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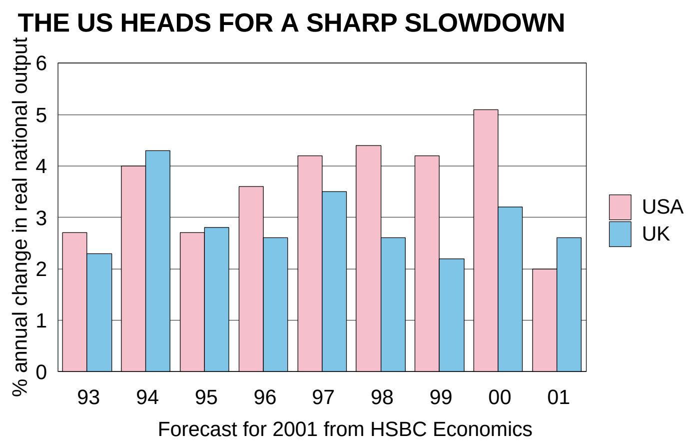
# Weekly Economics Briefing

**Volume 3 Issue 4** **4 February 2001**

# Greenspan slashes US interest rates by 0.5%




*"It is perhaps inevitable that in the aftermath of four years of sustained GDP growth of four to five per cent, any economic slowdown will feel like a recession"*

**National Institute Economic Review**
**January 2001**

*"After an extended honeymoon period, the UK Monetary Policy Committee now faces its most difficult task"*

**HSBC UK Macroeconomic Analysis**
**February 2001**

The decision by the **Federal Reserve** to cut interest rates is a response to the fear that the sustained expansion of the US economy is in real danger of coming to an end. Falls in consumer and business confidence are advanced warning indicators of a drop in consumption and business investment. Banks appear less willing to lend to corporates who have hit the markets with profit warnings in recent weeks. A collapse in the **Nasdaq index** will increase the cost of capital funds available to new economy businesses. And this week we also saw signs of a rise in unemployment as companies have moved decisively to trim pay-rolls in anticipation of a fall in demand and output.

The United Kingdom has been a "country of choice" for investors in the United States looking for a good rate of return on their investments. Will a severe slowdown in the USA lead to cutbacks in American foreign investment into the UK? How will the profits of British firms who have bought assets in the United States be affected by a general downturn? Central Banks have the power to act in a bid to stabilise confidence and spending. The Fed has made its move. Now for the BoE?

## UNITED STATES ECONOMY AT A GLANCE

| | | 1998 | 1999 | 2000 | 2001 forecast |
|---|---|---|---|---|---|
| Real GDP | % annual change | 4.4 | 4.2 | 5.0 | 2.4 |
| Household Spending | % annual change | 4.7 | 5.3 | 5.3 | 2.9 |
| Business Investment | % annual change | 13.0 | 10.1 | 12.9 | 4.7 |
| Unemployment | % of labour force | 4.5 | 4.2 | 4.0 | 4.2 |
| Consumer Price Inflation | % change | 1.1 | 1.8 | 2.4 | 2.1 |

The National Institute forecast a halving of the US growth rate in 2001—lower interest rates should help to cushion the slowdown in the rate of economic growth. Sharp slowdown forecast in business investment and household spending.

# Will a US recession hit the UK?

Sterling is forecast to drop against the Euro this year but a fall in the US stock market will make life difficult for some UK firms

How will a slowdown or possible recession in the United States affect the British economy? This issue will be under consideration when the Monetary Policy Committee have their February 2001 meeting—a discussion that marks the first anniversary since the last decision to change interest rates to 6%.

## Negative effect on UK exports

The **exposure** of the UK economy to **cyclical fluctuations** in the United States is greater than for many other Western European economies. In part this is because 15% of the UK's exports of goods are sold to the United States. And given that over 40% of total manufacturing output is sold overseas, a fall in US demand for British goods will have a depressing effect on UK exports to North America this year.

