Office for National Statistics

Economic Review, July 2012

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Abstract

This note provides some wider economic analysis to support the Statistical Bulletin relating to the latest GDP release and other major economic releases during the latest month. By drawing on the wider array of economic releases surrounding the GDP release, for example the labour market, trade, retail sales and inflation releases, this note attempts to provide a more comprehensive picture of how the economy has performed in the latest quarter and, where relevant, the latest month.

Summary

Interpreting the course of the economy over the summer months is complicated by the change in bank holidays arising from celebration of the Queen's Diamond Jubilee. So while a number of indicators - manufacturing output, exports, retail sales - showed some buoyancy in May, it is difficult to assess how much of this was due to the addition of the extra working day compared with a normal May. By the same token, the loss of two working days in June might be expected to result in weaker than usual output in that month. The preliminary estimate of GDP for the second quarter of 2012 has been estimated on the basis of a substantial drop in output in June, largely founded on the experiences in 1977 and 2002 when the Silver and Golden Jubilee celebrations respectively caused identical changes to the pattern of bank holidays.

The picture of the economy in the second quarter is further clouded by the unseasonably wet weather in both April and June, which may have had a detrimental effect on activity in those months. The relatively subdued figures for growth in retail sales volumes in June may have been affected by the bad weather.

Nevertheless, the overall picture is of an economy that remains fragile, against a similarly weak global economic backdrop. UK GDP is estimated to have contracted by 0.7 per cent between the first and second quarters of 2012, with the construction sector making a substantial negative contribution to growth for the second consecutive quarter.

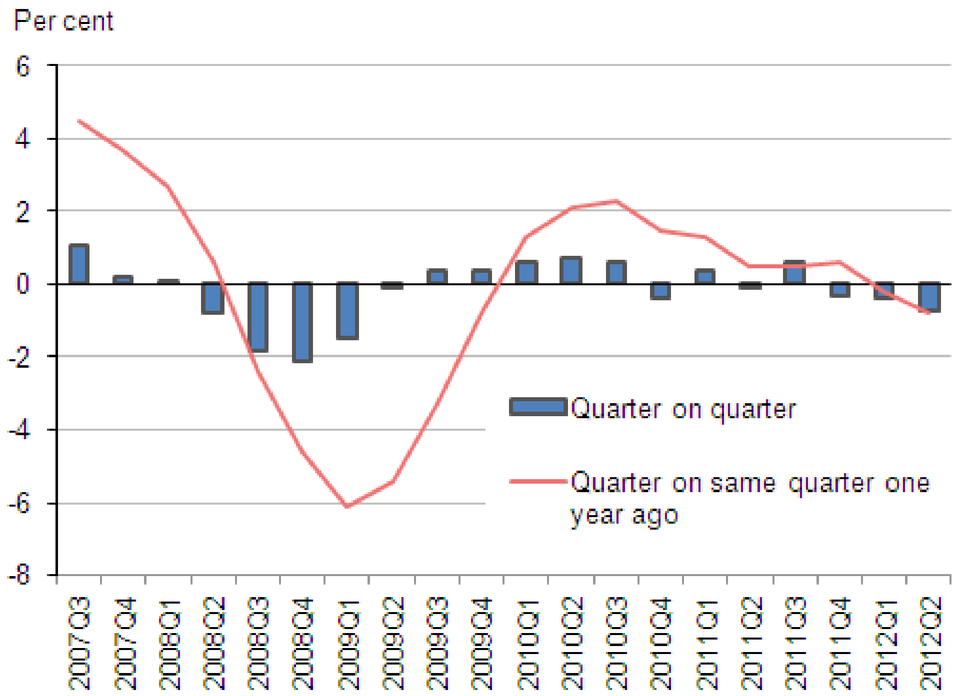
The UK labour market has continued to show resilience in relation to the level of economic activity, with employment continuing to grow modestly. The growth in employment continues to be driven by higher part-time working, but full-time employment has also started to pick up in recent quarters.

Falling inflation has provided some welcome relief for households from the relentless squeeze on their real incomes in the last few years. Headline consumer price inflation dropped to its lowest in over three years in June 2012, but at 2.4 per cent, it remains above the 1.5 per cent rise in average earnings.

UK economy contracts by 0.7 per cent in 2012 Q2

Preliminary estimates show that Gross Domestic Product (GDP) fell by 0.7 per cent in the second quarter of 2012. Output has now contracted for the third consecutive quarter and is 0.8 per cent lower than it was in the same quarter in 2011. This is the largest quarterly contraction since 2009 Q1 and the economy has now contracted by almost 1 per cent since the third quarter of 2010.

