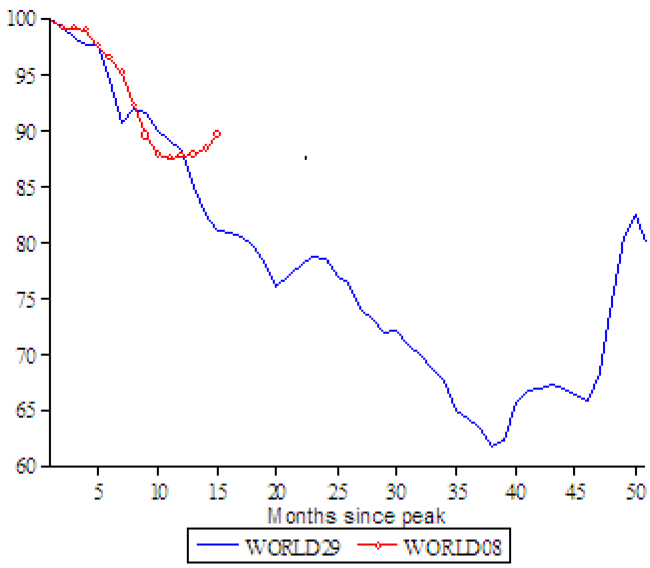
The State of the United Kingdom (UK) Economy at the end of Quarter Three 2009: the Third Slump

By Raphie de Santos

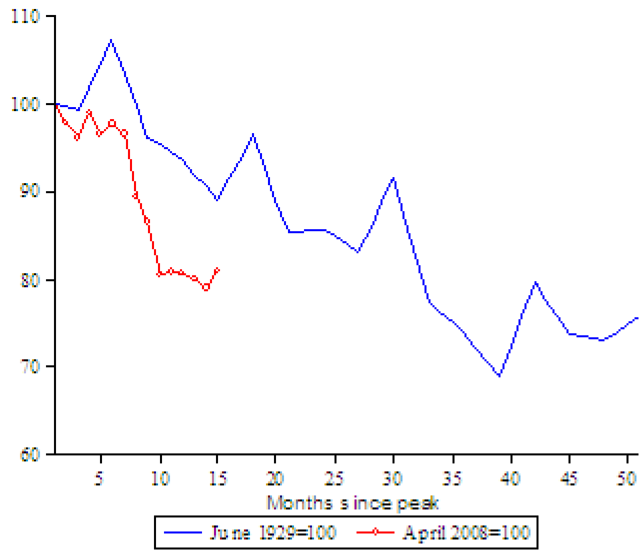
The UK is in the midst of what even most mainstream economists are now calling its most severe recession since the 1930s. Our earlier assessment of the UK economy at the end of the first quarter of 2009 described it as entering its third major slump. Over six months later the economic statistics have confirmed that description.

Bank of England Deputy Governor John Gieve said during a speech to London School of Economics on 19 February 2009 that policy makers are fighting to protect Britain from the threat of a decade long depression similar to that suffered by Japan in the 1990s. Mervyn King speaking in early autumn described the banking system in the UK as damaged for a generation.

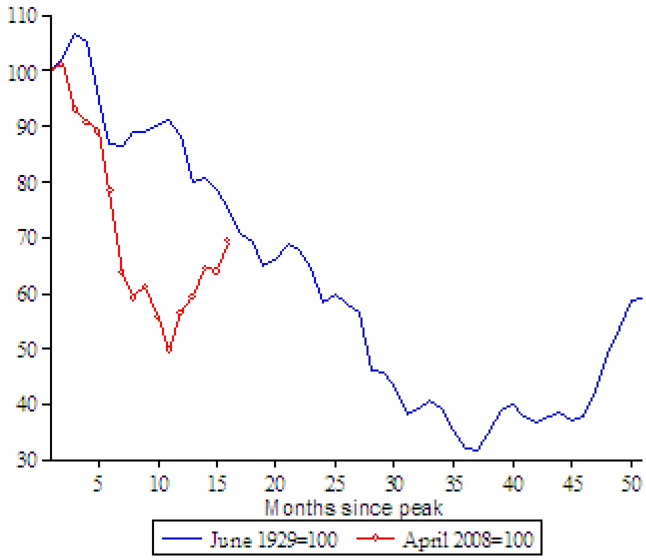
All this reflects a general crisis of the capitalist economic and financial system rather than just a "credit crunch" as has been popularised by the media as the reason for all our woes. The graphs below show that the economic slump in the UK was part of a global slump which in its early phase matched and in some cases exceeded comparative measures of the 1930s depression.



