

## 2. Economic prospects

Developments in the UK economy over the past year have been broadly in line with the projections in last year's Green Budget. A year ago, we expected GDP growth in 2000 to be 2.9% and RPIX inflation (retail prices excluding mortgage interest payments) to run below target throughout the year, averaging 2.0% in the fourth quarter. The out-turn for RPIX inflation was 2.1%, while GDP is now estimated to have grown by 3.0%.

In early 2001, recessionary winds appear to be blowing from the US. Thankfully, given the UK's excellent inflation performance, the Monetary Policy Committee of the Bank of England is in a very good position to respond quickly to adverse shocks. Thus the pace at which the UK economy can grow in 2001 is determined less by international factors than by the question of what growth rate is consistent with keeping inflation on target. Our judgement is that GDP growth of 2½–3% can be maintained in 2001 and beyond while meeting the government's 2½% inflation target.

### 2.1 A chill wind from overseas

Growth in the world economy slowed significantly during 2000 – OECD GDP growth peaked at an annualised quarterly growth rate of 4.8% in the second quarter and dropped to around 2¾% in the fourth. The slowdown occurred in each of the major geographical regions but was most pronounced in the US. Several factors were responsible, including higher oil prices, higher interest rates and a collapse in share prices in the technology sector.

A further slowdown in growth is likely in early 2001, followed by a gradual pick-up as easier monetary policy, particularly in the US, takes effect. The Goldman Sachs forecast is for OECD real GDP growth to fall from 3.8% in calendar year 2000 to 2.3% in 2001. Growth of this magnitude is slightly below the rate of increase in supply potential for the OECD area and should prevent any rise in core inflation this year.

There are two main downside risks to these projections for economic activity, both stemming mainly from the US. First, the unwinding of the technology bubble could have a more significant detrimental impact on growth. New orders for electronic products in the US stopped expanding last summer, suggesting that a pause may be occurring in investment in information technology products. Since this form of expenditure accounts for 4% of nominal US GDP, and since it has been rising at an annual rate in excess of 30% in recent quarters, stagnation in this sector could remove more than one percentage point from US GDP growth this year. This would be a contractionary shock for the world economy that is larger than the Asian crisis of 1997–98.

Second, this could be combined with retrenchment elsewhere by US households and companies. Until the early part of 2000, the increase in net borrowing by the US private sector was roughly what might have been

expected, given the rise in the ratio of wealth to private sector income. However, the decline in share prices has taken the wealth ratio back to levels last seen in early 1998, when private sector net borrowing was only around 2–3% of GDP compared with 6% of GDP at the end of last year. If the private sector were suddenly to become aware of this wealth shortfall, a correction of 3–4% of GDP in US private expenditure could be feasible, only about one-half of which would be cushioned by a decline in the current account deficit of the balance of payments (due to lower imports) and a reduction in the government's budget surplus (for cyclical reasons and due to discretionary tax cuts).

These two contractionary effects – a potential IT investment collapse and a possible decline in the US private sector's financial imbalance – could, if left unchecked, be sufficient to cause a recessionary phase of economic activity. The US Federal Reserve's decision to cut its federal funds rate from 6.5% to 6% on 3 January was a clear signal that it is ready to act to prevent the downward spiral in confidence that would cause a hard landing. The Federal Reserve's action may have come too late to prevent stagnation in the US economy in the first quarter. But an outright recession should be avoided if, as seems likely, the Federal Reserve is prepared to continue in this vein in coming months. Thus, while the risks of a hard landing for the world economy cannot be ignored, this is not the most likely outcome in 2001.

## **2.2 How fast can the UK economy grow?**

While the UK economy is not immune from adverse shocks from overseas, policymakers are in a very good position to respond flexibly to any such developments. The Monetary Policy Committee (MPC) of the Bank of England has a mandate to hit a target of 2.5% for RPIX inflation. This target is symmetrical and hence it provides just as much of a guarantee against inadequate demand as against excess demand. In the event of a negative demand shock from overseas, the correct response from the MPC, other things being equal, is a loosening of monetary policy.

