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ITEM Club

Winter 2011-12 Forecast

Economic outlook for business

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

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

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Forecast highlights

- The crisis in the Eurozone has already put business spending and recruitment on hold, while doubts are increasing about the ability of China and other emerging markets to drive the global recovery. This forecast is based on the assumption that the Eurozone finds a way out of this crisis, but even so, this sees UK GDP growth of just ¼% this year followed by 1¾% in 2013.
- Prospects of weak global growth would normally hit commodity prices, but this silver lining is now looking very tarnished. Although other commodity prices are adjusting, the oil price has been kept up by social and political tensions in MENA, and a showdown with Iran would threaten much higher energy prices.
- With private sector recruitment on hold, public sector redundancies are now adding to unemployment, which is already very high. The forecast shows unemployment just shy of 3 million early next year, at 9.3% of the workforce. That will worry the consumer just as the pressure of inflation on disposable incomes begins to abate.
- The UK is probably in technical recession at the moment and likely to remain stalled until the second half of the year when falling inflation should provide a platform for a consumer recovery. However, the current resilience of the US and many other overseas markets and the strength of large company finances mean that the ITEM Club does not envisage a serious double dip.

The UK economy is on hold...

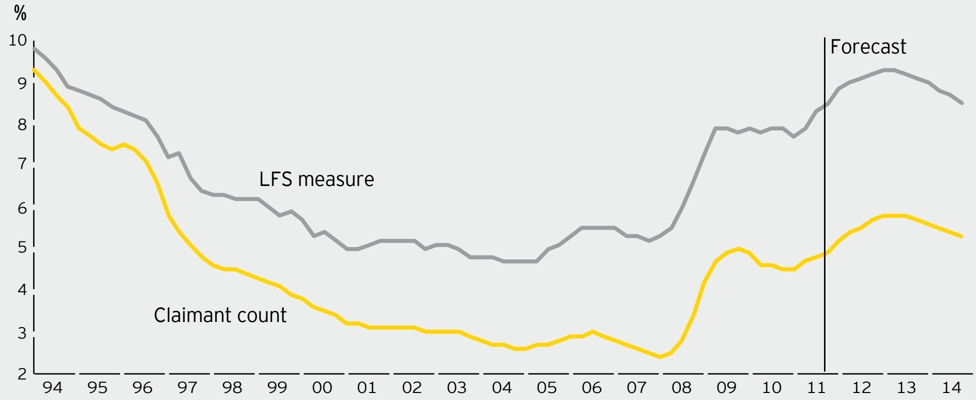
With the consumer still reeling from the effects of high inflation, the political paralysis in the Eurozone and worries about emerging nations' ability to drive the recovery have put the UK economy on hold. Export growth and business spending have decelerated dramatically. The economy is probably in a technical recession at the moment and is unlikely to move out of this until lower inflation builds a platform for growth in the second half of this year.

...as huge uncertainty in the Eurozone...

The failure to resolve the crisis in the Eurozone means that the new Italian government faces interest rates which seem to be stuck at around 7%, despite its austerity plan. High levels of government debt and low growth rates make that unsustainable, reinforcing doubts about default and even Italy's continuing membership of the EMU. It is hard to see any way out of this impasse short of a support programme for Italy coordinated by the ECB, EFSF and IMF. The fiscal compact discussed at the December summit does nothing to resolve the immediate crisis but is designed to prevent a recurrence.

2012 looks like being a very difficult year for the Eurozone even if it does manage to remain intact. Austerity is biting hard and, as European banks were not recapitalised post-Lehman, they are very vulnerable to sovereign default, with governments in the periphery and possibly some in the core unable to help them out. The ECB has been forced to provide Euro liquidity on an unprecedented scale. With US banks uneasy about lending to Euro banks, dollar liquidity

UK unemployment, 1994-2014



has to be provided by currency swaps between the ECB and the Federal Reserve.

...creates a bleak outlook for UK exports...

As in previous forecasts, the ITEM Club is assuming that an orderly resolution of this crisis will eventually be found. Even so, ITEM thinks the Eurozone GDP will be flat next year. Moreover, political paralysis in the Eurozone has already had its debilitating effect on the UK. Export orders have slowed right down and investment intentions are flat. Confidence is likely to deteriorate further in the absence of decisive action to resolve the crisis. Now, the Euro banking crisis threatens to spill over into UK credit markets.

...and with uncertainties in emerging nations...

At the same time, serious worries are emerging about the ability of emerging nations to drive the recovery. They are also plagued by imbalances, and heavily dependent upon investment and exports. There are particular concerns about the ability of Chinese policymakers to soft-land the economy. That is always difficult, particularly after an extended credit boom. Bankruptcies have already hit China's property sector, which plays an important role in local authority finances and could threaten the banking system.

