

ICAEW



UK ECONOMIC FORECAST

Q3 2013

BUSINESS WITH CONFIDENCE

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INTRODUCTION

Welcome to the fifth edition of the *ICAEW Economic Forecast*, based on the views of the people running UK plc: ICAEW Chartered Accountants working in businesses of all types, across every economic sector and across all regions of the UK, surveyed through the quarterly *ICAEW/Grant Thornton UK Business Confidence Monitor (BCM)*.

Not only have we raised our economic growth forecast for 2013 but our initial view for next year is 2.3% GDP growth, suggesting that the UK economy is starting to see a return to more robust levels of economic activity. However, muted investment intentions suggest that businesses are not confident that the recovery is on a sustainable footing.

Since its launch in 2004, the BCM has provided a reliable steer on the overall direction of travel in the economy. It pointed to the weakening real economic environment at the end of 2007 and into 2008 and indicated the return to growth at the end of 2009. It also correctly predicted the UK entering a second economic downturn at the end of 2011. In addition, BCM data cover a range of business performance and planning indicators that build up a picture of how different businesses are faring and how the economy is likely to evolve in the coming months. This was demonstrated by analysis published in 2011 by Cebr, ICAEW's economic consultants, which concluded that the BCM dataset has tracked a wide range of key economic indicators remarkably well in recent years.

In the short term, after a lengthy recession, any growth feels like good growth. But in the longer term, we must create the conditions for sustainable growth. The current GDP expansion seems driven more by consumer demand and sustained public spending – there is still a significant way to go in getting the public finances into good order. What the UK needs is growth based on greater investment by businesses and stronger exports.

ECONOMIC OUTLOOK

FIG. 1 REAL GDP – ANNUAL GROWTH

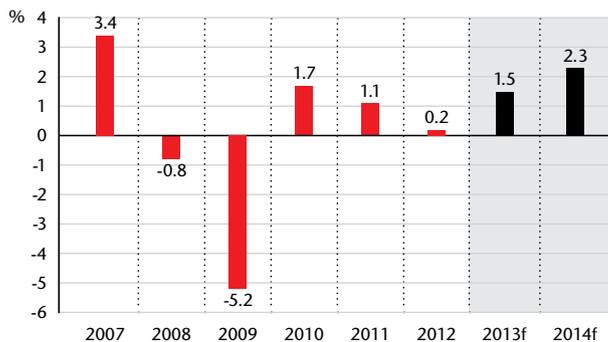
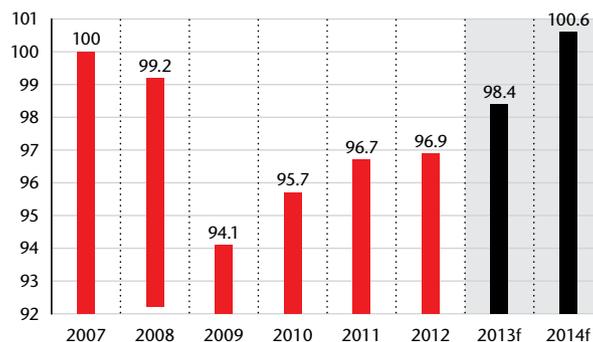


FIG. 2 REAL GDP – INDEX (2007 = 100)



Source: ONS, ICAEW forecasts

Economic, business and consumer confidence data has improved in recent months. ICAEW expects the economy to grow by 1.5% this year, with growth breaching the 2% mark in 2014 as conditions strengthen further. Despite the overall growth of the economy, there remain concerns over the factors driving the recent growth. Data suggest the economy is being stimulated by rising consumer demand and continued public spending, calling into question whether this is the right kind of growth.

