

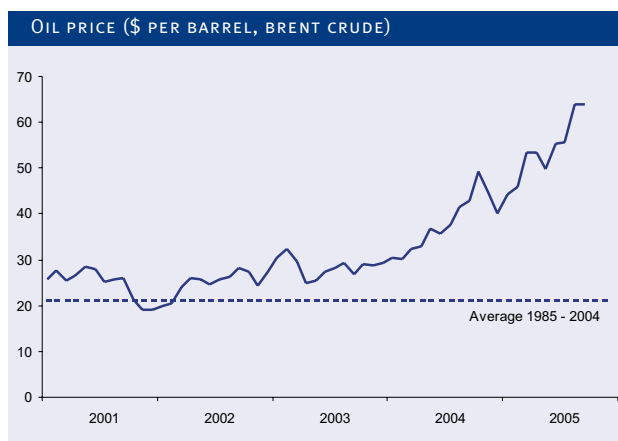
UK economic outlook

Where next as oil prices hit a new high?

Though oil prices recently peaked above \$65 per barrel, and are set to remain high by the standards of the last two decades, the impact on economic growth and inflation should not approach that seen after the 1970s and 80s price 'shocks'. Nevertheless, some pain will be felt by consumers and firms alike.

The price of Brent crude oil breached the \$67 per barrel mark for the first time at the end of August, up two thirds on the start of the year. Oil prices have since eased slightly, but are widely expected to remain high over the next few years, by the standards of the past two decades. The CBI forecast assumes that oil prices end 2006 at \$50 per barrel; the average price in 1985-2004 was \$21.

It is tempting to compare this position with the two oil price 'shocks' of the 1970s and early 80s, which were followed by high inflation and declining GDP. But there are several reasons to believe that the effect will not be so adverse today. First, oil prices are still some 15% short of the peak reached in 1981, when measured in inflation-adjusted sterling terms. And while they are on a par with the 1974 peak on that basis, the recent upward trend has



been more gradual. Secondly, the UK is a less energy-intensive economy now, thanks to improved energy efficiency and the structural shift from industry towards services. For example, UK energy consumption has risen by only 10% since 1989, despite a 44% increase in GDP.

Thirdly, the 1970s and 80s 'shocks' were caused by a cut in oil supply. Today, though there have been some

CBI ECONOMIC FORECASTS (AUGUST)

% yoy unless stated	2003	2004	2005	2006
Real GDP	2.5	3.2	1.9	2.2
Household consumption	2.6	3.6	1.7	2.2
Government consumption	4.5	3.1	3.2	3.0
Fixed investment	0.1	4.1	3.0	3.3
of which : Business Investment	-2.2	3.4	1.7	1.9
Manufacturing output	0.1	2.1	-0.2	0.7
CPI	1.4	1.3	2.0	2.0
Unemployment (ILO measure), mn	1.48	1.41	1.43	1.45
Public Sector Net Borrowing (£bn)*	35.1	36.9	38.0	39.5
Current Account (£bn)	-16.8	-23.1	-21.2	-23.0
£ effective exchange rate	96.9	101.6	100.2	99.8
World GDP**				
United States	2.7	4.2	3.5	3.3
Japan	1.4	2.6	2.0	1.8
Euro-12	0.7	1.8	1.3	1.7
of which :				
France	0.9	2.0	1.5	1.8
Germany	-0.2	1.6	0.9	1.3
Italy	0.4	1.0	-0.1	1.0

* Financial years

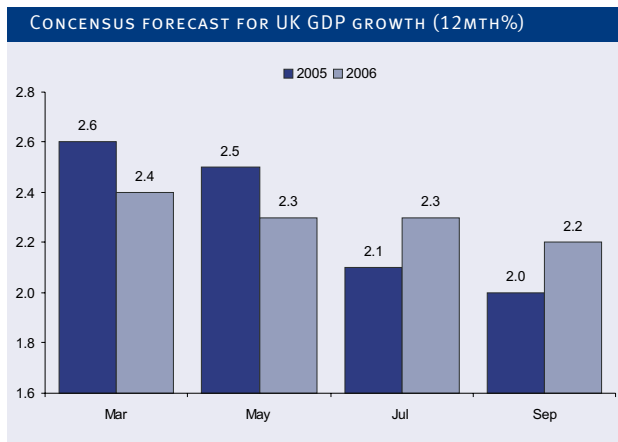
** Source: Consensus Forecasts, September 2005

NOTE: Data used for forecasts was the latest available at the time.

