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Economics Revision Focus: 2004

A2 Economics

Evaluating the UK Economy

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Revision Focus on the Recent Performance of the British Economy

A2 Syllabus Requirements

It is expected that candidates will acquire a good knowledge of **recent trends and developments in the economy which have taken place during the past ten years** but they may also benefit from a general awareness of earlier events when this helps to put the last decade into a meaningful context.

Overview of the performance of the economy since 1994

	Household Consumption	Real Disposable Income	Savings Ratio	Real GDP	Claimant Count Unemployment	RPIX Inflation	Trade Balance (Goods)	Current Account
	% change	% of income	%	% change	% of labour force	% change	£ billion	£ billion
1994	2.9	1.5	9.3	4.4	8.7	2.4	-11.1	-6.8
1995	1.6	2.3	10.0	2.8	7.6	2.8	-12.0	-9.0
1996	3.8	2.4	9.3	2.7	6.9	3.0	-13.7	-7.0
1997	3.7	4.1	9.6	3.3	5.2	2.8	-12.3	-0.9
1998	3.8	0.3	6.5	3.1	4.5	2.7	-21.8	-4.0
1999	4.6	3.3	5.3	2.8	4.1	2.3	-29.1	-24.4
2000	4.4	6.2	5.5	3.8	3.6	2.1	-33.0	-24.1
2001	3.1	4.7	6.7	2.1	3.2	2.1	-40.6	-23.5
2002	3.4	1.6	5.5	1.7	3.1	2.2	-46.6	-18.0
2003	2.3	2.5	5.6	2.1	3.1	2.8	-46.8	-27.4
2004*	**2.6**	**3.2**	**6.1**	**2.9**	**2.9**	**2.3**	**-53.7**	**-35.4**

Key points from the table above

- Average growth of **real GDP** has been close to 3% since 1994 – above the long term trend
- UK has managed to avoid a recession despite a series of **external shocks** (e.g. the Asian financial crisis of 1997-98, the end of the dot.com stock market boom in 2000, the fall-out from 9-11 and the global economic slowdown of 2002-03
- **Strong household consumption** has been the main factor behind continued growth of AD
- Consumption has grown more strongly than real disposable incomes – implying **a fall in the savings ratio** i.e. much of the increase in spending has been financed by borrowing (linked strongly to trends in the housing market)
- Steady and sustained **fall in unemployment** – claimant count has fallen below 3% - effective full-employment – and certainly full-employment in many areas/regions
- **RPIX inflation** has averaged 2.5% from1994-2004 – the centre point of the old inflation target! Consumer price inflation has been below the new target for over two years
- Sharp worsening (increase) in the **trade deficit** in goods since 1997 – forecast to surge above £52 billion in 2004. But the overall **current account deficit** is not as bad (because of strong services surplus and net inflow of interest, profits and dividends from investment incomes). The

current account deficit as a percentage of GDP is not as high as it was during the last consumer boom of the late 1980s and has been easily financed by capital inflows

	Government Budget Balance	Government Budget Balance	Short Term Interest Rate	Sterling Exchange Rate Index	Estimated NAIRU	Output Gap Actual GDP – Potential GDP
	£ billion	% of GDP	%	1990=100	%	% of potential GDP
1994	-45.8	-6.7	5.5	89.2	9.1	-0.1
1995	-41.4	-5.8	6.7	84.8	8.7	0.5
1996	-31.7	-4.2	6.0	86.3	8.0	0.4
1997	-17.8	-2.2	6.8	100.5	7.2	0.9
1998	0.6	0.1	7.3	103.9	6.4	0.8
1999	10.0	1.1	5.4	103.7	5.8	0.0
2000	15.0	1.6	6.1	107.5	5.4	0.6
2001	8.1	0.8	5.0	105.8	5.0	-0.1
2002	-15.3	-1.5	4.0	106.0	5.0	-0.8
2003	-34.3	-3.1	3.7	100.2	5.0	-1.1
2004*	-38.6	-3.3	4.3	102.4	5.0	-0.6

