

# UK Economic Forecast Report

February 2010

Bridgecourt & Company  
29 Farm Street  
London W1J 5RL

Telephone:  
+44 (0)20 7347 7700

Fax:  
+44 (0)20 7347 7701

Web:  
[www.bridgecourtandco.com](http://www.bridgecourtandco.com)

Author:  
Robert Robinson  
[robert.robinson@bridgecourtandco.com](mailto:robert.robinson@bridgecourtandco.com)

## Modest Growth Forecasts and Inflation Concerns – Is the UK Facing a Period of Stagflation?

### *Introduction*

Overall in 2009 the UK's GDP fell by over 6%, a level of decline that exceeded even the most pessimistic forecasts at the beginning of 2009.

Independent economists<sup>1</sup> forecasts that were published in February 2009 indicated that the average expectation of decline in GDP in 2009 would be around 3%, but even the lowest forecasts did not expect the economy to fall below 4%.

The severity of the decline and the extremely modest return to growth in the last quarter of 2009 raises a number of questions about the likelihood of a return to a period of sustained economic growth in 2010 and beyond, the pace of that growth, and the robustness of forecasts which are helping to shape business planning decisions over the next few years.

A number of uncertainties and apparently contradictory conditions characterise the current economic situation. This lack of transparency underpins the relatively conservative forecasts recently published in February 2010 by independent economic forecasters.

---

<sup>1</sup> Independent economists include a selection of academic, not for profit, and private sector forecasting organisations that are independent from the views and forecasts of HM Treasury. Their inclusion on a list of independent forecasters is subject to review and no significance should be attached to the inclusion or exclusion of any particular forecasting organisation.

The average forecast in February 2010 predicts the UK economy will grow by about 1% this year. The more optimistic forecasts predict growth in GDP to be around 2%, whereas the more pessimistic forecasts predict growth will be less than 0.5%.

The threat of a sustained period of deflation appears to have subsided for the time being. RPI inflation, which fell into negative territory towards the end of 2009, increased to 3.7% in January 2010 in part due to rising oil prices and the end of the VAT cut. The fall in sterling has also contributed to inflation as this has made imports more expensive. Whether the increase in import prices is a one off event or an event that translates into encouraging higher domestic prices remains to be seen. A key concern for the UK economy as it moves out of recession is the scale and speed of higher inflation and higher interest rates, which may have the potential to set back the economic recovery.

This risk of a reversing economic recovery on the one hand or higher inflation on the other, poses an economic policy dilemma for government in particular the decision as to whether to go ahead with further quantitative easing (QE) or to roll back the QE programme. Measures to address economic demand can end up being inflationary and measures to address inflation can result in a further weakening of demand, whichever policy path is taken there is a strong possibility that there will be some unintended consequences. One possible outcome may be that there will be a period of economic stagnation together with higher inflation, often referred to as stagflation.

### *Inflation Risk*

Despite the recent increase in inflation figures, most economic forecasters are expecting RPI inflation to remain relatively subdued at around 3% and below over the next few years. These forecasts are supported by assumptions regarding the large amount of spare capacity in the economy, a relatively slow recovery, and continued moderate wage increases during this period. Given the very recent concerns about an extended period of deflation, it is probably fair to say that combating inflation risk is perhaps not currently the highest priority on the economic policy agenda, nevertheless there are a number of factors that could make inflation a major issue in the not too distant future and these factors are already being reflected in the considerations of investors in longer term government bonds.

Despite concerns about the output gap dampening demand and suggesting only a shallow recovery, there is some uncertainty regarding the extent of the available spare capacity in the economy. A number of economists consider that a significant proportion of the assessed level of spare capacity has been permanently lost to the UK economy and consequently there is perhaps less of a constraint on inflationary pressures as the economy recovers. Furthermore the flexible labour market and competitive exchange rates achieved through the devaluation of sterling during the recession means the UK could be well placed to grow quickly as markets recover.

Much of the funds provided by QE have not yet filtered through into the wider economy and instead is propping up bank balance sheets. While this appears to have successfully stabilised the banking sector, it also provides a risk that at some stage the excess reserves held by the banks will flow into the wider economy and could result in above expected inflation levels.

There are several reasons why a high level of excess reserves is being kept aside by the banks. Firstly, there is low demand for debt reflecting the continued lack of confidence in the strength of the economic recovery. Secondly, there is uncertainty regarding future bank regulation and this may result in banks having to hold higher levels of reserves relative to the level of their risk exposure than has been the case to date. Thirdly, the banks face another potential wave of liquidity problems, associated with need to refinance massive amounts of bank debt lent at the height of the credit boom that will have to be refinanced at higher rates.

