Office for National Statistics

Article

Quarterly economic commentary: April to June 2019

Economic commentary for the latest quarterly national accounts, prices and labour market indicators.

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1 . Main points

- Real UK gross domestic product (GDP) contracted by 0.2% in Quarter 2 (Apr to June) 2019, in part reflecting changes in the timing of activity related to the UK’s original planned exit date from the European Union in late March.

- While corporations and the government continued to be net borrowers in Quarter 2 2019, households are now estimated to be net lenders, in part reflecting the reclassification of student loans in the UK National Accounts.

- The current account deficit narrowed to 4.6% of GDP in Quarter 2, although trade flows have been particularly volatile this year, which in part reflects the unwinding of the large increase of imports of unspecified goods including non-monetary gold (NMG) earlier in the year.

- The employment rate remained at a record high of 76.1% in the three months to July 2019 and the unemployment rate hit a multi-decade low of 3.8%, although the number of vacancies has now fallen for seven consecutive months.

- The annual Consumer Prices Index including owner occupiers’ housing costs (CPIH) rate of inflation eased to 1.7% in August 2019, marking the lowest rate of inflation since November 2016.

2 . Gross domestic product

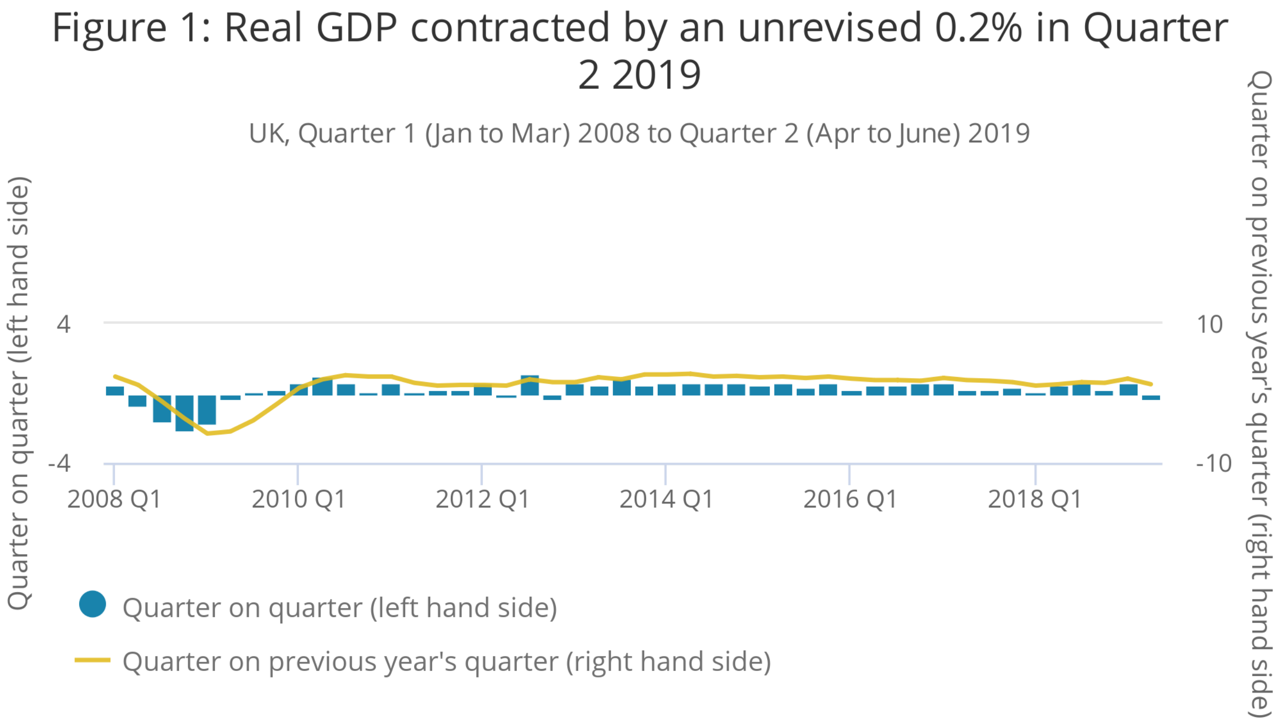
UK gross domestic product (GDP) contracted 0.2% in Quarter 2 (Apr to June) 2019 following an increase of 0.6% in the first quarter of the year. GDP and some of its components have been particularly volatile through the year so far, in part reflecting changes in the timing of activity related to the UK’s original planned exit date from the European Union in late March. There is evidence that stockpiling was taking place in the first quarter of the year, which would have provided a boost to GDP, and that these increased stock levels were then run down in Quarter 2.

Furthermore, it was also reported that several car manufacturers had brought forward their annual shutdowns to April as part of contingency planning. More timely estimates show that growth of the UK economy was flat in the three months to July[1], following the 0.3% increase in output in July. Having flatlined in the previous four months, services output increased by 0.3% in the month.

While early estimates are prone to revisions, the underlying trend of services output has been subdued over the last year. Monthly estimates of GDP can also be volatile in nature, particularly this year in manufacturing where some temporary factors have impacted the timing of activity taking place.

Figure 1: Real GDP contracted by an unrevised 0.2% in Quarter 2 2019

UK, Quarter 1 (Jan to Mar) 2008 to Quarter 2 (Apr to June) 2019



Source: Office for National Statistics – GDP Quarterly National Accounts, UK: January to March 2018

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

2. Real GDP figures are volume estimates that are adjusted for the effects of inflation over time.

The implied GDP deflator represents the broadest measure of inflation in the domestic economy, reflecting changes in the price of all goods and services that comprise GDP. This includes the price movements in private and government consumption, investment, and the relative price of exports and imports. In the year to Quarter 2 2019, the implied GDP deflator increased by 2.3%. Increases in the implied deflator are in part the result of increases in fuel prices – particularly crude oil prices – which are in line with quarterly movements in CPI. Nominal GDP increased by a revised 0.7% in Quarter 2 2019.

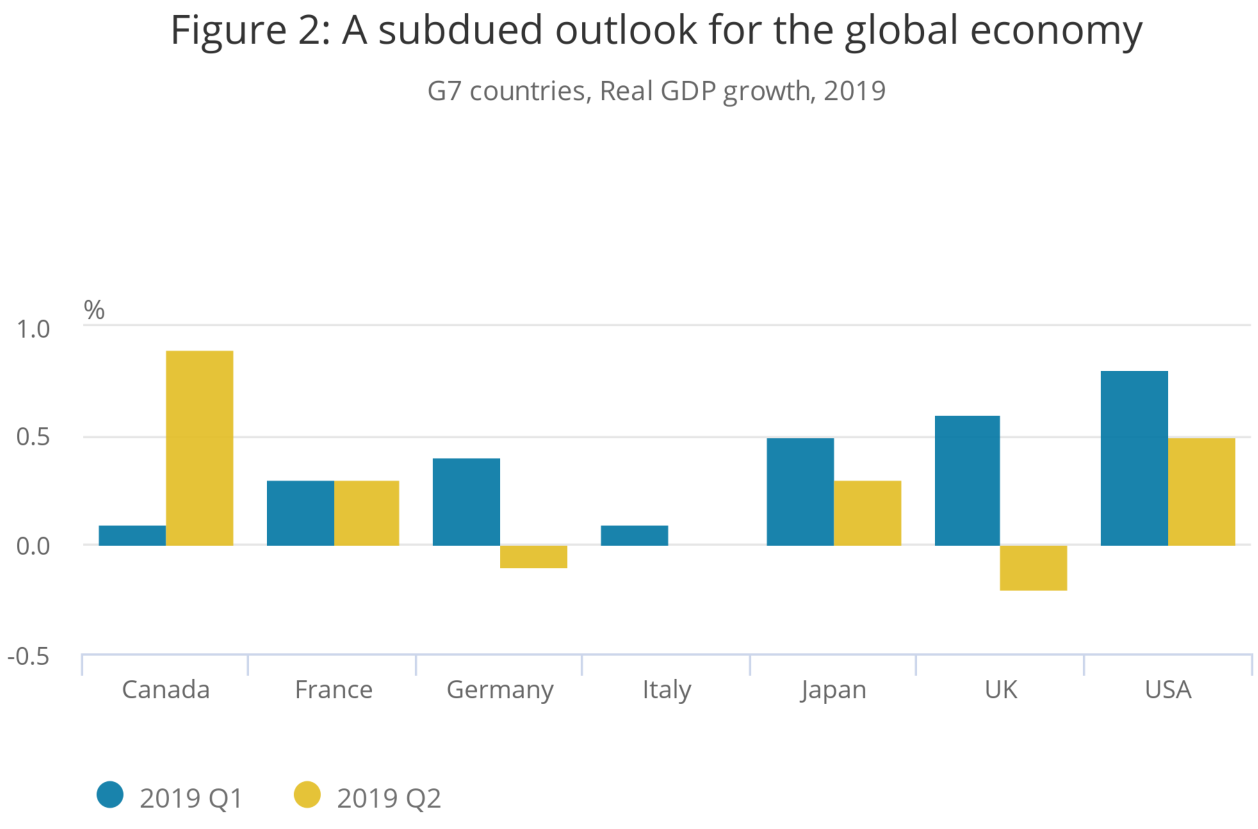
International

In its latest Interim Economic Outlook, the Organisation for Economic Co-operation and Development (OECD) refers to a global outlook that is “increasingly fragile and uncertain”, highlighting the subdued picture for global GDP and the fall in global trade flows. The OECD now expects a slowing in the world economy to 2.9% this year and 3.0% in 2020, in response to the escalating trade policy tensions that affect confidence and investment and create policy uncertainty. The themes here correspond with the latest World Economic Outlook by the International Monetary Fund (IMF), which also identifies trade tensions, a sharper-than-expected slowdown in China, and financial vulnerabilities as downside risks to the outlook.

Figure 2 shows how the UK economy has performed compared with other G7 countries in the first half of this year. There has been a slowdown in the euro area in the latest quarter, largely reflecting the contraction in the German economy where GDP fell by 0.1%. Having entered a technical recession in the second half of 2018, the Italian economy continues to perform in a subdued manner as there was no pickup in GDP in Quarter 2. French GDP maintained its quarterly rate of growth of 0.3%. Having increased by 0.8% in Quarter 1, US GDP growth slowed to 0.5% in the latest quarter.

