INSTITUTE OF DIRECTORS

UK economic outlook

FIRST QUARTER 2004

incorporating IoD business opinion survey

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This economic paper was written by Graeme Leach, Chief Economist and the Business Opinion Survey was undertaken by NOP business. The report was produced by Lisa Tilsed, Policy Unit Manager.

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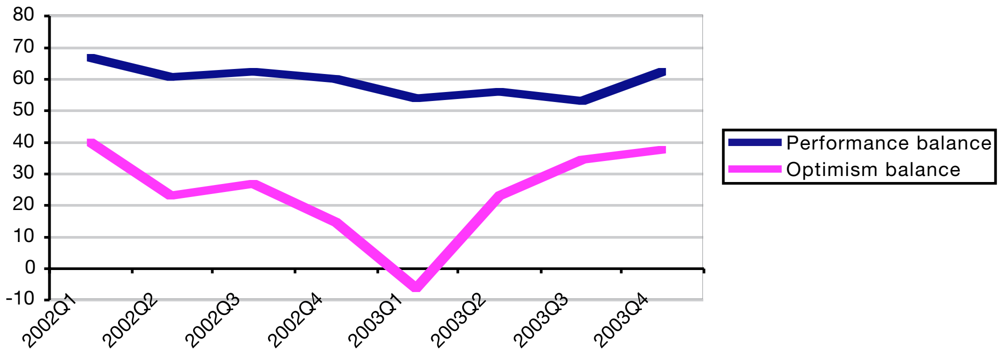
1: Summary

- Business optimism and performance continued to improve in the latest IoD Business Opinion Survey. The balance of those companies performing well versus those performing badly rose to 62% in the latest survey from 53% previously. The balance of those companies more optimistic about their company's prospects, rose to 38% in the latest survey from 35% previously. The Business Opinion Survey supports the view that economic growth will be stronger this year.

- Global economic growth is set to be much stronger in 2004 than in 2003. The IoD agrees that global GDP growth will be much stronger in 2004, but also argues that Euro-zone GDP growth this year and US GDP growth next year, are likely to be below consensus expectations. On a positive note, the main emerging markets now make up one seventh of world GDP but contribute around one third of global growth - punching above their weight.

Chart A IoD Business Opinion Survey



- The IoD forecasts UK GDP growth of 2.7% in 2004 and 2.6% in 2005. The IoD's latest forecasts show the UK economy is set to re-balance in 2004, but not in a dramatic way. Household consumption is expected to slow without crashing, whilst business investment is set to accelerate, but more slowly than in previous upturns.

- The IoD's debt 'Top-up' model of consumer behaviour explains conceptually, at the individual level, how households have become overextended in recent years. Aggregate data shows that contrary to received wisdom, total debt servicing costs are very high by historic standards.

- The debt 'Top-up' model, together with total debt servicing costs, suggest the UK economy can be re-balanced with only a modest rise in interest rates. The IoD forecasts that base rates will peak at 4.5% or less in 2004. Inflation expectations will be improved by the switch to the new CPI inflation measure. On the new harmonised measure the UK has the lowest inflation in the EU (with the exception of Finland).

- The IoD Business Opinion Survey identifies the interest rate expectations of company directors 3, 6 and 12 months ahead. The latest survey shows company directors expect interest rates will be 3.9% in three months, 4.1% in six months and 4.2% in 12 months (average of responses).

- The latest Business Opinion Survey shows that 90% of companies have made no change to their sales forecasts in 2004, as a result of the recent interest rate rise. In addition, 92% of companies have made no change to their expected employment levels in 2004 as a result of the recent interest rate rise.

- If household consumption continues to rise as a proportion of GDP, at the same time that business investment accelerates, interest rates may need to rise further than predicted by the IoD. If house price growth and equity release remain very strong throughout 2004, the risk of a subsequent house price crash will become much more likely. The IoD believes that this scenario can be avoided, but the risk is obvious.

- The Business Opinion Survey shows continued improvement in investment intentions. The balance of those more optimistic about the investment outlook rose to 26% in the latest survey from 18% previously. A year ago, at the time of the Iraq War, this balance had fallen to -28%.

- We have used the latest Business Opinion Survey to examine the issue of whether defined benefit pension fund deficits were a constraint on business investment. In our survey 88% of respondents said their company did not have an unfunded pension fund problem. Of the 12% that stated they had a problem, roughly half said the deficit had an adverse impact on investment plans. The survey suggests that defined benefit scheme shortfalls are having an impact on investment in roughly 1 in 20 companies.

- However, the overall responses to the pension fund deficit question mask significant differences across company size. Only 12% of all companies say they have a problem, but the proportion ranges from 2% for companies with a £6-10 million turnover to 30% for those with a £51-100 million turnover. Generally, larger companies were more likely to have a deficit problem and were more likely to have curtailed investment plans as a result.

- The Business Opinion Survey shows that IoD members are unhappy with the conduct of fiscal policy. When asked whether the conduct of fiscal policy was favourable or unfavourable towards business, there was a negative balance of -21% saying it was unfavourable. This compared with a positive balance of 57% for the conduct of monetary policy towards business. 51% of IoD members think the Government's spending plans are too high. 29% think the spending plans are about right.

- The fiscal pressures on the Chancellor are set to increase. The Golden Rule surplus on the current budget has collapsed from a projected £100 billion in the 2001 Budget to just £14 billion in the latest Pre-Budget Report. Moreover, public discontent about the rising tax burden is likely to become all the more intense owing to weak (or negative) public sector productivity growth and future tax projections. Latest figures show that government spending rose by 10.2% (yr-on-yr) in cash terms in 2003Q3, but this only led to a 1.7% (yr-on-yr) increase in real expenditure. Of the projected 3% of GDP rise in the tax burden - estimated by HM Treasury over the 1996-97 to 2007-08 period - only 1% of GDP will have occurred by the end of the 2003-04 tax year.

TABLE 1 IOD BUSINESS OPINION SURVEY - MAIN RESULTS

BOS question	2002 Q2	2002 Q3	2002 Q4	2003 Q1	2003 Q2	2003 Q3	2003 Q4
Company performance	61	62	60	53	56	53	62
- of which manufacturing	51	58	58	57	39	52	71
Company optimism	23	27	15	-6	23	35	38
- of which manufacturing	12	28	22	-25	15	25	31
Capacity utilisation	-25	-21	-18	-27	-28	-30	-26
- of which manufacturing	-39	-14	-17	-37	-30	-32	-17
Reported prices	-5	-1	1	-3	-3	-5	7
- of which manufacturing	-21	-23	-3	-21	-20	-12	4
Profits	29	29	28	4	18	34	27
Investment intentions	12	2	-1	-28	3	18	26

Detailed survey tables are available from www.iod.com

2: The global economy

2.1 Global growth

The G7 leading indicator published by the OECD, has risen sharply over the past six months and indicates strong economic growth in 2004. It should also be remembered that the G7 indicator does not incorporate China, Russia, India and East Asia (excluding Japan) which are the fastest growing areas of the global economy - the Chinese economy grew by around 9% in 2003. As Table 2.1 below shows, the main emerging markets make up only one seventh of world GDP but contribute around one third of global growth.

TABLE 2.1 ADVANCED VERSUS EMERGING ECONOMIES - GDP AND GROWTH SHARES

Country/grouping	2003 GDP (nominal)	Growth trend	$ Growth
USA	$11 trillion	3-3.25%	$330-350 billion
China	$1.4 trillion	9%	$125 billion
Other Tigers	$1.8 trillion	6%	$110 billion
India	$0.6 trillion	5.5%	$30 billion
Russia	$0.4 trillion	5%	$20 billion
Australia	$0.5 trillion	3.75%	$20 billion
Emerging Sub-total	$4.7 trillion	6.5%	$305 billion
Western Europe & Japan	$15 trillion	1.5%	$225 billion

(Source: Lombard Street Research Emerging Market Trends, January 2004)

The latest Consensus Forecasts survey of world economic activity is shown in Table 2.2. Table 2.2 shows that global economic growth is expected to rise from 2.5% in 2003 to 3.6% in 2004, before falling back to 2.8% in 2005. Clearly the USA is forecast to be the strongest growing advanced economy again. Euro-zone GDP growth is expected to pick-up from 0.5% to 1.8% in 2004. However, the IoD argues below that the 2004 Euro-zone forecast and the 2005 US forecast may prove optimistic.

