

Economic Outlook for Business

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Forecast highlights

- The UK economy has been growing strongly and the ITEM Club expects this momentum to deliver GDP growth of 3.1% over 2007. However, the tightening of monetary and credit conditions over the summer means that growth is now set to slow, and ITEM forecasts UK GDP growth to fall to 2.1% over 2008.
- Financial services have been growing at over 10% a year recently, but the credit market reversal could halve that, with widespread effects for the economy.
- The danger of a severe 'credit crunch' has receded, but for many borrowers credit costs will rise and availability will tighten. If the PBR is to be believed, the public sector will also begin to retrench next year. This leaves growth dependent upon investment, employment and the strength of the non-financial business sector.
- The Northern Rock fiasco has threatened the credibility of the UK system of financial regulation. The government and financial authorities need to address this problem swiftly if London's position as a financial centre is to be maintained.

Background

Credit is becoming more expensive and harder to obtain...

After a turbulent summer, the credit markets are beginning to stabilise, with spreads moving back to levels that are higher than before the crisis hit, but consistent with a more rational aversion to risk. However, credit is becoming more expensive and harder to get, particularly for high-risk borrowers. A recent survey by the Bank of England shows a clear deterioration in the availability and cost of credit to companies over the past three months, which is expected to worsen over the coming three months. Three-month market rates are above the 6% level that the Bank's August Inflation report indicated should control inflation. The cost of new borrowing for corporates is now over 2% higher than a year ago – threatening the outlook for business investment.

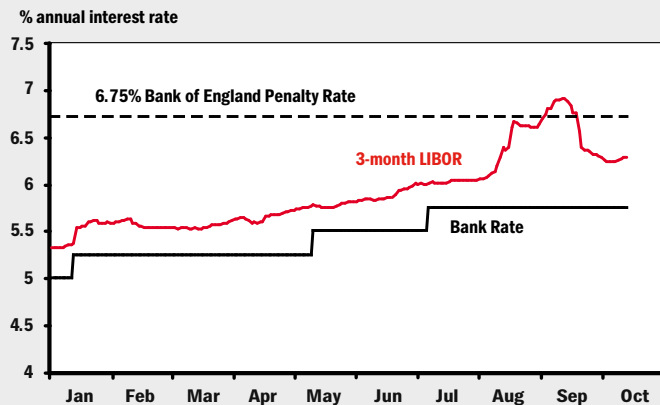
One reason for this is that banks are no longer able to fund their Special Investment Vehicles (SIVs) and other off-balance sheet vehicles using the commercial paper market, and this has driven rates in the inter-bank market to a premium over base rate. These off-balance sheet vehicles can no longer be used to channel cheap and plentiful credit to mortgage and other borrowers.

UK inter-bank rates have eased back recently and are now about ½% above base rate. These premia act as a barometer of the underlying balance sheet financing strains. Many companies borrow at LIBOR and other rates that move automatically with inter-bank rates, so their interest charges have already gone up. Household borrowing rates, which had been held down by competition, are now likely to rise significantly.

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

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UK: 3-month LIBOR and Bank rate, 2007



These premia persist in all major markets, despite attempts by central banks to add liquidity to offset the underlying pressures. This effect has been particularly marked in the UK, where the Bank of England has been criticised for doing too little too late, contributing to the pressures that led to the ‘run on the bank’ at Northern Rock.

...while the run on Northern Rock...

The irony is that the run was triggered by the Bank of England’s announcement of its ‘lender of last resort’ support on 13th September. 3-month inter-bank rates had moved up to 6.9% earlier in the week. The Treasury’s deposit guarantee finally stopped the run on the 18th. The Bank announced a relaxation of the maturity and collateral conditions for support to other banks the following day. However these relaxations had little impact – eg, there were no bidders at the Bank’s 3-month money auctions.

...raises a major question mark over the 1997 financial reforms.

