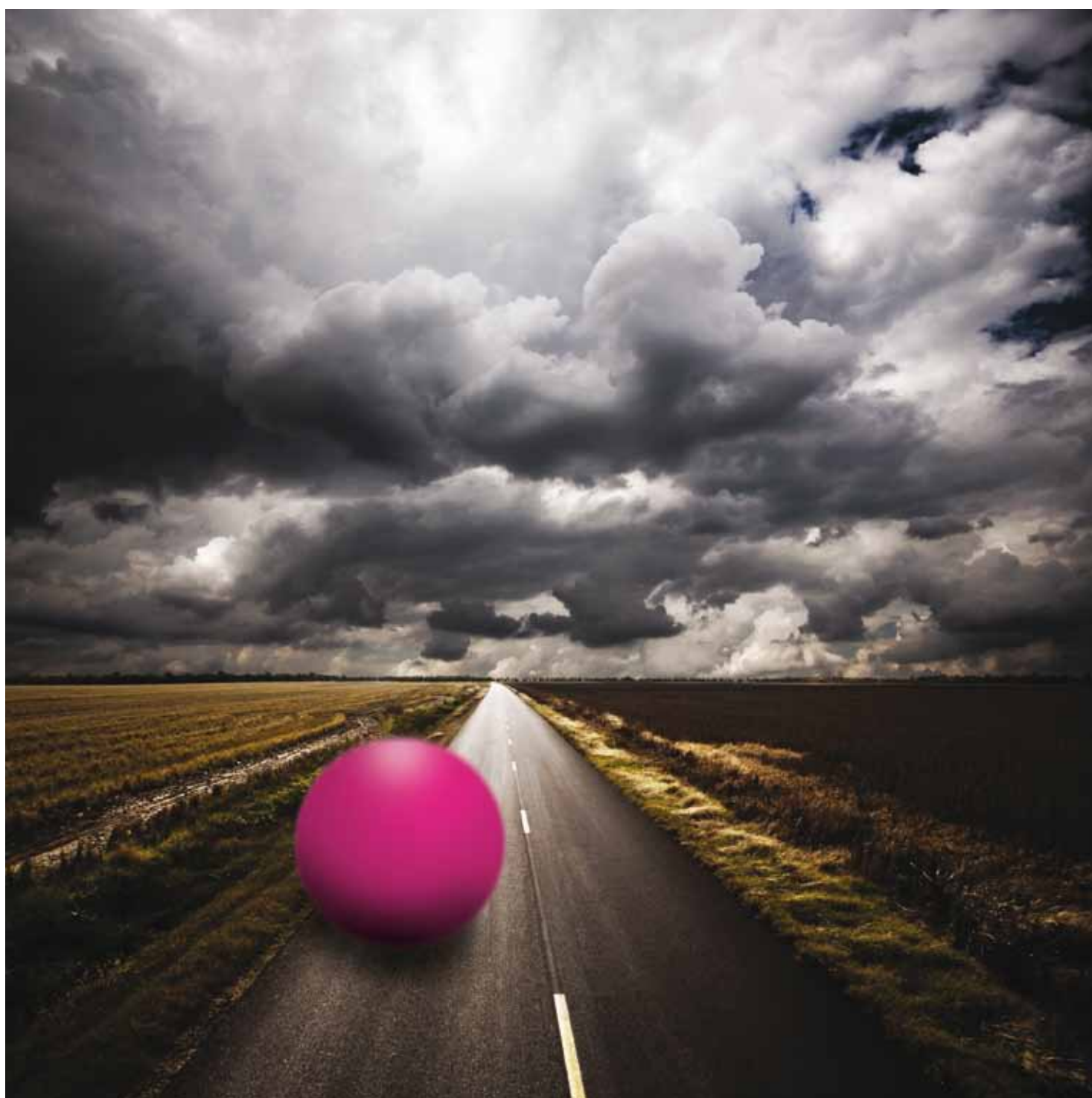


Economic Outlook

Issue 4 – October 2010



Professor Lord Eatwell



Introduction

The Chartered Management Institute's (CMI) Economic Outlook research series examines managers' views on the economy. This fourth edition presents the latest findings from the Economic Outlook survey which has been conducted on a six-monthly basis since September 2008. The report provides insights into the impact of the economy on UK organisations and managers' expectations of future economic performance. It also reviews managers' support for different public policy measures and the actions being taken by managers to steer their organisations through the challenges they face.

