Economic review

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Anis Chowdhury

Office for National Statistics

SUMMARY

GDP output continued to grow fairly robustly in 2007 quarter four, similar to the rate in previous quarter. Growth continued to be driven by the service sector and offset by flat output expansion in the manufacturing sector. On the expenditure side, household spending and business investment weakened in quarter four in comparison with quarter three. The current account deficit narrowed in quarter four; the goods trade deficit was unchanged in quarter four and contributed negatively to growth. The labour market continues to be buoyant in quarter four but average earnings remain relatively subdued. The public sector finance position deteriorated in February 2008. Consumer price inflation accelerated in February and was above the Government's inflation target. Producer output price inflation was unchanged in February but continued to exhibit inflationary tendencies; input price inflation accelerated in February 2008.

GROSS DOMESTIC PRODUCT

Fourth quarter growth of 0.6 per cent

GDP growth for the fourth quarter of 2007 is estimated to have grown fairly strongly, similar to the rate in the previous quarter but a modest easing from growth in the second quarter of 2007. GDP growth in the latest quarter was 0.6 per cent, unchanged from the previous quarter but down from 0.8 per cent growth in the second quarter. The annual rate of growth also slowed, reaching 2.8 per cent,

down from 3.1 per cent in quarter three (Figure 1).

The growth rate in the UK economy in quarter four continued to be driven by strong although slower service sector output compared with the previous quarter. This was offset by a marginal pick up in industrial production growth – although this sector continued to display weakness for the second successive quarter. Within total production, growth was driven by a sharp acceleration in the output of the electricity, gas and water supply industries. Mining and quarrying

(including oil and gas) output contracted slightly. Manufacturing output was flat. The construction sector continued to grow strongly.

OTHER MAJOR ECONOMIES

Global growth weakens in quarter four

Data for 2007 quarter four are now available for most major OECD countries. Data for quarter four reported a mixed but a broadly weakening picture of global growth, reversing the generally strong picture of growth recorded in the previous quarter.

US GDP data for the fourth quarter of 2007 showed a sharp deceleration compared with quarter three. Growth was just 0.2 per cent on a quarter on quarter basis compared with 1.2 per cent growth in the previous quarter. The marked slowdown in growth was primarily due to a contraction in inventories after showing positive growth in the previous quarter; a slowdown in net exports but still contributing positively to growth, with exports exceeding imports and slower consumption growth. Residential investment also contributed to lower growth with continued contraction in this sector.

Japan's GDP growth showed a marked acceleration in 2007 quarter four. Growth was 0.9 per cent compared with 0.3 per cent in the previous quarter. Growth was mainly driven by an increase in business investment and net exports. Government expenditure also added to growth, though to a lesser extent. This was offset by continued contraction in residential investment growth. Private consumption made a relatively subdued contribution to growth.

Data for Italy was not available for 2007 quarter four as it is in the process of revising its methodology for measuring GDP. Data will be available with the next quarterly release (23 May). Growth for the other two big mainland EU economies – Germany and France – showed a weakening in 2007 quarter four compared with the previous quarter. According to Eurostat's estimate, euro area GDP decelerated to 0.4 per cent in 2007 quarter four compared with the strong 0.8 per cent growth in quarter three.

German GDP grew by only 0.3 per cent in 2007 quarter four, a marked slowdown

Figure 1
Gross domestic product

from growth of 0.7 per cent in quarter three. The breakdown to the growth was not available at the time of the headline release; indications are that the slowdown in growth was likely to be led by lower private consumption growth.

French GDP growth decelerated to 0.3 per cent in 2007 quarter four, from 0.8 per cent growth in the previous quarter. The weakening in growth was mainly due to a marked slowing in private consumption growth and decelerating inventories. This was offset by solid investment growth and a positive net trade picture.

FINANCIAL MARKETS

Share prices flat; pound depreciates

Equity performance has been volatile recently, and recorded muted growth in 2007 quarter four. The FTSE All-Share index rose by just 0.5 per cent. This follows a fall of 3.1 per cent in quarter three. The weakness in equity growth can mainly be attributed to global growth concerns, particularly regarding the US economy, brought on by continued problems regarding the credit squeeze, attributable to the US housing and the sub-prime mortgage market. Increasing interest rates in the UK further contributed

to this lack lustre performance. Equity prices weakened further in 2008 quarter one by falling on average by 4 per cent in the two months to February 2008.

