Research @ Citi Podcast, Episode 15: UK — Charting a Better Path

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Host: Lucy Baldwin, Head of Research, Citi

Guests: Ben Nabarro, Chief UK Economist, Citi

Transcript:

Lucy Baldwin (00:01)

Welcome to the Research @ Citi podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe.

Hello, everybody. I'm delighted today to be joined by Ben Nabarro, our Chief UK Economist here at Citi. Ben, welcome to the podcast.

Ben Nabarro (00:27)

Hello.

Lucy Baldwin (00:28)

Now, today, Ben, I'm really keen to explore with you a number of things that you've been writing about recently around the UK and how to really chart a bit of a new path for the UK. There's really been a narrative, I think, that UK growth has stalled, has been lackluster, and that I guess growth, and in particular productivity growth, has been less good than many other countries around the globe. How do you see that diagnosis and where the UK is at in terms of growth and productivity at the moment?

Ben Nabarro (00:58)

Absolutely, Lucy. I think the first thing I would say is that broad public narrative and the associated diagnosis is broadly right. Let's just look at UK GDP in a headline sense to begin with. The current level is around 36% short of the post-war pre-GFC trajectory, so a very, very large shortfall. And while other jurisdictions — for example, the euro area has also a 30% plus shortfall — what's striking about the UK's experience is that that has coincided with pretty strong labor force growth. So the implication is per worker output, so productivity, either measured per worker or per hour, that has been very, very poor and effectively the weakest, we think, in about 150 years, so this has been strikingly weak. Now, there are a few elements to the story here. What should worry UK policymakers perhaps most in all of this is that the UK having seen productivity move very closely in lockstep with the United States for some time, what we've started to see post GFC is actually an increasing shortfall away from the frontiers, so there's been a decoupling of UK and U.S. productivity growth.

And then in terms of the drivers, this is perhaps where, in our view, that some of the narrative certainly carries some weight, but perhaps there are some things that are being missed. So for example, investment has of course been a very prominent theme, particularly post the Brexit referendum and indeed in the post-Covid recovery, and it is true that less capital deepening has contributed to that trend productivity slowdown. But if you actually look and break it down, what we have found is that in terms of the main drivers of that softening, actually, total factor productivity is a much larger net contributor, and just to explain that for a moment, total factor productivity is the residual, the growth that you can't explain either through labor force growth or through capital deepening, it's the bit that sort of reflects the efficiency with which you're putting those components of production together.

And what we think that reflects is this strangling effect where post GFC as particularly intangible investment has become harder for firms. It's been harder to finance some of those things and firms have generally become more cautious in the way they're managing their own liquidity. You've seen a trend deterioration in growth in those particular areas of the economy. That has weighed on competition and business dynamism, and with it, the productive engine of the UK that was this service-orientated, intangible, often quite small firm dynamic growth story of the mid-2000s, that has been strangled in the last decade or so. And for us now, I think in terms of trying to improve that trend growth rate, it's really that that has to be the focus. So overall, the narrative is not wrong. Certainly investment has a role to play in that and productivity is the fundamental issue. But in terms of the actual nub of the problem, this total factor productivity story, and this issue of business dynamism and reallocation, we feel, is perhaps slightly under-discussed in terms of some of the public commentary.

Lucy Baldwin (04:06)

And Ben, just taking a step back as we think about the “why” in terms of why we've ended up here. Things that were seen as real positives for the UK. Do you feel they've suddenly become headwinds being such a small open economy? And have those things contributed to the perception, or perhaps the reality, that the UK has been hit a lot harder by some of the supply shocks that we've seen?

Ben Nabarro (04:30)

I think there's a lot of truth to that. The UK — just take the experience of recent years — has been hit harder by the adverse— what economists call terms of trade dynamics. So effectively, the increase in import prices for the UK has been larger than almost any other advanced economy. And that has reflected, for example, our dependence on imported manufactured goods, for example, which was an important factor in the UK growth story through the 1990s and early 2000s, and obviously of late, that seems to have bitten back somewhat in terms of, as you mentioned, Lucy, becoming more of a headwind. Also think the point you make more structurally about the UK being this small open economy heavily invested in wider global integration, that has hit the UK, I think, quite hard. Of course, some of it has also been self-imposed to an extent in the form of Brexit, where particularly for the UK's manufacturing sector, the divestment from some of those close European relationships has been quite profound. But I do think the two elements where I draw out where the UK does feel particularly exposed by virtue of that global change is one, the UK has always felt like an economy that has been very heavily optimized.

