

UK ECONOMICS WEEKLY

21st Nov. 2011



Is the euro-zone really to blame?

- The Government was lambasted last week for blaming the UK's poor economic performance on events in the euro-zone. **While the Government is not barking up completely the wrong tree, it would be a stretch to say that the euro-zone crisis has been the main driver of the UK's poor performance.** After all, much of Europe itself is doing *better* than the UK.
- The more important point, though, is that the effects on the UK from the euro-zone crisis are yet to come through fully, while the euro-zone situation itself is likely to get worse. **So while the Government might have jumped the gun a bit, it won't be long before the impact of events across the Channel becomes painfully clear.**
- The Government might have more bad news to contend with this week, with weak corporation tax receipts perhaps pushing up public sector borrowing in October. We also expect a slight downward revision to quarterly GDP growth in Q3. (Pages 2-3.)

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Is the euro-zone really to blame?

A debate opened up last week about whether the UK's recent poor performance has been more a reflection of the crisis in the euro-zone or the result of domestic factors. But whichever has been the bigger factor, the most important point is that the effects on the UK from the euro-zone crisis are set to get much worse.

Economic backdrop

As his Autumn Statement draws closer, the Chancellor must be hoping for at least some improvement in the economic backdrop. Last week's news was not all bad – inflation fell and retail sales rose in October. But the Bank of England's *Inflation Report* was a depressing read, employment fell sharply in October and youth unemployment broke through the one million mark.

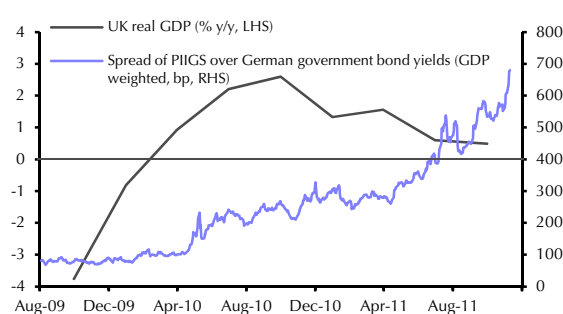
It is of little surprise that the Government has jumped at the opportunity to blame all of this on what is happening outside the UK. Prime Minister David Cameron has spoken of the "chilling effect" the euro-zone crisis is having on the UK, while Chris Grayling, the employment minister, said that the latest unemployment figures "show just how much our economy is being affected by the crisis in the euro zone." And following the *Inflation Report*, the Treasury issued a statement saying that "today's Bank of England *Report* reiterates that the UK economy is not immune from the problems faced by its trading partners, in particular the euro-zone."

Various commentators and, unsurprisingly the opposition, immediately retorted that it was rubbish to blame the UK's predicament on the euro-zone, highlighting the time lags that should be involved and pointing out that the deterioration in the economy and the labour market pre-dates the troubles in the euro-zone.

But to be fair to the Government, it is not barking up completely the wrong tree. Although the European crisis has recently reached new heights, it has been rumbling on for a while. Concerns about the peripheral euro-zone countries started to escalate back in the spring/summer of this year and it is getting on for two years since serious concerns

about Greece first started to spread. Although it is clearly very simplistic, Chart 1 does show that as concerns about peripheral euro-zone countries (shown here by the spread of their bond yields over German bunds) have intensified, GDP growth in the UK has slowed.

CHART 1: UK GDP GROWTH & EURO-ZONE BOND YIELDS

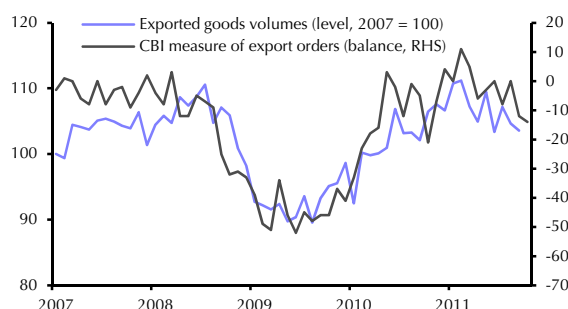


Sources – Thomson Datastream, Bloomberg

At the very least, the uncertainty about Europe could have been weighing on sentiment in the UK, both reducing demand in the economy and making firms nervous about hiring. Note that business confidence has been falling for several months now.

