Economics for Business

The UK economy experienced a slowdown in 2005. **Steve Adams** explains why it happened, how policy-makers knew about it and what they did in response.

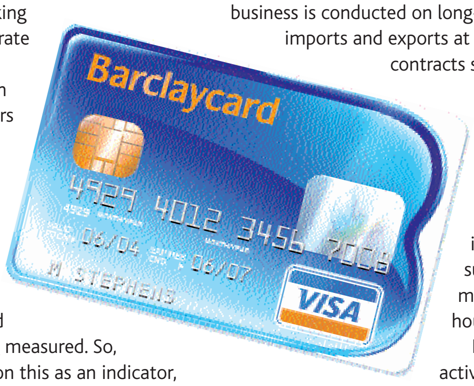
In the summer of 2005 there were growing signs of a deceleration in the growth of economic activity in the UK. This did not necessarily mean that the level of economic activity fell, but there was certainly evidence that the rate of growth had slowed and fallen below that which the government had expected. One response to this was the first reduction in interest rates by the Bank of England for nearly two years.

This process raises a series of questions about the nature of an economic slowdown. The most important of these are:

- Which indicators signal that the economy is slowing down?
- Why do economies slow down?
- Why should policy-makers worry about a slowdown?
- What sorts of policies might be used to counter a slowdown?

Which indicators signal that the economy is slowing down?

The level of economic activity is measured by adding up the value of all market transactions in an economy. The most common measure of this is gross domestic product. If an economic slowdown is taking place, we would expect a decline in the rate at which GDP is growing – or, more seriously, a decline in GDP. The definition of a recession is two consecutive quarters of falling GDP. Although the UK economy as a whole has not experienced a recession since the early nineties, the country's manufacturing sector experienced falling output in the first two quarters of 2005 and was, therefore, in recession.



Of course, GDP data can be collected only after the period in which it is being measured. So, if policy-makers were to depend solely on this as an indicator, they would have no early warning of a slowdown and be unable to take preventive action. They also use leading indicators, which are economic variables that tend to change early on in the process and so warn of impending changes in GDP. Some of the UK's most important leading indicators are:

- Measures of business and consumer confidence.
- Measures of business investment intentions.
- Business stockholding.
- Consumer spending.
- Manufacturing orders.
- Money supply data.
- Mortgage applications and house prices.
- The level and growth of consumer credit.

If all of these measures are pointing in the same direction – declining confidence, reduced investment, fewer mortgage applications etc – it's fairly convincing evidence that a slowdown is under way. We would expect the subsequent GDP figures to confirm the deceleration in economic growth.

There are also lagging indicators, which are variables that tend to change in response to a slowdown and hence occur later in the process. These are of no use in predicting a slowdown, of course, but they are important signs of its likely severity and duration. The most important lagging indicator is unemployment. It rises when there is a fall in economic activity, but takes time to do so. The initial response of businesses to changes in sales tends to be a rise or fall in stocks of finished goods. Businesses will cut jobs only when they are convinced that a serious decline in economic activity is occurring.

We might expect a change in economic activity to affect a country's trade with the rest of the world and, therefore, its balance-of-payments position. But, since much international business is conducted on long-term contracts, the level of imports and exports at any one time largely reflects contracts signed months and, probably, years before. So there is a long time lag before a change in the level of economic activity affects a country's balance of payments.

Three important areas of the UK economy seemed to be indicating a slowdown last summer: consumer activity, manufacturing activity and the housing market.

Most indicators of consumer activity for the first half of 2005 pointed towards the end of the great spending boom that had occurred over the previous three years. Since consumer expenditure is the biggest single component of aggregate demand for goods and services, a slowdown in this area is likely to have a large impact on the economy as a whole. Evidence of a slackening in consumer activity could be found in a variety of indicators:

- The level of consumer spending in high-street stores stopped growing. Many stores reported difficult trading conditions and a number of firms extended their sale periods or started them earlier than usual.
- The growth of consumer credit also ceased. Consumer debt had increased hugely in the UK (especially on credit cards),

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but by 2005 this growth had ceased and there were months when outstanding consumer debt fell. Consumers were repaying more old debt than they were taking on new debt.
- Surveys of consumer confidence – a good indicator of future expenditure – showed waning confidence as consumers became concerned about their level of debt in relation to their expected future income.

