

Novus Capital Markets Research

Nobody said it was easy

30 June 2011

11q1 data: as a modern-day Micawber might put it: income up 1%, prices up 2%, result the misery of a second successive quarterly drop in real income and the largest (2.7%) annual decline in 34 years. Consumers tend to smooth out fluctuations in real income both across the cycle and over their lifetimes by adjusting their savings. So consumption fell less in 11q1 than real incomes (-0.6% vs -0.8%) brought about by a 0.5pp reduction in the saving ratio to 4.6% (less saving rather than more borrowing). The saving ratio has fallen from a 2009 peak of 7.5% and will need to fall further in the coming quarters if consumption is to reverse its recent weakness. Further out, as the baby-boomers retire and draw down their saving to finance (say) expensive four-week trips to New Zealand and Australia, the saving ratio could settle at a lower level. The productivity data make for grim reading. Most of the Q1 increase in output came from higher employment though a drop in hours meant underlying productivity growth (output per hour) was up 0.4%. Even so, productivity is still 0.9% below the pre-recession peak and the annual increase (0.3%) is nowhere near the 2% that the Bank and the OBR consider to be trend.

Is it just me? I certainly wasn't alone last week in thinking that Richard Lambert's agenda would do little to get business investing again. So am I the only one who bridled at a Times article entitled "airports in capacity crisis". Heathrow, it seems, is running at 98% capacity and has major congestion problems which it solves by stacking aircraft in four separate areas around London – we've all been in them. Using a queuing system to solve supply shortages is as old as the hills but more appropriate, you might have thought, to an old soviet-style system than to a modern free-market economy. So why doesn't Heathrow use its premium status to charge more for landing slots and bring demand into supply that way? I've no idea myself – answers on a postcard please.

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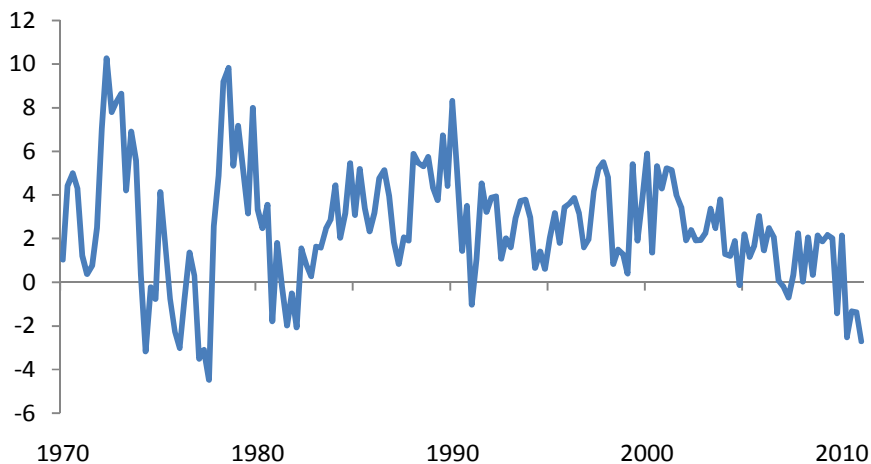
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11q1 data – income, spending and saving

The full national accounts data reveal the intense squeeze on the household sector. A rise in household disposable income of a little over 1% was fully cancelled out by a near-2% rise in consumer prices with the result that real household disposable income (RHDI) was down 0.8% from 10q4. This followed a 0.9% decline in the previous quarter and took the y/y fall to 2.7%, the biggest annual fall since 1977 (Chart 1). Consumer spending also contracted for a second successive quarter (-0.6% following -0.2% in 10q4) and has fallen 0.5% over 12 months.

Chart 1: RHDI (% y/y)



Source: ONS, Novus

The fall in spending, which was less than the drop in real incomes, was cushioned by another 0.5pp decline in the saving ratio to 4.6%, nearly 3pp below the 2009 recession peak (Chart 2). Unlike the pre-recession period, when the saving ratio went fleetingly negative, the current decline is less the product of high levels of borrowing and more a genuine reduction in household saving. This may be something that we see continuing as the baby-boomers retire and dip into their savings (to finance their expensive four-week trips to New Zealand and Australia).

