



Economic Review

Can the UK survive the squeeze?

Foreword

John Connolly



John Connolly
Senior Partner & Chief Executive
Deloitte

In this Review, Roger Bootle, Economic Adviser to Deloitte, turns his attention to whether the UK economy can withstand the biggest fiscal squeeze since the Second World War. His main points are as follows:

The fiscal tightening now in motion adds up to some 8% of GDP. It therefore has the potential to do the economy serious damage.

Many take comfort from the so-called “expansionary” fiscal squeezes seen in several other countries, with Canada being the example most often referred to recently. However, the UK does not have the advantages – such as robust overseas demand or scope for sharp falls in interest rates – that these countries relied on during their fiscal contractions.

Accordingly, necessary though it is, the improvement in the public finances will come at the price of a weaker economy in the near-term. With the private sector unlikely to compensate for the drag from the public sector, the recovery is likely to remain sluggish. A double dip recession cannot be ruled out.

But Roger thinks that there is a silver lining. He thinks that the fiscal squeeze will *eventually* do the economy good, by reducing the role of the inefficient public sector.

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

A handwritten signature in black ink that reads "John P. Connolly". The signature is written in a cursive style with a large, looping initial 'J' and a circular flourish at the end.

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This review has been prepared by Roger Bootle,
Economic Adviser to Deloitte.
Tel: 020 7823 5000 Fax: 020 7823 6666
Email: business@capitaleconomics.com
Web: www.capitaleconomics.com

Deloitte, 2 New Street Square
London EC4A 3BZ
Tel: 020 7936 3000 Fax: 020 7583 1198
Web www.deloitte.co.uk

Editor: Katherine Marshall
Tel: 020 7007 3421 Fax: 020 7583 1198
Email: economic.review@deloitte.co.uk

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The UK's biggest fiscal tightening since the Second World War is now underway. Yet with the economic recovery still at an early and fragile stage, can the UK withstand such a sharp squeeze?

Executive summary

Roger Bootle



Roger Bootle
Economic Adviser to Deloitte

- **The fiscal contraction is now well and truly underway. However, we doubt that the conditions are in place for the economy to take such a sharp squeeze in its stride.**
- Admittedly, the fiscal tightening – which adds up to some 8% of GDP by 2015/16 – does not *necessarily* condemn the economy to a period of subdued growth and the risk of a double-dip recession.
- After all, a fiscal tightening can bring about a fall in market interest rates, as well as a boost to consumers' and firms' confidence. Cuts in public spending programmes can create opportunities for the private sector to fill the gap, spurring private sector investment. And strong overseas demand can help net trade to compensate for the drag from the public sector. What's more, other countries have managed to achieve so-called "expansionary" fiscal squeezes.
- **However, the UK currently has very few of the conditions that have generally helped other economies to maintain strong rates of growth throughout their own squeezes.**
- On the plus side, there is at least a consensus that spending cuts, rather than tax rises, should do the bulk of the work in reducing borrowing. But actually achieving the spending cuts is another matter.
- **Meanwhile, with official interest rates and bond yields already very low, there is limited scope for either to drop further.** The MPC could still increase its policy of quantitative easing, but there are question marks over how effective QE has been.
- Meanwhile, a strong net trade boost is looking less promising than a few months ago. About half of the UK's exports go to the euro-zone and we expect growth there next year of just 0.5%. What's more, we doubt that the UK will enjoy the further depreciation in its currency seen during other fiscal squeezes.
- How about the ability of the private sector to spend more? With household incomes under pressure from the fiscal squeeze and little scope for household saving to fall, we doubt that consumers will come to the rescue.
- Business investment has perhaps the brightest prospects. But even if companies start to spend more, investment on its own is unlikely to rise by enough to sustain solid GDP growth.
- The upshot is that the scope for the fiscal squeeze to have big positive effects and/or for the rest of the economy to compensate appears limited. **The squeeze should still put the UK economy on a firmer footing *eventually*, with less of a role played by the relatively inefficient public sector.** But we find it hard to see how it will not hurt in the near-term. We still expect GDP growth of just 1% this year and 1.5% in 2011 and have pencilled in continued sub-par growth of 2% in 2012.
- **Against this backdrop, monetary policy will have to remain exceptionally loose. We think that the first interest rate rise will not come until 2012 or even later.**

Can the UK survive the squeeze?

Lessons from other fiscal tightenings

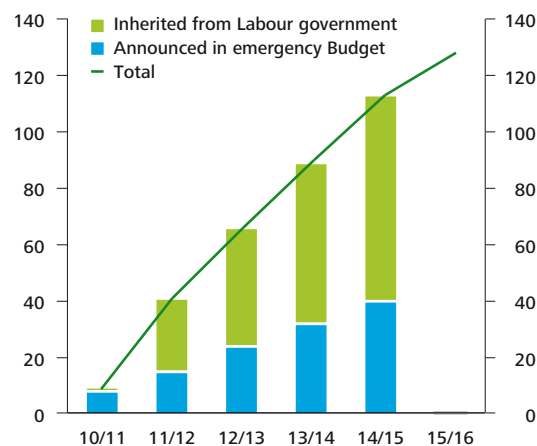
The UK's biggest fiscal tightening since the Second World War is now underway. Yet with the economic recovery still at an early and fragile stage, can the UK withstand such a sharp squeeze?

One way to answer this question is to look at other countries' past fiscal squeezes. How have other economies fared during similarly sized fiscal contractions? What conditions were present in those countries where growth held up well? And are those conditions present in the UK at the moment? **In this Report, we look more closely at whether the fiscal tightening will inevitably undermine the UK's economic recovery.**

The squeeze is upon us

Last month's Budget gave us a bit more clarification on just how bad the squeeze will be under the new coalition government – and it will be bad. Mr Osborne announced an additional fiscal tightening building up to £40bn per annum by 2014/15. Adding this onto the policy inherited from the previous Labour Government, the overall discretionary tightening adds up to some £113bn by 2014/15 and £128bn by 2015/16. (See Chart 1.)

Chart 1. Discretionary policy tightening (cumulative, £bn)



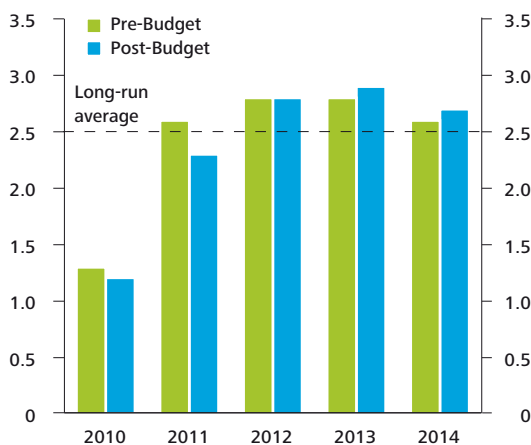
Source – HM Treasury

Equivalent to 8% or so of GDP, this clearly has the potential to do the economy some serious damage. The cuts in government spending will directly reduce GDP. And the combination of rising taxes and cuts in the public sector pay bill will have knock-on effects to other parts of the economy, especially consumers.

Yet bad though this sounds, it does not necessarily condemn the economy to a period of subdued growth and the risk of a double dip recession.

Indeed, if the Office for Budget Responsibility's prognosis is anything to go by, the fiscal tightening could have a pretty limited impact on the economy. The OBR's updated forecasts published in the Budget suggested that the additional £40bn of tightening – equivalent to about 2% of GDP – would knock only 0.4% off GDP over the next two years – half of which would be made up again over the subsequent three. Even taking into account the total tightening, the OBR expects GDP growth to be back above trend by 2012. (See Chart 2.)

Chart 2. OBR's GDP forecasts (%/y)



Source – OBR

What's more, a look at fiscal tightenings undertaken previously – both here and overseas – suggests that this view is not entirely unfounded. Although it may feel as though the UK is experiencing an exceptional squeeze on its public finances, countless other countries have been in a similar position in the past. **And research shows that so-called “expansionary” fiscal squeezes, although not exactly commonplace, can certainly be achieved.** (Definitions of “expansionary” vary but generally mean stronger growth during and immediately after the squeeze than immediately before it.) For example, a 2009 study of 107 periods of fiscal adjustment in OECD countries between 1970 and 2007 found that 26 were expansionary.¹ Meanwhile, a study by the European Commission of fiscal tightenings in EU countries between 1970 and 2002 found that roughly half were expansionary.²

Surviving the squeeze

So how might an expansionary – or at least a non-contractory – fiscal tightening in theory be achieved? **There are various ways in which the negative effects of the fiscal squeeze might be offset, or even outweighed, by its *positive* effects.**

First, a fiscal squeeze should bring about some fall in market interest rates. Admittedly, this is not quite as simple as neoclassical theory would have you believe; interest rates will not fall *automatically* to bring saving and investment back into balance. The behaviour of short interest rates instead depends on policy decisions, and of long rates on market sentiment. Nonetheless, greater market confidence that the government will avoid having to default or inflate its way out of debt should bring about at least some drop in market interest rates. And although short-term interest rates cannot be cut much more, there is scope for more quantitative easing (QE) to encourage longer-term market interest rates to fall further.

Second, the squeeze could have positive effects on consumer and business confidence. For example, if people and businesses believe that the fiscal position is being rectified, they become less pessimistic about the need for tax rises further ahead or the risk of a government debt crisis.

In economic theory, this is so-called Ricardian equivalence: consumers recognise that extra government borrowing and spending today will have to be financed by tax rises in the future and thus save more – and vice versa. International experience suggests that the worse the position to start with – both in terms of the size of the deficit and the state of the economy – the greater the benefits that can come about through this route.

The structure of the fiscal squeeze might also potentially be important in this regard, with spending cuts perhaps having less of an adverse effect on confidence than tax rises. If the government is thought to be cutting “wasteful” spending, consumers and firms might think that the future economy will be more prosperous. It can also be harder for those suffering from spending cuts to identify themselves as such.

Third, a fiscal squeeze that involves cuts in certain programmes can create opportunities for the private sector to provide goods and services previously provided by the government. This, in turn, can spur greater private sector investment. For example, cuts in education spending and the quality of state schools might prompt more *private* sector schools to be built.

And fourth, a squeeze that includes structural reforms can improve the underlying performance of the economy. For example, fiscal squeezes that have involved reforms in public sector wage-setting have usually had knock-on effects on the behaviour of private sector wage-setters. And the subsequent reductions in real wages have then created a greater incentive for firms to invest. Meanwhile, reforms to benefits can encourage more people to work and thus boost the labour market participation rate.

Lastly, even if the tightening still has an overall negative impact on demand, the economy could nonetheless grow strongly if other factors – such as a robust global environment – helped private sector activity to strengthen sufficiently to offset the weaker contribution from the public sector.

1 See “Alesina and Ardagna, “Large changes in fiscal policy: taxes versus spending,” October 2009. Their original work in the 1990s is the most oft-quoted on the subject; this latest paper provides an update including more recent examples of fiscal tightenings.

2 See “Can fiscal consolidations in EMU be expansionary?” *European Economy*, 2003

So much for the theory

It would be useful at this point to look at some individual examples to highlight how a country can get through a fiscal squeeze. Table 1 summarises eight of the biggest fiscal tightenings that have been accompanied by strong economic growth, many of which have been put forward as examples for the UK to try to emulate.³

The tightening that has recently been most commonly referred to is that seen in Canada in the 1990s. Between 1992 and 1997, Canada managed to replace its primary structural deficit (i.e. cyclically adjusted borrowing, net of debt interest payments) of 6.9% with a surplus of 5.5% – and at the same time achieve average real GDP growth while the deficit was falling of 3.2%.

But Canada is certainly not the only example, as Table 1 illustrates. What’s more, we do not even have to look abroad to find evidence of a relatively painless fiscal tightening – the UK’s fiscal squeeze in the 1990s is a good case in point. Between 1993 and 1999, the UK reduced its cyclically adjusted primary deficit from 4% of GDP to a surplus of 3%. And its overall borrowing deficit (i.e. public sector net borrowing) fell by almost 12% of GDP. But over the same period, real GDP growth averaged a not to be sniffed at 3.5%.

So what helped these countries to withstand their fiscal squeezes? Of course, it is pretty much impossible to disentangle whether their strong economic performance was a reflection of the positive side-effects of the fiscal squeeze, or whether it was just that other factors helped. In practice, we suspect that it was a bit of both. But at the very least, we can identify what common elements these tightenings shared, in order to help to ascertain how well-placed the UK is now.

Table 1: Expansionary fiscal squeezes

Country	Years*	Peak to trough fall (as % of GDP) in:		Average GDP growth (%y/y)*
		CA primary deficit	Total deficit	
UK	93-99	6.9	11.7	3.5
Canada	92-97	12.3	12.1	3.2
Sweden	93-00	10.4	14.9	3.5
Denmark	82-86	10.4	14.2	3.9
New Zealand	91-95	4.0	7.2	4.0
Ireland	81-89	11.4	9.6	3.1
Finland	92-99	6.8	15.2	3.8
Netherlands	90-99	5.1	11.2	3.1
UK now?*	10-15		8.9	

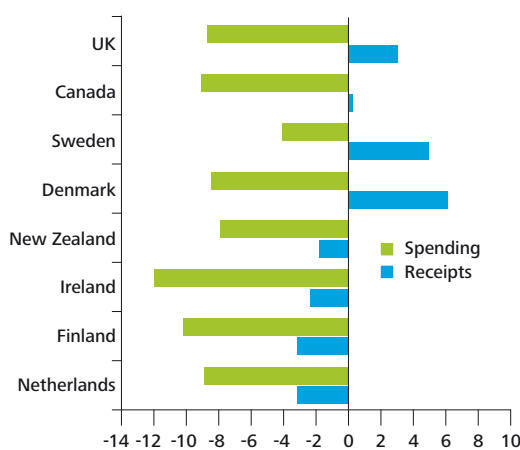
*Years during which CA primary deficit falling

** Based on emergency Budget forecasts

Source – Thomson Datastream

The first point to note regards the composition of the fiscal squeeze. **All saw spending restraint do the bulk of the work, with government spending falling sharply as a share of GDP in every case.** (See Chart 3.) Tax rises played a relatively small role – in fact, in half of our eight cases, receipts as a share of GDP fell.

Chart 3. Change in government spending & receipts as a % of GDP during fiscal squeezes

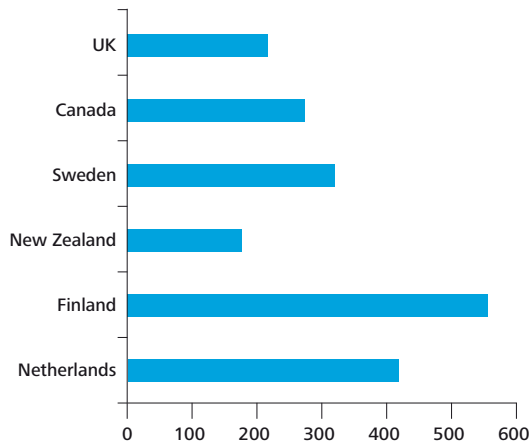


Source – Thomson Datastream

3 Our choice of case studies is based on compilations by the OECD and HM Treasury of the biggest fiscal tightenings overseas. (Examples of big fiscal tightenings that have not been accompanied by strong GDP growth include Portugal and Belgium in the 1980s and Iceland, Spain and Greece in the 1990s.) By strong economic growth, we mean annual GDP growth averaging at least 3% for the duration of the squeeze, as well as averaging more than in the two or three years prior to the squeeze.

Second, all saw significant drops in government bond yields. In the six of the eight countries for which we have data, ten year government bond yields dropped by an average of 330 basis points during the fiscal squeeze. Even the smallest fall (seen in New Zealand) was 180 basis points. (See Chart 4.)

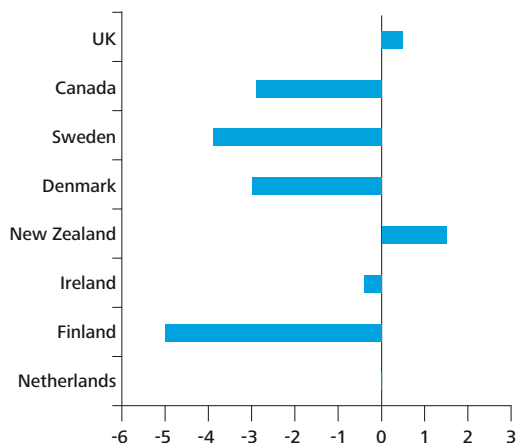
Chart 4. Drop in 10 year government bond yields during fiscal squeeze (bps)



Source – Thomson Datastream

Third, most countries generally saw fairly sharp falls in official interest rates. **The average change in rates over the fiscal squeeze was a fall of 200bps.** (See Chart 5.)

Chart 5. Change in official interest rates during fiscal squeeze (%)



Source – Thomson Datastream

The two exceptions in our sample were the UK (which saw rates rise by 50bps) and New Zealand (which saw rates rise by 150bps). But in both cases, rates had fallen sharply just before the fiscal squeeze. In the UK, rates had fallen continuously for four years, and by a total of about 10%. In New Zealand, four years of interest rate falls ahead of the fiscal squeeze had taken them down by about 16% in total.

Fourth, all countries appear to have benefited significantly from positive trade effects, which in turn stemmed from a strong global backdrop and/or a drop in the exchange rate. Average annual growth of export volumes of goods and services during the fiscal squeeze was 8%, with even the weakest growth in our sample (Denmark) achieving 4% average growth. (See Chart 6.)

