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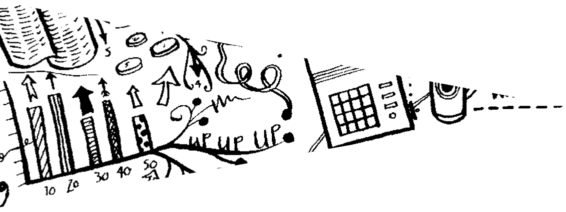


Economic outlook for business

'Economic outlook for business' summarises the latest UK quarterly forecast by the ITEM Club, and gives its assessment of the implications for business

Ernst & Young is the sole sponsor of the ITEM Club, which is the only independent economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias

Forecast highlights

- After a steep fall over the winter, the economy has been stabilised, but hopes of recovery are now running ahead of reality. GDP is set to fall by 4½% this year, with only a subdued recovery of ½% in prospect for next year. It is hard to see any boost to the economy until world trade starts to recover.
- The flexibility of the labour market has meant that the rise in unemployment has not been as bad as was feared. However, disposable incomes remain under severe pressure and consumer spending is likely to weaken further over the second half of the year.
- Although the underlying rate of monetary growth has picked up a little since the Bank of England began its programme of Quantitative Easing, corporate liquidity remains critical. The Bank has been swimming against a very strong tide, but must continue this effort.
- The next decade will be very different from the previous one. Growth will be constrained by the lack of capital, capacity and competition in banking. Bank lending rates will be high relative to money market rates, keeping policy rates relatively low. Base rates will be pinned to the floor over the next 18 months, undermining a recovery in sterling.
- The main risks remain on the downside, and include the threats posed by the H1N1 swine flu virus which could cut a further 3% from GDP this year and 1.7% in 2010.

The signs now point to recovery...

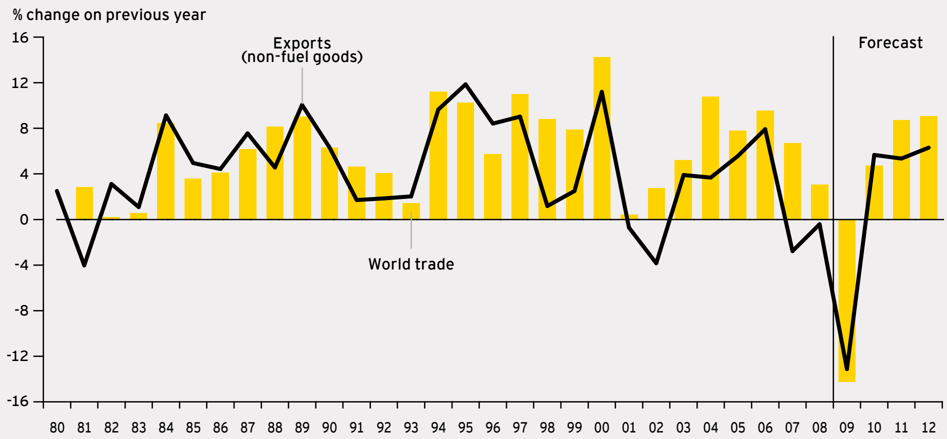
Although GDP fell by 1.8% in the final quarter of last year and a staggering 2.4% in the first quarter of this year, there have been encouraging signs recently. Industrial surveys suggest that output is already growing. The ITEM Club's view is that the economy has now been stabilised but remains critical and on life support. It remains unclear how quick and complete the recovery will be and there is still the chance of a serious relapse.

The financial markets certainly seem stronger. Equity and bond markets have continued to recover, allowing our larger PLCs to side-step the banking sector. It is one of the strengths of the Anglo-Saxon financial model that companies are less dependent on their banks. Rights and other capital market issues have been very strong so far this year, providing UK plc with an extra £70 billion of new funding. However, the lion's share has gone to financial institutions. Non-financial companies have raised £18 billion in the sterling capital markets, and this has been used to repay overseas issues as well as bank loans and commercial paper, leaving liquidity worryingly weak.

...but the UK has major adjustments to make.

Indeed, it is beginning to look as though the continental system could fare better in this crisis than the Anglo-Saxon financial

UK exports and world trade, 1980-2012



model, despite its reliance on banking markets. German companies have been hit for six by the collapse of world trade which fell at a more dramatic rate over the winter than it did during the onset of the Great Depression. Nevertheless German industrialists are adamant that they can work through this crisis in partnership with their bankers.

In contrast, British banks and their customers traditionally regard the 'customer relationship' as short-term rather than symbiotic. Moreover, German companies just have to wait for the world market to recover since they have the products and production facilities to sell into this. The UK has to make a more radical adjustment, rebalancing the economy towards export production.

