



BCC UK Economic Forecast – June 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 June 2010 Forecast

- Britain's economic recovery started in the fourth quarter of 2009, and GDP growth remained in positive territory in the first quarter of 2010.
- But the recovery is fragile, and the risks of a relapse are high. We expect GDP growth to strengthen in the next few quarters. But Britain's recovery faces serious impediments. In the medium term, UK growth is likely to be modest and below the historical average.
- Our new UK GDP growth forecast for 2010 is higher than in March 2010, but our forecast for 2011 has been revised down slightly.
- In annual average terms, we are now forecasting positive growth UK GDP of 1.3% in 2010 and 2.0% in 2011, after a very large GDP decline in of 4.9% in 2009.
- In March 2010, we predicted GDP increases of 1.0% in 2010 and 2.1% 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 6.2% 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%, but quarterly GDP falls in 1979-81 were not all consecutive.

- If measured by the scale of GDP declines, the 2008-09 downturn was the deepest since the end of the Second World War. But unemployment rose less than in previous recessions.
- After mid-2009, UK labour market trends improved markedly. But the improvement was not sustained. Labour market trends have worsened slightly since the beginning of 2010.
- Unemployment is now lower and employment is higher than many people have predicted. But better than expected labour market trends since mid-2009 mask worrying developments.
- Inactivity is increasing at a rapid pace; full-time employment is falling; and private sector employment has declined by almost 1 people million between mid-2008 and end-2009.
- We expect UK unemployment to increase in the next 12 months, but at a much slower pace than at the height of the recession. We also expect modest falls in employment in this period.
- Our new forecast envisages that total unemployment would rise from 2.51 million (8.0% of the workforce) in Q1 2010, to a peak of 2.65 million (8.4% of the workforce) in Q1 2011.
- In March, we also predicted a jobless peak of 2.65 million. But, while we envisaged then that the peak would be reached in Q3 2010, we now expect the peak to be reached in Q1 2011.
- There are risks that unemployment may increase more sharply than our forecast indicates.
- Firstly, the aggressive deficit-reduction programme that the new coalition government plans to implement may result large declines in public sector employment.
- Secondly, if recent big inactivity increases are reversed, as discouraged workers return to the labour force, there is a distinct danger that unemployment would increase.
- UK public sector net borrowing (PSNB) excluding financial interventions totalled £156.1bn (11.1% of GDP) in 2009-10; this is a huge figure, but is smaller than the March Budget estimate, which indicated that PSNB would total £166.5bn (11.8% of GDP) in 2009-10.
- Our new forecast, which assumes that the new UK coalition government would adopt forceful measures to cut the Budget deficit, predicts bigger PSNB declines than in our March forecast, to £147bn (9.9% of GDP) in 2010-11 and £116bn (7.5% of GDP) in 2011-12.
- Although the UK fiscal position remains serious, there is now a better chance than a few months ago that the UK will be able to preserve its AAA credit rating.
- Net public sector debt is set to increase less sharply than previously predicted, and is likely to peak in the next 3-4 years at a level below 75% of GDP.
- The forecast assumes that the MPC will persevere for the next few months with its current expansionary stance. The Bank of England is very probably right in its assessment that the recent surge in inflation will prove temporary, with inflation likely to fall later in the year.
- But the Bank of England cannot ignore the risk that inflationary expectations would worsen, and its own credibility would be questioned, if inflation stays for long above the 2% target.
- The forceful fiscal measures that the new Government is planning to put into effect will squeeze demand and should in general make it easier for the MPC to postpone tightening.

- But the MPC's job will become more complicated if, as seems likely, the deficit cutting plan will include an increase in VAT, which would trigger a further temporary hike in inflation.
- We expect UK Bank Rate to stay at 0.5% until about November 2010; thereafter, we expect modest Bank Rate increases, to 1.00% before end-2010 and to 2.50% by the end of 2011.
- The Quantitative Easing (QE) programme is likely to be maintained at its current level of £200 billion for the remainder of 2010, and will then be scaled down gradually during 2011,