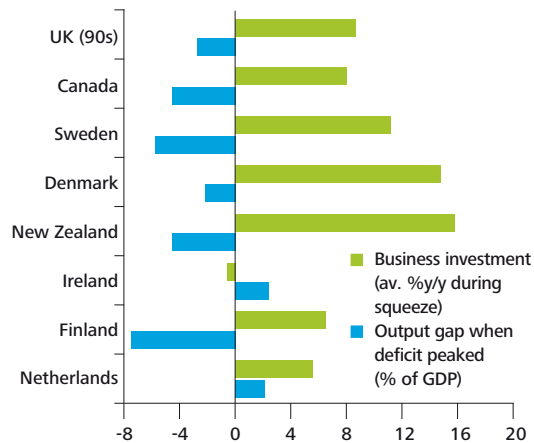
Chart 6. Average growth of export volumes during fiscal squeeze (%/y)



Source – Thomson Datastream

Lastly, it is worth noting that net trade did not do all the work in supporting growth – domestic demand tended to remain quite strong too. **This was seen most clearly in the strong growth rates of business investment seen in almost every case.** (See Chart 7.) This could potentially be evidence of the positive effects a fiscal tightening can have on firms’ confidence, but the drops in official interest rates would obviously have helped to bring borrowing rates down too. Particularly encouraging is the fact that investment rose strongly despite the fact that all countries started off with a large negative output gap (as the UK does now), which should have acted as a disincentive to invest.

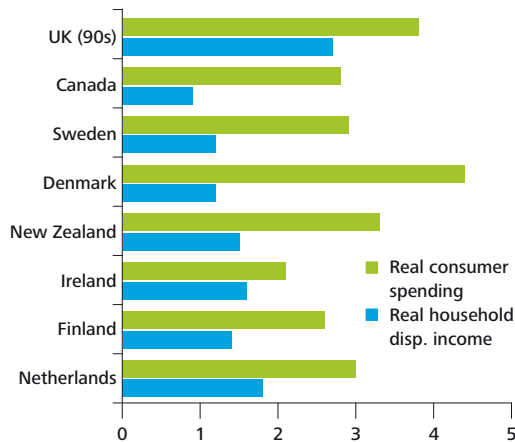
Chart 7. Average growth of business investment during fiscal squeeze & initial output gap



Source – Thomson Datastream

Meanwhile, consumer spending growth held up fairly well – even though the fiscal contractions squeezed household incomes. Average annual consumer spending growth during the fiscal squeeze was a respectable 3.1%, not that far short of the average rate of GDP growth of 3.5%. Yet this was despite the fact that in only one country (the UK) did real household disposable income growth average more than 2%. (See Chart 8.)

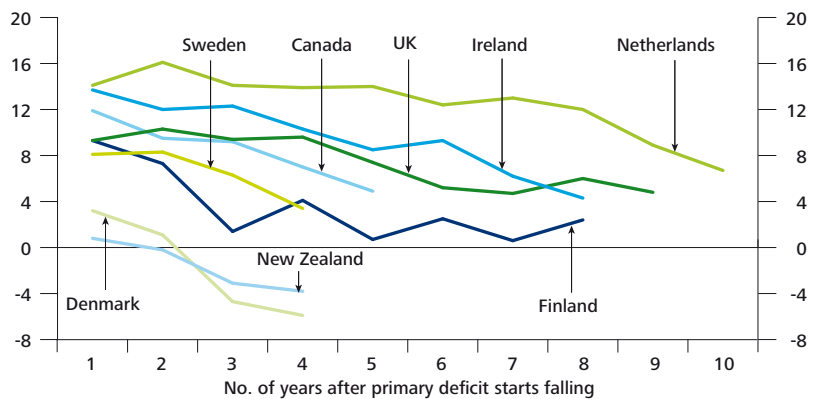
Chart 8. Average growth of real household income & spending during fiscal squeeze (%/y)



Source – Thomson Datastream

Instead, sharp falls in household saving rates helped to sustain consumption. On average, the saving rate fell by 8.2%. (See Chart 9.)

Chart 9. Household saving rates during fiscal squeeze (%)



Source – Thomson Datastream

In part, this reflected the fact that saving rates generally started from a relatively high level. That said, note that low initial levels of saving in both New Zealand and Finland did not stop the saving rate falling further – in both cases into negative territory. Again, this drop in saving could reflect the positive effects of the fiscal squeeze on consumer confidence – but obviously other factors such as the falls in official interest rates could just as easily have contributed.

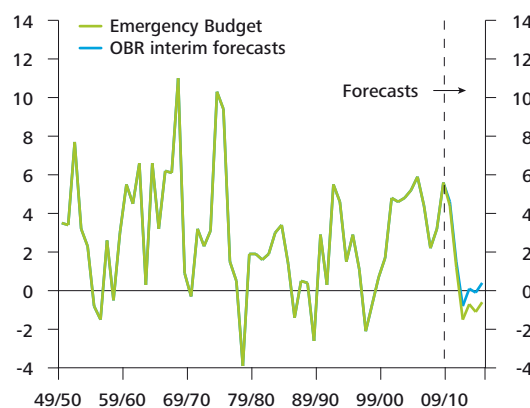
So will the UK benefit this time?

It therefore seems pretty clear what the UK will need to do to get through this fiscal squeeze relatively unscathed. We think that there are five main factors:

- A fiscal squeeze driven by spending cuts, rather than tax rises.
- A drop in bond yields.
- Looser monetary policy.
- A strong trade boost, helped by strong demand overseas.
- A private sector willing to spend, even if that involves a drop in saving.

Although the UK might not need all of them, it is notable that all five were seen in the fiscal tightenings we have studied. So which of them look likely? **On the plus side, there seems to be a broad consensus that spending cuts, rather than tax rises, should account for the bulk of the fiscal squeeze.** Indeed, the squeeze that is currently in the pipeline is composed of 77% spending cuts versus 23% tax rises. The current Government inherited from Labour plans for overall government spending to rise by just 0.8% per annum in real terms from 2011/12 onwards. And the coalition has already shaved some more off this, resulting in overall real spending cuts. (See Chart 10.)

Chart 10. Real government spending (%/y)



Source – HM Treasury

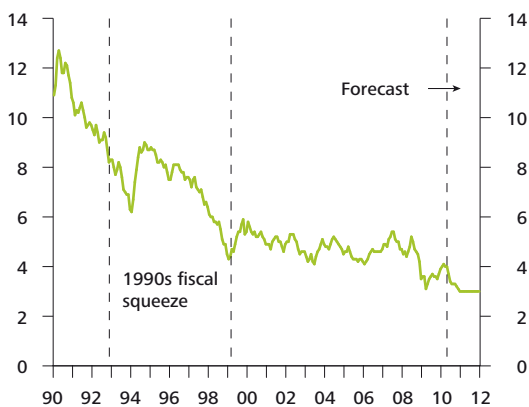
Indeed, it is encouraging that many of the factors seen in “successful” fiscal squeezes overseas (i.e. spending-driven adjustments that have led to a permanent reduction in public debt) are now present in the UK. These include a recent change of government (and hence a strong desire to alter the current situation), a large initial deficit and weak economy (which raise public awareness of the need to act), fiscal rules (which the UK now has in the form of the new fiscal mandate) and international support for tightening. The current Government also appears to want to get as much of the pain out of the way as quickly as possible (research shows that longer tightenings are susceptible to “fatigue” with deficit reduction efforts tending to peter out after about two years).

However, actually *achieving* the spending cuts is another matter and in other ways the UK looks less well-placed to drive through radical spending cuts. It has a coalition government which did not include sharp spending cuts in the mandate on which it won the election.

Meanwhile, the UK looks unlikely to benefit from any of the other factors that have helped to ensure decent economic performances during some other fiscal squeezes. **For a start, the fact that bond yields are already relatively low means they have fairly limited scope to drop further.** Of course, it has been a relief that markets have generally held their nerve as public borrowing has risen, with the UK avoiding the sovereign debt scares seen in the euro-zone. In fact, UK bond markets have actually somewhat ironically benefited from safe-haven flows this year, due to the even worse fiscal positions of many European countries.

What's more, we think that there is scope for *some* further drop in bond yields – we still expect ten year yields to fall from their current level of just under 3.4% to about 3% by the end of this year. But that 40bps change would be much less than the falls seen during the fiscal squeezes we looked at in Table 1. As Chart 11 shows, it would also be different to the UK's experience in the 1990s, when bond yields started the fiscal squeeze at above 8% and fell to 5%. Even a bigger fall in yields than we expect would almost certainly still fail to match the drops seen elsewhere.

Chart 11. Government ten year bond yields (%)



Source – Thomson Datastream

The same argument applies to interest rates. With official interest rates already at 0.5%, there is little scope for them to fall further. Of course, the economy is probably still benefiting from the *previous* cuts in rates between October 2008 and March 2009. But the full effects of those cuts should have been more or less fully felt by the time the fiscal squeeze really gets underway in 2011.

The MPC could still increase its policy of quantitative easing (QE). In a recent speech, Bank of England Governor Mervyn King hinted at this, saying that “the steady reduction in the very large structural deficit over the period of a parliament cannot credibly be postponed indefinitely. If the prospects for growth were to weaken, the outlook for inflation would probably be lower and monetary policy could then respond.”

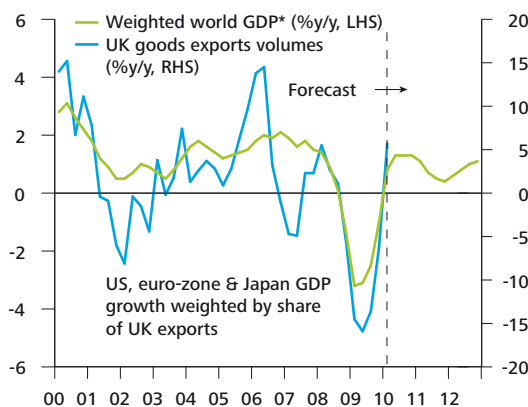
But QE lacks some of the advantages of interest rate cuts, particularly in terms of its effects on consumer confidence. (In the latest Bank of England's *Inflation Attitudes* survey, only one half of people surveyed had heard of quantitative easing). And some MPC members are clearly uncomfortable about the potential risks of creating another asset price bubble.

Net trade boost hampered by euro-zone crisis

A further reason why the UK might find it hard to enjoy the robust economic growth seen during some other fiscal squeezes is that the prospect of a trade boost, at least in the near-term, is looking rather less promising than a few months ago.

The UK, of course, has the previous drop in its pound in its favour. But we have pointed out before that exporters are only likely to capitalise fully on the improvement in their competitiveness once demand in the UK's main trading partners has recovered sufficiently. **Yet about half of the UK's exports go to the euro-zone and, given recent events, we now expect GDP growth there next year of just 0.5%.** So as Chart 12 shows, a weighted average of growth in the UK's main markets suggests that export growth is unlikely to pick up any further over the next year or two.

Chart 12. World GDP & export growth



Source – Thomson Datastream

What's more, we doubt that the UK will enjoy the further depreciation in its currency seen during some other fiscal squeezes. Admittedly, the pound could slide back a touch against the dollar as the recovery gains more ground across the Atlantic. But with the trend of broad euro weakness likely to continue, reflecting both fiscal austerity across the euro-zone and uncertainty about the future of the single currency, we think that the pound could rise further against the euro to €1.40 or so – and hence rise on a trade-weighted basis.

Private sector in a position to spend?

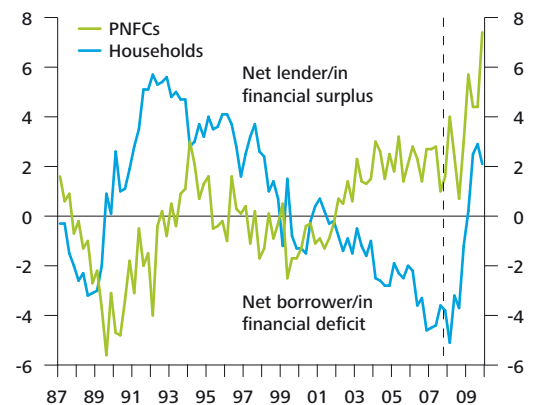
Lastly, what about the scope for the private sector to run down its saving in order to offset the shrinking deficit in the public sector? As far as households are concerned, the picture isn't particularly positive. The saving rate is back to its long-run average, but we have long argued that after a decade of below-average saving, it would be odd if saving were not now *above* its long-run average for a period. Meanwhile, this fiscal squeeze differs from all of those seen elsewhere over the past few decades in that it follows a near-collapse of the banking system. Credit constraints are loosening only gradually and hence are set to keep lending growth subdued.

Meanwhile, we are sceptical that the fiscal squeeze will boost consumer confidence by alleviating fears of tax rises further ahead. After all, the build-up in government debt has occurred so quickly that it is questionable whether households have yet fully factored in the scale of the *immediate* tax rises facing them.

Admittedly, the picture on the corporate side is more encouraging. The corporate sector has less of a debt problem than other parts of the economy. (See *UK Economics Focus*, "Indebtedness not a big problem for the corporate sector," 1st June.) In fact, firms have been running a financial surplus since 2002, meaning that they have built up a considerable buffer of savings which they could now spend. (See Chart 13.)

Firms also have reason to be comforted by the Government's longer-term aims, given that the Budget announced corporate tax reductions in each of the next four years. But there is still no guarantee that firms will spend their money when the demand outlook is so uncertain and there is still so much spare capacity.

Chart 13. Net financial balance of PNFCs & households (as a % of GDP)



Source – Bank of England

Some scenarios

To finish off, Table 2 shows just how strongly other parts of the economy would need to grow on average over the next couple of years to offset the effects of the fiscal squeeze and ensure overall GDP growth of around 2.5%.

- Let's start by assuming that net trade does all the work (and that consumer spending and investment are flat). Net trade would have to boost GDP by some 2.8% per annum. If imports grew in line with domestic demand at 1% or so a year, that would require annual export growth of almost 12%, something not achieved since 1973.

- Alternatively, let's assume that net trade makes a neutral contribution to growth and consumer spending is flat. In that case, investment would need to grow by 17% y/y. Only in 3 of the past 50 years has investment managed a double digit annual gain.
- Lastly, assume that it is down to consumer spending to pick up the slack. Spending would need to rise by 4.5% y/y. With incomes squeezed, that would mean the saving rate falling by about 3% each year – taking it back close to zero by 2012.

Of course, a more plausible explanation is that we see some combination of these three scenarios – as the OBR expects. As an example, it would take a positive net trade contribution of 1% of GDP per annum, annual investment growth of 5% and a fall in the household saving rate of 1% each year. While we think that the chance of seeing all of these is unlikely, it is not *impossible*. **But remember that's just to get GDP growth of 2.5%.** To get average GDP growth of more like 3.5% – in line with the Bank of England's forecasts – you could need to see a net trade boost of over 1% p.a., annual investment growth of 7% and a fall in the household saving rate of 2% each year. Such a favourable outcome seems pretty unlikely.

Conclusions

So will the UK survive the squeeze? We do not want to sound too negative. **After all, the fiscal squeeze should ultimately put the UK economy on a firmer footing, with less of a role played by the relatively inefficient public sector.**

But we find it hard to see how the squeeze will not hurt in the near-term. The UK simply does not have the advantages – such as robust overseas demand or scope for big falls in interest rates – that many other countries relied on during their fiscal contractions. Accordingly, the scope for the fiscal squeeze to have significant positive effects and/or for the rest of the economy to compensate appears limited.

Table 2. Possible ways to compensate for the fiscal squeeze (averages over 2011 & 2012)

%y/y (contribution in brackets)	Consumer spending	Inv.	Gov. spending	Net trade	GDP
Net trade does the work	0 (0)	0 (0)	-1.5 (-0.3)	– (2.8)	2.5 (2.5)
Investment does the work	0 (0)	17.0 (2.8)	-1.5 (-0.3)	0	2.5 (2.5)
Consumer spending does the work	4.5 (2.8)	0 (0)	-1.5 (-0.3)	0 (0)	2.5 (2.5)
A combination of all three	1.5 (1.0)	5.0 (0.8)	-1.5 (-0.3)	– (1.0)	2.5 (2.5)

Source – Boote Forecasts

We therefore continue to think that the next few years will see the economic recovery remain slow and sluggish. Without a pick-up in private sector hiring, unemployment could yet rise from its current level of 2.5m to about 3m. And GDP growth will struggle to return to its long-run average rate of 2.5%, let alone rise above it in order to use up the slack that remains after such a deep recession. **The great squeeze is now upon us – and much as we would like to conclude otherwise, it is going to hurt.**

Historical data table

	Average 1994-03	2004	2005	2006	2007	2008	2009
Demand (%/y)							
GDP	3.2	3.0	2.2	2.9	2.6	0.5	-4.9
Consumer Spending	3.7	3.2	2.3	1.5	2.5	0.9	-3.2
Government Consumption	2.0	3.0	2.0	1.6	1.2	2.6	2.2
Fixed Investment	4.6	5.1	2.4	6.5	7.8	-3.5	-14.9
Stockbuilding (% of GDP)	0.4	0.4	0.4	0.4	0.5	0.1	-1.2
Domestic Demand	3.5	3.5	2.1	2.4	3.0	0.1	-5.3
Exports ¹	5.7	5.0	7.9	11.3	-2.8	1.1	-10.6
Total Final Expenditure	4.0	3.8	3.2	4.2	1.8	0.3	-6.4
Imports ¹	6.9	6.9	7.1	8.8	-0.7	-0.5	-11.9
Output & Profits (%/y)							
Services Output	4.0	3.4	3.2	3.6	3.5	1.4	-3.5
Manufacturing Output	0.9	2.2	-0.2	1.6	0.6	-2.9	-10.5
Company Profits ² (nominal)	6.0	7.1	2.4	9.2	4.5	0.6	-5.1
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)	1.1	1.0	1.1	0.9	0.6	0.9	-1.5
Productivity (output per worker, %/y)	2.0	2.1	1.4	2.2	1.8	-0.5	-3.3
Income & Saving (%/y)							
Average Earnings ³	4.1	4.4	4.0	4.1	4.0	3.5	1.4
Real Household Disposable Income	3.0	1.1	2.0	0.7	0.5	1.6	3.2
Saving Ratio (%)	7.2	3.7	3.9	2.9	2.1	1.5	6.9
Prices (%/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	80.5
\$/£	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, period average)	7.6	8.7	11.0	12.8	12.9	12.3	13.6
Balance of Payments & Public Finances							
Current Account (£bn)	-13.2	-24.9	-32.8	-43.8	-37.7	-22.0	-18.4
% of GDP	-1.4	-2.1	-2.6	-3.3	-2.7	-1.5	-1.3
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)							
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	2.1	0.5	-2.4
Euro-zone GDP	n/a	1.9	1.8	3.1	2.7	0.5	-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