Methodology CMI invited 15,000 of its members to complete an online survey during late August and September 2010. A total of 820 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.

Due to rounding charts and tables displaying percentage figures may not add up to 100.

About the author



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, and the University of Amsterdam, and a teaching fellow at Harvard.

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 and the Royal Opera House Pension Fund. He is a Financial Commissioner for Jersey.

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Foreword

Storm clouds ahead for Britain's managers

This survey reveals that the UK economy is in a very serious position. Sharp falls in business optimism and morale are being reflected in plans to cut investment and employment. Much needs to be done to return the UK to acceptable levels of economic activity. Some things are in the hands of the Government, and others – notably what happens to international financial reform and to the performance of the Eurozone – are not.

The onset of the financial crisis two years ago led to a remarkable display of international unity and commitment at the G20 summits. Unfortunately, at the G20 meeting this June, that unity began to fracture. It now seems likely that the lowest common denominator will prevail, and that instability will remain a characteristic of global financial markets – with potentially serious consequences for the UK.

Meanwhile, the past year has cast doubt on the future of the Eurozone, destination of 55 per cent of UK exports. The response to the onset of the Greek crisis in January was a protracted debate on a Greek “bail-out”. At last, a €750bn guarantee fund was set up in May. But delay had fed the flames of volatility and it is not clear that this will be enough. These events exposed serious flaws in economic authority and management at the core of the Eurozone and that is bad news for Britain. We need Eurozone growth to fill some of the void left by cuts in Government spending.

The growth of demand for British goods and services is central to the future of our economy. Businesses need the prospect of growing demand in order to invest and innovate.

However, there has been a massive withdrawal of demand by the private sector. Households and businesses have increased their net savings by 10.5 percentage points of GDP. If those savings are not channelled back into spending the fall in output would be catastrophic. That is usually the job of the financial sector, but it is desperately cutting lending in an attempt to rebuild shattered balance sheets. So instead the Government has raised its net-spending (the deficit) as a share of GDP by about 9 percentage points, offsetting much of the decline in private sector demand.

Now the Comprehensive Spending Review will put that process into reverse, with the Government withdrawing demand by immediate, major cuts in spending. The question is: where then will demand come from? There are four possibilities: household consumption spending, increased private investment in house-building, increased investment by firms, and greater demand from abroad.

It is difficult to be very optimistic about growth in private spending, particularly spending on new houses. As for exports, the fall in the pound may lead to a better trade performance, but foreign markets are likely to be very tough territory in the next few years.

That leaves business investment as the key element in recovery and indeed the Office for Budget Responsibility has forecast that business investment will make a positive contribution of 1.1 per cent to the growth of GDP – although that is three times greater than it managed in the relatively prosperous period 1999-2008. Investment depends crucially on confidence in growing markets in the future and on a reliable supply of finance, yet lending to industry by British banks has fallen this summer.

This Economic Outlook surveys the opinions of Britain's managers on investment and employment, on their views of the future and on their access to finance. It reveals deep and growing pessimism and suggests that the flow of finance is still severely restricted. If Government policy is to be a success, managers must have access to the tools to do the job, and the confidence that economic circumstances will make using them worthwhile.

