ICAEW

BCM 10 YEARS

Shifting UK economic sands

Perspectives on the next decade

ICAEW/Grant Thornton UK Business Confidence Monitor

Gives a quarterly snapshot of the current state of the UK economy.

- Measures respondents' economic confidence about the next 12 months. This Confidence Index correlates closely with official economic growth measures.
- Is released at the start of each quarter, preceding official growth estimates by approximately three months. This makes it a more timely indicator for analysts trying to gauge economic performance at a particular point in time.
- Offers one of the broadest ranges of indicators of all UK business surveys, looking at financial performance, business stock levels and spare capacity, availability of skills, government regulation and the tax regime.
- Key performance indicators – business turnover, employment growth and employee wage growth – track official statistics very well, making them useful predictive tools and leading indicators for UK economic performance.
- Results have closely reflected changes in official measures of domestic demand and export demand, anticipating the official figures by several months.
- Is shared with a range of national and regional policymakers, the business community, academics and researchers.
- Findings are used to supplement official estimates of economic activity and other key economic variables.
- Provided clear signals of the start of the downturn in the real economy in 2008 and the recovery in 2009.
- Was referenced in the November 2010 Office for Budget Responsibility Economic and Fiscal Outlook publication.
- Has approximately 1,000 respondents per quarter and has had 40,000 responses over the last 10 years; ICAEW Chartered Accountants running and advising UK businesses of all sizes, across all industry sectors and in all regions

An insight into Britain's business future

Michael Izza
Chief Executive
ICAEW

Over the last decade, the *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM) has grown from strength to strength, and has consistently provided a unique perspective into how businesses view the environment in which they operate and the direction of the UK economy. As chief executives and chief finance officers of UK-based global businesses, ICAEW members are making daily decisions on investment, jobs, tax and corporate governance. This is why they can provide key insights into economic and business trends.

Despite growth, concerns remain

On the economy, ICAEW Chartered Accountants are saying that the worst of the recession is over, but they are still concerned about the shape of the recovery.

Since the first BCM in 2003, the UK economy has seen momentous change including the financial crisis, the recession, and more recently the return to growth. Five years after the deepest crisis since the 1930s, the UK economy is predicted to reach close to pre-crisis levels as one of the fastest growing western economies. In 2014 ICAEW has forecast 2.9% growth.

Despite the poor shape of the economy at the beginning of 2013, BCM gave an early indication of a pick-up in confidence and gradual upturn, a forecast which proved to be accurate over the course of 2013.

Looking over the horizon

However, we should not be complacent. Although recent growth is welcome, it is in its infancy and must not be taken for granted. As I travel around the country, I hear concerns about an uncertain recovery supported as much by credit-led consumer spending as by business investment and exports. BCM Q4 2013 shows that if these structural issues remain unresolved they will jeopardise the nascent recovery.

As a nation, we have a choice. We can stay on the existing path of low unsustainable growth with the underlying structural problems unresolved or chart a new direction towards prolonged prosperity. Concerns over low business investment and the widening trade gap will only be alleviated by building a more competitive economy with broad-based growth.

