



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

Q3 2007

# UK BUSINESS CONFIDENCE MONITOR





The **ICAEW UK Business Confidence Monitor** (BCM) provides a snapshot of the state of the economy from informed finance professionals working at the heart of business, across all commercial sectors, sizes of businesses and UK regions. It is one of the largest and most comprehensive quarterly reviews of business confidence in the UK.

We share the BCM findings with a range of policy makers at a national and regional level. It is utilised by the business community, academics and researchers, and provides a robust tool from which government and regional authorities can base decisions for developing both business and economic policy.

Finance professionals also find the BCM findings useful as a credible predictor of economic change. Many use the report as a basis for making business decisions or to enhance dialogue with clients and economic stakeholders in their region.

Please visit [www.icaew.com/bcm](http://www.icaew.com/bcm) for a summary report and full regional reports.

A handwritten signature in black ink that reads "Michael Izza". The signature is written in a cursive, flowing style.

Michael DM Izza  
Chief Executive  
The Institute of Chartered Accountants in England and Wales

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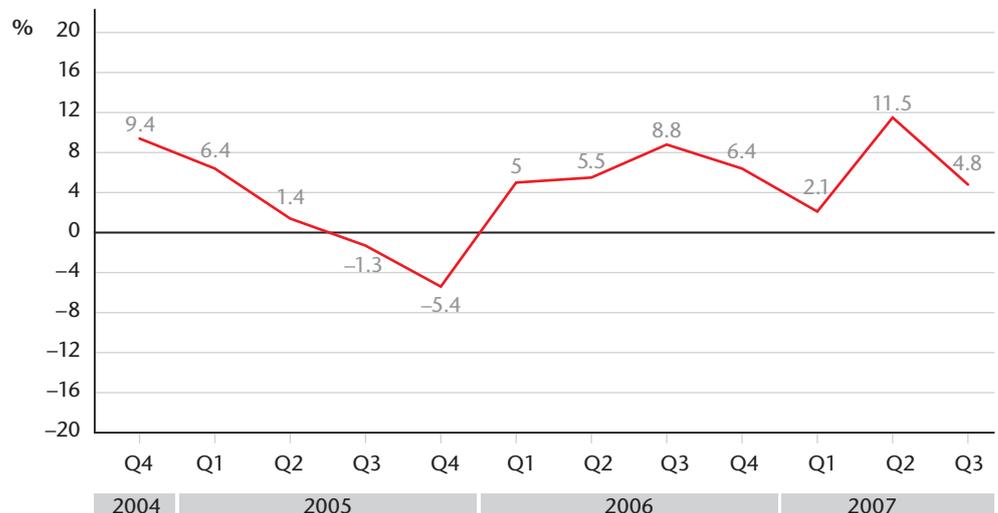
# FOREWORD

BY ICAEW CHIEF ECONOMIST, MAUREEN RAYMOND



Maureen Raymond

Fig. 1.1 Trend of UK business confidence



In our report of Q2 2007 we highlighted a number of risks which could exacerbate the chance of a slowdown later in the year. An important risk in our last survey was a sharp slowdown in the US housing market having a detrimental effect on the rest of the world, which we are now seeing through the financial market contagion caused by the sub-prime mortgage market spreading to the leveraged buy out (LBO) and other global financial markets. Most importantly for the UK economy, we warned that an abrupt end to the current private equity boom and merger and acquisitions cycle would leave London as a financial centre vulnerable.

We caution the government, particularly new Prime Minister Gordon Brown, that the City of London's premier economic status cannot be taken for granted. This report demonstrates the fragility of global markets and their interdependence. Policy should be continually reviewed in the context of emerging international themes to ensure the City retains its role as the jewel in the crown of the British economy.

What we are seeing this quarter is that finance professionals are factoring in tighter global liquidity over the next 12 months with confidence declining in key regions and broadly

**CITY OF LONDON'S  
PREMIER  
ECONOMIC STATUS  
CANNOT BE TAKEN  
FOR GRANTED**

**RECENT SUDDEN  
CLOSURE OF  
LENDING WINDOW  
COULD CAUSE  
CREDIT CRUNCH**

across sectors. The impact of higher interest rates, which the Bank of England increased twice since our last quarterly survey, has weakened confidence. There is increased evidence that the 1.25 percentage point rise in the bank base rate from August 2006 is manifesting a significant decline in confidence in London and the South East, which combined accounts for one third of the UK economy. London has reached its lowest level since the terrorist bombings in July 2005.

This was driven by the significant drop in confidence in the Banking, Finance and Insurance and Business Services sectors, which are vital to the financial capital's economy. The Banking, Finance and Insurance sector is particularly interest rate sensitive and the drop in confidence forecast by finance professionals over the next 12 months incorporates higher borrowing cost and possibly reflects the end of the private equity boom which has helped fuel growth in the City.

In addition, given the extent of house price growth in recent years in London and the South East, the impact of rising interest rates is of particular concern. The housing and consumer markets face strains from high interest rates and inflation, which have respectively increased indebtedness and eroded real income. Recent signs such as UK house price inflation easing in June to half the price of May, and declining new buyer enquiries over the same period, according to the Royal Institute of Chartered Surveyors, indicate that the housing market is slowing. Indeed, the BCM Property Index dropped to -10.0 in Q3 2007 from +1.0 in the previous survey.

As consumers remain cautious in light of these financial strains, other consumer-dependent business sectors are losing confidence also. The Retail and Wholesale sector has shown a Confidence Index drop to +6.2 in Q3 2007 from +14.6 in the previous survey.

