BBVA | RESEARCH

Economic Watch
UK

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Economic Analysis

Europe

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UK: growth-oriented economic policy

Better-balanced growth with no change in monetary policy and neutral fiscal policy with incentives for investment and exports

- **Growth in 4Q13 was more balanced, especially in the components of domestic demand**

  Detailed results of the National Accounts confirmed a GDP growth of 0.7% QoQ in 4Q13 (similar to the growth of the previous two quarters), representing average annual growth of 1.8% in 2013 and revealing a more balanced growth pattern (also as a result of the review of the latest quarterly data). Investment recovered strongly, taking over from private consumption in particular in being the principal driver, but also public spending. In addition, net exports contributed positively to growth as a result of the sharp decline in imports, although exports remained weak (Figure 1). Therefore, although these data may reduce policymakers' concern about the weight of consumption in growth, we believe it is still far too early to conclude that there has been a change in the pattern of growth and that it is sustainable, especially as regards export performance and its influence on investment, particularly in view of the fact the sectors responsible for the investment uptick are still the construction sector and public spending programmes. Thus, the recently announced economic measures are aimed at strengthening the process so that it does not derail.

- **In the first months of the year, investment recovery takes hold, while consumption moderates …**

  Recent data suggest relatively stable GDP growth (probably slightly lower) earlier this year (Figure 2), that will continue to be supported by higher investment and more moderate household spending. On the one hand, industrial production in January showed a slight slowdown compared to 4Q13 (Figure 5), but the production of intermediate and capital goods jumped significantly. This, together with the improvement in confidence (Figures 3 and 4) and profit margin, and with better access to credit (FLS focused on corporate finance) and low interest rates, suggests that growth in investment will remain robust. Meanwhile, retail sales in January significantly contracted, leaving household spending virtually flat compared to 4Q13 (Figure 6). Nevertheless, improving consumer confidence, together with the strong performance of the labour market, rising wages and lower inflation, point to relatively strong private consumption, although more moderate.

- **… but exports do not get off the ground**

  Data from the January trade balance continues to show no signs of recovery in exports (Figures 7 and 8). After the weakness observed in the last quarter of last year (0.4% QoQ), exports contracted significantly in January, resulting in a drop of about 1.5% compared to 4Q13, while imports virtually stagnated, meaning that net exports could again contribute negatively to GDP growth in the first quarter of 2014. In addition, confidence surveys showed that export orders decreased sharply in January and February, so this export behaviour is not expected to change in the short term. Despite the better performance of the economy in the eurozone (the UK's main trading partner), the recent appreciation of sterling, driven by the UK's better economic prospects and the increased demand for this currency as a safe haven after turbulence in emerging markets, could be slowing exports. In short, there still are doubts about the role of exports in the coming quarters in rebalancing growth.

- **The unemployment rate remains slightly above 7% in February, but is likely to reach that threshold in 2Q14**

  The unemployment rate (ILO definition) remained steady at 7.2% on the three months average in January, following the sharp decline observed since mid-2013 (Figure 9). However, it is expected to continue this positive trend in the coming months (in particular, the monthly rate was 6.9%), but at a slower pace as the economy continues its recovery. Slower employment growth resulted in increased productivity, so that the gain in nominal wages did not transfer to labour costs (Figure 10) and, therefore, should not provoke an increase in inflationary pressures, while it should continue to support private consumption.

- **Inflation eased to 1.9% YoY in January, leaving more room to keep an accommodative monetary policy**

  After four years above target, inflation moderated further in January by 0.1pp to 1.9% YoY, dropping slightly more than expected (2%) and with this moderation spread widely over components (Figure 11 and 12). The strength of sterling, together with the lower price of raw materials and the lack of wage inflation, suggests that inflation will once more oscillate slightly below the BoE target (1.9% YoY) on the horizon forecast.

