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ICAEW/GRANT THORNTON BUSINESS CONFIDENCE MONITOR

AN INDICATOR OF FUTURE ECONOMIC TRENDS



BUSINESS WITH CONFIDENCE

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EXECUTIVE SUMMARY

The *ICAEW/Grant Thornton Business Confidence Monitor* (BCM) has been running for seven years and has built up an extensive dataset on business confidence, financial performance and the challenges to business performance through the credit crunch, recession and recovery.

This paper assesses the BCM's relevance and usefulness to economists and business professionals. Using the BCM's dataset, we examine its effectiveness as a forecasting tool and as a bellwether to gauge business sentiment – both clearly important in business planning.

The overall conclusion of our analysis is that the BCM dataset has tracked a wide range of key economic indicators remarkably well in recent years. The solid, high quality sample of the BCM – averaging 1,000 senior business professionals every quarter weighted to match the UK economy's sector mix – in conjunction with the broad range of questions, means it gives compelling insights on the UK economy. It not only offers a strong steer of the overall direction of the economy but also illustrates what is driving change and highlights the key concerns of UK plc.

KEY FINDINGS OF THE ANALYSIS

- Over the past five years, the BCM Confidence Index has predicted approximately **75%** of the changes in the official estimate of UK annual real gross domestic product (GDP) growth. Given the scale of unpredictable factors (such as unexpected bad weather – as seen in winter 2010) that are likely to affect actual GDP changes in the real world, this is a good result.
- As such, the BCM passes conventional tests for statistical significance as an explanatory variable for economic activity.
- The findings of the BCM can be used to supplement official estimates of economic activity and other key economic variables.
- BCM key performance indicators of business turnover, employment growth and employee wage growth have tracked official statistics very well, and are more timely – making them useful predictive tools and leading indicators for UK economic performance.
- BCM questions on the factors businesses perceive to be a greater or lesser challenge than 12 months previously – first introduced at the end of 2007 – have had significant explanatory power to date.
- The proportion of businesses reporting customer demand to be a greater challenge than 12 months ago has closely reflected changes in official measures of domestic demand and export demand, anticipating the official figures by several months.
- The proportion of businesses reporting access to capital to be a greater challenge than 12 months ago also anticipated later business investment statistics very well.
- The proportion of businesses reporting staff turnover as a greater challenge than 12 months ago seems to be closely related to changes in unemployment and job vacancies.
- Hence, the BCM provides timely and leading insights on the latest developments in the UK economy.

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1 INTRODUCTION

The *ICAEW/Grant Thornton Business Confidence Monitor* (BCM) is one of the largest and most comprehensive quarterly reviews of UK business confidence and provides a regular snapshot of the UK economy, informed by senior business professionals running all types of businesses across the UK. The BCM has now been running for seven years and has provided clear signals of both the beginning of the downturn in the real economy in 2008 and the recovery in 2009. In summary, it provides excellent insights into the future of UK plc. Reflecting this, the survey was recently referenced in the November 2010 Office for Budget Responsibility *Economic and Fiscal Outlook* publication.

With sample sizes in recent surveys averaging 1,000, the BCM compares favourably with other business confidence and outlook surveys. Results are weighted by sector and region to match the profile of the UK economy. A wide range of questions is asked beyond those used to gauge business confidence – questions about actual and expected performance for a range of indicators, and questions covering challenges currently facing businesses. The breadth of the questions asked in the BCM, in conjunction with its robust sample size, allows detailed analysis to be conducted.

The aim of this BCM Analysis Paper is to assess the usefulness of the BCM to economic analysts and other business professionals. This paper investigates how well BCM indicators correlate with official statistics, and the extent to which BCM indicators can be used as a predictive tool. The findings outlined over the following pages suggest the BCM indicators have tracked official measures of economic growth, job creation and earnings particularly well over the last five years. Given that the BCM is released at the start of each quarter, it is a more timely indicator than official statistics and is thus a useful bellwether indicator for analysts looking to gauge economic performance at a particular point in time.

The BCM indicators are a useful input into economic forecasting models. Many existing forecasting models are backward-looking, in the sense that they look at how policy variables such as interest rates have impacted on factors such as business investment in the past. These historic relationships are then used to assess how the economy is likely to behave over the coming quarters. The key flaw with this approach is that it ignores the fact that historical relationships have a tendency to break down – especially following major economic events such as the recent financial crisis or the UK's ejection from the Exchange Rate Mechanism in the early nineties – and this leads to erroneous forecasts. The use of business survey data (such as that provided by the BCM) provides a possible way of circumventing this issue, as it is based on what businesses report to be the current economic environment as well as their expectations for the future. Economists and business professionals can, and should, use on-the-ground business experiences captured in business surveys like the BCM, as a means of better understanding and predicting the economic environment.

2 THE CONFIDENCE INDEX

The headline BCM indicator, the BCM Confidence Index, is calculated from the response to the following question:



Overall, how would you describe your confidence in the economic prospects facing your business over the next 12 months, compared to the previous 12 months?

