



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

Q4 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 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 style with a large, stylized 'I' and 'Z'.

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

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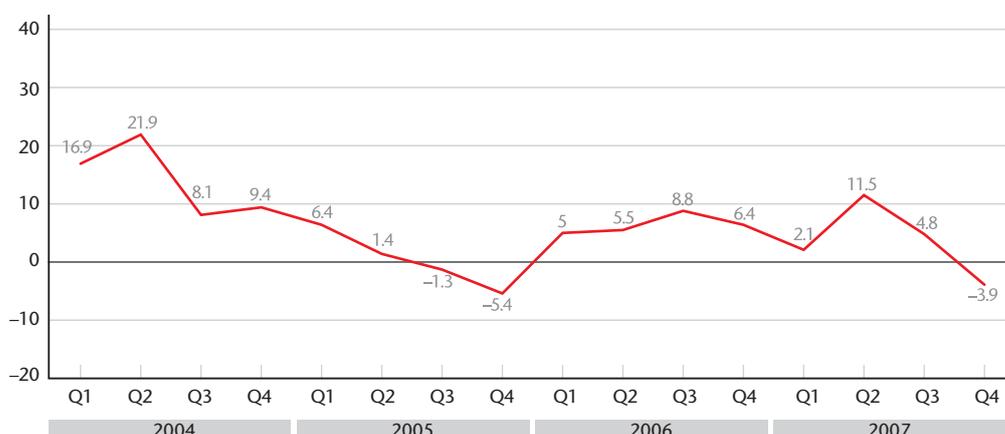
FOREWORD

BY ICAEW CHIEF ECONOMIST, MAUREEN RAYMOND



Maureen Raymond

Fig. 1 Trend of UK business confidence



Source: ICAEW UK Business Confidence Monitor

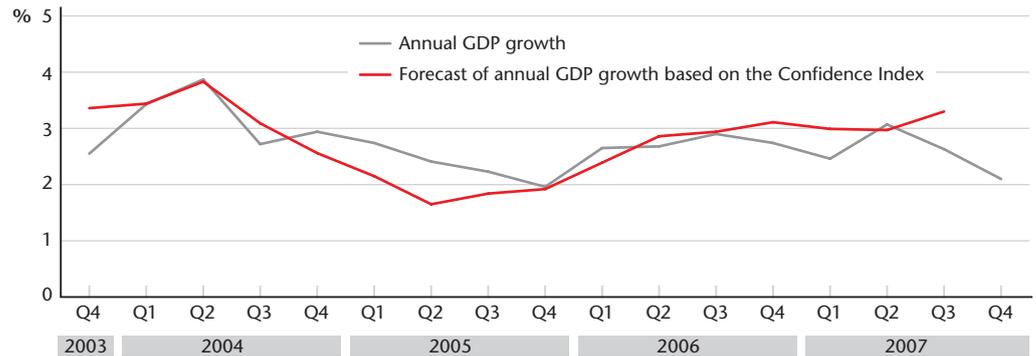
In our report of Q3 2007, written at the end of July, we highlighted the risk that financial contagion via the US sub-prime mortgage market would transmit through global financial markets and could exacerbate the chance of a slowdown in the UK. We also warned that it could spread into leveraged buy out and M&A activity leaving London as a financial centre vulnerable. Unfortunately these words of caution have materialised. Financial contagion has spread from the US to Europe and elsewhere causing financial shock to global credit markets. M&A and private equity deals are also off sharply.

CONFIDENCE INDEX FALLS TO LOWEST LEVEL IN TWO YEARS

The most important contributor to negative confidence this quarter has been financial disturbance and the credit crunch. Since August, the asset-backed securities market seized. Moreover, inter-bank rates have decoupled from official central base rates, increasing the cost of capital for the banks and other financial intermediaries. These costs will continue to be passed on to businesses. This was reiterated in the Bank of England's (BoE) first Credit Conditions Survey released in September.

The current divergence between the ICAEW Business Confidence Index and economic growth is likely reflecting a turning point for the economy (see Figure 2). Although it is too early to judge the full impact of financial turbulence and tighter credit conditions on the real economy, negative business confidence in most sectors and broadly across regions indicates a slowdown in the UK is on the horizon.

Fig. 2 Forecast of annual GDP growth based on ICAEW Confidence Index



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

It is our members' financial proficiency that makes the ICAEW Business Confidence Index a leading economic indicator with a proven track record of closely predicting GDP growth. This is particularly important because the BoE is focusing on business confidence and the housing market to monitor the UK economy, according to Kate Barker, Monetary Policy Committee (MPC) Member who spoke recently at an ICAEW event.

CITY AND PROPERTY MARKET LEAD DECLINE

With confidence declining in the majority of sectors, finance professionals are clearly factoring in the combination of financial uncertainty, tighter credit conditions and the scale of potential fall out. Property and finance sectors, accounting jointly for about 20% of economic output, have plummeted to their lowest levels since the survey began, a key point to note given the UK is more dependent on the housing market and the finance sector than most other large economies.

Higher interest rates have caused confidence within the property sector to drop from -10 in Q3 to -26 in Q4. A weakening housing market will feed through to consumer spending via the wealth effect. Property accounts for 43% of UK households' total net wealth compared to 28% a decade ago.

In addition, as banks lose billions of pounds City bonuses will be lower next year causing further downward pressure on property especially in the buy-to-let market. Confidence in the finance sector collapsed to -13.9 in the Q4 from +13.7 in the Q2 of this year.

The decline in confidence was broad based across sectors with only IT and business services remaining optimistic. In the business services sector optimism increased as firms continue to benefit from exporting services such as legal and accountancy. In addition, business services companies depend on the finance sector at the latter stage of transaction processes, suggesting confidence in the sector will take a hit in 2008.

