015296/EU XXV.GP
Eingelangt am 06/03/14

EUROPEAN
COMMISSION

Brussels, 5.3.2014
SWD(2014) 91 final

COMMISSION STAFF WORKING DOCUMENT

Macroeconomic Imbalances - United Kingdom 2014

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

The **United Kingdom** continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, developments in the areas of household debt, linked to the high levels of mortgage debt and structural characteristics of the housing market, as well as unfavourable developments in export market shares, continue to warrant attention.

More specifically, while recent growth in economic activity is welcome, it is driven mostly by household consumption and is accompanied by a rising current account deficit. Business investment and net exports are yet to pick up from their current low levels. Containing high indebtedness, in particular of the household sector, while minimising the impact on investment and growth, would help limit medium-term risks and vulnerability to rises in the cost of borrowing. Credit growth for mortgage loans has been modest but rising from high pre-existing levels of household indebtedness. The risks in the housing sector relate to a continuing structural under-supply of housing; the relatively slow response of supply to increases in demand results in high house prices, particularly in London and the Southeast, and in household mortgage indebtedness. While the declining export market share is unlikely to pose short-term risks, together with the current account deficit, it still points to structural challenges. These are related to skills gaps and a low level of infrastructure endowment. As regards public finances, the UK seems to continue missing its headline deficit targets and its structural adjustment targets by wide margins.

Excerpt of country-specific findings on The United Kingdom, COM(2014) 150 final, 5.3.2014

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EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that the United Kingdom was experiencing macroeconomic imbalances, relating to household debt, the housing market and, to a lesser extent, external competitiveness. In the Alert Mechanism Report (AMR), published on 13 November 2013, the Commission found it useful, also taking into account the identification of an imbalance in April, to examine further the persistence of imbalances or their unwinding. To this end, this In-Depth Review (IDR) provides an economic analysis of the UK economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are:

- **Growth picked up markedly in 2013 at 1.8% compared with 0.3% in 2012 and is projected to increase further to 2.5% in 2014.** Growth in the UK outstripped that in the euro area (-0.4% in 2013), the largest export market for the UK. However, growth has been driven predominantly by household demand and has been accompanied by a rise in the current account deficit. In 2013, domestic demand contributed 1.6 pps. to growth, driven mainly by an upswing in private consumption while net exports contributed slightly to growth by 0.1 pp. A more broadly based recovery is desirable in which both business investment and net exports contribute positively to growth.

- **The export market share continues to decline although it has stabilised recently and the pace of decline has fallen.** Reflecting the impact of the international economic crisis, financial services exports have fallen. Following the strong depreciation of sterling in 2008-2009, exporters responded by raising margins instead of increasing market share so the impact of the depreciation on export growth has been relatively subdued. The risks associated with the declining export share are less marked in the short term but are higher in the medium term - the current account deficit may gradually increase over the medium term should the export market share continue to deteriorate. Structural challenges to raising exports include a low level of infrastructure endowment, skills gaps, in particular, in technical areas and constrained access to finance for Small and Medium-sized Enterprises (SMEs). Policy initiatives are being developed to address these issues.

- **Fiscal consolidation is underway which aims to stabilise and reverse the high general government debt ratio** which averaged around 40% of GDP in the decade before the international economic crisis but rose swiftly to reach almost 90% of GDP in 2012-13. The budget deficit was below 3% of GDP in 2007-08 but increased rapidly to peak at 11.4% in 2009-10. Reflecting the impact of a substantial and necessary fiscal consolidation, the budget deficit fell to 5.2% in 2012-13. The fiscal consolidation is expected to continue and, as a result, the deficit is projected to decrease further with the pace of increase in general government indebtedness falling. The UK is currently subject to an Excessive Deficit Procedure.

- **Although the pace of private sector deleveraging has slowed recently, private sector indebtedness has fallen significantly from its peak, in particular, for private non-financial corporations (PNFCs).** PNFCs' balance sheets are strong and the PNFC sector is a net lender to the rest of the economy suggesting that the sector is resilient despite the slowing in deleveraging; the risks posed by high PNFCs' debt are less marked than at the time of the 2013 IDR.

- **Household sector indebtedness, despite having declined from its peak, remains high and continues to pose risks.** Households' debt predominantly comprises mortgages secured against houses. Demand for houses is increasing, reflecting increased confidence, the low cost of borrowing and easing credit constraints. The increase in supply of new properties has, however, been muted. As a result, house prices are rising and household mortgage indebtedness is expected to increase. In the short term, the increase in housing supply is likely to remain below that of household formation although the government is implementing reforms to boost the supply of land and the stock of housing in the short and medium terms. The housing market is marked by divergent developments in London and the rest of the UK**.** In the year to November 2013, house prices increased by 5.4% largely driven by rises in London where prices increased by 11.6% whereas, excluding London and the south east, house prices increased modestly by 3.1%.

- **Credit constraints are easing for households and credit supply is rising.** However, credit supply continues to fall for PNFCs – it fell by 3.4% in the year to December 2013 – while, for households, secured lending increased in the same period by 0.9%. There is a need to ensure adequate access to finance for PNFCs, particularly SMEs, that need it to invest and expand. Policies are in place to help address the issue.

This IDR analyses these imbalances and associated risks and challenges. It considers a number of ways in which government policy can address the challenges, minimise the risks associated with any imbalance and prevent it from worsening.

- **To improve external competitiveness, improvements in infrastructure, skills, credit access for SMEs and export promotion could be considered.** Firstly, transport bottlenecks and capacity shortages could be addressed by investing in infrastructure. The UK government's National Infrastructure Plan 2013 sets out ambitious plans to boost the quality and quantity of national infrastructure and envisages investment of GBP 375 billion, a significant portion (around three-quarters) of which is private sector funding; effective implementation and harnessing private sector funding is key. Secondly, businesses require a labour force with specific intermediate and advanced technical skills in order to expand. Gaps in this area could be reduced by focussing on STEM (science, technology, engineering and mathematics) skills and apprenticeships and cooperating with businesses in order to identify the professional and technical skills required by the tradable sector. The government published an implementation plan on apprenticeships and has initiatives in place to raise vocational skills. Thirdly, whilst credit constraints have diminished, particular challenges surrounding access to credit remain for SMEs. The establishment of the Business Bank is a positive step and should help SMEs obtain alternative sources of finance while the refocussing of the Funding for Lending Scheme to PNFCs only should help all PNFCs including SMEs. Fourthly, exports could be stimulated by providing export credit where constraints exist. Finally, facilitating the recruitment of foreign experts could improve external mobility and ability to engage in international trade.

- **To minimise the risks associated with rising house prices and high household indebtedness, there is a need to address the short and medium term imbalance between supply and demand for property.** A number of useful policy initiatives are being implemented but there is scope for further action. In relation to demand, at a time in which credit constraints are easing in the mortgage market, the need for the Help to Buy 2 policy may diminish. Close monitoring of credit availability and associated macroeconomic developments is required given the risks associated with Help to Buy 2 and the policy could be scaled back – and/or more closely targeted – should credit supply growth rise further and credit constraints continue to ease. In relation to macro-prudential regulation of credit conditions in the housing sector, there is a case for a more detailed public assessment by the Financial Policy Committee of the Bank of England of the merits of the various instruments available to it and the situations in which they would be deployed to increase markets' knowledge of its approach to regulation. In relation to supply, there is scope to consider the development of appropriate and targeted incentives for local authorities to release land with planning permission attached for development in the context of local solutions to inadequate supply. Local solutions may also include the taxation of vacant property. In relation to taxation, revaluation of the property roll would reduce distortions in the taxation system in favour of owner-occupied housing.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its third Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific "in-depth reviews" (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up in terms it will recommend to the Council.

This is the third IDR for the United Kingdom. The previous IDR was published on 10 April 2013 on the basis of which the Commission concluded that the UK was experiencing macroeconomic imbalances, in particular as regards developments related to household debt, the housing market and, to some extent, external competitiveness. Overall, in the AMR, the Commission found it useful, also taking into account the identification of an imbalance in May, to examine further the persistence of imbalances or their unwinding. To this end, this IDR provides an economic analysis of the UK economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

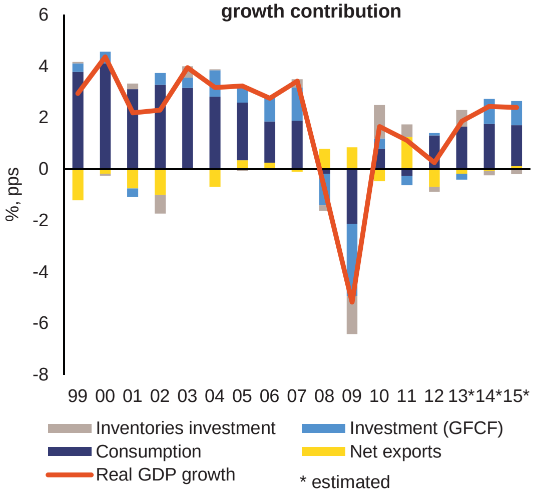
Section 2 provides an overview of general macroeconomic developments, section 3 considers the main imbalances and risks, including on export share, private indebtedness and the housing sector and section 4 discusses policy considerations.

2. MACROECONOMIC DEVELOPMENTS

Growth and inflation

The recovery since the international economic crisis had been slow and protracted until 2013. However, 2013 finally saw a decisive shift towards a more sustained recovery in which growth reached 1.8%. The main source of growth was domestic demand, particularly private consumption. Net exports detracted from growth in 2012 but made a small positive contribution in 2013. Despite the pick up in growth in 2013, the economy remains 1.4% below the pre-crisis peak. Growth is projected to rise further in 2014 to 2.5%, stabilise somewhat thereafter and broaden as growth gross fixed capital formation increases and the contribution to growth from net exports becomes positive but remains small (Graph 2.1).

Graph 2.1: **External and domestic demand - growth contribution**



Source: Commission Services

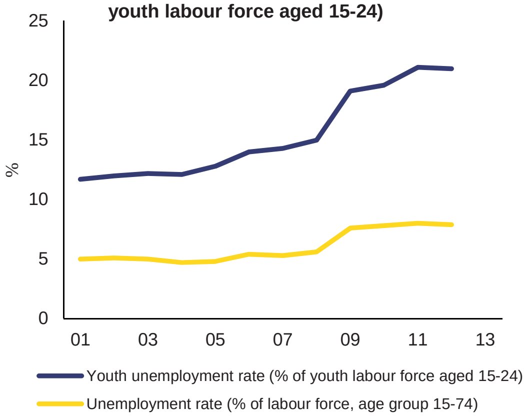
Inflation has been on a downward trajectory since September 2011 when it peaked at a 5.2%. Following some stickiness in the twelve months from October 2012 in which inflation averaged 2.7%, the rate has fallen more quickly in recent months to 1.9% in January 2014. The recent decline can be attributed to a fall in oil prices, delayed rises in utility charge increases and lower-than-expected increases in education costs. Inflation is expected to remain around the Bank of England's 2% target.

Unemployment and poverty

The unemployment rate peaked at 8.4% in the final quarter of 2011 and has fallen consistently since then. In the final quarter of 2013, the unemployment rate was 7.2%. The fall in the unemployment rate has occurred as strong rises in private sector employment have outweighed reductions in public sector employment. Between the third quarter of 2009 and the same quarter in 2013, public sector employment has fallen by some 10.6% ([1]). However, the improvements in employment have been accompanied by stagnant/ declining levels of productivity.

The regions with the highest unemployment rates in England are the North East and West Midlands and the rate increased in those regions in 2013. The lowest rates are in the East of England, and are falling, thereby contributing to an inter-regional division ([2]).

Graph 2.2: **Youth unemployment rate (% of youth labour force aged 15-24)**



Source: Commission Services

Youth unemployment has increased over the past ten years and reached 21% in 2012 (Graph 2.2) ([3]). Furthermore, almost one-third of youth have been unemployed for more than one year. Long-term unemployment has increased over the past decade and reached 2.7% in 2012 ([4]). Poverty indicators provide a mixed picture as the severe

[1] However, it should be noted that part of the decline is due to the reclassification of further education and sixth form colleges in England from the public to the private sector in 2012; this accounts for 3.2 pp. of the decline.

[2] ONS Labour market statistics, December 2013.

[3] Eurostat data.

[4] Idem.

material deprivation rate rose from 2008 to 2012 (the date of the last available data) ([5]); however, the at-risk of poverty or social exclusion rate has declined since 2005 and is now below the pre-crisis level.

Potential growth

In 2014, potential growth is projected at 1%([6]), around one-half of the level just prior to the crisis. Low potential growth reflects low productivity growth and the combination of a resilient labour market and growth in employment that outstripped that in GDP. Low productivity is likely to reflect a combination of factors such as the lower price of labour relative to capital leading to a rise in demand for labour, albeit possibly less productive labour, a rise in employment in less productive sectors of the economy and forbearance and cheap credit allowing some firms to remain in the market from which they would otherwise have exited.

In 2012, the Greater South East (London, the South East and East of England regions) contributed 45.4% of total Gross Value Added (GVA). This was an increase from 44.3% in 2007 and 43.1% in 2001. London alone accounted for 22.4% of GVA in 2012 and grew by 2.0% over the year; higher than the UK average of 1.6%.

The external side

Although the deterioration in export market share reversed in 2013, net exports only contributed 0.1pp to growth. The trade balance for services has been improving recently although the goods balance has been deteriorating. Exports are reorienting towards non EU markets but the EU still accounts for the largest export share by destination. In 2012, the single largest destination for exports was the US (13.7% of total exports), followed by Germany (10.6%) whereas China accounted for 3.5% of total exports. Growth in net exports is projected to remain subdued in 2014 in part reflecting relatively subdued growth in the euro area.

Along with weak export growth, there has been a sharp deterioration in earnings on overseas investments. In 2013, the current account balance reached a deficit of 3.8% of GDP.

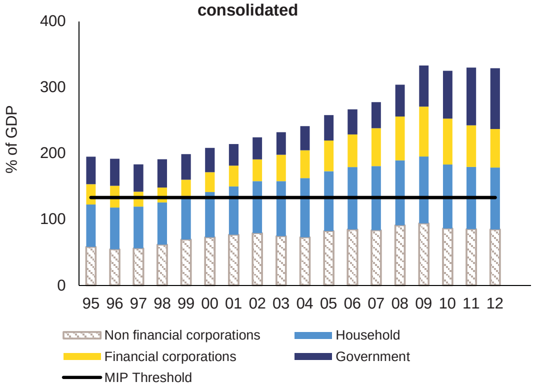
The fiscal position

Fiscal consolidation has been underway since the June 2010 Budget. This has resulted in a 6.2 pp. fall in the budget deficit to 5.2% of GDP in 2012-13. The consolidation has been assisted by certain one-off items which account for approximately one-third of the decline. Furthermore, the ongoing transfers from the Bank of England's Asset Purchase Facility also contributed to the decline ([7]). Gross government debt continues to increase and reached 88.1% of GDP in 2012-13.

Private sector debt

Private sector debt peaked at 195% of GDP in 2009 and has been declining since then although it remains high (Graph 2.3). Household debt and corporate debt both remain high despite having declined since 2009 and the pace of decline has fallen. The household savings ratio was high in 2012 but fell somewhat in 2013.

Graph 2.3: **Debt Decomposition, all sectors, consolidated**



Source: Commission Services

During 2013, activity in the housing market increased with prices rising from an already elevated level. The strongest rises were in London and the South East.

[5] Macroeconomic Imbalance Procedure Scoreboard

[6] Commission services Winter 2014 Forecast.

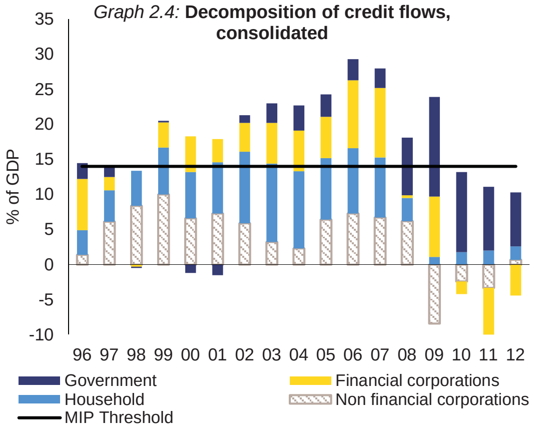
[7] As a result of quantitative easing, the coupon payments linked to assets held by the Bank of England Asset Purchase Facility Fund Limited (BEAPFF), a subsidiary of the Bank of England, are being transferred to the general government accounts.

The financial sector and credit

Credit conditions have been improving for households although the supply of credit remains muted for corporates (Graph 2.4). According to the Bank of England's Credit Conditions Survey([8]), the overall availability of credit for both small and large corporates increased significantly in the final quarter of 2013. This was the fifth consecutive quarter of increases. Secured credit to households also rose including for borrowers with high loan-to-value ratios. This trend may have been affected by the Help to Buy scheme. However, despite positive signs from surveys, overall credit growth remains low and continues to decline for corporates.

A number of government policies have been designed to improve the flow of credit in the economy, in particular, the Funding for Lending scheme (FLS) and quantitative easing (QE). The FLS was introduced in July 2012 and was extended by one year in April 2013; however, in November 2013, the terms of the lending were changed, effective from 1 January 2014, by excluding lending to households and focussing solely on corporate lending. As part of QE, between March 2009 and July 2012, the Bank of England purchased GBP 375 billion worth of government bonds but has not returned to the market since then.

Graph 2.4: **Decomposition of credit flows, consolidated**



Source: Commission Services

The government is establishing a Business Bank which should be operational by the second half of 2014. The Bank aims to assist SMEs to obtain alternative sources of funds.

Throughout 2013, the eight major banks and building societies continued to eradicate capital shortfalls based on the Prudential Regulation Authority's (PRA) recommendations of March 2013. By September, three-quarters of the shortfalls had been addressed in the banks in which issues had been identified. This represented a 1.5 pp. improvement in their capital ratios. Banks that were not identified as having a shortfall also took actions which raised their capital ratios by 0.5 pp. in aggregate. The Bank of England and the PRA are also developing a regular stress-testing framework to assess the resilience of the banking system to housing-related portfolios, among others, with the first tests to be carried out in 2014. Furthermore, stronger mortgage underwriting standards will be implemented in the context of the *Mortgage Market Review* from April 2014.

([8]) Bank of England (2014).

