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Sunday Wrap - Special Edition

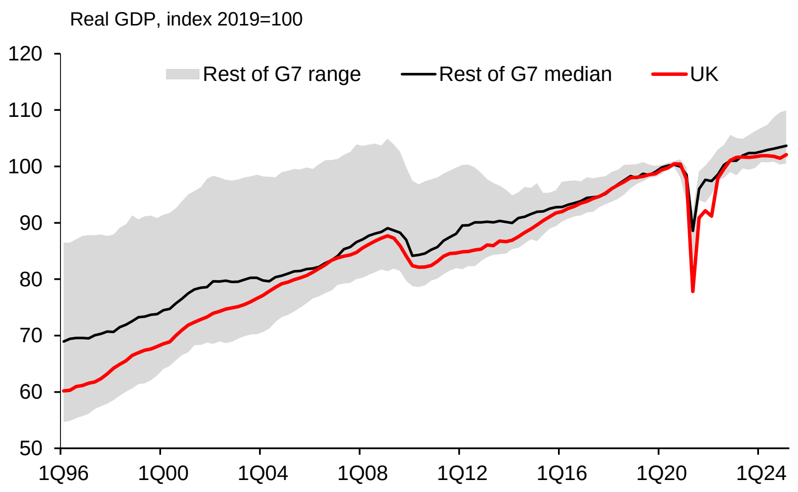
Happy Sunday,

This is Daniel Vernazza, UniCredit's Chief International Economist. Erik is off but he suggested I share an article with you that we published this past Friday on the challenges facing the new UK government. As you know, the center-left Labour Party won a landslide majority of seats in Thursday's general election, despite increasing its vote share by just 1.6pp. This gives them considerable power to implement, in its words, "change" after 14 years of Conservative Party government. In what follows, I will cover two main points:

- **The economic challenges facing the UK are huge, from low productivity and a cost-of-living crisis to a surge in economic inactivity and a less-open economy. The good news is that Labour seems to grasp the problems, but …**
- **Labour's plans to address these are too timid to make a significant difference. This cautious approach might change once Labour is in government, but stretched public finances, self-imposed and arbitrary fiscal rules, and a pledge to not raise the main tax rates will leave it with little room to maneuver.**

The starting point is weak, as the UK economy has underperformed the G7 average over the last few years and since the Brexit vote in mid-2016 (Chart 1).

CHART 1: UK GDP HAS UNDERPERFORMED THE G7 AVERAGE OVER THE LAST FEW YEARS

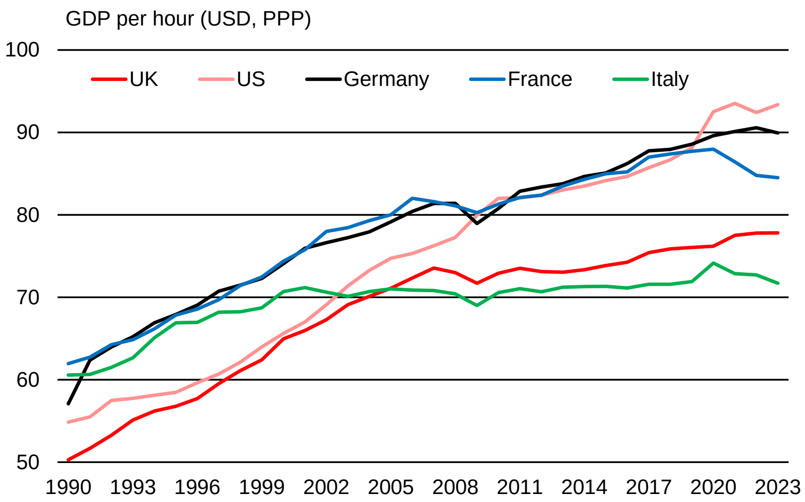


Source: OECD, UniCredit Research

Low productivity and chronic underinvestment

A long-standing problem is low productivity. Chart 2 shows that labor productivity (GDP per hour) in levels is low compared to other major advanced economies. Productivity in the UK is 17% below the US, 13% below Germany, 8% below France, but 8% higher than in Italy. This productivity gap between the UK and its peers has been persistent for many years, while the slowdown in productivity growth experienced since around 2003 is an international phenomenon.

