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Positive Economic Data Clouds Weak Medium-Term Fundamentals for the UK Economy, According to QNB Group

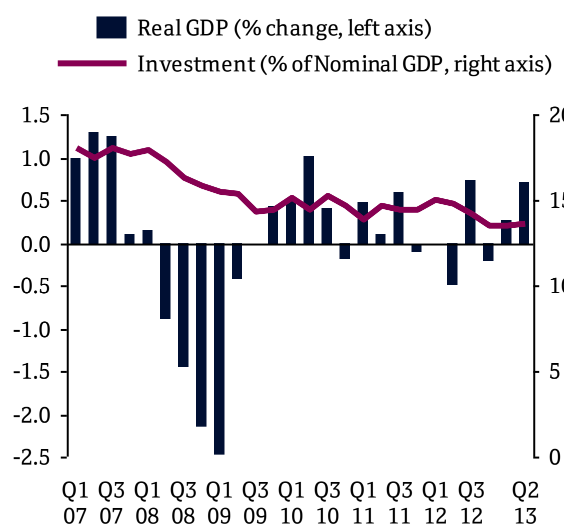
A raft of positive economic data on the UK economy has raised expectations that the economy may be emerging from an extended period of stagnation following the global economic crisis of 2008-09. According to QNB Group, much of the improvement however can be attributed to short-term temporary factors while structural weaknesses are likely to dampen the medium-term growth outlook, preventing a much-needed recovery in investment.

The flow of economic data coming from the UK has turned markedly positive in recent months. Real GDP growth has picked up in the last two quarters (see chart). Jobless claims fell faster than expected in August, leading to a surprise reduction in the unemployment rate to 7.7%. Advance indicators, notably surveys of purchasing managers, have shown stronger-than-expected growth across all sectors: mainly manufacturing, services and construction.

However, the UK economy continues to face a number of structural weaknesses. First, the economy has experienced decades of underinvestment in its industry and infrastructure. The private sector remains too concerned about structural weaknesses in the economy to commit to major long-term investments in vital sectors such as transport and energy. Investment in the economy remains well below pre-financial crisis levels and its share of GDP continues to fall (see chart).

Second, financial services are a key component of the UK economy, but weaknesses have persisted since the financial crisis. Banks received considerable financial support with the state retaining large stakes in two major banks (RBS and Lloyds). Banks remain overleveraged with unrecognized losses and considerable exposure to undercapitalized European counterparties. The financial sector is further holding back lending to the private sector, except for real estate.

UK Growth and Investment (2007 to Q2 2013)



Source: Global Insight and QNB Group analysis

Finally, economic weakness persists across key external trading partners in Europe. Although there are indications that Europe could be emerging from recession, the heavy reliance on trade with Europe means the outlook remains uncertain and this could continue to hold back UK growth.

The government has seized on the recent strong economic indicators as a vindication of its fiscal austerity policy. It argues that the pickup in growth has been achieved despite higher taxes and spending cuts that have seen the fiscal deficit almost halve from 11% of GDP in 2009 to around 6% currently. However, much of the discretionary fiscal tightening has been postponed to after the next parliamentary elections in 2014. The government has also recently introduced schemes to subsidize the housing sector, supporting home buyers and helping to bring down banks' financing costs and mortgage rates. These schemes are contradictory to the government's austerity policies. They may be helping to boost sentiment ahead of the elections, but they also raise questions about the sustainability of the recovery and concerns about a boom and bust cycle in the real estate market, which has been an Achilles' heel of the UK economy in the past.

On the monetary side, the UK economy is receiving unprecedented support. Bank of England policy rates have been at an all-time low of 0.5% since March 2009 and the incoming central bank governor recently introduced forward guidance on interest rates and committed to keeping interest rates on hold until unemployment falls below 7.0%. Additionally, the Bank of England continues its policy of quantitative easing, maintaining a stock of long-term government debt currently worth GBP375bn (USD596bn).

However, the extraordinary loose monetary policies and postponed fiscal austerity have failed to prevent a sharp increase in long-term government bond yields. These yields have risen by around 50 basis points since the beginning of August on expectations the US Federal Reserve will begin tapering its own quantitative easing. Rising long-term interest rates threaten to undermine the long-term growth prospects of the UK economy.

Therefore, despite recent positive indications of a UK economic recovery, growth is likely to continue to be muted over the medium term. Fiscal constraints will hold back public spending while investment will be discouraged by rising long-term interest rates as loose monetary policy appears to be largely ineffectual. According to QNB Group, unless the underlying structural weaknesses of the UK economy are addressed, it is unlikely that the economic clouds will clear over the British horizon.