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Economic Review

After the storm



Foreword

John Connolly



John Connolly
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In this Review, Roger Bootle, Economic Adviser to Deloitte, turns his attention away from the gloom of our immediate economic prospects to consider what the post-recovery economy might look like.

Once this recession is finally a memory, if not a distant one, the landscape will have changed dramatically. Roger believes that, in sharp contrast to the performance of the last ten years, neither the consumer nor government sector will play much of a role in driving economic growth over the next decade. In contrast, the star of the show will be the exporting sector, boosted by the drop in the pound.

He dismisses fears that the manufacturing sector has shrunk too far, instead arguing that the UK's manufacturing base can undergo a mini revival – helping to fill the hole left by the financial services sector's shrinking share of the economy.

UK exporters can clearly play to their traditional strengths such as aerospace and pharmaceuticals. The lower exchange rate will also boost services exports, from tourism to consultancy services.

Roger thinks that the implications of these sectoral changes will be wide-ranging. The renewed emphasis on manufacturing could raise trend productivity in the economy, as well as boosting the Northern regions of the UK. But there is no reason why London's share of the economy must shrink. Its reliance on financial services is smaller than is commonly thought and London will benefit from becoming a cheap place for international firms to locate.

Once again, I hope that this Review helps you in both your immediate and strategic thinking.

A handwritten signature in black ink that reads "John P. Connolly". The signature is fluid and cursive, with a large loop at the end of the last name.

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www.deloitte.co.uk/economicreview

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Sooner or later, recover the UK economy will and when it does, the landscape will have changed beyond recognition.

Executive summary

Roger Bootle



Roger Bootle
Economic Adviser to Deloitte

- A recovery could be months away or it could be years away. Sooner or later, though, recover the UK economy will. And when it does, the landscape will have changed beyond recognition.
- After a decade during which consumer spending growth outpaced overall GDP growth, we expect now to see a decade where consumer spending underperforms.
- Meanwhile the government will have to cut, or at least freeze, its spending in real terms for several years in order to reduce its sky-high borrowing levels.
- The star of the show will be the external sector. Although concerns have been voiced about whether the UK's manufacturing sector has shrunk too much, we see no reason why it cannot experience a mini-revival. Meanwhile, it is not just manufactured goods which will benefit from the drop in the pound – so will exports of services, from tourism to consultancy services.
- We think that, over the next decade, manufacturing's share of the economy could temporarily grow from 11% to 13% or even 15%. In contrast, the financial sector's share could shrink from 8% to more like 5%.
- The drop in the pound should help the UK to play to its traditional exporting strengths – such as the production of pharmaceuticals and aircraft. But with imports becoming less competitive, the lower level of sterling could have a wider impact, as more of the goods that the UK needs are produced domestically.
- Meanwhile, the services sector is particularly fertile ground for new or nascent services to spring up and expand, such as the provision of "green" consultancy services. And both the online and supermarket sectors could yet broaden their reach even further.
- The implications of these sectoral changes will be wide-ranging. For example, the renewed emphasis on manufacturing could boost trend productivity in the economy, given that manufacturing lends itself more easily to technical progress than the services sector. This could offset any dent to trend GDP growth caused by lower net migration.
- However, the regional implications might be smaller than is commonly thought. Regional disparities have shrunk considerably as manufacturing-dependent regions have diversified their economies. Meanwhile, London's reliance on the financial sector tends to be overstated – wholesale financial services account for at most 10% of its economy.
- But there remains a difficult period to get through before we see this "new world". The economy now looks likely to contract by some 4% or so this year.
- The outlook for next year depends heavily on the success of the various policy measures. However, mounting bank losses suggest that bank lending is unlikely to rise strongly. And the likely effects of quantitative easing are highly uncertain. For now, then, we retain our view that the economy will contract again in 2010 by around 1% and still think there is a big risk of a period of persistent deflation.

After the storm

What the UK will look like after the recovery

No-one knows exactly when the UK economy will pull out of this recession. While the optimists are looking for a recovery later this year, the downturn could easily continue beyond even *next* year.

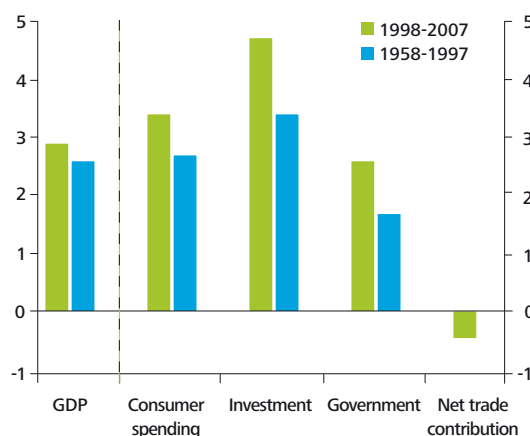
Sooner or later, though, recover the UK economy will. But when it does, what will it look like? Will the economy grow in the same way as after the last recession? Or has the downturn changed the landscape for good? In this *Quarterly Review*, we consider what the post-recovery economy will look like. Who will be the winners in this new world? And who will be the losers? And what knock-on effects will the changes have?

Back to normal?

The best place to start is with a brief reminder of how the economy looked in the years running up to the recession. Bank of England Governor Mervyn King summed it up well when he nicknamed it the “Nice” (non-inflationary constant expansion) decade. Annual real GDP growth over the ten years to 2007 averaged 2.9% – above its long-run average of 2.5%. In no year did GDP growth ever slip below 2%. Meanwhile, never once did inflation stray more than 1% away from its target.

However, as is now costing us dear, that growth was seriously unbalanced. (See Chart 1.) Consumer spending grew at an average annual pace of 3.4%, compared to its average rate over the previous 40 years of 2.7%. Government spending and investment also grew robustly by previous standards. In contrast, net trade made a positive contribution to GDP growth in only two years, as the current account deficit went from a position of balance to a deficit of some 3% of GDP.

Chart 1. Components of real GDP (%/y)



Source – Thomson Datastream

These imbalances both reflected and exacerbated the bubbles in asset prices and the rapid build-up of debt that characterised the Nice decade. On the Nationwide measure, annual house price inflation averaged 12% over the decade. Meanwhile, household debt rose at an average annual pace of 11%. Public sector net borrowing was close to zero when Labour took power, but rose to £36.5bn or 2.5% of GDP by 2007/8. And of course we cannot forget the banking sector. The UK banking system’s assets and liabilities exploded, from £2.5trn at the start of 1998 to a whopping £7trn by the end of 2007.

So even a return to “normal”, where normal is some sort of long-run average, would mark a significant change for the economy compared to the last decade or so. Admittedly, overall economic growth would be only a touch weaker than in the recent past. However, the *balance* of growth would look significantly different. Meanwhile, house prices would increase broadly in line with average earnings at between 4% and 5% per annum. Share prices would increase in line with overall nominal GDP growth. And debt would remain broadly constant as a share of GDP.

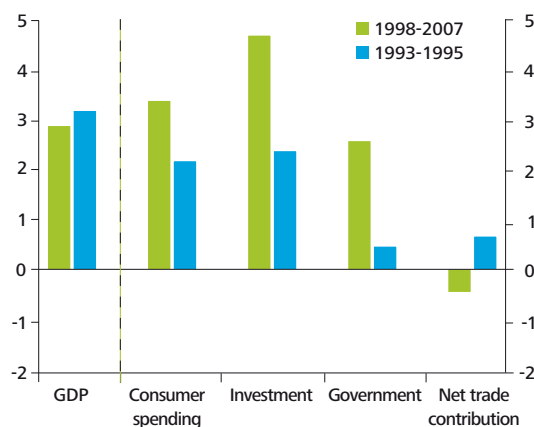
Or back to the '90s?

A return to "normal" is perhaps the least we should expect, though. In fact, we could see a much more fundamental change than this.

The obvious template is the early to mid 1990s, when the UK was last emerging from a recession. After all, during the "Lawson boom" of the mid to late 1980s, GDP growth was just as, if not more, unevenly balanced than growth over the past decade. Other parallels with the current situation include a housing market that became seriously overvalued, a sharp drop in the household saving rate and the opening up of a large current account deficit.

Although the economy began to expand again in 1992, it was not until 1993 that economic growth began to look relatively healthy. Accordingly, Chart 2 shows the shape of economic growth for the three years between 1993 and 1995. If this were the pattern of growth that we were to see over the next decade, the differences with the past few years would be pretty striking. Consumer spending in the mid-1990s, for example, under-performed overall GDP growth – in sharp contrast to the recent pattern. Government spending was even weaker. Yet net trade provided an average annual contribution to growth of some 0.7%.

Chart 2. Components of real GDP (%/y)



Source – Thomson Datastream

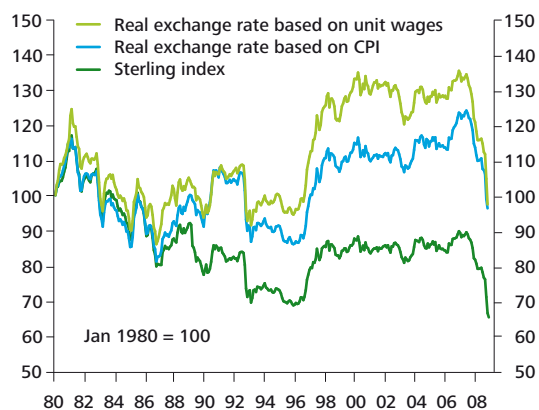
History repeating itself?

Of course, history need not necessarily repeat itself. Nonetheless, there are likely to be some big similarities between the situation back then and the situation the post-recovery UK is likely to find itself in.

The first is the sharp fall in the exchange rate seen in both cases. The sterling trade-weighted index has now fallen by about 27% from its peak, an even bigger nominal drop than the 17% fall seen after the UK's exit from the ERM in 1992. In real terms, the falls are broadly similar in magnitude. (See Chart 3.)

Of course, the fall in sterling might yet be reversed. But a full reversal is unlikely, given that the pound is now trading broadly in line with its fair value. In this article, we assume that the drop in the pound is more or less sustained.

Chart 3. Sterling trade-weighted index

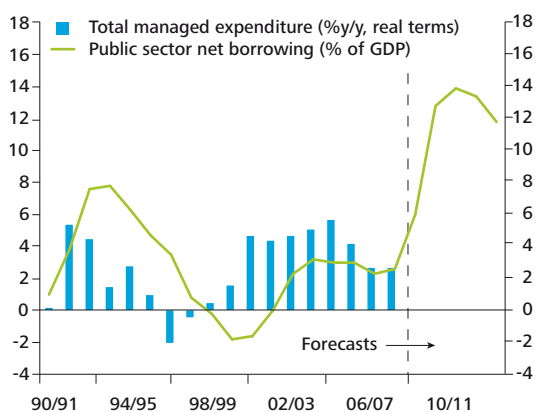


Sources – Bloomberg, Bootle & Thomson Datastream

The second common factor is the intense pressure on the Government to contain its spending in order to bring down its borrowing levels. Between 1993 and 1995, government spending was growing, but an average annual rate of just 1.9%. Spending then fell by 2.2% in 1996/7 and by a further 0.6% in 1997/8. (See Chart 4.)

The Government will have little choice but to impose as tight, if not tighter, controls on spending this time. After all, the chart also shows that we expect public sector net borrowing to peak at an even higher 16% or so of GDP during this recession, compared to a peak of 7.8% in 1993/4.

Chart 4. Public sector borrowing & real Gov. spending



Sources – HM Treasury & Bootle

Whichever party is in power after the next election will therefore have to make eye-wateringly tight spending commitments, on top of significant tax increases.

At the very least, we expect the Government to freeze overall spending in real terms for several years. And significant real cuts in spending are more than likely. Of course, actually sticking to the promises is a different matter from making them. However, the Government may have little choice but to do so. And in the mid 1990s, this is exactly what both the Conservative and Labour Governments did.

That said, there is one factor which clearly makes this post-recovery economy rather different from that seen in the mid 1990s, or indeed after any other recessions – namely the legacy of the credit crunch and the bursting of the asset price bubbles.

A return to the days of “easy money” is pretty much out of the question, with firms and households finding it permanently harder to access bank borrowing. But firms and households may be less keen to borrow anyway. They could be trying to pay down their existing debt for years to come. After all, we think that around one quarter of mortgage holding households could end up in negative equity by the time house prices have bottomed out – compared to between 10% and 15% of households in the early 1990s.

Admittedly, interest rates are likely to remain at relatively low levels by historical standards, keeping interest payments fairly low relative to income and profits. But with high inflation no longer eroding the real value of debt, debt repayments now make up the bulk of household debt servicing costs.

The new world

So what will the economy of the next decade look like? Overall economic growth could actually be fairly volatile. A further period of weak or negative economic growth is likely to be followed by several years of relatively strong growth as the large amount of spare capacity in the economy is used up.

On average, though, economic growth could be fairly similar to the rates seen in the past decade. **In other words, there is little reason to expect the underlying or trend rate of economic growth to have changed much.** Admittedly, the boost to the labour force from rising net migration has now largely run its course. Equally, however, trend productivity growth could receive a significant boost from shifts in the *composition* of growth. (We will return to both of these issues later).

Indeed, the shape of growth could be virtually unrecognisable by recent standards. For a start, government spending will be stagnant or falling in real terms.

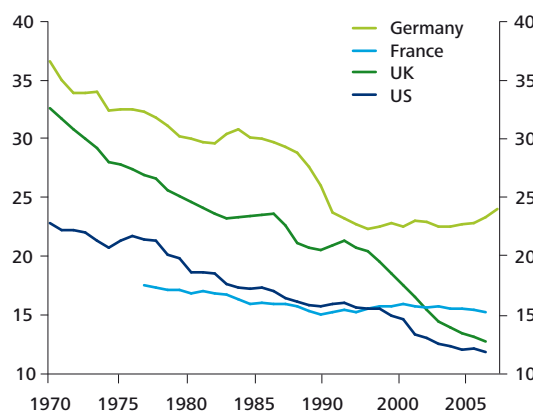
Consumer spending won’t perform quite as badly as this, given that house prices will probably be rising (albeit just in line with average earnings) and interest rates will still be pretty low by historical standards (assuming, of course, that quantitative easing does not go hideously wrong). And inflation will also remain low (ditto).

Nonetheless, after a decade during which consumer spending outpaced overall economic growth, it would not be surprising now to see a decade where consumer spending *underperformed* – particularly if the process of paying down debt is drawn-out and if the likely rise in taxes falls on the consumer sector. We have assumed sub-trend growth in consumer spending of 2% or so per annum.

Investment could be rather stronger, as firms use the recovery in their profits to build up their capacity. **But the real star of the show is likely to be the external sector.** Admittedly, concerns have been voiced about whether the UK's manufacturing sector is big enough to provide a significant boost to net trade. Manufacturing made up just 12.7% of the economy in 2007, a share which is likely to shrink this year to around 11%.

However, we see no reason why the manufacturing sector cannot see a mini-revival and rebuild its capacity to bring a temporary halt to, or even partially reverse, its long-run downward trend. After all, other mature economies have a much bigger manufacturing sector than the UK. In France, manufacturing accounted for 15% in the economy in 2007 (the latest data available). And in Germany, it accounted for some 24%. (See Chart 5.)

Chart 5. Manufacturing (as a % of GDP)



Source – HM Treasury

Even if we are being too hopeful about the manufacturing sector, the drop in the pound could give a significant boost to services exports.

Admittedly, the UK's biggest services exports (around one third) are financial services and they look unlikely to grow much. But tourism accounts for a further 12% of services exports and the number of visitors to the UK rose at double digit annual rates following the 1992 sterling depreciation. Other services exports which could benefit include the freight services offered by shipping operators and consultancy services such as advertising, architectural and legal services.

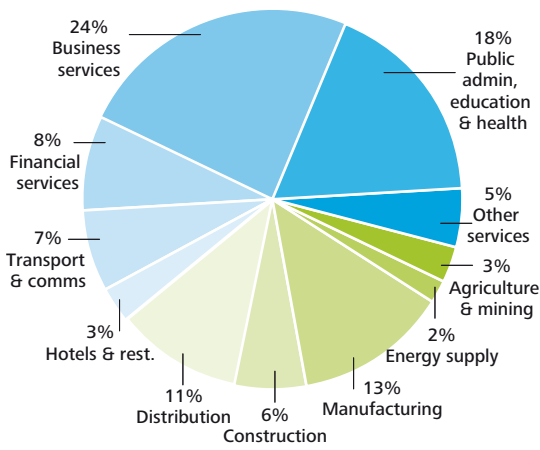
What's more, the drop in the pound should also improve the UK's trade position by reducing demand for foreign imports. For example, not only will more foreign tourists come to the UK, but more UK residents will take their holiday at home rather than abroad. Taking all of this into account, we think that net trade could easily contribute around 1% per annum to GDP growth. Just closing the trade in goods and services deficit would boost GDP by 3%.

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The winners and losers

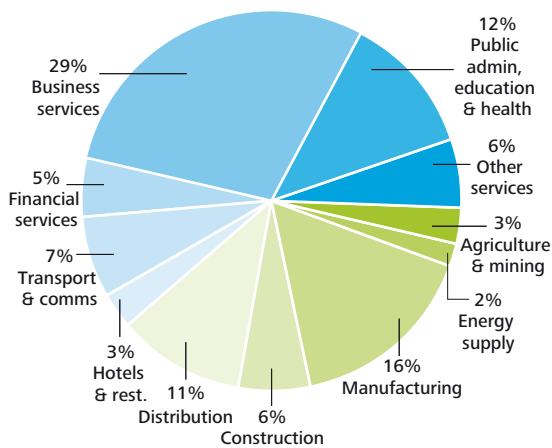
Charts 6 and 7 show how these different patterns of growth might affect the relative size of different sectors in the economy. Chart 6 shows the breakdown of the UK economy in 2007 (the latest data available) and Chart 7 shows how it might look in 2020. The services side of the economy is shown in blue, the industrial side in green.

Chart 6. Breakdown of GDP in 2007 (% of total)



Sources – Thomson Datastream & Bootle

Chart 7. Breakdown of GDP in 2020 (% of total)



Sources – Thomson Datastream & Bootle

The manufacturing sector could see a fairly significant rise in its share of the economy. We think that it could increase to 13% or even 15% (requiring average annual growth in manufacturing output of around 6% and 8% respectively). Business services are likely to see an increase in their share too, from 24% to approaching 30%.

