

CBI Director-General's New Year Message 2008



This will be a difficult year for British business. The domestic economy appears to have started a cyclical slowdown of uncertain depth and duration. And at the same time, structural changes that are now underway in the global economy pose big challenges for the longer term.

But it is important not to exaggerate the risks. The most likely outcome for the UK is that the coming 12 months will bring a soft – as opposed to a hard – landing, after two years of above average-growth. If we allow ourselves to get carried away by today's gloomy headlines, we could talk ourselves into something much worse.

Richard Lambert | Director-General | CBI

Business conditions to slow

With the economy growing at over 3 per cent in the year to September, it was always clear that business conditions were set to slow. Starting from August 2006, the Bank of England had raised rates five times in 13 months in order to lean against the inflationary pressures that were gathering steam as the economy ran out of spare capacity. By the late autumn this year, output growth and consumer spending were both coming off the boil.

But two big shocks have hit the system in the past few months, and made the outlook much more uncertain.

Credit crunch and cost increases make outlook uncertain

The first is the global credit crunch, which has paralysed the credit and interbank markets since August. So far, its impact has been mainly confined to the financial world. But it is likely to have an increasing impact on the economy at large, in the shape of tighter and more expensive credit for businesses and consumers.

The second big shock has been the rapid acceleration in the costs of energy, food and other commodities. This will put pressure on profit margins. And because it might also feed through into inflation, it will limit the ability of central banks to cut interest rates at a time when the credit crunch is depressing economic activity.

Financial services slowdown will leave its mark

These are problems for the whole industrialised world. But they pose particular difficulties for the UK. The financial sector plays a big part in our economy – it represents nearly a tenth of GDP – and has made a major contribution to growth in recent years. A slowdown here would leave its mark, especially in London and the South East.

Moreover house prices have risen very rapidly in the UK over the past decade, fuelled by ever-rising volumes of consumer debt. A sharp reversal here would have serious consequences.

Finally, the Government cannot do much to support a flagging economy by increasing public spending. The fiscal deficit has been allowed to grow to a point which now leaves little room for leeway.

Reasons to be more cheerful

But here are five reasons for feeling more cheerful.

First, rising house prices have pushed up the asset as well as the liability side of the typical household balance sheet. The latest Bank of England survey shows that around 60 per cent of mortgage borrowers have more than £100,000 of equity in their homes, compared to less than 10 per cent in 1993.

That gives them a comfortable cushion to fall back on if times get tough. It seems likely that modest falls in house prices would not have a big impact on overall consumer spending.

Flexible labour market

Second, the outlook for employment is set reasonably fair. In contrast to past decades, Britain's flexible labour market means that employers can adjust to changes in business conditions and output, at least over the short term, without having to take on large numbers of people – or make them redundant.

This acts as an important force for stability in the UK economy. And it is one reason why CBI members regard labour market flexibility as such a vital part of the UK's economic toolbox.

Bank on top of inflation

The third reason for a degree of New Year cheer is that the Bank of England has been doing a good job of managing inflation expectations through a very difficult period, and has room to act if it thinks the economy is going off the rails. After all, the UK has much the highest bank rate of any big developed economy.

The recent weakness in sterling may also be important. A lower pound should help to rebalance the economy after a decade in which the currency has often looked over valued.

Fair global outlook

Lastly, the global outlook remains fair, despite the likely slowdown in Europe and the US. Further strong expansion in China and India should help to push world GDP up by perhaps 4 per cent in 2008, which will support our export markets.

All this provides the background to the CBI's recent forecast that the UK economy would grow by around 2 per cent next year, and roughly the same again in 2009. That would be below both the long-term trend and our recent performance – and it could turn out worse than that. But it would not be anything like a disaster.

New phase in world economy

Beyond these cyclical trends, business people have to focus on longer-term structural changes in the global economy - and there are reasons to think that we may be entering a new phase. To summarise a few of the most obvious shifts that are now in prospect:

- The past decade has seen an extraordinary period of sustained growth and low inflation, driven at least in part by globalisation, technology, and falling trade barriers. It is possible that the most beneficial impacts of these trends have now been felt, and that as a consequence the world economy will be in for a bumpier ride in the years to come.
- The current financial turmoil will have a lasting impact on the shape of the international banking system. There will be questions about the nature of securitised lending, and the role of the regulators. Ownership is another issue, with sovereign wealth funds injecting much-needed capital into some of the biggest banks.
- The global economic balance of power is shifting towards the East. Measured in purchasing power terms, China and India together are already bigger than the US, and they have become the main driver of world growth as the US has slowed down.
- Partly as a result of this shift, energy security and climate change have become critically important challenges for policymakers and businesses everywhere. We appear to have moved into an era of high energy prices, and one where investment decisions will be dictated in part by the price of carbon – which in turn will become a new currency.

Priorities for a prosperous UK

So what are the priorities for the CBI in these challenging times? Our members want us to focus on the key issues that will enable the UK to prosper in a globalised world.

These include the absolute necessity of raising the national skills and knowledge base at every level. Then there's the vital importance of maintaining and strengthening our flexible labour market. The urgent need to develop our economic infrastructure, whether it be in the transportation system or in diverse and secure supplies of power. The major effort that will be required from business and government together to take on the challenge of climate change.

A competitive tax and regulatory regime will be an essential component of our future success. And as worrying signs of protectionism start to appear around the developed world, our members will want us to strain every sinew to defend the rules-based multilateral trading system.

So it is a busy as well as a rather uncertain time. We wish our members, and the whole of the British business community, a happy New Year and success in the challenges to come.

