Economic review

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SUMMARY

Revised estimates of GDP report that the UK economy grew by 0.3 per cent in the final quarter of 2009. In the services sector, growth was driven by the motor trades, wholesale distribution and other business activities industries. In the production sector, positive growth contributions came from the engineering and allied industries. In terms of the expenditure measure of GDP the main positive impact was in inventories as the rate of de-stocking declined. Household consumption and government spending also grew during quarter four, but gross fixed capital formation and net trade weighed on GDP growth. Retail sales fell due to a large fall in the purchase of automotive fuels in January, partly due to the impact of bad weather on the amount of travelling. However, excluding automotive fuels retail sales continued to be supported by Internet spending and discounting. In the labour market there was a small reduction in unemployment in 2009 Q4, but average durations of unemployment continue to rise. Evidence continues to suggest that younger people have been particularly affected by tighter labour market conditions, showing the strongest rise in unemployment and inactivity rates. Both CPI and RPI inflation picked up strongly in January due to rising motor fuel prices and also the reversion of VAT from 15 per cent to 17.5 per cent.

UK economic growth revised up to 0.3 per cent in 2009 Q4

Latest published data show the UK economy grew by 0.3 per cent in the final quarter of 2009. The Output, Income and Expenditure release is the second estimate of GDP for a particular quarter, and marks an upward revision

from the Preliminary estimate, published a month earlier, when GDP was estimated to have grown by 0.1 per cent.

Between 2008 Q1 and 2009 Q3, GDP contracted for six consecutive quarters, registering a total peak to trough fall of 6.2 per cent (**Figure 1**). This is a similar loss in output to that experienced in the recession of the early 1980s, and far more severe than the drop in GDP associated with the early 1990s recession.

Upward revisions to GDP growth for the final quarter of 2009 have been driven by the services sector. This is now estimated to have grown by 0.5 per cent over the quarter compared to the Preliminary estimate of 0.1 per cent (**Figure 2**). Within the sector, growth in the distribution, hotels and catering sector was revised up from 0.4 per cent to 1.6 per cent. Transport and communication, and business services and finance were both flat in the Preliminary estimate, but have since been revised up to 0.5 per cent and 0.3 per cent respectively. However, growth in government and other services was revised downwards from 0.2 per cent to flat.

In the production sector, manufacturing output growth was stronger at 0.8 per cent compared to 0.4 per cent. But this was offset by construction, where output is now estimated to have fallen by 1 per cent, having previously been estimated as flat.

Preliminary estimates of GDP are published within 25 days of the end of the reference quarter, and are the most timely estimates published by any National Statistics Institute in the world. They give policy makers, analysts and other data users a rapid indication of activity in the most recent quarter. However, timeliness of publication means that the data content is lower than in subsequent estimates, particularly for the final month of the quarter (December 2009). ONS estimates that the data content for the Preliminary estimate is around 40 per cent and rises to 77 per cent by the time of the Output, Income and Expenditure release. Data content in the third estimate of GDP – the Quarterly National Accounts – rises further to 92 per cent. Revisions are therefore the consequence of previously unavailable information being incorporated into the published data. Analysis of revisions over a long time period has shown, however, that Preliminary GDP estimates do provide an accurate description of UK economic activity (see Brown et al 2009).

The main cause of the upward revision was strong service sector

Figure 1
GDP growth

Source: GDP Output, Income and Expenditure

Figure 2
Contributions to GDP growth by industry, 2009 Q4

Source: GDP Output, Income and Expenditure and Preliminary estimates

growth in December 2009. This data was unavailable when the Preliminary estimate was compiled. The Index of Services grew by 0.6 per cent during this month, much stronger than the 0.2 per cent growth recorded in November and the unchanged index in October. There was particularly strong growth in motor trades and wholesale industries during December, where output grew by 5.8 per cent and 4.9 per cent respectively. These two industries account for the significant revision to the distribution hotels and catering sector shown in Figure 2, hence the majority of the revision to overall GDP.

Upward revisions in 2009 Q4 were accompanied by a small downward revision of 0.1 percentage points to growth in the third quarter, when output is now estimated to have declined by 0.3 per cent. This mainly reflected a larger contraction in the business services and finance sector.

