



BCC UK Economic Forecast – June 2009

David Kern, Chief Economist at the BCC

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 June 2009 Forecast

Conclusions and key policy issues

- GDP growth forecasts have been downgraded since our March forecast, both globally and in the UK. The economic outlook remains very precarious.
- But the mood of the financial markets has become more positive. While this improvement is not yet reflected in a significant way in the real economy, there are now signs that the worse phase of the recession is behind us. But recovery is neither imminent nor guaranteed.
- Our new UK GDP growth forecast is worse than in March, but is slightly better than indicated by our early preliminary estimates made some 4-5 weeks ago.
- In annual average terms, we are now forecasting a 3.8% GDP decline in 2009, followed by a very small rise of 0.6% in 2010.
- In March we predicted a 2.8% GDP fall in 2009, and a 0.8% increase in 2010. But, until recently, we envisaged a GDP decline of 4.2% in 2009
- Q1 2009 was probably the worst point in the current recession, with UK GDP recording a very sharp 1.9% decline quarter-on-quarter.
- From now on, we expect the pace of decline in UK GDP to moderate significantly, with much smaller quarterly GDP falls in Q2 and Q3.

- In Q4 2009, we expect a small quarterly increase in UK GDP; the pace of quarterly growth, though remaining low, is likely to improve slowly in 2010 & 2011.
- We now predict cumulative GDP falls totalling 4.9% over the six quarters Q2 2008 to Q3 2009, worse than the cumulative GDP declines of 3.7% we predicted in March. But our early preliminary estimates made 4-5 weeks ago, indicated larger GDP declines than at present.
- The consensus amongst forecasters is now changing in a positive direction; but the view that positive growth has already commenced in Q2 2009 is probably too optimistic.
- The pace of decline in economic activity is set to ease, after the very sharp falls recorded in Q4 2008 and Q1 2009. But the UK recession is still very severe.
- There is no guarantee that any improvement would continue. A renewed relapse is a serious danger, and policy must focus on preventing such an outcome.
- Our new June 2009 forecast predicts a much bigger cumulative decline in UK GDP in the current recession than in the early 1990s recession: 4.9% 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.
- Though our new GDP growth forecasts are worse than in March, we continue to predict that UK unemployment would rise to a peak of 3.2 million, or just over 10% of the workforce in the second half of 2010; this is unchanged from our March forecast.
- The greater flexibility of the UK labour market is likely to prevent a worse outcome in the current recession, with much smaller falls in employment than in the early 1990s recession.
- We are now predicting larger Budget deficits than we envisaged in March.
- Britain's fiscal position is unsustainable in the medium term, with public sector borrowing of more than 12% in both 2009-10 and 2010-11, and with debt rising to dangerous levels.
- The UK international credit rating will be under threat unless credible measures are taken to curb fiscal deficits and debt in the medium term.
- The Government must present a credible exit strategy, with most of the emphasis on big cuts in spending programmes. But, until the severe recession ends, economic policy (both fiscal and monetary) must remain expansionary.
- Sharp falls in manufacturing output (down 10.3% in 2009), and plunging capital investment (down 11.1% in 2009), remain two particularly worrying features of our new UK forecast.
- 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 unduly small manufacturing base.
- We need policies that would facilitate the rebalancing of the UK economy towards industry.
- Unless the huge falls in UK capital investment are halted and reversed, our 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 expect falls in output to moderate significantly starting in Q2 2009 - due to the cumulative impact of large injections of stimulus, earlier sharp falls in sterling, and a reversal in the stock cycle, as the massive rate of running down stocks eases and eventually reverses.
- A return to positive GDP growth before Q4 2009, though unlikely, cannot be ruled out.
- But a temporary rebound driven primarily by the stock cycle will not produce a sustainable recovery, unless consumer spending, investment, and net exports start to improve.
- The immediate risk is that the recession would worsen further, because stimulus would be withdrawn too early. In the short-term, economic policy must therefore remain expansionary.
- We accept that stimulatory measures, though essential at present, can exacerbate medium-term problems relating to excessive indebtedness, fiscal sustainability, and inflation risks.
- But these problems can only be dealt with after the economy stabilises.
- Our forecast assumes that UK bank Rate will remain at 0.5% until Q2 2010. Thereafter, we assume very modest increases, with Bank Rate reaching 1.25% in Q4 2010.
- Our forecast also assumes a further increase in the Asset Purchase Scheme to at least £150 billion. Additional increases should not be ruled out if recessionary pressures worsen.
- Longer-term inflation threats cannot be shrugged off. They need to be addressed with a credible exit strategy, but only after the real economy stabilises
- The UK medium-term economic outlook is grim and we are facing a period of austerity.
- The need to slash Government borrowing and reduce debt after the recession ends will inevitably dampen UK growth prospects for considerable period.
- While our central scenario envisages a return to modest UK growth from Q4 2009, the pace of expansion is likely to be weak by pre-recession standards for a number of years.
- Over the next 4-5 years, the trend growth of UK GDP is likely to be considerably weaker 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.
- The painful but vital medium-term reduction in Government debt and 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.
- Given the dire state of our public finances, tax increases are also unavoidable; these should mainly focus on indirect consumption taxes that are least likely to damage incentives.
- Since businesses will drive any sustainable recovery, it is vital to avoid at all costs additional business taxes, higher NICs, and taxes that damage initiative enterprise and innovation.
- 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.

UK economy: the main components of demand

- In annual average terms, the June 2009 forecast predicts negative GDP growth of 3.8% in 2009, worse than the 2.8% negative 2009 growth indicated in our March forecast, but better than the preliminary estimate of 4.2% negative growth we expected 4-5 weeks ago.
- For 2010, we are now predicting very shallow positive growth of only 0.6%, below the 0.8% growth indicated in our January forecast, but better than our preliminary estimate of 0.4%.
- The main drivers of the UK GDP recession in 2009 remain sharp cutbacks in investment spending, marked falls in consumer spending, and big reductions in inventories.
- Household consumption, in annual average terms, having dropped from 3.0% in 2007 to 1.4% in 2008, is forecast to record a big outright decline of 3.4% in 2009, followed by shallow positive growth of only 0.6% in 2010.
- In average year-on-year terms, our forecast signals very sharp falls in spending on capital investment.
- After plummeting from strong positive growth of 6.8% in 2007, to -3.1% in 2008, investment spending is set to record massive negative growth of -11.1% in 2009.
- For 2010, we are predicting further large negative growth in investment of -6.0%.
- Our new forecast predicts some 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 to make a positive net contribution to UK GDP growth.
- Though UK exports will be weak, because of sluggish growth in world trade, UK imports will be even weaker, because of sharp falls in 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%	-3.8%	0.6%
<u>Household Consumption</u>	2.0%	2.0%	3.0%	1.4%	-3.4%	-0.1%
<u>General Government</u>	1.7%	1.6%	1.5%	3.4%	2.4%	1.9%
<u>Investment</u>	2.2%	6.0%	6.8%	-3.1%	-11.1%	-6.0%
<u>Exports</u>	8.1%	11.0%	-4.1%	0.1%	-11.8%	1.3%
<u>Imports</u>	7.0%	9.6%	-1.5%	-0.6%	-13.2%	1.3%

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 likely to record bigger output declines in 2009 than we predicted in March.
- The biggest downward revision since March has been for construction output.
- But the worse appears to be over, and there have been distinct signs of improvement in the past few weeks.
- Our new forecasts are a little stronger than our preliminary estimates made 4-5 weeks ago.
- After persistent falls since the early months of 2008, manufacturing output recorded small increases in March and April 2009.
- But, in any longer-term perspective, manufacturing is still showing deep declines. In the latest three months, manufacturing output was 13.2% lower than in the same period a year ago.
- Our new forecast, which is signalling a very large annual average decline of 10.3% in UK manufacturing output in 2009, is very worrying. Though the sector has the potential to recover, it must be nurtured to ensure that viable firms do not lose their skills base.
- In 2010, the output recovery in all the three main UK sectors is expected to be very weak. But in the case of manufacturing, the new 2010 forecast is stronger than in March.
- 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%	0.2%	-2.5%	-10.3%	1.2%
<u>Services Output</u>	3.0%	3.6%	3.5%	1.5%	-2.2%	1.1%
<u>Construction Output</u>	1.0%	1.0%	2.5%	0.3%	-7.3%	0.5%

UK inflation

- UK inflation is now falling, and we expect further declines during 2009; this reflects much weaker economic activity and earlier falls in energy and food prices.
- But the expected declines in the next few months are less sharp overall than we predicted in March, mainly due to the more recent renewed increases in oil prices.
- 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</u>	2.1%	2.3%	2.3%	3.6%	1.7%	1.8%
<u>RPIX</u>	2.3%	2.9%	3.2%	4.3%	1.2%	1.9%
<u>RPI</u>	2.8%	3.2%	4.3%	4.0%	-1.4%	1.7%

- 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.
- But annual CPI inflation is unlikely to fall below zero in the current recession.
- In contrast, annual RPI inflation is already in negative territory, and the deflation on this measure is set to deepen in the second half of 2009.
- However, deflation is likely to be short-term problem only for the UK economy. In 2010, annual inflation is expected to be again positive on all measures.

