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# ECONOMIC PROSPECTS 2010

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JANUARY 2010

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*EEF's analysis of economic prospects for the year ahead*

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## Review and Preview

- Recession brings economic imbalances to the fore
- Impact of downturn varies across the world
- 2010 will bring growth
- ...but how much?
- ...and what will be the lasting effects?

Last year was a record year, but not for the right reasons. As 2009 ended, the UK was emerging from one of the longest and deepest recessions in post-war history. In the six consecutive quarters of falling output since the early months of 2008, UK GDP had contracted by a total of nearly 6%. And the downturn was synchronised across the world, knocking around 5% off GDP across the G7 and eurozone economies.

In the UK, no sector of the economy was spared, but manufacturing was among the hardest hit – a trend repeated across the developed world. The recession took a particular toll on export-oriented economies – such as Japan and Germany – which have recorded some of the most significant declines in total exports and manufacturing output. But the sharp shock to world trade led to similarly large falls in emerging economies.

### *Recession takes its toll*

*% change since the beginning of the recession*

	GDP	Manufacturing output	Exports	Employment
UK	-5.8	-14.0	-11.8	-1.6
France	-3.0	-13.6	-13.1	0.1
Germany	-5.6	-19.2	-15.6	0.7
Japan	-7.7	-22.6	-27.7	-2.4
US	-3.0	-12.7	-11.6	-3.7
Eurozone	-4.8	-17.3	-15.4	-1.5

Source: OECD

In 2008, governments and Central Banks implemented coordinated fiscal and monetary responses to the global financial crisis. Interest rates were cut quickly – in the UK to historically low levels – and the Bank of England stepped into the unknown with a substantial asset purchase programme. But around the world monetary policy is still a long way from normal. On the fiscal side, stimulus packages helped to arrest the decline in demand and will continue to provide support for the world economy in the near term. The UK, however, was one of the last to return to growth. Other

countries were able to mount a greater fiscal response and were less dependent on the financial services sector.

### *2010: A little up, but not much swing*

Our central forecast indicates that the recovery is unlikely to have much momentum, certainly in the first half of the year. Consumers were the driving force behind the UK economy for much of the past decade. While the recession hasn't hit the labour market as hard as expected, there is likely to be little cheer on the High Street in 2010 and households will continue to pay down debt and rebuild savings. Credit constraints and a slow recovery in profitability are also likely to hold back business investment. The best prospects for growth look set to come from exports – supported by an upturn in world trade flows and a weak Sterling exchange rate. That said, the global economic recovery has not fully taken root with the most acute risks remaining in the financial sector. An export-led upturn is, therefore, not assured. Companies will therefore need to be agile in responding to what is likely to be a bumpy road out of recession over the next twelve months.

All parts of the world will face some challenges in the year ahead. But financial markets are likely to pose the most significant risk. The initial response to the crisis may have been a collaborative one, but the recovery will pull economies in different directions which could leave the global economy vulnerable to further shocks. The timing and pace of tighter monetary policy and fiscal consolidation will also be central to global economic prospects. But after contracting by around 1% in 2009, the global economy should post growth of 3.5% in 2010. As was the case before the recession emerging markets look set to post the strongest gains. The global financial crisis highlighted the extent to which the global economy has become interconnected, and also the imbalances that will need to be addressed in 2010 and beyond.

This analysis of economic prospects in 2010 will consider how these factors are likely to evolve over the next 12 months. In addition, it will also provide some potential scenarios and assessment of some of the indicators that will impact on UK manufacturers as the sector returns to growth.

## UK Outlook

In 2010, the UK economy faces a daunting rebuilding task, as the foundations of growth must be broadened to begin addressing twin budget and trade deficits. The UK's economic prospects in 2010 will therefore be determined by the extent to which business investment, consumer spending and export-driven growth can mitigate the pain of the adjustment.

Our central forecast implies that, as with previous recessions, profits and investment will be slow to recover. Consumers will remain weary in the first quarter, continuing to pay down debt and increase savings even as low wage rises fall behind higher inflation and fail to compensate for potential increases in personal taxation. The recovery, however, will eventually gather pace through the spring and the second half of 2010 on the back of export growth.

This outlook for the UK economy 2010, however, is far from certain. Like many previous banking and credit crises, the UK could face a creditless, jobless recovery. The financial sector remains some way from good health. Whilst credit conditions do not currently appear to be deteriorating further,

growing demand for working capital as the economy starts to improve will be a real test of whether efforts to address the underlying problems in the banking system have made a difference. Cautious consumers could retrench after their holiday spending spree and bed down for an extended period of austerity. And having fallen by almost a fifth, world trade could struggle to gain traction.

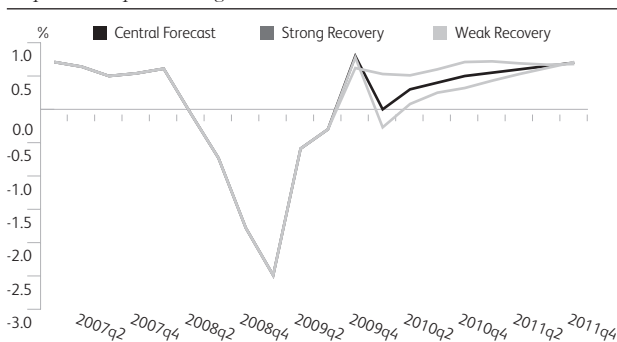
But growth could also surprise on the upside. Sustained recoveries in China and the US, coupled with a weak pound, could kick start world trade and boost UK exports. A healthier labour market would embolden consumers to become more confident about their finances and increase spending.

