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ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

OCTOBER 2011



STATE OF THE ECONOMY DOMINATES PARTY CONFERENCE SEASON

Unsurprisingly, against a backdrop of slow growth, an ongoing debt crisis on the Continent and a significant squeeze on living standards in the UK, the fragile state of the economy has dominated party conference season.

Despite rumours of a £5bn increase in government capital investment to boost growth, senior coalition figures – including David Cameron, George Osborne and Nick Clegg – have all stated over the past few days that there can be no significant deviation from the current deficit reduction plan. Rather than attempting to create more room for manoeuvre and minimise the potential political damage from changing course, the coalition has restated its commitment to 'Plan A', meaning that a slowing of the pace of public sector cutbacks is unlikely.

The Chancellor announced proposals for 'credit easing', which would involve the Treasury buying corporate bonds as a way of improving lending to businesses and preventing a second credit crunch. However, as small companies generally don't issue bonds, it remains unclear how credit easing will benefit many businesses in the UK – full details of the scheme are yet to emerge.

The Bank of England has this month announced that it will be expanding its programme of quantitative easing by a further £75bn – surprising markets as it came a month earlier than expected and was considerably more than a predicted £50bn. This suggests the Bank's Monetary Policy Committee is now so concerned about the economic outlook that it believes immediate and increased monetary stimulus is required to prevent a slip back into recession.

Overall, the global economic outlook remains highly fragile, with significant downside risks to growth. Even with additional quantitative easing and pro-growth measures from government, the UK economy may still struggle to gain significant momentum – especially if the ongoing sovereign debt crisis in the eurozone triggers another financial crisis.

Market losses take their toll on savers

Ongoing concerns about growth have taken their toll on stock markets in recent months, as investors throughout the world have had to concede that the emergence of the developed world economies from the most significant financial crisis in decades will be slow, choppy and with significant downside risks. In Q3 2011, the FTSE 100 saw its biggest quarterly fall in nine years.

Investors remain especially concerned about the colossal sovereign debt crisis looming over the eurozone. Despite numerous bailout fund announcements and a raft of austerity measures being implemented across the eurozone, many market analysts and economists believe this is merely papering over the cracks in the single currency area and the eurozone in its current form is inherently unsustainable – unless some countries leave the euro or there is movement towards closer fiscal integration in the single currency area.

Figure 1: FTSE 100 index



Source: Macrobond

The recent sharp fall in share prices is a major concern – not just for investment bankers and the wealthy, but for ordinary UK households. Workers who have been ploughing money into private pension schemes have seen sharp falls in the value of their funds, which are

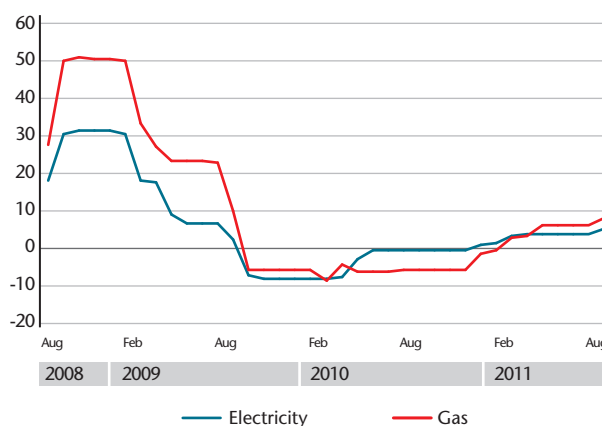
intrinsically linked to movements in the stock market. Similarly Individual Savings Accounts (ISAs) that track the FTSE 100 have seen a fall in their value since the start of the year as the index has tumbled (Figure 1). Research by financial information service Moneyfacts suggests that an average Stocks & Shares ISA of £10,000 at the start of the year is now only worth about £8,778 – a decline of over 12%. Falling markets have really begun to hit savers and those planning for retirement.

Cost of living continues to soar

The slow pace of economic recovery in the UK has yet to significantly bear down on consumer price inflation (CPI) which, at an annual rate of 4.5% in August, is still well over double the Bank of England's central target of 2%. Households are thus facing a triple-whammy of slow earnings growth, elevated unemployment and a rising cost of living – the most prolonged squeeze on living standards since the 1920s.

And things could get worse before they get better. With all of the big six energy companies in the UK implementing price hikes, the cost of domestic gas and electricity is likely to keep inflation elevated for the rest of this year at least. The Bank of England believes the rising price of utilities – illustrated in Figure 2 – could push CPI inflation above 5% over the coming months.

Figure 2: Annual % change in consumer electricity and gas prices



Source: ONS

Despite the high rate of inflation, the Bank of England's Monetary Policy Committee continues to keep interest rates on hold at record lows, for fear of derailing an already fragile recovery. In addition, it has announced plans to expand its programme of quantitative easing by a further £75 billion. While this may prop up the economy, it could also keep inflation elevated for longer and the Bank of England risks losing credibility in its commitment to a 2% central target for price growth.

