United Kingdom

The UK economy continues to exhibit greater resilience than most other OECD countries. Growth, led by private and public consumption, has remained close to potential, while inflation and unemployment are internationally low. The recent pick-up in activity should lead to above trend growth in 2004-05, with a more balanced expenditure composition, providing instability stemming from the housing market can be avoided.

A gradual continuation of the recent tightening of monetary policy will be needed to ensure consistency with the inflation target and would also reduce the risk of another surge in house prices. The public sector deficit has widened considerably and, though arguably still consistent with the "golden rule", may call for a slowdown in spending or a rise in taxes during the current upswing to avoid a destabilising adjustment later on.

Growth has picked up

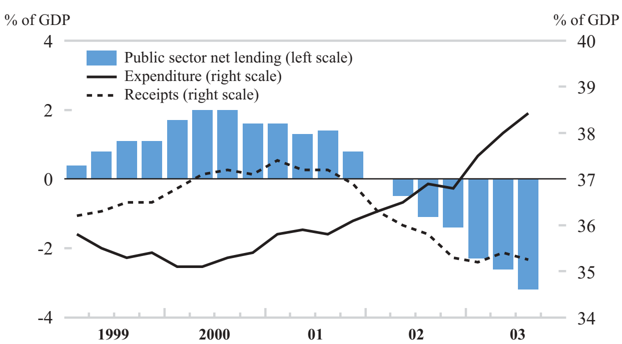
GDP rebounded in the second and third quarters of 2003, implying growth over the year to the third quarter of 2 per cent, while output in the other major European economies has either fallen or stagnated. The composition of growth continues to be skewed towards private and public consumption, although less than previously estimated following data revisions and chain-linking of national accounts. Real business investment has remained subdued, partly because companies have needed to divert funds into shoring up company pension schemes. With demand growth more robust than in much of the rest of Europe, net exports have continued to be a drag on activity.

Consumption is still supported by the housing market

Continued growth in private consumption has outpaced personal disposable income since early 2002, with the housing market becoming an increasingly important driver. The boom in house prices has almost entirely offset the effect of the fall in equity prices on household wealth since 2000 and led to mortgage equity withdrawal running at close to a record high of 6 per cent of disposable income in the first half of 2003. Signs of a slowdown in the housing market at the beginning of the year appear to have been confounded, with mid-year house price inflation running at annualised rates of around 15 per cent.

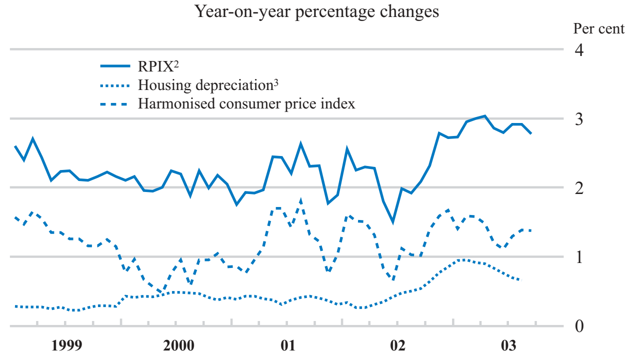
United Kingdom

The public sector deficit is widening[1]



A large gap persists between inflation measures

Year-on-year percentage changes



1. Four quarter moving-average.
2. Retail price index, all items excluding mortgage interest payments, seasonally-adjusted data.
3. Contribution to RPIX inflation.

Source: HM Treasury and National Statistics.

United Kingdom: **Employment, income and inflation**

Percentage changes from previous period

	2001	2002	2003	2004	2005
Employment	0.8	0.7	0.9	0.5	0.6
Unemployment rate[a]	5.1	5.2	5.0	4.9	4.8
Compensation of employees	5.9	4.2	4.2	4.3	5.0
Unit labour cost	3.7	2.4	2.2	1.5	2.1
Household disposable income	7.0	2.8	3.1	3.3	4.7
GDP deflator	2.3	3.2	2.8	2.2	2.5
Consumer price index[b]	2.1	2.2	2.8	2.6	2.7
Private consumption deflator	2.2	1.3	1.2	1.7	2.3

a) As a percentage of labour force.
b) Retail price index excluding mortgage payments RPIX.
Source: OECD.

