ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S ECONOMIC ADVISERS

DECEMBER 2011

UK ECONOMY TO LIMP INTO NEW YEAR AS GLOBAL GROWTH SLOWS

The UK economy is likely to stagnate at best in the near term and may well be contracting now according to recent indicators. Both the Bank of England and the Office for Budget Responsibility (OBR) sharply downgraded their forecasts for growth in 2012 in November as short-term indicators such as the ICAEW/Grant Thornton *Business Confidence Monitor* showed a sharp drop off in business confidence in the final quarter of 2011.

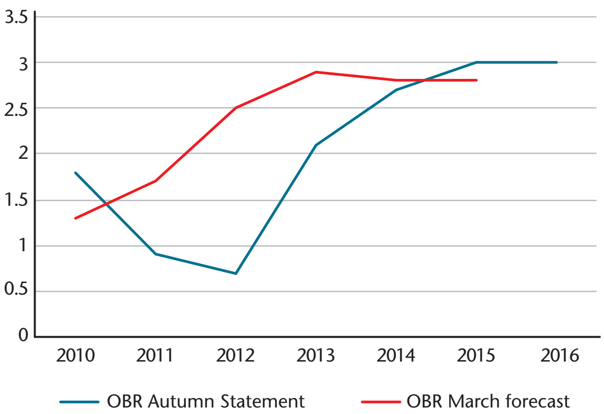
There is now widespread evidence that the global economy is slowing sharply as the uncertainty over the eurozone plagues financial markets and growth in real economic activity weakened the world over. Even China and India have recently reported a reduced pace of growth while the eurozone and UK could well experience recession through Q4 2011 and Q1 2012.

The key question is whether policy-makers can do enough to turn the economy around in 2012. Emerging markets are unable to escape the slowdown but are likely to have the monetary and fiscal policy firepower to turn things around through 2012. However, the outlook for the advanced economies of the West looks far tougher, particularly in the eurozone.

OBR slashes UK growth forecasts yet again

In the Autumn Statement, the OBR published its latest forecast for the UK economy with yet another downward revision to growth. The OBR now expects the UK economy to grow by just 0.9% in 2011, down from its previous projection of 1.7% in March 2011. However, there was a far larger downward revision to its bullish forecast for growth in 2012. The OBR now expects the UK economy to expand by just 0.7% next year as the economy looks set to contract in the final quarter of 2011 and growth prospects look increasingly uncertain heading into the New Year.

Figure 1: UK GDP growth, annual percentage change



Source: Office for Budget Responsibility

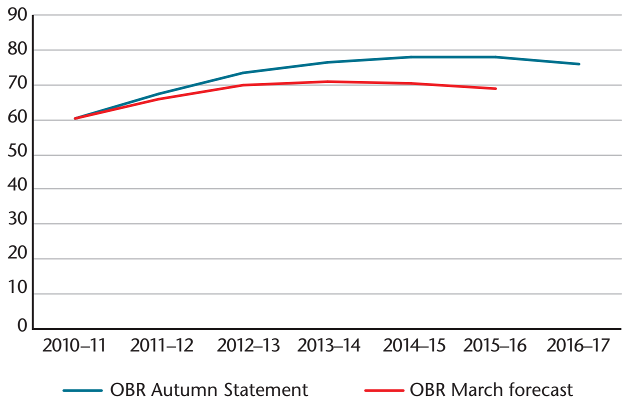
Although Chancellor Osborne and the government have insisted the weakness in the economy is due to problems in the eurozone, the OBR admitted to having completely underestimated the extent of the real income squeeze in 2011. The reality is that UK households have faced the biggest two-year decline in living standards in the post-war era as weak wage growth is outstripped by the rising cost of living. The OBR now agrees, forecasting a 2.3% drop in real household incomes in 2011 and expecting the squeeze on living standards to continue in 2012, with a further 0.3% decline in real income before returning to growth in 2013.

