

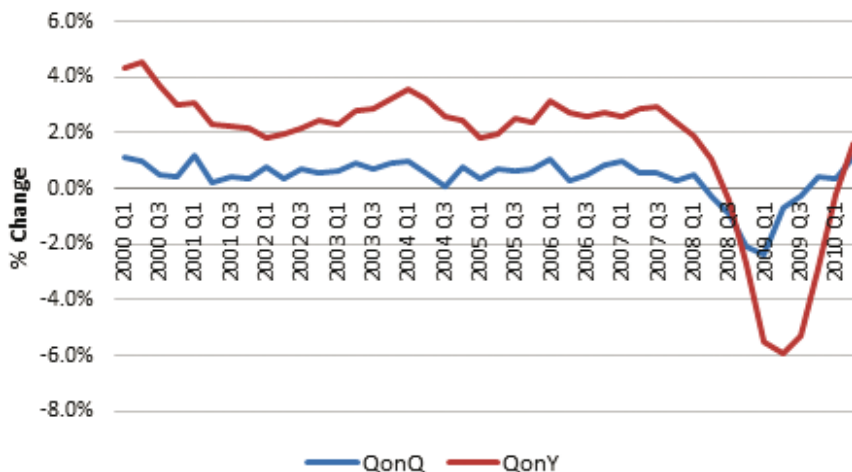
Economic update

GDP bounces back

An unexpected GDP increase, government announcements on spending and a downgrading of Ireland's credit rating. Graham Pontin, ACE economic analyst reports.

To analysts surprise the preliminary estimate of GDP in the second quarter grew 1.1% on the previous quarter and 1.6% on the same period a year earlier. This contrasts with expectations of a 0.6% rise. The quarterly expansion was the fastest expansion since the start of 2006 and is a significant improvement on the last quarter's rate of 0.3%. Within the figures it was revealed that the construction industry, which has been one of the hardest-hit sectors in the recession, expanded by 6.6% in comparison to a decline of 1.6% in Q1.

GDP



These figures will help to alleviate some of the concerns regarding the fragility of the UK economy and reduce the possibility of a double dip recession. However, despite the above being good news, caution should still be urged over the ever-present public sector cuts. Excessive cuts in public spending will lower future growth prospects and could dent both domestic and international confidence in the UK's ability to control its sizable deficit.

The downgrading of Ireland's credit rating by Moody's continues to show the concerns international investors and companies have regarding a country's ability to repay and control debt levels. On this basis the coalition government's efforts to make efficiency and spending

savings in order to reduce the public deficit will continue to be welcomed by markets.

Given the above it is important that government cuts are transparent to promote confidence within the market. Removing large proportions of public spending without credible plans for the private sector to take the reins will have the opposite effect.

In some respects this has been the problem with the recent cancellation of the Building Schools for the Future (BSF) programme. The inaccuracy and uncertainty with which projects were cancelled and the lack of transparency

over the programme's replacement has not had the effect of promoting confidence within the construction sector or the wider economy. The blanket agenda of cutting the deficit is likely to wear thin very quickly given the Comprehensive Spending Review and the real reduction in services that individuals are likely to experience.

For example, the following may provide some confidence within the market that action is being taken:

"George Osborne, chancellor, on Friday night began work on the biggest round of Whitehall cuts since the second world war, after cabinet ministers sent in their plans to curb spending by anything up to 40 per

cent." – Financial Times, July 16 2010

However, at some point government departments and local authorities are going to have to justify these cuts to the individuals that voted for them, a far harder task. Eventually the public sector cuts will feed through into the employment market, potentially raising the level of unemployment.

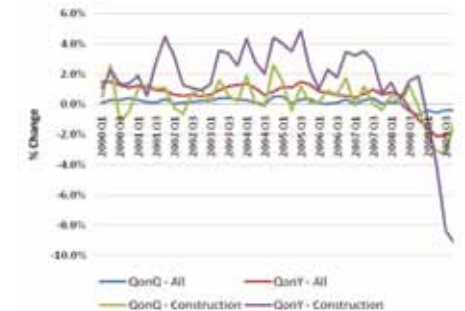
Employment and Unemployment

One must also continue to urge caution as the labour market remains fragile. The unemployment rate for Mar-May 2010 was reported as 7.8%; this was down 0.1% on the previous quarter. The number of people unemployed over the period decreased by 38,000 with the total number unemployed now standing at 2.47 million.

The employment rate now stands at 72.3%. In conjunction with this, the claimant count in April 2010 was also down 20,800 and currently stands at 1.46 million.

