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THE ANALYSIS OF MACROECONOMIC DEVELOPMENT OF THE UNITED KINGDOM BEFORE BREXIT

Abstract:

The paper analyzes strengths, weaknesses, opportunities, and threats of the UK's economy from 2000 to 2018 - in the period before Brexit. The method of research is the comparison with the average of OECD, Eurozone members and with other countries. Results of the analysis are stated in SWOT matrix. As the strong sides of the UK's economy were identified: stable and attractive currency, high final consumption of households an NPISH's, low unemployment rate, macroeconomic stability, large market size, low corruption rate, responsive fiscal and monetary policy, effectiveness in collecting taxes, growth in labor productivity exceeds growth in real wages. As the weak sides of the UK's economy were identified: low security rate, quality of road infrastructure, low number of innovative companies, high tax on personal income, high tax on property, slow growth in labor productivity, large government debt.

Keywords:

competitiveness; Brexit; SWOT analysis; United Kingdom; European Union

JEL Classification: E00, F01, H00

1. Introduction

The paper analyzes the macroeconomic development of the United Kingdom (hereafter "UK") in the period from 2000 to 2018. The author has chosen for the analysis the UK as this economy is one of the largest in the world and its development influences other economies as well. Another reason for choosing the UK is a current situation when the UK left the European Union (hereafter "EU") which has induced lively discussions whether consequences for the UK´s economy will be rather positive, or negative. It is almost impossible to evaluate the impacts of Brexit due to two external shocks – Covid-19 pandemic and Russian war against Ukraine. Recent data are significantly affected by those shocks. The analysis of the development of the British economy before Brexit might provide a valuable contribution which could also serve for an economic assessment of Brexit. The aim of the paper is to evaluate the performance of the British economy based on SWOT analysis which evaluates strengths, weaknesses, threats and opportunities for the UK's economy.

2. Methodology

The paper analyzes the performance of the UK's economy regarding the indicators of inner and outer equilibrium. The analysis focuses on all macroeconomic fundamentals. The comparison with the average of OECD and Eurozone is used as a research method. In occasional cases, the UK is also compared with the average of the EU. The paper mainly uses data from OECD, International Monetary Fund and World Bank. The paper analyzes economic policies conducted during the analyzed period as well. The analysis of the monetary policy focuses on monetary policies conducted over the observed period and their appropriateness. The paper analyzes competitiveness of the UK's economy, too. The analysis is based on the competitiveness ranking which is annually published by the World Economic Forum. The paper also provides the SWOT analysis. A SWOT analysis or a SWOT matrix is a widespread business strategy. The aim of this technique is the identification of strengths, weaknesses, opportunities, and threats related to business. This strategy is not only valid for businesses but also for individuals or states. This paper will use a SWOT analysis to determine strengths, weaknesses, opportunities, and threats of the British economy.

3. Results

3.1. The Development of Macroeconomic Fundamentals

3.1.1. Gross Domestic Product

The British economy experienced quite stable economic growth over the period. The exception is a sharp decline in the middle of the period due to the global financial crisis which hit mainly the American economy and European economies. The UK experienced an economic drop of 3.4%. Highest growth occurred in 2000 when the British economy experienced 3.4% economic growth. Until the global financial crisis, economic growth was around 2.5% (World Bank, 2019a). After the financial crisis, the UK economy's performance has been again rather solid. According to OECD economic survey (OECD, 2017), recent British growth is mostly stimulated by a strong business- friendly environment, extremely supportive and reactive monetary policy, and a flexible approach in fiscal goals.

3.1.2. The Development of Public Finance and Government Debt

There was rather stable growth of debt until the financial crisis. However, the crisis caused a dramatic increase of the government debt. The British government debt increased from 41.7 % to 81.8% between 2007 and 2012. That is a tremendous and anomalous increase. The debt represents 86.9 % of GDP in 2018 (IMF, 2019).

3.1.3. Inflation

In general, development of inflation in the UK has been stable and without potential risks. The inflation rate in the UK has slightly deviated from the stipulated inflation target; however, that does not seem to be a significant issue. The UK provides stable inflation environment for investors. The price level in the UK does not considerably differs to other economies; thus, the current account of the balance of payments (hereafter "BoP") is not substantially affected by British inflation (World Bank, 2019b).

