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Europe

UK Economics Weekly

The "Great Stagnation" Continues

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- Based on available data, we currently expect that the ONS's initial release (due 25 January) will show Q4 GDP falling slightly, by 0.1% QoQ, although a flat figure is possible. The industrial sector and exports are particularly weak, despite the sharp drop in sterling in 2007-09. The level of manufacturing output is 4-5% below the mid-90s level, markedly underperforming versus the euro area and US, while the trade deficit reached a record high in nominal terms in the first 11 months of 2012.

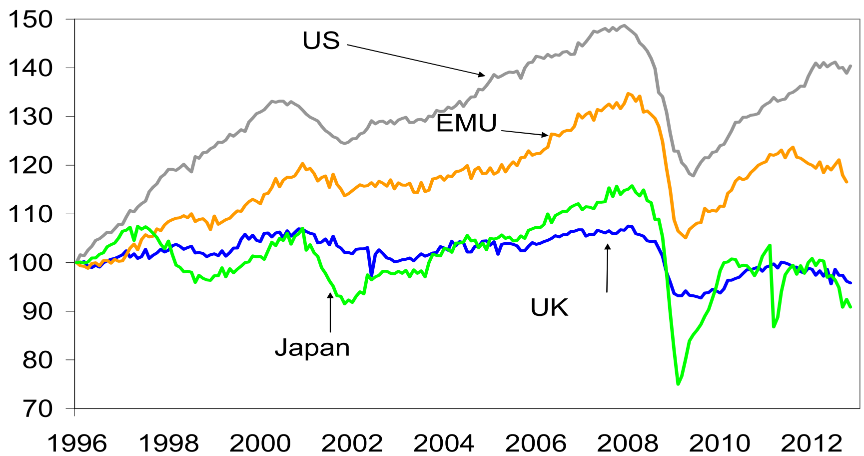
- The underperformance of UK manufacturing output versus other EU15 countries is most evident in high-tech and medium-high tech goods. Similarly, the share of exports of high-tech and medium-high tech goods in GDP is among the lowest of the EU15 countries. 60% of global imports of manufactured goods are high-tech or medium-high tech goods, and the share is even higher in emerging Asia. The UK's underperformance in these sectors is a key reason why the low pound and rapid EM growth have not delivered the boost to UK exports that many had hoped. A lower pound would probably help over time, but, for now, stagnation lies ahead.

Figure 1. Citigroup Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs. Bunds	$/£	£/€
Mid-2013	0.50	£400bn	1.95	21bp	1.54	0.79
End-2013	0.50	£450bn	1.80	31bp	1.52	0.79

Source: Citi Research

Figure 2. UK, US, EMU, Japan — Manufacturing Output, Volume Terms, Indexed to Jan 1996 = 100, 1996-2012



Sources: Datastream, ONS and Citi Research

Economic Stagnation Continues

The economy continues to flatline

The latest data highlight the continued weakness of the economy and in particular the industrial sector, which continues to languish despite the sharp drop in sterling in 2007-09.

Industrial production fell sharply in Q4 and is about 14% below the pre-recession peak

- The level of industrial production in October-November was 14% below the pre-recession peak (Q4-07) and the lowest since 1991. This weakness partly reflects lower oil output, but the UK manufacturing sector also is clearly underperforming the US and euro area average. The level of manufacturing output is 4-5% below the mid-90s level – roughly matching Japan's long stagnation – versus gains of 17% and 40% in the euro area and US respectively.