Risks and key policy issues

- The global economy is now recovering. Most economies are now recording positive growth.
- But the global outlook is very uncertain, and the Eurozone is facing major problems.
- In 2009 as a whole, UK GDP fell 4.9%; this was broadly similar to the GDP declines of Germany (-5.0%), Japan (-5.0%), and Italy (-5.0%). But Britain's 2009 growth performance was worse than that of the US (-2.4%) and France (-2.2%).
- The UK economy has returned to positive growth in Q4 2009, later than most other major economies. UK GDP continued expanding in Q1 2010.
- Although UK growth lagged behind in the third quarter of 2009, our growth was higher than in the Eurozone in Q4 2009 and in Q1 2010.
- But US growth remains consistently stronger than in both the UK and the Eurozone.
- China & India have avoided recession altogether and are growing at a faster pace than both the US and Europe.
- The UK's recovery is fragile and still faces major risks. A sustained recovery cannot be guaranteed. Risks of a setback remain serious. Preventing a double-dip recession must be a key policy priority as the Government embarks on a tough deficit-cutting programme.
- Huge cutbacks of stocks since Q4 2008, which have been major drivers of the severe UK recession, are now easing and will gradually be reversed.
- Our forecast envisages that this turnaround in the stock cycle will ensure a relatively strong 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.

- Although there are welcome signs that business investment is starting to recover, small and medium-sized firms (SMEs) risk being hampered by weakness in bank lending.
- 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.
- An over-indebted personal sector, weakened by relatively high unemployment, will have to rebuild its finances at a time when taxes are set to increase and many benefits are likely to be cut; 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.
- 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.
- 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.
- Big increases economic inactivity, falls in full time employment, the record number of people working part-time because they could not find a full-time job, and falls in private sector jobs, are all posing future threats to Britain's productive potential.
- Sharp falls in manufacturing output (down 10.5% in 2009), and plunging capital investment (down 14.9% 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 the recovery in capital investment is sustained, 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.
- The new Government's decision to adopt forceful measures to deal with the budget deficit will help to restore market confidence and will underpin Britain's AAA rating.
- It is vital to present a credible plan for curbing the fiscal deficit, which spells out in detail the proposed measures and includes a clear and realistic timetable.
- But the economy is still weak and fragile, and it is critically important to avoid steps that damage business and threaten to unleash a new recession.

- A deficit-cutting plan, and a freeze on public sector pay and recruitment should be announced immediately. But other significant features of the fiscal tightening programme, beyond the £6 billion announced already, should only be implemented when the recovery is more secure.
- Our central scenario envisages 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.
- 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, 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 huge challenge involved in stabilising 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 must 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.

UK economy: the main components of demand

- The UK economy has recovered for two quarters in a row, after a long and deep recession.
- 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 6.2% during this period.
- UK GDP recorded positive quarter-on-quarter growth of 0.3% in Q1 2010 and 0.4% in Q4 2009, after quarterly falls 0.3% in Q3 2009, 0.7% in Q2, and 2.6% in Q1.
- In year-on-year terms, UK GDP fell 0.2% in Q1 2010, after year-on-year declines of 3.1% in Q4 2009 and 5.3% in Q3 2009.
- In annual average terms, our new forecast predicts positive growth of 1.3% in 2010 and 2.0% in 2011, after a large negative GDP growth of 4.9% in 2009.