Towards a broader recovery

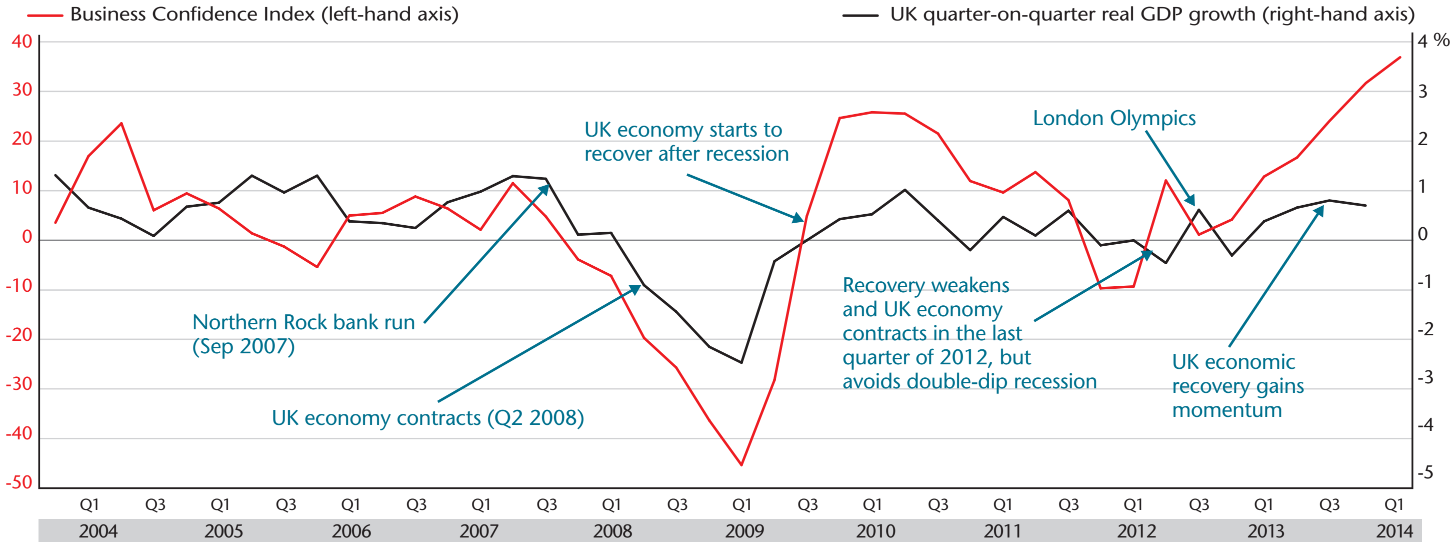
In 2014 ICAEW will be putting forward proposals to reduce the regulatory burden, to support SMEs in exporting and to create a fairer, competitive tax system, all of which can help drive business growth. There is still more work to be done to reduce the government deficit and debt with greater financial skills needed in Whitehall. And with chartered accountants as one of the largest graduate recruiters, it is crucial we get our young people equipped with the financial skills they need to compete in a global economy.

By getting the business environment right, government can secure rewards for all. BCM has been important to policymakers in its first 10 years of existence and will continue to provide an insight into the views of the nation's business leaders in the future.

Michael Izza

An extraordinary first 10 years of the Business Confidence Monitor

FIG. 1 Key events that shaped the UK's economy over the last 10 years



Source: ICAEW/Grant Thornton UK BCM, Office for National Statistics (ONS), Cebr analysis

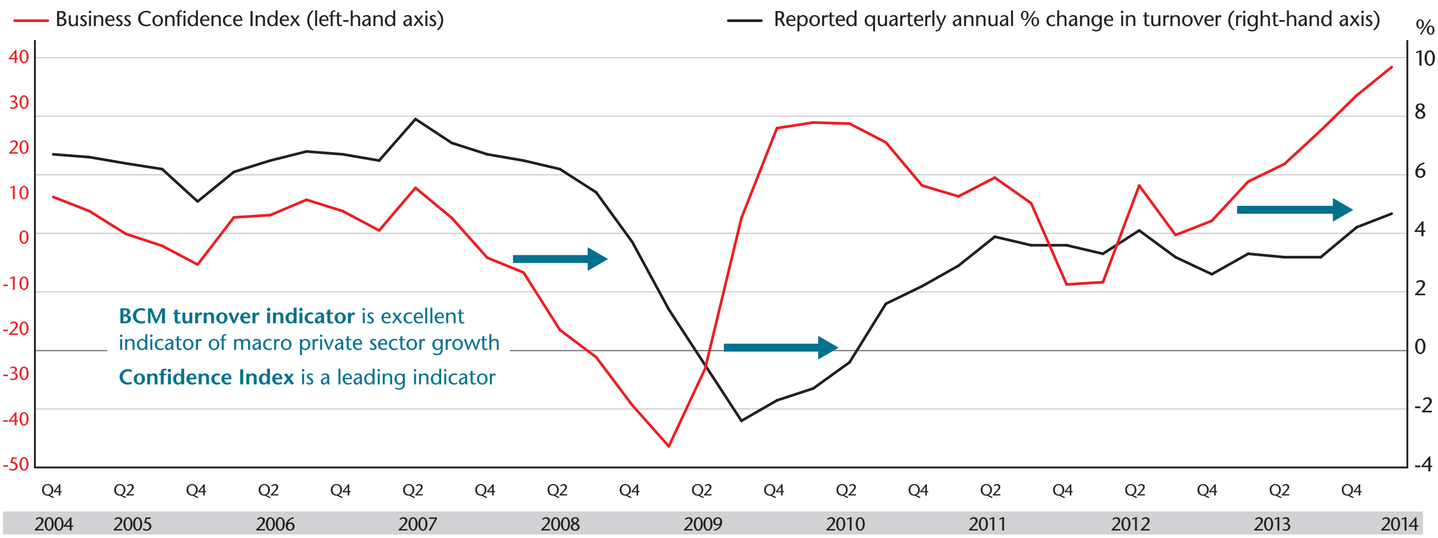
BCM has witnessed an extraordinary decade. After a relatively serene period for the global and UK economy in the mid-2000s, the nascent global financial crisis dramatically captured the world's attention as the Northern Rock bank run burst onto our screens in September 2007.

