

## Novus Capital Markets Research

### Grin and bear it

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**Q2 GDP – a suitable case for treatment:** Q2's 0.2% increase in GDP was variously described as meagre, weak or feeble; the recovery as sluggish or faltering. This is clearly not good enough and requires a policy response: a Plan B (to slow the deficit-reduction programme before it has even properly started) or a Plan for Growth (a combination of supply-side measures and tax cuts which often amount to little more than special pleading) or even a paradigm shift to make us more Asian. All of which ignores the fact that GDP ex-oil & gas rose 0.3% and that without a series of one-off factors GDP growth would have been 0.7% or an above-trend 0.8% ex-oil & gas. They also ignore the fact that the main drag on the economy is inflation, which is squeezing household incomes and holding back spending – in Q1 consumer spending rose 5.2% y/y in cash terms but inflation of 5.7% (on the CED) meant spending was down 0.5% in real terms. They even ignore the fact that long-term interest rates dipped below 3% this week solely because we are committed to a deficit-reduction programme.

**What should we do?** As the July Minutes made clear, inflation is going to rise quite sharply over the next few months to a peak over 5% as the latest round of energy price increases feeds through. Thereafter it will fall gradually back to 3% by mid-2012 and to 2% by early 2013. That by itself will ease the squeeze on household budgets and produce some growth in consumer spending. There is very little the MPC can do about inflation in the near term. It could speed up the process by raising rates but that would do nothing for growth. The Government could ease the budgetary squeeze but that would put our long-term interest rates at risk. Supply-side measures are always useful but slow working. Much as it goes against the policy-activist's grain, there is very little we can do about the near-term outlook for either inflation or growth other than grin and bear it.

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## **Q2 GDP – a suitable case for treatment?**

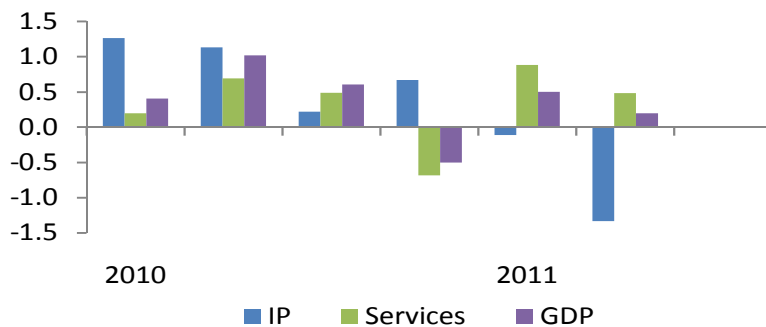
GDP growth of 0.2% in the second quarter was variously described as meagre (FT), feeble (Times, Guardian), weak (Telegraph) and unspectacular (City AM). For commentators, leader-writers and politicians this is not good enough and requires a policy response. We need a Plan for Growth (we can't just leave it to the private sector) or a Plan B (which only ever amounts to a slower reduction in the budget deficit) or more QE (Gavyn Davies in the FT), or bold supply-side measures (Telegraph). For Will Hutton, writing in the Guardian, the 'faltering' growth figures require 'nothing less than a paradigm shift' – we have to become more like Asia. For Boris Johnson cuts in National Insurance and the 50% rate of income tax are needed to stimulate consumption; for Shadow Chancellor Ed Balls a reversal of the hike in VAT from 17½% to 20% would 'give our stalled economy the jump start it urgently needs and so help get the deficit down for the long term'.

### **1. How bad were the numbers?**

A former colleague used to accuse me of cheating (because I looked at the data), so that's where I'll start. The headline measure of GDP includes the North Sea oil & gas sector which is in structural decline. Mining & quarrying, which is mainly the North Sea, fell 6.6% in Q2 and 14.4% over 12 months. The index number was 68.7 which means the sector has contracted by nearly one third since 2006. This is important for the Government finances (though less so given the level of the oil prices) but has few implications for employment. That is why the Treasury and now the OBR use non-oil GVA as the basis for their estimates of trend GDP and the output gap. GDP ex-oil & gas rose from 100.6 to 101.0 which the ONS translates into an increase of 0.3% (the index numbers are consistent with 0.4%). Ex-oil & gas GDP is up 1.1% over the last year against 0.7% for headline GDP.