It was clear in late 2004 and early 2005 that the UK's manufacturing sector was in considerable difficulty. Output had fallen in the first two quarters of 2005 and so had the number of orders. Also, the prices of manufactured goods had been falling for most of the previous 18 months. This was partly a consequence of increased competition domestically, but mainly the result of intense pressure from imports, especially from the rapidly industrialising countries of Asia. By contrast, the service sector, facing much less intense competition, showed increasing output and prices over the same period.

The housing market is peculiarly important to the UK economy. When property prices are increasing, consumer spending also tends to increase. This is partly because more people move house when house prices are rising and, in doing so, they buy more new household goods such as carpets and furniture. It's also because rising house prices increase households' perceived net wealth. When people feel wealthier, they tend to spend more. They may even use the increased value of their houses to finance further expenditure through increased mortgage borrowing.

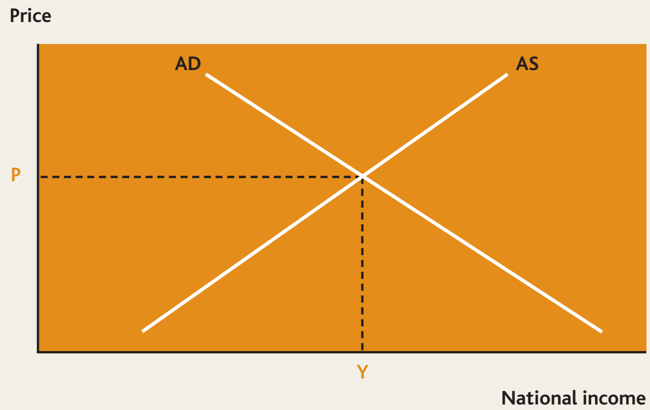
But the UK housing market had slowed down by 2005. The number of new mortgage applications declined, house prices ceased to rise and, in some regions, they began to fall slowly. The most worrying trend was that the number of cases of mortgage arrears and house repossessions, although still low in comparison to the early nineties, had started to rise. All these signs suggested that the boom in the housing market, which had lasted since the late nineties, was coming to an end.

Why do economies slow down?

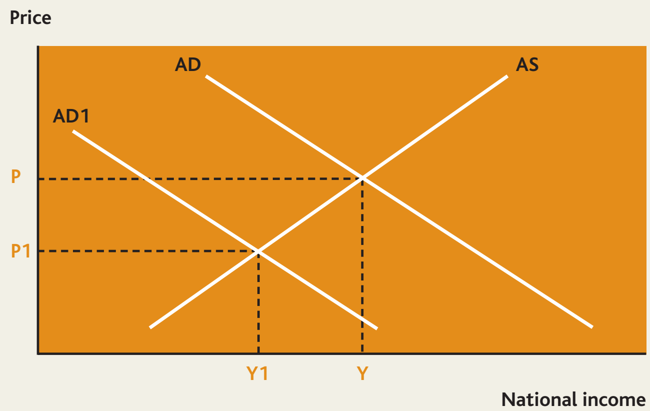
Economists have devoted a lot of effort to explaining the trade cycle of a rapid expansion followed by a slower expansion or even a decline in economic activity. There is also considerable disagreement among economists as to the underlying mechanisms in this cycle. But they generally agree that the direct mechanisms inducing a slowdown are either a change in the total demand for goods and services or a change in the underlying supply conditions. This can be illustrated using the concepts of the aggregate demand curve and the aggregate supply curve.

The aggregate demand (AD) and aggregate supply (AS) concepts are illustrated in panel 1 at the top of the page. Aggregate demand is the total demand for goods and services in the economy at different overall price levels. The AD curve slopes downwards from left to right, showing that, with other things being equal, total demand for goods and services rises as the price level falls. The AS curve shows the total supply of goods and services at different price levels. The AS curve slopes upwards from left to right, showing that, with other things being equal, the total supply of goods and services will rise as the price level rises. The economy will tend to settle at that level of activity (measured by national income on the horizontal axis) and that price level (measured on the vertical axis) where aggregate demand and aggregate supply are equal. So the level

1 AGGREGATE SUPPLY AND AGGREGATE DEMAND



2 A SHIFT IN THE DEMAND CURVE



of economic activity, and those variables associated with it – notably, the level of employment – will change if there is a shift in either the AD curve or the AS curve.