Table 2.1:

Key economic, financial and social indicators - United Kingdom

								Forecast	
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP (yoy)	3.4	-0.8	-5.2	1.7	1.1	0.3	1.8	2.5	2.4
Private consumption (yoy)	2.7	-1.0	-3.6	1.0	-0.4	1.5	2.3	2.4	2.2
Public consumption (yoy)	0.7	2.1	0.7	0.5	0.0	1.6	0.9	0.5	0.4
Gross fixed capital formation (yoy)	7.5	-6.9	-16.7	2.8	-2.4	0.7	-1.5	6.5	7.1
Exports of goods and services (yoy)	-2.0	1.1	-8.7	6.7	4.5	1.1	0.8	2.9	3.7
Imports of goods and services (yoy)	-1.5	-1.7	-10.7	7.9	0.3	3.1	0.4	2.6	3.3
Output gap	2.6	0.5	-5.1	-4.0	-3.3	-3.4	-2.4	-0.9	0.2
Contribution to GDP growth:									
Domestic demand (yoy)	3.2	-1.3	-4.5	0.8	-0.6	1.4	1.6	2.6	2.5
Inventories (yoy)	0.3	-0.2	-1.5	1.3	0.5	-0.2	0.3	-0.1	-0.1
Net exports (yoy)	-0.1	0.8	0.8	-0.5	1.2	-0.7	0.1	0.0	0.1
Current account balance BoP (% of GDP)	-2.4	-1.3	-1.4	-3.3	-1.3	-3.7	.	.	.
Trade balance (% of GDP), BoP	-3.2	-3.3	-2.2	-2.8	-1.9	-2.4	.	.	.
Terms of trade of goods and services (yoy)	0.0	-0.9	-0.6	-0.3	-1.6	0.0	1.1	0.8	1.0
Net international investment position (% of GDP)	-22.6	-6.9	-20.8	-23.5	-16.8	-9.8	.	.	.
Net external debt (% of GDP)	43.3	37.3	45.7	45.6	44.1	31.5	.	.	.
Gross external debt (% of GDP)	392.1	436.4	410.0	407.8	419.6	385.3	.	.	.
Export performance vs. advanced countries (5 years % change)	-10.0	-14.9	-14.2	-16.4	-18.6	-10.4	.	.	.
Export market share, goods and services (%)	4.2	3.8	3.8	3.5	3.5	3.4	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	-3.7	-2.7	2.3	2.9	2.2	2.8	.	.	.
Private credit flow (consolidated, % of GDP)	15.3	9.5	-7.3	-0.6	-1.3	2.6	.	.	.
Private sector debt, consolidated (% of GDP)	180.8	189.8	195.6	183.3	179.8	178.6	.	.	.
Deflated house price index (yoy)	8.0	-4.1	-9.6	3.2	-4.7	-0.9	.	.	.
Residential investment (% of GDP)	4.4	3.8	3.0	3.4	3.4	3.3	.	.	.
Total Financial Sector Liabilities, non-consolidated (yoy)	16.7	48.0	-17.6	8.2	8.9	-4.3	.	.	.
Tier 1 ratio (1)	.	.	.	.	.	.	.	.	.
Overall solvency ratio (2)	.	.	.	.	.	.	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	.	.	.	.	.	.	.	.	.
Employment, persons (yoy)	0.7	0.7	-1.6	0.2	0.5	1.2	1.3	1.3	1.0
Unemployment rate	5.3	5.6	7.6	7.8	8.0	7.9	7.5	6.8	6.5
Long-term unemployment rate (% of active population)	1.3	1.4	1.9	2.5	2.7	2.7	.	.	.
Youth unemployment rate (% of active population in the same age group)	14.3	15.0	19.1	19.6	21.1	21.0	.	.	.
Activity rate (15-64 years)	75.5	75.8	75.7	75.5	75.7	76.3	.	.	.
Young people not in employment, education or training (% of total population)	11.9	12.1	13.3	13.7	14.3	14.0	.	.	.
People at-risk poverty or social exclusion (% total population)	22.6	23.2	22.0	23.2	22.7	24.1	.	.	.
At-risk poverty rate (% of total population)	18.6	18.7	17.3	17.1	16.2	16.2	.	.	.
Severe material deprivation rate (% of total population)	4.2	4.5	3.3	4.8	5.1	7.8	.	.	.
Persons living in households with very low work intensity (% of total population)	10.3	10.4	12.6	13.1	11.5	13.0	.	.	.
GDP deflator (yoy)	2.3	3.2	2.2	3.1	2.3	1.7	1.9	1.9	2.1
Harmonised index of consumer prices (yoy)	2.3	3.6	2.2	3.3	4.5	2.8	2.6	2.0	2.0
Nominal compensation per employee (yoy)	4.8	1.7	2.4	3.1	2.0	1.9	1.9	2.1	2.8
Labour Productivity (real, person employed, yoy)	2.7	-1.5	-3.6	1.5	0.6	-0.9	.	.	.
Unit labour costs (whole economy, yoy)	2.0	3.2	6.2	1.7	1.4	2.9	1.0	0.9	1.4
Real unit labour costs (yoy)	-0.3	0.0	3.9	-1.4	-0.9	1.2	-0.6	-1.0	-0.7
REER (ULC, yoy)	1.6	-13.2	-8.6	2.7	-0.6	5.5	.	.	.
REER (HICP, yoy)	1.5	-12.8	-9.5	0.9	0.5	4.3	.	.	.
General government balance (% of GDP)	-2.8	-5.0	-11.4	-10.1	-7.7	-6.1	-6.3	-5.2	-4.2
Structural budget balance (% of GDP)	-4.4	-5.1	-9.0	-8.4	-6.4	-6.5	-5.3	-4.8	-4.3
General government gross debt (% of GDP)	43.7	51.9	67.1	78.4	84.3	88.6	91.4	93.4	94.5

(1) domestic banking groups and stand-alone banks.

(2) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.

Source: Eurostat, ECB, AMECO

3. IMBALANCES AND RISKS

3.1. EXPORT SHARE AND COMPETITIVENESS

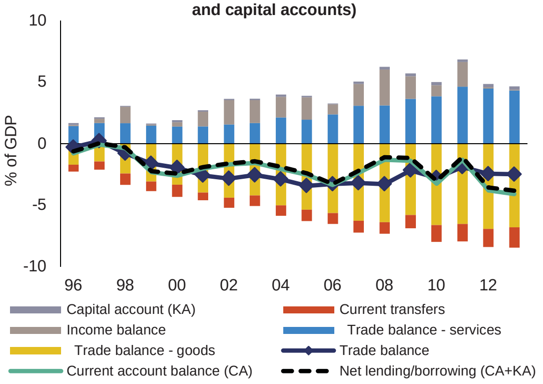
The 2013 IDR described the external dimension of the UK economy as "less as a source of macroeconomic instability, and more a field of often underexploited growth possibilities". The reasons for the deterioration in the export share were analysed in the 2012 and 2013 IDRs. This IDR sets out an update of developments in the current account balance and export share and examines the role of government policy in addressing potential bottlenecks to export growth including in relation to infrastructure, access to finance and skills.

3.1.1. The current account deficit

The UK has registered persistent current account deficits since the late 1990s and stood at 3.8% of GDP in 2013. For more than 15 years, the current account balance showed a consistent trend - a negative and increasing goods balance goods and, while slightly smaller, a positive and increasing services balance (Graph 3.1). However, both have flattened recently. The trade deficit increased steadily over most of the past 15 years although it too has stabilised in the last few years. In 2013, the trade deficit in goods is projected to have reached almost 7% of GDP while the surplus in services stood at almost 5% of GDP.

The deterioration in the current account balance following the international economic crisis was dominated by movements in the income balance. Historically, the income balance has been in surplus but has recently moved into deficit and contributed to the rise in the current account deficit. The deterioration appears to be mostly driven by differential returns between inward and outward investment of the UK. Notably, the UK has been growing at a faster pace than the EU - its most important trading partner and investment destination (the EU absorbs about half of the UK's exports and accounts for approximately 40% of its inward investment). As a consequence, profits earned by UK companies on investments abroad may have developed less favourably than those of inward investment. A recovery in net investment income in 2014 is projected, which should – if sustained over the medium term - contribute to a narrowing of the deficit ([9]).

Graph 3.1: **Decomposition of external position (current and capital accounts)**

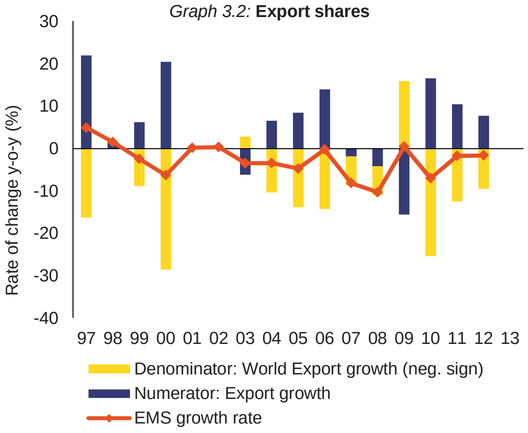


Source: Commission Services

The pattern of recent economic growth in the UK compared with its major trading partners might explain part of the deterioration in the trade balance. Since the end of 2009, growth has been driven by growth in domestic demand rather than net exports (as discussed in Chapter 2). Recently, growth in the UK has outstripped that in the euro area – for example, the UK grew by 1.8% in 2013 compared with -0.4% for the euro area – which may have affected relative import and export growth to the detriment of the trade balance. As domestic demand picks up further, imports are likely to increase further which is likely to result in a further deterioration in the trade balance should growth in imports continue to outstrip growth in exports. Nevertheless, relative losses in export market share stabilised in 2012 and 2013 (Graph 3.2).

[9] European Commission (2013d).

Graph 3.2: **Export shares**



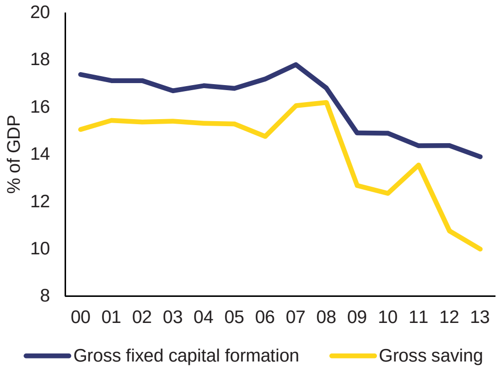
Source: Commission Services

The deterioration in the current account deficit may be associated with movements in gross savings and investment (Graph 3.3). Since the international economic crisis, domestic demand has been sustained by a substantial decline in the national savings rate. Gross national savings have fallen sharply from 16% of GDP in 2008 to 10% of GDP in 2013 and have been accompanied by a fall in investment from over 17% of GDP before the crisis to below 14% of GDP. Neither the fall in investment nor the deterioration in the current account is consistent with balanced medium-term growth.

The prospect of a more balanced pattern of growth depends on a shift in the composition of growth towards exports and investment. Despite rising recently, the current account deficit is associated with a modestly negative net investment position of -9% of GDP in 2012 and zero in 2013. Furthermore, these developments need to be seen in the context of a floating exchange rate, which facilitates external adjustment.

However, if the current pattern of growth is to become more balanced, growth in investment and net exports need to rise to complement growth in household consumption so that balanced growth is accompanied by a fall in the current account deficit and an increase in the net savings rate in the order of a significant 7% of GDP. To achieve this feat in a growing economy, improved external performance plays a crucial a role. Rebalancing away from domestic demand towards net exports would be also consistent with an increase in savings and investment.

Graph 3.3: **Investment and gross savings**



Source: Commission Services

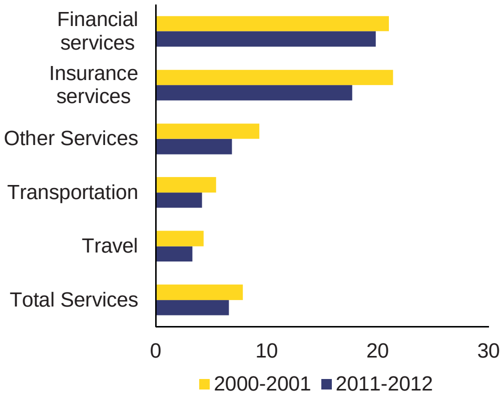
The medium-term prospects for net exports need to be analysed in the context of several potential adverse developments which include: the loss in export market share, especially for services exports, the long-term decline in goods exports, the muted response of exports in the wake of the substantial depreciation of sterling and the fall in financial services exports since the start of the international economic crisis.

3.1.2. Export shares challenge

In the five years to 2012, the UK lost approximately 20% of its export market share in goods and services although the pace of decline slackened in 2012. There is not a single obvious driver of the decline in export shares. Rather, it is determined by a number of factors including weakness in exports of financial services, itself reflecting broader weakness in the financial sector, and the mix of destinations and product markets for export. Other factors may include impaired access to finance for exporters and long-standing issues relating to the quality and quantity of infrastructure and skills.

Despite the relative strength in exports of services (contributing 4.5pp of GDP to the current account balance in 2012), the UK's world market share for services decreased from 7.9% in 2000-2001 to 6.6% in 2010-2011. A breakdown by industry shows an across-the-board decline in most sectors over the past ten years (Graph 3.4), including, in particular, a decrease in the world market share of the financial and insurance services industries (see Box 3.1).

Graph 3.4: **UK's world market share for services**

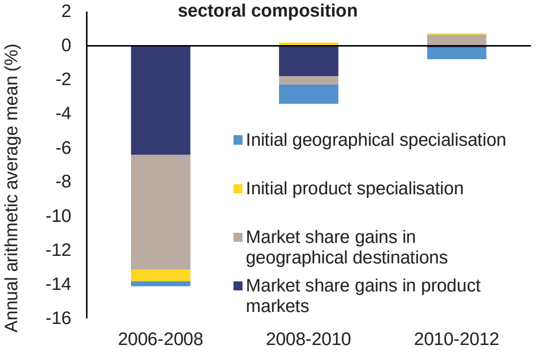


Source: Commission Services

The persistence of a deficit in the goods trade balance reflects deep-rooted characteristics of the economy. The trade balance is marked by a structural shift toward services and increased competition from emerging markets for goods exports. The weakness in certain goods exports is also linked to intense competition in export destinations. A decomposition of the nominal growth of goods exports by geographical specialisation and product specialisation (Graph 3.5) shows that, between 2006 and 2008, the decline of market share was driven mainly by the loss of market share within existing destinations and product markets rather than the 'dynamism' ([10]) of such destinations and markets ([11]).

More recently – between 2010 and 2012 - the UK gained market share in its export destinations, which, however, are losing 'dynamism'. Graph 3.6 shows the relationship, in the top-10 destinations for UK goods exports, between the growth in imports of these countries (market dynamism on the vertical axis) and the extent to which exports are growing in these countries (competitiveness on the horizontal axis) ([12]). The graph shows that the UK's top export destinations are disproportionately represented in the bottom-left quadrant of the graph, which means that - except for Switzerland and China – they are either losing dynamism or the UK is losing share in those countries compared to other export competitors.

Graph 3.5: **Goods export: geographical and sectoral composition**



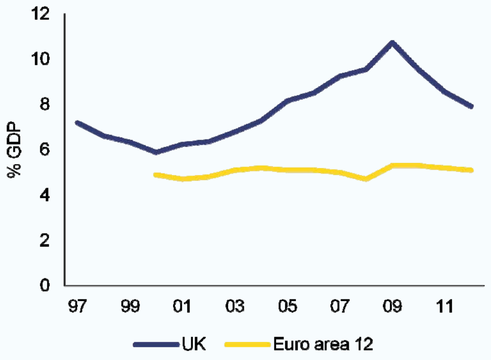
Source: COMTRADE data (HS 1992 Commodity Classification), Commission Services

[10] A destination country is 'dynamic' if its total imports grow faster than world total imports.
[11] In terms of relative growth rates of imports.
[12] The size of the bubble indicates the weight of a destination on total exports of the UK.

Box 3.1: The Financial and Insurance services sector

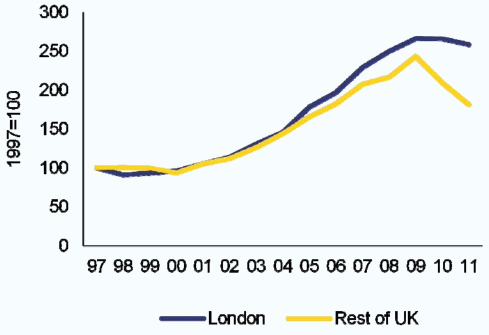
The UK financial and insurance services sector has experienced adverse developments in the last 5 years. Its gross value added (GVA) reached a peak of 10.7% of GDP in 2009, but fell to 7.9% of GDP in 2012 – a lower share than in 2005. It remains, however, well above the Euro Area 12 average (graph 1a). The shrinkage of the sector, which contributed substantially to growth in the previous decade, could have important repercussions for the UK economy. While in 2000-08 financial services (excluding life insurance) contributed on average 23% of total corporation tax receipts, this fell to approximately 13% in 2012-2013 ([1]). The proportion of UK workforce which is accounted by the sector declined from 4.6% in March 2009 to 4.2% in March 2013, accelerating the downward trend since 1995. Rising GVA and falling employment were among the main contributing factors to increased productivity in the UK in the decade until 2009. The financial sector contributes to the surplus in services trade of the UK. The degree to which the sector can recover and increase its contribution to the trade balance has a significant impact on the economic prospects of the country.

Graph 1a: **GVA of the financial and insurance service industry**



Source: Commission Services

Graph 1b: **Workplace based GVA, Financial and insurance activities, at current basic prices**



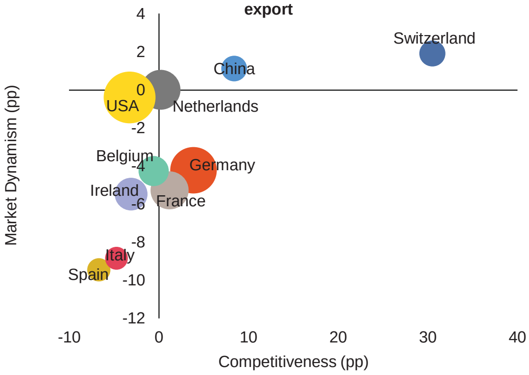
Source: Office for National Statistics

There are signs that the export performance of the sector will improve with global economic recovery. This is most visible in the divergent developments in London ([2]), which accounted for 52% of financial sector GVA in 2011, and the rest of the UK. Graph 1b shows that income of financial and insurance activities taking place in London stayed flat in 2009-2011, while it fell strongly in the rest of the UK. Since London-based financial firms have a higher propensity to export than in the rest of the country, most likely focused on retail banking, this bodes well for the prospects of financial services exports. It is indicative, however, of the depth of the issues facing the retail banking industry outside the capital and consistent with the reported difficulties of SMEs to access finance. However, there are indications of a gradual recovery in the sector. Net receipts ([3]) from the banking sector which had decreased substantially to less than GBP 18 billion in 2008-10 from GBP 23 billion of 2007-08 have started to climb again to above GBP 20 billion since 2010-11; this is a strong rise taking into account that this includes the GBP 1.6 billion from the introduction of the Bank Levy - an annual tax on certain equity and liabilities of banks, building societies, banking and building society groups. The financial sector remains therefore in a position that would allow it to contribute to export growth significantly as the global economy recovers.

[1] HM Revenue and Customs
[2] NUTS 2 statistical region Greater London
[3] PAYE, Bank Payroll Tax, Corporation Tax and Bank Levy

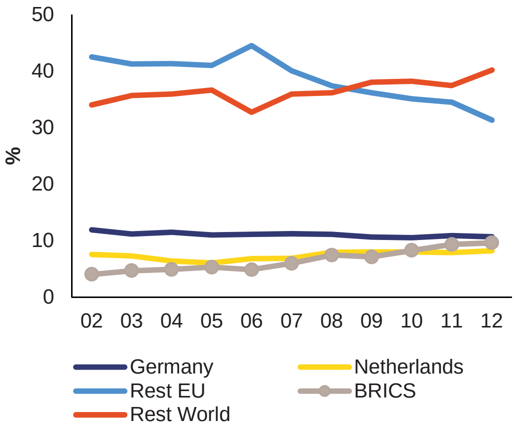
Over the medium term, geographical specialisation might diversify continuing a rebalancing away from the EU to emerging markets (Graph 3.7). While the EU is still the main export destination for goods, accounting for half the trade in value, the share of BRICs in total exports has grown from 4.9% in 2006 to 9.6% in 2012.

Graph 3.6: **Dynamism and competitiveness of goods export**



Source: COMTRADE data (HS 1992 Commodity Classification), Commission Services

Graph 3.7: **Export destinations, goods**

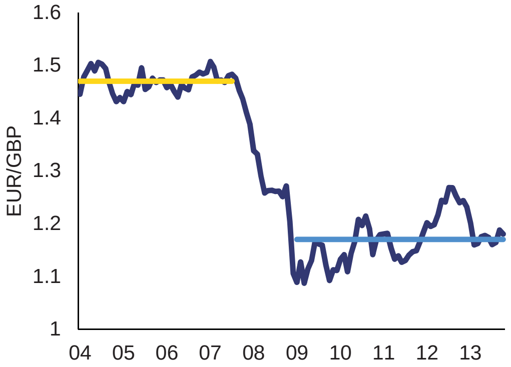


Source: Office for National Statistics

3.1.3. The impact of the depreciation

Sterling fell significantly vis à vis the euro between 2007 and 2009. It is now at a mean of approximately 1.2 euro from a 4-year pre-crisis average of almost 1.5 euro (Graph 3.8). The depreciation could be expected to improve external competitiveness and the current account balance, the impact on the latter by boosting exports – which become cheaper for foreign purchasers – and deterring imports – which become more expensive for domestic purchasers - however, there may be circumstances in which a depreciation is less effective than expected ([13]).

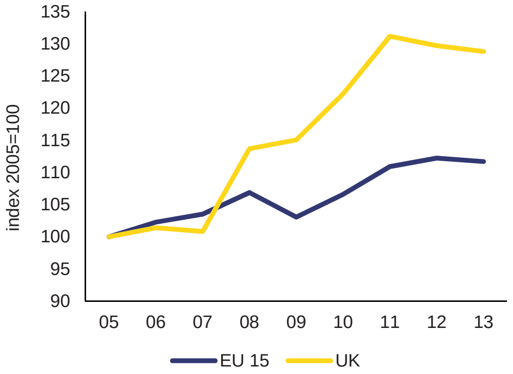
Graph 3.8: **Exchange rate developments**



Source: Commission Services

Export growth may have responded by less than expected to the fall in the exchange rate because, following the depreciation, prices may have risen relative to those of foreign competitors, thus eroding the competitive advantage that may normally be expected. It is noteworthy that the export price deflator has risen by more than that of the Euro 15 (Graph 3.9).

