

The UK Economy

the forecast period but the public finances are expected to improve over the same period.

Overview

The world economy is still in good shape despite the recent slowdown in the US housing market and the consequent knock on into weak growth in the first quarter of 2007. China and India continue to grow at very fast rates as do a number of Far East economies. Economic performance in Japan and in the Euro Area was stronger than expected. Higher oil prices had previously pushed inflation up throughout the world economy but there are signs that in most major economies that inflation will be brought back to relatively low levels by the end of the year. Monetary policy is tightening across the major economies and interest rates have been rising in; the US, the UK, the Euro Area and Japan. There are even signs that the Chinese might increase their interest rate by 25 basis points. Trade is flourishing especially in the Far East and there are few problems with economic fundamentals. Imbalances across countries still exist, the prospect of sustained higher oil prices or a spill-over from the US housing market into asset prices across the world economy would damage growth prospects considerably. The outlook for the world economy remains good and all developed economies are forecast to grow at a reasonable pace.

The UK grew by 2.8 per cent in 2006 and CPI inflation in May 2007 was 2.5 per cent compared to 2.8 per cent in April of 2007. While consumption remains important to the UK, growth is expected to be much more broadly balanced. The expectation is for the Bank of England to raise interest rates twice more in 2007, perhaps by 25 basis points in July and a further 25 basis points in either August or November in order to avoid inflation at a later date. The labour market remains relatively buoyant despite a decrease in employment, a significant increase in economic inactivity and a slight rise in unemployment. The current account is forecast to widen in the next two years but the public finances are forecast to improve.

Outlook

The consensus forecasts for the main UK economic indicators are taken from a monthly survey by HM Treasury of City and other independent forecasters and are presented in Table 1. Real GDP growth was 0.8 per cent in 2007Q1 and is forecast to be 2.7 per cent in 2007. In 2008 real GDP growth is forecast to be 2.4 per cent. It should be noted that HM Treasury forecast for UK real GDP growth is $2\frac{3}{4}$ to $3\frac{1}{4}$ per cent in 2007 and by $2\frac{1}{2}$ to 3 per cent in 2008. The forecasting record of HM Treasury is also superior to the consensus forecast record. Inflation is forecast to be back on target by the end of 2007. Employment growth is forecast to slow slightly over 2007 and 2008. The current account is forecast to widen over

Table 1: Independent forecasts of the UK economy, 2006 to 2008

	2006	2007	2008
Real GDP growth (%)	2.8	2.7	2.4
Inflation rate (CPI %)	2.3	2.1	2.0
Inflation rate (RPI %)	3.2	3.7	2.7
Inflation rate (RPIX %)	3.5	2.8	2.6
Claimant count, (million)	0.94	0.91	0.94
Employment growth (%)	0.9	0.7	0.7
Average Earnings (%)	3.7	4.4	4.2
ERI (2000=100)	110.6	114.1	113.8
Current account (£ billion)	-40.9	-47.5	-49.6
(per cent of GDP)	-3.4	-3.5	-3.6
PSNB (£ billion)	34.4	35.5	34.0
(per cent of GDP)	2.6	2.6	2.3

Source: National Statistics, National Institute Economic Review, **200**, April 2007 and "Forecasts for the UK economy", HM Treasury, **241**, May 2007 and **242**, June 2007. Note: PSNB is given for financial years, e.g. 2006 is 2006/07

Output growth and components of demand

Real GDP growth (chained volume measure) for the UK grew by 0.7 per cent in 2007Q1 compared to 0.8 per cent growth in the previous two quarters. On an annualised basis growth is 3.0 per cent, marginally down from 3.1 per cent in the last quarter. GVA increased by 0.7 per cent in 2007Q1, down slightly on the 0.8 per cent growth recorded in the previous two quarters. However, the MPC have not yet ruled out the possibility that UK first quarter growth may be revised upwards slightly. On the same quarter last year GVA growth was 3.1 per cent but when oil and gas are excluded this rises to 3.2 per cent.

