

ECONOMIC DEVELOPMENTS AND PROSPECTS

HEADLINE MESSAGE

- Due to the government's **strong macroeconomic policy framework**, the UK weathered the recent global economic slowdown **better than many of our major competitors and better than in past global downturns**.
- **Unemployment rates are close to their lowest levels** since the 1970s, **inflation is low and stable** and interest rates are at levels not seen since 1955
- Despite a period of global uncertainty, the UK has continued to grow- **experiencing the longest unbroken economic expansion on record** and because of **strong economic fundamentals** the UK is well placed to respond positively when the world economic recovery shifts up a gear
- UK government is comfortably on track to **meet firm fiscal rules** over the next five years. At the same time the government is able to deliver substantial investment in the reform and modernisation of the public services

HEADLINE FACTS

- **Employment has increased by over 1.8 million** since early 1997
- **The unemployment rate has been close to record lows** on both measures over the last year. The claimant count is below 1 million for the first time since December 1975 and the rate, at 2.7 %, at it's lowest since June 1975.
- Since 1997 UK **GDP growth has been more stable** than any other G7 country. By contrast growth in the UK was the most volatile in the G7 in the period 1979-1996, with the exception of Canada.
- The UK is enjoying the **longest period of sustained low inflation since the 1960s**.
- The **government remains on track to meet its strict fiscal rules over the economic cycle**, on the basis cautious assumptions, with public finances remaining sound and sustainable in the long term.
- **Public sector net debt** is low and stable through to the end of the cycle, stabilizing at just over 36 per cent of GDP thereby meeting the sustainable investment rule.

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Output (C1)

- **GDP growth** in the first quarter of 2003 was subdued at 0.2 per cent but progressively improved throughout the year rising to 0.6 per cent in Q2, 0.8 per cent in Q3 and, in the final quarter, reached 0.9 per cent, the fastest rate of quarterly growth since 2000Q1. Growth in the first quarter of 2004 is estimated at 0.7 per cent.
- The estimate of **GDP growth in 2003**, at 2.2 per cent, was above the PBR forecast of 2.1 per cent growth but fully consistent with the Budget forecast range of 2 - 2 ½ for 2003 as a whole.
- **GDP growth in 2002** has been revised up from 1.6 per cent to 1.8 per cent.
- The UK has now experienced a record **47 consecutive quarters of growth**.
- June's independent forecasts for growth in the UK average **3.1 per cent for 2004** and **2.6 per cent for 2005**.

Labour Market (C3)

- **Unemployment** stands at 4.8% and **claimant count unemployment** at 2.7%, both measures are close to their lowest levels since the 1970s.
- The working age **employment rate** is close to record highs at **74.8 per cent** with LFS employment averaging 28.3m in the 3 months to May, up 246,000 on the year. Employment has increased by over 1.8 million since early 1997.
- Over **493,000** young people have moved into work through the **New Deal** (to March 2004).
- **UK work stoppages** fell to 133 in 2003; the lowest on record and 20 per cent lower than the previous record of 166 observed in 1998.

Inflation and monetary policy (D1)

- The **new inflation target** was set at PBR 2003 to 2% target for the 12-month increase in the Consumer Price Index (CPI). **CPI currently stands at 1.6 %** (May).
- The **new target is equivalent to the old RPIX** target of 2½ per cent in two years time - the typical forecast horizon for monetary policy.
- The **difference between the targets** is consistent with the expected long-run difference between the two measures due to the formulae used (known as the formula effect). Differences in coverage are expected to be zero in two years time.
- The **CPI measure of inflation** is a better measure of inflation for monetary policy purposes.

- The UK is benefiting from the **longest period of low, sustained inflation** since the 1960s and so the Monetary Policy Committee remains well placed to respond to changes in economic conditions.
- **Interest rates**, at 4.5%, are still low by historical standards.

