Economic Update United Kingdom

6 March 2012

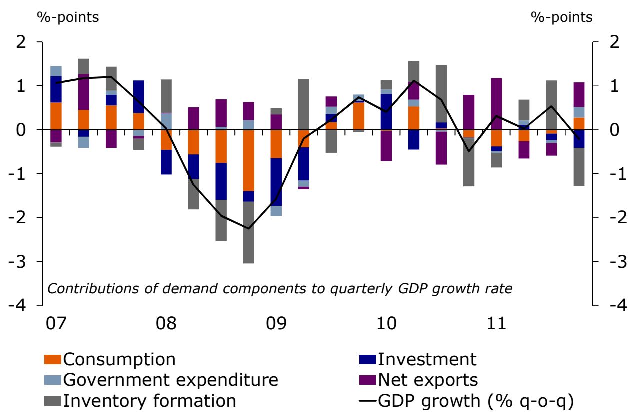
Consumer spending may surprise on the upside

Year-on-year change (%)	'11	'12	'13
Gross Domestic Product	0.8	1	1½
Private consumption	-0.8	¾	1
Government expenditure	-1.2	-¾	-½
Private investment	2.1	¼	5¾
Exports	4.8	3½	5¼
Imports	0.6	1	3¾
Inflation	4.5	2¼	2
Unemployment (%)	8.2	8¼	8½
Government balance (% GDP)	-8.5	-7	-5
Government debt (% GDP)	80.7	84¼	86

Source: Reuters EcoWin, Rabobank

- The UK GDP contracted by 0.2% q-o-q in 11Q4. This was largely thanks to a dip in the pace of stock building by firms.
- Household spending finally grew after 4 quarters of contraction.
- Going forward, falling inflation should continue to alleviate the squeeze on real incomes and this may result in stronger consumer spending.
- This does not imply that consumers are now out of the woods. A dramatic worsening of the labour market together with tightening credit conditions can throw sand in the wheels of the consumer recovery.
- The Bank of England's quantitative easing programme is unlikely to alter the outlook.

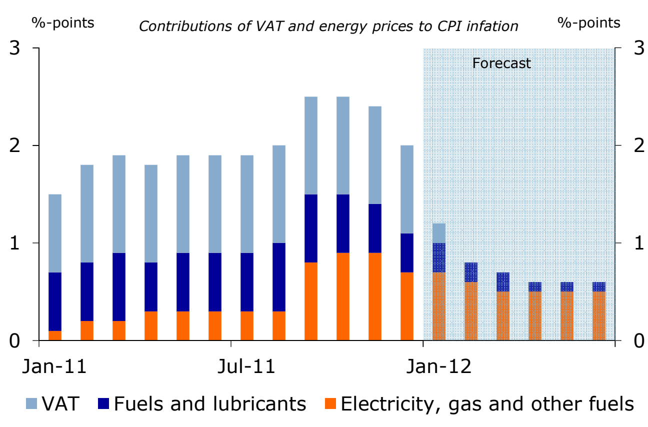
GDP fell in 11Q4, but a small rise is expected in 12Q1



Source: Reuters EcoWin, Rabobank

The UK GDP contracted by 0.2% q-o-q in 11Q4. The slower pace of inventory formation subtracted some 0.8%-points from GDP growth. The sharp fall in investment (knocking 0.4%-point off growth) was particularly disturbing. Cash-rich corporates are apparently reluctant to spend while the economic outlook remains uncertain. On a positive note, household spending rose by 0.5% q-o-q after contracting for 4 consecutive quarters. This was largely due to the fall in inflation. Looking ahead, we expect a modest increase in GDP in Q1 and a volatile pattern of quarterly growth through the year, in part because of the additional bank holiday in Q2 and the Olympic games in Q3.

Consumer spending may pick up slightly…



Source: Bank of England

An important reason why we are somewhat upbeat concerning the consumption outlook is because of the sharp drop in inflation, which will provide a welcome boost to real incomes. The CPI rate fell to 3.6% in January 2012, from 4.2% in December 2011. Going forward, we expect inflation to decline further as the VAT hike and increases in energy prices a year ago drop out of the calculation. More timely indicators indeed suggest that the consumer recovery is gaining more momentum. Two notable examples are the recent pick-up in retail sales (+0.9% m-o-m in January, building on December's 0.6% rise) and rise in consumer confidence (both the GfK and the EC index rose in January).