Professor Lord Eatwell

Chief Economic Adviser
Chartered Management Institute

Summary of findings

- The UK economy**
- **Impact of the current state of the UK economy** – the number of managers reporting that the economy is negatively affecting their organisation has stuck at 82 per cent in the last two surveys. Those being severely impacted continues to rise and is now at a record level of 45 per cent.
 - **Impact of the economy by sector** – the survey suggests the economy is having a significantly worse impact on the public sector than other sectors. Some 96 per cent of public sector managers report they are being negatively affected by the economy – 74 per cent being severely affected. This compares to 32 per cent severely affected private sector managers.
 - **Economic growth over the next 12 months** – the proportion of managers expecting GDP to grow has fallen from 27 per cent six months ago to 19 per cent, and the number expecting a fall, a “double dip”, has risen from 26 per cent to 29 per cent – though the largest group expect no significant change (43 per cent).
- Policy measures**
- **Government deficit reduction** – around half of managers (46 per cent) think that the Government is taking measures to reduce the deficit “at about the right pace”, while 35 per cent think that the deficit is being reduced too quickly. Over three quarters of managers say deficit reduction should come from reduced Government expenditure rather than increased taxation, either at the current 80:20 rate, or with even greater emphasis on cuts. Ninety per cent of public sector managers think a cut in the deficit would have a damaging impact on their organisations (up from 57 per cent six months ago).
 - **Comprehensive Spending Review** – 76 per cent of public sector managers believe the Comprehensive Spending Review to be a threat to their organisation, compared with 37 per cent of private sector managers.
 - **Taxes** – 56 per cent are against the proposed increase in Value Added Tax to 20 per cent in 2011, while 49 per cent of managers (down from 58 per cent) support cuts in business taxes. Sixty-four per cent are keen on the idea of giving new businesses an exemption from National Insurance on their first 10 employees.
 - **Skills development** – as ever, Britain’s managers are convinced that fiscal support for investment in skills should be a priority (84 per cent of respondents). There remains strong support for greater autonomy for businesses over public investment in skills (69 per cent of managers).
- UK organisations**
- **Business optimism** – there has been a serious deterioration in business optimism over the last six months, with a net position of -16 on the six month horizon (against +1 six months ago). Managers remain more optimistic over the medium term with a net optimism of +23 over a three year period, although this is down from +35 earlier this year and +56 eighteen months ago.
 - **Business optimism by sector** – there has been a collapse in optimism in the public sector, over the next six months, net optimism is -49 per cent, compared to -29 per cent six months ago, and +2 per cent in the private sector (down from +11 per cent). Looking three years ahead public sector managers remain pessimistic (net -32 per cent), whilst the private sector is very positive (+52 per cent), though this figure remains low compared to that in 2008 (+67 per cent).
 - **Investment** – managers continue to expect all forms of investment to be cut even further. In every dimension of investment from marketing to plant and machinery to product development, the expectation is for decreased activity. Cuts in training and management and leadership development are greater than six months ago.

- **Availability of finance** – 48 per cent of managers have experienced a deterioration in the availability of finance over the long term (up from 42 per cent) while 47 per cent (up from 40 per cent) have seen a deterioration over the last six months for short term investment funding.
- **Damaging economic factors** – the impact of the cost of energy remains a significant fear amongst Britain’s managers. Government debt is also seen as a damaging factor, though its salience has weakened somewhat (to a figure of 61 per cent, 65 per cent six months ago). Pension liabilities have now risen to the third most damaging factor (43 per cent).
- **Responses to the recession** – organisations continue to make hard choices to deal with the current economic climate. Pay freezes are sharply up (implemented by 60 per cent of managers compared with 48 per cent six months ago). Over half (53 per cent) are reducing their business overheads and have frozen recruitment.

UK managers

- **Job security** – job insecurity is at record levels with 38 per cent of managers feeling insecure (up from 32 per cent six months ago) and 13 per cent very insecure (up from 8 per cent). Insecurity is greatest amongst women managers, and regionally, the north of England and the west Midlands are worst affected.
- **Morale** – for a large majority of managers (68 per cent) employee morale has worsened yet further over the last six months. For 85 per cent employee engagement has either stagnated or decreased.