Manufacturing (C7)

- **The slowdown in manufacturing** over the last few years has been a global phenomenon furthered by heightened uncertainty affecting the global economic outlook. There are increasingly encouraging signs regarding world economic prospects. UK manufacturing output has started to rise over the course of the last six months.
- **Manufacturing output** rose by 0.5 per cent between April and May, by 0.4 per cent in the three months to May and up 1.4 per cent on the same three months a year ago.
- After data revisions, **manufacturing output** grew in every quarter of 2003 and, as a whole, is estimated to have risen by 0.2 per cent on the year.
- The latest CIPS manufacturing survey (for June) reported the headline PMI above the no-change mark for the twelfth successive month, although falling slightly from last month. The survey results suggest that the strength in the headline index can be attributed to robust growth in new orders and export orders which continued to rise in June, although at a slightly slower rate than in May. This measure, an indicator of growth in the manufacturing sector as a whole, has now risen for twelve successive months although it appears that supply-side pressures are continuing to intensify. Survey evidence of a recovery continues to accumulate, with CIPS, CBI and BCC surveys all telling a similar story. However, official manufacturing data has yet to catch up and has, thus far, pointed to only a muted recovery. Nevertheless, a stronger pick-up is expected to emerge during this year.

Households (C2)

- **House price data** released in May indicated that the housing market is continuing its re-acceleration. The Halifax and Nationwide both reported that house prices rose in May, although Halifax reported a slightly stronger monthly increase at 2.2 per cent compared to the Nationwide rate of 1.9 per cent. Both lenders show further increases in annual house price inflation on the month with their respective measures, at 21.8 per cent and 19.5 per cent, back up to the rates seen before the general moderation through the second half of 2003. Nationwide figures for June show a fall in the monthly and annual inflation rates to 0.9 per cent 19.1 per cent respectively. A more comprehensive analysis of June's house price data will be available next week as soon as the Halifax survey results are published. Demand for housing is strong, supported by a robust labour market and consumer confidence above its long-run average. But with increasing levels of personal debt, coupled with the effects of slower income growth and the possibility of further interest rate rises, underlying economic factors are pointing to weaker price growth during 2004 as a whole.

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- Aggregate **consumer confidence** was down two points in June from May, and is below the level recorded 12 months previous, for the first time in 2004. However, the index remains above its long-run average, which taken in combination with record employment figures and low interest rates, should continue to support retail sales growth in the near future. Nonetheless, with households' borrowing marginally below the record high levels recorded in April, a mounting debt burden and the effects of slower income growth are likely to keep household consumption growth comfortably below the rates seen over the late 1990s and into this decade.
- **Equity price falls** (since its peak in 1999, the FTSE 100 is down 37.3 per cent (15/07/04)) have been partially offset by housing wealth gains, with households' **total net wealth up over 40 per cent since 1997Q1**.

Investment (C6)

- **Whole economy investment** rose in 2002 by 1.8 per cent and, after a slight fall in 2003Q1, rose again in Q2 by 1.2 per cent. Whole economy investment is expected to recover during 2004 with projected growth of 5½ - 5¾ per cent for the year as a whole.
- **Business investment** fell 0.9 per cent in 2003 (revised up from an original estimate of -1.1 per cent) but rose by 7.2 per cent in 2004Q1 on a year earlier (revised up from 4.4 per cent) and has now grown for four consecutive quarters.
- **Government Investment** grew by 11.8 per cent in 2002 on the previous year.

Trade (C4)

- **UK exports** fell 3.1 per cent for the first quarter of 2004 having risen by 2.2 per cent in 2003 Q4 however, export volume growth is expected to pick up throughout 2004 as the global recovery gains momentum. Although goods export volumes are down both on the quarter and the year, when the impact of missing trader fraud is excluded, export volumes were up 0.2 per cent on a year ago.
- Recent trade releases included the news of the “**missing trader fraud**”, those not declaring imports coming in from the EU, leading to imports being under-recorded by £11.1bn, or 1 per cent of GDP in 2002. These revisions reflect the initial adjustments for the impact of VAT Missing Trader Intra-Community Fraud and remove previously unquantifiable weakness in the quality and coherence of UK trade statistics and National Accounts.
- The **current account deficit** stood at 1.9 per cent of GDP in 2003, revised up from 1.7 per cent, but well below past peaks. In 1989 the current account deficit reached over 5 per cent in 1989.

