Economic Update United Kingdom

2 April 2013

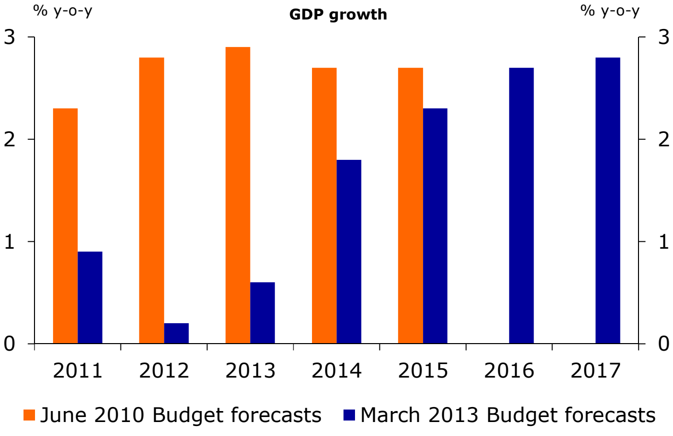
Osborne to Carney: Tag, you're it!

Year-on-year change (%)	'12	'13	'14
Gross Domestic Product	0.2	1	1½
Private consumption	1.0	1	1½
Government expenditure	2.2	-½	-1
Private investment	1.5	3¾	4½
Exports	-0.3	1½	4¼
Imports	2.0	¾	3¼
Inflation	2.8	2½	1¾
Unemployment (%)	8.1	7¾	7¾
Government balance (% GDP)	-8.2	-7¼	-5¼
Government debt (% GDP)	88.7	93¼	96

Source: Reuters EcoWin, Rabobank

- The Budget 2013 had no surprises as the government decided to opt for a fiscally neutral package.
- A number of measures are being taken to revive the housing market, which is already showing signs of stabilisation.
- But success is not guaranteed. Households may refuse to take on extra debt while being busy improving their balance sheets.
- The Bank of England has got extra room to stimulate the economy. This is unlikely to change the outlook amid private sector deleveraging.
- The quick pace of fiscal tightening is likely to weigh on UK growth in the coming years.

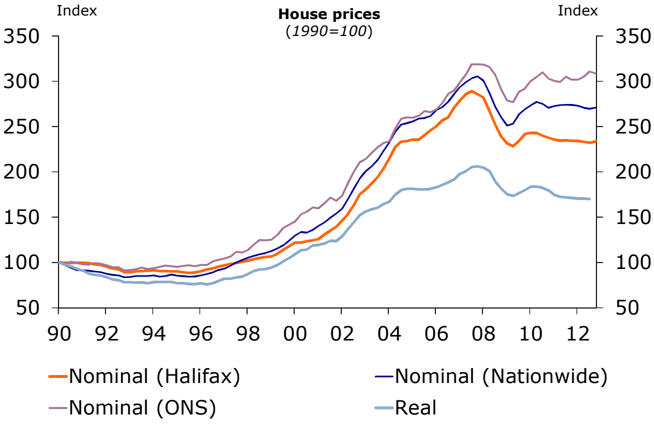
Osborne continues to ignore the poor recovery…



Source: Office for Budget Responsibility

The Budget 2013 had no surprises as George Osborne decided to stick to his guns. There were certainly positive measures such as the 1% cut in corporation tax in 2015 (to 20%) and the allowance to reduce firms' National Insurance contributions. But these were balanced by new spending cuts and tax hikes, meaning that the overall package was fiscally neutral for (i.e. there is no deviation from the existing fiscal austerity plan). Meanwhile, the Office for Budget Responsibility decided to significantly lower growth projections (see figure). As a result, the public sector net debt to GDP ratio is now forecast to peak at 85.6% in 2016/17 (Back in June 2010, it was forecast to peak at 70.3% this year).

…and tries to revive the housing market…



Source: Reuters EcoWin, Dallas Fed, Rabobank

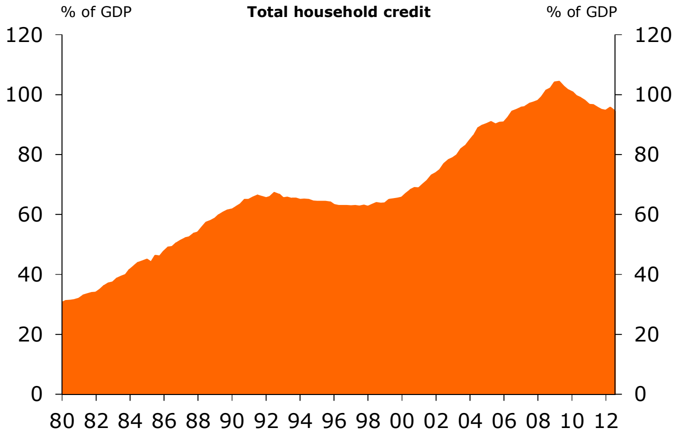
Mr. Osborne has announced two schemes, badged under the heading "Help-to-Buy", to support the housing market. The two elements of this are (i) a shared-equity loan where the government will put in up to 20% of the value of a new-build home worth up to GBP 600k and (ii) offering lenders a partial guarantee on mortgages to people who buy homes worth up to GBP 600k. In both cases, home buyers need at least a 5% deposit to qualify. Note that house prices appear to have stabilised and some forward-looking indicators are consistent with a further improvement in housing activity. But we must realise that house prices can drop further as they are still above their long-term average.

