The UK economy

Overview

The UK economy is clearly suffering as a result of the global slowdown and the political and economic uncertainty following the events of September 11th. However, the impact is relatively modest in comparison with some economies and there is a feeling among some commentators, the Chancellor of the Exchequer included, that the UK is relatively well placed to ride out the worst of the global slowdown. Consumption is relatively buoyant, and although there are signs of slackening activity in the labour market, by historical standards unemployment is still low and employment healthy.

In part the optimism may be explained by the policy stance of the monetary authorities. Interest rates have been cut at the regular October and November meetings of the Monetary Policy Committee. These cuts followed on from the emergency cut in mid-September in the immediate aftermath of the terrorist attacks on the US. The prospects for inflation suggest that there may be scope for further cuts in the New Year if circumstances demand.

The Chancellor's Pre-Budget Report in late November may have added to the feeling of relative optimism. As we discuss below the Chancellor himself took an optimistic view of the economy's prospects and even though the Government's fiscal position is set to deteriorate, the current policy stance means that the Government should meet its two fiscal rules.

Outlook

The prospects for the UK economy continue to weaken. In Table 1 we show forecasts taken from a monthly survey of City and other independent forecasters compiled by HM Treasury. Since our last Commentary in September the extent of the slowdown expected for next year has increased with the GDP forecast marked down form 2.6% to 1.9%. Claimant count unemployment in 2002 is now expected to be in the region of 1.08 million compared with the earlier forecast of 1.01 million.

Longer range forecasts by the National Institute of Economic and Social Research published in their October Review and prepared after the events of September 11th shows real GDP growth returning to a trend figure of 2.6% in 2003. This projection is consistent with a view that the UK is in a good position to ride out the current global slowdown, although it should be noted that the National Institute is also less pessimistic about GDP growth in 2002 (forecast at 2.2%) than the panel surveyed by the Treasury.

The forecasts in Table 1 also demonstrate increasing pessimism about the external position of the UK with a project current account deficit of some £23.6 billion. The public finances are also expected to deteriorate with a small deficit anticipated next year. We discuss the Treasury's own view of the public finances later in this section.

Table 1: Independent forecasts of the UK economy

	1999	*2000*	*2001*	*2002*
Real GDP growth (%)	2.1	2.9	2.2	1.9
Inflation rate (PPIX %)	2.3	2.1	2.3	2.3
Unemployment (claimant count, million)	1.25	1.09	0.97	1.08
Employment growth (%)	1.0	0.7	0.4	-0.2
Current account (£ billion)	-19.1	-18.4	-16.5	-23.6
PSNB (£ billion)	-14.8	-16.9	-5.3	3.5

Source: National Statistics; "Forecasts for the UK economy", HM Treasury, November 2001.

UK macroeconomic trends

Output growth

The latest revision of third quarter GDP shows that real output in the UK grew by 0.5% quarter on quarter or 2.1% year on year. This represents a fall of 0.6 percentage points on the year on year rate for the same quarter in the previous year, and a fall of 0.1 percentage points on the year on year rate for 2001 Q2.

Manufacturing output has fallen by some 0.8% compared with the previous quarter and by some 1.6% between August and September. Output in the electronics and optical instrument industries fell dramatically by 5.6% over the quarter and 3.5% over the month up to September. This fall should probably not be surprising given the slowing global economy and the particular exposure of high tech products to this slowdown. Output in the distribution industries increased by 1.1% over the last quarter or 4.1% year on year.

Components of demand

The UK national accounts for the third quarter of 2001 show that household consumption continues to hold up well with year on year growth of 4.5% compared with 4.2% in the second quarter. The more volatile quarter on quarter growth rate is flat at 1.3% in both the second and third quarter. The prospects for consumers expenditure are undoubtedly less healthy with the latest release of consumer confidence data for November showing a balance of -3, compared with the third quarter average of +1. Households continue to be more concerned about the general economic situation rather than their own position. Retail sales data for October do provide some early evidence of an actual slowdown with the month on month rate showing a contraction of 0.1% and the annual growth rate falling to 5.7% from 6.0% the previous month.

The worsening external situation is reflected in lower exports, now falling quarter on quarter at 3.6% and at 2.3% year on year. This is the second quarter in which UK exports fell compared against a sustained earlier run of increases in export volumes. Fixed investment is also falling back and there is evidence of de-stocking in the second and third quarters.

Inflation

In August inflation as measured by RPIX, retail prices excluding mortgage interest payments, exceeded the official inflation target of 2.5% for the first time since March 1999. At the time there was some concern that underlying inflation had risen steadily during the spring and summer and that the Bank of England's Monetary Policy Committee may have had to start worrying about the level of inflationary pressure in the economy. Fortunately, since August the RPIX inflation rate has eased back from 2.6% to 2.3% in both September and October and this concern now seems to have passed. Indeed the lower inflation rate may provide some further scope for future reductions in the interest rate.

Input prices for manufacturing producers fell by 9.0% in the year up to October and by 3.6% over the month between September and October. This fall mainly reflects a decline in Sterling oil prices of some 34% over the year and of 19% during October. Output prices have been more stable with the year on year inflation rate showing small price falls for both September and October. This suggests that manufacturing firms are building their profit margins rather than passing on lower costs onto retailers and consumers.

Whole economy average earnings growth has been slowing since the summer with the September rate down 0.1 percentage points from August to an annualised 4.4% over the last three months. The year on year growth rate stands at 4.5%. The gap between public and private sector earnings growth noted in our previous Commentary continues with public sector earnings growing at an annualised rate of 5.8% compared with private sector growth of 4.1%. The gap can probably be explained by lower bonus payments within the private sector since earlier in the year.