- **No surprises in the Bank of England's analysis, which stays on message about its monetary policy stance**

  The vote to keep monetary policy instruments unchanged was unanimous in the March meeting, noting that although the forward guidance announced in August last year continues, the 7% unemployment rate threshold will be reached in the coming months and will lead to the adaptation of the strategy, as announced in the February Inflation Report, so that this new strategy will be subject to the progress of the economy. The meeting's minutes emphasise the limited reaction of the markets after that announcement and that expectations on the evolution of interest rates remain unchanged.

The BoE positively evaluates the signals of a more balanced growth (higher weight of investment and less of private consumption), and the recent increase in productivity resulting from the slowdown in job creation. However, it underlines the existence of contradictory signs about excess capacity in the economy. On the one hand, the number of unemployed could limit production capacity and thus result in excess capacity being less than expected. On the other hand, it considers that good labour market data (especially the increased numbers of self-employed people who may be underemployed) may be giving the wrong idea of excess capacity, being somewhat higher than might be interpreted at first sight. The latter would be in line with a moderate increase in nominal wages, while the significant reduction of inflation expectations will assist wage negotiations. All of this suggests that inflationary pressures will remain low, thus it maintains its projection for inflation around 2% in the forecast horizon.

- **We expect interest rates remaining at 0.50%, with the first rise in 2Q15**

  In short, the BoE kept both its analysis of the economic situation and the message about its stance on monetary policy unchanged, so that we continue to expect the first increase in interest rates in the second quarter of next year, with a very slow exit strategy.

- **Neutral fiscal measures in 2014, leaving the settlement until after the elections**

  The tax measures announced in the budget this week are neutral from the point of view of the deficit in the medium term, and are designed to encourage investment and exports, to contribute to the containment of inflation and to favour household incomes. They are neutral because the stimuli they announced (GBP5.5bn accumulated until 2018-19) will be offset by a spending reduction and revenues from the fight against tax evasion (GBP5.75bn accumulated until 2018-19). Between the stimuli, it is worth underlining the rise of the threshold (up to GBP500,000 from GBP150000) for 100% capital investment deductions up to December 2015, while the increase in personal allowances and the saving through tax reductions will favour agents' disposable income. Support for exports will be reflected in the rise of credit available to these companies (doubled to GBP3bn). Finally, changes in excise duties on alcohol and tobacco should support the containment of inflation.

  Therefore, these measures have no impact on public accounts, nor will additional discretionary measures be taken, so that the downward revision of the public deficit to 5.5% of GDP (-0.1pp) in 2014-15 from 6.6% in the fiscal year, is basically due to the cyclical upturn in the economy, which also resulted in a downward revision of deficit of about 0.2pp until 2018-19 (Table 1). In short, much of the fiscal adjustment will still be pending after the elections in 2Q15 (around 5.1% of GDP). Better growth expectations also affected the public debt forecast and it is now expected to reach a maximum of 78.7% of GDP (-1.2pp) in 2015-16.

  Finally, the economic forecasts of the Office for Budget Responsibility are less optimistic than those submitted by the BoE (Table 1), and more in line with our scenario (Table 2), with growth still primarily supported by household spending and a strong investment recovery, which means that excess capacity will not vanish until 2018.

Tabla 1
OBR forecasts updated in March 2014

Rate YoY	2013	2014	2015	2016	2017	2018
GDP	1.8	2.7	2.3	2.6	2.6	2.5
Private consumption	2.3	2.1	1.8	2.5	2.7	2.4
Public consumption	0.9	1.2	-0.5	-1.2	-1.8	-0.9
Private investment	-1.2	8.0	9.2	8.1	8.7	7.7
Public investment	**-6.4**	**10.7**	**1.0**	**2.2**	**0.8**	-0.5
Net exports (*)	0.1	-0.2	0.1	0.0	0.0	-0.1
Inflation	2.6	1.9	2.0	2.0	2.0	2.0
Public deficit (% GDP)	**6.6**	**5.5**	**4.2**	**2.4**	**0.8**	-0.2
Public debt (% GDP)	**74.5**	**77.3**	**78.7**	**78.3**	**76.5**	**74.2**

(*) Contributions to growth
Source: BBVA Research

Tabla 2
BBVA Research forecasts of GDP growth and inflation (February 2014)

