

## 3. The economic outlook

David Miles, with Melanie Baker and Vladimir Pillonca (Morgan Stanley)

### Summary

- The UK economy has been unusually stable in recent years, with growth less variable, and inflation lower and less volatile, than in previous decades. But there is no strong evidence that economic stability and government policies have raised the sustainable long-term growth rate of the economy and living standards.
- The Treasury believes that the sustainable 'trend' growth rate of the economy is 2¾% a year, falling to 2½% in 2007. This looks plausible. The Treasury uses a deliberately cautious growth estimate – a quarter of a point lower – to project the public finances. But caution would be better incorporated in other ways.
- The Treasury estimates that economic activity was around 1% below the level consistent with stable inflation in the third quarter of 2004. But statistical filtering of output data and analysis of the use of capital and labour in production suggest that there is little or no spare capacity in the economy.
- The Treasury forecasts relatively strong above-trend economic growth over the next two years. We think growth will be somewhat weaker than the Treasury expects over this period, but its longer-term projections look plausible. There is the risk of a more dramatic slowdown if a steep downturn in the housing market hits consumer spending or if global conditions weaken the UK's export markets.

### 3.1 Introduction

The constraints within which the government makes tax and spending decisions are sensitive to what happens in the wider economy. The outlook for government revenues and expenditure depends very sensitively upon the overall level of economic activity and upon the composition of aggregate income and spending. In this chapter, we analyse the outlook for the economy and the plausibility of the government's Pre-Budget Report projections in both the short and medium term. We consider alternative scenarios for how the economy might evolve and, in the next chapter, assess how they would affect the evolution of the public finances and the government's hopes of meeting its fiscal rules. Our main conclusion is that while the Treasury's projections for the medium-term outlook look reasonable as central estimates, the near-term forecast may be overoptimistic. There is substantial uncertainty around central projections over all time horizons both because the trend path of the economy is uncertain and because cyclical variations around that path can be significant.

The chapter proceeds as follows: Section 3.2 describes recent developments in the economy; Section 3.3 focuses in detail on the trend growth rate of national output, cyclical variations around that trend and amount of spare capacity that may or may not be left in the economy, all of which are important in assessing the underlying health of the public finances; Section

3.4 assesses the main risks to the Treasury's relatively benign economic projections, notably the housing market and the global economic environment.

## 3.2 Recent developments

Economic growth has been robust in the past few years, driven by domestic demand, with relatively strong increases in both household and (more recently) government spending. The unemployment rate is now at its lowest since the mid-1970s and inflation has remained at very low levels (see Table 3.1). But there are significant near-term risks to the outlook for growth. There has also been deterioration in the trade balance, the current account and the public sector fiscal balance in recent years. These imbalances will need to be addressed.

**Table 3.1. The recent past: inflation low and growth robust**

	1997	1998	1999	2000	2001	2002	2003	2004 <sup>a</sup>
Real GDP growth (%)	3.3	3.1	2.9	3.9	2.3	1.8	2.2	3.2
Real household consumption spending growth (%)	3.6	3.9	4.4	4.6	2.9	3.3	2.3	3.4
Real fixed investment spending growth (%)	6.8	12.7	1.6	3.6	2.6	2.7	2.2	6.3
Real export growth (%)	8.4	2.8	4.3	9.4	2.9	0.1	0.9	1.9
Real import growth (%)	9.8	9.3	7.9	9.1	4.9	4.1	1.8	4.5
Trade balance (£ billion)	1.1	-8.5	-15.9	-19.6	-27.4	-31.1	-31.8	-39.6
Current account deficit (%) <sup>b</sup>	-0.1	-0.5	-2.7	-2.5	-2.3	-1.7	-1.7	-2.4
National saving rate (%) <sup>c</sup>	17.0	17.7	15.1	15.0	15.1	15.0	14.8	15.3
Unemployment rate (%) <sup>d</sup>	7.0	6.3	6.0	5.4	5.1	5.2	5.0	4.8
Inflation (%) <sup>e</sup>	1.7	1.6	1.2	0.9	1.0	1.7	1.3	1.5

<sup>a</sup> Figures based on latest data for 2004, which are, where relevant, annualised.

<sup>b</sup> As a share of GDP.

<sup>c</sup> Gross saving divided by GDP – whole economy.

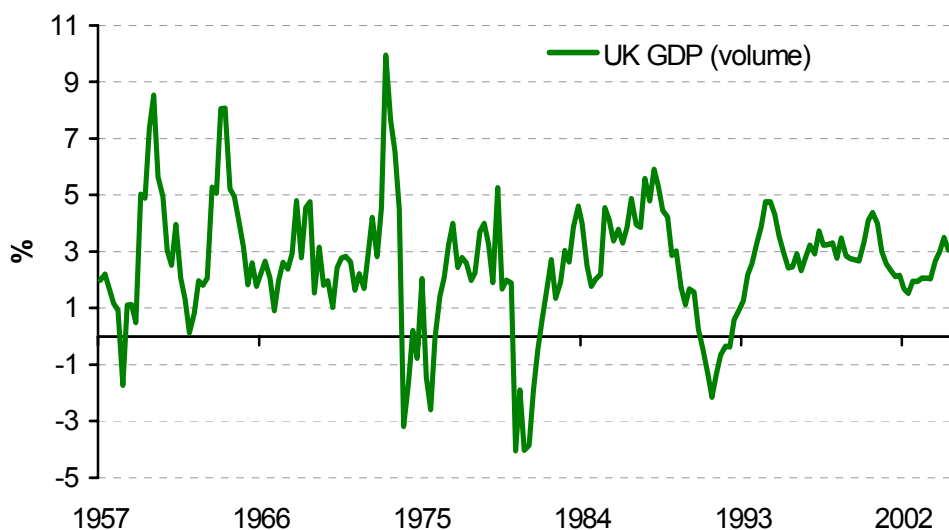
<sup>d</sup> ILO definition. Year average.

<sup>e</sup> CPI inflation. End-year on end-year.

Sources: Office for National Statistics; DataStream; Morgan Stanley Research.

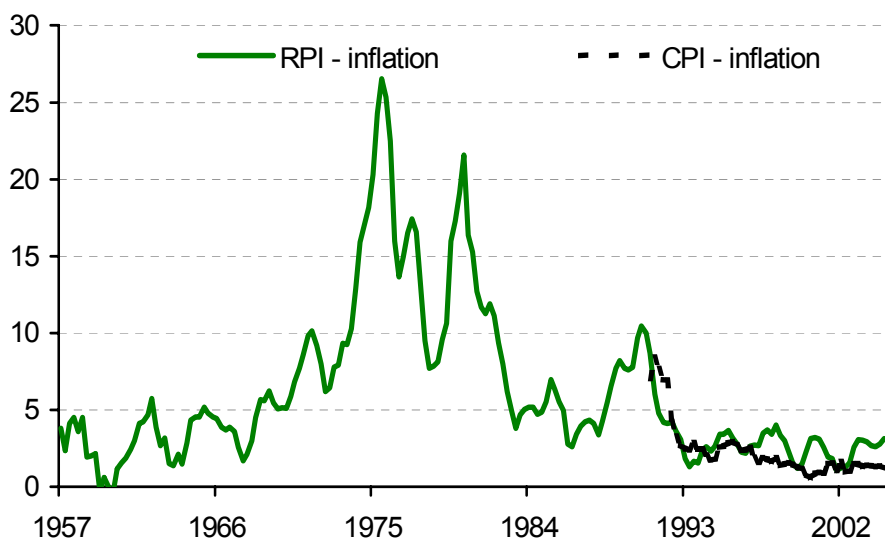
The UK's recent economic performance looks remarkably stable in a longer-term context. Over the past 10 years, economic growth has been less variable (Figure 3.1), and inflation much lower and less volatile (Figure 3.2), than in the past. The UK has enjoyed the longest period of continuous expansion in over a century, with no negative quarter-on-quarter growth since 1992. This raises the question of whether the nature of cyclical variability in the UK economy has changed – in terms of both the volatility and the duration of the cycle. We return to this question in Section 3.3.

