COUNTRY REPORT

United Kingdom

The UK at a glance: 2002-03

OVERVIEW

Despite its comfortable re-election in June 2001 the Labour government, led by Tony Blair, faces a difficult second term which could be marked by growing voter disaffection, reduced party loyalty and rising industrial unrest. Although the Conservative Party, led by Iain Duncan Smith, remains unpopular with the electorate, there are at least signs that it is finally starting to form an effective opposition. Having dropped to its lowest level since the mid-1960s in 1999, public spending's share of GDP is set to increase sharply, as the government strives to bring improvements to the UK's decrepit public services. With public spending rising at a time when cyclical tax revenue will be weakening, the general government financial balance will deteriorate, moving from surplus to deficit in 2002. The Economist Intelligence Unit expects monetary policy to tighten in late 2002. as the economy begins to recover. After growing by an estimated 2.3% in 2001, real GDP growth is forecast to slow to 1.6% in 2002 before rebounding to 2.2% in 2003. Despite relatively stable term of trade, the UK's already large trade deficit will widen further in 2002-03.

Key changes from last month

Political outlook

- The opposition Conservative Party continues to languish in the opinion polls, but it is starting to make an impression in parliament.

Economic policy outlook

- The launch of euro notes and coins in January 2002 appears to have pushed the question of UK participation in economic and monetary union back up the political agenda, but it remains unclear whether the government will hold a referendum in 2003, as some observers believe.

Economic forecast

- We have reduced our real GDP growth forecast for 2002 from 1.7% to 1.6%.

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The Economist Intelligence Unit

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Outlook for 2002-03

Political outlook

Domestic politics

Despite its huge majority in parliament the Labour government, led by Tony Blair, faces perhaps its most challenging year since entering office in 1997. Not only is it having to cope with the continued domestic and international fallout from the events on September 11th last year, but the economic and social climate at home is beginning to deteriorate. The manufacturing sector is experiencing its worst recession since the early 1980s; the rate of unemployment is rising; public frustration with the parlous state of key public services is set to grow, as the rail network continues to experience disruptions and the National Health Service struggles to treat rising numbers of patients more rapidly; and there is a growing risk of industrial unrest among public-sector workers such as teachers, doctors, nurses and policemen, whose working practices the government is seeking to change. As if this were not enough, the most divisive issue in UK politics—the question of participation in economic and monetary union (EMU)—could return to the top of the agenda following the introduction of euro notes and coins in January 2002.

Throughout its first term, the government's popularity had rested largely on voters' disdain for the opposition Conservative Party. Although opinion polls indicate that the party remains unpopular and that its new leader, Iain Duncan Smith, has yet to make much of an impression on voters, there are signs that it is finally starting to form a more effective opposition. Should the Conservative Party manage to exploit the government's difficulties in 2002, it may finally succeed in making some lasting inroads into Labour's still massive lead in the opinion polls.

International relations

The government is likely to come under growing pressure to downgrade the importance which it has attached to foreign policy in the wake of the terrorist attacks on the US on September 11th. Mr Blair's globetrotting diplomacy may have made him by far the most visible leader in western Europe, but his efforts to build international coalitions and solve intractable problems abroad have jarred with some voters at home, particularly at a time when the transport and health services are widely perceived to be in crisis. Mr Blair's habit of taking personal charge during crises will probably see him devote more of his energies to domestic issues.

Mr Blair's main foreign policy ambition—to act as a "bridge" between the US and the EU—is in any case unlikely ever to be fully realised. Recent events have shown that while the US appreciates UK support, it will not allow the price of that support to be the constraint of its freedom of action. Meanwhile, the UK's tendency to subordinate its relations with the EU to those with the US will continue to be viewed with suspicion by other EU member states, particularly in countries such as France, where anti-Americanism runs deep. That said, the drift in Franco-German relations should continue to provide the UK with a rare opportunity to increase its political influence in the EU. Mr Blair, the most pro-European British prime minister since the early 1970s, has proved more adept than his more Eurosceptic Conservative predecessors at building alliances with other EU countries in areas where they share common interests or outlooks, and the UK cuts a less isolated figure as a result. Even so, the UK's decision to remain outside EMU for the time being will continue to prevent its influence in the EU from reaching its full potential.

