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ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

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ECONOMIC MALAISE IN THE WEST WORSENS

Over the last month, the outlook for the global economy has deteriorated appreciably. Weak growth in the US and the UK, volatile financial markets concerned about sovereign debt in Europe and the US and worsening leading indicators suggest that a return to recession is increasingly likely – but not yet a foregone conclusion.

What was billed as a temporary 'soft patch' of economic growth appears to be turning into a sustained period of sluggish output expansion. This concern has prompted UK businesses to revise their outlook downwards, driving the Q3 2011 *ICAEW/Grant Thornton Business Confidence Monitor* to its lowest level since 2009, when the economy was still in recession. The recent spate of riots across England may further affect business and consumer confidence.

Despite a weak domestic consumption outlook, another UK recession is likely to be avoided if global momentum can keep from stalling – although there now are significant risks to this. Most analysts expect the Office for Budget Responsibility (OBR) to revise down its growth forecast for 2011 in its autumn statement, to take proper account of the precarious state of the world economy.

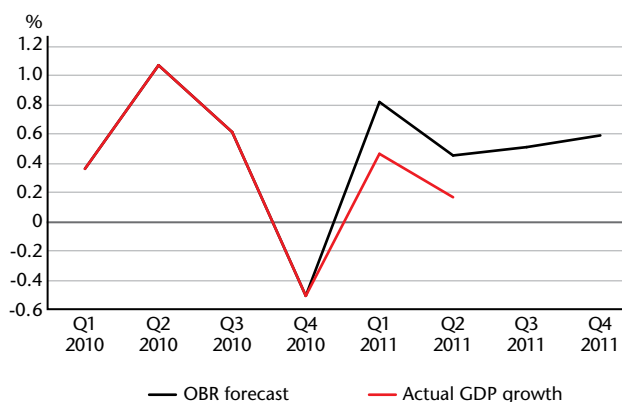
Weak growth means OBR will almost certainly have to revise down growth forecast

The official UK growth forecast for public finances comes from the Office for Budget Responsibility. With growth in the first half of the year so lacklustre – as illustrated in Figure 1 – the current OBR projections for 2011 growth will almost certainly have to be adjusted downwards given the poor performance in the first half of the year, as the Bank of England has already done so in its August *Inflation Report*.

Weak Q2 quarter-on-quarter GDP growth of only 0.2% was said to have been impacted by factors such as the weather (again), the royal wedding and even Olympic ticket sales. However, it seems likely that weak consumption, ailing industrial production despite the cheap pound and lacklustre investment due to a muted growth outlook are also major culprits.

The hope of an export-led recovery has been fizzling out as it becomes clear that the UK manufacturing sector recovery has lost momentum, at least for now. The June foreign trade balance declined further to a monthly deficit of £4.5 billion, more than double February's figure of a £2.2 billion deficit, showing that exports have not been able to give significant support to the economy.

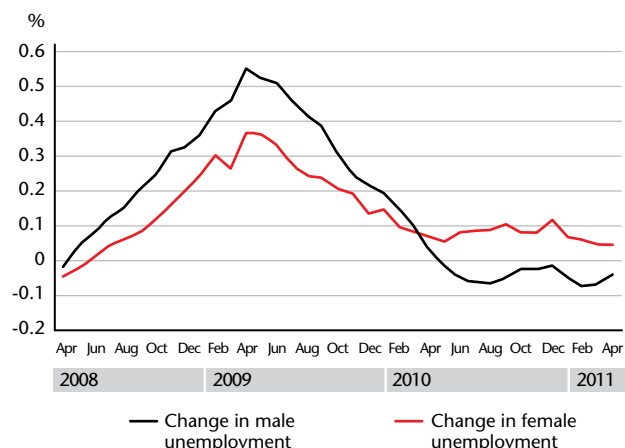
Figure 1: Quarterly gross Domestic Product Growth, actual and OBR projection



Source: Office for National Statistics and Office for Budget Responsibility

Public sector austerity is hitting women hardest

Figure 2: Monthly percentage change in unemployment, males and females



Source: Labour Force Survey, Office for National Statistics

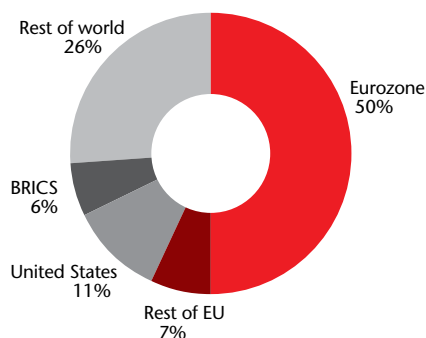
The UK labour market is showing a significant disparity between outcomes for men and for women. Figure 2 illustrates that women fared better throughout the recession as female unemployment increased less sharply than for males. Since the second quarter of 2010, this trend has reversed. Whereas unemployment for males has been decreasing steadily, the number of unemployed women has kept rising steadily.

This discrepancy can partly be explained by differences in the gender balance of the work force in the public and private sectors; more women than men choose to work in the public sector. In local government, for example, 76% of employees are female. This means that women are more affected by public sector cutbacks than men, a trend that will persist over the coming years due to planned reduction in public sector employment of around 400,000 by fiscal year 2015–16, according to OBR estimates.

