The UK economy

Overview

Growth in the world economy has slowed significantly but more so in the developed economies and in particular the US, whilst China and India continue to do well. The financial crisis, lack of credit, a collapse in the US housing market and high oil and commodity prices have combined to adversely affect growth in 2008 and into 2009. One of the major problems for the world economy is the uncertainty this situation brings. Financial assets are seen as risky, property is not performing as well as in previous years so funds have been channelled into oil and other commodities. This has contributed to their current high price but speculation is not the sole driver of change. The risk for the world economy is that if this behaviour persists then there is real danger of prolonged and stronger inflationary pressures building in the economy. Governments and monetary authorities have recognised this early on and acted aggressively to combat this with lower interest rates and fiscal packages. The dollar and sterling have depreciated sharply while the Euro has gained on these currencies. Trade makes a significant contribution to GDP in the Asian economies and it is expected to become more important in Europe in 2008 and 2009. The world is forecast to grow at slightly lower rates in 2008 but activity is expected to pick up in 2009 and 2010. China, India and Japan are not expected to suffer significant effects from the current crisis. The risk for the world economy remains prolonged inflation, further fallout from financial markets, a slower recovering in the housing markets and any unanticipated weakening of labour markets.

UK GDP increased by 0.4 per cent in 2008Q1 and was 2.5 per cent higher than the same quarter of 2007. GDP increased by 0.6% in the third and fourth quarters of 2007. The service sector grew by 0.6 per cent in 2008Q1 on the previous quarter while industrial production contracted by 0.2 per cent.

Consumption rose by 1.3 per cent in 2008Q1 which is 3 per cent higher than the same quarter of 2007. Consumption only grew by 1.6 per cent in the previous year. Investment slowed from 7.2 per cent in 2006 to 6.2 per cent in 2007. In the first quarter of 2008 investment declined by 1.6 per cent. In the same period export growth was flat while imports contracted by 0.6 per cent. The UK employment rate has remained fairly constant although the net job creation slowed slightly in 2007 compared to 2006. Employment only grew by 12,000 in February 2008 compared to 48,000 in the previous month. ILO unemployment increased in Dec 2007 and in Jan and Feb of 2008 but the unemployment rate remained at 5.2 per cent. Claimant count increased to 806,300 in April 2008, up from the previous two months but again the rate stayed at 2.5 per cent. CPI inflation rose to 3 per cent in April from 2.5 per cent in March largely due to rising oil and food prices.

Outlook

The consensus forecasts for the main UK economic indicators are taken from a monthly survey by HM Treasury of City and other independent forecasters and are presented in Table 1. Real GDP growth is forecast to grow by 1.7 per cent in 2008 and by 1.6 per cent in 2009 according to HM Treasury comparison forecasts, the Treasury's own forecast is for growth are slightly higher than this. HM Treasury forecast for the UK real GDP growth are 2 per cent for 2008; 2.5 per cent in 2009 and 2.75 per cent in 2010. Comparing city and independent average forecasts against those of HM Treasury demonstrates that HM Treasury has a more accurate forecasting record. Inflation is forecast to grow by 2.8 per cent this year and 2.1 per cent next year. This will continue to be driven by high and rising oil prices and strong food price growth. The labour market remains relatively strong, although there are signs of a slight rise in unemployment, and this should help to support consumption. The two key factors for recovery in the UK economy are how well the labour market performs and supports incomes and consumption, and secondly if there any further unanticipated adverse effects still to come from the financial crisis, the housing market or from prolonged high and rising prices. Given that household spending increased by only 0.1 per cent in 2007Q4, retail sales fell by 0.4 per cent in March and the lack of robust consumer confidence it does look a gloomy picture going forward. However, consumers have proved resilient before and it may be the UK is in a stronger position with a significant number of people in employment and earning incomes. This and the fact that most commentators believe the majority of the fallout from the housing and financial crisis have occurred. This leaves the UK in a relatively healthy position looking to the next three years.

Output growth and components of demand

Real GDP growth (chained volume measure) for the UK grew by 0.4 per cent in 2008Q1 compared to 0.6 per cent growth in both the previous two quarters. On an annualised basis growth is 2.5 per cent, down from the 2.8 per cent annual growth of the last quarter. GVA increased by 0.4 per cent in 2008Q1 compared to the growth of 0.6 per cent in 2007Q4. GVA annual growth was 2.5 per cent but when oil and gas are excluded this rises marginally to 2.6 per cent. These data also fit with the preliminary estimate of GDP and GVA.