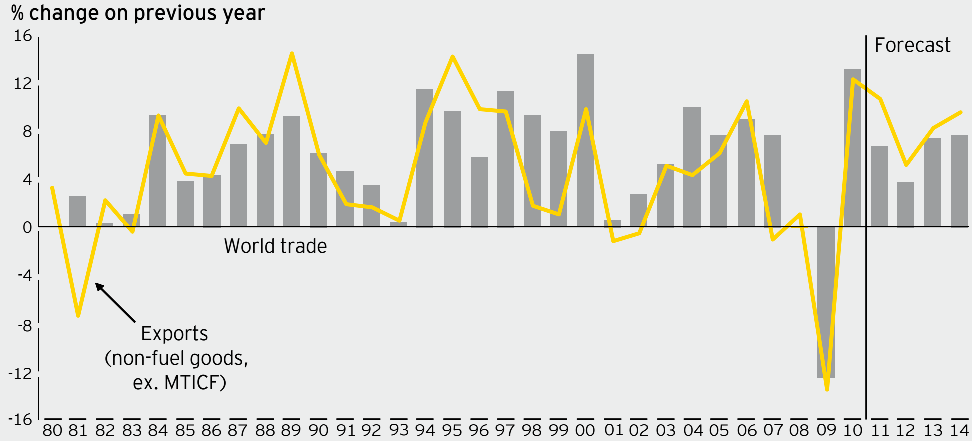
...prospects in other export markets have deteriorated

UK exports to emerging markets have recently been moving ahead impressively, but would be seriously affected by problems in China, which would quickly transmit to other Asian markets. Moreover, although non-oil commodity prices have eased back in response to the slowdown in the emerging economies, oil and other energy prices have remained stubbornly high, supported by worries about social and political unrest in the MENA region, and in recent weeks renewed worries about Iran. Global political and economic developments are likely to provide yet more challenges for the UK in 2012.

UK companies' financial position is strong...

Fortunately, British business remains in a strong position to ride these challenges. Large Plcs cut back heavily on investment and other spending during the last recession and now enjoy remarkably strong cash flows and balance sheets as well as a very low cost of capital. They have been holding back

UK exports and world trade, 1980-2014



from investment because of uncertainties about home demand. They now face even bigger imponderables overseas, and surveys of investment intentions suggest that the recovery in business investment is faltering. M&A activity and advertising have also been hit by uncertainty.

...but uncertainty has killed investment and job cuts are likely to follow

Companies ramped up dividends and share buy-backs in 2012 as a way of getting surplus cash back to shareholders. However, finance directors are now likely to keep a tight grip on their cash as an insurance against adverse developments.

More of a worry for the consumer, recruitment is weakening, at the time when the government most hoped private sector recruitment would offset public sector redundancies. In earlier quarters, the former easily outweighed the latter, but in the third quarter of 2011 private payrolls increased by just 5,000, while government employment shrank by 67,000. Employment levels remain exceptionally high in relation to output, and employers may shed staff if prospects deteriorate further.

The forecast shows the UK in technical recession...

The forecast assumes that problems facing policymakers in Europe, China and elsewhere are successfully negotiated. Even this optimistic assumption implies that world trade growth will slow to 3½% from 6½% in 2011. However, this should allow commodity prices to ease back and monetary policy to remain stimulative. The forecast sees oil prices falling back to an average of $100 a barrel over this year from a record $111 in 2011. World food commodity prices fall back by 4% and industrial commodity prices by 12%. In the UK, with last January's hike in VAT and fuel duties falling out of the index, CPI inflation falls back into line with the 2% target in the third quarter of this year, vindicating the MPC's stance on interest rates.

...before starting to pick up later this year

On current prospects, inflation should remain subdued, allowing interest rates to remain on hold until growth prospects pick up towards the end of this year. The forecast sees GDP falling by 0.2% in the final quarter of 2011 and a further 0.15% in the first quarter of this year, marking a technical recession. Even though small increases are likely in the second half, the UK economy will struggle to post a positive growth figure for 2012.

But investment remains on hold...

The forecast sees business investment flat in the final quarter of 2011 and again in the first quarter of this year, before starting to pick up in the second half as some of the uncertainties play out. Over 2012 it grows by 3.9%, up from 1.4% in 2011. However, with investment in dwellings flat or falling and government investment being cut back by 12% a year or more, total investment expenditure falls by 2.6% in 2011 and is broadly flat in 2012.

...and the axe hangs over payrolls...

