The Actuarial Profession
making financial sense of the future

Highlights of the Life Conference 2011
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UK Economy Outlook

Economic growth prospects

Short-term volatility; deleveraging limits upside over the medium-term

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Short-term growth: Back in recession?

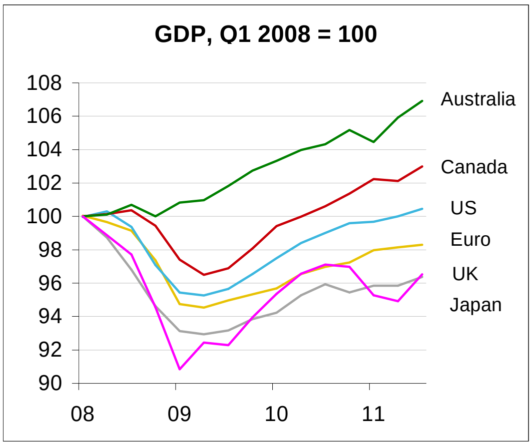
A sluggish recovery: UK peak-to-trough decline in GDP of 7.1%. The level of output has since recovered half of that decline.

Also a weak recovery by international standards.

GDP fell 0.2% in Q4.

Our central forecast is for the UK to avoid technical recession: growth of 0.3% q/q in Q1 2012.

RBS GDP forecasts: 0.9% in 2012 and 1.7% in 2013.



Medium-term growth: Slower for longer?

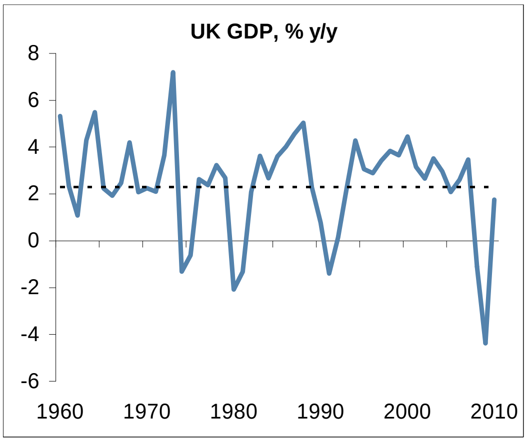
Long-run average UK GDP growth is around 2¼-2½%.

These trends underpin the official (OBR) medium-term GDP projections.

OBR assumes real trend rate of 2.3% from 2014 onwards:

Output per hour worked:	+2.2%
Average hours worked:	-0.2%
Employment rate:	-0.2%
Population:	+0.5%

Long-run trend rates are determined by factors such as technological progress – hard to incorporate this into an economic forecast. But balance sheet constraints and deleveraging will provide a persistent headwind.



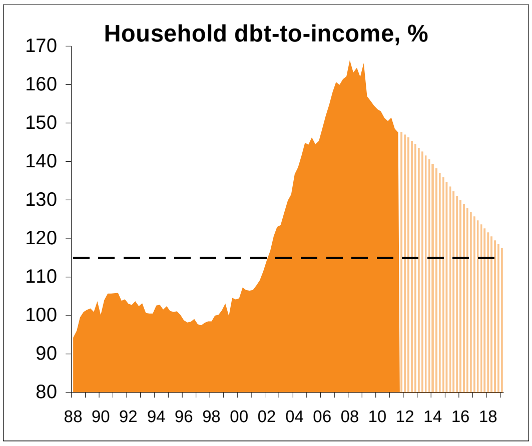
Household deleveraging

We estimate UK households are one-third of the way through their deleveraging process.

The ratio has fallen from a peak of 166% in 2008 to 148% in late 2011. We believe it will trend down to a 'sustainable' level around 115%.

This 'sustainable' level is the amount of debt we judge to be consistent with affordable debt-servicing costs when mortgage rates were in line with longer-term averages (ie, around 4½% vs 3½% at present).

This deleveraging is not synonymous with 'recession' but does imply a subdued outlook for consumer demand and inflation – and suggests monetary conditions will remain accommodative.



Inflation outlook

CPI back to target by end-2012

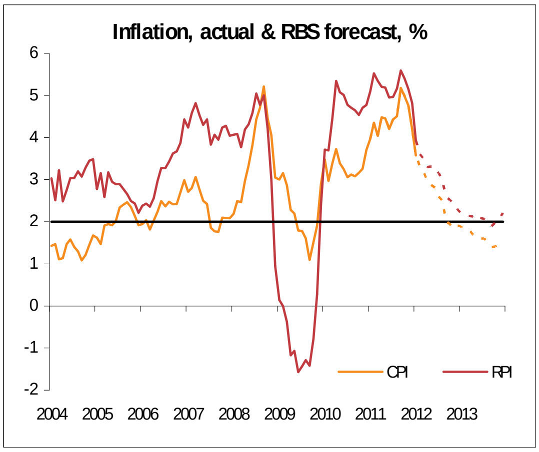
Inflation – back to target by year-end

CPI inflation peaked at 5.2% in September 2011 and has fallen to 3.6% in January 2012.