Real GDP growth



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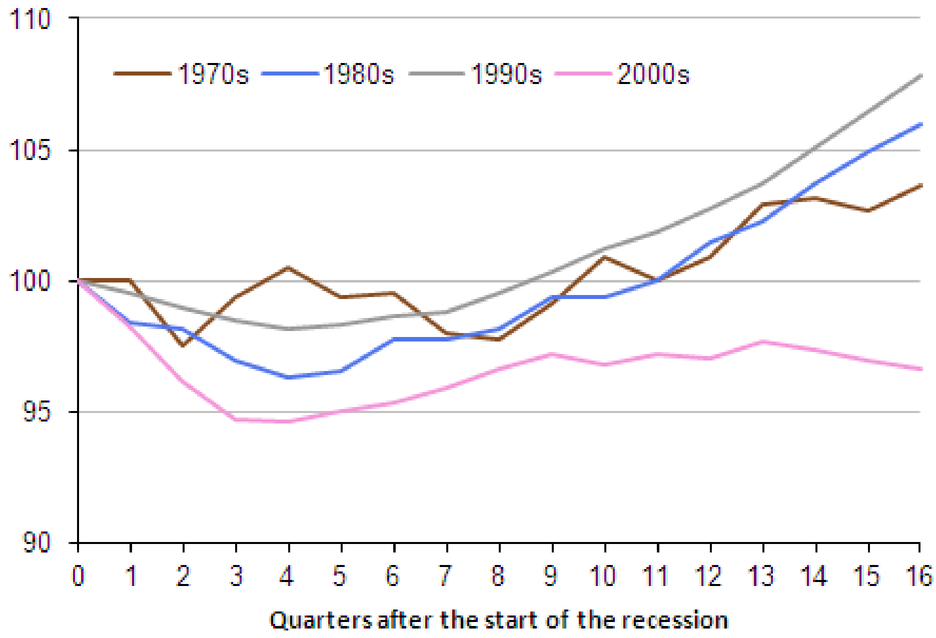
The following graph shows GDP growth in previous UK recessions. The 2008-09 recession was somewhat deeper than those in the preceding three decades. Equally noticeable is that the subsequent recovery began to falter relatively soon in 2010, in contrast to previous episodes when economic growth was starting to gather significant momentum.

The level of output therefore remains 4.5 per cent below its pre-recession peak even four years after the start of the 2008 recession.

GDP output level across post war recessions (Pre-recession peak =100)



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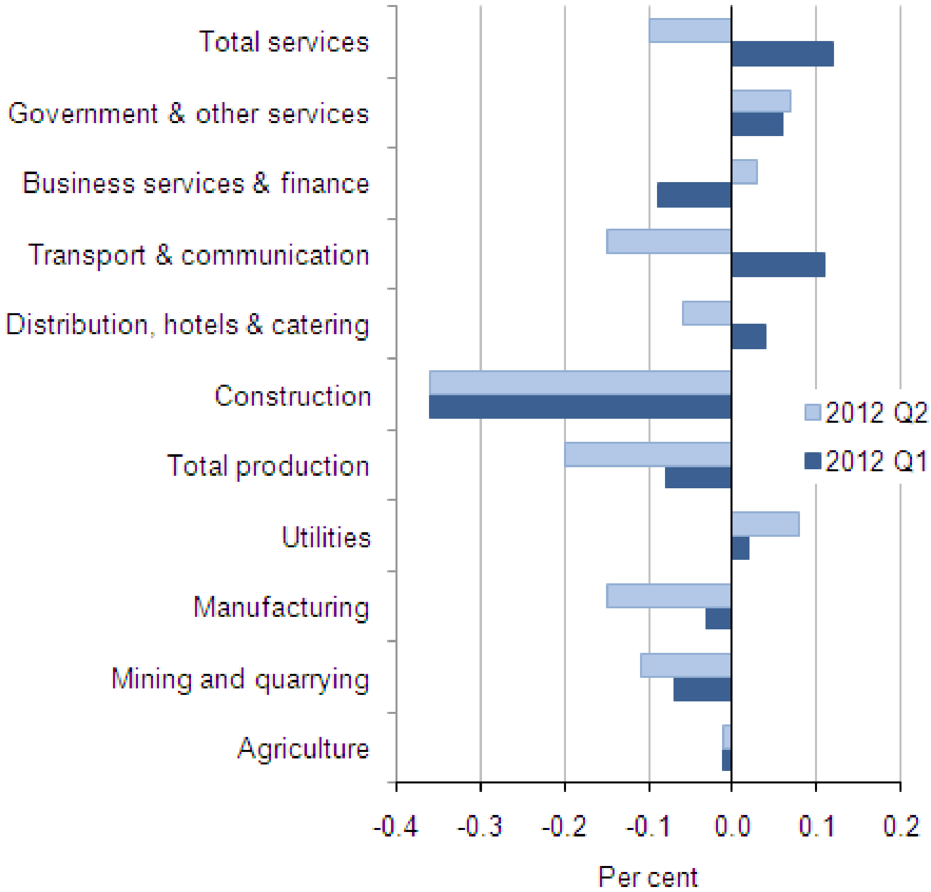
Note that the preliminary estimate of GDP is produced using a limited amount (around 44 per cent) of actual data content. At the time of publication estimates of the first two months of the quarter are available for most industries and the third month is estimated using established forecasting procedures.

