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IoD Business Opinion Survey  
March 2002

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The Business Opinion Survey report was written by Graeme Leach, Chief Economist.

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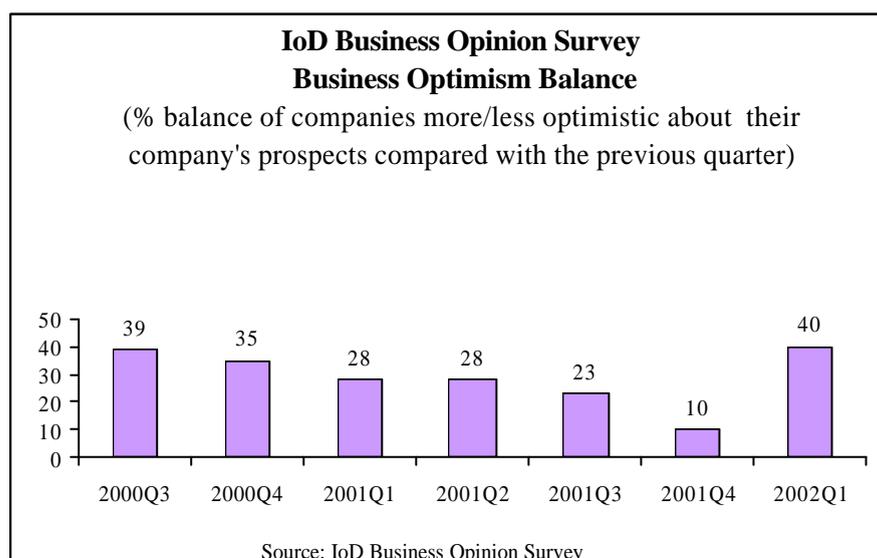
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## Summary

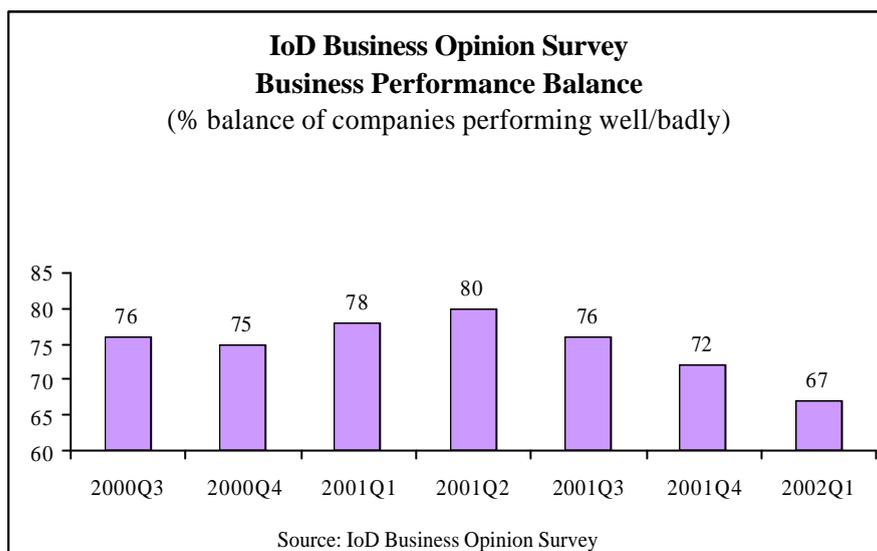
### Optimism and performance

In the latest March IoD Business Opinion Survey there has been a significant upturn in company optimism. The latest survey shows a balance of 40% of companies who were more, rather than less optimistic about their company's prospects, compared with three months ago.

Over the past two years there has been a continued decline in the optimism balance, from 57% in March 2000 to just 10% in December 2001. The latest result clearly breaks this trend. However, what is not clear is the nature of the recovery. Does the shift represent a definite upward move in expectations, or is it merely a reaction to a downward overshoot in the previous survey, in the wake of September 11th? The optimism balance for manufacturers rose to 32% in the latest survey - the highest level in 18 months.



The latest survey shows that the balance of those companies performing well, versus those performing badly, stood at 67% (see overleaf). In the previous survey, in December, this balance stood at 72%, whilst in September it had been 76%. This is only the second time in four years, the performance balance has fallen below 70%. However, the fall is not sharp and could, at least in part, be explained by issues of statistical sampling. Manufacturing continues to be the worst-performing sector, with a balance of 58% of companies stating that they are performing well, versus those performing badly.



## Capacity, orders & employment

Capacity utilisation has continued the deterioration exhibited in the previous survey. Between September and December last year, the balance of those companies operating at full capacity, versus those not, deteriorated from -7% to -21%. In March this balance fell to -29%. The capacity utilisation balance for manufacturers deteriorated from -34% to -39% in the latest survey.

The balance of those companies reporting above normal order books, versus those reporting below normal order books, stood at 7% in March, compared with 6% in December. The balance of those companies reporting above normal export order books versus those reporting below normal export order books, rose sharply from -17% in December to 4% in March. The improvement in export orders was most notable in manufacturing where the balance jumped from -26% in December to 3% in March.

The reported employment balance - of those companies reporting the trend in the number of employed up versus down - was almost unchanged at 12% in the latest survey. The expected employment balance picked up significantly in the latest survey, rising to 29% from 13% in December. The expected employment balance for manufacturers also picked up from zero to 13% over the same period.

## Output and profits

The balance of those companies reporting output up, versus those reporting output down, improved marginally from 33% to 36% in the latest survey. The latest survey displayed very significant improvements in expected output. The balance of those companies expecting output to be up, versus those expecting output to be down, stood at 63% in the latest survey, compared with 35% previously. The expected output balance is at its highest level in two years. This improvement was also evidenced in manufacturing where the balance improved from 30% to 52% over the same period.

The balance on reported profits dipped from 13% in December to 9% in the latest survey. For manufacturers, the reported profits balance deteriorated from 6% to -8% over the same period. The gloomy performance shown in the reported profits balance stands in marked contrast to future expectations. The balance, of company directors expecting profits to be up,

versus those expecting them to be down, rose from 24% in December to 42% in March. For manufacturers the expectations balance soared from 5% to 43% over the same period.

## Costs, prices and pay

The balance on both reported and expected costs has increased in the latest survey. The balance of those companies reporting costs up, versus those reporting costs down, stood at 23% in March, up from 14% in December. This balance is now back to the levels witnessed last September, before it plunged to 14% in December. The pick-up was most notable in manufacturing where the reported costs balance jumped from just 2% in December to 26% in March. The expected costs balance rose from 10% to 32% in the latest survey and is now back to the levels of a year ago. Again, there has been a very sharp movement in the balance for manufacturers, which jumped from -2% to 27% in the latest survey.

