QUARTERLY

ECONOMIC REPORT
Autumn 2009

Covering July to Sept 2009

Ref:QER09/2

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TWRI
1st Floor Provincial House
Northumberland Street
Newcastle upon Tyne
NE1 7DQ
Tel: (0191) 277 1912
Fax: (0191) 277 1911
E-MAIL: twri@twri.org.uk
WEBSITE: www.twri.org.uk

Supported jointly by Cities of Newcastle and Sunderland and the Metropolitan Boroughs of Gateshead, North Tyneside and South Tyneside

KEY POINTS

Firms in Tyne & Wear are **now expecting** some **recovery**. They expect turnover to grow over the next year (balance[1] of 16% in Q2, strengthened to 26%[2] in Q3). This is a marked improvement from the negative balances of the previous two quarters.

Local economic data show that the Tyne & Wear economy probably came **close to stopping shrinking** in the **second and third quarters**. Domestic (UK) sales and orders (for firms in TW) were still falling but at a much slower rate than in the first quarter (Section §1); balances have improved from around -25% in Q1 to about -13%. Source: Chamber of Commerce quarterly surveys.

Claimant **unemployment** in Tyne & Wear has been **broadly flat** for the period since April (more detail in the Labour Mkt. Report) but does not mean that the economy has returned to a normal growth rate. This unexpected respite seems to be due to firms (notably Nissan and suppliers) taking back some workers, and other firms 'hoarding' them, expecting growth to resume soon.

Export orders have been **less negative** in both Q2 and Q3. (Balances on orders have improved to -10% but slipped a bit to -6% for sales). The NE Q2 export data showed growth in some export markets, and only a 3½% fall overall.

The big fall in **house sales volumes**[3] stopped in the first quarter; in Tyne & Wear in Q2 they **rose** to be **37% above Q1**(§2).

In the **UK**, the economy was **close to, or resumed growth in the third quarter**; ONS estimated -0.4% but TWRI judges from other evidence that ONS understated output. In particular, survey data had indicated the strongest service sector growth for 2 years (§7). The UK economy broadly stabilised in the third quarter, although the official ONS estimate was that it was in the sixth quarter of recession. There is higher activity in the housing market and car sales are up compared with a year ago.

Globally, **world trade volumes** have **risen sharply** from their low in May, up 5% by July. The IMF expects the world economy to grow by about 3% in 2010, although industrialised countries by only around 1%.

1 The balance is the difference in the proportion of firms who said the variable was rising minus those who said it was falling.

2 The balance in 'normal' times is, however, over 50%.

3 Caution: not seasonally adjusted.

For **national policy-makers**, it is vital to sustain private sector demand and growth. Also reducing the very large fiscal deficit is very important (to avoid an unsustainable debt burden).
The start of a recovery presents new challenges; for the MPC, when to stop quantitative easing (see back page), and for govt., when to reduce the budget deficit (now over 12% of GDP) and how quickly? (Feature in TWRI's Economic Monthly Bulletin).

Tyne & Wear is somewhat more dependent on employment in the public sector than nationally and thus a bit more vulnerable[4].
Conversely, the NE is a **manufacturing and export** region and thus these sectors are "well-placed"[5] to grow more strongly than in the decade to 2007. This presents something of **an opportunity** for the NE.

NE exports of **machinery and transport (Tyne & Wear's key exports) recovered by 22% in Q2** from Q1 (to £865m), but were still 37% down from the peak of £1,373m in Q1 2008 (but back at 2006 levels). NE goods exports, as a whole (£2,229m), were down 3½% in Q2, and down 25% on a year earlier (§3). NE exports to the EU (down 20% from the peak of Q2 2008) were down by somewhat less than the total and down just 2% in Q2 (and account for 59% of exports). Exports to Asia recovered by an impressive 28% in Q2 (to £269m), to account for 12% of total exports. Exports to W Europe (exc. EU) [i.e. Norway and Switzerland] also recovered, by 64% in Q2 (to 4% of NE exports). Exports to Eastern Europe (exc. EU) [i.e. probably mainly Russia] have dropped by about 2/3 since 2008 to now be only around 2% of NE exports.

