

## The economy

## Firing on one cylinder

**Britain's recovery is picking up steam, but its engine is weak**

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THE crisis that started in the dodgy mortgage markets of California, Florida and Nevada did more harm to Britain than to America. Britain had the first bank failure, and it had the biggest one. In just 18 months between 2008 and 2009 GDP dropped by 7.2%, more than it had in the 1930s. As unemployment rose, benefits kicked in and the budget deficit swelled: by 2010 Britain had the largest of any G20 nation. Given this list of woes, the fact that Britain is now outstripping all its rich-world peers seems suspicious.

But it is true. The headline figure—GDP growth—looks great. At an annualised rate of 3.2% British growth is higher than in any other G7 country (see chart). The number of people working in Britain is, at close to 30m, the largest ever. Income-tax receipts have risen, helping the exchequer. And outgoings are falling as the number claiming jobseeker's allowance, the main out-of-work benefit, has dropped by 300,000 from its peak. George Osborne, Britain's chancellor, will finally have some good news when he delivers his autumn statement on December 5th.

But Britons hoping for lower taxes or a rush of investment spending will be disappointed. The chancellor's main message will be that the country should expect more of the same. Mr

Osborne is less than halfway through an austerity drive; unless the pace of growth speeds up, five more years of cuts can be expected.

With austerity nibbling at public spending, Britain needs other reliable sources of demand. Thankfully, the largest chunks of the economy are doing well. Household spending, which accounts for 62% of GDP, is expanding steadily: it is now just 2% below its pre-crisis high. Services, long the biggest part of British economic output, have become even more important—they now account for over 80% of it. Although finance and insurance are still in the dumps, transport, real estate and health services are growing strongly.

Yet the recovery is worrying because all other sources of demand look weak (see chart). Official data released on November 27th showed that exports had declined by £3 billion (\$4.8 billion) in the latest quarter. Services industries may be strong at home but they are performing poorly abroad: exports have been flat in real terms since 2008. Though exports of goods are up, the overall increase, just 5%, is disappointing given the one-fifth depreciation in sterling.

Although investment rose by 1.4% in the most recent quarter it is still 25% below its previous peak. And even this slight gain was achieved by firms building up inventories. While it is good that Britain's businesses are better stocked, this is not the kind of investment that generates growth both today and tomorrow.

The lack of investment and the persistent weakness of exports sap the whole economy of strength. Britain's exporters are more productive than its non-trading firms. With exports growing more slowly than domestic consumption, the economy is becoming inward-focused and unproductive. Low investment means Britain's workers toil in grubbier offices, with rustier kit and slower computers. Productivity per worker, up 8% in America since the crash, is down by almost 5% in Britain.

Thanks largely to the decline in workers' output, wage growth has been slow. With prices up by 20% since the start of 2008, median pay has fallen back to its 2003 level. The fact that the crisis has more than wiped out the bubbly years is not just a problem for the low-paid or the post-industrial north of England. Although there are some sharp losers (men who work part-time have done particularly badly) real-terms pay cuts have been felt across Britain's pay scales and through its counties and cities.

With productivity and pay still slumping, Britain's recovery starts to look much more iffy. Wages are not rising, but mortgage and credit-card borrowing are. The household savings rate, which had risen following the financial crisis as Britons trimmed their debts, has fallen to below its historical average. This debt-fuelled consumption is a return to Britain's old, pre-crisis growth model.

Weak wages are a problem for George Osborne, too. Even if the economy does not fall back into a slump, a low-pay recovery could prove politically fatal. A recent YouGov poll for the Resolution Foundation, a think-tank, showed that although voters still blame Labour for the country's economic mess, they think the opposition will do more to ensure wages rise in line with economic growth, keep energy prices down and boost the supply of affordable housing. Mr Osborne needs to act soon in



each of these areas. He will need to innovate, coming up with policies that drive investment and exports without adding to the deficit. He has built his reputation on steering a steady, austere course. In the latter half of this first term, being bold would be more prudent.

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