The balance of those company directors reporting prices up, versus those reporting them down, rose slightly from -1% to 4% in the latest survey. For manufacturers, the pick-up was more marked, with the balance rising from -19% in December to -5% in March. Despite the pick-up, price pressures remain weakest in manufacturing. In contrast, the expected prices balance - those company directors expecting prices to be up, versus those expecting them to be down - was flat at 1% for manufacturers, but rose from 6% to 13% for all company directors. This balance is now back to the levels seen a year ago.

In the latest survey the balance of those company directors reporting a higher company pay award - compared with the previous pay award - versus those reporting a lower award, fell to 5%. This compares with a balance of 16% in December and 20% in September last year. In the latest survey the average pay settlement stood at 4%, down from 4.6% in the previous survey.

# Survey Method

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The IoD Business Opinion Survey is designed to provide an up-to-date indication of current trends within the UK economy. The survey is carried out on behalf of the IoD by NOP Business and is conducted every three months by telephone.

The results presented in this summary are based on interviews with 500 members of the IoD carried out between 27 February - 12 March. The sample was randomly drawn from the IoD membership database and is structured so as to be representative in terms of company size, industrial sector and region. A detailed breakdown of the sample structure is provided in the data tables. For simplicity, different types of firms are referred to as follows:

**Size**

1 - 20 employees	“Micro”
21 - 100 employees	“Small”
101 - 200 employees	“Medium”
201+ employees	“Large”

**Sectors**

Manufacturing	
Distribution	
Others including construction/mining/transport	“Others (including construction)”
Government/Educational/Medical/Personal services	“Non-business services”
Business/Finance/Professional services	“Business services”

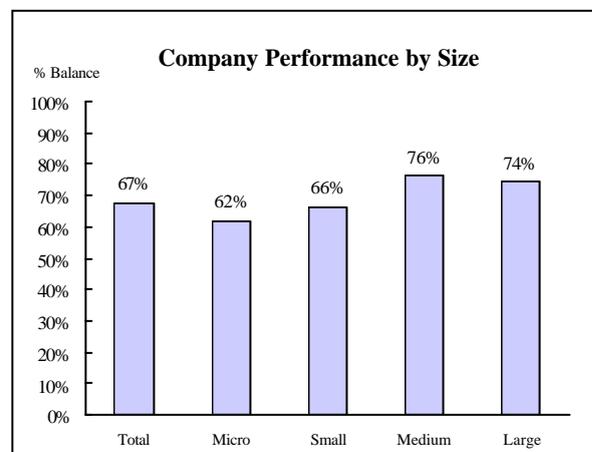
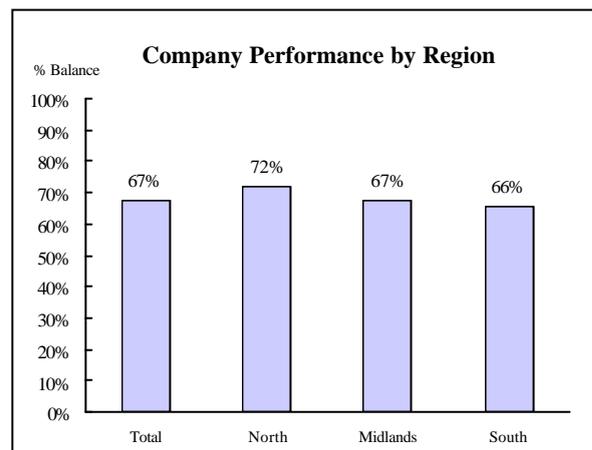
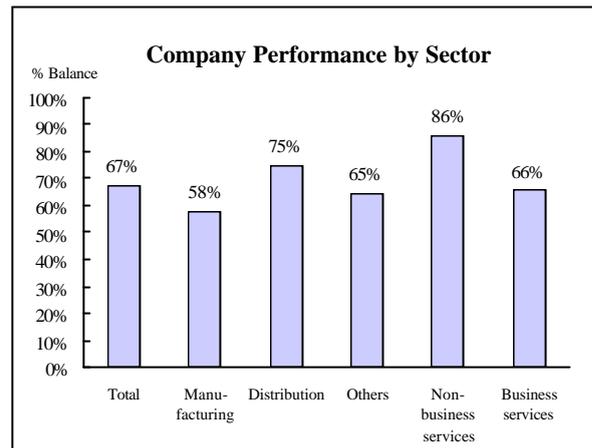
In order to give a simple, clear indication of the trend in any particular variable, the survey results are summarised throughout in terms of a positive or negative balance. The balance is computed by simply subtracting the number of respondents replying less/down/badly to a question from those replying up/more/well to give a single number.

# Survey Results

## Company Performance

<i>How well is your company performing overall?</i>	
Well	73%
Neither well nor badly	22%
Badly	6%
Balance	+67

- The latest survey shows that the balance of those companies performing well, versus those performing badly, stood at 67%. In the previous survey, in December, this balance stood at 72%, whilst in September it had been 76%. This is only the second time in four years, that the balance has fallen below 70%. However, the fall is not sharp and could, at least in part, be explained by issues of statistical sampling.
- Manufacturing continues to be the worst performing sector, with a balance of 58% of companies stating that they are performing well, versus those performing badly.

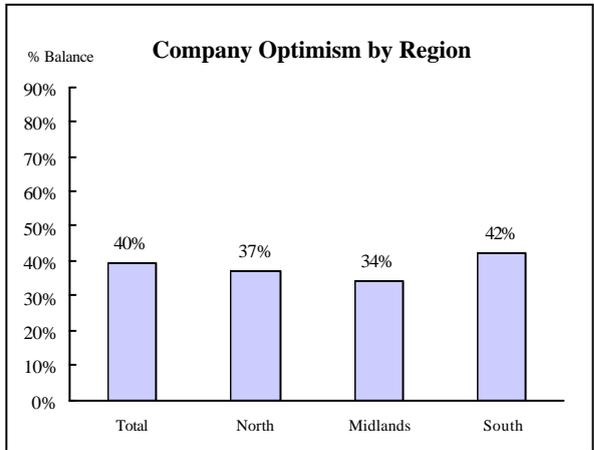
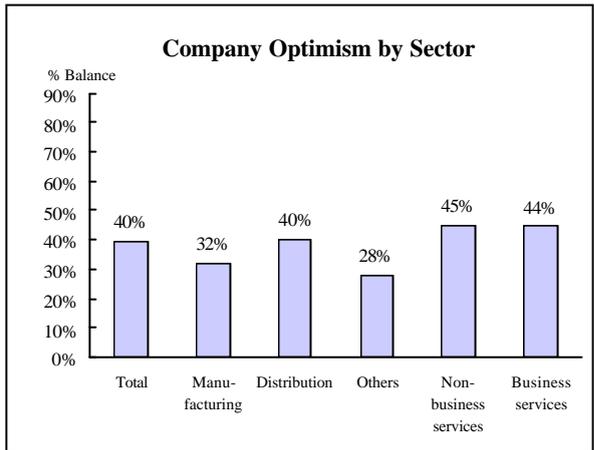


