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Outlook for the UK Economy:

Green shoots or weeds ?

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The Global Context

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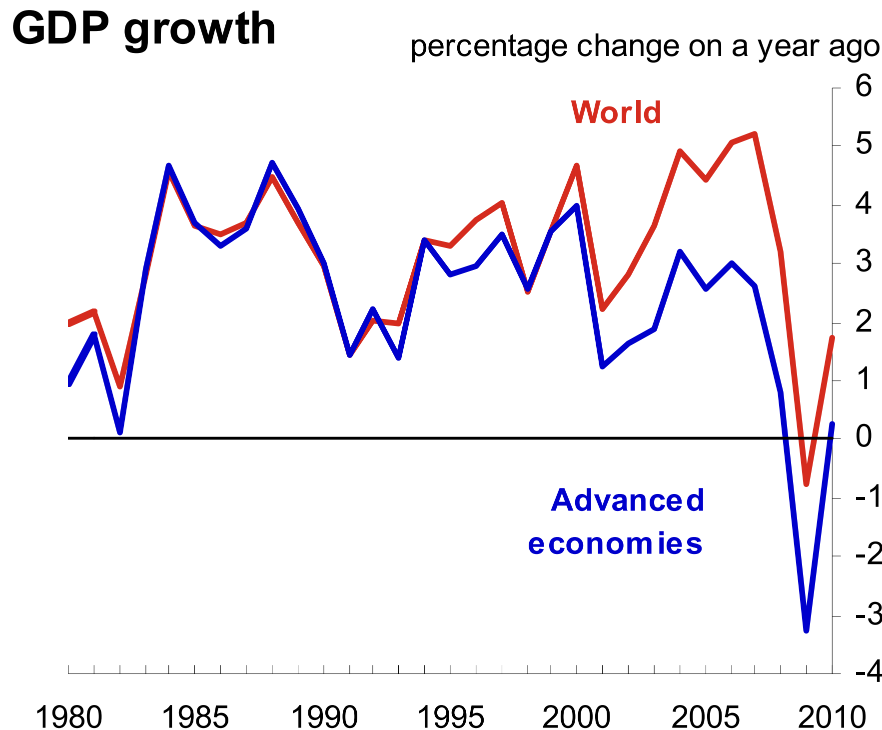
The worst global growth outlook since World War II…



Source: IMF WEO

From 2004 onwards, global growth picked-up well above its long run average of 3.5% to rates around 5%, its strongest performance since the 1980s.

This year the world is expected to contract for the first time in 60 years.

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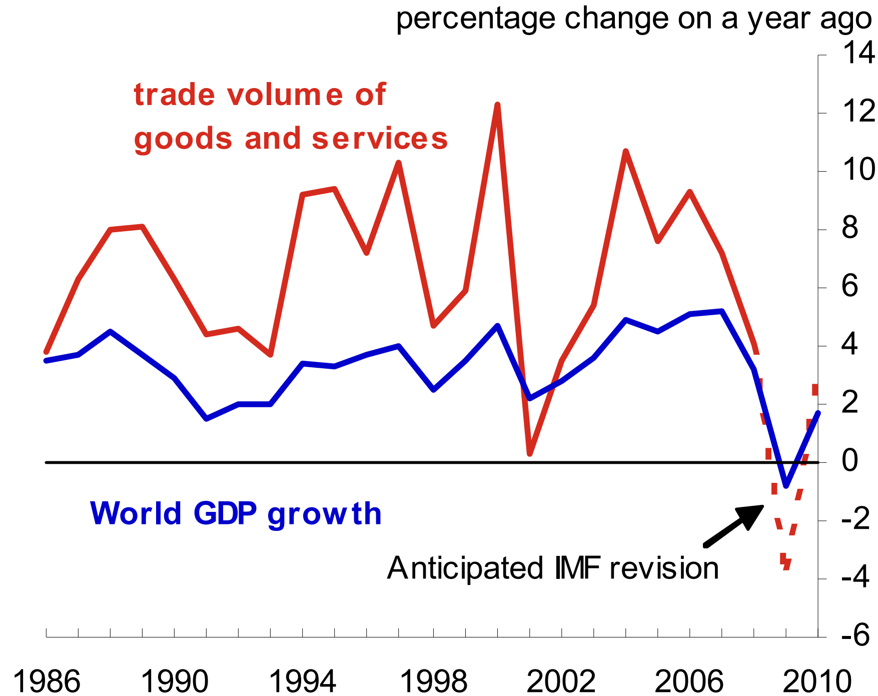
Trade is leveraged to GDP…



Trade volumes typically grow around twice that of GDP. With the bulk of trade being conducted between Advanced economies, the IMF are now expecting a contraction in trade far shaper than the slowdown seen in 2001.