In the currency markets, 2007 quarter four saw sterling's average value broadly depreciate compared with the previous quarter. The pound appreciated against the dollar by around 1 per cent in 2007 quarter four, a lower rate of appreciation compared with 1.7 per cent in the previous quarter. Against the euro, sterling's value depreciated by around 3 per cent after depreciating by 0.2 per cent in the previous quarter. Overall, the quarterly effective exchange rate depreciated by approximately 3 per cent in quarter four after flat growth in the previous quarter (Figure 2). In the two months to February 2008, the pound depreciated on average by around 1.4 per cent against the dollar. Against the euro, the pound depreciated on average by 2 per cent. Overall, the effective exchange rate depreciated on average by 2 per cent in the two months to February 2008.

The recent movements in the exchange rate might be linked to a number of factors. First, exchange rate movements can be related to the perceptions of the relative strengths of the US, the euro and UK economy. The lower rate of appreciation in quarter four may have come in response

to fears about lower growth in the UK economy and therefore prospects of lower interest rates to stimulate the economy. Indeed, the Bank of England reduced interest rates by 25 basis points in February 2008 to 5.25 per cent. This followed the 25 basis points cut in December 2007, and was mainly in response to the effects of the sub-prime crisis in terms of downward risks to growth and inflation. Another reason could have been due to concerns about the size of the UK current account deficit.

In the US, however, there have been particular concerns in recent months regarding the relative weakness of GDP growth, brought on by housing market weakness and the sub-prime crisis. In fact, US interest rates were lowered by a further 0.75 basis points in March 2008 to 2.25 per cent following a 0.75 basis points reduction in January 2008, in response to fears of a potential recession. These interest rate reductions will have made the dollar less appealing to investors compared with other currencies.

Another factor could be the lack of international appetite for US dollar denominated assets, particularly from central banks, who are choosing to spread their currency assets on their balance sheets (for portfolio and risk management purposes), thereby further undermining the value of the dollar.

In contrast in the euro area, the depreciation of the pound against the euro in the fourth quarter of 2007 may have come in response to prospects of monetary tightening in the eurozone. The eurozone interest rate is currently at 4 per cent, having been maintained there since the 0.25 basis point increase in June 2007, partly in response to concerns about inflationary pressures.

OUTPUT

Services sector slows but continues to drive economic growth

GDP growth in 2007 quarter four was estimated at 0.6 per cent, similar to the rate in the previous quarter. On an annual basis it was 2.8 per cent, down from 3.1 per cent in the previous quarter.

Construction activity continued to grow strongly in the fourth quarter of 2007. Construction output is estimated to have grown by 1.1 per cent, an acceleration from growth 0.4 per cent in the previous quarter. Comparing the quarter on the same quarter

Figure 2
Exchange rates

Figure 3
Construction output

a year ago, construction output rose by 2.5 per cent following growth of 2.3 per cent in the previous quarter (**Figure 3**).

In terms of external surveys of the construction sector, the Chartered Institute of Purchasing and Supply (CIPS) survey signalled weakening activity in 2007 quarter four with the average headline index at 55.9, down from 62.3 in the previous quarter, but still indicative of strong growth. In February 2008, the headline index weakened with the balance at 52.4. The Royal Institute of Chartered Surveyors construction survey for 2007 quarter four reported an easing in the growth of construction workloads with the balance at plus 16, down from plus 17 in the previous quarter.

Total output from the production industries recorded virtually stagnant growth in 2007 quarter four, although it registered a modest improvement from the previous quarter. Growth was just 0.2 per cent, reversing a contraction of 0.3 per cent in the previous quarter. On an annual basis growth rose by 0.7 per cent, up from 0.1 per cent in the previous quarter.

The weakness in total production continued to be led by a lacklustre performance in the manufacturing sector. Manufacturing output was flat in the latest quarter following a contraction of 0.3 per cent in the previous quarter. On an annual basis, manufacturing output grew by just 0.2 per cent, unchanged from the previous quarter (**Figure 4**). Mining and quarrying output also showed a weak picture in the latest quarter. Growth contracted by 0.1 per cent, a lower rate of contraction compared with the 1 per cent decrease in the previous quarter. On an annual basis, growth was 1.8 per cent, up sharply from a fall of 0.5 per cent in quarter three.

This was partially offset by an acceleration in the output of the electricity, gas and water supply industries. Growth was 2.8 per cent in 2007 quarter four compared with 0.7 per cent in quarter three. On an annual basis, growth was 4.6 per cent, up markedly from 0.1 per cent in the previous quarter.

