

Morgan Stanley

The UK Economic Outlook

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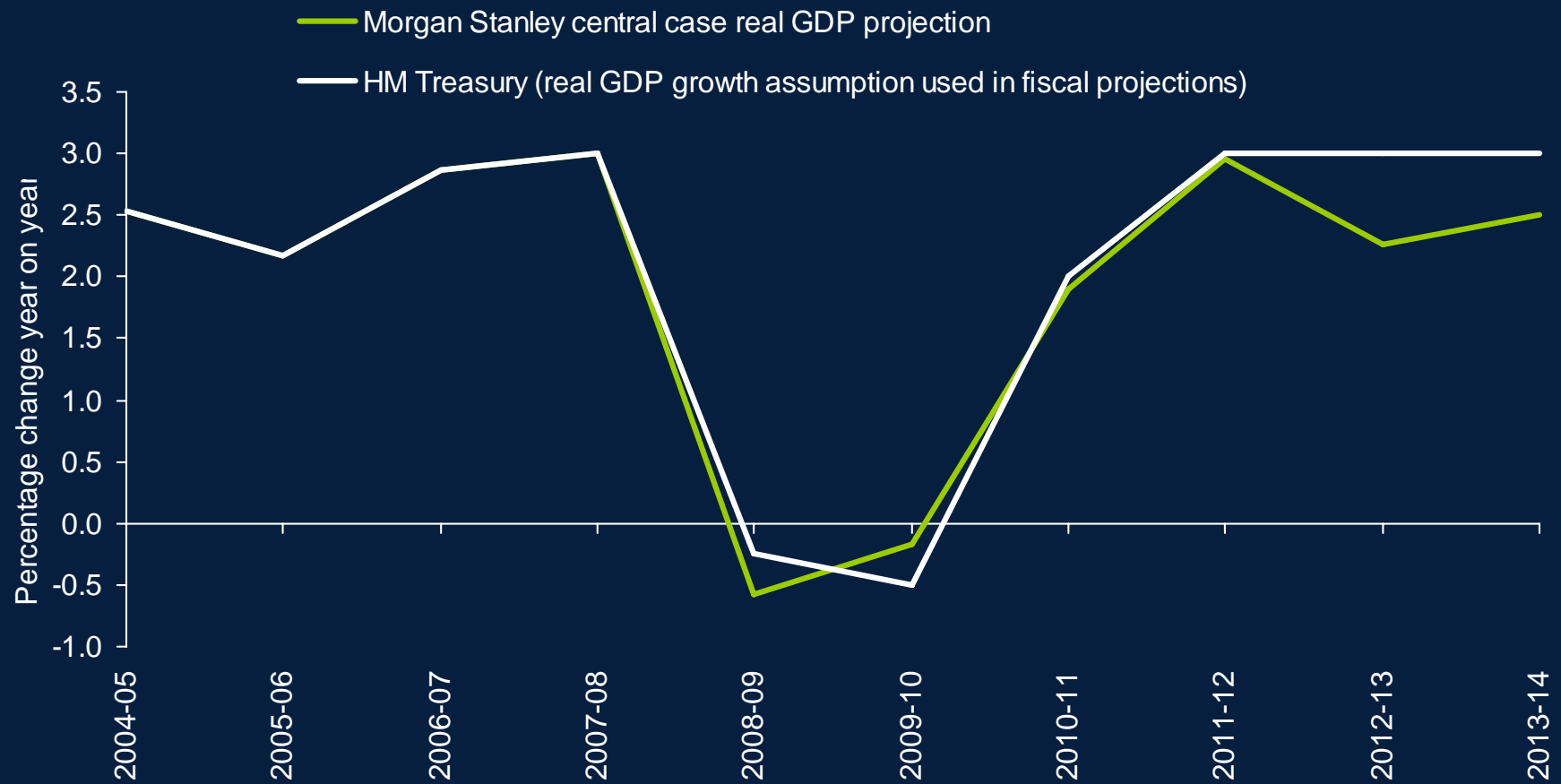
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Summary

- The UK economy is already in recession and the near-term outlook is worse than it has been for many years...
- Central forecast: Massive policy stimulus means UK will avoid a deep and prolonged recession.
- The Treasury's forecast is not wildly optimistic. Credit crunch plausibly reduces capacity by about 4%.
- But on balance the risks to this outlook remain skewed to the downside.

Alternative GDP growth scenarios



Sources: ONS; HM Treasury; Morgan Stanley Research estimates.