Yet despite the very real possibility of either a strong or a weak recovery in 2010, in our view the central forecast of a recovery sluggish start to 2010 remains the most likely outcome. While there are some concerns about the prospects of a double dip driven by further problems in the financial sector, continued credit constraints and a lacklustre recovery in the world economy, we view the probability of the UK returning to recession in 2010 as minimal.

### Chart 1

#### Uncertain recovery in 2010

% quarter-on-quarter change in GDP



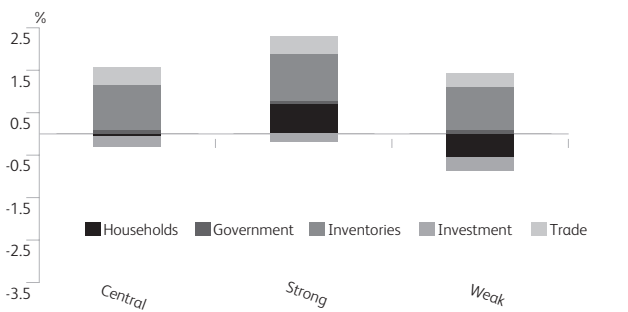
Source: EEF and Oxford Economics

As the UK begins to put the recession behind us, the profile of the recovery remains uncertain. To avoid the rise in VAT, a significant degree of consumer spending will have been brought forward to the tail end of 2009 at the expense of activity in 2010. With the economy starting from a standstill in the first quarter, the recovery will only slowly gather pace through the year as 0.9% growth in 2010 paves the way for 2.2% growth in 2011. Risks to this central forecast, however, are finely balanced. A pick-up in world trade and exports could restore business and consumer confidence and drive a stronger, sustained turnaround. In contrast, the economy could slip back into recession if debt and future tax rises dampen consumer spending, and exports disappoint as global growth stutters.

**Chart 2**

*Growth to come from exports in 2010*

Contribution to GDP



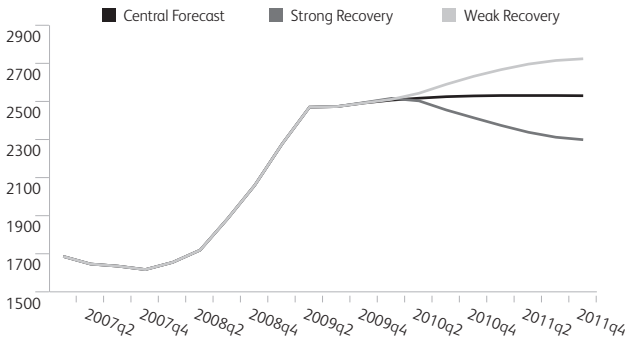
Source: EEF and Oxford Economics

Despite uncertainty around the strength of the recovery, there are three components of GDP growth that are relatively constant across all of our 2010 scenarios – inventories, investment and government spending. The unwinding of the inventory cycle has its own momentum, contributing to growth regardless. But investment, which typically takes 3-4 years to recover after recessions, will remain a drag on growth. And despite driving much of economic and employment growth outside of London over the past decade, government spending will provide only a minimal boost over the next 12 months. The two factors that could swing the economy towards a stronger or weaker recovery are export growth and consumer spending. Export growth will depend on the strength of the global recovery, whilst consumer spending will depend largely on the state of the labour market and consumer confidence.

**Chart 3**

*A jobless recovery will weigh on confidence and growth*

Unemployment levels, ILO measure, (000s)



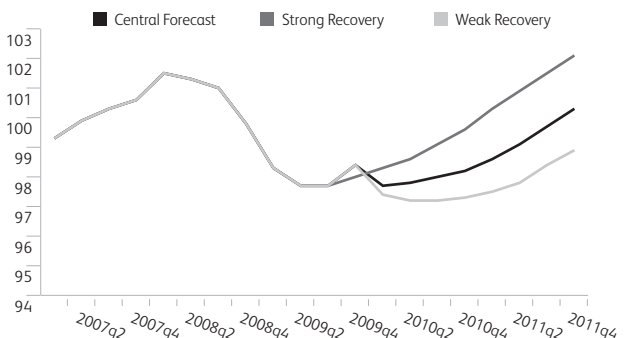
Source: EEF and Oxford Economics

In the first half of 2009, unemployment was set to breach the 3 million mark. Yet unemployment has currently levelled out below 2.5 million as labour market flexibility led to muted wage growth, fewer shifts and shorter hours rather than job losses. The UK is likely to experience a jobless recovery, with unemployment remaining elevated and only a handful of more than 700,000 jobs lost during the recession being replaced by the end of 2010. A stronger recovery would see over a quarter of the jobs lost coming back by the end of 2010, while a weaker outcome would add another 140,000 added to the unemployment register over the same period.

**Chart 4**

*Consumer confidence is central to the outlook for spending*

Consumer spending, 2007=100



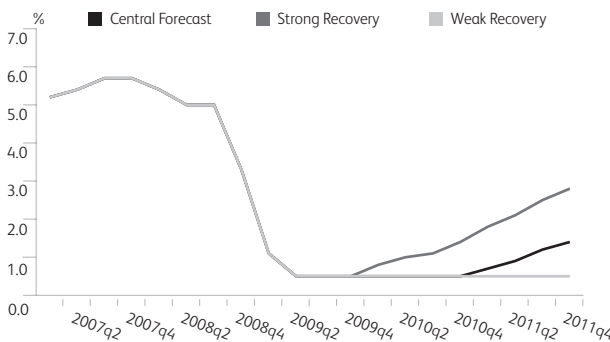
Source: EEF and Oxford Economics

The VAT rise at the beginning of the year and the dwindling car scrappage funds will have encouraged households to bring forward spending to the 2009 holiday season at the expense of the first quarter of 2010. The prospect of a jobless, sluggish recovery will also make households cautious about spending and boost savings in the first quarter of 2010. Spending only rebounds through the year as confidence and wage growth does. But if the labour market continues to build on the improvements seen in q4 2009, households will feel they need to save less, driving strong growth as consumer spending follows a path similar to that after the previous two recessions. Yet if the economy starts to stutter in 2010, consumer confidence could tumble as households become worried about future tax rises. This would push savings rates higher at the expense of spending, contributing to a weak recovery.