# Company Optimism

- In the latest survey there has been a significant upturn in company optimism. The latest survey shows a balance of 40% of companies who were more, rather than less optimistic about their company's prospects, compared with three months ago.
- Over the past two years there was a continued decline in the optimism balance from 57% in March 2000 to just 10% in December 2001. The latest results clearly break this trend. However, what is not clear is the nature of the recovery. Does the shift represent a definite upward move in expectations, or is it merely a reaction to a downward overshoot in the previous survey, in the wake of September 11th?
- The optimism balance for manufacturers rose to 32% in the latest survey - the highest level in 18 months.

*Are you generally more or less optimistic than you were three months ago about your company's prospects?*

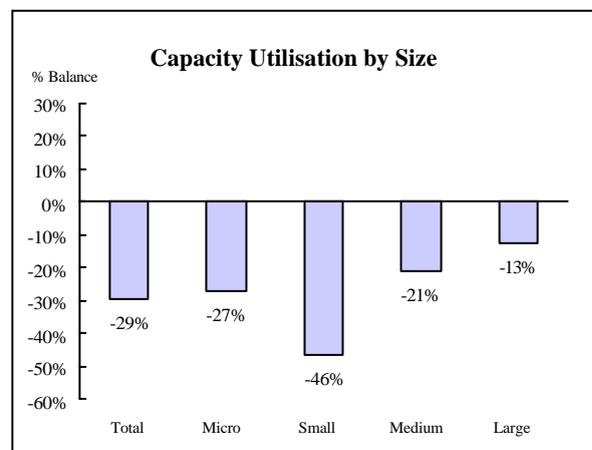
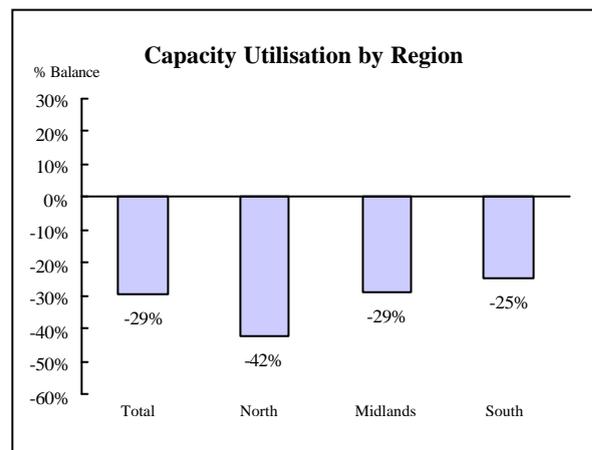
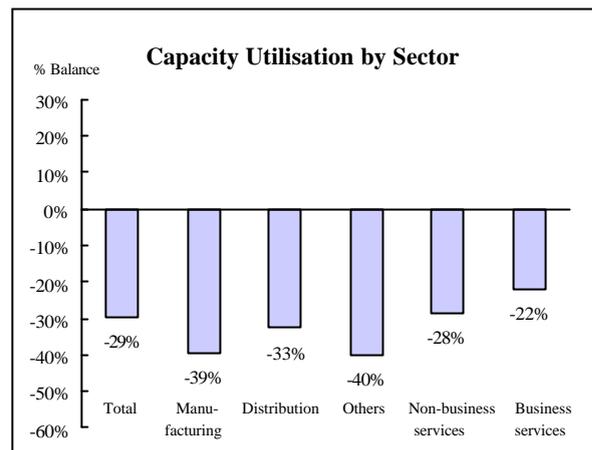
More	60%
Same	20%
Less	20%
Balance	+40



# Capacity Utilisation

<i>Are you currently operating at full capacity?</i>	
Yes	35%
No	65%
Balance	-29

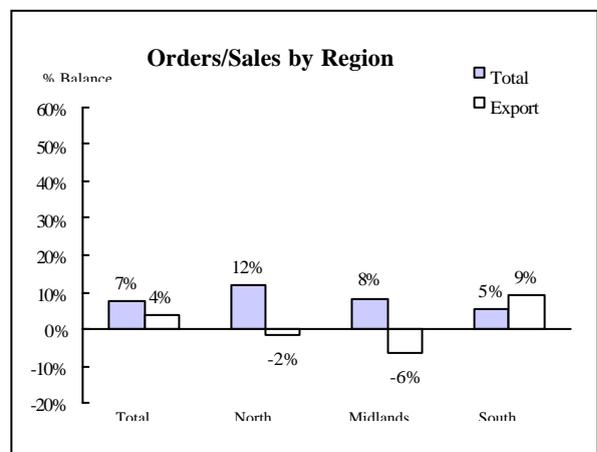
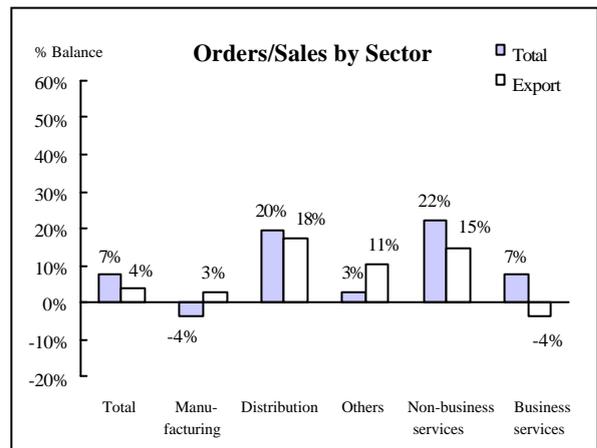
- Capacity utilisation has continued the deterioration exhibited in the previous survey. Between September and December last year, the balance of those companies operating at full capacity, versus those that were not, deteriorated from -7% to -21%. In March this balance fell to -29%.
- The capacity utilisation balance for manufacturers deteriorated from -34% to -39% in the latest survey.



