

Back on its feet

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The world economy is getting back on its feet, with the recovery in Japan gaining momentum and the Euro Area pulling out of recession in Q3. However, a sustainable rebound is not yet assured, as growth in the developed world remains dependent on the fiscal and monetary stimulus packages put in place to stem the downturn.

There were encouraging signs from the UK labour market. The unemployment rate ticked up only slightly to 7.8% in the three months to September, from 7.7% in August. Moreover the rise was driven by an increase in the number of people looking for work, rather than from job losses. (The first rise in employment since July 2008.)

But scratch beneath the surface and market conditions remain difficult. The rise in employment was very small (just 6,000) and the changing composition of employment provides ample evidence of continued weakness. A sharp fall in full time employment was offset by a near identical rise in part time working. Indeed, the 997K people working part time as they couldn't find a full time position was the highest on record (almost 5% of all employees). In addition, average earnings growth fell to its lowest level since 2001, to just 1.8% y/y, while the number of vacancies also declined to its lowest ever level. In total this points to continued softness in consumer spending.

The housing market recovery continued. The Government's "official" measure by the Department for Communities and Local Government was the latest house price index to confirm rising prices. Although prices in September were still 4.1% lower than last year, they were 3.1% higher than the summer lows (seasonally adjusted). Price declines are showing significant differences across the home nations. Annual house prices have fallen least in Scotland (-0.9%), moderately in England (-4.0%), and most violently in Northern Ireland (-18.3%) y/y.

Even commercial property prices are getting in on the act. Prices rose by 2% m/m in October, the largest gain since December 2005. Prices are now 3.2% above their July trough, though this is still 42% below their June 2007 peak. On the way down the price correction was pretty indiscriminate, with all sectors falling in broadly equal measure, but figures suggest we might see much more variety in the recovery: retail is leading the revival (+4.5%), with office prices trailing (+1.9%).

The Bank of England's quarterly Inflation Report provided more insight as to why the Monetary Policy Committee opted to extend QE at its November meeting. Inflation is still expected to undershoot the 2% target (at 1.6%) at the two-year forecast horizon, as the amount of spare capacity in the economy bears down on price pressures. Even

assuming unchanged interest rates, inflation is projected to only slightly overshoot the target two years out (at 2.2%).

In the US, the trade deficit widened by much more than expected in September, rising \$5.7bn to \$36.5bn, the largest gap since January. Exports grew 4% but this was not enough to offset the 7% rise in imported goods. Much of this increase was due to a rebound in petroleum inflows which climbed by \$4.4bn due to both higher prices and volumes. Excluding petroleum, imported goods still advanced by a healthy 4.4%, underscoring the recent improvement in US domestic demand. On a less positive note, the University of Michigan consumer sentiment index for November fell by nearly five points to 66.0, dropping back to its July/August levels. Consumers' assessments of their finances and the outlook for the economy grew noticeably more negative - both barometers fell to their lowest levels since the spring.

The euro area emerged from recession in Q3, expanding 0.4% q/q in the three months to September, marking an end to the worst recession since World War II. France and Germany saw economic output growing for the second consecutive quarter and Italy declared an end of its recession, recording a +0.6% q/q gain in Q3.

Japanese growth was stronger than expected at +1.2% q/q in Q3. Growth was evenly split between private consumption, increased inventories and net exports. External demand has helped industry bounce back from a very deep recession. Capacity utilisation has improved to 80% from 60% in February. Consumers are also feeling more positive about the outlook with confidence indicators rising to their highest levels for two years.

China's trade surplus doubled from \$12bn in September to \$24bn in October. The fact that China has weathered the downturn better than almost any other nation and is leading the global recovery, makes it an appealing prospect to investors. But large trade surpluses and strong global capital flows poses risks. It requires the authorities to keep amassing foreign exchange reserves to maintain their managed exchange rate. But these actions are fuelling asset price growth, even as consumer price inflation remains in negative territory. Preventing a bubble without de-railing the recovery will be a tricky feat to achieve.

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