A score is applied to each response, as set out in the table below, and a weighted average of these scores yields the Confidence Index value. A Confidence Index of +100 would indicate that all survey respondents were much more confident about future prospects, while -100 would indicate that all survey respondents were much less confident about future prospects.

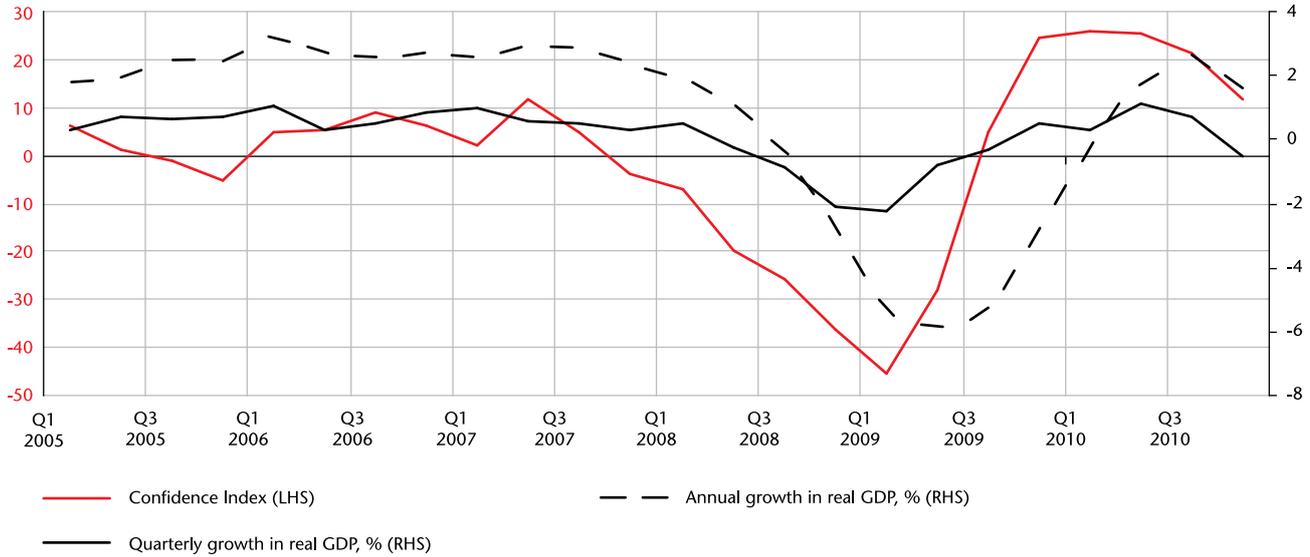
Survey response	Score
Much more confident	+ 100
Slightly more confident	+ 50
As confident	0
Slightly less confident	- 50
Much less confident	- 100

Critically, the Confidence Index is a forward-looking indicator. That is, it is gauging respondents' economic confidence about the next 12 months, suggesting that it should have some predictive power. Of course, respondents' beliefs about the economy over the next 12 months are likely to be shaped in part by current events, suggesting that the Confidence Index should also correlate contemporaneously with variables. Our analysis over the preceding pages suggests that this is indeed the case.

The timeliness of the Confidence Index means that it is a useful leading indicator. The BCM is generally released at the start of each quarter and therefore precedes official growth estimates for a given quarter by approximately three months.

If businesses have an informed view about the state of the economy, the Confidence Index should be strongly correlated with official economic growth measures. As Figure 1 shows, the Confidence Index has tracked quarterly and annual growth rates in real GDP very closely. The Confidence Index appears to lag **annual** growth in GDP by two quarters, though appears to be contemporaneously correlated with **quarterly** GDP growth.

Figure 1 Confidence Index versus real GDP growth

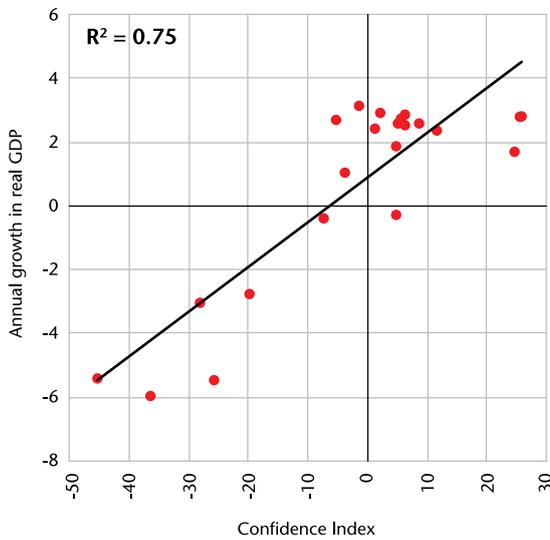


SOURCE: ICAEW, ONS

Over the last five years, the value of the Confidence Index lagged two quarters explains approximately 75% of the variation in annual GDP growth – a significant amount. Similarly, the Confidence Index explains about

