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Economic Review
A bumpy road to recovery

First Quarter 2011

Foreword
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In this Review, Roger Bootle, Economic Adviser to Deloitte, turns his attention to how the economic recovery will fare during the new year. While he thinks that the road to health will be a bumpy one, he is optimistic that stronger and better-balanced growth will result eventually.

Roger thinks that the recovery will struggle to maintain its recent momentum in the coming months. In particular, he doubts that the private sector is in a fit enough state to compensate fully for the fiscal squeeze that is set to get well underway this year. He expects GDP growth of just 1.5% in both 2011 and 2012.

But the recovery in some parts of the economy will keep getting stronger. Roger thinks that business investment is the area likely to see the strongest growth over the next couple of years, partly because firms will invest in new capacity in order to exploit the opportunities created by the drop in the pound.

What's more, further ahead the economy will have the scope for a period of faster growth to use up the reserves of unused capacity. And Roger thinks that the current period of deleveraging and belt-tightening will ultimately pave the way for healthier and more sustainable growth than that seen over the past decade.

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

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Executive summary
Roger Bootle

Roger Bootle
Economic Adviser to Deloitte

- **We doubt that the economic recovery is on the secure footing required for it to maintain its recent pace. It could take until well into 2013 for the economy even to get back to its pre-recession levels of activity.**

- On the face of it, the UK appears to be getting quickly back onto its feet. **However, a look at what has driven this strength creates some cause for concern.** The recent surge in construction output looks unlikely to last. And the positive contribution from government spending will of course fade.

- **Admittedly, the fiscal tightening will be spread over several years. And many of the major welfare cuts do not come in until 2013.**

- **But the squeeze will still get well underway in 2011.** Departmental spending is set to fall by over 4% in real terms in 2011/12 – and the Government seems to have no plans, for now at least, to scale back the cuts. Public sector employment is *already* falling. And VAT and national insurance contributions will soon rise.

- Given all this, the recovery's prospects clearly hinge on the *private* sector's ability to continue to pick up steam. **Perhaps the first hope is that the direct adverse effects of the fiscal squeeze on the private sector are offset by support from other sources.** Private sector employment, for example, has risen strongly in the past few months.

- But we doubt that this will last when firms still have scope to raise productivity significantly and parts of the private sector are vulnerable to cuts in government procurement spending.

- Meanwhile, high inflation will further squeeze households' real incomes – which we expect to fall by over 1% next year.

- **At least there are now tentative signs of a re-balancing towards the external sector.** And the recoveries in the US and Germany are progressing well. But against that, the euro-zone's peripheral economies – the destination of about 15% of UK exports – will continue to struggle.

- And although business investment could grow quite strongly in 2011, it is simply not a big enough part of the economy to have a significant effect on overall GDP growth.

- **The overall economic recovery might manage to keep up its momentum for a little while longer** – especially if consumers take time to adjust their spending in response to the tax rises. However, we expect growth then to slow to pretty sluggish rates. **We expect GDP growth of just 1.5% in both 2011 and 2012.**

- **But at least the UK has turned a corner.** And, although a difficult couple of years lie ahead, growth should eventually accelerate. **It will also be more soundly-based than the growth seen over the past decade or so.**

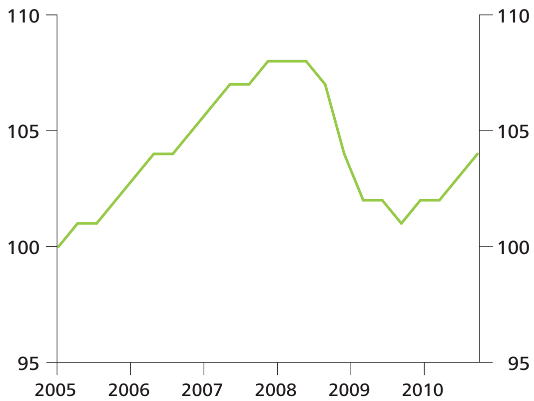
- **Moreover, the prolonged fiscal tightening means that monetary policy can remain extraordinarily loose to compensate. We do not expect interest rates to rise until 2013 at the earliest.**

A bumpy road to recovery
The prospects for the economy in 2011

It has now been just over a year since the UK economy emerged from recession and so far, so good. Even though it was the deepest recession in decades – and a recession driven by a banking crisis at that – the UK appears to be quickly getting back onto its feet. GDP growth is back above its long-run average or trend rate and about 40% of the output lost during the recession has been regained. (See Chart 1.)

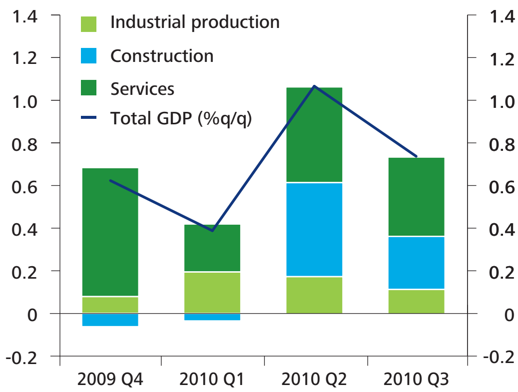
Do the recent sources of strength look sustainable?
Unfortunately, a look at the recovery from the output side of the economy is not particularly reassuring. Chart 2 illustrates how it has been disproportionately dependent on one small part of the economy – the construction sector. Construction accounted for over a third of GDP growth in Q2 and Q3, despite making up just 6% of overall GDP.

Chart 1. Real GDP (Level, 2005 = 100)



Source – Thomson Datastream

Chart 2. Contributions to quarterly GDP growth (% points)



Sources – Thomson Datastream, Bootle

But, of course, the true test of the recovery is yet to come – namely the looming fiscal squeeze required to repair the damage done to the public finances by the downturn and the measures put in place in response. Indeed, in a sense, the current uncertainty about the economic outlook is even greater than a year ago. In this *Quarterly Review*, we take a closer look at whether the recovery has the potential to maintain momentum over the next year or two. **Is a sustainable recovery now underway? Or will the pick-up seen during 2010 turn out to be something of a false dawn?**

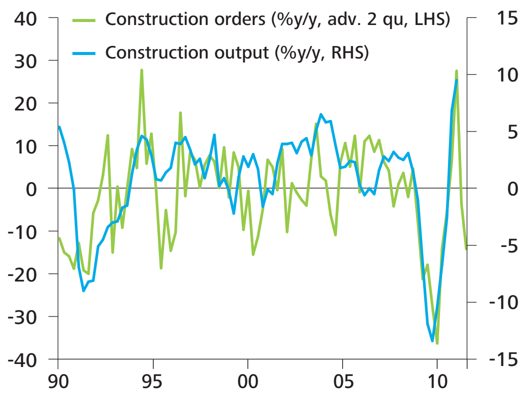
What's driving the recovery?
Perhaps the best place to start is with a look at what has been driving the recovery so far.

Indeed, the surge in construction output has been so strong that some have questioned the accuracy of the figures – suggesting that GDP growth might not have been as strong as the published figures suggest.

And even if the figures are correct in showing a sharp rise in construction output, the sector is unlikely to support this recovery for much longer.
For a start, output in the sector has already almost returned to its pre-recession peak, suggesting that the "bounce-back" effect is pretty much exhausted. Output fell by 14% during the recession, but has now recovered by 11%. What's more, public sector works account for about a third of construction output – and investment is the part of government spending set to be slashed the most.

Indeed, the sharp drop in new construction orders in the past two quarters suggests that construction output will soon be falling again on an annual basis. (See Chart 3.)

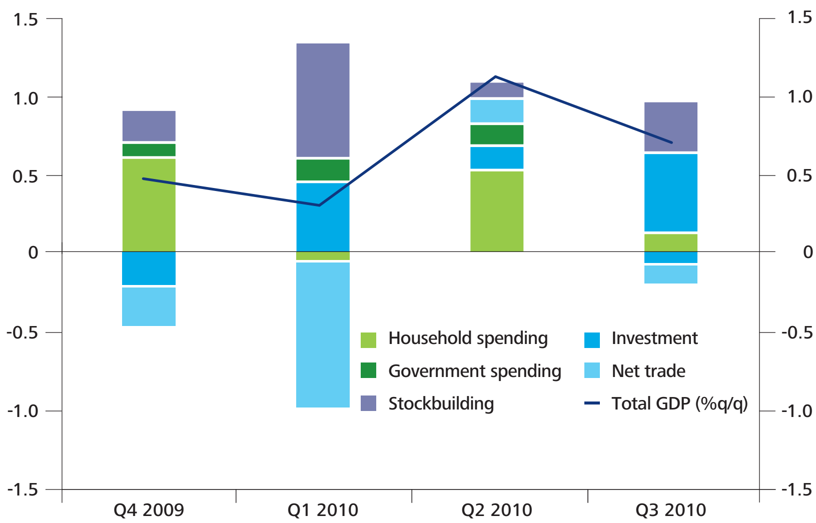
Chart 3. Construction output & orders



Sources – Thomson Datastream, Office for National Statistics

At least a look at GDP from the alternative spending breakdown is a bit more encouraging, suggesting that the recovery is based on more than just temporary sources of growth. The recovery maintained momentum in Q3, even though government spending fell by 0.4%. What's more, investment posted a robust 3.4% increase, driven by a strong rise in business investment. (See Chart 4.)

Chart 4. Contributions to quarterly GDP growth (% points)



Sources – Thomson Datastream, Bootle

But only so much comfort can be taken from this. After all, the drag from government spending could yet get even bigger as the fiscal squeeze intensifies. And stockbuilding is still playing a role in the recovery, accounting for 0.3% of the 0.7% quarterly rise in GDP in Q3. This support is unlikely to last. Accordingly, it won't just be enough for the other parts of the economy to maintain their recent performance (which, in any case, is far from guaranteed) – they will need to step up another gear.

When will the fiscal squeeze really start?

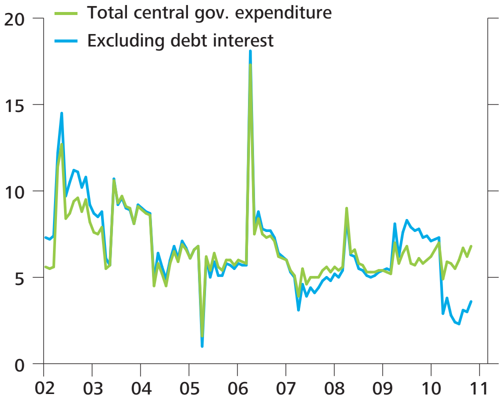
Admittedly, this is all based on the assumption that the looming fiscal squeeze will kick in soon. But just how looming is looming? **Does the recovery actually have a bit more breathing space to develop yet?**

After all, central government spending is still rising at a rapid annual rate of almost 7%. Remember, too, that the Government's fiscal mandate is to get the public finances back in order over a five year period. And many of the policy changes announced so far do not actually come into effect for up to several years, particularly those relating to cuts in the welfare bill. As an example, one of the biggest changes – a cut in child benefit for higher earners – does not take effect until 2013. Indeed, the social security bill is projected to keep rising, even in real terms, until 2012/13.

But while it is fair to say that the fiscal squeeze will be spread out over a number of years, it nonetheless looks likely to get well underway in 2011. For a start, it is worth noting that government spending growth has recently been boosted by a rise in debt payments compared to a year ago (when negative rates of RPI inflation pulled payments on index-linked debt *down* sharply).

Excluding debt payments, spending growth has already slowed sharply, from annual rates of over 7% at the start of 2010 to about half that now. (See Chart 5.)

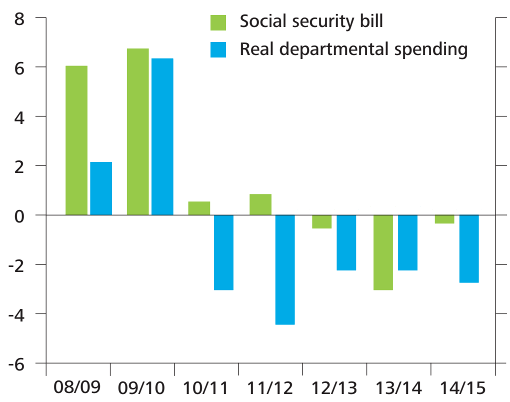
Chart 5. Central gov. spending (cumulative so far during fiscal year, %y/y)



Sources – HM Treasury, Thomson Datastream

Meanwhile, even though the welfare bill will take time to fall, departmental spending (which is roughly twice the size of spending on social security) is certainly due to start falling sharply in 2011. In fact, 2011/12 is, according to the Government's plans, due to be the year of the heaviest falls. (See Chart 6.)

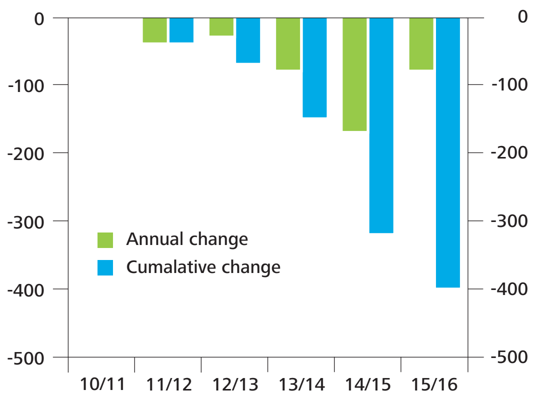
Chart 6. Real Government spending (%y/y)



Source – HM Treasury

Admittedly, despite this, the Office for Budget Responsibility (OBR) expects the job cuts in the public sector to be significantly back-loaded, with the biggest cuts not coming until 2014/15. (See Chart 7.)

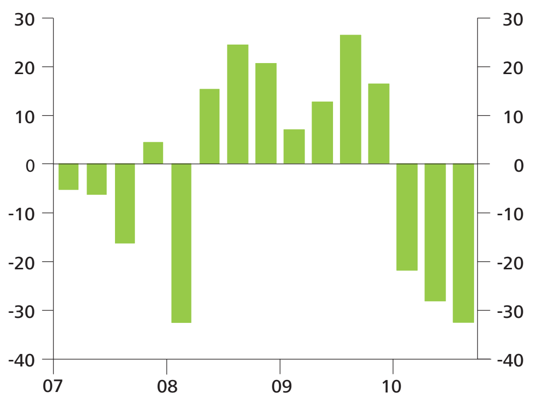
Chart 7. Public sector job cuts (000s)



Source – OBR

However, this partly reflects the fact that near-term cuts in the real pay bill will be achieved through the two year public sector pay freeze which starts in April. Accordingly, the incomes of public sector workers will still be squeezed. What's more, we think that the OBR is under-estimating the extent to which cash-strapped departments that are finding it hard to make savings might resort to cutting headcounts sooner rather than later. Note that public sector employment is *already* falling, having dropped by a total of over 80,000 in the first three quarters of 2010. (See Chart 8.)

Chart 8. Public sector employment (000s, q/q)



Source – Thomson Datastream

Meanwhile, whatever happens to government spending, tax rises are certainly imminent. Most obviously, VAT rises by 2.5% on 4th January – dealing an immediate blow to either firms' profits or consumers' spending power, depending on how much of the rise is passed on in the form of higher prices. And further tax rises are due in April, including the 1% rise in employees' national insurance contributions. **Table 1 summarises the main tax rises due to come into effect and shows that altogether, they have the potential to knock about 0.8% off GDP in 2011/12.**

Admittedly, their effect on the economy depends on how quickly consumers (on whom the tax rises primarily fall) react. Indeed, one possibility is that they have *already* adjusted their spending in anticipation of the rises. Although the recent resilience of consumer spending suggests that this is perhaps unlikely, without the looming tax rises, spending might of course have been even stronger.

What's more, we have neglected so far the possibility that the government *deliberately scales* back the magnitude of the fiscal tightening, perhaps in response to concerns that it will undermine the recovery. However, the recent strength of the recovery has somewhat sidelined this argument, while the continued troubles in the euro-zone periphery have underlined the need for governments to keep a tight grip on their fiscal consolidation plans.

Indeed, rumours ahead of the Spending Review in November that the spending cuts would be "re-profiled" or pushed back amounted to nothing, as has speculation that the VAT rise in January would be postponed.

That's not to say that, further ahead, the government won't have to reconsider its plans if economic growth disappoints, with adverse effects to the public finances. One "Plan B" that has been suggested is for the Government to maintain the programme of spending cuts in order to reassure the markets about its long-term commitment to cutting public sector debt, but also to cut taxes temporarily in order to bolster the economy. But for now, the Government's only back-up plan is to assume that, if necessary, the MPC will come to the rescue with more quantitative easing.

The upshot, then, is that we still expect the fiscal squeeze to exert significant downward pressure over the coming year – albeit perhaps skewed towards the second half of 2011, once consumers have had time to react to the tax rises.

Any relief for consumers?

Given all this, the recovery's prospects clearly hinge on the *private* sector's ability to continue to pick up steam to compensate for the weaker contribution from the public sector. **Perhaps the first hope is that the direct adverse effects of the fiscal squeeze on the private sector – and consumers in particular – are offset by support from other sources.**

Table 1. Upcoming tax changes (£bn effect on GDP relative to where it would otherwise have been)

	Measure	10/11	11/12	12/13	13/14	14/15
January 2011	VAT rise	2.9	12.1	12.5	13.0	13.5
January 2011	Insurance tax rise	0.1	0.4	0.4	0.4	0.4
April 2011	Rise in personal allowance	0.0	-3.5	-3.7	-3.8	-3.9
April 2011	New 5% rate of stamp duty	0.0	0.1	0.2	0.3	0.3
April 2011	Council tax freeze	0.0	-0.6	-0.6	-0.6	-0.6
April 2011	Pensions tax relief reduced	0.0	0.6	4.0	4.1	5.1
April 2011	Changes to employees' NICS	0.0	1.6	1.6	1.5	1.8
April 2011 onwards	Freeze in tax thresholds	0.0	0.5	1.4	2.0	2.4
April 2013 onwards	Rise in duties	0.0	0.0	0.0	0.2	0.9
	Total (£bn)	**3.0**	**11.1**	**15.7**	**17.1**	**19.8**
	% of household incomes	0.3	1.2	1.6	1.8	2.0
	% of GDP	0.2	0.8	1.1	1.2	1.3

Sources – Bootle & HM Treasury

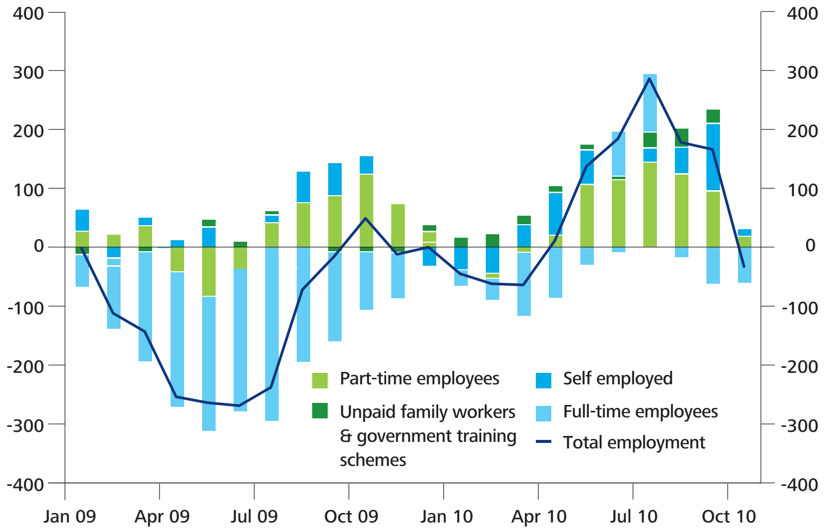
Arguably the most important question is whether the private sector can generate enough jobs to offset the public sector cuts. And recent news in this regard has been encouraging. In the six months between March and September, the economy generated 350,000 jobs (on the Labour Force Survey measure of employment) – *more* than the Office for Budget Responsibility's estimate of the total public sector job losses over the next four years. Admittedly, most of these have been part-time roles. (See Chart 9.) Nonetheless, part-time employment is a natural place for the recovery to start. After the last recession, a rise in part-time employment in 1993 was followed about a year later by a strong pick-up in full-time employment.