## Chart 5

### Interest rate decisions to become interesting again

Bank of England Base Rate



Source: EEF and Oxford Economics

Having pushed monetary policy a long way from normal, the Monetary Policy Committee now faces difficult decisions on when to begin unwinding its £200bn quantitative easing programme and, ultimately, the timing and pace of interest rate rises. The prospect of sluggish recovery in the central case suggests the Bank's base rate will remain at 0.5% for the remainder of 2010. The MPC will instead focus on reducing its balance sheet by reversing quantitative easing. A stronger recovery, however, could push the MPC to begin raising rates as early as February 2010, as a rebound in activity and spending removes the Committee's concern about the medium-term outlook. In contrast, a weaker-than-expected economy in 2010 and through to 2011 would see the base rate remain low through 2011 as well.

## Electoral economics

We can't forecast the outcome of the next election, or even when it will be called but the electoral cycle complicates the outlook for the economic cycle. While the Conservative Party has been leading in the polls, a hung parliament or a minority government would create an uncertain economic environment that would stifle business investment and consumer spending.

### Getting on top of the deficit

The debate on putting the UK's public finances back on the straight and narrow is in full swing. The difference between the two main parties has so far been around the timing of fiscal tightening – when to start and how quickly to move. But both have yet to show their hand on the detail of future tax rises and spending cuts.

A successful Conservative party has promised a Budget within 50 days of winning. A new Labour government would also need to outline further details of its intentions – particularly on its spending plans. Until then, businesses and households face uncertainty about where the burden of addressing the public finances will fall.

### Tax...

Businesses are already set to foot a large part of the bill, with tax changes that have already been announced. Potential future tax changes can impact on actions businesses have already taken (e.g. scrapping the Industrial Building Allowance). The risk of new measures, which might effectively be applied retrospectively, may lead to a stasis in decision-making on new investment until the parties' priorities are clearer.

### ....and spend

Over the past decade the UK has seen a public spending boom, with total expenditure rising from 37% of GDP to nearly 44%. The Institute for Fiscal Studies has crunched the numbers and the squeeze on department budgets is likely to be significant, but if health and education are ring-fenced the pain could be greatest in departments such as transport and defence. With government a major customer of industry, uncertainty about these budgets in particular could be another reason for the private sector to keep investment plans on hold for the time being.

## Signs we're on the way up ... or down

Most official statistics and data can only tell us what has already happened, rather than provide early warning signals of turning points. There are, however, some specific indicators that can provide a fairly accurate steer on the state of the economy and future prospects. The table below sets out some of the leading indicators that we'll be looking out for in the next year.

## Indicators we'll be watching

<b>Production</b>	
Enquiries	A change in new enquiries and orders – the earliest stages of production – provides an indication of a shift in demand conditions and a signal on future output levels.
New orders	
<b>Labour Market</b>	
Recruitment of temporary workers	Changes to hours worked can pre-empt longer term labour market adjustments. So an increase in average hours or the recruitment of temporary employees could be a response to increased demand, but permanent recruitment will follow only when there are clear signs that a sustainable recovery is underway.
Average hours worked	
<b>Trade</b>	
Freight index	Trends in global surveys on production, new orders or business expectations provide a guide to short term trade prospects. A more tangible indicator is increases in freight movement. A change in the cost of freight indicates not only a rise/fall in the movement of finished goods – but also raw materials used in the production process.
<b>Consumer Confidence</b>	
New house buyer enquiries	Households will rein in spending if they expect their financial situation to deteriorate – as a result of job losses for example. Equally, plans to purchase big ticket items, or dipping a toe in the housing market would provide a good indicator of confidence and future consumption plans.
Expectations on household finances	

Sources EEF Business Trends Survey  
National Statistics  
GfK/NOP

CIPS/Markit Purchasing Managers' Indicator (PMI)  
Baltic Dry  
Royal Institute for Chartered Surveyors

## UK Forecasts

% change from previous period (unless otherwise stated)

	2010				2009	2010	2011
	q1	q2	q3	q4			
<b>Output</b>							
GDP	0.0	0.3	0.4	0.5	-4.5	0.9	2.2
World Trade Index	0.0	1.9	1.7	2.4	-13.8	5.9	7.9
<b>Costs and prices</b>							
Consumer Price Index	2.2	1.84	1.24	1.29	2.1	1.7	1.2
Average earnings	0.7	0.3	0.3	0.6	1.4	1.7	2.8
Oil price (\$/barrel)	73.6	74.9	76.9	77.9	62.5	75.8	78.8
<b>Employment</b>							
Employment (000s)	26690	26694	26700	26707	26,751	26,698	26,726
Unemployment (000s)	2507	2517	2525	2529	2,428	2,520	2,531
Unemployment rate (%)	8.0	8.0	8.0	8.0	7.8	8.0	8.0
<b>Currencies</b>							
Exchange rate (€/£)	1.66	1.68	1.66	1.66	1.6	1.7	1.6
Exchange rate (\$/£)	1.10	1.11	1.12	1.13	1.1	1.1	1.5

Source: EEF and Oxford Economics

## International Outlook

- Manufacturers look to export markets for growth
- Europe takes lead out of recession
- But US looks set to overtake in 2010
- Emerging economies have held up better than expected
- ...can it last?

