The UK economy

Overview

There remains strong growth in the US, Japan and the Far East despite a significant slowing in China and weaker data from the US. Japan is performing better than expected while the Euro Area is still relatively weak. The Euro Area is however, forecast to pick up in 2005. Inflationary pressures are continuing to build in the world economy principally because of capacity constraints and higher oil prices. The monetary authorities are taking what they believe is the most appropriate response to inflation in the sphere of influence. The Federal Reserve has indicated interest rates will rise further and the ECB are holding interest rates as are the Bank of Japan. The main downside risks are the imbalances in the world economy and the prospect of sustained higher oil prices. Overall the conditions in the world economy remain favourable.

UK real GDP growth was only 0.4 per cent in 2004Q3 after growth of 0.7 per cent and 0.9 per cent in the first and second quarters respectfully. This may mean that the upper limit of the Chancellor's forecast of 3.5 per cent for real GDP growth may be unobtainable now. It may be however, that GDP growth of 3.3 per cent could still be achieved in the UK, if this is a temporary phenomenon rather than a sustained slowing of growth. Investment is a more important driver of growth now and both consumption and government spending contribute significantly to domestic demand. There will be a more substantial pick up in trade when the Euro Area recovers more fully. Inflation remains relatively low in the UK economy with CPI inflation of only 1.1 per cent in the 12 months to September. We are still concerned about the current account deficit and PSNB. We also believe that UK interest rates have risen too quickly over the middle of 2004 and ultimately this has contributed to the low growth seen in the economy. The UK labour market remains relatively buoyant despite some signs of tightening and our expectation is that services will continue to lead employment growth while unemployment will remain at relatively low levels. The outlook for the UK economy is still relatively promising.

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 3.3 per cent in 2004 and 2.5 per cent in 2005. There has been little change to the Treasury forecasts since the last quarter. Inflation (using the CPI measure) is forecast to be 1.3 per cent in 2004 and 1.8 per cent in 2005. When we look at the difference between CPI and RPIX inflation we see that they are both close to target by 2005 and certainly by 2006. As explained below this may be due to expectations. The Bank of England increased interest rates in February, May, June and August of 2004 and this is discussed in further detail below. Interest rates are now 4.75 per cent in the UK. Clearly concerns over house price growth, debt and markets continue to either dominate or unduly influence thinking at the Bank of England. It is difficult to assess the weight that is put on the different aspects of the economy. Current implicit messages from the Bank may suggest that interest rates have peaked in the UK. The forecast for unemployment is that it should remain low and that the growth in average earnings over 2004-06 will be non-inflationary. There is little evidence to suggest that wage pressure is mounting in the economy. Both the current account and the PSNB give cause for concern (especially the latter).

Table 1: Independent forecasts of the UK economy

	2004	2005	2006
Real GDP growth (%)	3.3	2.5	2.5
Inflation rate (CPI %)	1.5	1.8	2.0
Inflation rate (RPIX %)	2.3	2.3	2.4
Inflation rate (RPI %)	3.2	2.6	2.5
Claimant count, million)	0.84	0.85	0.85
Employment growth (%)	0.7	0.6	0.4
Average Earnings (%)	4.5	4.4	4.4
Sterling Effective Exchange Rate	100.1	100.5	99.4
Current account (£ billion)	-26.3	-27.9	-29.3
PSNB (£ billion)	35.2	36.2	35.7

Source: National Statistics, National Institute Economic Review, 189, July 2004 and "Forecasts for the UK economy", HM Treasury, October 2004.
Note: PSNB is given for financial years, e.g. 2004/05

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UK macroeconomic trends

Output growth

UK second quarter chained volume GDP growth (2001 prices, where 2001=100) was 0.4 per cent compared to 0.9 per cent in the second quarter of 2004 and 0.7 per cent in the first quarter. The level of GDP is now 3.1 per cent higher than it was in 2003Q3 but down from the 3.4 per cent recorded in the last quarter. GVA at basic prices also increased in the third quarter by 0.4. This is the preliminary estimate and the data may yet be subject to revision.

