Economic Review

October 2010

Graeme Chamberlin
Office for National Statistics

Summary

Gross Domestic Product (GDP) grew by 1.2 per cent in the second quarter of the year. The acceleration from the previous quarter reflected a pick up in household consumption, exports (net trade) and stockbuilding as businesses increased their holdings of inventories for the first time since late 2008. The UK corporate sector remains a net-lender to the rest of the economy, mainly due the weakness of fixed capital spending. Cash reserves have been used to reduce liabilities (loans) rather than purchase new assets. The household sector became a net borrower in 2010 Q2 for the first time since 2009 Q1, mainly due to the fall in the saving ratio to 3.2 per cent. Central government was a large net borrower, consistent with the large current budget deficit. The UK current account remained in deficit (£7.4 billion in 2010 Q2), with recent movements driven by the balance in direct investment income.

Household consumption and business restocking lead growth in the second quarter

The United Kingdom Economic Accounts, published on 28 September 2010, provide a full set of National Accounts for the second quarter of the year. This not only includes a fuller description of economic activity as measured by the output, expenditure and income methods, but also a set of financial balance sheets for each of the main sectors (households, corporations, government and so on). This article will focus on recent expenditure and income patterns in the UK as this is where the latest data adds most value. The two previous monthly Economic Review articles concentrated more on the output or production side of the economy, in line with data availability in earlier National Accounts releases covering 2010 Q2.

Gross Domestic Product (GDP) picked up strongly in the second quarter as the headline seasonally adjusted chain volume measure grew by 1.2 per cent. GDP has now expanded for three successive quarters, but the latest data shows a marked acceleration from the 0.4 per cent growth recorded in the final quarter of 2009 and the first quarter of 2010.

Contributions to growth by the main categories of expenditure are shown in **Figure 1**. This identifies household consumption, net trade and the 'other' category as having the strongest impact on growth in 2010 Q2 relative to the previous quarter.

Figure 1 Contributions to GDP growth by main items of expenditure

Percentages

Quarter of quarter

Source: UK Economic Accounts

Household consumption was flat in the first quarter, sandwiched between stronger growth in both the preceding and succeeding quarters. In January the rate of Value Added Tax (VAT) returned to the higher rate of 17.5 per cent having been temporarily cut to 15 per cent in December 2008 as part of the fiscal stimulus package announced in the 2008 Pre-Budget Report. Consequently some consumption may have been brought forward to the final quarter of 2009, especially on durable goods. Disruption caused by heavy snowfall in January may also have weighed on household consumption in the first quarter, as evidenced by weaker retail sales and lower spending in the distributive, hotels and restaurants sectors. Stronger growth in second quarter consumption may therefore be partly in response to a weaker first quarter. The level of household consumption is still 3.6 per cent lower than before the recession started in 2008 Q1.

Although Gross Fixed Capital Formation (GFCF) grew in the latest quarter, following two quarters of small declines, the overall contribution to GDP growth was small at around 0.1 percentage points. GFCF is now just under 20 per cent below its pre-recession peak in 2007 Q4, and the fall was larger in this most recent recession compared to those in the early 1980s and 1990s. In contrast, government consumption has continued to grow consistently, making a small positive contribution to growth.

Net trade made a significant negative contribution to growth in the first quarter of the year. This could partly be attributed to the impact of the bad weather disrupting the transport of goods to ports and thus exports. Imports would not have been so adversely affected. Exports rebounded in the second quarter reducing the extent to which net trade made a negative contribution to GDP growth. Since the global economy started to recover in the second half of 2009, growth in imports has tended to outstrip the growth in exports, so despite the large depreciation in sterling in the second half of 2008, net trade has subtracted from GDP growth.