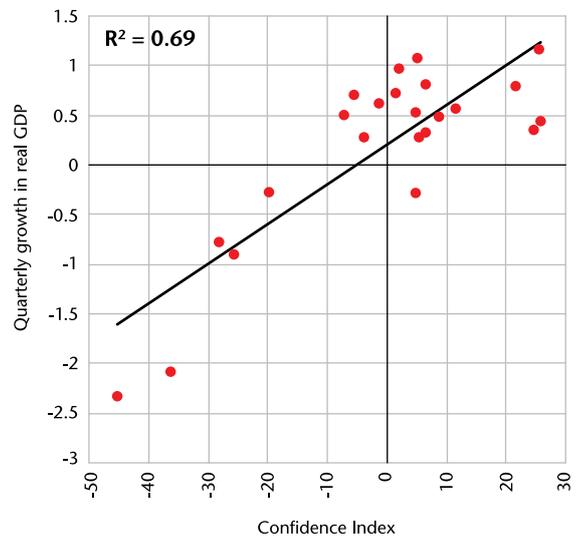
69% of the variation in contemporaneous quarterly real GDP growth. Figures 2 and 3 illustrate the correlations in scatter graph format.

Figure 2 Confidence Index versus annual GDP growth two quarters ahead (%)



SOURCE: ICAEW, ONS

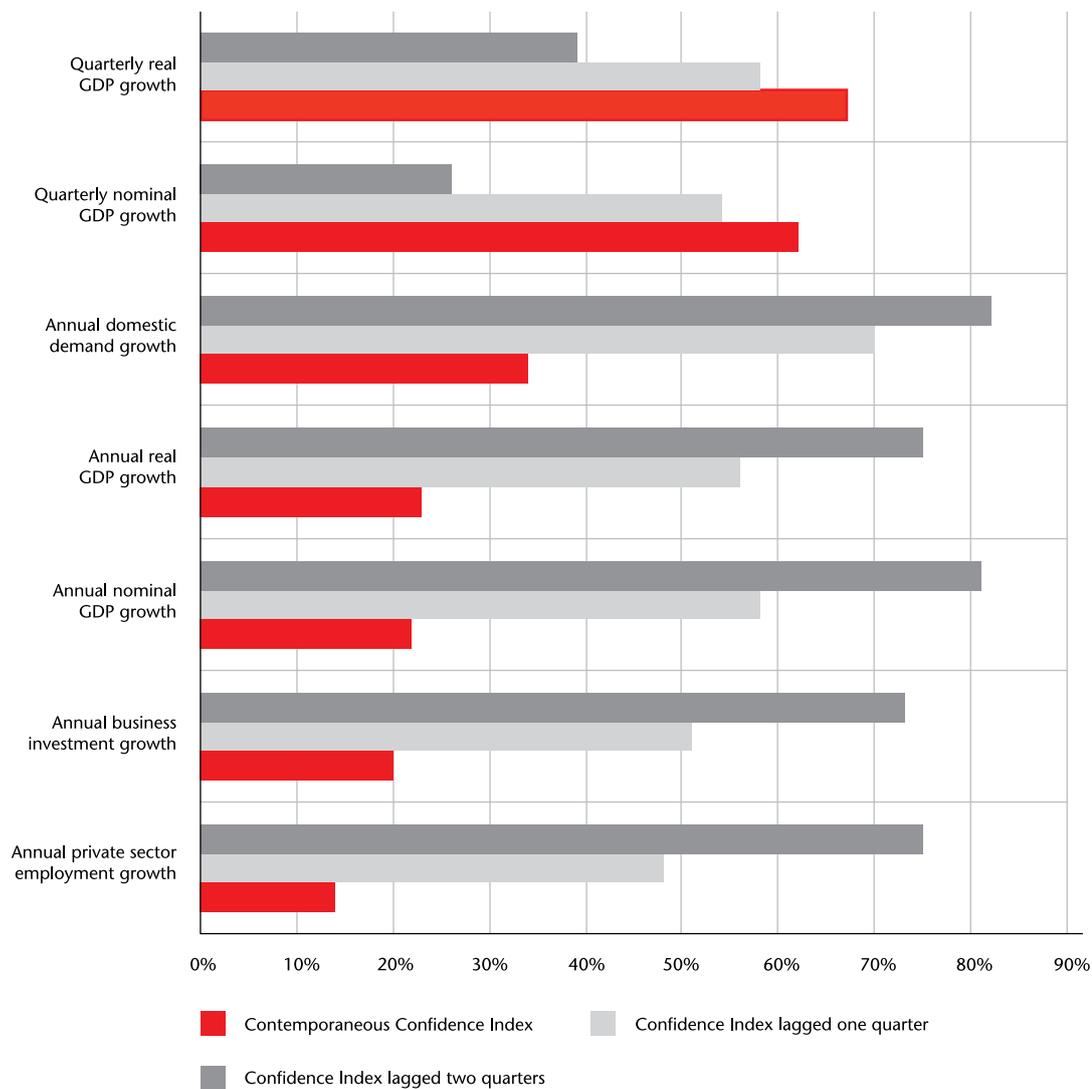
Figure 3 Confidence Index versus contemporaneous GDP growth (%)



The Confidence Index also correlates well with a range of other economic indicators, though as with the GDP relationship, a careful consideration of leads and lags is required. For annual growth indicators, the Confidence Index lagged two quarters appears to yield the greatest explanatory power, while for quarterly growth indicators, the contemporaneous value of

the Confidence Index is more informative. This is clearly evident in **Figure 4** below. Once lagged by two quarters, the Confidence Index explained over **70%** of the variation in the annual growth of domestic demand, real GDP, nominal GDP, business investment and private sector employment growth, over the last five years.