TABLE 2.2 CONSENSUS FORECASTS - JANUARY 2004 SURVEY

Country/grouping	2003	2004	2005
USA	3.1	4.6	3.6
Euro-zone	0.5	1.8	2.1
Japan	2.3	2.1	1.6
Germany	0.0	1.8	1.9
UK	2.1	2.8	2.6
France	0.2	1.7	2.1
Italy	0.5	1.6	2.1
World	2.5	3.6	2.8

(Source: Consensus Forecasts, A Digest of International Forecasts, January 2004)

How realistic are the Consensus Forecasts? We now examine the main drivers and risks to GDP growth in the US, Japan and the Euro-zone.

2.2 US economy

US GDP growth surged in 2003Q3 to more than 8% on an annualised basis and the sources of this growth are not difficult to identify:

Monetary policy - Low interest rates with the Fed Funds rate at just 1%.

Fiscal policy - Significant tax cuts in 2003.

Replacement cycle - Recovery in IT investment following the capital overhang from the previous boom-bust .

Productivity growth - Rapid productivity growth boosting corporate profits.

Looking forward in 2004 a number of influences are likely to sustain strong US GDP growth:

Business confidence and investment - Corporate confidence has clearly improved in the wake of the strong growth in productivity, corporate profits and equity prices. Consensus Forecasts suggest business investment will take over from consumption as the main driver of growth, with business capex rising 10.5% in 2004 and 9% in 2005.

Employment - The latest recovery has been described as a jobless recovery, but more precisely this means not fewer jobs but fewer relative to GDP growth. There is a large discrepancy between the payroll and household survey measures of employment. Over the past year the payroll measure has fallen by 70,000 whereas the household measure shows a 2 million increase in employment. US firms are engaged in continuing debt pay down after the excesses of the boom years. Corporate profits are close to the 1990s peak (as a % of GDP) but the return on capital has some way to go yet and so cost cutting should continue. It is quite possible that US companies could aim to raise the profit share above 1990s levels in order to maintain equity prices. Companies may also be engaged in capital-labour substitution which has a limited effect on capacity, but greatly improves existing efficiency. Nevertheless, if US GDP growth remains firm, and productivity tails-off towards more sustainable rates of growth, employment growth will accelerate.

Inventories - The inventory sales ratio is at an all-time low, suggesting that some degree of stock re-building could be expected. However, the inventory sales ratio is also trending downward over time, as a result of structural changes (new economy influences) which may mean that expectations of an inventory re-build are overstated.

Output gap - Weak US GDP growth over the 2001-02 period indicates that the output gap is now of a sufficient size to dampen inflationary pressures in 2004. It should also be remembered that the surge in US imports over recent years has left many US companies with significant spare capacity. So-called 'pass through' price pressures from imports - from the fall in the dollar - may be limited by price wars between US firms and foreign firms desperate to maintain market share. In other words, a weaker dollar and higher import price pressures may not translate into higher domestic prices in the US. This reduces the pressure on the Fed to raise interest rates.

The dollar - Despite the fall in the dollar, and an improvement in US exports, the US current account deficit is likely to remain stuck around $600 billion in 2004 and 2005. The dollar is likely to fall further against Asian currencies over the coming year, despite Central Bank intervention. The outlook against the euro is discussed below.

The Fed - The Federal Reserve is unlikely to begin tightening monetary policy until there is sustained employment growth of around 200,000 per month. This raises an interesting dilemma because the lack of employment growth on the payroll measure means that any prospective interest rate rise is unlikely in the first half of 2004. If the Federal Reserve keeps interest rates on hold in the first half of 2004, it will then become difficult to raise interest rates in the second half of the year, because of the close proximity to the Presidential Election in November.

These six influences should ensure US GDP growth remains strong in 2004. However, there are a number of other influences, which suggest US GDP growth could underperform against consensus expectations in 2005:

Slowdown in money growth - There has been a sharp deceleration in US money supply growth over recent months. The US economy is now experiencing the unusual combination of rapid nominal GDP growth and money contraction.

Current account deficit - The size of the US current account deficit would almost certainly have forced a run on the currency in any country but the US, but as the world's largest economy and the world's reserve currency, the dollar clearly holds a special status. There must however be a question as to how large the overseas liabilities of the US can grow and how far Asian Central Banks in particular will be prepared to let their dollar portfolios grow. Upward pressure on Treasury bond yields could then be felt.

Budget deficit - Further growth in the US budget deficit threatens higher bond yields, which in turn could threaten investment growth. Bond market prices at present depend on the willingness of overseas buyers to purchase securities in a depreciating currency. Domestically, current bond prices also depend on US investors continuing to believe the inflation threat is benign, even with strong GDP growth.

Household savings - The household savings rate has now fallen below 2%, with the risk that any economic shock could push it up sharply.

Stock market - Strong growth in equity prices over the past year means that Wall Street is trading on a current price earnings ratio of 28. There are echoes of the previous bubble beginning to be heard.

These factors suggest that US GDP growth may begin to slow in the second half of 2004 and into 2005.

2.3 Japanese economy

In Japan the central question at present is whether the current recovery can last long enough to end deflation and create a virtuous circle of growth, or whether the economy is still too dependent on US and Chinese GDP growth, with the result that any slowdown in these economies could have a disproportionate impact in Japan. There are tentative signs that GDP growth in Japan may be about to become self sustaining for the first time in more than a decade. The problem is assessing how 'real' recent growth has been, given the difficulties of estimating GDP deflators in a deflationary environment. Overstating deflation results in exaggerated constant price GDP growth.

Our interpretation of economic developments in Japan is that the situation is not as bad as a year ago, but that the jury is still out regarding how sustainable the latest upturn is. Other, less immediate concerns for Japan relate to business investment, which is high as a proportion of GDP, in comparison to other advanced economies. If rates of return on capital in Japan are to converge with higher rates elsewhere, the investment-GDP ratio in Japan will need to decline. In the short-term this could depress growth.

2.4 Euro-zone economy

In both Japan and the Euro-zone currency strength is reducing GDP growth prospects. Euro-zone GDP increased by 0.4% (qtr-on-qtr) in 2003Q3, following a fall of 0.1% (qtr-on-qtr) in 2003Q2. Final domestic demand made no contribution to quarterly GDP growth in 2003Q3. Business confidence remains muted. According to the European Commission Survey, the Euro-zone business confidence indicator fell to -8 in December from -6 in November. The Euro-zone purchasing managers index for manufacturing rose from 52.2 to 52.4, whilst the index for the services sector fell from 57.5 to 56.6 over the same period. The Euro-zone consumer confidence index rose slightly to -16 in November from -17 in October. All in all a pretty subdued picture.

Thus far the ECB view seems to have been that whilst exchange rate developments were having a dampening effect on exports, overall export demand would benefit from strong GDP growth in the US and Asia. The risk now is that Euro-zone GDP growth will disappoint against the already moderate consensus expectations for this year.

Euro-zone recovery is unlikely to be strong due to:

Monetary policy - The German economy requires much lower interest rates and on current policies may even experience deflation in 2004. German consumer prices are rising by just 1.3% compared with 2.2% across the Euro-zone. Latest figures suggest the German economy may have contracted by 0.1% in 2003. There are two important dimensions to German monetary policy at present. First, the one size fits all Euro zone interest rate policy is a real constraint on cyclical recovery in Germany. Second, problems of under capitalisation in parts of the German banking system are dampening credit and broad money growth.