Figure 2: A subdued outlook for the global economy

G7 countries, Real GDP growth, 2019



Source: Office for National Statistics, Organisation for Economic Co-operation and Development

Notes:

1. All OECD figures correct as of 23 September 2019.

Revisions

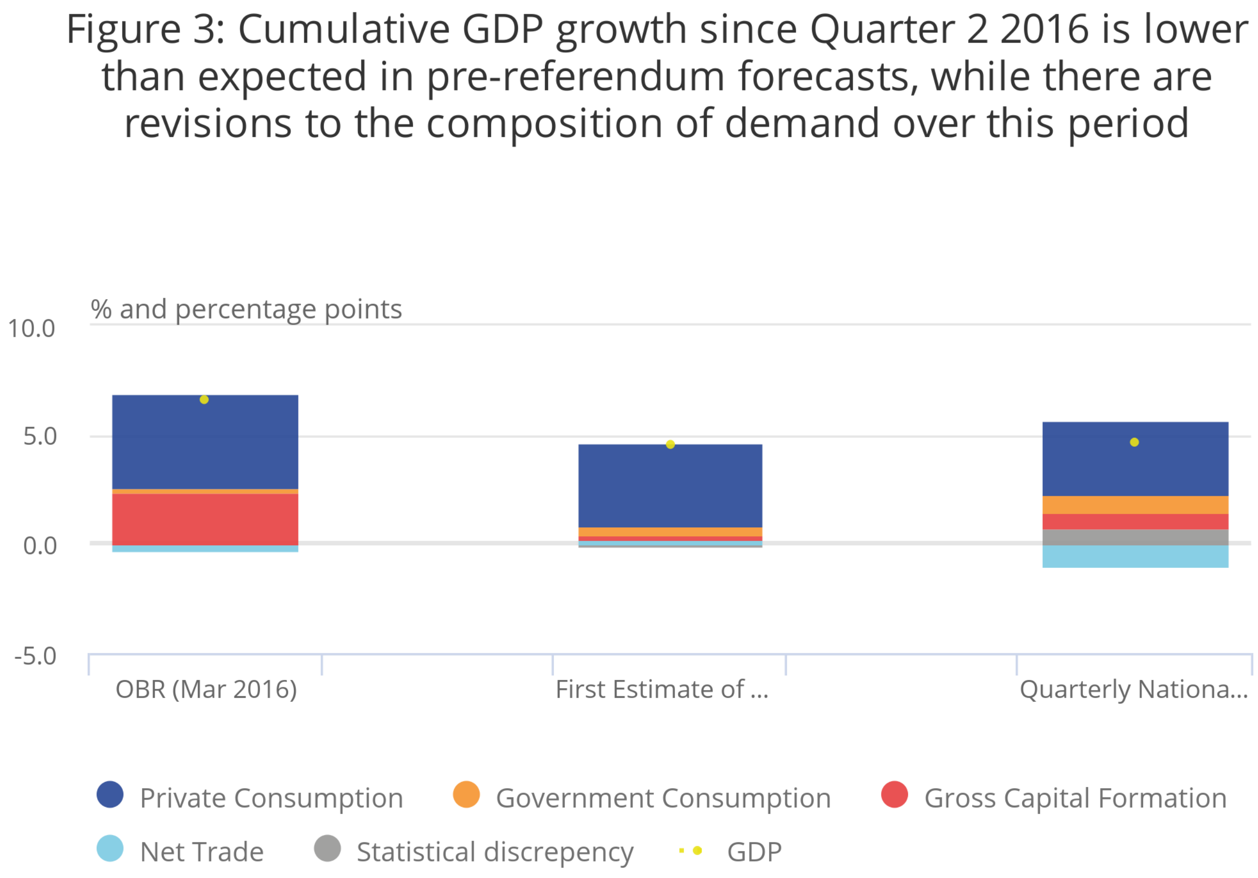
Previous analysis showed how the UK economy had been weaker than pre-referendum forecasts produced by the Office for Budget Responsibility (OBR) in March 2016, which were conditioned on a vote to remain in the European Union. It is important to note that the outlook produced at the time would have been subject to forecast errors, with subsequent unforeseen developments in the UK and global economy, but this updated analysis provides some context around the size and composition of revisions in recent years.

Figure 3 shows how cumulative GDP growth over this period has been revised, with the latest estimates showing that the size of the economy has increased by 4.7% since Quarter 2 2016. This compares with the 6.6% that was forecast in March 2016. It also shows the extent to which the composition of demand over this period has been revised. Cumulative GDP growth over this period has been less reliant on private consumption and net trade, as demand has shifted more towards gross capital formation and government consumption.

Relative to those forecasts, there has been a weaker contribution of private consumption over this period, which in part reflects the effect of a squeeze in purchasing power from higher import inflation following the fall in the exchange rate. Heightened levels of uncertainty are likely to be an important factor in explaining the relative weakness in gross capital formation.

There has been much less external rebalancing than forecast at the time, which might reflect developments in the global economy recently. It might also imply that there is less of a competitiveness boost to UK export volumes, given that these forecasts are conditioned on a vote to remain which would have not reflected the adjustment in the exchange rate. This has been offset by stronger-than-expected government consumption.

Figure 3: Cumulative GDP growth since Quarter 2 2016 is lower than expected in pre-referendum forecasts, while there are revisions to the composition of demand over this period



Source: Office for National Statistics, Office for Budget Responsibility

Notes:

1. Components contributions may not sum to total due to rounding.

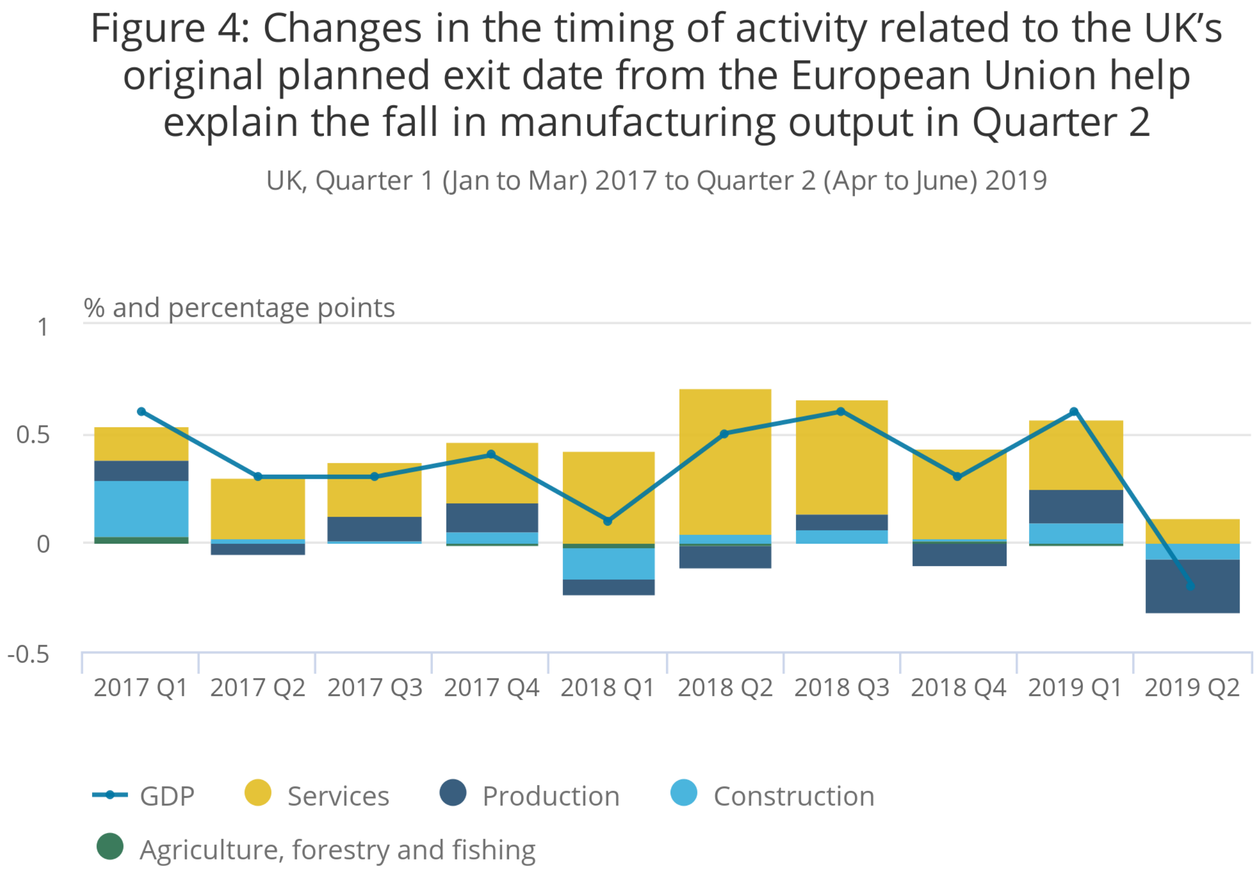
Output

The fall in output in Quarter 2 2019 is likely to be reflecting changes in the timing of activity related to the UK's original planned exit date from the European Union. Production output fell 1.8% in the latest quarter – the largest decline since Quarter 4 (Oct to Dec) 2012 – driven by a revised 2.8% fall in manufacturing output (Figure 4). This largely reflected the changing in the timing of activity in the first quarter of the year and the decline in car production as summer shutdowns for planned maintenance were brought forward to April.

The Manufacturing PMI for June 2019 reported that output had contracted, attributed to a combination of factors including high stock levels and ongoing Brexit uncertainty. More timely indicators find that there continues to be a loss of momentum in the manufacturing industry. The August Manufacturing PMI fell for a fourth consecutive month, reaching a seven-year low as new orders and export orders fell, reflecting "ongoing global trade tensions, slower world economic growth and Brexit uncertainty". The latest Bank of England's Agents' Summary paints a similar picture, as output and exports rose at their slowest rate in three years. Respondents cited the "unwinding of stocks following the extension of the Brexit deadline", concerns around the "risk of supply disruption" and "rising trade tensions" for the subdued outlook.

