

UK ECONOMICS WEEKLY

16th Nov. 2009



Editors: Roger Bootle and Jonathan Loynes

It's the levels, stupid!

- The apparent contrast between the extremely optimistic forecasts for economic growth published in November's Bank of England Inflation Report, and Governor Mervyn King's gloomy tone when presenting it, no doubt partly reflected the fact that the Inflation Report forecasts do not incorporate the forthcoming fiscal squeeze.
- In addition, though, Mr King has continued to stress the important distinction between growth rates and levels. Even if growth accelerates in the way the Bank expects, the level of GDP will not return to its pre-recession levels until 2011. And it may be much longer before it returns to its *trend* or sustainable level.
- The upshot is that even a very sharp acceleration in the rate of economic growth over the coming quarters is unlikely to prompt the MPC to tighten monetary policy. And if growth is slower because of the fiscal squeeze, then the Committee may yet have to provide the economy with further support. (Pages 2 and 3.)

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It's the levels, stupid!

Question: When is an apparently very optimistic central bank not really that optimistic at all? Answer: When its extremely upbeat forecasts for the economy knowingly overlook a development which looks set to act as a very severe drag on growth for the best part of a decade.

The elephant in the room in the Bank of England's November Inflation Report was, of course, the coming enormous fiscal squeeze. Admittedly, the existing fiscal plans incorporated in the Monetary Policy Committee's projections for growth and inflation include some consolidation in the form of the renewed rise in VAT at the end of this year and higher rate tax increases from April 2010, as well as the slowdown in the growth of public spending from 2011 onwards.

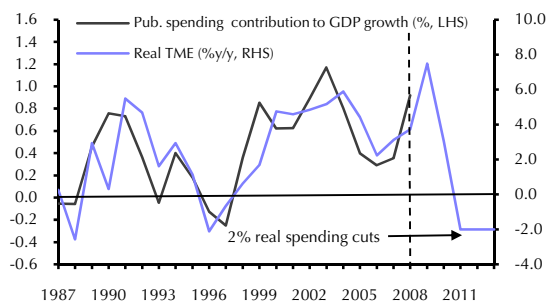
But it seems very clear that these measures do not go far enough and the Bank has been unusually explicit in discussing the need for and likelihood of a further "significant fiscal consolidation", which the Inflation Report itself judged will put "significant downward pressure on nominal spending and therefore inflation".

Of course, it might be argued that it is impossible for the Bank actually to take account of the fiscal squeeze in its forecasts when there are such uncertainties over its timing and size. The former, in particular, may be heavily affected by outcome of next year's general election. But these uncertainties are surely no greater than those surrounding many other potential influences on the path of growth and inflation.

After all, it seems crystal clear that the required consolidation will be big enough to have a sizeable impact on the economy. To eliminate the projected structural budget deficit over the next five years or so, for example, fiscal policy would need to be tightened by around 5% of GDP, or about £70bn. If, as seems likely, that is achieved primarily via cuts in public expenditure, then we estimate that real spending would need to fall by around 2% per annum for about five years.

That would probably have a profound effect on economic growth. As Chart 1 shows, the direct effect of falling government spending would reduce annual real GDP growth by around 0.3%, a big change from the average *positive* contribution of around 0.7% seen over the last decade. But the ultimate effects are likely to go well beyond this, given the knock-on effects on employment, household spending and activity in the private sector. We have estimated that the squeeze could knock up to 2% off GDP growth compared to the rates seen over the last decade. (See *UK Quarterly Review*, "The great squeeze", Vol. 4, 2009).

CHART 1: PUBLIC SPENDING & CONT. TO GDP GROWTH



Source – Thomson Datastream

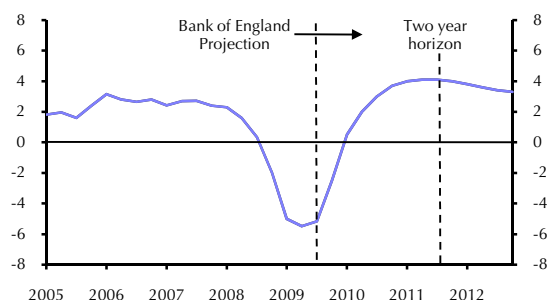
The upshot is that, when the fiscal squeeze is finally announced and incorporated into the MPC's forecasts, its medium-term profiles for growth and inflation could come down markedly from those presented in the November Inflation Report. That process could start as soon as the next Report in February if, as we expect, next month's Pre-Budget Report pre-announces some measures to bring borrowing down more quickly beyond next year. **Knowing that, it's perhaps not surprising that Mervyn King sounded notably more gloomy than the Inflation Report itself in the accompanying press conference.**