If, however, one or more of these factors changes positively from the banks point of view, they may wish to improve profitability by increasing lending activity into the wider economy. Such a flow of credit may have inflationary consequences.

In the shorter term the continued low demand and levels of unemployment are likely to dampen inflationary pressures, but the relationship between weak economic demand and low inflation does not necessarily hold out indefinitely. Inflation can be triggered by changes in the prices of goods outside the domestic economy, and timings in adjustments in the domestic economy, for example changes to government spending, tax, and borrowing rates.

### ***Borrowing Rate Risk***

With low inflation forecasts, interest rates are also forecast to increase at relatively low pace over the next few years. Most forecasters are expecting the official bank rate to stay at around 0.5% in 2010, rising slowly to around 4% by 2014 as the economy picks up. Key to economic recovery is the continued confidence in the banking sector and the level of interest offered by the commercial banks. The low official bank rate is, however, only part of the cost of funding offered by commercial banks. Commercial lending rates also reflect the level of interest commercial banks are charged for interbank loans (the LIBOR rate).

As well as facing liquidity risks associated with the refinancing of debt maturing over the next few years, confidence in the banks may also be undermined by a decline in sovereign quality given that sovereign support underpins bank liabilities. Furthermore, the recent announcement by the Bank of England to put on hold its QE programme will reduce the amount of liquidity going into the banking sector. If confidence in the banking sector deteriorates to any significant degree than LIBOR rates would be expected to increase and lending conditions further tightened, which may have serious consequences for the sustainability of the recovery.

On the other hand if the economy recovery more quickly than forecast and inflationary pressures come to the fore, then it may be expected that the official bank rates would be increased to address this which would impact commercial lending rates.

### ***Forecasts for key economic measures***

Very modest levels of growth forecast by independent economists for 2010 and 2011 suggest there may well remain spare capacity in the economy and high levels of unemployment may persist

throughout a recovery. The general consensus among independent economists appears to suggest a slow recovery, with growth only returning to its pre-recession levels after several years.

While the economy slowly moved out of recession at the end of 2009, a combination of growing unemployment, higher interest rates, tax rises, government spending cuts, and further problems associated with the banking sector may make the recovery far from straightforward. On the other hand, further stimulation by government may risk higher inflation should a full recovery be underway. In an uncertain economic environment different scenarios outside the consensus range are worth considering for business-planning purposes.

The graphs shown below are taken from "Forecasts for the UK Economy – A Comparison of Independent Forecasters", published by HM Treasury in November 2009 and February 2010. The forecasts include medium term forecasts to 2013 for the November 2009 forecast and to 2014 for the February 2010 forecast. The independent economists selected for the February forecasts are not necessarily all the same as those selected for the November forecast. The purpose of the comparison is to show broad trends across a range of forecasts and forecasters.

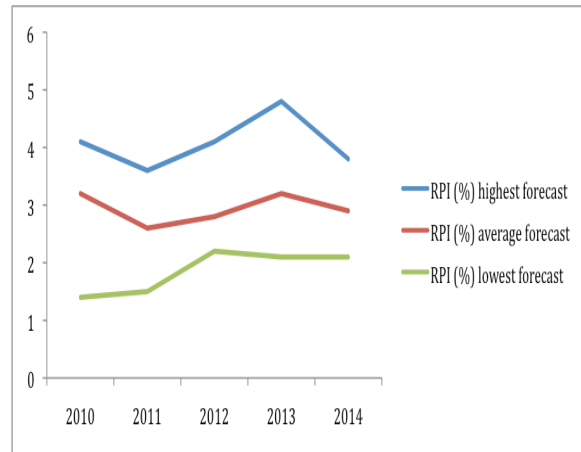
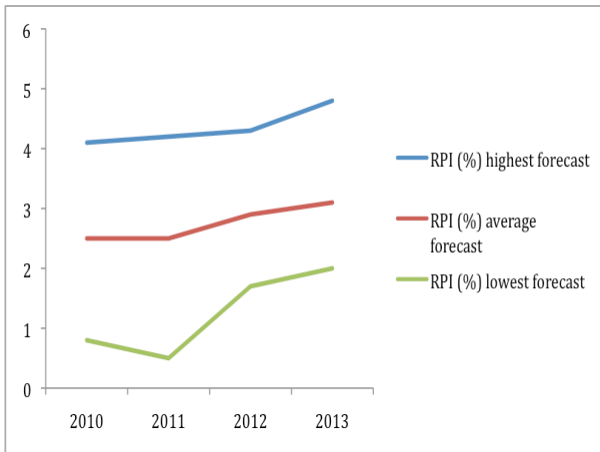
The graphs show the average forecast for key economic indicators across a group of independent forecasters, as well as the range between the most optimistic and most pessimistic individual forecast. The graphs also track the broad changes to forecasts to key economic indicators between November 2009 and February 2010.