UK consumption slowed to 0.1 per cent in 2007Q4 but grew by 1.3 per cent in 2008Q1. Annual growth in 2007Q4 was 2.4 per cent and in 2008Q1 it was 3.0 per cent. The performance for consumption in 2008Q1 is better than expected given the economic conditions and was only matched recently in 2007Q1 and 2006Q2.

Table 1: Independent forecasts of the UK economy, 2006 to 2012

	2006	2007	2008	2009	2010	2011	2012
Real GDP growth (%)	2.9	3.0	1.7	1.6	2.5	2.6	2.6
Inflation rate (CPI %)	2.3	2.3	2.8	2.1	2.2	2.2	2.1
Inflation rate (RPI %)	3.2	4.3	3.1	2.4	-	-	-
Inflation rate (RPIX %)	2.9	3.2	3.3	2.5	2.6	2.7	2.6
Claimant count, (million)	0.94	0.86	0.87	0.96	0.99	1.00	0.96
Employment growth (%)	0.5	0.5	0.5	0.1	0.3	-	-
Average Earnings (%)	4.8	3.8	4.0	4.0	3.8	3.7	3.7
ERI (2000=100)	102.7	105.0	93.3	93.3	95.5	95.2	95.1
Current account (£ billion)	-50.7	-57.8	-56.2	-50.3	-45.1	-44.8	-44.8
(per cent of GDP)	-3.9	-4.2	-3.5	-3.1	-2.8	-2.7	-2.6
PSNB (£ billion)	32.1	35.2	41.9	42.1	41.0	39.0	36.5
(per cent of GDP)	2.4	2.5	2.9	2.7	2.6	2.3	2.1

Source: National Statistics, *National Institute Economic Review*, **204**, April 2008 and *"Forecasts for the UK economy",* HM Treasury, **253**, May 2008. Note: PSNB is given for financial years, e.g. 2006 is 2006/07

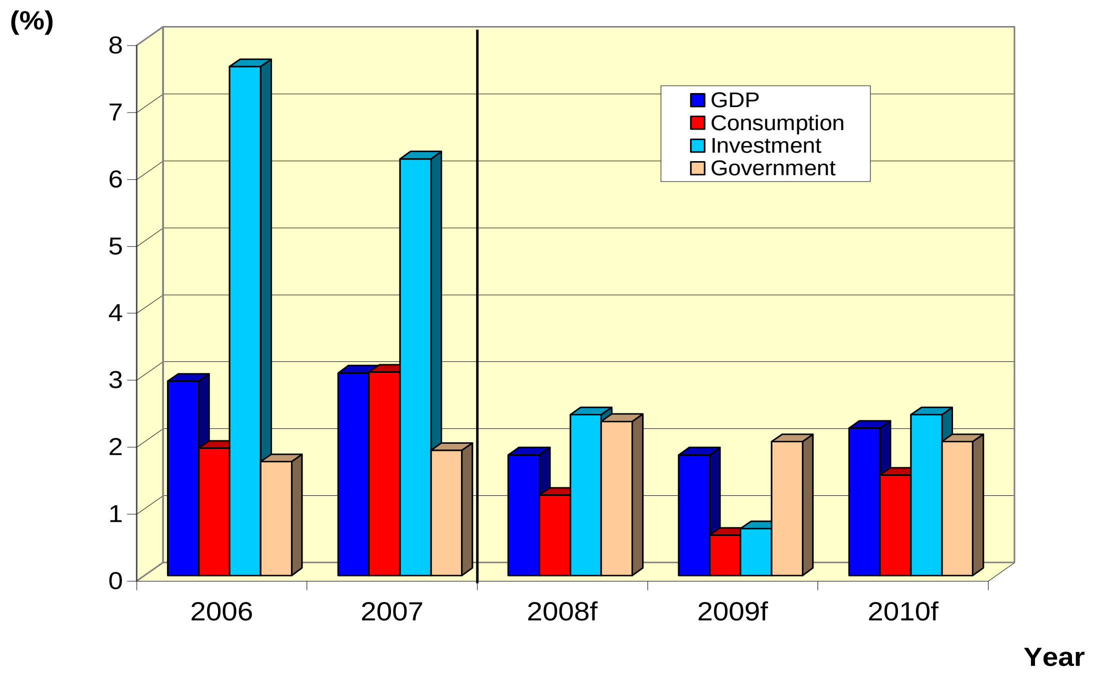
In contrast investment contracted by 1.6 per cent in the 2008Q1 and grew by 1.8 per cent and 2.1 per cent respectively in the previous two quarters. Annualised growth in 2008Q1 was 1.1 per cent but this compares with growth of 4.1 per cent for 2007 and by 9.3 per cent on the year 2007Q1 on 2006Q1.