The collapse in business confidence shown on the Confidence Index in late 2007 captured the increasing concern among ICAEW members in business in the aftermath of the Northern Rock collapse. As confidence sapped away, an ever more concerning weakening in the pertinent financial performance indicators in the survey pointed to greater signs of distress in the real economy. As the financial crisis further snowballed, key benchmarks in BCM dropped like a stone.

By autumn 2008 the global financial system came close to complete collapse and the deepest global recession since the Second World War was in train. In the UK, the most severe economic slump since the Great Depression of the 1930s had started in the first half of the year, foretold by the precipitous slide in the Confidence index. The low point in business confidence coincided with the steepest rise in job seekers since records began in the early 1970s. However, as central banks and governments intervened to stop the rot, confidence gradually started to return.

After a tumultuous decade is there finally light at the end of the tunnel?

FIG. 2 Reported quarterly annual % change in turnover and BCM Confidence Index



Source: ICAEW/Grant Thornton UK BCM, Cebr analysis

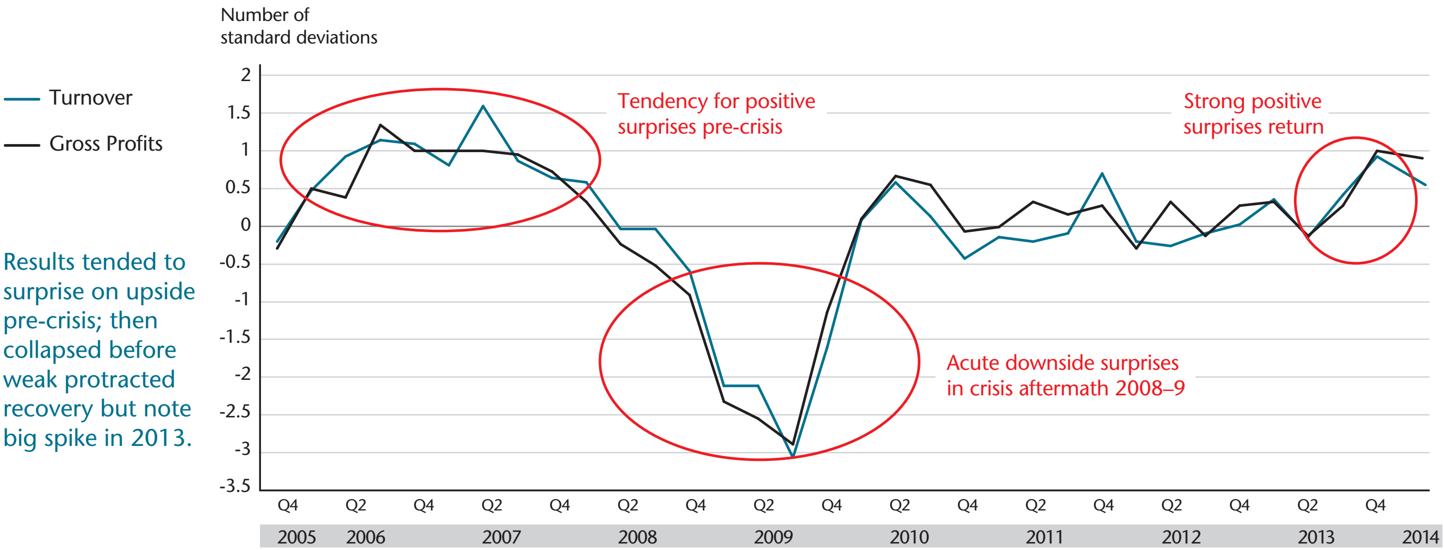
As the Confidence Index picked up, the short-term outlook appeared to be improving even if the economy was still contracting. By the third quarter of 2009 ICAEW became the first major business organisation to correctly predict that the UK economy would exit recession as the Confidence Index picked up appreciably. It took around a year for Office for National Statistics (ONS) revised estimates of economic activity to correctly re-estimate that recession had ended in Q3 2009. By the time this was confirmed, the global economy was lurching back into another crisis.