Figure 4 Proportion of variation of economic indicator explained by contemporaneous and lagged values of the BCM Confidence Index, %



SOURCE: ICAEW, ONS

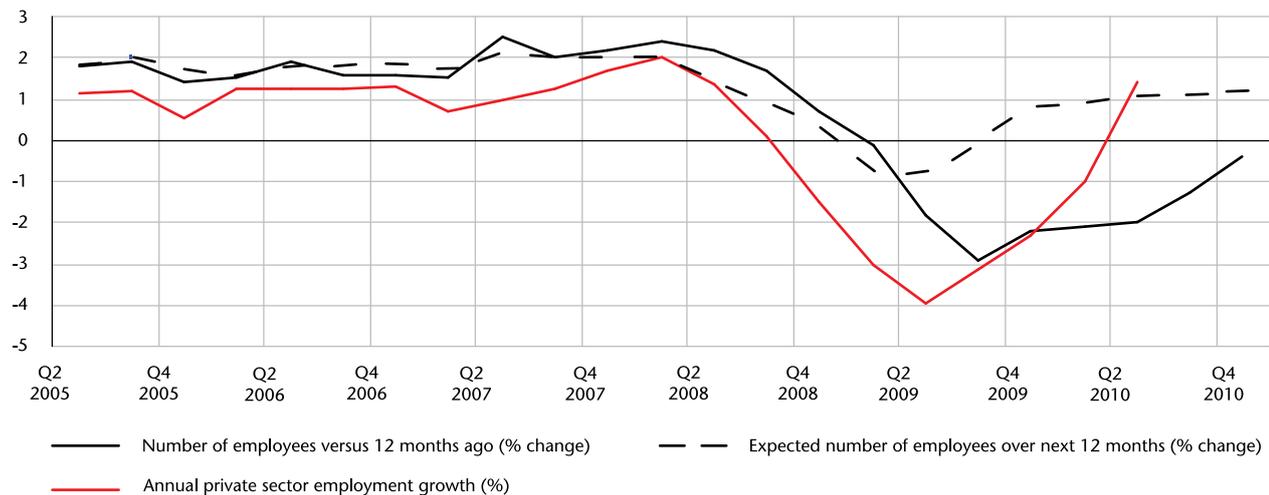
3 KEY PERFORMANCE INDICATORS

In addition to the question used to construct the Confidence Index, the BCM asks businesses about their current and expected growth in key performance indicators. These also appear to be well correlated with official statistics.

Figure 5 depicts BCM average employee growth versus 12 months ago for each quarter, and compares it with the official ONS estimate of private sector employment growth. The correlation between the two estimates of job creation is highest when the BCM indicator

one-quarter-ahead is considered. This is probably because the BCM indicators are issued at the start of each quarter. Taking into account this lag, the BCM measure of employment growth explains approximately **76%** of the variation in the ONS measure of private sector employment growth. Despite the need to look at the BCM indicator one quarter ahead of the ONS employment statistic, the BCM indicator is still a more timely measure of labour market performance, given the slower release of ONS labour market estimates.

