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ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

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UK ECONOMY BETTER THAN EXPECTED, BUT RISK OF RECESSION REMAINS

The UK economy grew at a quarter-on-quarter rate of 0.5% in the third quarter of 2011 – broadly in line with the Q3 2011 ICAEW/Grant Thornton Business Confidence Monitor forecast.

However, the latest Business Confidence Monitor (BCM) shows the UK economy taking a severe turn for the worse in recent months. The BCM Confidence Index stands at -9.7 in Q4 2011, down from 8.1 in Q3 2011 – the sharpest quarterly fall on record and pointing to a 0.2% contraction in output in the final quarter of the year. Whenever the Confidence Index has been this low, or lower, the economy has contracted. If the UK economy performs in Q4 as predicted by BCM, it will have grown by just 0.9% in 2011 compared with the Office for Budget Responsibility's March projection of 1.7% growth.

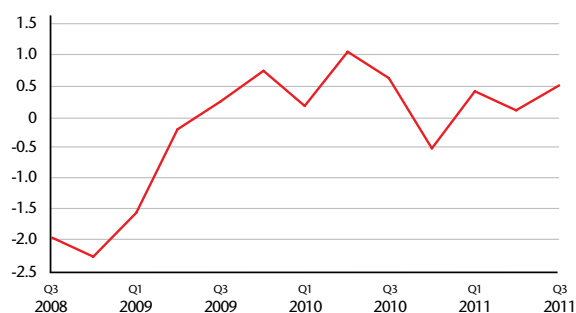
Ongoing turbulence in the eurozone appears to have significantly dented business confidence, and firms have sharply reduced their expectations for investment and employee headcount growth over the next 12 months. Overall, this quarter's BCM highlights the need for policy-makers in the UK (and across the developed world) to restore confidence in the markets and deliver a convincing growth agenda. Unless this happens, there is a real risk of the current crisis of confidence among businesses developing into an economic and financial crisis.

Economy has a long way to climb in order to reach the pre-crisis level

Many analysts had predicted very slow growth for the UK economy in Q3 2011, with some even expecting a decline in output. So, when the first estimate of GDP showed a 0.5% quarter-on-quarter increase in output – up from 0.1% growth in Q2 2011 – most commentators were surprised by the strength of the economy in the three months to the end of September.

However, rather than signifying a sustained upturn in economic activity, it is likely that the better-than-expected growth estimate is best explained by taking the previous quarter into account. As at the end of 2010 and the start of 2011, when temporary factors may explain the better-than-expected performance. In particular, the extra bank holiday in Q2 2011 may have curbed growth in this quarter and led to a displacement of production into Q3 2011 – skewing the growth figures.

Figure 1: UK gross domestic product, quarter-on-quarter growth, %



Source: Office for National Statistics

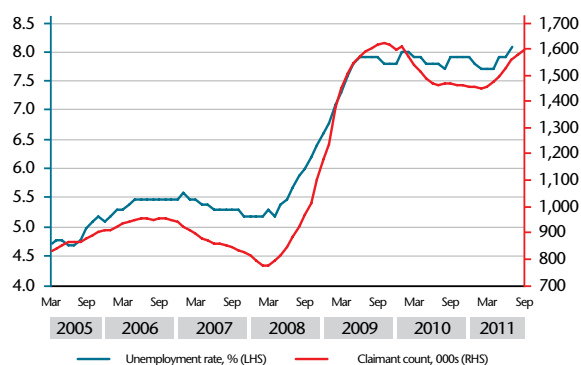
Overall, the underlying pace of economic expansion is sluggish and, compared with a year ago, GDP has grown by just 0.5% according to the latest data. Furthermore, economic output is still some 4.0% lower than its peak pre-recession level and, with the latest BCM pointing towards a contraction in output in the final quarter of this year, it will take some time before economic activity meets or exceeds this.

Youth unemployment reaches record high as labour market remains fragile

Following a period of stagnation just below 8.0%, the UK unemployment rate increased to 8.1% over the three months to August. The increase is of real concern for growth prospects, because employment does not just follow output, it also partly determines it via domestic consumption. Purchasing power is determined by

income and prices, with inflation raising the latter. Obviously, a rise in unemployment will lower the income of the newly unemployed, but it will also indirectly affect those working via lower pay growth as employee bargaining power is diminished. For this reason, a rise in unemployment tightens the much-cited squeeze on UK consumers.

Figure 2: UK unemployment benefit claimant count, 000s, and ILO unemployment rate, %



Source: Office for National Statistics

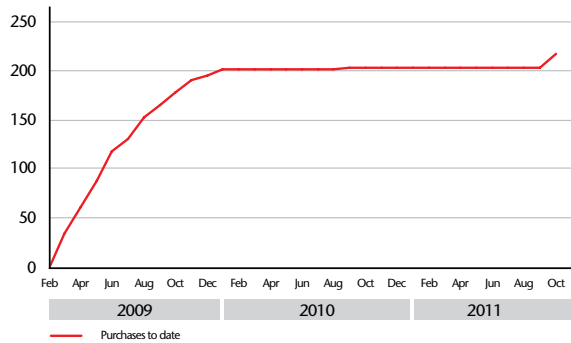
The group most affected by the weak labour market are those without much work experience – the youth. For those aged from 16 to 24, over one in five (21.3%) are now unemployed. This is the highest level since records began in 1992, suggesting that the economy is failing those just setting out on their careers, with the possibility of a lower-productivity workforce in the future. Such a weak labour market would normally prompt the government to stimulate the economy, but austerity measures mean that the exchequer is unable to make significant fiscal interventions. This requires the Bank of England to step into the breach.

