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Consumption remains the driver of economic growth
House price inflation stays high and borrowing surges
The MPC keeps interest rates on hold at 4%

The Keynesian theory of consumption finds a clear link between household spending and real disposable income. As real incomes rise, so people are able to increase their demand for goods and services.

A key related concept is the **marginal propensity to consume (mpc)** i.e. how much of a rise in income is spent and how much is saved. At the moment, the household savings ratio is falling below 5% - suggesting that consumers are confident enough to spend a large proportion of any extra income they earn.

Many other factors influence total consumer demand—among them, changes in household financial wealth, interest rates and expectations of future income, employment and taxation. Underlying all of this, fluctuations in consumer confidence or sentiment has a big impact on spending decisions.

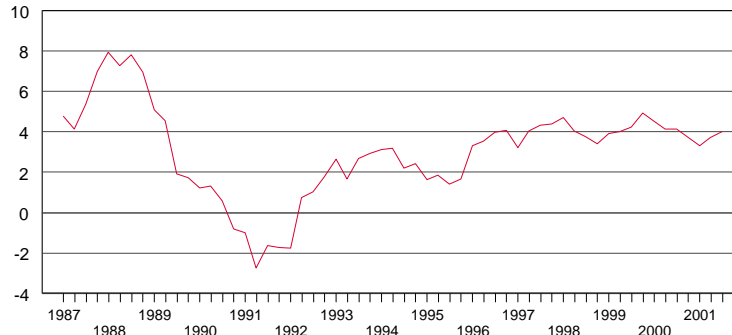
CONSUMERS REMAIN FUNDAMENTALLY BULLISH

The vulnerability of the UK to a recession has been lessened by the continued robust level of consumer demand over the last twelve months and a raft of economic data released this week provides ample evidence that household spending has stayed remarkably firm. The strength of consumer expenditure is a major reason behind the decision of the Monetary Policy Committee to keep interest rates on hold at their February meeting. Base rates stayed at 4%.

In recent years, the growth of consumer demand has boosted real GDP by about 2.5% per year—consistently above the forecasts of the Bank of England and many other city economics teams. Household spending power has been boosted by the excellent labour market performance, with unemployment falling to its lowest levels since the mid 1970s. The recent boom in house prices has also consolidated consumer confidence and a willingness to make major purchases.

GROWTH OF UK HOUSEHOLD SPENDING

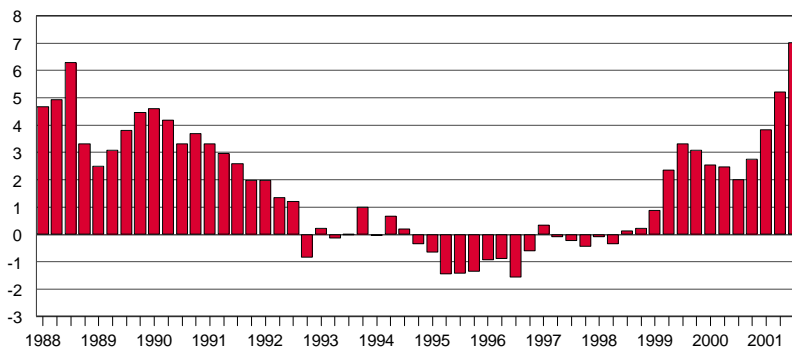
Annual % Change in Real Consumer Spending (at constant 1995 prices)



Booming Housing Market Drives Equity Withdrawal to Record Levels

MORTGAGE EQUITY WITHDRAWAL

£ billion per quarter (seasonally adjusted)