Government expenditure advanced by 1 per cent in the latest quarter after contracting by 0.5 per cent in 2007Q4. Annual growth was 2.5 per cent in 2008Q1 compared to 2.8 per cent for 2007 as a whole. In 2007Q1 growth over the year was 3 per cent. At the moment the components of demand look relatively healthy but these are not likely to grow at the current rate. Figure 1 demonstrates the possibility of a sharp reduction in investment and slightly less aggressive cut in consumption in the next two years. Business investment fell by 1.4 per cent in 2008Q1 but was 3.7 per cent higher than the first quarter of 2007. Manufacturing investment contracted by 4.9 per cent in 2008Q1 and by 2.8 per cent annually.

Figure 2 illustrates UK broad sectoral growth. Clearly services drive GDP growth but it can be seen from 2006Q4 this growth has been trending down. UK GDP since the second half of 2007 has also been slowing. Manufacturing appears to be slightly volatile and suffers more from external pressures (exchange rates, interest rates, changing commodity and raw material prices etc.). Agriculture, construction and all the service sectors (except government) grew at or above 2.5 per cent on an annual basis in 2008Q1. The strongest performers were financial services (12.8 per cent annually); REBS (4.9 per cent) and transport, storage and communication service (4.5 per cent). These are accepted as the ‘fast’ growing services. When quarterly growth is considered for 2008Q1 then the strongest sector was financial services which expanded by 5.2 per cent. The weakest sectors are mining & quarrying and electricity, gas & water supply which both contracted. Growth in hotels & catering was flat in 2008Q1 and only grew by 0.3 per cent annually and REBS contracted by 0.3 per cent in the first quarter of 2008, following growth that slowed from 2.1 per cent in 2007Q3 to 1.1 per cent in 2007Q4. Most commentators expected the data to be weaker but the growth in retail and financial services was stronger than expected (more so in the case of the latter).This was contrary to expectations because the tighter credit conditions and housing slowdown led to the belief that retail sales, investment, consumption, construction, financial services and property activity would all be reduced. Perhaps in the second quarter there will be a more marked slowing of activity as indicators are more pessimistic going forward.