In Europe, the small, peripheral economies of the eurozone had faced a deep economic downturn and their highly leveraged financial sectors were unable to cope. Greece, Ireland, Portugal and Spain faced soaring borrowing costs as bond markets became fearful of these countries' ability to service their debt repayments. The shock waves emanating from this situation again sapped business confidence in the UK. This coincided with a spike in commodity prices on the back of resurgent emerging market expansion, as well as the painful medicine that the UK started to take to deal with its huge public borrowing requirements and mounting debt after the Coalition Government's Emergency Budget of June 2010.

As confidence drained away again, there was soon talk of a double-dip recession. According to the latest ONS data, although there was not a second technical recession, there was certainly a double dip in the rate of growth. Indeed, the economy slowed to a crawl through 2011–12 and business sentiment remained fitful with key financial performance indicators pointing to feeble growth that was structurally weaker than before the crisis. After a further contraction at the end of 2012 – foretold by a drop-off in business confidence – pundits were seriously assessing the possibility of a triple-dip recession. However, from early 2013 there has been a sustained improvement in the UK economic environment – reflected in five consecutive rises in business confidence; the first time this has happened in the 10 years of BCM.

Businesses forced to adjust expectations in an uncertain world

FIG. 3 Growth surprises – standardised difference between expected and achieved turnover and gross profit growth



Results tended to surprise on upside pre-crisis; then collapsed before weak protracted recovery but note big spike in 2013.

Source: ICAEW/Grant Thornton UK BCM, Cebr analysis

A decade of BCM spans a remarkable period of economic history during which the whole tone of economic discussion has changed completely. Before the financial crisis and recession, there was a period of remarkable stability in which economic growth was consistently strong, unemployment low by historical standards and inflation relatively contained. This led to relatively predictable environments for business decision-making and contained uncertainty over outcomes.

Before the start of the UK recession in 2008, the variation seen in key business indicators like profit growth and turnover was relatively small. Consequently, key business decisions like capital investment and changes in staffing levels similarly were relatively predictable. The financial crisis completely transformed the environment with the collapse in business confidence, profound uncertainty widespread and greater volatility in outcomes for businesses.

As events unfolded at a relentless pace, business expectations for growth were destroyed and businesses were forced to tear up their plans and find ways to adapt. That experience and the continuing aftershocks from the eurozone crisis have forced businesses to become used to a structurally lower trend rate of growth and realign their expectations for future growth. However, from early 2013 a sustained improvement in performance has finally led to a period of 'positive surprises' as businesses outperformed their plans and returned to more robust growth. The rapidly improving environment allowed Chancellor George Osborne to make the largest upward revision to an official growth forecast in 14 years.

