ECONOMIC PROSPECTS 2010

AUGUST 2010

EEF's analysis of economic prospects for the year ahead

eef The manufacturers' organisation

In partnership with BDO

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At the beginning of this year the UK economy had yet to officially emerge from recession and the prospects for recovery looked very uncertain. Many of the challenges and risks to growth that were with us in the midst of recession continued to linger. We had, however, expected growth to return this year with a modest expansion in GDP over the year, driven by inventories and net trade, deemed the most likely.

What we've seen in the year so far is the beginnings of a moderate recovery in the UK economy with growth of 0.3% and 1.1% in 2010q1 and 2010q2 respectively. Comparing this with our forecast earlier in the year, the recovery has not shaped up as we were expecting. The economy avoided a dip in the first quarter of the year despite many of the fiscal stimulus measures to support spending coming to an end. But growth has largely been underpinned by government spending and ongoing inventory adjustments.

We did, however, see a positive contribution to growth from investment in the first quarter of the year. Temporary changes in the tax system may have led businesses to pull forward investment spending before they expired, meaning this contribution may not be sustained in the remainder of this year. Net trade has been a continued drag on growth in the early part of this year – exports have been growing, but imports have also picked up. The combination of a disappointing trade contribution and uncertainty over continued growth in investment raises questions around whether the UK economy is on the path to a better balanced economy.

Recovery building slowly

% change since end of the recession

	GDP	Industrial Production	Exports	Employment
UK	1.8	2.4	3.1	-0.6
France	1.6	6.2	6.8	-0.9
Germany	2.3	9.6	7.8	-0.2
Japan	4.4	29.4	46.0	-0.9
US	3.5	7.5	14.9	-0.8
Eurozone	1.0	6.5	7.8	-1.1

Source: Oxford Economics and EEF

2010 & 2011:

The second half of 2010 will seem like much of the same as the past few months. The UK economic recovery will rumble on, potentially stumbling, as the government presses ahead with fiscal consolidation and global markets remain unsteady. Sovereign debt fears will persist through the end of 2010 and into 2011, even as the growth versus austerity debate continues to infatuate economists and politicians, but worry already cautious households and businesses.

For the UK, the challenge through the end of 2010 is establishing clear momentum behind the recovery before the tax rises and public spending cuts begin in 2011. While the VAT rise in January might encourage extra spending during the holidays, households are unlikely to shed their cautious mentality. The prospect of tax rises, higher interest rates and job losses is likely to hold back consumer spending.

Another key economic risk is political, as the strength of the coalition government will be tested as October's Comprehensive Spending Review will make clear the severity and the details of the public sector spending, pay and job cuts. And in 2011, a referendum on electoral reform will test the coalition yet again and raise the prospect of another election. Beyond 2010, the economic challenge for the UK comes from the pace at which the private sector can fill the void left by public sector retrenchment.

The clear risk to global growth is that the US or the Eurozone slips back into recession, that China struggles to engineer a soft landing for its inflated economy or that a sovereign default breeds contagion spreads the crisis to other over-indebted economies. Consequently, financial markets are likely to remain volatile until the global recovery takes root in solid ground.

For the UK, this means that gilts will remain close to historically low levels over the next twelve months. Sterling, however, is likely to remain volatile as it fluctuates in response to the latest economic news and as international capital switches between an appetite for risk and the search for safe havens.

UK Outlook

At the start of year, we noted that the recovery was likely to be sluggish over the first half of 2010 as consumers remained cautious and business investment struggled to gather pace. While we thought that a double dip into recession was just as likely as a strong, export-led boom, the actual recovery has followed fairly closely to our central forecast for a modest, uncertain upturn.

Consumers have continued to save, pay down debt and reign in their spending. Businesses have exploited fast growing Middle and Far East markets, but kept investment on hold because of uncertainty in bigger, traditional markets in Europe and North America.

Many of the risks to growth in the second half of 2010 remain the same as at the start of the year. The strength of private sector investment and export growth will be determined by the strength of the recovery in key export markets, notably Europe, China and the US. The stronger, more sustainable economic growth proves to be in these economies, the faster exports demand will firm up and businesses will have the confidence to spend their cash on new investments.

Domestic economic policy, however, has become a greater risk to the recovery. In January, the looming election had fostered a degree of economic uncertainty. Now with the coalition government in place, the Emergency Budget set out £8bn in tax rises and benefit cuts by 2014-15. Meanwhile, the economic impact of looming public sector spending and job cuts will only be felt over the next few years.

However, businesses and households will also be acutely affected by the dilemma facing the Bank of England (BoE). The Monetary Policy Committee (MPC) would prefer to keep its base rate – currently at 0.5% – stable or low during a tough period of fiscal consolidation. The UK, however, is facing persistently high inflation even as the recovery struggles to gather pace. Given the depth of the recession, a few on the MPC believe that there is enough slack in the economy to keep inflation in check while also allowing for strong economic growth. But others think that there's less spare capacity in the economy, and inflation could remain stubbornly high because consumers expect it to increase even further over the next two years.