However, there was still room for optimism for the OBR. They expect the UK economy to pick up to 2.1% growth in 2013, although this is reliant on the eurozone recovering to 1.6% growth and 9% business investment growth. Indeed, the OBR forecasts a boom from 2014–16 with GDP growth averaging 2.9% per annum, consumer spending growing by 2.6% a year and business investment growing by 38% in real terms. Unless the UK dramatically improves its competitiveness, this sort of growth performance could be hard to achieve.

Weaker growth forces Chancellor to issue more debt

Slower growth means that public borrowing will be around £100bn higher than previously expected by 2015–16. The implication of this is that the government's deficit reduction is going to take longer and the UK will continue acquiring debt. By 2015–16, public sector debt as a share of GDP will reach 77.7%, only marginally down from 78.0% in 2014–15 as shown in Figure 2. Previously, the OBR forecast that public debt would fall below 70% of GDP by 2015–16.

Figure 2: UK public sector debt share of GDP, %, fiscal years



Source: Office for Budget Responsibility

The key consequence of weaker growth is that the Chancellor was forced to announce additional public spending cuts for the next Parliament in order to stick to his own fiscal mandate that national debt as a proportion of GDP should fall between 2014–15 and 2015–16. Indeed, in 2015–16 total managed expenditure by the UK government is projected to be £17.2bn lower than in the March forecast – meaning that the UK faces the prospect of two Parliaments of fiscal austerity measures.

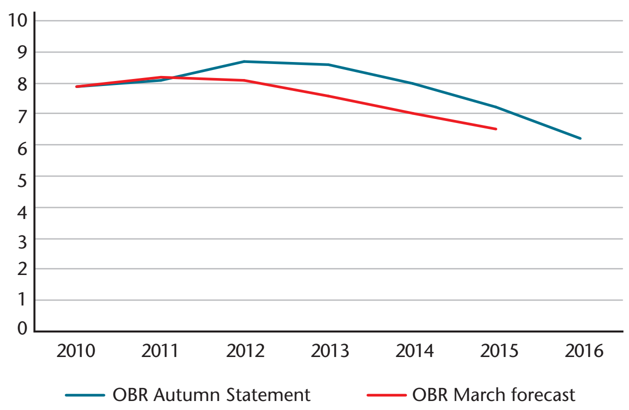
However, by cutting back some current spending commitments, the Chancellor was able to find sufficient room to push through several capital investments as part of an array of pro-growth measures. The government announced £5bn of capital additional infrastructure spending including projects such as the London Underground Northern Line extension to Battersea, the electrification of the Trans Pennine train route and a range of road building projects. While unlikely to provide an immediate boost to growth, these measures should support growth and job creation in the medium term.

Massive upwards revision to public sector job losses contributes to bleak labour market outlook

Further public spending cuts inevitably mean more public sector job losses but the OBR also revised how many jobs disappear per pound of public spending cut, so there has been a massive upward revision to the previously announced 400,000 public sector job losses. The OBR's revised estimate for public sector job losses between Q1 2011 and Q1 2017 came in at 710,000, some 44% higher than previously estimated. Hence, the private sector has even more work to do to fill in the spare capacity created by public sector job losses.

The result of this and the bleak economic outlook is that the OBR has now admitted that we are in for an extended period of high unemployment. Unemployment on the International Labor Organisation measure is now expected to average 8.7% in 2012 – 0.6 percentage points higher than the OBR's March projection. The cumulative effect of higher joblessness is that the claimant count measure of unemployment is projected to stand 357,000 higher in 2014 than previously expected.

Figure 3: UK unemployment rate (ILO measure), percentage of economically active population



Source: Office for Budget Responsibility

This bleaker picture has been corroborated by recent outturns in the labour market data. Over the three months to September, the unemployment rate was 8.3%, up 0.4 percentage points from the previous quarter and reaching its highest level since January 1996. The timelier claimant count measure of unemployment rose by 5,300 in October too, suggesting labour market conditions remain weak coming into Q4 2011; a view supported by the Q4 2011 ICAEW/Grant Thornton *Business Confidence Monitor*, which pointed to weaker hiring intentions from businesses amid an increasingly uncertain environment.

