The UK economy

Overview

The UK economy is weaker at this time than expected in early summer. As growth in the global economy continues to be weak forecasters have tended to revise down slightly their forecasts for both this year and next. Against this background the inflation picture has improved and the prospect of a rise in interest rates has receded. But the labour market has weakened slightly over the last few months. The net trade position is improving as exports pick up and the growth of domestic consumer demand appears to be moderating slightly. The prospects of a shift to export-led growth as the world economy recovers therefore seem brighter than earlier in the year. Nevertheless, there are considerable uncertainties in the world economy for both real economic as well as political reasons, such as the growing threat of a war with Iraq.

Outlook

Table 1 shows the average of independent forecasts for the UK economy taken from a monthly survey by HM Treasury. Compared to the forecasts presented in the July Commentary the prospects for the UK economy have deteriorated slightly for both this year and next. Average GDP growth forecast for 2002 is now 1.6% compared to 1.7% in June and for 2003 2.6% compared to 2.8% in June. The anticipated slower growth is associated with a slight improvement in the inflation picture in 2002, a smaller current account deficit and a larger net borrowing requirement. Unemployment is, perhaps surprisingly, also forecast to be slightly lower during 2002 than predicted in June.

Table 1: Independent forecasts of the UK economy

	2002	2003
Real GDP growth (%)	1.6	2.6
Inflation (RPIX %)	2.2	2.4
Unemployment (claimant count, million)	0.98	0.98
Current account (£bn)	-21.4	-23.4
PSNB (GBP million)	12.7	16.6

Source: "Forecasts for the UK Economy", HM Treasury, September 2002

UK macroeconomic trends

Output growth

Real GDP growth in 2002 Q2 represented an improvement on the previous two quarters. Despite the figures for Q2 being revised downwards in the latest release, real GDP is still estimated to have grown by 0.6% over the previous quarter. This can be compared to the previous two quarters where the economy was largely flat exhibiting only 0.1% growth in each quarter. Over the year to 2002 Q2 GDP rose by 1.2%.

The growth of manufacturing output was lower than anticipated in June and this was the primary reason for the downward revision in the Q2 GDP statistic. During the quarter manufacturing output fell by 0.7% and by 5.3% over the year. This is the sixth successive quarter that manufacturing output has fallen and constitutes the longest decline in the post-war period. The fall in manufacturing output of 5.5% in June may in part have been due to the effects of the Jubilee celebrations and even the World Cup. Some support for this is given by the data for July where manufac- turing output is estimated to have risen by 4.9%, the largest monthly rise since February 1979. The main sectors within manufacturing exhibiting output losses during the second quarter were textiles, metal products and chemicals. Output in the engineering sector remained unchanged, while the food and drink sector grew slightly. The stabilisation of engineering output and turnover is encouraging, with signs that both export and home sales were beginning to pick up in 2002 Q2. However, over the year to the second quarter home turnover remains down by 12.2% and export sales are 22.6% lower.

The service sector continued to display positive growth in the second quarter growing by 0.6% over the 2002 Q1 and by 2.1% over the previous twelve months. Distribution, hotels and catering, exhibited the strongest growth within services during the quarter (1.2%), followed by Business services and finance (0.9%), while transport storage and communication contracted (-0.3%). Over the year distribution, hotels and catering was the strongest growth sector within services (3.2%), followed by business and finance (2.6%), government and other services (2.0%) and transport and communication (-0.6%).

Components of demand

In the second quarter, real household consumption grew quite strongly at 1.2%, significantly faster than the 0.5%, on revised figures, reported for the first quarter. Year on year growth in 2002 Q2 was 3.9%, up from 3.5% the previous quarter. However, retail sales growth slackened to 0.3% in July and the CBI Distributive Trades survey for August suggested that sales growth was slowing further. The Bank of England's August ***Inflation Report*** indicated that some slowing in consumption growth was anticipated later in the year. Nevertheless, consumer borrowing and the housing market remain strong. Falling equity markets as yet appear to have had little impact on the confidence of the consumer or on consumer demand, but the slower growth of personal incomes and wealth would appear likely to affect demand as the year progresses. General government consumption fell by 0.9% in 2002 Q2 but increased by 4.2% over the year.