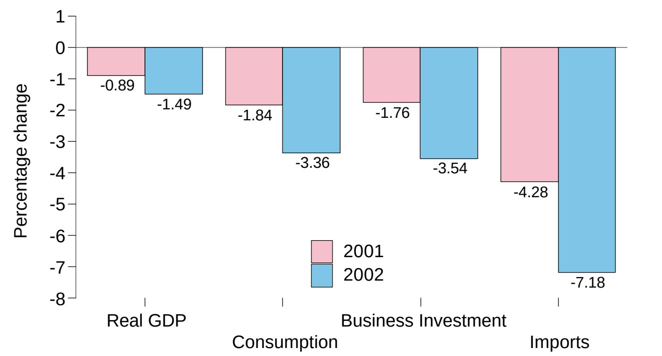
Economists at HSBC are forecasting a large slowdown in the rate of growth of UK export volumes during 2001. Since sterling started to appreciate in 1996, the growth of UK exports has held up remarkably well. The last downturn came in the wake of the Asian economic crisis in 1998-99. This time, a sharp dip in US growth is likely to cut the growth of UK exports from 8.3% in 2000 to 4.4% in 2001. This will be one factor contributing to a cut in the overall rate of economic growth towards 2.5%.

## Business confidence and capital investment

A US slowdown will have a negative effect on the UK in other ways. British businesses have invested heavily in the US economy over the last ten years. It is likely that the profits from these investments will decline this year, reducing the funds available for internal finance of capital investment projects. There is a fear that the sharp decline in the value of technology stocks on the US Nasdaq index will cause a similar drop in the UK markets—leading to a drop in business confidence and a decline in investment in technology, media and telecoms sectors.

The National Institute estimate that a 20 per cent fall in US stock prices together with a 10% decline in European stock valuations will reduce the growth of UK national output by nearly 0.8% in 2001 and a further 0.4% in 2002. Partly this is based on a forecast of a sharp fall in US interest rates leading to a rise in the value of the pound against the dollar. Much will depend on how quickly the Monetary Policy Committee reacts to events in the United States. They cut interest rates aggressively when the scale of the Asian crisis became clear. Will they respond as quickly and decisively this time around?

**IMPACT OF A FALL IN US AND EUROPEAN SHARE PRICES**

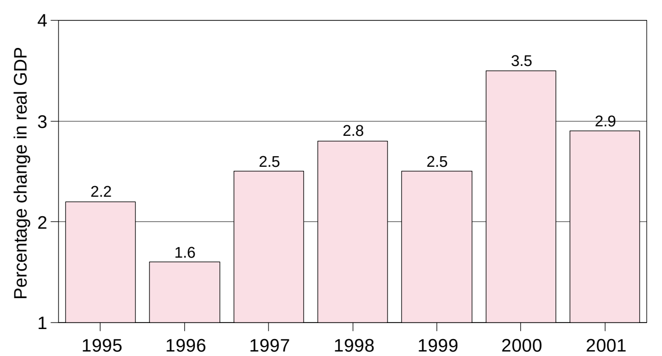



### US Stock prices and the real economy

The chart above is a National Institute forecast of how the US economy is affected by a 20% fall in US stock market levels and a 10% decline in European share prices. A fall in stock market wealth is forecast to lead to a sharp decline in consumer wealth, confidence and spending. Business investment is also hit by a rise in the cost of capital and a fall in consumer demand.

One beneficiary of a US slowdown will be the enormous US trade deficit. Last year the US ran a current account deficit of 4.3% of their total GDP with import volumes growing by 14.4%. The expected deceleration in spending and output should lead to a decline in the trade gap in goods and services. Lower wealth and consumer demand will reduce the demand for imported goods and services

**EURO ZONE GROWTH MAY CUSHION UK**




Economic growth in the twelve member nations of the Euro Zone is likely to weaken a little this year. Strong growth of 3.5% in 2000 helped to bring down Euro Zone unemployment and provided a major boost to UK exporters. Output growth in the European economy seems to have peaked in the middle of last year—but the underlying forces for continued growth are fairly strong. If growth stays close to 3% in 2001, the rebound in the value of Euro (which makes UK businesses more competitive in European markets) allied to strong demand will give UK producers a chance to increase their export sales. This should help to cushion the effects of a US economic decline.

## Measuring the Money Supply

In the 1980s the amount of money in circulation and the growth of bank lending to individuals and businesses was a central feature of monetary policy. But the experiment with targeting the money supply came to an end with the decision to join the ERM and latterly the post ERM) the government moved away from explicit target setting for money—preferring instead to set a clear target range of inflation.