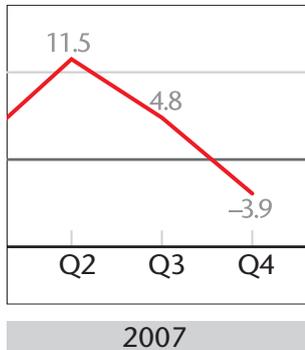
The credit crunch has caused finance professionals to reduce capital investment growth further next year. Firms also expect to see a slowdown in turnover and profits growth in 2008. However, the decline could prove to be deeper than expected as oil prices hit a record \$97 per barrel eroding profits further, and the negative fallout from tight credit continues to impact economic activity.

So, while the Confidence Index suggests an economic slowdown, the BoE relied on the latest official data and kept interest rates high. Despite inflation retreating below the 2.0% target for the moment, record high oil prices will put upward pressure on inflation. The BoE may have lost its golden opportunity to make a pre-emptive cut to prevent a sharper economic slowdown. A recession in the US and slowdown in the Eurozone will only exacerbate this.

Maureen Raymond
Chief Economist, ICAEW

**CONFIDENCE IN
PROPERTY SECTOR
AT LOWEST SINCE
SURVEY BEGAN**

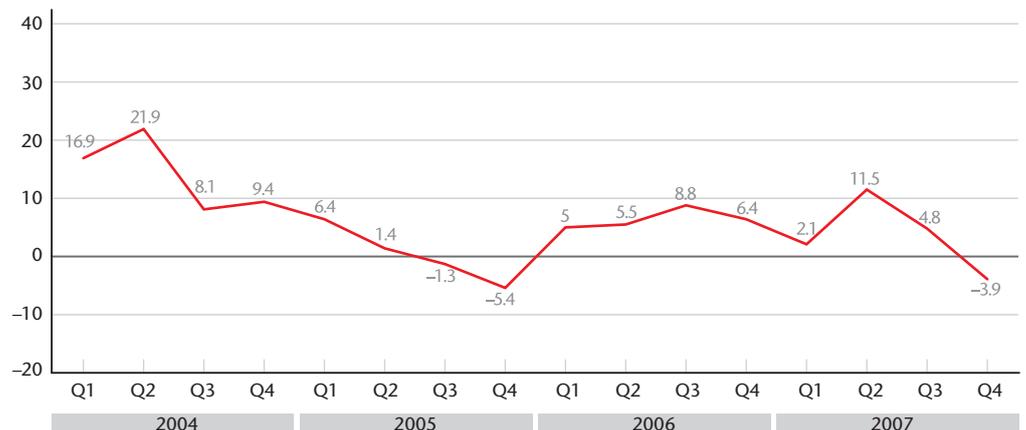
1 BUSINESS CONFIDENCE IN QUARTER 4 2007



Detail showing Q2–Q4 2007

The Q4 2007 ICAEW UK Business Confidence Index declined for a second consecutive quarter to a two-year low. The Confidence Index slipped to -3.9 from $+4.8$ last quarter and $+11.5$ in Q2 2007. Finance professionals have become increasingly concerned about the impact on their business of the five interest rate hikes since August 2006, a slowing housing market and turmoil in the financial markets. Only in one previous wave did the index register a lower score than this quarter.

Fig. 1.1 Trend of UK business confidence



BUSINESS CONFIDENCE MONITOR SUGGESTS DECLINE IN ECONOMIC GROWTH

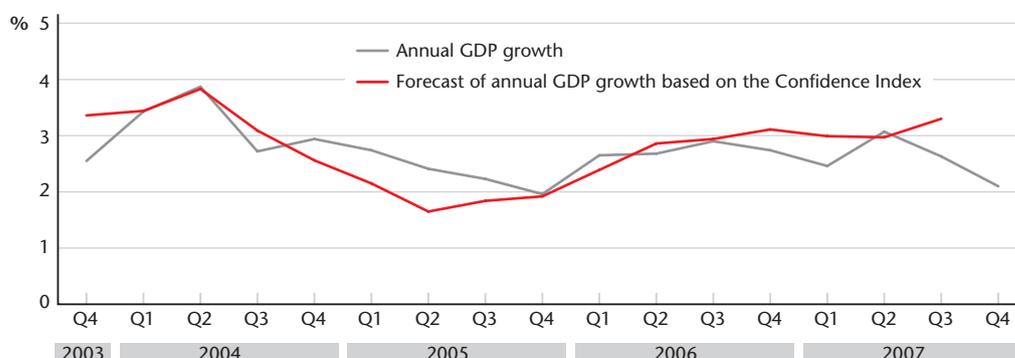
In contrast to the Confidence Index, economic growth according to official statistics continued to rise resulting in the largest gap between the Index and official growth in the economy for over two years. The economy expanded by 0.8% in the third quarter, a fourth consecutive quarterly rise, taking year-on-year growth up to 3.3%.

The current disjoint between the Confidence Index and economic growth is likely to reflect an economic slowdown edging closer although with a longer lag than we might have expected three months ago. The current negative Confidence Index is consistent with year-on-year growth of 2.1%.

A large number of economic factors have contributed to the negative mood this quarter. The most important contributor to negative confidence this quarter has been financial disturbance and the credit crunch. Since August the asset-backed securities market seized. Moreover, inter-bank rates have decoupled from official central base rates, increasing the cost of capital for the banks and other financial intermediaries. These costs will continue to be passed on to businesses. The credit crunch is likely to add to the impact of a slowing

**DISJOINT BETWEEN
CONFIDENCE INDEX
AND ECONOMIC
GROWTH SUGGESTS
ECONOMIC
SLOWDOWN**

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



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

housing market and a high base interest rate in slowing down economic growth. In addition, slower government spending growth, higher tax revenue growth, tight personal finances, record high oil prices and a constrained US economy are also likely to contribute to a weaker outlook next year.

However, the latest official economic and retail sales data suggest that the UK economy is taking a while to be affected given current levels of household and consumer debt, migration flows and the continued inflow of liquidity into the financial markets and the economy from countries such as Russia and China.

