

Monthly economic commentary

July 2010

Monetary policy takes a back seat

Monetary policy continues to take a back seat as the new Government wields fiscal policy to grapple with the record deficit and reduce the size of the public sector. Interest rates have not moved since March 2009 and the programme of quantitative easing stopped at £200 billion in February this year. For several months, it seemed almost as if the MPC was just going through the motions of a monthly meeting. But the debate within the MPC has now become a little more animated, with two of the current eight members having recently spoken out about the risk of an upward creep in inflation and one of them – Andrew Sentance – voting for a rate rise at the June meeting.

Those concerns may be shared, in varying degrees, by other members, but they believe it is too soon to increase Bank Rate because of the fragility of growth and the marked fiscal squeeze implied by June's Emergency Budget. A 'double dip' recession still seems improbable, but the prospect of government spending cuts (= public-sector job losses), higher taxes (= lower consumer spending), and the Eurozone's problems (= weaker UK export prospects) have renewed uncertainty. And with the Bank of England expressing concerns about the availability of credit, the risks to even the modest growth forecasts for 2010 remain on the downside.

Despite the more pessimistic tone of media comment on the economy, there is little in the numbers to suggest that activity is turning down again. At worst, one or two indicators seem to have stalled, but most are still inching upwards. This may be disappointing, but it is in line with the GDP growth of 1.2% that is predicted for 2010 by the newly-created (and independent) Office for Budget Responsibility (OBR) and by HSBC. Unemployment, spare capacity and a squeeze on profits will remain a feature of the economic landscape until growth gets back to an annual rate of around 2.5%. This could take until 2012 and so, for many businesses, the economic climate will still feel very much like recession.

In the housing market, house prices and activity have continued to edge up, with mortgage approvals showing small monthly increases (though they are still well below pre-recession levels). The Government's decision to abolish HIPs is likely to increase the number of properties on the market. Retail sales in May were stronger than expected, partly due to consumers stocking up on food and televisions for the football World Cup. In general, however, consumers still seem to want to pay off debt, as evidenced by figures showing weak credit card lending, a small net repayment of unsecured lending and a slightly larger repayment of personal loans, overdrafts and mortgages.

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As is often the case, the labour market data are confusing. The traditional claimant count measure of unemployment fell by 30,900 in May, following similar declines in March and April. The Labour Force Survey, on the other hand, was less encouraging. Although the number of people in work rose by 5,000 in the three months to April, this was entirely due to part-time employment, as the number in full-time jobs continued to fall. By the same survey method, the number looking for work rose by 23,000, with another increase in the 'economically inactive' group.

Viewed in industrial terms, the news is largely positive. A little of the shine came off the manufacturing sector in June's surveys as well as in the official index of output, perhaps reflecting tighter export markets, especially in Europe. Yet the closely-watched PMI surveys remain above the important expand/contract benchmark score of 50, where they have been since the final quarter of 2009. The Emergency Budget, however, spelt out tough public sector spending cuts which will have implications for the construction industry in particular, and responses to the surveys in coming months may be less upbeat.

There was even some comfort from the latest inflation numbers. The official measure, the CPI, although still above the target range, eased back down from 3.7% in April (the highest for 17 months) to 3.4%. And the so-called 'core' rate (which excludes food and energy) fell back to 2.9%. The softening of the rise in manufacturers output and input prices supported the Governor of the Bank of England's view that inflationary pressures will subside and that it is unnecessary to raise interest rates. The inflation hawks, however, point to the impact of the global recovery on commodity prices, weaker sterling on imported prices and the VAT rise from January, which will feed straight through to the CPI.

The one economic issue that mattered at the election was the size of the government deficit and the level of accumulated debt. Chancellor Osborne met the issue head on and surprised many people by doing exactly what he said he would do. Yet, for all the tough action that is now being proposed, there will still be a budget deficit in 2015 and the national debt-to-income ratio will remain above 60%. It will be a long haul.

June's Emergency Budget can be viewed as a success on several fronts. There is a clear path to restructuring the public finances, the size of the state will be reduced, the business sector benefited by being punished least, and growth appears to be kept on track. But these medium-term gains will come with a short-term price tag. Public-sector jobs (in the hundreds of thousands) will be lost, perhaps before the private sector is ready to take on extra staff, and there will be wide regional and sectoral disparities. The prospect of industrial unrest and a test of the Government's nerve cannot be ruled out.

Yet the negative impact should not be overstated. By the time of the VAT increase, the economy should have recorded five straight quarters of growth, making the recovery almost as long as the recession. And interest rates will have been at 0.5% for almost two years, giving the household sector in particular time to unwind some of its debt. Forecasts for growth next year of around 2% moreover, are not over-optimistic and do not depend on a buoyant consumer sector.

While Chancellor Osborne has presented a very plausible medium-term outlook, there are risks, but these are more international than domestic. If consumer and government spending are to make smaller contributions to growth in the future, trade and investment must fill the gap. The weaker pound helps exports but this is being offset by the problems in Europe (which accounts for 50% of the UK's exports) and the sluggish response of the US economy (still the UK's largest single market). Should the weaknesses in our key markets continue and even worsen, it is not clear whether the authorities have a Plan B.

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