Capital goods lead the rise in production output

Output in the production sector fell sharply during the recession, registering a peak to trough fall of 13.8 per cent between 2007 Q4 and 2009 Q3. As a high proportion of UK industrial production is exported, the sector was adversely affected by the large fall in international trade as the main

global economies entered a synchronised downturn. Production output also tends to exhibit greater cyclical volatility than the rest of the economy due to the workings of the stocks cycle – that is production falls faster than demand (GDP) as businesses increasingly meet orders by running down stocks of finished goods, works in progress or raw materials.

Figure 3 compares the growth of the main industrial groupings making up the production sector in the third and fourth quarters of 2009. In the third quarter, production output fell by 0.9 per cent, but after contracting for seven consecutive quarters, there was growth in quarter four when the sector expanded by 0.4 per cent.

Consumer durables production growth picked up significantly in the fourth quarter to 1.8 per cent, but as this accounts for only about 3.5 per cent of

total production activity, the contribution to overall growth was small. Growth in consumer non-durables (26 per cent of production activity) was largely unchanged between the two quarters, contracting by 1.5 per cent in Q3 and 1.4 per cent in Q4 respectively. The biggest contributions to the improvement in growth between the third and fourth quarters came from the capital goods and the intermediate goods and energy industries.

Capital goods producers (21.5 per cent of total production output) saw output growth accelerate from 0.2 per cent to 4.1 per cent. In terms of contributions to growth, this represents a move from broadly flat to 0.9 percentage points, and may be a reflection of improving overseas demand as growth in the rest of the world starts to pick up and from government stimulus spending on infrastructure.

However, it is worth noting that the recent recovery in capital goods production is slight when compared to the 17.1 per cent fall in output between 2008 Q1 and 2009 Q1. This sector had been particularly adversely affected by the global recession. As capital goods purchases are usually lumpy and irreversible, they tend to be very sensitive to credit conditions, sentiment and the economic outlook, and therefore strongly procyclical.

Intermediate goods and energy account for about one half (49 per cent) of the output of the UK production industries. In 2009 Q4 output contracted by 0.2 per cent, but this was a significant easing compared with the 1.2 per cent decline in the previous quarter. The slower pace of contraction meant the contribution to quarterly production growth improved from -0.6 per cent to -0.1 per cent

Figure 3
Contributions to production sector growth in 2009 Q3 and 2009 Q4

Source: Index of Production

Figure 4
Manufacturing output growth in 2009 Q3 and 2009 Q4

Source: Index of Production

Figure 5
Contributions to services sector growth in 2009 Q3 and 2009 Q4

Source: Index of Services

between the third and fourth quarters. This provides some evidence of improving activity in the domestic and international economies. Output of intermediate goods rose for the second successive quarter, in line with the reported slowdown in the rate at which companies are de-stocking (running down inventories). And the speed at which energy output was falling slowed from -3.3 per cent in quarter three to -0.8 per cent in quarter four, suggesting that business activity may be starting to improve, or at least is declining at a slower rate than before.

Production activity consists of manufacturing, the extraction industries, and the supply of electricity, gas and water. Manufacturing is the largest of these three broad industry groupings accounting for nearly 80 per cent of all production. Faster growth in capital goods production has been reflected in the patterns of growth within the UK manufacturing sector over the last two quarters (Figure 4).

Between 2008 Q1 and 2009 Q3 manufacturing output fell by 14 per cent. Particularly sharp falls of 5.4 per cent and 5.2 per cent were recorded in the final quarter of 2008 and first quarter of 2009 respectively, but since then the pace of contraction eased, declining by 0.2 per cent in 2009 Q3, before growing by 0.8 per cent in quarter four. Most of the improvement between the third and fourth quarters has been concentrated in industries producing equipment. Growth in the machinery and equipment industry picked up from -2.9 per cent to 2.1 per cent. In the electrical and optical equipment industry a contraction of -0.3 per cent gave way to growth of 2.8 per cent. And transport equipment growth rose sharply from 2.4 per cent to 8.0 per cent. Together, these three industries are classified as the engineering and allied industries, accounting for around 30 per cent of total manufacturing output. Combined growth picked up from zero in quarter three to 4.6 per cent in quarter four, contributing 1.4 percentage points to total manufacturing growth in the final quarter of 2009.

