

# Leapfrog

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**Last week it was announced that China had supplanted Japan as the world's second largest economy. This was the second time Japan lost the title in one year after China leapfrogged its neighbour in late 2009 but then lost out to a Japanese growth spurt early in 2010. It is expected that China will have firmly laid claim to the crown by Christmas, leaving only the USA (a long way) ahead in the economy size rankings. But one can't imagine there will be parties in the street just yet. On a per capita basis, China is barely ahead of El Salvador and still some way behind Albania!**

**UK inflation edged down to 3.1% in July, helped by falling second hand car prices.** However, transport costs are still a big part of the reason inflation is above the 2% target – this element of CPI is responsible for over a third of the headline inflation rate. Fuels and air fares are both up almost 15% in the last twelve months, helping to keep CPI above 3% every month so far this year. Subtracting the effect of VAT changes gives a different story: inflation excluding the effects of taxes is currently just 1.4% and hasn't broken the 2% barrier at all in 2010.

**Uncertainty over the extent of spare capacity in the economy muddled the Bank of England's inflation outlook.** In minutes published last week for its August meeting, the Monetary Policy Committee (MPC) noted that slack in the labour market and businesses operating below their potential should exert downward pressure on inflation. But a number of shocks to the price level, such as the upcoming rise in VAT, and the ongoing weakness of sterling, will keep inflation above target until 2012. Voting patterns remained the same as in the last two meetings with one member, Andrew Sentence, favouring an early rise in base rate, while the eight others preferred to maintain the status quo.

**Retail therapy appears to remain the UK consumer's favourite pastime.** Retail sales volumes were up 1.1% m/m in July, the fastest increase in five months. Non-food retailers did very well, particularly those involved in fashion. Sales in textile, clothing and footwear stores increased by 5.5% year-on-year, helped by hefty discounting to get shoppers through the door. High prices at the pumps encouraged greater prudence from motorists though, as the amount of automotive fuel bought was almost 11% lower than in July last year. With the many headwinds facing consumers it would be surprising if households could keep spending at this rate. That said, they have a remarkable capacity to defy expectations.

**Markets were spooked by a surge in US weekly jobless claims.** This data series is notoriously volatile from week to week, but the fact that the number of people filing unemployment claims rose to its highest level since 2009 fanned investor concerns that the labour market situation is deteriorating again, which could further undermine the recovery.

**In the US industrial sector the recovery appeared to be more assured.** However, it is vital to draw a distinction between apparently healthy rates of growth and subdued levels of output to keep the industrial recovery in perspective. The headline figures showed an impressive 7.7% y/y increase in total output in July, but this is still 7% below the 2007 peak and hides significant variation across sectors. The high tech sector has already surpassed previous highs, while motor vehicles, which are currently recording the strongest annual rates of growth, have the most ground to recover. Auto production is around 60% higher than its 2009 lows, but is still more than 20% below pre-crisis levels. Structural problems in the industry suggest production is unlikely to surge past pre-crisis levels any time soon.

**Inflation in the Eurozone hit a 20-month high in July, climbing to 1.7% from 1.4% in June.** Similar to the UK, transport costs rose sharply and were a major contributor to the increase in prices. Consumer price inflation has been on an upward trend since recording price declines of 0.6% in July 2009. But it is unlikely to keep rising. A weak recovery and firmly anchored price and wage expectations mean there is little chance of inflation exceeding the ECB's 2% target ceiling for any length of time. The only significant divergences from the regional average were in Ireland (-1.2%) and Greece (+5.5%).

**In Japan, growth slowed sharply in the second quarter.** Losing the title of "World's Second Largest Economy" to China was the least of Japan's worries, as economic growth almost completely disappeared in the three months to June. The economy slowed from a healthy 1.1% q/q pace of expansion in Q1 to just 0.1% in Q2, a whole half percentage point lower than market expectations. Exports provided the only boost as domestic demand contracted – reflecting a combination of lower private and public spending. Japan's recovery has been bumpy to say the least since growth resumed in Q2 last year. These figures will stoke fears that Japan's two-decade long economic stagnation may be set to continue.

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