	2010f	2011f	2012f	2010f		2011f	
				H1	H2	H1	H2
Demand (%y/y)							
GDP	1.0	1.5	2.0	0.4	1.7	1.7	1.3
Consumer Spending	0.0	0.5	1.5	0.0	0.1	0.2	0.8
Government Consumption	2.0	-1.0	-2.0	2.7	1.3	-0.4	-1.5
Fixed Investment	0.0	4.0	5.0	-1.9	2.1	3.8	4.2
Stockbuilding (% of GDP)	-0.3	0.0	0.2	-0.4	-0.2	0.0	0.0
Domestic Demand	1.2	1.0	1.5	0.9	1.5	1.0	1.0
Exports ¹	4.5	3.5	4.0	4.2	4.9	3.9	3.2
Total Final Expenditure	1.9	1.5	2.0	1.6	2.2	1.5	1.4
Imports ¹	5.0	1.5	2.0	6.0	4.1	1.1	1.9
Output & Profits (%y/y)							
Services Output	0.9	1.3	1.9	0.4	1.5	1.5	1.1
Manufacturing Output	3.7	5.0	5.0	2.2	5.2	5.4	4.7
Company Profits ² (nominal)	-2.0	-1.0	2.0	0.6	-4.5	-3.8	1.9
Labour Market							
Unemployment (claimant count, millions)	1.6	1.7	1.8	1.6	1.6	1.7	1.8
Unemployment (claimant count, %)	5.2	5.6	5.7	5.2	5.1	5.4	5.7
Employment (%y/y)	-0.7	-0.7	-0.8	-0.9	-0.1	-0.4	-1.0
Productivity (output per worker, %y/y)	1.5	2.2	2.9	1.3	1.8	2.1	2.3
Income & Saving (%y/y)							
Average Earnings ³	2.0	0.7	1.0	2.7	1.4	0.8	0.6
Real Household Disposable Income	-0.3	0.0	1.0	0.0	-0.6	-0.1	0.0
Saving Ratio (%)	6.6	6.0	5.6	6.2	7.0	5.9	6.1
Prices (%y/y)							
CPI	2.9	1.5	0.3	3.3	2.5	1.7	1.3
Core CPI ⁴	2.6	1.3	-0.2	3.0	2.3	1.6	0.9
RPI	4.2	2.6	1.0	4.5	4.0	2.8	2.3
RPIX	4.6	3.0	1.4	4.8	4.3	3.3	2.6
Nationwide House Prices (end period)	-5.0	-10.0	-10.0	8.8	-5.0	-12.5	-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 (%)	3.0	3.0	3.0	3.3	3.0	3.0	3.0
Sterling Trade-weighted Index	82.1	87.3	87.3	81.7	82.1	87.3	87.3
\$/£	1.40	1.40	1.40	1.49	1.40	1.40	1.40
Euro/£	1.27	1.40	1.40	1.22	1.27	1.40	1.40
M4 (%y/y, period average)	2.5	3.0	4.5	3.6	1.5	2.5	3.6
Balance of Payments & Public Finances							
Current Account (£bn)	-18.6	-16.0	-7.1	-9.1	-9.6	-8.4	-7.5
% of GDP	-1.3	-1.1	-0.5	-1.3	-1.3	-2.3	-2.0
PSNB (£bn, financial year)	155	120	95	-	-	-	-
% of GDP (financial year)	10.5	8.0	6.0	-	-	-	-
World Scene (%y/y)							
World GDP ⁵	4.5	3.5	3.5	4.3	4.7	4.0	3.0
US GDP	3.5	2.5	2.5	3.1	3.7	2.9	2.1
Euro-zone GDP	1.0	0.5	1.0	0.8	1.2	1.0	0.0
G7 Consumer Price Inflation	1.3	0.8	1.0	1.5	1.0	0.6	1.0
World Goods & Services Trade Volumes	8.0	6.0	5.0	9.0	7.0	6.0	6.0
Oil Price (Brent, \$ per barrel, end period)	60	60	60	75	60	60	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

US recovery starting to lose momentum

- Our long-held view that US economic growth would slow in the second half of this year is now being borne out. The boosts to economic growth from inventory rebuilding and the fiscal stimulus are already starting to fade, the housing market is suffering a major relapse and export growth is slowing, as demand weakens in both Europe and Asia.
- Nevertheless, although we expect US GDP growth to slow from 3.5% this year to 2.5% in 2011, we don't anticipate that slowdown developing into a full-blown double-dip recession. (See Chart 1.)
- Most recently, both consumer and business confidence have weakened slightly. (See Chart 2.) The pace of private sector employment growth has also slowed. (See Chart 3.)
- But the incoming data on private sector final sales have actually been quite encouraging. Consumption growth accelerated in the first half of the year, supported by an even stronger rebound in incomes which, at the same time, allowed households to increase their saving rate too. (See Chart 4.)
- The rebound in business investment has been even stronger, with spending on capital goods growing at a double-digit annualised pace. (See Chart 5.) Even the contraction in investment in commercial real estate has slowed markedly.
- Unfortunately, the acceleration in private final sales growth isn't going to be enough to offset the impact of the fading boosts from inventory rebuilding and the fiscal stimulus.
- Since the recovery began in mid-2009, the slowing pace of inventory liquidation, which eventually developed into an actual restocking, was responsible for more than half of the average 3.5% annualised rate of GDP growth. We suspect that the contribution over the next 12 months will be closer to zero.
- For now, there are no plans in the US to introduce the sorts of fiscal austerity measures being implemented elsewhere. Nevertheless, the reduction in the size of the fiscal stimulus over the next 12 months will be equivalent to nearly 2% of GDP.
- Housing will also become a renewed drag on the wider economy. The pending sales index suggests that in the aftermath of the tax credit expiration, home sales plummeted by 30%. (See Chart 6.) It is only a matter of time before we see renewed declines in homebuilding activity and house prices.
- With core inflation already below 1% and economic growth set to slow, the risks of a slide into deflation cannot be stressed enough. Lower energy prices mean that headline inflation will fall below zero early next year, albeit only temporarily. (See Chart 7.)
- Low inflation and weak economic growth mean that the markets have largely come around to another of our long-held views; that the Fed isn't going to raise interest rates from near-zero until at least 2012. (See Chart 8.)

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

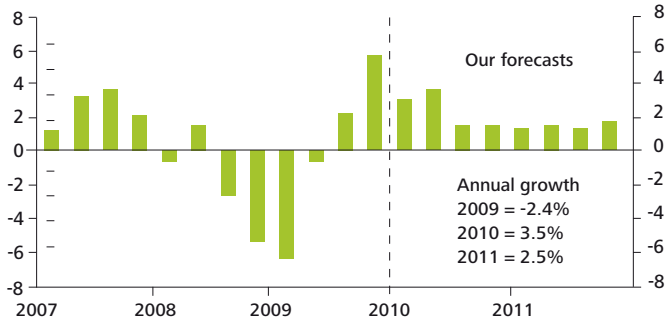


Chart 2. US business & consumer confidence

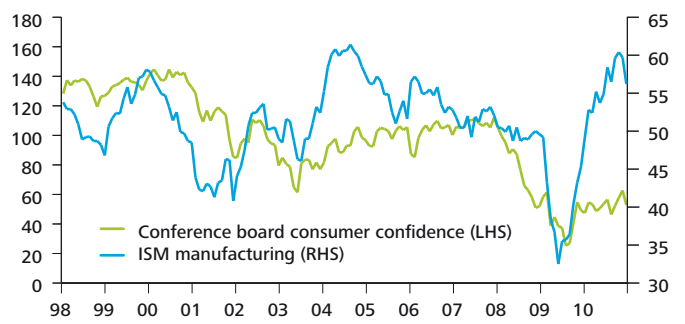


Chart 3. US monthly change in payroll employment (000s)

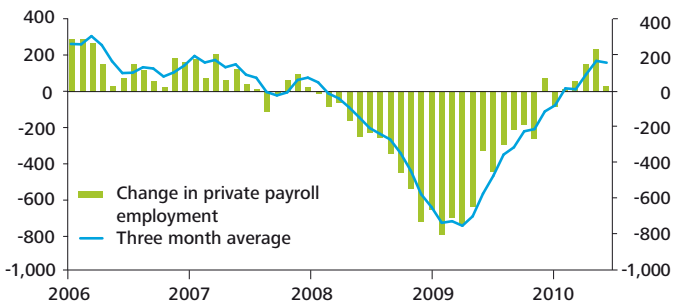


Chart 4. US real income & consumption (%3m/3m Ann.)

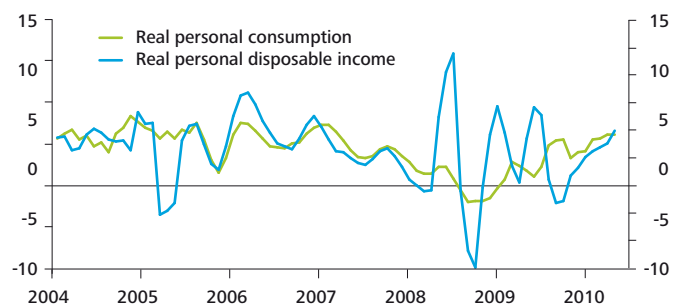


Chart 5. US core capital goods shipments (%3m/3m Ann.)

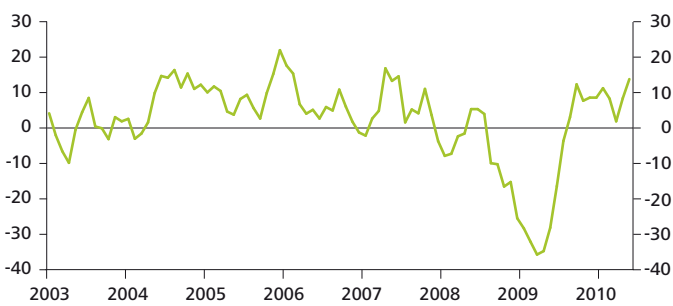


Chart 6. US home sales (million, annualised)

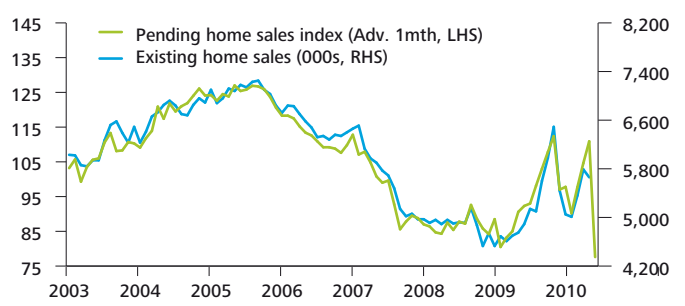


Chart 7. US CPI inflation (%y/y)

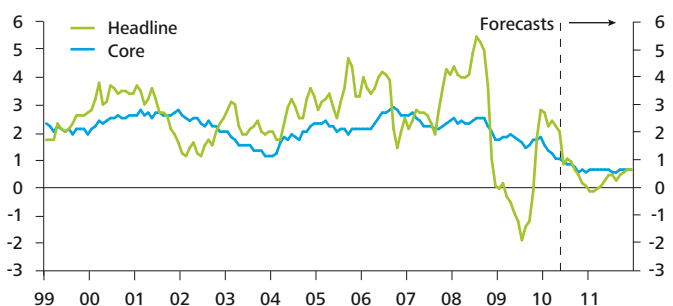
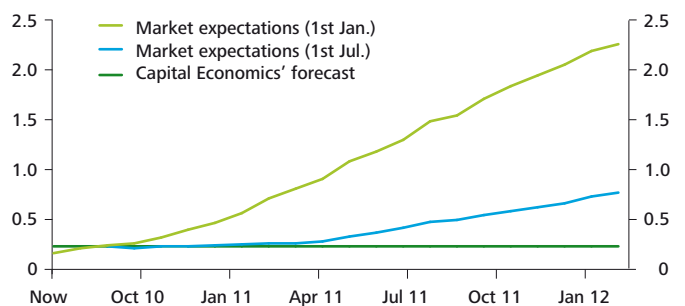


Chart 8. US Fed funds rate expectations (%)



Source – Thomson Datastream

Analysis: The world economy

Fiscal cloud over Europe darkens

- The darkening fiscal cloud hanging over the euro-zone looks set to plunge parts of the region back into recession and may eventually threaten the survival of the single currency in its current form.
- Admittedly, the euro-zone recovery may gather pace in the short-term. After all, the industrial sector is growing at a record-breaking annual rate. And despite recent falls, the composite PMI still points to healthy quarterly GDP growth for now. (See Chart 9.)
- But there are signs that the huge fiscal austerity measures announced this year are starting to hit business and consumer sentiment, particularly in the periphery where the fiscal squeeze will be greatest. (See Chart 10.)
- Of course, the fiscal tightening may be offset partially by the plunging euro boosting export growth. (See Chart 11.) But note that the Southern European economies are rather more closed than their core counterparts, suggesting that the biggest gains from the weaker euro will be in the core – the region where the fiscal austerity measures will be smallest.
- Accordingly, the outlook for the periphery looks pretty grim and the likes of Spain look set to drift back into recession. Germany and the rest of the core will fare better, but we expect the region as a whole to expand by just 1.0% this year and 0.5% in 2011. (See Chart 12.)
- Given this weak backdrop, spare capacity in the region will continue to grow. And with wage growth set to slow in response to past rises in the unemployment rate, CPI inflation will fall back towards zero over the coming quarters. (See Chart 13.) Parts of the periphery will probably fall into deflation.
- Of course, falling prices and costs will help the periphery to regain lost competitiveness. (See Chart 14.) But the downside is that deflation will result in a period of weak, or even falling nominal GDP growth. This will make it even harder for peripheral governments to return their public finances to a more stable footing.
- Accordingly, a euro-zone government default or an eventual break-up of the single currency as we know it remain distinct possibilities. We expect such fears to prompt the euro to fall to parity against the dollar next year.
- Of course, the depreciating euro is bad news for exporters in the developed European economies outside the single currency. But at least these economies' public finances are in a pretty healthy position, implying that a deep and prolonged fiscal squeeze is unlikely. Accordingly, these economies will continue to outperform the euro-zone. (See Chart 15.)
- Elsewhere, most countries in Emerging Europe are now experiencing a decent recovery in industrial production. But this is likely to peter out as growth in Western Europe starts to fade. And with domestic demand still extremely weak, we expect the recovery in the region to stall next year. (See Chart 16.) Turkey and Poland remain the only bright spots, while Romania and Bulgaria are most exposed to the problems in Greece.

Chart 9. Euro-zone GDP & composite PMI

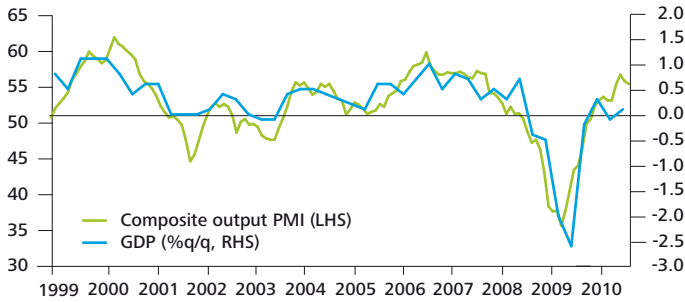


Chart 10. EC consumer sentiment index

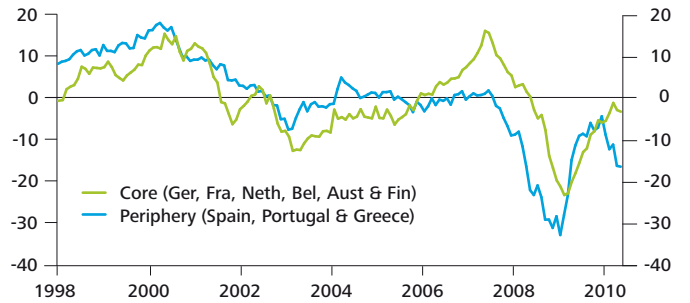


Chart 11. Euro-zone exports & the trade weighted euro

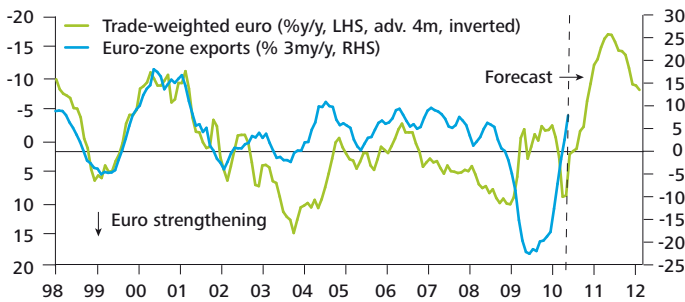


Chart 12. Euro-zone GDP (%/y)

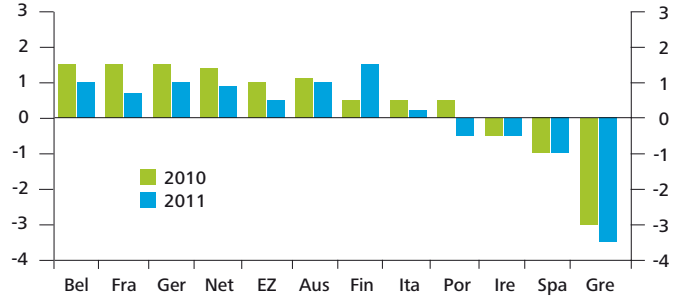


Chart 13. Euro-zone unemployment & hourly labour costs

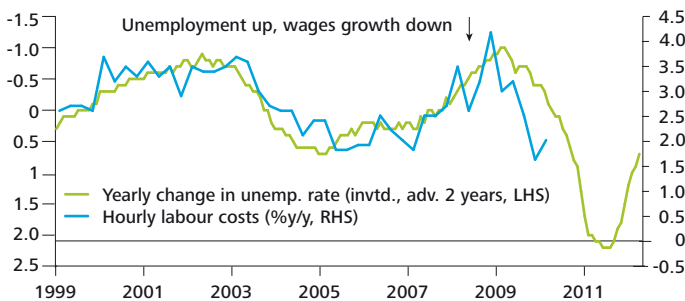


Chart 14. Real exchange rate (whole econ ULC, Q1 2000 = 100)

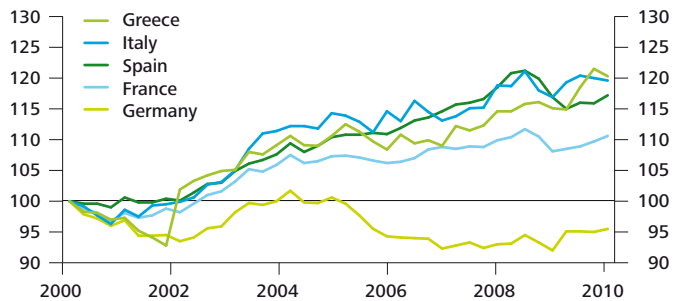


Chart 15. Developed Europe GDP (%/y)

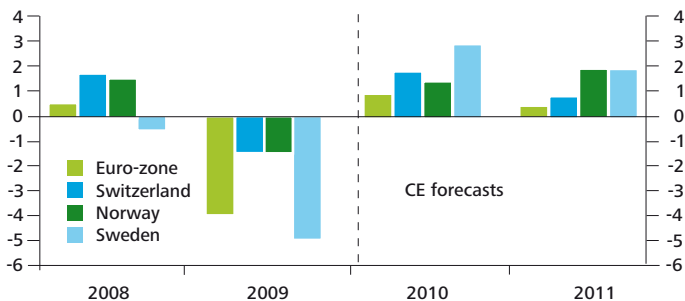
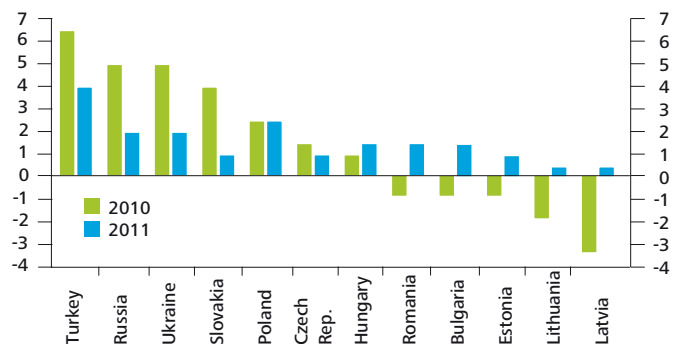


Chart 16. Emerging Europe GDP (%/y)



Sources – ECB, IMF, Markit, Thomson Datastream

Analysis: The world economy

China slowing, not collapsing

- Optimism that Asia will continue to lead a strong global recovery is giving way to worries that China is heading for a hard landing that will undermine the rest of the world. The truth probably lies somewhere in between.
- China's manufacturing PMIs dropped sharply in the second quarter, suggesting that the recovery there has only recently run out of steam. (See Chart 17.) In fact, the economy has probably been slowing in quarter-on-quarter terms since the middle of last year. The government does not publish data on this basis, which means that attention is typically focused instead on the year-on-year numbers. These annual data have remained strong because of the favourable comparison with the period of weakness during the depths of the global crisis, but should drop sharply from the second quarter too. (See Chart 18.)
- Nonetheless, fears of a hard landing are overdone. The slowdown reflects the fading of the boost to growth from the policy stimulus, which mainly took the form of a surge in bank credit in the first half of last year. But there is little evidence of the overheating that might prompt an aggressive *tightening* in policy.
- Headline CPI inflation will rise further over the summer due to base effects, but the most recent data suggest that price pressures are easing. (See Chart 19.) Property prices have risen by less than wages in four of the last five years, suggesting that the recent increases represent catch-up rather than the emergence of a bubble. (See Chart 20.)
- The announcement in June of greater flexibility for the renminbi (RMB) also reduces the pressure for a tightening of policy in other ways. The RMB will probably resume the gradual climb against the dollar that was in place between mid-2005 and mid-2008. (See Chart 21.) However, that rise was helped by the general weakness of the US currency, which limited the appreciation of the RMB in trade-weighted terms. The current strength of the dollar is therefore another reason why the RMB's climb this time is likely to remain slow.
- Overall, China's economy is cooling without the need for aggressive tightening. Indeed, fading inflation pressures and a strong budget position mean that policy could yet be loosened further if the slowdown threatened to become a hard landing. Nonetheless, expectations that buoyant Chinese growth will continue to support commodity prices have long been on shaky ground.
- Elsewhere, Japan's economy has rebounded strongly and the survey evidence at least suggests that momentum is still positive. (See Chart 22.) However, deflation remains entrenched, even excluding the one-off impact of cuts in tuition fees. (See Chart 23.) Falling prices do not appear to have held back the recovery, but they have contributed to a marked worsening in the fiscal position that will have to be tackled soon.
- In contrast, overheating remains the biggest risk in India. (See Chart 24.) We expect further rate hikes from the Reserve Bank, although not enough to derail strong domestic growth.

Chart 17. China manufacturing purchasing managers Indices

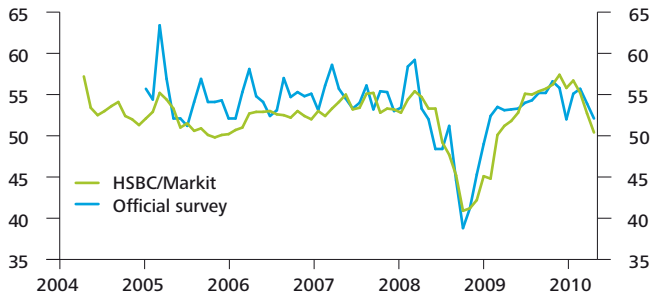


Chart 18. China GDP

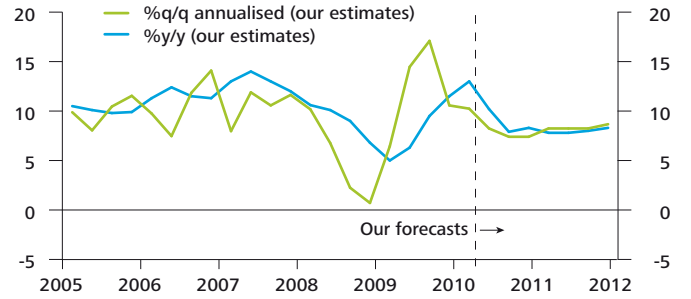


Chart 19. China consumer prices

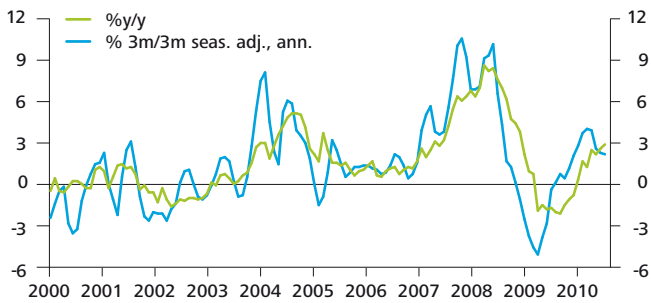


Chart 20. China wages & property prices (%/y)

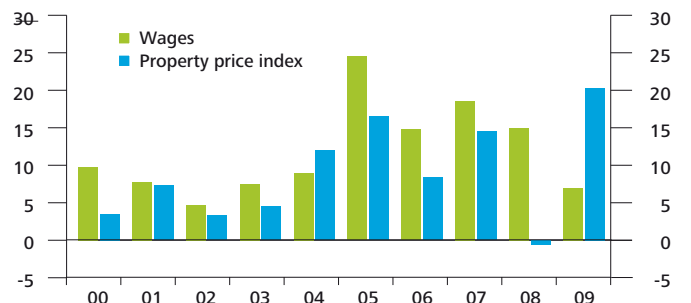


Chart 21. China Renminbi exchange rate

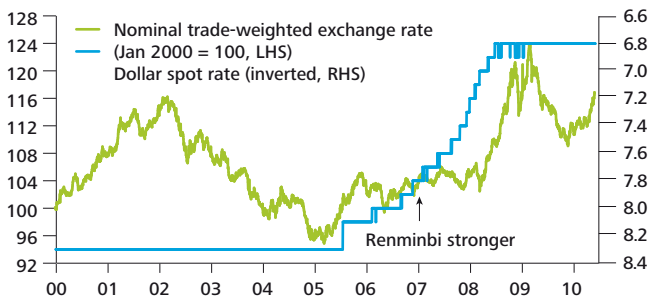


Chart 22. Japan consumer confidence

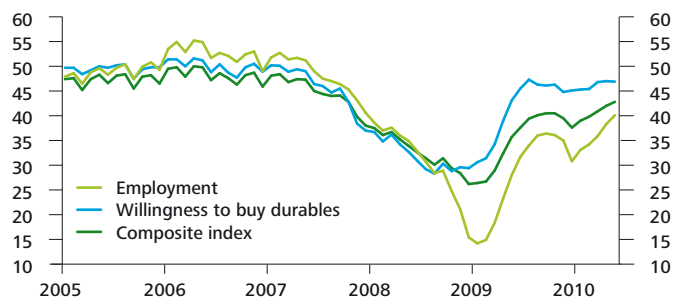


Chart 23. Japan consumer prices (Jan. 2000 = 100)

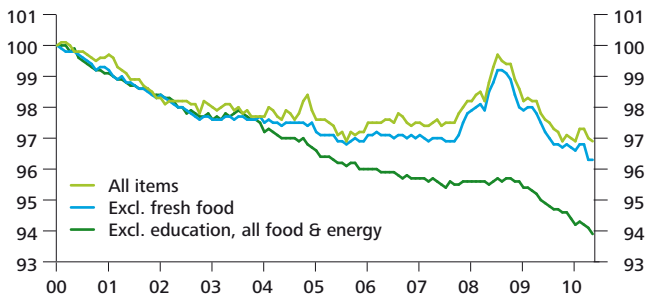
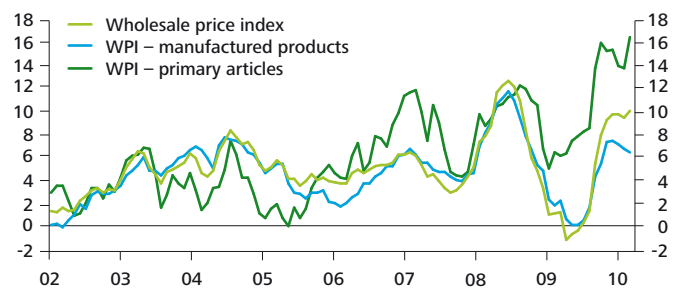


Chart 24. India wholesale prices (%/y)



Sources – Thomson Datastream, Bloomberg, CEIC, Markit

Analysis: UK output and activity

The economy is in a temporary “sweet-spot” ...

- An unprecedented fiscal consolidation, a renewed deterioration in the labour market and continued retrenchment in the private sector are all likely to mean that the recovery remains weak for the foreseeable future.
- The UK economy has shown some signs of resilience recently. Although output only grew by 0.3% in the first quarter, the rise was respectable given January's VAT hike and bad weather. The CIPS/Markit activity surveys also suggest that the economy grew by around 0.6% in the second quarter. (See Chart 1.)
- In addition, unemployment has risen less sharply than during past downturns. (See Chart 2.) The economy has also begun to rebalance. Industrial production has picked up at a faster pace than activity in the larger service sector, while households are saving more of their income. (See Charts 3 & 4.)
- Nonetheless, we struggle to see which parts of the economy will be able to drive the recovery given the constraints on spending by the government, households and firms.
- For a start, government spending is set to fall sharply amid the most severe and prolonged fiscal consolidation since the Second World War. The new coalition government has committed to eliminating by 2015-16 the “cyclically-adjusted current deficit” – the portion of government borrowing that will not be reduced by economic growth.
- Around £100bn of this £128bn fiscal consolidation will be achieved through spending cuts. Government spending will therefore go from adding 0.8% or so to annual GDP growth to knocking 0.2% off growth from next year for *several* years. (See Chart 5.)
- The public sector's contraction may stimulate private sector activity. But households or firms do not appear to be in a position to respond.
- For a start, households will be hit by a series of tax hikes next year, including a VAT rise from 17.5% to 20% in January and rises in national insurance contributions in April.
- The labour market also looks set to take another leg down. We think that around 750,000 public sector employees may lose their jobs during the next parliament. The private sector is unlikely to take up the slack – firms can squeeze more output out of their existing employees, given the sharp fall in productivity during the recession. (See Chart 6.) Unemployment may yet top 3 million.
- A further deterioration in the labour market would also bode ill for house prices, the rally in which already appears to have lost some steam. We think that house prices could fall by 5% this year, 10% in 2011 and a further 10% in 2012, helping further to improve affordability. (See Chart 7.)
- The slowdown in the housing market and looming fiscal squeeze may help to explain the recent renewed fall in consumer confidence. As Chart 8 shows, the GfK/NOP composite measure now points to flat household spending growth this year.

Chart 1. Real GDP growth & business surveys

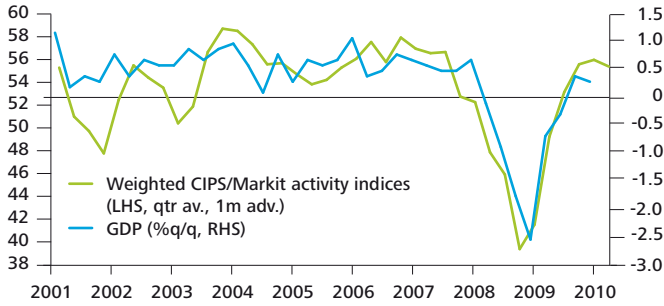


Chart 2. Measures of unemployment (000s)

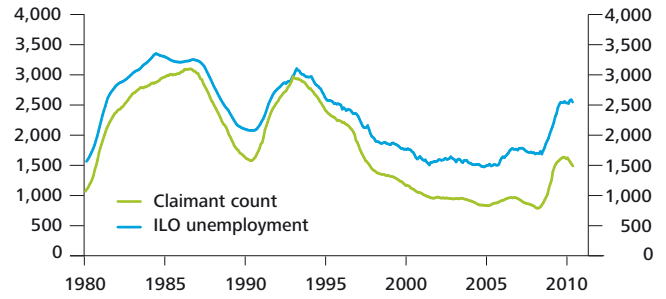


Chart 3. Industrial production & services output (% 3m/3m)

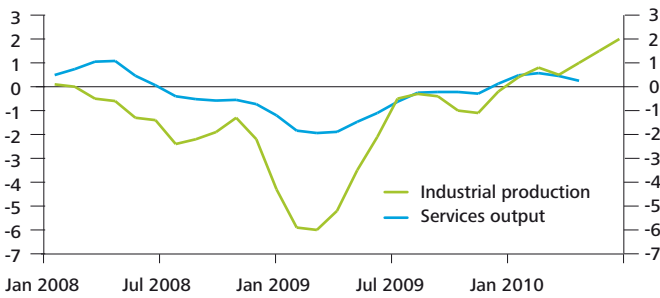


Chart 4. Household saving ratio (% of income)

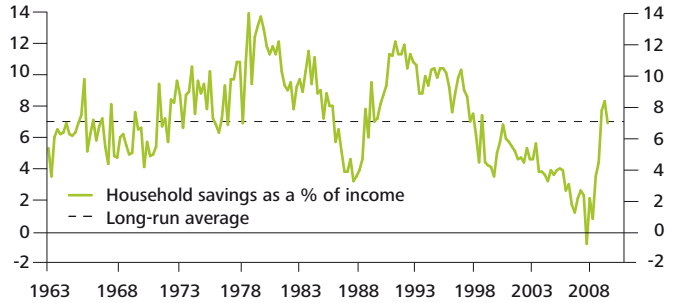


Chart 5. Real government spending & government contribution to GDP growth

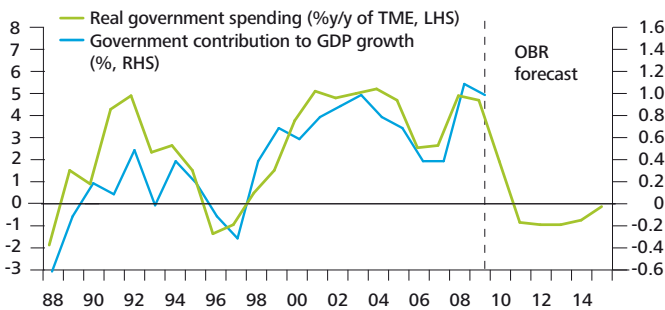


Chart 6. Productivity (%/y)

