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Review of the UK economy in 2002

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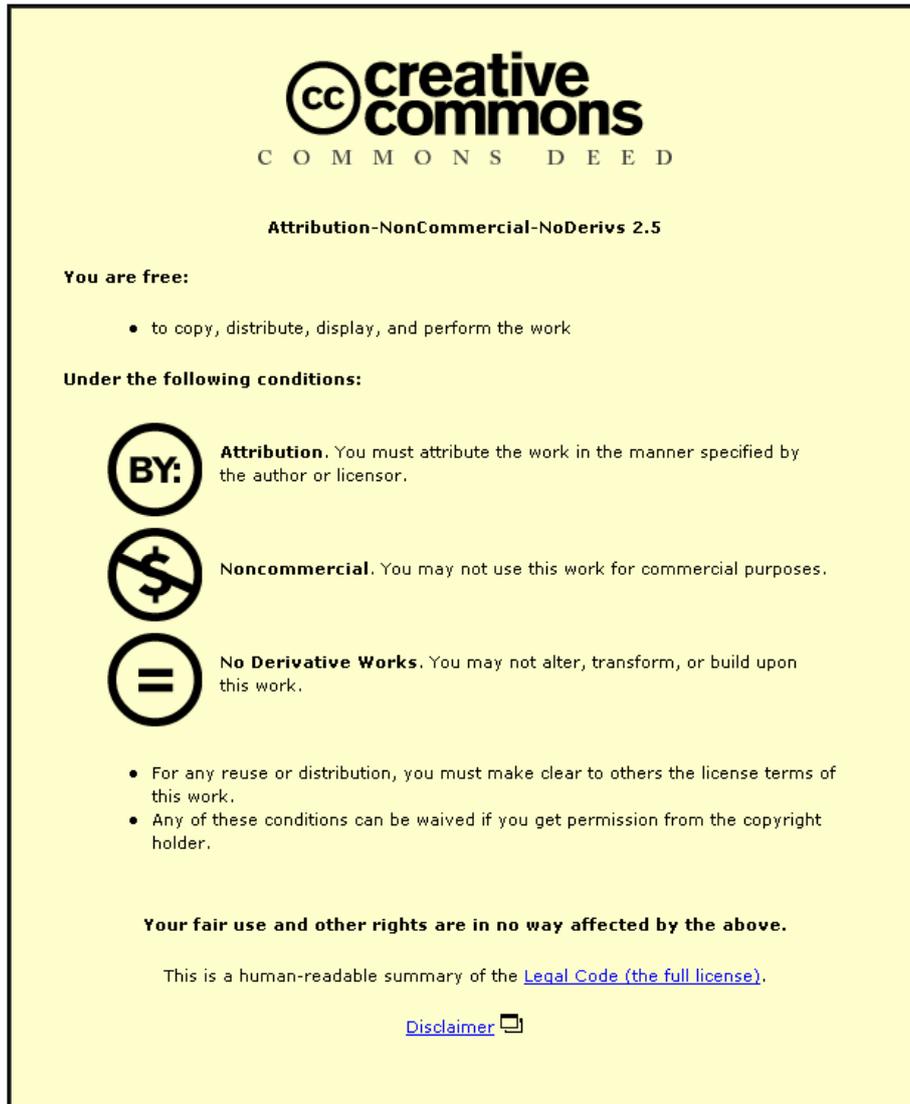
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Review of the UK Economy in 2002

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Introduction

In this article we will look at how the UK economy has performed over the past year and put this in the context of events in the world economy. This year has seen lower than average growth in the UK economy. In the short term this may cause problems for the government's fiscal strategy in that tax receipts look set to fall at a time when expenditure is planned to increase. However, there are signs that the worst of the slowdown may be over and that output growth will pick up in the coming year. Inflation has remained below its target rate throughout the year and unemployment has continued to fall.

