

# CBI Economic Forecast

- **Financial markets and the world economy**

Since our last forecast, the magnitude and severity of financial market problems have become increasingly evident. Credit markets have continued to deteriorate as banks and special purpose financial vehicles still do not know the full extent of each other's exposure to assets which cannot be adequately valued and which may have little or no value. Periodic forced selling of assets has impaired the signals that yields provide, and it is likely that ongoing disorder and dysfunction in particular markets will continue for some time.

The deterioration in the US economy that was already underway will be amplified by financial market problems, and this will feed through to further write-downs of assets on bank balance sheets. Banks' need for cash and increased risk aversion will limit the pass-through of the aggressive cuts to official US interest rates that we have already seen.

The unwinding of the credit crunch will provide a significant headwind for advanced economies, which we expect will be a drag on the world economy well into 2009, despite policy action across central banks. For this reason, our new assumption for OECD GDP growth is 1.7% in both 2008 and 2009, a downward revision of 0.6% in 2008 and 0.7% in 2009. While the USA will be hardest hit, we also expect to see sub-trend growth rates in the Eurozone and Japan.
- **UK output**

UK output growth started to moderate late last year, but the slowdown so far has been consistent with what we would have expected given monetary tightening and substantial cost shocks over the course of 2007. The impact of tighter lending conditions on the real economy is yet to be fully felt. However, the process of credit tightening will act as a drag on real activity, thus prolonging the slowdown into 2009. The sharp depreciation of sterling will exacerbate the slowing in domestic demand through higher import prices, but the gain in competitiveness should see net exports provide a significant cushion to GDP growth over 2008 and 2009. We now forecast growth of 1.8% in 2008 and 1.7% in 2009, a downward revision of 0.2% and 0.4% respectively.
- **Consumption**

The outlook for consumer spending has deteriorated significantly. Surging import prices will erode purchasing power in the near-term, while employment growth is not expected to support consumer income as in 2007. On top of this, tighter lending conditions will reduce consumers' ability to bring forward spending over this period of weak real income growth. We expect that consumers will use the opportunity of a modest recovery of real income growth in 2009 to increase their rate of saving which has fallen to unusually low levels over recent years.
- **Business investment**

Our business investment forecast is slightly weaker than in December, reflecting a weaker economic outlook and lower availability of bank finance, and we continue to expect modest falls in buildings investment. However, despite a weaker outlook for 2008 and 2009, healthy profitability growth and balance sheet improvement over recent years will enable many UK companies to continue to invest in anticipation of stronger GDP growth from 2010 onwards.
- **Inflation and monetary policy**

On top of sharp increases in the cost of petrol, gas, electricity and food which were already in the pipeline in late 2007, a weaker currency will add to inflationary pressures over coming quarters. Although some of this pressure will be absorbed into retailers' margins as consumer demand slows, we now expect CPI inflation to pick up sharply and peak at 3.2% in 2008 Q3.

Over this period, the Bank of England will be mindful of the risk that high inflation expectations become ingrained, limiting its room for manoeuvre. We expect one cut in interest rates before the peak in inflation in Q3. Thereafter, as the effects of surging commodity prices start to unwind and the economy slows, CPI inflation will fall back, possibly quite sharply. This should give the Bank scope to reduce interest rates twice more in response to the weaker growth outlook, to 4.5% by 2009 Q1.

