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Introduction

Although the performance of the economy in 2001 was reasonably satisfactory, there are worrying signs that the economic environment is deteriorating rapidly. The economy has managed to survive one major domestic shock in the form of the foot and mouth crisis without a major downturn. However, the current international situation has far more serious repercussions and may well lead to the first significant recession in the UK for ten years. In particular the downturn of economic activity in the United States is likely to lead to problems throughout the world and, although both the Federal Reserve in the US and the Bank of England in the UK have responded by relaxing monetary policy, this is unlikely to be enough to offset the recessionary forces which have become evident in the second half of the year.

The domestic economy

In Table 1 we present a snapshot of the UK economy according to the figures available in November 2001. Superficially at least, economic performance looks quite satisfactory. GDP growth is close to the long run average rate of 2.4% per annum, inflation is close to the target rate of 2.5% and unemployment has continued to fall. The only really negative feature is the sharp fall in manufacturing output in the second quarter of the year.

Table 1. Summary Statistics for the UK Economy

	GDP	Manufacturing	RPIX Inflation	Unemployment
1997	3.6	1.3	2.8	1.6
1998	2.6	0.8	2.6	1.3
1999	2.7	0.3	2.3	1.2
2000	2.4	1.9	2.1	1.1
2001.1	2.7	1.6	1.9	1.0
2001.2	2.3	-1.4	2.4	1.0
2000.3			2.4	0.9

Figures are percentage changes relative to the previous year, except for unemployment which is millions claiming benefit. GDP is Gross Domestic Product, RPIX inflation is the rate of increase of the retail price index excluding mortgage interest payments.

Figure 1 shows the relationship between overall GDP growth and that of manufacturing over the past few years. In general these two series move together though the growth rate of manufacturing has been consistently lower by about 1%. During the second half of 1999 and into 2000, there were signs of a recovery in manufacturing performance in that the growth rate increased to within ½% of that of GDP. However, the position deteriorated sharply in the first half of 2001 with manufacturing growth becoming negative. The danger is that this trend may continue and lead to a downturn in the overall rate of GDP growth.

There are a number of reasons for the relatively slow rate of manufacturing growth. One important factor has been the high value of the exchange rate which has made it difficult for UK firms to compete in overseas markets and has made foreign goods relatively more competitive in UK markets. This was certainly a factor in the mini-recession experienced by UK manufacturing in the first half of 1999. However, this is unlikely to be the reason for the current downturn since the exchange rate has not appreciated noticeably over the past year. Relative to the dollar, the exchange rate depreciated sharply in 2000 and has remained stable during 2001. Although sterling did appreciate relative to the Euro in 2000 it has since fallen back close to its original value during the current year. The current downturn is probably more related to the general downturn in global economic conditions and the US economy in particular. Since manufacturing is much more closely tied in to the world economy than other sectors, a world recession will cause it significant problems. Moreover, if firms are forward looking, then they will choose to respond to the change in conditions sooner rather than later and cut back on production and employment in anticipation of the forecast downturn.

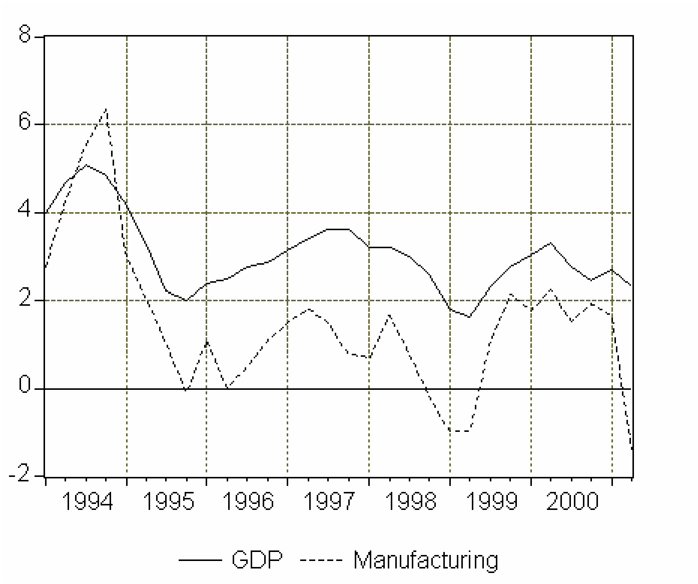

Figure 1: GDP and Manufacturing Growth 1994q1 – 2001q2

More detailed examination of the sectoral composition of UK growth indicates that performance over the last few years has been distinctly patchy. Table 2 shows the percentage growth rates for the main sectors of the economy since 1997. This indicates that services is the only sector to experience steady growth throughout the period. In the latest quarter for which we have data we see that overall GDP growth is dependent on the services and construction sectors with all other sectors experiencing negative growth. While we can expect some recovery in agriculture in the second half of the year, the prospects for manufacturing in particular remain bleak.