Almost deliberately, there's been very little investment in core resilience, instead much more of an emphasis on efficiency more broadly. And that's probably left the UK more exposed to some of these supply shocks as the global environment becomes more volatile, so small and open, but also I think the UK has become exposed as being a bit less resilient than perhaps it could have been. And then the other element that is more specific is just the Brexit issue. And I don't want to be too partisan about this. I think there's obviously a very large debate in literature about the impact of Brexit on the UK. But I do think it's true that if you look at the drivers that previously drove particularly UK firm-level growth, there is a very direct link between small firms exporting into the European Union. Some of the associated FDI flows, so investment back from European counterparts into the UK, and some of the most productive areas of the UK economy before 2016. So I do think the loss of that is quite profound alongside this resilience issue that has become clearer.

Lucy Baldwin (06:44)

Ben, thanks for that. You're clearly setting the scene that the macroeconomic resilience of the UK has suffered. What do you think the implications are here of lower growth economically, and also fiscally?

Ben Nabarro (06:57)

So the impact on living standards is profound and deeply worrying. The implication of that 36% shortfall in the level of activity when you look at it on a per-household basis is quite remarkable — many, many thousands of pounds in terms of real-term equivalent living standards. And I do think that's had a range of ramifications, be it politically or socially. We've seen, for example, trends in UK longevity stall, which should worry all of us. But I think the factor that we're thinking most about in terms of the financial world is this weaker growth picture, what it implies for the tax base, versus the implicit liabilities that the UK state has written. So one way of thinking about this is, imagine you think about the future discounted value of all your tax flows, and then the future discounted value of all the liabilities that the state has written, either in the form of public sector pensions, health provision, so on and so forth. And the implication of this deterioration in growth is that the gap between those two — negative gap, if you like, between revenues and future liabilities — that has been widening very sharply since 2007, effectively a gap in public equity.

Now, many other economies have the same same issue, particularly large parts of Europe. But what is perhaps a bit different about the UK is that the UK has to continuously attract foreign capital in order to fund its external deficit is one of the things that makes us a bit different. So if you like, we've got this underlying fundamental solvency problem that's increasingly coming about because of low growth. But we also have the potential that actually one way or another, that underlying solvency problem becomes real and binding, that becomes sufficiently problematic that we can no longer attract that capital. The implications of low growth are, of course, lower living standards directly, but also a reduction in the tax base and wider fiscal challenges associated with that. But there also is this binding vulnerability that sits alongside that picture that just makes all of these challenges a little bit more acute. What I would say about all of this is previously, over the last few decades or so, when these kind of issues have come about, one of the things that has ultimately bailed us out fiscally, of course, been lower interest rates. It does feel as though now with those changes in the global environment and the fact that we are close to the effective lower bound anyway, that release valve is no longer there. So this underlying solvency issue is real and it's made all the more difficult by this associated liquidity challenge as well.

Lucy Baldwin (09:27)

Well, Ben, of course that begs the question: What can we do? What should the new government do to address some of these challenges, and is it a fiscal throw of the dice, or is there more to it than that, Ben?

Ben Nabarro (09:38)

I think there has to be more to it than that, unfortunately. I understand the impulse to try and do something bold, given the challenges that we face, and certainly some of the reporting I've seen over recent weeks is consistent with that, a sort of narrative of “Well, look, it can't get any worse, you may as well give it a go.” Given this external vulnerability, I think we have to be really careful about particularly significant increases in, and front-loaded increases in aggregate debt. The implication of this sense in which we need people to buy sterling assets regularly, but it is, of course, possible that they choose not to, and it's much easier for people to choose not to for a short time. That does mean that our budget constraint is effectively tighter than it is either in the United States or in the European Union, if for slightly different reasons. So the UK faces a more material constraint in terms of meeting some of these challenges. I do think, nonetheless, public investment does have a role to play. It doesn't so much go to the heart of the growth issue that we've seen previously over the last decade in terms of this sort of gradual bearing down on business dynamism. But if we are moving into this more volatile world, public investment probably does have a role to play in terms of improving underlying macroeconomic resilience, and lots of things that this new government had been suggesting speak to that need, be it with respect to energy infrastructure or otherwise.