Level-headed

The other possible explanation for the disparity between the Bank of England's upbeat forecasts and its generally gloomy tone involved the important – but often under-appreciated – distinction between

growth rates and levels. Much of the media focus on the Bank's optimism was prompted by its forecasts for annual GDP growth, which were revised yet higher from the already upbeat projections presented back in August. As Chart 2 shows, growth is now projected to average around 2% in 2010 before reaching 4% in 2011. These forecasts are significantly above the latest consensus prediction amongst outside forecasters (about 1.3% in 2010) and stronger even than the numbers presented by the Chancellor in the April Budget.

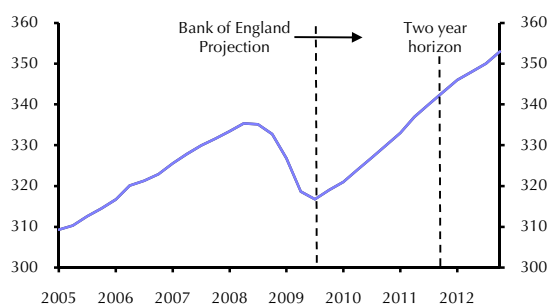
CHART 2: BOE FORECAST FOR GDP GROWTH (%Y/Y)



Source – Thomson Datastream

However, Mr King has been stressing for some time now (as have we) that it is not the rate of growth of output which matters for the outlook for inflation and the appropriate stance of monetary policy, but rather the level. And to underline the point, the November Inflation Report included for the first time charts of the MPC's GDP forecasts expressed as levels, as well as growth rates. (See Chart 3.)

CHART 3: BOE FORECAST FOR GDP LEVEL (£BN PER QTR)



Source – Thomson Datastream

As Chart 3 shows, the central forecast (based on market interest rate expectations and current plans for quantitative easing) suggests that GDP will return to its pre-recession level (of around £335bn per quarter) sometime early in 2011. However, it is not expected to return to a level consistent with its pre-recession trend by the end of the forecast period in 2012.

This does not necessarily mean that there will still be an enormous amount of spare capacity or slack left in the economy in 2012. The Inflation Report acknowledged that the lower path of output reflects “in large part the substantial impact of the downturn on the supply capacity of the economy” – in other words, the *trend* or sustainable level of output, which is consistent with stable inflation, is likely to have fallen along with the actual path of output.

As usual, both the Report and MPC members themselves in the press conference were unspecific on just how much capacity might have been destroyed and the implications of that for the degree of slack. The fact that inflation is expected to stabilise around its target in 2012 might indicate that output will have returned to its trend level by then. But if the economy grows less quickly than the Bank's current forecasts show - either because of a fiscal tightening or some other factor - then spare capacity will be obviously used up at a slower rate and, other things being equal, inflation will be lower.

Of course, all this is highly uncertain. But at the very least, the MPC's emphasis on the level of output means that even a very strong acceleration in the rate of economic growth over the coming quarters is unlikely to prompt the Committee to tighten monetary policy. And if, as looks likely, growth turns out to be rather weaker than the Inflation Report predicted, then it is still not impossible that the Committee will need to provide the economy with yet further support.

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Data Preview – Consumer Prices (Oct.)

