Drifting to disaster – is the UK living beyond its means?

This article argues that the UK is in danger of a sterling crisis and a prolonged recession.

7th July 2006 – by Angus Hanton (business economist)

Please send comments to: angus@woodlands.co.uk (please state if you don't want your comments to be quoted. If you agree with the thrust of this article and would like more people to read it the best way you can do that is to put a link to it from your website - if you have one that you control/influence).

For a long time the UK has been spending more than it earns. Our appetite for spending has created problems which have recently intensified, and which are now endangering our economic well-being. The UK has been importing very large volumes of manufactured goods in a spending boom, which has been financed by the sale of capital assets to foreign buyers and by consumer borrowing. This process is like selling the family silver - and much of the family estate - to pay for current consumption ... and then borrowing to allow further consumption. This seems to have gone almost unnoticed by both the British people and the political establishment, but can surely only lead to a slump in the short term and impoverishment in the long term.

At the heart of the UK's current worsening trade imbalance there is an important mechanism that makes the problem worse. With recent sales of UK assets capital has been flowing into the UK from the buyers of those assets. This inflow of capital keeps up the exchange rate (the value of the pound) in the short term so that goods from abroad are kept artificially cheap and levels of imports are kept artificially high. In other words the asset sales don't just help to give us the money to spend on imports but, through this exchange rate mechanism, they actually make imported goods cheaper. And in the UK we have been importing on a remarkably large scale. To put it graphically the "typical" family of four in Britain is, on average, a net importer of over £4,400 worth of goods each year (2005 figures).

The prices of imported manufactured goods have also been dropping because of the liberalisation of the world economy and the emergence of the low-cost BRIC countries (Brazil, Russia, India and, most importantly, China). Lower prices have fuelled an appetite for imports and in most product categories the UK could not produce substitutes at anything like the imported prices, if at all.

In due course this spending and importing binge must come to an end: the UK will run out of assets to sell. As these problems become more apparent people's confidence in the pound will at some point disappear - leading to a "flight of capital" out of the country and a recession. Such a recession will be caused by a reduction in demand as people find they cannot afford so many imported goods and it will very likely be aggravated by higher interest rates.

A devaluation would lead to higher prices in sterling terms - inflation. The Monetary Policy Committee of the Bank of England, which is independent of the government and sets interest rates, may well then raise interest rates to combat this inflation. Higher interest rates would aggravate a recession and lead to a slump in house prices. It is possible that this powerful committee will choose to keep interest rates low, but that is unlikely as their primary objective of maintaining "price stability" has been set out by legislation.

What is the current trade balance, in round numbers?

In 2005 the UK had a deficit in goods traded of £65 billion while there was a surplus in services of £18 billion. These two figures give an overall trade deficit of £47 billion. Due to other factors (government transfers etc.) the actual current account balance wasn't quite as bad as this but there was still a very negative overall position – a deficit of £32 billion (so for our "typical" four-person family there was a £2,000 deficit in 2005).
The most recent figures, published on 30th June 2006, suggest that the trade in goods deficit is widening fast and that for the first quarter of 2006 it was £19.6 billion, which if repeated for the whole year would be 20% higher than last year.

How many of our assets have already been sold?

