Markit Economic Research

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United Kingdom

First quarter GDP shows strongest annual rise since 2007

- **GDP rises 0.8% in Q1, up 3.1% on a year ago**
- **Economy set for strong year as recovery broadens out**
- **Data revisions could spark increased debate over spare capacity and policy response**

The UK economy is enjoying its best spell of growth since 2007, with strong expansion in the first quarter setting the scene for a robust year of growth in 2014.

Today's data will not affect policy. After all, the Bank of England's economists had pencilled in 1.0% GDP growth in the first quarter, yet not one member of the Monetary Policy Committee saw any need to tighten policy at the latest meeting.

However, such unanimity is surprising given the strength of the economy, and it would be even more surprising if discussions at the MPC did not start to heat up in coming months. Forthcoming revisions to GDP could in fact mark a turning point in the Bank's policy guidance.

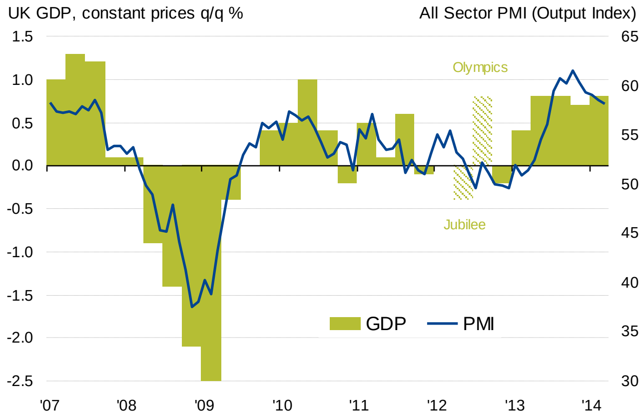
Fastest annual GDP growth since 2007

The economy grew 0.8% in the first quarter of 2014, according to initial estimates of gross domestic product from the Office for National Statistics, a pace of expansion which is all the more remarkable for having occurred despite extreme weather, including flooding, which affected many parts of the country.

The quarterly expansion pushed GDP 3.1% higher than a year ago, the fastest annual rate of growth since the final quarter of 2007.

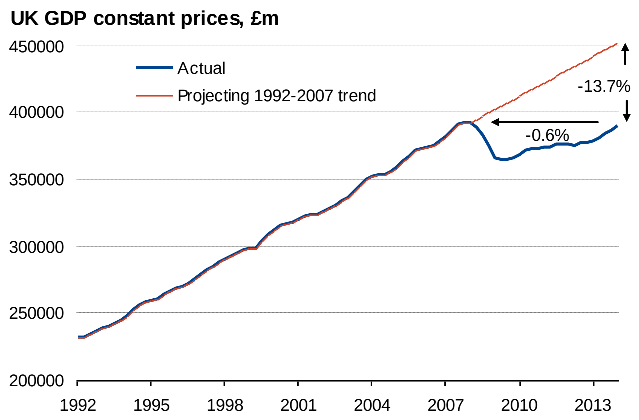
Manufacturing production surged 1.3% higher in the first three months of the year, and service sector output rose 0.9%. The disappointments, which caused GDP to come in below consensus expectations of 0.9%, were all in sectors where weather may have hit activity and are therefore areas which are likely to rebound in the second quarter. Construction output rose a mere 0.3%, agriculture saw a 0.7% fall in output, extractive industries, such as energy, saw production fall 1.1%, and electricity and gas supply dropped 2.0%.

GDP and the PMI® compared



Sources: ONS, Markit.

'Recovery' to date



Sources: Markit, ONS

The latest expansion builds on robust increases in the previous three quarters and leaves GDP just 0.6% below its pre-crisis peak. With further robust growth likely in the second quarter of 2014, the economy is therefore set to surpass its pre-crisis peak in the summer.

Let the good times roll, for now

The outlook for the rest of the year looks positive for the UK economy, which is projected to expand by 3.0% or more, which would be the best year since 2007, when GDP expanded by 3.4%.

The improving outlook reflects signs that the economic growth engine should start to fire on all cylinders:

household spending should be boosted by falling unemployment and rising real wages; business investment should start to rise in earnest as companies are finally feeling confident that the upturn is genuine and sustainable, freeing up cash that has been hoarded in recent years due to uncertainty; and a recovery in our largest export market, the eurozone, should boost trade flows.