There are three areas where, certainly for us, we think that there should be greater focus. One is working more proactively to try and lever the university sector. One of the reasons for relative optimism in the UK is still when you think about the knowledge-intensive economy and particularly the digital economy, the UK does maintain some comparative advantages, particularly compared to Europe, and many of those are to do with the intensity of our top tier research offering. So there is more that can be done in terms of building links with industrial leaders and funding spinouts and so forth. I think the second area where the UK can focus is in terms of a rebalancing between debt and equity investment. So particularly for smaller firms, there is a disproportionate lien, of course, on either bank lending or debt vehicles. The issue with that in an economy that's becoming more intensive in terms of its use of intangible assets is, of course, those don't offer effective sources of collateral, so that generally weighs on investment and is one of the reasons why we've ended up with quite uncompetitive markets. So I think that's important. And then the third element speaks to this issue about previous areas of strength where the UK has increasingly been suffering. That's to do with flexibility and speed of reconfiguration. In a small open economy like ours, that's absolutely crucial, particularly when dealing with some of these large external shocks, the UK economy has to change shape quite quickly. But as we've seen both post–Great Financial Crisis and now through Covid, the UK economy feels like it's becoming more sclerotic, and a part of that is to do with geographical and skills level mismatches, and that's an area where policy by being more proactive can have an important effect. So overall, you know, I think a throw the dice would be very unwise at this moment, but I think what Labour is suggesting at present is a more responsible effort to try and boost macroeconomic resilience, which is probably welcome.

Lucy Baldwin (12:56)

Yeah, it’s interesting, Ben, and you remind me of the Bernanke comment to the Bank of England where he said to pay more attention to the supply-side elements rather than demand shocks and, in particular in sort of determining inflation and growth. I think he singled out areas like changes in productivity, in labor supply, and in that sort of job-worker matching, essentially. Do you think that dovetails a little with what you're alluding to there, Ben?

Ben Nabarro (13:25)

I think so. I think what Professor Bernanke was saying in elements of his review was more work was needed from a monetary policy perspective to think carefully about the structural state of the supply side and to take it into account when setting monetary policy, which I think is true. What I actually had in mind in these comments was another Ben. It was actually

Ben Broadbent, who did a lot of the really good work over the last decade in terms of noting the UK's slow speed of reconfiguration post the Great Financial Crisis. And I think those points have been borne out again in terms of the UK's experience through 2021, [2022], and [2023] in terms of the slow speed at which capacity was reallocated, and subsequently a weaker supply recovery overall. One thing that we're increasingly thinking about and is probably underestimated in some of this discussion, I think, is the impact of the actual policy response in terms of interacting with some of these supply dynamics. So just to give one example, if you suffer a large supply shock in the form of say, an energy price shock, obviously, one of the things you might want the economy to do is to prioritize investment and drive some of that economic reallocation, that ultimately leads to a better supply picture in the medium term and probably also a stronger recovery in the medium to longer term. But by using rates as the primary policy lever in response to some of these shocks, what you can do is disincentivize exactly that reconfiguration-inducing adjustment or those kind of processes that ultimately aid the longer-term recovery. So I think Professor Bernanke is absolutely right, so you need to think more about the supply side in general and was referring to some of those structural changes, I think in his comments implicitly. But in terms of what's driving that gradual sclerosis or how it may interact with policy in terms of what you do in response to some of these supply shocks, I still think there's much, much more work to be done on that.

Lucy Baldwin (15:20)

Fascinating, and indeed, it just is a reminder that monetary policy alone or fiscal policy alone aren't going to solve all the problems, it needs to be a holistic response. And Ben, when you think back further afield, we think about the UK's competitiveness on the global stage. How do you think about its external competitiveness today and going forward? Do you think the areas that it's going to win in are profoundly different from the ones that it has historically been a winner in in the past?

Ben Nabarro (15:48)

I don't think so. I think that the UK has to develop, I think, a much stronger answer to that question, Lucy, than perhaps it has done in recent years. What is the UK's business model? 2003, 2004, one could have answered that quite easily. It's a question of high-value, highly regulated services, exporting many of those professional services globally. That combining with flexible domestic labor markets, relatively low domestic and particularly consumer services wages, and that in turn generating an economy that overall had some technological leadership globally, and a relatively competitive underlying price level and position. It's a pretty competitive industrial mix. I think today it is still true that if the UK is going to win or where it's going to win sectorally is still in the professional services space. But I think what's increasingly been coming true is some of those demands in that space has changed, particularly when you look at the relative demand, for example, for STEM skills, just to provide one illustration, versus non-STEM skills. UK has really struggled to keep up with some of those changes and in turn keep itself at the productivity frontier. This is particularly true for some of those professional services sectors outside of London. Particularly if you look at cities like where I'm from in Leeds, Manchester, Birmingham — it's those kind of cities where the combination of skills, mismatches and to some extent, weak infrastructure development have stymied the ability of those cities to stay at the global frontier. So I think from here, the overall sectoral composition in terms of whether UK is going to win probably hasn't fundamentally changed. If I wanted to give an intuitive sense where the UK really has to focus in order to expand that, I think it's very much in that question of lifting some of those professional services sectors in those second cities back up to being globally competitive.

