

UK Monthly Economic Update - August

6th August 2009

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

Comment from Stephen Boyle, Head of RBS Group Economics:

"We won't know for another few quarters if the first £125bn of asset purchases by the Bank of England has managed to stop the rot, but the MPC has clearly decided that it's better to be safe than sorry and will buy another £50bn of bonds. This tells us that the Committee believes the UK economy remains in intensive care and that a bigger defibrillator is needed to help it emerge from the worst downturn for a generation."

UK recession deepened in Q2 but we are past the worst

The recession in the UK continued in the second quarter of the year, as economic output contracted by 0.8% compared to the previous three months. This was significantly worse than expected by city analysts (-0.3%), but was a marked improvement on the 2.4% drop seen in Q1 (chart 1). This suggests we are past the worst but by no means out of the woods. Declines in Q2 were broad based, with no sector of the economy remaining unscathed. The largest contributor to falling output was the financial and business services sector, which accounted for just over half the contraction. Manufacturing continued to be hit hard by falling demand at home and abroad (-12.7% y/y), but construction stood out as the poster-boy for the recession. Building activity has fallen 15% since Q1 last year, the largest for any sector.

Are house prices really coming back up or is there something else going on?

According to the Nationwide Building Society, house prices in the UK rose for the third consecutive month in July, bringing the average price of a house to £159K. Recent gains mean that prices could end the year above where they started it (they were 0.8% higher in July than January). On the Halifax survey, house price declines also seem to be levelling off. But short term movements in prices should not be interpreted as a sign the market has recovered. It has stabilised but is fragile.

Prices have been supported by a shortage of decent properties on the market. Coupled with the gradual return of demand, this has meant there weren't enough properties to go round, and prices were pushed up. According to the Royal Institute of Chartered Surveyors, supply is down 35% compared to last year. In an environment of falling prices and negative equity, households are reluctant to sell unless they have to. In the early 1990s a sharp rise in interest rates and high unemployment forced many to sell – pushing down prices. In this recession aggressive policy action and increased forbearance by lenders have reduced the number of homeowners who would otherwise have been forced to sell.

So whilst the return of demand to the market has supported prices, transaction volumes are very weak. The sales-to-stock ratio has risen in recent months as the number of new mortgage approvals has risen. But the rise has been modest, and approvals remain 50% below their long run average. Fewer available mortgages have weighed on transactions, as has the withdrawal of high loan-to-value (LTV) mortgages which has pushed many first time buyers out of the market. According to the Council for Mortgage Lenders, an average deposit of £30K is needed to secure a first mortgage (roughly a year's salary), which has led to 80% of new buyers under 30 to seek parental support.

The return of affordable housing?

The corollary of house prices consistently rising faster than incomes was that households had to borrow more to buy property. Despite low interest rates, the share of income spent servicing mortgage debt rose, pushing borrowing to the limit of affordability. Now, even lower interest rates are supporting affordability, but this cannot continue forever. An increase in the cost of borrowing will negatively affect house prices, meaning they can only rise if households are either prepared to devote more income to servicing their debt, or a structural shortage of housing forces this upon borrowers.

Contacts:

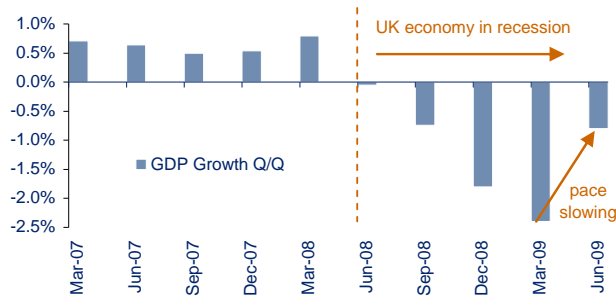
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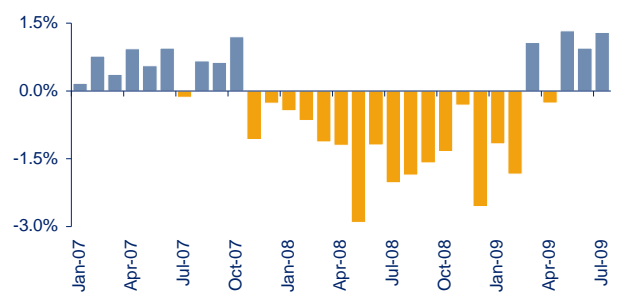
1: Pace of recession easing, but some way left to go

Source: ONS



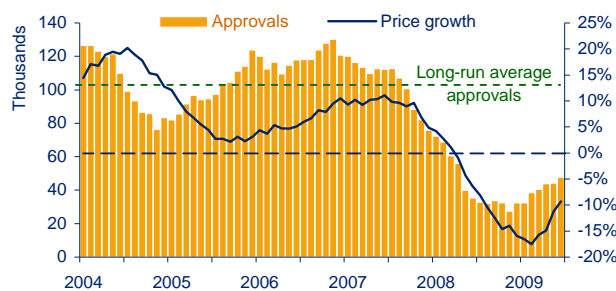
2: House prices appear to be stabilising

Source: Nationwide Building Societies, M/M growth



3: Demand is still very low by historical levels

Source: Nationwide Building Society (Y/Y house price growth), Bank of England



Interest rate facts & figures

Source: Bank of England, RBS Group

| | Bank of England | RBS Group |
|--|--------------------------|--------------------------|
| Current rate | 0.5% | 0.5% |
| Since | 5 th March 09 | 5 th March 09 |
| Month ago | 0.5% | 0.5% |
| Year ago | 5.00% | 5.00% |
| <i>Minutes of June MPC meeting released: 19th August 2009</i> | | |
| <i>Next MPC announcement: 10th September 2009</i> | | |
| <i>Next Inflation Report Published: 12th August 2009</i> | | |

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 | -0.1 | 3.0 |
| | -1.3 | 2.1 |
| | -2.0 | 0.6 |
| | -1.5 | 0.5 |
| 2010 | 0.8 | 0.5 |
| | 1.5 | 0.5 |
| | 1.7 | 1.0 |
| | 1.8 | 1.0 |

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