

The UK economy

Overview

Growth in the world economy is relatively strong and strong trade growth is forecast. The UK is well placed to enjoy the benefits of trading with the US, expanding new markets in the Far East, especially China, to pick up from the forecast recovery in the Euro Area and to reap rewards from domestic demand. When UK GDP growth for 2004Q3 was recorded as only 0.4 per cent this was unexpected. Fourth quarter growth appears to be much stronger at 0.9 per cent. Employment remains relatively strong while unemployment is low. Inflation is also low and stable despite recent surges in both house price inflation and the oil price. Interest rates appear to have stabilised at 4.75 per cent. Consumption, government spending and investment are the main drivers of UK growth.

Outlook

HM Treasury provides consensus forecasts for the main UK economic indicators from a monthly survey of City and other independent forecasters. These are presented in Table 1. Real GDP growth is forecast to be 3.1 per cent in 2004 and 2.6 per cent in 2005. Fourth quarter growth was 0.7 per cent and this was better than expected. Inflation remains on target despite being low for part of the year. The Bank of England have held interest rates at 4.75 per cent and are waiting to see how the economy performs before moving up or down. Many commentators already think that interest rates have peaked and that they will fall to 4.25 per cent by the end of the year. We are much more benign on this as the economy could stay in this position for sometime yet (certainly the first half of this year). House price growth has slowed and consumers may take account of rising interest rates in 2005. This is why most commentators believe growth will slow somewhat this year. Unemployment is forecast to be very low and employment is

forecast to rise steadily. The current account is forecast to widen while PSNB is forecast to rise to £38.6 billion in 2005-06.

UK macroeconomic trends

Fourth quarter GDP grew by 0.7 per cent in 2004. GVA also grew by 0.7 per cent. Manufacturing declined by only 0.2 per cent whereas the service sector increased output by 1 per cent in the last quarter. All the service sectors contributed to growth.

UK GDP grew by 0.5 per cent in the third quarter of 2004 (having been revised up from 0.4 per cent). GDP is 3.1 per cent higher than it was in 2003Q3. Gross value Added (GVA) increased by 0.5 per cent over the quarter and by 3.2 per cent (revised up from 3 per cent) than the third quarter of 2004Q3. Manufacturing output declined by 0.8 per cent while the agricultural sector remained broadly flat. Construction output increased by 1.2 per cent in the third quarter and grew by 2.3 per cent on the same quarter in 2003. Services only grew by 0.9 per cent in 2004Q3. Distribution increased by 0.9 per cent in the third quarter while hotels and restaurants growth was modest. Post and telecommunications increased by 3.4 per cent while business and financial services increased by 1.1 per cent. Public services grew by 0.7 per cent over the quarter.

Consumption grew by 0.6 per cent in the third quarter, largely driven by durable goods growth of 3 per cent. Government spending increased by 1.4 per cent in 2004Q3 and is now 4.8 per cent more than that of 2003Q3. Investment grew by 0.6 per cent in the third quarter while business investment increased by 1 per cent (it is now 5.3 per cent above the level seen in 2003Q3). Exports increased by 0.7 per cent over the quarter (goods increased by 2.5 per cent but exports of services fell by 2.8 per cent). Imports of goods and services increased by 1.3 per cent in 2004Q3. The UK trade position improved slightly in November 2004 when the current account fell to 3.1 billion from 3.6 billion in October. The current account had a deficit of 8.8 billion in the third quarter of 2004

Table 1: Independent forecasts of the UK economy, 2004-2007

| | 2004 | 2005 | 2006 | 2007 |
|----------------------------------|-------|-------|-------|-------|
| Real GDP growth (%) | 3.1 | 2.6 | 2.5 | 2.6 |
| Inflation rate (CPI %) | 1.4 | 1.8 | 1.9 | 2.1 |
| Inflation rate (RPIX %) | 2.2 | 2.2 | 2.5 | 2.6 |
| Unemployment (CC, million) | 0.84 | 0.86 | 0.86 | 0.91 |
| Employment growth (%) | 0.6 | 0.3 | 0.4 | 0.5 |
| Average Earnings (%) | 4.5 | 4.4 | 5.1 | 4.7 |
| Sterling Effective Exchange Rate | 102.4 | 99.3 | 100.5 | 99.6 |
| Current account (£ billion) | -27.4 | -29.2 | -27.3 | -28.8 |
| PSNB (£ billion) | 37.0 | 38.6 | 36.9 | 37.4 |

Source: National Statistics, National Institute Economic Review, 191, January 2005 and "Forecasts for the UK economy", HM Treasury, November 2004 and January 2005. Note: PSNB is given for financial years, e.g. 2002/03

(revised from £5.8 billion in the second quarter). Industrial production (particularly manufacturing) was weaker in the second half of 2004. The two main risks to the UK economy are if exports do not pick up sharply or if there is a sharper house market correction than most people believe will occur.

ago but down from 2.9 per cent in the previous quarter. Unit wage costs increased by 1 per cent for the whole economy.

Kenneth Low
2nd February 2005

Inflation

The Consumer Price Index (CPI) was 112.5 in December 2004, a change of 1.6 per cent over the previous 12 months. The Retail Price Index excluding mortgage interest payments (RPIX) increased by 2.5 per cent whereas the Retail Price Index (RPI) grew by 3.5 per cent. The largest upward effects on the RPI came from household goods, travel costs and fuel and light. Smaller effects came from food and personal services. The largest effect on CPI came from furniture and the smaller effects included recreation and culture, food and non-alcoholic beverages and housing, water, electricity, gas and other fuels. We believe that over the course of 2005 CPI will draw closer to the inflation target. The Bank of England has held interest rates at 4.75 per cent for the moment. Interest rate expectations have declined recently without increasing inflation expectations. Fiscal policy remains loose and there is little likelihood of any tightening prior to the election. After the election some increases in taxes (preferred to cuts in expenditure) may be necessary – this would also help to stimulate savings. Sterling fell in trade-weighted terms between 2004Q2 and 2004Q3 by 2.3 per cent. We expect a further depreciation of sterling of 1.5 per cent this year and possibly by 2 per cent in 2006.

The labour market

UK employment increased by 99,000 (0.3 per cent) in the quarter September to November 2004 to 28,491,000, and by 271,000 over the year (1.0 per cent). The employment rate increased marginally to 74.8 from 74.7 in the last quarter. This is up by 0.3 percentage points over the year. Self-employment grew by 30,000 jobs in September to November 2004 or by 0.8 per cent but was down slightly over the year. Both the workforce series and the employee jobs series declined slightly in September 2004 and that measure of self-employment also decreased. The number who were economically active was 29,891,000 or an increase by 112,000 over the quarter or up by 207,000 over the year. Construction and manufacturing shed jobs while services were relatively flat with regard to job growth in September 2004. Financial services and the public sector were the only two sub-sectors to grow at substantial rates.

LFS unemployment grew by 13,000 for the period September to November 2004 giving a rate of 4.7 per cent. The rate has declined by 0.2 percentage points compared to the same period last year. The claimant count measure of unemployment for December 2004 declined by 6,200 or by 0.7 per cent. The rate of 2.7 per cent is down by 0.3 percentage points on a year ago. The number of vacancies for December 2004 increased slightly compared to last month. Average earnings increased by 4.2 per cent (including bonuses) or by 4.4 per cent (excluding bonuses). This rate of growth is consistent with non-inflationary growth. Productivity in the third quarter grew by 2.4 per cent compared with the same quarter a year