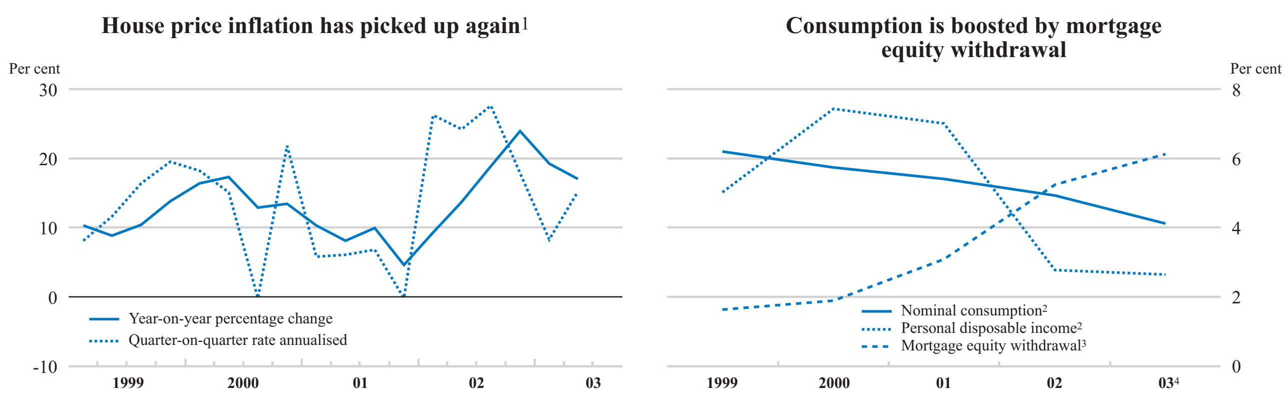
The fiscal stance has supported activity

The fiscal stance has been strongly supportive of activity with the general government financial balance, on a Maastricht basis, declining from a surplus of ¾ per cent of GDP in 2001 to a deficit of 1½ per cent of GDP in 2002. This reflects a combination of higher public expenditure, aimed at raising the performance of public services, particularly in health and education, as well as a fall in the tax-to-GDP ratio from both cyclical weakness and lower equity price related tax revenues. While the within-year borrowing profile must be treated with caution, figures to the third quarter suggest that there has been slippage relative to the 2003 Budget plans. The deficit (on a Maastricht basis) may rise to 3 per cent of GDP, despite the increase in national insurance contributions which raised revenues by about ¾ per cent of GDP from the second quarter of 2003.

Some tightening of fiscal policy may be prudent

On the basis of current plans, the ratio of public expenditure to GDP is likely to rise by a further ¾ percentage point over the next two years. In the absence of a strong recovery in financial company profits or asset-related tax revenues, the usual

United Kingdom



1. House prices from Office of the Deputy Prime Minister, seasonally-adjusted data by OECD.
2. Percentage change from previous year.
3. In a per cent of personal disposable income, figures for 2003 are based on 4-quarter sum to 2003 Q2.
4. Figures for 2003 are based on 4-quarter sum to 2003 Q2.
Source: National Statistics and OECD.

United Kingdom: **Financial indicators**

	2001	2002	2003	2004	2005
Household saving ratio[a]	6.7	5.3	4.8	4.2	4.3
General government financial balance [b]	0.7	-1.5	-2.9	-2.9	-3.2
Current account balance[b]	-1.8	-1.8	-2.7	-3.5	-3.6
Short-term interest rate[c]	5.0	4.0	3.6	4.4	5.0
Long-term interest rate[d]	4.9	4.9	4.4	4.7	5.2

a) As a percentage of disposable income.
b) As a percentage of GDP.
c) 3-month interbank rate.
d) 10-year government bonds.
Source: OECD.

cyclical upswing in revenues will still leave a government deficit of around 3 per cent of GDP. Structural deficits of this size may still be consistent with the "golden rule" – that, over the course of the cycle, the public sector should only borrow to invest – given the large surpluses banked at the beginning of the cycle. Moreover the government's debt position as a proportion of GDP will remain the lowest among the seven major countries with the exception of Canada. Nevertheless, either an increase in taxes or a slowing in expenditure growth would be prudent before the end of the current cycle to ensure adherence to the broader principles of the government's Code for Fiscal Stability. In particular, these require a clarification of how the fiscal position will be sustained in the long run and the avoidance of instability that might result from postponing adjustment to substantial structural deficits.

