Office for National Statistics

Article

Quarterly economic commentary: October to December 2018

Economic commentary for the latest quarterly national accounts, prices and labour market indicators.

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1 . Main points

- Real UK gross domestic product (GDP) increased by an unrevised 0.2% in Quarter 4 (Oct to Dec) 2018, while the 1.4% increase in 2018 is the weakest annual growth rate since the financial crisis.

- Households, corporations and government continued to be net borrowers in Quarter 4 2018, borrowing or running down their savings to finance their spending and investment, financed by the rest of the world being a net lender to the UK.

- The current account deficit widened to 4.4% of GDP in the final quarter of 2018, financed by a large net inflow of portfolio investment into the UK.

- The employment rate hit a record high of 76.1% in the three months to January 2019, with the unemployment rate falling to 3.9% – its lowest level since January 1975.

- The 12-month Consumer Prices Index including owner occupiers' housing costs (CPIH) rate of inflation was 1.8% in February 2019, as goods price inflation remained at one of its lowest rates in the last couple of years while services price inflation was unchanged on the month.

2 . GDP

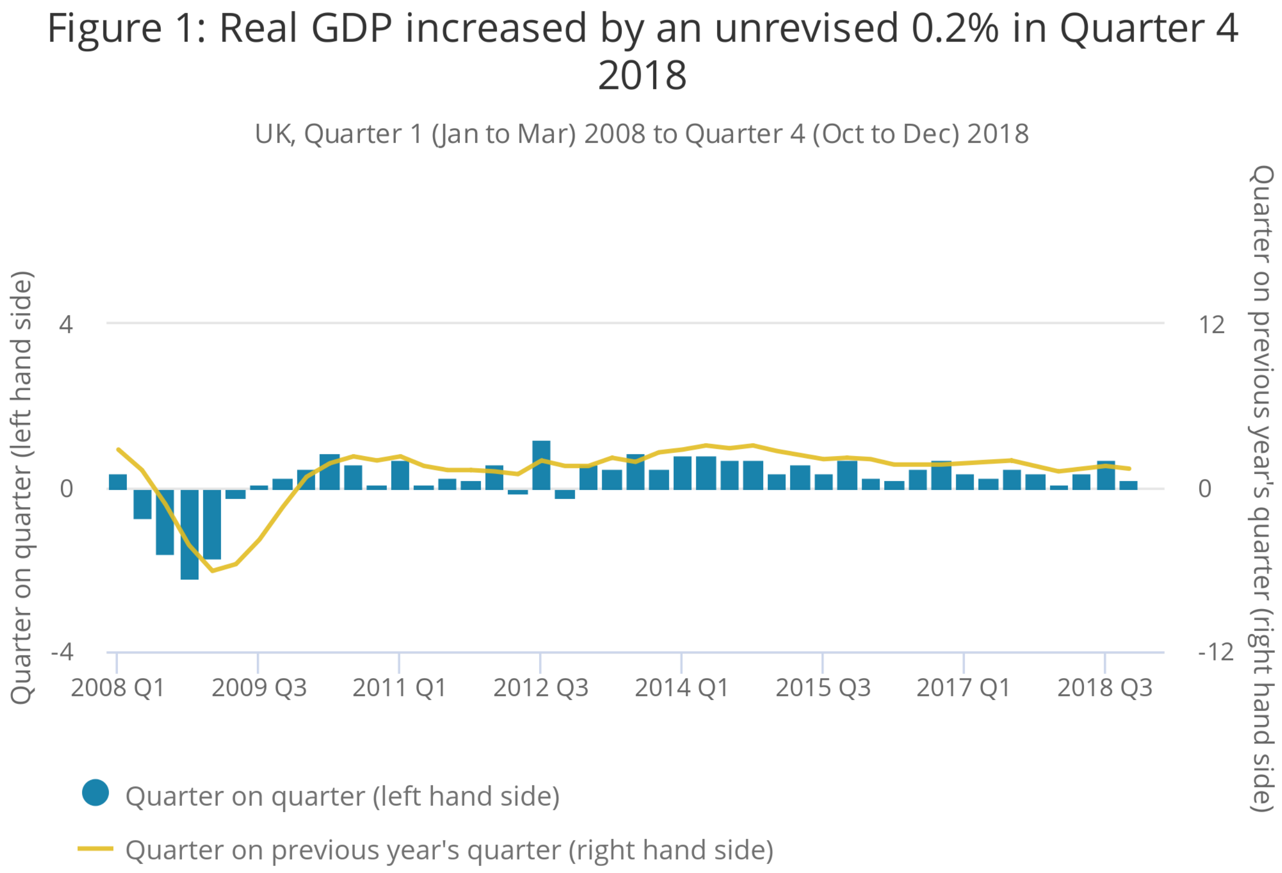
Growth of UK gross domestic product (GDP) is estimated to have slowed to 0.2% in Quarter 4 (Oct to Dec) 2018, unrevised from the previous estimate.

Growth in Quarter 3 (July to Sept) 2018 has been revised up slightly to 0.7%, where some of this activity is likely to have reflected one-off effects of the warm weather and the World Cup. In comparison with the same quarter a year ago, UK GDP increased by a revised 1.4%, continuing the relatively subdued performance of late (Figure 1).

More timely figures are available on the UK economy, which cover the three months to January 2019. However, these monthly figures have not incorporated the revisions in the latest quarterly national accounts so this is not covered here.

Figure 1: Real GDP increased by an unrevised 0.2% in Quarter 4 2018

UK, Quarter 1 (Jan to Mar) 2008 to Quarter 4 (Oct to Dec) 2018



Source: Office for National Statistics - Quarterly National Accounts: October to December 2018

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

UK GDP increased by an unrevised 1.4% in 2018, which is the weakest annual growth rate since the 2009.

One way of capturing the recent slowing in the UK economy is to look at forecast errors from those produced before the referendum on membership of the EU. Since Quarter 2 (Apr to June) 2016, the latest estimates show that UK GDP has now increased by a cumulative 4.3%. This compares with the cumulative 5.5% that was expected over the same period in the forecasts produced in March 2016 by the Office for Budget Responsibility (OBR), which had been conditioned on a vote to remain in the European Union.

That said, it is important to note that the outlook produced at the time would have been subject to uncertainty, while there would have also been subsequent unforeseen developments in the UK and global economy not factored into forecasts produced at that time.

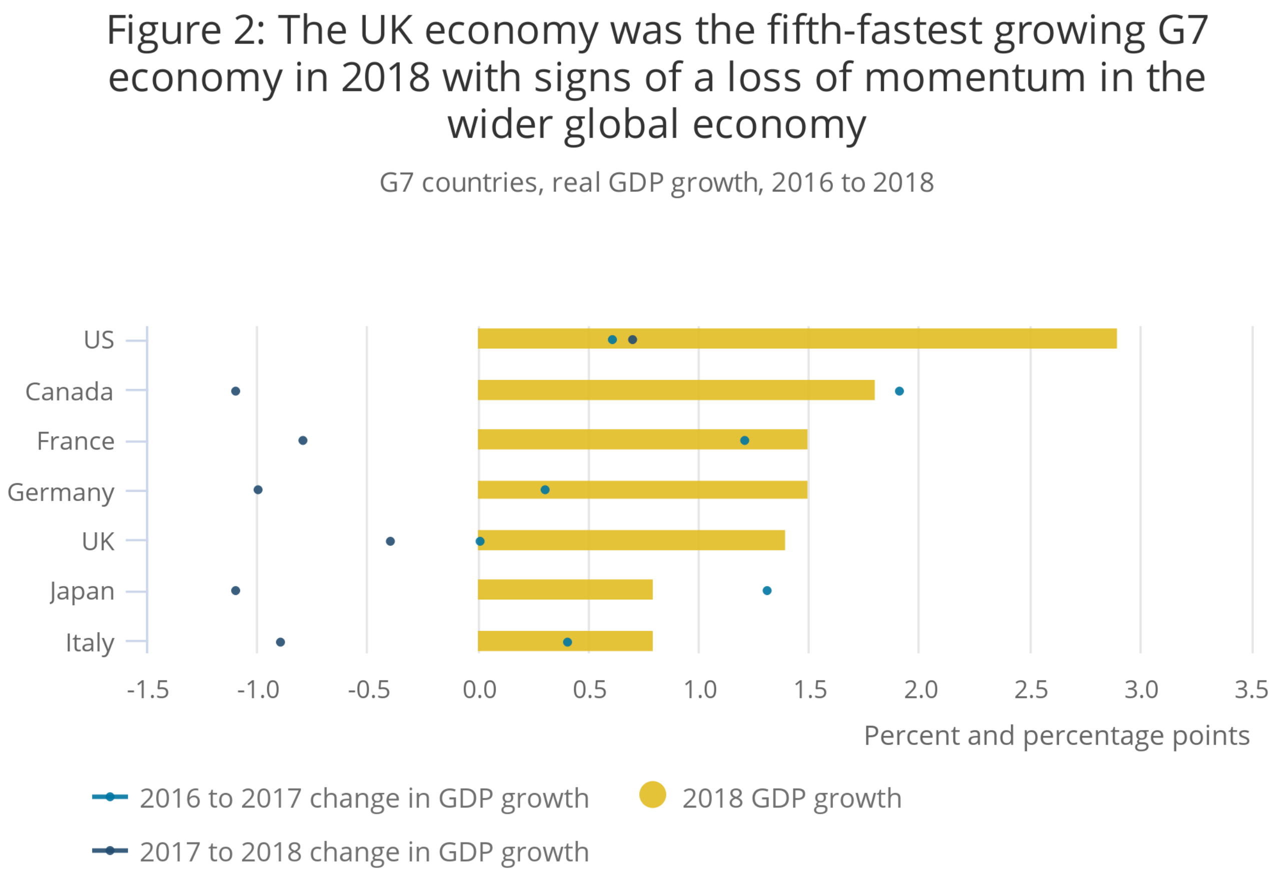
There are also signs that global momentum has weakened recently. Figure 2 shows how the UK economy has performed compared with other G7 countries in the last few years.

In 2017, the UK was the only advanced economy not to experience a pick-up in growth, as the global economy recorded its strongest uptick in activity since 2011. As such, the UK was only the sixth-fastest growing G7 economy that year, slipping down these international rankings. In 2018, the majority of G7 countries – except the United States – experienced a loss in momentum.

The latest estimates show that the UK was only the fifth-fastest growing advanced economy in 2018, ahead of Japan and Italy – the latter entering a technical recession in the second half of the year. The latest [Interim Economic Outlook (PDF, 532KB)] produced by the Organisation for Economic Co-operation and Development (OECD) attributes the global slowdown to “high policy uncertainty, ongoing trade tensions and a further erosion of business and consumer confidence”. This chimes with the latest [World Economic Outlook] produced by the International Monetary Fund (IMF), which highlights trade tensions and financial market sentiment as risks to the global outlook.

