# The UK economy

## Overview

The UK economy is starting to show signs of slowing down. The preliminary estimate of GDP quarter on quarter growth in 2001 Q1 at 0.3 percent was the lowest since 1998 Q4. The year on year growth rate fell to 2.5 percent in 2001 Q1, compared with 2.6 percent the previous quarter and 3.0 percent for 2000 as a whole. The output of production industries has fallen in February and March, partly due to the continuing weakness of mining, oil and quarrying output and partly due to a fall in manufacturing output in March. Of particular concern is the 3.3 percent fall quarter on quarter in the output of electronics and optical equipment. Since our last Commentary the Bank of England has cut interest rates twice by 0.25 percentage points in April and May. On both occasions the Bank cited concerns about the global economy and the need to meet the inflation target in the medium term.

Foot and mouth disease has had a major impact upon some parts of the livestock industry since February. The direct impact upon the economy as a whole is likely to be relatively modest, although there are concerns about reductions in spending by tourists.

## Outlook

Since our last Commentary prospects for 2001 appear to have weakened slightly, although there is more optimism about the chances of a recovery in 2002. In Table 1 we show forecasts taken from a monthly survey of independent City and other forecasters compiled by HM Treasury. We show the average figures for forecasts made in February, March and April. Separate figures are available for forecasts made in April, but on this occasion they were very close to the three-month average and we do not report them here.

The forecasts in Table 1 show an expectation that GDP growth will weaken from its 2000 growth rate of 3.0 percent by some 0.6 percentage points to 2.4 percent. In 2001 GDP growth is expected to recover slightly to 2.7 percent. When compared with the forecasts reported in our previous Commentary in January the 2001 growth rate is marginally lower and the rebound in 2002 is marginally stronger.

## UK macroeconomic trends

### Output growth

We noted above that there were signs of slowing output in the UK. Quarter on quarter GDP growth in 2001 Q1 was the lowest since 1998 Q4. The year on year growth rate fell to 2.5 percent in 2001 Q1, compared with 2.6 percent the previous quarter and 3.0 percent for 2000 as a whole.

Manufacturing output fell back slightly in March 2001 after two months in which the index was constant. In the three months since the start of 2001 manufacturing has shrunk by 0.7 percent. Output growth in manufacturing has been lagging behind growth in the economy as a whole for some time, whereas services have grown more quickly. It must be of some concern that detailed index of production data reveals that the output of electrical and optical equipment fell by some 3.3 percent in the latest quarter.

**Table 1: Independent Forecasts of the UK Economy**

| | *1999* | *2000* | *2001* | *2002* |
|---|---|---|---|---|
| GDP growth (%) | 2.3 | 3.0 | 2.4 | 2.7 |
| Inflation rate (RPIX %) | 2.3 | 2.1 | 1.9 | 2.3 |
| Unemployment (claimant count, million) | 1.25 | 1.09 | 1.01 | 1.03 |
| Employment growth (%) | 1.0 | 0.6 | 0.3 | 0.3 |
| Current account (£ billion) | -9.1 | -14.2 | -18.8 | -20.1 |
| PSNB (£ billion) | -15.5 | -16.5 | -8.1 | -2.4 |

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

### Components of demand

The national accounts for the final quarter of 2000 Q4 show that household consumption is still growing more rapidly at 3.7% over the year compared to GDP growth of 3.0 percent. The quarterly path shows a slowing down during the course of the year. Prospects for 2001 appear mixed from early indicators. Consumer confidence is still strong by historical standards despite a fall between March and April. The latest retail sales figures show an unchanged quarterly growth rate, while the annual growth rate showed a sharp fall.

Total fixed investment grew roughly in line with GDP, though investment by the government and NHS trusts displayed far faster growth than business investment.

### The impact of foot and mouth disease

The first case of foot and mouth disease was reported in February 2001. Since then there have been restrictions on the movements and sale of livestock as well as the well-publicised culls of animals in various parts of the country. Distressing as the disease has been for rural communities, the direct effects of the reduced output in the agricultural sector will probably be relatively small. Livestock output represents about 0.5 percent of GDP and about half of this is accounted for by milk production which so far has held up reasonably well during the epidemic. In terms of exports, livestock accounted for roughly 0.6 percent of the total volume of goods and services exported from the UK in 2000.

The effects on tourism are potentially more serious given the size of the tourism and travel spend. However, some categories of this spend, such as business travel, are unlikely to be affected by foot and mouth disease. Other categories, such as domestic day trips, are likely to be displaced from the countryside to urban areas or parts of the countryside unaffected by foot and mouth. By way of illustration national accounts data show that output of hotels, restaurants and pubs account for about 2.6 percent of GDP. This includes output consumed by domestic residents on both a day to day basis and on day trips as well as overseas visitors. The British Tourist Authority estimates that in 1998 tourists spent £7.3 billion on retail goods and services and £6.7 billion on travel.

