UK in Focus

Economics
United Kingdom

Raising UK productivity

- While activity indicators appear to be improving after the UK fell into recession last year…
- …the UK's long-run growth challenges – particularly poor productivity – might be extremely difficult to overcome…
- ...posing ongoing headwinds to UK living standards, corporate profits, the public finances, rates, and GBP

UK data review (December/January 2024)

- **UK GDP** fell 0.1% m-o-m in December 2023 (consensus: -0.2%). Alongside downward revisions to October and November GDP levels, this meant it fell 0.3% q-o-q in Q4 2023, a second consecutive quarter of negative growth (after a 0.1% fall in Q3), meaning the UK ended 2023 in technical recession. For 2023 as a whole, the UK economy grew by just 0.1% – the weakest annual growth rate since 2009 (excluding 2020). But we aren't too worried, for two reasons. First, for most people, a recession will be associated with a rise in unemployment, and latest data suggests the opposite is true. Second, the news from 2024 so far has been more positive, with rising real wages, falling offered mortgage rates, and recovering house prices.

- **UK CPI** and **core CPI inflation** held steady at 4.0% and 5.1% y-o-y, respectively, in January, defying consensus expectations for an uptick. The RPI rate dropped from 5.2% to 4.9% y-o-y, partly due to softer housing components. Prices were surprisingly soft in components where we had expected positive base effects to kick in – namely air fares and hotels. And more broadly, there are encouraging disinflationary signs across the consumption basket, with sequential core inflation coming in somewhat below average.

- **UK labour market** data for December were a little stronger than expected, in line with a broader pick-up in other economic indicators in recent months. Total pay growth slowed from an upwardly revised 6.7% 3m/yr in November to 5.8% in December (consensus: 5.6%). Regular pay was also revised up for November to 6.7% and slowed to 6.2% (consensus: 6.0%). In 3m/3m annualised terms, whole economy regular pay growth dropped to 2.2%, while private sector pay dropped to 2.6% – well below the 3.5% rate we think would be roughly consistent with the Bank of England's 2% inflation target.

- The **UK composite PMI** rose to 53.3 in the February flash from 52.9 in January (consensus: 52.9). That took the composite to its highest since May 2023 and bodes well for the UK exiting its technical recession. Within this, the headline services index was unchanged at 54.3 (consensus: 54.1), while the manufacturing PMI ticked up to 47.1 from 47.0 (consensus: 47.5).

HSBC

Raising UK productivity

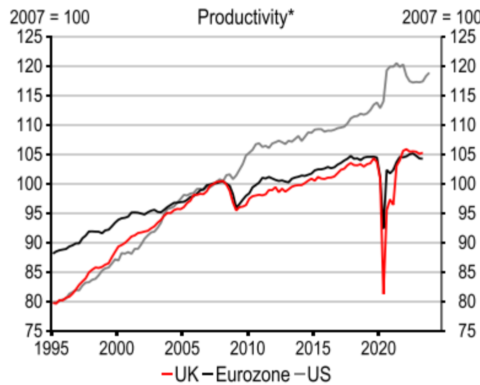
Pull the other one

With a general election fast approaching, it is understandable that politicians are talking about boosting economic growth. UK Chancellor, Jeremy Hunt, has said "smart" tax cuts are a route to economic dynamism. Labour leader, Keir Starmer – who polls suggest will be the next Prime Minister – has said he will pull "the growth lever".

UK productivity growth has slowed in the last 15 years…

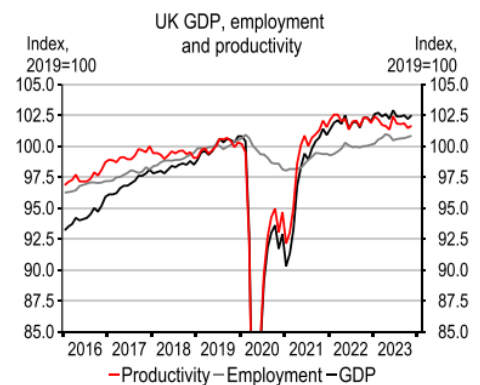
The problem is, the UK has faced 15 years of lacklustre growth. At the heart of this lies an inauspicious shift in productivity performance. Before the Global Financial Crisis (GFC), UK output per worker grew in line with that of the US, at 2% per year. While much of the developed world has seen a slowdown since, UK trends have become more European. Over the past 15 years, **UK productivity has grown at 0.5% per year**, in line with the eurozone.

1. UK productivity grew in line with the US, now it grows in line with the eurozone…



Source: ONS, Eurostat, BEA, Macrobond, HSBC calculations
*GDP per worker

2. …and after the post-COVID-19 bounce, output per head has been flat-to-falling



Source: ONS, Macrobond, HSBC calculations

What's gone wrong, and can it be fixed?

To work out whether a (metaphorical) 'growth lever' actually exists, it first makes sense to work out what lies behind the UK's so-called 'productivity puzzle'. To start, we think around a third of shortfall versus pre-Global Financial Crisis trends reflects the end of unsustainable growth in North Sea oil output and the financial sector. Not much can be done about that.

…dragged down by weak investment…

Much of the rest of the 'puzzle', we think, **hinges on weak investment**, driven by a number of headwinds which have become more acute in recent years. These include **high house prices, costly infrastructure projects, restrained public investment spending and perhaps, more recently, Brexit**. Some of these headwinds could be alleviated, but doing so may well be fiscally or politically costly. So, unless new technologies such as Artificial Intelligence come to the rescue, there's a risk that the next 15 years might not look much better than the last 15.

Six inconvenient implications

…which could lower living standards and profit growth

We see six implications of ongoing UK productivity weakness. First, lagging living standards. Second, paltry profit growth. Third, the government could face increasingly tough choices between raising taxes, increasing borrowing, or allowing public services to atrophy. Fourth, limited cost-saving productivity growth might make it harder for central banks to deal with inflationary wage 'shocks'. Fifth, in the long run, low potential growth could keep long run 'equilibrium' UK interest rates low – more in line with the eurozone than the US. And sixth, the combination of low growth and low interest rates could act as long run headwinds to GBP.

Can things only get better?

Reform and focused fiscal policy to help longer term

There are things that policy makers could do, whether it is **planning reform or refocusing fiscal policy more towards investment**. But either fiscally or politically, major reform might be hard to implement and might take a very long time to bear fruit. So, while we don't think there's much scope for the UK's productivity woes getting much worse from here, it is hard to see things getting much better any time soon. And until then, the adverse implications for prosperity, profits and policy will be here to stay.

Key upcoming UK economic data

Date	Indicator	Period	Prior
26-29 Feb	Nationwide house price y-o-y	Feb	-0.2%
13 Mar	GDP y-o-y	Jan	0.0%
20 Mar	CPI y-o-y	Feb	4.0%
21 Mar	Bank of England Bank Rate	Mar	5.25%
22 Mar	Retail sales y-o-y	Feb	0.7%

Source: Refinitiv Eikon

Disclosure appendix

Important disclosures

1 This report is dated as at 23 February 2024.

2 All market data included in this report are dated as at close 22 February 2024, unless a different date and/or a specific time of day is indicated in the report.

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