

# UK QUARTERLY REVIEW

Q3 2011



Growing apart or coming together?  
- *The regional outlook for the economy*



- UK's fringes most reliant on government spending.
- ... and constrained by reliance on financial services.
- Growth across the UK to become more evenly balanced.
- But London hit hardest by benefit cuts and higher taxes...
- Rebalancing of economy to favour the manufacturing North.
- No region to escape sluggish recovery in next two years.



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Design by Bobby Gunthorpe

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## Third quarter 2011

*Growing apart or coming together?*

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## Executive Summary

- **The common perception is that the fiscal squeeze will prompt the traditional North-South divide to widen. However, we think it is more likely that the different regions of the UK will see a more uniform performance in the next few years than in the past.**
- Their dependence on public sector spending often marks Northern Ireland, Wales, Scotland and the North out as being in for the roughest ride over the next few years.
- But not all government spending will be cut equally. For example, benefit cuts are initially focused on housing benefit and London will be one of the biggest losers from this.
- What's more, the fiscal squeeze is not just about government spending cuts. **Given that the tax increases have been aimed at higher earners, Londoners are again the worst off from the changes.**
- Meanwhile, government spending cuts are not the only influence on regional economies. **And those regions most dependent on public spending are also best-placed to take advantage of a mini-revival in manufacturing.**
- Admittedly, there have been signs recently that the previously strong manufacturing recovery has faltered. But if any sector is going to do well over the next couple of years, it should be industry, given that the lower pound has yet to have its full benefit. **Exports of goods account for the highest percentage of regional output in the North East and Wales.** London, by contrast, will be held back by its reliance on the financial sector.
- A final reason to think that London and the South East might struggle to pull ahead is that they might start to hit various constraints on how fast they can grow. **Perhaps the most obvious constraint is the cost of living and the shortage of affordable housing.** Slower population growth is also likely to hold back London's growth rate somewhat.
- We doubt that regional growth rates will converge completely. While the South East could increase its share of overall UK GDP by almost 0.5% over the next decade, Scotland could lose almost the same. **But the various constraints facing London suggest that the capital could see its share of overall UK GDP fall over the next few years.**
- In the longer-term, this will mean that all regions will share more equally in the fruits of the UK's success. In the near-term, however, it means that the pain of the next couple of years will be borne more equally.
- We now expect real GDP growth this year of just 1% (compared to our previous forecast of 1.5%). **We still expect growth of only 1.5% in 2012 and think that it is unlikely to beat 2% or so in 2013.**
- With the economy failing to grow fast enough to use up the slack in the economy, inflation still looks likely to fall sharply next year. **Accordingly, we still expect interest rates to remain on hold until 2013 or even 2014.**

## Growing apart or coming together?

### *The regional outlook for the economy*

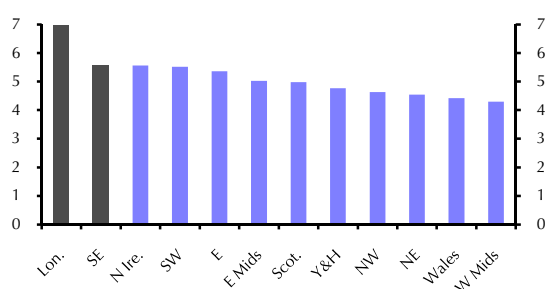
The UK economy is far from a homogenous entity, with its regional disparities for years encapsulated in the term “North-South divide.” But as a significant re-balancing of the economy gets underway, could the changing sectoral shape of the economy prompt the regional profile to alter course too?

In this *Article*, we discuss the outlook for the UK’s regional economies and whether the divergences of past years look set to narrow or instead get even wider. We will conclude by presenting for the first time some formal forecasts for economic growth and employment by region, which we intend to update and publish on a regular basis. We will also now be including in the *Quarterly Review* regular commentary on the regions. (See *Analysis: Regions*, pages 36 to 37.)

#### North-South divide continues to grow

London and the South East have for a long time been the fastest growing areas of the UK, in large part due to their reliance on the rapidly-growing services sector. And the last decade was no different. (See the black bars in Chart 1.)

**CHART 1: AVERAGE NOMINAL GDP (% Y/Y, 1998-2007)**



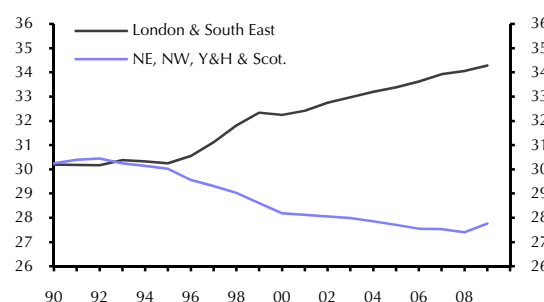
Source – Thomson Datastream

In the ten years leading up to the recession (i.e. 1998 to 2007), nominal GDP growth in London – the fastest growing region – averaged 7%, compared to growth of just 4.3% in the West Midlands, the slowest growing region.

Growth in the South East and South West was significantly stronger than in the northern regions and Wales. Northern Ireland was the only exception to this pattern of southern dominance, with its economy benefiting from a “peace dividend” following an end to conflict in the region.

At the start of the 1990s, London and the South East accounted for broadly the same share of overall UK GDP as the North East, North West, Yorkshire and Humberside, and Scotland combined. But by 2008, London’s share had risen from 30% to 34%, while the share of these other four regions had fallen from 30% to 28%. (See Chart 2.)

**CHART 2: NOMINAL GDP BY REGION (AS A % OF UK TOTAL)**

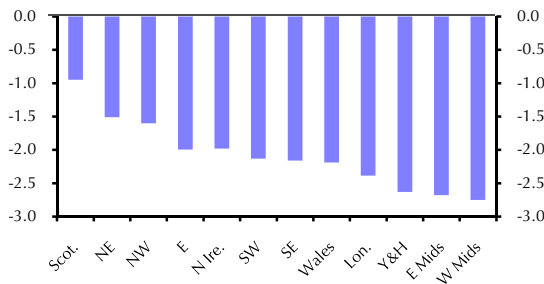


Source – Thomson Datastream

This pattern altered slightly during the recession, when their exposure to financial services meant that London and the South East slipped to the middle of the pack. Scotland and the northern

regions in fact saw the smallest drop in GDP in 2009. (See Chart 3.)

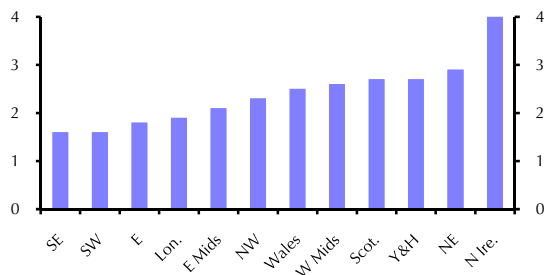
**CHART 3: NOMINAL GDP IN 2009 (% Y/Y)**



Source – Thomson Datastream

Nonetheless, in other ways, London and the South East emerged from the recession relatively unscathed – indeed, many have questioned whether London experienced a recession at all. Chart 4 shows that the unemployment rate has risen much more sharply in the North than in the South since the start of 2008.

**CHART 4: CHANGE IN REGIONAL UNEMPLOYMENT RATE (% , JAN. 2008 – MAY 2011)**

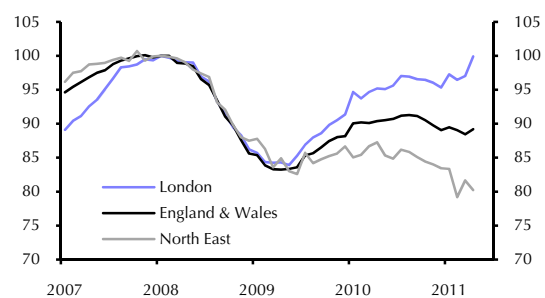


Source – Thomson Datastream

What’s more, the regional PMIs – which are a timelier indicator of economic activity than the annual GDP figures – suggest that London bounced back more strongly than the overall economy once the recession ended. **This is**

**without doubt the case in the housing market.** As Chart 5 shows, while house prices in some northern regions have fallen further below the trough reached in 2009, house prices in London are now pretty much back to their pre-recession peak.

**CHART 5: HOUSE PRICES (JAN. 2008 = 100)**



Source – Land Registry

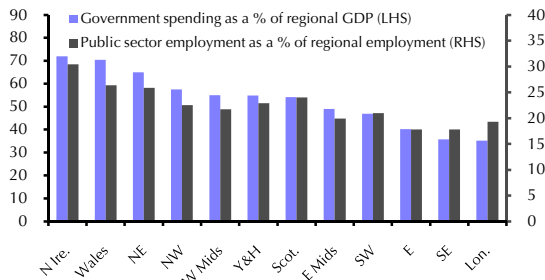
### Spending cuts to hit fringes of the UK the hardest

On the face of it, then, this might suggest that London and the South are well-poised to continue to outperform the rest of the country.

After all, one of the biggest factors determining both the overall and regional economic performance over the coming years is the fiscal squeeze. **And it has been well-flagged that the government spending cuts are set to hit the North and the outlying parts of the UK the hardest.** As the blue bars in Chart 6 show, overall total managed expenditure in 2009/10 was 48% of the UK’s total GDP. It was just 35% of GDP in London, but some 72% of GDP in Northern Ireland.<sup>1</sup>

<sup>1</sup> Note that about 12% of government spending is on things such as defence which cannot be allocated to a particular region, so we have assumed spending on “non-identifiable” expenditure in each region is in proportion to other spending.

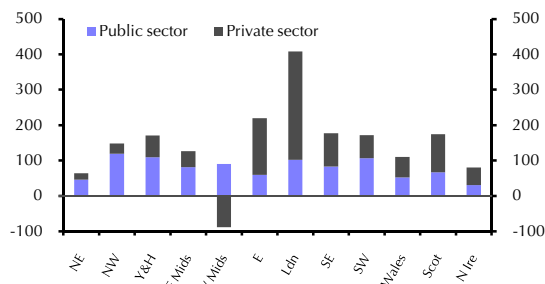
**CHART 6: GOVERNMENT SPENDING & EMPLOYMENT (AS A % OF REGIONAL GDP & EMPLOYMENT)**



Sources – ONS, HM Treasury

Meanwhile, overall public sector employment in the UK as a whole stood at 21% at the end of last year. While it was just 17% in the East of England, it was some 30% in Northern Ireland. (See the black bars in Chart 6.) Indeed, in some regions, public sector employment has been responsible for almost all of the rise in overall employment over the past decade. In regions such as the North East and North West, the public sector has accounted for over 70% of employment growth since 2000. (See Chart 7.)

**CHART 7: PUBLIC & PRIVATE SECTOR EMPLOYMENT GROWTH SINCE 2000 BY REGION (000s)**



Source – Thomson Datastream

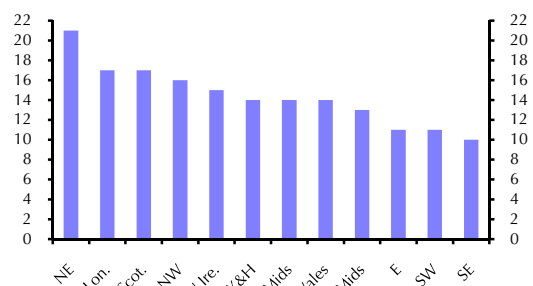
Some of those regions particularly exposed to the public sector job cuts will also be particularly badly affected by the Government's benefit cuts.

Northern Ireland, for example, has the highest share of households on disability benefit and child benefit, both of which are being cut. And its dependence on the construction sector means that it will suffer most from the severe cuts in government investment.

### London not immune from the fiscal squeeze

However, none of this means that the South will continue to pull away unchecked. **For a start, the regional dimension to the fiscal squeeze is not as clear-cut as Chart 6 might suggest.** Not all government spending will be cut equally; for example, benefit cuts are initially focused on housing benefit. And London will be the biggest loser from this. Given its high rent levels, London has a relatively high proportion of households on housing benefit (17%) compared to regions like the South East (10%). (See Chart 8.)

**CHART 8: % OF HOUSEHOLDS ON HOUSING BENEFIT**

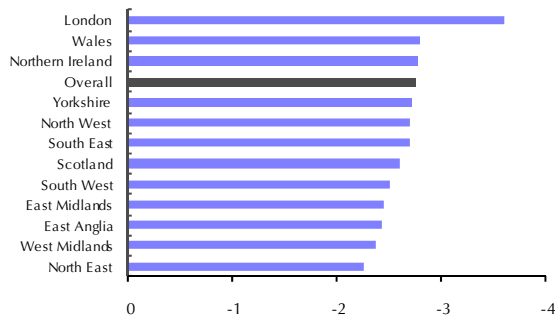


Source – ONS

Indeed, in a recent report by Centre for Cities, London was ranked as one of the cities likely to be worst hit by welfare spending cuts. Cuts per capita were estimated at £162 by 2014/15 – not as bad as the worst city (Birkenhead, at £197 per capita), but far higher than cities such as Oxford and York, which face cuts of less than £100 per capita.

What's more, the fiscal squeeze is not just about government spending cuts. Tax rises account for about one fifth of the fiscal consolidation – and are the part that has been enacted most quickly. **Given that the tax increases have been aimed at higher earners (the 50% income rate, the restriction of pension tax relief and changes in tax thresholds), Londoners are again the worst off from the changes.** Indeed, the Institute of Fiscal Studies has estimated that London is the biggest loser in terms of the tax and benefit changes taking place between 2010/11 and 2012/13. (See Chart 9.)

**CHART 9: EFFECT OF ALL TAX & BENEFIT CHANGES BETWEEN 10/11 & 12/13 BY REGION (LOSS AS A % OF NET INCOME)**



Source – IFS

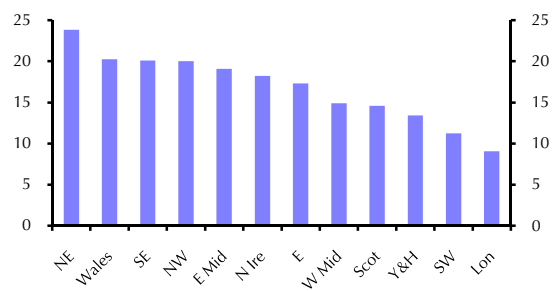
### Rebalancing to favour the North

Meanwhile, we should not get too gloomy about the regions most exposed to the cuts in public sector employment and spending. **After all, generally speaking, these are the areas best placed to take advantage of the mini-revival in manufacturing that we expect to see over the next few years.**

Admittedly, there have been some signs recently that the previously strong manufacturing recovery has faltered. But if any sector is going to do well over the next couple of years, it should be industry, given that the lower pound has yet to have its full benefit. **And the boost to exporters'**

**competitiveness should disproportionately benefit Wales and the North.** As Chart 10 shows, these are the areas where exports of goods account for the highest percentage of regional output. Note that, somewhat surprisingly, the South East comes third in this ranking. The South East is particularly specialised in high-tech products, with the Thames Valley region known for its technology, telecommunications and pharmaceutical companies.

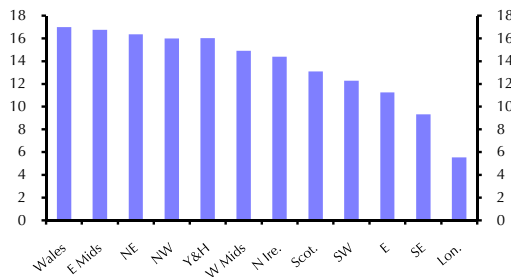
**CHART 10: GOODS EXPORTS (AS A % OF REGIONAL GDP IN 2009)**



Source – Thomson Datastream

Of course, it is not just exporters who should benefit from the lower pound. The rise in the cost of imports as a result of the pound's drop should encourage manufacturers to produce those things currently made and imported from abroad. Accordingly, traditional manufacturing heartlands such as the East Midlands should also benefit. (See Chart 11.) The West Midlands is particularly likely to benefit if the lower pound encourages more vehicle production back to the UK. Assembly plants tend to be shifted from country to country quite regularly depending on where costs are lowest. Even for those cars that are still put together abroad, the UK can produce more of the component parts.

**CHART 11: MANUFACTURING OUTPUT (AS A % OF REGIONAL GDP IN 2008)**



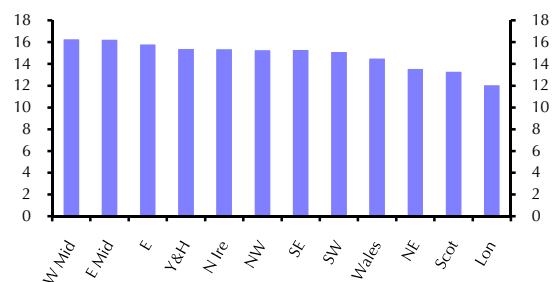
Source – Thomson Datastream

The traditionally manufacturing regions are also least likely to be held back by sluggish growth of the financial services sector – on which London is particularly reliant. Banks are still repairing their balance sheets, and their activity is likely to be constrained by the introduction of new global and national regulatory requirements. Even once banks have adjusted to these pressures, it is generally considered that the pace of banks’ balance sheet expansion in the run-up to the recession was unsustainable and that growth of the financial services sector over the next ten years will be rather slower than that over the past ten. Indeed, note that the recovery in the wider economy has yet to spread to the overall financial sector – where output has continued to fall. (See Chart 12.)

Areas such as Northern Ireland and the East Midlands have less than 5% of their output accounted for by the financial sector. In contrast, in 2008, almost 20% of London’s output was provided by the financial sector, followed by 8% of Scotland’s output.

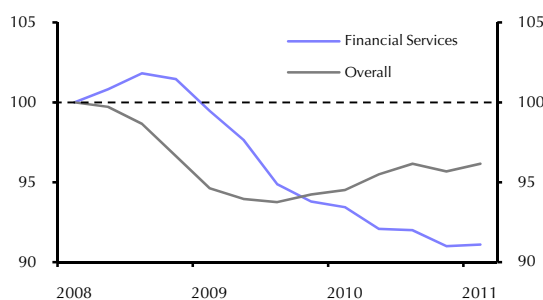
Given the sluggish outlook for consumer spending over the next few years, growth of the consumer services sector (retail, pubs, hotels and restaurants) looks set to be relatively weak too. **However, Chart 13 shows that the dependence on consumer services varies rather less by region than that on manufacturing.** What’s more, what dispersion there is does not fall neatly into the traditional North-South divide, with the two regions that have the smallest shares of their economies devoted to consumer services being Scotland and London.

