

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

- ▶ Output is likely to fall by 2.7% this year, the worst outcome since 1946. The pound has suffered its largest depreciation since 1949. The banks are still in intensive care and now companies are desperately hoarding cash. Headline RPI inflation will turn sharply negative this year, raising the spectre of a decade of deflation.
- ▶ To avoid this threat, the Darling bank rescue plan needs to be reformulated quickly and the government must begin to under-fund its deficit. Base rates must be reduced further. The weaker pound will have the beneficial effect of supporting inflation and demand this year.
- ▶ The current situation remains fraught with uncertainty, leaving policymakers with much more to do. Failure to revive the credit market would turn recession into slump. Yet if these policies work, the UK will move next year from recession into a decade of economic rebalancing rather than a decade of deflation.

Confidence continues to fall...

The financial panic that followed the Lehman collapse in September finally pushed the economy over the edge of the proverbial cliff. The ITEM Club estimates that GDP shrank by 1.5% in the fourth quarter. All of the economic statistics are now in free fall. Confidence in the corporate sector has suddenly collapsed, hitting investment spending and employment hard. It seems that the cash-hoarding behaviour

of the banking system is spreading out to the rest of the economy.

It is easy to conclude that none of the policies adopted by the government to deal with the situation are working. However, in the ITEM Club's view, these policies have provided huge benefits, but have been overwhelmed by the mounting scale of the crisis. They will need to be extended rapidly and radically this year. On this assumption, the prospect of a 'lost decade' of recession and deflation should be avoided. Even so, the prospects look grim, with GDP likely to fall by 2.7% this year and a further fall in prospect for 2010.

...as bankers remain pole-axed...

The banking system remains paralysed. Capital adequacy ratios remain vulnerable despite the recapitalisation in October. As in earlier phases of the crisis, this has reinforced concerns about counterparty risk and liquidity. In this situation cash, bills and government bonds all share the advantage that - unlike lending to the private sector - they do not need to be backed by new regulatory capital. It is this requirement which makes banks reluctant to lend to the private sector. The ITEM Club believes that the Chancellor's October banking measures need to be modified to take account of this. Illiquid mortgage and other assets should be bought from the banks to make room for new lending to the private sector within the existing loan book. This lending may also have to be supported by government guarantees against default.

Inflation rates, 1993-2008



...meaning more policy measures are needed...

We also need a more aggressive monetary policy. Interest rates should be reduced further and quantitative monetary policy techniques should be adopted. That would mean government purchases of gilts, mortgage-backed or other securities, pushing down their running yields and effectively replacing them in private portfolios by notes and coin or bank deposits with the Bank of England, which form the monetary 'base'. This would mean a move back to under-funding: the government would not fund all of its new borrowing in the gilt market. The aim would be to supply any cash that people want to hold - and some - in the hope that these surplus funds would be spent or invested.

...to support the economy and the inflation target.

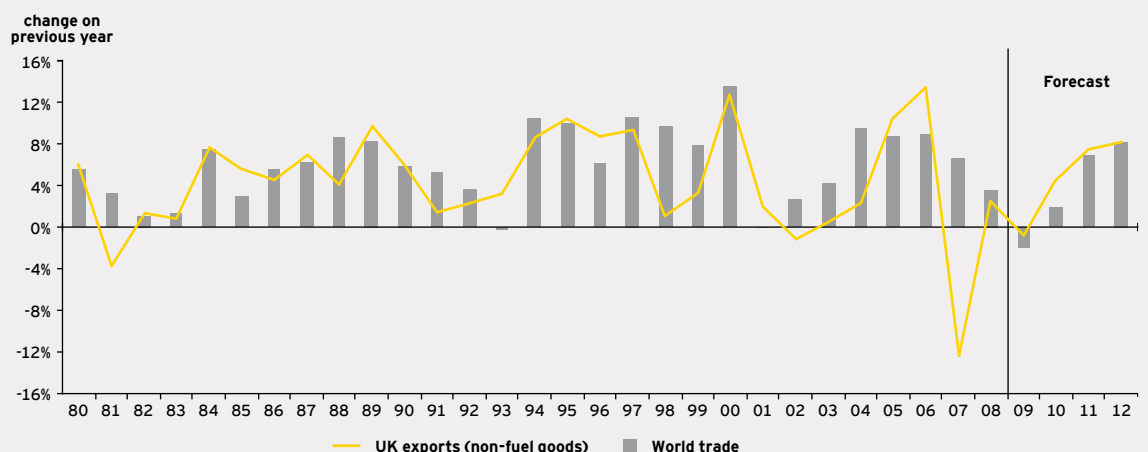
Of course, if the current uncertainty has already made companies and consumers paranoid about spending they will just sit on additional cash balances too. In this case we hit the famous Keynesian liquidity trap. To prevent this it is now critical that the MPC underlines its determination to support the 2% inflation target over the medium term.

