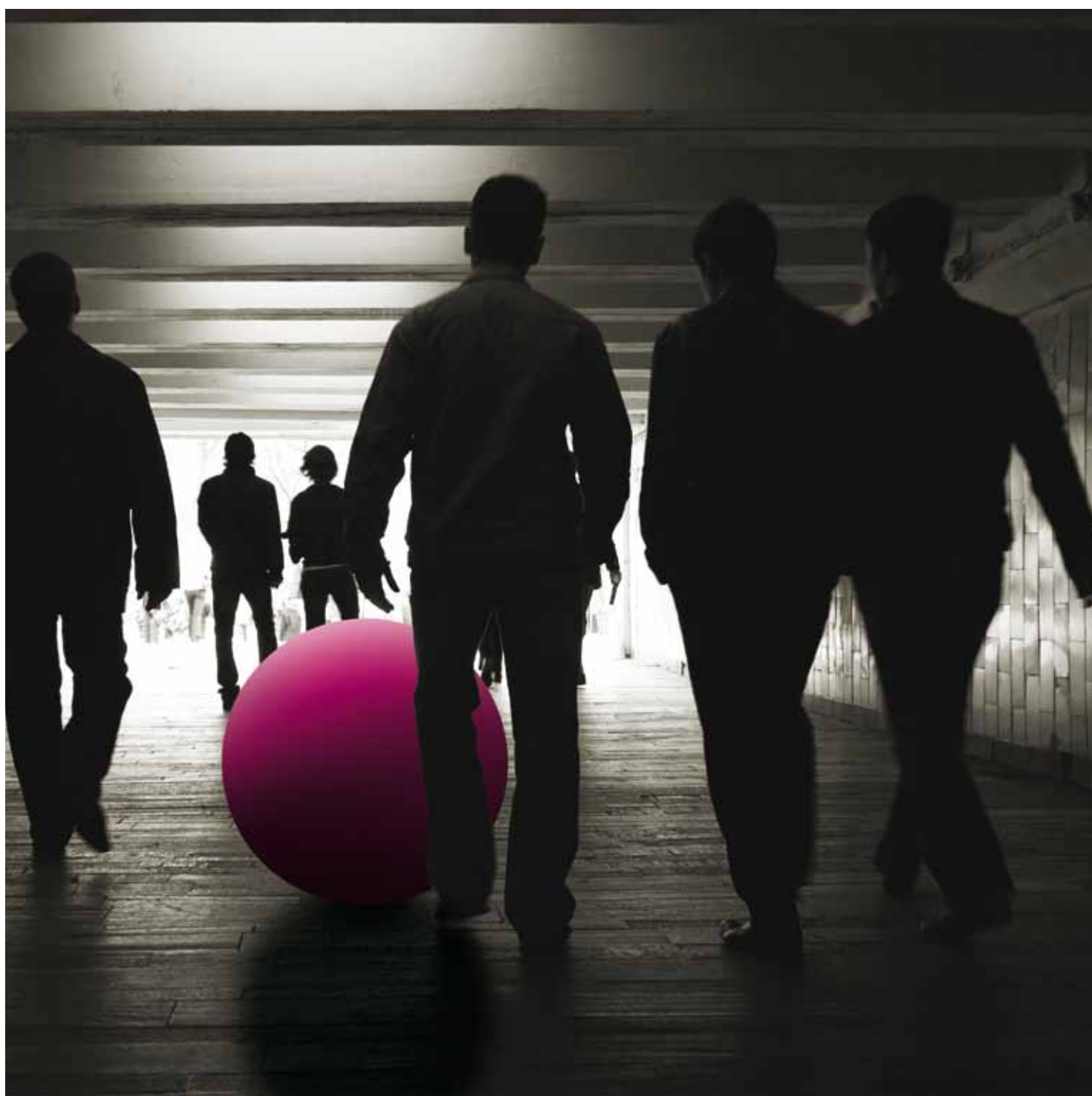


Economic Outlook

Issue 3 – April 2010



Professor Lord Eatwell



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Foreword



Crawling along the bottom

So, was that it? Is the recession truly over now that the economy is growing again? Is it back to business as usual?

