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- Rising house prices and low interest rates stimulate consumer borrowing
- No frills airlines winning the battle of the skies
- The Bank of England keeps official interest rates at 5.0%
- The "Marconi Effect" – manufacturing continues to slump in July

Nationwide remain confident on house prices in 2001

We see no pressing need for a correction in house prices... Current levels of confidence and borrowing suggest consumers remain relatively optimistic despite recent job loss announcements

Nationwide Review– August 2001

Waiting for the Consumer Slowdown

Consumer spending accounts for nearly two thirds of total demand for goods and services and changes in spending hold the key to whether the economy manages to avoid a hard-landing this year. This article considers the strength of consumer demand despite fears for the well-being of the economy as a whole

High Street spending remains strong despite a global downturn

Data on the personal sector this month paints a picture of consumers in remarkably good financial health! The Nationwide reported that house prices rose by 0.4% in August driving annual house price inflation to 11.9% (from 10.9% in July). The British Retail Federation (BRF) calculates that High Street spending is nearly 8% higher than a year ago. Even with an adjustment made for an expansion in total floor space, like-for-like sales among leading retailers are still 5.6% up on the last twelve months. Food, clothing, new furniture and carpets are among the sectors enjoying the most rapid growth in volume sales.

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		HOUSEHOLD SPENDING IN THE UK			
* 2001 data is a forecast from Merrill Lynch		1998	1999	2000	2001*
Total Consumer Spending	% Change	4.0	4.5	3.7	3.5
Non-Vehicle Durables	% Change	12.6	13.6	12.6	Not available
Food	% Change	-0.3	1.0	2.8	Not available
Clothing and Footwear	% Change	4.7	6.5	7.1	Not available
Transport & Communications	% Change	5.7	10.1	3.8	Not available

Low Cost and No-Frills—A Recipe for Success in the Skies?

Budget airlines such as Ryanair, Easyjet and Go are proving popular with passengers and forcing traditional airline rivals to rethink their strategies. What lies behind the success of the no frills approach and how have these new market entrants changed the rules?

Prime Ministerial Approval

Tony Blair's decision to fly his family to their French villa on Ryanair once again brought the spotlight onto the popularity of the budget airlines. A BA flight from Gatwick to Toulouse would have been quicker and more comfortable. But Blair followed the example of 10 million UK voters this year and booked a no-frills flight. Why? Because it was substantially cheaper.

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JP Morgan on the resilience of the British consumer

"Rising fears about the general economic climate do not seem to deter shoppers as long as they remain comfortable about their own household's finances— low unemployment is keeping confidence at relatively high levels"

Consumer Confidence Index

The GfK index is a monthly measure of consumer confidence— it asks people a series of questions about their own financial circumstances, and their expectations for the economy as a whole. A rise in the index shows an improvement in consumer optimism

No Change in Base Interest Rates

*Base rate is currently 5%
Rates have come down from 6% last year
This is the lowest level in over 20 years
In July 1980 rates peaked at 16%, the highest level for 20 years*

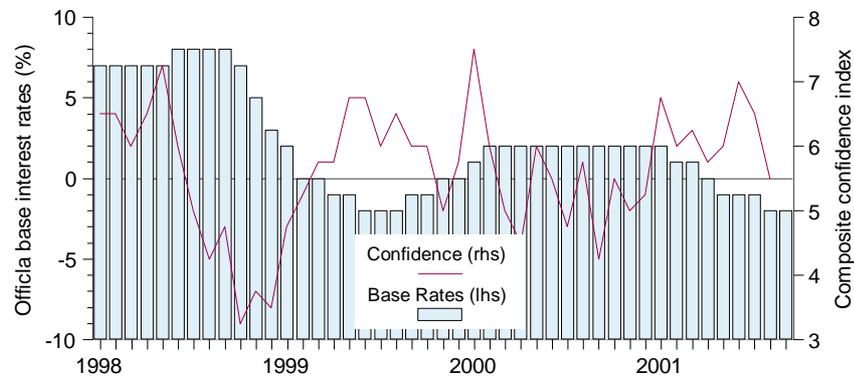
Further evidence of the strength of consumer demand comes from record mortgage lending and consumer credit growth in July. The number of new mortgage approvals (a key sign of the level of demand in the housing market) is now at its highest level for over four years. Net mortgage approvals are growing at an annual rate of 9%. In July alone, net mortgage lending reached £4.5 bn and 111,000 new mortgages were approved by banks, building societies and other lenders. Consumers are also demonstrating a remarkable willingness to fund their spending through credit cards. In July, the net level of consumer credit (new credit minus repayments) rose £1.7 bn—only a touch below the record high of £1.8 bn seen in the spring of this year.

