United Kingdom

Recession 'made in Downing Street'

UK's economy has been going sideways since mid-2010 owing to harsh fiscal austerity measures. The release of 12Q1 GDP figure showed that the country entered a technical recession. Going forward, economic recovery is likely to remain tepid amid simultaneous public and private sector retrenchment. The export sector cannot materially alter this outlook while UK's major trading partner, the eurozone, is mired in a sovereign debt crisis.

Table 1: Key figures United Kingdom

year-on-year change (%)	'11	'12	'13
Gross Domestic Product	0,7	½	1½
Private consumption	-1,2	½	1
Government consumption	-0,9	-¾	-½
Investment	0,8	-¼	5¾
Exports	4,6	3¼	5¼
Imports	1,2	1¼	3¾
Inflation	4,5	2¼	2
Unemployment (%)	8,2	8¼	8½
Government balance (% GDP)	-8,5	-7,0	-5,0

Source: Reuters EcoWin, Rabobank

The UK's GDP release for 12Q1 (-0.3% q-o-q) was simply disappointing. The economy shrank for the second quarter in a row suggesting that a technical recession, which most (our-selves included) were not expecting, became reality. Admittedly, the fall in GDP was driven by a 3% quarterly drop in the construction output and there are doubts over the reliability of these numbers. The statistical office (ONS) has stated that there is a tendency for construction output to be revised up by 1-2%. Overall, we should stress that over the past 20 years, the average revision to the initial estimate of UK quarterly GDP growth has been +0.2%. So we shouldn't be surprised if the growth figure would be revised upwards by the ONS. In fact, the weakness in output is difficult to reconcile with some leading indicators of activity. Specifically, the PMI surveys, which have been strong predictors of post-revision GDP data, were pointing to quarterly GDP growth of around 0.5% in 12Q1. That said, industrial production's 0.3% m-o-m drop in March, which left it 0.4% lower in 12Q1 as a whole than in 11Q4, does not support the view that GDP growth in the previous quarter is to be revised up. In any case, we will need to wait for the publication of the *Blue Book* (will be released somewhere in 2014) to obtain the final revision of UK GDP.

Barring a very large revision, which we deem highly unlikely, the big picture is that the economy remains exceptionally weak. The stuttering nature of growth following the recession means that the economy is now weaker relative to its pre-recession peak than at the corresponding stage of the depression in the early 1930s. Even worse, UK's weak economic performance strongly matches that of the hard-hit eurozone periphery countries (see figure 1). This does not come as a surprise to us. We have been saying from the start that the government's harsh austerity drive was going to be harmful for growth (e.g. see our Special Report – UK Budget: good politics, bad economics?, June 2010).

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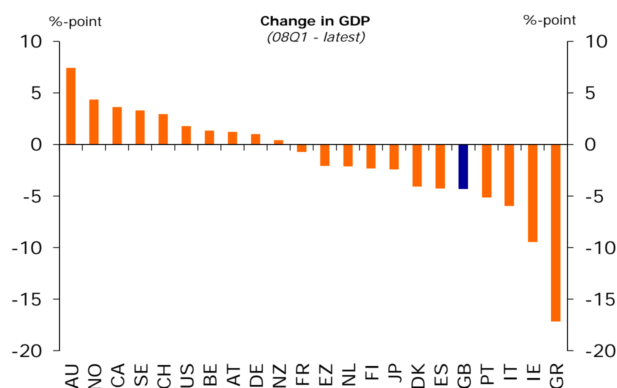
Going forward, economic recovery will remain anaemic as the public sector continues with its harsh fiscal belt-tightening measures (see figure 2) amid private sector deleveraging (see figure 3). At the very extreme, the UK will achieve external rebalancing through this policy path (i.e. current account will move towards a surplus), but this will only come at the cost of even higher unemployment and lower incomes (i.e. the country will be further away from internal balance). To avoid such an outcome, the country needs to export more. But how can we expect the export sector to come to the rescue while UK's major trading partner, the eurozone, is mired in a debt crisis? Besides, the recent switch of the BoE towards a less dovish tone has resulted in the appreciation of the sterling. This will further dent hopes for an export-led recovery.

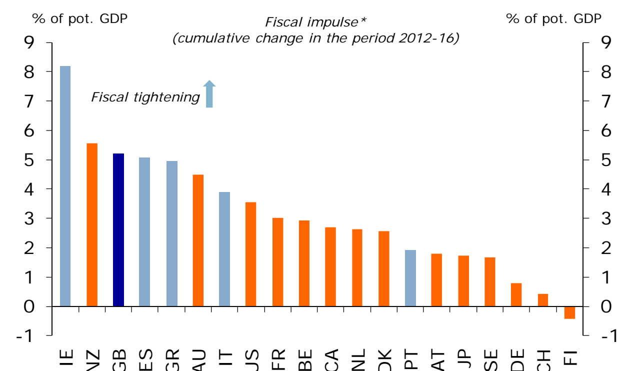
Figure 1: UK's recovery similar to EMU's periphery



Source: Reuters EcoWin, Rabobank

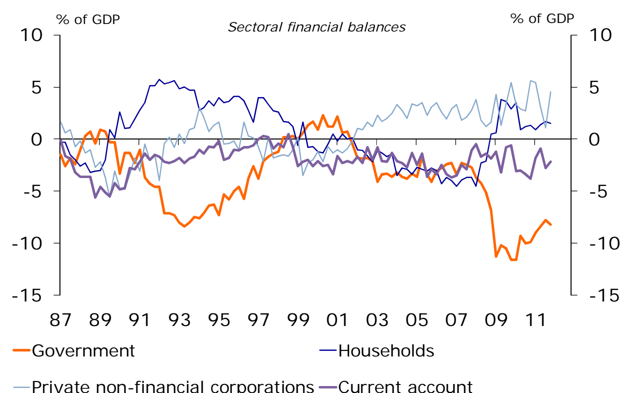
Against this backdrop, we maintain the view that a slower pace of fiscal adjustment is a better medicine for UK's economic woes than the current policy prescription. This is especially necessary given that (i) the private sector is busy improving its balance sheet, (ii) the external environment remains challenging and (iii) monetary policy is ineffective in jump-starting the economy. The risk is that fiscal consolidation measures lead to a weaker recovery and this, in turn, forces the government's hands to carry out even further austerity to reach its fiscal target. Such policy will hurt the country's long-term growth rate as some workers who have lost their jobs for a prolonged period will eventually leave the labour market (*the hysteresis effect*).

Figure 2: Fiscal adjustment too fast for comfort



Source: IMF, Rabobank

Figure 3: Households and firms are net savers



Source: Bank of England

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