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UNITED KINGDOM'S RESPONSE TO THE CRISIS

Deep recession, higher unemployment

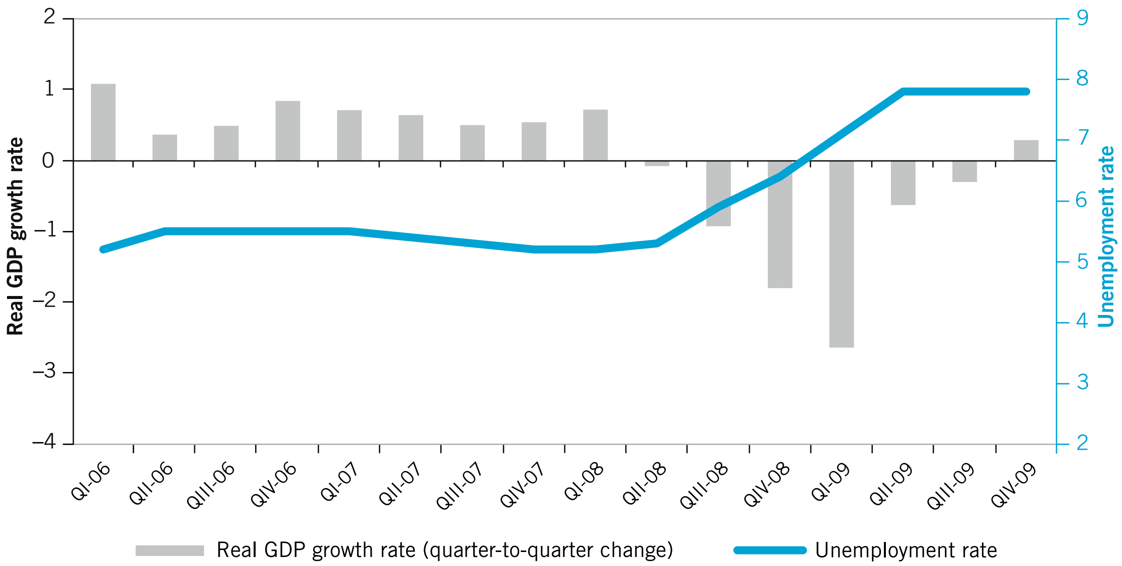
Prior to the onset of the global financial and economic crisis, the United Kingdom's economy was growing steadily, with the annual rate of growth in gross domestic product (GDP) averaging 2 to 3 per cent in 2006-2007. Unemployment was low, averaging 5.2 per cent in the first three months of 2008, with the number of people claiming unemployment benefit falling below 800,000 for the first time in 32 years. At the same time, the level of employment reached record highs.

As financial markets collapsed and the global crisis unravelled, the UK was plunged into one of its deepest recessions in the post World War II era. Quarterly GDP began contracting in the second quarter of 2008 and subsequently declined more sharply, reaching its lowest point in the first quarter of 2009, –2.6 per cent.

Total contraction in real GDP from the peak level in the first quarter of 2008 to the trough in the third quarter of 2009 was 6 per cent, while estimates for the fourth quarter of 2009 indicate that the UK economy grew slightly for the first time since the start of the downturn, by 0.3 per cent over the previous quarter.

Unemployment, measured under the ILO definition, rose 2.6 percentage points between the first quarter of 2008 and the second quarter of 2009, reaching 7.8 per cent. This increase is on a par with the average increase in unemployment in OECD countries over the same period. The unemployment rate remained stable at 7.8 per cent through the fourth quarter of 2009. Figures for the UK claimant count in January 2010 reached 1.64 million, the highest level since 1997, although somewhat lower than earlier predictions.

Figure 1. Unemployment rate and real GDP growth rate, by quarter, 2006–2009 (percentage)



Source: U.K. Office for National Statistics. Seasonally adjusted data.