Production growth has generally been slow since the second quarter of 2006 due to weakness in mining and quarrying and utilities output, offset through most of this period by relatively strong manufacturing output. There was a pick up in production in 2007 quarter two, but this appears not to have been sustained in quarter three and four, due to weak manufacturing output growth in the latest two quarters. However, manufacturing output has been volatile in

Figure 4
Manufacturing output

recent quarters.

According to the latest Index of Production figures, total production growth was flat in the three months to January 2008 compared with the previous three months. Output of the electricity, gas and water supply industries increased by 1.9 per cent but this was offset by a decline in the output of the mining and quarrying industries of 1.9 per cent. Manufacturing output was flat.

The output of the agriculture, forestry and fishing industries strengthened in the latest quarter with output increasing by 2.1 per cent, reversing a contraction of 0.5 per cent in the previous quarter.

External surveys of manufacturing for 2007 quarter four showed a fairly positive

picture (**Figure 5**). In the past, it has not been unusual for the path of business indicators and official data to diverge over the short term. These differences happen partly because the series are not measuring exactly the same thing. External surveys measure the direction rather than the magnitude of a change in output and often inquire into expectations rather than actual activity.

The CIPS average headline index for manufacturing indicated a stable but robust picture in the latest quarter. The headline index was 53.4, down from 55.4 in the previous quarter. In February 2008, the CIPS headline was 51.3, up from a virtually stagnant 50.6 in the previous month. The

Figure 5
External manufacturing

Figure 6
Services output

Confederation of British Industry (CBI) in its 2007 quarter four Industrial Trends survey reported a strengthening in its total order books with the balance at plus two, up from minus six in the previous quarter. That position further strengthened according to the CBI's monthly survey in March 2008 with the balance at plus seven – driven by overseas demand. The British Chambers of Commerce (BCC), in its 2007 quarter four survey, reported a mixed but overall a fairly buoyant picture of manufacturing activity. The home sales balance was plus 32 from plus 37 in the previous quarter.

Overall the service sector, the largest part of the UK economy, continues to be the main driver of UK economic growth. Growth continued to be fairly buoyant despite easing in the latest quarter compared with the previous quarter.

Services output grew by 0.7 per cent in 2007 quarter four, a moderate reduction from 0.9 per cent growth in the previous quarter (**Figure 6**). On an annual basis services output expanded by 3.4 per cent, down from 3.9 per cent in the previous quarter.

Growth was recorded in varying degrees across all four broad sectors. The main contribution to the decline in services output growth came from businesses services and finance, where output decelerated sharply in the latest quarter to 0.6 per cent from 1.4 per cent in quarter three. On an annual basis growth was 4.4 per cent, down from 5.2 per cent in the previous quarter. The distribution, hotels and catering sector also contributed, but to a lesser extent, towards the downward adjustment to services output. Growth was only 0.2 per cent compared with 0.8 per cent in the previous quarter. On an annual basis growth was 3.0 per cent, down from 4.5 per cent in quarter three. The weakening in the above two sectors was offset by the strengthening in the output of the transport, storage and communication sector with growth of 1.7 per cent, reversing the contraction of 0.1 per cent in quarter three. Growth annually was 3.9 per cent, slightly down from 3.8 per cent in quarter three. Government and other services output also grew fairly strongly at 0.7 per cent, up marginally from growth of 0.6 per cent in the previous quarter. Growth annually was 2.1 per cent, up from 1.8 per cent in the previous quarter.

The external surveys on services showed a mixed picture of service sector activity. The CIPS average headline index in 2007 quarter four was 52.5, although markedly

Figure 7
External services

Figure 8
Household demand

down from 57.1 in the previous quarter but still buoyant and above the long-run average. In February 2008 the headline index picked up to 54.0 from 52.5 in January. It should be noted that the CIPS survey has a narrow coverage of the distribution and government sectors.

The CBI and BCC reported a generally weakening picture of service sector activity (**Figure 7**). The CBI service sector survey for February 2008 reported falling sentiment and business volumes for the business and professional services sector and the consumer service sector compared with the previous quarter. The consumer services volume balance was at minus seven down from plus four in the previous quarter. For business and professional services, the balance was at plus six, down from plus 26 in the previous quarter. The BCC survey for 2007 quarter four survey reported a weakening picture of service sector activity, but overall balances for home orders and sales remained positive at plus 18 and plus 28 from plus 26 and plus 29 respectively.

The UK sectoral account shows the UK corporate sector being a net lender in 2007 quarter four. However, the level was relatively modest and an improvement compared with the substantial net borrowing position in the previous quarter.

