Annex C

Economic Background

Global economy

1. The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid May. A second crisis, this time over Ireland in November, culminated in Ireland also having to take a bail out. At the time of writing (early January 2011) there is major concern that Portugal will also shortly need to take a bail out. That, in turn, would then stoke major concerns as to whether the current size of the bail out facility put together by the EU and IMF would be big enough to cope with any crisis that then blew up over Spanish government debt.

2. The unexpectedly high rate of growth in quarters 2 and 3 of 2010 in the UK and the Euro zone in Q2 were driven by strong growth in the construction sector catching up from inclement weather earlier in the year and by other short term factors not expected to be enduring; general expectations are for anaemic (but not negative) growth in 2011 in the western world.

UK economy

3. Following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The result of fiscal contraction will be major job losses during this period, in particular in public sector services. This is likely to have a knock on effect on consumer and business confidence and appears to have also hit the housing market as house prices started on a generally negative trend starting in mid 2010. Mortgage approvals are also at very weak levels, all of which indicates that the housing market is likely to be weak in 2011.
4. **Economic Growth** – GDP growth is likely to have peaked in the current period of recovery at 1.2% in quarter 2 of 2010. Growth in quarter 3 @ +0.7% was also unexpectedly high. However, the outlook is for anaemic growth in 2011/12 although the Bank of England and the Office for Budget Responsibility are forecasting near trend growth (2.5%) i.e. above what most forecasters are currently expecting.
5. **Unemployment** – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July 2010 with small increases which may be the start of a new trend for some years ahead of rising unemployment.
6. **Inflation and Bank Rate** – CPI has remained high during 2010. It peaked at 3.7% in April and then gradually declined to 3.1% in September (RPI 4.6%).

However, the outlook from there is a rising trend which could even reach as much as 4% in early 2011 before starting to subside again. Although inflation has remained stubbornly above the MPC's 2% target, the MPC is confident that inflation will fall back under the target over the next two years.

7. The Bank of England finished its programme of quantitative easing (QE) with a total of £200bn in November 2009. However, major expectation that there could be a second round of quantitative easing in late 2010 or early 2011, to help support economic growth, has evaporated after the surprises of the Q3 GDP figure of +0.7% and the November Inflation Report revising the forecast for short term inflation sharply upwards.
8. Sector's central view is that there is unlikely to be any increase in Bank Rate until the end of 2011.
9. **AAA rating** – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors viewed UK government gilts as being a safe haven from EU government debt during mid 2010. The consequent increase in demand for gilts helped to add downward pressure on gilt yields and PWLB rates.

Sector's forward view

10. It is currently difficult to have confidence as to exactly how strong UK economic growth is likely to be during 2011/12, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:
    - the strength / weakness of economic growth in our major trading partners - the US and EU
    - the danger of currency war and resort to protectionism and tariff barriers if China does not adequately address the issue of its huge trade surplus due to its undervalued currency
    - the degree to which government austerity programmes will dampen economic growth and undermine consumer confidence
    - changes in the consumer savings ratio
    - the speed of rebalancing of the UK economy towards exporting and substituting imports
    - the potential, in the US, for more quantitative easing, and the timing of this , and its subsequent reversal in both the US and UK
    - the speed of recovery of banks' profitability and balance sheet imbalances and the consequent implications for the availability of credit to borrowers

- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy
- political risks in the Middle East and Korea

11. The overall balance of risks is weighted to the downside and there is some residual risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

12. Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries