



## **BCC UK Economic Forecast – March 2010**

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**The main purpose of the BCC Economic Forecast is to articulate a BCC view on economic topics that are relevant to our members, and to contribute to the wider public debate on policy issues. The Forecast also aims to complement the messages conveyed by the BCC's Quarterly Economic Survey (QES).**

### **Main features of the March 2010 Forecast**

- Britain's economic recovery started as expected in the fourth quarter of 2009, but GDP growth is forecast to be modest and below the historical average in the next two years.
- The UK economic outlook will remain highly uncertain for a considerable time. The recovery will be fragile, and the risks of a relapse are high.
- Our UK GDP growth forecast for 2010 is unchanged since December 2009, but our forecast for 2011 has been revised down slightly.
- In annual average terms, we are now forecasting positive growth UK GDP of 1.0% in 2010 and 2.1% in 2011, after a very large GDP decline in of 5.0% in 2009.
- In December 2009, we predicted GDP increases of 1.0% in 2010 and 2.3% in 2011.
- In the 2008-09 recession, UK GDP fell over six consecutive quarters (starting in Q2 2008 and ending in Q3 2009) and recorded cumulative declines of 6.25% during this period.
- This is a much bigger cumulative decline than in the recession of the early 1990s, when GDP recorded cumulative declines totalling 2.5%.
- On the basis of the most recent GDP estimates, the 2008-09 recession was also slightly worse than in 1979-81. In the 1979-81 recession, peak-to-trough falls in GDP totalled 6.0%, and quarterly GDP falls in 1979-81 were not all consecutive. If measured by GDP declines, the 2008-09 downturn was the deepest since the end of the Second World War.

- UK labour market trends have improved markedly since mid-2009, after worsening sharply in the previous year. Over the last six months, total UK employment and unemployment have both shown little net changes. In contrast, between the spring and 2008 and the middle of 2009, employment fell sharply and unemployment recorded big increases.
- However, recent labour market improvements mask a number of worrying developments, mainly rising inactivity and steady falls in the number of people in full-time employment.
- In spite of recent positive trends, UK unemployment is likely to increase further (and UK employment is likely to fall further) in the next 6-9 months, but at a much slower pace than at the height of the recession before mid-2009.
- Our new forecast envisages that total unemployment would rise from 2.46 million (7.8% of the workforce) in October-December 2009, to a peak of 2.65 million (8.4% of the workforce) in Q3 2010. In December, we predicted a slightly higher jobless peak, of 2.7 million.
- UK public sector borrowing is forecast to total £163bn (11.6% of GDP) in 2009-10 and £165bn (11.2% of GDP) in 2010-11, before easing to £147bn (9.6% of GDP) in 2011-12.
- Our forecast envisages lower UK deficits than HM Treasury predicted in the December 2009 Pre-Budget Report: £178bn for 2009-10 & £176bn for 2010-11. But the improvement in the deficit envisaged by HM Treasury from 2011 onwards appears too optimistic.
- Our new forecast confirms that UK public finances are on an unsustainable medium term path, with net UK public sector debt set to increase to dangerous levels in excess of 80% of GDP. Unless firm corrective measures are taken, Britain's credit rating will be threatened.
- A significant part of Britain's deficit is structural rather than cyclical. This structural element of the deficit will still persist even after the economy returns to normal growth.
- HM Treasury estimated recently that the financial crisis and the recession added £73 billion, or 5.2% of GDP, to Britain's structural budget deficit.
- The surge in the structural deficit is mainly due to the permanent loss suffered by the UK economy's productive potential, i.e. its ability to produce goods and services without inflation.
- The Treasury estimates a lasting real loss in productive potential totalling 5% of GDP, but some analysts believe the loss in productive capacity could be larger.
- Policy measures that aim to stabilise Britain's public finances must primarily concentrate on reducing and ultimately eliminating the £73 billion structural deficit caused by the recession.
- This inevitably means a combination of spending cuts and tax increases.
- The forecast assumes that the MPC will maintain for the next few months the £200 billion currently allocated to the Quantitative Easing (QE) programme.
- On balance, there is no need at present to increase the QE stimulus above £200 billion.
- But, if the economy weakens, the MPC may have to consider additional measures.