What happens in the rest of the world will play a big part in the UK's economic performance in 2010 and also that of manufacturing. A recent survey by EEF<sup>1</sup> on exporting showed that manufacturers see their best prospects in existing European and North American markets. And a significant minority also predict opportunities in emerging economies – particularly the Middle East and India.

Green shoots appeared earlier in other developed economies than in the UK, but that won't necessarily mean that the path to growth will be quicker or easier. In the second half of 2009 activity in manufacturing and services began to grow again in both Europe and the US. But the increase came after nearly a year of very rapid falls leaving activity levels some way to recover to 'normal' levels.

### Europe

The big eurozone economies got a headstart out of recession in 2009q3 with a boost from exports, stockbuilding and government spending. The positive effects of inventory adjustments will diminish throughout 2010. Similarly, while economies such as France and Germany are in a relatively stronger fiscal position compared with the UK, growth in government spending will also slow over the course of 2010. This will again leave exports as one of the drivers of growth next year, unless household spending can take up the reins.

However, the eurozone faces a couple of other challenges that may offset the benefits from stronger world trade growth. Schemes to protect jobs in a number of European economies limited the rise in unemployment, but with significantly lower levels of output, productivity will take a knock in 2010. Labour hoarding may also hold back firms' ability to carry out necessary restructuring, with consequences for competitiveness. In addition, households and businesses are likely to face continued credit constraints in 2010 as banks repair their balance sheets and look ahead to a changing regulatory landscape.

<sup>1</sup> Forthcoming – EEF Export Survey

### US

Difficult credit conditions are also likely to be a feature of a US recovery. But overall, prospects are looking rather better. US firms made significant headcount cuts at the height of the recession, but signs of improvement in labour market conditions have emerged, with a fall in initial jobless claims and an increase in temporary workers and average hours worked. Consumer confidence levels have increased from the lows of early 2009 and stronger household disposable income growth should see consumer spending continue to grow throughout 2010.

Despite the more optimistic outlook for the US economy in 2010, it is unlikely that the Federal Reserve will be quick off the mark to tighten monetary policy. The priorities for growth and employment will keep interest rate hikes off the table in the first half of 2010.

### Headline forecasts

% change on a year ago

	GDP			Inflation		
	2009	2010	2011	2009	2010	2011
France	-2.3	1.3	1.4	0.1	1.3	1.6
Germany	-4.8	1.6	1.7	0.4	1.3	1.6
Japan	-5.3	1.0	1.6	-1.2	-0.3	0.2
US	-2.5	2.6	3.1	-0.4	1.8	2.2
Eurozone	-4.0	1.1	1.5	0.2	1.2	1.7

Source: Oxford Economics

### Emerging economies

In emerging Asian economies the impact of the global recession was not as pronounced as initially expected. There were concerns in the early part of 2009 that China would officially enter recession, but stimulus measures again fended off the threat of a severe downturn. Forecasts for growth in both China and India were steadily revised upwards during 2009. The end of the stock cycle in China and fading effects of the stimulus measures look to be offset by growth in exports. In addition, other parts of Asia have been riding high on the back of stronger Chinese demand.

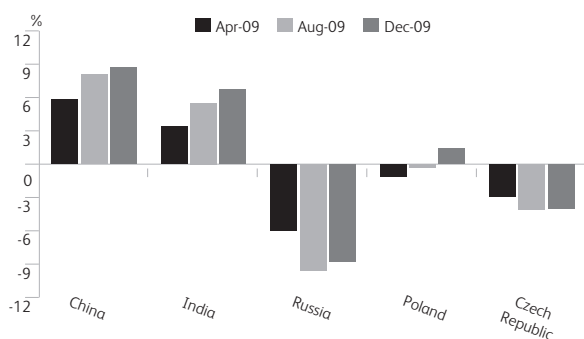
But what the Chinese government does next will determine whether growth will be plain sailing in 2010. Massive growth in investment raises the threat of China overheating. Lending will need to be curtailed if an inflation and asset price bubble is to be avoided.

In recent years UK manufacturers have made inroads into Middle Eastern markets. The construction boom and demand for oil and gas-related equipment provided a ready market for UK companies and growth in export sales to these markets had been predicted. The financial crisis in Dubai towards the end of 2009 and concerns that problems could be more widespread across the region will dampen capital flows, confidence and investment.

### Chart 6

#### *Asian markets did better than expected*

forecast % annual change in GDP in 2009



Source: Oxford Economics

Eastern European economies face similar risks. Exposure to foreign banks, non-performing loans and the ongoing risk of insolvencies complicate the outlook for Eastern Europe. Moreover, export-led economies, some with production concentrated in a narrow number of sectors, took a big knock in 2009. The prospects for 2010 are mixed and have risks attached. World trade growth will again play an important part in spurring a return to growth, but large fiscal deficits in some Eastern European countries will need continued tight expenditure control.

