# Economic Update United Kingdom

## 6 September 2011

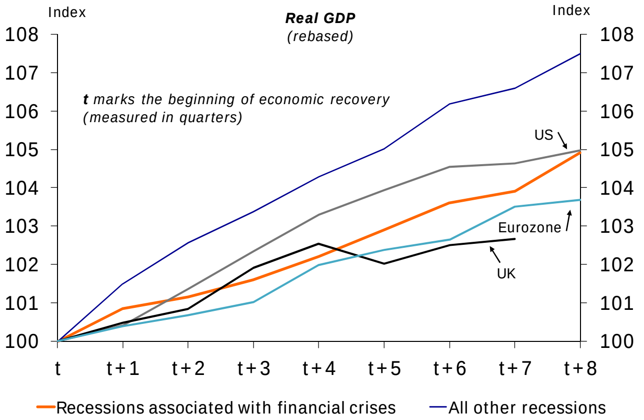
### News on the economy going from bad to worse

| Year-on-year change (%) | '10 | '11 | '12 |
|---|---|---|---|
| Gross Domestic Product | 1.4 | 1¼ | 1½ |
| Private consumption | 0.7 | -½ | ¾ |
| Government expenditure | 1.3 | ¾ | -1¼ |
| Private investment | 3.7 | 1¾ | 6¼ |
| Exports | 5.2 | 6¼ | 5¼ |
| Imports | 8.8 | 1¼ | 2 |
| Inflation | 3.3 | 4¼ | 2 |
| Unemployment (%) | 8.0 | 8 | 7¾ |
| Government balance (% GDP) | -10.4 | -8½ | -7 |
| Government debt (% GDP) | 77.2 | 83 | 86½ |

Source: Reuters EcoWin, Rabobank

- The 0.2% q-o-q growth in 11Q2 is blamed on a host of 'special factors' (such as the extra bank holiday, the royal wedding and the after-effects of the Japanese earthquake).
- But this is absurd, in our view. The lackluster post-recession recovery cannot only be blamed on the financial crisis.
- The leading indicators are pointing to anaemic recovery going forward. Most worrisome are the signs that the job market conditions are worsening.
- Households are not expected to get the recovery going again while facing strong headwinds.
- The BoE has turned dovish, meaning that rate hikes will be further postponed. Although this is unlikely to help much without fiscal rethink.

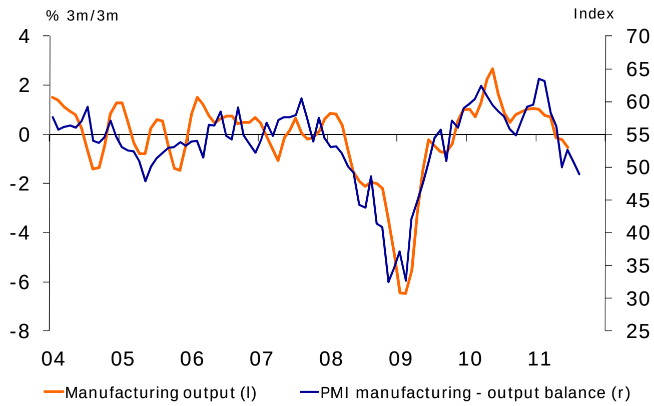
### Excuses, excuses




Source: IMF, Reuters EcoWin, Rabobank

First it was the very cold winter that explained GDP contraction in 10Q4. Then it was higher commodity prices, Japan's earthquake and the very warm weather conditions that resulted in the disappointing growth figure in 11Q1. And now a host of 'special factors' (such as the extra bank holiday, the royal wedding and the after-effects of the Japanese earthquake) are to be blamed for the measly 0.2% quarterly rise in 11Q2 GDP. That may well be true, but stating that the UK economic recovery is very solid, *ceteris paribus*, is unconvincing if not plainly absurd. The fact of the matter is that the post-recession recovery has been very weak even accounting for the financial crisis.

### PMI manufacturing is sending worrying signals...




Source: Reuters EcoWin

Admittedly, growth in 11Q3 will receive some support as the temporary adverse factors unwind. But don't expect the recovery to quickly become impressive or entrenched. In particular, August's PMI manufacturing (down from 49.4 to 49) brought further evidence that the slowdown in the global economic recovery is starting to hit the UK manufacturing sector hard. The breakdown shows that manufacturers can no longer rely on overseas demand despite the continued weakness of the pound (new export orders plunged from 53.8 to 46.6). Also noteworthy was the drop in the employment balance from 50.1 to 48.9), adding to signs that labour market dynamics are deteriorating in the sector.