Rate YoY	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	-1.0	-3.6	1.0	-0.4	1.5	2.3	2.2	2.1
Public consumption	2.2	0.6	0.5	0.0	1.6	0.4	0.5	-0.2
Gross fixed capital formation	-6.9	-16.7	2.8	-2.4	0.7	-2.0	6.7	5.8
Inventories (*)	-0.2	-1.5	1.2	0.4	-0.5	0.7	0.0	0.0
Domestic demand (*)	**-1.6**	**-6.1**	**2.1**	**-0.1**	**0.9**	**2.0**	**2.4**	**2.2**
Exports	1.1	-8.7	6.7	4.5	1.1	0.5	2.7	4.2
Imports	-1.7	-10.7	7.9	0.3	3.1	0.9	1.8	3.4
Net exports (*)	**0.9**	**0.9**	**-0.5**	**1.2**	**-0.7**	**-0.1**	**0.3**	**0.2**
GDP	**-0.8**	**-5.2**	**1.7**	**1.1**	**0.3**	**1.9**	**2.6**	**2.4**
Inflation	**3.6**	**2.2**	**3.3**	**4.5**	**2.8**	**2.6**	**1.9**	**2.0**

(*) Contributions to growth
Source: BBVA Research

United Kingdom

National Accounts: towards a better balanced growth

Net exports contributed positively to GDP growth, although because of the fall in imports, at the expense of the role of private consumption. Investment is recovering at robust rates. We expect the pace of recovery to remain stable or moderate slightly earlier this year.

Chart 1
GDP (%QoQ) and contribution by component (pp)*

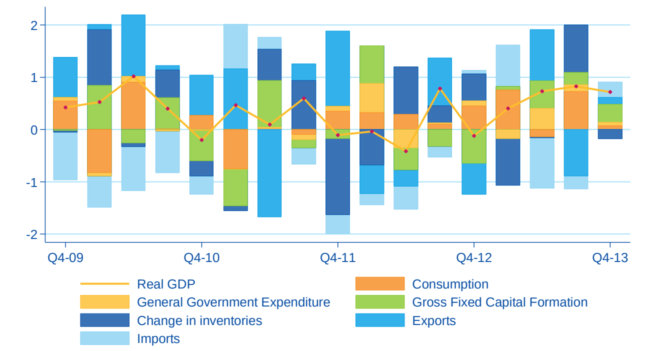
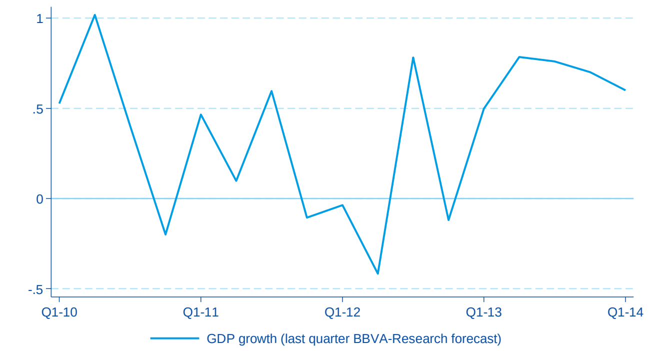


Chart 2
GDP growth (%QoQ) & forecasts*



Confidence: high but moderating earlier this year. suggesting a somewhat lower growth

Despite the moderation in recent months, confidence remains high (above the historical average), which should result in the materialisation of the decisions of economic agents, especially in investment.