However, we are far from optimistic about the outlook for employment. **For a start, we think that the OBR is underestimating the scale of the public sector job losses.** If the public sector paybill sees 12% real cuts – in line with overall departmental spending – savings of about £20bn will need to be made. Some of these will come through the public sector pay freeze and rise in employees' pension contribution. But these measures are estimated to save only £3.3bn and £1.8bn respectively – leaving another £15bn or so. That magnitude of saving would require about 520,000 job cuts.

What's more, employment in those firms directly dependent on government spending is likely to fall. In 2009/10, £196bn of government spending went on procuring goods and services from the private sector. This is equivalent to about 13% of GDP, suggesting that the public sector indirectly supports about 4 million private sector jobs. A cut in procurement spending of 12% – again in line with the cuts in overall departmental spending – could therefore put a further 500,000 jobs at risk. Note that BAE has already announced a further 1,400 job losses as a result of the cuts in defence spending announced in the Spending Review.

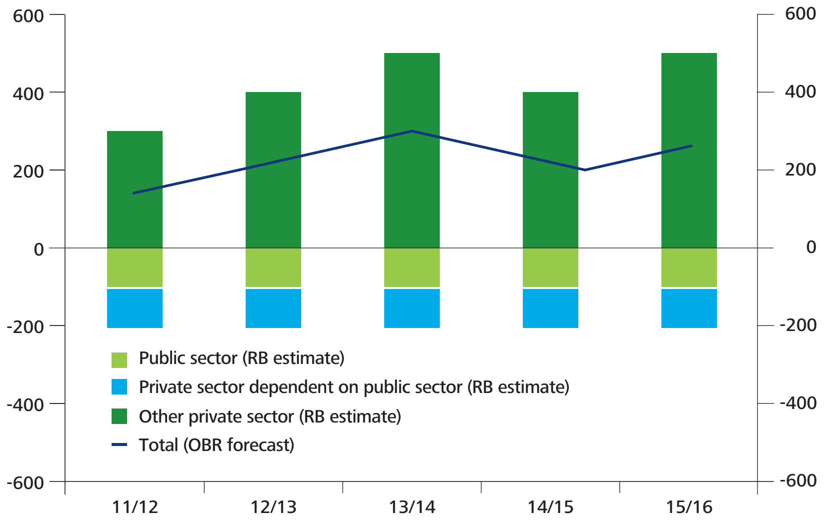
Given all this, we think that, just to stop overall employment from falling, employment in the parts of the private sector *not* directly affected by the cuts in government spending will need to rise by about 1% a year. And to generate the overall employment *growth* that the OBR expects, it would need to rise, on average, by some 400,000 or 2% a year. (See Chart 10.)

Chart 9. Employment (000s, q/q)



Sources – Thomson Datastream

Chart 10. Employment (000s, y/y)

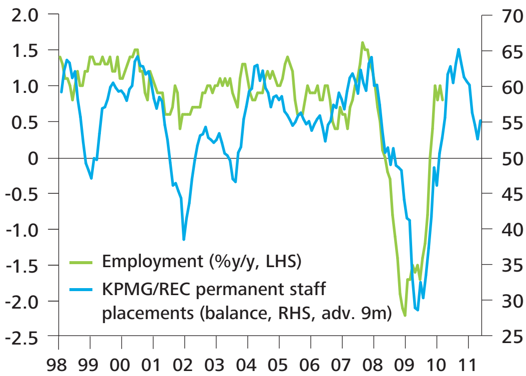


Sources – OBR, Bootle, Thomson Datastream

While not impossible (indeed, it was achieved during the fiscal squeeze of the early to mid 1990s), we think that this is pretty unlikely. We have pointed out before that the fairly small fall in employment seen during the recession means that, in theory, firms should still have plenty of scope to produce more using their existing workforces.

In fact, the labour market recovery already appears to be stalling, with employment falling in October and some of the latest employment surveys pointing to a slowdown in employment growth. (See Chart 11.) **The upshot is that we still expect overall unemployment to start to climb again in the coming months once the public sector axe starts to fall more heavily.**

Chart 11. Employment growth

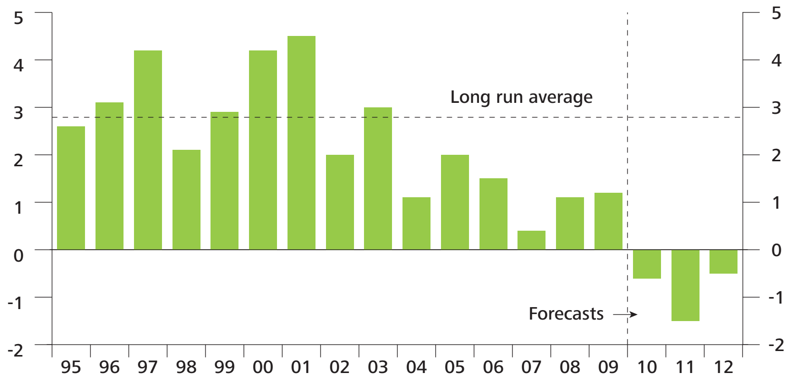


Sources – KPMG/REC, Thomson Datastream

Rising inflation hits real incomes

What's more, it is hard to see what else might support consumer spending as the job losses mount. If we are right about unemployment, pay growth will stay very weak. And the fact that inflation is taking longer to fall than we expected – and in fact is *rising* again – will put an additional squeeze on households' *real* income growth. **Indeed, we now expect real disposable incomes to fall by about 1.5% in 2011 and probably drop even further in 2012.** (See Chart 12.)

Chart 12. Household real disposable income (%, y/y)



Sources – Thomson Datastream, Bootle

At least the low level of interest rates means that there is still no urgency for households to get on with the deleveraging that still looks necessary in the longer-term. Despite the stubbornness of inflation, the MPC looks unlikely to hike official interest rates any time soon. And if we are right in expecting a further extension of quantitative easing next year, bond yields and market interest rates might come under further *downward* pressure.

That said, the renewed downturn in the housing market provides a powerful incentive for those households on expiring mortgages to accelerate their debt repayments, in order to boost their housing equity and hence qualify for a lower interest rate. What's more, the continued problems in the banking sector suggest that there is still little hope of consumers borrowing more to see them through their income squeeze.

In fact, if anything, there is a risk that credit conditions start to *tighten* again. For a start, UK banks have significant exposure to the troubled peripheral euro-zone countries. Admittedly, exposure to the sovereign debt of the so-called "PIIGS" (Portugal, Ireland, Italy, Greece and Spain) accounts for only 1.8% of all UK banks' assets. But add in the UK's holdings of bank and non-bank private sector debt in those countries and the figure rises to almost 5%.

What's more, banks still face significant domestic risks – most obviously the renewed house price falls, but also lingering problems in the commercial property market. Meanwhile, the upward pressure on banks funding costs already stemming from the recent rise in LIBOR rates is only likely to worsen as banks seek to replace the funding provided by the Bank of England through the Special Liquidity Scheme.

The upshot, then, is that consumers are unlikely to get through the fiscal squeeze unscathed. In fact, we still expect household spending to fall in 2011.

Net trade to the rescue?

The onus is therefore firmly on those parts of the economy which are relatively immune from the *direct* effects of the fiscal squeeze – namely exports and investment – to drive growth instead.

And at least there are now some signs of a re-balancing towards the external sector. Exports are now only a fraction below their pre-recession peak, having risen by about 10% in value terms over the past 12 months. On the face of it, the major factor behind this has been the pick-up in global demand – as Chart 13 shows, goods exports have risen broadly in line with overall world trade.

Chart 13. UK goods exports & world goods trade (Jan. 2008 = 100)

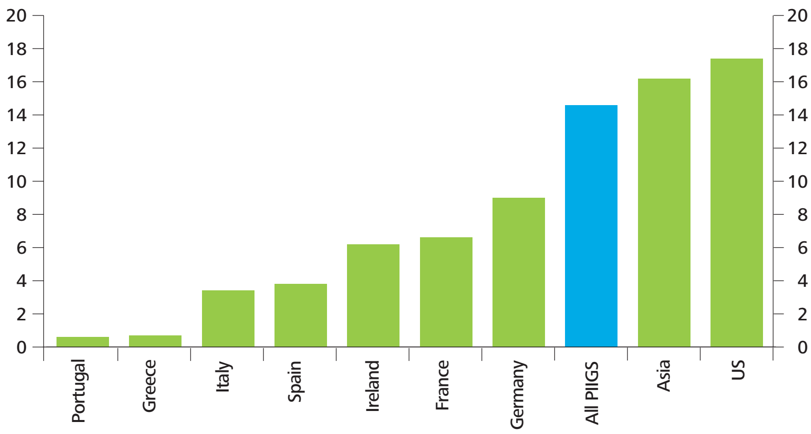
Sources – CPB, Thomson Datastream

The key question, then, is whether global demand will continue to provide this support to UK exports. And on the positive side, the recently announced plans for an extra fiscal stimulus in the US clearly leave the outlook for global demand a bit brighter.

But the US accounts for only 17% of the UK's exports. Obviously far more important is what is happening in Europe, the destination for over half of UK exports. And while it is reassuring that the recovery in Germany (the UK's biggest export market in Europe, taking 9% of exports) is still going strong, it remains heavily dependent on exports itself. There is still limited evidence that households there are about to start consuming a large amount of UK goods and services. Indeed, we expect German consumer spending to do little better than stagnate in 2011.

What's more, Chart 14 shows that the beleaguered peripheral euro-zone economies are collectively a bigger export destination for UK exports than Germany – and not that far off the whole of Asia. And after growing slightly in 2010, we expect GDP in the PIIGS to contract in 2011.

Chart 14. UK goods & services exports by destination (% of total)



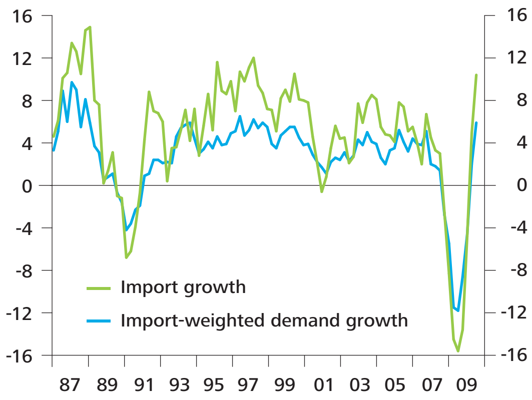
Source – Thomson Datastream

Accordingly, we don't see the global demand environment as being particularly supportive for the UK's external sector. But what about the lower pound? While there is little evidence of UK exporters taking a bigger share of the world export cake, that doesn't mean that the pound is having no effect – without it, the UK's export share could well have fallen. Indeed, the UK's overall trade deficit has stabilised after falling for several years. Equally, though, the deficit has not started to narrow at all.

Part of the problem is that there is still little evidence of so-called import substitution – i.e. UK firms and consumers switching from buying foreign to domestically produced goods and services.

In fact, as Chart 15 shows, imports have been growing *faster* than domestic demand (weighted according to the import intensity of its different components). Reports from the Bank of England's regional agents suggest that this reflects the "lack of appropriate supply capacity in the UK" and, in time, domestic producers are likely to invest in new capacity to correct this. But this process could take several years.

Chart 15. Imports & domestic demand (%y/y)



Source – Bank of England

Another spanner in the works could be a renewed appreciation in the pound. In the big scheme of things, the rise so far has been pretty modest – on a trade-weighted basis, sterling is at about the same level as a year ago and still more than 20% down on its peak. But if we are right in expecting the troubles in the euro-zone to weigh further on the euro – potentially taking it all the way to parity against the dollar – sterling could yet rise a fair bit further. We expect the trade-weighted index to rise by between 5% and 10% in 2012.

We don't want to sound *too* gloomy. **To be clear, we certainly expect net trade to provide a positive, and fairly decent, contribution to growth over the next couple of years.** After all, even if export growth does not accelerate any further, import growth is almost certain to slow from the rapid rates seen recently. We just don't think that the boost – which we would put in the region of between 0.5% and 1% of GDP in 2011 – will keep the recovery going on its own. **After all, a boost of this magnitude would do little more than fill the hole left by falling consumer and public spending – which together we expect to knock about 0.5% off the level of GDP in 2011.**

Investment just not big enough

At least we've saved the best for last. **Business investment is the area of the economy likely to see the strongest growth over the next couple of years.**

To be sure, there are some factors set to keep some check on the investment recovery – including the spare capacity that firms still have to use up, as well as uncertainty about the demand outlook. **Nonetheless, there are powerful incentives to invest – most obviously to make the most of the opportunities created by the lower pound.** What's more, firms have money to spend, having been in financial surplus for almost a decade now.

Indeed, investment intentions have been rising. And it is production of investment goods that has been driving the rises in industrial production recently – accounting for about half of production *growth*, even though it makes up only a fifth of production as a whole.

Nonetheless, the weakness in the rest of the economy clearly leaves a heck of a lot of work for business investment – which accounts for less than a tenth of the economy – to do on its own. A strong but fairly plausible 10% rise in business investment over the next year or two would take investment as a share of GDP back to more "normal" levels – but would add just 1% or so to GDP.

Conclusions

So can the economy continue to recover? Of course, the answer depends in part on what we mean by recover. **If we mean can the economy continue to expand and claw back the output lost during the recession, the answer is yes.** The odd quarter of contraction is not out of the question – especially at the start of the year when VAT rises. But, for now at least, the risk of a sustained return to recession has receded significantly.

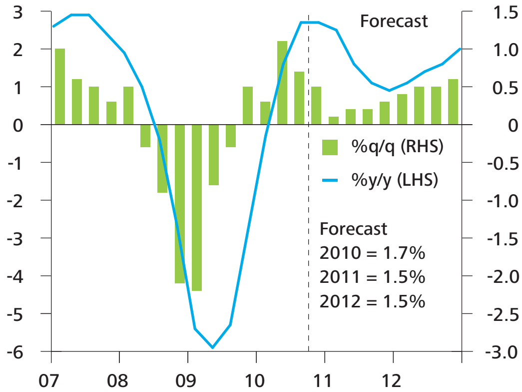
But if the question is whether the recovery can maintain or improve on the above-trend rates of growth seen in the past couple of quarters, the answer, in our view, is probably not.

Admittedly, the recovery might manage to keep up its recent momentum for a little while longer. After all, we still think that there is a bit of a boost from restocking yet to come, which – if the timing worked fortuitously – could offset any adverse effect from the VAT increase on consumer spending in the first quarter of 2011.

But the key point is that we doubt that the recovery is on the sustainable footing required for it to maintain its recent pace. To be sure, the recovery in some parts of the economy will keep getting stronger. But the relatively small size of these sectors will prevent them from compensating fully for the slowdown seen elsewhere in the economy.