Long-term, these developments, following hard on the heels of the CPI overshoot in May, raise profound questions about the twin monetary and regulatory reforms announced by Gordon Brown following the May 1997 election. The new system begins to look like a fair-weather vehicle that breaks down under strain. The government and the financial authorities need to address this problem swiftly if London’s position as a leading world financial centre is not to be threatened.

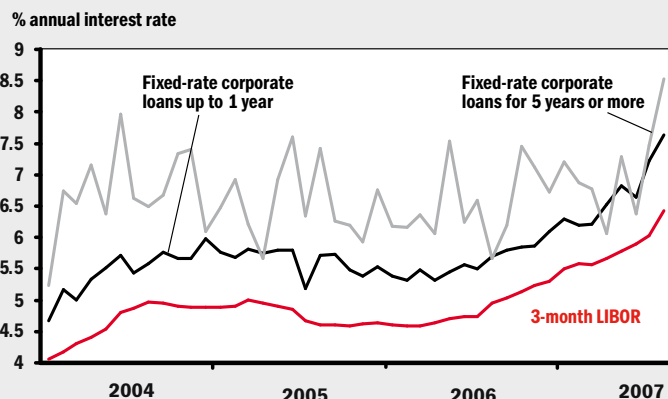
Higher interest rates have yet to hit most consumers...

Although rates for sub-prime mortgages have already moved up by over 2% into the low teens, most households do not yet appear to have been affected by the credit squeeze, partly because household variable rates tend to move more slowly than business rates. Yet in the months to come, consumers are likely to be more affected by the tightening availability of credit than companies (which typically have credit lines in place which they can draw upon readily).

...while the housing market cools and consumer credit falls back.

The latest survey from the Halifax – which has proved a reliable indicator in the past – suggests a levelling off in the housing market. House prices fell by 0.6% in the month to September, taking the annualised three-month increase down to 10.7% from 11.4% in August. Moreover, the number of mortgage approvals – another reliable advance indicator - fell by 6,000 in August to 109,000 while mortgage lending dipped

UK: Corporate borrowing rates for new business



from £8.9bn in July to £8.5bn. Consumer credit growth also fell in August, running at £1.0bn compared to £1.1bn in July. In the second quarter – even before the crisis hit – housing equity withdrawal fell to a two-year low. This has been a major support for consumption when incomes have been under pressure, but this support has now gone.

The ITEM Club Forecast

The City is set to slow...

The UK financial sector, which has been sporting annual growth rates in the teens and makes up 9% of GDP, is likely to slow. Arithmetically, a halving of this growth rate would take 0.4% off UK GDP growth, but knock-on effects in related activities could increase this. The investment and employment effects of this sector are considerable, and negative knock-on effects from reduced employment and lower bonus payments are now expected, with major implications for the London residential housing market.

...amidst a general slowing in the services sector...

There is already evidence of these effects. The September CBI survey of the financial sector found the most negative balance of expectation since 2004 Q3. The September Purchasing Managers survey showed that the service sector as a whole grew at its slowest pace in more than a year and that the financial services sector was particularly affected. Service sector surveys in the US and Europe also moved lower in September.

...hitting the new Chancellor's budget plans.

Alistair Darling is tightly boxed in by high levels of public spending and taxation and a current fiscal position that remains in deficit despite the strength of the financial sector, oil prices and the economy. Now the reversal in the credit markets will expose this position, forcing him to try to halve the growth of public spending. The consequences are likely to be much more significant than the Pre-Budget Report suggests. Taxes paid by financial companies and their employees are particularly sensitive to market conditions, as we saw following the post-millennium downturn in the equity market. Tax revenues were weakening even before these effects were felt, and public spending has been growing much faster than projected in the Budget.

But the rest of the UK business sector remains strong...

To set against this doom and gloom, the rest of the business sector looks remarkably buoyant. Profitability in UK companies is running at record levels. The manufacturing PMI remains well above its long-run average, despite a slight fall in September. So far it has shrugged off the effects of a falling dollar and weakening US market. However, the index for output prices rose to an all-time-high, despite easing pressure on input prices – indicating that the Bank of England's battle against inflation is not yet over.