09.30 Tue. 17th Nov.

Forecasts	Previous	Median	Capital Economics
CPI	+0.1%(+1.1%)	+0.1%(+1.4%)	-0.1%(+1.3%)
RPI	+0.4%(-1.4%)	+0.1%(-1.0%)	-0.1%(-1.1%)

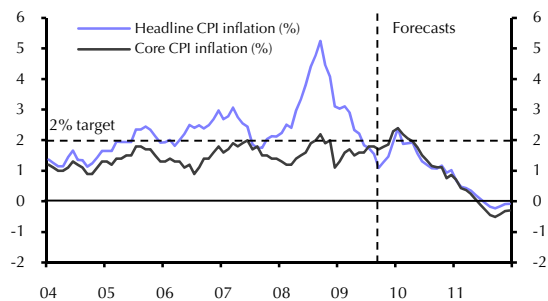
Turning point

October's consumer prices figures will mark a turning point in inflation after the steady downward trend of the last year. Over the next six months or so, energy base effects will turn from strongly negative to strongly positive, while the renewed rise in VAT in January will also have an upward influence. Together, these effects will lift the headline inflation rate back above its 2% target, and perhaps even close to 3%.

No doubt this will lead to some concerns that the Bank of England's quantitative easing programme is stoking inflation. But the vast amount of spare capacity should mean that underlying price pressures remain very subdued. Indeed, once the energy and VAT effects fade again, we still think there is a real risk of deflation in 2011. (See Chart 1.)

As for October, we have pencilled in a rise in CPI inflation to 1.3%. RPI inflation should edge up to about -1.1%.

CHART 1: CONSUMER PRICE INFLATION (%)



Source – Thomson Datastream

Data Preview – MPC Minutes (Nov.)

09.30 Wed. 18th Nov.

Forecasts	Previous	Median	Capital Economics
Vote (£175bn – £200bn - £225bn)	9-0-0	-	0-6-3

A split vote?

Last week's Inflation Report has already shed some light on the decision by the Monetary Policy Committee (MPC) earlier this month to extend its quantitative easing (QE) programme by another £25bn. Unsurprisingly, the Committee's new set of growth and inflation forecasts suggested that more asset purchases were necessary if inflation were to hit its target at the two year policy horizon.

However, we still do not know how divided the Committee was about the decision and the minutes will at least show us whether the vote was unanimous. Signals from MPC members before the meeting suggested that some (such as Mervyn King, David Miles and Adam Posen) probably wanted to do more QE, while others (perhaps Paul Tucker and

Paul Fisher) wanted to pause. Comments by Mervyn King at the press conference, suggesting that he did not share the concerns expressed by other members about rising asset prices, also indicated that he may have wanted to do more. We therefore expect a split vote, with some members voting for £50bn of QE – which would clearly dampen speculation that further QE is now off the agenda.

But a unanimous vote is not impossible. If the decision to extend QE by £25bn was a compromise between these factions, all members may have voted for this middle ground. Meanwhile, with QE still having a limited impact, it will be interesting to see if the MPC has given further thought to other options, such as cutting the rate on banks' reserves.

Data Preview – CBI Industrial Trends Survey (Nov.)

11.00 Wed. 18th Nov.

Forecasts	Previous	Median	Capital Economics
Output Expectations Balance	+4	n/a	+5

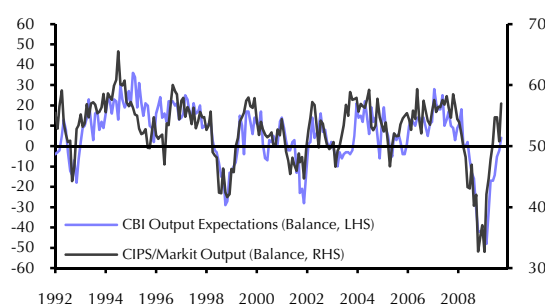
Orders weakness clouds outlook

The CBI's Industrial Trends Survey has continued to paint a mixed picture of conditions in the industrial sector. On the one hand, sentiment has rebounded – the monthly output expectations balance rose from -2 to +4 in October, while the quarterly business optimism balance rose from -16 to +10 in Q4. And, if the relationship holds, the jump in the output balance of October's CIPS/Markit manufacturing report suggests that the output expectations balance could get to around +20 this month. (See Chart 1.)

On the other hand, orders remain weak – the total orders balance fell from -48 to -51 in October, close to its record low. As a result, the recent rise in output appears to be largely due to an easing in the rate of destocking by firms, rather than the result of a pick-up in demand. This boost may have a little further to go, as there are now signs that firms' stock

levels are below average, pointing to the potential for restocking (which would boost output) soon. But at some point this boost will fade. So while we have pencilled in a small rise in the output expectations balance to +5 in November, the balance may fall further ahead if demand remains in the doldrums.