Provided that figure remains fixed in the public mind - as it did during the recent inflation surge - a low nominal interest rate should be enough to anchor expectations and prevent the idea of a lost decade of deflation from taking hold. The ITEM Club forecast is based on that view. Base rates are reduced below 1% over the next couple of months and money market rates fall back to 1%. This should allow the pound to settle close to recent levels, preventing import costs and inflation from falling too far too quickly.

Companies' concern about the future...

The corporate sector entered this crisis in a strong financial position and has acted quickly to protect this by slashing employment and investment as credit has tightened and demand has fallen. These cutbacks are evident right across the board, not just in the blackspots of financial services, construction and retailing. Some companies have no doubt been forced into these measures by financial pressure but others appear to be taking them as a precaution against a deterioration in the economy this year.

UK Exports and World Trade, 1980-2012



...will curb investment and continue to hit jobs.

Business investment is very vulnerable in this uncertain climate. The forecast sees this falling back by nearly 17% in 2009, with an additional fall of nearly 6% in 2010. Private housing investment fell by about 13% in 2008 and ITEM sees this falling by another 25% this year, with a further fall likely in 2010. In response, the government is accelerating its capital expenditure programme. This should grow by 10% in 2009, but this will not be sufficient to prevent a major contraction in total investment. The forecast shows a fall of over 15% in capital spending this year, followed by a fall of over 4% in 2010.

With news of job cuts hitting the screens almost every day, the ITEM Club thinks that over a million jobs will be lost over the next two years. In this harsh climate people will be very worried about job security. Earnings growth will subside, reinforcing the pressure on disposable income. ITEM sees average earnings growth falling below 2% in 2009. Some relief will be provided by inflation, which is set to fall below the 1% CPI threshold next summer, but real disposable incomes are set to fall by 0.4% in 2009, and to recover by just 1.1% in 2010.

The housing and equity markets show no signs of recovery...

The housing market remains in dire straits, starved of new mortgage finance. Net lending will remain at negligible levels until overseas mortgage-backed loans are repaid. Although bargain hunters are active, there seems very little reason to buy until house prices stop falling. The ITEM Club does not see that happening until the end of 2010, by which time prices will have fallen back

by a third from the peak in the autumn of 2007. The mortgage famine has naturally slashed housing transactions. They fell back by about a third in 2008 and the forecast sees another 22% reduction in 2009. Meanwhile the equity market has recovered its poise, but it is hard to see much of a recovery in 2009. Against this bleak background consumer spending is set to contract by 2.6% this year, and by a further 0.6% in 2010.

...yet there are positive signs for a rebalancing of the economy after the recession...

The forecast shows total domestic demand falling back by 3.8% this year and 0.8% next. However, as would be expected in an open economy like the UK, GDP is cushioned by net trade. This adds 1.2% to GDP this year and another half point in 2010 and the following year. Imports fall back by over 5% this year, with only a weak recovery likely in 2010. With overseas markets weakening, exports are unlikely to make any contribution until then. Indeed it is hard to think of any country that will escape the downturn in the world economy this year. World trade is likely to fall by 2% this year, while UK exports are likely to fall back by 1.4%. Nevertheless with sterling at these very competitive levels, UK exporters are in pole position for the world recovery and the ITEM Club sees exports increasing by 4% in 2010 and 6.5% the following year.