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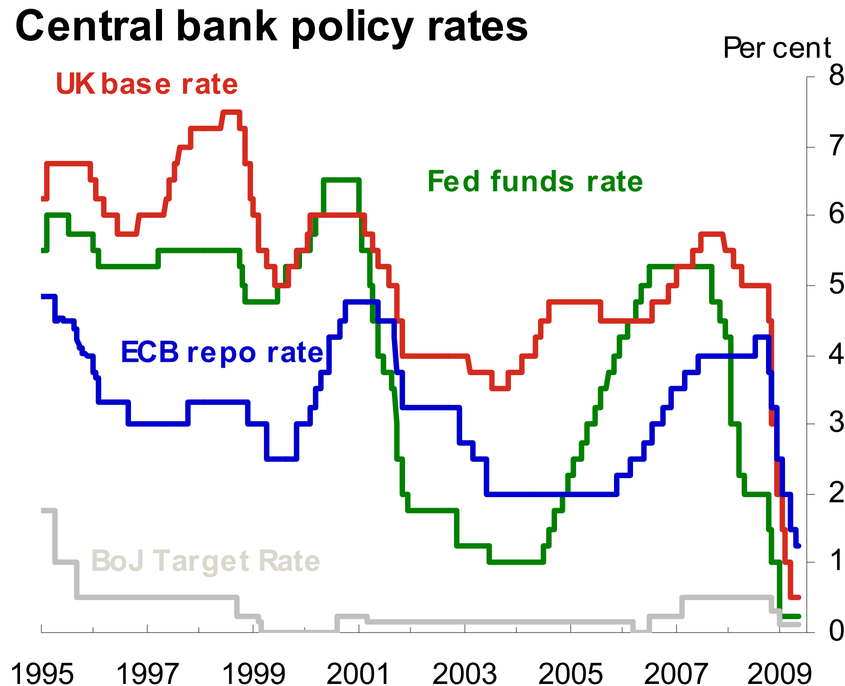
So we are now seeing unprecedented policy measures



Source: Bloomberg

In the US we are now in ZIRP territory. The laggard is the ECB, which will takea toll on the outlook.

Attempts to reduce the cost of money are now running alongside attempts toincrease its quantity.

Previous history suggests that central banks are happy to create steep yield curves to recapitalise the banking system as well as other methods.

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And governments are busy reflating

Measure	Argentina	Australia	Brazil	Canada 2/	China	France	Germany	India	Indonesia	Italy	Japan	Korea	Mexico	Russia	Saudi Arabia	Spain	UK 3/	US
Expenditure																		
Infrastructure investment	T	T		T	T	T	T	T	T		T	T	T		T	T	S	T
Support to SMEs and/or farmers							T				T	T		T				
Safety nets	T	T	T	T	T	T	T		T	T	T	T	T	T		T	T	T
Housing/construction support		T	T	T	T	T	T				T			T		T	T	
Strategic industries support				T	T		T	T						T		T		
Increase in public wage bill																		
Other		T		T	T	T	T	T			T	T	T			T	T	T
Revenue																		
CIT/depreciation/incentives 2/		P	P	P		P	P		P		P	P	P	P				P
PIT/exemptions/deductions 3/			P	P		T	P		P		P					P	P	P
Indirect tax reductions/exemptions 4/			T		P		P	T	P							S	S	
Other											P						P	

T: temporary measures (with explicit sunset provisions or time-bound spending).

S: self-reversing measures (measures whose costs are recouped by compensatory measures in future years).

P: permanent measures (with recurrent fiscal costs).

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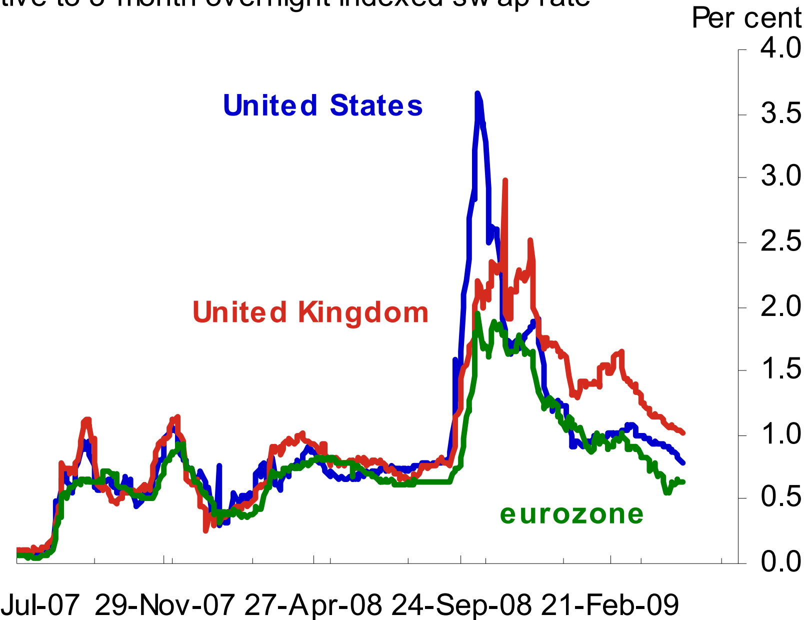
…but financial market tensions remain