Foreign buyers have already bought a large proportion of those assets that can be sold. Looking at property in the City of London, a recent report says that 45% of city property is now foreign-owned, whereas in 1998 it was only 20%. (Source: "Who Owns the City 2006?"). It is being transferred at about 3% per year.
As to the ownership of major companies, figures from the Office for National Statistics for foreign ownership of UK quoted shares show that by the end of 2004 33% of quoted shares were owned abroad, the largest proportion ever recorded and this figure is increasing: in 1963 it was only 7%. The Office for National Statistics states, "the long term trend shows that the percentage of shares owned by foreign investors continues to increase."
The true picture is probably even bleaker: when a company is taken over by a foreign entity it usually loses its quotation so that the quoted shares are a biased sample – they are only the "survivors" of the original group. This 33% figure is only the percentage of the "surviving" companies owned abroad. The recent takeover boom, led by foreign investors, has reduced the number of quoted companies. Many companies are now 100% owned abroad, so that the percentage of large companies operating in the UK is probably significantly higher than 33%. One recent example of such a takeover is Abbey which was bought for £9 billion by a Spanish bank. The result is that Abbey is no longer in the quoted sector to which these ownership figures relate. That will also be true for BAA which in June 2006 agreed to be taken over for £10 billion by another Spanish company and for ABP (Associated British Ports) currently being taken over by an American consortium for £2.5 billion and for P&O, bought by Dubai's DP World for £4.4 billion. Many other companies have been taken over by foreign buyers in the last few months including: Allied Domecq (to a French company for £7.6bn), Aggregate Industries (to a Swiss Group for £1.8bn), RMC (to a Mexican company for £2.3bn), Marconi (to a Swedish company for £1.3bn), British Plasterboard, BPB, (to a French company for £3.9bn) and Exel (to a German company for £3bn). There are also several large companies quite likely to be taken over in the next few months including Aegis, the giant media buyer, and even the London Stock Exchange itself. The Sunday Times (25.6.06) estimates that in the first three months of this year, 2006, overseas companies spent about £19.4 billion acquiring UK companies while the flow in the opposite direction was only £6.8 billion.
An indication of the scale of this selling of assets is shown by the OECD figures released on 28th June 2006 showing that for 2005 the UK drew in $164 billion of direct investment whereas even the much larger US economy only drew in $110 of foreign investment. Whilst some of this "inward investment" into the UK relates specifically to the "Shell" restructuring and some to greenfield developments and reinvested earnings, a large amount represents overseas takeovers of UK companies.
A sterling crisis followed by a devaluation of the pound might not stop foreign buying of UK companies and property: if UK assets are attractive to overseas buyers at the current exchange rate they will be even more so after a devaluation.

The long term balance of payments consequence of these asset sales is a stream of dividends abroad

In the short term each of these sales means an injection of foreign capital, which is provided by the acquiring company buying sterling to pay out the former owners, but inevitably the new owners will want to see a return on their investments. This comes in the form of cash being sent over future years back to the country of the owning company. Put another way, each foreign-owned UK company represents a claim by the new foreign owners on UK assets. Such a claim is paid in the form of dividends sent abroad – this dividend stream must be paid for an indefinite period - a "rent" payment. Such payments may be smaller in the first year or two after acquisition while the newly acquired subsidiary is being reorganised with associated costs (often including redundancies). However, in future years these dividends can grow quite rapidly. For example in June 2006 Thames Water, now owned by a German conglomerate, announced that it is increasing the dividend to be sent to its parent company by 50% and is sending £200m back "home".
There is, too, another downside to foreign ownership for employees: in a downturn of the world economy a foreign conglomerate may well have to choose between making people redundant in their foreign subsidiaries or in their home country. Many of the functions could be carried out either locally or in the company's home country. Human nature and domestic politics may well lead to redundancies in the UK subsidiary companies rather than at home.

Isn't this just part of globalisation, where UK companies are buying equivalent assets abroad?

The actual figures do not support this optimistic view. According to the latest "Pink Book", which the Office for National Statistics produces each year, the net change in foreign assets of UK residents in 2004 was negative to the tune of £141 billion just for that year: this is a net sale of assets of £9,400 in that year for our "typical" four person family. Each of the last ten years has shown a deficit on the assets account so that by the end of 2004 the total net assets position was minus £683 billion (table 8.1, page 102), which spread over the UK population proportionately, leaves a net foreign liability of over £45,000 for our "typical" four person family.

But doesn't the US have a similar problem?

The US does have a serious balance of payments deficit but its position is very different in that it still has a large manufacturing base and the dollar is the currency of world trade. It has many other sources of income from the globalised economy with many of its companies controlling large and profitable international businesses (American Express, McDonalds, Morgan Stanley, Google, Microsoft and Coca Cola to name just a few). It has the further advantage that, issuing treasury bonds denominated in dollars means that a dollar devaluation would significantly reduce the real size of both its deficits (government borrowing and trade) expressed in other currencies.

Have high house prices contributed to the current boom in UK consumption and imports?

Yes, they have been very important. Higher house prices have enabled people to borrow more for consumption and to spend more from properties when they are sold. High property values have also led to what economists call a "wealth effect" – people feel wealthier so they spend more and save less. Much of this spending is on imported goods, including cars and electrical goods.
Borrowing against property for consumption has become a way of life for many people and is largely made possible by rising house prices. Total mortgage debt is now over £1 trillion (£1,000 billion). A significant part of the increase in the level of mortgage borrowing has come from people releasing equity for consumption. Cash can be taken out of residential property in various ways:

outright sales, remortgaging and by taking a bigger mortgage than needed when moving to a new home. All this borrowing is called "mortgage equity withdrawal" (MEW) and is the amount of money people are taking out of their homes for non-building purposes – mainly for consumption. For the fourth quarter of 2005 the figure was £11.8 billion according to the Bank of England's latest release on the subject. This is just part of a surge in such new borrowing which began rising in 2001. Assuming this level of borrowing for a whole year and putting it in terms of our "typical" four-person family they are borrowing an extra £3,150 against their home each year for spending. Of course if this is the average amount it means that very many people must be borrowing a lot more.

