



Economics Group

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U.K. GDP Slumps in Q2

Some special factors helped to depress GDP in the second quarter. In a broader context, however, the economy is very weak and it likely will remain so for the foreseeable future.

Special Factors Help to Explain Weakness in Q2

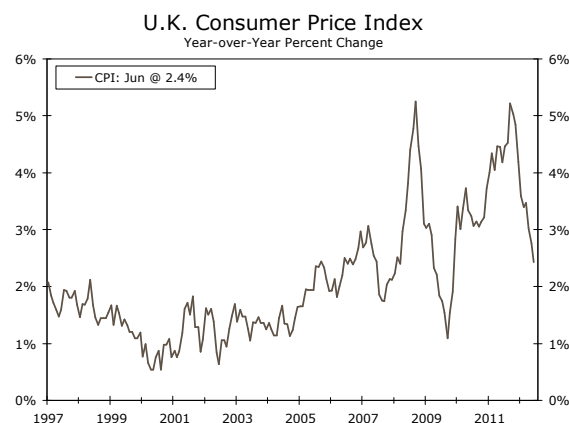
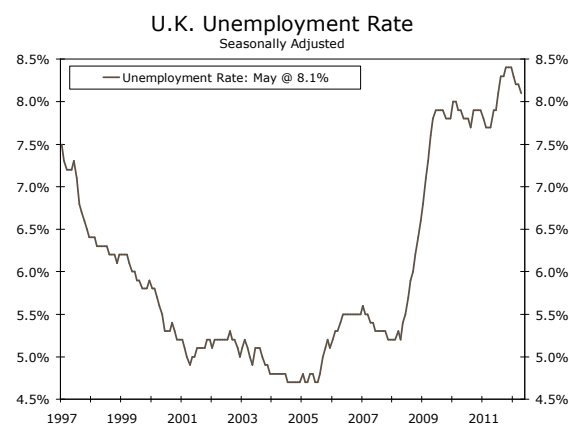
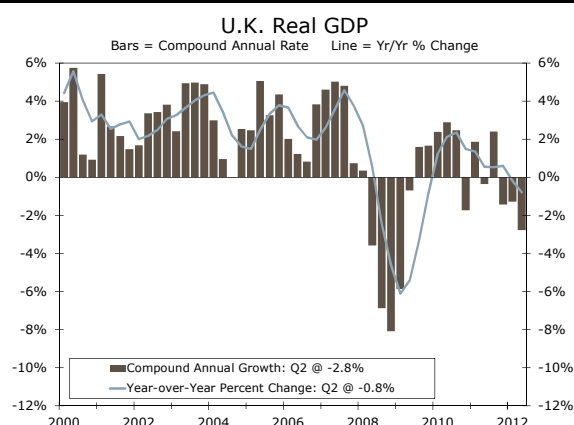
Real GDP in the United Kingdom fell 0.7 percent (2.8 percent at an annualized rate) in Q2-2012, marking the third consecutive quarter in which the economy has contracted. Not only was the outturn significantly weaker than expected, but it also left real GDP 0.8 percent smaller than it was a year ago (top chart).

There are some special factors that helped to depress GDP in the second quarter. There was an extra holiday during the quarter due to the Queen's Diamond Jubilee that closed many production facilities, and the renewed downturn in the Eurozone, to which the United Kingdom sends one-half of its exports, also contributed to the weakness in production. Indeed, manufacturing production dropped 1.4 percent (not annualized) on a sequential basis during the quarter. The 5.2 percent plunge in construction output may reflect, at least in part, record rainfall during the quarter. We look for a rebound in production in the third quarter as inventories swing the other way. The Olympic Games, which kick off on Friday, should also provide a modest, if only temporary, boost to economic activity in the current quarter.

Despite Rebound in Q3, Economy Likely Will Remain Weak

In a broader context, however, the British economy is very weak, special factors notwithstanding. Not only has real GDP been flat on balance over the past two years, but it remains 4.5 percent below its peak more than four years ago. The unemployment rate has edged a bit lower in recent months, but at 8.1 percent it remains near a 16-year high (middle chart). Despite the rebound in GDP that we expect will occur in the third quarter, we project that economic growth in the United Kingdom will remain sluggish through next year. Not only will the ongoing debt crisis in the Eurozone exert some headwinds on the British economy, but continued de-leveraging and weak credit growth should also keep a throttle on the overall rate of U.K. real GDP growth. In addition, the fiscal consolidation that the British government still plans to implement over the next few years should also keep growth constrained. A full-blown financial crisis in the Eurozone, should one occur, would lead to further weakness in the British economy.

On a positive note, the drop in the overall rate of CPI inflation over the past few months has been faster than expected (bottom chart). This decline in inflation has given the Bank of England scope to ease monetary policy further. The Monetary Policy Committee (MPC) agreed at its last policy meeting earlier this month to increase the size of its quantitative easing program to £375 billion from £325 billion. Along with H.M. Treasury, the Bank of England has also undertaken a scheme to provide reduced funding to banks in return for more lending to businesses. Further easing measures could be ahead if, as we expect, the economy continues to struggle.



Source: IHS Global Insight and Wells Fargo Securities, LLC

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