Economic Update United Kingdom

3 June 2013

Signs of recovery are emerging, but very slowly

Year-on-year change (%)	'12	'13	'14
Gross Domestic Product	0.3	1	1½
Private consumption	1.2	1	1½
Government expenditure	2.2	-¼	-½
Private investment	1.3	1½	5¾
Exports	-0.2	½	4¾
Imports	2.7	0	3¾
Inflation	2.8	2¾	2
Unemployment (%)	8.1	7¾	7¾
Government balance (% GDP)	-8.3	-7	-6½
Government debt (% GDP)	90.3	93½	97

Source: Reuters EcoWin, Rabobank

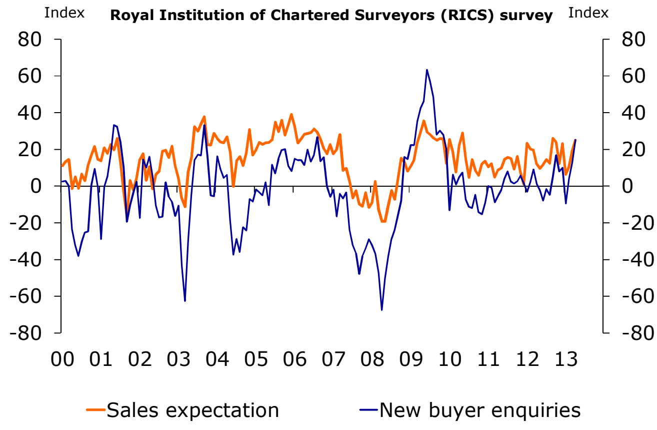
- The recent batch of positive data suggest that the recovery has arrived. For one, the UK managed to record stronger growth compared to the major eurozone countries.
- The housing market is showing signs of life too and activity may rise further going forward.
- The labour market dynamics are weakening, however, and households' incomes will remain under pressure until inflation falls in 13H2.
- On balance, the recent pick up of sentiment and loosening of financial conditions suggest that economic activity will slowly gather pace in the coming months.
- But the growth outlook will be determined by external demand, which still remains weak.

Economic growth driven by inventory formation

Source: Reuters EcoWin

The proponents of fiscal austerity interpret the recent batch of positive data as a sign that the recovery has arrived. We admit that some macro data have surprised on the upside. For one, GDP rose 0.3% q-o-q in 13Q1. Although output is still 2.6% below its pre-crisis peak, the UK managed to record stronger growth compared to the major eurozone countries. But the breakdown paints a less rosy picture. Investment fell 0.8% q-o-q, the third consecutive quarterly decline, while net trade knocked 0.1%-point off the level of GDP. Meanwhile, household spending increased by a meagre 0.1% q-o-q. In fact, if we were to exclude the volatile inventory formation component, GDP would have *declined* by 0.1% in 13Q1.

Housing market on the road to recovery?



Source: Reuters EcoWin

UK's credit conditions have loosened significantly since the introduction of the Funding for Lending scheme. This may support the housing market, which is already showing some signs of stabilisation. The rise in mortgage approvals, property transactions and RICS surveys in 13Q1, together with the recent drop in mortgage rates suggest that housing activity may pick up going forward. The newly introduced "Help-to-Buy" scheme (see April UK Economic Update) will also lend a helping hand. But a housing boom is not on the cards while households face falling real wage growth, a weakening labour market and elevated economic uncertainty. Not to mention that the balance sheet repair process is far from complete.