Why is consumer spending so strong?

So far, fears that a global economic slowdown would lead to rising unemployment in the British economy have proved unfounded. Labour market data this summer showed UK employment continuing to grow (the rising number of redundancies was more than matched by new jobs created predominantly in the service sector) and the seasonally adjusted claimant count unemployment figure remains below the one million barrier. The UK economy is as close to full-employment as it has been for nearly thirty years.

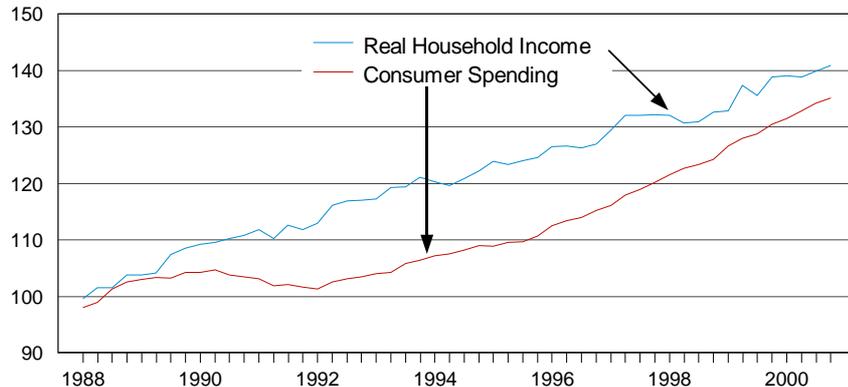
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UK CONSUMER CONFIDENCE AND INTEREST RATES



REAL INCOMES SUPPORT RISING SPENDING

£ billion per quarter at constant prices



Blair, like millions of customers was faced with the classic **consumer trade-off: price versus service**. The consumer has to weigh up the advantages of a lower price against the loss of comfort, reliability and other "value added" features that the well-established airlines believe justify the price of air travel. For the budget airlines, there is no such thing as "Business" and "Economy Class". There is one service—and customers can take it or leave it. And in an interesting example of **price discrimination**, the price of a budget airfare increases as the date of departure gets nearer. With Easyjet and Ryanair, the cheapest prices are available to those who book several months in advance. Passengers who need to join a flight at the last minute pay the highest price. Compare this with the traditional pricing model in travel—where many bargains and discounts can be obtained by leaving reservations until the last moment.

Ryanair's View

"We get the rich guys, who would normally fly business class for work, with their wives and kids. It can save them thousands of pounds."

Latest financial results issued by Ryanair in August 2001 confirmed that the budget airlines are in good financial health. In the three months to June 2001, Ryanair's passenger numbers increased by 42% to 2.4 million, with profits up 28% to £14.3 million (EUR 23.2 million). The Dublin-based airline stated that its target growth rate would remain at an impressive 25% per annum. Easyjet, which floated on the London Stock Exchange in 2000, also reported strong growth. Passenger numbers for July 2001 were 667,000, some 100,000 up on the same month last year. However, in contrast, British Airways recently reported a fall in passenger numbers and load factors (the proportion of seats full) down below 70%. Easyjet's load factors are now above 85%.

The Journalist's View

"Stansted Airport— the human face of a millennium phenomenon. A kind of classless flying where everyone is uncomfortable, no-one gets a meal or a drink and where there are as few airline staff in the passenger cabin as the law allows. Yet there are a surprising number of business suits"

Venture Capitalists Target the Sector

The management buy-out (MBO) of Go from British Airways points to the attractiveness of the low-cost airline sector. 3i, Europe's largest venture capitalist, funded the MBO of Go in June 2001, paying £100 million. Go carried 2.8 million passengers in 2000 and made a profit of £4 million. In 2001 it expects to carry 4 million passengers, including 650,000 from its newly-opened hub in Bristol.