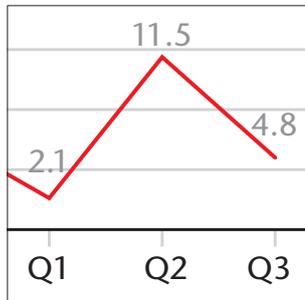
This quarter the BCM has confirmed our expectations that the economy is likely to grow at a slower pace in the second half of this year (see Figure 1.2). Whilst recent data suggests that the economy has slowed only moderately so far, finance professionals are concerned that the economic environment may become more difficult to operate in especially considering the tightening of global credit conditions. We will see more of a drag on confidence in the fourth quarter as the seizing of the LBO market and the ensuing credit crunch has a deleterious effect on key regions and sectors.

After the Monetary Policy Committee raised interest rates in July to 5.75%, official inflation has retreated to 2.4% from 3.1%. However, it remains above the 2.0% target set by the Bank of England. Medium-term inflation risks remain, firms continue to face a sizeable rise in input costs driven by record level commodity prices and attempts to maintain profit margins mean that inflation may prove rather stubborn.

Finally, the recent sudden closure of the lending window at the banks will prove much more powerful than any interest rate move by the Bank of England. It is our expectation that the Bank of England will be forced to hold interest rates as a credit crunch looms and they will be hard pressed to continue the fight against inflation.

**Maureen Raymond**  
Chief Economist , ICAEW

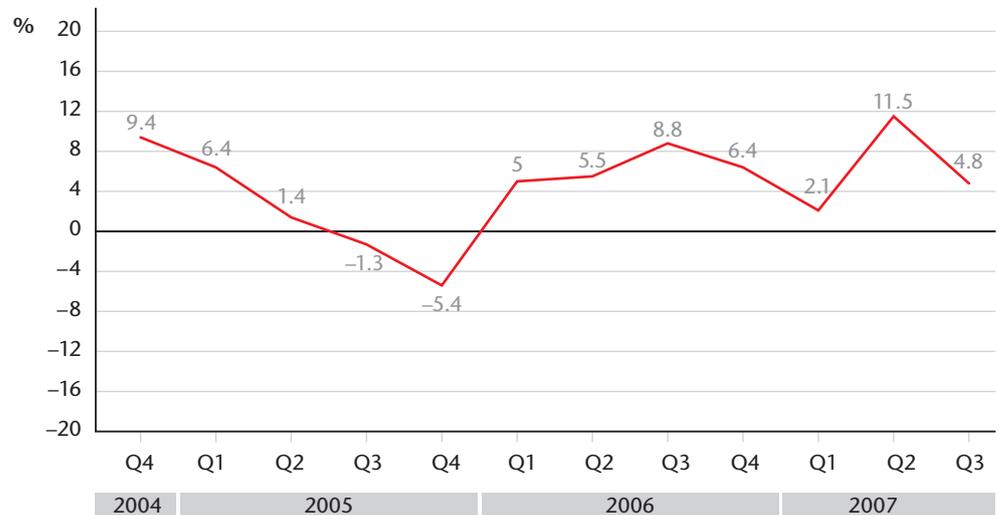
# 1 BUSINESS CONFIDENCE IN QUARTER 3 2007



2007

Detail showing Q1 – Q3 2007

Fig. 1.1 Trend of UK business confidence



## BUSINESS CONFIDENCE MONITOR SUGGESTS END TO ECONOMIC UPTURN

Last quarter the Confidence Index rightly suggested that the upturn in economic growth was likely to last. Quarter-on-quarter economic growth in the UK rose from 0.7% in Q1 2007 to 0.8% in Q2 2007. This trend was consistent with the rise in the Confidence Index from +2.1 to +11.5 last quarter.

The significant dip in the Index this quarter suggests that economic growth is likely to slow in the coming months. The rise in interest rates in July, a less buoyant high street, record level oil prices and a levelling off of house price growth have dampened the outlook for UK business this quarter. The decline in the index to +4.8 suggests year-on-year economic growth will slow from 3.0% in Q2 2007 to 2.6% in Q3 2007.

However, as with the dip in optimism seen in Q1 2007 when the Index fell to +2.1, the slowdown suggested by the Index is likely to be over stated. This is because the Confidence Index captures business's mood rather than being a measure of economic output. Our expectation is for economic growth to slow to 2.9% this quarter, before retreating towards 2.6% in the last quarter of the year.

**CONFIDENCE INDEX DECLINED FROM A THREE YEAR HIGH IN LAST QUARTER**

**Fig. 1.2 Forecast of annual GDP growth based on ICAEW Confidence Index**

— Annual GDP growth  
— Linear regression for Confidence Index



Source: National Statistics First Release – Gross Domestic Product (GDP) – and cebr regression calculations

**CONFIDENCE HAS DECLINED IN MOST SECTORS IN Q3 2007**

### CONFIDENCE FALLS IN MOST SECTORS

Just as the rise in confidence last quarter was spread across most sectors of the economy, the decline this quarter also extends across a number of sectors. Business Services and Banking, Finance and Insurance sectors are amongst those that saw the greatest moderation in their business prospects this quarter. The volatility in confidence seen in the latter sector over the past year suggests that while it has been doing well with the FTSE at record levels, uncertainties remain in the form of the potential impact of rising interest rates on consumer and housing debt. On the other hand, confidence in the Business Services sector has been more stable, sustained by an upturn in business investment as well as by the stock market. The decline in confidence in this sector to the lowest level in over eighteen months suggests business investment growth may be starting to wane.