Source: Bloomberg

Recent developments suggest that we are now at the end of the beginning as banks are actively forced to deleverage in order to remain in business

Further consolidation looks inevitable.

Note that the UK is now lagging, which suggests that markets are more nervous about the health of banks.

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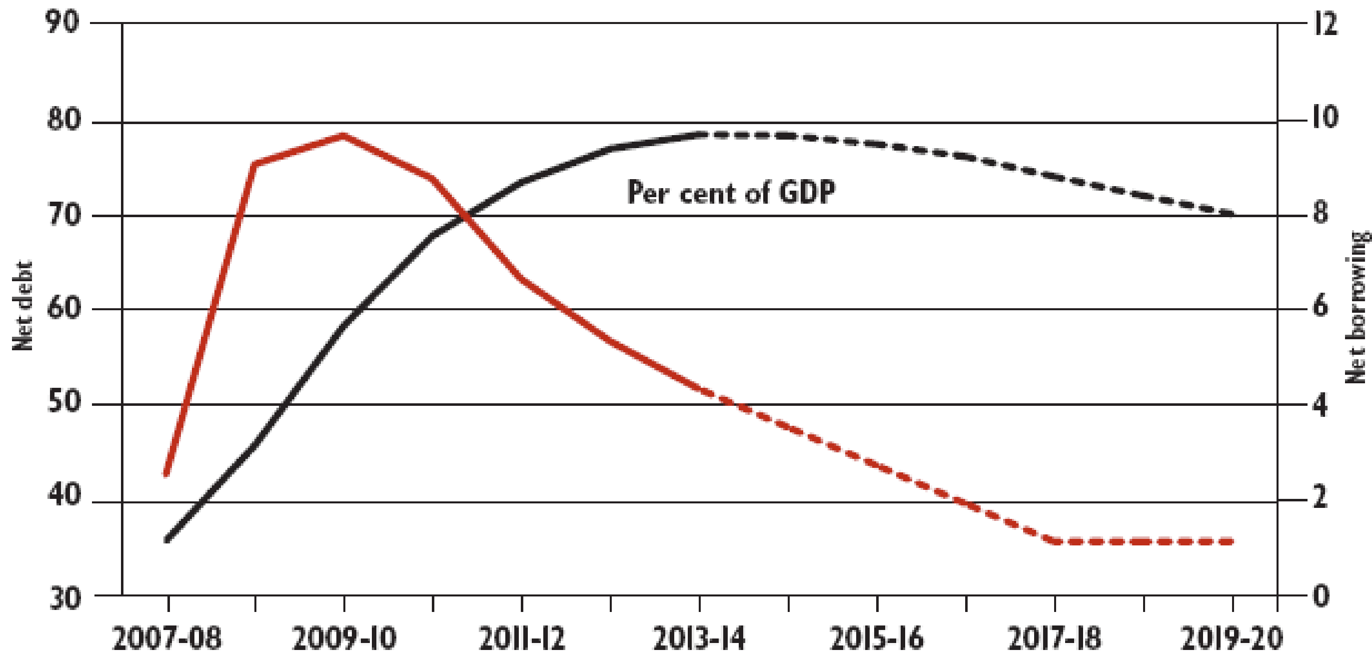
The UK Budget Forecasts

HMT forecasts for deficit and debt as percentage of GDP



Government borrowing is expected to reach 12.4% of GDP in 2009-10, falling to 5.5% by 2013-14

The total stock of government debt is forecast to keep growing from to 79.0% in 2013-14.

Assumption is for subsequent decline but no details are provided for this !!