The 'other' category shown in Figure 1 consists of the consumption expenditure of the non-profit sector and changes in business' holdings of valuables and stocks (raw materials, work in progress, finished goods). In level terms each of these is a relatively small proportion of GDP, but changes in stockholdings (or inventories) have an important impact on changes in GDP. Positive contributions to GDP growth have recently occurred as firms reduce the rate at which they were de-stocking (running down their inventories). This deceleration was particularly strong in the first quarter of the year, when it is now evident that GDP growth would have been much stronger had it not been for the weather-disruption to household consumption and exports. This trend continued into the second quarter to the extent that businesses have started to restock for the first time since 2008 Q4.

Figure 2 **Change in inventories**

£ millions

Source: UK Economic Accounts

The recent pattern in inventories is shown in more detail in **Figure 2**. Clearly as the economy entered recession in the second quarter of 2008 businesses first began to reduce the rate at which

they accumulated inventories before leading to actual de-stocking. Since the economy started to recover the rate of de-stocking has slowed before positive stockbuilding was recorded in the latest quarter. It is also noticeable that these trends have been uniform across the production, distributive and other sectors of the economy, and had it now been for the alignment adjustment which is used to help reconcile the output and expenditure measures of the economy, the increase in inventories in the second quarter would have been even stronger.

Stronger growth in consumption deflators than investment deflators

Implied deflators can be calculated for the expenditure components of GDP from chain volume and current market price measures. **Figure 3** shows the GDP deflator, and those for consumption and investment (GFCF). In 2010 Q2, the GDP deflator was 4 per cent higher than the same quarter a year earlier, having picked up in the last two quarters. The consumption deflator (consisting of household, NPISH and government consumption) appears to have been the main factor in driving the trend in the GDP deflator. Here recent movements, as also shown in headline rates of Consumer Price Index (CPI) inflation, have reflected the increase in VAT and annual increases in fuel and food prices.

Figure 3 Consumption and fixed investment deflators

Percentages

Quarter on same quarter one year ago

Source: UK Economic Accounts

Annual growth in the fixed investment deflator though has remained muted through the recession and into the early stages of recovery. Being predominately exempt from VAT, the deflator is unlikely to be affected by the reversion to the higher rate than the household consumption deflator. However, as many investment goods are imported, it might have been expected that the depreciation of sterling could have had a positive impact on the GFCF deflator by increasing the price of imported capital goods.

Household consumption rises by 0.7 per cent in 2010 Q2

Contributions to the quarter-on-quarter growth in household consumption by main type of spending are shown in **Figure 4**. In the latest quarter, positive contributions arose from all the categories – net tourist, durable, semi- and non- durables, and services. All these items of spending have generally behaved as would be expected through the recession period and in the early stages of recovery in line with movements in consumer confidence.

Figure 4 Contributions to growth in household¹ expenditure

Percentages

Quarter on quarter

Source: UK Economic Accounts

Note

¹ Includes spending by non-profit institutions serving households (NPISH)

In the final quarter of 2009 household consumption grew by 0.8 per cent, which was more than accounted for by the durable goods component. This is supportive of the notion that households brought forward spending on bigger ticket items (household goods, cars and so on) before the return of VAT to the higher rate in the new year. This and the bad weather may also explain why durable goods consumption then subsequently fell in the first quarter of the year.

Net tourism spending reflects the difference between household consumption overseas and the spending by foreign visitors to the UK. This is designed to adjust household consumption data so they reflect the spending of UK households anywhere in the world rather than the spending by households (UK and foreign) in the UK. This will make a negative contribution to household consumption growth if foreign spending in the UK grows faster than domestic tourist spending overseas. Overall, net tourist spending is a fairly small part of total household consumption, averaging about one and a third per cent between 2005 and 2010. Despite this, the contribution to changes in total consumption growth can be important, as evidenced by the strong negative contributions through 2008 Q4 and 2009 Q1. Data on travel and tourism, taken from the International Passenger Survey, support this viewpoint, recording a strong fall in overseas trips by UK residents during the recession whilst visits to the UK from overseas' residents were more robust. The depreciation in sterling, especially against the euro, may have been an important factor here in making domestic trips relatively cheaper compared to those overseas. Recent analysis undertaken by the Tourism Intelligence Unit within the Office for National Statistics found evidence of a 'staycation' effect during the recession, with UK households choosing to substitute foreign holidays by those in the UK.

