

The UK economy

slowed from 3.7 per cent in the second quarter of 2004 to 2.1 per cent in the first quarter of 2005. GDP is estimated to have grown by 3.2 per cent in 2004. Net trade reduced GDP by 0.7 percentage points but most of the growth was driven by household consumption.

Overview

The US, Japan, China and the UK were growing at above trend levels in 2004. This year growth has slowed slightly due to increasing oil prices but growth is still relatively strong in the US, China, and the UK and in other non-Japan Asian economies. Some emerging economies are also growing relatively strongly. While the oil price has risen there does not appear to be sustained global inflation simply because the dependency on oil is less than it was; oil revenues are recycled more quickly now; monetary policy is more appropriate and there is no spiral effects because of increased wage demands on the back of oil price increases. Consequently inflation is more subdued.

UK national accounts underwent rebasing to 2002 prices and there have also been significant data revisions. In the second half of 2004 the economy decelerated (and into the first quarter of 2005). There was also below trend growth in the second quarter of the year. Annualised UK GDP growth

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 3.2 per cent in 2004 and is forecast to be 2.0 per cent in 2005 (revised down from 2.5 per cent in our last forecast). We forecast growth of 2.3 per cent in 2006 (similar to our previous forecast). Inflation (whether measured by CPI or by RPIX) remains on target and both are forecast to be close to target over the period. Unemployment remains at low levels and employment growth is relatively buoyant. The current account is forecast to improve in the short-run but to widen in the medium-term. PSNB is forecast to rise from £33.4 billion 2004-05 to £39.2 billion in 2005-06, a considerably worsening. Thereafter it is expected to improve.

Table 1: Independent forecasts of the UK economy

	2004	2005	2006	2007
Real GDP growth (%)	3.2	2.0	2.3	2.6
Inflation rate (CPI %)	1.4	2.2	1.9	2.0
Inflation rate (RPI %)	3.0	2.6	2.4	2.5
Inflation rate (RPIX %)	2.2	2.3	2.4	2.5
Claimant count, million	0.85	0.88	0.92	0.91
Employment growth (%)	0.6	0.5	0.3	0.4
Average Earnings (%)	4.3	4.3	4.4	4.4
ERI (1990=100)	102.0	101.6	99.1	98.2
Current account (£ billion)	-28.1	-24.3	-25.8	-27.8
PSNB (£ billion)	33.4	39.2	38.6	38.0

Source: National Statistics, National Institute Economic Review, **193**, July 2005 and "Forecasts for the UK economy", HM Treasury, September 2005. Note: PSNB is given for financial years, e.g. 2003/04

Output growth

UK chained volume measure of GDP increased by 0.5 per cent in the second quarter of 2005. This was revised up by 0.1 percentage point. This is the fourth quarter in a row where UK GDP growth has been below trend. This is now the slowest rate of growth since the recovery from the period 1990-1991. The level of GDP is now 1.5 per cent higher than it was in the second quarter of 2005. In the first quarter GDP growth was only 0.3 per cent. Growth has slowed considerably in the first half of 2005. GVA at basic prices grew by 0.5 per cent in the second quarter

compared to 0.3 per cent in the first quarter. GVA is now 1.4 per cent higher than it was in the same quarter of the previous year.

Components of demand

Consumption grew by 0.4 per cent in the second quarter (revised up from 0.2 per cent) while government spending grew by 0.5 per cent. Investment spending increased by 1 per cent. Exports had an impressive performance growing by 4.4 per cent while imports only grew by 1.9 per cent in

the second quarter. The UK trade deficit widened from £3.9 billion in July to £5.3 billion in August. This was primarily because of a £1.4 billion payout by Lloyds for hurricane Katrina. The deficit in the three months to August was £11.6 billion compared to £11.1 billion for the previous three months. We note that the Bank of England is continuing to interpret this data (investment and exports) with caution. This is because of past heavy revisions and possible seasonal adjustments still to come. The UK balance of payments data shows the UK has a deficit that represents 1 per cent of GDP. The deficit is £3.1 billion for 2005Q2 compared with a revised deficit of £7.3 billion (-2.5 per cent of GDP) in the first quarter. A deficit of £4.8 billion was recorded with the EU compared to £6.7 billion in the previous quarter.

The largest quarterly growth was seen in agriculture (1.1 per cent); electricity, gas and water supply (1.0 per cent) and business and finance services (0.8 per cent). In the service industries the strongest growth was in health and social work (1.2 per cent) while real estate and business services grew by 1.0 per cent. Only manufacturing declined (by 0.2 per cent) in the second quarter although transport and storage services growth was flat.

Manufacturing activity had increased by 0.1 per cent in July but energy output declined by 1.9 per cent. Industrial production was therefore 0.3 per cent lower than it was in June. The SIPS survey suggested that manufacturing activity had strengthened slightly. The CBI survey of manufacturing orders declined in August. The three month growth rate for retail sales grew by 0.7 per cent in July, despite a decrease in retail sales in July. There may be some very modest improvements in the UK housing market after the considerable slowing in the UK housing market. Car registrations also fell in the three months to August.

Prices

Import price inflation increased to 2.7 per cent in the second quarter, up from -1.0 per cent a year ago. Manufacturing price inflation grew by 13.4 per cent in July 2005. This probably reflects a rising oil prices. Manufacturing output prices increased to 3.1 per cent in July. CPI inflation was 2.3 per cent in July, up considerably from the 1.1 per cent recorded in September 2004. Interest rates have been on hold in the UK and this is probably going to continue into 2006. If the UK recovers at a slower pace then there may be a further cut in interest rates but perhaps not until 2006.

The labour market

Employment in the UK was 28,759,000 in June-August 2005, an increase of 103,000. This is equivalent to an employment rate of 74.8 per cent. In March-May 2005 the number was 28,656,000 which was a decrease of 24,000. Unemployment fell from 1,424,000 in March-May 2005 to

1,417,000, a decline of 7,000. The unemployment rate was 4.7 per cent in June-August 2005, unchanged from the previous period. Claimant count unemployment increased to 875,500 (2.8 per cent) from 867,300 (2.8 per cent). In June-August 2005 the number of economically active people was 30,080,000 (78.5 per cent) and this rose to 30,176,000 (78.6 per cent) in June-August 2005, an increase of 96,000. There were 17,639 (21.4 per cent) people who were economically inactive in June-August compared to 17,633,000 (21.5 per cent) in March-May 2005.

Self employment fell to 3,622,000 in June-August from 3,638,000 in March-May. Average earnings increased by 4.2 per cent in the twelve months to August 2005. Full-time employment increased from 21,341,000 in March-May to 21,445,000 in June-August 2005. The increase was 43,000 men and 61,000 women. The number of people with second jobs declined slightly over the same period.

The outlook for the UK economy remains promising despite a slowing of growth. Forecast growth for 2005 is 2.0 per cent and 2.3 per cent for 2006. It may be that the outlook for the third quarter of 2005 could be relatively muted but it is likely that the outturn for the fourth quarter will demonstrate strong growth in the period prior to Christmas. There is a clear requirement to balance the tax revenues and public spending otherwise the Golden Rule will be broken and the long-term macroeconomic stability will be jeopardised. The main downside risks to the UK economy are the lack of activity in the Euro Area, a sustained high oil price and significant imbalances in the world economy.

Kenneth Low
15th October 2005