



BCC UK Economic Forecast – March 2009

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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 2009 Forecast Update

Conclusions and key policy issues

- The economic situation has worsened further since our January forecast, both globally and in the UK. Growth forecasts for 2009 have been downgraded in all major economies
- Our UK GDP forecasts have been revised down markedly. We now predict larger UK GDP declines in the current recession than we envisaged in the January forecast.
- Consequently, we now expect bigger unemployment increases and larger Budget deficits than we envisaged in January.
- We now predict that in the second half of 2010 UK unemployment would rise to a peak of 3.2 million, or just over 10% of the workforce, a little higher than the jobless peak of 3.1 million (also some 10% of the workforce) envisaged in our January forecast.
- Our new forecast also indicates that total government borrowing would reach 158 billion, or 10.7% of GDP, in 2010/11, after 143 billion (10.0% of GDP) in 2009/10.
- These figures signal a very serious UK budgetary position, which will have to be addressed vigorously as soon as the present recession ends.
- Producing a credible plan to reduce Government debt and borrowing over the medium-term is a critical condition to maintaining the UK's credit rating and the confidence of the markets.

- Our March 2009 forecast still envisages cumulative falls in GDP totalling 3.5% over the five quarters Q3 2008 to Q3 2009, inclusive; this compares with cumulative GDP declines of 2.9% predicted in the January forecast. We also predict zero growth in Q4 2009.
- The new March 2009 forecast predicts a much bigger cumulative decline in UK GDP in the current recession than in the early 1990s recession: 3.7% in 2008-09 vs. 2.5% in 1992-93.
- But the current recession is still likely to be less severe than the early 1980s recession.
- Sharp falls in manufacturing output (down 9.0% in 2009), and plunging capital investment, (down 9.9% in 2009), are two particularly worrying features of our new UK forecast.
- Manufacturing has the potential to recover. But the sector must be nurtured in the face of a recession triggered by a financial and banking crisis.
- We need policies that would facilitate the much needed rebalancing of the UK economy towards industry.
- Unless the huge falls in capital investment are halted and reversed, the UK's productive potential would be seriously weakened in the medium term.
- Falling investment increases the danger that UK industry would find it difficult to increase output once the recession comes to an end and demand starts recovering.
- We assume that GDP declines would gradually lessen during 2009, due to the cumulative impact of large injections of stimulus, earlier sharp falls in sterling, and a turnaround in the stock cycle as the rate of running down stocks eases.
- But a temporary rebound driven primarily by the stock cycle cannot produce a sustainable recovery, unless consumer spending, investment and net exports start to improve.
- The main immediate risk is that the recession would worsen further. In the short-term, economic policy must therefore remain expansionary.
- But stimulatory measures, though essential at present, can exacerbate longer-term problems relating to excessive indebtedness and fiscal sustainability.
- The UK medium-term economic outlook is grim. The critical need to reduce significantly Government borrowing after the recession ends will inevitably dampen UK growth prospects for a considerable period.
- While our central scenario envisages a return to modest UK growth from 2010, the pace of expansion is likely to be weak by pre-recession standards for a number of years.
- The trend growth of UK GDP is likely to be considerably weaker after 2010 than in the period preceding the current recession.
- Against this background, the Government must ensure that wealth-creating businesses have adequate capacity to respond to an eventual upturn in demand when the recession ends.
- Oppressive labour market regulations must be scrapped, or at least temporarily suspended.
- Proposed policies that are inimical to job creation, i.e. the proposed increase in NICs in 2011, must be abandoned without delay.

- The painful but vital medium-term reduction in Government borrowing, which will have to be implemented once the recession is over, should primarily entail curbing public spending growth in all areas except for vital infrastructure expenditure.
- Tax increases that damage the economy's productive potential should be avoided all costs.