So while the recent momentum in the economy has persuaded us to nudge up our GDP growth forecast for this year from 1% to 1.5%, this would still be well below the economy's potential or trend growth rate. And although obviously much could change over the next year or so – including the fiscal plans – for now we expect growth to be much the same in 2012. (See Chart 16.) **The economy could take until well into 2013 even to get back to its pre-recession levels of activity.**

Chart 16. Real GDP growth



Sources – Thomson Datastream, Bootle

Nonetheless, the UK *has* turned a corner. And, although a difficult couple of years lie ahead, growth should eventually accelerate. Indeed, given the large amount of slack that we think still exists, it could reach pretty rapid rates. What's more, it will be more soundly based than the growth rates seen over the past decade or so. **So although the next year or two may be a difficult time, a period of strong and sustainable growth lies beyond it.**

Historical data table

	Average 1994-03	2004	2005	2006	2007	2008	2009
Demand (%y/y)							
GDP	3.2	3.0	2.2	2.8	2.7	-0.1	-4.9
Consumer Spending	3.7	3.2	2.3	1.8	2.2	0.6	-3.3
Government Consumption	2.0	3.0	2.0	1.4	1.3	1.6	1.0
Fixed Investment	4.6	5.1	2.4	6.4	7.8	-5.0	-15.4
Stockbuilding (% of GDP)	0.4	0.4	0.4	0.4	0.5	0.0	-1.2
Domestic Demand	3.5	3.5	2.1	2.5	3.1	-0.7	-5.5
Exports[1]	5.7	5.0	7.9	11.1	-2.6	1.0	-10.1
Total Final Expenditure	4.0	3.8	3.2	4.2	1.9	-0.3	-6.4
Imports[1]	6.9	6.9	7.1	9.1	-0.8	-1.2	-11.9
Output & Profits (%y/y)							
Services Output	4.0	3.6	3.1	4.1	3.5	0.5	-3.2
Manufacturing Output	0.9	2.2	-0.2	1.6	0.5	-2.9	-10.7
Company Profits[2] (nominal)	6.0	7.1	2.4	7.8	6.3	-0.5	-7.5
Labour Market							
Unemployment (claimant count, millions)	1.5	0.9	0.9	0.9	0.9	0.9	1.5
Unemployment (claimant count, %)	4.7	2.6	2.9	2.9	2.5	3.6	4.9
Employment (%y/y)	1.1	1.0	1.1	0.9	0.7	0.9	-1.5
Productivity (output per worker, %y/y)	2.0	2.0	1.3	2.1	2.0	-1.0	-3.5
Income & Saving (%y/y)							
Average Earnings[3]	4.1	4.2	4.6	4.9	4.7	3.5	0.0
Real Household Disposable Income	3.0	1.1	2.0	1.5	0.4	1.1	1.1
Saving Ratio (%)	7.2	3.7	3.9	3.4	2.6	2.0	6.0
Prices (%y/y)							
CPI	1.7	1.3	2.0	2.3	2.3	3.6	2.1
Core CPI[4]	n/a	1.1	1.5	1.3	1.7	1.6	1.8
RPI	2.6	3.0	2.8	3.2	4.3	4.0	-0.5
RPIX	2.5	2.2	2.2	3.0	3.2	4.3	2.0
Nationwide House Prices (end period)	10.4	13.9	3.3	9.3	6.9	-14.7	3.4
Monetary Indicators (end period unless stated)							
Base/Repo Rate (%)	5.52	4.75	4.50	5.00	5.50	2.00	0.50
10 Year Gilt Yield (%)	6.7	4.6	4.1	4.7	4.5	3.1	4.1
Sterling Trade-weighted Index	95.8	99.6	98.2	104.3	98.1	74.0	80.8
$/£	1.61	1.91	1.72	1.96	1.99	1.47	1.62
Euro/£	1.45	1.41	1.46	1.48	1.36	1.03	1.13
M4 (%y/y, period average)	7.6	8.7	10.9	12.8	12.9	12.3	13.5
Balance of Payments & Public Finances							
Current Account (£bn)	-13.2	-24.9	-32.8	-44.9	-36.5	-23.8	-23.9
% of GDP	-1.4	-2.1	-2.6	-3.4	-2.6	-1.6	-1.7
PSNB (£bn, financial year)	13.1	39.8	37.4	30.8	34.0	87.0	167.0
% of GDP (financial year)	1.6	3.3	2.9	2.3	2.4	6.0	11.8
World Scene (%y/y)							
World GDP[5]	3.4	4.9	4.5	5.1	5.2	3.0	-0.8
US GDP	3.3	3.6	3.1	2.7	1.9	0.0	-2.6
Euro-zone GDP	n/a	1.9	1.7	3.1	2.8	0.3	-4.0
G7 Consumer Price Inflation	1.8	2.0	2.3	2.4	2.2	3.3	-0.1
World Goods & Services Trade Volumes	6.8	10.7	7.6	9.3	7.2	2.8	-12.0
Oil Price (Brent, $ per barrel, end period)	19.8	38.4	58.3	59.4	93.8	36.2	77.4

1 Includes VAT fraud distortion. 2 Gross trading profits of non-financial corporations. 3 Including bonuses. 4 Excluding energy, food, alcohol & tobacco. 5 PPP terms.

Macro forecast table

				2011f		2012f	
	2010f	2011f	2012f	H1	H2	H1	H2
Demand (%y/y)							
GDP	1.7	1.5	1.5	2.0	1.0	1.2	1.8
Consumer Spending	1.3	-0.5	0.0	0.2	-1.1	-0.4	0.4
Government Consumption	1.2	-1.0	-2.0	-0.5	-1.4	-2.0	-1.9
Fixed Investment	3.5	5.5	6.5	6.4	4.7	6.1	6.9
Stockbuilding (% of GDP)	-0.1	0.5	0.5	0.4	0.5	0.5	0.5
Domestic Demand	2.7	0.8	0.7	1.5	0.1	0.4	1.0
Exports[1]	5.3	6.5	4.5	7.1	5.9	4.9	4.2
Total Final Expenditure	3.2	2.0	1.5	2.7	1.3	1.3	1.7
Imports[1]	8.0	3.5	1.5	4.6	2.4	1.7	1.3
Output & Profits (%y/y)							
Services Output	1.4	1.0	1.5	1.4	0.8	1.0	2.0
Manufacturing Output	3.8	4.0	2.0	4.6	3.5	2.5	1.5
Company Profits[2] (nominal)	1.0	3.0	4.0	1.5	4.5	4.3	3.8
Labour Market							
Unemployment (claimant count, millions)	1.5	1.7	1.9	1.6	1.7	1.8	1.9
Unemployment (claimant count, %)	4.8	5.3	5.9	5.2	5.5	5.8	6.0
Employment (%y/y)	0.0	-0.2	-0.8	0.4	-0.8	-0.8	-0.8
Productivity (output per worker, %y/y)	1.5	1.7	2.3	1.7	1.8	2.1	2.6
Income & Saving (%y/y)							
Average Earnings[3]	2.2	1.0	0.7	1.4	0.6	0.4	1.0
Real Household Disposable Income	-0.5	-1.5	-0.5	-0.9	-2.0	-0.9	0.0
Saving Ratio (%)	5.1	4.5	4.0	4.5	4.5	4.0	4.1
Prices (%y/y)							
CPI	3.3	3.2	1.0	3.3	3.0	1.4	0.7
Core CPI[4]	2.9	2.2	0.6	2.6	1.8	0.7	0.5
RPI	4.5	3.2	1.2	3.4	3.0	1.4	1.1
RPIX	4.8	4.3	2.1	4.5	4.0	2.3	2.0
Nationwide House Prices (end period)	-0.9	-10.0	-10.0	-8.2	-10.0	-10.7	-10.0
Monetary Indicators (end period unless stated)							
Base/Repo Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.50
10 Year Gilt Yield (%)	3.75	2.75	2.75	3.75	2.75	2.75	2.75
Sterling Trade-weighted Index	81.3	82.0	87.2	80.2	82.0	87.2	87.2
$/£	1.55	1.40	1.40	1.45	1.40	1.40	1.40
Euro/£	1.19	1.27	1.40	1.21	1.27	1.40	1.40
M4 (%y/y, period average)	2.3	3.0	4.5	2.1	3.9	4.0	4.9
Balance of Payments & Public Finances							
Current Account (£bn)	-33.0	-30.0	-25.0	-15.5	-14.4	-13.5	-11.5
% of GDP	-2.3	-2.0	-1.6	-2.1	-1.9	-1.8	-1.5
PSNB (£bn, financial year)	150	120	100	–	–	–	–
% of GDP (financial year)	10.1	7.7	6.2	–	–	–	–
World Scene (%y/y)							
World GDP[5]	4.5	3.5	3.0	4.0	3.0	3.0	3.0
US GDP	2.9	3.0	2.0	3.0	2.9	2.2	1.8
Euro-zone GDP	1.7	1.0	0.5	1.5	0.5	0.3	0.7
G7 Consumer Price Inflation	1.3	1.4	0.4	1.5	1.2	0.5	0.3
World Goods & Services Trade Volumes	16.0	6.0	5.0	7.0	5.0	5.0	5.0
Oil Price (Brent, $ per barrel, end period)	90	75	60	85	75	65	60

1 Includes VAT fraud distortion. 2 Gross trading profits of non-financial corporations. 3 Including bonuses. 4 Excluding energy, food, alcohol & tobacco. 5 PPP terms.

Analysis: The world economy
Fiscal stimulus just a temporary boost

- US economic growth picked up notably in the closing stages of 2010. Based on the higher starting point for GDP going into 2011 and the new fiscal stimulus, which is worth an additional $300bn (or 2% of GDP) above what we previously had factored in, we now expect growth of 3% in 2011. (See Charts 1 & 2.)

- The question is whether the temporary fiscal stimulus, and possibly even more quantitative easing, will be the trigger that prompts a sustained pick-up in the growth in private sector demand. We still have our doubts about this. We fear that the balance sheet problems facing households and financial institutions will continue to hold the economy back for several more years.

- Nearly one in four mortgage borrowers still owe more than their home is worth and the renewed fall in house prices will put many more underwater. (See Chart 3.)

- Under those circumstances, we suspect that the fiscal stimulus will prove to be a stop-gap measure, but it does not change our outlook beyond that. We expect the US to return to more muted growth of 2% in 2012.

- Admittedly, households have recently started to spend more freely. Retail sales growth has picked up sharply since the lull in the summer. (See Chart 4.) In addition, real disposable incomes will receive a boost at the start of 2011 from the payroll tax cut. Even if a sizeable proportion of that money is saved, we still anticipate that first-quarter consumption growth could reach 4% at an annualised pace.

- More generally, however, the persistent weakness of the labour market suggests that income growth will otherwise remain muted. Despite the pick-up in various measures of activity, there has been no corresponding acceleration in the pace of employment growth. (See Chart 5.)

- Despite GDP growth of nearly 3% in 2010, America's unemployment rate has remained stubbornly close to 10%, basically unchanged over the past 12 months. (See Chart 6.)

- Even if the unemployment rate falls to 9% by the end of 2011, that would still leave a considerable amount of spare capacity, which will weigh further on inflation. Higher gasoline and food prices may boost the headline rate in the near-term, but core inflation will continue to slide gradually towards zero. (See Chart 7.)

- Finally, after proving to be a big drag on overall GDP growth for much of 2010, we expect net external demand to be a more neutral influence in 2011. The problem was the massive surge in imports, which was out of all proportion to the strength of domestic demand. In recent months, however, import growth has slowed markedly, even dropping below the growth rate of exports. (See Chart 8.)

- There has been a corresponding drop in the size of the external trade deficit as well, which may quieten the protectionist rhetoric for a while. Nevertheless, we expect to hear more about protectionism once it becomes clearer next year that the fiscal stimulus has not made a permanent difference.

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

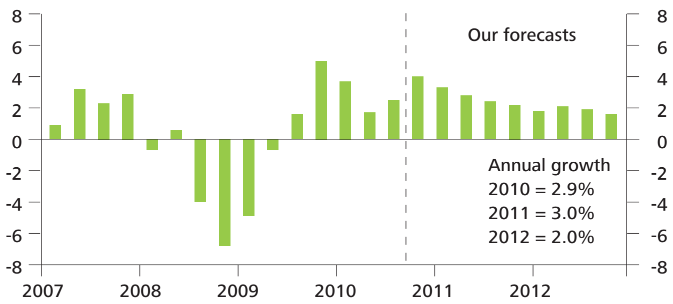


Chart 2. US ISM activity indices

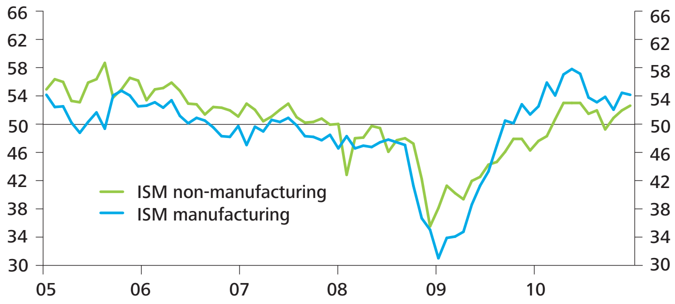


Chart 3. US Case-Shiller 20-city house prices (%m/m)

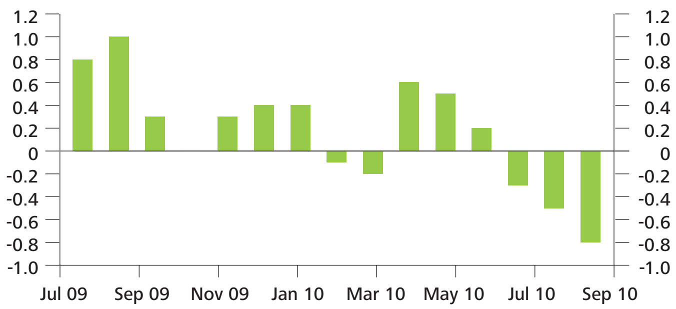


Chart 4. US retail sales (%m/m)

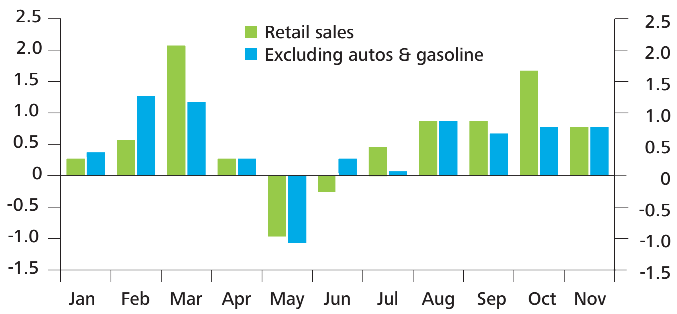


Chart 5. US monthly change in private payrolls (000s)

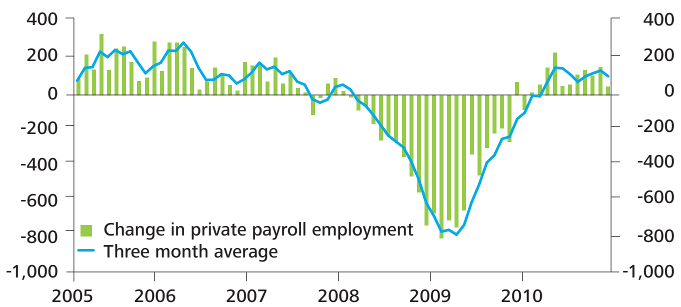


Chart 6. US unemployment rate (%)

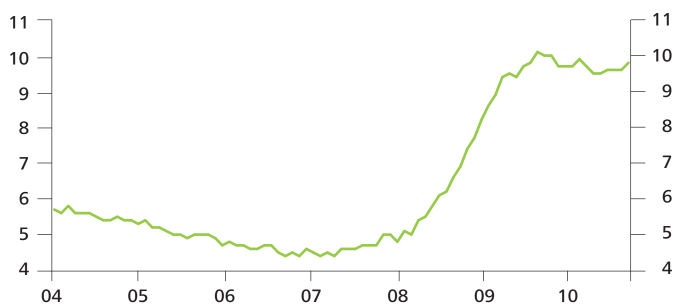


Chart 7. US CPI inflation

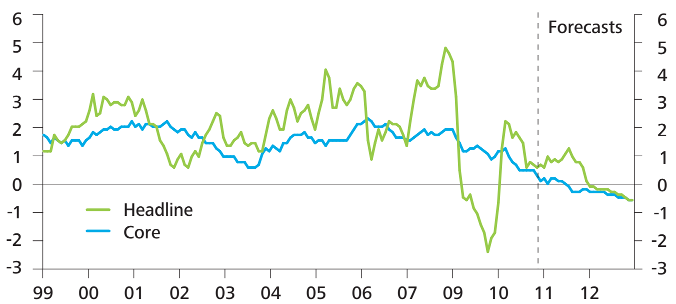
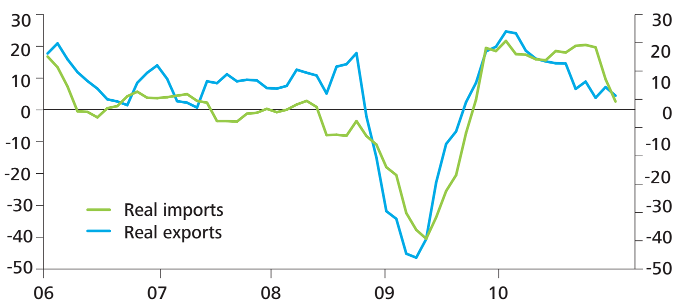


Chart 8. US real exports & imports (%3m/3m ann.)



Sources – Thomson Datastream, Bloomberg, Bootle

Analysis: The world economy
Euro-zone divergences continue to widen

- The recovery in the euro-zone as a whole has continued, but divergences between the core and the periphery are growing. With the core's resistance to adopting bolder policies to help the periphery hardening, concerns about the future of the euro are likely to intensify.

- The euro-zone economy has continued to expand at a reasonably healthy pace. The composite PMI points to another solid gain in GDP of 0.5% or so in Q4 2010. (See Chart 9.)

- Note though that the recovery remains reliant on firms rebuilding their stocks and the external sector. (See Chart 10.) Admittedly, the recent pick-up in survey measures of firms' export orders (see Chart 11), the weakening euro and the improving global outlook imply that external prospects remain bright. But growth should still slow from its current robust pace. Meanwhile, the boost from inventories will fade once stocks return to normal levels.

- Encouragingly, the rise in consumer confidence (see Chart 12) and the fall in unemployment in parts of the region suggest that household spending may pick up some of the slack. But as the fiscal squeeze intensifies and spreads to the core, any upturn may falter.

- Meanwhile, inflationary pressures should remain muted, allowing the ECB to leave interest rates at 1% for the foreseeable future. While the ECB is keen to phase out its unconventional policy measures, peripheral banks' heavy reliance on the ECB for funds means that they will be wound down only gradually. (See Chart 13.)

- But such support will not be enough to reduce markets' concerns about the periphery. Given that the ECB seems reluctant to step up its purchases of peripheral bonds dramatically and the core economies are unlikely to agree to bolder support measures such as common bonds, peripheral yields may climb higher. Accordingly, the likes of Portugal and Spain might come under heavy pressure to seek international financial support next year.

- In all, then, the euro-zone looks set for unspectacular growth of around 1% in 2011 and 0.5% in 2012. (See Chart 14.) While Germany will perform rather better, huge fiscal squeezes and a fundamental lack of competitiveness mean that the peripheral economies may fall back into recession. Accordingly, concerns about the future of the region will remain and are likely to prompt a renewed decline in the euro.

- In Norway, Switzerland and Sweden, exporters will suffer from strong currencies. But low levels of public debt, a lack of fiscal tightening and fairly healthy labour markets will ensure that these economies continue to expand at a pretty healthy pace. (See Chart 15.)

- Emerging Europe as a whole should grow by around 3.5% in 2011, but some countries will fare much better than others. (See Chart 16.) Turkey is likely to outperform and looks set to grow by around 5% next year. Poland should do well too. But growth in the rest of Central Europe remains tied to Germany, and is likely to slow in 2011 as a result. Meanwhile, Russia will suffer if oil prices fall back, as we expect.

