

Making Business Sense

ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

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BUSINESSES CAUTIOUS AGAINST GLOOMY ECONOMIC BACKDROP

The latest *ICAEW/Grant Thornton UK Business Confidence Monitor (BCM)* shows that business confidence remains firmly in negative territory at the start of 2012 with little movement from the previous quarter. The BCM Confidence Index rose slightly to -9.3 in Q1 2012, similar to the -9.7 result in Q4 2011.

The Confidence Index is a leading indicator for growth; it correctly predicted the end of the recession in 2009, provided early warning signs in 2007–08 and pointed towards economic contraction in Q4 2011. This quarter's Confidence Index suggests the UK economy could already be in the midst of recession, defined as two consecutive quarters of declining gross domestic product (GDP).

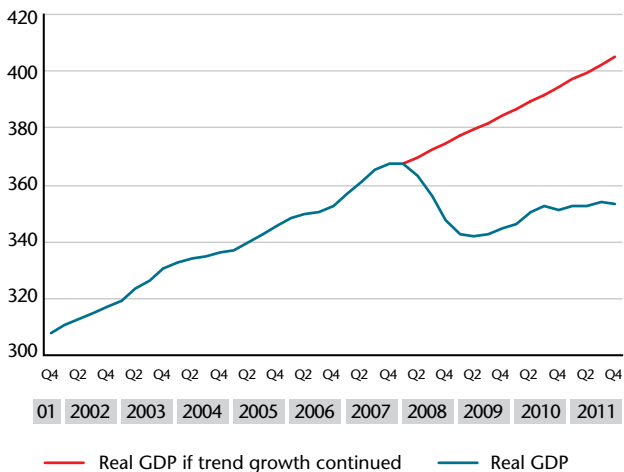
BCM this quarter also shows that turnover and profit growth expectations remain well below levels seen before the financial crisis. Businesses also appear to be reining in plans for capital investment while employment growth expectations remain weak – suggesting that firms are reluctant to invest in the future. Overall, BCM points towards a long, hard road to recovery for the UK economy – something which businesses, politicians and policy-makers slowly seem to be coming to terms with.

UK economy contracts in final quarter of 2011

The Office for National Statistics' (ONS) preliminary estimate of GDP in the UK for Q4 2011 showed the economy contracting at a quarter-on-quarter rate of 0.2%, reigniting fears that the UK could be heading for a double-dip recession. Sector data showed output in the production industries fell at a quarter-on-quarter rate of 1.2%. Output in the construction sector decreased by 0.5%, while in the services sector output was unchanged compared with Q3 2011.

An economy is technically in recession when GDP falls for two consecutive quarters, and the latest *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) suggests that this may be the case; the BCM Confidence Index points towards a further quarterly contraction of 0.2% in the economy in Q1 2012. But, even if the UK economy does not contract further at the start of this year, growth is likely to remain lacklustre in the short term as weak consumer spending and government austerity measures bear down on the economy.

Figure 1: Real GDP (£bn, 2008 prices)



