



# What does 2001 hold for the UK economy?

Although medium term prospects remain satisfactory, the UK economy will face difficulties during 2001. David Kern of Kern Consulting assesses the outlook.

The UK economic background has been positive in recent years, reflecting a combination of domestic and international developments. But I expect the pace of activity to slow markedly in 2001, both globally and in the UK, and although growth will continue increased risks will emerge.

The global economy was remarkably strong in 2000, driven by surprisingly high US growth, a gradual upturn in the euro-zone and a rapid recovery in Asia, Latin America and Eastern Europe, following the 1997/98 financial crisis. While benefiting from the improving international background, the UK has also displayed considerable domestic strength and resilience.

## Steady growth in the 1990s

Since mid-1992, the UK has enjoyed sustained growth averaging 2.9% a year, well above the long-term trend of 2.3%. Moreover, the economy has followed an unusually stable path in recent years, reflecting the determination of the Conservative as well as the Labour government to maintain a stable macro-economic framework, so as to eliminate the damaging uncertainties created by the traditional volatility of the UK cycle.

Steady output growth, combined with much lower inflation (from an average of 6%-7% before 1992 to only 2.5% in recent years) and interest rates (the base rate has declined from an average of some 11% in the 1980s to roughly 6% in recent years) has transformed UK's economic performance.

The reduced threat of boom and bust, coupled with the strong commitment to a competitive market economy, has stimulated enterprise and

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encouraged the creation of new firms. Between 1995 and 2000, the business services sector saw a net increase of 36%, or 110,000 firms.

Growth in rapidly expanding services has modernised the UK economy, making it more flexible and competitive, and helping to create new jobs. Since 1994, employment has risen by more than two million, and unemployment has fallen to levels not seen since the 1970s. Despite a tightening labour market, earnings remain under control.



David Kern

## Slowdown in 2001 but satisfactory medium term prospects

Although inflation risks still linger, and some commentators expect modest additional base rate increases over the next few months, the pressure for higher interest rates has virtually disappeared. Base rate has probably peaked at 6%, and gradual falls are likely over the course of 2001.

While sterling's strength against the euro has caused difficulties for internationally exposed businesses, particularly those in exports and manufacturing, the economy as a whole has proved remarkably resilient in 2000. Services, which account in total for some 70% of GDP, have remained strong, particularly, business, financial and IT services. Meanwhile, manufacturing is also growing, albeit at a more subdued pace. Most surprisingly, exports have risen strongly, capitalising on buoyant world markets.

In 2001, with UK interest rates easing, I expect sterling to weaken moderately against the euro. However, it is likely to harden against the dollar and in the longer term UK businesses will have to cope with a strong currency.

Although medium-term prospects remain benign, the UK economy will be exposed to a number of international dangers in 2001:

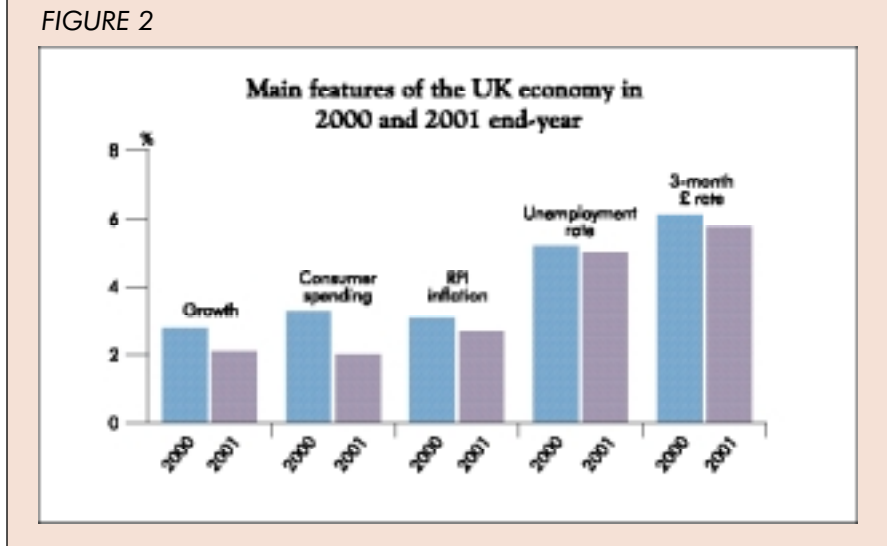
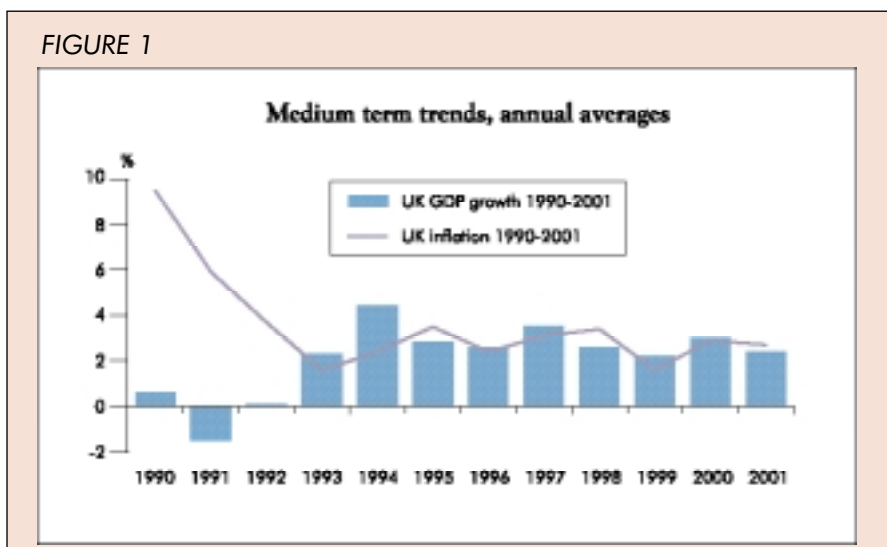
- the US economy, although still growing, has already slowed more sharply than most people expected and the deceleration in activity is set to continue in the first half of 2001. While additional Fed easing should mitigate the downturn, the position could worsen much further if the stock market falls sharply, the dollar