Structural policy - The unemployment rate in the Euro-zone remains high, at almost 9%. Moreover, despite limited reforms in recent years, structural rigidities in labour and product markets mean that there is likely to be a weak employment response to any pick-up in GDP growth. We remain doubtful that recent reforms will have made EU GDP growth substantially more 'jobs intensive'.

Further strengthening of the euro is very plausible, reducing GDP growth and putting mounting pressure on the ECB to respond. The IoD expects the Euro-zone will under perform against consensus expectations with GDP growth of 1.5% this year. Moreover, we are forecasting that this growth rate will only be achieved if the ECB reduces interest rates. If the euro breaks through $1.3 on a sustained basis a quarter point reduction is very likely over the next three months. If the euro breaks through the $1.4 level on a sustained basis a half point reduction by the middle of the year is possible. Even if the euro stabilises at current levels below $1.3, a quarter point interest rate reduction is still possible before the end of 2004.

3: The UK economy

3.1 GDP growth and inflation

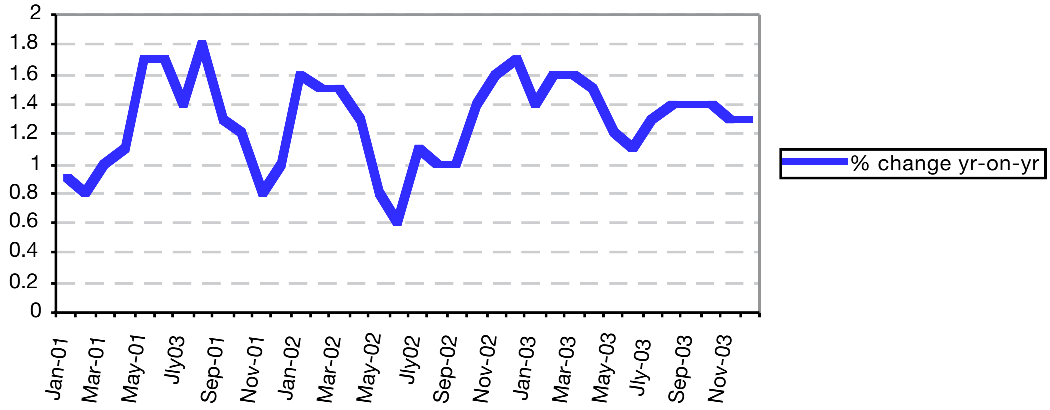
The preliminary estimate of GDP growth in 2003Q4 shows quarter-on-quarter growth of 0.9%, with service sector output expanding 1.0% (qtr-on-qtr). Full year GDP growth last year is now estimated at 2.1%. Given the Bank of England's view that there was little spare capacity in the UK economy - a small output gap - the latest figures displaying above trend growth strongly suggest further interest rate rises are on the way. The case for an interest rate rise in February is further supported by the tendency for preliminary GDP estimates to be revised upwards. This means that the final GDP estimate could show quarter-on-quarter growth 0.2% higher i.e. 1.1% (qtr-on-qtr) or an annualised rate of 4.5%.

Deciding the size of the output gap is no easy task and one made more difficult by alternative measures of GDP growth telling a slightly different story. The headline GDP estimate is measured at market prices and displays a different rate of growth in 2003 to the gross value added (GVA) at basic prices measure (which excludes taxes less subsidies on products - VAT and excise duties etc). GDP at market prices rose by 0.6% more than GVA at basic prices in 2003. In the past, GDP and GVA have shown the same growth but over recent quarters taxes less subsidies on products have been growing faster than GVA - and so GDP has been growing faster than GVA. GDP at market prices is the standard measure focused on, but in the murky world of estimating output gaps, the current divergence between the two measures is significant. Estimating output gaps will always be an imprecise process, but it is made all the more difficult at present by the differences in GDP measures.

Further economic complication at present has been created by the switch in the inflation target from the 2.5% RPIX to the new 2% CPI measure. The latest inflation figures show the CPI measure unchanged at 1.3% (yr-on-yr) in December, whilst the old RPIX measure rose slightly from 2.5% to 2.6% between November and December. The new measure is significantly below target. Despite the contrasting performance between the two measures, the Bank of England has indicated that the switch will have little impact on actual interest rates because these are formed in the light of the MPC’s view on inflation prospects two years ahead.

The good news is that the UK CPI measure has been consistently below 2% over recent years (see Chart 3.1) and that if this headline rate becomes embedded in inflation expectations over time, it should further establish the UK’s low inflation performance. International comparison of the new harmonised measure shows the UK has the lowest inflation in the EU – with the exception of Finland at 1.2%.

Chart 3.1 UK Consumer price inflation - new measures



In the wake of the interest rate rise to 3.75% a number of stylised scenarios can be foreseen over the 2004-05 period:

- Scenario 1: Modest interest rate rises – peaking at 4.5% or less – bring about a re-balancing of the economy in 2004.
- Scenario 2: Modest interest rate rises – peaking at 4.5% or less – bring about a sharper slowdown in the economy. Interest rates begin to fall in the second half of 2004.
- Scenario 3: Modest interest rate rises in the first half of 2004 fail to slow economic growth and bring about a re-balancing of the economy. Interest rates continue to rise, reaching 5% or more by the end of 2004. Re-balancing of the economy shifts into 2005.
- Scenario 4: Interest rates rise above 5% in early 2005 and trigger a sharp slowdown in household consumption.

TABLE 3.1 UK GDP GROWTH – STYLISED SCENARIOS

Scenario	2004 GDP % (yr-on-yr)	2005 GDP % (yr-on-yr)
Scenario 1	2.7%	2.6%
Scenario 2	2.0%	2.6%
Scenario 3	2.8%	2.2%
Scenario 4	3.0%	1.5%

This paper will argue that the first scenario is the most likely outcome. The IoD believes that a crash in consumption can be avoided and that the UK economy can achieve a successful re-balancing with a rise in interest rates to 4.5% or less.

Central to this view is the IoD's new 'Top-up' model of consumer behaviour, which explains conceptually, at the individual level, how households have become overextended in recent years. This analysis is reinforced by aggregate data showing that contrary to received wisdom, total debt servicing costs are very high (discussed below).

3.2 Households

The outlook for the household sector is central to UK economic performance over the 2004-05 period. The IoD has argued[1] there needs to be a re-balancing of the UK economy in 2004. In other words, the share of household consumption in GDP needs to stabilise or decline whilst the share of business investment increases. But first, we'll examine the risk to the UK economy from the household sector. With total household debt heading towards £1 trillion in 2004, there have been obvious concerns as to the destabilising effect this might have, with the risk of a pronounced boom-bust in the economic cycle over the 2004-05 period.

This fear is compounded by the knowledge that throughout the post-war period the peak in the house price cycle has been followed subsequently by a fall in real house prices. If this tendency were to be repeated there would be a clear risk of falls in nominal house prices – given that general inflation is so low.

If household consumption continues to rise as a proportion of GDP, at the same time business investment accelerates, interest rates may need to rise further than projected by the IoD. If house price growth remains strong throughout 2003, the risk of a subsequent crash and negative knock-on effects becomes more likely. Household spending and house prices need to slow to sustainable growth rates.

Recent UK house price modelling by the OECD[2] has highlighted the potential threat to macroeconomic stability. The OECD model simulation shows how changes in housing wealth have a relatively large short run impact on consumption, so that short run changes in consumption are better correlated with contemporaneous changes in house prices than disposable income. The clear implication of this result is that a sharp slowdown in house prices could have an abrupt impact on consumption.

OECD model simulations show the effect of continued 20% house price inflation through 2004, followed by an abrupt subsequent fall in house prices of 20%. Model simulations suggest GDP growth would be lowered by 1% point in 2005 (compared with what it otherwise would have been) and there would be a sharp upward spike in the savings ratio. Moreover, much of the negative GDP effect is offset by lower imports, so the impact on domestic demand growth would be more than 1%. Clearly the MPC could respond with lower interest rates under such a scenario and if they were lowered by 100 basis points over the course of 2005 the GDP growth effect would be lowered by 0.5%.

