

# The UK economy

## Overview

The global economy remains relatively strong given the pick-up in growth in 2006 after the slower growth seen in 2005. Higher oil prices pushed inflation up slightly across the globe but in the second half of 2006 oil prices fell significantly especially in September. The US in particular slowed slightly in 2006 from previous expectations whereas the Euro Area outperformed expectations. In the UK growth was relatively strong but 2007 may see a slight slowing of growth across the globe as households and businesses feel the impact of higher prices and interest rates.

Economic performance in China and India continued at a blistering pace. The outlook for the world economy remains good and all developed economies are forecast to grow at a reasonable pace.

The UK grew by 2.7 per cent in 2006 and CPI inflation in 2006Q4 was 3.0 per cent. This is likely to be the peak of UK inflation given the significant fall in oil prices although it is likely that the Bank of England will raise interest rates again in 2007 to 5.5 to 5.75 per cent before allowing them to slip back to 5 per cent or below in 2008. The labour market remains buoyant and with steady employment

growth and low unemployment. The contribution to UK GDP was more dependent on consumption and the public sector. It is more likely that GDP will be more broadly based in 2007. This is better for the economy because as business investment expands then the productive capacity of the economy will be greatly enhanced. The UK current account and public finances are not a matter of concern. It is expected that during 2007 and 2008 that sterling will depreciate slightly. There are some downside risks, notably the potential of a further sustained rise in the oil price, a spillover from the US housing market into asset markets that could significantly reduce growth across the OECD or a further slowing of growth in the Euro Area that would impact adversely on the UK economy.

## 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 2006Q4, which is 2.7 per cent for the year. The forecast for UK real GDP growth is 2.5 per cent in both 2007 and 2008. The growth in GDP is more likely to be broad based in the coming years as it was recently dependent on consumption and government spending. Investment is forecast to pick-up and therefore to improve the productive capacity of the economy over the next two years. Inflation is forecast to be above target in 2007 but to return to target by 2008. Employment growth is expected to slow in 2008 while

unemployment rises slightly. There has been little change to the forecasts of the current account and PSNB.

Inflation has been rising recently although with the recent decline in oil prices that occurred in September, the likelihood of inflation peaking is relatively strong. The prospect for next year is for inflation to remain relatively static in the early part of the year before beginning to subside towards target in the latter part of the year. By 2008 inflation is forecast to be close to target.

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

	2006	2007	2008
Real GDP growth (%)	2.6	2.5	2.5
Inflation rate (CPI %)	2.6	2.0	2.0
Inflation rate (RPI %)	3.9	2.9	2.5
Inflation rate (RPIX %)	3.3	2.6	2.5
Claimant count, (million)	0.96	0.98	1.03
Employment growth (%)	0.8	0.7	0.5
Average Earnings (%)	4.2	4.3	4.2
ERI (2000=100)	103.7	100.2	101.5
Current account (£ billion)	-34.8	-34.7	-36.8
(per cent of GDP)	-2.5	-2.6	-2.6
PSNB (£ billion)	38.7	37.2	36.7
(per cent of GDP)	3.1	2.9	2.5

**Source:** National Statistics, National Institute Economic Review, 199, January 2007 and "Forecasts for the UK economy", HM Treasury, 236, December 2006 and 237, January 2007. Note: PSNB is given for financial years, e.g. 2006 is 2006/07

## Output growth and components of demand

UK real GDP growth (chained volume measure) increased by 0.7 per cent in 2006Q3, revised down from the 0.8 per cent published as the estimate. In 2006Q4 UK real GDP grew by 0.8 per cent and is 3.0 per cent higher than at the same time in 2005. GDP increased by 2.7 per cent in 2006 compared to 1.9 per cent in 2005. GVA at basic prices grew by 0.8 per cent in 2006Q4 and by 2.7 per cent for 2006. For the same quarter as last year GVA growth was 2.9 per cent.

UK consumption grew by 1.0 per cent in 2006Q4 compared to 0.4 per cent in 2006Q3 and to growth of 0.6 per cent in 2005Q4. Compared to 2005 as a whole when consumption growth was 1.5 per cent, clearly consumption has improved considerably growing at 2.0 per cent in 2006 and has helped to strengthen domestic demand. Government spending rose by 0.4 per cent in the last quarter of 2006, compared to 0.6 per cent in the previous quarter and to growth of 0.6 per cent in 2005Q4. For 2006 government spending grew by 1.9 per cent (3.1 per cent in 2005). Government spending although remaining important as a driver of domestic demand has decreased in significance in