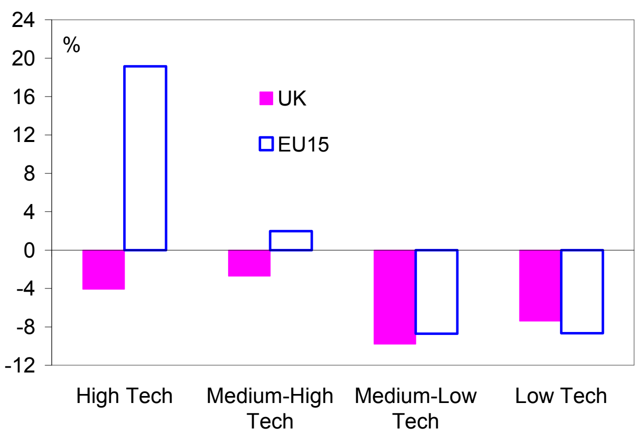
We expect the ONS will report that GDP in Q4 fell slightly

- Based on available data and surveys, it now seems likely that the ONS's initial release (due on 25 January) will show Q4 GDP falling slightly, by 0.1% QoQ, although a flat figure is possible[1]. Our estimate assumes that the Q4 figures for IP and construction match the October-November averages, and that Q4 services output matches the October level. Note that our estimate for Q4 GDP may well differ from that of the NIESR, and this is because the NIESR base their estimate for services output on the PMI and other surveys rather than the actual ONS services output data[2]. We stress the uncertainties in these estimates. In particular, the actual Q4 GDP figure will incorporate the November figure for service sector output, which is released at the same time as the GDP data. If that figure is particularly strong or weak (or the October data are revised) then this could yet tilt the balance in favour of greater weakness in Q4 GDP or even a small rise. Either way, a range of other guides also indicate that the economy remains weak, with marked declines in the services PMI and EC Economic Conditions Index in December.

Exports have been roughly flat in recent quarters

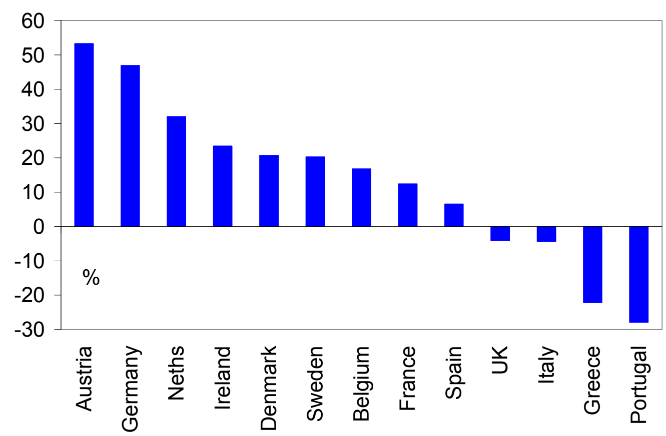
- Export volumes (of goods) have been roughly flat since Q4-2010 and hence, with imports continuing to rise, the trade deficit reached a record high in nominal terms in the first 11 months of 2012.

Figure 3. UK and EU15 – Change in Output (Volume Terms) of Manufactured Goods, 2005-12



Note: We use the standard Eurostat definitions of high-tech, low-tech etc.
Sources: Eurostat and Citi Research

Figure 4. EU15 Countries – Change in Output (Volume Terms) Of High-Tech Manufactured Goods, 2005-12



Note: 2012 data measured as average level for January-October, annualized
Sources: Eurostat and Citi Research

[1] See "*UK: Data Point to Continued Weakness in the Economy*", Michael Saunders, 11 January 2013, Citi.

[2] For this reason, the actual QoQ gain in GDP often differs quite markedly from the NIESR figure, with an average gap of 0.3% in absolute terms since Q1-2008.

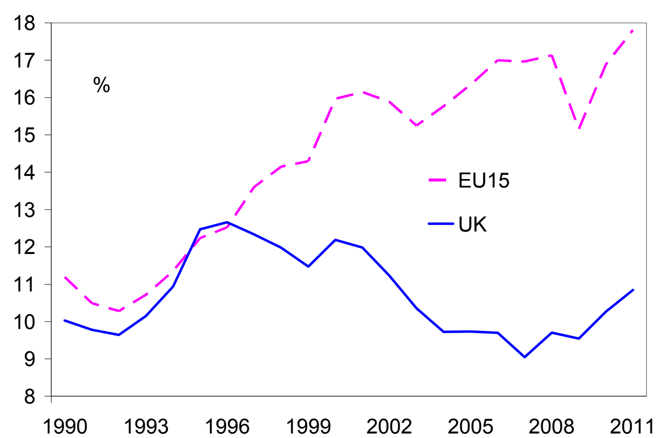
The underperformance of UK manufacturing is particularly marked in high-tech and medium-high tech manufacturing…