Chart 9. Euro-zone GDP & the composite PMI

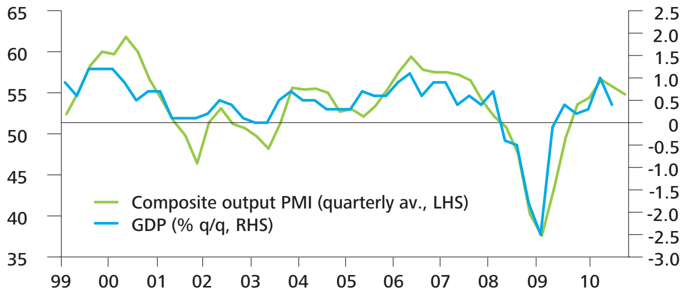


Chart 10. GDP, GDP ex. stocks & fin. dom. demand (%y/y)

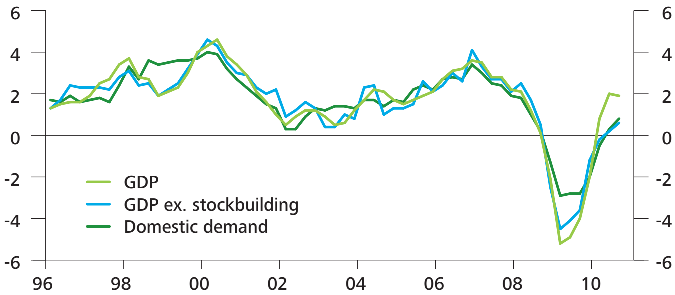


Chart 11. Exports & PMI export orders

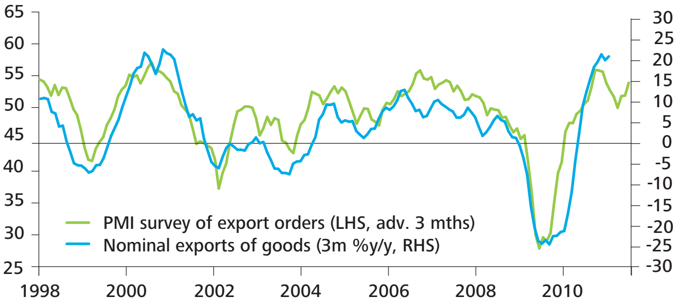


Chart 12. Euro-zone consumer confidence & spending

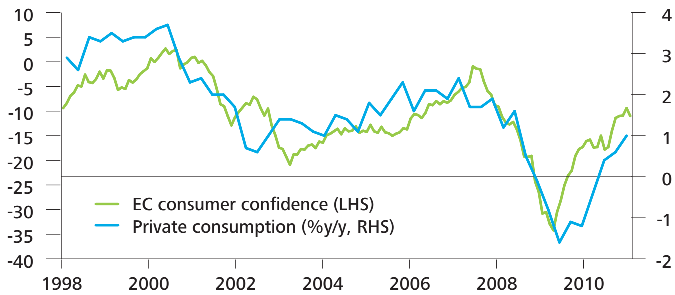


Chart 13. ECB lending to banks (% of banks' assets)

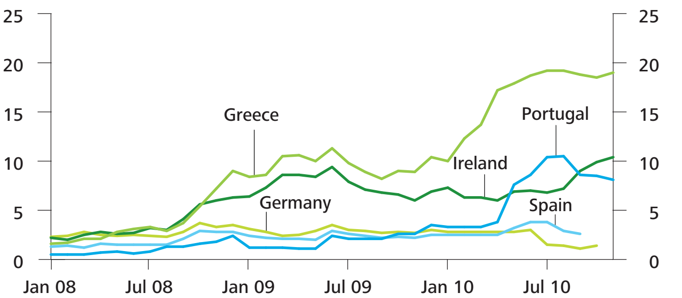


Chart 14. Euro-zone GDP

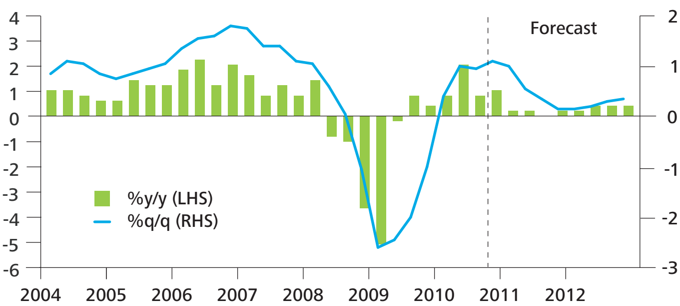


Chart 15. Developed Europe GDP (%y/y)

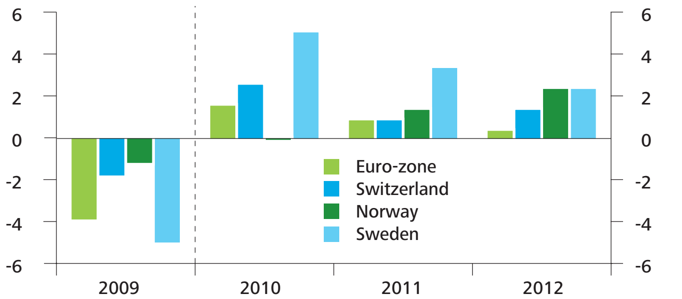
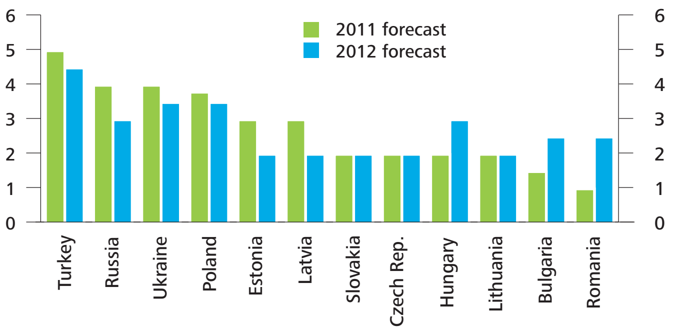


Chart 16. Emerging Europe GDP (%y/y)



Sources – ECB, IMF, Markit, Thomson Datastream, Bootle

Analysis: The world economy
Relatively robust recovery in Asia – Japan excluded

- China's economy has resumed its impressive recovery after last summer's lull. (See Chart 17.) In part this reflects a surge in bank lending which probably far exceeded the official quotas and has kept investment spending bouyant. The trade surplus has remained high (see Chart 18), although imports have recently been growing more quickly than exports as domestic demand has accelerated.

- Consumers, however, are less enthusiastic than businesses (see Chart 19), which suggests there has still been little progress towards a lasting rebalancing of the economy. In part this caution may reflect the recent food-driven surge in inflation. (See Chart 20.)

- Markets have been scaling back their expectations for policy tightening over the coming year as several senior officials have come forward to suggest that the inflation threat should not be overdone. Nonetheless, the government's sanguine policy position seems to be based at least as much on the view that the recovery is not yet broad enough to risk withdrawing policy support.

- The risk of overheating is probably greater in India. Monetary policy is already being gradually tightened and headline inflation appears to have peaked. (See Chart 21.)

- However, the economic upswing is likely to stay strong in coming quarters, concerns over asset bubbles (particularly in property) will continue to grow, and non-food inflation pressures will probably stay acute. The Reserve Bank of India may have a lot more work to do.

- Japan is the main exception to the general picture of Asian strength. Japan's GDP growth was probably the fastest of any G7 economy in 2010, but this followed a particularly deep recession. (See Chart 22.)

- What's more, the rebound has been flattered by government subsidies for the purchase of cars and environmentally-friendly household appliances, which have now expired or been scaled back. The government has essentially run out of spending categories to support, as well as the money to do so.

- In the meantime, the policy stimulus has not provided enough of a kick-start to private sector demand to sustain a strong recovery or end deflation. Unemployment remains high by Japanese standards and consumer confidence is weakening again. (See Chart 23.)

- Indeed, Japan's GDP probably fell outright in the fourth quarter of 2010. Business confidence is also declining (despite the improvements in other major economies) and investment has remained sluggish.

- The upshot is that Japan may already be slipping back into recession. This will present a huge policy challenge to the weak government, which has to decide soon when to raise the consumption tax to help pay for the imminent retirement of the "baby boom" generation. The huge financing burden leaves no margin for error. (See Chart 24.) Japan could still be the first Asian casualty of the global financial crisis.

Chart 17. China manufacturing PMI

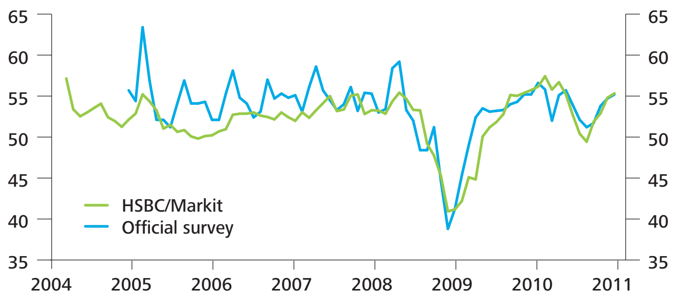


Chart 18. China merchandise trade balance ($bn)

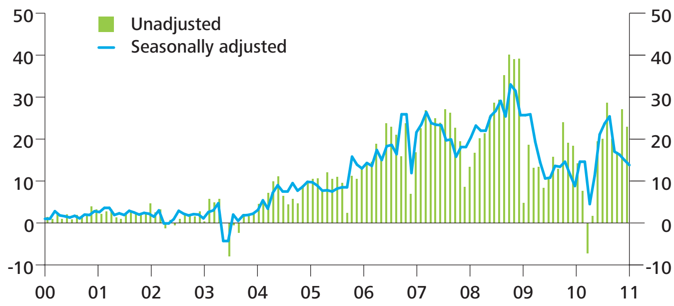


Chart 19. China consumer confidence

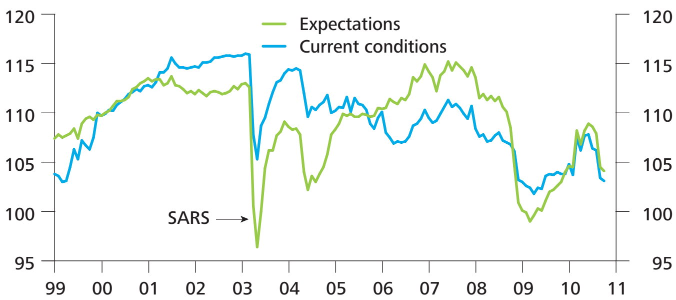


Chart 20. China consumer prices (%y/y)

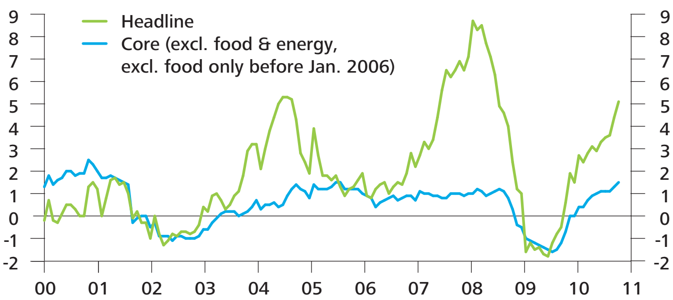


Chart 21. India Contributions to wholesale price inflation (% pts)

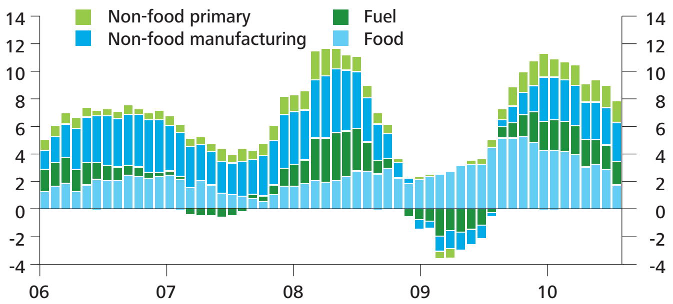


Chart 22. Real GDP (Q1 2008 = 100)

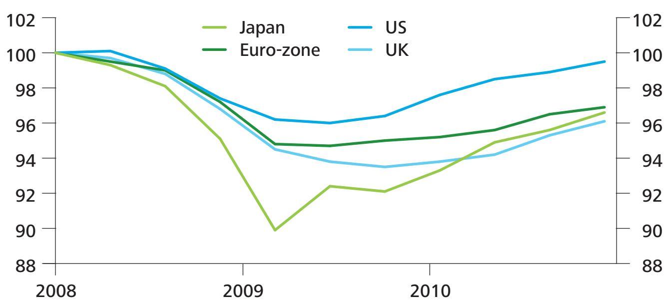


Chart 23. Japan consumer confidence

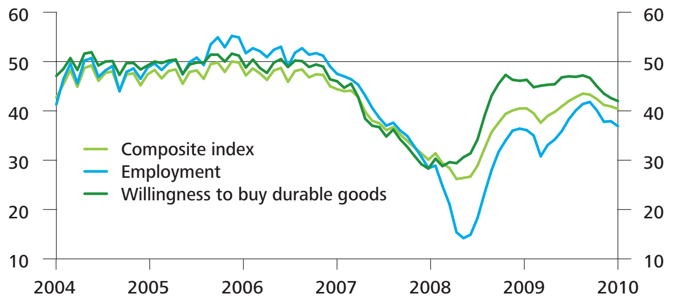
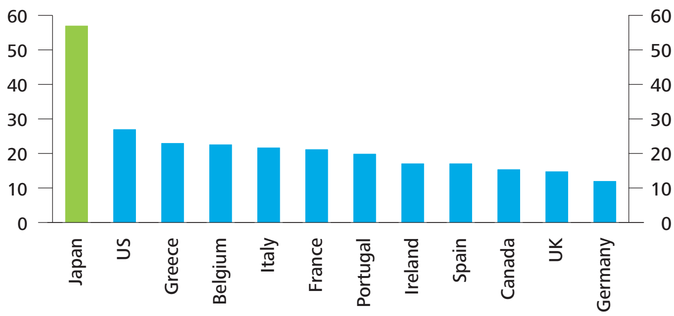


Chart 24. Government gross financing requirement (maturing debt + budget deficit, % GDP, 2011)



Sources – ECB, IMF, Markit, Thomson Datastream

Analysis: UK output and activity
The recovery is holding up for now …

- By and large, the recovery has continued at a brisk pace. But with the fiscal squeeze about to intensify, the labour market set to weaken and the recovery in exports dependent on the precarious outlook for demand overseas, the recovery still looks set to slow sharply in 2011.

- Admittedly, the recent strong GDP data have raised hopes that the economy might be able to withstand the fiscal squeeze well. Indeed, the quarterly growth of 1.1% in Q2 and 0.7% in Q3 was above trend and contrasted with the bumpy recoveries seen after some past recessions. (See Chart 1.)

- And while the recovery appears to have lost some pace since then, a relapse into recession seems to have been avoided. While the CIPS activity surveys briefly pointed to stagnation, they have since re-strengthened. (See Chart 2.)

- Despite all this, the recovery still looks set to lose pace next year. For a start, the recent growth has been partly due to temporary factors which now look likely to fade. As Chart 3 shows, while the recovery has been boosted by stockbuilding, historical experience suggests that this support tends to peter out quickly.

- Moreover, the fiscal squeeze still looks set to be the dominant influence on the economy. On the Government's current plans, cyclically-adjusted public sector net borrowing is set to fall by 2.3% of GDP in 2011/12. (See Chart 4.) If achieved, that will be the largest annual reduction in this measure of borrowing (as a share of GDP) since 1981/82. In future years, the squeeze will only be slightly less intense.

- Tax rises will hit households much harder than firms. (See Chart 5.) In addition, the decision in October's Spending Review to deliver a further £7bn per annum (by 2014-15) of spending cuts through benefits payments (instead of departmental spending) has further darkened the outlook for household income.

- What's more, job losses in the public sector, perhaps totalling 500,000 over the current parliament, may mean that unemployment eventually rises to near three million. (See *Analysis: Labour Market*, pages 28-29.)

- Consumer confidence has already fallen in anticipation of the fiscal squeeze. Indeed, the GfK's index has already begun to point to renewed falls in consumer spending. (See Chart 6.)

- The fiscal squeeze also looks set to hit households just as the housing market is faltering again. Leading indicators suggest that housing market activity will continue to tail off in early 2011. (See Chart 7.) Affordability also remains stretched. A 10% fall in house prices in 2011 still seems plausible.

- In addition, while the relationship between house price inflation and the household saving rate has not been close recently, our forecasts for the former suggest that saving could rise sharply again. (See Chart 8.)

