



Perspectives by Ruth Lea

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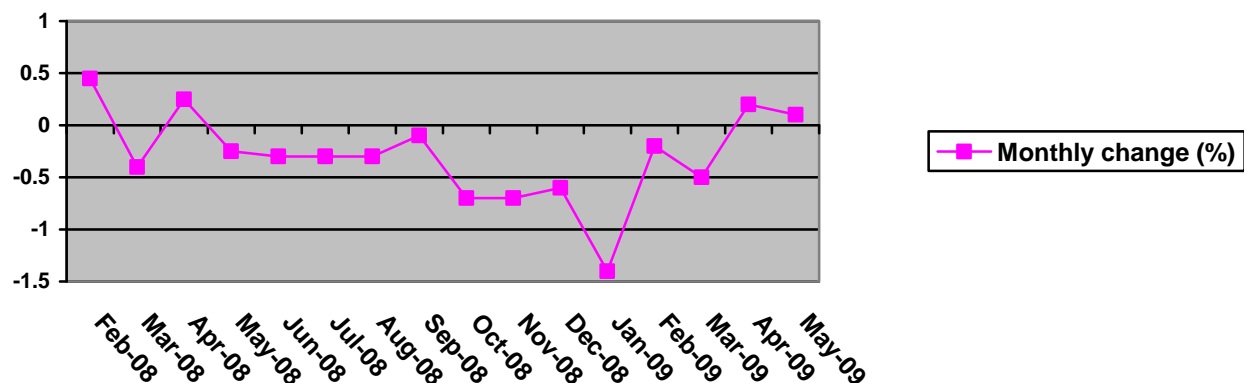
More green shoots: but don't get too carried away

Introduction

Two months ago I wrote a Perspective on the “green shoots” of economic recovery and how they should be kept in “perspective”. Nevertheless I concluded on the basis of survey data of the services and manufacturing industries, better housing market data and modest improvements in credit availability that, at the very least, the rate of decline was decelerating after the much, much worse than expected falls in GDP in the final quarter of 2008 and the first quarter of 2009.¹

The green shoots seem to be gaining strength. In the last week there were two exceptionally encouraging pieces of information. The first was from the ONS which suggested manufacturing output had picked up a tad in April, after falling since the beginning of 2008.² The second were some estimates from the National Institute of Economic and Social Research (NIESR) showing that GDP may have risen in April (0.2%) and May (0.1%).³ Whilst NIESR emphasises that monthly data can be extremely erratic, their overall track record for projecting GDP ahead of the ONS's estimates has been good and should be taken seriously. NIESR's estimates of monthly GDP data are shown in the chart below.

NIESR estimates of real GDP, seasonally adjusted, monthly changes (%), base year 2003, February 2008 to May 2009



Source: NIESR, “Economic stabilisation confirmed output rising in April and May”, 10 June 2009. Note the calculations reflect the ONS's recent announcement that construction output had fallen by 9% in 2009Q1 and that, other things being equal, this implied that the GDP estimate for 2009Q1 would be revised down by 0.3%.

In addition to these data, there continue to be steady improvements in business surveys and further signs of increasing activity in the housing market. The latest Land Registry data suggested the house price falls could be bottoming out and both Nationwide and the Halifax registered modest increases in prices for May. And even though mortgage lending is still subdued, the Council for Mortgage Lenders reported a 16% increase in mortgage approvals in April. Mortgage approvals for first-time buyers rose by 11% and for other house purchasers by 19%.

One of the major negative factors in this more positive scenario remains the continued weakness of overall bank (and building society) lending. The most recent data from the Bank of England were discouraging. Even though total lending to individuals in April was higher than in March, it was still lower than the 6 month average. This pattern applied to both lending secured on dwellings and consumer credit. M4 lending to private non-financial corporates (PNFCs) fell by £4.7bn in April and the annual growth continued to fall, to a paltry 0.8%.^{4, 5}

Caution on the green shoots

Partly reflecting weak lending data, the Bank of England has been going out of its way to urge caution about the green shoots. Mervyn King in his opening remarks at the Inflation Report Press Conference in May said that, even though there were solid reasons for believing activity would rebound in the short-term, there was a very solid reason for believing that a sustained recovery would take “considerably more time”.^{6, 7}

The reasons for expecting a rebound were the unprecedented policy stimulus (both monetary and fiscal) that had been injected into the economy, the further boost to activity provided by the depreciation in sterling (which is now being partly reversed) and last, but by no means least, a turning in the stock cycle.

