Economic Review

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Summary

Gross Domestic Product fell by 0.5 per cent in the final quarter of 2010 according to preliminary estimates. The Office for National Statistics judges that this contraction was mainly due to disruption caused by severe weather conditions in the run up to Christmas. However, even allowing for the effects of bad weather, GDP would otherwise have been broadly flat on the quarter – marking a slowdown in growth from earlier in the year – particularly in the services sector. In the calendar year 2010, public sector net borrowing excluding the impact of government intervention in the financial sector fell below 10 per cent of GDP. However, the current budget balance was broadly unchanged from 2009, with the fall in net borrowing reflecting a fall in public sector investment. Public sector net debt measures now include the liabilities of RBS and Lloyds Banking Group (LBG) – and in December 2010 totalled 154.9 per cent of GDP. Excluding the government's interventions in the financial sector, public sector net debt was significantly lower at 59.3 per cent. Consumer prices inflation rose to 3.7 per cent in December, and continue to be driven by indirect taxes, energy prices and food prices.

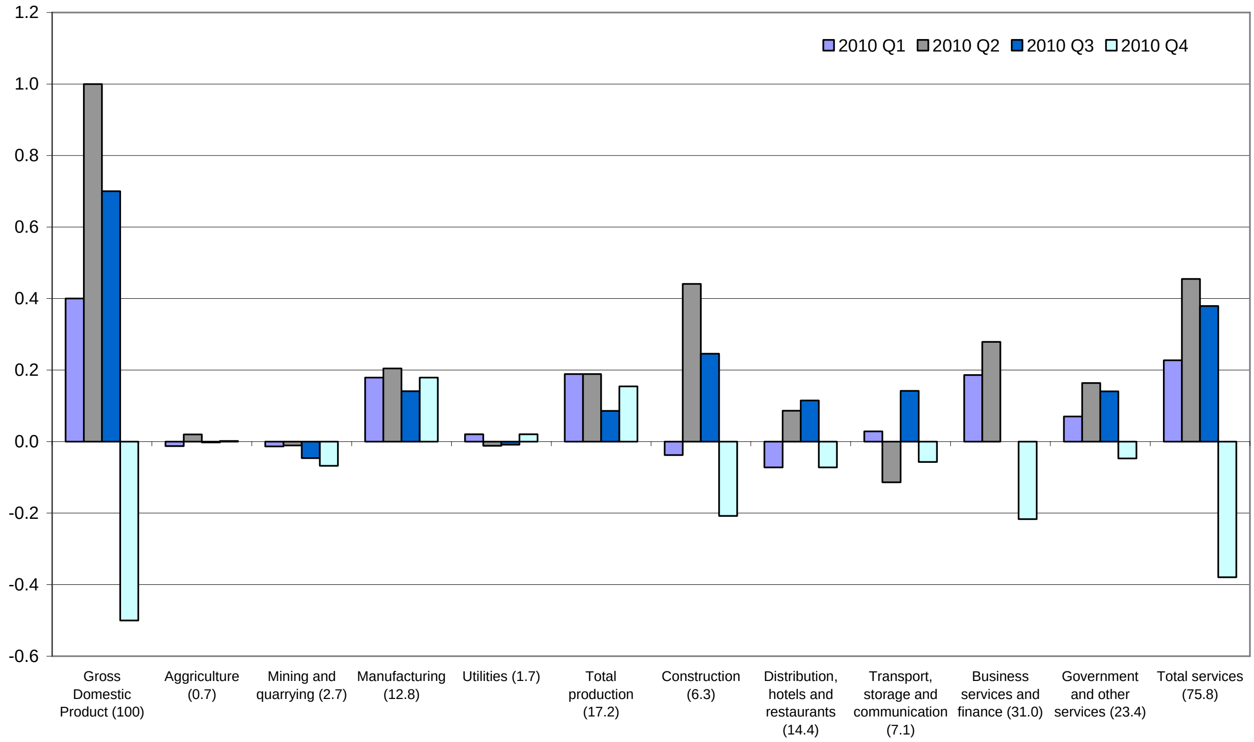
Gross Domestic Product falls in the final quarter of 2010

Preliminary estimates of Gross Domestic Product (GDP) show that the UK economy contracted by 0.5 per cent in the final quarter of 2010 (**Figure 1**). This brings to an end a run of four successive quarters of positive growth after GDP fell to a trough in the third quarter of 2009. The decline in output largely reflects disruption caused by bad weather conditions in December. The Office for National Statistics (ONS) judge that this subtracted about 0.5 percentage points from the fourth quarter growth rate. Without this negative impact, GDP would otherwise have been flat over the quarter.

Due to the rapid publication of preliminary estimates, at around 23 days after the reference period, missing or incomplete data have to be filled with forecasts and imputations in order to present a full set of accounts. Information is particularly limited for the third month of the quarter – in this case December – which created additional forecasting problems as this just happened to be when the bad weather hit. In response, compilers have looked to use more information for the third month of the quarter than usual by bringing forward response chasing and undertaking more analysis in the industries most likely to be adversely affected, such as hotels and restaurants and transport. The impact of the bad weather in January 2010 and the effects of the Ash Cloud in April were also used to help guide the forecasting process as previous examples of when economic activity had been affected by random and unpredictable shocks. Naturally, this is a difficult issue and due to the added uncertainty faced by ONS, preliminary estimates may be subject to greater revision than usual.

Figure 1 Contributions to economic growth by industry[1] in 2010

Percentage points



1. Industry weights shown in brackets

Source: GDP preliminary estimate, Office for National Statistics

Figure 1 also shows the contributions to growth by each main type of industry. Whilst manufacturing growth has continued to grow robustly in 2010 Q4, construction and services output fell. This differential pattern of growth was echoed by business survey data. Purchasing Managers Index (PMI) data and the British Chambers of Commerce (BCC) *Quarterly Economy Survey* both recorded relatively strong activity in UK manufacturing compared to construction and services towards the end of the year.

