

# UK Economic Forecast Report

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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)

## Comparing Independent Economists Forecasts for UK

### *Introduction*

Prospects for inflation and interest rates remain uncertain for 2009 and beyond. Many businesses rely on inflation linked income streams from Government or Government related entities for a significant proportion of their revenue, and these businesses are likely to benefit in 2009 from the relatively high level of inflation in 2008 (which set inflation linked income for 2009). On the other hand businesses with inflation-linked costs, such as wages, may find revenues not matching costs. This situation, however, could be reversed in following years if there are low levels of inflation (or deflation) in followed by a period of high inflation. Any rapid change in inflation, with associated lags in inflation linked income and costs, may lead to short term cash flow pressures.

Businesses, and in particular providers of infrastructure with high capital requirements, have until recently benefited from cheap debt, much of which was fixed over the longer term. The cost of debt, however, has been rising despite recent cuts in base rates. Furthermore, changes in the funding markets point towards shorter term lending arrangements and an increase in refinancing risk. Unexpected changes to interest rates can impact this refinancing risk, and can impact hedging arrangements for managing interest rate risk exposure through, for example, margin calls for additional collateral.

Volatility in key economic indicators, and the lagging effect associated with regulated income and expenditure streams, can undermine the credit position of social businesses and lead to planning uncertainty and potential loss of competitive position.

### *UK Economic Performance*

Levels of GDP have fallen in recent months and the decline in economic performance in the UK is expected to continue well into 2009. Interest rate cuts to stimulate the economy do not appear to have had the desired effect and there is limited scope for further reduction. The Government and the Bank of England are considering “unconventional” approaches to stimulate spending in the UK economy by essentially funding Government borrowing by creating money. It is not clear how much additional money will be added to existing base money in the economy in order to create the necessary levels of demand, nor is it clear what assets will be purchased by this additional money. Furthermore it is uncertain whether plans to increase the supply of money in the economy will actually filter down to businesses and individuals. Even if it did, there will be concerns in the current climate whether this money will in fact be saved rather than spent.

With demand in the economy falling, inflation is expected to decline further in 2009. It is likely that inflation, measured in terms of the Consumer Price Index (CPI), will significantly undershoot the Bank of England’s CPI 2% target level in 2009. Inflation measured in terms of the Retail Price Index (RPI) is already at around zero and is expected to be negative for most of 2009. The main difference between CPI and RPI is that RPI includes costs for housing. Although CPI is the headline inflation target, RPI is the inflation index most frequently used for setting annual changes to incomes and expenditures (such as rents and wages). Proposals to increase money supply to stimulate demand therefore should be seen in the context of the Bank of England’s determination to keep to its 2% CPI inflation target over the medium term, recognising that interest rate cuts alone will not be sufficient to achieve this.

A feature of the current downturn is the uncertainty regarding the depths of the recession, the timetable to recovery, and the scale and nature of Government measures required to support and stimulate the economy. If the Government overplays its role in supporting banks and businesses and too much liquidity is put into the system, then there is a risk the Bank of England will overshoot its inflation target and interest rates will increase. Bearing in mind there must be a General Election in the UK by mid 2010, it may be expected that the Government will seek to achieve a recovery in the economy that is of sufficient political significance several months ahead of an election date. Forecasting economic performance over the next year or so may therefore be as much about interpreting political events as about traditional economic analysis.

Although the economic outlook is uncertain and commentators and forecasters are generally pessimistic, there are a few factors worth considering that may speed up a recovery in the UK. The recent fall in sterling has increased the competitiveness of UK firms and unless there is a wave of international protectionism, the UK is in a strong position to trade its way out of recession when markets start to pick up. In the short term however, overseas markets are weakening reflecting the downturn in the world economy. The UK economy is flexible and the corporate sector is relatively financially strong. Many companies have responded to the economic situation by cutting back quickly on jobs and investment, and would be expected to respond as quickly in terms of hiring and investing when the recovery starts.