Figure 5 BCM versus ONS employment indicators

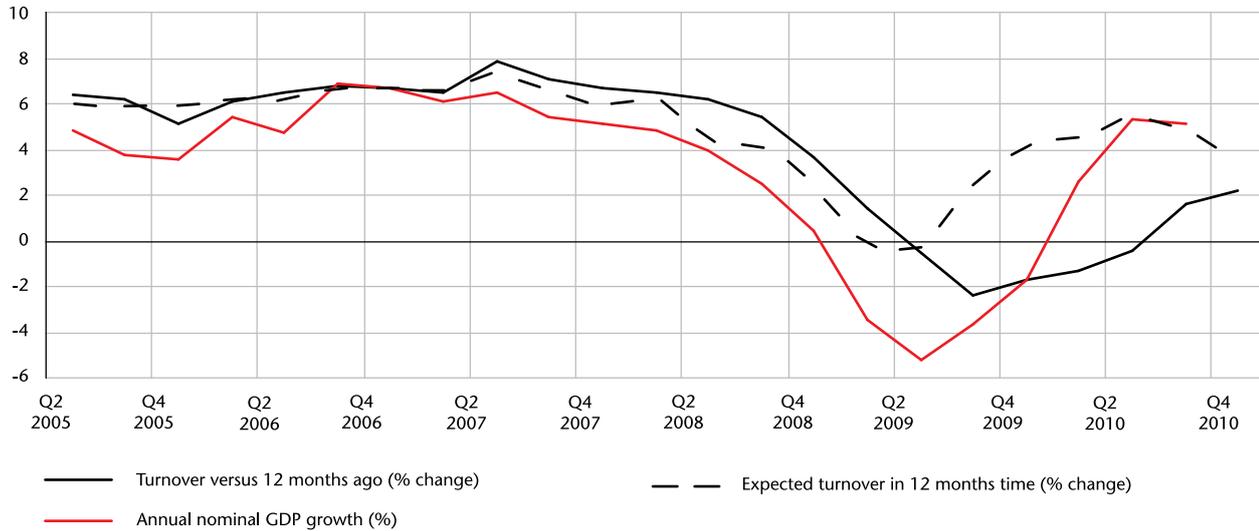


SOURCE: ICAEW, ONS

Figure 5 also shows business expectations of employment growth over the next 12 months. Businesses in general underestimated the number of private sector jobs which would be lost during the recession, though correctly predicted the return to positive annual employment growth a year before it actually occurred.

There also appear to be strong correlations between stated business turnover and nominal GDP growth. As **Figure 6** shows, business stated turnover growth versus 12 months ago (one quarter ahead) explains about **80%** of the variation in ONS nominal GDP growth. This is intuitive – one would expect a strong relationship between total business turnover growth and growth in nominal income.

Figure 6 BCM turnover indicator versus annual nominal GDP growth

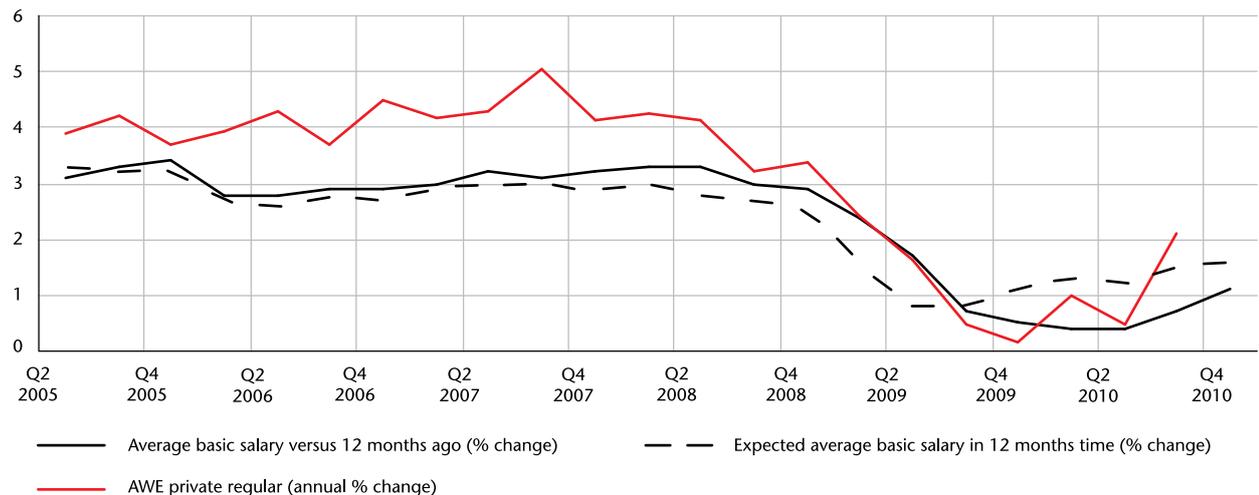


SOURCE: ICAEW, ONS

Businesses' stated average basic salary growth is highly correlated with growth in ONS average weekly earnings data for private sector regular pay. Indeed, the BCM indicator for basic salary growth explains approximately

87% of the variation in the ONS measure. The ONS indicator is more volatile than the BCM indicator (Figure 7 illustrates).

Figure 7 BCM salary indicator versus private sector average weekly earnings (AWE) growth excluding bonuses



SOURCE: ICAEW, ONS

There is thus good evidence that the change in key performance indicators measured in the BCM are informative about movements in a range of official economic indicators – from employment and nominal

GDP growth to growth in employee average earnings. The more timely release of BCM data when compared with ONS data makes it a useful predictive tool, and an economic bellwether.

