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ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

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WORLD ECONOMIC OUTLOOK DETERIORATES

With markets now convinced that a Greek sovereign debt default is almost inevitable – it's more of a question of 'when' than 'if' – attention is increasingly turning to other countries that may potentially need a bail-out, especially Italy. Its struggle to pass an austerity package is a real cause for concern as an Italian or Spanish default would seriously challenge European solidarity and put the euro's future at risk.

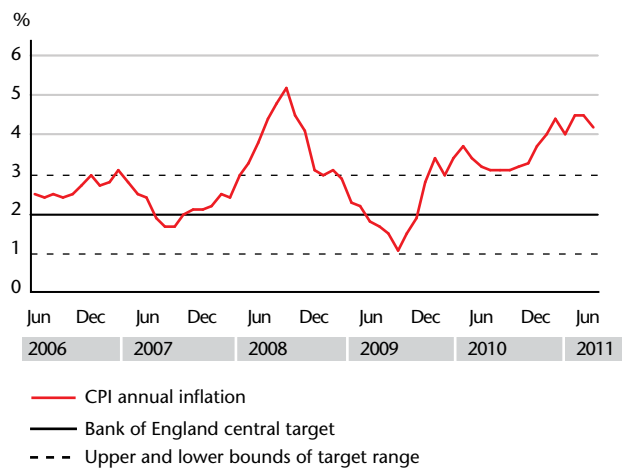
The latest US labour market figures showed only a small increase in employment in June that disappointed markets and underlined concerns about the surprisingly weak state of the world's largest economy. The UK economy continues to show signs of frailty: elevated unemployment and inflation are squeezing retail sales and industrial production remains below pre-recession levels. Given this situation, the Bank of England continues to keep its base interest rate at the historic low of 0.5%.

A wide range of leading indicators across the globe are falling or remaining weak. While many indicators still point towards limited expansion, the overall trajectory has been downward. In the current environment, another adverse shock such as a sovereign debt default in the eurozone could be the tipping point which pushes numerous countries back into recession – clearly a very precarious economic environment.

Inflation shows surprise fall...

The latest data from the Office for National Statistics (ONS) showed annual consumer price index (CPI) inflation in June was 4.2%, down from 4.5% in May and lower than market expectations.

Figure 1: UK consumer price index (CPI) annual inflation



Source: ONS

Notably, the most significant negative contribution to the change in the annual rate of inflation came from the recreation and culture component of the index, where prices fell by 0.9% between May and June this year. Over this time period, there was downward pressure on the prices of games, photographic equipment, books and audio-visual equipment.

This suggests that the weakness of domestic demand is starting to bear down on inflation, with retailers having to discount the prices of discretionary goods given frail consumer confidence and the ongoing squeeze on household real incomes. Some retailers, such as Marks and Spencer, brought forward their summer sales to prop up revenue during this difficult time for the sector.

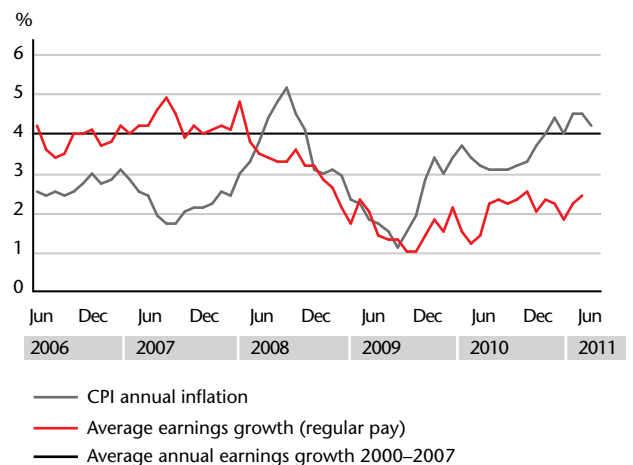
While the fall in the headline rate of inflation may prompt a sigh of relief from some corners, the move clearly needs to be placed into context and there are still some grim readings in the details. Firstly, the price of essential goods remains elevated – over the 12 months to June, food prices were up 6.9% while transport prices were up 7.9%. And there is still rising utilities price inflation in the pipeline, with companies such as Scottish Power and British Gas implementing price rises from August. So inflation could start rising again in the autumn.

... though earnings growth continues to trail

The latest labour market data showed the rate of unemployment on the broad International Labour Organisation (ILO) measure standing at 7.7% over the three months to May. This is slightly down from 7.8% for the three months to February but still elevated. Furthermore, the more timely claimant count measure of unemployment rose by 24,500 in June – the largest monthly increase since May 2009. This points to ongoing fragility in the labour market.

Wage growth showed some signs of picking up, with regular pay (excluding bonuses) increasing at an annual rate of 2.4% in May, up from 2.2% in April. However, as Figure 2 shows, growth remains well below pre-recession averages and continues to significantly trail behind consumer price inflation – implying that a substantial erosion of household spending power is still taking place.