Monetary policy has begun to tighten

The Monetary Policy Committee of the Bank of England increased the repo rate by ¼ percentage point on 6 November 2003, the first rise in almost 4 years, reflecting the need to contain pressures which could generate future increases in inflation. Currently, inflation measured by the retail price index excluding mortgage interest payments (RPIX) is at 2¾ per cent, above the 2½ per cent target, but partly reflecting

United Kingdom: **Demand and output**

	2000	2001	2002	2003	2004	2005
	Current prices billion £	Percentage changes, volume (2000 prices)				
Private consumption	626.5	3.1	3.6	2.4	2.4	2.2
Government consumption	177.8	1.7	2.4	3.4	1.7	2.4
Gross fixed investment	161.2	3.6	1.8	2.9	4.9	6.4
Public[a]	12.1	12.0	7.4	19.3	19.6	21.6
Private residential	36.8	0.9	16.1	1.0	4.9	4.3
Private non-residential	112.3	3.6	-3.5	1.5	2.7	4.5
Final domestic demand	965.5	2.9	3.0	2.7	2.7	2.9
Stockbuilding[b]	5.3	-0.2	-0.2	-0.3	0.3	0.2
Total domestic demand	970.8	2.7	2.9	2.4	3.0	3.1
Exports of goods and services	267.0	2.5	-0.9	-0.9	6.5	8.0
Imports of goods and services	286.6	4.5	3.6	1.1	7.0	8.0
Net exports [b]	- 19.6	-0.6	-1.4	-0.6	-0.4	-0.4
GDP at market prices	951.3	2.1	1.7	1.9	2.7	2.9

a) Including nationalised industries and public corporations.
b) Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
Source: OECD.

United Kingdom: **External indicators**

	2001	2002	2003	2004	2005
			$ billion		
Goods and services exports	391.4	409.7	442.9	484	527
Goods and services imports	431.2	456.9	500.5	554	603
Foreign balance	- 39.8	- 47.1	- 57.7	- 70	- 76
Invisibles, net	13.8	18.9	9.9	3	3
Current account balance	- 25.9	- 28.2	- 47.7	- 67	- 73
			Percentage changes		
Goods and services export volumes	2.5	- 0.9	- 0.9	6.5	8.0
Goods and services import volumes	4.5	3.6	1.1	7.0	8.0
Export performance [a]	1.9	- 3.1	- 3.5	0.3	0.2
Terms of trade	- 0.7	3.4	0.6	- 0.7	0.0

a) Ratio between export volume and export market of total goods and services.
Source: OECD.

a large contribution from housing costs. According to the harmonised index of consumer prices (HICP), which excludes housing costs and is likely to become the new target variable before the end of 2003, inflation is only 1½ per cent, which is below the likely new target of 2 per cent. Nevertheless, the labour market remains tight with unemployment stable at about 5 per cent, slightly below OECD estimates of the structural rate. While there has yet to be any sign of a generalised pick-up in wage inflation, public sector wages have increased more strongly than in the private sector, with the public sector accounting for all of the recent employment growth. Given the pick-up in growth and the absence of slack in the labour market, monetary policy is expected to continue gradually to tighten, particularly as additional cost pressures may emerge as a delayed response to exchange rate depreciation and higher social insurance contributions.

Growth will pick up and become more balanced

Various leading indicators, in particular buoyant retail sales, suggest a continuation of growth at trend, or slightly above, for the remainder of 2003. With a gradual fall in house price inflation, private consumption, together with rising public expenditure, have remained the main drivers of activity in 2003. As exports recover with the projected pick-up in world trade, and the United Kingdom may make some modest gains in market share following the depreciation of sterling since the beginning of the year. The current account deficit is nevertheless likely to widen to around 3½ per cent of GDP given a weaker recovery in the rest of Europe. There should also be a boost to activity from stockbuilding as the stock-output ratio is restored to more normal levels. However, a substantial strengthening in business investment may be delayed until 2005 as companies continue to divert funds into reducing pension fund deficits. Overall, GDP growth of 2¾ per cent is projected for 2004, rising to 3 per cent in 2005.

Major risks stem from the housing market

Apart from international factors, the major risk to the outlook concerns possible instability stemming from a sudden drop in house prices leading to a sharp retrenchment of consumers' expenditure. This would be all the more likely to occur if house price inflation were to continue at double digit rates well into next year and reinforces the case for a continued, but gradual tightening of monetary policy.