Graph1 World Industrial Production: Eichengreen & O'Rourke Sep 2009



Graph 2 World Trade: Eichengreen & O'Rourke Sep 2009



Graph 3 World Stock Markets: Eichengreen & O'Rourke Sep 2009

The crisis in the UK has a particular manifestation because of the maturity of traditional manufacturing industry and its dependence on a financial sector centred in the middle of the East and West time zones.

In this updated article we will examine, with the aid of statistics, the current state as at the end of September 2009 of the UK economy which technically entered a recession – two successive quarters of negative gross domestic product (GDP) growth at the end of quarter three in 2008.

We will use classical economic measures such as GDP, rate of profit, inflation, unemployment, manufacturing production and utilisation of manufacturing capacity to determine what lies behind this recession. In addition we will take a look at the levels of personal debt and the state of the housing market and relate them to the economic cycle which is depicted by the classical measures. Finally, we will assemble a picture of the structure of the UK economy and see how this structure will determine the likely future performance of the UK economy to the global recession.

UK in a Deep Slump

The UK "officially" entered a recession at the end of 2008. We had predicted this in January of that year[1]. But on closer examination of the data the date of entry was only down to a rounding error. Using the revised seasonally adjusted data from the office of national statistics,GDP shrank from quarter one to quarter two in 2008 as chart one below shows. So technically the UK actually entered recession at the end of third quarter of 2008. Despite claims of a strong UK economy prior to the "credit crunch" by Gordon Brown, average quarterly growth was 0.6% for the new millennium compared to nearly 1% for the last fifty tears of the last century.

We have now witnessed the longest successive sequence of quarterly declines since the 1930s depression and the cumulative decline in GDP of just under 6% matches that of the UK's previous deepest post-war recession of the early 1980s.

The 0.4% fall in UK GDP in quarter three 2009 was led by the manufacturing and construction sectors which contracted 0.2% and 1.1 % respectively. The fall in construction reflects a slump in the commercial and housing property markets. The services sector which now accounts for 76% of the economy fell by 0.2%.

Unlike the other major mature economies – United States (US), Japan, Germany and France there has been no recovery in UK GDP even if the other recoveries prove to be in the end temporary recoveries.

This reflects the amount of money the UK government has spent on bailing out the banking system which has reduced the amount available for stimulus programmes such as a subsidy on buying new cars – the so called cash for clunkers scheme in the US. Additionally, manufacturing is a much smaller part of the UK economy than the other G8 countries and is much less competitive as we will show later. The UK has not despite its weak currency been therefore able to benefit from the restocking of global inventories which took place in quarter two and three of 2009.

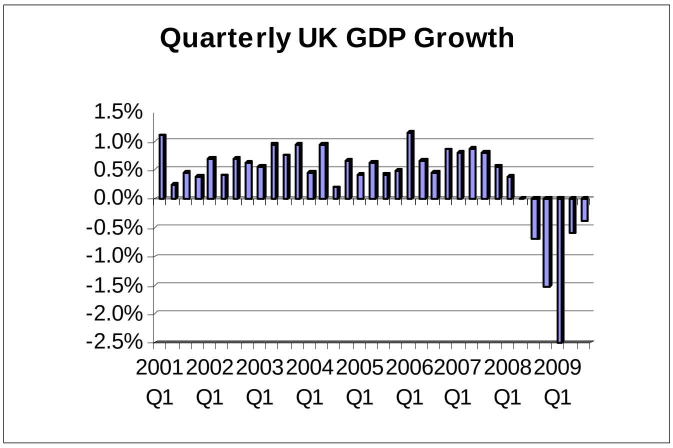


Chart 1: Office of National Statistics

One can see from the chart that GDP growth started to slow dramatically from the third quarter of 2007. This ties in with the "credit crunch" breaking in August of 2007. That is the start of the tightening of credit to consumers. Chart two below shows for 2007, 2008 and 2009 monthly new consumer credit secured on property and other forms of credit mainly credit cards.