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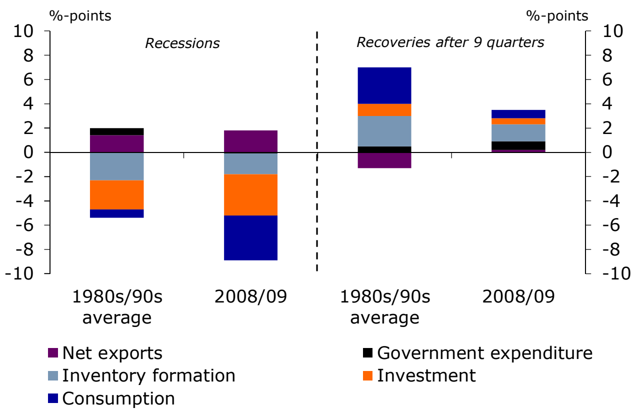
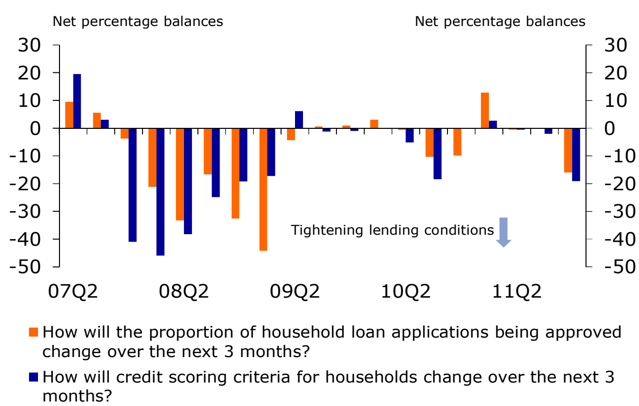
…and this may bolster the economic recovery…



Source: Bank of England

The easing of the squeeze on consumers' real incomes can prove crucial for the economic recovery. To appreciate this, one must realise that household consumption has been the biggest drag on growth during the recession in 2008/09 and has contributed marginally to the recovery when compared to the past episodes in the 1980s and 1990s. Of course, this was for a large part due to the continuing headwinds from the unwinding of excessive debt and the government's severe fiscal consolidation measures. But the contraction of real wage growth over the past two years as a result of high inflation should not be overlooked. The upshot is that falling inflation can lead to a stronger economic recovery.

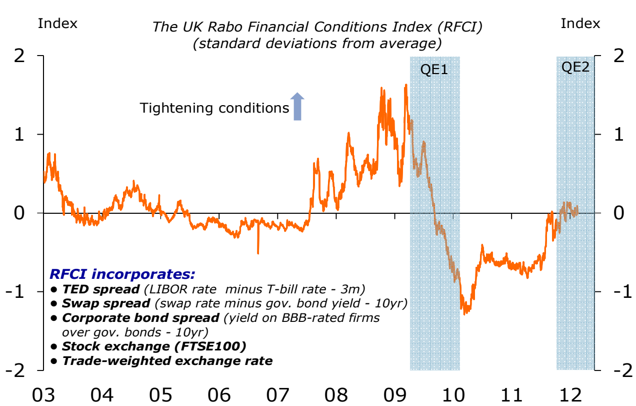
…unless downside risks spoil the party



Source: Bank of England

While being relatively optimistic, we should not ignore the strong headwinds that households are still facing. Consumption is unlikely to pickup if the labour market and credit conditions worsen dramatically throughout the course of the year. The former is already showing signs of weakness. The jobless rate rose to 8.4% in the three months to December, from 8.3% in the previous three months. As regards the latter, there are already worrying signs that credit conditions for households are being tightened. The latest survey carried out by the Bank of England (BoE) shows that lenders expect the proportion of total loan applications being approved to fall over the coming quarter. This is not a welcome development.

The Bank of England can't transform the outlook



Source: Reuters EcoWin, Rabobank

The BoE's decision to extend the second round of quantitative easing (QE2) by another GBP 50bn in February was intended to address tightening financial conditions. However, QE2 has hardly any success in this regard, especially when compared to QE1. A series of disappointing macro data may eventually force the hands of the BoE to extend its asset purchase programme even further. But we need to remind ourselves that there is a limit to what monetary policy can achieve amid harsh austerity measures and a challenging external environment. In such a scenario, all the QE2 programme will accomplish is to serve as a 'signaling function' that the BoE is doing everything in its power to jump-start the economy.

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