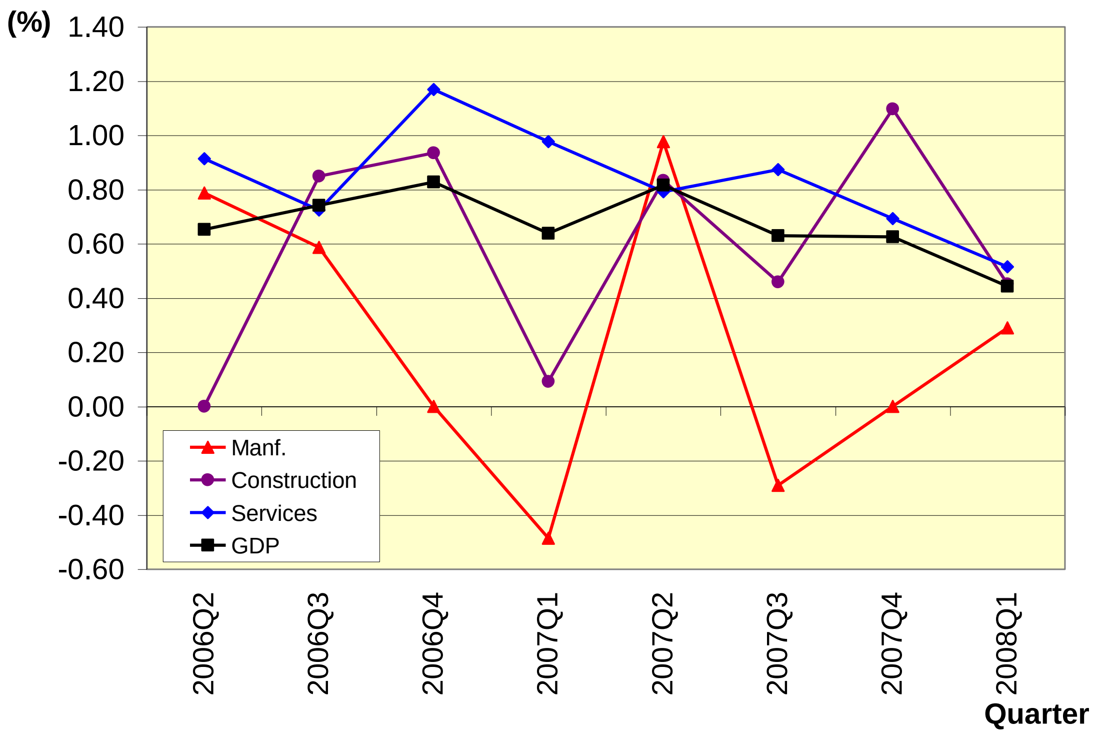
One reason put forward for this unexpected performance is the improved resilience of the UK economy (Gurney (2008)[1]. The author cites long-term macroeconomic stability and less stringent product and labour market regulation. The two key outcomes from economic shocks are (i) the impact of the shock and (ii) the persistence of the shock. Overall, all OECD economies improved their resilience over the study period but in the period 1994-2005 the UK was the most resilient economy to shocks. This suggests that economies are better able to absorb shocks; that the credibility of policy is enhanced and consequently the persistence of shocks is shorter. Of course the caveat to this type of work is that past performance may not necessarily be a good guide to future outcomes. Given the nature of the outturn data in 2008Q1 it may be that the UK economy is more resilient to shocks than previously thought. In 2006 energy prices soared by 14.7 per cent and whilst this was accompanied by a slowdown in the housing market spending still increased by 1.9 per cent.

Figure 1: UK Components of Demand and GDP Growth (Actual and Forecast) 2006-2010



Source: ONS UK National Accounts, May, 2008 and National Institute Economic Review, 204, April, 2008 (forecasts)

Figure 2: UK Broad Sector Quarterly Growth (%) 2006-2008



Source: ONS UK National Accounts, May, 2008

In the three months to April 2008 retail sales grew by 1.5 per cent but between March and April the volume of sales month-on-month declined by 0.2 per cent. In March 2008 retail sales grew by 1.9 per cent. Sales in April were 4.8 per cent higher than in the same period one year ago. The index of production in 2008Q1 fell by 0.2 per cent. Between March and April manufacturing output declined by 0.5 per cent but for 2008Q1 it increased by 0.3 per cent. Most sectors weakened from 2007 onwards and the trend in sectors is either flat or slightly negative with no sector demonstrating a substantial increase. Manufacturing is the most upbeat sector with growth of 1.5 per cent in 2006 and 0.6 per cent in 2007. The index of services grew by 0.5 per cent in March 2008 compared to 0.4 per cent in February and 0.6 per cent in January. The trend in services is generally upwards but the trend in hotels & catering services is relatively flat. Overseas visits to the UK increased by 6 per cent to 8.5 million in the three months to March 2008. Business and financial services have slowed in the first quarter growing by 0.4 per cent compared to 0.6 per cent in the previous quarter. Overseas earnings grew by 4 per cent to £4 billion in the same period. However, over the year the number of visitors to the UK declined by 1 per cent as visits from the US decreased by 6 per cent.

Construction orders were unchanged in the first three months to March 2008 and orders in the first quarter decreased by 8 per cent when compared to the same quarter a year earlier. Private housing orders fell by 13 per cent in the year to March 2008 while public housing orders declined by 11 per cent. Infrastructure orders rose by 17 per cent in the same period and public non-housing construction grew by 15 per cent. Commercial orders (non-housing) increased by only 2 per cent in the 12 months to March 2008 and private industrial orders decreased by 13 per cent over the same period.