Gross Domestic Product (GDP) in the UK grew at a quarter-on-quarter rate of 0.7% in Q2 2013, according to the Office for National Statistics' second estimate of growth in that quarter. ICAEW predicts that, this year, the UK economy is set to grow at its fastest rate since 2010, with growth of 1.5% for the year as a whole. This is up from our Q2 2013 forecast of a 1.2% expansion. Growth is expected to accelerate to 2.3% in 2014, with economic output finally breaching its 2007 peak level, standing 0.6% higher. However, GDP will remain much lower than would have been the case if the financial crisis had never occurred and the economy continued to grow at pre-crisis trend levels – the UK economy still has a lot of catching up to do.

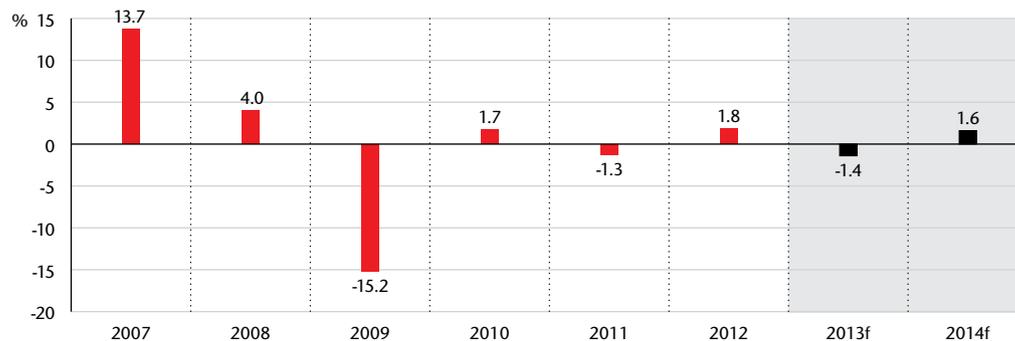
The BCM Confidence Index stands at +24.0 this quarter – the highest level since Q2 2010 – and suggests

that sentiment is gradually picking up as the economic recovery gains momentum. The YouGov/Cebr Consumer Confidence Index also stood at its highest level since April 2010 in the three months to July. In addition, Bank of England data suggest that schemes such as Help to Buy are feeding through into increased housing market activity; the number of mortgage approvals for house purchase was 29.9% higher in July than the same month a year ago.

Moreover, the recovery seems to be becoming broader-based, with sectors such as manufacturing and construction returning to economic growth. The construction sector, which has fared poorly since the financial crisis, shows record confidence in this quarter's BCM, suggesting that the worst may be over for the sector.

BUSINESS INVESTMENT

FIG. 3 BUSINESS INVESTMENT – ANNUAL GROWTH



Source: ONS, ICAEW forecasts

Business investment activity remains much weaker than before the financial crisis. Despite the rise of most economic indicators including growth, firms are reluctant to significantly expand capital investment. One of the factors holding businesses back could be a lack of confidence in the long-term sustainability of the recovery. Providing greater certainty over government policy towards business should help to address this.

In this quarter's BCM, businesses report that capital investment is expected to increase by 1.6% over the next 12 months, broadly unchanged from that seen in Q1 and Q2 2013. Despite business confidence rising in each quarter of 2013 to date, business investment intentions have not risen in line with this increase in confidence.

ICAEW's latest forecast is for total real business investment to decline by 1.4% in 2013, down from a Q2 2013 forecast of 2.5% growth. This largely reflects revisions to ONS data which show that business investment activity in recent years was weaker than previously estimated. In our Q2 2013 forecast, we reported that real terms business investment in 2012 stood 8.1% below its 2007 peak level. The latest revised data show investment 9.8% lower than in 2007. While the UK economic recovery is picking up,

an investment-led recovery is proving elusive.

Although business confidence has increased in recent quarters, it seems that businesses need a bit more certainty about the sustainability of the recovery before they become willing to part with their cash and ramp up capital investments. While ICAEW expects real business investment to expand by 1.6% in 2014, the level of investment would still stand 9.6% lower than in 2007. Credit market conditions remain relatively tough for the smallest businesses according to Bank of England data. Indicative median interest rates offered to small enterprises on variable rate credit facilities stood at 4.8% in May 2013, up from the 4.6% average offered the same month a year before.