# CBI Economic Forecast

12mth% unless otherwise stated				2008				2009			
	2007	2008	2009	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>GROWTH &amp; CONSUMPTION</b>											
Real GDP	3.1	1.8	1.7	2.5	2.0	1.6	1.3	1.3	1.5	1.8	2.3
Manufacturing output	0.5	0.4	0.4	1.0	0.0	0.2	0.5	0.0	0.1	0.4	0.8
Household consumption	3.1	1.6	1.1	2.3	1.8	1.1	1.0	0.8	0.9	1.1	1.5
Government consumption	1.9	2.3	2.0	2.0	2.4	2.6	2.2	2.0	2.0	2.0	2.0
Household savings ratio	3.1	2.8	3.2	2.9	2.8	2.7	2.8	2.8	3.2	3.3	3.3
<b>INVESTMENT</b>											
Fixed investment	5.0	1.4	1.9	1.0	2.3	0.7	1.6	1.0	1.5	2.2	2.9
of which:											
Total business*	6.7	2.3	2.9	2.7	2.9	1.1	2.3	2.0	2.5	3.3	3.8
General government*	5.2	6.7	3.6	0.9	12.3	6.6	7.4	5.2	3.7	2.9	2.9
Manufacturing*	4.1	1.2	1.2	0.5	2.5	1.5	0.5	0.9	0.5	1.5	1.8
* Exc. BNFL transfer											
<b>EXTERNAL TRADE</b>											
Exports**	-5.4	3.8	5.5	3.1	3.4	3.3	5.2	4.8	5.6	5.6	6.0
Imports**	-3.2	2.2	3.3	2.9	3.5	0.3	2.1	2.0	2.8	3.8	4.8
Current account (£bn)	-68.1	-66.3	-64.6	-17.5	-15.8	-16.3	-16.7	-16.7	-15.9	-15.9	-16.1
% of GDP	-4.9	-4.6	-4.3	-4.9	-4.4	-4.5	-4.6	-4.5	-4.3	-4.2	-4.2
** Inc. MTIC fraud											
<b>PRICES</b>											
CPI	2.3	2.8	2.0	2.4	2.8	3.2	2.7	2.2	1.9	1.8	1.9
RPI	4.3	4.0	2.9	4.0	4.0	4.1	3.6	3.3	2.9	2.7	2.5
RPIX	3.2	3.6	2.6	3.5	3.6	4.0	3.3	2.9	2.6	2.5	2.5
Producer output prices	3.0	5.8	3.9	5.6	6.0	6.2	5.3	4.5	4.0	3.7	3.6
<b>LABOUR MARKET</b>											
Unemployment (ILO, mn)	1.65	1.65	1.75	1.62	1.64	1.66	1.69	1.72	1.75	1.77	1.78
Unemployment rate (%)	5.3	5.3	5.6	5.2	5.3	5.3	5.4	5.5	5.6	5.7	5.7
Employment (mn):											
Manufacturing	2.91	2.86	2.84	2.88	2.87	2.86	2.85	2.85	2.84	2.84	2.83
Non-manufacturing	24.34	24.51	24.55	24.48	24.50	24.52	24.53	24.52	24.53	24.56	24.60
Average earnings inc. bonus	3.9	4.1	4.0	3.5	4.4	4.0	4.3	4.1	4.0	4.0	4.0
<b>PUBLIC SECTOR</b>											
Net borrowing (£bn)***	36.4	43.2	46.0								
% of GDP	2.6	3.0	3.0								
*** 2007/08, 2008/09, 2009/10											
<b>FORECAST ASSUMPTIONS</b>											
	2007	2008	2009	2008	Q2	Q3	Q4	2009	Q2	Q3	Q4
OECD GDP	2.7	1.7	1.7	2.3	2.0	1.3	1.1	1.2	1.5	1.8	2.2
UK Base rate	5.51	4.98	4.50	5.33	5.08	5.00	4.75	4.50	4.50	4.50	4.50
Oil prices \$ per barrel	70.9	93.0	89.0	96.0	93.0	92.0	91.0	90.5	89.0	88.5	88.0
GBP Trade-weighted index	103.6	95.7	96.3	95.6	95.6	95.7	95.9	96.0	96.2	96.4	96.5
USD/GBP	2.00	1.99	1.96	1.98	2.02	2.00	1.98	1.96	1.96	1.96	1.95
GBP/EUR	0.68	0.76	0.74	0.76	0.76	0.77	0.76	0.76	0.75	0.73	0.73