UK economy: the main components of demand

- In annual average terms, the March 2009 Forecast predicts negative GDP growth of 2.8% in 2009, much worse than the 2.2% negative 2009 growth indicated in our January forecast.
- For 2010, we are now predicting very shallow positive growth of only 0.8%, below the 1.1% growth indicated in our January forecast.
- The main drivers of the UK GDP recession in 2009 remain sharp cutbacks in investment spending, marked falls in consumer spending, and big falls in inventories.
- Household consumption, in annual average terms, having dropped from 3.0% in 2007 to 1.6% in 2008, is forecast to record a big outright decline of 2.5% in 2009, followed by very shallow growth of only 0.3% in 2010.
- Our forecast signals very sharp falls in investment spending in average year-on-year terms. After plummeting from strong positive growth of 7.2% in 2007, to -4.3% in 2008, investment is set to record massive negative growth of -9.9% in 2009.
- For 2010, we are predicting further large negative growth in investment of -4.1%.
- Our new forecast predicts that that there will be a rebalancing of the UK economy during the current recession. But, on present trends, the expected rebalancing is likely to be modest and inadequate.
- Changes in net exports are likely make a positive net contribution to GDP growth in both 2009 and 2010. Though UK exports growth will be weak, because of sluggish growth in world trade, UK imports growth will be even weaker, because of very weak domestic demand.
- 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>GDP</u>	2.1%	2.8%	3.0%	0.7%	-2.8%	0.8%
<u>Household Consumption</u>	2.0%	2.0%	3.0%	1.6%	-2.5%	0.3%
<u>General Government</u>	1.7%	1.6%	1.7%	3.5%	3.1%	3.4%
<u>Investment</u>	2.2%	6.0%	7.2%	-4.3%	-9.9%	-4.1%
<u>Exports</u>	8.1%	11.0%	-4.2%	-0.1%	-2.5%	3.7%
<u>Imports</u>	7.0%	9.6%	-1.6%	-0.5%	-3.7%	3.2%

UK main sectors - manufacturing, services, & construction

- Since our January forecasts, the outlook for all the main sectors of the UK economy – manufacturing, services, and construction – has worsened.
- The new forecast indicates that all three sectors are expected to record bigger output declines in 2009 than we predicted in January.
- The biggest downward revision since January has been for manufacturing, largely reflecting very large output falls in the final months of 2008.
- Manufacturing output has contracted globally in recent months. Recent falls in manufacturing production have been smaller in the UK than in other major economies.
- Even so, our new forecast, signalling a very large 9.0% fall in UK manufacturing output in 2009, is very worrying. Though the sector has the potential to recover, it must be nurtured in the face of a recession triggered by a financial and banking crisis
- In 2010, the output recovery in all the three main UK sectors is expected to be very weak.
- 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>Manufacturing Output</u>	-0.2%	1.8%	0.6%	-2.9%	-9.0%	0.7%
<u>Services Output</u>	3.0%	3.6%	3.6%	1.3%	-1.9%	1.3%
<u>Construction Output</u>	1.0%	1.0%	2.8%	1.3%	-2.6%	0.5%

UK inflation

- UK inflation is now falling, and we expect further sharp declines during 2009, reflecting much weaker economic activity and recent falls in energy and food prices.
- Our new inflation forecasts for 2009 are lower than we predicted in January.
- 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>CPI (HICP)</u>	2.1%	2.3%	2.3%	3.6%	1.2%	1.9%
<u>RPIX</u>	2.3%	2.9%	3.2%	4.3%	0.6%	1.6%
<u>RPI-All Items</u>	2.8%	3.2%	4.3%	4.0%	-1.4%	1.8%

- While the sharp falls in sterling will moderate somewhat the pace at which inflation is falling, the downward pressures on annual inflation will be accentuated during 2009, as the impact of earlier increases of food and energy prices come out of the annual calculation.
- Annual CPI inflation is forecast to fall well below 1% in the second half of 2009, and this will necessitate letters of explanation from the Governor of the Bank of England to the Chancellor of the Exchequer.
- There is a distinct risk of deflation in the second half of 2009. In particular, the RPI measure of inflation is very likely to register deflation during significant periods of 2009.

UK unemployment

- Our new March 2009 forecast predicts that in H2 2010 UK unemployment would rise to a peak of 3.2 million (just over 10% of the workforce), a little higher than the jobless peak of 3.1 million (also some 10% of the workforce) envisaged in our January Forecast.
- 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.
- In absolute terms, the new unemployment peak is slightly higher than in the early 1990s.
- But, as a percentage of the workforce, the peak in UK unemployment rate in the present recession is forecast to be lower than in the early 1990s.
- The UK workforce in the early 1990s was more than 2 million lower than at present. Therefore, a smaller absolute level of UK unemployment in the early 1990 has reflected at that time a bigger percentage of the workforce.

UK public finances and the balance of payments

- Our new March 2009 forecast predicts that total UK government borrowing would increase to £143 billion (10.0% of GDP) in 2009/10, and 158 billion (10.7% of GDP) in 2010/11, above the borrowing figures envisaged in our January Forecast.
- The worsening UK fiscal position in the new forecast is mainly due to larger than predicted deficits recorded in recent months, and the expectation of weaker GDP growth and higher unemployment than envisaged in January.
- If the Government decides on additional fiscal stimulus, and/or if the recession proves to be deeper than we now predict, public sector borrowing would increase even further.
- UK Government borrowing is unacceptably large, and Britain's budgetary position will remain extremely serious in the next few years.
- But large and rising budget deficits are nevertheless a necessary requirement in the near future, in order to alleviate and eventually end the recession.