Figure 3.1. Economic growth less variable than in the past



Source: Office for National Statistics.

Figure 3.2. Inflation low and stable since the mid-1990s



Source: Office for National Statistics.

Table 3.2 shows the dramatic decline in the variability of economic growth and of inflation over the past 10 years relative to earlier periods. But it also shows that average growth in national output (gross domestic product or GDP) per person – the best single indicator of the increase in material living standards – has not changed much relative to earlier decades. So, despite greater economic stability and the enormous importance the government has attached to raising productivity, there is no strong evidence that the sustainable rate of growth in output per person and material living standards in the UK has increased.

Table 3.2. Annual growth and inflation by decade

	1957– 64	1965– 74	1975– 84	1985– 94	1995– 2004
Growth in real GDP	3.3	2.7	1.5	2.6	2.8
Growth in real GDP per capita <sup>a</sup>	2.6	2.3	1.5	2.3	2.4
Variability of real GDP growth <sup>b</sup>	2.6	2.3	2.4	2.2	0.7
Variability of retail price inflation <sup>b</sup>	1.6	3.8	6.3	2.5	0.8

<sup>a</sup> Real GDP per resident population; 2004 is a Morgan Stanley estimate. Other indicators are year-to-date.

<sup>b</sup> Standard deviation of the year-on-year percentage change using quarterly data.

Sources: Office for National Statistics; Morgan Stanley Research.

Table 3.3 shows that the UK has closed the gap in output per capita in relation to the other main European countries in recent years. This owes more to a slowdown in growth in the rest of Europe than to an acceleration in the UK.

Table 3.3. UK per capita output catches up with its European peers

% of US	1980	1990	2000	2003
UK	66	67	72	74
France	77	75	73	72
Germany <sup>a</sup>	80	78	72	70
Italy	74	74	71	71
US	100	100	100	100

<sup>a</sup> West Germany through 1990.

Sources: OECD, constant 1995 prices and PPP. Morgan Stanley Research.

### 3.3 The cycle, trend growth and spare capacity

Here we analyse the changing nature of the UK economic cycle and assess the degree of spare capacity and the trend rate of growth of the economy. We judge that the Treasury's assumptions about the longer-term trend rate of growth are reasonable. But its assumption that there is now spare capacity in the UK is less plausible. The Treasury makes no judgement about the volatility or duration of future cycles – the fiscal projections in the Pre-Budget Report are based on the assumption that once remaining spare capacity in the economy has been exhausted over the next year or so, output will then grow at a sustainable 'trend' rate consistent with maintaining stable inflation.

Economic cycles are often summarised by the *deviation* of real national output from an underlying trend. The key features of the business cycle are

- the duration of the cycle;
- the amplitude of the cycle;
- asymmetries in the behaviour of the phases of the cycle.

The 'potential' level of output consistent with stable inflation will tend to grow over time, principally reflecting productivity growth as economic inputs are used more efficiently to generate more output. The level of actual output minus the 'potential' level consistent with

stable inflation provides a simple measure of slack or tightness in the economy. Potential output is not directly observable. So we need to estimate it by applying some procedure that separates movements in observable output from the underlying trend.

When actual output exceeds potential output, the output gap is said to be positive. A positive output gap tends to be associated with rising inflation. Conversely, a negative output gap signifies that economic inputs are less than fully utilised. This tends to be associated with a falling rate of inflation. When the output gap is zero, demand and supply are balanced, and there are no upward or downward pressures on the rate of inflation. We define spare capacity as the difference between actual GDP and trend GDP (the output gap), divided by *actual* GDP. (The Treasury measures spare capacity as the output gap divided by *trend* GDP – but in practice this makes little difference.)

## The Treasury view

The Treasury estimates the trend growth rate of potential output by using a wide range of survey and other information to estimate points in time at which there was no upward or downward pressure on inflation, and when actual output must therefore have been equal to potential output. Over past economic cycles, it assumes that the trend growth rate was equal to the average growth rate of actual (and therefore potential) output<sup>1</sup> between those points.

The Treasury then decomposes the estimate of trend growth over these periods into contributions from growth in labour productivity (output per hour worked), average hours worked per person, the size of the working-age population and the proportion of the working-age population in employment. It then judges how growth in these four elements is likely to evolve to generate a projection for trend growth in potential output looking forward.<sup>2</sup>

The Treasury currently estimates trend growth at 2¾% a year between the fourth quarter of 2001 and the fourth quarter of 2006. From the first quarter of 2007 onwards, its estimate of trend growth falls to 2½%, reflecting a decline in the growth rate of the working-age population. According to HMT, the decline in the growth rate of the working-age population alone is expected to lower trend growth by 0.2 percentage points. Trend productivity growth (output per hour) is assumed to be 2.3%.

The Treasury believes there is still some spare capacity in the economy. Its Pre-Budget Report forecasts imply that output was around 1% below potential in the third quarter of 2004 (although, as we noted in Chapter 2, revisions in the latest national accounts data might prompt the Treasury to revise the figure down slightly). This implies that the economy has the potential for further non-inflationary above-trend growth in the short term (an issue to which we return below). This contrasts with the assessments of the OECD and the Bank of England, who both believe that there is little or no spare capacity in the economy.

The assumptions the Treasury makes about trend growth and spare capacity are important in planning the public finances for two reasons. First, they inform the judgement on where we are in the cycle and when the cycle is likely to end – which defines the period over which the

---

<sup>1</sup> The Treasury uses real gross value added, excluding oil and gas, as its output measure for these purposes.

<sup>2</sup> HM Treasury, *Trend Growth: Recent Developments and Prospects*, London, April 2002 (<http://www.hm-treasury.gov.uk/media/D6678/ACF521.pdf>).

golden rule is assessed in the short term. Second, the future rate of trend growth is crucial for the outlook up to the end of the Treasury's forecasting horizon in 2010 and beyond. The evolution of the trend is relatively more important than cyclical deviations around the trend for long-term projections. The opposite is true over the near term.

The shape of the economic cycle is important for determining the period over which the government needs to think about balancing the current budget to meet the golden rule. If we believe that cycles in output around trend in the future might resemble those in the past, then they might typically last about six or seven years. With a borrowing target defined over the cycle, that would mean that a negative shock to the public finances early in the cycle could be offset gradually over several years. But if the cycle lasts only three years, a shock would need to be offset almost immediately.

But the Treasury's method of identifying the economic cycle is not the only one. We now examine some alternative methods and ask what confidence they suggest we should have in the Treasury's assessment on the trend growth rate and the amount of spare capacity in the economy.

## **Using statistical techniques to identify the cycle**

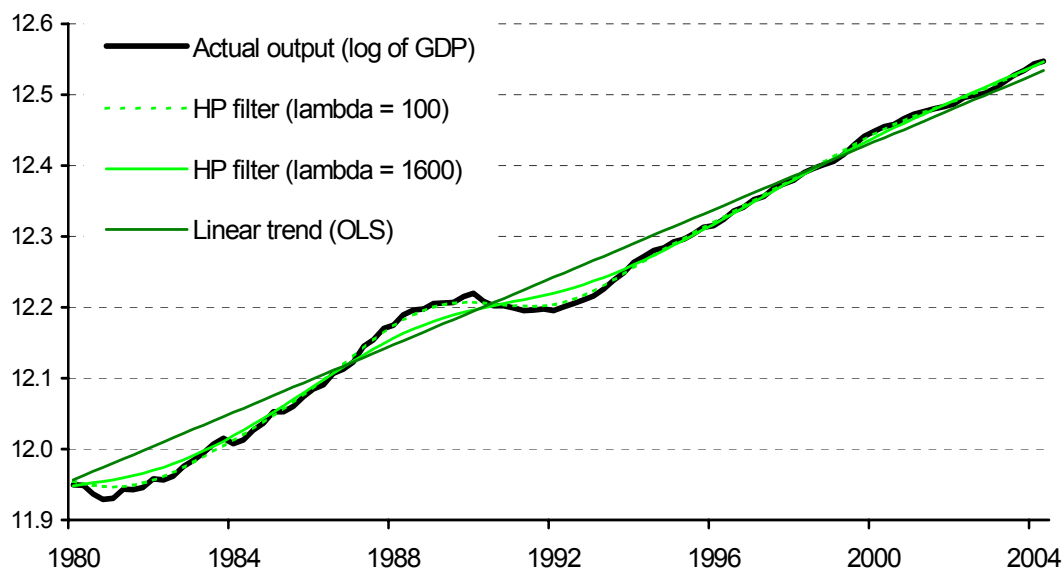
Among statistical techniques to identify trends, the most popular is the Hodrick-Prescott (HP) filter. (More recent evolutions are the Christiano-Fitzgerald (CF) and the Baxter-King band-pass filters.) Spare capacity can also be estimated from a production function – which specifies how much output can be extracted from a given level of technology, labour and capital. We first consider what statistical filters tell us about spare capacity and cycles in the UK economy and then briefly look at what more we can learn from other measures based on the capital stock and labour market conditions.