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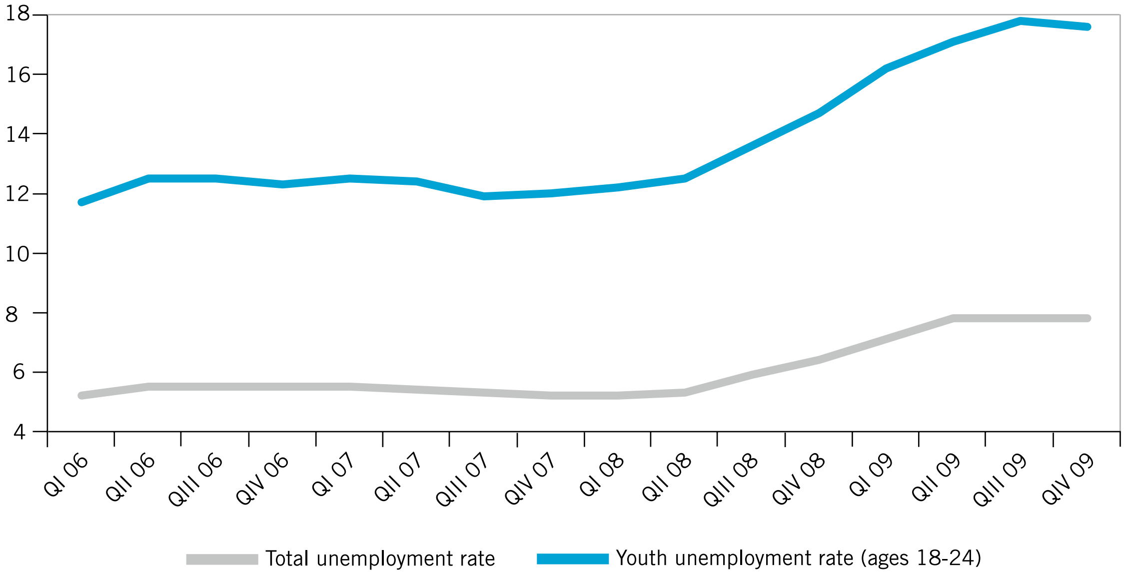
Figure 2. Total and youth unemployment rates, by quarter, 2006–2009 (percentage)



Source: ONS. Seasonally adjusted data.

Finance and business services, manufacturing and construction were the hardest hit sectors, with 300,000 jobs lost in manufacturing from the pre-crisis level of employment. There has been a widespread use of a range of flexible working arrangements to offset layoffs across sectors. Youth unemployment rose proportionately in line with other groups, by 5.6 percentage points from the first quarter of 2008 through the fourth quarter of 2009. It stood at 17.8 per cent in the third quarter of 2009, indicating that young people are in a particularly vulnerable position in the labour market.

Four-pillar reponse

The UK government adopted a four-fold response to the crisis, consisting of the following pillars:

- *Preventing the collapse of the banking system.* This entailed providing temporary liquidity through government guarantees of up to £250 billion, in addition to purchasing assets and lending; protecting depositors by supporting individual banks, including Northern Rock; and recapitalizing the banks in return for shares, including a £37 billion bailout to three banks in October 2008, and a further £31 billion in November 2009.
- *Supporting the economy.* This pillar consisted of stimulating demand through cutting interest rates to record lows; and providing a fiscal stimulus amounting to £20 billion to help mitigate the impact of the downturn.
- *Supporting bank lending to individuals, families and businesses.* This involved reducing uncertainty through asset protection; and providing support for business lending through purchasing of high-quality private sector assets and provision of loans to SMEs.
- *Investing for recovery and preparing the country to take advantage of the opportunities of globalization.* This pillar consists of a variety of principles pertaining to improved governance of the financial sector, investment in skills and education, commitment to medium-term macroeconomic stability, investment in low-carbon infrastructure and active labour market programmes.

