

The UK economy

Overview

The US is driving world growth with very strong growth in the domestic economy. The dollar has depreciated significantly and this is boosting US growth. The decline of the dollar cannot continue indefinitely however and we are forecasting that this will reverse when US employment data picks up and remains relatively robust. This is likely to be towards the end of this year. China continues to provide a strong stimulus to world economic growth and Japanese economic performance is much stronger than expected. The Euro Area continues to be slow with very weak domestic demand. Germany and Italy are now out of recession and we do not expect the Euro Area to pick up until 2005.

UK real GDP growth was 2.3 per cent in 2003, revised up from 2.1 per cent while GVA at basic prices grew by 1.9 per cent. The forecast for 2004 is 2.8 per cent and consumption and government spending are forecast to be the main components of domestic demand. As the Euro Area recovers we expect exports to pick up but this will depend heavily on the real effective exchange rate. It is unlikely that investment growth will be strong until 2005. There are no serious inflationary pressures in the UK economy although there are concerns over the widening current account deficit and the increase in PSNB. We believe that UK interest rates will rise over the course of 2004. Again, as previously forecast, unemployment is expected to remain at low levels with steady employment growth during the year. The outlook for the UK economy is very good, and is slightly better than last quarter.

Outlook

The consensus forecasts for the main UK economic indicators taken from a monthly survey by HM Treasury of City and other independent forecasters are presented in Table 1. Real GDP growth is forecast to be 2.8 per cent in 2004 and 2.6 per cent in 2005. Fourth quarter growth was 0.9 per cent and this was better than expected. Inflation (whether measured by CPI or by RPIX) remains on target. The Bank of England raised interest rates by 25 basis points to 4 per cent and will probably raise interest rates to at least 4.75 per cent by the end of 2004. House prices continue to grow and debt is at very high levels, however consumers appear to be checking spending somewhat although retail sales remain strong. Unemployment is forecast to be very low and employment is forecast to rise steadily. The current account is forecast to widen while PSNB is forecast to rise to £37 billion 2003-04. This forecast to grow to £39.8 billion by 2006-07.

UK macroeconomic trends

Output growth

UK fourth quarter chained volume GDP growth (2000 prices) was 0.9 per cent compared to 0.8 per cent in the third quarter of 2003 and 0.7 per cent in the second quarter. The level of GDP is now 2.8 per cent higher than it was in 2002Q4. GDP at current market prices rose by 1.4 per cent in the last quarter of 2003 and by 5.5 per cent in 2003.

GVA at basic prices increased in the third quarter by 2.3 per cent on a quarterly basis and by 1.9 per cent on an annual basis. Construction growth was extremely strong at 7.1 per cent in 2003Q4 and 6.3 per cent over 2003 as a whole. Manufacturing grew by 1.1 per cent in the last quarter of 2003 but remained flat over the year. UK services increased by 2.6 per cent in 2003Q4 and by 2.5 per cent annually. Within services the strongest quarterly growth was observed in business and financial services (3.5 per cent) and government and other services (2.4 per cent). This was

Table 1: Independent forecasts of the UK economy

	2003	2004	2005	2006
Real GDP growth (%)	2.3	2.8	2.6	2.5
Inflation rate (RPIX %)	2.7	2.4	2.5	2.5
Inflation rate (CPI %)	1.4	1.7	1.9	2.0
Unemployment (claimant count, million)	0.94	0.90	0.90	0.91
Employment growth (%)	0.4	0.6	0.4	0.4
Average Earnings (%)	3.5	4.0	4.5	4.3
Current account (£ billion)	-22.2	-33.3	-32.1	-34.0
PSNB (£ billion)	33.4	37.0	37.7	39.8

Source: National Statistics, National Institute Economic Review, 187, January 2004 and "Forecasts for the UK economy", HM Treasury, February 2004. Note: PSNB is given for financial years, e.g. 2002/03

also true over 2003 with business and financial services growing by 2.9 per cent while government and other services increased by 2.5 per cent.

Components of demand

UK consumption (chained volume measure) increased by 1.1 per cent in 2003Q4 on the previous quarter or by 3.2 per cent on the same quarter last year. Annual consumption growth was 2.8 per cent in 2003. Government spending rose by 1.9 per cent quarter-on-quarter and by 2.1 per cent over 2003. UK investment performance is encouraging, growing by 1.6 per cent in the latest quarter and by 2.6 per cent on an annual basis. UK exports declined in 2003 by 0.5 per cent although growth in the fourth quarter was 1.8 per cent. Conversely, imports increased by 0.8 per cent in 2003 with growth of 2.2 per cent in the final quarter of 2003.