3.1.4. Savings and Investments

The level of investments exceeds the level of savings (World Bank, 2019c). In other words, the UK is a net debtor. However, that does not mean something harmful for the British economy. That simply means that the UK provides more investment opportunities than it can afford itself. Thus, it needs to borrow from abroad. That causes capital inflow into the British economy, as foreign investors are purchasing British securities. The imbalance between the rate of savings and rate of investments spills over into the imbalance of the current account of the BoP. Thus, that creates the outer imbalance as well. It is crucial to realize that a deficit of the current account of the BoP is driven by the financial account of the BoP. As long as the UK stays attractive for foreign investors, there is no need to be concerned by the imbalance between the savings rate and the investments rate. In the author's view, the British currency should remain attractive despite of current circumstances.

3.1.5. Consumption

The data on consumption confirms a generally accepted theory that consumption is an extremely stable variable (FRIEDMAN & SCHWARTZ, 1963; Kuznets, 1955). At the beginning of the period, the ratio of consumption on the British GDP created 66.83%. At the end of the period, it was 66.11 %. Eurozone and OECD members experienced stable development as well (World Bank, 2019d). The author of the thesis affirms that consumption is a crucial draught - horse of British economy.

3.1.6. Labor Market

It is important for economic growth so that growth in real wages was covered by growth in labor productivity. In other words, growth in labor productivity should exceed growth in real wages. The data for the UK show that growth in real wages dramatically exceeded growth in labor productivity until the financial crisis (World Bank, 2019e). The author is persuaded that such unrestrained growth in real wages significantly contributed to the extent of the financial crisis in the UK.

After the financial crisis, growth in labor productivity exceeded growth in real wages. This is a positive precondition for future economic growth. The difference was 0.6 % in 2018. However, growth in labor productivity was rather poor over last years; for example, labor productivity growth reached only 1.1 % in 2018 which is rather slow growth (World Bank, 2019e).

A generally accepted new Keynesian theory claims that wages are sticky-down, at least in the short run (Dixon & Hansen, 1999; Hall, 2005). In other words, deflation should not lead to a decrease in wages. We cannot confirm that from our data as the UK did not experience deflation. Nevertheless, we can conclude from the data that wages are definitely not sticky-up as their growth exceeded inflation in a great part of the period (World Bank, 2019e). We can also observe that lower growth of inflation leads to lower growth of wages. In general, wages in the UK do not seem to be really rigid. A case in point is a drop in the rate of wages growth during the financial crisis. The general unemployment rate in the UK was significantly low over the analyzed period in comparison with the average unemployment rate in the EU (World Bank, 2019e).

3.1.7. Balance of Payments

The UK has experienced the deficit of the current account during the whole period 2000-2018 (OECD, 2019a). At the first sight, it seems that the UK's deficit indicates something harmful. According to the author, the UK does not need to be worried by this deficit. The CA of the BoP is driven by the financial account of BoP and the surplus of the financial account infers that the British securities are attractive for investors. A high demand for the British currency causes its appreciation; accordingly, British goods and services become relatively less competitive which leads to a general decrease in imports.

3.2. The Analysis of Economic Policy

3.2.1. Fiscal Policy

The British tax revenues considerably exceeded the average of Eurozone and the average of OECD members (World Bank, 2019f). That could be caused by two factors. The first reason might be that the UK set significantly higher tax rates than other countries. However, there are not large differences between tax rates of particular economies. Thus, the author does not consider that to be an important factor. Moreover, higher tax rates do not necessarily mean higher tax revenues as it was proved by the Laffer curve (Wanniski, 1978). The second reason, which is, according to the author, valid, is that the UK is more efficient in collecting taxes. In the author's opinion, it is given by an advanced level of E- governance in the UK.

The UK maintained tax wedge under the average of OECD in the whole period (OECD, 2019b). A rather low tax wedge in the UK contributes to keep a low unemployment rate. The UK recorded a slightly higher tax wedge than the USA in a great part of the period; however, the difference was not significant. Countries with significantly high tax wedge might suffer a higher unemployment rate since firms might be discouraged to employ workers due to high labor costs.

3.2.2. Monetary Policy

The Bank of England carried out an expansive monetary policy between 2000 and 2008 (World Bank, 2019a). In the author's view, it is difficult to define optimal growth of money. It is necessary to create new money in order to boost economic growth; however, excessive growth of money eventually merely leads to high inflation (Friedman, 1956). There was huge creation of new money. However, this massive amount of new money did not really stimulate economic growth which remained rather stable. In the author's view, excessive creation of money also helped to deepen economic recession in the UK. The BoE should have increased an official bank rate in the period before the financial crisis. That would have prevented such expansive creation of money which was caused by a high number of loans granted. Another option was to establish a stricter regulation on the amount of loans. That would have also prevented such enormous money creation.