**BUSINESS SERVICES
SECTOR
CONFIDENCE MAY
DECLINE IN 2008
DUE TO LAG IN
RELATIONSHIP WITH
FINANCE SECTOR**

CITY AND HOUSING MARKET LEAD DECLINE

The brunt of the decline in the Confidence Index this quarter was led by the banking, finance & insurance and the property sectors. Confidence in both fell to the lowest level since this survey began. The index in the finance sector stands at -13.9, while the property sector hit 26.2, trouncing the previous record low of 16.2 in Q1 2007. These declines reflect the extent to which the finance sector remains concerned about the credit squeeze in the wholesale financial markets, and the extent to which estate agents are detecting a drop in house market activity.

Numerous other sectors also saw a decline in confidence in the quarter. Manufacturing & engineering hit a two-year low at -2.5 – its first negative score in seven quarters – while confidence in the construction sector declined from +9.6 in the third quarter to -0.8 in the fourth.

On the other hand, the IT sector remains the most optimistic as it continues to benefit from the global growth of computing and the internet. Confidence in the sector moderated by 3.2 points, but remained robust at +21.2. In the business services sector – one of the United Kingdom's most important – optimism actually increased this quarter to +7.4 from +4.8. This is a like to reflect the extent to which the sector continues to benefit from the export of services such as legal and accountancy to the emerging markets. However given the sector's lagged relationship with the financial sector, confidence in business services may take a hit in 2008.

LONDON INDEX
SCORE RISES AS
BUSINESS SERVICES
AND IT SECTORS
BUOY
CONFIDENCE

MICRO-SIZED
BUSINESSES, THE
MOST COMMON
BUSINESS SIZE IN
UK, ARE LEAST
CONFIDENT IN Q4

COMPANIES PLANNING TO HALVE INVESTMENT GROWTH

As a result of the credit crunch, finance professionals expect to further extend cutbacks in capital spending growth in the next year compared with those seen in recent months. Firms also expect to see a slowdown in turnover and profits growth in 2008. However, the degree of the decline could prove stronger than expected since input price inflation is also expected to retreat despite oil prices hitting a record \$94-a-barrel in October.

CONFIDENCE NEGATIVE IN MOST REGIONS

The average firm in most of the UK is pessimistic about its business outlook over the next year. Firms in the North West, West Midlands, South East and South West are the most pessimistic. Wales, the Northern region and the East Midlands also record a negative Confidence Index. Only Yorkshire & Humber and London remain optimistic about their prospects although confidence in the capital stands at only +2.9, up marginally from the +1.5 registered three months ago.

MICRO FIRMS THE MOST PESSIMISTIC ABOUT 2008

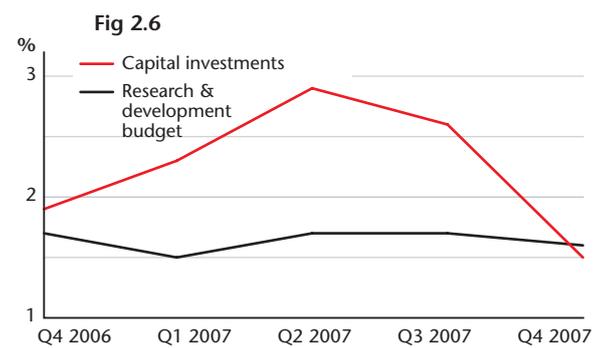
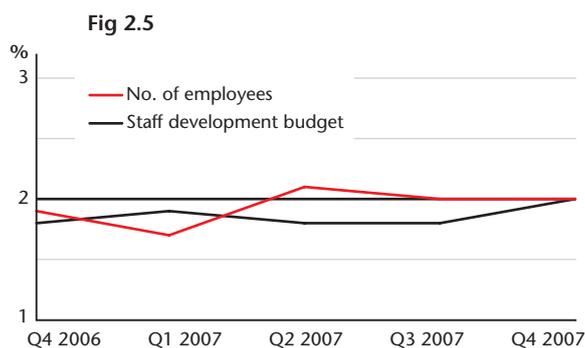
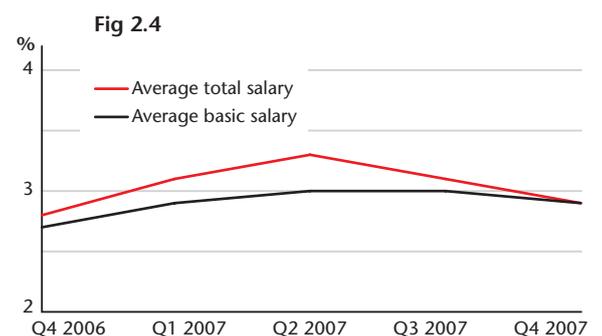
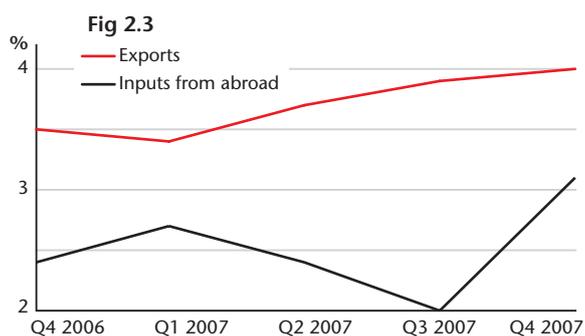
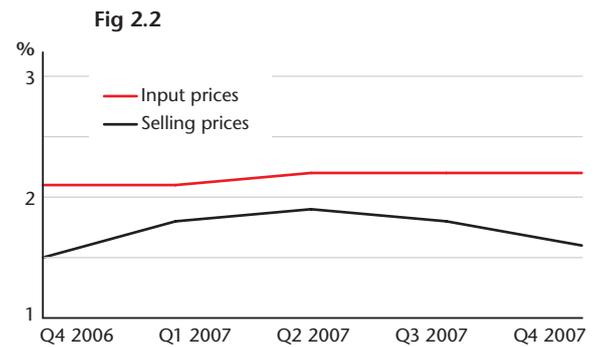
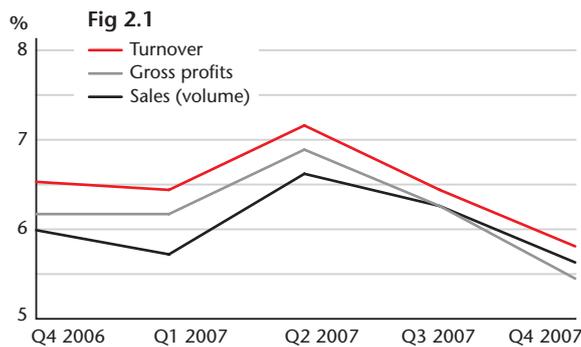
Considering different firm sizes, those employing less than 10 employees are, on average, the most pessimistic about their business prospects. Most businesses in the country are of this size.