If there is a shift to the left in the AD curve (*see panel 2, page 26*), the level of economic activity will fall and the price level will also fall. But what would cause a shift in the AD curve to the left? If the AD curve moves to the left, it must mean that at least one component of aggregate monetary demand (AMD) has fallen. AMD has four components: consumer demand, business investment, government expenditure on goods and services, and net exports. Consumer demand may fall for several reasons, but all are related to the ability or willingness to buy goods and services. Consumer demand may fall because:

- Consumer income has fallen – as a result of rising income tax, for example.
- Net disposable consumer income has fallen as a result of interest rate rises, which have increased the cost of servicing debts including mortgages.
- Consumer wealth has fallen as a result of falling asset values, especially those of houses and shares.
- Consumers have lost confidence in the future in terms of their employment and income prospects.
- Consumers have high levels of debt and are unwilling or unable to increase their debt further as a method of financing their spending.

Several of these processes seem to have been operating in 2005. Higher interest rates in 2003 and 2004, falling house prices in 2005 and excessive personal debt were all identified as sources of the slowdown in consumer spending. Since consumer expenditure is the biggest single element of AMD, changes in it are particularly important.

Business investment is a more complex matter, but again it relates to the ability and willingness of the private sector to fund new projects. Companies' ability to invest may be affected by changes in: profits, company taxation, the cost and ease of borrowing, and their ability to raise funds by issuing new shares. Their willingness to invest will be affected by their expectations of the return on their investments. This will reflect expected sales and revenues, expected costs and the rate of interest.

Although business investment did not seem to be the main source of the slowdown in 2005, there were some problems. Falling consumer demand and rising costs – the price of oil, for example – clearly served to reduce business confidence.

Government expenditure falls into two broad categories: spending on goods and services (eg, the NHS) and transfer payments (eg, pensions). The latter does not make up part of AMD because it appears in other AMD components, notably consumer spending. But expenditure on goods and services does matter, since it makes up about 20 per cent of all spending in the economy. It might change either if there are changes in government policy on the provision of goods and services by the public sector, or if there are changes in the restraints imposed on expenditure by taxation income.

In the UK's case, there had been a sizeable increase in government spending on health and education between 2002 and 2005 as a result of a deliberate policy decision. This had been a significant factor in raising AMD and encouraging an increase in economic activity in that period. The problem from 2005 was one of financial constraint. Given the chancellor's "golden rule" that, over the whole economic cycle, current spending should be financed by taxation and not by borrowing, it was clear that further increases in expenditure could not be made.

For a country with a high ratio of foreign trade to national income, a change in the balance of trade can have considerable effects on its economy. So a decline in net exports (exports minus imports) could lead to a reduction in AMD and hence a decline in economic activity. At any given level of national income, there might be a decline in net exports primarily as a result of lost competitiveness. This reduction in competitiveness may arise from:

- A domestic rate of inflation that is higher than those of the country's major trading partners.
- An overvalued currency exchange rate.
- The appearance of new, low-cost competition.

The UK inflation rate has been extremely low in recent years, but sterling has been overvalued and this has contributed to a large deficit on the balance of trade. The manufacturing sector has faced the extra problem of low-cost competition, especially from China and India. This is good for consumers but tends to reduce domestic economic activity.

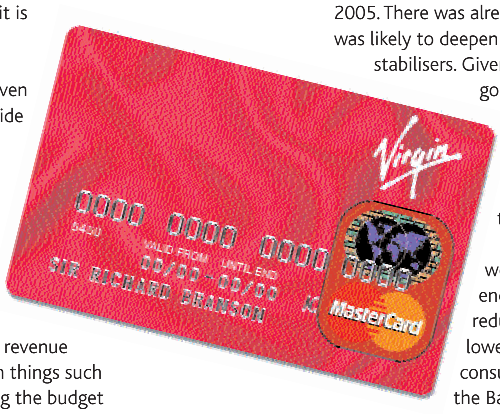
The main factors in raising AMD in the UK have, therefore, been consumer and government spending. As the growth in these decelerated in 2005, the growth in AMD and hence in overall economic activity was greatly reduced. In terms of the diagrams, the AD curve was shifting to the left. But this raises the question of what was happening to the AS curve.