The data may since have been revised - the latest data can be found on page 4

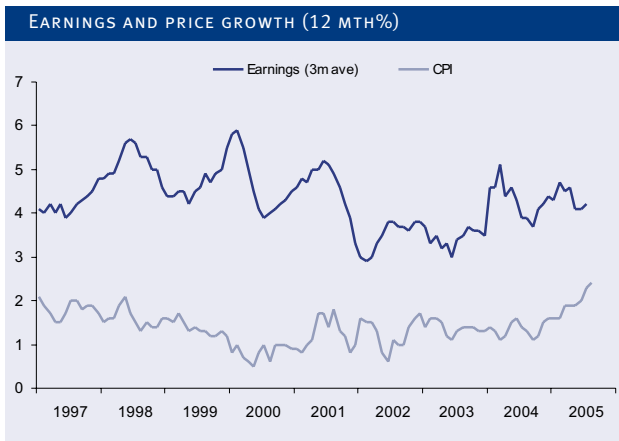
disruptions to output and refining capacity, the main driver of price has been the strength of global demand, including that from China. If as expected global demand continues to grow at a reasonable if more modest pace, UK GDP could continue to expand despite high oil prices. If on the other hand global growth slowed sharply, oil prices should fall back – reinvigorating the global economy in the process. Further, the potential impact on demand in the western world may be more limited than in the 1970s, given the potential for OPEC profits to be recycled back to the west via the financial markets – something which did not happen back then.

Finally, the possibility of the oil price rise feeding a UK price-wage spiral, as in the 1970s, is remote. The labour market is very different, with reduced trade union power, decentralised pay bargaining, and fiercer international competition all working against higher-than-affordable wage settlements. And UK monetary policy is much more credible. Wage bargainers, producers, consumers and the financial markets all know that interest rates will be set at whatever levels required to prevent an inflationary spiral taking hold, and should act accordingly – in turn ensuring that high interest rates should not in the event be necessary, and avoiding any ‘need’ for recession.



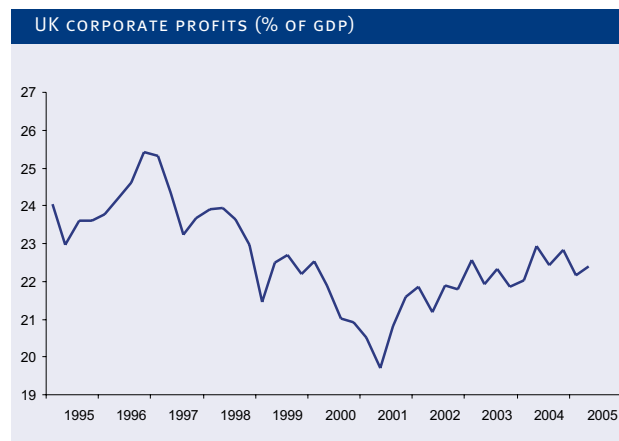
Even so, there will still be a modest impact on growth and inflation. The fall since the spring in the consensus forecast for UK growth this year reflects revisions to past data, as well as the oil price effect. But projections for next year have also been revised down, from 2.4% in March to 2.2% in September. Similar, modest downward revisions can be found in the consensus forecasts for next year’s growth in the US (from 3.4% to 3.3%), Germany (1.6% to 1.3%) and France (2.1% to 1.8%).

While we do not expect any price-wage spiral to assert itself, a small ‘one-off’ impact on consumer inflation is being felt, with CPI inflation up from 1.6% in January to



2.4% in August, thanks to the price of petrol, travel fares and household energy. So while the impact on economic growth and jobs will be limited, individuals will still feel some pain. The gap between earnings growth and CPI inflation has been running at just under two percentage points in recent months, compared with an average of three points between 1997 and 2004. This situation is unlikely to change much over the year ahead.

The (non-oil) business sector will also suffer, squeezed between higher oil-related costs and heightened consumer resistance to price rises. This is especially unfortunate, as it coincides with a host of other constraints on profits growth compared with the 1990s: fiercer global competition; sterling strength; regulatory and tax costs; pension fund top-ups; competition with the expanding public sector for labour and capital; and the high cost of raw materials such as metals. Reflecting these pressures, profits for the corporate sector as a whole appear to have peaked as a share of GDP last year, at a lower level than the previous peak in 1996 – 22.9% versus 25.4%. Going forward, the typical firm will now find profits growth very challenging, despite continued expansion in the wider economy.