Reported[6] **job gains exceeded losses by about 1,300** in Q3. This positive balance of reported job change is stronger than Q2 (which was +500). Both are marked improvements from a net loss of 1,100 in Q1 (§5)
It is possible that *actual* employment may have been close to stability in Q3 (also reinforced by claimant unemployment's stability). This suggests that UK unemployment could peak (in 2010) at a lower level than originally feared. Caution: Many job changes are omitted from the press. More detail will be given in the TWRI Labour Market Report.

Oct 29th 2009.

4 See IPPR report; 'Public Sector cities: Trouble Ahead' (July 2009).

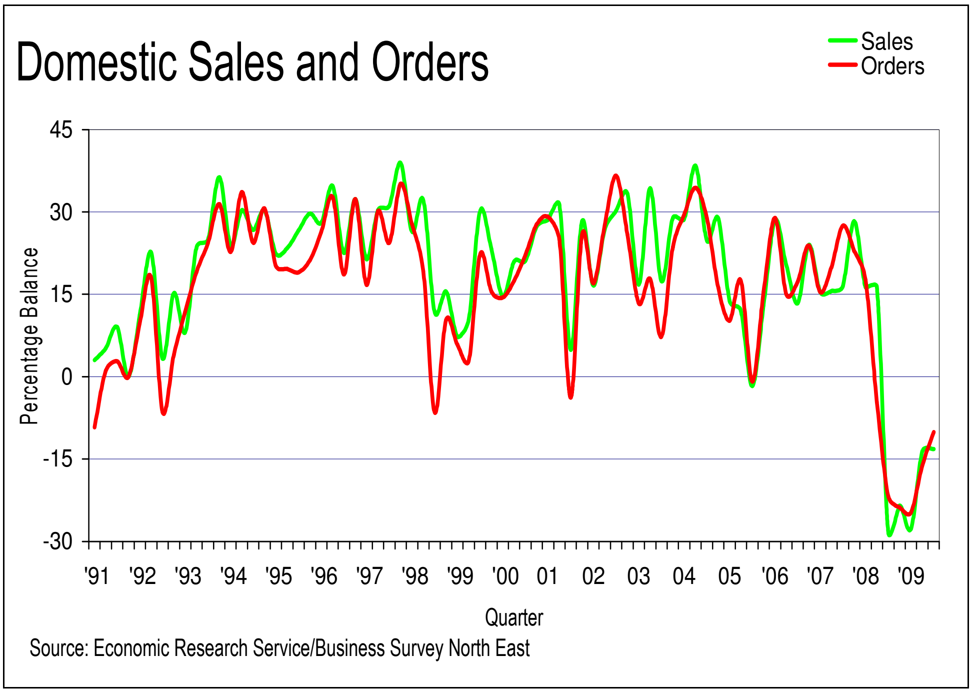
5 Governor of the Bank of England, visit to the NE, Sept 2009.

