Economics Weekly

20 October 2008

Uncertain outlook for UK economy

Client support

Economic Research Team

Trevor Williams
0207 158 1748
trevor.williams@lloydstsb.co.uk

Nichola James
0207 158 1741
nichola.james@lloydstsb.co.uk

Jeavon Lolay
0207 158 1742
jeavon.lolay@lloydstsb.co.uk

Hann-Ju Ho
0207 158 1745
hann-ju.ho@lloydstsb.co.uk

Kenneth Broux
0207 158 1750
kenneth.broux@lloydstsb.co.uk

Rabia Bhopal
0207 158 1747
rabia.bhopal@lloydstsb.co.uk

Nikesh Sawjani
0207 158 1749
nikesh.sawjani@lloydstsb.co.uk

Paul Rodriguez
0207 158 1744
paul.rodriguez@lloydstsb.co.uk

Distribution

Sarah Pedder
0207 158 1746

Information Manager

Hugh Green
0207 158 1740

Customer sales

Andrew Willett
0207 158 1616
andrew.willett@lloydstsb.co.uk

John Haines
0207 158 1675
john.haines@lloydstsb.co.uk

Ton Roeten
0207 050 6047
ton.roeten@lloydstsb.co.uk

Financial market turmoil makes economic forecasts even more uncertain than usual...

The prospects for UK economic growth have deteriorated sharply in the last two months. The main reason for this relate to the higher than expected level of price inflation which has hit consumer incomes and company profits badly and so is leading to weaker consumer and investment spending. In addition, the intensification of the credit crisis - the loss of confidence in financial markets that is reflected in sharp falls in share prices and housing markets - is adding a more worrying twist to the outlook. This makes forecasting economic variables and outcomes even more fraught than usual. In a recent Weekly, we looked at how projections of economic growth 1 year ahead performed in the last decade and noted that the average error in predicting gdp growth was 1 percentage point, see table 1.

Table 1: Large forecast errors in growth estimates in last decade

GDP forecasts	UK	US	Germany	Average
Standard error	0.7	1.1	1.2	1.0
Standard deviation	0.9	1.2	1.1	1.1
Directional accuracy	70%	70%	90%	77%

...and a single view for the year ahead is almost certainly likely to prove incorrect

Point estimates in the current period of extreme uncertainty and market turmoil are far less likely to be accurate, or useful, than even the usual 1 percentage point error, which itself is an average. For this reason, using a range of possible outcomes is likely to be better than any point estimate, and these are likely to have very similar probabilities attached to them as well. In other words, instead of being much more confident about a central outlook than any other possible outcome, it may be that a significantly different forecast can have a very similar confidence attached to it. The reasoning is that, given how great volatility is, the central view could be quite different from the view of a month earlier that at the time seemed most likely.

This is true for a range of key UK economic variables...

What does this view imply for forecasts of some key UK economic indicators for 2009? The range of outcomes for economic growth in 2009 is broad, between +1.5% and -1.9%, with an average of -0.2% for the full year, based on consensus economic forecasts made in October. This range is outside the 10-year average error of 1 percentage point - based on a central forecast of -0.2%, any outcome between +0.8% and -1.2% is equally likely – but, given the huge uncertainty currently, one would expect this to be the case. Indeed, it could be argued that the forecast range in October is not wide enough. In this regard, it is worth noting that the directional accuracy was only correct 77% of the time and that the actual accuracy of the point estimate over the 10 year period we looked at was zero, see table 1. In short, at no time in the 10 year period did the consensus forecast correctly predict the actual outcome.

Other variables in the forecast for next year are equally subject to this uncertainty. In the charts below we show the standard deviation of economic growth, household consumption and consumer price inflation. These show that private sector consumption may rise by 0.5% or fall by 0.5%. Also that price inflation could fall back below 2% before the end of 2009 or it could end the year above 3%. It should be remembered that there is also a 23% chance, or nearly 1 in 4, that the direction of the forecasts for next year is wrong as well. This leaves a huge range and implies that the outcome for interest rates in 2009 is equally wide, from a range of 2.5% to 4.5%. With all the current uncertainty, point estimates in our view are simply not very useful and a range of possible outcomes would serve analysis best going forward, especially for financial planning purposes, as what seems plausible or implausible now could easily switch around next month as conditions change.

