



making business sense

ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

DECEMBER 2010

OBR REVISES UP GROWTH IN 2010, DOWN IN 2011

Unsurprisingly, in its November update, the Office for Budget Responsibility (OBR) revised up its economic growth estimate for 2010, taking into account the much better-than-expected growth performance of the UK economy in the second and third quarters of the year. Annual real gross domestic product (GDP) growth for 2010 now looks set to be around 1.8%, compared with the OBR's June forecast of 1.2%. The current bout of adverse weather sweeping the UK could leave growth falling short of this revised projection, as the snow and ice will derail a substantial amount of business activity towards the end of the year.

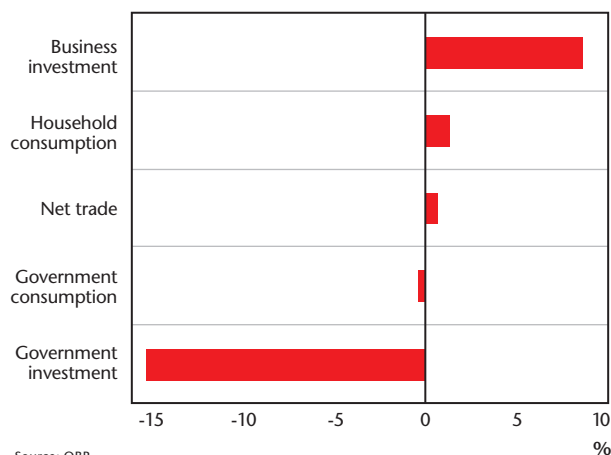
Looking forward, the OBR has revised down annual growth in 2011 and 2012, but it remains among the more bullish forecasters for the UK economy. In particular, the OBR seems very optimistic on business investment over the next four years, given that access to capital is likely to remain a challenge for many small businesses in the post-financial crisis environment. The OBR also seems relatively optimistic on export growth, despite the fact that sovereign debt crises and austerity budgets in Europe remain a major risk to a trade-led recovery materialising. For example, UK exports of goods and services to Ireland, which totalled almost £24bn in 2009, are likely to struggle as a result of spending cuts and tax rises being implemented by the Irish government to cut its fiscal deficit.

Next year to be a challenge for the UK

The OBR has revised down annual economic growth in 2011 from 2.3% to 2.1% – still stronger than many independent forecasters are anticipating. Few commentators are disputing the OBR’s projections for government expenditure going forward. The real divergence of opinion lies in discussion about the strength of the private sector recovery, and to what extent it can pick up the slack created by public sector cutbacks.

The OBR’s exceptionally strong business investment projections over the next four years seem to be creating the greatest stir – they expect annual growth of 8.6% in 2011, as Figure 1 shows. Yet it is unclear whether business confidence has recovered sufficiently to drive such a level of investment. This quarter’s *ICAEW/Grant Thornton Business Confidence Monitor* (BCM) showed confidence falling sharply. Moreover, the BCM showed expected capital investment growth over the next 12 months falling from 2.0% in Q3 2010 to 1.6% in Q4 2010.

Figure 1: Annual growth rates of GDP components, 2011, OBR forecasts



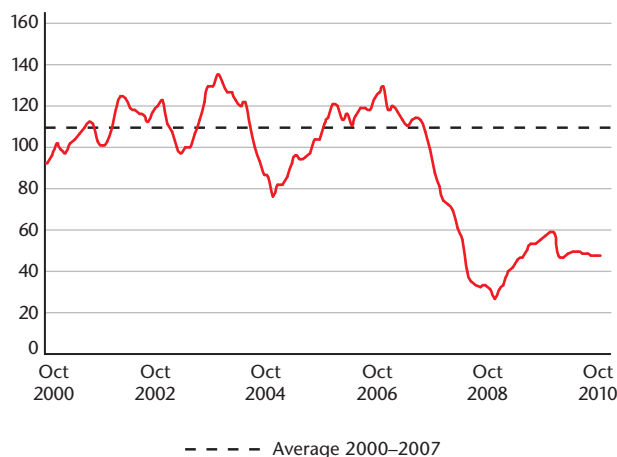
The OBR’s forecasts for consumption also look optimistic for a year in which household spending power is likely to erode still further, in the face of above-target consumer price inflation (mostly owing to the January 2011 VAT rise) and below-trend average earnings growth. The OBR is projecting annual consumer price index (CPI) inflation of 2.8% next year, which more than offsets projected average earnings growth of 2.2%. The potential for households to maintain their consumption in real terms by disposing of savings seems limited, given that households appear to have already eaten into their savings this year – the Office for National Statistics (ONS) estimates that the household saving ratio fell from 5.5% to 3.2% between Q1 2010 and Q2 2010.