In reality, the impact on consumer and business expectations is difficult to gauge, as is the speed with which compensatory interest rate reductions may take effect. This means that the house price cycle as described would probably be more damaging than suggested by model simulation.

Will house price inflation slow in 2004? UK house price inflation (year-on-year measure) slowed throughout 2003. Nationwide figures show that UK house price inflation fell in each quarter last year, from 25.8% (yr-on-yr) to 21.1% (yr-on-yr) to 17.1% (yr-on-yr) and 15.5% (yr-on-yr) in the final quarter. However, the statistics also show that in December the month-on-month growth in UK house prices was 1.5% - an annualised rate 18%. It seems reasonable to assume that higher interest rates will slow the housing market in 2004 and quarter-on-quarter house price growth could fall from 3% in 2003Q1, to 2%, 1% and zero thereafter. This would translate into annual house price inflation of 14.4%, 12.8%, 10.5% and 6.1% in successive quarters this year, giving full year house price growth of 11%. We hasten to add this is not a forecast, but an illustration of the minimum slow down which needs to occur.

If house price inflation was to exceed these rates, the risk of a destabilising cycle would become very real. Much will depend on how quickly the south-north ripple effect fades. House price inflation in the south has already weakened significantly.

The table matrix below was produced by Lombard Street Research and shows the number of years required to restore the long-term house price to earnings ratio of 3.6 from its current record high of 5.1 - depending on alternative movements in house prices and earnings. The matrix shows that even if house prices show zero change each year, and earnings grow by 4.5% per annum, it will take 7.4 years to restore the long-term average for the house-price income ratio. The matrix illustrates another key point which is that in the wake of previous peaks in the house price-earnings ratio (post 1974 and 1989 for example) the long-term average was restored in 3-4 years. If this remains the case in the latest cycle (assuming earnings grow on a trend 4.5%) the matrix implies house prices would need to fall around 3-6% per annum over the period.

TABLE 3.2 YEARS TO RESTORE THE LONG TERM HOUSE PRICE-INCOME RATIO

Rate of fall in house prices, % per annum	Rate of growth in average earnings, % per annum				
	2.5%	3.5%	4.5%	5.5%	6.5%
0	13.4	9.5	7.4	6.0	5.1
-3%	6.1	5.1	4.4	3.9	3.5
-6%	3.9	3.5	3.1	2.9	2.6
-9%	2.8	2.6	2.4	2.3	2.1
-12%	2.2	2.1	2.0	1.8	1.7

source: Lombard Street Reseach

Turning to household consumption there is an equally uncertain outlook. Household consumption growth weakened in 2003, having grown by 4.5% in 2000, 3.1% in 2001 and 3.6% in 2002. In the first three quarters of 2003, household consumption grew by 2.8% (yr-on-yr), 2.4% (yr-on-yr) and 2.5% (yr-on-yr). In other words, households were beginning to bring their spending under control, before the rise in interest rates last year. However, other indicators also suggest potential spending power remains strong.

Real household disposable income growth was strong in 2003Q3, rising 2.8% (yr-on-yr). Latest statistics show the household savings ratio stood at 5.9% in 2003Q3, compared with a figure of 7.5% in 2001Q1. In other words, the savings ratio has slipped but not collapsed. Household consumption and the savings ratio does not as yet suggest a sharp future upward spike in saving levels by previously overextended households. However, if the housing market remains strong, continued buoyant mortgage equity release risks a pronounced boom-bust in the economic cycle. Recent figures show mortgage equity withdrawal reached £13.4 billion – a huge 7% of disposable income – in 2003Q3. Latest data also shows that the savings ratio is not as low as previously thought. The cushion of housing wealth, potential equity release and the level of the savings ratio, makes for considerable economic uncertainty this year. Are households moderating their behaviour?

Retail sales were buoyant in December 2003, rising by 4% (yr-on-yr), with a three month annualised rate of growth of almost 8%. Retail sales volumes fell 1.7% (mth-on-mth) last January and so unless they fall by more this year, year-on-year retail sales growth will have accelerated in January. If retail sales were flat month-on-month in January, the annual rate of growth would have jumped to 6%. However, in contrast, credit card borrowing was at its lowest level since 1997 in December.

In the following section we examine consumer behaviour in more detail, in order to try and better understand what is driving household consumption and whether it can be slowed, without crashing, over the 2004-05 period.

3.3 Debt top-up behaviour

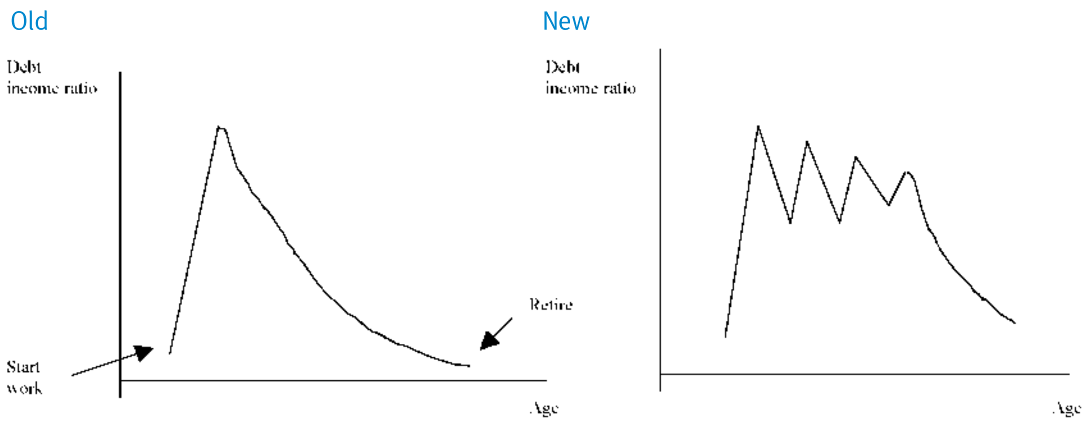
The IoD's debt top-up model of consumer behaviour illustrates how the temptations of the 'High Street' may have interacted with low interest rates over recent years:

- Myopic consumption smoothing – Economic theory predicts that consumption will be influenced not just by current disposable income (post tax), but also by consumer perceptions of permanent income. For example, a young professional might borrow heavily in their 20s and 30s, confident in the expectation that future income levels will easily meet debt payments – this is called consumption smoothing. The IoD's concept of myopic consumption smoothing focuses on discretionary income (post tax and debt service payments) and the possibility of mistaken expectations of permanent income. This arises when consumers willingly perceive every interest rate fall as a permanent boost to discretionary income – because they are looking for an excuse to spend. Myopic expectations therefore lead to a change in inter-temporal behaviour, which may need to be reversed in the future if the outlook for income and/or interest rates deteriorates, or the accumulation of debt is too large.

- Debt accumulation over the life cycle – Households may be pursuing new behavioural patterns whereby they allocate a set amount of their monthly budget for debt servicing – both mortgage (secured) and credit cards (unsecured) – and if interest rates then fall, debt levels can be increased, whilst maintaining previous monthly debt servicing costs. The concern of the IoD is that UK households do not seem intent on reducing debt burdens but are instead interested in attaining the maximum debt income ratio consistent with affordable debt servicing levels. The conceptual diagram of this 'top-up effect' for an individual in a low inflation environment is shown in Charts 3.2 and 3.3. Chart 3.2 shows a traditional view of how individuals accumulate debt over the course of the life cycle – borrowing when young, primarily for house purchase and then paying back the debt until retirement. Chart 3.3 shows what we believe is the contemporary picture, whereby across the age range people aim to maximise debt subject to the affordable debt servicing constraint – the monthly cost of borrowing. This process might be expected to start with people initially adding more to their credit card debt and then over time exploiting growth in house prices to increase mortgage equity withdrawal.

CHARTS 3.2 AND 3.3

The Top-up effect – a conceptual diagram over an individual life cycle



If individuals are continually 'topping-up' debt levels across all age groups, one would expect the average debt income ratio for each age cohort to be increasing over time.

