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The UK economy

Overview

World growth remains relatively strong but has cleared weakened slightly since the strong growth of 2004. The US continues to drive the world economy with strong growth from China and in 2005Q1 better than expected Japanese growth. The Euro Area remains a problem for the world economy with poor growth (1.8 per cent in 2004) and is not forecast to pick up until 2006. The Euro Area continues to rely on external demand but needs to boost domestic demand as well as introduce labour market reforms to get the economy moving. Inflation remains in check despite building inflationary pressures with rates being supportive of policy but on a gentle upward trend. World trade is forecast to remain strong this year and next. The dollar has weakened while the Yen and the Euro have appreciated and the world economy is still adjusting to these relative movements.

UK real GDP growth was 3.2 per cent in 2004 and is forecast to be 2.5 per cent in 2005. This is in stark contrast to the Treasury forecast of 3.25 to 3.5 per cent. There are no serious inflationary pressures in the UK economy although oil prices are a concern as are the widening current account deficit and the level of PSNB. We believe that UK interest rates will remain broadly stable over 2005 with the possibility of some movement towards the end of the year. Employment remains high and unemployment is low.

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 was 3.2 per cent in 2004 and is forecast to be 2.5 per cent in 2005 and 2.4 per cent in 2006. Inflation (whether measured by CPI or by RPIX) remains on target and both are forecast to be close to target over the period. RPIX is forecast to be slightly below target in 2005-06 but to be on target by 2007. Unemployment remains at low levels and is forecast to continue to do so. The current account is forecast to improve in the short-run but to widen in the medium-term. PSNB is forecast to rise from £33.4 billion 2003-04 to £35.6 billion by 2006-07.

Output growth

UK first quarter chained volume GDP growth (2001 prices) was 0.5 per cent (revised down from 0.6 per cent) compared to 0.7 per cent in the fourth quarter of 2004 and 0.6 per cent in the third quarter. The level of GDP is now 2.7 per cent higher than it was in the same quarter of 2004. GDP at current market prices rose by 0.9 per cent in the first quarter of 2005 and by 4.5 per cent on the same quarter in 2004.

GVA at basic prices increased in the first quarter by 0.5 per cent on a quarterly basis and by 2.6 per cent on an annual basis. Construction growth was estimated at 0.6 per cent in 2005Q1 and 3.1 per cent on the same quarter last year. Manufacturing declined by 0.7 per cent in the first quarter of 2005 but remained static at 0.2 per cent growth on 2004Q1. UK services grew by 0.8 per cent in 2005Q1 and by 3.7 per cent annually. Within services the strongest quarterly growth was observed in transport and communications services business (5.4 per cent on the same quarter last year) and business and financial services (4.4 per cent).

Components of demand

UK consumption (chained volume measure) increased by 0.3 per cent in 2005Q1 on the previous quarter or by 2.0 per cent on the same quarter last year. Government spending rose by 0.7 per cent quarter-on-quarter and by 3.4 per cent on the same quarter last year. UK investment performance was flat in the first quarter which was disappointing. Investment has increased by 4.2 per cent on an annual basis. UK exports declined in 2005Q1 by 1.0 per cent although growth over the same quarter last year was 2.8 per cent. Imports decreased by 1.9 per cent in the first quarter of the year but grew by 3.8 per cent on an annual basis.

These movements are in line with current forecasts as we expect UK growth to be supported by consumption (slightly weaker in 2005 compared to 2004) and government spending. We also expect investment spending to remain important (although with subdued growth) despite the slowing towards the end of 2004.

Sterling and interest rates

The Sterling effective exchange rate (ERI) was updated in April of this year but movements in the old ERI and the new one have been similar. The new index takes into account a wider range of trade and has updated weights. The ERI has not moved much since May of 2005 despite the significant movements between the dollar and the Euro. The ERI had depreciated slightly at the beginning of June but this was in line with both domestic and foreign interest rates. The Bank of England has kept interest rates at 4.75 per cent for months. There is speculation that rates may move down but equally rates could stay at their current level until the end of the year. The Monetary Policy Committee decision is very difficult to 'second-guess' at this moment in time. Market yields are also consistent with an expectation of the interest rate remaining close to 4.75 per cent.

Prices

CPI increased by 1.9 per cent in the twelve months to May of this year (unchanged from April). The RPI increased by

Table 1: Independent forecasts of the UK economy

	2004	2005	2006	2007
Real GDP growth (%)	3.2	2.5	2.4	2.6
Inflation rate (CPI %)	1.4	1.9	2.0	2.0
Inflation rate (RPI %)	3.0	2.6	2.5	2.5
Inflation rate (RPIX %)	2.2	2.2	2.3	2.5
Claimant count, million)	0.85	0.85	0.89	0.89
Employment growth (%)	0.6	0.5	0.4	0.4
Average Earnings (%)	4.3	4.5	4.4	4.4
ERI (1990=100)	-28.1	-26.9	-26.5	-28.9
PSNB (£ billion)	33.4	37.0	36.4	35.6

Source: National Statistics, National Institute Economic Review, 191, January 2005 and "Forecasts for the UK economy", HM Treasury, June 2005. **Note:** PSNB is given for financial years, e.g. 2003/04

2.9 per cent compared to 3.2 per cent in April. RPIX increased by 2.1 per cent in May compared to 2.3 per cent in April. The large downward effect on the CPI came from transport and diesel prices. This is in contrast to the sharp increase a year earlier due to increased crude oil prices. Some smaller downward effects came from clothing, housing services, household goods and communication costs. Items that had an increase included alcoholic beverages, recreation and miscellaneous goods.

The labour market

Employment in the UK labour market rose again in Feb-Apr 2005 by 11,000 taking employment to 28,578,000. This is an employment rate of 74.8 per cent. ILO Unemployment fell by 15,000 in the same period taking the unemployment rate to 4.7 per cent. The claimant count rose by 13,200, an unchanged rate of 2.7 per cent. Average earnings including bonuses grew by 4.6 per cent for the period Feb-Apr 2005. When bonuses are excluded the rise was 4.1 per cent. The economically active decreased by 4,000 to 29,974,000 (a rate of 78.5 per cent) but there was a large increase (74,000) in the numbers who are economically inactive, up to 7,905,000 or 21.5 per cent.

Part-time employment was recorded as 7,272,000 for Feb-

Apr 2005, a decline of 34,000 on the previous period and of 129,000 on a year ago. There were 30,625,000 workforce jobs recorded in March 2005. This is an increase of 78,000 on the previous quarter and 213,000 on an annual basis. The quarterly survey of employee jobs (seasonally adjusted) was 26,474,000 in March 2005, an increase of 90,000 over the quarter but an increase of 255,000 over the year. Jobs losses were only recorded in manufacturing (-23,000 over the quarter) and energy and water (-4,000 over the quarter). Self-employment fell in the last quarter (by 8,000) to 3,847,000. Self-employment declined by 29,000 over the year. There was a slight decline (-2,000) in the number of trainees (WRGTP) over the quarter although the decrease over the year was 8,000.

Overall the outlook for the UK economy remains promising for both 2005 and 2006. Clearly the importance of economic fundamentals cannot be stressed enough in the pursuit of long-term macroeconomic stability. There is no immediate or serious threat to the UK economy.

Kenneth Low
4th July 2005