Not according to the members of the Chartered Management Institute. CMI's Economic Outlook Survey, conducted in late March 2010, provides insights into how managers' reactions have changed as the recession has "bottomed out".

The short term outlook is better than it was six months ago, but it remains very, very fragile. Business investment is expected to continue falling in 2010 as lending conditions remain tight and firms remain uncertain about future demand. When confidence in the banking sector and capital markets collapsed a key issue was whether businesses would be able to raise finance to sustain activity. In the event, large businesses have been able to take advantage of the improvement in capital markets to raise funds by issuing equity and, to a lesser extent, bonds. In contrast, net borrowing from banks fell throughout most of 2009, with severe funding pressures hitting small and medium sized firms very hard. This survey confirms that managers are still experiencing difficulties in raising finance.

In the short term, it is likely that some of the triggers which made the recession so severe will be reversed quite quickly. The most obvious example is the stockbuilding cycle, which contributed substantially to the severity of the downturn. Similarly, the abrupt reduction in household spending on consumer durables will be temporary. The dramatic fall-off in private house-building also reflects its vulnerability to that area of discretionary spending. Should these factors recover more quickly in overseas economies that were less exposed to the downturn, we should benefit from an upturn in exports.

But household debt and the prospect of sharp cuts in government spending weigh against a rapid recovery. In past recessions, the switch into substantial net household saving was sustained for several years. It is the households that borrowed most heavily and bought at the peak that have had to cut spending most sharply, and it is therefore their behaviour that will have a disproportionate effect on total spending. All this adds up to only a slow recovery in household spending. But higher domestic savings have financed the sharp increase in the national budget deficit, with private sector savings tracking the increasing deficit. In effect we are borrowing from ourselves: British savings are financing the British deficit.

Nonetheless, the political cycle favours early action by the next government, in the hope that growth will pick up in time for the following election. Higher taxes and reduced current and capital spending will weigh heavily on growth for several years, an area of clear concern for British managers. Consequently, once the initial boost from short-term factors has passed, there is likely to be only slow GDP growth in the medium term – though with relatively high profitability courtesy of a falling exchange rate.

In these circumstances, British management faces major challenges: securing the funds and the skilled employees necessary to sustain efficiency, maintaining morale in their organisations, and developing the vision and commitment to the investment needed to rebalance the British economy. That these challenges are recognised is clear from the responses to this Economic Outlook Survey. British managers remain forward looking and their can-do approach is to be cherished – but they need the support of a business friendly stance from the new government.

Professor Lord Eatwell

Chief Economic Adviser
Chartered Management Institute

Introduction

This report is the third of the Chartered Management Institute's (CMI) series of research papers examining managers' views on the economy. It presents the findings of CMI's Economic Outlook Survey, which is conducted on a six-monthly basis to provide insights into the impact of the economy on UK organisations, managers' expectations of future economic performance, and the actions being taken by managers to steer their organisations through the challenges they face. It also examines managers' views on potential government policies to support economic growth.

This paper has been written by Professor Lord Eatwell, CMI's Chief Economic Adviser.

Methodology CMI invited 15,000 of its members to complete an online survey during March and early April 2010, with the first invitations sent out the day after the Government's 2010 Budget. A total of 877 responses were received from across the UK, drawn from industry sectors across the economy and from managers at a range of levels of seniority up to directors and chief executives.

Where reference is made to net percentage points, for example net level of business optimism, this figure is calculated by subtracting the percentage of those who are not optimistic from the percentage of those who are optimistic.

Trend analyses presented in this report are based on data from the Economic Outlook Surveys conducted in September 2009 and March 2009, and – in some cases – on data from a previous CMI survey in September 2008.