CHART 1: CBI & CIPS OUTPUT BALANCES



Source – Thomson Datastream

Data Preview – Retail Sales (Oct.)

09.30 Thu. 19th Nov.

Forecasts	Last	Median	Capital Economics
Retail Sales Volumes (s.a.)	+0.0%(+2.4%)	+0.5%(+2.9%)	+0.5%(+2.9%)

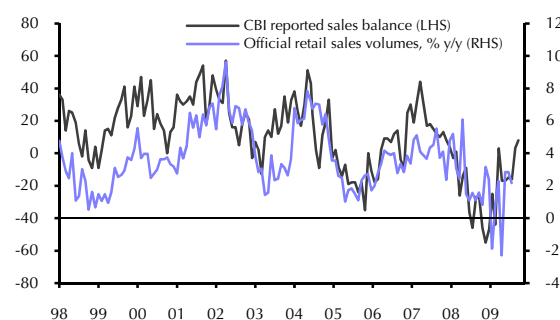
Weaker picture than the surveys suggest

At first sight, the retail surveys suggest that consumers are still weathering the economic downturn well. The reported sales balance of the CBI Distributive Trades Survey was consistent with annual growth in official sales volumes of over 4% in October. (See Chart 1.) And the BRC's measure of like-for-like sales values rose from 2.8% to 3.8% y/y. These strong annual growth rates are not surprising, given the weakness of sales in the months after the collapse of Lehman in September 2008.

However, the official measure of sales volumes would have to rise by a monthly 1.5% in October in order for the annual rate to reach the 4% or so suggested by the surveys. This would be the largest rise in 18 months and seems unlikely to occur, given the wider context of a weak labour market and

rising household saving. The official data has also been more downbeat than the surveys of late. So a smaller monthly rise than suggested by the surveys, perhaps of 0.5% or so in October, seems more plausible.

CHART 1: CBI REPORTED SALES BALANCE & RETAIL SALES VOLS



Source – Thomson Datastream

Data Preview – M4 Money Supply (Oct.)

09.30 Thu. 19th Nov.

Forecasts	Last	Median	Capital Economics
M4	+0.8%(+11.6%)	+1.0%(+9.9%)	+0.5%(+9.2%)
M4 lending	+0.6%(+6.5%)	-	+0.2%(+4.6%)

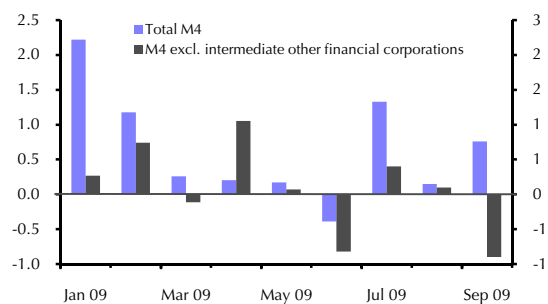
Money growth not as strong as it looks

The broad money supply is still failing to pick up strongly in response to the £175bn that the Bank of England has pumped into the economy. Admittedly, overall M4 posted a decent 0.8% monthly increase in September. But the breakdown subsequently showed that this was driven by those parts of the financial sector that just shift money between institutions. The MPC's preferred measure of M4 which strips this out fell by 0.9%. (See Chart 1.)

So even if overall M4 posts another strong rise in October, we would not read much into it until we get the detailed breakdown at the end of the month. What's more, even with a fairly strong monthly rise, base effects means that the annual growth rate is likely to drop from double to single digits.

Meanwhile, lending to firms and households stagnated in September, despite a 0.6% rise in total bank lending. The fragile banking system is likely to remain reluctant to lend for some time yet.

CHART 1: M4 (% M/M)



Source – Thomson Datastream

Data Preview – Public Finances (Oct.)