Figure 2: The UK economy was the fifth-fastest growing G7 economy in 2018 with signs of a loss of momentum in the wider global economy

G7 countries, real GDP growth, 2016 to 2018



Source: Office for National Statistics, Organisation for Economic Co-operation and Development

Notes:

1. All international estimates extracted from the OECD quarterly national accounts and are correct as of 26 March 2019.

The implied GDP deflator represents the broadest measure of inflation in the domestic economy, reflecting changes in the price of all goods and services that comprise GDP. This includes the price movements in private and government consumption, investment and the relative price of exports and imports. In the year to Quarter 4 2018, it increased by 1.8%, up from the previous estimate of 1.6%. Revisions to exports prices in particular have meant that there have been upward revisions to the implied GDP deflator in all quarters. Nominal GDP growth slowed from 4.1% in 2017 to a slightly revised 3.3% in 2018, reflecting a slowing in real GDP growth and lower price inflation.

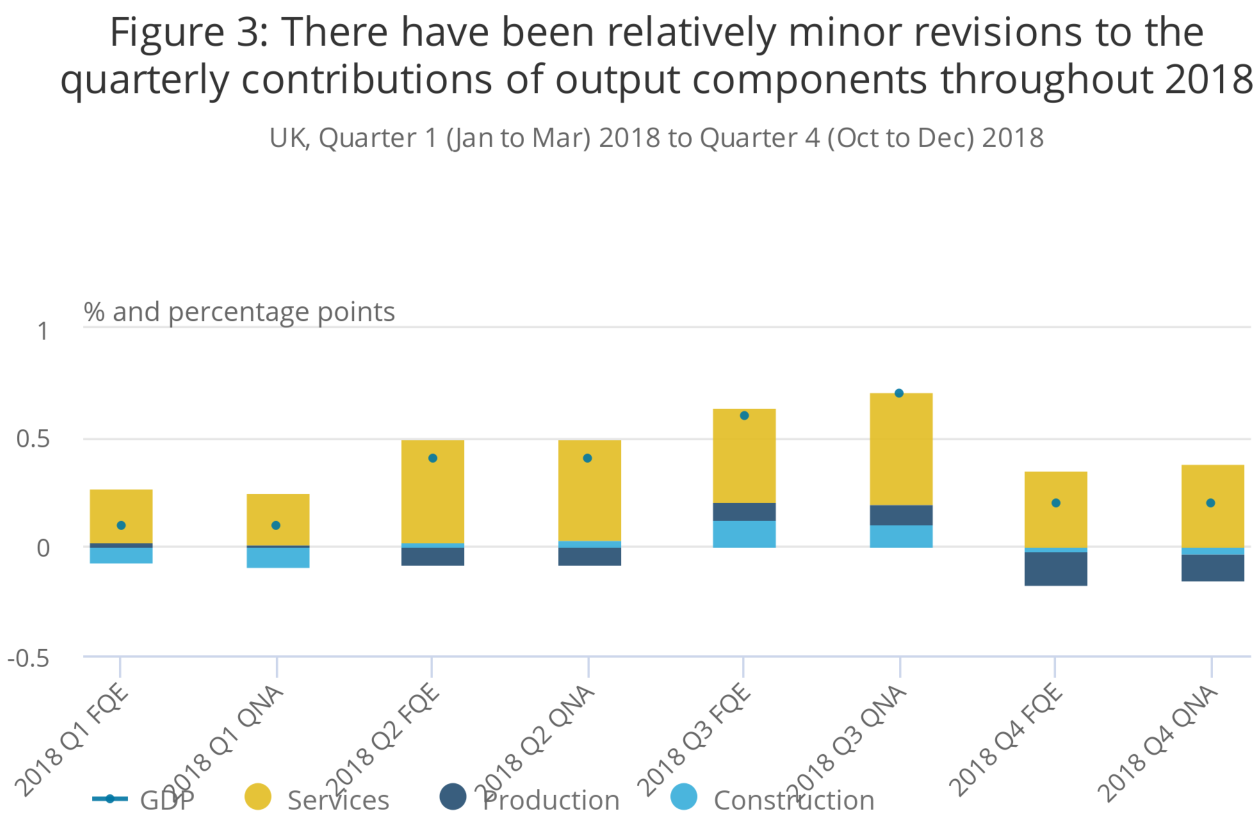
Output

The latest estimates reaffirm that there was a slowing in activity in the final quarter of 2018. Services output increased by 0.5% in Quarter 4 2018, revised up from 0.4%. However, annual growth for 2018 remains unchanged at 1.7% – the weakest it has been since 2011.

Production output declined by 0.8% in the final three months of the year, with a fall in output recorded across all four main areas of production. There have been some small revisions to the quarterly path of construction output throughout 2018. The overall impact shows a weaker picture for the year, with growth in construction output now estimated to have slowed to 0.3%. Figure 3 shows that the narrative for 2018 remains largely unchanged – the most notable development is the upward revision to GDP growth in the third quarter, principally reflecting revisions to government and other services.

Figure 3: There have been relatively minor revisions to the quarterly contributions of output components throughout 2018

UK, Quarter 1 (Jan to Mar) 2018 to Quarter 4 (Oct to Dec) 2018



Source: Office for National Statistics - Quarterly National Accounts: October to December 2018

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

2. FQE refers to GDP First Quarterly Estimate.

3. QNA refers to GDP Quarterly National Accounts.

4. Components contributions may not sum to total due to rounding.

Growth in services output has been relatively stable over 2018, but revised up slightly in the second half of the year, with the latest estimate showing an increase of 0.5% in Quarter 4, a slight easing from the previous quarter (Figure 4). This was evident in the December 2018 UK Services Purchasing Managers Index (PDF, 158KB), which noted that “Brexit-related concerns were a key factor weighing on business-to-business spending at the end of 2018”, as business activity rose at one of its slowest rates over the previous two and a half years.

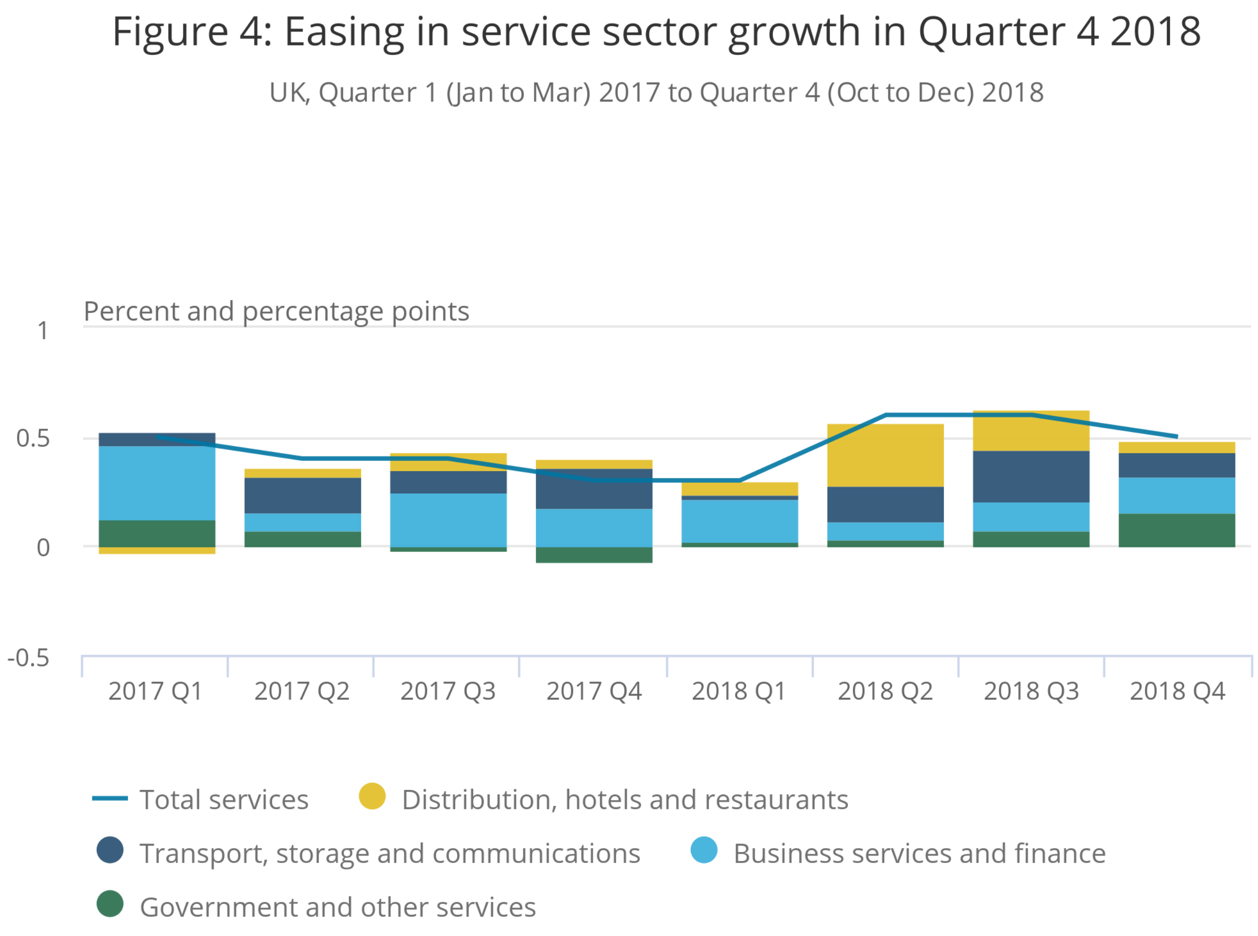
Output of business and finance services increased by 0.4% in the fourth quarter, driven primarily by growth in professional services. This is weaker than our previous estimate of 0.6% in Quarter 4 2018. The Quarter 4 Bank of England Agents' Summary of Business Conditions (PDF, 1.4MB) reports that demand for business and financial services continued to grow at a "modest pace", which may be followed by a further slowing in the first quarter of 2019 as "businesses were likely to avoid completing large transactions close to the date of EU withdrawal".

There have also been upward revisions to government and other services, specifically relating to estimates of health output. These volume estimates are based on a measure of output activity in the NHS, such as inpatient and outpatient attendances, where we have received updated estimates of such activity. There have also been revisions to transport, storage and communications throughout 2018, which reflect updated survey and administrative information.

More recent survey evidence points to a subdued picture for services in early 2019. The UK Services Purchasing Managers' Index (PDF, 163KB) fell to its lowest level in over two years in January, showing only a slight pick-up in February. Survey respondents cited EU exit uncertainty had weighed on business activity, while there have been reports that "political uncertainty had encouraged delays to corporate spending decisions and a general rise in risk aversion among clients". There was also evidence from the Confederation of British Industry that optimism in the services industries had deteriorated, falling sharply in the three months to February, which was pronounced in business and professional services.