The UK economy is set to experience lower economic growth and lower consumption growth. The growth that will occur will be driven by the service sector. There is considerably more uncertainty surrounding financial services and real estate & business services (REBS). Manufacturing is forecast to grow by 1.1 per cent in 2008 and by 1.6 per cent in 2009. The main problem for households is that banks are re-pricing risk and that makes personal credit conditions tougher. This combined with the slowdown in the housing market will particularly impact on investment and to a slightly lesser extent on consumption. Net trade will become a more important component of GDP as exports pick up and import growth slows. There was a fiscal boost to the slowdown of 2001-02 but this is not in place this time so consumers will have to bear most of the burden themselves. There will also be a deterioration in the public finances as a result of the slowdown.

The UK current account

The current account recorded a deficit of £8.5 billion in 2007Q4 and this was -2.4 per cent of GDP. The main movements include a surplus on income compared to a deficit in 2007Q3; a higher surplus on the trade in services and an increase in the deficit of current transfers. For 2007 the current account deficit was £57.8 billion or -4.2 per cent of GDP. This compares with a deficit of £50.7 billion for 2006 (-3.9 per cent of GDP). The outlook for the current account is that it will contract to -3.5 per cent of GDP (-£56.2 billion) in 2008 and to -3.1 per cent of GDP (-£50.3 billion) in 2009. The deficit with EU countries widened to £13.6 billion in 2007Q4 from £10.7 billion in 2007Q3.

The UK trade deficit on goods and services is estimated to have shrunk to £4 billion in March 2008 compared to £4.3 billion in February. In 208Q1 the deficit increased from £13.1 billion in 2007Q4 to £13.4 billion. The latest estimate of the trend deficit is that the trend remains flat. The balance of trade with most countries remains negative except the US and Ireland. The trade in oil is also in deficit and contracted slightly in 2008Q1 compared to 2007Q4. The depreciation in sterling is expected to help exports. In March 2008 imports declined by 0.2 per cent while exports increased by 0.7 per cent. The UK continued to have a surplus in services of £3.4 billion for March compared to £3.3 billion in February. The surplus for 2008Q1 was slightly down at £9.6 billion compared to £10.1 billion in 2007Q4.

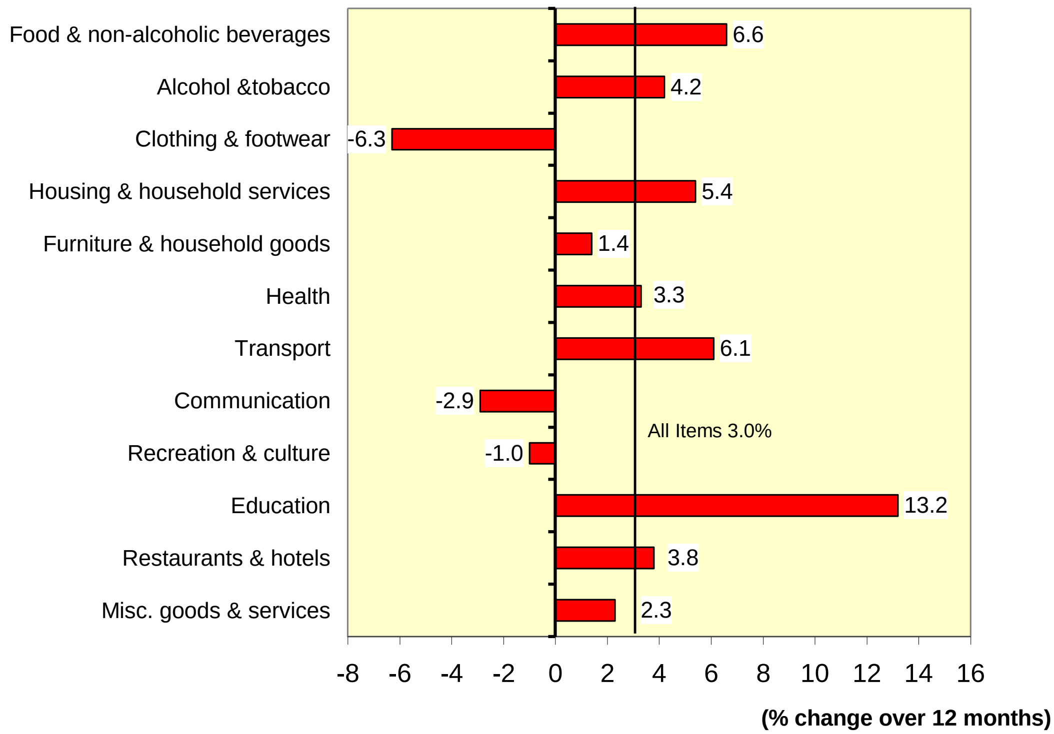
The public finances in April had a current budget surplus of £0.6 billion with net lending (PSNB) of £0.5 billion. For the financial year 2007-08 is £34.3 billion. Net debt at the end of April was £526.8 billion or 36.5 per cent of GDP. This compares with 35.5 per cent in April 2007.