...reflected in a healthier current account.

These developments are clearly reflected in the UK current account. This benefited from favourable movements in bank remittances and other invisible earnings in the first half

The ITEM Club Forecast for the UK Economy, January 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]
2006	2.8	2.6	2.1	6.0	11.0	9.6	1.8	3.9	3.2	2.3	4.8	104.6
2007	3.0	3.6	3.1	7.2	-4.2	-1.6	0.6	3.9	4.3	2.3	6.0	107.2
2008	0.7	0.6	1.6	-4.6	1.0	0.9	-2.3	3.3	4.0	3.6	5.5	94.1
2009	-2.7	-3.8	-2.6	-15.7	-1.4	-5.1	-8.8	1.8	-3.0	1.3	1.3	75.4
2010	-0.5	-0.8	-0.6	-4.3	4.0	2.5	1.6	2.4	1.6	1.1	1.0	74.4
2011	1.7	1.3	1.5	2.3	6.5	4.8	3.8	4.0	3.2	1.8	1.6	74.1

[1] Average over calendar year

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of 2008, bringing the deficit for the full year down to around £26 billion from a peak of £45 billion in 2006. The forecast shows a continued improvement. This is reflected in a gradual rise in domestic savings and financial balances, notably an increase in the household saving ratio from 1% last year to 5.5% in 2011. At the same time the household financial position turns from a deficit of £52 billion to a surplus of £20 billion.

Though the outlook is extremely uncertain...

Nevertheless, the banking system remains in a very shaky state and it may be wrong to assume that the Treasury and the Bank of England succeed in reviving the credit markets. Failure to do so quickly would profoundly deepen and lengthen the recession. Either way, spectacular bankruptcies and other 'extreme events' are likely. Private equity is vulnerable to credit and economic shocks and we have probably not seen the last of the problems in the hedge fund sector. Business investment is particularly prone to uncertainty and credit rationing. It is hard to be sure how young families who have never experienced negative equity or recession before will react to this difficult climate.

...there are opportunities which could hasten recovery.

Having said that, there are upside risks that might just make this forecast look too pessimistic next year. The unprecedented fall in the pound presents many businesses with heaven-sent opportunities. Importantly, this is certainly not like the kind of devaluation seen in the bad old days - one that boosts competitiveness temporarily, only to be offset by inflation. The recession will stop inflation in its tracks this year, after which the ITEM Club is confident that the MPC will maintain the 2% target.

There are plenty of businesses in areas like IT and education where output can be switched or expanded without much new investment. However in many cases this will involve large up-front costs. Large multinational companies that can access the necessary finance will surely boost their capital expenditure programmes to expand

their UK manufacturing base in anticipation of a recovery in the world economy. That could boost investment and also make the forecast look too gloomy. Certainly, if the pound remains close to today's level it is hard to think that negative inflation will be a persistent problem.

Implications for business

- ▶ The fall in the pound presents businesses with opportunities to switch production away from the home market and ultimately to develop new products and markets. This gain in competitiveness will not be eroded by wage and cost inflation and would put UK exporters in pole position for a world recovery in 2010.
- ▶ This recession will hit business-to-business spending particularly hard, but once the world economy revives, capital and other business expenditure will be boosted by the need to expand production for the export market.
- ▶ The squeeze on the consumer will continue as the labour market weakens. Margin pressure may be eased in areas like petrol but will be squeezed by rising import costs in areas like clothing and footwear. The housing market will keep household goods under pressure.
- ▶ Cash flow and counterparty risk need to be monitored carefully and continuously in this harsh environment. Consumer debt problems will increase with unemployment, even if market interest rates fall back. With credit remaining very tight and cash-flow increasingly volatile, it is important to ensure that funding lines remain adequate and in place. Banking relationships and shareholder communications remain of crucial importance.