Figure 4: Easing in service sector growth in Quarter 4 2018

UK, Quarter 1 (Jan to Mar) 2017 to Quarter 4 (Oct to Dec) 2018



Source: Office for National Statistics - Quarterly National Accounts: October to December 2018

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

2. Components contributions may not sum to total due to rounding.

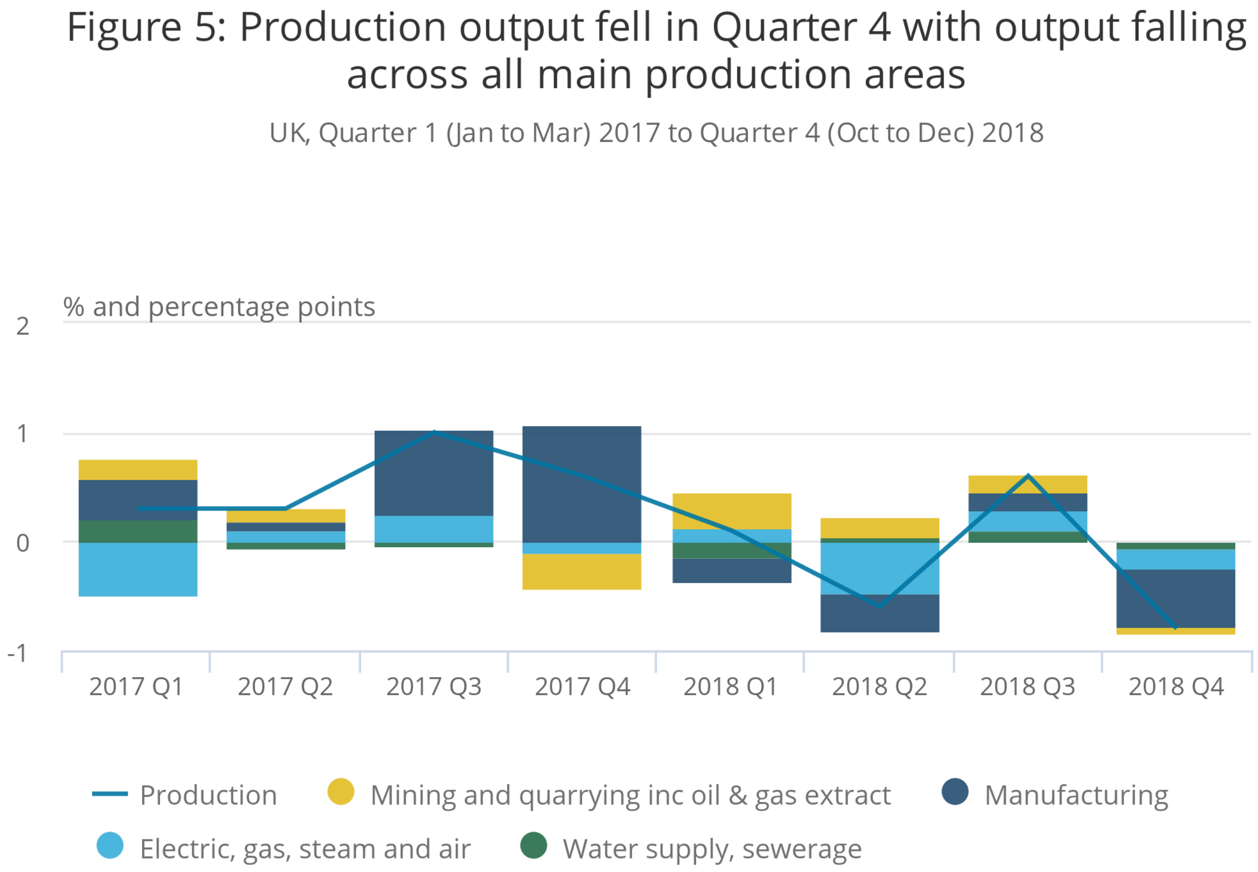
In the production industries, output is now estimated to have fallen by 0.8% in Quarter 4 2018, where there have been declines across all four main areas of production (Figure 5) – the first time this has taken place since Quarter 1 (Jan to Mar) 2009.

There has been a weak picture in manufacturing throughout 2018 with falls in three of the four quarters of 2018. In particular, manufacturing output of transport equipment fell during 2018, which is also echoed in the recent Society of Motor Manufacturers and Traders survey, which reports that UK car production fell 18.2% in the year to January 2019, reflecting a decline in domestic and foreign demand. Manufacturing output fell by a revised 0.7% in Quarter 4 2018, with 9 out of the 13 manufacturing sectors experiencing a contraction in activity.

More timely information points to a subdued picture in early 2019. The UK Manufacturing Purchasing Managers' Index (PDF, 149KB) slowed to a four-month low in February 2019, as new order inflows eased "amid signs of a slowing domestic market and a further drop in new export orders", which was linked to a weaker global economy. However, there was also evidence that the improvement in February was in part reflecting "efforts to reduce backlogs of work and build stocks of finished products in advance of Brexit".

Figure 5: Production output fell in Quarter 4 with output falling across all main production areas

UK, Quarter 1 (Jan to Mar) 2017 to Quarter 4 (Oct to Dec) 2018



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There have also been revisions to mining and quarrying output as well as smaller revisions to electric, gas, steam and air production output throughout 2018. The upward revisions to oil production throughout the year reflects under-reporting of new oil fields from the Department for Business, Energy and Industrial Strategy (BEIS) in previous estimates. Water supply and sewerage output fell by 0.9% in Quarter 4.

Some revisions have been made to the quarterly path of construction output in 2018, which paint a slightly weaker picture for the year. Construction output fell by 1.5% in the first quarter of the year, when activity is likely to have been affected by adverse weather. Following two consecutive quarters of growth, output of the construction industry fell by 0.5% in Quarter 4 2018.

The Quarter 4 Bank of England Agents' Summary of Business Conditions (PDF, 1.4MB) highlights that activity in the construction industry remains modest, while the UK Construction Purchasing Managers' Index slowed in December 2018, with signs of heightened uncertainty weighing on new orders.

More timely survey information points to a further fall in activity in February 2019, with the latest UK Construction Purchasing Managers' Index (PDF, 152KB) falling to its lowest level since March 2018, when the UK economy was affected by heavy snowfall. Survey respondents cited concerns about a lack of new projects to replace completed contracts, with anecdotal evidence that EU exit uncertainty had "slowed decision making on commercial projects" and that it had led to "subdued client demand so far this year".

Expenditure

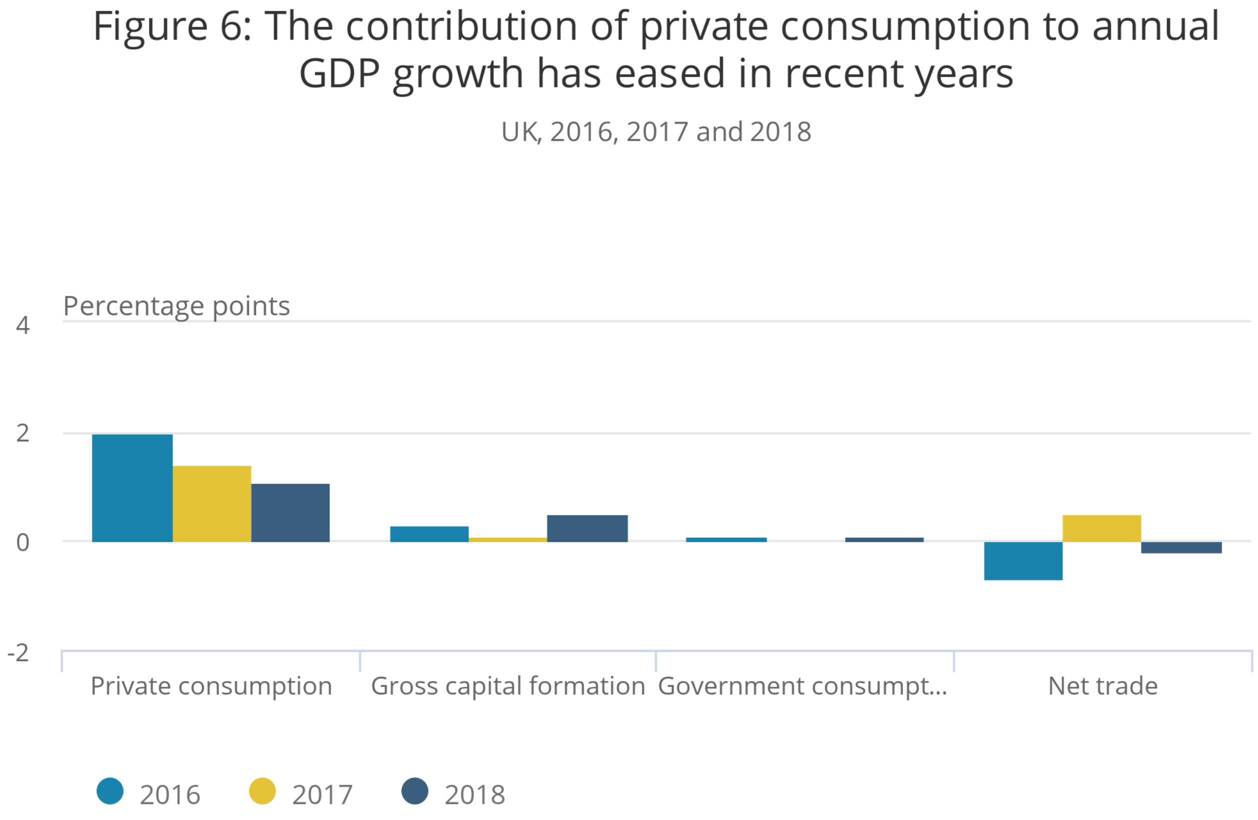
Private and government consumption contributed positively to GDP growth in Quarter 4 2018, partially offset by the negative contributions of gross capital formation and net trade.

Figure 6 shows how the economy has evolved in recent years, with the 2018 estimates largely unrevised. There has been a notable slowdown in the contribution of private consumption in the last couple of years. This in part reflects the effect of a squeeze in purchasing power from higher import inflation following the fall in the exchange rate after the referendum on membership of the EU. It also shows the positive contribution of gross capital formation in 2018, although the contribution of gross fixed capital formation was flat in 2018, which reflects a marked slowing from previous years.

Having provided a boost to GDP growth in 2017, net trade fell in 2018 – a possible reflection of the waning effects of sterling's depreciation and a slowing momentum in the global economy.

Figure 6: The contribution of private consumption to annual GDP growth has eased in recent years

UK, 2016, 2017 and 2018



Source: Office for National Statistics - Quarterly National Accounts: October to December 2018

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

2. Components may not sum to total gross domestic product due to rounding and loss of additivity in data prior to open period. The statistical discrepancy is also not displayed.

Household consumption increased by 1.8% in 2018, slowing over the last couple of years. This primarily reflects a slowing in how much households have spent on recreation and culture, and transport (Figure 7), though it should be noted that spending on recreation and culture in 2016 was at its highest point since 2009.