Key points from the table above

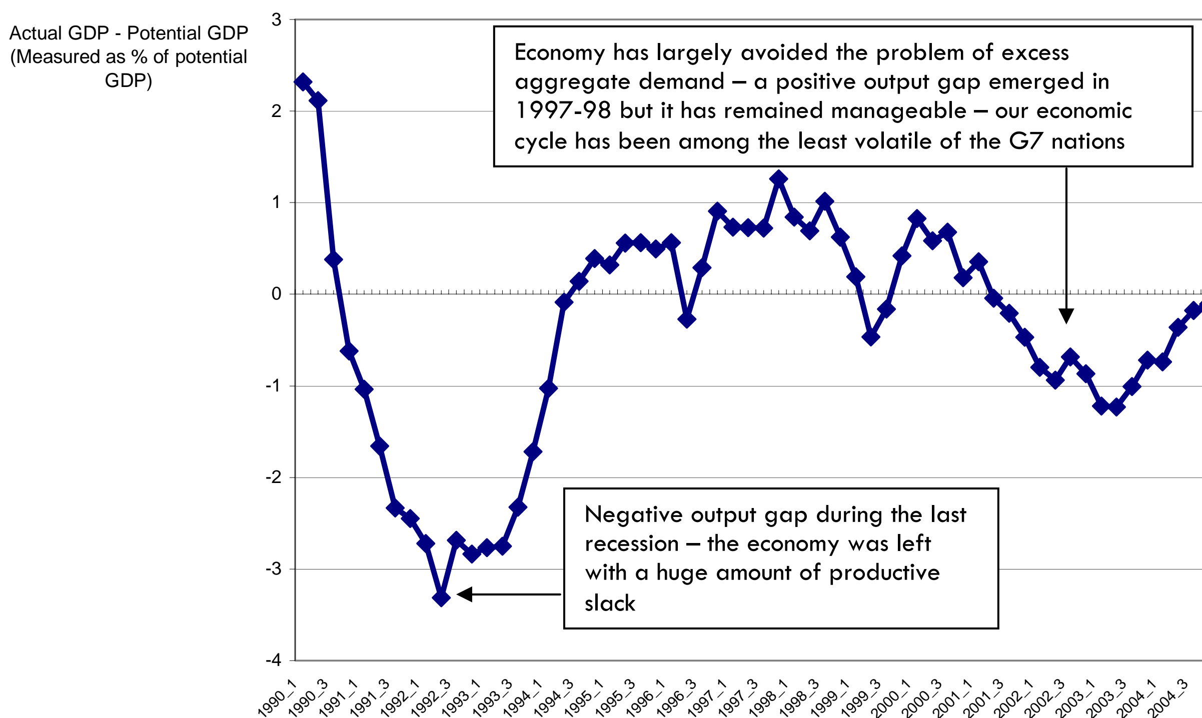
- The government's **budget balance** has shifted from heavy deficit in the mid 1990s to surpluses in 1999-2001 before moving back into deficit in the last three years. The surpluses were the result of sustained economic growth; falling unemployment and tight control of the government spending plans inherited from the last Conservative government
- The budget deficit in 2003 breached the 3% ceiling set by the European Union fiscal stability pact – but the UK is not a member of the single currency and so is not required to meet all of the conditions of the Pact. Gordon Brown has his own fiscal policy rules concerning government borrowing over the course of the economic cycle.
- Official **short term interest rates** have been under the control of the Bank of England since May 1997. Since the autumn of 1998, interest rates have been on a downward trend reflecting the absence of inflationary pressure and, latterly, the weakness of the global economy and the associated risks of recession and deflation.
- Interest rates averaged 3.7% in 2003 – well below what most economists believe is the **neutral rate of interest** for the UK which is probably closer to 5%. This means that for some time we have had a period of below-normal interest rates. Monetary policy has been expansionary in terms of its effect on aggregate demand – one product of which has been a stronger than expected housing boom. The result is that in 2004, household spending will remain very strong but that capital investment spending is also likely to recover quite well (good news for the long term growth potential of the economy).
- The counter-balance though is a **widening trade deficit** because of the strong exchange rate and the high income elasticity of demand for imported goods and services from UK consumers