The Domestic Economy

The first issue we will investigate is how the real economy has performed over the past year. In Table 1, we present some basic summary statistics for the UK economy. The first column gives figures for the growth rate of real Gross Domestic Product (GDP). These indicate a slowdown of growth in 2001 which has continued into the first three quarters of 2002. We can obtain a more detailed picture of the behaviour of GDP from the graph of GDP growth given in Figure 1. The horizontal line on this diagram shows the long term average growth rate of the UK economy of 2.4% per annum. Therefore periods in which GDP growth exceeds this value are periods of relative prosperity while those periods in which GDP growth falls below this value indicate relatively poor performance. It is clear from the diagram that, from a position of strong growth in 2000, there was a significant slowdown in 2001

A number of factors accounted for the disappointing growth performance of the last two years. These include the effects of the foot and mouth crisis on agriculture and tourism,

the lagged effects of monetary policy changes by the Bank of England designed to moderate inflation and finally, the effects of a downturn in the world economy which was made worse by the September 11th events on economic confidence. It may be too early to say that these effects have fully worked their way out of the system but there is some evidence from Figure 1 that the downturn in economic growth may have now reached its low point. Although growth rates for the first three quarters of 2002 are still somewhat lower than the long term average, they do mark something of an improvement on the last two quarters of 2001.

The slowdown of economic growth during the last year has meant that inflationary pressure has been low. During 2000 the Bank of England was concerned that higher than average growth might threaten its inflation target. As a result the base rate of interest increased twice from 5.5% at the start of the year to 6% by the end. Since then inflationary pressures have eased and the interest rate has been lowered in a series of steps to 4%. The average rate of change of RPIX (retail price index minus mortgage interest rates) for the first nine months of 2002 was 1.86%. However, it is unlikely that such a low rate will be maintained since some acceleration of inflation can now be expected as the growth rate picks up towards its long run average value.

Over the last few years the UK economy has seen a marked fall in the level of unemployment from a level of 1.35 million in 1998 to less than 1 million in 2002. This fall has been the result of a combination of buoyant economic activity during this period and a series of structural labour market measures which have been introduced by the government. The 'New Deal' has been one of the success stories of the Labour government in that it has facilitated the return of unemployed jobseekers back into employment. However, the fall in unemployment has slowed as a result of slower than average economic growth during the past year and it may be the case that unemployment will begin to rise again in the immediate future. A rise in unemployment would add to the budget problems facing the Chancellor in that it would add to the social security bill and

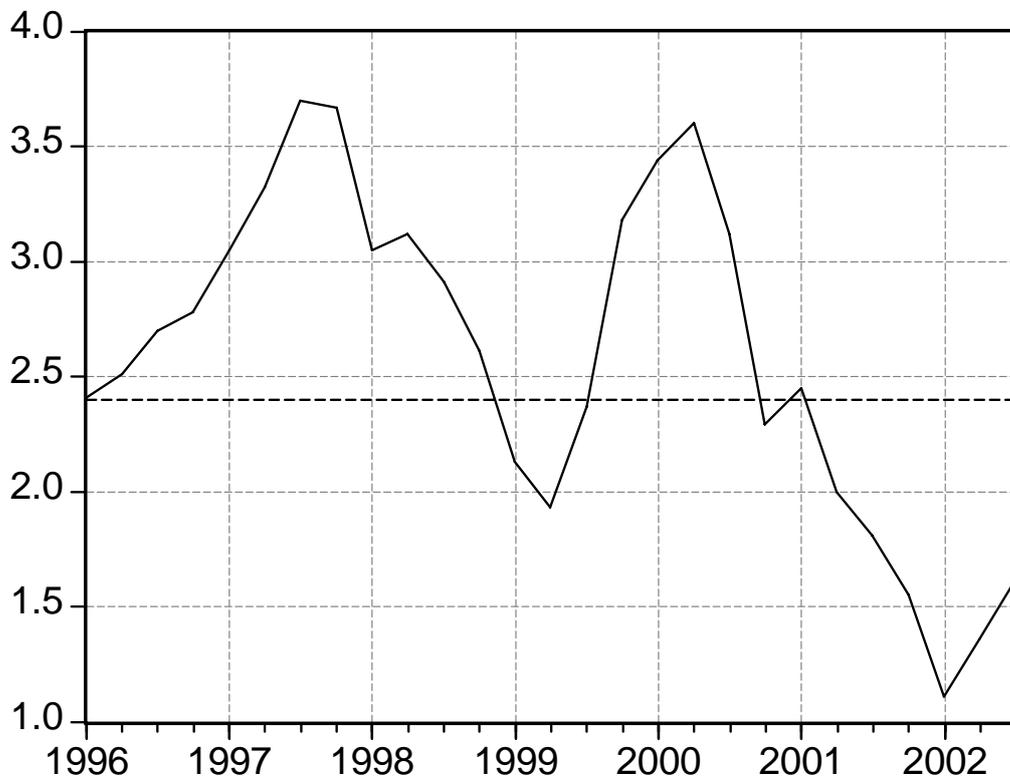
reduce taxation receipts at a time when the government is facing problems in funding its expenditure plans.

