

UK economic outlook:

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IoD ECONOMIC PAPER

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1 Summary

- This is as good as it gets. UK GDP growth has probably peaked in the latest economic cycle. The IoD forecasts GDP growth will slow from 3.3% this year to 2.6% next year. The UK economy is set to experience a slowdown, but not a downturn, over the next 12-18 months.
- The UK economy is difficult to interpret at present because it is in the midst of a growth transition - corporate spending is accelerating before the impact of higher interest rates has completed the slowdown in household borrowing and spending. The IoD forecasts the re-balancing of the UK economy will continue.
- Two important influences suggest household spending and borrowing will be brought under control, without interest rates needing to rise above 5%:
 - Wealth effects on household consumption appear to be weaker in the latest cycle.
 - Base rates are low by historic standards, but total debt servicing costs (including repayments of principal) are high.
- UK interest rates are forecast to peak at 5% in the current cycle.
- Forecast risk centres on the possibility that sustained double-digit money supply growth will combine with a positive output gap to force interest rates to 5.5% or more. This would result in a more pronounced economic cycle, with a sharp deceleration in GDP growth in the second half of 2005. There is also the possibility of a 10-20% fall in house prices, with or without the effect of higher interest rates.

2 This is as good as it gets

The IoD's latest forecasts show UK GDP growth of 3.3% in 2004, followed by 2.6% in 2005. These numbers are unchanged from our previous forecast, undertaken in July 2004. The IoD's forecasts are in line with the consensus¹ average and above HM Treasury projections of 3.3% growth both this year and next.

The lagged effects of the tightening in monetary policy over the past year - which has seen interest rates rise from 3.5% to 4.75% - will continue to dampen economic growth into next year. In proportionate terms, short-term interest rates have risen by 36% over the past year. The IoD expects the Chancellor will announce HM Treasury has revised down its' forecast of 2005 GDP growth, when the Pre-Budget Report is published later this year.

Table 1 shows the IoD's UK economic forecasts for 2004-05. The IoD's forecasts show the UK economy will experience a slowdown but not a downturn, over the next 12-18 months.

TABLE 1 IOD UK ECONOMIC FORECASTS - 2005-05

Economic indicator	2004	2005
GDP	3.3%	2.6%
Household consumption	3.1%	2.4%
Gross fixed investment	5.4%	4.1%
Consumer prices	1.5%	1.8%
Average earnings	4.4%	4.5%
Unemployment rate	2.8%	2.8%
3 month interbank rate	4.75% (end December)	4.75% (end December)

The IoD's interest rate forecasts are unchanged from before and show interest rates at 4.75% through the final quarter of this year, peaking at 5% in early 2005.

3 Will UK interest rates peak at 5%?

3 factors suggest that interest rates are very close to their peak in the current cycle:

- Expectations
- Labour market performance
- Competition

Expectations - The latest headline rate of inflation (measured using the CPI index) stood at 1.3% (yr-on-yr) in August - well below the 2% target rate - down from 1.4% in July. Consensus estimates suggest UK inflation will average 1.8% in 2005 compared with 1.5% this year.

Headline inflation cannot be described as fuelling inflationary expectations. There is however a sharp difference between goods and services inflation. The all goods CPI fell 0.7% (yr-on-yr) in August whereas the all services index rose 3.5% (yr-on-yr) over the same period. However, it should also be stated that the latest all services inflation rate is below that recorded over recent years.

UK inflation is well below the 2.3% rate in the Euro-zone. Clearly, the MPC is less concerned about inflation today, and more concerned about the outlook tomorrow, or looking out 2 years ahead, to be precise. We believe that following the increase in base rates to 4.75% in August, together with the lagged effects of previous and pending increases, CPI inflation is unlikely to move above the target rate over the next 2 years.

Labour market performance - The labour market is clearly tight, with the claimant count unemployment rate at 2.7% - its lowest level for almost 30 years. Moreover, certain labour market surveys are showing recruitment difficulties increasing. The Manpower Survey net employment balance has risen to its' highest level since the end of 2001.

However, we should also consider that the labour market has been 'tight' for some time. What is uncertain is the extent to which the UK economy can now run at a faster rate than historically. We don't really know what the non-accelerating inflation rate of unemployment is - the so-called NAIRU.

The Bank of England has described recent labour market performance as "surprisingly weak". This comment was based on a dip in employment and a rise in inactivity in 2004Q2. Total earnings growth stood at 4.2% (yr-on-yr) in July - below the 4.5% threshold generally interpreted as triggering alarm bells at the Bank of England.

Certain earnings data does suggest a potential inflationary threat. Earnings growth in the private sector has jumped from 2.9% to 4.4% over the past year. Private sector earnings growth (excluding bonuses) has reached a 2.5 year high and now exceeds that in the public sector.