The largest businesses (those with 250+ employees) register the next lowest score. The fact that the two least confident business sizes are those at either extreme suggests constraints to growth that are approaching are spread across the whole economy.

2 BUSINESS FINANCIAL PERFORMANCE

Finance professionals have become even less optimistic in their expectations for turnover growth. They expect turnover and profits to rise by 5.9% and 5.5% respectively in the next 12 months, after posting 6.7% and 6.0% growth in the past 12 months. Combined with the credit crunch, this change means capital spending budget growth is likely to slow significantly in the next 12 months after expanding 3.1% over the past 12 months.

EXPECTED CHANGE IN THE COMING 12 MONTHS IN ...



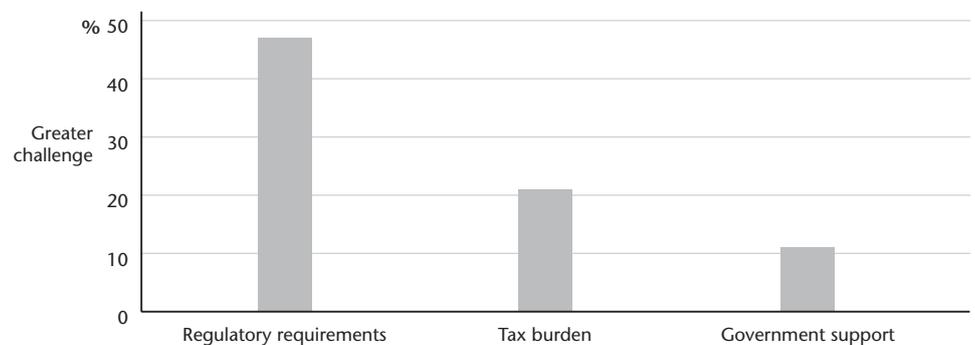
3 FACTORS AFFECTING BUSINESS PERFORMANCE

CHALLENGE POSED BY REGULATION INCREASES

Almost half (47%) of finance professionals claim regulatory requirements have become a greater challenge for their business over the last 12 months.

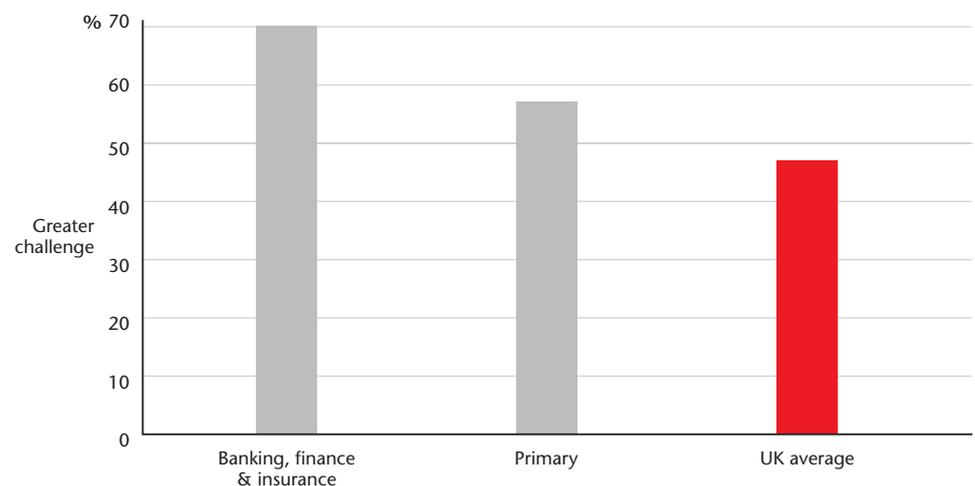
Government support for business and the tax burden are also posing a greater challenge when compared with a year ago for some businesses, though for a smaller proportion than is the case for regulation.

Fig. 3.1 Factors becoming greater challenge to business performance in past 12 months



The sectors with the highest share of finance and accountancy professionals claiming regulation to be more of a challenge in the last year are banking, finance & insurance (possibly reflecting the introduction of MiFID, the EU legislation attempting to create a single wholesale financial market in the bloc), hotels & catering and the primary sector. Meanwhile the energy, water & mining, property, IT and hotels & catering sectors have the largest share of finance professional claiming the tax burden has become more of a challenge in the past 12 months.

Fig 3.2 Regulation becoming greater challenge to business performance in past 12 months



4 CONFIDENCE BY INDUSTRY

The banking, finance & insurance and property sectors have led the general decline in confidence this quarter. The former reflects the ongoing turmoil in the financial markets, where banks remain uneasy about providing credit and woeful about the degree of exposure to the deepening US housing slump. Confidence in this sector fell to -13.9 this quarter – the lowest level recorded for banking, finance & insurance – from $+3.5$ in the last quarter, and $+13.7$ in Q2 2007.