The amount of money in circulation in the economy still matters—information on the growth of the cash base in the economy provides timely signals as to the strength of consumer demand. And the rate at which bank lending is increasing is used by the Monetary Policy Committee as a signal of the demand for credit at the prevailing rate of interest,

### Narrow Money (M0)

M0 is simply the total stock of notes and coins in circulation plus the commercial bankers' operational deposits held with the Bank of England. The Bank tends to act as a passive supplier of cash to the financial system. When retail sales are rising we expect to see an increase in the total demand for cash as consumers replenish their cash balances to pay for regular small-ticket spending.

M0 grew rapidly during 1999. Indeed M0 expanded by 12.0% in 1999 compared to 5.4% in 1998. There was a millennium blip in December 1999 when the Bank of England took the step of providing billions of pounds of extra cash to the banks to meet people's demand for money to cover the millennium celebrations. During 2000 the rate of growth of cash in circulation fell away—in part the result of higher interest rates in the early part of the year.

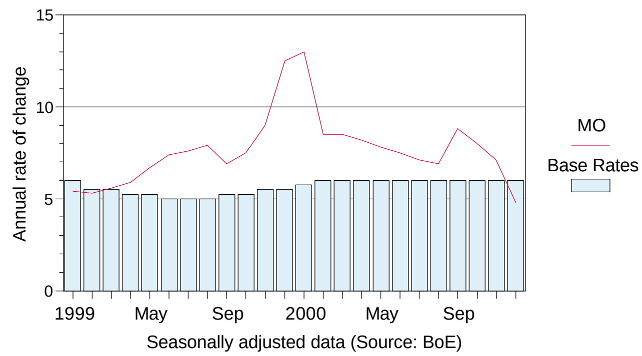
### Broad Money (M4)

A second measure of the money supply includes M0 plus sterling deposits held by UK residents at banks and building societies. Broad Money (or M4) comprises both the deposits lodged into accounts by people wanting to save, together with deposits created by commercial banks and building societies through their lending activities.

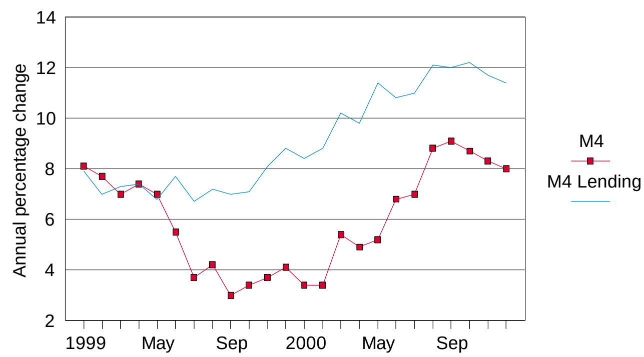
In the 3rd quarter of 2000, the total stock of money included in M4 was £871 billion. Of this figure, 61% was held by households—the rest residing with financial institutions and the corporate sector. Last year saw an acceleration in the demand for loans—reflected in a faster rate of growth of M4. This is a sign that consumer demand remained robust last year and that many businesses were borrowing funds to finance expansion.

## Measuring the Money Supply

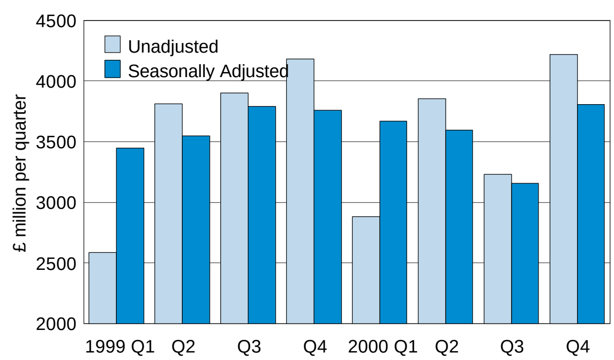
**NARROW MONEY - M0 and INTEREST RATES**




