

The UK economy

Overview

Across the globe world economic growth remains relatively strong despite a slight slowing in the US. Inflationary pressures are more clearly seen as a threat to prices as energy costs continue to grow. The general trend is for a tightening of monetary policy to combat inflation. The performance of the US, Japanese and Chinese economies have all stimulated world demand and trade. The Euro Area is forecast to pick up significantly as activity strengthens there. The only real concern there is the growth of German consumption. Emerging markets and other Far East economies also continue to perform well.

In the UK real GDP growth was 0.7 per cent in 2006Q2, revised down from its original estimate of 0.8 per cent. This was identical to first quarter growth and growth in 2005Q4. The level of GDP is 2.6 per cent higher than the same quarter in 2005. Consumption growth returned to trend and the expectation is that UK real GDP growth will be close to trend over the next year. The labour market continues to perform well and there is a broad based contribution to GDP. The public finances and the current account are in manageable positions and do not pose a threat to the economy. The UK economy is performing well overall and faces an optimistic future.

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 was 0.7 per cent in 2006Q1 or 2.6 per cent over the year. This is similar to growth in the previous quarter. The forecast for UK GDP growth is 2.6 per cent in 2006 (up from 2.3 per cent in the last quarter) and 2.4 per cent in 2007. Consumption is expected to pick up significantly going forward since it was at its weakest in 2005 since 1992. Investment and government spending remain strong drivers of UK growth.

Inflationary pressures are steady but relatively subdued e.g. average earnings are well within expected bounds and there appears to be no significant pass through effects from high oil prices. The labour market is forecast to continue to perform strongly. The current account is forecast to be -£31.4 billion in 2006 or -2.3 per cent of GDP. The PSNB is forecast to increase to £38.1 billion in 2006-07. As a percentage of GDP this remains at 3.0 per cent.

Output growth and components of demand

UK real GDP growth (chained volume measure) increased by 0.7 per cent in 2006Q2, identical to growth in the previous two quarters. The preliminary estimate was growth of 0.8 per cent. GDP is now 2.6 per cent higher than it was in the second quarter of 2005. GVA at basic prices also grew by 0.7 per cent and by 2.6 per cent on the same quarter in 2005. GDP grew by 1.9 per cent in 2005 and is forecast to grow by 2.6 per cent in 2006. The

service sector continues to drive GDP although manufacturing growth continued its strong performance seen in the first quarter of this year. Overall the UK has a broad based contribution to GDP.

Following a poor performance in the first quarter of 2006 consumption growth of 0.9 per cent was recorded in the second quarter. This is 2.3 per cent higher than the same period last year. Government spending rose by 0.8 per cent in 2006Q2 compared to only 0.3 per cent in the previous quarter. Government spending increased by 2.1 per cent on the same quarter of last year. Growth in investment was 0.6 per cent in 2006Q2 compared to 2.0 per cent in the first quarter. Growth in the latest quarter on the corresponding quarter of last year was 5.9 per cent. Overall domestic demand increased by 0.4 per cent for 2006Q2 on 2006Q1 whereas on the same quarter of last year growth was 3.0 per cent. Exports grew by 4.5 per cent in the second quarter compared to 8.5 per cent in the previous quarter. Growth on the same quarter of last year was 6.4 per cent. Import growth moderated to 3.4 per cent compared to 8.9 per cent in the first quarter. On the same period last year import growth was 19.1 per cent. The deficit in net exports has narrowed from £10.3 billion to £9.6 billion in the second quarter.

The most encouraging news from the second quarter was the rebound of consumption from its previous poor performance. The National Institute (see NIER, 197, p44) however, expect consumption growth to remain below its 10 year average and therefore unlikely to stimulate higher real GDP growth in the third quarter. Real GDP growth over the last three quarters was 0.7 per cent per quarter, which is close to trend growth. There is little evidence that the third quarter will show any sizeable increase on this although the Bank of England suggest that growth will be stronger in the third quarter. If growth remains close to trend then the current cycle (which started in 2003) could end in the early part of the year 2008. ONS warns that the data regarding exports and imports of goods are vulnerable to VAT Missing Trader Intra-Community (MITC) Fraud therefore these data should be treated with caution.