Economic policy outlook

Policy trends

Labour's second term will contain fewer innovations on the economic policy front than its first term, but three issues will loom large. The first will be to bring visible improvements to the UK's creaking public services, which have suffered from decades of underinvestment. Large increases in public spending are in store, but these will need to be funded by potentially large increases in taxation. A second priority will be to introduce measures aimed at closing the UK's productivity gap with leading OECD economies. An early initiative will be to take the reform of competition policy in 2000 a step further by copying the US example and making legal provision to jail directors of firms engaging in anti-competitive practices. The government's final priority will be to decide whether to hold a referendum on UK membership of EMU. The physical introduction of euro notes and coins in January 2002 has brought this domestically explosive issue into sharper focus, but the Economist Intelligence Unit is more cirumspect than many domestic commentators about the likelihood of a referendum in 2003. We put the chances of a referendum on EMU in 2003 at no higher than 40%, and we still think it likelier than not that the UK will remain outside EMU for the duration of the current legislature.

Fiscal policy

Having fallen to its lowest level since the mid-1960s as a result of the tight public spending limits to which the Labour government adhered during its first two years in office (1997-99), public spending is set to rise sharply over the outlook period. Most of the increases will be channelled into key public services (education, health and transport). Despite the increases envisaged, however, public spending's share of GDP will only return to the level which the government inherited from its Conservative predecessor in 1997. With public spending rising sharply at a time when cyclical tax receipts are set to weaken, the general government finances will deteriorate over the next two years. After four successive years of budget surpluses, we expect the cyclically unadjusted general government finances to move back into deficit in 2002. However, lower debt interest payments resulting from the huge debt repayment that has occurred in recent years, allied to the growth in nominal GDP, should still allow the ratio of general government debt to GDP to continue falling.

In focus: Public spending and the future tax burden

A key question for the government over the outlook period will be to decide whether public spending should continue to rise sharply after 2003/04, and if so, how such increases should be funded. The government's stated ambition is to raise health spending to the EU average, but it will not be able to do so by redirecting public spending from other areas: not only may public spending on the education and transport sectors have to continue to rise as well after 2003/04, but the "peace dividend"—which has seen defence expenditure cut from 5% of GDP in the mid-1980s to just 2%—may have to be reassessed in light of the new threat posed by international terrorism. The tax burden will have to rise, therefore, but it remains unclear which taxes the chancellor of the exchequer will target. The government ruled out any increases in income tax during the election campaign, and indirect taxes—particularly duties on oil, alcohol and tobacco—are already at such punitive levels that smuggling from other EU countries and crossborder shopping have become widespread (resulting in lost tax revenue). The government, in these circumstances, will probably have to abolish the ceiling on national insurance contributions, even if this risks alienating middle-income households, on whose support it will depend to be re-elected.

Monetary policy

Having cut its key repo rate to 4% on November 8th, the Bank of England's Monetary Policy Committee (MPC) left official interest rates on hold at its meeting on January 10th. It now looks increasingly likely that the cycle of monetary easing—which saw official interest rates drop by 200 basis points during 2001—has come to an end, and we expect interest rates to remain on hold for much of the first half of the year. Monetary policy will tighten rapidly as the recovery takes hold in the second half of 2002, with the repo rate returning to 5% before the end of the year. The repo rate will rise further in 2003.

The MPC's task in the short term will be complicated by the conflicting pressures which it continues to face. Although the manufacturing sector has now been in recession for several months, consumer spending remains strong, the ratio of household debt to disposable income has reached record levels, and house price inflation remains unsustainably high. The dilemma facing the MPC is that further interest-rate cuts could overstimulate consumer demand and exacerbate existing economic imbalances, but failure to ease monetary policy risks pushing inflation further below the official central target of 2.5% and deepening the current downturn.

Economic forecast

International assumptions

The world economy is experiencing its most severe slowdown since the 1973-74 oil price shock. In 2000 world growth averaged 4.7% (in terms of purchasing power parity), the fastest pace since 1984. However, we estimate that the world economy expanded by just 2.2% in 2001, the slowest rate recorded since 1992. The OECD performed even worse, growing by 0.9% in 2001, its weakest year since 1982, when the US was in deep recession. The scale of the downturn in the OECD reflects synchronised weakness in the world's three largest economies—the US, Japan and Germany—each of which has fallen into recession. With few signs of recovery emerging anywhere in late 2001, the world economy will have little momentum as it enters 2002. Global activity is forecast to remain weak up to the middle of the year, but with a recovery taking hold in the second half of the year, world GDP growth should accelerate from an anaemic 2.4% in 2002 to 4.2% in 2003.

