Outlook 2013: United Kingdom

Give recovery a chance

The UK recovery remains unimpressive due to harsh austerity measures in a weak macroeconomic environment. We maintain the view that the pace of fiscal adjustment must be slowed down so that recovery gets a chance.

As the zigzag year draws to a close, it is worthwhile to look through the economic volatility to assess the strength of UK's recovery during 2012. The big picture is still that Britain's economic performance has been nothing short of disappointing. Output has been moving broadly sideways since David Cameron started his austerity drive in May 2010 and is now around 3% below its peak in 2008. According to the government, the blames lies squarely on adverse external forces such as the eurozone crisis. That seems unfair though. Looking at the industrialised world, we see that since 08Q1, the UK economy has only outperformed the hard-hit periphery countries in the eurozone plus Denmark. So something else must explain this dismal performance. As we have repeated for some time now, the missing piece in the 'puzzle' is the government's fiscal adjustment, which has been too aggressive amid private sector deleveraging and weak external demand. Even the Bank of England's (BoE) measures (lowering the policy rate to a record low and purchasing GBP 375bn worth of securities during three rounds of quantitative easing) could not reignite growth. This is simply because fiscal policymakers were pulling up the handbrake as the monetary authorities were pressing on the gas pedal.

The chancellor must lower the handbrake to allow growth to accelerate

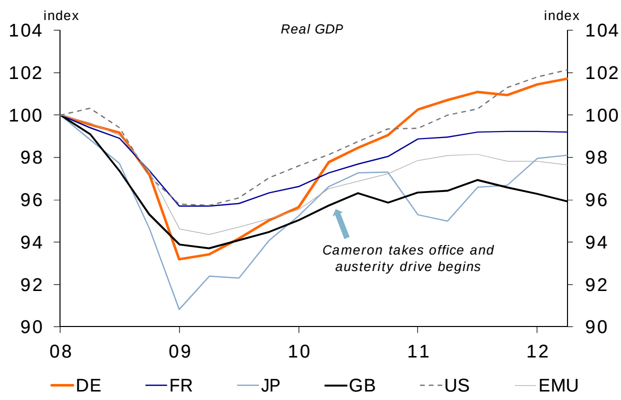
On a positive note, there are some signs that the 'Funding for Lending' scheme (FLS), which involves the BoE providing funding to banks for a period of 4 years at rates below existing market rates, is leading to slightly looser credit conditions. That said, even if banks are willing to increase credit availability, the private sector may still be unwilling to borrow while balance sheets are being

Figure 1: Key figures

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

Figure 2: Recovery? What recovery?

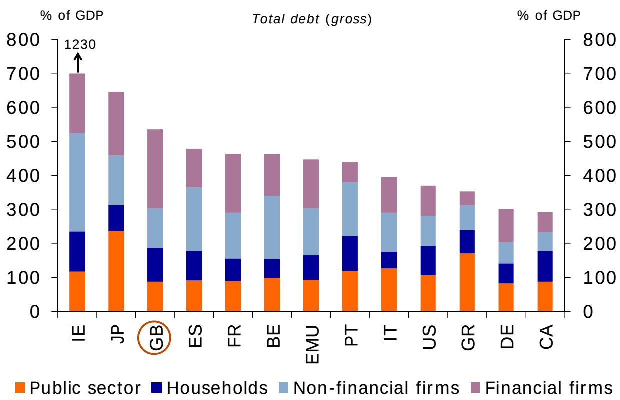


Source: Reuters EcoWin

repaired. Mind you that this process may take many years to complete given that UK's private sector is still highly indebted (figure 3). The uncertain economic outlook and depressed confidence levels act as extra deterrents for raising leverage. Of course, consumers may still be willing to spend more going forward as household finances get a bit of breathing space thanks to falling inflation and improving labour market dynamics. Overall, household spending may pick up somewhat next year but there are enough headwinds to prevent a full-blown consumer-led recovery. As far as the external sector is concerned, the chances that it supports the recovery over the next year or so are slim. Exporters are not only facing a weaker global demand but their competitiveness is also being eroded by the appreciation of the pound.

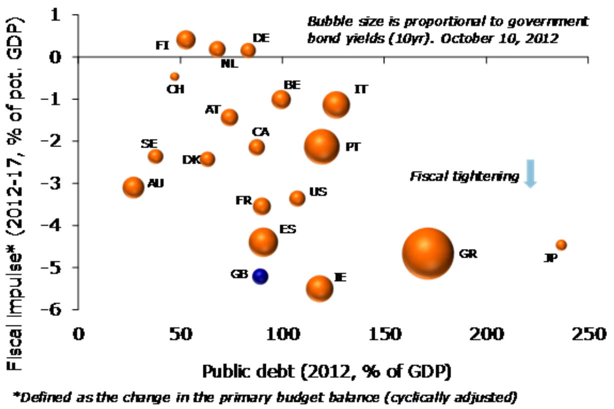
This leaves the onus on the fiscal policymakers to boost activity. Figure 4 shows that the UK has one of the largest fiscal adjustments in the coming years while it is under no market pressure and its public finances, while certainly weak, still leave room for manouvre. Even the IMF, which has been a staunch supporter of the government's fiscal consolidation plans in the past, is having second thoughts. Not only did the Fund say that the so-called automatic stabilisers should be allowed to operate in full, but it said that economies with enough fiscal space such as the UK "*should smooth their planned adjustment over 2013 and beyond*" if large downside risks materialised. On the face of it, then, the government seems to have the green-light to slow down the pace of fiscal adjustment to give recovery a chance. Should Mr. Osborne, the chancellor of the Exchequer, decide to carry out even further belt-tightening measures to reach his fiscal targets, there is a risk that growth will falter further than we currently forecast. We will only know if the chancellor is willing to bite the bullet once he presents his Autumn Statement on December 5.

Figure 3: Who wants more credit?



Bron: IMF

Figure 4: UK's fiscal tightening is too aggressive



Bron: Reuters EcoWin, Rabobank

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