The Bank of England's track record since gaining independence in May 1997 is such that it is possible to have a great deal of confidence in the MPC's willingness to respond quickly to any adverse shocks, particularly in the current environment with RPIX inflation running slightly below the government's target. There is also room for manoeuvre on the fiscal side. Although fiscal policy is a much less flexible instrument than monetary policy, we show in Chapter 3 that the government is a long way from being constrained by its fiscal rules.

This means that the pace at which the UK economy can grow in 2001 is determined less by international factors than by the question of what growth rate is consistent with keeping RPIX inflation on target. The answer to this depends on two factors – what is the trend rate of GDP growth and how far is the UK from trend?

## **Trend growth**

The economic upswing began in mid-1992 and hence the UK is now well into its ninth year of expansion. Over this period, GDP has grown on average by 2.9% a year, somewhat faster than the average growth rate of 2.5% a year during the post-war period. Much of this difference is attributable to a decline in unemployment – according to the International Labour Office (ILO) definition, the unemployment rate has fallen from a peak of 10.7% to 5.3% over the past eight years.

Unemployment may be able to fall somewhat further but this cannot continue indefinitely. If the UK is to sustain its recent rate of expansion, it will have to do so primarily by improving the productivity of existing workers instead of employing many more of them. Britain's productivity trend has not been particularly impressive in recent years. From 1995 to 1999, business productivity growth averaged only 1.3% a year. This compares with an historical average of 2.4% a year and annual growth of 3.1% in the first half of the 1990s. This is in marked contrast to the US where annual productivity growth picked up by 1 percentage point between the first and second halves of the 1990s.

To some extent, slower productivity growth and falling unemployment may be two sides of the same coin. If, as seems possible, many of the new jobs created during the second half of the 1990s added relatively little to value added, compared with existing jobs, falling unemployment will have depressed measured productivity growth. Once unemployment begins to level out, this effect should dissipate. There is already evidence of this. Between 1993 and 1999, the ILO unemployment rate fell by 0.8 of a percentage point a year, on average. Over the last year, the unemployment rate has fallen by 0.6 of a percentage point, and productivity has grown by 2.5%, the fastest rate for five years.

There are grounds for being reasonably optimistic about UK productivity growth in the next few years. UK companies appear to have invested in information and communications technology as much as US companies,<sup>1</sup> leaving them well placed to reap the rewards of rapid growth in internet commerce, which Goldman Sachs economists have identified as an important source of future efficiency gains.<sup>2</sup> Productivity may not accelerate in the same way as it has in the US over the last few years, primarily because the IT-producing sector, where productivity has grown particularly rapidly, is significantly smaller in the UK.

The baseline fiscal projections in Chapter 3 are based on the cautious assumption for trend GDP growth adopted by the government, namely 2¼% a year. Our central view, however, is that the UK economy will grow at 2¾% in the next few years – midway between Britain's historic trend growth rate and

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<sup>1</sup> Goldman Sachs calculations. To be comparable with the US, real investment spending on UK information and communications technology is derived by applying US hedonic price indices (adjusted for exchange rate movements) to nominal UK investment data.

<sup>2</sup> M. Brookes and Z. Wahhaj, *The Shocking Effect of B2B*, Goldman Sachs, Global Economics Paper no. 37, February 2000.

the rate achieved over the past five years. We expect faster productivity growth to take over from falling unemployment as the main driving force behind this more optimistic view about GDP growth.

### **The output gap**

Over time, the key to maintaining a stable rate of inflation is to keep the difference between actual and trend output – the output gap – as small as possible. Actual and trend output do not always move together – demand shocks tend to drive them apart. The MPC recognises this, and a major focus of monetary policy is to offset demand shocks.

We cannot observe the output gap directly, but the weakness of price inflation (particularly once allowance is made for oil price shocks) suggests that it is small. Some MPC members have been concerned that inflation may have been depressed temporarily by the unusual strength of the exchange rate. Other factors, such as increasing trade penetration, may also have increased competitiveness, depressing domestic prices still further. While it is difficult to be certain how enduring these disinflationary forces will prove, the absence of any marked upward pressure on wage inflation provides a further indication that the economy is operating reasonably close to trend.