Services are estimated to have grown by 0.8 per cent in the third quarter compared to 0.9 per cent in the second quarter. Distribution, hotels and catering only grew by 0.7 per cent in the third quarter whereas in the second they grew by 1.2 per cent. Production industries declined by 1.1 per cent in the latest quarter after growing by 1.2 per cent in the previous quarter. Although there is no data available for manufacturing we have to assume that UK manufacturing has declined significantly because manufacturing is 79 per cent of production. Also, in the previous two quarters when manufacturing figures were –0.2 and 1.2 per cent respectively the corresponding figures for production were –0.4 and 1.2 per cent. There are no data for the third quarter for agriculture, construction nor the sub-sectors of manufacturing and services. Second quarter growth for manufacturing was 1.2 per cent or 0.4 per cent over the year. In agriculture there was a slight contraction and on an annual basis the sector decline d by 2.6 per cent. There was only 0.6 per cent growth in construction in the second quarter but the industry grew by 4.9 per cent over the year.

Components of demand

Again, there is not any data for the third quarter available yet. In the second quarter of 2004, consumption increased by 0.6 per cent giving growth over the year of 2.3 per cent. Government spending increased by 0.4 per cent in 2004Q2 but on an annual basis growth was 3.5 per cent. This is the strongest component of demand in the UK economy. Investment increased by 2.4 per cent in the second quarter taking growth in investment to 2.2 per cent over the year. Exports grew by 1.5 per cent in the second quarter but growth on an annual basis was marginal (0.1 per cent). Import growth remains relatively strong at 1.1 per cent in 2004Q2 and over the year growth was 1.3 per cent – considerably above that of exports.

We believe that the data we have seen for the UK are in line with both the global environment and the economic situation in the UK. Consumption may slow slightly due to higher interest rates and cooling house prices but government spending is expected to remain strong. Investment is clearly becoming an important driver while net exports are making a negative contribution to UK GDP and this may not be positive until 2006. 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.

The National Accounts were rebased using 2001 as a base year but this has resulted in a significant revision to UK government consumption. The largest revisions occurred in 2002 and 2003. Government consumption growth was revised up by 1.3 and 1.6 percentage points respectively due to this. One of the issues that is a main contributor to this is the way health output is measured (see ONS (2004) 'Revisions resulting from improving the methodology for measuring government healthcare output in the National Accounts.') When looking at forecasts of the UK it should be noted that over the period 2004-06 this could add approximately 0.5 percentage points to government consumption growth in these years (see NIER, (2004) 189, July).

Inflation and interest rates

CPI inflation for the year up to September 2004 was 1.1 per cent while RPIX was 1.9 per cent and RPI was 3.1 per cent. The target for CPI inflation is 2 per cent with the previous target for RPIX being 2.5 per cent. Retail sales grew by 1.1 per cent for the three months to September 2004 and by 6.9 per cent over the year. The former is the lowest rise since August 2003. The implied deflator for September 2004 on September 2003 indicates a decline of 1.6 per cent. Given these data the key questions are why is inflation so low at this time and is monetary policy appropriate? As stated before here in the QEC, the simplest statement of monetary policy is from Svensson (1997), p1126:

> "If the inflation forecast is on target, monetary policy is appropriate. I cannot imagine simpler principles, and I cannot imagine anything easier to explain to the public, or anything more conducive to public understanding of monetary policy."

