Rabobank

Economic Update United Kingdom

4 December 2012

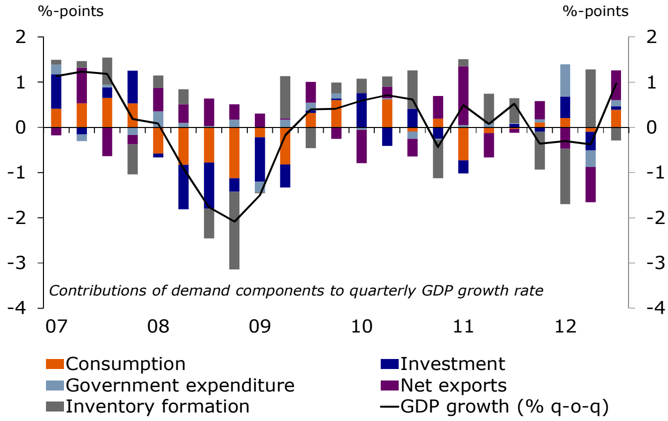
Heading for a quadruple dip

Year-on-year change (%)	'11	'12	'13
Gross Domestic Product	0.9	-¼	1¼
Private consumption	-0.9	½	1¾
Government expenditure	-2.0	-¼	-2
Private investment	2.6	4½	3
Exports	4.5	½	4½
Imports	0.5	2	4¼
Inflation	4.5	2½	2½
Unemployment (%)	8.2	8¼	8
Government balance (% GDP)	-8.5	-8¼	-7¼
Government debt (% GDP)	82.0	88½	93¼

Source: Reuters EcoWin, Rabobank

- UK's GDP was boosted by temporary factors in 12Q3. Output is expected to contract in 12Q4.
- The improvement in the labour market is slowing down as Olympics-related hiring ends.
- Inflation is expected to fall less rapidly, which will be an extra headwind for households in 2013. This will not entice the Bank to tighten policy unless the recovery gets going.
- There are tentative signs that the Funding for Lending Scheme is beginning to work.
- In particular, we are cautiously optimistic about the banking sector's stronger balance sheets. Credit growth will remain muted until the deleveraging process in the private sector is complete though.

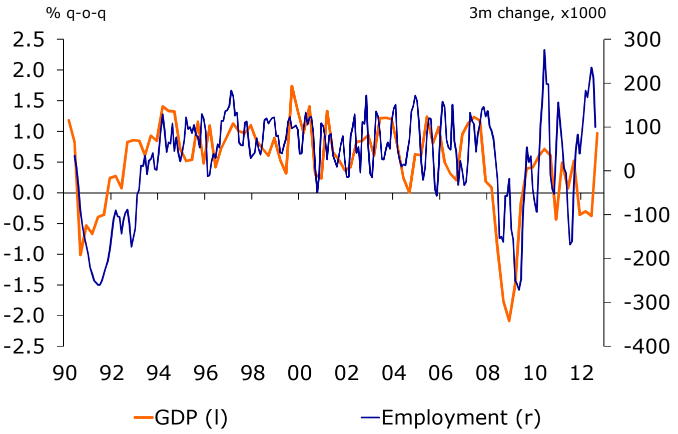
12Q3 growth must be taken with bucket-loads of salt



Source: Reuters EcoWin

UK's economy grew by a robust 1% q-o-q in 12Q3, as expected. Before we get carried away, we must consider the three temporary factors that boosted growth. First, the growth rate was based on the level of GDP in 12Q2, which had one fewer working day. Second, the Olympic Games may have boosted economic activity over and above normal seasonal variation that is routinely corrected for. Third, the country experienced very poor weather conditions in Q2 (it was the wettest April to June on record). This means the underlying pace of activity has grown by much less than 1%. Going forward, we expect UK's GDP to contract in 12Q4 as the 'zigzag' year draws to a close.

The job market pulled down by economic gravity



Source: Reuters EcoWin

The strong rate of improvement in UK's labour market data seems to be slowing. Employment increased by 100k in the three months to September. This was the smallest rise since February. As we mentioned before, the puzzle of a struggling economy combined with a buoyant labour market was partly due to the Olympics. The employment figures are an average for the three months to September, so they probably benefited from Olympics-related hiring in July and August. The timelier claimant count measure of unemployment was up by 10,000 in October, while September's drop was revised to a small increase. This suggests that the job market is being pulled down by UK's economic gravity.