Performance in other manufacturing industries was mixed, but on the whole weaker than in the third quarter. Output in food, drink and tobacco declined by 2.2 per cent, in line with the output of consumer non-durables (Figure 3), and making a -0.3 percentage

points contribution to fourth quarter manufacturing growth. However, chemicals and man-made fibres and basic metals and metal products, both accounting for just over 10 per cent of total manufacturing output, recorded an improvement in output growth between the third and fourth quarters of 2009.

Motor trades, wholesale distribution and business services contribute to faster service sector growth

As service sector output accounts for around three-quarters of UK GDP it tends to be the main driver of economic growth. Compared to previous recessions, the recent fall in services output has been relatively severe. So despite growth picking up to 0.5 per cent in the fourth quarter of 2009, following a contraction of 0.3 per cent in quarter three, output is still 4.2 per cent lower than the pre-recession level.

Figure 5 shows contributions to service sector output growth in the third and fourth quarters of 2009 for the main divisions of the Index of Services. Three divisions accounted for the majority of service sector growth in the latest quarter – motor trades (division 50), wholesale distribution (division 51) and other business activities (division 74).

Motor trades grew by 5.2 per cent in each of the last two quarters, adding approximately 0.16 percentage points to total service sector growth. Motor car sales may have been supported towards the end of 2009 by the vehicle scrappage scheme and also the lower rate of VAT

before it reverted from 15 per cent to 17.5 per cent in January 2010. Even though output has recovered strongly in the latest two quarters it remains 8.6 per cent below the level in April 2008. It is worth noting that stronger recent growth is from a low base – after motor sales fell substantially at the start of the recession as consumer confidence plunged and credit was restricted.

Wholesale distribution growth accelerated from 0.3 per cent in quarter three to 2.7 per cent in quarter four. Given its relative weight in the level of output, this contributed around 0.15 percentage points to total service sector growth. However, like motor trades, output is still far below its pre-recession level, currently 10.2 per cent lower than in April 2008.

Other business activities include a myriad of services such as management consultancy, accountancy and legal services. As these largely consist of business to business services the output of this sector may reflect the degree of activity and confidence in the corporate sector as a whole. And as a relatively large weight in the Index of Services (12.6 per cent of total services output) it is an important factor in determining services growth. Between the third and fourth quarters growth picked up from 0.4 per cent to 1.3 per cent contributing 0.17 percentage points to services output growth.

The remainder of the services sector either recorded a small improvement in output growth, or an easing in the speed of contraction. However, taking into account relative Index of Services weight, no particular industry significantly impacted on growth in either direction.

In 2009 Q4, the largest downward contributions to growth came from financial services (where output fell by 1.2 per cent) and recreation, cultural and sporting activities (-2.3 per cent), but in both cases the impact on the overall growth rate was smaller than -0.1 percentage point in magnitude.

Slower rate of de-stocking adds to growth, but business investment contracts strongly

The Output, Income and Expenditure statistical bulletin provides the first estimates for the demand side of the economy for a given quarter. Figure 6 shows the contributions of the main categories of expenditure to total GDP growth in the third and fourth quarters of 2009.

These contributions had a mixed impact on GDP growth in the fourth quarter. Positive contributions came from consumption, government spending, and also the 'other' category which consists of non-profit institutions serving households (NPISH), valuables and inventories. Negative contributions came from gross fixed capital formation and net trade (the difference between exports and imports).

Consumption growth increased to 0.4 per cent in quarter four from 0.1 per cent in quarter three. Although consumption has now grown for two successive quarters, the increase in spending has been modest. The rise in the saving ratio during 2009 suggests that households remain cautious, looking to pay down debts, strengthen balance sheets and provide buffers against shocks to future income. Presently there is no information available on the components of expenditure for the latest published quarter, but this detail will be available when *Consumer Trends* are published alongside the Quarterly National Accounts next month – the third estimate of GDP for 2009 Q4.