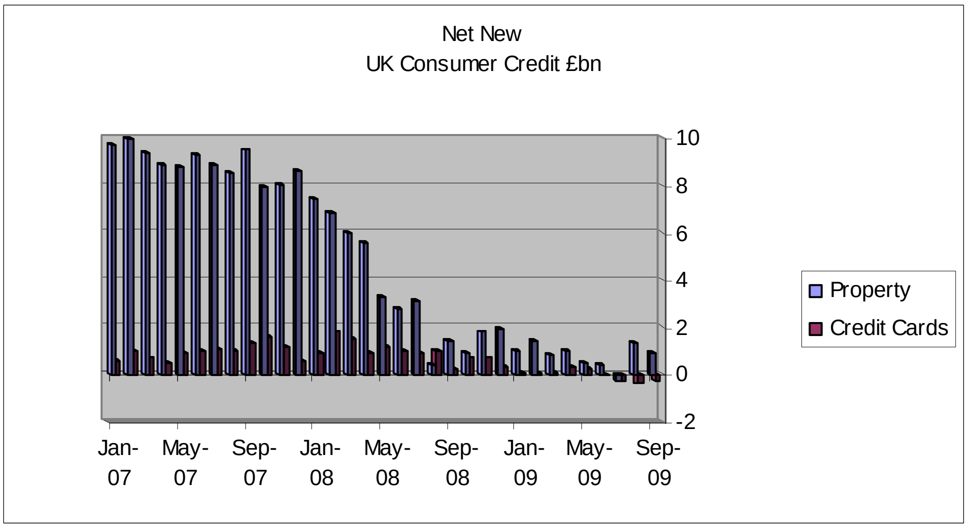
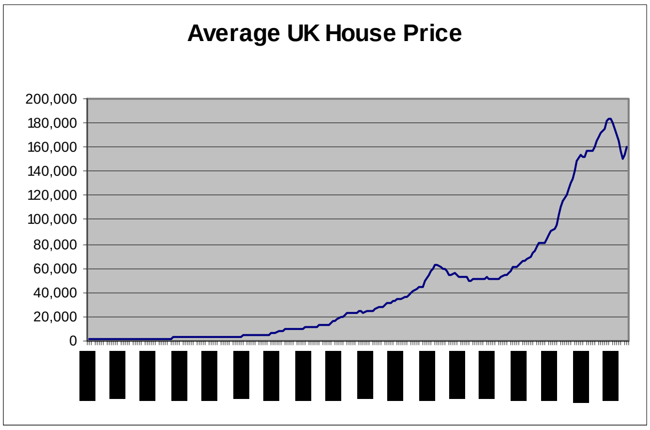


Chart 2: Source Bank of England

One can see from the chart that the bulk of new consumer credit comes from the re-mortgaging of property and this has been dropping off sharply along with other forms of credit since the start of the "credit crunch" in August 2007 with an acceleration in this decline in May 2008. This decline in credit is tied to the housing market which itself linked to the tightening of credit. The UK average house price is displayed in chart 3 below and it shows that a large bubble in housing prices has burst reaching a peak in October 2007 and falling 20.6% from this peak by the end of February 2009. We have written about this bubble previously[2] in April 2008. We predicted then that house prices in the UK, if growth was to return to pre-bubble levels of the last millennium, would need to fall by 40% from their peak so there is still some way to go for house price declines.



<u>Chart 3: Source Nationwide</u>

House prices have made a small recovery in quarter two and three of 2009. This is as a result of more funds having flowed from banks into the mortgage market. In the first half of 2009 the average monthly new funds for mortgages stood at £5 billion. In quarter three 2009 this had risen to average of £7.3 billion. This is the only modest gain from the government's quantitative easing (QE) scheme - pre-credit crunch average new monthly mortgage funds ran at £16 billion.

