



# Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



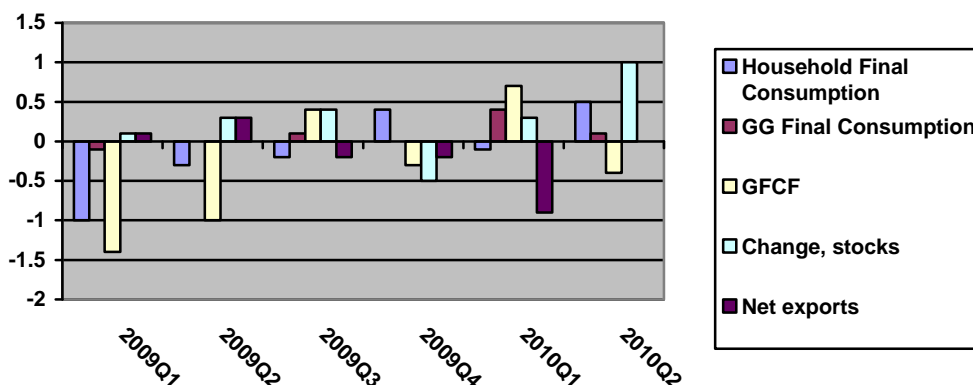
**The second quarter GDP figure was erratically good:  
slower growth ahead**

*Introduction: an erratic second quarter GDP figure*

Revised GDP data for 2010Q2 showed a quarterly increase of 1.2%, revised up from the preliminary estimate of 1.1%, which in itself was higher than expected.<sup>1</sup> The increase in 2010Q1 had been just 0.3%. Inspection of the data suggests that the 2<sup>nd</sup> quarter figure was an erratically, well-above trend increase. On the industry side, construction had recorded an 8.5% jump after falling by 1.5% in the adverse weather affected 1<sup>st</sup> quarter.

On the expenditure side, much of the growth was driven by a sizeable turn-round in inventories (chart 1). They rose by nearly £1bn in the second quarter, compared with a fall of over £2bn in the first quarter. The cumulative turn-round of £3bn accounted for much of the increase in total GDP (£4bn). This behaviour in the “stocks cycle”, after a recession, is however quite usual. The key factor in the near-term is whether the other demand components will pick up the baton of growth from stocks and drive growth forwards sustainably. Elsewhere in the expenditure accounts, household spending contributed positively, after a weak first quarter, whilst there was a surprise fall in fixed investment (GFCF). Disappointingly there was no contribution to growth from net exports, after a very poor first quarter.

**Chart 1 Quarterly contribution to growth, expenditure components, GDP (%)**



Source: ONS, “UK output, income and expenditure”, 2010Q2, 27 August 2010. GG stands for General Government and GFCF stands for Gross Fixed Capital Formation (fixed investment).

### *Slower growth ahead*

There is very little hard data so far available for the 3<sup>rd</sup> quarter, but what there is suggests a return to more “normal” growth rates after the erratically buoyant 2<sup>nd</sup> quarter.<sup>2</sup> But of far greater economic significance than returning to normality after an erratic number, are the increasing expectations that underlying growth will soften in the second half of the year as households and businesses adjust to the prospects of fiscal consolidation.

Recent surveys show deteriorating optimism. According to the August Markit/YouGov survey household pessimism was greater than at any time since the end of the recession. 47% of households expected their finances to deteriorate over the next year.<sup>3</sup> Businesses too are less optimistic. According to the August ICAEW/Grant Thornton UK business confidence monitor, nearly a fifth of businesses were less confident about the coming year, compared with 14% in the first quarter of this year.<sup>4</sup> And the CIPS/Markit manufacturing PMI slipped in August.<sup>5</sup> The reasons for the falling confidence are not hard to find. Consumers expect a squeeze on incomes as higher taxes and job losses bite, while businesses expect spending cuts to constrain demand, both directly and indirectly. The coalition government’s tough austerity language appears to be undermining confidence. Signs of a weaker US economy are adding to the negative sentiment.

### *The economic outlook: GDP*

Our latest GDP forecast (outlined in the table below) factors in slower growth for the second half of 2010 than experienced in the first half of 2010. It shows overall growth of 1½% for this year, partly driven by a turn-round in stocks and higher General Government expenditure. And it shows growth picking up to a relatively modest 2% to 2½% in 2011 and 2012. The outlook is of course clouded with uncertainty.

