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ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

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BCM POINTS TO CONTINUED RECOVERY

The latest *ICAEW/Grant Thornton UK Business Confidence Monitor (BCM)* shows that business confidence ticked up in Q2 2011, following four consecutive quarters of decline. However, the BCM Confidence Index remains some 11.8 points lower than a year ago.

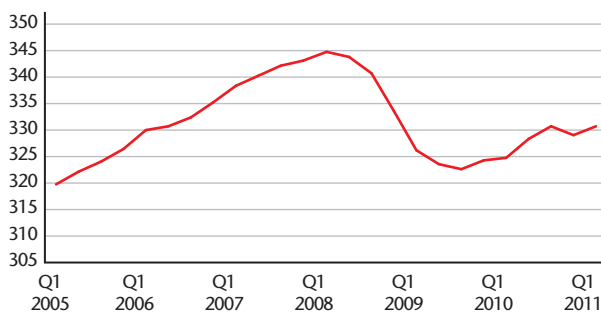
While businesses this quarter report that financial performance continues to improve compared with 12 months ago, annual growth remains notably below pre-recession levels for most indicators. Moreover, there are large sector variations in confidence. While confidence in the Manufacturing & Engineering sector is buoyant, the Retail & Wholesale sector is the least confident – most likely a result of the ongoing squeeze on real household incomes in the UK, as weak earnings growth fails to keep pace with the rising cost of essential goods and services.

Indeed, BCM points to rising inflationary pressures this quarter; firms expect stronger prices growth than forecast since Q3 2008. This corroborates the findings of May's Bank of England *Inflation Report*, which warns that consumer price index (CPI) inflation could reach as high as 5.0% later this year. Overall, the latest BCM points to a slow-but-steady recovery, though growth is likely to be fragile for sectors dependent on domestic demand, such as Retail & Wholesale.

Lacklustre growth leaves economy broadly in the same place as six months ago

The preliminary estimate of UK gross domestic product (GDP) in the first quarter of 2011 showed the economy growing at a quarterly rate of 0.5%. Although positive, the surprise contraction in the final quarter of 2010 means that the overall level of UK output is broadly unchanged from six months ago, as shown in Figure 1.

Figure 1: UK quarterly gross domestic product, £ billion, real 2006 prices



Source: ONS

Economic performance continues to be variable across different sectors of the economy. For example, while output in the consumer-dependent Distribution, Hotels and Restaurants sector increased by 0.3% over the last quarter, output in the Manufacturing sector grew by a much more robust 1.1%.

The construction statistics were probably the most surprising in the latest release. The Office for National Statistics (ONS) estimate shows that output contracted at a quarterly rate of 4.7% in the first quarter of 2011, following a decrease of 2.3% in the previous quarter – meaning the sector entered a technical recession. Many commentators felt that these figures painted an overly bleak picture for the sector, and the chief executive of builders' merchant group Travis Perkins has argued that there is a 'big disconnect' between the official statistics and what the sector is actually experiencing on the ground. There is now a general expectation that the construction growth estimates – and therefore the GDP growth estimates – will be revised up when the second estimate is released later this month.

Collapse in global commodity prices as investors become more bearish on the world economy

After rallying for several months, global commodity prices experienced a sharp collapse in early May as international investors took an increasingly bearish stance on the world economy. This follows a range of lacklustre statistics across the developed world and the start of monetary policy tightening in emerging market economies. For example, the Reserve Bank of India recently raised rates for the ninth time in 15 months.

While the price of oil shot above \$120 per barrel earlier this year as unrest in North Africa and the Middle East led to concerns about a shortage of supply, panic-selling in early May pushed prices below \$110 per barrel – though there has been some recovery in prices since then.

The prices of other commodities such as silver have also tumbled in recent weeks, though remain notably higher in price than in early 2010. It is noteworthy that, despite the recent fall in the price of oil, Brent crude prices are still some 31% higher than a year ago, as shown in Figure 2.

If commodity prices start to stabilise or fall further over the coming months, following their rally in the second half of 2010 and early 2011, inflation is likely to ease across the world – beneficial to developed world countries, such as the UK, which are currently experiencing real-terms falls in incomes as price growth outstrips earnings growth.

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



Source: US Energy Information Administration

When will rates rise?