The main risks to our baseline forecast continue to come from the US. One is that the sharp rises in unemployment and falling confidence lead to a deeper and more protracted recession than we are forecasting (an outcome to which we ascribe a 30% chance); the other is that the huge fiscal and monetary stimulus applied in 2001 to the US economy allows US real GDP growth to rebound to an above-trend pace early in 2002 (an outcome to which we assign a 20% probability). The risks to our baseline forecast, in other words, are still weighted on the downside.

International assumptions summary
(% unless otherwise indicated)

	2000	2001	2002	2003
Real GDP growth				
World	4.7	2.2	2.4	4.2
OECD	3.8	0.9	0.9	3.0
EU	3.3	1.5	1.3	2.5
Exchange rates (av)				
¥:US$	107.8	121.5	128.8	123.5
US$:€	0.924	0.896	0.960	1.015
SDR:US$	0.758	0.785	0.771	0.751
Financial indicators				
¥ 2-month private bill rate	0.24	0.18	0.10	0.10
US$ 3-month commercial paper rate	6.32	3.59	1.71	4.88
Commodity prices				
Oil (Brent; US$/b)	28.5	24.3	18.3	20.2
Gold (US$/troy oz)	279.3	268.8	255.0	250.0
Food, feedstuffs & beverages				
(% change in US$ terms)	–6.1	–1.0	11.9	13.4
Industrial raw materials				
(% change in US$ terms)	13.4	–9.7	1.3	14.8

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

Economic growth

UK real GDP is estimated to have expanded by 2.3% in 2001. This was down from the rate of 3% recorded in 2000 but still made the UK the fastest growing economy in the G-7 (a remarkable achievement, given the disruption caused by domestic shocks such as foot-and-mouth disease, extensive flooding early in the year, and the virtual closure of sections of the rail network following a fatal accident in late 2000). With external demand still weak and domestic demand moderating after several years of buoyant growth, we expect real GDP to grow by 1.6% in 2002. The growth path which this implies is consistent with the UK economy as a whole avoiding two successive quarters of negative growth, even if some sectors of the economy, notably manufacturing, will suffer their worst recession since the early 1980s. A recovery in foreign demand, allied to a reversal of the stock cycle, should allow activity to rebound from mid-2002 onwards. The recovery will carry over into 2003, when real GDP is forecast to grow by 2.2%.

The next two years are likely, however, to witness a significant rebalancing of economic activity. The consumer boom, which has provided the main support to activity since 1996, is likely to come to an end, as employment contracts and weaker confidence encourages financially overstretched households to rebuild their savings ratios (which have dropped to historical lows). Private consumption will continue to provide the main support to GDP growth in 2002, but this will no longer be the case in 2003. Gross fixed investment, which has also grown strongly since the mid-1990s, slowed sharply in 2001 and is set to contract in 2002 against a backdrop of weak company profitability and low rates of capacity utilisation. Government consumption, by contrast, should accelerate in 2002, while the foreign balance and the stock cycle should exert less of a drag on growth than in 2001. Although private consumption is expected to continue slowing in 2003, a positive contribution to growth from stockbuilding and a recovery in business investment should support a modest economic rebound.

Gross domestic product by expenditure

(£ bn at constant 1995 prices; % change year on year in brackets unless otherwise indicated)

	2000[a]	2001[b]	2002[c]	2003[c]
Private consumption	558.6	579.6	593.0	601.9
	(4.1)	(3.7)	(2.3)	(1.5)
Public consumption	151.9	156.2	161.3	166.8
	(1.9)	(2.8)	(3.3)	(3.4)
Gross fixed investment	157.8	159.7	157.6	160.2
	(4.9)	(1.2)	(–1.3)	(1.6)
Final domestic demand	868.6	895.5	912.2	929.0
	(3.9)	(3.1)	(1.9)	(1.8)
Stockbuilding	2.5	0.3	0.2	3.0
	(–0.3)	(–0.3)	(0.0)	(0.3)
Total domestic demand	871.0	895.8	912.4	932.0
	(3.6)	(2.8)	(1.8)	(2.2)
Exports of goods & services	285.6	287.6	282.1	295.5
	(10.3)	(0.7)	(–1.9)	(4.8)
Imports of goods & services	–329.7	–336.7	–333.8	–348.0
	(10.9)	(2.1)	(–0.9)	(4.3)
Foreign balance	–44.1	–49.1	–51.7	–52.5
	(–0.7)	(–0.6)	(–0.3)	(–0.1)
GDP	827.5	846.8	860.7	879.5
	(3.0)	(2.3)	(1.6)	(2.2)

[a] Actual. [b] EIU estimates. [c] EIU forecasts. [d] Contribution to real GDP growth.