In the UK consumption increased by 0.5 per cent in 2007Q1, compared to 1.1 per cent in the previous quarter. On the same quarter last year this was 2.9 per cent up to 2007Q1 compared to 2.5 per cent up to 2006Q4. Annual growth in consumption was 1.9 per cent up to 2006Q3 so there is a clear rising trend of annual consumption growth. Government spending grew by 0.5 per cent in both 2007Q1 and in 2006Q4. For 2005Q4 and 2006Q1 the growth rates were 0.5 per cent and 1.4 per cent respectively. Annual growth in government spending up to 2007Q1 was 1.1 per cent, significantly lower than the 1.9 per cent recorded in the previous two quarters. Investment growth was 1.1 per cent in the last quarter compared to 3.1 per cent in 2006Q4 while annual growth peaked at 9.8 per cent up to 2006Q4, sliding to 8.9 per cent up to 2007Q1. Domestic demand grew by 0.7 per cent in the last quarter and by 0.6 per cent in 2006Q4. Annual growth up to 2007Q1 was 3.2 per cent,

down slightly from the 3.5 per cent recorded in 2006Q4. GDP growth remains more broadly balanced with all the main components of domestic demand contributing significantly to GDP. Exports decreased by 0.8 per cent in 2007Q1 and by 0.3 per cent in the previous quarter. Currently, annual growth in exports contracted by 11.6 per cent. Import growth has shrunk by 0.7 per cent in the latest quarter and by 0.8 per cent in 2006Q4. This gives an annual decline in import growth of 9.8 per cent for the 12 months up to 2007Q1. The household saving ratio was 2.1 per cent in 2007Q1 compared to 3.9 per cent in the previous quarter and 6.3 per cent in 2006Q1. With the exception of the external sector the UK economy has performed well recently and is positioned to continue to grow at a steady pace.

Overall, sectoral growth was positive except for manufacturing which declined by 0.3 per cent on a quarterly basis but increased by 1.4 per cent on the same quarter of last year. Manufacturing output increased by 0.7 per cent in 2006Q3 and was flat in 2006Q4. Construction growth in 2007Q1 was 0.8 per cent and 2.7 per cent for the same quarter of last year. The strongest annual growth came from business and finance services at 5.2 per cent on the same quarter of last year (1.1 per cent on a quarterly basis) and transport services at 4.0 per cent (1.7 per cent). Total service sector growth on an annual basis was 3.5 per cent or 0.8 per cent in 2007Q1 compared to 0.9 per cent in 2006Q4. Service sector growth in the UK was strong throughout 2006. Retail; distribution; hotels and catering services rose by 2.9 per cent on an annual basis and by 0.6 per cent in the first quarter. Government services increased by 0.4 per cent in 2007Q1 or by 1.5 per cent on the same quarter in last year.

The index of production indicated that in the 3 months to April 2007 the seasonally adjusted chain volume measure of industrial production was 0.2 per cent lower than the previous period and that manufacturing output decreased by 0.4 per cent. Electricity, gas and water supply declined by 0.7 per cent for the three months to April 2007. The weight of manufacturing in 2003 was 792.1 out of 1,000 for all production industries. The weight of manufacturing over the years has declined significantly. In 2003 it was 14.7 per cent of total GVA (1,000). It is probable that the manufacturing weight is close to 13 per cent at the moment but over the next 10 years it is more likely to shrink to about 11 per cent. Some sectors: chemicals, pharmaceuticals, aerospace, electronics etc. are strong and growing however the less skilled areas are vulnerable to competition from Eastern Europe and China. As the economy matures there will be a greater demand for services – this sector will become stronger. In the US manufacturing only accounts for 12 per cent of their economy while in Hong Kong the figure is 5 per cent. China accounts for 8 per cent of the world's manufacturing total. The natural progression for China is to move into the production of capital goods, ships and aircraft etc. e.g. the high value end of manufacturing. The index of services

rose by 1.0 per cent in the three months to April 2007. Within that the largest increase was transport services (2.2 per cent) and the weakest was government and other services (up by 0.7 per cent). Surprisingly business and financial services only increased by 0.8 per cent. Transport services had their strongest growth since November 2000 (also 2.2 per cent). Business investment for 2007Q1 fell by 0.6 per cent to £34.762 million. Manufacturing investment increased by 2.5 per cent on the previous quarter. Surprisingly, business investment in services declined by 0.5 per cent. Retail sales in the UK for the period March-May 2007 increased by 1.1 per cent on the previous quarter and by 4.4 per cent on the same period one year ago. Clearly, retail sales remain buoyant with household stores reporting strong growth following a weaker period in April. The annual growth rate of the value of retail sales for the quarter ending in May was 5.3 per cent. Overseas travel and tourism increased by 4 per cent to 8.6 million visits for the three months to April 2007. Overseas earnings rose by 3 per cent to £3.9 billion and UK residents' visits abroad remained flat at 17.1 million. UK residents' expenditure abroad grew by 1 per cent to £8.3 billion.

