ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S ECONOMIC ADVISERS

JUNE 2011

CONCERNS ABOUT GLOBAL ECONOMY AS UK AUSTERITY MEASURES GET IMF SEAL OF APPROVAL

A range of weaker-than-expected indicators across some of the world's largest economies have prompted renewed concerns about the global economy. Data from the US pointed towards a significant loss of momentum in the US labour market, while purchasing managers' indices in Germany and the UK disappointed and suggest some slowdown in manufacturing growth over the coming months. Markets have subsequently shifted towards the view that monetary policy in the developed world is likely to remain loose for longer, with central banks in the UK, US and Japan keeping interest rates at near-zero levels until there are more signs of their recoveries gaining a solid foothold.

This array of disappointing global and domestic data increased the pressure on Chancellor George Osborne to reconsider his plans for spending cuts over the coming years; a letter published in the *Observer* earlier this month, signed by 52 academics, argued that the economy remained fragile and that the government needs to consider an alternative plan if growth shows further signs of cooling.

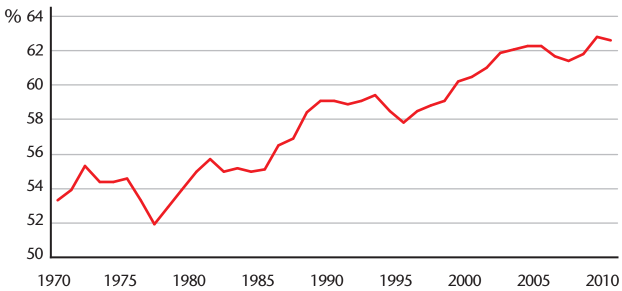
However, the Chancellor received support when the International Monetary Fund (IMF) and European Commission broadly endorsed his plans for deficit reduction. This, combined with the political difficulties of significantly changing course, means that a Plan B for the deficit reduction strategy remains unlikely.

Consumers back in recession

The second estimate of UK gross domestic product (GDP) in the first quarter of 2011 was unchanged, showing the economy grew at a quarterly rate of 0.5%. Worryingly, however, the data revealed that household consumption fell by 0.6% between Q4 2010 and Q1 2011 – the largest quarterly fall since Q2 2009, when the UK was in the midst of the economic downturn. This is the second consecutive quarter in which household consumption has declined, implying that consumers have entered a technical recession.

The weaknesses on the consumer side of the economy are particularly concerning at present, given that household consumption accounts for over 60% of the UK's national income.

Figure 1: UK household consumption, as a share of total gross domestic product



Source: ONS, Cebr analysis

It is noteworthy that the reliance on consumption to generate growth has increased substantially over the past 30 years. As Figure 1 shows, since the 1970s household consumption has taken up an increasing share of total UK output – between 1970 and 2010 the share rose by 10 percentage points from 53% to 63%.

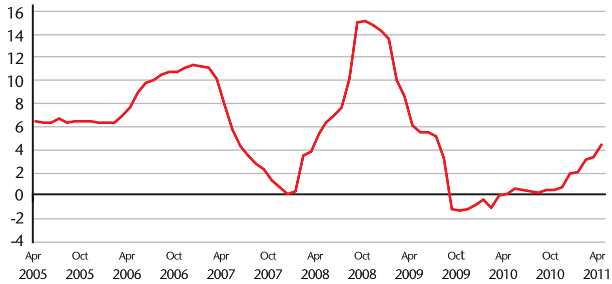
While this consumer-dependence was not a cause for concern during the years of rising household real incomes and easy access to credit, such as the decade before the recession, it could now lead to years of weak growth unless the UK is successful in rebalancing towards a more export and investment-driven economy.

Concerns about rising utilities prices…

The Bank of England's May *Inflation Report* suggested that rising utility prices will be a significant source of inflation in the second half of 2011, keeping the annual rate of price growth elevated even if food and transport prices show some signs of stabilising.

Earlier this month, Scottish Power announced that it was planning to raise its electricity prices by 10% and gas prices by 19% later this year and it is likely that other energy suppliers will follow suit; pointing towards inflationary pressure in the pipeline. According to Office for National Statistics (ONS) data, housing, water and fuel prices were 4.4% higher in April 2011 than a year ago, with electricity prices on average 4.0% higher and gas prices some 6.4% higher. As Figure 2 shows, price inflation for utilities has been steadily increasing in recent months though remains below its 2008 peak.

Figure 2: Housing, water and fuel prices, annual % change



Source: ONS

There is ongoing concern about the changing nature of inflation in the West, with inflation increasingly being driven by rising **essential** goods prices than by changes in the price of discretionary products – largely attributable to movements in global commodity markets.

