The UK economy

Overview

The world economy has weakened slightly towards the end of 2002. In particular geopolitical tensions and concerns over equity markets have dominated the economic picture. The UK has performed relatively well and is expected to recover in 2003 and firmly in 2004, following recovery in the US. Inflationary pressures have been subdued and interest rates are very low. The labour market has performed relatively better than expected and is forecast to continue to do so therefore unemployment will remain low. There are no significant macroeconomic risks despite some concerns over the current account, which are minor and increased government borrowing.

UK real GDP growth is forecast to be 2.2 per cent in 2003 and 2.4 per cent in 2004. Consumption and government spending are expected to boost domestic demand while investment is forecast to pick up. There are no significant inflationary pressures other than temporary pressure from oil prices that should be resolved soon and considerable house price inflation, although this is expected to slow slightly over the next two years. Unemployment is forecast to remain at low levels with steady employment growth. Despite the economy being weaker towards the end of 2002 and at the start of 2003 there are important signs that indicate recovery is taking place and therefore the outlook for the UK is still relatively promising.

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. The outlook for the UK is that GDP growth is forecast to be 2.2 per cent in 2003 and 2.4 per cent in 2004. This is down slightly compared to the December forecast. Inflationary pressures are relatively muted despite strong house price inflation and short-term oil price pressure. Unemployment is forecast to remain at very low levels and employment growth is forecast to be steady. The current account is of little concern as it is close to its 40-year average. Government spending has however increased PSNB. Despite the economy being weaker towards the end of 2002 and in the beginning of 2003 we believe that there are clear signs of recovery and that the UK outlook is relatively promising.

UK macroeconomic trends

Output growth

We maintain our view expressed in the previous QEC that the relative economic performance of the UK is still better than most other OECD countries. GDP growth in 2001 was 1.6 per cent and the same again in 2002. This is above the EU average of 1.5 per cent in 2001 and 0.9 per cent in 2002. It considerably outperforms the US in 2001 where growth was only 0.3 per cent but is below US growth of 2.4 per cent for the year 2002. GDP rose by 0.4 per cent in 2002Q4 on 2002Q3 and is 2.1 per cent higher than in the same quarter of 2001.

Gross Value Added at basic prices (GVA) increased by 2.1 per cent in 2002 on the previous year and by 1.7 per cent for 2002Q4 on the same quarter in the previous year. The latest quarterly change however indicated that the rate of growth slowed towards the end of the year with a rise of only 0.3 per cent.

Table 1: Independent forecasts of the UK economy

	2002	*2003*	*2004*	*2005*
Real GDP growth (%)	1.6	2.2	2.4	2.5
Inflation rate (RPIX %)	2.6	2.4	2.4	2.2
Unemployment (claimant count, million)	0.95	0.98	1.02	0.99
Employment growth (%)	0.2	0.3	0.3	0.4
Current account (£ billion)	-16.0	-20.5	-21.9	-26.7
PSNB (£ billion)	20.7	26.8	29.8	28.3

Source: National Statistics and "Forecasts for the UK economy", HM Treasury, February 2003.

Manufacturing contracted by 4.0 per cent on an annual basis and by 1.5 per cent for 2002Q4 on 2001Q4. For 2002Q4 on the previous quarter the decline was 0.9 per cent. Production as a whole declined by 3.5 per cent for the year. The latest Index of Production for January indicated that for the latest three months on the previous three months the index declined by 0.8 per cent and for the latest three months on the same three months in the previous year by 1.1 per cent. Construction demonstrated strong annual growth of 7.3 per cent (7.1 per cent for 2002Q4 on 2002Q3) but again growth slowed in the last quarter with an increase of only 1.1 per cent. There was a similar pattern in services with relatively strong annual growth in distribution, hotels and catering (3.8 per cent), business and financial services (2.7 per cent) and in government and other services (2.5 per cent). The respective figures for growth for 2002Q4 on 2002Q3 for these sectors are 0.5 per cent, 0.3 per cent and 0.5 per cent. The fourth quarter growth was broadly similar to third quarter growth in manufacturing, distribution hotels and catering, business and financial services and also government and other services.

There are clear signs that manufacturing remains weak while services continue to contribute to UK GDP growth. There is evidence that supports this; the UK manufacturers'

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Purchasing Managers Index (PMI) is below 50.0 for the third successive month. The index for services is only marginally above 50.0 (its lowest level since 2001) reflecting recent economic pressures and in particular concerns over equities. The British Retail Consortium (BRC) data indicated that the growth of sales values was 6.8 per cent in January but dropped to 3.6 per cent in February. The Chartered Institute of Purchasing (CIP) survey indicates that orders and output remain weak. Both the Confederation of British Industry (CBI) and the British Chambers of Commerce (BCC) surveys are slightly more optimistic. This data does however reflect particular concerns at the end of 2002 (when growth was slowing) and now we know that the outlook seems slightly more promising given that the uncertainty over geopolitical tensions is expected to be resolved in the near future.