Biography Professor Lord Eatwell became CMI's Chief Economic Adviser at the start of 2009. He is President of Queens' College, University of Cambridge and Professor of Financial Policy. He is also Director of the Cambridge Endowment for Research in Finance (CERF). He has been a Visiting Professor at Columbia University, the University of Massachusetts at Amherst, the University of Amsterdam and a teaching fellow at Harvard University.

John Eatwell was previously an economic adviser to Neil Kinnock, the then-leader of the Labour Party. He was made a life peer in 1992 and from 1993 to 1997 was Principal Opposition Spokesman in the House of Lords on Treasury and Economic Affairs. He is currently a non-executive director of SAV Credit and adviser to the private equity firms Warburg Pincus & Company International Ltd and Palamon Capital Partners. He is also Chairman of the Classic FM Consumer Panel.

Summary of findings

- The UK economy**
- **Impact of the current state of the UK Economy** – 82 per cent of managers say the economy is negatively affecting their organisation, the same as six months ago. Those severely affected have risen, from 36 per cent six months ago to a record of 41 per cent. The number of managers experiencing a positive impact has held relatively steady at 9 per cent (compared to 8 per cent six months ago).
 - **Economic performance over the next 12 months** – for the first time since this survey began, more managers expect GDP to grow (27 per cent) than fall (26 per cent) – though the majority expect no significant change (43 per cent). Worries about inflation have grown with 66 per cent of managers expecting it to increase, while serious concerns over business taxation have emerged 64 per cent expect an increase, up from 49 per cent in the last survey. Concerns also remain about the level of employment, with 39 per cent expecting it to fall and only 28 per cent expecting it to rise. Most worryingly, 70 per cent of managers expect business insolvencies to increase.
 - **Investment** – managers continue to expect all forms of investment to be cut. Reduction in the investment in management development is anticipated to fall by 56 per cent of managers, while 52 per cent expect a cut in R&D funding and 41 per cent in ICT investment.
 - **Availability of finance** – 42 per cent of managers have experienced a deterioration in the availability of finance for long term investment, while 40 per cent have also seen a reduction in short term investment. Eighty-one per cent agree that government should introduce measures to improve bank lending to businesses.
- Policy measures**
- **The government deficit** – 67 per cent of managers agree that the UK government should accelerate deficit reduction even though only 22 per cent say it would have a positive impact on their organisation, while 31 per cent say it would have a damaging impact and 47 per cent no impact. Half of managers (49 per cent) think government deficit reduction should happen immediately, while half feel it should be delayed until either ‘green shoots’ of growth appear (22 per cent) or the economy is back on trend growth (29 per cent). Managers are more consistent about the form of deficit reduction measures: 74 per cent say they should take the form of reduced government expenditure.
 - **Skills development** – managers are even more convinced that fiscal support for investment in skills should be a priority (with net support at +81 percentage points). There is also strong support for greater autonomy for businesses over the public investment in skills (+69 net support).
 - **Business taxes** – a majority of managers are against the proposed increase in employer National Insurance Contributions from 2011: 68 per cent oppose the move, with 13 per cent opposed and 17 per cent saying they do not know (net +53). There is net support of +42 for cuts in business taxes.
- UK organisations**
- **Business optimism** – there has been a slight increase in business optimism for the coming six months with net optimism now at +1 percentage points, compared to -3 last autumn, and -4 twelve months ago. This is still some way off the +23 seen eighteen months ago. Managers remain more optimistic over a three year period with a net optimism of +35, although this has weakened from +56 a year ago.

- **Damaging economic factors** – the cost of energy (66 per cent) has replaced government debt (65 per cent) as the most damaging issue facing business over the next six months. Employment disputes have risen to the third most damaging factor (40 per cent) while management skills shortages are also damaging competitiveness (38 per cent).
- **Responses to the recession** – organisations continue to make hard choices to deal with the current economic climate. Over half (52 per cent) have reduced their business overheads and the same proportion have introduced a recruitment freeze. Forty-eight per cent have frozen pay levels and 39 per cent have deferred investment decisions.
- **Job security** – job insecurity is at record levels with 44 per cent of managers feeling insecure or very insecure in their current jobs, compared to 39 per cent six months ago.
- **Morale** – for the majority of managers (63 per cent) employee morale has worsened over the last six months. For 42 per cent of managers, employee engagement had decreased.