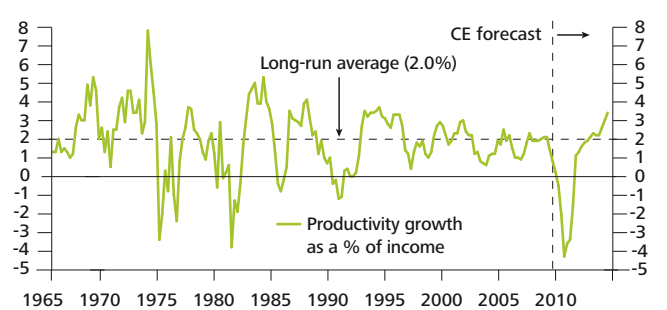


Chart 7. Measures of housing affordability

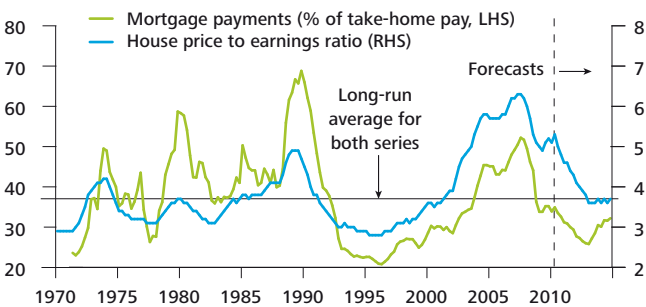
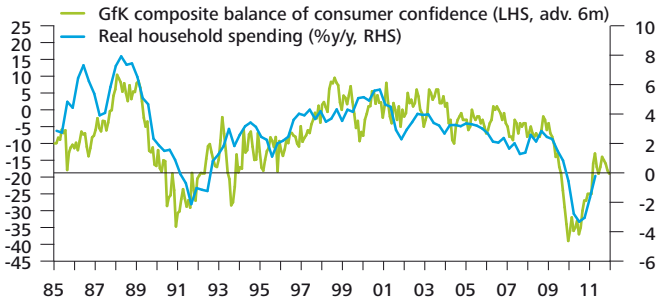


Chart 8. Consumer confidence & household spending



Sources – Thomson Datastream, BoE & Bootle Forecasts

Analysis: UK output and activity

... but fiscal and private sector retrenchment will subdue growth

- As a result, we expect household spending to remain unchanged this year, and to grow at lethargic rates of just 0.5% in 2011 and 1.5% in 2012. (See Chart 9.)
- The outlook for business investment also looks subdued. Admittedly, corporate profits have held up much better than in past downturns. However economic growth seems unlikely to be strong enough for profits to grow by much in the years ahead. (See Chart 10.) In addition, firms are unlikely to use their profits to increase investment while the path of the recovery remains uncertain and considerable slack remains in the economy. (See Chart 11.)
- Instead, firms are likely to use their profits to pay down their high levels of debt. Note that firms (and households) deleveraged for six years after the 1990s recession. (See Chart 12.)
- As a result, demand for credit looks set to remain very weak. But even if it were to pick up, banks are unlikely to increase the supply of credit. An even smaller number of banks stated that they plan to increase the supply of credit over the next three months in June than in March, according to the Bank of England's *Credit Conditions Survey*. (See Chart 13.)
- What's more, previous commitments by banks to increase lending have not been honoured. Spreads on new lending to both firms and households are still exceptionally wide. The introduction of the UK's Bank Levy in January and the threat of stricter global capital requirements may also mean that banks remain reticent to lend.
- At least the weak pound *should* enable the external sector of the economy to support the recovery. But as Chart 14 shows, the recovery in export volumes has been no stronger than in other economies. This perhaps suggests that structural weaknesses, such as UK exporters' exposure to markets with poor growth prospects, are holding exports back. What's more, sterling may appreciate further against the euro over the next year or so if fiscal frailties continue to blight the euro-zone.
- Overall then, the recovery looks set to be fitful and sluggish. We expect real GDP growth of only 1% or so this year, 1.5% in 2011 and 2% in 2012. (See Chart 15.)
- While our central forecast is not for a double dip recession, the main risks to our view seem to be on the downside. There is a fair chance that the private sector will not be able to withstand the fiscal squeeze, pushing the economy back into recession. This may then entail even deeper spending cuts if the government honours its fiscal mandate.
- In addition, a larger fall in asset prices or pick-up in loan defaults than we expect would further weaken the ability of banks to lend in the near future. And this time, the public sector would not be able to bear the costs of repairing the banking system.
- Meanwhile, the economy is unlikely to grow fast enough to start to absorb the large amount of spare capacity in the economy. As a result, deflation remains a very real risk in the medium term. (See Chart 16 and *Analysis: Inflation*, pages 24-27.)

Chart 9. Household spending and disposable income

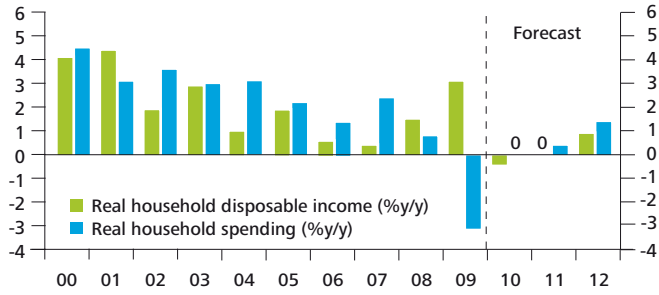


Chart 10. Real GDP & real gross trading profits

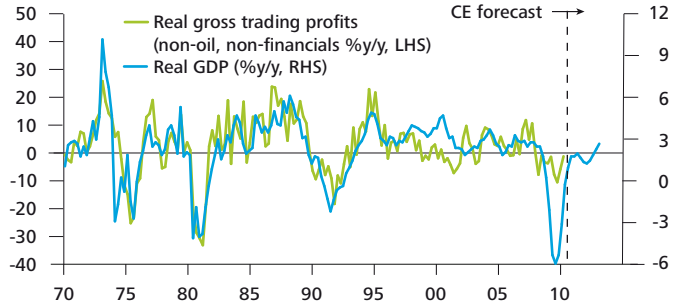


Chart 11. Measures of spare capacity in the economy

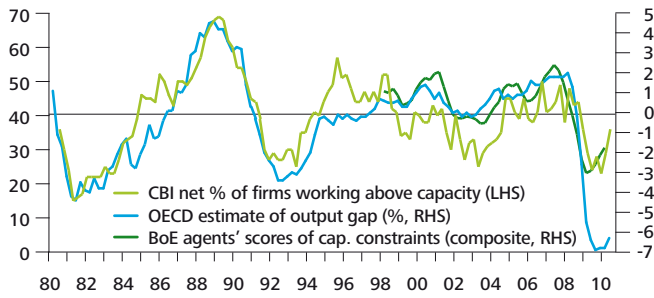


Chart 12. Private sector debt ratios

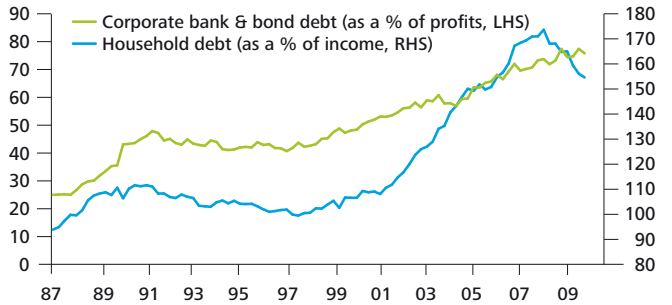


Chart 13. Net % balance of lenders expecting change in credit availability in next 3m

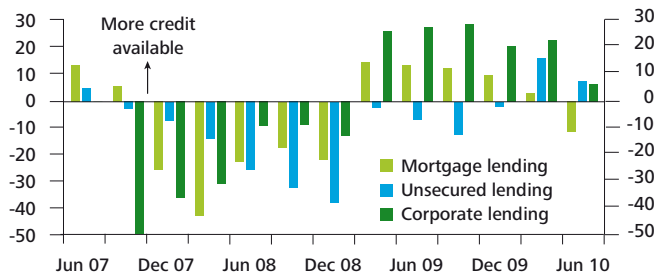


Chart 14. Export volumes (Jan 2008=100)

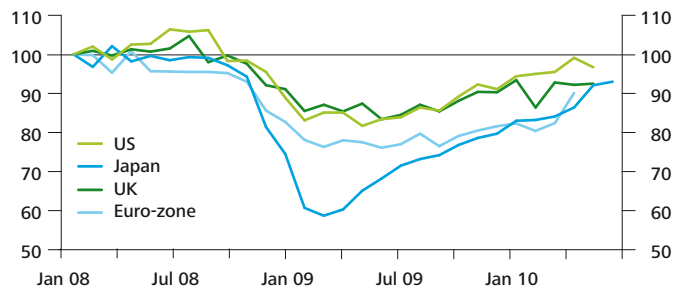


Chart 15. Real GDP growth

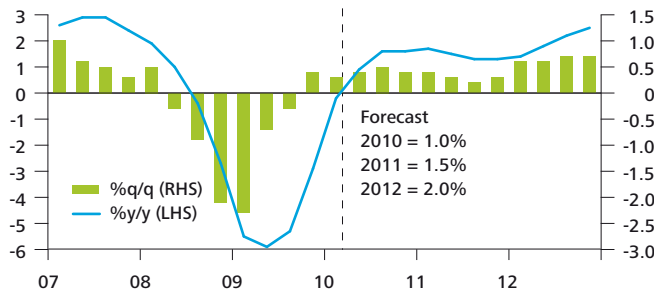
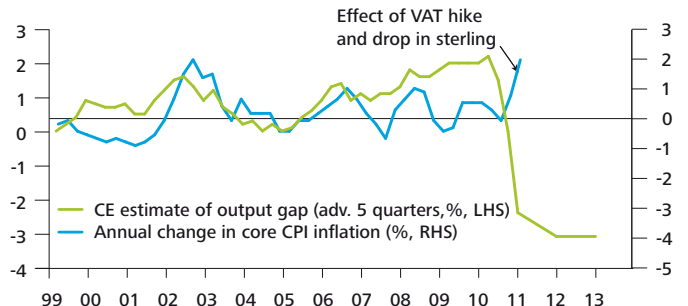


Chart 16. Core inflation & output gap



Sources – Thomson Datastream, Bank of England & Bootle Forecasts

Analysis: UK inflation

UK inflation has been stubborn so far

- UK inflation has proved unexpectedly stubborn over recent months. But we still expect the combined effects of the spare capacity in the economy, fading energy effects and a stronger pound to bring inflation down sharply over the next year or two.
- UK consumer price inflation has continued to hold up stubbornly over recent months. As Chart 1 shows, CPI inflation has remained well above its 2% target. Alternative measures such as RPI and RPIX, which include some elements of housing inflation, have been even higher.
- Of course, inflation has risen in other parts of the world too. But UK inflation has remained well above that in the US and, perhaps most surprisingly, the euro-zone. (See Chart 2.)
- This has fuelled concerns that underlying price pressures in the UK economy may be more persistent than previously thought. As Chart 3 shows, having previously shown little clear tendency to under- or over-shoot expectations, inflation has consistently surprised on the upside in the last couple of years.
- And more importantly, inflation has also turned out stronger than the Monetary Policy Committee (MPC) has anticipated. As Chart 4 shows, only in one quarter over the last two years has inflation been lower than the MPC predicted two years earlier, and that was after the unanticipated cut in VAT.
- Perhaps most worryingly, there have been signs of a pick-up in the various measures of inflation expectations. (See Chart 5.) This has led to concerns that the low inflation psychology evident over the last decade or so is under threat.
- However, we still think that there are very good reasons to expect inflation to fall back sharply over the next year or two. For a start, we still believe that the spare capacity in the economy created by the deepest recession in over 60 years will have at least some downward influence on inflation.
- Admittedly, some indicators of capacity pressures support the view that the degree of slack in the economy has been limited by the destruction of some of the economy's supply potential. As Chart 6 shows, they point to an "output gap" of around 2% of GDP, rather than the 6% or 7% suggested by some estimates like that from the OECD.
- Nonetheless, the experience of previous cycles suggests that the amount of slack should have at least some downward influence on core inflation. (See Chart 7.)
- At the same time, several upward influences on inflation which may have recently been offsetting the impact of the spare capacity look set to fade or go into reverse over the coming quarters.
- Most immediately, having had a strong upward effect on inflation over the last year or so, petrol prices are set to work in the opposite direction as oil price inflation drops back sharply. (See Chart 8.) This alone could take 1% or so off the overall inflation rate.

Chart 1. UK inflation measures (%/y)

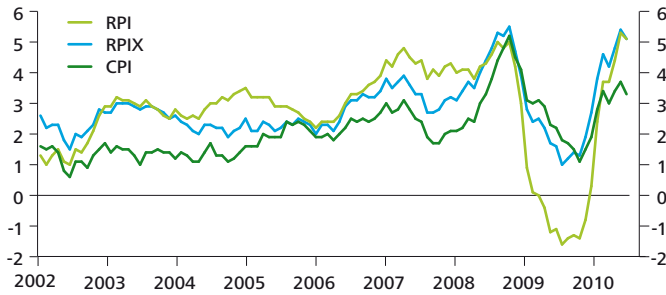


Chart 2. International consumer price inflation (%/y)



Chart 3. Inflation outturns vs. forecasts

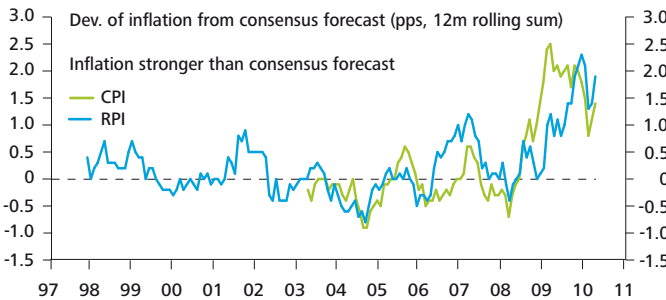


Chart 4. Inflation outturns vs. MPC forecasts

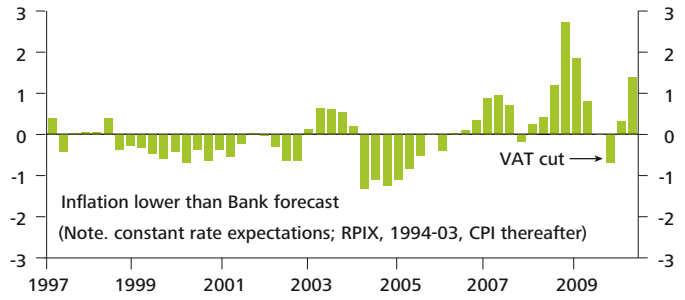


Chart 5. Households' inflation expectations

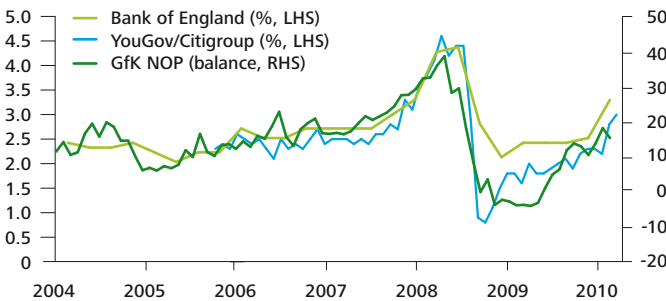


Chart 6. Measures of spare capacity

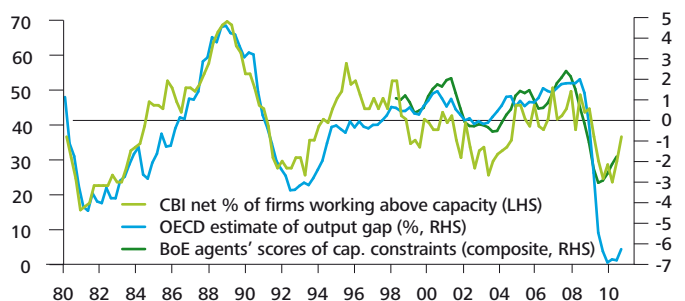


Chart 7. Output gap and core CPI inflation

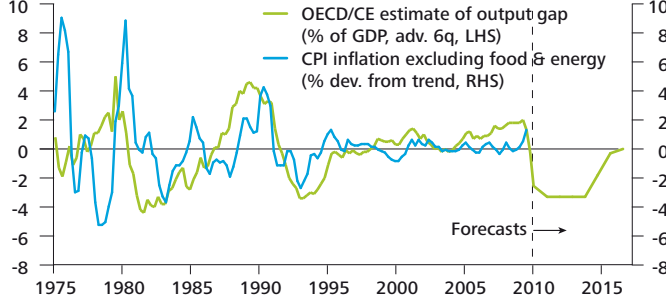
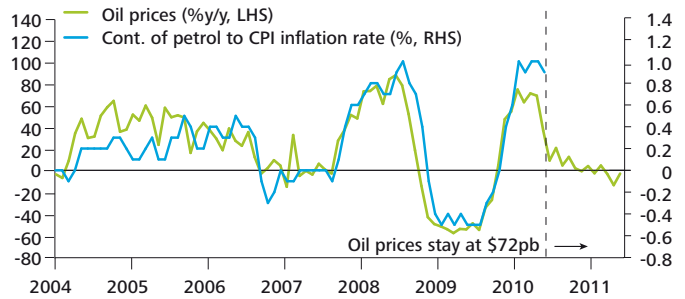


Chart 8. Oil Prices & Petrol Contrib. to Inflation



Sources – Thomson Datastream, YouGov/Citigroup, Bloomberg

Analysis: UK inflation

But will fall sharply in time

- More fundamentally, core goods inflation should soon start to fall sharply in response to the previous steep falls in producer price inflation. (See Chart 9.) Indeed, this process has already begun in the last few months.
- Admittedly, PPI inflation has since climbed again. But with cost pressures in industry starting to ease, we expect this to be a relatively short-lived phenomenon.
- The same picture applies to imported goods inflation. As Chart 10 shows, having previously risen sharply in response to the drop in the sterling exchange rate, import price inflation has eased back considerably over the last year. Allowing for the usual lags, this will also have a downward influence on high street goods inflation. And import price inflation will fall further if, as we expect, the pound strengthens. (See Chart 11.)
- Meanwhile, inflationary pressures in the labour market remain very subdued. Admittedly, average earnings growth has re-accelerated somewhat over recent months, partly in response to a renewed rise in bonuses. However, Chart 12 suggests that earnings growth is still at levels consistent with a further slowdown in inflation in the services sector.
- At the same time, the sharp slowdown in the growth of manufacturing unit wage costs already seen as output and productivity in the sector have re-accelerated should intensify the downward pressure on consumer goods inflation. (See Chart 13.)
- Another potential downward influence on inflation is the slowdown in the growth of the money supply seen over the last year or two. As Chart 14 shows, while the short-term relationship between money growth and inflation is not extremely close, sharp monetary contractions have often been followed by falling inflation in the past.
- Finally, we do not expect the recent rise in inflation expectations to prevent actual inflation from falling back sharply. As Chart 15 shows, an examination of the correlations between inflation expectations and actual inflation suggests that the former is very much a *lagging*, rather than leading indicator. As such, should inflation itself drop fall back, expectations are likely to follow, just as they did in 2008. (See Chart 5 again.)
- The one development which *will* have some upward effect on inflation over the next year or so is the rise in VAT to 20% announced in the emergency Budget. Still, the fact that the rise is delayed until January – the anniversary of the renewed rise in VAT from 15% to 17.5% – means that, while inflation will fall less quickly as a result, it shouldn't actually *rise*.
- In any case, the impact of the VAT hike will be much more than offset by the combined effects of the spare capacity, falling import prices, low wage growth and weak money growth. As Chart 16 shows, we therefore still expect inflation to fall well below its target next year. What's more, *deflation* is a possibility once the VAT effects drop out in 2012. (See Chart 16 and *Forecast Table: Inflation* on page 36.)