Service sector growth was 0.9 per cent in 2006Q2 (2.9 per cent on an annual basis) compared to 0.7 per cent in the first quarter. Financial services grew by 3.9 per cent in the first quarter of 2006 but only increased by 1.2 per cent in the second quarter. On the same period last year growth in this sector was 7.7 per cent. REBS demonstrated an opposite stance with growth of only 1.2 per cent in the first quarter of the year but in 2006Q2 it was 4.0 per cent. Over the same period last year growth in this sector was 6.6 per cent. Wholesale and retail growth increased by 0.9 per cent in the second quarter compared to 0.4 per cent in the previous quarter. Public services and other services increased by 0.4 per cent in 2006Q2 compared to 0.4 per cent in 2006Q1. Other private services grew by 1.4 per cent this quarter compared to a flat performance in the previous quarter. Transport, storage and telecommunications services increased by 0.6 per cent in the current quarter after only growing by 0.1 per cent in the previous quarter.

UK production was flat in 2006Q2 compared to 0.8 per cent in the previous quarter, and declined by 0.7 per cent on the second quarter of 2005. Manufacturing grew by 0.8 per cent in 2006Q2 compared to 0.9 per cent in the first quarter. The robust performance of manufacturing has been eagerly awaited given that the last time this happened was 2004Q4 and it only lasted for one quarter. Mining and quarrying declined by 3.9 per cent in the latest quarter and decreased by 11.1 per cent on the same period of 2005. Output in electricity, gas and water supply contracted by 2.6 per cent in the current quarter compared to growth of 0.3 per cent in the previous quarter. Agricultural output declined by 1.1 per cent on a quarterly basis and contracted by 2.0 per cent on the same period of last year. Construction growth was 0.5 per cent this quarter compared to 0.8 per cent in the first quarter. The UK economy therefore has a broad based contribution to GDP growth. Only a few sectors detract from that growth.

The UK current account recorded a deficit of £7.0 billion in the second quarter of 2006 which was equivalent to -2.2 per cent of GDP. In the first quarter the deficit was £8.7 billion or -2.8 per cent of GDP. For 2005 as a whole after revisions the current account deficit was £27.4 billion or -2.2 per cent of GDP. The UK deficit on trade in goods fell from £21.2 billion in 2006Q1 to £19.8 billion in 2006Q2. The surplus on trade in services also declined slightly from £6.9 billion to £6.4 billion in the second quarter. There has been a steady improvement in the current account deficit since 2005Q3 when the deficit was -3.5 per cent of GDP. The surplus on income has risen marginally this quarter to 2.8 per cent of GDP. The deficit on trade in goods and services is equivalent

to -4.2 per cent of GDP. Our deficit narrowed with EU countries while our deficit with non-EU countries widened. The UK still has a strong surplus on direct investment which stood at £13.1 billion in 2006Q2. The capital account showed a small deficit for the first time since 1999Q1 but this was driven largely by debt relief to Nigeria. The latest figures on UK trade (October 2006) show a deficit of £4.4 billion in August, unchanged from July. In the three months ending in August the deficit narrowed to £12.9 billion from £13.5 billion in the previous three months. It is estimated that the trend for trade in goods and services is to be relatively flat over the next few months.

The latest data on the public finances show a current budget deficit of £5.6 billion was recorded in August 2006 compared to a surplus of £7.9 billion in July 2006 and a deficit of £3.6 billion in August 2005. Net borrowing was recorded as £7.6 billion in August compared to £5.5 billion in August 2005. Net debt was estimated to be £474.2 in August (36.7 per cent of GDP) up from £470.0 billion in July (36.4 per cent of GDP). Net debt was £436.2 billion (35.3 per cent of GDP) in August 2005. The PSNB requirement for April to August 2006/07 was £19.5 billion compared to £16.8 billion in 2005/06. Overall for 2005/06 public sector net debt was 36.2 per cent of GDP. General government borrowing was 2.9 per cent of GDP in 2005/06 compared to 3.2 per cent in 2004/05. At the end of 2005/06 general government gross consolidated debt (nominal value) was £529.1 billion (42.1 per cent of GDP) compared with £481.5 billion (39.9 per cent of GDP) at the end of 2004/05.

