QUOTE OF THE WEEK

"With prudence matched by higher productivity, Britain can grasp the great interest rate prize that has eluded us for a generation: a long-term future of low and stable interest and mortgage rates upon which people can rely and business can plan ahead"

Gordon Brown, Speech to the CBI Conference

Weekly Economics Briefing

10 November 2000

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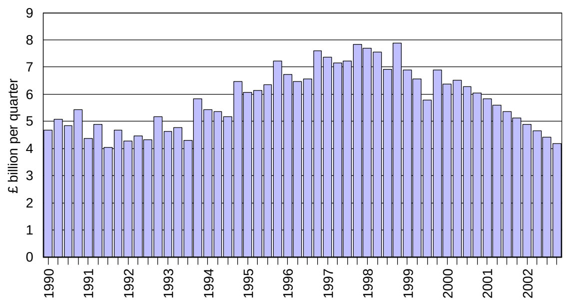
Weekly Economics Briefing

The End of the Politics-Free Economic Cycle?

THE SURPLUS REDUCES DEBT INTEREST REPAYMENTS



Data for 2001 and beyond is a government forecast

Chancellor Brown has played heavily on his reputation for fiscal conservatism. He has presided over a significant improvement in Government finances—turning a heavy budget surplus into a strong (and rising) budget surplus. At the same time he has started to pay back huge sums of existing government debt (helped by the windfall of licences for 3rd generation mobile phones) and also introduced strict guidelines for government borrowing over the course of the economic cycle.

Having experienced 3 1/2 years of fiscal control, the Chancellor now seems to be bringing political calculations explicitly into his budget Budget calculations. How else can one explain the extra provision made this week to pensioners (a package worth nearly £1.8 billion) and to the road haulage industry (the free on road fuel duty is worth about £0.6 billion per year)? The total net injection of extra spending into the economy is estimated to be around £4.6 billion—an increase in government spending that comes at a time when the country is already operating level of economic activity that in the past has caused an acceleration in inflation.

The Monetary Policy Committee must expect a slowdown in private sector spending—if this does not happen, the extra public sector spending will undoubtedly put upwards pressure on interest rates in the months to come.

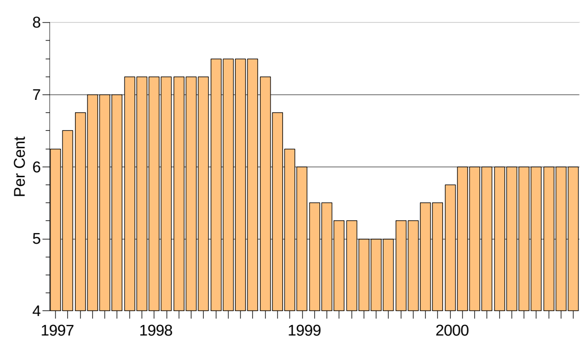
AT each Budget and Pre-Budget statement, Brown announces that government finances are stronger than he had previously predicted. This is then transformed into the dual dividend of debt repayment and extra spending on priority areas. Tax cuts remain firmly on the agenda for March—but unless there are signs of an economic slowdown by then (and a slowdown in particular by consumers) the Bank of England is likely to have raised interest rates at least twice.

The Bank of England keeps rates on hold for November

For the ninth month in a row the MPC kept rates on hold at their November meeting. The current crop of macroeconomic statistics shows no real need to increase rates at the moment.

The Bank's Inflation Report is published on November 16th and will contain their latest two year forecast for inflation. There is still a good chance of one more 0.25% rate hike before Christmas

INTEREST RATES STAY ON HOLD FOR NINE MONTHS



Business and Industry Focus

Exports are performing much more strongly than last year—has industry adjusted to the strong pound?

A WELCOME REBOUND IN UK EXPORTS

A welcome economic development in recent months has been the recovery in the growth of exports of goods and services from the UK economy. The volume of exports sold overseas grew by just 2.8% in 1998 and 3.0% in 1999 (less than half the rate of increase in the previous two years and well down on the terrific export performance achieved in the mid 1990s). But this year there has been a sharp surge in export orders even though sterling has remained fundamentally strong when measured against a basket of leading international currencies.

