

# The UK economy

## Overview

Recent events in the US have heightened fears that the continuous expansion of the UK economy since 1992 may be put in danger. Some commentators have revised their forecasts of GDP growth downwards and there is a general expectation that the next change in UK interest rates will be downwards. However, the likely impact of a US downturn on the UK will be relatively small. GDP growth remains strong at 3.0% in the four quarters up to 2000 Q3, although there are signs that industrial production and manufacturing output are slowing. Inflation as measured by RPIX is currently beneath the Government's inflation target and is expected to remain so during 2001. The ILO unemployment rate was 5.3% over the three months between September and November 2000, unchanged from the previous three months.

## Outlook

The outlook for the UK economy in 2001 and 2002 remains relatively benign. In Table 1 we show forecasts taken from a monthly survey of independent City and other forecasters by HM Treasury. Two sets of figures are shown: averages over forecasts produced in November, December and January and also averages from forecasts produced so far in January. The relatively small number of forecasters included in the January sample implies that we should be cautious about using these numbers, although they do illustrate that there has been a small but perceptible hardening of views about a potential slowdown in the UK economy.

The forecasts in Table 1 show an expectation that GDP growth will weaken from its current annualised rate of 3.0% by about half a percentage point. Claimant count unemployment looks set to stabilise according to the January forecasts. The public finances are expected to show a £11 billion surplus in the 2000/ 2001 financial year with the surplus more than halving to just over £5 billion in 2001/ 2002. These forecasts are roughly in line with the Treasury's own projections in the November 2000 Pre-Budget Report.

## The impact of a US downturn

As Table 1 illustrates most UK forecasters appear to be relatively relaxed about the potential impact of a US

slowdown upon the UK economy over the next two years. Some of the forecasts in the three month average figures in Table 1 will have been prepared before sentiment about the US changed in the light of data published in December and the Federal Reserve's interest rate cut in early January. However, the January only figures will have been produced in the light of this new information.

**Table 1: Independent forecasts of the UK economy**

	3 month average		January only	
	2001	2002	2001	2002
GDP growth (%)	2.6	2.5	2.5	2.6
Inflation rate (RPIX %)	2.2	2.4	2.2	2.4
Unemployment (claimant count, million)	1.03	1.02	1.04	1.04
Employment growth (%)	0.4	0.3	0.3	0.3
Current account (£ billion)	-18.2	-18.0	-18.3	-18.5
PSNB (£ billion)	-10.7	-5.3	-10.9	-5.2

Source: "Forecasts for the UK economy", HM Treasury, January 2001

There are two principal reasons why a US downturn will have a relatively modest impact upon the UK economy: the importance of the US as a market for exports in comparison with the Euro zone and the vulnerability of UK financial portfolios to falling US asset prices.

The Euro zone is about three times as important as the US as a destination for UK exports. Just under 3% of UK GDP is exported to the US, compared with about 10% to the Euro zone. Similarly, about 55% of UK manufacturing exports are sold to the Euro zone while 15% are sold to the US. It is true the UK is more reliant upon trade with the US than the Euro zone economies, where roughly 2% of GDP is exported to the US. Nevertheless the direct effect of a UK downturn on UK trade is likely to be modest.

A similar comparison can be between the impact on the UK and the Euro zone economies of falls in US asset prices. Direct equity holdings by households in the UK are more important than in the Euro zone, though less so than in the US. This means that if a fall in US asset prices spread to domestic stock markets the impact on UK consumers would be stronger than on Euro zone consumers. Probably more important though is the radical difference in the health of private sector balance sheets in the UK and Europe when compared with the

position in the US. This means that the UK and European private sectors are better placed to withstand a fall in asset prices.

Simulations by Oxford Economic Forecasting on their UK macroeconomic model suggest that a short lived downturn in the US of two successive quarters with no growth followed by a return to reasonable growth would lead to UK growth being reduced by 0.25 percentage points in 2001. A more serious downturn in the US involving a fall in output lasting for three successive quarters would knock one percentage point off UK growth. These simulations do assume that the Bank of England responds to a potential UK downturn with appropriate interest rate cuts.