So why is inflation so low according to the CPI measure? Richard Lambert (a member of the Monetary Policy Committee) in his speech (see Lambert (2004)) went some way to answering this question. He played down the effects of higher oil prices despite prices breaching $50 a barrel and the price of Brent crude rising by 43 per cent in the twelve months to September. Instead he pointed to the fact that house prices may 'be on the turn' and that high street sales may 'cool off more rapidly than had been expected.' Clearly the data for retails sales shows that the increase is the slowest since August 2003. However, steel prices increased by 34 per cent, house prices rose by 19 per cent, gas and electricity increased by 6 per cent, as did council tax bills. When household bills are taken together then they account for nearly 20 per cent of the RPI and we also know that this particular part of that basket has increased by 11 per cent. But prices are falling for other components of the basket, e.g. clothing (decreased by 40 per cent between 1991 and 2003), food and ICT equipment (this has fallen by more than 50 per cent between 1995 and 2002. Simply it is that goods price inflation is weak while services inflation since 1997 has been close to 4 per cent. Even in the labour market where average earnings have increased by 4.3 per cent in the year to September this is accepted as non-inflationary growth in wages. The increasing flow of imports puts further downward pressure on prices. Lambert (op. cit.) also cites increasing technology, globalisation and deregulation as further factors that put downward pressure on inflation. He believes that inflation (using the CPI measure) will remain low and it will be stable. He hints that interest rates may have peaked. It is what he does not say however that is really interesting.

One of the problems with CPI inflation is that the public have yet to get to grips with it. There is an expectations factor that has not yet sufficiently adjusted. Broadly, many still think of inflation being close to 2.5 per cent (with RPIX, it is 1.9 per cent, still some way off 2.5 per cent) but expectations may be conditioned on RPIX being close to 2 per cent. Balls and O'Donnell (2002) p8 describe the 'credibility gap' between the rate of inflation and the expectation of inflation. We may be experiencing this problem at the moment where we are anticipating relatively higher inflation but for a number of reasons inflation is actually significantly lower. Secondly, CPI inflation is calculated slightly differently from RPIX. RPIX is calculated using an arithmetic average whereas CPI is calculated using a geometric mean average. Essentially this reduces the weights of those retail outlets where prices are rising the fastest. This 'formula' effect may have reduced inflation in the UK by approximately half a percentage point per year (see King, 2004). This is why the target has been lowered.

In fact CPI inflation since 1997 has rarely been above 2 per cent. The large difference between CPI and RPIX is that RPIX included housing costs and council tax (but excludes mortgage interest payments), whereas CPI does not include these. When house price inflation is rising at a faster rate than prices in general then the gap between RPIX and CPI becomes wider. As house price inflation slows then the difference will narrow.

This brings us to the next point, if house prices are excluded from the measure of CPI but clearly are still important in economic decisions of the public then how much weight should the MPC attach to house price inflation? This is the $64,000 question. We are not given that information. There is little doubt that market sentiment and house prices are taken very seriously by the MPC as financial markets are the first item in the MPC minutes. House price inflation takes up a considerable part of the debate, particularly the effects on consumption, future mortgage lending and debt. Some members of the MPC have made statements to the effect that the MPC is not there to monitor house prices but inflation per se. Also we need to appreciate the two-year lag before the full effects of the policy decision impacts fully on prices. There are some nagging doubts however, that the Bank of England pays too much attention to house price inflation and markets rather than concentrating on the inflation target.

This is rather a challenging statement but recent work may demonstrate this may be a potential problem. As oil prices are high at the moment, it is anticipated that this will increase inflation significantly. This has not been seen yet, although we accept that oil may move to $30-35 in the medium-term. Furthermore the impact of oil shocks on an economy largely depends on the response of the monetary authorities to them (see Barrell and Pomerantz, 2004a). Oil demand has increased by about 0.5 per cent per annum in the OECD over the period 1973-2003 while world supply grew by 1 per cent per annum. The US, the UK and Europe

Table 2 The impacts of both temporary and permanent price shocks

A 15 per cent permanent shock

		Euro Area		UK		US
Year	Inflation	Output	Inflation	Output	Inflation	Output
2004	0.11	-0.18	0.04	-0.05	0.19	-0.11
2005	0.07	-0.18	0.09	-0.05	0.38	-0.18