Table 2: Economic Growth by Sector

	Agriculture	Mineral and gas extraction	Manufacturing	Electricity, gas and water	Construction	Services
1997	-0.9	-1.2	1.3	0.6	2.9	4.2
1998	1.7	2.2	0.8	1.7	1.2	4.5
1999	2.3	3.7	0.3	1.8	0.7	3.0
2000	-2.3	-1.2	1.9	3.4	1.8	3.4
2001 1	-3.9	-8.2	1.6	5.1	-0.8	3.6
2001 2	-4.8	-4.9	-1.4	-1.0	3.0	3.7

Source: ONS database

The negative growth observed in the agricultural sector during the early part of 2001 is largely the result of the foot and mouth crisis. This was arguably the most significant economic event for the domestic economy during the current year. The crisis began late in February with the first reported cases and reached a peak in April. Since then the number of new reported cases has declined, reaching zero by September. The direct effects of the crisis are obvious in terms of the mass cull of cattle necessary to control the spread of the disease. However, there were important secondary effects in terms of the ban on the movement of cattle and the closure of international markets to British produce.

The effects of the foot and mouth crisis were not just felt in the agricultural sector. Tourism has also suffered badly due to the closure of large parts of the countryside to walkers and a sharp fall in the number of foreign tourists visiting the UK. Figure 2 shows that for both agriculture and tourism, the crisis impacted on sectors which were already struggling. Both sectors experienced a sharp recession in 2000 due in part to the high value of sterling. In the absence of the foot and mouth crisis some degree of recovery might have been expected in 2001. However, in both cases the growth rate has continued to be negative into the first half of 2001. Although it is too early to quantify the effects of the crisis with any degree of precision, some rough estimates are presented in a report by the Countryside Agency in August which valued the effects of losses due to the crisis at £2.4bn - £4bn. This amounts to 1%-

1.5% of GDP and is enough in itself to constitute a major deflationary shock to the economy.

Figure 2: Agriculture and Tourism (% Growth Rates over previous year)

Source: ONS Database

It should be noted that, although most of the media attention during the year has been on the problem areas of agriculture and tourism, there have been success stories. In particular, non-residential construction is currently enjoying something of a boom with investment in this sector during the first two quarters of the year being well above the growth rate of GDP. Similarly, although the transport sector has been perceived as being in crisis over the last two to three years, the result has been a significant increase in investment in the transport infrastructure during the first part of the year.

Inflationary pressures have remained relatively muted during 2001. Figure 3 shows the annual growth rate of the headline retail price index and RPIX (the retail price index net of mortgage interest payments). Both have remained close to the government's target rate of 2.5% throughout the year. Given the likely slowdown of the economy in the coming year, it seem unlikely that substantial inflationary pressure will build up in the coming months. However, there remains the possibility that a sharp depreciation of the exchange rate could add to inflation despite the downturn in real economic activity.

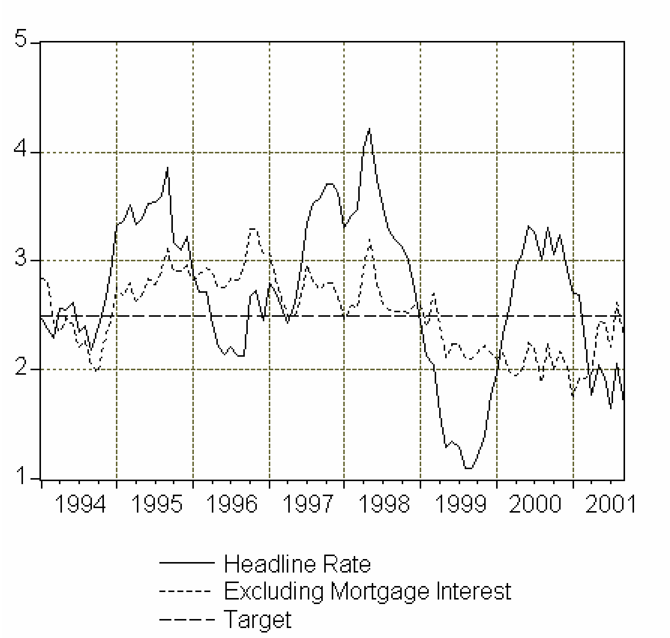

Figure 3: Inflation January 1994 – September 2001

Source: ONS Database

The lack of any perceived inflationary threat has meant that the Bank of England has cut interest rates at several points during the year. At the start of the year the base rate stood at 6%. This was cut by a quarter point in February and again by the same amount in April and May. The rate then stabilised at 5.25% until August when there was a further quarter point cut. Following the September 11th events there have been two further cuts and base rates now stand at 4%. The effects on economic activity of interest rate cuts take some time to come through and it is therefore rather too soon to judge the effectiveness of the Bank's actions. However, there is considerable concern within the US that similar interest rate cuts by the Federal Reserve Board do not seem to be halting a slide into recession by the American economy.