6 Caution: press coverage effectively omits many industries.

TYNE & WEAR ECONOMY

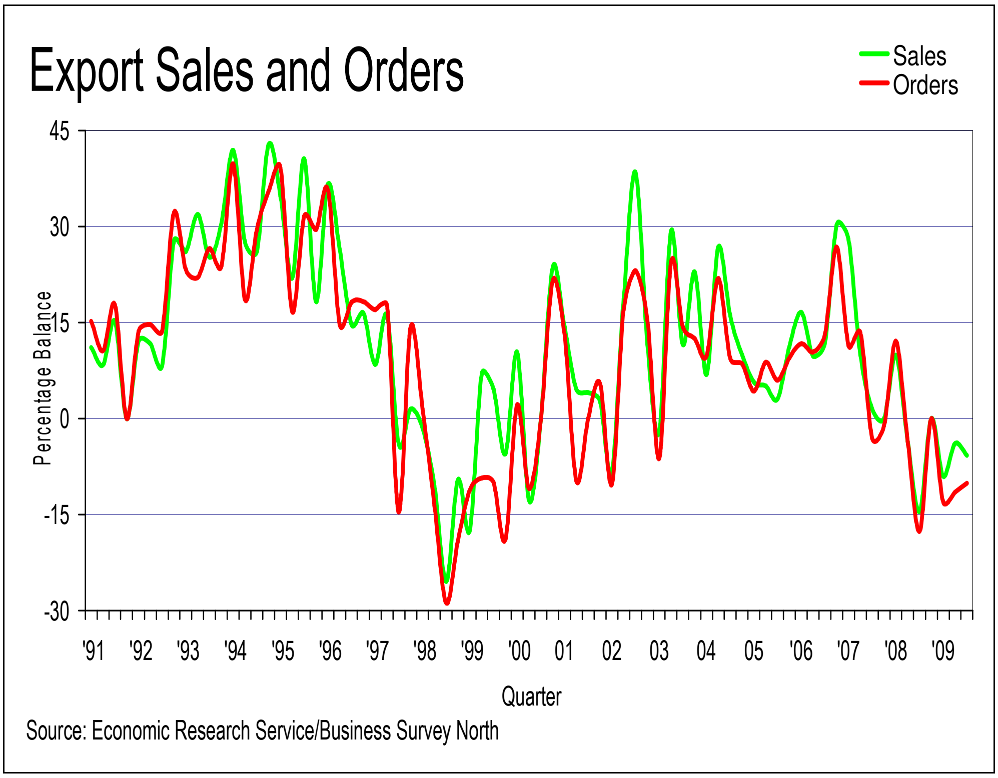
1. Indicators of Demand:

Domestic demand fell most steeply in Q1 (with a record fall of around -25% on the balance), but the fall has eased in both Q2 and Q3, to around -13%. As the graph shows, however, the fall in domestic demand is still steeper than in the recession of 1991-92.



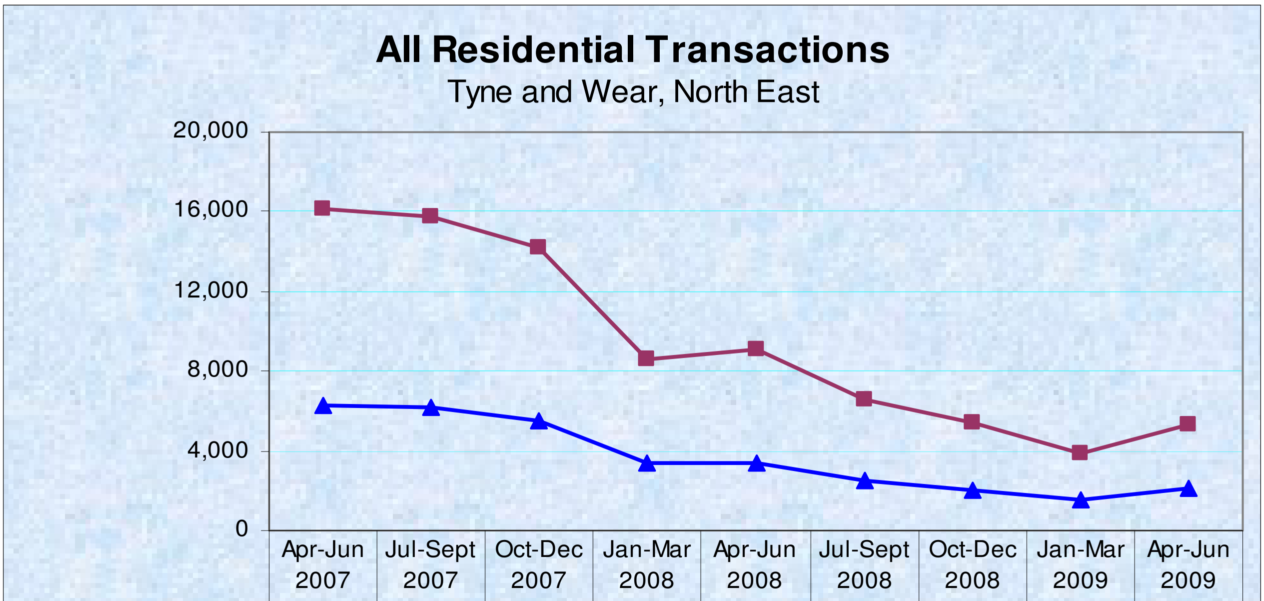
Note: these indicators of demand are from firms in Tyne & Wear (only).