Unfortunately debt-income statistics by cohort are not available beyond 2000. However, the British Household Panel Survey (BHPS) does provide comparisons between 1995 and 2000. The BHPS shows that between 1995 and 2000 total debt income ratios by cohort rose for the 55+ age group.[3] Recent years have also seen strong growth in equity release plans for the retired – so-called 'blowing the kids inheritance'. These schemes tend to be either roll-up (whereby homeowners borrow money against their property, without paying interest, and the debt is then paid off at a future date when the property is sold) or reversion plans (whereby homeowners sell their home but are then allowed to remain in the property until death).

The BHPS also shows that unsecured debt-income ratios rose across all age groups. Our strongly held suspicion is that the findings of the next BHPS will show that since 2000 secured debt-income ratios will also have increased owing to the sharp rise in mortgage equity withdrawal in recent years. Unsecured debt-income ratios are expected to have increased further as well.

If top-up behaviour has been a characteristic of UK households over recent years, overall levels of debt servicing should be high. However, the general perception is that they are low, because of historically low interest rates. We now examine the issue of debt servicing costs and whether in reality they are at an historic low.

Total debt service costs

Basic debt servicing ratios (interest rate-income gearing) are at a historic low when measuring the cost of interest rate servicing. Council of Mortgage Lenders data shows that for the average UK household with a mortgage, the mortgage interest-income gearing ratio is now 14% compared with 34% in 1990. We are paying much lower mortgage interest costs but the size of mortgages are much higher than they used to be. This illustrates the obvious point that consumers need to repay debt. They also have unsecured (credit card, personal loans etc) payments as well. Taking all mortgage and unsecured interest and principal repayments, households with an average mortgage and average levels of unsecured debt are now paying 34% of income in debt servicing costs (17% in interest payments alone).

Recent work by Capital Economics[4] provides strong additional evidence that households are highly geared at the present time.

Capital Economics have constructed an aggregate measure of total income gearing, incorporating all interest, mortgage interest, regular mortgage repayments, endowment redemption payments and unsecured repayments. This shows that whilst income gearing measured using interest costs is just 7% of household income, when debt repayments are included this rises to 15% and 20% if endowment redemption payments are included. Capital Economics has estimated that:

"Whereas income gearing on just interest payments measures is less than half its early 1990s level, on both of the wider measures, it is almost at the levels reached in the last boom/bust … the amount of their income that households are paying to service their record levels of debt is not far off the peak in the late 1980s. This is despite the fact that interest rates have only just started to rise from a 48 year low."

We are now faced with the turn in the interest rate cycle with higher interest rates needing to be paid on record levels of outstanding debt. Capital Economics have estimated what would happen if debt continued to rise at recent growth rates and interest rates increase by a further 1%, 2% and 3% respectively. Their conclusions are:

- A 1% rise in interest rates takes income gearing to just over 24% – its previous peak in 1988.
- A 2% rise would result in households paying just over a quarter of their income in debt.
- A 3% rise would raise this figure to 28%.

This aggregate analysis clearly supports the IoD's stylised top-up model and our hypothesis that households are close to their affordable limit in terms of total debt servicing costs. The conceptual analysis and aggregate data support the IoD's hypothesis that household consumption can be slowed relatively easily. However, our conclusions depart with those of certain commentators in that we believe a crash in consumption can be avoided.

Will there be a crash in consumption?

Consumption has risen sharply as a proportion of GDP in the UK over recent years and cannot realistically be expected to continue to rise at current rates. Between 1997 and 2003 household consumption increased from 61% to 65% of GDP. This increase is measured at constant prices, which is slightly misleading, because over the period falling import prices for PCs and other items – and due to the exchange rate – has meant that at current prices the consumption share has only risen from 62% to 63% over the same period. Despite this caveat, it is clear that the Bank of England wants to bring about a re-balancing of the economy. The MPC is obviously worried that if left unchecked, household borrowing and consumption will continue apace and de-stabilise the economy.

According to the Bank of England, secured mortgage debt has increased from 76% to 96% of household income over the 1997-2003 period. The stock of unsecured mortgage debt has increased to 22% of household income in 2003 – attributable to a combination of easier availability of credit and/or falling unsecured borrowing costs.

The increase in the secured debt ratio is probably due to a combination of cyclical and structural influences. The primary structural explanation is long-term growth in owner occupation. Cyclical factors relate to the low interest rate environment, the boom in house prices and the associated explosion in mortgage equity release to more than 7% of disposable income over the past year.
Despite the surge in debt levels to date, there is good reason to believe that this process will not necessarily end in tears:

- Nominal versus real measures of consumption – Recent growth in household consumption looks less excessive when measured in nominal as opposed to real, terms. Does this mean that the risk of a sharp retrenchment in household consumption is low? The IoD's view is yes, but with certain qualifications attached. First, similar observations regarding the difference between real and nominal measures could have been made at the end of the 1980s, and this did not prevent a subsequent sharp retrenchment in household spending. Second, the relative strength of real household spending has been facilitated by the relative weakness of the prices of goods and services purchased by households compared with those in the rest of the economy. Certain commentators[5] have been prominent in arguing that "this weakness could soon come to an end as a lower exchange rate worsens the terms of trade and the upward pressure on prices in the public sector fades".

- Structural changes in debt – Growth in fixed rate mortgages may mean that traditional econometric models are misleading as to the effects of variable interest rate changes on the economy. Moreover, financial services providers are enabling unsecured debt to become secured debt and thereby reducing the spread over base rates. Other forms of credit consolidation are also possible, such as continual shifts in credit card balances to take advantage of zero interest rates on transfers.

- Measurement issues – The debt ratio is misleading as a measure of economic exposure. The numerator is the sum of total debt, whilst the denominator is the sum of all incomes i.e. those with and without debt. A better measure would show the ratio of total debt to the total incomes of those in debt. Such a measure[6] is only available up until 2001, but does show that over the 1995-2001 period the secured debt to income ratio for mortgage holders increased from 1.24 to 1.25 – at a time when the standard debt income ratio rose much faster. There can be little doubt that the adjusted debt income ratio will have increased since 2001, at the very least because of the growth in mortgage equity release in recent years.

- Housing equity – The growth in equity release has not been alarming when measured against retained housing wealth. Bank of England estimates show that because of the growth in house prices over recent years, undrawn housing equity has actually increased from 65% to 77% of housing wealth over the 1996-2003 period.

- Debt wealth ratios – The ratio of total debt to total assets is relatively close to the average of the past two decades. Wealth is now being underpinned by: (1) Housing market ripple effects extending north across the country. (2) The rise in the stock market in 2003 has led to double digit growth in net financial wealth. On some calculations the net wealth to income ratio may be close to the all time peak recorded in 2000. As a result, positive wealth effects on consumption remain strong.

- Net acquisition of financial assets – Net acquisition of financial assets actually rose from 0.2% to 1.2% of household income between 1998 and 2003. In aggregate, households have been expanding both the liability and asset sides of their balance sheet. What is unclear from the data is the extent of any mismatch i.e. debt accumulation concentrated in certain households and asset accumulation in others.

- Disposable income growth – The slow down in household disposable income growth seen in 2003Q2 reversed in 2003Q3.

- Savings ratio – The household savings ratio has been relatively stable over recent years and stood at 5.9% in 2003Q3. At current levels the savings ratio does not suggest a sudden upward shift as a result of a swing towards precautionary behaviour on the part of consumers. The inflation adjusted savings ratio is not low by historical standards. The Bank of England argues that since the mid-1990s income volatility has been lower, and this may have helped to reduce consumer perceptions of future income uncertainty – such as at times of rising unemployment and falling household income. If so, this would have led to a reduction in the desired savings ratio. In other words, macroeconomic stability may have permitted lower levels of saving and higher levels of debt. Of course, if these improved expectations prove to be false, households could swiftly revise down their expectations and raise the level of desired savings rate.