**CHART 13: CONSUMER SERVICES (AS A % OF REGIONAL GDP IN 2008)**



Source – Thomson Datastream

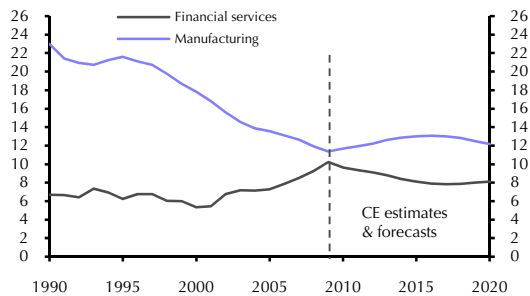
**CHART 12: OUTPUT SINCE START OF THE RECESSION (Q1 2008 = 100)**



Source – Thomson Datastream

**Admittedly, the rebalancing process away from financial and consumer services and towards industry is unlikely to persist indefinitely.** In the longer-run, manufacturing is likely to continue its structural decline in response to competition from abroad, while the long-term outlook for the financial sector remains relatively bright, as globalisation continues to increase the number of markets open to UK financial firms. (See Chart 14.)

**CHART 14: MANUFACTURING & FINANCIAL SERVICES (AS A % OF TOTAL UK GDP)**



Source – Thomson Datastream

**What’s more, the regional effects of structural changes in the economy are not as clear-cut as they once were.** Regional distinctions have blurred in recent years as, for example, the South West has built up its manufacturing sector and northern regions have diversified into consumer and financial services.

Nonetheless, the general picture is that the shift in the sectoral structure of the UK economy over the next few years will help to narrow the differences between regional growth rates seen in the past.

### Hitting the buffers

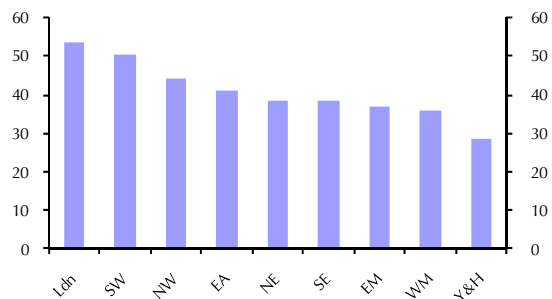
**A final reason to think that London and the South East might struggle to pull ahead is that they might start to hit various constraints on how fast they can grow.**

Perhaps the most obvious constraint is the cost of living and the shortage of affordable housing. As Chart 5 showed, the gap between house prices in London and the rest of the UK has widened even further over the last year.

Admittedly, over the next couple of years, we expect London house prices to drop along with house prices in the UK as a whole. And given that

houses look more overvalued in London than in any other region, London house prices might ultimately fall by more than those in other regions, helping to narrow this gap somewhat. (See Chart 15.) However, this process might take a few years. And if house prices do fall more sharply in London than elsewhere, consumer spending in London will suffer more in the meantime.

**CHART 15: HOUSE PRICE TO EARNINGS RATIO (% ABOVE LONG-RUN AVERAGE)**



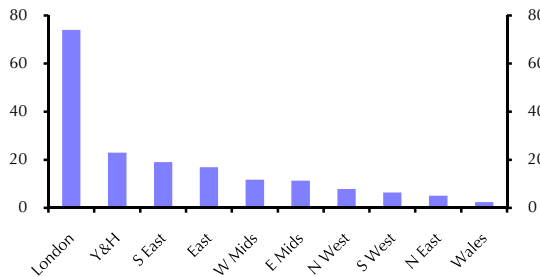
Source – Capital Economics

The increasing pressure on London’s infrastructure, as well as its pollution, crime and congestion charge also all increase the attractiveness of moving to another part of the UK, while technology is making it increasingly easy to work from home.

**Slower population growth is also likely to constrain London’s growth rate somewhat.**

London is the most popular destination for immigrants to the UK. (See Chart 16.) But migration slowed during the recession as unemployment in the UK rose. And if we are right in expecting unemployment to rise further, the UK’s attractiveness to migrants will fade further. The Government’s aim to reduce the level of net migration to “tens of thousands” by 2015 could also have an impact, although there are doubts over whether it can achieve this given that it cannot control migration within the EU.

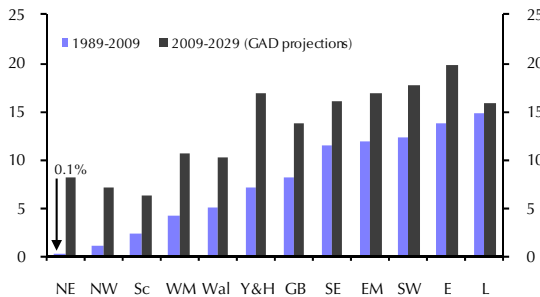
**CHART 16: NET MIGRATION (000s, AVERAGE 2000-2009)**



Source – ONS

More generally, the Government Actuary's Department's latest forecasts made in 2009 suggest that population growth is likely to be more evenly distributed than it has been in the last twenty years. (See Chart 17.)

**CHART 17: REGIONAL POPULATION GROWTH (CUMULATIVE, %)**



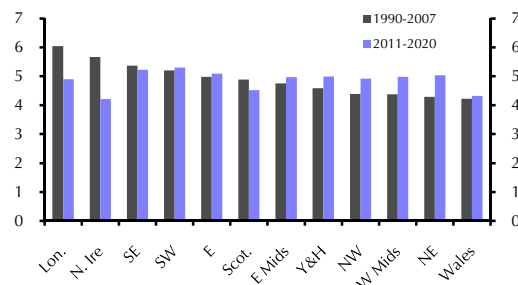
Sources – ONS, Government Actuary's Department

### Regional Forecasts

The upshot, then, is that the different regions of the UK should, if anything, see a slightly *more* uniform performance in the next few years than in the past. (See Chart 18.) Their dependence on public sector spending often marks Northern Ireland, Wales, Scotland and the North out as being in for the roughest ride over the next few years. To some extent that is true. But government

spending cuts are not the only influence on regional economies. And those regions most dependent on public spending are in other respects relatively well-placed. Meanwhile, the big structural changes that drove big regional patterns in the past are largely over – and, in the near-term at least, are actually going into reverse.

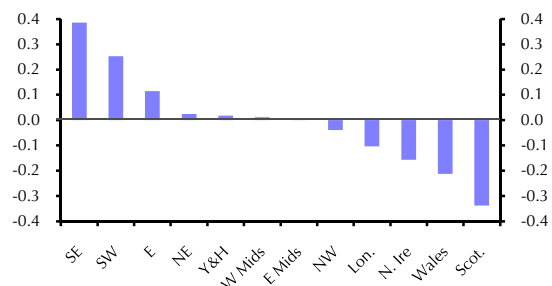
**CHART 18: AVERAGE RATE OF NOM. GDP GROWTH (% Y/Y)**



Source – ONS

We doubt that regional growth rates will converge completely. While the South East could increase its share of overall UK GDP by almost 0.5% over the next decade, Scotland could lose almost the same. **But note that the various constraints facing London suggest that the capital could see its share of overall UK GDP fall over the next few years.** (See Chart 19.)

**CHART 19: CHANGE IN SHARE OF UK GDP 2011 – 2020 (% POINTS)**



Source – ONS

Looking beyond the broad North-South divide, what can we expect? **In Chart 20, we have tried to show which regions are best or worst off from the key factors we have discussed.** For each factor, we have split regions into three groups; those marked red will be worst affected, those marked green will benefit most/emerge the most unscathed. The amber group lies in the middle. Perhaps the first point to note is the lack of any obvious pattern – with many regions seeing a mix of red, amber and green. **This reinforces our judgement that it is too simplistic just to characterise the regional outlook as a neat North-South divide.**

**CHART 20: THE REGIONAL OUTLOOK**



Source – Capital Economics

**In terms of the outlying parts of the UK, Northern Ireland looks very vulnerable, due to its reliance on public sector employment and the provision of state benefits, as well as the poor outlook for the housing market.** It may also have exhausted any “peace dividend” that has boosted its growth over the past decade or so. Indeed, since 2007, growth in Northern Ireland has fallen back in line with, or below, that of the UK as a whole.

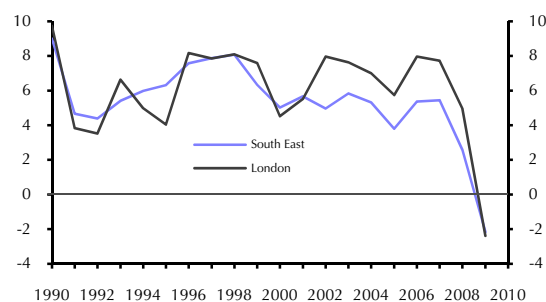
Wales looks poorly placed for the same reasons, although it does have a slightly bigger manufacturing sector to fall back on than Northern Ireland. Scotland’s reliance on public sector employment, together with the importance of the financial sector in the region, makes it only slightly better placed.

The Midlands do not look too badly off – given their moderate exposure to the public sector, the prospect of middling house price falls and a reasonably big manufacturing sector. As for regions within the North, we expect to see little significant differentiation, with the North East’s reliance on public sector employment perhaps offset by its lower reliance on the financial sector.

Lastly, a glance at the chart suggests that London is at a rather bigger disadvantage from many of the factors we have discussed than the South East. **Accordingly, it is possible that the South East expands about as - or even more - strongly than London over the next few years.** As Chart 21 shows, it is only during the last few years of financial sector strength that London outperformed; until then, London and the South East grew at broadly similar rates.

**CHART 21: NOMINAL GDP IN LONDON & THE SOUTH EAST**

(% Y/Y)

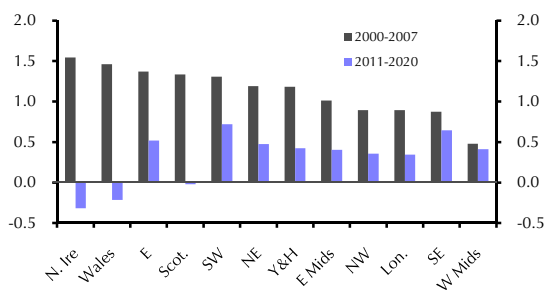


Source – Thomson Datastream

Our regional growth forecasts are shown in more detail for the first time in the tables on Page 43. Of course, we cannot hope to encapsulate all the forces affecting the relative regional performance, but we think that they give a good broad-brush guide to what to expect. Obviously we shall adjust the forecasts in response to new data and developments.

We are also publishing regional employment forecasts for the first time. (See Chart 22.) For the large part, these derive from our GDP growth forecasts for each region and therefore follow a similar pattern to that described above.

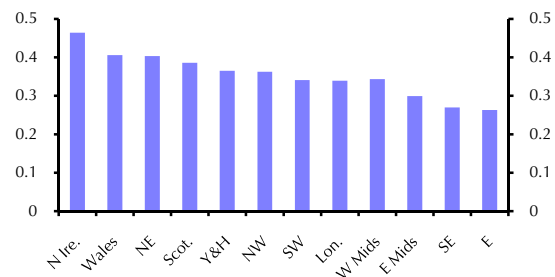
**CHART 22: AVERAGE EMPLOYMENT GROWTH BY REGION (%)**



Source – Thomson Datastream & Capital Economics

The extent of public sector job cuts in each region is obviously a big driver of our employment forecasts. We have assumed that public sector employment in each region falls at the same rate as our overall public sector employment forecasts (i.e. by about 1.5% per annum for each of the next four years). The higher share of public sector employment in Northern Ireland means that this knocks almost 0.5% of annual employment growth, whereas in the East it deducts about half that. (See Chart 23.)

**CHART 23: ANNUAL PUBLIC SECTOR EMPLOYMENT CUTS (AS A % OF REGIONAL EMPLOYMENT)**



Sources – ONS, Capital Economics

### Conclusions

**The UK economy will always look quite different depending on what part of the country you are in.** And within the regions we have discussed, there will of course be countless sub-regional differences too. Nonetheless, one of the favourable consequences of the “rebalancing” of the economy that is underway is that regional disparities in growth rates should be rather less pronounced over the next ten years than over the past few decades.

**The UK is set to become a better-balanced economy - in more ways than one.**

## Historical Data Table

	Average 1995-04	2005	2006	2007	2008	2009	2010
<b>Demand (%y/y)</b>							
GDP	3.1	2.2	2.8	2.7	-0.1	-4.9	1.4
Consumer Spending	3.7	2.3	1.8	2.2	0.6	-3.3	0.9
Government Consumption	2.2	2.0	1.4	1.3	1.6	1.0	1.0
Fixed Investment	4.7	2.4	6.4	7.8	-5.0	-15.4	3.7
Stockbuilding (% of GDP)	0.4	0.4	0.4	0.5	0.0	-1.2	0.2
Domestic Demand	3.5	2.1	2.5	3.1	-0.7	-5.5	2.7
Exports <sup>1</sup>	5.3	7.9	11.1	-2.6	1.0	-10.1	5.2
Total Final Expenditure	3.9	3.2	4.2	1.9	-0.3	-6.4	3.2
Imports <sup>1</sup>	7.0	7.1	9.1	-0.8	-1.2	-11.9	8.8
<b>Output &amp; Profits (%y/y)</b>							
Services Output	3.9	3.1	4.1	3.5	0.5	-3.2	1.1
Manufacturing Output	0.6	-0.2	1.6	0.5	-2.9	-10.7	3.4
Company Profits <sup>2</sup> (nominal)	4.9	2.4	7.8	6.3	-0.5	-7.5	4.5
<b>Labour Market</b>							
Unemployment (claimant count, millions)	1.3	0.9	0.9	0.9	0.9	1.5	1.5
Unemployment (claimant count, %)	4.2	2.9	2.9	2.5	3.6	4.9	4.5
Employment (%y/y)	0.7	1.1	0.9	0.7	0.9	-1.6	0.1
Productivity (output per worker, %y/y)	1.9	1.4	2.0	1.9	-0.8	-3.2	1.3
<b>Income &amp; Saving (%y/y)</b>							
Average Earnings <sup>3</sup>	4.1	4.6	4.9	4.7	3.5	0.0	2.3
Real Household Disposable Income	3.0	2.0	1.5	0.4	1.1	1.1	-0.8
Saving Ratio (%)	6.6	3.9	3.4	2.6	2.0	6.0	5.3
<b>Prices (%y/y)</b>							
CPI	1.6	2.0	2.3	2.3	3.6	2.1	3.3
Core CPI <sup>4</sup>	n/a	1.5	1.3	1.7	1.6	1.8	2.9
RPI	2.6	2.8	3.2	4.3	4.0	-0.5	4.6
RPIX	2.5	2.2	3.0	3.2	4.3	2.0	4.8
Nationwide House Prices (end period)	11.5	3.3	9.3	6.9	-14.7	3.4	0.0
<b>Monetary Indicators (end period unless stated)</b>							
Base/Repo Rate (%)	5.38	4.50	5.00	5.50	2.00	0.50	0.50
10 Year Gilt Yield (%)	6.7	4.1	4.7	4.5	3.1	4.1	3.5
Sterling Trade-weighted Index	97.2	98.2	104.3	98.1	74.0	80.8	79.8
\$/£	1.65	1.72	1.96	1.99	1.47	1.62	1.55
Euro/£	1.46	1.46	1.48	1.36	1.03	1.13	1.16
M4 (%y/y, period average)	8.0	10.9	12.8	12.9	12.3	13.4	2.0
<b>Balance of Payments &amp; Public Finances</b>							
Current Account (£bn)	-15.0	-32.8	-44.9	-36.5	-23.8	-23.9	-46.3
% of GDP	-1.5	-2.6	-3.4	-2.6	-1.6	-1.7	-3.2
PSNB (£bn, financial year)	12.7	37.4	30.9	33.3	96.1	156.4	145.9
% of GDP (financial year)	1.3	2.9	2.3	2.4	6.7	11.1	9.9
<b>World Scene (%y/y)</b>							
World GDP <sup>5</sup>	3.5	4.5	5.1	5.2	3.0	-0.8	4.8
US GDP	3.3	3.1	2.7	1.9	0.0	-2.6	2.9
Euro-zone GDP	n/a	1.7	3.2	2.8	0.2	-4.0	1.7
G7 Consumer Price Inflation	1.8	2.3	2.4	2.2	3.3	-0.1	1.4
World Goods & Services Trade Volumes	7.0	7.6	9.3	7.2	2.8	-12.0	16.0
Oil Price (Brent, \$ per barrel, end period)	21.4	58.3	59.4	93.8	36.2	70.0	90.0

<sup>1</sup> Includes VAT fraud distortion; <sup>2</sup> Gross trading profits of non-financial corporations; <sup>3</sup> Including bonuses; <sup>4</sup> Excluding energy, food, alcohol & tobacco; <sup>5</sup> PPP terms