- Since the QE programme has failed so far to produce significant increases in the level of demand in the economy, the MPC should consider using credit quantitative methods, similar to those that have been applied by the US Fed.
- The MPC should also re-examine the option of applying a negative interest rate on deposits held by banks at the Bank of England.
- We expect UK Bank Rate to remain at 0.5% until Q3 2010; thereafter, we expect modest and gradual Bank Rate increases, to 1.00% in Q4 2010 and to 2.50% by the end of 2011.

## **Risks and key policy issues**

- Most major economies other than the UK have returned to positive growth in Q2 or Q3 2009. Until recently, the UK has lagged behind, with our GDP still falling in Q3.
- In Q4 2009, the UK has returned to positive growth, but the global outlook has become more uncertain. GDP growth in the US, Japan, China, and India has strengthened in Q4 2009.
- However, Eurozone growth has stalled in Q4 2009, and German GDP growth fell to zero.
- In 2009 as a whole, the UK's 5% GDP fall was similar to the performances of Germany, Japan, and Italy. But Britain's 2009 performance was worse than that of the US and France.
- The UK's recovery is fragile and still faces major risks. A sustained recovery cannot be guaranteed. Risks of a setback remain serious, and preventing a double-dip recession must be the main policy priority.
- Huge cutbacks of stocks since the autumn of 2008, which have been major drivers of the severe UK recession, are now easing. Our forecast envisages that this turnaround in the stock cycle will ensure a bounce-back in economic activity in the next few quarters.
- The cumulative impact of earlier sharp falls in sterling and huge injections of stimulus, both monetary and fiscal, should also support UK activity in the next few quarters.
- But a sustained recovery requires steady medium-term growth in investment, net exports, and consumer spending. Unfortunately, the UK economy must make difficult adjustments, and meet challenges in the next few years, that would limit the pace of recovery.
- In particular, the need to cut significantly the budget deficit, strengthen the banking sector, and reduce personal sector debt will inevitably limit UK growth in the next few years.
- The fragility of the banking sector has engendered a mood of caution and risk aversion; this could be a factor limiting UK companies' access to finance. Small and medium-sized firms (SMEs) risk being most hampered by recurring weakness in bank lending.
- Even companies with easy access to finance will not plan to invest on a significant scale, until they expect steady economic growth and rising long-term demand for their products.

- Net UK exports are now benefiting from a competitive sterling exchange rate. But net exports contribution to UK GDP growth will be limited by the sluggishness of the Eurozone economy, and by the weakening of Britain's productive potential due to collapsing investment.
- An over-indebted personal sector, weakened by relatively high unemployment, will have to rebuild its finances; this will dampen future increases in UK consumer spending.
- The UK labour market is now much more flexible than in previous recessions.
- This greater flexibility, particularly the willingness of workers to accept wage reductions, has ensured that falls in employment, and rises in unemployment, in the 2008-09 downturn have been much smaller than in the recession of the early 1990s.
- Securing higher employment and lower unemployment levels in the current recession have been positive developments. But, with employment levels falling much less than output in the 2008-09 recession, UK productivity has recorded very big falls in the past two years.
- However, unless the UK labour market remains flexible and adaptable during the recovery, productivity is unlikely to recover, and there is a serious risk that low productivity would damage Britain's medium term growth prospects.
- Rapid increases in the number of economically inactive people, and persistent falls in the number of people in full-time employment while the number of those in part-time employment continues to increase, could aggravate future threats to Britain's productive potential.
- Sharp falls in manufacturing output (down 10.5% in 2009), and plunging capital investment (down 14.6% in 2009), remain two worrying features of our new UK forecast.
- Falling investment and damaging regulations increase the risk that, once the recession ends and demand starts rising more rapidly, UK industry would find it difficult to increase output.
- Unless huge falls in capital investment are reversed, and the regulatory burden on business is eased, Britain's productive potential would be seriously weakened in the medium term.
- Manufacturing has the potential to recover. But many viable firms risk losing their skills base.
- The sector must be nurtured, to ensure that transitory difficulties triggered by the recession do not cause permanent and irreversible damage to our manufacturing base.
- The UK medium-term economic outlook is grim. A fragile recovery has started, but prospects are uncertain. We are facing a period of austerity. The need to slash Government borrowing and curtail debt will inevitably dampen UK growth prospects for a considerable period.
- Britain's fiscal position is unsustainable over the medium term. A major correction will be needed over the next few years in order to stabilise our public finances.
- It is increasingly urgent to present a credible plan for curbing the fiscal deficit. This must spell out in detail the proposed measures, and must include a clear and realistic timetable.
- But trying to cut the fiscal deficit significantly before the economy starts growing again at a more normal pace would be a major mistake, which could unleash a new recession.
- Longer-term dangers of inflation, and loss of fiscal sustainability, cannot be shrugged off.