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Conventional signs

$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mbd	Million barrels per day	Trillion	Thousand billion
. .	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
–	Irrelevant		

Summary of projections

	2003	2004	2005	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	Fourth quarter 2003	Fourth quarter 2004	Fourth quarter 2005
							Per cent						
Real GDP growth													
United States	2.9	4.2	3.8	3.3	7.2	3.4	4.0	4.0	4.1	4.1	3.8	4.1	3.6
Japan	2.7	1.8	1.8	3.9	0.6	2.6	1.3	1.7	1.5	1.7	2.4	1.6	1.9
Euro area	0.5	1.8	2.5	0.0	1.1	1.6	2.1	2.1	2.3	2.3	0.6	2.2	2.6
European Union	0.7	1.9	2.5	0.3	1.3	1.8	2.2	2.2	2.4	2.4	0.9	2.3	2.7
Total OECD	2.0	3.0	3.1	2.0	3.3	3.1	2.9	3.0	3.2	3.3	2.4	3.1	3.1
Inflation													
United States	1.6	1.2	1.2	1.0	1.7	1.2	1.3	1.0	1.0	1.0	1.6	1.1	1.2
Japan	-2.5	-1.3	-0.8	-2.6	-0.4	-0.9	-1.9	-1.5	-1.0	-0.9	-1.6	-1.3	-0.6
Euro area	1.9	1.7	1.6	1.9	2.1	1.8	1.7	1.6	1.4	1.4	1.9	1.5	1.7
European Union	2.1	1.8	1.7	1.9	2.0	1.9	1.8	1.7	1.6	1.6	2.0	1.7	1.8
Total OECD	1.8	1.4	1.4	1.4	1.1	1.4	1.5	1.5	1.4	1.3	1.5	1.4	1.4
Unemployment rate													
United States	6.1	5.9	5.2	6.2	6.1	6.2	6.1	5.9	5.8	5.6	6.2	5.6	5.0
Japan	5.3	5.2	5.0	5.4	5.3	5.3	5.3	5.3	5.2	5.2	5.3	5.2	4.9
Euro area	8.8	9.0	8.7	8.8	8.8	9.0	9.0	9.0	8.9	8.9	9.0	8.9	8.6
European Union	8.0	8.1	7.9	8.0	8.0	8.2	8.2	8.1	8.1	8.1	8.2	8.1	7.8
Total OECD	7.1	7.0	6.7	7.1	7.1	7.2	7.1	7.1	7.0	7.0	7.2	7.0	6.4
World trade growth	4.0	7.8	9.1	2.6	5.2	7.5	8.6	9.0	9.1	9.1	4.3	9.0	9.0
Current account balance													
United States	-5.0	-5.0	-5.1										
Japan	2.9	3.6	4.3										
Euro area	0.4	0.7	0.9										
European Union	0.1	0.1	0.3										
Total OECD	-1.4	-1.3	-1.3										
Cyclically-adjusted fiscal balance													
United States	-4.5	-5.1	-5.0										
Japan	-6.9	-6.5	-6.6										
Euro area	-1.7	-1.5	-1.8										
European Union	-1.7	-1.5	-1.9										
Total OECD	-3.4	-3.6	-3.7										
Short-term interest rate													
United States	1.2	1.5	2.7	1.2	1.1	1.1	1.1	1.4	1.6	1.9	1.1	1.9	3.4
Japan	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Euro area	2.3	2.0	2.2	2.4	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.5

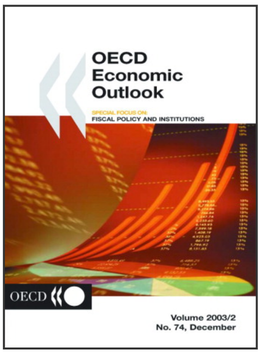
Note: Real GDP growth, inflation (measured by the increase in the GDP deflator) and world trade growth (the arithmetic average of world merchandise import and export volumes) are seasonally and working-day-adjusted annual rates. The "fourth quarter" columns are expressed in year-on-year growth rates where appropriate. The unemployment rate is in per cent of the labour force while the current account balance is in per cent of GDP. The cyclically-adjusted fiscal balance is in per cent of potential GDP. Interest rates are for the United States: 3-month eurodollar deposits; Japan: 3-month CDs; euro area: 3-month interbank rates.

Assumptions underlying the projections include:

- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 3 November 2003; in particular 1$ = 111.20 yen and 0.873 euros;

The cut-off date for other information used in the compilation of the projections is 7 November 2003.

Source: OECD.



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