### ***Different measures of spare capacity***

The estimate of the trend that comes from applying the HP filter depends on assumptions about how smooth that trend is. This is a matter of judgement.

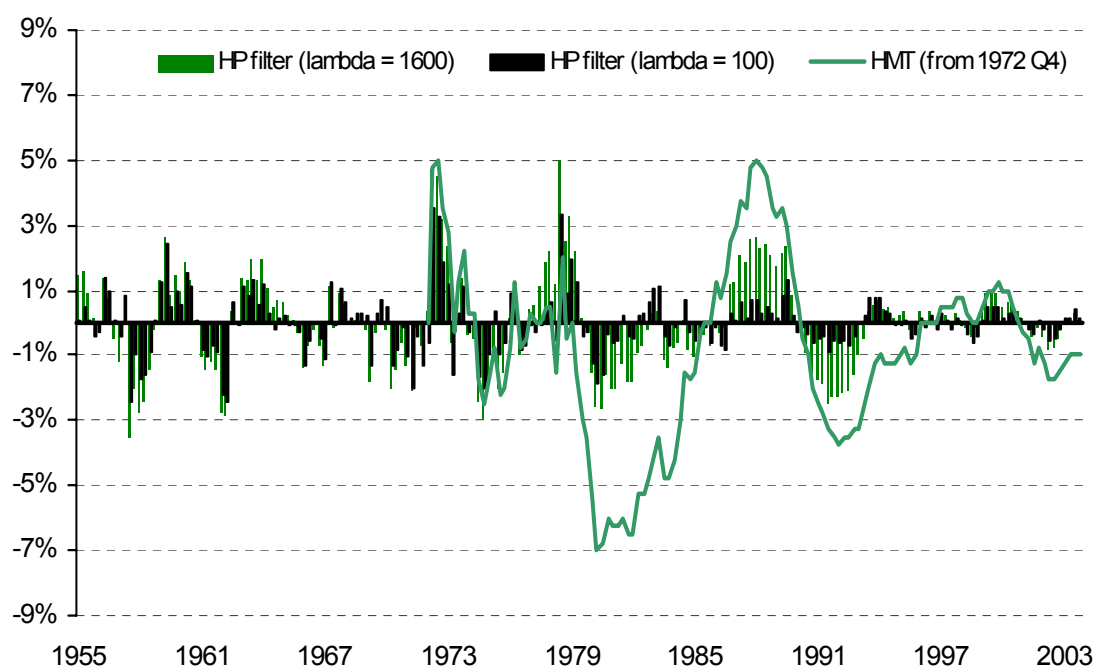
We show a range of estimates of spare capacity based on different values for the smoothness of the trend. Figure 3.3 shows the paths of potential output corresponding to two different values of lambda – the parameter controlling the smoothness of the trend. We also show a linear trend. The dotted line depicts the HP filter for lambda set to 100, which penalises only very mildly any deviation from a smooth (i.e. linear) trend, so that potential output tracks actual output relatively closely. When we set lambda at 1600 – our benchmark case – the estimate of trend growth in output is a much straighter line, because the algorithm penalises more heavily deviations from a linear trend. Figure 3.4 shows the amount of spare capacity corresponding to these two HP measures of the trend. (For comparison, we also show the latest estimates of spare capacity calculated by the Treasury.)

Figure 3.3. Actual output and alternative views of the trend



Sources: Office for National Statistics; Morgan Stanley Research.

Figure 3.4. Hodrick-Prescott filter measures of spare capacity



Sources: Office for National Statistics; Morgan Stanley Research.

The HP filter at standard frequency (1600) suggests that the cycle that began in 1999 ended in the first half of 2004 and that there is currently no slack in the economy. The CF filter suggests the cycle ended more than a year ago and that output is now rather significantly above trend (Figure 3.5). This is in contrast to the Treasury's assessment of 1.4% of spare capacity in 2003–04 as a whole and 1% at the start of 2004. With the HP filter, we need to employ a strongly linear approximation (i.e. setting lambda to 3600) to conclude that there is currently any spare capacity in the economy at all (see Table 3.4).

Figure 3.5. Hodrick-Prescott and Christiano-Fitzgerald measures of spare capacity

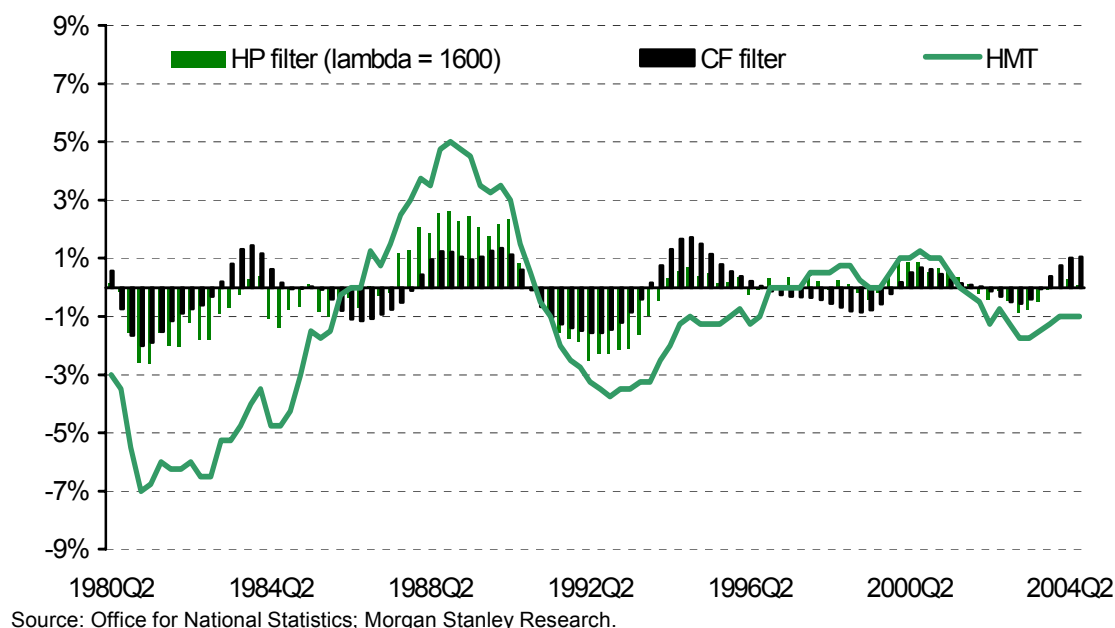


Table 3.4. Alternative estimates of spare capacity

Method	Q1 2004 (% of GDP)	Q2 2004 (% of GDP)	Q3 2004 (% of GDP)
HP filter ( $\lambda=1600$ )	0.0	0.3	0.1
HP filter ( $\lambda=3600$ )	-0.2	0.1	-0.1
HP filter ( $\lambda=100$ )	0.2	0.4	0.1
CF filter	0.8	1.0	1.0
Linear trend	1.2	1.5	1.3
HM Treasury <sup>a</sup>	-1.0	-1.0	-1.0

<sup>a</sup> % of potential output.