The government through QE has printed £150 billion of money and used it to buy back government and corporate debt from banks and other financial institutions in the hope that they will pump this money into the economy. This has clearly failed with only about £8 billion of this money finding it ways into the mortgagee market. Other areas of consumer credit have remained at very low levels or have shrunk as chart two shows. The banks and financial institutions have used the money from QE to replace capital and to buy other more attractive assets helping create a new financial asset bubble as we will see later.

But it was this credit linked to the housing bubble which was propping up the capitalist economy in the UK. The tightening of the credit markets and the corresponding fall in the housing market and reduction of property linked consumer credit has led to a big reduction in demand for goods and services, a decline in GDP and the recession we are now in. As Marx said in Capital 'the ultimate reason for all real crises always remain the poverty and restricted consumption of the masses, as opposed to the drive of capitalist production to develop the productive forces as though the absolute consuming power of society constituted their limit'.

Profitability of UK Industry

We can take a look at the profitability of UK companies' rate of profit. Chart four below shows the rate of post tax profits for manufacturing and service companies in the UK for 1989 to quarter two 2009..

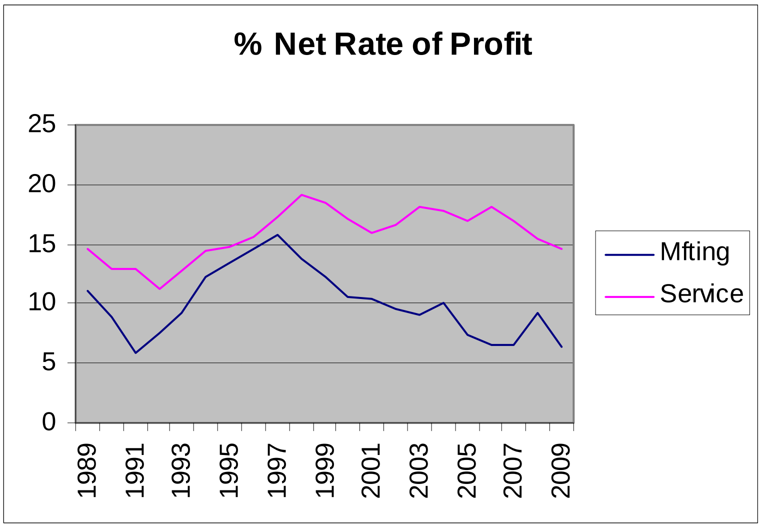


Chart 4: Source Office of National Statistics

The chart shows that for both segments of UK industry the rate of profit has declined from the peaks of the late 1990s. This indicates a build up of automation and consequently machinery including computers and telecommunications. Classically Marxists economists would say living (humans) labour is being replaced by dead (machinery etc) labour to maintain profits and reduce costs. However, this also reduces the rate of profit as the human contribution to the creation of goods or services is where the capitalist makes their profit. This effect is more profound in manufacturing where the process is more mature and more machinery is used. In the service sector there is less automation and it is more human labour intensive.

There is also, a much larger reserve army of labour for this sector of unskilled and semi-skilled workers particularly with the free movement of people across the EU states. The difference in the rate of profits between the service sector and the manufacturing sector also partly explains the diminishing size of the manufacturing sector. Capital has flowed to the more profitable sector.

We have no exactly comparable data for UK banks but if we use the net return on equity (ROE) number for banks the average ROE for 2000 to 2005 is 18.4% compared to 9.5% and 17.1% respectively for the manufacturing and service sector for the same time period. Clearly the high returns offered by banks attracted a lot of capital and contributed to their excessive high risk investment practices as they sought to maintain these returns and retain this new capital. But the striking point of note is that the decline in the rate of profit in the manufacturing and service sector pre-dated the "credit crunch" and the recession and led to more flows of hot capital to the banking sector which eventually led to the "credit crunch".