09.30 Thu. 19th Nov.

Forecasts	Last	Median	Capital Economics
PSNB (£bn)	+£14.8bn	+£6.8bn	+£5.0bn
PSNCR (£bn)	+£19.4bn	+£4.0bn	+£3.0bn

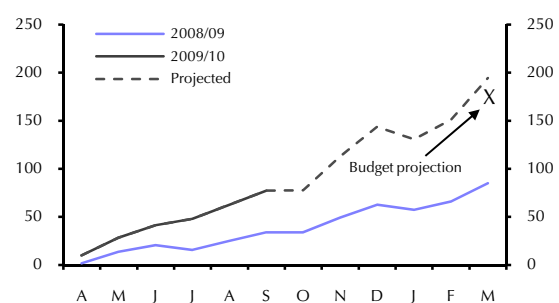
No pre-PBR boost for Mr Darling

As the last monthly public finances figures before the Pre-Budget Report on December 9th, the Chancellor Alistair Darling will no doubt be hoping for some good news from the October release. But he should not hold his breath. Admittedly, September's figures revealed a slight slowdown in the rate of increase in public borrowing. As a result, borrowing is now on track to total around £200bn in the full fiscal year, rather than the £220bn that previously looked likely. (See Chart 1.)

But we would be wary of expecting any further improvement in the trend at a time when the economy has yet to emerge convincingly from

recession. We anticipate an October PSNB total of about £5bn compared to close to zero last year.

CHART 1: PUBLIC SECTOR NET BORROWING (£BN)



Source – Thomson Datastream

Latest Data & Main Forecasts

LATEST UK ECONOMIC INDICATORS

Monthly Indicators %m/m(%y/y) unless stated	July	Aug	Sep	Oct
Retail prices (%y/y) CPI	+1.8	+1.6	+1.1	-
RPIX	+1.2	+1.4	+1.3	-
RPI	-1.4	-1.3	-1.4	-
Producer prices Input, n.s.a.	-1.1(-12.2)	+2.0(-7.7)	-0.2(-6.2)	+2.6(+0.1)
Output, n.s.a.	+0.2(-1.3)	+0.3(-0.3)	+0.5(+0.4)	+0.2(+1.7)
Average earnings, headline (actual %y/y)	+1.8(+1.2)	+1.6(+1.5)	+1.2(+1.0)	-
ILO unemployment, q/q change thous., (rate %)	+209(7.9)	+88(7.8)	+29(7.8)	-
Retail sales	+0.3(+2.9)	0.0(+2.2)	0.0(+2.4)	-
Manufacturing output	+0.4(-11.5)	-2.0(-11.1)	+1.6(-10.5)	-
PSNB £bn, latest (FY cumulative)	+6.6(+47.8)	+14.7(+62.5)	+14.8(+77.3)	-
Global trade in goods balance, £bn	-6.5	-6.1	-7.2	-
Nationwide house prices	+1.4(-6.2)	+1.4(-2.7)	+0.9(0.0)	+0.4(+2.0)

Quarterly Indicators %q/q(%y/y) unless stated	Q4 2008	Q1 2009	Q2 2009	Q3 2009
GDP	-1.8(-1.8)	-2.5(-5.2)	-0.6(-5.5)	-0.4(-5.2)
Household spending	-1.1(-0.8)	-1.3(-3.1)	-0.6(-3.6)	-
Productivity, whole economy	-1.7(-2.0)	-2.0(-4.4)	+0.3(-3.9)	-
Current account, £bn	-8.1	-4.2	-11.4	-

LATEST MARKET DATA

Instrument/rate	1 mth ago	1 week ago	Latest*	Instrument/rate	1 mth ago	1 week ago	Latest*
Official rates UK repo	0.50	0.50	0.50	Global yields US 10 year	3.41	3.50	3.44
US Fed funds	0-0.25	0-0.25	0-0.25	E12 10 year	3.29	3.36	3.34
ECB refi	1.00	1.00	1.00	Japan 10 year	1.34	1.45	1.35
Japan o'night	0.10	0.10	0.10	Equity indices FTSE 100	5190	5143	5290
Market rates 3mth LIBOR	0.57	0.61	0.61	S&P 500	1088	1069	1087
12mth LIBOR	1.13	1.20	1.20	Nikkei 225	10258	9789	9770
Gilt yields 2 year	0.88	0.83	1.29	Exchange rates Sterling index	79.0	80.9	80.5
5 year	2.65	2.91	2.70	\$/£	1.63	1.66	1.67
10 year	3.60	3.89	3.74	Euro/£	1.10	1.12	1.12
20 year	4.10	4.39	4.27	\$/Euro	1.49	1.48	1.49
Yield curve (20 year-2 year)	323	356	299	Brent crude oil price (\$ pb)	76.0	75.7	76.5