The lower growth in private sector earnings is encouraging in that although the whole economy growth figure is just on the threshold at which the Monetary Policy Committee has said is consistent with 2.5% price inflation, it is mainly private sector earnings that are passed on into higher prices.

The latest data on productivity shows that whole economy productivity growth was down to 1.6% over the year up to the second quarter, compared with the first quarter growth of 2.1%. More timely manufacturing data shows that year on year productivity growth declined from 1.8% in the second quarter to 1.3% in the third quarter. Such declines in productivity are usually observed in the early stages of a slowdown.

When the productivity data is combined with information on earnings, the year on year growth in unit wage costs was 3.5% for the whole economy up to the second quarter. This is the highest rate since 2000 Q1 and it represents a full percentage point increase in the annual rate over the previous quarter.

The labour market

There are now obvious signs that the slowdown in UK output is now staring to have an impact upon the labour market. It is normally the case that employment and unemployment tend to lag behind the business cycle, as firms are initially reluctant to lay people off given the high fixed costs of hiring if output were to pick up in the near future. There are signs that the economy is now moving beyond that stage with rises in unemployment on both the claimant count and ILO definitions, and a fall in employment. However, this softening has taken place against the background of a tightening labour market earlier in the year.

The ILO unemployment rate was 5.1% over the three months between July and September, this was marginally up on the 5.0% rate over the previous three months. In terms of individuals this represented an increase of some 28 thousand unemployed. Over the year as a whole though the rate was down 0.3 percentage points and the total number of people unemployed was down 75 thousand. The contrast between the year on year changes and the quarter on quarter changes is explained by the fact that the labour markets was still tightening early in the year whereas the market is currently becoming loser. The latest claimant count data is for October with an unemployment rate standing at 3.2%, up by 0.1 percentage points on the previous month.

The central LFS measure of employment based on those aged between 16 and the official retirement age fell by 24 thousand in the three months between July and September. Once again there is a contrast with the data over the past twelve months where employment increased by 159 thousand.

Monetary policy

The Monetary Policy Committee has made two further cuts in interest rates since its emergency decision in mid September following the terrorist attacks in the US. At its regular October meeting the Committee trimmed a further 0.25 percentage points off its repo rate citing the weakness in the global economy and the increased uncertainty following the terrorists attacks. In November there was a further cut of 0.5 percentage points taking the repo rate down to 4.0%. Once again the Bank cited the depth of the global slowdown. On both occasions the Bank also mentioned the relative strength of the UK economy, but noted their concerns about the impact of September 11th and the slowing global economy on UK business and consumer confidence. Although UK interest rates are at historically low levels there are expectations amongst some commentators of further cuts in the New Year as inflationary pressures ease further.

Fiscal policy - The Pre-Budget Report

Gordon Brown's Pre-Budget Report, presented on November 27th, was in some ways a low-key affair. The Treasury's economic forecasts, summarised in Table 2, are relatively optimistic when compared against the independent projections in Table 1.

Table 2: HM Treasury forecasts of the UK economy

	2001	*2002*	*2003*	*2004*
Real GDP growth (%)	2.25	2 to 2.5	2.75 to 3.25	2.25 to 2.75
Inflation rate (RPIX %)	2.25	2.25	2.5	2.5
Current account (£ billion)	-14	-26.75	-28.75	-30.5

Source: Pre-Budget Report, HM Treasury, November 2001

The Treasury's detailed projections show that household consumption is expected to slow down from 2002 onwards, but in 2003 this is offset by far stronger growth in fixed investment accompanied by a recovery in exports. We can probably attribute the investment growth to a process labelled the "accelerator". When an economy slows down firms tend to cut investment disproportionately and so when the recovery comes investment tends to be boosted disproportionately as firms try to put in place enough physical capital to deal with the recovery in their order books.

Even though the Treasury's latest forecasts are on the optimistic side they do involve a marking down of the official view on the economy for 2001 and 2002 compared against last March's Budget projections. When added to the actual slow down in the economy that we have already seen this year it is no surprise that the health of the public finances suffers. Back in March the Treasury forecast debt repayment of nearly £5 billion in the current fiscal year. As Table 3 shows this has now been transformed to an anticipated deficit of £2.5 million. The position for next fiscal year is even worse with an anticipated extra borrowing of £10 billion taking the projected deficit up to £12 billion.

Table 3: The public finances

	2000-01	*2001-02*	*2002-03*	*2003-04*
Surplus on current budget:				
£ billion	25.1	10.3	3	4
Per cent of GDP	2.6	1.0	0.3	0.4
Public sector net borrowing:				
£ billion	-18.8	2.5	12	15
Per cent of GDP	-2.0	0.3	1.1	1.3
Cyclically adjusted PSBN:				
Per cent of GDP	-1.6	0.3	1.1	1.4

Source: Pre-Budget Report, HM Treasury, November 2001

According to the Treasury's analysis this worsening in the fiscal position can be attributed to various aspects of the slowdown, including lower equity prices, lower profits and of course lower GDP growth. Perhaps here though we can find some comfort. Most commentators are relatively relaxed about public sector deficits in bad times provided that they are matched with debt repayment in good times. Indeed, this is exactly the position that the Government's own fiscal rules take. It seems reasonable to expect that once the UK economy bounces back the public finances will return to health too as Table 3 implies.

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