Growth expectations pick up – but an export-led recovery has not materialised

FIG. 4 Expected growth in turnover and exports over the next 12 months

Source: ICAEW/Grant Thornton UK BCM, Cebr analysis; graph shows the 4 quarter moving average for each series

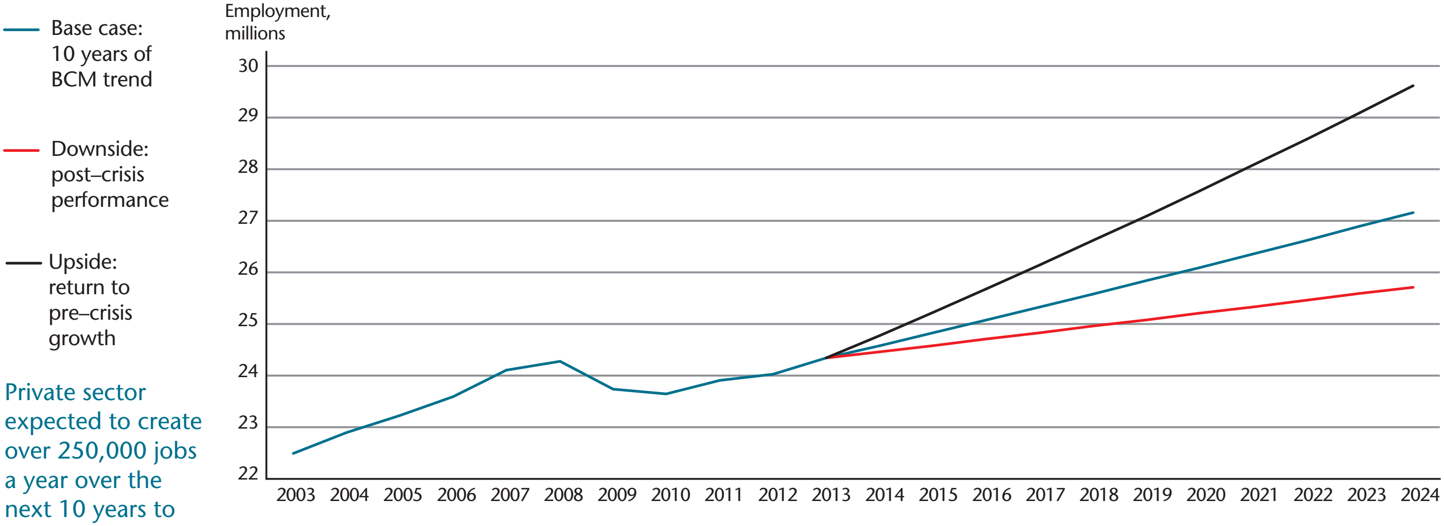
As the economy finally delivered stronger performance, businesses could think about upgrading their growth outlook. The growth expectations of businesses through the history of BCM divide into three clear periods: pre-crisis stability; collapse and uncertainty; and protracted weak recovery. As we move into the next 10 years, the question is: what level of business growth can we expect to see over the next period?

Recently we have seen an accelerating recovery. By the end of 2013 business confidence had posted a record five consecutive increases and business expectations for important indicators like turnover, profit, investment and employment growth were all heading upwards. Turnover and profit growth are still some way from their robust trend before the financial crisis but these key measures of macro business performance seem to be making a clean break from the feeble trend of recent years.

However, concerns remain over the shape and make-up of the economic recovery. With overall growth having been consistently faster than export growth before the crisis, a stronger trade performance is believed to be a key plank of a sustainable, balanced recovery. Despite a year of upward revisions to forecasts and increasingly strong performance for UK plc, export growth performance and expectations remain relatively modest. This may partly be due to the weak growth trend in the eurozone – a key UK trading partner – and points towards the need for UK exporters to reach out to fast-growing markets across the globe from the BRICs (Brazil, Russia, India, China) to the MINT (Mexico, Indonesia, Nigeria, Turkey) countries and beyond.