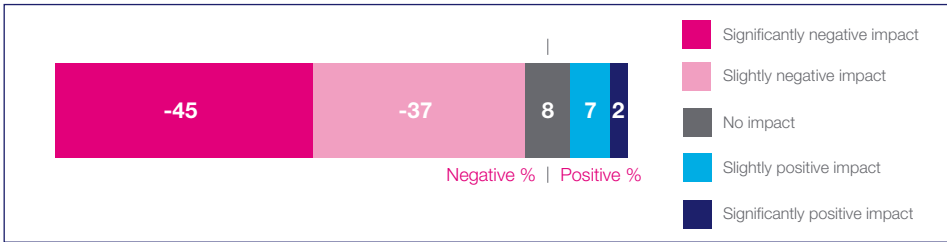
Commentary on findings

It is clear from this latest CMI Economic Outlook survey, that Britain's managers believe the economic condition of the country to have deteriorated since our last survey in April of this year – and deteriorated seriously. There are a few chinks of light. For example, 21 per cent of respondents assessed the overall performance and financial results of their organisation to be “slightly better”, compared with only 16 per cent a year ago. But even this has to be seen in the context of a seriously negative overall assessment of performance, a downgrading of investment intentions (whether in capacity or skills) and an appalling collapse of morale (particularly startling in the public sector, but dramatic enough in the private sector too). This survey captures the views of a managerial class supervising an economy in deep trouble.

The UK economy

The Government has two central economic goals, alongside the central programme of deficit reduction. First, the enhancement of public sector efficiency, second, and most importantly, that the private sector should expand to take up the resources being released by the public sector. This survey indicates that the people who the Government is relying on to attain both these goals are very concerned about the possibility of a positive outcome.

Chart 1
Impact of economy on organisation



Any hope of an “upturn” in economic fortunes is dashed by net balance (positive respondents minus negative respondents) of 73 per cent of managers who report that the state of the economy is having a negative impact on their organisation. This is worse than the number recorded in March 2009, in the statistical depths of the recession, of 70 per cent. The results are particularly gloomy in the public sector, with a net 93 per cent, as compared with a private sector net 61 per cent. But even in the private sector there is no significant improvement to be found.

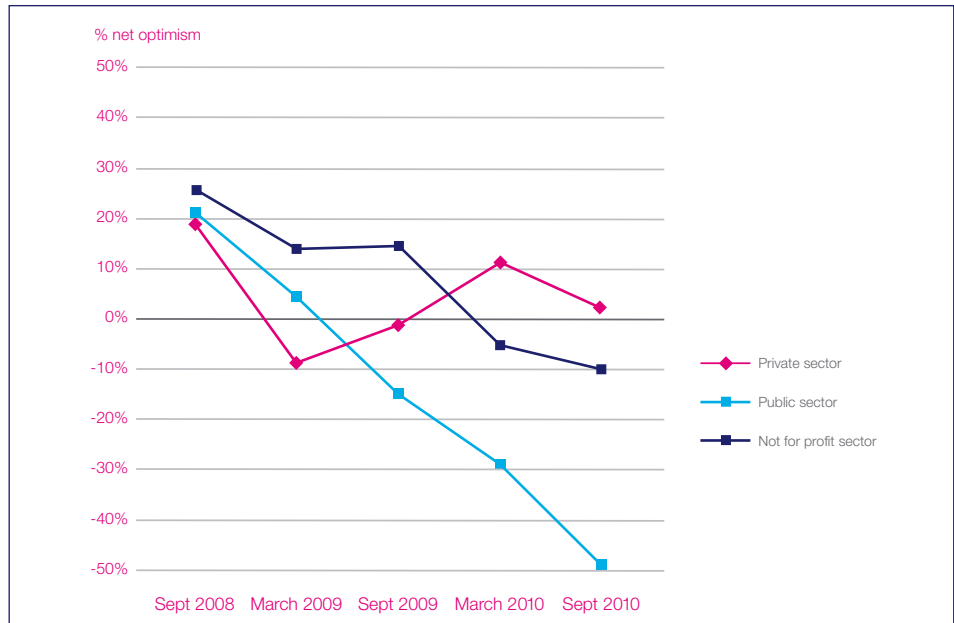
The economic outlook

Looking forward, levels of business optimism are down, whether the horizon is six months, a year, or three years. Unsurprisingly, the decline in optimism is nothing short of catastrophic amongst public sector managers. However in the private sector too, all optimism measures have declined over the past 6 months, the only exception being private sector optimism over the 3 year period where views are unchanged and remain quite optimistic at 52 per cent.

A persistent theme of the survey is the collapse in nearly all measures of public sector economic health. In our last Economic Outlook we highlighted the difference in business optimism that had emerged between the public and private sectors and, as shown below, that divergence has become even more pronounced. Indeed, we are now dealing with two groups of people encountering very different managerial problems.