Despite the surplus, the overall debt level remains high due to the heavy borrowing between 1997 and 2001. The household sector remains a net borrower as income growth proved insufficient to finance total outlays. Households debt levels continue to be relatively high, although the quarterly interest payments on the loans are still being kept down by low interest rates as a proportion of income, although they have steadily increased in recent quarters due to rises in interest rates. The level of central government borrowing increased in 2007 quarter four from the previous quarter and still remains high due to higher rises in cash expenditure exceeding tax receipts. The current account of the UK balance of payments continues to be in deficit.

EXPENDITURE

Consumers' spending weakens

Household consumption expenditure decelerated in 2007 four compared with the previous quarter. Growth was just 0.1 per cent, down markedly from that of 0.8 per cent in quarter three. Compared with the same quarter a year ago, growth was 2.4 per cent, down from 3.5 per cent in quarter three (**Figure 8**).

Lower spending was primarily driven by a fall in durable goods expenditure and slower growth in semi-durables and non-durable goods expenditure. There was fairly buoyant growth in services expenditure.

There are a number of reasons why consumer spending could have slowed; primarily amongst them are the impact of the credit crisis and past interest rate rises feeding through to spending decisions. Both these factors may have contributed to some extent towards spending weakening. In particular, the Bank of England's recent quarter four Credit Conditions Survey highlighted increased tightening in credit conditions for some households.

One key indicator of household expenditure is retail sales which slowed in 2007 quarter four compared with quarter three. Retail sales volumes grew by 0.6 per cent in quarter four, a deceleration from growth of 1.5 per cent in the previous quarter.

The slowdown in retail sales in the latest quarter occurred despite widespread discounting and early sales, the impact of which is reflected in the price deflator (that is, shop prices) which fell on average by around 1.1 per cent in 2007 quarter four. This could suggest the impact of previous interest rate rises and the effects of the credit crunch may have been a constraining

factor in retail sales growth, together with diminished confidence on the part of consumers.

Retail sales figures are published on a monthly basis and the latest available figures for February 2008 showed a strengthening picture compared with the previous month and indicative of fairly buoyant growth (**Figure 9**). In the three months to February the volume of retail sales increased by 1.0 per cent compared with a 0.7 per cent increase in the three months to January. On an annual basis in February, the latest three months growth compared with the same three months a year ago recorded growth of 4.7 per cent, up from 4.4 per cent growth in January.

In the latest month, discounting still seems to be playing a part in retail sales growth although to a lesser extent compared with previous months. The price deflator fell by 0.3 per cent in February 2008 compared with a fall of 0.8 per cent in January.

Retail sales can be disaggregated into 'predominantly food' and 'predominantly non-food' sectors. In the three months to February 2008 retail sales growth was mainly driven by the 'predominantly food stores' sector which recorded growth of 1 per cent jumping from 0.3 per cent growth in the three months to January. The

'predominantly non-food stores' sector in contrast registered subdued growth of 0.2 per cent. Within this sector 'non-store retailing and repair stores' grew by 7.3 per cent, followed by 'household goods stores' with growth of 1.8 per cent. 'Textile, clothing and footwear stores' grew by 0.8 per cent. This was offset by a fall in sales in the 'non-specialised stores' of 3.6 per cent.

External surveys for retail sales presented a slowing picture of growth in February 2008. The CBI's monthly Distributive Trades survey for February reported a further slowdown, with the balance at minus three from plus four in January. The British Retail Consortium reported an increase of 1.5 per cent in retail sales on a like-for-like basis in February 2008, down from 2.6 per cent in the previous month (**Figure 10**).

Another indicator of household consumption expenditure is borrowing. Household consumption has risen faster than disposable income in recent years as the household sector has become a considerable net borrower and therefore accumulated high debt levels. Bank of England data on stocks of household debt outstanding to banks and building societies shows household debt at unprecedented levels relative to disposable income.

There are two channels of borrowing available to households: secured lending, usually on homes; and unsecured lending, for example on credit cards. On a general level, an increase in interest rates increases debt servicing costs, may discourage borrowing and in the process displace consumer expenditure on certain goods.

The financial account shows that the general movement from net lending to borrowing since 1992 has primarily been facilitated by increases in both secured and unsecured lending, but is mainly driven by loans on secured dwellings. In the latest quarter, there was a substantial fall in secured lending which rose by around £10 billion compared with around £33 billion in the third quarter. Unsecured lending also fell to around £3 billion, down from around £4 billion in 2007 quarter three.