Chart 9. Core PPI & core goods CPI inflation

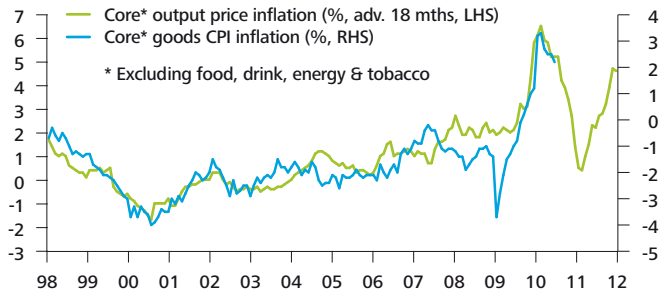


Chart 10. Import price & core goods inflation (%/y)

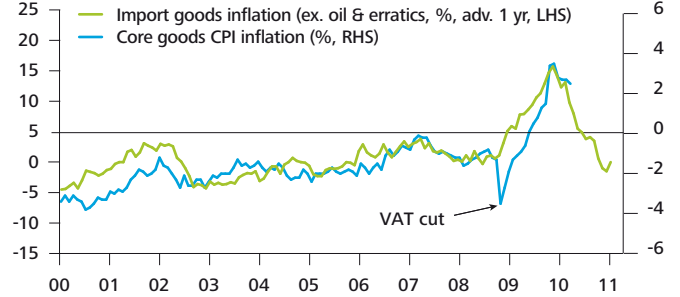


Chart 11. Sterling trade-weighted index & import price inflation

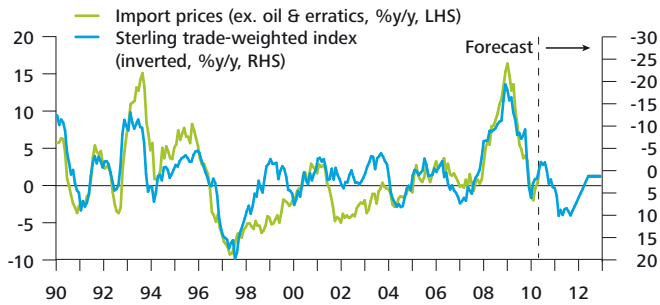


Chart 12. Average earnings and service CPI inflation

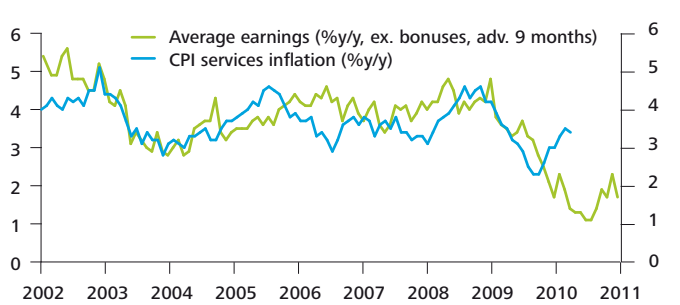


Chart 13. Man. unit labour costs & core goods CPI

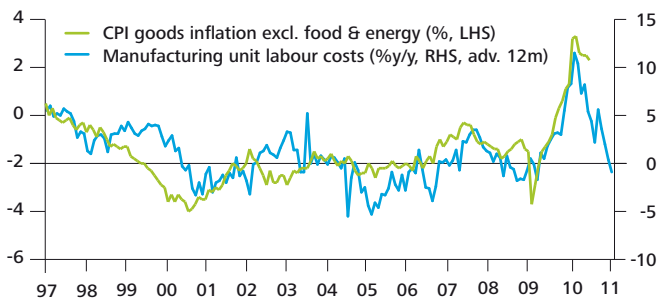


Chart 14. Broad money supply & CPI inflation

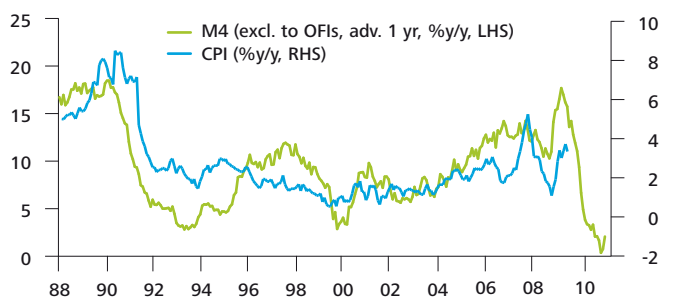


Chart 15. Correl. between CPI inf. & expectations

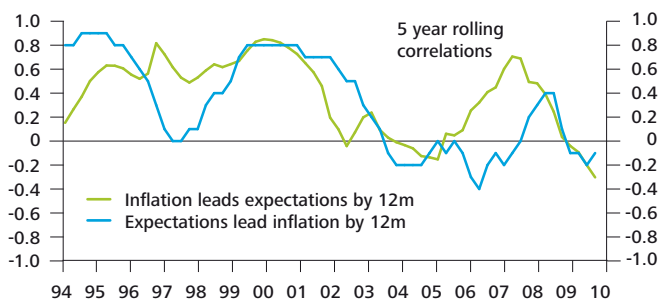
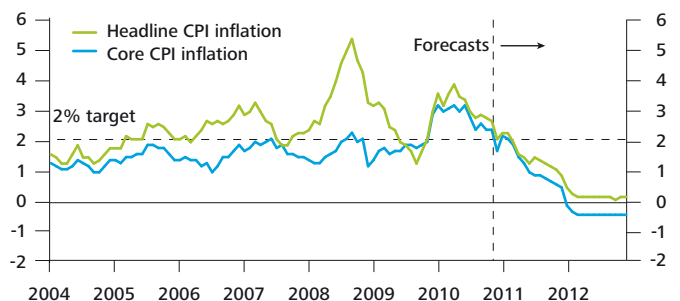


Chart 16. CPI inflation forecasts (%/y)



Sources – Thomson Datastream, Bank of England, OECD

Analysis: UK labour market

Public sector job cuts soon to start

- Severe public sector job cuts loom and we doubt that they will be offset by a pick-up in private sector hiring. A renewed rise in unemployment will also keep pay growth subdued.
- Admittedly, the labour market has recently shown some tentative improvement and this could continue in the near-term. The claimant count has continued to fall. (See Chart 1.) Employment has just about started to rise. And employment intentions have continued to increase. (See Chart 2.)
- However, we still think that this improvement will peter out and expect unemployment to start rising again. Most obviously, severe public sector job cuts loom. The Office for Budget Responsibility expects public sector employment to fall by about 600,000 as a result of the planned government spending cuts. (See Chart 3.) We think that the drop could be an even bigger 750,000.
- Admittedly, similar public sector job cuts in the 1990s did not stop overall employment from rising, as the private sector plugged the gap. (See Chart 4.) However, this partly reflected the fact that firms cut headcounts sharply during the early 1990s recession.
- In contrast, the recent recession saw firms instead hoard labour, suggesting that they can now increase output using their existing workforce. Indeed, firms are generally still reporting that they are operating below normal or full capacity. (See Chart 5.) And average hours worked are still below average.
- Accordingly, we doubt that private sector hiring will pick up by much. In fact, if the recovery turns out to be weaker than firms expect, the private sector may start to cut jobs again. The upshot is that we continue to expect unemployment to reach 3m or so from its current level of 2.5m – perhaps towards the end of 2012. (See Chart 6.)
- At least the high rates of unemployment have not stopped average earnings growth from picking up recently. Although this largely reflects a rebound in bonuses during the main bonus season at the start of the year, underlying pay growth has shown signs of bottoming out. Pay settlements have stabilised too.
- However, pay growth is still being supported by the public sector. (See Chart 7.) And with a two year public sector pay freeze looming, this will not last. What's more, the stabilisation of pay growth is less impressive when set against the sharp rise in inflation – meaning that real earnings have generally been falling. (Chart 8.)
- We still think that the combination of a renewed rise in unemployment and falling inflation will keep a cap on pay growth. We expect average earnings growth of just 1% or so next year. With inflation set to remain high in the near-term, real pay will continue to fall.
- Overall, the private sector labour market does not look strong enough to cushion workers from the effects of the fiscal squeeze.

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

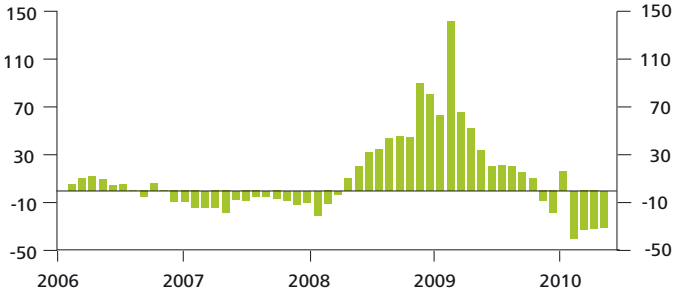


Chart 2. Employment growth & employment intentions

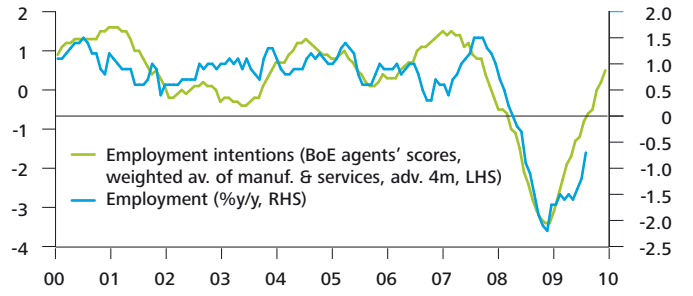


Chart 3. OBR forecast of public sector employment (000s)

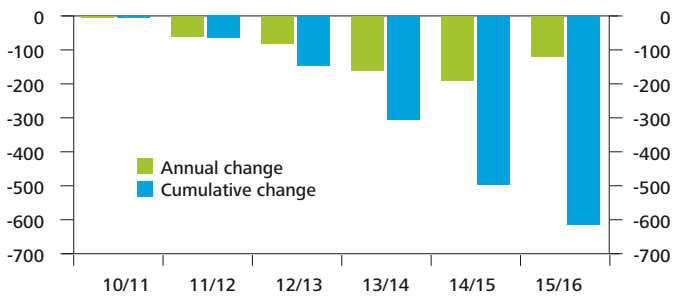


Chart 4. Change in employment since 1992 (Cum., 000s)

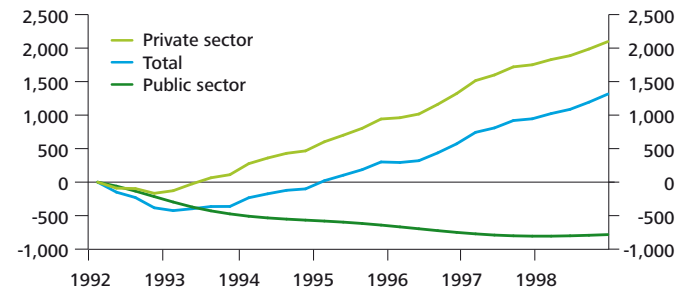


Chart 5. Capacity constraints

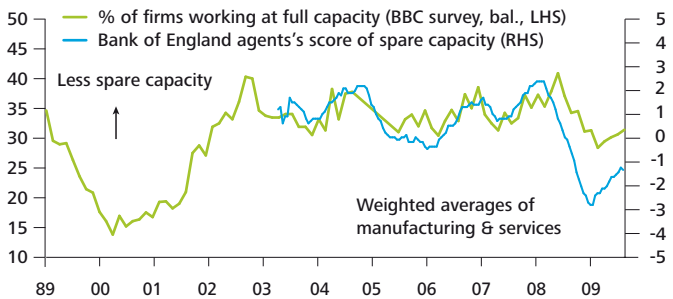


Chart 6. ILO unemployment (000s)

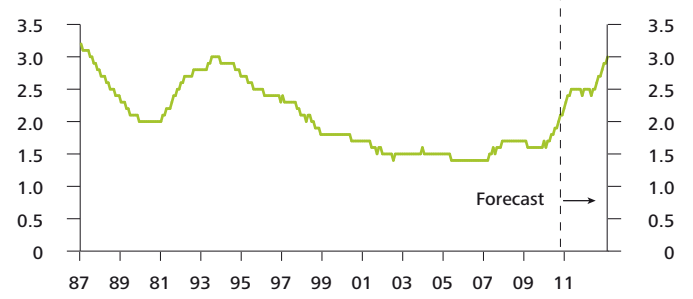


Chart 7. Average earnings (%/y)

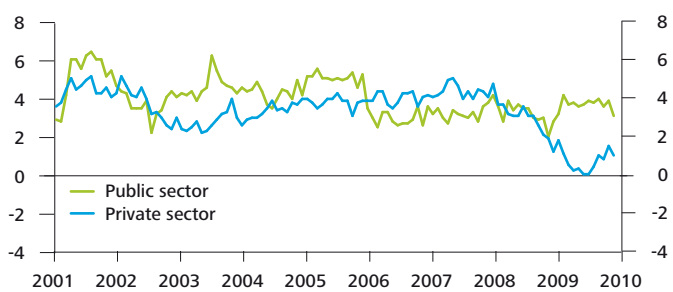
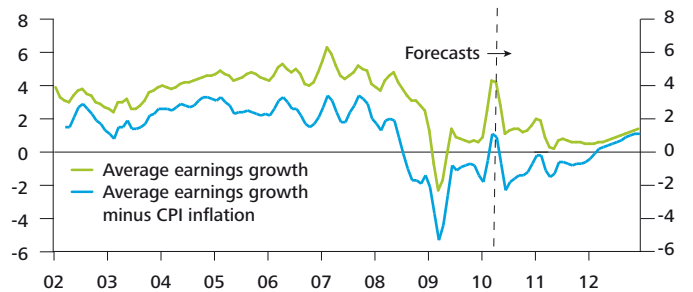


Chart 8. Real average earnings (3m av. of %/y)



Source – Thomson Datastream

Analysis: UK monetary policy

More QE could still be needed

- The recent rise in inflation has tested the nerves of the Monetary Policy Committee (MPC). But if we are right in expecting inflation to fall sharply, a near-term interest rate rise is unlikely. If fact, if anything, the MPC may have to give further support to the economy.
- Inflation has remained surprisingly strong and has even prompted one member of the Committee, Andrew Sentance, to vote for an interest rate rise. However, the Committee as a whole still believes that the large amount of spare capacity in the economy will bring inflation down sharply. Some members have also been reassured that the high inflation rates have not been accompanied by rapid money or pay growth. Although the MPC's preferred measure of M4 growth has accelerated recently, this may just be temporary unless bank lending growth picks up. (See Chart 1.)
- What's more, other things equal, the additional fiscal tightening announced in the emergency Budget will push down the Committee's growth and inflation forecasts. May's forecasts (which were based on March's Budget plans) showed inflation already struggling to meet its target at the two year horizon. (See Chart 2.)
- We therefore think that a near-term interest rate rise is unlikely. Markets no longer expect interest rates to rise this year, but there is still scope for expectations for 2011 to fall further. (See Chart 3 and *Forecast Table: Monetary*, page 38.) This should help longer-term interest rates to fall too. We still expect ten year government bond yields to fall to 3%. (See Chart 4.)
- The MPC might even have to give further support to the economy. In the first instance, this would probably take the form of further quantitative easing (QE). At the very least, this might help to narrow the gap between gilt yields and riskless interest rates that has opened up since QE was paused in February. (See Chart 5.)
- But other policy tools – such as cutting the rate paid on banks' reserves or reducing Bank rate all the way to zero – might come back onto the agenda. The MPC could also buy more corporate assets which have accounted for a tiny fraction of its purchases so far. (See Chart 6.) This might help companies to bypass the impaired banking sector, especially given that corporate bond issuance has weakened a bit recently. (See Chart 7.) Buying foreign assets would also help to keep the pound low and aid a re-balancing of the economy.
- More generally, monetary policy now looks set to become less narrowly focused on simply keeping consumer price inflation stable. After all, Chart 8 shows that the current regime has not stopped house prices from fluctuating widely, with destabilising effects on the real economy. The new government has already announced the creation of a Financial Policy Committee, which will have macroprudential tools to control the credit cycle.
- It has even been suggested that the inflation target could be raised temporarily. But while we think this is possible further ahead, the government has shown no inclination to go down this route now.