The Property and Retail and Wholesale sectors have also seen a substantial dip in confidence this quarter, edged down by concerns about the impact of rising interest rates on consumers and house buyers as well as price pressures. However, optimism in the Manufacturing and Engineering sector has remained benign, sustained by growth in exports to the European mainland and R&D investment.

### COMPANIES PLANNING TO CURTAIL INVESTMENT GROWTH

Whilst financial performance expectations remain robust in the average UK company, finance professionals expect to lower the rate of growth of investment in the next 12 months because of the rising cost of capital as well as increased expectations of weaker economic growth. However, firms do expect to maintain wage and job growth at broadly the same pace as that seen over the past year. This should mitigate the extent of the impact of an expected slowdown on the labour market and on households.

**MEDIUM-SIZED  
(50-249  
EMPLOYEES)  
BUSINESSES ARE  
MOST OPTIMISTIC  
FOR FOURTH  
CONSECUTIVE  
QUARTER**

### **BUSINESS PROSPECTS WORSEN IN MOST REGIONS OF THE UK**

The average firm in each of the UK's regions, other than in the East of England, has become less optimistic in its outlook. Whereas the East registered the only rise in confidence this quarter, London, the North East and Yorkshire & Humber recorded the greatest drop in confidence in England. The Index has also dropped into the negative in Scotland and Wales driven down by uncertainty in the financial sector in the former and numerous factory closures in the latter.

### **MEDIUM-SIZED FIRMS REMAIN MOST OPTIMISTIC**

Medium-sized firms remain the most optimistic of all firms for the fourth quarter in a row. The Confidence Index for such firms stands at +7.3. Medium-sized firms are the most buoyant, despite the weakness in overall confidence because a relatively high proportion of such firms are likely to be in the more buoyant sectors of Construction and Manufacturing and Engineering.

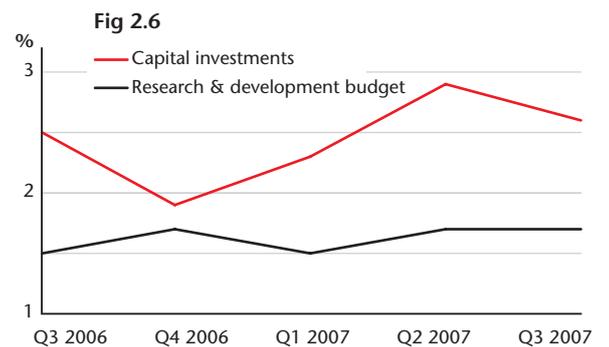
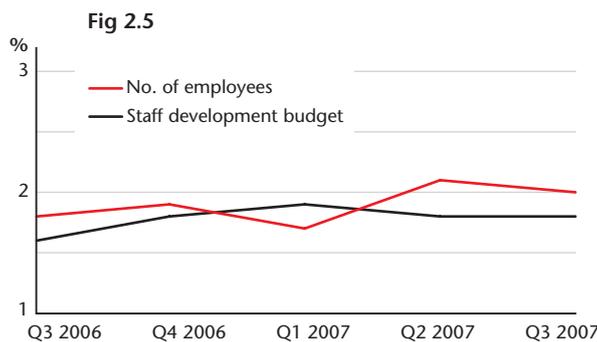
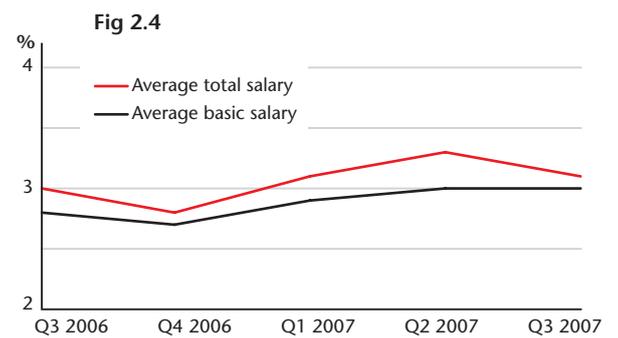
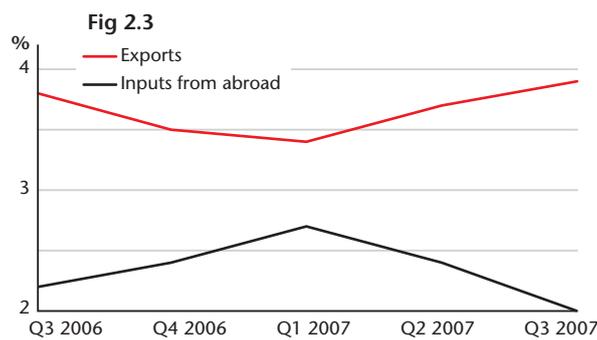
The business outlook for Micro (firms employing up to ten employees) and Medium firms (those employing between 50 and 250) evidenced the largest decline amongst different business sizes this quarter.

## 2 BUSINESS FINANCIAL PERFORMANCE

Finance professionals have become less optimistic regarding their expectations for turnover growth. They expect turnover and profits to rise by 6.6% in the next 12 months after posting 7.1% growth in the past 12 months.

However firms expect profit growth to remain stable supported by a forecast for weaker input price inflation despite oil prices rising to a near record level this quarter. Firms expect to curb their investment growth but remain confident that they will continue to increase headcount at the same pace as that seen over the past 12 months.