Sector differences

- **Impact of the current state of the economy** – managers from the public sector are experiencing the most significant negative impact, with 89 per cent agreeing they are negatively affected – 51 per cent severely. This compares to 81 per cent in the private sector and 84 per cent in the charity/not for profit sector.
- **Business optimism** – public sector managers are most downbeat about their organisations' future prospects. In terms of the outlook over the next six months, net optimism in the public sector is -29 per cent, compared to +11 per cent in the private sector. The net outlook in the private sector is positive for the first time since September 2008, while public sector optimism has collapsed.
- **Government deficit** – 57 per cent of public sector managers think a cut in the deficit would have a damaging impact on their organisations. Despite this, a majority still think the government should accelerate deficit reduction (58 per cent compared to 71 per cent of private sector managers).
- **Morale** – 78 per cent of public sector managers report that morale has declined over the past six months, substantially more than the private sector (58 per cent).

Gender differences

- **Impact of the current state of the economy** – female managers report a slightly more negative impact (86 per cent) from the current state of the economy compared to their male counterparts (82 per cent).
- **Job security** – female managers feel more insecure in their jobs with 48 per cent reporting insecurity, 14 per cent of whom feel very insecure, compared to 44 per cent of male managers, of whom 11 per cent are very insecure.

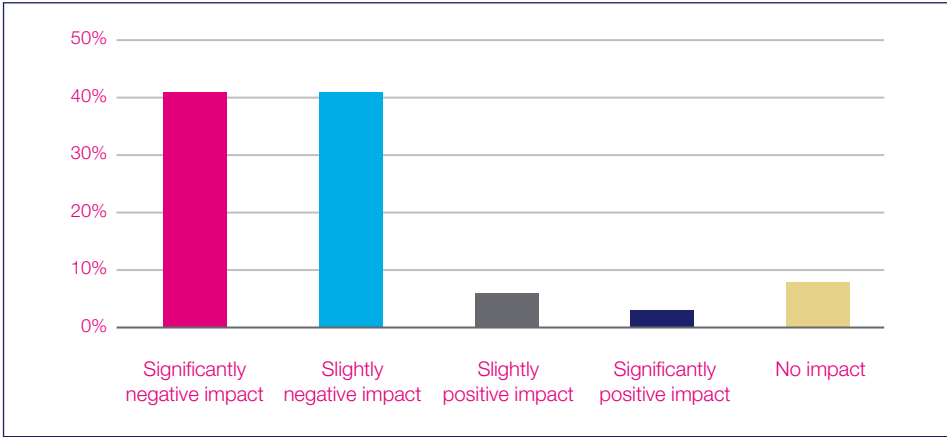
Commentary on findings

The UK economy

Managers report little change from six months ago with respect to the negative impact that the state of the economy is having on their businesses. Eighty-two per cent of our respondents are still suffering negative effects from the overall state of the economy, a figure that is the same as six months ago. Medium and larger organisations are being particularly hard hit. The strongest impression from the survey is that the UK is crawling along the bottom.

There is some glimmer of hope with respect to GDP growth, with those expecting higher growth up from 20 per cent to 27 per cent, although 69 per cent still expect a deterioration or no change. But there are emerging fears about increased inflation. Sixty-six per cent of respondents expect an increase (50 per cent six months ago), and have serious worries about increased business taxation, with 64 per cent now expecting increases compared with just 49 per cent last September.

