The UK economy

Overview

There is now clear evidence of the downturn in the UK economy. GDP growth has fallen back in the second quarter to 2.1% year on year. The slowdown has also spread to the labour market with employment now falling and unemployment flat according to the ILO definition. Once again there is concern about the development of a two-speed economy in which the services sector prosper and production falls behind. The concern must be all the higher given the concentration of problems in sectors such as electronics.

On the other had domestic demand has held up, primarily as a result of strong private and government consumption. Consumer confidence is still above its historical average, although there is evidence of weakening in the most recent data. At the same time monthly data on the public finances suggest that there have been large increases in public spending.

Prior to the terrorist attacks on the US on Tuesday 11th September there were few reasons to expect further reductions in UK interest rates. The decision by the Monetary Policy Committee to cut interest rates by 0.25 percentage points in early August surprised many commentators. Following on from that cut and the rise in RPIX inflation rate from 1.9% in March to 2.6% in August (marginally above the 2.5% inflation target) added to the relative strength of domestic demand there was a feeling that there was little if any scope for further cuts this year.

It is too early to judge the impact of the terrorist attacks in New York and Washington on the UK economy. However, in the light of the interest rate cuts by the US Federal Reserve, the European Central Bank and a number of other central banks as the New York markets re-opened on Monday 17th September it was probably inevitable that the Monetary Policy Committee would also cut interest rates. However, it was a little surprising that the Bank of England's repo rate was reduced by only 0.25 percentage points compared with the 0.5 percentage point reductions elsewhere. Market explanations for the size of the cut include the publication of inflation rate data earlier in the morning that breached the government's target and concern that the UK had already cut its interest rate four times since the start of the year.

Outlook

The prospects for the UK economy continue to weaken. In Table 1 we show forecasts taken from a monthly survey of City and other independent forecasters compiled by HM Treasury. Since our last Commentary in May the slowdown in 2001, as measured by GDP growth and unemployment, has deepened while the strength of the expected recovery in 2002 has weakened. The forecasts underlying Table 1 will all have been prepared before a number of recent pieces of bad news (including the new outbreaks of Foot and Mouth in Northumbria, the poor industrial production statistics released in early September and the terrorist attacks in the US). As a result the forecasts no doubt significantly overstate current market sentiment.

Table 1: Independent forecasts of the UK economy

	1999	*2000*	*2001*	*2002*
GDP growth (%)	2.3	3.1	2.2	2.6
Inflation rate (RPIX %)	2.3	2.1	2.2	2.4
Unemployment (claimant count, million)	1.25	1.09	0.99	1.01
Employment growth (%)	1.0	0.6	0.4	0.2
Current account (pounds billion)	-9.9	-16.2	-16.1	-20.4
PSBN (pounds billion)	-11.4	-18.5	-7.5	-1.1

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

The forecasts in Table 1 illustrate deterioration in the current account suggesting that prospects for final demand remain quite buoyant while output is subdued. At the same time the public finances look set to move closer to balance and by 2002 will be just in surplus. This reflects both falling tax revenue as the economy slows down and higher expenditure, both planned and as a result of the weaker economy. A second, and more worrying, feature of Table 1 are the inflation forecasts for 2001 and 2002. The UK inflation target is set at 2.5 percent as measured by RPIX (retail prices excluding mortgage payments) and, although the average forecasts for this year and next are beneath the target, there is concern that inflation may be creeping upwards.

UK macroeconomic trends

Output growth

The preliminary estimates of second quarter GDP released in late July showed a quarter on quarter growth rate in real terms of 0.3 percent. This is the lowest rate since the fourth quarter of 1998 and a fall of 0.6 percentage points on the rate for the same quarter last year. The annual growth rate in 2001 Q2 stands at 2.1 percent, again indicating a slowdown in the economy when compared with the annual rate of 2.7 percent for 2001 Q1 on 2000 Q1.

The decline in second quarter GDP growth is almost entirely due to a decline in manufacturing output (down 2.0% quarter on quarter). In contrast services grew by 0.8% quarter on quarter.

Detailed index of production data for July provides more detail on the state of manufacturing - and well as indicator of things to come for third quarter GDP. Over the three months up to July production fell by 1.3%. The narrower manufacturing sector showed a decline of 2.1% over the same three months, with engineering output falling by some 4.7%. The fall in turnover in the electronic and optical equipment sector of 7.9% over the three months to July was probably to be expected given trends in the world economy, but it must be of concern particularly to those regions of the UK that rely heavily on the sector.

Components of demand

National accounts data for the second quarter of 2001 show that domestic demand growth (at 2.4% year on year) continues to outstrip output growth (at 2.1%). Household consumption is growing at 3.7% year on year and illustrates the underlying buoyancy of the UK household sector, despite the slowdown in the output side of the economy and early signs that the slowdown is now being passed through to the labour market. Retail sales figures for August suggest that consumption growth in the third quarter will be healthy with the volume of retail sales up 6.0% year on year, although it does appear that growth is starting to ease off. This is in line with the consumer confidence data. This is still above its historical average, however, the latest observation does show a fall in confidence back to the levels seen last December. Households appear to be concerned about the general economic situation rather than their own personal financial position.

Government consumption is also growing reasonably strongly at 3.2% year on year. As to be expected total investment is growing weakly at 1.8% year on year and, more worryingly, was completely flat quarter on quarter. Exports fell by 2.9% quarter on quarter, although over the year there was moderate growth at 1.7%.

Inflation

Inflation as measured by RPIX, retail prices excluding mortgage interest rates, rose above the official inflation target for the first time since March 1999. The year on year inflation rate in August was 2.6%, up from 2.4% the previous month. The largest upward effect on the annual rate came from oil and petrol prices that fell less this year than this time last year. Additional upward pressure came from car prices that fell this time last year and have been stable since, and the cost of fresh food.

Although some commentators have passed off this rise in the inflation rate as being due to "statistical" reasons it still reflects a turn around in the focus on inflation of only a quarter ago when we published our previous Commentary. At that time concern focus on inflation undershooting the official target and given the symmetric nature of the UK target the potential that inflation would breach the lower bound at which the Bank's Governor would need to formally write to the Chancellor of the Exchequer.

The producer input prices index fell by 0.2 percent in August. Year on year the inflation rate was -2.3 percent. This is only the second month since July 1999 in which the annual inflation rate has been negative (the first month was July this year in which the inflation rate was -1.0 percent). Producer output prices fell by 0.1 percent in August and the year and year inflation rate is currently 0.3% and has been edging downwards from 1.8% at the start of this year.

Whole economy average earnings grew at 4.4 percent over the year to July 2001. This is a fall of 0.4 percentage points compared with the previous month and is the lowest rate since March 2001. There is now a significant gap - the largest since 1993 - between public and private sector pay, with public sector earnings increasing at an annual rate of 5.9 percent compared with 4.0 percent in the private sector.

Productivity growth edged downwards to 2.2 percent in the first quarter of 2001. When combined with average earnings growth unit wage cost inflation increased to 2.1 percent year on year. This is the highest growth rate since the first quarter of 2000. More timely data for manufacturing only shows that productivity growth has slowed down considerably leading to an annual inflation rate in unit wage costs of 3.0 percent.

The labour market

In our last Commentary we remarked that the upward trend in employment, and the accompanying falls in unemployment, had continued to level out since the start of the year. The latest data suggests that the corner in labour market activity has now definitely been turned with employment falling and unemployment stable by the internationally agreed ILO definition.

The ILO unemployment rate was 5.0 percent over the three months between May and July, unchanged from the February to March figure and down marginally by 0.3 percentages points from May to July 2000. The most recent claimant count unemployment rate was 3.1 percent in August 2001, down 0.1 percentage points from the previous month and 0.4 percentage points compared with August 2000.

The central LFS measure of employment based on those aged between 16 and the official retirement age actually fell back by 27,000 over the three months May to July 2001 compared with the previous three months. This was the first quarter in which employment has fallen back for some time as is indicated by a healthy increase of some 172,000 additional people in work over the last twelve months.

Monetary and fiscal policy

As we noted earlier the Bank of England reduced its repo rate by 0.25 percentage points on 18th September in response to the international round of rate cuts following the US terrorist attacks. The grounds for this cut on purely domestic terms are probably quite weak, especially given the cut in early August. Unless the economy weakens significantly over the next few months further rate cuts before Christmas are unlikely.

As Table 1 illustrates the public finances are set to deteriorate during the course of 2001 and 2002. The growth of public spending is now greater than the growth of tax receipts - thus pushing the public finances towards a deficit over the next couple of years. Nevertheless, there seems to be a consensus amongst commentators that the government's plans are sustainable.

John Ireland
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