In 2010 Q4, manufacturing output expanded by 1.4 per cent on the quarter adding 0.2 percentage points to overall GDP growth. Manufacturing output has now grown at or above 1.0 per cent for five successive quarters and is 6.7 per cent higher than its trough in 2009 Q3. However, it is worth noting that manufacturing output is still 8.8 per cent lower than its pre–recession peak in 2008 Q1. This shows the extent to which manufacturing output fell during the recession and therefore its capacity to rebound alongside the global recovery. PMI, BCC and Confederation of British Industry

(CBI) surveys all report relative strong growth in UK manufacturing output in the final quarter of 2010, and especially in exports/foreign orders.

Following two quarters of relatively strong growth, construction output fell by 3.3 per cent in the latest published quarter, reducing overall GDP growth by 0.2 percentage points. ONS estimated that the impact of the bad weather in the construction industry was to lower GDP growth by 0.1 percentage points. PMI data covering the UK construction industry also reported a weather–related fall in output in December, especially in the residential sector.

Services account for around three–quarters of all UK economic activity so it is not surprising that these usually exert the biggest influence on GDP figures. Total services output was estimated to have contracted by 0.5 per cent in quarter four of last year, reducing GDP growth by around 0.4 percentage points. ONS judges that this fall was entirely down to weather–related factors. But even accounting for the effects of the snow, services growth has slowed in the second half of the year.

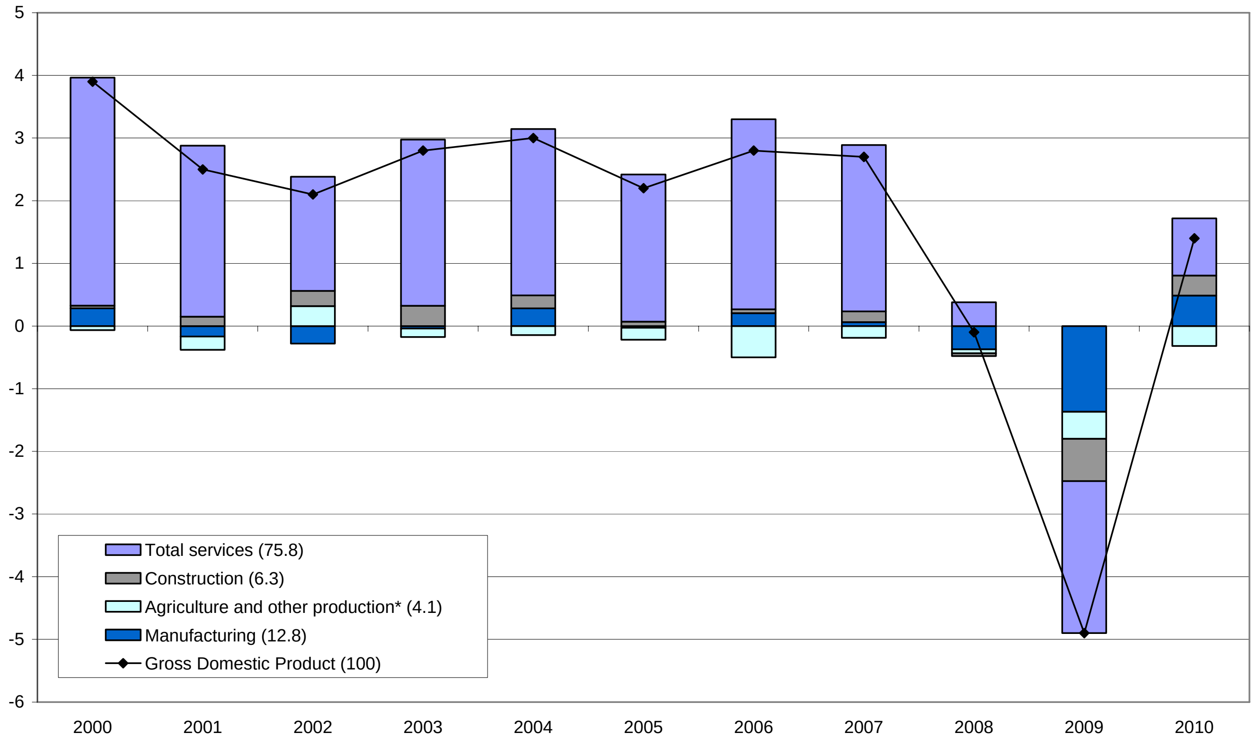
All the main sub–sectors of the services industry are estimated to have contracted in 2010 Q4. Distribution, hotels and restaurants saw output fall by 0.5 per cent, transport, storage and communications by 0.8 per cent, business services and finance by 0.7 per cent and government and other activity by 0.2 per cent. The services PMI for December also concluded that poor weather was responsible for a marginal fall in activity, especially in the distribution, transport and personal services industries. Although the BCC *Quarterly Economic Survey* was conducted before the snowfall in mid–December, it too reported weaker balances for services activity, especially stemming from home orders.

Now that preliminary data are available for 2010 Q4 it allows a first estimate of economic growth for 2010 as a whole to be produced. As **Figure 2** shows, after contracting by 0.1 per cent in 2008 and 4.9 per cent in 2009, GDP expanded by 1.4 per cent in 2010. If GDP growth in 2010 Q4 had been flat instead of a weather–affected -0.5 per cent, then growth for 2010 as a whole would have been 1.5 per cent. A weaker final quarter meant that actual GDP growth in 2010 was lower than the 1.8 per cent forecast made by the Office for Budget Responsibility (OBR) at the end of November. In their Economic and Fiscal Outlook, OBR predict GDP growth will be 2.1 per cent in 2011 and 2.6 per cent in 2012. This would mark a slower recovery compared to previous recessions, reflecting the protracted impact of the financial crisis on credit conditions, an extended period of private sector deleveraging and a significant fiscal contraction.

Of the 1.4 per cent increase in GDP, manufacturing accounted for 0.5 percentage points, services for 0.9 percentage points, construction for 0.3 percentage points, and agriculture and other production for -0.3 percentage points.