The reason for the divergence is obvious – the Government promise of very large spending cuts in the Comprehensive Spending Review due on 20 October. It is hardly surprising that the two groups have very different assessments of the impact of those cuts. But this divergence, serious though it is, should not be allowed to obscure the fact that there has been a downturn in private sector optimism too.

Chart 2
Net six month business optimism by sector



Worries about inflation have also grown again, up from 66 per cent to 68 per cent (it was 50 per cent a year ago), while the number expecting employment to either stagnate or fall is up to 77 per cent (from 71 per cent) with only 22 per cent expecting an increase. Most worryingly, is that 74 per cent of managers expect business insolvencies to increase.

These findings bear directly on the current debate over how to deal with the Government deficit. The sharp cuts in Government expenditure that are planned will leave a big hole in aggregate demand. In the face of this withdrawal of public sector demand, where is the demand going to come from to drive the UK economy?

The answer should be business investment. However, unfortunately our survey results do not support this. Managers continue to expect all forms of investment to be cut. Falls in investment are expected in recruitment, management consultancy, plant and machinery, training and development, management development, pay, research and development, IT and corporate social responsibility. All indications are that investment is expected to fall – and fall more rapidly than at any ever before. This does not suggest the rise in investment that is required to drive Britain's economy forward.

Table 1
Organisational investment decisions over the next six months

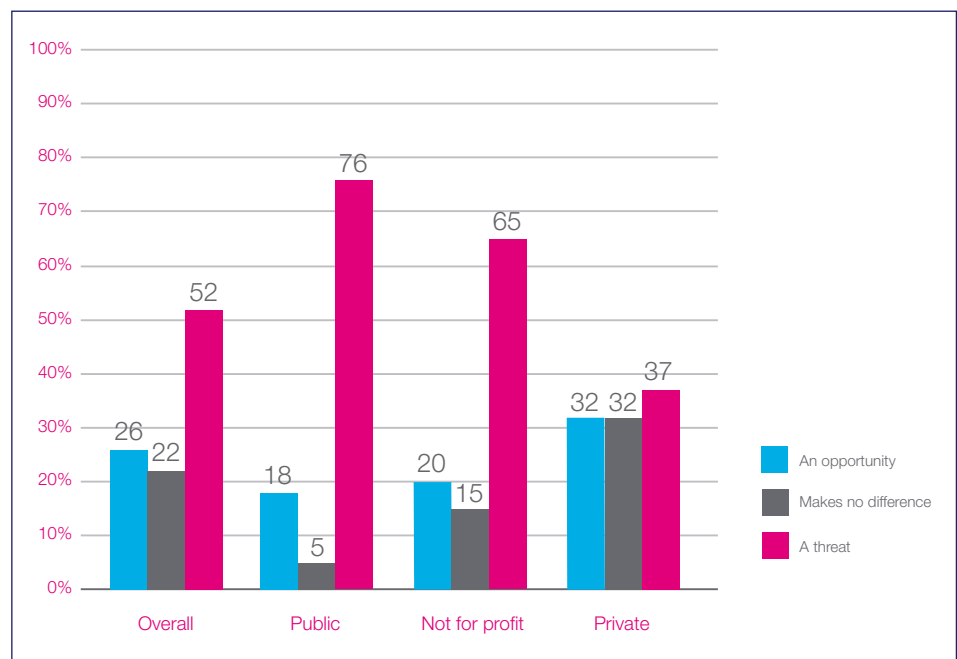
	Sept 2008	March 2009	Sept 2009	March 2010	Sept 2010
	net level of change				
Recruitment	-19	-38	-30	-22	-37
Management consultancy	-20	-30	-29	-23	-34
Plant and machinery	-11	-26	-28	-21	-24
Training and development	13	-21	-16	-13	-23
Management and leadership development	n/a	-22	-14	-10	-19
Employee pay	n/a	-12	-10	-1	-18
Product research and development	11	-14	-14	-8	-17
IT	16	-17	-10	-4	-16
Corporate social responsibility	6	-9	-11	-6	-16
Marketing	31	7	8	16	1
Business development/sales	38	12	14	21	14

Policy – the Comprehensive Spending Review and beyond

As the discussion above illustrates, the Government's Comprehensive Spending Review is the major economic policy issue of the day – perhaps even of recent decades. So what do managers think about it?