In quarter two 2012, the end of May bank holiday was moved to the first Monday in June and an additional Bank holiday was granted for the Queen's Diamond Jubilee celebrations. It is therefore likely that these might have an impact of estimates of output in 2012 Q2. The preliminary estimate of GDP for the second quarter of 2012 has been estimated on the basis of a substantial drop in output in June, largely founded on the experiences in 1977 and 2002 when the Silver and Golden Jubilee celebrations respectively caused identical changes to the pattern of bank holidays. The figures are in line with early survey returns for June. However there is more uncertainty than usual about the preliminary estimate of GDP in this quarter.

The second quarter was also characterised by record amounts of rainfall in both April and June. This may also have had a detrimental effect on output in some sectors.

The following graph shows the contributions to growth in the last two quarters. It shows the fall in GDP was largely driven by the construction and production sectors. The largest contribution to the quarterly fall in GDP came from the construction sector that recorded a fall of 5.2 per cent, compared to a drop of 4.9 per cent in 2012 Q1. This was the largest quarterly fall since 2009 Q1 and deducted 0.4 percentage points from the quarterly growth rate of GDP. The construction sector accounts for approximately 7 per cent of the GDP and 6.6 per cent of all jobs in the UK. But its volatility in recent quarters means that it has had a disproportionate impact on total GDP growth.

Fig 2: Contribution to GDP growth by industry



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The fall in the construction sector's output over the past year is broadly based across most elements of activity, but can be explained in large part by the weakness of infrastructure and public sector investment. In the three months to May, output in these sectors has dropped by more than 20 per cent compared with the same months of 2011, reflecting the squeeze on public sector investment as well perhaps as an ending of the major Olympics construction projects.

The output of the production industries fell between the first and second quarters of 2012, reflecting the subdued performance of the manufacturing sector, which has suffered from weak domestic and global demand this year, as well as continuing declines in output of the mining and quarrying sector. In 2012 Q2, the output of the manufacturing sector (which makes up over two-thirds of the output of production industries) fell by 1.4 per cent compared to a 0.3 per cent fall in the previous quarter.

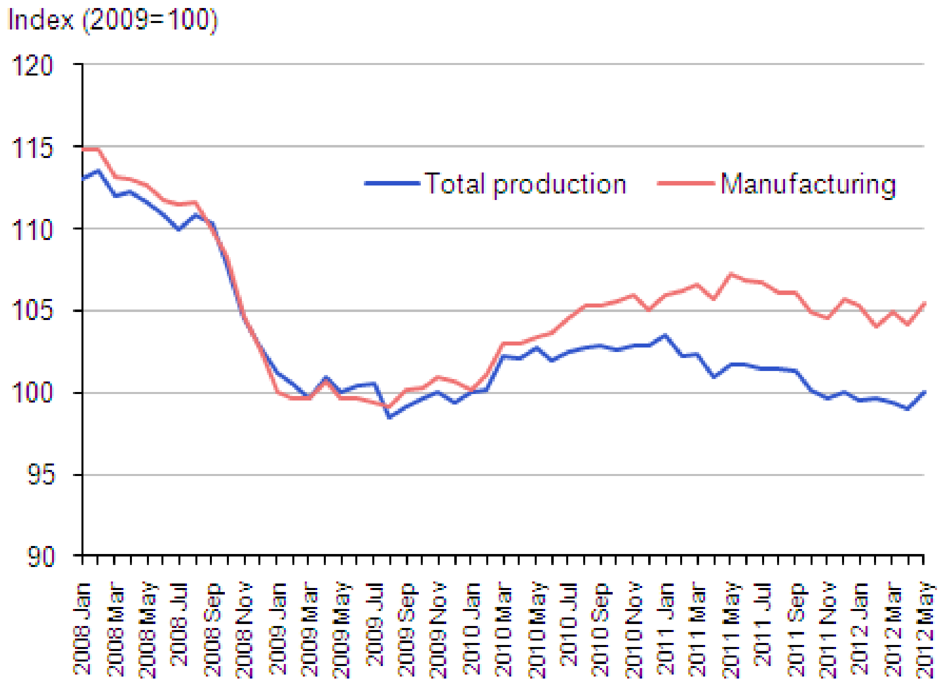
Output of the services sector, which accounts for around three-quarters of whole economy output, contracted by 0.1 per cent in the second quarter, following a 0.2 per cent rise in the previous period.