What can the last 10 years tell us about the next decade?

FIG. 5 Scenarios for total UK private sector employment over the next 10 years



Source: ICAEW/Grant Thornton UK BCM, Office for National Statistics (ONS), Cebr analysis

Private sector expected to create over 250,000 jobs a year over the next 10 years to take total private sector employment to above 27m.

Looking forward, can BCM provide clues for the future? The 40,000 business responses received over the last 10 years give us a vast evidence base on which to make some future suggestions. Three scenarios have been derived:

1 the base case scenario assumes that the long-run trend seen in reported outcomes over the business indicators prevails over the next 10 years;

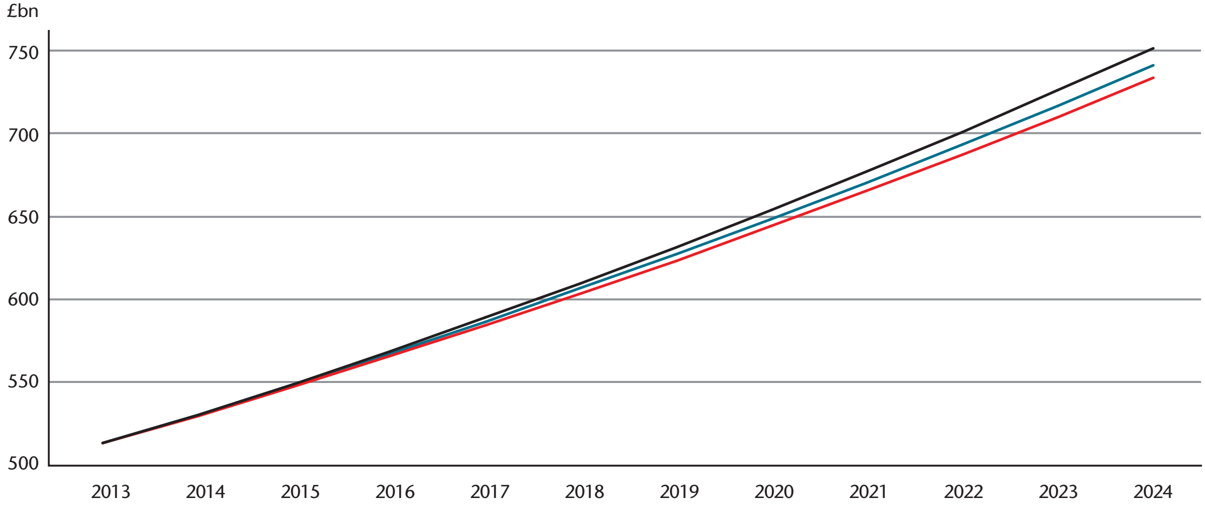
2 the downside scenario assumes that the post-crisis trend performance continues over the medium term; and

3 the upside scenario envisages what impact a return to pre-crisis growth performance would have on the key business indicators.

A return to a trend of stronger growth would of course lead to stronger job creation, but would need to rely on sustained productivity growth. The central scenario would see private sector employment rise from around 24.5m to 27.1m; a rate of 257,000 additional jobs per year. Against a background of further public sector job cuts likely after the next General Election, whoever wins, a significant number of these new private sector jobs would be needed to compensate for the job losses created by reduced state employment.

The right kind of recovery?

FIG. 6 Scenarios for total annual UK exports over the next 10 years



UK unlikely to achieve £1 trillion export growth target without clean break in export performance.