Notes: Negative numbers imply spare capacity; positive numbers imply output is above trend. The linear trend is estimated via ordinary least squares (OLS).

Sources: HM Treasury, Statistics Office; Morgan Stanley Research.

On the basis of the results from applying the HP filter, it would appear that the UK economy is now close to trend growth, and perhaps output is fractionally above the trend level. On the basis of such measures, the cycle that began in 1999 has probably just ended. A similar message emerges from the application of alternative purely statistical filters.

### *The changing pattern of cycles over the past 50 years*

The amplitude of the cycle describes the vertical distance between the peak (or trough) of the cycle and the level of potential output at the time. Figure 3.4 shows that amplitude peaked in the 1970s, reflecting large international economic shocks, such as the oil shock. The severity of these shocks was compounded by less effective stabilisation policies, notably from the monetary authorities. This is likely to have increased the persistence of deviations from the trend growth path. Conversely, the switch to inflation targeting and the Bank of England's increased independence may have reduced the volatility of the cycle – perhaps significantly.



There is some evidence that the move to inflation targeting was a significant factor behind the decline in cyclical variability.<sup>3</sup> Figure 3.4 suggests the amplitude of the cycle has, since the mid-1990s, been less than 1% of GDP, compared with  $\pm 2.5\%$  in the 1980–90 cycle.

Table 3.5 shows dates for the UK business cycle based on the HP 1600 filter. One key feature is the longer duration of periods of beneath-trend output than of periods of above-trend output. The average period when there is spare capacity lasts 13 quarters compared with 10 for periods when output is above trend. The mean duration of a cycle is six years. But the overall length of business cycle is sensitive to the technique and the choice of lambda. Partly for this reason, on the basis of our analysis, there is no robust evidence suggesting the overall duration of business cycle has changed significantly in recent years, although amplitude has recently been much lower than in the past.

Table 3.5. Simple estimates of the business cycle: HP filter (lambda = 1600)

Cycle identified	Number of quarters of output above trend	Number of quarters of output below trend
1957 Q2 – 1961 Q3	8	9
1961 Q4 – 1966 Q2	11	7
1966 Q3 – 1974 Q3	7	20
1974 Q4 – 1980 Q2	11	11
1980 Q3 – 1990 Q3	13	24
1990 Q4 – 1998 Q4	15	14
1999 Q1 – 2004 Q1	9	9
2004 Q2 – present	2	-
Mean duration	10	13
Median duration	10	11
Standard deviation of duration	4	6

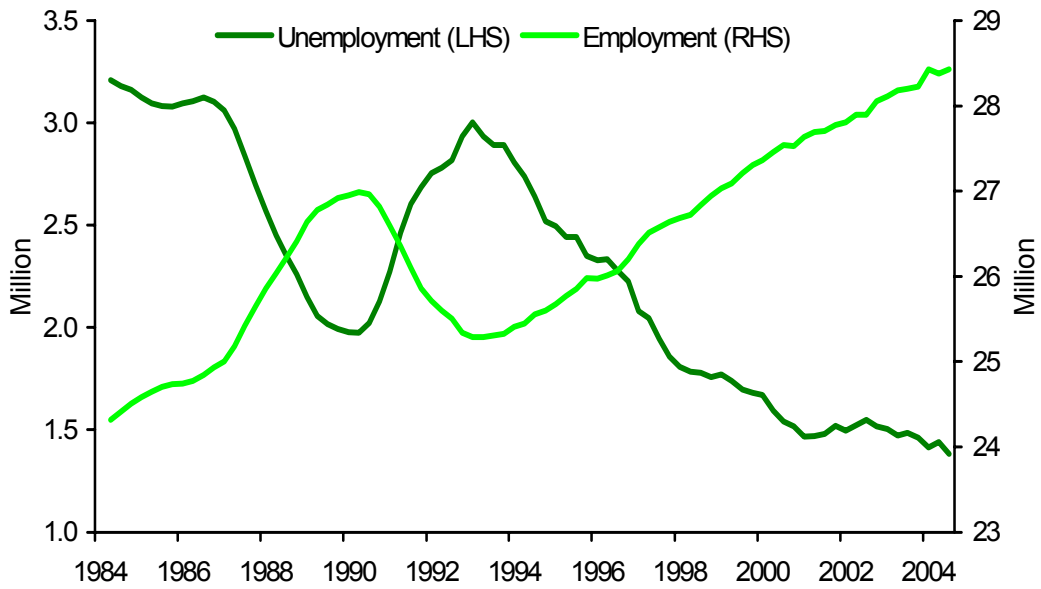
Source: Morgan Stanley Research.

## A production function approach to spare capacity

Simply focusing on how output has evolved historically suggests there is no spare capacity in the economy. But looking at measures of tightness in the labour market, and assessing how output has evolved relative to the stock of productive capital, yield alternative measures of the degree of spare capacity. Figures 3.6 and 3.7 show indicators of labour market tightness. The level of unemployment has been falling fairly steadily, and the employment rate has been rising, for over 10 years. Output (GDP) relative to the stock of tangible assets net of residential buildings tends to rise over time due to technological progress. But Figure 3.8 shows that, relative to a simple trend, output is now above the level that one could expect, given the stock of fixed capital in the economy. The ratio of output to fixed capital is just over 1% above the level consistent with constant growth in capital productivity.

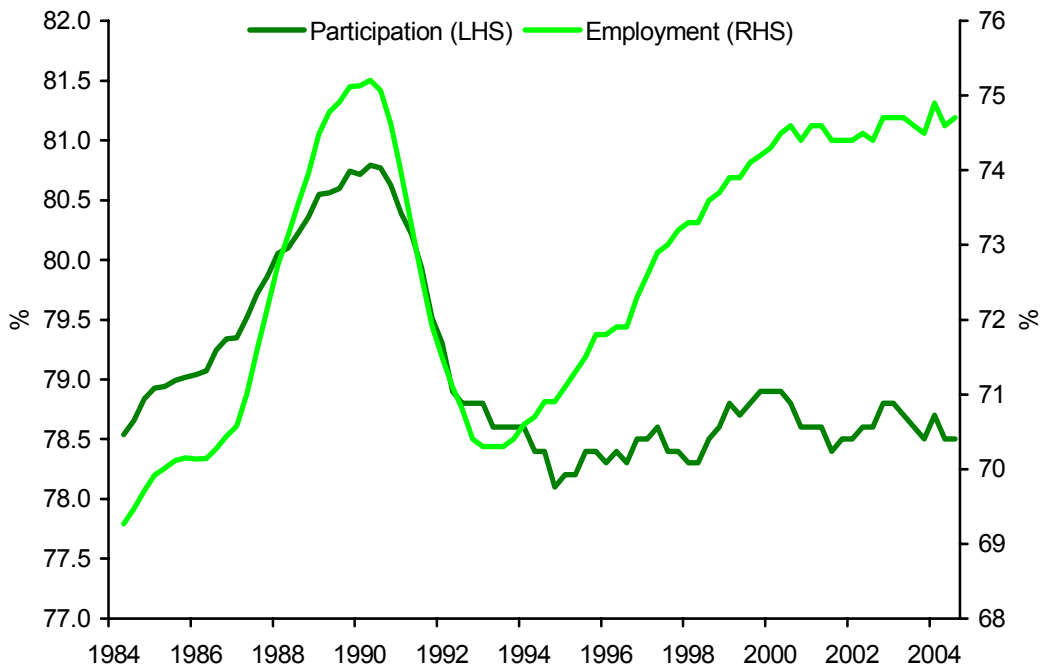
<sup>3</sup> See L. Benati, 'Evolving post-World War II UK economic performance', Bank of England, Working Paper no. 232 (<http://www.bankofengland.co.uk/workingpapers/wp232.pdf>).

