

The UK economy

Overview

The world economy has strengthened slightly particularly with the signs of recovery seen in the US and in Asia. Domestic demand in the Euro Area is weak however and this will hamper UK export growth. UK GDP growth is weaker than expected but is expected to gather strength in the second half of 2003. The economy is forecast to return to trend growth in 2004. Inflation remains benign and the Bank of England have left interest rates at 3.5 per cent with scope for a further cut although it is unlikely that they will need it. The UK labour market remains healthy with a steadily rising employment rate and low unemployment.

UK real GDP growth is forecast to be 1.7 per cent in 2003 and 2.3 per cent in 2004. Consumption and government spending are forecast to be the main components of demand but as the recovery sets in we expect investment to become more important. As previously forecast unemployment is expected to remain at low levels with steady employment growth during the year. The outlook for the UK economy remains good.

Outlook

Table 1 contains the consensus forecasts for the main UK economic indicators taken from a monthly survey by HM Treasury of City and other independent forecasters. UK GDP growth is forecast to be 1.7 per cent in 2003 and 2.3 per cent in 2004. As in the last QEC there is a slight downward revision to the GDP forecast. Inflation remains on target and there are no immediate inflationary pressures threatening the economy. The housing market has slowed slightly but this is welcome news as there were concerns of overheating in this market. As in the previous QEC unemployment is forecast to remain at very low although there has been some upward revisions of unemployment in the

medium term. Employment growth is slow but steady is relatively broad based. Given the lag in the labour market this is encouraging. The current account is expected to remain in deficit. PSNB is forecast to rise to £34.5 billion in the medium-term from £22.2 billion in 2002/03.

UK macroeconomic trends

Output growth

GDP (at constant 1995 prices) grew by 0.3 per cent in the second quarter of 2003 compared to a 0.1 per cent rise in the first quarter. GDP is now 1.8 per cent higher than it was at the same time last year. GDP (at current prices) increased by 0.9 per cent for 2003 Q2 on the previous quarter and by 4.7 per cent on the same quarter last year. GVA at basic prices increased by 1.7 per cent over the year and by 0.3 per cent over the latest quarter.

A decline in sectoral output was only observed in two sectors. Mining and quarrying decreased by 1.9 per cent on the previous quarter (a decline of 7.1 per cent over the year) and business and financial services fell by 0.4 per cent on a quarterly basis but grew by 2.3 per cent on an annual basis. The best performing sectors include:

- Æ construction where growth was 0.8 per cent on a quarterly basis and 2.5 per cent on the same quarter last year;
- Æ public and other services where growth was 0.4 per cent for the second quarter and 2.1 per cent on an annual basis;
- Æ transport and communication services grew by 0.3 per cent for the second quarter on the previous quarter and by 4.3 per cent over the year and
- Æ and distribution, hotels and catering with growth of 1.1 per cent on a quarterly basis and 2.1 per cent over the year.

Table 1: Independent forecasts of the UK economy

	2002	2003	2004	2005
Real GDP growth (%)	1.9	1.7	2.3	2.7
Inflation rate (RPIX %)	2.2	2.8	2.3	2.3
Unemployment (claimant count, million)	0.95	0.99	1.03	1.03
Employment growth (%)	0.2	0.1	0.2	0.2
Current account (£ billion)	-16.0	-15.6	-21.4	-25.1
PSNB (£ billion)	22.2	28.4	31.8	34.5

Source: National Statistics and "Forecasts for the UK economy", HM Treasury, August 2003. Note: PSNB is given for financial years, e.g. 2002/03

Although electricity, gas and water supply grew by 2.3 per cent in the second quarter, over the year it declined by 1.1 per cent. Similarly agriculture grew by 1.0 per cent in 2003 Q2 but over the year only increased by 0.1 per cent. Services remain the main engine of growth for the UK economy but construction is providing a strong stimulus to growth. Manufacturing, agriculture and other industries are relatively weak.

Components of demand

Consumption growth in the UK was 1.3 per cent for the second quarter (3.3 per cent over the year) while government spending grew by 1.1 per cent in 2003 Q2 (4.9 per cent on the same quarter last year). Investment remains weak and fell by 0.5 per cent in the second quarter compared to the first quarter. The decline over the year is 1.4 per cent. The change in inventories has increased almost fourfold over the last quarter. Exports again decreased by 2.9 per cent in the second quarter (a fall of 5.3 per cent over the year) whereas imports rose by 0.5 per cent in the second quarter and by 1.7 per cent on the same quarter last year.

