

Business Customer Economic Focus

May 2008

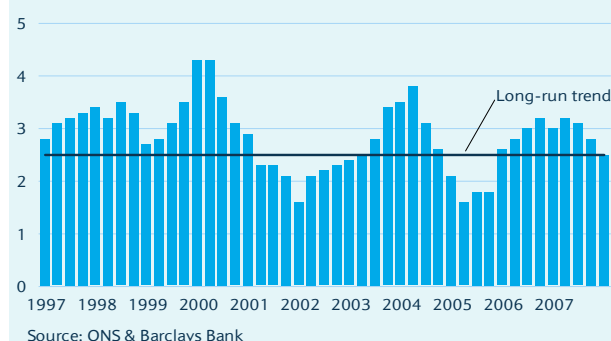
Economic Backdrop

The impact of the upheaval in international financial markets, which originated last summer in the US sub-prime mortgage market, has spread more widely. As conditions deteriorated further in the early months of this year, the backwash has been felt in most developed economies, particularly those with major financial centres. Growth prospects for the UK economy have been progressively downgraded, with a considerably below-trend pace of expansion now expected for both this year and 2009. This is a clear departure from the experience of 2006-07, when growth was running at a robust rate of around 3%. Tighter credit market conditions for households and businesses are likely to hold back both consumption and investment.

UK economic growth slowed to a below-trend annualised rate of 1.6% in the first quarter of the year and could have lost further momentum during the spring. Survey evidence suggests that service sector activity outside of retailing is barely growing, with similar weakness being reported in the manufacturing sector and outright declines in construction. Official **retail sales** data have held up relatively well, but margins are coming

Whole-economy output growth

Annual % change



under increasing pressure and trading updates from retailers suggest that a sharper slowdown lies ahead.

Profitability was strong as the corporate sector entered the current downswing, with non-oil trading profits growing by 10.2% last year. Competitiveness has been helped by the sharp fall in sterling, but generating sales is likely to prove more difficult as the growth in international trade moderates from its recent strong pace. A weaker pound will also add to import costs, with sharply higher prices for fuel and agricultural products adding to margin pressure.

Key UK Economic Forecasts¹

Annual % Change	2006	2007	2008	2009
Real GDP	2.9	3.0	1.7	1.8
Real Disposable Income	0.9	1.2	2.0	2.2
Real Consumer Spending	1.9	3.0	1.5	1.5
Volume of Business Investment	7.1	7.9	2.0	1.0
Export Volumes (goods & services) ²	7.5	0.7	3.3	4.4
Import Volumes (goods & services) ²	6.9	2.8	3.2	3.6
Employment	0.7	0.7	0.6	0.2
Consumer Prices (CPI)	2.3	2.3	2.8	2.5
Average Earnings	4.1	3.9	4.0	3.9
Non-Oil Profits	3.7	10.2	0.0	0.0

¹Forecasts based on 'consensus' view of economic prospects.

²Underlying rate.

Source: ONS, HM Treasury and Barclays Bank.

Business investment rebounded in 2006-07, as strong corporate cash flow and the limited amount of spare capacity in the economy provided powerful incentives to undertake capital projects. But uncertainty about trading prospects as the international economic climate deteriorates, together with a tightening of credit conditions, will encourage firms to conserve cash flow by putting investment plans on hold.

Government spending has made a considerable contribution to demand growth in recent years, reflecting sharply increased spending on priority programmes such as health and education. But the October 2007 Pre-Budget Report and Comprehensive Spending Review confirmed that the period of exceptionally strong public spending growth was coming to an end. Going forward, the spending envelope is considerably tighter, with public sector current expenditure projected to grow by about 2% a year ahead of inflation.

UK exporters have benefited from exceptionally strong world economic growth – which is estimated to have continued to hold close to 5% in 2007 – but the outlook has deteriorated. Those trading with the United States might face particular difficulties as it has suffered most directly from the upheavals in international financial markets. Combined with a loss of competitiveness resulting from the chronic weakness of the dollar, this will hold back export opportunities in North America.

