

# The UK economy

The world economy is still growing relatively strongly with a slight slowing in the US but as Japan has performed above expectations this has compensated for the US. Non-Japan Asia and China are also performing well. The Euro Area is showing signs that 2006 and 2007 will be better years as there are consistent signs of a pick-up in growth. The main risks to the world economy include imbalances in the world economy, high oil prices being sustained beyond the medium-term and significant second round effects on inflation.

Real GDP growth was 0.6 per cent in the fourth quarter of 2005 giving growth of 1.8 per cent for 2005 as a whole. Services continue to drive the UK economy particularly financial services and retail, hotel and catering and business services.

**Table 1 Independent forecasts of the UK economy**

	2005	2006	2007	2008
Real GDP growth (%)	1.7	2.1	2.5	2.6
Inflation rate (CPI %)	2.2	1.9	2.0	2.0
Inflation rate (RPI %)	2.4	2.3	2.4	2.5
Inflation rate (RPIX %)	2.3	2.2	2.4	2.5
Claimant count, (million)	0.90	0.97	0.97	0.95
Employment growth (%)	0.8	0.4	0.4	0.5
Average Earnings (%)	4.1	4.3	4.4	4.5
ERI (1990=100)	100.9	97.4	98.0	97.5
Current account (£ billion)	-24.6	-27.3	-29.6	-30.6
(per cent of GDP)	-2.1	-2.3	-2.2	-2.1
PSNB (£ billion)	37.7	38.4	38.5	37.1
(per cent of GDP)	3.2	3.1	2.9	2.7

Source: National Statistics, National Institute Economic Review, 195, January 2006 and "Forecasts for the UK economy", HM Treasury, January 2006 and November 2005. Note: PSNB is given for financial years, e.g. 2005 is 2005/06

## Output growth and components of demand

UK GDP (chained volume measure) grew by 0.6 per cent in 2005Q4 according to the advance estimate and by 0.4 per cent in 2005Q3. Growth is estimated to be 1.8 per cent for 2005 as a whole. There were revisions of growth going back to 2004Q1 in the latest national accounts indicating that the slowdown in growth in the second half of 2004 was less marked than previous estimates. The main point of the revisions was that the service sector was slightly stronger than the original estimates and this brings these data into line with survey and other evidence. The GDP growth rates for 2005 were left unchanged. It may be that service sector

## Outlook

The consensus forecasts for the main UK economic indicators taken from a monthly survey by HM Treasury of City and other independent forecasters are presented in Table 1. Real GDP growth was 3.5 per cent in 2005 and is forecast to be 2.1 per cent in 2006. We forecast growth of 2.5 per cent in 2006 and 2.6 per cent in 2007. Consumption, investment and government spending are all forecast to grow significantly in the period 2005 and in 2006. Inflationary pressures are becoming clearer but there is no serious threat to price stability nor are there any signs of oil price increases feeding through into wage bargains. The labour market is expected to remain relatively buoyant. The current account is forecast to improve in the short-run (to -2.1 per cent of GDP) but to widen in the medium-term (to -£30.6 billion) which is similar to our projection in the last quarter. The PSNB is forecast to rise from £37.7 billion 2005-06 to £38.4 billion in 2006-07. As a percentage of GDP this is 3.2 and 3.1 per cent respectively.

growth could still be revised up given previous revisions. GVA at basic prices increased by 0.4 per cent in 2005Q3 compared to 0.5 per cent in 2005Q2. GVA at basic prices is now 1.7 per cent higher than at the same time last year.

Consumption increased by 0.5 per cent in 2005Q3 or up by 1.3 per cent for 2005Q3 on 2004Q3, government spending was flat – the lowest quarterly growth rate since 2001Q2 (0.6 per cent on the same quarter last year) and investment grew by 0.5 per cent (3.9 per cent for 2005Q3 on 2004Q3). Business investment rose by 0.3 per cent. Exports increased by 0.7 per cent in 2005Q3 while import growth

was 2.1 per cent. The contribution of net trade to GDP was -0.4 percentage points.