## Macro Forecast Table

	2011f	2012f	2013f	2011f		2012f	
				H1	H2	H1	H2
<b>Demand (%y/y)</b>							
GDP	1.0	1.5	2.0	1.3	0.8	1.2	1.7
Consumer Spending	-1.5	-1.0	0.5	-0.9	-2.0	-1.6	-0.5
Government Consumption	0.8	-1.0	-2.0	0.9	0.7	-0.5	-1.5
Fixed Investment	2.5	5.0	4.5	1.8	3.1	6.2	3.9
Stockbuilding (% of GDP)	0.6	0.7	0.7	0.4	0.7	0.7	0.7
Domestic Demand	-0.1	0.1	0.6	0.4	-0.5	0.1	0.0
Exports <sup>1</sup>	8.0	6.0	4.0	8.6	7.5	6.2	5.8
Total Final Expenditure	1.6	1.3	1.4	2.0	1.2	1.4	1.3
Imports <sup>1</sup>	3.5	1.0	-0.5	4.5	2.6	2.3	-0.2
<b>Output &amp; Profits (%y/y)</b>							
Services Output	1.0	1.3	2.0	1.2	0.8	0.9	1.8
Manufacturing Output	3.0	2.0	2.5	3.4	2.6	2.2	1.9
Company Profits <sup>2</sup> (nominal)	8.0	2.0	3.0	12.0	3.9	2.0	2.0
<b>Labour Market</b>							
Unemployment (claimant count, millions)	1.5	1.7	1.8	1.5	1.5	1.6	1.7
Unemployment (claimant count, %)	4.7	5.2	5.7	4.6	4.8	5.1	5.4
Employment (%y/y)	0.9	-0.7	-0.6	1.2	0.0	-0.7	-0.8
Productivity (output per worker, %y/y)	0.6	2.3	2.6	0.3	1.0	2.0	2.5
<b>Income &amp; Saving (%y/y)</b>							
Average Earnings <sup>3</sup>	2.3	2.6	2.8	2.4	2.2	2.5	2.7
Real Household Disposable Income	-2.0	-1.0	1.0	-1.6	-2.3	-2.0	0.0
Saving Ratio (%)	4.8	4.8	5.6	5.0	4.7	4.5	5.1
<b>Prices (%y/y)</b>							
CPI	4.7	2.8	1.2	4.3	5.2	3.7	1.9
Core CPI <sup>4</sup>	3.1	1.3	0.9	3.2	2.9	1.5	1.0
RPI	5.5	3.4	2.2	5.2	5.7	4.1	2.8
RPIX	5.5	3.5	2.3	5.3	5.7	4.2	2.9
Nationwide House Prices (end period)	-5.0	-7.0	-5.0	-1.2	-5.0	-9.1	-7.0
<b>Monetary Indicators (end period unless stated)</b>							
Base/Repo Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.50
10 Year Gilt Yield (%)	2.75	2.75	2.75	3.38	2.75	2.75	2.75
Sterling Trade-weighted Index	79.3	80.6	82.3	77.8	79.3	80.6	80.6
\$/£	1.60	1.55	1.50	1.60	1.60	1.55	1.55
Euro/£	1.14	1.19	1.25	1.11	1.14	1.19	1.19
M4 (%y/y, period average)	-0.5	1.5	3.0	-0.9	-0.2	1.0	2.1
<b>Balance of Payments &amp; Public Finances</b>							
Current Account (£bn)	-30.0	-27.0	-15.0	-15.9	-14.1	-14.6	-12.4
% of GDP	-2.0	-1.7	-0.9	-2.1	-1.8	-1.9	-1.5
PSNB (£bn, financial year)	130	115	95	-	-	-	-
% of GDP (financial year)	8.5	7.3	5.7	-	-	-	-
<b>World Scene (%y/y)</b>							
World GDP <sup>5</sup>	4.1	3.9	3.6	3.8	3.8	3.9	3.7
US GDP	2.5	2.0	2.3	2.3	2.6	2.0	2.0
Euro-zone GDP	2.0	0.5	0.0	2.2	1.7	0.7	0.3
G7 Consumer Price Inflation	2.8	1.5	0.4	3.1	2.5	2.0	1.0
World Goods & Services Trade Volumes	8.0	6.0	5.0	9.0	7.0	6.0	6.0
Oil Price (Brent, \$ per barrel, end period)	85	80	80	112	85	80	80

<sup>1</sup> Includes VAT fraud distortion; <sup>2</sup> Gross trading profits of non-financial corporations; <sup>3</sup> Including bonuses; <sup>4</sup> Excluding energy, food, alcohol & tobacco; <sup>5</sup> PPP terms

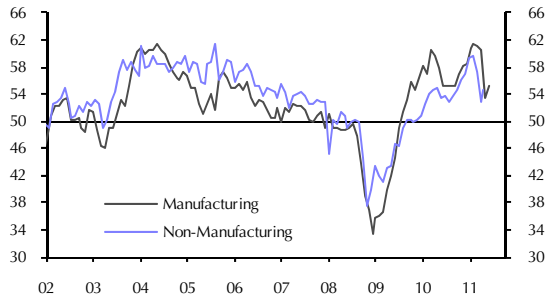
## Analysis: The World Economy

### *Fiscal consolidation will constrain US growth*

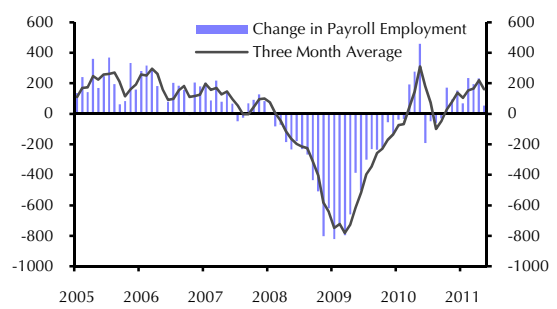
- Even if the US economy were to emerge from its recent soft patch in the second half of the year, a tightening in fiscal policy next year will probably result in a slowdown in GDP growth from 2.5% in 2011 to just 2.0% in 2012.
- The sharp declines in the ISM activity surveys and the disappointing 54,000 gain in payroll employment in May, which came after an average increase of 220,000 in the previous three months, show that the economy recently hit a wall. (See Charts 1 & 2.)
- The easing in GDP growth, from 3.1% in the fourth quarter of last year to 1.9% in the first quarter of this year, was probably maintained in the second quarter. (See Chart 3.)
- Some of the weakness can be blamed on temporary factors, such as the disruption caused by the Japanese earthquake and the surge in commodity prices. As auto parts sourced from Japan come back on line, motor vehicle sales are likely to reverse May's 11% m/m fall. (See Chart 4.)
- The end of the upward trend in commodity prices could also provide a temporary boost to real GDP growth in the third quarter. Even if commodity prices were just to stabilise at current levels, CPI inflation would still drop back sharply next year. (See Chart 5.)
- More generally, after an initial rapid burst in the early stages of the recovery, GDP growth has remained mired in a range of between 2% and 3%. This has not been enough to reduce the unemployment rate quickly. (See Chart 6.)
- Even though the recession ended two years ago, it seems unlikely that GDP growth will break out of this range anytime soon. It is well known that recoveries following financial crises are often muted and drawn out, normally because of the lack of credit availability. This has certainly played a role in the weakness of the current recovery.
- The effect of the falls in asset prices on household balance sheets is a further constraint. Indeed, house prices are still declining. (See Chart 7.) As households focus on rebuilding savings and reducing debt, consumption growth will remain muted.
- Even the lacklustre economic recovery seen so far has relied on an unprecedented mix of monetary and fiscal stimulus. But fiscal policy will be tightened soon. Balanced budget rules mean that state and local governments have been cutting spending for some time now. (See Chart 8.) Over the next couple of years, that ongoing contraction will be compounded by what could be a very severe fall in Federal spending and/or rise in Federal taxes.
- The Federal Reserve will offset some of the impact by leaving interest rates at near-zero, perhaps until 2014. If we are right in thinking that the unemployment rate will fall slowly and that the threat of deflation will re-emerge, the Fed may even embark on a further round of large-scale asset purchases. Nonetheless, the Fed will be powerless to prevent a number of years of weak economic growth.

# The World Economy Charts

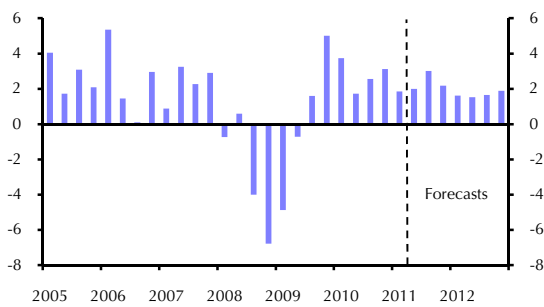
**Chart 1: US ISM Activity Indices**



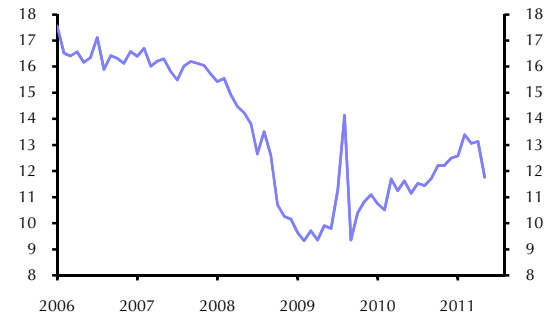
**Chart 2: Change in US Non-Farm Payroll Employment (000s)**



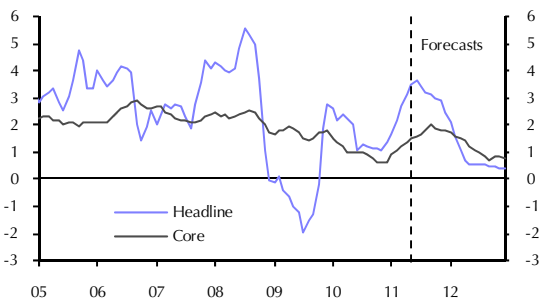
**Chart 3: US GDP (%q/q Annualised)**



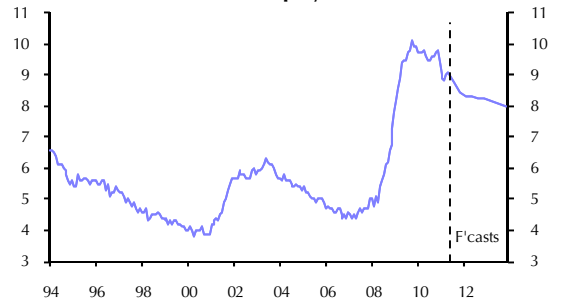
**Chart 4: US Motor Vehicle Unit Sales (Millions, Annualised)**



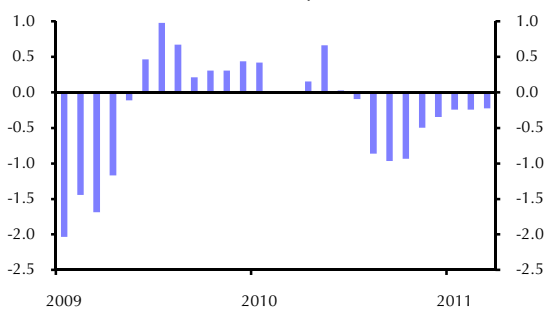
**Chart 5: US CPI Inflation (%)**



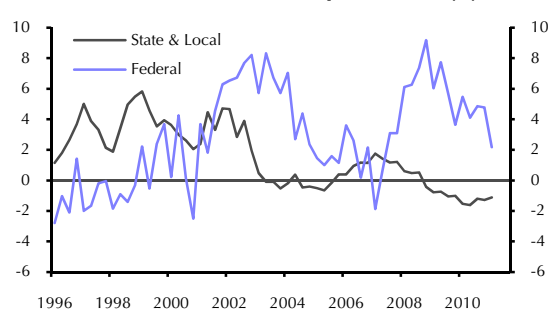
**Chart 6: US Unemployment Rate (%)**



**Chart 7: US Case-Shiller 20-City House Prices (%m/m)**



**Chart 8: US Government Expenditure (%y/y)**



Sources – Thomson Datastream, Capital Economics

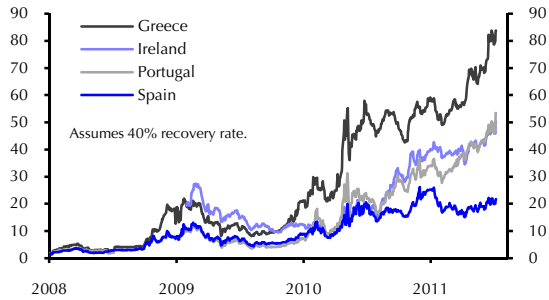
## Analysis: The World Economy (Continued)

### *Deepening debt crisis raises break-up risks*

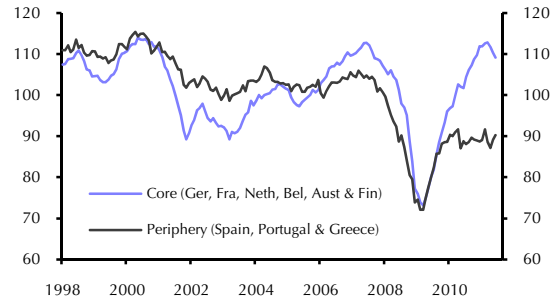
- The continued escalation of the debt crisis in the euro-zone's peripheral economies and signs of slowing economic growth in the core have added to the uncertainties over the future of the single currency union.
- Hopes that a combination of bail-out loans and austerity measures would contain the euro-zone's debt crisis have faded. It now looks inevitable that Greece will undertake some form of debt default. Ireland and Portugal will probably have to follow in time.
- This could have adverse financial and economic effects in itself. But the bigger concern is the growing signs of contagion to bigger economies such as Italy and Spain, where borrowing costs and fears of default have also risen. (See Chart 9.)
- Unsurprisingly economic sentiment in the periphery remains very subdued. (See Chart 10.) But confidence now appears to be waning in the core too and growth in the region as a whole is slowing. (See Chart 11.)
- Admittedly, the slowdown may partly reflect the reversal of temporary positive factors in Q1. But there are signs that the underlying pace of growth is easing too. Global trade growth now appears to be slowing and the continued strength of the euro will also pose problems for exporters, particularly in the less competitive periphery. (See Chart 12.)
- Meanwhile, measures of consumer sentiment point to a further pick-up in household spending growth. (See Chart 13.) But with the full effects of the ongoing fiscal squeeze unlikely to have been fully felt, particularly in the core economies, and signs that the labour market upturn may be faltering, household spending growth will remain pretty subdued.
- Despite all this, the ECB has maintained a pretty hawkish stance. But as evidence of a slowdown in growth increases, we expect the ECB to soften and for rates to remain at or close to 1.5% for a prolonged period.
- In all, with the fiscal crisis casting an ever longer shadow over the region, we expect growth in the euro-zone to slow from 2.0% this year to just 0.5% in 2012 and zero in 2013. (See Chart 14.) This outlook will add to worries about the long-term viability of the euro-zone. Indeed, we continue to think that some form of euro-zone break-up over the coming years remains more likely than not.
- Domestic demand prospects in Norway, Switzerland and Sweden appear markedly better, partly reflecting the sound position of their public finances. But strong currencies and tighter policy mean that growth will gradually slow over the next year or two. (See Chart 15.)
- Emerging Europe's economies continue to recover, with the region as a whole set to grow by just under 5% this year. But growth will vary greatly, with Turkey risking overheating and Croatia still struggling to expand. Meanwhile, the slowing of key euro-zone export markets will cause regional growth to moderate to around 3.5% in 2012 and 2013. (See Chart 16.)

## The World Economy Charts (Continued)

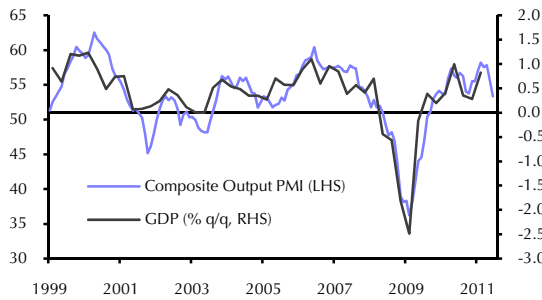
**Chart 9: Estimated Implied Probability of Default Over the Next Five Years (% , Derived From Sovereign CDS Premia)**



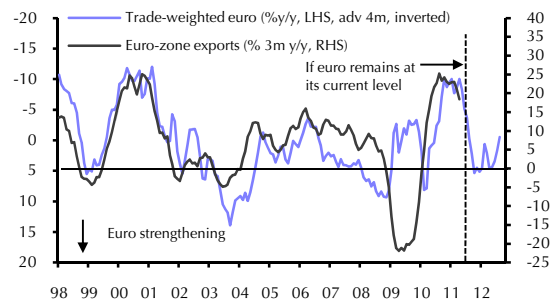
**Chart 10: EC Economic Sentiment Indicator**



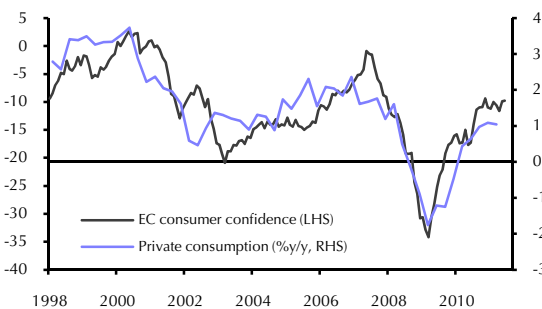
**Chart 11: Euro-zone GDP & the Composite PMI**



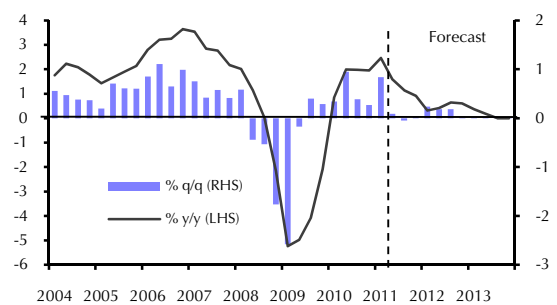
**Chart 12: Euro-zone Exports & the Trade-weighted Euro**



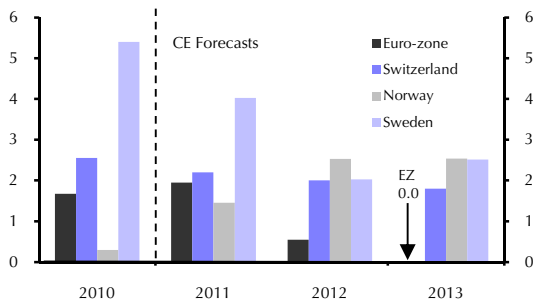
**Chart 13: Euro-zone Consumer Confidence & Spending**



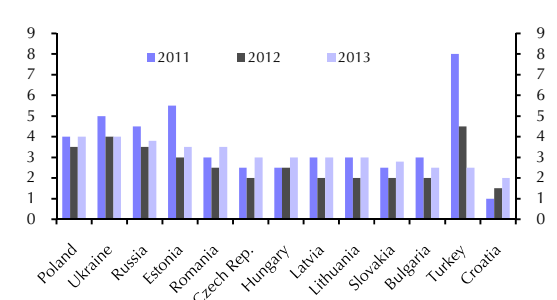
**Chart 14: Euro-zone GDP**



**Chart 15: Developed Europe GDP (% y/y)**



**Chart 16: Emerging Europe GDP (% y/y)**



Sources – ECB, IMF, Markit, Thomson Datastream

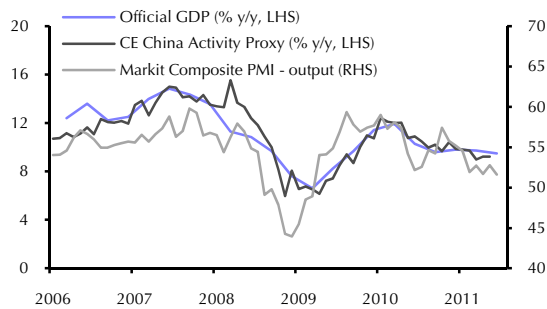
## Analysis: The World Economy (Continued)

### *China's inflation still uncomfortably high*

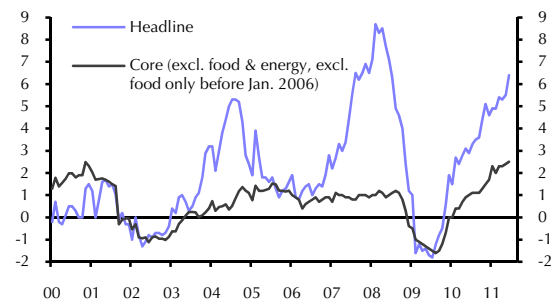
- China's economy has continued to slow in annual terms, but the Q2 GDP data helped to dispel concerns about an imminent hard landing. (See Chart 17.) Indeed, the official figures suggest the economy accelerated fractionally in seasonally-adjusted quarter-on-quarter terms, though other indicators have been less upbeat.
- Inflation remains the main immediate policy concern. But policy is unlikely to be tightened much further. Inflation is still driven predominantly by food prices. Core inflation has picked up recently but it remains fairly low. (See Chart 18.)
- The economic slowdown is partly due to monetary tightening which has halved credit growth over the last 18 months. However, it also reflects the weakness of consumer spending – which is not directly related to the tightening (personal credit is a tiny share of total lending). (See Chart 19.)
- China's new Five-Year Plan is centred on the need to rebalance the economy to be led by consumer spending rather than investment and exports. But the current weakness of household spending should dampen hopes that China will emerge as a key driver of demand for other economies any time soon. Indeed, China's trade surplus with Europe and the US continues to climb. (See Chart 20.)
- In India, too, growth has slowed in the past six months, although revised industrial production figures suggest the slowdown has been less pronounced than previously thought. (See Chart 21.) As in China, we expect India to avoid a hard landing.
- Indian inflation has repeatedly come in higher than expected. The headline WPI measure reached 9.1% in May and increases in administered prices will push this rate up further. As a result, the Reserve Bank of India is likely to hike the repo rate by an additional 50bp, to 8%. (See Chart 22.)
- However, after peaking at around 11% in the third quarter, inflation should drop back in the fourth quarter due to more favourable base effects and the tightening of monetary policy. Thereafter, disinflation will be gradual.
- In Japan, the recovery from March's earthquake has been swifter than most expected, though almost certainly not sufficient to prevent a further contraction in GDP in Q2. Survey measures for June have indicated that momentum is fading at the start of Q3, even before output has been restored to its pre-earthquake level. (See Chart 23.) The recovery will also be held back by power shortages, particularly during the summer months when electricity demand peaks, and the weakness of the labour market.
- The dire state of Japan's public finances also means that the boost from reconstruction work will be partly offset by tax increases and cuts in other spending to pay for the government's share. The upshot is that, while GDP should pick up in the second half of the year, the recovery will remain fragile. (See Chart 24.)

