DR ANDREW MCLAUGHLIN SUGGESTS THAT WHAT HAPPENS NEXT TO UK GROWTH IS FIRMLY IN THE HANDS OF THE CORPORATE SECTOR.

Will corporates step up to the plate?

Last year was a good year for the UK economy and a fantastic year for the world economy. According to the IMF, global demand was at its strongest for over 30 years in 2004, despite a near doubling of oil and commodity prices, and the onset of interest rate tightening in most economies. World trade reached a whopping 28% of global GDP and, in so doing, confirmed this as the most rapid period of globalisation since the Victorian era. Against this backdrop, it is perhaps no surprise that the UK economy chalked up its 12th year of uninterrupted growth with an annual rate of 3.1% in 2004 – well above trend. But UK growth was in fact driven ahead by domestic demand in the form of robust consumer and government spending, with a negative contribution from trade, reflecting the drag imposed on GDP by a large amount of imports. Indeed, over the course of the current economic cycle, which began in 1999, consumption has accounted for 79% of cumulative growth.

In 2005 we will see clear signs of consumers retreating from their vanguard position in economic growth. This may already be happening: in the final quarter of 2004, consumer spending grew at its slowest rate since the Iraq war, corroborating stories of pain on the high street. Slower consumer spending poses a real challenge for the Chancellor's optimistic growth forecast of another year of 3% plus growth in the UK. That is only likely to happen if the corporate sector steps up to the plate with increased business investment and faster export growth. That would maintain our enviable growth record and cushion the fall in consumer spending growth. This article explains why the corporate sector might just surprise us all in 2005.

50 QUARTERS OF POSITIVE GROWTH AND COUNTING In his recent Budget the Chancellor announced with much mirth that the UK economy had surpassed Arsenal's 49-match unbeaten run in 2004. That line might have been lost on the Tory leader, Michael Howard, a committed follower of Liverpool FC, a club which has failed

Table 1 – WHAT TO LOOK OUT FOR IN THE YEAR AHEAD

Drivers of business investment	Upside potential
Higher-than-expected profitability	There was a strong rebound in profitability last year and, as a result, business investment. Profitability is unlikely to be as strong in 2005 but we could be wrong if, for example, a drop in the price of oil, or the value of sterling, enables companies to rebuild profit margins. The rise on the FTSE-100 in recent months is consistent with bullish expectations for the year ahead, although this is coming under pressure from stubbornly high oil prices.
High liquidity	Corporate cashflow will probably weaken in 2005 if the economy slows but, with liquidity at record levels, companies will still have ample resources to fund investment.
High capacity utilisation	The proportion of firms operating at full capacity in the manufacturing sector is close to a four-year high, according to survey evidence from the British Chambers of Commerce; in the service sector, utilisation is at an eight-year high. The main measure of spare capacity in the economy – the 'output gap' – may not fully capture these pressures, and the increase in investment they imply.
Long-term interest rates are still very low	The base rate may have risen by 100 basis points in 2004, but longer-term interest rates ended the year roughly where they started it, at around 5%. Most corporate sector debt is priced relative to the long-term interest rate, whereas households are more exposed to the base rate via floating rate mortgage debt. I expect further rate tightening in 2005 but if this is delayed, or doesn't happen (e.g. if the base rate has already peaked at 4.75%), there would be additional support for investment.

to win the league championship at any point in the last 12 years. There is no doubt, however, that we are experiencing an unprecedented period of stability for companies and households alike. With volatility at a post-war low and average economic performance high by historic standards, it is fair to say that the UK is enjoying something of a purple patch. Matters improve further when we take inflation, interest rates and unemployment into account: all are low and, it would appear, likely to stay that way for the foreseeable future.

My predecessor Jeremy Peat would always caution against complacency. Just because economic conditions have been relatively favourable in recent years does not mean they will continue to be so in future years. Indeed, the Governor of the Bank of the Bank of England has referred to the past 10 years as the NICE decade (Non-Inflationary Consistently Expansionary), but cautioned that the next decade might only be NOT-SO-BAD (Not Of The Same Order But Also Desirable). Even if we do get a fair wind, business life isn't going to be easy. Globalisation brings with it many opportunities, but it can be an unforgiving process. Manufacturers are under pressure to search out the lowest cost global production platform and, for now, that means China. Companies also find themselves under constant pressure to find innovative ways to grow and compete on value in an increasingly international environment. If the challenge of the last 10 years was to achieve much needed stability in UK economic management, the challenge ahead is to move British productivity up towards European levels and then, beyond this, to those of the US. That is essential if we are to preserve living standards at home while meeting the competitive challenge in world markets.