Chart 1
Impact of economy on organisation



We do not have to look far to find the source of business gloom. All business costs other than labour costs are expected to increase, whilst all the activities that our members really care about – investing in people, productive capacity and new products – are expected to maintain a sharp downward trend. Managers are therefore entirely consistent in looking for reductions in business taxation and regulation to reduce the cost of doing business, and for increased regulation of a financial sector that is failing to meet their needs. There has been no significant improvement in the availability of finance either for short term needs or for longer term investment. The situation with respect to finance is particularly bad for larger companies, with 22 per cent of companies with turnover in excess of £500 million reporting that the availability of short term finance has become “much worse”.

Policy measures

On the broad principles of economic policy there is widespread support for measures to reduce the deficit. An increased proportion of respondents want immediate action: 49 per cent, up from 35 per cent. Three quarters (74 per cent) feel this should be done by cutting expenditure rather than raising taxes (13 per cent) but there is one caveat to this: 31 per cent of respondents predict that cuts in government expenditure will damage their businesses, a figure unchanged from six months ago.

While managers are supportive of the need to accelerate deficit reduction, they are opposed to the increase in employer National Insurance Contributions scheduled for 2011, as shown in Table 1 below. There is also consistently strong net support for cuts in business taxes. Notably, there has been a big increase in those supporting public spending cuts, with net support of +31, which is a 36 point change from -5 in September 2008.

However, the strongest support is once again for a policy of tax breaks for employers investing in skills (+81 net support). In a similar vein, managers would like more control over funding for skills development, with +69 net support, up from +61 six months ago. It is encouraging that UK management has remained dedicated to developing skills even in tough economic times.

Table 1
Net level of agreement
with possible economic
policy positions

	Net level of agreement March 2010
Government should provide tax breaks for employer investment in skills development	81
Government should introduce measures to improve bank lending to businesses	76
Regulation of the financial sector should be tightened	69
Employers and learners should be given greater control over funding for skills development	69
Measures to reduce business regulation should be accelerated	55
The UK government should accelerate deficit reduction	54
The proposed increase in employer National Insurance Contributions from 2011 should be suspended	53
Business taxes should be cut	42
Public spending should be cut	31
Government should direct investment towards green infrastructure	31
Government should restrict international labour movements	24
Import controls to protect Britain from foreign competition	-1
The possibility of joining the Euro should be re-examined	-21
Interest rates should be cut	-26
Government can do little to affect the circumstances of my organisation	-44

UK organisations

As far as the business reaction to the recession is concerned, the current survey tells a story of steady retrenchment. More firms than ever are cutting overheads, freezing recruitment and pay levels – or even introducing pay cuts – deferring investment decisions, cutting prices and reducing dividend payments. On the brighter side, there has been an upturn in attempts to diversify into new markets, and marketing spend has come back after the depths of last autumn.

Table 2
Most common responses
to the recession

	Sept 2008	March 2009	Sept 2009	March 2010
	%	%	%	%
Reduced business overheads	n/a	49	49	52
Recruitment freeze	32	47	50	52
Frozen pay levels	13	33	44	48
Deferred investment decisions	n/a	n/a	39	39
Improved cash flow management	49	36	35	34
Compulsory redundancies	n/a	31	33	33
Voluntary redundancies	n/a	28	29	33
Improved customer responsiveness	61	30	31	31
Introduced new products/services	48	26	27	31
Diversified into new markets	27	23	20	30
Focused on developing core internal staff	44	22	26	25
Increased flexible working	n/a	13	18	24
Reduced price of products/services	n/a	18	18	22
Reduced stock levels	19	20	22	20

