

Election watch One valid argument for the coalition lasting its full parliamentary term until May 2015 is that the impact of the fiscal squeeze will make both governing parties so unpopular that neither will want to trigger an early poll. To a large extent, both parties are relying on economic conditions having improved sufficiently in the minds of voters by the time of the 2015 election. The next election may be contested under a new voting system with redrawn constituency boundaries, but even if the planned referendum in May 2011 is successful—polls show no clear trend for or against—it would not lead to a major change in parliamentary seat allocation. Given the fiscal retrenchment ahead, Labour will believe that it has a good chance of winning the next election. Support for the party has risen since May 2010, primarily at the Lib Dems' expense, and Labour will seize any opportunity to exploit the coalition's unpopularity. A major challenge for Labour (and the left-leaning Mr Miliband) will be to convince voters that it can offer an alternative credible framework for government, particularly if the coalition's programme is seen to be achieving its aims.

International relations A coalition including the pro-European Lib Dems has tempered earlier fears that a Conservative-led government would trigger a sharp deterioration in UK-EU relations. An earlier pledge by the Conservatives to negotiate opt-outs from EU social policies has been dropped, although the public will be given a vote in a referendum on any perceived future transfer of power from Britain to the EU. In contrast with the pragmatic tone of the Conservative leadership, Euroscepticism dominates among the party's rank and file, and UK-EU relations may be tested by negotiations on the EU budget, financial services reform and the unfolding crisis in the euro area, particularly if the government comes under pressure to offer additional financial aid to struggling euro members. The UK will retain close relations with the US, but it is apparent that the US is now attaching less importance to Europe and more to emerging powers in Latin America and Asia—regions with which the UK is aiming to enhance commercial ties.

Economic policy outlook

Policy trends More than two years after the financial crisis hit, economic policy remains in uncharted waters, with enormous levels of financial sector support, record-low interest rates, a record-high peacetime fiscal deficit and the possibility of further money printing by the Bank of England (BoE, the central bank). The outlook for the economy will remain uncertain as policymakers seek to reverse—gradually—earlier stimulus measures. The dominant issue is how the coalition reconciles its twin aims of deficit reduction and economic recovery, with policy action in many areas being dictated by fiscal constraints. The government has identified investment in digital technology, low-carbon industry and "green" transport infrastructure as growth drivers, in an effort to encourage a rebalancing of the economy away from debt-financed consumption, financial services and public expenditure towards private investment, manufacturing and exports. Moderate progress is expected, but with the productive capacity of the economy most likely impaired by the recession, public capital spending being slashed, credit availability still constrained and some key trading partner economies subdued, achieving any significant rebalancing will stretch beyond the forecast period.

and will necessitate a period of declining living standards. Fairly radical public services reform (of health, education and policing) is planned, as is an overhaul of the complex welfare system. Such measures are unlikely to devolve as much power away from the UK's heavily centralised state as the government suggests. A contentious hike in university tuition fees is also set to be imposed. At a time of fiscal austerity and financial-sector bonuses, the policy programme will meet opposition from various interest groups (particularly in the public sector), with resentment over the "fairness" of cuts likely to test coalition cohesion. There is a significant risk of widespread strike action and industrial unrest.

Official support has underpinned a return to profitability among UK banks and is subsidising large bonus payments, but underlying weaknesses persist in the financial sector, given banks' substantial refinancing needs (reflecting a reliance on short-term wholesale borrowing) and counterparty risk stemming from the interconnectedness of the weak European financial system. Official guarantees to support the sector remain in excess of £500bn (US\$800bn), with taxpayers holding major stakes in two banks—Royal Bank of Scotland and Lloyds. In terms of refinancing risk, UK banks have an estimated £800bn due to be funded by end-2012, reflecting in part the scheduled expiry early next year of the BoE's Special Liquidity Scheme, a £185bn facility helping to prop up the UK mortgage market. With banks also facing a modest balance-sheet levy and (albeit longer-term) global regulatory demands for tighter capital and liquidity requirements, the combination of underlying balance-sheet strains and weak competition in the banking sector is likely to keep lending spreads at elevated levels. Later in 2011 an independent commission will present recommendations on banking sector reform aimed at enhancing competition and reducing taxpayer exposure. Agreeing international co-ordination on structural reform will be tricky, with the coalition aware that unilateral moves to split investment and retail banking would risk exposing the UK's large financial sector to regulatory arbitrage.

Fiscal policy

The UK entered recession with one of the largest structural deficits in the OECD and substantial public-sector net debt once off-balance-sheet items are included. A slump in unsustainable revenue streams from the finance and property sectors contributed to the general government deficit widening sharply to 11.3% of GDP in 2009, the UK's largest-ever peacetime deficit. An emergency budget in June 2010 detailed an ambitious five-year programme of dramatic fiscal tightening, with the dual aims of eliminating the estimated large structural hole in the public finances and placing the public debt burden on a declining path by 2015. The consolidation plan comprises a mix of tax rises and the deepest sustained period of real-term spending restraint since the 1940s. It emphasises expenditure savings over tax increases (73% and 27%, respectively, of the overall adjustment), but front-loaded tax rises and cuts in capital investment (rather than in current outlays) will bear more of the burden in 2011-12. The austere tone of the deficit-reduction programme and comparatively low government borrowing costs have tempered market concerns over fiscal sustainability, but a public backlash is likely as cuts in welfare and departmental spending begin to bite. The Economist Intelligence Unit believes that the coalition's growth outlook is too optimistic and doubt its ability to implement the scale of planned spending cuts. We expect the fiscal deficit to narrow at a slower pace than envisaged by

the government, from an estimated 10.1% of GDP in 2010 to around 4% in 2015 (against an official target of 1-1.5%).