Size: The £20 billion fiscal stimulus package, consisting predominantly though not exclusively, in tax cuts over the course of 2009, amounted to 1.5 per cent of the UK's GDP. While the package was relatively modest compared to other G20 countries, it should be considered in the context of the extraordinary additional support provided by the UK government to the banking sector. The package was adopted as a targeted and temporary measure, so as not to jeopardize medium-term sustainability. It is not expected to be further augmented in 2010, due to concerns over the size of the UK public debt. The UK government estimates that action taken by the government and Bank of England has created or saved up to half a million jobs.

Composition: Tax cuts account for an estimated 73 per cent of the stimulus package, with the principal mechanism a temporary cut in the rate of Value Added Tax (VAT), from 17.5 per cent to 15 per cent, for a 13-month period from 1 December 2008 until 31 December 2009. This is examined in further detail below. In addition, £3 billion of capital spending was brought forward from 2010-2011, involving public investment to support infrastructure – primarily on schools, social housing, motorways and energy efficiency. In connection with this, the government is requiring that successful contractors have apprentices as an identified proportion of their workforce, which could lead to an extra 7,000 apprenticeships in construction alone over the next three years.

In 2009 an estimated £5 billion was spent on employment-related measures, the equivalent of 0.4 per cent of 2008 GDP. Within this context, a number of direct workforce reintegration measures valued at £1.3 billion were announced in the November 2008 Pre-Budget Report, in addition to a further £1.7 billion allocated to the Department for Work and Pensions in the April 2009 Budget for active labour market policies. The government's overall approach towards promoting employment, outlined in the white paper on employment, "Building Britain's Recovery: Achieving Full Employment," includes support for those with low skills, people with disabilities or health conditions and lone parents and others with caring responsibilities. Government measures also involve significant support for young people.

Future jobs fund – fighting youth unemployment

The Future Jobs Fund (FJF) is a £1 billion initiative that was announced in the 2009 Budget, to be implemented between October 2009 and March 2011. It is a challenge fund run by the Department for Work and Pensions in partnership with the Department for Communities and Local Government with facilitation from Jobcentre Plus and Regional Government Offices. Recognizing the pervasive problem of high and rapidly growing youth unemployment linked to the economic downturn, the FJF aims to create 170,000 jobs in England, Scotland and Wales, primarily for youth in danger of entering the category of long-term unemployed. It is expected that 120,000 of these jobs will be reserved for 18-24 year olds and 50,000 will target areas suffering from high unemployment, known as unemployment hotspots. Moreover, a minimum of 10,000 of the jobs created will be green jobs, and at least 15,000 will be in social enterprises. The FJF forms a core part of the Young Person's Guarantee, which will guarantee an offer of a job, work experience or a minimum of six months training to all 18-24 year olds who have been out of work and claiming Jobseeker's Allowance for six months from January 2010.

The Future Jobs Fund functions by providing employers with subsidies up to a maximum of £6,500 for each job created. It is open to all organizations from the public, private and third sectors (which consists of voluntary or non-profit bodies), although it is particularly targeted at partnerships led by local authorities or the third sector. Bidding organizations – or partnerships of organizations – are expected to create a minimum of 30 new jobs. The bidding criteria stipulate that the jobs created must be additional, in that they would not exist without the funding. Moreover, the new jobs should last a minimum of six months for at least 25 hours work a week and should pay the national minimum wage or more; they must be suitable either for 18-24 year olds who have been on Jobseeker's Allowance for 10 months and/or for people in unemployment hotspots, where the claimant unemployment rate is more than 1.5 percentage points above the national average. Bidding organizations must also demonstrate that the work done will benefit local communities in the long term and that support is provided to help workers employed through the FJF move into longer-term, sustained employment.

The social partners have been involved in setting up the FJF and are actively supporting its implementation. Local chambers of commerce participate in regional FJF teams to support employers and workers through the process. Concurrently, trade unions and the Trades Union Congress have lobbied for full employment rights for workers employed through the FJF, have been involved in the process of deciding where FJF jobs should be and are engaged in efforts to recruit and organize FJF workers.