## The World Economy Charts (Continued)

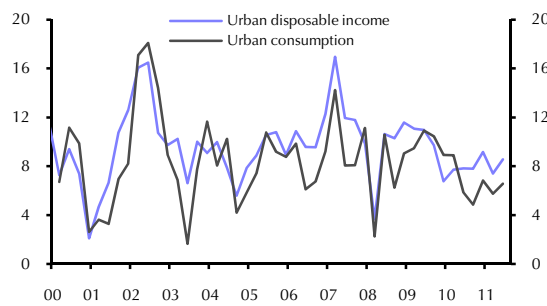
**Chart 17: China GDP, China Activity Proxy & Composite PMI**



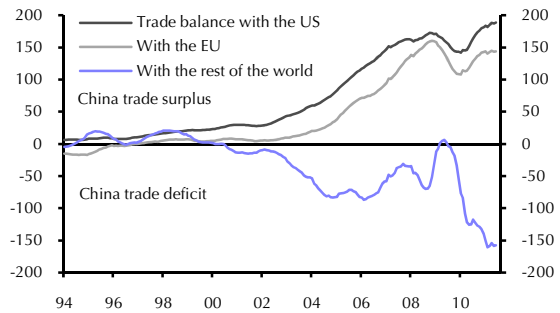
**Chart 18: China Consumer Prices (% y/y)**



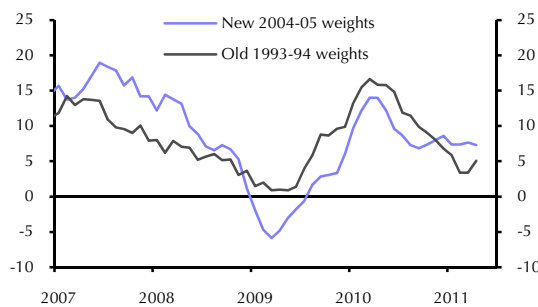
**Chart 19: China Per Capita Income & Consumption (% y/y)**



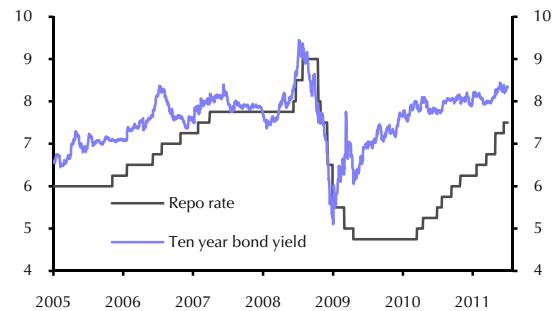
**Chart 20: China Trade Balance (\$bn, 12m sum)**



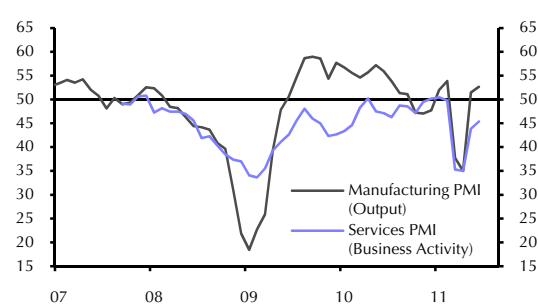
**Chart 21: India Industrial Output (% 3m y/y)**



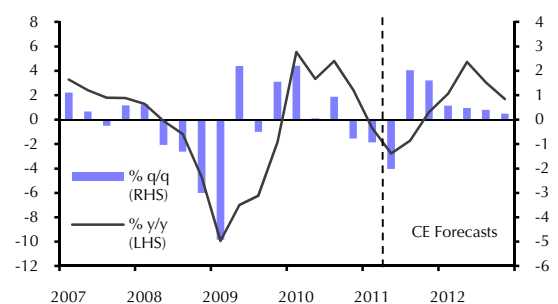
**Chart 22: India Interest Rate & Bond Yield**



**Chart 23: Japan Manufacturing & Services PMI**



**Chart 24: Japan GDP**



Sources – Markit, Thomson Datastream, IMF

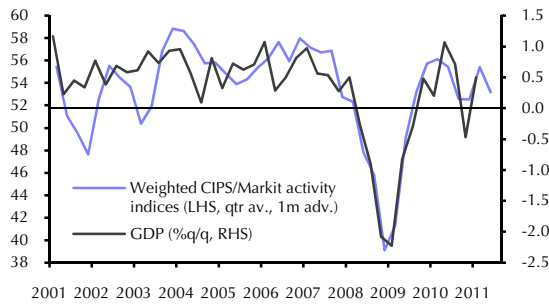
## Analysis: UK Output and Activity

### *The squeeze on consumers will get worse...*

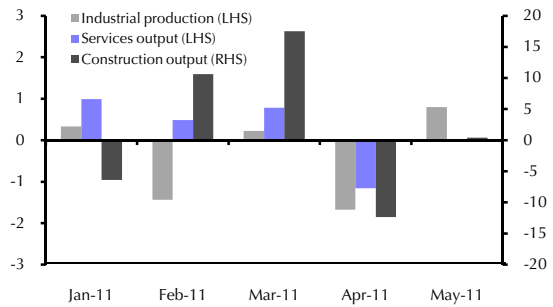
- The economic recovery has lost momentum and we expect it to struggle to get back on track. The fiscal squeeze is only part-way through, the squeeze on consumers' real pay is intensifying and weak global demand could limit the contribution to growth from net trade.
- The underlying trend in output was broadly flat between October and March and it looks as if there was only a marginal improvement in the second quarter. The business surveys point to quarterly growth of just 0.2% or 0.3%. (See Chart 1.) It is even possible that the economy contracted.
- Admittedly, a number of temporary factors have weighed on output, including the extra bank holiday in April and the knock-on effects from the Japanese earthquake. As Chart 2 shows, output dropped sharply in April, but then bounced back in May.
- However, there are growing signs of a more fundamental slowdown in demand too. For example, the new orders balances of the CIPS surveys have weakened. (See Chart 3.)
- In the near-term, the path of output will be quite volatile. Growth in the third quarter may receive a short-lived boost as the temporary factors recently pushing it down unwind.
- However, the big picture is that the recovery is likely to stay sluggish. After all, two thirds of economic activity is accounted for by consumer spending and the squeeze on consumers' real pay is likely to intensify even further.
- Inflation is set to rise above 5%. And nominal pay growth is unlikely to follow. (See *Analysis: Labour Market*, pages 28 to 29.) What's more, we still expect unemployment to rise.
- Consumers could support their spending by borrowing more or saving less. However, they will find it hard to get more credit from the banks. Net lending to households is still barely rising. (See Chart 4.) And we doubt that they will feel confident enough to use up their savings. The level of confidence is still consistent with further falls in spending. (See Chart 5.)
- By 2013, the squeeze on real incomes should have eased somewhat. If inflation falls sharply next year as we expect, it should have dropped below pay growth by next autumn, allowing real pay to start rising again. (See Chart 6.)
- However, cuts in government benefits and public sector employment will still be weighing on overall disposable incomes at that point. What's more, a rebound in real incomes would not necessarily prompt a rebound in spending if households used this extra cash to get their balance sheets back in order instead.
- One consequence of the squeeze on real pay is that households have not had the money available to get on with the deleveraging that still looks necessary. Household debt is still high, and at 4.6% in Q1, the household saving rate is still some way below its long-run average. (See Chart 7.) Accordingly, we think that the squeeze on consumer spending might last rather longer than the squeeze on incomes. (See Chart 8.)

# UK Output & Activity Charts

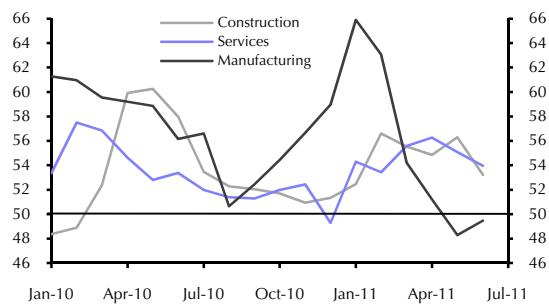
**Chart 1: Real GDP Growth & Business Surveys**



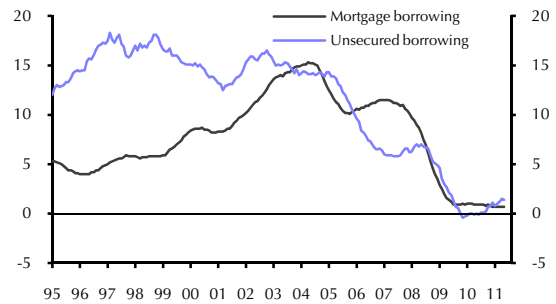
**Chart 2: Output (% m/m)**



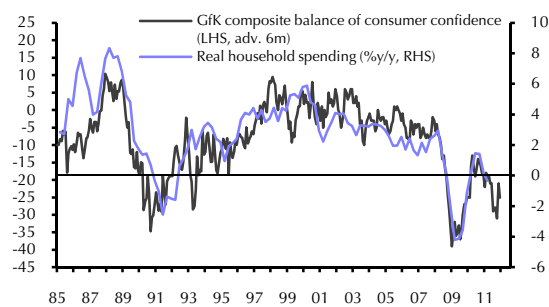
**Chart 3: CIPS/Markit New Orders Balances**



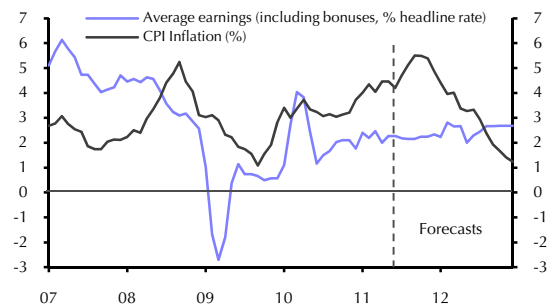
**Chart 4: Net Lending To Households (% y/y)**



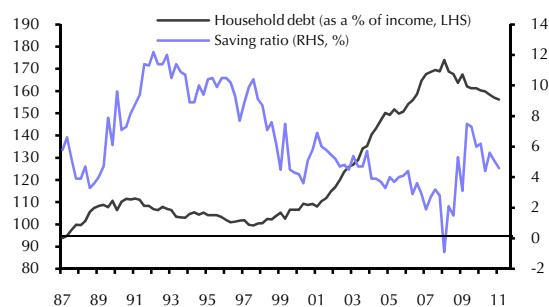
**Chart 5: Consumer Confidence & Real Household Spending**



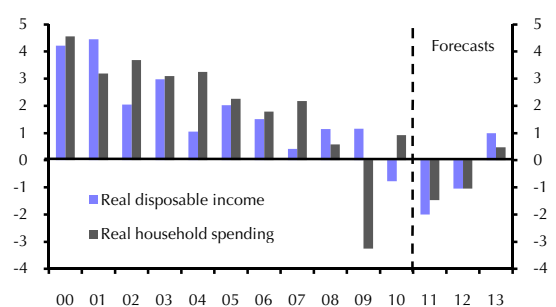
**Chart 6: Average Earnings & Inflation**



**Chart 7: Household Debt & Saving Ratio**



**Chart 8: Real Household Spending & Income (% y/y)**



Sources – Thomson Datastream, Markit, GfK/NOP, Capital Economics

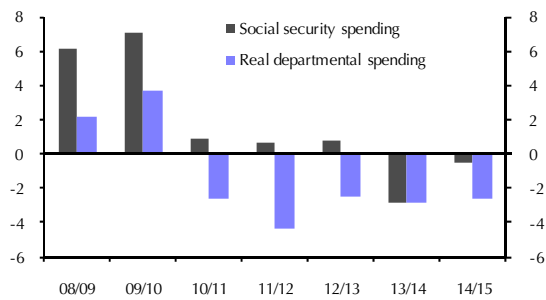
## Analysis: UK Output & Activity (Continued)

### *...and the boost from net trade just won't be big enough*

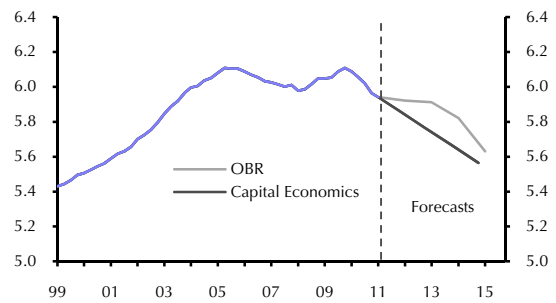
- Meanwhile, the bulk of the fiscal squeeze is yet to come. Admittedly, the tax increases have all now been enacted. And while national insurance contributions rose for many people in April, some people were made better off as a result of the rise in tax allowances.
- But about four fifths of the fiscal consolidation comprises cuts in government spending and these are only just getting going. (See Chart 9.) Public sector employment has already fallen by almost 150,000, but we think that the eventual drop will be more like 500,000. (See Chart 10.) Meanwhile, many of the cuts in benefits only take place in 2012 or 2013.
- Of course, it is possible that the Government eases off on its austerity plans. However, we doubt that a Plan B is imminent. And if it were focused on stimulating investment, it might have little impact on the economy in the near-term anyway. Even a VAT cut - as advocated by the Shadow Chancellor - might not boost consumer spending by much, if the experience of the cut to 15% in late 2008 is anything to go by. (See Chart 11.)
- The onus therefore remains on the corporate and external sectors of the economy to get the recovery going again. Despite the recent falls, we still think that business investment will grow strongly over the next couple of years. After all, it is still a fifth below its pre-recession level. (See Chart 12.) Meanwhile, firms still have a large cash surplus, while profits growth has been picking up too.
- But business investment accounts for less than 10% of GDP, so more important is what happens to net exports. The trade deficit narrowed sharply at the start of the year, but this improvement has now gone into reverse.
- We are still optimistic that the boost from the lower pound is yet to come through fully. And weaker domestic demand should reduce import growth further. But in the near-term, the slowdown in global demand could slow the rebalancing towards the external sector.
- Overall, then, we remain pretty gloomy about the outlook for the next couple of years. Even with a strong net trade contribution, we now think that growth of just 1% this year is more likely than our previous forecast of 1.5%. (See Charts 13 and 14.) Although a renewed recession is not our central forecast, it is certainly a risk.
- We still expect growth of only 1.5% in 2012. And even in 2013, we doubt that the economy will expand by much more than 2% or so. So only by the start of 2014 will GDP have returned to its pre-recession level. (See Chart 15.) We remain gloomier than other forecasters. (See Chart 16.) But the consensus forecasts for growth have been steadily falling.
- A stronger recovery is possible if commodity prices fall very sharply. But there are downside risks to our forecasts too. The risk of a near-term interest rate rise has receded, but not disappeared entirely. Meanwhile, the weak economy is likely to mean that government borrowing falls more slowly than planned – which could prompt the Government to ratchet up its austerity plans even further.