Households cut their spending when the financial crisis occurred. The BoE promptly responded by reducing an official bank rate from 5.50 % to 0.50 % in order to boost consumption and investments in 2009. However, that was not enough. The British economy remained in recession. The BoE did not have any other conventional tool to boost the economy; thus, it decided to use an extremely unconventional instrument called quantitative easing (hereafter "QE")(Bank of England, 2019).

In the theory, an expansive monetary policy, such as cuts in repo rates or QE, should lead to an increase in economic growth in the short run and an increase in inflation in the long run (Holman, 2010; Mankiw & Taylor, 2014). Nonetheless, we cannot observe that from the British data. Although there was a huge increase in the British money supply, economic growth did not appear to be significantly influenced. An exception occurred in 2009 when QE helped to overcome recession. If we focus on the relationship between the money supply and inflation, we will not notice correlation (World Bank, 2019a).

The quantitative theory of money claims that an increase in the money supply eventually leads to an increase in the price level (Fisher, 1920; Friedman, 1968). However, the data for the UK showed a different picture. Even though there was a high increase in the money supply, an inflation rate remained fairly stable for the whole period.

The explanation of this phenomenon could be given by the fact that people prefer to keep cash on hands. QE causes growth in liquidity; however, it does not ensure that people increase their spending. Moreover, the surplus of liquidity in the banking system might cause serious problems in the future since banks do not know how to use their liquidity.

A low interest rate also does not necessary persuade individuals to increase their consumption. John Maynard Keynes asserted is his famous work - The General Theory of Employment, Interest, and Money – that there is the possibility that the interest rate has fallen to a certain level when almost everyone prefers to hold cash and avoids purchasing bonds. The reason is that he/she expects an increase in interest rates in future and therefore, a decrease in bond prices as there is an inverse relationship between bond yields and bond prices (Keynes, 1935). In this case, a monetary authority would have lost its ability to influence interest rates. If we focus on the case of the UK, the liquidity trap could explain inefficiency of QE. The BoE purchases a large amount of government bonds. That causes a decrease in yields of these bonds. That decrease pushes down the interest rates offered on mortgages or business loans, since interest rates on government bonds affect other interest rates in the economy. That should motivate households and businesses to borrow money as it is cheaper for them (Bank of England, 2019). If they do that, new money will be created in the British economy. This creation of new money will stimulate consumption and investments which ensures growth in the British GDP.

However, as we found out previously, the last wave of QE did not support economic growth at all. The liquidity trap could provide an explanation. It is interesting that Keynes explicitly mentioned in his book that he never experienced an example of it hitherto (Keynes, 1935).

Milton Friedman criticized Keynes' theory. Friedman claimed that Keynes had omitted that people have more options where to invest their income. It is actually a great deal of options, such as properties, currencies, obligations, shares or human capital. Thus, interest rates have a limited effect on the demand for money (FRIEDMAN & SCHWARTZ, 1963).

In the author's view, the demand for money depends on several variables, such as income, wealth, transaction costs of holding money or interest rates. The British might prefer to keep their money on current accounts as they are risk - averse. Low economic growth could also indicate that the British are afraid of borrowing money as they still keep in mind the root of the financial crisis. The solution could be to abolish deposit insurance. That would motivate people to increase their spending and investments as they would lose their certainty that their deposits are in safe.

3.3. Competitiveness

Competitiveness is a crucial indicator which strongly influences the development of an economy. The table below shows competitiveness ranking for 2019.

Table 1 - Competitiveness ranking for 2019

			diff from 2018	
Rank	Economy	Score	Rank	Score
1	Singapore	84.8	+1	1.3
2	United States	83.7	–1	-2
3	Hong Kong	83.1	+4	0.9
4	Netherlands	82.4	+2	—
5	Switzerland	82.3	–1	–0.3
6	Japan	82.3	–1	–0.2
7	Germany	81.8	–4	–1.0
8	Sweden	81.2	+1	–0.4

9	United Kingdom	81.2	–1	–0.8
10	Denmark	81.2	—	0.6
11	Finland	80.2	—	—
12	Taiwan,	80.2	+1	1
13	Korea, Rep.	79.6	+2	0.8
14	Canada	79.6	–2	–0.3
15	France	78.8	+2	0.8
16	Australia	78.7	–2	–0.1
17	Norway	78.1	–1	–0.1
18	Luxembourg	77	+1	0.4
19	New Zealand	76.7	–1	–0.8
20	Israel	76.7	—	0.1

The source of data: own processing (World Economic Forum, 2019a)

The table displays that the UK occupies the ninth position in the ranking in 2019. If we focus merely on European economies, the UK places the fifth behind the Netherlands, Switzerland, Germany and Sweden. Overall competitiveness ranking clearly shows that the UK belongs to the strongest economies and there is an unambiguous precondition for stable economic growth in the UK. Overall competitiveness comprises twelve pillars : Institutions, Infrastructure, Macroeconomic environment, Health and primary education, Higher education and training, Goods market efficiency, Labor market efficiency, Financial market development, Technological readiness, Market size, Business sophistication, Innovation (World Economic Forum, 2019b).