Graph 3.9: **Deflator of exports**



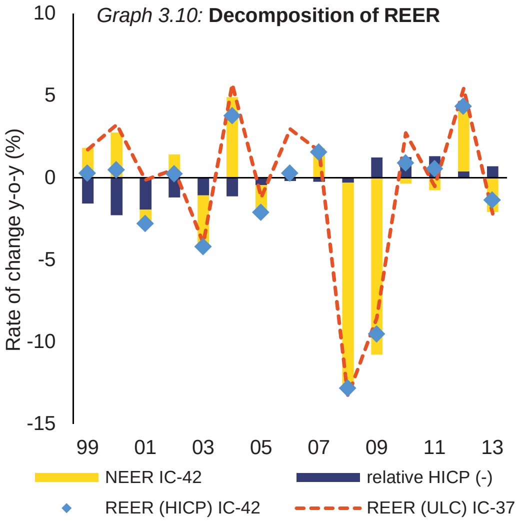
Source: Commission Services

The strong nominal depreciation in 2008 is matched by a marked fall in the real effective

[13] For example, Bahmani et al (2013) show that a devaluation may be less effective than might be supposed in its effect on a country's competitive position. Although for some sectors there may be an improvement in net exports, for many others there is not, and it is not clear a priori which sectors will react positively.

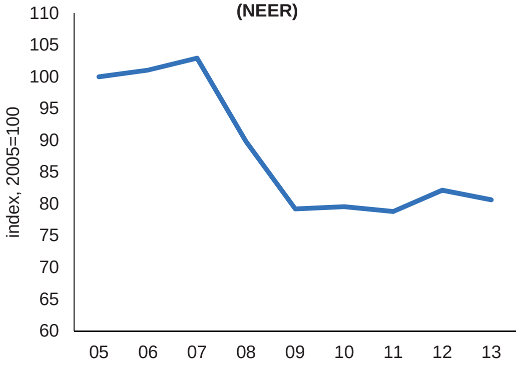
exchange rate (REER) (Graph 3.10) (a standard measure of competitiveness). The close relationship between the REER and the nominal effective exchange rate (Graph 3.11) reflects the relatively small impact of relative inflation to changes in competitiveness since the depreciation in 2008.

Graph 3.10: **Decomposition of REER**



Source: Commission Services

Graph 3.11: **Nominal effective exchange rate (NEER)**

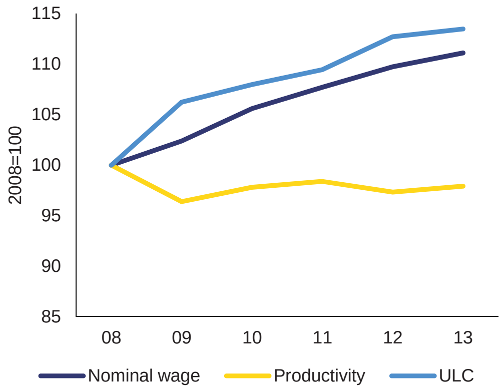


Source: Commission Services

Since 2008, the sizeable depreciation has not had a significant relative impact on export growth or the contribution to growth from net exports. Although goods exports grew between the trough in 2009 and 2013 by 21% - broadly in line with that in the EU 15 of 24% - services' exports remain relatively subdued, growing in real terms by 7% compared with that in the EU 15 of 14%.

It is likely to be the case that exporters have responded to the depreciation by increasing margins rather than significantly expanding output (Graph 3.9). In addition, nominal unit labour costs have risen consistently since 2008 (Graph 3.12) as growth in nominal compensation has continued, albeit at a subdued rate, but labour productivity has fallen.

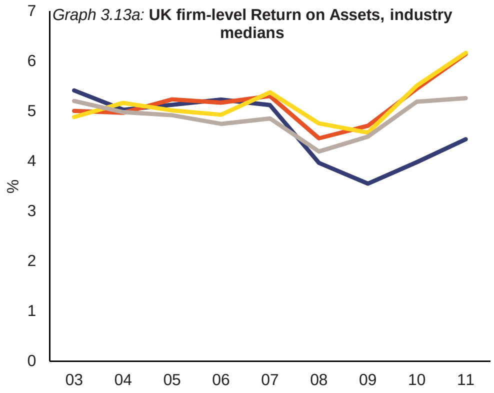
Graph 3.12: **Unit labour costs and its components**



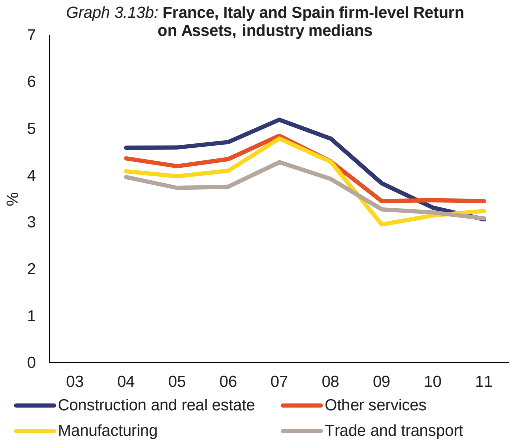
Source: Commission Services

A sectoral assessment suggests that, between 2009 and 2011, firms in the tradable sectors, specifically in the manufacturing sector, may have benefited from the depreciation of sterling (Graphs 3.13a and b) ([14]). Higher margins may have improved the relative profitability of tradables compared to non tradables which might provide incentives to firms in the tradable sector to allocate more resources in the production process. In the pre-crisis period, profitability in the non tradables (in particular construction and real estate) did not rise above that of other sectors, as it did in certain other large EU Member States (Graph 3.13a).

([14]) Chapter II.2 in the Product Market Review 2013 European Commission (2013g) explores the capital allocation process between tradable and non-tradable sectors in terms of incentives and constraints using firm-level data.



Graph 3.13a: **UK firm-level Return on Assets, industry medians**



Graph 3.13b: **France, Italy and Spain firm-level Return on Assets, industry medians**

Source: ORBIS

However, increased profitability has not resulted in a significant increase in exports as discussed above. It may also be the case that demand from major trading partners for exports fell during the international economic crisis – although that impact should unwind as the crisis recedes. In addition, the price elasticity of demand for high value exports is likely to be low because demand may depend on non price as well as price characteristics. In addition, resource allocation towards the export sector could also be affected by uncertainty as to whether the fall in the exchange rate is temporary or permanent – although this effect should have receded by now ([15]).

Government policy can play a role in improving the environment in which exporters operate, facilitating rebalancing over the medium term. As noted above, productivity has declined since 2009. Government policy may help address bottlenecks to exports as discussed in the following subsection by helping to raise productivity and competitiveness.

3.1.4. Policy responses: Infrastructure, skills and SME finance

Previous IDRs identified structural constraints in infrastructure, skills and access to finance that might affect export performance - especially for SMEs. There are policies in place to address these bottlenecks. Moreover, the government has an ambitious objective to "double the UK’s exports to GBP 1 trillion by 2020 and a program to attract more inward investment in UK infrastructure projects" ([16]). However, there are challenges relating to detail and delivery.

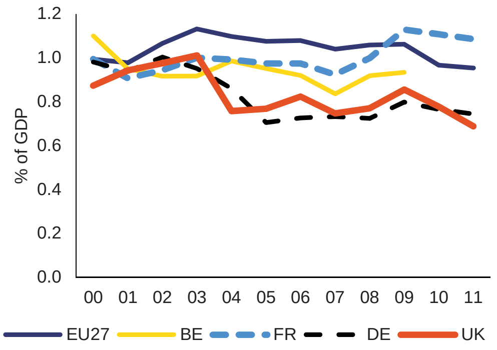
Infrastructure

Investment in infrastructure is below the EU average ([17]). Investment in transport infrastructure are particularly relevant (Graph 3.14) - in the last decade, the UK has invested less in transport infrastructure as share of GDP than the EU27 average and countries - such as France and Belgium – which, like the UK, have a mature transport network. Moreover, the investment share in GDP has fallen over time, similar to the trend in Germany, but the fall has become more pronounced since 2009. In an advanced economy, adequate investment in infrastructure – while not sufficient in itself – may be a pre-condition to enhancing export performance; recent research indicates a positive association between domestic transport infrastructure improvements and small and medium-sized firms' probability of exporting ([18]).

([15]) Firm-level data also shows that investment rates in tradables are, at best, reaching their pre-crisis levels.

([16]) UK government (2013a).
([17]) European Commission (2013c).
([18]) Albarran et al. (2013).

Graph 3.14: **Transport gross investment spending (exluding maintenance)**



Source: Commission Services

There are also concerns about the quality of the infrastructure. A survey by the World Economic Forum shows a relatively low assessment of the quality of infrastructure in the UK, as well as a relatively low assessment of the quality of roads. Perceptions from abroad about the quality of infrastructure are, however, mixed. For example, according to a survey of foreign-based companies ([19]), 81% of respondents acknowledged transport and logistic infrastructure as a good reason to invest in the UK and 89% of respondents praised technology and telecommunications infrastructure – which is consistent with the fact that the UK has an above EU average percentage of broadband lines with speed above 10 MBps ([20]).

London's economic success risks exacerbating the regional divide within the UK. A large rail project, High Speed 2, initially planned to run between London and Birmingham, has the potential to change regional dynamics but its potential impact is ambiguous: on the one hand it will make London easier to reach and thus increase the attractiveness of siting business in London but, on the other hand, it will allow easier access to Birmingham and other regional centres from London. A further option to enhance growth outside London could be to enhance connectivity between cities in northern England (Manchester, Newcastle, Liverpool), as well as between different parts of the UK.

The government has announced an ambitious infrastructure program and has published a 'pipeline' of infrastructure investment worth GBP 375 billion between 2015 and 2020 ([21]). GBP 100 billion of infrastructure investment is expected to be funded publicly while the remaining GBP 275 is expected to be raised from private funds – for instance a group of large insurance companies has agreed to invest GBP 25 billion in the 5 years from 2014 ([22]). The National Audit Office ([23]) has, however, expressed concerns about how the private financing might impact on consumers , who will eventually be charged higher tariffs, especially those on low incomes. Most of the value of the pipeline is in the energy and transport sectors, worth over GBP 340 billion of combined investment.

There are inherent risks in the private sector element of the financing – which accounts for around three-quarters of the total financing; in particular, the degree and timelines in which the private financing will materialise. While anecdotal evidence suggests that investment in infrastructure could be considered attractive by institutional investors, and that business networks may welcome even larger investment plans, greater detail and clarity is required on the composition of the private financing and reassurance that the required amount of that finance will materialise.

Potential investors in infrastructure include international investors (e.g. sovereign wealth funds) and domestic investors (pension funds). The Pensions Institute has forecast that the defined contribution pension schemes' auto-enrolment market will increase to GBP 1680 billion ([24]) of assets under management by 2030. The extent to which those assets will be invested in infrastructure is linked to the concentration of pension funds, as in an overly fragmented market, individual funds might lack scale for such large investments. A solution may be provided by platforms that pool the resources of more pension funds for infrastructure investment – such as one recently announced by the National Association of Pension Funds ([25]). Nevertheless, there remains a

[19] Ernst & Young (2013).
[20] Besides infrastructure, the UK holds Foreign Direct Investment's leadership in Europe – measured by number of new projects - and further market research finds that foreign investors' perceptions of the UK's labour skills, employment costs, transport infrastructure and corporate taxation are of world-class and have all improved recently.
[21] HM Treasury (2013b).
[22] UK government (2013b).
[23] National Audit Office (2013).
[24] Pensions Institute (2013).
[25] National Association of Pension Funds (2013).

need for greater detail on the infrastructure investment plans in relation to the source, composition and timing of funds

Further risks to delivery of the infrastructure programme include alleged uncertainty in the regulatory environment – for example - the Confederation of British Industry's infrastructure survey [26] identified planning as the biggest constraint (96%) for infrastructure investment. The fact that the delivery of the projects is spread over a number of years is a further element of risk.

Skills and job matching

The 2012 and 2013 IDRs identified a gap in skills, in particular, there are an insufficient number of workers with intermediate vocational training. While the skills base is strong overall, there is room for improvement in basic and intermediate skills. It is noteworthy that, compared to the EU average, the UK has a larger number of early leavers from education and training.

International comparisons [27] also show a relative underperformance in attainment in basic skills and foreign languages. Although English is the global language of business, knowledge of foreign languages by UK citizens could increase their ability to participate in international trade and boost international mobility; to eventually facilitate this, it is a positive development that language classes in schools will be made compulsory [28] for pupils from the age of 7 in England.

On the positive side, employers are generally satisfied with skills availability [29]. The UK has a high share of adults between 30 and 34 of age with tertiary educational attainment [30] and a relatively high employment rate of graduates. Higher education provides additional reasons to be optimistic: universities are internationally renowned and could be a driver of regional rebalancing. In fact, the creation of clusters of firms which exploit the specialisations of universities outside London could create attractive jobs in different cities and counteract the centripetal force that brings graduates to London.

The demand for skilled labour is likely to increase as soon the economy recovers. This would be a positive development for the economy, as, according to OECD, the UK [31] has been more effective in providing opportunities to their more highly skilled adults than many other countries.

Nevertheless, the problem of the vertical skills mismatch in the UK might have worsened after 2008. While graduates usually do well in the labour market, according to the Office for National Statistics, the percentage of graduates working in non graduate roles has risen, particularly since the 2008-2009 recession. This suggests that the increasing supply of graduates and the possible decrease in demand for them has had an effect on the type of job they undertake [32]. Since new graduates could not be absorbed into the labour market to the same extent as previously, some may have to 'down-skill'. To address the situation, promotion of STEM subjects (science, technology, engineering and mathematics) in higher education may assist.

Job matching efficiency has recently worsened, in particular, for long-term unemployed. This is suggested by the Beveridge curve, which depicts the relationship between unemployment and job vacancies. The curve is usually downward-sloping: economic upswings are characterised by low unemployment and many vacancies and vice versa in downturns. Shifts of the curve are departures from the usual downward-sloping trajectory and may indicate structural changes in the labour market. An outward shift of the Beveridge curve is an indication of a deterioration of job market matching.

The Beveridge curve showed little movement in the years before 2008 (Graph 3.15a) [33] which can be explained by the fact that the economy then operated at high factor utilisation, low unemployment and a relatively high vacancy rate (the number of vacant posts as a percentage of total posts, vacant or occupied). As the international economic crisis unfolded, vacancies

[26] Confederation of British Industry (2013).

[27] OECD (2013a), OECD (2013b), McKinsey (2013).

[28] Schools can fulfil the requirement by offering either ancient or modern languages.

[29] McKinsey (2013).

[30] European Commission (2013b).

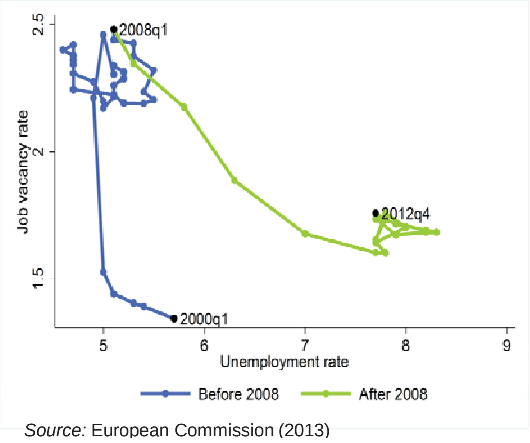
[31] The survey covered England and Northern Ireland.

[32] Office for National Statistics, 2013.

[33] The analysis is based on European Commission (2013e).

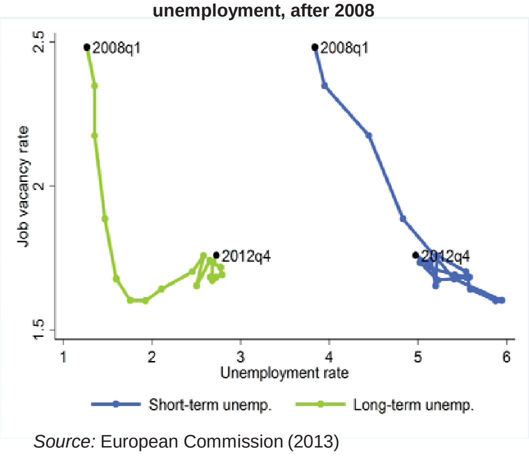
fell and unemployment increased to levels where it remained until the last quarter of 2012, the last observation available.

Graph 3.15a: **Beveridge curve - pre- and post-crisis**



Source: European Commission (2013)

Graph 3.15b: **Beveridge curve - by duration of unemployment, after 2008**



Source: European Commission (2013)

A large majority of unemployment is short-term (shorter than 12 months in duration). Graph 3.15b depicts the post-crisis Beveridge curve in the UK by duration of unemployment ([34]). It shows that the short- and long-term Beveridge curves have a different pattern. The Beveridge curve corresponding to short-term unemployment is characterised by the usual downward-sloping pattern. By contrast, the Beveridge curve corresponding to long-term unemployment exhibits an outward shift of about 1 percentage point in 2009-2010, presumably about 12 months after the first wave of dismissals during the crisis), and did not increase further after 2010. It appears that a large part of unemployment remains cyclical, and a smaller, albeit rising, part potentially structural (Graph 3.15b). Short-term unemployment could be expected to decrease as the economy moves along the short-term Beveridge curve.

The government intends to address the shortage of intermediate skills. The government published "The Future of Apprenticeships in England: Implementation Plan" in October 2013 ([35]). This was a response to the 2012 Richard Review ([36]), an independent report on improving the quality of apprenticeships. Apprenticeships are to be based on standards designed by employers in order to better meet the needs of the economy. These standards, which will replace the current frameworks, aim to simplify the system. In relation to quality assurance, the government will set a small number of criteria: apprenticeships will be required to last at least 12 months; off-the-job training will continue to be a requirement of all apprenticeships and English and maths requirements will be stepped up gradually. Implementation will be completed by 2017-18.

Compared to that in 2011-12, the number of apprenticeship starts at advanced level and higher level has increased, while apprenticeship starts at intermediate level decreased. This may be a first sign of a rebalancing of apprenticeships towards higher skill levels. Ongoing reforms of vocational qualifications are also part of the effort to increase vocational skills among young people and adults.

Policy initiatives to raise vocational skills are likely to be beneficial if maintained, or even stepped up. Indeed, skills forecast expect an increased demand for medium qualifications in the UK. CEDEFOP, the European Centre for the Development of Vocational Training, estimated projections about employment trends by qualification up to 2020. Compared with 2010, it expects an 17.8% increase in jobs requiring medium qualifications in the UK, much higher than an EU average increase of 4.6%; a 20.6% increase in jobs requiring high qualifications,

([34]) The Beveridge curves corresponding to short and long term unemployment exhibit the same movement along the Y-axis, as the vacancies are not specific to the duration of unemployment.

([35]) HM Government (2013).

([36]) Richard (2012).

broadly in line with an EU average increase of 19.1%; and a 42.9% decrease in jobs requiring low qualifications, which is more pronounced than an EU average decrease of 20.2%.

The effectiveness of policy responses to skills shortages can be improved. According to the Social Mobility and Child Poverty Commission, the Youth Contract has not worked "effectively enough" ([37]). There is anecdotal evidence that business associations are supportive of apprenticeships, provided that they are of high quality and targeted at certifying relevant work experience and skills.

Work is underway to increase the attractiveness of vocational education as an alternative career path, as currently there might be 'stigma' attached to it, perhaps because of better perceptions attached to academic education. The key to the success of these policies is productive cooperation with employers in the design and development of occupational standards and skills profiles to make vocational qualifications more attuned to labour market needs ([38]). As young people are "not much better equipped with literacy and numeracy skills than those who are retiring" ([39]), there is also scope for thinking strategically about the role of lifelong learning.

Fine-tuning of immigration policies has the potential to broaden the skills base of the UK. It would make it easier to recruit experts from new export destinations and UK employers would have access to a larger pool of talent ([40]).

Access to finance for SMEs

International comparisons suggest that UK SMEs have a lower export propensity than EU peers ([41]). According to a recent survey ([42]), only a minority of SMEs (14%) were internationally active. Of all survey respondents, 8% reported having exported while 11% reported having imported in the third quarter of 2013.

A constraint on the decision of SMEs to export may be an inability to easily obtain access to external finance. SMEs can potentially benefit from the significant depreciation of sterling that took place since 2008. However, difficulties accessing finance, particularly credit, and/or accessing it on competitive terms, may constrain SMEs' ability to expand and access export markets ([43]). It may also affect their ability to compete internationally by constraining productivity ([44]).