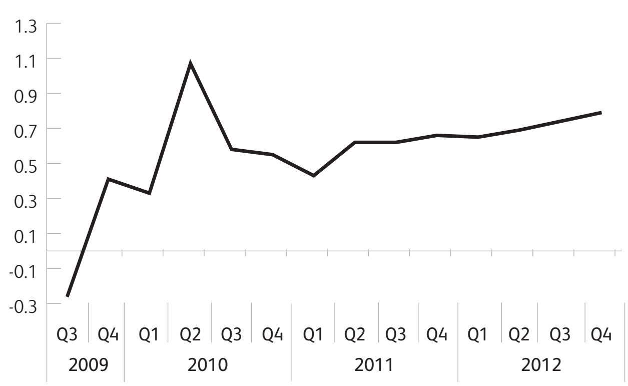
What are the risks to businesses and households if the MPC gets the judgement wrong? Persistently rising costs and higher interests rates over the next few years. For already cautious consumers and businesses, this would put a further break on spending and investment, curtailing future economic growth.

The dilemma for the MPC is whether to expand quantitative easing to stimulate growth or to push interest rates higher to bring inflation and inflation expectations under control. How the MPC balances will be just as important as public sector spending cuts in determining the strength of the UK's economy and the fortunes of businesses and households over the next year.

Chart 1

The recovery to remain bumpy

% quarter-on-quarter change in GDP



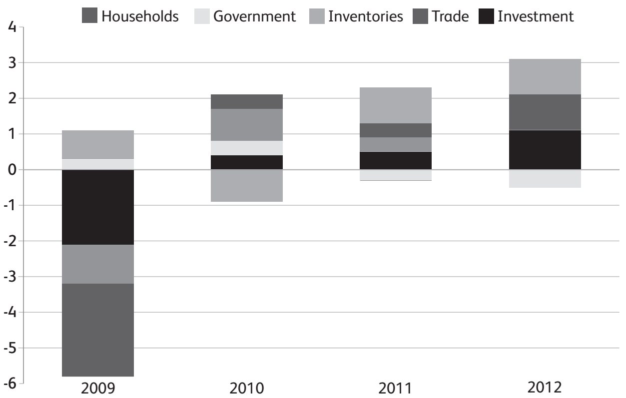
Source: EEF and Oxford Economics

Our central forecast is for economic growth to remain bumpy over the next 12 months. Subdued and uncertain growth in key markets will reinforce business caution and keep investment on hold. Meanwhile, the VAT rise to 20% from 04 January 2011 will knock consumer spending slightly, further limiting the strength of the recovery. Most of the growth in the first half of 2010 came from the inventory cycle and a modest pick-up in non-manufacturing investment. The boost from restocking will be temporary and as that wanes, muted consumer spending and business investment will struggle to make-up for retrenchment in government consumption and the drag from net exports. However, the risk of double-dip recession is still only moderate – the current recovery is likely to mirror those of the 80s and 90s when growth bounced around for a few quarters before ultimately stabilising.

Chart 2

A modest beginning to rebalancing?

Contributions to growth



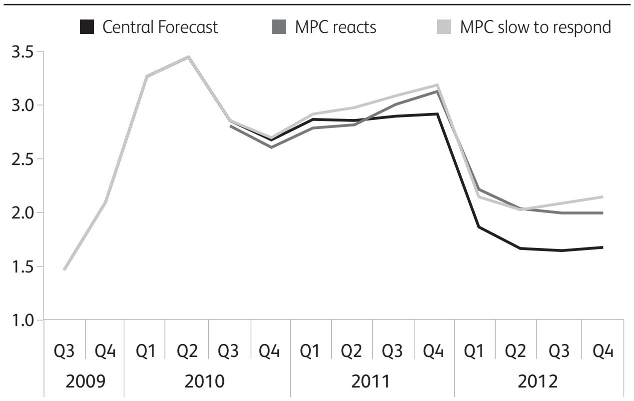
Source: EEF and Oxford Economics

Although the recovery remains shaky, the economy is likely to begin to see some rebalancing in the sources of economic growth over the coming quarters. Weak consumer spending in advance of the VAT rise, the last boost from the inventory cycle and net trade are most likely to generate the 0.5% growth we are forecasting for q3 and q4 this year. Heading into 2011, however we start to see modest, though not substantial, contributions from investment and net exports, even as the fiscal consolidation sets in and begins to drag on the economy. Yet this highlights the risks to growth, especially from business investment and trade, both of which depend on sustained demand from global markets.

Chart 3

Inflation could prove a persistent problem

% change a year ago



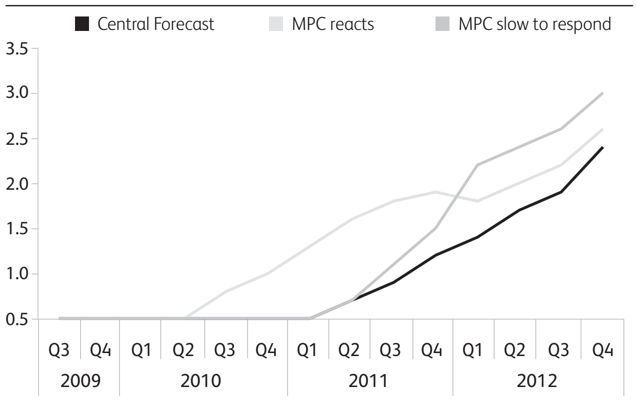
Source: EEF and Oxford Economics

Because of the VAT rise, inflation is set to remain higher than the Bank of England's 2% target through 2011, before falling well below target in 2012. But low levels of investment, rising numbers of long-term unemployed and smaller finance and public sectors may have reduced the spare economic capacity of the economy. As the chart shows, if there is less spare capacity and the MPC is slow to recognise it, then inflation will remain at or around 3% for much of the next 18 months. But if there is less slack and the MPC quickly responds, then it will be able to get inflation in line with its target, keeping price pressures in check.

