

# Economic Outlook for Business

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## Forecast highlights

- With the weakness in the high street likely to hold down inflation, there is room for interest rates to be cut to prevent the abrupt reversal in the credit markets leading to a reversal in the economy.
- On this view, the 2008 economic outlook is one of rebalancing rather than recession. The forecast shows GDP growth slowing from 3.1% in 2007 to 1.8% in 2008 with base rate down to 4¾% by the year end and inflation close to 2%.
- The pound has fallen back as part of this adjustment, and will help exports and investment compensate for the weakness in the housing market and the high street. Although this poses a threat to inflation and interest rates, the weakness of the domestic market should make it difficult for importers to pass their higher costs on to the consumer.
- Unfortunately, fiscal policy cannot be relaxed to cushion the economy over this difficult period. One reason why the pound is so weak is that fiscal policy cannot be used to complement monetary policy and support the economy as it was in 2002; the brunt of the adjustment must come through lower interest and exchange rates.
- The Treasury is actually planning to tighten fiscal policy over the next two years, but this is no longer appropriate or feasible. Policy should have been tightened during the upswing and it would be compounding the error to tighten it up now. It will be very difficult to meet the fiscal rules in the upcoming cycle, but this has to be a secondary consideration at this juncture.
- The crisis in the money markets has been eased by central bank intervention, but this does little to solve the underlying shortage of regulatory capital. If these funding routes remain frozen for much longer there could be serious consequences for sterling and the housing market, which rely indirectly upon international banking markets for support.

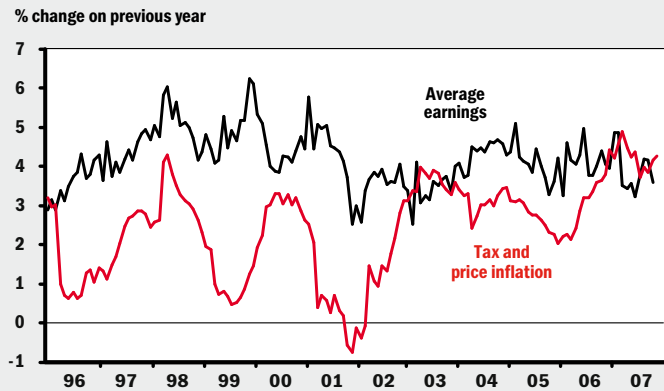
## The ITEM Club Forecast

The forecast shows GDP growth slowing from 3.1% in 2007 to 1.8% in 2008, with CPI inflation ending the year close to the 2% target. The abrupt reversal in the credit markets in 2007 could lead to a sharp fall in economic growth. But the ITEM Club believes that there is room for interest rates to be cut to cushion this, since the inflationary pressure of higher energy and food prices should be offset by the prospective weakness of consumer demand. Retail prices have been falling over the last year. Sterling weakness may be more of a problem, but ITEM is reasonably confident that this can be managed without a rise in inflation.

'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: Real earnings growth**



*We have been living beyond our means...*

Nevertheless, as Mr Brown has said, the economic outlook remains ‘dangerous’. Unfortunately, fiscal policy cannot be relaxed to cushion the economy over this period because he left the public finances in a very poor condition. The Exchequer was running a large current deficit before the credit crisis hit home, ruling out the flexibility that in 2002 allowed Mr Brown to fend off a world recession and fight a war in the Middle East as well as a general election. It is hard to see his successor doing anything like that. The best he can do is to keep fiscal policy on hold, allowing the growth in tax revenues to slow as the economy slows. Borrowing will increase, but there is little that can be done about that now.

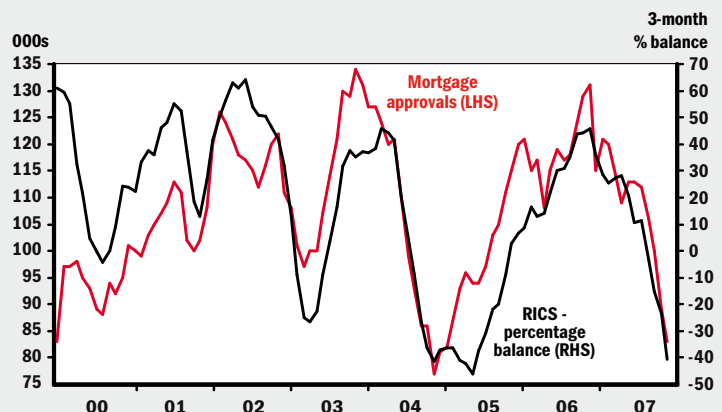
As the current account figures show, as a nation we have been living beyond our means. We have been paying for this by selling our companies to overseas bidders and running up our overseas borrowings. The deterioration in our external balance sheet is clearly reflected in UK balance sheets. In particular, the balance sheets of mortgage lenders have been growing by about £9 billion a month, well ahead of retail savings deposits at about £6 billion. The difference has been funded through mortgage securitisation and the inter-bank market, both of which are ultimately financed by overseas banks at the margin.

*... but now the funding routes have frozen.*

These wholesale market funding routes have now frozen over and credit is becoming much more expensive and harder to get. In August, banks suddenly found they could no longer fund their off-balance sheet securitisation vehicles using the commercial paper market. Most of them had to refinance these themselves, increasing the need for regulatory capital. They also had to accommodate the LBO and other loans they were expecting to move off balance sheet to pension funds and other investors. The Bank of England estimates that if the UK banks had to refinance these in full, this would increase funding by a staggering £170 billion, representing 14% of the stock of lending to households and non-financial companies.