- The **sterling exchange rate** has depreciated in the last twelve months – but is still well above the levels seen in the mid 1990s. Sterling has depreciated against the Euro but appreciated against the US dollar.
- There is little sign of exchange rate weakness arising from our growing current account deficit. This is because trade plays a much less important role in determining the value of a floating exchange rate. Capital flows now dominate foreign exchange market transactions

Macroeconomic equilibrium

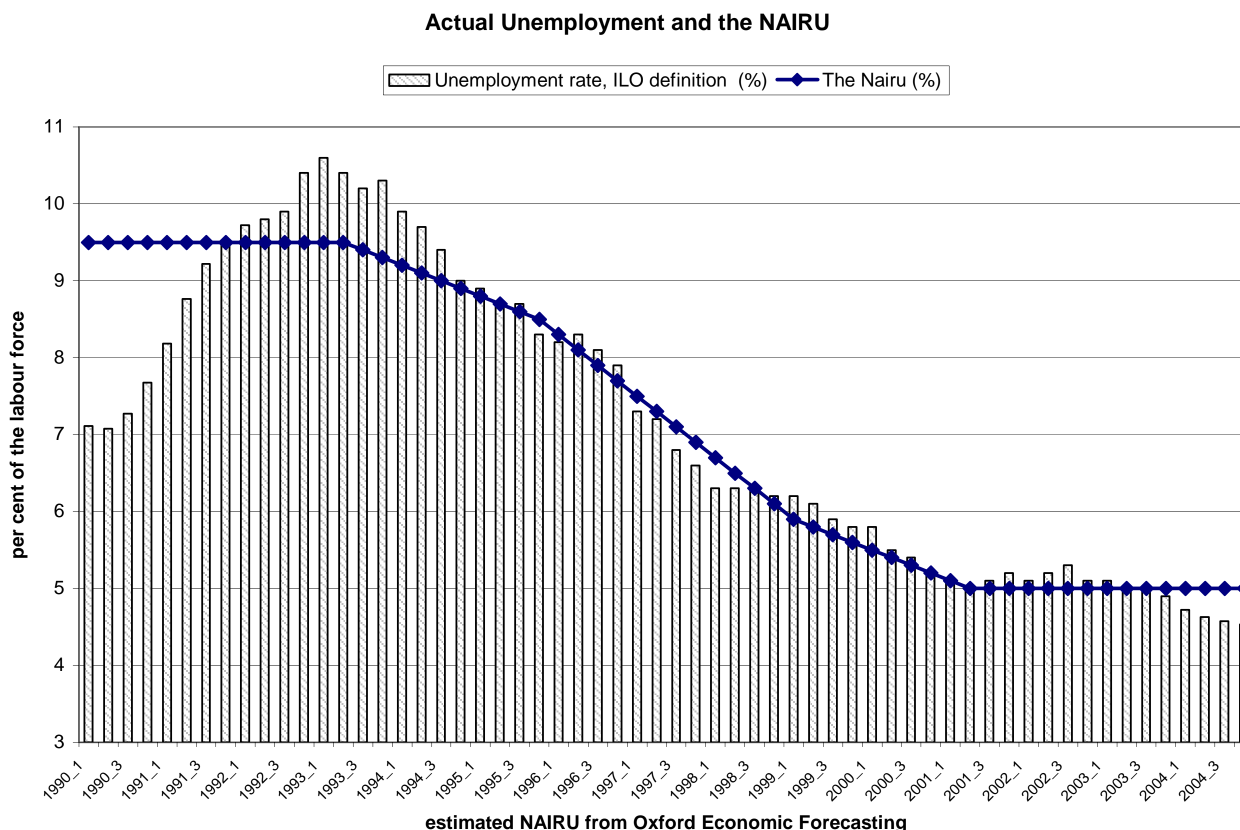
The chart below tracks the estimated output gap for the UK economy