Output of the production industries

Output in the production sector fell by 1.6 per cent in May 2012 compared with a year earlier. Manufacturing output fell by 1.7 per cent over the same period. The largest contributors to this fall in manufacturing came from the manufacture of pharmaceutical products & preparation industries (which fell by 13.2 per cent) and the manufacture of food, drink & tobacco (a fall of 3.9 per cent). The largest positive contribution to the manufacturing sector came from the manufacture of transport equipment industries, which increased by 8.8 per cent between May 2011 and May 2012.

Between April and May, the index of production increased by 1.0 per cent, while the manufacturing sector grew by 1.2 per cent. The additional working day in May (as a result of the moving of the late May bank holiday to June) may have been a contributing factor to the strong growth in the month.

Index of production and manufacturing (Index=100)



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Manufacturing output fell sharply during the 2008-09 recession, by around 13.8 per cent from a peak in January 2008 to its trough in August 2009. Output recovered slightly throughout 2010, increasing by 4.3 per cent between December 2009 and December 2010, but has drifted down slightly since mid-2011. This reflects the uncertain economic conditions prevailing in both the UK and abroad, especially in the euro-zone countries which are one of the UK's most important export markets.

Construction output

Construction output (not seasonally adjusted, constant prices) grew by 6.2 per cent between April and May following a fall of 13.6 per cent in April. Because these figures are not yet seasonally adjusted, it is important to consider this in relation to the experience of previous years. The pattern in the last two years is that May has been a strong month for construction, growing by 2.9 per cent between April and May in 2010 and 3.7 per cent in 2011. In both years, these increases followed large falls in the April figures.

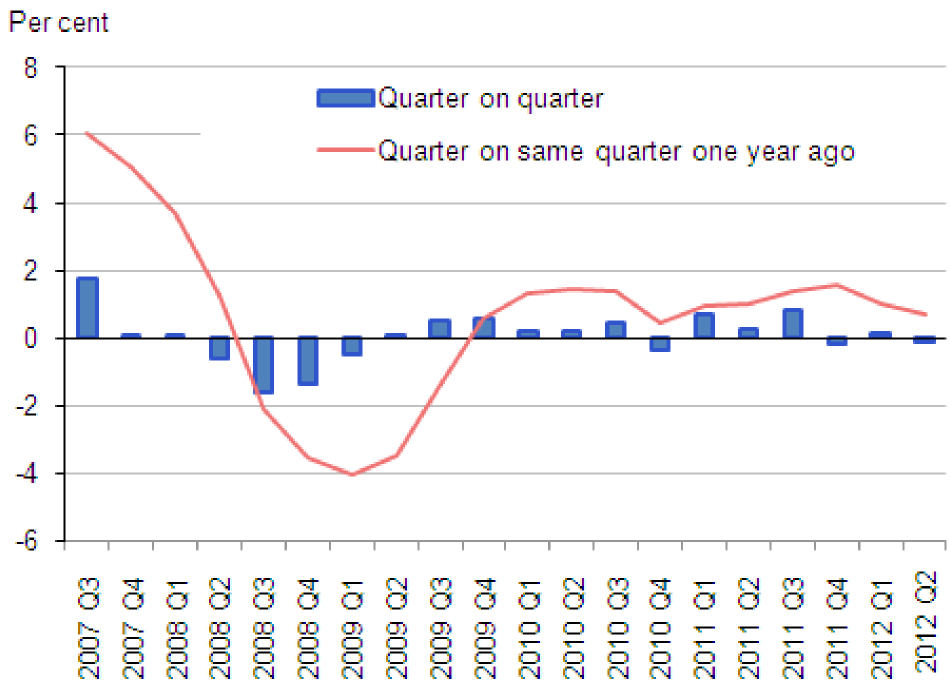
Between April and May 2012, output rose in every sector of the construction industry.

Output fell by 6.3 per cent in May compared with the same month a year earlier. New public sector construction has experienced strong declines on the year, with the main categories all showing year-on-year falls of more than 20 per cent.

Services sector

Like manufacturing, the service sector may have benefited from the additional working day in May. Output grew by 0.9 per cent between April and May after a 0.2 per cent fall in the previous month; driven by increases in human health activities, architectural and employment activities. On an annual basis however, growth eased to 1.3 per cent in May compared to the 1.8 per cent growth recorded in the twelve months to April. On a quarterly basis, growth is estimated to have contracted by 0.1 per cent in the second quarter of 2012, following a 0.2 per cent growth recorded in the previous quarter.

Service sector growth



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The performance of the service sector was mixed in the second quarter, with growth in business services & finance and in the government sector offset by a contraction in the distribution, hotels & catering and transport, storage and communications sectors.

The restructuring of the UK economy away from production towards the services sector in recent decades has led to sectors such as business services and finance, which make up almost 30 per cent of the service sector, now a major contributor to GDP growth. In Q2 the business services and finance sector is estimated to have grown by only 0.1 per cent, significantly lower than its historical average and indicative of weaker demand across the economy.