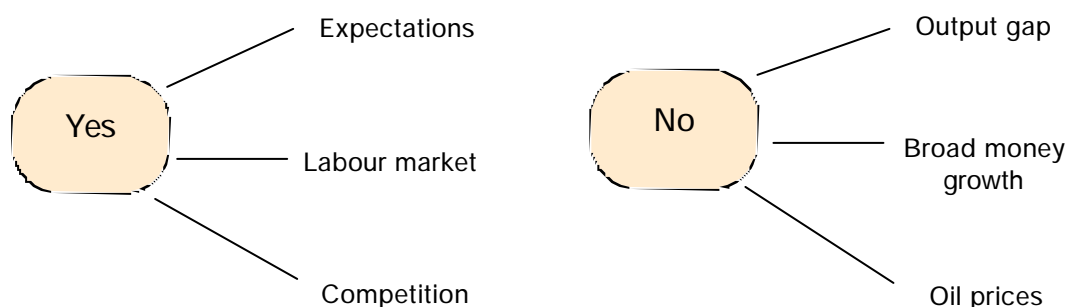
Some re-assurance on the inflation outlook can be obtained from the most recent unit labour cost statistics. Firm productivity growth resulted in whole economy unit labour cost growth declining from 2.9% (yr-on-yr) in 2004Q1 to 2% (yr-on-yr) in 2004Q2.

Declining unit labour cost growth helped increase the net rate of return for UK companies in 2004Q2. Net rates of return for private non-financial corporations rose to 13.8% in 2004Q2, up from 13.2% in 2004Q1 and 12.5% a year before. Net rates of return are at their highest level since 1998. What is uncertain at present is the extent to which the profit share will now plateau off, as employees recoup their share of higher profits in higher earnings growth and bonuses.

In other words, is the employment share of national income set to increase at the expense of the profit share? The IoD's analysis suggests that expected rates of return and profits will level off in the second half of the year as the peak in the economic cycle is passed. We do not expect a significant upward movement in the employment share.

Competition - Competition in the High Street is intense, as evidenced by the all goods deflation cited above. Both retail and total household spending, in nominal terms, showed their smallest increase in 2003, since records began in 1961. Long-term influences such as on-line competition and globalisation, imply continued downward pressure, although some of this effect may be offset by any future devaluation of sterling. The uncertainty here is the extent to which High Street deflation fans out to moderate inflation elsewhere.

FIGURE 1 - WILL INTEREST RATES PEAK AT 5%?



Although the 3 factors above suggest interest rates are close to their peak in this cycle, there are 3 other influences which may undermine our confidence on the inflation and interest rate outlook:

- 📦 Oil prices and the pound
- 📦 The output gap
- 📦 Broad money growth

At the present time, the IoD's economic forecasts assume the effects of these influences will be benign and will not adversely effect our inflation and interest rate outlook.

Oil prices - Sterling strength over the past year has helped insulate the UK economy from the increase in global commodity prices (which are generally denominated in dollar terms). However, we now face a situation of continued high oil prices together with the threat of sterling weakness. In the wake of higher interest rates in the UK, sterling appreciated by almost 9% (on a trade weighted basis) over the January-July period. Since the beginning of August sterling has depreciated by around 4% in trade weighted terms. Whilst the link between the value of sterling and producer price movements is difficult to quantify, it will concern the MPC.

Against this argument is the view that headline inflation is low and any oil or sterling induced price pressures are unlikely to take CPI inflation above target in the short-term, and in the long-term, more than 12 months ahead, any oil price spike this year, will fall-out of the year-on-year index.

Core producer output prices rose by 2.1% (yr-on-yr) in August, having been zero or negative over most of the 1998-2003 period. Latest data shows UK manufacturing output fell for the third successive month in August - a cumulative decline of 1.6%. Manufacturing risks slipping back into recession. At best, trend output is probably flat at present, suggesting inflationary pressures will be subdued.

The IoD's forecasts assume global GDP growth will slow from around 4% this year to 3% next and this slowdown will reduce the upward pressure on oil and commodity prices. The slip in global growth is driven by our projected slowdown in the US economy - due to higher oil prices and a tighter monetary policy by the US Federal Reserve.

The output gap - Analysis by the IoD (and other economic commentators such as Lombard Street Research and the NIESR) suggests the UK output gap has been closed or has moved into positive territory i.e. actual output is above potential output. When actual output is above potential output, inflationary pressures increase.

The minutes of the Monetary Policy Committee in September stated that robust growth was likely to be continued in the second half of 2004, albeit slowing a little. Quarterly GDP growth accelerated from 0.6% to 0.9% between the first and second quarters of this year.

The IoD has argued consistently that the UK economy would re-balance in 2004, with an acceleration in business investment and a slowdown in household consumption. This is now occurring, but what is uncertain is whether household consumption will slow sufficiently, to make sure that overall GDP growth is not too far above trend, given that public expenditure growth remains strong.