Export demand has fallen less steeply since Q1, falling at rates broadly last seen in 2002.



2. Housing Market

In Q2 2009, house sales rose (TW up 37%) but were still two-thirds below the volume two years earlier (chart below). Housing market activity had fallen by around ¾, beginning with lenders greatly restricting lending (from Q1, 2008). Activity continued to fall throughout 2008 and into the first quarter of 2009 in both the NE and Tyne & Wear

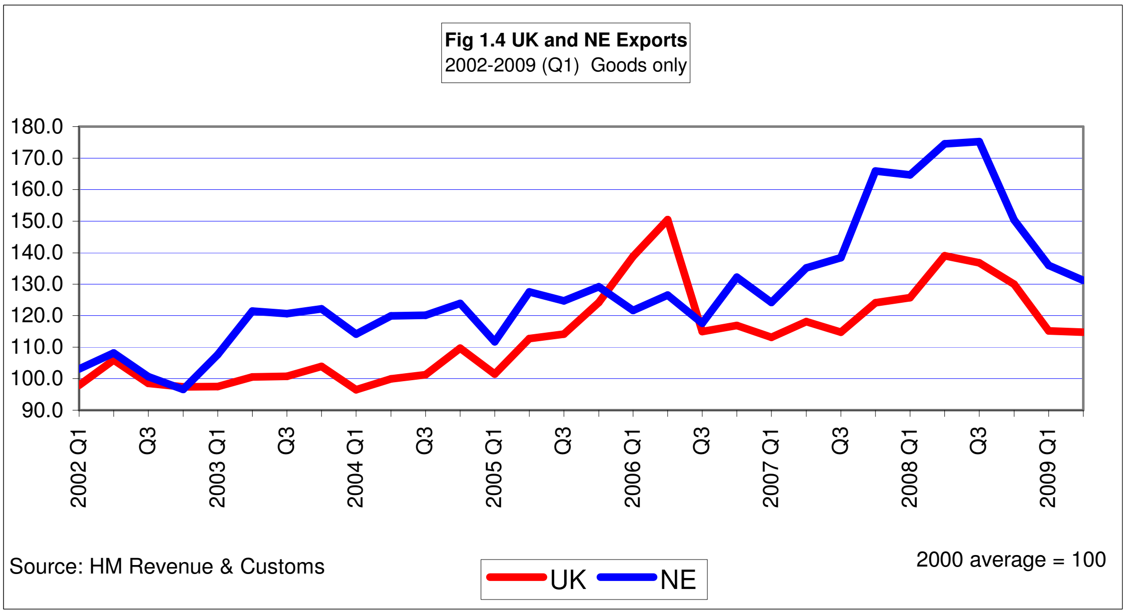


	Apr-Jun 2007	Jul-Sept 2007	Oct-Dec 2007	Jan-Mar 2008	Apr-Jun 2008	Jul-Sept 2008	Oct-Dec 2008	Jan-Mar 2009	Apr-Jun 2009
Tyne and Wear	6,311	6,185	5,513	3,372	3,429	2,546	2,022	1,568	2,143
North East	16,151	15,722	14,225	8,606	9,048	6,563	5,370	3,841	5,295

Source: Land Registry Address file (compiled by TWRI). Caution:data are not seasonally adjusted.