These movements are in line with current forecasts as we expect UK growth to be supported by consumption (stronger in the second half of 2004 than in the first) and government spending, with public sector investment volumes set to grow at 30 per cent this year. We anticipate the government sector (consumption and investment) to contribute about 1 per cent of UK GDP in 2004 and just less than 1 per cent in 2005.

Net trade is estimated to have made a negative contribution of 0.8 per cent to GDP in 2003. We believe import growth in 2004 will be stronger than that seen in 2003. We also think that export volumes will rise significantly this year as sterling depreciates against the Euro, particularly in the second half of 2004. The current account balance will probably deteriorate to about 3 per cent of GDP in 2004 before recovering slightly in 2005.

Sterling and interest rates

Sterling has breached the \$1.90 level and is expected to continue to appreciate in the short-run to \$2. This is due to higher interest rates in the UK and a deliberate loose stance in the US. Interest rates in the US are 1 per cent and are unlikely to rise significantly until US employment data demonstrates a robust improvement. It is unlikely that the MPC will consider a further increase in the near future if the appreciation of sterling continues. This is despite rising house prices and significant levels of debt. The sterling effective exchange rate had depreciated by 4 per cent since the end of 2002 up to the third quarter of 2003 as sterling moved with the dollar against the Euro (a depreciation of about 9 per cent). Gains in competitiveness have been wiped out by the sharp depreciation of the US dollar in the last quarter of 2003 and in early 2004. Sterling has remained broadly stable with the Euro over this period. This is much more significant as approximately 60 per cent of UK trade is with Europe compared to only 17 per cent with the US. We are now back to a position last seen in 1999Q3 in terms of the Euro/Sterling exchange rate. The recent appreciation of sterling is likely to decrease inflation in 2004 by 0.1 percentage points.

Prices

The Consumer Price Index (CPI) now measures inflation and is the new name for the Harmonised Index of Consumer Prices (HICP). As set out in the Pre-Budget Report the target for CPI is 2 per cent. This is slightly lower than the RPIX target of 2.5 per cent. The change is due to methodological reasons. Currently (January 2004) the rate of growth of CPI is 1.4 per cent compared to 2.6 per cent for RPI and 2.4 per cent for RPIX on an annual basis. Producer prices for manufactured products increased by 1.6 per cent in February 2004, unchanged from last month. When excise duties are excluded the change is only 1.4 per cent. The data along with other supporting data demonstrate that there are no significant upward pressures on inflation. Strong house price inflation will be curbed by the anticipated rise in interest rates during 2004.

The labour market

Overall in the UK labour market, employment rose again but slightly more slowly than previously observed and claimant count unemployment fell more sharply than in recent months. In the period October-December 2003 employment rose to 28,156,000, up 5,000 from the previous period giving an employment rate of 74.5 per cent (marginally down). Employment has increased by 156,000 compared to the same period one year ago. ILO unemployment decreased by 21,000 to 1,459,000 or 4.9 per cent. Claimant count for January 2004 decreased by 13,000 to 892,100 (2.9 per cent). Average earnings including bonuses grew by 3.4 per cent for the period October-December 2003. When bonuses are excluded the rise was 3.6 per cent. The economically active decreased by 14,000 to 29,615,000 (a rate of 78.5 per cent) but there was a large increase (74,000) in the numbers who are economically inactive, up to 7,848,000 or 21.5 per cent.

Part-time employment was recorded as 7,270,000 for October-December 2003, an increase of 27,000 on the previous period and up by 151,000 on a year ago. There were 29,779,000 workforce jobs recorded in September 2003. This is an increase of 63,000 on the previous period. The quarterly survey of employee jobs (seasonally adjusted) was 25,809,000 in September 2003, a decline of 27,000 over the quarter but an increase of 3,000 over the year. Jobs losses were recorded in manufacturing, transport and communications services and in business and financial services. Self-employment increased again in the last quarter (by 21,000) giving an annual change of 294,000. There was a further decline in the number of trainees (WRGTP) over the quarter although an increase over the year of 8,000 was recorded. The figure is however significantly below the level in 2001.

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