Annual changes in the household consumption deflators are presented in **Figure 5**. The overall consumption deflator has predominately moved in line with consumption of services – the largest component of household consumption – and the recent increases reflect the higher rate of VAT. For consumption goods, the annual growth rates in deflators have converged and are now also broadly in line with the trends in services. Before the second half of 2009 these goods categories showed more marked differences.

For instance, the rate of inflation in the non-durable goods deflator rose strongly through the second half of 2008 as significant price increases in oil and commodities fed through to energy, fuel and food prices. Deflators for durable consumption goods though showed the opposite movement, with prices generally falling within this category of consumption up until the end of 2009. Falling prices of durable goods has, in part, been a longer term phenomenon. Increasing production in lower-cost emerging market economies, notably China, has pushed down on manufactured goods prices around the world, benefiting UK consumers through a stronger terms of trade. Price indices have also been adjusted downwards to reflect rapid quality improvements in many household goods such as computers, audio-visual equipment, mobile and telecommunication devices and so on. Furthermore, as the UK entered recession stronger deflation may have resulted from more aggressive discounting in the face of weaker demand.

Durable goods consumption would be expected to be particularly vulnerable in the downturn. Households concerned with protecting or rebuilding their balance sheets would be less inclined to make larger and more discretionary purchases, as reported in several surveys of consumer confidence at the time. Durable goods, by their very description, are not fully used up in consumption so households can also delay their replacement. The credit crunch, and its tightening

of consumer credit would also have reduced the ability of households to undertake 'bigger ticket' purchases.

The general fall in durable goods prices though may have acted to offset some of these negative factors. This also appears to be a similar feature in the retail sales data, where strong discounting in the predominately non-food sector, particularly clothing and footwear, has supported volumes through the recession period. Falling prices of consumption goods allow households to maintain the same volume of consumption whilst reducing the share of consumption in household income in value terms.

Figure 5 Consumption deflators

Percentages

Quarter on same quarter one year ago

Source: UK Economic Accounts

Fixed investment growth remains weak

The level of gross fixed capital formation (GFCF) fell by 20.7 per cent between 2007 Q3 and 2009 Q4 before recovering by 4.3 per cent over the first half of 2010. The peak to trough fall in GFCF was more severe in the latest recession than those of the early 1980s and early 1990s, where the peak to trough falls were 14.9 per cent and 13.9 per cent respectively. The current weakness in GFCF growth reflects the uncertain economic outlook and the unwillingness of businesses to commit to expanding future capacity. There is also some evidence, looking at financial sector

balance sheets, that investment may have been restricted in order to generate cash reserves as a defence against the uncertain economic outlook and to pay down existing debts (the corporate sector has become an increasing net lender with cash reserves used to reduce its financial liabilities). Restrictions in the availability of credit may also constrain investment spending, with loans to the private non-financial corporations (PNFC) sector remaining at low levels – although here it is difficult to identify the extent to which this is demand led or supply led. A number of business surveys have suggested that credit constraints have only been of secondary importance in accounting for low investment intentions, with uncertainty over future demand much the primary factor.

GFCF estimates can be disaggregated both by sector (**Figure 6a**) and by asset (**Figure 6b**).

Figure 6a Contributions to GFCF growth by sector

Percentages

Quarter on quarter

Source: UK Economic Accounts

By sector, business investment, accounting for around 60 per cent of the level of fixed investment, has generally been the largest contributor to growth. General government fixed investment has made a positive contribution to growth over the period, although it fell by 8.6 per cent in 2010 Q2 reducing overall GFCF growth by 1.7 percentage points. Investment in dwellings and existing buildings and structures have broadly followed the same cyclical path of the economy and property

market in particular. In the latest quarter, though, these two components added 1.9 percentage points and 0.8 percentage points respectively to GFCF growth, which is in line with the strong rise in construction output during the quarter.