Figure 2 UK economic growth#, 2000–2010

Per cent



Industry shares reported in brackets

* Agriculture and other production also includes the basic price adjustment and any rounding errors

Source: GDP preliminary estimate, Office for National Statistics

Weak services growth in October and November 2010

Preliminary estimates for the final quarter of 2010 show a fall in service sector activity. Even accounting for the disruptive impact of bad weather, services output would have otherwise been flat marking a slowdown in growth during the second half of the year. This slowdown is also reported by business survey data.

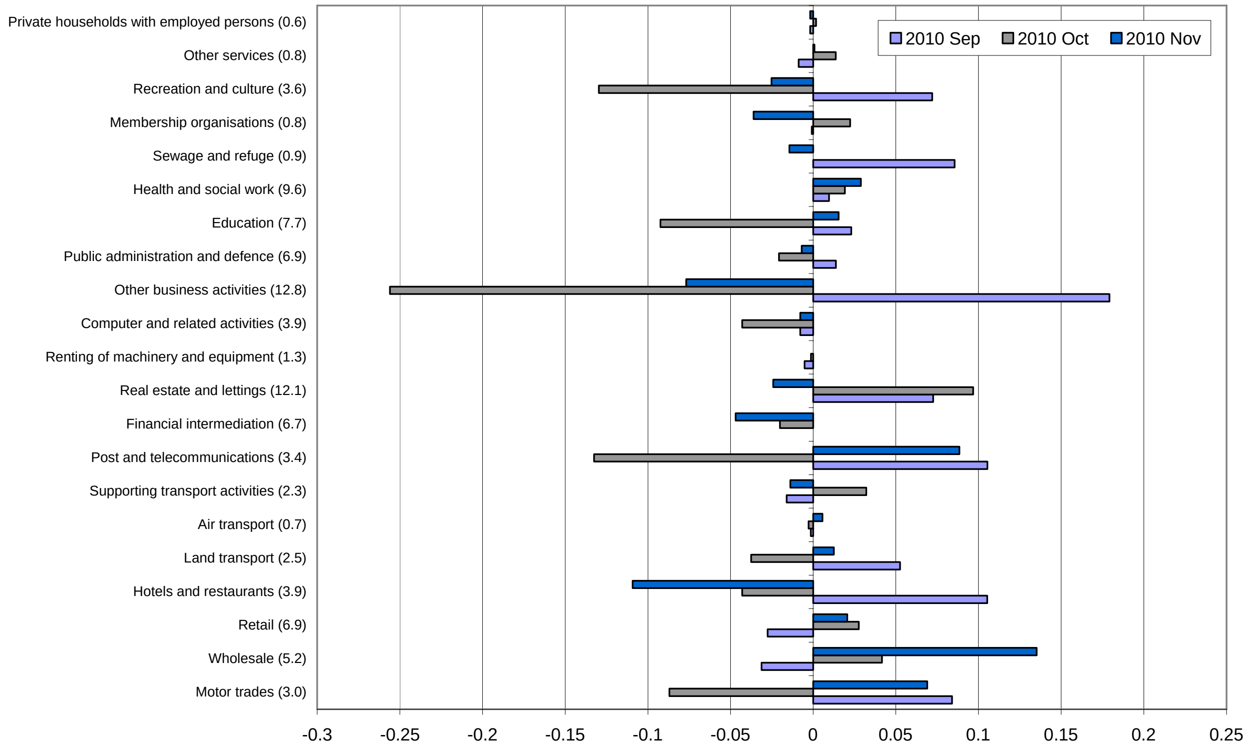
To explore this further, **Figure 3** looks at monthly changes in the Index of Services by industry between September and November 2010 – the most up–to–date figures currently available. These show that month–on–month growth was negative in October (-0.6 per cent) and flat in November. An overall contraction in the first two months of the quarter suggest that, even without the predicted impact of the weather disruption in December, fourth quarter services growth had weakened. For example, if service sector output was to increase in line with the consensus forecast of 0.5 per cent for 2010 Q4, then providing the October and November Index of Services remained unchanged, it would require a 1.5 per cent increase in the December index. Since the start of the time series in 1995, month–on–month growth in the Index of Services has only exceeded 1.5 per cent on one occasion. This was in July 2002, when output increased by 1.9 per cent following a contraction of 2.1 per cent in June 2002 due to an extra public holiday to celebrate the Queen's Golden Jubilee.

As Figure 3 also shows, the monthly contraction in October partly reflects fairly strong growth in the previous month. In September 2010, the Index of Services was 0.7 per cent higher than in August. It is noticeable that many of the industries that contracted in the October index had exhibited strong growth in the September index, for example other business activities. The total Index of Services was flat in November, mainly because positive month–on–month growth in some sub–sectors (motor trades, wholesale, retail and post and telecommunications) was offset by contractions elsewhere.

Slower service sector growth towards the end of the year may reflect a number of factors, including the start of a significant fiscal tightening and higher inflation eroding real incomes. Other factors likely to weigh on demand include a weakening in the housing market and ongoing credit constraints.

Figure 3 Contributions by industry* to monthly services growth, September to November 2010