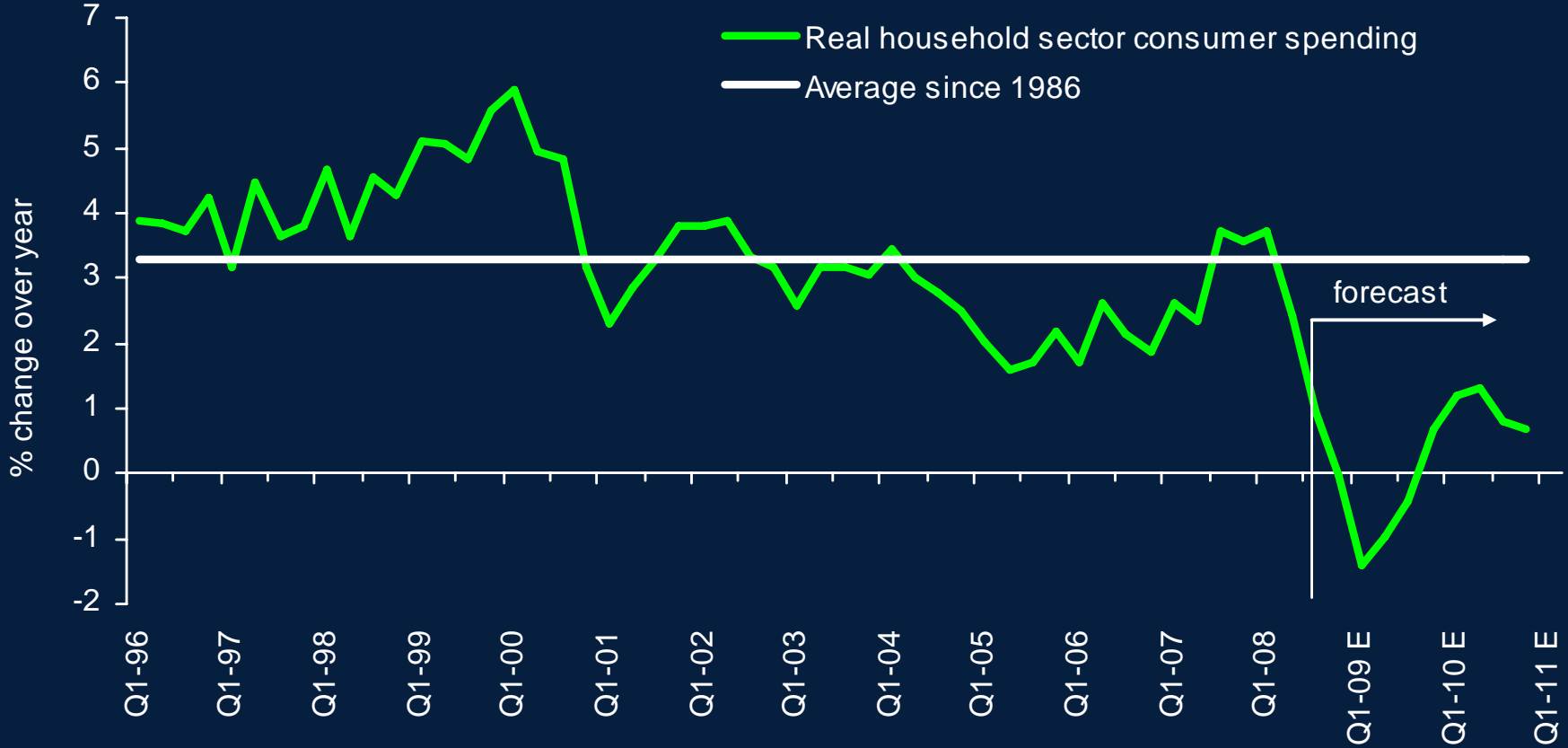
Relative optimism: significant stimulus

- We are *relatively* optimistic on the UK outlook
- Key is the enormous and very recent policy stimulus.
- Collectively the stimulus could give a boost to demand of around 5% of GDP:
 - Interest rate cuts (350bp since October): £10-15 billion or approaching 1% of GDP
 - Fiscal policy (announced last November) : £20 billion or a bit above 1¼% GDP
 - Huge Sterling depreciation to an open economy: 3% GDP