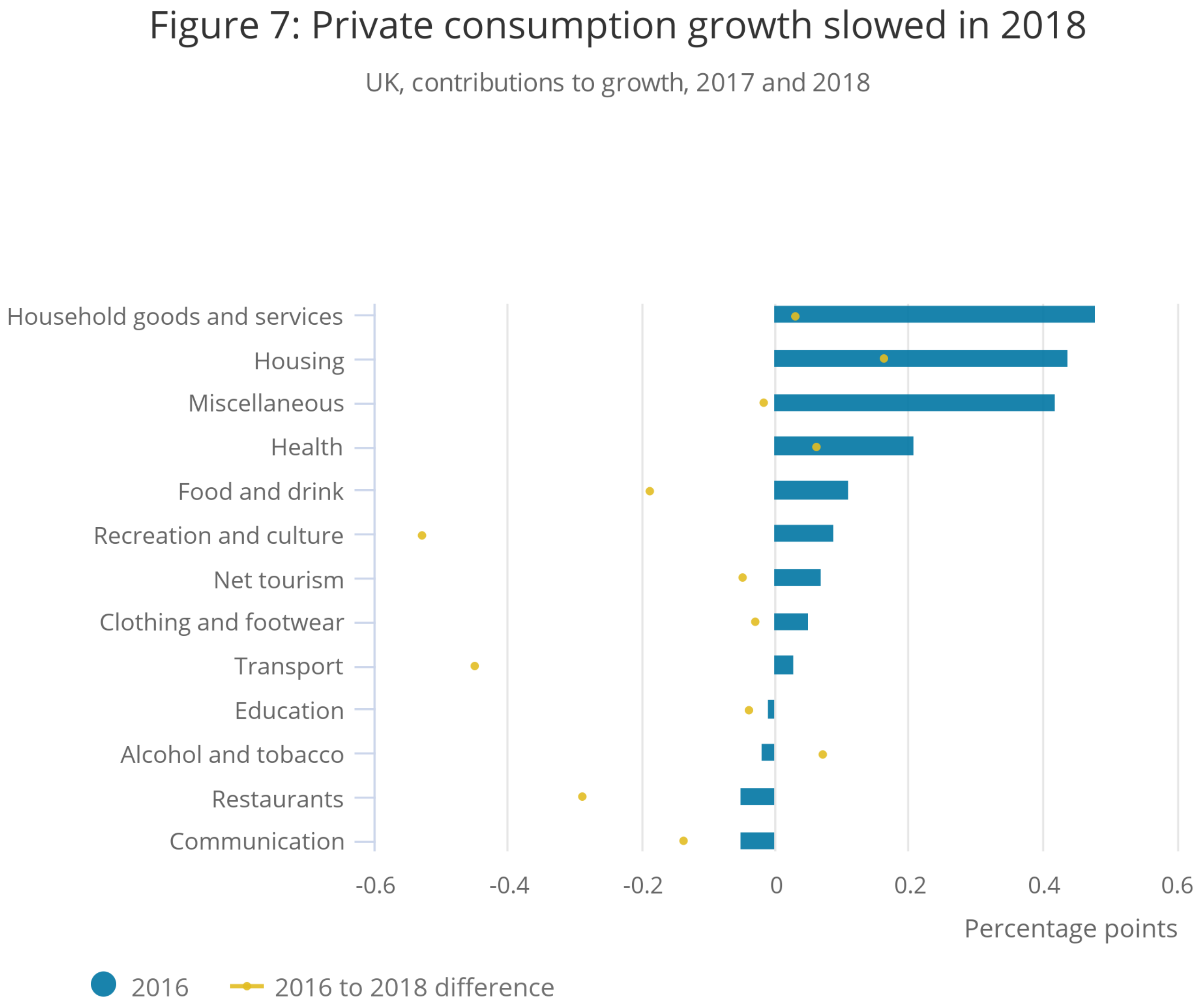
In Quarter 4 2018, growth in household consumption slowed slightly to 0.3%. Spending on housing and household goods and services were the main drivers in the latest quarter.

The latest GfK Consumer Confidence figures highlight that confidence continued to be somewhat subdued, as views on the general economy over the past 12 months and the economic outlook for the year ahead continues to weigh heavily. Visa's UK Consumer Spending Index (PDF, 1.0MB) provides more timely information on household spending, with the latest figures showing that overall spending fell by 1.8% on the year in February 2019. This is the fifth consecutive month in which spending has fallen.

Having slowed through the second half of 2018, in part reflecting the pick-up seen over the summer because of the warm weather, the volume of retail sales increased by 0.7% in the three months to February 2019. The recent business surveys show a more muted picture, as the British Retail Consortium reported a slowing in the year to February where it is likely that uncertainty had driven a "cautious approach to retail spending", while the Confederation of Business Industry reported that sales were flat on the year to February.

Figure 7: Private consumption growth slowed in 2018

UK, contributions to growth, 2017 and 2018



Source: Office for National Statistics - Quarterly National Accounts: October to December 2018

Government consumption increased by 1.3% in the final three months of 2018, with a significant contribution from increased defence spending. Expenditure in these areas has been lower across this financial year compared with previous years. However, the latest estimates show that there has been a pick-up in such spend.

Business investment has now fallen for four consecutive quarters – the first such instance since 2009 – mainly driven by declines in transport equipment as well as IT equipment and other machinery.

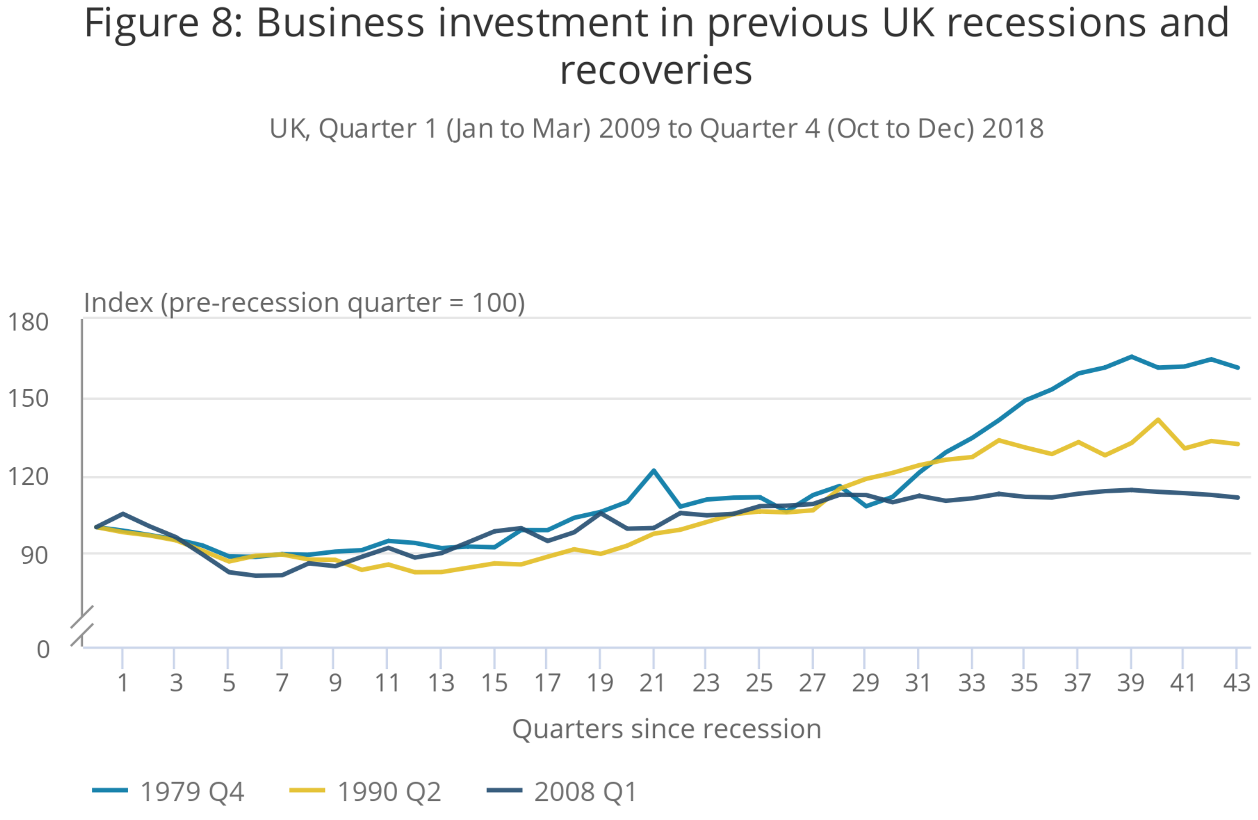
The latest estimates show that there have been some upward revisions in the second half of 2018, with business investment now estimated to have fallen by 0.9% in Quarter 4. These revisions to the quarterly path have resulted in an upward revision to the annual figure with business investment falling 0.4% in 2018. The Bank of England Inflation Report (PDF, 4.2MB) states that this weakness appears to "primarily reflect Brexit and associated uncertainty", also echoed in the Quarter 4 Decision Makers' Panel, which highlights the UK's EU exit as one of the top sources of uncertainty.

The latest Deloitte CFO Survey (PDF, 899KB) reports that perceptions of economic and financial uncertainty continued to rise in the final quarter of 2018 while the outlook for capital expenditure has deteriorated. Recent analysis (PDF, 609KB) finds that "almost 70% of the slowdown" in business investment could be accounted for by EU exit. The findings from the latest Decision Makers' Panel findings that the proportion of businesses for which the UK's EU exit was considered one of the main sources of uncertainty increased further in the three months to January 2019.

Figure 8 provides some historical context for the recent weakness in business investment, showing its path following each of the last three UK recessions. In contrast to previous episodes, it appears that businesses have held back on capital spending at a point in the cycle where previous historical episodes would point to a pick-up.

Figure 8: Business investment in previous UK recessions and recoveries

UK, Quarter 1 (Jan to Mar) 2009 to Quarter 4 (Oct to Dec) 2018



Source: Office for National Statistics - Quarterly National Accounts: October to December 2018

Notes:

1. Estimates of business investment prior to 1997 are indicative only due to the basic method of calculation and other limitations in the methods used for compiling this dataset.

Government investment increased by 0.5% in Quarter 4 2018, revised down due to updates from central government. There were also revisions to the quarterly path in 2018, partly reflecting revisions from local government due to updated data for Crossrail. Overall, this has led to an upward revision in general government investment growth figure to 1.5% in 2018.

Alignment adjustments and balancing adjustments are typically applied to the inventories component to help balance the different approaches to GDP. The adjustments to inventories in Quarter 4 2018 were larger than usual, reflecting weakness in the expenditure approach to measuring GDP.

There was a £4.2 billion increase in inventories in Quarter 4 2018, including these adjustments. However, excluding these adjustments, the estimates show a slight decrease of £1.2 billion in stocks being held by UK companies. This is in contrast to a range of business surveys, which have recently reported a marked increase in building up inventories in preparation for any potential disruptions to supply chains.

For instance, the latest UK Manufacturing Purchasing Managers' Index (PDF, 149KB) points towards record-high levels of an expansion in input inventories, as "almost 70% of the companies offering a reason behind the build-up of stocks attributed to Brexit". The latest Agents' Update on Business Conditions also finds evidence that UK businesses are stockpiling in preparing for the UK's EU exit. Around two-fifths of those businesses that were preparing for the UK's EU exit reported to be building up their stocks of inventories, with some evidence pointing to contacts "building inventories of up to three-times normal levels". That said, this was not necessarily expected to provide a boost to GDP growth, as many of those inventories had been imported.