Government consumption growth increased from 0.4 per cent to 1.2 per cent. Stronger growth may possibly reflect counter-cyclical spending. For example maintenance work in the public sector was brought forward as part of the government's fiscal stimulus package.

Figure 6
Contributions to GDP growth by main expenditure categories in 2009 Q3 and 2009 Q4

Source: GDP Output, Income and Expenditure

Figure 7
Contributions to GDP growth by main expenditure categories in 2009 Q3 and 2009 Q4

Source: GDP Output, Income and Expenditure

Figure 8
Growth in UK imports and exports and contributions of net trade to GDP growth

Source: GDP Output, Income and Expenditure

However, despite growing faster than consumption, the lower share in total expenditure meant the contribution to GDP growth in quarter four was similar at around 0.25 percentage points.

The largest positive contribution came from the 'other' category of expenditure adding around a half percentage point to 2009 Q4 GDP growth and was driven almost entirely by changes in inventories. These are stocks of raw materials, semi-finished and finished goods, held by businesses, in order to meet future demand or production needs. Inventories are a small part of the level of GDP (-0.9 per cent in 2009 Q4), but changes in inventories can impact strongly on changes in GDP. This is through the aforementioned stocks cycle where production can fall almost abruptly in a downturn as businesses meet orders by running down stocks. In the upswing of the economic cycle this effect should go into reverse.

Figure 7 shows the pattern of inventories (including and excluding alignment adjustments which are used to help balance the expenditure and output measures of GDP) over recent quarters.

This confirms that although the change in inventories continues to be negative (meaning that firms are running down stocks), the speed at which de-stocking is taking place slowed in quarter four, thus contributing positively to GDP growth.

The speed at which inventories are being run down slowed considerably in the manufacturing and 'other' industries (which includes motor trades among others) sectors, which is consistent with increased output in both these industries. Changes in inventories in wholesale distribution though became increasingly negative in the fourth quarter, even though this industry made a relatively important contribution to services output growth.

Negative contributions to GDP growth came from gross fixed capital formation (GFCF) and net trade.

GFCF contracted by 3.1 per cent in the fourth quarter, pulling total GDP growth down by 0.5 percentage points. Complete data on the components of GFCF will not be available until the publication of the Quarterly National Accounts. However, provisional 2009 Q4 results for business investment reported a contraction of -5.8

per cent. As this accounts for around 60 per cent of total GFCF, the contribution to overall GFCF growth was -3.4 percentage points.

Business investment has now contracted in every quarter since reaching a peak in 2008 Q2. In 2009 Q4 business investment was 27 per cent lower than this peak level. Ongoing weakness in business investment may reflect uncertainty or low confidence over the future strength of the economic recovery, explaining the unwillingness to spend in installing extra capacity. Businesses, looking to rebuild their balance sheets and reduce debt, may also be cautious about borrowing to spend on capital items.

Net trade has made a negative contribution to GDP growth in each of the last two quarters, as imports grew faster than exports (**Figure 8**). In quarter four, exports grew by 3.7 per cent but imports rose by 4.1 per cent. As a result, net trade had a -0.2 percentage points impact on GDP growth.

As **Figure 8** shows, net trade generally made a positive contribution to GDP growth during the recession as the fall in imports outstripped the fall in exports. The UK has been running a persistent current account deficit for several years so it was suggested that the recession may prompt a rebalancing in the UK economy away from domestic (household) spending to exports. But as the economy emerges from recession, and domestic spending returns to growth, import growth has been stronger than exports. This may also reflect the slow recovery in demand in the rest of the world, particularly within the European Union, where household spending has been sluggish.

It is difficult to identify the precise impact of sterling depreciation on exports and imports. Business surveys have reported little positive effect, largely because this has been outweighed by the weakness in global demand. Net trade and sterling depreciation played an important role in the recovery from the early 1990s recession, but at the time, growth in the rest of the world was relatively robust. Naturally, it is also difficult to prove the counterfactual that the contribution of net trade to growth in the recent quarters would have been smaller had it not been for the effect of sterling depreciation.