What's more, both export volumes and export orders have been falling since the start of 2011. (See Chart 2.) Although some people have noted that exported goods to the euro-zone were still some 17% higher than a year ago in September, this mainly reflects higher commodity prices. In *volume* terms, annual export growth was less than 5%. Indeed, this week's GDP release should show that net trade was a *drag* on growth in the third quarter.

CHART 2: EXPORTS & EXPORT ORDERS

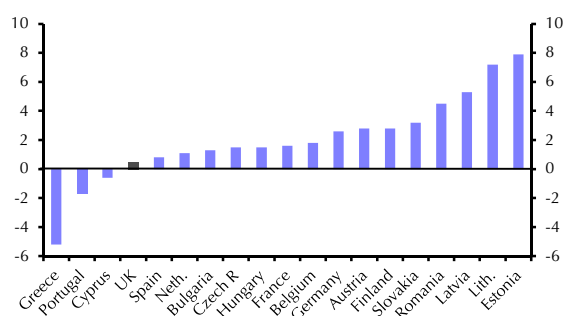


Source – Thomson Datastream

A home-grown slowdown?

However, it would be a stretch to say that the euro-zone crisis has been the *main driver* of the UK's poor performance. After all, much of Europe itself is doing *better* than the UK. Chart 3 shows the annual growth rates of GDP across Europe in Q3 (for those countries which have published data). The UK is clearly towards the bottom of the pack.

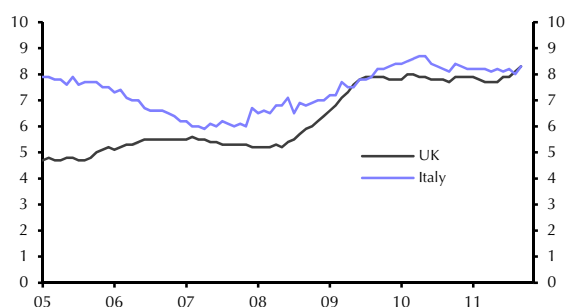
CHART 3: REAL GDP IN 2011 Q3 (% Y/Y)



Source – Thomson Datastream

It is a similar story with unemployment. Chart 4 shows that (as least as far as the published figures show), the recent rise in the unemployment rate in the UK has taken it to the same level as in Italy, the country now at the centre-stage of debt concerns.

CHART 4: ILO UNEMPLOYMENT RATES (%)



Source – Thomson Datastream

That does not mean that Labour is therefore right to lay all of the blame at the Government's door. The coalition would perhaps have been on firmer ground had it blamed the UK's woes on other external factors, such as the rise in food and energy prices. As Mervyn King said last week, the squeeze on households' real take-home pay has been "an unavoidable consequence" of these factors.

Nonetheless, much of the downturn is related to the fiscal squeeze. Government spending growth has slowed sharply and the VAT rise at the start of the year compounded the squeeze on real pay. Meanwhile, a survey published in the *Inflation Report* showed that 15% of households had saved more over the past year because of the austerity measures. And as far as unemployment goes, public sector job cuts have so far driven more of the recent rise than weaker private sector jobs growth.

It has probably therefore been a bit disingenuous of the Government to shift the blame for the UK's problems elsewhere. **But while the Government might have jumped the gun a bit, it probably won't be long before the impact of what is going on across the Channel becomes painfully clear.** Not only are the effects of recent developments in the euro-zone yet to feed through fully to the UK, but the euro-zone situation itself is likely to deteriorate further. **Indeed, in our recent *Quarterly Review*, we calculated that the crisis could knock at least 1% off UK GDP, and more like 3% or more if we see a major break-up of the single currency.** (See "How big is the euro threat?" 28th October.)

The domestic economy still looks unable to offset this. In fact, the OBR's new forecasts could show that the Government needs to *ratchet up* its austerity drive in order to meet its fiscal mandate. (See our forthcoming Autumn Statement preview.) **With a renewed recession looming, the Government is wise to start getting its excuses in.**

The week ahead

The Government might have more bad news to contend with this week, with weak corporation tax receipts perhaps pushing up public sector borrowing in October. We also expect a slight downward revision to quarterly GDP growth in Q3.

