Chief Economist's Weekly Brief

The Royal Bank of Scotland Group

Short Back and Sides, Sir?

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Private investors in Greek government bonds shied away from an agreement to accept just half of the capital they lent in the first place and take a lower interest return on the remaining debt. The haircut alone was less of a trim than a short back and sides, but if Greece defaults these investors risk a scalping, in the form of losing all of their money. Whether Greece will qualify for the bailout it needs is now in question and has unsettled markets again, despite the better news from Ireland last week. The Irish government managed to bring its deficit down well below the level needed to qualify for its next bailout and looks to be in safer territory as a result – at least for now.

UK inflation fell at its fastest rate in three years in December. Lower petrol, gas and clothing prices brought the UK CPI inflation rate down to 4.2%y/y in December - its lowest level since December 2008. This fall was expected, but it will be no less welcome at the Bank of England for that. This news adds credibility to its long held view that high inflation is temporary. A further drop January, as the effects of higher oil prices and VAT drop out of the annual comparisons, will push inflation down further and weaker economic growth should mean that its close to its target by the end of the year.

UK unemployment rose to 2.86 million in November. Unemployment rose by 118,000 in the three months to November, bringing the UK rate up 8.4%. The shocking thing is that the rise in the last three months accounts for two-thirds of the 169,000 rise in the last year. It's still youth unemployment that is taking the strain. The rate for 16-24 year olds, excluding those in education, rose to 20.7% in November. It's a quite different picture for older workers. The rate in the 35-49 age group is just 5.5% and for those 50-64 it is 5.2%. Such high levels of youth unemployment are bad news for the UK's future skills base and productive potential. But in the short term, lower unemployment in the home-owning age range is certainly good news for stability in the housing market.

UK earnings growth slowed slightly in November and consumer confidence fell again. UK average weekly earnings growth slowed to 1.8%y/y from 2.1%y/y in October, with similar contractions in both the public and private sectors. Slower wage growth is bad news for households and consumer spending. But its worse with high inflation. Even though inflation is coming down, real earnings growth is still negative - to the tune of about 2.5%y/y. It's no wonder that consumers' confidence fell again in December according to the Nationwide. Not surprisingly its survey showed that consumers' expectations about the future economic situation had deteriorated the most.

UK retail sales are remarkably resilient. In spite of the all of the headwinds UK shoppers spent just over £42 billion in December 2011. This is up 6.2% y/y or 2.6% y/y if we strip out price increases and the "best" December for five years. Automotive fuel and clothing and footwear were the big drivers. Unsurprisingly things were less buoyant in household goods where sales fell 3.6%y/y in volume terms. Nevertheless, this is very upbeat news given the conditions retailers are facing.

IMF asks for more contributions. Another sign that the Eurozone crisis isn't over yet came from IMF Chief Executive Christine Lagarde. She asked members to contribute another $500bn in loans to its fund in anticipation of the need for up to $1 trillion in bailouts. Apart from the political arguments about who will and won't contribute, the request doesn't add to confidence that the crisis may be nearing an end.

US CPI inflation rate slowed in December. The annual rate of inflation fell to 3.0% in December, from 3.4% the previous month. Just like the UK, US inflation is expected to slow in the months ahead as high oil prices, which have been a big factor in higher than expected consumer price inflation, fall out of the equation.

China's economic growth at its slowest pace since 2009. The world's second largest economy grew by 8.9%y/y in Q4. This robust growth was probably influenced by higher than usual production and retail sales because of the early Chinese New Year. Its contribution brought the overall growth rate in 2011 to 9.2%y/y, down from the 10.4% in 2010. This isn't much of a slowdown by global standards. But recent survey data suggests the brakes are still on. January's Purchasing Managers Index showed a contraction in manufacturing for the third month in a row. This modest slowing in growth it is expected to continue into 2012 – hardly a roaring start to the Year of the Dragon.

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