Figure 9
Retail sales growth including and excluding automotive fuel

Source: Retail Sales Index

Figure 10
Contributions to retail sales spending (excluding automotive fuel)

Source: Retail Sales Index

Internet spending supports retail sales volumes

The January 2010 Retail Sales statistical bulletin introduced a significant classification change with the inclusion of automotive fuels and improved methodology for experimental Internet statistics.

Incorporating automotive fuels into the index has altered the path of retail sales in recent years (Figure 9), and particularly so in the last two months when the indices including and excluding automotive fuels diverged. For the three-month period to January 2010, retail sales were 0.5 per cent lower when compared to the previous three-month period. However, once automotive fuel is excluded, retail sales growth over the same period was up 0.7 per cent.

Retail sales from predominantly automotive fuel establishments fell sharply in the three-months to January by 15.1 per cent, and by 11.1 per cent in the month of January alone. This may be the result of further increases in fuel prices and also poor weather impacting on the amount of travelling undertaken in that month.

Excluding automotive fuels, retail sales have been relatively robust throughout the recession period, especially when compared to wider measures of household consumption. The contributions to retail sales growth by main category of retail establishment over the last two years are shown in Figure 10. It can be seen that retail sales only briefly contracted towards the end of 2008 and beginning of 2009, but recovered well in the middle of last year. Of particular note has been the growing contribution of non-store retailing despite its relatively small share in total retail spending, and also the strength of predominantly non-food retailing even though this consists of the discretionary consumer items on which consumers may be expected to spend less in a recession.

In the three months to January 2010, the non-store retailing sector grew by 6.1 per cent, much faster than other categories of retail spending, contributing 0.3 percentage points to growth. This segment includes Internet spending, which has been rising rapidly as a proportion of total retail sales volumes in the last three years – from 3 per cent in January 2007 to 8 per cent in 2010. This growing trend in Internet purchases

has therefore been supporting retail sales, although this may have come at the expense of more traditional high street spending.

Other ONS data also highlights the growing importance of Internet spending in the UK economy. The 2008 E-commerce survey, covering private non-financial firms employing 10 or more people, reported a strong rise in sales over the Internet, from £65.8 billion in 2004 to £222.9 billion in 2008. Also, nearly three-quarters (73.5 per cent) of the businesses in the sample had a website and the strong increase in Internet sales has been broadly reflected across all sectors. However, the wholesale and retail sector reported the strongest rise, up from £20.5 billion in 2004 to £83.6 billion in 2008.

At the same time, there has been growing access to and wider use made of the Internet by households. The Internet access statistical bulletin, based on the National Statistics Omnibus survey, reported that 18.31 million households (70 per cent of all households) had internet access in 2009. Of these 90 per cent had a broadband connection. Both these ratios have risen significantly in recent years. In 2006, 57 per cent of households had Internet access of which 70 per cent had a broadband connection. Now only 21 per cent of the UK adult population have never accessed the Internet, concentrated in the more elderly categories. Internet usage has also become more frequent. The 2009 survey reported that 73 per cent of those who said they were frequent users accessed the Internet every day or almost every day.

These trends have also been reflected in household and individual purchases over the Internet. 69 per cent of UK adults have purchased over the Internet, up from 58 per cent in 2008. And of those who reported that they had purchased over the Internet, 83 per cent had made a purchase in the three-months prior to the survey, with films, music, clothes, sporting goods, household goods, holiday accommodation, and books and magazines the most popular items. The main reason for buying over the Internet was convenience, but other important factors highlighted by the survey included easy to use websites, opportunity to buy goods not available in the area, lower prices and a wider choice of goods.

Retail spending, particularly in the predominantly non-food sector, appears

to have been supported by strong discounting. Inflation in the retail sales deflator, excluding automotive fuels, has consistently been lower than consumer price inflation in recent years. Prices in household goods stores, textiles clothing and footwear stores, non-specialised stores and other stores have been falling for most of the last decade, but the rate of deflation quickened at the end of 2008 and beginning of 2009.