Table 1: Summary Statistics for the UK Economy

	GDP Growth Annual % Change	RPIX Inflation Annual % Change	Unemployment Claimant Count (Thousands)	Current Balance % of GDP
1998	2.92	2.62	1348	-0.21
1999	2.38	2.30	1248	-0.56
2000	3.04	2.07	1089	-2.19
2001	1.99	2.15	970	-2.02
2002	1.36	1.86	948	-1.53

Source: ONS Database. Figures for 2002 are averages for quarters or months available at date of writing.

Figure 1: GDP Growth 1996-2002



One of the worrying features of the economy during 2002 has been the behaviour of the stock market. Figure 2 shows daily figures for the Financial Times 100 (FTSE 100) share price index over the period January 2001 to November 2002. The value of the stock market fell by about 14% in the year 2001 and by a further 20% between January and November 2002. The fall in 2001 was partly a necessary correction to what was clearly an overvalued market at the start of the year and partly the result of a loss of confidence caused by the September 11th events. However, it is noticeable that the sharp fall in the market immediately after September 11th was fairly quickly reversed.

The behaviour of the market during 2002 is somewhat harder to explain. There were particularly sharp falls in August and September 2002 and as yet there is no sign of any recovery. What seems to have happened is that a number of high profile company failures in the United States have revealed that corporate profit figures may have been kept artificially high by dubious accounting practices and this has led to a generalised loss of confidence in the American corporate sector and a fall in US equity values. It is not yet clear whether these falls represent a genuine adjustment of the market to reflect the underlying fundamentals of company profitability or whether the market will recover in the coming year.

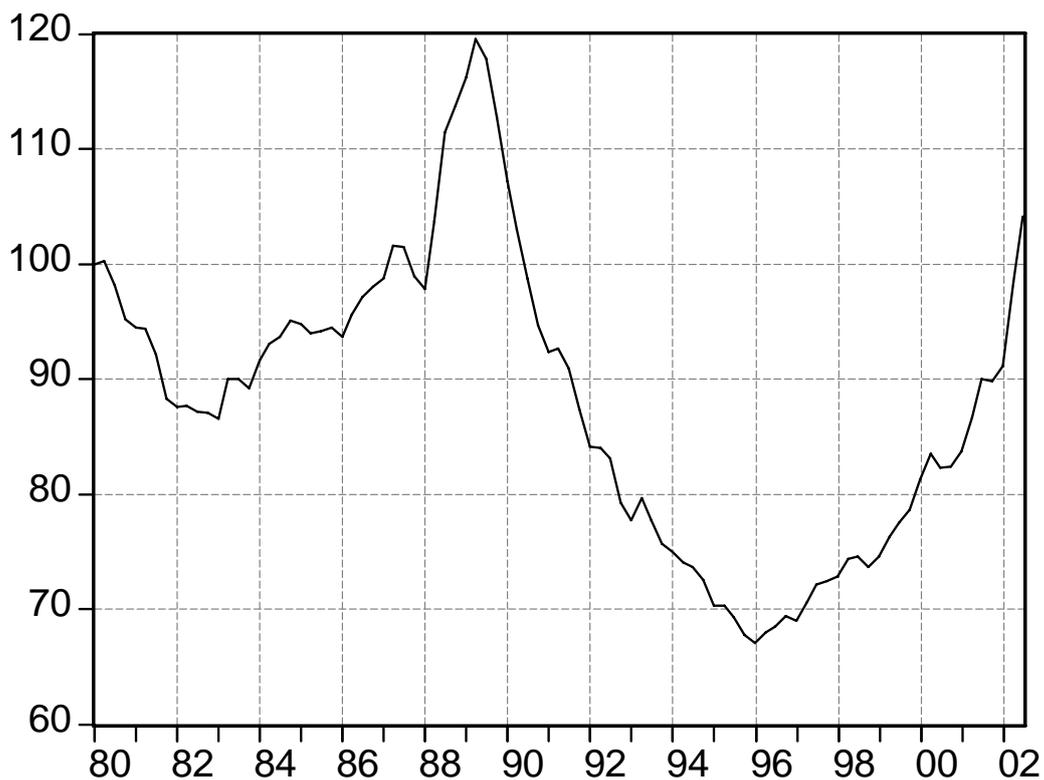
Figure 2: FTSE 100 Index January 2001 to November 2002