Source: ICAEW/Grant Thornton UK BCM, Office for National Statistics (ONS), Cebr analysis

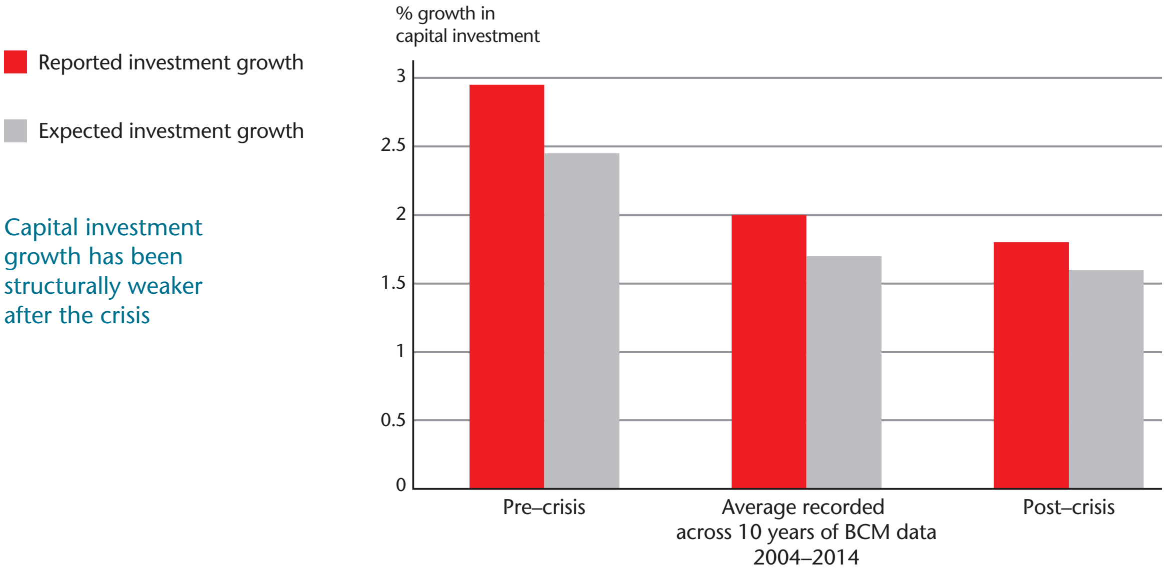
Reflecting on the different scenarios raises the question: would we want to see a return to pre-crisis growth anyway? At first glance you might assume that high growth, low consumer price inflation, low unemployment and real income growth are desirable. However, the challenge is to ensure we have the right balance of sustainable growth to avoid large imbalances and disproportionate concentrations of risk.

As the UK enters 2014 with a large current account deficit of around £55bn there are lingering concerns over the shape of the recovery and the type of growth that we are seeing in the UK. As the housing market accelerates and house prices in London record double-digit growth, critics suggest that the UK still needs to do more to break out of the pre-crisis mould. In some ways this is supported by BCM data showing little deviation in export growth prospects perceived by ICAEW members.

Under the optimistic scenario of the strongest trend growth recorded, total UK exports would rise by £221bn over the next 10 years. At £752bn this would still only be 75% of Chancellor Osborne's target for exports to reach £1 trillion by 2020. For a sustainable, balanced recovery the UK's disappointing export performance to date needs to be considerably improved.

A sustained recovery needs investment and the right conditions for businesses to flourish

FIG. 7 Median expected and reported annual percentage growth in capital investment, post-crisis, pre-crisis and across the whole 10 years of BCM