## UK Output & Activity Charts (continued)

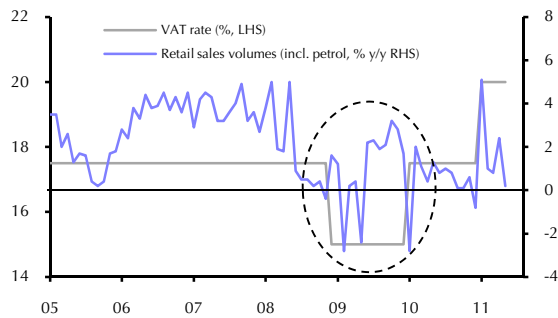
**Chart 9: Real Government Spending (% y/y)**



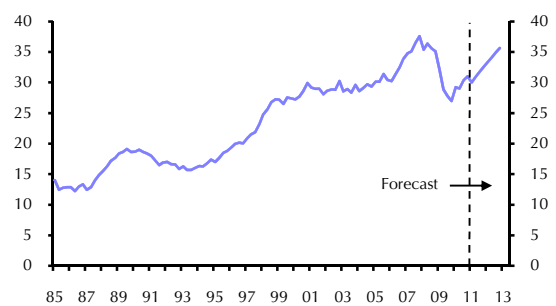
**Chart 10: Public Sector Employment (Millions)**



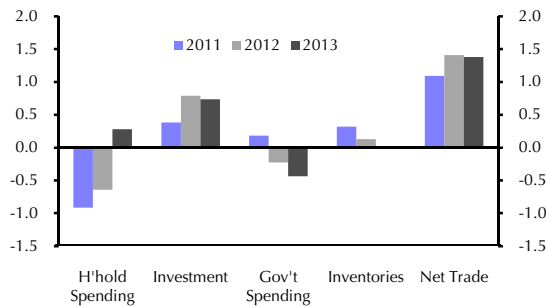
**Chart 11: VAT Rate & Retail Sales Growth**



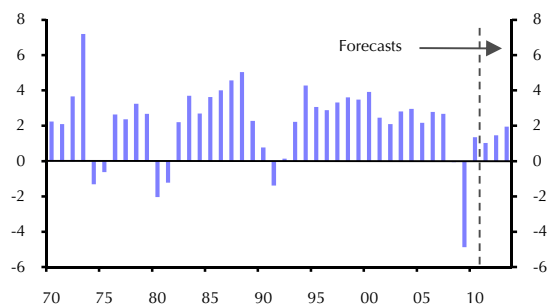
**Chart 12: Real Business Investment (£bn Per Quarter)**



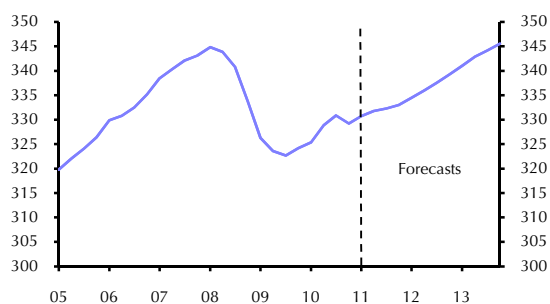
**Chart 13: Contributions to Annual GDP Growth (% Points)**



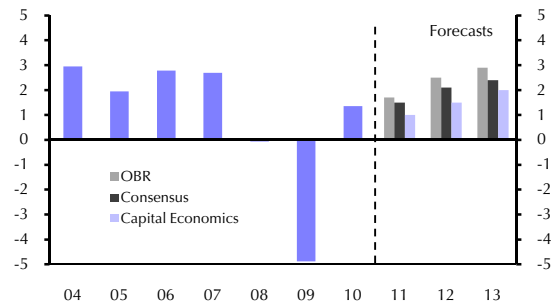
**Chart 14: Real GDP (% y/y)**



**Chart 15: Real GDP (£bn Per Quarter)**



**Chart 16: Real GDP (% y/y)**



Source s– Thomson Datastream, Capital Economics, OBR

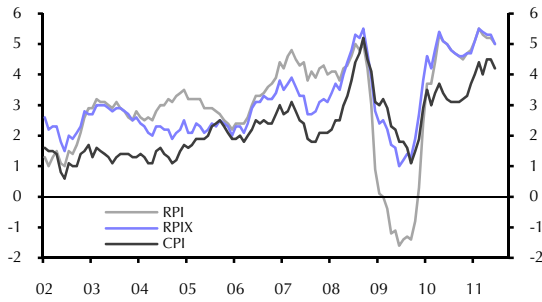
## Analysis: UK Inflation

### *Inflation still climbing*

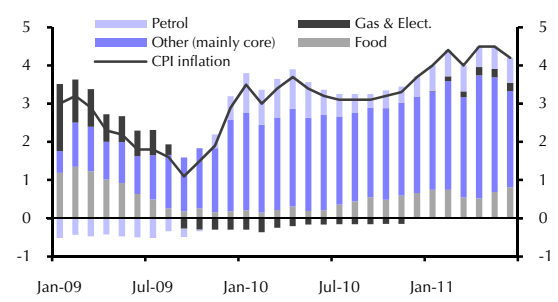
- Food and energy effects will continue to lift UK inflation over the coming months. But there are still few signs of meaningful “second-round” effects which might lead to permanently stronger price pressures in the economy.
- The various measures of consumer price inflation have continued to edge higher over recent months. As Chart 1 shows, some are close to the highs seen back in 2008. Much of the upward pressure has come from the food and energy components. But *core* (ex. food and energy) inflation has also had an upward influence. (See Chart 2.)
- Inflation will no doubt climb even further over the next few months. In particular, the likely continued pass-through of previous rises in agricultural commodity prices means that further sizeable rises in food price inflation are already “baked in the cake”. (See Chart 3.) These alone could add another 1% odd to overall inflation.
- At the same time, while oil prices themselves have fallen back somewhat over the last few months, their effects on inflation will remain positive for some time yet. Admittedly, the inflationary influence of petrol prices may now be close to a peak, provided that oil prices do not rise again. (See Chart 4.)
- But gas prices could continue to rise over the coming months as the previous increases in wholesale prices gradually feed through to household bills. (See Chart 5.)
- The same goes for electricity prices, though the upward pressures are a bit weaker. (See Chart 6.)
- Together, these forces could push headline CPI inflation up to 5.5% or even higher by this Autumn. This could deepen concerns that stronger inflation pressures will become permanently ingrained in the economy.
- However, so far at least, there are few indications that medium-term inflationary pressures are building up to any meaningful extent.
- Admittedly, core inflation has remained higher in the UK than elsewhere, suggesting that underlying domestic price pressures have also been rather more stubborn. (See Chart 7.)
- But at least some of that reflects the upward effects of the various Value Added Tax (VAT) changes seen over the last couple of years. If fully passed through, the increases from the reduced rate of 15% back to 17.5% in January 2010 and the further rise to 20% in January 2011 would have added roughly 1.5% to CPI inflation over the last year or so.
- Accordingly, measures of UK core inflation which also exclude the VAT effect (what we might call “core CPIY”) remain significantly lower, though much depends on what assumptions are made on what portion of the VAT changes was passed on by retailers. (See Chart 8.)

# UK Inflation Charts

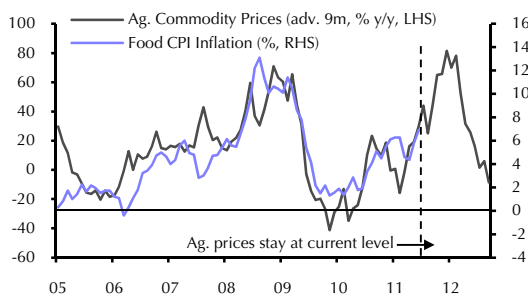
**Chart 1: UK Inflation Measures (%)**



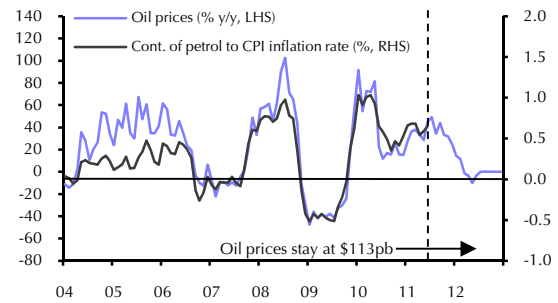
**Chart 2: Contributions to Inflation (% points)**



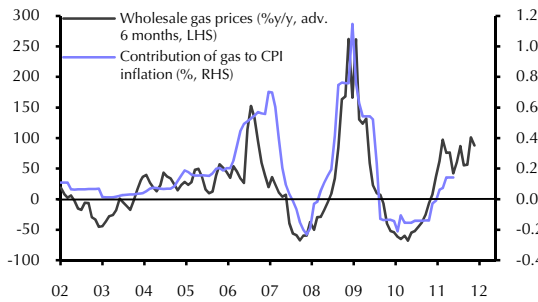
**Chart 3: Food CPI Inflation & Ag. Commodity Prices**



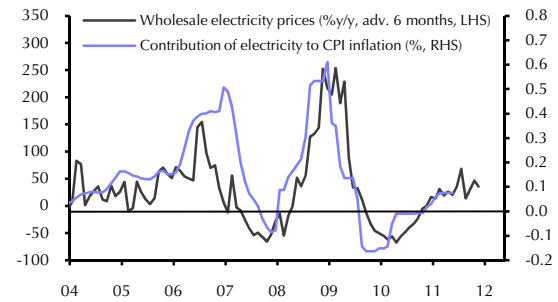
**Chart 4: Oil Prices & Contribution of Petrol Cont. to CPI**



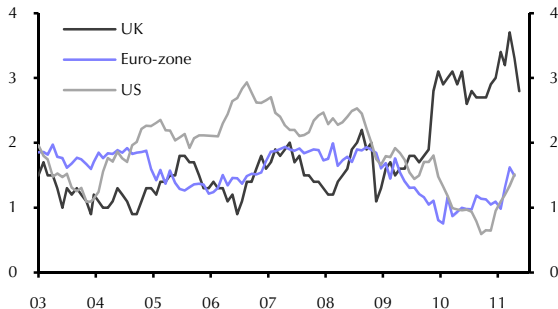
**Chart 5: Wholesale Gas Prices & Gas Cont. to CPI**



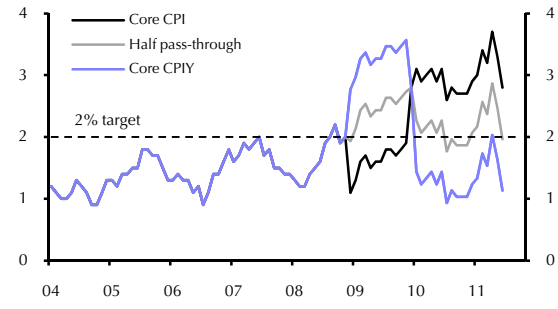
**Chart 6: Wholesale Electricity Prices & Elec. Cont to CPI**



**Chart 7: International Core CPI Inflation (%)**



**Chart 8: Core CPI & Core CPIY Inflation (%)**



Sources – Thomson Datastream, Bloomberg

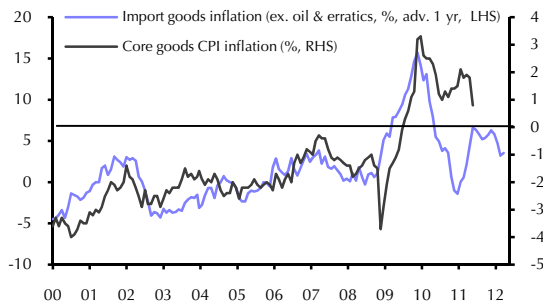
## Analysis: UK Inflation (continued)

### *But medium-term outlook still benign*

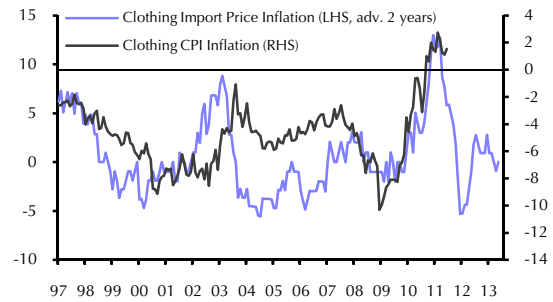
- Another upward influence on core inflation has been the ongoing effects of the drop in the sterling exchange rate seen back in 2008 and the corresponding sharp rise in import prices.
- This effect should soon start to fade, however. As Chart 9 shows, import price inflation has fallen back sharply over the last two years and core goods CPI inflation had started to respond before the process was interrupted by the effects of the VAT hike.
- But this trend may have started to reassert itself in the last few months and could go considerably further. In particular, Chart 10 suggests that clothing inflation could soon plunge back to the deeply negative rates seen for the bulk of the previous two decades as sharply falling imported clothing price inflation feeds through to the high street.
- Admittedly, VAT and exchange rate effects are less plausible explanations for the continued stubbornness of inflation in the services sector. As Chart 11 shows, that has also been much stronger than in other countries.
- This might be an indication that there is less spare capacity in the economy than thought - or that a given amount of spare capacity has a smaller downward influence on inflation. This, in turn, might reflect the fact that the economy's trend rate of output has been damaged during the recession.
- But we continue to find it hard to believe that the aftermath of the deepest recession for decades will have no downward effect on inflation at all. Chart 12 shows that marked variations in spare capacity in previous cycles have had clearly observable effects on core inflation, albeit after some quite long lags.
- Meanwhile, other medium-term influences continue to point to lower inflation ahead. Admittedly, households' inflation expectations have remained at fairly elevated levels. (See Chart 13.)
- But with a large amount of slack in the labour market, this has not translated into any material pick-up in pay settlements and wages growth and does not look likely to. As a result, unit wage costs growth remains subdued, pointing to lower rates of core CPI inflation ahead. (See Chart 14.)
- Meanwhile, the growth of the broad money supply also continues to point to downward, rather than upward, pressure on inflation over the medium term. (See Chart 15.)
- Overall, then, inflation is still a little way off its peak and will remain at uncomfortably high levels for the rest of 2011 and part of 2012. This will maintain the squeeze on households' and companies' spending power and hence depress growth and activity.
- But as temporary upward forces fade and the effects of weak demand and spare capacity take hold, inflation should fall back sharply next year and remain very subdued in 2013. (See Chart 16 and *Forecast Table: Inflation*, page 36.)

## UK Inflation Charts (continued)

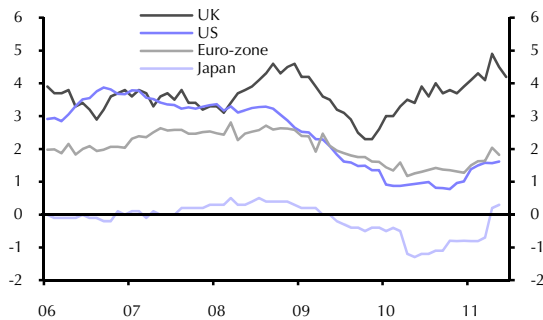
**Chart 9: Import Prices & Core Goods CPI Inflation (%)**



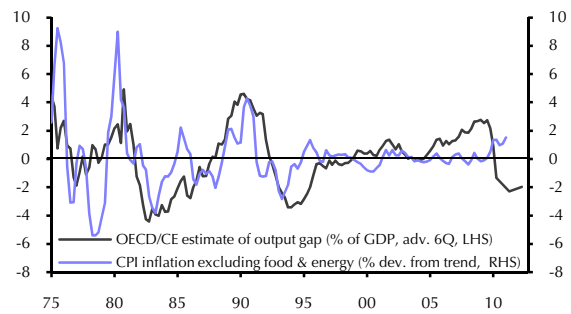
**Chart 10: Clothing Import & CPI Inflation (%)**



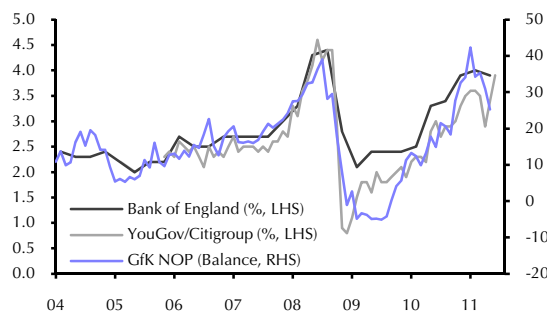
**Chart 11: International Services Inflation (%)**



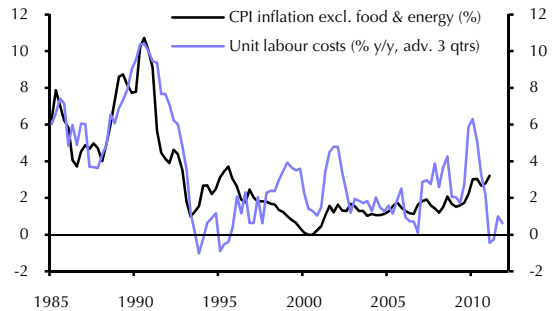
**Chart 12: Core CPI Inflation & Output Gap Estimates**



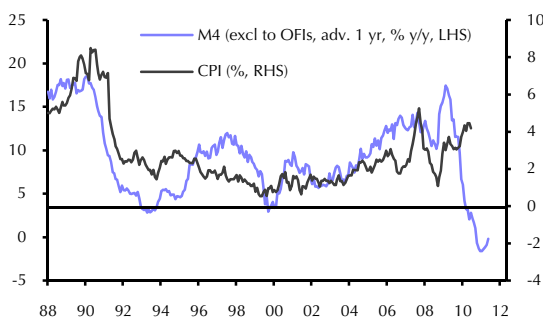
**Chart 13: Households' Inflation Expectations Over Next 12m**



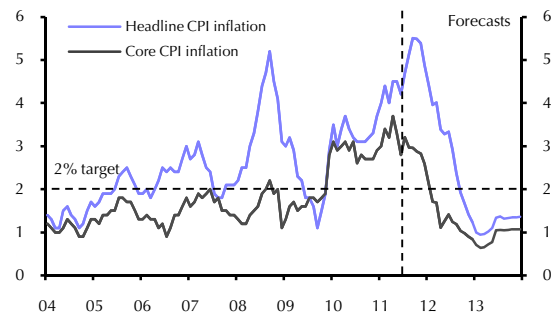
**Chart 14: Core CPI Inflation & Unit Wage Costs**



**Chart 15: Broad Money Growth & CPI Inflation**



**Chart 16: CPI Inflation Forecasts (%)**



Sources – Thomson Datastream, Citigroup/YouGov, OECD, BoE, GfK

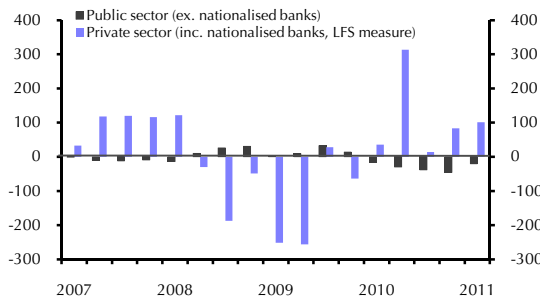
## Analysis: UK Labour Market

### *Squeeze on real pay to get worse*

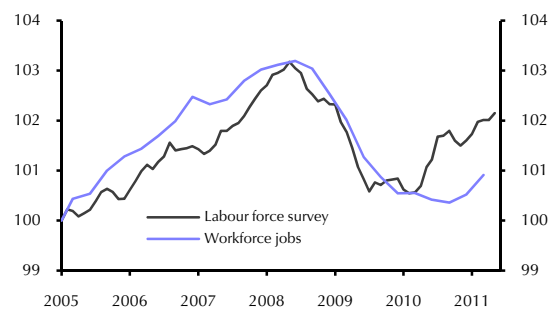
- Employment has been surprisingly robust in the last few months, but we doubt that this can last. Meanwhile, the squeeze on households' real pay looks set to get worse.
- So far, the private sector has created more than enough jobs to offset falling public sector employment. The monthly Labour Force Survey (LFS) measure of employment suggests that three private sector job cuts have been created for every public sector job lost. (See Chart 1.)
- However, other measures of employment have painted a weaker picture. Whereas the LFS measure has risen by 1.5% from its trough, the Workforce Jobs measure has risen by only 0.4%. (See Chart 2.)
- And there are signs that the jobs recovery will not last much longer. Employment intentions have been strengthening in the manufacturing sector, but weakening in the services sector. (See Chart 3.) Meanwhile, the number of job vacancies has fallen and points to renewed drops in employment. (See Chart 4.)
- We expect the private sector to scale back its hiring plans in response to the recent slowdown in the economic recovery. In our view, then, further rises in unemployment still lie ahead. We still think that the ILO measure of unemployment could reach 3 million, although that may not be until 2013. (See *Forecast Table: Labour Market*, page 39.)
- Stronger employment growth has not led to any pick-up in pay growth. Pay settlements rose at the start of the year, but have since levelled off or fallen. (See Chart 5.) Overall average earnings growth has continued to hover at around 2%.
- With inflation now heading to over 5%, workers might start to push more strongly for bigger rises. But we think that there is still enough slack in the labour market to keep a lid on wage demands. For example, the number of people working part-time because they cannot find full-time work is at a record high. (See Chart 6.)
- Moreover, the impact on overall pay growth of any pick-up in earnings growth in the private sector will be tempered by the public sector pay freeze that began in April.
- Accordingly, pay growth is likely to lag well behind inflation and prompt the squeeze on real pay to intensify. We expect average earnings growth of just over 2% this year and about 2.5% next year. Using the RPI measure of inflation, real pay could get down to levels last seen in 2001. (See Chart 7.)
- Admittedly, the slow rate of productivity growth means that weak pay growth has not stopped unit labour costs from picking up. Nonetheless, unit labour costs in Q4 were only 0.7% higher than a year ago. And if employment weakens as we expect, productivity growth should strengthen. (See Chart 8.) Overall, then, the labour market should continue to pose little inflationary threat.