Labour Market

The labour market continued to show resilience in the three months to May. Employment rose to 29.4 million, up 181,000 compared with the previous three month period. The employment rate correspondingly rose from 70.4 to of 70.7 per cent, thereby returning to its level in the same three months of 2011. The rise in employment was broadly based with both part-time and full-time employment rising by 0.6 per cent between the two latest three month periods. The proportion of part-time workers that could not find a full-time job dropped back, and has started to fall for the first time since 2008.

Actual weekly hours worked rose by 1 per cent in the three months to May compared with the previous period, and by 2.9 per cent compared with March-May 2011. The year-on-year comparison is distorted by changes to the pattern of bank holidays in this period in both 2011 (one fewer working day due to the royal wedding) and 2012 (one additional day because of the change in timing of the Diamond Jubilee). However average weekly hours worked by full-time workers were unchanged between the two latest three month periods despite the additional working day in May.

The unemployment rate has also fallen to 8.1 per cent from a recent peak of 8.4 per cent in the September to November period and is now down to a level last seen in summer 2011.

The number of long-term unemployed (six months and over) increased from the level in the previous three-month period. The numbers unemployed for over 12 months as a proportion of total unemployment continued to rise, reaching 34.3 per cent which is considerably higher than the 24.5 per cent at the start of the recession. The claimant count for June was 6,100 higher than May and was 78,600 higher on the year.

Average weekly earnings growth remains subdued across the economy compared to its historical average. With inflation higher than wage growth for most of the past year, this has eroded the value of real household incomes and thereby contributed to weaker demand.

Although the labour market has shown resilience through the crisis and has been showing improvement in recent months, the regional picture is mixed as it shows Scotland, Wales and Northern Ireland have experienced decreases in employment rates compared with a rise in England.

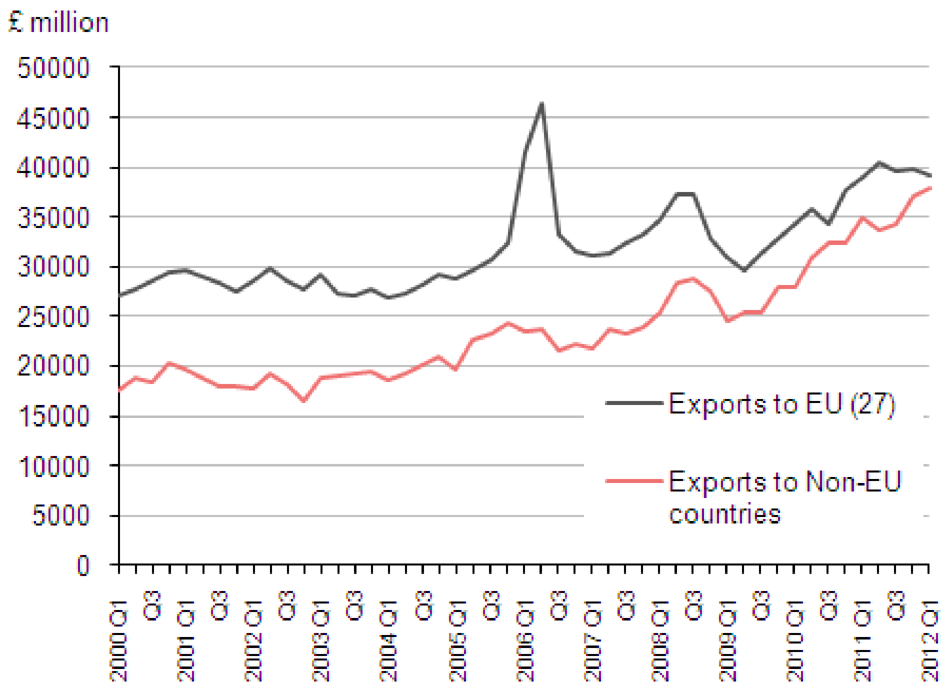
Trade

The UK's deficit on trade in goods and services was 2.7 billion in May, down from £4.1 billion in April. The improvement in May's deficit can be attributed to a decrease in the deficit on traded goods, which improved to £8.4 billion in May from £9.7 in April. This was due to a rebound in exports between April and May which partially offset the large fall in April. The surplus on trade in services was unchanged at £5.6 billion.

Monthly trade data can be erratic, so it is more appropriate to analyse trends over time. The volume UK goods exported during the past three years has increased at a slightly faster rate than imports, although the balance of trade in goods has deteriorated slightly as a result of the rising price of imports of goods such as fuel.