LABOUR MARKET

FIG. 4 AVERAGE EARNINGS – ANNUAL GROWTH

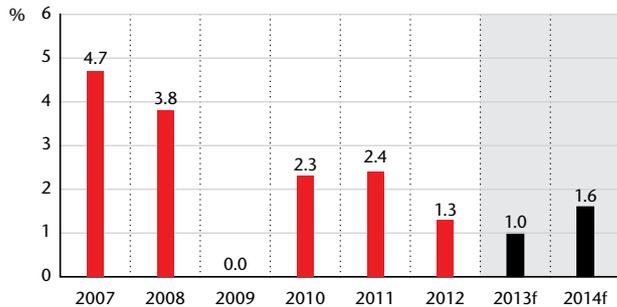
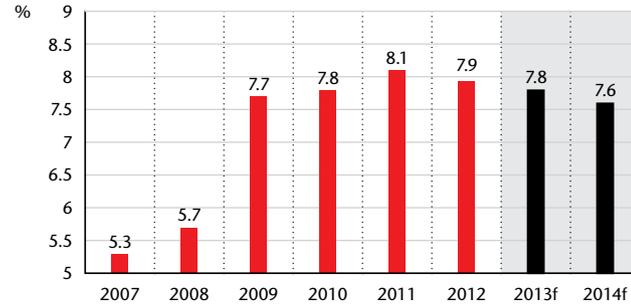


FIG. 5 UNEMPLOYMENT RATE, %



Source: ONS, ICAEW forecasts

Source: ONS, ICAEW forecasts

Earnings growth shows little sign of picking up despite an improving economic picture. Unemployment remains elevated, though is expected to continue to fall back gradually. Incomes will continue to be squeezed as average earnings growth remains lower than inflation, which could rein in consumer spending growth further down the line.

Unemployment figures have taken on a new significance following the Bank of England's August announcement that it will not raise the Bank Rate or reduce the stock of assets purchased under its quantitative easing (QE) scheme until the unemployment rate falls to 7.0%. This forward guidance will hold provided inflation expectations remain subdued and financial markets stable, so there are some knockout conditions for the rule.

ICAEW's latest economic forecasts suggest that the unemployment rate will fall from an average of 7.8% this year to 7.6% in 2014, reflecting continued economic growth. Overall, given the Bank of England's policy of forward guidance, this would imply that interest rates will not rise next year, providing no shocks to inflation or financial market stability. If unemployment continues to fall at a

steady pace beyond 2014, an increase in interest rates would be unlikely until 2016 at the earliest.

Earnings growth remains extremely weak and shows little sign of picking up, according to the latest ONS data. ICAEW expects average employee earnings to grow by just 1.0% this year and 1.6% in 2014, far below the latest consumer price index (CPI) data on inflation, which showed price growth standing at 2.8% in July. Employee spending power is still being eroded, and this is expected to continue into 2014. Annual average earnings growth has stood below CPI inflation for each year since 2008, meaning that working households are going through a prolonged period of declining real earnings.

FOCUS ON: THE SUSTAINABILITY OF THE RECOVERY

FIG. 6 EXPECTED GROWTH IN DOMESTIC SALES AND EXPORTS OVER THE NEXT 12 MONTHS

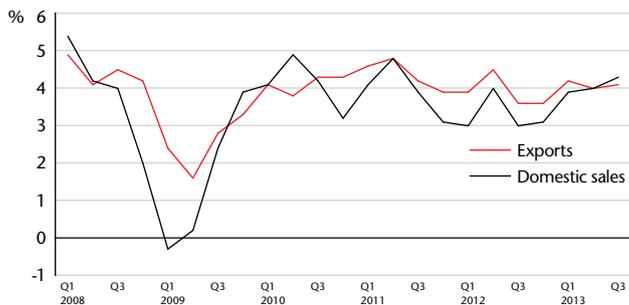
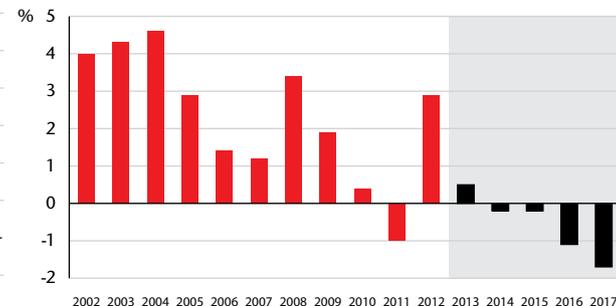