- In our March 2010 forecast we predicted lower annual average GDP growth of 1.0% for 2010, but we slightly higher growth for 2011, at 2.1%.
- Though our 2010 GDP growth forecast is now higher than in March, our 2011 forecast has been downgraded, because obstacles to sustained medium-term recovery now seem greater.
- Following the modest slowdown in Q1 2010 growth, due to weather-related disruptions and the reversal of the VAT cut, we expect a relatively strong temporary bounce back in UK GDP.
- The early stages of the recovery would be driven by the stock cycle, as the massive rate of running down stocks eases and is gradually reversed. Huge injections of stimulus, fiscal & monetary, and earlier sharp falls in sterling, should also support an initial upturn.
- But longer-term growth prospects are weak. In particular, the need to slash the budget deficit, strengthen the enfeebled banks, and reduce personal sector debt will limit UK growth.
- 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 3.2% in 2009; it is forecast to record positive growth of 0.7% in 2010 and 1.6% in 2011, weaker than the expected growth in GDP.
- Investment spending plummeted, from annual average growth of 7.8% in 2007, to -3.5% in 2008, and massive negative growth of -14.9% in 2009. Although investment recorded positive quarterly growth in Q1 2010, and a gradual upturn is set to continue, we still expect a modest average fall of 0.7% in 2010. For 2011 we predict modest positive annual growth of 1.7%.
- With world trade strengthening and the UK enjoying a competitive exchange rate, we expect positive annual average growth in UK exports, by 4.2% in 2010 & 3.8% in 2011.
- UK imports are forecast to record annual average growth of 5.9% in 2010 and 3.3% in 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%	-4.9%	1.3%	2.0%
<u>Household Consumption</u>	2.3%	1.5%	2.5%	0.9%	-3.2%	0.7%	1.6%
<u>General Government</u>	2.0%	1.6%	1.2%	2.6%	2.2%	2.6%	2.2%
<u>Investment</u>	2.4%	6.5%	7.8%	-3.5%	-14.9%	-0.7%	1.7%
<u>Exports</u>	7.9%	11.3%	-2.8%	1.1%	-10.6%	4.2%	3.8%
<u>Imports</u>	7.1%	8.8%	-0.7%	-0.5%	-11.9%	5.9%	3.3%

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 the manufacturing & services sectors are likely to record positive annual average growth in 2010 & 2011. But construction is set to show a further small average decline in 2010, before recording modest positive growth in 2011.
- Services, the largest sector in the economy, has recorded (in annual average terms) negative growth of -3.5% in 2009; it is forecast to register positive growth of 1.1% in 2010 and 2.2% in 2011, a very modest pace when compared with the increases recorded before 2008.
- Manufacturing output, though fluctuating sharply from month to month, recorded very large quarterly falls, in excess of 5%, in both Q4 2008 & Q1 2009; output then fell only modestly in Q2 & Q3 2009, before moving into positive territory from Q4 2009.
- Manufacturing output quarter-on-quarter growth was 0.8% in Q4 2009 and 1.2% in Q1 2010, a very satisfactory performance in view of the sector's dismal growth record in recent years.
- In year-on-year terms, manufacturing rose 1.5% between Q1 2009 and Q1 2010, after large year-on-year declines of 4.9% in Q4 2009, 10.6% in Q3, and 12.4% in Q2.
- Our new forecast indicates that manufacturing output, in annual average terms, will record positive growth of 3.0% in 2010 and 2.0% 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 10.8% in 2009. Our new forecast envisages a further small average decline of 0.2% in 2010, and a return to very modest positive growth of 0.7% 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%	3.0%	2.0%
<u>Services Output</u>	3.1%	3.6%	3.5%	1.4%	-3.5%	1.1%	2.2%
<u>Construction Output</u>	1.1%	1.1%	2.7%	-0.8%	-10.8%	-0.2%	0.7%

UK inflation and labour costs

- All reported measures of annual UK inflation have risen much more sharply than expected in recent months. These increases come after big falls in inflation between 2008 & 2009.
- The 2009 falls in inflation were 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 3.7% in March 2010. RPI annual inflation rose to 5.3% in March 2010.
- The recent rise in inflation is largely accounted for by three factors: first, the impact of higher oil prices, which in April 2010 were nearly 80% higher than at the beginning of 2009; second,

the restoration at the beginning of January 2010 of the standard rate of VAT to 17.5%; and third the continuing effects on UK inflation of the sharp depreciation of sterling in 2007-08.

- The MPC stated that these factors more than account for the deviation of CPI inflation from target, and that the temporary effects of these factors are masking the downward pressure on inflation from the substantial margin of spare capacity in the economy.
- The fall in oil prices in recent weeks should reinforce the downward pressure on inflation.
- But the MPC will not be able to ignore for too long the risk that expectations might worsen and its own credibility might be questioned. The fact is that declines in UK inflation earlier in 2009 were smaller than expected, and recent increases have been bigger than expected.
- Looking ahead, our new forecast now incorporates the assumption that VAT would be raised to 20% within the next 18 months, probably in 2 stages: an increase to 18.5% in April 2011, and a further increase to 20% in the autumn of next year.
- Specifically our forecast envisages that inflation has peaked in April 2010. But CPI inflation is set to remain above 3% until Q1 2011, and above the 2% target until Q1 2012.
- 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%	3.3%	2.9%
<u>RPIX</u>	2.2%	2.9%	3.2%	4.3%	2.0%	4.9%	4.6%
<u>RPI-All Items</u>	2.8%	3.2%	4.3%	4.0%	-0.5%	4.8%	4.8%