Elsewhere, the Bank of England's Financial Policy Committee meets for the third time on Wednesday. Lastly, we doubt that the minutes of November's MPC will show that the *Inflation Report* prompted any members to vote for more QE immediately.

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Data Preview – Public Finances (Oct.)

09.30 Tue. 22nd Nov.

Forecast	Previous	Median	Capital Economics
PSNB (ex.)	+£14.1bn	+£6.6bn	+£8.0bn
PSNCR	+£19.9bn	-	-£5.0bn

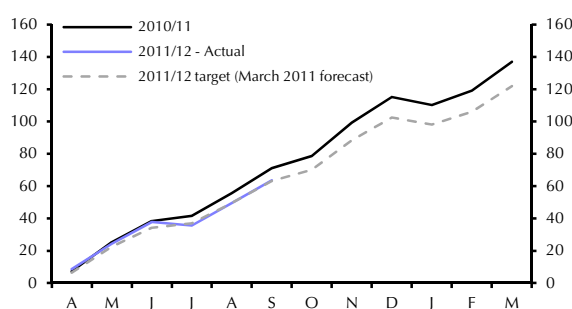
Tax receipts to fall short of plans

The public finances have weathered the recent economic slowdown well so far. The £7.5bn fall in borrowing on the PSNB ex. measure in the first half of 2011/12 compared to the same period last year has been broadly in line with the fiscal forecasts, despite the fact that the forecasts were based on expectations of stronger GDP growth. (See Chart 1.) However, we fear that borrowing in October will exceed the £7bn or so figure that would leave the fiscal consolidation on track.

For a start, there are lags between developments in the economy and their impact on the public finances. October is a key month for corporation tax receipts and recent weak profitability in the financial sector may cause them to fall short of the plans. We have therefore pencilled in a PSNB ex.

figure of £8bn for October. The latest public finances figures may therefore strengthen the case for expecting substantial upward revisions to the borrowing forecasts on 29th November.

CHART 1: PNSB Ex. (£BN, CUM.)



Source – Thomson Datastream

Data Preview – MPC Minutes (Nov.)

09.30 Wed. 23rd Nov.

Forecast	Previous	Median	Capital Economics
Vote (more QE – no more QE)	9-0	-	0-9

Minutes to echo dovish Inflation Report

It seems reasonable to expect the minutes of November's meeting to echo the dovish tone of the *Inflation Report* and press conference last week.

The fact that the *Inflation Report* pointed to the need for more policy support could even mean that some people voted to increase the size of the total asset purchase programme immediately. Obviously Adam Posen is the most likely candidate, having already been voting for some time for more QE. But one of the other dovish members – such as David Miles or Mervyn King – could have joined him.

That said, at the press conference, Sir Mervyn said that there was little point in fine-tuning policy and implied that he wanted to wait to check that inflation did start to fall before worrying about the

projected undershoot of the inflation target. And in an interview last week, MPC member Martin Weale seemed open to doing more QE, but talked about the case for doing more in February, rather than any sooner. With the extra QE announced in October not completed yet, we expect the vote to leave policy unchanged to have been unanimous – with Posen falling back in line with the majority.

Nonetheless, the minutes are likely to show that the Committee is biased towards undertaking more policy stimulus and we will watch closely for any clues that this could be as soon as next month. Also of interest will be any preliminary assessment of the effects of the asset purchases undertaken so far.

Data Preview – GDP By Expenditure (Q3)

09.30 Thu. 24th Nov.

Forecasts	Previous	Median	Capital Economics
GDP	+0.5%(+0.5%)	+0.5%(+0.5%)	+0.4%(+0.4%)

Downward revision possible

The provisional estimate of a 0.5% quarterly rise in GDP in Q3 was better than expected, but the data released since then point to a possible downward revision.