Chart 4

Interest rate changes likely in next 12 months

%, Bank of England base rate



Source: EEF and Oxford Economics

The MPC is likely to keep rates on hold until it gets a better sense that the UK and global recoveries are sustainable or until it feels that inflation risks getting out of control. If spare capacity does not dampen inflationary pressures, the MPC could be forced to move on interest rates as early as q3 2010. If there is less slack in the economy and the MPC decides not to act, the base rate would stay lower for longer, but would need to rise rapidly in 2012 as the MPC tried to stamp out stubbornly high prices and persistent inflation expectations. The MPC, therefore, faces difficult decisions in keeping one eye inflation and the other on growth.

The 'Two-thirds Way' – The economics of coalition

In some ways the coalition government's economic policies were always going to be dictated by the prevailing economic and fiscal situation. At a time when the UK's public sector net debt stands at nearly 64% of GDP, tax rises and cuts to public sector spending were more or less inevitable. But the choices the government takes in how to raise taxes and cut spending says as much about the state of the economy as it does about the government's economic world view.

The coalition's approach – somewhere between the Third Way and Thatcherism – is based around a faith in markets and business. This "Two-Thirds Way" believes that our economic competitiveness requires a smaller government and smaller government debt, as it believes this will reduce long-term interest rates and encourage private sector investment and growth. In the Emergency Budget, however, it appears a traditional free market purist approach has been tempered by a concern for low-income earners, as business taxes were cut alongside a higher personal allowance threshold for income taxes.

The government also departed from the traditional free market approach with some more interventionist tax measures, including the banking levy and creating tax incentives for start-ups to locate outside of the greater South East. The "Two-Thirds Way" is ultimately pro-market, but sees a distinct, yet targeted role for government in encouraging investment and regulating business.

Shifting economic philosophies since the 1980s

	Obamanomics	The Third Way/ Rubinomics	The Coalition's "Two-Thirds Way"	Thatcherism/ Reganomics
	Public investment ←			→ **Tax cuts**
Finances	• Increasing public infrastructure spending is seen as an investment in the economic future. • No particular emphasis on immediate budget restraint.	• Rubinomics promoted deficit reduction to stimulate private investment • UK Third Way economics focused on fiscal/monetary responsibility, with spending for investment	• Prioritises deficit reduction to stimulate private investment • Deep cuts to government capital spending, but offset by business tax cuts and incentives	• Belief in low tax and low spend • Focus on low public sector debt
	Government-supported ←			→ **Market-led**
Growth	• Properly regulated free markets should reward hard work and effort. • Public spending can be used to spur on growth at a time of limited private sector demand.	• Used economic prosperity and growth to support social policy and welfare. • Public investment in human and physical capital deliver longer-term growth	• Belief that markets, with only targeted state interventions, are best for growth. • Promote a competitive business environment with targeted tax cuts to boost jobs and business growth.	• Growth through private sector and opening up new markets • Tax cuts seen as a way to spur on growth and jobs and to encourage people to save, invest and take risks.
	Broad-based support ←			→ **Minimal interference**
Welfare	• "Bottom-up economics": making government work for all people and not just the better off. • Defends social welfare policies.	• Believed that it is the state's role to tackle social exclusion through investment in education and communities. • Welfare combined with support to return to work.	• Welfare budgets cut with the aim to provide incentives to work. • Benefits means-tested to minimise cost • Belief in less state involvement and a 'Big Society' with civic provision of public services.	• Welfare to work policies focused on providing a minimum of support to encourage jobless to look for work.

Signs of the recovery…or a return to recession

Whilst most official statistics and data can only tell us what has already happened, these leading indicators provide signals as to where the economy is headed. There are some signs of strength – with order books and temporary recruitment growing – but there are also signs of ongoing under-employment of workers and slack global demand. While current data show some reason for optimism, the leading indicators raise questions about the sustainability of the recovery.

Production		
⇔	New orders	EEF's business trends survey showed that New Orders were on the up, with a balance of 26 % of companies experiencing increased orders in 2010q2, and 15 % expecting to see increased orders in 2010q3.
Labour Market		
⇔	Recruitment of temporary workers	REC's report on jobs for June 2010 showed that whilst the recruitment of temporary workers is rising, it is now rising at the slowest rate for seven months. Pay rates for temporary/contract staff also rose in June, though at lower levels than the long-term average.
↓	Hours worked	The number of people working part time has risen considerably. However, the proportion of people taking a part-time job because they cannot find a full time job stood at 13.9 % in Mar-May 2010, compared with 9.2 % over the same period in 2008.
International trade		
↓	Freight index	The volatile lately, as of 20th July, the Baltic Dry Index (BDI) had fallen by almost 60 % since the end of May. While consistent with contracting trade, the steep fall also reflects a recent increase in the number of ships (which reduces freight costs) and Chinese stockpiling of iron ore (which reduces freight traffic). However, US road and rail freight indicators have also shown falls in traffic, suggesting trade and economic activity remains subdued.
Households		
↓	New house buyer enquiries	After several recent rises, the number of new buyer enquiries fell back in June 2010 according to the RICS housing market survey. At the same time, the number of new instructions rose, which is likely to put a downwards pressure on prices.
⇔	Expectations of household finances	Expectations of household finances in Nationwide's consumer confidence survey had been improving to start the year, but fell back in May and remained flat in June. Largely reflecting a negative jobs outlook, a balance of 0 % of households expects their financial position to improve in the next six months.

