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Economic review of January 2011

Let's hope 'double dip' is limited to Strictly Come Dancing

Double-dip recession?

Experiencing negative growth during the last quarter of 2010 could lead to fears that we are facing double-dip recession, as the opposition has threatened ever since the coalition announced its plans to reduce the inherited spending deficit. Time will tell if they are right, but a 0.5% fall in output for the period could easily be revised upwards later, in the same way that the third quarter figures have been revised downwards from 0.8% to 0.7% growth. Part of the downturn was attributable to exceptionally poor weather, rather than underlying weakness within the economy. We can therefore expect either that the data is revised upwards within a month or so, or the next quarter will be much stronger than might otherwise have been the case.

Many opposed to spending cuts ask why hard-pressed consumers, rather than the banks, should pay for our economic mess. But the credit crisis was only the 'final straw'; the underlying cause was the overspending that the country – and many individuals – had pursued for more than a decade. The banks were not responsible for the fact that we spent more than we earned, although they may have some culpability for failing to ensure that all borrowers could afford their repayments. However, the level of bankruptcies and insolvencies to date does not suggest that a high proportion of UK borrowers have defaulted.

Steady as she goes

Confidence is the key

Despite claims by such figures as Sir Richard Lambert, outgoing head of the Confederation of British Industry, that the coalition has taken its eye off the ball as far as growth is concerned, it appears that there is no "plan B". Whether or not the coalition is correct to focus entirely on cutting spending while apparently hoping that its tax revenues will be sustained, we can at least hope that our national credit rating will not go the way of Ireland's, last December.

While Downing Street appears willing to hold its line, however, it is equally important to the recovery that consumers overcome the doom and gloom being projected by much of the press. This is not a matter of how unpopular or otherwise the government may become; the chance of another election within four years is low, so they do not have to face the electorate other than at by-elections. What matters is that lack of consumer confidence could lead to lower spending, which could hit productivity. The government needs to have – and publicise – a growth plan; simply asking businesses to "stop hoarding cash and use it to create jobs" *(Sunday Times 30/1/11)* is unlikely to be sufficient.

As household budgets are squeezed by rising prices and higher interest charges on unsecured borrowings, such as credit cards, on the one hand and low (if any) pay increases on the other, there is likely to be an adverse impact on manufacturing. On a more positive note, a weak pound helps exporters (though sterling did recover slightly in January) and this could be good for the economy at large by increasing profitable activity and therefore tax revenues.

Perhaps consumers need to be reminded that it is essential to remain confident and spend wisely, in order to assist the recovery.

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Businesses may hold the future of our recovery

Business

According to the Bank of England's Agents' Summary for January, investment intentions in manufacturing are now broadly in line with those seen prior to the recession. Employment intentions are also in positive territory, although to a lesser extent, with both manufacturing and services anticipating modest growth over the next six months. It may appear that 'modest' growth will be inadequate to make up for public sector job losses, but it should be remembered that those losses will not all take place within the current year. In any event, private sector jobs are arguably more economically valuable at the moment, because they generate tax revenue without costing the country anything. They can also increase output as measured by the GDP figures.

Exporters' confidence also shows the highest score in the Agents' Summary since July 1997, with the main growth coming from emerging markets for the engineering and energy-related sectors. Admittedly, imports are also growing quickly but there are suggestions that uncertainty over delivery times, transport costs and quality could lead to lower import levels in the future as more production is repatriated to the UK.

Markets had a mixed month

Markets (Data compiled by the Insurance Marketing Department Ltd.)

January was something of a mixed month for stockmarkets. Poor growth figures in the UK may have been a contributory factor to the FTSE100's -0.63% fall during the month, a fate it shared with the mid-cap FTSE250, which lost -0.76%, the blue-chip index having first spent a third of the month above the 'magic' 6,000 level. Putting this into context, the FTSE100 currently stands at roughly the same level as it was during June 2008, having suffered a significant fall during the intervening period, and is now 13% higher than a year ago.

Elsewhere, markets were more robust with the Dow Jones gaining 2.72% over the month, while the Nasdaq100 managed 1.78%. Closer to home, the Eurostoxx50 grew by 5.76%, building on a similar figure in December.

Sterling strengthened during January with the pound ending the month 2.83% higher against the dollar and 0.21% up against the euro. Gold has finally lost something of its shine, ending January -5.38% lower, at US$1,338.44 per troy ounce, after a five-month bull run, but is still almost 24% higher than this time last year. Unfortunately, oil continues to climb, adding 6.8% to end the month at US$99.42 a barrel for Brent crude 1-month futures. This level is almost 40% higher than at the end of January 2010.

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Hopefully, we can keep this stag at bay

Interest rates round the world		
UK	0.50%	No change for 22 months
USA	0.25%	No change for 25 months
Europe	1.00%	No change for 20 months
Japan	0.10%	No change for 25 months

Inflation and interest rates

Talk of a return to 'stagflation' may not only be premature, it could be wrong. Around the start of the credit crunch, Graeme Leach, Chief Economist at the Institute of Directors, talked about the gentler 'stickyflation', which is a different animal because it represents rising prices against a background of zero economic growth (stagflation is much worse, because it involves even higher inflation and high unemployment but with at least some economic growth). At the moment, we appear to be in stickyflation territory with inflation robustly refusing to fall below 3% for the CPI and growth, adjusted for the poor weather last December, would probably have been about zero during the fourth quarter.

The Bank of England's Monetary Policy Committee has again declined to increase base rate – despite a second member, Martin Weale, having joined Andrew Sentance in calling for a rise, this month – because while this might slow inflation, it would almost certainly depress economic growth.

On the other hand, there are few mechanisms that can bring down the rate of inflation, so we have to hope that the Bank is correct in seeing the current situation as a temporary aberration. Holding interest rates at such a low level harms savers, as well as making it more difficult to raise them later without causing panic. If the Bank fears that high inflation is here to stay, then it may have to increase base rate, at least modestly, soon or it will have to do much more later on. Some believe that its reluctance to move more quickly in 2008 is one reason why it had to drop the rate so far. The reverse could prove true on the way up; act too late and you have to go higher.

Twilight for the housing market?

Property

The housing market is likely to be facing a difficult year, according to some commentators. There are two main reasons for this. First, it is expected that the number of transactions will remain low, partly because of the difficulty of obtaining a mortgage and partly because property is simply not coming onto the market in sufficient numbers to stimulate activity. Vendors see no point in trying to sell while there are so few buyers about. Suggestions that Stamp Duty should be replaced by an annual property tax to remove one market inhibitor are unlikely to gain widespread support amongst consumers or legislators, so other stimuli are needed.

Secondly, lenders appear to be withdrawing some of their more attractive fixed-rate mortgages, making borrowing more expensive. The reason for this is that they are influenced not by base rate but by five-year swap rates within wholesale money markets, which is where they actually get most of their money for lending; these have recently become more expensive.

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