



11 January 2011

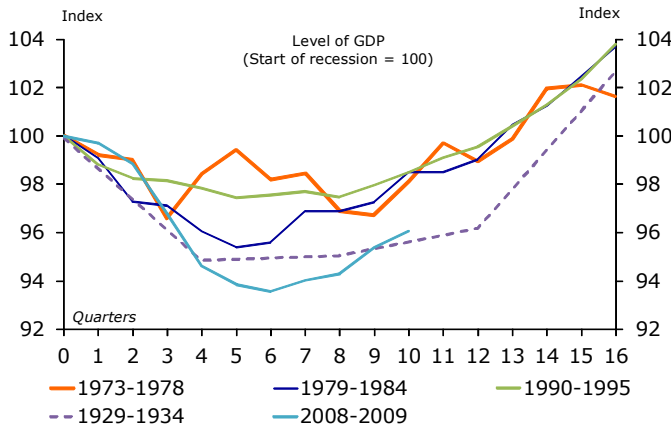
Tough (and uncertain) year ahead

Year-on-year change (%)	'09	'10	'11
Gross Domestic Product	-5.0	1¾	1½
Private consumption	-3.3	¾	½
Government expenditure	2.6	1½	-1¼
Private investment	-20.1	4½	7¾
Exports	-11.1	5¼	7
Imports	-12.3	7¾	3½
Inflation	2.2	3¼	3¼
Unemployment (%)	7.7	8	8¼
Government balance (% GDP)	-10.9	-10¼	-8½
Government debt (% GDP)	61.8	74¼	80¾

Source: EcoWin, Rabobank

- The recovery had plenty of pace in the closing stages of 2010. That said, the services sector weakened considerably.
- We expect private consumption to grow robustly in 10Q4. Consumption frontloading ahead of the VAT hike is an important factor.
- Consumption growth in 2011 will be weak amid the upcoming fiscal squeeze.
- Purchasing power will be further under pressure due to rising inflation.
- The only hope, therefore, is that the external sector will finally support the recovery. But we remained concerned about growth prospects in the European periphery, given that they account for roughly 15% of UK exports.

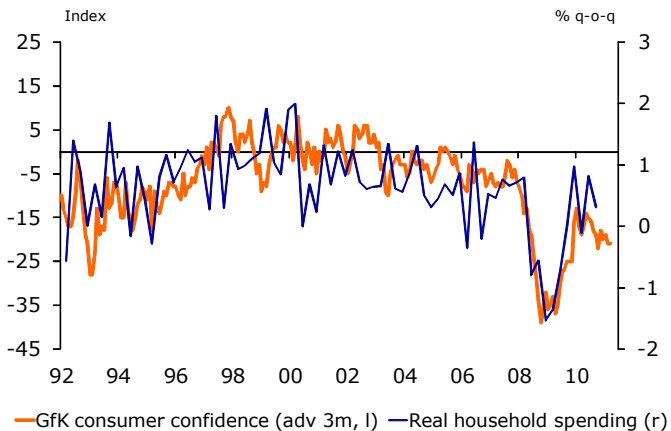
2010 economic recovery has been relatively strong ...



Source: Reuters EcoWin, Capital Economics

After going through the worst output slump in living memory, the UK economy started showing some signs of life in 2010. GDP grew 2.7% since 09Q3 and leading indicators point to a solid growth figure in 10Q4. As far as industrial output is concerned, the rise of the PMI manufacturing index from 57.5 to 58.3 in December suggests that the recovery had plenty of pace in the closing stages of 2010. The bad news is that the services sector, which accounts for roughly 78% of gross value added, has weakened considerably in December. The PMI services index plunged from 53 to 49.7. Probably some of this is due to the heavy snowfall. If that is the case, activity should rebound somewhat in January.