### *Independent Forecasts for UK Economy Increasingly Pessimistic*

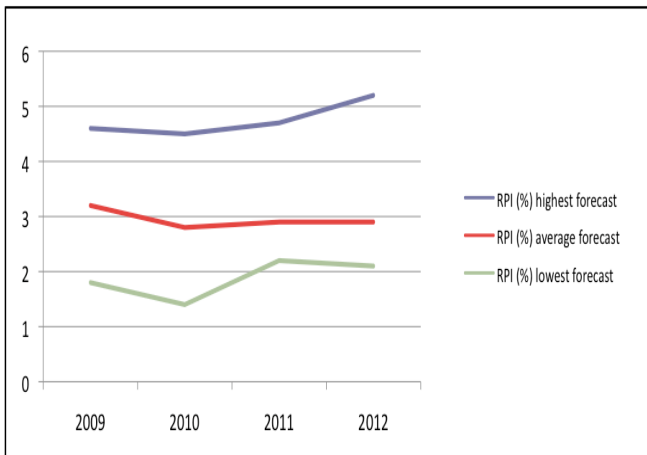
Forecasts for 2009 are pessimistic, with independent economists expecting falling GDP levels throughout the year with low inflation and low interest rates. Recent economic data seems to point to forecasts getting even more pessimistic. Having said that, the speed of the decline and the unexpected combinations of economic indicators was typically not reflected in the forecasts across a range of independent economists in 2008, with most predicting higher levels of GDP growth, higher interest rates, and lower levels of inflation than was actually recorded at the end of the year. Forecasters tend to cluster around a consensus view of economic trends on the basis that the probability of events occurring that result in key economic indicators moving away from such a trend is judged to be low. As 2008 demonstrated, outcomes outside the forecasting range can occur. Measuring the probability of the occurrence of particular events is difficult, but in a volatile environment organisations need to take a view of the likelihood of particular scenarios unfolding, and the impact on their business plans.

A range of scenarios may be worth considering, including an extended period of low inflation (or deflation), as well as a relatively quick recovery characterised by rapid growth in inflation. It is not clear that the Government's policies to revive the credit markets and intervene in the economy will have the desired outcomes, and being prepared for possible events outside of the consensus forecasting range may be an appropriate assumption for 2009.

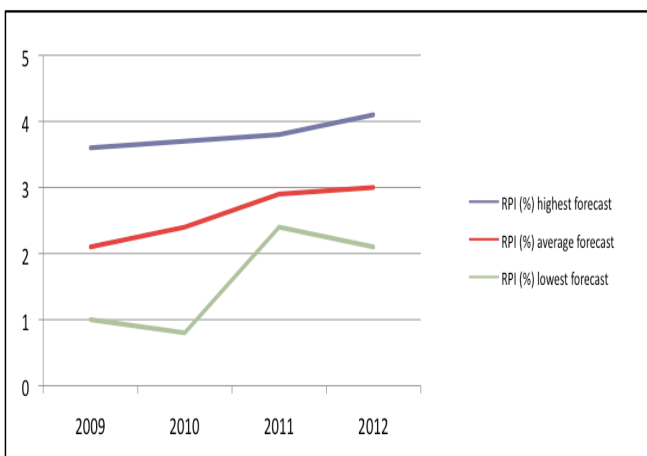
The graphs shown below are taken from "Forecasts for the UK Economy – A Comparison of Independent Forecasters", published by HM Treasury in August 2008, November 2008, and February 2009. The forecasts in August 2008 and November 2008 include medium term forecasts to 2012, and the forecast in February 2009 includes medium term forecasts to 2013. The graphs track the changes made by forecasters to key economic indicators. Over a six-month period between August 2008 and February 2009 forecasts have followed a noticeable downward trend in response to worsening economic data. In particular, forecasts for 2009 and 2010 have been adjusted downwards. Forecasts for the end of the medium term period are relatively stable, however it remains to be seen whether these later forecasts will be similarly adjusted over time.

The latest set of independent forecasts published in February 2009 show that starting from a position of negative GDP growth in 2009, most forecasters predict that the recession will bottom out in 2009 and the economy will record flat or positive growth in 2010. Having said that, some forecasters predict continued negative growth in 2010. Similarly most forecasters point to a period of deflation (on an RPI basis) in 2009 before prices pick up thereafter, and the bank rate is also expected to remain low before gradually increasing to 3% to 6% by the end of the five year forecast period.