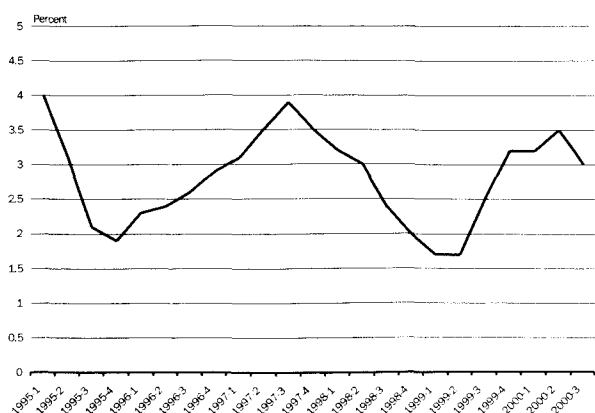
## UK macroeconomic trends

### Output growth

Figure 1 shows the annual growth rate of real GDP, calculated using data from the same quarter in the previous year. On this basis the UK economy was growing at 3.0% in 2000 Q3, the latest quarter for which we have information. This represents a very slight weakening since the previous quarter and there is a general anticipation that the fourth quarter figure will show further signs of weakening. In part this anticipation is based on flat industrial production figures for last October and November.

At an annual rate of 3.0% GDP growth is still above the Treasury's estimate of trend growth of 2.25%, although this estimate is widely recognised as being deliberately cautious.

**Figure 1: UK real GDP growth**



### Components of demand

According to the national accounts, real private consumption is continuing to grow strongly at an annual rate of 4.2% up to 2000 Q3. This directly contributed 2.8 percentage points to the 3.0 point growth rate of GDP. Government consumption also continues to grow strongly at an annual rate of 3.9%, making a contribution of 0.7 percentage points to GDP growth. Fixed investment by both the private and public sector is growing at a far slower rate (2.1% in annual terms) and there must be a concern that general consumption is crowding out fixed investment in the economy at present.

Table 1 suggests that the UK current account deficit is not expected to deteriorate rapidly over the next two years. Nevertheless, imports showed very strong growth in the four quarters to 2000 Q3 and outstripped growth in export demand by a significant margin. Net trade made a negative contribution of 1.5 percentage points to the GDP growth rate.

### Inflation

Recent trends are on the whole encouraging and suggest that the Bank of England has some room to manoeuvre on interest rates if needed. The headline inflation rate as measured by the all items Retail Price Index was 2.9% for the twelve months up to December 2000, slightly down on the rate up to November of 3.2%. There was also a small fall in the RPIX (all items excluding mortgage interest payments) rate down to 2.0% for the twelve months up to December compared with the November figure of 2.2%. These reductions are accounted for by a reduction in motoring costs as the price of unleaded petrol fell in December and, for all the all items index, a reduction in mortgage interest rates as compared with the increase in December 1999. There was also a slight upward pressure on both indexes as a result of the depreciation of Sterling. Inflation as measured by the Harmonised Consumer Price Index as used by the European Central Bank stood at 0.9% in the twelve months up to December 2000, compared with 1.0% in the twelve months up to November.

Producer input prices fell during December 2000 by some 3.4%, again primarily as a result of lower oil prices. This meant that the input price inflation rate in the twelve months up to December 2000 fell to 5.7% from 11.5% in the twelve months up to November. Since early 1999 input price inflation has exceeded output price inflation by significant amounts suggesting that margins in manufacturing have been under significant pressure from increasing oil prices. December's fall in

input prices suggests that the pressure on margins is currently abating. For the economy as a whole, the fact that higher oil prices have not fed through to output prices is encouraging in that it suggests that trends observed elsewhere in the world economy for oil prices not to feed into the *general wage-price spiral* also apply in the UK.