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The UK Economic Outlook

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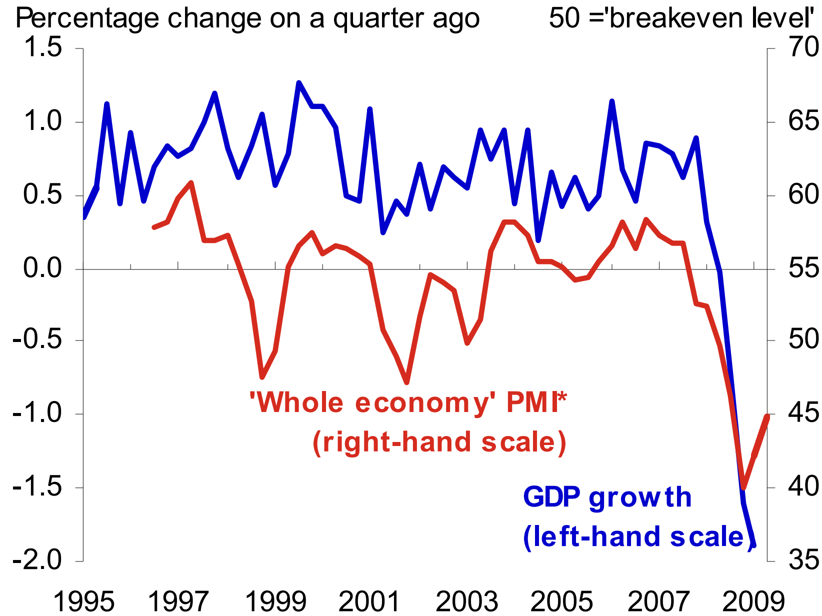
With only a slim hope of an upward revision



Source: ONS

Survey data suggest that the fall in output should not have been that extreme.

There could be a problem with data as ONS only have January and February data.

That said, the largest upward revision to UK GDP has only been 0.3pp.

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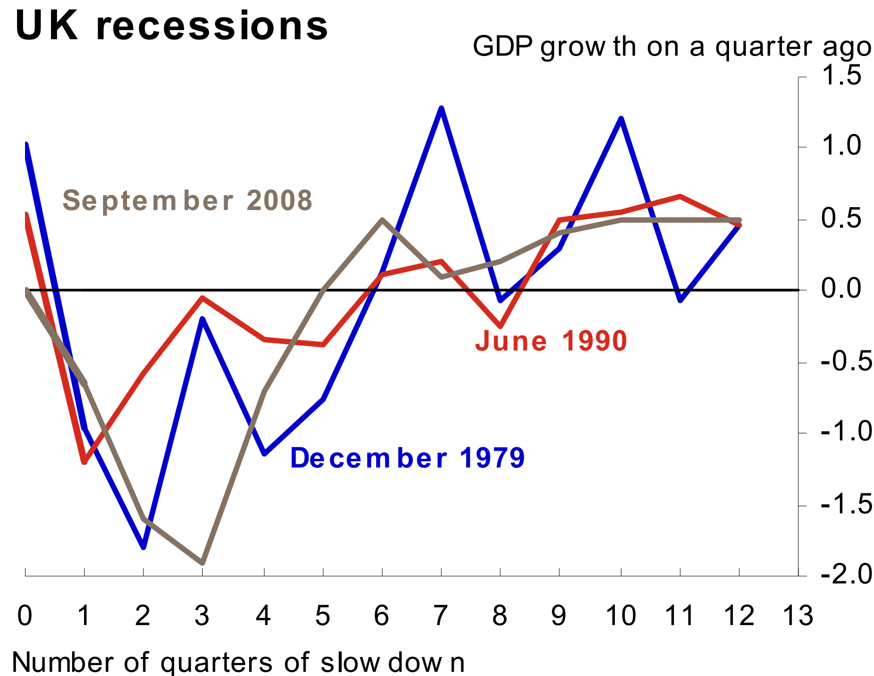
Recession on track to match 1980s…



We look for a 'W'-shaped recovery but doubt that the recovery will be as strong as the 1980s despite output losses being just as large (if not larger).