At the broadest level, 52 per cent of managers see October's Comprehensive Spending Review as a threat to their organisation (37 per cent of private sector managers, 76 per cent of public sector managers and 65 per cent of managers in not-for-profit organisations), while only 26 per cent see it as an opportunity (32 per cent private sector, 18 per cent public sector, 20 per cent not-for-profit). The distinction between the private and public sectors is stark, even though expected. But it is worth making the point that the private sector figures are not in the least encouraging. Overall, 65 per cent of managers expect the Government spending cuts to have a negative impact on their organisation.

Chart 3
Comprehensive Spending Review as an opportunity or threat to organisation



Despite this, around half of managers (46 per cent) still think that the Government is taking measures to reduce the deficit “at about the right pace” – only 35 per cent think that the deficit is being reduced too quickly. Over three quarters of managers say deficit reduction should come from reduced Government expenditure rather than increased taxation, either at the current 80:20 rate, or with even greater emphasis on cuts.

Even in the face of such pressures on them and their organisations, Britain's managers retain a commitment to open markets. The interest in restricting labour movements evident in our survey six months ago has now waned and the upswing of support for import controls has been sharply reversed. The enthusiasm for joining the Euro that accompanied the onset of the Irish banking crisis has disappeared altogether.

Table 2
Net level of support
for possible economic
policy measures

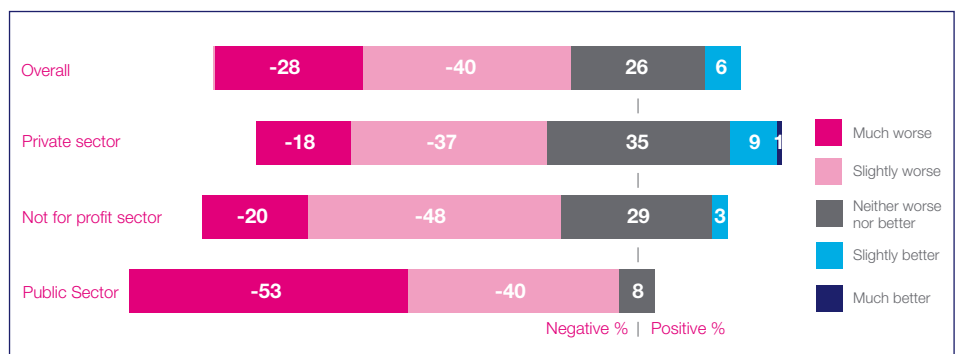
	Net level of agreement Sept 2010
Government should provide tax breaks for employer investment in skills development	79
Government should introduce measures to improve bank lending to businesses as a matter of urgency	76
Regulation of the financial sector should be tightened	75
Employers and learners should be given greater control over funding for skills development	62
Measures to reduce business regulation should be accelerated	51
New businesses should be given National Insurance exemptions on their first 10 employees	50
The UK Government should continue with accelerated deficit reduction	38
Government should direct investment towards green infrastructure	37
Public spending should be cut	33
Business taxes should be cut	30
VAT should not increase to 20%	29
Government should restrict international labour movements	18
Import controls to protect Britain from foreign competition	-15
Interest rates should be cut	-39
Government can do little to affect the circumstances of my organisation	-56

Managers are broadly against the proposed increase in Value Added Tax to 20 per cent in 2011 (56 per cent), although 27 per cent are for the tax. Support is strong for the idea of giving new businesses exemption from National Insurance on their first 10 employees (64 per cent agreement). Managers support low interest rates with 62 per cent against a rise.

UK organisations

In light of the worrying findings about the state of the economy reported above, it is unsurprising that over two-thirds of managers report deteriorating morale in their organisations. While some 55 per cent of private sector managers report declining morale, an extraordinary 93 per cent of public sector managers are experiencing worsening employee morale.