The ability of SMEs to raise external finance appears to have been impaired during the global financial crisis and subsequent UK recession. As discussed in Box 3.3, PNFCs as a whole were excessively reliant on credit as a source of finance in the lead-up to the international economic crisis and recession in the UK and have been adversely affected by the continuing decline in bank credit, not least because they have been unable to obtain external finance by alternative means. The reliance on external credit to expand is likely to be a particular issue for SMEs which can lack the size or sophistication to issue fixed-interest debt and equity or seek other means of external finance and are mostly reliant on bank credit to raise funds.

Neither credit available to SMEs nor their perceptions of their ability to access credit have improved significantly since the 2013 IDR. Net lending to PNFCs, and to SMEs in particular, continued to decline in 2013 (Graph 3.16). In addition, surveys of SMEs continue to show that access to finance on suitable terms remains a concern. According to BDRC Continental's SME Finance Monitor, more than a third of SMEs applying for a loan did not manage to obtain the desired facility either because they were turned down or because of other issues with the 'offer'

[37] Social Mobility and Child Poverty Commission (2013).

[38] See UK Commission for Employment and Skills (2013).

[39] OECD (2013b) shows that England is the only country where adults aged 55-65 perform better than 16-24 year olds in both literacy and numeracy.

[40] In addition, migration could be good for the economy as a whole. Dustmann and Frattini (2013) show that immigrants to the UK have made a positive fiscal contribution between 1995 and 2012.

[41] See European Commission (2010).

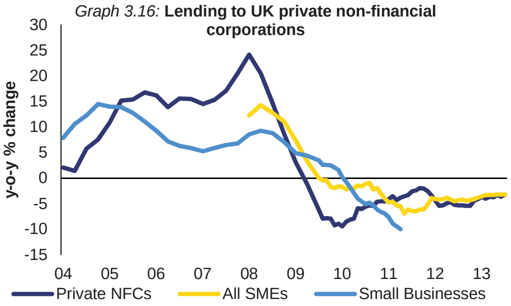
[42] BDRC (2013).

[43] European Commission (2013a) finds that access to finance is reported as the third most pressing problem for UK businesses (15.4%, equal to the EU average).

[44] See European Commission (2013f) for evidence on how difficulties accessing finance decreased the probability of manufacturing firms becoming exporters in 2008 by negatively affecting their productivity.

[45]. Additionally, 17% of applicants managed to obtain funding only after going through issues with the offer. Another recent survey carried out by the Federation of Small Businesses in the fourth quarter of 2013 showed that approximately four in 10 ten SMEs applying for loan had been unsuccessful [46]. These comparatively high loan rejection rates have been a persistent characteristic of the post-crisis period in the UK [47]. A recent report to the UK government [48] estimated a funding gap for SMEs of GBP 8.2-12.6 billion in 2012. The size of the gap was split reasonably equally between 'loan rejections' and 'discouraged demand' (that is, SMEs that did not consider it worthwhile to apply for a bank loan to begin with). Finally, bank lending to SMEs is relatively concentrated which may render them particularly dependent on the relationship established with their own bank (see Section 3.1.12).

Graph 3.16: **Lending to UK private non-financial corporations**

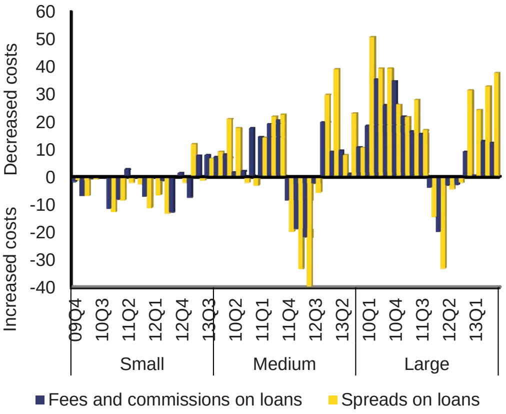


Source: Trends in Lending April 2012 (Bank of England, British Bankers' Association and Department for Business Innovation and Skills) for data up until February 2012; Bank of England for data from April 2012 onward.

Note: the private NFC and SME series are subject to a break in March 2012 due to a new data collection by the BoE; the small businesses series was terminated

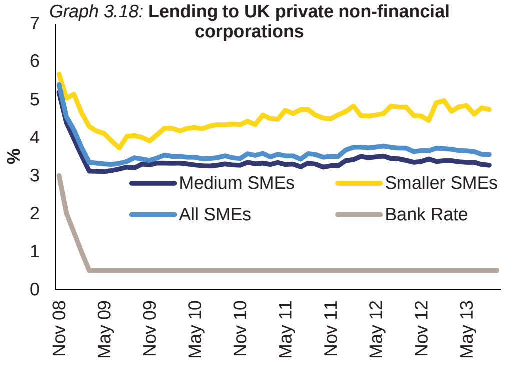
Not only does credit supply remain constrained, the cost of credit is comparatively high for SMEs. Survey evidence suggests that borrowing cost developments since 2009 have been more unfavourable for smaller companies than for larger ones (Graph 3.17). Although the cost of borrowing declined when the Bank of England cut its reference rate to 0.5% in 2008, margins have risen, particularly for smaller SMEs (Graph 3.18). The relatively high margins may be partly explained by the risk characteristics of SMEs but, nevertheless, may remain a deterrent to SMEs requiring cost-effective finance in order to expand.

Graph 3.17: **Corporate credit costs by firm size**



Source: Bank of England's Credit Conditions Survey and Bank of England calculations

Graph 3.18: **Lending to UK private non-financial corporations**



Source: Department for Business Innovation and Skills

Note: Interest rates are indicative medium rates on new SME variable-rate facilities.

The government has responded to concerns surrounding SME access to finance with a number of measures. These include *inter alia*, the Funding for Lending Scheme designed to boost credit availability and reduce the cost of borrowing for firms, including SMEs; the proposed Business Bank, to provide alternative sources of finance to SMEs. (These measures are discussed in the following section.) While a number of access to finance policies have been in place for a significant period of time, they nevertheless have yet to exert a marked impact on SMEs' credit conditions.

[45] BDRC Continental (2013). Survey results refer to loan applications made between the second quarter of 2012 and the third quarter of 2013.

[46] Federation of Small Businesses (2013).

[47] See Monteiro (2013) for a review of survey evidence.

[48] Business Bank Advisory Group to the Department of Business Innovation and Skills (2013)

3.1.5. Conclusions

The UK's export share in world exports continues to decline but the pace is less rapid than in previous years. This continues the pattern of gradual but persistent decline of the past decade. There is no apparent single reason to explain the decline; rather, it is likely to be the outcome of a number of smaller factors and wider issues relating to the structure of exports and its export markets. Such trends need to be interpreted in the context of the rising share of emerging markets in world trade.

Government policies could support a rebalancing towards net exports. For example, the effective delivery of the announced 'pipeline' of infrastructure investment has potential to remove bottlenecks and boost export performance. In addition, the focus on apprenticeships is likely to raise skills provided that the quality of the apprenticeships is high. The authorities could also continue to monitor the impact of credit access and export finance policies and extend them if necessary.

Overall, the declining export share is unlikely to pose short-term risks to the economy. However, in the absence of a major change in the structure of exports or export markets, or government policy to support rebalancing, the export share is likely to continue to slowly deteriorate over the medium term. In turn, the main risk associated with a slow deterioration of the export share is, other factors held constant, an associated deterioration, over the medium term, of the current account deficit and the net international investment position.

3.2. PRIVATE SECTOR INDEBTEDNESS

3.2.1. Introduction

High private sector indebtedness was identified as a macroeconomic imbalance in the IDRs in 2012 and 2013 and has been identified again as a potential imbalance in 2014. This section analyses: recent trends and developments in private sector indebtedness, risks associated with high levels of private sector indebtedness, particularly for Private Non-Financial Corporations (PNFCs), the need to maintain adequate access to finance, especially for SMEs while orderly deleveraging continues, the impact of government policy in facilitating sufficient access to credit and sets out conclusions on the state of any imbalance and the risks associated with it.

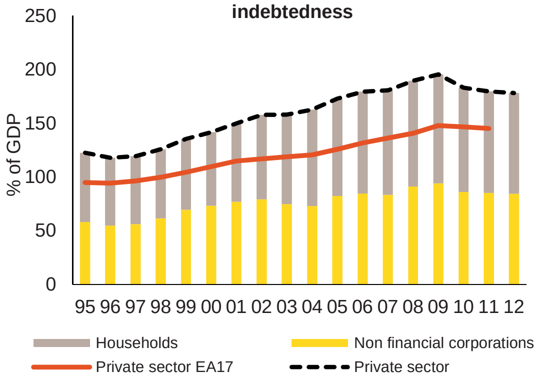
Developments in the housing market and household sector indebtedness have been particularly marked over the past year and have potential implications for the existence of, and risks surrounding, any macroeconomic imbalance and are analysed separately in Section 3.3.

3.2.2. Trends and developments

Size of deleveraging

After having increased steadily during the previous decade, private sector indebtedness has peaked at 195% of GDP ([49]) in 2009 (Graph 3.19). Since then, private sector indebtedness has fallen to 179% of GDP in 2012 reflecting deleveraging by households and PNFCs as the size of the economy grew in nominal terms. However, the pace of reduction in indebtedness declined in 2012 – as minimal economic growth was matched by a small fall in debt holdings.

Graph 3.19: **Households' and PNFCs' indebtedness**



Source: Commission Services

Private sector indebtedness is, broadly, split equally between indebtedness of households and PNFCs (Graph 3.19) and the pace at which both sectors reduced holdings of debt fell in 2012:

- for PNFCs', debt as a % of GDP has fallen since its peak in 2009 but the pace of decline lessened in 2012 as PNFCs' debt began to stabilise at a relatively high level; and

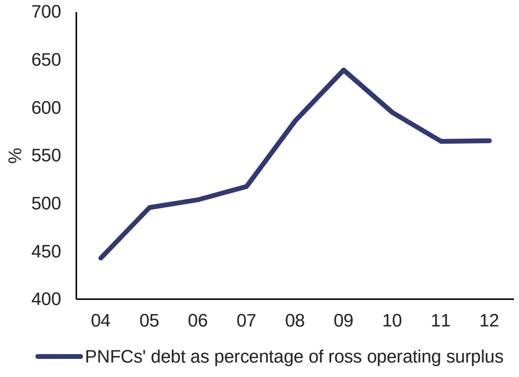
- for households, debt as a % of GDP has also fallen since its peak in 2009 and the pace of decline lessened in 2012 as debt also began to potentially stabilise at a relatively high level.

Despite recent falls, the current level of private sector indebtedness remains historically high.

Alternative measures of indebtedness corroborate the slowdown in deleveraging by the corporate sector: PNFCs' debt as a % of gross operating surplus has fallen from the peak of 2009, although the pace of decline slowed in 2012 (Graph 3.20) and corporate debt as a % of financial assets and corporate debt as a % of total assets (or gross wealth) have also fallen but the decline has slowed more recently (Graph 3.21).

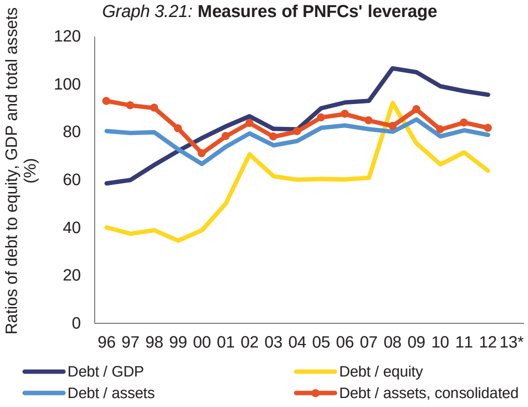
[49] All data is quoted on a consolidated basis unless otherwise indicated.

Graph 3.20: **PNFCs' debt as percentage of gross operating surplus**



Source: Commission Services, Office for National Statistics

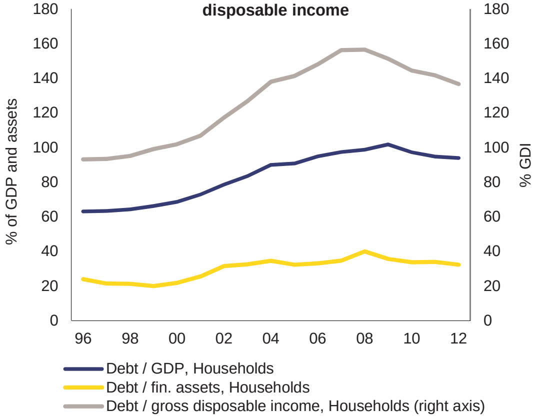
Graph 3.21: **Measures of PNFCs' leverage**



Source: Commission Services

The pace of deleveraging by the household sector has also slowed. Trends in household debt as a percentage of financial assets and household debt as a percentage of total assets (or gross wealth) indicate that household deleveraging has slowed recently and that it has plateaued at a relatively high level (Graph 3.22).

Graph 3.22: **Household debt as a percentage of gross disposable income**

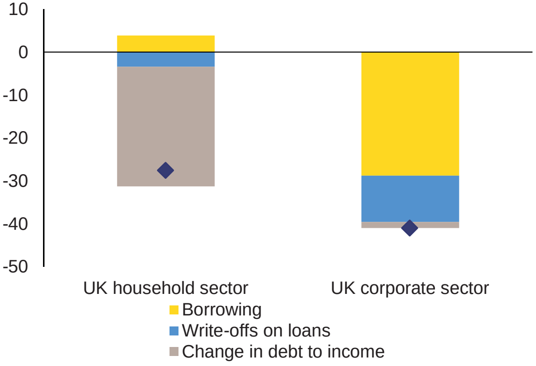


Source: Commission Services

Composition of deleveraging

The composition of deleveraging since 2008 has differed between households and PNFCs (Graph 3.23). For PNFCs it has been achieved, predominantly, by reductions in gross borrowing and, to a lesser extent, write offs on loans. By contrast, for households, the greatest contribution to deleveraging has been a rise in nominal disposable income – a relatively minor role has been played by write offs and, in absolute terms, the level of borrowing has actually increased.

Graph 3.23: **Composition of household deleveraging**



Source: Bank of England

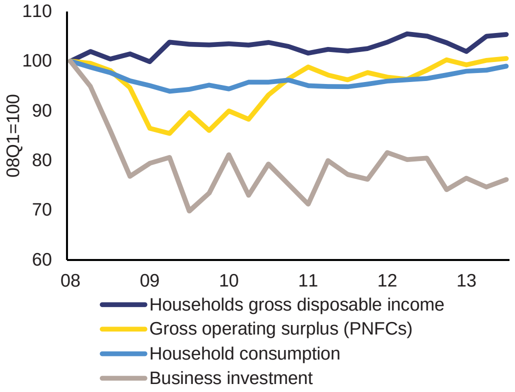
Broadly, there are five possible drivers of deleveraging [50]: increased economic growth, increased saving, increases in inflation, 'financial repression' and debt restructuring. The preferred option to facilitate deleveraging is an increase in GDP growth. However, this has not, to date, been

[50] See European Commission (2013h).

the predominant route by which PNFCs have deleveraged [51] – rather, deleveraging has been achieved largely through a reduction in borrowing - and, therefore, may have impacted adversely upon future economic growth by more than would have been the case if it had been achieved through, for example, an increase in gross operating surplus. It may also explain the subdued performance of business investment *vis a vis* household consumption (Graph 3.25).

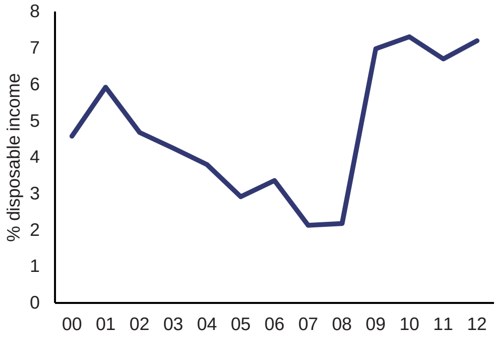
During deleveraging, households' consumption rose less than disposable income. As a result the household saving ratio rose (Graph 3.24). In 2012 and 2013 the gap between the two narrowed somewhat as the saving ratio stabilised (Graph 3.25). For PNFCs, the pattern has been different: gross operating surplus has risen only slightly while business investment has fallen sharply.

Graph 3.24: **Gross operating surplus and household gross disposable income**



Source: Office for National Statistics

Graph 3.25: **Household saving ratio**

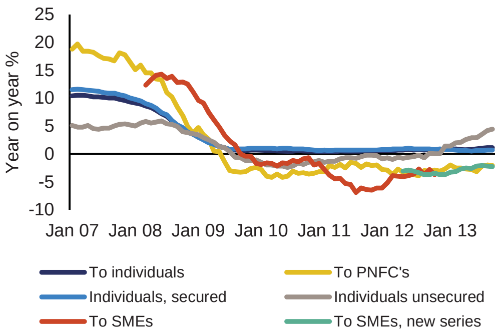


Source: Commission Services

3.2.3. Credit supply

The stalling in the pace of deleveraging has been accompanied by divergent trends in credit supply. The experience of households and PNFCs noticeably differs: increases in credit supply to the household sector increased in late 2012 – and, in particular, growth in unsecured credit has been relatively brisk - and grew further in 2013 but credit supply to PNFCs continued to decline throughout this period (although the pace of decline slackened). For PNFCs, credit supply has fallen more heavily for SMEs than for PNFCs overall (Graph 3.26).

Graph 3.26: **Credit growth by sector**



Source: Office for Budget Responsability

The reasons for the significant rise in growth of household unsecured credit may reflect increases of purchases of large items such as cars. More broadly, growth in demand for unsecured credit may reflect the boost in economic sentiment and confidence associated with the return to growth. For example, consumer confidence as measured by the GfK Survey has picked up steadily throughout 2012 and 2013 [52] (Graph 3.27), amidst rise in expected income growth and a loosening of credit conditions so that unsecured credit is more easily available than in the previous three years.

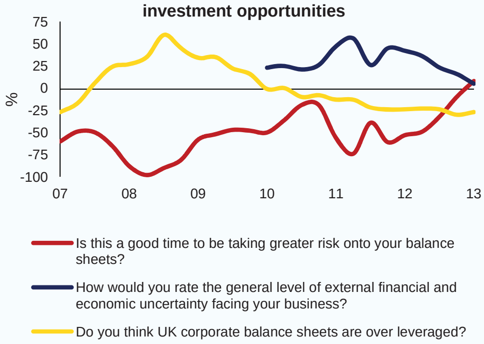
[51] See Cuerpo et al (2013).

[52] GfK UK Consumer Confidence Measures December 2013.

Box 3.2: PNFCs - supply and demand for credit.

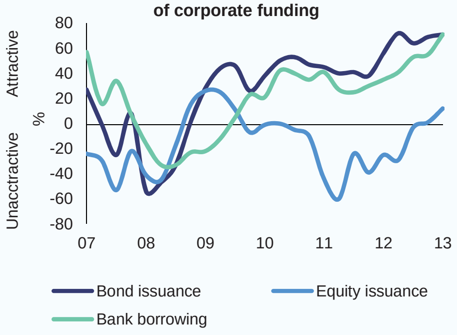
The reduction in the availability of credit can be examined from the supply and demand sides ([1]).

Graph 1a: **Perceived riskiness of future investment opportunities**



Source: Deloitte CFO Survey

Graph 1b: **Attractiveness of different sources of corporate funding**



Source: Deloitte CFO Survey

Demand side factors

Larger PNFCs ([2]) may have reduced their demand for credit. For example, the perceived riskiness of investment opportunities may have increased thus deterring demand although while there is some evidence, overall it is mixed (Graph 1a). In addition, the attractiveness of raising finance by equity and bonds may have risen increased relative to that of bank loans although again the evidence is mixed – while bonds may have been increasingly perceived as a preferred source of funding, that is less likely to have been the case for equity (Graph 1b). Moreover, given the depth of the downturn in growth in 2008-12 and its uncertain aftermath, it is reasonable to expect that PNFCs' expectations for future growth fell.

It is a consistent theme of PNFCs' responses to surveys on demand for credit that they are unable to obtain the amount of credit that they ideally desire and at an acceptable price. The outcome is particularly marked for SMEs. While there may be a reduction in demand for credit there remains, nevertheless, clear survey evidence of unmet demand for credit.

Supply side factors

Risk perceptions of PNFCs

Risk perceptions may be related to asymmetric information between the finance provider and PNFC – eg in relation to its creditworthiness and future performance. A rise in risk aversion may result in a credit provider being reluctant to provide funds without any track record and/or collateral to mitigate the risk of default.