Lucy Baldwin (17:47)

And Ben, just a pivot to the topic of ecological change and challenge, I know the UK have had an awful lot of ambition around this area. How does that now sit, I guess, with other countries' agendas, whether that's the rise of China and the dominance in this space, particularly in energy transition? How does that look to you now given the ability to perhaps finance significant investments in that arena going forward, but also how that fits — or doesn't — with the growth agenda and that need to raise both productivity and indeed just raise the base level of growth in the country?

Ben Nabarro (18:27)

I think for the UK in particular, being a large manufacturer in some of those areas, probably that moment has now passed. Difficult as we stand to envisage the UK becoming, for example, a global leader in the manufacture of solar panels, partly because as you mentioned, other countries have invested heavily in that tech, and the UK doesn't really have a large-scale background in large-scale manufacturing of that kind of capital, and so it would certainly be a fairly abrupt shift in terms of the UK's industrial mix and one least initially is quite hard to see. I think that there are some specific areas in terms of the tech, particularly around the energy grid, where the UK is much better placed. One example that I've often had discussed and is an interesting proposition is, for example, the modular reactor space where certain firms in the UK by virtue of previous defense contracts and so on are well placed potentially, or do have globally leading tech in some of those areas. In order to sort of win or play a productive role in the transition in a way that utilizes its current base, where the UK is going to be more successful is not in necessarily producing the physical capital, but in providing the associated professional services that go with it. So reconfiguring both its research base and elements of the professional services space, things like legal services and consulting to really better complement some of that transition globally. So for the green transition, the UK has to make those domestic investments, it probably will still be a primarily an imported story on the good side. Again, where the UK can really focus is on the export of complementary services. And there, there's a lot the UK has to offer, be it from insurance to the legal side, and as I say, to the consulting side as well, and of course, finance too.

Lucy Baldwin (20:15)

Ben, that's really helpful. This has been a hugely insightful conversation structurally around the UK's positioning in the world, but it would be remiss if I didn't pick your brains around where we are from a cyclical perspective right now, and obviously great to have heard that structurally there are some green shoots around the corner too.

Ben Nabarro (20:35)

I think on the cyclical side, we would expect the Bank of England to cut rates ultimately into accommodative territory over the next 12 to 18 months. And what I mean by that is, sort of take policy rates to a level where they're supporting growth, supporting spending, rather than just being roughly neutral. To be clear, they start, we think, from a relatively restrictive position. The UK really has been pushed from pillar to post over the last few years by some absolutely enormous supply shocks. And what we're now starting to see is as those supply shocks are fading, supply growth is beginning to pick up a little bit, which of course is very welcome news. I don't know what the Chancellor will set out precisely in her budget, but our expectation is that fiscal policy will be roughly neutral to perhaps, even in the near term, a little bit of a headwind. So if what's happened over the last few years is these supply shocks have pushed inflation to very high levels. They've also, as they've emerged quite suddenly, driven a little bit of an excess demand problem because supplies been hit quite hard, but that hasn't fed back into incomes instantaneously.

And then also fiscal policy on top of that has further supported incomes, even as the capacity potential of the UK has been hit hard. We're now entering a period where all three of those trends are beginning to reverse. So recent views on UK inflation, we think has been really quite good. Supply is improving, and we're also starting to see that fiscal tailwind disappear. All of which implies that monetary policy will probably have to cease being a headwind to become more of a tailwind really quite quickly. And so for us, you know, right now, the Bank of England is waiting for a bit more insurance on inflation, we think ex post that might turn out to be a little bit of an error. They're still operating in a very cautious way given the experience of recent years. But as we get into next year in the implications of that changing supply and demand balance become clearer, unemployment hypothetically goes up a little bit, inflation continues to trend down, then we think monetary policy will begin to react. The key difference for us is if you compare to the U.S. where the Federal Reserve is being very proactive in the face of an economy that remains resilient in an underlying sense. For both the Bank of England and to some extent, the ECB, there's much more of a sense of waiting for reassurance, and in turn, that probably implies central banks will have to do more in time to make up for that gap. So overall, we're expecting rates to fall perhaps to about 2% through the start of 2026 and then settle at around a 2 ½ to 3% range as fiscal policy begins to take on more of a proactive role later in the Parliament.

Lucy Baldwin (23:11)

Ben, thank you. It's been brilliant to talk to you today, and it's very clear that with the global macro and financial environment certainly remaining fairly challenging, it is critical that the UK is able to lift growth in order to deal with these choppier waters that may continue to lie ahead. It's been a hugely illuminating conversation, and we look forward, Ben, to getting you back on the podcast to see what progress the UK is able to make over the coming months.

Ben Nabarro (23:39)

Thank you very much having me.

Lucy Baldwin (23:41)

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[Disclaimer] (24:07)