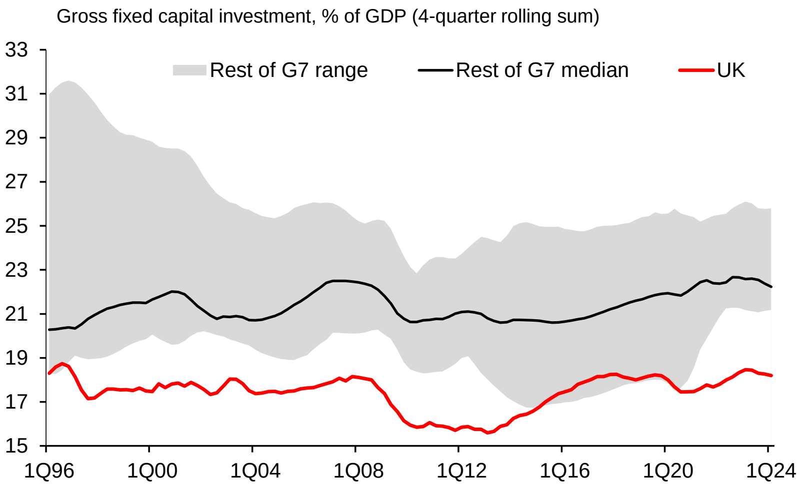
CHART 2: THE UK'S LOW PRODUCTIVITY



Source: Conference Board Total Economy Database, UniCredit Research

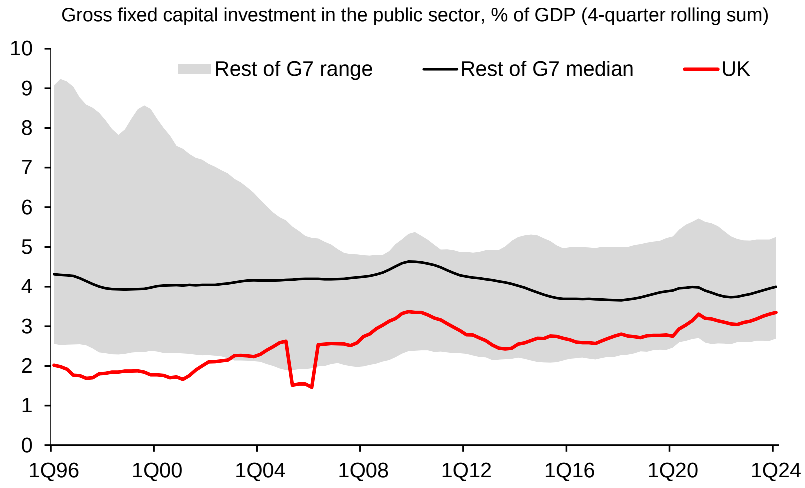
A key driver of labor productivity is investment, both public and private. The UK has been investing less than its G7 peers for many years (Chart 3). This is also the case for public-sector investment (Chart 4).

CHART 3: UNDERINVESTING FOR DECADES



Source: OECD, UniCredit Research

CHART 4: PUBLIC-SECTOR INVESTMENT LOW COMPARED TO PEERS, ALTHOUGH THE GAP HAS NARROWED



Source: OECD, UniCredit Research

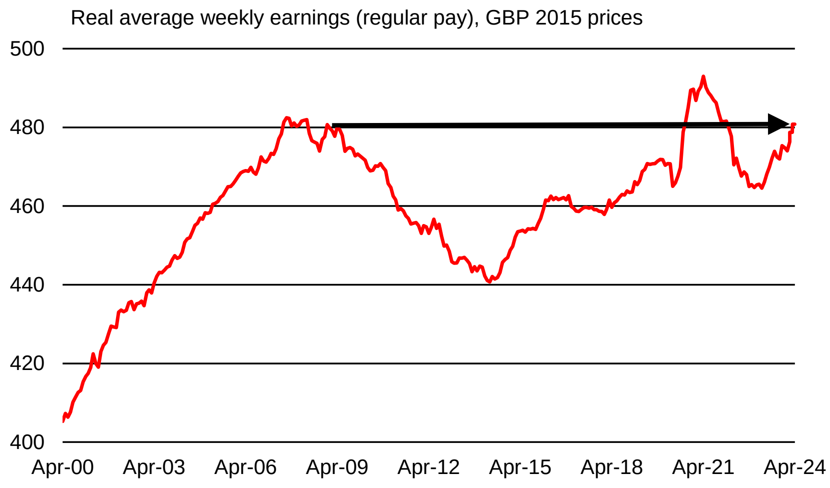
Labour has said it will replace the outgoing Conservative government's fiscal rule for the total budget to not exceed 3% of GDP by the fifth year of the forecast with a new rule to balance the current budget (i.e. the budget excluding investment), again by the fifth year of the forecast. On its own, this would give Labour more flexibility to borrow to fund public investment than the outgoing Conservative government. However, we see Labour's plans here as timid. In its manifesto, Labour pledges to boost public investment by only around GBP 5bn per year by 2028-29 (at a cost of GBP 17.5bn over five years), mostly through green investment initiatives. This is a small number (less than 0.2% of GDP) and would not stop public investment from falling as a share of GDP over the next parliament.

