Economic Update United Kingdom

5 February 2013

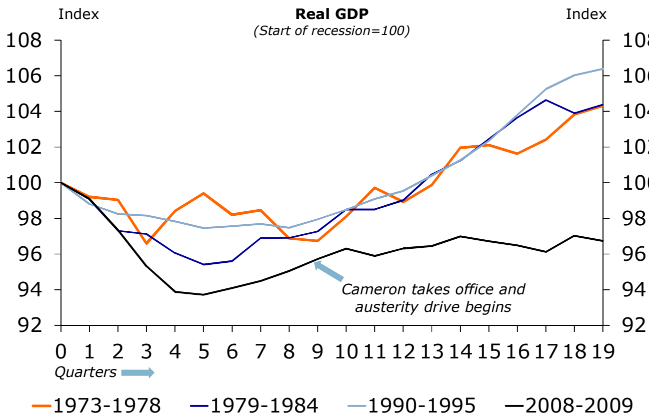
Stagnation is still the name of the game

Year-on-year change (%)	'11	'12	'13
Gross Domestic Product	0.9	0	1
Private consumption	-1.0	1	1
Government expenditure	-2.8	2¾	-¼
Private investment	3.3	-¼	3
Exports	4.6	-¼	1¼
Imports	0.5	2¼	1¾
Inflation	4.5	2¾	2½
Unemployment (%)	8.2	8	7¾
Government balance (% GDP)	-8.5	-8¼	-7¼
Government debt (% GDP)	82.0	88¾	93¼

Source: Reuters EcoWin, Rabobank

- UK's GDP contracted in 12Q4. The reversal of the 'Olympics effect' and maintenance affecting North Sea oil production provided two distortions that weighed on growth.
- The labour market continues to surprise on the upside as the jobless rate fell to 7.7%.
- Inflation is expected to rise further, which will be an extra headwind for households this year.
- There is a risk that the Bank of England welcomes this development if they switch to a new mandate of nominal GDP targeting. But we believe this is undesirable and, therefore, not very likely.
- There are tentative signs that the Funding for Lending Scheme is gaining further traction.

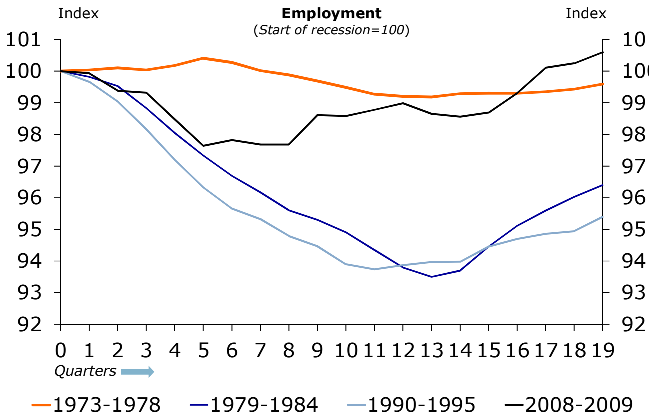
Another disappointing growth figure…



Source: Reuters EcoWin, Rabobank

UK's GDP contracted by 0.3% q-o-q in 12Q4. Admittedly, the drop in GDP primarily reflected the unwinding of the boost from the Olympic games in 12Q3. Extended maintenance of the UK's biggest North Sea oil field also contributed to the weakness of industrial production. But the big picture is still that the UK economy is going nowhere. The fact that GDP stagnated throughout 2012 and is still 3.3% below its pre-crisis peak suggests that the current fiscal policy stance is unjustified. A slower pace of deficit reduction would have given the economy the chance to reach 'escape velocity'. The risk is that the Bank of England will over-extend its mandate in the future to buoy growth (see below).

…increases the UK's labour productivity puzzle



Source: Reuters EcoWin, Rabobank

As opposed to the sluggish GDP growth, the UK's labour market is going from strength to strength. The 90,000 rise in employment in the three months to November took the total number in work to 29.7m. Note that employment in November 2012 was up by more than 500,000 y-o-y. And this is not all due to growth in the number of part-timers and self-employed. The rise in full-time employment accounted for half the increase. Thus, either labour productivity has fallen strongly as companies hoard labour to avoid the costly hiring/firing process, or UK's GDP is being significantly underestimated by the statistical agency (ONS). Future revisions of GDP will hopefully solve this puzzle.

