

Dear CBI member,

One year after the first shock of the credit crunch, this seems a good moment to reflect on current business conditions in the UK, and on the policies best suited to get us through these troubled times. The short term pressures are intense. But it's vital that Government and business do everything possible to ensure that the UK is well positioned for the recovery that will emerge once we are through this stage of the business cycle.

The CBI, along with most other forecasters, has been consistently overoptimistic about the economic outlook over the past 12 months. There have been two main explanations.

The first is that the surge in price inflation – mainly in energy and food – took us by surprise. In July last year, inflation as measured by the Consumer Price Index was running at 1.9 per cent, and the Bank of England expected that it would remain around that level – close to its target – well into 2010. Fast forward 12 months, and it now seems likely that CPI inflation will peak somewhere around 5 per cent later this year.

This has been a double blow. First, the fact that inflation has been running so far above target has meant that the Bank has not been able to cut interest rates to support a rapidly slowing economy. Second, it has put a sharp squeeze on household budgets, which is now being reflected in surveys showing steep declines in consumer confidence and spending.

The second main reason for the missed forecasts is that the credit crunch has turned out to be bigger and broader than at first appeared likely. A year ago, it seemed reasonable to hope that the worst would be over by now. This has not turned out to be the case. Signs of stress remain in the wholesale financial markets. The Royal Bank of Scotland spoke this week about increased evidence of strain among its small business clients. Sir James Crosby, in his recent analysis for the Treasury, forecast that a shortage of mortgage finance would persist through 2008, 2009, and 2010.

For a number of reasons, the UK has turned out to be especially exposed to this problem. The market for mortgage-backed securities has all but dried up: this form of funding represented two thirds of net new mortgage lending in the UK by 2006, and the amount outstanding in the first quarter of this year came to Euros 280 billion, or four times the combined total of France, Germany and Italy.

Then again, the financial services sector has played an important part in our economic growth in recent years, and has been a major source of tax revenue. It's now facing harsher times in the face of the credit crunch.

Finally, years of unsustainable increases in government spending have left the public finances in a poor shape to cushion the economy against these adverse shocks. In an ideal world, the Government would now be in a position to cut taxes or increase spending to help offset the economic slowdown. This is not a sensible option today.

Business conditions are not as bleak as you would conclude from the newspaper headlines. I come across lots of companies that are still doing well, especially in some of the business to business sectors, and in high value manufacturing. But there is no doubt that the mood has darkened in the last two or three months, and this has been reflected

in a sharp downturn in all the major surveys covering manufacturing, distribution, services and construction.

This is why most analysts are now suggesting that the economy will at best only manage to stagnate in the coming few quarters, and that the growth prospects through 2009 and into 2010 look no better than anaemic.

Over the same period, however, the problems should start to be overcome. The hope is that energy costs will stop pushing up overall prices sometime in the New Year, and that the impact will not be passed through into the economy more generally in the form of wage inflation. If that turns out to be the case, the year-on-year pace of consumer price inflation would be falling steeply by the second half of next year. The Bank of England, which has to be forward looking when setting monetary policy, might then already be cutting interest rates – and consumers would be starting to feel more confident about the world.

The credit squeeze could take longer to unwind. But at least the other side of the valley should be clearer by this time next year.

What should be the governing principles for policymakers in the meantime?

The first and most important is: do no harm.

Don't mess with monetary policy. This would be the worst possible time to move the goal posts, for example by shifting the target in some way.

And be very careful about the management of fiscal policy. Some vulnerable citizens are going to need help – for example, when it comes to paying their fuel bills this winter. The worst way to approach this would be through an arbitrary and unfair tax raid, that would jeopardise badly needed investment in our energy infrastructure in the years ahead.

Elsewhere, the Government is reported to be considering reforms of its fiscal rules – which is probably sensible, given that the current arrangements are so little respected. But in the words of the National Institute Economic Review, “a new framework that immediately loosens fiscal policy would have next to no credibility.” The probable result, it suggests, would be a loss of confidence in sterling, and upward pressure on interest rates.

As well as doing no harm, of course, policymakers should also be looking for ways to do good. This means prioritising those areas which are vital to the long term well-being of the country, whether it is investment in skills, energy security and a low carbon economy, or economic infrastructure more generally.

Every government initiative has to be tested against a single benchmark: will this make the UK a better place to create jobs and wealth when the recovery comes?

Businesses also have a challenging job to do, balancing short term budget pressures against the long term opportunities for investment and growth here in the UK.

A sharp economic slowdown is a new experience for many people in government and in business. It's going to be uncomfortable. But these are the times when it's vital to retain the longer view.

As always, I would be most interested in your views

Best regards,

Richard

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Please send any comments or views to [chris.aylett@the-mia.com](mailto:chris.aylett@the-mia.com) as the CBI member, and he will forward these to Richard Lambert..