However, the export market for UK goods has changed considerably over this period. Throughout the last decade the EU has been the largest export market for UK goods. During the early part of the decade nearly two-thirds of UK exports goods were destined for EU countries. However, although exports to the area have continued to grow, exports to countries outside the EU have increased at a much faster rate, especially in the last three years. For the first quarter of 2012, the value of exports to EU countries was broadly similar to the value of exports to non-EU countries. In May itself, exports to non-EU countries were greater than exports to EU countries for only the second time since the series began in 1998. This reflects the changing patterns of activity within the world economy, with relatively weak economic growth in the euro area contrasting with faster growth rates in the emerging market economies.

Destination of UK exports



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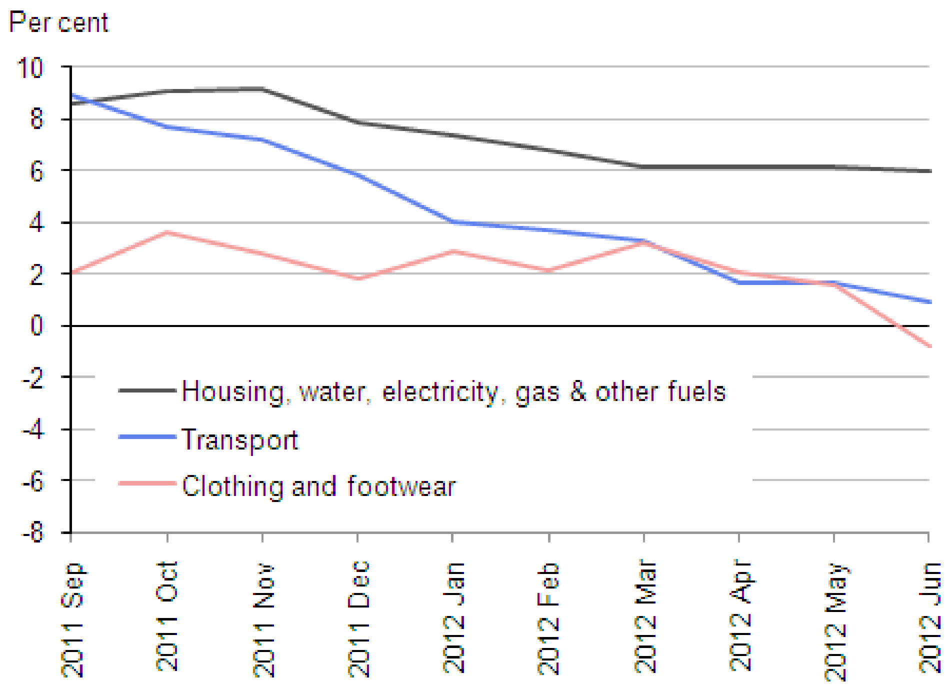
Consumer Price Index

Headline consumer price (CPI) inflation fell to 2.4 per cent in June from 2.8 per cent in April, the largest fall in prices between a May and June since the CPI was launched in 1996. With the exception of a small increase in March, the index has fallen each month since its record equalling high rate of inflation of 5.2 per cent in September 2011.

During this period of falling inflation, lower oil prices led to a reduction in the growth of transport costs and energy prices, while price increases as a result of the change in VAT in January 2011 also fell out of the annual inflation measure. During June transport costs continued to provide downward pressure on the headline rate, contributing 0.13 percentage points to the drop in inflation from 2.8 to 2.4 per cent. Food & non-alcoholic beverages made a similar contribution. However, the main downward pressure in June was from clothing and footwear prices, which had not previously contributed substantially to the fall in inflation since September. Clothing and footwear prices fell by 4.2 per cent between May and June 2012 compared with a fall of 1.9 per cent between the same two months a year ago. The fall was broad based, with reports of summer sales starting earlier than last year. This may suggest that shops are resorting to price discounting (particularly in discretionary items) to encourage shoppers into the shops, although it may also in part reflect the impact of the poor weather this summer and its impact on the pattern of clothes purchases.

Growth of selected CPI components, 12 months percentage change



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The fall in inflation continued to ease the squeeze on household budgets. Inflation has been above earnings growth for over three years and consequently real household disposable incomes have fallen markedly.

