



Making Business Sense

# ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S  
ECONOMIC ADVISERS

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## SIGNIFICANT RISKS TO WORLD GROWTH IN 2012

**This year looks set to be a challenging one for economies in the West, with significant downside risks to growth in the short term. The main driver of the weak outlook for 2012 has been the downward spiral of the eurozone which, due to lack of political commitment to agreeing a lasting solution for highly indebted states, has undermined confidence in the region and beyond.**

The eurozone debt crisis makes for an 'unusually uncertain' global economic environment. If politicians fail to agree on a solution for the economic governance challenges facing the currency union, market pressure would likely force out one or more countries from the euro. As this would most likely cause sovereign default, damage to banks' balance sheets may cause a renewed credit crunch and thus a major recession as lending dries up and companies and consumers stop all but the most essential spending. Even if politicians in the eurozone are able to reassure the markets that a solution to the debt crisis can be reached, a recession for the currency area will not necessarily be avoided, as fiscal austerity and economic uncompetitiveness continue to constrain growth.

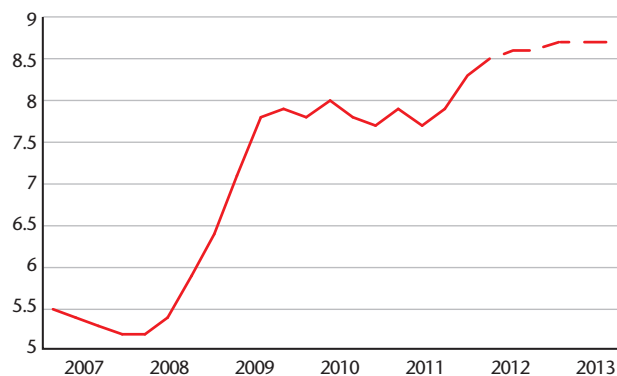
The weak economic outlook for the eurozone will almost certainly make for a poor short-term growth outlook for the UK, as demand for exports dries up and businesses become more reluctant to invest. Further quantitative easing looks increasingly likely as a means of propping up what is already a fragile recovery. The Bank of England also looks set to keep its base rate on hold at a record low of 0.5% throughout 2012.

## Unemployment set to rise further while earnings growth remains weak

The labour market looks set to deteriorate further this year as the UK economy struggles to grow and the public sector continues to shed jobs. Some 110,000 central and local government jobs are set to be axed in the 2012/13 fiscal year, and private sector job creation is likely to remain lacklustre over this timeframe as business confidence remains in the doldrums.

The Office for Budget Responsibility (OBR) currently expects the UK unemployment rate to rise from its current level of 8.3% to about 8.7% by the end of this year, as shown in Figure 1 below. This is equivalent to 2.8m people being out of work. Furthermore, these unemployment forecasts are based on the UK economy growing by 0.7% this year. A more sluggish pace of growth or another recession, both of which are well within the realms of possibility, would point towards even higher levels of unemployment by the end of this year.

Figure 1: ILO unemployment rate, %



Source: ONS, OBR

High unemployment in the short term will bear down on living standards for those in work as employee wage bargaining power is limited by the risk of job loss. Consequently, the OBR expects average weekly earnings to grow by just 2.0% this year, far below the average of 4.3% seen over the years 2001–2007 and also below consumer price inflation, which is expected to average 2.7% this year.

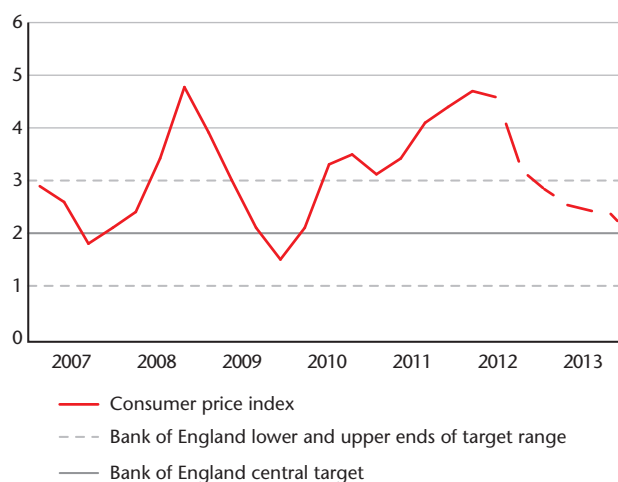
Overall, weaknesses in the labour market mean that household spending power is likely to be flat at best this year, limiting the ability of consumer expenditure to drive economic growth in the short run. As household consumption accounts for some 60% of UK gross domestic product, weak growth in consumption almost certainly means weak growth for the economy as a whole.

## Inflation still high on the latest data, but a sharp fall in 2012 looks likely

Although the latest official data shows annual consumer price inflation at over double the Bank of England's central target of 2.0%, at 4.2% in December 2011, inflation can be expected to fall relatively sharply over the coming months. Cooling growth in the Western world ought to help curb commodity price growth. Furthermore, the impact of last January's VAT rise on the price of goods and services will drop out of the annual rate of inflation, helping to drive the fall in price growth back towards the Bank of England's central target of 2.0%.