...as does the world economy.

The outlook for the world economy continues fair. World equity markets have staged an impressive recovery and should now be underpinned by profitability and growth, rather than artificially inflated by credit-based takeover activity.

So much now depends on the money markets.

Having propelled the economy forward rapidly, the credit markets are now likely to act as a major drag on economic growth. However, three-month money markets rates have begun to subside recently and ITEM's forecast assumes that they stabilise at 6%, but the situation needs to be monitored since there is a risk of monetary overkill.

The ITEM Club Forecast for the UK Economy, October 2007

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]
2005	1.8	1.6	1.5	1.5	8.2	7.1	-1.2	3.7	2.8	2.1	4.7	103.3
2006	2.8	3.0	2.1	8.2	10.3	9.8	1.3	4.0	3.2	2.3	4.8	104.6
2007	3.1	3.4	3.0	5.7	-4.3	-2.8	0.8	3.7	4.2	2.3	5.9	107.4
2008	2.1	2.1	2.0	1.8	5.7	5.1	0.9	4.2	2.3	1.9	5.4	104.9
2009	2.5	2.4	2.3	2.7	5.6	5.1	1.0	4.7	2.2	1.9	5.0	104.1
2010	3.0	3.2	3.1	4.2	6.6	6.6	1.2	4.8	2.8	2.0	5.0	103.1

[1] Average over calendar year

The ITEM Club forecasts that GDP growth will be 1% lower next year.

Base rate should fall once M4 and GDP growth have slowed...

...but this is unlikely to revitalise demand.

ITEM believes that the underlying momentum this year should be sufficient to deliver GDP growth of 3.1%. But the tightening of monetary and credit conditions over the summer has caused ITEM to reduce its 2008 growth forecast from 2.5% to 2.1%.

With CPI inflation back below the 2% target, and forecast to stay there until the end of the year, there is speculation that base rate could be reduced. However, the ITEM Club thinks the MPC will want to assess the state of the economy and the effect of the credit tightening before making a move. One factor is M4, which may increase temporarily as banks absorb off-balance sheet items. However, ITEM expects both M4 and GDP growth to slow next spring as banks attempt to restrain the growth in their balance sheets, paving the way for a rate cut.

Real disposable incomes showed practically no increase in the year to the second quarter, and discretionary incomes probably fell over this period. Earlier in the year people kept consumption growing by dipping into their savings or withdrawing equity, but they are now likely to have second thoughts about that. At the same time the PBR foreshadows a long overdue retrenchment in the public sector. And although the corporate sector remains remarkably strong and is flush with cash, investment and employment will not remain supportive if monetary policy remains too tight.

Implications for business

- Overseas markets remain very strong, although the weak dollar makes the going tough in the North American market. The UK consumer and government are over-borrowed and can no longer drive the economy forward. This leaves GDP growth critically dependent upon overseas demand and business investment and spending.
- Corporate floating-rate borrowing costs are 2% up on a year ago but should have reached their peak. ITEM expects LIBOR rates to subside with inter-bank rates as the premium over base rates falls. Base rate is likely to be cut in the new year.
- Companies that have benefited from the rising housing and equity markets should be careful. While base rates are unlikely to rise, the mortgage market is likely to be less competitive now that lenders relying on securitisation and inter-bank funds have been hit. House prices could be vulnerable to buy-to-let selling after April.
- Asset values are looking increasingly stretched. It may be hard to identify factors that could cause a sharp correction, but a period of adjustment is likely in which residential and commercial property prices rise no faster than other prices.



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The ITEM Club, sponsored by Ernst & Young, is the only economic forecasting group to use the HM Treasury model of the UK economy, and its forecasts are independent of any political, economic or business bias.

Economic Outlook for Business is published quarterly in January, April, July and October. The most recent issue is available on Ernst & Young's UK website at www.ey.com/uk/economy Any updates to ITEM's forecast are also available at this address.

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