Over the three-month period between November 2009 and February 2010, forecasts for the main economic indicators have remained relatively stable. Following data showing that the UK had moved out of recession at the end of 2009, forecasts for economic growth in February 2010 are slightly more positive than forecasts were in November 2009. The most pessimistic forecasts in November 2009 indicated that the economy would remain in recession (albeit with very low negative growth) in 2010. The forecasts in February 2010 show that all independent forecasters are predicting growth in 2010 and over the forecast period, and there is no expectation of a return to a recession over the forecast period.

The slightly higher growth forecasts are matched by slightly higher inflation forecasts in February. On average RPI inflation is expected to remain at around 3% over the forecast period, forecasts for 2010 have been amended upwards for 2010 again in response to the higher than expected inflation figures at the beginning of 2010. The highest inflation forecast does not expect inflation to exceed 5%, and inflation is forecast to trend downwards in 2014.

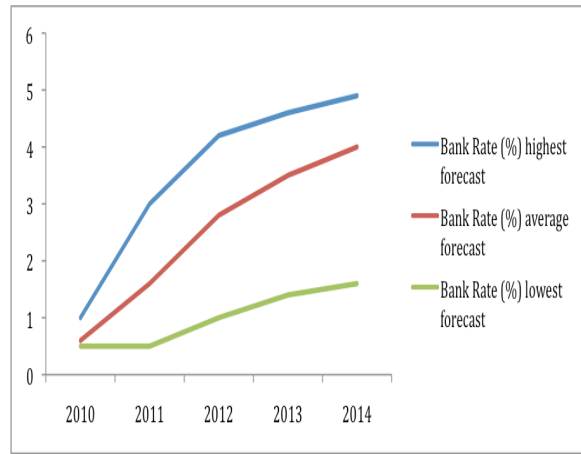
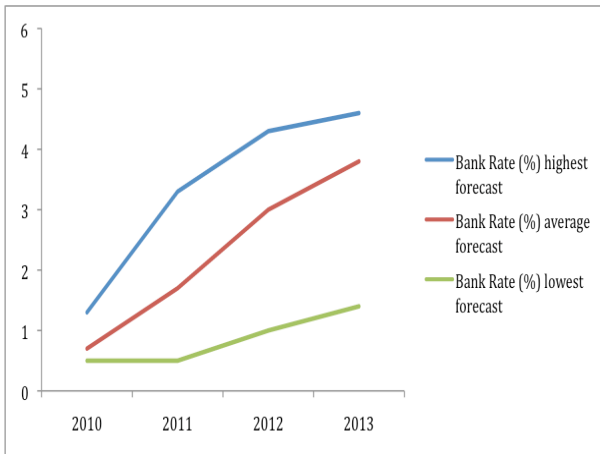
According to most independent economists, high inflation remains a relatively remote risk over the forecast period at this stage. Nevertheless, in the same way that forecasts in 2009 were adjusted in response to unexpected economic data, forecasts this year may be expected to be revised as new information is made available. The reliability of the forecasts over a five-year period cannot be certain, and businesses planners would be wise to consider other scenarios outside the forecast range.

**Independent Economists' Forecast Annual average % RPI - November 2009 & February 2010**



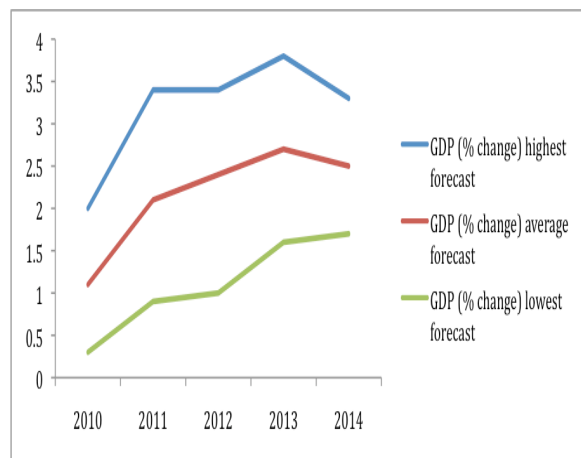
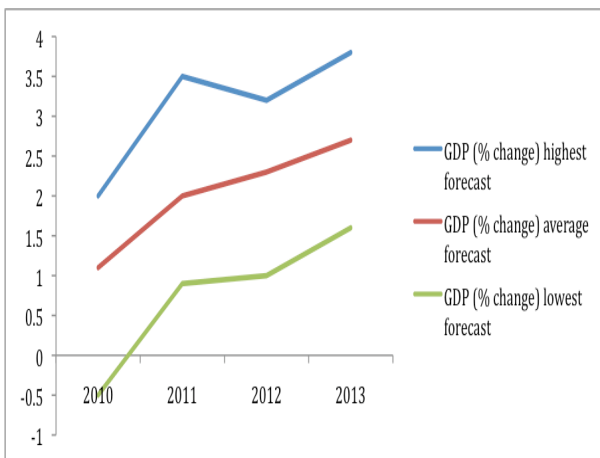
Source: HM Treasury