**FINANCE SECTOR
DECLINES TO
LOWEST
CONFIDENCE
INDEX SCORE
TO DATE**

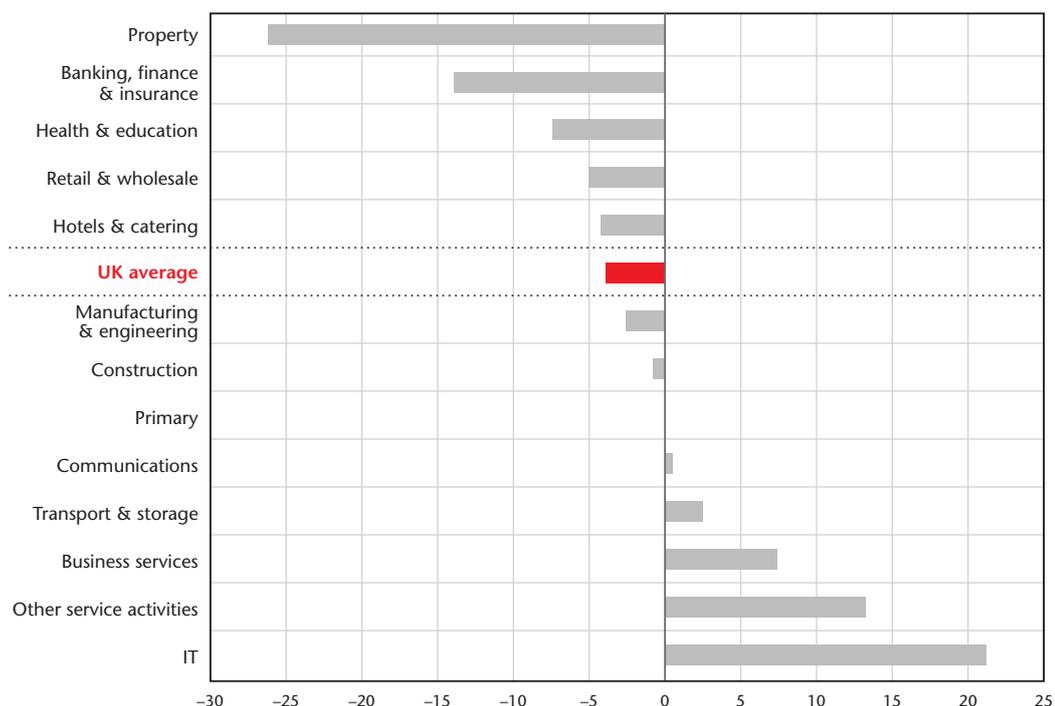
Similarly, the decline in housing activity being evidenced has driven confidence in the property sector to -26.2 , again its lowest level on record. This is supported by recent data showing that in September the number of new mortgage approvals declined to the lowest level in two years according to Bank of England analysis.

In addition, confidence in the retail & wholesale sector, that which best represents the consumer, declined by 11.2 points this quarter to -5.0 .

For a sixth consecutive quarter, the IT sector is the most confident in the UK. Although the index for the sector declined in this quarter by 3.2 points, it remains at the robust level of $+21.2$. This sustained level of confidence demonstrates a degree of detachment from the wider UK economy 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.

Confidence also rose in the business services and other service activities sectors this quarter. This very likely reflects exports of services such as law and accountancy, and the creative industries, which continue to benefit from rapid growth in existing and emerging markets.

Fig. 4.1 Business confidence by sector



Confidence has declined in most other parts of the economy including manufacturing & engineering, construction and health & education reflecting weaker production growth, the rising cost of commodities, the slowing housing market and plans by the government to cap public spending growth at 2% in most areas.