### EXPECTED CHANGE IN THE COMING 12 MONTHS IN ...



## 3 FACTORS AFFECTING BUSINESS PERFORMANCE

### CONSTRUCTION SECTOR MOST AFFECTED BY SUPPLY-SHORTAGE OF NON-MANAGEMENT SKILLS

#### CONCERNS REGARDING TRANSPORT PROBLEMS EASE

The share of respondents claiming that transport problems have worsened when compared with one year ago has declined for a second consecutive quarter. According to finance professionals surveyed, the greatest transport problems are currently in the East Midlands and Yorkshire & Humber, with transport problems tending to have a disproportionately greater effect upon Micro and Small businesses rather than larger sizes.

Meanwhile, nearly one quarter (23%) claim that the tax burden is having a worse impact on their business when compared with one year ago. This compares with a small minority (4%) claiming that the impact of the fiscal regime has improved. Similarly, just over one in four (43%) claim that regulatory requirements have worsened in the past 12 months

Finally, finance professionals in the Construction sector most affected by a shortage of supply of non-management skills. Given the strength of the sector over the past few years, the demand for construction workers remains unsatisfied despite the influx of workers from the countries that joined the EU in 2004.

Fig. 3.1 Transport and infrastructure

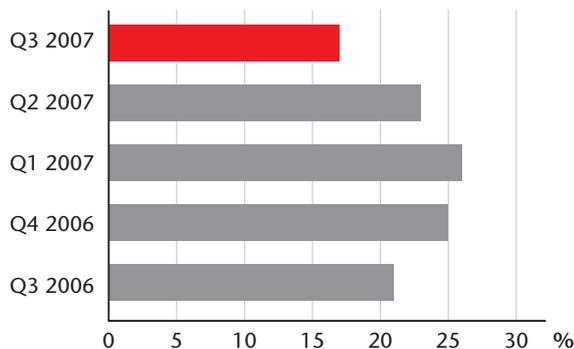


Fig. 3.2 Transport and infrastructure

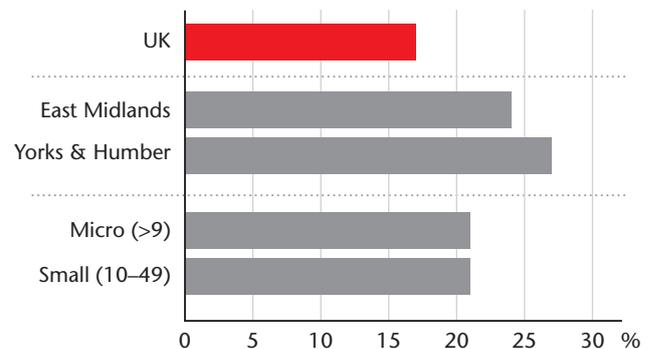
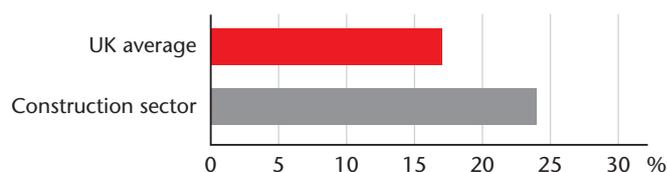


Fig. 3.3 Availability of non-management skills Q3 2007



## 4 CONFIDENCE BY SECTOR

In contrast with most other sectors, confidence in the IT sector rose this quarter to allow it to regain the title of most optimistic industry in the UK. The rise in optimism this quarter demonstrates a degree of detachment from UK interest rates as IT firms based in the UK continue to make extensive productivity gains from the internet boom and demand for software and IT services from emerging markets.

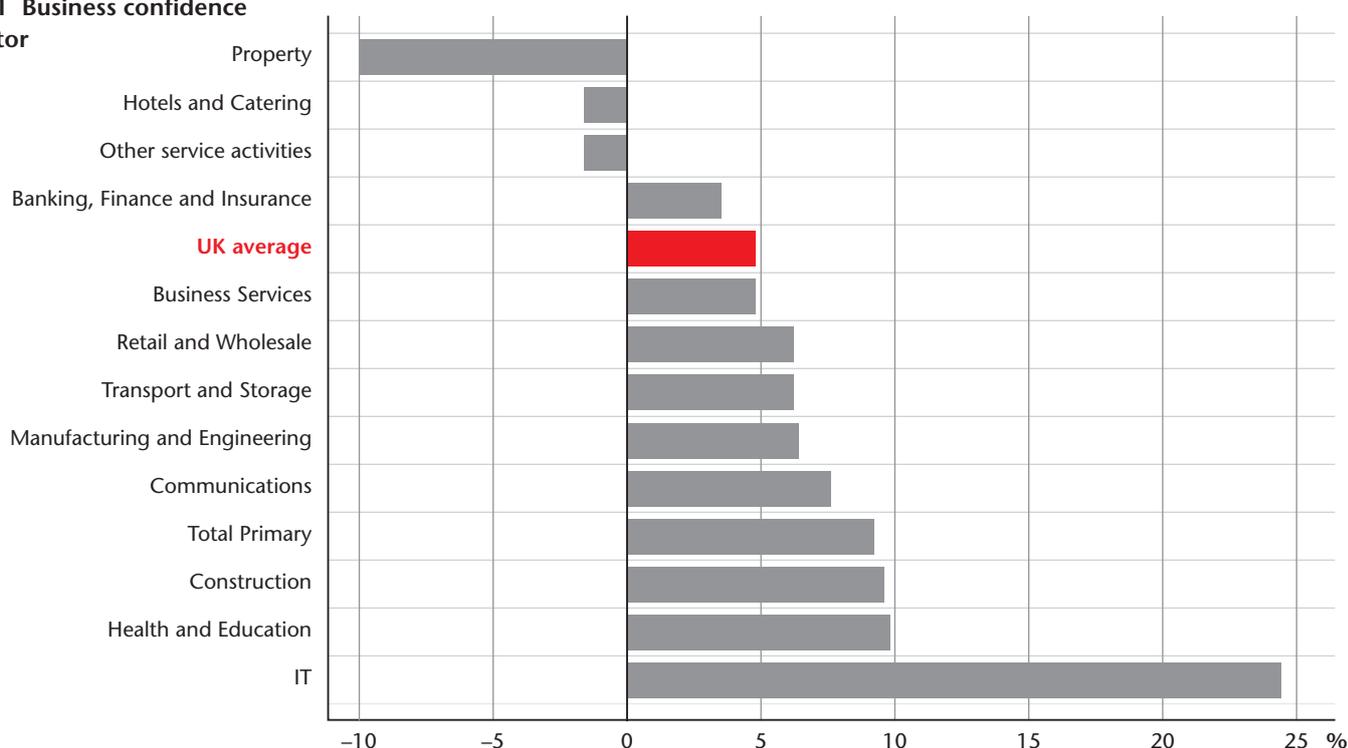
However confidence has declined in most other sectors. The Index of the Business Services sector has retreated to the lowest level in over eighteen months whilst that of Banking, Finance and Insurance also headed south as a result of concerns that interest rises may weaken consumer spending and the housing market, as well as capital investment. The latter has been growing robustly following three years of weak growth and has helped support the recent upturn in economic growth.