Chart 1. Real GDP (Level, 100 = start of recession)

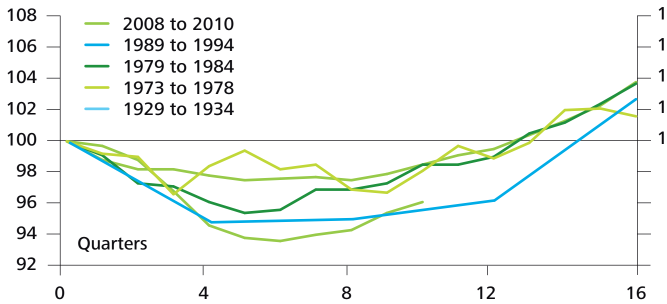


Chart 2. Real GDP growth & business surveys

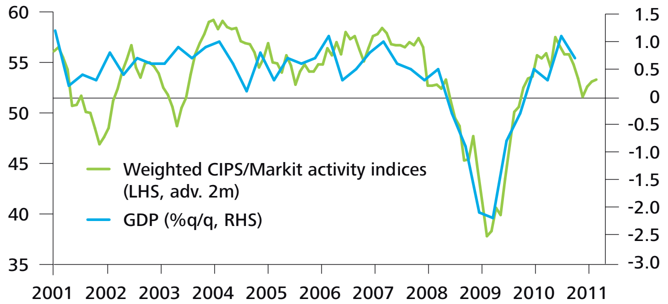


Chart 3. Contribution from stockbuilding to quarterly GDP growth (%)

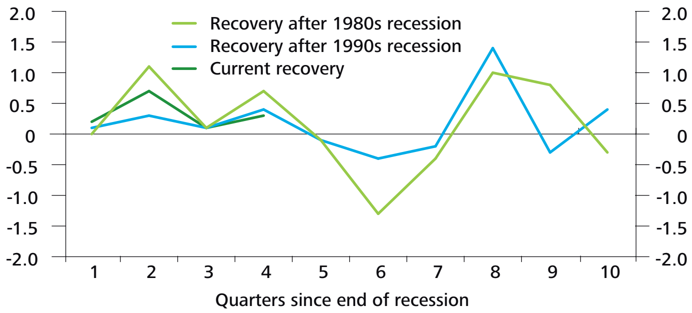


Chart 4. Change in cyclically-adjusted PSNB as a % of GDP

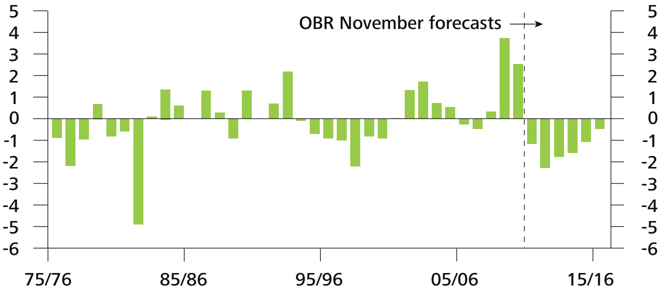


Chart 5. Total planned tax measures (£bn)

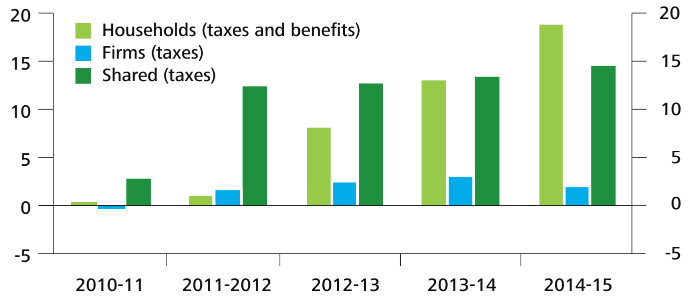


Chart 6. Consumer confidence & real household spending

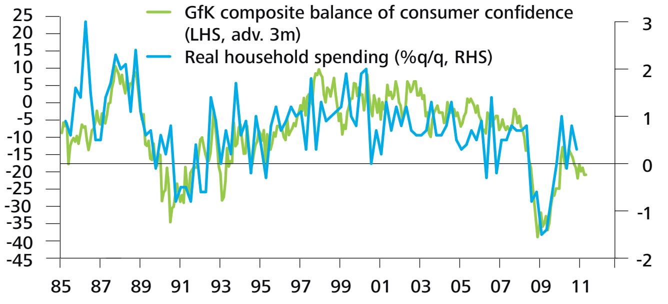


Chart 7. RICS New buyer enquiries & mortgage approvals

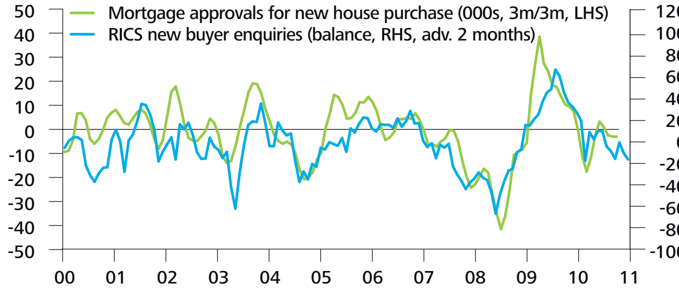
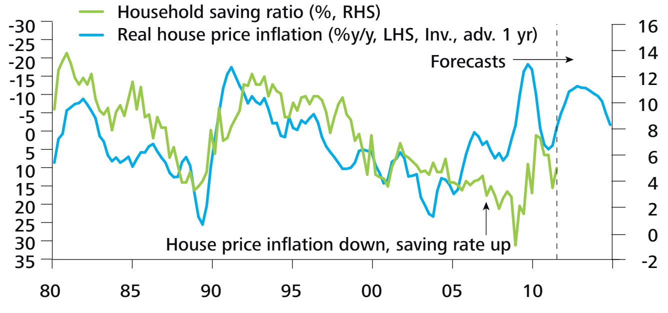


Chart 8. Real house price inflation & household saving ratio



Sources – Thomson Datastream, OBR, Bootle

Analysis: UK output and activity
… but will slow to a sluggish pace in 2011

- Furthermore, the persistence of high inflation in 2011 looks set to squeeze spending power. As a result, we think that household spending could fall by 0.5% in 2011. (See Chart 9.)

- At least firms should continue to make a decent contribution to the recovery. Business investment rose by 3.1% q/q in Q3, following on from a surge at the start of the year. Surveys of investment intentions have also largely continued to improve.

- In addition, credit constraints on firms appear to be loosening, for now at least. According to the Bank of England's latest *Credit Conditions Survey*, lenders have increased the overall availability of corporate credit for seven consecutive quarters. Surveys of firms also suggest that the availability of credit is no more of a constraint on output and investment now than in the mid-2000s. (See Chart 10.) Firms have also built up their cash reserves, suggesting that they can invest without having to borrow. (See Chart 11.)

- Admittedly, firms may not *want* to invest just as the fiscal squeeze is kicking in. But the withdrawal of the public sector should also create opportunities for private enterprise. As a result, even accounting for the likely weakness of public and housing investment, we think that total investment could grow by around 6% in 2011 and in 2012. (See Chart 12.)

- In addition, while there are still pretty mixed signs from the external sector of the economy, we still think that net trade can provide a decent boost to growth in 2011. Admittedly, net trade dragged on GDP growth again in Q3. What's more, UK exporters are quite poorly placed to benefit from the relatively rapid growth set to take hold in emerging markets. (See Chart 13.)

- Nonetheless, surveys of industrial order books suggest that export volumes growth should pick up in the months ahead. (See Chart 14.) The recent plans to extend the fiscal stimulus in the US should also support demand for UK exports. Meanwhile, import growth should fade as the fiscal squeeze hits UK consumers.

- But overall, the recovery still looks set to be sluggish. While its near-term momentum has persuaded us to nudge up our forecast for annual GDP growth in 2011 from 1% to 1.5%, we doubt that the recovery will gain any pace in 2012. (See Chart 15.) A large amount of spare capacity therefore looks set to remain, even assuming that the recession has purged some supply capacity. (See Chart 16.)

- Needless to say, the economic outlook is very uncertain at present – and there remains a big risk that growth turns out to be weaker than we expect. A second shock to the economy from the banking sector could occur if house prices fall further or the euro-zone fiscal crisis intensifies. Meanwhile, above-target inflation may prevent the Monetary Policy Committee (MPC) from extending QE next year – currently the only "Plan B" – even if the recovery fades.

- In addition, if GDP growth and inflation stay strong in the coming months, there is a risk that the MPC prematurely raises rates, potentially accentuating the eventual downturn.

Chart 9. Household spending & disposable income

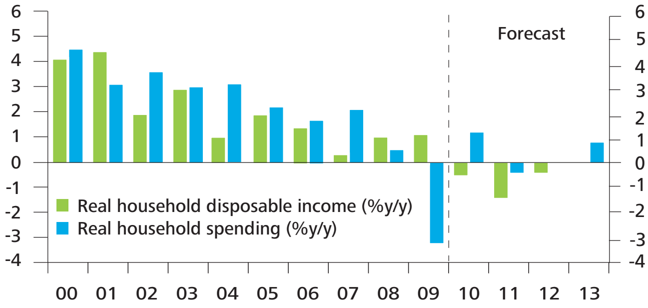


Chart 10. Firms reporting credit as a constraint on output or investment (% balance)

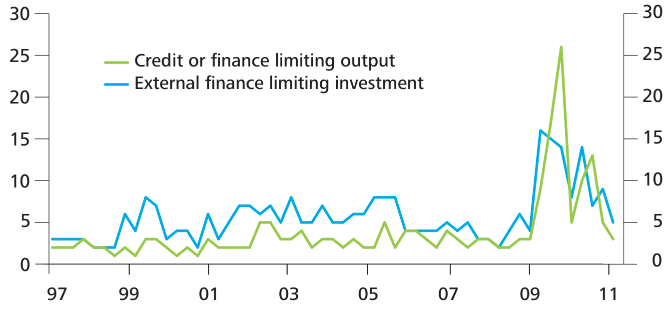


Chart 11. Investment & corporate financial balance

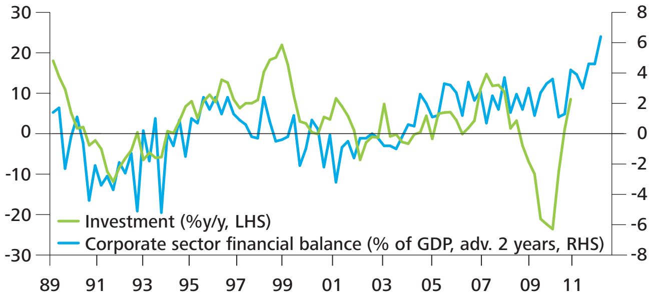


Chart 12. Investment and GDP (%y/y)

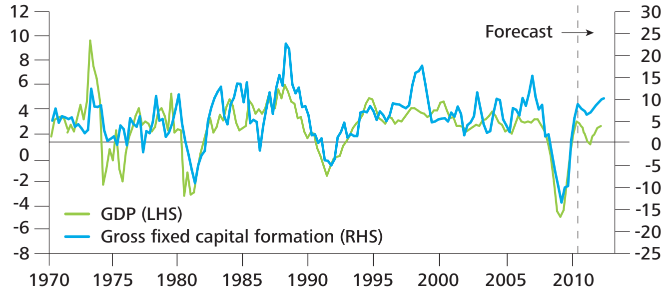


Chart 13. Real GDP growth & UK goods exports

Chart 14. Export orders balance of CBI industrial trends survey & export goods volumes

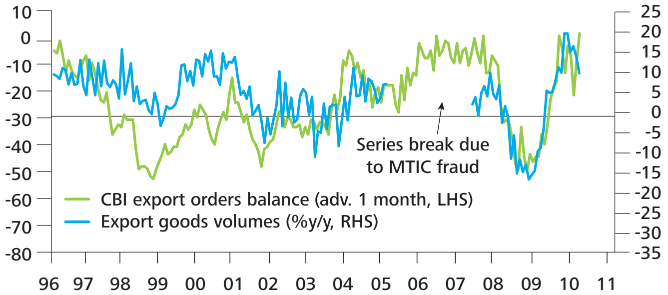


Chart 15. Real GDP growth

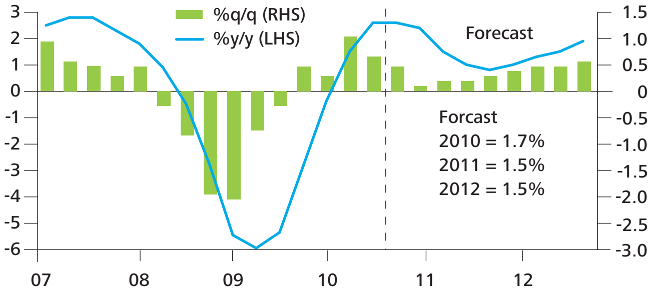
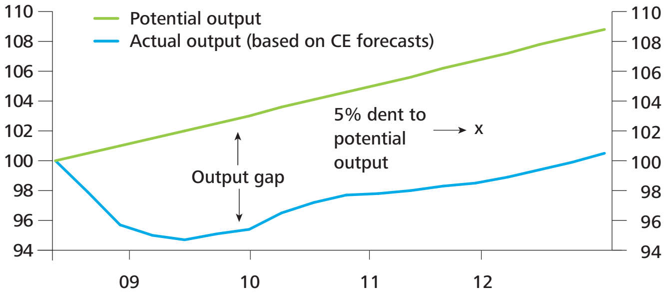


Chart 16. Output gap (100 = Q3 2008)



Sources – Thomson Datastream, CBI, Bootle

Analysis: UK inflation

Inflation still proving stubborn

- UK inflation has remained undesirably high in relation both to its own target and to inflation in other countries. But there are still good reasons to expect it to fall back over the medium term.

- As Chart 1 shows, having risen sharply at the end of 2009, the various measures of UK consumer price inflation have held up stubbornly over the last year or so. CPI inflation has overshot its 2% target in all but nine of the last 54 months.

- Inflation has also been consistently higher than predicted by the Bank of England's Monetary Policy Committee (MPC). (See Chart 2.) This has lead to some concerns that the MPC's anti-inflation credibility is under threat and even some suggestions that it has consciously neglected its inflation-targeting mandate.

- Of course, some of the recent upward pressure has reflected unexpectedly sharp rises in global oil and commodity prices, which have pushed up domestic energy and food prices. (See Chart 3.)

- These forces are likely to remain in place in the early months of 2011. Indeed, food price inflation next year could return to the sort of double digit rates seen back in 2008 unless agricultural commodity prices soon fall back. (See Chart 4.) Meanwhile, domestic energy suppliers have already announced price hikes in response to the rise in wholesale gas prices over recent months and further increases may follow. (See Chart 5.)

- Together, these forces could lift headline inflation towards 4% in the early months of 2011. Still, provided that energy and commodity prices do not carry on rising forever, their effects on UK inflation should prove temporary, as they did in 2008/09.

- More worrying, however, has been the continued stubbornness of core (ex. food and energy) inflation. As Chart 6 shows, this contrasts with similar measures in the US and the euro-zone, which have trended steadily lower over the last two years in response to the disinflationary effects of the recession.

- There are a couple of specific factors which have lifted core inflation in the UK. First, the renewed increase in Value Added Tax (VAT) from the reduced rate of 15% back to 17.5% in January 2010 could have added as much as 1.5% to overall CPI inflation and a similar amount to the core rate. (See Chart 7.) As a result, measures of inflation which mechanically strip out such effects have continued to be much lower. (See Chart 8.)

- In reality, the actual impact on inflation has probably been rather smaller than such measures imply, since some of the VAT rise has probably been absorbed or offset by retailers. Nonetheless, the further hike to 20% in January 2011 will delay the end of the VAT effect on inflation for another 12 months and may even have an additional upward impact if a bigger portion of the latest rise is passed on by retailers.

Chart 1. UK inflation measures (%)

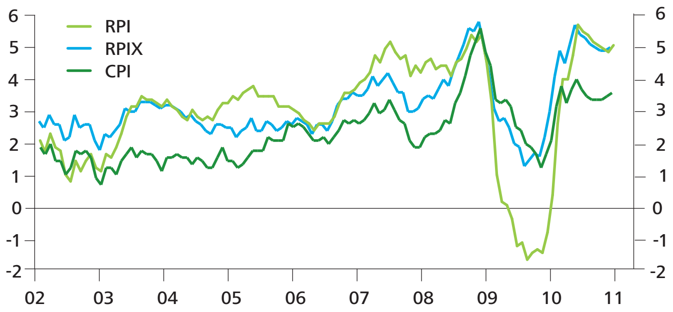


Chart 2. Inflation out-turns vs MPC forecasts (%, rolling 12m cumulative total)

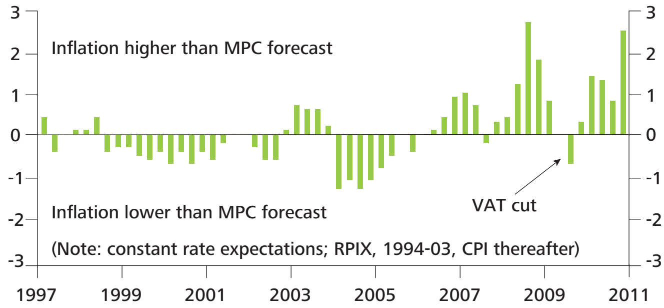


Chart 3. Contributions to inflation (% points)

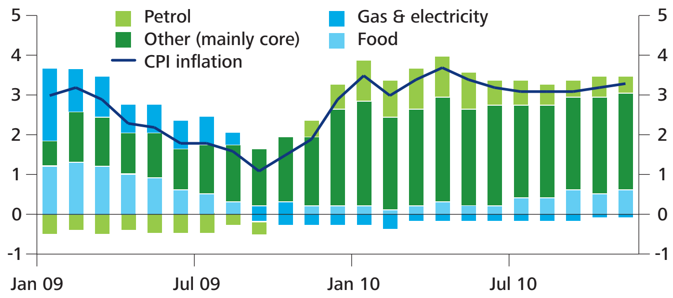


Chart 4. Ag. commodity prices & CPI food inf. (%)

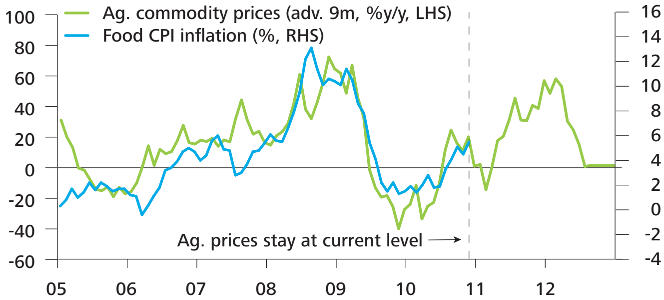


Chart 5. Wholesale gas prices & gas cont. to CPI

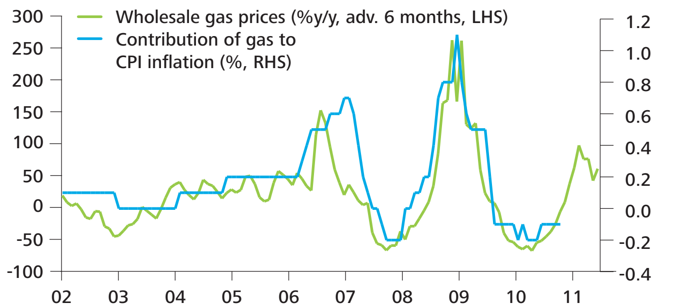


Chart 6. International core CPI inflation (%)

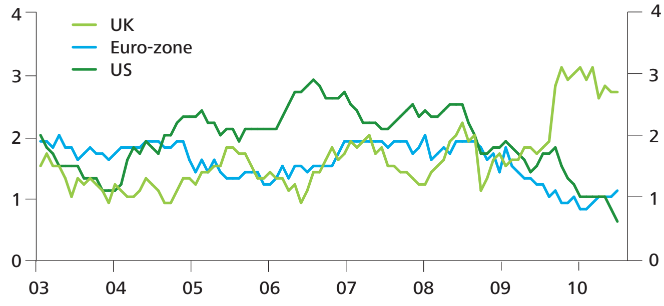


Chart 7. VAT effects on inflation (%)

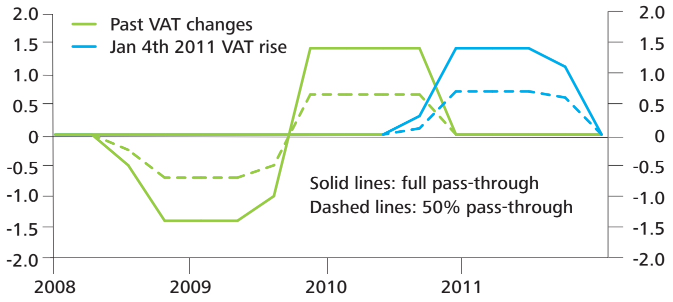
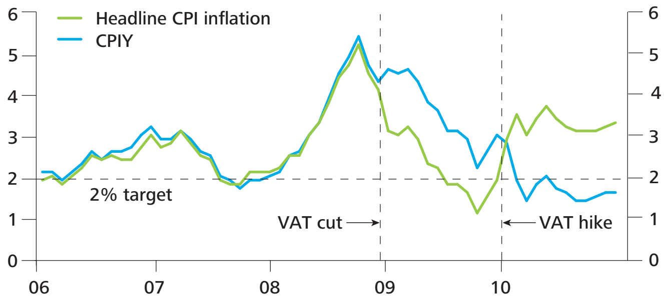


Chart 8. CPI & CPIY inflation (%y/y)



Sources – Thomson Datastream, Bloomberg, Bank of England

Analysis: UK inflation
Upward forces will fade in time

- The second identifiable force likely to have contributed to the stubbornness of UK inflation is the effect of sterling's 25% trade-weighted depreciation back in 2007 and 2008.

