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GFC ECONOMICS

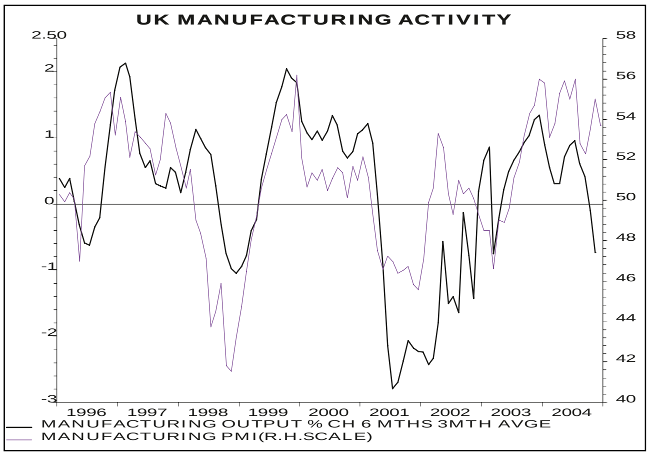
DAILY COMMENTARY

RISE IN UK INFLATION OVERDONE

The housing market is undoubtedly the biggest uncertainty for the economic outlook over the coming year - both in terms of the size of any decline in prices and its impact on consumer spending. But it is certainly not the only ambiguity at the moment. For one, the downturn in manufacturing in recent months has been a surprise and is at odds with much of the survey data. It could mean the economy is that much more vulnerable to any downturn in consumption. However, the inflation picture has been muddied by recent data. Producer price inflation has fallen back sharply, but wage gains continue to edge higher. Furthermore, while CPI inflation has picked up significantly, this rise is down to only a few components and does not herald a more general pick up in price pressures. Even so, it could be enough to delay any rate cut by the Bank for a few months yet, increasing further out the downside risks to the economy and the prospect of the yield curve inverting between 2 and 10 years.

Industrial Output Disappoints Again

Industrial production undershot expectations once again in November. Even if it did rise 0.2% m/m, this was its first gain in six months and left production 0.9% lower than a year earlier. Oil and gas extraction has seen by far the sharpest declines in production due to temporary maintenance work, but manufacturing output has also turned down. The smoothed 6-month annualised growth rate has swung from just under +1.0% in the summer to -0.7%. Manufacturing output now looks set to decline for the second quarter running in Q4, moving into technical recession.



However, these declines are questionable on two counts. First, they do not fit too well with the survey data, which continues to paint a rather brighter picture. The manufacturing PMI may have fallen back in December, but the latest reading of 53.7 is well above levels typically associated with outright declines in output. The CBI survey has been more mixed, with orders up recently but expected output down sharply. Secondly, there is no clear reason why manufacturing should suddenly have turned down. While retail sales have slowed since the summer, they have still been increasing at a respectable pace. Business investment growth was also revised up in Q3 to a quarterly annualised 3.9%. Furthermore, the trade numbers have improved recently as exports have picked up. The deficit excluding oil and erratics, which hit a high of £5.59bn in August, narrowed to £4.86bn in November. That said, there is no sign of the steady deterioration in the trade position seen over the last eight years coming to an end.

There is, however, an alternative explanation for the downturn in manufacturing, which would reduce the risk posed to the economy. Rather than being a response to a fall in demand, it could be partly due to reduced stock-building. The national accounts show whole economy inventory accumulation (ex. the alignment adjustment) running at its lowest rate since 1993 - with the exception of one quarter in 1996. Businesses may have taken precautionary action to ensure they are not overladen with inventories in the event of an economic slowdown, which looks all too possible given the rise in UK rates and fragility of the global recovery. Either way, the continuing weakness in manufacturing means GDP growth looks set to remain below trend in Q4.