Public Finances (E1)

- Government remains **on track to meet its strict fiscal rules** over the economic cycle, on the basis cautious assumptions, with public finances remaining sound and sustainable in the long term. The average annual surplus on the current budget for the end of the cycle since 1999-00 is projected to be around 0.1 per cent of GDP.

- **Public sector net debt is low and stable** through to the end of the cycle, stabilizing at just over 36 per cent of GDP thereby meeting the sustainable investment rule.
- The **UK's public finances** are better placed than other major countries: in 2003 the UK had the lowest ratio of debt to GDP in the G7 and is also forecast to have lower borrowing than the average for OECD economies for 2004 and 2005.

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ECONOMIC NEWS LAST WEEK

Consumer Price Indices data released this month showed that May was a fairly uneventful month on the inflation front. The largest upward contribution to 12 month CPI inflation was from recreation and culture with prices on many items rising this year, in contrast to falls in June 2003. Advanced booked foreign holidays also made an upward contribution. CPI inflation is expected to fall back a little next month, remaining broadly flat through the remainder of the summer.

Labour Market Statistics this month, although surprising, are expected to prove to be a blip given the clear strength of the economy generally. Employment has fallen slightly but this should be seen in the context of very high employment rates and the underlying trend is still increasing. Unemployment levels have increased slightly but the rate remains unchanged - close to a record low - and the claimant count continued to fall.

BCC Quarterly Report for 2004Q2 showed manufacturers reporting a decent performance during Q2, with overall balances remaining above average levels. Most services balances increased, indicating further robust growth in the services industry.

Equity Prices

| | Close Thursday 15/07/04 | Month earlier 15/06/04 | % change over month | % change since peak |
|-----------------|----------------------------|---------------------------|------------------------|------------------------|
| Dow Jones | 10163.2 | 10379.6 | 2.1 | -13.3 |
| S&P 500 | 1106.3 | 1132.9 | 2.4 | -27.6 |
| CAC | 3616.2 | 3718.1 | 2.7 | -47.8 |
| DAX | 3863.2 | 4008.5 | 3.6 | -52.1 |
| FTSE 100 | 4345.0 | 4491.1 | 3.3 | -37.3 |

FORTHCOMING UK STATISTICS

The week ahead sees the release of data on Public Sector Finances, HMT Comparison of Independent Forecasts and GDP preliminary estimate for Q2.

FACTS IN DETAIL

Inflation

| Index | Rate (June) | Movement (on the month) |
|-------|----------------|----------------------------|
| CPI | 1.6% | <i>Up 0.1ppt</i> |
| RPI | 3% | <i>Up 0.2ppt</i> |
| RPIX | 2.3% | <i>Unchanged</i> |

Labour Market

- Unemployment averaged 1.432m in the 3 months to May - up by 6,000 (0.4%) on the quarter but down 52,000 (3.5%) over the year. At 4.8%, the unemployment rate was unchanged on the quarter and down 0.2 ppts over the year.
- Claimant count unemployment level fell by 9,600 (1.1%) on the previous month to 850,900 and by 97,500 (10.3%) over the year to June. The rate, at 2.7% was unchanged on the previous month but 0.3 ppts lower than in June 2003.
- LFS employment fell by 29,000 (0.1%) to 28.301m in the 3 months to May, but was up by 206,000 (0.7%) on a year ago. The working age employment rate was 74.7%, down 0.2ppts on the previous quarter, but unchanged on the year.
- Three-Month Whole Economy Average Earnings including Bonuses growth rate was 4.3% in the 3 months to May unchanged on the April rate. Public sector three-month average earnings growth was 4.3%, unchanged on the April rate and earnings in the private sector grew by 4.4% - up 0.1ppts on the previous month. Three-Month Whole Economy Average Earnings excluding Bonuses was 4.2% - up 0.1ppts on the previous month.

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BCC Quarterly Report

| Indicator | Balance | Movement (on quarter) |
|----------------------------|---------|--------------------------|
| Services Home Sales | 38 | <i>Up 6 units</i> |
| Services Export Sales | 11 | <i>Up 4 units</i> |
| Manufacturing Home Sales | 21 | <i>Up 2 units</i> |
| Manufacturing Export Sales | 15 | <i>Down 4 units</i> |