In last November's Pre-Budget Report, the Treasury estimated that the economy was operating 0.5% above trend in 2000–01. This is close to the Goldman Sachs estimate of 0.6%. Given that RPIX inflation is currently running below target, the output gap can be eliminated gradually to push inflation back to its target.

## **2.3 Economic prospects**

On these estimates for trend GDP growth and the output gap, the economy should be able to grow somewhere in the range of 2½–3% while keeping inflation close to target. The forecasts in this publication assume that the MPC sets interest rates in order to try to achieve GDP growth of this magnitude. Official interest rates are projected to fall ½ a percentage point in 2001, from the current level of 6% to 5.5%, to offset the negative shock from overseas.

The economy will get considerable support in coming quarters from a shift to a more expansionary fiscal stance. Although we expect public spending to undershoot the government's plans by £4½ billion this year (see Chapter 3 for details), it is still set to rise on IFS / Goldman Sachs estimates by around 5% in real terms in both 2000–01 and 2001–02.

Consumer spending growth has averaged 4% a year since 1997 and consumer confidence remains stable at a high level. However, consumer spending growth is likely to slow in 2001 as employment growth diminishes and negative wealth effects put modest upward pressure on the savings ratio. Consumer spending growth is forecast to slow from 3.8% in 2000 to 3.0% in 2001.

There is a great deal of uncertainty about investment. Business investment may be adversely affected by the weakening in share prices and uncertain

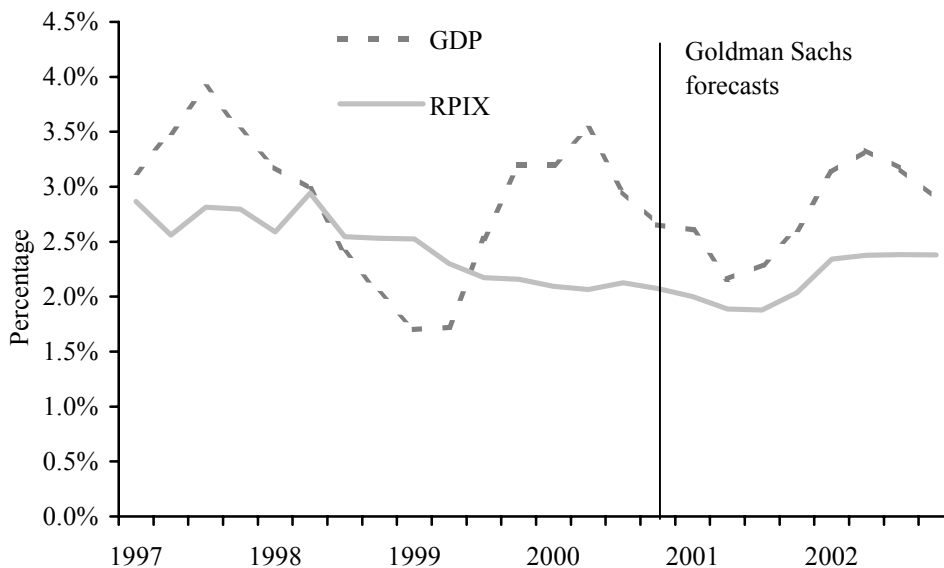
global growth prospects. Public investment is projected to grow rapidly in line with the government's plans. As a result, total fixed investment is projected to grow by 3¾% in 2001 after 1½% growth in 2000.

A weakening in global growth prospects means that the drag on the economy from net trade is likely to remain extensive. Although this may be offset to some extent by a continued depreciation in sterling, particularly against the euro, net trade volumes are likely to curb GDP growth by around 1% in 2001, similar to their effect in 2000.