- Dutch disease – The Dutch economy experienced a large rise in household debt in the 1990s and a subsequent sharp economic slowdown. However, part of the severity of the Dutch slowdown could be attributed to a loss of control over interest rate policy within the euro, and an inability to set monetary policy appropriate for domestic economic conditions. Unlike the Netherlands we still have control of monetary policy and could therefore reduce interest rates if the economy begins to slow too fast.

3.4 Companies

Latest figures show the business investment to GDP ratio (at current prices) fell to its lowest recorded level (since 1965) in 2003Q3[7] - partly because the price of investment goods has fallen relative to other prices in the economy. Business investment was down 1% (yr-on-yr) and 1.2% (qtr-on-qtr) in 2003Q3.

The following analysis explains why business investment has been slow to recover thus far, but should now do so in 2004. However, the IoD does not expect business investment to strengthen at the pace of previous cyclical recoveries.

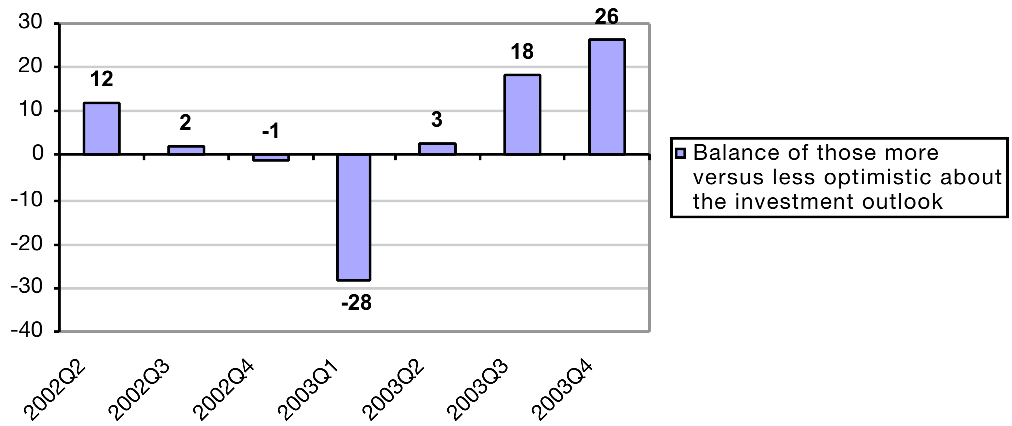
Table 3.3 identifies a number of reasons why business investment did not recover in 2003.

TABLE 3.3 REASONS FOR SUBDUED UK BUSINESS INVESTMENT IN 2003
Geo-political uncertainty in early 2003 associated with the Iraq war
Historically high levels of corporate gearing
Capital overhang from IT investment boom
Global demand weakness
Subdued business confidence
Defined benefit pension fund deficits
Overall uncertainty – postponement incentive

Table 3.3 highlights the complex array of influences on the business investment decision, which resulted in a high degree of uncertainty and provided companies with an incentive to postpone investment. The influence of uncertainty highlights the fact that additions to the capital stock may be irreversible – in other words the capital stock can be adjusted upwards (easily) but not downwards (easily). Not investing today still leaves a firm with the option of investing tomorrow and at times of great uncertainty, the ‘on hold’ option makes economic sense.

What’s the future outlook for UK business investment? The IoD’s Business Opinion Survey supports the view that business investment will recover in 2004. Chart 3.4 shows investment intentions further improved in the latest December survey. Chart 3.4 shows that over the past year there has been a considerable improvement in investment confidence.

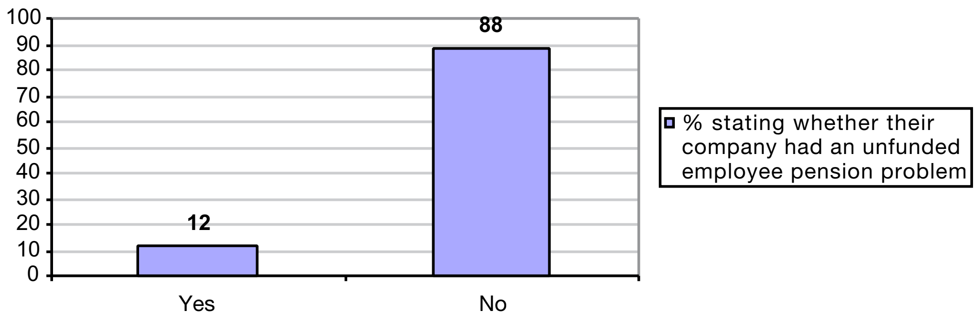
Chart 3.4 Investment intentions – IoD Business Opinion Survey



(Source: IoD Business Opinion Survey)

One issue that has received much discussion is the impact of defined benefit pension fund deficits on company investment. We have used the latest Business Opinion Survey to examine the issue of whether pension fund deficits were a constraint on investment. In our survey 88% of respondents said their organisation did not have an unfunded pension fund problem. Of the 12% that stated they had a problem, roughly half said that the deficit had an adverse impact on investment plans.

Chart 3.5 The impact of pension fund deficits



(Source: IoD Business Opinion Survey)

However, the overall responses to the pension fund deficit question masked significant differences across different sizes of company. Only 12% of all companies have a problem, but the proportion ranges from 2% for companies with a £6-10 million turnover to 30% for those with a £51-100 million turnover. Generally, larger companies were more likely to have a deficit problem and were more likely to have curtailed investment plans as a result.

TABLE 3.4 THE IMPACT OF PENSION FUND DEFICITS – BY COMPANY TURNOVER

	Under £1m	£1-5 m	£6-10 m	£11-20 m	£21-50 m	£51-100 m	£101-500 m	Over £500m
Yes, company has an unfunded employee pension fund problem (all respondents)	6%	9%	2%	11%	21%	30%	16%	28%
Has the scale of the deficit had an adverse impact on investment plans (those responding yes to above question)	56%	43%	100%	-	57%	48%	65%	50%

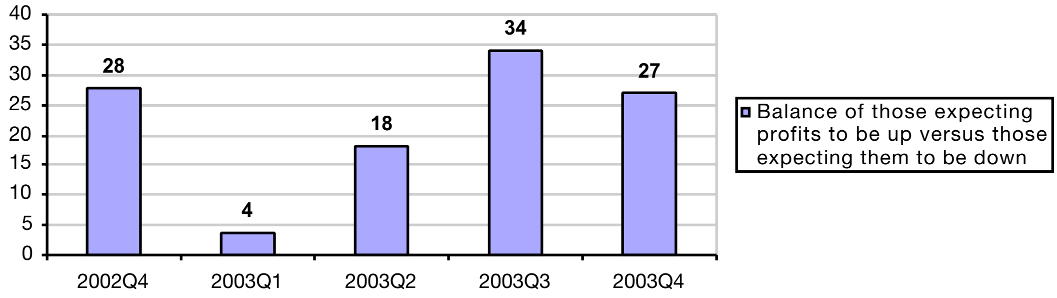
(Source: IoD Business Opinion Survey)

When combined with the improvement in equity markets over the past year we believe defined benefit scheme shortfalls should not prove too serious a drag on investment in 2004. Standard Q models of investment (relating business investment to expectations through share price movements) are flashing green as a result of the growth in equity prices over the past year. The FT all share index rose by around 30% between March and December 2003. Total equity returns in the major markets (in local currencies) were between 20% and 40% in 2003. However, it should not be forgotten that our survey still suggests defined benefit scheme shortfalls are having an impact on investment in roughly 1 in 20 businesses.

Corporate finances and profitability have notably improved over the past year. Private non-financial corporations (PNFC) borrowed £14.5 billion in 2001, but then restructured rapidly to record a £6.6 billion surplus in 2002. In the first 9 months of 2003 PNFCs recorded a surplus of £10.6 billion. Corporate liquidity is not a constraint on investment and recent growth in unused corporate credit facilities suggests borrowing will pick-up over the coming months.[8] On a more cautionary note, historically high levels of capital gearing - whilst improving - provide a continuing restraint on UK business investment. PNFC capital gearing rose from 23% to 38% over the 1999-2002 period, compared with a post 1990 average of 28%. Consequently, the PNFC sector is likely to remain a net lender for some time yet.