The slowdown in secured lending could be primarily attributed to the credit squeeze. This may have manifested itself in banks and building societies adopting tight lending criteria, particularly towards first time buyers and those considered higher risk. There may also be an impact in the form of higher interest rates charged by banks for customers who have borrowed on variable interest rate mortgages in the short term, and in the longer term, there may be

Figure 9
Retail sales

Percentage growth

Figure 10
External retailing

Balances

an impact on those who took out fixed-rate mortgages.

The housing market plays a major influence on consumer expenditure patterns. Firstly, as a barometer of confidence in the economy and therefore a willingness to spend; secondly, in terms of demand it creates for household goods via house purchases; and thirdly, household expenditure may be linked to household equity withdrawal – slower house price growth can signify lower equity growth and therefore lower purchasing power. The recent slowdown in house prices and the housing market generally may have affected all three of the above, compounded by the credit squeeze. Both Nationwide and Halifax report an easing in growth in house prices in quarter four compared with quarter three. Despite this slowdown, house price growth is still holding up fairly well and its contribution to consumer spending may be imprecise. According to the Nationwide, annual house price growth in quarter four was 6.9 per cent compared with 9.3 per cent in the previous quarter. Halifax reported annual house price growth of 5.2 per cent in quarter four, down from 9.8 per cent in quarter three and below the long-run average of 8 per cent.

The saving ratio is also a determinant of household expenditure. In quarter four, there appears to be signs of retrenchment amongst consumers with a reorientation towards higher savings; this could be in light of ongoing economic uncertainty as a result of the credit crisis. The saving ratio in 2007 quarter four was 3.3 per cent, up from 2.6 per cent in the previous quarter (Figure 11).

An alternative measure of expenditure also showed a weakening picture. M4 (a broad money aggregate of UK money supply) rose by around £35.0 billion in 2007 quarter four compared with around £50.0 billion in quarter three. M4 lending (including cash and bank deposits) also fell sharply from around £77.0 billion in quarter three to around £51.0 billion in 2007 quarter four.

Finally, pressures on current disposable income together with uncertainty regarding future projection of incomes may have been factors in reducing consumption expenditure in quarter four.

Figure 11
Saving ratio

Figure 12
Total fixed investment

Figure 13
Government spending

BUSINESS DEMAND

Business investment buoyant

Total investment grew by 1.8 per cent in quarter four compared with growth of 2.7 per cent in the previous quarter.

On an annual basis, total investment increased by 4.1 per cent, a slowdown from 5.1 per cent growth in the previous quarter. The growth in total investment was primarily due to an increase in machinery and capital equipment investment (Figure 12).

Business investment grew relatively strongly in the latest quarter, although it slowed compared with the previous quarter.

Business investment recorded robust growth of 1.8 per cent in 2007 quarter four, a deceleration from growth of 2.7 per cent in quarter three. On an annual basis, business investment grew by 5.3 per cent, down from 7.8 per cent in the previous quarter.

Business investment could have slowed for a number of reasons. Firstly, increased uncertainty and pessimism, particularly in regards to global demand, may have deterred investment; secondly, the downturn in investment could have come on the back of lower corporate profits; thirdly, the weakness in the equity market in recent quarters may have constrained revenue generation and hence investment; and last but not least, the general weakness

Figure 14
Balance of payments

in the property market in terms of lower price growth may have inhibited investment spending.

Evidence on investment intentions from the latest BCC and CBI surveys painted a weak picture. According to the latest quarterly BCC survey, the balance of manufacturing firms planning to increase investment in plant and machinery fell from plus 33 to plus 21. The CBI's Quarterly Industrial Survey in January 2008 reported a subdued investment picture, with the investment balance of plant and machinery weakening at minus 12 from minus 14 in the previous quarter.

According to the sectoral accounts, the private non-financial corporate sector was a net lender in 2007 quarter four lending £600 million, reversing net borrowing of £2.9 billion in the previous quarter. This turnaround was mainly due to higher earnings on direct foreign investment. Corporate sector debt levels remain high despite the sector surplus of recent years. The financial balance sheet shows the corporate sector had net liabilities of around £1.9 billion.

GOVERNMENT DEMAND

Government expenditure falls

Government final consumption expenditure contracted in the latest quarter. Growth fell by 0.5 per cent following an increase of 0.6 per cent in the previous quarter. On an annual basis, growth was 1.3 per cent, down from 2.3 per cent in the previous quarter (Figure 13).