- In January-March 2010, annual growth in total UK average earnings was 4.0% (including relatively volatile bonuses), the highest growth rate since June 2008, and up from 2.5% for the three months to February 2010.
- The earnings growth for regular pay (excluding bonuses) was 1.9% for the three months to March 2010, up from 1.7% for the three months to February 2010.
- Annual growth in regular pay (excluding bonuses) remains well below inflation, both the CPI and RPI measures.
- Recent earnings figures show a persistent sharp contrast between the public and private sectors, with pay in the public sector continuing to grow much faster.
- Excluding bonuses, annual growth in average earnings in January-March 2010 was 1.2% in the private sector, and 4.0% in the public sector.
- Including bonuses, annual growth in average earnings in January-March 2010 was 3.6% in the private sector, and 4.4% in the public sector.
- Our forecast assumes that earnings growth for regular pay (excluding bonuses) will edge up slowly from mid-2010, to reach 2.5-3% in the final months of 2011. In annual average terms we predict CPI inflation at 3.3% in 2010 and 2.9% in 2011.

UK labour market – unemployment & employment

- Since the UK recession started in the spring of 2008, UK unemployment on the ILO definition has risen by almost 900,000.
- Labour market trends worsened sharply between the spring of 2008 and the middle of 2009, as the deep recession resulted in big employment falls and unemployment increases.
- After mid-2009, labour market trends improved markedly. In contrast to forecasts that the earlier deterioration would continue, both employment & unemployment recorded little net change in the second half of 2009, and there were some tentative signs of improvement.
- But the improvement was not sustained. Although the position is now much better than many people have expected on the basis of the historical experience in previous recessions, UK labour market trends have worsened slightly since the beginning of 2010.
- Over the past three months, UK unemployment has risen by 53,000, while employment has fallen by 76,000.
- Better than expected labour market figures since mid-2009 mask worrying developments.
- Inactivity is rising at a rapid pace, even though the recession in output is over.
- The number of “economically inactive” people (i.e. those that have effectively left the workforce) has risen by some 540,000 since the recession started in the spring of 2008.
- The increase in inactivity has accelerated to an average of 40,000 in the last few months.
- Without the large increases in the number of “economically inactive” people, rises in UK unemployment during the recent recession would have been much bigger.
- Full-time employment is falling, while the number of people working part-time because they could not find a full-time job is rising to record highs.
- The number of people working part-time because they could not find a full-time job increased by 25,000 in the last quarter, to reach 1.07 million, the highest figure since comparable records began in 1992.
- Private sector employment has declined by almost 1 million people between the first quarter of 2008 and the end of 2009.
- We expect UK unemployment to increase in the next 12 months, but at a much slower pace than at the height of the recession. We also expect modest falls in employment in this period.
- Our new forecast envisages that total unemployment would rise from 2.51 million (8.0% of the workforce) in Q1 2010, to a peak of 2.65 million (8.4% of the workforce) in Q1 2011.
- In March, we also predicted a jobless peak of 2.65 million; but while we envisaged then that the peak would be reached in Q3 2010, we now expect the peak to be reached in Q1 2011.
- There are risks that unemployment may increase more sharply than our forecast indicates.
- Firstly, the aggressive deficit-reduction programme that the new coalition government plans to implement may result in large declines in public sector employment.

- Secondly, if some of the currently discouraged "economically inactive" people decide to start seeking work because the economy is recovering, unemployment would rise more sharply than we now predict, even if the output grows 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.
- To achieve a sustainable improvement in Britain's productive potential, recent adverse trends in the labour market must be reversed. Inactivity must decline, full-time employment must grow, and private sector employment must increase.