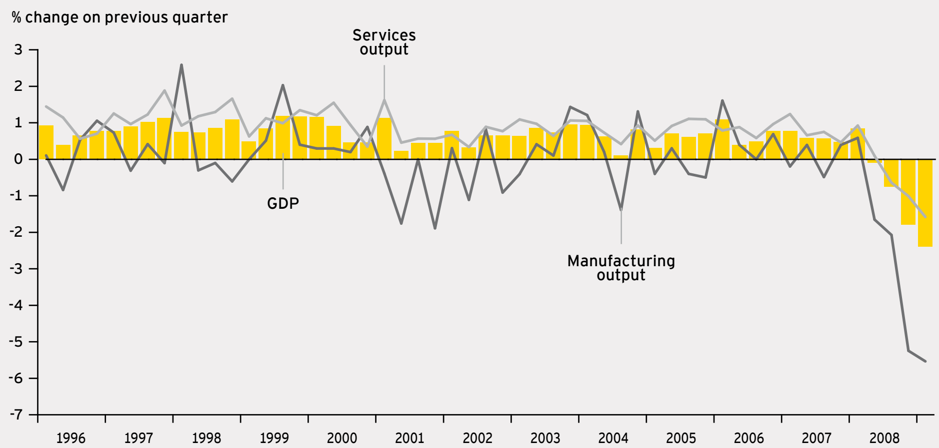
Recovery will be held back by the supply of credit...

Capital remains short and expensive for the banks and there is currently little sign of any extra lending to either companies or consumers. The Bank of England's latest credit conditions survey suggests that 14% of lenders increased their lending to corporates in the second quarter, compared with 26% that were planning to do so three months earlier. A similar picture emerges for mortgage lending. Banks are saying that they will expand lending more aggressively over the next three months, but another big shortfall seems likely. Spreads or profit margins are increasing on all types of business.

These surveys are clearly reflected in the monetary statistics. Corporate liquidity and borrowing remains worryingly weak, while net lending to the housing market remains close to zero. New mortgages are being financed by mortgage repayments, leaving the housing market supported by speculative cash buyers rather than first-time mortgage borrowers. Purchases of gilts and other assets from long-term investment funds under the Asset Purchase Facility programme are helping to increase the underlying rate of monetary growth, but the Bank is swimming against a very strong tide and this programme needs to be further expanded. Against this weak monetary background, any recovery in the economy will be anaemic and prone to relapse.

This situation is unlikely to change materially until banks succeed in re-building or raising shareholder capital, allowing them to repay the expensive preference shares injected by the government during

UK output, 1996-2009



the crisis. Once that happens, the flow of credit should increase, but at a heavy price. Companies are likely to find refinancing easier but expensive. In particular, private equity companies which cleverly refinanced their balance sheets using cheap ‘cov-lite’ five-year loans in the run-up to the crisis will find that they are kept on a much shorter and tighter leash, allowing the banks to use higher interest rates to extract the lion’s share of the profit as this recovers.

...while the reduction in competition has wider economic effects.

The contraction in capacity and competition in banking will have macroeconomic implications, driving a large wedge or spread between loan rates on the one hand and policy, money market and gilt rates on the other. We will see the mirror image of the picture that emerged in the mid-years of this decade, when competition kept down loan rates in the face of increases in money market and policy rates. This meant that policy and money market rates were higher than they would otherwise have been, helping to reinforce sterling’s high exchange rate. Looking forward, the rise in UK lending margins is likely to mean that the MPC will be relatively slow in raising policy rates once recovery begins, undermining a recovery in the exchange rate.

Unfavourable microeconomic effects will also be apparent. For example, the PFI programme will be handicapped by the high cost of capital. PFI providers are currently finding it very difficult to fund their activities, and although the flow of funds should recover as banks repair their balance sheets, PFI firms will find the cost of funding remains exorbitant.

The forecast shows a feeble recovery...

The forecast shows the economy stabilising this year, with a small technical bounce over the summer due to re-stocking. Spending should also be supported over Christmas by the VAT reduction (which will be reversed on 1 January). However, in the absence of any obvious stimulus, the economy remains very feeble next year, growing very slowly. Consumers remain under heavy pressure from company cut-backs in employment and earnings. While the employment outlook is not quite as dire as it was three months ago, this is partly because of the flexibility of the workforce, meaning that the pain is felt in wage rates rather than employment.