# Order Books

- In the previous survey there was a sharp contrast in total order books and export order books. The latest survey reveals only a very small gap. The balance of those companies reporting above normal order books, versus those reporting below normal order books, stood at 7% in March, compared with 6% in December.
- The balance of those companies reporting above normal export order books versus those reporting below normal export order books, rose sharply from -17% in December to 4% in March.
- The improvement in export orders was most notable in manufacturing where the balance jumped from -26% in December to 3% in March.

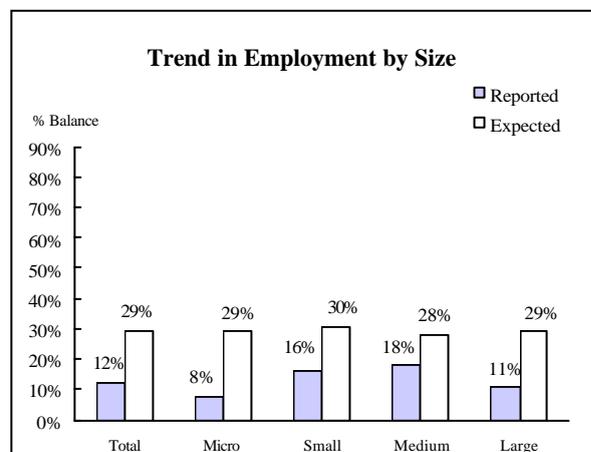
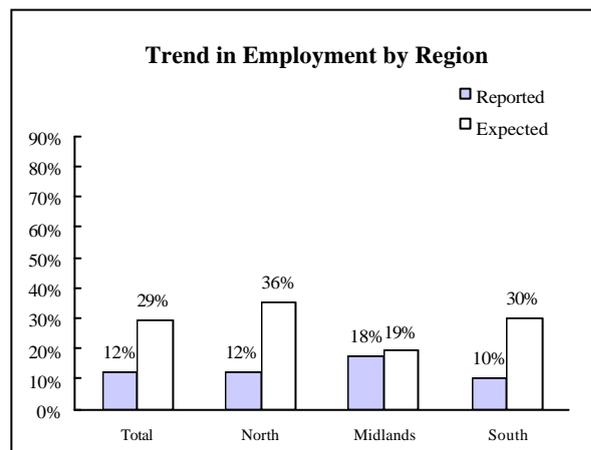
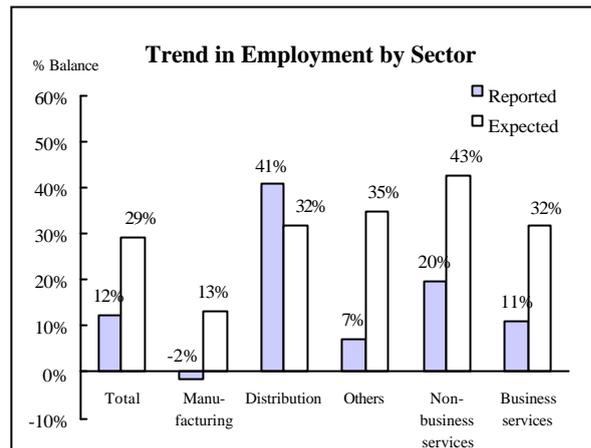
<i>Order books</i>	
Above normal	34%
Normal	40%
Below normal	26%
Balance	+7
<i>Export order books</i>	
Above normal	31%
Normal	41%
Below normal	28%
Balance	+4



# Employment

	Reported	Expected
Up	30%	37%
Same	51%	8%
Down	18%	55%
Balance	+12	+29

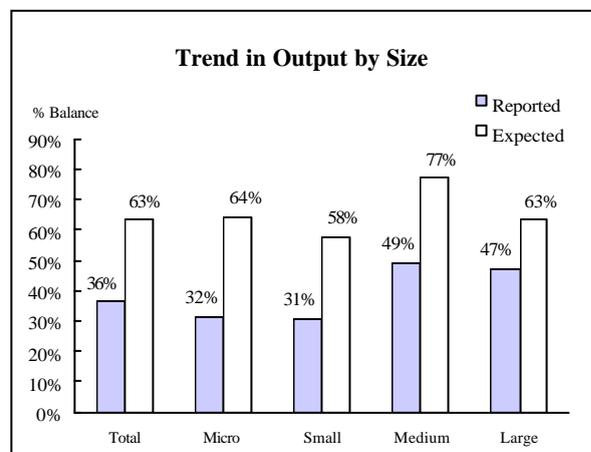
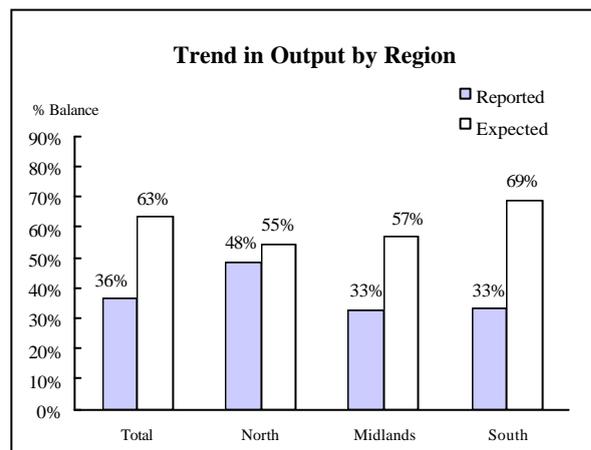
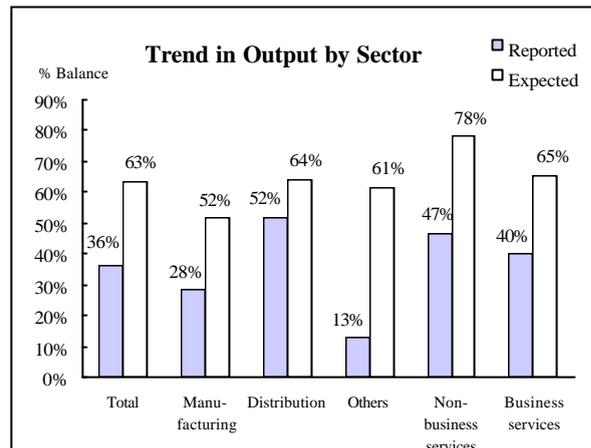
- The reported employment balance - of those companies reporting the trend in the number of employed up versus down - was almost unchanged at 12% in the latest survey. Between September and December last year this balance had fallen sharply from 28% to 11%. The balance for manufacturers was also unchanged, at -2%.
- The expected employment balance picked up significantly in the latest survey, rising to 29% from 13% in December. The expected employment balance for manufacturers also picked up from zero to 13% over the same period.