Chart 2: Household saving ratio (% disposable income)



Source: ONS, Novus

11q1 data – productivity

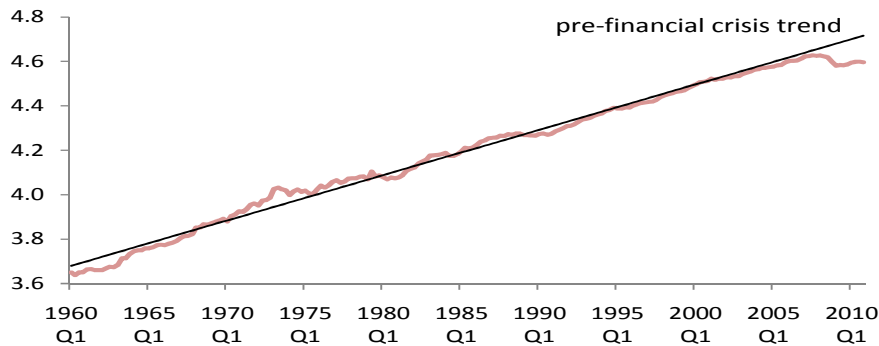
The productivity data confirm what was implicit in the previously released GDP (+0.5%), employment (+0.4%) and hours (+0.1%) data. According to the ONS, whole economy productivity fell 0.1% on an output per job basis and rose 0.4% on an output per hour basis. On a longer-term basis the figures are disappointing. Over 12 months whole economy output per hour (the best measure of underlying productivity) has risen 0.3% and is still 0.9% below the pre-recession peak (Table 1). If anything the gap between the pre-recession trend and the current level of productivity is widening (Chart 3).

Table 1: Productivity

% change	11q1 (level)	11q1/10q4	11q1/10q1	11q1/08q1
GDP (2006 = 100)	99.6	0.5	1.8	-4.0
Employment (m)	29.2	0.4	1.4	-0.9
Output per job (2006 = 100)	99.1	0.0	0.1	-3.0
Hours (m)	921.9	0.1	1.4	-2.9
Output per hour (2006 = 100)	100.8	0.4	0.3	-0.9

Source: ONS, Novus

Chart 3: Productivity (output per job, log scale)



Source: ONS, Novus

11q2 – another sub-trend quarter

Largely because of the Royal Wedding and the extra bank holiday, the second quarter started badly. Industrial production (IP) fell 1.7% in April and service sector output (IS) was down 1.2%. Construction fell more than 13% according to eurostat. Together these point to a 2% m/m decline in GDP, similar to what we saw as a result of December's heavy snow.

In June 2002 the extra bank holiday for the Golden Jubilee had a similar effect on output – IP fell 4.5% and IS 2.1%. Most of the fall in IS (1.9%) was recouped in July though less than half of the drop in IP was recovered (2.1%) as mining & quarrying slumped a further 11.4% in July as summer maintenance programmes kicked in. The net effect on quarterly GDP was a slowdown from 0.8% q/q growth in 02q1 to 0.4% in 02q2 followed by a rebound to 0.7% in 02q3.

Something similar is likely to happen this year. But what is critical to Q2 GDP is whether output makes good all of April's loss in May (or less than all of the loss or all of the loss and more). Table 2 illustrates what would happen if IP and IS recover all of the loss in May and expand further in June and construction makes good only some of the loss. This produces a Q2 rise in GDP of 0.4%, still below the pre-crisis trend. It would take the annual increase to 1%, well below the 1.4% forecast by both the MPC and the OBR.