www.rabobank.com/economics

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

2 April 2013

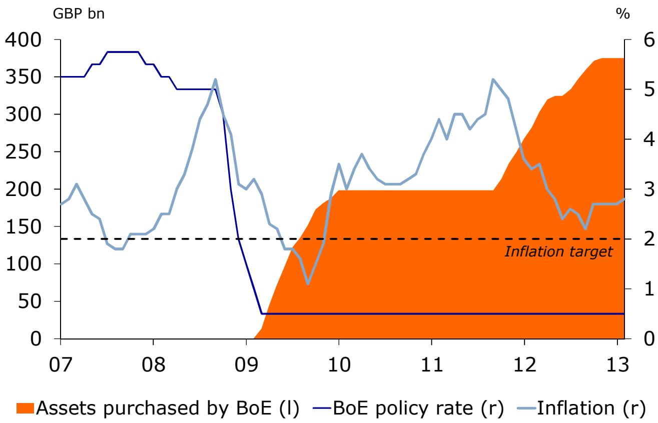
…but will households take on extra debt?…



Source: BIS, Reuters EcoWin

Households may also be less able/willing to buy a house while facing strong headwinds in the form of falling real wages and still high indebtedness. This perhaps explains why the Funding for Lending Scheme (FLS) is so far failing to boost lending. The new data on the FLS shows that financial institutions took GBP 9.5bn from this scheme in 12Q4 but net new lending to the private sector in the same period was negative (GBP -2.4bn). Of course, it may take some time for lending to rise. For example, the drop of fixed mortgages rates by around 50bps between August 2012 and January 2013, which improves debt servicing capacity, may eventually entice some to purchase a house.

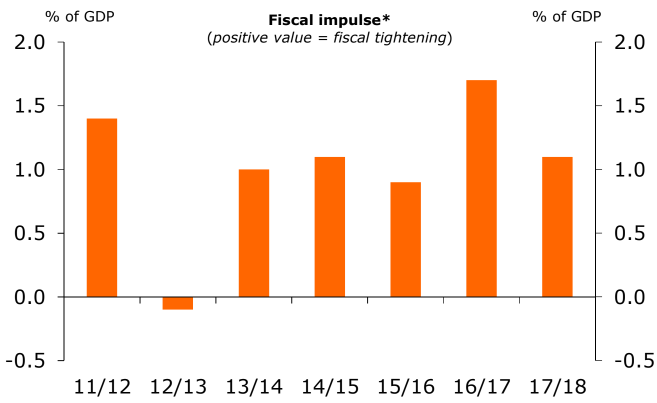
…if not, monetary policy activism may rise…



Source: Reuters EcoWin, Bank of England

Once again, Mr. Osborne delegated the task of propping up the ailing economy to the Bank of England. The inflation targeting framework and the target itself (2%) stayed intact. He did, however, hint at an even more flexible approach to monetary policymaking. We are not sure how this will help as the Bank has kept its loose policy stance while inflation surpassed its target. More important, though, was the request that the "*the merits of intermediate thresholds*" be assessed whereby the BoE pledges to keep policy loose until, say, jobless rate falls below a certain level. We remain sceptical about the success of such forward-guidance because markets already expect rates to stay low for a prolonged period.

…but it won't do the trick without a fiscal plan B



**Defined as the change in the primary budget balance (cyclically adjusted)*

Source: HM Treasury

While promising to keep policy rates low for an extended period is unlikely to boost the recovery, some have pinned down their hopes on even more asset purchases (quantitative easing) to do the trick. But again we are not convinced that piling up more assets on top of the GBP 375bn purchased so far will make a big difference. Long-term interest rates are already close to historic lows and bank lending is not going to pick up materially until the private sector balance sheet repair process is complete. So pump-priming the economy cannot help unless the planned fiscal tightening in the coming years is slowed down. Otherwise, the UK recovery will struggle to gain momentum.

www.rabobank.com/economics

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