



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

Q3 2007

# UK BUSINESS CONFIDENCE MONITOR

Summary Report



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The **ICAEW UK Business Confidence Monitor** (BCM) provides a snapshot of the state of the economy from senior finance professionals working at the heart of business, across all commercial sectors, sizes of businesses and UK regions.

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.

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

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

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

## Q3 2007 KEY POINTS

- 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.
- These regions have reached their lowest level of confidence since the terrorist bombings in July 2005.
- UK interest rate rises and the negative impact of the financial market contagion caused by the problems in the US sub-prime mortgage market have spread to the leveraged buy out and other financial markets. This could cause a global credit crunch.
- Most importantly for the UK economy, an abrupt end to the current private equity boom and merger and acquisitions cycle is likely to leave London as a financial centre vulnerable.
- These are clear early warning signs to which government needs to be alert. The position of the City as a leading capital market cannot be taken for granted.
- High interest rates are likely to take the steam out of the economy in the second half of the year.
- Industries most affected include the Banking, Finance and Insurance sector, which is particularly interest rate sensitive.
- The BCM Confidence Index for the Property sector dropped to -10.0 in Q3 2007, from +1.0 in the previous survey, indicating that the housing market is slowing.
- The Retail and Wholesale sector has also shown a drop in confidence to +6.2 in Q3 2007 from +14.6 in the previous quarter.
- Official inflation has retreated to 2.4% from 3.1%, but remains above the 2.0% target set by the Bank of England. 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.
- The recent closure of the lending window at banks will prove much more powerful than any decision by the Bank of England which may now be forced to hold interest rates if financial markets remain turbulent and tighter global credit conditions loom.

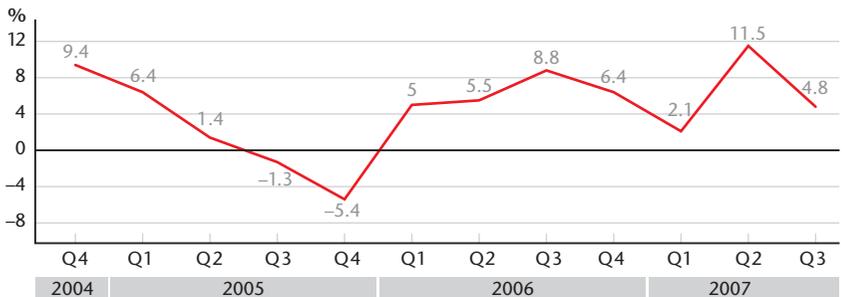
# FOREWORD

BY ICAEW CHIEF ECONOMIST, MAUREEN RAYMOND



This quarter the ICAEW UK Business Confidence Monitor (BCM) has reversed the rise in confidence seen three months ago which took the Index to the highest level in three years. After confounding expectations and hitting +11.5 in Q2 2007, confidence has moderated this quarter to a relatively weak +4.8 (see Fig. 1). This rather abrupt turnaround suggests those risks threatening growth that we have been writing about are beginning to bite.

Fig. 1 BCM Confidence Index trend



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 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. These regions have reached their 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,

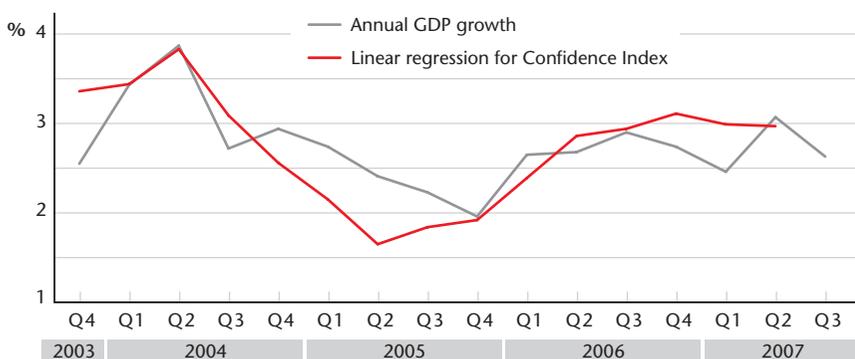
Finance and Insurance sector is particularly interest rate sensitive and the drop in confidence forecast by finance professionals over the next 12 months incorporates higher borrowing cost and possibly reflects the end of the private equity boom which has helped fuel growth in the City.

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 Fig. 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.

**Fig. 2 Forecast of annual GDP**



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

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.