UK Forecasts

% change from previous period (unless otherwise stated)

	2010		2011		2009	2010	2011
	q3	q4	q1	q2			
Output							
GDP	0.5	0.5	0.35	0.6	-4.9	1.1	2.1
World Trade Index	1.6	1.4	0.3	2.67	-13.1	9.7	6.7
Costs and prices							
Consumer Price Index (% y-y)	2.85	2.67	2.86	2.85	2.2	3.1	2.9
Average earnings (% y-y)	2.7	2.3	1.66	1.86	2.0	2.9	2.0
Oil price ($/barrel)	72.0	72.0	74.5	77.2	74.7	72.0	81.6
Employment							
Employment (000s)	26,456	2,436	26,427	26,426	26,670	26,477	26,436
Unemployment (000s)	2,495	2,521	2,549	2,568	2,420	2,489	2,569
Unemployment rate (%)	8.0	8.1	8.2	8.2	7.7	8.0	8.2
Currencies							
Exchange rate (€/£)	1.27	1.33	1.33	1.33	1.12	1.23	1.33
Exchange rate ($/£)	1.46	1.44	1.40	1.40	1.57	1.49	1.39

Source: EEF and Oxford Economics

International Outlook

- A halt to recovery in the developed world will have implications for global growth
- Despite an earlier start to recovery risks are building in Europe
- US growth could also be knocked off course
- Emerging economies continue to lead the way

While the global economy has been in recovery mode for much of the past year, the major risk to demand for future exports is continuing problems in Europe from the speculation of possible sovereign debt defaults. Strong growth in emerging economies and a stronger-than-expected first half of 2010 performance from the U.S. recovery have offset these risks somewhat.

Europe – Recovery faltering?

The recovery that began to take hold in 2009q3 has faltered with forecast growth weaker than previously expected across the eurozone for 2010 and 2011. Growth is also likely to be uneven; 'peripheral' eurozone countries (e.g. Spain) face weaker prospects with risks of defaulting on sovereign debt, following in the footsteps of recent difficulties in Greece [see sovereign debt pullout].

These sovereign debt risks have raised government financing costs and are driving faster and deeper fiscal recovery plans – in turn a further risk to growth if private demand cannot pick up sufficiently.

'Core' eurozone countries (e.g. Germany) face the prospect of co-financing any necessary sovereign bailouts as well as softening in their own domestic demand. Short-work job protection schemes may lead to jobless recoveries in some countries with a decline in competitiveness a legacy of supporting inefficient firms. This underlines the dependence on exports for any boost to expected growth.

The introduction and coordination of levies on banks to guard against another financial crisis as well as the continuing desire of banks to strengthen their balance sheets will be a constraint on lending supply right across Europe.

Further weakness in Europe will lower demand and push sterling up relative to the euro, undoing some of the increase in competitiveness for UK exports from depreciation during the recession.

U.S. – Recovery under threat

The U.S. recovery continues to build with growth forecasts revised upwards for 2010 and 2011 on the back of strong increases in domestic demand in the first half of 2010. Facilitative fiscal and monetary policy has played an important role in this boost to domestic demand. As did low Federal fund rates, which are likely to continue through 2010 as inflation is forecast to remain low.

However, fiscal policy is now entering a phase of consolidation with temporary measures being withdrawn (e.g. federal housing tax credit) and improvements in the fiscal balance required to stabilise federal debt. There are also some signs that consumer confidence is abating, leading to weaker growth in the second half of 2010.

The main risks to sustained growth in the U.S. are fragilities in domestic demand, weak credit conditions, and the implementation of financial reforms. Domestic demand is threatened by persistently high unemployment and a soft housing market. Credit conditions remain weak, especially for small, creditworthy firms trying to secure loans.

The moderately improved scenario for the U.S. relative to January's expectations is good news for UK manufacturers though this is likely not sufficient to offset the poorer prospects from the EU.

Headline forecasts

% change on a year ago

	GDP			Inflation		
	2009	2010	2011	2009	2010	2011
France	-2.6	1.3	1.7	0.1	1.6	1.7
Germany	-4.9	1.7	1.7	0.3	1.1	1.4
Japan	-5.3	2.8	1.4	-1.4	-0.7	0.3
US	-2.4	3.1	3.3	-0.3	1.4	1.6
Eurozone	-4.1	0.8	1.3	0.3	1.5	1.5

Source: Oxford Economics

Emerging economies

Emerging Asia has surpassed expectations so far this year. A strong recovery has continued in the region's economies over the past six months as global demand, the inventory cycle and growth in domestic consumption combined to boost activity in the first half of 2010. Activity indicators for both manufacturing and services have pointed to a robust expansion in Asia's largest economies with other Southern and Eastern Asian economies benefiting from the rise in intra-Asian trade flows.

Despite being growth hotspots, emerging Asia is not immune from risks in the second half of the year. We previously highlighted the threat of overheating in China and in recent months we've seen steep rises in property prices which the authorities are seeking to mitigate with policies to curb real estate speculation. But inflation is also on the rise and wage pressures are building.

The most recent indicator from China suggest that the pace of acceleration is starting to moderate (see chart 7). The exposure of China and other export-focused Asian economies to Europe poses a further downside risk to our forecast of 8% growth in Emerging Asia for 2010 and 7.3% in 2011.