One of the consequences of retail goods price deflation has been a separation in the paths of retail sales values and volumes. **Figure 11** plots the ratio of retail sales to gross household disposable income in both current and also constant (2005) prices. (It should be noted here that not all retail spending is actually done by households, although they are the largest source of retail demand, as businesses and foreign tourists also buy goods from retail establishments.) While retail spending has steadily increased as a proportion of real household disposable incomes in volume terms, the ratio in value terms has been much more stable. More recently, the ratio in value terms has fallen back, while in volume terms it has remained broadly unchanged.

Figure 11 gives different perspectives on the strength of retail spending. In the period leading up to the economic downturn, retail spending grew faster than disposable incomes in real terms. But because retail goods prices were falling and disposable income rising, higher volumes of purchases could be achieved while keeping the value of retail spending at a more stable level relative to disposable incomes. From this perspective, households may not view their past retail spending relative to disposable incomes as very profligate. In turn, this might reduce the extent to which they cut back on the volume of retail spending in the downturn. The volume of retail spending is thus being supported by discounting in the recession.

Unemployment falls, but duration of unemployment increases

In the final quarter of 2009, headline unemployment fell marginally by 3,000 to 2.457 million. The unemployment rate remains at 7.8 per cent for the third successive quarter, having risen from 5.2

per cent in the final quarter of 2007 as the downturn in output passed through to the labour market. Latest data supports the view that the labour market has somewhat stabilised in the second half of 2009.

However, the average duration of unemployment has been rising steadily. Although flows into unemployment have slowed, in line with the lower reported redundancy rate, flows out of unemployment into employment are yet to show any marked improvement. Business surveys have reported an easing in the level of redundancies after firms implemented cost saving and efficiency

programmes in 2008, but recruitment intentions remain passive due to the uncertain economic outlook and existing spare capacity.

These flows suggest that those who became unemployed at the start of the recession have continued to face a difficult labour market. Between 2007 Q4 and 2009 Q3, the number of unemployed people per vacancy increased from 2.4 to 5.7. Although the ratio fell back to 5.3 in the final quarter of 2009, it remains well above the long term average. As a result the average duration of unemployment has been on an upward path.

Figure 11

Proportion of retail sales to gross household disposable income

Source: Retail Sales Index

Figure 12

Numbers of unemployed by duration

Source: Labour Force Survey

Figure 13

Change in the unemployment rate from 2007 Q4 to 2009 Q4 by age group

Source: Labour Force Survey

Figure 12 shows the level of unemployment by duration. Although the majority of unemployed have been so for less than six months (1.258 million in 2009 Q4), as a proportion of total unemployment these have been falling in the last year from 61.2 per cent in 2008 Q4 to 51.2 per cent in 2009 Q4. Numbers unemployed for 6 to 12 months have more than doubled in the last two years, rising from 256,000 in 2007 Q4 to 536,000 in 2009 Q4. As a proportion of total unemployment, this duration increased from 15.9 per cent to 21.8 per cent over this two year period.

Those unemployed for 12 to 24 months and over 24 months have also increased in numbers. Between 2007 Q4 and 2009 Q4 the total unemployed for more than a year increased from 387,000 to 663,000, rising as proportion of total unemployed from 24 per cent to 27 per cent.

Unemployment and inactivity rates for young people increase the most

Between 2007 Q4 and 2009 Q4, while total unemployment has risen, the change in the unemployment rate has varied between different age groups (Figure 13).

In the 16 to 17 years age category, the unemployment rate increased markedly, up 8.5 percentage points to 33.6 per cent. For the 18 to 24 years age category the unemployment rate rose by 5.6 percentage points to 17.6 per cent and for the 24 to 49 years age group the unemployment rate increased by 2.4 percentage points to 6.2 per cent. The pattern of smaller increases in the unemployment rate for each successive age category continues to the over 50 age category, where the increase in the unemployment rate was the lowest – rising by 1.8 percentage points to 4.7 per cent.

This pattern suggests that younger people have been disproportionately affected by the recession and the associated downturn in the labour market. As these groups tend to be more reliant on graduate recruitment and other entry schemes, their job prospects may have been severely impaired by the sharp fall in employers' recruitment intentions.