Table 1: Independent forecasts of the UK economy

	2006	2007	2008
Real GDP growth (%)	2.6	2.4	2.5
Inflation rate (CPI %)	2.5	2.0	2.0
Inflation rate (RPI %)	3.5	2.7	2.4
Inflation rate (RPIX %)	3.1	2.5	2.4
Claimant count, (million)	0.97	1.02	1.04
Employment growth (%)	0.9	0.9	0.6
Average Earnings (%)	4.1	4.3	4.4
ERI (2000=100)	102.0	102.1	101.5
Current account (£ billion)	-31.4	-31.3	-38.0
(per cent of GDP)	-2.5	-2.6	-2.5
PSNB (£ billion)	38.1	36.2	34.9
(per cent of GDP)	3.0	2.8	2.4

Source: National Statistics, National Institute Economic Review, 197, July 2006 and "Forecasts for the UK economy", HM Treasury, 232, August 2006 and 233, September 2006. Note: PSNB is given for financial years, e.g. 2006 is 2006/07

Prices

CPI inflation was 2.5 per cent for the 12 months to August 2006 compared to 2.4 per cent in July 2006 and to 2.4 per cent in August 2005. RPI growth in the same period was 3.4 per cent compared to 2.8 per cent 12 months ago. RPIX increased by 3.3 per cent in August 2006 compared to 2.3 per cent in August 2005. The largest upward pressures in

CPI came from recreation and culture; furniture and household equipment; housing, water, electricity, gas and other fuels as well as clothing and footwear. The only downward effects came from operation of personal transport equipment and transport services. The RPI over the last twelve months increased by 29.2 per cent for fuel and light, the next largest increase was 5.5 per cent. Producer prices for manufactured products rose by 1.8 per cent in the year to

September compared with a 2.7 per cent increase up to August. The unadjusted index fell by 0.3 per cent over one month. GB average earnings including bonuses grew by 4.4 per cent for May-July 2006 while excluding bonuses the figure was 3.7 per cent. Average earnings growth remains non-inflationary and there is little likelihood of oil prices feeding through into the wage bargain. House prices continue to rise with the all dwellings index increasing by 7.7 per cent for the 12 months to August 2006 up from 6.0 per cent in July. This compares to 2.8 per cent in August 2005 and 4.0 per cent in July 2005. Average mortgage interest rates fell marginally from 5.25 per cent in June 2006 to 5.24 per cent in July. The Halifax house price index increased by 9.4 per cent in 2006Q2 while the Nationwide index grew by 4.8 per cent in the same period. The Halifax change was significantly up on the first quarter (6.2 per cent) while the Nationwide index was relatively unchanged. Given that there is close to trend growth, significant rises in energy prices (although oil prices have fallen recently and this is likely to feed into petrol pumps in the near future), house prices continue to advance and consumption appears to have picked up as net income increases then it is likely that the MPC will vote to increase interest rates at the November meeting. Interest rates were increased to 4.75 per cent at the August meeting and it is probable they will rise to 5.0 per cent in November. This is what most commentators and markets believe as Bank of England rhetoric appears to be preparing the public for this. The outlook for inflation and interest rates is presented in Table 1.

The CIPS/RBS PMI survey for services in the UK indicated a 13.9 per cent net increase in the business activity index as it rose to 57.0. New business, output prices and input prices all showed a slight decrease in the index whereas there was an increase in the indices for employment and future expectations. The signals for the service sector remain buoyant despite a slight weakening in some areas. In manufacturing the index increased from 53.0 to 54.4. New orders, export orders, employment delivery times and quality of purchases all indicated increases in these indices. Manufacturing output appears to have strengthened significantly. The profitability of UK companies in 2006Q2 increased to 14.7 per cent from 14.4 per cent in the first quarter. Manufacturing profitability dipped slightly while services profitability increased from 19.5 per cent to 20.1 per cent.