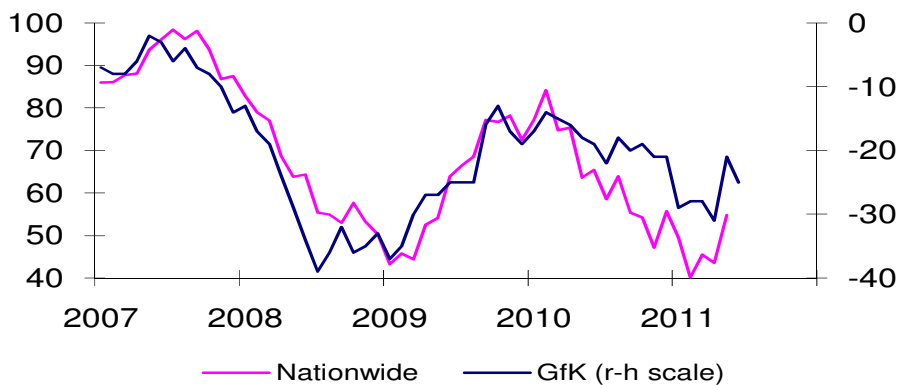
Table 2: GDP estimates

	10q4	11q1	11q2	Mar	Apr	May	Jun
Industrial production	89.9	89.8	89.1	89.5	88.0	<i>89.5</i>	<i>89.7</i>
Construction	99.5	96.1	100.1	<i>109.9</i>	<i>95.2</i>	<i>100.0</i>	<i>105.0</i>
Services	101.7	102.6	103.0	103.3	102.1	<i>103.3</i>	<i>103.5</i>
GDP	99.4	99.9	100.3	<i>101.3</i>	<i>99.2</i>	<i>100.6</i>	<i>101.1</i>
GDP (3m/3m)	-0.5	0.5	<i>0.4</i>	<i>0.5</i>	<i>0.9</i>	<i>1.4</i>	<i>0.4</i>

Source: ONS, Novus estimates (italics)

The risks to this are probably to the downside – that either IP or IS does not make good all of April’s losses in May. That is the picture provided by retail sales which were boosted by the extra holidays in April (+1.1%) but more than reversed these gains in May (-1.4%). A 0.2% rise in June would produce a flat quarter for sales while a 0.7% increase would give a q/q increase of 0.2%, unchanged from 11q1 (when total consumer spending fell 0.6%). At this stage, with consumer confidence taking another dip in June (Chart 4), another q/q drop in consumer spending may be on the cards.

Chart 4: Consumer confidence



Source: GfK, Nationwide

Is it just me?

I asked this question last week in the context of Richard Lambert's agenda for supply-side initiatives which he set out in the Times on 20 June. From the feedback I received it wasn't just me: I was not the only one who thought that Bob Dylan had more to offer on the subject and that Lambert had not come up with any measures that might persuade industry to invest.

So, taking my text from the Times of 28 June, I repeat the question. The article that got me going was headed "airports in capacity crisis"; it described the congestion problems at Heathrow which is running at 98% of capacity and where, apparently, 60% of arrivals are delayed in holding patterns on their run in to the airport. Well we know that in old-style soviet economies queuing was used as an alternative to the price mechanism but is it not the case that in a modern free market economy resources are allocated according to demand and supply? Supply at Heathrow presumably is very inelastic in the short term (and limited by technology over the longer term) so the price of landing slots would be expected to go up and down with demand.

So why don't the Heathrow authorities just charge more for landing slots and ease their congestion that way? If Heathrow is seen as the airport of choice for international carriers, surely it can charge accordingly. Or is there some super-regulator who fixes the price or has some RPI+ formula for annual price increases? I don't know the answer to these questions – maybe Andrew Sentance from his time at BA does.

The Government has vetoed the construction of a third runway at Heathrow which means there is no easy cure to its congestion problems. That is all the more reason to charge airlines for the right to land there especially as capacity is also limited at Gatwick and Stansted (though passenger numbers at the latter have been falling for the last four years). The airlines would pass any higher charges onto their customers which would make flying more expensive and would at the margin reduce the number of flights – consistent with the Government's green agenda.

The key point is that airport capacity in South East England is limited and should be rationed by price. If that drives some international business abroad, so be it.

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