GFCF contributions by asset bear a close resemblance to those by sector. 'dwellings' and 'other new buildings and structures' assets have shown the same general movements as the 'dwellings' and 'existing buildings and structures' sectors. Both 'transport equipment' and 'other machinery and equipment' have moved in roughly the same directions as business investment.

Figure 6b Contributions to GFCF growth by asset

Percentages

Quarter on quarter

Source: UK Economic Accounts

Implied deflators of these main GFCF assets are shown in **Figure 7**. This chart also provides a breakdown of the components making up the total GFCF deflator which is also presented in Figure 3. The overall change in fixed investment appears to be the outcome of two main trends. For dwellings and other new buildings and structures, deflator movements have followed price trends from the housing and commercial property markets. Depressed prices through the recession have therefore held the total GFCF deflator down.

Deflator movements for transport and other machinery and equipment though have followed the opposite trajectory, with price inflation of these capital goods picking up through late 2008 and

early 2009. Here there is more evidence that sterling depreciation in the second half of 2008 has impacted on the price of imported capital goods.

Figure 7 Price deflation for main GFCF assets

Percentages

Quarter on same quarter one year ago

Source: UK Economic Accounts

Imports grow faster than exports for the fourth successive quarter

There has been much interest in the contribution of net trade to GDP growth. First, the UK has run a persistent deficit in its current account, so it has been suggested that in the long run there would be a rebalancing of the economy away from consumption towards exports (replacing some domestic demand with foreign demand). Second, and more immediate, following the depreciation of sterling in the second half of 2008 it was anticipated that net trade would make a positive contribution to growth in much the same way as when sterling left the European Exchange Rate Mechanism in the Autumn of 1992.

Figure 8 shows recent growth in UK exports and imports, and also the contributions of services and goods to each. In the early quarters of the downturn, net trade made a positive contribution to growth as imports contracted faster than exports. However, as the global economy began to recover, and UK imports and exports began to increase again, the growth of UK imports has

outstripped that of exports. As a result, net trade has subtracted from GDP growth over the last four quarters.

Figure 8 Growth in volumes of UK imports and exports

Percentages

Quarter on quarter

Source: UK Economic Accounts

Sterling depreciation has therefore not provided the boon that was expected, although it is difficult to disprove the counterfactual that the UK's net trade performance would have been worse had it not been for the competitive advantages of depreciation. There are a number of possible reasons why this may be the case.

First, although the 25 per cent depreciation in sterling in the second half of 2008 was similar in magnitude to that in late 1992, the impact on the UK terms of trade has been less pronounced. This suggests that 'pricing to market effects' may have offset the impact of the exchange rate change on export and import prices through margins. UK exporters could use depreciation to increase their margins when selling in overseas markets, whilst exporters to the UK may have reduced their margins in order to sustain a certain price in the UK market.

This leads to the second argument – that the structure of UK trade has changed to make the net trade position less price sensitive than in previous decades. In the last three decades UK trade has tended to move up the value chain, especially in response to the rise of low-cost producers in emerging market economies. As a result, the competitiveness of UK exports, in areas like

pharmaceuticals and aerospace, rely more on quality and less on price. Likewise, by increasing imports of lower-grade manufactured goods, which are more competitively priced in global markets, means that exporters to the UK may be more willing to absorb the effects of depreciation in margins than exporters from the UK. Results from business surveys have tended to find that exports remain more sensitive to foreign demand than pricing considerations.

Annual income growth picks up in the first half of 2010

Figure 9 shows the growth rates in GDP at factor cost (which removes the effects of taxes and subsidies from market prices) and the main income components of GDP (in current prices). Clearly, as the economy entered recession, income growth slowed or turned negative but in the first half of 2010 there is evidence of a recovery.

Compensation of employees stagnated, as unemployment rose and wages growth slowed. However, gross operating surpluses of the corporate sector and 'other' income (which includes the income of the self-employed and operating surpluses of the non-corporate sector) fell even more sharply, being the main factors in turning overall income growth negative.