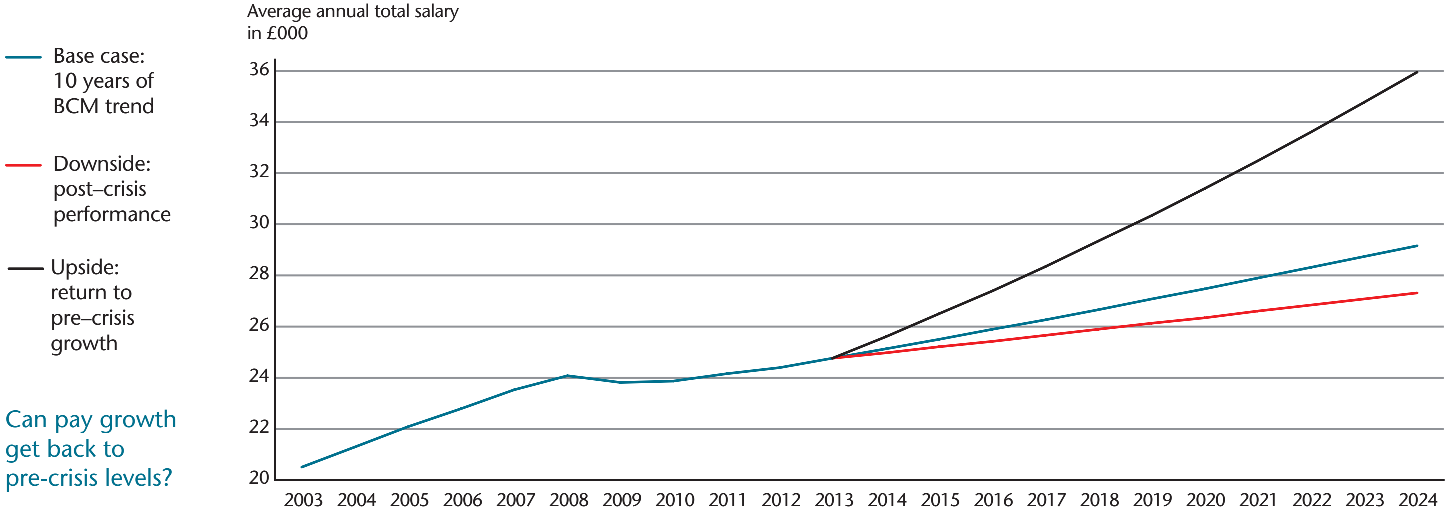
Capital investment growth has been structurally weaker after the crisis

Source: ICAEW/Grant Thornton UK BCM, Cebr analysis

Moreover, a reversal to the continued weakness in business investment will be required to make the recovery self-sustaining and to support the economy as the government cuts back the public sector in order to reduce annual state expenditures and the public borrowing requirement. On the base-case scenario, business investment rises by £29bn over the next 10 years – but this does not make up for years of weak growth and raises long-run concerns over the UK's productive capacity.

Can the UK economy get back to delivering rising living standards?

FIG. 8 Scenarios for UK average annual total salary over the next 10 years



Source: ICAEW/Grant Thornton UK BCM, Office for National Statistics (ONS), Cebr analysis

A major feature of recent economic history has been the extended squeeze on real household incomes as pay growth lagged behind inflation in the prices of consumer goods and services. As the labour market creates more jobs and the recovery strengthens will businesses be in a position to break from the post-crisis trend weakness in pay growth?

On the long-run trend over the course of BCM, average total cash pay rises by £4,034 over the next 10 years but a return to pre-crisis trends would see pay grow by £10,340 over the same period – the stakes are huge. However, any increase in real pay requires a return to stronger productivity growth supported by business investment as well as continued innovation, skills, infrastructure and the flourishing of enterprise. Only then will the UK economy be able to deliver a healthy return to real household income growth and rising living standards.

About the Centre for Economics and Business Research

Cebr – the Centre for Economics and Business Research – is a leading economics consultancy, founded in 1993 by Douglas McWilliams. Cebr has wide ranging experience and expertise on subjects from micro-economic impact studies to macro-economic forecasting across the UK, the eurozone and the world economies.

Over the last year we've looked at economic contribution in the UK made by Arts and Culture, assessed the economic impact of EU migrant workers and considered how the Government's apprenticeship programme will affect the economy over the next 10 years.

Regular Cebr analyses include: the *Asda Income Tracker*, a monthly analysis of average family discretionary spending power, the *ICAEW/Grant Thornton Business Confidence Monitor*, the Federation of Small Businesses *Small Business Index indicator* and the annual World Economic League Table which ranks the largest economies across the globe and achieves coverage around the world.

For more information and the latest reports from Cebr, please visit www.cebr.com

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ICAEW is a world leading professional membership organisation that promotes, develops and supports over 142,000 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.

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