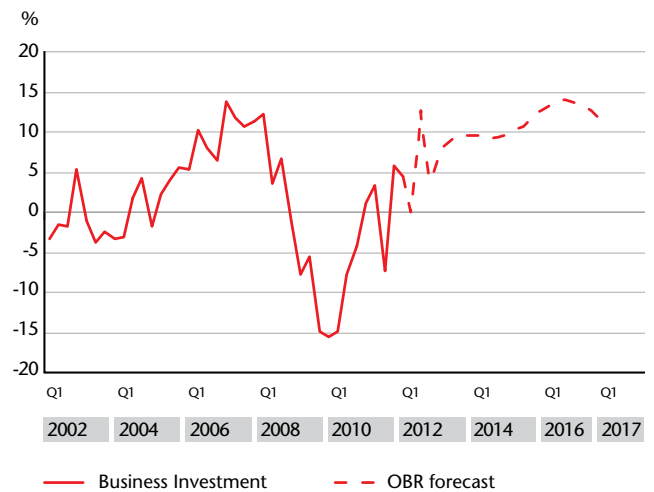
Source: ONS, Cebr analysis

The financial crisis and subsequent recession has had a profound impact on the UK economy. Even on the latest data, GDP is still some 3.8% below its pre-recession peak in Q1 2008, as illustrated in figure 1. And GDP is even further below where it would be if the economy had continued growing at its long-term trend rate from 2008 onwards, rather than the UK entering recession followed by sluggish recovery. Indeed, if trend growth had continued, output in Q4 2011 would be a staggering 14.5% higher than it actually was – illustrating the size of the 'output gap' created by the financial crisis.

BCM points to slowdown in capital investment growth

With consumers seeing their spending power squeezed by rising unemployment and weak earnings growth, and the government embarking on an ambitious programme of spending cuts, business investment – along with exports – is expected to be a key driver of growth in the UK economy over the coming years. Indeed, as figure 2 shows, the Office for Budget Responsibility (OBR) expects business investment to grow strongly especially in the outer years of its forecasting horizon. In 2015, business investment is expected to grow by 13% and in 2016 it is expected to grow by 12%, in real terms. Even this year, the OBR expects business investment to grow at a relatively robust rate of about 8%.

Figure 2: Business investment, annual % change



Source: ONS, OBR

Many analysts argue that these projections for investment are far too bullish; with a relatively gloomy economic backdrop and credit conditions still tight compared with before the financial crisis, it is unclear how and why businesses are going to expand investment spending so rapidly.

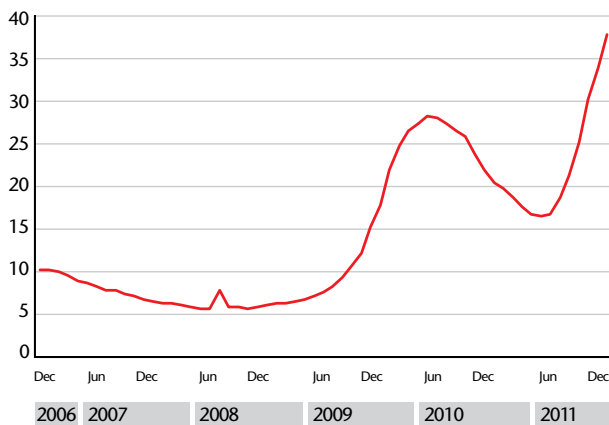
This quarter's *ICAEW/Grant Thornton UK Business Confidence Monitor* suggests that these concerns about the OBR's forecasts are well founded. Businesses expect capital investment to grow by just 0.9% over the next 12 months and capital investment growth expectations have now fallen for three consecutive quarters, indicating that businesses are becoming increasingly reluctant to invest in the future, probably related to cautiousness over the economic outlook. Overall, real-terms business investment growth of 8% this year is highly unlikely.

Unemployment continues to rise

Data from the Office for National Statistics (ONS) showed that the UK unemployment rate increased to 8.4% for the three months to November 2011, a rise of 0.3 percentage points on the quarter. The unemployment rate is now at its highest level since the three months to November 1995.

The claimant count for December rose by 1,200 from November's total, representing a 0.1% rise from the previous month, bringing the total number of claimants to just under 1.6m, up 9.8% on a year earlier. A closer look at the claimant count data reveals more worrying trends for young people, with long-term unemployment continuing to rise sharply. Over the last six months, the number of 18–24 year olds claiming Jobseekers' Allowance for over a year has grown by an average of 14% every month, representing a doubling of the total from July 2011. This is illustrated in figure 3.