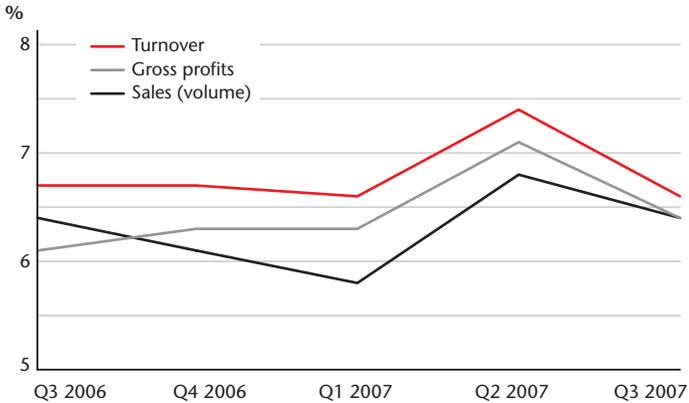
Finally, the recent sudden closure of the lending window at the banks will prove much more powerful than any interest rate move by the Bank of England. It is our expectation that the Bank of England will be forced to hold interest rates as a credit crunch looms and they will be hard pressed to continue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

**Maureen Raymond, Chief Economist, ICAEW**

# BUSINESS FINANCIAL PERFORMANCE

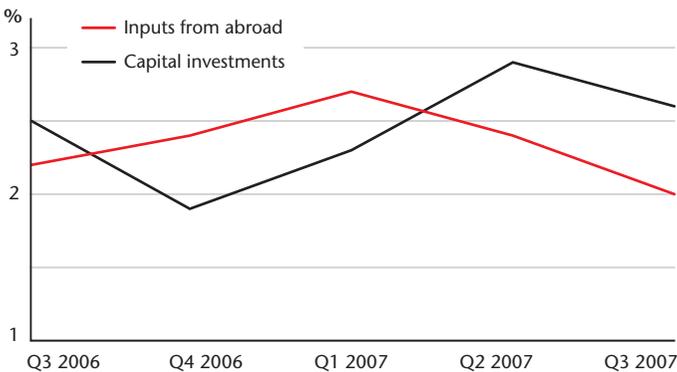
Finance professionals have become less optimistic regarding their expectations for turnover growth. They expect turnover and profits to rise by 6.6% in the next 12 months after posting 7.1% growth in the past 12 months. However firms expect profit growth to remain stable supported by a forecast for weaker input price inflation, despite oil prices rising to a near record level this quarter.

**Fig. 3 Expected change – next 12 months**



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 impact of an expected slowdown on the labour market.

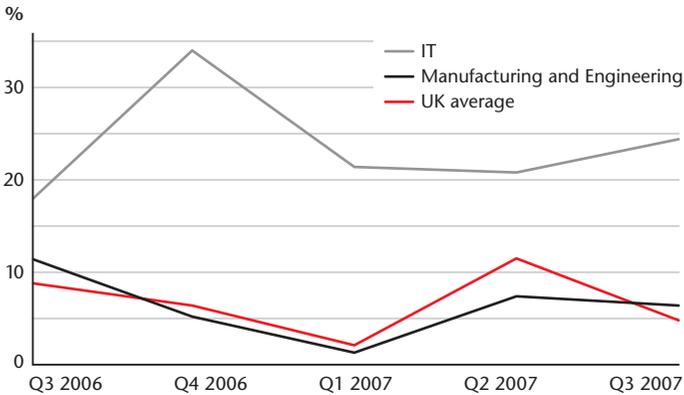
**Fig. 4 Expected change – next 12 months**



# SECTOR SUMMARY

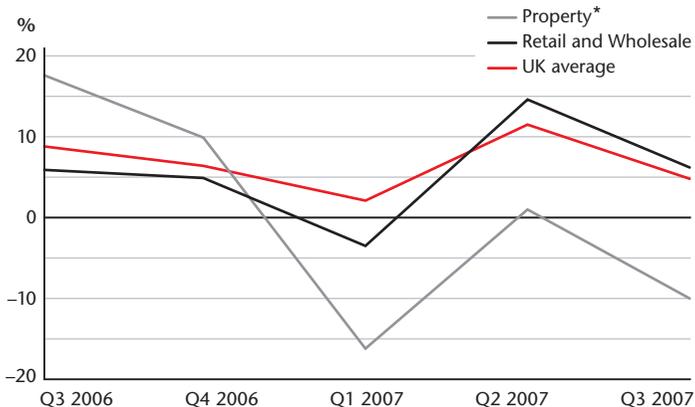
In contrast to most other sectors, confidence among IT businesses rose this quarter. The sector is again the most optimistic in the UK. The rise in optimism this quarter demonstrates a degree of detachment from UK interest rates as IT firms based in the UK continue to make extensive productivity gains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

**Fig. 5 BCM Confidence Index trend**



Property and Retail and Wholesale sectors experienced 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.

