission services, own calculations

Graph 16: Decomposition of the UK current account



Source: Commission services, own calculations

Finally, the increase in UK ULCs has been more pronounced than euro area ULCs in most years since 1998, as can be seen in Graph 17, delivering a negative contribution to external competitiveness during the past decade. Whereas in the pre-crisis years the increase in ULCs was largely driven by increases in real compensation, since 2008 nominal ULCs rose due to a drop in labour productivity in 2008 and 2009 as well as, to some extent, the spell of high inflation in 2010 and 2011. The decrease in labour productivity during the crisis years can be seen as a benign development which followed from the resilience of the labour market, limited business insolvencies and labour hoarding by UK firms. The negative effects on competitiveness and the real effective exchange rate (REER) of a 30% cumulated increase in ULCs in the decade to 2010 have been offset to some extent by the 25% depreciation of sterling that took place since 2007. More recently, real compensation per employee decreased, further evidencing the adjustment capacity of the economy.

Among the conjunctural factors driving a drop in market shares are a fall in financial services exports in the wake of the crisis, a decade-long period of a strong value of sterling and short-run negative price effects of the 2008-2009 depreciation.

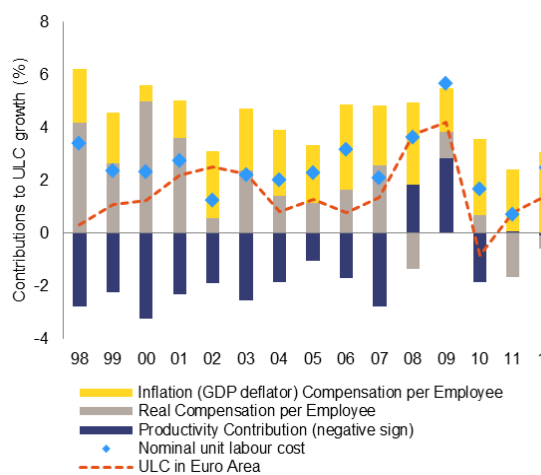
As regards insurance and financial services, their importance for service exports grew steadily both in absolute and relative terms from a share of total service exports of 13.5% in 1991 to a peak of 28.5% in 2008. However, these exports dropped noticeably and inevitably in the wake of the financial crisis and by 2010 represented 23.4% of total service exports, subtracting up to 0.3 pp. and 0.8 pp. from the current account in 2009 and 2010.

After a rapid appreciation in 1996 and 1997, the sterling nominal effective exchange rate (NEER) remained strong throughout the following decade. During this period the UK current account deteriorated visibly, in particular regarding trade in goods. A sharp drop in the NEER followed with the onset of the financial crisis. In fact, after having reached historically high levels during the first half of 2007, the NEER started on a downward path in the second half of the year which lasted until 2009. As

highlighted in Graph 18 a rapid depreciation of sterling and the NEER drove a similarly-sized depreciation in the REER.

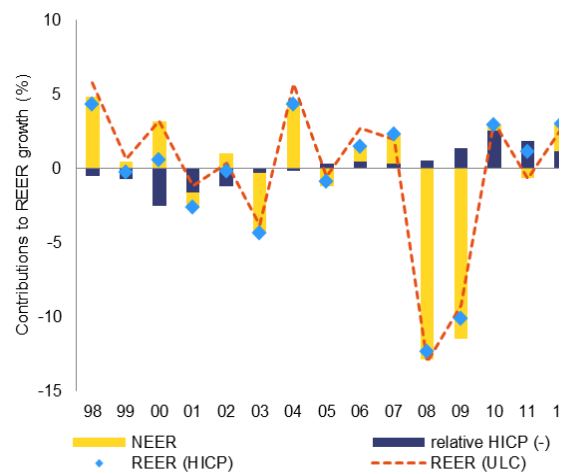
A depreciation of sterling implied *ceteris paribus* a decrease in UK export values measured in euro and thereby accounts to some extent for the record drop in market shares witnessed in 2008. However, a large drop in export market shares is still evident when controlling not only for the currency depreciation but also for the increase in export prices.¹⁷ Furthermore, the drop in export shares which took place in 2007 cannot be accounted for by an exchange rate movement as the sterling NEER, as well as the bilateral euro rate, remained broadly constant on average terms with respect to 2006.

Graph 17: Decomposition of developments in the UK ULCs



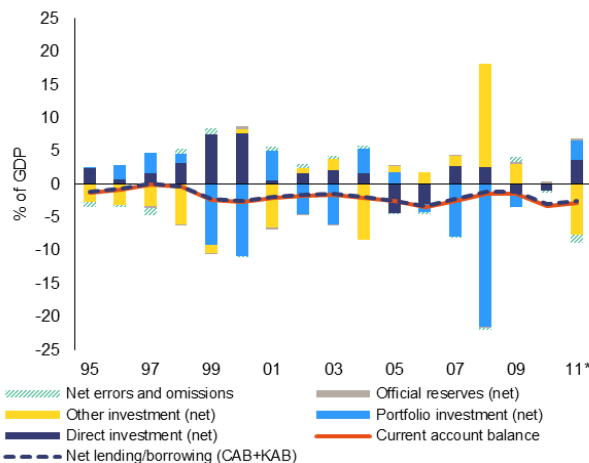
Source: Commission services, own calculations

Graph 18: Decomposition of developments in the UK REER



Source: Commission services, own calculations

Graph 19: Financing of the UK current account



Source: Commission services

* Estimated

¹⁷ UK exporters opted to partially offset the effects of the recent depreciation by increasing their prices in sterling terms, a development captured by an increase in the sterling-denominated export deflator.

The UK current account benefits from a structurally positive income balance, though this is partially offset by structurally negative current transfers. The UK has managed to derive a positive income from a negative net international investment position (NIIP), a consequence of the favourable composition of its NIIP and a testimony to the quality of UK foreign assets and production factors. However, income flows have decreased since 2008 due to the lower profitability of foreign equity assets in the wake of the crisis. Government transfer outflows¹⁸ and the UK's position as a net immigration destination¹⁹ have translated into significantly negative net current transfers.

The funding of the UK current account deficit shows a generally positive profile. As evidenced in Graph 19, the negative UK current account balance has been financed in most years by either portfolio investment into UK securities (i.e. bonds and shares) or by other investment in the form of unsecuritised funding (i.e. loans). The UK has been a net foreign direct investor in most years. The crisis year of 2008 stands out for its outflow in other investments, namely due to a flight of deposits, which was more than compensated by a marked inflow of portfolio investment. Historically however, the funding of the UK's current account does not appear to be dependent on portfolio investment, which registered net outflows in many years. In fact, overall funding requirements should decrease in the future as the current account continues to move to a more balanced position. The capital account plays a residual role in the UK's balance of payments.

The UK is undergoing a process of rebalancing and competitiveness adjustment which has already helped to support its external performance and is expected to continue to do so in the future. In fact, the REER depreciated markedly in 2008 and 2009 and real employee compensation has remained contained and even decreased in some years. Private agents have reinforced their savings and the government is implementing a fiscal consolidation plan to bring down the deficit and to tackle the high level of government debt. The negative trend of trade in goods has been halted, while the surplus of trade in services has continued to increase. The current account is forecast by consensus to continue to move to a more balanced position while the economy is expected to continue to rebalance towards the external sector.

2.6. Sustainability of external positions

The UK has a modestly negative NIIP. By year-end 2011, the UK NIIP amounted to about -13% of GDP,²⁰ well within the AMR threshold of -35%.

The composition profile of the UK NIIP is a favourable one whereby high quality assets, namely a positive net foreign direct investment position, have allowed the UK to derive net positive income inflows in the presence of larger but lower-yielding foreign liabilities. As can be seen in Graph 20, these have mainly taken the form of other investment and portfolio investment, as the UK benefited from an inflow of loans and deposits into its banks, and of funding to NFCs (namely in the form of bond securities), under generally favourable conditions. An inflow of foreign investment into government securities is particularly noticeable in 2010 and 2011

¹⁸ Such as international aid and contributions to international organisations such as the EU.

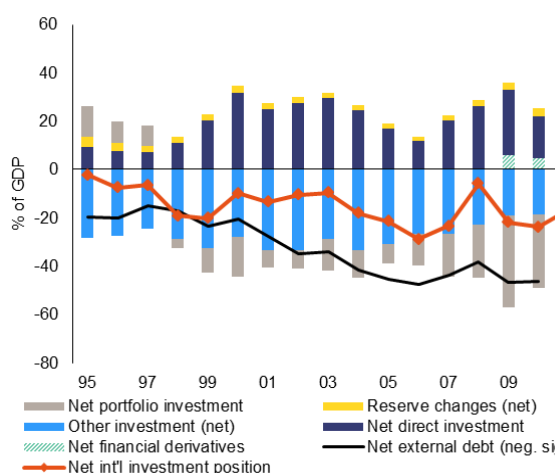
¹⁹ Immigration flows to the UK have been about 50% higher than emigration outflows in average terms over the past decade (Eurostat data).

²⁰ Eurostat data.

given the government's increased financing needs and the perceived 'safe haven' status of sterling in the context of the euro-area sovereign debt crisis. However, foreign investment into private debt securities changed little in the same period. It should also be noted that foreign direct investment accounting, which is typically based on book values, likely underestimates the size of the positive net position of the UK. Finally, the currency composition of the NIIP is a favourable one (most UK liabilities are denominated in sterling) and there does not appear to be any salient issues regarding maturity mismatches.²¹

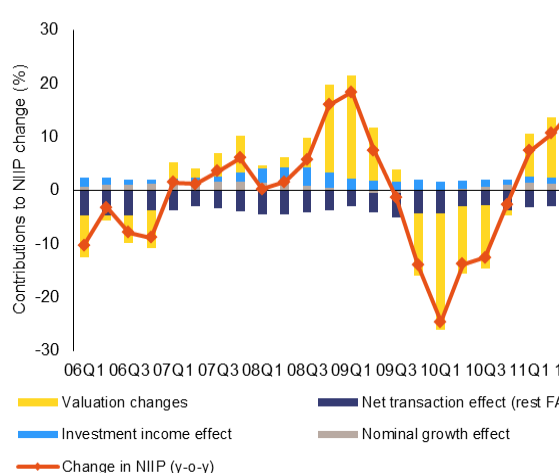
The UK NIIP has improved since a trough in 2006. However, its evolution is rather volatile, as is often the case across countries. This volatility is due to the effect of erratic valuation changes, as evidenced in Graph 21. In fact, the large improvement in the NIIP that is noticeable in 2008 was largely due to the depreciation of sterling, which increased the size of UK foreign assets in sterling terms.²² This effect partially reversed in the 2009 and 2010 as the UK stock market rebounded (part of which is counted as foreign liabilities) and the global financial crisis brought down the value of some UK foreign assets. As previously seen in Graph 16, a negative trade balance has contributed to the deterioration of the UK's NIIP²³, while positive foreign investment income flows have helped cushion the NIIP every year since 1996. The UK NIIP is not expected to worsen significantly over the forecast horizon according to Commission services' analysis, with the current account forecast to move closer to the NIIP-stabilising value.