- Postponing unduly the presentation of a credible plan for restoring stability could threaten the UK's international credit rating, with damaging effects for sterling and the gilt-edged market.
- Yields on UK Government debt have recorded worrying increases in recent months. The cost of servicing Britain's debt would worsen further if we lose our AAA rating.
- A multi-year fiscal plan, which the markets can accept as realistic, must avoid damaging the economy's growth potential and must enable businesses to invest and export.
- Our central scenario envisages a return to steady positive growth over the next few years. But the pace of UK expansion is likely to be relatively weak by pre-recession standards.
- Over the next 4-5 years, growth of UK GDP is likely to average just under 2% per annum, considerably less than the 2.7% average growth recorded in the period 2003-07.
- Against this background, it is vital to ensure that wealth-creating businesses have adequate capacity to respond to an upturn in demand when the recovery strengthens.
- The painful but vital medium-term reduction in Government debt and borrowing, which will have to be implemented in the next few years, should primarily entail curbing public spending in all areas except for vital infrastructure expenditure.
- Given the urgent need to stabilise our public finances, the Government cannot afford to ring-fence other spending categories, however desirable. Public sector pay and pensions must be part of a credible medium-term fiscal plan. Action in these areas can start without delay.
- Given the scale of the fiscal adjustment facing us, some tax increases are unavoidable; these should focus on areas least likely to damage incentives, e.g. indirect consumption taxes.
- Since the business sector will drive any sustainable recovery, it is vital to avoid new business taxes, higher NICs, and measures that damage initiative, enterprise, and innovation.
- Proposed policies that are inimical to job creation should be discarded without delay.
- Oppressive labour market regulations must be scrapped, or at least temporarily suspended.
- The proposed 1% increase in employer National Insurance Contributions, scheduled to take effect in April 2011, should be abandoned in the Budget. Raising the standard rate of VAT by one percentage point, to 18.5%, will broadly offset the lost revenue.

## **UK economy: the main components of demand**

- The UK recession has ended. UK GDP recorded positive quarter-on-quarter growth of 0.3% in Q4 2009, after quarterly falls 0.3% in Q3 2009, 0.6% in Q2, and 2.6% in Q1.
- In year-on-year terms, UK GDP fell 3.3% in Q4 2009, after year-on-year declines of 5.3% in Q3 2009 and 5.9% in Q2.
- In the 2008-09 recession, UK GDP fell over six consecutive quarters (starting in Q2 2008 and ending in Q3 2009) and recorded cumulative declines of 6.25% during this period.