The Current State of the UK Banks

The four major banks and the wholly state owned Northern Rock reported their results, which were described as mixed, during the business week ending the 7 August

2009. We show these in the table1 below - all the figures are in billions of pounds sterling.

	Barclays	HSBC	Lloyds	RBS*	Nthn Rock
Pre Tax Profits	3.0	3.5	-4.0	0.2	-0.7
Write-downs	-4.6	-9.6	-13.4	-7.5	-0.5
Investment Banking Profits	1.0	4.2	0.0	5.1	0.0
Profits ex Investment Banking	2.0	-0.7	-4.0	-4.9	-0.7

*RBS Suffered a post-tax loss of £1bn

Table 1 UK Banks First Half of 2009 Results

The points of interest are: only Barclays made a profit when investment banking revenues are excluded; and the revenues from investment banking are a one off. Stock markets have rallied by nearly 50% from their March 2009 lows and the price fluctuations – called volatility – of financial assets have fallen making derivatives easier to trade and reducing daily profit and loss moves. In the credit markets the cost of buying insurance against bankruptcy has also fallen. All these factors have combined to create bumper investment banking profits. Normally stock markets would move no more than 10% over such a time span. But as we show later the sharp rally we have just seen is common in stock market crashes. In the past these have proved to be false dawns – often called sucker rallies - with the market falling again to levels below the previous lows.

The write downs in six months are nearly £36 billion. This money was lost as the value of assets the banks hold and loans to individuals and companies were written off. These losses are not paper losses but have to be matched from the banks capital. These are the losses from the banks exposure to the recession. They will continue dripping losses of this magnitude while the recession lasts and house prices continue to drop. If you add a major market fall and an increase in asset volatility, then on top of these losses will be potentially huge daily losses from derivatives – banks globally have a $700 trillion exposure to these assets. Such a scenario would lead to a similar financial meltdown as we experienced September 2008.

Even without a market correction the banks are likely to all return losses in the second half of 2009. The write-downs are probably underestimated as new rules give the banks leeway in accounting for “difficult to value assets”.

Non-Financial Company Results

If the decline in the banks earnings have been arrested all be it temporarily this is not the picture in the rest of UK industry. Table 2 below shows the decline in earnings for

UK companies reporting in 2009 compiled by Bloomberg Financial for the current and previous reporting cycles.

Results Cycle	No of Cos	Current Growth	No of Cos	Previous Growth
Annual	44/228	-24.0%	264/264	-38.1%
Semi		NA	983/983	-38.4%
Quarterly	15/62	-25.0%	57/57	-26.0%

Table 2 UK company earnings – source Bloomberg Financial

The decline in earnings is continuing but the rate of decline is slowing down. This is not down to an increase in revenues but cost cutting – reductions in wages and jobs and an increase in productivity.

Unemployment, Manufacturing Production and Capacity Utilisation

Unemployment in the UK had accelerated rapidly as chart 5 below shows which shows quarterly unemployment in the UK from Q1 2000 to Q3 2009 when it had reached 2.47 million.

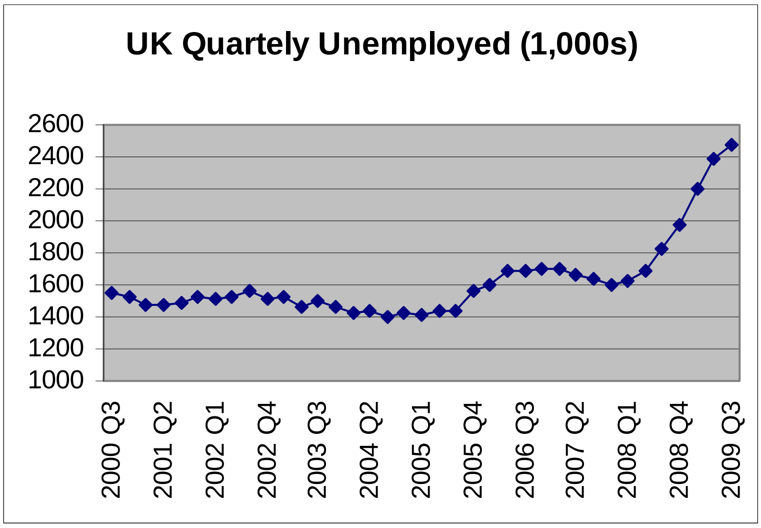


Chart 5: Source Office of National Statistics

There is normally a lag between an economy going into recession and unemployment rising. If this is the case then unemployment is likely to rise to well over three million by the end of the recession.

