

Novus Capital Markets Research

Gloomier MPC

24 February 2011

MPC lowers GDP forecast: the MPC has become gloomier about the real economy in two distinct ways. First, as we learned last week from the *Inflation Report*, the near-term outlook for inflation is higher, and for GDP lower, than at the time of the November forecast. In a nominal GDP framework this is the normal (inflation = deflation) trade-off. Second, although the MPC is looking for GDP to bounce back in the first quarter, it has lowered the *level* of GDP right through the forecast period. The hawks emphasise the point but the MPC as a whole appears to have concluded that the level of demand consistent with achieving the inflation target is lower than previously thought.

Near-£100bn hole still in the public finances: January's £3.7bn surplus on the public finances, the first for two years, was a pleasant surprise. Revenues, buoyed by higher income tax receipts and the hike in VAT to 20%, rose 12.4% from the previous year. For the first time since March 2008 tax receipts on a 12-month basis are rising more rapidly than spending. Nevertheless the gap between the two is still only just shy of £100bn – the gap that the crisis opened up as receipts plunged is far from being closed.

Where does the cash come from? My suggestion that retail sales volumes might fall in January proved wide of the mark. Even allowing for the effects of snow a year ago and in December, I found it hard to imagine that the cash spend could rise anywhere near the 8.2% headline and 6.7% (ex-petrol) that the ONS estimated. With earnings rising at about 2% a year, how do we find the cash? The answer may be that we were having one last fling ahead of the VAT increase and that, since then, the High Street has gone very quiet. The gathering momentum behind a rate hike notwithstanding, the MPC would be well advised to see how February and March are panning out before it raises rates.

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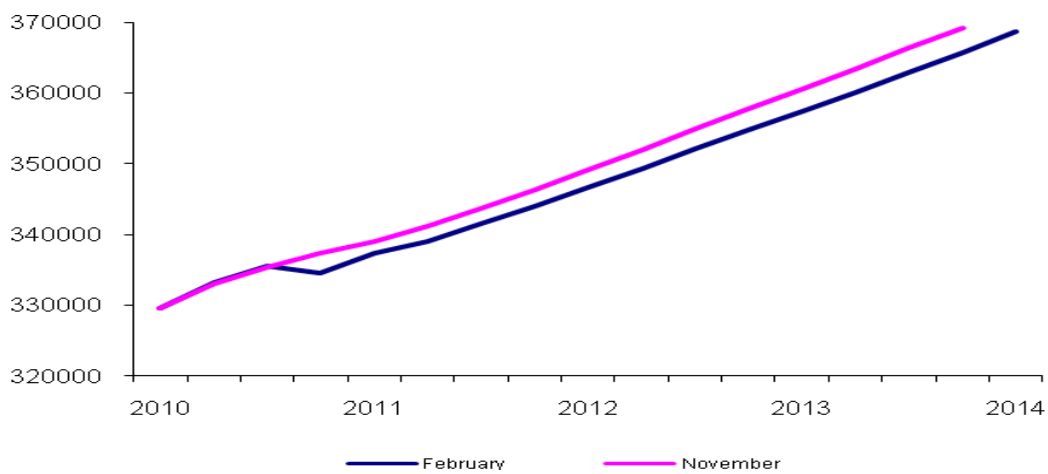
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Gloomier MPC

The numerical parameters of the February forecast reveal that the MPC is gloomier about the level of GDP throughout the forecast (Chart 1). We knew from the *Inflation Report* that the near-term outlook for inflation was higher, and for growth lower, than in November. This week's release shows that the drop in GDP in 10q4 (which the MPC estimates at -0.3% vs the ONS preliminary estimate of -0.5%) is not made good over the next few years (in the sense of getting back onto the November trajectory). GDP rebounds by 0.8% in 11q1 but even so the level of Q1 GDP is around ½% below what was expected in November. Over the next three years the gap widens to nearly 1%.

Chart 1: MPC forecast for level of GDP (mode)



Source: BoE

As David Miles points out in a speech this week¹, this is extraordinary – the deepest recession of the postwar period and no recovery (in the sense of a period of above-trend growth) to speak of. In fact, it is not until 12q1 that the level of GDP gets back to its pre-crisis peak (08q1).