The strong growth of Ryanair, Easyjet and Go indicates that they have taken market share from existing scheduled and charter airlines. These three carriers now command about 20% of the passenger market around London and are growing at around 20% per year compared with 5% growth for higher-cost established airlines. Within a few years, it is possible that the budget airlines will dominate the market for cheap, short haul flying, leaving the major airlines to battle for the long-haul and premium business market.

How does the low-cost flying model work? What are the areas where the budget airlines make cost savings that enable them to charge such competitive fares? In reality, it is all about cutting complexity out of the business. Eliminating services that consumer can probably do without, or whose absence is made tolerable by a heavily discounted fare. The key cost-saving areas are outlined below:

Low-Cost / No-Frills Feature	Implications for Cost Structure
Fly directly between two airports— no connections	Uses aircraft more intensively; fewer "empty legs"
Use the same type of aircraft	Cuts down on training costs, maintenance and spare parts
No free meals or complex catering	More seats (smaller kitchen facilities and maybe even fewer toi-
Easy to use, online booking technology	Reduces distribution costs; Ryanair's sales cost are just 4% of sales compared with 12% at British Airways
No pre-assigned seats	Customers board quicker, reducing waiting costs
Fly to Secondary (less popular) airports	Lower landing fees

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The housing market is undoubtedly helping to support consumer demand. Economists at the Nationwide this week revised upwards their forecast for UK house price inflation during 2001. And we must not forget that high levels of employment and continue low rates of inflation mean that real incomes for the majority of the 28 million (+) people in work are continuing to rise this year.

The Marconi Effect

The Office for National Statistics reported that two thirds of the 0.9% of the monthly decline in manufacturing output during July was attributable to electrical & optical equipment. This is becoming known as the Marconi effect—the troubled tele-coms equipment maker that has seen its share value collapse by over 95%

Although consumer credit is rising to threatening levels, consumers are confident enough to pay back their accumulating debt because relatively low interest rates make servicing that debt less costly. Perhaps consumers now expect a long period ahead of low interest rates—this makes servicing the accumulated debt on credit cards relatively easier. The key concept here is the debt-service burden—measured, for example, by the percentage of disposable income taken up in interest payments on existing debt.

Consumer confidence has dipped in the last couple of months (see the chart on page three which tracks the Gfk/European Union index of consumer confidence against UK base interest rates). But the decline in confidence is much shallower than in the United States—and remains much higher than in the early months of 2000 and in 1998-99 when there were genuine fears that the Asian financial crisis would provoke a widespread recession in Western Europe. As long as prices remain competitive and real incomes continue to grow, it is highly unlikely that we will see a sudden retrenchment in household spending. Such is the importance of consumption in total national output, this will provide an underlying strength to aggregate demand for goods and services.

Britain remains a nation of spenders—although the strong pound means that much of this spending goes on imports rather than domestic production.

Manufacturing slips further into recession territory

UK manufacturing output dropped by 0.9% in July as the industrial sector plunged further in recession. There was a 5.5% decline in the manufacture of telephone, radio and electronic equipment, partly offset by gains in the fuels, chemicals, food and clothing sectors. In the three months to the end of July, the growth of industrial output is at its lowest since 1991 at -2.1%. Although this is the third recession manufacturing has entered into this decade, it is without doubt the most serious. The Monetary Policy Committee cannot (and will not) set interest rates to address the specific problems of one sector of the economy—but manufacturing industry is now in danger of a severe downturn even though the rest of the economy is growing steadily.

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An excellent collection of articles tracking news of the emerging recession around the globe

Prospects for the UK Economy www.tutor2u.net/redirect.asp?link=4104&tree=2497

Nick Fawcett of Cambridge University has written this very useful perspective on the UK economy

Public Private Partnerships http://news.bbc.co.uk/1/hi/english/in_depth/business/2001/ppp/

A wide range of articles covering the issues of public and private sector co-operation, from the BBC

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