The State of the United Kingdom Economy

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The island of the United Kingdom is considered the third largest economy in Europe after Germany and France. The UK due to their highly mechanized and efficient agricultural industry is able to produce 60% of food needs with less than 2% of the labor force. However, due to their depleting oil and natural gas reserves, the UK has been a net importer of energy since 2005. Therefore rendering the manufacturing sector as about 10% of the economic output. The services, particularly banking, insurance, and business services, are key drivers of British GDP growth[1].

In the last decade, one of the UK's major decisions impacting its economy was Brexit. The UK's economy has begun to slow since the referendum vote to leave the EU in June 2016[9]. A sustained depreciation of the British pound has increased consumer and producer prices, weighing on consumer spending without spurring a meaningful increase in exports. The UK has an extensive trade relationship with other EU members through its single market membership and economic observers have warned the exit will jeopardize its position as the central location for European financial services. And economists believe that the UK will not be able to preserve the benefits of EU membership without the obligations[10].
**Inflation**

**Current Statistics**
Over the past 3 years the inflation rate has experienced many changes in the United Kingdom. In 2015 the average inflation rate was 0.04%, in 2016 it was 0.66%, in 2017 is was 2.63% and as of now the inflation rate has slightly fallen to 2.5%.[6][7]

**Brexit’s Effect**
The sudden rise in inflation rate in 2017 can be linked to the prospective withdrawal of the United Kingdom from the European Union. Immediately after Brexit was announced the Sterling depreciated in value by approximately 10%.[7]. This in essence made the cost of imports more expensive. Being a developed economy, the UK has a greater service sector, than that of a manufacturing sector, therefore the UK is a major importer of fuel and other factors of production. This means that when the cost of imports increased so did the cost of production, which caused cost - push inflation, which both Keynesian and New Classical economists believe to be dangerous for an economy. The increased cost of production causes a decrease of the short-run aggregate supply (AS₁ to AS₂), which puts upward pressure on price levels resulting in an inflation (P₂ - P₁) and decreases the real GDP (from Y₁ to Y₂).

**Economic Growth**

**Current Statistics**
The United Kingdom as of 2017 had the 5th highest nominal GDP of $2.624 trillion. Throughout the last three years the UK’s GDP has been growing at an average rate of 2% where it has fallen from a rate of 2.3% in 2015, to 1.9% in 2016, and then to 1.8% in 2017[3].
**Brexit’s Effect**
As a result of Brexit and the depreciated value of the Pound Sterling, consumption in the UK has increased. This is because for tourists the UK has become a “cheaper” destination as it once was. Recent news reports have even suggested that London is now the cheapest city in the world to buy a Louis Vuitton handbag or get a Bremont watch\(^\text{[10]}\). Exports are able to benefit from the depreciated value of the GBP since their exports increase. People from foreign countries are more likely to buy from the UK as they believe that they can get more goods and services for their money. Along with this the imports will decrease as the price of them has risen. These three aspects - consumption, exports, and imports - are all determinants that will increase the aggregate demand and therefore the real GDP. However the uncertainty that will potentially arise in the future trading of the United Kingdom, as a result of the high inflation, will decrease investments. One of the attractions to invest in the UK is its access to the Single Market, which enables foreign companies to be able to export from the UK to Europe without tariffs and barriers. If the UK were to leave the Single Market as a result of Brexit, countries might not be as willing to invest with the UK. This could lead to a relative decline in UK inward investment and reduce demand for Sterling. And in essence decrease the potential economic growth. Another factor that could have potentially affected the decrease in GDP growth in 2016 was the decrease government spending that occurred after Brexit was announced. From April 2016 to July 2016 government spending decreased by £232 million. Nevertheless, overall, there was GDP growth (\(Y_1\) to \(Y_2\)) and potentially an increase in AD (\(AD_1\) to \(AD_2\)) in 2016 and 2017 but the economic growth slowed down.

**Unemployment**

**Current Statistics**
The current unemployment rate in the UK is 4.2% which a rate that has decreased in the last 3 years. At the end of 2015 the unemployment rate was 5% which then decreased to 4.9% in December of 2016. This number further lowered in 2017 where is dropped to around 4.4%\(^\text{[13]}\).
Brexit’s Effect

According to the Phillips curve, inflation and unemployment are inversely related. However, this theory does not hold when aggregate supply shifts as in a cost-pull inflation when both inflation and unemployment is expected to increase (from point A to point B). Although this is the theory in reality, as seen through the statistics, the unemployment rate has decreased in the last 3 years. This could be linked to the economic growth as aggregate demand is directly correlated to employment. So when aggregate demand increased in the last three years, employment also increased. The unemployment rate is calculated using the proportion of people in the total labour force who are actively looking for work but cannot find a job. However, due to the flaws in calculating unemployment, economists believe that unemployment rate has decreased due to a rise in the number of discouraged workers – people who have stopped looking for work which is referred to as.

Equity

Current Statistics

The approximate gini coefficients for the years 2015, 2016, and 2017 are 0.34, 0.35, and 0.34 respectively. At each end of the spectrum, 31% of the UK’s income is owned by the top 10% of the population and approximately 3% of UK’s income is in the bottom 10% of the population. This leaves the income distribution in the UK to be relatively unequal - not the most equal but also not the least equal.[15]

Brexit’s Effect

Unlike in the other areas of economic goals, Brexit did not seem to have a significant effect on the income distribution in the UK. As in the years of 2016 and 2017 the gini coefficient seemed to decrease by 0.01 which does mean that the distribution of income is more equal than before but not much different. This could be because there was a slight decrease in
the unemployment rate, which could - assuming that there was little to no increase in discouraged workers or hidden employment - increase the overall quality of life in the UK as more people will be able to support themselves economically.

