World & UK outlook: Heading for a double dip?

John Walker
Chairman, Oxford Economics

jwalker@oxfordeconomics.com
### Forecast performance compared

#### 2007-2010

(average absolute forecast divergence for real GDP growth)

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>Eurozone</th>
<th>UK</th>
<th>Japan</th>
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Note: Forecasts made in December for year ahead.
## World GDP growth

% change on previous year

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
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<tr>
<td><strong>Real GDP</strong></td>
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<td>0.0</td>
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<tr>
<td>Japan</td>
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<td>India</td>
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<td>6.5</td>
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<td><strong>World</strong></td>
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<td>2.5</td>
<td>3.5</td>
<td>3.8</td>
<td>3.7</td>
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2011 was a disappointing year
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A number of factors can account for weaker than expected growth in 2011:

- Commodity prices have remained high on supply concerns

- Policy tightening:
  - Fiscal policy in advanced economies
  - Fiscal and monetary tightening in emerging markets

- Japan’s tsunami caused severe disruptions to global supply chains

- Ongoing uncertainty about the Eurozone crisis and the US debt debate dampened business and investors confidence
Commodity prices like tax rise for net importers

World: Commodity prices

2007=100 (rebased)

Source: Haver Analytics

Oxford Economics
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Fiscal policy tightening more than expected

Advanced Economies: Government Balance
Change in cyclically-adjusted balance, % of GDP

Emerging economies: Government balance
Change in cyclically-adjusted balance, % of GDP

Source: IMF
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Crippling uncertainty has dampened confidence.
UK was below par in 2011

The UK slowed particularly sharply because of:

- Relatively larger fiscal tightening (change in structural deficit was 1.7% of GDP vs 0.6% in the US and nearly 1% in Germany)
- Monetary policy tighter than appropriate
- Higher inflation
  - Partly related to fiscal policy with VAT hike
  - Partly accounted for by weakness of sterling
- Large exposure to the Eurozone
Growth in the money supply remains very weak

UK: Broad money money measures

% year

Source: Oxford Economics/Haver Analytics
Lending flows are very subdued

UK: Lending to firms and households

Source: Oxford Economics/Haver Analytics
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UK highly exposed to neighbours’ woes

<table>
<thead>
<tr>
<th>Exports to the Eurozone</th>
<th>% of total exports (2010)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>50.3</td>
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<tr>
<td>Central &amp; Eastern Europe</td>
<td>48.6</td>
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<tr>
<td>Germany</td>
<td>43.0</td>
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<td>China</td>
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<td>India</td>
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<td>US</td>
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<td>Latin America</td>
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<tr>
<td>Emerging Asia</td>
<td>9.2</td>
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Source: IMF Direction of Trade
2012 will be another difficult year

- Ongoing – in some cases deepening – fiscal austerity

- Credit conditions remain very tight, particularly in the Eurozone:
  - Eurozone banks facing liquidity squeeze
  - Ill-timed requirement to raise capital ratios

- Eurozone likely to be in recession in 2012H1

- But the news isn’t all bad
  - US data has been much better recently, particularly in the labour market
  - Emergers have plenty of room to loosen policy
Further fiscal tightening to come

Advanced Economies: Fiscal tightening
Change in cyclically-adjusted balance, % of GDP

Source: IMF
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UK will struggle in short term…

Domestic economy is unlikely to be able to offset the external weakness in the short-term:

- Business confidence will remain fragile while the Eurozone crisis remains unresolved, so companies will be wary of investing and recruiting
- Further job cuts are in the pipeline in both public and private sectors. Unemployment is likely to rise to 9% by end-2012
- UK credit conditions could tighten, and the cost of credit could increase, if the Eurozone crisis escalates
- The UK has more deleveraging still to do, particularly in the household sector
Unemployment set to flirt with 3 million

Source: Oxford Economics
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...but further out prospects are better

More favourable factors should begin to outweigh the short-term constraints, allowing recovery to take hold from 2012H2:

- Inflation is set to fall back below 2% by early autumn, raising consumer purchasing power

- UK businesses are in good financial shape and have the resources to support the recovery

- Monetary policy may well become more supportive, with rates at 0.5% until late-2013 and more QE in February
Household finances will strengthen through 2012
...but further out prospects are better

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UK corporate position remains strong

**UK: Company profits**

% of GDP

- 2000: 19.0
- 2001: 19.5
- 2002: 20.0
- 2003: 20.5
- 2004: 21.0
- 2005: 21.5
- 2006: 22.0
- 2007: 22.5
- 2008: 23.0
- 2009: 23.5
- 2010: 20.0
- 2011: 20.5

Average since 2000: 21.0

Source: Haver Analytics

**UK: Corporate sector financial balance**

% of GDP, 4QMA

- Financial corporations
- Non-financial corporations

Source: Haver Analytics
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Monetary policy should remain supportive

Advanced Economies: Quantitative Easing

% of GDP

Source: Oxford Economics/Haver Analytics
OBR short-term forecast looks a little strong

UK: Comparison of GDP forecasts

% year

- Oxford Economics (Jan)
- OBR (Nov)
- HMT consensus (Jan)

Source: Oxford Economics, OBR, HMT
The medium-term outlook

There is conflicting evidence on the degree of spare capacity in the economy. We place greater emphasis on the labour market data, which suggests an output gap of more than 3% of GDP.

Potential output growth will be hampered by:

- Legacy of financial crisis – tighter credit conditions, slower growth in financial services output
- Higher NAIRU – large increase in the number of long-term unemployed, skills & regional mismatches
- Weaker in-migration flows due to poorer employment prospects
- Weak short-term recovery in business investment – the strength of the recovery in business investment is the key difference compared with the OBR forecast
Output gap remains large

UK: Output gap
% of potential output

Source: Oxford Economics
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GDP – a long-term view

UK: GDP

Ln(GDP)


Actual GDP  Trend GDP

Source: Oxford Economics/Haver Analytics
Risks for the UK

- Greatest downside risk especially in the short term is that Eurozone crisis deteriorates. We have looked at a range of outcomes and the one below assumes five counties leave the Euro area in the coming months.

- There remains a good deal of uncertainty about both potential growth and the amount of spare capacity in the UK economy. It would be wise for the government not to become too constrained on this issue and leave plenty of room for manoeuvre when judging the fiscal stance. With better performance and appropriate policy its possible that UK growth could be better than expected over the medium term.
UK GDP growth under different scenarios

UK: GDP forecasts under different scenarios

% year


Baseline
Eurozone break-up
Stronger potential output

Source: Oxford Economics
Summary

- 2011 was a disappointing year for the global economy, due to policy tightening, high commodity prices and an escalation of the Eurozone sovereign debt crisis.

- The short-term outlook is challenging, particularly for the UK, which is highly exposed to the Eurozone crisis. Looser monetary policy could well be necessary to offset fiscal tightening and the recession in Eurozone.

- ...but UK prospects should improve through the year, with inflation coming down.

- In the short term risks remain skewed to the downside. A Eurozone collapse has the potential to cause a deep recession in UK.

- Potential output growth may be weak in the short term, so the medium-term recovery could be slower than in previous cycles. But important that government allow for possibility that potential output growth will be much stronger than many expect.