- plummet, or private sector confidence weakens sharply;
- Japan will remain disappointingly slack, with serious problems persisting in the financial and corporate sectors;
- elsewhere in Asia, in spite of the strong recovery, many structural problems remain unresolved and there are worrying signs of renewed financial turbulence, particularly in the Philippines, Indonesia and Thailand; and
- high oil prices, although unlikely to cause a global crisis, will inevitably subdue activity and dampen confidence, particularly if OPEC restricts output again and reverses some of the recent welcome easing in prices.

The reduction in UK growth, from 2.8% at the end of 2000 to 2.1% at the end of 2001, although not unduly severe will nevertheless subdue profits and create problems for UK business planners. Private sector consumption will bear the main burden, slowing fairly sharply from 3.3% at end 2000 to 2% at the end of 2001, while government spending will expand strongly. However, modest falls in official interest rates next year, coupled with some weakening of sterling against the euro, should help to alleviate the pressures facing vulnerable sectors such as manufacturing and agriculture.

Credit risks will inevitably increase during 2001, but the deterioration in UK credit quality will be manageable. Businesses must clearly exercise greater caution, but they should continue to invest and plan for future growth, to ensure they are well placed to exploit new opportunities when the economic cycle enters its next expansionary phase in 2002.

The pace of economic activity is likely to slow quite markedly in 2001, both globally and in the UK. However, while in the US the 'landing' will be very bumpy, perhaps even 'hard', in Europe we can still talk about a 'soft landing'. Although the impact on the UK of the sharp US deceleration will not be unduly severe, increased difficulties will clearly emerge. The main threats facing the UK economy are international. However, robust private sector demand and the Government's expansionary fiscal stance will make it necessary for monetary policy to remain cautious;



and sizable interest rate cuts are unlikely.

Even so, with the pace of activity gradually slowing, and with underlying inflation remaining slightly below the 2.5% target, the Monetary Policy Committee will probably start cutting interest rates in the spring, to offset the adverse effects on confidence of worsening US prospects. I expect base rate to be at 5.5% by end-2001, but a temporary decline to 5.25% around the middle of the year cannot be ruled out.

Against this background, I expect sterling to weaken to £0.67 against the euro by the middle of the year, before recovering to £0.65 by end-2001. Against the US dollar, I expect the pound to rise to a temporary peak of \$1.61 around the middle of the year, as the dollar falls below parity with the euro; but as the dollar recovers later in the year, sterling should ease back to \$1.55 by end-2001. Meanwhile, the

**TABLE 1**

**Currencies in 2001**

	mid-2001	end-2001
\$ per £	1.61	1.55
£ per euro	0.67	0.65
DM per £	2.92	3.01
\$ per euro	1.08	1.00

approach of the next general election, which will very probably be held before mid-2001, and the acrimonious debate about the euro, will dominate the public debate and add to the uncertainties facing UK businesses. ■

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