Figure 2 illustrates the OBR's central projections for consumer price inflation. Weaker growth than they are expecting would likely imply a sharper and more rapid fall in price growth.

Figure 2: Consumer price index, annual % change



Source: ONS

The key upside risk to inflation this year is likely to be the price of oil, which remains stubbornly high despite concerns about the global economy. Although weak demand in the West ought to bear down on commodity prices, political tensions between the West and Iran risk leading to a spike in oil prices as markets become concerned about a fall in global oil supply. This could keep inflation elevated for longer than currently expected.

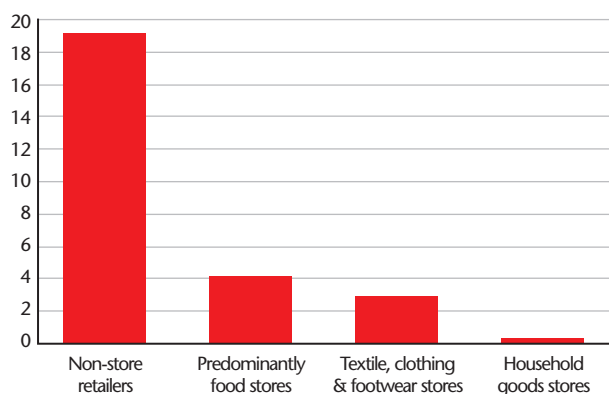
## Outlook for the retail sector remains challenging, but divergent

Announcements from the UK retail sector continue to paint a very mixed picture. While companies such as HMV have announced sharp falls in retail sales in recent months, other companies such as John Lewis have announced strong performance over the Christmas period – with like-for-like sales up 6.2% over the same period a year ago. Overall, evidence is beginning to emerge of a polarised retail sector, with both the luxury and value ends of the market performing relatively well while mid-market retailers continue to struggle.

Undoubtedly, the shining light in the retail sector remains non-store retailers – in particular, internet retailers. Non-store retail sales values rose by 19.1% over the 12 months to November 2011, far in excess of sales growth seen for store based retailers, as shown in Figure 3.

Internet retail sales in particular were 32.8% higher than 12 months ago in November, and accounted for 12.2% of all retail sales – up from just 3.0% five years ago. In addition to the ongoing squeeze on household incomes, traditional High Street brands in the UK need to get to grips with the changing nature of retail and how consumers choose to purchase goods and services. Failure to adapt can only result in continued financial woes for some of these companies.

**Figure 3: Annual growth in retail sales values, by store category, November 2011**



Source: ONS

## US could be the economic superstar in the West this year

Data released this month by the United States Bureau of Labor Statistics (BLS) showed that non-farm employment in the US rose by 200,000 in December, significantly above the market's median forecast of an increase of 150,000 and also more than the average gain for the prior 12 months. The unemployment rate in the US fell by 0.2 percentage points to 8.5%, down from 8.7% in November. The latest data is encouraging news, comparing favourably with a US unemployment rate peak of 10.1% in October 2009. These figures are a tentative sign that the US's 'jobless' recovery has undergone a step change and is now putting people back into work.

The US has emerged as one of the leading lights in the global economic recovery as the pace of growth in most of the other major economies, particularly in Europe, continues to slow. Indeed, it looks increasingly likely that the US will emerge as the West's economic star in 2012. Reinforcing the view given by the latest unemployment figures, the ISM Index for Manufacturing rose to 53.9 in December, up from 52.7 in November, which signals an increase in the rate of US factory output growth.

**Figure 4: Monthly change in non-farm payrolls**



Source: US Bureau of Labor Statistics

The US Federal Reserve expects the encouraging trend in the labour market to continue. By June 2012, the Fed expects the US unemployment rate to have fallen to 8.0%. However, a continuation of positive trends in the US labour and manufacturing markets is contingent on US housing market concerns and spillovers from the eurozone sovereign debt crisis not blowing a hole below the water line in the US economy.

## More QE in the pipeline this year?

Rising unemployment and a possible economic implosion in the eurozone pose a significant challenge to policy-makers in the UK. With interest rates already at rock bottom levels and fiscal stimulus measures limited by market concerns over sovereign debt, the tools available to respond to an economic slowdown or recession are now extremely limited.

However, further quantitative easing (QE) from the Bank of England remains one option for stimulating the economy,

should things take a turn for the worst. By purchasing government bonds, the Bank of England can keep long-term interest rates low in addition to creating a positive wealth effect for individuals holding bonds and shares.

However, even with further QE, the short-term outlook for the UK economy is likely to remain highly challenging. Although falling inflation will provide some respite for households, this will be offset by rising unemployment and weak earnings growth.

## Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
25 January	GDP Q4 2011 preliminary estimate	Slowing growth – possible contraction
25 January	Minutes of the Monetary Policy Committee Meeting held on 11 & 12 January	Discussion of whether further QE is needed
31 January	Lending to Individuals	Still weak
6 February	ICAEW/Grant Thornton Business Confidence Monitor	Business confidence still in the doldrums

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