But the bulk of UK exports are to Europe, where trading conditions are likely to prove more resilient as the **eurozone** economies appear less directly exposed to the credit market fall-out. UK exporters will also be able to benefit from a competitive boost resulting from sterling's sharp decline against the euro. The continuing rapid growth of emerging market economies, particularly China, should also underpin the growth in world trade.

Concerns about the **US economy** have intensified, with fears that the sharp deterioration in housing market conditions may already have pushed the wider economy into recession. However, there have recently been signs of the tension in international financial markets beginning to ease and equity markets have regained some of the ground lost in the heavy sell-off that occurred earlier in the year. The Federal Reserve has responded aggressively by announcing deep interest rate cuts and a package of tax rebates is providing a fiscal stimulus.

Until last summer, **UK interest rates** had been raised progressively - with base rates increasing from 4.5% to 5.75% in the year to July 2007 - to prevent demand from running ahead of supply potential and putting upward pressure on pay awards. But monetary policy has now

been put into reverse gear, with base rates being cut progressively to 5.0%. Unlike the position in the United States, where the Federal Reserve has cut interest rates sharply in an attempt to stave off recession, the Bank of England's approach has been measured.

For the Bank of England, the challenge is to steer a course between the conflicting pressures presented by deteriorating output prospects and the threat of inflation expectations being dislodged by higher energy costs and a weaker exchange rate. The surge in fuel and food prices, together with the impact of a weaker pound on import costs, suggests a further rise in **consumer price inflation** from its current rate of 3%. This would require the Governor of the Bank of England to write an open letter to the Chancellor explaining why inflation had moved more than one percentage point above the 2% target. Cutting interest rates against this inflation backdrop would present a policy dilemma, as it could increase the risk of inflation expectations being dislodged.

But there have been no signs that higher living costs are putting pressure on pay awards, with settlements holding around 3%. Weaker bonus payments this year are also likely to help keep overall **earnings growth** running at less than 4%. Subdued wage pressures should increase the chance that inflation will fall back towards the 2% target over the course of 2009. With real wages taking some of the strain, this would limit the impact of rising energy costs on corporate profit margins.

Employment conditions have so far remained strong, despite the slowdown in the economy, and firms are likely to face less need to cut payroll costs if wage pressures are contained.

Financial Environment

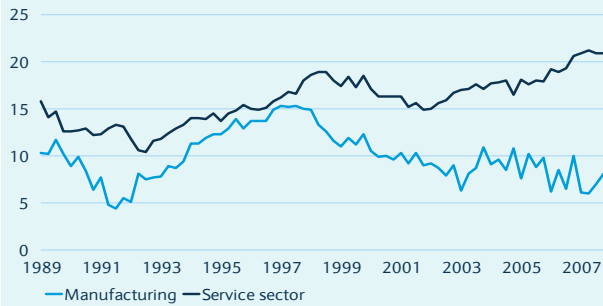
Corporate profitability moved to a record high in the unusually benign economic environment that prevailed following the bursting of the dotcom bubble at the beginning of the decade. **Profits growth** was robust in 2006-07, but a combination of margin pressure and a weaker trading environment suggests a much more subdued outlook.

Despite the recent strength of profits, the benefits have been very unevenly distributed. The return on North Sea operations has been boosted by the surge in oil prices and the profitability of non-financial service companies has surpassed the previous peak established in the late 1990s. But the return on capital generated by manufacturers remains chronically weak, making no clear headway since the early years of the decade.