Policies

**Decrease inflation**

To combat this increased inflation the [Monetary Policy Committee](https://www.bankofengland.co.uk/monetarypolicy) (MPC) of the [Bank of England](https://www.bankofengland.co.uk) has set a monetary policy in which an inflation target has been given by the government. This target is 2% ± 1 and using interest rates the MPC is trying to achieve and maintain this target. By increasing interest rates to 0.5%, in November 2017, the growth in aggregate demand would, theoretically, reduce for the UK economy. The higher the interest rate the higher the cost of borrowing and spending is, which in turn makes saving money more attractive. As well as this increased interest rates reduce the disposable income of those with mortgages. This overall will decrease the consumption in an economy and therefore impact and reduce aggregate demand as a statistic shows that in 2016 approximately 66.36% of the UK’s GDP is made up by consumer expenditure[^1]. However interest rates can also increase aspects of aggregate demand such as net exports. Exports grow and imports decrease because the goods and services in the UK have become relatively cheaper from prior years. And consequently the foreign markets might demand more exports. Although inflation was still present in 2018, after this policy was implemented, the degree of the inflation compared to prior years was lower - disinflation. This inflation, known as demand pull inflation, is considered to be tolerable by Keynesian economists as aggregate demand is increasing and so is GDP as Y₁ shifts to Y₂ and inflation is considered to be relatively low (P₂ - P₁). Also by insuring that the economy is still growing, unemployment rates are expected to decrease as there is a positive correlation observed between economic growth and employment. When unemployment decreases the distribution of income is more equal than it was before.
Economic growth

After Brexit was announced, the Bank of England unveiled a four part stimulus package that was designed to boost the economy and prevent a recession[22]. The stimulus package included an extra £60bn of newly created money to buy government bonds, drive down gilt yields and force investors into riskier assets, a new £100bn scheme to encourage banks to lend cheaply to UK companies, and a pledge to buy £10bn of corporate debt issued by UK companies who make a genuine contribution to the UK economy[23]. All these increase aggregate demand since more money is being circulated in the economy. By increasing AD (from AD\(_1\) to AD\(_2\)), the UK government is not only avoiding a recession but is also increasing economic growth (as \(Y_1\) shifts to \(Y_2\)). Because of the increase in AD, price levels will rise (P\(_1\) shifts to P\(_2\)) resulting in demand pull inflation. The employment rate, nonetheless, should increase with this new increase in aggregate demand as the overall demand for goods and services has increased and therefore potentially an increase in labour is needed. Jobs could be getting created and therefore workers are needed. As well as this, with a higher GDP and a lower unemployment rate, a more equal income distribution will exist since more people are potentially more economically stable and government transfer payments can increase.

Increase employment

In January 2018 government spending increased from £91337 million to £91747 million. This increase in spending contributed to the public spendings in economic affairs, general public services, and health programs[14]. This increase in government spending, theoretically should increase the aggregate demand from AD\(_1\) to AD\(_2\). These will result in a higher GDP of \(Y_2\) and, depending on the size of the increase, a higher price level (P\(_2\)). Resulting in inflation and economic growth. However this does create demand pull inflation which unlike Keynesian economists, New Classical economists argue to be hurtful in the long-run. This is because they believe that an increase in aggregate demand will
result in an upward pressure on wages and so in the long run (LRAS) the aggregate supply curve will shift back (SRAS) and there will be no increase in output/GDP (back to $Y_1$). Although this might be the case in the perspective of a New Classical, in the short run this increased government spending on for example the public services will help decrease unemployment as more than 5.4 million people in the UK work in the public sector - 17.1% of all those in employment - and by expanding this sector the demand for workers will increase\(^{[18]}\). As well as this, the increased government spending should help increase equity as the government is funding for health care programs, education, and infrastructure - all of which are desired goods. The quality of life overall improves and more people are able to participate productively in the labour market.

**Equity**

In the United Kingdom the government offers transfer payments such as unemployment benefits. As of 2018 the unemployment benefits are a maximum weekly rate is £56.80 (age 16-24) and £71.70 (age 25 or over) to those who are out of work and are actively seeking employment\(^{[21/22]}\). Transfer payments can help those who are considered to have low to medium incomes as long as those transfer payments are not abused. People in these situations can struggle to pay for the basic needs such as food and shelter and therefore by providing them with these goods, for a while they will be better off. Transfer payments help improve income distribution as the government is able to support low income families so that their income and ability to consume increases as well. If there are more people able to consume aggregate demand will increase and therefore so will GDP. However a common counter argument to transfer payments such as unemployment benefits is that the government is making it too easy to not work. Unemployment might not decrease if transfer payments exist as people might prefer the idea of getting a moderate amount of money for not working rather than a slightly greater amount of money for working.
Potential solution

The government of the United Kingdom could potentially resolve the inflation caused by the increased cost of production as a result of Brexit by increasing both the current and potential long run aggregate supply through increase land, labour, capital, or enterprise. This can be done by loosening immigration laws. This will increase the quantity of labour and By increasing aggregate supply (AS₁ to AS₂), real GDP will increase (Y₁ to Y₂) and price levels will decrease (P₁ to P₂). This needs to be controlled as a high decrease in price levels can result in deflation. This will not only lead to economic growth but will also therefore decrease unemployment. And when unemployment decreases, the quality of life will improve and the income disparity will decrease.

References