US/UK ECONOMIC OUTLOOK: THE VIEW FROM WASHINGTON
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US/UK economies
- Close ties: UK is number one investor in the US
- Similarities: below-par growth, resilient, strong consumer
- Differences: unemployment, productivity, tax cuts, interest rates
- Politics: Blair/Brown/King and Bush/Snow/Greenspan

UK economy – leading Europe
- UK avoided recession: 44 consecutive quarters of growth – record expansion
- Doing much better than EU: 1.8% GDP growth 2002 - twice eurozone average (but less than US 2.4% growth)
- Now picking up, after slow start to 2003: 1.8% annualized growth in second quarter
- Meanwhile, Germany and Italy in recession, France not much better

Positive data:
- Interest rates 3.5%, lowest since 1955 (but higher than US)
- Core inflation 2.9%, well within BoE 1.5-3.5% target (higher than US)
- Employment up 1.5m since 1997, up 250k in the last year (500k US jobs lost this year)
- Unemployment 5.0%, lowest in G7 (over 9.0% in France and Germany, 6.2% in US)
- Equities recovered since war, FTSE up 2% since Jan
- Consumer confidence up 4th month in a row, after Iraq
- Retail sales up 6.0% oya in June
- Industrial output up 2.2% oya, manufacturing up 3.5%

But:
- Government borrowing up: $32bn & $37bn deficits (03-04)
- Consumer credit boom: personal borrowing up $16bn in June
- House prices up 25% last year, moderating now
- Bank would cut rates further, but risk of house price bubble

Outlook:
- IMF forecast: 2.2% growth (03)
- Budget forecast: 2-2.5% growth (03) and 3-3.5% (04)

Euro:
- UK still not ready to join euro
- Support entry in principle: “If the economics are right for Britain, we should join”
- Assessment, June 03: not yet achieved sustainable convergence or sufficient flexibility needed for euro to be good for investment and jobs
- Now embarked on reforms to increase convergence, eg move to long-term, fixed-rate mortgage market
- Govt will report on progress, Spring 04: if assessment is positive, then referendum
US economy - on road to recovery

Story so far:
- 2001 recession was short and shallow (March-November), more to do with investment overhang than 9/11
- Recovery has been modest, gradual and erratic: positive growth since late 01, but has fluctuated a lot
- Series of shocks have held back recovery, eg 9/11, corporate scandals, pre-war jitters
- Bush and Greenspan have responded with massive fiscal/monetary easing: 3 Bush tax cuts = $1.7 trillion, interest rates cut from 6% to 1%

Result – jobless recovery:
- 2002 growth was 2.4%, 2003 second quarter also 2.4%
- Consumer spending has been major driver of growth
- Also, high federal (especially defence) spending
- Business investment has been delayed
- Imports much higher than exports, big drag on growth
- Productivity growth very strong, 5.7% in second quarter
- 2.4% is well below 3.0-3.5% needed for job creation
- Jobless recovery: unemployment has risen to 6.2%, 500k jobs lost this year (esp manufacturing)

Outlook:
- More reasons for optimism now, but still downside risks
- Fed will keep interest rates at 1% for as long as it takes
- Latest Bush tax cut already boosting consumer spending
- Business investment starting to pick up
- Unemployment likely to remain around 6%, but initial claims now starting to edge down

But:
- Mortgage rates starting to edge up and refis have peaked
- Equities have levelled off, after Q2 rally
- Consumer confidence has fallen since post-Iraq rebound
- FY03-04 federal budget deficits set to hit $455bn and $475bn (4.2% of GDP): manageable or upward pressure on long-term interest rates?
- State/local deficits will offset around 1/3 of Bush tax cut

Conclusion:
- Should see 3-3.5% growth by end-year, but mainly deficit-driven growth
- Risk of renewed weakness next year, once tax cut effect wears off - if business investment does not pick up strongly, interest rates go up and deficits get worse

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