Admittedly, the drop in construction output in Q3 has been revised from 0.6% to a smaller 0.2%. However, industrial production has been revised down, as have the trade figures for Q3. Accordingly, we think that GDP growth could be nudged down, perhaps to 0.4%.

As for the expenditure breakdown, consumer spending looks pretty likely to have fallen again. Retail sales volumes fell by 0.2% in Q3 and spending off the high street still seems to have been suffering. Meanwhile, the widening in the trade deficit in Q3 suggests that net trade could have

knocked as much as 0.7% off growth compared to Q2. (See Chart 1.) Offsetting this, investment should have rebounded after Q2's sharp fall. And if the economic slowdown has caught some firms by surprise, stockbuilding should have risen too.

CHART 1: TRADE BALANCE (£BN)



Source – Thomson Datastream

Data Preview – CBI Ind. Trends Survey (Nov.)

11.00 Thu. 24th Nov.

Forecasts	Previous	Median	Capital Economics
Output Expectations Balance	-11	-	-10

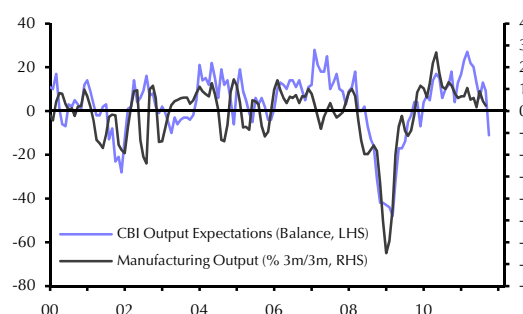
Continuing to contract

The output expectations balance of the CBI Industrial Trends Survey plunged from +9 to -11 in October, suggesting that the manufacturing sector has re-entered recession. November's survey seems unlikely to paint a significantly less bleak picture.

Granted, the output expectations balance is volatile from month to month, so an improvement is possible. However, the balance was consistent with quarterly falls in output of around 1% in October, so a very strong bounce-back would be needed to suggest that output has stopped falling. (See Chart 1.) In addition, the CIPS manufacturing survey for October, which, unlike the CBI's survey, covered all of the month, was also consistent with similarly large falls in output. Meanwhile, the

further intensification of the euro-zone debt crisis suggests that the full impact of the crisis on exports has not been felt yet. As a result, the CBI's survey looks set to maintain a gloomy tone in November.

CHART 1: MEASURES OF MANUFACTURING OUTPUT



Source – Thomson Datastream

Latest Data & Main Forecasts

LATEST UK ECONOMIC INDICATORS

Monthly Indicators %m/m(%y/y) unless stated		Jul	Aug	Sep	Oct
Retail prices (%y/y)	CPI	+4.4	+4.5	+5.2	+5.0
	RPIX	+5.0	+5.3	+5.7	+5.6
	RPI	+5.0	+5.2	+5.6	+5.4
Producer prices	Input, n.s.a.	+0.4(+18.2)	-1.8(+16.2)	+1.8(+17.7)	-0.8(+14.1)
	Output, n.s.a.	+0.2(+6.1)	+0.0(+6.0)	+0.3(+6.3)	+0.0(+5.7)
Average earnings, headline (actual %y/y)		+3.0(+2.9)	+2.2(+2.8)	-	-
ILO unemployment, q/q change thous., (rate %)		+80(7.9)	+114(8.1)	+129(8.3)	-
Retail sales (incl. petrol)		+0.1(-0.4)	-0.5(-0.7)	+0.5(+0.5)	+0.6(+0.9)
Manufacturing output		-0.2(+2.6)	-0.3(+1.6)	+0.2(+2.0)	-
PSNB ex. £bn, latest (FY cumulative)		-2.0(+35.7)	+13.7(+49.4)	+14.1(+63.5)	-
Global trade in goods balance, £bn		-8.7	-8.6	-9.8	-
Nationwide house prices		+0.3(-0.4)	-0.6(-0.4)	+0.1(-0.3)	+0.4(+0.8)