Percentage points, month on previous month



* Industry weights in brackets

September month on month growth = 0.7 per cent

October month on month growth = -0.6 per cent

November month on month growth = 0.0 per cent

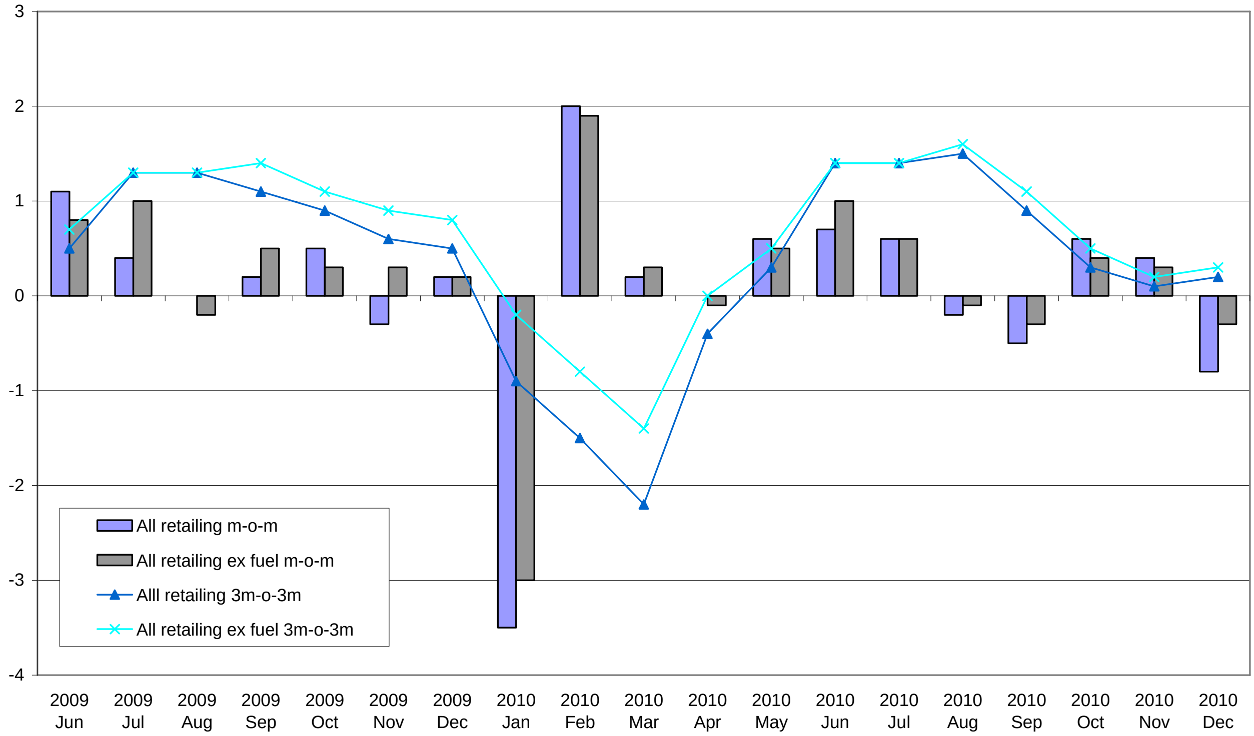
Source: Index of Services, Office for National Statistics

Bad weather hits December's retail sales

Retail sales fell by 0.8 per cent in December 2010 (**Figure 4a**). Excluding automotive fuel, the contraction was smaller at 0.3 per cent. These figures confirm the expected negative impact of the pre–Christmas snowfall, both on road transport and footfall through shopping centres and down high streets. Figure 4a also shows that the decline in retail sales was smaller than in January 2010, which was also adversely affected by winter weather conditions. However, in January 2010 the snowfall occurred towards the beginning of the month, compared towards the middle and end in December. It is also clear that retail sales rebounded strongly in February 2010. Whether such a rebound happens in January 2011 is difficult to predict. Some anecdotal evidence suggests that postponed Christmas shopping is unlikely to be redone at a later date. The rise in the rate of VAT in January 2011 also complicates matters, as ordinarily this would be expected to shift some consumption forward to December.

Figure 4a Retail sales growth

Per cent

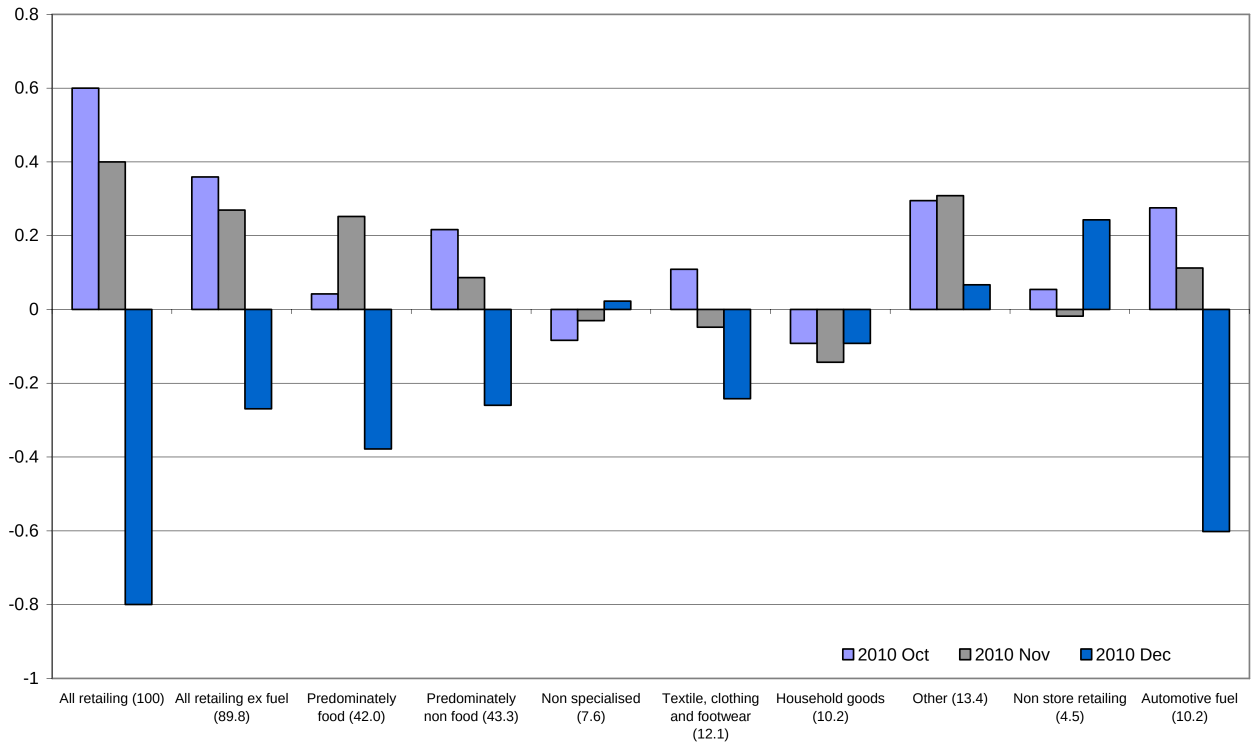


Source: Retail Sales, Office for National Statistics

Figure 4b presents the contributions to month–on–month retail sales growth in the final three months of the year. Clearly the largest negative contribution came from automotive fuel, a reflection of the impact of bad weather on travel. It is notable that the sector making the largest positive contribution to growth in December was the non–store sector, which predominantly includes catalogue and internet retailers. This may partly reflect a growing trend, but also a reaction to the bad weather with more shopping done online or through mail order than in person.