An increase in negative risk perceptions towards PNFCs may have adversely affected the supply of credit; write off rates on lending to PNFCs have increased somewhat since 2009 (Graph 2a). However, write-off rates have fallen sharply since 2011 (although they remain high). In addition corporate insolvency rates have declined since the recent peak in 2009 and also remain low. This suggests that the influence of risk perceptions on supply may begin to wane.

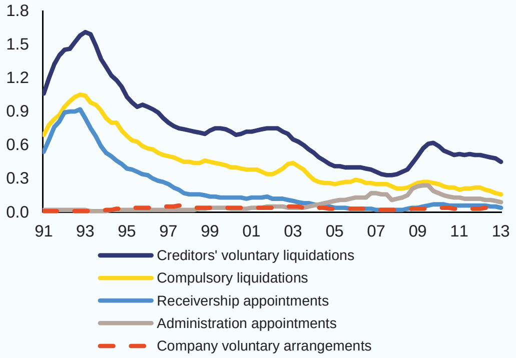
[1] The analysis in this box is taken from Monteiro, D. (2013).

[2] The source for Graphs 1a and b is the Deloitte's survey of Chief Finance Officers of the top 350 companies listed on the FTSE. As such, it does not cover the borrowing pattern of SMEs.

(Continued on the next page)

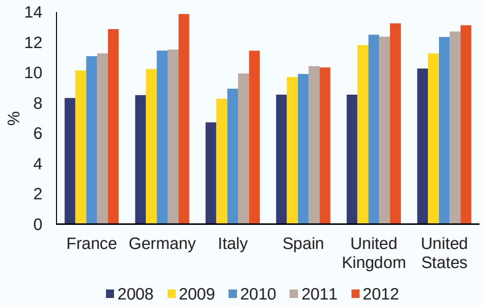
Box (continued)

Graph 2a: **Write off rates for lending to PNFCs**



Sources: The Insolvency Service and Bank of England

Graph 2b: **Changes in core Tier One capital ratios and risk-weighted assets**



Source: SNL Financial, published accounts and Bank of England calculations

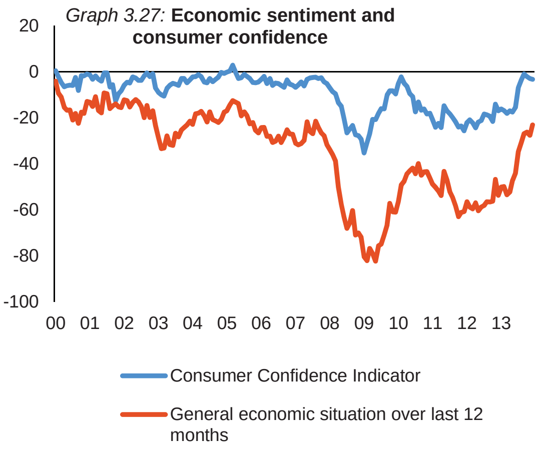
Restoration of capital by the banking sector

The banking sector reduces the size of its risk-weighted assets and increase holdings of high quality capital to meet strengthened regulatory requirements – which may have adversely affected credit supply. The banking sector has substantially increased its core Tier One capital ratio and reduced its risk-weighted assets. The capitalisation of the UK banking system now compares favourably with that of other major countries (Graph 2b).

According to the Financial Policy Committee of the Bank of England ([3]), the banking system is soundly capitalised and risks had been significantly reduced. While banks needed to raise more capital to meet regulatory requirements, such amounts were small compared to those raised in the past few years. Overall, the increased health of the banking system should support its ability to supply funds.

([3]) Financial Policy Committee of the Bank of England (FPC). See Bank of England (2013e).

Graph 3.27: **Economic sentiment and consumer confidence**



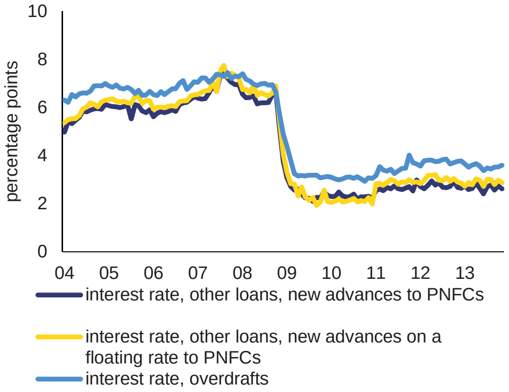
Source: GfK and Commission Services

The reasons for the divergence in credit growth between SMEs and PNFCs as a whole may relate to certain characteristics of SMEs. This issue is considered in more detail in Section 3.1. However, credit supply for all PNFCs continues to decline. Factors that may have influenced the demand and supply of/for credit over 2009-13 are discussed further in Box 3.2.

3.2.4. Cost of credit

The cost of credit for PNFCs remained low in 2013. Having fallen steeply in late 2008 and 2009 - coinciding with the reduction in the bank rate to 0.5 pps. - the cost of credit for PNFCs remained at historic low levels throughout 2013 as shown in Graphs 3.17 and 3.28.

Graph 3.28: **PNFCs' cost of borrowing**



Source: Bank of England

3.2.5. Near-term outlook for credit supply and demand

Recent survey results present a mildly positive picture for corporate credit supply and demand ([53]):

- corporate credit availability increased significantly in Q4 2013 for small PNFCs and large PNFCs, although it was muted for medium-sized PNFCs, and a further improvement is expected in Q1 2014; and

- demand for corporate credit picked up further in Q4 2013 for medium and large PNFCs although it was subdued for small PNFCs, and a further improvement is expected in Q1 2014 for small and large PNFCs.

3.2.6. Risks

Inadequate access to funds

Adequate access to funds is important if PNFCs are to take full advantage of the projected increase in growth in 2014 ([54]) to expand and/or increase investment ([55]). Moreover, sufficient access to credit during a period of deleveraging can help ensure that such deleveraging is smooth and orderly ([56]). The potentially adverse impact of deleveraging on growth and stability can be mitigated if credit supply remains healthy.

Since the advent of the international economic crisis, the supply of funds available to – and raised by - PNFCs has fallen sharply. Prior to the international economic crisis PNFCs were disproportionately reliant on credit to raise funds (Box 3.3). Since the crisis, PNFCs have been unable to seek alternative sources of funds in large quantities – and to the extent that they have raised funds, it has been largely via equity issuance although larger PNFCs have raised funds via bond issuance. As has been discussed in previous IDRs, PNFCs', and particularly SMEs', access to credit was adversely affected by the weakness in the banking sector as, in response to the international economic and financial crisis and UK recession, banks reduced the size of their balance sheets, lowered lending to PNFCs and reduced risk as they addressed capital shortfalls and strengthened capitalisation ratios.

According to the 'Breedon Report' (2012) ([57]), between 2012 and 2016 the projected 'financing gap' for PNFCs could range from GBP 84-191 billion depending on GDP growth and its relationship to credit supply. A continuing inability to raise funds, through credit or alternative means, is a risk for PNFCs – particularly SMEs (SMEs' access to finance is considered in more detail in section 3.1).

[53] Bank of England (2014), Credit Conditions Survey, 2013 Q4.

[54] See European Commission (2013a)

[55] There is also a link between adequate access to funds and productivity. Evidence suggests that, in the euro area, decreases in firm level productivity can be linked to credit supply conditions See European Commission 2013(d).

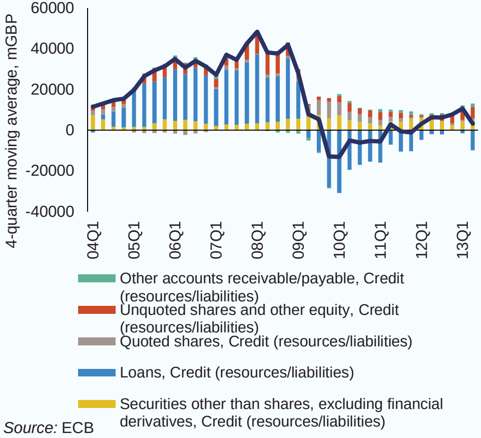
[56] See Cuerpo, C. et al (2013) which states 'credit conditions are an important qualifying factor for deleveraging processes and their assessment provides useful information to better understand deleveraging pressures…..in short, credit supply constraints….have a direct impact on non-financial sector deleveraging'.

[57] Breedon (2012).

Box 3.3: Sources of funds for PNFCs

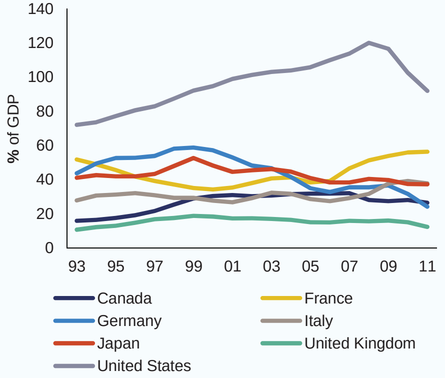
Broadly, the main sources of funds for PNFCs are: bank credit, bond issuance and equity. Prior to 2009, PNFCs were heavily dependent on bank credit as the major source of funds prior to the international economic crisis and UK recession (Graph 1a). Since then, fund-raising has been limited and below the levels of the preceding decade. PNFCs have reduced credit holdings and relied on bond, equity issuance and retained earnings to raise funds.

Graph 1a: **Sources of funds**



Source: ECB

Graph 1b: **Private bond market capitalisation in G7 countries**



Source: World Bank's financial structure dataset 2013

While the UK is generally regarded as having deep and liquid financial markets ([1]) the experience of the period since 2008 suggests that PNFCs' ability to raise funds is impaired. Credit supply has fallen and continues to falls; far from raising funds through the acquisition of credit, in aggregate, PNFCs have reduced their reliance on credit as a source of funds. Private bond markets in the UK have remained relatively underdeveloped; this has been a long-standing feature of the funds market – so smaller PNFCs had relatively little ability to switch from credit to bond issuance as a means to raise finance once credit market conditions changed (Graph 1b). Although recourse to public equity is possible, PNFCs may not always wish to list – it may not always be possible, or appropriate, particularly for smaller PNFCs which may be unwilling to lose control and management freedom associated with equity finance. Moreover, the costs of securing equity finance may be excessive and lack of knowledge of how to obtain it may be a deterrent.

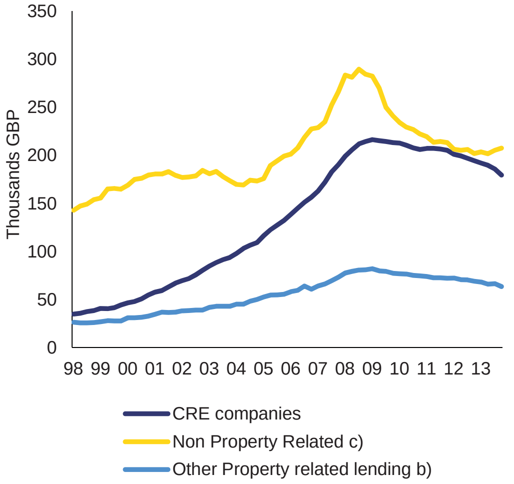
[1] See World Economic Forum Global Competitiveness Report 2013-14. The Global Competitiveness Report ranks countries on a number of measures including measures of access to financial services which include (the UK's rank is in parentheses among EU 28): availability of financial services (1), affordability of financial services (3), financing through local equity market (1), ease of access to loans (15) and venture capital availability (4).

High indebtedness of PNFCs in the property-related sector

The composition of corporate deleveraging varies significantly by type of firm according to whether firms' business is predominantly property related. As noted above, corporate sector indebtedness has fallen by 17 percentage points since its peak in 2009. However, while loans to non-property firms have fallen by around 30% (GBP 57 billion) since 2008, that for core real estate (CRE) firms has fallen by around 7% (GBP 29 billion) while that for property-related sectors has fallen by 15% (GBP 14 billion) (Graph 3.29). The indebtedness of these firms remains relatively high while commercial property prices remain well below their previous peak in 2007 – by around 40% in total and almost 50% for secondary property ([58]).

[58] See Bank of England (2013a).

Graph 3.29: **Stock of UK loans by sector a)**



Source: Bank of England

(a) Data show values of outstanding total lending by UK MFIs excluding the effects of securitisations and loan transfers, and excluding securities. Data are for lending in all currencies stated in sterling terms. Data are not seasonally adjusted. From 2011 Q1, data are on the SIC 2007 basis. Changes in the SIC codes have led to some components moving between industries.
(b) CRE includes the buying, selling and renting of real estate, and the development of buildings.
(b) Other property related lending includes construction, hotels and restaurants, and health and social work.
(c) Non property related lending includes agriculture hunting and forestry, fishing, mining and quarrying, manufacturing, electricity, gas and water supply, wholesale and retail trade, transport, storage and communications, profesional services and and support activities, public administation and defence, education, and community service activities.

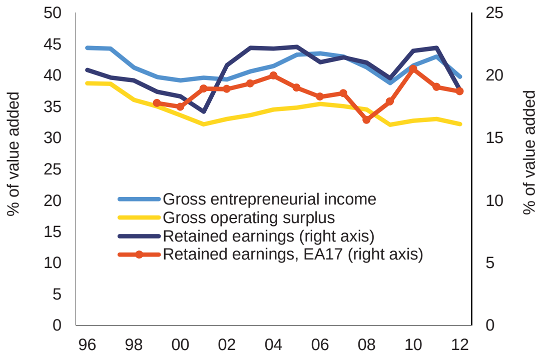
Inadequate deleveraging by previously highly indebted PNFCs

Aggregate trends may mask other differences between PNFCs. The Bank of England ([59]) discusses the extent of deleveraging by the type of firm distributed by pre-existing levels of indebtedness. It finds that the leverage of firms that were already highly indebted has continued to rise since 2008, in marked contrast to the least indebted firms.

Prudent PNFCs' balance sheets

The risks associated with high PNFCs' indebtedness may be ameliorated by a consideration of PNFCs' balance sheets and profitability. Despite the weakness in the level of gross operating surplus, profitability ratios remain high (Graph 3.30). Measures of relative profitability held up from 2009 to 2012 – a pattern that has continued in 2013 as growth in gross operating surplus has outstripped that in gross value added. In addition, a feature of the PNFC sector that it is a net lender. This trend has continued in 2012 and 2013.

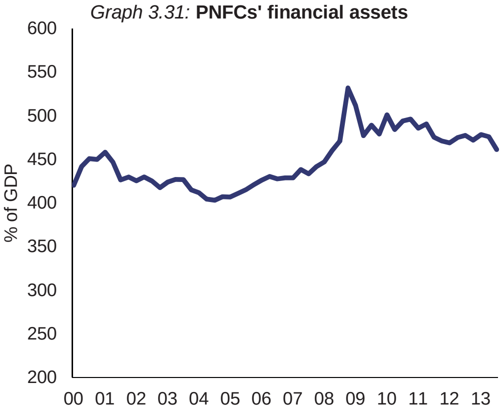
Graph 3.30: **PNFCs' profitability ratios**



Source: Commission Services

PNFCs' holdings of financial assets, including cash, have risen sharply in the last ten years (Graph 3.31). Moreover, PNFCs' loans to deposit ratio has fallen sharply recently (Graph 3.32). The rise in PNFCs' financial assets, including (near-) cash holdings provides a counterweight to high levels of gross debt and lessens the risks associated with it.

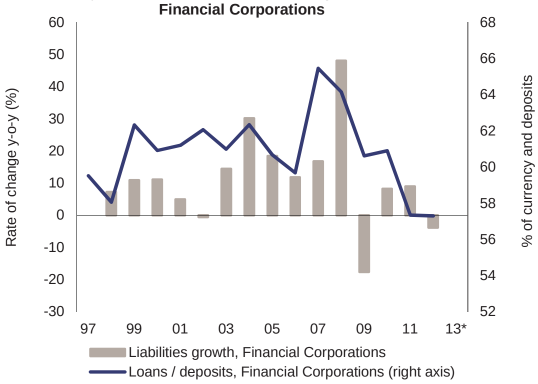
Graph 3.31: **PNFCs' financial assets**



Source: Office for National Statistics

[59] See Bank of England (2013a).

Graph 3.32: **Liabilities and Loans/Deposits Ratio, Financial Corporations**



Source: Commission Services

Rising household unsecured lending

Although the rise in unsecured lending to households is worth noting, it is unlikely to constitute a major risk. Most importantly, unsecured lending accounts for a small proportion of households' debt (less than 5%) so is unlikely to be of sufficient *relative* size to constitute a macroeconomic risk. The vast majority of household debt is secured. Growth in household disposable income should continue in 2014-15 and cushion the risks associated with high absolute levels of household debt. Moreover, 'write off' rates for unsecured lending have decreased sharply since early 2010 and have now returned to the rates preceding the international economic crisis.

3.2.7. Government policy – developments and impact

The Government has instituted policies to improve PNFCs' access to finance, in particular:

- the Funding for Lending Scheme (FLS); and
- the Business Bank.

The Funding for Lending Scheme

The Funding for Lending Scheme (FLS) was introduced in August 2012 by the Bank of England. The aim of the FLS is to provide incentives – by providing funding at below market rates - to banks (and building societies) to expand lending to PNFCs (and households) by reducing their funding costs which, ultimately, should translate to lower effective rates of lending and increased availability of credit. As at Q3 2013, total loans outstanding under the FLS were GBP 23 billion.

The evidence to date on the impact of the FLS on bank lending to PNFCs has been mixed. On the one hand, it is difficult to disentangle the impact of the FLS itself and international factors that reduced wholesale bank funding costs inside and beyond the UK since the middle of 2012. In addition, the borrowing margin for PNFCs remains low. Crucially, however, since the advent of the FLS, lending remains muted and continues to fall.

Conceptually and practically, the FLS is a well-designed policy; overall, however, it is yet to significantly affect the supply of credit outstanding to PNFCs. It may be that further time is required for the FLS to have a significant impact or it may be that, in the absence of the FLS, credit availability would have been even lower – that is, other factors are weighing down on lending. The recent withdrawal of the FLS for loans for housing ([60]) may lessen the likelihood of any 'crowding out' of loans provided under the FLS for SMEs by loans for households.

The Business Bank

The aim of the Business Bank, which is expected to be operational by the second half of 2014, is to deploy capital to address gaps in the provision of finance for SMEs. The Bank has been provided with GBP 1.25 billion (**[61]**) of new capital. In addition, a number of existing schemes to support access to finance - of a total value of GBP 2.4 billion – of both a debt and equity nature - will be rolled into the Bank.

The capital provided to the new bank is relatively small – however, it is expected that the funds will be leveraged up with the addition of private sector funds.

The government intends that the Bank will not directly lend or invest in businesses; rather, it

([60]) See Bank of England (2013d). The changes took effect on 1 January 2014.

([61]) Department for Business Innovation and Skills (2013) The capital will be used to: invest in late stage venture capital funds which in turn invest in high growth potential SMEs, launch a scheme to support the provision of lease and asset finance, and provide wholesale guarantees for loans to SMEs.

will work in conjunction with the private sector providers to support and increase the capacity of existing channels of finance. Such providers may include challenger banks (see above).

The establishment of the Business Bank is a positive first step forward. Conceptually and practically, it enables SMEs to obtain funds that they may not be able to do so via bank credit. However, design and implementation will need to proceed carefully given the complexities of the issue so that the Bank gains the confidence of SMEs and potential niche providers of funds to SMEs. It remains to be seen, however, how quickly the Bank can provide finance to SMEs on a scale that helps to meet the gap caused by the lack of other funding sources and that the leverage provided by the private sector will materialise to the extent envisaged. Moreover, it is important that the Bank operates alongside the market, and provides funds in a way that is not currently provided by the market, rather than replace the market ([62]).

Competition in the banking sector

PNFCs' access to finance may be affected by the degree of competition in the banking sector. The banking sector is characterised by a small number of large national banks and relatively few regional banks or regional building societies with a presence limited to a narrow geographical area. Moreover, the degree of concentration has increased since the international economic crisis – between 2007 and 2013, for the six largest banks: the share of total assets among all monetary financial institutions increased from 46% to 55%, for loans to PNFCs it increased from 64% to 70% ([63]).

SMEs are heavily dependent on their own bank to raise funds. For example, over half of SMEs that sought finance first approached their main bank. Moreover, 71% of SMEs contacted only one provider in seeking finance ([64]). Anecdotal evidence suggests that some businesses, particularly SMEs, are deterred from expansion and investment if an application is rejected by their existing bank as they are unable or unwilling to seek additional sources of finance, including from other banks.