4 REPORTED CHALLENGES

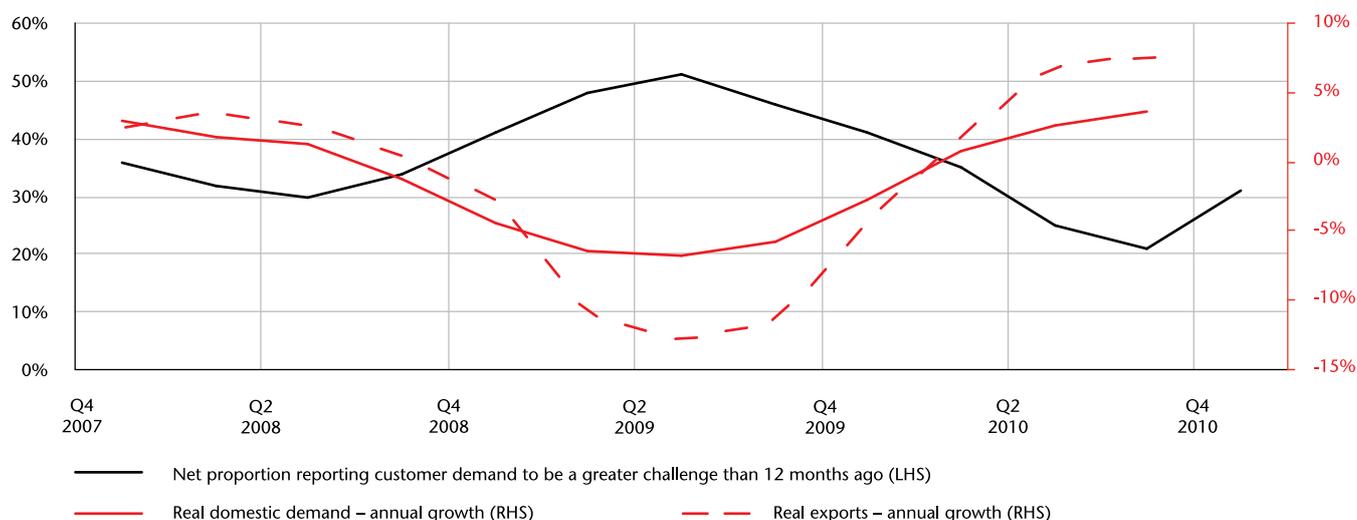
Since the fourth quarter of 2007, *Business Confidence Monitor* survey respondents have been asked to identify whether the following issues have become a greater or lesser challenge than 12 months ago:

- Competition in the marketplace
- Customer demand
- Availability of management skills
- Availability of non-management skills
- Staff turnover
- Bank charges
- Access to capital
- Transport
- Non-transport infrastructure

- Ability to expand into new areas
- Regulatory requirements
- Government support for business
- Tax burden

It is reasonable to posit that a number of these will be correlated with economic outcomes and our analysis shows that this is indeed the case. As **Figure 8** shows, the net proportion¹ of businesses reporting customer demand to be a greater challenge than a year ago is highly correlated with the annual growth of both domestic demand (the sum of consumption, investment and government demand) and export demand.

Figure 8 Net proportion of businesses reporting customer demand to be a greater challenge than 12 months ago, versus annual growth in domestic demand and exports



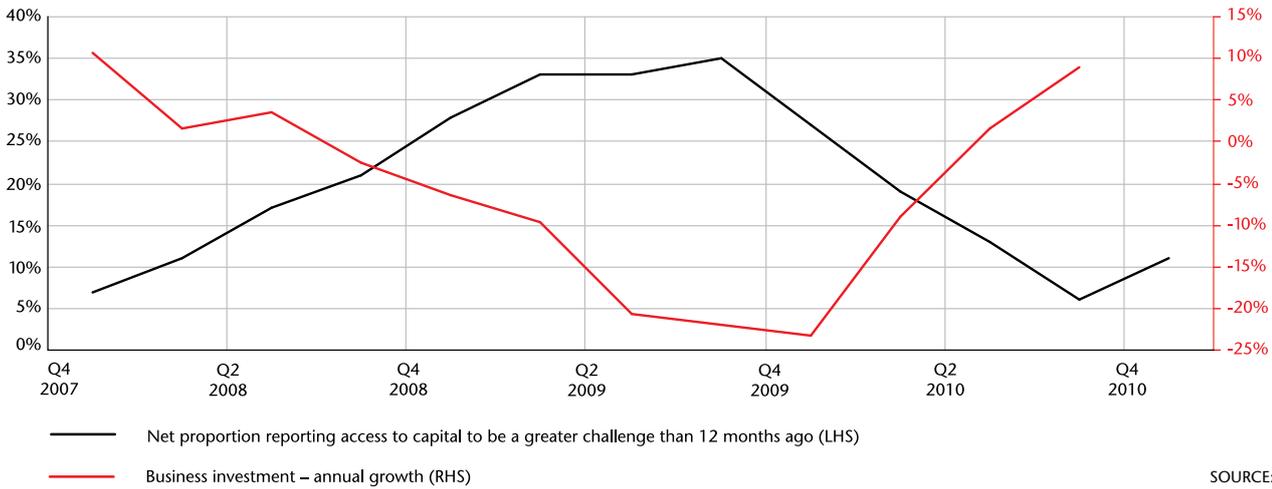
SOURCE: ICAEW, ONS

The explanatory power statistics are particularly striking – the net proportion of businesses reporting customer demand to be a greater challenge than 12 months ago explained **85%** of the variation in annual domestic demand growth, and **92%** of the variation in annual export growth between Q4 2007 and Q3 2010.

The net proportion of businesses reporting access to capital to be a greater challenge than 12 months ago appears to be negatively correlated with annual business investment growth, as **Figure 9** shows. This is intuitive, as investment is often contingent on capital being available.

¹ Defined as the proportion reporting the factor as a greater challenge less the proportion reporting the factor as a lesser challenge.