The weakness in the UK manufacturing sector, which has been a persistent feature of the last 15 years or so, is particularly concentrated in high-tech and medium-high tech goods. A new Eurostat report confirms that the high-tech and medium-high tech sectors have been the "*main drivers of the EU27's industrial growth*" in recent years[3]. Comparing the average level of output in January-October 2012 with the 2005 average, the EU15 countries show a gain of 19.2% for high-tech manufactured goods and a gain of 2.0% for medium-high tech goods, but declines of 8.7% for output of both low-tech goods and medium-low tech goods. The UK's trends roughly matched the EU15 average for low-tech and medium-low tech goods, with declines of 7.4% and 9.8%, respectively. However, the UK has underperformed a bit in terms of medium-high tech goods, with a decline of 2.7% over 2005-12, and underperformed markedly in output of high-tech goods, with a decline of 4.1% over 2005-12 (versus the 19.2% gain among the EU15 countries as a whole). Among the EU15 countries, only Italy, Greece and Portugal also suffered declines in output of high-tech goods over 2005-12.

…and the same applies to the UK's exports

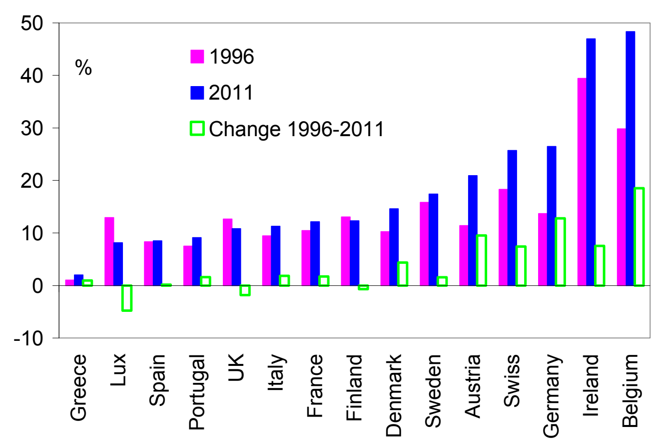
This weakness also is evident in UK export data. In 1996, exports of high-tech and medium-high tech manufactured goods accounted for 12.7% of UK GDP, close to the EU15 average (12.5% of GDP). Since then, exports of high-tech and medium-high tech manufactured goods have fallen to just 10.8% of GDP in the UK (the fourth lowest among EU15 countries, exceeding only Greece, Spain and Portugal) whereas this ratio has risen to 17.8% of GDP on average in the EU15 countries. Among the EU15 countries, only Luxemburg has seen a bigger drop in the share of its GDP that consists of exports of high-tech and medium-high tech manufactured exports over recent years[4]. Indeed, this ratio has risen in all EU15 countries apart from the UK, Luxemburg and Finland.

Figure 5. UK and EU15 – Exports of High-Tech and Medium-High Tech Goods as Pct GDP, 1990-2011



Sources: OECD and Citi Research

Figure 6. EU15 Countries (and Switzerland) – Exports of High-Tech and Medium-Tech Goods as Pct of GDP, 2006-11



Sources: OECD and Citi Research

The UK's trade performance in high-tech and medium-high tech goods is markedly worse than the EU15 average

The UK's imports of high-tech and medium-high tech manufactured goods (12.2% of GDP) are fairly close to the EU15 average (14.7% of GDP). Hence, with the UK's relatively small export sector, the UK runs a trade deficit of about 1½% of GDP in high-tech and medium-high tech manufactured goods, whereas the EU15 countries

[3] See Eurostat note of 8 January 2013.