But, he reminded us, this recession was different because of the quite unprecedented financial crisis. This would undermine recovery. The world’s largest banks, taken together, had expanded unsustainably for several years and were now having to restructure their balance sheets. This restructuring would act to restrict credit. Banks would behave in a risk-averse manner and would aim to raise capital ratios. It may be added that banks’ reluctance to lend currently also reflects the riskiness of offering credit in a recession.⁸

Such is the heady talk of “green shoots” and “recovery” Mr King’s reminder about the difficulties of the banking sector is only too timely.

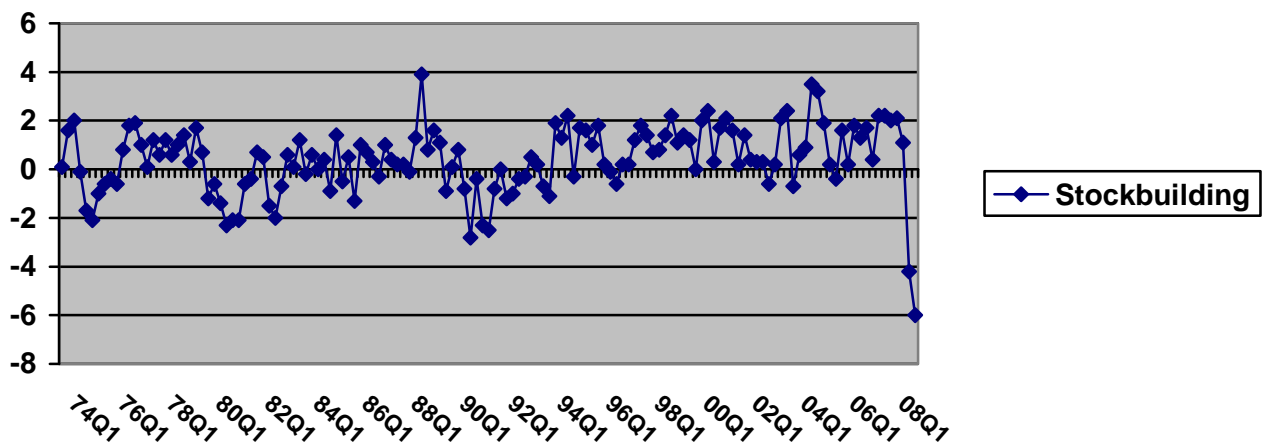
The stock cycle

The stock cycle tends to exaggerate the cyclical swings in GDP in normal times. As demand weakens, then businesses run down stocks – thus weakening demand. When stocks are depleted, orders increase and demand picks up. Whether this pick-up is sustained or ephemeral depends on the underlying state of final demand. De-stocking occurred in the most dramatic form in 2008Q4 and 2009Q1 and, incidentally, goes a long way to explain why GDP fell so rapidly (unexpectedly) in these two quarters.

Following the unexpected collapse of Lehmans last September, the financial markets suffered a cardiac arrest. There was an immediate dislocation in the financial markets which led to a sudden increase in the cost of credit and a reduction in its availability. Given the sudden and dramatic increase in uncertainty about the economic outlook, it is not surprising that the demand for many products fell away. The collapse in car sales was especially notable and catastrophic. The decline in demand left manufacturers and retailers/dealers with significant excess stocks. Many businesses cut back production and their decisions affected a wide range of manufacturing and services activities. Construction, already suffering from a rapid decline in activity in both domestic and commercial property, was also badly hit.

The following chart shows just how dramatic the falls in stocks were at the turn of the year. Even allowing for growth in the economy over the past 35 years, the collapse was unprecedented.

Change in inventories, £bn, volume terms, 1974Q1 to 2009Q1



Source: ONS database, www.statistics.gov.uk. The figures refer to chained volume measures, reference year 2003.

In real terms (2003 prices), stocks fell by £4.2bn (over 0.3% of annual GDP) in 2008Q4 and £6.0bn (nearly 0.5% of annual GDP) in 2009Q1. If there had been no de-stocking in these two quarters the decrease in GDP would have been very modest in 2008Q4 and GDP would not have fallen at all in 2009Q1 (on current ONS estimates). This de-stocking, following autumn's unprecedented financial crisis, helps to explain why the downturn was so abrupt and so much more severe than had been widely forecast. The rapid de-stocking was probably

enabled by the spread of computerisation and the generally lower level of stocks now held throughout the supply chains, which means that changes in demand ripple across the economy more rapidly than in the past.