Table 2: Single most likely outcome for UK economy

	2008e				2009e				2008	2009
Quarterly growth rates, %	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	% annual rates	
Real gdp	0.3	0.0	-0.2	-0.1	0.0	0.1	0.2	0.4	1.1	0.3
Consumer spending	1.1	-0.1	-0.3	-0.2	0.1	0.2	0.3	0.5	1.7	0.5
Manufacturing output	0.3	-0.8	-0.3	-0.3	0.0	0.1	0.2	0.3	-0.4	-0.1
Consumer price inflation (YoY, %)	2.4	3.4	4.8	4.6	4.1	3.1	2.5	2.4	3.8	3.0
Base rate, end period	5.25	5.0	5.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0

2008/09 calendar of central bank meetings

European ECB (3.75%) 6 November, 4 December, 15 January, 5 February
US FOMC (1.50%) - 29 October, 16 December, 28 January, 17 March
UK MPC (4.50%) - 6 November, 4 December, 8 January, 5 February

Rolling calendar of UK data releases and events

Mortgage approvals (29/10)
GfK consumer conf. (31/10)
PMI manufacturing (3/11)
Industrial production (5/11)
Manufacturing output (5/11)
PMI services (5/11)
NIESR GDP estimate (6/11)

Rolling calendar of US data releases and events

Consumer conf. (28/10)
Durable goods (29/10)
Q3 GDP (30/10)
PCE deflator (31/10)
Chicago PMI (31/10)
ISM manufacturing (3/11)
Factory orders (4/11)

Chart a: Big range of outcomes for gdp growth...

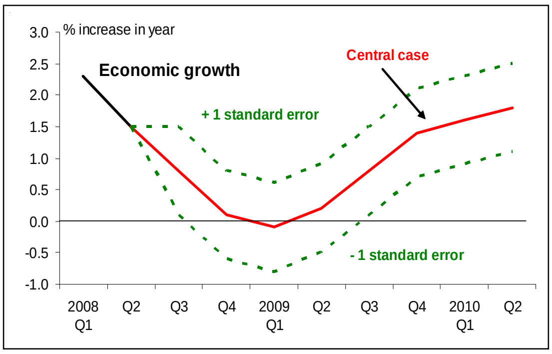
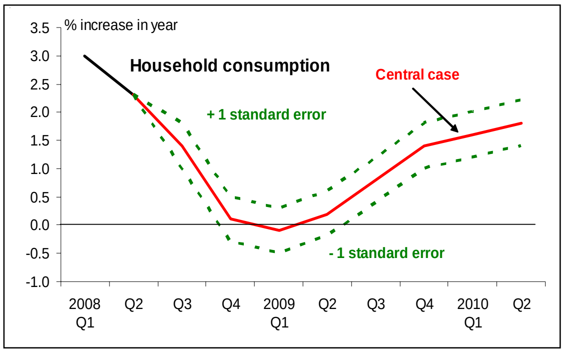


Chart b: ...and for household consumption...



...making a better approach to have a range of most likely outcomes as the basis for planning

Hence, our views about the most likely outcome for the UK next year should be seen in this light; it is just what seems like the single most likely outcome now, but other outcomes are also almost equally likely at this time of such huge turmoil and uncertainty. Nevertheless, there is clearly a lot of pessimism about the UK economy and this is reflected in the consensus forecast of -0.2% gdp growth in 2009. This suggests that output will fall but not as deeply as in the early 1990s. We would tend to concur with this view, but expect a slightly stronger number on the basis that the authorities seem prepared to use fiscal, monetary and regulatory instruments to ensure that a deep recession does not occur. For this reason, we believe that interest rates are likely to be cut to 4% by the end of the year, possibly in November. (Why wait? If the authorities are prepared to act to prevent a fall in output, the sooner they do the better).