How has the credit boom made things worse?

The figure above, being an injection for consumption of almost £12 billion per quarter from non-building related mortgage borrowing, only affects those with a home to borrow against. Those who do not own property have also been borrowing in a big way. Unsecured lending has increased dramatically in the last few years. For the first four months of 2006 it increased by £1 billion per month and is now in total at £191 billion. This means the average person has an outstanding unsecured debt of about £3,000, so that our family of four has, on average, unsecured debt of over £12,000. The increase in this sort of debt has meant a large boost to consumption and imports. Should the economy turn down sharply, much of the population will find it very painful or impossible to service this debt.

All this extra income coming into the economy creates a "multiplier effect" – consumers spend money and some of this goes to other consumers who in turn spend it, so that a large injection of new money has an even larger impact on overall consumption than one might expect. Added to this is the confidence factor – people see most people around them spending freely and talking optimistically of the future. Together these effects create a boom in spending.

Will our invisible exports surplus (trade in services) compensate for our lack of manufacturing?

Unfortunately our "invisible exports" are not big enough and this surplus from trade in services is not growing significantly. The surplus on invisibles comes mainly from banking and insurance and is a bit erratic and subject to shocks - such as that recently suffered from hurricane Katrina and periodic crises in the financial sector. To put this services contribution into perspective and taking the monthly figures for April 2006, the trade in goods deficit was £5.8 billion whilst the surplus in the trade in services was £1.8 billion so the resulting monthly deficit is reduced, but was still £4 billion in one month.

Won't our North Sea oil help us?

No, we are now net importers of oil and other fuels. In 2005, although we exported £22 billion worth of these we imported almost £24 billion – a deficit in oil and fuels of about £2 billion. In 2005 the UK became a net importer of oil for the first time since 1979.

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What about all the investments held abroad by UK residents? Can't those be used to fill the gap?

In principle it does make sense to set total national liabilities off against total national assets, but there is an important difference that makes "off-setting" these amounts unwise: the repatriation of earnings is out of the UK government's control. If a foreign company buys an asset, such as a water company, then the foreign company will take dividends back to its home country. By contrast a UK

company or individual owning assets abroad, does not need to bring these dividends back to the UK. The UK owner cannot be compelled to repatriate foreign earnings. Indeed, a sterling crisis, with the inevitable talk of further devaluation and talk of exchange controls, may well discourage holders of foreign assets from bringing money back to the UK. Fundamentally, however, the problem is that the foreign-owned UK assets now significantly exceed the net assets owned abroad by UK residents (by £683 billion, as above).

Are other factors making things better or worse? What about all the new workers coming into Britain?

In May 2004 the EU was expanded to 25 countries including as new members Poland, Hungary, Slovak Republic, Slovenia, the Czech Republic and the three Baltic states of Estonia, Latvia and Lithuania. The result has been a large inflow of new Eastern European workers. The UK has received a particularly large number because, whilst France, Italy and Germany have limited the rights of foreigners to work in their countries, Britain has allowed free access to its labour market. The result has been an influx of new workers who have overwhelmingly gone into the service and construction industries. Anecdotal evidence suggests that very many of these workers are sending significant amounts of money back to their home countries. This flow of money out of sterling from foreign remittances looks likely to increase.
The UK's problem has fundamentally been low productivity – we do not need more foreign workers but a more productive use of the indigenous workforce.

Won't a modest devaluation correct the position?

Unfortunately the nature of the imbalance is not one that will be easily corrected by a small change in the exchange rate. The problem is that a modest adjustment may not be enough to improve the trade position significantly. A larger devaluation will probably be needed.
Whilst a modest devaluation would help exports it may do very little for the cheap imports to which we have become addicted. Although it would lead to a higher price for these imported goods, it is hardly likely to lead to widespread manufacturing in the UK. The UK minimum wage is around £40/day, whereas we are competing with countries where the daily wage is a small fraction of this ("dollar-a-day countries"). The most relevant question in most product groups is, "how much would the pound have to be devalued in order to choke off demand so that less sterling was being spent on those goods?" The fear is that to reduce demand for foreign goods the pound may have to be devalued a great deal.