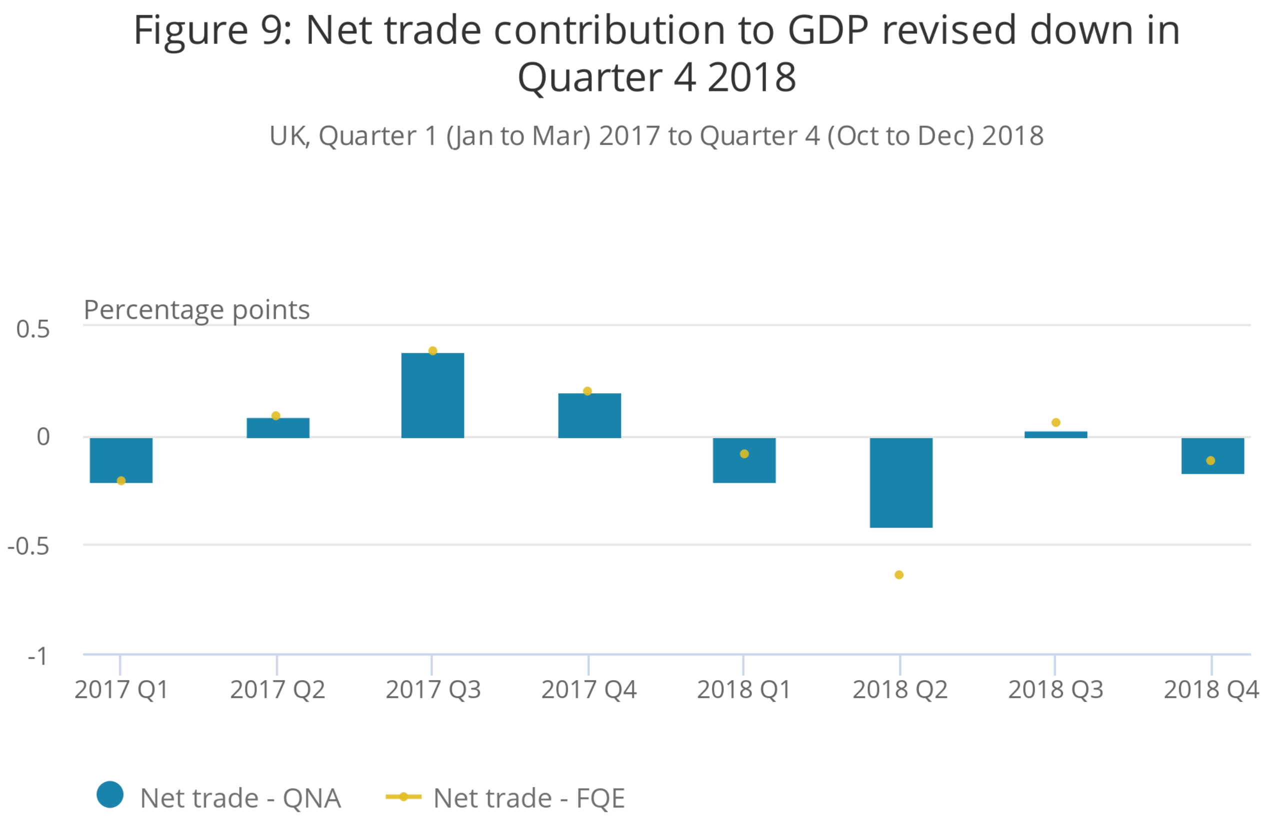
There have also been revisions to the latest estimates of non-monetary gold (NMG), which is recorded within the national accounts as a change to valuables and in trade in goods. Movements in NMG do not affect headline GDP as these are recorded as equivalent offsetting impacts, but this is reflected in contributions to GDP growth. There was a sizeable export of NMG in Quarter 4 2018, reflected in an offsetting fall in the acquisition less disposal of valuables, which helps explain the size of the contribution of gross capital formation. Despite this NMG movement, net trade made a negative contribution to GDP growth in the last three months of 2018.

There have been notable revisions to the volume estimates of export and import flows through 2018, which in part reflect revisions to the International Passenger Survey (IPS) estimates on personal travel. The estimates in the first quarter of the year have been revised down, although there have been offsetting revisions through the rest of the year. This is reflected in the latest net trade contributions (Figure 9). The overall impact is that the narrative on external rebalancing is largely unrevised for 2018.

In its latest [Economic and Fiscal Outlook (PDF, 3.7MB)](), the Office for Budget Responsibility cite the softening in world trade growth. There has also been a downward revision to its outlook for UK export market growth, as the weaker world trade picture has been concentrated in advanced economies, which comprise a higher share of UK exports.

Figure 9: Net trade contribution to GDP revised down in Quarter 4 2018

UK, Quarter 1 (Jan to Mar) 2017 to Quarter 4 (Oct to Dec) 2018



Source: Office for National Statistics - Quarterly National Accounts: October to December 2018

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

Income

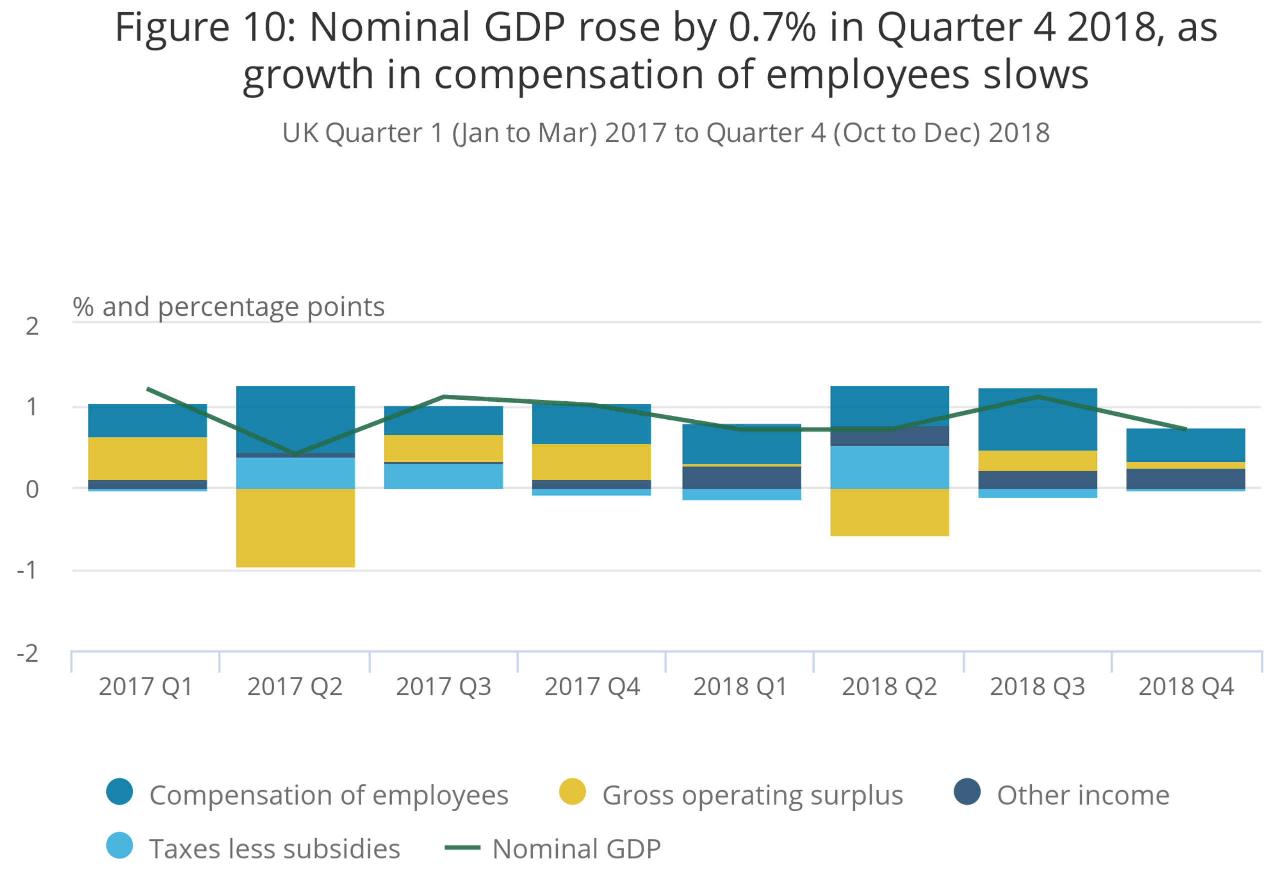
Nominal GDP grew by 0.7% in Quarter 4 2018, revised up from 0.6% (Figure 10). There have been some revisions throughout 2018, which have resulted in an upward revision to nominal GDP growth for the year. The latest estimates now show that nominal GDP increased by 3.3% in 2018, still reflecting a slowing in growth from the previous year.

Growth in compensation of employees (CoE) slowed to 0.8% in Quarter 4 2018. This reflects a slowdown in the growth of wages and salaries, and a fall in employers' contributions to private pension schemes following increases in the previous two quarters.

Gross operating surplus (GOS) has been revised in 2018 with the latest estimates showing a slowdown to growth of 0.1% – a weaker picture for the year. There have been revisions to the quarterly path throughout 2018 reflecting improved data on financial services and updated survey estimates, with today's (29 March 2019) estimates showing an increase of 0.4% in Quarter 4. This is a marked upward revision from the previous estimate of a 0.8% fall. Other income increased by 1.4% in Quarter 4, in line with the quarterly profile of 2018.

Figure 10: Nominal GDP rose by 0.7% in Quarter 4 2018, as growth in compensation of employees slows

UK Quarter 1 (Jan to Mar) 2017 to Quarter 4 (Oct to Dec) 2018



Source: Office for National Statistics – Quarterly National Accounts, UK: October to December 2018

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

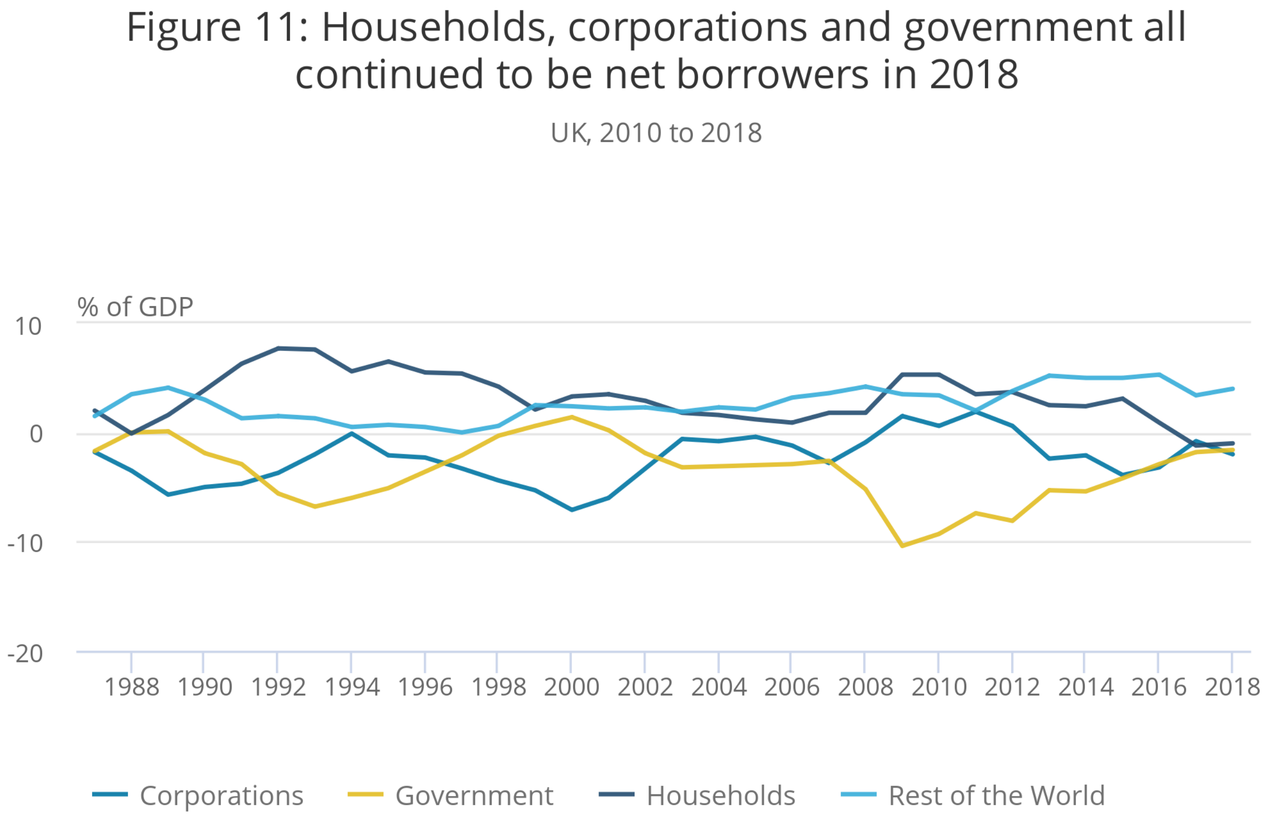
3 . Sector and financial accounts

Figure 11 shows the net lending or borrowing positions of households (including non-profit institutions serving households), corporations, government and the rest of the world. These must sum to zero, as total borrowing must be matched by total lending.