Figure 2: UK average annual earnings growth versus annual CPI inflation



Source: ONS

On the upside, the weakness of earnings growth at present suggests that there is little evidence of a wage-price spiral emerging – when rising prices lead to higher wage demands from workers and these higher wages in turn feed through into higher consumer prices, driving up inflation. This is a chief concern among inflation hawks such as former Monetary Policy Committee (MPC) member Andrew Sentance, but the statistical data continue to suggest we have little reason to be worried as slack in the labour market places a ceiling on employee wage demands. This gives the Bank of England room for manoeuvre in keeping interest rates on hold until the economic recovery in the UK becomes more convincing.

Retail sales gloom as big brands announce shop closures

There was a range of gloomy announcements from the retail sector over the past few weeks: chocolate manufacturer Thorntons has said that it will be shutting at least 120 of its shops, while Carpetright has announced the closure of up to 50 shops following a 70% fall in its annual pre-tax profits. The furniture store Habitat has also placed 30 of its stores into administration, and sold a remaining three London stores to Home Retail Group. Pressures on consumers are leading to pain on the High Street.

But the weaknesses in the retail sector cannot purely be attributable to short-term economic factors. It is especially noteworthy that, while traditional store-based retailers have made a range of bleak announcements, internet retail sales have continued to soar ahead. While non-internet sales values fell by 0.3% in May 2011 compared with a year ago, internet retail sales rose by a staggering 37%.

Figure 3: Internet retail sales values – annual % change



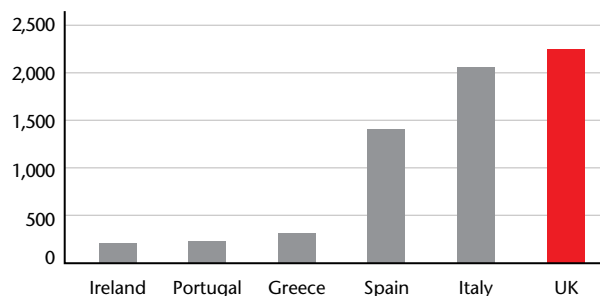
Source: ONS

So as well as tough economic circumstances, traditional High Street stores are having to come to terms with the fact that there is an ongoing shift towards consumers buying online rather than in shops. This means retailers can no longer be complacent about sticking with existing business models, nor can they solely blame weaknesses in the economy on poor performances – it is also a result of their struggle to adapt to the digital era.

Eurozone crisis deepens: the real risk is a Spanish or Italian default

Markets increasingly view Greek debt default and escape from the euro as nearly inevitable but although this would likely lead to similar debt crises in Portugal and Ireland, these are relatively small economies and not central to the euro, as Figure 4 shows. They could be bailed out at relatively small cost to the other much larger economies or alternatively they could be allowed to fail with knock-on effects but without necessarily being the deathbed of the European single currency.

Figure 4: 2010 GDP of Portugal, Ireland, Italy, Greece and Spain, in \$ billions (UK included for reference)



Source: International Monetary Fund

Spain and Italy are different, however. They are very large economies – Italy roughly the same size as the UK with GDP in 2010 of \$2.0 trillion and Spain only slightly smaller with GDP in 2010 of \$1.4 trillion. Both are therefore fairly central to the EU. Bailing out either would be costly but equally their leaving the eurozone would do immense damage to the reputation of the EU.

It is becoming increasingly difficult to see how the euro can survive in its current form in the longer term, given the inherent difficulties of having a single currency, single exchange rate and single stance on monetary policy for a range of countries with very different economic characteristics. Stability is only likely to be guaranteed by the exit of the weak periphery countries from the single currency area, or some form of fiscal union where fast growing countries send transfer payments to weaker growing ones. Given that neither of these measures are politically very palatable, it remains unusually uncertain what the outcome of the current sovereign debt crises will be – all eyes on developments in the region over the coming days and weeks.

With the recovery so fragile, a meltdown in the eurozone could prove disastrous for the UK

Global events are once again posing a threat to the UK economic recovery. In particular, a sovereign debt default in the eurozone remains a distinct possibility that could be enough to push the UK back into recession.

The key question then is how policy-makers respond if anything **does** go awry and economic growth shows a sharp slowdown. With interest rates already at rock bottom levels, there is little scope for further monetary policy stimulus. Although more quantitative easing remains a possibility, this could prove unpalatable

at a time of high inflation when the Bank of England is already under fire about losing credibility. And the Chancellor continues to maintain that there can be no Plan B for government spending plans, meaning fiscal policy is unlikely to be loosened – as to do so would be politically highly embarrassing.

Policy measures were exhausted during the 2008/09 recession, leaving little scope for using these again if another crisis occurs – making for a particularly dangerous economic environment at the moment.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
21 July	Trends in Lending	Lending to businesses still weak
26 July	Q2 2011 GDP first estimate	Inspid growth
29 July	Lending to Individuals	Credit still constrained

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