The dominance of the banking sector, and the behaviour of SMEs in relation to it, may reflect information issues in the market. Incumbent banks have an advantage in relation to retaining SME business particularly if SMEs have been a customer of the bank for a long period of time – allowing the bank to make a full assessment of risk and hence the collateral and pricing terms of any loan. More generally, incumbent banks have an advantage through their provision of current account facilities which provide them with details on individual borrowers.

An increase in the number of banks would provide alternative options for SMEs to seek finance in the event that an initial application for finance was rejected by their existing main bank and wider benefits could be expected to flow from the increase in competition that such banks could provide.

A number of small and new so-called 'challenger banks' have commenced operation in the UK in recent years ([65]). It is unclear whether challenger banks will be able to gain significant market share and, where relevant, expand activities to the SME sector ([66]). There is potential for challenger banks to work with the Business Bank, once it is established, to provide access to finance for SMEs. More broadly, the government has recognised the issue and is

[62] The activities of the Business Bank will need to be compliant with the EU's State Aid Regime.

[63] Bank of England, unpublished data.

[64] See Breedon Report (2012).

[65] Year established as a stand-alone bank in the UK in parentheses: Metro Bank (2010), Aldermore (2009), Handelsbanken (2012) and Virgin Money (2012) although Metro Bank and Virgin Money have, to date, offered predominantly retail banking services. Virgin Money is not technically a new entrant to the market as it has increased market share by taking responsibility for much of Northern Rock's previous business.

[66] As argued by the UK Independent Commission on Banking (2011), for a new bank to inject competitive pressure into the market, it should have sufficient scale and financial backbone to act as a challenger bank. In the past, only banks with a sufficiently high share have been able to grow and act as challengers to the incumbents. The Commision on Banking also recommended the creation of a new challenger bank through the divestiture of assets belonging to Lloyds Bank. The creation of an independent new bank, TSB, is underway.

considering action to improve competition in the banking sector ([67]).

3.2.8. Conclusion

Private sector indebtedness remains high; however, the challenge posed by high private sector (excluding household secured lending) indebtedness is less marked than at the time of the 2013 *IDR*. In particular, PNFCs remain net lenders with strong balance sheets that should provide a cushion against vulnerabilities. However, credit supply remains muted despite recent signs from surveys that demand for, and supply of, credit may rise.

The main challenge is constrained access to funds, impeding PNFCs' ability to expand and invest. Excessive reliance on the banking sector for funds could constrain access to finance. A further risk relates to distributional issues, especially remaining high indebtedness in the property and property-related sectors.

The government's policy response is welcome: the Business Bank should, once operational, help SMEs obtain alternative sources of funds and the recent refocussing of the FLS towards PNFCs only is appropriate.

There are particular risks and challenges associated with high household mortgage indebtedness - flowing from risks and challenges associated with the housing market - given the high proportion of outstanding mortgage debt in total household debt. This issue is considered in Section 3.3.

3.3. THE HOUSING SECTOR AND HOUSEHOLD MORTGAGE INDEBTEDNESS

3.3.1. Introduction

The 2013 IDR concluded that high levels of household debt and developments in the housing sector posed a challenge to the economy noting that 'the macroeconomic imbalances that the UK is experiencing pose a more immediate threat to growth than to stability but, if not addressed, they could store up future risks to macroeconomic stability and to the financial sector'.

The housing sector is unusually important in the UK economy. Households' residential building assets account for some 400% of households' disposable income – a marked increase from the 230% of post-tax income in 1997 (the previous trough) and approximately equal to the share of financial assets in disposable income. Household debt has also increased over the medium term, from 90% in 1997 to 140% of disposable income in 2011.

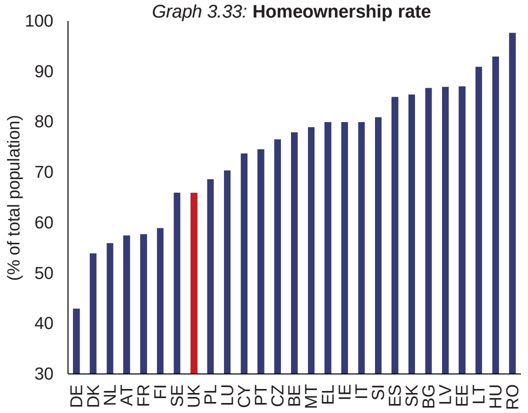
Although residential investment accounts for only around 3% of total output, the housing sector potentially impacts on economic growth and stability in a way that is disproportionate to its share in output. Residential investment decreased by around 40% from its peak in 2007 to its trough in 2009 – greater than the fall in total output of around 6% from its peak in 2007 to its trough in 2009.

House price movements can outstrip those in retail prices. For example**,** house prices increased by around 150% between January 2000 and their peak in late 2007 compared to an increase of 15% in the Consumer Prices Index (CPI) over the same period. Since their trough in early 2009, house prices have risen by around 20% while the CPI has risen by around 16%.

The rate of homeownership is above that of other large EU Member States – such as France and Germany – but below that of others – such as Spain and Italy (Graph 3.33).

[67] For example, the government is consulting on proposals to require banks to share information on their SME customers with other lenders through credit reference agencies. The Office for Fair Trading is collecting evidence on the anti-competitive practice of banks potentially requiring SMEs to open or maintain a business current account in order to qualify for a loan.

Graph 3.33: **Homeownership rate**



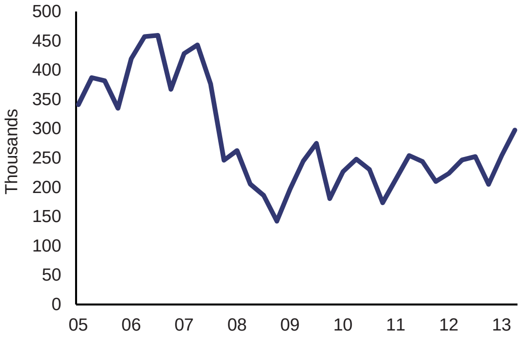
Source: Eurosystem Household Finance and Consumption Survey

3.3.2. Trends and Developments

Activity

Over the past year, activity in the housing sector has increased further but remains below the peaks of 2007 and early 2008. Property transactions have increased steadily throughout 2012 and 2013 to reach 300,000 in Q3 2013 – more than double the trough in early 2009 (Graph 3.34).

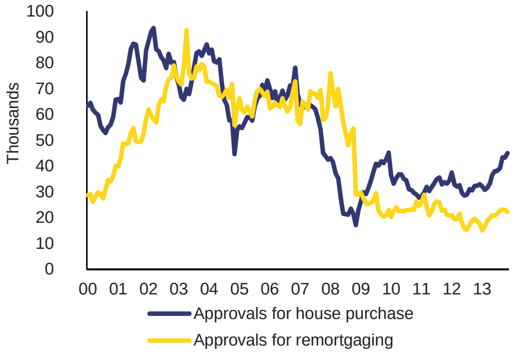
Graph 3.34: **Property transactions**



Source: HM Revenues and Customs

The number of mortgage approvals has also picked up and continues to increase at a steady pace and is at its highest level since late 2009. Mortgage approvals for house purchase and re-mortgaging have both picked up although the increase in activity is greater for mortgages for house purchase (Graph 3.35).

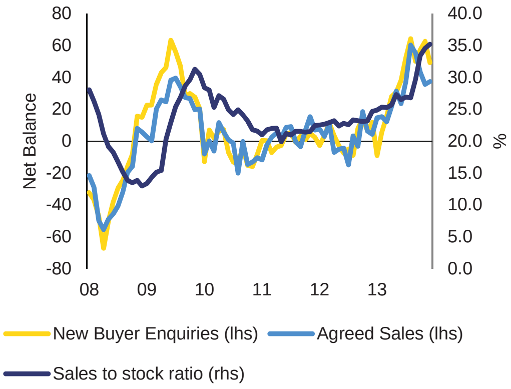
Graph 3.35: **Number of loans approval for house purchase and for remortgaging, seasonally adjusted**



Source: British Bankers' Association

Moreover, short-term forward indicators of near-term activity, such as the high sales-stock ratio and the net balance of new buyer enquiries and newly agreed sales, suggest that rising levels of activity will continue ([68]) (Graph 3.36). The positive near-term outlook is supported by indicators for demand for credit for house purchases.

Graph 3.36: **Measures of near-term demand**



Source: RICS Housing Market Survey Data

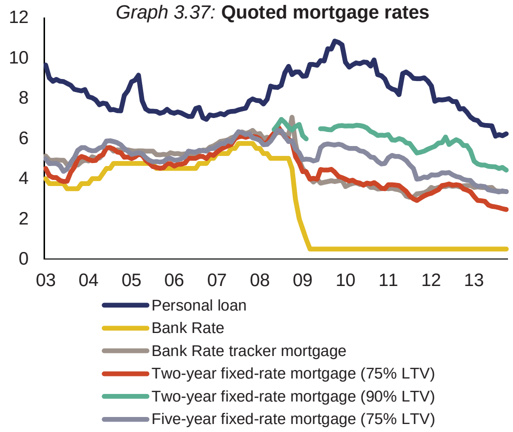
Rising levels of activity reflect rising demand for housing. A number of factors may have contributed to buoyant demand.

First, quoted interest rates on fixed and floating rate mortgages have continued to fall throughout 2012 and 2013 across a range of mortgage products (Graph 3.37). Broadly, the fall in quoted mortgage rates may reflect a fall in

[68] Royal Institute of Chartered Surveyors (RICS) *Residential Market Survey* December 2013.

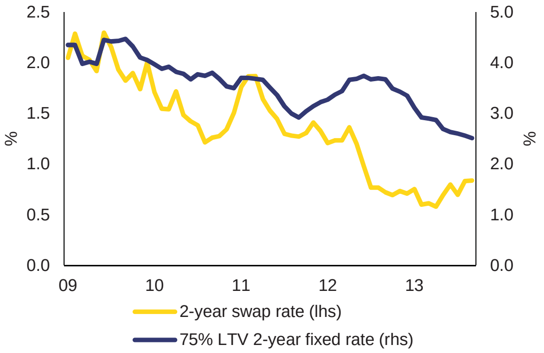
banks' funding costs over this period, for example, the two year swap rate has also fallen (Graph 3.38).

Graph 3.37: **Quoted mortgage rates**



Source: Bank of England and Bloomberg

Graph 3.38: **2-Year fixed mortgage Rate and 2-Year Swap Rates**

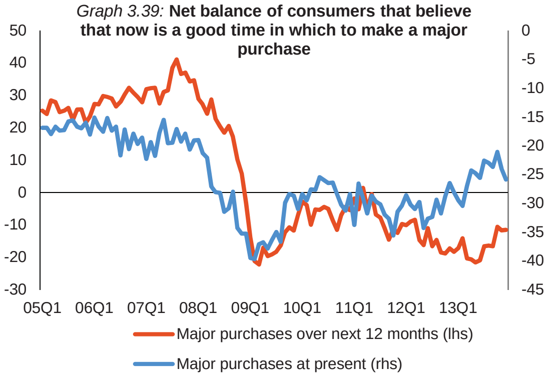


Source: Capital Economics

Moreover, the impact of the Bank of England's statements regarding the future impact of monetary policy, may have boosted households' confidence to purchase houses in the expectation that interest rates may remain low for an extended period of time.

Second, households' confidence and expectations of future income may have risen throughout 2013 in part reflecting the increase in growth in this period. Survey measures of households' expectations in relation to their personal financial position, unemployment and general economic situation all improved in 2013. In addition, there has been a steady increase in consumers' confidence that now is a good time in which to make a major purchase (Graph 3.39).

Graph 3.39: **Net balance of consumers that believe that now is a good time in which to make a major purchase**



Source: GfK and Commission Services

Third, credit conditions facing households continue to ease as improved conditions in the banking sector mean that households are subject to weaker credit constraints than in the immediate past. The availability of, and spreads on, secured loans to households have improved since their troughs in early 2012, indicating loosening credit conditions. Since June 2012, mortgage lending rates have fallen by 0.6-1 pps. depending on the type of mortgage. Credit availability is expected to improve further in Q1 2014 ([69]). In addition, the number and range of mortgage products available has increased and the proportion of loans at a loan-to-value ratio of over 95% is rising. Furthermore, the proportion of new mortgage advances with high income multiples of all new mortgage advances is increasing and stands at 42% compared with 38% a year ago and, for first-time buyers, the median mortgage as a multiple of income has steadily risen from a trough in February 2009 (of 3) to stand at 3.4 in December 2013 ([70]). However, easing in credit conditions is likely to be reflected in the stock of credit outstanding to households secured on dwellings with a lag. Credit outstanding grew at a 3-month annualised rate of 1.3% in the year to December 2013, a little more than double that at December 2012 and similar to the previous peak of March 2012.

Fourth, Government policy is also likely to have increased demand for housing, namely, through the impact of the Funding for Lending Scheme

([69]) See Bank of England (2014).

([70]) A high income multiple is defined as 4 or higher on a single income or 3 or higher on a joint income. Source: Bank of England (2013b), Capital Economics (2014a and b)

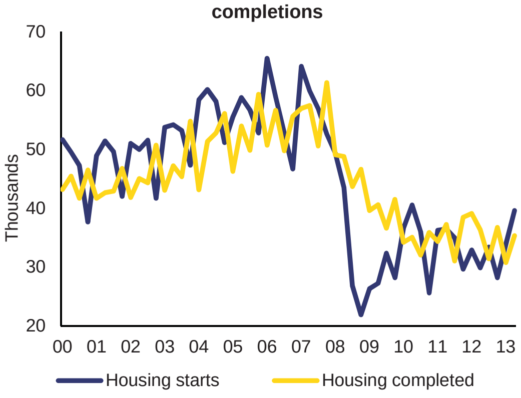
(FLS) ([71]) and Help to Buy policy. The second stage of the scheme, Help to Buy 2 (loan guarantee), which came into effect in October 2013, enables households to purchase a property of up to GBP 600,000 in value with a 5% deposit and with the government guaranteeing 5-15% of the loan. The objective is to support households to obtain a loan that they may not otherwise be able to do. Although recently withdrawn for lending to households (see below), the FLS was in force until the end of 2013 and may have contributed to the falling in the cost of borrowing noted above.

Fifth, buoyant demand is likely to reflect a delayed response to high levels of unmet demand during the economic downturn and international economic crisis – the result of a structural imbalance between high demand and low supply.

Supply

The increase in demand is slowly translating into increased construction of new property. UK-wide data show that starts and completions were broadly unchanged in 2011 and 2012 but began to pick up in Q2 2013 (Graph 3.40). For England**,** more recent data suggests that housing starts picked up in Q3 2013 - starts averaged a little over 10,800 per month in that quarter compared to around 8,300 per month in 2012 ([72]).

Graph 3.40: **Private sector housing starts and completions**



Source: Department for Communities and Local Government

Moreover, there has been a marked increase in indicators of future starts and completions - for example, planning approvals granted in Q3 2013 were 33% higher than a year earlier ([73]).

The increase in supply is already placing pressure on capacity in the construction sector. For example, there have been reports of shortages of skilled labour ([74]) and materials ([75]) that may impede builders' ability to respond to the need to increase supply to meet increasing demand.

Government policy and supply

A number of policies to stimulate supply have been announced since the 2013 IDR. The most significant development is a set of measures to strengthen the National Planning Framework (NPF) to ensure that economic factors are at the heart of the planning decisions ([76])([77]).

House prices

Despite some increase in supply, the increase in demand has resulted in increases in house prices. House prices increased by around 8% in the year to Q4 2013 and the average pace of growth has picked up from 2012 ([78]). House price levels are close to the level of the previous peak in 2008 (Graph 3.41). Moreover, house prices rises are occurring from already elevated levels.

A number of indicators indicate that buoyancy in house prices will continue in the near term. For example, the selling price achieved as a share

[71] A brief explanation of the FLS can be found in Section 3.2.8.

[72] The data in this sentence is for England only as data for the UK after Q2 2013 had not been published at the time of publication of the IDR.

[73] See Home Builders Federation (2013).

[74] See, for example, UK Commission for Employment and Skills (2014).

[75] See, for example, Construction Products Association (2013).

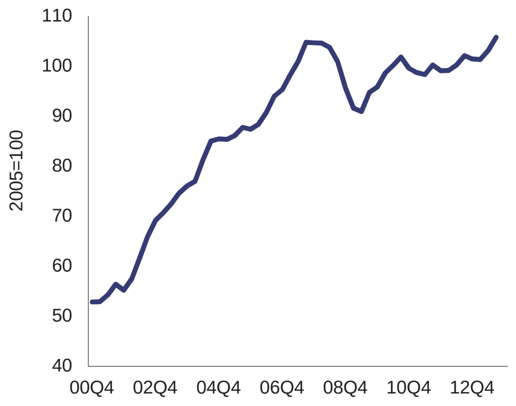
[76] See HM Treasury (2013).

[77] In December 2013, the government announced that it would consult on a proposal for a legal requirement for local authorities to have a local plan in place. Local plans need to set out expected demand for housing and the impact of economic factors such as employment and growth. Moreover, local authorities would be required by the NPF to take decisions in accordance with their local plan. If a local authority did not have a local plan in place and, therefore, is unable to demonstrate that an application for development is inconsistent with its objectives, then that application is treated as approved.

[78] According to the most recent monthly data, in the twelve months to January 2014, house prices increased by 8.8% and 7.3% according to the Nationwide and Halifax price indices respectively.

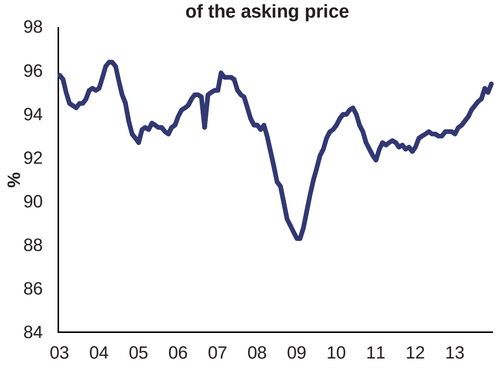
of asking price and surveyors' expectations for house price rises are projected to rise (Graphs 3.42a and b).

Graph 3.41: **House Price Index**



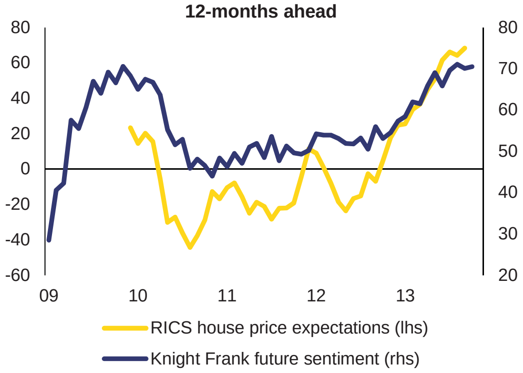
Source: Commission services

Graph 3.42a: **Selling price achieved as a share of the asking price**



Source: Bank of England

Graph 3.42b: **House price expectations 12-months ahead**

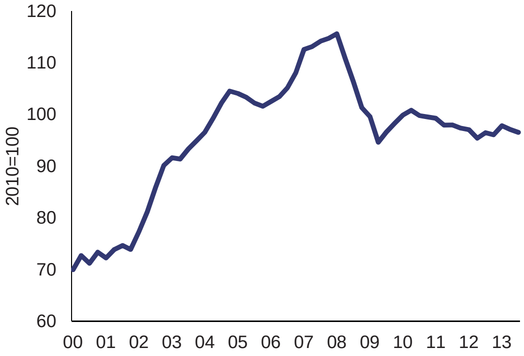


Source: RICS and Knight Frank

Affordability

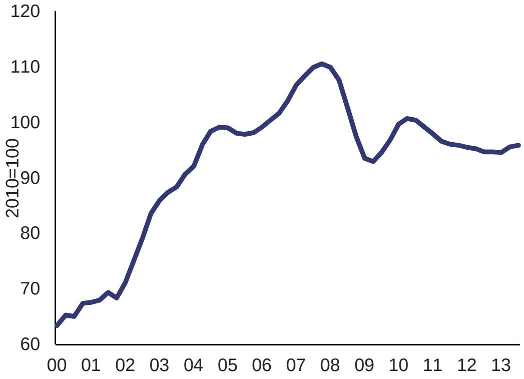
Despite the rise in house prices housing affordability remains, broadly, at its level of the past four years. Although the cost of borrowing remains low and modest nominal disposable income growth continues, both factors have been matched by the rise in house prices leaving affordability broadly unchanged. The pattern is confirmed by recent movements in the house prices to rent ratio which has also remained broadly unchanged over the past four years. Nevertheless, both measures of affordability remain at high levels (Graph 3.43 and 3.44).

