

UK Monthly Economic Update

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

Comment from Stuart Porteous, Head of RBS Group Economics:

"Is this the beginning of the end of the recession? While it looks like Q1 may well be the worst quarter of this downturn, any talk of recovery is premature. The Bank of England has emptied both its barrels, and it will be some months before we can judge just how successful it has been. What we do know is that policy cannot and should not avoid the necessary rebalancing of the UK economy, and this process has only just begun."

Some improvement but the UK economy remains far from turning the corner

Several rays of light emerged in the economic darkness. The best leading indicators for the economy, the Purchasing Managers' Index survey of business activity, jumped four points to 44, defying more pessimistic expectations. At this level, this business barometer is still consistent with an economy in recession, but it suggests that the pace of decline may be easing. Similarly, the latest Credit Conditions Survey by the Bank of England was less bad than feared, pointing to somewhat stronger supply of bank lending and more demand for external financing from SMEs.

But this is not a 'garden-variety' recession. This downturn is being driven by a drawn-out unwinding of structural imbalances. This process is still in its infancy – more painful adjustments are almost certainly ahead of us before we see a recovery that deserves the name. People have started to save more, illustrated by the leap in households' savings ratio from -1.3% in Q3 to 2.4% in Q4. But the ratio remains below its long-run average (5%) and will probably overshoot before it stabilises, implying that consumer spending is likely to stay depressed for longer. Debt burdens in the corporate sector continued to increase in the final quarter of last year (chart 1). Amid depressed demand from the private sector, it will be challenging for the government to plug the gap.

The government's hands are tied

The UK is running high public deficits – both historically and internationally. The OECD estimates that the UK's government budget deficit will be 9.3% of GDP this year and 10.5% in the subsequent twelve months (chart 2). This is significantly higher than the projected average deficit for all OECD countries of 7.2% and 8.7%, respectively. The UK's forecasted deficits also look sizeable from an historic perspective, given that the average deficit over the past five years was 'only' 3%.

Dwindling tax revenues are at the heart of the budget deficit. The recession is affecting all of the major sources of tax revenue (chart 3). Income tax and national insurance, accounting for almost 50% of total tax receipts, are poised to contract due to rapidly rising unemployment and stagnant wages. Intakes from the next biggest contributor, VAT, are going to be weaker as well, driven by lower consumer spending and, of course, the cut in the VAT rate in effect until the end of this year. The outlook for corporation tax (c. 9% of the total) is not promising either. A quarter of corporation tax revenue used to come from the financial sector – a trend that is very likely to break in the current financial crisis.

A new significant fiscal stimulus in the Chancellor's Annual Budget Report later this month looks unlikely. In the words of Mervyn King, Governor of the Bank of England: "I think the fiscal position in the UK is not one where we could say, well, why don't we just engage in another round of fiscal expansion." With the government's room for manoeuvre limited, the ball is back in the court of the Bank of England and its 'quantitative easing' operations.

The Bank of England has to tread carefully

The success of 'quantitative easing' requires credibility. The Bank of England's aim in its 'quantitative easing' operations is to lower long-term interest rates. This goal could become harder to achieve if markets started to harbour doubts about the government's commitment to bring the near-term record deficits back down in subsequent years. This would risk an upward shift in inflation expectations priced into long-term interest rates, ultimately restricting the Bank's flexibility in fighting the recession. The government has to set out a new credible fiscal framework to prevent this scenario from materializing – details are due in the upcoming Budget Report.

Chart 1: UK corporate sector gearing ratio (net debt/equity)

(in %)
Source: Datastream



Chart 2: government net lending as % of GDP

(%)
Source: OECD

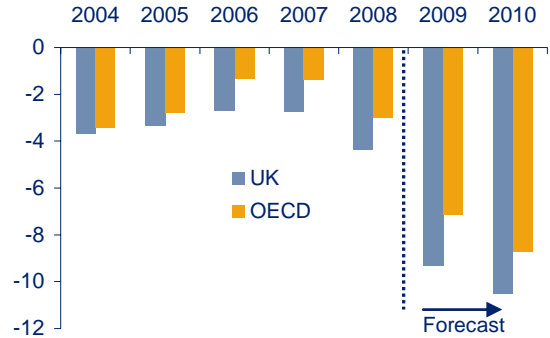
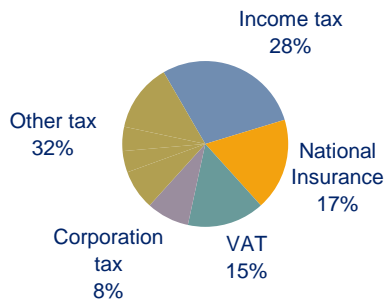


Chart 3: UK government receipt by source (projections for fiscal year 2008-09)

Source: HMT



Interest rate facts & figures

Source: Bank of England, RBS Group

	Bank of England	RBS Group
Current rate	0.5%	0.5%
Since	5 th Mar 09	5 th Mar 09
Month ago	0.50%	0.50%
Year ago	5.25%	5.25%

Minutes of December MPC meeting released: 22nd April 2009
Next MPC announcement: 7th May 2009
Next Inflation Report published: 13th May 2009

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
2007	4.5	2.9
	4.4	2.6
	3.9	1.8
	4.2	2.1
2008	4.0	2.4
	4.4	3.4
	4.9	4.8
	2.7	3.9
2009	-0.3	2.2
	-1.3	1.1
	-2.4	-0.6
	-1.8	-0.6
2010	0.8	0.5
	1.5	0.5
	1.7	1.0
	1.8	1.0

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