A macroeconomic analysis of the united kingdom

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The UK economy is the fifth largest country economy in the world by real GDP. (Economic Watch 2008) From 1992 to 2006, the UK maintained in an average economic growth of 2. 5%, without any booms and busts. (Dunnell 2008) This steady growth was probably caused by easy credit and low interest rates, and it encouraged businesses to expand and invest, which led to the narrowing of the margin of spare capacity within businesses and caused unemployment to flatten off, at around 5%, since 1990s (DATA). Moreover, the low interests rates (2%) attracted individuals to buy house and this resulted in a double bubble in the stock and housing market which house prices tripled in some areas. This pulled the RPI and CPI to 4% and 3% respectively. As asset prices remained buoyant and high, the Bank of England raises the interest rate to 5% gradually to balance the aggregate demand and the aggregate supply so as to prevent the economy from overheating. This shifts hot-money in the stock market to banks and reduced investment spending as it increased cost for businesses to borrow. Finally, in terms of balance of payment, there was a widening of current balance deficit as exports increases while imports fall. This leads to an outflow of foreign currency, putting downward pressure on sterling.

However, problems with the repayment of subprime mortgages in the US triggered a tidal wave of concern about lending around the world in August 2007, which was the beginning of credit crunch. This was followed by the falling house prices and the instability of the banking market, such as the collapse of Bears Stearns and Lehman Brother. This raised concerns about banks' solvency and strains in global money markets and in turn created fragile consumer and business confidence. (Overview 2008) Their fragile

confidence was highlighted in the assets market where house prices and stock prices plummeted dramatically. Consumer felt poor and started to save due to the wealth effect (The saving rose to 5. 6%, the highest rate since 2004) whereas businesses stopped investing in new projects and ran down their inventories very sharply, (Chambenlin 2009a) significantly amplifying the decline in economic activity and pushing the economy into recession.

Although there is an increase of government spending by 3. 5%, the substantial fall of the retail spending (3. 9%), the investment levels (0. 1%), the exports(14%) offset the rise in government spending, which results in 3. 5% shrink in the UK economy. (Seager 2009) This slump in aggregate demand led to dramatic fall in prices, and pushed the RPI into negative (-1. 5%), implying the UK entered deflation. Worse still, as businesses and customers were uncertain about the future, they save and shed labour. Correspondingly, the unemployment rate rose to 7. 8% in the third quarter in 2009. As those unemployed were likely to tighten their belts, this in turn resulted in the drop of the aggregate demand and would have a negative multiplier effect on the economy and further spiral more unemployment.

To remedy this situation, government interferes the market by running demand management (expansionary fiscal policies) to boost the aggregate demand to reduce the deflationary gap (Gillespie 2008). Expansionary fiscal policies smooth out cyclical fluctuations by increasing government spending 3. 5%, such as building roads and airports. This initial spending can have a multiplier effect on the aggregate demand. Besides, the tax cut, such as cutting VAT to 15%, can increase peoples' disposable income and provide

incentives to spend. These can shift the aggregate demand to the right to speed up the recovery.

Although the fiscal policies can reduce unemployment in the short term, they cannot be used to change real output in the long term because the long run aggregate supply curve is vertical. Pushing the aggregate demand curve to the right will simply push up the price and cause demand-push inflation). (Gillespie 2008) Therefore, fiscal policy is often accompanied by monetary policy (controlling the money supply and the interest rates of an economy). The slash of interest rates from 5% to 0. 5%, (BBC) can encourage people to spend and invest instead of saving as the interest return is reduced. However, the effect seemed be very limited and hence, £75bn was injected by quantitative easing in terms of government bonds and gilts to increase money supply and encourage banks to lend. (BBC) Additionally, by lowering the interest rate, the exchange rate of the UK will depreciate as price of export will fall while the price of import will increase. As people tend to buy cheaper goods, the net export (Balance of Payment) will improve, which then again right-shift the aggregate demand.