In contrast, the financial sector is likely to see its share of the economy shrink. Banks themselves are likely to retain a cautious attitude for years to come. Even if their risk appetite does return, an overhaul of the regulatory system is likely to restrict severely what they can do. Amongst the various recommendations in the Turner review of global banking regulation published in March were the increased reporting requirements for unregulated financial institutions such as hedge funds and higher levels of capital to support risky trading activity. Alistair Darling has also openly supported the idea of a new European Union framework for financial regulation. If output in the financial services sector stagnates, its share could shrink to just 5% or so of GDP.

Similarly, stable output in the public administration, health and education sector would shrink its share of the economy from 18% to just 12%. Meanwhile, the relatively slow growth of consumer spending compared to overall GDP suggests that the share of the consumer services sectors in the economy (i.e. distribution and hotels/restaurants) might also drop back modestly.

We assume that most other areas of the economy (namely transport/communications, construction, energy supply and other services) grow broadly in line with overall output.

A closer look

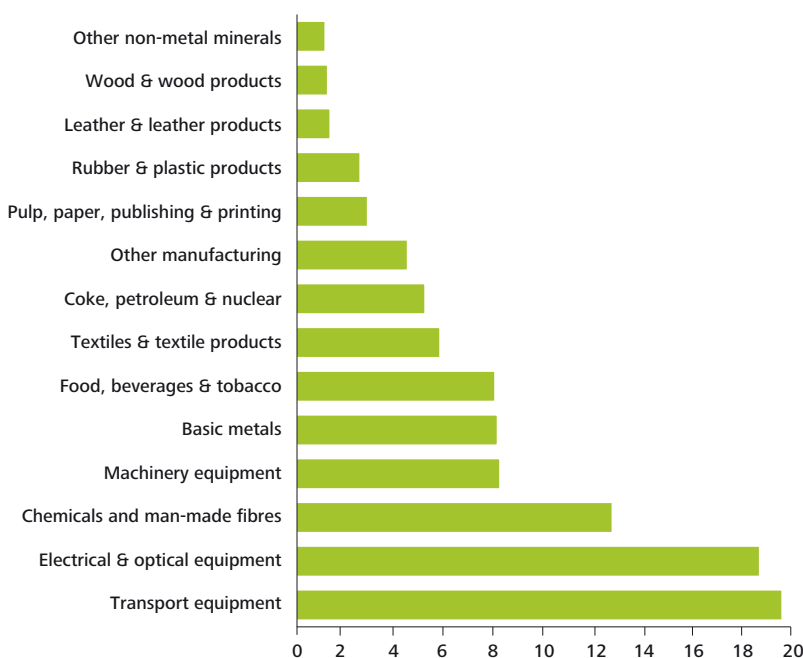
This is still very much a broadbrush picture of the economy. What if we drill a little deeper?

Some of the most significant developments could be seen in the manufacturing sector. The drop in the pound should clearly help the UK play to its traditional exporting strengths – such as the production of aircraft, pharmaceuticals, engines, high-tech IT equipment and electrical components. But by making imports less competitive, the drop in the pound could have an even wider impact by encouraging UK manufacturers to produce more of the goods and services which have previously tended to be imported.

The car industry, in particular, could do well. Chart 8 shows that transport equipment, including vehicles, accounted for 20% or £54bn of goods imports in 2007. More of this vehicle production may now be shifted to the UK. Assembly plants tend to be shifted from country to country fairly regularly depending on where costs are lowest. And even for those cars that are still put together abroad, the UK can produce more of the component parts.

Meanwhile, we think that the services sector is particularly fertile ground for new or nascent types of services to spring up and expand. The provision of regulatory and advisory activity related to “green” or environmental issues is yet really to take off. Yet more and more of companies’ time and resources will be devoted to complying with environment legislation and new green taxes. And firms will need to be increasingly advised on how to incorporate these green issues into their mainstream corporate disclosure.

Chart 8. Goods imports to the UK in 2007 (as a % of total)



Source – Thomson Datastream

Another 19% of goods imports are accounted for by electrical and optical equipment. It is perhaps hard to see the production of basic office equipment shifting back to the UK. But the UK could start to produce more of the high-tech goods that it needs, such as medical precision equipment. Meanwhile, environmental concerns about flying food around the world might also reduce demand for food imports.

In contrast, the drop in the pound is unlikely to halt the continued decline of some of the UK’s traditional manufacturing bases – such as textiles. And the UK’s North Sea oil sector could dwindle away as the UK’s oil and gas reserves are depleted.

Meanwhile, the online sector could also expand into new areas. A few years ago, no-one would have guessed that people would be buying their music or postage over the internet, for example. **The shape of consumer-facing industries could therefore continue to change quite significantly, with the role of the high street declining further.** We also doubt that we have reached the limits of what supermarkets can offer – as their venture into providing financial services underlines. We could yet see Sainsbury’s restaurants or Tesco gyms attached to the stores.

As people get richer and can afford to pay more for convenience, we should also expect a greater provision of personalised and time-saving services. We already have supermarket home-deliveries, personal trainers and companies that will book you a restaurant and pick up your dry cleaning. Why not personal chefs? Could granny-minders become as common as child-minders? Related to this, the ageing population is likely to give rise to continued growth opportunities in sectors related to old-age care, such as nursing homes.

Lastly, technological advances could provide a whole host of opportunities that we can barely imagine. Of course, by their very nature, we do not know what they are yet! But areas such as biotechnology, robotics and energy conservation seem particularly promising in this respect. During a recession, it may be hard for innovators to get firms to buy and develop their technology. But in the post-recovery economy, these discoveries could be quickly and widely adopted.

The regional implications

Clearly the changes in the sectoral composition of the UK economy will have crucial knock-on implications, not least on the regional picture of the UK. **Perhaps most obviously, it has been suggested that the demise of the financial sector will be devastating for London. However, we think that these concerns are somewhat overdone.**

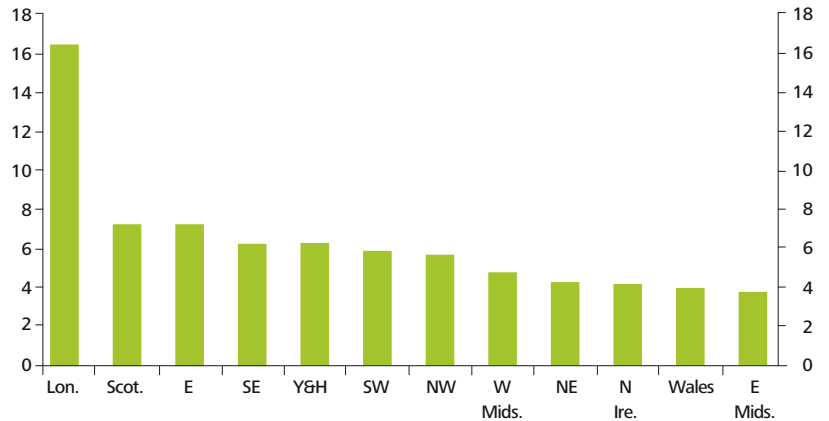
Of course, there is no denying that London is more heavily reliant on financial services than the rest of the country. But the sector is perhaps not quite as important as is commonly assumed, accounting for just 16.5% of the region's output in 2006 (the latest data available), compared to between 4% and 8% in other regions. (See Chart 9.)

What's more, only a fraction of those financial services are the wholesale or City-type services that will suffer the most serious long-term damage from the credit crunch. We think that City-type financial services account for only one quarter of financial services in the UK as a whole. Even if all of these were located in London (which they are not, given the growing financial centres in cities like Edinburgh and Leeds), they would still account for only 10% of London's economy.

Meanwhile, London is set to remain a world leader in a host of other fields, from accountancy to the arts. The drop in the exchange rate is only likely to reinforce London's position by making it cheaper for international firms to locate in the UK. Similarly, London seems well-placed to be at the forefront of the creation of the new areas of strength, such as "green" advice. In fact, it is not obvious that London's share of the economy has to shrink at all – it could even continue to grow.

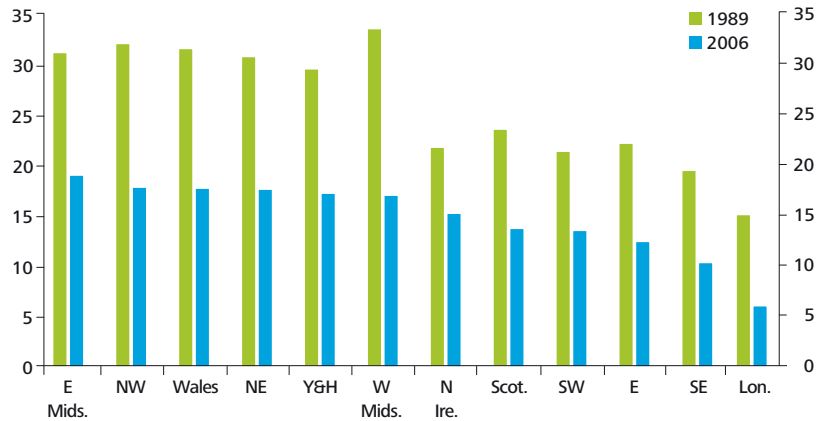
Equally, however, those hoping that the manufacturing revival will mark a sea-change in the fortunes of the relatively industrialised regions of the north might be disappointed. Regional disparities are far smaller than they used to be, in part because many northern regions have successfully built up their services sectors in order to compensate for their declining manufacturing bases. Chart 10 shows that even in the most manufacturing dependent regions, manufacturing accounts for less than a fifth of output.

Chart 9. Financial services as a % of regional GDP



Source – Thomson Datastream

Chart 10. Manufacturing as a % of regional GDP



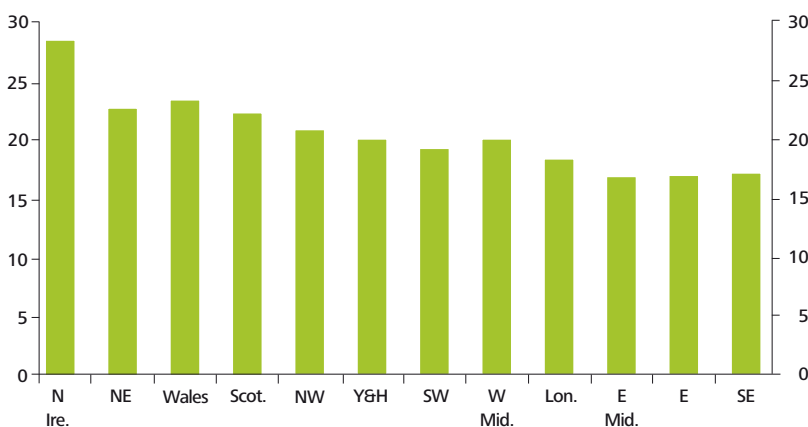
Source – Thomson Datastream

... only a fraction of those financial services are the wholesale or City-type services ...

Nonetheless, some regions will still benefit from a growing manufacturing sector more than others. Chart 10 shows that the North, Yorkshire, the Midlands and Wales are those regions with the biggest manufacturing sectors relative to the size of their regional economies.

Perhaps the biggest driver of regional change, however, could be the slowdown in public sector spending growth. The effects of this spending is perhaps most visible in the labour market. Chart 11 shows that some 29% of employment in Northern Ireland is accounted for by the public sector – compared to just 17% in the East and South East.

Chart 11. Public sector employment as a % of total regional employment



Source – National Statistics

However, we doubt that the regional shifts will be on anything like the scale seen during the de-industrialisation of the past few decades. What's more, even those regions which fail to keep pace with the overall UK economy might see some benefits of this. If London's share of the economy did slip, most London residents would welcome an easing of the pressure on its creaking infrastructure.

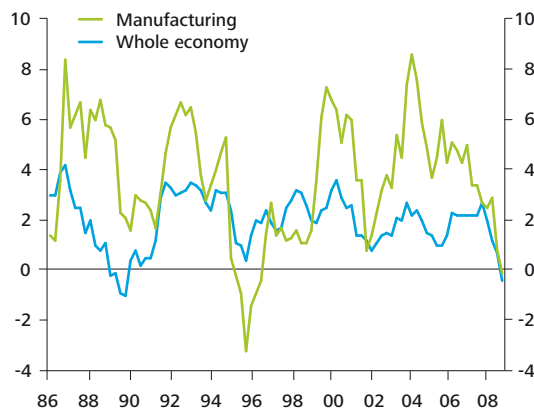
Labour market changes

The changing shape of the economy is also likely to involve pretty significant changes in the shape of the labour force.

On the face of it, there could a significant skills mismatch, as demand for labour in the public and financial services sectors wanes and demand for manufacturing labour increases. **However, the labour mismatch is perhaps not as severe as it might look.** After all, the manufacturing sector is not the sole preserve of the blue-collar manual worker that it once was. According to the Work Foundation, the "better educated" rose from 1% of the manufacturing workforce in 1970 to 13% by 2005. Office of National Statistics data show that almost 20% of manufacturing employees hold degree level qualifications.

What's more, the shifts in the economy could in fact improve the productivity of the labour force, given that manufacturing is inherently more productive than the services sector. Chart 12 illustrates how manufacturing productivity growth has outperformed productivity growth in the economy as a whole for almost all of the past twenty years. This is because manufacturing lends itself more easily to automation and technical progress than the services sector, which is more labour-intensive.

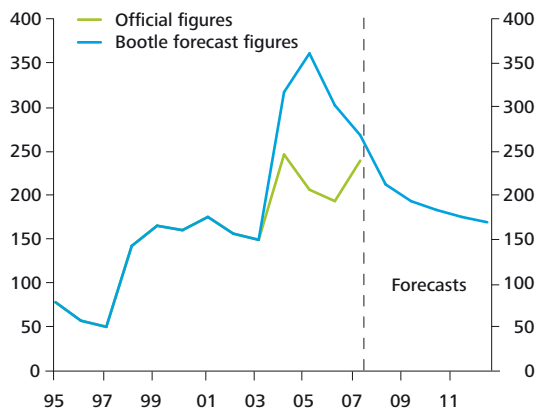
Chart 12. Productivity (% y/y)



Source – Thomson Datastream

The other main change in the labour force is likely to be much lower levels of net migration than those seen over the past decade. The official data show that net migration doubled in the latter part of this decade, and even these numbers are likely to be a gross underestimate of the true extent of migration. (See Chart 13.)

Chart 13. Net migration (000s)



Sources – National Statistics & Bootle

Net migration surged after the expansion of the European Union in 2004. Not only were large numbers of immigrants entering the UK, but relatively few were leaving the UK, given that they generally came with the intention to work for at least a few years. Now, however, we have reached the stage where some of these immigrants are starting to return to their home countries. Even if inflows of immigrants remain strong, then, net migration is likely to be much lower.

But inflows of immigrants could easily fall too. The lower level of sterling against currencies such as the Polish zloty (even after the recent depreciation in Eastern European currencies) will permanently reduce the repatriated value of migrant earnings. Meanwhile, other European countries will have to open their borders over the course of the next few years, once the temporary restrictions on the movement of labour from the accession countries expire. They are thus likely to attract immigrants who would otherwise have come to the UK.

Positive impact on the income distribution?

The changes won't stop there. Discussing them all is beyond the scope of this piece. But we think that there are a couple more worth mentioning.

First, firms' requirements in terms of property and capital goods will change. Demand for industrial property will increase relative to demand for retail space, for example. This could have crucial implications in turn for the relative performance of different areas of commercial property.

Second, it is possible that the distribution of income becomes more compressed. Research by the Institute of Fiscal Studies shows that income inequality remains at historically high levels. However, pay growth of the highest earners is likely to be rather more restrained over the next decade than the last. Not only will increased financial regulation include limits on financial sector bonuses, but tax increases could be concentrated on the highest earners (the Conservatives have said that they will not reverse the increase in the top rate of income tax from 40p to 45p that Labour plans to introduce).

Conclusions

While we should not underplay the enormity of the economic and social costs of the current recession, it is all too easy to get caught up in the present and to forget that a world beyond the credit crunch does exist. And any business planning for the future needs to bear these longer-term developments in mind too.

Equally, though, it would be misleading to talk about when things "get back to normal". After all, what is normal? It could mean how the economy was before. But what's certain is that the economy over the next ten years will look significantly different to the economy of the last ten years. Many things that we have taken as given – from a declining manufacturing sector to a burgeoning role of the state – could now be turned on their head. **The UK economy is in a constant state of flux – and the next decade will be no different.**

Historical data table

	Average 1992-01	2002	2003	2004	2005	2006	2007
Demand (%y/y)							
GDP	2.9	2.1	2.8	2.8	2.1	2.8	3.0
Consumer Spending	3.3	3.7	3.1	3.1	2.0	2.0	3.0
Government Consumption	1.3	3.4	3.5	3.4	1.7	1.6	1.7
Fixed Investment	4.1	3.6	1.1	4.9	2.2	6.0	7.2
Stockbuilding (% of GDP)	0.3	0.2	0.3	0.4	0.4	0.4	0.5
Domestic Demand	3.2	3.2	2.9	3.4	1.9	2.6	3.6
Exports ¹	6.3	1.0	1.8	4.8	8.1	11.0	-4.2
Total Final Expenditure	3.8	2.7	2.7	3.6	3.2	4.4	1.9
Imports ¹	7.2	4.9	2.2	6.8	7.0	9.6	-1.6
Output & Profits (%y/y)							
Services Output	3.4	2.4	3.5	3.2	3.0	3.7	3.6
Manufacturing Output	1.3	-2.1	-0.3	2.2	-0.2	1.9	0.5
Company Profits ² (nominal)	5.5	5.8	8.4	5.4	1.6	5.1	10.1
Labour Market							
Unemployment (claimant count, millions)	1.9	0.9	0.9	0.9	0.9	0.9	0.9
Unemployment (claimant count, %)	6.1	3.0	2.9	2.6	2.9	2.9	2.5
Employment (%y/y)	0.7	0.5	1.3	0.9	1.3	0.6	0.7
Productivity (output per worker, %y/y)	2.4	1.1	1.9	1.9	1.9	2.1	2.2
Income & Saving (%y/y)							
Average Earnings ³	4.3	3.5	3.4	4.4	4.0	4.1	4.0
Real Household Disposable Income	3.1	2.0	3.0	0.8	2.8	1.5	0.0
Saving Ratio (%)	8.5	4.8	5.1	4.0	5.0	4.2	2.2
Prices (%y/y)							
CPI	2.1	1.3	1.4	1.3	2.0	2.3	2.3
Core CPI ⁴	n/a	1.5	1.3	1.1	1.5	1.3	1.7
RPI	2.6	1.6	2.9	3.0	2.8	3.2	4.3
RPIX	2.8	2.2	2.8	2.2	2.2	3.0	3.2
Nationwide House Prices (end period)	11.5	25.3	15.5	13.9	3.3	9.3	6.9
Monetary Indicators (end period unless stated)							
Base/Repo Rate (%)	6.7	4.00	3.75	4.75	4.50	5.00	5.50
20 Year Gilt Yield (%)	7.1	4.5	4.7	4.5	4.1	4.5	4.5
Sterling Trade-weighted Index	92.8	100.3	98.4	99.5	98.3	104.2	97.9
\$/£	1.61	1.61	1.79	1.91	1.72	1.96	1.99
Euro/£	1.39	1.53	1.42	1.41	1.46	1.48	1.36
M4 (%y/y, period average)	7.1	6.1	7.1	8.7	11.0	12.8	12.7
Balance of Payments & Public Finances							
Current Account (£bn)	-11.0	-18.7	-18.3	-25.2	-32.7	-45.0	-39.5
% of GDP	-1.4	-1.7	-1.6	-2.1	-2.6	-3.4	-2.8
PSNB (£bn, financial year)	19.3	25.0	33.1	39.6	37.8	30.4	36.6
% of GDP (financial year)	3.0	2.3	2.9	3.3	3.0	2.3	2.6
World Scene (%y/y)							
World GDP	3.1	2.8	3.6	4.9	4.5	5.1	2.2
US GDP	3.3	1.6	2.5	3.6	2.9	2.8	2.0
Euro-zone GDP	n/a	0.9	0.8	1.9	1.8	3.0	2.6
G7 Consumer Price Inflation	2.4	1.3	1.7	2.0	2.3	2.4	2.2
World Goods & Services Trade Volumes	7.2	3.5	5.4	10.7	7.6	9.3	7.2
Oil Price (Brent, \$ per barrel, end period)	18.4	30.0	30.0	38.4	58.3	59.4	93.8

1 Includes VAT fraud distortion. 2 Gross trading profits of non-financial corporations. 3 Including bonuses. 4 Excluding energy, food, alcohol & tobacco.