Inflation

The government's preferred measure of inflation, the RPIX (which excludes mortgage interest payments), crept briefly above the official central target of 2.5% in August 2001 but has since fallen back, reaching 1.9% in December. The rise in inflation up to August was driven by temporary factors, such as a sharp increase in fresh food prices as a result of poor weather, but these are now unwinding and are not expected to have any second-round impact on wages. Price pressures, moreover, are expected to remain benign over the next two years. Not only is RPIX inflation forecast to stay below the government's central target in both 2002 and 2003, but inflation as measured by the EU's harmonised index of consumer prices (the HICP) should remain among the lowest in the EU.

Inflationary pressures in the short term will be particularly subdued. Food prices have been falling and should continue to do so as they return closer to levels suggested by long-term trends; weak international oil prices should largely eliminate inflationary pressures at the factory gate; frozen excise duties on alcohol and reduced duties on fuel will continue to have a disinflationary impact on domestic prices through to the end of the first quarter of 2002; and retailers' pricing power will be constrained by weakening consumer confidence and fierce competition. Increased excise duties in the forthcoming March budget will exert upward pressure on certain components of the consumer price index, but the overall effect should continue to be offset by lower international oil prices and weak import prices.

Exchange rates

After strengthening almost uninterruptedly between 1995 and 2000, sterling's real effective exchange rate stabilised slightly in 2001. Since the middle of 2000 sterling has traded in a narrower range against the euro than the US dollar, and we expect this pattern to continue throughout the outlook period. Sterling is projected to weaken slightly against the euro in 2002, but not sufficiently to prevent it from shadowing the euro's projected appreciation against the dollar.

Despite the economy's resilience in 2001, sterling continues to be overvalued relative to the euro and needs to weaken if the competitiveness of the export-oriented manufacturing sector is to be restored and the imbalances between the domestic and external sectors of the economy are to be corrected. Since it is unlikely that the UK could join the EU's single currency at sterling's current exchange rate against the euro, a catalyst to a sharper than projected depreciation might be the announcement of a referendum on EMU membership.

Forecast summary

(% unless otherwise indicated)

	2000[a]	2001[b]	2002[c]	2003[c]
Real GDP growth	3.0	2.3	1.6	2.2
Industrial production growth	1.5	–1.6	–1.1	1.7
Unemployment rate[d] (av)	5.6	5.1	5.5	5.9
Consumer price inflation (av)	2.1	2.2	2.0	2.3
EU harmonised measure	0.8	1.2	1.0	1.3
3-month Treasure rate (av; %)	6.1	5.0	4.4	5.6
Government balance (% of GDP)	2.0	0.2	–0.7	–1.1
Exports of goods fob (US$ bn)	284.0	274.9	273.4	310.5
Imports of goods fob (US$ bn)	329.9	323.3	329.4	363.5
Current-account balance (US$ bn)	–27.9	–22.5	–32.0	–36.6
% of GDP	–1.9	–1.6	–2.0	–2.2
Exchange rates				
£:US$ (av)	0.661	0.695	0.661	0.647
£:¥100 (av)	0.613	0.564	0.535	0.547
£:€ (av)	0.611	0.617	0.641	0.674
£:SDR (av)	0.872	0.873	0.865	0.884

[a] Actual. [b] EIU estimates. [c] EIU forecasts. [d] EU/OECD standardised measure.

External sector

After deteriorating sharply in local currency terms between 1997 and 2001, the UK's trade balance is expected to sink further into deficit in 2002 against a backdrop of slowing external demand. However, we expect the trade deficit to peak in 2002 and to fall thereafter, as external demand recovers. The current-account deficit, which has deteriorated sharply since 1998, is estimated to have fallen slightly in local currency terms in 2001, owing to a higher surplus on the income balance. However, tourism revenue has been hit hard by a sharp fall in visits from the US (following the terrorist attacks in September last year). With the UK tourism industry unlikely to witness a recovery before 2003 at the earliest, and the trade deficit set to increase further in 2002, the current-account deficit will rise in local currency terms this year. We expect the UK's current-account deficit to peak at 2.2% of GDP in 2003, before declining thereafter.

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