Average earnings increased by 4.5% over the twelve months up to November 2000. This is the highest annual rate calculated on this basis since April 2000 when the figures appear to have been inflated by bonuses paid at the end of 1999 and in early 2000. The acceleration in November does not appear to have been driven by higher bonuses, but by a pickup in public sector pay up from 3.5% until October 2000 to 4.1% in November 2000. A run of good productivity growth figures for the last few quarters means that unit wage costs are increasing at a fairly subdued rate of 1.4% in the four quarters up to 2000 Q3.

The central inflation rates for policy purposes in the UK is based on RPIX and at 2.0% this is currently well below the central target of 2.5%. As Table 1 shows, the independent forecasters surveyed by HM Treasury expect inflation to be 2.2% in 2001 and there does not to be any significant concern that the inflation target will be breached this year. In 2002 inflation is expected to move upwards to 2.4% and although this is beneath the target there must be some concern about a potential overshooting.

The forecasts in Table 1 include the effects of any interest rate changes judged to be necessary by the forecasters in contrast to the projections included in the Bank of England's fan chart of inflation forecasts. The latest public version of the fan chart was published in the November 2000 Inflation Report and shows that at that time the Bank's central assessment was that inflation would remain beneath 2.5% during 2001. We anticipate that the central assessment will be lower in the fan chart to be published in the February 2001 Inflation Report.

### **The labour market**

The latest release of labour market data suggests that both unemployment and employment are levelling out at the end of 2000. Given the recent downward trend in unemployment, and increase in employment, these figures could provide support for the view that the UK economy is starting to gently slow down. The alternative - and perhaps less likely - interpretation is that the slack in the labour market has now been taken up and that

any further increases in output will have to come from productivity improvements.

The ILO unemployment rate was 5.3% over the three months between September and November 2000, unchanged from the previous three months and down from the 5.9% over the same period in 1999. The claimant count unemployment rate has moved in a similar way during 2000 with the rate stabilising at 3.6% in December.

Employment fell marginally over the three months between September and November 2000. The employment rate stood at 74.5% during this period, up 0.3 percentage points when compared with the same period in 1999.

### **Public finances and the pre-budget report**

In November 2000 the prospects for the public finances were looking sufficiently healthy for the Chancellor to announce an additional £3 billion of spending and £1 billion of tax cuts per annum by the 2002/3 financial year in his November 2000 Pre-Budget Report. In addition Gordon Brown responded to political pressure by proposing a package of tax cuts aimed at motorists that would cost £1.75 billion in a full year.

These measures were significantly more generous than expected immediately before the Chancellor's statement and there was some initial speculation that the Bank of England may be forced to raise interest rates as a result. The Chancellor argued that the Government is still on course to satisfy its two fiscal rules to maintain a budget that is balanced or in surplus over the economic cycle and to bring the debt to GDP ratio beneath 40%. In addition he argued that the measures announced in the Pre-Budget Report and those in the July 2000 Spending Review do not represent a loosening of fiscal stance compared to that announced in the 2000 Budget. They simply take advantage of stronger tax receipts, projected savings on the social security budget and lower debt interest payments when compared with the Budget projections.

Most commentators acknowledge that the Treasury's calculations are based on cautious assumptions and if anything they understate the health of the public finances. Regardless of the Government's ability to satisfy its fiscal rules there are concerns about the growth in government spending. In real terms government spending is set to grow by 4% in 2001 while evidence from the national accounts data suggests that government consumption grew faster than the trend

increase in GDP in 1999 and in 2000 up to Q3. Nevertheless, the pressure on the Bank of England to raise interest rates as a result of the Government's expenditure plans has lessened since the Federal Reserve cut US interest rates in early January.

John Ireland  
17th January 2001

crisis management

[www.businessam.co.uk](http://www.businessam.co.uk)

Now you know

**business a.m.**

**US vulture swoops on £2bn Scots investment**

**Now you know**

**US vulture swoops on £2bn Scots investment**

**Now you know**