... partly thanks to robust consumer spending



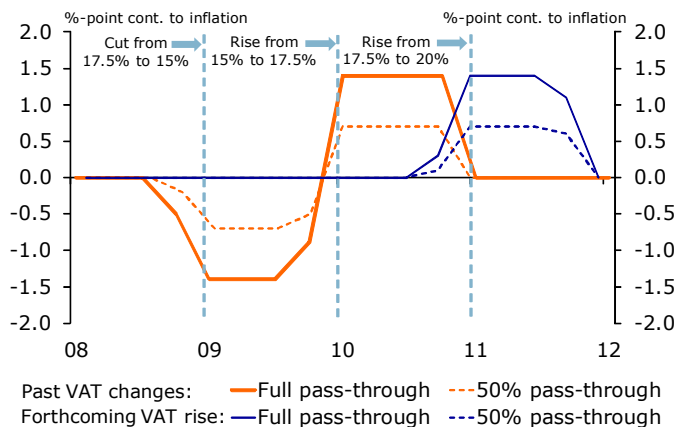
Source: Reuters EcoWin

Household indicators suggest that consumer activity has held up fairly well in the three months to December partly owing to consumers' decision to frontload spending ahead of the January 2011 VAT hike. Real retail sales rose by 0.3% m-o-m in November and the CBI Distributive Trades survey was upbeat in December. That said, the GfK's consumer confidence index stayed low in December and points to falls in spending going forward. Consumers are feeling gloomy given the severe headwinds they will face in 2011. Not only will real disposable incomes drop amid rising inflation, but people will also start feeling the upcoming fiscal squeeze. On top of that, rising job insecurity and the weakening housing market will act as an extra drag on private consumption.

Economic Update United Kingdom

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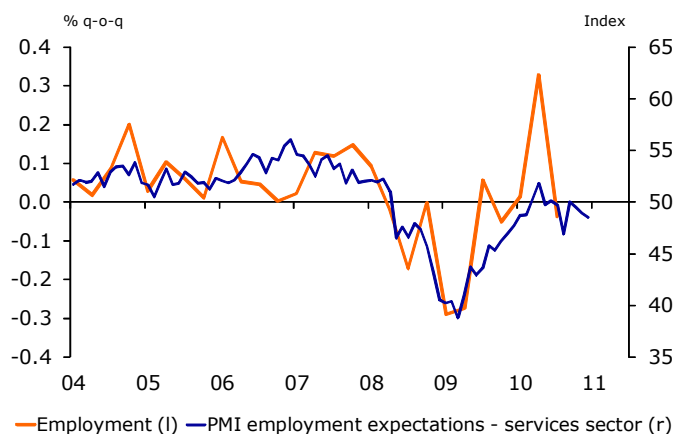
VAT hike will push prices upwards in the short-term



Source: Bank of England

Inflation managed to consistently surprise on the upside in 2010. This was mostly due to the surge in commodity prices, last year's VAT hike and the greater-than-expected exchange rate pass-through from past sterling depreciation. Unfortunately, the recent VAT hike will push inflation even higher in the short-term (possibly towards 4% y-o-y). But we expect the slack in the economy to push inflation down in the medium-term, especially now that unit labour costs are falling. There are some upside risks, however. In particular, the rise in households' long-term inflation expectations is a bit worrying. But those expectations cannot easily translate into higher wages in the current macroeconomic environment.

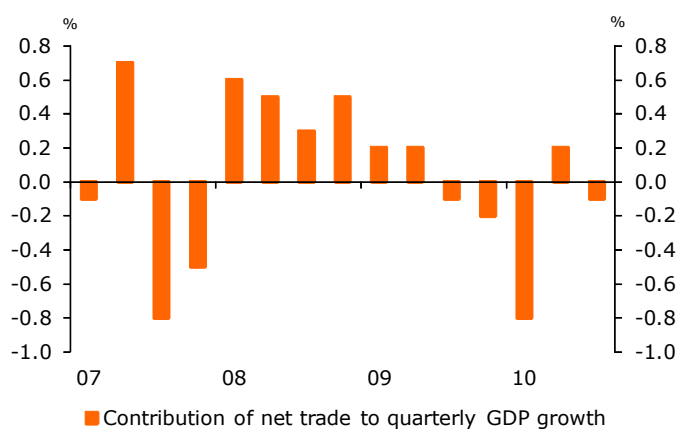
Is the labour market recovery stalling already?



Source: Reuters EcoWin, Markit

Employment dropped by 33,000 in the three months to October. This is particularly worrisome given that the expected public sector job cuts (around 330,000 by 2014-15) have not even started in earnest. In other words, the current level of private sector job creation is not enough to keep the unemployment rate in check. What's more, the austerity measures will further worsen the private sector employment prospects. This is because government spending on procuring goods and services from the private sector accounted for 13% of GDP in 2009/10. It should come as no surprise, therefore, that employment expectations, especially in the services sector, are weakening.

Hopes for rebalancing are still alive, but...



Source: Reuters EcoWin

So far the strong depreciation of the sterling has not resulted in a much-needed strong pick up in exports. Hopes that the external sector might finally support the recovery were dashed when net trade's contribution to GDP growth in 10Q3 was revised down from 0.4% to -0.1%. On a positive note, the main export orders balances (CBI and PMI) continued to rise in December, though it may take some time for stronger orders to feed through to exports. The recent US fiscal stimulus poses an upside potential for UK exports. There are some notable downside risks too. The beleaguered peripheral eurozone countries are collectively a bigger export destination for UK exports than Germany (the periphery accounts for roughly 15% of UK exports).

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