Macro forecast table

	2008f	2009f	2010f	2009f		2010f	
				H1	H2	H1	H2
Demand (%y/y)							
GDP	0.7	-4.0	-1.0	-4.2	-3.8	-1.6	-0.4
Consumer Spending	1.4	-3.5	-1.5	-3.2	-3.8	-2.2	-0.8
Government Consumption	3.4	3.0	2.0	3.6	2.5	1.9	2.1
Fixed Investment	-3.1	-8.0	-5.0	-7.9	-8.0	-6.2	-3.7
Stockbuilding (% of GDP)	0.1	-0.5	-0.1	-0.8	-0.3	-0.2	-0.1
Domestic Demand	0.6	-3.4	-0.8	-3.9	-2.9	-1.2	-0.4
Exports ¹	0.1	-10.0	-3.0	-9.2	-10.8	-5.1	-0.7
Total Final Expenditure	0.5	-4.8	-1.2	-5.0	-4.5	-2.0	-0.4
Imports ¹	-0.6	-7.5	-2.0	-8.0	-7.0	-3.6	-0.6
Output & Profits (%y/y)							
Services Output	1.5	-1.5	-0.5	-1.3	-1.3	-0.7	-0.4
Manufacturing Output	-2.6	-15.0	-3.0	-15.0	-15.0	-5.8	-0.8
Company Profits ² (nominal)	-1.3	-25.0	-13.0	-30.9	-30.9	-20.4	-5.5
Labour Market							
Unemployment (claimant count, millions)	0.9	1.9	2.5	1.6	2.2	2.4	2.5
Unemployment (claimant count, %)	2.8	5.8	7.5	4.9	6.6	7.3	7.8
Employment (%y/y)	0.9	-2.7	-2.7	-1.6	-3.6	-3.4	-2.0
Productivity (output per worker, %y/y)	-0.1	-1.4	1.7	-2.3	-0.2	2.0	1.5
Income & Saving (%y/y)							
Average Earnings ³	3.6	0.1	0.6	0.3	-0.1	0.3	0.9
Real Household Disposable Income	2.2	0.0	1.0	1.1	-1.1	0.3	1.8
Saving Ratio (%)	1.9	4.4	6.7	3.3	5.6	5.5	8.0
Prices (%y/y)							
CPI	3.6	1.4	0.8	2.2	0.5	0.8	0.7
Core CPI ⁴	1.6	1.1	1.0	1.3	0.9	1.2	0.8
RPI	4.0	-1.6	0.0	-0.8	-2.3	-0.2	0.2
RPIX	3.2	0.8	0.3	1.5	-0.4	-0.1	0.0
Nationwide House Prices (end period)	-14.8	-19.8	-2.3	-18.0	-19.8	-14.0	-2.3
Monetary Indicators (end period unless stated)							
Base/Repo Rate (%)	2.0	0.5	0.5	0.5	0.5	0.5	0.5
20 Year Gilt Yield (%)	4.0	3.3	3.2	3.5	3.3	3.2	3.2
Sterling Trade-weighted Index	73.8	83.1	82.8	81.3	83.1	82.8	82.8
\$/£	1.46	1.40	1.40	1.45	1.40	1.40	1.40
Euro/£	1.03	1.27	1.27	1.21	1.27	1.27	1.27
M4 (%y/y, period average)	12.6	12.0	5.0	15.4	9.2	5.0	5.0
Balance of Payments & Public Finances							
Current Account (£bn)	-24.6	-32.0	-17.0	-17.8	-14.6	-11.4	-6.0
% of GDP	-1.7	-2.4	-1.3	-2.5	-2.1	-1.7	-0.9
PSNB (£bn, financial year)	96	200	230	-	-	-	-
% of GDP (financial year)	6.7	14.2	16.3	-	-	-	-
World Scene (%y/y)							
World GDP	3.2	-2.0	1.5	-2.3	-1.7	0.8	2.2
US GDP	1.1	-3.0	0.0	-3.3	-2.7	-0.5	0.5
Euro-zone GDP	0.7	-4.0	-1.0	-4.1	-3.9	-1.6	-0.3
G7 Consumer Price Inflation	3.3	-0.4	0.9	-0.2	-0.6	0.7	1.2
World Goods & Services Trade Volumes	2.0	-10.0	3.0	-14.0	-6.0	0.0	6.0
Oil Price (Brent, \$ per barrel, end period)	50	40	40	40	40	40	40

1 Includes VAT fraud distortion. 2 Gross trading profits of non-financial corporations. 3 Including bonuses. 4 Excluding energy, food, alcohol & tobacco.

Analysis: The world economy

US economy unlikely to expand until 2010

- The US economy is suffering its most severe downturn since the 1930s. We expect GDP growth of *minus* 3% this year and don't see the economy expanding again on a quarterly basis until next year. (See Chart 1.)
- There are a few isolated signs in the incoming data that the worst of the contraction could now be behind us. Since the start of this year, the ISM activity indices have rebounded (see Chart 2), retail sales have bounced back and housing activity has leveled off. However, employment, industrial output, exports and inventories are all still falling sharply.
- The unemployment rate climbed above 8% in February, for the first time in more than 25 years, and we expect it to peak at close to 10% early next year. Disposable incomes have continued to rise, mainly because of the lagged impact on wage deals and social security benefits of last year's spike in inflation. But this boost will only be temporary.
- The personal saving rate has already jumped to a decade high of 5% in January, from near zero the year before. (See Chart 4.) Continued uncertainty about the outlook for the economy and jobs, along with the massive declines in both housing and financial wealth, suggest the saving rate could eventually reach anything up to 10%. This will keep spending subdued.
- Despite the length and severity of the recession, we are yet to see any meaningful run-down in inventories. Producers and retailers were initially caught out by the severity of the slump in demand late last year.
- As a result, the inventory-to-sales ratio shot up. (See Chart 5.) Signs are now emerging, however, that a massive inventory liquidation is underway, which we expect to be a sizeable drag on GDP over the first half of this year.
- The economy should soon start to receive a boost from the recently enacted \$787bn fiscal stimulus (worth 5.6% of GDP), as tax cuts kick in and spending on infrastructure and other projects is increased. However, on its own the stimulus will not be enough to drag the economy out of recession. The stimulus will be spread over the next two years, while there is no guarantee that the tax cuts will be spent by nervous households.
- That stimulus is expected to push the Federal budget deficit up to an astonishing 12% of GDP in the current fiscal year and we anticipate only a modest improvement next year. (See Chart 6.)
- The threat of a pernicious debt-deflation spiral is still one of the principal downside risks to our forecast. Headline inflation will temporarily drop below zero this year. But aside from the fall in energy prices, there are few signs of a more widespread decline in prices. (See Chart 7.)
- What's more, the Fed is taking no chances with its increasingly aggressive quantitative easing. The monetary base has already more than doubled to \$1,600bn and the Fed's plans to expand its asset purchases and loan provisions should push it up to \$4,500bn, or 33% of GDP, later this year. (See Chart 8.)

Chart 1. US GDP (%q/q annualised)

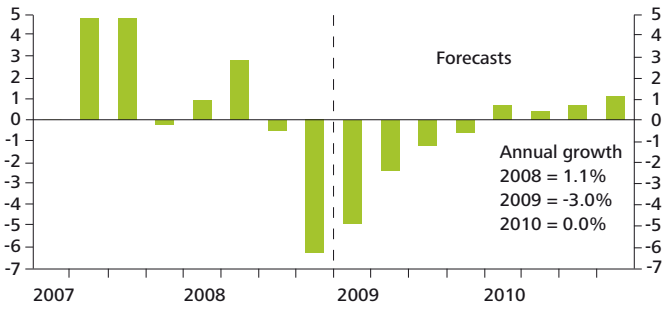


Chart 2. US ISM activity indices

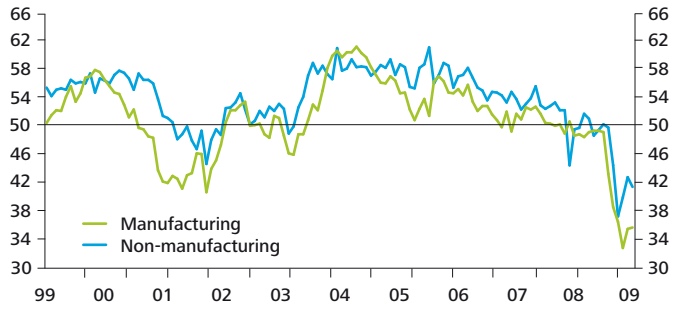


Chart 3. US unemployment rate (%)

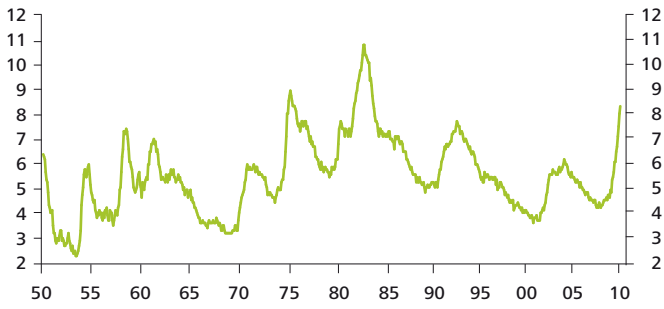


Chart 4. US personal saving rate (as a % of disp. income)

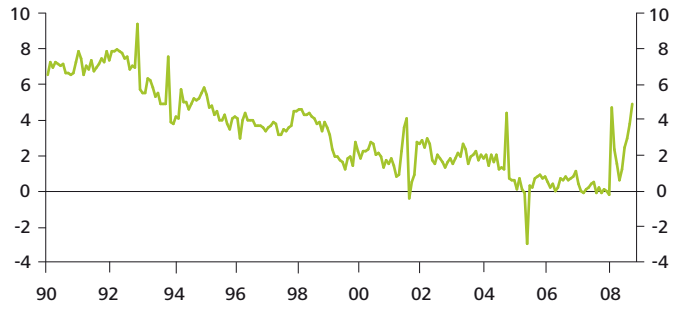


Chart 5. US inventory-to-sales ratio (%)



Chart 6. US Federal budget balance (as a % of GDP)

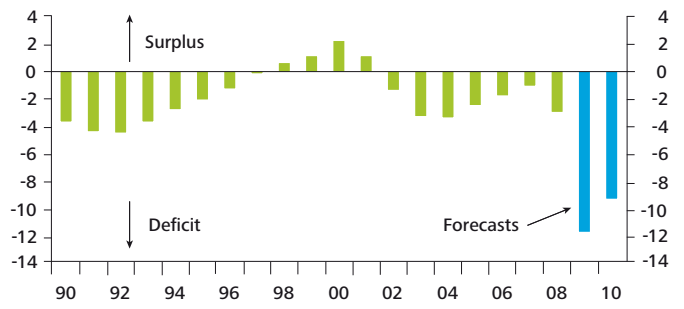


Chart 7. US CPI inflation (%/y)

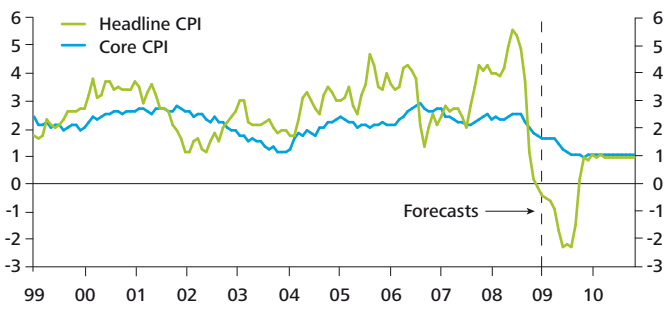
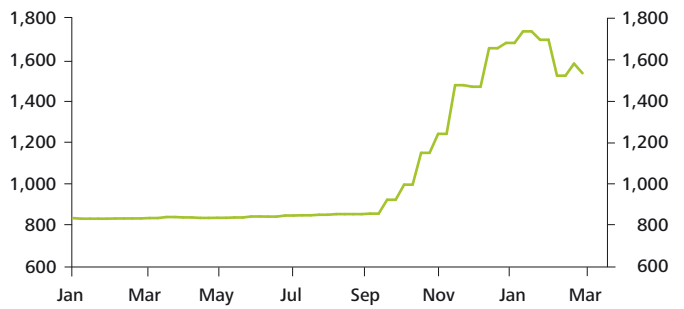


Chart 8. US monetary base (\$bn)



Source – Thomson Datastream

Analysis: The world economy

Euro-zone at risk of a longer-lived recession

- Despite the relatively low level of household debt in the euro-zone, a collapse in industrial and external activity has driven the region into a particularly severe recession. We still expect the euro-zone to begin a very modest recovery next year as global demand edges up. But there is a growing risk that an inadequate policy response leads to a much longer-lived downturn.
- The recent drop in activity has been driven largely by exports, which are now plunging at annual rates of over 20%. Survey measures of export orders point to further double digit falls in the coming months, as do our forecasts for demand from the region's major export markets. (See Charts 9 and 10.) In the near term, this weakness looks set to be exacerbated by the strength of the euro.
- The drop in global demand has had a particularly severe impact on the export-dependent industrial sector. (See Chart 11.) Worryingly, the business surveys suggest that manufacturers' inventories are now larger than they would like (see Chart 12), implying that there could be an even sharper drop in industrial production to come.
- Despite earlier fears that inflation might be relatively sticky in the euro-zone, price pressures have receded more rapidly than in the UK and almost as quickly as in the US. (See Chart 13.) But rather than buying larger *quantities* of goods and services as inflation has fallen, households have pocketed the savings so that both the value and volume of retail sales are now contracting. (See Chart 14.)
- Looking ahead, a further sharp drop in inflation and a short period of outright *falls* in prices will further boost real incomes. But the positive effect will be offset by a rapid deterioration in labour market conditions (see Chart 15), suggesting that household spending will remain weak for some time.
- One hope is that, with a few notable exceptions, households in euro-zone countries are far less indebted than those in the UK. Given no need for a painful adjustment to higher saving rates, the euro-zone economy might begin to expand modestly as global demand starts to improve next year. Germany, which has maintained a strong competitive position, will probably lead any recovery.
- However, there is still a risk that relatively cautious fiscal and monetary policy leads the euro-zone into a far more prolonged recession than elsewhere. Government stimulus packages, which so far amount to around 2% of the region's GDP, have fallen far behind the equivalent policies in the US. And although we think that the ECB will eventually follow other central banks into a bold program of quantitative easing, the Bank has so far maintained a relatively cautious tone.
- The upshot is that we now see the euro-zone economy contracting by a steep 4% or so this year. For now, we expect only a modest decline of about 0.5% in 2010. (See Chart 16.) But some economies, most notably Italy, Spain and Ireland, will fare much worse and the risks of a longer-winded recession in the euro-zone as a whole are mounting.

Chart 9. Euro-zone exports & industrial PMI export orders

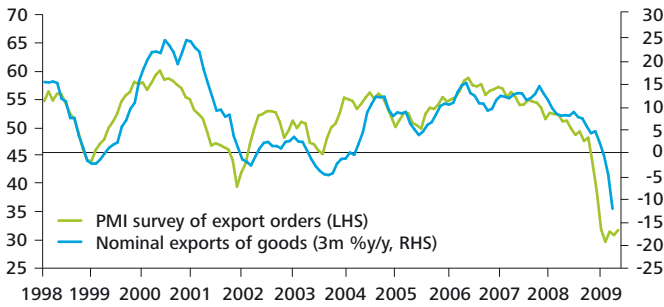


Chart 10. Euro-zone exports & trade-weighted world GDP

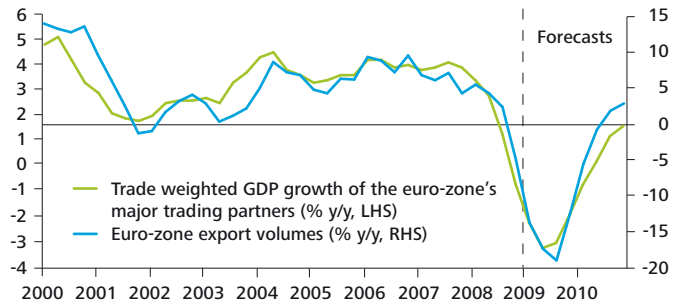


Chart 11. Euro-zone manuf. PMI & industrial production

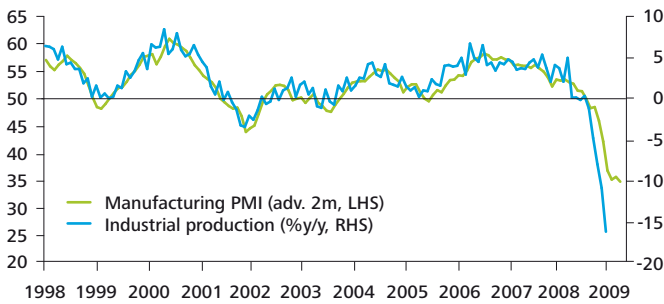


Chart 12. E-Z EC survey stocks relative to desired level

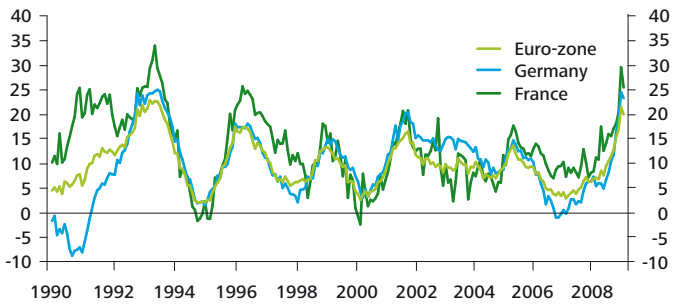


Chart 13. Euro-zone, US & UK CPI inflation (%)

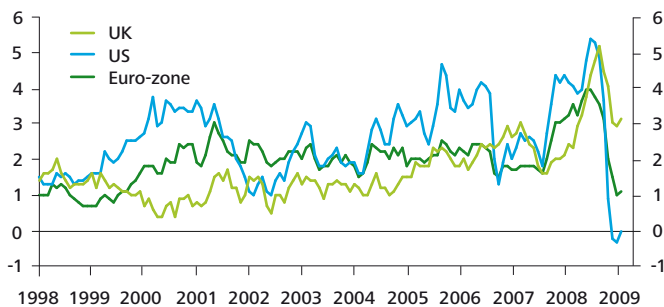


Chart 14. Euro-zone retail sales values & volumes (3 month av. %y/y)

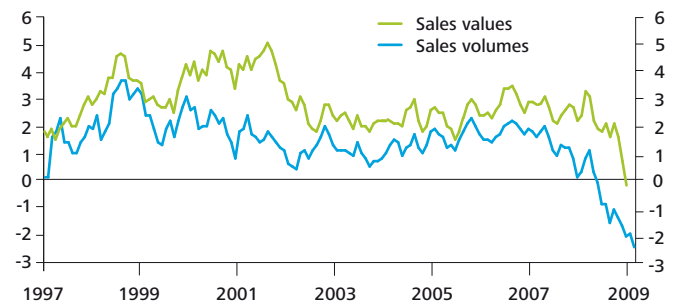


Chart 15. Euro-zone employment & EC survey hiring intentions

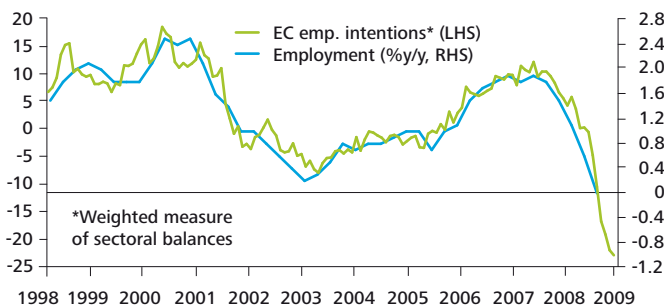
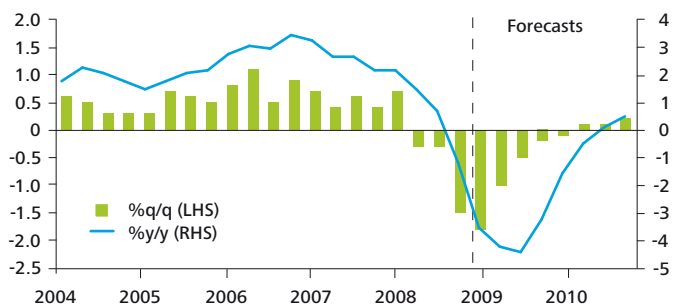


Chart 16. Euro-zone GDP



Source – Thomson Datastream

Analysis: The world economy

Asia hammered by collapse in world trade

- Any optimism about Asia's ability to decouple from the financial crisis in the West has long since been dashed by the collapse in world trade, which is hitting export-led economies in the region especially hard. Both world GDP and trade will see their biggest declines since the 1930s. (See Chart 17.)
- The deterioration in trade flows partly reflects the weakness in final demand, especially for capital goods and discretionary consumer goods such as cars – all areas in which Asian exporters are traditionally strong. However, the extent of the collapse in recent months (see Chart 18) suggests there are additional factors at work. The prime suspect is a temporary shortage of trade finance, which could return quickly as and when the financial sector starts to operate normally again. Trade might therefore stage a partial recovery before the world economy itself picks up.
- In the meantime, Japan's output in the export-orientated industrial sector has fallen off a cliff. (See Chart 19.) However, aside from exports and related investment spending, the rest of the economy has held up fairly well in the circumstances.
- In particular, consumer confidence has been cushioned by the unwinding of last year's food and energy price shocks, which has supported spending on other goods and services. This helps to explain why consumers' willingness to buy durable goods has edged higher, albeit from very depressed levels, despite growing nervousness about jobs. (See Chart 20.)
- Japan was the first of the major economies to fall into recession (GDP contracted by 0.7% last year) and has suffered some of the steepest quarterly declines. But this does at least mean that Japan should be among the first to return to positive quarterly growth. (See Chart 21.) This would require only a slight bounce in exports after the recent exceptional falls.
- The Chinese economy also appears to have slowed sharply. The government will almost certainly report that its GDP target of 8% has been met this year. But we suspect that growth will actually be much weaker, slowing to around 5%. (See Chart 22, which shows our forecasts of the true picture rather than the likely evolution of the official data.)
- China should, however, manage a decent recovery in 2010. A short bout of deflation will support real incomes. (See Chart 23.) Measures to encourage bank lending are already starting to have an effect – as might be expected in what is still largely a command economy. The government has also announced a large fiscal stimulus. There are valid concerns about how much of the spending is truly additional and how it will be financed, but there is plenty of scope for Beijing to do more if required.
- India is less integrated into the global economy but is also slowing sharply. The poor fiscal position and political uncertainty means there is little prospect of a substantial fiscal stimulus here. We expect the Indian economy to grow by a below-par 4% this year, similar to the low in 2001. (See Chart 24.)

Chart 17. World trade & GDP

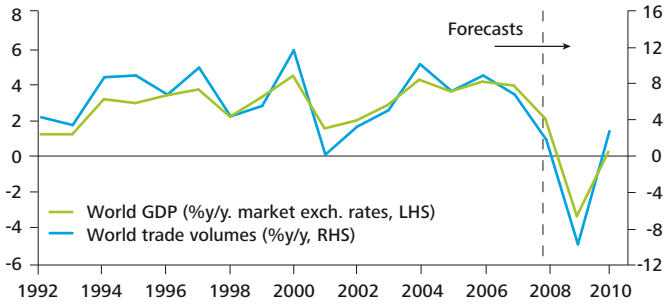


Chart 18. World trade in goods (3m annualised, %)

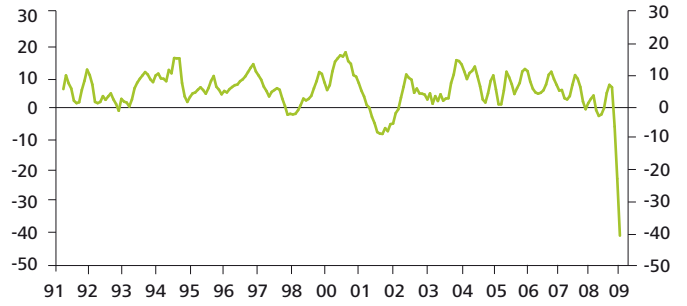


Chart 19. Japan exports & industrial production

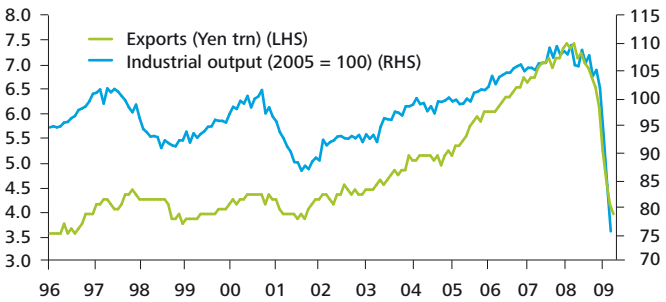


Chart 20. Japan consumer confidence

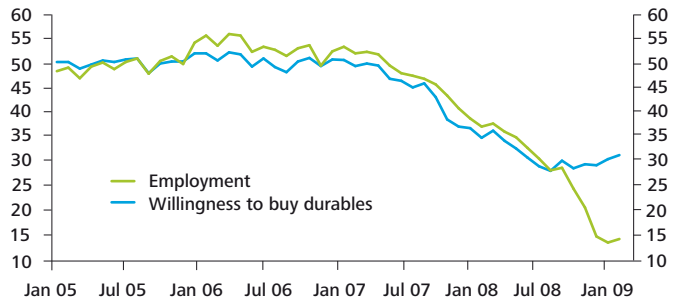


Chart 21. Japan GDP

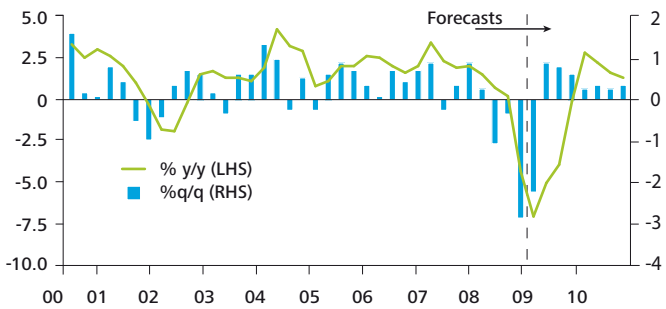


Chart 22. China GDP (%y/y)

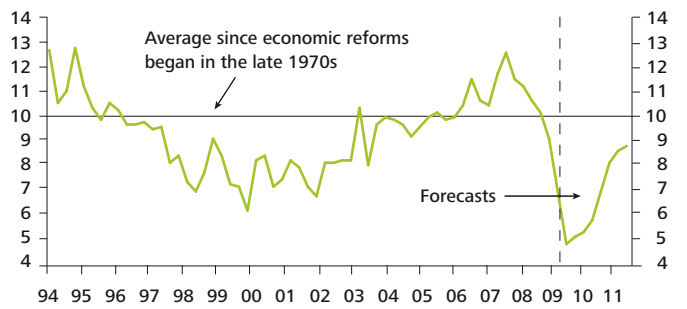


Chart 23. China consumer prices (%y/y)

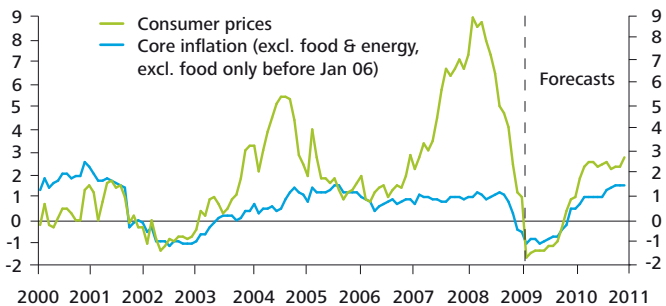
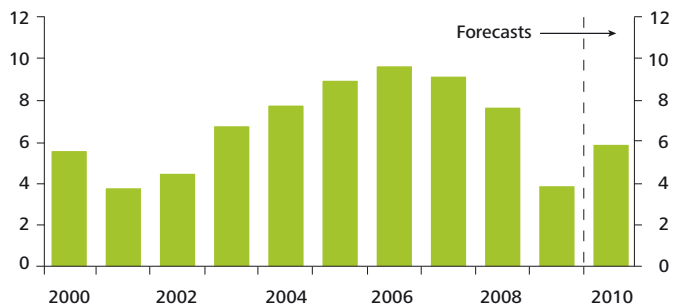


Chart 24. India GDP (% annual change)



Sources – IMF, CPB, Bloomberg

Analysis: Output and activity

Recession still looks likely to stretch into next year ...

- The recession is still in its early stages. The first quarter has already set the UK up for a dreadful 2009. And we continue to think that output is likely to decline further in 2010, with this recession set to be on a par with that in the early 1980s.
- The loss of output in the first quarter now looks like it could match the fourth quarter's eye-watering 1.6% quarterly drop. (See Chart 1.) What was initially a financial services and construction-led downturn has turned into a recession that is affecting virtually all of the private sector. (See Chart 2.)
- Policymakers are throwing everything but the kitchen sink at the problem. The Bank of England has slashed official interest rates to a record low of 0.5% and has already purchased more than £16bn of the £75bn of gilts, corporate bonds and commercial paper it has voted to buy through the "quantitative easing" programme.
- Furthermore, Lloyds, RBS and Northern Rock have committed to £92bn of net new lending over the next two years, in return for a Government guarantee of losses on their toxic assets (the Asset Protection Scheme).
- However, banks are continuing to blunt the effectiveness of monetary policy by failing fully to pass on the cuts in official interest rates, to new borrowers in particular. (See Chart 3.) Meanwhile, the lending commitments are equivalent to only 25% of the new lending we think could be required to return GDP growth to its long-run average.
- Indeed, bank lending growth to households and non-financial companies has continued to slow. (See Chart 4.) This may, of course, be partly demand-driven. But there has been a sharp increase in the proportion of firms citing the availability of credit as a constraint on output growth. (See Chart 5.)
- Tighter credit conditions, combined with the dismal economic outlook, prompted business investment to fall at an annual rate of 4.5% in Q4. What's more, the latest surveys are consistent with even larger annual falls in the coming months. (Chart 6.) We expect business investment to drop by around 10% this year.
- At least consumers are enjoying a significant boost to their spending power from falling inflation. Falling utility and petrol prices, in particular, have freed up money to spend on discretionary or "fun" goods and services.
- However, there are other offsetting factors pushing *down* on households' real income growth. Unemployment is now rising at monthly rates not seen since records began nearly forty years ago. (See Chart 7.) We expect a further rise in the widest ILO measure of unemployment of some 1.5 million over the next couple of years. (See Analysis: Labour Market, pages 28-29.)
- In addition, average earnings (including bonuses) are falling. Regular pay growth has held up better, but will slow too as pay freezes and reduced hours become widespread. This will mute the boost to real average earnings growth from falling inflation. (See Chart 8.)

Chart 1. Real GDP growth & business surveys

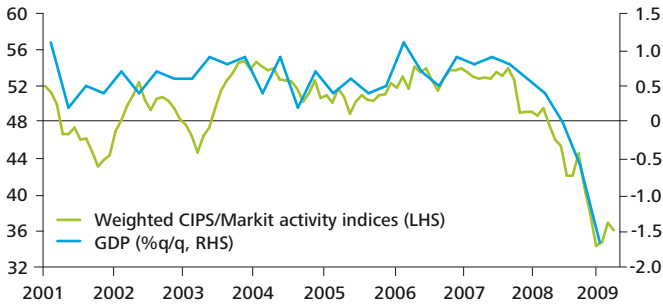


Chart 2. Quarterly real GDP growth by sector in 2008 Q4

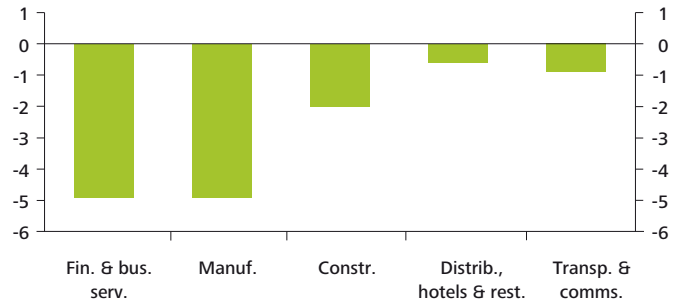


Chart 3. Average spread of new tracker mortgages (%)

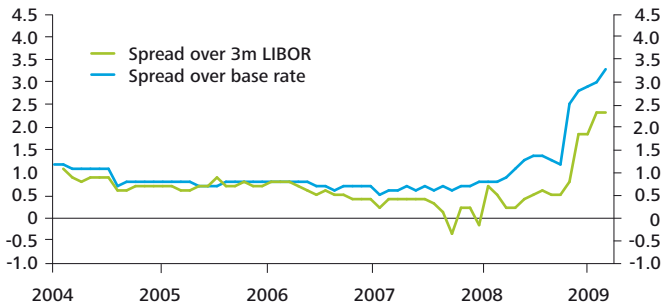


Chart 4. Annual growth in M4 lending

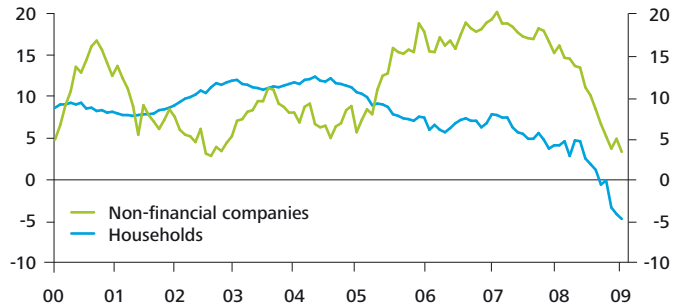


Chart 5. % of respondents to the CBI quarterly survey citing credit or finance as a factor limiting output

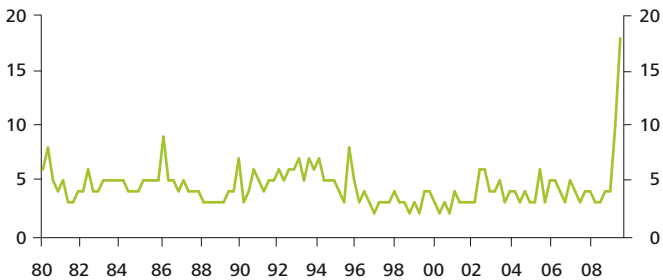


Chart 6. Business investment & investment intentions

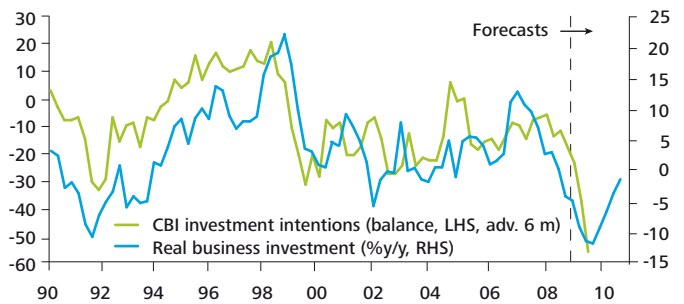


Chart 7. Monthly change in claimant count (000s)