3.4. SWOT analysis

The following picture summarizes an overview of the analysis in SWOT matrix.

Table 2: SWOT matrix

Strengths	Weaknesses
Stable and attractive currency	Low security rate
High final consumption of households an NPISH's	Quality of road infrastructure
Low unemployment rate	Low number of innovative companies
Macroeconomic stability	High tax on personal income
Large market size	Large government debt
Low corruption rate	Slow growth in labor productivity
Responsive fiscal and monetary policy	
Effectiveness in collecting taxes	
Growth in labor productivity exceeds growth in real wages	

Opportunities	Threats
Decreasing tendency in government budgets	Political instability
Decreasing tendency in government spending	Excess liquidity
Decreasing administrative requirements	Declining freedom of press
Increasing quality of research and development	Decrease in trade openness
Improvement of security	Increase in trade barriers
	Decrease in market size
	Low pupil- to- teacher ratio in primary education

The source of data: own processing

3.4.1. Strengths

The strong side of the UK's economy is a high demand for the UK's currency which causes inflow of foreign capital. That leads to higher economic growth. Another strong side of the British economy is enormous private consumption. Private consumption is a key factor for economic growth.

The UK experiences a fairly low and stable unemployment rate. That means that the UK is able to utilize a crucial production factor. That also saves government budget and ensures tranquility in society. All these factors stimulate economic growth.

The UK has been evaluated as a leader in the macroeconomic stability ranking (World Economic Forum, 2019a). The UK reached that result mainly due to a low inflation rate and a tendency to recently create lower budgetary deficits. Macroeconomic stability does not directly contribute to economic growth, but it is a key precondition for growth in the GDP.

Another strong side of the British economy is a large market size (World Economic Forum, 2019a). The UK has a large domestic market and, so far, has simultaneously taken advantage of being a member of the EU market. Both facts lead to a higher level of competitiveness in the UK.

The UK's economy keeps a low corruption rate (World Economic Forum, 2019a). That aids to trustworthiness in society which eventually leads to a higher number of transactions in the economy. Thus, that factor boosts economic growth.

An important factor stimulating positive economic growth is a responsive economic policy. The author considers the decisions of the British policy makers being appropriate. He especially appreciates suitable responses to economic recession which helped to overcome it.

The UK is efficient in collecting taxes due to an advanced level of E-government (World Economic Forum, 2019a). That is a further strong side of the UK's economy.

Another important strength of the British economy is the fact that labor productivity has being raised faster than real wages. If real wages rise faster than labor productivity, there will be a pressure on growth in inflation which would endanger economic stability.

3.4.2. Weaknesses

The UK suffers a high rate of organized crime and terrorism incidence (World Economic Forum, 2019a). Both creates insecure environment in society which results in lower economic growth. The UK should also improve the quality of road infrastructure which lags behind other developed countries (World Economic Forum, 2019a).

The UK does not have many innovative companies in comparison with other developed countries (World Economic Forum, 2019a). The number of innovative companies is important for competitiveness of economy.

The British taxes on personal income and on property are relatively high (TRADINGECONOMICS, 2019). Rates of these taxes significantly affect economic growth; thus, the UK should keep them low.

The UK has recently experienced low growth in labor productivity. An increase in labor productivity should be reached by an increase in human capital of workers.

Another weakness of the UK's economy is a large government debt. A current ratio of general government debt on the GDP is 86.9%. That causes problems for policy makers as they have limited options for conducting an appropriate economic policy. The UK's government should carry out more significant cuts in government spending.

3.4.3. Opportunities

The UK is successful in reducing the size of budgetary deficits which should eventually lead to a decrease in the size of the government debt. Another factor which contributes to a decrease in the government debt is that British economic growth was higher than interest rates of government bonds. A low government debt enables to conduct a responsive fiscal policy as the government is not limited by its debt; thus, it is important for the ability to conduct an appropriate fiscal policy. The author considers a decreasing tendency in government spending being the opportunity of the UK's economy. That creates more room for private investments and contributes to a decrease in the size of the government debt.