Graph 20: Decomposition of the UK net international investment position



Source: Commission services
* Estimated

Graph 21: Decomposition of changes in net international investment position



Source: Commission services

²¹ For a discussion see Kuenzel, R (2011).

²² Due to the large share of foreign liabilities denominated in GBP, the positive effect from a valuation change in assets predominates.

²³ Counted as negative 'net transaction effects' in the IIP.

3. IN-DEPTH ANALYSIS OF SELECTED TOPICS

This section analyses two areas of potential concerns in the UK in more detail:

Household debt and the housing market; and
External competitiveness.

3.1. Household debt and the housing market

As set out in section 2 the relatively high level of household debt in the UK is linked mainly to mortgage debt. This section's further analysis considers the drivers and dynamics of UK household debt in three parts. It firstly focuses on relevant characteristics of the housing market, such as levels and developments in house prices, purchases and issues related to the functioning of the housing market, secondly on the impact of the latter on household debt, and finally on whether developments in household debt are a potential cause of macroeconomic instability.

3.1.1. *Characteristics of the UK housing market*

Tenure, supply and demand characteristics of the UK housing market and the UK government's policy response contribute to persistently high house prices.

The UK has a high rate of owner-occupation, which means a large proportion of households hold mortgages. As documented in section 2, with the UK's tight planning laws and scarcity of land available for house building, supply has been relatively unresponsive to demand and the UK now has a housing shortage. House prices rose sharply in the decade to 2007, driven both by a lack of supply and by loose financing conditions. The housing sector entered a correction path following the financial crisis, with prices falling by more than 10% from their peak in 2007 before stabilising again. However, house prices are still high relative to earnings and affordability remains stretched. The UK government is engaged in a major reform of the planning system aimed at increasing supply but this will take time to feed through to the overall size of the housing stock and its impact is uncertain.

High level of home ownership driven by preferences, historic capital gains and government policy

The UK housing market is dominated by home-ownership. In 2010, 70% of UK households were owner-occupiers. Three fifths of the remaining 30% renters were in subsidised rental accommodation. The UK home-ownership rate is similar to the EU average (70.7%), well above the ratio in Germany (53.2%) and France (62%) but much lower than in many of the newer EU Member States such as Romania (97.5%) and Lithuania (93%).

Owner-occupation has always been a politically charged topic, with UK governments tending to promote high rates of home ownership as a desirable goal. The rate of home ownership rose sharply in the 1980s, driven in large part by the Right to Buy scheme under which tenants in state-owned houses were able to buy their homes at discounted prices. Historically, mortgage interest relief at source (MIRAS) provided tax relief on mortgage interest payments and an effective subsidy for the purchase of a primary residence. MIRAS was gradually reduced from 1991 and abolished entirely in 2000.

Home ownership, which rose until the early 2000s before levelling off, has recently fallen. In periods of strong house price rises, demand to purchase (rather

than rent) housing has also been driven by an expectation of further house price rises, both to avoid 'missing out' on potential capital gains and due to concerns that in future housing would become even less affordable. Until 2007 the increasing availability of mortgage finance helped to open up debt-financed home ownership to a wider range of people. As set out below, the rate of home ownership has fallen in recent years due to limited affordability for first time buyers.

Housing is a key investment for most households. For the 70% of UK households who are owner-occupiers, residential property is typically a household's largest asset and a mortgage typically its largest liability. In November 2011, the share of outstanding lending to households secured on dwellings was 85.7% of all household debt and this ratio has been quite constant in recent years. The remaining debt is in the form of consumer credit.

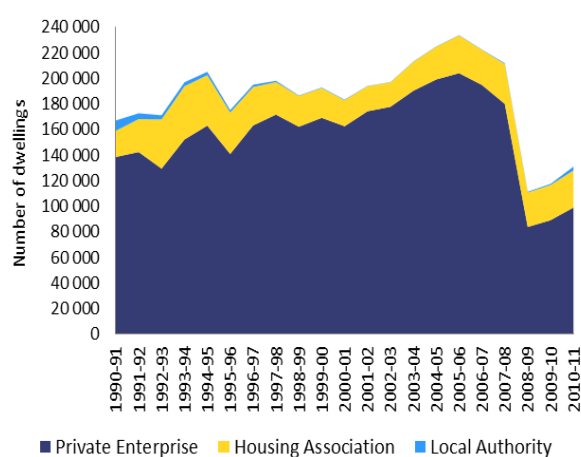
Housing supply has not kept pace with growing demand, due largely to government policy

Government policy has contributed to tensions in the housing markets. While successive UK governments have taken action to support both housing supply and demand in response to the decreasing affordability of housing, on the whole **UK policy has continued to tightly restrict housing supply, especially in areas of high housing demand.** The UK has a rather rigid planning system and the poor functioning of the land market is at odds with its generally flexible market economy. According to the National Audit Office, planning laws create the highest regulatory costs of any type of regulation in the UK. This constitutes a barrier to investment, growth and efficiency as it has put tight restrictions on the supply of land for development, along with a high degree of regulatory delays and uncertainty, which raises the cost of new and existing property.

The UK now has a housing shortage, which contributed to house prices rising to a high level relative to earnings. Residential investment is low given high property prices and the response of housing supply to demand in the UK has been one of the lowest among OECD countries over the last twenty years.²⁴ Many groups, mainly existing home owners, have benefitted financially from the increase in housing wealth that a scarcity of housing supply has brought. This has often contributed to political opposition to development from existing residents at a local level, where most decisions on residential development applications are made, especially where prices are highest.

²⁴ OECD (2011).

Graph 22: UK dwelling completions by type



Source: Department for Communities and Local Government (DCLG)

Demographic trends and preferences will continue to generate a growing and geographically concentrated demand for housing. The UK's population in 2010 was 62.3 million, an increase of 5.3% since 2001, and in recent years the UK population has grown more quickly than at any point in the last forty years. From 2012 to 2035 the UK population is projected to grow by 17.6%, and **the number of households in the UK is projected to increase by an average of around 250,000 or nearly 1% per annum for the next 25 years.**²⁵

Housing supply is unlikely to match demand in the near term. Given the projected increase in the number of households and the need to replace housing that has been demolished, the rate of house-building will have to increase dramatically to match the growth in demand. As shown in Graph 22, the completion of private enterprise dwellings has fallen dramatically, by close to half, since 2007-08, reflecting difficulties in the construction and financial sectors. Even at its pre-crisis peak, residential construction was not keeping up with the overall growth in demand and construction has not necessarily been concentrated in the areas of highest demand. Declining affordability is the clearest impact of a lack of supply, and evidence of supply constraints is also shown by the small size of new UK dwellings compared to other European countries.

House prices rose to historically high levels on the back of the supply shortages and loose lending standards

As set out in section 2 and shown in Graph 10, **the average house price in the UK rose sharply and almost continuously relative to earnings for eleven years from 1996 to 2007.** In a rising market, banks were willing to lend at high earnings multiples and loan-to-value (LTV) ratios and consumers anticipated capital gains from house purchases, creating the conditions for a house price bubble. The housing sector has entered a correction path in recent years, with prices falling by more than 10% from 2008 through 2010 since their peak in 2007, but house prices remain high relative to earnings.

Housing affordability remains considerably stretched

²⁵ Department for Communities and Local Government (2011).

Households on average incomes cannot afford to buy a house across large parts of the UK. Between 2001 and 2010, the (simple) average house price in the UK increased by 123% whilst the average income of borrowers increased by only 71%. Average house prices as a multiple of average income increased dramatically (Graph 23) from 4.9 in 2000 to 8.2 in 2007, before falling to 7.1 in 2010. While house prices have continued to be highest in London and Southern England, affordability is now stretched across large parts of the country. In 2000 only 6% of local authorities had affordability ratios²⁶ of over 7.7, while by 2010 this had increased to 44% of local authorities.²⁷ In 2001, the average loan-to-value ratio for all buyers was 68% but this fell to just over 60% by 2010. The growing inability of potential first-time buyers on average incomes to buy a house out of their own income is demonstrated by a fall in the average loan-to-value ratio for first time buyers from a peak of 90% in 1996 to just 56% in 2010. The proportion of first time buyers under 30 years old requiring financial assistance rose from 36 % in 2005 to 77% in 2010.

Social housing costs as a proportion of GDP are higher in the UK than in almost any other Member State. High house prices mean that large numbers of households are reliant on Housing Benefit, which both reduces work incentives and living standards for younger and poorer households and imposes a large fiscal cost on the government. In 2009, the government spent 1.08% of GDP on Housing Benefit, a subsidy for households renting social or private housing.²⁸ The share of households receiving subsidised rents (18.1% of all households) is the highest in the EU after Malta (18.5%), and is much higher than the EU average (11.4%) and Germany's 7.1%. The ratio had been declining since 2006 but rose again between 2009 and 2010. In the context of a housing market with increasingly restricted supply and a low response of supply to market signals, demand subsidies are likely to have further bid up house prices and rents (and therefore public spending) in high demand areas by making householders in receipt of Housing Benefit unresponsive to price signals.

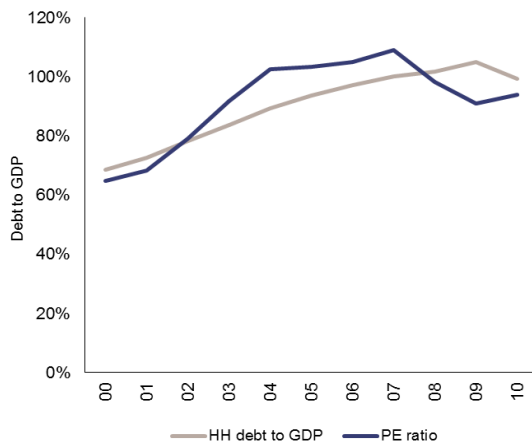
Rents have been much more stable than house prices. As shown in Graph 24, in the pre-crisis decade the sharp rise in house prices relative to incomes was not matched by similar increases in the ratio of average rents to incomes, which fell slightly. As a result price-to-rent ratios deviated markedly from fundamentals. The overall stability of rents masks pressures in the rental market. The number of people on waiting lists to be placed in subsidised housing has increased sharply in the past decade, from 1.04 to 1.84 million in England in the decade to 2011. According to Eurostat's 'housing cost overburden rate', 46.1% of the population in privately rented accommodation are overburdened compared to an EU average of 26.6% in 2010. All of this points to severely restricted affordability for UK households, and rising rents are likely to put a floor under house prices in the medium term.

²⁶ The ratio of local average house prices to local average earnings.

²⁷ HM Government (2011a), Figure 3.