Figure 4b Contributions* to retail sales growth, October – December 2010

Percentage points



* Weights are in brackets

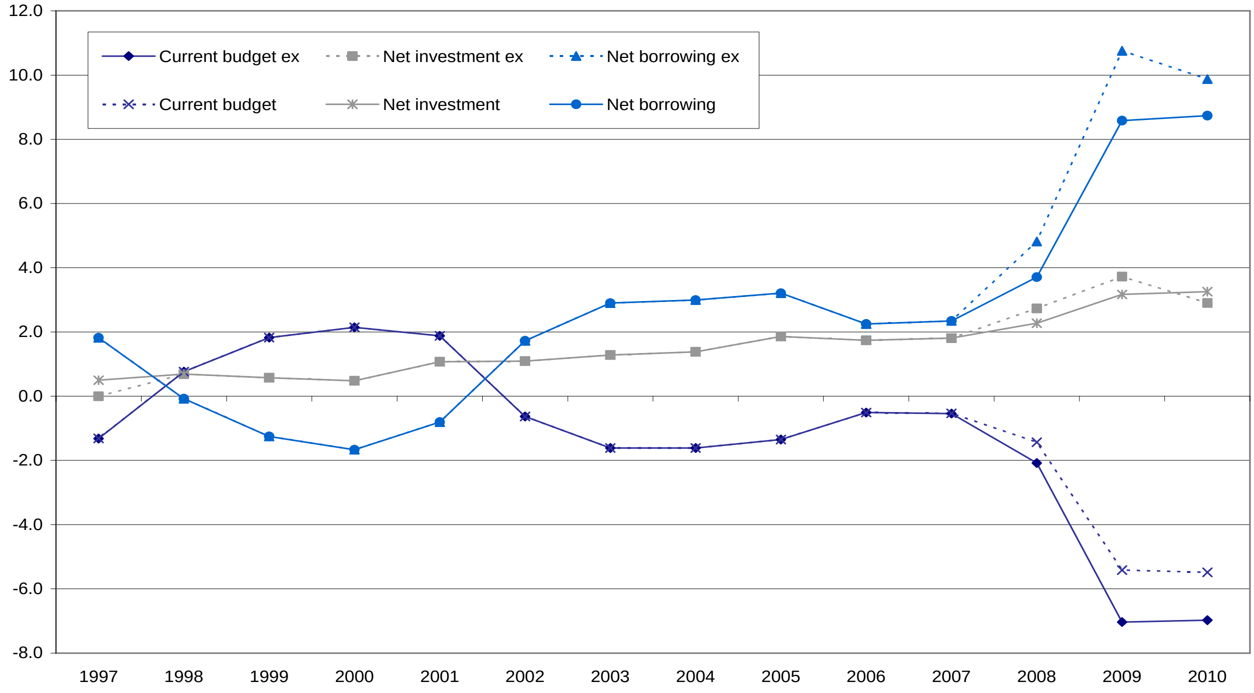
Source: Retail Sales, Office for National Statistics

Public sector net borrowing falls to below 10 per cent of GDP in 2010

Public sector net borrowing (PSNB) reflects the difference between public sector revenues and public sector consumption and investment expenditures. Excluding the effects from government interventions in the financial sector (PSNB ex), in the calendar year 2010 the public sector recorded a current budget deficit of 7.0 per cent of GDP, broadly unchanged from 2009. Public sector investment, as a share of GDP fell from 3.7 per cent to 2.9 per cent, and as a consequence, total net borrowing declined from 10.8 per cent of GDP to 9.9 per cent of GDP (**Figure 5**).

Figure 5 **Public sector finances, main balances**

Per cent of GDP



Source: Public Sector Finances, Office for National Statistics

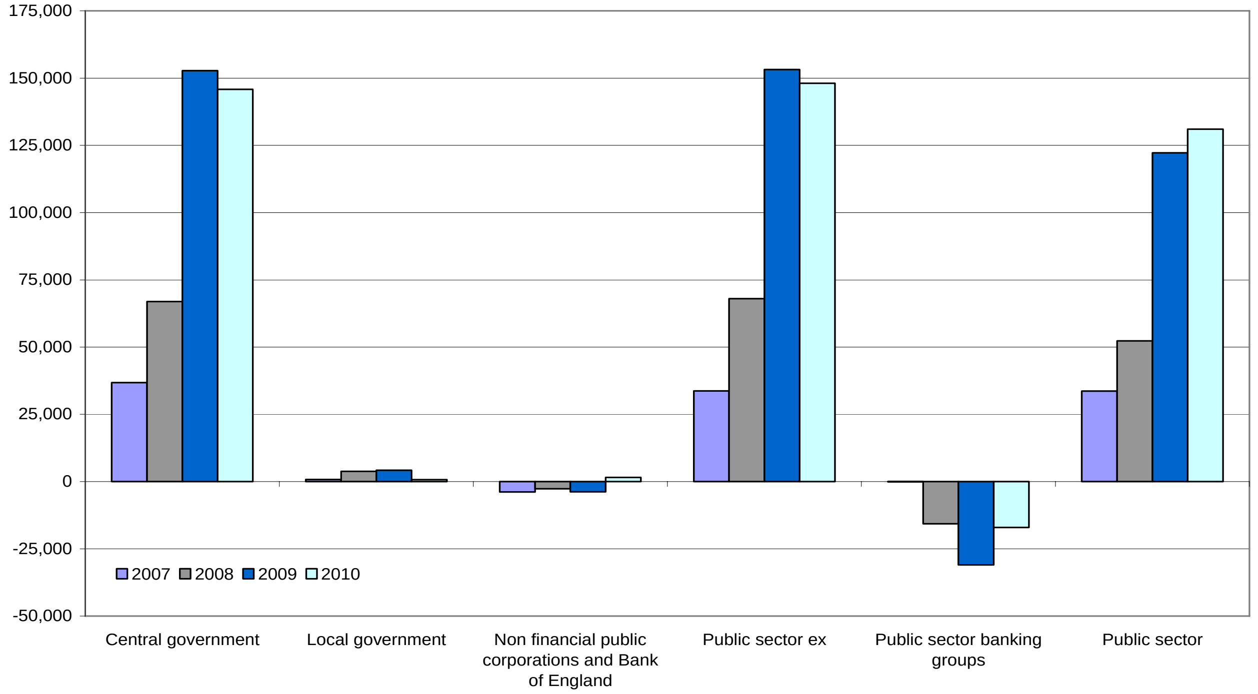
Including the impact of the government's interventions in the financial sector, public sector net borrowing does not look quite so bad. On this basis, the current budget balance is around 5.5 per cent of GDP and net borrowing (PSNB) lower at 8.7 per cent of GDP. This is because the government's interventions have resulted in it owning financial assets, such as shares in RBS and Lloyds Banking Group (LBG). Any positive income from these assets and the net profits of the publicly owned banks would then be scored to the current budget balance. As the government intends to ultimately return these asset and bank holdings to the private sector, their impact on the public sector finances is regarded as temporary and excluded from the underlying measure PSNB ex.