The National Institute for Economic and Social Research in London estimate that, taking account of agricultural and tourism effects, foot and mouth disease will lower GDP growth by about 0.2 to 0.3 percentage points in 2001.

**Inflation**

Inflation as measured by RPIX, retail prices excluding mortgage interest rates, has been beneath the Government's inflation target of 2.5 percent since April 1999. For the first three months of 2001 the year on year inflation rate has been less than 2 percent, with a rate of 1.9 percent in March.

Unlike the European Central Bank, which is required only to ensure that inflation is less than its target, the Bank of England is also required to avoid undershooting its target. We are still some way from an inflation rate of 1.5 percent, at which point the Bank's Governor is required to write an open letter to the Chancellor of the Exchequer explaining why the target has been undershot. However, the Bank is clearly worried that RPIX inflation out turns may be too low and has cited the need to hit the target in both of the press releases explaining its recent interest rate reductions. There is still some concern amongst analysts about longer-term prospects for RPIX and there is a general expectation that further cuts in interest rates will follow later in the year.

The producer input prices index fell by 2.0 percent in March. Year on year the inflation rate was down to 3.6 percent from 5.5 percent the previous month. March's fall in prices was mainly due to reductions in the cost of crude oil and electricity. Producer output prices were constant in March with the year on year inflation rate falling to 0.8 percent from 1.4 percent the previous month.

Whole economy average earnings grew at 5.9 percent over the year up to February 2001. This represents an increase of some 1.6 percentage points compared with the previous month and is driven by private sector earnings growth of 6.5 percent compared with public sector earnings growth of 3.0 percent. The acceleration in private sector earnings is due to larger bonus payments, particularly in the services sector, and may therefore be of less concern than a corresponding acceleration in underlying earnings. The headline growth in average earnings is an annualised rate based on the past three months growth and in February this stood at 5.0 percent, up 0.5 percentage points on the previous month.

Productivity growth edged downwards in the last quarter of 2000, although it was still reasonably strong at a year on year rate of 2.3 percent. When combined with the acceleration in average earnings in the corresponding quarter unit wage cost growth edged up marginally by 0.1 percentage points to 1.7 points. More timely data for manufacturing for February 2001 showed a continuing fall in unit wage costs at a year on year rate of 1.0 percent due to strong productivity growth of 6.0 percent.

## The labour market

In our last Commentary we noted that the upward trend in employment, and the accompanying downward trend in unemployment, had both started to level out towards the end of 2000. The latest release of the quarterly Labour Force Survey, and the more timely claimant count data, reinforce this view. The levelling out can probably be attributed to the start of a gentle slowing down of activity in the labour market and the economy more generally. Nevertheless, the labour market remains relatively tight and the scope for further falls in unemployment must be limited if demand were to pick up.

The ILO unemployment rate was 5.2 percent over the three months between December 2000 and February 2001, down marginally from the previous three months. The claimant count unemployment rate in March was 3.3 percent, unchanged from the previous month. An important psychological barrier was breached in February when the claimant count fell beneath the one million mark for the first time in over two decades.

Employment increased by 113,000 on the LFS measure over the three months December 2000 to February 2001 compared with the previous three months. The employment rate increased by 0.2 percentage points over the same period to 74.7 percent, and by 0.5 percentage points on a year earlier.

In April National Statistics changed the source of its employee jobs statistics to the Annual Business Inquiry resulting in an upward revisions to the series by an average of 876,000 since 1978. The revision will have repercussions for a number of other series, including the claimant count unemployment rate where employee jobs appears in the denominator and on UK productivity measures.

### Monetary and fiscal policy

In financial year 2000-2001 the public sector surplus, or debt repayment, was £16.5 billion. As the economy slows down in 2001 and 2002 revenues will be weaker. With the planned growth in public spending projected surpluses in 2001-2002 and 2002-2003 will be lower, as illustrated in Table 1. Nevertheless, both the Treasury and a number of independent commentators expect the government to easily meet its two fiscal rules over the next two financial years.

As we noted earlier the Bank of England has reduced interest rates by 0.25 percentage points in both April and May citing concerns about the strength of the world economy and the need to meet the RPIX inflation target. These rate cuts have taken place against the background of a series of cuts by the Federal Reserve in the US and a single cut by the ECB on the same day as the Bank's May cut. Although relative interest rates are thought to have some relevance for the determination of exchange rates, the domestic benefits of a cut are not negated by the fact that other central banks have cut rates at the same time.

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