In conclusion, expect considerable variability in actual outcomes in 2009 compared with forecasts

For us, this would mean that the UK economy may experience a technical recession - six months of falling output – for the first time since the early 1990s. However, it may be that there is only 1 quarter when growth falls but the economy stagnates for up to nine months, both are consistent with modest economic growth in annual terms. So, either economic conditions improve in the next few months, and we avoid recession or they do not and the economy contracts by up to 1% in 2009, see chart d. This would clearly give a different outcome for interest rates and exchange rates. In that scenario, Bank rate would be cut to 3% in 2009. If not, we expect that it stays at 4% for most of the year. This may mean that sterling could fall even further below our end 2009 central forecast of $1.58, which is based on base rates of 4%. But the key point is that a number of very different outcomes are very possible for 2009 and forecasts are particularly prone to be wrong, however plausible they may seem at the moment.

Trevor Williams, Chief Economist, Corporate Markets

Chart c: ...and for CPI inflation

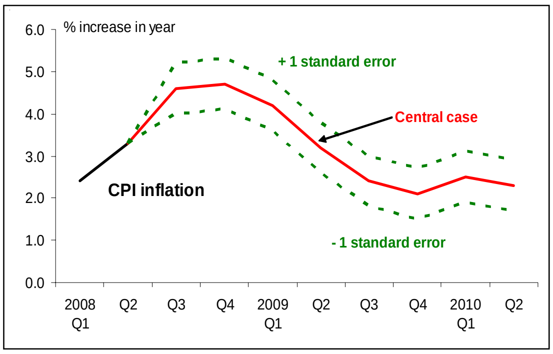
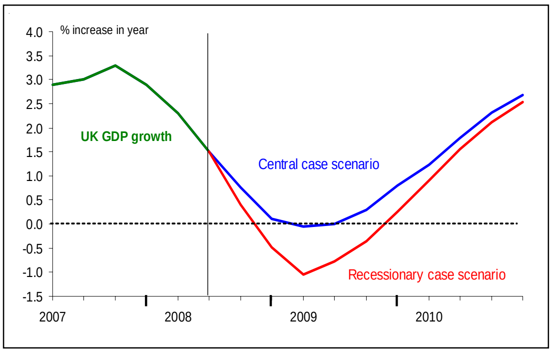


Chart d: Can the UK economy avoid recession?



**** All charts are sourced to Lloyds TSB Corporate Markets Economic Research and Datastream***

Weekly economic data preview

W/c 20 October 2008
www.lloydstsb.com/corporatemarkets

UK economy may have contracted in Q3

The preliminary release of UK Q3 gdp and developments in the money and equity markets will command most attention this week. A negative outcome for gdp growth is widely forecast and would probably add pressure on the Bank of England to further reduce interest rates in November. The release of the October MPC minutes on Wednesday should give further indication of how close the Bank is to relaxing monetary policy in the light of a darkening economic backdrop and heavy losses in equities. In the US, Fed chairman Bernanke testifies on the economy on Monday where his assessment may shape expectations with regard to the FOMC meeting next week. In the euro zone, we forecast further falls in the preliminary PMI surveys of activity in the manufacturing and services sectors.