**Independent Economists' Forecast Change in Bank Rate - November 2009 & February 2010**



Source: HM Treasury

**Independent Economists' Forecast Change in GDP - November 2009 & February 2010**



Source: HM Treasury

### *Safer Havens than UK Sovereign Debt ?*

Investment in sovereign bonds is not without risk. While there is no expectation that the UK will default on its debt, a combination of the threat of UK sovereign rating downgrades, the reluctance of the market to lend, and inflation concerns are all factors that can impact the value of government bonds.

Concerns about the size of annual fiscal deficits, the build up of debt levels towards the annual GDP, and political willingness to put in place credible fiscal reforms are contributing to an erosion of confidence in the creditworthiness of the UK.

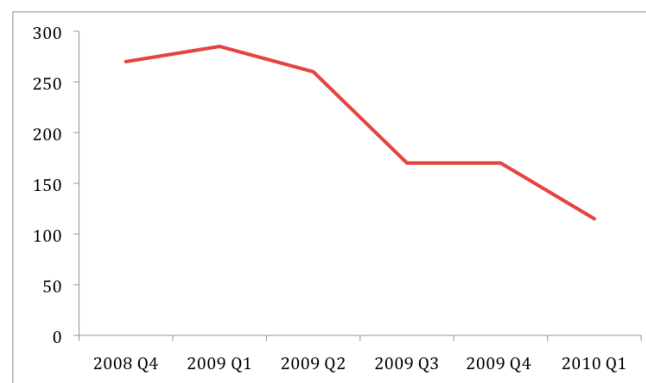
High levels of government debt may help to stimulate the economy in the short term, but over the longer term it risks slowing down recovery as government will be faced with higher costs of servicing its debt which can only be funded by increasing the tax burden or further cutting back government spending.

Furthermore, what may appear to be a sustainable level of government debt today may need to be reassessed rapidly if there is a sudden change in market sentiment. Investors are likely to be increasingly discerning between different sovereign bond investment opportunities, and there is a significant degree of uncertainty regarding the potential room to manoeuvre for certain governments regarding the continuation of stimulus packages that increases the national debt burden.

The value of government bonds will also reflect supply and demand considerations. Recently this market has been characterised by the purchasing of gilts by the Bank of England as part of the QE programme which has helped hold up values. The value of gilts in the future may become more volatile in response to adjustments in demand and supply conditions, in particular if the QE programme is rolled back.

If investors continue to lose confidence in UK gilts, then they may be increasingly attracted to government related or other highly rated investments that are underpinned by security. Theoretically, such investments may in fact be perceived to be lower risk than gilts because investors have physical assets to fall back on. If a period of inflation is anticipated then the security associated with the investment is more likely to maintain its value.

**Secured Social Housing Bond Spreads - Q4 2008 to Q1 2010**



The table above shows the narrowing of recent secured social housing bond spreads. Only one or two issues have occurred in each quarter and therefore the data is not statistically significant. Nevertheless, over a similar period gilt prices have been falling and relative to investing in gilts, investments in secured highly rated issues (such as social housing bonds) could be seen to be increasingly attractive.

**Disclaimer**

This report has been issued by Bridgecourt & Company Limited and has been provided to you solely for your information and should not be considered as an offer, or solicitation of an offer, to sell, buy or subscribe to any securities or any financial instruments.

This report is intended for use by professional and business investors and issuers only. Any information and opinion contained in this report has been based on sources believed to be reliable, but, neither Bridgecourt & Company, nor any of its directors, employees, or affiliates accepts liability from any loss arising from the use this information and opinion.

Any opinions, forecasts or estimates in this report are judgments made at a point in time, and there can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance.

Information in this report is subject to change without notice, its accuracy is not guaranteed, it may be incomplete, and it may not contain all material information concerning a particular organisation, security or financial instrument. Bridgecourt & Company is not agreeing to, nor is it required to, update the information, opinions, forecasts or estimates contained in this report.

The value of any securities or financial instruments mentioned in this report can fall as well as rise. Investors should seek financial advice regarding the appropriateness of investing in any securities, financial instrument or investment strategies mentioned in this report.

This report may not be reproduced in whole or in part, copies circulated, or disclosed to another party, without the prior written consent of Bridgecourt & Company.