Figure 3.6. Employment and unemployment headcounts



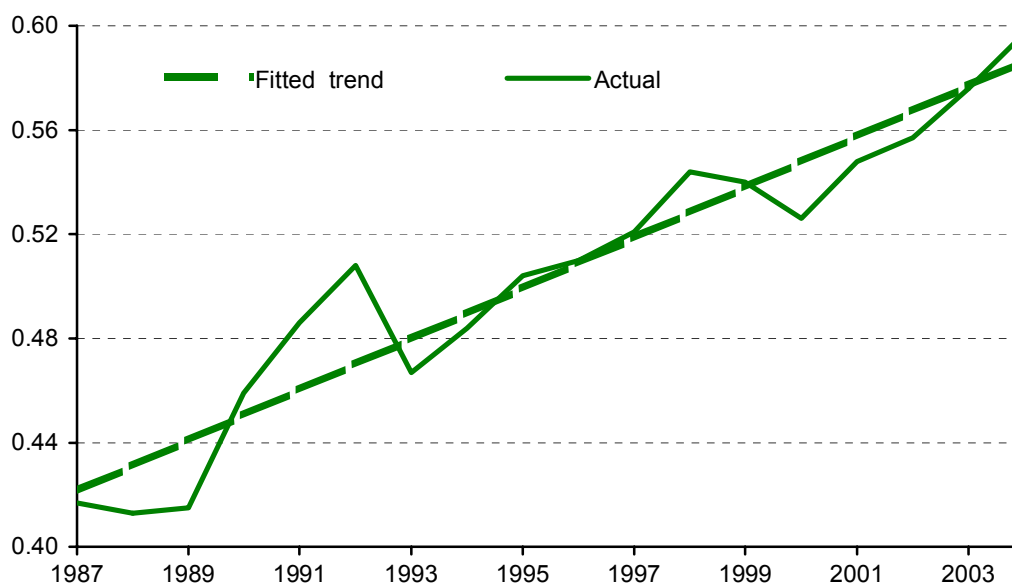
Note: UK Labour Force Survey employment and unemployment levels in millions, headcount.  
Sources: Office for National Statistics; DataStream.

Figure 3.7. Employment and participation rates



Note: The labour force participation rate is calculated by expressing the number of persons employed plus the number of persons unemployed as a percentage of the working-age population.  
Sources: HM Treasury; Office for National Statistics; DataStream.

Figure 3.8. Ratio of output to the stock of capital



Note: Net of residential housing.

Sources: Office for National Statistics; Morgan Stanley Research.

Overall, output looks to be at a level that is high relative to the sustainable rate of output given the resources – capital and labour – used in production.

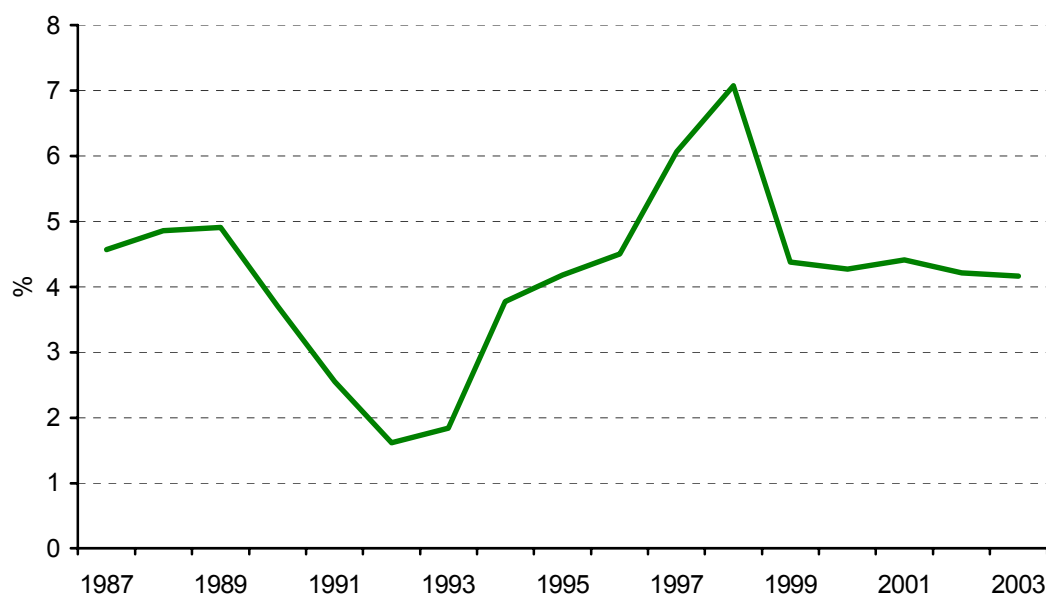
### What is the trend rate of growth now?

Based purely on our estimates from applying the HP filter to output data, trend growth is now estimated to be roughly in the 2.5–2.6% range. This outcome is robust to different choices of lambda. The CF band-pass filter suggests a trend rate below 2.5%. The UK's long-term historical real GDP growth rate is 2.5%.

It is disappointing that so little evidence emerges that the trend rate of growth of the UK economy is different from the long-run average. As yet, the factors that one might hope would boost growth – low volatility in the real economy, low real and nominal interest rates, increases in public sector net investment – have had no readily identifiable impact upon trend growth.

The net national saving rate in the UK – the key factor behind the growth in the stock of assets that produce national income – has also fallen back to the low levels of the late 1980s, having risen to about 7% at the end of the 1990s (see Figure 3.9). This does not suggest that an acceleration of growth driven by more rapid expansion of the stock of productive assets is imminent. The Treasury's estimate that the growth of productive potential to 2007 is 2¾% is, in the light of all this, on the optimistic side (although it uses the more conservative 2½% for the forecasts of the public finances themselves).

Figure 3.9. Net national saving rate



Sources: Office for National Statistics; DataStream.

The Treasury's view that trend growth after 2007 is 2½% is plausible. (The Treasury actually uses 2¼% in the fiscal projections themselves.) Using 2¼% for the trend growth for the medium-term fiscal projections is, in an important sense, conservative. It would be more sensible and transparent to use a central forecast and assess the impact of shocks on the projected values rather than taking a conservative projection for one key variable as a way of incorporating a safety margin. This is why, in Table 3.6, we focus on two alternatives to the Treasury's projections in assessing risks to the fiscal outlook in the next section.

Table 3.6. Treasury and Morgan Stanley trend growth estimates

	HM Treasury	Morgan Stanley benchmark case (HP lambda=1600)	CF band-pass filter
1986H1 – 1997H1	2.55	2.44	2.50
1997H2 – 2001Q3	3.06	2.98	3.02
2001Q4 – 2006Q4	2.75	2.55	1.90–2.10
2007Q1 – 2009Q4	2.50	2.55	2.45

Sources: Office for National Statistics; Morgan Stanley Research.

### 3.4 Risks to the Pre-Budget Report forecast

The Treasury expects two more years of robust growth, driven by several factors (Table 3.7). These include a much smaller drag from net trade in the near term (as UK export markets are forecast by the Treasury to grow strongly in 2005 with growth in world trade assumed to be in the range 7¼–8½%) and relatively strong growth in domestic demand. The contribution to growth in overall demand from consumer spending is projected to fall slightly.

Table 3.7. Treasury forecasts for key economic variables

<b>Year-on-year growth (%)</b>	<b>2003 (out-turn)</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Real GDP	2¼	3¼	3–3½	2½–3	2¼–2¾
Domestic demand	2½	4	3–3½	2½–3	2¼–2¾
Household consumption	2¼	3¼	2¼–2¾	2–2½	2–2½
General government consumption	3½	4½	3	3	2½
Fixed investment	2¼	6½	6¾–7¼	3¼–3¾	2¾–3¼
Exports	0	2¼	6½–7	6¼–6¾	6¼–6¾
Imports	1¼	4¾	6–6¼	5¼–5¾	5¼–5¾
CPI (Q4)	1½	1¼	1¾	2	2
Nominal GDP	5¼	5½	5¾–6	5¼–5¾	5–5½

Source: HM Treasury, *Pre-Budget Report*, London, December 2004 ([http://www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr04/prebud\\_pbr04\\_index.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm)).