- Signs of some thawing in UK money markets occurred last week and offered some cautious optimism that the coordinated central banks actions to provide liquidity is starting to bring back some life in the inter-bank market. However, the decline in Libor rates is still mostly concentrated in the very short-term maturities, where for example overnight rate fell by more than 60bps last week. By contrast, the much smaller 10bps drop last week in 3-month Libor to 6.16% is illustrative of continuing unwillingness to lend for longer periods. Tight credit conditions and record high inflation are likely to have caused business investment to shrink for a 2nd successive quarter and consumer spending to stagnate or fall, causing the UK economy to contract in Q3 for the first time since Q2 1992. Our forecast of a 0.2% q/q drop follows the stagnation in growth in Q2 and puts the economy in the position of having a technical recession (6 consecutive months of falling output). We expect Q3 growth to have slowed to 0.5% y/y from 1.5% y/y in Q2. Rising unemployment and falling wage growth will help to bring down inflation, the BoE's main objective, but could cause more economic pain in the interim. The collapse in oil and other commodity prices should help to alleviate inflation pressures, and assisted by below trend gdp growth, explains why BoE MPC members voted for a rate cut. How this is changing the tone of MPC policy discussions will emerge in the October MPC minutes, due on Wednesday. Market participants will pay particular interest to the votes of MPC members Sentance and Besley, and the Bank's latest appraisal of the growth and inflation perspectives to judge whether another rate cut is imminent following the emergency reduction in base rate two weeks ago. Another cut of 0.50% now looks likely in November. The CBI industrial trends survey will be published on Tuesday and September retail sales data are due on Thursday. UK public finances have come under close scrutiny this month as a result of the government's capital infusion in some of the country's banks. The September figures may show a significant deterioration in tax receipts and higher borrowing. Unless this is matched by falls in expenditure, we expect the cumulative PSNCR deficit to rise to £18.6bn for the (fiscal) year-to-date, £5bn ahead compared to the same period last year.
- A quiet week for US economic data means the thrust of attention will be on Fed chairman Bernanke's testimony on the economy on Monday and company earnings through the course of the week. Very weak economic releases for retail sales and manufacturing activity last week underlined the likelihood that the US economy shrank in Q3, an outcome that may lead the Fed to again cut interest rates at the FOMC meeting next week. Mr Bernanke cast a gloomy outlook on the economy at a speech last Wednesday when he said that a 'broader economic recovery will not happen right away', even if recent actions by the central bank help to stabilise financial markets. Weekly initial claims are due on Thursday and may indicate whether the labour market is stabilising. Last week's claims data showed a drop to 461,000.
- Prospects of further interest rate cuts will also be debated in the euro zone this week where the flash PMI indices for October are published on Friday. Business and consumer confidence have taken a severe knock in the wake of the banking crisis and with demand for new business and employment prospects dimming, we expect the PMI indices to have fallen again in October. Taking on board the easing in inflation pressures - euro zone CPI slowed to 3.6% in September - this could make some ECB members more inclined to vote for lower interest rates in November or December.

Kenneth Broux, Economist

Chart 1: UK gdp growth is forecast to have contracted by 0.2% in Q3; first negative growth number since 1992

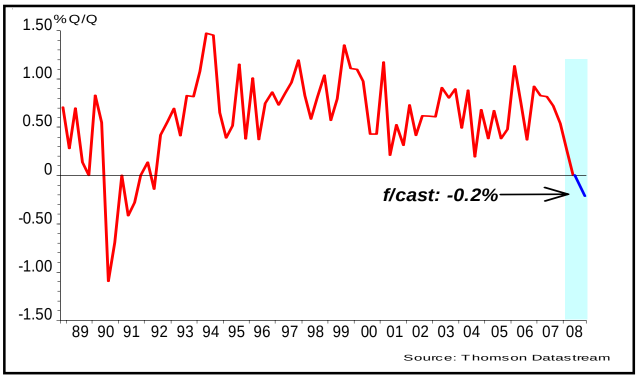
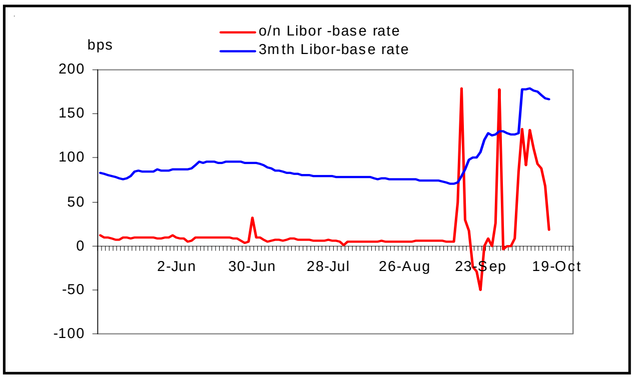


Chart 2: Will UK libor spreads narrow again this week? Note how 3-month rates are lagging very-short maturities.