- As Chart 9 shows, the bulk of the direct impact on import prices came through back in 2008 and 2009. However, it takes time for changes in imported goods prices to be fully reflected in CPI inflation. And it takes even longer for variations in imported raw materials prices to work their way along the production pipeline.

- Nonetheless, Charts 10 and 11 show that, given the normal lags, the impact of previous rises in import prices and producer prices should be fading by now. And yet this process has so far been limited.

- It is possible that it has simply been interrupted by temporary developments such as retailers raising prices in advance of the VAT hike. Alternatively, though, it might suggest that retailers and suppliers are taking advantage of an increase in their pricing power in order to widen their profit margins. This, in turn, might be an indication that there is rather less spare capacity or slack in the economy than has generally been thought – or that a given amount of spare capacity has a smaller downward influence on inflation.

- One factor which might support this more pessimistic interpretation is the continued stubbornness of inflation in the services sector, which Chart 12 shows has also been above equivalent measures in other countries. This is less readily explained by VAT or the pound.

- But we find it hard to believe that the deepest recession for decades will have no disinflationary effects at all. Chart 13 shows that marked variations in spare capacity in previous cycles have had clearly observable effects on core inflation, albeit it after lags.

- Indeed, one part of the economy in which spare capacity already is bearing down on prices is the labour market. The combination of weak wage growth and the recent pick-up in productivity growth has prompted a sharp slowdown in the growth of unit labour costs. As Chart 14 shows, this should help to bring core inflation down before too long.

- Meanwhile, although we never put too much emphasis on the near-term link between inflation and money growth, we can at least dismiss concerns that increases in the latter caused by the Bank of England's quantitative easing programme are forcing inflation higher. As Chart 15 shows, what link there is between broad money and inflation points to a sharp fall in the latter.

- Overall, then, inflation is set to remain well above its 2% target throughout most of 2011, perhaps prompting further worries over the MPC's anti-inflation credibility. But provided that inflation expectations and wage growth remain contained, VAT and sterling effects should fade in 2012, allowing more fundamental downward pressures to come to the fore and eventually bring inflation back to its target and probably well below it. (See Chart 16 and *Forecast Table: Inflation* on page 36.)

Chart 9. Sterling & import prices (%y/y)

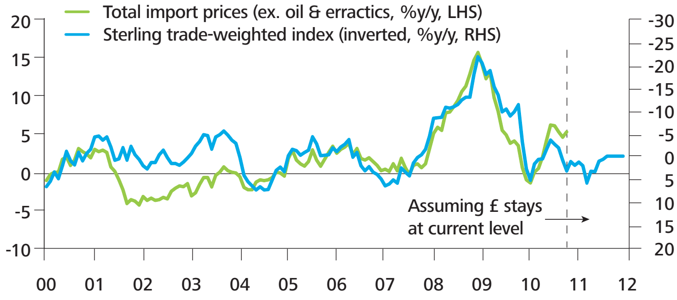


Chart 10. Import prices & core goods CPI inflation (%)

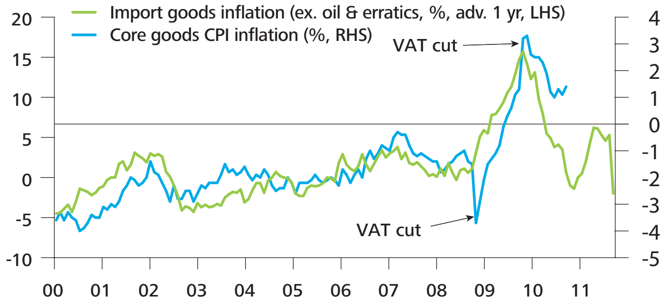


Chart 11. Core PPI & CPI goods inflation (%)

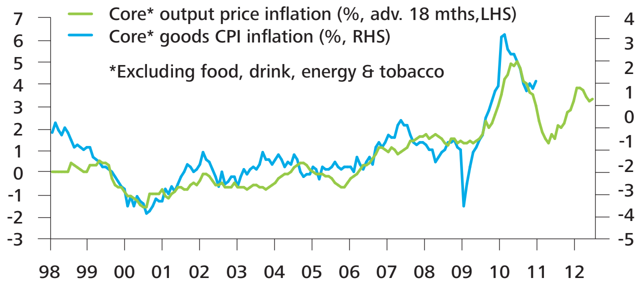


Chart 12. International services inflation (%)

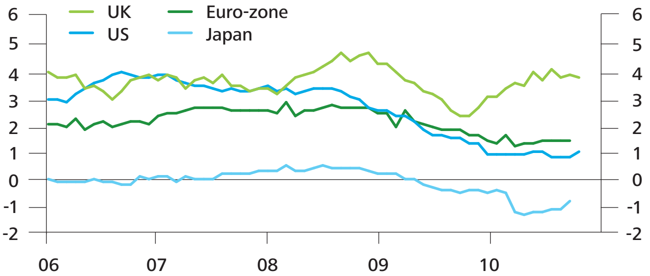


Chart 13. Core CPI inflation & output gap estimates

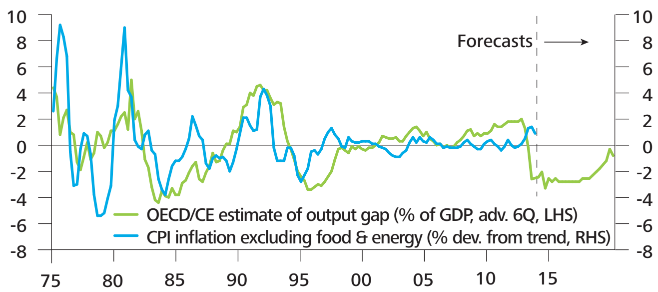


Chart 14. Core CPI inflation & unit wage costs

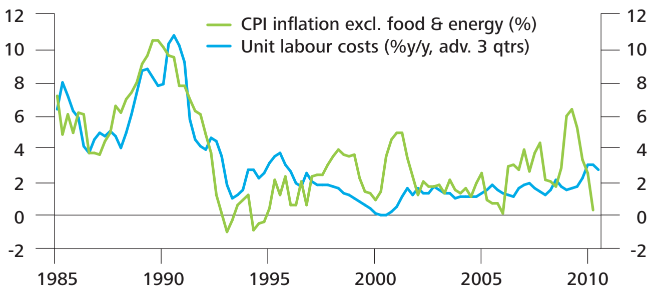


Chart 15. Broad money growth & CPI inflation

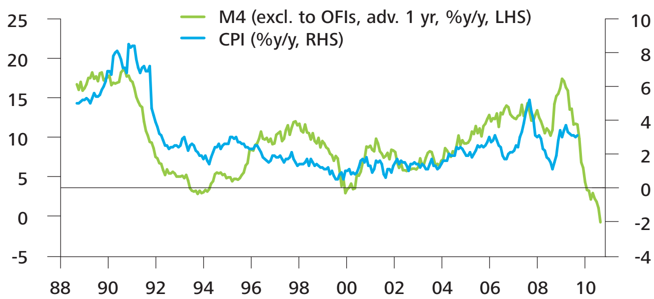
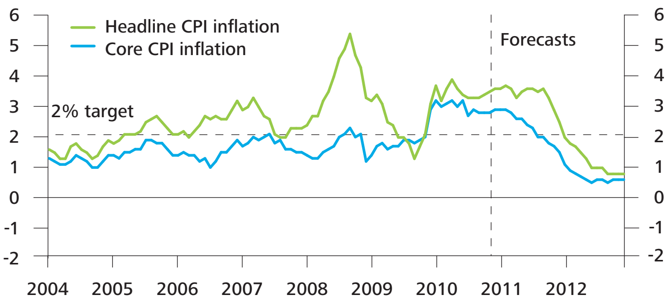


Chart 16. CPI inflation forecasts (%)



Sources – Thomson Datastream, Citigroup/YouGov, OECD

Analysis: UK labour market
Unemployment to rise in 2011

- The labour market recovery has, on the whole, remained strong. That said, there are tentative signs that it is losing pace and we still expect unemployment to rise further once the public sector job cuts gather pace.

- Employment on the timeliest Labour Force Survey measure is now about 260,000 or almost 1% higher than at the start of 2010.

- However, the quarterly Workforce Jobs measure has barely risen. (See Chart 1.) This might mean the LFS measure has been boosted by people doing just a few hours of casual work each week. Indeed, even on the LFS measure, full-time employment growth has been sluggish. (See Chart 2.)

- What's more, the rise in employment has been broadly matched by a rise in the number of people seeking work – meaning that the level of *unemployment* has barely budged.

- The key issue remains whether the private sector will be able to generate enough jobs to keep employment growing as public sector job losses mount. Although the Government has slightly scaled down its plans for departmental spending cuts, we still expect at least 100,000 job cuts a year for the next five years.

- At least some of the forward-looking employment surveys suggest that employment will continue to rise at an annual rate of 1% or so in the near-term. (See Chart 3.)

- But other surveys have weakened. (See Chart 4.) Meanwhile, we still think that there is scope for firms to increase their output using their existing workforces. And we estimate that about 500,000 private sector jobs are at risk from cuts in government spending on procurement of goods and services.

- Accordingly, we still think that the public sector job cuts could be accompanied by renewed job losses in the private sector. We continue to expect unemployment to get to about three million, perhaps by the end of 2012. (See Chart 5 and *Forecast Table: Labour market* on page 37.)

- At the very least, unemployment is unlikely to *fall*, meaning that the large amount of slack in the labour market will continue to put downward pressure on wages. Adding together the unemployed, people who are not actively looking for work but would like a job, and part-time workers who want full-time work, there are some 6m people who aren't working as much as they would like. (See Chart 6.)

- This slack in the labour market is already being reflected in very weak rates of pay growth of 2% or so. We expect this to continue. (See Chart 7.) Pay growth could even slow once the public sector pay freeze starts in 2011. And with inflation likely to remain high in the near-term, pay will continue to fall in real terms, squeezing consumers' spending power.

- Unit labour costs are already barely rising and should soon start to fall. (See Chart 8.) This should help to bring down inflation in the labour-intensive services sector, in particular. (See *Analysis: Inflation*, pages 24-27.)

Chart 1. Employment (mns)

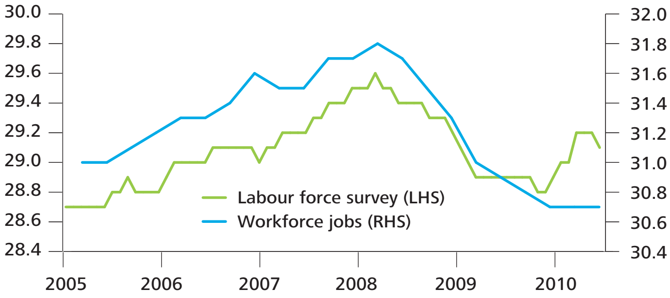


Chart 2. LFS employment (000s, q/q)

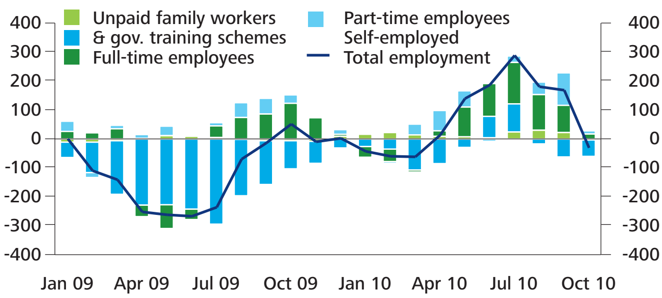


Chart 3. Employment growth & employment intentions

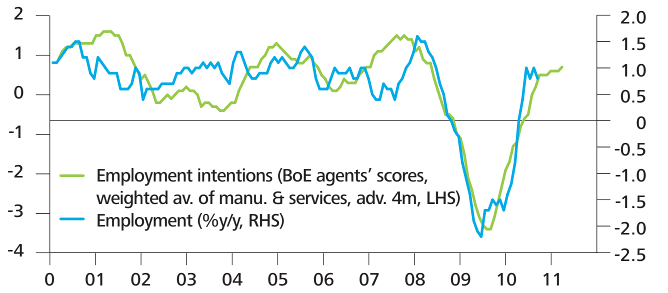


Chart 4. Employment growth & permanent staff placements

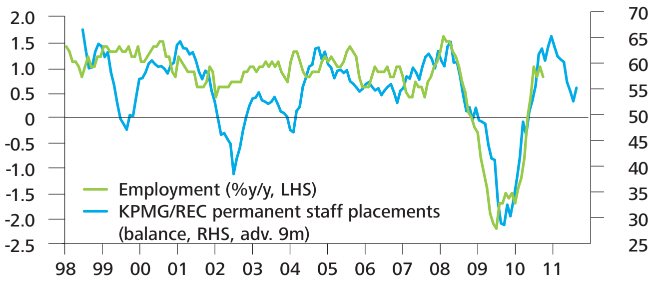


Chart 5. ILO unemployment (mns)

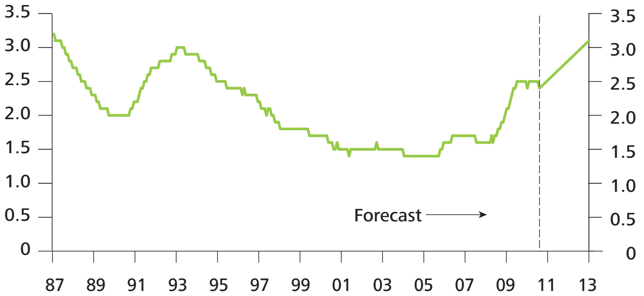


Chart 6. Unemployed & all under-employed (mns)

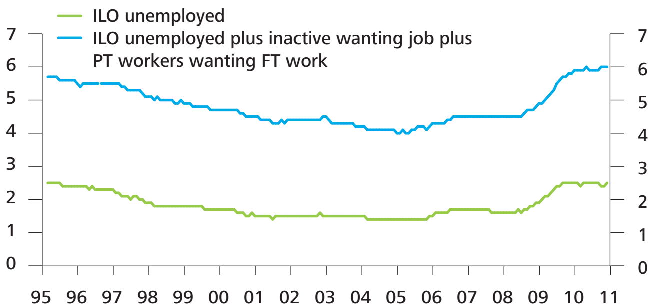


Chart 7. Average earnings (incl. bonuses, 3m av. of %y/y)

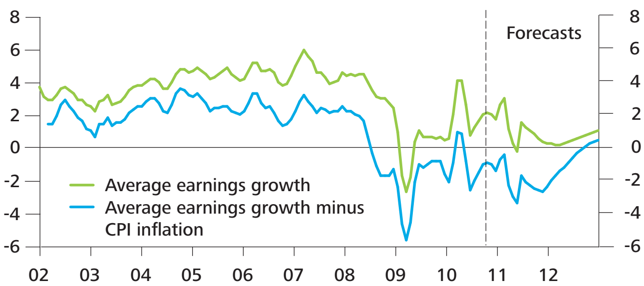
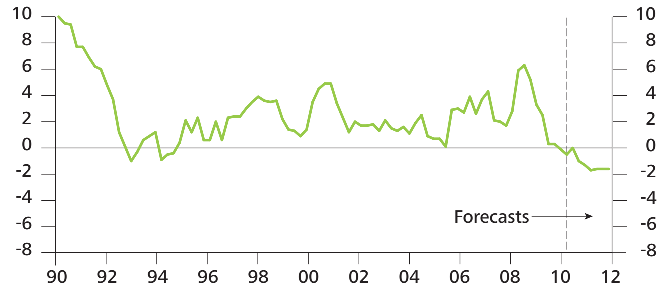


Chart 8. Productivity & unit wage costs (%y/y)



Source – Thomson Datastream, Bootle

Analysis: UK monetary policy
QE2 still likely in 2011

- We doubt that rising inflation will panic the Monetary Policy Committee (MPC) into raising interest rates in 2011. In fact, we still think that more quantitative easing (QE) is likely to offset the effects of the fiscal squeeze.

- The MPC continues to argue that the high rates of inflation are due to temporary factors which should ease in time. Most Committee members still believe that there is a significant amount of spare capacity in the economy and that a persistent inflation problem is unlikely when pay and broad money growth are so weak

- Accordingly, the MPC still seems genuinely to believe that inflation will fall back to target further ahead. (See Chart 1.) There is certainly little evidence to support theories that the MPC is *deliberately* letting inflation rise in order, in part, to reduce the government's debt burden.

- Admittedly, the Committee concedes that the continued overshoot of the inflation target might cause inflation expectations to rise. Some commentators are already claiming that the Bank has lost its anti-inflation credibility.

- But although households' short-run inflation expectations have risen, longer-run expectations have been relatively stable. (See Chart 2.) Bond market break-even inflation rates remain contained too. (See Chart 3.)

- Meanwhile, the economic recovery does not yet look strong enough to justify tighter monetary policy. The CIPS/Markit surveys are at a level consistent in the past with interest rate staying on hold. (See Chart 4.) We think that the markets are premature in expecting interest rates to rise next year. (See Chart 5.)

- In fact, we still think that more policy stimulus will be needed to counteract the effects of the fiscal squeeze. The MPC, in our opinion, is still too optimistic about the ability of the economy to weather the fiscal tightening. The MPC expects GDP growth in 2011 of 2.6%, while we expect just 1.0%. (See Chart 6.)

- Indeed, one member, Adam Posen is already voting for more QE, while other members have sounded open to the idea of doing more if it looks necessary. Admittedly, the economic recovery would have to collapse quickly for our long-held forecast of an additional £50bn of asset purchases in February to prove right. But we still think that additional asset purchases could come in the first half of 2011.

- The initial purchases will probably take the form of more government bonds. The MPC will probably aim to narrow the gap that has opened up between gilt yields and riskless interest rates. (See Chart 7.) But the Committee might also do more to stimulate bank lending, such as buying loan-backed securities.

- We still think that the outlook for gilts remains favourable. Interest rates should stay low for a long time, the MPC could buy more gilts, growth is set to slow and inflation worries should ease in time. Gilt yields may rise in the near-term as inflation rises further. But we expect ten year yields to end 2011 at below 3%. (See Chart 8 and *Forecast Table: Monetary*, page 38.)