Importantly, higher interest rates are not expected to act as the usual kill-joy to the growth being enjoyed in 2014. The Bank of England has indicated that it does not expect to raise interest rates until next year at the earliest. Strong growth such as that currently being experienced would normally trigger higher interest rates to ward off future inflation, but policymakers believe that large amounts of spare capacity mean that stronger than usual growth can be tolerated without resulting in higher prices, at least until much of this spare capacity gets used up.

Uncertainty over spare capacity

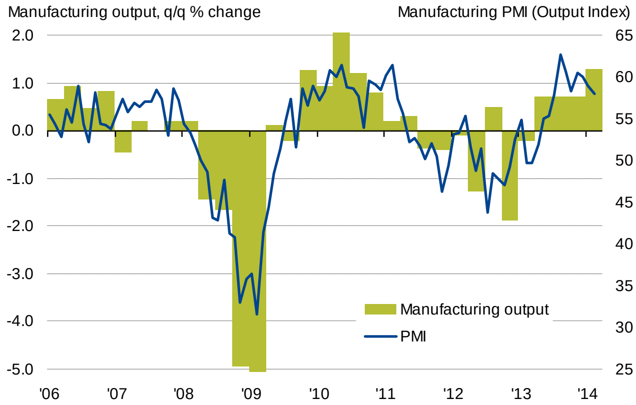
The policy discussion is likely to heat up, however, as the view on how much spare capacity exists gets challenged.

At 6.9%, unemployment has fallen below the Bank's prior forward guidance threshold of 7.0%, and wage growth is starting to creep higher. Upward price pressures could therefore start appearing later this year.

In addition, there may in fact already be a lot less spare capacity than currently estimated, meaning the Bank could bring forward its expectation of when interest rates may need to start rising. We expect growth in the final quarter of last year to eventually be revised higher than the current 0.7% estimate from the ONS, further closing the gap on the pre-crisis GDP peak, as more data become available on the performance of companies, especially in construction, towards the end of last year.

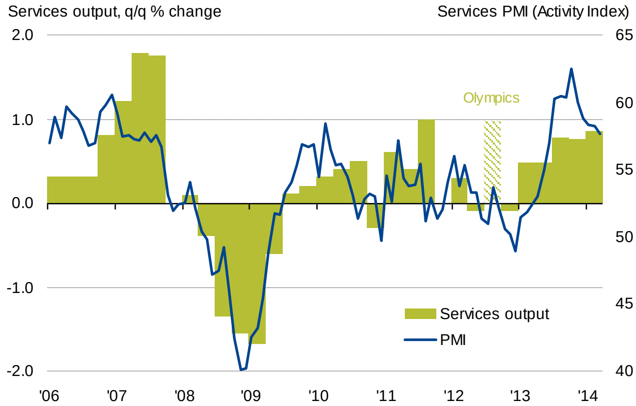
Perhaps more importantly, in terms of the spare capacity debate, the ONS has already indicated that forthcoming revisions to GDP methodology mean that data updates in the autumn are likely to show that the recovery to date has been stronger than previously estimated, meaning that we may in fact already be above the pre-crisis peak. If the Bank of England needed a reason to back-track on its forward guidance, these revisions could be the perfect excuse.

Manufacturing



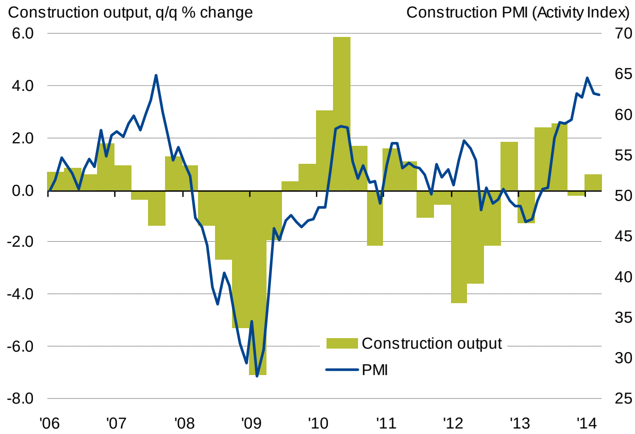
Sources: Markit, ONS.

Services



Sources: Markit, ONS.

Construction



Sources: Markit, ONS.

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