Lloyds TSB Corporate Markets Economic Research, 10 Gresham Street, London, EC2V 7AE, Switchboard 020 7626 1500

20 - 27 October 2008

Date	United Kingdom	United States	EU-15
Mon 20	**Rightmove house prices (00:01)** Oct -1.0% Y-O-Y -4.9% **Public finances - PSNCR** Aug +£5.1bn Cumulative +£8.6bn Sep (act) +£12.6bn Cumulative +£21.2bn *Median +£10.0bn Range +£8.9bn:+£14.5bn* **Public finances - PSNB** Aug +£10.3bn Cumulative +£28.0bn Sep (act) +£8.1bn Cumulative +£36.1bn *Median +£6.8bn Range +£6.0bn:+£8.5bn* **Money supply, M4 (prel, sa)** Aug +1.4% Y-O-Y +11.5% Sep (act) +1.4% Y-O-Y +12.2% *Median +0.9% Range +0.3%:+1.1%*		**German producer prices (07:00)** Aug -0.6% Y-O-Y +8.1% Sep (act) +0.3% Y-O-Y +8.3% *Median -0.5% Range -0.9%:zero*
Tue 21	**CBI Industrial trends survey (11:00)** Sep -26 Oct (f'cast) -30 *Median -30 Range -36:-10*		
Wed 22			
Thu 23	**Retail sales volume (sa)** Aug +1.2% Y-O-Y +3.3% Sep (f'cast) -0.6% Y-O-Y +2.2% *Median -0.7% Range -1.8%:+0.3%*	**Initial claims (w/e 23/10) (13:30)** Previous 461K Forecast 460K *Median 465K Range 460K:470K*	**French business confidence (07:45)** Sep 92 Oct (f'cast) 90 *Median 89 Range: 86:94* **French consumer spending (07:45)** Aug -0.3% Y-O-Y -0.1% Sep (f'cast) -0.3% Y-O-Y +0.4% *Median -0.1% Range -0.8%:+0.7%* **EU-15 current account (sa) (09.00) (Aug)** Jul -€1.7bn **EU-15 industrial orders (10:00)** Jul +1.0% Y-O-Y +1.6% Aug (f'cast) -1.0% Y-O-Y -1.7% *Median +0.3% Range -2.0%:+2.0%*
Fri 24	**GDP (first estimate)** Q2 zero Y-O-Y +1.5% Q3 (f'cast) -0.2% Y-O-Y +0.5% *Median -0.2% Range -0.5%:-0.1%*	**Existing home sales (15:00)** Aug 4.91mn Sep (f'cast) 4.95mn *Median 4.98mn Range 4.70mn:5.20mn*	**French Manufacturing PMI (08:00) (prel)** Sep 43.0 Oct (f'cast) 42.6 *Median 42.3 Range 41.0:44.5* **French Services PMI (08:00) (prel)** Sep 50.1 Oct (f'cast) 49.5 *Median 49.0 Range 46.0:50.1* **German Manufacturing PMI (08:30) (prel)** Sep 47.4 Oct (f'cast) 47.6 *Median 46.0 Range 44.5:48.1* **German Services PMI (08:30) (prel)** Sep 50.2 Oct (f'cast) 49.8 *Median 48.8 Range 46.0:50.0* **EU-15 Manufacturing PMI (09:00) (flash)** Sep 45.0 Oct (f'cast) 44.5 *Median 44.0 Range 42.2:45.5* **EU-15 Services PMI (09:00) (flash)** Sep 48.4 Oct (f'cast) 47.5 *Median 47.0 Range 44.4:48.0*
Mon 27	**Nationwide house prices (07:00) (Oct) (27-31)** Sep -1.7% Y-O-Y -8.1%	**New home sales (14:00) (Sep)** Aug 0.46mn	**EU-15 money supply, M3 (sa) (09:00) (Sep)** Aug Y-O-Y +8.8%

NB: UK data released at 9.30 a.m., unless otherwise stated. Market medians are as of preceding Friday. Release times of US data are stated in brackets after the description of the indicator. Events are listed in the events column on the next page.

