Rabobank

Economic Update United Kingdom

8 August 2012

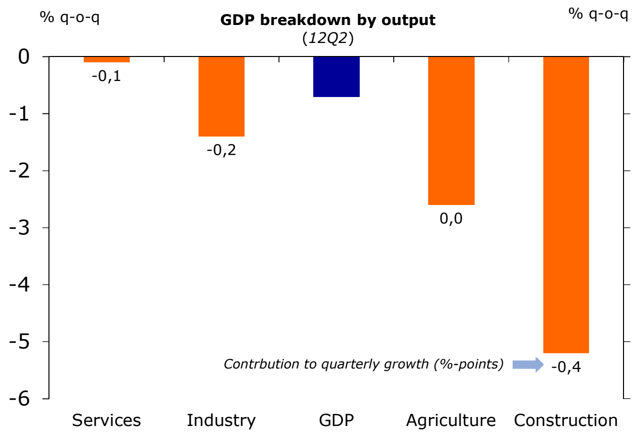
Recovery to remain unimpressive

Year-on-year change (%)	'11	'12	'13
Gross Domestic Product	0.8	-¼	1¼
Private consumption	-1.0	½	1¾
Government expenditure	-1.2	-¼	-2
Private investment	1.1	4½	3
Exports	4.4	½	4½
Imports	0.5	2	4¼
Inflation	4.5	2½	2
Unemployment (%)	8,2	8¼	8¼
Government balance (% GDP)	-8.5	-8	-6½
Government debt (% GDP)	82.5	88¼	91½

Source: Reuters EcoWin, Rabobank

- UK GDP contracted by a whopping 0.7% q-o-q in 12Q2. This was largely due to the Diamond Jubilee and an extremely wet weather.
- The final GDP data may be revised upwards as some reliable indicators were pointing to smaller contraction in the second quarter.
- Going forward, output is expected to rebound in 12Q3 due to the unwinding of the statistical bank holiday effect and the boost from the Olympic games.
- Inflation resumed its downward trend in June.
- The Bank of England extended its quantitative easing programme in July. In our view, this will not materially alter the outlook unless banks start lending again.

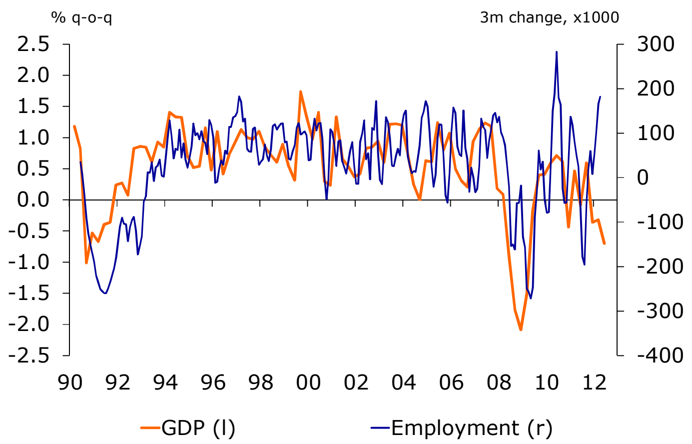
UK GDP: Shock, Horror



Source: ONS

We had pencilled in a minor contraction in UK GDP in 12Q2 due to the extra bank holiday. But the eye-watering 0.7% q-o-q contraction caught almost everyone by surprise, including us. As we mentioned before, the Bank of England (BoE) expected the Queen's Diamond Jubilee to lower GDP growth by around 0.5%-point in Q2. If this estimate is correct, then there has been some underlying contraction too. The unusually bad weather is partly to blame. Mind you that Q2 was the wettest second quarter in the UK since records began in 1910. The GDP-breakdown shows that the construction sector was particularly hard hit. The drop in construction output managed to single-handedly shave 0.4%-point off growth.

Will GDP data eventually be revised upwards?



Source: Reuters EcoWin

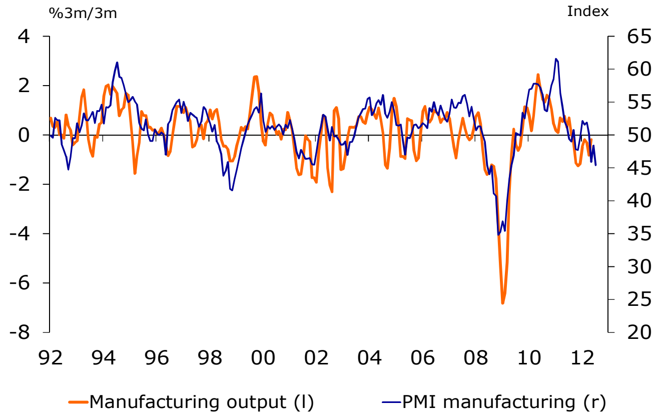
These temporary factors make it difficult to assess the underlying strength of activity. Even the statistical agency (ONS) admitted that the preliminary estimate was subject to "*greater uncertainty than usual*", which increases the chances of a revision to the GDP data. We expect a small upward revision when more output data become available because the weakness of growth is difficult to reconcile with some other reliable indicators of economic activity. For one, employment rose by 182,000 in the three months to May – the largest 3-month rise in nearly two years. Of course, this may be partly explained by the impact of the Olympics. Moreover, PMIs in Q2 were also consistent with stronger GDP growth.

