



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



Growth prospects worsen as the economy skirts recession

The British economy: growth is stalling

The recently released second quarter GDP data confirmed a still weakening economy.¹ GDP rose by only 0.2% in the quarter, following the marginally stronger increase of just 0.3% in the first quarter. Construction output, reflecting the contracting house-building sector, fell by 0.7% whilst manufacturing was down 0.4%. “Business services and finance” rose by a paltry 0.1%, compared with a marginally stronger 0.2% in the first quarter. The ONS’s press release contained the explanation that “activities auxiliary to financial intermediation drove the deceleration, which was partly offset by increased growth in computer services and other business services”. In other words, the output of financial services almost certainly fell.

Given the toxic combination of the impact of the ongoing credit crunch and inflationary increases in oil prices, which currently rule out interest rate cuts, the likelihood is that the British economy is beginning to stall. And it is our central case that it will stall in the second half of the year, as shown in the table below. Technically we are forecasting a marginal (0.1%) increase in the third quarter but a flat economy in the fourth.

Table 1: Central case forecast for private consumption and GDP: quarterly data, growth rates (%)

	2008					2009				
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
GDP:										
Quarterly growth	0.3	0.2	0.1	0	Na	0.2	0.25	0.3	0.3	Na
Year-on-year	2.3	1.7	1.1	0.5	1.4	0.5	0.6	0.8	1.0	0.7
Private consumption:										
Quarterly growth	1.0	0.3	-0.2	-0.5	Na	0	0.2	0.3	0.4	Na
Year-on-year	3.0	2.6	1.5	0.6	2.2	-0.4	-0.5	0.1	1.0	0

Inevitably there is the increased risk that the economy could enter a technical recession, as defined by two consecutive quarters of falling output, but much will depend on the future course of oil prices and other commodity prices and the state of the credit markets. Both are notoriously difficult to forecast. But the recent falls in oil prices are encouraging and we would not only expect these falls to be maintained but to be extended, barring major geopolitical disturbances in the Middle East. There are even a few (though very few) glimmers in the credit markets – with some modest easing in some mortgage rates.

We are forecasting a GDP growth rate of just 1.4% in 2008 and, even though the economy should start recovering in 2009, providing oil prices ease and the credit markets improve, the overall year-on-year increase for next year is now expected to be a disappointing 0.7%. These forecasts are more pessimistic than the prevailing consensus.²

Consumer retrenchment, but modest growth elsewhere

Table 1 also contains our central case for the forecast of private consumption, which comprises about 65% of GDP and, pumped by rising debt, drove growth for much of the past decade.³ But British consumers are now heavily indebted, the household saving ratio was a paltry 1.1% in the first quarter, and their real incomes are being squeezed by higher inflation. There is also rising concern about unemployment and the housing market continues to deteriorate. Consumers are reining back on non-essential items and we would expect this to intensify in the second half of this year.

Indeed we are forecasting a “consumer recession” of two consecutive quarters of falling consumer spending in the second half of 2008.⁴ We do, however, expect some improvement in sentiment next year, but zero growth overall (year-on-year).

Even though we are forecasting a consumer recession, our central case does not show a recession for the economy as a whole because we expect some modest growth in some of the other components of GDP. Table 2 shows that government consumption will continue to contribute to GDP growth, though at a subdued rate compared with the earlier part of the 21st century, and there should be some improvement in the external balance as Britain’s consumer recession dampens imports growth. Gross Fixed Capital Formation, however, is expected to decrease in both 2008 and 2009 despite the relatively robust public sector spending in this area.

Table 2: Central-case forecast for GDP and labour market: annual data

	2007	2008	2009
<u>Economic activity (year-on-year % change):</u>			
Private consumption (including non-profit institutions (NPISH))	3.1	2.0	0
Government consumption	1.9	2.2	2.0
Gross Fixed Capital Formation	6.0	-0.3	-1.0
Exports	-5.1	1.0	5.0
Minus Imports	-2.4	0.1	3.0
GDP	3.1	1.4	0.7
<u>Labour market (annual averages):</u>			
Unemployment: claimant count (thousands)	863	850	1,050
Claimant count unemployment rate (%)	2.7%	2.7%	3.3%
Unemployment: ILO survey (thousands)	1,652	1,660	1,900
ILO unemployment rate (%)	5.4%	5.4%	6.2%

Table 2 also shows our central case forecasts for the labour market. Unemployment is now rising, albeit lagging the slowing economy. Announcements about job losses in the construction, manufacturing and financial sectors are now frequent. The claimant count rose 15,500 in June and unemployment (obtained from survey material) on the ILO (International Labour Organisation) definition is also picking up. Unemployment is expected to rise throughout the rest of 2008 and throughout 2009, though the increases are likely to be dampened by migrants returning home to Eastern Europe as the labour market deteriorates here.

Higher unemployment will inevitably have knock-on effects for the housing market, consumer sentiment and household spending. But it will also depress the pressure for higher wage settlements, which should lessen the probability of a “wage-price” spiral developing.

Inflation and interest rates

There is little doubt that the recent surge in CPI inflation is significant and, primarily, driven by specific, “external” factors. As the Governor of the Bank of England noted in his letter of explanation to the Chancellor of the Exchequer when May’s CPI inflation rate first topped 3% in 2008, in the year to May⁵:

- world agricultural prices had increased by 60%,
- oil prices had risen by more than 80%,
- wholesale gas prices had increased by 160%.

There are still inflationary pressures in the pipeline. Utility companies are expected to push through 20% increases in utility prices this year. But, providing oil prices ease as we expect, the worst in terms of inflationary pressures should be over in the 4th quarter of 2008. If CPI inflation falls in the 4th quarter of 2008 and through 2009, and there are no signs of a “wage-price spiral” developing, there should be scope for interest rate cuts. We have pencilled in a 0.25% cut in Bank Rate in the 4th quarter of 2008 and another 0.25% by mid 2009. Providing inflation is easing, there could be scope for more aggressive cuts if the weakness of the economy justifies them.

Central-case forecast: CPI inflation (year-on-year, %) and Bank Rate (%): quarterly data

	2007	2008					2009				
		Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
CPI inflation	2.3	2.4	3.3	4.5	4.3	3.6	4.0	3.0	2.8	2.5	3.1
Bank Rate	5.5*	5.25	5.00	5.00	4.75	4.75*	4.75	4.5	4.5	4.5	4.5*

* End year Bank Rate.

The economy is skirting recession

The economy is undoubtedly skirting recession and our forecasts are gloomier than economists’ “consensus”. But we still expect the economy to avoid outright recession providing inflationary pressures do not become entrenched (which would surely lead to higher interest rates). This relative optimism could, of course, be comprehensively de-railed if there is another burst of commodity prices inflation and/or the credit crunch fails to ease over the next 12 months. Mervyn King’s NICE (“non-inflationary consistent expansion”) decade is emphatically over.

References

1. Office for National Statistics, *Gross Domestic Product: preliminary estimate: 2nd quarter 2008*, 25 July 2008.
2. The “consensus” forecasts for GDP growth are 1.5% (for 2008) and 1.0% (for 2009). See Consensus Forecasts: survey date, 14 July 2008.
3. Ruth Lea, “After the spending binges, the belt-tightening”, Arbuthnot Banking Group Perspective, 4 February 2008 discusses this more.
4. The latest NIESR forecasts show a fall of 0.8% in household consumption in 2009. See NIESR, *National Institute Economic Review*, July 2008.
5. Governor’s letter to the Chancellor, 16 June 2008, available from www.bankofengland.co.uk.

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