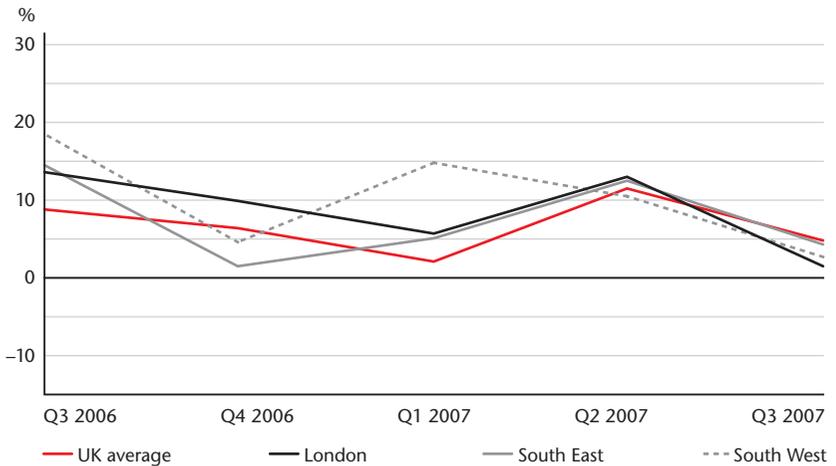
**Fig. 6 BCM Confidence Index trend**



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

# REGIONAL RESULTS

Fig. 7 BCM Confidence Index trend



## LONDON

The capital city has registered its lowest score in almost two years and for the first time is the most pessimistic region in England. Finance professionals in London are concerned about the implications that the rise in interest rates may have on consumer spending and the housing market in the capital, but also on the Business Services and Banking, Finance and Insurance sectors. At +1.5, the region is markedly lower than the UK average of +4.8.

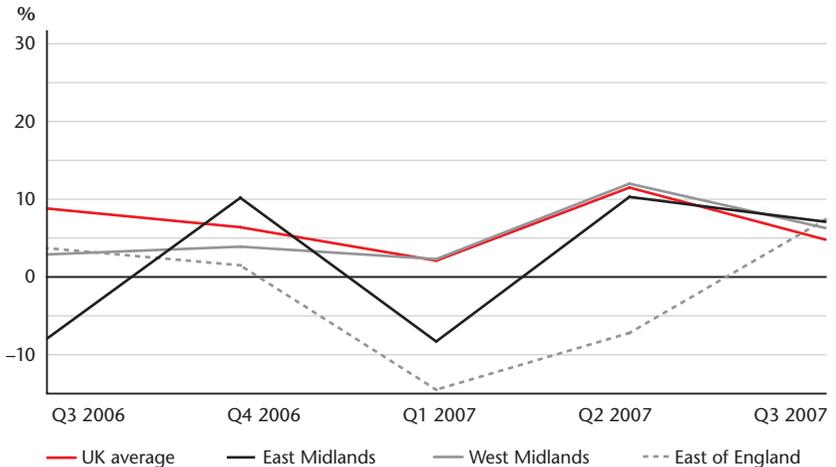
## SOUTH EAST

This region has experienced a significant deterioration in business prospects, much like many other regions of the country. The weakness in the Hotel and Catering, Other (Consumer) Services and Business Services sectors of the South East economy are the main factors that have depressed the outlook for the region. In comparison with the UK average of +4.8, the region is slightly less confident at +4.3.

## SOUTH WEST

The index in the South West has slipped by 7.8 points this quarter to +2.7. The decline in the Retail and Wholesale sector has contributed to this decline as did the weaker outlook for Business Services and Banking, Finance and Insurance firms located in towns such as Bristol, Swindon, Bournemouth and Salisbury. Negative house price growth last quarter also contributed to the downturn. This leaves the region's Confidence Index at 1.9 points lower than the UK average of +4.8.

**Fig. 8 BCM Confidence Index trend**



### EAST MIDLANDS

Optimism in the East Midlands has declined this quarter in line with the decrease seen nationwide. However, at +7.1 the Confidence Index for the region remains among the highest. The buoyant Transport sector and robust house price growth this quarter have supported optimism in the region. The region's index score of +7.1 is 2.3 points ahead of the UK average of +4.8.

