# United Kingdom

| UOB Economics Projections – UK | 2008 | 2009 | 2010F | 2011F |
|---|---|---|---|---|
| GDP | 0.5 | -4.9 | 1.2 | 2.3 |
| CPI | 3.6 | 2.2 | 2.6 | 1.9 |
| Unemployment Rate (year-end) | 5.6 | 7.5 | 7.9 | 7.7 |
| Current Account (% of GDP) | -1.6 | -1.3 | -1.4 | -1.0 |

- *The UK general election has come and gone. Yet, little can be said with certainty about the macroeconomic landscape. Of more interest, though, was the Emergency Budget unveiled on June 22 by Britain's new Conservative Liberal Democrat government.*
- *We think that risks still remain for the recently-volatile GBP/USD pair. Any announcement relief will probably be temporary only, with absolute direction keying off the broader trends in risk markets and broader perceptions over the growth outlook since the sizable retrenchment on the fiscal side is likely to bring a sharp slowdown in economic activity for the UK.*
- *The fiscal tightening represents an important downside risk to our view of economic recovery going forward, and that may change the path of the Bank of England (BoE)'s interest rate tightening process.*

## Emergency Budget Gambles on Growth

The UK general election has come and gone. On May 11, David Cameron became Britain's new prime minister, breaking five days of deadlock after an inconclusive general election and becoming the first Conservative premier for 13 years. Yet, little can be said with certainty about the macroeconomic landscape. Nevertheless, all eyes were on the Emergency Budget unveiled on June 22, with Chancellor George Osborne delivering most of what had been expected by market participants. He would slap a levy on banks, ramp up taxation on goods and services, freeze public sector pay and slash benefits spending in an attempt to curb the huge public deficit.

| Budget Highlights |
|---|
| ✓ Value-added tax (VAT) to rise from 17.5% to 20.0% from January next year. |
| ✓ Welfare cuts of 11 billion pounds by 2014-2015 – child benefit frozen for three years; maximum limits for housing benefits; tougher assessment for disability allowance. |
| ✓ Public sector workers to face a two-year pay freeze. |
| ✓ Speeding up increase of state pension age to 66. |
| ✓ Most government departments face cuts around 25.0% over four years. |
| ✓ Payments to Queen Elizabeth frozen; system to face a shake-up. |
| ✓ Joint move with France and Germany to introduce bank levy expected to raise 2 billion pounds annually. |
| Source: Agence France-Presse |

Whilst only half of the measures were specified (the other half will be specified in the Autumn Spending Review to be published on October 20), the combination of tax rises and spending cuts are aimed at reducing the structural deficit from 4.8% of GDP this year to a surplus of 0.3% of GDP by 2014-2015 and 0.8% in 2015-2016. The OBR had (a week earlier) said that the budget plans laid out by the previous Labour government in March would leave the structural current deficit at 1.6% of GDP by 2014-2015.

Having said that, with government spending within the national accounts contributing to close to a quarter of overall GDP, the OBR has revised down its near-term forecasts for growth further to reflect the negative impact that the announced spending cuts and tax increases are expected to have on the British economy. Using figures provided by the new independent fiscal council, the OBR, Osborne said the economy would grow 1.2% in 2010, 2.3% in 2011, 2.8% in 2012, 2.9% in 2013 and 2.7% in 2014 and 2015. On inflation, in the June OBR forecasts, CPI was seen at 2.3% by the end of this year, falling to just over 1.5% by the end of 2011 then rising back to the 2.0% target thereafter. The near-term forecasts for inflation have been raised on account of the increase in VAT – the end-2011 forecast now stands at 2.4%.

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## Outlook on Sterling Still Not Clear

Attaining lows of 1.4231 in May, GBP/USD was on a decline for most of the quarter. The downward move in the currency pair was almost inevitable given the general election held in the country, as well as the worries about fiscal debt as European woes rattled markets. Of late though, the GBP/USD has been benefiting from the rise in risk appetite, with a steady climb to about 1.4842 (as of writing).

Osborne's first budget was in line with expectations, and that was reflected in a stronger GBP following the announcement. Bond markets rallied and rating agencies had also gave it a cautious welcome. Rating agency Fitch's indicated "that it sets out an ambitious deficit reduction path that, if delivered upon, will materially strengthen confidence in UK public finances and its 'AAA' status". We think that following this Budget, rating agencies are unlikely to downgrade the UK's AAA sovereign rating.

Having said that, risks still remain for the recently-volatile GBP/USD pair. The announcement will probably be of a temporary relief only, with absolute direction keying off the broader trends in risk markets and broader perceptions over the growth outlook since the sizable retrenchment on the fiscal side is likely to bring a sharp slowdown in economic activity for the country. The question now is whether monetary policy will need to turn yet more accommodative to prevent a slide back into recession, and that may potentially weigh on the GBP. Hence, we may need to wait for more substantive shifts in expectations on the BoE to take a bias on the GBP/USD. We see prices hovering around 1.450 by the end of 3Q, before going to around 1.440 by year-end.

## The BOE Keeps Stimulus in Place

The latest monetary policy decision was the first since the creation of Britain's coalition government on May 11. The Monetary Policy Committee, led by Governor Mervyn King, left the benchmark interest rate unchanged at 0.5% and also left the target for its bond holdings unchanged at 200 billion pounds.

The minutes of the latest meeting revealed that the MPC voted 7-1 to keep the benchmark interest rate at 0.5% (Andrew Sentence had made the first push for an increase); as well as a widening split on the committee on officials' judgment of the outlook for consumer prices. While some policymakers felt that the risk of inflation overshooting the 2.0% target had increased, some others said that financial market developments pointed to a shift in the risks "slightly to the downside". However, King had cautioned that the Bank should not react to faster inflation based solely on energy-cost and exchange rate fluctuations.

Furthermore, the fiscal tightening represents an important downside risk to our view of economic recovery going forward, and that may change the path of the BoE's interest rate tightening process. We think the central bank is widely expected to hold a cautious outlook, as the MPC looks for ways to achieve a sustainable recovery. We are keeping to our view that the MPC may start to unwind its emergency measures only when recovery gathers pace and a rate hike would only take place in 1Q11 at the earliest.