

Achieving balance

31st August 2010

There is general agreement that the UK and US economies need to be less dependent on the spending power of their consumers and more reliant on exports. Progress is slow to say the least. Household spending was the main driver of UK growth in Q2, while an insatiable appetite for imports meant that trade was an enormous dragging anchor in the US over the same period.

The UK was in rude health in Q2 2010, according to data released last week. The economy grew by an upwardly-revised 1.2% q/q in inflation-adjusted terms (the preliminary estimate had been 1.1%). That represents an impressive bounce by any standard, and means that the UK has now recovered about a quarter of the ground lost in the recession.

The mix of growth in Q2 was less impressive than the headline rate, however. Household spending was the star of the show, but a positive swing in inventories provided some of the impetus (principally due to wholesalers and retailers). Further stockbuilding is probably required following a brutal period of liquidation during which inventories fell by more than £22 billion in just 18 months. But this process will only take the economy so far. A sustainable recovery will have to be built on more fundamental sources of demand – including business investment and exports.

On the face of it, the reduction in business investment was a disappointing setback – and hardly a ringing endorsement of the prospects for a lasting recovery. But the 1.6% q/q contraction needs to be viewed in context. Capital expenditure is a highly volatile series and it was always likely there would be a reversal in Q2 after the sharp increase in Q1 (+7.8%). It makes more sense to look at the y/y growth rate of +1.9% which points to a gradual improvement, albeit from a very low base following a whopping 28% peak to trough contraction in business investment during the recession.

Data from the US economy disappointed on all fronts last week. The estimate for growth in the second quarter was revised down showing the economy lost even more momentum than previously thought. In the three months to June the economy expanded by just 1.6% q/q on an annualised basis, down from a first estimate of 2.4% and less than half the pace of growth seen at the start of the year. A 25% increase in investment spending gave a boost to the economy, but this was more than offset by an even larger increase in imports which caused the net trade position to deteriorate further. As many of the stimulus measures that have supported the economy over the last year expire, growth momentum, and thus the recovery, could falter.

Poor home sales data in the US added to the gloom. As the backlog of sales supported by the recently expired homebuyers tax credit worked through the system, there was only one direction July's figure could go. However, it was worse than even the most pessimistic of forecasts. Existing home sales fell 27% compared to June to the lowest level of sales since 1996. The tax credit brought sales forward to support the economy in its darkest hour. With its expiration we can expect sales to be depressed for several months and for prices to come under further pressure as housing demand evaporates. Even sales of shiny new homes did badly, falling 12% from an already suppressed level to just 40% of the long run average level.

In the Eurozone, volatility in business surveys reflects the uneven path of the recovery. The flash PMI survey, a good leading indicator of activity, showed a solid expansion for August, but with a slight loss of momentum from recent months. The composite index fell slightly to 56.1, from 56.7 in July. This index has remained comfortably above 56 since March, a good distance above the 50 mark which signals no change in output, but has exhibited volatility, yo-yoing from one month to the next. Output in the manufacturing sector has been particularly variable, and lost more momentum than service sector production. This has led forecasters to expect a slow down in economic growth from the 1% rate of expansion achieved in Q2, to a still healthy 0.7% in Q3. The Eurozone economy looks like it will keep growing, but the path is bumpy.

The continuing divergence of fortunes with the Eurozone remains a cause for concern. The solid output growth indicated by the headline PMI was particularly dependent on the two largest economies, Germany and France. In France, the composite PMI currently stands at 59.0, whilst Germany recorded an increase in its headline rate to 59.3 in August. More detail will emerge with the full PMI report, but such strength in the big two must hide considerable weakness elsewhere. Indicative of this was the construction PMI in Ireland, showing continued contraction across all categories of activity. Ireland has come under unrelenting pressure recently, culminating in the downgrade of Ireland's sovereign credit rating by ratings agency Standard & Poor's. The rationale for the downgrade was concern about Ireland's level of public debt.

Contacts:

Andrew McLaughlin
 Chief Economist
 +44 131 626 3868
 rbseconomics@rbs.com

www.rbs.com