Figure 6a shows that public sector net borrowing is mainly centred in the central government sector. Other parts of the public sector make a fairly minimal contribution to PSNB. Figure 6a also shows that public sector banking groups are net lenders, hence reducing PSNB relative to PSNB ex.

Figure 6b highlights the impact of the recent recession on central government's net borrowing position. Whilst central government expenditure has continued rising, receipts have levelled off. The fall in 2009 was largely driven by a temporary reduction in the rate of VAT. This was restored to the higher rate in 2010, but receipts continued to reflect weaker revenues from income and wealth taxes. For example, in 2010, income and wealth tax revenues were over 8 per cent lower than in 2008 in current prices.

Figure 6a Public sector net borrowing

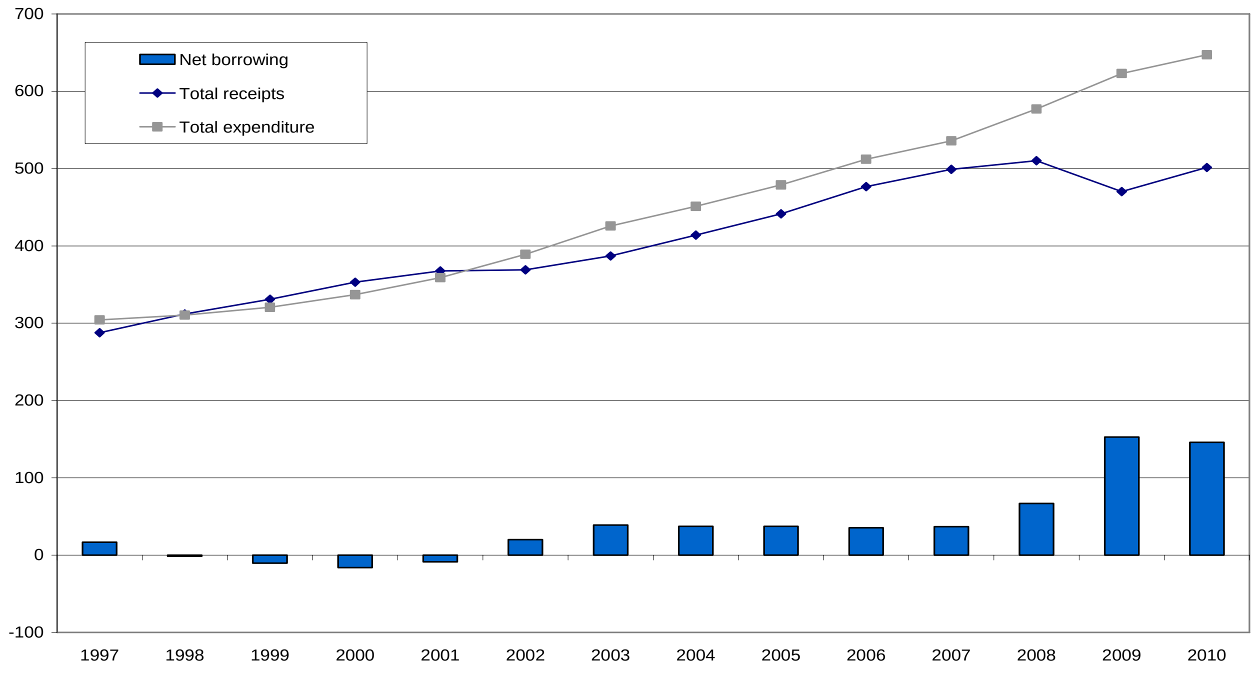
£ millions



Source: Public Sector Finances, Office for National Statistics

Figure 6b Central government net borrowing

£ billions



Note: Total expenditure equals current spending, public sector investment, depreciation and capital transfers
Source: Public Sector Finances, Office for National Statistics