While developments on the growth front should be the primary factor driving the actions of the MPC in 2005, inflation will also play its role. In this respect, recent data has seemingly pro-

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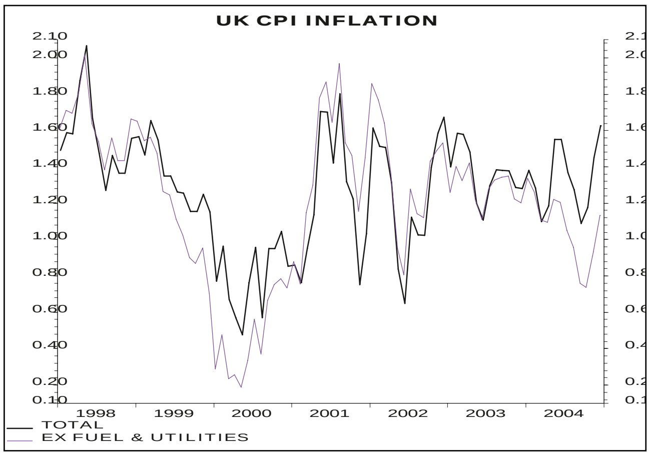
vided some ammunition for the inflation bears, with the rise in the CPI overshadowing the fall in the PPI. All the same, the producer price data for December was reassuring. The fall in oil prices pushed input price inflation down from 6.7% to 3.4%. More surprisingly, core producer output prices recorded their largest drop since July 1999, courtesy of a sharp decline in secondary raw material prices such as scrap metal. Core factory gate inflation as a result fell back from an eight year high of 3.0% to 2.3%. While we were always sceptical that the run-up in producer prices would be passed onto consumer prices to any significant extent, these numbers will undoubtedly ease one of the inflationary concerns at the Bank of England.

The labour market is the other obvious potential source of upward pressure on inflation and the latest numbers here have been less encouraging. Average earnings growth excluding bonuses edged up to 4.4% in the three months to October, and is now only just below 4.5%, which is traditionally thought to be the ceiling of the MPC's comfort zone. While the gradual drift upwards in wage pressure is occurring both in the private and public sectors, the latter is much more to blame because it has been the main source of employment growth in recent years. Since 1998, following declines for fifteen years in a row, public sector employment has grown each year. Over the last four years, gains in public sector employment have exceeded those in the private sector, even though the number of public sector jobs in 2003 was still only 22.9% of the number in the private sector. The latest official data on the private/public sector split relates to mid-2003, but recent labour market data suggests the divergence between the two sectors may have increased further since then. Jobs in education, health and public administration have increased further over the last year, whereas jobs elsewhere in the economy have declined. All the same, the public sector bonanza is now drawing to an end and cost pressures so far have been contained by the pick up in productivity. Despite the rise in earnings growth, unit wage cost growth fell back to 2.1% y/y in Q2.



Inflation worries have superficially been given credence by today's report that the CPI rose 1.6% y/y in December, up from a low of 1.1% y/y in September. However, there is good reason to doubt that this rise will be sustained, as the upward pressure has come from a few isolated components. The largest contributor to the increase in December was furniture, furnishings and carpets, where the annual rate surged from -0.2% to 3.1%. This looks like an aberration; it is the highest rate since the CPI data start in 1997 and the largest since 1991 on the RPI definition. Furthermore, the CPI data was collected on December 14th and will not have picked up the heavy discounting, which probably occurred later on in December. It is also at odds with the BRC shop price index, which showed deflation increasing again last month. Two other factors pushing up the CPI recently have been utility and petrol prices. While the latter will continue to exert upward pressure over the next couple of months, petrol prices have already started to fall back and should, due to base effects, depress inflation further in the spring. The rise in inflation has not been confined to goods; services inflation has picked up from 3.2% in September to 3.7%. But again, two non-representative components are principally to blame - package holidays and air travel. They account for only 8% of the services sector and neither rise can really be blamed on higher wage settlements, which are the main factor likely to push up services inflation longer term. All this means inflation remains rather more contained than recent data would have one believe. Even so, the CPI data will give the MPC another reason to hold off from cutting rates until the picture on the real economy becomes rather clearer.