## UK Labour Market Charts

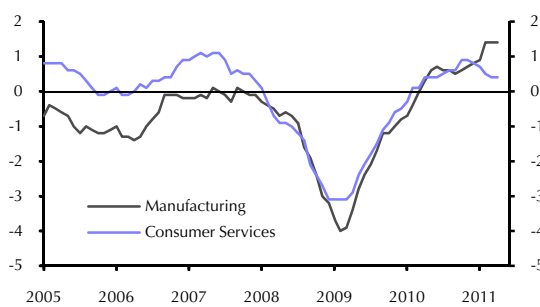
**Chart 1: Employment (000, q/q)**



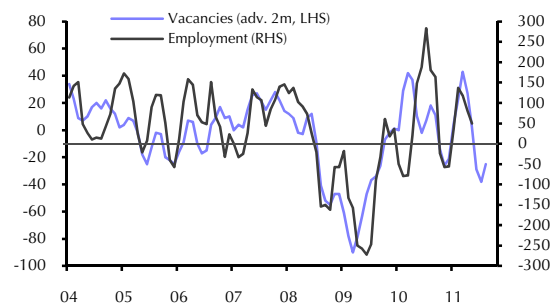
**Chart 2: LFS Employment (Jan. 2005 = 100)**



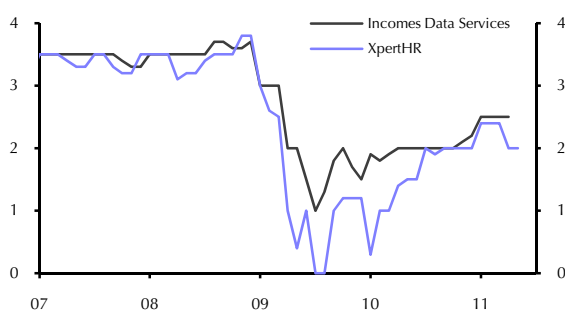
**Chart 3: BoE Agents' Scores of Employment Intentions**



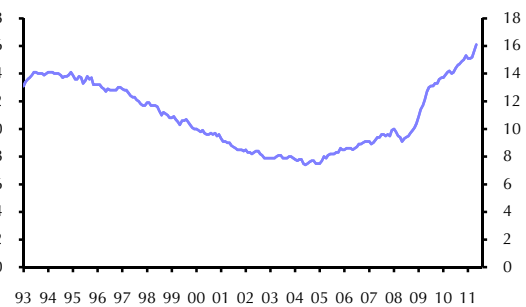
**Chart 4: Employment & Job Vacancies (000s, q/q)**



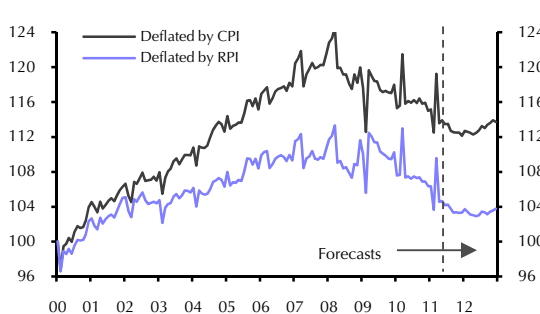
**Chart 5: Median Pay Settlements (%)**



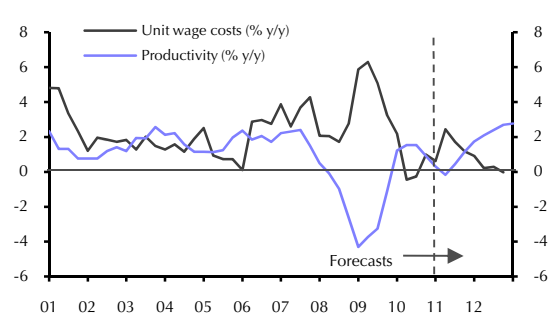
**Chart 6: % of Part-Time Workers Wanting to Work Full-Time**



**Chart 7: Level of Real Pay (Jan. 2000 = 100)**



**Chart 8: Productivity & Unit Labour Costs (% y/y)**



Sources – Thomson Datastream, IDS, XpertHR

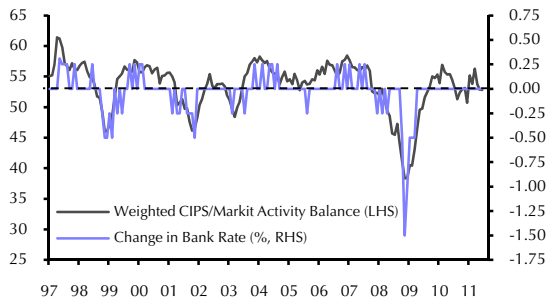
## Analysis: UK Monetary Policy

### *Risk of rate rise has receded*

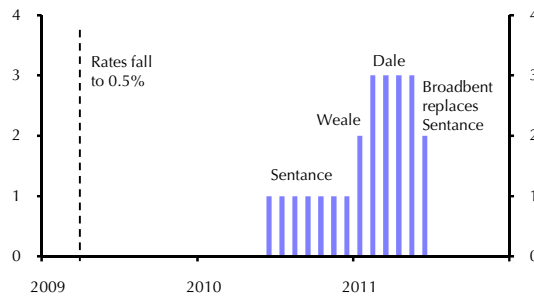
- The risk of a near-term interest rate rise has receded in recent weeks. In fact, discussion of renewed asset purchases has come back onto the agenda. We still doubt that interest rates will rise until 2013 or even 2014 at the earliest.
- The sluggishness of the economic recovery and the continued absence of any second-round effects from the rise in inflation have weakened the case for an interest rate rise. Indeed, the CIPS/Markit surveys have fallen to a level consistent with interest rates staying on hold. (See Chart 1.)
- Two members of the Monetary Policy Committee (MPC) are nonetheless still voting for a 25bps hike. However, Andrew Sentance – who was voting for a 50bps increase – left the Committee in May, and was replaced by Ben Broadbent, who voted for no change at his first meeting. (See Chart 2.)
- The seven voting to leave interest rates on hold appear to fall into two camps; those who are seriously worried about a rise in inflation expectations and those who are not. The latter group have said that more asset purchases might be necessary if the downside risks to inflation materialise.
- A rate rise is still a risk. If wage growth starts to follow inflation up, or if the economy bounces back strongly over the next quarter or two, a policy tightening will come back onto the agenda. But we think it is more likely that the recent soft patch continues, keeping inflation expectations and wage growth subdued.
- We still think that interest rates will remain on hold for the rest of 2011 and all of 2012. It is quite conceivable that interest rates do not rise until 2014. After all, even in 2013, economic growth is unlikely to be strong enough to use up much, if any, of the spare capacity in the economy. Interest rates were kept on hold at just 2% for almost 20 years in the 1930s and 1940s. (See Chart 3.)
- Indeed, markets have scaled back their interest rate expectations considerably in the past few months. In February, markets were expecting rates to have increased already. (See Chart 4.) But now they do not expect the first rate rise to come until next summer and anticipate less than 25bps of tightening over the next 12 months. (See Chart 5.)
- Admittedly, most MPC members seem to think that the outlook would have to deteriorate sharply to justify restarting the asset purchase programme. But this is quite possible. Our GDP forecasts remain much lower than the MPC's. (See Chart 6.) And although it is questionable how much good further QE2 would do, it might at least boost confidence by showing that the MPC is "doing something." QE1 also appeared to push gilt yields closer to riskless interest rates. (See Chart 7.)
- Gilt yields have fallen sharply along with rate expectations and renewed concerns about the euro-zone. But there is still scope for expectations for inflation and interest rates to fall further. Accordingly, we still think that ten year yields could fall below 3%. (See Chart 8 and *Forecast Table: Monetary*, page 40.)

# UK Monetary Policy Charts

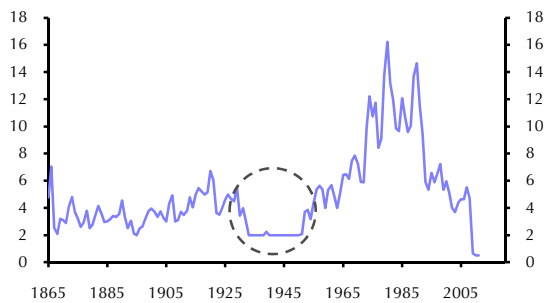
**Chart 1: CIPS/Markit Surveys & Official Interest Rates**



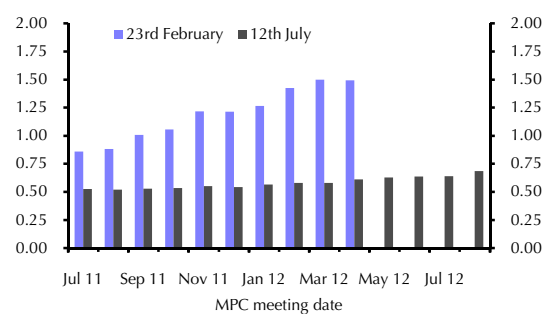
**Chart 2: No. Of MPC Members Voting For a Hike**



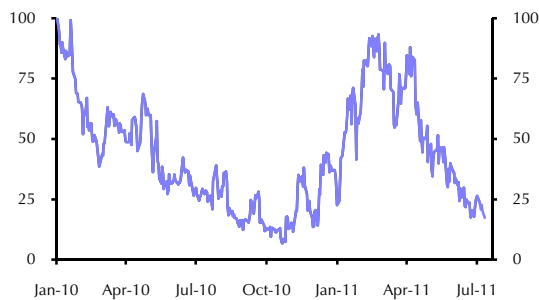
**Chart 3: Official Interest Rates (%)**



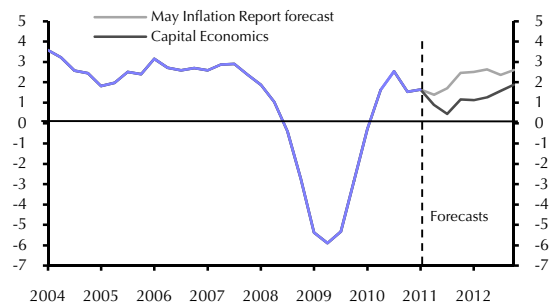
**Chart 4: Implied Overnight Interest Rates (%)**



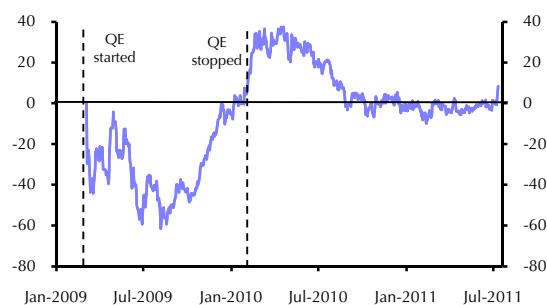
**Chart 5: Expectations for Change in UK Overnight Interest Rates Over Next 12 Months Derived From OIS Rates (bps)**



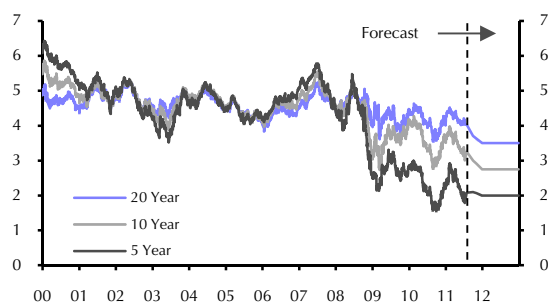
**Chart 6: Real GDP (% y/y)**



**Chart 7: Change In Spread Between 10 Year Gilt Yield & OIS Rate Since Start of QE (bps)**



**Chart 8: Bond Yields (%)**



Sources – Thomson Datastream/Bloomberg/Bank of England/Markit

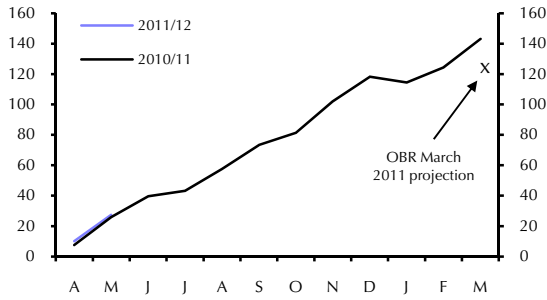
## Analysis: UK Public Finances

### *Cracks appearing in Plan A?*

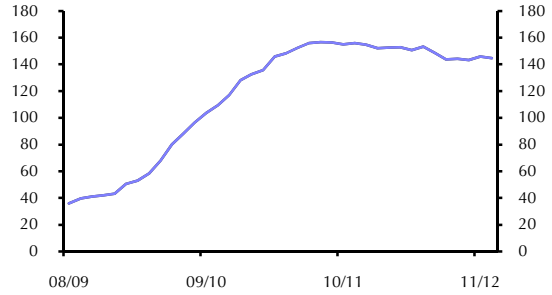
- The weakness of the economy is threatening to put cracks in the Government's plans to restore the public finances to health.
- The news on the public finances has deteriorated in recent months. As Chart 1 shows, public borrowing has made little downward progress so far this fiscal year. On a 12 month rolling basis, it also seems to have stopped falling. (See Chart 2.)
- The deterioration appears to have reflected a slowdown in the growth of tax receipts in response to the recent sluggishness of growth in the broader economy. As Chart 3 shows, receipts growth has weakened in line with short-term activity indicators such as the composite CIPS index.
- What's more, while the latter suggests that receipts growth may temporarily pick up again over the next few months, it looks likely to remain below the Office for Budget Responsibility's (OBR's) full-year forecast of 7.3% growth in the near future.
- More generally, the Government's fiscal plans continue to rely heavily on a strong expansion in the economy over the next few years. Although the OBR nudged down its forecast for GDP growth in 2011 from 2.1% to 1.7%, it expects above-consensus growth of 2.5% in 2012 and 2.9% in 2013. (See Chart 4.) Needless to say, weaker growth would see tax revenues continuing to undershoot.
- The better news from a fiscal perspective is that the Government appears to have succeeded in bringing public spending under control. As Chart 5 shows, the growth of central government public spending has slowed sharply over the last year and has recently been below the OBR's Budget forecast for 2011/12 as a whole.
- But there are still doubts over whether the spending plans can actually be met. As Chart 6 shows, they involve the biggest squeeze on real current spending since at least the late 1950s and probably well before. Some slippage on these plans is seems likely.
- All of this suggests that the public finances will show less improvement over the next few years than the Government hopes. As Chart 7 shows, on the basis of our economic forecasts, public borrowing may fall at around only half the pace predicted by the OBR. But if growth is even weaker, borrowing may not fall at all.
- Against this background, calls for the Government to switch to a "Plan B" involving a slower pace of fiscal consolidation may grow louder. But political and ideological factors suggest that it won't scale back the tightening significantly unless the economy is very weak indeed or already in recession.
- High borrowing levels and heavy bond redemptions will keep gilt issuance elevated over the next few years. (See Chart 8.) But with short-term interest rates remaining low and gilts maintaining some safe-haven status, the Government's borrowing costs should remain low. (See *Forecast Table: Public Finances*, page 41.)