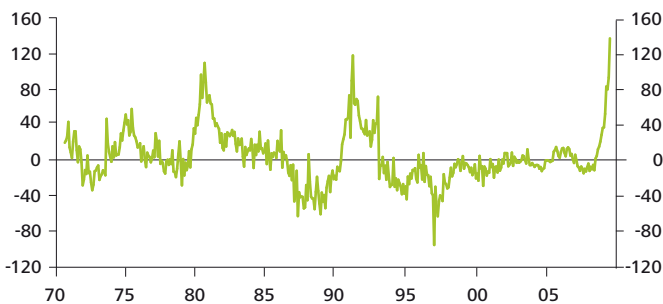
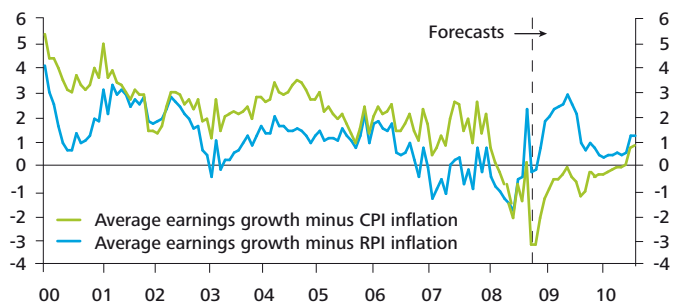


Chart 8. Real average earnings including bonuses (%/y)



Source – Thomson Datastream

Analysis: Output and activity

... with a deflationary spiral still a key downside risk

- What's more, households have so far saved, rather than spent, any extra cash. With job insecurity still rising and house prices still falling, we think that the rise in the saving rate has much further to go. (See Chart 9.)
- On balance, then, we expect to see further falls in real consumer spending of around 3.5% this year and 1.5% next year. Indeed, as consumers undergo a long period of deleveraging, consumer spending is likely to underperform for several years. (See Chart 10.)
- The UK's salvation therefore lies in the pound's weakness. Admittedly, the most recent data on exports indicate that the pound is so far failing to provide much support to export orders or manufacturing output. (See Chart 11.) But, of course, imports are falling faster too. This allowed net trade to make a rare positive contribution to GDP growth in the last two quarters of 2008.
- So far, this positive contribution is too small to offset much of the weakness in the domestic economy. But as global demand recovers, we expect net trade to become a much more important driver of growth.
- Meanwhile, government expenditure is likely to increase as a share of GDP, as the automatic stabilisers (such as rising unemployment benefit payments) kick in. But we doubt that there is room for a significant *discretionary* fiscal expansion in the upcoming Budget. As Chart 12 shows, debt interest payments are likely to take up an ever larger share of the Government's budget.
- Overall, then, we expect the economy to contract by around 4% in 2009. And we think that it is optimistic to expect a recovery before the end of this year. After all, the only leading economic indicator to show any improvement in the past month or two is consumer confidence. And GDP does not tend to start rising until some 4 to 5 quarters after confidence begins to recover. (See Chart 13.)
- We expect the economy to contract by another 1% or so in 2010. (See Chart 14.) In total, output could fall by around 6% from peak to trough – making this recession broadly comparable in severity to that seen in the early 1980s. (See Chart 15.)
- The outlook is obviously unusually uncertain, though. Chief amongst the downside risks is a prolonged deflationary spiral. The growing amount of spare capacity in the economy is already consistent with a sharp drop in core inflationary pressures. (See Chart 16 and Analysis: Inflation, pages 24-27.) There also remains a risk of a secondary crisis in the financial sector. Concerns are growing, for example, about the impact of falling corporate bond prices on insurers.
- On the upside, however, the action undertaken by policymakers may prove to be more effective than we have assumed, particularly in kickstarting bank lending. A quicker recovery in the global economy than we expect could also prompt a speedier pick-up in export growth. And finally, we may be overestimating just how far the household saving rate needs to rise to bring the sector back into some sort of equilibrium.

Chart 9. Household saving ratio (saving as a % of income)

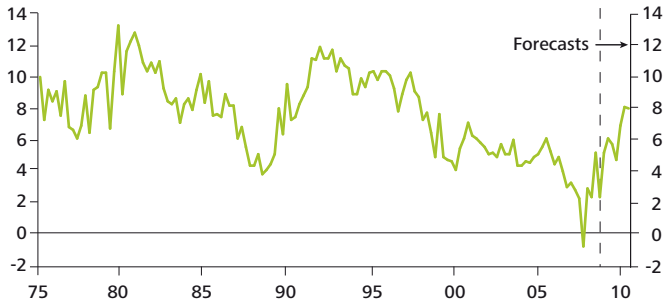


Chart 10. Real household spending (% y/y)

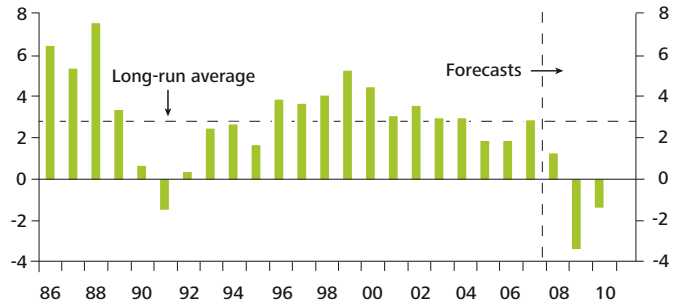


Chart 11. Export orders (balances)

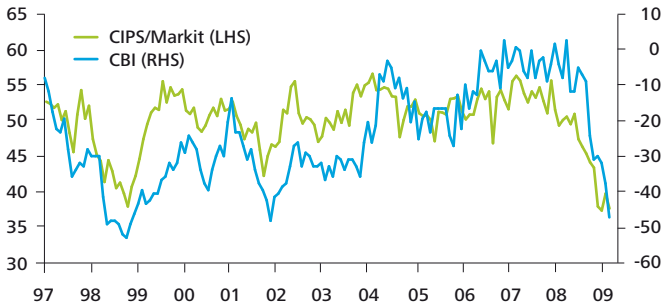


Chart 12. Public sector debt & interest payments

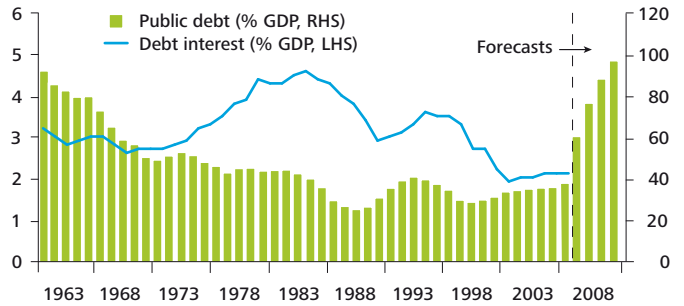


Chart 13. MORI balance of consumer confidence

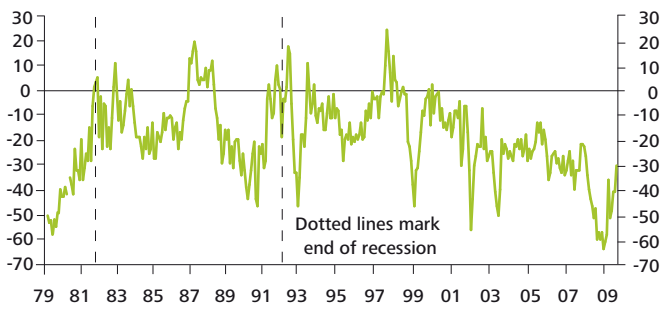


Chart 14. Real GDP growth

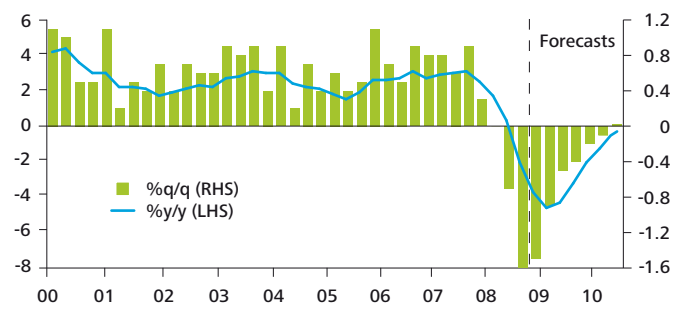


Chart 15. % peak to trough changes in real GDP

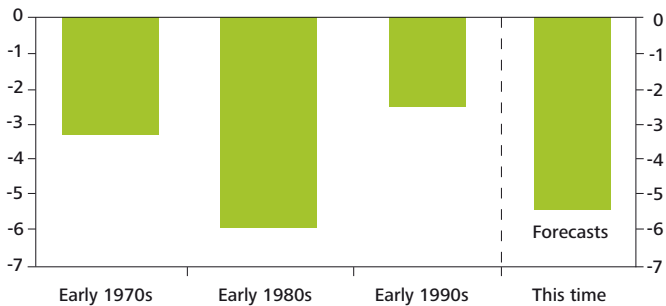
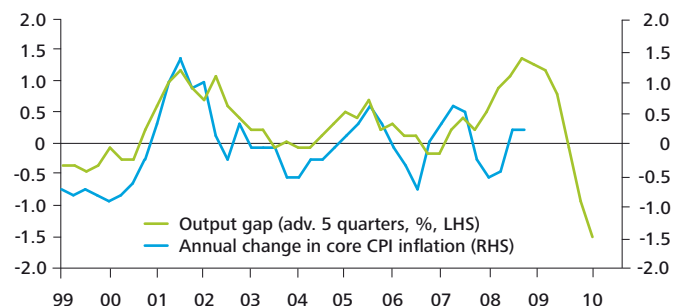


Chart 16. Output gap & change in core CPI inflation



Source – Thomson Datastream

Analysis: Inflation

Pound and QE prompt inflation jitters

- The steep drop in the exchange rate and the scale of the policy measures put in place to boost the economy have led to some suggestions that inflation pressures may be set to re-appear. But we still believe that *deflation* is a bigger threat to the UK economy over the next couple of years.
- The downward pressure on consumer price inflation appears to have eased somewhat over recent months. As Chart 1 shows, while sharp falls in housing costs have pushed RPI inflation all the way down to zero, CPI inflation (which excludes housing) has stalled at a level still well above the Monetary Policy Committee's 2% target.
- CPI inflation is set to fall significantly further over the summer, however, if only because of further downward pressure on energy prices as gas and electricity bills finally respond to the previous drop in oil prices and wholesale energy prices. (See Charts 2 & 3.)
- At the same time, the recent falls in global agricultural prices could soon start to pull UK food prices lower. Both food producer price inflation and food import inflation have recently slowed, though the latter remains uncomfortably high at more than 20%. (See Charts 4 & 5.)
- Between them, these forces could still push CPI inflation into negative territory later on this year, while RPI inflation is set to drop as far as -3% as house prices keep falling.
- But the outlook for inflation further ahead is rather more uncertain. For a start, there is still a possibility that the gradual pass-through of previous sharp rises in producers' costs and selling prices prompts a pick-up in underlying or core inflation. As Chart 6 shows, it can take up to 18 months for changes in producers' selling prices to feed fully into the high street.
- Similarly, the historical relationship between import price inflation and core goods inflation suggests that the full inflationary effects of the drop in the exchange rate may take some time to come through. (See Chart 7.)
- Meanwhile, there are enormous uncertainties over the likely impact on inflation of the various policy measures implemented over recent months, not least the commencement of so-called quantitative easing – i.e. official asset purchases financed by the creation of central bank reserves designed to boost asset prices and the money supply.
- This has attracted unfavourable parallels with some historical episodes in which “printing money” has eventually led to a sharp rise in inflation, or even hyper-inflation. As Chart 8 shows, inflation expectations in bond markets have certainly moved up somewhat over recent months, though they remain relatively low by historical standards.
- But we suspect that these potential upward influences on inflation will be more than offset by the very powerful downward pressures associated with the deep and protracted downturn in the economy.

Chart 1. Retail & consumer price inflation (%)

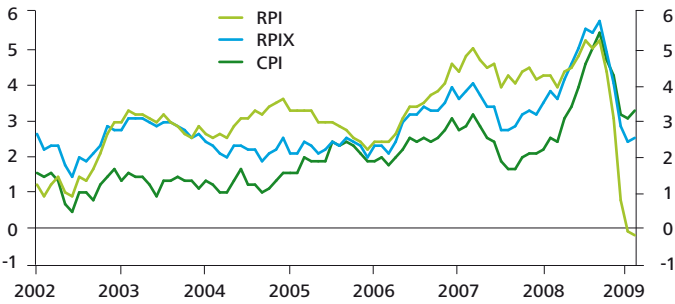


Chart 2. Wholesale gas prices & gas cont. to CPI inflation

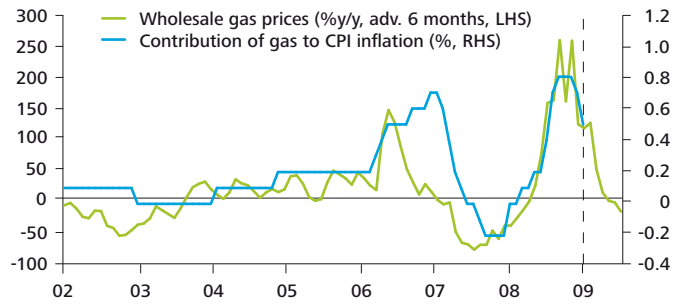


Chart 3. Oil price & energy contribution to CPI inflation

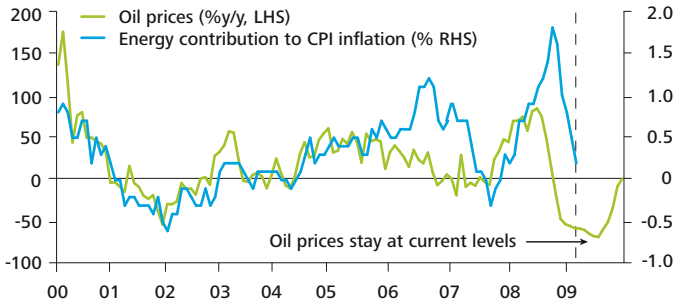


Chart 4. Agricultural commodity prices & PPI food prices

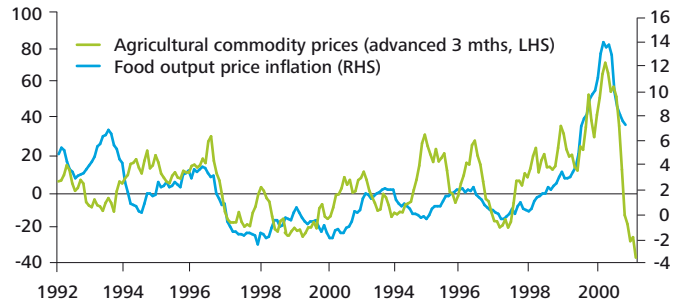


Chart 5. Food PPI & import prices (%/y)

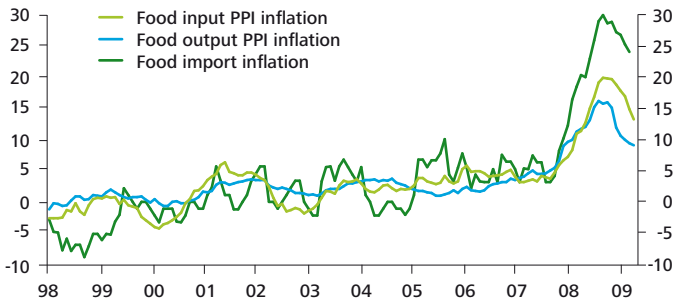


Chart 6. Producer prices & core goods CPI (%/y)

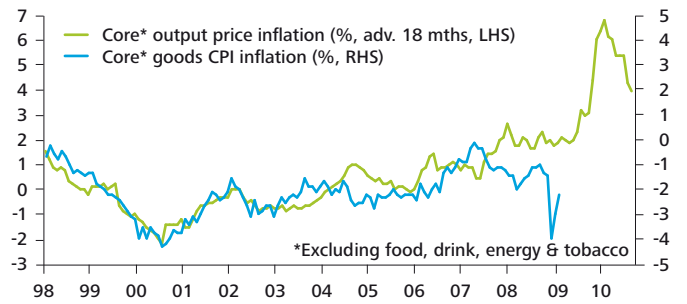


Chart 7. Import prices & core goods CPI

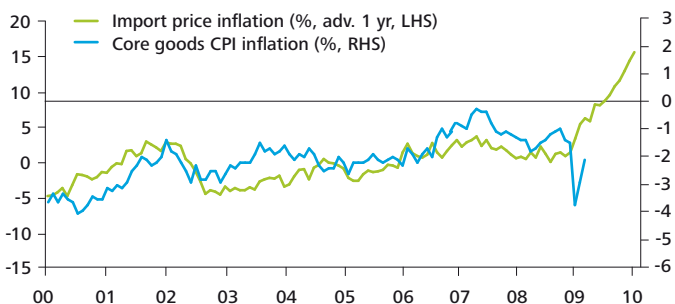
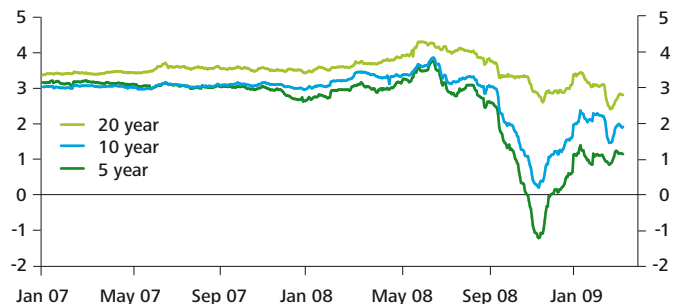


Chart 8. Bond market inflation expectations (%)



Source – Thomson Datastream

Analysis: Inflation

But deflation still the bigger danger

- In particular, the opening up of a very large amount of spare capacity in the economy is likely to put strong downward pressure on prices. As Chart 9 shows, despite suggestions that inflation is primarily determined by global factors, there is nonetheless still a fairly close relationship between the “output gap” and changes in core inflation.
- If we are right in expecting the output gap to expand to 5% of GDP or more (even allowing for some reduction in “trend” output) core consumer price inflation could obviously fall very sharply indeed.
- More specifically, there is already evidence that some companies are coming under intense pressure to absorb previous increases in costs into their profit margins. As Chart 10 shows, the CBI’s monthly measure of manufacturers’ price expectations has recently fallen sharply as demand and output in the sector have plummeted.
- Admittedly, Chart 11 shows that the equivalent measure of price expectations amongst retailers has held up rather more stubbornly, perhaps reflecting the surprising buoyancy of high street spending over the Christmas/New Year period. Nonetheless, recent indications of a renewed slump in spending suggest that retailers’ margins are also likely to come under stronger pressure.
- Meanwhile, inflation pressures in the labour market are fading fast in response to the surge in unemployment and drop in bonus payments in the financial sector.
- As Chart 12 shows, average earnings growth (including bonuses) has already turned negative and indicators of labour market slack point to further downward pressure on wages ahead. (See *Labour Market* section, pages 28 to 29.) Falling household inflation expectations should also make it easier for firms to cut pay. (See Chart 13.)
- Finally, we remain unconvinced that the commencement of quantitative easing will necessarily have much of an upward impact on inflation. Not only are there major uncertainties over the likely impact on bank lending – banks could simply “hoard” the increase in their reserves – but the relationship between bank lending and inflation is notoriously loose. (See Chart 14.)
- The upshot is that, while the outlook for inflation is perhaps particularly uncertain at the moment, our judgement is that the risks of a bout of deflation are greater than the danger of a serious upsurge in inflation.
- The stubbornness of food prices may have reduced the likelihood that CPI inflation will drop well below zero later this year, but there is still a chance that it turns briefly negative before the downward effects of energy prices start to fade again. (See Chart 15.)
- More significantly, though, we still see a real risk of a broader and potentially much more damaging bout of falling prices a bit further ahead in response to the fundamental weakness of demand and the creation of a large amount of spare capacity. (See Chart 16.)