# Output

<i>Trend in Output</i>		
	Reported	Expected
Up	51%	69%
Same	31%	6%
Down	16%	25%
Balance	+36	+63

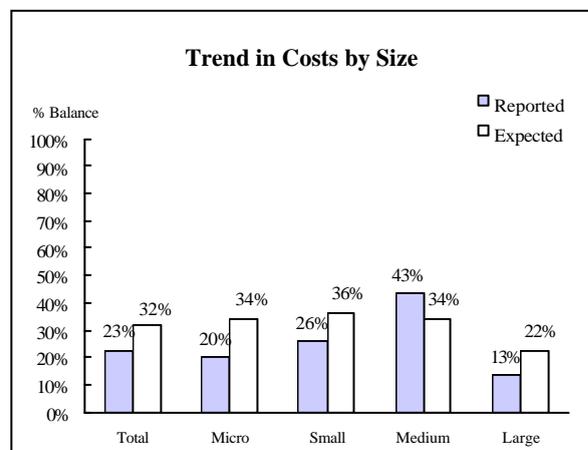
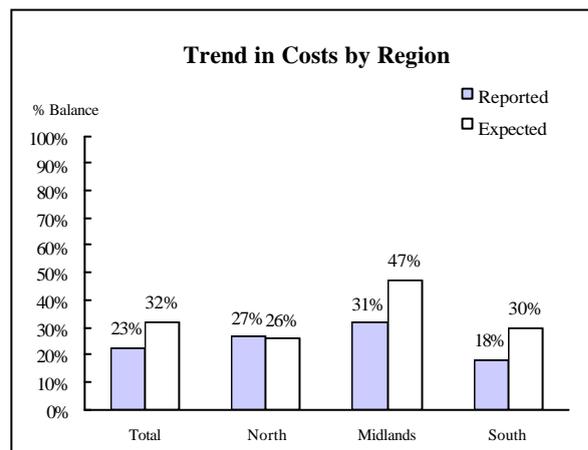
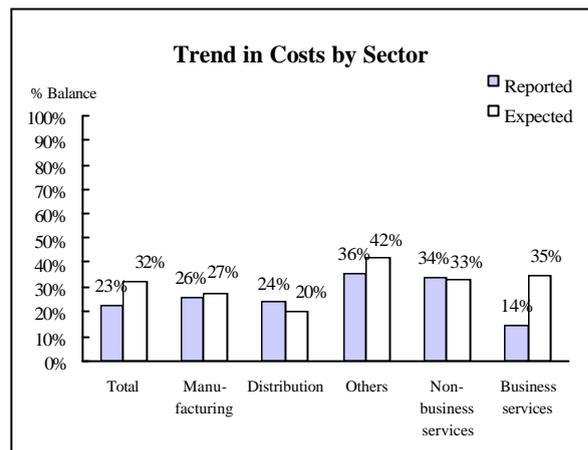
- The balance of those companies reporting output up, versus those reporting output down, improved marginally from 33% to 36% in the latest survey. The improvement in reported output was slightly more marked in manufacturing, where the reported output balance rose from 20% to 28% in the latest survey.
- The latest survey displayed very significant improvements in expected output. The balance of those companies expecting output to be up, versus those expecting output to be down, stood at 63% in the latest survey, compared with 35% previously. The expected output balance is at its highest level in two years. This improvement was also evidenced in manufacturing where the balance improved from 30% to 52% over the same period.



# Costs

	Reported	Expected
Up	40%	43%
Same	43%	45%
Down	17%	11%
Balance	+23	+32

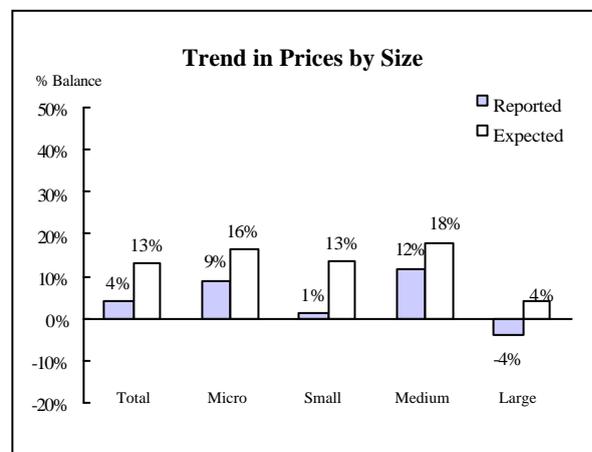
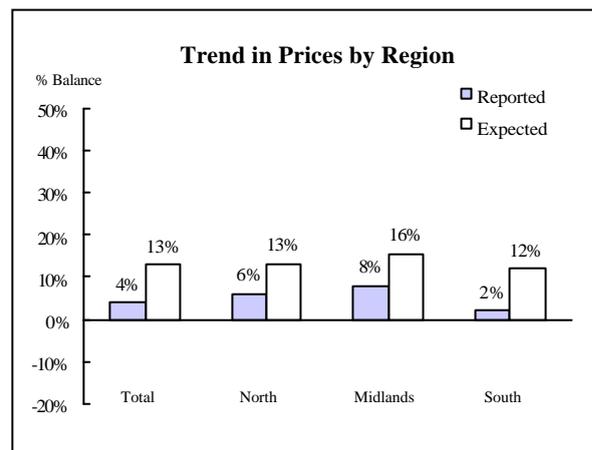
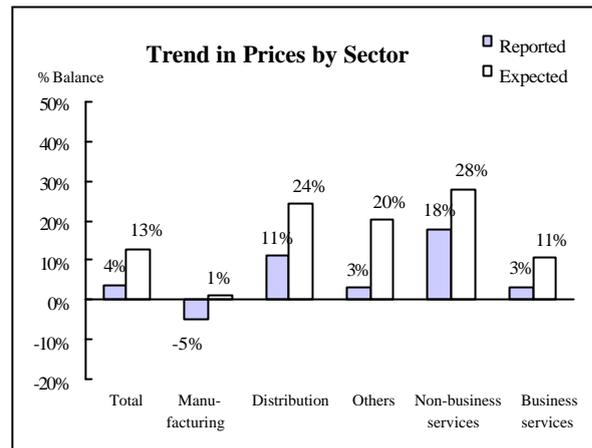
- The balance on both reported and expected costs has increased in the latest survey. The balance of those companies reporting costs up, versus those reporting costs down, stood at 23% in March, up from 14% in December. This balance is now back to the levels witnessed last September, before it plunged to 14% in December. The pick-up was most notable in manufacturing where the reported costs balance jumped from just 2% in December to 26% in March.
- The expected costs balance rose from 10% to 32% in the latest survey and is now back to the levels of a year ago. Again, there has been a very sharp movement in the balance for manufacturers which jumped from -2% to 27% in the latest survey.