Service sector growth was 0.6 per cent in the third quarter but is estimated to be 0.9 per cent in the fourth quarter. Production declined by 0.6 per cent in both 2005Q4 and 2005Q3. Manufacturing growth declined by 0.8 per cent in the fourth quarter and was only 0.3 per cent in 2005Q3 (revised down from 0.4 per cent in the Index of production estimate). Construction growth in 2005Q4 was 0.3 per cent compared to 0.5 per cent in the third quarter.

The UK current account widened to -£10.2 billion in the third quarter of 2005 compared to -£1.4 billion in the second quarter. As a percentage of GDP these values are -3.4 per cent and -0.5 per cent respectively. The trade deficit climbed to -£17.0 billion (-4.7 of GDP) in the third quarter while the trade in goods and services was slightly lower at -£14.1 billion (-3.2 per cent of GDP). This big change is primarily due to lower investment income.

The current budget deficit equalled -£4.0 billion in December 2005 compared to -£4.8 billion in December 2004. Net borrowing increased to £6.5 billion in the last month of 2005 compared to £6.2 billion a year earlier. Net debt was estimated to be £460.3 billion or 37.2 per cent of GDP. At the same time last year it was £419 billion or 35.2 per cent of GDP. The public sector net borrowing requirement was calculated to be £38.9 billion for April to December 2005-06 compared to £38.4 billion in the same time period for 2004-05.

## Prices

CPI inflation was 2.0 per cent in December compared to 2.1 per cent in November. RPI grew by 2.2 per cent in December down from 2.4 per cent in November. The biggest falls were due to a reduction in travel costs, especially air passenger transport and because petrol and diesel prices fell for the third consecutive month. RPIX grew by 2.0 per cent in December compared to 2.3 per cent in November. Producer price inflation grew by 2.4 per cent in December and by 2.2 per cent in November. Interest rates have been on hold in the UK and currently stand at 4.5 per cent. There have been signs however of a debate about if rates should be cut by 25 basis points. The outlook for inflation and interest rates is presented in Table 1.

The household savings ratio fell marginally to 5.5 per cent in 2005Q3 from 5.6 per cent in the previous quarter. Retail sales increased by 1.6 per cent in the three months to December compared to 1.0 per cent in November. In the period November to December the volume of sales increased by 0.4 per cent.

Output indicators suggested that Q4 GDP had grown in line with its historic average. In the service sector, the CIPS business activity index increased to 57.9 in December. The CIPS manufacturing index increased between 2005Q3 and 2005Q4. The Bank of England regional agents reported a

healthy rise in consumer spending in the last quarter. Housing market indicators have also strengthened towards the end of 2005.

## The labour market

UK employment stood at 28,764,000 in September-November 2005, a decrease of 22,000. This is equivalent to an employment rate of 74.5 per cent, a reduction of 0.3 percentage points on the previous period. Unemployment fell by 111,000 to 1,528,000 in September-November 2005, giving an unemployment rate of 5.0 per cent. This is a rise of 0.4 percentage points on the last period. Claimant count unemployment increased to 909,100 (2.9 per cent) in December from 901,900 (2.9 per cent) in November. The number of economically active was 30,292,000 or 78.6 per cent. This represents an increase of 89,000 people. There were 7,940,000 (21.4 per cent) people who were economically inactive in September-November or an increase of 25,000 people but there was no change in the rate. There were 606,500 vacancies in the three months ending in December 2005, a decrease of 12,700.

Self employment increased by 64,000 for September-November on June-August to stand at 3,690,000. This is an increase of 42,000 on the year. Full-time employment decreased from 21,466,000 in June-August to 21,450,000 in September-November 2005. The composition of the change was a decline of 10,000 men and of 7,000 women. The number of people with second jobs declined significantly (by 36,000) over the same period. Part-time employment declined by 6,000 to stand at 7,314,000 in September-November compared to 7,323,000 in September-November 2004. Average earnings increased by 3.4 per cent in the twelve months to September-November 2005 and excluding bonuses by 3.8 per cent.

The outlook for the UK economy remains relatively promising despite a slowing of growth in 2005. The forecast is for growth to return to trend growth around 2.5 per cent in 2007. Inflationary pressures seem to be well controlled and it is unlikely that there will be any shocks in the UK economy especially arising out of higher oil prices. As stated before more attention needs to be paid to balancing the public finances. There are concerns that the taxation on oil fields is the wrong move – time will tell. 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 the wage bargains through second round effects.

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12 February 2006