We think the reason Labour has not been bolder is because it has decided to stick with the outgoing Conservative government's second fiscal rule, which is to get the debt-to-GDP ratio falling by the fifth year of the forecast. According to the latest (March 2024) forecast by the Office for Budget Responsibility, this would not leave room for Labour to do more regarding investment. This is an arbitrary fiscal rule (as the debt-to-GDP ratio in the fifth year of the forecast must be lower than in the fourth year of the forecast) and one that makes no distinction between day-to-day spending (which generally has a fiscal multiplier of below one) and investment spending (which has a higher multiplier of around one).

Education and health spending is also an important contributor to human capital, although accounting definitions of investment exclude these as they treat capital expenditure as expenditure on "fixed assets". Labour has penciled in spending increases on health (see below) and education of about GBP 5bn per year by 2028-29, to be financed by tax rises (from limiting [legal] tax avoidance, applying VAT to private-school fees and closing the carried interest "loophole"). Again, these numbers are small.

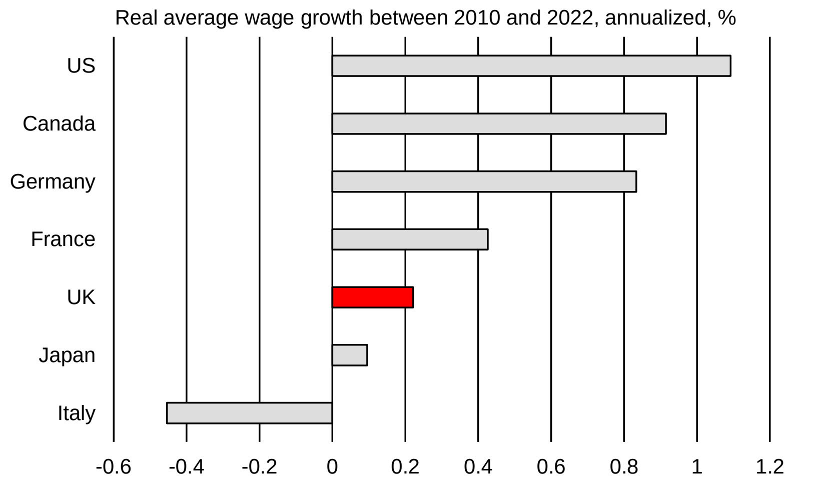
Productivity growth is key to increasing living standards over time, and UK real wages have stagnated over the last 14 years under the outgoing Conservative government (Chart 5). The UK has also underperformed its peers in terms of real wage growth since 2010 (Chart 6). Real wages have recently picked up somewhat, as Europe's energy crisis fades and as inflation has fallen to 2%, but sustainable real wage gains require productivity gains.