Bank of England attempts to support the economy by buying more debt

To counter the negative demand implications of rising unemployment and expected weak exports to the UK's main trading partners in the eurozone, the Bank of England expanded its quantitative easing programme (QE) in October. The Bank is now buying an additional £75 bn of long-dated securities on the open market in order to stimulate the economy. However, questions remain over the effectiveness of further QE and it should not be viewed as a cure-all solution to the UK's economic woes.

One of the mechanisms by which it is supposed to impact the real economy is via a change in security prices. Buying large amounts of public debt is expected to reduce yields (ie, interest rates), making mortgages more affordable and reducing borrowing costs for firms. QE should also lead to a shift by investors into equities, raising share prices and making households feel richer, thus boosting consumption. In reality, however, market interest rates have remained fairly stable regardless of QE, as the Bank of England's *Trends in Lending* publication reveals. Further, given the globalisation of corporations, equities are arguably more sensitive to the international environment, limiting the impact of QE on prices.

Figure 3: Asset purchases by the Bank of England, £ bn



Source: Bank of England

In sum, QE is a relatively blunt instrument with which to stimulate a fragile economy and the impacts of further QE are uncertain. With consumer price index (CPI) inflation standing at 5.2% in September 2011 – well over double the Bank of England’s central target of 2.0% – inflation hawks may also find the latest policy announcement from the Bank of England highly unpalatable, questioning the Bank’s commitment to containing price growth in the UK.

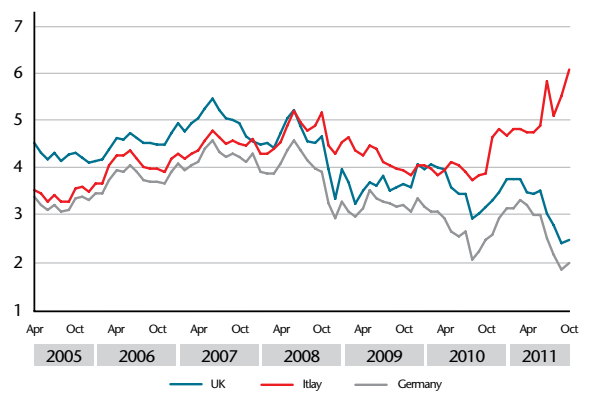
Investors set their sights on Italy as sovereign debt crisis intensifies

Consensus forecasts for eurozone growth have been falling consistently in recent months, with the Organisation for Economic Co-operation and Development now only forecasting 0.3% growth in 2012 (compared to 2.0% earlier in the year) and some economists predicting outright recession. This downward revision is the obvious result of a confidence crisis resulting from the fate of the euro hanging in the balance. Investors remain highly concerned about a sovereign debt default in Greece and Italy.

Italian borrowing costs have risen as markets lost faith in the ability of the country to outgrow its mountain of debt standing at around 120% of the annual output of the country. This rise in Italian government bond yields means that new debt has to be paid back at a more expensive rate, making the fiscal position less sustainable. The loss of faith can thus turn mere doubts into a self-fulfilling prophecy unless the situation is reversed.

Figure 4 shows Italian borrowing costs for long-term debt compared with German and British debt. As markets have fled to supposedly ‘safe’ countries, Italy has had to pay more and more to get money from creditors, despite interventions by the European Central Bank. The difference between benchmark German and Italian yields stood near 4.5 percentage points in early November, approaching the levels at which Greece, Ireland and Portugal had to ask for bailouts from other members of the currency union. Even after the latest eurozone summit, the size of the bailout fund will be insufficient to cover Italy, which is the third-biggest public debt market in the world.

Figure 4: 10-year government bond yields, percentage points



Source: Macrobond

Weak domestic demand and troubles abroad offer little hope of a fast turnaround for the UK

In summary it can be said that the latest GDP figures have been better than expected, but that rising unemployment points to sustained weak domestic demand. A sharp decline in business confidence also suggests that a return to economic contraction in the final quarter of the year remains possible. The Bank of England hopes that QE will boost the economy, but questions remain over the effectiveness of this policy measure. With fiscal austerity resulting in higher unemployment and also restraining the ability of government to intervene, a difficult period of restructuring lies ahead – it will take time for the private sector to absorb the workers being laid off in the public sector.

The data for the coming month will likely offer few surprises. With banks nervous about the potential fallout from the eurozone crisis on their capital position, lending is likely to remain muted. The Office for Budget Responsibility will almost certainly substantially revise down its forecast for economic growth in this and next year, meaning a higher expected budget deficit in future years and thus a longer time until public debt sustainability targets are expected to be reached.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
9 November	ICAEW/Grant Thornton Business Confidence Monitor	Increased concern about the UK economy
24 November	Second GDP estimate	Downward revision
29 November	Bank of England Lending to Individuals	Continued weak lending
29 November	Office for Budget Responsibility Economic and Fiscal Outlook	Upward revision of projected public deficit

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