Of some concern is that improvements in the labour market statistics appear to be occurring via part-time employment. This indicates a degree of flexibility but would also appear to suggest that individuals are still having difficulty getting full time work.

Workforce jobs



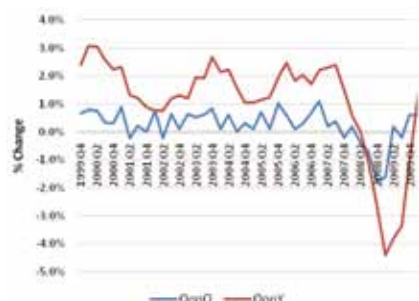
Looking more specifically at workforce jobs within the whole economy and the construction sector, it can be seen that the construction sector has undergone a significant reduction in its workforce when compared to that of the whole economy. Construction jobs fell by 9.3% in Q4, (compared to 1.7% for the whole economy) on the same quarter a year earlier

The above will be of particular concern to the consultancy and engineering sector. The recent BSF cuts and the possibility of further maintenance and capital project reductions in effect make further redundancies a real possibility.

There continue to be some positive signs, with whole economy output per

worker for Q1 increasing 1.3% compared with the same quarter a year ago. On a quarter on previous quarter basis, output per worker increased by 0.6 per cent in the first quarter of 2010.

Productivity



Inflation

June's inflation figures continue to show a slight cooling in inflationary pressures but currently stand well above the 2.0% inflation target. The CPI measure of inflation fell 0.1% to a rate of 3.2% on the same period a year earlier, whilst the RPI index was reported as having fallen 0.2% to 5.0%.

The Bank of England is slowly beginning to show an increased level of concern that the current inflation rate may not be just a short term shock. Given this and the surprising provisional GDP figures for Q2 the likelihood of a near-future rise in the interest rate has increased.

Below is a brief outline of the rationale behind why the markets may have concerns over a rising, non-stable inflation rate. Inflation generally occurs through

rising costs (supply side-cost push) and/or excessive demand (demand-push) conditions. However, the extent to which business and consumers adjust their inflation expectations is also important.

For example, businesses and consumers will adjust their prices and wage expectations based upon past inflation rates. Thus their perceived/expected inflation rate will feed through into the actual inflation rates as they negotiate wages and costs are set based upon these expectations.

This demonstrates the need for an inflation target to be credible and why action should be taken to ensure that the actual rate of inflation does not deviate significantly. Otherwise, consumers and businesses will adjust their expectations away from this target rate. If decisions are made under a regime with a less stable inflation rate there is a greater chance of errors of judgement and so the system become less efficient and stable. This is one of the advantages to a low and stable rate of inflation.

Given the budget announcement of public sector pay freezes there will be a significant number of individuals that see their real incomes fall. That leaves them with less disposable income, leading to a lower demand for goods and services. Fortunately this should place downward pressure on inflation. However, if the reduction in inflation does not occur at a rate individuals perceive as reasonable then we may see wage tensions starting to appear within the public sector as pay rises are demanded to counter inflation's erosion of spending power.

Bank of England reviews price setting behaviour

The Bank of England has released a paper reviewing the results of a survey of how 700 UK firms set their prices. Price setting behaviour has implications for the mechanisms surrounding monetary policy. The paper is an attempt to outline the importance of understanding the speed with which price expectations feed through into the real economy, and the value of data that helps to account for this within economic modelling.

Below are some selected quotes from the summary of the key findings that *Impact* readers may find of interest:

- "When determining the optimal price, around a fifth of firms used a rule of thumb."
- "Around one third of firms set their prices based on their expectations of the near future."
- "[The] survey evidence supported the use of the mark-up over costs form of pricing."
- "Firms reviewed prices more frequently than actually changing them."
- "There were marked differences between sectors – for example, UK construction and retail companies changed their prices more often than companies in the manufacturing and other services sectors."
- "Higher costs – in particular, labour costs and raw materials – were the most important driver behind price rises."
- "Lower demand and competitors' prices were the main factors resulting in price falls."

The report also concludes that in the decade prior to the survey a large number of firms had increased the frequency of price resets, with the main driver behind this being increased competition. Under such conditions the cost of a firm deviating from the optimal price, is greater given the potential volume of work they might lose. This adds pressures to firms with regards to margins as it is risky to increase prices even when raw material costs increase if competitors do not follow suit. However, the stability of the macroeconomic environment prior to the recent recession, particularly low and stable inflation, meant that other firms were able to decrease the frequency of price changes.

Inflation