- In annual average terms, our new forecast predicts positive growth of 1.0% in 2010 and 2.1% in 2011, after a large negative GDP growth of 5.0% in 2009.
- In our December 2009 forecast we also envisaged annual average GDP growth of 1.0% for 2010, but we predicted slightly higher growth for 2011, at 2.3%.
- Our 2011 average GDP growth forecast has been downgraded since December, because the obstacles to a sustained medium-term upturn now seem greater.
- The early stages of the recovery would be driven by the stock cycle, as the massive rate of running down stocks eases significantly. Huge injections of stimulus, fiscal & monetary, and earlier sharp falls in sterling, should also support an initial upturn.
- Following a slowdown in Q1 2010, due to weather-related disruptions and the reversal of the VAT cut, we expect a relatively strong temporary bounce back in UK GDP, driven by the turnaround in stocks and the policy stimulus. But longer-term growth prospects are weak.
- In particular, the need to cut significantly the budget deficit, strengthen the enfeebled banks, and reduce personal sector debt will inevitably limit UK growth in the next few years.
- Household consumption growth has dropped in annual average terms from 2.5% in 2007 to 0.9% in 2008 and a big outright decline of 3.1% in 2009; it is forecast to record positive growth of 0.9% in 2010 and 1.7% in 2011, weaker than the expected growth in GDP.
- Our new forecast signals very sharp falls in spending on UK capital investment.
- Investment spending plummeted, from annual average growth of 7.8% in 2007, to -3.5% in 2008, and massive negative growth of -14.6% in 2009. Our forecast envisages further large negative growth of -5.0% in 2010, and a return to modest positive growth of 1.3% in 2011.
- During the 2008-09 recession, there has been some rebalancing of the UK economy towards net exports. But the rebalancing appears relatively modest and inadequate.
- With world trade strengthening, we expect positive growth in UK exports, by 4.9% in 2010 & 3.8% in 2011. But UK imports are forecast to increase only marginally slower than exports.
- Net trade as a proportion of GDP fell markedly in 2008 & 2009. But the ratio is forecast to remain mostly unchanged in 2010 & 2011.
- Table 1 summarises our forecasts for UK GDP and its main demand components.

**Table 1: UK GDP & Main Demand Components, % Change Year on Year**

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
<u>GDP</u>	2.2%	2.9%	2.6%	0.5%	-5.0%	1.0%	2.1%
<u>Household Consumption</u>	2.3%	1.5%	2.5%	0.9%	-3.1%	0.9%	1.7%
<u>General Government</u>	2.0%	1.6%	1.2%	2.6%	2.0%	2.6%	2.2%
<u>Investment</u>	2.4%	6.5%	7.8%	-3.5%	-14.6%	-5.0%	1.3%
<u>Exports</u>	7.9%	11.3%	-2.8%	1.1%	-10.9%	4.9%	3.8%
<u>Imports</u>	7.1%	8.8%	-0.7%	-0.5%	-12.1%	4.8%	3.6%

## **UK main sectors - manufacturing, services, & construction**

- All the main sectors of the UK economy – manufacturing, services, and construction – have recorded big annual average falls in 2009.
- The new forecast envisages that all three sectors are likely to record positive annual average growth in 2010 & 2011, but the pace of growth is set to be modest.
- Services, the largest sector in the economy, has recorded (in average terms) negative growth of -3.6% in 2009; it is forecast to register positive growth of 1.2% in 2010 and 2.7% in 2011.
- Manufacturing output recorded very large quarterly falls, in excess of 5%, in both Q4 2008 & Q1 2009; output broadly stabilised in Q2 & Q3 2009, though fluctuating sharply from month to month. In Q4 2009, manufacturing output recorded satisfactory quarterly growth of 0.8%.
- In year-on-year terms, manufacturing fell by 4.8% between Q4 2008 and Q4 2009, after large year-on-year declines in excess of 10% in the first three quarters of 2009.
- Our new forecast indicates that manufacturing output, in annual average terms, will record positive growth of 1.7% in 2010 and 1.6% in 2011, after declining by 10.5% in 2009.
- Though the manufacturing sector has the potential to recover in the next few years, it must be nurtured and supported, to ensure that viable firms do not lose their skills base.
- Construction sector output fell (in average year-on-year terms) by 0.8% in 2008, followed by a huge decline of 9.3% in 2009. Our new forecast envisages a return to very modest positive growth, at 0.9% in 2010 and 0.9% in 2011.
- Table 2 summarises our specific forecasts for manufacturing, services, and construction.