TREND OF BUSINESS CONFIDENCE BY SECTOR

Fig. 4.2

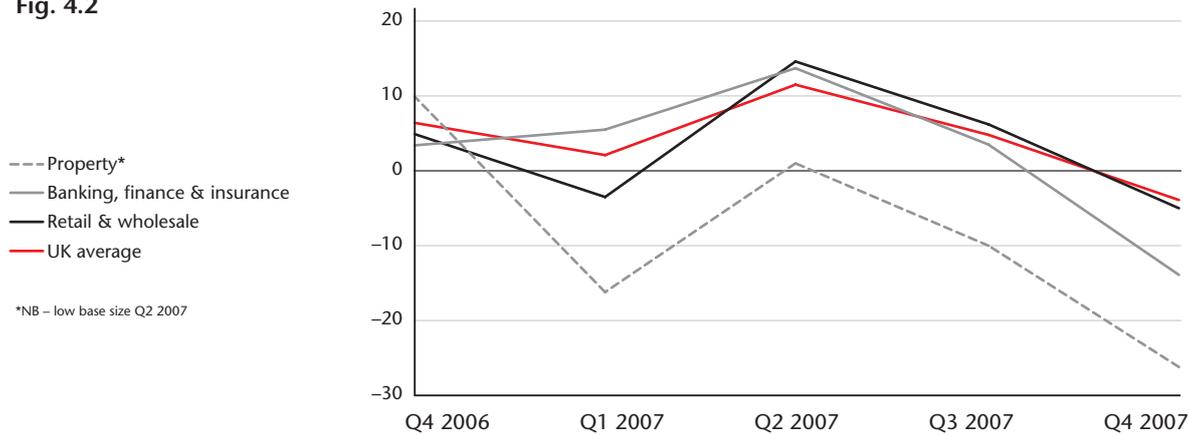


Fig. 4.3

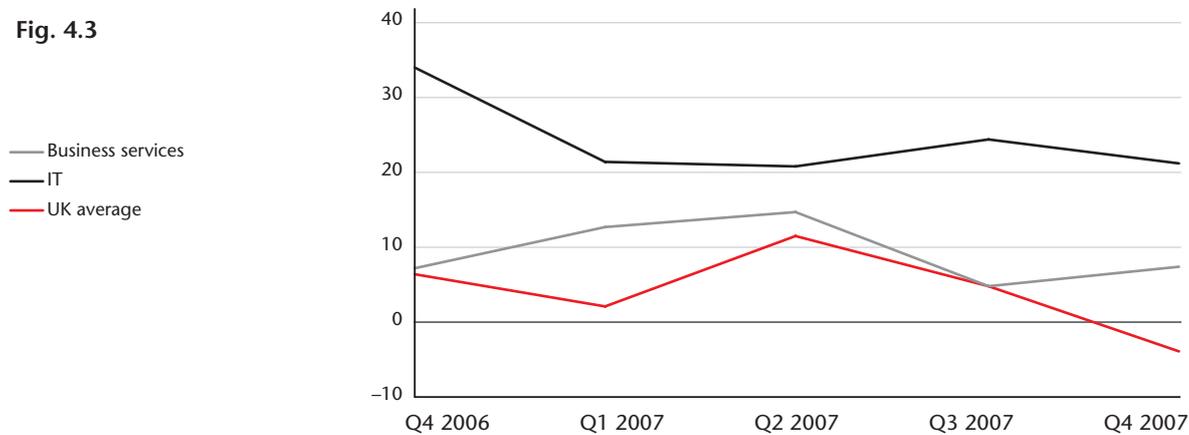
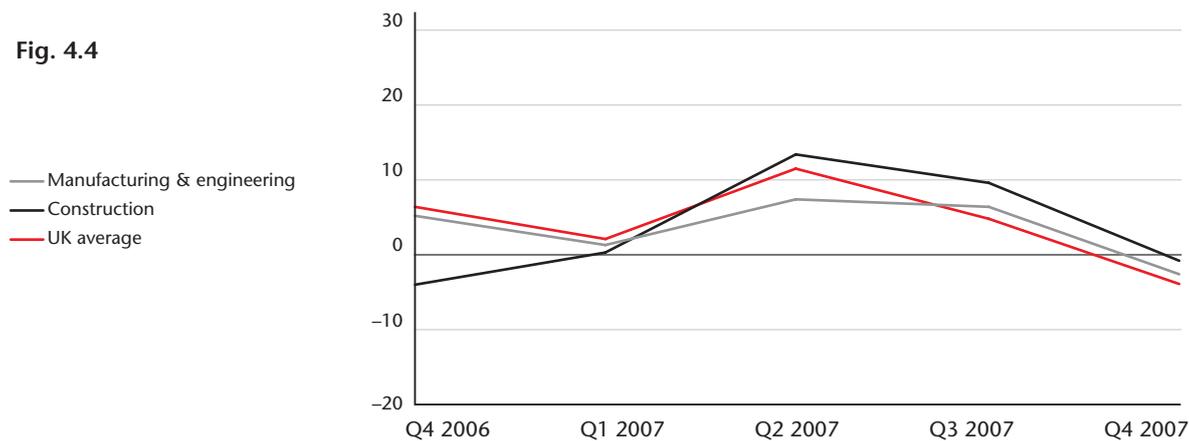