Figure 4: Changes in the timing of activity related to the UK's original planned exit date from the European Union help explain the fall in manufacturing output in Quarter 2

UK, Quarter 1 (Jan to Mar) 2017 to Quarter 2 (Apr to June) 2019



Source: Office for National Statistics

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

2. Chart shows contribution to real GDP quarter-on-quarter growth.

3. Components contributions may not sum to total due to rounding.

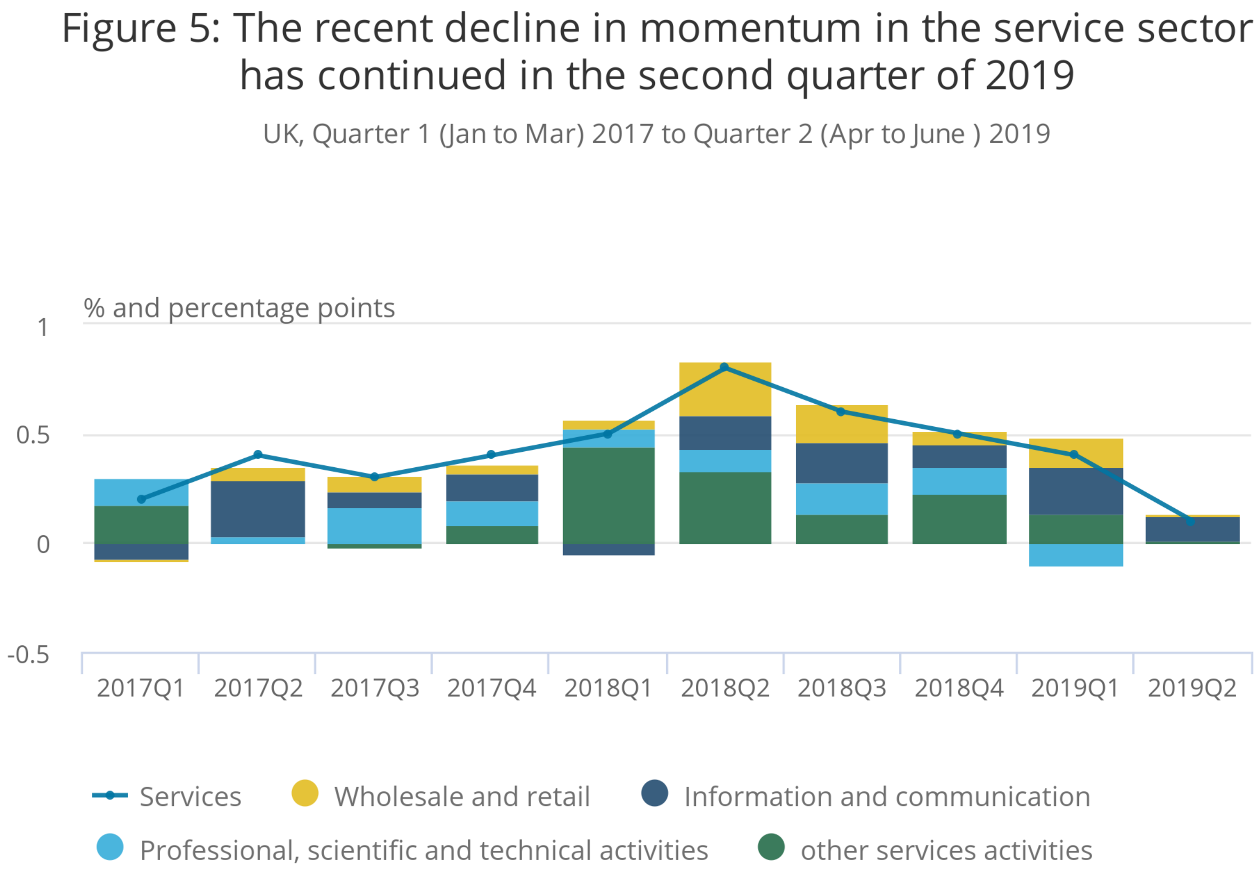
There has also been a loss of momentum in the services industry over the last year, as services output increased by 0.1% in Quarter 2 – the weakest quarterly figure in three years. The slowing in Quarter 2 has been reflected in wholesale, retail and motor trades. The slowdown is in line with the Services PMI for June 2019 which reported that the services industry was close to stagnation, linked to the "sluggish domestic economic conditions and greater risk aversion among clients in response to ongoing Brexit uncertainty".

More timely figures show that the Services PMI slowed further in August, in response to increased levels of uncertainty and subdued corporate spending, while optimism continued to fall. The easing has also been reflected in the recent Confederation of Business Industry Service Sector Survey, where volumes are expected to fall sharply over the next three months, as respondents citing overseas business as a factor limiting business was at its highest level since early 2013.

The main positive contribution came from the transport, storage and communications industries, which increased by 0.6% in Quarter 2. This was driven by an increase in the information and communication sector, specifically, continued strength in computer programming. Financial and insurance activities output fell 0.4% in Quarter 2 2019, continuing the decline seen since Quarter 2 2018; this weakness is reflected in the [Bank of England's Agents' Summary Survey](). This attributes the weaker demand for professional services – which includes financial services – to the recent political uncertainty.

Figure 5: The recent decline in momentum in the service sector has continued in the second quarter of 2019

UK, Quarter 1 (Jan to Mar) 2017 to Quarter 2 (Apr to June) 2019



Source: Office for National Statistics

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

2. Chart shows contribution to services quarter-on-quarter growth.

3. Components contributions may not sum to total due to rounding.

Construction output fell by 1.2% in Quarter 2 2019, primarily because of a decline in repair and maintenance work. The latest [Bank of England's Agents' Summary]() reports that uncertainty had been a constraint on activity, while the latest [Construction PMI]() reports that new orders fell at its sharpest rate since March 2009 reflecting the weak demand conditions.

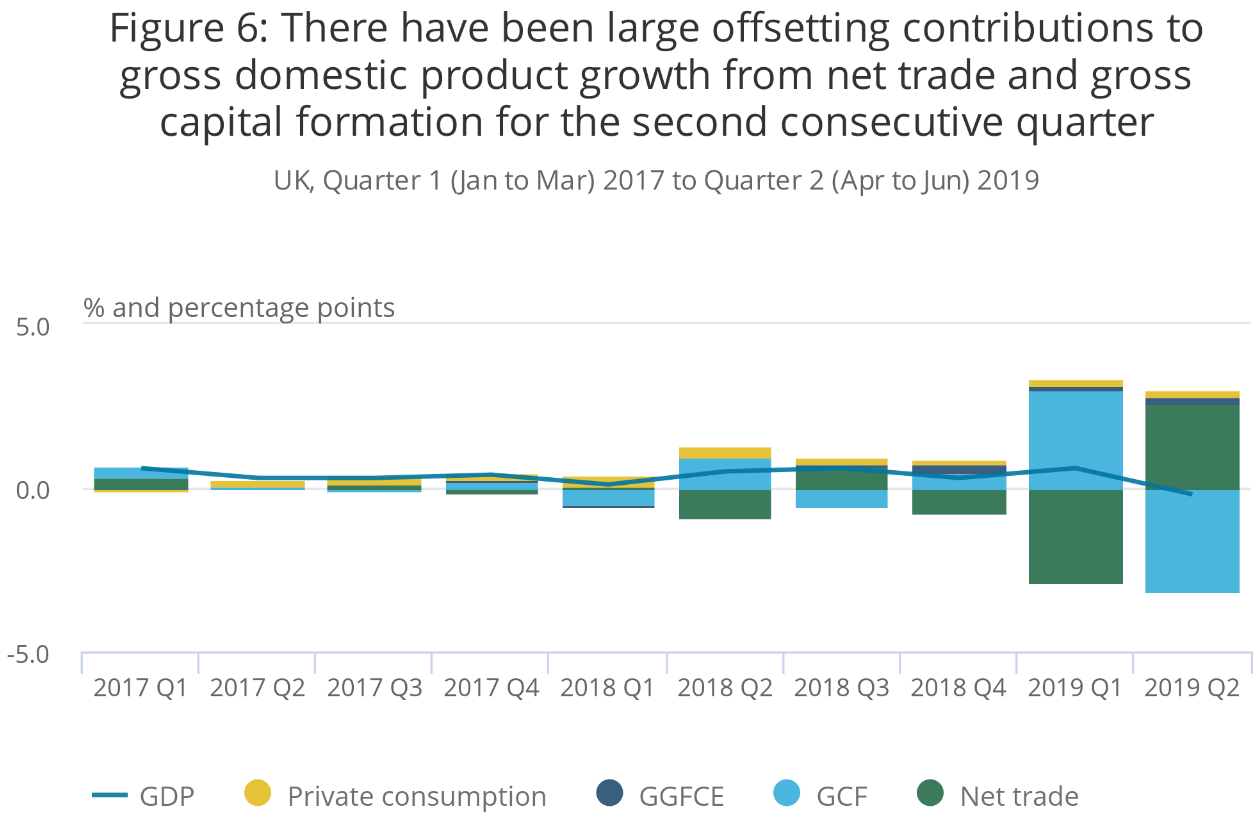
Expenditure

There has been a reversal in the contribution of gross capital formation (GCF) in Quarter 2. This reflects the pronounced building up of stocks in the run-up to the UK’s original exit date from the European Union at the end of March, which appear to have then been subsequently run down by businesses in the latest three months. GCF – which includes gross fixed capital formation (GFCF), changes in inventories and acquisitions less disposal of valuables – declined 15.6% in Quarter 2, as changes in inventories [2] made a large negative contribution to the change in GDP over this period.

Trade flows have also been particularly volatile this year, in part reflecting the effects of movements of unspecified goods – which include non-monetary gold (NMG) [3] – in the first two quarters of the year. The notable movements in the trade of unspecified goods, which had led to a significant widening in Quarter 1 had unwound in the second quarter of 2019, also helps explain the movements in GCF.

Figure 6: There have been large offsetting contributions to gross domestic product growth from net trade and gross capital formation for the second consecutive quarter

UK, Quarter 1 (Jan to Mar) 2017 to Quarter 2 (Apr to Jun) 2019



Source: Office for National Statistics

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).

2. Chart shows contribution to GDP quarter-on-quarter growth.

3. Components contributions may not sum to total due to rounding. The statistical discrepancy is also not displayed.

Household consumption has been revised down in the first two quarters of 2019, which is more in line with some external indicators that point to a more subdued picture. The latest GfK Consumer Confidence index fell in August 2019, as uncertainty was weighing on views on personal finances and the general economic outlook. The latest Bank of England Agents' Summary finds a softening in consumer demand, as some had reported that "Brexit uncertainty had also weighed a little on spending recently" with the softening in car sales reflecting higher levels of consumer caution.

There was also evidence that the weakness in the housing market has weighted on purchases of household goods and furniture. That said, the subdued figures also reflected base effects from the boost from the heatwave and World Cup last summer. The latest Confederation of British Industry Distributive Trends Survey reports that in the year to September, retail sales volumes fell for the fifth consecutive month and are expected to ease further in October, albeit it at a slower pace.

GFCF fell by an unrevised 0.9% in the second quarter of 2019, in part reflecting a 2.8% fall in government investment. Business investment also fell by 0.6% in the latest quarter [4], in line with its recent trend of late in which there were four consecutive quarters of decline throughout 2018. This is consistent with a variety of external evidence, including the recent Deloitte CFO Survey which recorded continued corporate caution due to high-risk aversion among businesses centred around the recent political uncertainty. The latest Bank of England's Agents Summary for Quarter 3 2019 recorded a further weakening in investment intentions, which remained at their lowest level in nine years as uncertainty weighed on the appetite to invest with evidence of businesses "reducing, postponing or cancelling projects".