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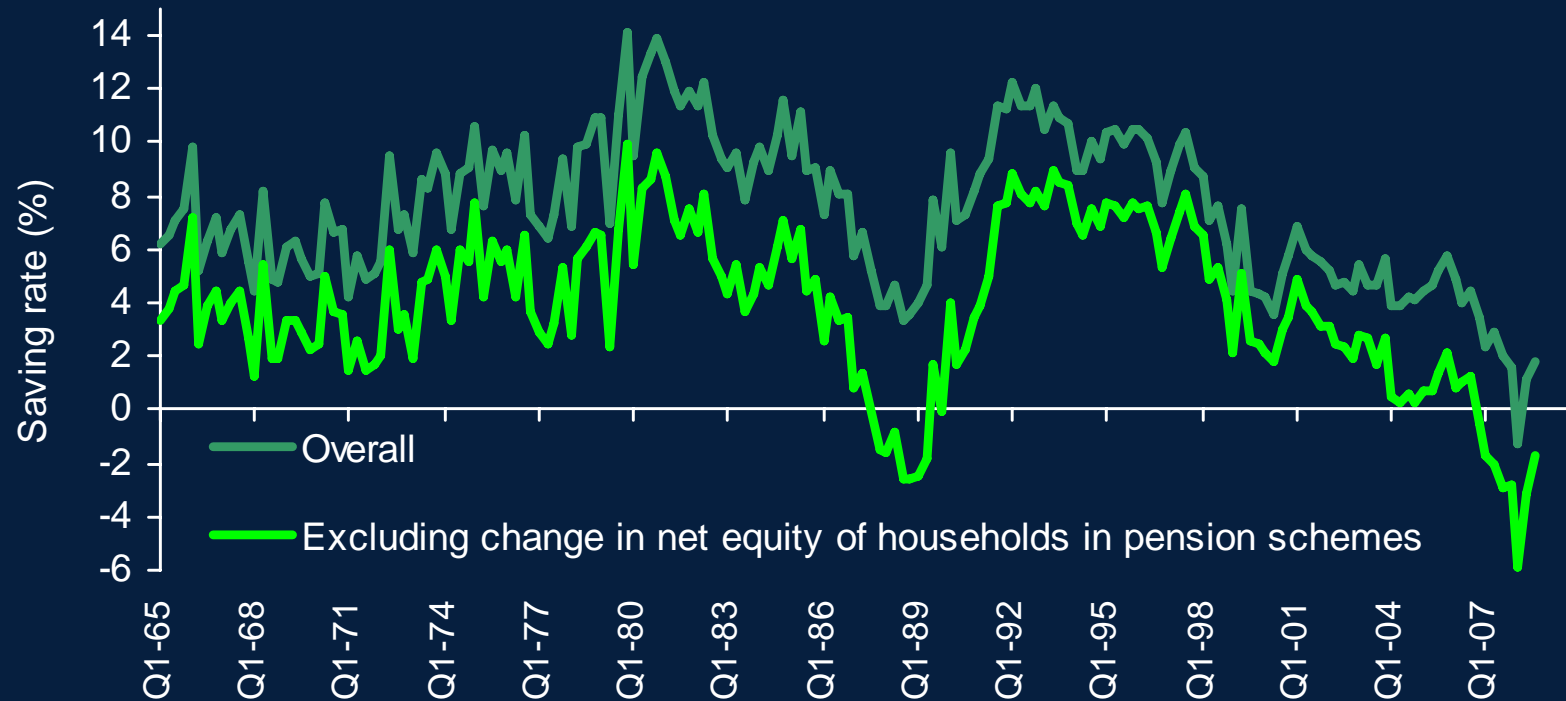
Big Risk 1: Rapid increase in the savings rate

Real consumer spending growth



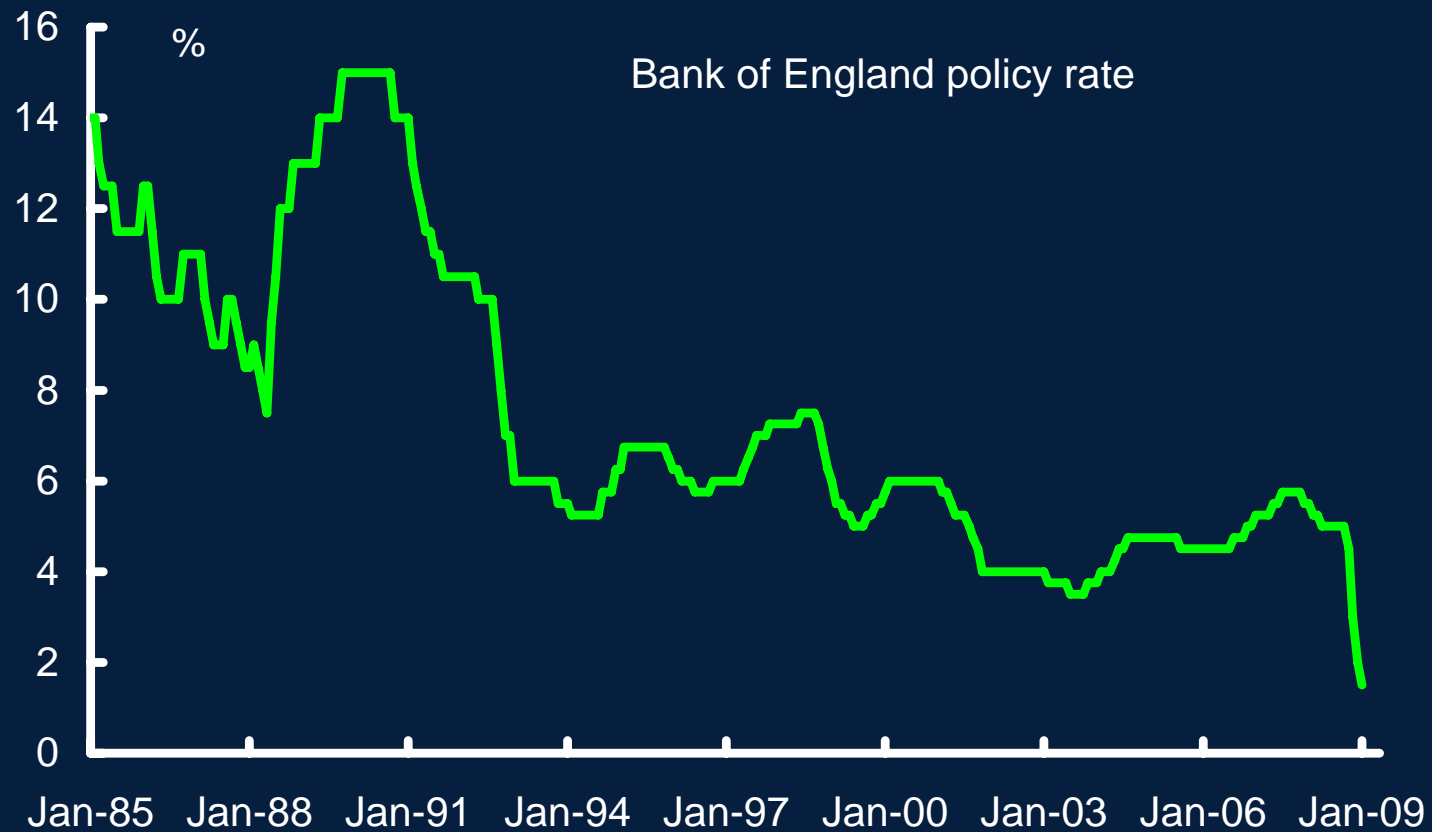
Source: ONS; Morgan Stanley Research. E = Morgan Stanley Research forecasts