Recent trends have shown households, corporations and government have had to borrow or run down their savings to finance their spending and investment, as each of the domestic sectors in the UK are now net borrowers. In 2018, this was equivalent to 1.0% of gross domestic product (GDP) for households (including non-profit institutions serving households), 2.0% for corporations and 1.6% for government. As such, the rest of the world continues to be a net lender to the UK to finance these net borrowing positions.

Figure 11: Households, corporations and government all continued to be net borrowers in 2018

UK, 2010 to 2018



Source: Office for National Statistics – Quarterly Sector Accounts, UK: October to December 2018

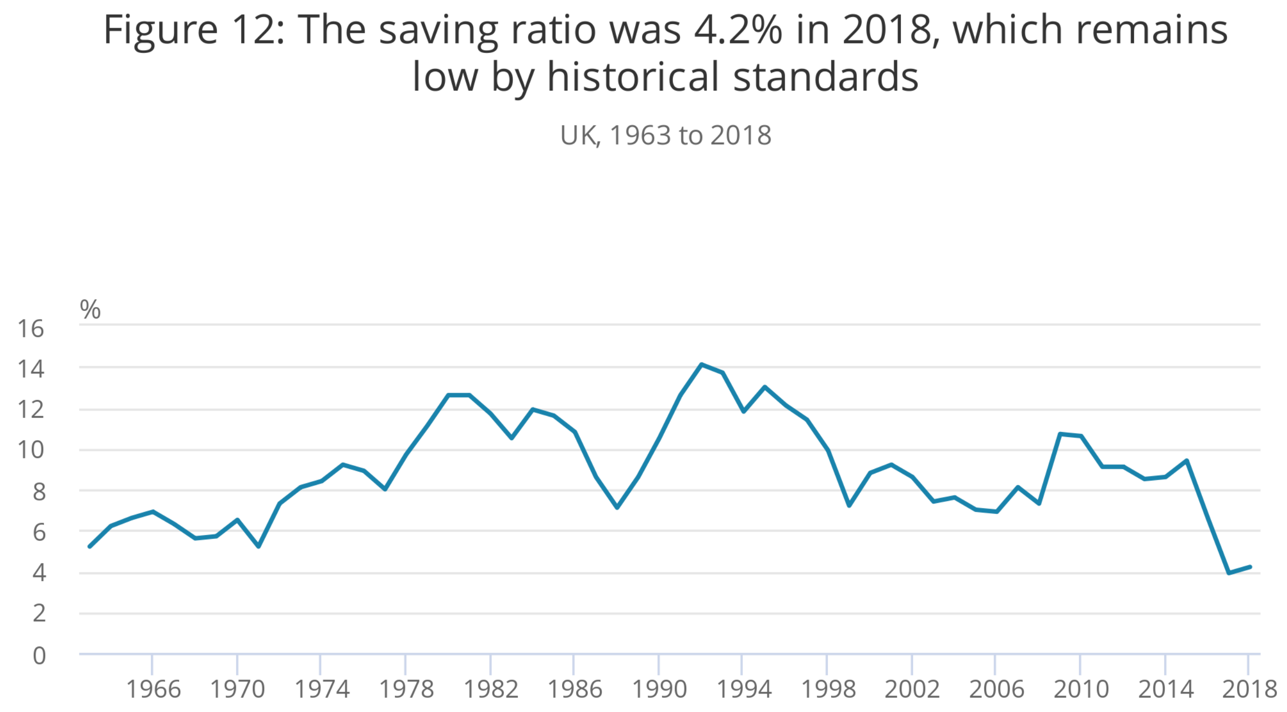
Households have traditionally been a net lender. However, in recent times that has not been the case, as households have now been net borrowers for the ninth consecutive quarter, which is an unprecedented run. Whilst early estimates can be prone to revision, the underlying downward trend provides a clear reflection that households have recently saved less to support spending in the face of the squeeze in real incomes. Household net borrowing was 0.6% of GDP in Quarter 4 (Oct to Dec) 2018, an improvement from 1.1% in the previous quarter, reflecting an increase in wages and salaries.

In 2016, households financed their borrowing through long-term loans and the disinvestment in mutual funds. More recently, there has been a sharp drop in deposits made to UK banks by households, while the net acquisition of long-term loans and the disinvestment in mutual funds continued throughout this period to help fund households' net borrowing.

This has also been reflected in the household saving ratio, which has been on a downward trend in recent years. Having peaked at 10.7% in 2009 following the effects of the financial crisis as households rebuilt their financial positions, the saving ratio has trended downwards, which has been particularly pronounced in the last couple of years. This reached a record low of 3.9% in 2017. Whilst there has been a slight increase to 4.2% in 2018, this is still low by historical standards – the saving ratio in 2017 and 2018 are the two lowest since records began in 1963 (Figure 12).

Figure 12: The saving ratio was 4.2% in 2018, which remains low by historical standards

UK, 1963 to 2018



Source: Office for National Statistics – Quarterly Sector Accounts, UK: October to December 2018

More timely figures from the Bank of England show that consumer credit growth continued to slow, easing to 6.5% in the year to January 2019. Although these figures can be somewhat volatile, there is an underlying trend of a slowing in consumer borrowing, where consumer credit growth reached its peak of 10.9% in November 2016. Credit card lending growth slowed to 6.7% over the 12 months to January 2019, whilst growth in other loans and advances ticked up from 6.3% to 6.4%.

There was an increase in the net borrowing of corporations in Quarter 4 2018, which increased from 2.6% in the previous quarter to 3.0% of GDP, reflecting increased net borrowing by private non-financial corporations (PNFC) and financial corporations.

Given that there has been survey evidence that political uncertainty has weighed on investment, it might have been expected that PNFCs would have seen a fall in their net borrowing. However, in the latest quarter, PNFCs' net borrowing remained at 2.0%, the highest since Quarter 3 (July to Sept) 2016. This partly reflected a continued fall in incomes, specifically distributed income received, most of which is dividends. There was also an increase in expenditure on inventories, although it should be noted that these have been subject to alignment and balancing adjustments in the latest estimates of GDP.

In 2018, PNFC net borrowing was mainly financed by a draw-down in deposits, as there was an easing in the reliance on loans. Businesses can raise money by borrowing from banks or from financial markets.

General government was a net borrower in Quarter 4 2018 of 1.5% of GDP. In the latest Economic and Fiscal Outlook (PDF, 3.7MB), public sector net borrowing (PSNB) is now forecast to be 1.1% of GDP – or £22.8 billion – this financial year. This is a slight improvement from the previous forecasts, reflecting higher Income Tax receipts and lower debt interest spending, due to lower market expectations of future interest rates. The Office for Budget Responsibility (OBR) notes this is “only the fifth time that revisions to receipts and debt interest spending have pushed borrowing in the same direction in the 19 forecast revisions since June 2010”.

The updated forecasts provide additional headroom against the fiscal mandate from the OBR (PDF, 3.7MB), which requires the structural budget deficit to lie below 2% of GDP in the financial year ending 2021. That said, the upcoming changes in the accounting treatment of student loans are not reflected in the forecast. The OBR estimates that reflecting the changes could increase the structural budget deficit by around 0.5% of GDP in the financial year ending 2021, which would “absorb almost half the government’s current headroom of 1.2% of GDP against the fiscal mandate”.

The latest official figures show that PSNB continues to fall in the financial year ending 2019, as it reached its lowest year-to-February for 17 years. PSNB in the first 11 months of the financial year was £23.1 billion, which is £18.0 billion lower compared with the same period a year earlier. This reflected a broad-based increase in tax receipts and lower debt interest spending. Net debt was 82.8% of GDP as of the end of February 2019, which was 1.4 percentage points lower than a year earlier.

4 . Balance of payments

The UK runs a current account deficit, which captures the extent to which the UK is borrowing from the rest of the world, so that it can finance these overall net borrowing positions of households, corporations and government. This has widened to levels that are high by historical and international standards, reaching 5.2% of gross domestic product (GDP) in 2016.

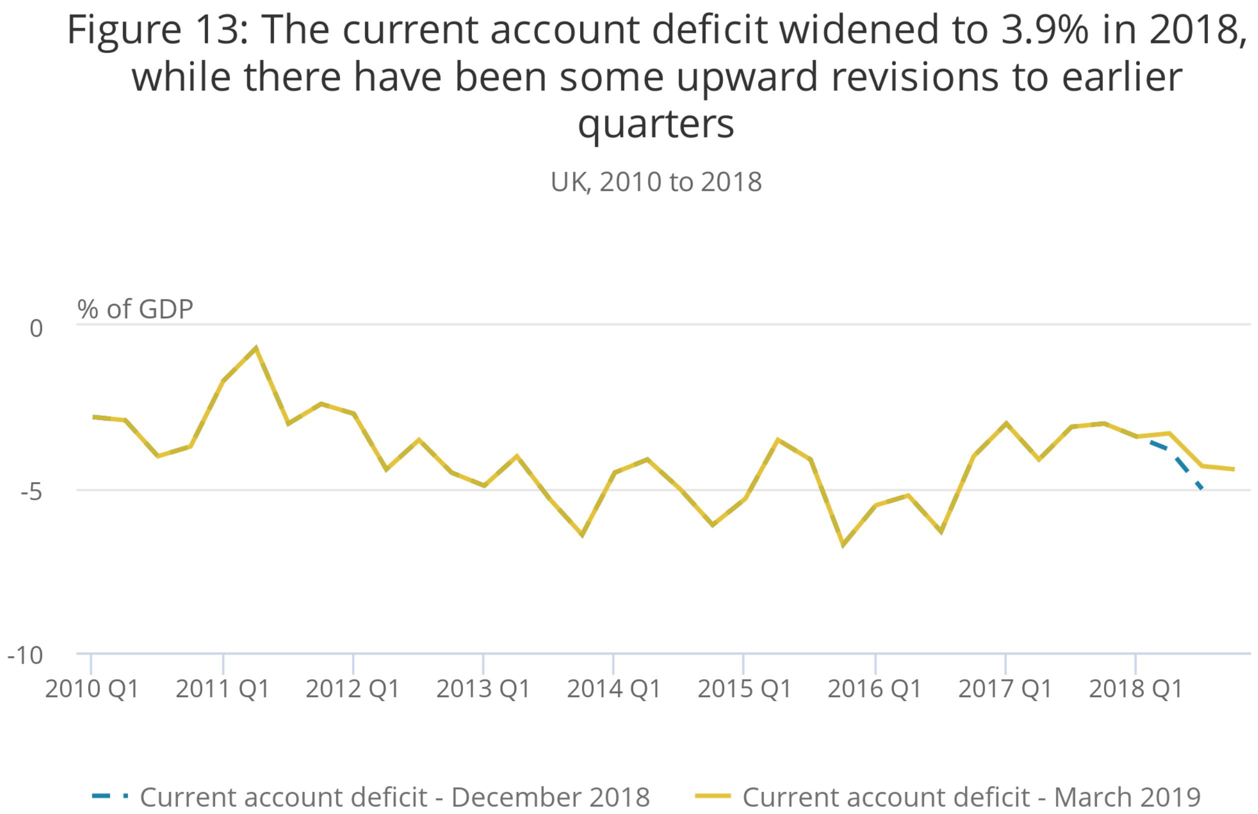
This has raised concerns around whether the UK can rely on record-high levels of external financing to help fund its domestic expenditure. These concerns have been further heightened by the uncertainty over the future of the UK’s trading arrangements. In periods of increased uncertainty, foreign investors may be less willing to invest in the UK, and if this were to happen this could potentially lead to a “sharp fall in sterling, bringing about a more abrupt demand-led narrowing of the current account deficit” (see Office for Budget Responsibility (PDF, 3.7MB), 2019 for more information).