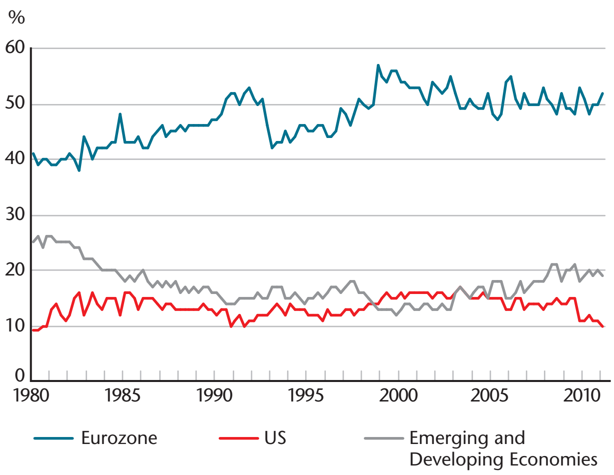
Euro crisis hangs over global economy but how much will it affect UK plc?

The biggest uncertainty hanging over the global and UK economic outlook is the ongoing eurozone debt crisis. Talks between eurozone governments are ongoing and rhetoric has become stronger recently, but the world economy desperately needs firm actions to bring the crisis under control. Recent data have clearly pointed to a likely contraction in economic activity across the euro area in the final quarter of 2011 – leading many to speculate that the eurozone is likely to endure another technical recession. Further, talk of a possible eurozone break-up has led to conjecture on what the economic impact would be.

The Organisation for Economic Co-operation and Development has forecast a 'mild recession' in the eurozone through Q4 2011 and Q1 2012 and expects the single currency area to expand by just 0.2% in 2012. The OBR is more bullish, expecting 0.5% growth. Other commentators have speculated that a euro break-up scenario could see another deep recession, with perhaps a 3% or more contraction in euro area output.

How much would this affect the global and UK economy? The answer is: significantly, especially since UK plc's post financial crisis 'business model' is heavily reliant on strong growth in exports and the euro area is by far the UK's largest trading partner, as illustrated in Figure 4. The UK tends to sell around half of its merchandise exports to the euro area, while only around one in five exports goes to emerging economies, which although not unaffected by the global economic slowdown at present, are still likely to experience relatively strong growth; probably growing faster than advanced economies by a factor of about three. Hence, the UK real economy is likely to be hard hit by any downturn in the eurozone, notwithstanding the potential impact on financial markets and the associated effects of this.

Figure 4: UK merchandise export destination, percentage share of total merchandise exports to world



Source: Macrobond; IMF DOTS database

2012 set to be another tough year as 'flat is the new growth'

The economic outlook has darkened as the eurozone crisis rumbles on and UK consumers remain squeezed by real income declines caused by the surging cost of living and weak earnings growth. While inflation looks set to fall back sharply in 2012 providing some relief to hard-hit consumers, the labour market remains very weak and the latest update from OBR saw the government admit that unemployment will rise towards (although not quite reaching) 9% in 2012.

The increasingly challenging environment, especially in the retail sector, led Arcadia owner Sir Philip Green to declare that 'flat is the new growth'. With about a 50% chance of another recession in the UK and growth next year set to be a very modest 0.7% on the OBR's new central forecast, Sir Philip's remarks match an increasingly gloomy reality. The good news is that the fall in inflation will ease the pace of real income decline in the UK. However, with the economy very weak another year of exceptionally loose monetary policy from the Bank of England seems likely, with interest rates on hold and further quantitative easing likely in 2012.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
13 December	Consumer price index	Inflation falls back again
14 December	UK labour market	Unemployment edges up

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