Vol.27 No.3, pp.14-15.

Investment in fixed capital was flat in the second quarter and had fallen by 5.4% over the year. However, business investment was up 0.3% on the first quarter but down by 8.3% over the year. The indications are that despite the quarterly volatility of the series, the decline in business investment is slowing down. Manufacturing investment, on the other hand, fell by 4.6% in the quarter, down by 17.8% on the year.

Export performance improved in the second quarter, rising in real terms by 3.0%, although down by 2.7% on the year. Imports also rose but by 1.5% in the quarter and were down slightly by 0.1% on the year. Net trade therefore contributed 0.4% to growth in 2002 Q2. In the three months to July the balance of trade in goods and services was £4.2 billion in deficit, a narrowing from the deficit of £4.8 billion in the previous three months. The latest ONS estimate of trend suggests that the UK trade deficit is narrowing, with the balance of trade in services continuing to be positive and the deficit on trade in goods beginning to narrow as export growth picks up.

Inflation

In August, the underlying inflation rate as measured by RPIX, retail prices excluding mortgage interest payments, fell by 0.1 percentage points to 1.9% compared with July. The downward movement is attributed to changes in clothing and footwear prices, household goods and household services. The inflation rate continues to remain below the official inflation target of 2.5%.

Output prices for the manufacturing sector rose by 0.3% in the year to August, unchanged from the previous month, while input prices fell by 2.2% up from the 3.8% fall in the year to July. As noted in the July Commentary the gap between output and input price growth is an indication that manufacturers are seeking to rebuild margins after their erosion over the past two and a half years.

Average earnings growth began to rise in March of this year after falling almost continuously since the early months of 2001. The latest data are for July and these indicate that annual average earnings growth edged up by 0.3 percentage points to 4.1%. The removal of bonuses makes no difference to the measured growth of core earnings. Private sector earnings are continuing to grow faster than public sector earnings, thus sustaining the position that came about in April after a year in which public sector earnings growth had outstripped the private sector.

Productivity, as measured by output per filled job, fell slightly by 0.1% for the economy as a whole in the first quarter of 2002 but rose by 0.4% over the year. In manufacturing, productivity, which fell while the sector was in recession, rose by 1.9% in July. However, over the year to the latest three months productivity was down by 0.2%.

The labour market

The labour market in the UK continues send out contradictory messages but appears to have weakened slightly since the July Commentary. The number of people in employment rose by 38,000 over the three months May-July and by 198,000 over the year. The average monthly rise over the three months to May-July was 12,700, compared to an average monthly rise of 20,800 over the six months to May-July. The number of hours worked per week fell during the quarter. Employee jobs were down by 50,000 over the quarter to June while self-employment rose by 65,000. The ILO unemployment level rose by 7,000 over the three months to May-July and was up 52,000 on a year earlier. The claimant count, in contrast, exhibited an average monthly fall of 2,600 over the three months to August and in that month was 10,100 down on a year earlier.

So, while net jobs are still being created the rate of growth of employment appears to be subsiding. Unemployment, on the preferred ILO measure is rising because the jobs being created are insufficient to match the growth in the labour force.

Monetary policy

The Bank of England's Monetary Policy Committee last met on September 4th and 5th and agreed unanimously to hold interest rates at 4%. The MPC took the view that the decision to hold the rate at 4% should not be construed as a lack of response to the slower-than-expected recovery in activity in the world economy and the large falls in equity prices. The earlier expectation for inflation was a move above the target rate at the two-year horizon. Official rates were therefore expected, as noted in the July Commentary, to rise. Accordingly, the decision to hold rates should be viewed as a positive policy response to the changed prospect for inflation. The unexpected sluggishness of the recovery now perhaps suggest that the prospects for interest rates are now shading in favour of a rate cut although subsequent outturn data may make such a move unnecessary.

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Vol.27 No.3, pp.14-15.