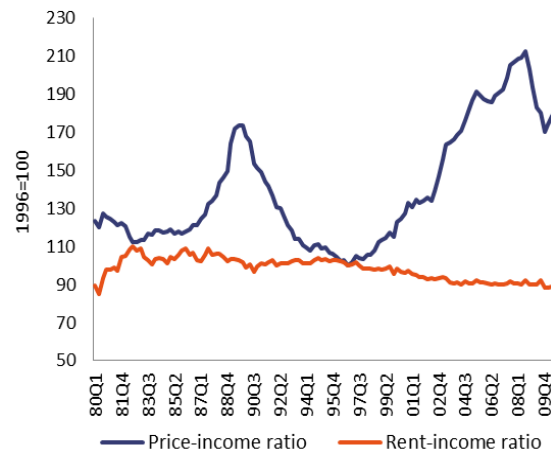
²⁸ The closest rival is the Netherlands which only spends 0.37% of GDP on social housing, followed by Ireland (0.35%) and France (0.31%). Eurostat figures.

Graph 23: Household debt and price earnings ratio



Source: Nationwide Building Society, ONS, DCLG

Graph 24: Price-to-income and rent-to-income ratios (1996=100)



Source: OECD

Planning reforms aim to address long term housing supply shortage but impact will be gradual and uncertain

The UK government is attempting to increase housing supply through a major and controversial reform of the planning system, which has contributed to the UK's housing shortage. In November 2011, it published its housing strategy for England which concluded that the housing market is not currently working as the supply of housing is not sufficient to satisfy current demand, and that the demand shortage is likely to worsen over time without action.

The government aims to increase housing supply through a range of measures including a presumption in favour of sustainable development. The reforms affect the control of residential, commercial and infrastructure development and aim to devolve more power to local authorities and simplify the process for securing planning consent. While the streamlining of the planning decision process is clearly positive, to date local authorities' response to the abolition of national house building targets has contributed to a record low volume of house building. A lack of confidence, access to finance and regulatory uncertainty are also restricting housing investment in the short term. In February 2012, the government introduced a financial incentive, the New Homes Bonus, to encourage local authorities to allow houses to be built in their area. Four major landholding government departments published strategies to release thousands of acres of surplus public sector land for development in October 2011.

The outcome of the planning reforms is uncertain and their impact will be gradual. The government's reforms are controversial and led to an extensive national debate, with many groups who benefit from a restrictive planning strongly opposed to the prospect of increased housing development. The National Planning Policy Framework (NPPF), published in March, confirmed the government's plans with some amendments that are likely to reduce its impact on future housing supply. There could also be difficulties with a lack of administrative capacity and local political will to implement a more streamlined planning system on the ground. However, if the new planning system is ultimately more supportive of development, in the medium to long

term it could deliver better-functioning UK land and housing markets, promote macroeconomic stability, support the rebalancing of the UK economy away from debt towards investment, and help to revitalise output and employment in the construction sector.

The government is also taking action to boost demand as a short term stimulus.

Currently a lack of confidence, financing constraints and regulatory uncertainty in the context of a weak recovery are holding back residential construction investment. Subsidies for the purchases of new build properties are also being introduced over the course of 2012, including a New Build Indemnity Scheme that will support buyers with small deposits to get mortgages with up to a 95% loan-to-value ratio. In the short term, this is a legitimate way of trying to kick-start a stalled market but in the longer term policy interventions designed to make mortgage finance more affordable or accessible could be counterproductive if implemented without effective supply side reform, as they risk just further bidding up the price of housing.

Tax policy has likely contributed to high house prices, but does not appear to be a potential source of housing market-related instability

The share of total revenues from property taxes is approximately 10% in 2010-11 in the UK, by far the highest in the EU. While, in general, the taxation of land ownership is considered as relatively economically efficient, there is some scope to increase the efficiency of UK property taxes.

Slightly over half is levied on residential property, comprising a recurrent Council Tax and a transaction-based Stamp Duty Land Tax (SDLT). Council Tax is paid by the residing tenant or landlord, where the amount due is set according to property price bands. Council tax is based on old valuation bands and the tax structure is regressive as the properties in the top band are at least eight times as valuable as those in the bottom band but pay only three times as much tax. SDLT²⁹ is charged on land and property transactions by bands based on the transfer price, with a progressive schedule of rates from 0% for the cheapest properties to 7% for the most expensive. SDLT is distortionary and highly cyclical. SDLT revenues halved from 1% of GDP in 2007 to 0.5% in 2009, contributing disproportionately to the growth of the UK budget deficit. Despite the pro-cyclicality of SDLT revenues, there is no evidence that it is effective in dampening the house price cycle. The property tax system could be made less distortionary with increased stability of receipts by a combination of either abolishing SDLT or setting it at a low flat rate, and changing council tax as a fixed percentage of the property value.

There are some further biases in the UK tax system towards home ownership, but mortgage interest is not deductible in the UK.

Rental income is taxable in the UK while imputed rents from owner-occupation are not. A combination of the exemption of primary residences from capital gains tax, and the exemption of the first GBP 325,000 of bequests from inheritance tax (now effectively GBP 650,000 for couples), means that capital gains from increases in house prices can be retained and transmitted inter-generationally with relatively little taxation³⁰. The increasing proportion of first time buyers who are assisted with deposits by family members has,

²⁹ Note that SDLT applies to all property so the yields discussed here include both residential and commercial property transactions. The recurrent property tax for commercial property is business rates, which are not discussed in this paper.

³⁰ This relative under-taxation of housing in other parts of the tax system is one argument for retaining some form of transactions tax such as SDLT.

in a context of restricted supply, enabled house prices to rise further than they otherwise could have done. However, the UK restricted the gradually abolished mortgage interest tax relief between 1973 and 2000, removing a significant bias in the tax system towards mortgage debt, which due to other factors did not prevent sharp rises in both house prices and debt. Overall the tax system does not appear to be a primary driver of high household debt and potential instability, although it could contribute to high house prices.

3.1.2. The links between the housing market and household debt dynamics and prospects

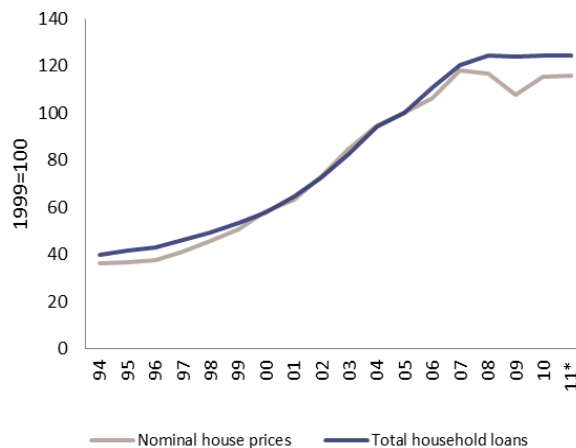
Developments in the UK housing market feed through into household debt through the dynamics of house prices, the home ownership rate, the level of property transactions, the loan to value (LTV) ratio for new house purchases and changes to the stock of existing debt (interest rates, speed of repayment, default rates). There is a very close link between house prices and household debt in the UK, so rising house prices did lead to a sharp rise in housing debt. Household balance sheets have begun to deleverage since 2009 as a lack of affordability and tight lending standards have reduced the volume and average loan-to-value of new mortgage lending, leading to a falling home ownership rate. For as long as housing market activity remains unusually subdued, a low level of new mortgage lending is likely to keep exerting modest downward pressure on the ratio of household debt to income.

In the medium term, household debt is likely to remain relatively high as the housing shortage keeps house prices high relative to earnings and a more 'normal' volume of new lending resumes. Compared to the early 1990s, when house prices fell significantly relative to earnings for a number of years, housing supply is tighter and interest rates are much lower. The UK Office for Budget Responsibility, an independent government body set up in 2010, forecasts the household debt-to-income ratio to remain broadly stable from 2012 to 2014. In contrast with the US, the stock of existing UK household debt has not been significantly reduced by default and repossession, largely due to low interest rates reducing the cost of servicing existing debts, but also because it appears that more checks on lending remained.

Household debt tends to track house prices, which remain high

The high level of private debt in the UK is driven to a great extent by the indebtedness of households. Of this household debt, approximately 85% is held in the form of mortgages and this rate has been quite constant in recent years; the remainder is in the form of consumer credit. Comparing household debt levels to nominal house prices, as shown in Graph 25, shows how closely they track each other. Thus, as long as the supply of houses in the UK is low and prices remain elevated then the prospects for UK household deleveraging may be poor for the foreseeable future.

Graph 25: House prices and household debt



Source: Commission services, OECD, own calculations
* Estimated

A correction phase can be observed since 2008, when house prices and private debt started decreasing. The household loans-to-disposable-income ratios decreased from a peak of 154% in 2008 to about 140% by year-end 2011. From the perspective of macroeconomic stability this is arguably a reasonable pace, striking a balance between the need to reduce risk exposure and the need to prevent consumption levels from contracting too fast in a low growth environment. As set out in Graph 11, most European countries which appear to have experienced a real estate bubble have since witnessed an adjustment in house prices.

This correction left households with a gap between their debt stock and the value of their housing assets. There is a debate over whether it is gross or net debt that matters for households, as changes in house prices in some sense represent a 'zero sum game' for the household sector as a whole. As the effects of high house prices are not evenly distributed among households, involving intergenerational transfers, and as high levels of debt can make purchasers financially vulnerable, it appears that gross household debt does matter and the history of house price booms and busts across countries shows significant impacts on the real economy.

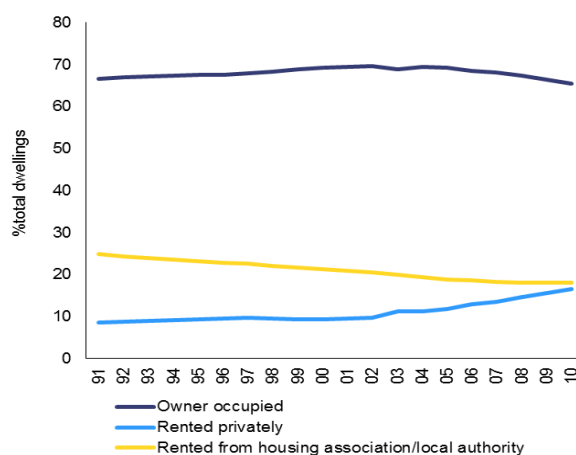
Overall, if house prices continue to remain high relative to income with restricted supply, households are likely to remain highly leveraged in the future. Household debt could in fact rise relative to income if house prices stay at current price to earnings ratios as the current debt level is based on only part of the stock of mortgage holders having purchased their houses at elevated price levels. Over time, high house prices would work their way through to a higher stock of mortgage debt at longer mortgage maturities than is the case now.

Increasing the housing supply, especially in London and the south east, would appear to be the most effective way for allowing UK house prices to fall gradually thereby allowing future generations of purchasers to acquire more affordable dwellings and for household debt levels to reduce. A gradual decline in house prices relative to earnings would be preferable to a sharp correction in house prices in the short term, as this could lead to negative equity for households which are already financial stretched, potentially hindering labour mobility.