- There is a **negative output gap** when actual GDP < potential GDP implying that the economy has a margin of spare capacity that can be used up if aggregate demand was the grow in excess of the trend rate of growth
- There is a **positive output gap** when actual GDP > potential GDP implying that the amount of spare capacity is low and there is a risk of demand-pull inflation



Considering the **external shocks** to which the UK economy is exposed to (trade accounts for a large and rising share of our national output) – the output gap has remained relatively small over the last ten years – usually within 1 per cent of estimated potential GDP.

Macroeconomic policy has apparently succeeded in keeping the economy growing at a time of global economic weakness – both monetary policy (lower interest rates) and fiscal policy (higher government spending and a rising budget deficit) have acted to dampen the economic cycle and reduce the risk of a domestic recession. Similar stimulatory policies have been implemented in the United States (under Bush and the Federal Reserve) although the scale of the fiscal deficit in the USA is much larger than in the UK.



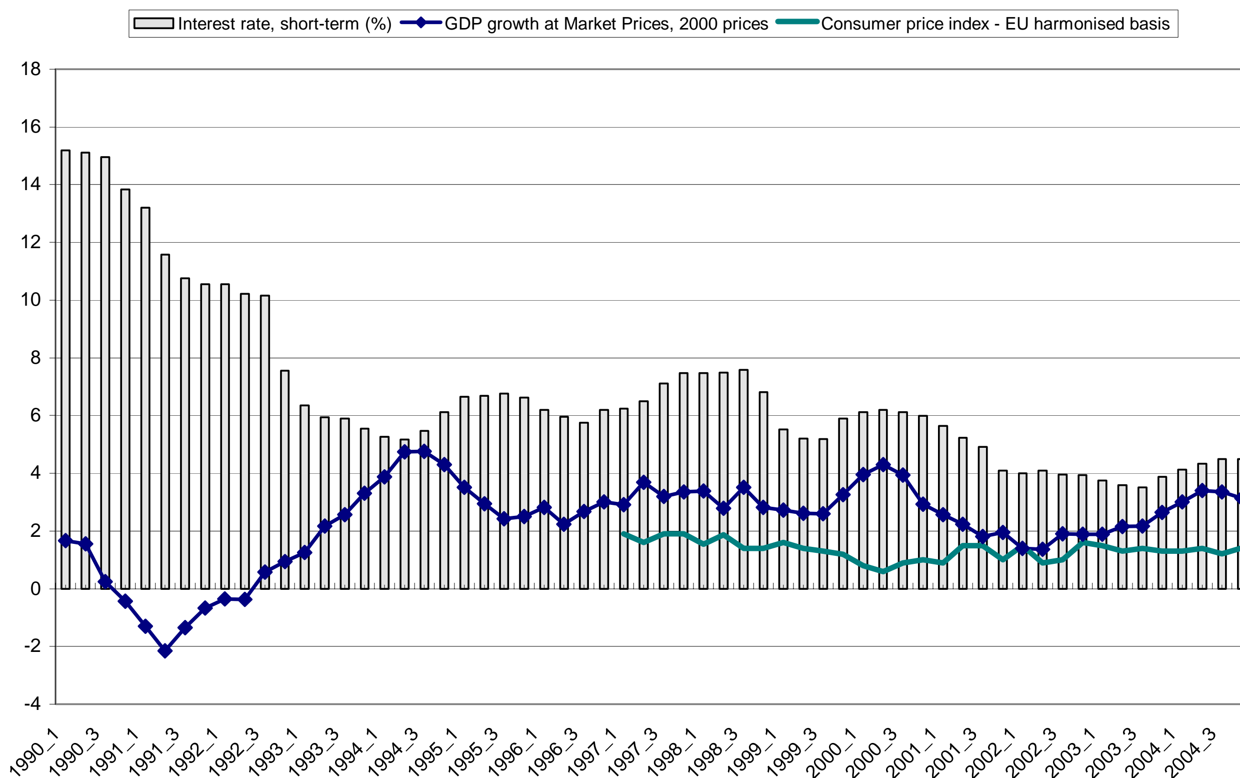
The success of the British economy in achieving a decade of falling unemployment without a rise in cost and price inflation is solid evidence of a more flexible labour market, reductions in structural unemployment and an associated fall in the non-accelerating inflation rate of unemployment. The **NAIRU** cannot be observed directly but according to Oxford Economic Forecasting, the NAIRU has fallen from 9.5% of the labour force at the start of the 1990s to 5.0% now.

