## Economic background – Detailed Assessment at June 2011

Output in the services sector rose by 1.3% m/m in January. But given that output fell by 1.1% in December, the level of output was only a little above November's level, suggesting that the underlying growth rate in the sector is close to zero. Official construction data revealed that output in the sector fell by 7.7% m/m in January, following December's large 16.6% fall. However, the recovery in manufacturing has gathered further pace. Industrial production rose by 0.5% m/m in January.

There are signs that the recovery in consumer spending has run out of steam. The official measure of retail sales volumes rose by 1.5% m/m in January. Sales volumes fell by 0.8% in February, leaving the level of sales essentially unchanged on its level of six months ago. The GfK composite measure of consumer confidence was consistent with quarterly falls in overall household spending in all three months of the quarter. Meanwhile, data on the labour market have painted a mixed picture. On the one hand, employment rose by 36,000 in the three months to January. The weighted average of the employment balance of the CIPS surveys also rose in January and February, pointing to faster employment growth ahead. However, ILO unemployment rose by 37,000 in the three months to January.

Data on the housing market have perhaps suggested that house prices have found a floor. The Halifax measure rose by 0.8% m/m in January, although it then fell by 0.9% in February. The Nationwide measure has been stronger – it fell by 0.1% in January, but then rose by 0.7% in February and 0.5% in March.

The fiscal tightening intensified at the start of the year, with the hike in VAT in early January. The latest public finance figures have suggested that borrowing is still on track to undershoot the OBR's full-year forecast of £148.5bn in 2010/11, perhaps by £5bn. The Budget on 23rd March left the scale of the fiscal squeeze largely unchanged. Elsewhere, there are still few signs that the net trade boost to growth is coming through. However, the trade in goods and services deficit narrowed from £5.5bn to £3.0bn in January, but this was largely driven by temporary factors, such as a bounce-back in exports following December's snow and the imposition of a new tax on aircraft imports.

Meanwhile, inflation has continued to rise. CPI inflation rose from 3.7% to 4.0% in January and then to 4.4% in February. The rise in inflation did not just reflect higher food and energy costs – core inflation also rose from 2.9% to 3.4%. This probably reflected January's VAT rise, given anecdotal evidence suggesting that retailers passed on a larger proportion of this year's VAT rise onto consumers than last year's. Pipeline price pressures have also continued to build – in particular, oil prices have surged from around $95pb at the end of December to $115pb at the end of March. But high inflation still looks set to be temporary. Households' inflation expectations have not risen further – indeed, the YouGov/Citigroup measure of long term inflation expectations has fallen from 3.8% in December to 3.5% in March. And the annual rate of average earnings growth (exc. bonuses) was only 2.2% in January.

Nonetheless, the rise in inflation persuaded two more members of the Monetary Policy Committee (MPC) to start voting for rate hikes (Andrew Sentance was first joined by Martin Weale in January and then Spencer Dale in February). What's more, the Bank of England's February Inflation Report forecasts suggested that interest rates would need to rise broadly in line with the markets' expectations (then, for a 150bp rise in interest rates by the end of 2012) in order for inflation to hit the 2% CPI inflation target at the two year horizon. However, continued uncertainty about the underlying strength of the recovery persuaded the majority of MPC members to keep rates on hold at 0.5%. In financial markets, UK equities underperformed.

FTSE100 finished the quarter at around 5,950 – approximately the same level as at the end of 2010. 10-year gilt yields rose from 3.58% to 3.67% on the back of higher interest rate and inflation expectations. Meanwhile, sterling rose against the dollar from around $1.55 to $1.60, but fell from €1.16 to €1.13 against the euro. In the US, recent data has been mixed. On the one hand, the rise in both the US ISM manufacturing and non-manufacturing indices for February suggested that growth is picking up in the US economy. The unemployment rate has also fallen from 9.4% in December to 8.9% in February. But on the other hand, the rise in global food and energy prices appears to have weakened real consumer spending growth. Economic growth appears to have picked up in the euro-zone, albeit from sluggish rates. February's rise in the euro-zone composite PMI to its highest level since July 2006 left the index pointing to quarterly GDP growth of around 1%. Data on consumer spending in the region has also improved.