Public sector finances deteriorate

The latest figures on the public sector finances reported an deterioration in the current financial year to February

2008, compared with the last financial year. It showed a higher current budget deficit and a higher level of net borrowing. Overall, the government continued to operate a financial deficit, with government expenditure continuing to exceed revenues, partly to fund capital spending. In the financial year April to February 2007/08, the current budget deficit was £5.7 billion; this compares with a deficit of £3.0 billion in the financial year to April to February 2006/07. In the financial year April to February 2007/08 net borrowing was £27.8 billion; this compares with net borrowing of £23.0 billion in the financial year April to February 2006/07. Although corporation, income tax and VAT receipts rose on a calendar basis, this was outweighed by a larger increase in total current expenditure, particularly on capital projects by central government, leading to the higher current budget deficit together with the higher net borrowing.

The financial account shows that the issuance of both sterling treasury bills and government securities has financed this net borrowing. The latest quarter saw the outstanding amount of government securities at £490.0 billion and of Treasury bills at £18.0 billion.

Since net borrowing became positive in 2002, following the current budget moving from surplus into deficit, net debt as a proportion of annual GDP has risen steadily. Public sector net debt in February 2008 was 36.0 per cent of GDP, up from 35.5 in February 2007. In the financial year 2006/07, net debt as a percentage of GDP was 36.6 per cent.

TRADE AND THE BALANCE OF PAYMENTS

Current account deficit narrows; goods deficit unchanged

The publication of the latest quarterly balance of payments figures shows that the current account deficit narrowed in 2007 quarter four to £8.5 billion, from a deficit of £19.1 billion in the previous quarter (Figure 14). As a proportion of growth domestic product (GDP), the deficit fell to 2.4 per cent of GDP from 5.5 per cent in 2007 quarter three. The narrowing in the current account deficit in 2007 quarter four was due to a switch from a deficit on income to a surplus on income, together with a higher surplus on services. The surplus on income stood at £9.3 billion and the surplus on trade in services widened to £10.1 billion. The deficit on trade in goods was unchanged at £23.2 billion compared with the previous quarter.

The run of current account deficits since 1998 reflects the sustained deterioration in the trade balance. The UK has traditionally run a surplus on the trade in services, complemented by a surplus in investment income, but this has been more than offset by the growing deficit in trade in goods, partly due to the UK's appetite for cheaper imports.

Data for 2007 quarter four recorded a continuation of the large trade deficit in goods. Exports of goods fell but imports of goods fell by a lesser amount resulting in the wide trade deficit. The goods trade deficit was £23.2 billion in the fourth quarter, unchanged from the previous quarter. In terms of growth, exports of goods fell by 0.9 per cent while goods imports fell by 0.6 per cent. Services exports fell by 0.2 per cent and services imports fell by 2.7 per cent. Over the quarter, total trade contracted by 1.0 per cent following growth of 4.3 per cent in the previous quarter.

Overall, the persistence of the current account deficit has led to the deterioration in the UK's international investment position with the rest of the world. The net asset/liability was negative to the tune of £351.3 billion at the end of the fourth quarter of 2007 compared with net external liabilities of £318.4 billion at the end of the previous quarter. UK assets abroad stood at £6,445.9 billion compared with a level of £6,169.3 billion at the end of the third quarter. UK liabilities stood at £6,797.2 billion in the fourth quarter compared with a level of £6,487.7 billion in the fourth

quarter. The rise in the level of both UK assets and UK liabilities in the fourth quarter reflects increases in net investment, price movements in government bonded securities and exchange rate movements, particularly the depreciation of sterling against the dollar.

According to the latest trade figures, in the three months ended January 2008, the deficit on trade in goods and services narrowed to £12.5 billion, from a £13.2 billion deficit in the previous three months. The deficit on the trade in goods narrowed to £22.9 billion in the three months to January compared with £23.2 billion in the previous three months. The surplus on the trade in Services widened to £10.4 billion in the three months to January compared with £10 billion in the previous three months.

However, these figures are distorted by volatility in VAT Missing Trader Intra-Community (MTIC) fraud and therefore need to be treated with caution. According to the latest figures, the level of trade in goods excluding trade associated with MTIC fraud is estimated to be £0.1 billion in January 2008, unchanged from the previous month, and was £0.2 billion in the fourth quarter of 2007.