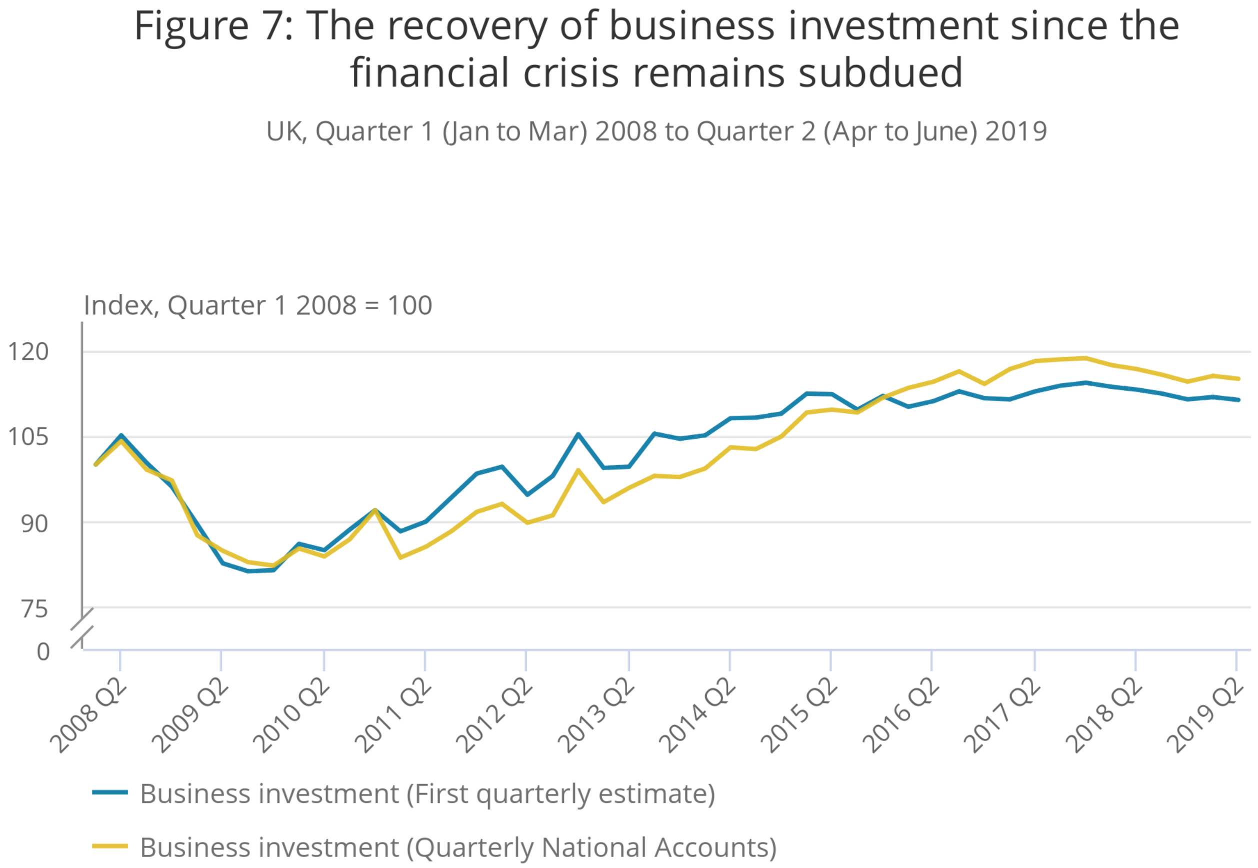
Previous analysis has shown that in each of the previous three UK recessions, there would typically be a pickup in capital spending by businesses at this point in the cycle. However, this is not the case in the period following the 2008 recession. Figure 7 shows the latest estimates of this path since the financial crisis and while there have been some revisions, this narrative is largely unchanged. Business investment is now a little higher at this point compared to the onset of the last recession in Quarter 1 2008, but remains much lower than where it has been in previous cycles, and has largely been flat in recent years.

Given the strength in the labour market and financial market conditions, as well as the experience of previous recoveries in the UK, it is likely that heightened uncertainty about the future trading relationship with the European Union might be weighing on investment intentions. The latest Decision Maker Panel Survey reports that "almost 60% of firms said that Brexit was an important source of uncertainty for their business in August".'

Recent analysis finds that the "anticipation of Brexit is estimated to have gradually reduced investment by about 11% over the three years following the June 2016 vote" relative to what would have been the case otherwise. The findings also show that this is estimated to have reduced UK productivity by between 2% and 5% over this period.

Figure 7: The recovery of business investment since the financial crisis remains subdued

UK, Quarter 1 (Jan to Mar) 2008 to Quarter 2 (Apr to June) 2019



Source: Office for National Statistics

Notes:

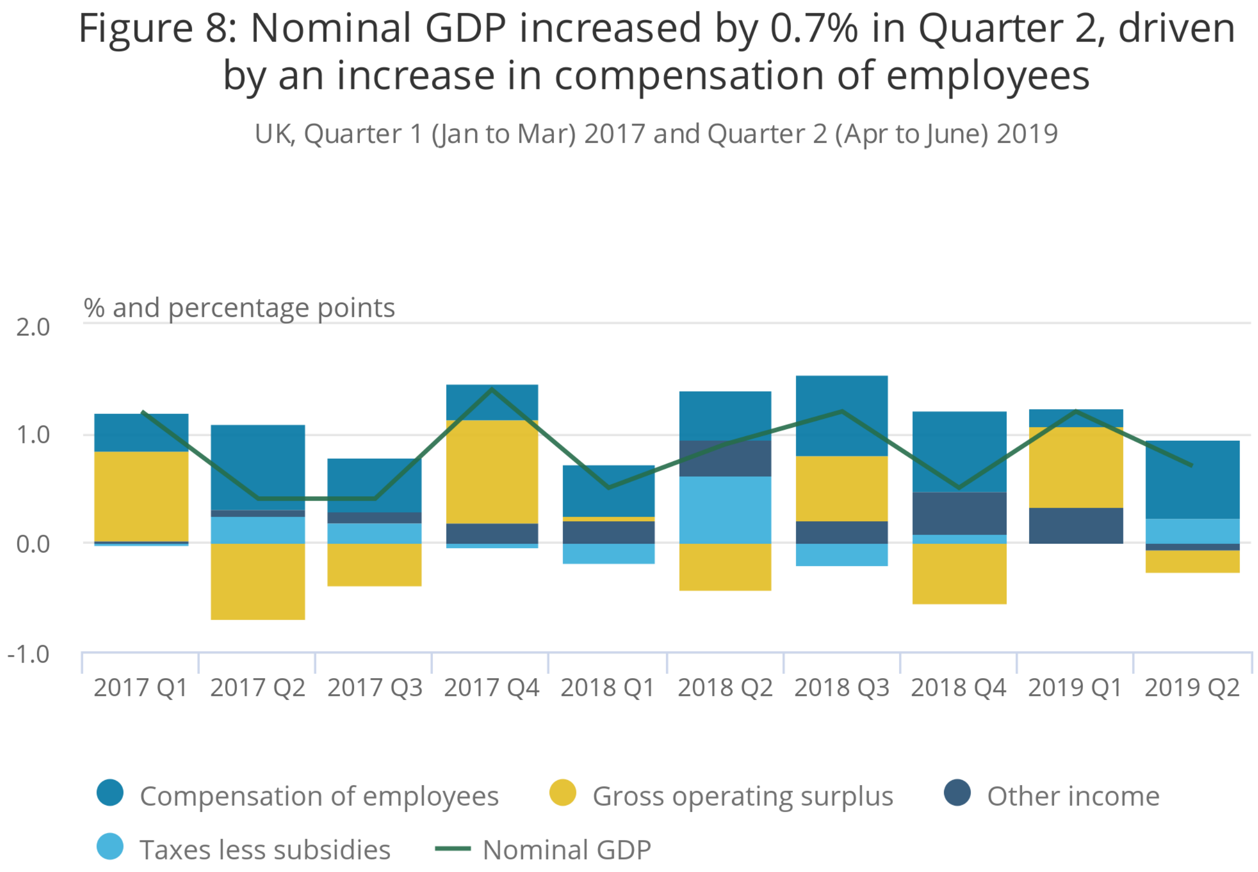
1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (April to June), Q3 refers to Quarter 3 (July to Sept), Q4 refers to Quarter 4 (Oct to Dec).

Income

Nominal gross domestic product (GDP) increased by 0.7% in Quarter 2 (Apr to June) 2019, an upward revision of 0.3 percentage points, following an increase of 1.2% in the first quarter of 2019 (Figure 8). Compensation of employees increased by 1.5% in the latest quarter, picking up from the 0.3% recorded in the first quarter. Gross operating surplus fell 0.9%, a notable slowing from the previous quarter. There have been large revisions to mixed income through 2017 and 2018. The latest figures show a slowing from 3.8% in the first quarter to 0.5% in Quarter 2.

Figure 8: Nominal GDP increased by 0.7% in Quarter 2, driven by an increase in compensation of employees

UK, Quarter 1 (Jan to Mar) 2017 and Quarter 2 (Apr to June) 2019



Source: Office for National Statistics

Notes:

1. Q1 refers to Quarter 1 (Jan to Mar), Q2 refers to Quarter 2 (Apr to June), Q3 refers to Quarter 3 (July to Sept), and Q4 refers to Quarter 4 (Oct to Dec).
2. Chart shows contribution to nominal GDP quarter-on-quarter growth.
3. Components contributions may not sum to total due to rounding.

Notes for: Gross domestic product

1. The latest official estimates of monthly GDP do not reflect the revisions that have been incorporated as part of the latest Quarterly National Accounts published on 30 September. Fully consistent figures will be published on 10 October.

2. Alignment and balancing adjustments are typically applied to the inventories component to help balance the different approaches to GDP. When these adjustments are removed, the underlying figures show a substantial decrease in stocks being held by UK companies in the most recent quarter. Excluding these adjustments, changes in inventories subtracted 1.19 percentage points from GDP growth.

3. Movements in non-monetary gold (NMG) do not affect headline GDP as they are recorded as equivalent offsetting impacts in the UK National Accounts, but they are reflected in the composition of GDP growth. More information on how non-monetary gold features in GDP is available .

4. These figures should be interpreted with some caution as early estimates of business investment can be prone to revision. Furthermore, it should be noted that these estimates are subject to higher levels of uncertainty in this release, reflecting the introduction of International Financial Reporting Standard (IFRS) 16 Leases in January 2019.