2006 compared to the previous year. Investment spending increased by 2.5 per cent in 2006Q4 compared to 1.9 per cent in the third quarter and to 0.5 per cent in 2005Q4. In 2006 growth on an annual basis was 6.0 per cent compared to 3.4 per cent in 2005. This rebalancing of the components of demand provides the UK with a broader contribution to GDP, which will strengthen growth in the economy going forward in 2007 and into 2008. UK domestic demand has grown by 0.9 per cent in the fourth quarter of 2006 compared to 0.2 per cent in the third quarter. Growth in 2005Q4 was 0.6 per cent. For 2006 and 2005 as a year growth was 2.9 per cent and 1.9 per cent, respectively. Stronger domestic demand has meant that both the service and manufacturing sector has received a further boost, stimulating economic growth in 2007. Exports contracted by 1.0 per cent in 2006Q4 compared to annual growth in 2006 of 11.2 per cent. Export growth in 2005 was lower at 7.9 per cent. Import growth for 2006 was 11.5 per cent compared to growth of 7.0 per cent in 2005. So for both 2005 and 2006 the net contribution to GDP from trade has been slightly negative. The position has worsened slightly with exports declining by 1.0 per cent in 2006Q4 while import growth only declined by 0.2 per cent. Despite the external position the UK economy has strengthened as it moves into 2007.

The UK economy is set to have relatively strong economic performance in 2007. Most commentators assume that there will be a further interest rate rise in 2007, particularly now we know that average housing prices increased by 10 per cent in 2006, retail sales growth was 5 per cent, the pound strengthened again and GDP growth is forecast to be 2.5 per cent in 2007. Personal consumption is set to increase at a faster rate in 2007 and investment is likely to be much more important. Savings are also likely to increase by around 1 per cent in 2007. It is likely however that there will have to be both a fiscal and monetary tightening going forward as most business surveys are very optimistic. With strong economic growth driven by domestic demand the economy is either close to capacity or slightly above it. Inflation is expected to fall back to target fairly quickly unless there are any unexpected surprises. Given the overall macroeconomic picture the economy remains in a healthy state and the outlook is very promising.

In the fourth quarter of 2006 services grew by 1.0 per cent on 2006Q3 and increased by 3.6 per cent in 2006Q4 on the same quarter last year. Annual growth in services was 3.7 per cent for 2006. UK services growth was driven by financial services, which grew by 8.7 per cent on an annual basis but only by 1.6 per cent on a quarterly basis. Other strong service sector performances came from REBS, 7.1 per cent on an annual basis; hotels and catering, 6.3 per cent and transport and storage services, 4.0 per cent. Only post and communications and public administration had annual growth of less than 1 per cent.

UK manufacturing increased by 1.3 per cent in 2006 as a whole and grew by 2.6 per cent on a quarterly basis.

3.0 per cent in 2006Q4. UK agriculture declined by 1.8 per cent in 2006 and contracted by an identical amount in 2006Q4. Electricity, gas and water supply contracted again falling by 4.4 per cent in 2006Q4 and by 2.7 per cent in 2006.

The UK current account deficit widened in 2006Q3 to £9.4 billion compared to £8.2 billion in the previous quarter. In the second quarter the deficit was 2.6 per cent of GDP but this has increased to 2.9 per cent of GDP. In 2006Q3 the surplus on trade in services rose to £7.2 billion while the trade in goods narrowed to £20.5 billion (compared to £20.9 billion in the second quarter). The surplus on income fell to £6.5 billion. It should be noted that the sustained current account deficits since 1998 reflects a worsening of the UK's trade position. Historically, the surplus on income and trade in services has previously offset the deficit on trade in goods but this is no longer the case. The UK increasingly has seen strong import growth, which has two effects; this leads to a negative contribution to GDP and any appreciation of sterling leads to cheaper and thus stronger growth in imports. It appears that the UK has experienced a deterioration in its net asset/liability position with the rest of the world to £237.5 billion in 2006Q3. It is unlikely that the trade position will improve markedly in the short-run and the forecast for to widen to -£36.8 billion by 2008.

Government spending increased to 0.8 per cent in 2006Q3 compared to 0.6 per cent in the previous quarter but the financial deficit over April to November 2006/07 was £16.1 billion lower than the £20.0 billion a year earlier in 2005/06. Net borrowing increased from £31.1 billion to £31.9 billion for April to November 2006/07. The main reasons for the reduction in the deficit were higher VAT, North Sea oil tax revenues and growth in corporation tax receipts. Government investment continues to grow strongly so net borrowing follows a similar path. The latest data show government has outstanding stock of £444.2 billion in securities. Public sector net debt in November 2006 has risen to 37.1 per cent of GDP compared to 36.6 per cent in October and 36.4 per cent over the financial year 2005/06.

## Prices

Annual CPI inflation in January 2007 was 2.7 per cent, down from the 3.0 per cent recorded in December 2006. The largest downward effect was due to declining transport costs, driven down by the fall in the oil price in September 2006. Food and non-alcoholic beverages also made a contribution to a fall in inflation. Upward pressure on inflation came from alcohol and tobacco. Using CPI inflation as a comparator, UK inflation at 3.0 per cent in December 2006 was above the EU25 average of 2.1 per cent for the same period. RPI inflation declined to 4.2 per cent on an annual basis in January 2007 from the 4.4 per cent of December 2006. Household goods, motoring expenditure, household services, clothing and leisure

helped reduce RPI whereas housing costs exerted the most significant upwards pressure on the RPI. RPIX inflation was 3.5 per cent in January 2007, down from 3.8 per cent in December 2006. It may be that UK inflation has peaked in December 2006 but most commentators expect the Bank of England to increase the interest rate to at least 5.5 per cent this year, just to make sure that any inflationary pressure is firmly checked. The outlook for inflation and interest rates is presented in Table 1.