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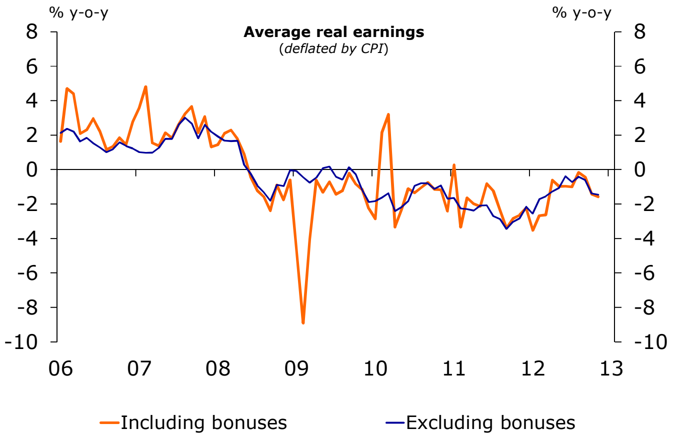
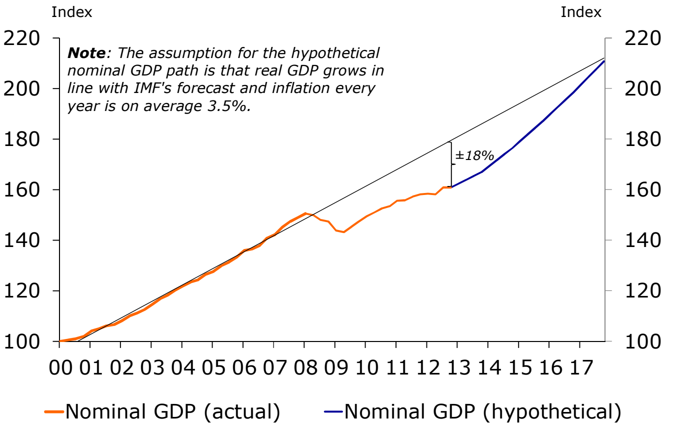
Inflation is expected to rise further…



Source: Reuters EcoWin, Rabobank

CPI inflation held steady for the third consecutive month at 2.7% y-o-y in December. The rise in university tuition fees, domestic energy prices, water and sewerage charges and rail fares have recently pushed up the rate of inflation. Into early 2013, hikes in household energy bills (which was mainly concentrated in December last year) will further push consumer prices up-wards, probably even over 3%. Needless to say that the 'stickiness' of inflation is an unwelcome development for UK households since real wages will continue to remain under pressure. Annual growth of average earnings (excluding bonuses) fell to 1.4% in November, the lowest rate since June 2010.

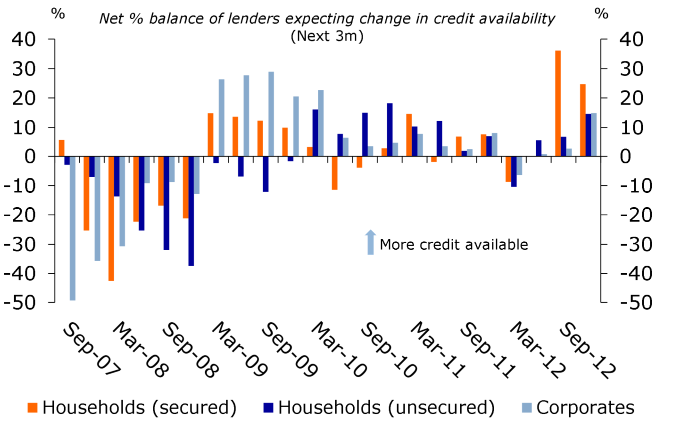
…and this may be welcomed by the Bank of England?



Source: IMF, Rabobank

Mark Carney, who will take over the helm of the BoE in July, has suggested that under certain circumstances there is a favourable case for nominal GDP targeting. In a simple exercise we show that if the UK's real GDP grows in line with IMF's forecast and inflation averages 3.5% every year (current target is 2%), then it will take 5 years or so for nominal GDP to return back to its pre-crisis trend. Against this backdrop, some fear that Mr. Carney may opt for higher inflation to close the gap faster. But it remains to be seen whether the Bank's mandate will change at all. Unanchoring the already high inflation expecta-tions is dangerous. Besides, the current policy framework provides enough flexibility.

Credit easing is gaining traction



Source: Bank of England

The latest BoE Credit Conditions Survey (12Q4) provided additional evidence that the positive impact of the Funding for Lending Scheme (FLS) is building. Credit availability for both households and corporates rose strongly. But before we get carried away we must realise that the private sector may not materially increase borrowing while being busy repairing balance sheets. The December data show that the loosening of credit standards has not fed through into a meaningful pick-up in M4 lending yet. That said, the recent fall in fixed mortgage rates and rise in mortgage approvals have been encouraging. The latter rose from a low of 44,500 in the past six months to 55,800 in December.

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