Economic Review - September 2011

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Abstract

This note provides some wider economic analysis to support the Statistical Bulletin relating to the latest GDP release and other major economic releases during the latest month. By drawing on the wider array of economic releases surrounding the GDP release, for example the labour market, trade, retail sales and inflation releases, this note attempts to provide a more comprehensive picture of how the economy has performed in the latest quarter and, where relevant, the latest month.

Key points

- The latest month's figures fit the emerging picture of a slowing economy, with little respite from immediate inflationary pressures.
- GDP growth in the second quarter was 0.1 per cent, revised down from 0.2 per cent. Growth in the first quarter is also slower than previously estimated. As a result, the level of GDP in the second quarter of 2011 is broadly unchanged from its level three quarters earlier.
- In the second quarter, growth in the services sector was weaker than previously estimated, offset by markedly stronger growth in the construction sector and a smaller contraction in the production sector.
- Household consumption expenditure has now fallen in each of the first two quarters of 2011, while the positive contribution from net trade in the first quarter was reversed in the second.
- The weak growth picture continues in early data releases for July. The trade balance little changed as import growth matched that of exports. The labour market labour market and real wage growth have both weakened, retail sales growth has weakened and construction and production growth has also weakened.
- The production sector weakened in July, and has been relatively weak for some months now, due to significant weakness in the mining and quarrying sector, relating to North Sea maintenance of installations, and some weakness in the utilities distribution sector. Manufacturing growth remained positive but has been easing in recent months.
- Construction output contracted in July, compared to both June 2011 and July 2010. Although the two main components of 'all new work' and 'repair and maintenance' have been growing since April, both contracted in July. Housing construction was particularly weak, especially in the public sector.
- The trade deficit was unchanged in July. Import growth continues to keep pace with that of exports despite sluggish domestic demand and the relatively weak pound.

- Retail sales in August were barely changed in volume terms compared with a year earlier. However rising prices, especially of food, generated a strong growth in the value of retail spending.
- Employment fell by 69,000 in May-July compared with the previous period, as a result of a 111,000 drop in public sector employment, while unemployment rose to just over 2.5 million. Average weekly hours rose slightly but have not recovered to the level prior to the additional bank holiday. Regular pay growth (excluding bonuses) at 2.1 per cent, remains well below inflation.
- Inflation rose back to 4.5 per cent in August, from 4.4 per cent in July. Core inflation, excluding energy, food, alcohol and tobacco, was 3.1 per cent. The strength of inflation means that real wage growth continues to be depressed, and has been negative for most of the last three years.

Quarterly national accounts

New GDP data for the second quarter of 2011 – which is consistent with the forthcoming Blue Book 2011 - include the first estimates of the expenditure and income components of GDP.

The new Blue Book methodology incorporates a range of changes to the compilation of the national accounts and the methodology underpinning the data. They include:

- Updating the base year and reference year from 2006 to 2008
- Changing the basis of deflation from the RPI to the CPI
- Making the deflation methodology consistent across the components of GDP
- Moving the classification of industries from the SIC 03 basis to the SIC 07 base
- Taking on later information, in particular revised HMRC data
- Supply-use balancing of current price measures of GDP, with particular reference to the years 2007 to 2009 – the first time this has been done for 2009.

Articles explaining the methodological basis of the revisions are available on the ONS website:

- Overview: Everett (2011), 'Methods changes in the 2011 Blue Book';
- Classification changes: Hughes et al (2009), 'Implementation of Standard Industrial Classification 2007: December 2009 update';
- RPI to CPI-based deflation: Drew (2011) 'Deflation Improvements in the UK National Accounts';
- Updating the base year: Beadle (2007) 'Modernising the UK's National Accounts'

Analysis of the revisions to data for the period since 1997 are discussed in an additional note released alongside the Quarterly National Accounts (Patterson, Lee and Myers (2011), 'Impact of Changes in the National Accounts and Economic Commentary for 2011 quarter 2').

The sector accounts (UK Economic Accounts), along with the UK Balance of Payments, which would normally be published alongside the Quarterly National Accounts, have been delayed until the 25th October.

GDP

GDP growth weakened slightly in the second quarter, from 0.2 per cent to 0.1 per cent. This reflects:

- A smaller contraction in output of the production sector, with quarter-on-quarter growth revised from -1.6 per cent to -1.2 per cent;
- an upward revision of 0.6 percentage points to construction output growth; and
- a downward revision to services sector growth by 0.3 percentage points.

In addition, GDP growth in the first quarter is also slower than previously estimated – revised from 0.5 per cent to 0.4 per cent. This was due to a downward revision to services sector growth, from 0.9 per cent to 0.7 per cent. Although growth in the production sector remained at 0.1 per cent, manufacturing growth was stronger, but this was offset by a downward revision to the negative growth in the mining and utilities industries. These revisions, as with the revisions to the second quarter, reflect a combination of reclassification of industrial sub-sectors through the move from SIC03 to SIC07, as well as some additional data that will have been taken on for the first quarter.

As a result of these revisions, GDP in the second quarter of 2011 is broadly unchanged from its level three quarters earlier

Revisions to contributions to GDP growth by industrial sector for the second quarter

Percentage points

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The expenditure measure of GDP has been published for the second quarter 2011 for the first time in the Quarterly National Accounts. This indicates that:

- General government consumption, gross fixed capital formation and inventories made positive contributions to GDP growth in the second quarter, but
- Household consumption and net trade pulled GDP growth down.

Compared to the first quarter, household consumption deteriorated further, contracting by 0.8 per cent in the second quarter compared to 0.6 per cent in the first quarter. This reflects the impact of factors such as negative real wage growth, weak consumer confidence and uncertainty about employment prospects. Similarly, the contribution from net trade deteriorated between the first and second quarters. But these worsening positions were offset by improvements in government consumption, investment and inventories.

Contributions to GDP growth in 2011 by main expenditure component

Percentage points

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Production sector

Output in the production sector weakened in July, having been flat between May and June. Since its peak in January this year, output has now fallen by 2.4 per cent. This represents a turnaround in the production sector, and more specifically in the manufacturing sector, which had been an

important contributor to the recovery in GDP growth through the latter part of 2009 and the first half of 2010.

The weakening in the production sector has been driven by persistent weakness in the mining and quarrying sector, and reinforced by some negative growth in the electricity, gas and water distribution sector. Although manufacturing activity has held up reasonably well into 2011 despite a challenging environment, growth has been easing gradually since mid-2010. Since March, when growth in the manufacturing sector started easing, year-on-year growth in manufacturing output has averaged 2.1 per cent. This compares with annual average growth of 5 per cent between July 2010 and February 2011, when the manufacturing sector was performing relatively strongly.

Construction

The construction sector contracted in July 2011 compared to both June 2011 and July 2010. The main sectors contributing to the falls in the month were new public and private housing work and new infrastructure work. The effects of the Government's austerity measures are beginning to appear in public housing, which declined by 15.8 per cent compared to June 2011 and 12.3 per cent compared to July last year.

The higher level components of the construction sector, 'all new work' and 'repair & maintenance', have been growing since April but both contracted in July by 3.5 per cent and 2.8 per cent respectively compared with June.

Services

Due to the change in classification methodology, from Standard Industrial Classification (SIC) 2003 to SIC 2007, as well as further additional data, growth in the services sector has been revised down in both the first and second quarters of 2011. Some sub-sectors have moved from the service sector to the production and construction sectors, and new data has been incorporated.

There are now lower estimates for growth in transport, storage and communications and in the business services and finance sectors. There were upward revisions to the government and other services sector.

Nevertheless, survey evidence suggests that, while activity in the services sector continues to expand, the pace of growth has tended to ease during the first half of 2011. While consumer facing parts of the services sector have been weakening for some months, demand for business services is now also moderating.

Contribution by services sub-sector to the downward revision to services sector growth

Percentage points

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Trade

The trade balance was unchanged at -£4.5 billion in July, with the deficit on trade in goods remaining at -£8.9bn and the surplus on trade in services rising by £0.1 billion to £4.5 billion. The overall trade balance has been broadly steady over the past year, and continues to demonstrate little benefit from the relatively weak level of sterling in foreign exchange markets.

The volumes of both exports and imports of goods (excluding oil and erratic items) were little changed in July from their average levels in the second quarter of 2011. Since 2008, when the pound's value depreciated markedly, export and import volumes have broadly kept pace with one another. Although exports grew more rapidly than imports in the first quarter of 2011, raising hopes that the UK might see a rebalancing of the economy towards overseas demand, this was partially reversed in the second quarter as renewed signs of weakness were revealed in the economies of many of the UK's trading partners. This is most apparent in the UK's export performance to non-EU countries, where a sharp fall in volumes in the second quarter was sustained in July. The balance of trade in goods with non-EU countries has therefore deteriorated somewhat over the past year.

The continuing robustness of growth in UK import volumes is perhaps unexpected in view of the weakness in consumer demand, as well as the recent moderation in the pace of manufacturing output growth.

The sharp deterioration in the deficit in trade in oil in June was only partially reversed in July, despite some stabilisation in global oil prices, because of a sharp increase in the volume of imported oil in the month. The average deficit of £3.2 billion in the three months to July is the largest since 2008, when oil prices touched \$150 per barrel.

Growth of exports and imports of goods, and the effective exchange rate

Per cent and EER index

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Contributions to import growth by type of commodity

Percentage points

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Note: the sum of the contributions do not exactly add up to the import of goods growth rates because the weights of each commodity do not sum to 1000. Data is taken from table 8 of the UK trade release.

Retail Sales

The volume of retail sales declined slightly in August compared to the previous month (by 0.2 per cent) and has been flat over the past year. However, the strength of price inflation in the retail sector was such that the value of retail sales in August was nearly 5 per cent higher than a year earlier.

The impact of high inflation is most evident in the “predominantly food stores” component of retail sales, where the value of sales increased by 5 per cent compared to August 2010, but volumes declined by 0.8 per cent. The implied price deflator therefore rose by 5.7 per cent in the twelve months to August. This difference in growth rates between the value and the volume of retail sales stores is indicative of the financial pressures on household budgets. Households are obliged to increase their spending significantly in nominal terms just to maintain a constant volume of retail purchases.

Despite the strong price growth in the food retailing sector, inflation is less pervasive in other sectors. Prices have fallen slightly in the “household goods stores” sector in August compared with a year earlier. The volume of sales has decreased by 4.1 per cent while the value of sales fell even

faster - by 4.6 per cent. Within this sector, prices charged by electrical household appliance stores are estimated to have declined by 0.3 per cent. This too may reflect the squeeze on household budgets as consumers are forced to cut back on discretionary items of spending.

There is little evidence that the riots have had a significant impact on overall retail spending in August.

The chart below illustrates the main types of retail activity that tend to drive the retail sales growth rates, with food stores and non-store retailing tending to contribute the bigger proportions to total retail sales growth. However, household goods stores and fuel tend to also make fairly regular contributions to growth, with household store sales averaging a contribution of -0.6 percentage points since February and predominantly fuel retail sales contributing an average of +0.3 percentage points since February. These averages are taken from February because January was a somewhat exceptional month because of the snow in the preceding month.

Contributions to the growth of retail sales volumes, month on month a year ago

Percentage points

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Labour market

The latest set of labour market statistics, covering the three months May to July, present a weakening picture across a range of indicators - employment, unemployment, hours worked, and wage growth.

The level of employment fell by 69,000 in the three months to July. This was the result of a sharp fall in public sector employment, which fell by 111,000 between March and June, partly offset by a rise of 41,000 in private sector employment. Public sector employment has now fallen for six consecutive quarters, and by 290,000 from its peak of 6.3 million at the end of 2009. In June, the public sector accounted for 20.7 per cent of total employment, the lowest since 2008.

Unemployment among workers aged 16-24 rose by 78,000 compared to an increase across all age groups (16 and over) of 80,000.

Average weekly hours increased from 31.2 in the three months to April to 31.4 in the period May to July. The full extent of the decline in hours in the preceding three months (down from 31.8 to 31.2) has not therefore been unwound, despite the possible dampening effect of the additional bank holiday in March. Growth in total hours worked appears to have followed a slightly declining path since the middle of 2010.

Unemployment rose from 7.7 per cent in February to April to 7.9 per cent in May to July. The 80,000 increase in the number of unemployed people was the largest quarterly rise since August 2009 and takes the total to more than 2.5 million. The claimant count has been growing for six consecutive months and in July it rose by a further 20,000.

Average earnings rose by 2.8 per cent in the three months May to July, above the average of 1.4 per cent over the last three years (November 2008 to April 2011). This reflects strong bonus payment growth, which rose by 20 per cent in the latest period compared to a year earlier. Regular wage growth (excluding bonuses) was 2.1 per cent in May-July. Wage growth for the majority of the economy is below this figure, which includes the 4.8 per cent increase in average earnings (regular pay) in the financial sector. With consumer price inflation rising to 4.5 per cent in August, real wage growth remains sharply negative, continuing the trend of much of the last three years.

Hours worked: Average weekly and growth

(Average weekly hours worked and % growth)

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Average weekly earnings growth

(% change month on month a year ago)

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Consumer and producer price inflation

Consumer price inflation rose back to 4.5 per cent in August, having dipped to 4.2 per cent in June. This reflected continuing increases in energy and food prices – excluding food, energy, alcohol and tobacco, inflation was 3.1 per cent and has averaged 3.2 per cent during 2011, compared to 4.3 per cent average for headline CPI.

Inflation

Consumer price index, % change month on month a year ago

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Producer price inflation continues at high levels, for input prices (in the manufacturing sector) compared to output prices. This scenario is driven by high and rising commodity prices against the difficulty in raising output prices due to weak domestic demand and competition in a tight market. The inability of domestic producers to pass on much of the increase in input prices, coupled with weak productivity growth and relatively high unit wage costs, means that profit margins of domestic producers may be squeezed. However, producers of exported goods are more able to maintain profit margins because they can maintain prices in foreign markets while still realising a relatively good return because of the weakness of sterling.

Public sector finances

Excluding the temporary effects of financial interventions, August's public sector borrowing was £15.9 billion, an increase of £1.9 billion on August 2010 which saw borrowing at £14.0 billion. However in the 2011 financial year, April-August 2011 borrowing is £51.5 billion, down from £55.3 billion in April- August 2010. The fall of £3.9 billion in borrowing is due to a fall of £1 billion in the public sector current budget and a fall in net investment of £2.9 billion.

Public Sector finances - current budget and investment, main areas of spending and main sources of revenue

£ billion

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