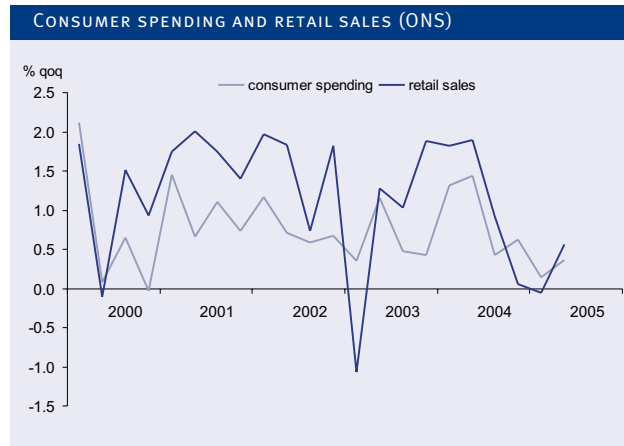


Focus on..... Consumer spending

In the current climate, there is uncertainty as to what direction consumer spending will take. The quarterly data series (chart inset) suggest that the slowdown since the second quarter of 2004 may have found a turning point. The latest quarterly data shows a slight pick-up in growth, both in consumer spending and retail sales. Other data - on mortgage approvals and housing transactions - would also be consistent with us being past the worst.

However, there are sound reasons to expect the growth of consumer spending to remain slow, not least higher oil prices and utility bills. And the latest CBI Distributive Trades Survey - DTS - (see below), casts some doubt on the view that we are indeed past the worst.

Following the close relationship between National Statistics retail sales figures and the CBI DTS

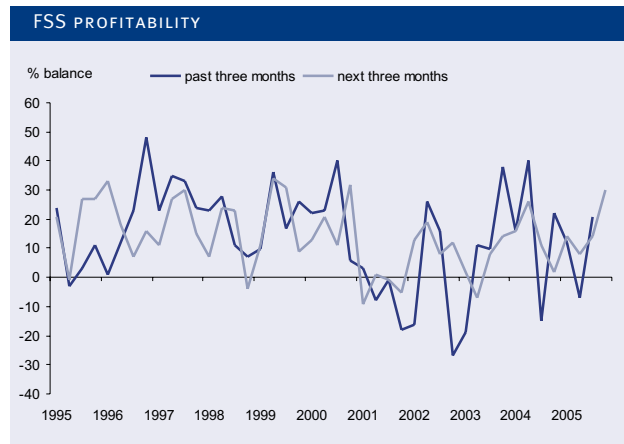


(comparisons made to a year ago), it may well be that the retail sales growth pick-up (chart above) may yet be revised downwards. The data is revision prone.

Recent CBI Survey Results

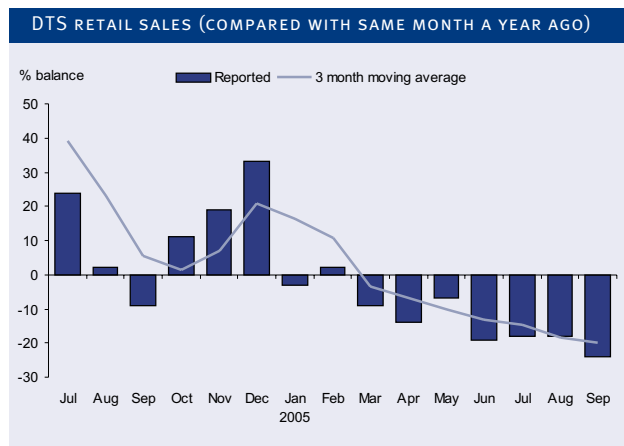
Quarterly Financial Services Survey

- After a moderate first half of 2005, financial services firms saw increases in business volumes, values, profits and employment in the third quarter, with expectations for a similar performance next quarter. Firms expect to invest more strongly in marketing activity and on IT and land and buildings in the coming year than they did in the past year. On a cautionary note, firms saw a squeeze on spreads between lending and borrowing terms for the second successive quarter, as well as rising total costs, and a slight but unwelcome increase in the value of non-performing loans.



Monthly Distributive Trends Survey

- Retailers reported a larger than expected deterioration in the volume of retail sales over the year to September, and sales continued to be well below average for the time of year. Motor traders also saw a larger than anticipated fall in sales, and sales in the sector have now been declining continuously for a year. Wholesalers reported further growth in sales, although at a slower rate than they had anticipated. Looking forward, retailers and motor traders expect to see a further decline in sales in the year to October, whilst wholesalers expect sales to increase at a faster rate.