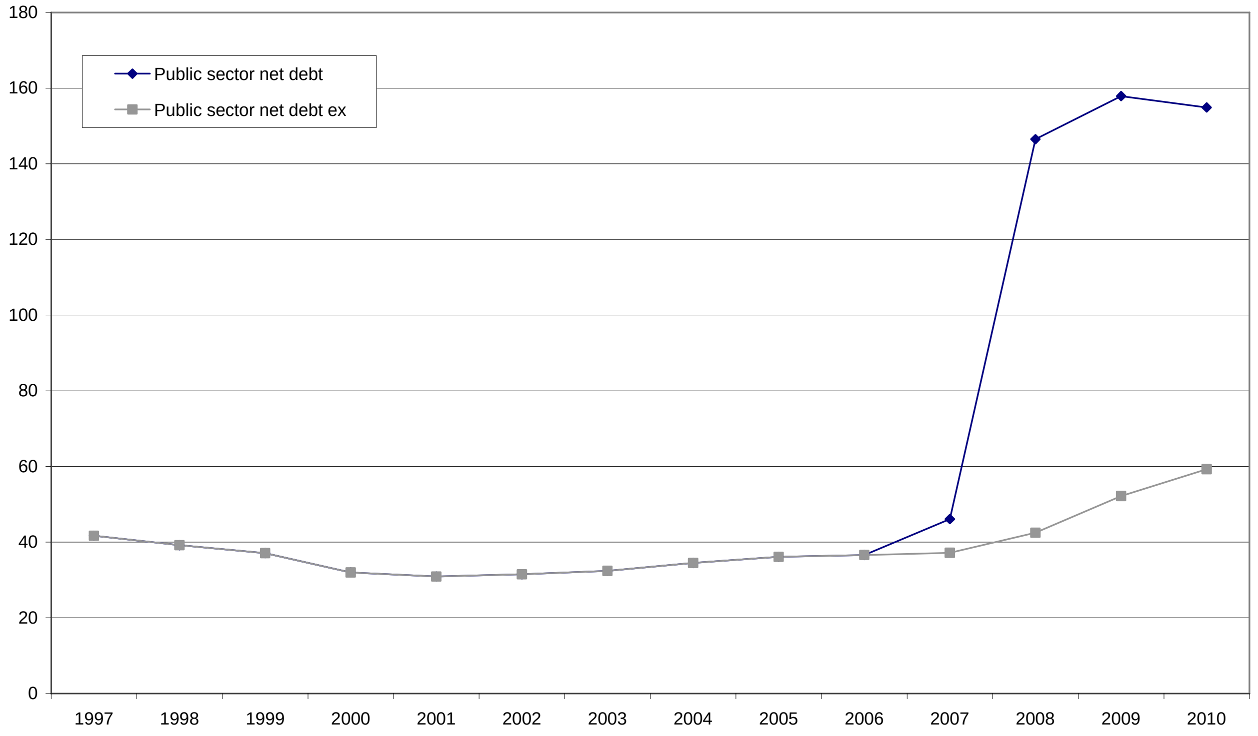
Public sector net debt over 150 per cent of GDP as RBS and LBG liabilities now included

ONS publishes two measures of public sector net debt (PSND) – both including and excluding financial sector interventions (**Figure 7**). Including interventions in the financial sector, public sector net debt was 154.9 per cent of GDP in December 2010. This is largely due to the liabilities of the public sector banks that are included on the public sector's balance sheet, now including RBS and LBG (which added approximately £1,300 billion to PSND) . This measure though does not include the majority of these bank's assets, including mortgages, commercial paper and loans to businesses because these are deemed as being insufficiently liquid to be realised quickly and hence not scored against net debt.

Excluding the government's intervention, public sector net debt was 59.3 per cent of GDP, up from 52.2 per cent the previous year and 37.2 per cent before the crisis started in 2007. The rise in this measure of net debt is a result of the surge in public sector net borrowing shown in Figures 5, 6a and 6b reflecting the weakening in the government's current budget balance through the recession.

Figure 7 Public sector net debt

Per cent of GDP



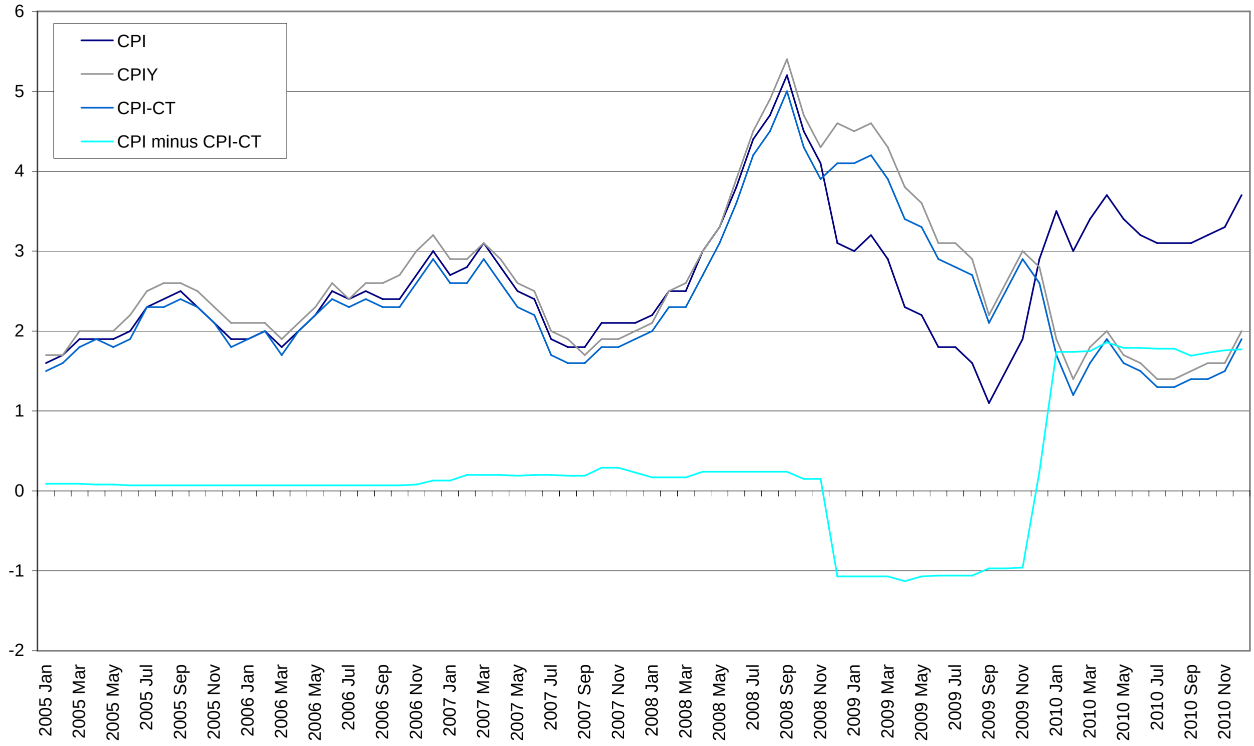
Source: Public Sector Finances, Office for National Statistics