Saving rate



Source: ONS; Morgan Stanley Research

No rapid increase in savings

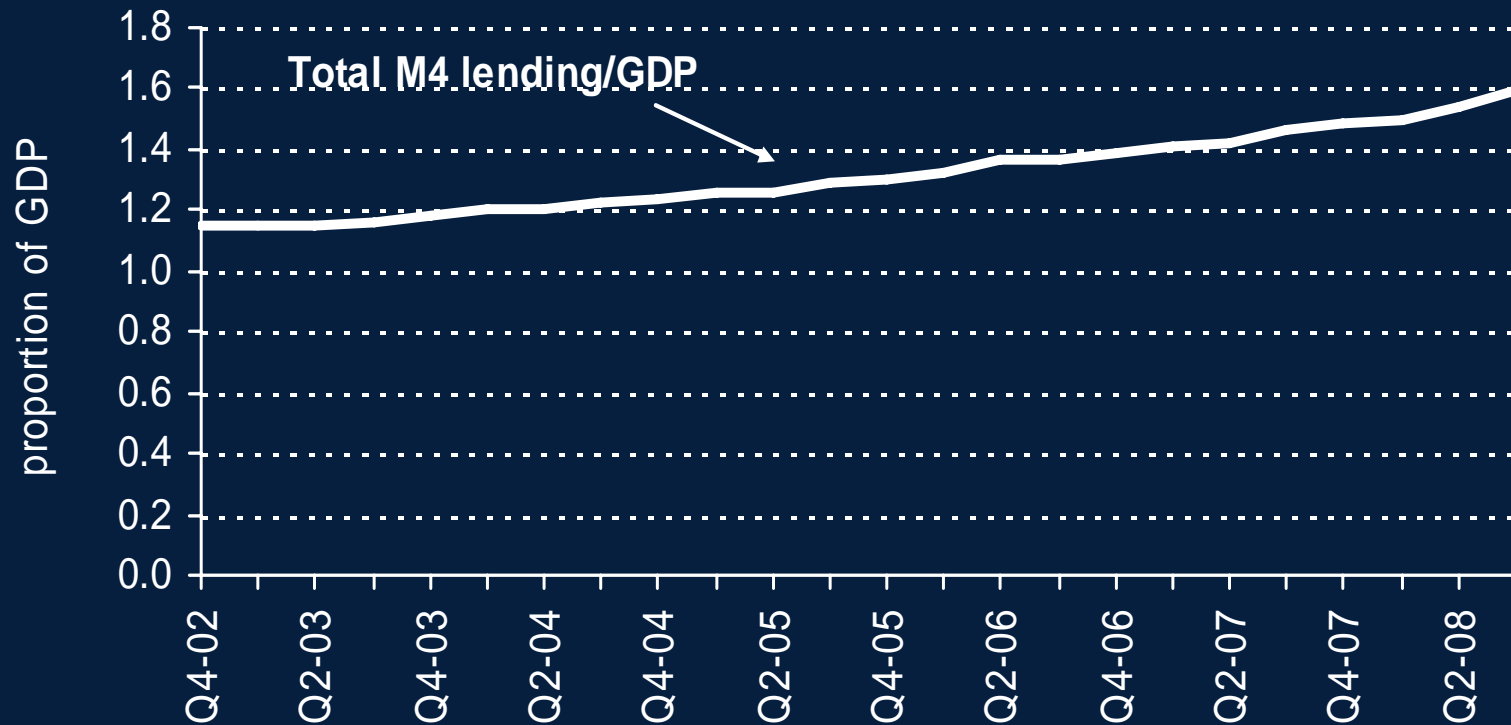


Source: Datastream

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Big Risk 2: Deleveraging

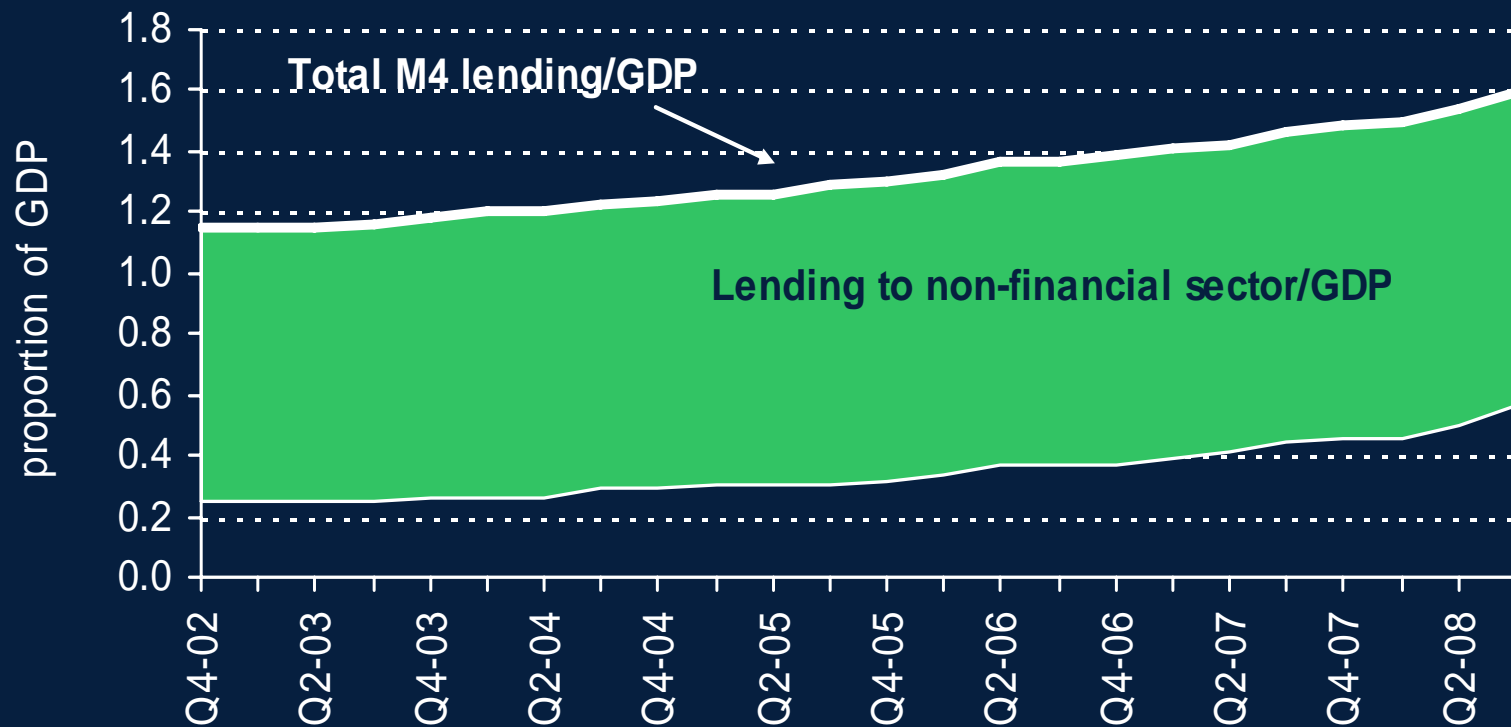
UK bank and building society sterling lending (M4 lending)



Note: Figures show lending by M4 lending institutions (banks and building societies) in sterling to the non-bank private sector – disaggregated into lending to the private non-financial sector and loans to other (non-bank) financial institutions.

Sources: Bank of England; ONS; Morgan Stanley Research.