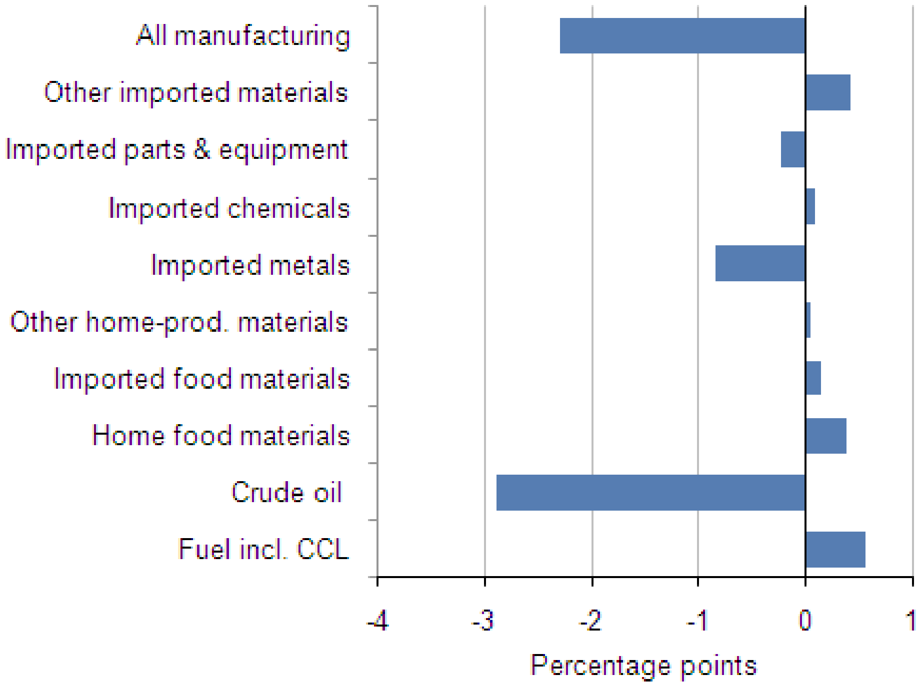
Producer Prices

Annual producer price inflation for both manufacturers' outputs and inputs continued the downward trend in June to rates last seen in 2009. Input prices fell by 2.3 per cent in the 12 months to June compared, with no movement in May, while output price inflation rose by 2.3 per cent between May and June compared with a rise of 2.9 per cent in the previous month.

The recent fall in crude oil prices has been the result of the deterioration of global output and recent rebuilding of global stockpiles. The weakening of economic growth in the US, China and Europe has led to a fall in demand for oil and hence lower prices; at the same time global stockpiles have recently been expanding with the Saudi Arabia extraction rate reaching a 30 year peak.

The movement in the price of crude oil led to a 2.9 percentage point negative contribution to the 2.3 per cent fall in input prices in the year to June. Imported metals and imported parts and equipment also contributed negatively to the total input price index for June (deducting 1.06 percentage points). Although these three product groups placed large downward pressures on input prices these were partially offset by all other product groups (1.63 percentage points). The strongest positive contributions were fuel (including the climate change levy) and other imported materials.

Contribution to input prices, 12 months percentage change



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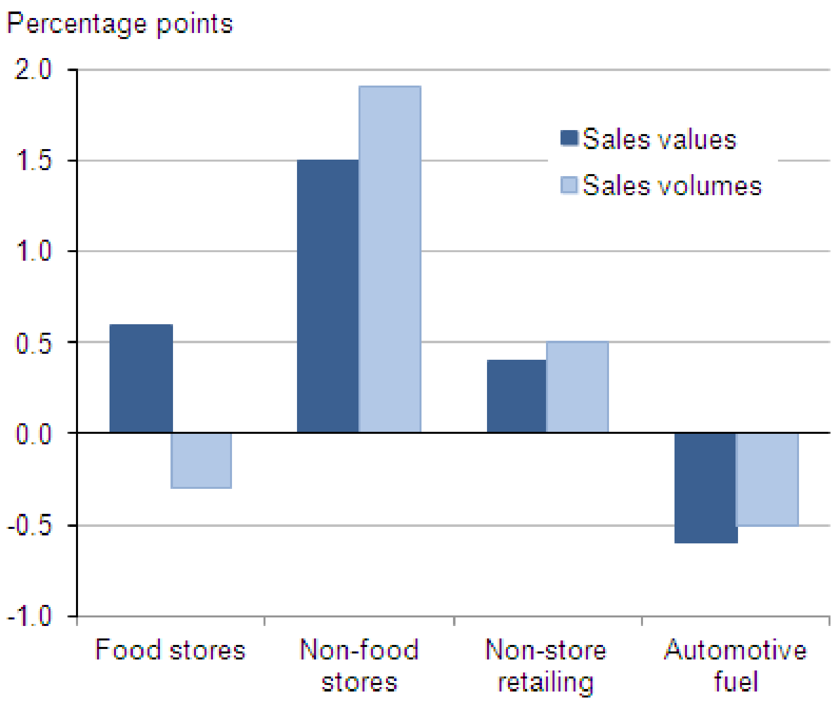
Annual output price growth in the manufacturing sector grew by 2.3 per cent and is the lowest since October 2009. Petroleum products were the only negative contributor (0.26 percentage points). Tobacco & Alcohol (0.81 percentage points) and other manufactured products (0.56 percentage points) made the largest positive contributions.

Retail Sales

Retail sales volumes increased by 1.6 per cent in June 2012 compared with June 2011. Sales values increased by 1.9 per cent over the same period. Comparing the monthly change, retail sales volumes increased by 0.1 per cent from May 2012, while values decreased by 0.5 per cent.

