

UK Monthly Economic Update

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Contacts:

Robert Gardner
Group Economics
0131 626 3697

robert.a.gardner@rbs.co.uk

Robert Blotevogel
Group Economics
0131 626 3953

robert.blotevogel@rbs.co.uk

[Group Economics Internet](#)

Monetary Policy Committee (MPC) keeps the Bank Rate on hold at 5.00%

Comment from Stuart Porteous, Head of RBS Group Economics:

"All good things come to an end, and, unfortunately, UK growth is no exception. After the economy broke its astonishing winning streak of 15 years of continuous growth this summer, the next UK rate move will almost certainly be down. But not just yet. The MPC looks set to keep rates on hold until it is unambiguously clear that inflation has passed its peak – and that probably won't happen until early in 2009."

Labour market holds the key to domestic demand

Empirically, unemployment explains a significant chunk of fluctuations in consumer expenditure. This is important, because consumer spending is the largest source of demand in the UK, representing 62% of all spending in the economy over the last four quarters. But its contribution to economic growth was even higher, with household consumption responsible for more than three quarters of GDP growth. The trajectory of consumer spending will therefore exert a major influence on what happens to the wider economy in the months ahead. It is all but certain that spending will ease, only the severity of the slowdown has yet to be determined. Forming a view on the course of unemployment is therefore crucial to predict the fortunes of the UK economy in 08/09.

Unemployment will rise – even without a technical recession

The first cracks have started to emerge. Although starting from a very strong position, with record numbers in employment, the rate of unemployment rose to 5.4% in June (Chart 1). This is still largely a labour supply issue – the economy could not generate jobs fast enough to absorb 70,000 additional people looking for work since the beginning of the year. In July, vacancies were also down 8% from their all-time highs in March. But current economic weakness is not yet fully reflected in the labour market statistics. Historically, there is a lag of 2 to 3 years before an economic downturn feeds through to peak unemployment.

A rise towards an unemployment rate of 6% is already 'baked in the cake'. Given the lag structure between growth and changes in the labour market, the unemployment rate is likely to climb to around 6% due to the dip in activity seen so far, even without any further deceleration. But the experience of previous downturns suggests that unemployment could rise by much more if the economy continues to weaken. If history is anything to go by, a peak in excess of 7% is possible, especially if the economy starts to contract.

But greater workforce flexibility could mitigate pressures on unemployment

Unemployment is the difference between the number of people looking for work (labour supply) and the demand for workers. If labour supply falls as well as labour demand, it can act as a 'buffer', tempering the rise in unemployment. This happened after the early 1990s recession (Chart 2). Total employment fell by 1.7mn. Meanwhile, the economically active population (those looking for a job) shrank by 600,000. The result was that unemployment rose by just over 1mn. This was in stark contrast to the experience of the 1980s, when falling labour demand coincided with an increase in labour supply, exacerbating the rise in unemployment (again, Chart 2).

Today's workforce is more flexible than in the past. Greater flexibility means that the relationship between growth and unemployment might be more favourable this time round – fewer people unemployed and a shorter average duration of unemployment. The first reason underlying the improvement in flexibility is the relatively high share of migrant and older workers in the labour force (Chart 3). Both groups have an above-average propensity to exit the labour market once career prospects deteriorate. Migrant workers often return home, while older workers typically have retirement savings to fall back on. The recent shift in the UK economy towards services also bolsters flexibility. Whereas skill sets in manufacturing tend to be job specific, service jobs develop skills that are more easily transferred across occupations.

Chart 1: Unemployment is rising, but still low by historic standards

(in %)
Source: Datastream

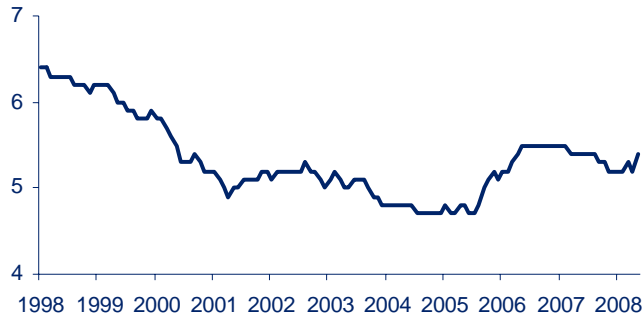


Chart 2: Falling labour supply can mitigate weakening labour demand

Source: Datastream

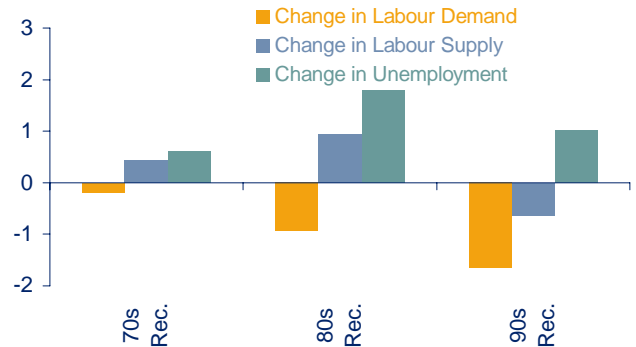
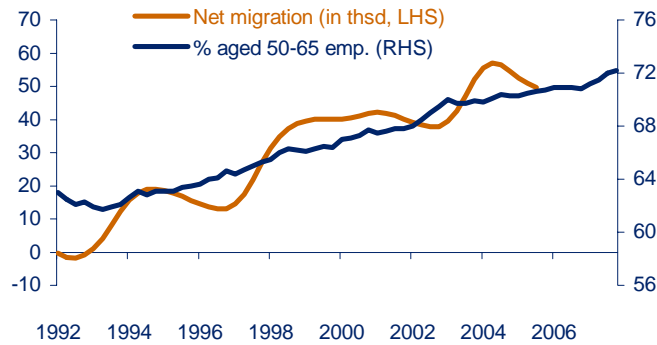


Chart 3: More migrant and older workers increase labour market flexibility

(%, y/y)
Source: Datastream



Interest rate facts & figures

Source: Bank of England, RBS Group

	Bank of England	RBS Group
Current rate	5.00%	5.00%
Since	10 th April 08	10 th April 08
Month ago	5.00%	5.00%
Year ago	5.75%	5.75%

Minutes of July MPC meeting released: 17th September 2008
 Next MPC announcement: 9th October 2008
 Next Inflation Report published: 12th November 2008

Following the decision, The Royal Bank of Scotland, National Westminster Bank plc and Ulster Bank Ltd. will keep their Base Rate on hold at 5.00%

All %s	Retail Price Index (all items)		Consumer Price Index	
	RPI		CPI	
2006	2.4		1.9	
	3.0		2.2	
	3.4		2.4	
	4.0		2.7	
2007	4.5		2.9	
	4.4		2.6	
	3.9		1.8	
	4.2		2.1	
2008	4.0		2.4	
	4.4		3.4	
	5.0		4.7	
	5.1		4.9	
2009	4.6		4.4	
	3.6		3.5	
	2.7		2.6	
	2.0		2.1	

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