**BUSINESS SERVICES  
OPTIMISM AT  
LOWEST LEVEL  
IN NEARLY  
TWO YEARS**

Confidence has also declined in other major sectors such as Property, Retail and Wholesale, Hotels and Catering and Other Services suggesting that in the consumer, tourism, leisure and housing markets, weakness may be setting in. The Manufacturing and Engineering sector experienced only a slight decrease in its Confidence Index this quarter as a robust upturn in the continental economy has sustained the demand for British goods.

Since around 70% of UK exports are to Europe, the sector has not been significantly affected by the appreciation of the pound against the yen and the dollar. Optimism in the Energy, Water and Mining (Total Primary) sector rose this quarter on the back of record oil prices, while confidence in the Construction sector moderated but remained close to double digit levels.

**Fig. 4.1 Business confidence by sector**



TREND OF BUSINESS CONFIDENCE BY SECTOR

Fig. 4.2

— Banking, Finance and Insurance  
 — Business Services  
 — UK average

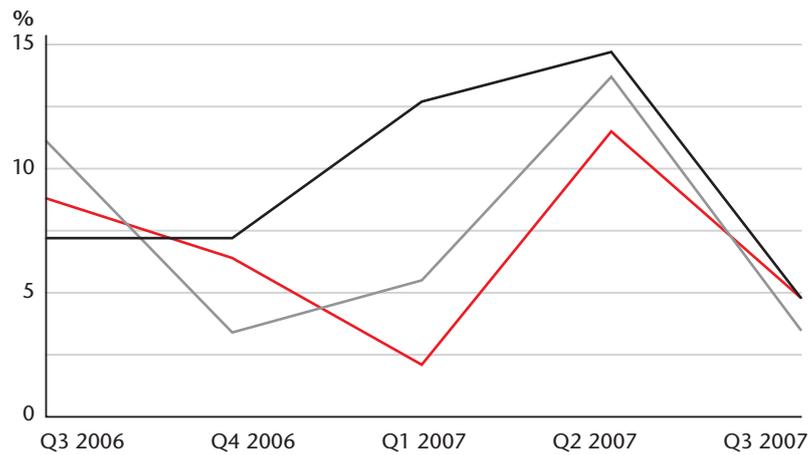


Fig. 4.3

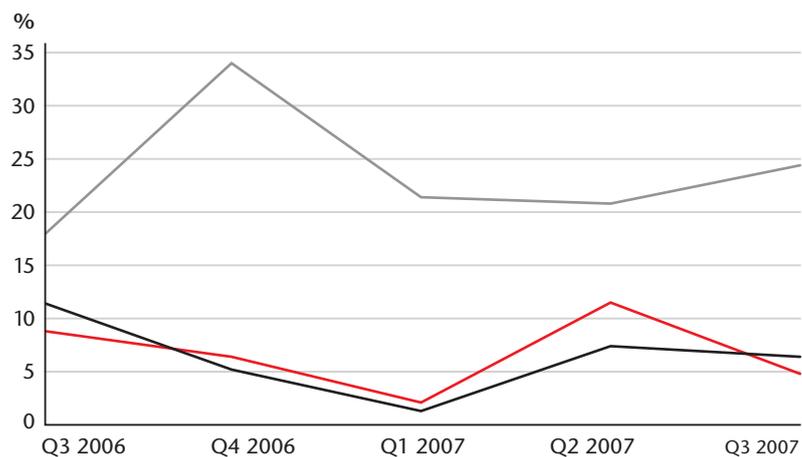
— Property\*  
 — Retail and Wholesale  
 — UK average



\*NB – low base size Q3 06 – Q2 07 (n=31-34)