How do the prospects look? - aren't things getting better?

In general the economy is becoming more open - driven by both government policies and technical changes such as the increasing use of the Internet. This openness seems to be harming British businesses in relation to foreign ones. Indicative of this is the dominance of the Internet by US corporations. Looking at the top 10 sites visited by the British on the internet, nine of them are American and the tenth is French (Wanadoo), according to the researchers Hitwise, quoted in Marketing Week on 25th May 2006. In addition, business is now massively dependent on "search and search-driven advertising" – both the main agencies in this field, Google and Yahoo!, are US owned. The logic of this seems to be that as Internet usage grows, and rapid online growth is projected for almost all parts of the economy, American companies will become increasingly dominant and will be making larger profits which they will take back to the US, putting further pressure on the pound.
As has been said, "Globalisation is good for lions, but not for rabbits."

So, why should a balance of payments crisis matter?

A severe devaluation would quickly reduce overall demand in the economy as so many of our businesses depend on cheap imports - which would suddenly not be so cheap. Spending throughout the economy would be reduced. As the pound reduces in value, most manufactured goods will go up sharply in price and both foreign goods and holidays will become increasingly expensive.
The difference between pay rates in the UK and abroad may come to be seen to be too high for an economy which is so open and whose manufacturing base so shrunken. A significant devaluation will at least be effective as a way to reduce real wages.
A devaluation also matters because the people of the UK rely on a strong economy – people need to be paid, they need to eat, they want to buy things to use and they need the economy to be sustainable so that they and their children can face a prosperous future. A downturn of the sort envisaged would be particularly damaging to a nation which is now so highly borrowed: higher interest rates and higher unemployment together may provoke a sharp reduction in both real wages and house prices.

Couldn't we stop the imports by imposing import taxes?

No: the EC wouldn't allow it and even if they did it probably wouldn't help. Other countries would respond in a similar manner and we would find those exports which we do have would be equally hit. Protectionism may be a realistic route for a country which has a large manufacturing base, but the UK has lost that base – it may lead to widespread pain as prices of large numbers of products go up sharply. This will be inflation in goods, but skewed towards imported goods. Real wages may fall significantly both from a devaluation itself and from higher unemployment.

Why hasn't this been brought to our attention by the politicians?

It seems that most politicians simply don't realise what is happening and have little concern for the UK's balance of payments position. They will only react either in the event of a crisis or when they are put under pressure. If a crisis is indeed inevitable, it will be better for the problems to be generally recognised sooner rather than later – as has been said, "the better the party the worse the hangover". Perhaps it is time to stop the party.

What do our politicians feel about the sale of British assets to foreigners?

Mostly they have welcomed it! What many countries would regard as undesirable foreign purchases our politicians refer to in celebratory tones as "inward investment". In contrast the Italians and French have been very protective of sales of their assets. Although some foreign investments are genuinely new investments in new production facilities, our government appears to make no distinction between these "real" investments and purchases of existing UK assets. The UK government has welcomed the sale of most of the utility businesses to foreign companies – for example, to take just a few, Innogy, Npower, Yorkshire Power and Thames Water are all owned by the German firm RWE.

Implications for individuals

For individuals who own assets the sensible course of action is clear: sell sterling assets and buy foreign-currency-denominated assets. Investors should not feel guilty about this - stockpiling before a famine is in the public interest: it is trying to stockpile once the famine has started that is anti-social.
For those without assets, they should, as far as possible, be prepared for a downturn in the economy and perhaps not assume that their jobs are secure – reducing debt would be desirable and as far as possible one should build a lifestyle less dependent on imported goods.

Conclusion

If the arguments presented above are correct then the UK economy is drifting towards a sterling devaluation and a recession at some point. Such a recession would be characterised by increased prices of goods, falling wages and probably higher interest rates. The government might still be able to avoid this by acting to make UK companies less attractive to foreign buyers and by adopting policies to make foreign goods less attractive to UK consumers.

Author's note: I am indebted to my friend and colleague Karl Grossfield for many ideas and discussions on these issues and to my American friend George Kegler for his constructive and challenging comments. Note on trade figures: there were some relatively small revisions made immediately after this article was written but as these do not affect the argument I have left in the figures based on the ONS original estimates.