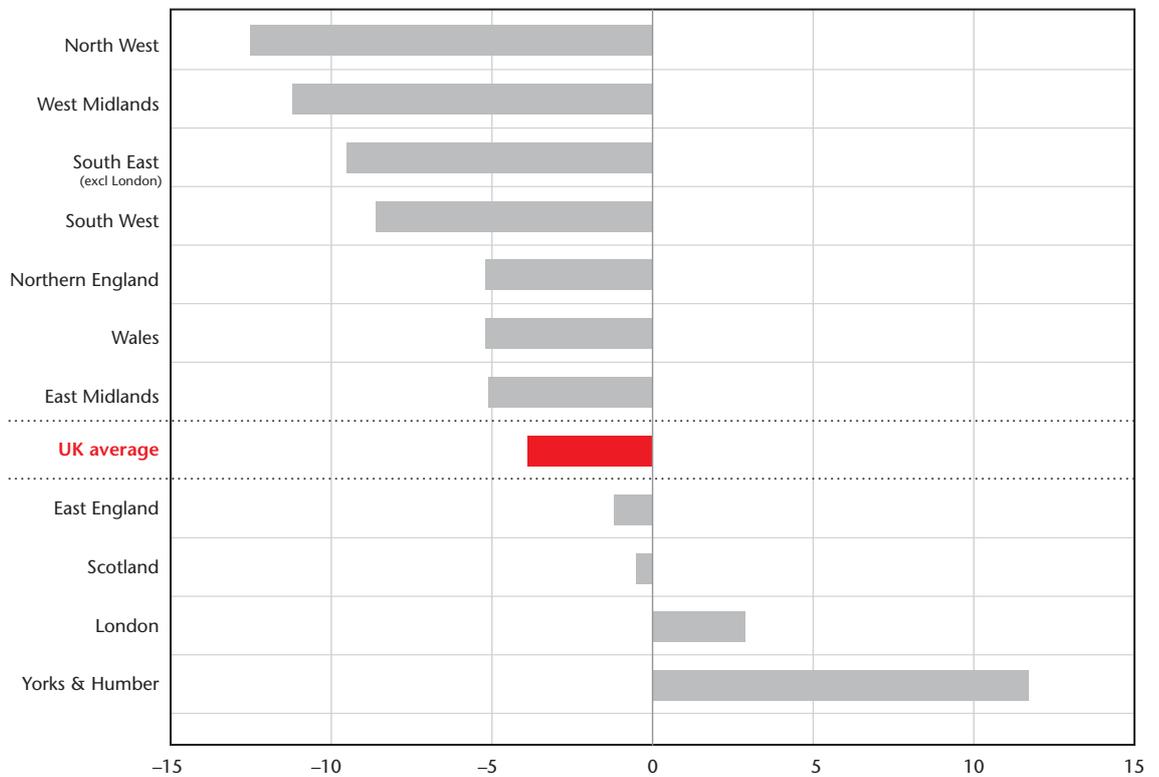
Fig. 4.4



5 CONFIDENCE ACROSS UK REGIONS

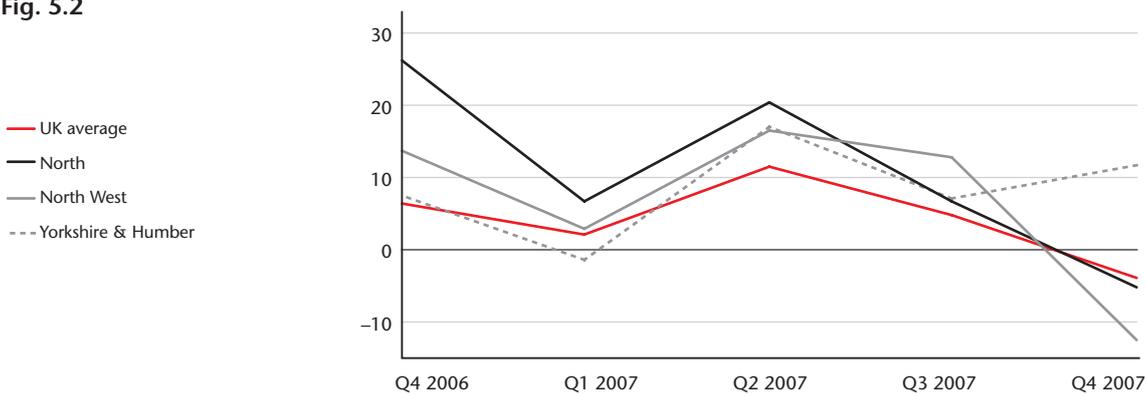
The average firm in most regions of the United Kingdom is pessimistic about its outlook through 2008. Only Yorkshire & Humber and London record positive confidence, with the score rising from +7.1 to +11.7 in the former and from +1.5 to +2.9 in the latter. It is likely that confidence of firms in Yorkshire & Humber is sustained by transport activity – the region is home to the UK’s largest port – and in London by the IT and business services sectors which play an important role in the capital’s economy.

Fig. 5.1
Regional confidence
Q4 2007



TREND OF REGIONAL CONFIDENCE

Fig. 5.2



Finance professionals in the North West and the West Midlands are more concerned about the outlook for their business than their colleagues in any other region, registering scores of -12.5 and -11.2 respectively in the fourth quarter of this year.

This may be rooted in concerns regarding the housing market and finance sector being exacerbated by a decline in confidence in the manufacturing & engineering sector in these regions.

Confidence in most other regions ranges between zero and -6, indicating that the average firm is marginally pessimistic about business prospects over the next 12 months.

TREND OF REGIONAL CONFIDENCE

Fig. 5.3

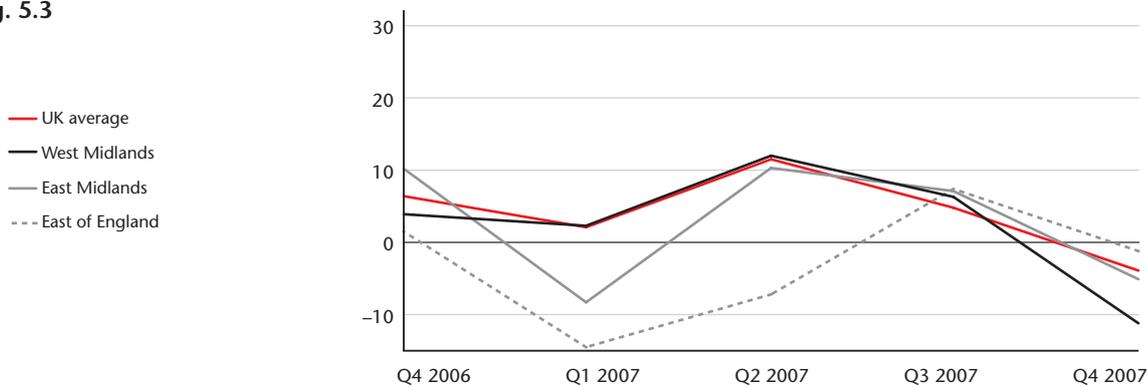
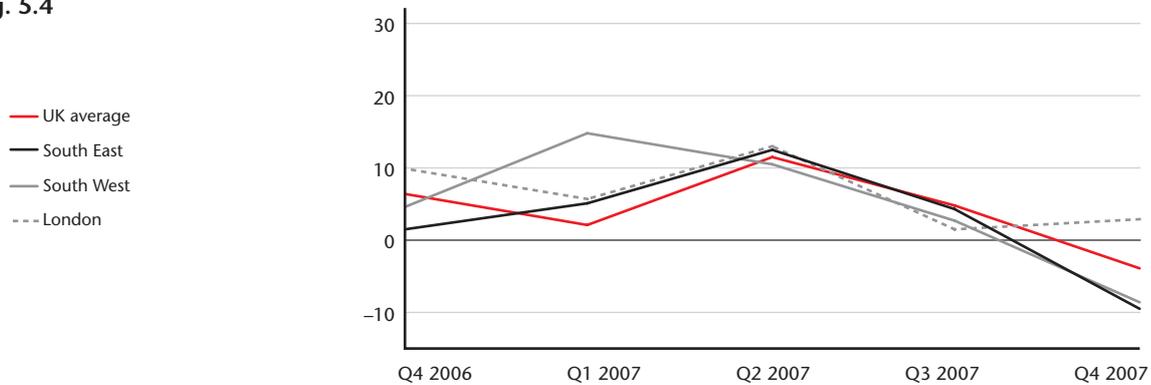
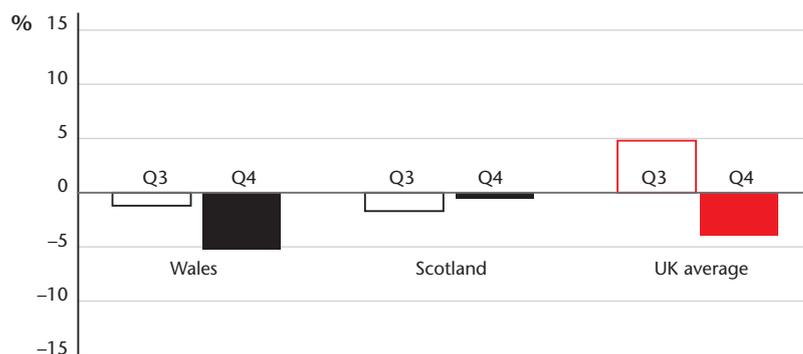


Fig. 5.4



REGIONAL CONFIDENCE Q4 2007 – SCOTLAND AND WALES

Fig. 5.5



6 CONFIDENCE BY SIZE OF BUSINESS

The business outlook for micro firms (those with less than 10 employees) evidenced the largest decline of the different business sizes this quarter.