- At the same time, the Government must act forcefully to curb the deficit after the recession.
- Producing a credible plan to reduce Government debt and borrowing over the medium-term is a critical condition to maintaining the UK's international credit rating and the confidence of the financial markets.
- The outlook is grim. The critical need to reduce significantly Government borrowing after the recession ends will inevitably dampen UK growth prospects for a considerable period.
- The UK current account deficit is likely to total 2.0% of GDP in both 2008 & 2009.
- Table 4 and 5 below summarise our new specific forecasts for UK public finances and for the balance of payments on current account.

Table 4: UK Public Finances – Comparison of Forecasts

	<u>2005/06</u>	<u>2006/07</u>	<u>2007/08</u>	<u>2008/09</u>	<u>2009/10</u>	<u>2010/11</u>
<u>Current Budget-£bn-March2005 Budget</u>	-6	1	4	9		
<u>Current Budget-£bn-March2006 Budget</u>	-11.4	-7	1	7	10	12
<u>Current Budget-£bn-March2007 Budget</u>	-15	-9.5	-4	3	6	9
<u>Current Budget-£bn-Oct2007 PBR</u>	-14.1	-4.7	-8	-4	3	9
<u>Current Budget-£bn-March2008 Budget</u>	-15	4.3	-7.9	-10	-4	4
<u>Current Budget-£bn-BCC Forecast</u>	-14.0	-4.6	-5.4	-49.8	-84.9	-91.0

<u>PSNB-£bn-March2005 Budget</u>	32	29	27	24		
<u>PSNB-£bn-March2006 Budget</u>	37.1	36	30	25	24	23
<u>PSNB-£bn-March2007 Budget</u>	37.8	35	34	30	28	26
<u>PSNB-£bn-Oct2007 PBR</u>	37.5	31	38	36	31	28
<u>PSNB-£bn-March2008 Budget</u>	37.8	30	36.4	42.5	38	32
<u>PSNB-£bn-BCC Forecast</u>	37.8	30.6	35.2	90.9	143.1	157.7

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

***Positive PSNB figure indicates budgetary deficit, negative PSNB figure indicates surplus*

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

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
<u>BofP-CurrentAccount-%GDP</u>	-2.1%	-2.6%	-3.4%	-2.8%	-2.1%	-2.0%	-2.0%
<u>PSNB-FinYears-%GDP</u>	3.3%	3.0%	2.3%	2.5%	6.3%	10.0%	10.7%
<u>CurrentBudget-FinYrs-%GDP</u>	-1.6%	-1.1%	-0.3%	-0.4%	-3.5%	-6.0%	-6.2%
<u>BofP-CurrentAccount-£bn</u>	-25.2	-32.7	-45.0	-39.5	-30.0	-28.0	-29.0
<u>PSNB-FinYears-£bn</u>	39.6	37.8	30.6	35.2	90.9	143.1	157.7
<u>CurrentBudget-FinYrs-£bn</u>	-18.9	-14.0	-4.6	-5.4	-49.8	-84.9	-91.0

**Positive PSNB figure indicates budgetary deficit, negative PSNB figure indicates surplus*

UK interest rates and monetary policy

- UK Bank Rate has been cut as expected to 0.5% in March, the lowest level on record.
- While the effectiveness of the interest rate weapon diminishes at very low levels, the net effect of a rate cut is still stimulatory overall and is likely to benefit the economy. The impact of lower rates on the banking sector's capital base, and on asset prices, is positive overall
- UK monetary policy will have to remain expansionary even after interest rates fall to almost zero. But the policy focus from now on must be primarily on quantitative and credit easing.
- This will entail a further significant expansion of the central bank's balance sheet, and aggressive purchases of a wide range of assets.
- To be effective, the quantitative easing measures will have to be forceful as well as transparent.
- It is important for the UK authorities to clarify the scale and timing of the planned operations. Without greater clarity, the quantitative measures will not work effectively.
- During the period of quantitative easing, the authorities must also spell out the allocation of responsibilities between the Bank of England, MPC and the Treasury.
- If, in addition to removing credit market blockages, the aim is to increase the money supply, the Bank of England must spell out what rate of monetary growth they are aiming to achieve.
- Greater clarity of the aims and scale of the quantitative strategy will bolster confidence, help to assuage concerns in the markets, and should lessen potential speculation against sterling

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