### *Emerging market forecasts*

% annual change in GDP

	GDP		
	2009	2010	2011
China	8.7	9.3	9.0
India	6.7	7.4	9.1
Brazil	0.0	4.9	5.0
Hungary	-6.5	-0.6	4.1
Russia	-8.8	4.3	4.8
Poland	1.4	1.7	3.0
Czech Republic	-4.0	1.8	3.4
Emerging markets	0.8	5.2	6.2

Source: Oxford Economics

The world economy as a whole contracted by around 1% in 2009 but we are forecasting growth in the region of 3.5% in 2010, strengthening in subsequent years. However, neither the developed world nor emerging economies are assured a problem-free year ahead and a number of potential risks and challenges could yet hit in the year ahead. For example, the recent lessons from Dubai and Greece highlight the continued risks to the global financial system.

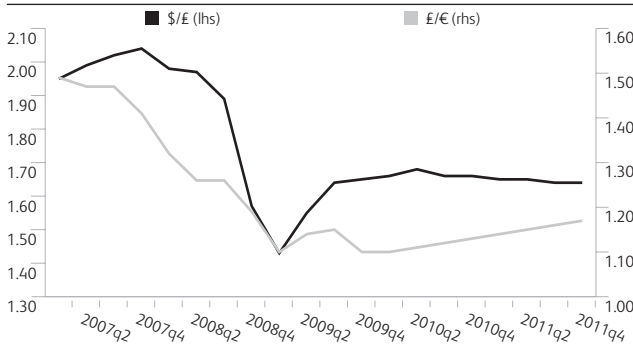
Moreover, the response to the initial financial crisis by governments and central banks across the world was a coordinated one. But it is not yet clear how individual countries will exit from temporary fiscal stimulus packages and monetary policy, which is a long way from normal, in 2010. We are also likely to see a greater emphasis on the supervision and regulation of financial markets, which in itself could pose some uncertainties in the year ahead.

While emerging markets look set to be the strongest performers again in 2010, we should not assume that global growth will return to business as usual. The process of addressing global account imbalances will need to begin this year, with growth in Asia being refocused on the domestic market and less on exports and vice versa in the developed world. How these challenges are tackled will also determine growth prospects in the year ahead.

Chart 7

*Expect more exchange rate volatility*

Average exchange rate



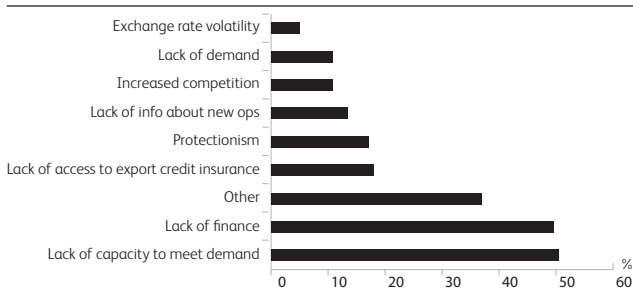
Source: EEF and Oxford Economics

Most manufacturers learned to live with a strong pound in the years prior to the recession, the financial crisis that began in the summer of 2007 kick-started a depreciation in Sterling. But the process hasn't been a smooth one. Having fallen by 25% between mid-2007 and the start of 2009, the broad effective exchange rate jumped by almost 10% in the first half of 2009. This volatility has proved costly for UK manufacturers, raising margins and costs rather than orders. In 2010, the sterling is likely to remain volatile as it gets caught between movements in financial markets and tensions between the dollar and renminbi.

Chart 8

*Concerns around volatility and the recovery*

% of companies citing risk to export sales growth in next 12 months



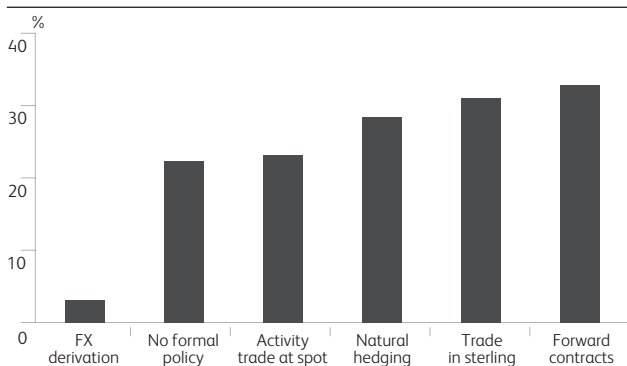
Source: EEF Export Survey 2009

Over the past year we've seen some sharp movements in Sterling. And with many manufacturers expecting their best growth prospects to come from Europe and North America, further volatility over the course of 2010 has been identified as a potential barrier to increasing export sales. An export-led recovery on the back of a weaker exchange rate is, therefore, not assured. A high degree of uncertainty around the direction of Sterling in the short term will inevitably impact not only pricing of new orders, but also on assumptions of imported input costs. The flipside is, that with Sterling at its current level the UK has become a more attractive place for investment for companies selling into the European market.

Chart 9

*FX management an inexact science*

% of companies using foreign exchange risk management



Source: EEF Export Survey 2009

Around half of manufacturers use some form, or combination of, foreign exchange risk management strategy. But this hasn't lessened concerns about the potential costs of exchange rate volatility. For much of this decade Sterling has been relatively stable against the euro. While the potential costs of large movements in exchange rates are greatest for those with a greater exposure to export markets, smaller companies can find their options for risk management limited by the size and volume of foreign currency transactions. This is especially applicable at this point in the upturn, when new orders are just starting to recover. Instability is always undesirable, but an unpredictable exchange rate can hit margins or lead to a more cautious approach to new markets – both of which could dampen an export-led recovery.

## Manufacturing

The middle of 2008 saw the beginning of the deepest manufacturing recession in the UK since the 1980s. The reverberations of the financial crisis hit industrial production hard across the world and UK manufacturers had to react quickly to a sudden and significant collapse in demand. Consumer-facing parts of manufacturing such as motor vehicles and sectors in the construction supply chain went into recession first. Throughout 2009 some sectors have seen unprecedented declines in output. Stimulus measures across the developed world aimed at boosting demand, such as the car scrappage schemes, helped put a floor under the recession. However, output levels are significantly below pre-recession levels.