Prices

The Bank of England's Governor has already had to write to the Chancellor once when CPI inflation exceeded 3 per cent in March 2007. He may have to do so again as CPI inflation rose to 3 per cent in April, up from 2.5 per cent in March. The index now stands at 107.6 in April 2008. The all items RPI increased by 4.2 per cent in April but in March 2007 this rose by 4.8 per cent. When mortgages are excluded then RPIX inflation rose by 4.0 per cent in April 2008 compared to 3.9 per cent in March 2007. There are clear indications that inflation is rising relatively strongly across all measures. The main upward movement in CPI inflation is driven by housing; water; electricity; gas and other fuels. Other significant contributions came from food and non-alcoholic beverages; miscellaneous goods and services; alcoholic drinks in restaurants; increased excise duty on alcohol and cigarettes; recreation and culture and from furniture and household goods. The most significant downward contribution came from transport costs (mainly air fares to Europe) and clothing prices fell slightly. Petrol increased by 1.9 pence per litre on average and is now 108.2 pence per litre. The price of diesel also increased but by 4.3 pence per litre.

Figure 3 clearly shows that food, household goods and services, transport and education are driving inflation. Externally the high price of oil and commodities feed into

Figure 3: Twelve month Comparison of CPI Main Components, April 2008



Source: ONS CPI First Release, May 2008

these pushing up their prices. This poses a dilemma for the Bank of England who has a remit of maintaining CPI at the target (2 per cent with 1 per cent either way). The interest rate is used to control domestic inflation but this works with a lag. If rates are increased too much or too soon then growth and spending will be adversely affected. The Bank of England reduced the base rate from 5.25 per cent to 5 per cent in April. They are balancing the risks: on the upside above-target inflation this year could raise inflation expectations. On the downside the crisis in financial markets could potentially be very severe and drag inflation below the target. The MPC are perhaps relying on the spare capacity in the economy later on in the year and that the depreciation in sterling will help exports. These factors may help to keep inflation subdued in the medium-term. If persistently high commodity and oil prices exert pressure on the economy externally then inflation will be driven up despite the best efforts of the MPC. On balance rising inflation is probably a more significant threat to the UK economy than the loss of output from slowing growth. The outlook for inflation and interest rates is presented in Table 1.

The labour market

UK employment increased by 117,000 in the period Jan-Mar 2008 and the employment rate increased marginally (by 0.1 percentage point since the last quarter) to 74.9 per cent. Over 12 months employment has increased by 466,000 while the employment rate has increased by 0.6 percentage points. Employment now stands at 29,538,000 for Jan-Mar 2008. This is good news for the UK economy at this time because a healthy labour market will be needed to support the economy through the difficult conditions ahead. Economic activity increased by 131,000 in the last quarter and by 383,000 over the year. The economic activity rate is now 79.1 per cent and has increased steadily since 2006. The economically inactive declined by 22,000 in 2008Q1 compared to a fall of 7,000 in the previous quarter. On an annual basis economic inactivity has climbed by 43,000. The economic inactivity rate has fallen to 20.9 per cent in 2008Q1. In Jan-Mar 2007 it was 21.2 per cent. Within employment the number of people who are self-employed increased by 39,000 in 2008Q1 and over the year by 54,000. There are 3,863,000 self-employed people in Jan-Mar 2008. For employees only, the quarterly increase was

69,000 and the annual rise was 391,000 with 25,450,000 employees in 2008Q1.