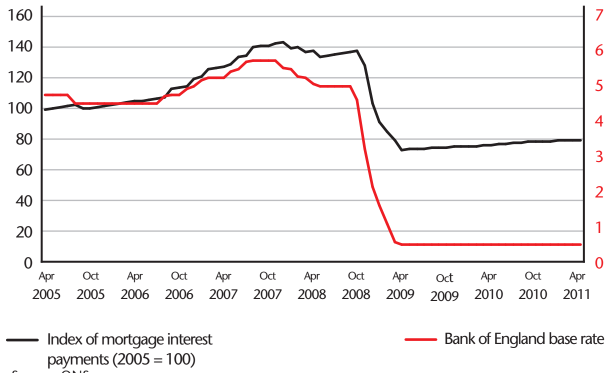
This different type of inflation is not having an equal impact on all households, given differences in spending patterns. For example, recent research by the Resolution Foundation has shown that 20% of benefit reliant households' expenditure can be attributable to housing, water and fuel payments. This compares with just 11% for higher earners. Ultimately, this means that the 'new inflation' in the West is disproportionately bearing down on the living standards of those on low and middle incomes.

… although Bank of England keeps rates at record low

Despite ongoing concerns about high inflation in the UK, the Bank of England voted to keep interest rates on hold at its June Monetary Policy Committee (MPC) – the 27th consecutive month of no change in the base rate.

The fact that monetary policy has been so extraordinarily loose for so long suggests that the MPC continues to have reservations about the strength of the UK economy. With consumers still under significant financial duress as their incomes fail to keep pace with the rising cost of living, the Bank is all too aware that a monetary tightening too soon could severely derail the recovery. It remains the case that low interest rates are propping up household discretionary incomes; as Figure 3 shows, even in April 2011 mortgage interest payments are some 20% lower than 2005 levels – a direct result of interest rates being pushed down to historic lows.

Figure 3: Bank of England base rate versus index of mortgage interest payments



Source: ONS

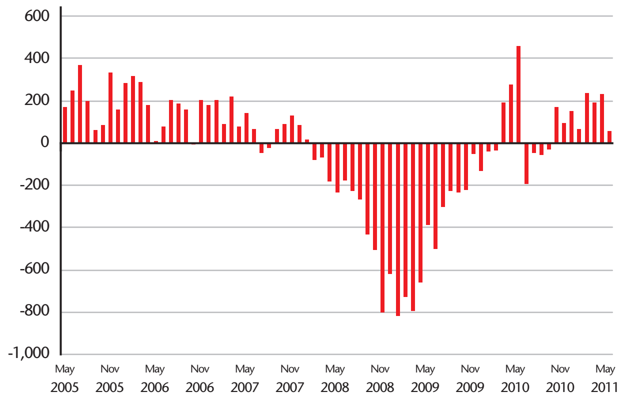
Even if a rate increase were to bring down price growth in other goods and services, an associated rise in mortgage payments could more than offset this – meaning that households may end up worse off as a result of measures to contain inflation. With a rate rise also having the potential to dampen businesses investment and worsen the UK's export price competitiveness through an appreciation in sterling, it remains a risky option.

US payroll data renews concerns about world's largest economy

Data released earlier this month by the US Bureau of Labor Statistics (BLS) showed an increase in total non-farm employment of just 54,000 in May. This compares with consensus expectations for a 190,000 increase in payrolls and is down from average increases of 220,000 over the previous three months, pointing towards a major slowdown in the rate of job creation in the world's largest economy.

Private sector job creation was lacklustre, with an increase in payrolls of 83,000 in May – compared with an average increase of 244,000 over the previous three months. Job shedding continued in the public sector, with local government jobs falling by some 28,000. Local government has lost 446,000 jobs since an employment peak in September 2008 and it remains unclear as to whether the private sector in the US is yet in a position to compensate for impending public sector cutbacks when a fiscal deficit reduction plan is fully agreed.

Figure 4: Change in US non-farm payrolls, seasonally adjusted



Source: US Bureau of Labor Statistics

The Federal Reserve now looks set to keep rates on hold this year and the payroll data may even fuel debate on whether more quantitative easing ('QE3') is required to prop up growth. With the US currently going through a phase of near 'jobless growth', unemployment will almost certainly be a focal point in the lead up to the 2012 presidential elections.

Time for Plan B?

Despite calls for an alternative Plan B from the UK government if the economy shows further signs of wobbling, the case remains unclear. As the IMF has noted, economic fragility is largely attributable to external factors beyond the government's control, such as soaring global commodity markets which have placed pressure on living costs.

It is difficult to argue that weaknesses in the economy can be attributed to government spending cuts, which have not begun in earnest. Indeed, according to the latest data from the ONS, government expenditure rose at a quarterly rate of 1.0% in Q1 2011 and public borrowing in April 2011 was higher than in any April on record. Deficit reduction combined with continued loose monetary policy still remains the most likely course of action.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
28 June	GDP final estimate	No change
21 July	Trends in Lending	Still weak

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