Stronger business investment has been stimulated by improved corporate confidence, higher profitability, improved liquidity, the IT replacement cycle and the business capex to GDP ratio, which is below average.

Broad money growth - The Bank of England has recently stated that M4 growth may be consistent with continued strong growth in nominal GDP. Essentially this means that sustained double-digit broad money supply growth will not be compatible with a 5% peak in UK interest rates. Latest broad money M4 growth is around 10% (yr-on-yr) with M4 lending growth around 12% (yr-on-yr) and 14% (yr-on-yr) excluding the effects of securitisation. Continued money supply growth at this rate, could shift the interest rate peak towards 5.5%.

Household debt may have topped £1 trillion in 2004 and the debt to income ratio hit 140%, but there is no guarantee household borrowing will slow. The debt income ratio has reached 160% in Australia and more than 170% in the Netherlands.

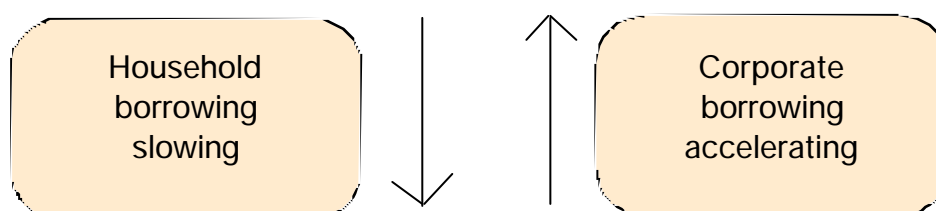
Total net worth in the UK, including financial assets, rose by £460 billion in 2003, to reach a total of £5.3 trillion. The Bank of England is obviously concerned as to the potential decline in the savings ratio which might ensue from the impact of wealth effects on consumption. The inflation adjusted savings ratio does not suggest households are about to rein back spending.

There are however 2 important influences which suggest that household spending and borrowing will be brought under control, without interest rates needing to rise above 5%:

- Wealth effects on household consumption appear to be weaker in the latest cycle, compared with the late 1980s.
- Although base rates are low by historic standards, total debt servicing costs, including repayments of principal, are actually high not low. This issue was analysed in the two previous IoD Economic Outlooks. For example, if interest rates rise to 5%, the all interest, plus regular mortgage principal, repayment burden, will rise to 15% of household income in 2005 - compared with a peak of 16% in 1991.

The IoD argues that the lagged effects of previous interest rate hikes will continue to slow household borrowing, but this effect has not fully worked through yet and we are seeing a simultaneous increase in borrowing by companies.

FIGURE 2 - UK GROWTH TRANSITION



4 Forecast risks

Broad money growth (discussed above) provides an upside risk to our GDP growth, inflation and interest rate forecasts.

There is also a downside risk from the housing market as well. This stems from the possibility that the UK housing market might crash with or without the effect of higher interest rates. We examined this issue in the Summer Economic Outlook, and argued that whilst the ratio of house prices to incomes - reaching 5.9, up from 3.7 in 1997 - made a crash more likely, the odds of a HISS (sharp slowdown in UK house price growth in 2005) versus a POP (falls in UK house prices) were and still are, around 50:50.

It is worth remembering that if house prices were to fall 10% in 2005 and a further 10% in 2006, they would merely lose the gains made over the past year. Analysis of previous house price cycles shows that price falls do not have to be preceded by a sharp increase in unemployment. The IoD's forecasts assume the UK housing market will go HISS not POP. If there is a house price crash, GDP growth could fall towards 2% or less, but at the present time we do not believe this negative wealth effect is the most likely scenario.

House price data can be volatile month-to-month, but the latest Halifax index shows house price growth in 2004Q3 at just over 2% (qtr-on-qtr), compared with an average of 5.8% (qtr-on-qtr) in 2004Q1 and 2004Q2. RICS surveys together with BBA, BSA and CML data provide clear evidence of a slowdown in the UK housing market, but not a collapse. Year-on-year house price growth will remain positive. If monthly house price inflation is zero until January, annual house price inflation will stand at 12% in January 2005. Even if monthly house price inflation is zero until next June, annual house price inflation will remain positive, at 2%.

The 'Big 3' consumption slumps of 1974, 1979 and 1990 were associated with a collapse in the main index of consumer confidence to below -20. The GfK index currently reads -7. Over the past 30 years the index has averaged -8 and household consumption growth has averaged 2.6% per annum.

Of course, the index might deteriorate rapidly, but at present this seems unlikely. The 1990 deterioration was associated with double-digit inflation, sharply higher unemployment and a spike in interest rates to 15%.

References

1. Consensus Forecasts - A Digest of International Economic Forecasts, Consensus Economics, survey date 13th September 2004.