[4] Note that the drop in Luxemburg (more than 4 percentage points) is from 1999 to 2011 due to data availability.

in aggregate run a surplus of about 3% of GDP. At the same time, the UK also runs a deficit of about 3½% of GDP in low-tech and medium-low tech manufactured goods, whereas the EU15 countries as a whole are roughly in balanced trade in these categories.

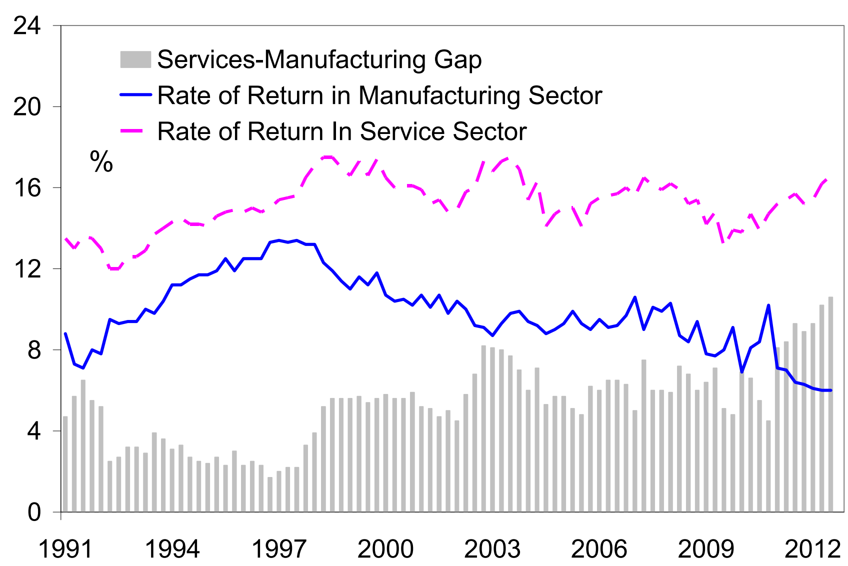
Most of the imports by emerging markets – and especially China – are high-tech or medium-high tech goods…

We do not want to elevate high-tech and medium-high tech manufacturing as the only valid generator of economic growth. However, the key point is that these sectors are relatively small in size and persistent underperformers in the UK. By contrast, high-tech and medium-high tech manufacturing have relatively high levels of value added per head and – amidst strong demand growth in many emerging markets – have been powerful generators of growth in exports and industrial production in many other EU countries. Over the period 2007-11, 51% of the growth in high-tech imports globally came from emerging markets, as did 63% of the growth in medium-high tech imports. In all, 60% of all global imports of manufactured goods are high-tech or medium-high tech goods. For emerging markets as a whole, 65% of imports of manufactured good are high-tech or medium-high tech goods: for China, fully 76% of imports of manufactured goods are high-tech or medium-high tech goods[5]. Hence, apart from commodity producers, the only countries that are well-placed to gain a major boost from rapid Asian domestic demand growth are those with strength in high-tech or medium-high tech goods.

…and the UK's continued underperformance in these sectors is a major reason why the hoped for boost in exports repeatedly fails to materialise

The UK's continued underperformance in these sectors is a key reason why the UK has been unable to derive as much export boost from the low pound and rapid EM growth as many had hoped, and why the long-awaited shift to export-led growth is not happening. In turn, with domestic demand still weak, the economy is flat-lining.

Figure 7. UK — Gross Rates of Return on Capital in Manufacturing and Service Sectors, 1991-2012



Sources: ONS and Citi Research

5 Data from OECD.

The credit boom probably contributed to the erosion of the UK's high-tech and medium-high tech manufacturing sectors…

A range of factors probably lies behind the UK's underperformance in high-tech and medium-high manufacturing. But a key factor probably has been the indirect side-effects of the long credit boom of 1997-07. With the economy propelled by rapid growth in domestic credit, housing and financial services (hence generating high real interest rates in the UK), the trade-weighted pound surged by 26% from mid-96 to end-2000). This greatly reduced manufacturing profitability, with the gap between the rate of return in the service sector and that in manufacturing expanding from about 2% at end-96 to about 8% at end-02. Inevitably, the expansion of high-tech and medium-tech manufacturing (which did occur in many EU countries) prompted by the Asian EM boom did not happen in the UK. And now, with domestic demand held back by private deleveraging and fiscal drag, the UK needs to achieve export-led growth to have any hope of getting decent growth. But, the UK lacks the sufficient presence in high-tech and medium-high tech manufacturing to achieve this.