The labour market

UK employment stood at 28,975,000 in May-July 2006, an increase of 38,000, giving an employment rate of 74.6 per cent down marginally from 74.7 per cent on the previous period. ILO Unemployment was 1,699,000 or 5.5 per cent for January-March 2006, an increase of 93,000, compared to 1,605,000 (5.4 per cent) in February-April 2006. Claimant count unemployment for August 2006 was 950,100 or 3.0 per cent compared to 954,000 (3.0 per cent) in July 2006 and 869,300 (2.7 per cent) in August 2005. Claimant count has increased by 80,800 or by 9.3 per cent over the year. The unemployment rate has only increased by 0.3 percentage points. There were 30,673,000 (79.1 per cent) economically active people in May-July 2006 compared to 30,542,000 (78.9 per cent) in February-April 2006. The change over the year is 377,000 (0.5 percentage points) respectively. The numbers of economically active people have increased by 0.8 per cent

on an annual basis. There was a small change (-38,000 over the previous period and -123,000 over the year) in those who were economically inactive (17,501,000) and the rate fell slightly to 20.9 per cent from 21.1 per cent in the previous period.

Self employment decreased by 24,000 over the latest quarter to 3,730,000 but increased by 109,000 over the year. Full-time employment increased to 21,628,000 in May-July 2006, up 17,000 over the quarter and by 211,000 over the year. Part-time work rose from 7,326,000 to 7,347,000, a rise of 22,000 over the period but only up by 9,000 over the year. The number of people with second jobs increased by 18,000 over the quarter but declined by 25,000 over the year. Manufacturing employment decreased by 7,000 while there were 6,000 less jobs in distribution, hotels and catering. Financial services shed 2,000 jobs in June 2006. All other sectors demonstrated increases in the number of jobs over the quarter, the largest being 27,000 in public services, 23,000 in other services and 21,000 in construction. Manufacturing lost 58,000 jobs over the year, distribution, hotels and catering lost 43,000 and agriculture lost 18,000 jobs. All other sectors added jobs with the service sector adding 256,000 jobs (more than the total gain of 248,000). There were 608,800 vacancies in the period June-August 2006 which is up 14,800 giving a rate of 2.3 per cent. There were 1.5 million foreign nationals working in the UK in 2005, equivalent to 5.4 per cent of the employed population. 2004 saw a net inflow of 187,000 foreign nationals who had been in employment immediately prior to migrating. In 2005-06 there were 662,400 new NI number registrations given to foreign nationals of which 41 per cent came from EU accession countries¹.

Output per worker increased by 1.8 per cent in 2006Q2 compared with the same quarter a year ago and up from the 1.5 per cent recorded in the previous quarter. On a quarterly basis the change was 0.6 per cent. Unit wage costs for 2006Q2 increased by 2.0 per cent on the same quarter last year, down from 2.2 per cent in the previous quarter. Output per hour worked demonstrated that hourly productivity grew by 1.7 per cent in the second quarter on an annual basis compared with 1.8 per cent in the previous quarter. Manufacturing productivity (output per job) increased by 3.5 per cent in 2006Q2 up from 2.7 per cent in the previous quarter. Manufacturing output per hour worked rose by 4.3 per cent in the second quarter while the first quarter figure was 2.9 per cent. Productivity has been driven by increased output and an easing in the decline of productivity jobs. However, productivity in the UK, lags that of the US and France, is similar to that in Germany but is higher than productivity in Japan.

The UK labour market continues to perform well with high rates of employment, economic activity and low rates of unemployment. There are few signs that the UK labour market will not continue to perform well. Despite these data it

is clear that there is room for improvement in the number of self-employed, higher levels of productivity and more higher-skilled workers.

The outlook for the UK economy is good with growth slightly above or close to trend growth. 2006 appears to have stimulated a broad based contribution to GDP. The forecast for growth in 2006 is 2.6 per cent. Inflationary pressures are relatively subdued but not absent as fuel prices continue to rise. It is unlikely that the UK economy will suffer significantly from higher fuel costs. The main risks to the economy are global imbalances, a significant correction either to the US or

the UK housing market or oil prices feeding into wage bargains through second round effects (although the latter is remote). Consumption growth appears to have picked up and manufacturing has strengthened also. Exports are likely to increase due to increased Euro Area activity although imports will probably rise at a faster pace given the increased income in the UK.

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Endnote:

¹ Source: ONS, Labour Market Trends, News Release, 5 October 2006.