A strong profit performance as the UK economy enters the downswing means that most companies will be well

Return on capital

Operating surplus net of depreciation as a % of net capital stock



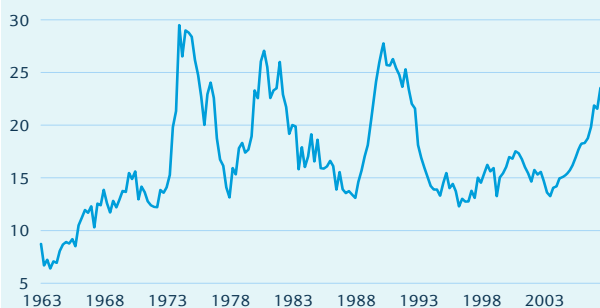
Source: ONS

placed to weather the onset of less favourable trading conditions as demand slows and it becomes more difficult to pass on the higher cost of fuel and agricultural products. In the **domestic market**, above-trend growth is giving way to a period of more sluggish demand and less robust **world economic activity** will result in a slowing of international trade.

The rebound in capital spending in 2006-07 is likely to have contributed to the strength of **bank borrowing**, but greater caution in undertaking investment projects suggests that external financing needs will now grow more slowly. But the financing implications of balance sheet restructuring – often involving heavier reliance on debt – have made the impact of this more traditional driver of the credit cycle difficult to disentangle. UK companies participated fully in the world-wide move to enhance financial performance by gearing-up balance sheets as a combination of share buy-backs and cash-based acquisitions has reduced the importance of equity in corporate balance sheets.

Corporate income gearing

Gross interest payments as a % of post-tax income



Source: ONS & Barclays Bank

Heavy reliance on bank finance to support leveraged buyouts helped push the annual growth of bank borrowing by companies and partnerships into the 15%-20% range in 2006-07 from around 5% in mid 2004. But difficulties in the securitised debt market have led to heightened risk awareness and made new deals difficult to transact. Tighter credit conditions are also likely to contribute to some slackening in bank lending, as

fundamentals do not support a continuation of the rapid pace of growth seen in recent years.

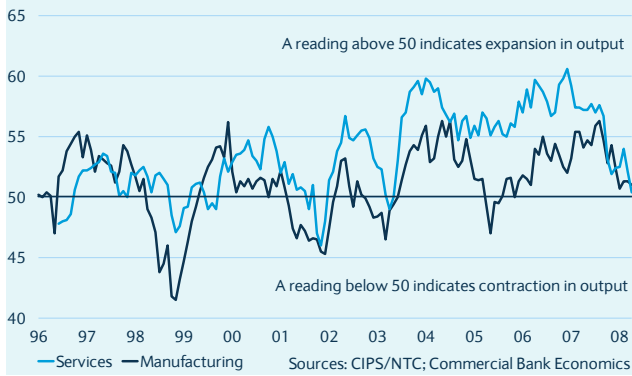
High levels of gross indebtedness have coincided with a rapid build up of **liquidity**, which has kept the corporate sector's net debt to income ratio below the peak level recorded earlier in the decade. The deliberate choice of some companies to gear-up balance sheets has contributed to the increase in **income gearing** seen over the last four years. This increased call on cash flow could make the corporate sector more vulnerable to the deteriorating economic outlook.

Loan demand among **small firms** was unexpectedly resilient in 2004-05 but, unlike their larger counterparts, has grown at a relatively modest pace over the past two years. The emphasis has been on term lending, rather than overdraft borrowing, suggesting a move to put business finances on a firmer footing. Improving trading conditions also allowed firms to build up liquidity, although this is likely to prove more difficult as the economy slows.

Industry Perspective

Manufacturing output was 1% higher in the first quarter of 2008 compared with a year earlier but recent surveys are beginning to flag a loss in momentum. The latest survey by the CBI continues to indicate good order-books but new order flows are easing and manufacturers' sentiment about prospects is being tempered by fears about the risks of the impact of a wider economic slowdown both in the UK and overseas, particularly in the United States. Profitability improved further in the fourth quarter of last year but remains low on a longer term perspective. Manufacturers are encountering strong cost pressures arising from the boom in oil and commodity prices but are able currently to push through increases in output prices, which are rising at their strongest rate since records began in 1986. The recent weakening in sterling against the euro will benefit manufacturers' competitiveness in the major European markets. Overall, we expect manufacturing output to rise by a further 1% this year and by 0.5% next, but profit margins are likely to remain under pressure.