Chart 1. CPI inflation (%)

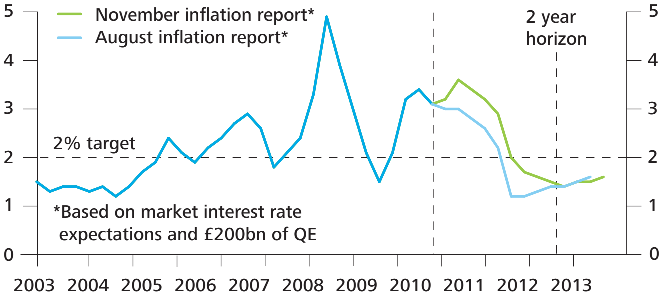


Chart 2. Household's inflation expections (%)

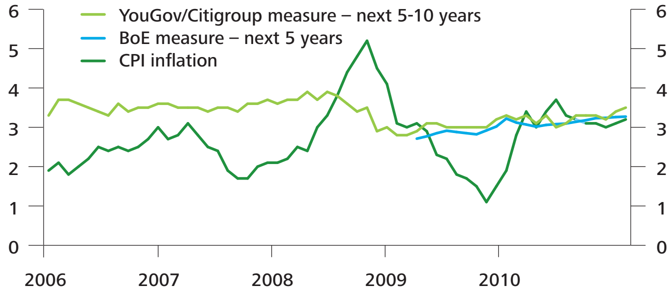


Chart 3. Break-even inflation rates (%)

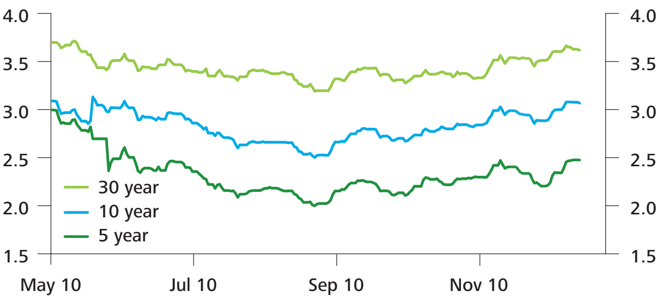


Chart 4. CIPS/Markit surveys & official interest rates

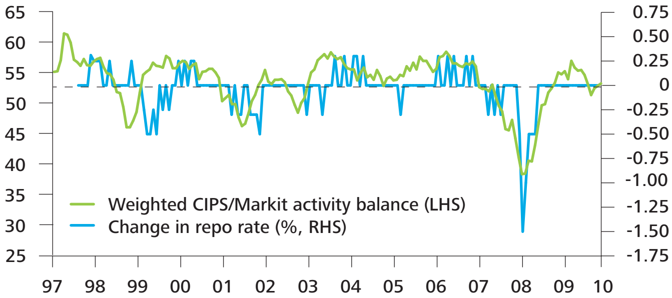


Chart 5. Market expectations for official interest rates (%)

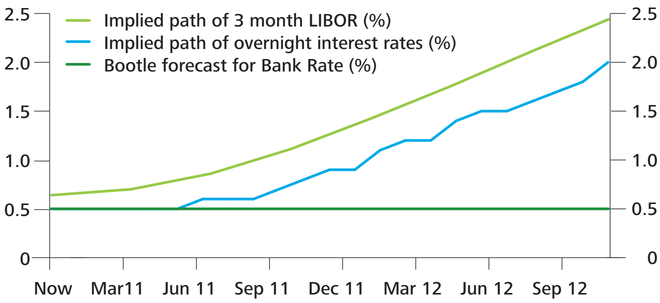


Chart 6. Real GDP (%y/y)

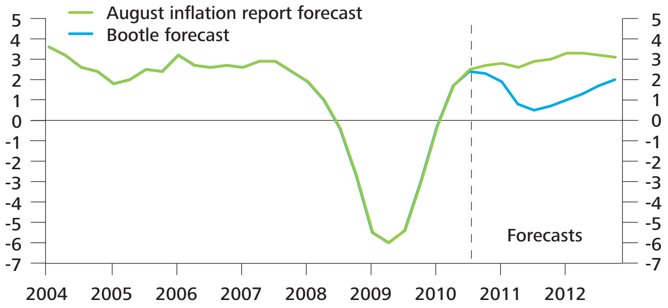


Chart 7. 10 year gilt yield over 10 year OIS rate (bps)

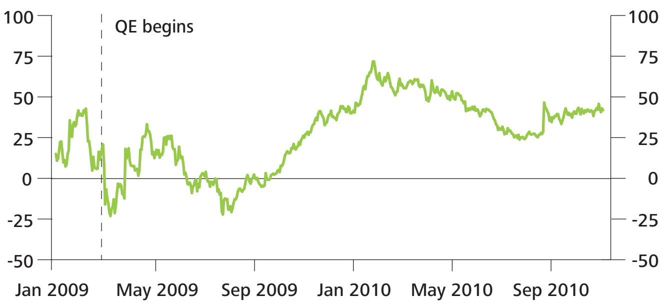
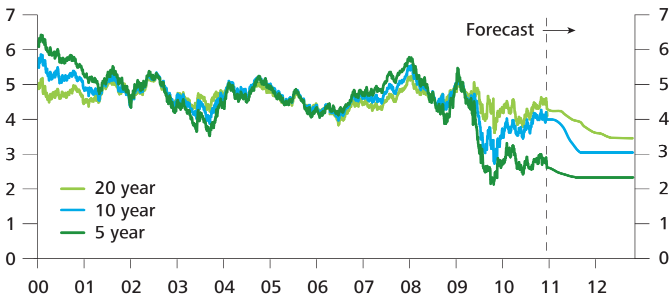


Chart 8. Bond yields (%)



Sources – Thomson Datastream, Bloomberg, Bank of England, Bootle

Analysis: UK public finances
Fiscal prospects still far from rosy

- The uncertain outlook for the economy and doubts over the achievability of the Government's spending plans leave plenty of clouds on the fiscal horizon.

- The public finances have shown disappointingly little improvement in response to the recovery in the broader economy. As Chart 1 shows, public sector net borrowing (PSNB) has broadly followed last year's path. On this trend, it will overshoot the Office for Budget Responsibility's latest forecast of £148.5bn in 2010-11 by about £7bn.

- Admittedly, the growth of tax receipts has accelerated in response to the pick-up in GDP growth and the tax increases already implemented. (See Chart 2.) Corporation tax revenues have rebounded particularly strongly, though they remain erratic. (See Chart 3.) However, this has so far been offset by stronger growth in public spending, both current and investment.

- This adds to existing doubts over whether the Government will actually be able to achieve the highly ambitious spending cuts set out in its fiscal plans. As Chart 4 shows, while investment will see particularly savage cuts, current spending is also projected to fall in real terms over the next five years.

- And while November's Spending Review shifted some of the burden onto bigger cuts in welfare spending, spending on core public services still faces the biggest sustained squeeze since the Second World War.

- Meanwhile, the economic assumptions upon which the fiscal plans are based continue to look optimistic. The OBR has nudged down its assumption for economic growth next year but it still expects a reasonably solid expansion of 2.1% in 2011 and 2.6% in 2012. As Chart 5 shows, forward-looking activity indicators like the CIPS surveys are already pointing to rather softer growth, even before the fiscal squeeze kicks in.

- All of this suggests that, without additional policy measures, the budget deficit is likely to fall rather less quickly than the OBR has predicted. (See Chart 6.)

- Admittedly, the Government's main fiscal mandate – to return the *cyclically adjusted* current budget to balance over the next five years – allows for some adverse impact on the public finances from a weaker economy, as well as some flexibility to boost investment spending. Note too that, on the current plans, the mandate is expected to be met a year early. (See Chart 7.)

- Nonetheless, market pressures and political considerations suggest that the Government is unlikely to scale back its austerity programme too far.

- Even if borrowing falls as expected, the high starting point and a heavy redemption schedule mean that gilt issuance will remain at very high levels over the next few years. (See Chart 8. and *Forecast Table: Public Finances*, page 39.)

Chart 1. Public sector net borrowing (£bn)

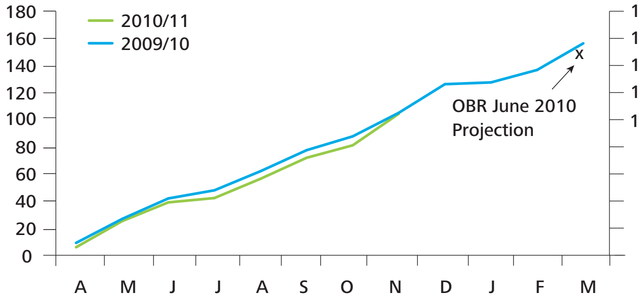


Chart 2. GDP growth & tax receipts (%y/y)

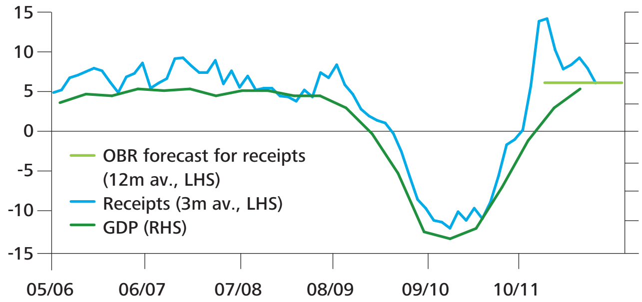


Chart 3. Central government tax receipts (%y/y, 3m av.)

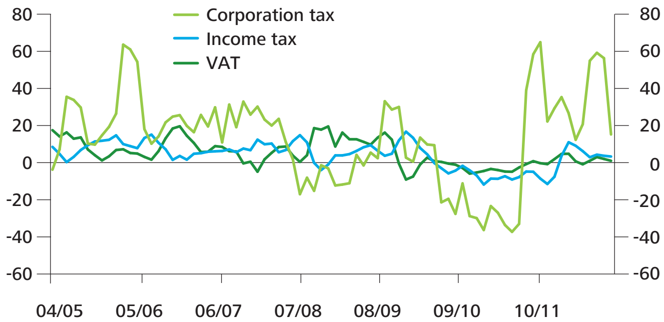


Chart 4. Real public spending (£bn)

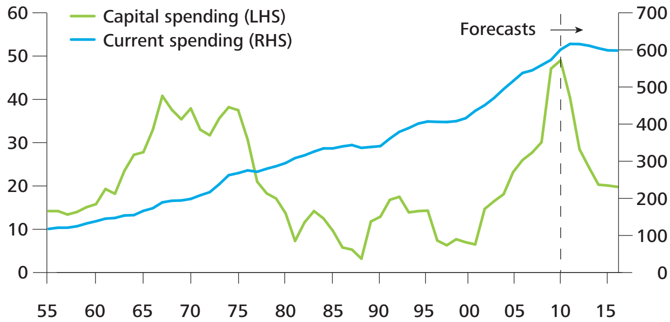


Chart 5. CIPS activity index & GDP growth

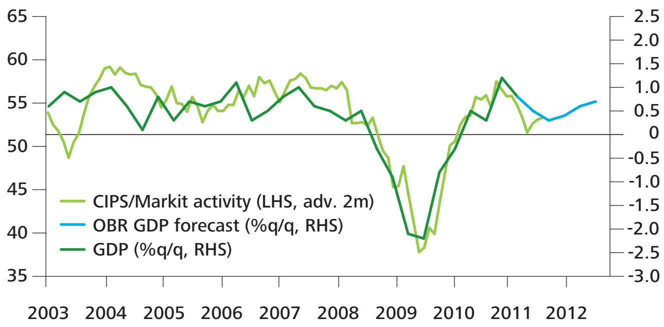


Chart 6. Public sector net borrowing (£bn)

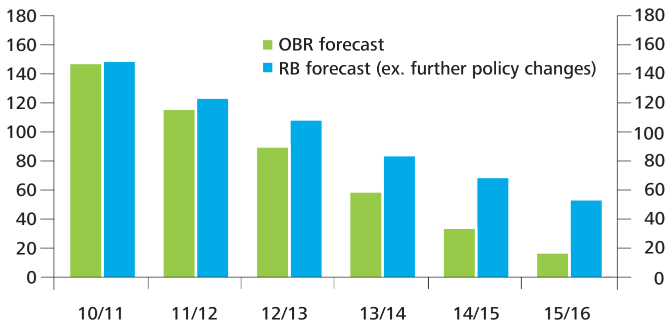


Chart 7. Cyclically adjusted current budget (% GDP)

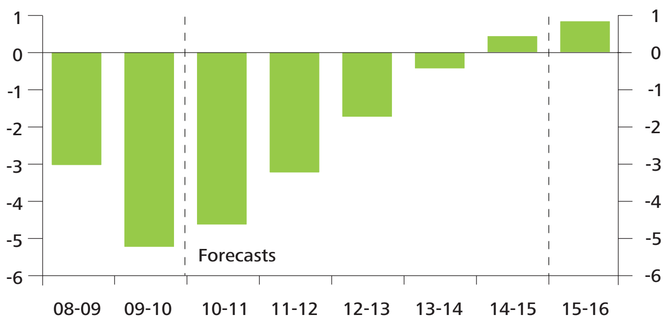
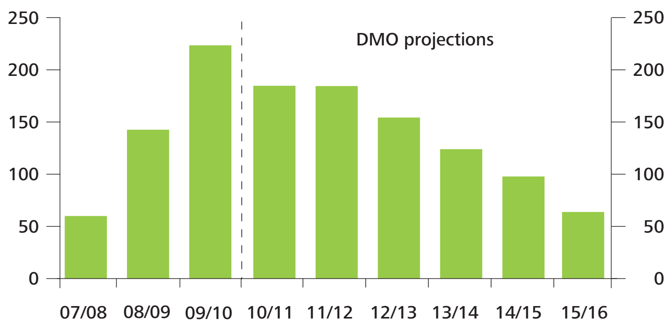


Chart 8. Gross gilt issuance (£bn)



Sources – Thomson Datastream, HMT/OBR, CIPS Markit

Analysis: External sector
Net trade boost still in doubt

- There have been some tentative signs that the long-awaited net trade boost to the recovery might finally be coming through. But we doubt that the external sector will be able to prevent the economy from slowing in 2011.

- Admittedly, net trade has continued to drag on GDP growth recently, calling into question whether the lower pound really has provided much support to the economy. (See Chart 1.)

- Nevertheless, there are still reasons to think that exports could support the recovery. Export volumes rose by 1.5% q/q in Q3. Meanwhile, the export orders balance of the CBI's Industrial Trends Survey rose to its highest level in over 15 years in December. As Chart 2 shows, the balance is consistent with faster rates of export growth in the months ahead.

- As a result, there still seems to be a fair chance that exports grow at a pace not dissimilar to the 8-9% annual rates seen in the mid-1990s.

- Nonetheless, there are still three key risks ahead which may prevent the net trade boost from being as large as back then. First, there is a risk that sterling appreciates sharply soon. The persistence of above-target inflation in 2011 may see rate expectations rise in the UK vis-a-vis other economies, even if official rates remain on hold. Fiscal concerns also look set to linger in the euro-zone, which may push the euro down further against the pound.

- Second, the euro-zone recovery looks set to fade sharply in the second half of 2011 as austerity measures – particularly in the periphery – start to bite. Around 14% of UK exports go to the weak euro-zone periphery – exceeding the 9% that go to Germany, where the economic outlook is less bleak.

- As a result, even decent growth in the US – the UK's largest single export market – in 2011 may not be enough to prevent exports growth from slowing later on. (See Chart 4.)

- At least the likely slowdown in the growth of domestic demand suggests that import growth should slow sharply soon. (See Chart 5.) That said, the third risk is that consumers keep spending on the high street and cut back on services, or run down their savings – developments that could support imports. A stronger pound may also cut import prices.

- As a result, while our main forecast is for the overall trade deficit to narrow from around £47bn in 2010 to £33bn in 2012, we would certainly not be surprised if the deficit narrowed at a slower pace. (See Chart 6.)

- Quite what might happen to the overall current account is clouded by the investment income balance, which is volatile and can be revised significantly. Our working assumption is that the surplus will shrink as the stronger pound reduces the sterling value of income flowing into the UK. (See Chart 7.)

- All in all then, we have penciled in a modest narrowing of the current account deficit from around £33bn in 2010 to £25bn in 2012. (See Chart 8 and *Forecast Table: External Sector*, page 40.)