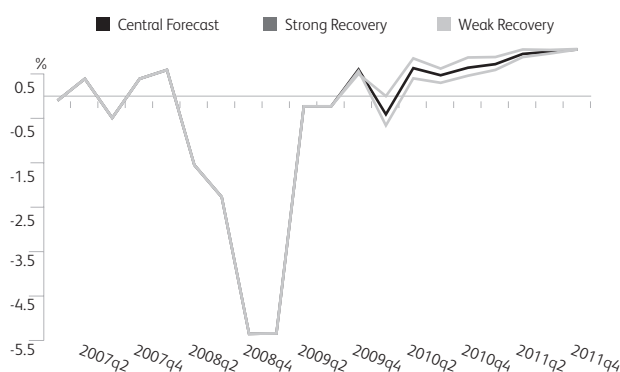
EEF's Business Trends Survey for the fourth quarter of 2009 showed that trading conditions had finally stabilised, with a balance of companies reporting an end to the decline in output and new orders. There were also tentative signs of an uptick in orders across some sectors, including mechanical equipment and electronics. However, companies remain cautious about recovery prospects. Our survey also pointed to expectations of similar conditions in the early months of 2010. Continued weakness in the UK economy and the end of a range of stimulus measures were contributing to a more cautious outlook.

The significant strides made by UK manufacturers earlier in the decade to improve productivity and competitiveness certainly put the sector on a stronger footing going into this downturn, compared with previous recessions. We've also seen many examples of close collaboration across the supply chain, which has lessened the number of insolvencies. But while the worst effects of the recession are now behind us, a number of issues that could choke off recovery remain. We have already identified some of the economic uncertainties facing companies in the UK; in addition continued pressure on working capital, an inability to finance new investment and persistent skill shortages could yet hamper a stronger recovery.

Chart 10

### Manufacturing output

% quarterly charge



Source: EEF and Oxford Economics

Much like the rest of the economy, manufacturing faces a weak start to the year. Uncertainty about the strength of the recovery, coupled with the end of scrappage scheme will curtail investment and production in the first quarter. But the slow start to the year will mask wide sectoral variations. Some sectors that are more exposed to global capital investment – such as mechanical and electrical equipment – will receive an immediate boost from export orders. Others, such as aerospace, defence and construction products, are likely to begin feeling the squeeze from public sector investment cuts. Companies that were able to retain skilled staff through the recession should be able to capitalise on a strong, export-led recovery. In contrast, further job cuts could be necessary if orders fail to materialise in a weak turnaround.

### Manufacturing forecasts

% change from previous period (unless otherwise stated)

	2010				2009	2010	2011
	q1	q2	q3	q4			
Output	-0.4	0.7	0.6	0.8	-10.7	1.2	3.8
Investment	-0.9	-0.4	0.0	0.3	-16.5	-6.3	2.5
Employment (000s)	2,510	2,495	2,483	2,472	2,571	2,490	2,450
Exports	0.8	0.5	1.0	1.4	-14.6	4.3	6.9
Producer prices (annual % change)	2.0	1.9	1.9	1.4	1.9	1.8	1.3

Source: EEF and Oxford Economics

## Manufacturing sectors – overview

Our central forecast of a muted manufacturing recovery in 2010 masks an extremely varied performance in some sectors over the next few years. While a diverse manufacturing base has been one of the UK's strengths, some parts of manufacturing responded more quickly to the challenges of globalisation than others. EEF research shows that some succeeded by providing unique products and solutions and complementing these with services. Others looked for new market opportunities; either geographical, industrial niches or in areas which offered environmental benefits for example.

Such strategies had underpinned buoyant growth, but were not necessarily enough to protect against the headwinds of a global downturn. While some sectors can safely say the worst is behind them,

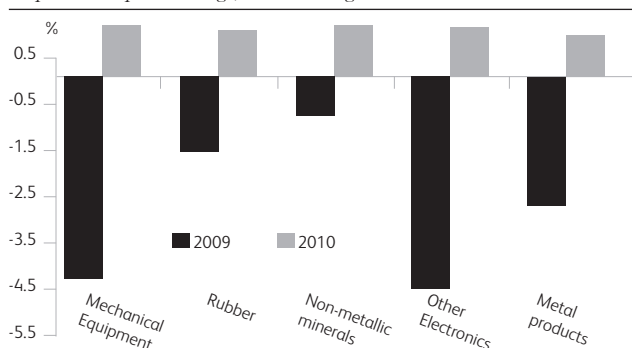
longer lead times in other means the pain is only just beginning. In contrast there are other industry sectors that have not felt the cyclical effects of a global downturn and others for which movement away from the UK, and developed economies more broadly, began long before the recent recession.

Here we look at examples of sectors in each of these categories. However even an assessment of future performance at the aggregate sector level will hide individual firm performance, where investment in the latest machinery, cutting edge design or a niche product or service will continue to provide growth opportunities in future. Our sectors forecasts provide an indication of where UK manufacturing's likely strengths and weaknesses will lie over the next twelve months and beyond.