Impact – Job Creation Begins

While the employment guarantee associated with the scheme did not take effect until early 2010, new job creation was already well under way in 2009. Between July 2009 and January 2010, the FJF announced six rounds of awards, amounting to approximately 104,000 jobs, about 61 per cent of its envisaged allocation. Specifically targeting long-term unemployed youth and regions most in need of short-term support should enhance the impact and ultimate success of this extensive jobs scheme. Moreover, putting in place mechanisms to promote longer term sustainability of employment beyond the duration of the FJF subsidy helps to allay concerns that the scheme is overly focused on the short term.

Vat cut to stimulate demand

In the Pre-Budget Report of 24 November 2008, the Chancellor of the Exchequer announced a temporary reduction in the rate of VAT, from 17.5 per cent to 15 per cent for a 13 month period from 1 December 2008 until 31 December 2009. At the end of this period, the VAT rate returned to its former level of 17.5 per cent. The measure was estimated to cost £12.4 billion (£3.8 billion in the fiscal year 2008-2009, rising to £8.6 billion in 2009-2010), equivalent to about £440 per household. The rationale for the VAT reduction was that it would make goods and services cheaper and, by encouraging spending, would help to stimulate growth and demand for labour.

There are two mechanisms through which the temporary VAT reduction could affect spending. Firstly, there could be an income effect, whereby the lower level of prices increases people's purchasing power. This extra value may be divided between immediate consumption and savings for future consumption. Secondly, there may also be a substitution effect, whereby the lower level of prices relative to the future may encourage consumers to bring forward their spending. While this is less likely to occur among consumers who are close to their credit limits, it

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could prove attractive to consumers who do not face binding credit constraints.

It was estimated that if the VAT reduction were fully passed on by retailers to consumers, the average relative fall in consumer prices would be 1.2 per cent. At the same time, consumption was estimated to increase by about the same amount, regardless of whether the consumer was credit constrained. Therefore, the same level of expenditure would produce a higher volume of sales, while the lower VAT payments would allow retailers to keep more of these revenues. If less than the full amount of the VAT reduction were passed on by retailers to consumers, consumption would increase by whatever proportion prices fell, and firms would bolster their margins by the amount of the reduction not passed on.

Impact

The VAT reduction attracted significant debate within political and academic circles. While it is somewhat premature to be able to assess its impact, the expenditure switching effect is argued to be stronger than originally envisaged, leading to assertions that it is indeed "a better stimulus measure than its critics suggest".[1] Retail sales figures show that the seasonally adjusted value of retail sales for October 2009 was 3 per cent higher than in October 2008 and for the three months to October 2009, sales were 2.3 per cent higher than the same period a year earlier. Higher retail spending supports jobs in the retail sector and, through multiplier effects, in the economy more broadly.

Outlook and challenges

GDP contracted by 4.8 per cent in 2009 overall and is forecast to return to growth of approximately 1.3 per cent in 2010, supported by better financial conditions, expansionary monetary policy and stronger international growth. However, the labour market remains dependent on the recovery in the economy, with total unemployment predicted by the OECD to pass from 9.3 per cent in 2010 to 9.5 per cent in 2011. EU forecasts show unemployment, under the ILO definition, peaking in mid 2010 and averaging 8.7 per cent for the year. The Treasury's projection published in November 2009 is that claimant count will peak at 1.75 million in mid-2010, and then fall to 1.5 million at the end of 2012 and 1.25 million in 2014.

The evidence suggests that the government's investment in labour market programmes and other stimulus measures in 2009 has yielded positive results. The rate of increase in unemployment had slowed significantly in the third quarter of 2009, and the number of unemployed actually fell in the fourth quarter, resulting in a lower than predicted level of joblessness. However, the sizeable increase in part-time work and a slight rise in inactivity as a result of movement into full time education is a reminder of the fragile state of the labour market. While 2010 is likely to witness fiscal tightening in an attempt to rein in a budget deficit approaching an estimated 14 per cent of GDP, continued targeted measures to mitigate further deterioration of the labour market, supporting households and businesses, will remain necessary in 2010 and 2011.

[1] Institute for Fiscal Studies, *The IFS Green Budget*, January 2009, page 194