**Table 2: Manufacturing, Services & Construction Output, % Change Year-on-Year**

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
<u>Manufacturing Output</u>	-0.2%	1.6%	0.6%	-2.9%	-10.5%	1.7%	1.6%
<u>Services Output</u>	3.1%	3.6%	3.5%	1.4%	-3.6%	1.2%	2.7%
<u>Construction Output</u>	1.1%	1.1%	2.7%	-0.8%	-9.3%	0.9%	0.9%

## **UK inflation and labour costs**

- All reported measures of annual UK inflation fell in average terms between 2008 & 2009, due to the combined impact of a number of factors: the recession, the temporary VAT cut, and falls in energy and food prices from their 2008 peaks.
- CPI annual inflation fell to a low point of 1.1% in September 2009, but has risen markedly since then, reaching 3.5% in January 2010. RPI annual inflation rose to 3.7% in January.
- All UK annual inflation measures have risen in recent months, as food & energy prices have reversed some of their earlier falls.
- The VAT rise back to 17.5% pushed up significantly the inflation figures for January 2010.

- Overall, declines in UK annual inflation earlier in 2009 were smaller than expected, and the more recent subsequent increases have been bigger than expected. This was mainly due to earlier sharp falls in sterling. UK inflation is now higher than in the US and the Eurozone.
- Looking ahead, the current widely expected surge in CPI annual inflation is likely to reach its peak in Q2 2010 at around 3.8-3.9%, before falling later in 2010.
- Although the recent renewed falls in sterling may push up temporarily annual CPI inflation to higher levels, we expect big falls in CPI inflation later in 2010, towards the 2% target; this will mainly be due to the large measure of spare capacity in the economy.
- As the economy continues to recover, spare capacity in the economy will gradually diminish, and annual CPI inflation will move towards the 2% target in 2011.
- Table 3 summarises our specific forecasts for various measures of UK inflation.

**Table 3: UK Annual Inflation, % Change Year on Year**

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
<u>CPI</u>	2.1%	2.3%	2.3%	3.6%	2.2%	3.2%	2.2%
<u>RPIX</u>	2.2%	2.9%	3.2%	4.3%	2.0%	4.3%	3.5%
<u>RPI</u>	2.8%	3.2%	4.3%	4.0%	-0.5%	4.3%	3.1%

- The pace of increase in UK labour costs has decelerated markedly over the past year.
- In October-December 2009, annual growth in total UK average earnings was 1.2% excluding bonuses, and 0.8% including bonuses. A year earlier, the corresponding annual growth in average earnings was 4.0% excluding bonuses and 4.1% including bonuses.
- Recent figures continue to show a sharp contrast between the public and private sectors.
- The deceleration in earnings growth was much more pronounced in the private sector, and earnings growth is now much higher in the public sector.
- Excluding bonuses, annual growth in average earnings in October-December 2009 was 0.2% in the private sector and 3.9% in the public sector.
- Including bonuses, annual growth in average earnings in October-December 2009 was 0% in the private sector and 3.7% in the public sector.
- Our forecast assumes that total average earnings growth will remain around current levels over the next few months, and will edge up slowly from mid-2010, to reach 2.5-3% in 2011.

## **UK labour market – unemployment & employment**

- Labour market trends have improved considerably in recent months, after worsening sharply in the previous year. Over the last six months, total UK employment and unemployment have both shown little net changes. In contrast, between the spring and 2008 and the middle of 2009, UK employment fell sharply and unemployment recorded big increases.

- Since the end of 2007, UK unemployment on the ILO definition has risen by 845,000.
- The rate of increase in UK unemployment has accelerated in the second half of 2008 and the early months of 2009. But, in spite of month-to-month fluctuations, UK unemployment has recorded little net change in recent months.
- UK unemployment has increased on average by 37,000 per month in the past twelve months, but has fallen on average by 1,000 per month in the latest three months.
- Over the nineteen months to October-December 2009, total UK employment fell by almost 660,000. Over the past 12 months employment falls have averaged some 35,600 per month, but over the past three months employment has declined by only 4,000 per month.
- However, these positive trends mask a number of worrying developments:
  - The number of economically inactive people is rising rapidly, and the pace of increase in inactivity has accelerated in the latest three months.
  - The number of people in full-time employment is falling steadily, albeit at a diminishing pace, while the number of people in part-time employment continues to increase.
- The number of “economically inactive” people (i.e. those that have effectively left the workforce) has risen by 420,000 in the past nineteen months, and the rate of increase has accelerated in the last three months.
- Without the large increase in inactivity, rises in UK unemployment would have been bigger.
- 1.04 million employees and self-employed people worked part-time in the three months October-December 2009, because they could not find a full-time job. This is the highest figure since records for this series began in 1992.
- Though recent labour market trends have been relatively benign, UK unemployment is likely to increase further (and UK employment is likely to fall further) in the next 6-9 months, but at a much slower pace than at the height of the recession before mid-2009.
- Our new forecast envisages that total unemployment would rise from 2.46 million (7.8% of the workforce) in October-December 2009, to a peak of 2.65 million (8.4% of the workforce) in Q3 2010. In December, we predicted a slightly higher jobless peak, of 2.7 million, or 8.6% of the workforce.
- The forecast entails big uncertainties, most critically the large number of “economically inactive” people. If some of these people decide to return to the workforce and start seeking work at a relatively rapid pace, unemployment would rise more sharply than we now predict, even if the economy recovers and employment rises.
- The new unemployment forecast compares with an unemployment peak of some 3 million (10.7% of the workforce) in the recession of the early 1990s.
- The UK labour market is now much more flexible than in previous recessions.