### **GDP and components, (constant prices, reference year 2006), annual growth rates (%), except inventory changes+**

	2009	2010f	2011f	2012f
Household final expenditure	-3.2	0.5 (0.2)	1.5 (1.3)	1.7 (1.7)
General Government expenditure	2.2	1.7 (1.7)	-1.1 (-1.1)	-2.0 (-2.0)
Gross fixed capital formation	-14.9	1.1 (-0.5)	4.0 (3.9)	5.5 (7.9)
Changes in inventories (£bn)	-£15.4bn	-£0.2bn	£3.0bn	£5.0bn
Total exports	-10.6	3.2 (4.3)	6.0 (5.5)	6.0 (6.3)
Total imports	-11.9	4.9 (5.6)	2.0 (2.1)	2.5 (2.7)
GDP, market prices	-4.9	1.5 (1.2)	2.2 (2.3)	2.3 (2.8)

+ Please note: (i) Household final expenditure includes non-profit institutions, (ii) Gross fixed capital formation includes acquisitions less disposables of valuables; (iii) the statistical discrepancy is omitted. The OBR’s post-Budget forecast is shown in brackets for most components, source: HM Treasury, *Budget 2010*, HC61, June 2010.

Turning to the individual expenditure components of GDP, household consumption is by far the largest component, accounting for over 60% of GDP. In the decade running up to the credit crunch, it grew by an average annual rate of over 3%, fuelled by a rapid take-up of easy consumer credit and driven by a booming housing market. There are several reasons for believing that there will be no replay of these growth rates in the near-medium term. And our forecast includes much more modest growth rates.

Firstly, even though the labour market data have been better to date than feared,<sup>6</sup> there is a very good chance that unemployment could start to rise again over the forecast period as the new government takes the axe to public employment (assuming it does). This will inevitably act as a dampener on consumer spending. Secondly, even for those in work, households are still repairing their balance sheets after overextending them. The saving ratio was negative in 2008Q1, but has since recovered to 6.9% (2010Q1). Housing equity withdrawal is still negative. And, even though we expect that much of the “repair job” to the balance sheets will be done over the next year, we do not expect any resumption of the credit boom prior to 2007, reflecting both demand and supply factors. Thirdly, higher taxes will depress people’s disposable incomes; the standard VAT rate is due to rise from 17.5% to 20% in January 2011. Fourthly, the strong possibility that prices inflation will outstrip earnings inflation over much of the forecast period (see below) will also squeeze real personal disposable income. Finally, evidence suggests that last year’s semi-recovery in the housing market, which supported some consumer spending, is running out of steam.

Government spending has been a strong driver of growth in recent years, but it will of course be curtailed over the next few years, as we have discussed in previous Perspectives.<sup>7</sup> Fiscal consolidation really begins to bite in 2011 and 2012. We are assuming that the Budget’s deficit reduction and spending cuts programmes will be achieved.

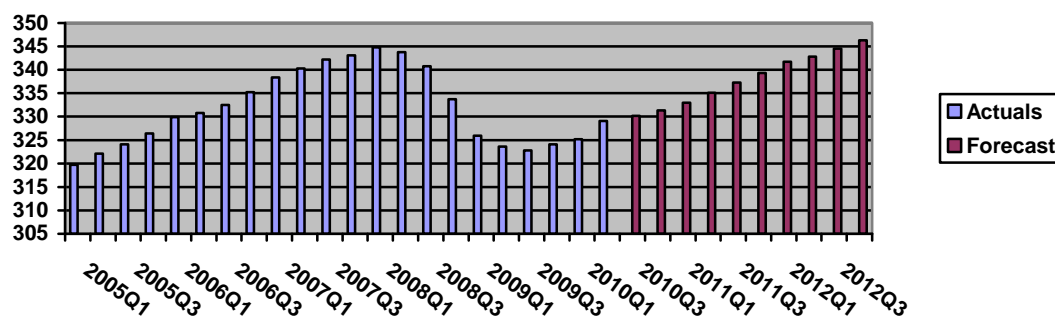
Our forecast for fixed capital investment is less optimistic than the OBR’s, despite the fact that the balance sheets and cash flows of large PLCs are remarkably strong at the moment. There will still be significant surplus spare capacity in the economy over the forecast period and this will act as a drag on private sector investment spending. Fixed investment spending tends to lag economic recovery for this very reason. Tight credit conditions are also likely to bear down on the investment decisions, more specifically for small and medium sized enterprises. Public sector fixed investment will almost certainly be severely cut back over the next few years. It is due to be cut by 25% between FY2010 and FY2014.