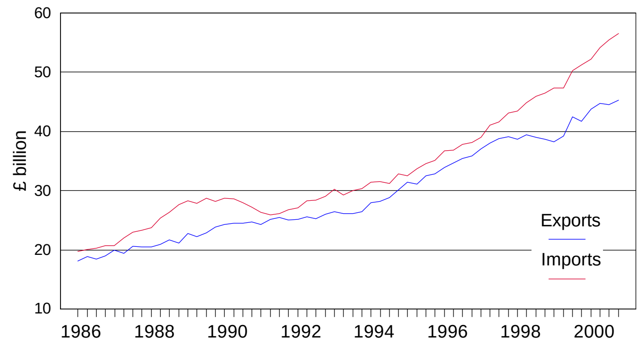
Exports are rising close to 10% per year

In August 2000, export volumes were rising at 9.7% per year—a touch down on the rates of growth seen in the summer—but hard evidence that British industry and other sectors seem to be adjusting well to the demands of the strong currency. What lies behind this improvement in fortunes?

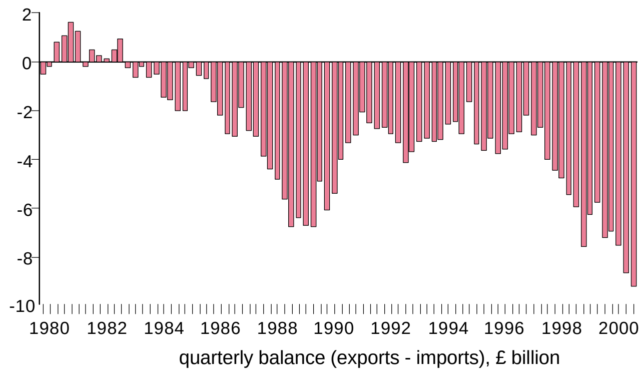
- *A fall in sterling against the US dollar has improved the international competitiveness of UK producers in North America*
- *The growth of world trade has picked up this year—with nearly all the major regions of the global economy enjoying strong cyclical growth in incomes and spending*
- *Manufacturing productivity growth has increased—allowing British firms to offset the strong exchange rate and maintain their competitiveness in overseas markets*

Unfortunately the deficit in the balance of trade in goods is still wide. The strength of private sector demand in the UK together with the attractiveness of cheap imports due to sterling strength means that import volumes continue to grow in excess of 11% on an annualised basis.

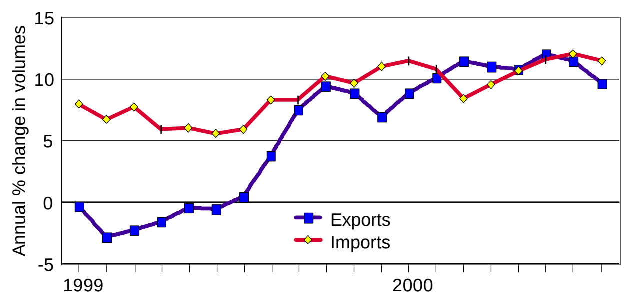
UK MANUFACTURING EXPORTS AND IMPORTS



BALANCE OF TRADE IN GOODS

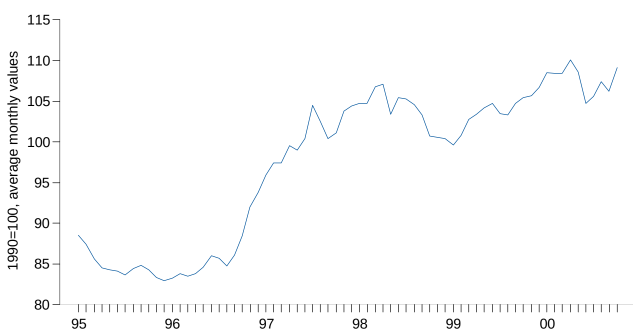


EXPORTS SURGE ON BACK OF RISING WORLD TRADE



Source: Office for National Statistics

STERLING EXCHANGE RATE INDEX



KEY POINTS ON TRADE FLOWS

- **British exports are responding well to surging world trade growth**
- **Many firms are adjusting to a long run increase in the external value of sterling**
- **Higher productivity helps to control costs**
- **Strong consumer demand means that import spending remains well above exports**

Is the Euro turning a corner?

Intervention in the currency markets
The European Central Bank (ECB) has intervened several times in the currency markets in recent weeks in a bid to stop the fall in the Euro against the dollar and other currencies. Clearly the ECB is now concerned that the weakening Euro will lead to rising inflationary pressure inside the Euro-Zone.