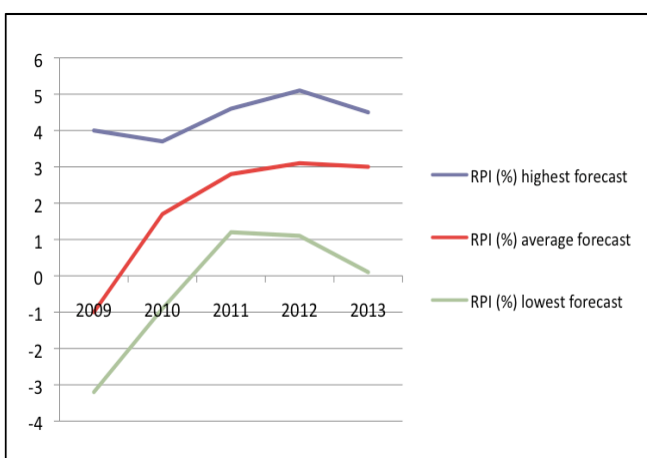
**Independent Economists' Forecast Changes in % RPI – August 2008**



**Independent Economists' Forecast Changes in % RPI – November 2008**

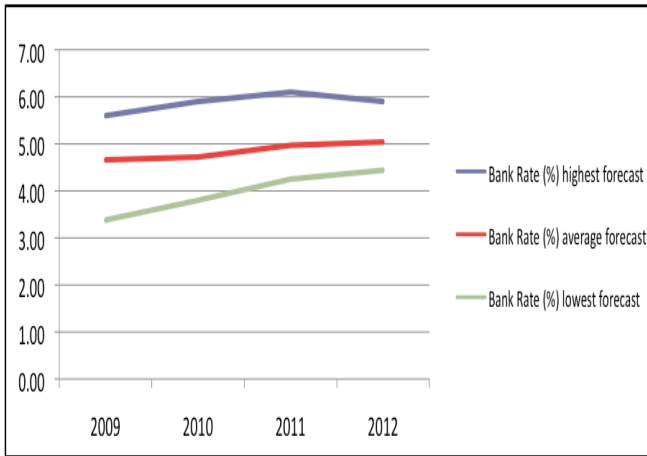


**Independent Economists' Forecast Changes in % RPI – February 2009**

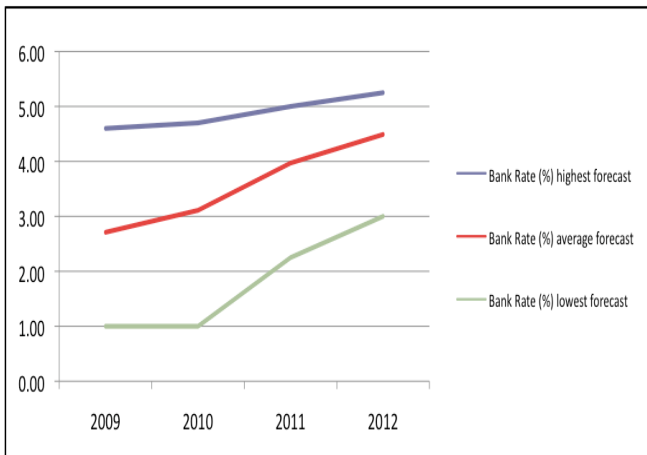


Source: HM Treasury

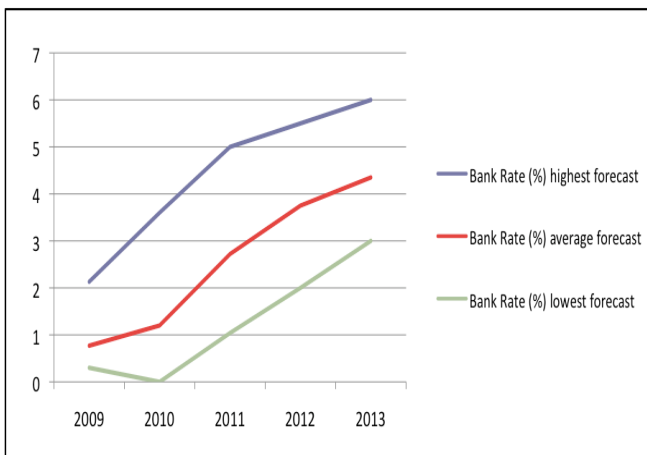
**Independent Economists' Forecast Changes in % Bank Rate – August 2008**