- This greater flexibility, particularly the willingness of workers to accept wage reductions, has ensured that falls in employment, and rises in unemployment, in the 2008-09 downturn have been much smaller than in the recession of the early 1990s.
- Reducing job losses in the current recession has been a positive development.
- But, with employment falling much less than output in 2008-09, UK productivity has recorded very big falls in the recession that has now ended.
- However, unless the UK labour market remains flexible and adaptable during the recovery, there is a risk that falling productivity would damage Britain's medium term growth prospects.
- Rapid increases in the number of economically inactive people, and persistent falls in the number of people in full-time employment while the number of those in part-time employment continues to increase, could worsen future threats to Britain's productive potential.

### **Unemployment in the 16-17 & 18-24 age groups**

- The unemployment rate among people aged 16-17 is very high, having risen from 25.1% in October-December 2007, to 33.6% in October-December 2009. The unemployment total among people aged 16-17 has risen from 188,000 in October-December 2007, to 206,000 in April-June 2009, but has fallen back to 198,000 in October-December 2009.
- The 18-24 age group has recorded particularly big unemployment increases in the 2008-09 recession, from 499,000 (a rate of 12.0%) in October-December 2007, to 738,000 (a rate of 17.8%) in July-September 2009 but has fallen back to 198,000 in October-December 2009.
- However, it must be stressed that the ONS unemployment figures for these age groups include people in full-time education that are looking for part-time employment.
- With total UK unemployment forecast to peak at 2.65 million, or 8.4% of the workforce, in Q3 2010, and with the level of inactivity in both age groups expected to continue to increase, our specific forecast for the 16-17 and 18-24 age groups are as follows:
  - Unemployment in the 16-17 age group is forecast to total around 195,000 (a rate of 33.5%) in Q3 2010.
  - Unemployment in the 18-24 age group is forecast to total around 720,000 (a rate of 17.5%) in Q3 2010.

### **UK public finances and the balance of payments**

- Our new forecast indicates that UK public sector borrowing is forecast to total £163bn (11.6% of GDP) in 2009-10 and £165bn (11.2% of GDP) in 2010-11, before easing to £147bn (9.6% of GDP) in 2011-12.

