Rabobank

Country Report

UNITED KINGDOM

Summary

The UK economic recovery is struggling amid the harsh fiscal squeeze. A significant slowdown in the pace of recovery, which will possibly have adverse spill-over effects to the banking sector, is a major risk, in our view. The good news is that the UK policymakers can still announce a credible budgetary plan B – slowing the pace of spending cuts or introducing temporary tax cuts – if debt metrics fail to improve due to significantly slower economic growth.

Things to watch:

The economic impact of the austerity measures

The strength of the property market

The developments in banking sector reforms and profitability

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United Kingdom

National facts	
Type of government	Constitutional monarchy
Capital	London
Surface area (thousand sq km)	243
Population (millions)	61.8
Main languages	English
	Scots
Main religions	Christian (71.6%)
	Muslim (2.7%)
	Hindu (1%)
Head of State (president)	Queen Elizabeth II
Head of Government (prime-minister)	David Cameron
Monetary unit	Pound (GBP)

Economy	2010	
Economic size	*bn USD*	*% world total*
Nominal GDP	2273	3.65
Nominal GDP at PPP	2150	2.91
Export value of goods and services	661	3.54
IMF quotum (in mln SDR)	10739	4.94
Economic structure	*2010*	*5-year av.*
Real GDP growth	1.4	0.5
Agriculture (% of GDP)	1	1
Industry (% of GDP)	22	23
Services (% of GDP)	77	76
Standards of living	*USD*	*% world av.*
Nominal GDP per head	36532	372
Nominal GDP per head at PPP	34555	296
Real GDP per head	37319	466

Social and governance indicators	rank / total
Human Development Index (rank)	26 / 169
Ease of doing business (rank)	4 / 183
Economic freedom index (rank)	16 / 179
Corruption perceptions index (rank)	20 / 178
Press freedom index (rank)	19 / 178
Gini index (income distribution)	36
Population below $1.25 per day (PPP)	N/A

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
US	15	Germany	13
Germany	11	US	10
France	8	China	9
Netherlands	8	Netherlands	7

Main export products (%)	
Machinery & transport equipment	30
Chemicals & related products	20
Mineral fuels, lubricants & related materials	11
Food, drinks & tobacco	6
Main import products (%)	
Machinery & transport equipment	30
Chemicals & related products	13
Food, drinks & tobacco	10
Mineral fuels, lubricants & related materials	10
Openness of the economy	
Export value of G&S (% of GDP)	27
Import value of G&S (% of GDP)	30
Inward FDI (% of GDP)	3.3

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economy

The UK economic recovery has been very sluggish given the enormity of the output collapse in 2009 (-4.9%). Unfortunately, the outlook is highly uncertain. Household indicators suggest that British consumers are going through a very tough time while they are strengthening their balance sheets. Home prices and real wages are still falling, credit conditions are not improving and the labour market is deteriorating further. To add insult to the injury, the government will carry out one of the toughest austerity measures amongst the advanced economies. Between 2010 and 2015, the IMF forecasts that, out of 29 advanced economies, only Greece will see a sharper decline in its cyclically-adjusted primary budget balance. This will undoubtedly pose substantial downside risks to economic growth. So far, the government believes that the economy is sufficiently flexible and robust to grow at a modest rate, even in the face of private and public sector deleveraging. Admittedly, business investment may surprise on the upside in response to strong profits growth and large cash balances. Of course, many firms may wish to postpone investment decisions while capacity is lying idle and there is still much uncertainty about the outlook for demand.

If domestic demand remains weak, the authorities hope that robust external demand will take its place. The significant depreciation of the sterling – down nearly 25% since the start of the crisis – certainly makes the UK exporters well-positioned to benefit from stronger foreign demand. But we must not forget that the beleaguered peripheral eurozone countries, which are collectively a bigger UK export destination than the US, will weigh on Britain's export performance. Hence, it remains yet to be seen whether the external sector will give the economy the support it needs to withstand the sharp fiscal squeeze that lies ahead. Until now, the contribution of net exports to growth has been nothing short of disappointing given the weakness of the sterling.

Given that inflation has overshot the Bank of England's (BoE) target for more than a year now, we deem it highly unlikely that the central bank will take more measures to offset the contractionary impact of public spending (e.g. through more quantitative easing). Note that three of the nine members of the BoE MPC are already voting for a rate hike even though there are no real signs of underlying domestic price pressures nor risks of second-round effects. Such premature rate hike will make life even more difficult for the Britons given the predominance of floating rate mortgages, which will feed rate hikes rapidly through to households. High inflation is currently posing another headache for the policymakers given the importance of inflation-linked gilts in the UK's debt stock (they account for more than one-fifth of the total public debt outstanding).

