Economic background – Detailed Assessment at September 2011

Activity indicators suggest that the economic recovery has ground to a halt. Indeed, the weighted output balance of the CIPS/Markit surveys fell in August to a level that has been consistent with contraction in the past. The surveys also exclude retail activity – and the latest news from the high street suggests that the sector is in a similar position. While sales volumes rose by 0.2% m/m in July, they fell by the same amount in August.

However, output for the first quarter was depressed by a variety of factors (including the one-off
Bank Holiday for the Royal Wedding in April and the after-effects of the Japanese earthquake), so the economy might still register growth in the second quarter.

Meanwhile, the fading of the economic recovery has impacted on the job market. The Labour Force Survey measure of employment fell by 70,000 in the three months to July, the first fall this year. And the ILO measure of unemployment rose by 80,000 over the same period – the largest rise in two years. The timelier (but narrower) claimant count measure also rose by a monthly 33,700 in July and 20,300 in August. The pace of job losses across the whole economy looks unlikely to ease off in the coming months. Job vacancies in the three months to August were 1.3% lower than a quarter ago, while the employment balances of all three of the CIPS surveys were below the 50-mark in July and August (below 50 marks a contraction in expectations).

Meanwhile, the public finances are on track to miss this year's fiscal forecasts. If the trend in borrowing seen over the first five months of the fiscal year continues, it will be around £5bn higher than the OBR expects. Admittedly, the full impact of some tax changes have yet to be felt, but the lags between developments in the economy and the public finances suggest that the recent slowdown is unlikely to have had its full effect on receipts.

Conditions in the housing market have also continued to deteriorate. Whilst the number of mortgage approvals for new house purchase rose from 48,800 in June to 52,400 in August, this has not prevented renewed falls in house prices. The Nationwide index ended the second quarter 0.2% lower than at the end of the first.

The trade in goods and services deficit was £4.5bn in July, compared to an average monthly deficit of £3.8bn in Q1. The survey measures of export orders also point to falls in exports ahead – the new export orders balance of the CIPS Manufacturing survey, for example, fell to its lowest level since May 2009 in September. At that level, it points to a quarterly drop in the volume of manufactured goods exports of around 5%.

Inflation continued to climb in the second quarter. CPI inflation rose from 4.2% in June to 4.4% in July and 4.5% in August. A series of rises in electricity and gas prices also took effect in late August and September which, together with a rise in food inflation reflecting past rises in agricultural commodity prices, could push inflation close to 5% in September.

Inflation may creep a little higher in the third quarter – but recent developments suggest that it should fall quite sharply next year. Oil prices fell from $113 per barrel at the end of Q1 to $106 at the end of Q2. Agricultural prices also fell over the past quarter. Surveys of manufacturers pricing intentions in Q2 also pointed to a fall in producer output price inflation ahead. Meanwhile, the continued weakness of the broad money supply and lending data in Q2 and the persistence of a large degree of spare capacity in the economy also suggest that inflation will fall sharply in 2012.

Measures of inflation expectations have drifted up – the Bank of England's measure of households' inflation expectations in the year ahead rose from 3.9% to 4.2% in Q2. However with conditions in the labour market continuing to deteriorate, these expectations seem unlikely to become ingrained. The annual rate of average earnings growth including bonuses fell from 3.1% to 2.9% in July (the rate excluding bonuses fell from 2.2% to 1.7%). Real pay growth has thus remained negative.

Meanwhile, the MPC became distinctly more dovish during Q2. Spencer Dale and Martin Weale both abandoned their votes for a rate hike at the meeting in August. The minutes of September's meeting also suggested that QE2 will be launched soon, although, no other members have yet joined Adam Posen in voting for more QE. Most have however accepted that the case for policy stimulus has significantly strengthened and that "a continuation of the conditions seen over the past month would probably be sufficient to justify an expansion of the asset purchase programme at a subsequent meeting."

Financial market sentiment deteriorated sharply in the second quarter, reflecting declining prospects for economic growth and renewed risk aversion as a result of the intensification of the euro-zone sovereign debt crisis. The FTSE 100 finished the quarter at 5,128 – about 14% lower than its level at the end of the first quarter. Ten year gilt yields plummeted from 3.38% to 2.43%, reflecting falling interest rate expectations, safe-haven flows as a result of a perceived rise in default risk on sovereign debt in the euro-zone and perhaps expectations that further QE might soon be on the way. Meanwhile, a global shift away from risk saw the dollar strengthen. As a result, sterling weakened against the dollar from about $1.60 to $1.56, but strengthened slightly against the euro from €1.16 to €1.10.

In the US, economic data was weak, but a little stronger than in the UK. The US ISM indices pointed to annualised quarterly GDP growth of around 1.5% in July and August. Growth in payrolls also stagnated in August. And while President Obama proposed a $450bn job creation bill, equivalent to nearly 3% of GDP, it seems unlikely to be passed by Congress in full.

Growth has also slowed sharply in the euro-zone. In particular, the ECB composite PMI now pointed to outright falls in GDP in August. A steep drop in the EC Economic Sentiment Indicator in August also left the index consistent with a sharp slowdown in annual GDP growth in the region.