Purchasing managers' survey



Growth in the **construction** sector picked up last year with output rising by about 2.5%. According to data from BERR, new construction work rose by about 4% in 2007 but repair, maintenance and improvement activity was unchanged. In the new build sector, public sector infrastructure and buildings work was depressed but that of private commercial building has risen very strongly, in part driven by buoyant activity in the London office market but also reflecting the benefits of PFI schemes. The private commercial sector is likely to remain a driver of growth in construction activity in the near term as existing projects are completed but new orders in the first quarter are down by 8% compared with a year earlier and are likely to fall further in response to the downturn in the commercial property sector. The output of the private house-building sector rose by 17% last year. But new orders were down by 30% in the first quarter compared with a year earlier and prospects are poor in the near term. Surveys by the Home Builders' Federation have detected a progressive deterioration in the number of new reservations and an increase in the use of sales incentives by house-builders for some time, which shows no signs of abating in the near term given the sharp fall in mortgage approvals.

Retail sales were relatively resilient in the first quarter of this year, increasing by over 5.6% in volume terms compared with a year earlier according to government data. However, the signs are that this performance has been underpinned by aggressive price discounting and

extended sales periods, which will impact retailers' profit margins. And recent business surveys have indicated deterioration in sales in recent months while the major retailers seem to be uniformly cautious and downbeat about prospects as the after effects of the credit crunch and rising inflation weighs down on consumers' expenditure. Trading conditions are likely to be increasingly challenging in the second half of the year, particularly for retailers of household goods and big ticket items.

Activity in the **wholesale** sector has slowed in the past six months. Although trade surveys indicate an improvement in the near term, renewed weakness is expected later in the year as the slowdown in the retail sector feeds through to demand on suppliers/wholesalers. Car registrations have been surprisingly resilient in the first four months of the year and were broadly unchanged from the same period in 2007. However, the profit margins of motor dealers have come under pressure and registrations are expected to fall in the second half of 2008.

Although the **hotel and restaurant** sector (which includes pubs) achieved growth of 4% in the year as a whole, annual growth slowed markedly during 2007, slipping to just 1.5% by the fourth quarter (the latest period for which data are available). The available data for the first quarter suggest that growth has remained subdued. This suggests that consumers have begun to rein in discretionary spending in the face of continued pressure on household incomes and tighter credit conditions. The slowdown also reflects a decline in overseas visitor numbers (and associated spending) in the second half of 2007, especially from the US, where the weak dollar and economic uncertainty appear to have had a negative impact on travel to the UK. While data for the first quarter of 2008 show some improvement in visitor numbers, this has been driven by visitors from emerging market regions and expenditure continues to decline. For pubs in particular, the smoking ban that was extended across the whole of the UK from 1 July 2007, continues to dampen growth, while rising

Output by Industry Group

	2006	2007	2008	2009
Annual % Change				
Manufacturing	1.6	0.6	1.0	0.5
Construction	1.0	2.4	2.5	2.0
Retail and Wholesale Distribution	2.7	3.9	2.0	2.0
Hotels and Catering	6.4	4.0	2.0	2.0
Transport and Storage	5.3	4.2	2.0	2.0
Real Estate, Renting and Business Services	7.0	7.5	3.5	3.5

Sources: ONS and Barclays Bank.

food and utility costs have added to pressures facing operators, although this may have been offset to some degree by a more moderate increase in the annual minimum wage (3.2% from October 2007). Looking ahead, slower forecast growth in consumer spending and overseas visitor numbers means that growth in this sector is likely to remain subdued.

Growth in the **transport and storage** sector accelerated to an annual rate of 5% in the fourth quarter, resulting in full-year growth of 4.2%. This likely reflects resumed growth in goods trade during the second half of 2007 following strong growth in 2006, as well as continued growth in manufacturing, retail and wholesale and construction, which has supported freight transport activity. At the same time, the available data suggest that growth in passenger transport remains supportive. However, profit margins across the transport industry remain under pressure from high fuel costs. Whilst improved trade volumes should help sustain demand for transport services in the year ahead, the slowing domestic economy is likely to see growth moderate.