# Prices

	Reported	Expected
Up	17%	21%
Same	70%	71%
Down	13%	8%
Balance	+4	+13

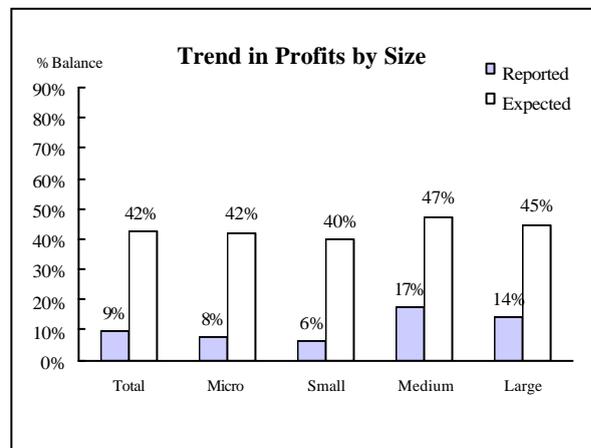
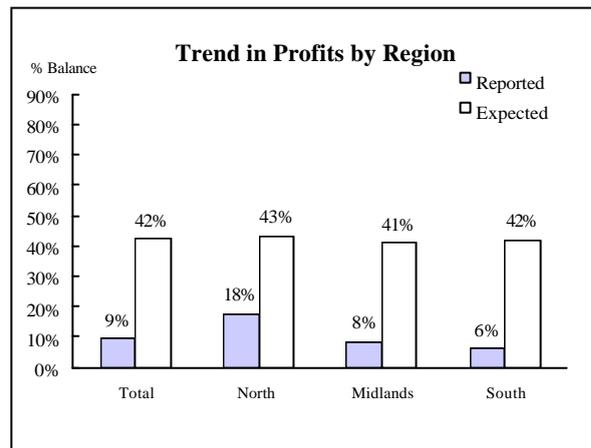
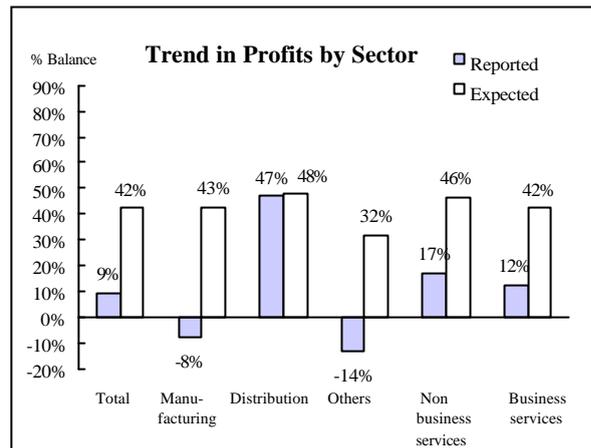
- The balance of those company directors reporting prices up, versus those reporting them down, rose slightly from -1% to 4% in the latest survey. For manufacturers the pick-up was more marked, with the balance rising from -19% in December to -5% in March. Despite the pick-up, price pressures remain weakest in manufacturing.
- In contrast, the expected prices balance - those company directors expecting prices to be up, versus those expecting them to be down - was flat at 1% for manufacturers, but rose from 6% to 13% for all company directors. This balance is now back to the levels seen a year ago.



# Profits

	Reported	Expected
Up	35%	52%
Same	40%	38%
Down	25%	10%
Balance	+9	+42

- The balance on reported profits dipped from 13% in December to 9% in the latest survey. For manufacturers the reported profits balance deteriorated from 6% to -8% over the same period.
- The gloomy performance recorded in the reported profits balance stands in marked contrast to future expectations. The balance of those company directors expecting profits to be up, versus those expecting them to be down, rose from 24% in December to 42% in March. For manufacturers the expectations balance soared from 5% to 43% over the same period.

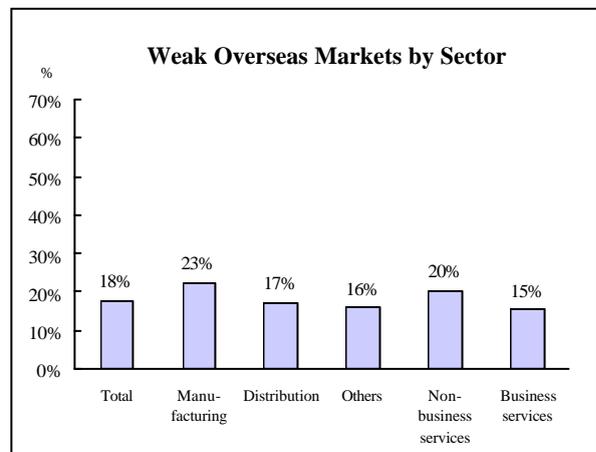
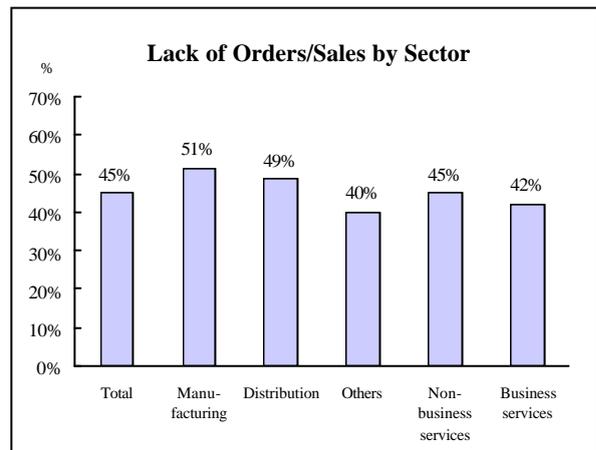
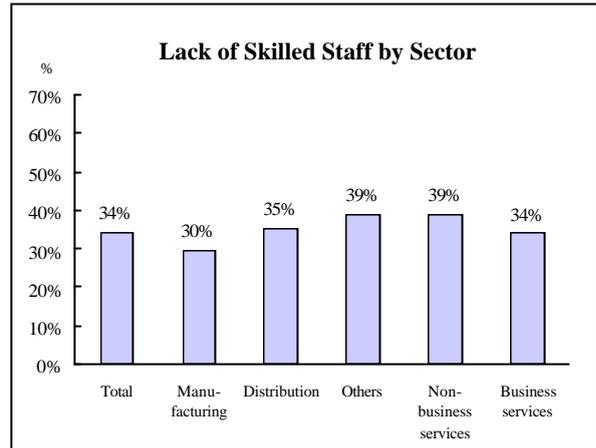