Key statistics on the UK economy

ECONOMIC INDICATORS		12MTH% UNLESS STATED										
		2003					2004				2005	
		2003	2004	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP		2.5	3.2	2.2	2.5	3.2	3.5	3.7	3.0	2.5	1.8	1.5
Total Fixed Investment		0.0	4.9	-0.2	-2.5	-0.8	2.6	5.7	7.2	4.1	3.3	2.2
Manufacturing Investment		-3.1	2.5	-9.1	-9.9	2.5	-8.5	8.4	7.2	4.4	3.4	2.9
Construction Output		5.2	3.5	5.3	6.7	5.9	5.9	4.0	1.8	1.9	1.8	2.2
Total Household Consumption		2.6	3.6	2.8	2.7	2.4	3.4	3.7	3.6	3.9	2.7	1.6
Company Profits		7.9	6.6	8.7	7.8	6.4	3.1	10.3	5.2	9.6	5.0	1.8
Savings Ratio (%)		5.3	4.2	5.4	5.3	5.7	4.8	4.1	4.5	4.1	4.5	5.0
Current Account (£bn)		-16.8	-23.0	-4.6	-5.6	-6.0	-4.8	-5.4	-9.0	-4.1	-7.3	-3.1
Services Trade Balance (£bn)		16.9	20.2	4.2	4.3	4.2	5.5	5.3	5.0	5.4	4.6	4.8
		2005										
		2003	2004	DEC	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG
Manufacturing Output (3m/3m yr ago)		0.1	1.8	1.2	1.5	1.1	-0.1	-0.8	-1.4	-1.1	-0.6	NA
Retail Sales (3m/3m yr ago)		3.5	6.0	4.8	4.1	3.2	2.8	2.4	1.6	1.5	1.2	1.2
ILO unemployment (mn)		1.49	1.44	1.42	1.42	1.44	1.41	1.41	1.42	1.43	1.42	NA
Goods Trade Balance (£bn)		-47.9	-58.6	-5.3	-5.4	-5.3	-5.0	-5.3	-5.1	-4.2	-5.1	NA
Consumer Prices Index (CPI)		1.4	1.3	1.6	1.6	1.6	1.9	1.9	1.9	2.0	2.3	2.4
Retail Prices Index (RPI)		2.9	3.0	3.5	3.2	3.2	3.2	3.2	2.9	2.9	2.9	2.8
Producer Prices Index - output		1.5	2.5	2.9	2.6	2.7	2.9	3.3	2.7	2.5	3.1	3.0
- input		1.4	4.0	4.4	9.7	10.8	11.0	10.1	7.4	11.9	14.1	12.9
Manufacturing Unit Labour Costs		-1.5	-2.0	-0.8	-0.4	-0.3	1.9	1.7	-0.3	0.1	-0.5	NA
Average Earnings (3mth avg) - manufacturing		3.6	3.6	3.3	3.2	3.5	3.4	3.5	2.9	2.8	2.8	NA
- services		3.4	4.4	4.5	4.4	4.9	4.9	5.1	4.5	4.5	4.5	NA
- whole economy		3.3	4.4	4.4	4.3	4.7	4.5	4.6	4.1	4.1	4.2	NA
FINANCIAL INDICATORS		PERIOD AVERAGE										
		2003					2004					2005
		2003	2004	DEC	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG
\$/£		1.63	1.83	1.93	1.88	1.89	1.90	1.90	1.85	1.82	1.75	1.79
Euro/£		1.45	1.47	1.44	1.43	1.45	1.44	1.47	1.46	1.50	1.45	1.46
£ Effective (Jan 2005=100)		96.9	101.6	101.2	100.0	101.0	101.1	102.0	101.1	101.9	99.0	99.8
UK Base Rate (end month)		3.69	4.40	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.50
U.S. 3-mth interest rate		1.22	1.62	2.50	2.66	2.82	3.03	3.15	3.27	3.43	3.53	3.80
Eurozone 3-mth interest rate		2.33	2.11	2.17	2.14	2.14	2.14	2.14	2.13	2.11	2.11	2.13
UK 10-yr interest rate		4.49	4.87	4.53	4.55	4.62	4.81	4.62	4.41	4.27	4.21	4.30
FTSE 100		4047.2	4521.4	4750.9	4825.9	4999.0	4960.1	4887.8	4926.2	5050.3	5228.0	5307.4
CBI SURVEY DATA*												
QUARTERLY		2003			2004				2005			
		JAN	APR	JUL	OCT	JAN	APR	JUL	OCT	JAN	APR	JUL
Industrial Trends Survey	- business confidence	-19	-27	-13	-7	+17	+12	+7	-10	-22	-15	-16
	- unit cost expectations	-6	+7	-4	-2	-4	+5	+13	+14	+19	+18	+5
	- plant investment intentions	-22	-23	-23	-14	+6	-1	0	-17	-19	-16	-15
MONTHLY		2005										
		OCT	DEC	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP
Industrial Trends Survey	- output expectations	+14	-6	+10	+19	+9	+5	-1	-5	+6	+3	+6
	- price expectations	+1	+10	+19	+11	+9	+5	-3	-6	-11	-8	-8
Distributive Trades Survey	- retail sales volumes	+11	+33	-3	+2	-9	-14	-7	-19	-18	-18	-24

* balance = % of respondents reporting increases less % of respondents reporting falls. For further details on official data please contact the Office for National Statistics, +44 (0)20 7533 6363/6364.

FURTHER INFORMATION

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