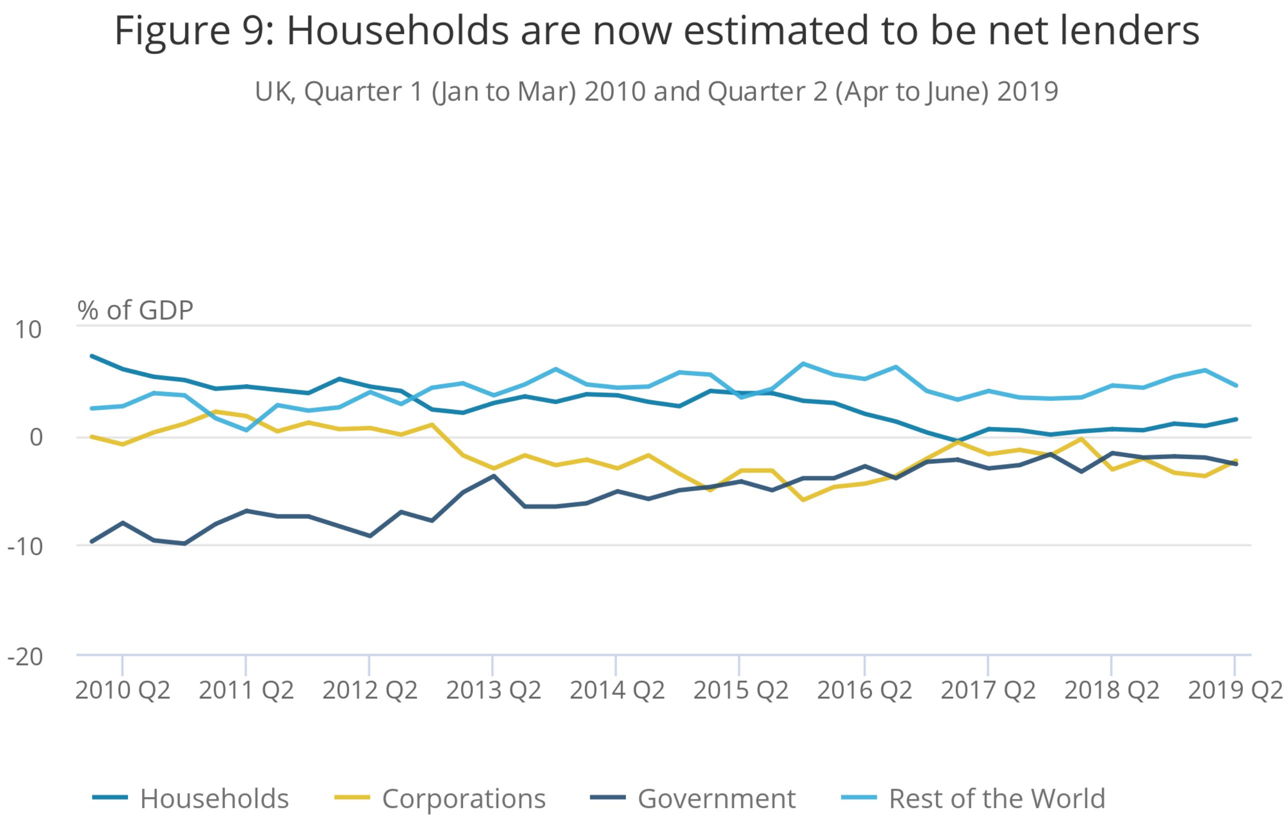
3 . Sector and financial accounts

The paths of sectoral income and expenditure determine whether households (including non-profit institutions serving households), corporations, the government and the rest of the world are net lenders or borrowers. Figure 9 shows these net lending or borrowing positions, which must sum to zero, as total borrowing must be matched by total lending. Previously, there has been a trend that had shown households, corporations and the government had to borrow or run down their savings to finance their spending and investment.

There have been revisions to this picture, specifically that households are now net lenders. This primarily reflects revisions to mixed income, transfers from households to the non-profit institutions serving households and the impacts of a change in the accounting treatment of student loans. In Quarter 2, households are net lenders equivalent to 1.6% of GDP, while net borrowing is 2.3% for corporations and 2.6% for the government. The rest of the world continues to be a net lender to the UK to finance that domestic saving is less than investment.

Figure 9: Households are now estimated to be net lenders

UK, Quarter 1 (Jan to Mar) 2010 and Quarter 2 (Apr to June) 2019



Source: Office for National Statistics – Quarterly Sector Accounts, UK: April to June 2019

The latest figures incorporate a change in the treatment of student loans in the public sector finances and the national accounts. Unlike typical loans, student loan repayments are contingent on borrowers' income and there are conditions in which these student loan obligations may be cancelled. The improved treatment splits this lending into two components: a loan to students, and government spending. The amounts that are expected to be repaid are treated as a financial asset, that is, loans, while the amounts that are not expected to be repaid are treated as a government expenditure, specifically capital transfers to households. As such, there have been revisions to the financial positions of households and government:

- There is an increase in the net borrowing of government, offset by an equivalent decrease in the net borrowing of households;this reflects that "government revenue will no longer include interest accrued that will never be paid; and government expenditure related to cancellation of student loans will be accounted for in the periods that loans are issued rather than decades afterwards".

- There is a fall in the stock of financial assets of government, which is matched by a fall in the stock of financial liabilities of households: this is because only those amounts that are expected to be repaid will now count as a financial asset or liability.

Previously, it had been reported that households had recently become net borrowers, although it is the case that early estimates can be prone to revision, the latest figures show that households are in fact net lenders of 1.6% of GDP in Quarter 2 2019. This partly reflects the reclassification of student loans; there have been upward revisions to gross disposable income, specifically households making lower interest payments overall to government, and households receiving higher capital transfers reflecting those amounts that are no longer expected to be repaid. This has been reflected in lower levels of financial liabilities that are held by households, namely other long-term loans.

There have also been other changes that have come into effect that explain the improvement in the financial positions of households. The main ones include upward revisions to estimates of mixed income and downward revisions to transfers from households to the non-profit institutions serving households. This reflected recent analyses published by the National Council for Voluntary Organisations (NCVO), which found that there has been a fall in donations by households.

The increase in household net lending in Quarter 2 2019 (including non-profit institutions serving households) primarily reflected an increase in in compensation of employees and a fall in income and wealth tax payments. The corresponding financial flows can be volatile, but households primarily financed its increase in net lending in the latest three months by increasing the amount of currency and deposits held.

These improvements have also been reflected in upward revisions to the households' saving ratio, other than the impact of the reclassification of student loans on capital transfers [1] (Figure 10). It is still the case that the saving ratio peaked in 2009 following the effects of the financial crisis as households rebuilt their financial positions. It has trended downwards in recent years, reaching 5.3% in 2017 before picking up to 6.1% in 2018. There has been a level shift to the saving ratio, reflecting the above revisions to gross disposable income. Despite this, the saving ratio is still relatively low by historical standards. In Quarter 2, there was a slight increase in the saving ratio from 6.4% to 6.8%, largely reflecting an increase in wages and salaries.

Figure 10: There have been upwards revisions to the saving ratio in recent years

Source: Office for National Statistics – Quarterly Sector Accounts, UK: April to June 2019

General government was a net borrower in Quarter 2 2019 of 2.6% of GDP. In the latest Economic and Fiscal Outlook published in March of this year, public sector net borrowing (PSNB) is forecast to be 1.1% of GDP this financial year. That said, while these forecasts at the time provide additional headroom against the fiscal mandate, the changes in the accounting treatment of student loans are not reflected in these forecasts. It was expected that this would increase the structural budget deficit by around 0.5% of GDP in the financial year ending 2021; the latest estimates show that the improvement in the accounting treatment of student loans added £12.4 billion to borrowing in the financial year ending 2019.

Furthermore, the latest estimates of Public Sector Finances also incorporate other revisions, including corrected estimates of Corporation Tax. This has had a net effect of increasing borrowing by £2.6 billion in the financial year ending 2019, and a change to the recording of public sector pensions. As such, like-for-like comparisons between these forecasts and latest outturns are not straightforward.

The latest figures show that PSNB is now estimated to have been £41.4 billion in the financial year ending 2019, revised from £23.6 billion. PSNB was £6.4 billion in August, lower than a year ago. However, borrowing in the financial year to date was £31.2 billion, which is £6.8 billion higher than a year ago reflecting relatively higher borrowing over the first four months of this financial year. The latest analysis by the Office for Budget Responsibility states that "it now seems likely that borrowing will exceed our restated March forecast for the financial year ending 2020", and includes an adjustment to its forecast for the treatment of student loans to improve comparability.

There was a fall in the net borrowing of corporations from 3.7% to 2.3% in Quarter 2. This primarily reflected an improvement in the financial positions of private non-financial corporations (PNFC), who reduced their net borrowing from 1.9% to 0.6%. This primarily reflected a fall in gross capital formation, which is likely to reflect to some extent the range of external surveys that provide evidence that uncertainty has weighed on capital spending. There was also evidence that there have been changes in the timing of activity related to the UK's original planned exit date from the European Union in late March, as stockpiling that was taking place in the first quarter of the year seem to have been run down in Quarter 2.

There have been some notable movements in non-monetary gold earlier in the year, which appears to have unwound in the latest quarter. Given the volatile nature of financial flows, quarterly movements in how borrowing is financed are not necessarily an indication of underlying trends. That said, the fall in borrowing was financed by a rise in currency and deposits of £29.3 billion, which follows the record fall in the first three months of the year. The net borrowing of financial corporations was largely unchanged in Quarter 2 at 1.7%.

Notes for: Sector and financial accounts

1. Capital transfers are excluded from the calculation of the saving ratio.

4 . Balance of payments

The UK current account deficit demonstrates the extent to which it is borrowing from the rest of the world. Overseas investors have historically been net lenders to the UK, shown in the low levels of national saving to finance national investment. As such, the UK is reliant on external financing so that it can finance the overall net borrowing position of the domestic sectors of the UK economy. In recent years, this has widened to levels that are high by historical and international standards, raising concerns around whether the UK can rely on record high levels of external financing to help fund its domestic expenditure.