Overall, the Goldman Sachs forecast is for GDP growth to slow from 3.0% in 2000 to 2.4% in 2001. This is fractionally more than the MPC would like to see, and RPIX inflation is expected to ease from 2.1% in 2000 to 2.0% in 2001. This should pave the way for a rebound in GDP growth to just over 3% in 2002 and a pick-up in RPIX inflation towards target, as shown in Figure 2.1. The deficit on the current account of the balance of payments is projected to worsen from around £14 billion (1.5% of GDP) in 2000 to £23¼ billion (2.4% of GDP) in 2001.

A summary of Goldman Sachs's main economic forecasts is shown in Tables 2.1 and 2.2.

**Figure 2.1. GDP growth and retail price inflation (excluding mortgage payments)**



Source: Goldman Sachs.

## Risks

There are various risks to these forecasts. The main downside risk comes from overseas. If the Federal Reserve is unable to prevent a hard landing for the US economy, this would necessarily entail a weaker period of growth in the UK economy. But, given the UK's excellent inflation performance, there is

**Table 2.1. Demand prospects**

<i>Annual percentage change</i>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>Household consumption</b>				
HM Treasury <sup>a</sup>		3½	2¼ to 2½	1¾ to 2¼
Goldman Sachs <sup>a</sup>	4.4	3.8	3.0	2.9
Consensus			2.9	2.5
<b>Fixed investment</b>				
HM Treasury		2½	4¼ to 4½	3¾ to 4¼
Goldman Sachs	5.2	1.6	3.8	3.9
Consensus			3.1	2.9
<b>Exports of goods and services</b>				
HM Treasury		8	7 to 7½	6 to 6½
Goldman Sachs	4.0	7.6	6.3	8.3
Consensus			5.5	5.6
<b>Imports of goods and services</b>				
HM Treasury		9	7¼ to 7½	6 to 6½
Goldman Sachs	8.1	9.1	7.9	7.6
Consensus			6.7	5.7
<b>Real GDP</b>				
HM Treasury		3	2¼ to 2¾	2¼ to 2¾
Goldman Sachs	2.3	3.0	2.4	3.1
Consensus			2.6	2.5

<sup>a</sup>Includes non-profit institutions serving households.

Sources: HM Treasury – *Pre-Budget Report, November 2000*, Cm. 4917, HM Treasury, London, 2000; Goldman Sachs – *The UK Economics Analyst, January/February 2001*; Consensus – HM Treasury, *Forecasts for the UK Economy: A Comparison of Independent Forecasts, No. 165, January 2001*, HM Treasury, London, 2001.

**Table 2.2. Other key indicators**

	<b>1999Q4</b>	<b>2000Q4</b>	<b>2001Q4</b>	<b>2002Q4</b>
<b>Price inflation (%)<sup>a</sup></b>				
HM Treasury		2¼	2½	2½
Goldman Sachs	2.2	2.1	2.1	2.4
Consensus			2.2	2.4
<b>Unemployment (million)</b>				
Goldman Sachs	1.19	1.05	1.04	0.98
Consensus			1.03	1.02
<b>Current account (£ billion)</b>				
HM Treasury		-14¼	-15	-17½
Goldman Sachs	-9.9	-13.9	-23.2	-25.9
Consensus			-18.2	-18.0

<sup>a</sup>RPI excluding mortgage interest payments.

Sources: As in Table 2.1.

nothing to prevent the MPC from easing monetary policy more aggressively. Thus any slowdown in the UK economy should prove temporary.

There are also downside and upside risks associated with the cyclical position of the UK economy. The labour market seems tight and the 2001 wage round will need to be monitored closely. Pay settlements averaged 3½% during the second half of last year. A small rise would be consistent with the inflation target. Anything more would suggest that the economy is operating further

above trend than expected, necessitating slower growth in 2001 than in the central forecast.

It is also possible that the supply-side performance of the UK economy has improved to a greater extent than allowed for in this forecast, particularly if the US experience of recent years is anything to go by. If this is the case, inflation will drift further below target unless the MPC eases monetary policy sufficiently to push GDP growth up.

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