During 2002, the UK housing market has continued to boom with the average house price rising by over 19% in the third quarter of the year relative to the same quarter in the previous year. This has undoubtedly contributed towards maintaining a high level of consumer demand and has acted to offset the effects of the fall in private sector financial wealth due to the collapse in equity prices. However, the high cost of housing coupled with a tightening of labour market conditions has led to recruitment problems for firms in high cost housing areas. This problem has been particularly acute for public service industries in London and the South-East, where it has become increasingly difficult to fill vacancies in the Health Service and education. The danger for the economy is that if wages rise to solve what is essentially a problem of regional imbalance, then this could lead to overall inflationary pressure for the economy.

A number of commentators have suggested that current levels of house prices are unsustainable. To help us assess whether this is the case we will investigate the relationship between house prices and GDP at current prices. Figure 3 shows the ratio of the Nationwide Building Society House Price Index to nominal GDP over the past two decades. The long time period is chosen to help us to compare the current boom with that of the later 1980s. From this diagram we see that the average house price has been rising relative to the rest of the economy from 1996. It should be noted however, that prices started from a very low base and even now are not up to the level observed in the previous boom. It is possible therefore, that the current boom may have some way to go.

Figure 3: Ratio of House Prices to GDP



Another source of concern for the UK economy during the past year has been an emerging public sector deficit which may cause some financing problems for the

government. In the 2002 Spending Review, the Chancellor set out an ambitious programme to revitalise public services across a whole range of Government Departments. The Government is also committed to meeting two basic fiscal rules. These are that over the economic cycle, the Government should borrow only to invest and not to fund current spending (the 'golden rule') and that over the cycle, the ratio of public sector debt to GDP should be kept below 40%. Following the pre-budget report in November 2002, there was considerable concern that these rules might be broken since the borrowing totals had to be revised upwards. This has led some commentators to describe the revisions as a 'black-hole' in the government finances. However, such a description is something of an exaggeration. Given that the fiscal rules are only expected to apply over the business cycle as a whole, it is consistent for the Chancellor to maintain current spending plans on the basis that the fall in taxation revenues is likely to be temporary and that receipts should revive when the economy resumes a more normal growth rate.