Chart 11

### Leaders

% quarter-on-quarter change, annual average



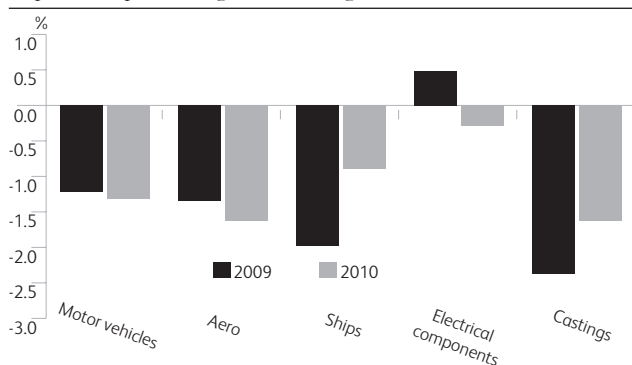
Source: EEF and Oxford Economics

The sectors that will lead manufacturing out of the recession are primarily those exposed to already growing export markets. Mechanical equipment, which includes domestic appliances, machine tools and agricultural equipment, is set to post strong quarter-on-quarter growth throughout 2010. UK rubber producers are set to benefit from significant demand from China and supply constraints from its Asian competitors. Other electronics is set to benefit from exports to Asian markets demanding electrical equipment that underpins the sharp rise in infrastructure investment. Non-metallic minerals will be buoyed by a weak pound, a pick-up in consumer spending and construction activity in export markets.

Chart 12

### Laggards

% quarter-on-quarter change, annual average



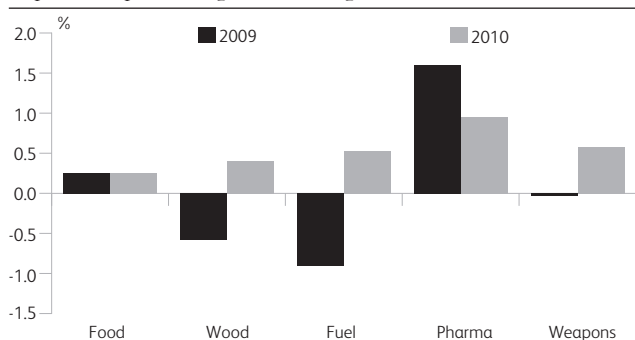
Source: EEF and Oxford Economics

Although the recession is technically over, many manufacturing sub-sectors will struggle through 2010. For example, long-lead times protected the aerospace, defence and shipbuilding markets from the worst of the recession. But output is set to fall this year as defence budgets are squeezed further and the civil aerospace market remains weak. Auto production will suffer a hangover in 2010 as the funding from the scrappage schemes in the UK, EU and US run out. Further down the supply chain, castings will be slow to turnaround from a bleak 2009. Production of electrical components, such as semi-conductors, is set to struggle through most of 2010 as the restocking cycle is set to end before end-user demand picks-up.

Chart 13

*Steady as she goes*

% quarter-on-quarter change, annual average



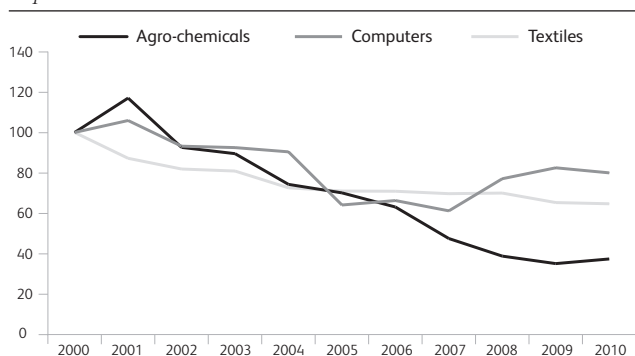
Source: EEF and Oxford Economics

Some manufacturing sectors have been cushioned from the effects of the global recession, and output levels have been increasing as a steady pace throughout 2009 and are expected to continue that trend during 2010. The food and drink industry saw a fairly stable performance in 2009 and manufacturers were able to respond to changes in household budgets by, for example, increasing focus on lower price ranges and offering fewer, stronger brands to the market. In contrast, pharmaceuticals output is driven by NHS spending and the risk of a swine flu outbreak has also boosted orders. Similarly, weapons and ammunition manufacture has seen robust growth in recent years as a result of increased defence spending.

Chart 14

*On the way out*

output 2000=100



Source: EEF and Oxford Economics

While some sectors have bucked the wider manufacturing trends, others have merely seen a continuation of the decline that was in train before the recession started. Manufacture of computers, for example has seen year on year declines in output since 2002. The commoditisation of computing equipment has led to a drift eastwards to lower labour cost economies. A similar trend has occurred in textiles, with relatively few plants able to compete with emerging economies producing for the mass market. The UK has however, retained its design excellence in this sector. Overall, the chemicals sector is forecast to recover in 2010, but agricultural chemicals have been in decline, as agriculture production in the UK has decreased. A pick up in food prices could provide some reprieve for the sector, but this is unlikely to be a long term one.

*Sector forecasts*

% change on previous period

	2010					2010			
	q1	q2	q3	q4		q1	q2	q3	q4
Food	0.3	0.4	0.4	0.6	Metals	0.0	0.6	1.3	1.5
Textiles	-0.7	-0.7	-0.6	-1.0	Metal Products	0.5	0.8	1.1	1.2
Wood	0.3	0.5	0.7	0.9	Mechanical Equipment	0.9	1.0	1.1	1.4
Paper	-0.2	0.2	0.4	0.6	Electronics	-0.4	0.1	0.3	0.5
Fuel	0.6	0.7	0.7	0.8	Electrical equipment	0.2	0.3	0.5	0.7
Chemicals	0.6	0.8	0.9	1.1	Precision equipment	-0.1	0.7	1.1	1.4
Rubber	0.6	0.9	1.1	1.4	Motor vehicles	-11.5	7.9	-1.3	-0.4
Non-metallic minerals	0.5	0.9	1.4	1.6	Other transport	-2.6	-1.9	-0.4	-0.8

Source: EEF and Oxford Economics

## Beyond 2010

As we look ahead to the next decade, there is still a lot to do to get the UK and global economies back on track. But a healthy, growing global economy could also create its own problems for economies and companies that aren't prepared. Volatile currencies, commodity prices and external imbalances will all continue to pose a threat to the UK and global economies beyond 2010.