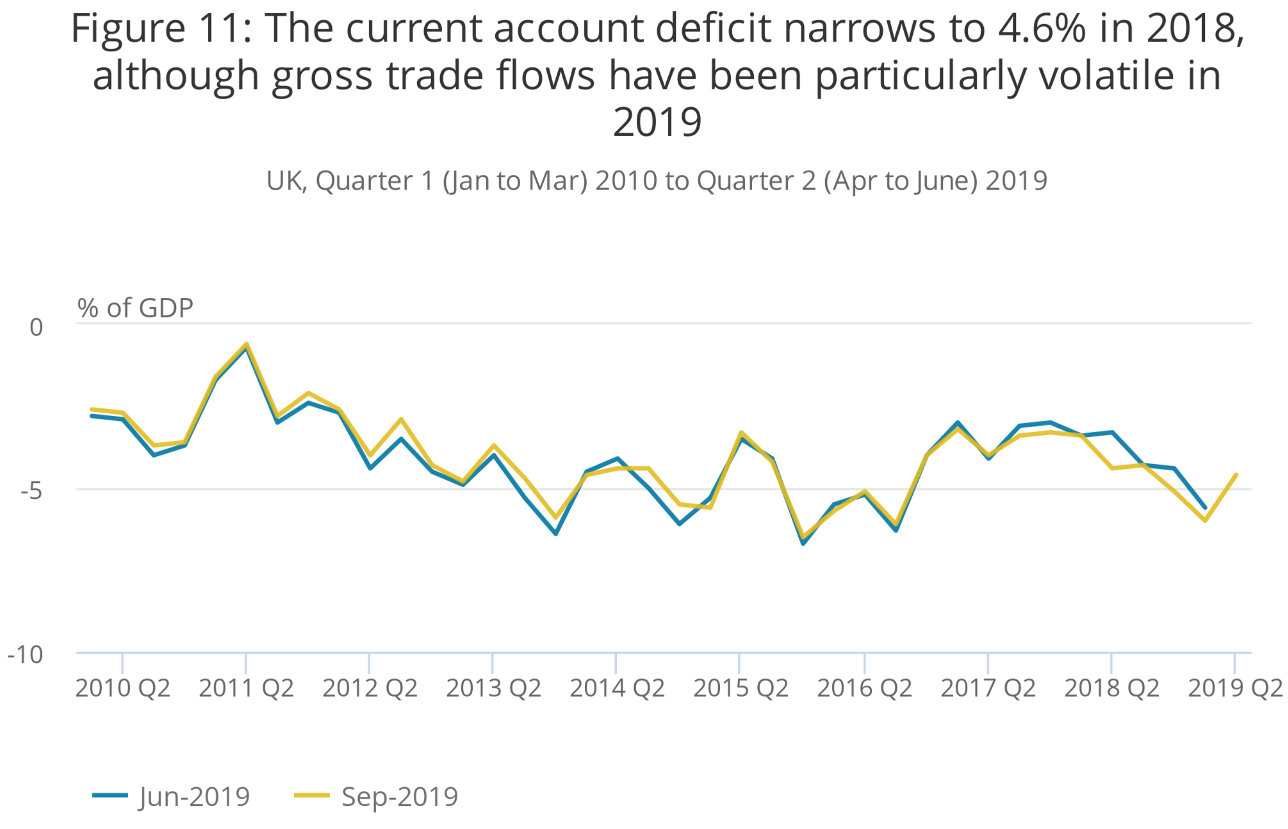
These concerns have been further heightened by the uncertainty over the future of the UK's trading arrangements. In periods of increased uncertainty, foreign investors may be less willing to lend to the UK. In its latest assessment of risks to the public finances, the Office for Budget Responsibility explains that "if investors' confidence in the UK economy were damaged, this could lead to a sharp fall in sterling causing an abrupt demand-led narrowing of the current account deficit". The latest Financial Stability Report outlines that there could be a such a fall in investor confidence "by perceptions of weaker or more uncertain UK long-term growth prospects or a significant change in the global risk environment".

There have been some volatile movements in gross trade flows in the first half of this year. This in part reflects the large increase of trade in unspecified goods, including non-monetary gold (NMG). Activity consistent with stockpiling by UK and European businesses in anticipation of the UK's original exit date from the European Union at the end of March 2019 has also affected export and import flows. Furthermore, early estimates can be prone to revision – Figure 11 shows the impact of the latest revisions, which show a worsening in how much the UK is a net borrower from the rest of the world.

These most recent movements may not necessarily be a good indication of the underlying external position. That said, the reliance on external finance remains elevated by historical standards. Having widened to a revised 6.0% of GDP in the first quarter of this year, the UK current account deficit narrowed to 4.6% in Quarter 2, driven by movements in the trade deficit. In recent years, movements in the UK's net investment income have been quite volatile. There was a larger increase in earnings paid out to foreign investors holding direct and other investment in the UK.

Figure 11: The current account deficit narrows to 4.6% in 2018, although gross trade flows have been particularly volatile in 2019

UK, Quarter 1 (Jan to Mar) 2010 to Quarter 2 (Apr to June) 2019



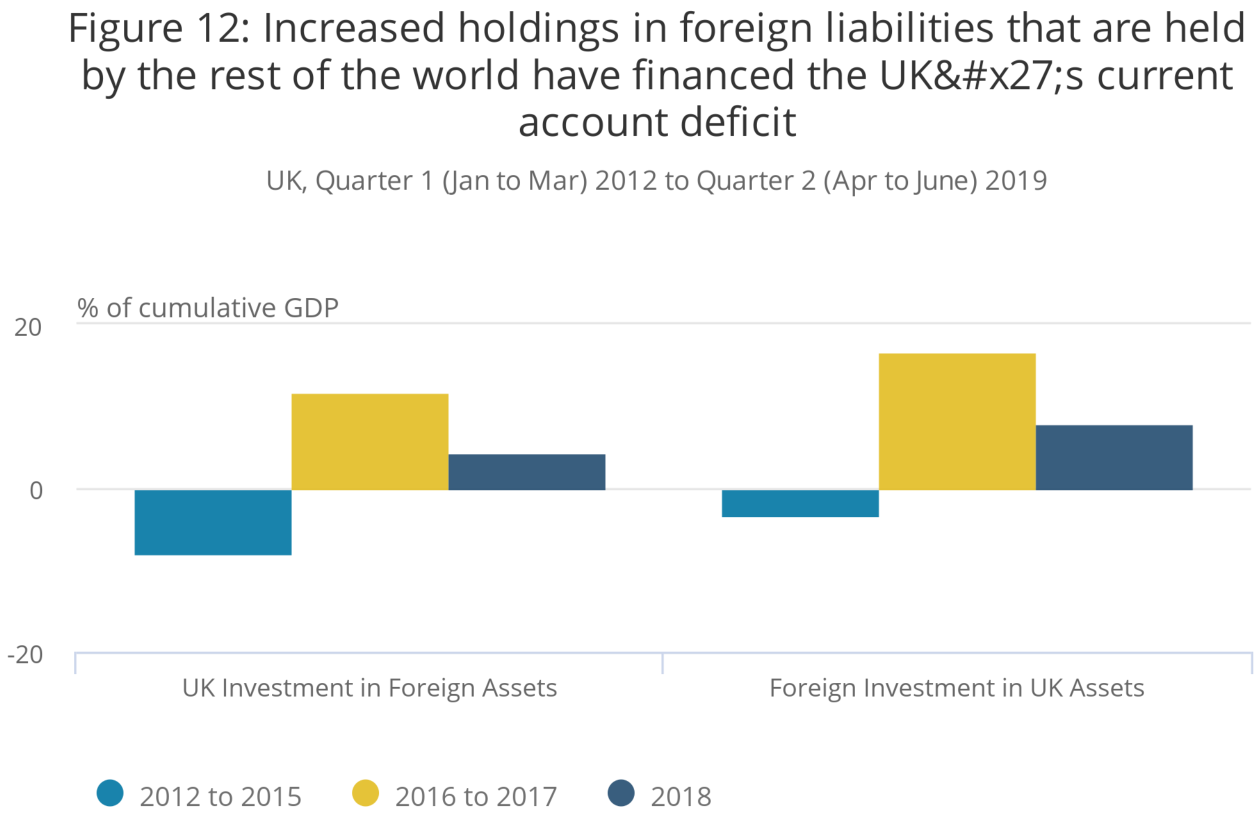
Source: Office for National Statistics – Balance of Payments, UK: April to June 2019

A current account deficit must be financed by net financial inflows, which can be achieved by the UK increasing liabilities to the rest of the world and/or disinvesting in previously owned foreign assets. Figure 11 shows how the UK's current account deficit has been financed in recent years, providing some historical context around the size of these flows. Between 2012 and 2015, the UK's external borrowing was generally being financed by UK investors selling more of their external assets than foreign investors were selling their UK assets. This overall financing position has since reversed, resulting in a large volume of foreign capital inflows – that is, an increase in the accumulation of financial liabilities to finance the current account deficit.

The latest Financial Stability Report highlights that this reliance on such foreign capital inflows leaves "the UK vulnerable to a reduction in foreign investor appetite for UK assets, which could lead to a tightening in credit conditions for UK households and businesses". This may be particularly relevant for the commercial real estate, and leveraged loan markets may be particularly exposed, given its exposure to foreign investment. The Bank of England reports that there is some evidence of reduced appetite for UK-focused equities since the EU Referendum, while the evidence is more mixed for UK corporate bonds.

Figure 12: Increased holdings in foreign liabilities that are held by the rest of the world have financed the UK's current account deficit

UK, Quarter 1 (Jan to Mar) 2012 to Quarter 2 (Apr to June) 2019



Source: Office for National Statistics – Balance of Payments, UK: April to June 2019

Financial flows in and out of the UK tend to be particularly volatile. This has been evident in recent quarters, where there have been pronounced swings in the flows of capital between the UK and the rest of the world. In Quarter 2 2019, the UK increased its liabilities to the rest of the world, specifically in direct and portfolio investment. It has been the case that there have typically been net inflows of direct and portfolio investment into the UK from foreign investors, but this position had reversed in the first quarter of the year. It is possible that this might have reflected a shift in the appetite of foreign investors, given the original deadline for the UK's withdrawal from the European Union.

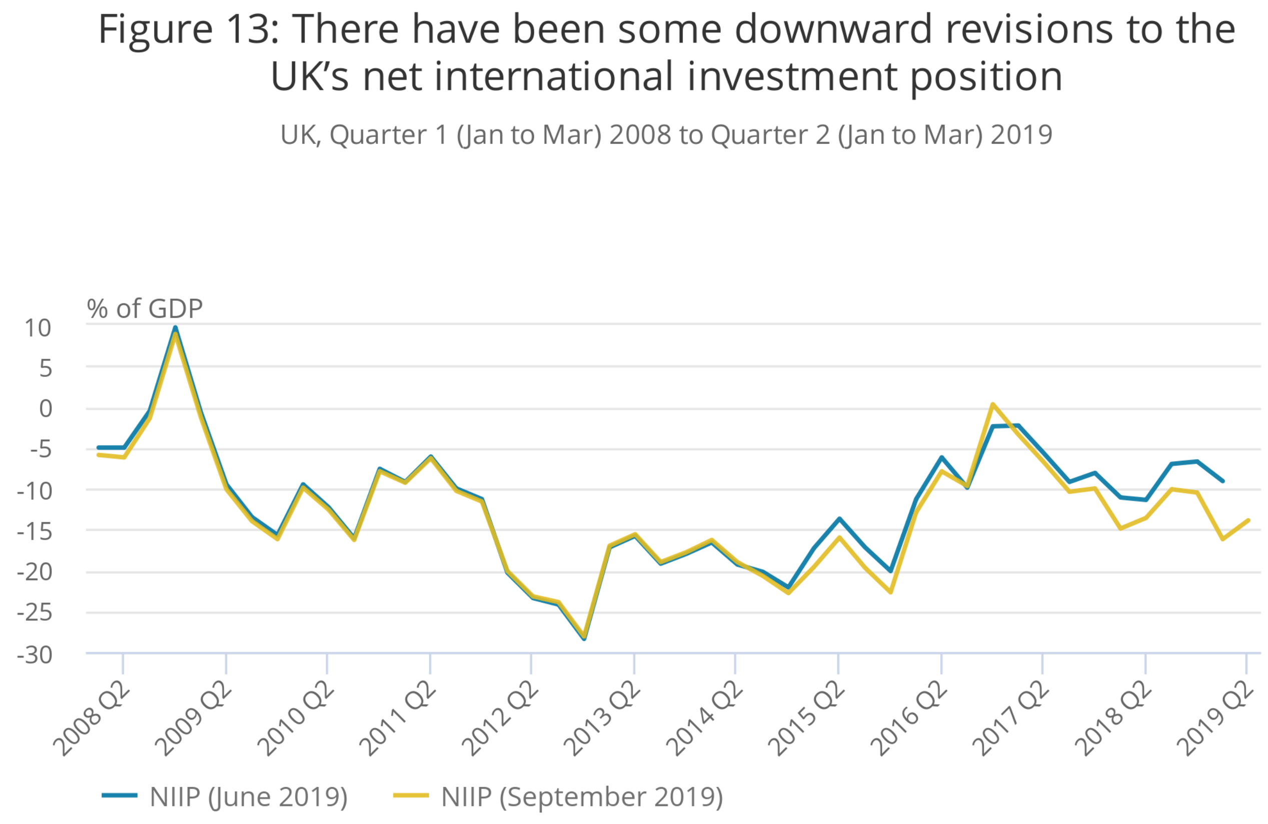
This may also help provide some context as to why there was a return to net inflows of these types of investment in Quarter 2 to help finance its borrowing from the rest of the world. Other investment tends to be the most mobile form of capital, comprising mainly short-term loans and deposits. These flows have been particularly volatile over the last couple of years. There were large withdrawals by foreign investors in Quarter 2 2018 and Quarter 3 2018, followed by large gross inflows in late 2018 and early 2019. However, this position has reversed once more, with there being a withdrawal of other investment in the latest quarter.