Chart 1. M4 Ex. intermediate other fin. corporations

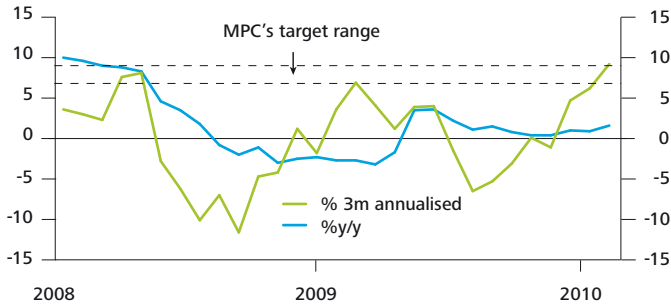


Chart 2. MPC's CPI inflation forecast in May infl. report (%)

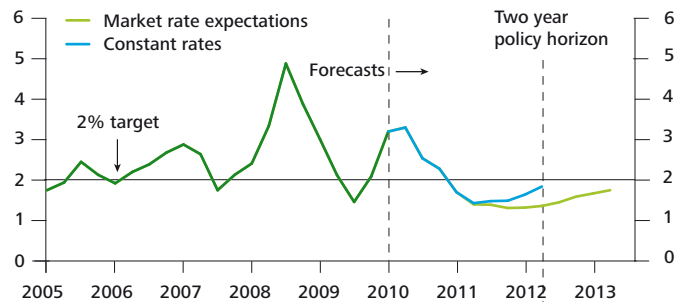


Chart 3. Interest rate expectations (%)

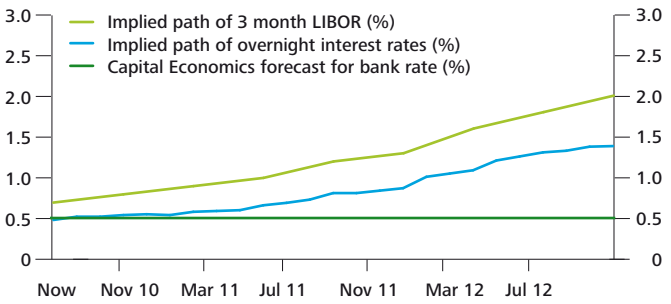


Chart 4. Bond yields (%)

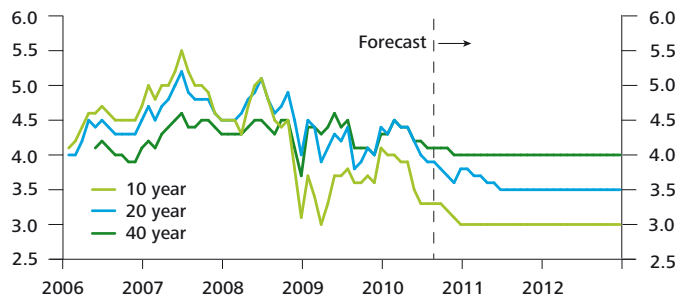


Chart 5. 10 yr gilt yields & o'night indexed swap rates (%)

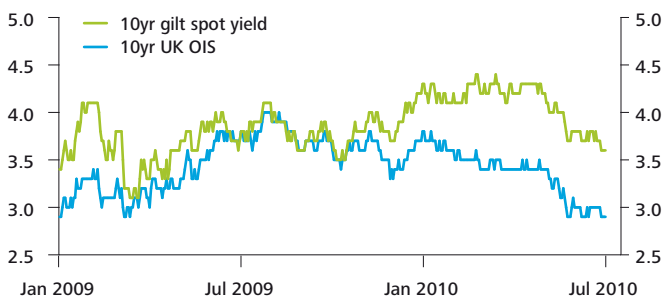


Chart 6. BoE asset purchases (£bn)

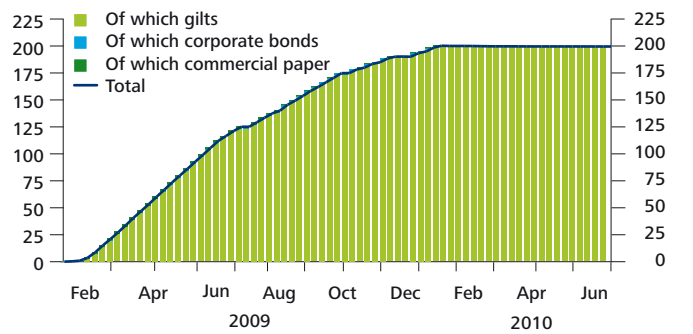


Chart 7. Corporate bond issuance (£bn)

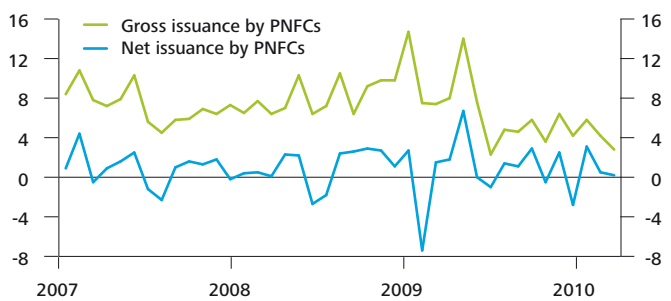
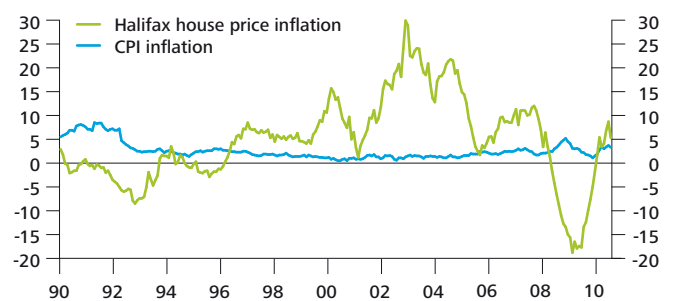


Chart 8. House price & CPI inflation (%)



Sources – Thomson Datastream, Bloomberg, Bank of England

Analysis: UK public finances

Here comes the squeeze

- While the biggest fiscal squeeze since at least the end of the Second World War is now underway, concerns about the UK's public finances are not about to evaporate altogether.
- The new coalition Government has taken decisive action to address the UK's fiscal problems. The emergency Budget on June 22nd included tax and spending measures building up to around £40bn p.a., roughly 2% of GDP, by 2014-15.
- When added to the measures already planned by the previous Government, the total fiscal tightening in prospect rises to around 7% of GDP. (See Chart 1.) This is on a par with the tightening being implemented in the crisis-hit economies of the euro-zone. (See Chart 2.)
- This action is expected to bring the budget deficit down rapidly over the coming years. As Chart 3 shows, the new Office for Budget Responsibility (OBR) expects the Government's fiscal mandate – to return the cyclically-adjusted current budget (which excludes borrowing for investment) to balance within five years – to be achieved a year early.
- However, it would be premature to conclude that the UK's fiscal troubles are now entirely a thing of the past. For a start, there are major doubts over whether the economy will be as robust as is assumed in the fiscal projections.
- Although the OBR's economic forecasts are less optimistic than those used by the previous Government, they still assume that GDP growth will accelerate to a solid 2.3% next year and to 2.8% in 2012. Our weaker forecasts for growth suggest that, without further policy measures, public borrowing will fall rather more slowly than the OBR's projections suggest. (See Chart 4.)
- Meanwhile, there is a clear risk that the planned cuts in public expenditure prove too demanding to implement in full. As Chart 5 shows, spending cuts account for close to 80% of the total fiscal tightening. This might be regarded as the best mix for the economy, but it means that real spending is set to experience its biggest sustained squeeze since the end of the Second World War, at least. (See Chart 6.)
- The full details won't be unveiled until the Spending Review on October 20th. But we know that unprotected areas of spending – essentially everything except health and overseas aid – will see average real cuts of around 25% over the next five years.
- The upshot is that more action, perhaps in the form of further tax hikes, may yet be needed to ensure that the fiscal position improves in line with the projections in the emergency Budget.
- Even if borrowing falls as expected, a heavy redemption schedule means that gilt issuance will remain at very high levels over the next few years. But with fiscal prospects improving, and the Bank of England perhaps extending its gilt purchases, we do not expect the Government to have serious problems financing its borrowing. (See *Forecast Table: Public Finances*, page 39.)

Chart 1. Fiscal tightening (£bn)

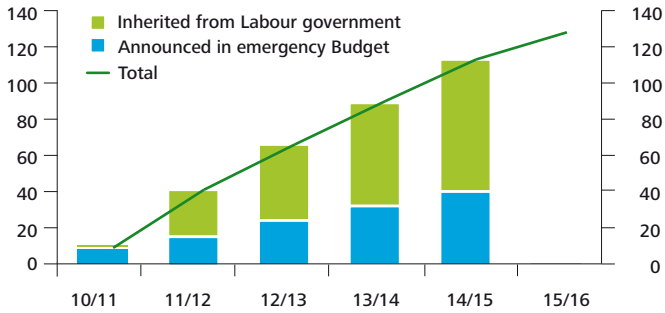


Chart 2. Fiscal tightenings (2010-13, % of GDP)

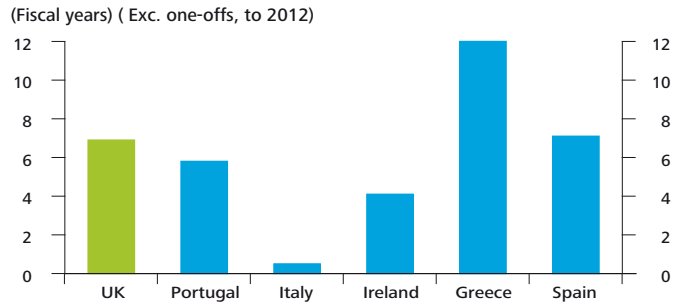


Chart 3. Cyclically adjusted current balance (% of GDP)

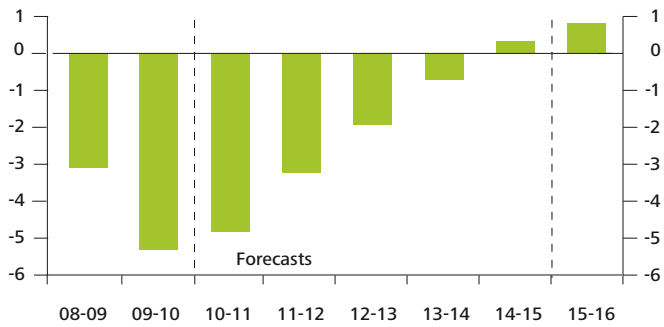


Chart 4. Public sector net borrowing (£bn)

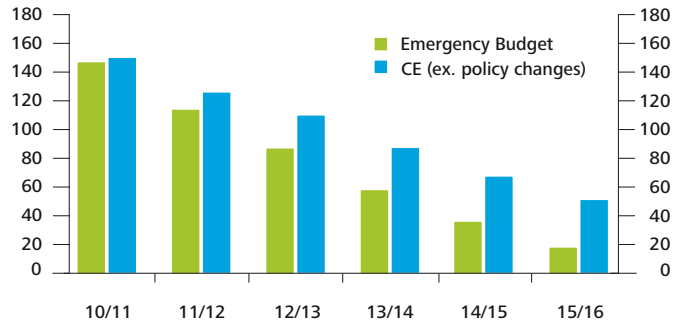


Chart 5. Breakdown of fiscal tightening (£bn)

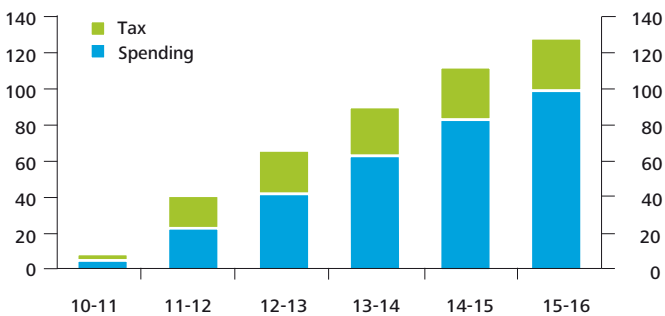


Chart 6. Real public spending (%/y)

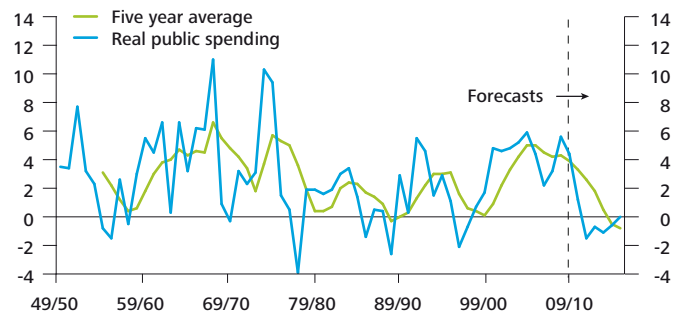


Chart 7. Real public spending (%/y)

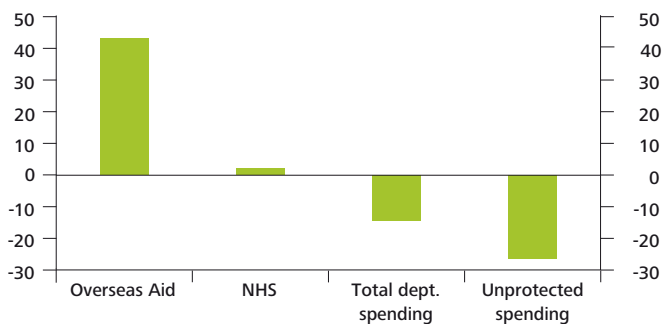
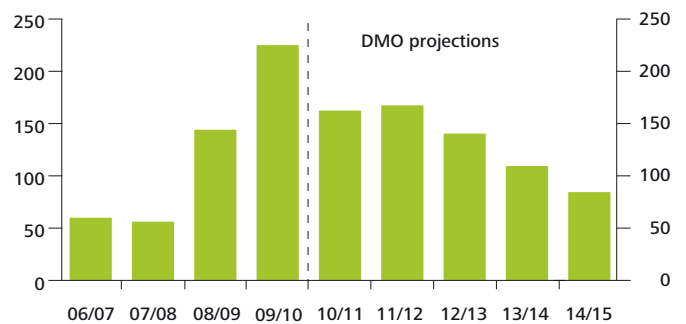


Chart 8. Gross gilt issuance (£bn)



Sources – Thomson Datastream, HM Treasury

Analysis: UK external sector

Fading euro-zone recovery will limit the size of the trade boost

- Recent trade data have cast doubt over the ability of the external sector to support the recovery. Nonetheless, the sector remains the UK's best hope for decent recovery.
- For a start, powerful forces remain in place for a decent trade boost to growth. While sterling has appreciated this year, it remains 25% or so below its trade-weighted peak. Global trade volumes are rising rapidly. UK consumers are also still highly indebted, limiting the potential for a strong revival in imports. (See Chart 1.)
- Given this backdrop, the external sector's recent performance has been concerning. The trade in goods and services deficit widened from £8.7bn to £9.0bn in Q1. Export goods volumes have picked up at a similar pace to those abroad, and fell by 0.5% in both April and May. Net trade has also made increasingly negative contributions to growth in the last three quarters. (See Chart 2.)
- Survey measures of export orders have also begun to turn down. As Chart 3 shows, the fall in the export orders balance of the CIPS/Markit report on manufacturing has left it pointing to flat growth in quarterly export volumes ahead.
- Three factors look set to constrain the size of the trade boost ahead. First, the recent slowing of the recovery in the euro-zone, where around half of all UK exports are sent, is likely to take its toll. We think that painful fiscal retrenchment and competitiveness problems will mean that GDP growth in the euro-zone slows from around 1% in 2010 to 0.5% in 2011.
- Indeed, the dependence of UK exporters on demand from the euro-zone represents a broader structural problem facing the sector, whereby the countries which account for the largest share of UK exports are the ones where growth looks set to be weakest. (See Chart 4.)
- Second, the pound looks set to strengthen on a trade-weighted basis. A fading recovery in the euro-zone could lead to safe haven flows into the UK. The UK's severe fiscal squeeze may also support the pound. (See Chart 5.)
- Third, UK exporters have dampened the boost from the lower pound by raising their sterling prices. If exporters respond in a similar way to sterling's last depreciation in the early 1990s, then it may be 18 months or so before they lower their prices. (See Chart 6.)
- These constraints may mean that the trade deficit fails to narrow on 2009's £33bn figure this year. However, the external sector should still help the recovery in time, perhaps helping the deficit to narrow to £20bn or so in 2012.
- For similar reasons, investment income (the other key component of the current account) may weaken. (See Chart 7.) A rising pound should act to reduce the sterling value of income flowing from the UK's large stock of overseas assets. Outflows of investment income may also rise more than inflows if the UK's recovery is stronger than in the euro-zone. As a result, the current account deficit may only narrow from 1.3% of GDP in 2009 to 0.5% or so in 2012. (See Chart 8 and *Forecast Table: External Sector*, page 40.)