Output growth in the **post & telecommunications** (telecoms) industry has been intermittent in recent years and remains volatile. At 4.6%, the industry recorded its fastest rate of growth last year since the end of the dotcom boom in 2000-01. However, quarterly data reveal that annual sector growth slowed to just 2% by the final quarter 2007 as the consumer and investment spending growth that had underpinned rapid growth earlier in the year began to slow. Services such as broadband and mobile continue to drive the telecoms industry growth as well as convergence with the IT and media industries. However, the resultant increase in competition continues to drive down the price of combined internet, television, telephone and, increasingly, mobile packages, which in turn erodes profit margins. With consumer spending growth set to slow and the corporate sector likely to be more cautious in the wake of the recent credit squeeze, some sectors of the industry are likely to face a more challenging environment in 2008.

Financial services has been one of the key drivers of the UK economy in recent years supported by a combination of factors including robust global economic growth, as well as buoyant financial markets and merger and acquisition (M&A) activity. Full year growth in financial intermediation activity accelerated to 11.2% in 2007 (a 20-year high), according to the ONS. However, the financial services industry has been negatively impacted by the turbulence in credit and financial markets and there were signs that growth had begun to slow in the final quarter of the year. The continued credit squeeze is likely to result in a marked slowdown in growth in financial services during 2008.

Partly as a result of the strength of the financial services industry, growth in **business services** activity also remained buoyant during the first three quarters of 2007, although here too growth began to ease in the final quarter of the year. While expected to continue to outpace the economy as a whole, growth in business services is, nevertheless, likely to moderate further next year as companies become more cautious amid slower economic growth and the ongoing credit squeeze.

Corporate professional services providers (such as legal and audit firms) have enjoyed double digit turnover growth in the past two years, largely as a result of the continued strength of the financial services industry. However, the recent financial market developments and their impact on related sector growth drivers, such as M&A activity, are likely to have had a negative impact on the prospects for professional services firms, although this may be offset by related litigation and audit work, as well as growth in insolvency activity as the economy slows.

Survey evidence suggests that other higher-value sectors of the business services industry, such as recruitment and management consultants, also continued to enjoy robust growth in the first half of the year, although that in the former has begun to slow as firms have become more cautious in their hiring intentions. Improved marketing budgets provided some support for the advertising industry in 2007. Nevertheless, growth is likely to slow in line with that of the wider economy and consumers' expenditure. At the same time, the steady shift of revenues from 'old' to 'new' media continues to challenge the sector. Firms providing facilities management services have generally seen growth slow during 2007, having previously benefited from the pick-up in demand for commercial property.

The resilience of the UK housing market supported firms providing real estate and other property-related services during much of 2006-07. However, tighter credit conditions combined with already stretched affordability, have seen housing market activity fall markedly in recent months. As mortgage approvals data suggest that recent trends are likely to persist during 2008-09, firms in related sectors are likely to see business decline.

Commercial property values have fallen by around 15% since the middle of last year. Following a long period of double digit growth in capital values, rental yields had been pushed down below the costs of finance (as indicated by 5 year swap rates) and some adjustment had been expected for some time. The adjustment has been exacerbated by the turmoil in financial markets which resulted in a withdrawal of investment demand and the sale of properties by investment funds to meet

redemptions. Rental market conditions remain reasonably robust currently but there are concerns about the implications for future demand if the economy slows and if recent developments in the financial markets impact future demand for commercial property space. While this prospect will continue to overhang the market, property values have already fallen to such an extent that yields have improved dramatically and should begin to provide some support to the sector. Indeed, there are tentative signs that the rate of decrease in capital values is beginning to slow.

In recent years, **public sector services** have benefited from robust growth in government spending aimed at increasing the provision and quality of services, particularly in areas such as health and education. However, this has stretched government finances. The October 2007 Pre-Budget Report (PBR) and Comprehensive Spending Review (CSR) reveal that real annual growth in total government spending will almost halve to 2.1% during the fiscal period 2008-11. This is roughly half the rate of recent years. Although still faster than growth in total government spending, real annual growth in spending on health and education is also set to slow somewhat (to 4% and 2.8% respectively).

