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Our best guess is that after a strong Q4, the economy will weaken in early 2010 – not the best background for an election – a ‘W shape’ is well within the margin of error



The pre-Budget report seems to be getting later and later in the year as ministers struggle to control the economy. This year's needs to be seen even more clearly than usual as the firing of the starting gun to an intense battle between the political parties over economic policy for the next 6 months. The key dates for the battle are the Pre Budget Report on 9 December, the Spring Budget (which with Easter on 4 April will probably be in mid to late March), the election which is almost certainly on 6 May and the post election Budget in late June.

The battle will be fought against a background of a still weak economy. Our view is that the decline in GDP registered in the Q3 data was at best misleading – it is inconsistent with the business surveys and the labour market data and seems to reflect an abundance of abnormal seasonal factors. As a result, the Q4 data is likely to record a misleadingly strong bounceback, added to by some improvement in consumer and investor confidence, a gradual loosening of bank lending restrictions and the effects of a price war on the high street. In addition, it appears that destocking continued quite strongly in Q3 and will slow sharply in Q4.

But early next year the prospects are not so bright. B2B looks ok, exports may be picking up a little, but disposable incomes are likely to be squeezed again, especially if the VAT cut – which we think has been notably helpful in sustaining consumer spending in the UK at a time when it has fallen much more sharply in the US – is reversed as planned on 1 January 2010. With business investment still on the backburner; government spending stymied by the run up to the election (which will put some major projects on hold) and no further boost from the end of destocking, it is quite likely that economic growth will stutter in early 2010. A W shape is well within the margins of forecasting error – not great for the unlucky Prime Minister Brown in the run up to an election.

In an ideal world this would justify more expansionary government action. But with the ratings agencies threatening a downgrading of UK debt, Chancellor Darling will have to tread very carefully.

A more credible plan to cut public spending in the medium term than simply relying on wildly optimistic forecasts – as seen in the last Budget – is absolutely necessary. The problem for the Chancellor is that this would retrospectively justify everything that George Osborne has said about public spending. A reversal of the 50% tax rate – a rise in tax that is actually likely to lose money – would be helpful but politically impossible. But a 6 month extension of the 15% VAT rate would be clever – it will not cost much if it helps sustain consumer spending and will in any case have no significant fiscal cost beyond 2010. And it would move some of the stuttering in the economy to after the election.

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