20 - 27 October 2008

Date	Japan	Other Countries	Main events
Mon 20	**Leading index (final) (06:00)** Aug (prel) 89.3% Aug (act) 89.0% **Coincident index (final) (06:00)** Aug (prel) 100.7% Aug (act) 100.6%	**Australia producer prices (01:30)** Q3 (act) +2.0% Y-O-Y +5.6% **Canada int'l secs transactions (13:30)** Jul -C$5.6bn Aug (f'cast) +C$1.5bn *Median +C$1.0bn Range -C$5.0bn:+C$3.0bn*	***• UK DMO plans to auction £1bn of 4% gilts due 2009 (10:30)*** ***• ECB member Tumpel-Gugerell speaks in Prague (13:00)*** ***• US Fed Chairman Bernanke testifies at the House Budget Committee on the economic outlook (15:00)*** ***• US Fed member Lockhart speaks in Atlanta (17:45)*** ***• US Fed member Kroszner speaks in Baltimore (17:45)***
Tue 21		**Canada interest rate decision (14:00)** Current: 2.50% Forecast: 2.50%	***• UK DMO to auction £4.75bn of 4.25% gilts due 2011 (10:30)*** ***• BoE Governor King speaks in Leeds (20:10)***
Wed 22		**Australia consumer prices (01:30) (Q3)** Q2 +1.5% Y-O-Y +4.5% **Canada retail sales (13:30)** Jul +0.1% Aug (f'cast) +0.1% *Median zero Range -0.7%:+0.3%*	***• ECB member Gonzalez-Paramo speaks in Dublin (time tbc)*** ***• US Fed member Stern speaks in Michigan (00:45)*** ***• BoE publishes minutes from its October meeting (09:30)*** ***• Germany to auction €5bn of 4% notes due 2013 (10:15)*** ***• New Zealand interest rate decision, rates expected to be cut by 100bps to 6.50% (21:00)***
Thu 23	**Trade balance (BoP) (00:50)** Aug +Y113.3bn Sep (f'cast) +Y160.0bn *Median +Y600.0bn Range +Y170.0bn:+Y995.0bn*		***• ECB member Quaden speaks in Brussels (time tbc)*** ***• BoE member Gieve to speak in London (time tbc)*** ***• Swedish interest rate decision, risk of a 25bps cut to 4.0% (08:30)*** ***• UK DMO to auction £3bn of 5% gilts due 2018 (10:30)*** ***• US Treasury to auction 2yr notes (15:00)*** ***• US Treasury to auction 5yr notes (15:00)*** ***• US Treasury to auction 5yr TIPS (15:00)***
Fri 24		**Canada consumer prices (12:00)** Aug -0.2% Y-O-Y +3.5% Sep (f'cast) zero Y-O-Y +3.4% *Median zero Range -0.1%:+0.1%* **Canada consumer prices, core (12:00)** Aug +0.3% Y-O-Y +1.7% Sep (f'cast) +0.4% Y-O-Y +1.8% *Median +0.3% Range +0.1%:+0.4%*	***• ECB member Gonzalez-Paramo speaks in Madrid (11:45)*** ***• ECB member Ewald-Nowotny and Tumpel-Gugerell speak in Vienna (14:30)***
Mon 27	**Retail sales (prel) (00:50) (Sep)** Aug Y-O-Y +0.7%		***• US Treasury to sell 5yr TIPS, amount tbc (17:00)***