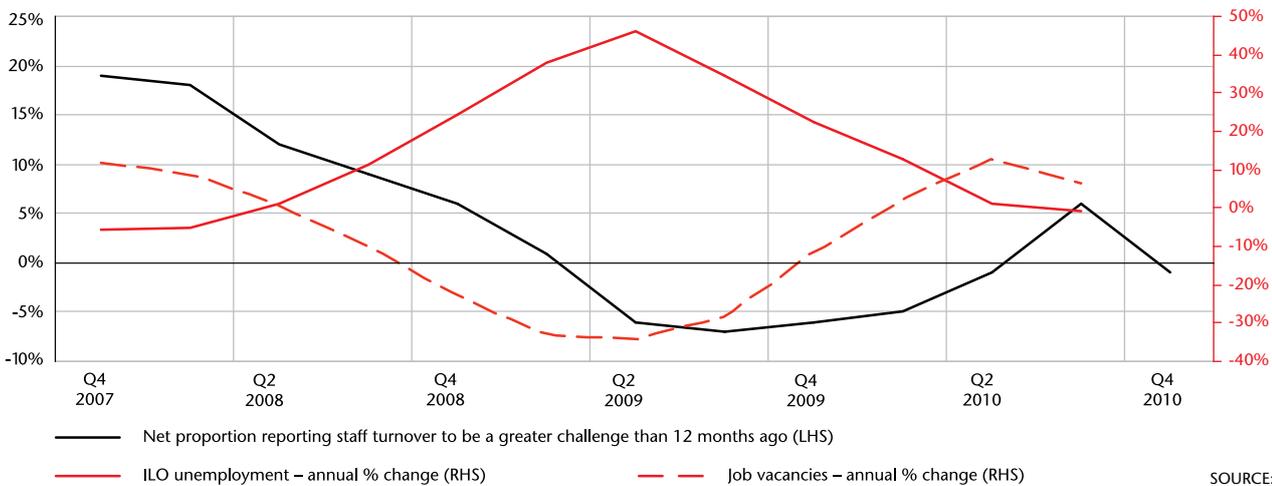
Figure 9 Net proportion of businesses reporting access to capital to be a greater challenge than 12 months ago, versus annual growth in business investment



The net proportion of businesses reporting access to capital to be a greater challenge than 12 months ago appears to lag the annual growth in business investment by one quarter. Once an adjustment for this lag is made, the net proportion of businesses reporting access to capital to be a greater challenge than 12 months ago explained **86%** of the variation in business investment between Q4 2007 and Q3 2010.

There is another close correlation between reported challenges and economic indicators – that between the proportion of businesses reporting staff turnover as a greater challenge than 12 months ago and annual growth in the International Labour Organisation (ILO) measure of UK unemployment, and annual growth in the number of vacancies. This is illustrated in **Figure 10**.

Figure 10 Net proportion of businesses reporting staff turnover to be a greater challenge than 12 months ago, versus annual growth in ILO unemployment



The net proportion of businesses reporting staff turnover to be a greater challenge than 12 months ago explained approximately **70%** of the variation in ILO unemployment between Q4 2007 and Q3 2010, and **70%** of the variation in annual job vacancy

growth. It is intuitive that this is the case – at times when unemployment is high and job vacancies are low, workers are less inclined to leave their existing jobs, and thus staff turnover (excluding the effects of redundancies) has a tendency to diminish.

5 COMPARISON WITH OTHER BUSINESS SURVEYS/CONFIDENCE INDICES

Of course, the BCM is not the only measure of business confidence, nor the only business survey, available in the UK. However, the BCM compares favourably with other surveys, both in terms of sample size and the range of performance indicators it covers. This section briefly introduces the other main surveys on the UK economy. **Table 5.1** summarises the strengths and weaknesses of each survey. The section concludes by assessing where the BCM has advantages and disadvantages compared with other surveys.

CBI SURVEYS

The Confederation of Business Industry (CBI) has the longest running of the private sector surveys on the UK economy. Its *Industrial Trends* report started in 1958, moving to a quarterly publication in 1972 and an abbreviated monthly version from 1975 onwards. With typically around 500 respondents, the survey is probably the best of its kind for the manufacturing sector but covers only that sector, which accounts for only 8% of workforce jobs down from 25% in the late 1970s. The CBI covers other sectors of the economy in:

- The monthly *Distributive Trades* survey, established in the 1980s to report the volume of sales for retailers among other things; sample sizes are typically less than 150.
- The quarterly *Financial Services* survey, launched in 1989 to assess the health, perceptions and plans of the financial services industry; sample sizes are typically less than 100.
- The quarterly *Service Sector* survey; launched in 1998 to cover a broad range of activities from accountancy to leisure and software design to telecoms and passenger transport; sample sizes are typically less than 200.
- Notably, the CBI does not pull together these surveys into a composite whole economy index.