Quarterly Indicators %q/q(%y/y) unless stated	Q4 2010	Q1 2011	Q2 2011	Q3 2011
GDP	-0.5(+1.3)	+0.4(+1.6)	+0.1(+0.6)	+0.5(+0.5)
Household spending	-0.1(+0.2)	-0.6(-0.4)	-0.8(-1.7)	-
Productivity, whole economy	+0.1(+1.7)	+0.2(+1.5)	-0.3(+0.5)	-
Current account, £bn	-9.7	-4.1	-2.0	-

LATEST MARKET DATA

Instrument/rate	1 mth ago	1 week ago	Latest*	Instrument/rate	1 mth ago	1 week ago	Latest*	
Official rates UK repo	0.50	0.50	0.50	Global yields US 10 year	2.22	2.06	2.00	
US Fed funds	0-0.25	0-0.25	0-0.25	E12 10 year	2.11	1.89	1.92	
ECB refi	1.50	1.25	1.25	Japan 10 year	1.01	0.97	0.95	
Japan o'night	0.10	0.10	0.10	Equity indices FTSE 100	5489	5545	5376	
Market rates 3mth LIBOR	0.98	1.01	1.01	S&P 500	1238	1264	1216	
	12mth LIBOR	1.75	1.78	1.79	Nikkei 225	8679	8514	8375
Gilt yields	2 year	0.58	0.54	0.51	Exchange rates Sterling index	79.2	80.6	80.5
	5 year	1.40	1.18	1.15	\$/£	1.59	1.61	1.58
	10 year	2.53	2.29	2.24	Euro/£	1.15	1.17	1.17
	20 year	3.27	3.06	2.97	\$/Euro	1.39	1.37	1.35
Yield curve (20 year-2 year)	269	253	246	Brent crude oil price (\$ pb)	110.8	113.8	109.0	

* Latest as at 09.30 GMT on 18th Nov 2011

MAIN ECONOMIC & MARKET FORECASTS

%q/q(%y/y)unless stated	Latest	Q3 2011	Q4 2011	2011	2012	2013
GDP	+0.5(+0.5) (Q3)	(+0.5)	(-0.3)	(+0.8)	(+0.0)	(+1.5)
Household spending	-0.8(-1.7) (Q2)	(-1.9)	(-2.1)	(-1.5)	(-1.5)	(+0.5)
CPI inflation (%y/y)	(+5.0) (Oct)	(+4.7)	(+4.8)	(+4.6)	(+2.8)	(+1.5)
ILO unemployment rate (%)	8.3(Sep)	8.0	8.3	8.0	9.3	9.8
Repo rate, end period (%)	0.50	0.50	0.50	0.50	0.50	0.50
10 yr gilt, end period (%)	2.24	2.00	2.25	2.25	2.00	2.00
\$/£, end period	1.58	1.50	1.50	1.57	1.50	1.45
Euro/£, end period	1.17	1.25	1.25	1.16	1.25	1.32

Economic Diary & Forecasts

THE WEEK AHEAD

Date/Country	Release/indicator/event	Time (GMT)	Previous*	Median*	CE Forecast*	UK Data Response
Mon 21 st	UK Rightmove House Prices (Nov)	00.01	+2.8%(+1.2%)	-	-	-
Tue 22 nd	UK Public Finances (Oct)	PSNBex. 09.30	£14.1bn	+£6.6bn	+8.0bn	DR
		PSNCR 09.30	£19.9bn	-	-£5.0bn	DR
	US GDP (Q3 2 nd Est.)	13.30	+2.5%	+2.5%	+2.5%	-
	US Fed FOMC Minutes (1 st -2 nd Nov Meeting)	19.00	-	-	-	-
Wed 23 rd	UK MPC Minutes (Nov) (More QE – No More QE)	09.30	9-0	-	0-9	DR
	UK BoE Agents' Scores (Nov)	09.30	-	-	-	-
	UK BBA Mortgage Approvals (Oct)	09.30	33,130	-	-	-
	US Durable Goods Orders (Oct)	13.30	-0.6%	-1.0%	-	-
	UK Financial Policy Committee Meeting (Nov)	-	-	-	-	-
	Thu 24 th	UK GDP (2 nd Est.)	q/q(y/y) 09.30	+0.5%(+0.5%)	+0.5%(+0.5%)	+0.4%(+0.4%)
UK Index of Services (Sep)		m/m(q/q) 09.30	+0.3%(+0.6%)	-	0.0%(+0.6%)	-
UK CBI Industrial Trends Survey (Nov)		11.00	-11	-	-10	DR
Ger IFO Business Climate (Nov)		09.00	106.4	105.2	-	-
Fri 25 th	UK No Significant Data Released	-	-	-	-	-