# UK Public Finances Charts

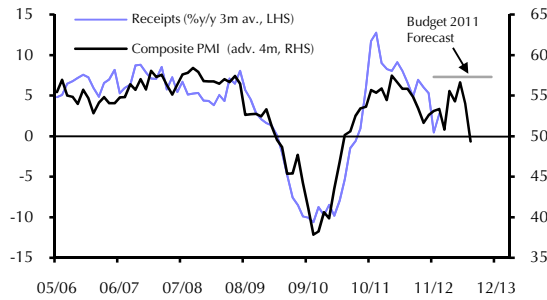
**Chart 1: Public Sector Net Borrowing (£bn, cum.)**



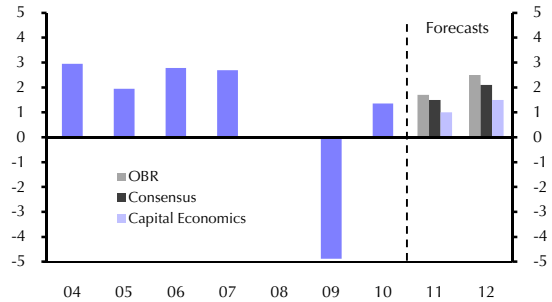
**Chart 2: Public Sector Net Borrowing (£bn, 12m rolling total)**



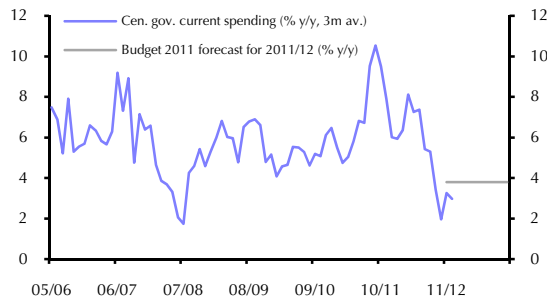
**Chart 3: Central Govt. Tax Receipts & PMI**



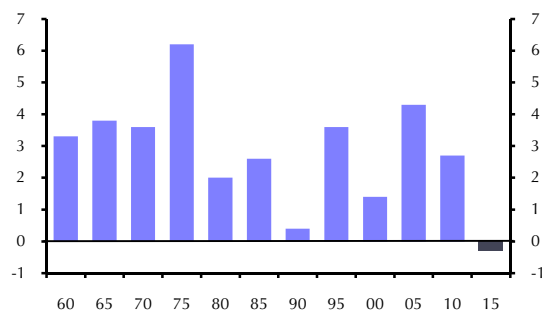
**Chart 4: Real GDP Growth Forecasts (%y/y)**



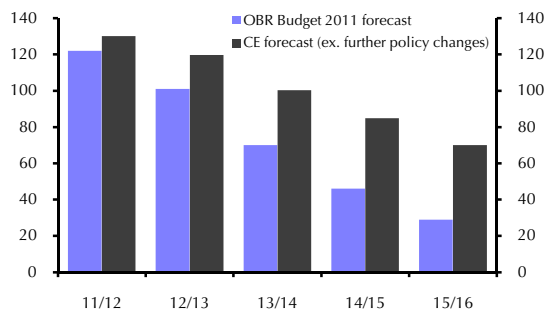
**Chart 5: Central Govt. Current Spending (% y/y)**



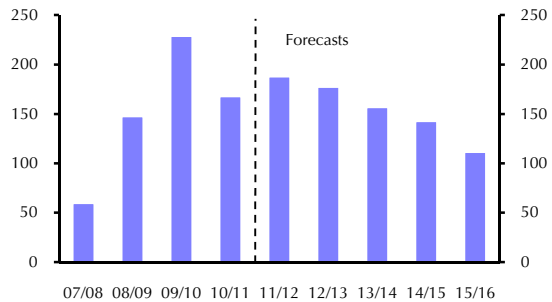
**Chart 6: Real Current Public Spending (% y/y, 5yr av.)**



**Chart 7: PSNB Forecasts (£bn)**



**Chart 8: Gross Gilt Issuance (£bn)**



Sources – Thomson Datastream, HMT/OBR

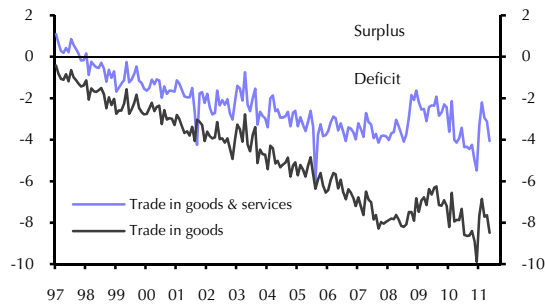
## Analysis: UK External Sector

### *Euro-zone crisis clouds export outlook*

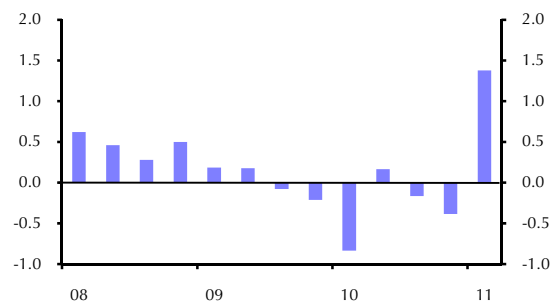
- The improvement in the trade position seen at the start of the year already seems to be going into reverse. Meanwhile, the crisis in the euro-zone threatens the export outlook and could slow the pace of rebalancing in the economy.
- The trade deficit narrowed sharply in the first quarter, from £15.1bn to £8.3bn. (See Chart 1.) As a result, net trade provided a huge 1.4% contribution to quarterly GDP growth in Q1. (See Chart 2.)
- However, this improvement was due in part to changes to the tax regime for aircraft. This led to volatility in aircraft imports around the turn of the year, exaggerating both the rise in imports in Q4 and the subsequent fall in Q1. (See Chart 3.) What's more, the trade deficit has recently deteriorated again.
- The underlying trend in import growth nonetheless appears to have slowed. And we expect it to cool further in response to the weakness of domestic demand that we expect.
- Unfortunately, exports also appear to have flattened off a bit. (See Chart 4.) This seems partly to reflect the recent falls in survey measures of export orders. (See Chart 5.)
- We are still optimistic that the lower pound will provide some support for exports over the coming year or two. Admittedly, the pound might rise a bit against the euro as growth in the euro-zone deteriorates. But the single currency has remained surprisingly resilient given the doubts about its future. So we find it hard to see the pound rising much above €1.20 or so. And we expect it to depreciate a touch against the dollar.
- However, the recent falls in business investment suggest that firms are being slow to build up the capacity required to exploit the rise in their competitiveness.
- Meanwhile, the euro-zone crisis continues to cast a cloud over the export outlook. Exports to countries such as Greece have already plummeted. But Greece accounts for less than 1% of UK exports. (See Chart 6.) The bigger risk is that of a potential European banking crisis, which affects those European economies which take a bigger share of the UK's exports.
- Given all this, we think that the trade deficit will continue to narrow, but at a much slower rate than that seen at the start of the year. Nonetheless, much of the deficit could be eradicated by the end of 2013. (See *Forecast Table: External Sector*, page 42.)
- Investment income is the other major component of the overall current account. The earnings of UK companies on overseas investments have been boosted by the recovery in banks' profits. But overseas earnings on banking subsidiaries in the UK have risen too. We assume that the surplus stays close to recent levels. (See Chart 7.)
- The narrowing in the trade deficit should allow the overall current account to narrow further. By 2013, we expect it to have shrunk to about £15bn, a relatively small 1% or so of GDP. (See Chart 8.)

# UK External Sector Charts

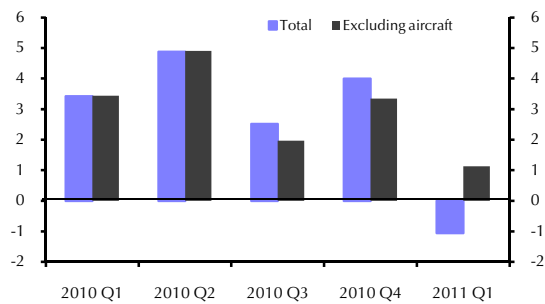
**Chart 1: Trade Balances (£bn)**



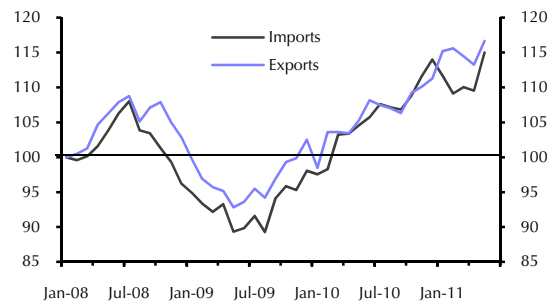
**Chart 2: Net Trade Contrib. to Quarterly GDP Growth (%)**



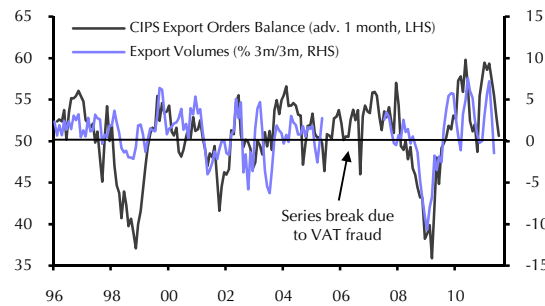
**Chart 3: Import Values (% q/q)**



**Chart 4: Imports & Exports (of Goods & Services) (Jan. 2007 = 100)**



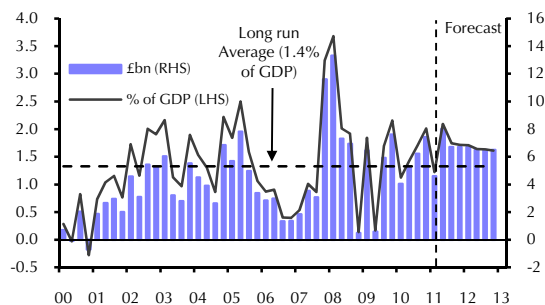
**Chart 5: Exports & Export Orders**



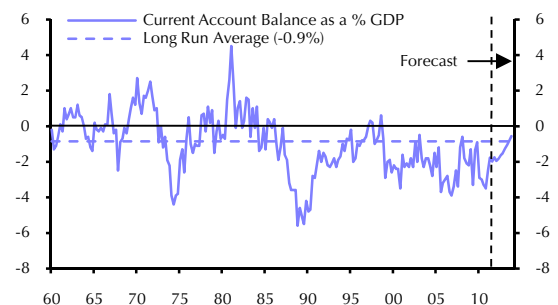
**Chart 6: Export Values in May 2011 (3m av. of % y/y)**



**Chart 7: Investment Income Balance**



**Chart 8: Current Account Balance**



Sources – Thomson Datastream, Capital Economics

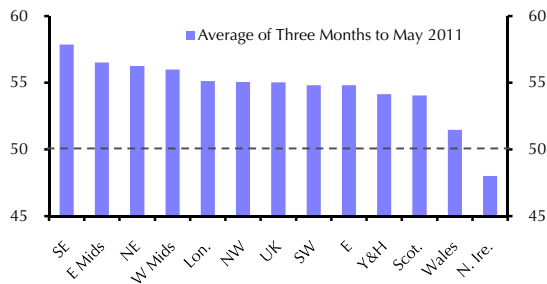
## Analysis: UK Regions

### *Growth in the North failing to bring unemployment down*

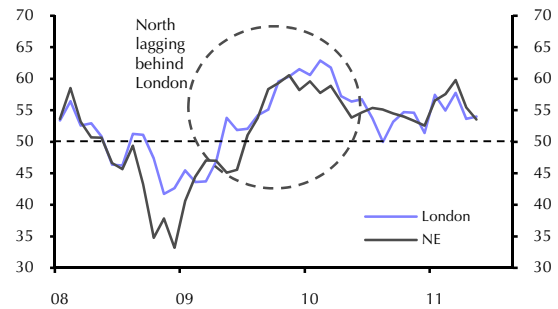
- The latest news on activity suggests that the recovery in the North is no longer lagging behind the pace set in the South. However, there has yet to be a meaningful improvement in the labour or housing markets in the North.
- The regional PMIs have been above the 50 expansion/contraction mark in all regions except Northern Ireland in the last few months. Wales has been lagging behind, while the South East has been growing at the fastest pace. (See Chart 1.)
- In the early stages of the recovery, London was outpacing the Northern regions. However, that gap now appears to have closed. (See Chart 2.)
- This could be a sign that the lower pound is starting to boost the regions most dependent on manufacturing. Note that regions where the activity PMI is significantly above its long-run average are generally those where manufacturing accounts for a larger share of GDP. (See Chart 3.)
- London somewhat surprisingly saw the biggest public sector job cuts in Q1, with public sector employment falling by 10,000. (See Chart 4.) Scotland and Northern Ireland escaped falls, even though public sector jobs growth has been particularly fast in those regions in recent years.
- Indeed, overall employment growth in these regions has recently been very strong. Employment has also grown rapidly in the East, London and East Midlands. However, employment has fallen over the last year in some parts of the North. (See Chart 5.)
- Accordingly, whereas the unemployment rate has fallen in regions such as Northern Ireland since the start of the year, it has picked up a bit in regions like the North West. (See Chart 6.)
- Meanwhile, all the main measures of house prices show that London's housing market is continuing to outperform the rest of the country. (See Chart 7.)
- According to Land Registry figures, house prices in London are just 0.1% below their 2007 peak. By contrast, prices in the North East and Yorkshire & Humber are still below the troughs reached in 2009.
- House prices in the capital have been boosted by overseas demand. But the strength of job creation in London has also no doubt helped. (See Chart 8.) So if unemployment rises across the country, as we expect, London will not be immune to further house price falls.
- Indeed, with the recent tax rises and benefit changes hitting London disproportionately hard, we doubt that GDP growth in London and the South will outpace the rest of the country to as big an extent as in recent years. No region will escape the effects of the fiscal squeeze over the next couple of years. (See *Main Article*, pages 2-11 and *Forecast Table: Regions*, page 43.)

# UK Regions Charts

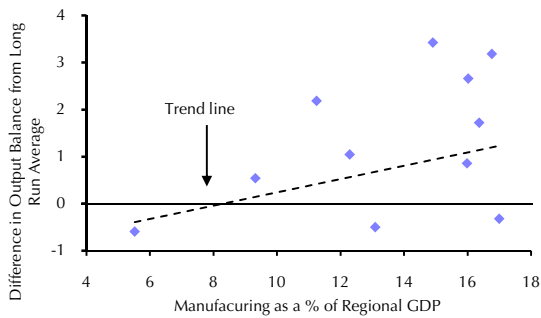
**Chart 1: Regional Output Balances**



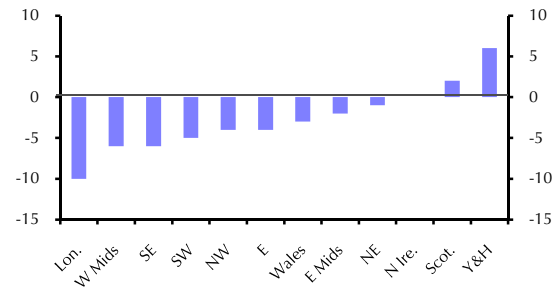
**Chart 2: Output Balances in London & NE**



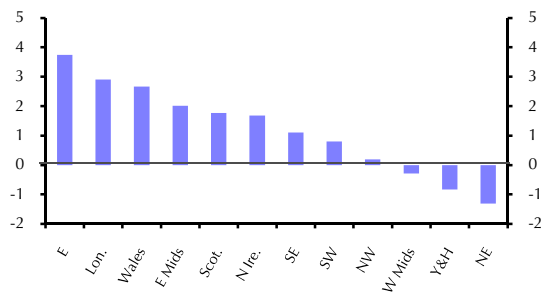
**Chart 3: Manufacturing Share of Regional GDP & Regional Output Balances**



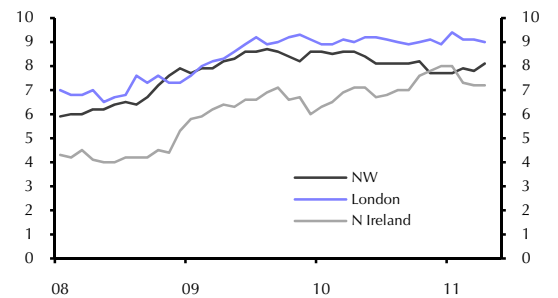
**Chart 4: Change in Public Sector Employment in Q1 (000s)**



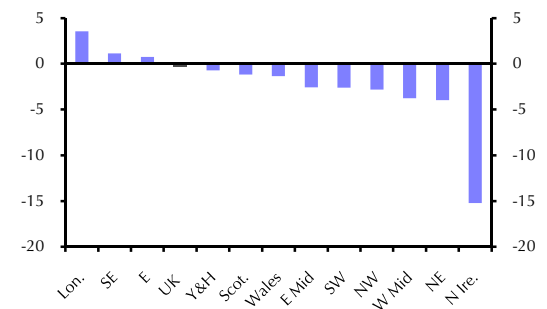
**Chart 5: Employment in April 2011 (% y/y)**



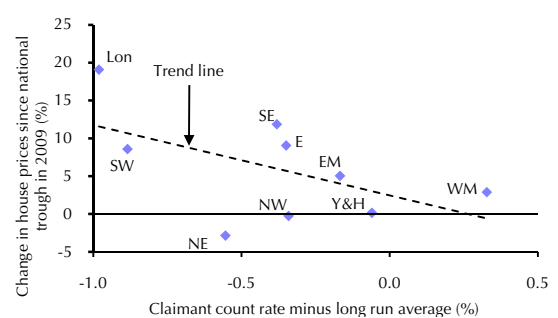
**Chart 6: Unemployment Rates (%)**



**Chart 7: Annual Rate of House Price Inflation in April (% CLG measure)**



**Chart 8: House Prices & Claimant Count Unemployment (%)**



Sources – Thomson Datastream, Markit, Land Registry, CE, CLG

## Forecast Table: UK Inflation

	Monthly Effect on Index							Level of the CPI Index	Annual Rate			
	s.a. Core	Rent	Other Items			Seas Eff.	Total Change		All CPI	CPI Core <sup>1</sup>	RPI	RPIX
			Alc. & Tobac.	Energy	Food							
<b>2011</b>												
Jan	0.5	0.0	0.2	0.3	0.0	-0.8	0.1	116.9	4.0	3.0	5.1	5.1
Feb	0.4	0.0	0.0	0.1	0.1	0.2	0.8	117.8	4.4	3.4	5.5	5.5
Mar	-0.2	0.0	0.1	0.2	-0.2	0.2	0.3	118.1	4.0	3.2	5.3	5.4
Apr	0.3	0.1	0.2	0.1	0.0	0.4	1.0	119.3	4.5	3.7	5.2	5.3
May	-0.2	0.0	0.1	0.1	0.2	0.0	0.2	119.5	4.5	3.3	5.2	5.3
Jun	-0.6	0.0	0.0	0.0	0.1	0.2	-0.1	119.4	4.2	2.8	5.0	5.0
Jul	0.2	0.0	0.0	0.1	0.2	-0.2	0.2	119.7	4.7	3.2	5.4	5.4
Aug	0.2	0.0	0.0	0.3	0.2	0.3	0.9	120.8	5.1	3.0	5.7	5.7
Sep	0.2	0.0	0.0	0.1	0.2	-0.1	0.4	121.2	5.5	3.0	6.0	6.0
Oct	0.1	0.0	0.0	0.0	0.2	-0.1	0.3	121.5	5.5	2.9	6.0	6.0
Nov	0.1	0.0	0.0	0.0	0.2	0.0	0.2	121.8	5.4	2.8	5.8	5.8
Dec	0.1	0.0	0.0	0.0	0.1	0.4	0.5	122.5	4.9	2.6	5.3	5.3
<b>2012</b>												
Jan	0.1	0.0	0.1	0.1	0.1	-0.8	-0.4	122.1	4.4	2.1	4.7	4.8
Feb	0.1	0.0	0.0	0.0	0.0	0.2	0.3	122.5	4.0	1.7	4.3	4.3
Mar	0.0	0.0	0.0	0.0	0.0	0.2	0.3	122.8	4.0	1.7	4.3	4.3
Apr	0.0	0.1	0.1	0.0	0.0	0.2	0.4	123.3	3.4	1.1	3.7	3.8
May	-0.1	0.0	0.0	0.0	0.0	0.1	0.1	123.4	3.3	1.3	3.7	3.8
Jun	-0.3	0.0	0.0	0.0	0.0	0.1	0.0	123.4	3.3	1.4	3.8	3.9
Jul	0.0	0.0	0.0	0.0	0.0	-0.2	-0.2	123.2	2.9	1.2	3.5	3.6
Aug	0.0	0.0	0.0	0.1	0.0	0.3	0.4	123.7	2.4	1.2	3.0	3.1
Sep	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	123.6	1.9	1.0	2.9	2.9
Oct	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	123.6	1.7	1.0	2.6	2.7
Nov	0.0	0.0	0.0	0.0	0.0	0.0	0.0	123.5	1.4	0.9	2.4	2.5
Dec	0.0	0.0	0.0	0.0	0.0	0.4	0.4	124.0	1.2	0.8	2.2	2.3
<b>2013</b>												
Jan	0.0	0.0	0.1	0.0	0.0	-0.8	-0.6	123.3	1.0	0.7	2.0	2.1
Feb	0.0	0.0	0.0	0.0	0.0	0.2	0.3	123.6	0.9	0.6	2.0	2.1
Mar	0.0	0.0	0.0	0.0	0.0	0.3	0.3	124.0	1.0	0.7	2.0	2.1
Apr	0.0	0.1	0.1	0.0	0.0	0.2	0.5	124.6	1.0	0.7	2.0	2.1
May	0.0	0.0	0.0	0.0	0.0	0.1	0.1	124.8	1.1	0.8	2.1	2.2
Jun	0.0	0.0	0.0	0.0	0.0	0.2	0.2	125.0	1.3	1.1	2.3	2.4
Jul	0.0	0.0	0.0	0.0	0.0	-0.2	-0.1	124.8	1.4	1.1	2.3	2.4
Aug	0.0	0.0	0.0	0.0	0.0	0.3	0.4	125.3	1.3	1.1	2.3	2.4
Sep	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	125.2	1.3	1.1	2.3	2.4
Oct	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	125.2	1.3	1.1	2.3	2.4
Nov	0.0	0.0	0.0	0.0	0.0	0.0	0.0	125.2	1.3	1.1	2.3	2.4
Dec	0.0	0.0	0.0	0.0	0.0	0.4	0.4	125.7	1.4	1.1	2.3	2.4

<sup>1</sup> Excludes energy, food, alcohol & tobacco.