ILO unemployment increased by 14,000 in Jan-Mar 2008 but was down by 83,000 over the year. Unemployment is currently at 1,612,000 or 5.2 per cent (aged 16+) or 5.3 per cent (16-59/64). The ILO unemployment rates have been dropping steadily since Jan-Mar 2007. The rate has fallen 0.3 percentage points since Jan-Mar 2007. Claimant count unemployment for April 2008 was 806,300 or 2.5 per cent (all aged 18+), an increase of 7,200 on the previous month but a decline of 83,000 over the year. At this time last year the claimant count rate was 2.8 per cent. Both measures of unemployment had been declining until January 2008 when unemployment started to rise. The trend for unemployment is relatively flat at the moment. The numbers of long-term unemployed has been falling; it is short-term unemployment that is rising.

Full-time employment rose by 84,000 to 22,027,000 in Jan-Mar 2008 and increased by 369,000 on an annual basis. Similarly part-time employment grew by 33,000 and by 96,000 over the same periods respectively. The number of government supported trainees has been rising for some time now and increased by 7,000 in the latest period and by 16,000 over the year. Unpaid family workers increased by a small amount; 3,000 over the first quarter and by 5,000 over the year. Workers with second jobs increased by 34,000 on an annual basis but dipped slightly on a quarterly basis.

The workforce jobs series for Dec 2007 largely support the LFS data with strong employment growth although self-employment contracted over the quarter. On an annual basis the number of workforce jobs increased by 208,000; employee jobs by 179,000; self-employment by 41,000 and the number of trainees declined by 4,000. The average earnings index for all jobs increased by 4 per cent for the three months to March 2008. The rise in the private sector index was also 4 per cent while the public sector increase was 3.8 per cent. In private sector services the AEI rose by 4.4 per cent and increased by 3.8 per cent for manufacturing. Unit wage costs increased by 2.7 per cent in 2007Q4 while output per worker growth slowed to 1.7 per cent compared to 2.3 per cent in 2007Q3. The number of vacancies decreased from 692,800 to 665,100 but increased by 13,000 over the year. The vacancy ratio was 2.6 per cent in April 2008.

For the period Dec 2007 job losses were recorded in manufacturing (-29,000 quarter-on-quarter and –53,000 over the year); construction (-19,000 quarter-on-quarter and –7,000 over the year) and other services (-13,000 quarter-on-quarter and –12,000 over the year). Finance & business services lost 5,000 jobs in Dec 2007 but gained 149,000 over the year. A total of 13,000 jobs were created in Dec 2007 and over the year total job gain was 208,000.

Overall the UK labour market remains healthy and currently continues to provide employment growth, a high level of economic activity and significant self-employment opportunities. UK unemployment continues to be low and is forecast to remain so. Clearly, productivity growth could be stronger, employment costs could weaken and there could be fewer people in the economic inactivity group than there are.

The outlook for the UK economy remains better than expected in the short-term although clearly there is going to be a slowing of growth moving forward into 2008 and 2009. The UK economy is forecast to grow by 1.8 per cent in 2008 and by 1.6 per cent in 2009. There is a probability that if there is no further adverse impacts from the housing or financial markets that the UK economy will recover towards the end of 2008 and that growth in 2009 could be the same as 2008 (as per the NIESRC forecast). CPI inflation is forecast to increase by 2.8 per cent in 2008 and 2.1 per cent in 2009. The most worrying aspect of the downside risks to the economy is the prospect of prolonged and/or strong inflationary pressures building in the economy. While the UK has avoided inflation a wage bargain spiral it would be difficult to sustain a tough stance on wages if inflation were high for a protracted period of time. The main risks to the UK economy are: any further unanticipated fallout from either the housing market or financial markets; a sustained rise in the oil price and/or combined with high commodity/food prices; a considerable weakening of the UK labour market and a stronger than anticipated significant slowdown in Europe. The two key factors for the UK economic recovery are the continued support for consumption and incomes from the labour market and the degree to which the financial/housing markets crisis impacts on the real economy.

Endnote:

[1]Gurney, A. (2008) 'Resilience in the UK and other OECD economies', HM Treasury Economic Working Paper No 2, March, HM Treasury.

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