Economic Update United Kingdom

10 January 2012

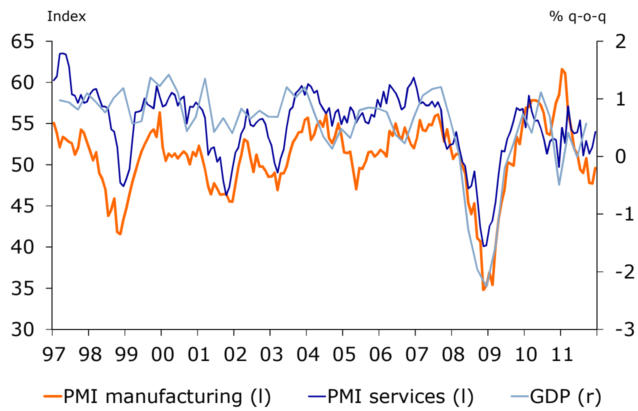
We started off 2012 in a jolly mood

Year-on-year change (%)	'10	'11	'12
Gross Domestic Product	1.4	1	1
Private consumption	0.7	-½	¼
Government expenditure	1.3	½	-1¼
Private investment	3.7	1¾	5
Exports	5.2	6¼	5¼
Imports	8.8	1¼	2
Inflation	3.3	4¼	2
Unemployment (%)	8.0	7¾	8¼
Government balance (% GDP)	-10.4	-8½	-7
Government debt (% GDP)	77.2	83	85

Source: Reuters EcoWin, Rabobank

- We kick-started the new year with a slew of positive news. December's leading indicators were stronger than expected, which indicate that the economy may have gained a bit of momentum going into 2012.
- The planned discretionary fiscal consolidation measures in 2012/13 will continue to weigh on output even if they are half as big as 2011/12.
- Worries concerning UK's loss of AAA rating are overdone, in our view. Only a major macro shock may result in a downgrade.
- Inflation dropped further in November 2011 and we expect this trend to continue this year.
- The BoE is expected to extend its asset purcase programme next month by GBP 50bn.

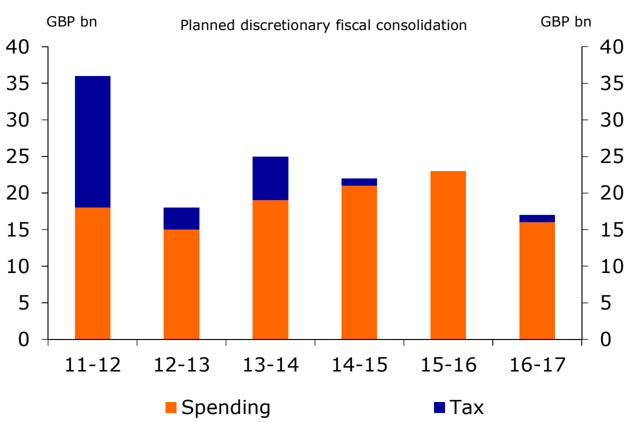
Is recession a done deal?



Source: Reuters EcoWin

The December's leading indicators got the data flow at the beginning of 2012 off to a relatively good start. The increases in the services PMI (from 52.1 to 54), the manufacturing PMI (from 47.7 to 49.6), the construction PMI (from 52.3 to 53.2) and the CBI distributive trades survey (from -19 to +9) is indicative of an encouraging pick-up in economic momentum. Of course, reading too much into a single month's data is unwise. But we have to admit that the evidence so far does not suggest that a recession is inevitable. Should external demand not weaken significantly going forward (e.g. due to the escalation of the eurozone crisis), the UK economy might manage to avoid a recession altogether.

Fiscal belt-tightening continues to be a drag, but less



Source: HM Treasury

The Autumn Report suggested that the government has no plans to backtrack on its harsh austerity measures. The only piece of good news is that the fiscal squeeze will not be as big this year as it was in 2011. The total value of the discretionary fiscal consolidation in 2012/13 will be GBP 18bn (equivalent to around 1.2% of GDP) compared to GBP 36bn in 2011/12. Then again, the austerity drive is set to remain a significant drag on the recovery in 2012 and beyond. To us, the government continues to be too optimistic in believing that the simultaneous retrenchment of the public and private sector will not hurt growth, and if it does, the Bank of England (BoE) will in some miraculous way pump-prime the economy.