At the same time, the regulatory capital base has been seriously eroded by loan loss provisions and other write-offs, pushing several major banks below their Basel

**Advance housing market indicators**



regulatory ratios. The problem is that the banks themselves have little idea of how large these refinancing requirements and write-offs could be. Even if their ratios look safe for now, they need to adopt a precautionary approach, making sure there is leeway for further adverse developments. The banks' initial reaction was to draw in their horns and try to stem the growth of their balance sheets by reducing their lending in the inter-bank (IB) market, pushing IB interest rates above policy interest rates in all major financial centres.

*The fundamental imbalances remain...*

Money market rates have eased back considerably since the year-end balance sheet crisis, helped by central banks' intervention. However, this situation has yet to be resolved properly. The central banks are just holding the line and cannot provide liquidity on this kind of scale indefinitely. Importantly, these liquidity requirements reflect the need to finance fundamental current account and other imbalances. In the case of the UK, the inter-bank market is a conduit which simultaneously helps finance the balance of payments deficit and the funding gap in the mortgage market. The frozen supply routes must be freed up for traffic quickly, otherwise the reverberations in the currency and housing markets could be very serious.

*...undermining the pound and the housing market.*

It is no coincidence that the pound has been falling in the currency markets since the crisis started on 9th August, despite the much higher interest rates the UK banks have been offering since then. European and other overseas banks were buying billions of pounds a week to lend into the UK IB market, helping to support the currency. The effects of the frozen funding routes are also obvious in the UK mortgage market which is being starved of supply. This largely explains the sharp slowdown in mortgage lending and approvals in October and November. The Council of Mortgage Lenders noted that the weak October figures were 'primarily a result of a lack of available funding' rather than a lack of demand. Commenting on the November figures it said that 'the credit crisis has resulted in funding difficulties for a number of mortgage lenders, reducing their capacity to lend.'

*It will take a lot of capital to free up the wholesale funding routes.*

Fortunately, it looks as though Sovereign Wealth Funds (SWFs) are coming to the rescue by providing the banks with more capital. (SWFs are government investment agencies funded by petrodollars and other export surpluses.) However, this is no panacea. So far, the US banks have raised about \$25 billion from the SWFs, which is only about a quarter of the total losses so far announced. Moreover these funds are expensive. They push up the banks' cost of capital and thus the interest rate margins they will expect on new business. In any case, in the UK the biggest problem seems to lie elsewhere – with mortgage banks and building societies that are now finding it difficult to borrow from other banks. It is not yet clear how this situation will resolve itself.

*The UK services sector will be hit...*

The UK economy went into the third quarter of last year with a strong momentum, but is now decelerating sharply. Although manufacturing seems to be holding up relatively well, service sector confidence surveys have fallen back abruptly. The forecast sees

## The ITEM Club Forecast for the UK Economy, January 2008

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	2.9	2.8	2.1	7.9	11.0	10.0	1.4	4.4	3.2	2.3	4.8	104.6
2007	3.1	3.7	3.3	6.1	-4.6	-2.5	0.6	4.1	4.3	2.3	6.0	107.2
2008	1.8	1.8	2.0	1.1	4.3	4.0	1.4	4.1	2.6	2.1	5.2	95.4
2009	2.5	2.4	2.2	3.2	5.6	5.0	2.5	4.7	2.3	1.9	4.8	92.8
2010	3.1	3.2	3.1	4.4	6.6	6.6	1.8	4.7	3.2	2.0	5.0	92.4

[1] Average over calendar year

**...and the housing market will be flat...**

growth in financial service output decelerating rapidly, from the recent double figure rates into the low single figures.

Advance indicators of the housing market – notably mortgage approvals and the RICS survey balances – also point to an abrupt slowdown. However, with the housing market characterised by inertia and in fundamental shortage, the ITEM Club sees house prices flat over the next few years. This will have a wealth effect – consumers can no longer afford to dip into housing equity to maintain growth in spending. The reduced availability of credit will also affect housing transactions. These have remained below the levels of the 1980s boom but are likely to fall back this year. This will as ever have a major knock-on effect, with spending on agency and legal services, refurbishment and white goods softening.

**...but base rate cuts should ease the pain.**

Cost increases remain a worry for the Monetary Policy Committee, but companies will find it hard to pass these on this year. However, the consumer will no longer be cushioned against the effect of rising dollar oil and food prices by sterling's appreciation against the dollar. The MPC hawks may fret about the inflationary impact of sterling, but against the background of a weak consumer market, sterling depreciation is not likely to be a major threat to inflation. So it is to be hoped that the necessary cuts in bank rate will not be delayed, with base rate down to 4¾% by the end of this year.

### Implications for business

- We are seeing a sea change in the balance of the economy as business spending and eventually exports pick up the baton dropped by the consumer and the government. With the exception of the US, overseas markets remain strong.
- The pound has fallen back as part of this adjustment. Although this poses a threat to inflation and interest rates, the weakness of the domestic market should make it difficult for importers to pass their higher costs on to the consumer.
- It is hard to forecast the sterling-dollar exchange rate at the moment since both are overvalued and – like two bungee-jumpers standing on a bridge – it is hard to know which will fall first, fastest or furthest. Yet sterling is likely to fall against the dollar this year, meaning that the weak dollar no longer helps shield UK producers and consumers from high oil, food and other commodity prices.
- Base rates are falling back, providing a cushion for house prices, which the ITEM Club expects to be flat this year. However, businesses that have benefited from rising housing and equity markets should be careful. The mortgage marketplace is likely to be less competitive now that lenders relying heavily on securitisation and inter-bank funds have been hit. House prices will be vulnerable to buy-to-let selling after April.



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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.

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