Retail sales increased by 4.4 per cent on a volume basis, seasonally adjusted for the year up to July 2003. This is 0.4 per cent below the June figure. The manufacturing purchasing managers' index increased to 51.9 in August and the business activity index rose to 57.0. The growth of the Nationwide house price index has slowed to 16.6 per cent on an annual basis. The Nationwide have upgraded their forecast of house price forecasts from 10 per cent to 13 per cent. Mortgage lending increased by £8.4 billion in July, the highest figure ever recorded. Consumer credit burgeoned by a record £2.2 billion in June and by a further £1.5 billion in July. Credit card borrowing also increased by £706 million and mortgage lending rose by £8.4 billion in July. As a result of this there are now significant concerns over the levels of debt in the UK. However we simply do not know if the level of debt has gone past a critical level but if the repayments to debt ratio remains constant then there are unlikely to be any nasty surprises awaiting households. The crucial issue for households is to plan to maintain repayments in the face of an adverse shock.

Our forecast for the UK economy is that it will grow by 1.7 per cent this year and by 2.3 per cent next year. This is because of the slower recover that is expected to be more gradual but hopefully also more sustained. The weakness of European domestic demand is a problem although the signs from the US economy are more encouraging. We have not changed our opinion in that we still expect low and stable inflation. We believe that the Bank of England have room for a further cut in interest rates if the economy were to require a further stimulus but it is more likely that they will remain at 3.5 per cent and gradually increase from mid 2004 as the economy picks up.

Inflation

Oil prices have remained relatively flat recently. The all items RPI rose by 3.1 per cent in July over the year although the level of the index remained unchanged from the June value of 181.3. RPIX declined from 180.0 to 179.9 but over the twelve months the index grew by 2.9 per cent, up on the 2.8 per cent in the previous month. The harmonised index of consumer prices (HICP) increased by 1.3 per cent over the year bring the index to 109.5. Producer prices increased by 1.6 per cent in the year to August 2003 compared to 1.4 per cent in the year to July. There are no significant inflationary concerns in the economy at the moment.

Interest rates were cut to 3.5 per cent in July in what many saw as a surprise move. Most commentators had expected this cut to come later in the year. The MPC has maintained them at this level and it is unlikely that we will see a further cut (although this cannot be ruled out). We expect that early to mid 2004 will see the interest rate rise and perhaps increase to 3.75 or 4.0 per cent by the end of 2004. rates could rise to 4.75 by the end of 2005 if the economy performs well.

The labour market

In the period April-June employment increased to 27,922,000, a rate of 74.7 per cent. ILO unemployment fell to 1,458,000 or 5.0 per cent for the same period. Claimant count for July 2003 fell to 939,200, a rate of 3.1 per cent. Average earnings grew by 3.1 per cent for the period April-June 2003. The number who are economically active increased by 21,000 to 29,380,000 (a rate of 78.7 per cent) whereas the number who are inactive increased by 25,000 to 7,712,000 or 2.3 per cent.

The number of workforce jobs was 26,602,000 in March 2003. This is an increase of 45,000 on a quarterly basis and an increase of 88,000 over the year. Within the workforce there was a loss of 45,000 employee jobs over the quarter and a loss of 147,000 over the year to March 2002. Self-employment has increased by 84,000 on the last quarter and by 203,000 on an annual basis. There has been a very small upward movement in the number of trainees to 101,000 from 97,000 in the last quarter. The largest changes in the workforce have been seen in the following sectors:

- Æ construction where 39,000 jobs were added in March 2003 and 53,000 over the year from March 2003;
- Æ 31,000 jobs were added in public and other services on a quarterly basis and 157,000 on an annual basis;
- Æ financial and business services employment increased by 30,000 in the quarter to March 2003 but over the year this sector lost 22,000 jobs and

Æ distribution, hotels and catering lost 37,000 in the period up to March 2003 but over the year added 63,000.

Full-time employment increased by 47,000 in April-June to 20,732,000 compared to an increase of 16,000 for part-time employees Full-time employment has declined for two successive quarters now and currently stands at 18,123,000. Over the year however full-time employment has expanded by 100,000 and part-time employment by 124,000.

Unemployment is still low with the ILO rate decreasing by 0.1 percentage point in the second quarter. The number of ILO unemployed has fallen steadily since the period July-September 2002. Male ILO unemployment is currently 5.6 per cent compared to the female rate of 4.5 per cent. The claimant count dropped by 8,000 to 939,200 in July 2003.

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