Source: Bank of England

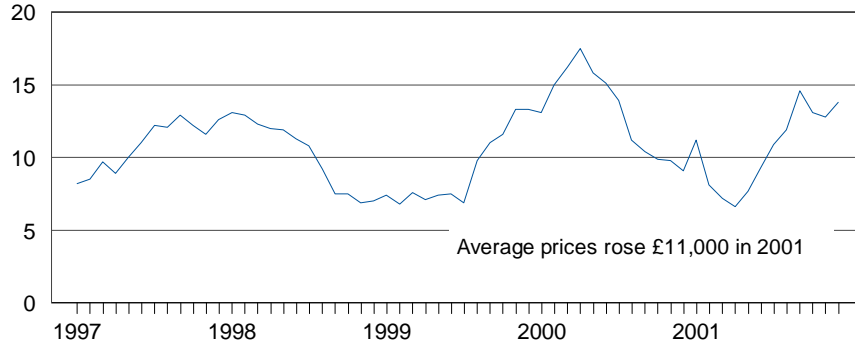
There was a 34% rise in the amount of cash people borrowed against the value of their homes in the third quarter of 2001. Mortgage equity withdrawal is now at a higher level than in the housing boom of the late 1980s.

The willingness to take loans secured on the value of property is symptomatic of the expectation that house prices will continue to rise and a reflection of people's preference to fund higher spending by borrowing rather than fund it out of current income.

Little sign of a slowdown in the housing market from data for December from the Nationwide Building Society. House price inflation edged higher to 13.8% over the last twelve months and activity remains strong with over 140,000 house sales in October. The Nationwide expect average house prices to rise by 6% in 2002.

NATIONWIDE HOUSE PRICE INFLATION

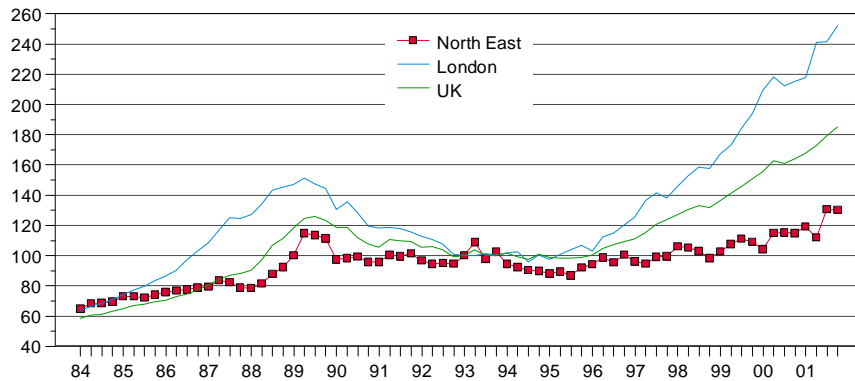
Annual % change in house prices



Source: Nationwide Building Society

All regions have seen a sustained increase in the prices for first-time buyers—but the gap between London & the South East and the rest of the UK has widened since 1999—leading to a sharp fall in housing affordability for younger home-buyers in the capital. This impedes the geographical mobility of labour

INDEX OF HOUSE PRICES FOR FIRST TIME BUYERS

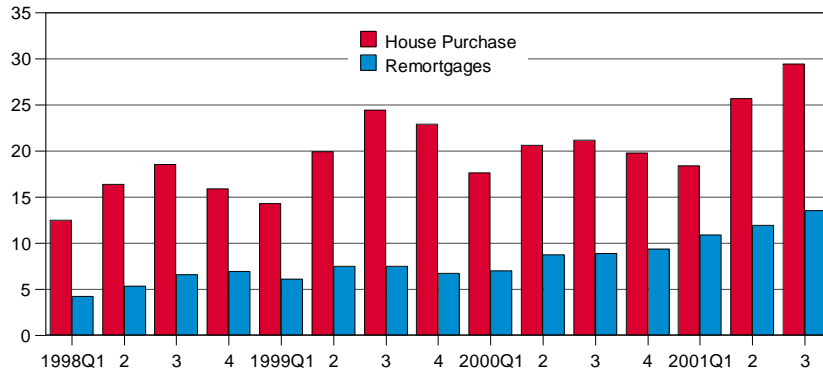


1993 = 100 Source: Nationwide Building Society

Remortgaging a property is becoming ever-more popular as this chart from the Bank of England shows. Remortgaging is estimated to be 30% than a year ago and much of this eventually finds its way into extra consumer spending. New loans for house purchase reached a record high last month—the housing market remains very strong despite the economic slowdown. Low interest rates and rising prices are driving demand for loans even higher.