Fig. 4.4

— IT  
 — Manufacturing and Engineering  
 — UK average



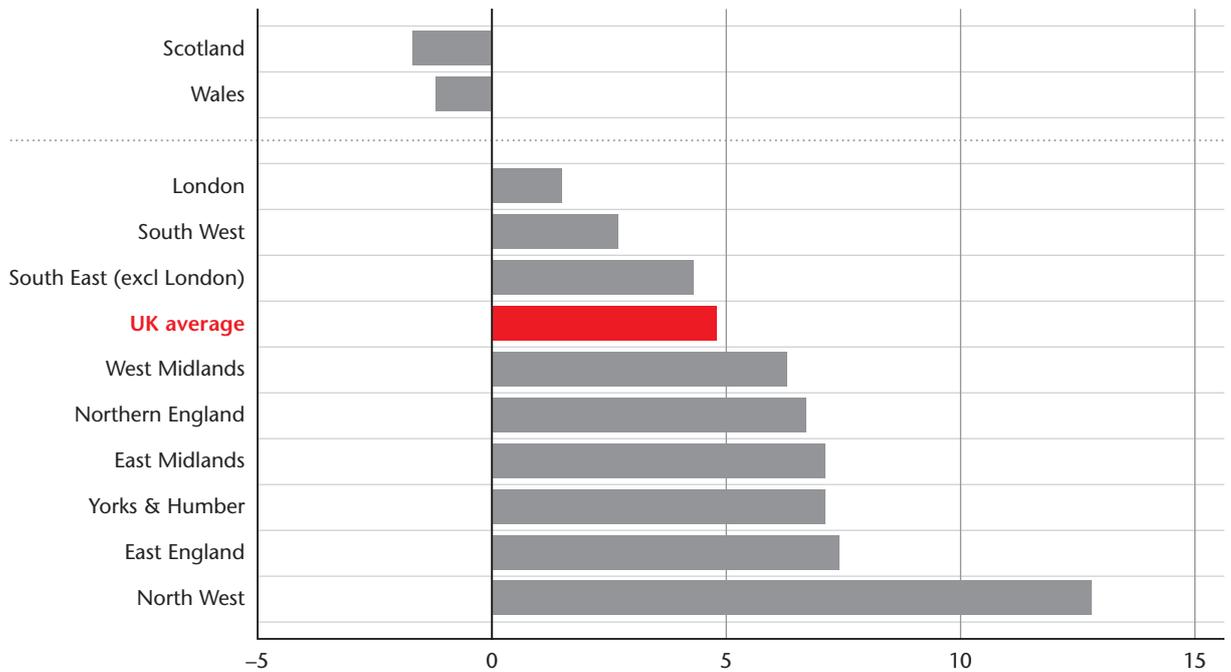
# 5 CONFIDENCE BY REGION

**CONCERNS ABOUT IMPACT OF RISING INTEREST RATES LIKELY TO BE PARTICULARLY ACUTE IN LONDON**

The economic outlook worsened in all regions of the country this quarter other than in the East of England, to undo the rise in confidence seen one quarter ago.

The average firm in Scotland, Wales and London are the least optimistic this quarter as concerns surrounding the Business Services and Banking, Finance and Insurance sectors weaken prospects for the next 12 months. Job losses in Wales such as those experienced at the Airbus factory in the north of the country are also contributing to the uncertainty. Confidence is also weak in the South West and the South East.

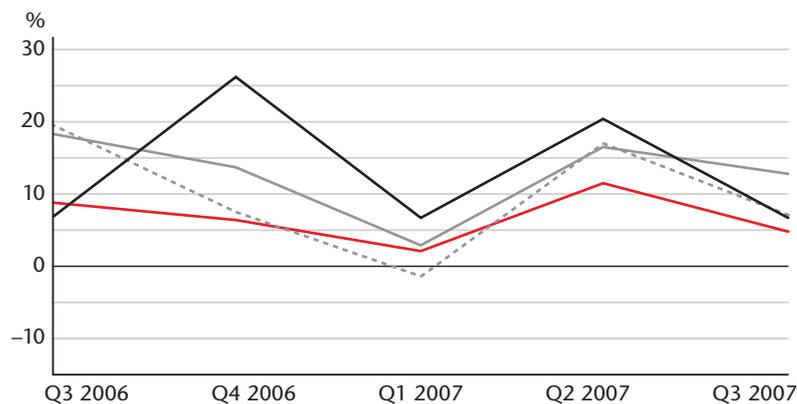
**Fig. 5.1 Regional confidence Q3 2007**



## TREND OF REGIONAL CONFIDENCE

**Fig. 5.2**

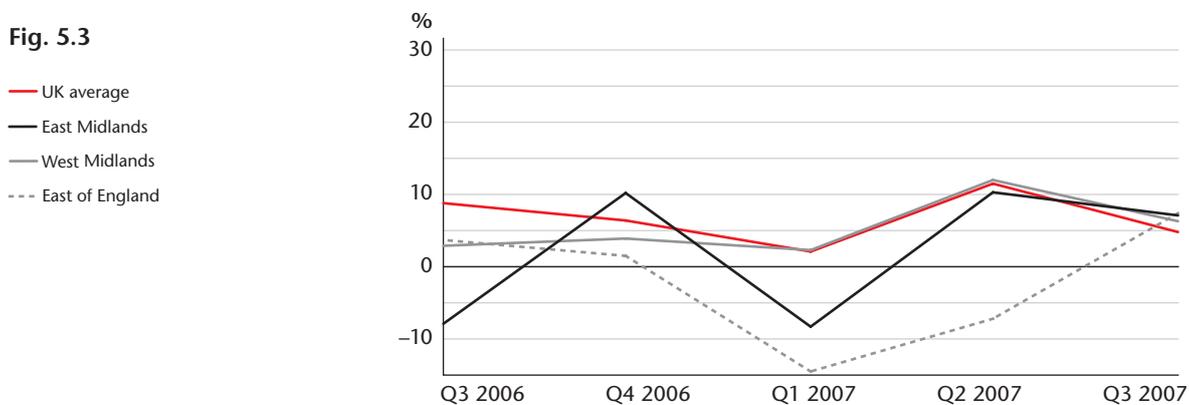
— UK average  
 — North  
 — North West  
 - - - Yorkshire & Humber



