

# UK Monthly Economic Update - June

4<sup>th</sup> June 2009

## Monetary Policy Committee (MPC) keeps the Bank Rate unchanged at 0.5%

Comment from Stephen Boyle, Head of RBS Group Economics:

*"Signs of stabilisation are one thing, a sustained recovery is an entirely different matter as demand conditions remain weak. The sustained upward movement in long-term interest rates in recent months threatens to pour weed killer on any green shoots, despite the Bank's efforts to lower borrowing costs across the economy."*

### Green shoots, or just weeds?

Green shoots seem to be popping up across the global economy, offering hope that we are past the worst of the recession and a recovery is around the corner. The UK service sector PMI, a good leading indicator of activity, snuck above the 50-mark that separates expansion from contraction in May, and the broadsheets are awash with references to a nascent recovery (chart 1). Retail spending continues to grow, outperforming wider spending in the economy by some margin. The economic picture might be getting slightly better, but it is still pretty bad. The improvement in the services PMI was primarily due to increased optimism about the future, not an improvement in current activity, and the manufacturing PMI remains firmly rooted in contractionary territory. Retail volume growth has slowed to just 0.7%, the slowest since 1996, and will come under further pressure as labour market conditions deteriorate. According to the PMI reports, employment continues to fall.

Talk of green shoots may contain its own risks. It suggests the normalisation of monetary policy sooner, and could undo the Bank's work to reduce long term interest rates. The rates on government bonds have moved up (chart 2), frustrating the efforts of the Bank's quantitative easing programme to reduce borrowing costs across the economy. This could mortally wound any fragile recovery.

### Standard and Poor's casts a shadow on UK credit worthiness

Standard and Poor's (S&P), a leading ratings agency, announced last month that it was downgrading its outlook for the UK economy's sovereign debt rating from "stable" to "negative". Whilst this does not change the long-term AAA sovereign credit rating (the highest possible grade), S&P has said there is a one-in-three chance the rating will be lowered when it next reviews the UK's credit worthiness after the approaching general election.

The Chancellor of the Exchequer predicts the UK budget deficit will reach £175 billion next year (five times the average of the last five years), and net debt issuance over the coming five years will be £750bn. Not small beans by any measure. As a result national debt is projected to reach 91% of GDP by 2013/14. Although the probability of default remains very low, S&P consider this level of debt to be too high to be consistent with what is essentially a default-free investment.

### What would a rating downgrade mean?

It would make the UK the fifth, and largest, EU country to be downgraded and likely leave the country with a AA+ rating, the same as Belgium (90% debt/GDP), but better than Italy (105% debt/GDP). A downgrade would be likely to raise the government's cost of funding as investors would require a higher return for holding UK gilts. This would increase the cost of issuing new bonds and raise the cost of rolling over older borrowings. Combined with greater competition for investors' cash from globally higher bond issuance, this could make it more difficult for the government to meet its borrowing requirements.

If overseas investors reduce their appetite for sterling assets the value of the pound could also fall victim. That said, the UK enjoys more flexibility in managing its finances than euro member countries and maintains an independent monetary policy.

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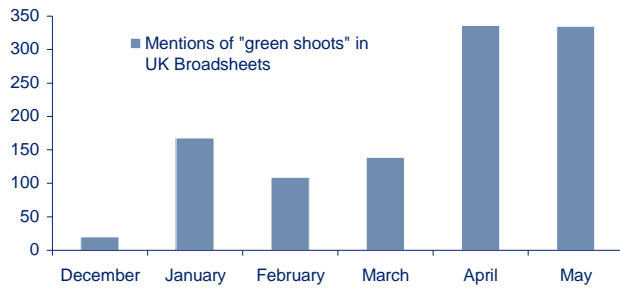
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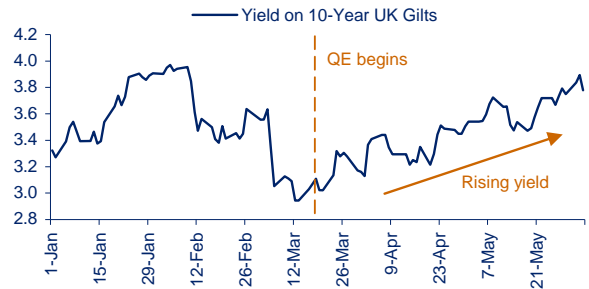
**1: Mentions of “green shoots” in the press rising**

Source: Factiva



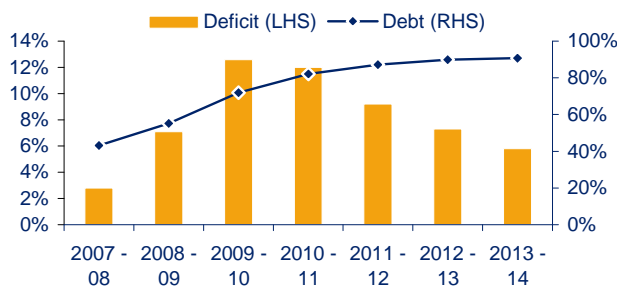
**2: Rising yield on long-dated gilts**

Source: Thomson Datastream, 2009



**3: Government deficits, and debt on the rise**

Source: HM Treasury Budget 2009, appendix C; figures as % of GDP



**Interest rate facts & figures**

Source: Bank of England, RBS Group

	Bank of England	RBS Group
Current rate	0.5%	0.5%
Since	5 <sup>th</sup> March 09	5 <sup>th</sup> March 09
Month ago	0.5%	0.5%
Year ago	5.00%	5.00%

Minutes of June MPC meeting released: 17<sup>th</sup> June 2009  
 Next MPC announcement: 9<sup>th</sup> July 2009  
 Next Inflation Report Published: 12<sup>th</sup> August

**Following the decision, The Royal Bank of Scotland, National Westminster Bank plc and Ulster Bank Ltd. kept their Base Rate unchanged at 0.5%**

All in %	Retail Price Index (includes mortgage payments)	Consumer Price Index
	RPI	CPI
<b>2007</b>	4.5	2.9
	4.4	2.6
	3.9	1.8
	4.2	2.1
<b>2008</b>	4.0	2.4
	4.4	3.4
	4.9	4.8
	2.7	3.9
<b>2009</b>	-0.1	3.0
	-1.3	1.6
	-2.4	-0.2
	-1.8	-0.6
<b>2010</b>	0.8	0.5
	1.5	0.5
	1.7	1.0
	1.8	1.0

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