LOANS FOR HOUSE PURCHASE AND REMORTGAGES

£ Billion per quarter

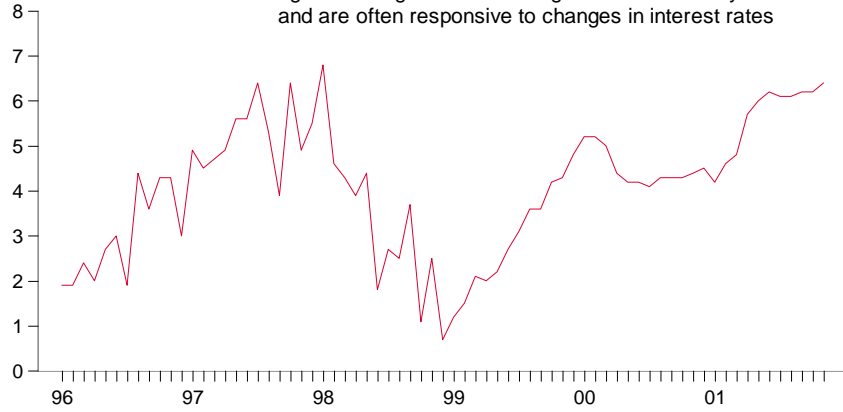


Source: Council for Mortgage Lenders

The underlying growth of retail sales is at its strongest since the late 1980s boom. Not every sector is sharing in the expansion—e.g. the recent collapse in demand for new mobile phones. Continued heavy discounting in consumer goods, the benign inflation data and aggressive rate cuts by the MPC have kept high street demand high.

RETAIL SALES

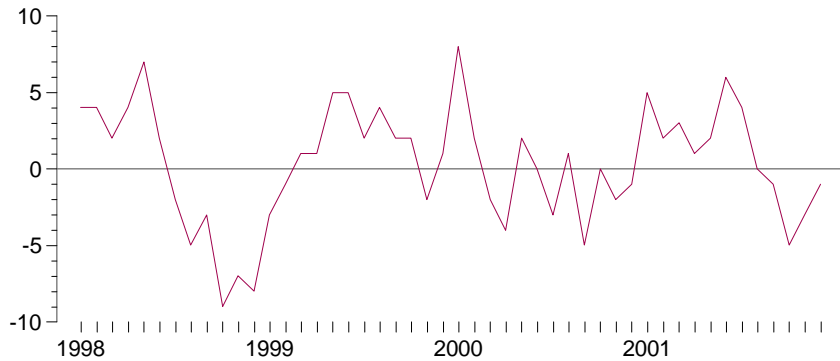
Non-food retail sales volumes are 8.7% higher than a year ago—these goods have a high income elasticity of demand and are often responsive to changes in interest rates



The Gfk index of confidence edged higher in December as sentiment recovered from the events of the 11th of September. Expectations of people's own financial circumstances remain positive—this is the most important gauge of future spending. Most consumers believe the environment for saving is not favourable at the moment.