Ultimately, if consumption and investment growth turns out notably weaker than the OBR is anticipating, 2011 could be a relatively weak year for the UK economy.

First time buyers failing to benefit from lower house prices

The housing market has lost momentum in the second half of 2010. Indeed, according to Nationwide statistics, average house prices in November were only 0.4% higher than the same month a year ago. Of course, before the recession, there were concerns about the opposite problem – house prices soaring out of the reach of people on average incomes. This may lead one to argue that the recent fall in house prices was a necessary market adjustment to more closely align prices with household income. Unfortunately, however, first time buyers have been unable to exploit the softening in house prices that occurred during the downturn, owing to a tightening of credit conditions following the financial crisis – monthly mortgage approvals in 2010 remain below half the monthly average for the years 2000 to 2007.

Figure 2: Number of loan approvals for house purchase, thousands



Source: Bank of England

Bank mortgages now require a typical deposit of 25% of a home’s value, and first time buyers are finding it as hard as ever to step onto the housing ladder. Research by the Home Builders Federation has found that first time buyers aged 22-29 have to save 45% of their take home pay every month for five years to afford a typical mortgage deposit. It is unsurprising, therefore, that the same research shows the average age of a first time buyer purchasing without financial assistance now standing at 37.

Over the longer term, the shortage of housing supply in the UK relative to future demand means that house prices will inevitably start to pick up. In the short-to-medium term however, unless mortgage approvals recover sharply, 2011 looks to be a fairly stagnant year for the housing market – a year that will neither be beneficial to home owners nor to first time buyers.

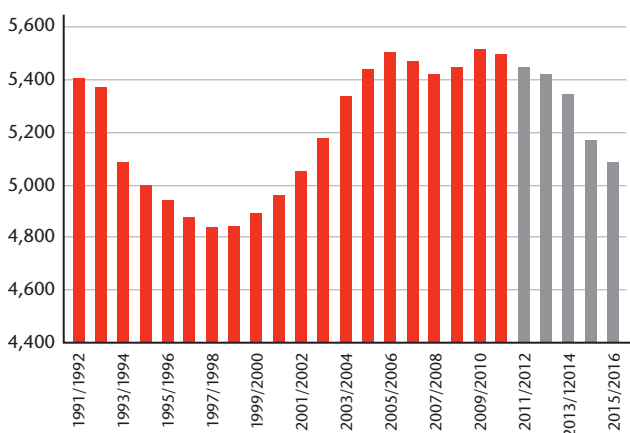
How severe are the public sector job losses?

The OBR has revised down its expected number of public sector job losses over the next four years, from 490,000 to a much lower 330,000. The new job loss projections take into account the fact that the Chancellor has decided to protect some public sector spending by cutting more from the welfare budget, through measures such as the withdrawal of Child Benefit from families with a higher rate taxpayer.

Figure 3 illustrates the OBR's projected profile of public sector job losses for the financial years 2011/12 to 2015/16. It is noteworthy that general government employment will still stand over 250,000 higher in 2015/16 than in 1997. Given this, it is perhaps unsurprising that some small-state commentators have been left underwhelmed by the coalition government's attempts to roll back the frontier of the state.