Given the openness of the UK economy, foreign investors have large holding of UK assets, with the latest figures showing that these external liabilities are 544% of annualised GDP as of the end of Quarter 2 2019. That said, the UK investors also hold a large volume of external assets, such that the net liability position is now 13.9% (Figure 13). In its latest assessment, the [Office for Budget Responsibility] notes that UK's net liability position is "modest" as a share of GDP, reducing the risk of the UK running a large current account deficit.

While this remains relatively modest by historical standards, there have been some revisions to the net liability position in recent periods. It is also the case that the currency mismatches on the UK's external balance sheet would likely reduce some of the risk associated with a currency depreciation.

Figure 13: There have been some downward revisions to the UK's net international investment position

UK, Quarter 1 (Jan to Mar) 2008 to Quarter 2 (Jan to Mar) 2019



Source: Office for National Statistics – Balance of Payments, UK: April to June 2019

5 . Labour market

In sharp contrast to the latest figures of capital spending, the UK labour market shows a continued resilience despite prolonged uncertainty in the economy. The latest headline figures for the three months to July appear to show a labour market that remains tight. The employment rate is at a joint record high 76.1%, while the unemployment rate is at 3.8% – its lowest figure since late 1974 – and is now slightly below some estimates of the natural rate of unemployment. Workers are more likely to move between jobs voluntarily when there are low levels of spare capacity. Job-to-job flows have recovered from the levels following the financial crisis and have stabilised, albeit slightly below pre-crisis rates.

While there is external evidence, such as the [Labour Market Outlook](), that points to recruitment difficulties and hard-to-fill vacancies, there are also some signs that this pace of tightening is now easing. This may be reflecting the uncertainty in the domestic and global economies weighing on demand and supply.

It is expected that employers are expected to offer higher wages in a tight labour market, as they compete over a smaller pool of available resource. While still below its pre-crisis rates, this tightness is now showing up in higher nominal wage growth. Total pay increased by 4.0% in the year to three months to July, the fastest increase since the middle of 2008. Regular pay increased by 3.8% over the same period, a slight easing in part reflecting one-off payments that were made to some NHS staff in April 2019, whose impact is not included in the latest three-month period.

The latest analysis by the National Institute of Economic and Social Research estimates that regular nominal pay growth will stabilise at slightly below 4% in Quarter 3 of this year, reflecting "survey evidence of a softening in hiring activity". This was corroborated by the Agents' Summary of Business Conditions, which highlighted "weaker employment intentions; lower staff churn; economic uncertainty and budget constraints, and a moderation in consumer price inflation" as pay pressures are expected to ease.

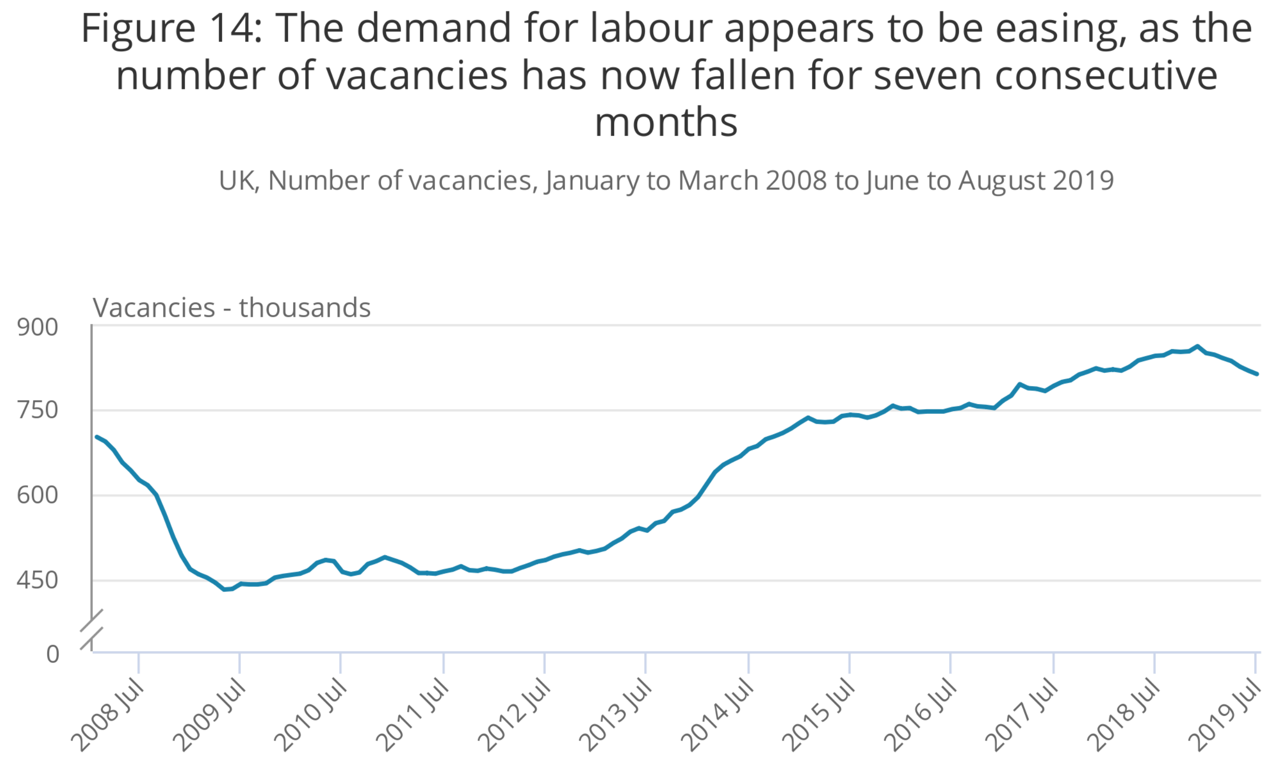
Previous analysis showed that there is a tendency for hiring and capital spending tend to follow each quite closely but that has not been the case recently. While the employment figures still point to labour demand being resilient, that has not been the case for business investment. This may reflect that firms may be more likely to substitute labour for capital in periods of elevated uncertainty, particularly if it is the case that it is easier and/or less costly to reverse hiring decisions. Analysis by the Bank of England shows there has been a trend of subdued capital spending in the G7 economies post-financial crisis, citing global policy uncertainty which may have been further compounded by "increased Brexit uncertainties" in the UK.

While employment increased by 31,000 from the three months to April to the three months to July, this has softened through the year so far. Employment grew by 0.1% in the three months to July, in line with the previous three-month period, but has slowed from the rates seen in late 2018 to early 2019. This softening has been more marked for full-time employees. The latest Inflation Report explains that this easing in employment growth may be because it is harder for businesses to recruit, given the smaller pool of available labour, or it may be that it reflects a slowing in underlying GDP growth.

Vacancies provide an alternative measure of the difficulty with which employers would be able to fill jobs. If there are relatively few unemployed people to the number of vacancies available, it would imply a tight labour market. The unemployment-to-vacancies ratio remains low by historical standards, although the number of vacancies has continued to ease through the year, which has now fallen for seven consecutive months with the number of vacancies 6% lower than its all-time high from earlier this year (Figure 14). There are signs that there is now an easing in the demand for labour.

Figure 14: The demand for labour appears to be easing, as the number of vacancies has now fallen for seven consecutive months

UK, Number of vacancies, January to March 2008 to June to August 2019



Source: Office for National Statistics

The evidence from external surveys also provides some evidence that the labour market might be cooling off slightly. The latest Report on Jobs by the [Recruitment and Employment Confederation](#) (REC) finds that the number of permanent staff appointments fell for the sixth consecutive month in August, falling at its fastest rate for over three years. This was attributed to some employers choosing to “postpone staff hiring amid heightened political and economy uncertainty”. While demand for staff did pick up in August, it rose at its weakest pace since early 2012. The latest figures also showed that labour supply continued to fall, albeit at a slower rate than in the previous month, driven by a decline in permanent candidates. The REC highlighted how there was a reluctance to seek new roles given the uncertain outlook. The [National Institute of Economic and Social Research](#) note that “the employment dynamics in manufacturing reflect a global trend to do with trade uncertainty while weaker employment growth in services than in other countries is consistent with the amplification of Brexit uncertainty”.

The latest [Agents’ Summary of Business Conditions](#) provides further evidence of a stabilisation in the labour market, with employment intentions for the year ahead being very slightly negative, as respondents cited “slower economic growth, uncertainty about the economic outlook and a desire to improve productivity to protect profit margins”. While recruitment difficulties remain high, there had been an easing of late. The tight labour market was cited as one possible explanation, while skill shortages and fewer migrants from the European Union were also offered as possible reasons.