Within GDP industrial production (IP) fell 1.4% mainly because of the drop in energy production (manufacturing was down 0.3%). By contrast both construction and services rose 0.5% (Chart 1). The ONS estimates that the various one-off events took 0.5pp off GDP with 0.4pp coming from services and 0.1pp from IP. Services account for 76.8% of GDP so a 0.4pp contribution to GDP equates to a 0.5% change in services. So but for the one-off factors the ONS is estimating that services would have risen a full 1% in Q2. That would not have been meagre or weak or feeble.

Chart 1: GDP and components (% q/q)



Source: ONS

## 2. Will the losses be made good?

According to the ONS a number of well documented one-off events (the royal wedding and the associated bank holiday, April's hot and sunny weather, the sales of Olympic Games tickets and the knock-on effects of the Japanese tsunami) reduced GDP by as much as 0.5%. Without these GDP would have risen 0.7% (1.2% y/y) and non-oil GDP by an above-trend 0.8% (1.6% y/y). That is comforting though what counts is not how much these events took off Q2 GDP but whether we will make up the shortfall in Q3 and beyond.

By and large the answer is probably that we won't. In the case of the Royal Wedding, for example, any output that was lost in April could have been made good in May or June. The monthly data show that output fell quite sharply in most sectors in April (manufacturing -1.6%, services -1.2%) and rebounded by more than that amount in May (manufacturing +1.9%, services +1.6%) but that still leaves the level of output in April-May combined below where it was in March (-0.7% in manufacturing, -0.4% in services) and where presumably it would have got to but for the wedding. Moreover the ONS quarterly estimate for services implies that the rebound in May was not maintained in June where the preliminary estimate suggests output was down 0.2%.

In the case of the Olympic ticket sales, which were worth 0.1% of GDP, the statistical convention is that these do not count to GDP when the tickets are sold (though for many households they will have required a reduction in spending elsewhere) only when the services from the tickets (ie the Olympics) are delivered in a year's time. Similarly, as the supply-chain problems associated with the tsunami are resolved, any production backlogs should be cleared.

Overall then I reckon the GDP data were nowhere near as bad as the headline measure suggests but that the 0.5% that the ONS calculates for the one-off events overstates their net effect. We will make good some of the loss (most obviously in the case of the Olympic tickets since this is just a statistical construct) but some of the loss is permanent (or we would have recovered it already).

### **3. What is holding us back?**

I addressed this question last week in the context of a David Smith article, which argued that a shortfall in bank lending was the principal culprit. For me it is quite clear that for consumer spending, which accounts for 60% of GDP, inflation is the main drag on demand (within a nominal framework inflation is deflation) and that demand should recover as inflation comes down. In real terms consumer spending fell 0.2% in 10q4 and a further 0.6% in 11q1. Over 12 months it is down 0.5%. In cash terms spending has risen a healthy 5.2% y/y, enough in 'normal' inflation conditions to produce a real increase of 3% or more. Today, with inflation on the consumer expenditure deflator (CED) running at 5.7%, RHD1 is down 0.8% y/y and a 1.6pp y/y decline in the saving ratio has not been enough to deliver positive growth in consumer spending.

Inflation itself is largely the product of a significant increase in a number of global commodities (oil and food most obviously) exacerbated by the fall in the exchange rate. If the MPC had raised rates earlier in the cycle, sterling would not have fallen as far but equally what has been a tepid recovery thus far would have been even weaker. In any case a low (competitive) pound is part of the rebalancing of demand away from consumption towards investment and net trade that, the Governor tells us, is both vital and necessary.