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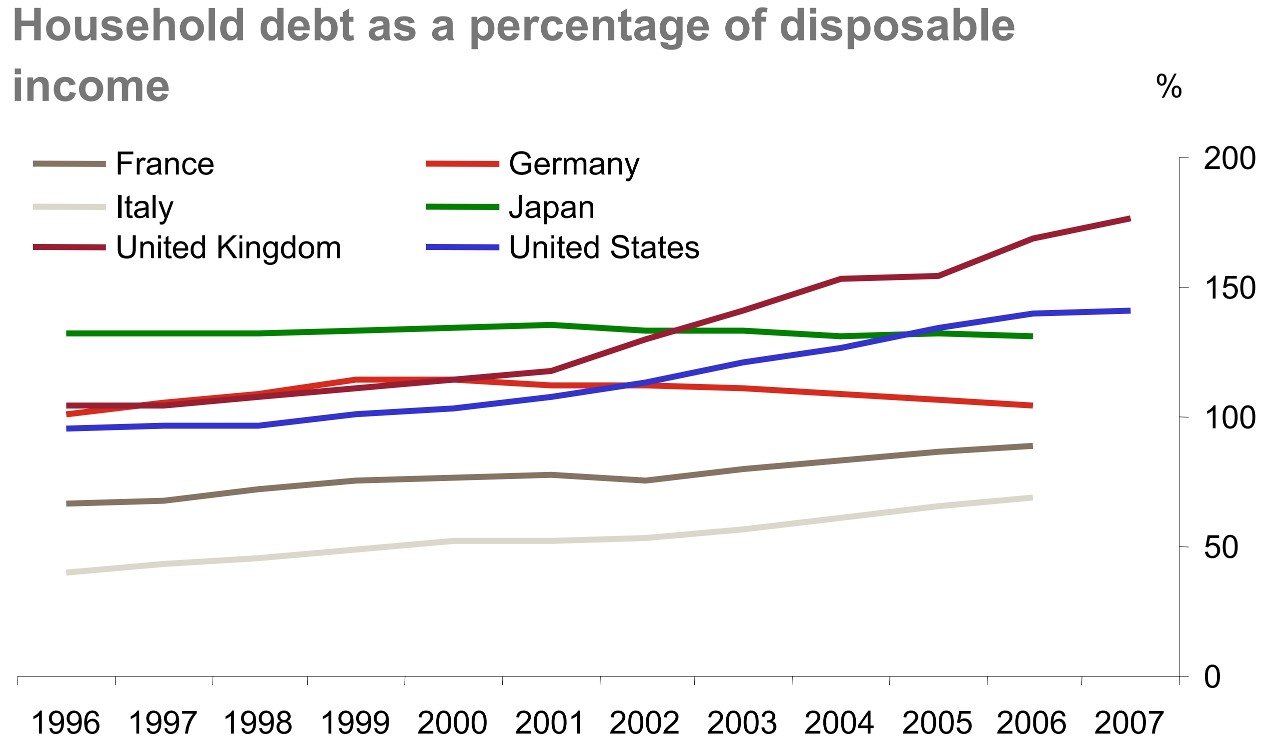
UK Household debt is the highest in the G7



UK household debt is highest in the world and also the highest in history

Debt to income ratio is more than double Italy's and more than 50% higher than France and Germany

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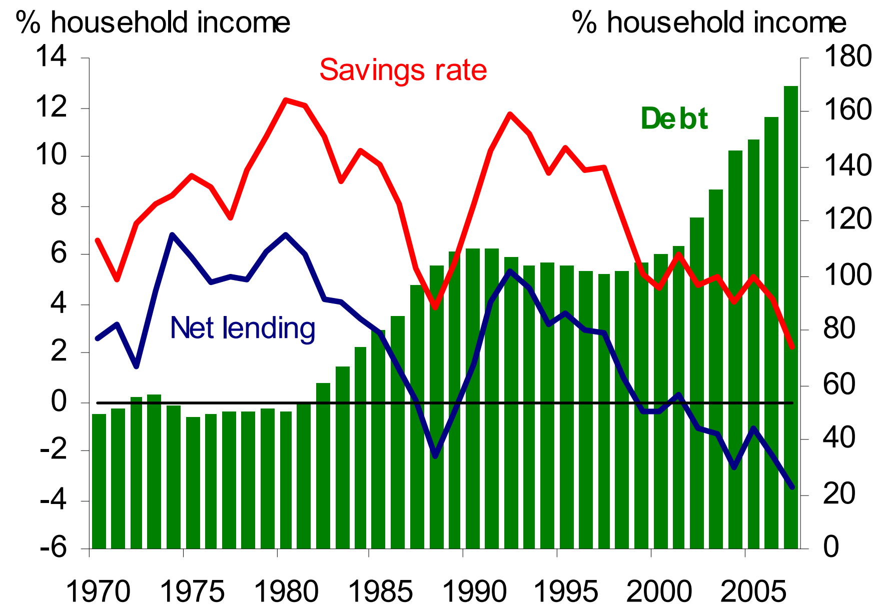
So a huge increase in savings is needed



It will take a much higher savings rate for a long time to get household debt back to previous levels