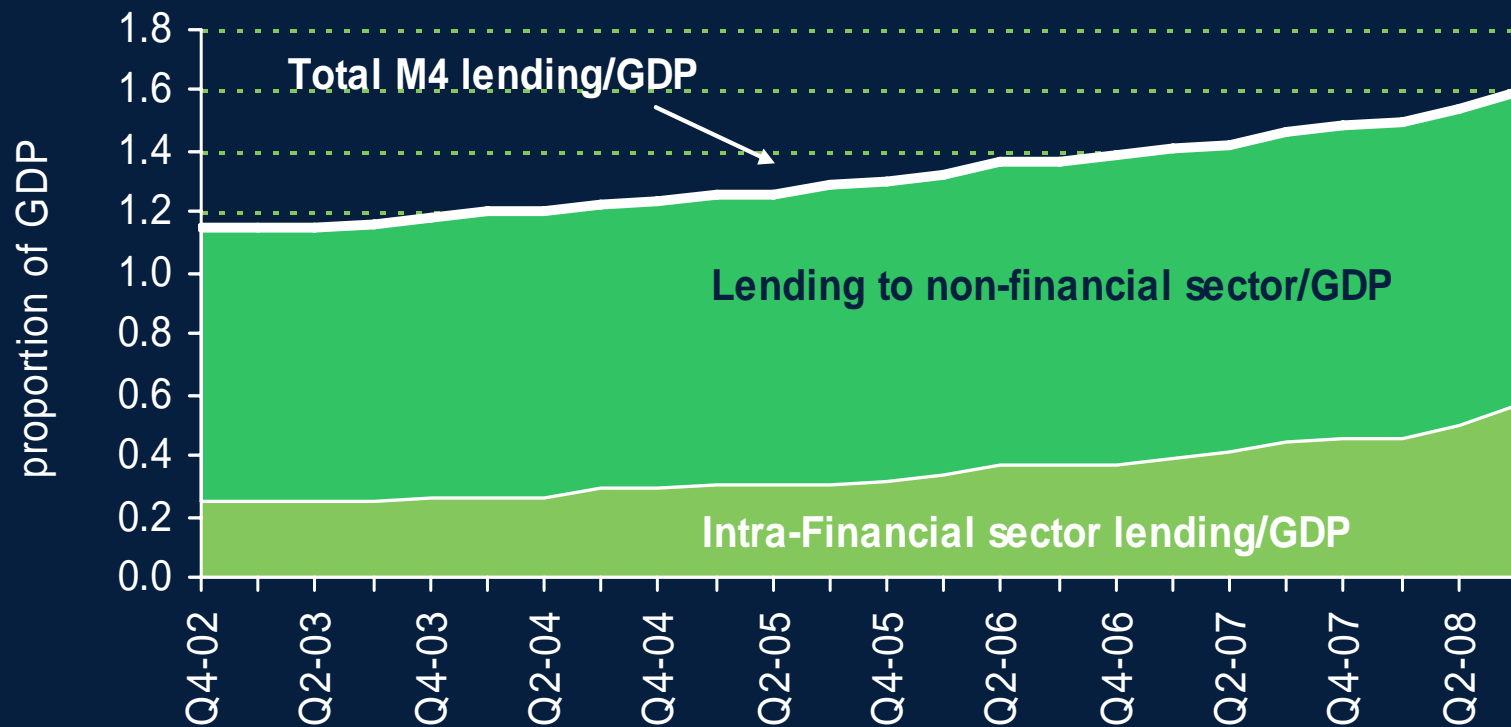
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Old bank/New bank: The creation and destruction of leverage

Old-fashioned bank

Assets

100 (loans)

Liabilities

10 (equity)

90 (deposits)

Total debt in economy = 190



New bank

Assets

100 (loans/ABCP)

Liabilities

10 (equity)

90 (deposits)

New non-bank financial firm

Assets

100 (ABS)

Liabilities

100 (loans/ABCP)