CHART 5: REAL WAGES HAVE STAGNATED SINCE 2010



Source: OECD, UniCredit Research

CHART 6: UK REAL-WAGE GROWTH LOWER THAN PEERS' SINCE THE CONSERVATIVE PARTY TOOK POWER IN 2010



Source: OECD, UniCredit Research

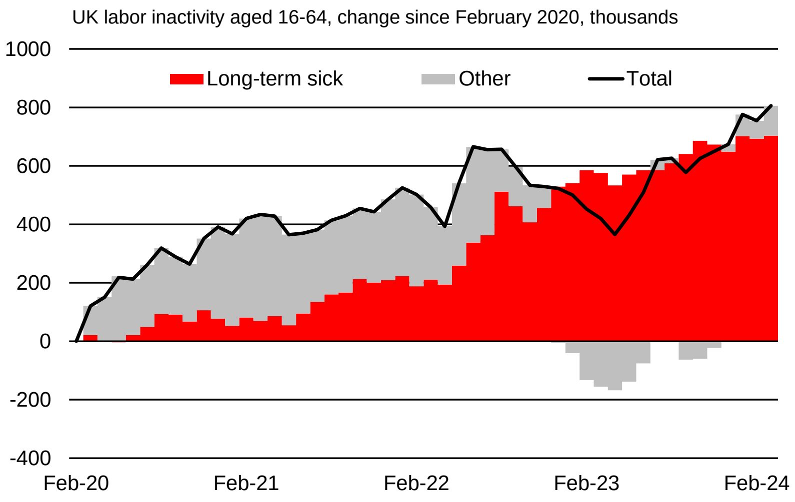
Surging economic inactivity

Not only is low productivity impacting output, but high economic inactivity (i.e. people neither in work nor actively looking for work) is also. Labor inactivity among those aged 16-64 has risen by around 800,000 since February 2020 (i.e. pre-pandemic), and the inactivity rate has risen to 22.3% from 20.7%. If instead the inactivity rate had not risen, and these people were activity seeking work, then the unemployment rate would be 6.1% instead of its actual rate of 4.4%.

As Chart 7 shows, this rise in economic inactivity is almost entirely made up of those who report that they are inactive because they are "long-term sick". It is unclear to what extent this is caused by mental health issues, long COVID or long National Health Service (NHS) waiting lists (there are currently 7.57mn cases on NHS waiting lists for consultant-led care, up from 4.47mn prior to the pandemic in February 2020).

Labour has pledged to cut NHS elective waiting times to 18 weeks or less by the end of the next parliament's term, thereby reversing a decade of longer waiting times. It has also pledged to increase the number of NHS staff (including 8,500 new mental health staff), to double the number of CT and MRI scanners and to build new hospitals. However, the amount of money to be allocated to these goals (GBP 1.8bn per year by 2028-29) is relatively small and will make up less than 1% of total health spending in the UK. The UK's ageing population also means that costs associated with health and social care will likely keep rising.

CHART 7: THE SURGE IN INACTIVITY DUE TO LONG-TERM SICKNESS



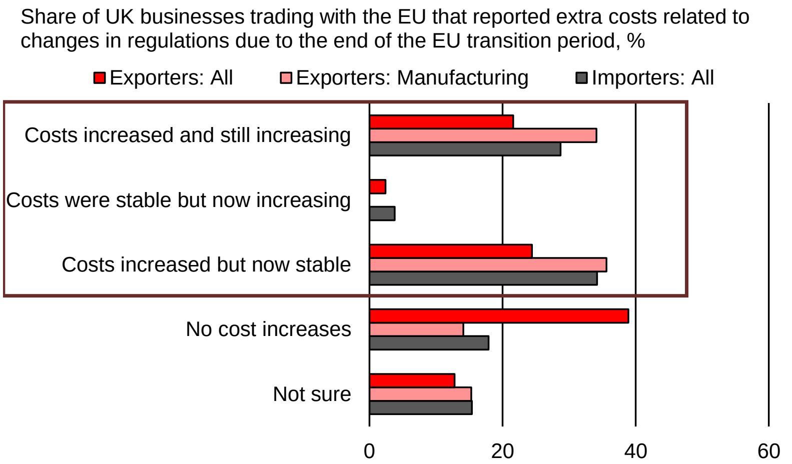
Source: ONS, UniCredit Research

Arguably the biggest change Labour has said it will make is to employment regulation. Labour has pledged to increase the minimum wage, particularly among younger workers, and to tighten workers' rights (including with regard to sick pay and protection from unfair dismissal). Stronger employment protection will likely weigh on hiring and firing while having little overall effect on unemployment, but it will reduce (typically productivity-enhancing) churn and flexibility in the labor market.

Brexit and a less-open economy

Since the UK left the EU, its trading relationship with the EU has been governed by the Trade and Co-operation Agreement (TCA) and the Windsor Framework for Northern Ireland (the latter came into effect on 1 October 2023). The TCA is a typical free-trade agreement that avoids tariffs on trade in goods but does very little in terms of harmonization and recognition of standards applied to goods and services, which requires customs checks on goods and impedes market access to services. This has raised costs for British businesses (Chart 8), both those that export to and import from the EU, which is still by far the UK's largest trade partner.