Corporate profitability improved through 2003, with latest figures showing the net rate of return for PNFCs (excluding oil companies) reached 11.7% in the third quarter, up from 10.4% at the end of 2002. This rate of return is consistent with higher levels of business investment. The net rate of return for PNFCs has ranged from a low of 9.3% in 1992Q1 to a high of 13.8% in 1998Q1. Rates of return then slipped, partly because of over investment during the boom, which led to lower returns on capital employed. Another contributory factor was the strength of sterling over the period. Net rates of return in manufacturing halved over the 1998-2001 period, but have since picked up from a low of 6.4%, to 7.5% in 2003.

Chart 3.6 Profit expectations

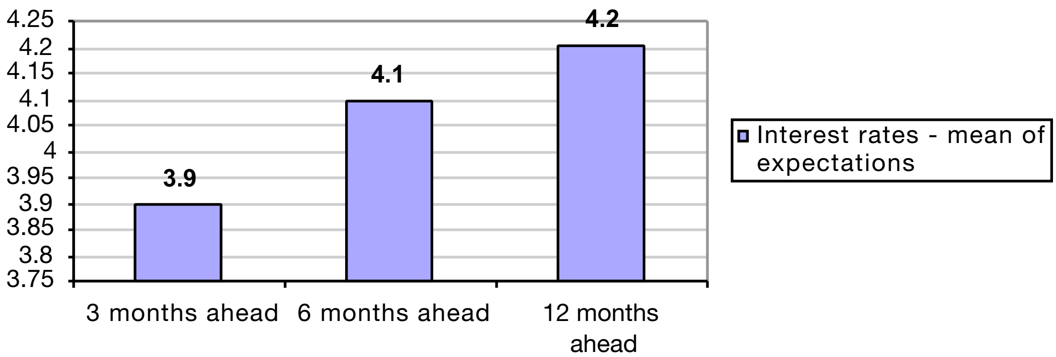


(Source: IoD Business Opinion Survey)

The IoD's latest Business Opinion Survey shows that profit expectations have improved over the past year. These results are not surprising. Demand is picking up and previous restructuring and cost cutting is boosting margins. Higher profits indicate a more favourable return on capital, encouraging firms to re-invest any surplus. Higher profits also boost confidence and raise the expected future return on proposed projects. In addition, higher profits may also raise investment as a result of the availability of internally generated funds.

One obvious dampener on the investment outlook is the potential impact of higher interest rates. The IoD's Business Opinion Survey identifies interest rate expectations 3, 6 and 12 months ahead. Average interest rate expectations 12 months ahead are around 4.25% showing that many company directors do not share the more pessimistic view from forward rates in financial markets.

Chart 3.7 UK interest rate expectations



(Source: IoD Business Opinion Survey)

These interest rate expectations do not necessarily directly drive business investment. Firstly, because companies can raise money by borrowing at the short or long end, or by issuing equity for example. Secondly, because there is debate as to the interest rate sensitivity of investment. However, interest rate expectations do provide a useful proxy of expected volatility (or lack of) in the economy.

The latest Business Opinion Survey shows that 90% of companies have made no change to their sales forecasts as a result of the recent interest rate rise. In addition, 92% of companies have made no change to their expected employment levels in 2004 as a result of the recent interest rate rise. These two results provide strong evidence that underlying business confidence has not been adversely affected by the tightening in monetary policy.

TABLE 3.5 REASONS FOR RECOVERY IN UK BUSINESS INVESTMENT IN 2004
Growing corporate surplus (further improving capital gearing)
Growing business confidence
Reduced concern of pension fund deficits
Growth in corporate profits
Extension of corporate credit facilities
Capital overhang replaced by new investment cycle
Global economic and equity market recovery

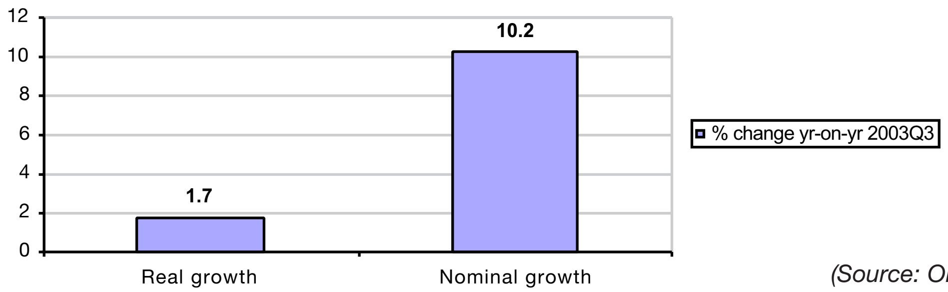
Table 3.5 summarises the IoD's analysis of why business investment is set to recover in 2004. On the IT front, the recent surge in investment in the US strongly suggests that any capital overhang from the dot-com boom years has now been supplanted by a new investment cycle. In the UK this view is supported by IT industry reports in the New Year. Moreover, neo-classical models of business investment, incorporating the user cost of capital, highlight the possibility of substitution between factor inputs – labour and capital – in an environment of strengthening productivity growth and low interest rates – attributable to IT gains as shown in the US at present.

The IoD forecasts that business investment will grow by around 4% in 2004. In other words, there will not be a strong cyclical recovery.[9]

3.5 Government

Latest GDP figures show a huge differential between the growth in Government consumption at current versus constant (chained volume) prices. In 2003Q3 general Government consumption rose by 10.2% (yr-on-yr) at current prices, but only 1.7% (yr-on-yr) at constant prices. The implied deflator of 8.5% shows the huge contrast in inflation performance between the public and private sectors.

Chart 3.8 Government spending (consumption) – real versus nominal growth



(Source: ONS)

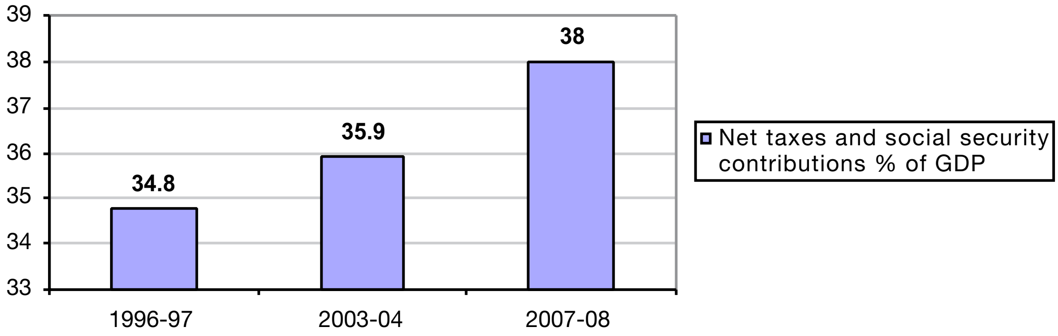
The public sector is experiencing large increases in expenditure at the same time that costs are increasing sharply as well. In this environment of very weak or negative productivity growth, output growth is very poor. Obviously the public sector is labour intensive and so more resources inevitably mean more staff, but the problem we now have is that higher staffing levels are only achieving minimal improvements in output. One recent experimental series of public sector productivity, produced by the government, showed that over the 1997-2001 period cumulative public sector productivity declined by 3%.[10]

Boosting spending by 10% to achieve a 1.7% increase in output is not efficient. We are therefore in the strange position of having very large increases in public expenditure which still manages to pull down recorded real GDP growth below the 2.5% to 2.75% trend. If public sector inflation declines and productivity rises, underlying GDP growth could improve even against the background of a lower overall growth in spending. Unfortunately, this almost certainly requires more radical structural reform than is in place or on offer.