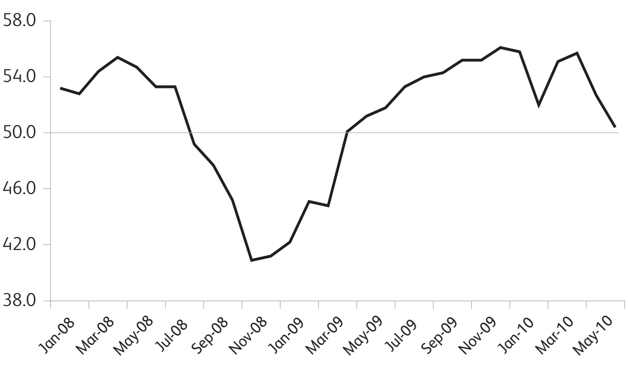
Other emerging markets face similar risks from a slowdown in the developed world – around two-fifths of Brazil's merchandise exports and are destined for the eurozone and the US. Economic reforms in Brazil and other parts of Latin America meant the impact of the global downturn was less pronounced and the region is on course for growth of more than 4% this year and next.

However, closer to home, the greater reliance of emerging Europe and Russia to Europe, the need to repair public finances and a still fragile banking sector will limit the pace of economic recovery in the region. Despite the recent problems facing the eurozone economy, Estonia will become the 17th member of the currency bloc on the 1st January 2011.

Chart 5

Expansion moderates in China

index of manufacturing activity, 50 = no change



Source: China Economic Net

Emerging market forecasts

% annual change in GDP

	GDP		
	2009	2010	2011
China	9.1	9.4	9.1
India	6.7	8.2	8.3
Brazil	-0.2	7.0	4.7
Hungary	-6.2	0.9	2.8
Russia	-7.8	5.0	4.8
Poland	1.9	3.0	3.4
Czech Republic	-4.0	1.4	2.6
Emerging markets	1.4	6.3	6.4

Source: Oxford Economics

Sovereign debt

Governments greatly increased sovereign debt to finance policies to help fight the recession. The growing level of debt has incurred rising interest payments. If governments continue to tax and spend at current levels, debt will keep growing.

High sovereign debt and uncertain growth prospects have led to doubts about whether some countries will pay back their debts at all. Banks hold most government bonds – and bonds make up a large proportion of their total assets. If countries default on their sovereign debt, banks may collapse. The interconnection of banks to other parts of the economy means this would transmit a major shock.

Higher risk of default leads to investors requiring higher compensation – sovereign debt becomes more expensive for governments.

Problems in Europe

Some eurozone countries, especially Greece, are at risk of default because fiscal consolidation is difficult given high debts and weak growth prospects.

Individual members of the euro cannot depreciate the currency to improve the relative competitiveness of their economies. The euro reflects the strength of the overall eurozone economy and may hinder export growth for the least competitive countries.

The slow speed of eurozone decisions has exacerbated difficulties. Germany's delay on agreeing terms for a Greek rescue package made it more expensive and heightened investors' fears.

However, the Europeans have demonstrated strong political will to keep the currency union together, at least for now. The agreement of the Greek package and the creation of the European Financial Stability Fund seem to have stemmed speculation of an imminent default.

Further out, uncertainty remains. The medium term future of the euro will depend on fundamental structural reform to boost competitiveness. This will require tough decisions at the national level for the least competitive countries and reform to the EU's governing principles – a process that has hardly been swift or easy in the past.

Manufacturing

The run of manufacturing data since our last report has been consistently upbeat. The latest official statistics for the first half of the year point manufacturing being on track to post the strongest growth in a sixth month period since 1994. In addition, the EEF/BDO Manufacturing Outlook reported some of the strongest balances on record in the second quarter of this year. Comparing this to our forecasts earlier in the year, the outturn has been considerably stronger than even our best case scenario. The first quarter dip that we had pencilled in as a result of stimulus being withdrawn from the economy didn't materialise as restocking and demand in both the UK and overseas markets more than compensated.

Notably, virtually all manufacturing sectors, with the exception of textiles and wood products, have seen some growth in the first half of the year – pointing to a broad based recovery across industry. But the positive trends so far this year will have to continue for some time to reverse the decline during recession as output remains more than 10% below its pre-recession peak.

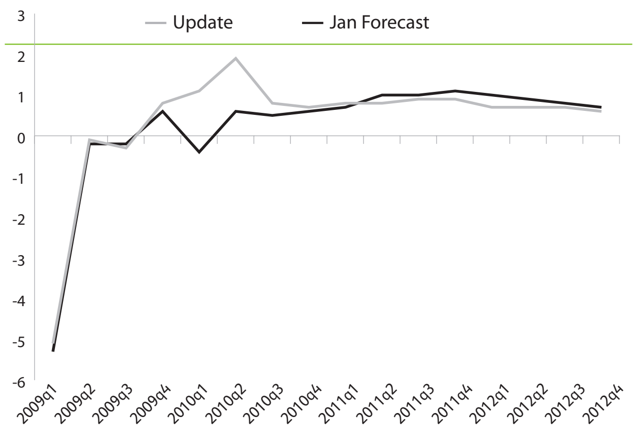
The turnaround in conditions at the end of 2009 tallied with a reversal of fortunes in the world economy and a rebound in world trade flows. While across the economy as whole net trade has yet to make a positive contribution to growth, manufactured exports have been rising faster. Again, actual growth in exports in the first half of the year has exceeded our previous forecasts.

Last time we highlighted a degree of caution amongst manufacturers about the strength of recovery. This remains the case. Order books may be starting to fill up, but anecdotal evidence suggests that volumes are relatively low. Credit conditions also remain largely unchanged from the beginning of the year and problems with access and cost of finance could still constrain some manufacturers. But the biggest risk remains the health of demand in key markets.

Chart 6

Early recovery stronger than expected

% quarter on quarter change in output



Source: EEF and Oxford Economics

The recovery in UK manufacturing now appears well underway. Indeed, the sector was faster off the starting blocks than we had anticipated earlier in the year. Growth of 1.4% and 1.6% in 2010q1 and 2010q2 respectively has been considerable stronger than forecast and faster than that across the economy as whole. Some of this improvement in the early part of the recovery will be in response to restocking and the quarter on quarter increase in output looks set to ease through the second half of this year, remaining fairly stable thereafter in 2011. Greater sectoral variation is also likely to emerge, particularly as public spending cuts start to bite – both domestically and in key markets. Despite the above trend growth forecast, we are not expecting a corresponding turnaround in job numbers.

Manufacturing forecasts

% change from previous period (unless otherwise stated)

	2010		2011		2009	2010	2011
	q3	q4	q1	q2			
Output	0.8	0.7	0.8	0.8	-10.6	3.8	3.4
Investment	-0.8	1.3	2.4	2.3	-21.1	-14.4	7.3
Employment (000s)	2,480	2,469	2,464	2,456	2,570	2,487	2,452
Exports	1.8	1.8	2.0	2.0	-14.6	8.9	8.0
Producer input prices (annual % change)	0.4	0.3	0.2	0.1	-14.3	10.6	1.3

Source: EEF and Oxford Economics

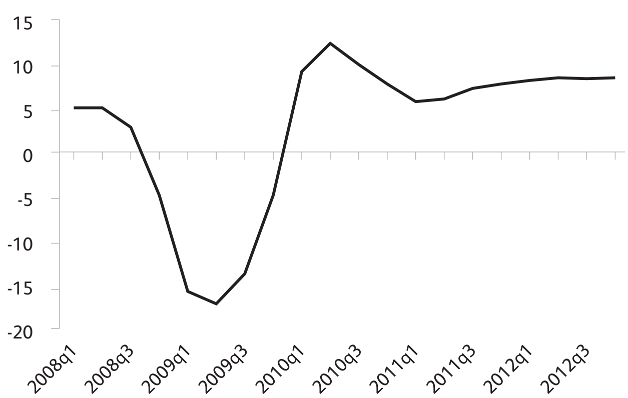
Trade & exports

Given the size of the domestic market compared to the expanding global one, it is unsurprising that exports are vital to UK-based manufacturers. In EEF's most recent export survey, conducted at the end of 2009, 58% of companies were expecting exports to increase this year from the trade lows of 2008 and 2009. How has this expectation stood up in the first half of 2010? According to our EEF's Business Trends survey export orders turned positive at the beginning of 2010 and a balance of 23% of companies saw an increase in export sales in the second quarter of the year – the highest ever recorded balance; a year previously the corresponding figure was -44%. Responses indicate increased demand from both EU and non-EU markets and exports have been boosted by the weaker sterling and a recovery in global demand.

Chart 7

World trade growth set to moderate

% change on a year ago



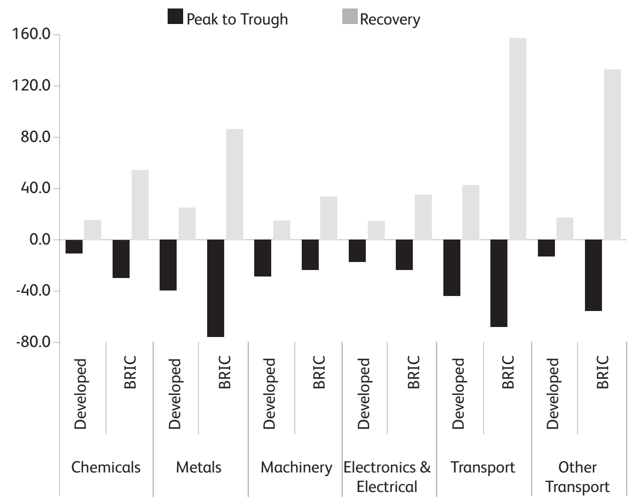
Source: EEF and Oxford Economics

The turnaround in world trade flows has been a driving factor in UK manufacturing's recovery. Growth ground to a halt in the middle of 2008, and following a 17% contraction, began to rise again in 2009q3. While the rebound has been rapid, the pace of growth in global demand is set to moderate from the latter part of 2010. A slowdown in the rate of expansion in Asia and growing downside risks to the recovery in developed economies means the pace of growth in world trade is likely to have peaked. Given the concerns we have highlighted about the eurozone's growth prospects, world trade growth could be more reliant on sustained growth in emerging markets. We expect trade to return to pre-recession levels in the second half 2011.

Chart 8

Greater recovery in exports to BRIC countries after recession

% change in export volumes from peak to trough and trough to latest volumes



Source: EEF and UK trade info (HMRC)

The chart shows the percentage change in UK export volumes to developed economies (EU27 and US) and the developing BRIC economies (Brazil, Russia, India and China) from the pre-recession peak to the trough of the recession as well as how much exports have recovered since that trough. No sectors were able to escape the collapse in world trade and exports were hit no matter where the destination. However, volumes have shown considerable growth since then which have contributed to UK growth as a whole. In all sectors, there has been larger percentage increases in exports to the developing BRIC economies than developed ones; particularly in the transport and metals sectors. Whilst trade volumes to these developing countries are less than those to developed countries they play no less greater importance – the demands from these countries help boost UK growth and will help bolster manufacturers should demand in developed economies begin to slow.