The numbers disguise the real extent of unemployment in the UK. Only 72.6% of people of working wage are employed. There are another 2.6 million people on incapacity benefit because of ill heath caused mainly by deprived working and living conditions who are not classed as unemployed.

The rise in unemployment is sharp given the drop in industrial production. By the end of August 2009 industrial production had fallen 14.9% so far from its peak, which was at the end of the second quarter of 2007, in this economic cycle. Given that the peak fall in the 1974/75 recession was 10.1% all the indications are that this recession will be much deeper than that one. It also reflects a move of capital from a low returning segment of the UK economy to higher returning parts. The continued decline in industrial production indicates this. After a bottoming out at the end of quarter one 2009 it fell a further 2.5% in the month of August 2009.

Chart six below shows the quarterly utilisation of industrial capacity from 2000 to the end of the third quarter of 2009 – there is a one quarter lag in the numbers. It clearly shows that an excess capacity in industry built up in the UK from the second quarter of 2008. A crisis of over production of goods had set in as the demand for goods and services fell on the back of the drying up of consumer credit. This excess capacity has increased more in 2009 as the recession deepened.

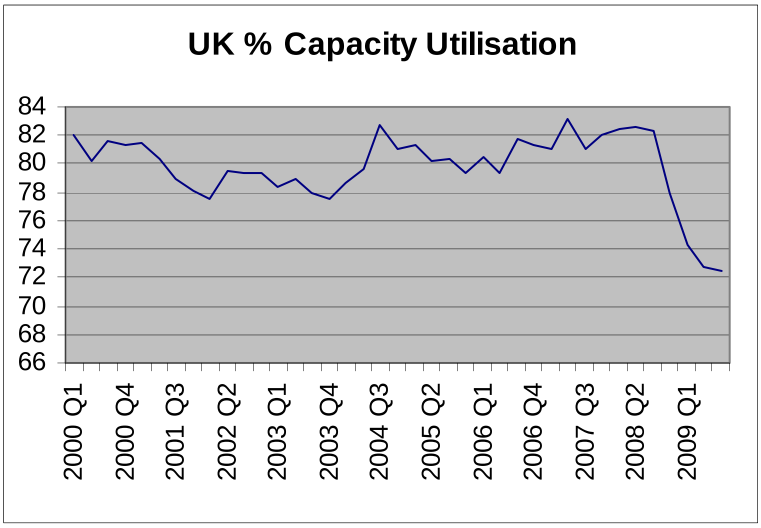


Chart 6: Source European Commission

Inflation

Chart 7 below shows the 12 month annualised rolling percentage rate for the different measures of inflation. The retail price index (RPI) is a broader and more representative measure of inflation and includes housing which the consumer price index (CPI) does not.

It is interesting to note that the massive expansion in consumer credit started to feed through into inflation from the start of 2005 as it began to creep up. This was one of the motives for the Bank of England monetary committee to start to raise interest rates in 2006 and 2007. A larger inflationary upsurge coincided with the out break of the “credit crunch” this time fuelled by increased demand from China and a speculative investment bubble. This meant that at the outbreak of the crisis in the financial system governments and their central banks were hesitant in cutting interest rates particularly outside the US. This undoubtedly hastened the onset of the recession and will mean that it will be much deeper as well.