The Treasury's economic forecasts (which underpin its fiscal projections) imply that growth remains slightly above trend for two more years and then grows at the estimated trend rate; inflation remains low, as output is assumed not to rise above its potential level.

The Treasury's longer-term economic assumptions are plausible. The near-term forecast for growth above 3% in 2005 is more doubtful, although the Treasury forecast for growth over the medium term, on which its fiscal projections are made, is – deliberately – on the pessimistic side of its own central assessment of trend growth. Its near-term forecast is less cautious. Two of the most important risks to that near-term outlook stem from the housing market and the global economy (particularly trade growth).

## The housing market

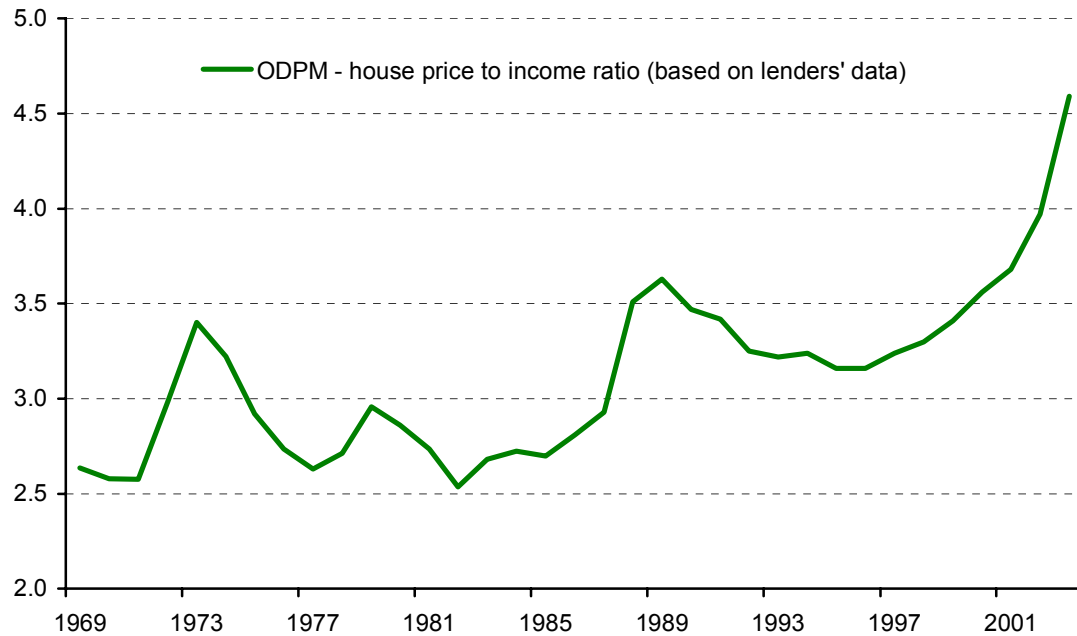
With some of the latest data showing house prices falling – and most of the forward-looking indicators suggesting a rapid slowdown – the Treasury's consumer spending forecast may be too optimistic.<sup>4</sup> Although the correlations between consumer spending and movements in house values appear to have been very different in recent years from in the past – with consumption growth less rapid than might have been expected given a near doubling in house values since 2000 – a sharp fall in house values could still generate a sharp cutback in household spending. And there are strong reasons to think that housing remains overvalued. It is plausible that some further, and much more significant, downward adjustment in the housing market may occur in 2005. Residential property is worth around three times annual national income<sup>5</sup> in the UK, so a fall of, say, 10% in average prices in a year wipes about 30% of national income off the money value of the wealth of the household sector. Although there are good reasons to believe that the knock-on effect of such an adjustment on consumer spending, debt problems and losses to mortgage lenders could be small, nobody should feel too confident that this will be the case.

<sup>4</sup> The word 'optimistic' needs to be used with care here; there are good reasons to believe that the UK saving rate is too low and that a significant rise in the household saving rate is desirable – a position we consider below.

<sup>5</sup> Measured as gross domestic product (GDP).

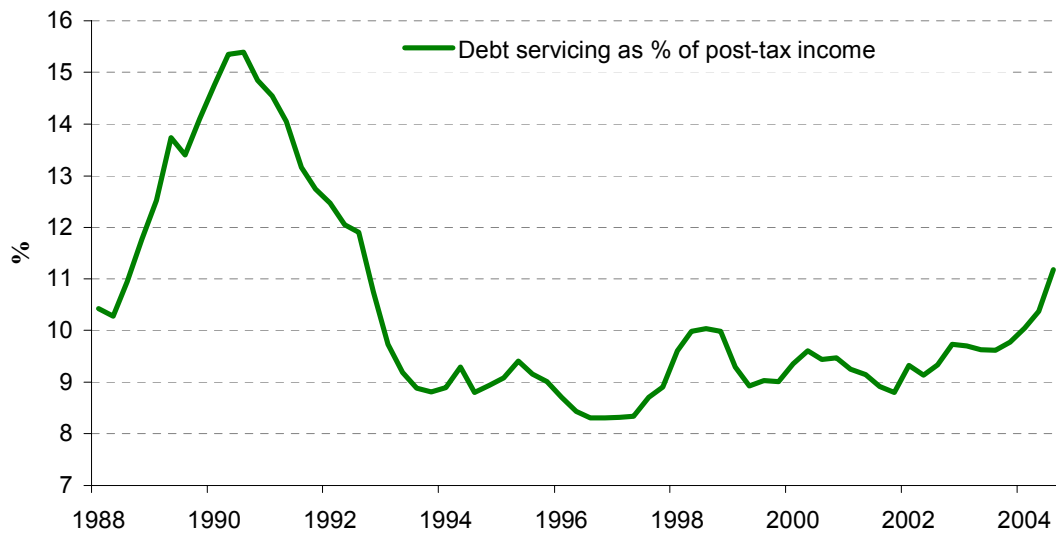
UK property prices are probably above sustainable levels. But different measures suggest very different degrees of overvaluation. Simple ratios (for example, of house price to income, as shown in Figure 3.10) suggest valuations are stretched, but the debt service burden does not look particularly unsustainable (Figure 3.11).

Figure 3.10. Income to house price ratios relatively high



Source: Office of the Deputy Prime Minister.

Figure 3.11. Mortgage payments still relatively affordable



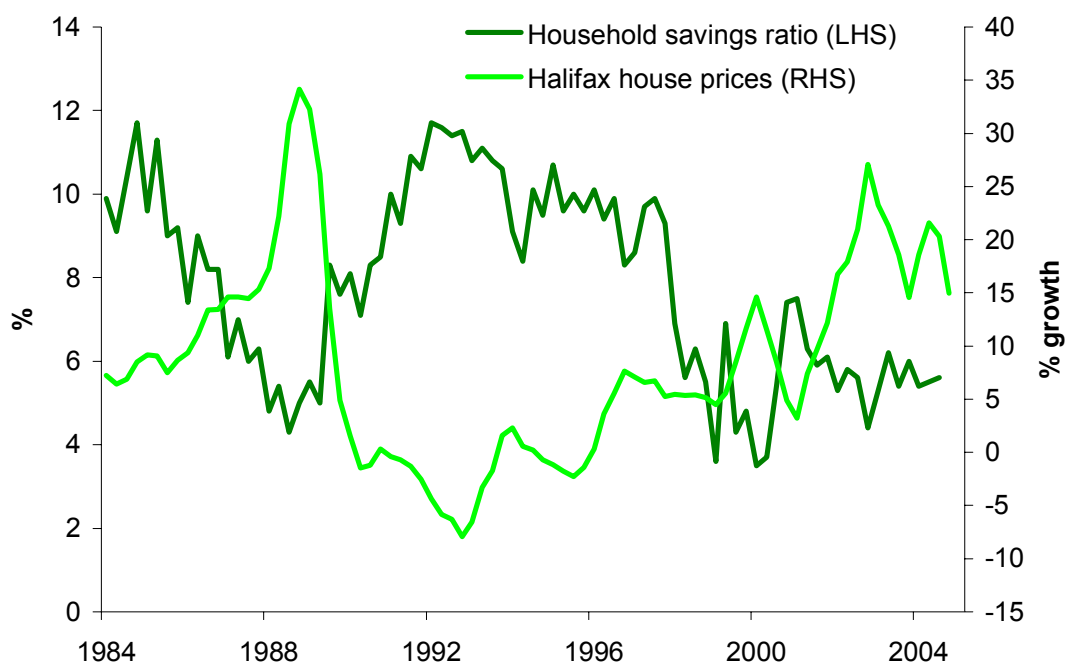
Note: Interest payments plus mortgage principal payments as % of post-tax household income.  
Sources: Bank of England; Office for National Statistics; Morgan Stanley Research.