FIG. 7 GOVERNMENT SPENDING (CONSUMPTION PLUS INVESTMENT) – ANNUAL GROWTH



Source: ICAEW/Grant Thornton Business Confidence Monitor, ONS, OBR forecasts for government spending

Although economic growth continues to pick up, some areas of economic expansion could prove unsustainable. Significant cuts in government spending have been put on hold for now, meaning that deep cuts loom in a few years' time.

Overall the economic outlook is improving and the recovery is gaining momentum. However, looking beyond 2014, questions remain over the sustainability of the recovery and whether growth can be expected to accelerate further into 2014.

The recovery at present appears to be heavily driven by a pick-up in consumer spending. Housing market activity and retail sales are growing despite the fact that earnings are trailing far behind inflation. The Household Saving Ratio fell sharply in the first quarter of 2013 – to its lowest level since 2009 – so consumers effectively chose to save less in order to spend more.

As BCM data show, expected growth in domestic sales has overtaken expected export growth this quarter, the first time that domestic sales growth has been higher since Q2

2010. Businesses have adjusted their expectations to take account of a recovery in domestic demand. This could potentially unravel further down the line as consumer spending adjusts to the fact that household incomes are struggling to grow in real terms.

In addition, the Chancellor has yet to get a firm grip on controlling government spending. According to the Office for Budget Responsibility's forecasts, government spending in 2015 (consumption plus investment) will actually be marginally higher in real terms than in 2012. Significant cuts in spending are not anticipated until 2016, after the next election, and this could weigh on growth in a few years' time.

FORECASTING METHODOLOGY

Headline economic forecasts

	2007	2008	2009	2010	2011	2012	2013f	2014f
Real GDP – annual growth	+3.4%	-0.8%	-5.2%	+1.7%	+1.1%	+0.2%	+1.5%	+2.3%
Business investment – annual growth	+13.7%	+4.0%	-15.2%	+1.7%	-1.3%	+1.8%	-1.4%	+1.6%

Labour market forecasts

	2007	2008	2009	2010	2011	2012	2013f	2014f
Earnings (total pay) – annual growth	+4.7%	+3.8%	+0.0%	+2.3%	+2.4%	+1.3%	+1.0%	+1.6%
Employment – annual growth	+0.7%	+0.7%	-1.6%	+0.2%	+0.5%	+1.2%	+0.8%	+0.6%
Unemployment rate	5.3%	5.7%	7.7%	7.8%	8.1%	7.9%	7.8%	7.6%

ICAEW's forecasts for economic growth, business investment and the outlook for the labour market are based on the correlation between ICAEW/Grant Thornton Business Confidence Monitor (BCM) indicators and official economic data. BCM contains data – from a survey of 1,000 UK businesses – on business confidence, financial performance, challenges and expectations. BCM indicators provide a useful and unique steer on future developments in the UK economy.

About Cebr

Centre for Economics and Business Research is an independent consultancy with a reputation for sound business advice based on thorough and insightful research. Since 1992, Cebr has been at the forefront of business and public interest research. They provide analysis, forecasts and strategic advice to major UK and multinational companies, financial institutions, government departments and agencies and trade bodies.

For further information about Cebr please visit www.cebr.com

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 140,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

Because of us, people can do business with confidence.

ICAEW is a founder member of Chartered Accountants Worldwide and the Global Accounting Alliance.

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