*m/m(y/y) unless otherwise stated; p=provisional. "DR" Data Response sent out after data is released

KEY FORTHCOMING EVENTS/DATA

Date	Event	Date	Event
28 th Nov	CBI Distributive Trades Survey (Nov)	6 th Dec	BRC Retail Sales Monitor (Nov)
29 th Nov	Autumn Statement	7 th Dec	Industrial Production (Oct)
29 th Nov	M4 Money Supply (Oct)	8 th Dec	BoE Interest Rate & QE Announcement (Dec)
By 30 th Nov	Nationwide House Prices (Nov)	9 th Dec	Trade (Oct)
1 st Dec	CIPS/Markit Report on Manufacturing (Nov)	13 th Dec	Consumer Prices (Nov)
2 nd Dec	CIPS/Markit Report on Construction (Nov)	14 th Dec	Labour Market (Oct/Nov)
5 th Dec	CIPS/Marlit Report on Services (Nov)	15 th Dec	Retail Sales (Nov)

Selected Recent Publications

Date	Publication	Title
Mon 14 th	Capital Daily	What next for the euro-zone?
	European Economics Update	Italy needs more than a new government
	European Economics Update	ECB unlikely to fire the silver bullet
	UK Commercial Property Analyst (Q4 2011)	Capital values to slide 5% in 2012
	Commodities Update	How much might conflict with Iran add to oil prices?
	Emerging Europe Central Bank Watch	Euro-crisis takes centre stage
	Global Economics Update	Will the IMF save the euro?
	US Economics Update	Monetary Indicators Monthly (Oct.)
Tue 15 th	Capital Daily	Italy - a lull in the storm?
	Euro-zone GDP (Q3) & German ZEW (Nov.)	Last expansion before new recession
	UK Consumer Prices (Oct.)	Finally past the peak?
	Emerging Europe Update	Pillars of decent Q3 growth already crumbling
	European Commercial Property Update	Czech industrial market outlook darkens, but further rent falls unlikely
	US Retail Sales & Producer Prices (Oct.)	Economy has decent amount of momentum
	Commodities Update	Is there any upside from the euro-zone crisis?
	Canada Survey of Manufacturing (Sep.)	Recovery in energy and auto production boosts sales
Wed 16 th	Middle East Economics Update	Raising deposit rates is not enough to support the Egyptian pound
	Capital Daily	Euro-zone crisis spreads to the core
	European Economics Update	Is France falling out of the core?
	UK Labour Market Data (Sep./Oct.)	Still no respite for households
	Bank of England Inflation Report (Nov.)	More QE on the way
	Emerging Europe Economics Focus	Russia's new oil tax: radical reform or damp squib?
	European Economics Update	Will the new Spanish Government steady the ship?
	European Economics Update	Are markets starting to price in a euro break-up?
Thu 17 th	UK Economics Update	Regional Monitor (Oct.)
	Global Markets Update	What to make of Greece's bigger "haircut"
	UK Housing Market Update	Can high income multiples prevent a further adjustment in house prices?
	Capital Daily	EMU break-up concerns likely to build
	UK Retail Sales (Oct.)	Resilient, for now
	Commodities Update	Brent-WTI spread returning to reality
	UK Consumer Monthly (Nov 11)	Labour market downturn worsens
	UK Economics Update	Little cause for cheer on Northern Rock sale
Fri 18 th	Emerging Asia Economics Chart Book	Growth falters in Q3
	Capital Daily	More pain in Spain
	China Economics Update	How badly will China's exporters be hit?
	UK Economics Weekly	Is the euro-zone really to blame?
	US Economics Weekly	-
	European Economics Weekly	-
	Japan Economics Weekly	-