Chart 3
PMI and GDP growth (%QoQ)*

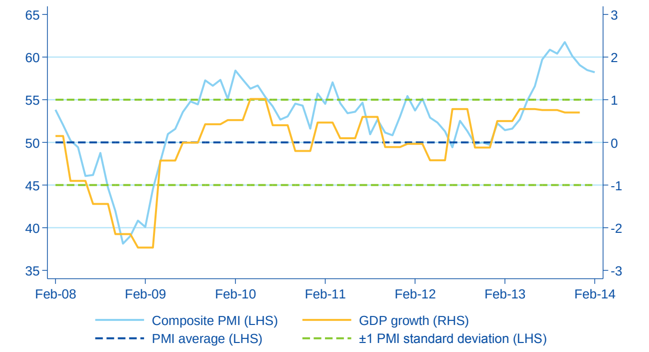
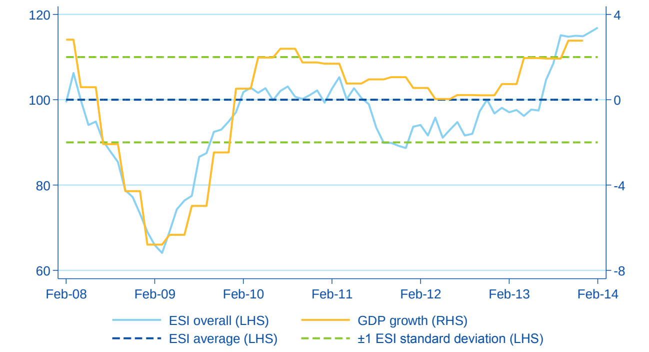


Chart 4
Confidence (ESI) and GDP growth (%YoY) **



Activity: more investment and less consumption

Industrial production increased again in January, especially capital and intermediate goods. The stagnation of retail sales suggest that private consumption will advance at a more moderate pace in 1Q14

Chart 5
Industrial prod.(%YoY), manuf. new order and output PMI*

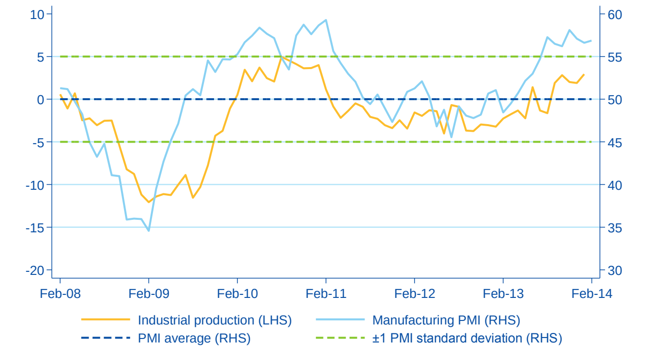
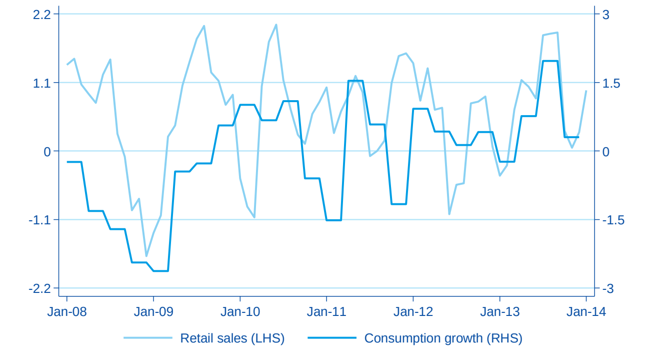


Chart 6
Retail trade (% 3m/3m) and consumption growth (%QoQ)*



*Fuente: HAVER y BBVA Research

Foreign sector: there are still doubts about the role of exports in the coming quarters

Net exports could once more contribute negatively to GDP growth in the first quarter of 2014.