However, although proportionately worse affected, due to lower numbers of

economically active people in the younger age groups, the absolute contribution to the rise in unemployment during the last two years was less significant. Total unemployment increased by 844,000 of which only 10,000 was attributed to the 16 to 17 years age group and 226,000 to the 18 to 24 years age group. The largest contribution was in the 25 to 49 years age category where the increase in unemployment of 445,000 accounted for over half the total increase. In the over 50 years age category the number of unemployed increased by 163,000.

Growing inactivity has also been concentrated in the younger age groups. In the last year (that is 2008 Q4 to 2009 Q4) working age inactivity increased by 241,000. This was almost entirely accounted for by the 54,000 increase in the 16 to 17 years age group and the 186,000 increase in the 18 to 24 years age group. The other three age groups, 25 to 34 years, 35 to 49 years, and 50 years to state pension age, only showed marginal changes. As a result the inactivity rate of 16 to 17 years age group increased by 4.9 percentage points to 61.7 per cent. For the 18 to 24 years age group the inactivity rate increased by 2.9 percentage points to 29.2 per cent. Changes in the inactivity rates of other age groups were slight.

Stated reasons for inactivity show a large increase in students. Of the 241,000 rise in the total inactive working age population in the last year, 217,000 were accounted for by growing student numbers, representing a 10 per cent increase on the year. When viewed alongside the increase in unemployment and inactivity rates of young people, it suggests that growing student numbers may be a reflection of the weak labour market conditions facing younger people.

Other reasons for inactivity showed smaller changes in the last year. The numbers of those looking after family or home fell by 27,000, while the temporary and long-term sick grew by 8,000 and 25,000 respectively and the number of retired increased by 10,000. The 28,000 increase in discouraged workers may be further evidence of the restricted labour market, but this still represents a low proportion of the working age inactive population.

CPI inflation up to 3.5 per cent, RPI inflation up to 3.7 per cent

Annual inflation in the Consumer Prices Index (CPI) increased to 3.5 per cent in January 2010 (Figure 14). Inflation has picked strongly since September 2009, when the CPI inflation rate reached a recent low of 1.1 per cent. The latest rise has been driven by motor fuel prices and by the reversion of the rate of VAT to 17.5 per cent in January 2010. The rate of VAT was temporarily reduced to 15 per cent in December 2009 as part of the fiscal stimulus package announced in the 2009 Pre-Budget Report.

After falling significantly in the second half of 2008, motor fuel prices have risen strongly throughout 2009. In January 2010, motor fuels and lubricants prices were 25.3 per cent higher than in the same month a year earlier, contributing around 1 percentage point to the overall CPI inflation rate. A further substantial increase in inflation has resulted from the increase in VAT. ONS estimates that changes in indirect taxes contributed 1.7 percentage points to CPI inflation in January 2010.

A strong rise in inflation has also been observed in the Retail Prices Index (RPI).

Figure 14
Annual inflation in the CPI

Source: Consumer prices

Figure 15
Annual inflation in the RPI

Source: Consumer prices

Figure 15 shows that the annual RPI inflation rate has increased from -1.4 per cent in September 2009 to 3.7 per cent in January 2010. Although RPI weights differ to those in the CPI, the rise in motor fuel prices and VAT increase have also contributed to the higher inflation rate.

However, the overall pick up in RPI inflation has exceeded that in the CPI. This is largely due to the inclusion of mortgage interest payments in the RPI. The large reduction in interest rates at the end of 2008, to the extent that they were passed through to lower mortgage

rates, reduced the RPI inflation rate throughout 2009, accounting for its fall into negative territory. However, this effect is now beginning to fall out of the annual calculation, pushing up RPI inflation. RPI-X is a measure that excludes mortgage interest payments – the increase in this measure of the inflation rate since September 2009 has been lower at 3.3 percentage points compared to 5.0 percentage point for the total RPI. RPI-Y excludes both mortgage interest payments and indirect taxes so excludes not just last year's reduction in mortgage interest rates but also the impact of the change in the VAT rate. As a result, the rise in the RPIY inflation rate between September 2009 and January 2010 was lower still at 1.3 percentage points.