Taxes, energy and food are the main contributors to consumer prices inflation

Inflation, as measured by Consumer Prices Index (CPI) stood at 3.7 per cent in December, up from 3.3 per cent in November. Air transport and rising petrol, diesel, gas and food prices are the most significant drivers of the increase in annual inflation between November and December. These factors are also, with indirect taxation, the longer run sources of the increase in CPI inflation rate, which has been at or above 3.0 per cent throughout 2010 despite being as low as 1.1 per cent in September 2009 (**Figure 8**).

Figure 8 **Consumer prices inflation including and excluding indirect taxes**

Per cent



Source: Consumer price indices, Office for National Statistics

ONS publishes two measures of CPI inflation that account, in different ways, for the impact of indirect taxes on inflation. CPIY excludes indirect taxes altogether, whereas CPI–CT keeps indirect taxes in the equation, but holds them at constant values. Both these measures in Figure 8 show the impact of indirect tax changes, specifically Value Added Tax (VAT) on CPI inflation over the last two years. In December 2010, the difference between CPI and CPI–CT annual inflation measures was 1.77 percentage points.

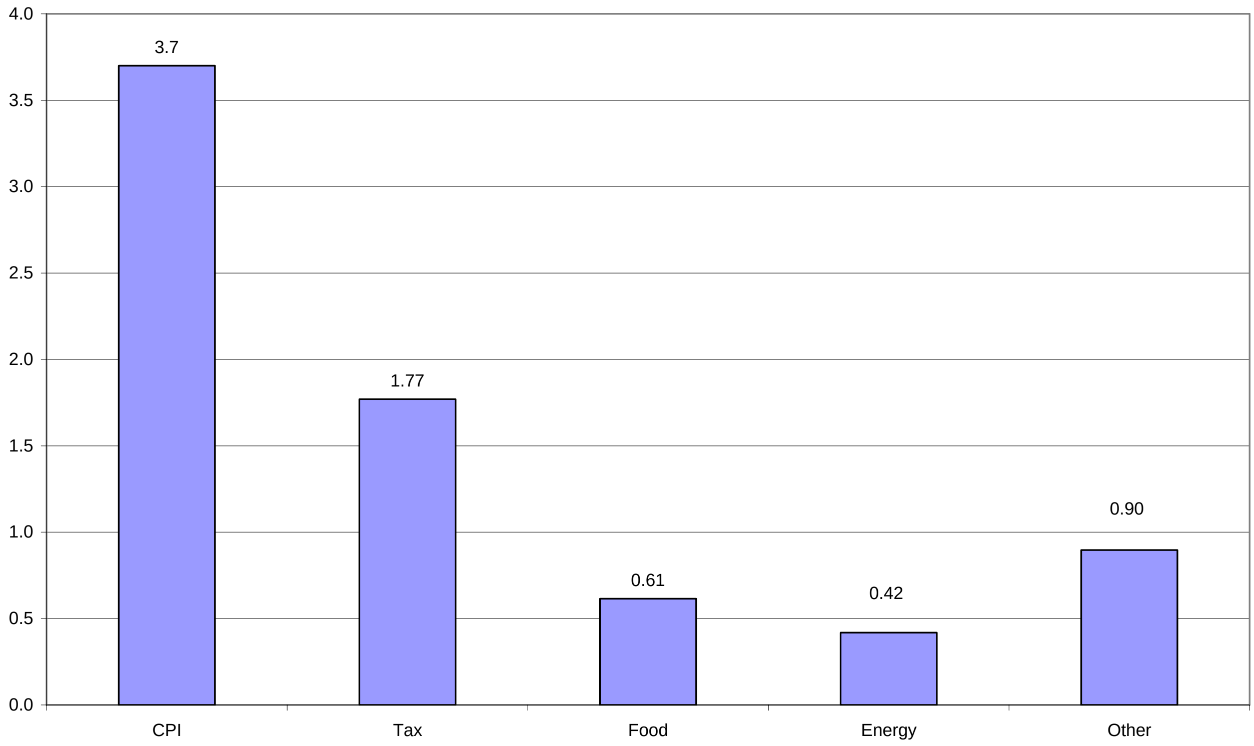
Increases in food and global energy prices are also feeding through to inflation, with their impact likely to have been extenuated by the 25 per cent depreciation in sterling in the second half of 2008 leading to higher import prices. Inflation in energy, food, alcohol and tobacco was 6.4 per cent in December 2010, and excluding this category from the all–items CPI would lower the annual rate of inflation from 3.7 per cent to 2.9 per cent. However, this will also include an element of an increase in indirect taxes.

Figure 9 attempts to identify the respective contributions to the December CPI inflation rate of 3.7 per cent from indirect taxes, food and energy. Author's calculations show that these percentage point contributions are 1.77, 0.61 and 0.42 respectively, leaving 0.9 percentage points accounted for by the other components of the all–items CPI.

Figures 8 and 9 therefore show, that although inflation has been above the Bank of England's upper ceiling of 3.0 per cent, this is largely due to changes in indirect taxes and global inflation in food and energy prices. Underlying inflation pressures may not be so strong once these factors are stripped out of the calculation. In January, VAT will rise to 20 per cent, and subject to the degree of pass–through to consumer prices, would be expected to put further upward pressure on the rate of inflation. This too though would only impact on the inflation rate for one year before falling out of the annual comparison in the event of no further tax changes.

Figure 9 CPI inflation, contributions in December 2010

Percentage points



Source: Consumer price indices, Office for National Statistics

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