More detailed reports on the major sectors are available on the Barclays Internet site, Banking for Business, Industry Reports or use the link below:

<http://www.business.barclays.co.uk/BRC1/jsp/brcontrol?task=articleFWvi4&site=bbb&value=8312&menu=4260>

Overview of English & Welsh Regions

Region	GVA (£bn) ¹	GVA per head (£000) ¹	Income per head (£000) ¹	Business stock per 1,000 people ^{1,3}	New firms per 1,000 people ^{2,3}
East	99.0	17.7	14.6	85	11
East Midlands	74.1	17.0	12.9	75	11
London	217.5	29.0	16.9	100	18
North East	38.8	15.2	11.8	55	9
North West	111.3	16.2	12.7	80	13
South East	167.4	20.3	15.4	95	13
South West	89.5	17.5	13.7	105	14
Wales	42.7	14.4	12.3	80	10
West Midlands	89.0	16.6	12.5	80	13
Yorkshire	82.1	16.0	12.5	70	10

¹Data for 2006.

²Data for 2007.

³Of working age.

Source: ONS and Barclays Bank

Regional Perspective

A disproportionate share of economic activity is located in **London** and the **South East**. On the latest official estimates these two regions accounted for 38% of the value of **goods and services produced** (Gross Value Added or GVA) in England & Wales during 2006, although only 30% of the working age population was resident in these areas. In contrast, only one of the other eight regions – the North West – saw the value of its output reach more than 10% of total output. In addition, the estimates show that there was a significant shift in the balance of the economy towards London and the South East over the decade to 2006, with the share of GVA accounted for by these regions rising by more than 2.5 percentage points over this period.

While GVA shows the distribution of economic activity across the country, it is not a good guide to relative living standards. In part this is due to the fact that the GVA figures presented in the table include the effects of commuting – economic activity produced by people not resident in that region. This is an important influence on London's economy. However, even allowing for this, official estimates of **disposable income per head** (in 2006) show a much narrower range than for GVA. In the case of the North East and London the differential is reduced from more than 90% for GVA (per head) to less than 40% for disposable income.

Aside from the effect of commuting – with some of the pay for economic activity carried out in London accruing to other regions – the lower level of inequality in living standards is primarily a function of the tax and benefit system. Regions with strong economic activity produce disproportionate tax revenues. In turn, the allocation of these revenues to income support and other benefits

disproportionately assist less economically successful areas.

In fact, the variation in living standards is almost certainly lower than suggested by the data on disposable income. This is because **prices** are not the same across the country. Differences in price levels are particularly apparent in housing costs, although they are also present in other areas of spending. Using the example given above – for London and the North East – and making an approximate adjustment for price levels using data from the Retail Prices Index, suggests that the gap in 'real' disposable between the two regions may be 'only' about 20%.

The regional differences, revealed by official estimates of economic activity and income, are also evident in the distribution of the **business stock** and the formation rate of **new firms**. The four regions in southern England – London, East, South East and South West – have business stock levels significantly above the rest of the country. Three of these regions also have relatively high rates of new firm formation, with London having an exceptionally high rate of 'churn' – entry relative to the existing stock – possibly a visible reflection of the dynamic character of its economy. The good performance of the South West on these measures contrasts with a more modest performance for the region on other economic statistics, a reminder that enterprise is only one element of a successful economy.