The more modest scale of the job cutbacks may also prompt some to take a bullish view on the UK labour market. However, this still seems a premature view to take, given the lacklustre nature of the private sector recovery to date. Critically, the private sector has so far failed to create many additional full-time jobs. In Q3 2010, part-time employment was 4.2% higher than the same quarter a year ago, while full-time employment was broadly unchanged (0.2% lower than a year ago).

Figure 3: General government employment, thousands

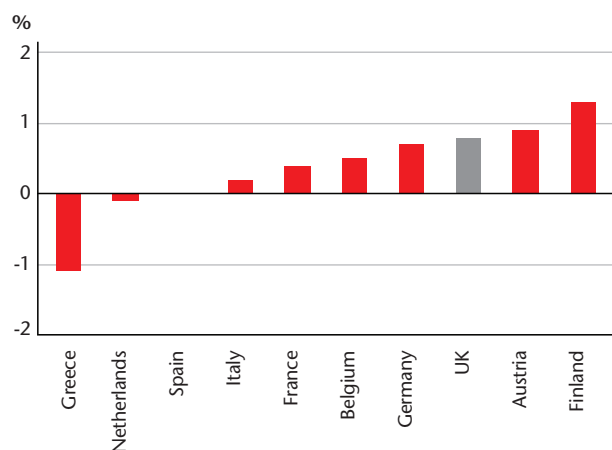


Source: ONS, OBR

Multispeed European recovery to place pressure on the single currency

The latest statistics from the euro area showed quarterly growth in real GDP of 0.4% in Q3 2010. However, disparities in growth between the euro member countries are significant, as Figure 4 illustrates. While the Greek economy contracted at a quarterly rate of 1.1% in Q3 2010, the Finnish economy expanded by 1.3%, for example.

Figure 4: Quarterly real GDP growth, Q3 2010, selection of euro area countries (plus UK for reference)



Source: Eurostat

Disparities in economic performance will place significant pressure on the euro and the more the European economies diverge over the coming years, the greater this pressure will be. It is becoming increasingly difficult to argue that the euro area is a region in which a one-size-fits-all approach to monetary policy is desirable. While economies embroiled in debt crises such as Ireland and Greece may long for an extended period of loose monetary policy as they implement their austerity measures, robustly growing euro area economies may call for a rise in interest rates to curb inflation and prevent their economies from overheating. The needs of divergent economies cannot be easily met with a single monetary policy stance and a single central bank interest rate.

Ultimately, the pressures created by divergent growth rates among euro member states may lead to some members leaving the single currency, or to the creation of a two-tier euro area with two different currencies – one for fiscally 'prudent' countries such as Germany, and one for fiscally 'imprudent' countries such as Greece. This would allow for different interest rates across Europe. Alternatively, if the political will to maintain the euro exceeds the economic pressures, the current turbulence in the euro area may spur further unification. In particular, to circumvent the problem of having one interest rate, some centralisation of fiscal policy may be implemented, whereby slower-growing economies receive transfer payments from faster-growing ones. However, it is hard to see why faster-growing economies, such as Germany, would be willing to subscribe to such a policy given that they would be net losers. Moreover, this does not seem a feasible outcome politically.

Austerity throughout Europe likely to curb growth

Austerity budgets across much of Europe, to address large fiscal deficits, are likely to curb growth in many countries and place pressure on the sustainability of the euro. Government spending will be withdrawn over the next four years, while other deficit reduction measures will bear down on the private-sector side of European economies. For example, in the UK VAT will rise to 20% from January and in Ireland VAT will rise to 24% by 2014 – this is likely to dampen household consumption. Similar measures are being implemented elsewhere in Europe.

Moreover, not only does deficit reduction throughout Europe mean that countries will struggle to grow through domestic demand, it also means that countries will face a harder time exporting to other European countries, due to weakened import demand. The growth prospects of Europe, to whom over half (56%) of UK goods and services exports were sent in 2009, will be central in determining the extent to which a trade-led recovery is feasible in the UK.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
20 December	Trends in Lending	Lending to SMEs still weak
22 December	Minutes of December MPC meeting	Three way split in interest rate/QE vote
29 December	Housing equity withdrawal	Still weak



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