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ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

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QUESTIONS REMAIN ABOUT THE DRIVERS OF GROWTH

To coincide with the March Budget, the independent Office for Budget Responsibility (OBR) published a new set of economic forecasts. The details of these predictions were not subject to much scrutiny immediately after the Budget, given the media focus on the main document, but economists have now had time to mull over the underlying assumptions and a number of questions have been raised.

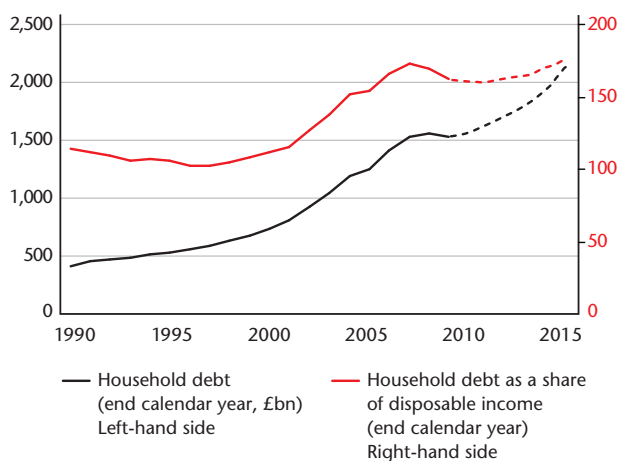
The assumptions made about household consumption have been especially questioned, given the significant pressure on household budgets this year as the cost of living continues to grow in excess of household incomes. Many analysts believe the OBR is too optimistic about consumption in both the short and medium term, and sources such as the latest British Retail Consortium (BRC) retail sales data corroborate this; UK households appear to be reining in discretionary spending at present.

The OBR also continues to take a relatively bullish stance on business investment and export growth compared with other forecasters. The Q1 2011 *ICAEW/Grant Thornton Business Confidence Monitor* also suggests the OBR is over-optimistic on these two factors for 2011. While most economists agree that these factors will have a prominent role in the economy in the medium term, bolstered by low interest rates and a weak exchange rate, many would argue that there are a number of significant downside risks in the pipeline. A slowdown in the economies of our key export markets, and a significant tightening of monetary policy to rein in inflation and weak business confidence could constrain growth in exports and investment – all reasons to believe that the economic outlook for the UK is less bright than the OBR currently anticipates.

Another consumer debt binge for the UK?

Following the financial crisis, household debt as a share of disposable income started to fall (see Figure 1) – a result of a significant tightening in credit conditions and households choosing to pay back their existing debts rather than borrowing more.

Figure 1: Total household debt, as a share of disposable income, in £bn



Source: ONS, OBR forecasts

The OBR is expecting household consumption to grow by 0.8% this year, despite forecasting average earnings to grow by less than half the annual rate of consumer price inflation. The implication is that households will have to increase their borrowing in 2011 to sustain their existing standards of living. By 2014, consumption is expected by the OBR to grow at an annual rate in excess of 2.0%. Household debt as a share of disposable income will have to reach an all-time high by 2015 – 175% of household disposable income and in excess of £2 trillion – to grow this strongly.

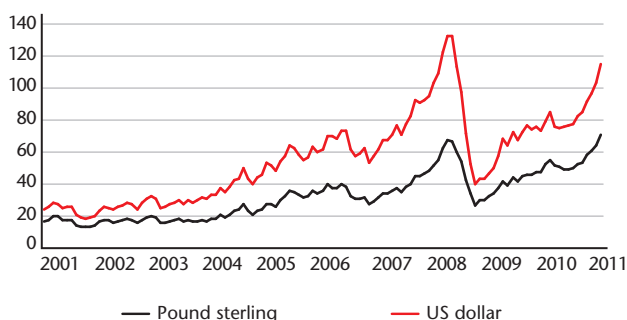
Many commentators argue this expansion of debt is unlikely to happen and that these consumption growth projections are too optimistic. There are two reasons to be cautious. Firstly, access to credit is currently much tighter than it was before the financial crisis. Secondly, consumer confidence remains weak and many households remain concerned about job security, which should suppress demand for credit.

Between 2000 and 2007, the UK economy was propped up by consumer debt, with households borrowing ever-increasing amounts to either improve or maintain their standards of living. Few economists would argue that this is a sustainable long-term economic model, the question is whether or not history will repeat itself over the next five years.

Sterling price of oil reaches a record high

The pound sterling value of Brent crude oil reached an all-time high in recent weeks, as political events in Africa and the Middle East continue to push prices upwards (see Figure 2). The price of Brent crude oil recently passed the \$125 (£76) per barrel mark.