New lending low and home ownership falling due to lack of affordability for younger households

A combination of the financial crisis leading to restricted finance availability, low nominal interest rates, prices that are still high and supply that is still low have led to a low supply, low demand equilibrium with a continued low level of transactions in the housing market. As a result of the low level of property transactions, the level of new mortgage lending has also been depressed. One aspect of tighter financing conditions is that banks have been requiring larger deposits for house purchases. This has both contributed to the depressed number of housing transactions and reduced the volume of lending for the purchases that have taken place. The average loan-to-value rate (LTV) has fallen and a smaller proportion of transactions have been to first time buyers, who typically borrow a higher proportion of the purchase price.

Graph 26: Tenure of dwellings



Source: DCLG

Despite the high price of houses in the UK, there is no evidence of a long term change in preferences away from owner-occupation, but a lack of affordability and concerns about the economic outlook have led to the recent decline in home ownership rates, as seen in Graph 26. This is more clearly obvious from the increase in the share of privately rented dwellings. Since purchasing a home has become less affordable over time, would-be purchasers have been forced into the rental market.

There is now a significant backlog of unmet demand for home ownership, with 2.9 million households (more than 10% of the total) currently renting but aspiring to own their own home.³¹ The recent fall in home ownership has contributed to the decline in household debt seen to date, as it has been driven by an unusually low number of first time buyers taking on new debts. However, with the significant backlog of unmet demand for home ownership among households who will now mostly be saving to accumulate a deposit for a house, when the housing market returns to 'normality' the rate of home ownership should level off. If affordability remains stretched home ownership may however remain below the peak level of 2000-2005. A growing private rental market is arguably positive for labour mobility, although the very high housing cost overburden rate for households in private rented accommodation demonstrates that growth of the private rental market is not by itself the solution to problems of housing affordability in a context of restricted housing supply.

³¹ HM Government (2011b).

Repossession rate has remained modest due to low interest rates and forbearance, but there has been a sharp fall in housing equity withdrawal

The recent fall in UK household debt has been driven more by a fall in new lending than by accelerated paying off of existing lending. Low interest rates have reduced the cost of servicing existing mortgages and cushioned the impact of the recession and weak earnings growth on household finances. Banks have also shown a degree of forbearance, in many cases allowing households in financial difficulty to reschedule mortgage payments rather than enforcing default and repossessing houses.

In other times and places economic downturns have seen higher levels of forced sales or voluntary foreclosure, larger price falls and hence higher transactions. For example, in the UK in the late 1980s and early 1990s a house price boom was followed by high interest rates and falling house prices at a time of weak economic growth and rising unemployment, and this led to a high rate of repossessions by lenders of houses whose owners could not keep up increased mortgage payments. In the US recent falls in household debt have been partly due to a high rate of mortgage default, both involuntary repossessions and in some US states home owners being able to voluntarily 'walk away' from negative equity without retaining liability for any outstanding debts after the house is sold.

Additionally the fall in house prices and increase in economic uncertainty has sharply reduced another form of secured lending, household equity withdrawal. When house prices were rising sharply, many households with newly increased levels of equity took out additional borrowing, often to fund consumption. This is now much less evident, despite lower interest rates, as reflected in the sharp increase in the saving rate since 2008.

3.1.3. How far is household debt a source of current or potential macroeconomic instability?

Despite the UK's consistently low share of residential investment in GDP, there is a relatively strong link between the state of the housing market (including mortgage rates) and the fortunes of the household sector and the economy as a whole. The UK mortgage system is characterised by a high proportion of variable interest rates, and regulatory policies have contributed to high house prices and household debt levels. In combination these factors have led to the housing market driving significant volatility in the asset position, debt servicing costs and therefore disposable income of UK households. They also arguably skew the distribution of savings in the UK economy towards housing. However in the short to medium term, the risk of household debt proving to be a destabilising imbalance should be limited unless interest rates rise sharply.

Loose lending practices helped drive rising house prices and increase the financial sector's exposure to the housing market

The UK housing market has had a destabilising effect on the economy via the financial sector. As the volume of mortgage debt grew in the 2000s, so did the financial sector's exposure to house prices. The crisis first came to public prominence in the UK with the near-collapse of Northern Rock. Northern Rock had expanded rapidly in the pre-crisis decade by taking on a large share of the market for new mortgage lending and funding this by securitising its mortgages on public markets. When this market seized up, it ran out of cash and the government had to nationalise it to prevent a disorderly collapse. The eventual cost to taxpayers of this intervention

could run into billions and the final cost to taxpayers will not be determined until the complete wind-down of the "bad bank" portion of Northern Rock, which has assets and liabilities of around GBP 20 billion, has been completed.

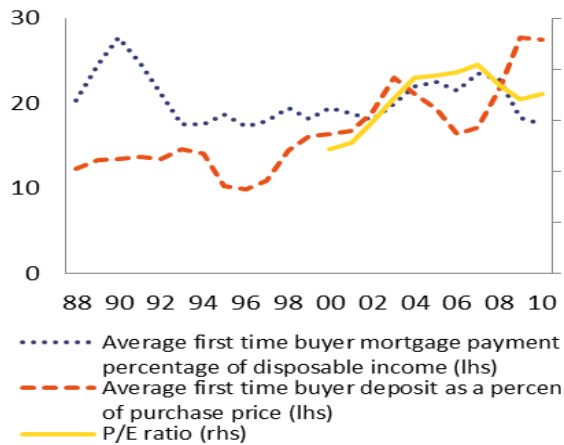
The interaction of adaptive household expectations and pro-cyclical fluctuations in risk appetite among mortgage lenders can combine to drive boom and bust cycles in house prices. With hindsight it is clear that banks themselves became, to some extent, caught up in the hubris around the housing market, creating self-reinforcing effects. As banks became more confident that house prices would continue to rise, they required smaller deposits and were willing to lend higher multiples of earnings as they were more confident of recovering their money in the event of a default. This made house purchases affordable for more people, even as house prices outstripped earnings, which in turn drove prices higher. These price increases reinforced banks' willingness to lend at high LTVs and households' confidence that housing assets were a good investment. As well as its unsustainable funding model, Northern Rock had also been at the forefront of more aggressive lending practices, particularly its products which attached unsecured loans to mortgages, thus allowing homebuyers to borrow more than 100% of the value of their property. Mortgage terms had also been increasing in the last decade with the ratio of mortgages set over more than 25 years increasing from 1.7% in 2000 to 22% in 2010. Laxer affordability standards during house price booms may seem beneficial at the individual level, but at the macro level they tend simply to push up prices as a bigger pool of money competes for largely the same stock of houses.

Mortgage lending in the UK never reached the same levels of hubris as in the US. Conduct of business regulation by the Financial Services Authority (FSA) (for first charge mortgages), while since shown not to have been sufficiently tight, was at least enough to prevent the more flagrant abuses with lenders or other distributors being forced to conduct some affordability checks before lending. As shown in Graph 27, the average size of first time buyer deposits has been consistently higher since 2000 than it was in the decade before, and increases in debt servicing costs for first time buyer were relatively modest.

This, along with low post-crisis interest rates, bank forbearance and the absence of a collapse in house prices³² explain why mortgage defaults in the UK have remained below 3%, with losses due to default also low.

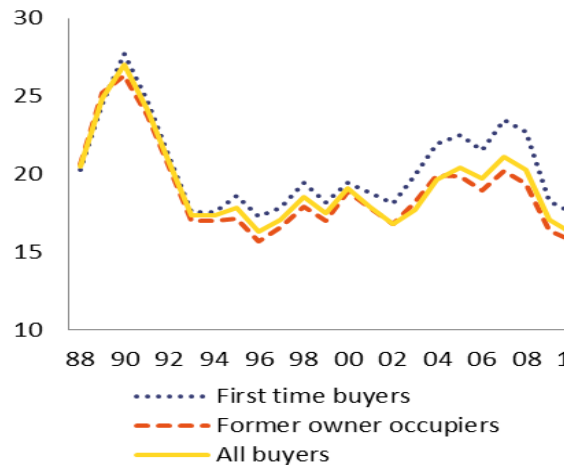
³² House prices are now around 15% below their peak.

Graph 27: Average deposit size and mortgage payments for first time buyers



Source: Regulated Mortgage Survey

Graph 28: Total mortgage payments as a percentage of income



Source: Regulated Mortgage Survey

Nonetheless, market concerns about banks' mortgage market exposures certainly contributed to the seizing up of interbank and other money markets in 2008-2009. The withdrawal of banks from high LTV lending has probably also contributed to the current weakness in consumption. The FSA has announced some recent measures to improve the quality of mortgages being approved. The changes are based on three principles of good mortgage underwriting – affordability assessment excluding potential house price rises, affordability assessment with interest rate rises and interest-only mortgages should only be offered where there is a credible plan to repay the capital. If applied correctly, these measures should promote better quality loans in the future.

High share of variable mortgage interest rates has supported household finances since 2008 but increases macroeconomics risks linked to the housing market

Mortgages in the UK are dominated by variable or short-term fixed interest rates. The existence of flexible interest rates combines with high and volatile house prices to make household finances sensitive to moves in the mortgage market and interest rates, which can lead to macroeconomic instability. However, the fact that a high proportion of mortgages are on flexible interest rates has had a positive effect on household finances since the onset of the crisis as interest rates have remained at historically low levels. Due to the low interest rates set by the Bank of England, mortgage repayments as a percentage of income have declined since 2007 where they peaked at 21% and fell to 16.2% on average in 2010, as shown in Graph 28. After 2008, the interest burdens of both households and non-financial corporations fell much more sharply in the UK than in the euro area. As discussed below, any increase in the interest rate in the future may make these flexible interest rate mortgages less affordable.

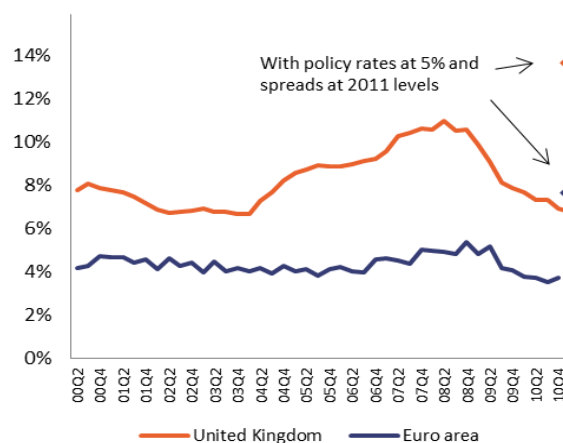
An increased use of long term fixed mortgage rates could dampen the impact of interest rate change on household disposable incomes. However, variable rate mortgages have helped cushion household incomes in the recession as rates dropped. Continued vigilance is also needed on the regulation of new mortgage lending, particularly given the risks of highly geared households falling into negative equity if

house prices fall significantly at any point or becoming unable to service their debts if interest rates rise. The UK has an independent monetary policy which theoretically permits the monetary authority to influence the interest payments-to-income ratios of households, and thereby their solvency. This is especially true given that the majority of mortgage loans in the UK are based on a variable-rate schedule. However, given the Bank of England's inflation target mandate, discretionary use of monetary policy instruments is largely limited.