CIPS/MARKIT SURVEYS

The Chartered Institute of Purchasing and Supply (CIPS) has run its manufacturing Purchasing Managers' Index since January 1992, while the service sector series has been running since July 1996 and the construction sector since April 1997. The Purchasing Managers' Indices offer timely indicators of changes in economic activity and business confidence. The CIPS/Markit Purchasing Managers' Index (PMI) indices are derived from continuous monthly surveys of business conditions and track what is actually happening at individual company level. Three monthly surveys are administered:

- The UK Services PMI survey collects monthly data on a sample of a representative panel of around 700 companies based in the UK services sector; the panel replicates the structure of the services economy.
- The original data from the Manufacturing PMI survey which is collected from a representative panel of over 600 companies based in the UK manufacturing sector. The panel is stratified geographically and by Standard Industrial Classification (SIC) group, based on the contribution – by region and industry – to the UK manufacturing output.
- The UK Construction PMI survey is compiled from monthly replies to questionnaires sent to purchasing executives in over 170 construction companies. The panel reflects the structure of the UK construction economy.

BRITISH CHAMBER OF COMMERCE

The British Chambers of Commerce Quarterly Economic Survey (BCC QES) is a large independent economic survey that has been conducted every quarter since 1989. Each quarter, over 5,000 businesses – part of the Chambers of Commerce in every region of the country – participate in the QES. Businesses are questioned on a wide range of issues, including: home sales and orders, export sales and orders, employment prospects, investment, recruitment difficulties, cash flow, confidence and price pressures. The survey covers the BCC's 100,000 businesses across the UK, employing five million people. The QES is the first economic indicator of the quarter, published in advance of official figures and other private surveys, and consistently mirrors trends in the national economy.

BANK OF ENGLAND AGENTS

The Bank of England's *Agents' Summary of Business Conditions* report is based on discussions with around 700 businesses, conducted by the Bank's network of regional Agents. The Bank's 12 Agents make quantitative assessments of economic conditions as seen from their respective countries and regions. These scores provide numerical measures of the intelligence that the Agents gather from month to month, and cover some areas of the economy where there are no official statistics. The scores are also timely and some have a high correlation with subsequently published ONS data.

Table 5.1 Business surveys compared

Organisation	Survey	Sectors covered	Started	Approximate sample of businesses surveyed	Frequency	Release timing	Strengths	Weaknesses
CBI	Industrial Trends	Manufacturing	1958	500	Monthly	Same month as data	Offers detailed surveys for respective sectors, timely and long run data sets.	No composite whole economy indicator; surveys undertaken at different times; interviewee characteristics may vary.
CBI	Distributive Trades	Retail	1983	100–150	Monthly	Same month as data		
CBI	Service Sector Survey	Services (ex financial)	1998	200	Quarterly	End of mid month of quarter		
CBI	Financial Sector Survey	Financial services	1989	100	Quarterly	2 weeks after quarter		
CIPS/MARKIT	Construction PMI	Construction	1997	200	Monthly	First week after month	Timely, collectively large sample, seasonally adjusted, long time series.	Purchasing managers may lack overview of whole business performance; they are particularly important when an inventory cycle is taking place but probably less so when the fluctuations are in final demand.
CIPS/MARKIT	Manufacturing PMI	Manufacturing	1992	600	Monthly	First week after month		
CIPS/MARKIT	Services PMI	Services	1996	700	Monthly	First week after month		
BCC	Quarterly Economic Survey	Manufacturing & Services	1989	5,000	Quarterly	2 weeks after quarter	Timely, very large sample.	Failure to cover large businesses; skewed towards SMEs.
Bank of England	Regional Agents	Whole economy	1997	700	Monthly	Same month as data	Timely, good sector coverage, proven correlations with ONS data.	Smaller sample size.
ICAEW	Business Confidence Monitor	Whole economy	2004	1,000	Quarterly	Middle of reference quarter	Quality of survey respondents; senior finance professionals likely to have strong overview of business performance, breadth of questions asked.	Aggregate sample size of other surveys larger; other surveys are monthly and so more timely.

HOW DOES THE BCM COMPARE?

The BCM survey has approximately 1,000 respondents per quarter and the sample is weighted to correspond to the UK's sector mix. The BCM offers one of the broadest ranges of indicators of all UK business surveys, gauging a wide array of data that can feed through into economic and business analysis on the following areas:

- Business confidence
- Key financial performance: profit, turnover, domestic sales, exports, employment, capital investment, salaries, R&D budgets
- Business stock levels and spare capacity
- Emerging challenges to business performance

The breadth of the questions asked means that the BCM survey can be used in a wider array of situations than other surveys. BCM indicators can complement other lead and economic indicators to enable better judgement of the prevailing economic environment. This judgement is hard to make with official datasets – given the un-timeliness of their release; they only provide a 'rear-view' snapshot of the UK economy rather than a feel for the current economic environment.

DISCLAIMER

This report has been produced for ICAEW by the Centre for Economics and Business Research (Cebr), an independent economics and business research consultancy established in 1993 providing forecasts and advice to City institutions, government departments, local authorities and numerous blue chip companies throughout Europe. The main contributors to this report are economists Charles Davis and Scott Corfe.

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Because of us, people can do business with confidence.

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