Contributions to growth by retail sector, June 2012 compared with June 2011, seasonally adjusted



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Non-food stores contributed 1.5 per cent to the 1.9 per cent increase in sales values in June 2012 compared with June 2011, and contributed 1.9 per cent to the 1.6 per cent increase in sales volumes. Particular strength in this sector came from textile, clothing and footwear stores. Sales values increased by 2.2 per cent and sales volumes increased by 2.4 per cent. This increase in sales volumes may have been partly due to retailers offering promotions and early summer sales. Anecdotal evidence from retailers also suggests that the wet weather has had an impact on the pattern of sales. This is reflected by the 0.3 per cent fall in the price of goods sold within this sector in June 2012 compared with June 2011.

Sales values in the automotive fuel sector fell by 5.2 per cent compared with June 2011 and sales volumes fell by 4.6 per cent. Average prices in this sector fell by 1.1 per cent over this period, driven by falling oil prices. However, because automotive fuel only makes up around 11.8 per cent of all retailing, the contributions to growth are smaller, at -0.6 per cent for sales values and -0.5 per cent for sales volumes.

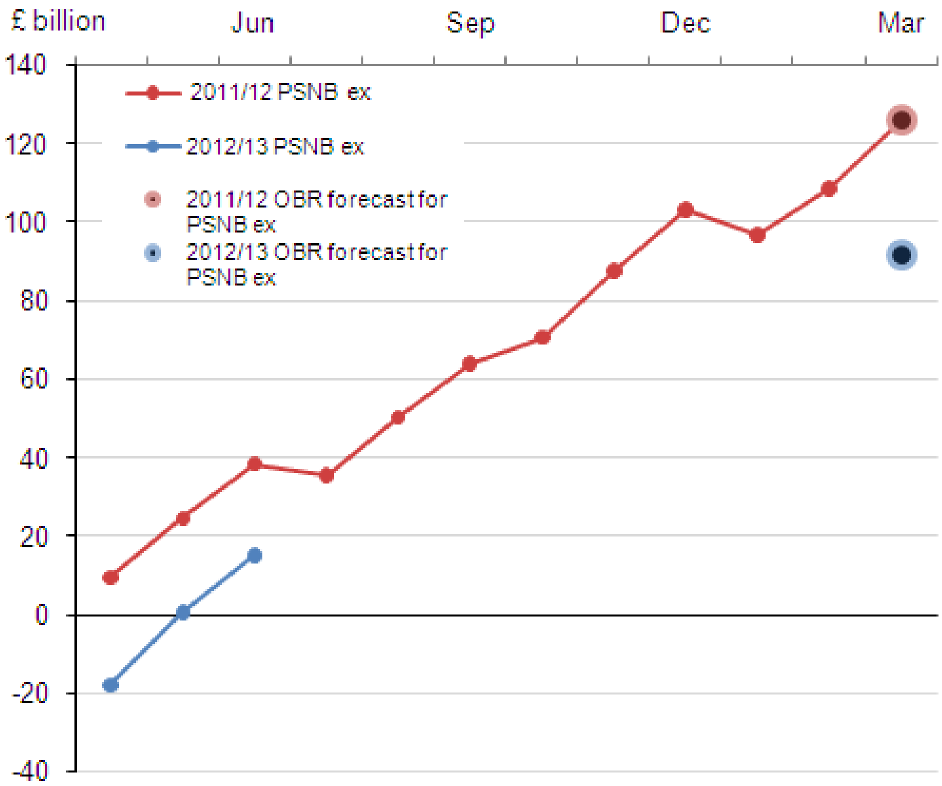
Public Sector Finances

Public sector net borrowing (excluding the temporary effects of financial interventions) increased when compared to the same month a year ago for the second successive month in June. Net borrowing was £14.4 billion in June, up from 13.9 billion in June 2011 and consequently net debt as a percentage of GDP increased to 66.1 per cent in June 2012 from 64.8 in the previous month.

The figures for net borrowing and debt in the current financial year have been distorted by the large one off transfer to government of £28 billion in April, as part of the transfer of the Royal Mail Pension Plan. Public sector net borrowing from April to June was lower in 2011/12 than in 2010/11, as the chart shows. However when the one-off transfer for the Royal Mail Pension Plan is excluded, public sector net borrowing was higher during the period.

This can be seen more clearly in figures for the public sector's current budget balance (excluding financial interventions). In the period April-June 2012, the cumulative deficit on the current budget was £41.6 billion, which is £6.5 billion higher than the deficit of £35.1 billion in the same period of 2011/12.

Cumulative public sector net borrowing



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Background notes

1. Details of the policy governing the release of new data are available by visiting www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html or from the Media Relations Office email: media.relations@ons.gsi.gov.uk

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