Graph 3.43: **House prices to disposable income**



Source: OECD

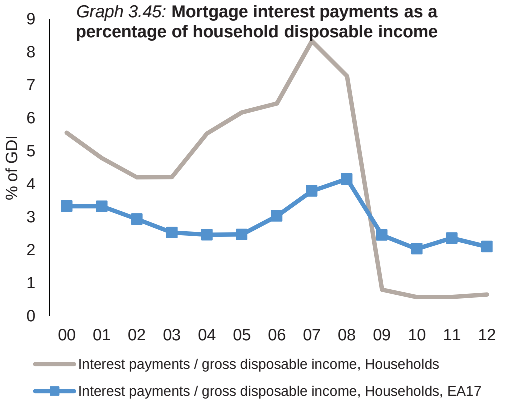
Graph 3.44: **Price to rent**



Source: OECD

Furthermore, a third measure of housing affordability, mortgage interest payments as a percentage of income, remains subdued, reflecting the importance of the continued low cost of borrowing in maintaining improved levels of affordability compared to the situation before the international economic crisis (Graph 3.45).

Graph 3.45: **Mortgage interest payments as a percentage of household disposable income**

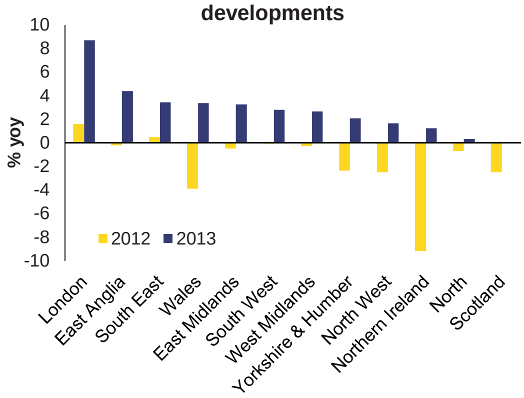


Source: Commission Services

Regional house price movements

Momentum in house prices varies across the regions. As can be seen in Graph 3.46, house price rises have been steepest in London since 2012, followed by the south east. House price rises outside London and the south east of England have been considerably more modest.

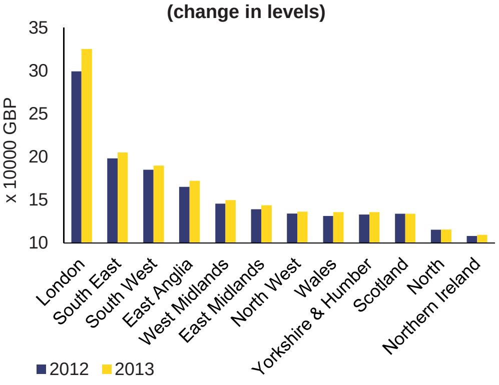
Graph 3.46: **Regional house price developments**



Source: Nationwide Building Society

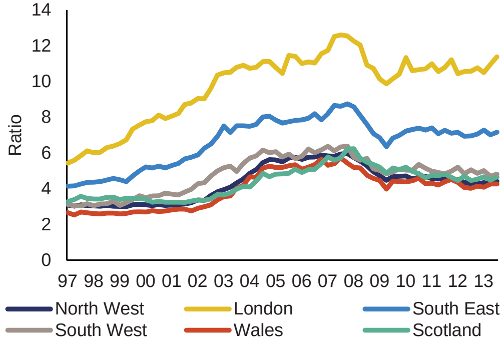
Moreover, the steep house price rises in London have occurred from a higher base; the average house price in London is now considerably higher than that in any other region (Graph 3.47). The high level of house prices in London has contributed to a reduction in affordability in London relative to other regions of the UK (Graph 3.48).

Graph 3.47: **Regional house prices (change in levels)**



Source: Nationwide Building Society

Graph 3.48: **Housing affordability by region**



Source: Nationwide Building Society, Halifax and Office for National Statistics

The difference in house price rises may reflect the different and prospective economic performance of the regions in the UK. It may also reflect factors specific to London, for example, the influence of foreign investors which make cash payments for property and who are attracted by the 'safe haven' status of the property market although the evidence to support this view is largely anecdotal. Moreover, the relative strength of London is unlikely to be a short-term phenomenon; there is a medium-term trend for large cities to outperform the rest of the economy ([79]). The study found that in some 'superstar' cities, house prices continually rise above the national average over a period of around 50 years.

Given the importance of London in the UK economy, it is unsurprising, that house price growth in London has outstripped that in the rest of the UK. Over the medium term, it is

([79]) As argued by Gyoruko, Mayer and Sinai (2006).

reasonable to expect the trend to continue. If it does, the high and rising house rises in London pose challenges to the authorities in terms of the affordability of houses in London, particularly for lower income groups, and labour mobility between regions of high and low house prices.

3.3.3. Risks

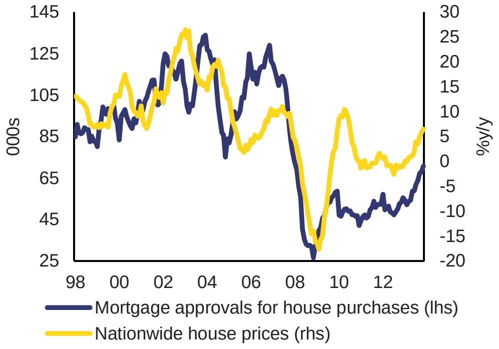
Four risks are discussed below: 'excessive' rises in activity, house prices and mortgage indebtedness, an unexpected rise in the cost of borrowing, a negative income shock, an excessive relaxation of credit standards and an inadequate response of supply.

Excessively rapid increases in the level of activity, mortgage debt and house prices

Most quantity-based measures of housing sector activity are rising. However, activity is increasing from a low base and remains well below previous peaks. For example, the number of transactions, completions and building approvals remain below their peaks of 2008 as noted above.

Nevertheless, even at modest levels of activity, house prices are rising (Graph 3.49). As discussed above, near-term indicators point to such rises continuing and, possibly, intensifying. Past experience suggests that present house price rises can be followed by further increases in house prices and be followed by self-fulfilling expectations of future price rises. Such rises may induce further increases in supply and, of themselves, deter demand.

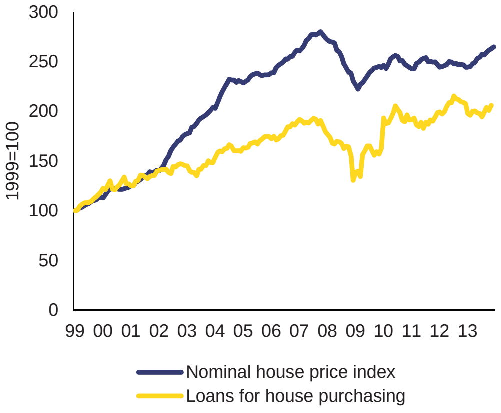
Graph 3.49: **Mortgage approvals and house price growth**



Source: Bank of England, Nationwide Building Society

The risks associated with rising house prices are likely to translate into increasing risks relating to household debt. Rising house prices can be expected to result in a rise in household indebtedness over the short and medium term as cumulative rises in new mortgage debt outstrip repayments of mortgage debt (Graph 3.50).

Graph 3.50: **House prices and mortgage debt**



Source: Nationwide

Although the stock of outstanding mortgage debt has increased modestly, it is, nevertheless, rising from high levels. Given the extent of house price rises, it could be expected to rise further ([80]).

Rising mortgage debt may leave households vulnerable to: a rise in the cost of borrowing, an unexpected shock to household disposable income and excessive relaxation of credit standards (in which households acquire excessive debt). These risks are discussed below.

However, house prices are rising rapidly only in London (and, to a lesser extent, the south east of England). Outside these regions, there has been modest evidence of house price growth and no evidence of excessive house price growth. Indeed, the affordability of housing has yet to deteriorate significantly outside London and has remained broadly unchanged for four years.

Therefore, until rapidly rising house prices spread beyond London and the south east of England, the risks associated with house price rises are assessed as moderate in the short term. However, should, in the medium term, rapid house

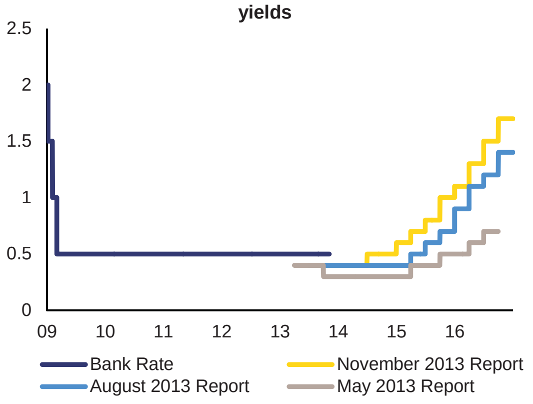
[80] Rises in household indebtedness are projected by the Office for Budget Responsibility (2013).

price rises spread more widely across the UK then the medium-term risks become pronounced.

Rises in the cost of borrowing

The main risk associated with high and rising household debt is the sensitivity of such debt to rises in interest rates. As noted above, quoted mortgage rates have been low and stable for the past four years. This reflects low yields in the money markets. However, as assessed by market expectations of future rises in the bank rate, forward market rates are projected to rise in the next 18-24 months (Graph 3.51). Moreover, as 2013 and 2014 have progressed, the date at which money market rates are projected to rise has become closer[81]; it is reasonable to expect that a rise in money market rates translates into a rise in mortgage rates.

Graph 3.51: **Market expectations of future yields**



Source: Bank of England and Bloomberg

The extent of the rise in rates faced by increasingly indebted households depends on whether rates on their mortgages are fixed or variable. Typically, the majority of loans taken out are variable rate mortgages. In Q3 2013 around two-thirds of new mortgage loans were variable rate mortgages [82] – a proportion in line with that of the last five years. As a result, the increase in mortgage rates following a rise in market rates could be swift. Moreover, households may not have fully taken into account such a rise in their calculations on their ability to service mortgage debt in terms of either magnitude or timing - unexpected rises in credit costs can be an example of 'dangerous near-sightedness' [83] which can result in a sharp correction in house prices and activity with macroeconomic consequences.

Crucially, as noted above, mortgage interest payments as a percentage of income are at relatively low levels reflecting a cost of borrowing that is historically low. In addition, household gearing ratios (i.e. interest and mortgage repayments as a percentage of disposable income also remain at historic low levels). There would seem to be at least some scope for households, in aggregate, and in the short term, to absorb a modest rise in mortgage interest rates should the risk eventuate.

However, in the medium term, the risk is more pronounced. A sequence of rises in the cost of borrowing following a rapid rise in house prices and mortgage indebtedness could leave households vulnerable in the face of higher levels of mortgage indebtedness. The Governor of the Bank of England (2013) [84] has warned households of the risks posed by possible future increases in the costs of borrowing.

Furthermore, the aggregate position masks vulnerabilities across household type. High levels of debt have amplified the impact of shocks on income but the degree of amplification is greater for highly indebted households [85]. An unexpected rise in the cost of borrowing is, therefore, likely to have a disproportionate impact on highly indebted households.

Overall, although households are increasingly vulnerable to rises in the cost of borrowing, the impact of such a risk on the economy is assessed as moderate in the short term.

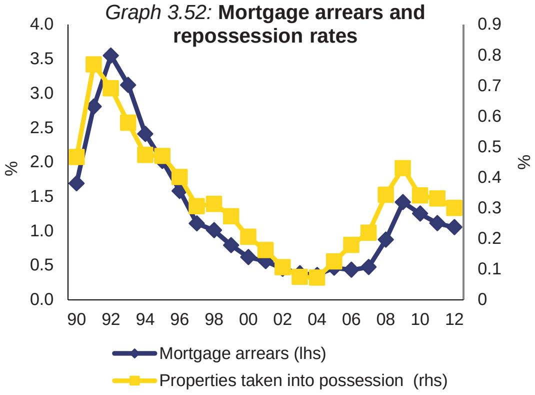
A negative shock to household disposable income

A further risk is an unexpected decline in household disposable income growth (or future expected income growth). Should the risk eventuate, the ability of households to service the mortgage stock may be reduced.

[81] Dates are indicated according to the date of various Inflation Reports published by the Bank of England.
[82] Bank of England (2013e).
[83] Glaeser et al (2008).
[84] Governor of the Bank of England (2013).
[85] Bank of England (2013c).

However, this risk needs to be set against a positive, and improving, economic outlook. Economic growth has surprised on the upside and is expected to continue at a strong rate in 2014 and 2015 ([86]). Continued growth in nominal disposable incomes is consistent with nominal economic growth. Moreover, such growth supports households' ability to service increased mortgages. Even if growth in nominal household disposable income remains below that of house prices, and mortgage indebtedness, there may be scope for households to run down savings further to service such debt as the household saving ratio remains well above its trough of 2008. Over the longer term, rates of arrears and repossessions have remained low, even during the crisis and subsequent recession, suggesting that households remain resilient to shocks (Graph 3.52).

Graph 3.52: **Mortgage arrears and repossession rates**



Source: Department for Communities and Local Government

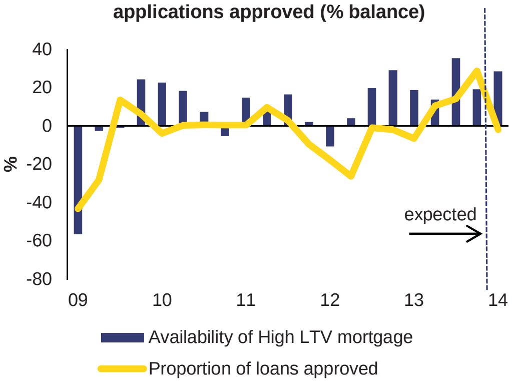
Therefore, the likelihood of the risk occurring in the short-term, and its impact, is assessed to be modest. However, rising levels of house prices and mortgage indebtedness leave households exposed to the risk of a negative income shock in the medium term.

Excessive relaxation of standards and increases in availability

There is a risk that the relaxation of credit standards and conditions could intensify and excessive credit made available to households. Further relaxation of credit standards could be excessive particularly if it further boosts house prices or vulnerable households acquire excessive debt and may be unable to service such debt**.**

The signs of the risk materialising are mixed. On the one hand, some indicators suggest a relaxation of standards that rivals or exceeds that of the previous sharp and prolonged rise in house prices. For example, the share of new mortgages for house purchase with a loan to income ratio greater than 4.5 has increased steadily since the trough in 2009 and, for properties of a value of GBP 300,000 or more, and for all properties in London, is well above previous peaks of 2007. Furthermore, more than half of first home buyers have taken out mortgages with a repayment period exceeding the typical 25 years. On the other hand, however, the proportion of lenders expecting to increase mortgage applications is not expected to continue (Graph 3.53). Also, on other measures, there are signs that standards remain conservative.

Graph 3.53: **Proportion of mortgage applications approved (% balance)**



Source: Bank of England

In any case, the authorities have responded to the risk - primarily by way of the Financial Conduct Authority's *Mortgage Market Review (MMR)* ([87]). The MMR is due to come into force in 2014. Banks will be required to verify fully borrowers' incomes and assess that a mortgage is affordable given net income and essential expenditure, taking into account market expectations of future interest rate rises. For interest-only mortgages, lenders will be required to assess affordability on a capital and interest basis.

[86] As set out by European Commission (2014).

[87] In addition, other actions taken by the authorities mitigate the risk: the FLS can no longer be used to provide credit for housing (see section 3.3.4), the Prudential Regulation Authority (PRA) has ended its temporary capital relief on new household lending qualifying for the FLS and the Financial Conduct Authority requires mortgage lenders to have regard to any future FPC recommendations on appropriate interest rates stress tests to use in the assessment of loan affordability.

Given the ameliorative measures in place, the risk of excessively low credit standards is assessed as modest. The measures underway should limit the risks associated with excessive mortgage lending to households and hence their vulnerability to unexpected rises in the future cost of borrowing or unexpected falls in future income.

Prudent balance sheets

There is little risk to balance sheets stemming from increased activity in the housing market. Households' real assets accounts for about half of households' total wealth. Households' mortgage debt accounts for about 10% of households' balance sheets. Therefore, households' hold considerable net wealth so their balance sheets are relatively strong despite high gross household debt levels ([88]). The structure of households' balance sheets increases resilience to shocks discussed above although this is an aggregate position and masks differences between households.

Inadequate response of supply

There is a risk that the supply of new houses does not respond to the signals sent by rising house prices. As noted above, supply has been slow to respond to recent increases in demand and, as a result, house prices are rising from an already elevated base. The extent to which increases in demand translate into higher prices or increased supply depends upon the price elasticity of the demand curve – the more price-inelastic the supply curve, the higher the prices that will result for a given increase in demand.

The sluggish response of supply to price signals is a typical feature of housing markets internationally ([89]) but nevertheless, a divergent response in supply could explain house price dispersion across countries. For example, one study ([90]) found that, following a house price shock, the price response is higher in countries with constrained supply.

The supply responsiveness - which has been estimated at 0.4 ([91]) - is likely to be lower than that for demand and is reasonably inelastic. The typical experience of UK housing cycles is that house price rises, and the rise in the number of transactions, rapidly outstrip increases in residential construction as discussed above.

The size of the supply response depends upon the responsiveness of the factors determining the availability of land that can be developed. Such factors include: fundamental geographic and demographic constraints, the planning system, insufficient incentives to for developers to develop land and/or constraints in obtaining finance. Evidence suggests that the elasticity of supply is associated with restrictions surrounding land use ([92]) and, moreover, that the elasticity of supply in the UK is around the average of EU comparative countries for which data is available (Table 3.1).

[88] However, although the aggregate solvency risk seems small, there is liquidity risk, for example, a proportion of households' financial assets are likely to be held as insurance reserves which are less liquid than other forms of financial assets.

[89] see e.g. OECD (2008).

[90] Gattini and Ganoulis (2012).

[91] OECD ibid.

[92] See OECD ibid.

Table 3.1:
Elasticity of supply

Country	Regulation restriction
BE	0.32
DK	1.21
DE	0.43
IE	0.63
ES	0.45
FR	0.36
IT	0.26
NL	0.19
AT	0.23
PL	0.44
FI	0.99
SE	1.38
UK	**0.40**

Source: OECD

Planning system

The role of the planning system in impeding supply has come under particular focus. It has been argued that the planning system is excessively bureaucratic and unresponsive to changes in demand [93]. As a result, the supply of land is restricted and the costs of developing it are unnecessarily high. The constraints may be particularly tight around large cities in which land designated as 'green belt' is protected from development.

Decisions relating to the supply of land available for housing development are typically taken by local authorities in the first instance although such decisions are subject to appeal which is assessed as part of an independent process. As part of these processes, the planning system attempts to balance legitimate competing interests on the use of land. Achieving such a balance is not straightforward in practice. However, in balancing competing interests it is crucial that the role of economic factors and the government's stated policy of increasing the supply of houses are given appropriate weight.

It is unlikely that supply will increase sufficiently rapidly to meet increases in demand in the short term - although the government has announced, and is implementing, a number of policies to boost supply, given the constraints and time likely to elapse before such policies take full effect, constraints on supply are likely to continue.

A further risk is that developers obtain planning permission to develop land but do not proceed with the development. Reasons for such action include: an inability to obtain development finance, an unexpected shortage of materials or skilled labour or speculation about future capital gains. Should such action be significant, the supply of land for development is restricted. It is difficult to assess the extent of this risk in practice. It is also important to note that at least some land banks are inevitable as developers seek to manage an appropriate continual supply of land of development in the pipeline. However, it is noteworthy that planning permission expires if land is not developed within a particular timeframe.

Capacity constraints

As noted above, there is evidence that the construction sector may be experiencing capacity constraints. Firms typically report that they are at or near capacity; should capacity constraints continue, the risk that supply is unable to increase to meet growing demand is intensified.

Medium-term gap between supply and demand

More broadly, a shortage of supply is unlikely to be a short-term phenomenon and could extend to the medium term. Medium-term demand for new houses is likely to be determined by the rate of new household formation. It is currently projected that, in England, an average of around 220,000 households will be formed each year between 2012 and 2021 [94]. However, new

[93] UK Government (2012).

[94] Department of Communities and Local Government (2013d).

supply is currently around 110,000 per year [95] – well below the rate of new household formation. The imbalance between supply and demand is likely to underpin currently high house price levels and spur further rises in house prices over the medium term as demand outstrips supply.

