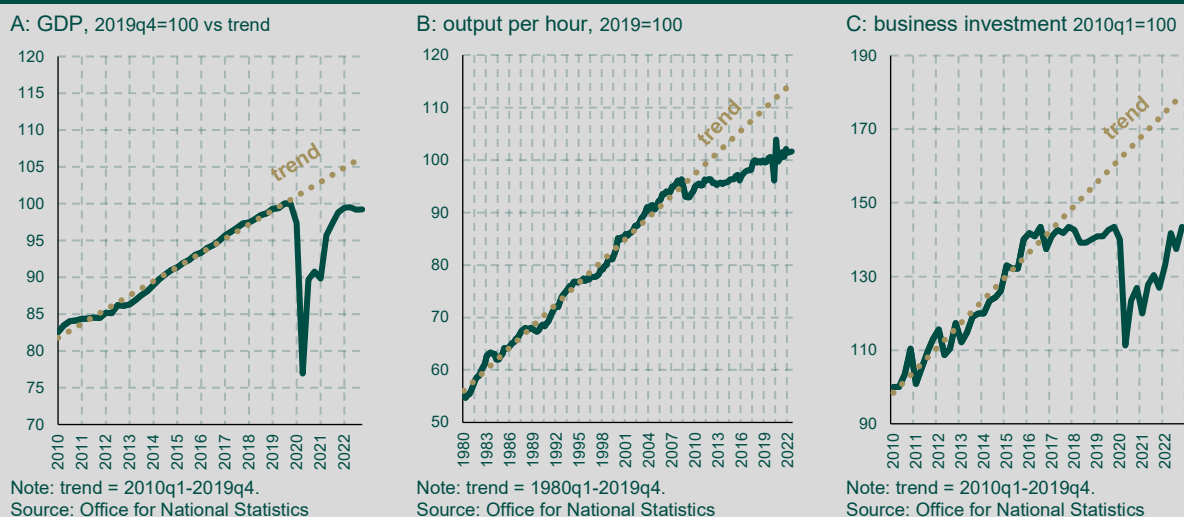


Box 2: Key macro-trends in the UK economy – an overview

Notwithstanding much greater diversification over the past half century or so, the UK remains an important market for Irish exporters. This is especially the case for indigenous firms in more traditional sectors, mainly comprised of micro- as well as small- and medium-sized enterprises. Given its prominence as an export market for many labour-intensive, Irish-owned firms, monitoring economic developments in the UK economy is an important part of the Department's economic assessment toolkit.

The evolution of UK output, productivity and investment since the beginning of the last decade is set out below (**figure 4A**). The dashed line represents the trend growth between 2010-2019, extrapolated forward to 2022. In a sense, it represents a hypothetical scenario in which there had been no pandemic or energy price shock; in other words, it is a reasonable approximation as to what the level of activity might have been in the absence of the pandemic and war in Ukraine.

Figure 4: Key macro trends in the UK since 2010



The most striking aspect is that, at the end of last year, the level of activity in the UK is not only 7/8 per cent below the level implied by the hypothetical no pandemic / no war scenario, it was also below its pre-pandemic level. This is in sharp contrast to other regions such as the euro area and US, where activity has surpassed pre-pandemic levels and almost back at levels implied by the pre-pandemic trend growth rate.

These trends beg the question as to source of the headwinds holding back economic activity in the UK. This is far from an academic question, given the importance of demand in the UK for Irish producers. While a full diagnosis of the UK economy is beyond the scope of this box, it is insightful to group the various headwinds into short-term (demand) developments and medium-term (supply-side) factors.

A key short-term headwind relates to inflation where, given a relatively high dependence on natural gas as an energy source, the dynamics of UK consumer prices have been more adverse than elsewhere.[^] Related to this, the monetary policy response in the UK has been more aggressive than in the euro area, which is also weighing on demand (it is also possible that the pass-through to the real economy is faster in the UK due to a greater home-ownership rates than in many euro area Member States).

Leaving aside these short-term factors, it is clear that the UK economy has underperformed in recent years, suggesting persistent supply-side factors at work. For instance, the post-pandemic participation rate is around 1 percentage point below its pre-pandemic level (the 'big quit'),^{^^} with most of this due to lower participation amount those aged >50 (early retirement, health issues associated with 'long-Covid'). Migration may also be a factor holding back labour supply, with the UK having formally exited the European Union at end-January 2020 and, in doing so, reduced net inflows (relative to the counter-factual scenario).

From a supply-side perspective, the other key input is labour productivity which, in the UK, has been almost stagnant since 2010 (**figure 4B**). While several explanatory factors have been put forward, perhaps the most compelling relates to the relatively low level of business investment (**figure 4C**), which has essentially moved sideways since 2016. One possible explanation for the stagnation in investment spending relates to heightened level of uncertainty regarding prospects for the UK economy upon exiting the European Union, with firms less likely to undertake large capital outlays against the backdrop of a more uncertain macro-economic environment.

[^] UK inflation vis-à-vis other jurisdictions is evident from the main text (**figure 2B**).

^{^^} The change in UK labour force participation rates is evident from the main text (**figure 10A**).