Figure 9 Growth in the main categories of UK income

Percentages

Quarter on same quarter one year ago

Source: UK Economic Accounts

These income flows form key parts of the balance sheets of individual sectors. The next sections will look at these in more detail for the private non-financial corporations (PNFC), financial corporations (FC), households (and non-profit institutions), central government and the rest of the world sectors, focussing on the impact of the recession and recent developments in the early stages of recovery. Financial balance sheets provide useful information that may help to understand better the financial health of each sector, helping to explain consumption and investment decisions taken.

PNFC net-lending grows as fixed investment remains weak

Figure 10 outlines the main components of the PNFC balance sheet and how they have behaved in recent years.

Figure 10 PNFC balance sheet and net lending

Percentage of GDP

Source: UK Economic Accounts

The balance of primary incomes reflects two main factors. First, gross operating surplus essentially measures the profits/losses generated from business activities. Second, net property income reflects the difference in income received and paid through the sector's ownership of financial assets. As Figure 9 shows, gross operating surpluses in the corporate sector as a whole fell

sharply in the recession (although the fall for the private non-financial sector was not as severe as that overall for the corporate sector). Despite some modest recent pick up, gross operating surpluses for the PNFC sector are still over 10 per cent lower than the pre-recession peak in 2008 Q1.

The impact on primary incomes though has been offset by a rise in net property income. The reduction in interest rates has reduced the cost of servicing debts – a loan represents a financial liability so the interest accrued is a property payment. Likewise, falling profitability has been transmitted into lower dividends (or other forms of distributed income) to shareholders and equity owners in other sectors. Therefore, as Figure 10 shows, PNFC primary incomes have been supported by falling net property income payments. In fact, PNFC primary incomes have started to improve in recent quarters in line with the recent upturn in gross operating surpluses whilst interest rates continue to remain low.

The sector's gross disposable income reflects the primary income balance adjusted for net social contributions and taxes on income. These too, as expected, have shown a small reduction during the recession as lower profitability and headcounts feed through to lower net social and tax payments.

The change in the sector's net worth is its gross disposable income for the period plus net capital transfers (that is investment grants minus capital taxes) – and reflects the amount the sector has at its disposal to increase its net worth by purchasing assets (or reducing liabilities). Purchasing capital goods, either fixed capital (GFCF) or working capital (inventories) is one means that the sector may increase its assets. The difference between investment spending and net worth equals net lending/borrowing – which shows the funds available to lend to or borrow from other sectors of the economy.

The robustness of primary incomes combined with a sharp fall in investment spending has resulted in the sector becoming an increasing net lender. In the most recent quarter investment has shown a slight increase as businesses begin to restock (purchase inventories), but overall fixed investment spending remains weak and is the main factor accounting for the net lending status of the sector.

In this sense, net lending may have arisen automatically as a result of weak investment spending. Faced with an uncertain economic outlook, businesses may be reluctant to invest in extra capacity, and therefore cash balances naturally accumulate. This could also be viewed in the opposite direction, that in order to strengthen balance sheets by building cash flows, firms have deliberately cut back on investment spending. For example, much of the net-lending generated by PNFCs appears to have gone in reducing liabilities to other sectors by paying down loans. Impairment in the credit market, the weak economic outlook and other issues such as the funding of pension fund deficits may have encouraged firms to build their cash positions by suppressing new capital goods spending.

Figure 3 shows that capital goods price inflation has been lower than that for consumption goods and services and the growth in the GDP deflator. This implies that capital goods are becoming cheaper relative to other goods and services and as a result the share of spending in nominal GDP will naturally decline over time unless GFCF grows faster than total expenditure as a whole.

Changes in the structure of the economy may also account for the downward trend in PNFC investment in GDP. Service sector businesses are less likely to purchase traditional plant and machinery, but are more likely to spend on intangible products such as software, R&D, design, training, organisational capital and so on. However, many of these intangible products are not recognised in the National Accounts as capital goods, suggesting that the 'narrower' definition of capital will increasingly bias measures of investment spending downwards.