A 30 per cent temporary shock

		Euro Area		UK		US
Year	Inflation	Output	Inflation	Output	Inflation	Output
2004	0.25	-0.25	0.08	-0.05	0.36	-0.09
2005	0.19	-0.19	0.20	0.01	0.78	-0.13

Source: National Institute Economic Review, July, 189, Tables 6 and Table 7, pp15-17.

have all decreased their dependence on oil by about one third since the 1970s oil price crisis. Nevertheless, as we see in Table 2.1 the impact of the oil price shock will vary according to the monetary response This work was carried out by the National Institute of Economic and Social Research (NIESR) who have undertaken some simulations regarding temporary and permanent oil shocks (see Barrel and Pomerantz, 2004b).

What is clear from this is that if the shock is temporary then the output effect will be less than if the shock is permanent because the latter increases long-term interest rates. The temporary shock will have a lesser effect on inflation than on output because wage bargainers know the shock is temporary and adjust accordingly. When compared to the US and the Euro Area we see the UK is an intermediate case because it remains a net fuel exporter. In the UK the temporary shock has half the effect on output as has the permanent one in the first year.

What we see in the UK data for the third quarter is very low inflation and a considerable drop in output (relative to the previous two quarters). This suggests that the oil price rise is a small permanent shock in the medium-run (to about $30-35). We present output growth and interest rates in Figure 2.1. The MPC raised interest rates in May when it was probably better to ‘wait and see’ (see O’Carroll, 2004) given that the UK has a flexible labour market with non-inflationary wage pressure, has low inflation, credible monetary policy but could of course be unsure of the cyclical position. It is possible however, that the Bank of England reacted too quickly to the situation and therefore the current profile of interest rate increases have damaged UK third quarter growth as manufacturing was still in a relatively weak position. The oil price rise would also hit utilities, transport, agriculture and sectors where consumption is discretionary (travel and tourism, durable luxury goods etc.) harder than other (predominately service) sectors. While we suggest this is a significant factor in the slower growth seen in the UK there are two important caveats:

Æ we are not arguing that interest rates did not need to rise but that this is a timing effect and

Æ we appreciate our case is made with some hindsight and that the decisions of the MPC are not made lightly or with ease.

The labour market

Employment in the UK rose by 10,000 to 28,392,000 for Jun-Aug 2004. The employment rate was 74.7 per cent in the same period. There has been an increase of 33,000 employees for Jun-Aug 2004 over the quarter to 24,559,000 and a rise of 189,000 over the year. UK self-employment declined by 13,000 over the quarter to 3,615,000 but still has grown by 17,000 over the year. Full-time employment grew by 31,000 on a quarterly basis and by 136,000 on an annual basis. Part-time employment contracted by 21,000

