

Core Stability

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Uneven Eurozone growth figures fanned investor concerns about the stability of the single currency. Growth was heavily concentrated in the core (France and Germany), renewing fears of a two tier recovery. Bond spreads widened leaving Greece and rest of the periphery facing higher borrowing costs and forcing the euro lower.

The Eurozone economy recorded a sprightly 1% q/q rate of growth in Q2. Buoyant exports and a cheap euro helped Germany once again to be the engine of European growth, expanding 2.2% q/q, the fastest pace since reunification in the 1990s. But there are cracks in the single-currency block. The two largest and core economies, Germany and France, accounted for 0.72 percentage points of this 1% growth rate while the periphery struggled. Bond spreads over German Bunds widened for periphery debt and the euro tumbled amid signs of a two-tier recovery. A weaker euro will only further support German exports, exaggerating the difference in performance in the region.

In the UK the outlook for house prices took a turn for the worse. RICS, the surveyors' organisation, recorded the balance of surveyors reporting price falls over the last three months at -8, the first negative figure since July 2009. This was attributed to more homes coming onto the market, but it didn't appear to be the result of people in financial distress being forced to sell. In fact, repossessions continued their downward trajectory. The Council of Mortgage Lenders (CML) said that 9,400 repossessions were made in Q2 2010, 4% fewer than during the first three months of the year. Along with lower-than-expected arrears data, this led the CML to revise its forecast for repossessions in 2010 down 25% to 39,000. With interest rates expected to stay lower for longer, fewer households will face difficulty repaying their mortgage in the near future.

However, weaker earnings growth can constrain households' ability to reduce their debt levels, even with low interest rates. Average weekly earnings increased 1.3% in the three months to June, compared to last year, down from 2.7% in May. Slower income growth will increase the time it takes for households to repair their balance sheets to make up for the wealth lost during the recession. The situation appears most acute for private sector workers who have seen pay rise by only 0.8% in the three months to June compared to last year, as public sector workers received a slightly better 1.4%.

High unemployment will act as a further headwind to any increase in wage growth. In the three months to June unemployment was 7.8%, on par with the previous three-month period even though 49,000 fewer people were looking for work. Although employment prospects are improving, the number of unemployed who have been out of work for more than a year reached a third of all those out of work. The longer someone is unemployed the harder it becomes to find new work as skills are lost and employers look less favourably on these workers.

In the US the Federal Open Market Committee extended the stimulus measures supporting the economy. The Fed Funds rate was left unchanged at 0% to 0.25%, but the Fed announced it would reinvest the proceeds of maturing mortgage bonds that it purchased as part of its asset purchase scheme. The funds will be used to purchase long dated Treasury securities which should help keep down longer-term interest rates, providing a modest on-going stimulus to the economy.

It's not hard to see why US policymakers are getting a little jittery about growth prospects. The economy probably grew by less than 2% (annualized) in Q2, and employment figures have been disappointing in recent months – a real worry given the high rate of unemployment and the central importance of the US consumer to the wider US economy. Retail sales were up 5.5% y/y in June, which on the surface sounds impressive, but is really a reflection of the depressed state of the economy in mid-2009. Retail spending is still almost 5% below the high water mark recorded in late 2007 (and more than 7.5% below the level of spending after taking account of inflation over the period). So in truth, the consumer spending data for July did little to alter the picture of a lacklustre recovery that is losing, rather than gaining, momentum.

US inflation ticked up to 1.3% in July from 1.1% in June, driven by higher energy prices. But core inflation, a better gauge of underlying price pressures, remained close to all time lows of 0.9%. With growth so weak, concerns about deflation (falling prices) are growing, but shouldn't be overdone. Shelter costs, which account for over 40% of the basket of goods and services used to calculate inflation, is a key reason for the decline, reflecting the extreme weakness in the housing market. Clothing prices (4% of the CPI basket) are also falling in y/y terms. But most other elements continue to see price increases. Transport (17% of the CPI basket), increased by 5.5% y/y in July, medical costs (6% of the CPI basket) were up 3.2% y/y, education (6%) by 2% y/y and other goods and services (10%) were up 2.8% y/y. This doesn't mean that the Fed can afford to be complacent about deflation risks, just that we shouldn't exaggerate them either.

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