The current account deficit improved from £14.5 billion in 2006Q4 to £12.2 billion in 2007Q1. This represents -4.3 per cent of GDP in 2006Q4 and -3.6 per cent of GDP in the latest quarter. The surplus on trade in services increased by £0.6 billion to £8.6 billion while the surplus on income rose by £2.0 billion to £2.4 billion and the deficit on current transfers decreased by £0.4 billion to £3.3 billion. All of these factors helped to decrease the current account deficit. The trade deficit grew by £0.8 billion to £20.8 billion. This partially offset the decrease in the current account deficit.

The strength of sterling continues to lead to stronger growth in imports compared to exports. The deficit with our main EU partners (France and Germany) widened to £9.8 billion due largely to a fall in exports. The forecast is for the current account deficit to increase from 3.4 per cent of GDP in 2006 to 3.6 per cent of GDP in 2008. UK trade balance fell to -£3.6 billion while the balance on services was unchanged at £2.7 billion for April 2007.

In May the current budget deficit was £6.9 billion and net borrowing was £8.2 billion. Compared to the previous year the current budget has increased by £0.6 billion and for the period April to May the 2007-08 balance was -£6.6 billion compared to the 2006-07 deficit of -£6.3 billion, a difference of -0.3 billion. Net borrowing has widened from £7.7 billion to £8.2 billion in May 2007. Over the period April to May the 2007-08 figure is £9.4 billion compared to 2006-07 was £9.7 billion, a decline of £0.2 billion. Net debt increased from £496.3 billion in May 2006 to £504.5 billion in May 2007, a difference of £8.2 billion. Net debt, expressed as a percentage of GDP, was 37.2 per cent in May 2007 compared to 36.5 per cent in May 2006, a change of £0.7 billion.

Prices

In the year to May 2007 the CPI increased by 2.5 per cent compared to 2.8 per cent in April. The most significant reductions came from housing services, gas and electricity bills, food & non-alcoholic beverages and clothing & footwear. Transport was the most significant upward pressure within CPI, particularly air travel. The RPI rose by 4.3 per cent compared to 4.5 per cent in April. Similarly the RPIX grew by 3.3 per cent in May compared to 3.6 per cent in April. Given that in March 2007 inflation rose to 3.1 per cent resulting in the Bank of England issuing an explanatory letter (the first time it has had to do so) then it is clear that monetary policy has been too loose. The mpc raised the rate to 5.25 per cent in January, maintained it there until May when it increased it to 5.5 per cent. It now looks set to raise it again in July to 5.75 per cent. This may not seem logical as CPI inflation is easing down towards 2 per cent (perhaps by the end of the year). What is worrying the mpc is the possibility of monetary growth coupled with high asset prices that will lead into higher demand especially as firms are able to raise their prices at the moment. The last three increases in the base rate have had little effect on consumer demand, particularly in the High Street. Producer price inflation increased from 2.7 per cent to 2.9 per cent in March and increased by 2.5 per cent in May (same rate as April). The March, April and May figures are worrying as PPI inflation has not been this strong for some time. It is these medium-term pressures that will be the focus of attention of the mpc. If they want to avoid a damaging run of higher than anticipated inflation then they have little choice but to raise rates, probably to 6 per cent by the end of the year. Average earnings (including bonuses) increased by 4.0 per cent in the year to April 2007, down from 4.4 per cent in March. Excluding bonuses the rate of growth was 3.6 per cent. While these rates are non-inflationary any slippage pushing the rate into the 4.5 to 5.0 per cent range will eventually put significant upward pressure on inflation. When examining prices it should be noted that total energy production was 13.5 per cent lower than that of 2006Q1. Final energy consumption was down 9 per cent (domestic sector reduced by 14.5 per cent, industry down 9 per cent and services fell by 6.5 per cent). Producers saw the price of material and fuels purchased increase by 1.2 per cent in May 2007.