3. Exports

The fall in **exports of goods** from **the North East**[7] **in Q2 slowed by** $^2/_3$ compared with the fall in Q1; **they fell by 3.5%** (by value) in **Q2 2009** (-£82m) to £2,229m. NE exports to Asia grew by an impressive 28% in the quarter, to £267m. Oddly, NE exports to N. America fell 33% in Q2, whilst they rose from the UK.



Note: exports may be critical to economic recovery in the medium-term (say 1-5 years).

[7] HMRC Tyne & Wear data are not available to TWRI.

The dominant export market, the EU, took 2% less exports (£1,308m) from the NE. The £24m fall to the EU was, however, more than offset by the very sharp 64% rise to Western Europe exc. EU [i.e. Norway and Switzerland], up £35m. The fastest drop in exports has been to E. Europe (exc. EU)[i.e. presumably mainly Russia] down by over $^2/_3$ (-£113m) from a year ago, to just £44m in Q2.

4. Aggregate Job Gains and Losses in TW (July-Sept 2009) – reported in the press:

There was a *reported* net job gain for TW of about +1,300*, an acceleration from the net gain of +500 in Q2. Both are marked improvements from a net loss of -1,100 in Q1.

Summary of job gains and losses (announced in the press).

July 1st-Sept 30th 2009, for Tyne & Wear

District	Gain	Loss	Net
Gateshead	170	80	90
Newcastle	478*	122	356*
North Tyneside	246	380	-134
South Tyneside	78	20	58
Sunderland	668	156	512
Unallocated #	450	40	410
Tyne and Wear	2,090*	798	1,292*

Note: * TWRI has estimated the actual gain at Jet2to be about 100 (for five new routes) rather than its stated "450….including supporting services". Thus the numbers in the text and table have been reduced by 350.

Unallocated gains and losses are usually estimates at County level of regional change.

Source: compiled by TWRI from the Journal and other local media.

Caution: press reports are very incomplete. In particular, they essentially omit construction job change, small job losses in retailers and other service firms. Historically they have omitted major growth in public service employment in health and education. Nevertheless, the reported job changes give a strong sense of overall employment change.

Claimant unemployment rose by about 15,000 in TW in the year to June but by about 12,000 in the year to September; this suggests employment may have fallen by about 12,000 (or nearly 2½%) in TW in the year to September.

More details, including an itemised list of gains and losses, will be presented in the TWRI Labour Market Report.

5. Structural Change in the TW economy:

Nissan is to develop a new factory to make (lithium) batteries for its range of new electric cars. The former Findus factory is to be re-opened by Longbenton Foods (in early 2010); this is a major gain for the Food & Drink sector in Tyne & Wear. In the offshore engineering, SLP is having a fabrication shop built which can be used to build large wind turbine components.

The extension to Eldon Square Shopping Centre, in Newcastle city centre is due to open after Christmas including the new Debenhams store (due to open in February).

Major property developments are now going ahead in Newcastle; the £200m Downing Plaza and the £200m Stephenson Quarter. These will bring 1-3 new hotels and some office space.

UK ECONOMY

6. The UK Economic Policy Framework:

National economic policy makers now have to work within a **policy paradigm** with ***four* dimensions** instead of two because of the risk of deflation; up to 2008 they were trying to (simply) maximise economic growth (and employment), subject to an inflation constraint (essentially by using interest rates).
Now they have to do the above, whilst also bringing **govt. debt** under control *and* maintaining **strong capital ratios of the banks**. This has required the introduction of new policy instruments, creating a new policy framework:

Quantitative Easing (QE), to eliminate the risk of deflation.

The use of fiscal policy (tax and borrowing) to reinforce the stimulus from low interest rates.