## The labour market

Employment in the UK increased by 51,000 to 29,036,000 in Oct-Dec 2006 up from 28,986,000 in Jul-Sep 2006. The employment rate was 74.5 per cent unchanged on the previous period and the same time last year but marginally down on the Apr-Jun period. The economic activity rate remained at 79 per cent but in Oct-Dec a further 27,000 joined the economically active as this has steadily increased to 30,723,000. This is a rise of 411,000 on the year (or an increase of 1.4 per cent year-on-year). However, those who were economically inactive rose by 66,000 to 17,593,000 in Oct-Dec 2006 from 17,527,000 in Jul-Sep 2006. Over the year the number of economically inactive people declined by 41,000. ILO unemployment decreased from 1,711,000 to 1,687,000 (down 51,000) in Oct-Dec 2006. The ILO unemployment rate was 5.6 per cent, a marginal decline from 5.7 per cent in the previous period. Over the year however, unemployment has increased by 133,000 (an 8.6 per cent rise) and the ILO unemployment rate in Oct-Dec 2005 was 5.3 per cent (the change in the rate over the year was 0.4 per cent). Claimant count unemployment was 925,800 in January 2007 (a fall of 13,500) compared to 939,300 in December 2006. The claimant count unemployment rate fell marginally from 3.0 per cent in December 2006 to 2.9 per cent in January 2007. On an annual basis claimant count increased by 20,700 for the 12 months to January 2007 (an increase of 2.3 per cent). The unemployment rate was unchanged over the year.

UK self-employment increased to 3,794,000, up 35,000 from 3,759,000 in Oct-Dec 2006 and has risen by 95,000 over the year. Full-time employment decreased to 21,544,000 in Oct-Dec 2006, down 30,000 over the quarter but increased by 80,000 over the year. Part-time employment rose by 81,000 from 7,412,000 to 7,492,000 in Oct-Dec 2006 and increased by 198,000 on an annual basis. WRGTP grew from 97,000 in Jul-Sep to 102,000 in Oct-Dec but over the year declined by 6,200. Unpaid family workers fell slightly from 104,000 to 101,000 in the latest period of 2006. Workers with second jobs stood at 1,072,000 in the period Oct-Dec; an increase of 16,000 over the quarter and 43,000 over the year. The workforce jobs series for Sep 2006 support the LFS data with strong self-employment growth although employment growth is more subdued on a quarterly basis but remains strong over the

year. Earnings growth was 3.8 per cent in Dec 2006 remaining non-inflationary (less than 4.5 per cent) and is forecast to do so in the near future. Output per worker increased by 2.3 per cent in 2006Q3 on an annual basis and unit wage costs increased by 1.9 per cent on the same basis. The number of vacancies increased to 607,900 (up 7,300 or by 1.2 per cent) in January 2007 giving a vacancy ratio of 2.3 per cent.

For the period Sep 2006 job losses by sector were recorded in agriculture (-1,000 q-o-q and -10,000 over the year); manufacturing decreased by 2,000 on a quarterly basis but by 39,000 on an annual basis and distribution, hotels & catering were the only service sector job losses totalling 5,000 in Sep 2006 and 42,000 over the year. Strong employment growth was observed in finance & business services (29,000); other services (23,000) and construction increased by 6,000 jobs in Sep 2006. A total of 54,000 jobs were created in Sep 2006. On an annual basis the strongest performing sectors were education, health & public admin (133,000); finance & business services (89,000); other services (80,000) construction (53,000) giving total net job creation over the year of 292,000.

The UK labour market is still in a healthy state and continues to provide employment growth, a high level of economic activity and significant self-employment opportunities as well as a considerable stimulus to self-employment. UK unemployment continues to be low and is forecast to remain so. Clearly, productivity growth could be stronger, as could full-time employment and manufacturing employment continues to weaken.

The outlook for the UK economy remains firm especially with the rebalancing of the components contributing to GDP growth. The UK economy is forecast to grow by 2.5 per cent in 2007 and by 2.5 per cent in 2008. CPI inflation is forecast to increase by 2.0 per cent in both 2007 and 2008. There are no clear signals of strong inflationary pressures building in the economy and few commentators believe inflation is feeding through into the wage bargain in a spiralling manner. The assessment of downside risks to the UK economy remain a further sustained rise in the oil price; a significant slowdown in Europe that would make a considerable impact on UK exports and tourism and a significant correction to the US housing market spilling over into assets markets that has the potential to slow UK growth considerably.

Kenneth Low  
March 2007