The forecast is that UK unemployment will dip below the NAIRU this year – implying a tightening labour market and perhaps the cause for a rise in wage inflation – something that the Bank of England will be watching out for carefully in the second half of the year. But this does not necessarily mean that inflation will accelerate. Other factors affecting aggregate demand and/or supply may act to keep inflation under control and within target.

Summary:

1. The UK economy will grow by more than 3% in 2004 – the 12th consecutive year of growth
2. Consumer spending and capital investment will be strong (as will demand for imports) but exports of will grow less quickly – causing a growing current account deficit
3. Exports are weak because of the strength of the pound and weak economic growth in the Euro Zone (where over 55% of UK exports are sold)
4. There is no evidence that the UK trend rate of growth has changed – it remains at 2.5% per annum despite a decade or more of supply-side strategies designed to raise it!
5. But the labour market has improved its performance considerably – the UK has one of the lowest unemployment rates in the EU and long-term unemployment has come down

6. Consumer price inflation is below target at the moment – but the BoE expects it to rise towards 2% within the next two years
7. The Bank of England is now tightening monetary policy (interest rates have increased from 3.5% in July 2003 to 4.25% in May 2004) and further rises in short-term rates are expected. The peak of interest rates in the current cycle is uncertain because of global economic uncertainties – not least what is likely to happen to oil prices, global economic growth and investment and possible volatility of the exchange rate
8. The government will run a budget deficit of 3% of GDP or more over the next two financial years – but there is scope to borrow now because long term interest rates are low and gross government debt as a % of GDP is well within Maastricht criteria limits. However Gordon Brown may well miss his golden rule on government borrowing over the course of the economic cycle – a rise in taxation may well be needed the other side of a 2005 general election.
9. The UK continues to enjoy a golden scenario of (i) steady growth (ii) low consumer price inflation (iii) high rates of employment (iv) low interest rates and (v) high levels of inward investment. In the near term, this is unlikely to change
10. But there are imbalances and risks to any forecast:
    a. Imbalanced growth between consumption and other components of demand
    b. The risks arising from a high level of household debt and the booming housing market – house prices are overvalued – what will be the consequences of a crash / correction
    c. Exposure to volatility in the global economy – i.e. where next for oil prices, how fragile will be any economic recovery in the Euro Zone?
    d. Little scope for further easing of fiscal policy (budget deficit already high) in the event of a sharp slowdown in domestic demand and the strong exchange rate would make it difficult for exports to take up the slack if consumption fell
    e. If UK growth turns out to be faster in 2004 than forecast, then the output gap will become positive once more and interest rates may have to rise by more than the financial markets are expecting. This would increase the risk of a hard landing for the UK housing market and expose millions of people who have borrowed heavily in recent years


GDP Growth, Inflation and Interest Rates for the UK
Interest rate, short-term (%)
GDP growth at Market Prices, 2000 prices
Consumer price index - EU harmonised basis
18
16
14
12
10
8
6
4
2
0
-2
-4
1990_1
1990_3
1991_1
1991_3
1992_1
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