Financial corporations net lending

As gross capital formation is relatively low, the financial corporations sector is generally a net lender to the rest of the economy, the extent to which is largely determined by the amount of disposable income it generates. In the second quarter of 2010 net lending was 3.2 per cent of GDP, slightly above the recent average of 3 per cent of GDP from 2007 Q1 onwards (**Figure 11**).

Figure 11 Net lending of financial corporations

Per cent of GDP

Source: UK Economic Accounts

Gross disposable income though has recently shown some quarter on quarter volatility, in turn driven by primary income balances. For example, in 2008 Q4 primary incomes fell sharply relative

to the previous quarter due to a large fall in reinvested earnings from overseas. The distributed income of corporations paid and received has also shown strong quarterly movements. Therefore most of the recent fluctuation in gross disposable income can be attributed to net property income. In 2008 Q3, net property income of financial corporations was 2.1 per cent of GDP but fell to -1.9 per cent in the following quarter. In the latest quarter net property income of financial corporations had picked up to 0.2 per cent of GDP relative to -1 per cent in the previous quarter – accounting for almost all the change in the sector's net lending between the first two quarters of 2010.

Households become net borrowers for the first time since 2009 Q1 as the saving ratio falls

A summary of the household balance sheets is presented in two parts in **Figures 12a** and **12b**. The first of these two charts shows the income and expenditure side of the sector, whilst the second shows the saving and net-lending components.

Figure 12a Household sector¹ total available resources and consumption

Per cent of GDP

Source: UK Economic Accounts

Note

¹ Includes NPISH

Household total resources basically show the primary incomes earned by the household sector, consisting of compensation of employees, operating surpluses from household businesses (and the income of the self-employed) and property income (dividends from equities, interest from savings and so on). As a proportion of GDP, household resources fell from 77 per cent in 2007 Q1 to 72.9 per cent in 2010 Q2. Falling property income, from lower interest rates and dividend payments, accounted for 4.4 percentage points of this fall.

Figure 12b Household¹ saving ratio² and net lending³

Per cent of GDP/Household available resources

Source: UK Economic Accounts

Notes

1. Includes NPISH
2. Saving ratio is gross saving as a proportion of total available resources
3. Net lending, gross capital formation (GCF which is GFCF, inventories and valuables) and the total change in assets are shown as a proportion of GDP

However, in terms of the balance of primary incomes, the household sector's position is more buoyant. This is because property income paid, as well as received, has fallen as a result of the sharp reduction in interest rates in 2008/09 which have been sustained through to the present. The strong rise in house prices between 1993 and 2008 meant that as new mortgages replaced older mortgages the stock of interest-bearing secured borrowing by the sector rose significantly. Consequently, as the UK entered recession and interest rates were cut sharply, the household sector's interest-bearing liabilities exceeded its interest-bearing assets. Therefore the cut in

interest rates generated overall positive net property income for the sector by reducing property payments by more than property incomes.

The balance in primary incomes is linked to household gross disposable income through net social transfers including taxes on incomes. In the aggregate these generally subtract from primary incomes, although net tax and social contributions tend to show a relative fall in a downturn as the tax and benefits system support gross disposable income. As a percentage of GDP, household gross disposable income was 5.5 percentage points lower than the balance in primary incomes in the latest quarter compared with a 10.8 percentage point gap in the first quarter of 2008.

Total available household resources, so called as this defines the size of funds available for consumption or saving, is gross disposable income with the addition of an adjustment for the change in net equity in pension funds. Household consumption is also plotted in Figure 12a. Gross saving is calculated as the difference between this and total available resources.

The saving ratio is the ratio of gross saving to total available resources. In 2010 Q2 the household saving ratio dropped to 3.2 per cent, a further decline from the local peak of 7.7 per cent reached in 2009 Q2 (see Figure 12b). As Figure 12a shows, this has been the result of recent falls in total household resources and a slight improvement in consumption spending. Between 2009 Q2 and 2010 Q2, both total household resources and balances of primary incomes, as a share of GDP, fell by around 4 percentage points leading to an eventual fall of total available household resources in GDP by around 3 percentage points.