…hence leaving the UK poorly placed to benefit from the rapid growth in Asian EM domestic demand

There is little sign that the UK is about to experience a renaissance in high-tech and medium-high tech manufacturing. Despite the sharp drop in sterling (more than 20% trade-weighted) from mid-07 to early-09, the rate of return on manufacturing is the lowest since data began in 1989 and the gap between the rate of return on services and manufacturing is at a record high. Business investment has fallen as a share of GDP in recent years, and surveys suggest that firms' investment intentions are weak. A lower pound would help revive UK exports over time, as would other factors such as more generous capital allowances, improved maths and science standards, stronger global transport links – and a stronger government focus that prioritises the revival of UK exports above all else, rather than seeking to revive the housing market or debating whether the UK should stay in the EU. But, even if all these ingredients were in place immediately, the UK's structural export weaknesses will continue to cap the economy's upside for some time. For now, stagnation lies ahead.

Economic Indicators

Tue 15 Jan	***Producer Input Prices (Dec)***	**Forecast: 0.2% MoM, 0.5% YoY**	**Prior: 0.1% MoM, -0.3% YoY**
	With commodity prices creeping up again (especially metals), we expect these data to show another small rise in input prices, similar to the trend of recent months. Nevertheless, in broad terms, the level of input prices is little changed from early 2011 and is likely to remain fairly flat in the year ahead.		
Tue 15 Jan	***Producer Output Prices (Dec)***	**Forecast: 0.1% MoM, 2.5% YoY**	**Prior: -0.2% MoM, 2.2% YoY**
	Output Prices Ex Tax (Dec)	**Forecast: 0.0% MoM, 2.1% YoY**	**Prior: -0.2% MoM, 1.9% YoY**
	Excluding Food, Drink, Tobacco, Energy (Dec)	**Forecast: 0.0% MoM, 1.5% YoY**	**Prior: 0.0% MoM, 1.4% YoY**
	Base effects from the very weak price reading a year earlier may cause the YoY rate for output prices to edge up slightly, but we doubt this is the start of a new uptrend. Given the weakness of demand, we expect that output price inflation will stay low in the year ahead.		
Tue 15 Jan	***Consumer Prices (Dec)***	**Forecast: 0.2% MoM, 2.5% YoY**	**Prior: 0.2% MoM, 2.7% YoY**
	CPI Ex Food, Drink, Tobacco, Energy (Dec)	**Forecast: 0.4% MoM, 2.6% YoY**	**Prior: 0.1% MoM, 2.6% YoY**
	Retail Prices (Dec)	**Forecast: 0.4% MoM, 3.0% YoY**	**Prior: 0.0% MoM, 3.0% YoY**
	RPIX – Excludes Mortgages (Dec)	**Forecast: 0.4% MoM, 3.0% YoY**	**Prior: 0.1% MoM, 2.9% YoY**
	Petrol prices fell by 1%-2% MoM in December and this probably will be enough to bring headline CPI inflation a little lower this month, although the YoY rate probably will remain clearly above the 2% target. On our current forecast, CPI inflation will stay above 2% YoY throughout 2013, but will not quite breach the 3% "letter-writing" threshold.		
Fri 18 Jan	***Retail Sales Volumes (Dec)***	**Forecast: 0.6% MoM, 1.4% YoY**	**Prior: 0.0% MoM, 0.9% YoY**
	We suspect that the retail sales figures will benefit from the relatively strong sales reported in late-December, although the December retail sales data do tend to be quite volatile given variations in the extent to which the first few days of the post-Christmas sales fall into the December or January data. A figure in line with our forecast would still leave volumes in Q4 0.2%-0.3% below the Q3 average.		
Tue 22 Jan	***Public Sector Net Borrowing (Dec)***	**Forecast: £14.5 bn deficit, £79.2 billion deficit fiscal year to date**	
	(Figures Exclude Costs of Financial Intervention)	**Year Ago: £14.8 bn deficit, £99.3 billion deficit fiscal year to date**	
	We expect the December deficit to be similar to a year earlier, with revenues continuing to run below the OBR's forecasts – and hence setting the stage for a modest deficit overshoot (perhaps £5bn) over the course of the whole year.		