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

- The unemployment rate among people aged 16-17 is very high, and has risen very sharply in the past two years, from 24.3% in January-March 2008, to 35.3% in January-March 2010. The unemployment total among people aged 16-17 has increased from 175,000 in January-March 2008, to 207,000 in January-March 2010.
- The 18-24 age group continues to record very high levels and rates of unemployment. There have been large net increases over the past two years, from 509,000 (a jobless rate of 12.2%) in January-March 2008, to 734,000 (a jobless rate of 17.9%) in January-March 2010.
- 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 8.6% of the workforce, in Q1 2011, 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 200,000 (a jobless rate of 36.4%) in Q1 2011.
 - Unemployment in the 18-24 age group is forecast to total around 740,000 (a jobless rate of 18.1%) in Q3 2010.

UK public finances and the balance of payments

- UK public sector net borrowing (PSNB) excluding financial interventions totalled £156.1bn (11.1% of GDP) in 2009-10; this is a huge figure, but is smaller than the March Budget estimate, which indicated that PSNB would total £166.5bn (11.8% of GDP) in 2009-10.
- Our new forecast, which assumes that the new UK coalition government would adopt forceful measures to cut the Budget deficit, predicts bigger PSNB declines than in our March forecast, to £147bn (9.9% of GDP) in 2010-11 and £116bn (7.5% of GDP) in 2011-12.
- Although the UK fiscal position remains serious, there is now a better chance than a few months ago that the UK will be able to preserve its AAA credit rating.
- Net public sector debt is set to increase less sharply than previously predicted, and is likely to peak in the next 3-4 years at a level below 75% of GDP.
- 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.
- The new Government's decision to adopt forceful measures to deal with the budget deficit will help to restore market confidence and will underpin Britain's AAA rating.
- It is vital to present a credible plan for curbing the fiscal deficit, which spells out in detail the proposed measures and includes a clear and realistic timetable.
- But the economy is still weak and fragile, and it is critically important to avoid steps that damage business and threaten to unleash a new recession.
- A deficit-cutting plan, and a freeze on public sector pay and recruitment should be announced immediately. But other significant features of the fiscal tightening programme, beyond the £6 billion announced already, should only be implemented when the recovery is more secure.
- 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, 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 huge challenge involved in stabilising 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.
- The UK current account deficit fell to 1.5% of GDP in 2008, and there was a further reduction in the current account deficit in 2009, to 1.3% of GDP.

- Our new forecast suggests that the UK current account deficit is likely to record a modest increase, to 1.5% of GDP in both 2010 & 2011. But the UK current account deficit will remain low by historical standards.
- Table 4 below summarise our new forecasts for UK public borrowing and for the balance of payments on current account.

Table 4: Balance of Payments Current Account & Public Sector Borrowing

	<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%	-1.5%	-1.5%
<u>PSNB-FinYears-%GDP</u>	2.9%	2.3%	2.4%	6.7%	11.1%	9.9%	7.5%
<u>BofP-CurrentAccount-£bn</u>	-32.7	-45.0	-37.7	-22.0	-18.4	-22.0	-23.0
<u>PSNB-FinYears-£bn</u>	37.4	30.8	33.6	96.5	156.1	147.0	116.0

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

UK interest rates and monetary policy

- The forecast assumes that the MPC will persevere for the next few months with its current expansionary stance. The Bank of England is very probably right in its assessment that the recent surge in inflation will prove temporary, with inflation likely to fall later in the year.
- But the Bank of England cannot ignore the risk that inflationary expectations would worsen, and its own credibility would be questioned, if inflation stays for long above the 2% target.
- The forceful fiscal measures that the new Government is planning to put into effect will squeeze demand and should in general make it easier for the MPC to postpone tightening.
- But the MPC's job will become more complicated if, as seems likely, the deficit cutting plan will include an increase in VAT, which would trigger a further temporary hike in inflation.
- We expect UK Bank Rate to stay at 0.5% until about November 2010; thereafter, we expect modest Bank Rate increases, to 1.00% before end-2010 and to 2.50% by the end of 2011.
- The Quantitative Easing (QE) programme is likely to be maintained at its current level of £200 billion for the remainder of 2010, and will then be scaled down gradually during 2011,

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