Executive Summary

- **Slowing consumer spending poses a challenge for Gordon Brown's growth forecast.**
- **If the figures are to be achieved then the corporate sector needs to step up to to the plate with increased business investment and faster export growth.**
- **The UK appears to be nearing the end of the current economic cycle which most believe started in 1999.**
- **As government and consumer growth slows, then the slack needs to be taken up by business investment. If that does not happen then the 50 quarters of positive growth will draw to a close.**

THE IMMEDIATE OUTLOOK As best we can tell, the UK is nearing the end of its current economic cycle, which is generally believed to have started in 1999. I therefore expect the economy to revert to its trend growth rate of around 2.5%. As it slows, some rebalancing is also likely: spending by consumers and government are set to decelerate as both rebuild their balance sheet, with exports and business investment taking up the slack. It is to the prospect of higher business investment that I now turn.

WILL BUSINESS INVESTMENT PROVIDE AN UPSIDE SURPRISE? This seems a tall order at first glance. I would normally expect a moderation in business investment consistent with the anticipated slowdown in GDP this year. There are other headwinds to consider. First, many companies are wrestling with pension fund deficits. Rectifying this situation involves a call on cashflow that might constrain investment intentions, though this is by no means certain. Second, shareholder sentiment is bearish on capital expenditure according to a recent survey of global fund managers by Merrill Lynch. This revealed a strong preference for free cashflow to be returned to shareholders. As a result of these factors, the consensus forecast is that business investment will grow by around 4% in 2005 following growth of 5% in 2004. This would represent the best back-to-back years for business investment since the late 1990s. I suspect, however, that companies may be primed to deliver an above-consensus performance.

The first point to make is that business investment is extremely volatile, so forecasting errors can be large. For example, the consensus expectation was for growth of 2.5% at the start of last year, almost half the eventual rate – a shortfall of £3bn. *Table 1* sets out the factors that help influence the level of business investment. In each case, I have briefly explored the scope for a stronger than expected outcome.

Overall, the balance of risks around the consensus business investment forecast is skewed to the upside. In other words, there is a decent chance that 2005 will turn out to be another good year (c5%, or better). This would represent its best back-to-back performance since the mid-1990s. It may be necessary if Gordon Brown is to achieve his 3-3.5% growth projection.

BUDGET 2005 – BUSINESS ESCAPES LARGELY UNSCATHED Pre-election Budgets raise hopes of large tax and spending giveaways, but I did not expect Gordon Brown to follow this path in Budget 2005. The corporate sector, meanwhile, was hoping to avoid any further increase in taxation, having borne the brunt of the Chancellor's fiscal tightening measures to date. In the event, there were a few pre-election sweeteners for key groups of the electorate while business escaped largely unscathed. The underlying theme was one of prudence, with the Treasury's self-imposed fiscal rules dictating as much. The Chancellor presented the overall package of measures as a modest fiscal tightening (+£415m), but the effect on demand may be expansionary at the margin. There were around £2bn of concessions to pensioners, first time buyers and families in receipt of tax credits. These groups have a high propensity to consume, so most of this money should end up being spent, rather than saved. A one-off change to North Sea corporation tax, worth £1.5bn over the next three years, was introduced to part-fund these concessions. This will have a negligible impact on demand. The Treasury argues the change will ensure that it 'receives an appropriate share of the benefits accruing to oil companies from the sale of North Sea oil'. I'm not sure the oil companies will quite see it that way!

THE CONFIDENCE OF THE CORPORATE SECTOR What happens next to UK growth depends a great deal on the confidence of the corporate sector with regards to trade and investment and an orderly transition in the consumer sector. I expect the recent trend of moderation in consumer spending to be with us for some time. Conditions are, however, conducive to a larger contribution to growth from UK businesses and this should be forthcoming in 2005. I would be the first to concede, however, that this view puts me at the optimistic end of the forecasting spectrum.

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