External surveys on exports reported a mixed picture for exports in the latest quarter. The BCC reported that the export sales net balance fell by nine points to plus 22 and the export orders balance fell 10 points to plus 19. The latest CBI quarterly survey in contrast reported an improving picture. The export orders balance was plus 10 in 2007 quarter four, up from plus six in the previous quarter. However, in the first quarter of 2008 this appears to have reversed with the export orders balance weakening to minus eight in February 2008, according to the latest monthly Industrial Trends survey.

LABOUR MARKET

Labour market activity buoyant

The labour market in the latest reference period illustrated a continued strong picture – with high levels of employment and low levels of unemployment as seen throughout 2006 and in 2007. The robust labour market continues to be a reflection of relatively strong demand conditions in the UK economy.

The latest figures from the Labour Force Survey (LFS) pertain to the three-month period up to January 2008. The number of people in employment and the employment rate rose. The number of unemployed people and the unemployment rate fell. The claimant count fell. The inactivity rate and the number of inactive people of working age have both fallen. The number of vacancies rose. Average earnings including bonuses fell, while the figure excluding bonuses was unchanged. Overall average earnings remain subdued with weak real wage growth.

Looking at a detailed level, the increase in the employment level was mainly driven by employees and part-time employment. In the case of the latter, it reversed the previous picture of the employment level mainly being driven by full-time employees. The current working age employment rate was 74.8 per cent in the three months to January 2008, up 0.3 percentage points from the three months to October 2007 and up 0.4 percentage points from a year earlier. The number of people in employment rose by 166,000 in the three months to January 2008 compared with the previous quarter, to an employment level of 29.46 million – the highest since records began in 1971. The unemployment rate was 5.2 per cent in

the three months to January 2008, down 0.1 percentage points from the three months to October 2007 and down 0.3 percentage points from a year earlier (Figure 15). The number of unemployed people decreased by 32,000 in the three months to January 2008 and was down 89,000 from a year earlier, leaving the current level of unemployment at 1.61 million.

According to the LFS, in the period November 2007 to January 2008, the number of people in employment rose by 166,000. The increase was led by a rise in employees of 150,000 and a 10,000 rise in self-employment. In terms of full and part-time workers, the numbers of people in full-time employment rose by 58,000 while the number of people in part-time employment increased by 108,000.

Workforce jobs increases

According to employer surveys, there was an increase of 13,000 jobs in the three months to December 2007. The largest quarterly contribution to the increase came from distribution, hotels and restaurants (up 43,000), followed by transport and communication (up 18,000), and education, health and public administration (up 10,000). This was offset by decreases across a number of sectors with the largest decrease in manufacturing (down 29,000) followed by construction (down 19,000) and other services (down 13,000). Over the year, total workforce jobs increased by 208,000. Of the total, the largest contribution to the increase over the year came from finance and business services (up 149,000) followed by distribution, hotels and restaurants (up 103,000) and education, health and public administration (up 23,000). The manufacturing sector, in contrast, lost the largest number of jobs on the year (down 53,000), followed by other services (down 12,000).

Claimant count level continues to fall

The claimant count measures the number of people claiming the Jobseeker's Allowance. The latest figures for February 2008 showed the claimant count level at 793,500, the lowest level since June 1975. The claimant level was down 2,800 on the previous month and down 126,500 on a year earlier. The claimant count rate in February 2008 was

Figure 15
Employment and unemployment

2.5 per cent, unchanged from the previous month but down 0.4 percentage points from a year earlier.

Vacancies rise

The number of vacancies created in the UK continued to show a healthy demand position for the economy. There were 678,500 job vacancies in the three months to February 2008, up 1,600 from the previous three months and up 59,700 from the same period a year earlier.

Inactivity level falls

The working age inactivity rate was 21.0 per cent in the three months to January 2008, down 0.2 percentage points on the three months to October 2007 and down 0.1 percentage points from a year earlier. In level terms, the number of economically inactive people of working age was down 68,000 over the quarter and by 2,000 over the year to reach a level of 7.89 million in the three months to January 2008. Inactivity falls in level terms were recorded across most groups. The largest level falls in inactivity were recorded for those categorised as 'looking after family/home' (down 61,000). This was offset by an increase in inactivity amongst the student category (up 29,000) followed by the long-term sick (up 17,000).

Average earnings subdued

Growth in whole economy average earnings showed a mixed picture in the three months to January 2008 compared with the three months to December, but overall remains relatively subdued. Average earnings including bonuses increased by 3.7 per cent in the three months to January 2008, down 0.1 percentage points from the previous month. Average earnings excluding bonuses rose by 3.7 per cent, unchanged from the previous month. In terms of the public and private sector split, the gap in average earning (excluding bonuses) narrowed in January. Public sector wage growth was 3.6 per cent, up 0.1 percentage points from December. Private sector wages grew by 3.7 per cent, unchanged from the previous month.