* Latest as at 11.00 am 13th Nov 2009

MAIN ECONOMIC & MARKET FORECASTS

%q/q(%y/y)unless stated	Latest	Q4 2009	Q1 2010	Q2 2010	2008	2009	2010
GDP	-0.4(-5.2) (Q3)	+0.5(-3.0)	+0.2(-0.3)	+0.5(+0.8)	(+0.7)	(-4.5)	(+1.0)
Household spending	-0.6(-3.6) (Q2)	+0.4(-2.0)	-0.5(-1.0)	0.0(-0.4)	(+0.9)	(-3.0)	(-0.5)
CPI inflation (%y/y)	+1.1	+1.6	+2.4	+1.9	+3.6	+2.1	+1.5
ILO unemployment rate (%)	7.8	8.7	9.1	9.6	5.6	7.9	9.7
Repo rate, end period (%)	0.50	0.50	0.5	0.5	2.00	0.50	0.50
10 yr gilt, end period (%)	3.74	3.00	2.75	2.50	3.02	3.00	2.50
\$/£, end period	1.67	1.55	1.55	1.50	1.46	1.55	1.50
Euro/£, end period	1.12	1.11	1.11	1.15	1.04	1.11	1.15

Economic Diary & Forecasts

THE WEEK AHEAD

Date/Country	Release/indicator/event	Time (GMT)	Previous*	Median*	CE Forecast*	UK Data Response
Mon 16 th	UK Rightmove House Prices (Nov)	00.01	+2.8%(+0.2%)	-	-	-
	UK BoE's Paul Tucker speaks in Brussels	08.15	-	-	-	-
	UK BoE's Andrew Sentance speaks in London	18.00	-	-	-	-
Tue 17 th	UK Consumer Prices (Oct)	CPI	0.0%(+1.1%)	+0.1%(+1.4%)	-0.1%(+1.3%)	DR
		Core CPI	(+1.7%)	(+1.8%)	(+1.8%)	DR
		RPI	+0.4%(-1.4%)	+0.1%(-1.0%)	-0.1%(-1.1%)	DR
		RPIX	(+1.3%)	(+1.7%)	(+1.6%)	DR
	EZ CPI (Oct Final)	10.00	(-0.1%)p	+0.3%(-0.1%)	+0.2%(-0.1%)	-
	EZ Core CPI (Oct)	10.00	(+1.2%)	(+1.1%)	(+1.2%)	-
	US Retail Sales (Oct)	13.30	-1.5%	+0.9%	+0.6%	-
	US Core Retail Sales (Oct)	13.30	+0.5%	+0.4%	+0.2%	-
Wed 18 th	UK BoE MPC Meeting Minutes (175-200-225)	09.30	9-0-0	-	0-6-3	DR
	UK BoE Agents' Scores (Nov)	09.30	-	-	-	-
	UK CBI Ind. Trends Survey (Nov) (Output Exp.)	11.00	+4	-	+5	DR
	US CPI (Oct)	13.30	+0.2%(-1.3%)	+0.2%(-0.2%)	0.0%(-0.5%)	-
	US Core CPI (Oct)	13.30	+0.2%(+1.5%)	+0.1%(+1.6%)	+0.1%(+1.6%)	-
Thu 19 th	UK BoE's Paul Fisher speaks in London	09.20	-	-	-	-
	UK BoE Trends in Lending Report (Nov)	09.30	-	-	-	-
	UK Retail Sales (Oct)	09.30	0.0%(+2.4%)	+0.5%(+2.9%)	+0.5%(+2.9%)	DR
	UK M4 Money Supply (Oct Prov.)	09.30	+0.8%(+11.6%)	+1.0%(+9.9%)	+0.5%(+9.2%)	DR
	UK Public Finances (Oct)	PSNB	+£14.8bn	+£6.8bn	+£5.0bn	DR
		PSNCR	+£19.4bn	+£4.0bn	+£3.0bn	DR
Fri 20 th	- No Significant Data Released	-	-	-	-	-

*m/m(y/y) unless otherwise stated; p=provisional. "DR" Data Response sent out after data is released.