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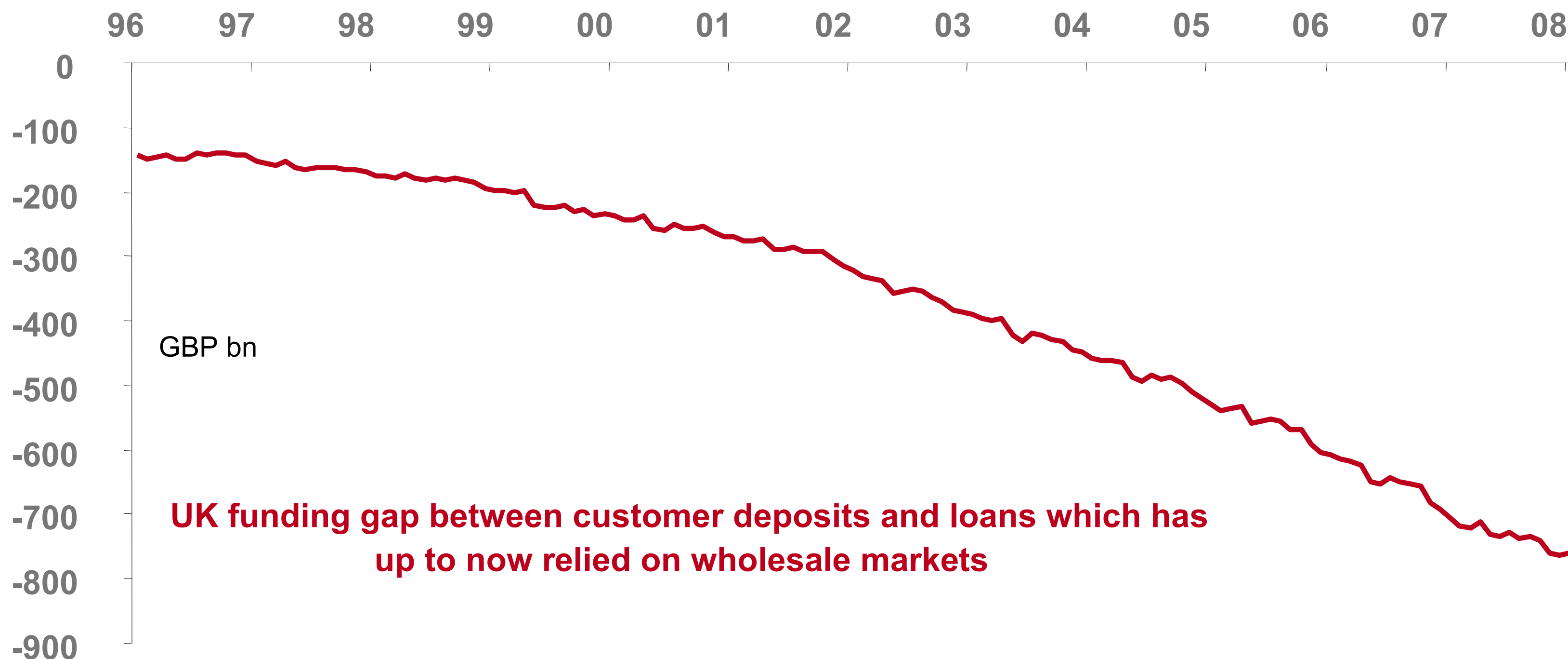
Reflecting their reliance on (now disfunctioning) wholesale markets



Source: Bank of England, nabCapital

Bank of England data on household and non-financial corporation depositholdings and lending, including lending to individuals shows the widening gap that has until recently been reliant upon wholesale funding. This has grown from GBP150bn in 1996 to over GBP700bn today (or 50% of GDP)

Money market paralysis has rendered this borrowing impossible – hence the credit crunch

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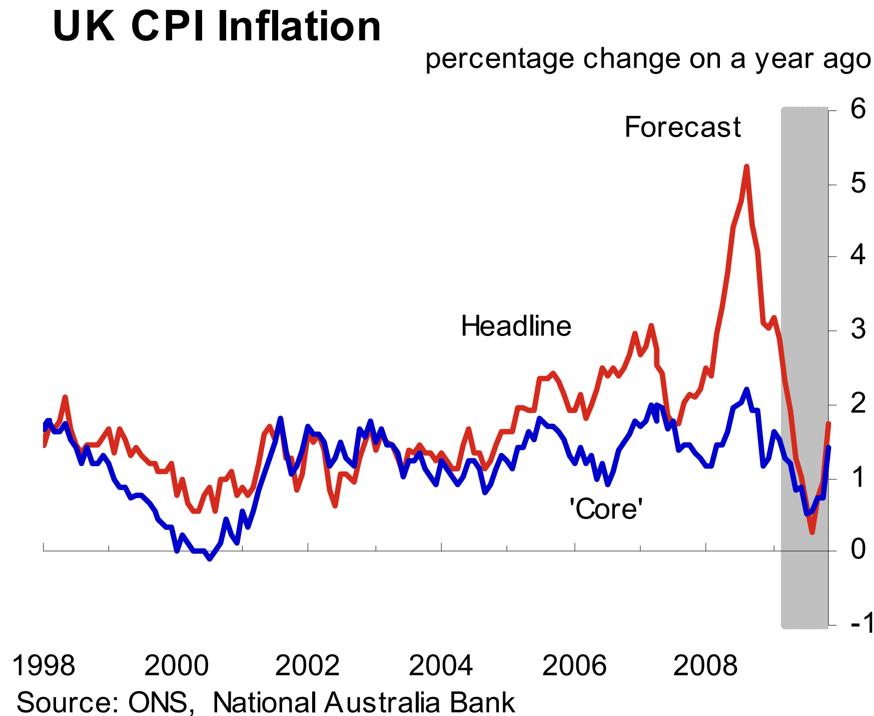
Inflation is easing rapidly, boosting spending power