Chart 4
Employee morale



Job insecurity is at record levels with 38 per cent of managers feeling insecure (up from 32 per cent six months ago) and 13 per cent very insecure (up from 8 per cent). It is also worth noting, because it has been a topic of some political concern, that there is a significant gender difference in the perception of job security in the recession. Of women managers, 58 per cent are now feeling insecure in their jobs, including 18 per cent who feel very insecure. Amongst men the corresponding figures are 48 per cent feeling insecure, including 11 per cent feeling very insecure.

Table 3
Job security by gender

	Very insecure	Insecure	Secure	Very secure
	%			
Male	11	37	45	7
Female	18	40	40	3

The cost of energy remains a significant problem for Britain's managers. Indeed this is seen as potentially the most damaging issue facing business over the next six months. This is an important finding, given that energy costs have not been a prominent element in recent economic policy debate.

Table 4
Factors impacting on
business over the
next six months:
% damaging impact

	March 2009	Sept 2009	March 2010	Sept 2010
	% damaging impact			
Cost of energy	60	60	67	61
Levels of Government debt	62	62	65	61
Pension liabilities	40	40	36	43
Employment disputes	32	38	40	41
Management skill shortages	34	38	38	40
Levels of personal debt	42	36	37	36
Labour shortages	29	32	30	34
Changes in value of pound	38	30	35	28
Availability of credit	36	28	28	27
Reducing carbon emissions	21	21	22	18

Government debt is still seen as a damaging factor, though its salience has weakened somewhat (to a figure of 61 per cent, from 65 per cent six months ago), perhaps as a result of the Coalition Government's focus on reducing the deficit. Pension liabilities have now risen to the third most damaging factor. Worries about the impact of industrial action remain a major concern.

The availability of credit to organisations – central to their ability to invest and grow – has fallen sharply. Those reporting a deterioration in the availability of credit for short term needs has risen from 40 per cent six months ago, to 47 per cent now. Similarly, for long term credit needs, those reporting a deterioration in the availability of finance have grown to 48 per cent from 41 per cent six months ago. Among private sector managers, those in large firms are more likely to report an improvement in lending conditions than those from small firms (17 per cent compared to 8 per cent).

Recommendations – the management challenge

Managers are the people at the “sharp end” of British industry. It is vitally important for the future of the economy that they see real opportunities and have the tools to grasp them but the poor prospects for investment and the perennial problem of a lack of finance bode ill. Meanwhile, public sector managers face enormous change driven by the new Government’s agenda.

Managers know there is no magic bullet to improve the situation they face. But they still believe that Government can help them turn their organisations around. Their priorities are very clear:

- Financial aid, such as tax breaks, to support investment in skills, plus greater control over the funding of skills development
- A reliable flow of bank lending – instead of the current situation where the banks are net borrowers from business
- Tighter regulation of the financial sector to de-risk Britain
- The prospect of growing demand for goods and services.

The change Britain needs will be achieved by persistent commitment to a wide range of complementary measures: in fiscal and monetary policy, in legal structures that define corporate governance and the scope and structure of markets, in education and training, in trade policy, transport policy, urban planning and in social security. All the elements of social and economic policy need to be aligned to the clearly defined goal of building a more productive, more competitive Britain, with straightforward, coherent goals on which all Government policies are focused.

As regards the banks, they of course must be helped to recover. But we need more lending to industry now, not in three year’s time. Banks are not lending because they are trying to repair their balance sheets, while companies are not borrowing because they are fearful of the future and borrowing has become too expensive. We need a new approach to financing industry, something that the many managers who support spending on green infrastructure recognise. Establishing a new Investment Bank, funded through the bond market, with the remit of ensuring that lending on reasonable terms is available to innovative investments by small and medium sized industries, would be an important step. It would end the funding drought, give banks time to build a secure financial system, and help drive vigorous competition in industrial lending instead of the current malaise.

But confidence in management skills will always be an important component in securing finance. It is the CMI’s mission to improve the quality of British management and investment in management development is complementary to the successful evaluation of lending proposals.

Ultimately, the key to recovery is securing British management’s confidence in the future. Managers need to know that there is a clear and consistent economic programme that will deliver a path of growing demand in the future that they can believe in.

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 sets the standard 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.

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