Overall, the numbers still point to a fairly buoyant labour market, with employment at high levels and unemployment at a stable level. This is consistent with higher

Figure 16
Inflation

Percentage change over 12 months

workforce participation rates, underpinned by robust GDP growth. Average earnings show stable but fairly modest growth, consistent with increased supply in the labour force.

PRICES

Producer output and input prices accelerate

Industrial input and output prices are an indication of inflationary pressures in the economy. During quarter four, output prices exhibited further signs of an acceleration of growth from quarter three 2007 and therefore provided signs of continued inflationary pressures. Input prices also accelerated in the fourth quarter compared with quarter three. This suggests that firms were attempting to maintain their profit margins by passing on the higher costs of inputs to customers after facing a profit squeeze earlier in 2007. In 2008 quarter one, there were continued inflationary pressures with further acceleration in both input and output prices.

Input prices on average rose by 10.6 per cent in 2007 quarter four. This compares with 2.8 per cent in 2007 quarter three. The core input price index, excluding food, beverages, tobacco and petroleum rose by an average of 3 per cent in 2007 quarter four (12 month non-seasonally adjusted growth), an acceleration from growth of 2.3 per cent in the previous quarter. The sharp rise in input prices came mainly on the back of rising crude oil and home food materials prices. According to the latest figures, input prices rose by 19.4 per cent in the twelve months to February 2008, up from 18.9 per cent in January. The largest contributions to the increase came from crude oil and home food materials which increased by 65.7 and 33.9 per cent respectively. The core input price inflation

measure also accelerated to 8.2 per cent, up from 7.4 per cent in January.

Output prices grew on average by 4.5 per cent in 2007 quarter four, an acceleration from growth of 2.6 per cent in the previous quarter. The underlying picture also suggests inflationary pressures. On the core measure which excludes food, beverages, tobacco and petroleum, producer output prices rose on average by 2.3 per cent in 2007 quarter four, up from 2.2 per cent in the previous quarter. The main contributions to the increase in output prices were provided by rises in petroleum products and food prices. In February 2008, the growth in output prices remained unchanged at 5.7 per cent from the previous month. The largest contributions to the increase came from petroleum products and food prices which rose by 23.4 and 8.4 per cent respectively. Core output prices also showed signs of inflationary pressures with growth of 3.0 per cent in February 2008, up from 3.2 per cent in January 2008.

Consumer prices rise and still above target

Growth in the consumer prices index (CPI) – the Government's target measure of inflation – was 2.5 per cent in February 2008, up from 2.2 per cent in January 2008. This is lower than the peak in March 2007 when inflation reached 3.1 per cent but above Government's 2 per cent inflation target (Figure 16).

The largest upward pressure came from housing and household services due to gas and electricity bills rising by more than a year ago. Part of the effect from these items comes from immediate implementation of tariff changes rather than the previous policy of phasing them in over a four month period. This means that the price rises announced over recent months are included in the February index whereas

previously only a part of these would have been included.

There were also small upward effects from: alcoholic beverages and tobacco with cigarette prices rising by more than a year ago; recreation and culture with an upward contribution from recording media such as pre-recorded DVDs partly offset by downward contributions from games, toys and hobbies, and cultural services.

The largest downward contribution came from food and non-alcoholic beverages, particularly fruit and vegetables. Fruit prices fell compared with a rise a year ago, with the largest individual contribution coming from strawberries. Vegetable prices rose by less than a year ago. A small

partially offsetting upward effect came from milk, cheese and eggs.

Small downward contributions came from: miscellaneous goods and services, where prices rose by less than a year ago, principally due to personal care appliances and products such as small electrical appliances and paper products; transport, where the price of passenger air and sea fares rose by less than a year ago, partially offset by an upward effect from fuels and lubricants; and communication, where landline telephone charges fell this year but were unchanged a year ago.

RPI inflation was 4.1 per cent in February, unchanged from January. The main factors affecting the CPI also affected

the RPI. Additionally, there was a large downward contribution from housing. The effect came mainly from mortgage interest payments where there was a smaller increase than last year but there was also a large downward effect from house depreciation.

RPIX inflation – the all items RPI excluding mortgage interest payments – was 3.7 per cent in February, up from 3.4 per cent in January.