Another labour market trend has been the increase in youth unemployment, which affects two in five 16 to 17 year-olds and one in five 18 to 24 year-olds. The UK's overall unemployment rate may mask variation among the unemployed, but at 7.7% in April, the labour market is still relatively healthy by comparison to other European countries. The unemployment rate in the Eurozone, for instance, stands at 9.9%, pushed up by countries such as Spain (21%), Ireland (14.2%) and Greece (15%).

UK relies on volatile eurozone for trade

Figure 3: Goods and services export shares of selected countries/regions, 2010



Source: IMF Direction of Trade Statistics

The elevated overall unemployment rate in Europe reflects the uneven pace of recovery on the Continent. While Germany, the largest European economy, has been benefiting from strong export sales to emerging markets, peripheral economies are facing serious private and public sector problems. In addition, surprisingly weak Q2 GDP figures in the US contribute further to an environment of weak external demand for the UK economy.

A look at the composition of exports in Figure 3 shows that the UK is highly dependent on developed countries for selling its goods and services. The eurozone alone makes up half of the country's exports, underlining that economic integration with the continent has been increasing despite the sometimes fraught political relationship with the EU.

Despite much media hype, emerging markets still account for a small share of UK exports, adding up to only 6% for the BRICS countries Brazil, Russia, India, China and South Africa. This has increased from 3% to 6% between 2000 and 2010. With its small manufacturing sector, the UK is not in a favourable position to directly benefit from strong emerging markets growth shown in trade statistics, but the expertise of the country's services sector should offer scope for expansion in business and financial services.

Together, the Western industrialised world makes up two thirds of UK trade. In terms of changes since 2000, the export share of the US has been roughly steady at around 11%. The largest gain in export share over the 2000s has come from the eurozone, which has increased its share of exports from 41% to 50%, underlining the risk from the on-going sovereign debt crisis.

Spreading euro crisis is risk to UK

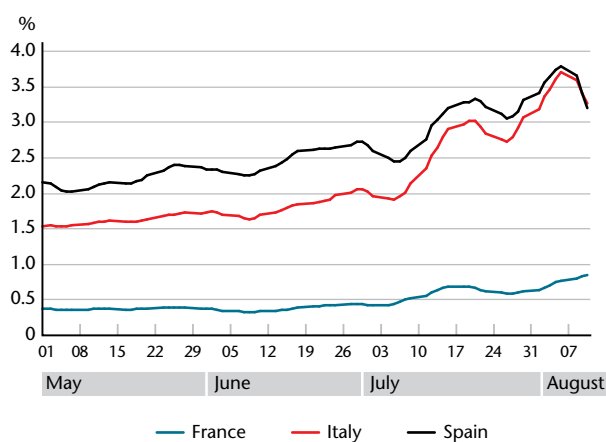
The fact that the eurozone accounts for half of UK exports illustrates just how important it is for the UK's economic future. In this light, the sovereign debt woes in the neighbouring economic bloc take on a high level of importance. Not only are worries about the solvency of eurozone governments causing wild swings in financial markets, but these worries also undermine business confidence and deter investment.

While a bail-out of small economies Greece, Ireland and Portugal was a manageable event as these countries only account for 6% of eurozone output, the situation is much more serious in case a major country also requires assistance. Spain accounts for 10% of eurozone GDP, Italy for 16%, and France for 23%.

A key measure of investor concern is the bond yield (bonds are publicly traded debt and the yield is akin to the interest rate that the market offers on this debt). With a common monetary policy and broadly similar inflation across the eurozone, the main difference in the return investors require is the perceived risk of not getting paid back in full or on time. This has driven the difference in bond yield, or 'spread', between debt considered risky and that of the perceived ultra-safe Germany to record levels since the introduction of the euro.

While Spain had already been mooted as a candidate for a bail-out, markets have recently decided that Italy was equally risky due to anaemic growth and complex fiscal politics (see Figure 4), resulting in spreads surging to over 3.5% – more than the 2.7% Germany pays in interest in the first place. A recent market intervention by the European Central Bank has pushed the risk premium down somewhat, but the spread remains at a high level. It now appears that France could come under pressure as well, with its spread over German debt creeping upwards since July despite public finances that were recently considered solid.

Figure 4: 10-year government bond spreads over German Bunds, 5-day moving average, percentage points (May–August 2011)



Source: Macrobond

Risks to outlook balanced on downside

The list of concerns regarding the global and UK economy is getting longer. Nervous bond markets are increasingly forcing the hands of politicians in wielding the red pen to cut public sector deficits. A prolonged fiscal contraction has already been announced in the UK, but now also appears likely in the US and much of Europe. This will dampen demand at a time when consumers are still reducing their personal debt levels and face elevated unemployment. High commodity prices due to fast-rising emerging market demand is furthermore cutting consumers' purchasing power and causing inflation, which in turn forced a restrictive monetary policy stance in many emerging markets that is acting as a brake on growth.

The main hope in this scenario, in which negative risk factors appear to outweigh upside potential, is that other emerging markets take over as the drivers of growth from China. Looking further ahead, there is also some hope that economic growth in the East turns these nations from producers of cheap goods for the West into consumers of Western high-value products. As such a shift is generally accompanied by an expanding service sector, the UK's professional expertise and long-standing international exposure should provide an opportunity to benefit from rising global prosperity in the long-term. We are, however, probably in for more bad news until we turn the corner.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
26 August	Q2 GDP second estimate	Unchanged from first estimate
30 August	Lending to individuals	Access to credit still constrained
08 September	Bank of England September decision	Base interest rate remains on hold

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