The main macroeconomic risk from household debt in the short to medium term is if interest rates or unemployment rise

There is a strong case for believing that the UK housing market has had an adverse effect on long term UK economic performance and stability, due both to its impact on the evolution of household consumption and debt, and on the allocation of resources in the wider economy. The link between economic and housing market stability is reinforced by Barrell *et al* (2010) who show that house price bubbles are good predictors of UK economic crises. As shown in Graph 28, the example of the UK in the late early 1980s and early 1990s, when official interest rates peaked at 15% in 1990, shows how large levels of household debt accumulated through the purchase of housing at high multiples of incomes on variable rate mortgages can have a destabilising effect on the economy. Household solvency is left vulnerable to rises in interest rates and unemployment, as the sharp rise in mortgage interest payments as a percentage of disposable income in 1990s shows, which can have knock on effects on consumption and potentially the financial sector. A return to the high interest rates of the early 1990s appears unlikely but, as Graph 29 shows, even a rise in official interest rates to 5% would cause a significant increase in the household debt service burden.

Graph 29: Interest payments as a percentage of disposable income



Source: European Central Bank, Office for National Statistics, Bank of England Calculations

In view of this apparent link, it seems likely that taming the highs and lows of the house price cycle would also help to reduce the long term danger of macroeconomic instability and support higher growth. The high and variable cost of housing and restrictions on land supply also affect labour market flexibility and the allocation of resources in the wider UK economy. However, the latter is more of an

issue for long term UK economic performance than a potential source of macroeconomic instability.

A large and rapid fall in nominal house prices would depress growth but looks relatively unlikely

If nominal house prices fell sharply it would depress consumer demand and could lead to financial instability and impair labour mobility. Historically, house price movements and consumption have been positively correlated in the UK. Although the causation is complex, they co-move for a number of reasons as discussed above. While rising house prices can raise consumption through positive wealth effects and enabling households to realise capital gains through additional borrowing or 'trading down' to cheaper or rental property, falling nominal house prices can leave households in negative equity. By contrast, households in negative equity experiencing a sharp negative wealth effect are unlikely to be able to undertake additional borrowing, and are often also unable to move house unless their house is repossessed, impairing labour mobility. After the late 1980s house price boom, real house prices fell continuously for several years. By the mid-1990s, the house price-to-earnings ratio was below the long term average and, despite moderately high inflation many, households remained in negative equity for several years.

UK house prices are less likely to continue to remain more buoyant than other countries that experienced a housing boom due to more restricted supply. A number of other countries that experienced housing market booms in the decade before the crisis have since experienced sharp corrections, including Spain, Ireland and the US. All experienced a sharp rise in construction during the boom and were estimated to have accumulated surplus housing stock by the end of the boom. In contrast, as discussed, above UK house prices remain high relative to earnings despite a prolonged period of weak economic growth and subdued housing market activity, and the UK has a housing shortage. The future path of UK house prices is highly uncertain and they may decline further relative to earnings in the medium term. However, both because of restricted housing supply and an expectation that interest rates will remain low for some time, the risk of a rapid and destabilising decline in house prices to or below their average level relative to earnings looks relatively unlikely, although there are precedents and the possibility cannot be discounted.

3.2. External competitiveness

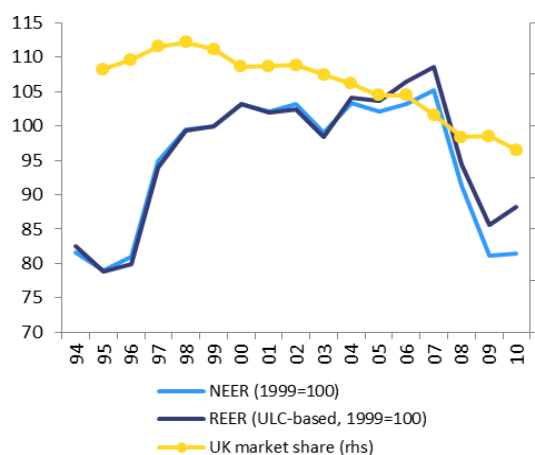
The UK experienced a drop in international export market shares in value terms of 24% in the five years to 2010, the highest among all EU Member States. At the same time, the REER saw a similarly sized drop of nearly 20%, a value breaching the lower AMR threshold.

The recent drop in the REER was driven by a depreciation of sterling and a concomitant fall in the NEER, as can be seen in Graph 30. The depreciation appears to have had a limited immediate effect in promoting external competitiveness. This was due largely due to the fact that an increase in export prices partly offset the depreciation of sterling and that the depreciation took place against a backdrop of falling global demand for UK exports. Nevertheless, the depreciation is seen to have supported the external performance in indicators other than value-based market shares, and should continue to do so in the future.

Impact of depreciation on competitiveness slowly unwinding

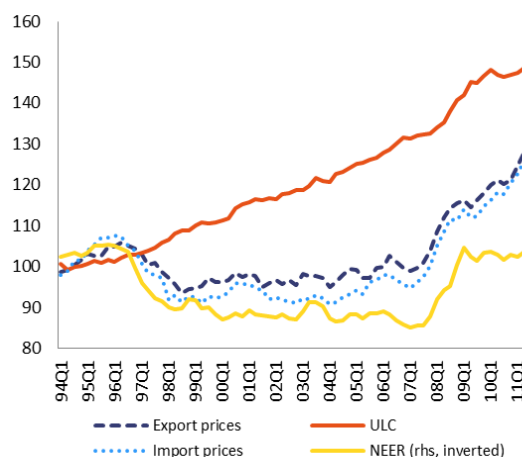
UK exporters largely compensated for the depreciation of sterling by raising their prices and, apparently, their margins, as depicted in Graph 31. Export prices decreased following sterling's appreciation in 1996-1997 and increased following the 2008-2009 depreciation, partially counteracting exchange rate movements. In between these two exchange rate episodes, export price growth remained subdued, implying a compression in exporter's margins as measured with respect to economy-wide ULCs. The recent depreciation saw UK exporters apparently restore their margins, as export prices grew more than ULCs.

Graph 30: Developments in UK exchange rates and market share



Source: Commission services

Graph 31: Evolution of exporter margins (1994 = 100)



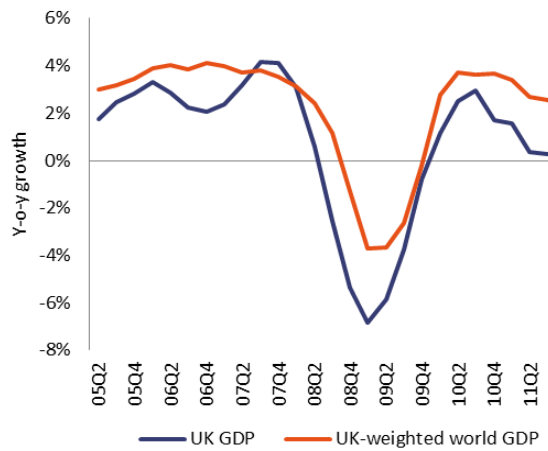
Source: Commission services

Several factors can explain the recent increase in export prices. Firstly, the depreciation increased the input prices of exporters.³³ In fact, as can be seen from Graph 31, import prices correlate strongly with the NEER and have co-moved almost on a one-to-one basis with export prices. Furthermore, some exporters may have decided to cash in the benefits of a more favourable exchange rate rather than to rely on it to expand their market shares due to an unwillingness to invest in a context of subdued and volatile global demand, as well as due to uncertainties regarding the future path of the exchange rate. Finally, the cost structure and the pattern of geographical and product specialisation of some UK exporters may mean that the price elasticity of demand is such that the losses from lower export prices would not be adequately compensated by the gains arising from higher export quantities. In fact, anecdotal evidence suggests that the UK has managed to carve out a number of export niches for itself which are to some extent insulated from international competition (e.g. in aeronautics, pharmaceuticals and certain financial services).

The recent depreciation of sterling took place as UK export markets and demand collapsed (Graph 32). This implies that the positive effect of the exchange rate on the current account will tend to be flatter than might have otherwise been expected.

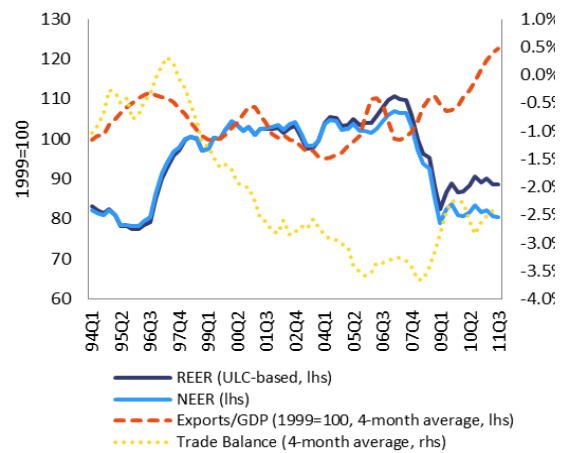
³³ The import content of goods exports is estimated at 30% for 2005 (IMF calculations), a value similar to that of other large EU countries such as Germany, France and Italy. The import content of goods exports has likely increased since 2005 as the UK has moved from being a net exporter to being a net importer of oil since then.

Graph 32: Developments in UK external demand



Source: Office for National Statistics, Bank of England calculations

Graph 33: UK export and trade balance performance



Source: Commission services

The recent depreciation of sterling is seen to have had a positive effect on external competitiveness when indicators other than export market shares are considered (Graph 33). After a decade of sterling strength during which the current account worsened significantly, both the trade balance and total exports have improved noticeably following the recent depreciation, within a broader context of rebalancing towards the external sector. UK exports of goods and services grew 8.5% in real terms in the five years to 2011³⁴, which represents a (geometric) mean growth rate of 1.64% per year. This figure is bound to be lower than worldwide export growth rates³⁵ but significantly higher than the UK GDP mean growth rate during the same period (0.5%), signalling a rebalancing towards the external sector.

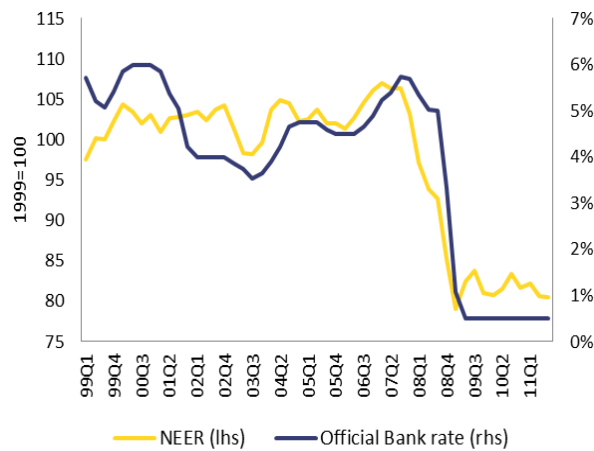
Finally, **the 2007-2009 depreciation appears to have been a normal adjustment of a possibly over-valued sterling**, as suggested by equilibrium exchange rate analysis.³⁶ A fall in sterling's value followed from the drop in official interest rates promoted by the Bank of England and from its quantitative easing programme, as well as from weakened economic prospects brought about by the financial crisis. These measures were implemented in the wake of the crisis to address, inter alia, expected deflationary pressures in the economy.

³⁴ National accounts data.

³⁵ Exact figures for worldwide real export growth are only available for trade in goods. However, a proper benchmarking of UK export performance would require considering both trade in goods and services, due to the high and increasing importance of the latter for the UK export mix.

³⁶ Commission services analysis suggests that the sterling exchange rate was broadly in line with equilibrium values in 2011. Similarly, estimations by the Peterson Institute for International Economics found that sterling was only slightly overvalued in October 2011 (by 2.8%) based on a net financial assets stabilisation approach.

Graph 34: Monetary policy developments in the UK

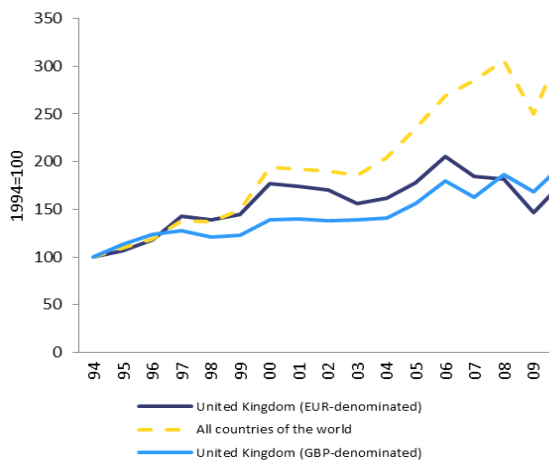


Source: Commission services and Bank of England

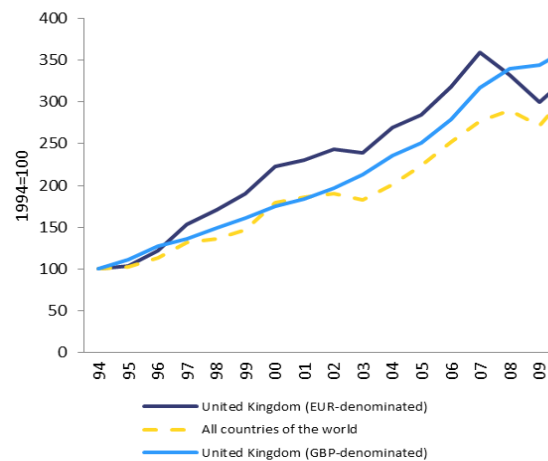
Evolution of UK export market shares driven by both short and long-term factors

The UK, like most advanced economies, has lost export market share to high-growth export-oriented emerging economies, as seen in section 2 and Graph 15. Additionally, **the dynamics of UK goods exports lag behind global trends as well as behind those of services exports** (Graphs 35 and 36). In fact, while the export performance of goods was unimpressive in the decade to 2011, the strength of the UK services export sector is evident: it outpaced global export growth and accounted for the largest average share in services trade among all EU 27 countries in the 2007-09 period. As regards goods exports, the UK ranked only sixth in terms of market share. In fact, by 2009-2010 the UK had witnessed a broad-based loss in market shares in all main CPA³⁷ categories, as shown in Graph 37.

Graph 35: Evolution of total goods exports (1994=100)



Graph 36: Evolution of total service exports (1994=100)

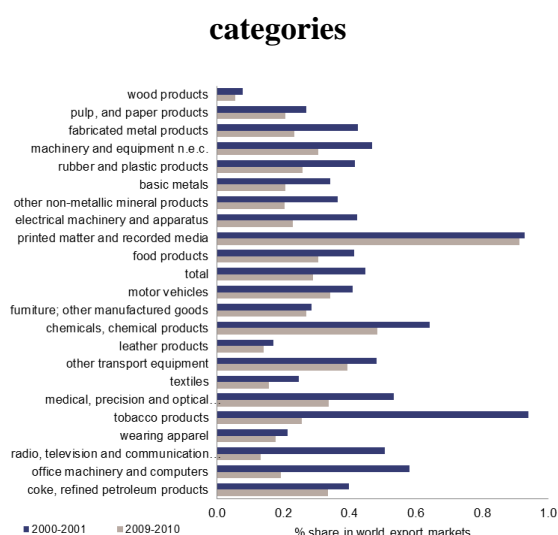


Source: Commission services

Source: Commission services

Graph 37: UK export shares by CPA

³⁷ Statistical classification of products by activity.



Source: Comtrade, own calculations

The UK has experienced unfavourable developments in ULCs, notably when compared with euro area averages, as noted in section 2 (Graph 17). However, even though nominal ULCs rose close to the AMR threshold of 12% in the three years to 2010, this was largely offset by the depreciation of sterling. With no large collective bargaining arrangements outside the public sector and very little automatic wage indexation, real UK wages have been falling since 2008.

Finally, **the evolution of UK world export market shares in value terms suffered from a short-term negative price effect due to the depreciation of sterling**. Table 1 illustrates the evolution of UK export market shares, as well as an estimation of the effect of exchange rate and export price shocks during the 2007-2010 period.³⁸

Table 1: UK Export Market Shares (y-o-y growth, value terms)

	2004	2005	2006	2007	2008	2009	2010	2006-10
Actual	-3.4%	-4.7%	-0.2%	-8.3%	-10.1%	0.5%	-7.1%	-23.0%
Exchange rate corrected ¹				-7.9%	4.6%	12.5%	-10.5%	-3.1%
Exchange rate and export prices corrected ²				-7.2%	-5.7%	9.7%	-13.2%	-16.8%

¹ Export market shares holding the average 2006 EUR-GBP exchange rate constant

² Export market shares holding the average 2006 EUR-GBP exchange rate constant and assuming export price growth in line with 1999-2006 average growth

As can be observed, UK export shares only show a small estimated decline in 2006-2010 when controlling for the effects of depreciation. However, when controlling additionally for the extraordinary and offsetting increase in export prices, the estimated fall in market share remains very large although not as large as the 'actual' fall captured in the MIP scoreboard.

UK trade balance persistently negative

A structural change is apparent in the UK's export mix and, in the decade to 2011, an increasingly negative trade balance in goods was largely counteracted by a thriving trade balance in services. The UK has long experienced a negative trade balance in goods, which has been deteriorating since 1998. Its value has recently stabilised in 2010 and 2011 at approximately -6.6% of GDP. This has been partly compensated by a positive and dynamic trade balance in services, worth approximately 4.7% of GDP in 2011.

³⁸ Behavioural effects on export quantities are ignored. Controlling additionally for these effects would mean a larger drop in estimated market shares in recent years.

Trade in goods and services is the main driver of the UK current account, which posted a small but significant average deficit since 1997. Current account deficits had accumulated to a negative IIP of -13.4% by year-end 2011³⁹, a figure which, like the current account indicator, is still well within the boundaries of the AMR thresholds. The Commission Services' 2012 spring forecast expects the current account to be close to balance by 2013.

Commission services' analysis suggests that the UK underlying current account balance⁴⁰ is currently somewhat more negative than would be expected on the basis of current account 'norms'. That is, the UK current account deficit is somewhat higher than would be expected from a number of structural features that the UK shares with other countries. This means that there appears to be some scope for the UK current account to move to a more balanced position in the future, although it should be noted that these estimates are subject to a significant degree of uncertainty.

The importance of services has risen steadily and by 2011 they represented 37% of total exports, signalling the UK's apparent comparative advantage in this area. As can be observed in Graph 38, service exports are dominated by business and financial services, with travel and transport also representing sizeable shares. The financial industry, in particular, has promoted the development of ancillary services (e.g. legal, consulting and accountancy services), which also carry an important export component. The importance of the financial and professional services cluster is, however, geographically delimited and the very large UK economy needs necessarily rely on other sectors for its export performance.

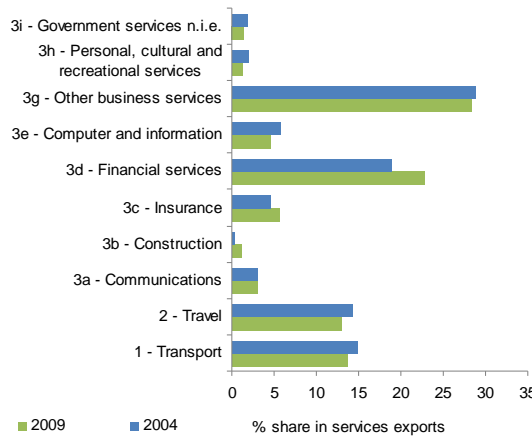
Recently, **the financial crisis inevitably affected financial services exports even as total service exports remained buoyant**, as shown in Graph 39. The combined financial and insurance categories, which at their peak in 2007 and 2008 represented approximately 28% of all services exports, had dropped to 23.6% in 2011. In fact, if financial exports had moved in line with other service exports since 2008, the current account balance would have been improved by up to 0.3 pp. of GDP in 2009 and by up to 0.8 pp. in 2010.⁴¹

³⁹ Eurostat data.

⁴⁰ The underlying current account is the current account balance excluding the effect of the business cycle. The business cycle currently flatters the UK current account balance due to the existence of a marked negative output gap.

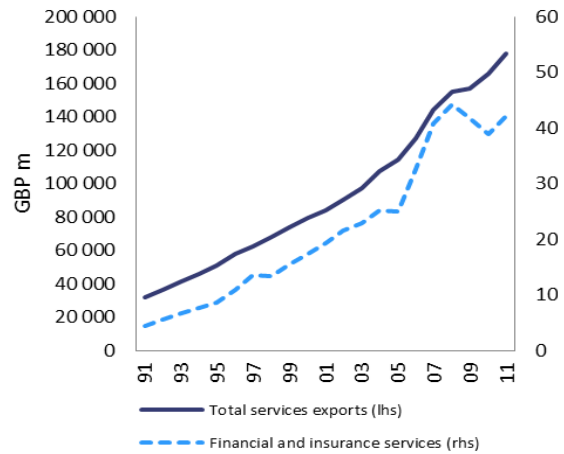
⁴¹ Assuming no offsetting increase in service imports.

Graph 38: Decomposition of UK service exports



Source: Commission services

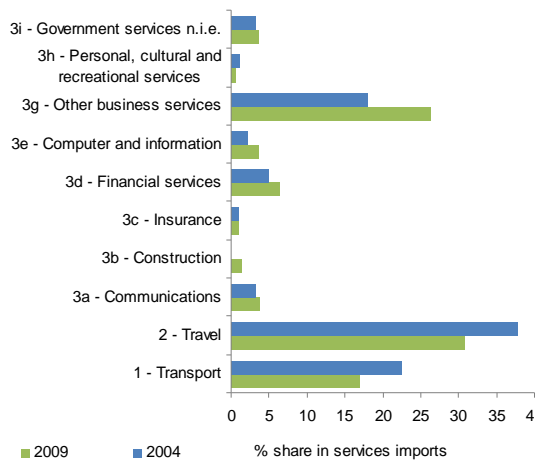
Graph 39: Developments in aggregate and financial services exports



Source: Commission services

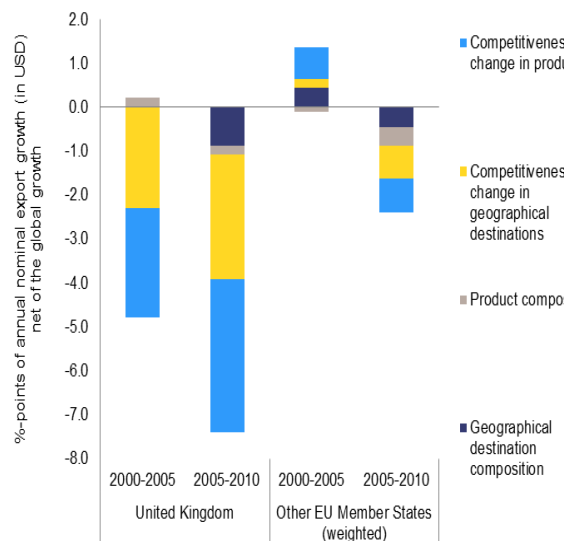
As regards imports, **a marked contraction in travel services (tourism) is apparent since 2008**, as depreciation reduced the purchasing power of British tourists and households became more cautious in the wake of the crisis (Graph 40). However, goods imports rebounded in 2010 after a drop in 2009. In fact, **a contraction in goods imports due to depreciation is not obvious**, possibly owing to the fact that for a significant number of goods there are no domestic alternatives available in the UK, or their prices are not sufficiently competitive vis-à-vis low-cost imported goods, even after depreciation. Also, **due to declining production of North Sea oil, the UK has moved from a net exporter to a net importer of crude oil since 2005**. Similarly, the UK became a net importer of natural gas in 2004.

Graph 40: Decomposition of UK service imports



Source: Commission services

Graph 41: Decomposition of nominal export growth



Source: Comtrade, own calculations

Export markets tilted towards slower growing economies

The UK has remained focused on a few traditional export markets, such as the US, Germany, the Netherlands and France. The fact that by 2010 the UK continued to export more to Ireland than to all the BRIC⁴² countries taken together is illustrative of the fact that UK firms may not be taking advantage of trade opportunities in emerging and high-growth economies.

The geographical composition of UK export markets delivered a negative contribution to export growth in 2005-2010, as evidenced in Graph 41. **Additionally, the UK lost more market share than would be warranted by its geographical and product mix.**

Between 2000 and 2005, the geographic orientation of the UK's manufacturing exports could have been better in the sense of being more oriented towards faster growing export markets, but it did not contribute negatively to market share growth. In fact, Asian markets may have been growing rapidly, but so too were the UK's traditional export markets. With the economic crisis, however, the gap between the export market growth of emerging and high growth economies and the export market growth of the UK's traditional export markets has widened, with the UK's traditional export markets slowing significantly. Hence, the UK's geographic orientation is now more tilted towards slower growing export markets. This is a significant issue because the price elasticity of UK exports is lower than its income elasticity.⁴³ Hence, the deterioration in the UK's geographic orientation makes it harder for UK exporters to recover global market shares by competing on price. By contrast, the product composition of its exports still remains relatively good, at least by comparison with the rest of the EU.

However, given the composition of its export markets and of the manufacturing products in which it specialises, the UK appears to be falling significantly behind its competitors (i.e. there were negative competitiveness changes, as noted in Graph 41). In fact, the consumption boom before the crisis likely meant that potential exporters were preferring to supply the domestic market where demand was strong, which may explain why UK sectoral exports failed to grow as fast as could have been expected between 2000 and 2005.

This phenomenon got worse in the most recent period when manufacturers might have been expected to try to substitute export markets for much slower growing domestic markets. Were the UK to adjust its geographic orientation appropriately, the fact that it is quite well focused sectorally on generally faster growing sectors could help provide a boost to its manufacturing export growth. However, if the UK takes a long time to adjust its geographic focus to the fastest growing markets its sectoral export structure may become less adequate to extract the maximum benefit from that geographic adjustment.

There is evidence that some rebalancing towards more dynamic markets is currently taking place. For example, the Bank of England's agents have reported that Asian demand has been an important driver of recent export growth and exports

⁴² Brazil, Russia, India and China.

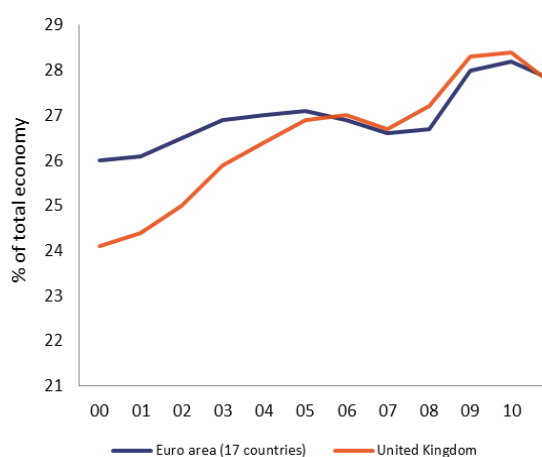
⁴³ A recent literature review by the Bank of England found that the average estimate for the price elasticity of UK exports was -0.4, the same as the price elasticity of imports. By contrast, the income elasticities of exports and imports are usually found to be unitary. See *Understanding recent developments in UK external trade*, Bank of England's Quarterly Bulletin, 2011 Q4.

to non-EU countries, which represented as little as 37% of total exports in 2006, had grown to 46% by 2010.

Non-tradables expanded as public sector grew and manufactures contracted

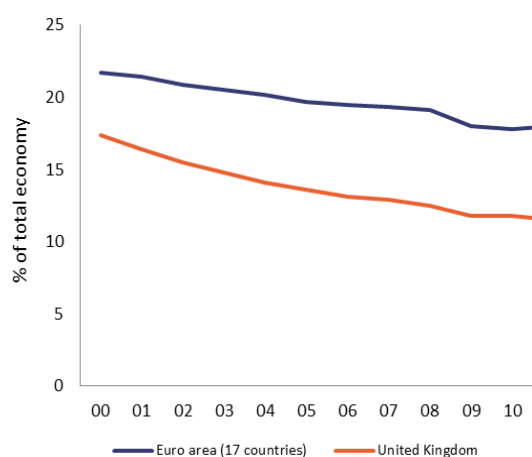
The importance of the non-tradable sector grew in the pre-crisis years as government services represented an increasingly higher share of total employee compensation in the economy. As evidenced in Graph 42, compensation in public sectors, while initially lower than the euro area average, quickly increased from 2000 onwards. By 2011, it represented approximately 28% of total employee compensation, a figure similar to the euro area average. The expansion of the public sector took place essentially in the pre-crisis years. The high levels of government debt in the crisis period were largely driven by the financial sector bail-outs and the economic downturn, and have had a limited impact in shifting the economy from the tradable to the non-tradable sector. In fact, current consolidation plans aim to downsize the government sector and have already contributed to reallocating a significant share of workers to the private, potentially tradable, sectors of the economy.

**Graph 42: Compensation of employees
- public administration, defence,
education, human health and social
work activities**



Source: Commission services

**Graph 43: Compensation of employees
- manufacturing**



Source: Commission services

The tradable sector shrunk due to a decline in industrial activities, and in manufacturing in particular, even as tradable services grew in importance. As evidenced in Graph 43, the importance of manufacturing in the economy, as measured by employee compensation, has followed a secular declining trend in both the euro area and the UK, although somewhat more markedly and from a lower basis in the latter. At the same time, service sectors often considered ‘non-tradable’ grew or otherwise retained an important share in total employee compensation in the UK. Some of these services carry, in fact, an important tradable component in the UK, as previously seen in in Graph 40. This is the case, for example, of financial services, professional services and even education.

Microeconomic dimension can be improved even if generally favourable

Regarding the microeconomic dimension of external competitiveness, **the UK appears to be a comparatively strong performer with respect to a number of**

benchmark microeconomic indicators, including indicators on productivity and ULCs, where **the leading position of the UK in the services sector is evident, while the performance in manufacturing sectors is less remarkable.**⁴⁴ In fact, the decade to 2010, the UK posted the seventh highest average labour productivity growth among EU-27 countries in the services sector, while raking just sixteenth in the industrial sector. The UK ranks second among EU countries in the World Bank's Ease of Doing Business indicator and the OECD's product market regulation database shows the UK to have a consistently low regulatory burden across the analysed industries.⁴⁵

The UK also performs comparatively well in the 2011-12 Global Competitiveness rankings⁴⁶, where it is placed sixth among EU peers and tenth globally. The accompanying report considered the macroeconomic environment, notably the government's fiscal position and the low savings rate, to be the main drag on competitiveness.

The UK has a comparatively high share of high-tech exports in total exports (Graph 44) but R&D investment rates and performance show, nevertheless, some room for improvement. The UK invested 1.8% of GDP in R&D in 2010, somewhat less than the EU-15 average (2.1%). Even though the UK R&D investment rate ranked between eighth and eleventh among EU countries in the five years to 2010, it is lower than that of other highly advanced economies such as Germany and France. Additionally, manufacturing is seen to lag behind the services sector with respect to a set of innovation indicators. In fact, while the UK has the highest share of knowledge intensive services in total services in the EU and the fourth highest R&D investment intensity in the services industry⁴⁷, R&D investment intensity in manufacturing is only the tenth highest.

However, a combination of relatively high prices and margins and low capital stock suggests that parts of the UK economy may suffer from weak effective competition and underinvestment. The UK economy has a high profit share and the lowest average⁴⁸ investment-to-GDP ratio in the EU, which cannot be fully explained by the sectoral composition of the economy. In both manufacturing and services, gross operating margins in the UK are among the highest in the EU. Graph 45 provides an estimation of the benefits accruing to the UK's trade balance from a 5 pps. reduction in the mark-ups of final and intermediate goods based on the European Commission's QUEST model.⁴⁹

⁴⁴ The analysis in this section relies partially on DG ECFIN's Sectoral Performance Indicators which are based on data from official public sources such as Eurostat, the World Bank, the OECD and the LIME assessment framework database.

⁴⁵ This piece of evidence contrasts somewhat with two of the World Bank's Ease of Doing Business indicators that show the UK to be a comparatively poor performer in the "getting electricity" and "registering property" categories.

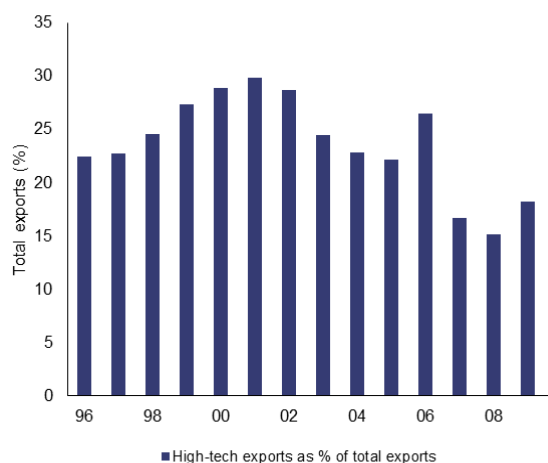
⁴⁶ World Economic Forum (2011).