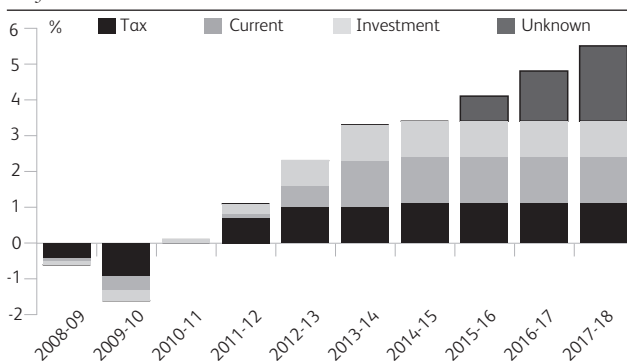
The UK's an over-reliance debt and finance for growth has brought home the need for the UK to develop a broader base for long term, sustainable growth. But economic disparities are not confined to the UK economy. Export-oriented economies, hard hit by the decline in world trade in 2009 will

need to refocus support on boosting the domestic economy and countries, like the UK, will need to rethink how they will pay their way in the world in future if twin fiscal and trade deficits are to be addressed. But rebalancing is unlikely to be a smooth process. The necessary adjustments will increase the risk of sovereign defaults, complicate central banks plans to unwind extremely loose monetary stimulus, raise the probability of protectionism and aggravate demand and supply tensions as trade flows adjust. How individual countries and the international community manage these challenges will determine the prospects for UK and global growth beyond 2010.

Chart 15

### Fiscal repair still needed

% of national income

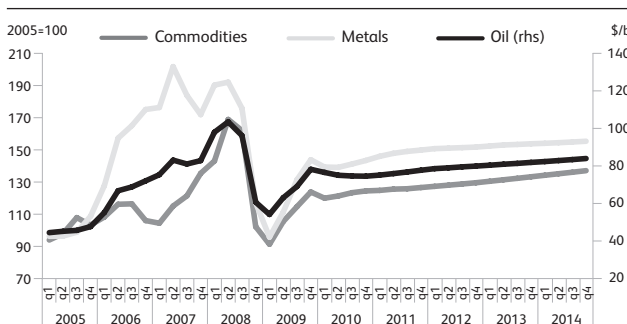


Source: Institute for Fiscal Studies

The election battle lines have been drawn over plans for tax and spending and calculations from the Institute for Fiscal Studies show the scale of the repair work that needs to be undertaken. And on its current trajectory debt as a share of GDP is unlikely to fall back until 2015/16. Consequently, the UK's economic prospects over the next decade are inextricably linked to how a new government manages the necessary fiscal without tipping the economy back into recession. The pain of this tightening, therefore, needs to be mitigated through broader-based and export driven growth. But that will only happen if the world's surplus economies – primarily China – expand their domestic economies fast enough and allow their currencies to adjust appropriately.

Chart 16

### Another spike in store for commodity prices?



Source: EEF and Oxford Economics

A return to global growth, however, could re-ignite the demand and supply tensions behind the sharp rise in commodity prices before the recession. The downturn has allowed the economies around the world to avoid fairly challenging questions about the security and costs of their food, energy, water and raw materials supplies. Some companies have already begun to adjust their supply chains to avoid exposure to sharp rises in commodity prices. But another spike in prices would be another hurdle to overcome at a time when most countries are already undergoing potentially painful economic adjustments.

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## About us

EEF is dedicated to the future of manufacturing. Everything we do is designed to help manufacturing businesses evolve, innovate and compete in a fast-changing world. With our unique combination of business services, government representation and industry intelligence, no other organisation is better placed to provide the skills, knowledge and networks they need to thrive.

Around a quarter of the UK's manufacturing businesses are our members and many more use our services to help them work better, compete harder and innovate faster. Because we understand manufacturers so well, policy makers trust our advice and welcome our involvement in their deliberations. We work with them

to create policies that are in the best interests of manufacturing, that encourage a high growth industry and boost its ability to make a positive contribution to the UK's real economy.

Our policy work delivers real business value for our members, giving us a unique insight into the way changing legislation will affect their business. This insight, complemented by intelligence gathered through our ongoing member research and networking programmes, informs our broad portfolio of services; services that unlock business potential by creating highly productive workplaces in which innovation, creativity and competitiveness can thrive.

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Most manufacturing clients are now active internationally. So are we and in regions that are important to manufacturing. Most are involved in acquisitions, public offerings and major capital projects. We have great experience in these areas. Our manufacturing clients have regulatory, reporting and legislative issues. We bring sector expertise and a proactive approach to assist. Our clients want to mitigate and manage tax liabilities globally. Our international specialist teams have the skills to assist. Manufacturing remains one of the key industries of the UK economy. We are delighted to be able to play an active role in supporting the businesses that operate in this vibrant, changing and challenging sector.

To talk about any issues your manufacturing business may be facing please contact Tom Lawton, Head of Manufacturing at BDO LLP, on 0121 352 6200 or 07778 343346 or email [tom.lawton@bdo.co.uk](mailto:tom.lawton@bdo.co.uk)

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