MPC - ESSENTIAL READING / FPC – BACKGROUND READING

UK Demand & Output Monthly

September 2015

UK Team

GDP and latest nowcasts*

	ONS 2nd estimate	UK Team expectation	Consensus	Latest backcast
2015 Q2	**0.7%**	**0.6%**	**0.7%**	**0.7%**
	Latest nowcast		Last month nowcast	
2015 Q3	**0.6%**		**0.7%**	

This month's data at a glance

Demand (%qoq)	2015 Q2	Aug IR	Contrib. to error	2015 Q1	2014 Q4
GDP	0.7	0.7	0.0	0.4	0.8
Consumption	0.7	0.9	-0.1	0.9	0.5
Govt consumption	0.9	0.0	0.2	0.9	0.1
Investment	1.0	0.9	0.0	2.6	-0.8
- Business	2.9	0.9	0.2	2.0	0.3
- Housing	-3.5	1.2	-0.2	2.4	-0.5
- Government	0.2	0.0	0.0	1.2	-0.2
Net Trade*	1.0	1.1	-0.1	-0.6	0.8
- Exports	3.9	2.6	0.4	0.4	4.5
- Imports	0.6	-0.8	-0.5	2.3	1.6
Other (inc. stocks)*	-1.1	-1.0	-0.1	-0.2	-0.2

*contributions to quarterly GDP growth

Monthly Output Indices	Jun	May	Apr	Mar	Feb
Index of Services	0.5	0.2	0.2	0.2	0.3
- PNDS	0.7	0.3	0.1	0.3	0.3
- Distribution	0.9	-0.2	0.8	-0.1	0.2
Index of Production	-0.4	0.3	0.2	0.6	0.1
- Manufacturing	0.2	-0.7	-0.3	0.4	0.5
Construction output	0.9	-1.0	0.0	1.4	-0.9

Trade and Retail Sales	Apr	Mar	Feb	Jan	Dec
Retail sales vols (inc fuel)	0.1	-0.1	0.3	0.7	-0.7
Retail sales vols (exc fuel)	0.4	-0.3	0.4	0.5	0.0
Goods imports	n/a	3.8	-3.4	-0.8	2.2
Goods exports	n/a	-0.5	3.0	4.8	1.5

Survey Measures	Aug	Jul	Jun	May	Ave
CIPS Services*	n/a	57.4	58.5	56.5	55.1
CIPS Manufacturing*	52.5	52.4	51.5	52.2	53.3
CIPS Construction*	n/a	57.1	58.1	55.9	54.6
GfK Consumer Conf	4.3	3.3	4.7	0.1	-9.3

*CIPS Construction and Services are confidential until the 2nd and 3rd September.

CBI Service Sector Survey	2015 Q3	2015 Q2	2015 Q1	2014 Q4	Ave
Business optimism	33	29	17	16	3
Employment: next 3 months	12	34	31	33	10
Inv. Intentions: vehicles, plant & machinery	4	11	11	7	-7

We have revised down our nowcast for growth in Q3 by 0.1pp to 0.6%. GDP growth in Q2 was unrevised at 0.7%.

The composite Markit/CIPS output balance fell in August, along with the predictions of several of our nowcasting models. We have trimmed the Q3 nowcast as a result.

In contrast, expectations of firms and consumers appear to be broadly unchanged on the month, so we have not revised our forecast for growth in Q4. However, most of our survey data pre-date the intensification of financial market volatility.

Q2 GDP growth was unrevised, at 0.7%. The expenditure split was largely as expected, with consumption, investment and net trade all making positive contributions to growth.

Chart 1: Markit/CIPS composite indices

We have reduced our Q3 nowcast

We now think GDP will grow by 0.6% in Q3, slightly lower than our expectation last month (0.7%).

The revision is partly the result of a fall in the Markit/CIPS composite activity index in August (Chart 1). The composite index, which weights together the services, manufacturing and construction indices, is now at its lowest level since May 2013.

This survey has historically been a relatively good predictor of GDP growth, so it gets a high weight in our 'weighted survey model'. The prediction of this model is 0.5%, roughly in the middle of a range of nowcasting models (Chart 2). We have revised down the nowcast to remain within this range.

Other surveys are positive, but possibly out-of-date

Other surveys paint a more positive picture of the economy. The Q3 CBI Service Sector Survey suggests that growth

Chart 2: Range of models

Diamond shows current Q3 nowcast for mature GDP estimate.
The range of models includes seven model predictions.

Chart 3: GfK/EC consumer confidence

Chart 4: GDP by output component

Chart 5: GDP by expenditure component

remained well above average, profitability was still improving, and employment growth over the past three months reached a survey high.