Total debt in economy = 290

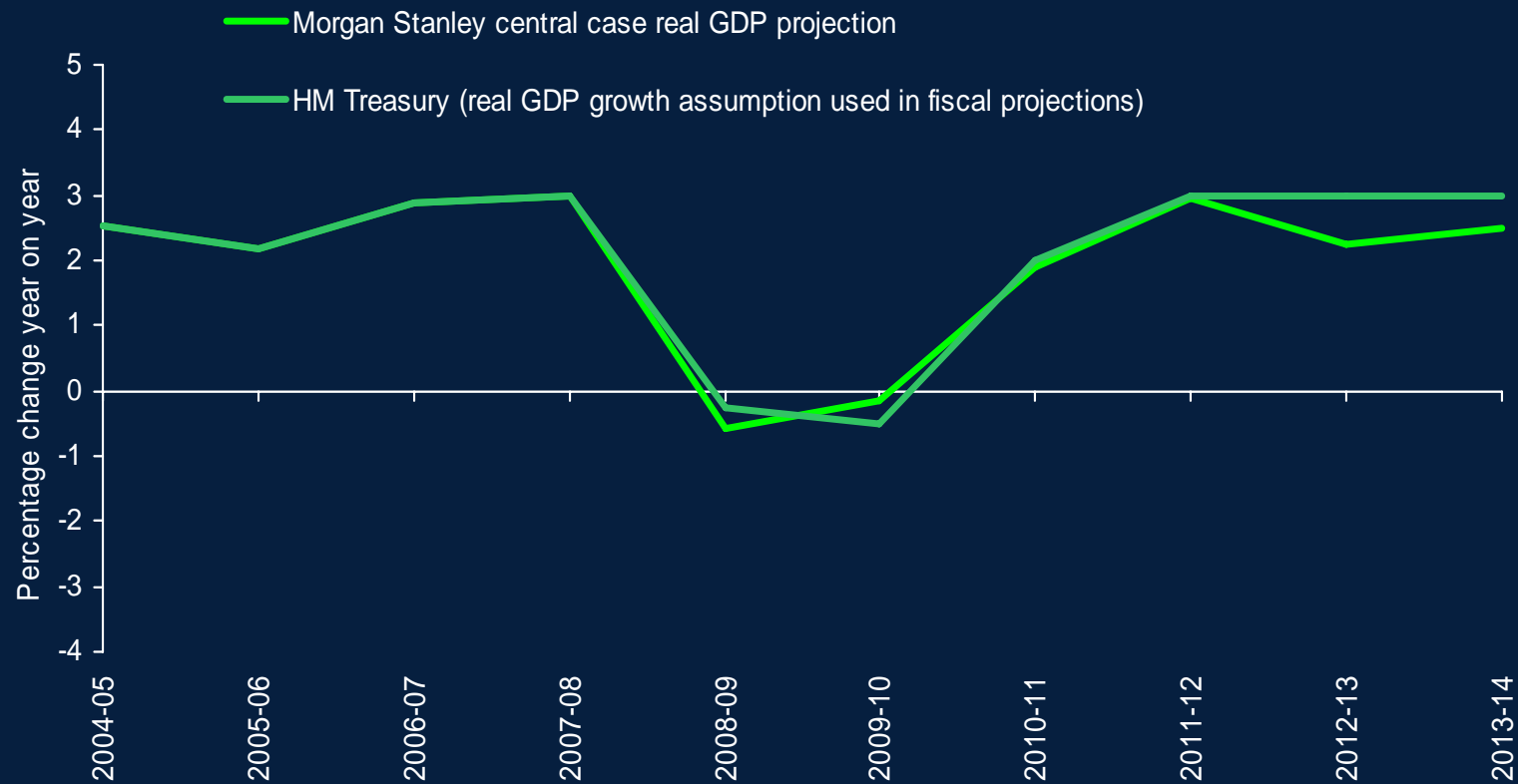
Potential growth

- The Treasury estimate that 4% of potential output will be lost during this downturn
- Our analysis suggests that this is plausible – based on filters or production functions built up from factor inputs