Banking Sector

The outlook for the banking system remains negative. This reflects a number of weaknesses in the system. First, the elevated uncertainty about the UK economy and the resulting downside risks to asset quality remains a concern. We expect the challenging macroeconomic environment, combined with a high level of consumer indebtedness, to weigh on banks' asset quality. We should note that renewed price falls in the property market – after experiencing a brief recovery last year – could trigger further losses in the banking sector (Lloyds and RBS would be especially vulnerable). Second, the high level of refinancing of wholesale funding over the next 1-2 years will remain a challenge. According to the Bank of England, around GBP 400bn to GBP 500bn of UK bank term debt is due to mature by the end of 2012 (to put this into perspective, major banks issued around GBP 150bn of term debt in public markets in 2009 and 2010). Finally, the high level of public sector indebtedness combined with the harsh austerity measures inflicted on the broader public means the political will for bailing out British banks in the future has diminished considerably. The UK government already bears the burden of its massive interventions in the banking sector as it still owns loss-making mortgage bank Northern Rock and has major equity stakes in Lloyds (41%) and RBS (84%). Another source of concern is the UK bank's relatively large exposure to the "peripheral" countries (Spain, Greece, Ireland and Portugal). At the end of June 2010, the UK banking sector accounted for 7.2% of the total exposure of BIS-reporting banks to the periphery countries, equivalent to 12.4% of UK GDP and 2.6% of total assets of UK banks.

There are some positive points concerning the banking sector as well. The six largest UK banks reported a high level of loan losses and credit market write-downs over the past two years but have since strengthened their balance sheets with more capital. Since the beginning of the financial crisis, the UK banking system has raised about £151.3bn in equity capital (120.7% of cumulative losses to date), half of which was public funding (£74.6bn). As a result, the weighted average Tier 1 ratio of the large UK banks increased from 7.9% at the end of 2007 to 12.3% at the end of H1 2010. In addition, although UK banks were historically some of the largest issuers of hybrid capital, the banks are now focused on building up their core Tier 1 ratios (weighted average core Tier 1 was 10.2% in 10H1).

United Kingdom

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	2.8	2.7	-0.1	-4.9	1.4	1.3	2.0
Consumer prices (average % change pa)	2.3	2.3	3.6	2.2	3.3	3.9	2.4
Current account balance (% of GDP)	-3.3	-2.5	-1.5	-1.7	-2.3	-1.8	-1.2
Economic growth							
GDP (% real change pa)	2.8	2.7	-0.1	-4.9	1.4	1.3	2.0
Gross fixed investment (% real change pa)	6.4	7.8	-5.0	-15.4	3.5	4.1	3.0
Private consumption (real % change pa)	1.8	2.2	0.4	-3.2	1.1	0.4	1.5
Government consumption (% real change pa)	1.4	1.3	1.6	1.0	1.2	-1.2	-1.6
Exports of G&S (% real change pa)	11.1	-2.6	1.0	-10.1	5.6	5.9	5.7
Imports of G&S (% real change pa)	9.1	-0.8	-1.2	-11.9	8.4	4.2	2.5
Economic policy							
Budget balance (% of GDP)	-2.6	-2.7	-4.9	-11.3	-10.1	-9.1	-7.6
Public debt (% of GDP)	43	44	52	68	76	80	84
Money market interest rate (%)	4.8	6.0	5.5	1.2	0.7	1.1	1.8
M2 growth (% change pa)	13	12	16	5	6	5	7
Consumer prices (average % change pa)	2.3	2.3	3.6	2.2	3.3	3.9	2.4
Exchange rate LCU to USD (average)	0.5	0.5	0.5	0.6	0.6	0.6	0.7
Recorded unemployment (%)	5.4	5.3	5.6	7.6	7.9	8.2	8.0
Balance of payments (mln USD)							
Current account balance	-81950	-71080	-41160	-37050	-53000	-43800	-30200
Trade balance	-140660	-179740	-173460	-128560	-148100	-135400	-123200
Export value of goods	447590	442280	468150	356350	408700	467900	495400
Import value of goods	588240	622010	641600	484900	556800	603300	618600
Services balance	60970	85530	84140	73640	76800	84700	91300
Income balance	19550	50250	74630	40650	44600	34400	30200
Transfer balance	-21820	-27110	-26490	-22790	-26300	-27500	-28500
Net direct investment flows	68490	-126020	-69630	30070	58870	39230	-5680
External position (mln USD)							
Total foreign exchange reserves	40698	48958	44348	55702	68345	N/A	N/A
International investment position	-757400	-647400	-148000	-492800	N/A	N/A	N/A
Total assets	11890700	15519200	16007400	14056700	N/A	N/A	N/A
Total liabilities	12648100	16166600	16155400	14549500	N/A	N/A	N/A
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-5.7	-6.4	-6.5	-5.9	-6.5	-5.7	-5.0
Current account balance (% of GDP)	-3.3	-2.5	-1.5	-1.7	-2.3	-1.8	-1.2
Inward FDI (% of GDP)	6.3	7.2	3.5	3.3	3.2	3.2	2.9
International investment position (% of GDP)	-30.9	-23.0	-5.5	-22.6	N/A	N/A	N/A

Source: EIU