The author sees the opportunity in a decreasing level of administrative requirements. That helps to improve British competitiveness. For example, the UK has the lowest cost of starting a business from all countries (World Economic Forum, 2019a). British economic growth will be also stimulated by permanent growth in the quality of R&D.

Another opportunity is an increase in security. After Brexit, the UK can carry out its own security policy which should reduce crime and terrorism in the country. The UK will be also able to conduct its own migration policy and perform more reasonable approach to migration. These factors should lead to higher security in the country and therefore, would boost economic growth.

3.4.4. Threats

The British economy is currently facing several threats. There is extremely unstable political environment. Recently, the UK has experienced several prime ministers and a great number of changes in the government (World Economic Forum, 2019a). Stable political environment is especially importan,t for foreign investments. Otherwise, foreign investors might be discouraged to invest their capital in UK's securities.

Another threat is extreme excess liquidity caused by QE. The author asserts that it will reduce the effectiveness of monetary policy on controlling inflation.

Other identified threats are declining freedom of press and decreasing low pupil-to- teacher ratio in primary education (World Economic Forum, 2019a). The former might discourage foreign investors. The latter might lead to a lack of workers in future.

The last three threats relate to Brexit. The British withdrawal from the EU would cause a dramatic reduction of trade openness, increased trade barriers and a major decrease in market size. All these factors would significantly harm the British economic growth.

4. Discussion

The United Kingdom belongs to the most developed economies in the world and its development affects the rest of the world. That was confirmed in the paper. The paper provided a comprehensive overview of the UK's economic performance.

The paper has showed that the UK experienced stable and solid economic growth over the observed period with a massive decline in 2009 due to the financial crisis. In a great part of the examined period, the UK's economic growth exceeded the average economic growth in Eurozone but was lower than the average economic growth in OECD.

The UK's government debt has increased dramatically since the financial crisis, in 2018 reaching 86.9% of GDP. High government debts represent a problem for the majority of European countries which create a threat of another severe debt crisis in Europe. On the other hand, the UK was quite successful in creating lower budgetary deficits. Moreover, UK's economic growth has been exceeding costs of debt. For these reasons, there is a postulate for a future decrease of the British government debt.

The UK's currency is fairly attractive for foreign investors and the UK is a safety place where to invest savings. These merits help to stimulate an inflow of foreign capital in the UK which helps to equalize the difference between gross capital formation and gross savings in the UK. That also causes a deficit of the current account. In the author's view, the deficit of the current account means nothing harmful for the UK unless there is a decline in demand for British securities.

The UK has slightly decreased the level of government expenditure since the financial crisis. The author acknowledges that it is usually politically sensitive issue to reduce government spending; thus, he appreciates this trend in the UK. However, he would cut government spending more dramatically in order to substantially reduce the government debt.

A crucial strong side of the UK's economy is a huge and stable private consumption which largely contributes to economic growth. Households and NPISHs final consumption has exceeded the average of OECD and Eurozone during the whole observed period.

The UK has one of the lowest unemployment rates in Europe, in 2018 reaching 3.93%. That is an important determinant for economic growth since a key production factor is utilized. A low unemployment rate also saves the government budget as there is no need to pay unemployment benefits. The UK has a low long-term unemployment rate as well which indicates that the UK is able to even decrease its general unemployment rate because a significant part of the general unemployment rate is only frictional (World Bank, 2019e).

The UK also has a low youth unemployment rate in comparison with the average of OECD and Eurozone (World Bank, 2019e). That implies an efficient relationship between the British labor market and the British school system. The UK has recorded a rather high unemployment rate of unskilled labor force which indicates a decreasing number of job vacancies for low-skilled workers (World Bank, 2019e), which leads to the idea that the UK should regulate a number of low-skilled immigrants.

Growth in real wages in the UK has been covered by growth in labor productivity in most of the observed period (World Bank, 2019e). This is an important indicator for inner equilibrium. However, the author argues that growth in labor productivity should be slightly better.

The UK experienced the deficit of the current account of the BoP over the whole period. That simply means that there has been a high demand for British securities The UK performed average results in other indicators of outer equilibrium without any special threats.

The UK is efficient in collecting taxes which has been considered being the strength of the UK's economy. Monetary and fiscal policies conducted over the period were evaluated to be rather appropriate and responsive, which were considered being a strong side of the UK's economy. Nevertheless, the author disagrees with the second and the third wave of quantitative easing as that has not boosted the UK's economy and creates significant excess liquidity which might lead to serious harms for the UK.

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