There was a narrowing of the current account deficit in 2017, which is likely to have reflected the effects of a pick-up in the global economy and the effect of a fall in the exchange rate. More recently, there has been a slowing in the world economy and world trade, which may have impacted on gross trade flows in the UK.

The first estimates for 2018 show that there has been a widening in how much the UK is reliant on external financing – specifically in the second half of the year – reaching 3.9% of GDP. This also incorporates revisions to earlier quarters in 2018, which show the UK is less reliant on external financing than previously estimated (Figure 13). This largely reflects that the UK is now estimated to have received more investment income on its foreign direct investment. The UK ran a current account deficit of 4.4% in the final quarter (Oct to Dec) of the year, broadly in line with the previous revised quarter. These updated estimates show that the current account deficit is the widest it has been since Quarter 3 (July to Sept) 2016, though early estimates can be prone to revision.

Figure 13: The current account deficit widened to 3.9% in 2018, while there have been some upward revisions to earlier quarters

UK, 2010 to 2018



Source: Office for National Statistics - Balance of Payments, UK: October to December 2018

As the rest of the world is a net lender to the UK, this borrowing must be financed by net financial inflows. This can be achieved by increasing liabilities to the rest of the world and/or disinvesting in previously-owned foreign assets.

Figure 14 shows how the UK's current account deficit has been financed in recent years, providing some historical context around the size of these flows. Between 2012 and 2015, the UK's external borrowing was overall being financed by UK investors selling more of their external assets than foreign investors selling their UK assets. This overall financing position has since reversed between 2016 and 2018, resulting in a large volume of foreign inflows – that is, an increase in the accumulation of financial liabilities. The latest Bank of England Financial Stability Report (PDF, 6.7MB) highlights this reliance on external financing as a risk to financial stability, noting that "sharp falls in foreign investor appetite for UK assets could lead to falls in UK asset prices and a tightening in domestic credit conditions".

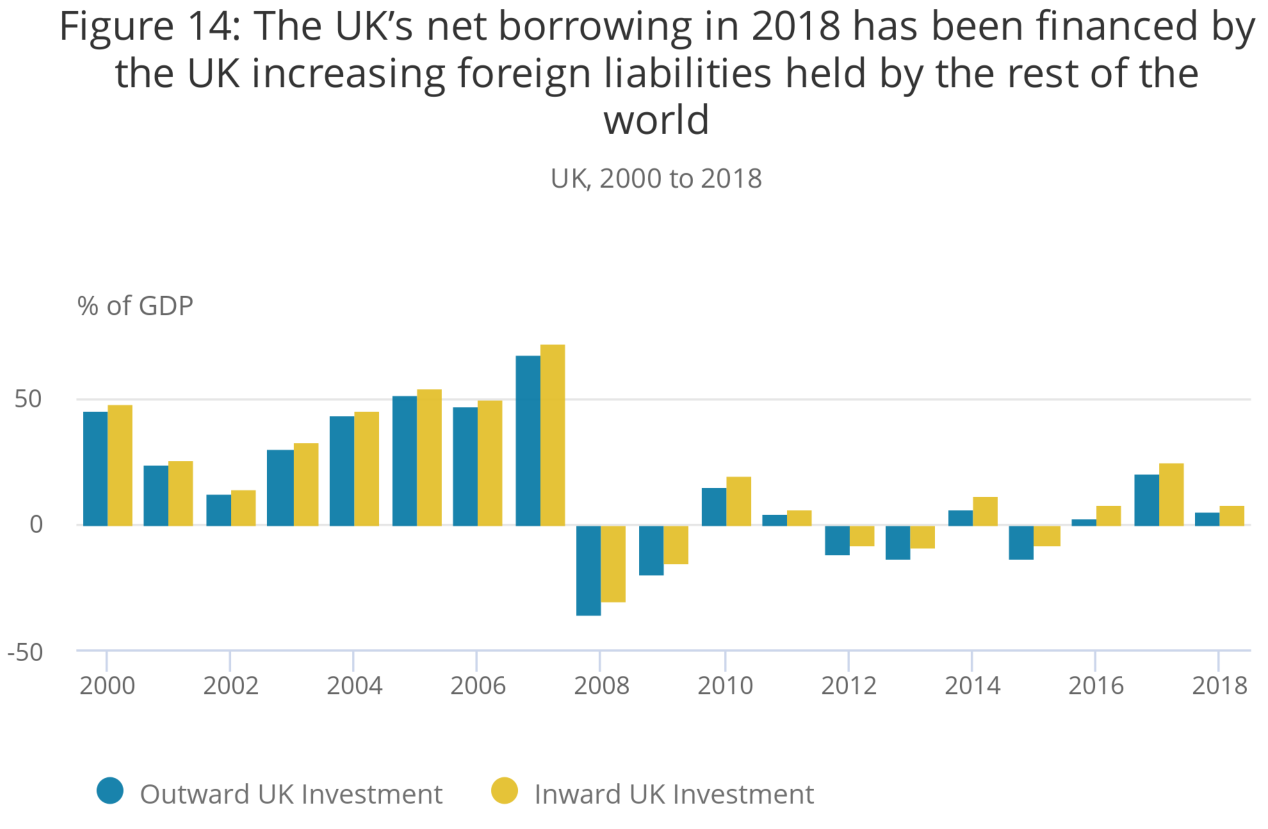
Financial flows in and out of the UK tend to be particularly volatile – and this has been particularly evident in 2018, where there have been pronounced swings in the flows of capital between the UK and the rest of the world. This has also been complicated by a range of factors that might be affecting the pattern of capital flows. For instance, some respondents have cited EU exit uncertainty as the reason for restructuring their holdings of overseas portfolio equity and debt securities, and inward foreign direct investment in Quarter 4 2018. However, there have also been a range of other factors at play, including falling global equity markets, heightened trade tensions, while there have also been longer-term merger and acquisition decisions undertaken by large multinational enterprises.

Previously, there have been some very tentative signs that there might have been a change in how the UK's reliance on net capital inflows has been financed, as there had been successive quarters of a divestment of the net acquisition of financial assets and the net incurrence of financial liabilities. As such, the UK's net borrowing has been financed by it disinvesting in previously-owned foreign assets. However, this position was reversed in the final quarter of the year, with a large net inflow of foreign investment into the UK.

There were large flows of other investment, which tends to be the most mobile form of capital – for instance, these comprise loans and deposits. However, there has also been a large net outflow of UK investment into the rest of the world, again reflecting large flows of other investment. In Quarter 4 2018, there was a net inflow of portfolio investment to finance the current account deficit. This helps explain why it has been the case that the UK's reliance on external financing in 2018 has been financed by the UK increasing the foreign liabilities that are held by the rest of the world. That said, the large volatile movements in 2018 imply that some caution is advised given the inherent volatility in these flows.

Figure 14: The UK's net borrowing in 2018 has been financed by the UK increasing foreign liabilities held by the rest of the world

UK, 2000 to 2018



Source: Office for National Statistics – Balance of Payments, UK: October to December 2018

Despite incurring an increase in flows of net liabilities in Quarter 4 2018, there has been a slight improvement in the UK's net international investment position (NIIP). The UK recorded a net liability position of 6.7% of GDP at the end of 2018. This improvement reflects revaluation effects, which capture the changes in the valuation of external assets and liabilities but when there is no change in the underlying stock. These can reflect changes in the exchange rate and/or equity prices.

For instance, there was a marked improvement in the NIIP in 2016, where the UK's net liability position improved from 20.1% to 2.4% of GDP over the year, largely reflecting the effects of the fall in the exchange rate where there was a bigger improvement in the sterling value of UK's external assets, where a higher relative share was denominated in foreign currency. In its latest assessment, the Office for Budget Responsibility (PDF, 3.7MB) notes that that UK's net liability position is "modest" as a share of GDP, reducing the risk of the UK running a large current account deficit.

5 . Labour market

Despite the slowing in the UK economy in recent months and survey evidence pointing to EU exit uncertainty weighing on the willingness of businesses to invest in capital in 2018, there appears to be little sign that this uncertainty is adversely impacting on the UK labour market.

Employment rose by 222,000 in the three months to January 2019, the largest quarterly increase in hiring since late 2015, as the employment rate hit a record high of 76.1%. This was driven primarily by a fall in the number of economically inactive people, which fell by 117,000 over this period. The number of unemployed people also fell in these three months, with the unemployment rate falling to 3.9% – its lowest level since January 1975 (Figure 15).