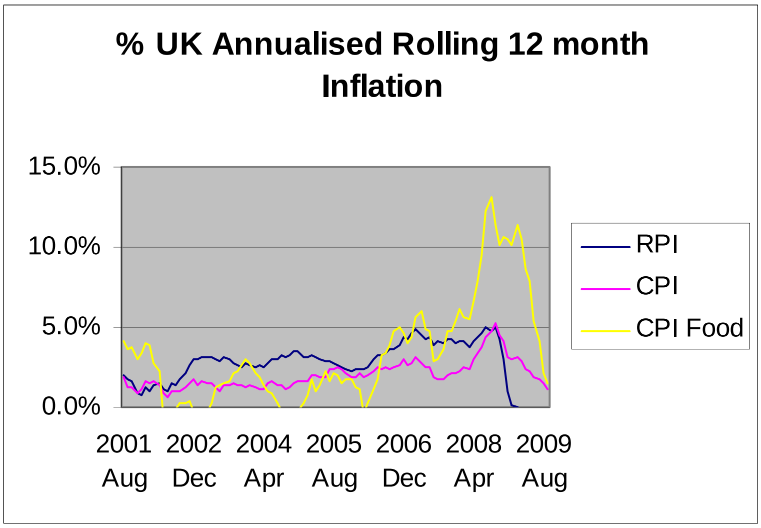


Chart 7: Office of National Statistics

Whether we will have the type of deflation that we had during the 1920/30s remains to be seen. The complete paralysis of the financial system and the banks unwillingness to lend to consumers because of their daily losses and future potential losses and the growing credit risk of consumers and other financial institutions that accompanies an acute recession means that consumer demand will remain weak.

However, food inflation, which as we can see from the chart, was stubbornly strong as climate change and demand from the growing Chinese middle-classes, kept food prices high. We are also big importers of food stuffs and with the weak pound this is helping support food prices. But a decline in demand for food as the slump hits more and more families has even seen this measure slip over the last few months.

Trade Deficit

The quarterly trade deficit is shown below in chart 8. It shows that this is has been widening since the start of the new millennium. This reflects the UK's diminishing manufacturing base and the demand for consumer goods. The gap has flattened out as the demand for consumer goods decreases on the back of the drying up of consumer credit and rising unemployment. The weakness of the pound is keeping the deficit artificially high as the cost of buying goods from other countries increases.

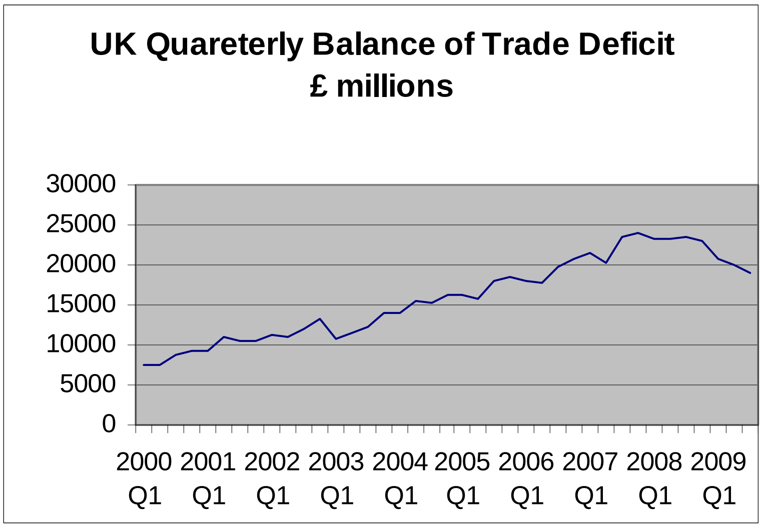


Chart 8: Source Office of National Statistics

Will the weak pound help our exports? Table 3 shows at the end of 2008 our main exporters and importers by country.

Exports		Imports	
USA	14.0%	Germany	13.0%
Germany	11.4%	USA	8.4%
Netherlands	7.8%	Netherlands	7.4%
France	7.5%	France	6.8%
Irish Republic	7.5%	China	6.4%
Belgium	5.2%	Norway	6.0%
Spain	4.0%	Belgium	4.7%
Italy	3.7%	Italy	4.1%
Sweden	2.0%	Irish Republic	3.5%
China	2.0%	Spain	3.0%

Table 3: Source the Federation of International Trade Organizations

It shows that our exports are heavily dependent on four countries which have been badly hit by the recession – the United States, Germany, Netherlands and Ireland. This will likely more than offset any gains from our weak currency.