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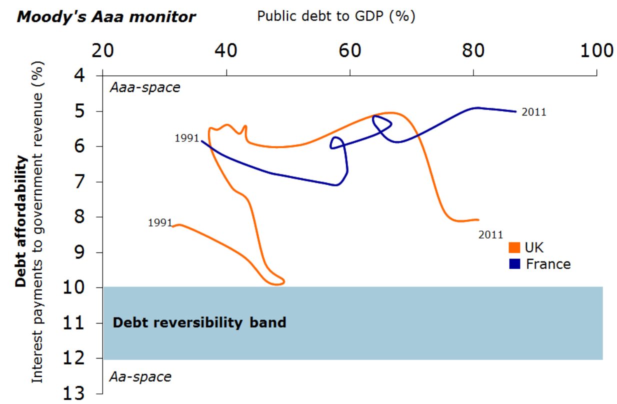
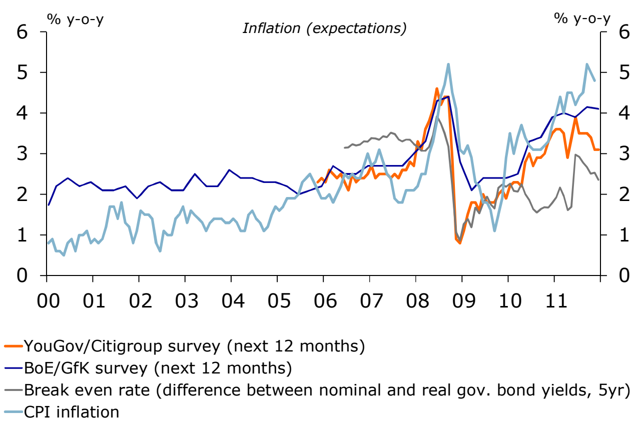
Is France's attack on the UK's AAA rating justified?



Source: Reuters EcoWin, Rabobank

The governor of the Banque de France recently caused some furore by stating that the rating agencies "*should start by downgrading the UK*" due to its poorer fiscal fundamentals. There is some truth to this statement. But why are rating agencies less worried? The most important reason is that the BoE can always buy gilts to avoid a costly sovereign default. The ECB won't be as forthcoming for any euro member. What's more, the UK government has set concrete austerity measures until 2016/17 whereby France has only concrete measures for 2012. This by no means implies that the UK's AAA rating is written on stone. A major shock may be enough to tip the balance in favour of a downgrade.

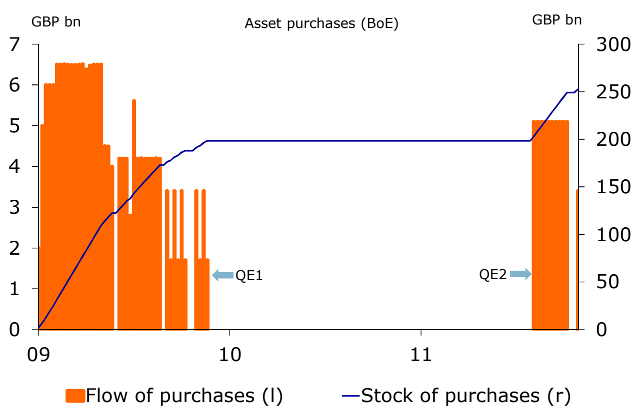
Inflation peaked in September, as expected…



Source: Reuters EcoWin

November's inflation figure provided further hope that inflation has now passed its peak. CPI inflation fell from 5% in October to 4.8%. The fall in core inflation from 3.4% to 3.2% was also a relief. Although the core rate is obviously above the BoE inflation target, it has probably been pushed up by the indirect effects of higher commodity prices. In any case, we still maintain the view that UK's (core) inflation will drop considerably this year owing to weaker domestic demand growth, falling commodity prices and statistical 'base effects'. This is why households' inflation expectations seem to be stabilising (BoE/GfK survey) or falling (YouGov/Citigroup survey). The break-even inflation rate (5yr) is also on a downward trend.

The BoE is expected to extend the QE2 program



Source: Bank of England, Rabobank

The minutes of December's MPC meeting suggested that the door remains open to more quantitative easing. The more dovish members continued to note that "*a further expansion of the asset purchase programme might well become warranted in due course*." The worries stemmed from the weakness in the labour market and strains in bank funding markets. Against this backdrop, we expect the QE programme to be extended by GBP 50bn in February, taking the total stock of asset purchased to GBP 323bn (accounting for almost one-third of total public debt outstanding). Thereafter, a wait-and-see mode will probably prevail until economic visibility improves.

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