Business Segment

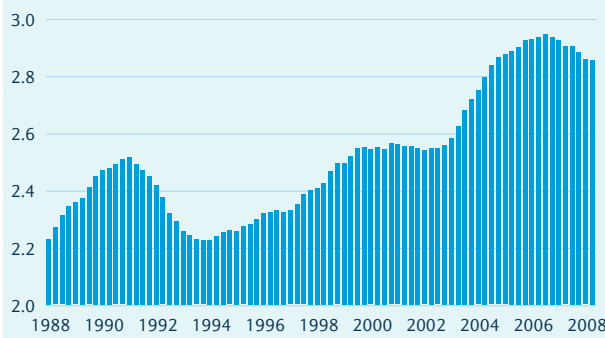
Business Stock

Official estimates show that there were 4.47 million **businesses** in the UK at the start of 2006, an increase of

more than 100,000 (3%) during 2005. The estimates show a continuing rise in the share of incorporated firms in business activity. There were more than 1.1 million independent and ultimate holding companies in 2006, 25% of the total business stock and a marked increase from less than 20% in 1998. This shift reflects a change in the balance of cost and benefit from incorporation, even for the very smallest firms.

Mainstream business stock

England & Wales, millions (start of quarter)



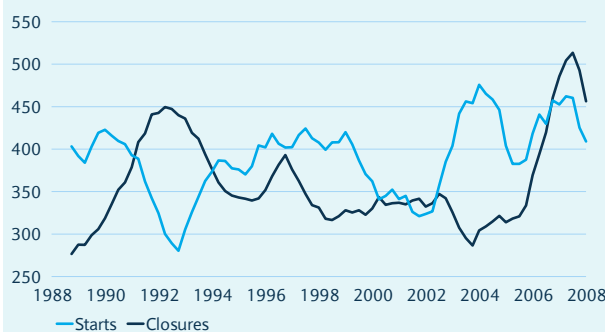
Source: Barclays Bank

Approximately four million firms of the UK business stock are based in England & Wales. The majority of these – about 2.9 million – are **mainstream businesses**. That is, they operate using a defined business current account. Estimates indicate that this section of the wider business stock contracted by about 2% during the course of 2007.

This contraction was the result of a modest decline in the number of new firms, together with an increase in the volume of **business closures**. There were 425,000 start-ups during 2007, a fall of 8% on 2006. Closures continued an increase that began in 2006, rising from 460,000 to 490,000 in 2007.

Mainstream businesses: starts & closures

England & Wales, thousands (four quarter moving total)



Source: Barclays Bank

The increase in closures over the past two years reflects two main factors. One is a return to more typical rates of business closure after very subdued levels between 2002 and 2005. The other was the two year 'surge' in start-ups, beginning in 2002, that resulted in a greater number

of businesses in the peak age range for business closure a number of years down the road.

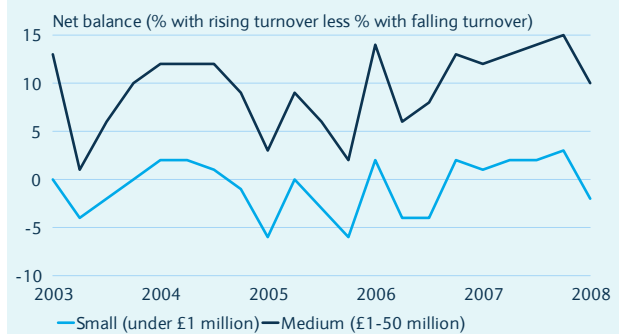
Trading Conditions

Barclays data suggests that sales growth in the SME sector slowed in the first quarter. The net balance for turnover change fell by five points for both small established firms (turnover less than £1 million) and their medium-sized counterparts (turnover of £1-50 million). This is consistent with official estimates of a slowing economy in this period.

The data for the ten **regions** of England & Wales suggest that growth rates were strongest in the East of England, South West and West Midlands, while conditions were more testing for firms in the North East and North West. However, overall variation in sales growth between the regions was quite modest.

Trading conditions

Established small & medium sized firms



Source: Barclays Bank

Among the **business sectors** differences in performance were more marked. Growth rates continued to be strongest in the areas of education and health – both closely linked to core aspects of public spending – with the trading conditions for construction and transport also remaining relatively good. In contrast, hotels & catering, retailing and wholesaling continued to experience growth rates well below average.

Prepared: 20 May 2008

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