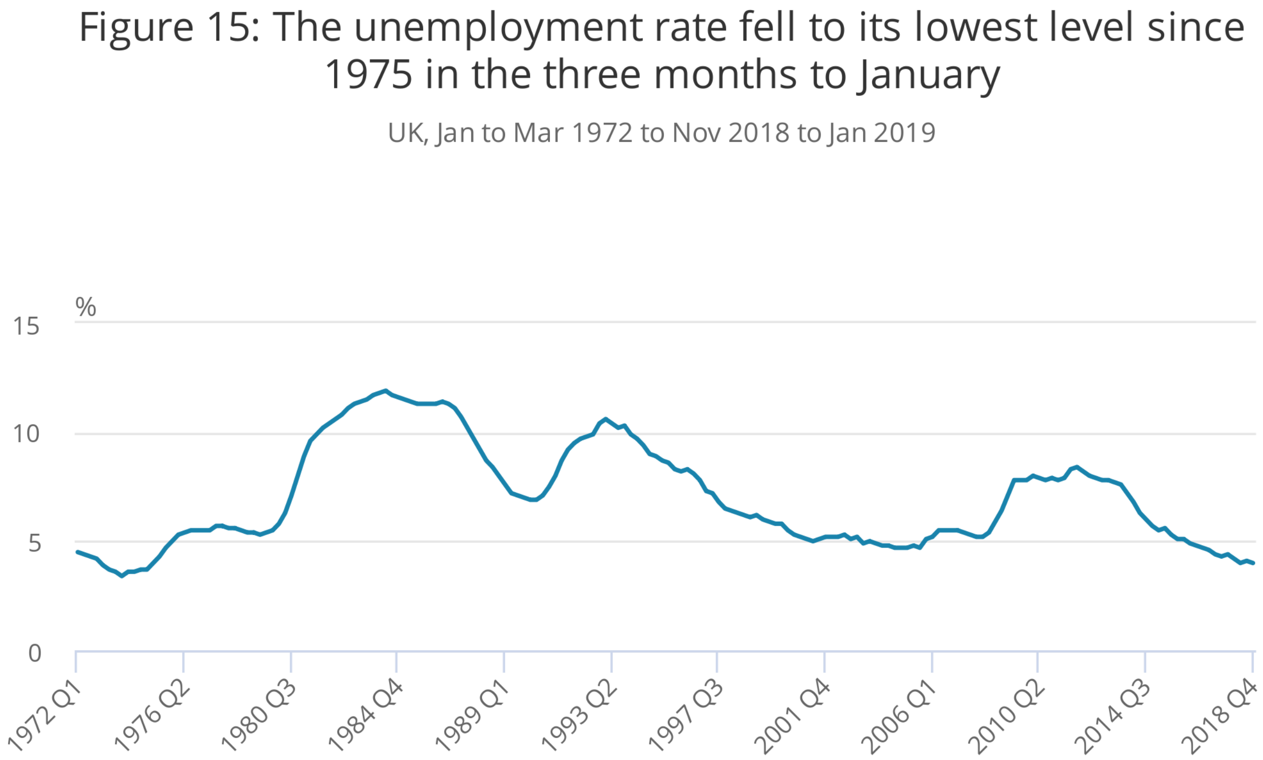
When there is limited spare capacity in the labour market, employers are expected to offer higher wages as they compete over a smaller pool of available labour resource. The unemployment rate is now slightly below some estimates of the natural rate of unemployment – including those by the Bank of England (PDF, 4.3MB) and the Office for Budget Responsibility (PDF, 3.7MB) – indicating a tight labour market.

Furthermore, the unemployment-to-vacancies ratio is now at its lowest level on record. Vacancies provide a measure of the difficulty with which employers would be able to fill jobs. If there are relatively few unemployed people to the number of vacancies available, it would point to there being a tight labour market. There have been increasing signs that this tightness is now showing up in higher nominal wage growth.

In the year to the three months to January 2019, regular pay increased by an unchanged 3.4% – the fastest increase since November 2008. Real regular wage growth increased by 1.4% over the same period, the fastest rate since 2016 when inflation was subdued. The latest analysis by the [National Institute of Economic and Social Research (PDF, 280KB)] estimates that regular pay growth will stabilise at 3.5% in Quarter 1 (Jan to Mar) of this year and that this will add to domestic inflationary pressure, given the weak productivity outlook.

Figure 15: The unemployment rate fell to its lowest level since 1975 in the three months to January

UK, Jan to Mar 1972 to Nov 2018 to Jan 2019



Source: Office for National Statistics - Labour market overview, UK: March 2019

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

The strength in the labour market is in contrast to some survey evidence. For instance, the latest Report on Jobs by the [Recruitment and Employment Confederation (PDF, 180KB)] (REC) finds evidence that heightened economic uncertainty has been weighing on hiring and staff availability, as labour “supply continued to fall markedly in February, while staff vacancies expanded at the slowest rate for nearly two-and-a-half years”. There is also evidence of softer survey evidence from the latest [UK Manufacturing Purchasing Managers’ Index (PDF, 149KB)], which reported the fastest rate of job losses in six years. A similar picture was painted by the latest [UK Services Purchasing Managers’ Index (PDF, 164KB)], where “employment numbers declined at the fastest pace for over seven years as businesses opted to delay staff hiring in response to subdued demand and concerns about the near-term economic outlook”.

6 . Prices

The latest figures show that 12-month Consumer Prices Index including owner occupiers' housing costs (CPIH) inflation was 1.8% in February 2019, unchanged from January 2019.

There was a broad-based increase in prices in the year to February – the one exception was clothing and footwear, where consumer prices fell in the year to February. Prices for these tend to rise in this month following the January sales. However, while this did take place in February, it was at a lower rate than a year ago.

The contribution of energy prices to CPIH has also fallen in recent months, in part reflecting the introduction of Ofgem's energy price cap in January. Also, oil prices rose steadily for much of 2018, before a sharp fall in the last quarter of 2018. Consumer Prices Index (CPI) inflation rose slightly in February from its two-year low in the previous month.

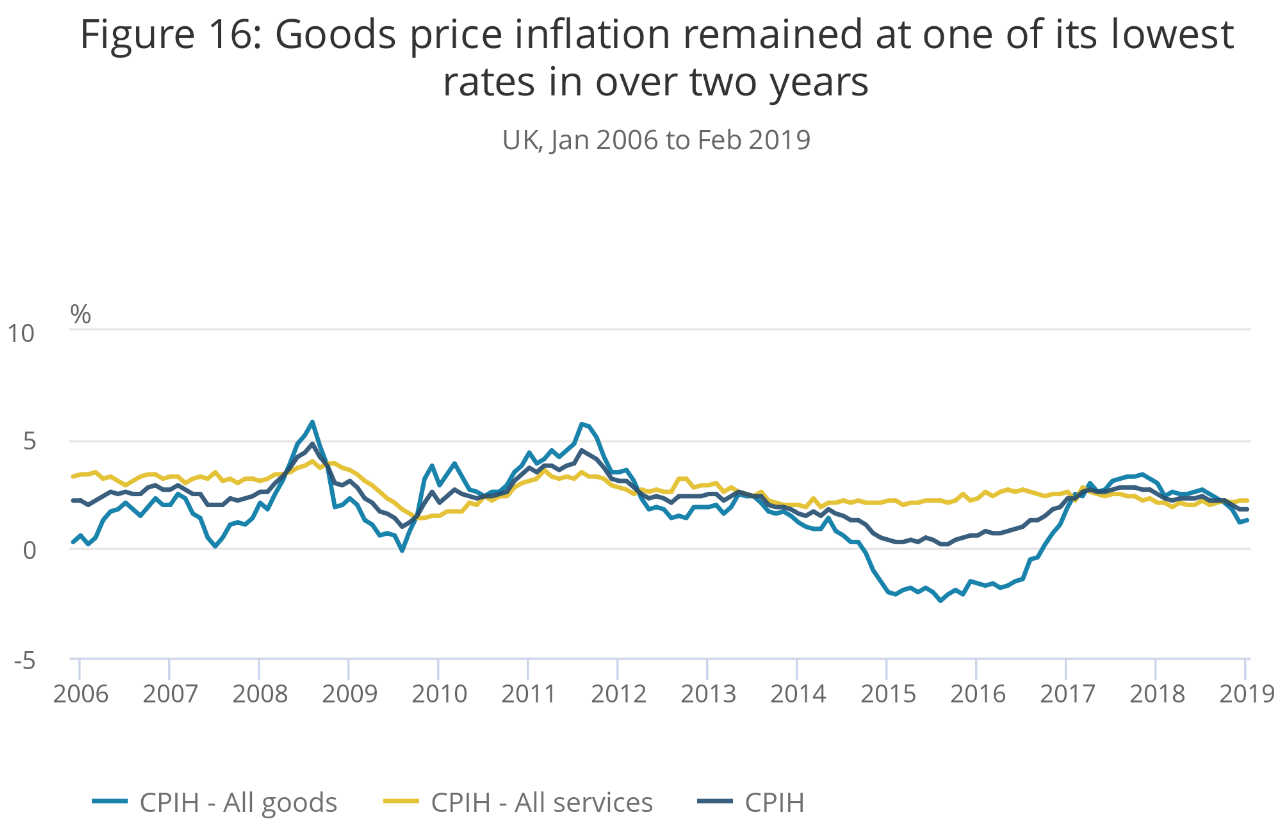
This was the first rise in inflation since August 2018. That said, the unrounded figures show that there was little change on the month.

CPIH goods price inflation ticked up slightly to 1.3% on the month, which remains one of its lowest rates in the last couple of years (Figure 16). This likely reflects the fading effects of import inflation, as goods tend to be imported much more than services.

The sterling value of goods and services in imported final and intermediate demand initially increased following the fall in the exchange rate after the outcome of the referendum on membership of the EU. However, these effects are now reflected in the price level of a year ago, so goods price inflation has fallen back of late. This is reflected in a steady fall in the contributions to CPIH of those components that have an import content of at least 40%. In contrast, services price inflation tends to be considered a proxy for domestic inflationary pressure, which was unchanged on the month at 2.2%.

Figure 16: Goods price inflation remained at one of its lowest rates in over two years

UK, Jan 2006 to Feb 2019



Source: Office for National Statistics - Consumer Price inflation, UK: February 2019

7 . Conclusions

The latest estimates show that growth of the UK economy slowed to 0.2% in the final quarter of the year. UK gross domestic product (GDP) increased by an unrevised 1.4% in 2018, which is the weakest annual growth rate since the effects of the financial crisis in 2009. There are also signs that global momentum has weakened recently, with the majority of G7 countries experiencing a slowdown in activity in 2018. The UK was the fifth-fastest growing advanced economy last year, ahead of Japan and Italy.

The rest of the world continues to be a net lender to the UK, with each of households, corporations and government being net borrowers. Recent trends highlight how households have become net borrowers, though there was an improvement in the final quarter of 2018 reflecting a pick-up in wages and salaries. The household saving ratio remains low by historical standards, reaching 4.2% in 2018. There was a fall in distributed income received, most of which is dividends, which increased the net borrowing requirements of private non-financial corporations to finance their expenditure. The current account deficit was 4.4% of GDP in Quarter 4 (Oct to Dec) 2018, financed by a large net inflow of other investment into the UK, which tends to be the most mobile form of capital.

There are no clear signs of uncertainty weighing on the labour market, as the tightness can be seen in a range of labour market indicators. The employment rate reached a record high of 76.1% in the three months to January 2019, while the unemployment rate fell to 3.9% – its lowest level since January 1975. There have been increasing signs that this trend is now showing up in higher nominal wage growth, which increased by 3.4% in the three months to January – the fastest increase since November 2008.

The 12-month Consumer Prices Index including owner occupiers' housing costs (CPIH) inflation rate was 1.8% in February 2019, unchanged from January 2019. The contribution of energy prices to CPIH has also fallen in recent months, in part reflecting the introduction of Ofgem's energy price cap in January. Also, oil prices rose steadily for much of 2018, before a sharp fall in the last quarter of 2018. The rate of CPIH goods price inflation ticked up slightly to 1.3% on the month, which remains one of its lowest rates in the last couple of years. The rate of services price inflation, which tends to be considered a proxy for domestic inflationary pressure, was unchanged on the month at 2.2%.