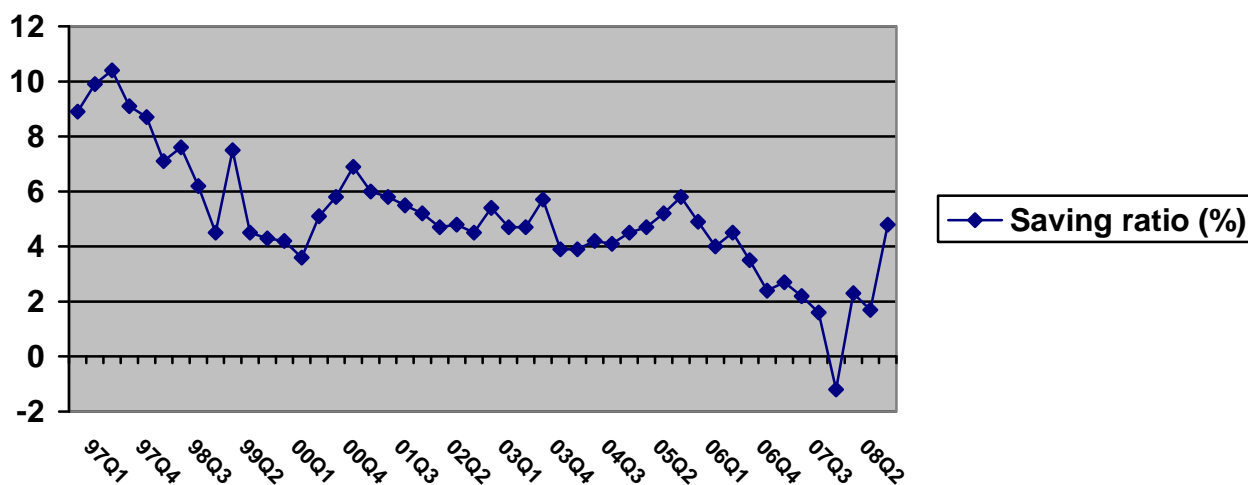
More reasons to be cautious

After such huge de-stocking it is clear that orders have picked up and are now feeding into production. Hence there is the pick-up in April's manufacturing output and the justification for NIESR's optimism about GDP for April and May.

Whether this spike of activity translates into a more sustained recovery will largely depend on the underlying strength of consumer demand and exports. If underlying demand is deficient then restocking will only give a temporary boost to growth and, once the restocking is completed, economic activity could fall away again – resulting in a “W” shaped recession. It is currently very difficult to assess the state of underlying demand but the durability, the sustainability, of the recovery should become clearer after the summer. And, of course, even if a recovery is sustained there is still the issue of the strength of the recovery. Apart from the tightness of credit availability, that has already been discussed, there are other reasons to be very cautious.

Concerning the consumer, there are two key factors. The first is the fact that unemployment is still rising and will probably continue to do so into next year as it is a lagging indicator. The second is that, even for those in work, households are repairing their balance sheets after overextending them - as the banks are repairing theirs. The next chart shows how the saving ratio turned negative in 2008Q1 – but has since partly recovered.

Household saving ratio (%), 1997Q1 to 2008Q4



Source: ONS database, www.statistics.gov.uk. The saving ratio is defined as households' savings as a % of total available households' resources which comprises disposable income (over 95%) and an adjustment for the change in net equity of households in pension funds.

A third factor can be added - higher taxes. The rise in the standard VAT rate to 17.5% is pencilled in for January 2010. The top rate of income tax will rise from 40% to 50% in April 2010, accompanied by the withdrawal of personal allowances for those earning more than £100,000. Beyond that further tax rises should be expected as a contribution to repairing the shattered public finances.

Turning to exports, the overall depreciation of the pound since last year will help though the recent appreciation will prove disadvantageous. The key issue, however, is the state of health of Britain's main overseas markets. The OECD has recently been encouraging. It announced that the leading indicators for the 30 OECD economies rose in April, suggesting recovery.⁹

But other sources are less optimistic. The latest US Federal Reserve's Beige Book summarised its findings as "reports from the Federal Reserve District Banks indicate that economic conditions remained weak or deteriorated further during the period from mid-April through May".¹⁰ Despite some indications of some tentative improvements in housing market, this cannot be taken as a ringing endorsement of recovery in the US. On the contrary, it suggests no recovery at all. Similarly the ECB's latest forecast of the eurozone economy was very downbeat. The ECB expects the eurozone to be stuck in recession until mid-2010.¹¹

References

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3. NIESR, "Economic stabilisation confirmed output rising in April and May", 10 June 2009.
4. Bank of England, "Lending to individuals, April 2009", 2 June 2009.
5. Bank of England, "Sectoral breakdown of aggregate M4 and M4 lending, April 2009", 2 June 2009.
6. Mervyn King, Inflation Report Press Conference, 13 May 2009, opening remarks, available from www.bankofengland.co.uk
7. Paul Fisher (Executive Director, Markets at the Bank of England) said in a recent speech ("The road to recovery and the inflation targets", 12 June 2009) that, even though there was better news on the economy, "...we should not be too complacent - there are likely to be bumps in the road ahead, with many twists and turns."
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