The remainder of Figure 12b refers to the components of household sector net lending. These are expressed as a proportion of GDP, rather than total available household resources as in the saving ratio, so care must be observed when looking at the chart. The total change in household assets refers to the resources available for the sector to increase assets or reduce its liabilities. This is mainly driven by the level of gross saving, but also includes the difference between capital transfers and taxes.

In the National Accounts purchases of new housing/dwellings is treated as investment by the household sector. In this case, each household is viewed as a small business which provides itself with housing services at the cost of an imputed rent. This allows GDP to be compared across different countries and times when the degree of owner-occupied housing differs. The fall in house prices and restrictions in the availability of mortgage lending acted to reduce the share of household fixed investment in GDP. Rising household saving and falling investment therefore meant that the sector became a net lender to the rest of the economy between 2009 Q2 and 2010 Q1. In the latest quarter, however, after a further fall in gross saving and a slight rise in investment spending, households became slight net borrowers once again to the tune of 0.7 per cent of GDP.

Central government current budget deficit over £100 billion in the year to August 2010

The central government sector accounts for the large majority of the flows that make up the public sector balance sheet (also including local government and public corporations). As a result, trends

in public sector finances can be mostly explained by developments in the central government balance sheet, which is summarised in **Figure 13**.

The gross disposable income of central government essentially reflects its net receipts from taxes on production and imports, property income, taxes on income and wealth and net social contributions. In the second quarter of 2010 these amounted to around 8 per cent of GDP, down from 14.4 per cent of GDP in 2008 Q1. As a share of GDP, central government disposable income has risen very slightly over the last year due to tax increases (notably the reversion of the rate of VAT to 17.5 per cent from 15 per cent and the levy on bank bonus payments among others) and due to an improvement in GDP growth. However, as Figure 13 shows, central government disposable income (net receipts) have been severely hit by the recession, and are currently far below the peak in 2008 Q1 as a proportion of GDP. In contrast, modest growth in central government spending has continued unabated.

As a result of the significant fall in disposable income and the steady rise in consumption, central government saving, which can be thought of as being similar to the current budget balance, has moved significantly into negative territory at around -6.3 per cent of GDP in the latest quarter.

Figure 13 Central government balance sheet and net lending

Per cent of GDP

Source: UK Economic Accounts

Central government net lending reflects the difference between the change in assets (net worth) of the sector and its gross capital formation (fixed investment and inventories). The change in assets primarily reflects gross saving, but also the difference between capital taxes received and capital

transfers paid. As capital investment grants tend to exceed the revenues from capital taxes this means the change in the asset position of the sector is slightly worse than its gross saving as a percentage of GDP. This measure describes the total resources available to the sector to purchase assets, but being strongly negative is a sign that the sector is in fact funding its position by increasing its liabilities, that is net worth is being reduced. As gross capital formation has been maintained at a fairly small percentage of GDP, the overall net lending position of the sector has been more negative still, implying that central government had become a large net borrower (8.8 per cent of GDP in 2010 Q2).

Central government net borrowing has increased markedly as its disposable income fell during the recession, from 1.8 per cent of GDP in 2008 Q1 to a high of 11.4 per cent in 2009 Q4. Slight recent improvements, as already mentioned, reflect increases in taxes in the first half of the year and also a reduction in capital transfers and investment grants from the previous quarter. However it should be noted that this component tends to be quite erratic from quarter to quarter.

Figure 14 Key elements of the public sector finances

£ millions

12 months to August (September–August)

Source: Public Sector Finances

Figure 14 shows some summary statistics from the latest Public Sector Finances release pertaining to Central Government in August 2010. In the 12 months up to and including August 2010, revenues from taxes on production (which includes VAT) increased relative to the same period a year earlier due to rises in the rate of VAT and other indirect taxes. Revenues from taxes on income and wealth continued to fall over the three year period shown in the chart, but at a

slower rate in the latest year. Overall, current receipts rose in the 12 months September 2009–August 2010 relative to the same period in 2009, but still remain below current receipts in the year to August 2008.