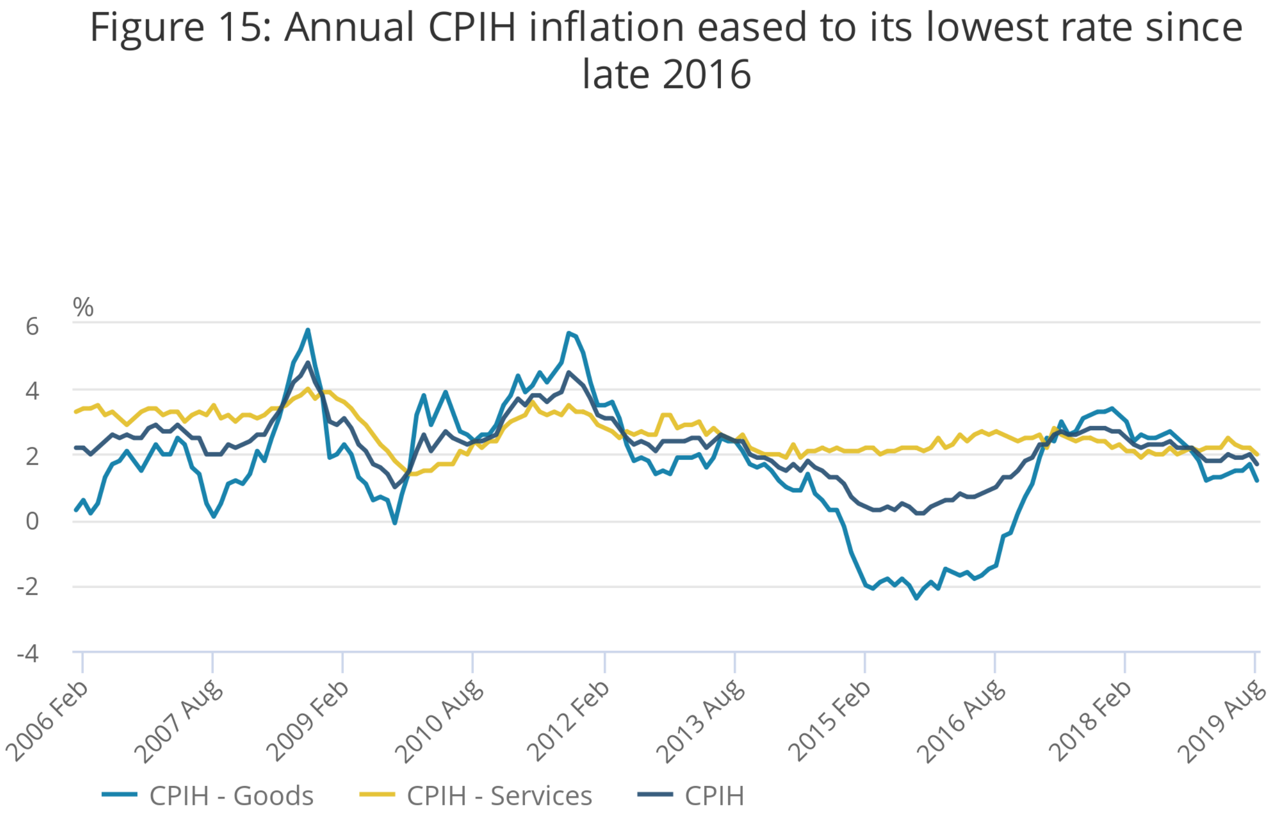
6 . Prices

The latest figures show that there was an easing in the annual Consumer Prices Index including owner occupiers' housing costs (CPIH) inflation rate to 1.7% in August. This was down from 2.0% in the previous month, marking the lowest rate of inflation since November 2016 (Figure 15). There was also an easing in the Consumer Prices Index and core inflation over the same period. Based on an analysis of almost 130,000 locally collected goods and services prices in the August index, the National Institute of Economic and Social Research found that "fewer firms raised prices than is typical for this time of year" as it might be that "firms are probably waiting to see beyond 31 October before adjusting prices".

As goods tend to be more import intensive than services, analysis of its respective inflation rates can provide some insight into trends in external and domestic price pressures. Having risen markedly, as the sterling value of imported final and intermediate goods increased in response to the large fall in the exchange rate, CPIH goods price inflation has fallen back since the beginning of 2018. It eased further to 1.2% in the year to August – the rate was last lower in January 2017.

At face value, this is slightly at odds with the increase in the buildup of wage pressures. When groups of products are categorised by import content, the overall inflation rate for those with an import content of at least 40% continues to be relatively muted compared to that experienced through 2017 and 2018. The contribution of those components that have a low import content – that is, an import content of 0-10% – was at its lowest rate since March 2017, providing some evidence of an easing in domestically generated inflation. CPIH services price inflation, which eased to 2.0% over the same 12-month period was the joint lowest experienced over the previous 12 months.

Figure 15: Annual CPIH inflation eased to its lowest rate since late 2016



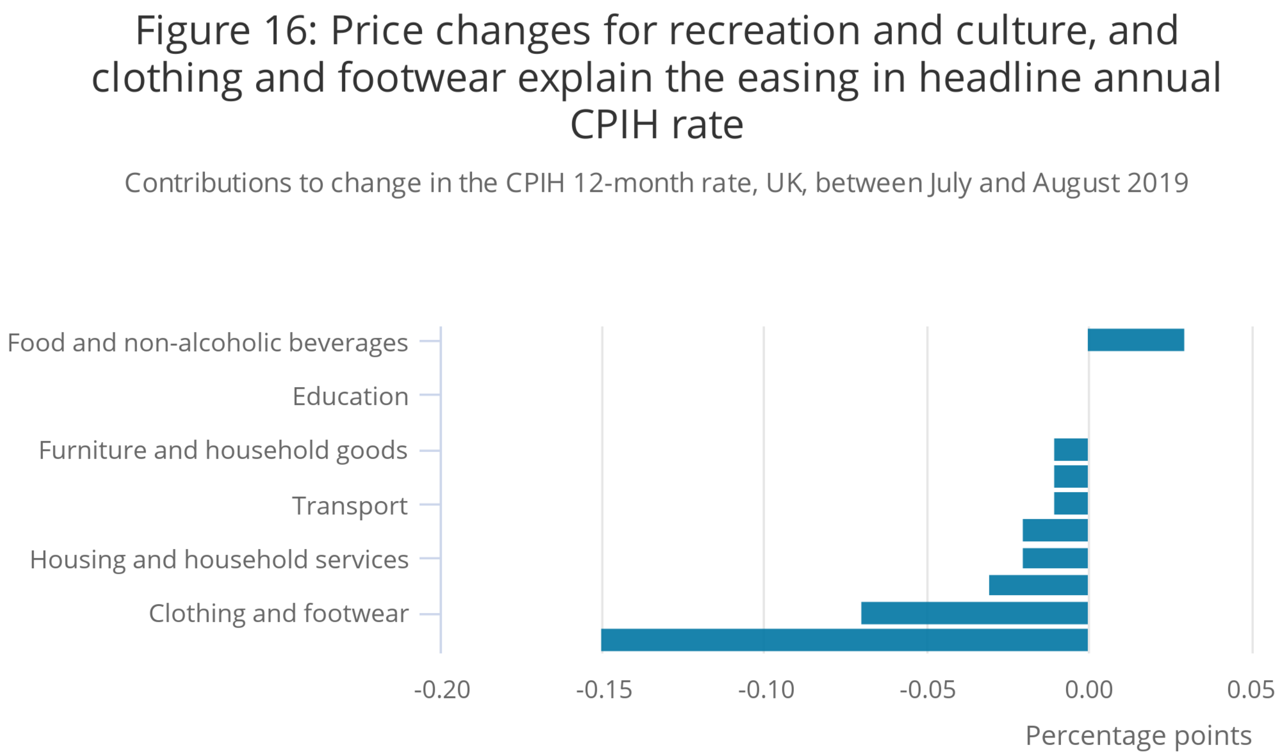
Source: Office for National Statistics - Consumer Price Inflation, UK: August 2019

There was a broad-based easing in annual price pressures on the month, with the largest downward contributions in recreation and culture and clothing and footwear (Figure 16). The former was largely driven by a 5.0% fall in the price of games, toys and hobbies (particularly computer games) between July and August, compared with a smaller fall of 0.1% over this same period a year ago. That said, the price movements of computer games can often be relatively large, reflecting the composition of bestseller charts. For example, this downward move follows a large upward monthly contribution in the previous month.

While clothing prices increased on the month, this was a smaller increase than in the same period a year ago and so exerted downward pressure on the headline CPIH rate. Movements reflect to some extent the level of seasonal price reductions at this time of year as the autumn range of clothing tends to enter shops following the summer sales season. However, price rises were smaller this year reflecting the relative proportion of items on sale this year compared to last year.

Figure 16: Price changes for recreation and culture, and clothing and footwear explain the easing in headline annual CPIH rate

Contributions to change in the CPIH 12-month rate, UK, between July and August 2019



Source: Office for National Statistics - Consumer Price Inflation, UK: August 2019

7 . Conclusions

The latest estimates show that the UK economy contracted 0.2% in Quarter 2 (Apr to June) 2019, following an increase of 0.6% in the first quarter of the year. However, there has been much volatility in the first half of this year, in part reflecting changes in the timing of activity related to the UK’s original planned exit date from the European Union in late March.

The rest of the world continues to be a net lender to the UK to finance that domestic saving is less than investment. While corporations and the government continue to be net borrowers, households are now estimated to be net lenders. There have also been upward revisions to the saving ratio, although this remains low by historical standards. This reflects revised estimates of mixed income, transfers from households to the non-profit institutions serving households, and the impacts of a change in the accounting treatment of student loans.

In Quarter 2, households are net lenders equivalent of 1.6% of GDP, while net borrowing is 2.3% for corporations and 2.6% for the government. The current account deficit narrowed to 4.6% GDP in Quarter 2 2019, largely reflecting the unwinding of volatile movements in non-monetary gold (NMG) early in the year. Financial flows in and out of the UK tend to be particularly volatile, which has been particularly evident through 2018 and into the first quarter of this year. In Quarter 2 2019, the UK increased its liabilities to the rest of the world, specifically in direct and portfolio investment.

There are no clear signs of uncertainty weighing on the labour market, as the tightness can be seen in a range of labour market indicators. In the three months to July, the employment rate remained at a record high 76.1%, while the unemployment rate hit 3.8%. While the unemployment-to-vacancies ratio remains low by historical standards, the number of vacancies has now fallen for seven consecutive months. Regular pay increased by 3.8% in the year to the three months to July.

The annual Consumer Prices Index including owner occupiers' housing costs (CPIH) inflation rate eased to 1.7% in August. This was down from 2.0% in the previous month, marking the lowest rate of inflation since November 2016. There was a broad-based easing in annual price pressures on the month, with the largest downward contributions in recreation and culture and clothing and footwear.

Notes for: Conclusions

1. The latest official estimates of monthly GDP do not reflect the revisions that have been incorporated as part of the latest Quarterly National Accounts published on 30 September . Fully consistent figures will be published on October 10.