The currency and inflation
A fall in the currency adds to the costs of importing goods and services (leading directly to an increase in the consumer price index) whilst it also encourages a faster growth of exports from the Euro Zone. An increase in exports adds to aggregate demand and can lead to a rise in demand-pull inflationary pressure inside the European economy.

Public worries over the Euro's decline
Of more significance in the long run is the public acceptance of the Euro within the 12 member nations of the currency union. As the Euro has weakened, so consumers inside the Eurozone have lost confidence in the long run sustainability of monetary union. We are less than two years away from the introduction of Euro notes and coins.

Higher interest rates have made little impact
The European Central Bank has raised interest rates in a series of small steps on a number of occasions this year - in part because of the growing inflationary risk within the Euro Zone. But these increases in interest rates have done little to reverse the downward path of the Euro.

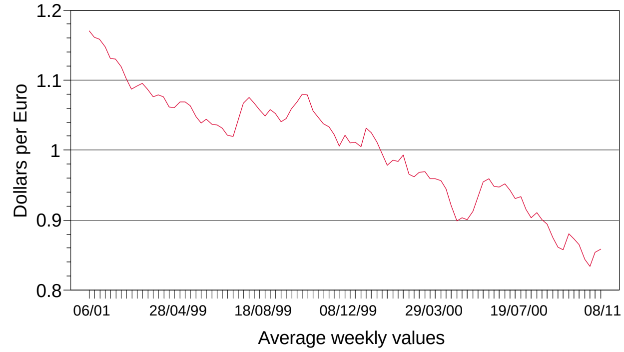
The fundamental problem is a significant capital outflow from European countries as investors seek higher rates of return in the United States capital markets and in other non-Euro countries such as the UK. Perhaps more aggressive interest rate increases are needed - with the ECB moving in 0.5% stages rather than the preferred o.25% moves.

Can intervention in the markets really work?

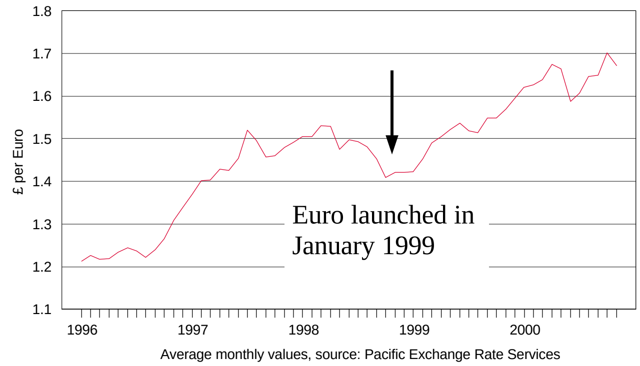
In the short term intervention does have an impact on the Euro's value. But in recent weeks the ECB's intervention has been sporadic - as they have attempted to catch currency speculators by surprise. But what is really needed is co-ordinated intervention by a group of central banks. Only then can intervention has a significant impact on the balance of demand and supply for a currency.

The weight of money counts in the foreign exchange markets - and the intervention needs to take place in the major centres of global foreign exchange (namely London, New York and Tokyo)

CAN INTERVENTION TURN THE EURO HIGHER?



STERLING AGAINST THE EURO



rather than second-tier currency markets in various centres around Europe.

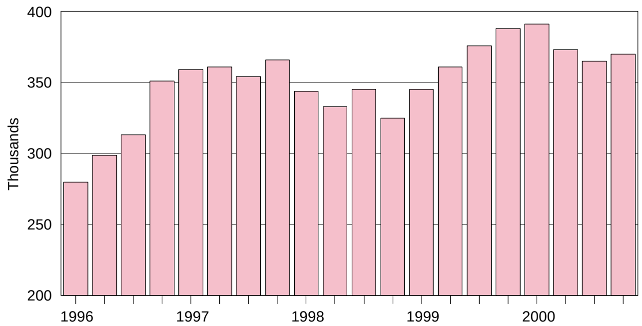
Until investors decide that the European capital markets will provide them with a higher risk-adjusted rate of return than investing in North America or East Asian markets, and until the Euro Zone balance of payments on the current account swings back towards surplus rather than deficit, intervention to reverse the decline in the Euro is unlikely to be effective - indeed it may prove to be a very costly approach to manipulating the exchange rate