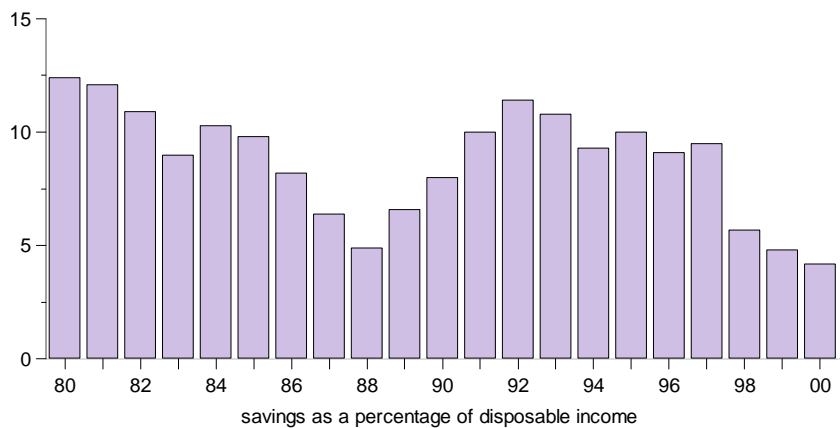
UK CONSUMER CONFIDENCE

Overall index of confidence



The decline in the savings ratio may reflect rational decisions by people to borrow on the expectation that (a) there has been a long-term downward shift in interest rates (b) that real incomes will continue to grow and employment will rise and (c) house prices will continue to stay high. If the UK economy avoids recession then households may not have to rebuild their savings to the levels last seen in the early 1990s.

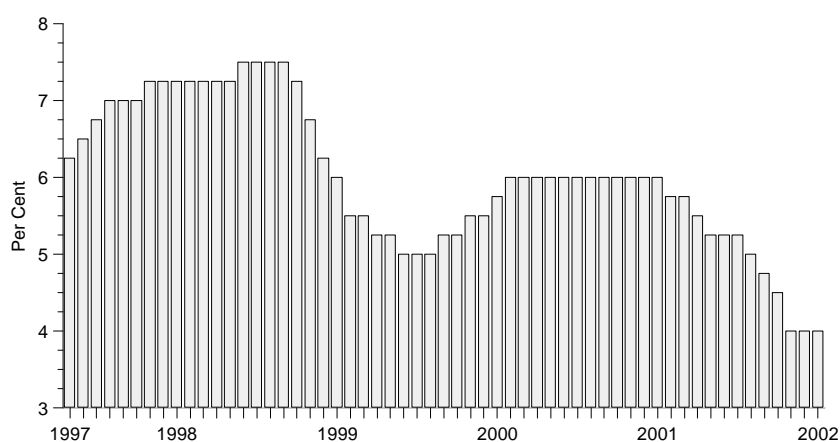
HOUSEHOLD SAVINGS RATIO



Borrowing money to spend in excess of current disposable income represents **dis-saving**—so the strength of demand for consumer credit is one reason for the fall in the household savings ratio in the last three years. Eddie George has expressed concern that the rapid rise in secured bank lending may be unsustainable in the long run

For a second successive month—base rates remained on hold. But the balance of risks is shifting by the week. The US economy is gaining momentum and the strength of UK consumer spending and confidence suggests that the floor may well have been reached for UK base rates in this cycle. No more emergency easing of monetary policy is justified.

UK BASE INTEREST RATES



The last twelve months has seen a coordinated easing of global monetary policy. Global interest rates have fallen by over 2.25% (weighting each country by their contribution to GDP). The European Central Bank has moved relatively slowly leading to criticisms that the ECB has reacted too slowly to the slowdown in the world economy during 2001.

Country	Current Interest Rate	Change since December 2000
United States	1.75%	-4.75%
United Kingdom	4.00%	-2.00%
Euro Zone	3.25%	-1.50%
Japan	0.01%	-0.24%
Asian / Pacific Average	2.15%	-0.57%
Global (GDP weighted average)	3.10%	-2.30%

Housing Market Lending—The Changing Structure of Borrowing

The strong aggregate demand for housing is shown in the data below—the total number of housing loans has surged since 1999 (it was even stronger in 2001). Just under two-thirds of loans are at variable interest rates. The proportion of fixed rate loans has declined recently reflecting an increase in the gap between average interest rates on variable and fixed rates.

Year	Total Number of Loans 000s	Average Rate of Interest %	Variable Rate			Fixed Rate		
			Loans 000s	% of Total	Average Interest Rate %	Loans 000s	% of Total	Average Interest Rate %
1994	416	6.36	205	49	6.03	211	51	6.69
1995	410	6.17	298	73	6.03	112	27	6.53
1996	458	5.60	367	80	5.50	91	20	6.01
1997	477	6.80	295	62	6.67	182	38	7.01
1998	1,108	6.77	513	46	6.85	595	54	6.70
1999	1,756	5.75	1,035	59	5.69	721	41	5.83
2000	1,679	6.15	1,113	66	6.06	566	34	6.34