⁴⁷ As measured by business enterprise R&D expenditure in market services as a share of the value added in market services.

⁴⁸ On a multi-year basis.

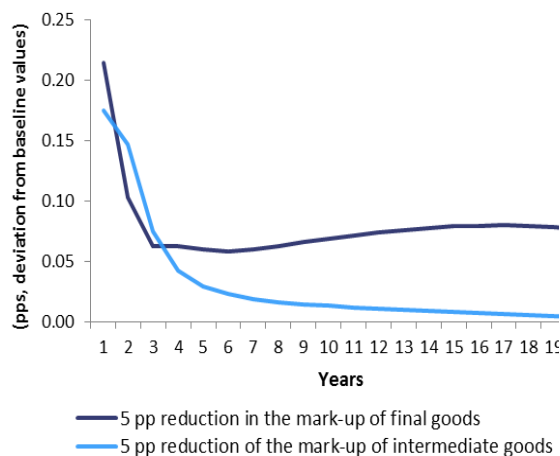
⁴⁹ For a description of the baseline model, see Roeger, W., Varga, J. and in 't Veld, J. (2008). The particular version of the model used for the estimations has been calibrated for the UK economy.

Graph 44: UK high-tech exports



Source: Comtrade, own calculations

Graph 45: Increase in the UK trade balance from a shock to mark-ups



Source: Commission services, own calculations

In general, microeconomic indicators shed a favourable light on UK competitiveness, while evidencing room for improvement in the manufacturing sector. It is therefore essential that possible policy responses aimed at improving competitiveness be precise and well-targeted.

Targeted investment in infrastructure and improved access to finance can contribute to boosting export performance

The UK business and government investment rates are among the lowest in the EU. Table 2 shows how the investment-to-GDP ratio in the UK has been consistently the lowest when taken as a multi-year average.

Table 2: Investment rates¹ for the UK and EU 27

	2005	2006	2007	2008	2009	2010	2008-2010	1995-2010
UK	17%	18%	18%	17%	14%	15%	15%	17%
EU 27²	23%	24%	26%	24%	19%	19%	21%	22%
UK's Rank	26	27	27	27	26	25	27	27

Source: Eurostat, own calculations

1) Investment rates defined as gross capital formation/GDP

2) The EU 27 rate is calculated as the simple average of the 27 EU countries.

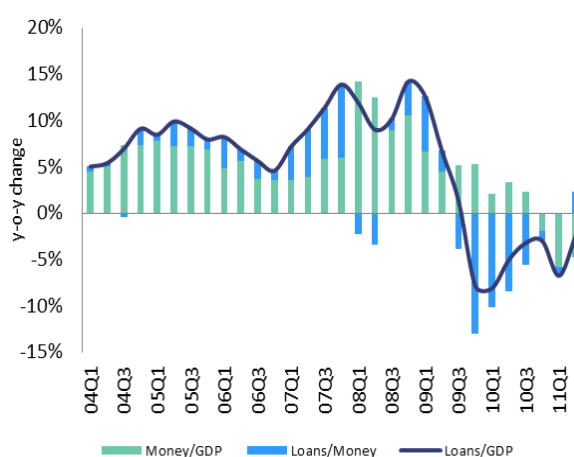
The UK faces serious challenges in improving its infrastructure and planning frameworks, including in areas that bear direct relevance for the UK export performance such as transportation and regulation. As discussed at length in the 2012 Commission Staff Working Document⁵⁰, UK networks tend to show high levels of congestion and significant capacity constraints. The 2011-12 Global Competitiveness Report of the World Economic Forum places the UK twelfth among EU-15 countries as regards "quality of overall infrastructure" and McKinsey & Co. estimate a substantial public sector funding gap for road and rail between 2010 and 2030.⁵¹ The passenger and freight usage intensity of the UK's road network is exceptionally high, as is the total cost per passenger-kilometre of the rail network.

⁵⁰ European Commission (2012a).

⁵¹ McKinsey and Company (2011).

There is a growing shortage of airport capacity in the South East, where demand is concentrated and UK ports, which handle most of UK trade, could benefit from better transport connections. As regards planning and regulation, planning laws create the highest regulatory costs of any type of regulation in the UK according to the National Audit Office. For instance, the gross costs of regulation associated with building office property in major cities, such as London and Manchester, are estimated to be considerably higher than in other major world cities and it takes on average more than twice as long to go through the procedures to build a warehouse in the UK as the USA.⁵²

Graph 46: Decomposition of the evolution of UK aggregate-loans-to-GDP



Source: Commission services, Bank of England and own calculations

Promoting access to finance can facilitate entry into exporting sectors and help current exporters expand. As previously seen, the recent depreciation has apparently boosted export margins, which may lead to further positive effects on the UK external performance as the exporting sector expands through increased capacity and new entry. However, either development likely requires access to external funding in a current context of tight lending conditions. In fact, as evidenced in Graph 46, notwithstanding monetary activism in the wake of the financial crisis which increased the money supply, money-to-loan transformation ratios broke down with the consequence that the flow of credit in the UK economy has been impaired. In particular, the flow of credit to the NFC sector turned negative in 2009, as previously shown in Graph 7, and remained so in 2011 according to Bank of England data.

Increased difficulties in accessing finance affected SMEs the most. Table 3 summarises some results of the 2007 and 2010 Eurostat surveys on SME access to finance, which included twenty EU countries. As can be observed, success rates in obtaining a loan dropped fast from 2007. In fact, one in five UK SMEs reported having had their loan applications turned down in the 2010 survey.

⁵² Further evidence on infrastructure and planning constraints in the UK, and on their economic implications, can be found in the Commission Staff Working Document assessing the 2012 national reform programme and convergence programme for the United Kingdom.

Table 3: Success rates in obtaining loan finance

	2010			2007			Change in 'no success' 10-07
	No success	Partial success	Success	No success	Partial success	Success	
Country Average	13%	16%	71%	3%	7%	90%	10 pp.
UK	21%	15%	65%	6%	6%	88%	15 pp.
UK's rank	6th	12th	12th	5th	13th	12th	6th

Source: Eurostat's 2010 and 2007 Access to Finance survey

Conclusions

The recent poor external performance of the UK can be explained by several reasons, notably increasing costs, less dynamic destination markets and slower productivity growth in manufacturing sectors. Foremost explanations are the slower growth of UK exports when compared with those of highly competitive emerging economies, rising ULCs, a manufacturing sector which lags behind an advanced and highly productive services industry, the drop in exports of financial services in the wake of the crisis, a focus on less dynamic export markets and short-term negative price effects of the depreciation on market shares.

While monetary policy may help cushion negative macroeconomic shocks, structural measures are needed to correct unfavourable external developments sustainably. It is particularly important to ensure that good economic and business frameworks, as measured by broad-based international benchmarks, translate into effective internal and export market functioning. The UK has to work to ensure it maintains its competitiveness in the services industry whilst pursuing policies to encourage manufacturing exporters to adjust more quickly to faster growing export markets. Effectively addressing the country-specific recommendations of the ECOFIN Council can have an important positive impact on competitiveness and can help to optimise the adjustment capacity of UK manufacturing exporters. For instance, promoting access to finance can help existing exporters expand and facilitate entry into exporting sectors, which have become more attractive following sterling's depreciation. Additionally, well-targeted growth-enhancing investment in infrastructure can help support the competitiveness of the manufacturing industry.

4. POLICY CHALLENGES

The preceding analysis has shown that the UK is experiencing macroeconomic imbalances, which are not excessive but need to be addressed. In particular, macroeconomic developments in the areas of household debt and the housing market deserve attention, as do unfavourable but less pressing developments in external competitiveness, so as to reduce the risk of adverse effects on the functioning of the economy.

As regards household indebtedness, the potentially destabilising effect of the housing cycle on the economy should continue to be addressed through reforms to the planning system and financial regulation, as recommended to the UK by the ECOFIN Council in 2011. A combination of high and volatile house prices, a shortage of housing supply, easy lending practices and abundant liquidity, as well as a large share of variable interest rate mortgages, have led to the accumulation of high levels of mortgage-related household debt and have rendered household finances particularly sensitive to interest rate rises. Household debt is only likely to decline significantly over time if house prices fall relative to disposable income. Effective

reforms to the UK's restrictive planning system could facilitate an increase in the supply of housing, which would improve affordability over time and reduce the pressure on households to take on high levels of mortgage debt. The government is in the process of a controversial planning reform with the stated aim of increasing residential construction, but it is not yet clear what the impact of the new system will be. Reforms to rental markets could help improve households' response to house price and labour market signals, and provide more viable long term alternatives to home ownership. In particular, housing benefit reform can reduce the very large subsidies paid to some households living in privately rented properties, which would help to moderate rents, and reforms to social housing would remove barriers to labour mobility. Appropriate credit frameworks and standards are key to reducing incentives for households to borrow excessively and avoid the potentially destabilising effect on the economy of periodic overheating in the housing market. Better financial information and higher risk awareness for households could also reduce their appetite for risky debt such as variable rate mortgages at a high loan-to-value ratio or a large earnings multiple. The Financial Services Authority has recently proposed a range of measures in this regard to ensure that lenders more systematically assess and stress test affordability before approving mortgage loans. Transaction-based property taxation involves significant distortions and biased incentives and generates highly cyclical revenues. Overall, the aim should be to support continued and gradual household deleveraging, endeavouring to reduce household risk exposure without unduly compressing consumption levels. Policies that support sustainable increases in disposable income and employment would obviously contribute positively to this process. The fiscal consolidation, necessary to contain government debt, will help to preserve stability and create growth-enhancing conditions over the medium term, though increasing pressure on incomes in the short term.

As regards external competitiveness, while unfavourable developments are less pronounced than those arising from the internal dimension of the economy, policy action should be considered to improve overall export performance. Even though current and expected external developments appear to entail limited risks for overall macroeconomic stability, there appears to be scope to counteract unfavourable long term trends in external trade which are somewhat more marked in the UK than in other EU Member States. Given the poor and, until 2008, worsening external performance of trade in goods, as well as a history of low public investment, there is a case for targeted investment in infrastructure aimed at supporting the manufacturing sector, while respecting the apparent competitive advantage of the UK in the services industry. Considering the skills and educational challenges which the UK faces⁵³, there is also scope for improvements in vocational training, human capital and R&D, especially to the extent that they can curtail increases in structural unemployment and boost the performance of the industrial sector to bring it more in line with that of the services sector, where labour productivity growth has been stronger. Given recent unfavourable developments in ULCs, action to foster productivity gains, which should outpace wage growth, would reinforce the competitiveness of the UK economy. Finally, improving access to finance in line with Council recommendations could support the expansion of the export sector, which has become more attractive following sterling's depreciation.

⁵³ For an analysis, see European Commission (2012a).

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