This sectoral pattern is echoed in employment this year, as private sector recruitment fails to offset job losses in the public sector. Total employment falls by 145,000 and unemployment increases by 309,000 on the wide LFS definition. A resumption of private sector recruitment in 2013 increases employment by 93,000, but this is insufficient to prevent unemployment rising, by 85,000. These increases in unemployment add to a total that is already

The ITEM Club Forecast for the UK Economy, January 2012

Figures are % changes on previous year (except government borrowing, current account, interest rates and exchange rates)

Year	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports	Net government borrowing [1]	Current account (% of GDP)	Average earnings	Inflation (CPI)	3-month interest rate [2]	Effective exchange rate [2]
2008	-1.1	-1.4	-1.5	-4.8	1.3	-1.2	6.8	-1.4	2.3	3.6	5.5	91.1
2009	-4.4	-4.4	-3.5	-13.4	-9.5	-12.2	11.0	-1.5	1.8	2.2	1.2	80.6
2010	2.1	1.6	1.2	3.1	7.4	8.6	9.4	-3.3	3.8	3.3	0.7	80.5
2011	0.9	-0.5	-0.5	-2.6	4.6	1.5	8.4	-2.8	1.8	4.5	0.9	80.0
2012	0.2	0.0	0.2	0.4	2.9	1.6	7.6	-2.3	1.9	2.3	1.0	81.5
2013	1.8	1.1	1.4	4.8	6.9	5.0	6.0	-0.8	2.8	1.9	1.8	80.4
2014	2.8	2.1	2.3	8.0	8.0	5.9	4.3	0.1	3.2	2.0	2.8	79.1

[1] Fiscal years, % of GDP [2] Average over calendar year

very high and is forecast to peak in the first half of 2013 at almost 3 million, 9.3% of the labour force, before beginning to fall back.

...delaying a recovery in consumer spending

These developments will no doubt worry the consumer, just as worries about inflation and real wages are at last beginning to abate. After falling by nearly 2% in 2011, real household disposable incomes fall by 0.8% over this year, but they begin to recover in the second half. In this situation the Diamond Jubilee and Olympics should support consumer spending which, although it remains flat this year, picks up by 1.4% in 2013 and another 2.3% in 2014 as employment prospects brighten and inflation remains low.

Exports to fast-growing overseas markets remain the only hope...

Net exports added 0.9% to GDP in 2011, accounting for all of last year's growth. Export prospects look much less promising this year, but remain positive. The ITEM forecast sees exports growing by 2.9% over 2012, ahead of import growth of 1.6% and adding 0.4% to GDP on balance. Over 2013-14, exports grow by 7 to 8% a year, well ahead of imports, as world trade picks up. But such growth won't be found in European markets while they are hampered by weak demographics, austerity policies and tight credit: UK exporters will need to continue to focus their energies on emerging high-growth markets.

...while the risks are quite unprecedented

The economic scene facing the UK in the New Year is very precarious. We face a financial crisis in a single currency zone covering a continent with 17 sovereign states, a situation that is unprecedented and unpredictable. The economic and social problems facing China, oil producers and other high-growth countries are also hard to comprehend and the scope for policymakers to mishandle these problems is hard to exaggerate.

Implications for business

Firms must consider the medium-long-term impacts on their business as well as the immediate challenges which include the risks to the Euro currency union and the reduction of liquidity in the market:

- The ECB and EFSF together with the IMF probably have enough firepower to prevent a disorderly disintegration of the Euro. But it would be foolish to bank on there still being 17 members in the Eurozone this time next year. Companies should be prepared for worst-case scenarios involving default, exits from the Euro and other disorderly outcomes. Cash flow and counterparty risk also need to be monitored carefully and continuously in this environment.
- The effects of the Eurozone banking crisis on UK liquidity are potentially very serious. Banks are deleveraging to meet increased capital requirements while uncertainty and volatility are further reducing the availability of credit. The Bank of England's Q4 Credit Conditions survey suggested they are already expecting to increase the rates they charge corporate borrowers. Careful management of banking arrangements therefore remains crucial.
- For the same reasons, companies dependent on a small number of suppliers and/or customers need to reduce their risk exposure by monitoring the strength, liquidity and risk exposure of those businesses.
- While many businesses will need to deal with inevitable shocks, they need to be aware of the danger of over-reacting. Regular external communications are vital in preparing stakeholders for such events and in managing them successfully.
- In the medium term, corporates must ensure their business models are appropriate for the new market conditions. Firms banking on a return to 'business as usual' are in for a nasty surprise. Business models built around constant growth in a growing economy must be challenged to identify the appropriate focus by segment and sector and the cost structure and activity mix appropriate for the new economic environment.
- While exports to European markets remain vital to the UK, these are likely to be held back over the medium term by austerity, credit restrictions and demographics. This makes exports to other destinations vital to the UK recovery, despite worries about China and other emerging markets. Astute company managers will review their long-term business models and strategy and pursue opportunities to tap into new markets.

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