The international environment

The main source of concern for the economy in 2001 was undoubtedly the international economic situation. The terrorist attacks on America on September 11th contributed to a downturn which had begun earlier in the year. Figure 4 shows US economic growth which reached a peak in the first quarter of 2000 but has been decelerating since then. Therefore, even before September 11th, there was a potentially serious problem for the international economy in that the world's biggest economy was heading for recession. The loss of confidence since the terrorist attacks is likely to result in a further slowdown in both consumer and investment spending within the US. World growth has historically been closely linked to that of the US and therefore we can expect significant repercussions for the UK economy. However, the UK economy has become much more integrated into that of Europe during the last two decades and as a result may prove to be less sensitive to movements in US GDP than in the past.

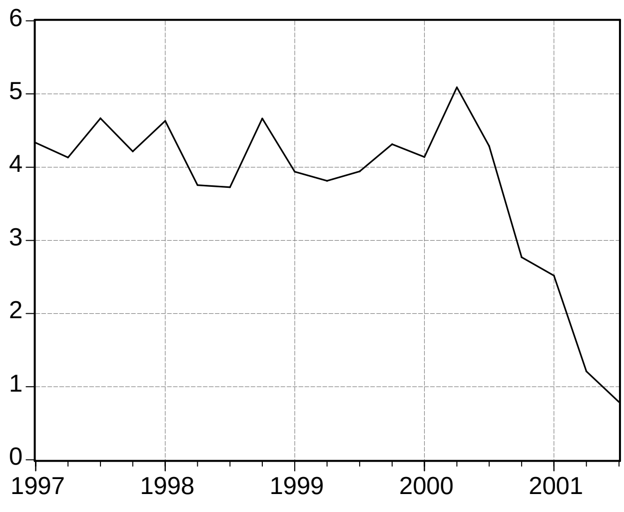

Figure 4: Annual Growth Rate of US GDP

Source: US Bureau of Economic Analysis, http://www.bea.doc.gov/

In the immediate aftermath of September 11th, many economic commentators concentrated on the impact on stock markets. While it is certainly true that most stock markets (including London) experienced a sharp fall, it is also the case that they recovered relatively quickly. This is illustrated in Figure 5 which shows the FTSE 100 index for the previous calendar year. The shaded area of the diagram shows the behaviour of the index after the 11th of September. Following an initial sharp fall, the index has recovered to approximately the same level as before the attacks. However, taking the year as a whole, the stock market has fallen by roughly 20%. This may result in a reluctance of firms to commit to new capital projects in the coming year and therefore add to the general deflationary pressure on the UK economy.

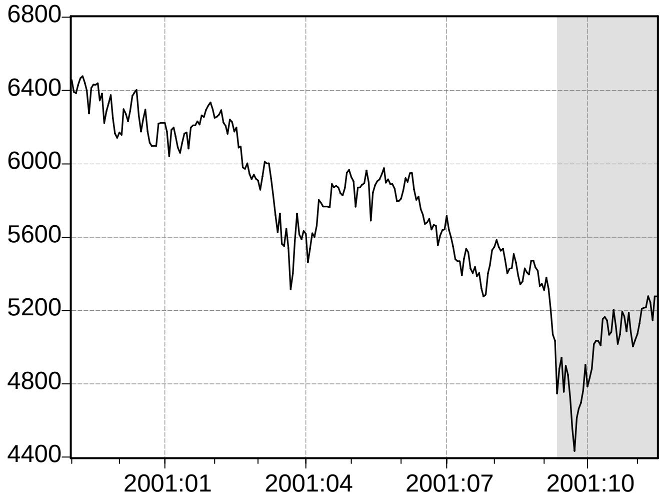

Figure 5: FTSE100 Index of share prices 15/11/00 to 14/11/01

Source: Datastream

Although stock markets have been highly volatile since September, there has been relatively little turbulence in foreign exchange markets. This may reflect the fact that the current crisis is perceived as truly global in nature and affects all economies in a similar manner. During the year the UK exchange rate against the US dollar has remained reasonably stable while there has been a depreciation of just over 5% against the Euro. This depreciation will be of benefit for UK exporters who have found the high value of sterling difficult to live with.

Prospects for the future

Despite numerous items of bad news for the economy in the second half of 2001, very few commentators are predicting an outright recession for the UK economy. An example is the forecast produced by the National Institute for Economic and Social Research in October as shown in Table 3. This predicts a moderate slowdown in overall GDP growth during 2001 itself, continuing into 2002 but then reviving in 2003. The prospects for manufacturing are rather less benign in that it is predicted to move into recession in the current year and only recover significantly in 2003. Inflation is forecast to remain near its target value throughout.

Table 3. Forecasts for the UK economy 2001-2003

	GDP	Manufacturing	RPIX inflation
2000-2001	2.2	-1.5	2.2
2001-2002	2.1	-0.6	2.0
2002-2003	2.6	2.5	2.4

Source: National Institute Economic Review, October 2001

The National Institute is not alone in forecasting a relatively modest slowdown in economic activity. The Treasury publishes a summary of eighteen independent forecasts – none of which forecasts an outright recession in the coming year. It has to be said that this is surprising given the severity of the downturn in the US economy and the damage to economic confidence caused by the September 11th events. Of course, forecasters have been caught out several times in recent years in forecasting recessions which did not occur. This may have led them to be much more cautious this time. In this case I would be surprised but delighted to see the forecasters proved right.