CHART 8: THE INCREASED COST OF TRADING WITH THE EU



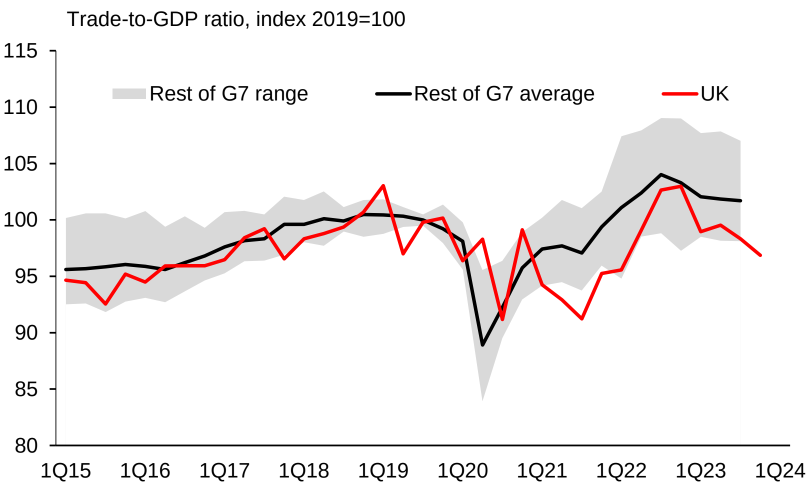
Note: survey was conducted 22 January 2024 to 4 February 2024.

Source: *ONS Business Insights and Conditions Survey Wave 101*, UniCredit Research

It has been four and a half years since the UK formally left the EU, and 3.5 years since the end of the transition period. EU nations applied full customs checks on UK exports from day one (at the start of 2021), while the UK has only recently started to impose checks on imports of goods from the EU (physical inspections started in April, while further declaration requirements will come into effect this October).

Using trade data to assess the impact of Brexit is difficult, in part because trade data are often revised and there are identification issues given the simultaneity of other large shocks from the pandemic and energy crisis. Still, trade data suggest the UK has become less open (Chart 9). This is not surprising because the only trade partner the UK has managed to sign an agreement with that the EU does not have an equivalent (or better) agreement with is Australia, and estimates of the gains from this agreement in the form of reduced barriers to trade are small, because the amount of trade affected by the agreement is relatively small and it is also a basic (not deep) free-trade agreement.

CHART 9: REDUCED OPENNESS TO TRADE



Source: OBR, OECD, UniCredit Research

Labour's manifesto refers to building "an improved and ambitious relationship with our European partners", although we think the details of what would constitute "ambitious" here are lacking, also in terms of how it intends to convince the EU to agree.

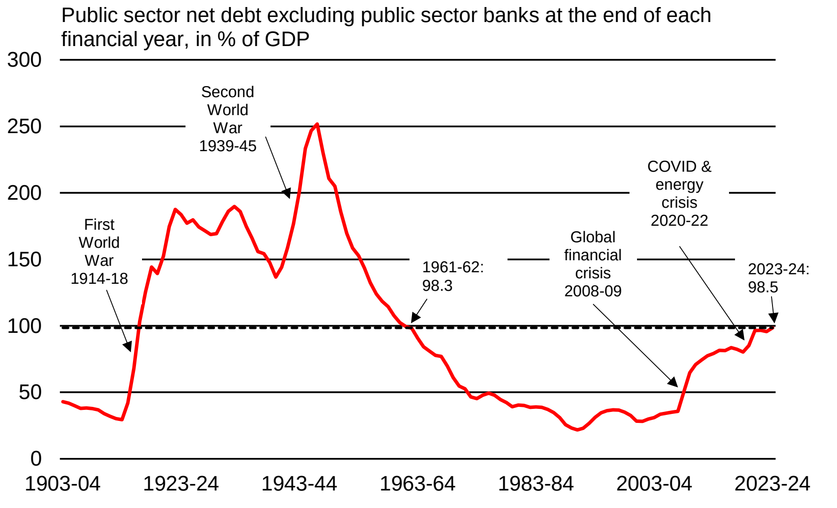
Instead, Labour has been clear about what it does not want: no single market, no customs union and no freedom of movement. As Michel Barnier, the EU's chief Brexit negotiator, famously showed at a European Council meeting in December 2017, these red lines would rule out a significant improvement in ties based on the EU's balance of rights and obligations set forth in existing agreements with non-EU members. For example, "no single market" and "no freedom of movement" rule out joining the European Economic Area (like Norway, Iceland and Liechtenstein), while "no freedom of movement" rules out joining the European Free Trade Association (like Switzerland). "No customs union" means there will have to be a customs border for goods trade.