CPI inflation rose back to 2.9% in February. But from here it should decline sharply.

A weak exchange rate and rising food prices look to have headed off deflationary fears for now.

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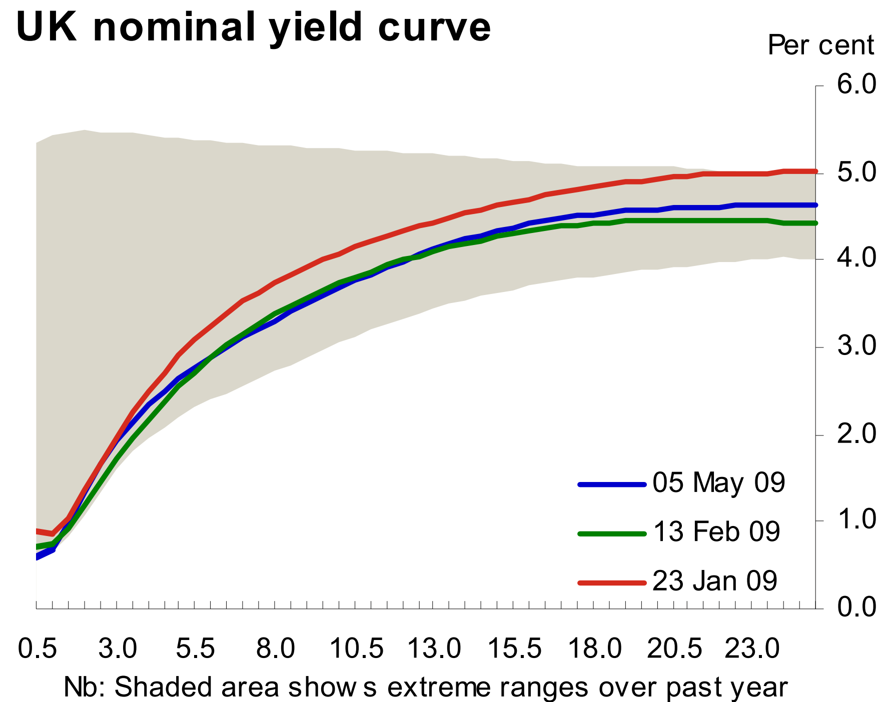
Rate cuts and QE have pushed yield curve lower



But high debt levels could easily see yields shift higher, especially as QE ends in the summer.

With markets veering between risks of depression to inflation/sovereign credit yields could shift upwards sharply at some point, indeed, we have seen some increases in recent weeks.

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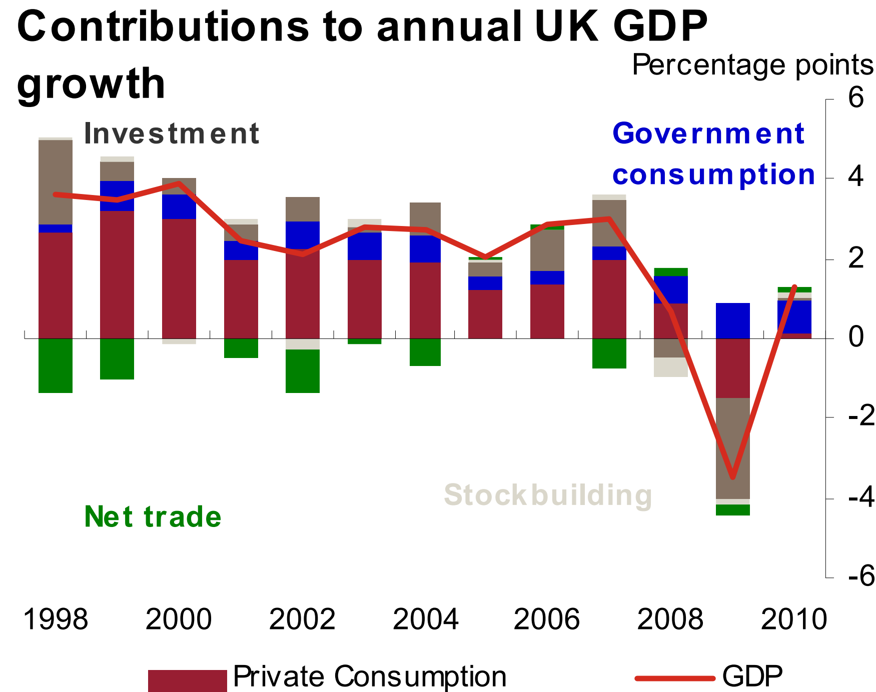
The economy should be growing just below trend by the end of 2010