Providing capital to the banks, which *allows* them to lend.[8]

The **Achilles Heel** in this framework is that ***no instrument ensures*** *that the* ***banks lend*** *a* ***sufficient amount*** *to* ***maintain economic growth***, and there are some powerful incentives for them to cut lending[9].
The (2D) diagram below outlines some of the main trade-offs, where the aim is to move from bottom left towards top right, over a number of years. This requires the banking system ("the 4th dimension", not shown) to continue growth of lending to businesses and households.

Low(er) govt
borrowing (3% of GDP).

Risks demand being too weak in the economy (hits growth and employment).	This box shows the Aim; More 'normal' conditions. But requires private-sector-led growth. This requires strong lending by the banks. Keeps the £ strong (as in 1997-2007).
Supports growth and employment (as in 2009) But risks the govt. debt becoming unsustainable.	Controls inflation (if necessary). Might be required, if govt finds it difficult to finance its deficit. But hits growth and emp.

High govt v Low (0.5%) >> Interest rates>> Higher (say 2%+)
borrowing
(12% of GDP).

The capital ratios of the banks (now one of the key dimensions of the new policy paradigm) can be strengthened[10] by policies;

- providing govt. capital (as in late 2008, which incurs a fiscal cost) or
- allowing the banks to effectively obtain the capital from their customers (i.e. greatly raising their profits, as in 2009). This weakens economic growth, because customers are being deprived of spending power (analogous to a tax, but which goes to the banks).

Timescale: RBS is planning to become financially viable (i.e. independent of govt.) by 2014. Other banks should return to more normal activity, earlier than this.
If this policy framework fails to deliver economic growth, new policy instruments may be required such as ordering the banks to lend, or controlling them (to lend).

[8] Guarantees to banks essentially stops them collapsing, it does not, directly, increase their lending.
[9] A bank which cuts lending thereby improves (raises) its capital ratio. This makes it more independent of govt..
[10] Capital ratios can also be raised by commercial actions; issuing more shares and/or cutting lending.

7. UK Economic Context:

TWRI judges that the UK economy is, slowly, coming out of recession, despite the ONS estimate that GDP fell 0.4% in Q3. The Purchasing Managers' Index (PMI) showed strong positive growth in the service sector in Q3 (55.3 is highest since Sept 2007). As the service sector is the largest part of the economy, this was widely taken to mean the whole economy would have grown in Q3. ONS, however, reported that its estimate of Q3 GDP fell by 0.4% from the previous quarter. The ONS estimate was a shock. The GDP estimate is the widest one of activity in the economy (and widely taken to be the most definitive). Crucially, it has a record of inaccuracy (based on comparing the first estimate with final ones two years later)[ii].

Nevertheless, economic growth is clearly weak; growth of only around 1% is forecast for 2010. Households are paying down some of their debts.

There is a concern that bank lending is contracting. The last Section of this report (on the Credit Crunch) sets out the evidence for this, from the Bank of England itself. It is weak by the Big Six lenders, and lending by foreign banks is shrinking more rapidly.
The contraction of lending is, by definition, a "credit crunch" and this makes achieving positive economic growth very difficult (because it cuts demand in the economy).

Export-led growth is the major route out of recession for the UK, and, UK goods exports began to grow again in Q2 in four of the ten broad product groups. Manufactured Goods exports were up 5.5% and even Machinery & Transport (the key export product group from TW) was up 0.6%. Overall, however, UK goods exports still contracted marginally (-0.4% in Q2). Geographically, UK exports grew to the Middle East (up 3%), North America (up 4%), particularly to W. Europe (exc. EU)(up 21%, an extra £400m) and most of all to Asia (up 14%, an extra £800m). Goods exports to the EU still fell 7% in Q2 (down £2,100m), but they can be expected to grow again as the Euro-zone economies return to growth in Q3 and Q4.

8. Prospects:

Future UK Economic Prospects are for significant *negative* economic growth in 2009 and slow growth in 2010. Tyne & Wear's economic prospects (for at least the next year or so) are determined largely by the UK trajectory.