Owing to the extensive macroeconomic stimulus implemented by governments and central banks, the pace of falling output has slowed considerably compared to the previous two quarters—the GDP rises from to negative -0. 6%, ‘ raising hopes that the UK is nearing a turning point’. (Chambenlin 2009b) Although the falling speed of the GDP has moderated, this trend does not appear in the labour market. In the second quarter of 2009, the unemployment rate stood at 7. 8 per cent, up from 7. 1 per cent in quarter one. This is because unemployment rate is a lagging indicator,

meaning that firms are unlikely to start recruiting until they are certain a sustained recovery is underway. Therefore, the labour market could continue to weaken even the economy officially emerges from recession. However, with higher demand for products, the demand for factors of production increases, which reduces firms' excess capacity and pulls up prices and causes inflation—The CPI increases from 1. 9% to 2. 9%. (Chambenlin 2009c)

Nevertheless, the timing and strength of that recovery is highly uncertain as Alistair Darling admitted in his Pre-Budget report that the recession is proving even deeper than feared. (Oxlada 2009) This is because the rise of GDP is solely supported by the government spending, rather than consumer spending—the most important element in the GDP. Because of that, the Bank of England decides to maintain the current interest rates 0. 5% to ensure the economy could emerge from recession fundamentally. Moreover, what the government did in 2008 may bail out major companies and be beneficial to the economy in the short-term, however, the long-term impact was unknown. For example, the government net borrowing rises to 750 billion pound, which is the equivalent of 5. 4% of GDP. (Chambenlin 2009b) This affects the tax rate in the future. Apart from that, hyper-inflation may occur due to the great injection of money by quantitative easing (75 billion), leading to the next recession. More extremely, economists argued that the economy will re-enter the recession and the recovery may be W-shaped once the government stops intervening the market. (Oxlada 2009)

Under this recession, businesses are affected in different degrees, depending on the slope of the short run average total cost curve (SRATC). The steeper the SRATC curve, the higher the cost penalty. This is because when demand

falls, a short run scale diseconomies exists and average cost rises, which then squeezes the profit margin. Airline industry (British Airways) is one of the most vulnerable businesses. It has a steep short run cost curve since it has a high fixed/variable cost. It owns a lot of aircrafts which will be grounded when the no. of passengers drop significantly. The maintenance and the parking cost for the aircraft is high, regardless of the no of passengers BA have. It also has high quasi-fixed personnel costs, such as crews. The average salary per crew was 29000 pounds per year. Although British Airways planned to cut the crew members from 15 to 14 per flight, it was not successful due to the employment law.

Not only does its asset utilization worsen, British Airways also faces a dramatic increase in external bought in costs, i. e. oil prices. According to the International Air Transport Association (IATA), the world's airlines would lose $5. 2 billion in total last year owing to the record fuel prices, and every $1 increase in a barrel of oil would add $470 million a year in jet fuel costs to the airline industry. Not surprisingly, owing to the tremendous high operation cost, British Airways is heading for 1 billon loss this year. This fluctuation in financial performance reflects their vulnerability and exposure to macro-economy shocks. Worse still, under a recession where straitened economic conditions affected consumer and business travelling, customers tend to be more price -orientated and may switch to low-cost airlines such as Ryanair and Easyjet. However, highly dependent on high cost fares and business passengers, BA cannot remain competitive with its rivals as it is too slow to respond to changing consumer demand. (Rego 2005)

In order to avoid themselves from external shocks, BA needs to lower the fixed/variable ratio so as to reduce the cost penalty. They should lease their planes rather than buying them. Though BA will lose the property ownership and that the balance sheet may not be that attractive in the short-term, its long term interests can be safeguarded. Moreover, salaries of BA crews should be cut as they are twice to crews in Virgin Atlantic. (Robertson 2009) Although this may have a negative influence on the morale of BA crews, managers can increase their fringe benefits and welfare to compensate it. Apart from that, BA should adjust their market approach and be more flexible. Rather than mainly focusing on business-class passengers, they should also concern about the economy-class passengers as they are the majority of passengers. The cost of air tickets need to be lowered, according to the economic situations and rivals' actions, especially under a recession. This can retain more passengers and avoid them to switch to budget airlines. More importantly, in the long-term, BA needs to exploit and create market imperfections in order to gain competitive advantage, e. g. product differentiation creates the protection which increases profitability and also reduces the cyclical variance of profit. For example, BA can add-value to their services by rising food quality and services standard. Although this may increase the cost, it helps to capture brand loyalty of customers to make repetitive flights.

To conclude, the UK economy has a steady GDP growth, low unemployment, low inflation before 2008, which produces a steady environment for businesses to invest. However, due to the collapse of major banks and the housing markets, the UK economy shrunk significantly with unemployment

rising to an unprecedented level. Spending on consumer durables fell further, reflecting weak consumer and business confidence. To tackle this situation, the Bank of England has adopted fiscal policy and monetary policy, such as quantitative easing and lowing interest rates, to ameliorate the global downturn and moderate the pace of contraction. Although there is some data showing that the UK is emerging out of recession, the future will be tough while the strength of the recovery remains uncertain. Facing this bleak future, businesses are recommended to differentiate themselves in order to gain competitive advantage.

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