It is already clear that the next Comprehensive Spending Review will be tough on negotiating departments, with the exception of the NHS, which is ring fenced by pre-existing commitments. However, if we look at the other side of fiscal policy, namely taxation, we see that here also, pressures are mounting to moderate the growth in public spending.

Chart 3.9 is taken from the December 2003 Pre-Budget report and shows HM Treasury projections of the change in the tax burden over the 1996-97 to 2007-08 period. The chart shows that despite rising public discontent over tax increases, the worst is still to come. Of the 3% of GDP rise in the tax burden over the projected period, only 1% of GDP will have been implemented by the end of the 2003-04 tax year. This suggests the Chancellor may be reluctant to add further to the tax burden, beyond existing projections.

Chart 3.9 Changes in the tax burden

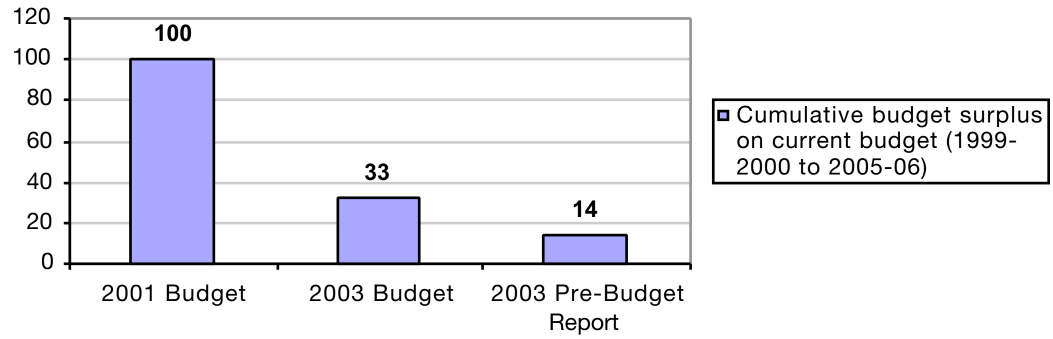


(Source: Pre-Budget Report, HM Treasury, December 2003)

The Chancellor is also constrained by the Golden Rule – the commitment to balance the current budget over the course of the economic cycle and only borrow for investment. Chart 3.10 shows that the cumulative surplus on the current budget has fallen sharply in recent years. In the 2001 Budget the Chancellor projected the cumulative budget surplus over the economic cycle at £100 billion. By the time of the 2003 Budget the projected cumulative surplus had fallen by two-thirds. In the 2003 Pre-Budget Report it fell further to just £14 billion.

The Chancellor has little or no slack left in the public finances. If GDP growth underperforms his assumptions, or the tax yield is less than expected for a given rate of GDP growth, he will have little choice but to raise taxes or moderate spending.

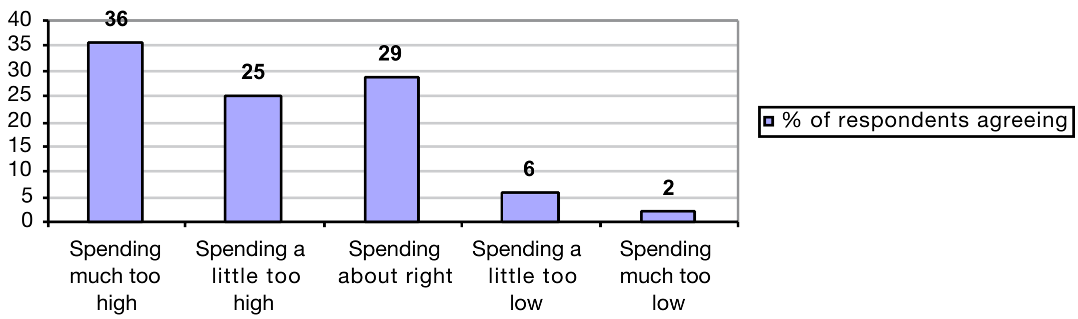
Chart 3.10 The Evolution of the Golden Rule (£ billion)



(Source: HM Treasury)

The latest Business Opinion Survey shows IoD members have serious doubts regarding the conduct of fiscal policy. Chart 3.11 shows that 51% of respondents thought Government spending plans were much too high or a little too high. Only 29% of respondents though spending plans were about right. When asked whether the conduct of fiscal policy was favourable or unfavourable towards business, a balance of –21% thought it was unfavourable.

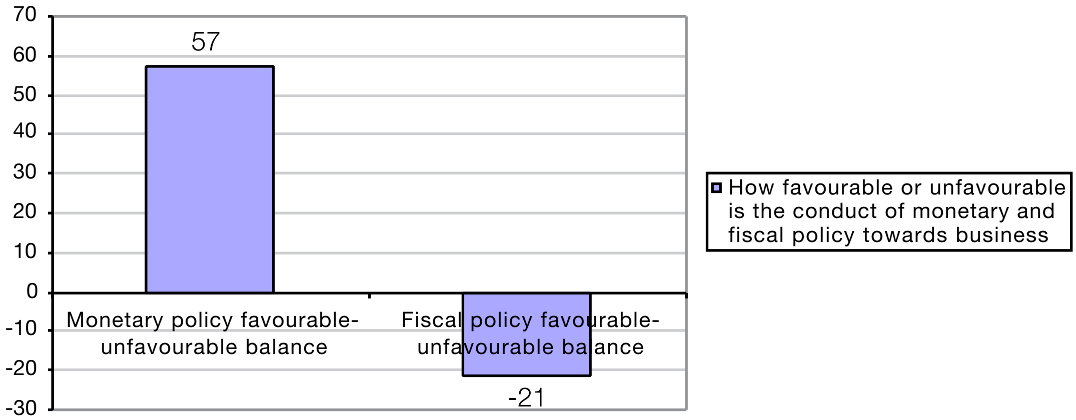
Chart 3.11 IoD member views on public spending



(Source: IoD Business Opinion Survey)

One simple rule of thumb indicator of the Chancellor's lack of room for maneouvre is the average forecast error for public borrowing, which is £10 billion one year ahead, £20 billion two years ahead, £30 billion three years ahead etc. One important issue at present is highlighted by the Chancellor hitting his GDP growth target for 2003 (2.1% actual versus the 2% to 2.5% range forecast by HM Treasury) but not raising the tax revenue he envisaged – in other words the rise in borrowing has been the result of structural rather than cyclical factors.

Chart 3.12 IoD member views on fiscal policy



(Source: IoD Business Opinion survey)

The Chancellor is keeping his fingers crossed and hoping for sustained and strong economic recovery. But this then raises the issue of whether the rates of growth the Chancellor needs are consistent with the inflation target set for the Monetary Policy Committee. Even without this issue, the Chancellor's tax revenue projections may be threatened by a re-balancing of the economy which shifts activity away from tax lucrative areas such as consumer spending to less lucrative ones such as investment and exports.

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7. The measure of business investment used in the National Accounts is outdated (plant and machinery, buildings etc) because it doesn't capture wider definitions of investment incorporating human capital and innovation, R&D etc. If companies have been moving a greater share of business investment into these areas, traditional statistical measures will under record the 'true' level of business investment.
8. Higher interest rates and corporate borrowing, Lombard Street Research, 3rd December 2003.
9. Normal cyclical recoveries in business investment are quite strong, often recording double digit growth. This is not surprising in view of accelerator models of investment which show how net investment is proportional to the change in output, rather than the level of output. For example, if company output is £1 million and annual investment £0.1 million and the desired capital stock-output ratio is 3 (a desired capital stock of £3 million), then a 10% increase in output to £1.1 million results in a new desired capital stock of £3.3 million and investment rising by 200% to £0.3 million. Clearly this is a very simplified example and the entire process may take a longer period of time, but it does illustrate the tendency for investment to be volatile.
10. Measuring public sector productivity is complicated. For example, increasing the number of teachers to reduce class sizes would reduce productivity on a pupils per teacher measure, but may still increase the overall quality of teaching as measured by results.