Consumers appear similarly confident in the economic outlook. The GfK/EC consumer confidence balance ticked up in August, and remains only slightly below its record high.[1] The small increase this month was due to an increasing number of consumers saying that now is a good time to make major purchases; the balance for this question is at its highest level since 2003.

However, much of the survey data come with a caveat this month. All the surveys with the exception of Markit/CIPS closed before China's 'Black Monday' and the worst of the financial market volatility. And although some responses to Markit/CIPS came in after this date, the vast majority were from earlier in the month. So if there has been a significant deterioration in confidence since then, these data will not have picked it up. We think that recent events in China suggest downside risks to our forecast for growth in Q4 of 0.7%.[2]

Q2 GDP unrevised, but the composition of output remains a concern

GDP growth in Q2 was unrevised at 0.7%. The composition of output was broadly the same as last month; the extraction sector, which accounts for around 2% of GDP, still contributed more than 0.1pp to quarterly growth (Chart 4). We do not expect a repeat performance from this sector in Q3, so we still need growth in other sectors to have picked up for GDP to match our expectation. This might suggest a downside risk to our nowcast.

Expenditure mix broadly as expected

In contrast, the breakdown of GDP by expenditure component was quite encouraging, albeit broadly as we had expected (Chart 5). Consumption, investment and trade all made a positive contribution to growth.

Net trade contributed a full percentage point to growth, as we had expected based on the monthly goods data. This has facilitated a closing in the quarterly trade deficit, which in Q2 was only 1% of nominal GDP, the smallest deficit since 1998 Q3 (Chart 6). However, this quarter was flattered by an odd spike in the export of organic chemicals to non-EU countries, which may prove to be temporary. It is possible that exports will fall in the coming months as a result.

As is often the case, a large positive net trade contribution was offset by a large negative stockbuilding contribution. 2015 Q2 was the first quarter in which firms ran down their stocks in over two years.

Business investment grew by 2.9% on the quarter, and is up 5.0% on a year ago. While most of the investment over the past few years has been by firms wishing to expand

Chart 6: Trade balance

their capacity, there is some evidence that firms are increasingly investing to increase efficiency (see **Box**).

Housing investment fell by 3.5%, driven by a fall in dwellings investment. But these data are often revised at a later date to look more like the housing construction data, where there was no such fall in Q2. So we have not taken much signal from these data just yet.

Consumption grew by 0.7% in Q2, a little lower than our expectation of 0.9%. Real compensation of employees – the only component of household income available at this stage – grew by more, at 1.7%. Using these data and forecasts for the remaining components of income, we think the saving ratio picked up to around 5.5% in Q2, up from 4.9% in Q1.

The Blue Book is coming

Next month sees the release of Quarterly National Accounts consistent with *Blue Book 2015*. A number of methodological improvements are being made this year, although the scope is considerably smaller than in *Blue Book 2014*. The ONS have already revealed that average growth between 1997 and 2013 will be unchanged, but the recovery from 2011 will look somewhat stronger.

Box: Why are firms investing?

Business investment as a percentage of GDP is now around its pre-crisis level, but the motivation to invest remains somewhat different, according to the CBI. More firms report they are investing to increase capacity than pre-crisis, and fewer firms are investing to increase efficiency. This is only now beginning to change.

The CBI ask firms in the services and manufacturing sectors what the main reasons are for any expected capital expenditure over the next 12 months. Replacement, capacity expansion, and a desire to increase efficiency are three possible answers common to both surveys. Firms can tick more than one box.

Chart B1 shows the difference in the percentage of firms selecting each option from the average between 2000 and 2007. A positive bar indicates a higher percentage of firms selected the option in that year relative to 2000-07 average.

A consistently high proportion of firms cite the need to replace capital as the main reason for investment, and this percentage was increasing over the crisis. Unsurprisingly, fewer firms cited the desire to expand or increase efficiency.

But the motivation to expand returned in 2011, and in 2014 and 2015 more firms reported this as the main reason for investment than did pre-crisis.

In contrast, investment for the sake of efficiency gains remains less popular than before 2008 (although in *absolute* terms it remains the second most selected option, after replacement). But its popularity has gradually increased since 2013. Chart B2 shows the percentage of firms selecting this option over time.

The lack of investment to increase efficiency over the past few years is one possible explanation for lacklustre labour productivity growth since the crisis. The surveys suggest that this may only now be coming to an end, consistent with the reduction in labour market slack beginning to limit the ability of firms to expand by hiring more labour.

Chart B1: Reasons for capital expenditure

*Based on survey data available to date (three out of four editions of CBI Service Sector Survey and two out of four editions of CBI Quarterly Industrial Trends)

Chart B2: % of firms investing for efficiency gains