# Factors limiting output

*What factors are likely to limit output over the next three months?*

Lack of orders/sales	45%
Lack of skilled staff	34%
Weak overseas markets	18%
Other staffing problems	17%
Credit or finance	13%
Plant capacity	10%
Lack of materials or components	6%

- Lack of orders/sales continues to be the most important factor limiting output. This is followed by skill shortages as the second most important factor limiting output over the next three months. Compared with the previous survey, these two factors remain the most important, but their relative importance has changed. In the previous survey 51% of respondents cited a lack of orders/sales (compared with 45% now) whilst 29% cited a lack of skilled staff (compared with 34% now).**



# Pay

- In the latest survey the balance of those company directors reporting a higher company pay award - compared with the previous pay award - versus those reporting a lower award, fell to 5%. This compares with a balance of 16% in December and 20% in September last year.
- In the latest survey the average pay settlement stood at 4%, down from 4.6% in the previous survey.

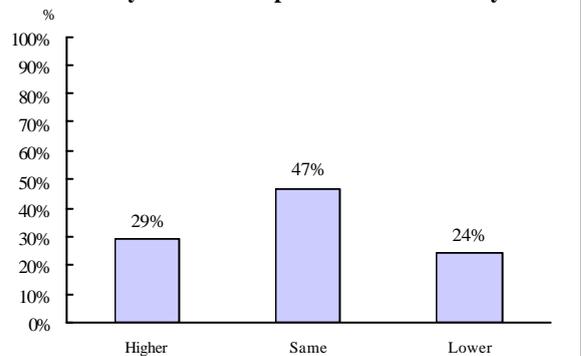
*If you made a pay award in the last 3 months, what was the average percentage increase?*

2% or less	13%
2-3%	30%
3-4%	20%
4-5%	11%
5-7.5%	10%
7.5% or more	16%

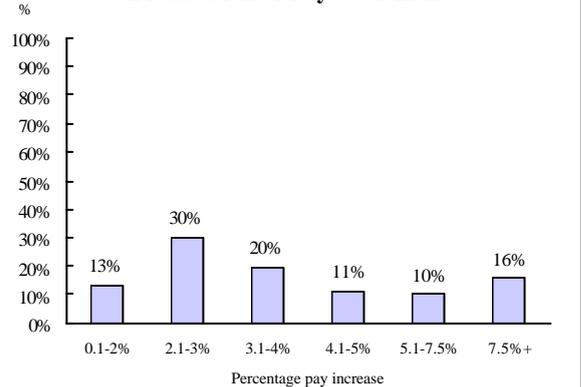
*How did it compare with the previous pay award?*

Higher	29%
Same	47%
Lower	24%
Balance	+5

**Current Pay Award Compared to Previous Pay Award**



**Distribution of Pay Settlements**



## Investment

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- Investment intentions are modestly more optimistic than those for the previous survey (figures in parenthesis are for the previous survey). The balance of those intending to invest more versus less over the next 12 months stands at 19% (13%) for buildings, 33% (25%) for plant, machinery & equipment, 34% (31%) for product and process innovation/R&D and 42% (39%) for training.

*Do you plan to invest more, the same, or less in the following areas over the next twelve months than you did in the previous twelve months?*

### **Buildings**

More	25%
Same	20%
Less	6%
None in either period	49%

### **Plant, machinery and equipment**

More	42%
Same	35%
Less	9%
None in either period	14%

### **Product and process innovation/R&D**

More	35%
Same	31%
Less	1%
None in either period	32%

### **Training**

More	45%
Same	41%
Less	3%
None in either period	11%

## UK Economic Outlook

The UK economy is very much a two-speed economy at present. Latest figures show that in the final quarter of last year, GDP growth was flat quarter-on-quarter but rose by 1.6% year-on-year. However, this overall growth rate hides considerable differences across the whole economy. Domestic demand growth was at 2.3% (yr-on-yr) in the final quarter. Moreover, the divide between manufacturing and services growth is at its highest in two decades. In the final quarter of last year services output rose by 3.8% (yr-on-yr) whereas manufacturing output fell by 2.3% over the same period.

### Which way for UK interest rates?

Interest rates to rise	Interest rates on hold
Double digit house price growth	Uncertain world economy
Strong retail sales growth	Manufacturing recession
Rising consumer debt levels	RPIX inflation below target
Services inflation	Low headline RPI inflation
Oil price rises	Wage settlements
Low unemployment	Moderate unit wage cost growth
Rising employment	Goods deflation
Future pick-up in money supply growth	Recent broad money supply growth

In the UK, fears about the negative impact of September 11th have given way to rising concerns that interest rates might need to go up in order to dampen an overheating economy.

There are strong parallels between the economic situation in 1987-88 and now. In October 1987 world stock markets fell sharply and fears of a global recession led to reductions in interest rates to prevent negative wealth effects inducing precautionary behaviour by consumers and companies. The interest rate reductions subsequently appeared mistaken, owing to the fact that the housing market continued to race ahead, fuelled by lower mortgage rates. There is now a concern that in the wake of September 11th, history might, at least in part, be repeating itself.

Outside of the manufacturing sector UK economic performance remains robust. Retail sales volumes rose by 5.9% (yr-on-yr) in February. In the latest three-month period retail sales volumes were up 5.3% (yr-on-yr). The strength of consumer confidence can be seen in household goods sales, which were up 8% (yr-on-yr) in February, and clothing and footwear sales which were up 11% over the same period. In contrast to expectations in the New Year, consumers haven't paused for breath since Christmas.

The most obvious sign of economic resilience can be seen in the housing market. According to the Nationwide, UK house prices rose by 0.9% (mth-on-mth) and by 13.8% (yr-on-yr) in March. The Nationwide report that in parts of London prices have risen by 32% (yr-on-yr). As a result of continued strong price growth, the Nationwide have revised upwards their 2002 UK house price growth forecasts from 6% to 10%. The Halifax report that UK house prices rose by 0.4% (mth-on-mth) and 16% (yr-on-yr) in March. This represented a slight easing on the 16.9% (yr-on-yr) growth recorded in February. Whether it is the Nationwide or Halifax index, current rates of house price growth are not sustainable in the long-term. Growth rates will be curtailed, either by rising too far out of line with incomes, or because mortgage rates have been increased to stem wider inflationary pressures.