## Forecast Table: UK Labour Market

Activity								
	Workforce		ILO/Labour Force Survey Employment		ILO Unemployment		Claimant Count Unemployment	
	Millions	%y/y	Millions	%y/y	Millions	%	Millions	%
<b>2010</b>	31.5	0.4	29.0	0.1	2.5	7.9	1.5	4.8
<b>2011f</b>	31.7	0.9	29.2	0.9	2.5	8.0	1.5	4.7
<b>2012f</b>	31.7	0.0	29.0	-0.7	2.7	8.7	1.7	5.2
<b>2013f</b>	31.7	0.0	28.8	-0.6	2.9	9.3	1.8	5.7
<b>Q1 2011</b>	31.7	0.3	29.2	1.3	2.5	7.8	1.5	4.6
<b>Q2</b>	31.7	0.0	29.3	1.1	2.5	7.7	1.4	4.5
<b>Q3</b>	31.7	0.0	29.2	0.0	2.5	8.0	1.5	4.7
<b>Q4</b>	31.7	0.0	29.1	0.0	2.6	8.2	1.5	4.9
<b>Q1 2012</b>	31.7	0.0	29.1	-0.6	2.7	8.4	1.6	5.0
<b>Q2</b>	31.7	0.0	29.0	-0.8	2.7	8.6	1.6	5.1
<b>Q3</b>	31.7	0.0	28.9	-0.8	2.8	8.8	1.7	5.3
<b>Q4</b>	31.7	0.0	28.9	-0.8	2.8	8.9	1.7	5.4
<b>Q1 2013</b>	31.7	0.0	28.8	-0.8	2.9	9.1	1.8	5.6
<b>Q2</b>	31.7	0.0	28.8	-0.7	2.9	9.2	1.8	5.6
<b>Q3</b>	31.7	0.0	28.8	-0.6	3.0	9.3	1.8	5.7
<b>Q4</b>	31.7	0.0	28.7	-0.5	3.0	9.4	1.8	5.8
Earnings & Costs								
	Average Earnings		Real Av. Earnings (Incl. Bonuses, %y/y)		Productivity %y/y	Unit Labour Costs %y/y		
	Incl. Bonuses % y/y	Excl. Bonuses % y/y	Deflated by RPI Inflation	Deflated by CPI inflation				
<b>2010</b>	2.3	1.9	-2.4	-1.0	1.3	0.6		
<b>2011f</b>	2.3	2.0	-3.3	-2.5	0.6	1.2		
<b>2012f</b>	2.6	2.2	-0.6	-0.1	2.3	0.3		
<b>2013f</b>	2.8	2.5	0.7	1.7	2.6	0.2		
<b>Q1 2011</b>	2.5	2.1	-2.8	-1.7	0.3	0.6		
<b>Q2</b>	2.3	2.2	-3.2	-2.3	-0.2	2.4		
<b>Q3</b>	2.2	1.8	-3.9	-3.2	0.4	1.7		
<b>Q4</b>	2.3	2.0	-3.3	-2.9	1.2	1.2		
<b>Q1 2012</b>	2.7	1.8	-1.5	-1.3	1.7	0.9		
<b>Q2</b>	2.3	2.2	-1.1	-0.8	2.1	0.2		
<b>Q3</b>	2.7	2.3	-0.2	0.5	2.4	0.3		
<b>Q4</b>	2.7	2.3	0.3	1.3	2.7	0.0		
<b>Q1 2013</b>	2.8	2.4	0.8	1.9	2.8	0.0		
<b>Q2</b>	2.8	2.4	0.7	1.7	2.8	0.0		
<b>Q3</b>	2.8	2.4	0.5	1.5	2.6	0.2		
<b>Q4</b>	3.0	2.6	0.7	1.7	2.4	0.6		

## Forecast Table: UK Monetary

Interest Rates & Bond Yields (end period)							
	Repo Rate	10-Year Gilts	20-Year Gilts	US Fed Funds Rate		Euro-zone Refi Rate	
	%	%	%	%	UK-US	%	UK-Euro-zone
<b>2010</b>	0.50	3.51	4.01	0.25	0.25	1.00	-0.50
<b>2011f</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>2012f</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>2013f</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q1 2011</b>	0.50	3.69	4.31	0.25	0.25	1.00	-0.50
<b>Q2</b>	0.50	3.38	4.19	0.25	0.25	1.25	-0.75
<b>Q3</b>	0.50	3.00	3.70	0.25	0.25	1.50	-1.00
<b>Q4</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q1 2012</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q2</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q3</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q4</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q1 2013</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q2</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q3</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00
<b>Q4</b>	0.50	2.75	3.50	0.25	0.25	1.50	-1.00

Sterling Exchange Rates (end period)					
Sterling versus...	\$	¥	Euro	Euro <sup>1</sup>	ERI <sup>2</sup>
<b>2010</b>	1.56	126	0.86	1.17	79.8
<b>2011</b>	1.60	136	0.88	1.14	79.3
<b>2012f</b>	1.55	140	0.84	1.19	80.6
<b>2013f</b>	1.50	143	0.80	1.25	82.3
<b>Q1 2011</b>	1.60	134	0.89	1.13	79.0
<b>Q2</b>	1.60	130	0.90	1.11	77.8
<b>Q3</b>	1.60	136	0.88	1.14	79.3
<b>Q4</b>	1.60	136	0.88	1.14	79.3
<b>Q1 2012</b>	1.60	136	0.88	1.14	79.3
<b>Q2</b>	1.55	140	0.84	1.19	80.6
<b>Q3</b>	1.55	140	0.84	1.19	80.6
<b>Q4</b>	1.55	140	0.84	1.19	80.6
<b>Q1 2013</b>	1.50	143	0.80	1.25	82.3
<b>Q2</b>	1.50	143	0.80	1.25	82.3
<b>Q3</b>	1.50	143	0.80	1.25	82.3
<b>Q4</b>	1.50	143	0.80	1.25	82.3

<sup>1</sup> Pound per euro <sup>2</sup> Effective exchange rate index.

## Forecast Table: UK Public Finances<sup>1</sup>

Government Spending & Receipts (£bn)							
	(1) Current Receipts (excluding tax changes)	(2) Revenue effect of tax changes	(3) Current Receipts (including tax changes)	(4) Current Spending <sup>2</sup>	(5) Current balance	(6) Net Investment	(7) = (4) + (6) Total Expenditure
<b>Recent History</b>							
07-08	549	n/a	549	555	-6	29	584
08-09	533	n/a	533	583	-50	37	620
09-10	513	n/a	513	620	-107	50	670
10-11	549	n/a	549	653	-105	41	694
<b>OBR Forecast</b>							
11-12	589	n/a	589	679	-90	32	710
12-13	620	n/a	620	693	-73	28	720
13-14	660	n/a	660	706	-46	24	730
14-15	698	n/a	698	720	-22	24	744
15-16	735	n/a	735	739	-5	25	764
<b>Capital Economics Forecast</b>							
11-12	584	0	584	678	-94	36	714
12-13	603	5	608	694	-85	30	724
13-14	632	10	642	711	-70	25	736
14-15	662	15	677	728	-51	23	751
15-16	697	20	717	750	-33	22	772
Government Borrowing & Debt							
	PSNB £bn	% GDP	Public Sector Net Cash Requirement (PSNCR) £bn	General Government Gross Debt % GDP <sup>3</sup>	Public Sector Net Debt % GDP	Gross gilt sales £bn	
<b>Recent History</b>							
07-08	31.8	2.4	35.1	43.3	36.0	58.5	
08-09	35.6	2.5	21.5	43.2	36.5	146.5	
09-10	86.7	6.1	59.6	55.8	44.0	227.6	
10-11	146	9.9	145	78.7	60.3	166.4	
<b>OBR Forecast</b>							
11-12	122	7.9	129	84.1	66.1	168	
12-13	101	6.2	109	87.0	69.7	164	
13-14	70	4.1	83	87.2	70.9	133	
14-15	46	2.5	52	85.7	70.5	112	
15-16	29	1.5	32	83.5	69.1	85	
<b>Capital Economics Forecast</b>							
11-12	130	8.5	138	86.1	68.1	187	
12-13	115	7.3	123	90.7	73.4	176	
13-14	95	5.7	108	93.0	76.7	155	
14-15	75	4.3	81	92.6	77.4	142	
15-16	55	3.0	57	90.7	76.3	110	

<sup>1</sup> Some figures in this table may not add due to rounding. <sup>2</sup> Includes depreciation. <sup>3</sup> Maastricht definition.

## Forecast Table: UK External Sector

Current Account										
	Goods		Services		Investment Income		Current Transfers		Current Account	
	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP
<b>2010</b>	-98.8	-6.8	55.9	3.4	22.9	1.6	-19.8	-1.4	-46.3	-3.3
<b>2011f</b>	-95.1	-6.2	56.6	3.7	26.0	1.7	-17.5	-1.1	-30.0	-2.0
<b>2012f</b>	-93.7	-5.9	59.1	3.7	26.2	1.6	-18.6	-1.2	-27.0	-1.7
<b>2013f</b>	-87.0	-5.4	65.5	4.0	26.6	1.6	-20.0	-1.2	-15.0	-0.9
<b>Q1 2011</b>	-22.2	-5.9	13.9	3.7	4.6	1.2	-5.5	-1.5	-9.2	-2.5
<b>Q2</b>	-24.2	-6.3	13.5	3.5	8.0	2.1	-4.0	-1.0	-6.7	-1.7
<b>Q3</b>	-24.5	-6.4	14.3	3.7	6.7	1.7	-4.0	-1.0	-7.4	-1.9
<b>Q4</b>	-24.2	-6.2	14.9	3.8	6.7	1.7	-4.0	-1.0	-6.7	-1.7
<b>Q1 2012</b>	-23.9	-6.1	14.2	3.6	6.7	1.7	-4.5	-1.2	-7.6	-1.9
<b>Q2</b>	-23.6	-6.0	14.6	3.7	6.5	1.6	-4.5	-1.1	-7.1	-1.8
<b>Q3</b>	-23.3	-5.9	15.0	3.8	6.5	1.6	-4.5	-1.1	-6.3	-1.6
<b>Q4</b>	-22.9	-5.7	15.4	3.8	6.5	1.6	-5.0	-1.2	-6.1	-1.5
<b>Q1 2013</b>	-22.5	-5.6	15.8	3.9	6.6	1.7	-5.0	-1.3	-5.1	-1.3
<b>Q2</b>	-22.0	-5.4	16.2	4.0	6.6	1.6	-5.0	-1.2	-4.2	-1.0
<b>Q3</b>	-21.5	-5.3	16.6	4.1	6.7	1.7	-5.0	-1.2	-3.2	-0.8
<b>Q4</b>	-21.0	-5.1	17.0	4.1	6.7	1.6	-5.0	-1.2	-2.3	-0.6

Exports, Imports & Prices (£bn)								
	Goods		Services		Goods & Services		Prices <sup>1</sup>	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports %y/y	Imports %y/y
<b>2010</b>	265	324	163	115	428	439	3.2	3.9
<b>2011f</b>	302	397	167	111	470	508	4.6	4.1
<b>2012f</b>	317	410	173	114	490	525	2.5	3.5
<b>2013f</b>	328	415	180	114	508	529	0.0	2.5
<b>Q1 2011</b>	75	97	41	28	116	124	2.4	4.6
<b>Q2</b>	75	99	42	28	116	127	4.4	3.3
<b>Q3</b>	76	100	42	28	118	128	6.3	4.6
<b>Q4</b>	77	101	42	28	119	129	5.3	4.0
<b>Q1 2012</b>	78	102	43	29	121	130	5.0	4.1
<b>Q2</b>	79	102	43	29	122	131	2.7	3.8
<b>Q3</b>	80	103	44	29	123	132	1.7	3.2
<b>Q4</b>	81	104	44	29	125	132	0.8	2.9
<b>Q1 2013</b>	81	104	44	29	126	132	0.1	2.6
<b>Q2</b>	82	104	45	29	126	132	0.0	2.4
<b>Q3</b>	82	104	45	29	127	132	0.0	2.4
<b>Q4</b>	83	104	46	29	128	132	0.0	2.4

<sup>1</sup> Excludes prices of oil and other erratic items

## Forecast Table: UK Regions

Nominal GDP (% y/y)													
	North East	North West	Yorks & Humber	East Mids	West Mids	East	London	South East	South West	Wales	Scot.	N Ire.	UK
<b>Av. (00-07)</b>	4.8	4.6	4.9	5.2	4.2	5.2	6.8	5.2	5.5	4.7	5.3	5.5	5.4
<b>2008</b>	2.6	2.8	2.6	2.4	2.2	2.5	5.0	2.6	2.8	2.2	3.7	2.3	3.5
<b>2009</b>	-1.5	-1.6	-2.6	-2.7	-2.7	-2.0	-2.4	-2.2	-2.1	-2.2	-0.9	-2.0	-2.9
<b>2010e</b>	3.3	3.0	3.4	3.8	3.1	3.6	2.9	3.3	3.5	1.8	2.2	1.6	3.1
<b>2011f</b>	4.9	4.7	5.1	5.4	4.8	5.2	4.5	5.0	5.2	3.5	3.9	3.3	4.8
<b>2012f</b>	3.4	3.2	3.6	4.0	3.3	3.8	3.1	3.5	3.7	2.0	2.4	1.8	3.3
<b>2013f</b>	3.3	3.1	3.5	3.8	3.2	3.6	2.9	3.4	3.6	1.9	2.3	1.7	3.2
<b>Av. (11-20)</b>	5.0	4.9	5.0	5.0	5.0	5.1	4.9	5.2	5.3	4.3	4.5	4.2	4.8

Employment <sup>1</sup> (% y/y)													
	North East	North West	Yorks & Humber	East Mids	West Mids	East	London	South East	South West	Wales	Scot.	N Ire.	UK
<b>Av. (00-07)</b>	1.2	0.9	1.2	1.0	0.5	1.4	0.9	0.9	1.3	1.5	1.3	1.5	1.0
<b>2008</b>	0.3	-0.4	-0.6	-1.9	-0.1	-0.3	3.0	-0.1	0.3	0.2	0.7	1.2	0.3
<b>2009</b>	-1.3	-0.5	-0.9	-2.0	-2.9	-1.1	-2.0	-1.7	-0.9	-1.2	-4.0	-2.9	-1.7
<b>2010</b>	-1.6	-1.2	-0.8	1.3	-1.2	1.2	-0.6	0.1	-2.1	-1.0	-2.5	-0.7	-0.7
<b>2011f</b>	1.0	0.8	1.2	1.5	0.9	1.3	0.7	1.1	1.3	-0.4	0.0	-0.6	0.9
<b>2012f</b>	-0.6	-0.8	-0.4	-0.1	-0.7	-0.3	-1.0	-0.5	-0.4	-2.0	-1.6	-2.2	-0.7
<b>2013f</b>	-0.5	-0.7	-0.3	0.0	-0.6	-0.2	-0.9	-0.4	-0.3	-1.9	-1.5	-2.1	-0.6
<b>Av. (11-20)</b>	0.5	0.4	0.4	0.4	0.4	0.5	0.3	0.6	0.7	-0.2	0.0	-0.3	0.4

<sup>1</sup> Workforce Jobs measure

House Prices (% y/y)													
	North East	North West	Yorks & Humber	East Mids	West Mids	East	London	South East	South West	Wales	Scot.	N Ire.	UK
<b>Av. (00-07)</b>	12.8	12.3	13.0	12.1	11.4	11.8	11.1	11.5	12.1	13.1	11.9	17.2	11.9
<b>2008</b>	-11.2	-14.5	-13.6	-14.2	-14.1	-16.7	-15.0	-15.4	-14.8	-12.1	-8.3	-34.2	-14.8
<b>2009</b>	-2.2	2.8	2.8	2.5	2.0	4.5	7.1	5.6	3.9	-0.2	0.9	-6.6	3.4
<b>2010</b>	0.5	-1.8	-3.6	1.7	0.6	3.4	2.5	2.1	2.2	-1.8	-2.2	-9.5	0.6
<b>2011f</b>	-8.0	-7.0	-5.5	-6.0	-7.0	-3.5	-2.0	-2.5	-5.0	-8.0	-7.0	-7.0	-5.0
<b>2012f</b>	-10.0	-9.0	-8.0	-8.0	-9.5	-5.0	-4.0	-5.0	-7.5	-10.0	-8.0	-9.0	-7.0
<b>2013f</b>	-3.5	-5.0	-3.0	-5.0	-4.0	-6.5	-6.0	-6.0	-6.5	-4.0	-4.0	-2.0	-5.0

# Capital Economics Ltd

CONOMICS

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