Following the precipitous fall in inventories in 2009, some positive stockbuilding resumed in 2010Q2, as we noted above. This should continue throughout the forecast period.

Finally, we expect the external sector to contribute to growth, with exports growth comfortably outstripping imports growth. The mid-1990s provide a precedent for this – though admittedly against a much more benign international background. Until recently the much desired “export-led recovery”, expected in the wake of the depreciated pound, showed few signs of materialising. The latest data were however more encouraging. June’s data showed exports growth exceeding imports growth, with the growth coming mainly from exports to non-EU countries. This improvement, we hope, will be sustained. Given the signs that the US is slowing down and the persistent doubts over the eurozone’s recovery (except for Germany), this part of the forecast is probably the most vulnerable.

Chart 2 shows the quarterly pattern for GDP since 2005. On the basis of our forecast we do not expect GDP to reach its 2008Q1 peak until the second half of 2012, such was the calamitous drop in GDP during the recession.

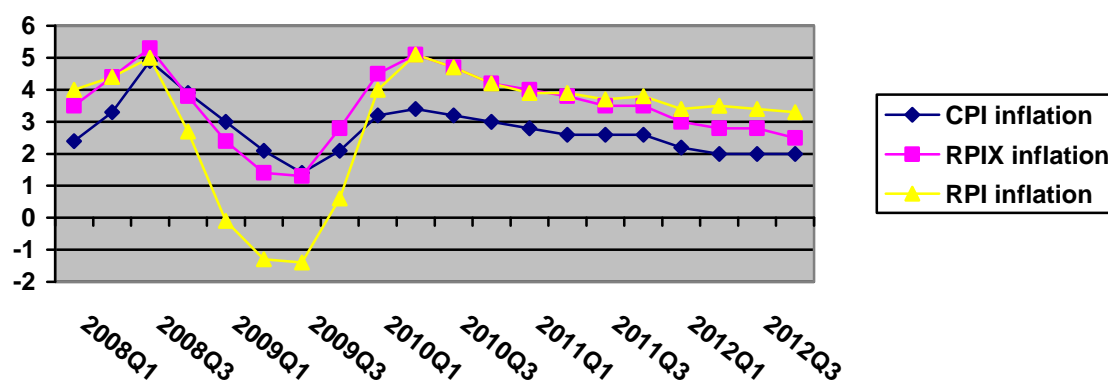
**Chart 2 GDP (constant prices, reference year 2006), quarterly data, £bn**



*The economic outlook: inflation and interest rates*

CPI inflation continues to run higher than the Bank’s 2% target and will probably continue to do so for the rest of this year and for much of 2011. The increase in the VAT rate from 17.5% to 20% in January 2011 has made this scenario an “almost certain” scenario. Increased commodity prices have also been driving inflation higher. But we expect CPI inflation to be back on target by 2012, when the base effects of the 2011 VAT increase and higher commodity prices will have dropped out of the annual calculation. (See chart 3.) If commodity prices fall in the meantime the target could well be achieved sooner. If, on the other hand, the VAT rate were to be increased again (in say 2012) and/or there was another bout of commodity prices inflation then the CPI could continue to run above target.

**Chart 3 Quarterly data for CPI, RPIX and RPI annual inflation rates (%): forecast from 2010Q3**



RPIX (RPI, excluding mortgage interest payments) and RPI inflation show a strong tendency to exceed CPI inflation, again as shown in chart 3. There are two main reasons for this:

- Coverage differences: in practice, the CPI's coverage is quite similar to the RPI. The main differences are in the area of housing costs. In particular, the CPI does not include council tax, as well as the following RPI categories relating to owner occupiers' housing costs: mortgage interest payments, house depreciation, buildings insurance, ground rent, and other house purchase costs (such as estate agents' fees and conveyancing fees). The RPIX excludes mortgage interest payments.<sup>8</sup>
- The "formula effect": the RPI uses an arithmetic mean at the lowest level of aggregation while the CPI uses a geometric mean.<sup>9</sup> According to the Royal Statistical Society, "over the last five years, according to the ONS press notice, the difference in the annual inflation rate due to the formula effect has never been less than 0.43 percentage points and has been as high (recently) as 0.86 percentage points. Over time this alone will make a substantial difference to the measured price level."<sup>10</sup>

Despite the overall pick-up in prices inflation over the last 12 months (though note it has slipped back since April) there are no signs of earnings inflation picking up. There is no sign of a "wage-price" spiral developing. In 2010Q2 total earnings annual inflation (including bonuses) was just 1.3%. Excluding bonuses it was only 1.6%. Moreover we expect earnings inflation to remain modest given the high, and possibly rising, unemployment. Under these circumstances, and given the deflationary impact on the economy of the forthcoming fiscal retrenchment, we expect interest rates to stay low. Indeed we would recommend that they should stay low.

Our forecast for the Bank Rate, incorporated in the forecast for RPI, is as follows:

- 2011Q2: increase from 0.5% to 0.75%.
- 2011Q4: increase from 0.75% to 1.0%.
- 2012Q2: increase from 1.0% to 1.5%.
- 2012Q4: increase from 1.5% to 2.0%.

Even at 2.0%, the Bank Rate is extraordinarily low by historic standards. It is also well below the conventionally-held 4.5% to 5.5% "neutral rate", the rate which acts neither to stimulate nor constrain growth. But there are two reasons why such a low rate looks feasible under the circumstances. Firstly, monetary policy will need to remain stimulatory to offset the fiscal tightening. Secondly, the spreads on lending rates have widened substantially relative to the base rate since the credit crunch. If the current increased spreads persist then the "neutral rate" could be as low as 2.5% to 3%.<sup>11</sup>

## References

1. ONS, "UK output, income and expenditure", 2<sup>nd</sup> quarter 2010, 27 August 2010.
2. NIESR has calculated that GDP increased by 0.9% in the three months ending in July. See "August 2010 GDP estimates", 6 August 2010, available from [www.niesr.ac.uk](http://www.niesr.ac.uk). The retail sales data for July, recording a 1.1% monthly rise, were however surprisingly strong.
3. FT leader, "Britain sings its economic blues", 31 August 2010.
4. Conor Nocher, "Household finance fears grow ahead of spending cuts", *Guardian*, 23 August 2010.
5. Daniel Pimlott, "Fears on spending cuts slow industry growth", *FT*, 2 September 2010.
6. Ruth Lea, "The labour market: better than expected so far but hard challenges ahead", Arbuthnot Banking Group, 23 August 2010.
7. For example, Ruth Lea, "The OBR's economic forecasts are 'challenging': but there'll be no 'double dip'", Arbuthnot Banking Group, 12 July 2010.
8. ONS, *Consumer Price Indices, Technical Manual*, 2007 Edition. In addition to the housing element, the CPI excludes trade unions' subscriptions, vehicle excise duty and, from 2006, television licence fees. Conversely, there are a few items which are included in the CPI, but excluded from the RPI, because they represent expenditure by people who are not covered by the RPI weights, including high income private households, residents of institutional households and foreign visitors. In addition, the *Technical Manual* points out that the differences in the population coverage between the CPI and RPI have a greater significance in terms of their impact on the calculation of weights for all of those items common to both the CPI and RPI baskets.
9. When calculating the geometric mean the numbers are multiplied and then the nth root (where n is the count of numbers in the set) of the resulting product is taken.
10. Letter from David Hand, President of the Royal Statistical Society, to Sir Michael Scholar, of the UK Statistics Authority, 25 August 2010, available from the RSS's website: [www.rss.org.uk](http://www.rss.org.uk)
11. Edmund Conway, "Neutral interest rate 'may be 2.5pc' ", *Daily Telegraph*, 19 January 2010, quoting a report by Melanie Baker and Charles Goodhart for Morgan Stanley.

**Ruth Lea, Economic Adviser, Director,  
Arbuthnot Banking Group,  
[ruthlea@arbuthnot.co.uk](mailto:ruthlea@arbuthnot.co.uk),  
Tel: 07800 608 674**