Growth in 2010 largely comes from the public sector and net trade.

But by the end of that year there should be some signs of a recovery in private sector activity.

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Conclusions

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Debt reduction will be a painful experience

Other than default, there are two ways to reduce debt:

Cut expenditure, raise taxes and create structural surpluses.

- De-leveraging in the banking system feeds through to households then corporates.
- With tax revenues falling, government cuts expenditure leading to 'debt deflation.'

Decrease the real value of debt through hyperinflation

- Weimar Republic, Zimbabwe show the costs of this.

The UK has experienced three major accumulations and run-downs of government debt in its history.

From **1795 to 1882** debt peaked at 185% of GDP then down to 30% by 1914.

- Sharp cuts in military expenditure combined with healthy growth helped generate surpluses.

From **1913 to 1933** debt rose to 178% of GDP then down to 141% by 1938.

- Debt reduction was slow and limited because growth was weak. Abandonment of Gold Standard allowed the pound to depreciate, reducing real interest rates through inflation spurring growth.

From **1938 to 1946** debt rose to 252% of GDP then down to 43% by 1980.

- Debt reduction was rapid die to austerity measures in 1950s and then inflation. But growth quality was poor.

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Conclusions: UK

In the UK the **household sector is under considerable stress** and a sharp retrenchment is taking place. **UK output will fall by 3.5% in 2009.** Consumer spending will fall sharply as household budgets fall and debt is repaid.

The economy entered a **technical recession** by the end of 2008. This will be deeper than the 1990s, and now looks to equal the 1980s. Unemployment will increase to 10% by mid 2010.

The recovery will be **extremely uneven**, we expect to see a '**W'-shape**, with growth in the fourth quarter of this year weakening in the first half of 2010 as any consumption bought forward ahead of the VAT increase disappears.

That will be the peak of uncertainty as it might look as if policy measures have failed –rates are at zero, government has no room for further fiscal measures.

Easing inflation has provided **scope for BoE rate cuts**. From now on focus looks likely to be on Quantitative Easing measures, which could prevent yields from increasing too rapidly in the face of higher borrowing.

Government borrowing is set to increase by £703bn over the next 5 years.

Fiscal consolidation will have to accelerate after the General Election if the UK is to escape a sovereign downgrade. Spending cuts will be even larger than the Budget forecasts suggest. Whole programmes will have to be scrapped.

Problem is the narrowness of the tax base and an overreliance on cyclical tax revenues.

The UK economy faces its toughest period since the early 1980's with official figures confirming recession began in Q3 2008.

Official data may soon show the economy is deteriorating at a slower pace but this is not the same thing as a pick-up in activity.

The fall in sterling means that UK manufacturers have rapidly regained competitiveness, but an absence of overseas demand is still holding back output.

Conclusions: UK

Retail and related sectors will bear the brunt of the adjustment.

We still see a very large adjustment in property prices as we have seen in every other recession. With inflation lower, the fall in nominal **house prices** will have to be even larger and a **fall in nominal terms of 30% is possible**.

Attempts to control bonuses could promote further falls in prices. FSA desire to limit mortgage lending to 3x salary means that regional housing markets will perform very differently. London would see the hardest landing, down another 40%?

Increases in salaries in wake of changes to pay structures as well as the latest reforms to pensions seen in the Budget could sound the death-knell for any remaining defined benefit schemes. With public sector following thereafter.

But **Government spending and investment will support some businesses**, especially those in infrastructure this year. Note though the 17.5% fall in infrastructure investment in the Budget from 2011.

Companies wholly reliant on government funding could start to struggle then, just as private sector activity starts to increase.

Household bankruptcies pre-date the cyclical downturn, which suggests that much of the problem is structural, with people simply borrowing too much. That raises the risk of a severe deterioration this year as the downturn continues.

By 2010 growth will get back towards trend, but growth could struggle to rise above 2% thereafter.

So far, more weeds than shoots…