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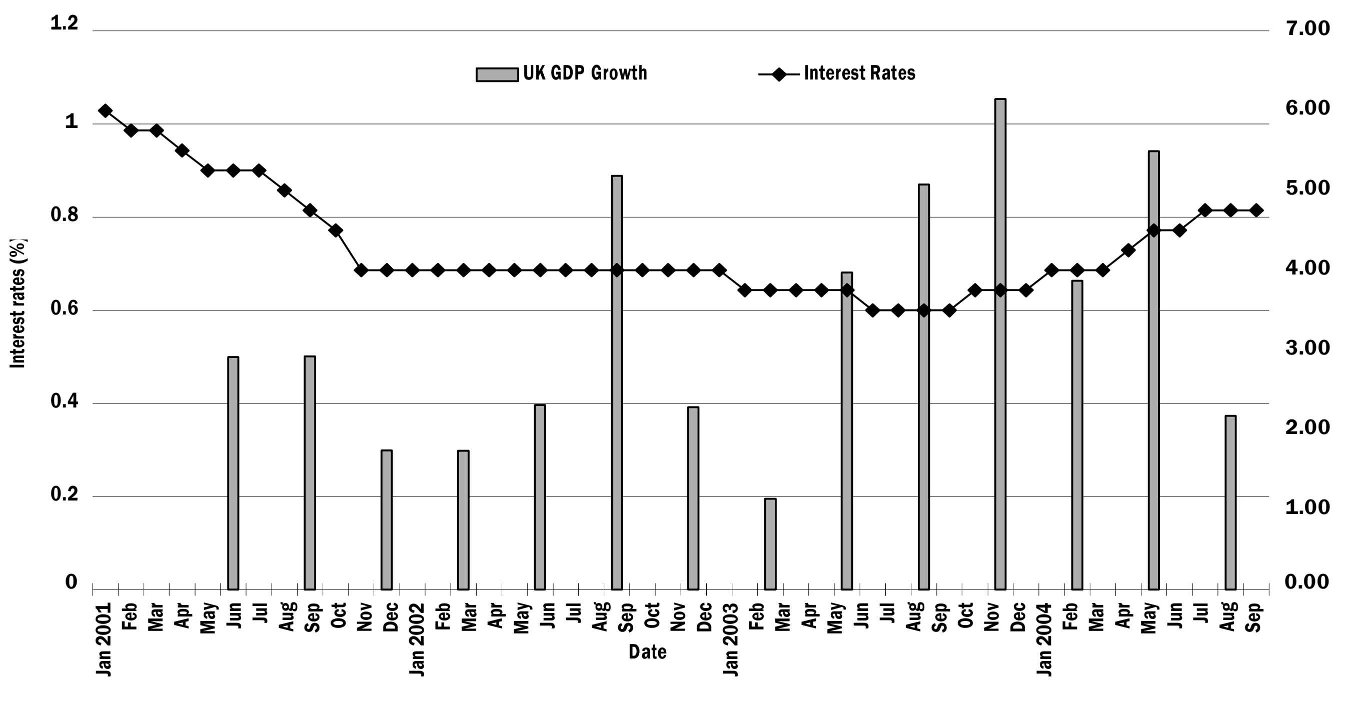

over the most recent quarter but still increased by 85,000 over the year. The Quarterly Survey of Employees indicates that total employment increased by 25,000 in June 2004 compared to a rise of 130,000 over the year. Manufacturing employment continued to decline, losing 18,000 jobs on a quarterly basis and fell by 95,000 over the year to June 2004. The service sector increased employment by 140,000 jobs in the quarter to June 2004 and employment in services over the year increased by 206,000 jobs. Government supported trainees increased by 6,000 in the latest quarter to Jun-Aug 2004 and by 27,000 on an annual basis. The number of workforce jobs was 30,324 in June 2004 with self-employment estimated to be 3,844. The workforce jobs series has increased by 10,000 over the quarter and by 1999,000 over the year. The estimate of self-employment has declined by 17,000 on a quarterly basis but still increased by 59,000 on an annual basis.

Average earnings including bonuses grew by 3.9 per cent for the period Jun-Aug 2004. When bonuses are excluded the rise was 4.3 per cent. These rates are accepted as being non-inflationary and are unlikely to increase significantly wage pressure on prices. The economically active decreased by 41,000 to 29,780,000 (a rate of 78.4 per cent) but still rose by 76,000 over the year. The economically inactive rose by 91,000 in Jun-Aug 2004 and now stands at 21.6 per cent.

ILO unemployment in the UK was 1,387,000 (4.7 per cent) in Jun-Aug 2004 whereas claimant count was 834,000 (2.7 per cent) for September 2004. ILO unemployment decreased by 51,000 whereas claimant count only declined by 200. Nevertheless, both measures of unemployment are relatively low and the UK labour market is performing well.

There are some signs of tightening but overall all forms of employment have demonstrated an increase over the year, there is no substantial wage pressure and unemployment is relatively low.

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Kenneth Low
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