¹ <http://www.bankofengland.co.uk/publications/speeches/2011/speech475.pdf>

Two factors explain the gloomier forecast. The first is the normal trade-off between inflation and GDP (within any given growth of nominal GDP inflation is deflation). The second is more sinister and comes from a gloomier view of the supply side.

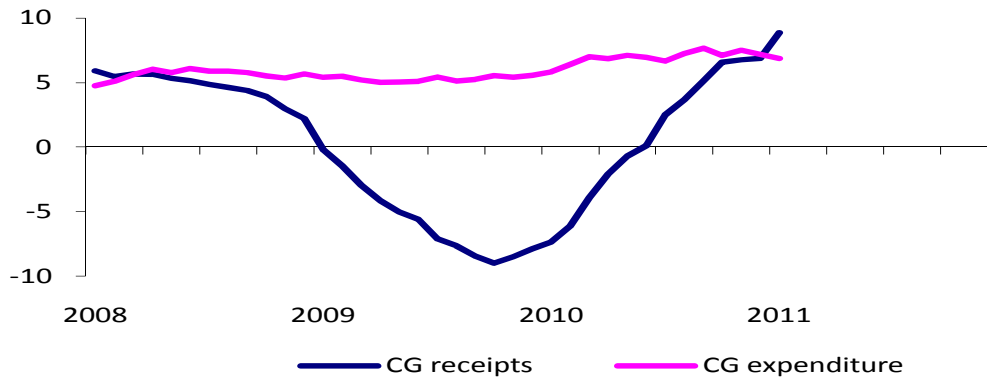
In the years following the financial crisis there has been considerable debate on the amount of capacity that was permanently lost in the crisis and on the effect of the crisis on trend GDP growth going forward. This is discussed in the February IR (page 44, How persistent will the reduction in productivity prove?). The issue is whether the very sharp drop in labour productivity during the recession (GDP fell much further than employment) is indicative of significant spare capacity within companies (labour hoarding) or whether there has been a more persistent reduction in underlying productivity, and so a deterioration in the economy's supply potential. The consensus on the MPC is that about half of the loss in productivity will be permanent.

For the three dissenting members (Spencer Dale joining Andrew Sentance and Martin Weale), that is too optimistic. They are more sceptical about the persistence of spare capacity; their concern is that *the level of demand consistent with achieving the inflation target might be lower than previously thought* (February Minutes, para 35). The fact that the MPC has revised down its forecast for GDP suggests that this argument is not lost on the Committee which, as a whole, has become more gloomy about the amount of spare capacity in the economy and what that means for inflation over the medium term. The majority is not yet persuaded of the case for a rate hike but they are moving in that direction.

Public finances – still near-£100bn gap

The January public finances revealed the first surplus (£3.7bn) in two years. Higher income tax receipts and the hike in VAT to 20% between them produced a £6.4bn (12.4%) rise in central government receipts against a £2.1bn (4.4%) rise in expenditure. As a result, and for the first time since March 2008, the rolling 12-month total of receipts is growing more rapidly than expenditure (Chart 2).

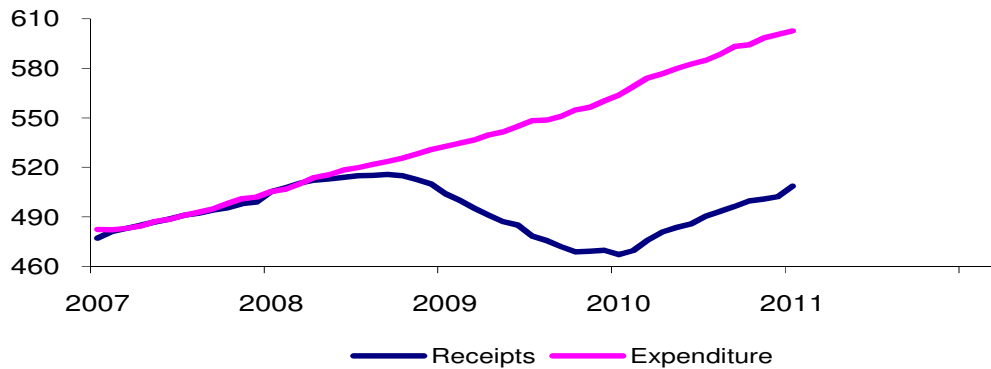
Chart 2: Central government receipts and expenditure (12m rolling sum, %)



Source: ONS

Despite this, the gap between receipts and spending, which was close to zero ahead of the financial crisis, is still £94bn on a rolling 12-month basis (Chart 3), only £5bn less than the February 2010 peak.