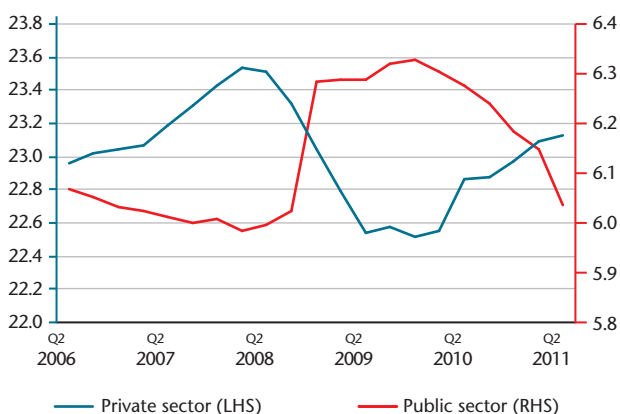
The current era of high inflation and slow growth means central bankers in the West are facing a difficult trade-off between curbing price growth and securing the economic recovery – something of a headache for policy-makers. But, for now at least, the need for economic growth appears to dominate the global policy debate and interest rates in the UK are unlikely to move upwards anytime soon.

Unemployment rises as public sector jobs are axed

Data released by the Office for National Statistics (ONS) showed the ILO rate of unemployment in the UK stood at 7.9% for the three months to July, up 0.3 percentage points on the quarter and the largest quarterly increase in unemployment since the three months to August 2009, when the UK was still in the midst of recession. The more timely claimant count measure rose by 20,300 between July and August, a further sign of weakening labour market conditions.

The number of people employed in the public sector fell by a staggering 111,000 between March and June 2011, suggesting that job shedding in the public sector is occurring at a much more rapid rate than anticipated; the Office for Budget Responsibility expected general government employment to fall by just 20,000 in the 2011/12 fiscal year. The fact that private sector job creation was just 41,000 over this period has prompted fears that the private sector recovery is still fragile and will be unable to offset public sector job losses over the coming quarters. A rise in the unemployment rate to above 8% looks increasingly likely.

Figure 3: Private sector and public sector employment, millions



Source: ONS

On the upside, compared with a year ago, employment is still slightly higher. Some 264,000 private sector jobs were created over the 12 months to Q2 2011, against 240,000 public sector job losses – implying a net increase in total employment. Private sector employment is still growing according to the latest data, as shown in Figure 3. Critically, the UK labour market has made headway in rebalancing away from public sector dependence over the past year – something which is necessary to restore the government’s finances to good order.

However, there remains a real risk of private sector recruitment grinding to a standstill amid falling business confidence and concerns about the eurozone crisis, leading to a sharp deterioration in labour market conditions. As with the inflation situation, things could get worse before they get better.

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The UK: A divided nation

Figure 4: Unemployment rates by UK region, Q2 2011, %



Source: ONS

With so much fixation on headline nationwide statistics, it can be easy for analysts to forget just how divided the UK economy is and how the burden of austerity and slow growth is hardly being shared equally. Yet any journey around the UK quickly reveals the stark differences in economic activity and employment opportunities. While over a third (36.1%) of shops in the seaside town of Margate stand vacant according to the latest statistics from the Local Data Company, retail sales in London continue to grow strongly despite the gloomy economic backdrop; in August 2011, retail sales values in the West End were 5.5% higher than a year ago and in September some 200,000 customers visited the Westfield Stratford City shopping centre on its opening day.

While 5.8% of economically active individuals in the South East were unemployed in Q2 2011, in the North East the unemployment rate was 10%, as shown in Figure 4. So as some parts of the country are flourishing or getting by, others are being strongly affected by falling real incomes and a dearth of job opportunities. Guaranteeing economic growth for the UK as a whole is proving a challenging task; guaranteeing growth for every region in the country is an even greater challenge.

Concerns about growth trigger a wave of new policy announcements

Economic policy-makers broadly have three objectives: ensuring growth, containing inflation and having a credible and sustainable fiscal strategy. Yet, worryingly, none of these objectives are being met in the UK (and much of the West) at present; inflation is running at over double the Bank of England's central target, the government looks set to miss its deficit reduction targets and growth remains sluggish and at risk of grinding to a standstill.

The parlous economic situation in the Western economies has prompted governments and central banks to step up efforts to prevent a double-dip recession. The US Federal Reserve recently launched 'Operation Twist', where it plans to buy \$400bn of long-dated Treasury bills to bring down long-term

interest rates and boost growth. President Obama announced a \$450bn jobs creation package to kick-start the US labour market, while in the eurozone politicians continue to battle for the survival of the single currency.

Party conference season in the UK has revealed an extension of the current Council Tax freeze to the 2012-13 fiscal year, increased lending to businesses, and a step up in house building, which could create up to 400,000 new jobs in the construction sector. Yet this has all been overshadowed by the Bank of England's shock announcement for an additional £75bn of quantitative easing. Moreover, with the Q3 2011 GDP preliminary estimate due beginning of November, it could end up showing the UK economy has already started contracting and that policy-makers have acted too late to prevent a second downturn.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
19 October	Minutes of October MPC meeting	Increased concern about the UK economy
20 October	Trends in Lending	Still weak
01 November	GDP Q3 2011 preliminary estimate	Growth close to zero

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