Figure 2: Price of Brent crude oil, in pound sterling and US dollars



Source: US Energy Information Administration, Cebr analysis

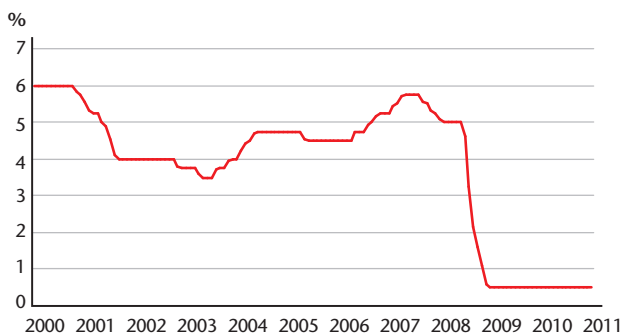
The rising price of oil – and in turn petrol – illustrates the danger of imported inflation that can arise from a weakened currency. The US dollar price of Brent crude oil was higher in 2008, when it exceeded \$130 per barrel. However, as sterling was about 17% higher in value against the dollar in 2008, the pound value of Brent crude oil was lower than it is today.

A rate rise could help alleviate some of the pain felt at the petrol pumps – interest rate rises generally trigger an appreciation in the currency as money flows back into the economy from overseas – though there are risks associated with this approach to dealing with the rising cost of living.

Interest rates remain on hold for 25th successive month – a rate rise in May?

The Bank of England kept interest rates on hold for the 25th month in succession after the Monetary Policy Committee's (MPC's) April meeting. In addition, the size of the asset purchase facility (known as quantitative easing) remained on hold at £200bn, where it has been since November 2009.

Figure 3: Bank of England base rate, percentage points



Source: Bank of England

The decision by the April meeting of the MPC comes despite ongoing concerns about inflation in the UK. In March the consumer price index (CPI) measure of annual inflation stood at 4.0% – double the Bank of England's central target of 2.0%. With the price of Brent crude oil now well in excess of \$120 per barrel, and the price of petrol in the UK at record levels, upside risks to inflation remain.

The need for the Bank of England to counter inflation by raising interest rates is being confounded by continued weakness in the UK economy. A wide range of retailers have issued profit warnings recently, a clear sign that the squeeze on household incomes is starting to feed through into reduced discretionary spending. The latest BRC retail sales value data was surprisingly poor for March 2011; like-for-like sales values were 3.5% lower than the same month a year ago.

Tightening monetary policy too soon could lead to a further weakening in consumer spending as household incomes are squeezed by higher mortgage interest payments and an increased rate of borrowing. Despite this, a rise of 25 basis points in May cannot be ruled out. The next Bank of England *Inflation Report* will be released next month, and historically rate movements are more likely to occur in months when an *Inflation Report* is issued. Furthermore, there is a real risk the Bank of England could lose credibility in its commitment to keeping inflation within target. A modest rate rise next month may be necessary to alleviate these concerns and prevent inflation remaining elevated in the medium term.

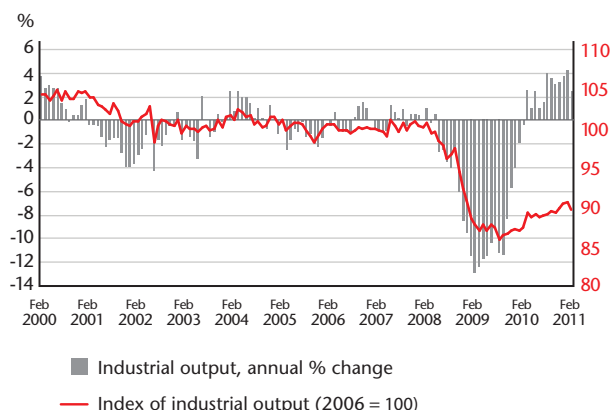
Industrial output shows signs of slowing down

February's UK industrial output data, released earlier this month, showed a surprise fall in output compared with January. Economists had generally expected an improvement as output continued to bounce back from December's bad weather. It was particularly surprising that manufacturing output was flat in February compared with the previous month.

If these weak growth figures repeat in subsequent months, UK economic growth in 2011 will turn out to be very poor. Policy-makers have generally been banking on growth in sectors such as manufacturing making up for poor performance in consumer-dependent sectors such as retail, and there are now concerns about whether or not this will happen. The latest industrial output release also raises questions about the role that goods exports will play in driving growth over the year ahead.

Of course, we should not read too much into one month's worth of data. It is noteworthy that, as shown in Figure 4, despite the strong growth in industrial output seen in 2010, monthly industrial output in February 2011 was still 10.4% below average 2006 levels. This suggests many industrial businesses continue to operate far below pre-recession capacity and that there is still significant potential for the sector to expand over the coming years.

Figure 4: UK industrial output, annual % change, and index of industrial output (2006=100)



Source: ONS

Squeeze on households dominates the UK policy debate

The pressure on household incomes continues to dominate the political discourse this month. The need to contain the rising cost of living is being confounded by the need to ensure the economic recovery does not falter. The recent array of profit warnings from retailers and the surprisingly poor latest industrial production data all give reason to be cautious about raising interest rates too soon.

In many respects, the current cost of living crisis is being driven by global economic events – the political unrest in Africa and the Middle East being the primary factors – which are largely beyond the Government’s and the Bank of England’s control. This shows how significantly the UK is tied into the globalised world economy and how events elsewhere can have huge ramifications for the standard of living experienced in this country.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
20 April	Minutes from April MPC meeting	Four-way split in voting intention continues
27 April	Q1 2011 GDP first estimate	Bounce back from Q4 contraction
11 May	BoE Inflation Report	Inflation forecasts revised upwards



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