Chart 9. Output gap & change in core CPI inflation

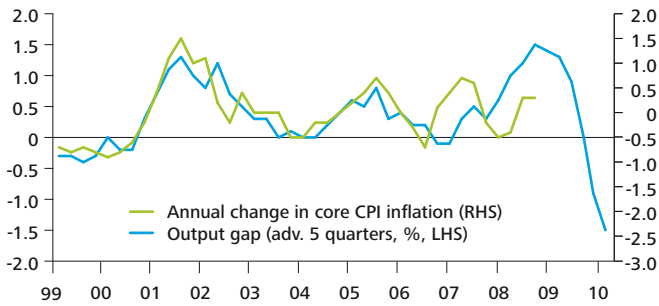


Chart 10. PPI inflation & manufacturers' price expectations

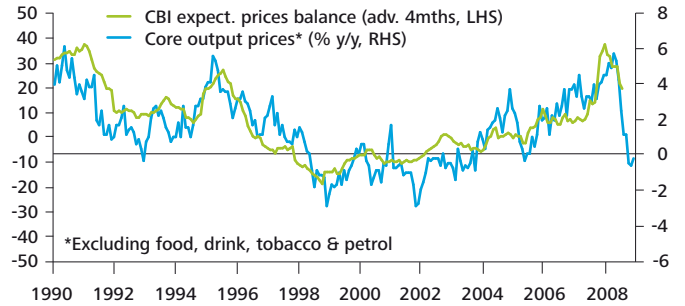


Chart 11. Core CPI goods inflation & retailers' expectations

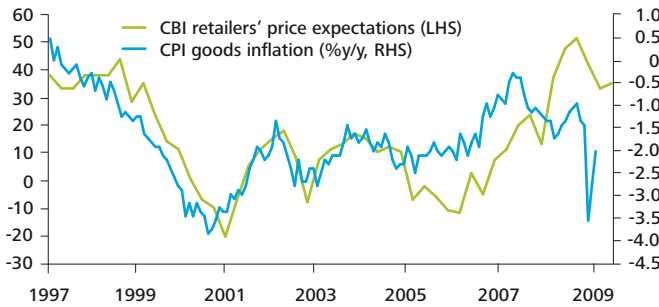


Chart 12. Average earnings (%/y)

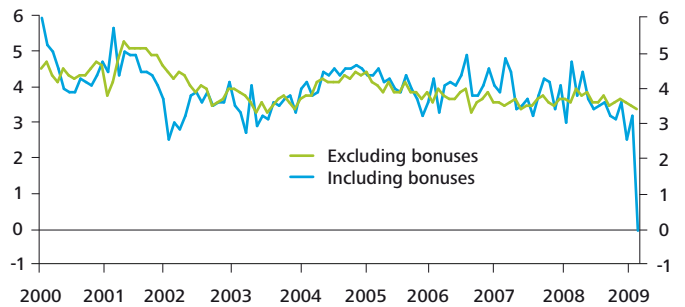


Chart 13. Household inflation expectations (%)

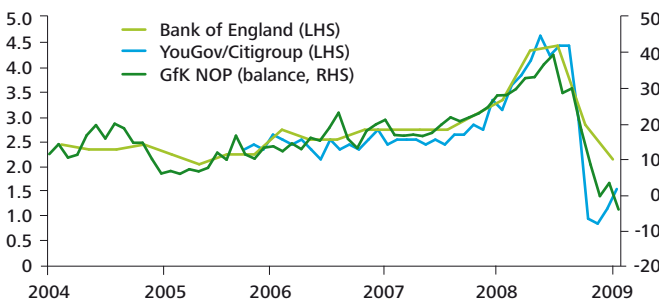


Chart 14. Bank lending & RPI inflation (%/y)

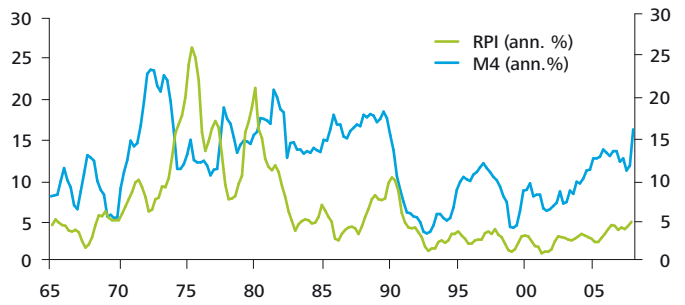


Chart 15. CPI & RPI inflation forecasts (%)

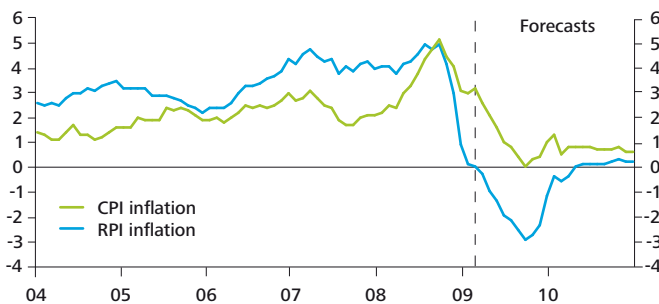
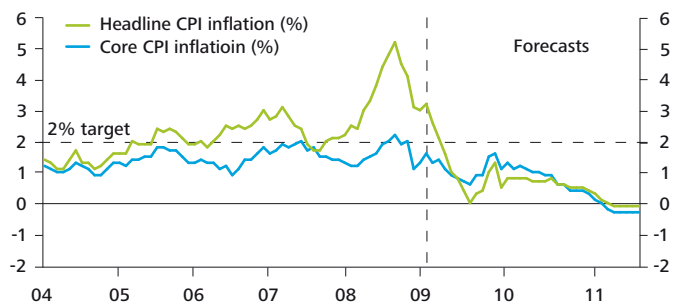


Chart 16. Headline & core CPI inflation forecasts (%)



Sources – Thomson Datastream, Bank of England

Analysis: Labour market

Slowing pay growth risks deflationary spiral

- The worst of the rise in unemployment is yet to come. And with pay growth already slowing, the labour market will be pivotal in determining whether the brief period of falling prices later this year turns into a more serious deflation problem.
- The ILO measure of unemployment (which includes all those looking for a job regardless of whether they claim benefit) recently surpassed 2 million, a 12 year high.
- Meanwhile, the number of people claiming unemployment benefit is close to 1.5m, from its trough of 0.8m. We had previously expected tighter rules about claiming benefits to restrain the growth of this measure. But it is in fact rising at an even sharper pace than in the past three recessions. (See Chart 1.) Perhaps the squeeze on finances is prompting some people to register to claim benefit who had previously not been bothered to do so.
- On both measures, the worst is yet to come. The lagging nature of the labour market means that it has yet fully to reflect the impact of the sharp contraction in the economy at the end of last year, let alone any further contraction this year or next. We continue to expect ILO unemployment to rise to 3.5m. (See Chart 2 & Forecast Table: Labour Market, page 37.)
- This peak may not be reached until the middle of 2011 at the earliest. Admittedly, consumer spending and the wider economy tend to recover well before unemployment has peaked. (See Chart 3.) But the rate of increase in unemployment has at least been slowing.
- The significant amount of slack opening up in the labour market will weigh heavily on pay growth. Annual average earnings growth plummeted in January to -0.2%.
- Admittedly, this was purely down to a negative contribution from bonuses. (See Chart 4.) Excluding bonuses, average earnings growth was in line with recent rates at 3.4%.
- However, the impact of lower bonuses cannot be dismissed out of hand – after all, they help to finance consumer spending. And in any case, regular pay growth should also slow sharply. (See Chart 5.) Many firms have already introduced pay freezes, while the median pay settlement in February dropped from 3.5% to 2.6%. (See Chart 6.)
- The public sector – which accounts for around a fifth of the workforce – is unlikely to see the pay freezes and cuts being implemented in the private sector. However, we still think that overall regular pay growth will slow to between 1% and 1.5% over the course of the coming 12 to 18 months.
- Together with the negative bonus effect, overall average earnings could therefore broadly stagnate. (See Chart 7.) It is not inconceivable that they fall outright.
- The combination of falling employment and slower average earnings growth will prompt households' earned income to fall sharply. (See Chart 8.) The bigger risk from the labour market, however, is that a deflationary cycle of falling prices and wages gets underway.

Chart 1. Claimant count (m/m, 000s)

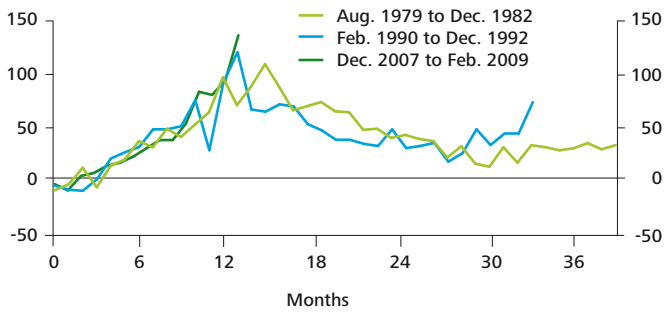


Chart 2. ILO unemployment

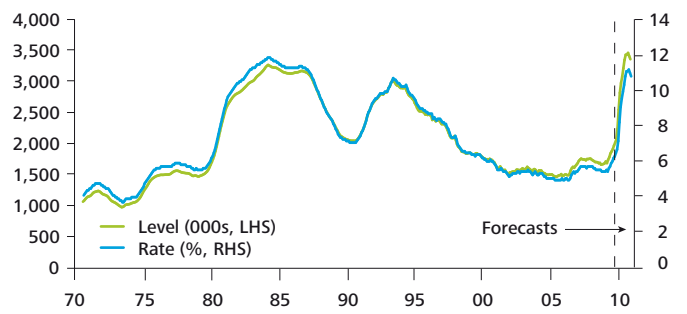


Chart 3. Real household spending & unemployment

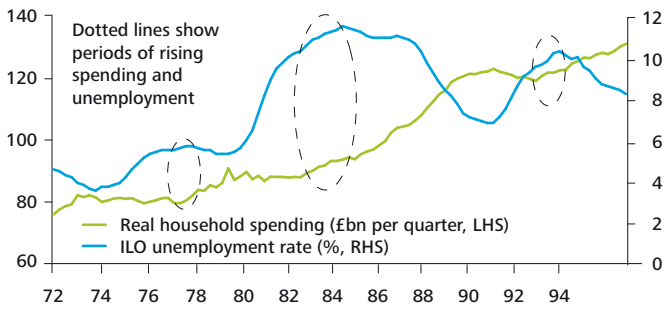


Chart 4. Bonus contribution to annual average earnings growth (%)

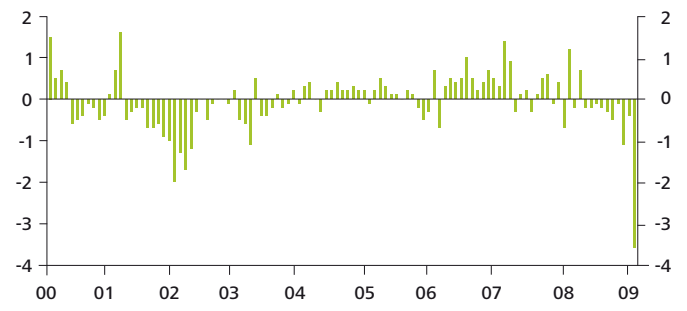


Chart 5. Average earnings & job vacancies

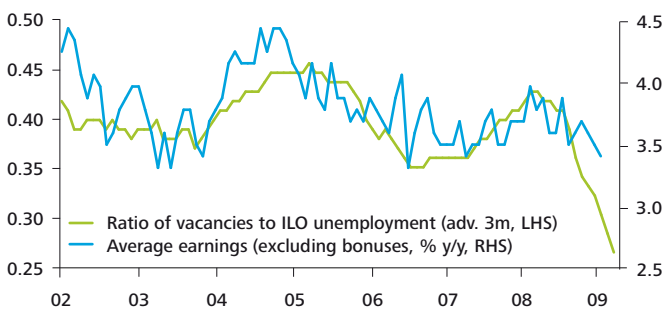


Chart 6. Median pay settlement (%)

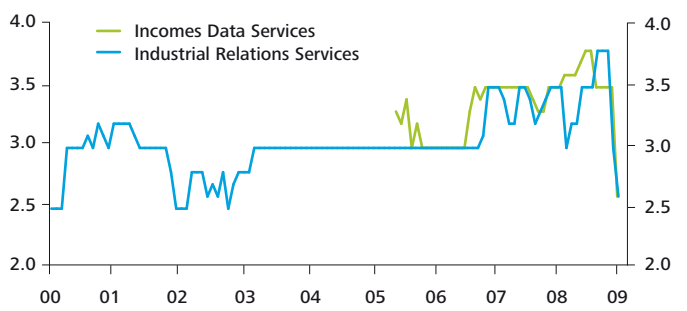


Chart 7. Average earnings (% y/y)

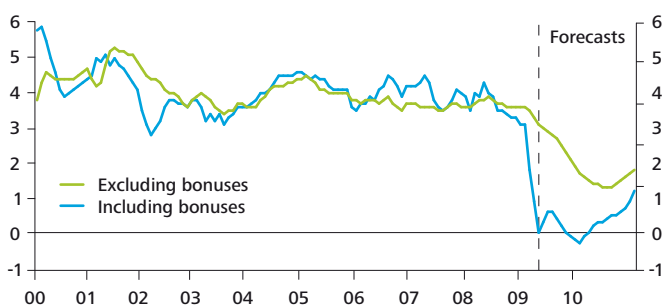
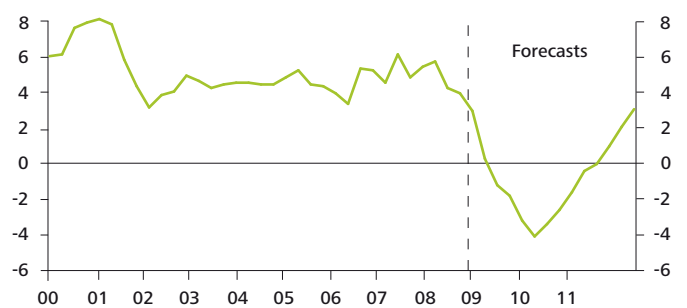


Chart 8. Household nominal earned income (% y/y)



Sources – Thomson Datastream, IRS, IDS

Analysis: Monetary policy

Unconventional measures underway

- UK monetary policy has entered the murky world of unconventional policy measures. However, the extreme uncertainty surrounding the potential effects of these measures suggests that policymakers may well fail to do enough to stave off the threat of persistent deflation.
- After cutting official interest rates all the way to a record low of 0.5%, the Monetary Policy Committee (MPC) has signalled that this is as far as rates will go. (See Chart 1.) After all, shorter-term interest rates, such as overnight rates, have generally been running below Bank Rate and so will probably be close to zero anyway. (See Chart 2.)
- Having reached the end of the road with rate cuts, the Committee has entered the uncharted territory of quantitative easing (QE) – policies aimed directly at increasing the quantity of money in the economy.
- Having asked the Chancellor for permission to buy £150bn of assets, financed by the creation of central bank money, the MPC has started by using £75bn of this money. The Committee is buying both gilts and private sector assets such as corporate bonds.
- The monetary base (M0) will broadly double. (See Chart 3.) But with bank losses still rising, this rise in commercial banks' reserves may fail to encourage them to lend more.
- Admittedly, overall bank lending growth remains strong. But this reflects banks lending to their off-balance sheet vehicles. Lending growth to households and non-financial corporates is still slowing. (See Chart 4.)
- And in any case, the link between bank lending and economic activity or inflation is variable. (See Chart 5.)
- Accordingly, the MPC has put the emphasis on the potential positive benefits of QE on asset prices, rather than increased bank lending. The idea is that the sellers of the assets (such as pension funds) will use their newly acquired cash to buy other assets, pushing up their prices and thus stimulating economic activity.
- QE has certainly succeeded in lowering gilt and corporate bond yields. (See Chart 6.) However, we have yet to see whether it has an impact on asset prices more generally. Meanwhile, the links between asset prices and economic activity are highly uncertain.
- Accordingly, the Committee might have to use the full £150bn of money sanctioned by the Chancellor for QE – or even ask for more. After all, its initial estimate that £75bn would be needed reflected the judgement that a "hole" in nominal GDP of 5% (about £75bn) needs to be filled. We think that the gap could end up at more like 10%.
- The upshot is that even the aggressive policy response seen so far may not be enough. Markets expect interest rates to start rising later this year, but we continue to expect rates to remain at record lows throughout this year and next. (See Chart 7.) With deflation also on its way, long bond yields are likely to fall even further. (See Chart 8 and Forecast Table: Monetary, page 38.)