**BROAD MONEY - M4 AND M4 LENDING**

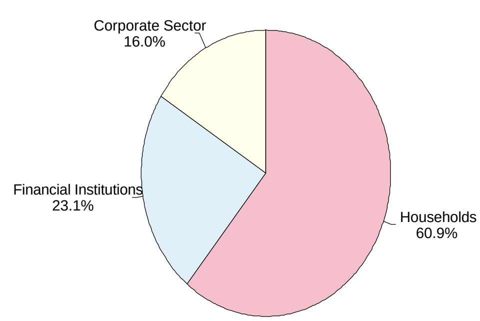



**CONSUMER CREDIT IN THE UK**



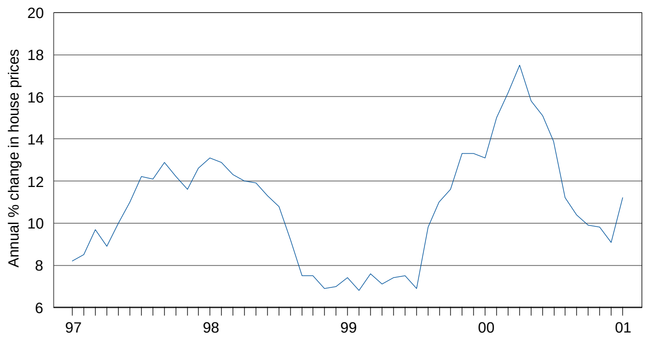

**M4 MONEY HOLDINGS**

3rd quarter 2000

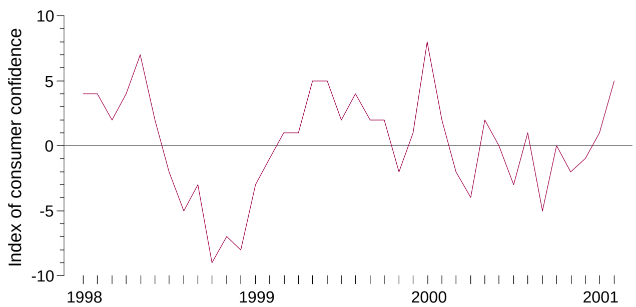


# ECONOMICS IN THE NEWS

NATIONWIDE HOUSE PRICE INFLATION

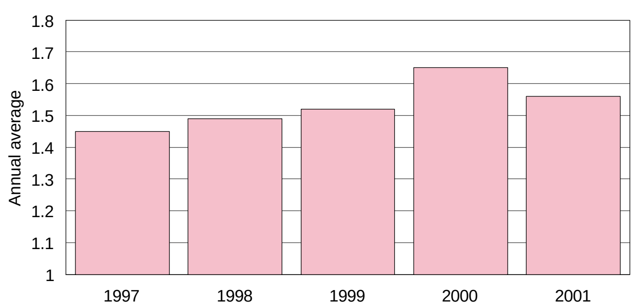



SHARP REBOUND IN UK CONSUMER CONFIDENCE




A rise in the chart shows an increase in confidence

STERLING SET TO FALL AGAINST THE EURO




Forecast for 2001 from the NIESR

## A round up of the week's economics news

### Surprise rebound in UK house price inflation

According to the Nationwide Building Society, the average price of a house jumped by 2.5% in January (the highest monthly rise in well over a year). That takes the annual rate of growth back to 11.2% where it was in August 2000, though still a long way off the 17.5% peak in April. The Halifax housing survey shows prices rising at a much slower rate—but there are signs that activity in the housing market is picking up in the early weeks of the year. Interest rate cuts in the spring might well stimulate increased interest among would-be house purchasers.

### Consumer sentiment improves in January

The GfK index of consumer confidence for January jumped to +5 —a sign that consumer sentiment is picking up again after a weak second half of the year. Together with the firmer than expected figures from the housing market, the consumer sentiment figures suggest that consumers are already anticipating cheaper borrowing costs during the spring and early summer. And, lower headline inflation combined with wages rising faster than inflation is adding to the growth of real incomes for those people in work.

### Euro set to gain against sterling this year

In recent months the Euro has staged a rally against the US dollar and also against sterling. Having averaged 1.65 Euros to the pound during 2000, the consensus forecast is that the Euro will strength further this year.

The National Institute have pencilled in an average rate of Euro 1.55 for 2001— a stronger Euro will help to contain inflationary pressure in the Euro Zone and provide limited relief for UK manufacturing firms.

## WEB SITES ON THE US ECONOMY

**United States Federal Reserve**
www.federalreserve.gov

**Get Exuberant—Alan Greenspan Fan Club**
www.getexuberant.com

**The Dismal Scientist (Economics Web Site)**
www.dismal.com/

**Tutor2u Economics www.tutor2u.net**
Tutor2u Economics is a resource for students and teachers. There are hundreds of pages of revision notes, links and a Discussion Forum. Visit the site and improve your grades

## NEXT WEEK'S ECONOMICS BRIEFING

**Monetary Policy Committee Meeting for February**

**Trends in Home Ownership**

**Income Inequality and the Tax System**

**Weekly Briefing**
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