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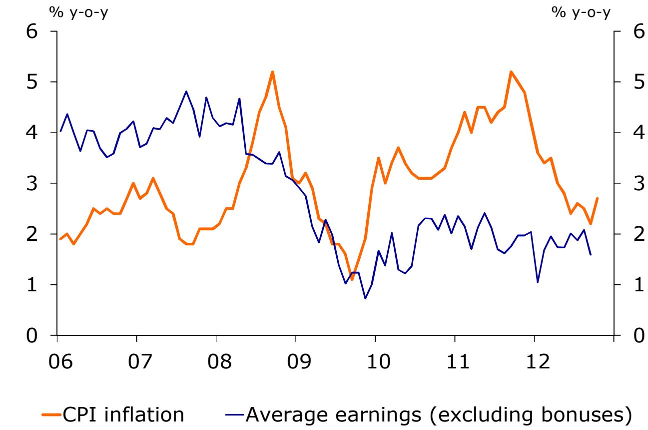
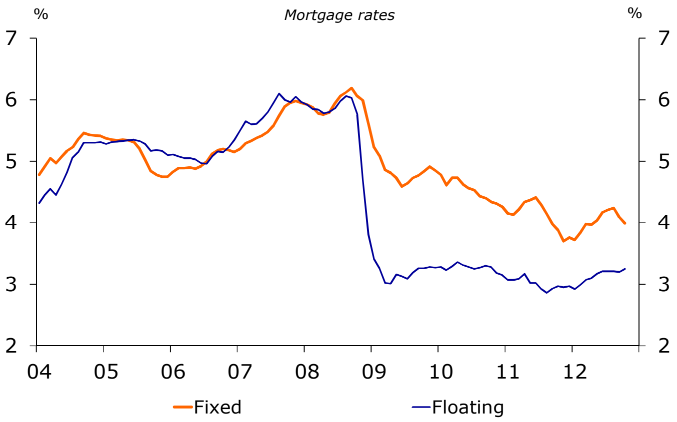
Inflation is proving to be 'stickier' than expected



Source: Reuters EcoWin

CPI inflation made an unwelcome push higher to 2.7% in October, from 2.2% in September. This increase was largely on the back of an increase in food prices and university tuition fees. Into early 2013, hikes in household energy bills (which will be mainly concentrated in December) mean that inflation is likely to remain 'stickier' than we envisaged. Needless to say that this is an unwelcome development for UK households since real wages will remain under pressure. It is important to stress that the Bank of England (BoE) is unlikely to backtrack on its easing policy unless there are signs that higher inflation is being passed into wages or the economy is taking a convincing turn for the better.

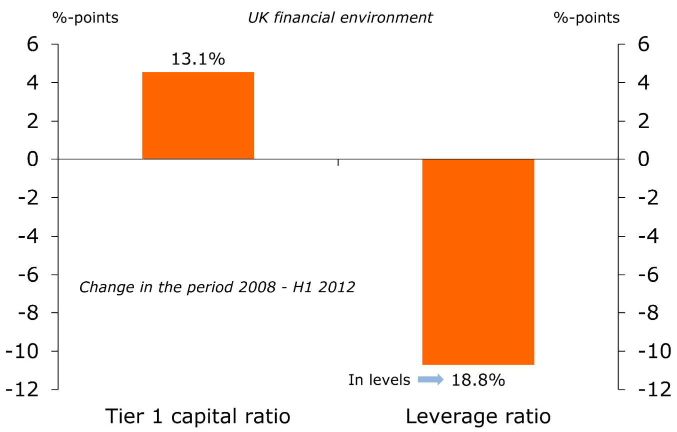
Tentative signs the lending scheme is working



Source: IMF, Rabobank

The first data on the usage of the Funding for Lending Scheme (FLS), which gives banks cheap funds as long as they maintain or raise their lending, shows that 35 institutions have signed up to the FLS, which account for about 80% of total lending. Today's data show that these institutions accessed GBP 4.36bn of cheap funds in Q3 and lent GBP 0.5bn of new credit. On the face of it, these are not very big numbers. But it is still early days as it will take time for reduced funding costs to feed through to lending volumes. Notably, the recent fall in fixed mortgage rates and rise in mortgage approvals have been encouraging. Not to mention the improvement in credit conditions for households.

Banks are better positioned to increase lending



Source: Bank of England

Another reason for expecting the FLS to buoy lending is stronger bank balance sheets. Specifically, the average tier 1 capital ratio of UK banks has risen from 8.5% in 2006 to 13.1% in 12H1. In the most recent Financial Stability Report, the BoE argues that the reported capital ratios may not provide an accurate picture of banks' health, in part because "*the risk weights used…may be too optimistic*". However, the decline in the leverage ratio – which is basically the inverse of the capital ratio, using unweighted assets – suggests that risk weighting is not the only driver of banks' improving balance sheets. That said, we cannot expect credit growth to rise materially until private sector deleveraging ends.

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