- HM Treasury predicted higher UK deficits in the December 2009 Pre-Budget Report: £178bn for 2009-10 & £176bn for 2010-11. But the falls in borrowing envisaged by HM Treasury from 2011 onwards appear too optimistic in our view.
- Our new forecast confirms that UK public finances are on an unsustainable medium term path, with net UK public sector debt set to increase to dangerous levels in excess of 80% of GDP. Unless firm corrective measures are taken, Britain's credit rating will be threatened.
- A significant part of Britain's deficit is structural rather than cyclical. This structural element of the deficit will still persist even after the economy returns to normal growth.
- HM Treasury estimated recently that the financial crisis and the recession added £73 billion, or 5.2% of GDP, to Britain's structural budget deficit.
- The surge in the structural deficit is mainly due to the permanent loss suffered by the UK economy's productive potential, i.e. its ability to produce goods and services without inflation.
- HM Treasury estimates a lasting real loss in capacity totalling 5% of GDP, but some analysts believe the loss in productive capacity could be larger.
- Policy measures that aim to stabilise Britain's public finances must primarily concentrate on reducing and ultimately eliminating the £73 billion structural deficit caused by the recession.
- This inevitably means a combination of spending cuts and tax increases.
- Britain's fiscal position is unsustainable over the medium term. A major correction will be needed over the next few years in order to stabilise our public finances.
- It is increasingly urgent to present a credible plan for curbing the fiscal deficit. This must spell out in detail the proposed measures, and must include a clear and realistic timetable.
- But trying to cut the fiscal deficit significantly before the economy starts growing again at a more normal pace would be a major mistake, which could unleash a new recession.
- Longer-term dangers of inflation, and loss of fiscal sustainability, cannot be shrugged off.
- Postponing unduly the presentation of a credible plan for restoring stability could threaten the UK's international credit rating, with dangerous effects for sterling and the gilt-edged market. One of the adverse effects would be to increase further the cost of servicing the debt.
- A multi-year fiscal plan, which the markets can accept as realistic, must avoid damaging the economy's growth potential and must enable businesses to invest and export.
- The painful but vital medium-term reduction in Government debt and borrowing should primarily entail curbing public spending in all areas except for vital infrastructure expenditure.
- The UK current account deficit fell to 1.5% of GDP in 2008, and figures for the first three quarters of 2009 point to a further improvement.
- Our new forecast suggests that the current account deficit is likely to record a further decline to 1.3% of GDP in 2009, before increasing slightly, to 1.6% in 2010 and 1.6% in 2011.
- Table 4 and 5 below summarise our new specific forecasts for UK public borrowing and for the balance of payments on current account.

**Table 4: UK Public Borrowing – Comparison of Forecasts**

	<u>2006/07</u>	<u>2007/08</u>	<u>2008/09</u>	<u>2009/10</u>	<u>2010/11</u>	<u>2011/12</u>
<u>PSNB-£bn-March2007 Budget</u>	35	34	30	28	26	24
<u>PSNB-£bn-March2008 Budget</u>	30	36	43	38	32	27
<u>PSNB-£bn-March2009 Budget</u>	31	35	90	175	173	140
<u>PSNB-£bn-Nov09-PBR</u>	31	34	95	178	176	140
<u>PSNB-£bn-BCC Forecast</u>	30.8	34.0	86.7	163.0	165.0	147.0

*\*BCC historical figures are the most up-to-date actual figures, as revised by the ONS*

*\*\*Positive PSNB figure indicates deficit; negative PSNB figure indicates surplus*

**Table 5: UK Twin Deficits - Public Borrowing & BofP Current Account**

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
<u>BofP-CurrentAccount-%GDP</u>	-2.6%	-3.4%	-2.7%	-1.5%	-1.3%	-1.6%	-1.6%
<u>PSNB-FinYears-%GDP</u>	2.9%	2.3%	2.4%	6.0%	11.6%	11.2%	9.6%

<u>BofP-CurrentAccount-£bn</u>	-32.7	-45.0	-37.7	-22.0	-18.0	-23.0	-25.0
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<u>PSNB-FinYears-£bn</u>	37.4	30.8	34.0	86.7	163.0	165.0	147.0
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*\*Positive PSNB figure indicates deficit; negative PSNB figure indicates surplus*

## **UK interest rates and monetary policy**

- The forecast assumes that the MPC will maintain for the next few months the £200 billion currently allocated to the Quantitative Easing (QE) programme.
- On balance, we do not see at present the need to increase the QE stimulus above £200 billion. But, if the economy weakens, the MPC may have to consider additional measures.
- Since the QE programme has failed so far to produce significant increases in the level of demand in the economy, the MPC should consider using credit quantitative methods, similar to those that have been applied by the US Fed.
- The MPC should also re-examine the option of applying a negative interest rate on deposits held by banks at the Bank of England.
- We expect UK Bank Rate to remain at 0.5% until Q3 2010; thereafter we expect modest and gradual increases, to 1.00% in Q4 2010 and to 2.50% by the end of 2011.

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