**Independent Economists' Forecast Changes in % Bank Rate – November 2008**

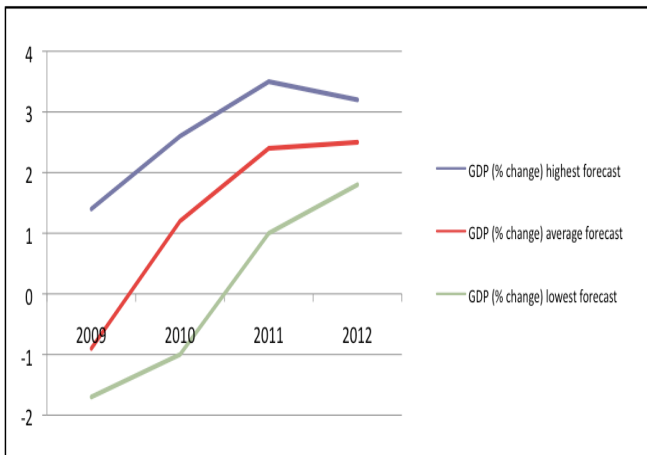


**Independent Economists' Forecast Changes in % Bank Rate – February 2009**

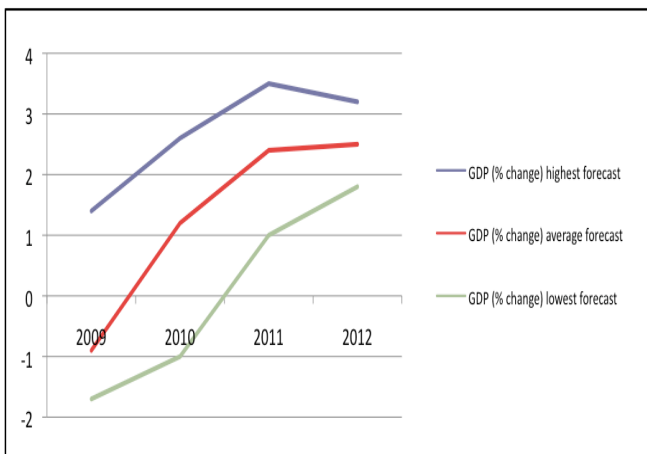


Source: HM Treasury

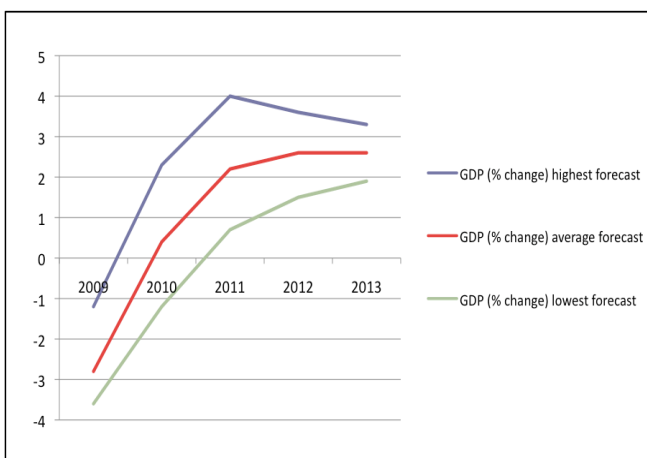
**Independent Economists' Forecast % Change in GDP - August 2008**



**Independent Economists' Forecast % Change in GDP - November 2008**



**Independent Economists' Forecast % Change in GDP - February 2009**



Source: HM Treasury

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