The labour market

The UK labour market remains in a buoyant position despite a drop in both the numbers in employment and the employment rate although the unemployment rate is unchanged. Employment in the UK fell by 10,000 to 29,012,000 in Feb-Apr 2007 giving an employment rate of 74.3 per cent, down 0.1 percentage points. The employment rate of 74.3 per cent is down 0.3 percentage points since 2006Q1. Over the last quarter employment fell by 10,000; unemployment declined by 15,000 and the total that were economically active decreased by 25,000 but there was a massive 118,000 people who joined the ranks of the economically inactive. For 2007Q1 on the same

quarter last year the number who joined the economically inactive climbed steeply by 226,000. Over the year the unemployed swelled by 58,000 with the unemployment rate rising from 4.7 per cent to 5.6 per cent. In the three months to April 2007, 129,000 people reported that they had been made redundant but this is down 7,000 from the January figure. The redundancy rate was 5.2 per 1,000 employees, again down by 0.3 percentage points on the January data. Vacancies over the last three months increased to 638,800, up 21,000 from the previous period. The rate of vacancies was 2.5 per 100 employee jobs, up 0.1 on the previous quarter. Claimant count unemployment fell by 9,300 in May 2007 to 880,400 leaving a rate of 2.7 per cent (unchanged from the previous month).

Productivity (measured as output per worker) increased by 2.7 per cent on an annual basis in 2007Q1 compared to 2.1 per cent in the previous quarter. On a quarterly basis productivity increased by 0.9 per cent compared to 0.7 per cent in 2006Q4. Unit wage costs for the first quarter of 2007 rose by 2.4 per cent over the year, up from 1.6 per cent in the previous quarter. When output per hour worked is considered the increase was 2.8 per cent, up from 2.7 per cent in 2006Q4.

Self-employment in the UK increased from 3,826,000 to 3,832,000 (up 3.9 per cent) and over the year it rose by 2.2 per cent as it was 3,750,000 in 2006Q1. Employees fell by 19,000 in Feb-Apr 2007 to 24,975,000 and over the year declined by a similar amount from 24,995,000. The number of people working full-time rose by 31,000 in Feb-Apr 2007 on the last quarter but declined by 28,000 on the 2006Q1 level. Part-time working increased by 31,000 in the latest period on the previous period to 7,442,000 and rose sharply by 115,000 (up 1.6 per cent) on the 7,327,000 recorded in 2006Q1. Further big swings included unpaid family workers increased by 19.3 per cent (up by 17,000) on an annual basis; Government Supported Trainees increased by 8.5 per cent over the year (up 8,000 places) and workers with second jobs rose by 21,000 (a rise of 2.0 per cent) or up 55,000 over the year (an increase of 5.5 per cent). The workforce jobs fell by 22,000 (-0.1 per cent) in the last quarter but was up by 265,000 jobs over the year (up 0.8 per cent).

In agriculture on a quarterly basis 22,000 jobs were lost in March 2007, the same number as the total job loss for the series. Energy and water jobs increased by 16,000 over the year while manufacturing shed 16,000 jobs in March 2007 and 43,000 over the year. Construction gained 75,000 jobs on an annual basis. Services realised 235,000 jobs (0.9 per cent growth) over the year and 18,000 over the latest month. Within services the strongest job gains were in finance and business services (126,000 over the year); and 29,000 in distribution, hotels and catering. The biggest loss came in transport services (down 24,000 over the year). Public sector employment declined to 5,787,000 (down 10,000) in 2007Q1. In central government it fell by

8,000 and the civil service lost 7,000 jobs. The main decrease over the year came from two sources: the NHS (-19,000) and the civil service (-17,000).

The UK labour market remains buoyant however and is expected to pick up in the second half of 2007. Unemployment remains historically low, employment opportunities still exist and many other aspects of the labour market remain positive. The main concern is manufacturing employment which has been on a downward trend for some time now.

The outlook for the UK economy remains positive and upbeat. GDP growth is well balanced and consumption growth is forecast to remain relatively strong. Forecast growth for the UK is 2.7 per cent in 2007 and 2.4 per cent in 2008. CPI inflation is forecast to be close to target by the end of 2007. Interest rates are expected to be 6 per cent by the end of the year. The downside risks to the UK remain a sustained higher oil price; a significant correction to US housing or financial markets causing a sharp slowdown in world growth and current imbalances in the world economy. The prospects of a significant slowing in Europe have receded significantly.

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