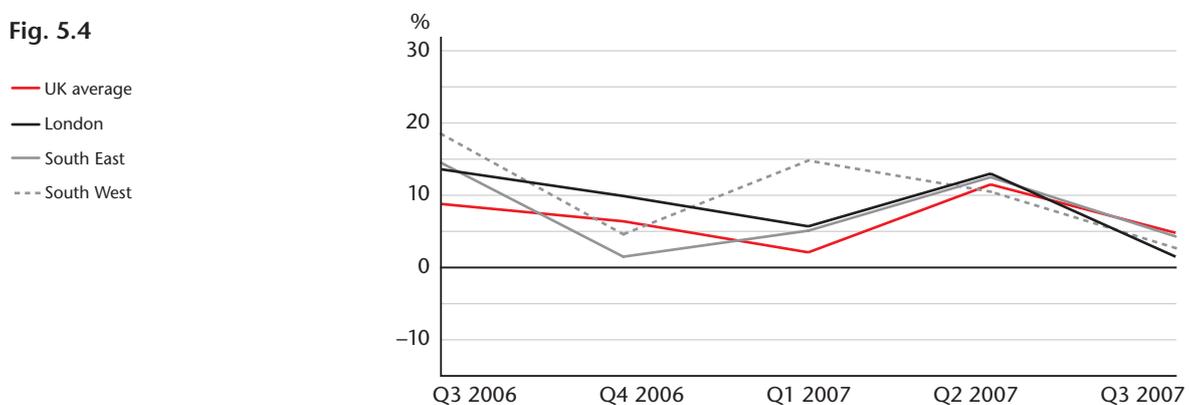
Compared with most other regions, optimism retreated only modestly in the North West this quarter to make it the most confidence region across the UK. Expectations of sustained regeneration benefits in Liverpool and Manchester are driving optimism, despite the impact of rising interest rates. The East Midlands, West Midlands, Yorkshire & Humber and East England are fairly buoyant, supported by the Manufacturing and Engineering, Transport and Storage, and Communications sectors.

**TREND OF REGIONAL CONFIDENCE**

**Fig. 5.3**

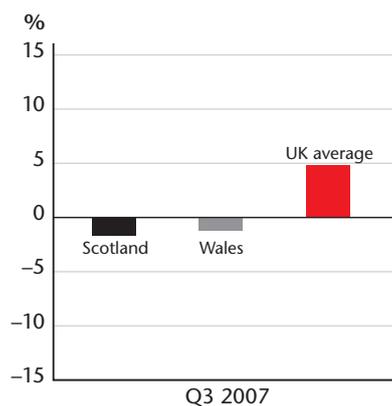


**Fig. 5.4**



**REGIONAL CONFIDENCE Q3 2007 – SCOTLAND AND WALES**

**Fig. 5.5**



## 6 CONFIDENCE BY BUSINESS SIZE

The business outlook for Micro (firms employing up to ten employees) and Medium firms (those employing between 50 and 250) evidenced the largest decline amongst different business sizes this quarter.

**MEDIUM-SIZED BUSINESSES MOST CONFIDENT**

Nevertheless, Medium-sized firms remain the most optimistic of all firms for the fourth quarter in a row. The Confidence Index for such firms stands at +7.3. Medium-sized firms are the most buoyant, despite the weakness in overall confidence because a relatively high proportion of such firms are likely to be in the more buoyant sectors of Construction and Manufacturing and Engineering.

Confidence in Micro, Small and Large businesses now stands close to the nationwide average of +4.8. However whereas optimism declined substantially in Micro and Large businesses from +14.6 and +11.0 respectively, it rose to the highest level in a year amongst Small businesses (those that employ between 10 and 50 employees).

### TREND OF COMPANY SIZE CONFIDENCE

Fig. 6.1

— UK average  
— Micro  
— Small

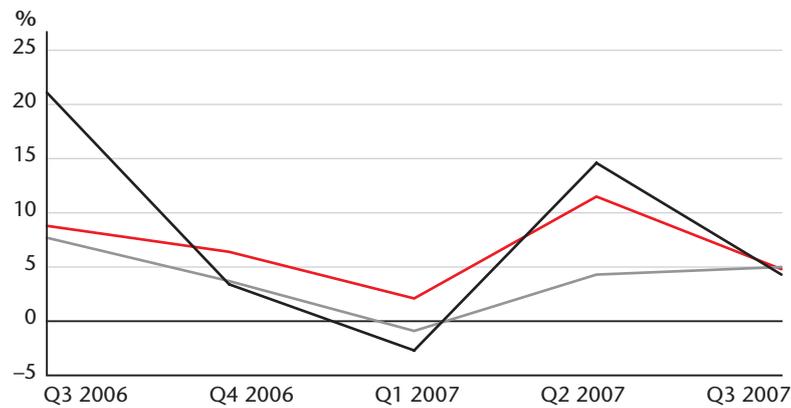
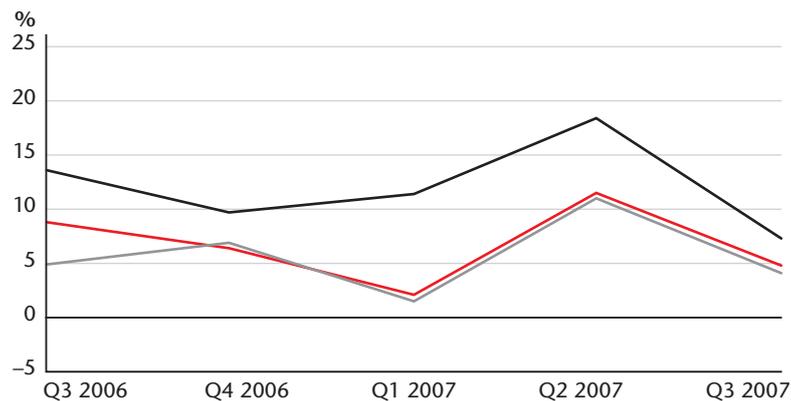