	2009	2010	Comments
Economic Growth	-4.3%	+1.0%	Upturn slightly less weak than June forecast (0.6%).
Claimant Unemployment	1.81m (Q4)	2.09m by Q4 2010	This year's rise in unemployment has been moderated by almost 0.2m since June. Then a further 200,000 in 2010, instead of 280,000.
CPI inflation (Q4 in each year)	1.4% and RPI inflation to be -0.9%,	1.7% and RPI inflation to 2.6%	Deflation is expected across the second half of 2009 (using RPI). But inflation returns in 2010.

Source: average latest revised UK forecasts from HM Treasury's survey of independent forecasts (Sept).

TW's ability to achieve a higher trajectory than the UK will, to an important degree, depend on its ability to raise exports, especially to fast-growing developing country markets (notably in Asia). Faster economic growth in the Euro-zone than in the UK would also be helpful to TW's economy (relative to the UK), because TW is (probably) more oriented to exports than is the UK, and this is the dominant export market. A recovery in demand from other markets, notably eastern Europe (excluding the EU), mainly Russia, would also be helpful.

[ii] Analysis by Goldman Sachs, reported in the FT 24th Oct. 2009.

9. Credit Crunch – recent developments

Bank lending has turned **negative** over the summer (**into net repayment**)*, and this *could explain* the weaker economic growth in Q3 than expected. The Bank of England, however, seems to believe this contraction is due to weak demand from companies, not banks constraining the supply of credit. The Bank, however, reports the constraint on smaller companies, but fails to highlight the potential importance of this.
Source: The Bank of England new monthly, introduced in April, now called 'Trends in Lending'. This is largely based upon a survey of the Big Six lenders; caution: it omits foreign lenders.
* Lending by all UK-resident banks 'showed the weakest flow of net lending since the monthly series began in 1998.' (Source: official figures in July).

The September report states;

- The flow of **net lending**[12] to **companies** was **negative** every month from April to July (-£7.0bn in April, to -£15.5bn in July), the largest monthly fall since 1998 (at least, because that was the start of records).
- 'The outstanding stock of loans to UK businesses held by UK–resident **foreign lenders** has been **contracting particularly rapidly** in recent months.'
- 'Lenders have **yet to detect** any significant **increase** in **demand** for new lending over and above the refinancing of existing facilities.' 'In part the preference [of companies] for bond finance reflected ongoing constraints on banks' abilities to provide longer-term (greater than 3-year) loans at a sufficiently attractive price.'
- '**Libor rates**, to which around two-thirds of new corporate loans are linked, **have…fallen** [to under 1% by July], helping to reduce the total cost of borrowing for companies.'
- 'Availability of finance remains **more constrained** for **smaller companies**.' 'In August a survey by the EEF, the manufacturers' organisation, indicated that over the previous two months, SMEs in the manufacturing sector were more likely to have experienced decline in the availability of new finance [balances around 25%, but only 5% for large companies], and an increase in its cost [balance around 40% or 50%+ for SMEs, 30% for large companies], than large companies.'
- 'The **flow** of **total net mortgage lending** was **negative in July,** the first net repayment since the monthly series began in 1993. In August, the major lenders reported that net mortgage lending picked up slightly.'
- 'The flow of net consumer credit was negative in July...Spreads on consumer credit remain elevated, in part reflecting higher arrears and write-offs.'

Quantitative Easing (QE)

The Bank of England's MPC now has the difficult task of judging when the QE programme should stop. It signalled (in w/b 12th Oct.) that the QE programme had worked, the minutes confirmed (20th Oct.) that the MPC had unanimously decided that QE was to end with the completion of the £175bn (expected in November).
The economic growth estimate for Q3 of a weak -0.4% (on 23rd Oct.) means that this debate is re-opened.
It is possible that the MPC will judge it to be so out of step with other (positive) evidence that it is effectively ignored, and QE ends soon.

12 Official data covering lending by all banks and building societies.