According to the Nationwide, UK house prices are now at a multiple of just over 4 times average earnings, compared with a long-term average of 3.5 times earnings. On this measure, house prices look expensive, but looked at in a different way affordability is less of a concern. The fall in mortgage rates to their lowest level in four decades, means that average UK mortgage payments have fallen to 14% of earnings, compared with a long term average of 22%. This means that mortgage rates would need to rise very significantly before property became as unaffordable as it was in the late 1980s boom. MPC member, Sushil Wadhvani, has estimated that interest rates would need to rise to 11% for the debt service ratio to return to the peak seen in the early 1990s.

Even in London, where house prices are highest, payments amount to only 21% of earnings compared with a long-term average of 27%<sup>1</sup>. There is a real risk of a speculative bubble developing as people believe house prices are set to increase at double-digit rates for years to come.

It is important to remember that the MPC has a two-year horizon when deciding to set interest rates. If it believes the current housing market threatens the RPIX inflation target two years from now, it will still raise interest rates, even if the headline RPI inflation rate stands at 1%.

Attractive affordability and strong house price growth has helped fuel a surge in mortgage equity withdrawal - despite the removal of MIRAS, as compared with the late 1980s. Calculations by Deutsche Bank suggest equity withdrawal reached a record £7 billion in the third quarter of last year - and is running at an annual rate of £30 billion. Mortgage lending has been hitting new heights, from month-to-month, on a regular basis.

Over the past decade mortgage debt has increased from just over £300 billion to nearly £600 billion. At the same time, other personal debt - credit cards, loans etc - has jumped from £50 billion to £140 billion. Given that this period has seen very low inflation, the real increase in debt has been considerable.

One key concern is that the pound might come under downward pressure as a result of the current account deficit and/or the build-up in household debt. The fear is that the pound might fall precipitously if the current account deficit widens further, triggering an upward spike in interest rates, which then induces some form of housing market collapse.

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1. Some estimates show that the mortgage servicing cost is currently at 15% in London, compared with a peak of 36% at the beginning of the 1990s.

These arguments are probably overstated<sup>2</sup>. During the final quarter of last year the current account deficit came in at a record £7.6 billion, but for the year as a whole the deficit is not much more than 2% of GDP. Not exactly a red alert signal. Part of the reason for the fourth quarter deterioration was a fall-of in net investment income - ironically in part reflecting the relatively stronger performing UK economy.

Alternatively, the build-up in household debt of itself might precipitate a minor sterling crisis. The counter argument is that consumer net wealth remains strong and that as a result, the debt burden is unlikely to worry financial markets. Moreover, any policy move that entails a deterioration in household debt service, may induce the boom-bust it was meant to avoid.

The increase in debt is, however, only one side of the balance sheet. Despite weak stock markets over the past two years, household assets are estimated to be £4,500 billion - roughly six times debt and disposable income.

The argument against a tightening in monetary policy is that inflationary pressures remain subdued:

- Latest pay settlement analysis by IDS shows that the median level of pay settlements stood at 2.5% in the first quarter, down from 3% in the final quarter of last year. The upper quartile and lower quartile measures also fell.
- Between December and January, whole economy headline average earnings growth fell by 0.7 percentage points to 2.7%. The fall largely reflected lower City bonuses, but annual wage growth excluding bonuses also moderated.
- RPIX inflation rose by 2.2% (yr-on-yr) in February, down from 2.6% (yr-on-yr) in January. Month-on-month RPIX inflation was 0.2%.
- Headline RPI inflation stands at just 1% (yr-on-yr).
- UK inflation (HICP measure) is 1.5% (yr-on-yr) - the lowest in the EU.
- All goods inflation fell from 0.5% (yr-on-yr) to 0.1% (yr-on-yr) between January and February. All services inflation fell from 4.6% to 4.5% over the same period.

However, despite this apparently benign inflationary environment, services inflation has increased over the past year from 2.8% to 4.5% - services account for around 70% of the economy. There are also tentative signs - see IoD Business Opinion Survey results - that the manufacturing sector may be about to turn, and in so doing, will not be exerting the strong deflationary pressures it has provided up to now. Very significantly, also, the labour market remains tight:

- The claimant count unemployment rate stands at 3.1%, and the absolute number of unemployed has fallen in early 2002, following a small rise at the end of 2001.
- The ILO unemployment rate stands at 5.1%, unchanged over the latest quarter. The number of unemployed people on the ILO definition has risen by just 8,000 over the past quarter.
- Total employment rose by 23,000 in the latest quarter. Total employment is up 127,000 year-on-year.

On balance we feel that the combination of a tight labour market and a booming housing market, suggest the MPC will intervene to raise interest rates, in order to prevent strong wealth effects from property, overheating the economy.

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2. The problem with the consumption-GDP theory is timing. It is quite possible for consumption to continue to outpace GDP growth for many years.

One factor that could delay any response by the MPC, is the recent behaviour of broad money supply. Surprisingly, M4 growth moderated to 6.2% (yr-on-yr) in February - a rate of growth consistent with the 2.5% inflation target. Broad money growth was held down by static corporate and non-bank financial sector loan demand. Any revival of lending to these sectors, in combination with continued buoyant mortgage lending, could well stimulate double digit M4 growth. The MPC will also be aware that the Government's return to deficit implies an increasingly positive public sector contribution to M4 growth in 2002.

The interest rate outlook would seem to hinge on the interpretation of the potential wealth effects now emanating from the housing market. We judge that the MPC will take the view that it is better to take mild pre-emptive action now, rather than painful remedial action later - and watch boom turn to bust.

Any forthcoming increase in interest rates is likely to be moderate at first, with a 25 basis point rise in May, followed by another 25 basis point increase before the end of the year.

However, one must also remember that this is a highly contentious issue, with the need for any tightening in the monetary policy noose, strongly challenged because:

- Any increase in interest rates might push the pound higher and exacerbate, rather than narrow, the current imbalance between manufacturing and services.
- Recent years have seen consumption growth consistently outpacing overall GDP growth. This cannot go on forever - otherwise consumption would rise to 100% of GDP - and so there might be some form of 'natural' adjustment in consumer behaviour.

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**IoD Economic Forecasts - April 2002**

Indicator	2002	2003
GDP	2.0	2.4
Household consumption	1.8	2.4
Government expenditure	4.2	3.6
Fixed investment	1.7	2.4
RPIX (yr-on-yr, end Q4)	2.3	2.4
Unemployment (average, millions, end Q4)	0.98	1.0
Unemployment (average, %, end Q4)	3.2	3.3
Base rate (% , end Q4)	4.5	4.25

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