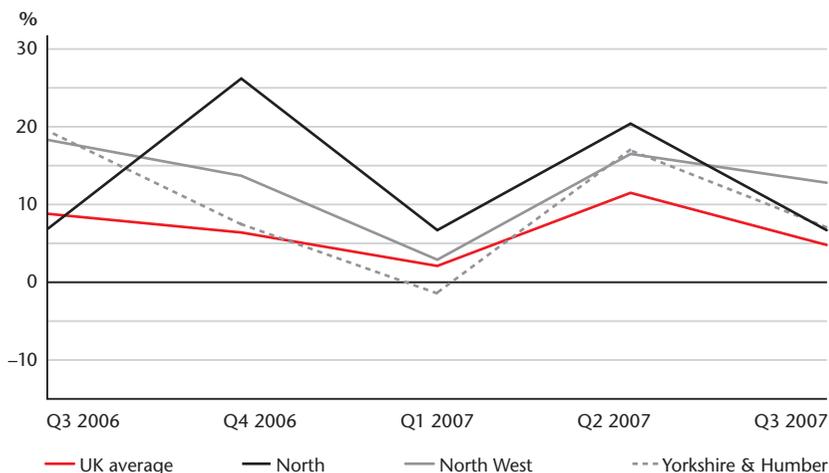
### WEST MIDLANDS

Firms in the West Midlands remain buoyant this quarter as the Manufacturing and Engineering sector continues to benefit from the reopening of the Longbridge plant, the European economic upswing and the stability of the exchange rate against the euro. The survey was carried out before the floods hit the region's economy. At +6.3, the region's confidence stands 1.5 points higher than the UK average of +4.8

### EAST OF ENGLAND

The East of England is the only region that has become more confident this quarter relative to the previous, and is now the second most optimistic. This is likely to be due to the region's higher than average proportion of Transport and Storage businesses, a sector which has become significantly more confident in Q3. With an index score of +7.4, the region is markedly more confident than the UK average of +4.8.

**Fig. 9 BCM Confidence Index trend**



### **NORTH**

After this region registered the strongest confidence last quarter, optimism has retreated this quarter. However, the Northern region remains amongst the most confident in the UK. The regeneration efforts in cities such as Newcastle are keeping house price growth high and the region relatively buoyant when compared with the rest of the country. Confidence in the Northern region is slightly higher than the UK average of +4.8, standing at +6.5.

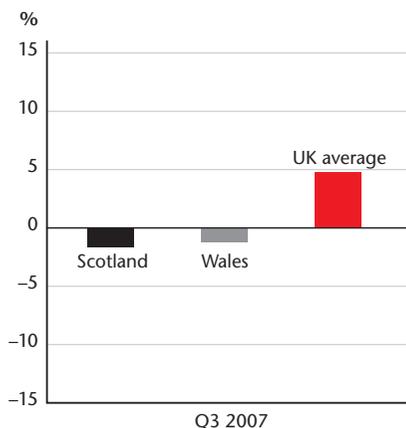
### **NORTH WEST**

The North West is the most confident region this quarter. Despite higher interest rates, the relatively high scores of sectors such as Construction, Health and Education and Manufacturing and Engineering have kept the region in double digit confidence. Robust job creation has also sustained the outlook for the North West. The North West's score of +12.8 is in marked contrast to the UK average of +4.8.

### **YORKSHIRE & HUMBER**

Confidence in Yorkshire & Humber declined sharply but remains amongst the highest in the UK, supported by a rise in confidence in the Transport sector this quarter. In addition, the region is feeling the benefits of relative stability in the Manufacturing and Engineering sector. At +7.1, the region's confidence is higher than the UK average of +4.8.

Fig. 10 Q3 2007 BCM Confidence Index



### SCOTLAND

Confidence in Scotland is the lowest across the UK due largely to concerns that the currently buoyant housing market may slow due to rising interest rates. Confidence in the Banking, Finance and Insurance sector has also retreated in the country as finance professionals start to bet on a slowdown in the Edinburgh-centred sector which has been growing robustly over the past few years. When compared with the UK average of +4.8, Scotland is lagging considerably behind in confidence by 6.5 points at -1.7.

### WALES

Welsh businesses are pessimistic about their outlook largely due to the impact of potential factory closures such as those of Airbus and Toyota and also due to the weak outlook for the Business Services sector which is clustered along the M4 corridor in South Wales. Negative house price growth over the past three months has also weakened confidence. The Welsh Confidence Index rating of -1.2 is distinctly below the UK average of +4.8.

## DETAILED RESULTS AND FURTHER INFORMATION

For more detailed national results and analyses, including full regional reports and summaries and further information on the UK BCM, please visit:

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