Manufacturing Sectors

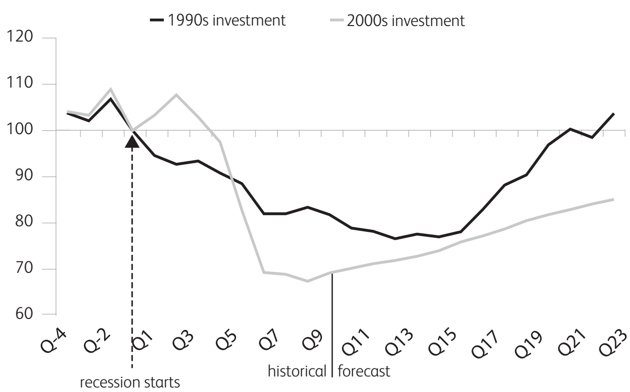
Our central forecast for manufacturing growth in 2010, of 3.75%, represents a sharp turnaround from the recession. However, there is likely to be considerable variation between sectors, with some recovering more quickly and others only expanding modestly, especially relative to declines during the recession.

In this section we review growth and investment prospects across manufacturing sectors as the recovery gathers pace. Although aggregated forecasts cannot predict the performance of individual firms – where investment, product development, and increased efficiency can all play a part – these forecasts will provide an indication of where the strengths and weaknesses of the UK economy will lie in the coming year.

Chart 9

Investment recovers slowly after recessions

(Investment quarter prior to recession = 100)



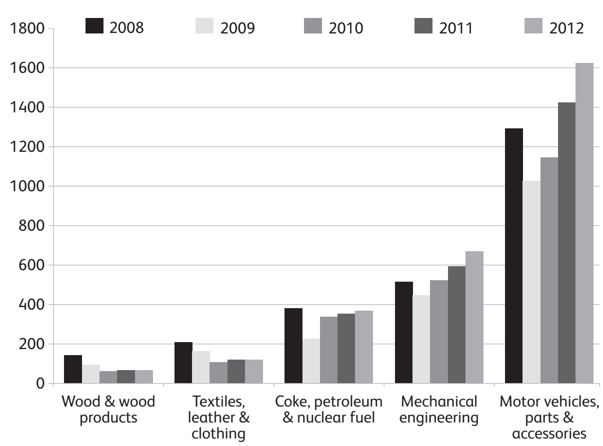
Source: EEF and Oxford Economics

It is not unusual for a recovery in investment to lag a recovery in growth. Confidence in the sustainability of the recovery will weigh on firms' investment decisions in the short term. In the 1990s investment did not return to pre-recession levels for five and a half years. If the recovery in investment levels takes longer this time, it will be because the fall in investment has also been deeper: nine quarters after the 1990s recession began investment had fallen by 17%, in this recession it had fallen by 33%. However, there are other reasons investment levels may remain low. The cut to capital allowances in the Budget and ongoing finance constraints will raise the cost of capital and slow investment growth. The Office of Budget Responsibility, however, is hoping that these factors will eventually be outweighed by lower corporate tax rates and lower long-term interest rates.

Chart 10

Investment returns in export oriented sectors

(£ thousands)



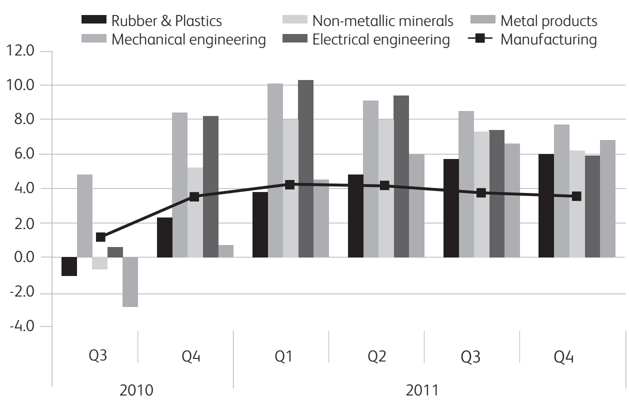
Source: EEF and Oxford Economics

Investment by manufacturing firms is expected to fall by 14.4% in 2010, but there is considerable variation between industries. For example, while investment by coke, petroleum and nuclear fuels firms is expected to grow by 49% in 2010, investment in by textiles companies is forecast to fall by 33% over the year. For coke, petroleum and nuclear fuels, however, the surge in investment follows a fall in investment of 41% in 2009. Other sectors are that are investing strongly include mechanical engineering and motor vehicles. These sectors also saw falls in investment during 2009, and are now increasing investment on the back of stronger order books, especially in export markets. Sectors where investment will remain well below pre-recession levels include wood and wood products, and textiles, where lower growth prospects are likely to be holding back investment.

Chart 11

Key sectors driving recovery forward

% annual change



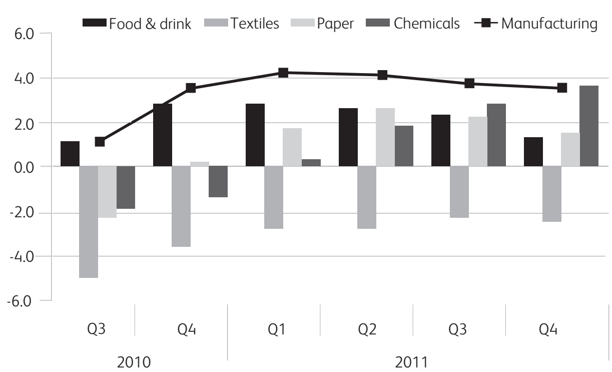
Source: EEF and Oxford Economics

Growth prospects for different sectors vary considerably through to the end of 2011. The largest output expansion relative to end of the recession lows is forecast to be in non-metallic minerals and mechanical engineering. Non-metallic minerals is benefitting from the slowly recovering residential construction sector and also from exports of glassware. Mechanical engineering experienced one of the largest drops in output during the recession and is highly cyclical – exports of machine tools should benefit from the depreciated sterling as the recovery takes hold. Rubber and plastics will benefit from strong emerging market demand as an input for tyres and cars and new industrial applications respectively.