Net lending by sector

Figure 15 summarises the overall net lending positions of the main sectors of the UK economy – corporations (private non-financial, financial and public), households and non-profit institutions, general government (central and local government) and the rest of the world sector. The rises in corporate sector net lending and general government net borrowing are clear, and although the household sector was a small net borrower in the second quarter, its net borrowing position has diminished significantly since the second half of 2008. It therefore appears that through the recession period and into the first quarters of the recovery, the private sector has been seeking to strengthen balance sheets by paying down existing financial liabilities while suppressing new investment, whilst general government indebtedness (borrowing) has risen markedly.

Figure 15 Summary of net lending by sector

Per cent of GDP

Source: UK Economic Accounts

As net lending in one sector implies net borrowing in another, the sum of these positions for a country should sum to zero. Net lending or borrowing from overseas will offset domestic total net

borrowing or lending. In Figure 15 the rest of the world sector has generally been a net lender to the UK, reflecting that the domestic sectors are an overall net borrower. This would be manifest in the UK running a current account deficit in its balance of payments.

UK Current Account deficit at £7.4 billion in 2010 Q2

The Balance of Payments records one nation's transactions with the rest of the world and is basically split into two parts. The current account records international trade in goods and services, income flows arising from workers' remittances and the cross-border ownership of financial assets and current transfers. The financial account is the counterpart to the current account, explaining how the current account position is funded by the accumulation of financial assets and liabilities.

In 2010 Q2 the UK current account was in deficit by £7.4 billion (2 per cent of GDP). As **Figure 16** shows, the UK current account deficit has averaged around 2 per cent of GDP between 2007 Q1 and 2010 Q2, but although the deficit hasn't shown a distinct up or down trend over this period, the deficit has fluctuated from a low of 0.2 per cent of GDP in 2009 Q4 to a high of 3.4 per cent of GDP in 2007 Q3. Figure 16 also breaks down the current account balance into its main constituent parts.

Figure 16 UK Balance of Payments Current Account balances

Per cent of GDP

Source: Balance of Payments

The UK deficit in the trade in goods in 2010 Q2 was 6.4 per cent of GDP (£12.6 billion), close to the average since 2007 Q1 of 6.3 per cent. This deficit has also been fairly stable around this average over the period shown in the chart. In services trade the UK has traditionally run a surplus, amounting to 2.9 per cent of GDP (£10.5 billion) in 2010 Q2, but this is below the post 2007 Q1 average of 3.5 per cent of GDP. Current transfers primarily consist of spending on aid and international development programmes and the financial contributions arising from membership of supranational organisations like the European Union and United Nations. The UK's deficit in current transfers has been very stable at close to 1 per cent of GDP.

Most of the recent variation in the current account balance has therefore been driven by the balance in income flows which are shown in more detail in **Figure 17**. Historically, the UK has run a surplus on the income account largely due to its large accumulation of overseas direct investment assets that have been built up over time. Recently, quarterly movements in the direct investment income balance have been volatile, ranging from 5.6 per cent of GDP in 2008 Q1 to 2 per cent in 2008 Q4, which has been transmitted into the current account balance as a whole. This has tended to coincide with volatility in the net property income of Financial Corporations.

Figure 17 Components of the UK Income balance

Per cent of GDP

Source: Balance of Payments

The path of the current account balance in Figure 16 shows a good correspondence with the path of rest of the world net lending in Figure 15. If the domestic sectors of the economy (households,

corporations and government) are together net borrowers, then it implies that spending on consumption and investment goods exceeds the resources generated by the sectors, with the difference accounted for by borrowing from the rest of the world. A current account deficit implies that a nation is consuming beyond its available resources. The counterpart to a current account deficit is an offsetting surplus on the financial account, implying that the current account position is being funded through the accumulation of foreign liabilities or a reduction in foreign assets – both of which correspond to net lending from the rest of the world.

Contact

elmr@ons.gov.uk