The forecast shows unemployment on the LFS measure topping out at 2¾ million next spring, 8.8% of the labour force. The claimant count almost reaches 2 million (6.1%). However, average earnings growth falls back more sharply than in previous forecasts, averaging 0.7% in 2009. Some relief is provided by inflation, with the CPI falling below its 1% lower threshold this autumn. Yet real disposable incomes are set to rise by just 1% in 2009 and again in 2010. Against this bleak background consumer spending is set to weaken further during the second half of the year, contracting by 3.2% in 2009 and by a further 0.2% in 2010.

Business investment remains very vulnerable in this uncertain climate. In the first quarter this was 7½% below a year earlier. The forecast sees it falling back by 10½% in 2009, with an additional fall of over 1% in 2010. Private housing investment fell by 12% in 2008 and the ITEM Club sees this falling by another 27% this year, with a further fall likely in 2010.

The ITEM Club Forecast for the UK Economy, July 2009

All figures are % changes on previous year (except interest and exchange rates)

Year	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports	Manufacturing output	Average earnings	RPI headline rate	CPI (Consumer Price Index)	3-month interest rate [1]	Effective exchange rate [1]
2007	2.6	3.0	2.1	7.8	-2.8	-0.7	0.6	5.5	4.3	2.3	6.0	107.2
2008	0.7	0.5	1.2	-2.8	0.8	-0.6	-2.8	3.4	4.0	3.6	5.5	94.1
2009	-4.4	-4.4	-3.2	-12.9	-10.2	-9.7	-9.9	0.7	-1.3	1.8	1.4	84.1
2010	0.5	0.5	-0.2	-1.9	5.2	4.8	3.3	1.9	2.4	1.1	1.5	86.7
2011	2.0	1.3	1.7	1.5	6.5	3.8	5.1	3.6	4.7	1.6	2.6	86.5
2012	2.5	3.0	3.4	4.8	8.0	9.1	3.9	4.5	6.4	2.0	4.3	85.3

[1] Average over calendar year

The government is accelerating its capital expenditure, but this will not be sufficient to prevent a major contraction in total investment. The forecast shows a fall of 13% in capital spending this year followed by a further fall of nearly 2% in 2010.

The weakness of the pound has helped many companies escape the worst effects of recession and is the main reason why UK confidence surveys are much stronger than those for the US and Euroland. However, these other economies are still very weak, and it is hard to see a durable recovery here unless and until they turn up. World trade appears to have stabilised after falling off a cliff over the winter, but in April it was still 20% below a year earlier. With both export and import volumes falling back this year, net trade adds just 0.2% to GDP.

...with risks still skewed to the downside.

The threat posed by the banking system has receded a little as the economy has stabilised, if only because the negative feedback effects of falling asset prices, output and employment onto bank balance sheets have been arrested. Nevertheless, the banks will remain on the worry list until the true scale of their losses is made clear. The ITEM Club's central assumption is that credit will stay tight and expensive and that the banks will not be in a position to support a recovery vigorously.

A second problem is that the extraordinary medicine the Treasury authorities have used to resuscitate the economic patient will seriously complicate any recovery. If this stimulus is withdrawn prematurely, that could precipitate a Japanese-style relapse. But if it is withdrawn too late, it is possible that the disinflationary gale could turn into an inflationary storm, though ITEM thinks that outcome is still very unlikely given the scale of the fall in output and the reluctance of banks to support any upturn.

The H1N1 swine flu virus also poses a serious risk to the economy. To estimate its potential effect, the ITEM Club has run a forecast variant assuming that a pandemic infection lasts for six months from August 2009. The infection rate is assumed to reach 50% and the mortality rate 0.4%. The main effect of such an epidemic on the supply side would be from employees staying off work because they or their dependents were ill. On the demand side, spending on discretionary goods and services such as restaurants, travel and tourism would be likely to fall as people stayed away from public places to avoid infection. Uncertainty about these developments would be likely to make businesses further postpone investment projects. ITEM estimates that such an epidemic would cut 3% from UK GDP in 2009 and a further 1.7% in 2010, hitting the economy hard just as it could have been starting to recover from the credit crunch.

Implications for business

- Companies will need to adjust to the whole new reality. The route to growth lies in overseas rather than domestic markets. This will be facilitated by the weakness of the exchange rate which will now be held back by a relatively low UK base rate.
- Bank lending rates are, however, likely to be much higher than in the previous decade. Businesses with access to capital markets will find that these are vital to support growth in the new environment. Investor relations, management of expectations and credit ratings will play a critical part.
- The H1N1 virus could be very disruptive and companies should review their plans for this kind of contingency. New home-working and video-conferencing facilities offer a way to deal with this. Retail and industrial units should carefully review their stock levels and supply chain.

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