Chart 1. Official interest rates (%)

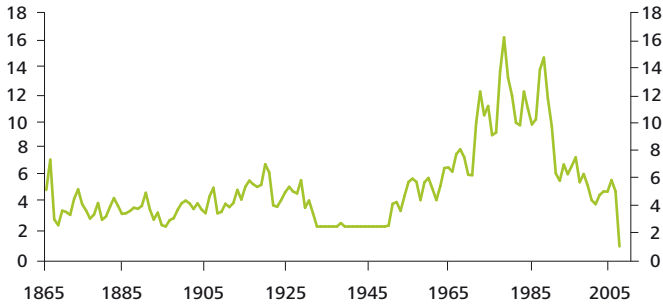


Chart 2. Official & overnight interest rates (%)

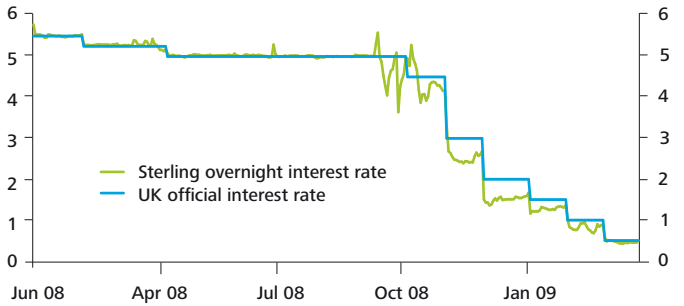


Chart 3. Monetary base (£bn)

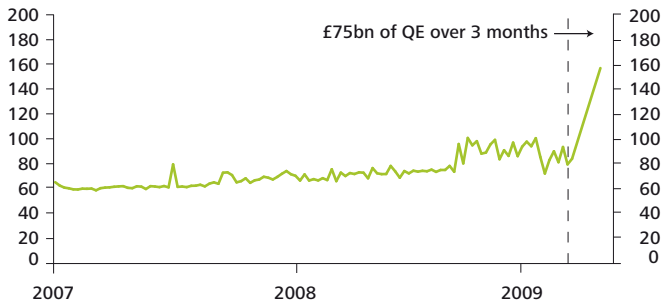


Chart 4. M4 lending (including securitised lending, % y/y)

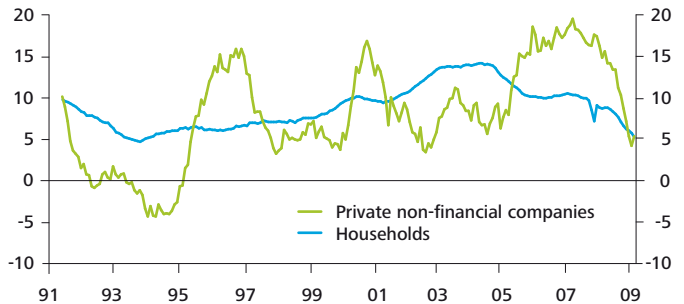


Chart 5. Lending & GDP (% y/y)

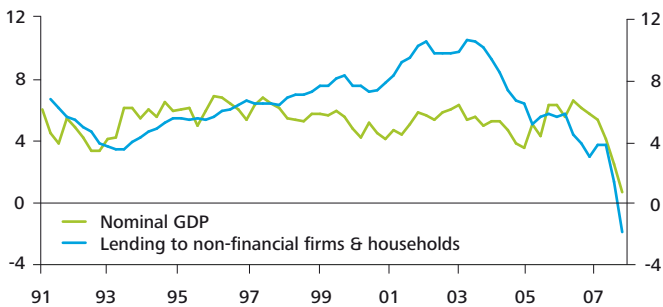


Chart 6. Corporate bond yields (%)

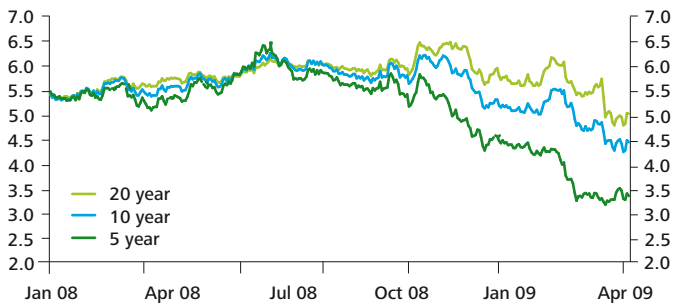


Chart 7. Interest rate expectations (%)

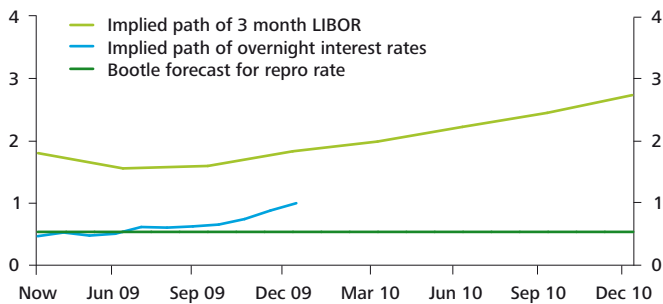
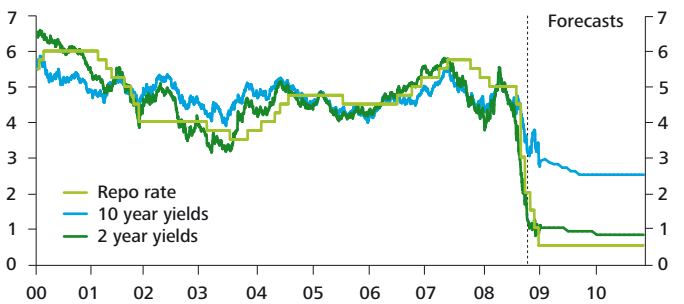


Chart 8. Official interest rates & bond yields (%)



Sources – Thomson Datastream, Bloomberg, Bank of England

Analysis: Public finances

Fiscal mess deepens

- The combined effects of the economic downturn and the potential costs of the various banking measures look set to push the public finances into their worst position since the early 1960s.
- The news on the fiscal position has continued to worsen dramatically. As Chart 1 shows, with just one month of the fiscal year left, it looks like public borrowing will come in at around £90bn in 2008-9. This would be more than £10bn higher than the Chancellor predicted back in the 2008 Pre-Budget Report and, at around 6% of GDP, the biggest UK budget deficit since 1994. (See Chart 2.)
- But things are set to get much worse. For a start, the full adverse effects on the public finances of the downturn in the economy have yet to come through. We expect nominal GDP to be some 10% lower than the Chancellor anticipated in his 2008 Pre-Budget Report by the end of 2010-11. (See Chart 3.) By the Treasury's own equations, this alone will push annual public borrowing up by over £100bn compared to the Chancellor's forecasts.
- These cyclical effects will be reversed when the economy eventually recovers. But there is a growing threat too of a *structural* deterioration in the public finances, reflecting permanently lower activity, income and profits in the financial and housing sectors. Finally, while pinning down the ultimate cost of the various measures to support the banking sector is a very uncertain process, we estimate that they could eventually cost something like £60bn. (See Table 1.)
- Overall, we now expect public borrowing to run at levels of £200bn p.a. or above for the next five years. (See Chart 4.) This will raise the level of public debt (excluding the nationalised banks) to close to £1.5trn or 100% of GDP, the highest since the post-war fiscal hangover in the 1960s. (See Chart 5.)
- This does not mean that the UK government is on the verge of bankruptcy. It has lived with even higher levels of debt for long periods in the past and, provided interest rates remain low, its interest bill will remain manageable. (See Chart 6.)
- Meanwhile, we doubt that the recent failed gilt auction signals a fundamental decline in the markets' appetite for UK sovereign debt, despite the prospective of huge amounts of gilt issuance over the coming years. (See Chart 7.)
- Nonetheless, the dreadful outlook for the public finances still has two serious consequences. First, it supports Bank of England Governor Mervyn King's recent suggestion that there is little room for a further significant loosening of fiscal policy to boost the UK economy.
- And second, the greater the deterioration in the public finances over the next few years, the larger and more painful the consolidation which will eventually be required to sort the fiscal mess out. (See Forecast Table: Public Finances, page 39.)

Chart 1. Public sector net borrowing (£bn, cumulative)

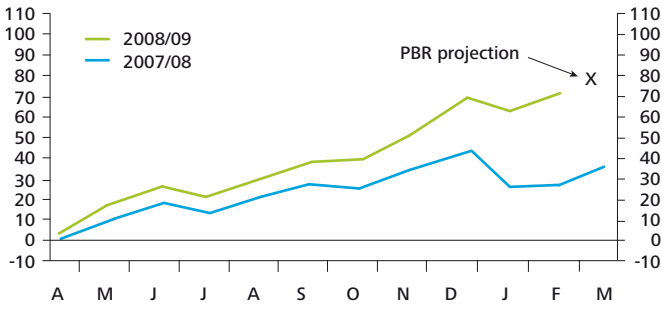


Chart 2. Public sector net borrowing (% of GDP)

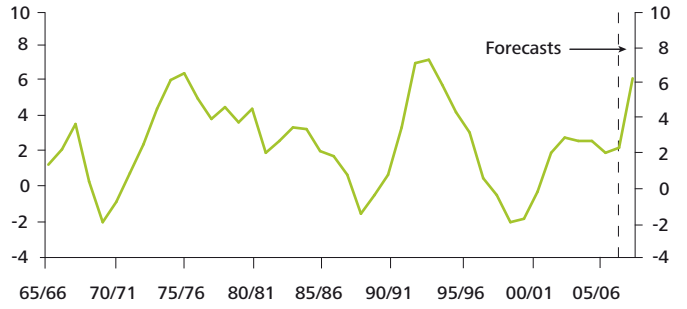


Chart 3. Real GDP forecasts (%/y)

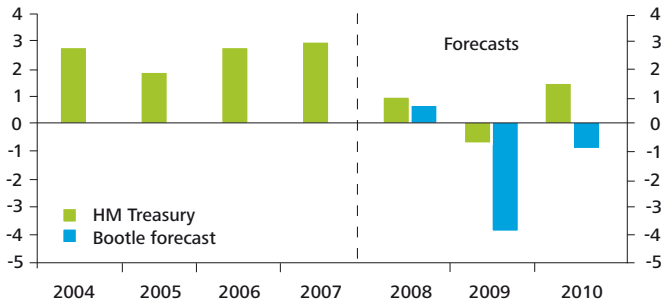


Table 1. Banking measures

Measures	Size £bn	Possible cost £bn
Liquidity measures/SLS	185	2
Bank recapitalisation	50	5
Guarantees	946	40
Asset purchase facility	150	15
Total	1,280	62

Chart 4. Public borrowing & debt

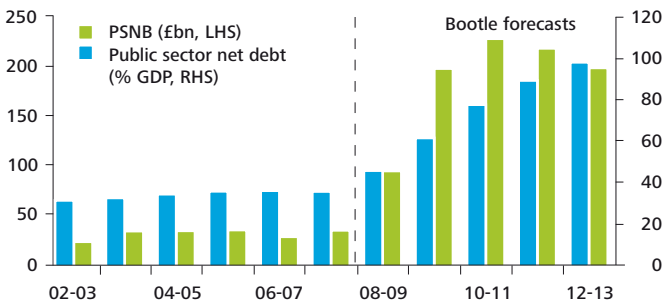


Chart 5. Public sector net debt (% of GDP)

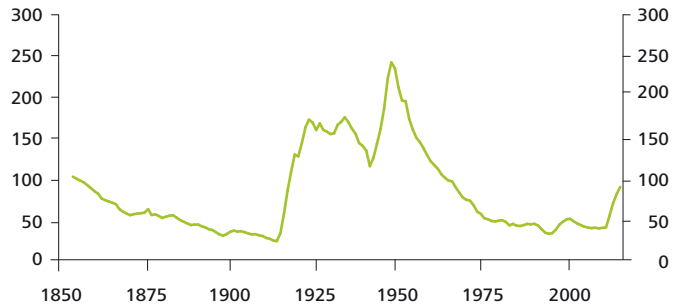


Chart 6. Public debt & interest payments (% of GDP)

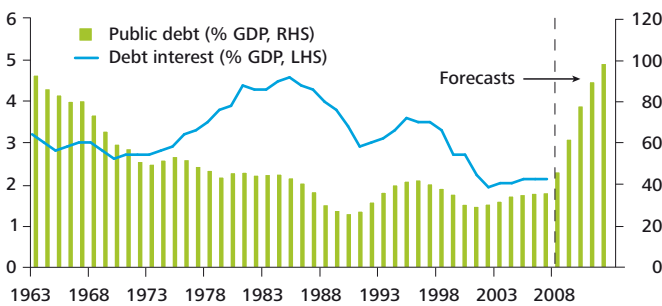
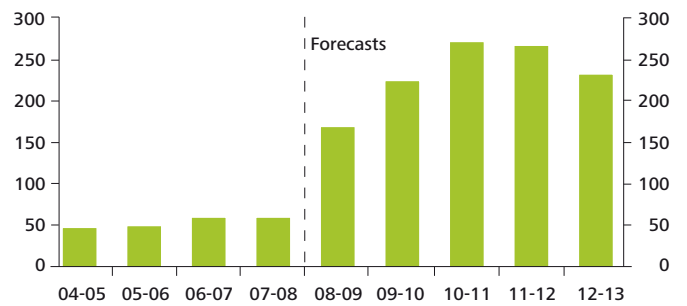


Chart 7. Gross gilt issuance (£bn)



Sources – Thomson Datastream, HM Treasury

Analysis: External sector

Trade to make positive contribution to GDP

- At present, the UK's external sector is suffering heavily from the worldwide collapse in trade flows. In time, however, the sector should make a significant positive contribution to GDP growth and prompt the current account deficit to narrow.
- The 30% or so depreciation of the pound witnessed since the autumn would normally boost export volumes considerably, whilst reducing the consumption of imports. In turn, this would narrow the current account deficit. (See Chart 1.) Indeed, previous UK recessions have also seen current account deficits narrow or close altogether as import volumes have fallen faster than exports. (See Chart 2.)
- Given this historical precedent, it is worrying how quickly exports have nosedived. Manufacturing export volumes, for example, were 20% lower in January than a year before. What's more, the more timely CBI measure of export orders has deteriorated further since then. (See Chart 3.)
- Falling export volumes may be partly explained by the fact that exporters have used the pound's fall to increase their margins, rather than to cut their prices. (See Chart 4.) But that doesn't explain why export *values* have fallen sharply too. The obvious explanation is the weakness of global demand.
- Import volumes have fallen at an even faster rate than exports. UK consumers might be responding to annual import price inflation of close to 15% by buying domestically produced goods instead. The key driver of weaker import growth, however, is probably more simply the weakness of domestic demand.
- Despite the drop in exports, net trade therefore made a positive contribution to quarterly GDP growth in the fourth quarter of around 0.6%. (See Chart 5.)
- Further ahead, the export sector is set to become the prime driver of overall economic growth as and when global demand recovers. After all, with UK households likely to take a number of years to pay down their debt, domestic demand for imports could remain subdued for several years to come. As a result, we expect the trade in goods and services deficit to narrow. (See Chart 6.)
- Meanwhile, investment income – the other major component of current account – looks set to contribute smaller surpluses than before. Recently, the UK has achieved massive surpluses, despite the value of foreign investments in the UK exceeding the value of the UK investments abroad. This is because UK investors tended to invest in riskier assets abroad than those who invested in the UK.
- Now that risky assets are generally yielding less income, net investment income has already deteriorated. (See Chart 7.) This may still have some way to go as the world heads into a collective recession. As a consequence, the annual current account balance is likely to be larger this year than last. (See Chart 8.)
- But investment income has little bearing on the real economic output. The more important message is that an early recovery in exports should make a positive contribution to economic growth, whilst also acting to reduce the current account balance. (See Forecast Table: External Sector, page 40.)

Chart 1. Sterling TWI and current account balance

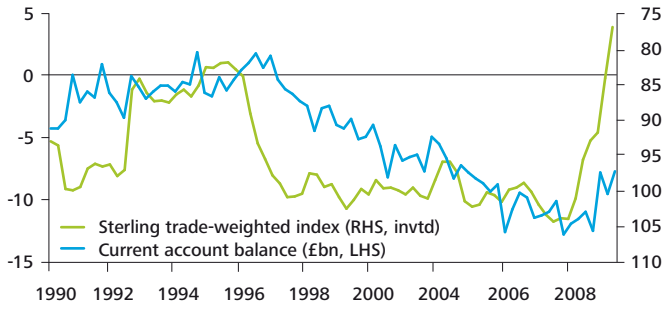


Chart 2. Current account (% of GDP)

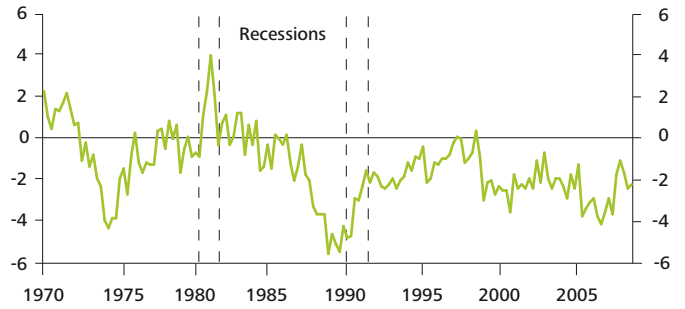


Chart 3. Manuf. exports & CBI export orders balance



Chart 4. Sterling & export prices

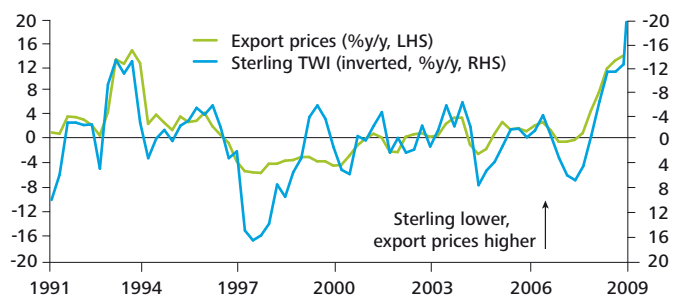


Chart 5. Contributions to quarterly GDP growth (%)

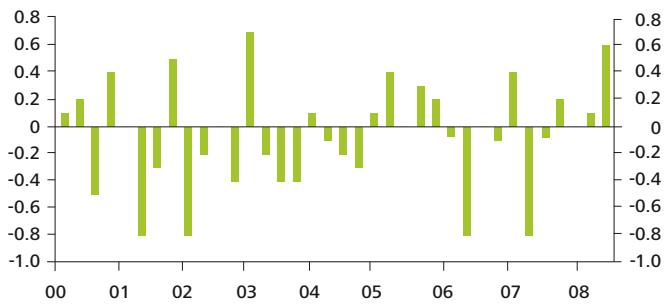


Chart 6. Trade in goods & services (% of GDP)

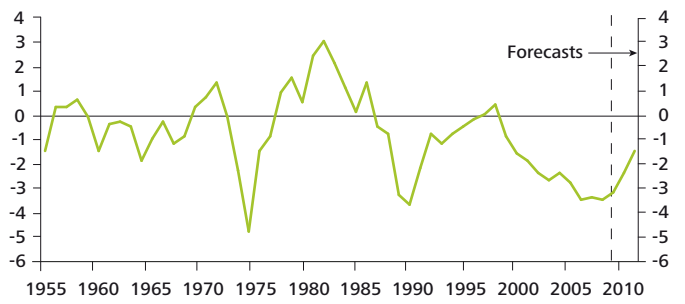


Chart 7. UK investment income & net inv. position (% GDP)

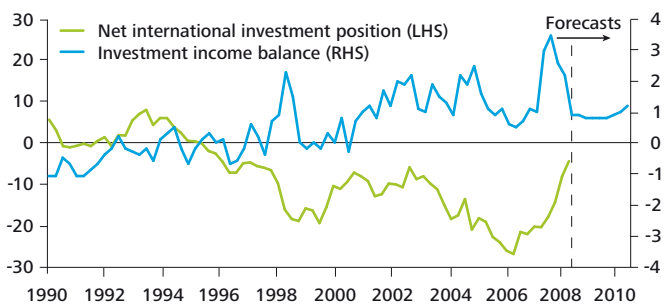
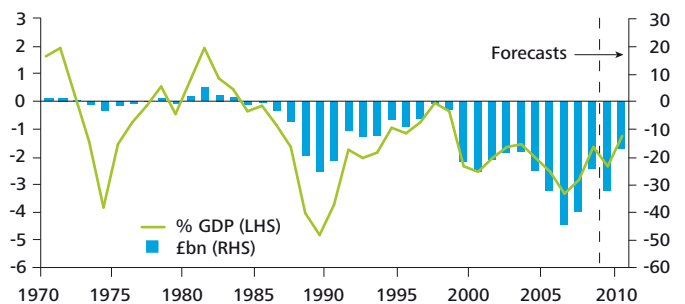


Chart 8. Current account balance



Source – Thomson Datastream

Forecast table: Inflation

	Monthly Effect on Index							Annual Rate				
	Other Items						Level of the CPI Index	All CPI	CPI Core ²	RPI ³	RPIX	
	s.a. Core	Rent	Alc & Tobac.	Energy	Seas Food ¹	Seas Eff.						Total Change
2008												
Jan	-0.3			0.1		-0.6	-0.7	105.5	2.2	1.3	4.1	3.4
Feb	0.2			0.4		0.1	0.8	106.3	2.5	1.2	4.1	3.7
Mar	-0.1			0.1		0.3	0.4	106.7	2.4	1.2	3.8	3.5
Apr	0.3			0.2	0.1	0.1	0.8	107.6	3.0	1.4	4.2	4.0
May	0.2			0.2	0.2	0.2	0.7	108.3	3.3	1.5	4.3	4.4
Jun	0.3			0.2		0.0	0.6	109.0	3.8	1.6	4.6	4.8
Jul	0.1			0.1	0.1	-0.2		109.0	4.4	1.9	5.0	5.3
Aug	0.1			0.1		0.3	0.6	109.7	4.8	2.0	4.8	5.2
Sep	-0.1			0.5	0.0	0.1	0.5	110.3	5.2	2.2	5.0	5.5
Oct	-0.3			-0.2	0.0	0.0	-0.3	110.0	4.5	1.9	4.2	4.7
Nov	0.0			-0.3	0.2	0.0	-0.1	109.9	4.1	2.0	3.0	3.9
Dec				-0.2	-0.1	0.2	-0.1	109.8	3.4	1.7	1.8	3.2
2009												
Jan	-0.3			-0.2		-0.6	-0.9	108.8	3.1	1.7	1.0	2.9
Feb	-0.2			-0.2	-0.1	0.1	-0.3	108.5	2.0	1.3	0.1	1.9
Mar						0.2	0.1	108.6	1.8	1.3	-0.4	1.6
Apr	0.3					0.1	0.5	109.1	1.4	1.3	-0.7	1.2
May					-0.1	0.1	0.1	109.2	0.8	1.1	-1.4	0.6
Jun	0.1							109.2	0.2	0.8	-2.0	0.0
Jul					-0.1	-0.2	-0.3	108.9	-0.1	0.6	-2.3	-0.3
Aug						0.2	0.2	109.1	-0.6	0.5	-2.7	-0.8
Sep					-0.1	0.1	0.1	109.1	-1.0	0.4	-3.2	-1.3
Oct							0.1	109.2	-0.7	0.6	-3.0	-1.0
Nov	0.2						0.1	109.3	-0.5	0.7	-2.6	-0.9
Dec	0.3					0.2	0.4	109.8	0.0	1.0	-1.6	-0.4
2010												
Jan	0.1					-0.6	-0.4	109.3	0.5	1.3	-0.5	0.1
Feb	-0.1					0.1	0.1	109.4	0.8	1.4	-0.1	0.4
Mar	-0.1					0.2	0.1	109.5	0.9	1.4	0.3	0.4
Apr						0.1	0.3	109.9	0.7	1.1	0.2	0.3
May						0.2	0.2	110.1	0.8	1.2	0.7	0.5
Jun								110.1	0.8	1.1	0.8	0.5
Jul						-0.3	-0.2	109.9	0.9	1.1	0.9	0.6
Aug						0.2	0.3	110.2	1.0	1.1	1.0	0.8
Sep						0.1	0.1	110.3	1.1	1.1	1.1	0.9
Oct	-0.1						0.1	110.4	1.1	1.1	1.2	0.9
Nov	-0.1						-0.1	110.3	0.9	0.9	1.1	0.8
Dec	-0.1					0.2	0.1	110.4	0.6	0.6	0.8	0.6

1 Fresh fruit and vegetables, fresh fish, eggs and home-killed lamb.

2 Excludes energy, food, alcohol & tobacco.

3 Assumes repo rate falls to 0% by end Q1 2009, remains at the level throughout 2010.

Forecast table: Labour market

Activity								
	Workforce		ILO/Labour Force Survey Employment		ILO Unemployment		Claimant Count Unemployment	
	Millions	%y/y	Millions	%y/y	Millions	%	Millions	%
2007	30.9	0.6	29.2	0.6	1.7	5.4	0.86	2.7
2008f	31.2	1.1	29.5	0.9	1.7	5.6	0.90	2.8
2009f	31.3	0.1	28.6	-2.7	2.6	8.4	1.89	5.8
2010f	31.1	-0.4	27.9	-2.7	3.3	10.5	2.45	7.5
Q1 2008	31.1	1.1	29.5	1.4	1.6	5.2	0.80	2.4
Q2	31.2	1.2	29.5	1.3	1.7	5.3	0.83	2.5
Q3	31.2	1.1	29.4	0.7	1.8	5.7	0.91	2.8
Q4	31.3	1.0	29.4	0.1	1.9	6.1	1.08	3.3
Q1 2009	31.3	0.7	29.1	-1.3	2.2	7.0	1.42	4.3
Q2	31.3	0.4	28.8	-2.5	2.5	8.1	1.80	5.5
Q3	31.2	0.0	28.4	-3.3	2.8	9.0	2.09	6.4
Q4	31.2	-0.5	28.2	-3.9	3.0	9.5	2.25	6.9
Q1 2010	31.1	-0.2	28.0	-3.7	3.1	9.9	2.32	7.1
Q2	31.1	0.0	27.9	-3.1	3.2	10.3	2.42	7.4
Q3	31.1	0.1	27.8	-2.3	3.4	10.8	2.51	7.7
Q4	31.2	0.1	27.7	-1.7	3.4	11.1	2.57	7.9

Earnings & costs							
	Average earnings		Real av. earnings (Incl. bonuses, %y/y)		Productivity	Unit labour costs	
	Incl. bonuses	Excl. bonuses	Deflated by RPI	Deflated by CPI			
	%y/y	%y/y	inflation	inflation			
2007	3.9	3.6	-0.4	1.5	2.3	1.8	
2008f	3.6	3.7	-0.4	0.0	-0.1	2.7	
2009f	0.1	2.5	1.6	-1.3	-1.4	4.1	
2010f	0.6	1.5	0.6	-0.2	1.7	0.5	
Q1 2008	4.3	3.8	0.3	2.0	1.0	1.5	
Q2	3.5	3.7	-0.8	0.2	0.7	2.4	
Q3	3.3	3.6	-1.7	-1.5	-0.2	2.5	
Q4	3.1	3.6	0.4	-0.8	-1.9	4.5	
Q1 2009	0.0	3.1	0.1	-2.9	-2.4	5.9	
Q2	0.6	2.8	2.0	-1.0	-2.2	5.0	
Q3	0.0	2.3	2.6	-0.4	-1.1	3.7	
Q4	-0.3	1.7	1.8	-0.8	0.8	1.7	
Q1 2010	0.2	1.4	0.7	-0.6	1.9	0.4	
Q2	0.4	1.3	0.3	-0.4	2.1	0.2	
Q3	0.6	1.5	0.5	-0.1	1.7	0.5	
Q4	1.2	1.8	1.0	0.5	1.3	0.9	

Forecast table: Monetary

Interest rates & bond yields (end period)							
	Repo rate %	10-year gilts %	20-year gilts %	US Fed Funds rate		Euro-zone %	Refi rate UK-Euro-zone
				%	UK-US		
2007	5.5	4.5	4.5	4.25	1.3	4.0	1.5
2008	2.0	3.1	4.0	0.13	1.9	2.5	-0.5
2009f	0.5	2.5	3.3	0.13	0.4	0.5	0.0
2010f	0.5	2.5	3.2	0.13	0.4	0.5	0.0
Q1 2008	5.25	4.3	4.6	3.0	2.3	4.0	1.3
Q2	5.0	5.1	5.1	2.0	3.0	4.0	1.0
Q3	5.0	4.4	4.7	2.0	3.0	4.25	0.8
Q4	2.0	3.1	4.0	0.13	1.9	2.5	-0.5
Q1 2009	0.5	2.8	3.6	0.13	0.4	1.5	-1.0
Q2	0.5	2.7	3.5	0.13	0.4	0.75	-0.3
Q3	0.5	2.5	3.4	0.13	0.4	0.5	0.0
Q4	0.5	2.5	3.3	0.13	0.4	0.5	0.0
Q1 2010	0.5	2.5	3.2	0.13	0.4	0.5	0.0
Q2	0.5	2.5	3.2	0.13	0.4	0.5	0.0
Q3	0.5	2.5	3.2	0.13	0.4	0.5	0.0
Q4	0.5	2.5	3.2	0.13	0.4	0.5	0.0

Sterling exchange rates (end period)					
Sterling versus...	\$	¥	Euro	Euro ¹	ERI ²
2007	1.99	228	0.73	1.36	97.9
2008	1.46	132	0.97	1.03	73.8
2009f	1.40	126	0.79	1.27	83.1
2010f	1.40	126	0.79	1.27	82.8
Q1 2008	1.98	200	0.80	1.25	92.6
Q2	1.99	212	0.79	1.26	93.2
Q3	1.78	187	0.79	1.27	90.4
Q4	1.46	132	0.97	1.03	73.8
Q1 2009	1.45	138	0.86	1.16	79.3
Q2	1.45	131	0.83	1.21	81.3
Q3	1.40	126	0.79	1.27	83.1
Q4	1.40	126	0.79	1.27	83.1
Q1 2010	1.40	126	0.79	1.27	82.8
Q2	1.40	126	0.79	1.27	82.8
Q3	1.40	126	0.79	1.27	82.8
Q4	1.40	126	0.79	1.27	82.8

1 Pound per euro. 2 Effective exchange rate index.

Forecast table: Public finances¹

Government spending & receipts (£bn)							
	(1) Current receipts (excluding tax changes)	(2) Revenue effect of tax changes	(3) Current receipts (excluding tax changes)	(4) Current spending ²	(5) Current balance	(6) Net investment	(7) = (5) + (6) Total expenditure
Recent history							
04-05	453	n/a	453	472	-19	20	492
05-06	487	n/a	487	501	-14	23	524
06-07	520	n/a	520	524	-4	26	550
07-08	548	n/a	548	554	-7	30	584
HM Treasury forecast							
08-09	546	n/a	546	587	-41	37	623
09-10	535	n/a	535	614	-79	40	654
10-11	576	n/a	576	649	9	33	682
11-12	621	n/a	621	675	-54	33	708
12-13	664	n/a	664	702	-38	33	735
Bootle forecast							
08-09	539	0	529	587	-57	39	626
09-10	504	0	484	614	-130	40	654
10-11	510	10	476	652	-177	33	685
11-12	532	30	519	686	-167	33	719
12-13	561	50	569	716	-147	33	749

Government borrowing & debt						
	PSNB		Public sector net cash requirement (PSNCR) £bn	General government gross debt % GDP ³	Public sector net debt & GDP	Gross gilt sales £bn
	£bn	% GDP				
Recent history						
04-05	36.0	3.0	30.8	42.7	35.0	50.1
05-06	36.8	3.0	33.4	43.7	36.4	52.3
06-07	30.0	2.3	35.4	43.3	36.7	62.5
07-08	36.5	2.6	36.5	43.2	36.3	58.4
HM Treasury forecast						
08-09	78	5.3	78	52.9	41.2	146
09-10	119	7.7	119	60.5	48.2	148
10-11	106	6.5	106	65.1	52.9	-
11-12	87	5.1	87	67.5	55.6	-
12-13	71	3.9	71	68.6	57.1	-
Bootle forecast						
08-09	96	6.7	98	58.1	46.4	146
09-10	200	14.2	202	74.5	62.2	200
10-11	230	16.3	232	90.5	78.3	250
11-12	220	14.9	222	101.9	90.0	250
12-13	200	12.9	202	110.3	98.8	230

¹ Some figures in this table may not add due to rounding. ² Includes depreciation. ³ Maastricht definition.

Forecast table: External sector

Current account											
	Goods		Services		Investment income		Current transfers		Current account		
	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP	
2007	-89.8	-6.4	42.6	3.0	20.6	1.5	-13.6	-1.0	-40.2	-2.9	
2008f	-92.9	-6.4	48.8	3.4	33.1	2.3	-13.6	-0.9	-24.6	-1.7	
2009f	-84.8	-6.1	53.2	3.9	11.2	0.8	-12.0	-0.9	-32.4	-2.4	
2010f	-74.3	-5.7	56.0	4.3	13.0	1.0	-12.0	-0.9	-17.4	-1.3	
Q1 2008	-23.2	-6.4	11.4	3.1	12.6	3.5	-4.1	-1.1	-3.4	-0.9	
Q2	-23.3	-6.4	12.0	3.3	9.4	2.6	-3.5	-1.0	-5.4	-1.5	
Q3	-23.6	-6.5	10.7	3.0	8.1	2.2	-3.3	-0.9	-8.2	-2.3	
Q4	-22.7	-6.4	14.7	4.1	3.1	0.9	-2.7	-0.8	-7.6	-2.1	
Q1 2009	-22.6	-6.4	12.8	3.6	3.0	0.9	-3.0	-0.9	-9.7	-2.8	
Q2	-21.4	-6.2	13.5	3.9	2.8	0.8	-3.0	-0.9	-8.1	-2.3	
Q3	-20.7	-6.0	13.5	3.9	2.6	0.8	-3.0	-0.9	-7.6	-2.2	
Q4	-20.1	-6.0	13.4	4.0	2.7	0.8	-3.0	-0.9	-7.0	-2.1	
Q1 2010	-19.3	-5.8	13.3	4.0	2.8	0.8	-3.0	-0.9	-6.2	-1.9	
Q2	-18.9	-5.8	13.7	4.2	3.0	0.9	-3.0	-0.9	-5.2	-1.6	
Q3	-18.4	-5.7	14.3	4.4	3.3	1.0	-3.0	-0.9	-3.8	-1.2	
Q4	-17.7	-5.6	14.7	4.6	3.8	1.2	-3.0	-0.9	-2.2	-0.7	

Exports, imports & prices (£bn)								
	Goods		Services		Goods & services		Prices ¹	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports %y/y	Imports %y/y
2007	220.9	310.6	149.4	106.7	370.2	417.3	1.1	1.4
2008f	251.1	344.0	165.9	117.1	417.0	461.1	11.2	9.7
2009f	210.2	295.0	160.7	107.5	370.9	402.4	10.2	9.1
2010f	206.0	280.2	161.4	105.4	367.3	385.6	4.7	3.8
Q1 2008	60.7	83.9	40.5	29.1	101.2	113.0	7.3	5.9
Q2	64.2	87.5	40.9	28.9	105.1	116.4	11.3	8.3
Q3	65.6	89.2	40.3	29.6	105.9	118.8	12.6	10.5
Q4	60.6	83.3	44.3	29.5	104.8	112.8	13.5	14.1
Q1 2009	55.4	78.0	41.3	28.5	96.7	106.5	12.7	11.9
Q2	53.0	74.4	40.5	27.0	93.5	101.4	10.9	10.1
Q3	51.1	71.8	39.7	26.2	90.8	98.0	9.8	8.5
Q4	50.6	70.7	39.2	25.8	89.8	96.5	7.2	6.2
Q1 2010	50.8	70.0	39.2	25.9	90.0	95.9	7.1	6.3
Q2	51.1	70.0	39.9	26.2	91.0	96.2	5.0	4.4
Q3	51.7	70.0	40.8	26.5	92.4	96.5	4.5	3.5
Q4	52.4	70.1	41.5	26.8	93.9	96.9	2.1	1.0

¹ Excludes prices of oil and other erratic items.

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