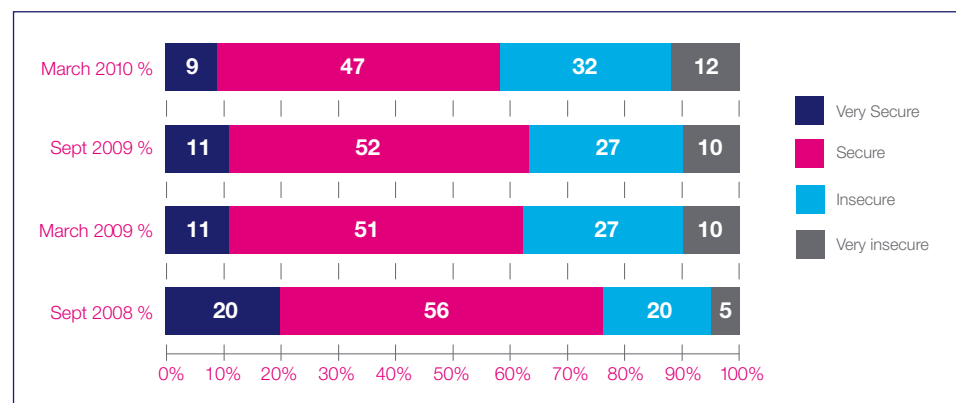
The generally negative views on the immediate future are being driven by, in order of seriousness, the cost of energy, levels of Government debt, fear of employment disputes, management skill shortages, levels of personal debt and pension liabilities. Managers still expect a negative impact on their businesses from the value of the pound, though, given the level to which the pound has fallen over the past year, it is not clear whether their nervousness is derived from an expected rise or an expected fall. Indeed, those operating in export markets were equally divided as to whether changes in the value of the pound would be beneficial or not.

Table 3
Factors impacting
on business over
the next six months:
% damaging impact

	March 2009 %	Sept 2009 %	March 2010 %
Cost of energy	60	60	66
Levels of Government debt	62	62	65
Employment disputes	32	38	40
Management skills shortages	34	38	38
Level of personal debt	42	36	36
Pension liabilities	40	40	35
Changes in value of pound	38	30	35
Labour shortages	29	32	31
Availability of credit	36	28	27
Reducing carbon emissions	21	21	22

Perhaps the most disturbing results to emerge from the survey concern business morale. Fewer managers feel secure in their jobs than did six months ago in the depths of the recession: 44 per cent report feeling insecure or very insecure, compared to 37 per cent previously. Only 9 per cent feel very secure, down from 11 per cent in September, as shown in Chart 2 below. Organisational morale is also suffering, with 22 per cent of managers reporting a situation that is much worse over the past six months, compared with a previous 19 per cent. Employee engagement is also suffering with 42 per cent of managers reporting a drop off in the last six months, and hence, not surprisingly, the ability to attract and retain talent has deteriorated. Far from the recession making employee performance better, with people working to keep their jobs and/or secure new ones, it seems to have made things worse. There has been no improvement in productivity, or in relationships with customers and suppliers. Overall performance is flat.

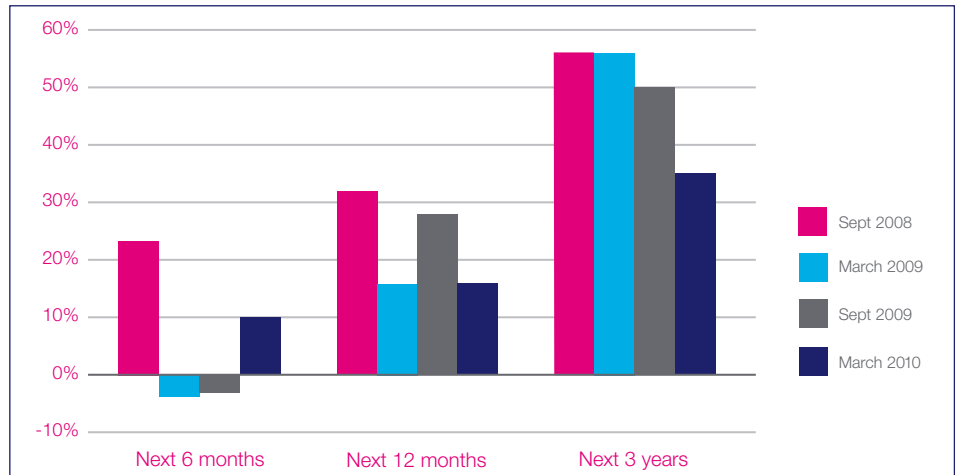
Chart 2
Respondents perceived
security in current job



The economic outlook

It is vital for the future of the economy that managers should be optimistic about the future, since from that optimism grows the enthusiasm to invest and innovate. The net level of optimism for the next six month period remains low with only a slight improvement from -3 to +1. Managers continue to be more optimistic over the next three year period, with +35 net optimism. Nonetheless, even this is down from a score of +56 a year ago.