Chart 1. Net trade contrib. to quarterly GDP growth (%)

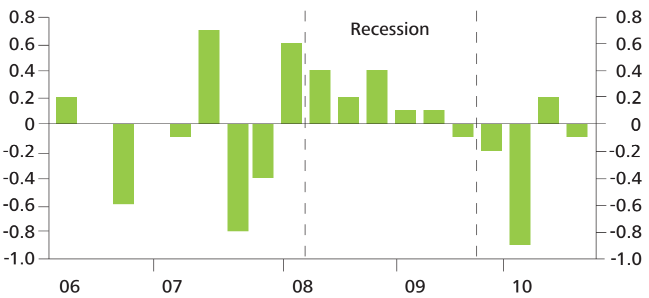


Chart 2. CBI export orders balance & exports volumes

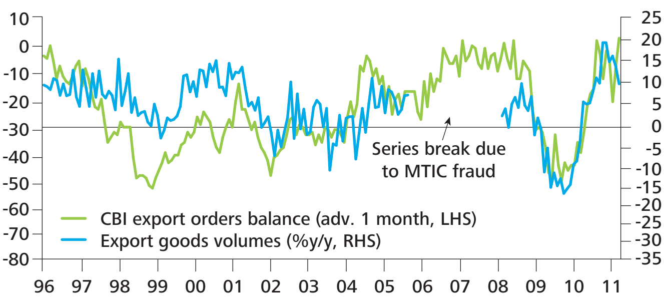


Chart 3. UK exports of goods & services to selected destinations (as a % of total)

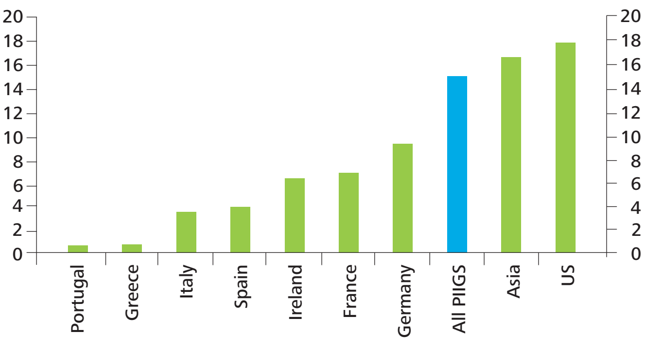


Chart 4. UK exports & GDP growth forecasts

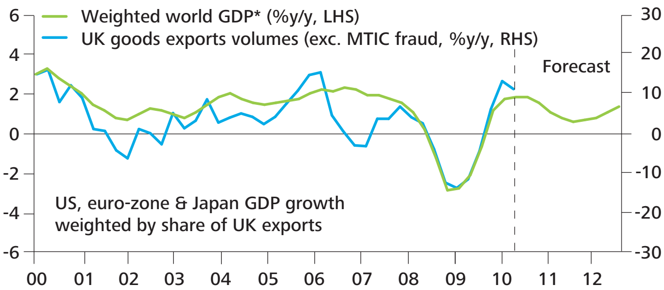


Chart 5. UK domestic demand & import goods volumes

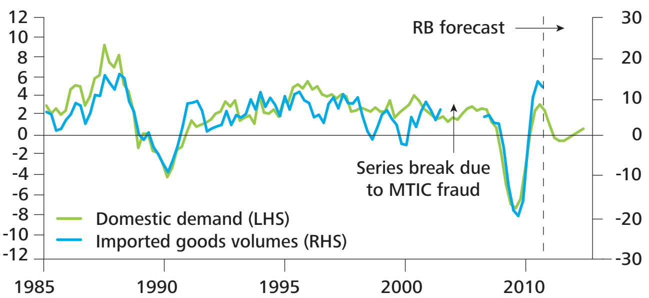


Chart 6. Trade in goods and services balance

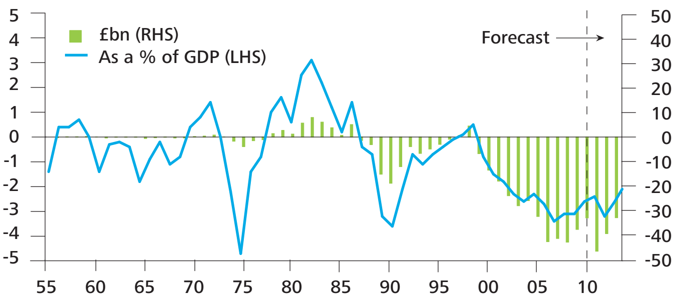


Chart 7. UK investment income balance

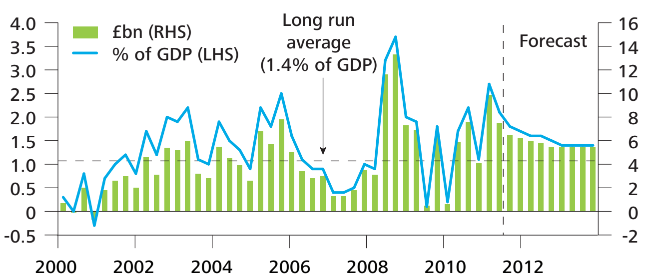
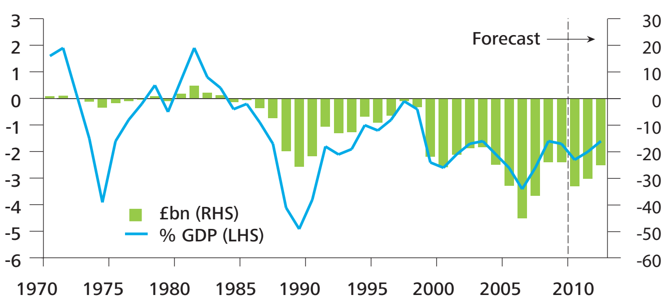


Chart 8. Current account balance



Sources – Thomson Datastream & Bootle

Forecast table: UK inflation

	Monthly Effect on Index								Annual Rate			
		Other Items										
	s.a. Core	Rent	Alc & Tobac.	Energy	Food	Seas Eff.	Total Change	Level of the CPI Index	All CPI	CPI Core[1]	RPI	RPIX
2010												
Jan	0.4			0.1		-0.8	-0.2	112.4	3.5	3.1	3.7	4.6
Feb	0.2				0.1	0.2	0.4	112.9	3.0	2.9	3.7	4.2
Mar	0.1			0.1		0.3	0.5	113.5	3.4	3.0	4.4	4.8
Apr	0.3			0.2		0.1	0.6	114.2	3.7	3.1	5.3	5.4
May	0.0			0.0		0.2	0.2	114.4	3.4	2.9	5.1	5.1
Jun	0.2			-0.1		0.2	0.2	114.6	3.2	3.1	5.0	5.0
Jul	-0.2				0.1	-0.2	-0.3	114.3	3.1	2.6	4.8	4.8
Aug	0.2					0.4	0.5	114.9	3.1	2.8	4.7	4.7
Sep	0.1					-0.1		114.9	3.1	2.7	4.6	4.6
Oct	0.2			0.1	0.1	-0.1	0.3	115.2	3.2	2.7	4.5	4.6
Nov	0.2			0.1	0.2	0.0	0.3	115.6	3.3	2.7	4.7	4.7
Dec	0.3			0.2	0.1	0.3	0.7	116.5	3.4	2.8	3.7	4.8
2011												
Jan	0.4			0.1	0.1	-0.8	-0.2	116.3	3.4	2.8	3.5	4.7
Feb	0.2				0.1	0.2	0.5	116.8	3.5	2.8	3.5	4.7
Mar	0.1				0.1	0.3	0.4	117.3	3.4	2.7	3.4	4.6
Apr	0.1				0.1	0.1	0.4	117.7	3.1	2.5	3.2	4.3
May					0.1	0.2	0.3	118.1	3.3	2.5	3.4	4.4
Jun					0.2	0.1	0.3	118.5	3.4	2.3	3.5	4.5
Jul	-0.3				0.1	-0.2	-0.2	118.2	3.4	2.2	3.5	4.5
Aug					0.1	0.3	0.4	118.7	3.3	1.9	3.3	4.3
Sep	0.1				0.1	-0.1	0.1	118.8	3.4	1.9	3.3	4.3
Oct						-0.1	0.0	118.8	3.1	1.7	3.0	4.0
Nov						0.0	0.0	118.8	2.7	1.6	2.7	3.7
Dec						0.3	0.3	119.1	2.3	1.4	2.3	3.2
2012						-0.8	-0.6	118.4	1.8	1.0	1.8	2.7
Jan						-0.8	-0.6	118.4	1.8	1.0	1.8	2.7
Feb					0.1	0.2	0.3	118.7	1.6	0.8	1.6	2.5
Mar						0.3	0.3	119.1	1.5	0.7	1.5	2.4
Apr	-0.1					0.1	0.2	119.3	1.3	0.6	1.3	2.2
May	-0.1					0.2	0.1	119.4	1.1	0.5	1.2	2.1
Jun	-0.1					0.1	0.1	119.5	0.8	0.4	1.0	1.9
Jul	-0.1					-0.2	-0.3	119.2	0.8	0.5	1.0	1.9
Aug						0.3	0.3	119.6	0.8	0.5	1.0	1.9
Sep						-0.1	0.0	119.5	0.6	0.4	1.1	2.0
Oct						-0.1	0.0	119.5	0.6	0.5	1.2	2.0
Nov						0.0	0.0	119.5	0.6	0.5	1.1	2.0
Dec						0.3	0.3	119.9	0.6	0.5	1.1	2.0

1 Excludes energy, food, alcohol & tobacco.

Forecast table: UK labour market

Activity

	Workforce		ILO/Labour Force Survey Employment		ILO Unemployment		Claimant Count Unemployment	
	Millions	%y/y	Millions	%y/y	Millions	%	Millions	%
2009	31.4	0.6	29.0	-1.5	2.4	7.6	1.5	4.9
2010f	31.5	0.4	29.0	0.0	2.5	7.9	1.5	4.8
2011f	31.7	0.6	29.0	-0.2	2.7	8.6	1.7	5.3
2012f	31.7	0.0	28.8	-0.8	3.0	9.4	1.9	5.9
Q1 2010	31.3	-0.1	28.8	-1.4	2.5	7.9	1.6	5.0
Q2	31.4	0.3	29.0	-0.1	2.5	7.8	1.5	4.7
Q3	31.6	0.6	29.2	1.0	2.5	7.8	1.5	4.7
Q4	31.6	0.1	29.1	0.8	2.5	8.0	1.5	4.8
Q1 2011	31.7	0.1	29.1	0.8	2.6	8.3	1.6	5.1
Q2	31.7	0.1	29.0	0.0	2.7	8.6	1.7	5.3
Q3	31.7	0.0	29.0	-0.8	2.8	8.7	1.7	5.4
Q4	31.7	0.0	28.9	-0.8	2.8	8.9	1.8	5.6
Q1 2012	31.7	0.0	28.8	-0.8	2.9	9.1	1.8	5.7
Q2	31.7	0.0	28.8	-0.8	2.9	9.3	1.8	5.8
Q3	31.7	0.0	28.7	-0.8	3.0	9.5	1.9	6.0
Q4	31.7	0.0	28.7	-0.8	3.1	9.7	1.9	6.1

Earnings & costs

	Average earnings		Real av. earnings (Incl. bonuses, %y/y)			
	Incl. bonuses %y/y	Excl. bonuses %y/y	Deflated by RPI inflation	Deflated by CPI inflation	Productivity %y/y	Unit labour costs %y/y
2009	-0.1	1.7	0.5	-2.3	-3.2	5.2
2010f	2.2	1.9	-2.3	-1.0	1.5	0.7
2011f	1.0	1.0	-2.2	-2.2	1.7	-0.7
2012f	0.7	0.5	-0.6	-0.3	2.3	-1.0
Q1 2010	4.2	1.8	0.3	1.0	1.1	2.5
Q2	0.8	1.3	-4.3	-2.6	1.3	0.3
Q3	2.1	2.2	-2.6	-1.0	1.7	0.3
Q4	1.8	2.3	-2.5	-1.4	1.9	-0.1
Q1 2011	1.2	1.7	-2.3	-2.3	1.7	-0.5
Q2	1.6	1.5	-1.8	-1.7	1.6	0.0
Q3	0.9	0.6	-2.5	-2.5	1.9	-1.0
Q4	0.3	0.2	-2.4	-2.4	1.7	-1.3
Q1 2012	0.2	0.0	-1.4	-1.4	1.9	-1.7
Q2	0.5	0.3	-0.6	-0.6	2.2	-1.6
Q3	0.8	0.6	-0.2	0.1	2.5	-1.6
Q4	1.1	0.9	0.0	0.5	2.8	-1.6

Forecast table: UK monetary

Interest rates & bond yields (end period)	Repo rate %	10-year gilts %	20-year gilts %	US Fed Funds rate %	US Fed Funds rate UK-US	Euro-zone Refi rate %	Euro-zone Refi rate UK-Euro-zone
2009	0.50	4.12	4.41	0.25	0.25	1.00	-0.50
2010f	0.50	3.75	4.20	0.25	0.25	1.00	-0.50
2011f	0.50	2.75	3.50	0.25	0.25	1.00	-0.50
2012f	0.50	2.75	3.50	0.25	0.25	1.00	-0.50
Q1 2010	0.50	3.94	4.39	0.25	0.25	1.00	-0.50
Q2	0.50	3.31	4.01	0.25	0.25	1.00	-0.50
Q3	0.50	2.89	3.62	0.25	0.25	1.00	-0.50
Q4	0.50	3.75	4.20	0.25	0.25	1.00	-0.50
Q1 2011	0.50	3.75	4.20	0.25	0.25	1.00	-0.50
Q2	0.50	3.75	4.20	0.25	0.25	1.00	-0.50
Q3	0.50	3.25	3.70	0.25	0.25	1.00	-0.50
Q4	0.50	2.75	3.50	0.25	0.25	1.00	-0.50
Q1 2012	0.50	2.75	3.50	0.25	0.25	1.00	-0.50
Q2	0.50	2.75	3.50	0.25	0.25	1.00	-0.50
Q3	0.50	2.75	3.50	0.25	0.25	1.00	-0.50
Q4	0.50	2.75	3.50	0.25	0.25	1.00	-0.50

Sterling exchange rates (end period) Sterling versus...	$	¥	Euro	Euro[1]	ERI[2]
2009	1.62	147	0.89	1.13	80.8
2010f	1.55	132	0.84	1.19	81.3
2011f	1.40	126	0.79	1.27	82.0
2012f	1.40	140	0.71	1.40	87.2
Q1 2010	1.52	140	0.89	1.12	78.2
Q2	1.49	133	0.82	1.22	81.9
Q3	1.57	133	0.87	1.15	79.9
Q4	1.55	132	0.84	1.19	81.3
Q1 2011	1.50	128	0.83	1.20	80.7
Q2	1.45	131	0.83	1.21	80.2
Q3	1.40	126	0.82	1.22	79.7
Q4	1.40	126	0.79	1.27	82.0
Q1 2012	1.40	126	0.71	1.40	87.2
Q2	1.40	133	0.71	1.40	87.2
Q3	1.40	140	0.71	1.40	87.2
Q4	1.40	140	0.71	1.40	87.2

1 Pound per euro. 2 Effective exchange rate index.

Forecast table: UK public finances[1]

Government spending & receipts (£bn)	(1) Current receipts (excluding tax changes)	(2) Revenue effect of tax changes	(3) Current receipts (including tax changes)	(4) Current spending[2]	(5) Current balance	(6) Net investment	(7) = (4) + (6) Total expenditure
Recent history							
06-07	519	n/a	519	525	-5	26	550
07-08	549	n/a	549	554	-5	29	583
08-09	534	n/a	534	584	-50	46	630
09-10	514	n/a	514	620	-107	49	670
HM Treasury forecast							
10-11	550	n/a	550	656	-106	42	698
11-12	586	n/a	586	673	-87	31	704
12-13	620	n/a	620	684	-64	27	711
13-14	659	n/a	659	696	-37	23	719
14-15	698	n/a	698	709	-11	24	733
Bootle forecast							
10-11	552	0	552	655	-103	47	702
11-12	585	5	590	672	-83	37	709
12-13	610	10	620	684	-65	35	719
13-14	639	15	654	700	-46	24	724
14-15	672	20	692	716	-24	26	742

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						
06-07	30.6	2.3	35.4	43.3	36.0	62.5
07-08	34.9	2.5	34.9	43.2	36.5	58.4
08-09	96.1	6.7	162.4	55.8	44.0	147.0
09-10	156.0	11.1	198.8	71.3	53.5	148.0
HM Treasury forecast						
10-11	148.5	10.0	144	77.9	60.8	165
11-12	117.0	7.5	120	82.6	66.3	169
12-13	91.3	5.6	91	84.7	69.1	144
13-14	60.3	3.5	70	84.2	69.7	117
14-15	35.0	1.9	39	82.3	68.8	98
Bootle forecast						
10-11	150	10.1	152	79.3	62.2	165
11-12	120	7.7	122	84.0	67.7	170
12-13	100	6.2	102	87.1	71.5	150
13-14	70	4.2	72	87.0	72.5	125
14-15	50	2.8	52	85.3	71.8	110

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

Forecast table: UK 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
2009	-82.4	-5.9	52.7	3.8	20.6	1.5	-14.7	-1.1	-23.9	-1.7
2010f	-96.0	-6.6	51.4	3.5	28.0	1.9	-16.4	-1.1	-33.0	-2.3
2011f	-98.1	-6.6	58.6	3.9	23.5	1.6	-14.0	-0.9	-30.0	-2.0
2012f	-94.8	-6.1	61.8	4.0	22.0	1.4	-14.0	-0.9	-25.0	-1.6
Q1 2010	-22.2	-6.2	12.7	3.5	4.1	1.1	-4.3	-1.2	-9.8	-2.7
Q2	-22.7	-6.3	11.7	3.2	9.9	2.7	-4.1	-1.1	-5.2	-1.4
Q3	-25.7	-7.0	13.1	3.6	7.5	2.1	-4.5	-1.2	-9.6	-2.6
Q4	-25.3	-6.9	13.9	3.8	6.5	1.8	-3.5	-1.0	-8.5	-2.3
Q1 2011	-24.8	-6.7	14.2	3.8	6.2	1.7	-3.5	-0.9	-7.9	-2.1
Q2	-24.6	-6.6	14.5	3.9	6.0	1.6	-3.5	-0.9	-7.6	-2.0
Q3	-24.3	-6.5	14.8	4.0	5.8	1.6	-3.5	-0.9	-7.2	-1.9
Q4	-24.3	-6.5	15.1	4.0	5.5	1.5	-3.5	-0.9	-7.2	-1.9
Q1 2012	-24.1	-6.3	15.1	3.9	5.5	1.4	-3.5	-0.9	-7.1	-1.8
Q2	-23.8	-6.2	15.3	4.0	5.5	1.4	-3.5	-0.9	-6.5	-1.7
Q3	-23.5	-6.1	15.6	4.0	5.5	1.4	-3.5	-0.9	-6.0	-1.5
Q4	-23.2	-6.0	15.8	4.0	5.5	1.4	-3.5	-0.9	-5.5	-1.4

Exports, imports & prices (£bn)	Goods		Services		Goods & services		Prices[1]	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports %y/y	Imports %y/y
2009	227.6	310.0	163.2	110.6	390.9	420.6	6.2	6.4
2010f	264.2	360.2	163.6	112.3	427.8	472.4	3.0	3.8
2011f	284.2	382.3	168.5	109.9	452.7	492.2	2.0	3.0
2012f	295.7	390.5	174.4	112.7	470.2	503.2	-1.5	-1.5
Q1 2010	62.5	84.7	40.3	27.6	102.7	112.3	1.2	-0.3
Q2	66.0	88.7	40.7	29.0	106.6	117.6	3.7	4.1
Q3	66.2	91.9	41.4	28.3	107.6	120.2	3.4	5.3
Q4	69.6	94.9	41.3	27.4	110.8	122.3	3.7	6.2
Q1 2011	70.3	95.1	41.6	27.5	111.9	122.5	2.0	5.0
Q2	70.8	95.4	42.0	27.5	112.8	122.9	1.9	2.9
Q3	71.3	95.7	42.3	27.5	113.6	123.1	3.1	3.3
Q4	71.9	96.1	42.6	27.5	114.5	123.6	1.0	1.0
Q1 2012	72.6	96.8	43.0	27.9	115.6	124.7	0.1	-0.2
Q2	73.5	97.3	43.4	28.1	116.9	125.4	-1.1	-1.0
Q3	74.4	97.9	43.8	28.3	118.2	126.2	-2.1	-1.9
Q4	75.3	98.5	44.2	28.4	119.4	126.9	-2.8	-2.8

1 Excludes prices of oil and other erratic items.

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