www.rabobank.com/economics

Shahin Kamalodin
Tel. +31 (0)30 – 2131106
S.A.Kamalodin@rn.rabobank.nl

8 August 2012

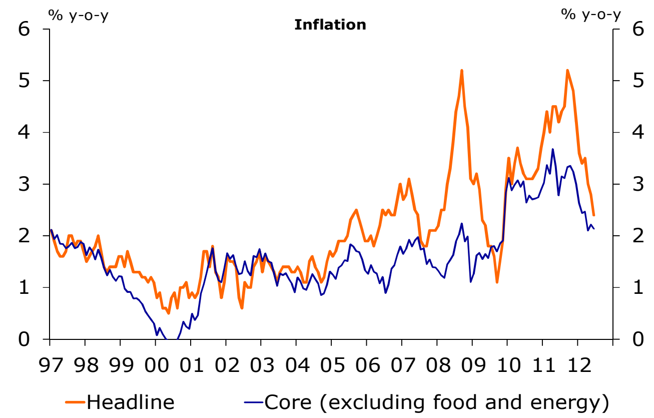
Output may rebound strongly in 12Q3



Source: Reuters EcoWin

We must stress that any revisions to the GDP data are unlikely to alter the big picture, which is that the pace of UK's economic recovery since the 2008 crisis has been exceptionally disappointing. Going forward, output is expected to rebound in 12Q3 thanks to the unwinding of the statistical bank holiday effect and the boost from the Olympic games. At the same time, July's PMI data suggested that the economy made a poor start to the third quarter. The manufacturing PMI dropped from 48.4 to 45.4 – its lowest level since May 2009. The dip in the services PMI from 51.3 to 51.0 took it to its lowest level since the end of 2010. This suggests that the risks to our rosy forecast in 12Q3 are tilted to the downside.

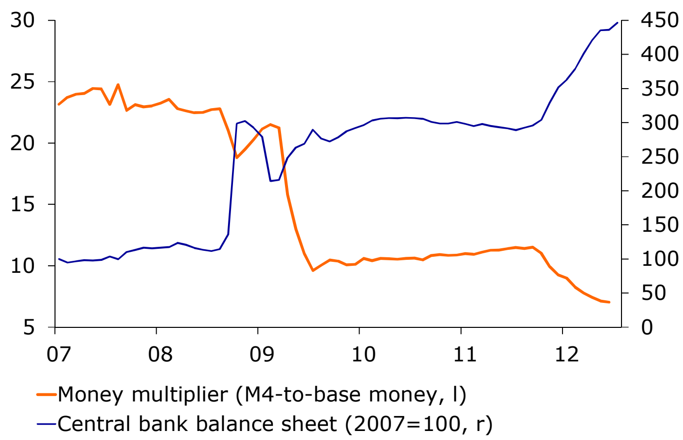
Inflation is finally within sight of the 2% target



Source: Reuters EcoWin

Inflation has continued to fall sharply. CPI inflation fell from 2.8% y-o-y in May to 2.4% in June. Much of this decline came as a result of base effects in VAT and commodity prices. The 3% monthly drop in petrol prices managed to knock about 0.1%-point off the headline rate. The drop in food price inflation knocked off another 0.1%. Due to the time lags involved, previous falls in commodity prices are still feeding through to consumer prices. Mind you that core inflation fell as well (from 2.2% in May to 2.1% in June), which suggests that the slack in the economy is also weighing on inflation. The fall in core CPI was largely driven by a sharp drop in clothing inflation (from 1.6% to -0.8%) amid early Summer sales.

QE1+QE2+QE3 = recovery?



Source: Reuters EcoWin, Rabobank

Against the worsening economic backdrop, the BoE decided on July 5 to increase its quantitative easing (QE) programme by GBP 50bn to a total of GBP 375bn. Naturally, the question is whether this third round of QE will support the recovery? The failure of its predecessors to stimulate broad money through bank lending gives us cause for caution. In theory, banks respond to an injection of liquidity through QE by providing loans to households and firms (i.e. the money multiplier should not fall, see chart). This relationship usually breaks down in times of financial market stress and banking sector deleveraging. The consequence is that more QE won't spur growth unless credit starts flowing again into the economy.

www.rabobank.com/economics

Shahin Kamalodin
Tel. +31 (0)30 – 2131106
S.A.Kamalodin@rn.rabobank.nl