- But we could see offsetting, positive supply side responses

Alternative futures....

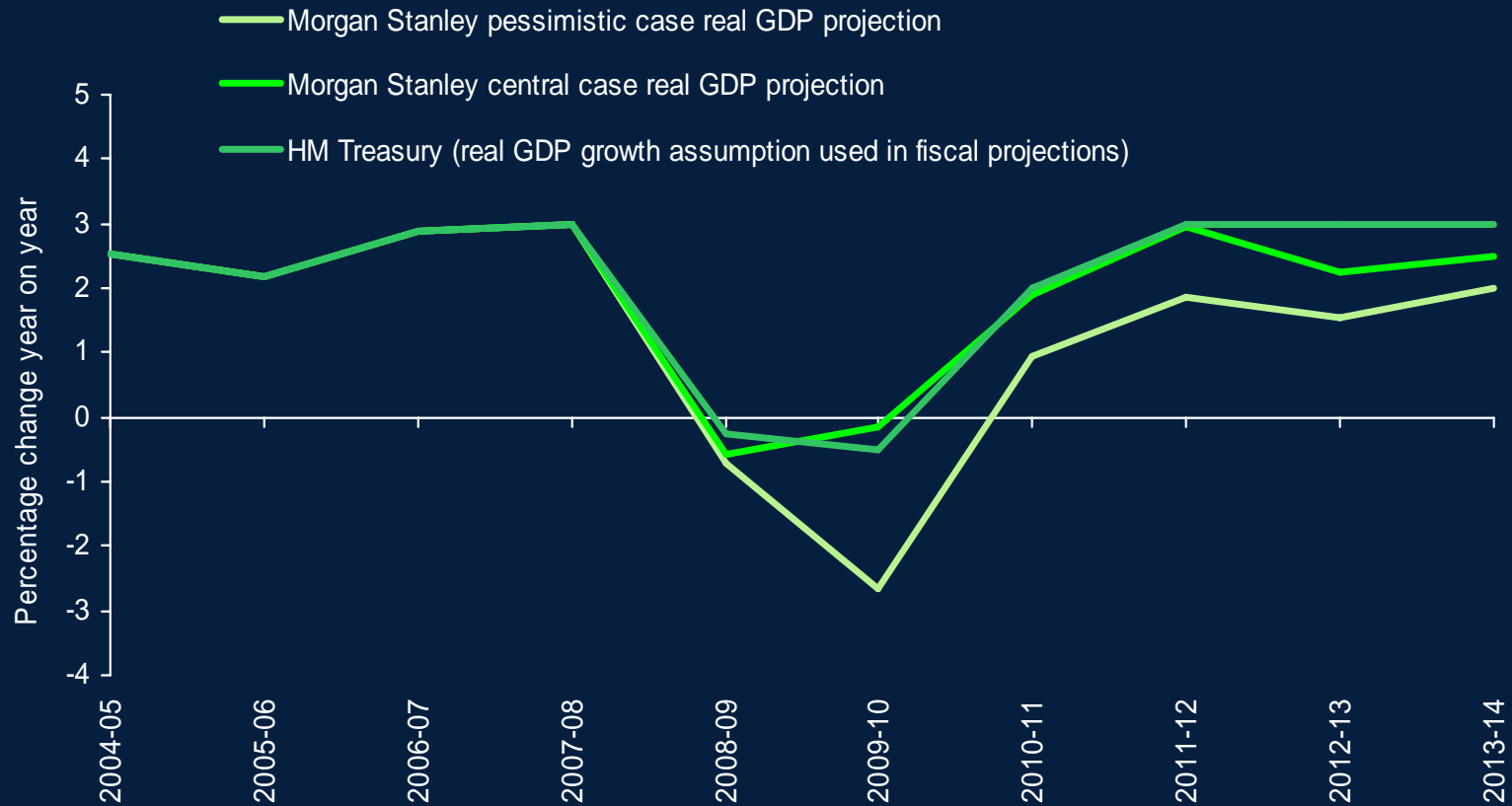
- Which responds most to wealth loss and limited credit: labour supply or savings?
- And if the latter, over what horizon does it just mean less output (Keynes) rather than more production (neo-classical growth theory)?