A user cost of housing measure – one that takes into account a comprehensive measure of the resources taken by home-ownership (for example, mortgage repayments, moving costs and expected capital loss/gain) and sets that against the implicit rental yield on property –

suggests substantial overvaluation.<sup>6</sup> On that measure, it is likely that unless people believe that prices will rise further (and substantially in real terms), then prices are now too high. That is almost a definition of an unsustainable position.

While some adjustment in the housing market seems likely in the year ahead, it is not necessarily the case that this will result in much weaker consumer demand. In recent years, the relationships between saving/consumption and house prices and between mortgage equity withdrawal and consumption appear to have been very different from in the past. Over the 1980s and 1990s, Figure 3.12 shows that there was a fairly strong correlation between house prices and the saving rate. Since then, despite very rapidly rising house prices over the past three or four years, there has not been any obvious fall in the household saving rate or any rise in consumption.

Figure 3.12. House prices and the saving ratio



Sources: Bank of England; Office for National Statistics; Morgan Stanley Research.

All this suggests that some unwinding of recent house price appreciation – in the absence of wider economic deterioration – may have only a limited impact on spending. Even a 20% decline in prices is no more than an unwinding of just over a year’s worth of recent price rises. No one should be too swayed by charts showing positive historic correlations between house price changes and the growth of consumption. All those forces that are likely to boost demand for housing and raise house prices (low interest rates, falling unemployment and expectations of steadily rising real income growth) will in themselves increase consumption. Hence, it is not clear that there is a strong direct causal link between house prices and spending/saving. But the degree of uncertainty here is acute. Consumer confidence might well

<sup>6</sup> See D. Miles and M. Baker, ‘The UK housing market: what do we really know?’, Morgan Stanley Research, October 2004.

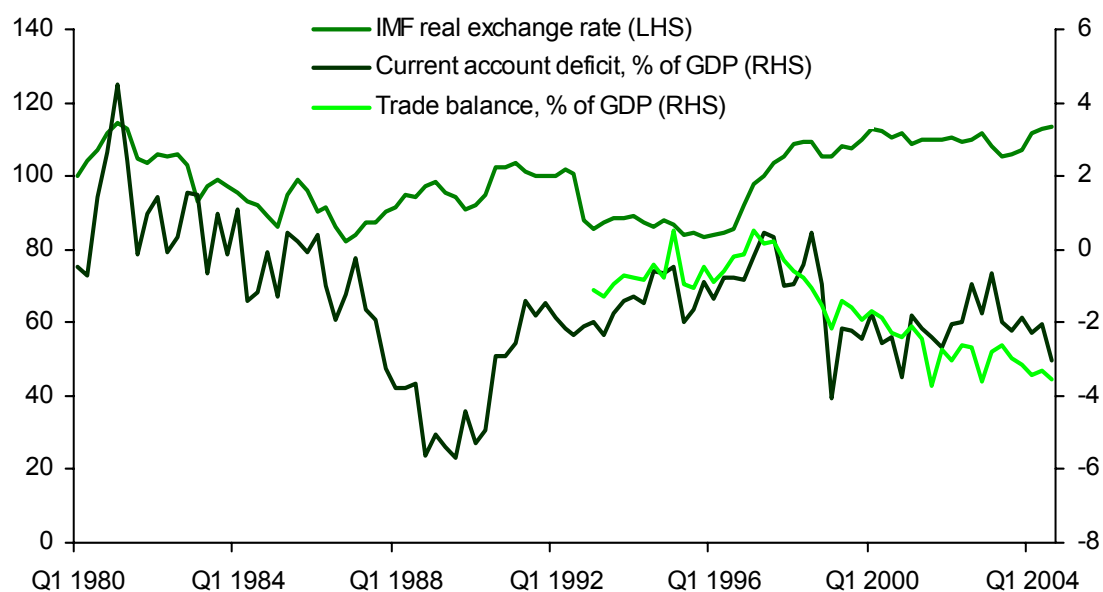
take a serious hit from several consecutive monthly falls in house prices, feeding through into spending decisions.

## The global economy

The main *external* risks to the outlook for the economy come from the possibility of slower-than-expected trade growth and currency volatility. With currency markets experiencing increased volatility in 2004, and with much of the world's global imbalances yet to be reduced, the Treasury forecasts for export growth seem particularly vulnerable.

There is much concern about global imbalances and how they might unwind. At the heart of these concerns is the size of the US current account deficit, which, at 5.6% of GDP, is at record levels. An unwinding of global imbalances could, potentially, be very disruptive for the UK economy, particularly if it generates sharp movements in sterling. The UK is a very open economy (a high ratio of exports plus imports to national income) with a completely floating exchange rate. In contrast, the Euro area has a floating currency but is very much less open than the UK; and Asian economies are very open but most do not have freely floating exchange rates. Sterling probably does need to fall – in real effective terms – so as to reduce a trade deficit that is persistent, has been rising and is growing faster than the scale of trade in services where the UK tends to run a surplus. (Figure 3.13.) Certainly sterling looks substantially overvalued on a ‘purchasing power parity’ basis against the US dollar. Whether in the shorter term the currency moves gradually in that direction – or swings more violently in that direction or in the other way – is very hard to judge. There is not much the UK can do about this – except take no small comfort from the fact that the Bank of England has the slack to cut interest rates if needs be and the independence to raise them if necessary.

Figure 3.13. UK trade balance and the real effective exchange rate

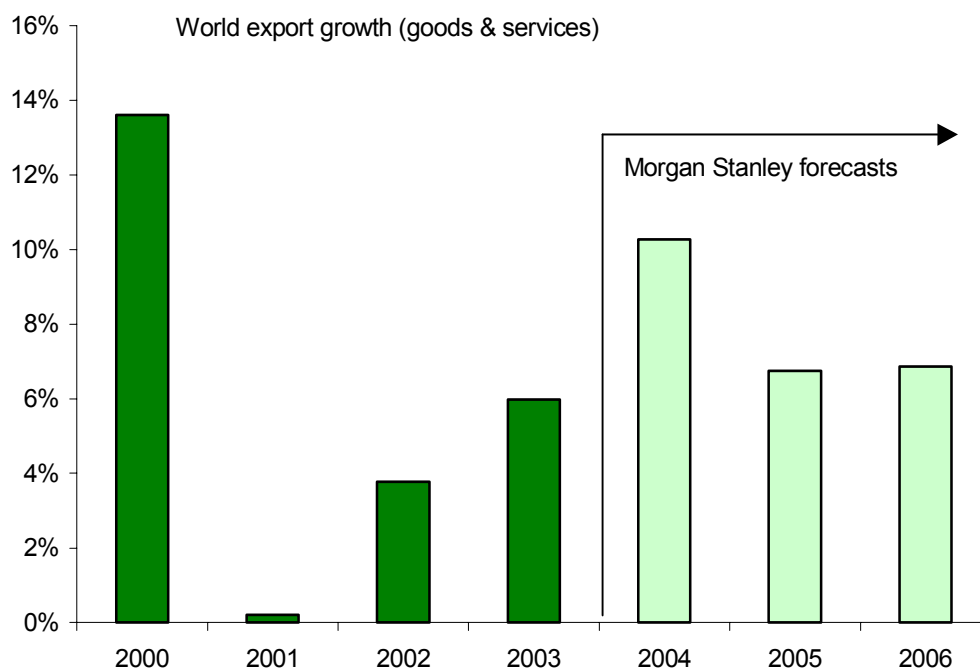


Sources: Office for National Statistics; International Monetary Fund.