Chart 3
Trends in net levels of business optimism



However, if we separate the responses from the public sector and the private sector, then a rather more optimistic picture emerges. Facing the threat of cuts from all political parties it is not surprising that public sector managers are pessimistic. But there has been an important turn-around in private sector optimism since the depths of the recession in the first half of 2009, as Chart 4 shows. For the first time since September 2008, the survey records a net positive score for private sector managers' optimism about the economic outlook over the next six months.

Chart 4
Private vs. public sector net six month business optimism



Despite this, there is little positive news with respect to the broad categories of investment. Managers expect there to be continuing cuts in budgets for training, plant and machinery, recruitment, and product development. The negative figures are not quite as bad as they were six months ago, but it would be premature to declare a significant improvement.

Recommendations – the management challenge

These results suggest that British management is facing a major challenge. The recession is undermining the medium term competitiveness of British industry by its impact on investment (in people, machines and innovation) and by its impact on the labour force. In these circumstances, re-balancing the economy, and, more ambitiously, creating an internationally competitive industrial and commercial base is very difficult indeed. Forward looking management is needed – and the survey demonstrates that British management is forward looking, with a majority of respondents displaying optimism about business prospects in three years time.

However, as was noted above, the optimistic majority is smaller than it was six months ago, suggesting that managerial optimism alone will not be enough and that there is a role for government. The optimistic, can-do approach of British management is an attitude to be cherished. They need the tools to do the job. Britain desperately needs a business friendly environment that sustains demand, encourages investment, and ensures a reliable flow of finance to industry.

The top five medium term measures that managers would like to see implemented are derived from their traditional concerns: the necessity of investing in skills and the need to ensure that there is a stable flow of funds available to fund investment.

This is the business friendly package that managers are looking for:

- 1.** Government should provide tax breaks for employer investment in skills development.
- 2.** Government should introduce measures to improve bank lending to businesses.
- 3.** Regulation of the financial sector should be tightened.
- 4.** Employers and learners should be given greater control over funding for skills development.
- 5.** Measures to reduce business regulation should be accelerated.

It is the goal of Britain's managers to put the economy back on its feet. They should be supported in that vital task. As has been clear from all our surveys, what managers need is clarity in economic policy. Business needs to know what government intends to do, in finance, in taxation, in skills policy, and so on. As we approach a General Election the direction of thinking of the major parties must be made clear. Whatever the result may be, managers will be asking: if the economic rules of the game are to be changed, what are the principles on which the new rules will be based?

Business also needs longer term consistency. In the process of re-building the economy clear goals are required, together with clarity about the means of achieving them. Managers know that there is no magic bullet. Instead, a range of policies on skills, on finance, and on innovation, embodied within a coherent framework, is needed. That framework will also require a supportive macro-economic stance that keeps interest rates low and the pound at competitive levels.

Chartered Management Institute

The Chartered Management Institute is the only chartered professional body in the UK dedicated to promoting the highest standards of management and leadership excellence. CMI is the guardian of the National Occupational Standards for Management and Leadership and sets the standards that others follow.

As a membership organisation, CMI has been providing forward-thinking advice and support to individuals and businesses for more than 50 years, and continues to give managers and leaders, and the organisations they work in, the tools they need to improve their performance and make an impact. As well as equipping individuals with the skills, knowledge and experience to be excellent managers and leaders, CMI's products and services support the development of management and leadership excellence across both public and private sector organisations.

Through in-depth research and policy surveys of its 86,000 individual and 450 corporate members, CMI maintains its position as the premier authority on key management and leadership issues.

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