UK unemployment

- Though our new GDP growth forecasts are worse than in March, we continue to predict that UK unemployment would rise to a peak of 3.2 million, or just over 10% of the workforce in the second half of 2010; this is unchanged from our March 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. Thus, a smaller absolute level of UK unemployment in the early 1990 has reflected at that time a bigger percentage of the workforce.
- The greater flexibility of the UK labour market is likely to prevent a worse outcome in the current recession, with much smaller falls in employment than in the early 1990s recession.

UK public finances and the balance of payments

- Our June 2009 forecast predicts that total UK government borrowing would increase to £172 billion (12.2% of GDP) in 2009/10, and 184 billion (12.7% of GDP) in 2010/11, above the borrowing figures envisaged in our March forecast.
- The worsening UK fiscal position indicated 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 March.
- In the recent Budget, the Chancellor has acknowledged the UK's worsening fiscal position.
- Britain's fiscal position is unsustainable in the medium term, with deficits of some 12% in 2009-10 and 2010-11, and with debt increasing sharply.

- The UK international credit rating will be under threat unless credible measures are taken to curb fiscal deficits and debt in the medium term.
- The Government must present a credible exit strategy, with most of the emphasis on big cuts in spending programmes. But, until the severe recession ends, policy (both fiscal and monetary) must remain expansionary.
- Britain's medium term economic outlook is grim and we are facing a period of austerity.
- 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 has fallen to 1.7% of GDP in 2008. Our new forecast suggests that the deficit is likely to remain at 1.7% of GDP in both 2009 & 2010.
- 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-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-March2008 Budget</u>	-15	-4.3	-7.9	-9.6	-4	4
<u>Current Budget-£bn-Nov08 PBR</u>	-15	-4.3	-6.7	-41.2	-78	-73
<u>Current Budget-£bn-March2009 Budget</u>	-14.2	-4.8	-5.3	-52.3	-132	-137
<u>Current Budget-£bn-BCC Forecast</u>	-14.2	-4.8	-5.3	-49.5	-129.5	-138.2
<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-March2008 Budget</u>	37.8	30	36.4	42.5	38	32
<u>PSNB-£bn-Nov08-PBR</u>	37.8	30	36.6	77.6	118	105
<u>PSNB-£bn-March2009 Budget</u>	37.7	30.8	34.6	90	175	173
<u>PSNB-£bn-BCC Forecast</u>	37.7	30.8	34.6	86.7	172.0	184.2

**BCC historical 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>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
<u>BofP-CurrentAccount-%GDP</u>	-2.6%	-3.4%	-2.9%	-1.7%	-1.7%	-1.7%
<u>PSNB-FinYears-%GDP</u>	3.0%	2.3%	2.4%	6.0%	12.2%	12.7%
<u>CurrentBudget-FinYrs-%GDP</u>	-1.1%	-0.4%	-0.4%	-3.5%	-9.2%	-9.5%
<u>BofP-CurrentAccount-£bn</u>	-32.7	-45.0	-40.3	-24.5	-24.0	-25.0
<u>PSNB-FinYears-£bn</u>	37.7	30.8	34.6	86.7	172.0	184.2
<u>CurrentBudget-FinYrs-£bn</u>	-14.2	-4.8	-5.3	-49.5	-129.5	-138.2

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

UK interest rates and monetary policy

- UK Bank Rate was cut to 0.5% in March, the lowest level on record. Our June 2009 forecast assumes that the rate will remain at that level until Q2 2010.
- Thereafter we assume very modest increases, with Bank Rate reaching 1.25% in Q4 2010.
- The Asset Purchase Facility has already been increased from £75 billion to £125 billion and we urge the MPC to accelerate the tempo at which they execute Quantitative Easing.
- Our forecast assumes a further increase in the Asset Purchase scheme to at least £150 billion. Additional increases should not be ruled out if recessionary pressures worsen.
- Longer-term inflation threats cannot be shrugged off. They need to be addressed with a credible exit strategy, but only after the real economy stabilises.
- The immediate risk is that the recession would worsen further, because stimulus would be withdrawn too early. In the short-term, economic policy must therefore remain expansionary.

Contact details:

David Kern, Chief Economist at the BCC,

Telephone: 020 8904 6293;

E-mail: david.kern@btinternet.com