The global economy looks set to slow in 2005 after a very strong growth performance this year. The Treasury expects 8.5% growth in global trade in 2005, and growth in UK export markets (in terms of other countries' imports, weighted according to their importance in UK exports) of 8%. But the forecasts of the Morgan Stanley global economics team imply that growth in UK export markets will be well under the 8% level (Figure 3.14).

Figure 3.14. Slowing world trade growth



Sources: International Monetary Fund; Morgan Stanley Research.

## Morgan Stanley forecasts for the economic outlook

### *The central case*

Table 3.8 shows that the Morgan Stanley central forecast is not substantially different from the Treasury's projections over the medium term, but shows significantly slower growth in 2005 and in the first part of 2006. This forecast does not project a severe knock-on effect from an adjustment in the housing market, though this is expected to have some impact on consumer confidence and we look for slightly slower consumer spending than the Treasury. We are probably a little more downbeat than the Treasury on the corporate profits outlook. Although we do not have an explicit Treasury forecast for the profits outlook, their forecasts for growth in corporate tax receipts look optimistic (see Box 4.1 in Chapter 4).

Table 3.8. Morgan Stanley forecasts – central case

<b>Year-on-year (%)</b>	<b>2003– 04</b>	<b>2004– 05</b>	<b>2005– 06</b>	<b>2006– 07</b>	<b>2007– 08</b>	<b>2008– 09</b>	<b>2009– 10</b>
Real GDP	2.8	2.9	2.1	2.8	2.5	2.5	2.5
Real household expenditure	2.6	2.6	1.9	2.5	2.4	2.3	2.3
Consumer prices	1.3	1.3	1.5	2.0	2.0	2.0	2.0
GDP deflator	2.8	2.0	2.3	2.7	2.8	2.8	2.8
Money GDP (£ billion)	1116	1170	1222	1290	1358	1430	1506

Source: Morgan Stanley Research.

**The ‘worse’ case**

It is instructive to consider the implications of a much-less-benign out-turn for the housing market and for consumption spending. So we create an alternative ‘worse’ case scenario (Table 3.9), with a rapid rise in the household saving rate partly generated by a big fall in prices in the housing market which (contrary to our central expectations) triggers flat consumption for 2005 and 2006. We then project a slow recovery in consumption after that. In such a scenario, we see the saving rate rising sharply (Figure 3.15).

Table 3.9. Morgan Stanley forecasts – ‘worse’ case

<b>Year-on-year (%)</b>	<b>2003– 04</b>	<b>2004– 05</b>	<b>2005– 06</b>	<b>2006– 07</b>	<b>2007– 08</b>	<b>2008– 09</b>	<b>2009– 10</b>
Real GDP	2.8	2.8	0.7	1.4	2.0	2.3	2.3
Real household expenditure	2.6	2.4	-0.1	0.6	1.0	1.0	1.0
Consumer prices	1.3	1.3	1.2	1.5	1.8	2.0	2.0
GDP deflator	2.8	2.0	2.1	2.3	2.5	2.8	2.8
Money GDP (£ billion)	1116	1169	1201	1246	1302	1368	1437

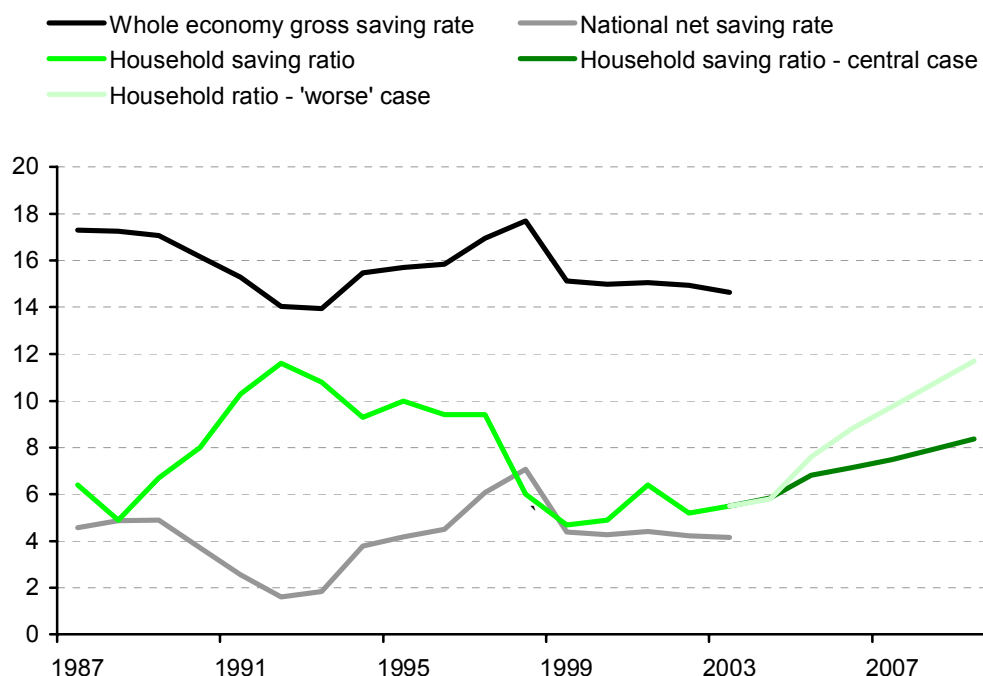
Source: Morgan Stanley Research.

With a sharp correction in consumer spending, we see potential for the household saving rate to rise to over 10%, triggered by a combination of factors. With a significant decline in house prices, households would see the non-financial asset side of their balance sheets eroded. Households may try to compensate by building up their financial assets (increase their savings). Second, fear over the adequacy of future pension income may also encourage an increase in savings. Some households will have been relying on the value of their home to provide for them in their old age. Constant media reports of a pensions and saving gap may also have an effect. The UK saving rate probably does need to be higher.<sup>7</sup> But to the extent

<sup>7</sup> The household saving rate in the UK has fallen to under 6%. The public sector is in deficit. The corporate sector has been saving – but not at a rate fast enough to keep the national saving rate from being one of the lowest in the developed world. What really matters in the long run is whether the country is saving enough to preserve its stock of wealth. If we focus on the stock of productive assets, the position is not healthy. Consider the following. Net of depreciation of existing tangible assets, the level of investment in fixed assets has been running at about 5% of GDP. The level of tangible capital (excluding land) is somewhere between 3 and 3.5 times annual GDP. Suppose we need to keep the stock of tangible assets constant as a share of GDP – something that is probably necessary to sustain

that a rise in desired savings happens very rapidly and is not matched immediately by a rise in investment or in net exports, it would create slower demand growth.

Figure 3.15. Saving rate under central and 'worse' case



Sources: Office for National Statistics; Morgan Stanley Research.

In the scenario where the household saving rate rises on the path illustrated in Figure 3.15 (shown as the 'worse' case), consumer spending falls slightly in real terms this year and grows by little more than 1% annually over the next three years. Output growth falls to less than 1% in 2005 and remains below 2% in 2006.

Such a sharp rise in the saving rate, and a sudden fall in growth in GDP, is not our central forecast, but it is useful to think about its implications for the public finances. The next chapter discusses the outlook for the public finances, based on the Treasury's assessment of the outlook for the economy and on both the central and 'worse' cases described in this chapter.

---

growth. Then capital needs to grow by the product of the growth rate of the economy and the ratio of capital to GDP. If UK GDP is to grow by 2.5% a year, then with capital worth 3 to 3.5 times GDP, we probably need *net* investment to be somewhere in the region 7.5–8.75% of GDP. There is a saving gap of maybe 3–4% or so of GDP. That is not a small gap. It would mean household saving rates would need to be about 5 percentage points higher – rising to about 10% – if all else were equal.