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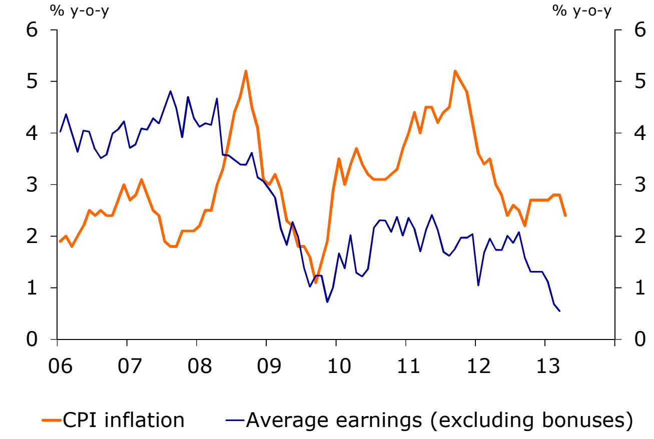
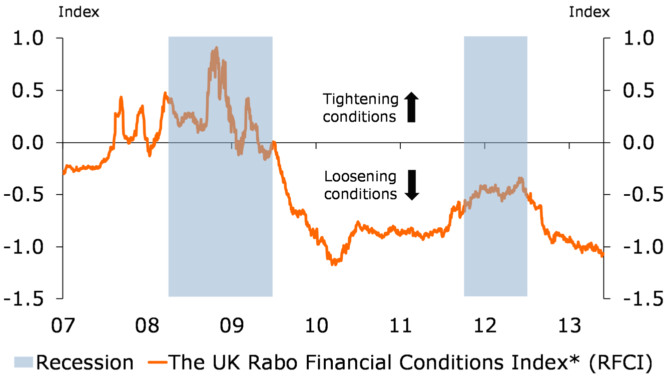
The labour market has lost some of its shine



Source: Reuters EcoWin

The latest labour market data make for grim reading. Employment declined by 43,000 in the three months to March. After rising strongly during 2012, employment has now been roughly flat since November. Over the same period, the unemployment rate was 7.8%, up 0.1%-points from October to December 2012. What's more, nominal wage growth continues to be under pressure. The annual growth rate of weekly earnings (excluding bonuses) averaged 0.8% in the three months to March, the lowest growth rate since records began in 2001. The good news is that inflation (2.4% in April) is expected to fall in 13H2, thereby alleviating the big squeeze on households' incomes.

The growth outlook has become a bit more positive…

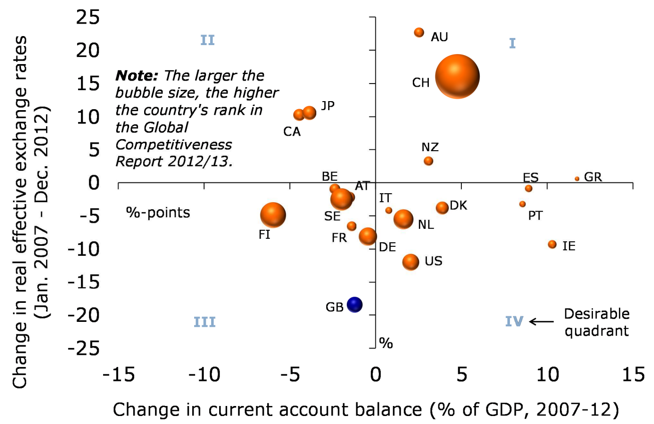


* ***RFCI incorporates:*** Government bond yield (10yr), BoE policy rate, TED spread, swap spread (10yr), corporate bond spread (10yr), stock exchange (FTSE 100), trade-weighted exchange rate. Standard deviations from average. All indicators carry equal weight.

Source: Reuters EcoWin, Rabobank

On balance, the recent improvement of producer and consumer sentiment (ESI, PMI and GfK index) and loosening of financial conditions suggest that UK's economic activity will slowly gather momentum in the coming months. But domestic demand is unlikely to contribute much amid private sector deleveraging. The incoming governor of the Bank of England, Mark Carney, may push for more quantitative easing or even provide 'forward guidance' on the monetary stance. But this will not materially alter the outlook while the fiscal authorities are firmly pressing on the brakes. We should remind ourselves that just over a third of the government's planned austerity measures have taken place so far.

…but strength of external demand remains key



Source: BIS, IMF, World Bank

Owing to weak domestic demand, it is the external growth environment – and, specifically, the evolution of the euro area crisis – that will largely determine UK's growth outlook. The sterling's sharp depreciation since the crisis has not led to much-needed external rebalancing. Apart from the euro crisis, the weakness of services exports – especially financial services – has been a key factor underlying the disappointing export performance. To be sure, improved market sentiment bodes well for UK's services exports but we must realise that the external sector will not come to the country's rescue as long as the eurozone, which accounts for roughly half of UK exports, remains mired in a recession.

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