Figure 3: Number of 18–24 year olds claiming Jobseekers' Allowance for over 12 months, thousands



Source: ONS

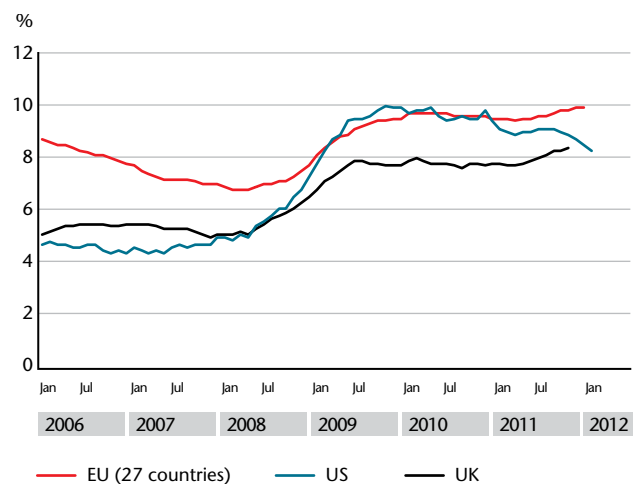
The latest official data highlights the fragile state of the UK labour market, which is quite likely to weaken over the coming months. Slow economic growth and a realisation among businesses that economic performance is likely to remain sluggish in the medium term both seem likely to cause unemployment to rise further this year. Many economists have pointed out that unemployment rose by less than expected during the recession, suggesting that UK employers have held on to overlarge, skilled workforces in the expectation that they would avoid rehiring costs when the economy returned to solid growth. Now that a return to solid growth anytime soon seems highly unlikely, businesses may start shedding 'surplus' staff, which will also push up unemployment.

Emerging contrast in US and European labour markets

Further encouraging news on the health of the US economy came this month as employment levels saw a strong boost and the unemployment rate fell back to its lowest since February 2009.

Data released by the US Bureau of Labor Statistics (BLS) showed that non-farm employment rose by 243,000 in January, compared to an increase of 203,000 in December. This is particularly good news compared to market expectations of an increase of 150,000 and the estimates of ADP, a payroll processor, of 170,000. The unemployment rate fell back to 8.3% in January, the fifth consecutive month of improvements. The last time that the unemployment rate was this low was almost three years ago, before it had started to rise in earnest following the recession of 2008–09. These latest figures suggest that peak unemployment following the downturn is well past and the US economic recovery may be gaining a stronger foothold.

Figure 4: Unemployment rates in the EU, US and UK



Source: US Bureau of Labor Statistics, Eurostat

In the EU, by contrast, unemployment has risen in recent months, as shown in figure 4. The EU unemployment rate was 9.9% in December 2011, unchanged from November but up from 9.5% in January 2011. With the eurozone looking set to enter recession this year, unemployment is likely to rise still further across Europe, meaning that a divergence in labour market trends between the US and EU is likely to emerge over the coming months.

Overall, the US economy looks set to significantly outperform the EU economy this year, though it too remains exposed to a global economic slowdown. These economies are important to the UK; exports of goods and services to the EU accounted for 48% of total exports in 2010, while exports to the US accounted for a further 17% of exports. Any slowdown in these economies would seriously derail the prospect of an export-led recovery in the UK.

Short-term economic outlook remains weak

The short-term economic outlook for the UK remains weak. Consumers in 2012 are unlikely to see their living standards improve significantly, as rising unemployment and weak earnings growth impact on household spending power. In addition, business investment is unlikely to be buoyant while confidence in economic prospects remains fragile – as illustrated in this quarter's *ICAEW/Grant Thornton UK Business Confidence Monitor*. Government spending cuts will weigh down on the economy, while

the eurozone sovereign debt crisis is likely to dampen export demand.

Bank of England Governor Sir Mervyn King recently described the path to recovery as 'arduous, long and uneven'. Indeed, it is difficult to see where significant, consistent growth will come from in the near term. Businesses appear to be preparing themselves for a long, hard road to economic recovery.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
24 February	Q4 2011 UK GDP Second Estimate	Unchanged
29 February	Lending to Individuals	Still weak
08 March	Bank of England interest rate decision	Rates on hold

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