

# UK Monthly Economic Update - July

9<sup>th</sup> July 2009

## Monetary Policy Committee (MPC) keeps the Bank Rate unchanged at 0.5%

Comment from Stephen Boyle, Head of RBS Group Economics:

*"The decision to leave rates on hold was an easy one, but whether or not to step up quantitative easing was a much trickier proposition. Recent green shoots may ultimately prove nothing more than stabilisation after an abysmal first quarter, when the UK economy lost as much ground as during the entire 1990s recession. A further stimulus may yet be needed to put the economy back on an even keel, but for now policymakers are prepared to wait and see."*

## The UK suffered a heavier blow in the first quarter than previously thought.

The economy shrank by 2.4% in Q1, significantly more than the initial estimate of -1.9%. The loss of output in the first three months of 2009 was as much as during the whole of the 1990s recession, which lasted fifteen months. So far, national income has fallen by 5% in this downturn, not far off the 6% decline experienced in the early 1980s (chart 1). Almost no area of the UK economy was left unscathed in Q1. The service sector, which makes up the bulk of the economy at 76% of output, provided the greatest drag, accounting for half of the 2.4% fall. But the steepest declines came from industry and construction. Lower levels of demand have forced factories to shut part time, and falling prices for homes and offices have discouraged building activity. The inventory cycle has also been playing a role in exacerbating the downturn and may exert an important influence on overall growth numbers in the quarters ahead, as discussed below.

## Stocks away! The role of inventories

Firms hold inventories as a buffer to help cope with unexpected changes in demand. So in the early stages of a downturn it's normal for firms to see their inventories rise, as demand falls off more quickly than they expect. But in a full blown recession the fall off in demand lasts longer than during "normal" fluctuations and stock levels quickly reach uncomfortably high levels. This ultimately contributes to the depth and length of the downturn in the wider economy, because in order to clear bloated stockrooms, firms have to cut production by more than they otherwise would have done simply to align production with a lower level of demand. This leads to more job losses and reductions in demand across the economy.

In the UK the de-stocking process has been in full flow over the past six months, as businesses were caught off guard by the extent of the slowdown at home and abroad. Since mid-2008 firms have been running down stocks at a breakneck pace – far faster than in previous downturns (chart 2). The decline is even more dramatic when we consider the technological advances and shift in industrial structure which has occurred in recent decades. "Just in time" management and better IT has allowed firms to keep production much more closely aligned with market conditions, meaning firms have been able to hold fewer inventories over time. Similarly, the move that we've seen towards a more service-based economy means that there is less scope for inventory build up across the economy (as service firms tend to hold less stock).

## Could we see a dead cat bounce?

Surveys indicate that a significant proportion of firms still view their inventories as being more than adequate (chart 3). Nevertheless, the savage nature of recent cutbacks suggest that we may be about to see a pause in the inventory liquidation process. This by itself could be sufficient to allow the UK to post a quarter or two of positive growth. For example, if de-stocking stopped in Q2 this would boost the quarterly growth rate by more than a percentage point. Though welcome, this would not necessarily herald the start of a sustained recovery and instead prove to be a "dead cat bounce". Ultimately, production will only be permanently ramped-up if it is supported by final demand. The omens on that front are not good. Consumers are under pressure from rising unemployment and slower wage growth. Pressure to bolster finances remains intense amid falling asset prices and still high debt levels. Similarly, firms have little appetite for capital goods, as utilisation rates of plant and machinery remain at low levels. In other words, a sustained recovery may still be some way off.

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### Contacts:

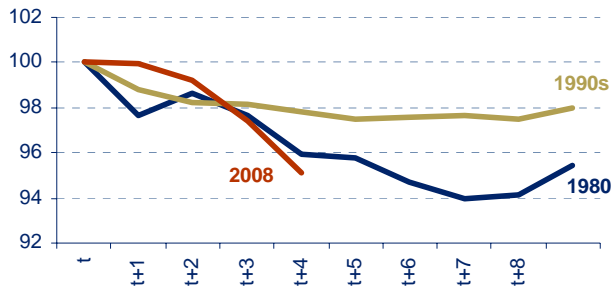
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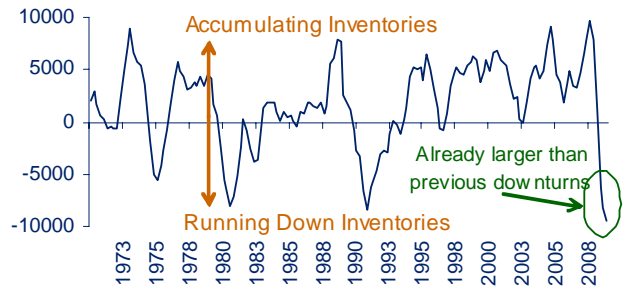
**1: This downturn has already surpassed the 1990s recession in terms of severity by a significant margin**

Source: Thomson Datastream, Index, start of recession =100, t= quarters



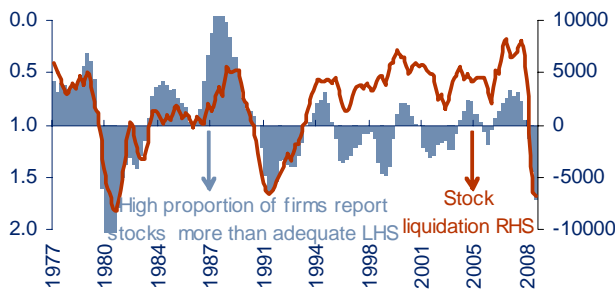
**2: Inventories have been liquidated at an unusually rapid pace (shaded areas denote recessions)**

Source: Thomson Datastream, £mn at constant prices



**3: Many firms are still reporting that inventories are high – usually a good leading indicator of de-stocking**

Source: Thomson Datastream



**Interest rate facts & figures**

Source: Bank of England, RBS Group

	Bank of England	RBS Group
Current rate	0.5%	0.5%
Since	5 <sup>th</sup> March 09	5 <sup>th</sup> March 09
Month ago	0.5%	0.5%
Year ago	5.00%	5.00%
<i>Minutes of June MPC meeting released: 22<sup>nd</sup> July 2009</i>		
<i>Next MPC announcement: 6<sup>th</sup> August 2009</i>		
<i>Next Inflation Report Published: 12<sup>th</sup> August</i>		

Following the decision, The Royal Bank of Scotland, National Westminster Bank plc and Ulster Bank Ltd. kept their Base Rate unchanged at 0.5%

All in %	Retail Price Index (includes mortgage payments)	Consumer Price Index
	RPI	CPI
<b>2007</b>	4.5	2.9
	4.4	2.6
	3.9	1.8
	4.2	2.1
<b>2008</b>	4.0	2.4
	4.4	3.4
	4.9	4.8
	2.7	3.9
<b>2009</b>	-0.1	3.0
	-1.3	1.6
	-2.4	-0.2
<b>2010</b>	-1.8	-0.6
	0.8	0.5
	1.5	0.5
	1.7	1.0
	1.8	1.0

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