Moody's ANALYTICS

News

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MOODY'S ANALYTICS UK OUTLOOK

RECOVERY IN SIGHT, BUT RISKS REMAIN

LONDON July 11, 2013 — Moody's Analytics, a leading independent provider of economic forecasting, today released its latest economic outlook for the U.K.. According to the report, U.K. Outlook: Tentative Signs of Revival, recent positive data suggest that economic recovery is finally in sight for the U.K. However, the economy faces a number of risks that could keep the nascent recovery from translating into a stronger expansion.

"Recovery is in sight for the U.K. economy and GDP likely accelerated in the second quarter. However, fiscal austerity is a key risk facing the economy this year as it may hit important household spending more than anticipated. In addition, failure to revive credit would hinder the recovery in the housing market and wider economy," stated Melanie Bowler, Economist at Moody's Analytics.

The International Monetary Fund recently revised up its GDP forecast for 2013 to 0.9% from 0.7% previously. Moody's Analytics expects a similar rate of expansion. Although this is still well below potential growth of around 2.7%, the forecast is stronger than for that of neighbouring euro zone economies, including Germany which is forecast to grow just 0.4% this year.

Second quarter GDP data, due out later this month, are expected to show an acceleration from the first quarter's 0.3% q/q expansion. Both the manufacturing and services purchasing managers' indexes improved through the second quarter to hit their highest level in two years in June; while the construction PMI rose to a one-year high. This suggests that, contrary to previous quarters, all sectors of the economy likely contributed to second quarter growth, though services likely remained the main driver.

According to the Moody's Analytics report, there are signs of stabilisation in the U.K. economy, but the risks remain weighted to the downside. A new shock could knock the tentative recovery off track and trade and financial linkages mean that the U.K. economy remains highly exposed to problems in the euro zone. At the same time, the pound has fallen to a three-year low versus the dollar which could further increase inflationary pressures.

"The pound's recent drop against the dollar largely reflect signs of divergence in the monetary policies of the Bank of England and the U.S. Federal Reserve. While the Fed has mooted paring back quantitative easing, the BoE is expected to keep policy accommodative for some time to counteract the adverse conditions," said Ms Bowler.

Talk of monetary tightening in the U.S. has also led to a sharp increase in the U.K.'s longer term interest rates, as measured by government bond yields. Since mid-June gilt yields have increased by around 40 basis points. The current budget is based on yields averaging 2.4% this year and the Office for Budget Responsibility estimates that a 100 basis point rise above this would add around £800 million to debt interest payments. Should the economy come in weaker than anticipated, it would also be harder to meet fiscal targets.

Paradoxically, austerity risks engendering slower economic growth and knocking the tentative recovery off track and the U.K. government is holding firm with its commitment to austerity. The government recently outlined a further £11.5 billion worth of spending cuts for 2015 and 2016, which indicates that fiscal tightening will be the norm in the U.K. for at least another three years. The deficit is forecast to come in around 6.8% of GDP this year and will not meet the EU fiscal rule of a deficit of no more than 3% before 2017.

The Moody's Analytics report also notes that the U.K. saw the biggest plunge in real disposable income in 25 years in the first quarter of 2013, and wage growth is expected to remain weak for some time on lingering labour market difficulties. With consumer confidence well below its long-run average and discretionary spending restrained, consumption remains down by 4% from its 2007 peak and is unlikely to pass that level before mid-2015. Further austerity could delay this until even later.

Moody's Analytics believes that reviving appetite for credit will be key in enabling a return to self-sustaining growth for the wider economy. The BoE recently announced that it will extend its "funding for lending scheme" to target small and medium-size enterprises. This sector, which accounts for three-quarters of U.K. businesses, has struggled to access credit since the 2008 recession. However, the BoE's latest credit conditions survey shows banks plan to increase lending to households but credit availability for businesses will remain more restrained. This suggests the improvement in private sector credit flows will take some time.

For more information, visit Moody's Analytics Dismal Scientist.

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