Chart 7
Trade balance (% of GDP)*

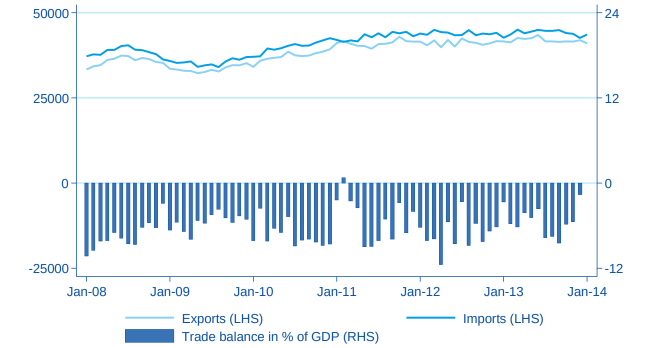
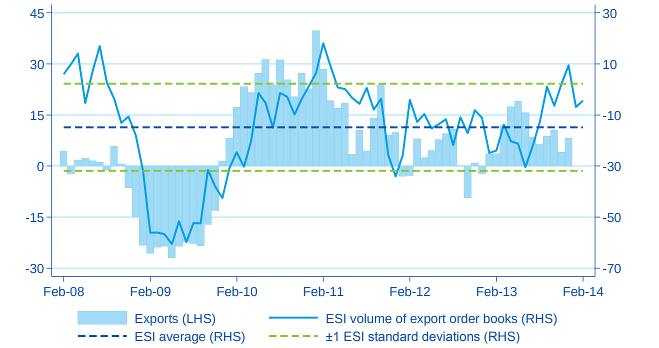


Chart 8
Export growth (%YoY) and volume of export order books*



Labour market: will continue to improve, but more slowly

Slower employment growth resulted in a rise of productivity, so the increase in nominal wages wasn't reflected in labour costs and, therefore, should not increase inflationary pressures.

Chart 9
Unemployment rate (%) and employment expectations*

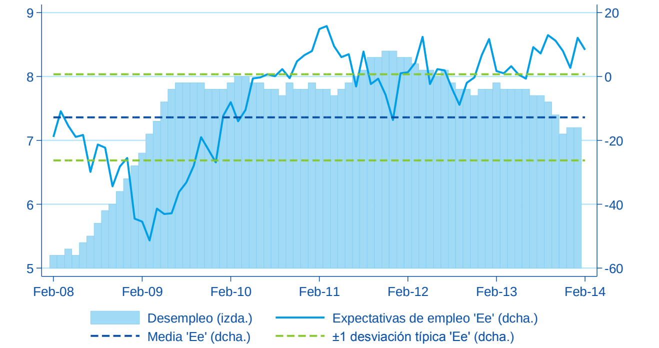
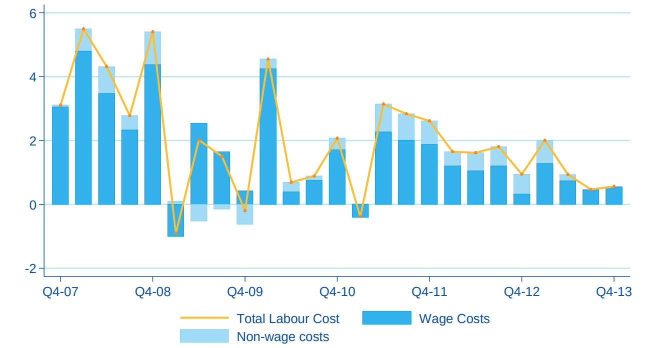


Chart 10
Labour cost in the business sector (%YoY)*

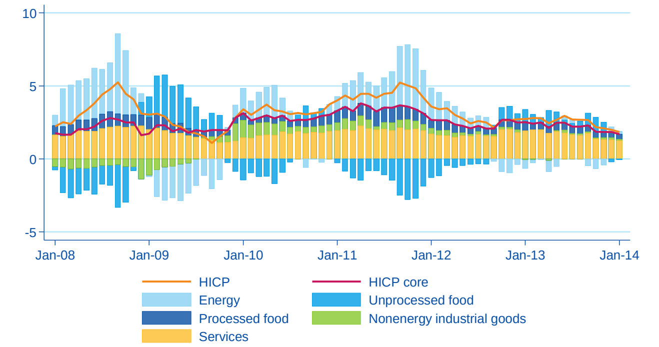


Prices: inflation will still be fluctuating somewhat below 2% YoY

After four years above target, inflation eased again in January by 0.1pp to 1.9% YoY, somewhat more than expected (2%) and with moderation spread over components

Chart 11
Inflation rate, headline and core (%YoY)*

Chart 12
Inflation by components (contribution in %)*



* Fuentes: HAVER y BBVA Research