Alternative GDP growth scenarios



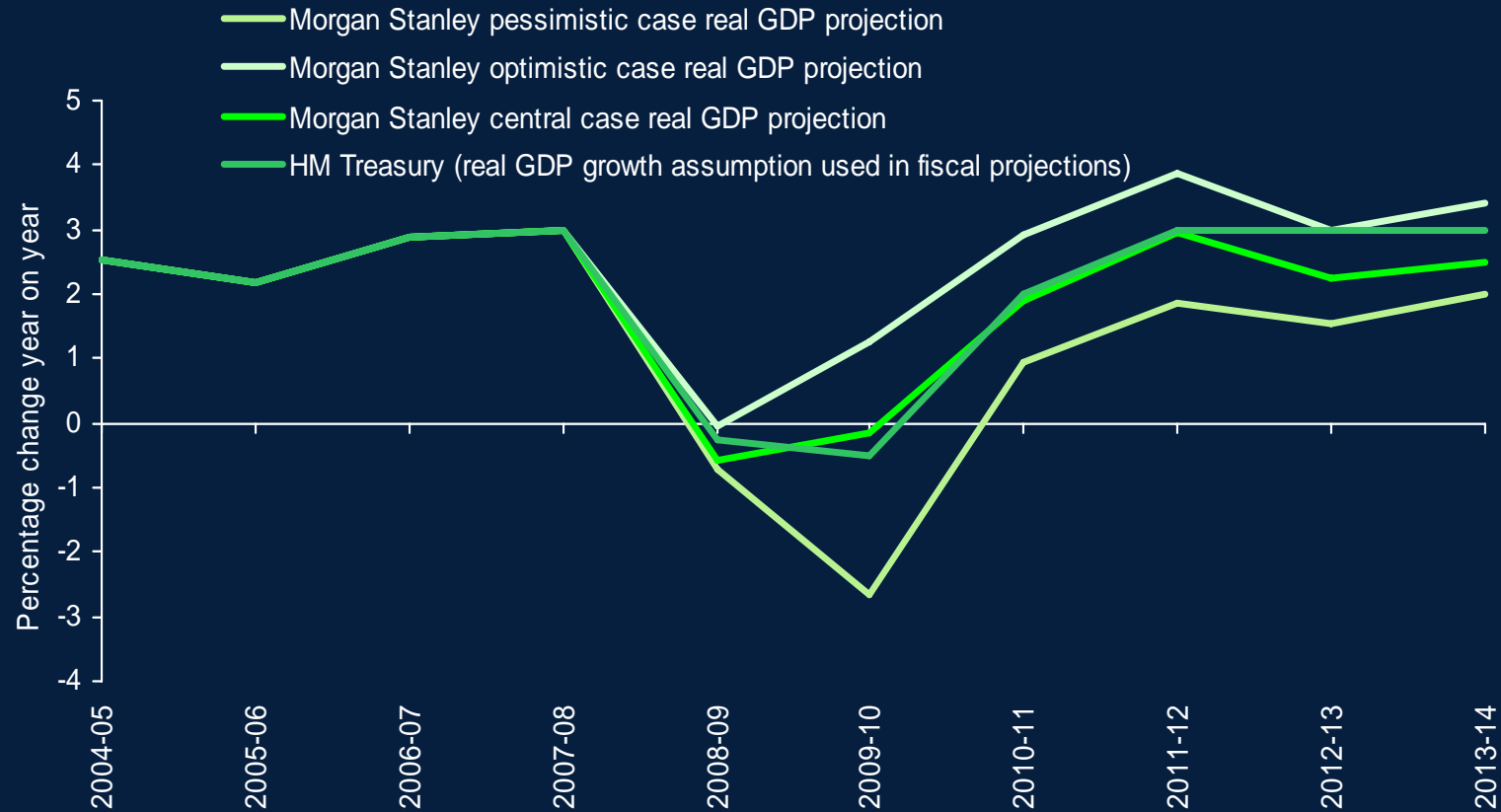
Sources: ONS; HM Treasury; Morgan Stanley Research estimates.

Alternative GDP growth scenarios



Sources: ONS; HM Treasury; Morgan Stanley Research estimates.

Alternative GDP growth scenarios



Sources: ONS; HM Treasury; Morgan Stanley Research estimates.

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