Economic Calendar, 7 January — 25 January 2013

7 January	8 January	9 January	10 January	11 January
Halifax House Prices (Dec, 09:00) Nov 1.6% MoM, 0.6% YoY Dec 1.3% MoM, 2.7% YoY	**British Chambers of Commerce Quarterly Economic Survey (Q4)**	**Trade Balance – Goods & Services (Nov)** Oct £-3.7bn Nov £-3.5bn **Profitability of UK Companies (Q3)** **MPC Meeting Starts**	**CPAC Outcome:** No Change to Calculation or Usage of Headline RPI, Begins New RPIJ index **MPC Meeting:** Rates Unchanged at 0.5% QE Unchanged at £375bn **ECB Meeting:** Rates Unchanged at 0.75%	**Industrial Production (Nov)** Oct -0.9% MoM, -3.0% YoY Nov -1.9% MoM, -2.4% YoY **Manufacturing Output (Nov)** Oct -1.3% MoM, -2.0% YoY Nov -0.3% MoM, -2.1% YoY **Construction Output (Nov)**
14 January	**15 January**	**16 January**	**17 January**	**18 January**
	RICS House Price Survey (Dec, 00:01) **Producer Input Prices (Dec)** Nov 0.1% MoM, -0.3% YoY DecE 0.2% MoM, 0.5% YoY **Prod. Output Prices (Dec)** Nov -0.2% MoM, 2.2% YoY DecE 0.1% MoM, 2.5% YoY **Consumer Prices (Dec)** Nov 0.2% MoM, 2.7% YoY DecE 0.2% MoM, 2.5% YoY **CPI ex F, D, T, E (Dec)** Nov 0.1% MoM, 2.6% YoY DecE 0.4% MoM, 2.6% YoY **Retail Prices (Dec)** Nov 0.0% MoM, 3.0% YoY DecE 0.4% MoM, 3.0% YoY **RPIX – Ex Mortgages (Dec)** Nov 0.1% MoM, 2.9% YoY DecE 0.4% MoM, 3.0% YoY			**Retail Sales Volumes (Dec)** Nov 0.0% MoM, 0.9% YoY DecE 0.6% MoM, 1.4% YoY
21 January	**22 January**	**23 January**	**24 January**	**25 January**
Eurogroup Meeting (Brussels, 16:00)	**PSNB ex (Dec)** Dec11 £14.8bn Deficit Dec12E £14.5bn Deficit **Fiscal Year To Date** Apr-Dec11 £99.3bn Deficit Apr-Dec12E £79.2bn Deficit **CBI Qrtly Industrial Trends Survey (Jan)** (11:00) **EcoFin Meeting (Brussels)**	**Claimant Count Unemployment (Dec)** **LFS Unemployment (Sep -Nov)** **MPC Minutes (Jan 10)** **BoE Agents' Summmary Of Business Conditions (Jan)** **Bank of Canada Interest Rate Outcome**	**BBA Mortgage Advances (Dec)** **CBI Retail Survey (Jan)** (11:00)	**GDP (Q4, Preliminary)** **Service Sector Output (Nov)**

E Citi estimate. B Billion. P Provisional. R Revised. Note: All data are released at 9.30 a.m., except those marked otherwise.

Sources: BoE, CBI, CML, ONS, national sources and Citi Research.

Notes

Appendix A-1

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