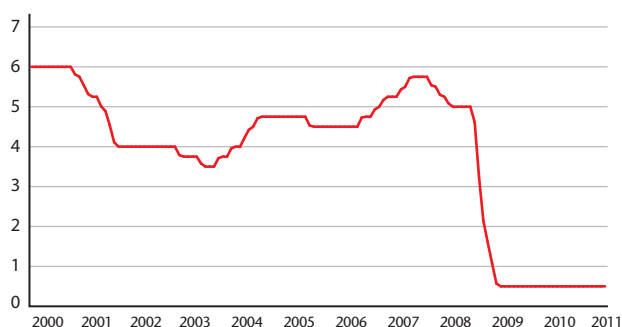
The Bank of England kept interest rates on hold for the 26th month in succession after the Monetary Policy Committee's (MPC's) May meeting. This is despite May's *Inflation Report* warning that consumer price index (CPI) inflation could rise to as high as 5.0% later this year, due to higher utilities prices.

The Bank of England continues to face criticism for being too complacent over the issue of inflation, with ongoing concerns about the Bank losing credibility over its commitment to a 2.0% central target for CPI annual growth.

While for some the Bank of England's constant rhetoric about inflation being driven by 'temporary' factors is starting to wear a bit thin, there is much truth in this argument. The VAT rises of the past two years have pushed up price growth in 2010 and 2011, while the commodity rally in the second half of 2010 – a global rather than UK-specific phenomenon – has also led to higher goods prices in the UK. By 2012, the effect of VAT on prices will have dropped out of the annual rate of inflation, and there are now early signs of some stabilisation in global commodity markets.

On the other hand, imported inflation could be an issue in the medium term. With the UK remaining a member of a shrinking club of countries committed to loose monetary policy, rate rises elsewhere in the world could lead to a further depreciation in sterling as money flows to countries with higher rates of return. While this would improve the UK's export competitiveness, the price of imported goods and services could continue to rise as a result. This risk could prompt the Bank to raise rates towards the end of this year, despite its reservations about the strength of the economy and belief that inflation is likely to ease in 2012.

Figure 3: Bank of England base rate, percentage points



Source: Bank of England

Stark difference in public sector dependence across the UK

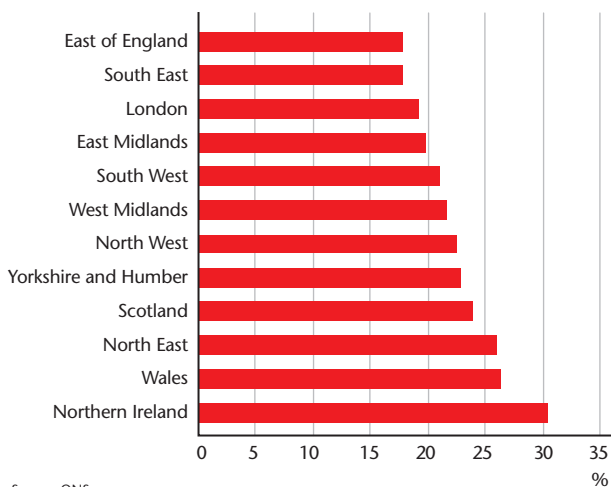
With public sector spending cuts about to commence in earnest, questions remain over which parts of the UK stand to lose the most as a result of austerity measures, especially with respect to job losses.

As Figure 4 shows, the proportion of total employment accounted for by the public sector workforce varies markedly across the UK. While public sector employment accounts for only 17.8% of total employment in East England, it accounts for 30.4% of employment in Northern Ireland.

Figure 4 suggests that the northern regions of England, plus Scotland, Wales and Northern Ireland will be disproportionately affected by public sector job losses over the coming years, given that the private sector accounts for a lower proportion of total jobs in these regions.

In terms of other austerity measures being implemented, there are also likely to be strong regional variations. For example, Londoners will be disproportionately affected by plans to cap housing benefit at £250 per week for a one-bedroom property and £400 per week for properties with four or more bedrooms, given much greater private rental costs in the capital. These regional differences will likely prompt questions about the equitability of the austerity measures being implemented.

Figure 4: Public sector employment as a share of total employment, %, by region



Source: ONS

Until growth picks up, a rate rise remains a risk

While this quarter's BCM points to continued expansion in the UK economy, most key performance indicators continue to grow at a slower rate than pre-recession levels – pointing towards a slow-but-steady recovery rather than a sharp bounce back to trend growth.

This would appear to be the view of the Bank of England as well, given its reluctance to raise interest rates despite inflation remaining well above target and warnings about the current squeeze on household real incomes. Until

these reservations about the economy ease, rates are likely to remain on hold. Markets now expect the base rate to remain on hold until November at the earliest. This seems especially likely now that Andrew Sentence – a key proponent of an immediate rate rise – will not be on the Monetary Policy Committee from this June.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
25 May	GDP second estimate	Upward revision to growth
9 June	MPC announcement	Rates on hold



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