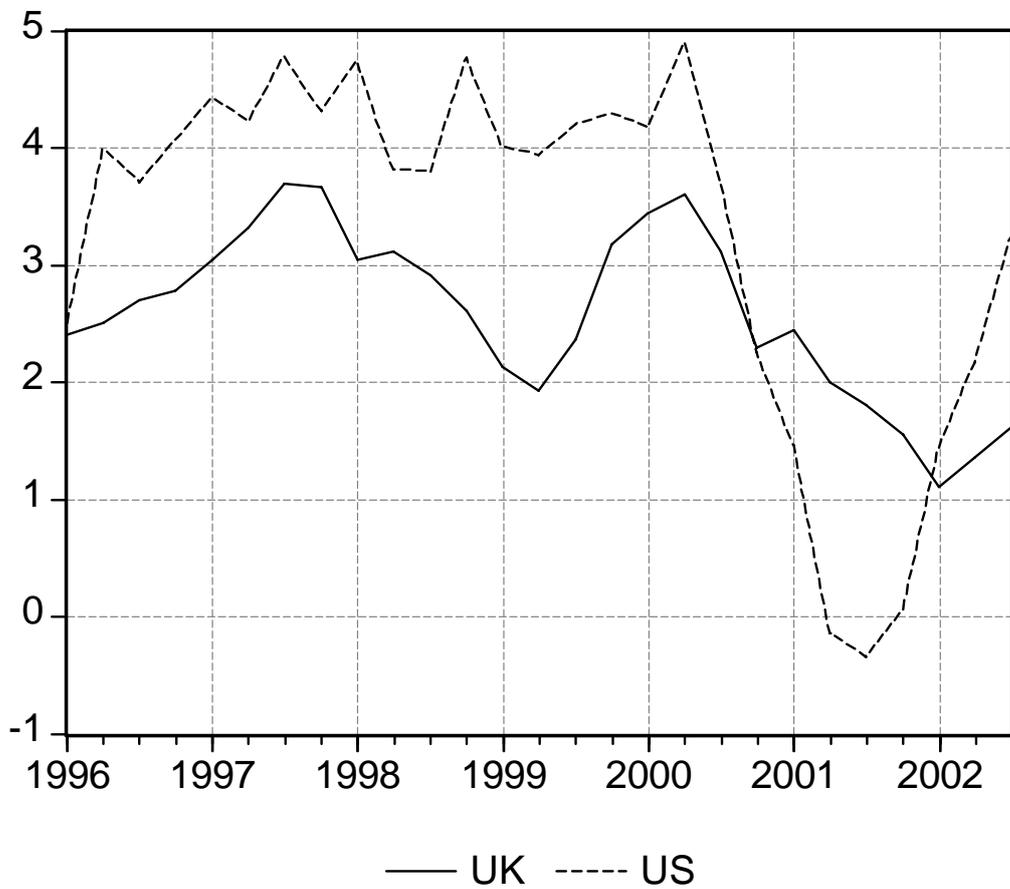
The International Environment

The downturn in economic growth in the UK has been part of a wider international slowing of growth. An important factor here has been the slow down in the United States economy which first became evident during 2000 and which appears to have bottomed out during 2001. Figure 4 shows the growth rates of the United States and the UK economy for comparison. From Figure 4, we see that growth in the US peaked in the second quarter of 2000 and then began to slow down significantly. By the second quarter of 2001 the US economy had experienced two consecutive quarters of negative growth and was therefore technically in recession. However, this recession was very short lived. By the end of 2001, despite the events of September 11th, the US had once again resumed positive – though modest – growth. This recovery appears to have continued during 2002 with output growth getting back to something like its long term average value. It remains the case however, that confidence in the US economy is low and many commentators have warned of the danger of a 'double-dip' recession. The concern is that the current recovery may prove temporary and the US will move back into recession in the near

future. The current weakness of the equity market has added to this danger although this has, to some extent, been offset by the tax cuts which have been implemented by the Bush administration. If the US was to move back into recession then the consequences for the UK and the other industrial economies would be potentially very serious.

Figure 4: UK and US Growth

Rates



Prospects for the Future

The prospects for the UK economy over the immediate future can best be described as reasonably positive but with significant downside risks. Table 2 shows the average of a set of independent forecasts published by the Treasury. This therefore gives a snapshot of the average private sector view of how the economy is likely to develop over the next few years. The general consensus appears to be that the growth rate of output will recover while inflation will accelerate to just over its target rate. Unemployment is expected to rise slightly while the current account of the balance of payments is expected to deteriorate.

Table 2: Average of Independent Forecasts for UK Economy

	GDP Growth Annual % Change	RPIX Inflation Annual % Change	Unemployment Claimant Count (Thousands)	Current Balance (£bn)
2002	1.6	1.7	960	-18.7
2003	2.6	2.6	1,000	-24.0
2004	2.9	2.8	990	-24.7

Source: Treasury Website www.hm-treasury.gov.uk

Over the past few years the UK has proved remarkably successful in avoiding the effects of an often turbulent international economy. There are risks however, in pursuing a significant increase in public sector expenditures at a time when the economy is slowing down. To some extent this marks a return to a Keynesian economic strategy in which a public works programme takes up the slack in demand at a time when private sector demand is low. It is noticeable however, that the current Chancellor has shown no tendency to adopt the short term fine tuning style of Keynesian economics which was popular in the 1950s and 1960s. Instead the strategy seems to be one of deciding on a

long term fiscal strategy and sticking to it despite the short term effects on taxation receipts caused by a business cycle downturn.