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UK economy

Recession continued in Q2, but rate of decline slowed

- **UK GDP down 0.8% q/q, following 2.4% reduction in Q1.**
- **Differences in coverage play some role in explaining recent divergence between GDP and PMI data.**

United Kingdom gross domestic product (GDP) contracted 0.8% q/q in Q2, according to preliminary data from the Office for National Statistics (ONS). Although pointing to a steep easing in the rate of contraction compared to the 2.4% decline in Q1, the Q2 fall was far sharper than economists had generally been expecting. The market consensus, according to Reuters, was for a fall of just 0.3%.

The contraction was also steeper than implied by the PMI surveys. On 3 July, a Markit commentary note observed that a weighted combination of the Output Indices from the three UK PMI surveys averaged 49.4 in Q2, up from 40.8 in Q1. A simple linear regression of the all-sector PMI output data against GDP indicates that, historically, the Q2 reading was in fact consistent with an increase in GDP of 0.1%.

However, we also noted that “with the actual declines in GDP in the final quarter of last year and Q1 far greater than had been signalled by the PMI, any interpretation of the stronger PMI readings in Q2 need to be treated with extreme caution, and it seems likely that GDP will have continued to contract in Q2, but at a much reduced rate”.

Part of the difficulty in using the PMI to estimate GDP lies in the difference in coverage. The PMIs cover activities in the construction, manufacturing and private services sectors, which account for around 60% of GDP. They do not, however, cover output in agriculture, extraction activities, utilities production, retail, and government. Some of these sectors registered particularly disappointing performances in Q2.

Government output fell 0.2%, following growth of 0.2% in Q1. Agriculture registered a fall of 2.3% compared to

Chart 1: All-Sector PMI Survey

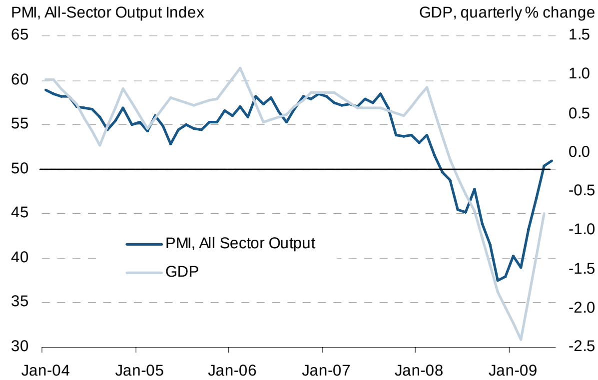

Chart 2: PMI Output by Sector

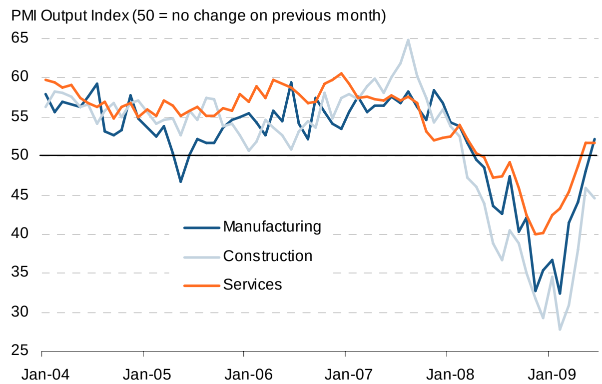

Table 1: Examples of UK GDP revisions (q/q % chg)

Q4 ’98	Initial:	0.2%
	Latest:	1.1%
Q1 ’00	Initial:	0.4%
	Latest:	1.2%
Q1 ’01	Initial:	0.3%
	Latest:	1.1%
Q1 ’02	Initial:	0.1%
	Latest:	0.8%
Q2 ’03	Initial:	0.3%
	Latest:	0.9%

Sources: Markit Economics, Office for National Statistics (ONS) a 0.1% decline in Q1, while utilities production – electricity, gas and water – saw a 3.8% decline (a slight acceleration on the 3.7% contraction in Q1).

Stripping out theses sectors to arrive at an "adjusted" GDP reading for Q2 that is broadly consistent with the PMI coverage shows that private sector output fell 0.4% q/q compared to a 3.8% decline in Q1.

There is also a strong possibility that the initial estimate of GDP in Q2 may be revised up. The grounds for this are:

(a) Historically, initially weak GDP data tend to overstate weakness (see table 1). Provisional early estimates of GDP were not published in previous recessions so it is not possible to see how sharply negative (rather than weak) GDP numbers tend to get revised, but on the basis of recent history, upward revisions to recent numbers seem likely.

(b) The sector where PMI and GDP data differ most is services, and in particular business services and finance (see Box 1). The services economy is where the ONS has typically appeared to have the greatest difficulty estimating growth if the scarcity of detailed and timely official data for this sector is anything to go by. For example, a monthly index of services output was only released as a national statistic in 2007 and remains under review.

(c) The ONS first estimates of GDP are derived only from production data available for the first two months of the quarter and partial information for the third month from all main sectors of the economy. PMI data show that June was the strongest of the three months of Q2 (the all sector Output Index rose from 50.4 in May to 51.0).

Box 1: GDP Sector Breakdown

- The PMIs and GDP data are both consistent with an easing in the rate of contraction of the manufacturing sector. The PMI Manufacturing Output Index averaged 48.1 in Q2, up from 36.8 in Q1 but still below the no-change level of 50.0, so signalling contraction but at a sharply reduced rate. The ONS estimate that manufacturing output fell 0.3% in Q2 compared to a 5.5% decline in Q1.
- There also appears to be little difference between PMI and GDP data for construction. The PMI's index of activity for the construction sector rose from an average of 31.1 in Q1 to 42.8 in Q2, consistent with the marked easing in the GDP estimate for this sector, which showed the rate of decline slowing from -6.6% in Q1 to -2.2% in Q2.
- Where the PMIs seem to differ most from the GDP estimates is for the service sector, were the PMI averaged 50.7 in Q2, rising above the 50.0 level from 43.7 in Q1 to indicate very modest growth. GDP data for the sector, on the other hand, showed a 0.6% decline in Q2 following a 1.6% contraction in Q1. However, this is the sector where differences in coverage between the PMI and GDP are the greatest.

In conclusion, GDP data have signalled a steeper recession than the PMIs, but both have indicated a substantial easing in the rate of decline in Q2. We remain wary of early GDP estimates, and suspect upward revisions to recent data are likely and that a return to growth in Q3 remains on the cards.

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