Labour has said it will seek a veterinary agreement with the EU, which could involve mutual recognition of sanitary and phytosanitary standards (and, hence, reduce or remove non-tariff barriers to UK-EU trade in agri-food). This would surely require the UK to dynamically align its agri-food standards with those of the EU and accept a role for the European Court of Justice in enforcing the rules, which Labour would likely be willing to do. Labour would also seek recognition of professional qualifications, but the EU seems unlikely to agree to this without the free movement of people.

Stretched public finances

The UK's public finances are in the worst shape they have been in for at least 60 years. Following a succession of major adverse shocks, namely the 2008-9 global financial crisis, the 2020-21 COVID-19 pandemic and the 2022-23 European energy crisis, public-sector net debt – i.e. gross debt minus liquid financial assets and excluding public-sector banks, which is the most widely watched measure of debt in the UK and the reference for one of the government's legislated fiscal targets – has risen to almost 100% of GDP (Chart 10). Budgetary pressure from an ageing population (health and social care) have also seen this trend rise, even during good times (Chart 11).

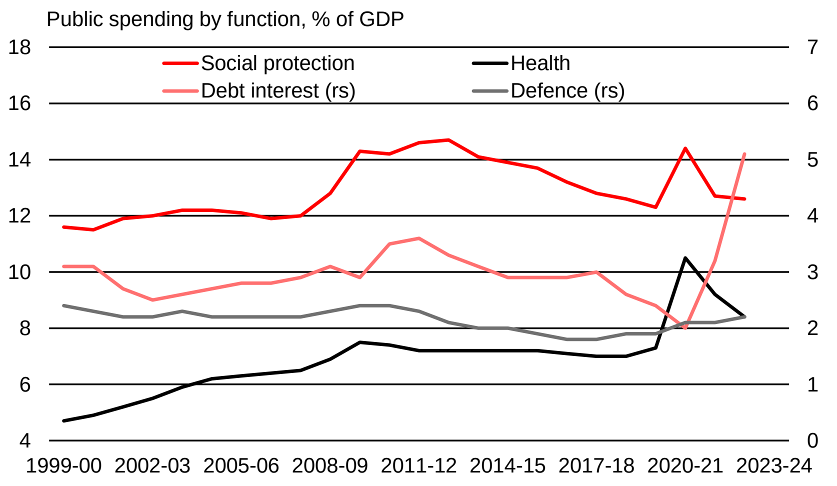
CHART 10: THE NATIONAL DEBT IS COSE TO 100% OF GDP



Source: OBR, ONS, UniCredit Research

Given increased spending needs related to health and defense (Labour has matched the outgoing Conservative government's pledge to raise defense spending to 2.5% of GDP by 2030), "unprotected" departments (i.e. excluding health, education and defense) are due to face large real-terms cuts. These real-terms cuts to "unprotected" departments (of between 1.2-2.9% by 2028-29, according to the Institute for Fiscal Studies) are unlikely to be deliverable. While Labour has said it will seek to find efficiency savings to ease these cuts, efficiency savings tend to be elusive. Therefore, it seems likely that taxes will have to rise by more than indicated. To be sure, Labour has pledged not to increase the four main tax rates (National Insurance, income tax, VAT and corporation tax) in the next parliament, but it could adjust tax thresholds or other taxes. Otherwise, it will likely have to break its fiscal rules.

CHART 11: SPENDING ON HEALTH AND DEFENSE IS SET TO CONTINUE RISING



Source: OBR, ONS, UniCredit Research

So, Labour has secured a massive majority to implement, what it calls, “change”. But Labour has so far not announced any radical policy changes. It has pledged to tax, spend and borrow only slightly more than the outgoing Conservative government had planned. It has promised to improve ties with the EU, but its red lines rule out a much closer relationship. If Labour is to properly address the country’s huge economic challenges, from low productivity and a cost-of-living crisis to surging inactivity and a less-open economy, it will surely have to be bolder. However, stretched public finances, (self-imposed and arbitrary) fiscal rules, and a pledge to not raise the main tax rates over the term of the next parliament, will leave it with little room to maneuver.

And on that note, I’m off for a walk with my family before settling down this evening to watch the results of the second round of the French parliamentary election.

Best,

Daniel

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