Firms of this size are typically least confident this quarter. At 7.8, the confidence score for micro firms is now at its lowest since this survey began reflecting concerns on the outlook for the housing market, the high street and the economy as a whole through 2008.

Confidence is also in negative territory for all other business size categories. Large firms (those employing more than 250 employees) have seen confidence fall to -4.7, the lowest level for this group since Q4 2005, while confidence in small and medium size firms retreated to -1.2 and -2.2 respectively from +5.0 and +7.3 in the third quarter. The decline in confidence across all business sizes confirms a worsening outlook for the economy as a whole, as well as for the global economy.

CONFIDENCE FOR ALL BUSINESS SIZES NOW IN NEGATIVE TERRITORY

TREND OF CONFIDENCE BY BUSINESS SIZE

Fig. 6.1

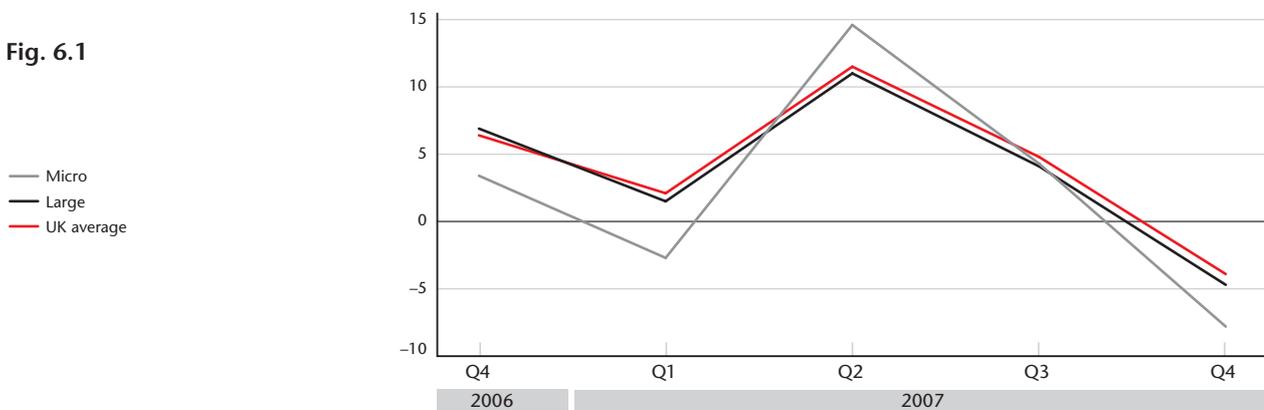
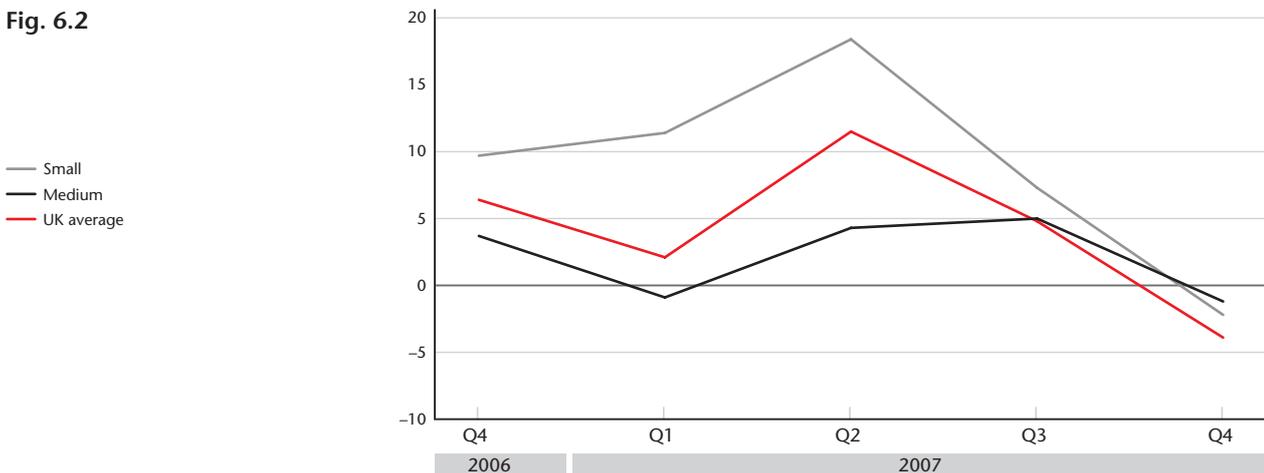


Fig. 6.2



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 20 August to 26 October 2007 1003 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

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For further information about the cebr, see: www.cebr.com

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 below: 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	%	%
REGION	total ▶ 1003		
South East (excl London)	140	14	16
London	154	15	18
South West	81	8	8
Wales	62	6	4
West Midlands	80	8	8
East Midlands	73	7	7
East England	92	9	10
Yorks & Humber	80	8	8
North West	103	10	10
Northern	71	7	3
Scotland	66	7	8
Northern Ireland	1	0	0.1
SIZE (EMPLOYEES)	total ▶ 1003		
Up to 49 (Micro & Small)	287	29	31
50–249 (Medium)	210	21	16
250+ (Large)	506	50	53
SECTOR	total ▶ 1003		
Agriculture & fisheries, energy, water & mining	65	6	3
Manufacturing & engineering	125	12	14
Construction	71	7	6
Retail & wholesale	108	11	13
Hotels & catering	63	6	3
Transport & storage	51	5	5
Communications	56	6	3
IT	73	7	3
Banking, finance & insurance	107	11	8
Property & business services	144	14	22
Other service activities	70	7	5
Health & 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	%
South East (excl London)	140	1.3
London	154	1.7
South West	81	1.3
Wales	62	1.4
West Midlands	80	1.2
East Midlands	73	2.1
East England	92	1.1
Yorks & Humber	80	1.4
North West	103	1.0
Northern	71	2.5
Scotland	66	0.5
Northern Ireland	1	0.0
United Kingdom	1003	1.2

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

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