Further downside influences from:
- VAT unwind (c.1pp)
- Q1 2012 utility price cuts
- Weak demand/excess spare capacity.

Main upside inflation risk: *sterling*. Essential the UK government retains credibility in global financial markets.

No particular reason to believe there will be any tendency for UK inflation to overshoot its target in the medium-term, or for the target to be changed.



Public finances

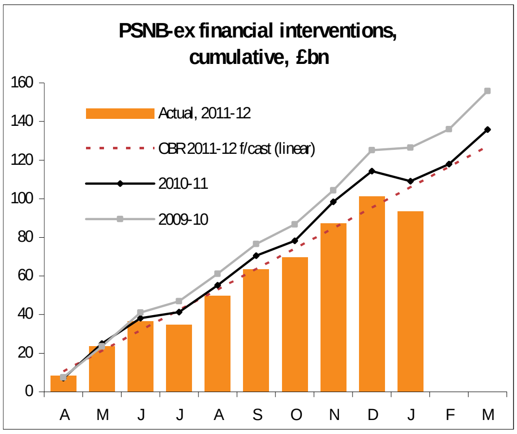
On track so far . . . But rising risks of a borrowing overshoot in the medium-term

£10bn borrowing undershoot in 2011-12 FY

With data for 10 of the 12 months of the 2011-12 FY, the public sector borrowing is on track for an undershoot: £117bn vs OBR forecasts of £127bn (£122bn previously).

The deficit reduction in 2011-12 (relative to forecasts) stems entirely from public spending restraint – tax receipts are in line with official forecasts.

Risks remain skewed towards a deterioration in the UK public finances – euro area recession, financial sector contagion – but deficit reduction is ahead of schedule despite a weaker GDP performance.



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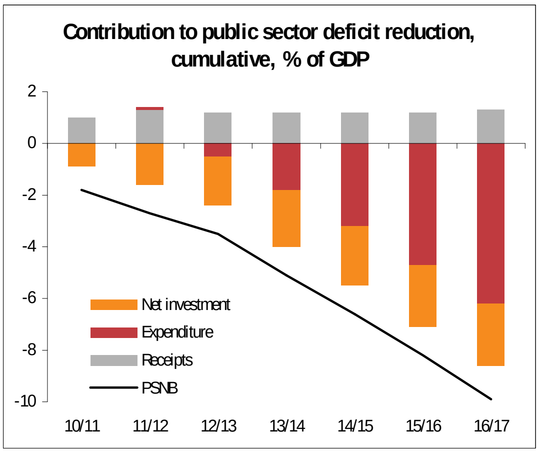
UK medium-term fiscal strategy

Over the seven year period to 2016-17, over 85% of the UK deficit reduction is planned to come from public expenditure restraint.

The tax rises (VAT, 50p income tax rate, NICs) have been largely implemented.

On the expenditure side, the cuts so far have been concentrated on net investment.

Current expenditure has been flat as a % of GDP – the 'cuts' have been to spending *growth*. Initial current expenditure cuts should be easy to identify given high levels of public spending, but will be politically difficult.



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Conclusions

Recent near-term pessimism surrounding the **public finances** looks exaggerated. Weaker economic outlook over the medium-term means *'Plan A for longer'* not *'Plan B'*.

UK **AAA-rating** is inevitably less secure following S&P's downgrade of France, Moody's 'negative outlook' on the UK, and more acute financial strains in the euro area. But UK fiscal policy is credible and consistent with ratings agencies' demands. UK has access to liquid markets; a longer-maturity debt profile and an independent central bank pursuing QE. We expect the UK to retain its AAA rating in 2012.

UK deficit-reduction rests on **spending restraint, not further tax rises** – political will is more important than the economic cycle.

Average **GDP growth** will be closer to 1½% over the next decade than 2½% previously.

Inflation is declining and expected to be back to its target around year-end: VAT and energy price shocks unwind, persistent spare capacity, subdued household demand.

Receding inflation + ongoing fiscal consolidation + household deleveraging = **looser for longer monetary policy**. We forecast a further £50bn of QE in H2 2012.

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