Outside the all-important consumer sector, inflation is less of a problem. In the public sector, where wages (which have been held down) are a key factor, inflation is running at only 2.4%. As a result, a

smaller increase in the cash spend (3.5%) has still been enough to deliver positive y/y growth of 1.1%. Here it is the need to reduce government spending in cash terms and to get the deficit down that will be the main drag on the economy (I say will be because a 3.3% rise in nominal terms hardly amounts to the huge cuts in public spending that the Government's critics tell us are already in place).

The fall in investment (public and private) over the last year has very little to do with inflation. Here there is a shortfall in nominal demand, mainly because of a sharp drop in general government investment but also because the cash-rich company sector is holding back its spending on investment (business investment rose 3.3% y/y in nominal terms in 11q1).

Overall nominal GDP rose 4.6% in 11q1 y/y which, after near-3% whole-economy inflation, translated into a volume increase of 1.6% (Table 1).

**Table 1: 11q1 GDP data (% y/y)**

	Nominal	Inflation	Real
Household consumption	5.2	5.7	-0.5
General Government consumption	3.5	2.4	1.1
Fixed investment	0.4	0.6	-0.2
Domestic demand	4.2	3.6	0.5
Exports	13.0	3.4	9.3
Imports	10.5	6.0	4.2
GDP	4.6	2.9	1.6

Source: ONS

For Q2 we know that CPI inflation picked up to 4.4% from 4.1% in Q1. If this is replicated in the CED and GDP deflators, then once again we should see a decent increase in nominal GDP accompanying only modest (0.7%) real growth. Special factors and one-off effects notwithstanding, it appears that there is not a lot wrong with the growth of nominal GDP and that GDP growth would be a lot healthier if inflation were anywhere near where it is supposed to be.

#### 4. What should we do about it?

Peter Jay (remember him?), writing in the Times this week, describes two fiscal balancing acts. The first is to achieve a sustainable balance of the public finances over the medium term. This is the course that George Osborne has charted. The second is to set a course for demand within the cycle that does not impose inflationary pressure on the supply side of the economy. He argues that there are times such as now when the two are in conflict and that the right approach is to 'chart a path to the longer-term equilibrium that also nurses the short-term equilibrium sufficiently for the gap between economic capacity and current demand slowly to close'. This is easier said than done and he accuses the Chancellor of going too fast towards medium-term balance such that there is a shortfall in demand which threatens to send the economy back into recession.

Apart from some bewildering references to hedgehogs and foxes, which apparently every school boy and girl recognises but were lost on me, I have a problem with this argument. I recognise that the short-term aim of policy is to balance demand and supply such that inflation is at the target. But it is palpably clear that inflation is nowhere near its target and, to me at least, it is inflation rather than fiscal tightening per se that is holding back demand in real terms (I accept that the VAT hike is part of the inflation story). There is nothing in the Jay argument about nominal and real magnitudes. Implicitly, Jay believes that policy-makers can and should target real variables where more realistically all they can do is to set a growth path for nominal demand that is consistent with the inflation target over the medium term. This is what the MPC tries to do; it is why it can justify doing nothing in response to inflation picking up to 5%.

If inflation is the principal drag on the consumer, and hence the real economy, it follows that, as inflation comes down (later this year after the current round of energy price increases has gone through), the squeeze on consumer spending will ease. In the meantime there is very little we can do to accelerate the process that doesn't have an adverse effect on GDP growth in the near term. My answer to what we should do, uncomfortable as it sounds to the policy-activists who want to speed up the process, is grin and bear it.

That does not mean that there is not scope for measures to improve the supply side of the economy. The problem I have with many of the proposals is that they are little more than special pleading and/or

that they will have adverse effects on the budget deficit. Cuts in national insurance or business rates or removing the 50% rate of income tax may be desirable in themselves but they run up against what has to be the Chancellor's priority, which is to reduce the budget deficit. On the basis of his commitment to do so (and as yet rather little evidence of any concrete action), we have long-term interest rates that dipped below 3% this week. Any backsliding on deficit reduction would endanger these rates. Or, as Chris Giles in a demolition of Ed Balls' voodoo economics concludes, 'Is it worth risking the credibility of the deficit reduction plan for a 0.3 per cent uplift in national income?'

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