KEY FORTHCOMING EVENTS/DATA

Date	Event	Date	Event
23 rd -30 th	Nationwide House prices (Nov)	1 st Dec	CIPS/ Markit Report on Manufacturing (Nov)
25 th Nov	GDP (Q3 2 nd Est.)	3 rd Dec	CIPS/Markit Report on Services (Nov)
26 th Nov	CBI Distributive Trades Survey	8 th Dec	Industrial Production (Oct)
30 th Nov	Gfk Consumer Confidence (Nov)	9 th Dec	Pre-Budget Report
30 th Nov	BoE Mortgage Approvals (Oct)	9 th Dec	Trade (Oct)
30 th Nov	M4 Money Supply (Oct Final)	10 th Dec	BoE Interest Rate Announcement

Selected Recent Publications

Date	Publication	
Mon 9 th	Capital Daily	Markets shrug off rise in US unemployment.
	Germany Industrial Production & Trade (Sep.)	Industrial data point to strong growth in Q3.
	Global Economics Update	Are we any closer to a global Tobin tax?
	Latin America Economics Update	Mexico: disinflation process has further to run.
	Emerging Europe Update	Latvia: Still no sign of growth.
	US Economics Update	Extended tax credit is a shot in the arm for housing.
	UK Treasury Monthly	Bounce in gilt yields may not last.
	US Economics Update	Fed survey suggests credit crunch fading fast.
Tue 10 th	Capital Daily	Bank costs to rise, regardless of Tobin tax.
	UK RICS Housing Sur. (Oct.) & CLG House Prices (Sep.)	Slow rebalancing of the housing market continues.
	Asian Economics Update	Is Japan's recovery already faltering?
	UK Trade (Sep.) & BRC Retail Sales (Oct.)	Trade boost still in doubt.
	Asian Economics Update	Indonesia's impressive upswing to stay on track.
	German ZEW (Nov.)/ French & Italian Ind. Prod'n (Sep.)	Expectations deteriorate, but level still high.
	Global Markets Update	Bond yields to drop back in 2010 as inflation fears fade.
	UK Commercial Property Update	Why have leisure and hotels held up relativ. well during downturns?
Wed 11 th	Capital Daily	New Zealand facing a long hard slog.
	Global Markets Update	The macroeconomic implications of the lower dollar.
	UK Labour Data (Sep./Oct.)	Inflation expectations may not have much further to rise.
	Asian Economics Update	A tough six months ahead for Indian stocks.
	UK Bank of England Inflation Report (Nov.)	Employment unlikely to keep rising.
	Emerging Europe Update	China's commodity imports slow.
	Global Markets Update	Dovish Report leaves door to further policy action open.
	European Commercial Property Update	Price pressures continue to fade.
Thu 12 th	Capital Daily	Turning bearish on the yen.
	UK Mortgage Arrears and Possessions (Q3)	Office development cut, but not enough to prevent rental declines.
	Euro-zone Industrial Prod. (Sep.) & Spanish GDP (Q3)	A darker outlook for the yen.
	UK CML Buy-to-let Lending (Q3)	Labour market flexibility helps keep possessions low.
	Latin America Economics Update	Industrial output surges in Q3.
	Asian Economics Update	Buy-to-let lags the wider upturn in the mortgage market.
	European Commercial Property Update	Mexico: Industry drives economic recovery.
	UK Economics Focus	Markets too aggressive on Korean rate hikes to come.
Fri 13 th	Capital Daily	Office v industrial rents: why have Italy and Portugal been different?
	China Hong Kong GDP (Q3)	UK faces a decade of high unemployment.
	Japan Economics Weekly	Bonds and equities are not breaking up just yet.
	Euro-zone Flash GDP (Q3)	Disappointment as consumption stalls.
	Emerging Asia Economics Weekly	Is Japan facing a sovereign debt crisis?
	US External Trade (Sep.) & Consumer Conf. (Nov.)	Out of recession, but domestic demand disappoints.
	UK Economics Weekly	Asian central banks moving towards the exit.
	US Economics Weekly	-
	UK Commercial Property Update	It's the levels, stupid!
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