In focus

Plotting a route to austerity

The acute fiscal deterioration in 2008-09 and official estimates of a large structural deficit (the gap between tax revenue and public spending that would remain if the economy were to return to trend growth) imply that public debt—and accompanying interest payments—would continue to rise sharply in the absence of a comprehensive fiscal consolidation programme. The UK has certain advantages when compared with the bleak fiscal situation facing weak euro zone countries such as Greece and Ireland. With an independent floating currency, a central bank with the ability to print *fiat* currency and the vast majority of its public debt denominated in sterling and with a long maturity, the UK does not face the same budgetary constraints. The scale of the fiscal challenge should not be downplayed, however, with the result that the coalition faces a dilemma: tighten too much (and too quickly) and risk choking the recovery and triggering a deterioration in industrial relations, or do too little and run the risk of investors shunning sovereign debt, placing upward pressure on long-term rates and borrowing costs, downward pressure on sterling, and threatening the UK's AAA sovereign rating. The government has been criticised in some quarters for targeting too rapid a pace of deficit reduction at a time of economic uncertainty and minimal funding pressures, but there is no accepted orthodoxy on the impact that fiscal austerity will have on economic activity.

The scale of fiscal consolidation proposed by the government is considerable. Total discretionary tightening of £110bn (US\$178bn) a year is planned by the 2014/15 financial year (April-March) compared with current levels, equivalent to around 6.5% of projected GDP. This will comprise £80.5bn of spending cuts (of which £17bn will be a reduction in capital expenditure) and £30bn of tax increases. The latter comprise a rise in value-added tax (VAT) from 17.5% to 20% from January 2011, higher national insurance contributions and a new banking levy (both from April 2011), in addition to higher capital gains taxes and a new 50% top rate of income tax, both of which were introduced in 2010. The headline rate of corporation tax will fall by 1% a year, to 24% by 2015. Overall government departmental expenditure is scheduled to decline by 13% in real terms by 2014/15. With spending on healthcare—the single largest budget expense—and overseas aid being ring-fenced, many departments face real-term cuts of 20-30% over the next four years. Defence and education spending will be squeezed less overall than other areas, but as a result additional savings will come from the welfare budget, which is to provide £18bn of savings, predominantly from a significant re-rating of price indexation of benefit payments and tax credits, restrictions on child benefit for higher earners, cuts in housing and council tax benefit, and in disability allowance. Non-departmental savings will also flow from higher employee contributions into public-sector pensions (from 2012) and from longer-term plans to raise the state pension age to 66 by 2020, for men and women. The Economist Intelligence Unit believes that the coalition will struggle to implement the scale of departmental budget cuts implied in the comprehensive spending review, raising the prospect of further tax rises and/or welfare savings.

Monetary policy The BoE reduced its policy rate from 5% in October 2008 to a record-low 0.5% in March 2009, before implementing a huge £200bn programme of quantitative easing (QE) over April 2009-February 2010. This involved creating new money electronically to acquire assets (primarily government debt—gilts) equivalent to 15% of GDP, with the aim of boosting broad money growth and private-sector spending. Evidence is mixed as to the scheme's effectiveness—the funds were mostly redistributed within the financial sector—but by supporting asset prices, QE helped to stabilise investor sentiment and kept a lid on gilt yields. However, credit markets remain constrained. Official statements highlight differing views within the BoE over the most appropriate policy stance—a reflection in part of the uncertain outlook—which is complicated further by the deteriorating trade-off between weak economic growth and persistent above-target inflation (driven mainly by supply-side pressures). The scale of fiscal austerity implies that any tightening of monetary policy, when it occurs, will be gradual, although we expect the BoE to raise interest rates before reversing QE. The timing of the first rate hike is difficult to predict, with the decision finely balanced. The BoE will be concerned about the negative impact of higher rates on over-indebted households already facing a squeeze in living standards; on a weak housing market; on the fragile banking system; and on business investment intentions. However, with headline inflation set to approach 5% in the coming months, our central forecast is that the BoE will raise its policy rate to 0.75-1% before mid-2011, in an effort to bolster the credibility of its inflation-targeting framework and in recognition that price pressures are more entrenched than it previously thought. Looking ahead, we expect interest rates to rise gradually thereafter to 3% in 2013-14. It cannot be ruled out that the BoE will move to resume its QE programme in 2011-12 should economic activity continue to disappoint.

Economic forecast

International assumptions

	2010	2011	2012	2013	2014	2015
Economic growth (%)						
US GDP	2.8	2.7	2.2	2.4	2.5	2.4
OECD GDP	2.9	2.3	2.1	2.2	2.3	2.1
EU27 GDP	1.9	1.6	1.6	1.7	1.8	1.9
World GDP	3.8	3.0	3.0	3.1	3.1	3.1
World trade	12.4	6.4	6.3	6.7	6.7	6.0
Inflation indicators (% unless otherwise indicated)						
US CPI	1.6	1.2	2.0	2.5	2.8	2.8
OECD CPI	1.3	1.1	1.6	1.9	2.1	2.3
EU27 CPI	1.8	1.8	1.8	1.9	2.0	2.1
Manufactures (measured in US\$)	3.2	0.8	0.1	1.8	1.2	1.8
Oil (Brent; US\$/b)	79.6	90.0	82.3	78.3	75.5	76.0
Non-oil commodities (measured in US\$)	24.0	13.9	-6.2	-4.9	1.1	0.0
Financial variables						
US\$ 3-month commercial paper rate (av; %)	0.2	0.3	0.7	2.2	4.1	5.1
€ 3-month interbank rate (av; %)	0.8	1.0	1.5	2.8	3.5	3.5
US\$:£ (av)	1.55	1.55	1.54	1.55	1.57	1.58
US\$:€ (av)	1.33	1.25	1.20	1.18	1.16	1.17

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