Components of demand

Consumption increased by 3.9 per cent for the year 2002, by 3.6 per cent for the latest quarter on the same quarter last year but only by 1.0 per cent for 2002Q4 on 2002Q3. Government spending grew strongly also with growth of 4.2 per cent for 2002. Growth for 2002Q4 on the previous quarter was only 0.8 per cent but for the latest quarter on the same quarter last year growth was 2.1 per cent. Both of these stimulated domestic demand significantly resulting in domestic demand increasing by 2.4 per cent in 2002 on the previous year but only by 1.3 per cent for the latest quarter on the third quarter. Inventories were relatively unchanged over the third quarter but made a negative contribution to GDP in the fourth quarter of 2002.

Exports declined by 1.4 per cent over the year and by 3.4 per cent on a quarterly basis. Imports however grew by 1.2 per cent for 2002 on 2001 and by 2.2 per cent for 2002Q4 on 2001Q4. Imports declined by 0.3 per cent for the latest quarter on the previous quarter. Net trade has made a negative contribution to GDP in 2002 and the gap between exports and imports has widened over the year by 15.8 per cent.

The UK's balance of trade in goods and services in January 2003 was estimated to be a deficit of £1.7 billion compared to £1.3 billion in December. The balance of trade on services has been declining slowly over the last two months. The balance of trade on goods with the EU is relatively static although it widened slightly in January. The balance of trade with the rest of the world however has declined further. The current account however is not unusually large as it is close to its 40-year average and it is not an immediate concern. The deterioration in the contribution of net trade to GDP is only likely to be reversed if exporters can maintain market share even if this is at the expense of margins.

Overall an exodus of manufacturing firms from the economy in general or in specific sectors could lead to a worsening of the current account. The displacement of manufacturers is not a new phenomenon but is seen across other countries. This reflects a shift in comparative advantage and the economy is slowly and painfully adjusting to this. A gradual change is preferable to a sector becoming entrenched in an unsustainable position and that sector then suddenly collapsing.

Investment declined by 4.5 per cent on an annual basis and by 3.3 per cent for quarter four on the same quarter of 2001. The decline in investment slowed however in the last quarter of 2002 to 0.6 per cent. Business investment declined by 1.1 per cent for 2002Q4 on 2002Q3 but for the latest quarter on the same quarter of the previous year the decrease was 9.2 per cent. Total manufacturing investment performed relatively worse declining by 7.9 per cent and 17.7 per cent respectively. Only in distributive services was investment growth positive.

The data and survey evidence confirm that consumption and government spending remain the drivers of GDP growth in the UK economy. Retail sales grew by 1.8 per cent in the fourth quarter of 2002 and by 1.1 per cent in December. The December figure, although higher than expected requires caution in interpretation due to the significant seasonal adjustment. In January retail sales grew by 1.0 per cent for the latest three months on the previous three months. The figure for January was 1.0 per cent below the December 2002 figure but 4.2 per cent higher than during January 2001.

Taking all of the available data and survey evidence into account we expect domestic demand to remain significant. Consumption and government spending are expected to remain strong. Consumption is expected to decline gradually over 2003 as is government spending. Investment is forecast to pick up in the second half of 2003. Stronger economic performance will stimulate investment further and this is expected to contribute to real GDP growth. We do not hold the view that consumers anticipated an increase in the terms of trade[1]. This has undoubtedly led to higher real incomes. We believe however that the decision to increase or maintain spending levels is due primarily to low interest rates and relatively low unemployment. Household sector financial flows are close to balance with the savings ratio above its long-term average. Households are acquiring financial assets at a pace that matches their rising liabilities but the value of these assets have been eroded recently due to the substantial falls in equity markets. This concern will need to be addressed before it becomes a real problem.

The expectation is for the UK to perform relatively well and that recovery will be in place by the end of 2003 and

1. See Bank of England, (2003), Inflation Report, February p11 and pp30-31.

certainly by 2004. The strong economic performance will be aided by low inflation and macroeconomic stability. This suggests that the labour market will improve over the period and that unemployment will remain low.

Inflation

There have been some concerns over inflation, particularly oil price pressure, which is expected to be short-term and perhaps more importantly house price inflation. The RPI rose by 3.2 per cent for the twelve months to February 2002 while RPIX rose by 3.0 per cent. RPIX was 2.7 per cent in December (up 0.6 percentage points from Septem- ber). The output price for manufacturing products increased by 1.6 per cent in the twelve months to February and the unadjusted increase was 0.3 per cent. The main pressure came from increased petrol prices. The input price index for materials and fuels rose by 5.9 per cent in the year to February and by 1.4 per cent (seasonally adjusted) on a monthly basis. The increase here is attributed to the rise in the price of crude oil. There is, as usual, conflicting signals from the house price indices. It is clear however that the level of mortgaging activity has increased. Lending rose by 13.7 per cent in January but 52 per cent of this was re-financing activity (compared to 41 per cent in January). Earnings growth was 4.0 per cent from May 2002 and average earnings grew by 3.7 per cent in the three months to December 2002. In manufacturing earnings rose by 4.1 per cent compared to 3.6 per cent in services. The decision to drop interest rates to 3.75 per cent had two vital factors:

Æ there were concerns that RPIX was above target and reducing rates would risk missing the target in the medium-term as high oil prices could push inflation beyond 3 per cent and

Æ the risk of not cutting rates meant that if inflation was weaker than expected and the oil price pressure was temporary then the continuing pressure that manufac-turers were under could significantly damage output growth.

The decision to cut rates meant that this should help to reduce producer costs. The safeguard is that if inflationary pressures are too strong then rates can be increased again. At the moment however there is still scope for a further rate cut in 2003 if required.

One important factor in assessing the UK economy this quarter and in making forecasts for the UK economy is that there are considerable risks attached to the data and forecasts. This is always the case but given the uncertainty in the world economy this has added significance at this time. The downside risks for the UK economy are:

Æ the situation in Iraq remains a significant concern particularly the effects on the economy following the conflict;

Æ oil prices could be a problem if the price increased during the conflict and the shortage was not met by the US strategic oil reserve, OPEC increasing supply and if the conflict is prolonged;

Æ recovery in the world economy needs to be sustained so any adverse effects (e.g. increased terrorism) on the major economies are likely to have global spill-over effects and

Æ equity markets remain in the balance and any adverse effects could cause a further severe fall in asset prices.

The labour market

The UK labour market has performed relatively well given the economic conditions of 2002. Employment was 27,812,000 in October-December 2002. The employment rate for October-December was 74.6 per cent up 0.3 per cent on the previous year and on the previous quarter. The increase over the previous three months was 150,000 and over the year it was 253,000. Manufacturing employment fell by 148,000 to 3,570,000 in the three months to December compared to a year ago. The largest falls were seen in electronics (-49,000), textiles (-19,000) and non-metallic mineral products and metal products (-22,000). The number of workforce jobs in September 2002 was 29,493,000 but this was a decrease of 27,000 over the quarter. The number of UK seasonally adjusted employees from the Employers Survey was 25,792,000 for September 2002 compared to 25,855,000 in June 2002. For Septem-ber 2001 there were 25,867,000 employees.

The number of employees rose by 45,000 (0.6 per cent) for this quarter on the previous quarter to 24,472,000 and this was an increase of 227,000 (0.9 per cent) on the year. Self-employment also increased by 0.3 per cent from 3,145,000 to 3,154,000 over the quarter. This was a rise of 62,000 (2.0 per cent) over the year. Full-time employment has increased by 159,000 (0.8 per cent) over the quarter and by 117,000 over the year (0.6 per cent). This compares with a rise of 136,000 part-time jobs over the year but over the quarter there was a decline of 9,000 part-time jobs leaving 7,089,000 in part-time employment. The number of WRGTPs was 94,000 in October-December falling by 4,000 (-3.9 per cent) on the quarter and by 24,000 (-20.1 per cent) over the year.

The numbers who were economically active in October-December 2002 was 29,318,000 (a rate of 78.7 per cent). This was a change of 114,000 or 0.2 per cent. 7,667,000 people were economically inactive and of these 5,417,000 did not want a job.

Unemployment was 5.1 per cent in October-December 2002 but down slightly by 0.1 per cent on the previous three months and on the year. The level of unemployment is 1,506,000 and is down 36,000 on the three months and 3,000 on the year. Claimant count was 928,500 (3.1 per cent) in January 2003, down by 3,500 on December 2002 (the rate remained at 3.1 per cent in December) compared to a reduction of 2,100 for December on November.

The trend in the labour market is for employment to rise, unemployment to fall and average earnings to grow more slowly than previously. The labour market is easing slightly with scope for more employment gains while unemployment is forecast to remain low.

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