

Cause for celebration

9th November 2009

Twenty years ago today, Europe witnessed a momentous occasion, as the Berlin wall was torn down and Germany embarked on the reunification process. This week is likely to see a less momentous, but still an important milestone, as the deepest European recession for a generation is likely to be declared officially over.

The UK's Monetary Policy Committee (MPC) extended its asset purchase scheme by £25bn to £200bn. The extra money will be created over the next three months and the scale of the scheme will be kept under review. The lack of clear evidence that the UK economy is on the path to recovery would have convinced the MPC that inflation is likely to undershoot its 2% target in the medium term, warranting further stimulus. This week's Inflation Report will shed more light on their forecast, with near term inflation likely to be revised up. Concern that the risks of doing too little outweigh the risks of doing too much probably helped the committee reach its decision.

The rise in insolvencies demonstrates that reverberations from the recession will be felt long after the initial shock has passed. There were 35K individual insolvencies in England and Wales in Q2, the highest since records began in 1975 (though debt is now more widely available). In the corporate world, the number of company liquidations surprised on the downside, as the number of compulsory (as opposed to voluntary) liquidations fell to its lowest level since Q1 2008. Still, almost as many businesses went into administration in the first nine months of this year as in the whole of 2008, as 1 in 114 companies went bankrupt, up from 1 in 120 in Q2.

Industrial production looked to have improved in September, posting a 1.5% m/m gain, the largest in five years. But this disguises a great deal. August was a very poor month, and even following this rebound, production remains weak at 13% below its peak in February last year.

Business surveys painted a brighter picture of UK activity. The manufacturing index reached its highest level for almost two years, solidly above the 50-mark which indicates expansion. According to the survey, trading conditions improved for manufacturers of consumer and intermediate goods, but things were gloomier for producers of investment goods (machinery, etc). On the services side, which represents a far greater share of the UK economy, business activity and new orders recorded their strongest reading in two years. But a note of caution is warranted - the relationship between the services survey and actual output hasn't been tested in a recovery. Given the disappointing performance of the UK economy in Q3 –

when the services index was above 50 – these results, while encouraging, should be taken with a pinch of salt.

The most significant development in the US last week was the continued deterioration in the labour market. The unemployment rate rose to 10.2%, reaching double figures for the first time since the early 1980s. The number of people employed (excluding farm workers) fell by 190K in October. Although the pace of decline has moderated (from 219K in September and c700K a month in Q1 2009), it has not done so as quickly as expected. Manufacturing jobs excluding the autos sector deteriorated for the first time since January, and retailers shed c40K jobs for the second month running.

Survey evidence suggests that industrial production improved in October. The ISM manufacturing index increased to 55.7 from 52.6 in September (above the 50 mark that indicates expansion), and showed an increase in the breadth of the recovery across the sector. The non-manufacturing index, which covers the service and construction sectors (roughly 80% of the economy), fell slightly to 50.6 from 50.9. Labour market concerns were reinforced, as even more businesses indicated they would be cutting their workforce in the months ahead.

At the Federal Reserve's Open Market Committee meeting last week monetary policy was left unchanged. The accompanying statement noted that rates were likely to be kept "extremely low" for an "extended period" because of slack in the economy, provided inflation expectations do not rise.

The monthly meeting of the European Central Bank (ECB) saw policy rates unchanged at 1%. But it looks as if policymakers already have one eye on the exit strategy. ECB President Trichet, commenting on the provision of unlimited liquidity to the banking sector, said that "not all liquidity measures will be necessary to the same extent as it the past." This suggests the banking sector is in a stronger position and the ECB is more comfortable letting extraordinary liquidity measures expire automatically in the next year or so.

Finally, euro area Q3 GDP is expected to be positive when announced on Friday, marking the end of the worst recession in a generation.

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