A shift in the AS curve to the left would have the effect of reducing the level of economic activity and raising the price level. This might lead to stagflation: the simultaneous occurrence of inflation and recession. The position of the AS curve is determined primarily by the underlying cost conditions in the economy. If underlying costs rise, the AS curve moves to the left. If underlying costs fall, it moves to the right. In the UK there have been no great shifts in cost conditions in recent

years. But in 2005 the price of oil reached record heights of over $60 a barrel. While western economies are less vulnerable to oil price rises than they were in the seventies, a substantial and sustained increase would tend to reduce economic activity.

So a combination of processes in the UK in 2005, mainly on the side of demand, suggested that a significant fall in the rate of growth of economic activity was occurring.

Why should policy-makers worry about a slowdown?
If the level of economic activity falls in a country, it is likely to have certain consequences:



- Unemployment increases. Indeed, if labour productivity is rising, unemployment can rise even if economic activity is increasing. The rough guide for the UK economy is that, if national income growth is less than two per cent a year, unemployment will increase.
- Inflationary pressures diminish. Inflation is largely a demand phenomenon, so a reduction in AMD will lessen the upward pressure on prices.
- Government finances deteriorate. If national income falls and unemployment rises, taxation revenue tends to decrease and government spending on things such as unemployment benefits will increase, moving the budget towards a deficit.
- The balance of trade improves. Declining economic activity in an economy will depress the demand for imports, thereby improving the balance of trade.

A recession does, therefore, produce some advantages for an economy – notably, by improving inflation and the balance of trade. But the overall cost in terms of unemployment and the slower growth, or even decline, in economic welfare, means that governments will try to design policy to avoid such a situation.

What sorts of policies might be used to counter a slowdown?
It's possible that a government will not have to take any remedial action in some cases. There are so-called automatic stabilisers that act to balance the economy on their own. The obvious automatic stabiliser works through the government budget: as the level of economic activity declines, taxation revenue falls and government spending on transfer payments, especially unemployment benefits, rises without the need for any change of policy.

Because taxation is a withdrawal from the circular flow of income, and government spending is an injection into the circular flow, this will tend to raise the level of AMD. A decline in AMD and economic activity is, therefore, dampened by the action of automatic stabilisers. But such processes are unlikely to be strong enough to prevent all of the reduction in the level of economic activity, especially if the initial fall in AMD is large.

In these circumstances, the government will have to consider discretionary policy measures. If the source of the decline in economic activity is a fall in AMD, the appropriate response is to try to raise AMD. This might be attempted through:
- Fiscal policy – either increasing government expenditure or reducing taxation.
- Monetary policy – cutting interest rates to encourage both consumer spending and business investment.

The UK government had little scope for active fiscal policy in 2005. There was already a large budget deficit and the slowdown was likely to deepen this through the operation of automatic stabilisers. Given that the government wanted to keep to its golden rule of financing current expenditure through taxation rather than borrowing, there was no real scope for increasing expenditure or decreasing taxation. So the emphasis was on monetary policy, which is the Bank of England's responsibility.

The appropriate monetary policy response would be to cut the interest rate. This would encourage business investment, and, by reducing the burden of debt servicing and lowering the cost of new borrowing, encourage consumer expenditure. The only constraint is that the Bank of England has an inflation target of two per cent. If rising oil prices impart an inflationary twist, it may feel unable to engage in rate cuts, because these may limit its ability to meet its long-term inflation target. Nonetheless, the Bank of England responded to evidence of a slowdown in August by cutting the base rate from 4.75 per cent to 4.5 per cent. It was the first reduction in two years.

So the pattern for 2005 was as follows: growing evidence of an economic slowdown from a range of indicators; a general awareness that the main source of this slowdown was a reduction in consumer spending; and an appropriate policy response in the form of a interest rate cut. Because it takes time for a economic policy response to make an impression, the effectiveness, or otherwise, of this will not be evident for a while. But some time in 2006 we may be able to say whether its scale and timing were right. **FM**

Steve Adams is a former CIMA examiner.

C4 Recommended reading

S Adams and P Periton, *Economics for Business Study System*, fifth edition, CIMA Publishing, 2004.
B Atkinson and R Millar, *Business Economics*, FT/Prentice Hall, 1999.