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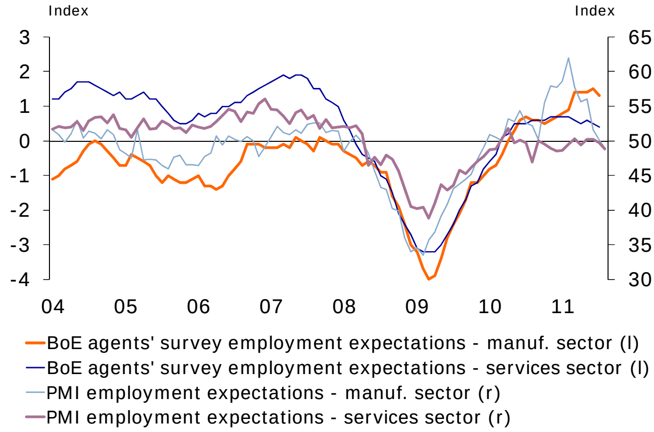
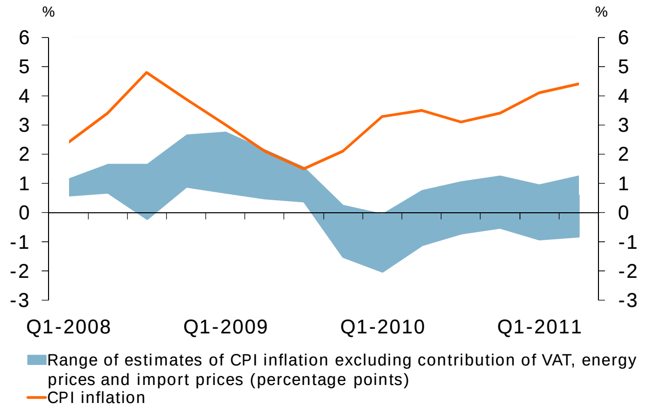
### ...similar to PMI services




Source: Reuters EcoWin

PMI services data in August suggests that growth in the largest sector of the economy (accounting for 78% of gross value-added) has also slowed sharply. The main business activity index plummeted from 55.4 to 51.1 – a larger monthly drop than seen even at the peak of the financial crisis in the autumn of 2008. Most worrisome was the significant drop of the employment balance (from 49.7 to 48.8), suggesting that the downturn in the labour market may be deepening. Meanwhile, the Bank of England's agents' report revealed a fall in firms' employment intentions in July (holds true for both the manufacturing and the services sector). Overall, the labour market outlook is getting darker by the hour.

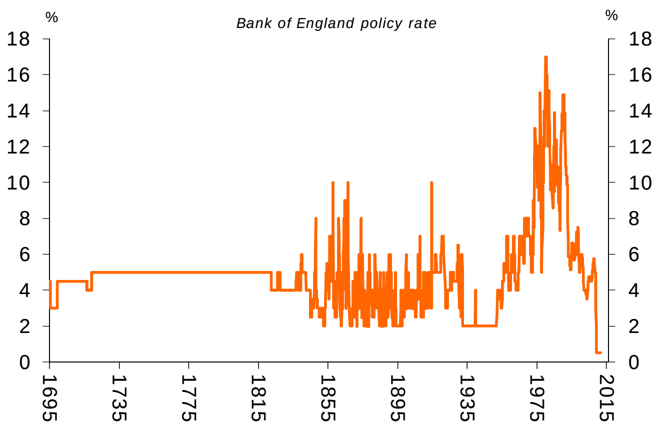
### Consumers are suffering from multiple body blows




Source: Reuters EcoWin, Rabobank

Highly leveraged UK households are not only witnessing worsening job market conditions, but they are also suffering from (i) falling net wealth (owing to falling stock prices), (ii) tightening fiscal policy and (iii) contracting real wages. As for the latter, the good news is that we expect inflation to fall considerably in 2012 owing to weaker domestic demand growth, falling commodity prices and mechanical 'base effects' (i.e. the recent increases in energy prices and the January VAT hike will simply drop out of the 12-month comparison next year). In any case, given the strong headwinds households are facing, we cannot expect them to support the recovery for some time to come.

### Don't put all your eggs in the Bank of England




Source: Bank of England

Given the weakness of domestic and external demand, the BoE is left to single-handedly fight stagnation. The doves in the Monetary Policy Committee (MPC) are thankfully gaining the upper hand. In their August meeting, the two remaining hawks in the MPC also voted for rates to remain *unchanged*. This distinctly dovish shift implies that the policy rate will remain at historic lows for a longer period than markets expected only a few months ago. We have now pushed back our rate hike expectation to Nov. 2012. Unfortunately, even this will not be enough to bolster growth by itself if it is not combined with a slower pace of fiscal consolidation. Dismal growth prospects demand fiscal rethink!

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