Chart 12

Some sectors struggling to keep pace with recovery

% annual change



Source: EEF and Oxford Economics

Growth of less than 2% in 2011 is forecast for food and drink, paper and publishing and computers and office equipment with only modest expansion in these sectors since the end of the recession. Food and drink experienced only a modest decline in output during the recession and is already back to pre-recession levels, however growth remains subdued as retailers put pressure on profit margins and regulation on alcohol increases. Paper, printing, and publishing suffered a loss in demand from Eastern Europe during the recession only partially counter-balanced by strong Asian demand. Future paper prospects are threatened by increasing moves from newspapers to focus on online provision. Computers and office equipment had a less-than-feared decline in output during the recession but the threat of shifting to low labour cost countries remains with only weak to flat growth anticipated. Only textiles, leather, and clothing is forecast to contract over this period, as noted in January the recession has had a further impact but this sector is in long term decline in the UK.

Beyond 2010

Looking ahead to 2011 and beyond, the global economy will continue to rebalance in fits and starts. In the UK, 2011 will be the first full year of fiscal consolidation. But as the VAT rise to 20% in January will make consumption relatively more expensive, business confidence will be key to determining whether investment growth will pick up faster than it has after previous recessions. Further uncertainty could creep into the economy if voting reform leads to political tensions and the prospects of another election. But as long as the recovery remains relatively on track and the coalition sticks together, sterling will retain its safe haven status and long-term interest rates will remain helpfully low.

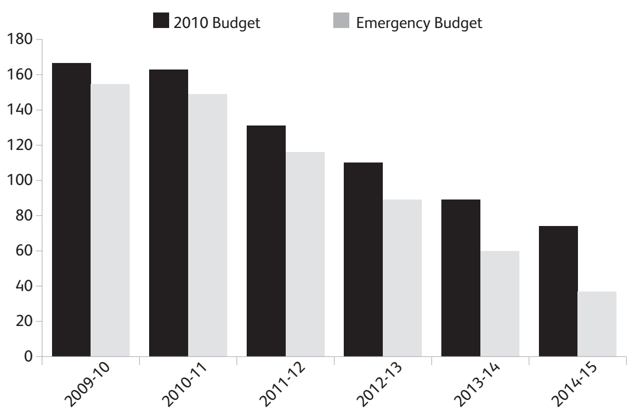
Key to global rebalancing will be how China and the US manage their economic tensions. The yuan is likely to continue a slow, managed appreciatic against the dollar, which should boost the competitiveness of US exports. Rising wage demands in China are likely to continue over the next few years, eroding its low-cost export advantage, but raising domestic spending power and consumption.

The sovereign debt crisis that began with questions being asked about Dubai and rapidly spread to Greece, Spain, Portugal and now Hungary, is likely to rumble on. One or more of these countries may need to restructure or default on their debt before they can put market pressure behind them.

Chart 13

Public finances on track

Public sector net borrowing (£bn)



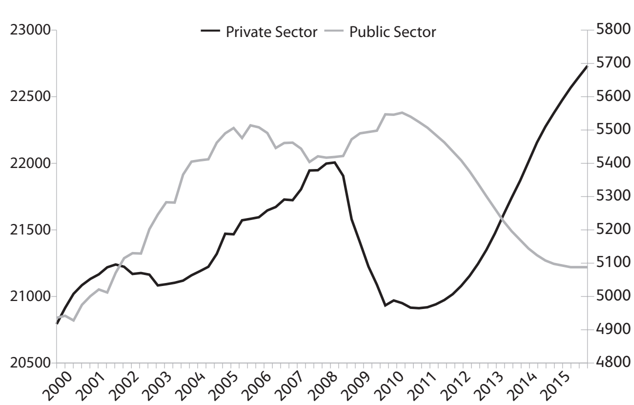
Source: HM Treasury and Office of Budget Responsibility

The 2010 Emergency Budget contained a large number of tax and spending initiatives, which are projected to deliver an additional fiscal consolidation of around £40 billion by 2014/15, over and above the measures included in the March Budget. By the end of the parliament, the consolidation is heavily weighted towards spending cuts rather than tax rises – with a ratio close to the 4:1 promised by the Conservatives prior to the election. By 2014/15, the deficit is projected to be around 2% of GDP lower as a result of the measures contained in the emergency Budget. While individual department spending totals won't be revealed until the Autumn, Ministers will be spending the Summer identifying cuts of around 25%–40% of their budgets.

Chart 14

Job growth in 2011 to remain muted

Employment (millions)



Source: EEF and Oxford Economics

Although unemployment levels remained relatively low during the recession there are likely to be significant public sector job losses over the next five years. While the government is already beginning to shed employees, the job losses are likely to be spread out over a period as spending cuts begin to bite. Although the private sector is likely to begin creating job in earnest beginning at the start of 2011, it won't create enough jobs to offset public sector cuts until the first half of 2012. Households, therefore, are likely to remain cautious about spending deep into 2011 and the beginning of 2012 as former public sector workers struggle to find work in a relatively jobless private sector recovery.

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