



Economic Commentary February 2010

Direction still uncertain

The recession is officially and technically over - just. But as GDP growth returned to positive territory, so doubts emerged about the strength of the recovery and the possibility of a 'double dip' loomed. And the worries relate not just to the domestic economy but also to the growing concerns about levels of government indebtedness in some European countries, which may have an impact on confidence in the UK and on export prospects.

It was the publication of the first estimate of Q4 2009 GDP that raised questions about the prospects for this year. At 0.1%, it meant that the recession was finally over after six quarters of negative growth. Welcome as this news was, the number was much lower than the 0.4% widely expected by analysts. It meant either that the ONS had got it wrong (the Bank of England is among those who think that the second estimate will be higher) or that activity is weaker than other data sources are suggesting. And, since the usual margin of error is 0.2% either way, the revised number could even show that the UK was still in recession

There is, moreover, concern that the first quarter of this year could well be weaker than the fourth quarter of last year. The restoration of the VAT reduction will squeeze spending power and add to inflation. In December, the annual rate of increase in the CPI jumped to 2.9% from 1.9% in November (its single biggest monthly increase), pushing right up against the ceiling of the target range. The Governor has probably already drafted his letter of explanation for the Chancellor later this month. More importantly, however, is that fact that inflation is rising faster than earnings, thus squeezing real incomes and placing downward pressure on spending.

Disappointment also came with the latest money supply figures and statistics on mortgage lending. The MPC's preferred measure of M4 broad money supply fell by 0.5% in December while headline M4 fell at the fastest pace on record (1.1%). These dismal figures were only partially offset by a modest monthly rise (0.3%) in deposits held by households and non-financial companies. Mortgage approvals fell unexpectedly during December, the first fall in 13 months. Net credit card lending was subdued (up by just £0.1 billion in December), there was a net repayment of £0.5 billion on personal loans, and lending to business fell by £1.5 billion.

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Pointing in the opposite direction and towards an upward revision in the GDP figure were several months of positive results from the key PMI surveys. Since May, the service sector has consistently reported an activity figure above 50, implying expansion. In manufacturing, in positive territory for six of the last seven months, the January figure of 56.7 was the highest reading for 15 years, driven largely by export orders. Construction, although still below 50 (47.8 in January) had improved markedly from the low of 26.3 in December 2008. The retail sector is not included in the services PMI but a separate survey (by the BRC) reported like-for-like sales in December up by 4.2% on the year, while total sales were 6% higher. With so much of the economy moving in the right direction, scepticism about the ONS figures seems justified.

These opinion surveys are underpinned by developments in the labour market. The latest unemployment figures were better than expected, with the claimant count falling in December by 15,200 (following a 10,800 drop in November) and the broader ILO measure declining by 7,000 in the three months to November. There was, however, a fall in the number of people at work, while pay growth remains very subdued with annual growth at just over 1% (flat in the private sector, but 4% in the public sector).

The dilemma facing policymakers was neatly summarised recently by public statements from one current MPC member (Andrew Sentance) and one former member (David Blanchflower). The view of Andrew Sentance is that the UK has 'bounce-backability' and will avoid the double dip recession. The recovery is progressing much as he expected. While there is no need to add to the current stimulus, neither is there a need to reduce it. In these circumstances, the MPC should pause for breath, although interest rates could rise by the end of the year. But Blanchflower believes the MPC is too bullish and if it tightens policy too quickly the double dip becomes inevitable. Historically low interest rates had prevented an even worse recession but, to kick start the recovery, it is important to continue with QE and the fiscal stimulus and worry about the budget deficit later.

In its latest Inflation Report, the Bank of England was typically cautious. It expects inflationary pressures to ease and credit conditions to remain restrictive and, with a large fiscal consolidation likely to follow the election, the pace of recovery will be very slow. But at least the direction will be forward not back and, against this background, QE was put on hold (with the option to increase beyond the current £200 billion at a later stage) with the prospect of Bank Rate being left on hold until well into the second half of the year. This judgement will be fully tested with the revised Q4 and first cut if Q1 GDP estimates in the coming weeks.

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