Public Sector Debt

Public sector net debt, expressed as a percentage of Gross Domestic Product (GDP), was 47.8% at the end of January 2009 and has now ballooned to 59% at the end of September 2009, compared with 42.2% at end of January 2008 and just over 35% before the Northern Rock crisis. Net debt was £824.8.4 billion at the end of September 2009, compared with £607.8 billion in January 2008. This dramatic increase in public debt is almost solely down to the government's bailout of the banking system since the crisis of credit broke in August 2007 since then around £300 billion has been spent on direct bailouts and quantitative easing (QE). We also, have

£1.5 trillion of liabilities on our balance sheet from the UK government's ownership of Northern Rock, RBS and Lloyds TSB/HBOS. The government is also proposing to underwrite up to £700 billion of the so called toxic assets of the two partly owned banks – RBS and Lloyds.

Ultimately this level of debt will become inflationary unless it can be financed by higher taxes or the issuance of more government debt. Higher taxes have to be put off until some sort of recovery begins but may have to be pursued as in Ireland because of the low credit rating given to its government's debt. Issuing more government debt also counters the so called "quantitative easing" solution where governments buy up debt to drive long term interest rates down and pump money into the markets.

But the way all the main political parties are proposing to cut the deficit is by making savage public sector cuts. Because the scale of the deficit is unknown the plans put forward are vague – there may be future bailouts, more QE and there is a growing gap between government revenues and expenditure as the slump creates unemployment and business bankruptcies.

What Do the Financial Markets Tells Us about Economy?

The credit default swaps market which is a market which insures country and corporate debt against bankruptcy rated, at the end of October, the UK government's five year debt above only Italy's and Japan's of the eleven major government issuers of debt. Although this risk premium has fallen it shows the difficulty that the UK government will have in closing the deficit by selling debt. The government is hoping to sell four times the amount of debt in 2009/2010 and the years after that than they did in the years 2003 to 2008. A failure to meet these targets will mean larger cuts in public services and higher taxes.
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The pound has fallen 26% in value against a basket of major currencies from its pre-credit crunch peak in 2007 to the end of October 2009. Sterling is in effect a share on UK Limited and its fall reflects the lack of confidence in the UK economy by international investors. Its weakness is also a result of foreign investors selling UK assets and exchanging the money from the sale back into there own currency.

This sale of UK assets is shown in the decline in the stock market. The FTSE 100 fell 48% in March 2009 down from its pre crash high in June 2007. By the end of October 2009 half these losses have since been recouped. The initial fall and partial recovery almost exactly match the stock markets behavior during and after the 1929 stock market crash when a similar partially recovery based on a hope that there would be a freeing up of US banking credit proved to a false dawn,

Conclusion

The UK economy was beginning to stall before the "credit crunch" broke. It was also starting to show decling profit rates even in the service sector and a widening trade deficit on a diminishing UK manufacturing sector and excess capacity. Only a huge mountain of consumer debt secured on the back of a housing bubble gave the illusion that all was well with UK plc. This large amount of debt was creating creeping inflation which threatened to turn into a gallop as Chinese demand and speculators pushed the price of resource commodities and foodstuffs up.

The "credit crunch" was in effect the bursting point of a huge wave of speculative investment driven by hot capital seeking higher returns than could be achieved in the manufacturing and service sectors. This led to a complete breakdown of the financial system and a drying up of credit to all. The dynamic of this process is still unfolding and could still lead the world into its second great depression. The banking and financial system will continue to hemorrhage money as long as the recession and the decline in property prices continue.

The extent of the UK's dependence on consumer credit has been starkly revealed as we sit in the midst of what is modern Britain's' third economic slump. This gives socialists the first opportunity for a generation to explain the bankruptcy of the capitalist system and put forward a radical socialist alternative of running the economy; an economy run by the people, for the people and owned by the people.

An economy driven by meeting the majority of population's needs is the only viable alternative to the cuts in public services, job losses, wage cuts and tax rises that the UK major parties are offering as a solution to save UK capitalism.

1 Money Market Madness, Scottish Socialist Voice 321.

2 What's going on with the Housing Market? Scottish Socialist Voice 324.

Raphie de Santos is a member of the Scottish Socialist Party and worked as a financial and derivative analyst in investment banking and management for sixteen years.

This article will appear in a special edition of the French journal Inprecor on the economic crisis to be published in December 2009.