Risks - conclusion

In conclusion, levels of activity remain below previous peaks. Nevertheless, house prices are rising and the increase in prices and level of activity is likely to be reflected in rising levels of mortgage debt (and that rise is occurring from an already elevated base). The main risk on the demand side is households' vulnerability to a rise in the cost of borrowing while the response of the authorities has mitigated risks associated with an excessive lowering of credit standards. The main risk on the supply side is that reforms to the planning system and other initiatives to increase supply do not deliver increases in new housing of the amount required, or do so sufficiently quickly, to forestall further rises in house prices and mortgage indebtedness.

Overall, the short-term risks are rising but remain modest. The rise in activity is based on stronger fundamentals in the housing market – improved confidence, a low cost of borrowing and some, and not wholly on an excessive relaxation in credit availability and standards.

However, in the medium term, as house prices and household mortgage indebtedness become increasingly elevated, the risks are more marked, as households are more exposed should the cost of borrowing rise rapidly and/or a negative income shock eventuates. There is, therefore, a case for a policy response to mitigate the impact of potential medium-term risks

3.3.4. Government policy - responses and challenges

Demand

Help to Buy 2

As noted above, under Help to Buy 2, the provision of guarantees by the government improves households' ability to obtain high value loans with a relatively small deposit. Help to Buy 2 compliments the earlier Help to Buy 1 [96] but there are significant differences on the impact on relative demand and supply. Under Help to Buy 1, there is an increase in the supply of new property to match each new equity loan whereas the guarantee under Help to Buy 2 extends to pre-existing property and is unlikely to generate a similar simultaneous increase in new supply [97].

The impact of Help to Buy 2 on housing activity and prices depends partly upon its size. The policy, which is in place for three years, is capped at a total exposure to the Government of GBP 12 billion, and could be expected to lead to a maximum increase in loans available of around GBP 100 billion. Even assuming a mid-point estimate of a contingent liability of GBP 6 billion, the increase in mortgage lending of around GBP 50 billion over three years is significant although it is difficult to assess the 'additionality' afforded by Help to Buy 2 – that is, the number of loans that would have been provided to the same households in the absence of the policy. However, and as is also the case for Help to Buy 1, Help to Buy 2 is likely to have boosted general confidence in the housing market and exerted an impact more widely on prices and activity.

In the absence of a strong supply response, the predominant impact of Help to Buy 2 is likely to increase house prices; indeed, supply is likely to respond only indirectly and slowly given its

[95] Department of Communities and Local Government (2013c).

[96] Under the Help to Buy 1 (equity loan) scheme that came into effect in April 2013 the UK Government provides an equity loan of between 5 and 20 per cent for households seeking a loan for the purchase of a new property of up to GBP 600,000 in value with a minimum deposit of 5%. The aim of the policy is to enable households to purchase new build property but would otherwise lack the funds sufficient to obtain a deposit to do so.

[97] As at December 2013, around 13,000 equity loans had been completed under Help to Buy 1 of which a little under 1000 were in London boroughs. See Department of Communities and Local Government (2013a)

historically lagged and muted response to price. House prices are likely to rise further at a time in which house prices are already rising although the extent of any increase depends on the regions in which guarantee loans are provided for purchase ([98]). The policy is also likely to increase household indebtedness – although part of that increase in debt is guaranteed by the government.

At a time in which credit constraints are easing in the mortgage market, the need for the policy may diminish. While some constraints remain – for example, as noted above, the median deposit required for a first home buyer is currently double that of 2008 while that for all home buyers has been volatile but broadly unchanged – the policy is not explicitly targeted to such segments of the market ([99]).

Close monitoring of credit availability and associated macroeconomic developments is required ([100]) given the risks associated with Help to Buy 2 and the policy could be scaled back – and/or more closely targeted – should credit supply growth rise further and credit constraints continue to ease.

The Funding for Lending Scheme

In November 2012 it was announced that the FLS would be withdrawn for lending to households – effective from January 2014. Other factors held constant, the FLS could be expected to affect the cost of borrowing and/or the quantity of finance available to households and, as such, could have boosted housing sector activity in 2013.

The withdrawal of the FLS for lending to households is appropriate. The need for the policy to continue is unclear given buoyant activity in the housing market and easing access to credit for households. Continuation of the policy risked further boosting demand and house prices.

Role of macro-prudential regulation

There may be scope for a regulatory response by the Financial Policy Committee of the Bank of England (FPC). Consistent with its responsibilities for protecting and enhancing the resilience of the UK financial system, in the event that it felt that excessive credit was flowing to the household sector, and that flow posed risks to financial stability, the FPC could take action to affect banks' provision of mortgages. Such actions could include ([101]):

- decisions on the countercyclical buffer – that is, to require banks to directly increase loss-absorbing capital against the impact (on banks) of an economic downturn;

- make recommendations on maximum loan-to-value ratios, loan-to-income ratios, debt to income ratios or mortgage terms – to restrict mortgages of a particular type;

- make recommendations – or directions – to the Prudential Regulation Authority (PRA) on bank capital requirements on residential real estate lending, that is, to require banks to directly increase loss-absorbing capital against the impact (on banks) of an economic downturn;

- make recommendations to the PRA or Financial Conduct Authority (FCA) on underwriting standards; and/or

- make recommendations to the Government regarding its Help to Buy policy.

The FPC only came into existence relatively recently – an interim FPC held its first meeting in June 2011 - so it is relatively untested. Many of the options available to the FPC have been used in other countries. The FPC's views on the trade-offs between the benefits, costs, risks and

[98] Under Help to Buy 1, as set out in footnote 79, the majority of equity loans were provided for purchase outside London. Should a similar pattern of guarantee loans be provided under Help to Buy 2, then the impact on house prices is likely to be less than if most loans were provided for purchase in London.

[99] Although it is worth noting that, as at September 2013, 92% of loans advanced under Help to Buy 1 were to first home buyers. See DCLG (2013b). Data is not yet available for guarantee loans under Help to Buy 2 although, under both arms of the policy, loans are available at only high loan-to-value ratios, suggesting that first home buyers are likely to benefit disproportionately.

[100] The Financial Policy Committee of the Bank of England is required to report to the Government if it believes that the policy poses risks to financial stability.

[101] As set out by the Bank of England) (2013b). Some of these actions are implemented by powers to give recommendations or directions to the PRA and the FCA.

unintended side effects associated with the above suite of options and their relative efficiency and effectiveness in addressing policy challenges could be further publicly developed.

There is a case for a more detailed public assessment by the FPC of the merits of the various instruments available to it and the situations in which they would be deployed. Such an assessment would increase markets' understanding of the FPC's reaction function which would boost not only transparency but also the effectiveness of the instruments if/when they are deployed.

Valuation of the cadastre

Broadly, taxation of owner-occupied property is levied through an annual council tax – which is collected by local authorities and is based on property values – and taxes on transfers, viz, stamp duty and inheritance tax. The property value roll – the basis for the assessment of council tax - has not been updated since 1991. The UK is one of more than half of Member States that levied property taxes on outdated cadastral values ([102]).

Use of an outdated property value roll may lead to distortions: owner-occupied property becomes under-taxed and there is a bias in the tax system to over-investment in owner-occupied property, the degree of regression in the tax system increases, as property values have not increased uniformly across, or within, regions there can be inter and intra-country distortions and the amount of tax collected moves inversely with value of the object of the taxation. Moreover, regular revaluation of the roll would reduce sudden increases in the annual council tax liabilities. However, other factors held constant, revaluation may lead to a large, and possibly sudden, increase in taxation, particularly for groups that have benefitted from rises in house prices since 1991.

An updating of the property value roll should reduce distortions in the taxation system. Any excessive tax increases falling on certain groups can be mitigated through adjustments elsewhere in the taxation system (including property taxation).

Housing supply

Until relatively recently, the planning system did not place appropriate weight on economic factors such as supporting economic and employment growth. Reforms enacted by the government in 2012 and 2013 as part of the *National Planning Framework* (NPF) ([103]) require local authorities to place economic factors at the heart of planning decisions including the demand for housing. A key component is the need to prepare a Strategic Housing Market Assessment to assess their full housing needs taking account of household and population projections, migration and demographic change and caters for housing demand and the scale of housing supply necessary to meet this demand. In addition, 'local plans' are required that set include the strategic priorities need to deliver the required number of homes and jobs in each area.

In **December 2013, the government announced that it would consult on a proposal for a legal requirement for local authorities to have a local plan in place.** Moreover, local authorities are required by the NPF to take decisions in accordance with their local plan. If a local authority does not have a local plan in place and, therefore, is unable to demonstrate that an application for development is inconsistent with its objectives, then that application is treated as approved. As at December 2013, 76% of local authorities had a plan in place.

The reforms to the planning system are appropriate. Nevertheless, it will take time for local authorities to fully reflect such criteria when taking decisions, not least because they will need to develop the expertise to do so. However, the increased role played by demand for housing in determining the supply of developable land for housing should, in time, stimulate supply and represents a major change from previous practice.

In addition, it is essential that decisions taken by local authorities are taken efficiently and transparently. Delays are minimised so that new supply can commence as quickly as possible.

([102]) European Commission (2013i).

([103]) Department of Communities and Local Government (2012).

Recent policies announced in 2013 aim to increase the efficiency of the planning system ([104]).

In order to encourage the release of more land for development, the government could consider the appropriate incentive structure for local authorities to increase and speed up the release of such land in the context of facilitating local solutions to the issue. Such local solutions may also include the taxation of vacant property. In addition, the government could consider whether there is a case for a stronger regional approach to decisions on the supply of land for development involving clusters of local authorities.

In conclusion, the government has undertaken some reform of the planning sector. Further time is needed to assess whether they will result in a timely increase in supply and further analysis is needed as to whether barriers to supply lie outside the planning system. However, there is scope to move further – including the development of appropriate and targeted incentives for local authorities to release land with planning permission attached for development in the context of local solutions to inadequate supply. Local solutions may also include the taxation of vacant property.

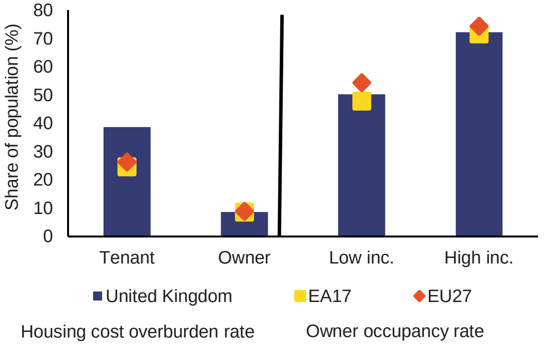
Rental sector

In part reflecting a medium-term decline in housing affordability, the proportion of households that own a house has decreased in the UK from 69% in 2001 to 65% in 2013 although the rate of home ownership in the UK is broadly in line with other EU Member States.

The private rented sector in the UK is relatively unregulated compared to that in other EU Member States. The rights of tenants and responsibilities of landlords are relatively limited.

The rental market may be dominated by a large number of short-term and relatively insecure temporary contracts. In addition, the 'household overburden rate' ([105]) is higher for renters than for home-owners (Graph 3.54) suggesting that there is considerable financial pressure on tenants.

Graph 3.54: **Housing tenure and housing cost overburden rates**



Source: Commission Services
Note: Average 2008-2011

There is a case to foster greater stability in the tenant-landlord relationship in a way that provides greater security of tenure to tenants. While some tenants and landlords may prefer short-term tenancy arrangements others may prefer greater stability in the form of longer-term contracts; in particular, some tenants may prefer long-term tenancy arrangements that landlords are unwilling to provide ([106]). Furthermore, uncertainty regarding tenure in the rental market may encourage home ownership thus increasing pressure in the housing market.

3.3.5. Conclusion

Activity in the housing sector can be expected to increase further. Given the gap between the formation of new households and supply, demand is likely to continue to outstrip supply. Relaxation of credit constraints is also likely to boost demand. Therefore house price rises are likely to continue to rise particularly in London. It follows that household indebtedness is also likely to rise.

[104] For example, it has been announced (UK Government 2013a) that the government would: review the Nationally Significant Infrastructure Planning Regime, consult on introducing a requirement to have a local plan in place, address delays associated with the discharge of planning conditions and reduce the number of applications for which statutory consultation is required.

[105] The overburden rate is the % of the population living in households for which the total housing costs (net of housing allowances) represent more than 40% of disposable income (net of housing allowances).

[106] For example, according to a recent survey among renters in London, 66% of respondents wanted reform for 'the option of a longer-term tenancy so I can settle in my home'. See Shelter (2013).

The challenge associated with high mortgage indebtedness is, therefore, likely to persist and worsen. There are a number of risks associated with high mortgage indebtedness: excessive rises in activity and prices, a rise in the cost of borrowing, a negative shock to household disposable income, excessive relaxation of credit standards and an inadequate response of supply. Although the likelihood of the risks materialising in the short term is assessed as modest, shocks to house prices and household balance sheets may pose more marked medium-term risks.

There is scope for action on the demand and supply sides of the housing market to reduce medium-term risks. Given the regional nature of house prices rises such action may require local solutions. In the absence of action, the challenge is likely to worsen further, and persist for longer, and the risks associated with it are likely to increase.

4. POLICY CHALLENGES

Following from the analysis in Section 3, potential imbalances relate to both the external and internal side of the economy, namely, a medium-term decline in the export share and high private sector indebtedness, particularly households mortgage indebtedness.

These challenges were also identified under the Macroeconomic Imbalance Procedure in the 2012 and 2013 IDRs and relevant policy responses were reflected and integrated in the country-specific recommendations (CSR) issued to the UK in July 2012 and 2013 (CSR 1, 2, 3, 5 and 6). The assessment of progress in the implementation of the recommendations will take place in the context of the assessment of the UK National Reform Programme and the Convergence Programme under the 2014 European Semester. This section discusses possible ways to address the challenges identified in this IDR.

The challenge of export performance

Recent growth is based predominantly on strong private consumption growth. A shift in the composition of growth towards exports over the medium term would be consistent with a reversal of the trend deterioration in export market share. To achieve such rebalancing, different policy approaches could be considered such as: strengthening the skills base, improving access to finance, export promotion and increasing investment in infrastructure.

Closing skill gaps

To stabilise, and possibly reverse, the decline in export market share, a key challenge is to ensure that the labour force has the necessary skills and aptitudes. A lack of both intermediate and advanced technical skills can result in capacity constraints.

In October 2013, the government announced plans to improve the quality of apprenticeships in England. Provision of high quality and targeted apprenticeships can help to boost the availability of relevant skills. Reviewing the exact nature of apprenticeships in cooperation with employers could contribute to meet the needs of the business and, particularly, the exporting sector.

Correctly accredited vocational training schemes and concentrating on science, technology, engineering and mathematics (STEM) in the education system could help meet the requirements of employers. Addressing the skills gap would also address the 2013 Council recommendation on young people's skills

Improving access to finance

Alleviating apparent credit constraints could enhance the ability of exporters to receive the finance they need to expand into export markets. Despite measures implemented by the government to boost credit supply and facilitate access to alternative sources of finance, credit supply remains weak, particularly for SMEs.

The government has a number of initiatives in place to boost access to finance. For instance, the Funding for Lending Scheme (FLS) was altered in November 2013 by removing use of the Scheme to lend to households; the remaining focus on lending to business enables closer targeting of finance to business. In addition, the government is establishing a Business Bank to provide alternative channels of finance for SMEs beyond bank credit. The Bank should be operational by the second half of 2014. SMEs, in particular, rely heavily on bank finance, thus, improving access to bank finance, via the FLS, as well as encouraging alternative sources of finance, via the Business Bank, are welcome and appropriate initiatives to ensure that SMEs obtain the finance they need to expand and export.

Furthermore, continuing to foster greater competition in the banking sector, e.g. by an increased presence of challenger banks, may help SMEs access credit. Initiatives in this area also respond to the 2013 CSR on improving credit availability.

Broad-based export promotion

There is potential to address information asymmetries that prevent firms that wish to export from seizing opportunities to do so. The government has established a number of initiatives to provide export credit and other supporting services; for instance, services provided by UK Export Finance and UK Trade & Investment.

The effectiveness of these initiatives hinges on awareness in the business community, as well as taking appropriate account of regional diversity in their design. More generally, trade openness relies on the ability to interact with foreign commercial partners. Finally, facilitating the recruitment of foreign experts could improve firms' ability to engage in international trade.

Investing in infrastructure

A potential bottleneck hindering competitiveness results from its under-investment in infrastructure. Improvement in the quality and quantity of infrastructure could also raise long-term potential growth by raising productivity. Upgrading and expanding the transport infrastructure could reduce bottlenecks in distribution.

The government published an ambitious National Infrastructure Plan 2013 in December 2013, which sets out investment plans worth GBP 375 billion to 2020 and beyond. Around two-thirds of the funds are to be provided by private sources of funds. Most of the investment is in the energy and transport sectors and is back-loaded time wise. A list of ‘Top 40’ projects has been published; priority projects were chosen based on their potential contribution to economic growth, national significance and attractiveness for private investors. Bringing forward the delivery of these planned projects where possible and ensuring effective implementation would boost the impact of the Plan. Facilitating increased investment in infrastructure and harnessing private sources of capital also responds to the 2013 Council recommendation.

The challenge of private sector indebtedness

Although the pace of deleveraging has slowed, and corporate indebtedness remains high, PNFCs as a whole are net savers and hold high levels of financial assets. However, aggregate PNFCs' indebtedness masks the divergence between the construction/property sector and other sectors for which the size of deleveraging has been greater.

The potential imbalance and risks arising from private sector indebtedness relate to high household mortgage debt, which in turn flows from developments in the housing market.

The housing market challenge

Demand for housing continues to increase particularly in London and the south east of England. The increase in demand may result in an increased imbalance in the housing sector in the short and medium term as the supply of new houses continues to fall below projected rates of household formation. House prices are rising steadily, especially in London and the south east of England and household mortgage indebtedness is likely to increase.

Policies to facilitate households' ability to purchase a house

The purpose of the government's Help to Buy scheme is to facilitate households' ability to buy a house. Whilst the first phase of the Help to Buy scheme ('equity loan' or 'Help to Buy 1') provides partial loans to facilitate a mortgage for new houses only, the second phase ('mortgage guarantee' or 'Help to Buy 2'), applies to all houses (existing or new). The effect on demand of 'Help to Buy 2' is likely to be immediate and direct while that on supply is likely to be indirect and slow given the historically lagged and muted response of new supply to demand. Therefore, the policy is likely to boost house prices further and at a time when they are already rising. The policy is also likely to increase household indebtedness, although part of that increase in debt is directly guaranteed by the government.

Close monitoring of credit availability and associated macroeconomic developments is required given the risks associated with Help to Buy 2 and the policy could be scaled back – and/or more closely targeted – should credit supply growth rise further and credit constraints continue to ease.

Macro-prudential regulation

Consistent with its responsibilities for protecting and enhancing the resilience of the financial system, in the event that the Financial Policy Committee of the Bank of England (FPC) felt that excessive credit was flowing to the household sector, and that flow posed risks to financial stability, the FPC could take action to affect banks' provision of mortgages.

There is a case for a more detailed public assessment by the FPC of the merits of the various instruments available to it and the situations in which they would be deployed. Such an assessment would increase markets' understanding of the FPC's reaction function which would boost not only transparency but also the effectiveness of the instruments if and when they are deployed.

Reform of property taxation

By EU standards, the share of property taxes in total government receipts is high in the UK. However, the efficiency and effectiveness of the property tax system could be improved. Taxation of owner-occupied property is levied through an annual council tax – which is collected by local authorities and is based on property values – and taxes on transfers via stamp duty and inheritance tax. The property value roll – the basis for the assessment of council tax – has not been updated since 1991; a revaluation would reduce distortions in the taxation system in favour of owner-occupied housing.

Reform of the planning system and supply

Despite improvements in the planning system, a shortage of supply persists. Better incentives for local authorities could be considered in order to increase and speed up the release of land with planning permission for development in the context of facilitating local solutions to inadequate supply. Improvements in this area would also be a response to the 2013 Council recommendation on housing.

Promotion of long-term tenancy agreements

The rental market is relatively unregulated by EU standards. There is scope to foster long-term tenancy agreements which could benefit both tenants and landlords. It could also reduce the tendency towards high home-ownership rates, which in turn might relieve pressure on rising house prices, driven by those attempting to get onto the property ladder.

Curtailing the risk of excessive relaxation of credit standards

The bank rate is currently at an historic low and many households are currently able to borrow at historically favourable mortgage rates. Given that much recent new borrowing is at a variable interest rate, there are potential risks to households' ability to service mortgages should the cost of borrowing increase. The reform of the mortgage market in the Financial Conduct Authority's *Mortgage Market Review* is due to come into force in April 2014 and is designed to limit particularly high-risk lending and support the maintenance of high credit standards and prudent lending.

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