Fig. 6.2

— UK average  
— Medium  
— Large



# APPENDIX

## TECHNICAL INFORMATION

This research was conducted by the Institute of Chartered Accountants in England & Wales (ICAEW) with assistance from centre for economic and business research (cebr).

During the period 12 June to 16 July 2007 1006 ICAEW members active in business in the UK were interviewed by telephone. The interviews typically lasted 12–15 minutes and gathered opinions on past performance and future prospects for members' businesses, as well as investigating perceived changes in impact of factors such as availability of skills, government regulation and the tax regime. A copy of the full question set is available upon request.

Data has been weighted to ensure the profile of the survey sample accurately represents the UK economy for company size (no. of employees), regional location and industry sector. Details of the weighting approach employed are included below.

Prior to June 2007 data for BCM was gathered via self completion methodologies, a mix of online and post.

The impact of design factors on data continuity were considered in detail before the decision to move to telephone data collection was made. Methodological testing indicated that the move to telephone would have limited impact on trends in the headline Confidence Index. The difference is not felt to invalidate comparison over time.

### FURTHER INFORMATION

For further information on the UK BCM please contact:

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### WEIGHTING APPROACH

Those who completed the survey (both current and historic data) were categorised by regional location, company size (no. of employees) and industry sector.

Rim weighting was applied to ensure the profile of the sample accurately represents the UK economy. Weighting factors applied are detailed on the following page. Target weights for sector and region were derived from Office of National Statistics published data on GVA (Gross Value Added) 2004. Weights for company size are based on turnover data for start 2005 published by the Small Business Analytical Unit of the Department for Business, Enterprise and Regulatory Reform.

	Sample number	Profile unweighted sample	Target profile weighted sample
	Number	%	%
<b>REGION</b>	total <sub>u</sub> 1006		
East England	86	9	10
East Midlands	74	7	7
London	155	15	17
North West	96	10	10
Northern	66	7	3
Northern Ireland	1	0	0.1
Scotland	71	7	8
South East (excl London)	144	14	16
South West	84	8	8
Wales	70	7	4
West Midlands	81	8	8
Yorks & Humber	78	8	8
<b>SIZE (EMPLOYEES)</b>	total <sub>u</sub> 1006		
Up to 49 (Micro & Small)	283	28	31
50–249 (Medium)	206	20	16
250+ (Large)	517	51	53
<b>SECTOR</b>	total <sub>u</sub> 1006		
Agriculture, Fisheries, Energy, Water & Mining	72	7	3
Manufacturing and Engineering	110	11	14
Construction	70	7	6
Retail and Wholesale	100	10	12
Hotels and Catering	63	6	3
Transport and Storage	57	6	5
Communications	64	6	3
IT	70	7	3
Banking, Finance and Insurance	120	12	8
Property	70	7	11
Business Services	70	7	11
Other service activities	70	7	5
Health and Education	70	7	13

Weighted figures may not sum to 100% due to rounding

## EMPLOYMENT COVERAGE RATIO

The coverage ratio is the ratio of total employees working in businesses in each region versus those in businesses covered as part of this survey. The ratio shows that coverage is strong for the UK and for most of the regions, allowing us to accurately capture the mood of businesses.

The coverage ratio is particularly important in allowing us to evaluate the reliability of regional trends, since sample sizes are much smaller than they are for the UK as a whole. Generally, a coverage ratio equal to or above the UK average adds to evidence that the regional Confidence Index is an accurate measure of finance professionals' confidence when the survey was conducted.

Regional sample sizes and coverage	Survey responses received	Coverage (% share of total regional or national employees represented)
	Number	%
East England	86	2.1
East Midlands	74	2.2
London	155	3.5
North West	96	2.1
Northern	66	2.7
Northern Ireland	1	0.2
Scotland	71	2.5
South East (excl London)	144	2.5
South West	84	2.5
Wales	70	2.4
West Midlands	81	2.6
Yorks & Humber	78	1.9
United Kingdom	1006	2.5

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UK Business Confidence Monitor regional analysis is available on request. Please visit [www.icaew.com/bcm](http://www.icaew.com/bcm) or contact the relevant regional office detailed below for a full report:

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Histon, Cambridge  
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116 Quayside  
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NE1 3DY  
Tel 0191 206 4548  
Fax 0191 206 4239  
[www.icaew.com/northern](http://www.icaew.com/northern)

**South East region**

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Guildford, Surrey  
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Fax 01483 245117  
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Fax 0115 988 6226  
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**North West region**

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Cinnamon Brow  
Fearnhead, Warrington  
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Fax 01925 661828  
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**South West region**

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Temple Quay  
Bristol  
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**Yorkshire and Humber region**

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