Chart 3: Central government receipts and expenditure (12m rolling sum, £bn)



Source: ONS

A simple extrapolation of the public finances over the remaining two months of the financial year gives a full-year outturn of just under £140bn. If achieved, that would be an improvement on the OBR's most recent forecast of just under £150bn and a huge improvement on Alastair Darling's Treasury at its most pessimistic (Table 1). The combination of economic recovery and some early, modest, fiscal tightening appears to have reduced PSNB by some £35-40bn compared with HMT's worst fears.

Table 1: PSNB forecasts, 2010-11

	HMT PBR Nov-09	HMT Budget Mar-10	OBR pre-Budget Jun-10	OBR Budget Jun-10	OBR EFO Nov	Extra- polation Jan
£bn	176.3	163.2	154.7	149.1	148.5	139.5

Source: HMT, OBR

Retail sales – where does the cash come from?

My suggestion two weeks ago that retail sales (on the definition that excludes petrol) might fall in January proved hopelessly wide of the mark. According to the ONS they rose 1.5% in volume terms after a 1% decline (revised from -0.3%) in December. The problem I had with forecasting an increase was that, for this to happen, and since High Street inflation was likely to head higher, the cash spend would have to increase by what I considered to be an implausible amount (*without a sharp fall in inflation, growth in the cash spend will need to jump to about 6% (which seems unlikely given that wages are up by less than half that amount) simply to get a positive outcome on volumes*).

As I expected, inflation (measured by the seasonally adjusted retail sales deflator) duly picked up from 1.1% to 1.4% in January. The cash spend proved far more robust, rising 6.7% in the same period, the fastest annual rate since May 2008. (On the broader definition that includes petrol, the increase was 8.2%.) That was enough to give a volume increase of 5.3%, up from 0.3% in December. So even with last year's m/m decline of 3.3% dropping out of the annual data, there was plenty to spare for an annual and monthly increase in volumes. The question I am left with is: when earnings are rising at a near-2% rate, how are we able to increase our cash spend by nearly 7% (more than 8% in total)?

The answer, at least for most of the last year, is not by borrowing more. Bank of England data show net unsecured lending to individuals rising at a 0.6% rate in December, up from the negative rates that we saw earlier in the year but nowhere near the 6-7% rates that prevailed before the crisis; housing equity withdrawal, or money released from the housing market to finance other purchases, has been negative for the last seven quarters.

Part of the answer is that January's surge in the cash spend was only making up for December's shortfall. For most of last year the annual growth in the cash spend was running at about 3% so December's 1.3% outturn was in large part the product of the severe weather. But even if we average December and January we get 4%, still a full 1pp above most of the rest of the year.

The most plausible answer is that January was a one-off, in large part the product of a two-day burst in spending ahead of the 4 January VAT hike. Sales in the second half of the month were, reportedly, a lot slower and it looks as if February has been even slower (on an unadjusted basis it always is one of the slowest months of the year). The CBI distributive trades survey retail balance dropped to +6 (36% up, 30% down) in the two weeks to 16 February from +37 (61% up, 24% down) in January while sales at John Lewis rose only 1.3% in the first two weeks of February from a year earlier.

Commenting on its survey, the CBI notes that *the positive effect of seasonal discounting on the high street that previously boosted sales has now waned. Retail sales are likely to be more challenging over the coming months ... At the same time prices are set to rise considerably as the VAT increase and the soaring cost of raw materials are passed on to shoppers. Why at the same time? Why not recognise the cause and effect and just say because?* The challenge for retailers is *not* to pass on the costs; only that way will they see volume increases.

Seasonal factors apart, it may very well be that consumers, having had one final fling in January, are now pulling in their horns. The squeeze on incomes from inflation is unrelenting and the outlook for consumer spending is poor. Retailers may have to respond by cutting prices to make household budgets stretch further. The gathering momentum behind a rate hike notwithstanding, the MPC would be well advised to see how February and March are panning out before it raises rates.

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