Chart 1. Domestic demand and imported goods vols. (%/y)

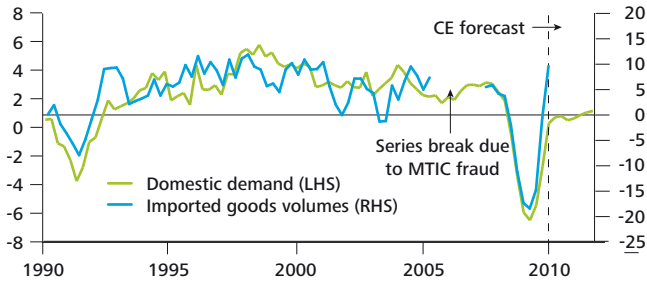


Chart 2. Net trade contrib. to quarterly GDP growth (%)

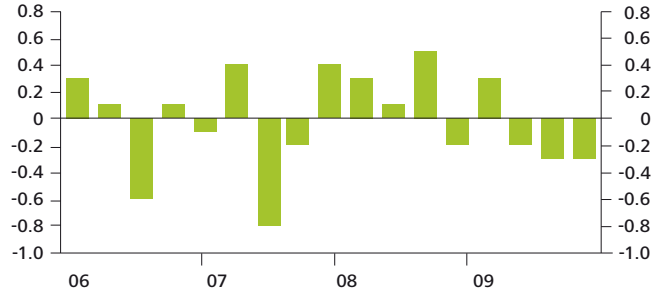


Chart 3. CIPS/Markit export orders balance & export volumes

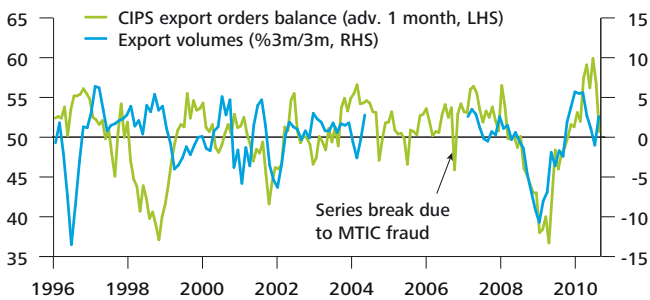


Chart 4. UK exports & GDP growth forecasts

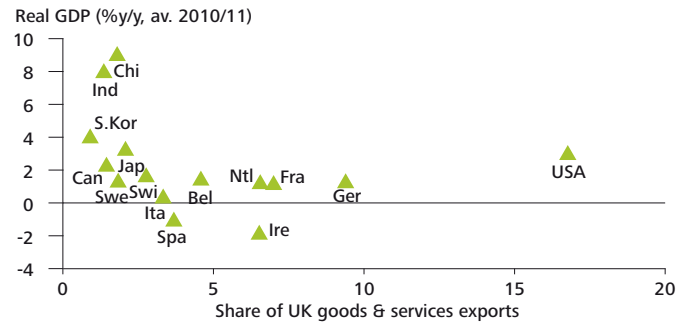


Chart 5. Sterling TWI & cyclically-adj. PSNB

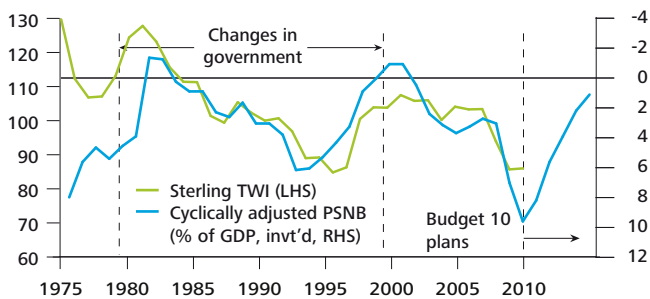


Chart 6. Sterling prices of UK exports (index)



Chart 7. UK investment income balance

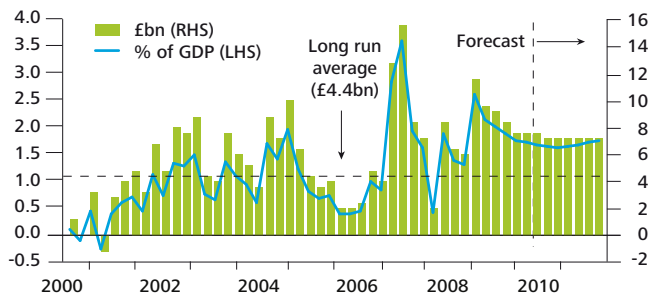
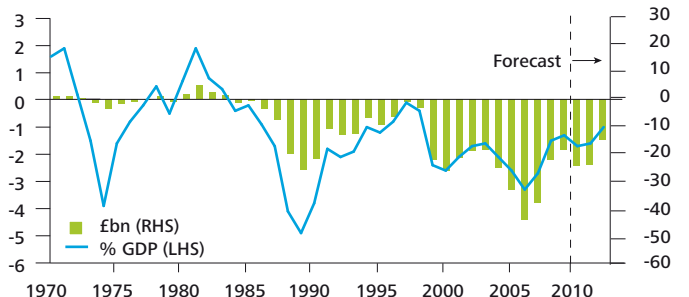


Chart 8. Current account balance



Source – Thomson Datastream & Bootle Forecasts

Forecast table: Inflation

	Monthly Effect on Index							Annual Rate				
	s.a. Core	Other Items					Total Change	Level of the CPI Index	All CPI	CPI Core ²	RPI	RPIX
		Rent	Alc & Tobac.	Energy	Seas Food ¹	Seas Eff.						
2010												
Jan	0.4			0.1		-0.8	-0.2	112.4	3.4	3.1	3.7	4.6
Feb	0.2			0.0	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		0.2	0.2	114.4	3.3	2.9	5.1	5.1
Jun	0.1			-0.2	0.1	0.1	0.1	114.5	3.1	2.8	4.6	5.0
Jul				-0.2		-0.2	-0.3	114.1	2.9	2.8	4.2	4.7
Aug						0.3	0.3	114.5	2.8	2.5	4.3	4.6
Sep						-0.1	0.0	114.4	2.6	2.3	4.2	4.4
Oct					0.1	-0.1	0.1	114.5	2.5	2.2	4.1	4.3
Nov					0.1		0.1	114.6	2.3	2.0	3.7	4.1
Dec					0.1	0.3	0.4	115.0	2.1	1.8	3.6	3.8
2011												
Jan	0.6					-0.8	-0.3	114.7	2.0	1.9	3.3	3.7
Feb	0.2				0.1	0.2	0.5	115.2	2.1	1.9	3.3	3.7
Mar						0.3	0.3	115.6	1.8	1.8	3.0	3.5
Apr	-0.1					0.1	0.1	115.8	1.4	1.4	2.6	3.0
May	-0.1					0.2	0.1	115.9	1.3	1.3	2.5	2.9
Jun	-0.1					0.1	0.1	116.0	1.3	1.2	2.4	2.8
Jul	-0.1					-0.2	-0.2	115.8	1.5	1.1	2.5	2.9
Aug	-0.1					0.3	0.3	116.1	1.4	1.0	2.4	2.8
Sep	-0.1					-0.1	-0.1	116.0	1.3	1.0	2.3	2.7
Oct	-0.1					-0.1	-0.1	115.9	1.2	0.9	2.2	2.6
Nov	-0.1							115.9	1.1	0.8	2.1	2.4
Dec	-0.1					0.3	0.3	116.2	1.0	0.8	1.9	2.3
2012												
Jan	-0.1				-0.1	-0.8	-0.7	115.3	0.6	0.2	1.5	1.9
Feb	-0.1				0.1	0.2	0.3	115.7	0.4	-0.1	1.3	1.6
Mar	-0.1					0.3	0.2	115.9	0.3	-0.2	1.2	1.5
Apr	-0.1					0.1	0.2	116.1	0.3	-0.2	1.1	1.5
May	-0.1					0.2	0.1	116.3	0.3	-0.2	1.1	1.4
Jun	-0.1					0.1	0.0	116.3	0.3	-0.2	1.0	1.4
Jul	-0.1					-0.2	-0.2	116.1	0.2	-0.2	0.9	1.3
Aug	-0.1					0.3	0.2	116.3	0.2	-0.2	0.9	1.2
Sep	-0.1					-0.1	-0.1	116.2	0.2	-0.2	0.8	1.2
Oct	-0.1					-0.1	-0.1	116.1	0.2	-0.2	0.8	1.1
Nov	-0.1				0.1			116.1	0.2	-0.2	0.8	1.1
Dec	-0.1				0.1	0.3	0.3	116.5	0.3	-0.2	0.8	1.1

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

2 Excludes energy, food, alcohol & tobacco.

Forecast table: 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
2010f	31.3	-0.1	28.9	-0.7	2.5	7.9	1.6	5.2
2011f	31.3	-0.1	28.7	-0.7	2.6	8.4	1.7	5.6
2012f	31.3	0.0	28.4	-0.8	3.0	9.2	1.8	5.7
Q1 2010	31.3	-0.2	28.8	-1.4	2.5	7.9	1.6	5.2
Q2	31.3	0.0	28.9	-0.4	2.5	7.9	1.6	5.1
Q3	31.3	0.0	28.9	0.0	2.4	7.7	1.6	5.1
Q4	31.3	0.0	28.9	-0.2	2.5	7.9	1.6	5.2
Q1 2011	31.3	-0.1	28.8	-0.2	2.5	8.1	1.7	5.3
Q2	31.3	0.0	28.7	-0.6	2.6	8.3	1.7	5.5
Q3	31.3	0.0	28.6	-1.0	2.7	8.6	1.8	5.7
Q4	31.3	0.0	28.6	-1.0	2.7	8.7	1.8	5.8
Q1 2012	31.3	0.0	28.5	-0.9	2.8	8.9	1.9	6.0
Q2	31.3	0.0	28.5	-0.9	2.9	9.1	1.9	6.1
Q3	31.3	0.0	28.4	-0.8	2.9	9.3	1.9	6.2
Q4	31.3	0.0	28.3	-0.8	3.0	9.5	2.0	6.4

Earnings & costs	Average earnings		Real av. earnings (Incl. bonuses, %y/y)		Productivity %y/y	Unit labour costs %y/y
	Incl. bonuses	Excl. bonuses	Deflated by RPI	Deflated by CPI		
	%y/y	%y/y	inflation	inflation		
2009	0.1	1.7	0.6	-2.1	-3.1	4.0
2010f	2.0	1.7	-2.2	-0.9	1.5	0.5
2011f	0.7	0.5	-1.9	-0.8	2.2	-1.5
2012f	1.0	0.7	-0.1	0.7	2.9	-1.6
Q1 2010	4.4	2.0	0.4	1.1	1.2	2.9
Q2	1.1	1.6	-3.9	-2.3	1.4	-0.3
Q3	1.3	1.9	-3.0	-1.5	1.7	-0.4
Q4	1.5	1.5	-2.3	-0.8	1.9	-0.4
Q1 2011	0.8	0.7	-2.4	-1.2	2.0	-1.2
Q2	0.7	0.7	-1.8	-0.6	2.2	-1.5
Q3	0.6	0.4	-1.8	-0.8	2.4	-1.7
Q4	0.5	0.3	-1.5	-0.6	2.3	-1.7
Q1 2012	0.6	0.3	-0.7	0.2	2.3	-1.7
Q2	0.8	0.5	-0.3	0.5	2.7	-1.9
Q3	1.1	0.8	0.2	0.9	3.1	-1.9
Q4	1.4	1.1	0.6	1.1	3.5	-2.0

Forecast table: Monetary

Interest rates & bond yields (end period)							
	Repo rate	10-year gilts	20-year gilts	US Fed Funds rate		Euro-zone Refi rate	
	%	%	%	%	UK-US	%	UK-Euro-zone
2009	0.50	4.12	4.41	0.25	0.25	1.00	-0.50
2010f	0.50	3.00	3.50	0.25	0.25	1.00	-0.50
2011f	0.50	3.00	3.50	0.25	0.25	1.00	-0.50
2012f	0.50	3.00	3.50	1.00	-0.50	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	3.25	3.80	0.25	0.25	1.00	-0.50
Q4	0.50	3.00	3.50	0.25	0.25	1.00	-0.50
Q1 2011	0.50	3.00	3.50	0.25	0.25	1.00	-0.50
Q2	0.50	3.00	3.50	0.25	0.25	1.00	-0.50
Q3	0.50	3.00	3.50	0.25	0.25	1.00	-0.50
Q4	0.50	3.00	3.50	0.25	0.25	1.00	-0.50
Q1 2012	0.50	3.00	3.50	0.25	0.25	1.00	-0.50
Q2	0.50	3.00	3.50	0.50	0.00	1.00	-0.50
Q3	0.50	3.00	3.50	0.75	-0.25	1.00	-0.50
Q4	0.50	3.00	3.50	1.00	-0.50	1.00	-0.50

Sterling exchange rates (end period)					
Sterling versus...	\$	¥	Euro	Euro ¹	ERI ²
22009	1.62	147	0.89	1.13	80.5
2010f	1.40	140	0.79	1.27	82.1
2011f	1.40	154	0.71	1.40	87.3
2012f	1.40	154	0.71	1.40	87.3
Q1 2010	1.52	140	0.89	1.12	77.9
Q2	1.49	133	0.82	1.22	81.7
Q3	1.40	133	0.82	1.22	79.8
Q4	1.40	140	0.79	1.27	82.1
Q1 2011	1.40	147	0.75	1.33	84.6
Q2	1.40	154	0.71	1.40	87.3
Q3	1.40	154	0.71	1.40	87.3
Q4	1.40	154	0.71	1.40	87.3
Q1 2012	1.40	154	0.71	1.40	87.3
Q2	1.40	154	0.71	1.40	87.3
Q3	1.40	154	0.71	1.40	87.3
Q4	1.40	154	0.71	1.40	87.3

1 Pound per euro. 2 Effective exchange rate index.

Forecast table: Public finances¹

Government spending & receipts (£bn)							
	(1) Current receipts (excluding tax changes)	(2) Revenue effect of tax changes	(3) Current receipts (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	515	n/a	515	620	-106	49	669
HM Treasury Forecast							
10-11	548	n/a	548	658	-110	39	697
11-12	584	n/a	584	673	-89	27	700
12-13	622	n/a	622	687	-65	24	711
13-14	662	n/a	662	702	-40	20	722
14-15	700	n/a	700	717	-17	21	738
Bootle forecast							
10-11	545	0	545	658	-113	42	700
11-12	573	5	578	673	-95	25	698
12-13	603	10	613	690	-77	23	713
13-14	639	15	654	708	-54	21	729
14-15	676	15	691	723	-33	22	745

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	154.7	11.0	198.9	71.2	53.5		148.0
HM Treasury Forecast							
10-11	149	10.1	146	78.9	61.9		185
11-12	116	7.5	121	83.6	67.2		187
12-13	89	5.5	90	85.5	69.8		159
13-14	60	3.5	65	84.9	70.3		141
14-15	38	2.1	35	83.1	69.4		142
Bootle forecast							
10-11	155	10.5	157	80.3	63.3		190
11-12	120	8.0	122	85.8	69.4		190
12-13	95	6.0	97	88.2	72.5		170
13-14	70	4.2	72	87.6	73.0		155
14-15	45	2.5	47	85.6	71.9		160

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

Forecast table: External sector

Current account										
	Goods		Services		Investment income		Current transfers		Current account	
	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP
2009	-81.8	-5.9	49.3	3.5	28.7	2.0	-14.6	-1.0	-18.4	-1.3
2010f	-85.6	-6.0	50.0	3.5	30.9	2.2	-14.0	-1.0	-18.6	-1.3
2011f	-82.6	-5.7	53.9	3.7	26.7	1.8	-14.0	-1.0	-16.0	-1.1
2012f	-78.3	-5.2	57.9	3.9	27.2	1.8	-14.0	-0.9	-7.1	-0.5
Q1 2010	-21.7	-6.2	12.7	3.6	8.5	2.4	-3.5	-1.0	-4.0	-1.1
Q2	-21.7	-6.2	12.1	3.4	8.0	2.3	-3.5	-1.0	-5.1	-1.4
Q3	-21.3	-5.9	12.4	3.5	7.5	2.1	-3.5	-1.0	-4.9	-1.4
Q4	-20.9	-5.8	12.7	3.5	7.0	1.9	-3.5	-1.0	-4.7	-1.3
Q1 2011	-20.8	-5.8	13.1	3.6	6.9	1.9	-3.5	-1.0	-4.3	-1.2
Q2	-20.7	-5.7	13.4	3.7	6.7	1.9	-3.5	-1.0	-4.1	-1.1
Q3	-20.6	-5.6	13.6	3.7	6.6	1.8	-3.5	-1.0	-3.9	-1.1
Q4	-20.5	-5.5	13.9	3.7	6.5	1.8	-3.5	-0.9	-3.6	-1.0
Q1 2012	-20.3	-5.5	13.8	3.7	6.6	1.8	-3.5	-0.9	-3.4	-0.9
Q2	-19.8	-5.3	14.2	3.8	6.7	1.8	-3.5	-0.9	-2.4	-0.6
Q3	-19.3	-5.1	14.7	3.9	6.9	1.8	-3.5	-0.9	-1.2	-0.3
Q4	-18.8	-4.9	15.2	4.0	7.0	1.8	-3.5	-0.9	-0.1	0.0

Exports, imports & prices (£bn)								
	Goods		Services		Goods & services		Prices ¹	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports %y/y	Imports %y/y
2009	227.7	309.5	161.2	111.9	388.8	421.3	6.4	6.2
2010f	257.1	342.7	162.8	112.8	419.9	455.5	3.4	3.5
2011f	269.0	351.6	168.2	114.3	437.2	465.9	-0.1	0.5
2012f	281.7	360.0	176.2	118.2	457.9	478.2	1.0	2.2
Q1 2010	62.3	83.9	40.5	27.8	102.8	111.8	0.8	-0.3
Q2	64.2	85.9	40.3	28.2	104.5	114.1	3.7	3.6
Q3	64.9	86.3	40.8	28.3	105.7	114.6	5.4	6.1
Q4	65.7	86.7	41.2	28.4	106.9	115.1	3.9	4.8
Q1 2011	66.4	87.1	41.6	28.5	107.9	115.6	1.6	2.5
Q2	66.9	87.7	41.9	28.5	108.8	116.2	0.2	0.4
Q3	67.5	88.2	42.2	28.6	109.8	116.8	-0.9	-0.5
Q4	68.2	88.7	42.5	28.7	110.7	117.3	-1.2	-0.5
Q1 2012	68.9	89.2	43.1	29.3	112.0	118.5	-0.5	0.6
Q2	69.9	89.7	43.7	29.5	113.6	119.2	0.7	1.9
Q3	70.9	90.3	44.4	29.6	115.3	119.9	1.5	2.8
Q4	72.0	90.8	45.0	29.8	117.0	120.6	2.1	3.5

¹ Excludes prices of oil and other erratic items.

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