KEY POINTS ON THE EURO

- The ECB has intervened several times to support the value of the Euro—with little success
- Co-ordinated intervention by several central banks is needed for this to be effective
- Capital outflows from Europe weaken the Euro
- The falling value of the Euro is causing a decline in public support for the Euro project

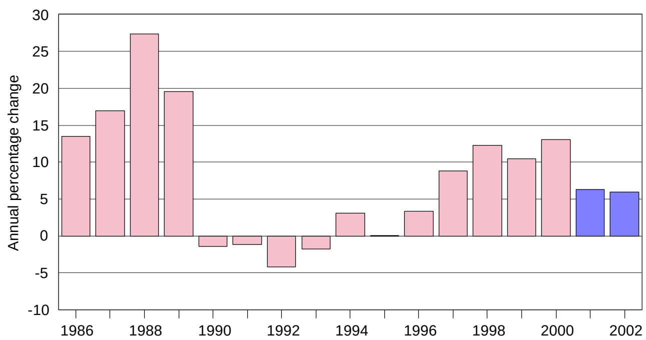
HOUSING MARKET DATA

HOUSING TURNOVER IN THE UK SEEMS TO HAVE PEAKED



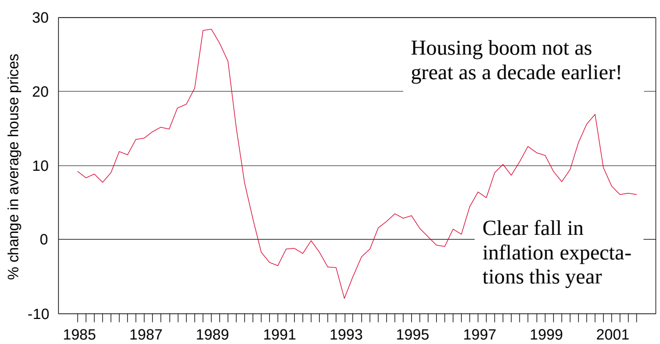
Quarterly Average Number

SECOND HAND HOUSE PRICES IN UK



Mix-adjusted house price index, forecasts for 2001 and 2002

HOUSE PRICE EXPECTATIONS ARE FLATTENING OUT



Expectations of annual change in house prices, 2001 is forecast

THE HOUSING MARKET SLOWS DOWN

The acceleration in house prices and market activity during 1999 and the first half of 2000 is now coming to an end raising hopes that UK house prices may rise at a more sustainable rate in the next twelve months. Data from the Nationwide BS shows that UK average house prices rose by a seasonally adjusted 0.9% in October with the annual rate of house price inflation falling to 9.9%. The more subdued nature of housing demand is putting a lid on house price inflation but the gap in regional house prices continues to widen.

The Halifax also reported a deceleration in price inflation with prices dipping 0.4% during October and the annual rate of increase dropping to just 5.7%. The standardised average price in the UK (using Halifax data) stood at £86,121 in October. The Nationwide index has average prices standing at £81,036.

Housing turnover is a vital indicator of the overall strength of activity in the market. The top chart shows the quarter average number of house transactions across the UK. There was a sharp pick up in transactions during 1999 and the first quarter of this year. This feeds into higher consumer spending as people furnish their new homes and spend extra amounts of removal services, estate agent and solicitor fees and other housing related spending. Turnover is now moving lower and (as the bottom chart shows) expectations for house price inflation are also significantly down on a year ago. Oxford Economic Forecasting are predicting 6% inflation in the prices of second hand homes for the next two years. This reflects the fall in housing affordability particularly in London and the South East where many first time buyers appear to have been priced out of the market with the double digit inflation rates experienced over recent years.

RECOMMENDED WEB SITES

TREASURY PRE-BUDGET STATEMENT 2000
www.hm-treasury.gov.uk/pbr2000/index.html

ROYAL BANK OF SCOTLAND ECONOMICS DEPT
www.rbs.co.uk/economics/default.htm

FINANCIAL TIMES ECONOMIC SURVEYS
http://surveys.ft.com/

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NEXT WEEK'S ECONOMICS BRIEFING

REVISION SPECIAL ON THE INCOME TAX SYSTEM

PARTICIPATION IN THE LABOUR MARKET

MEASURING PRODUCTIVITY IN THE UK ECONOMY

Weekly Briefing
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