

EUROPEAN ECONOMIC PERSPECTIVES



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European Economic Perspectives

UK Consumption: Scene Set For Gradual Improvement

Consumer spending is central to the outlook for UK interest rates. In our view, the fundamentals continue to support a gradual improvement in consumption. If this is correct, the Bank of England is likely to leave interest rates on hold.

Recent UK data have been mixed. Although the trend in retail sales is marginally up (**Display 1**), the July and August data failed to sustain June's strong momentum. In addition, survey data and company reports suggest that the retail environment remains challenging.

However, the good news for consumption is that labour-market data have been resilient. Wage growth has eased but is still running at 4.0% per annum, while employment growth has risen to 1.1%. This means that wage and salary income is growing at just over 5%, in line with the average of the last five years. In other words, there is sufficient income growth to support a rebound in consumer spending from its current depressed levels.

Moreover, two of the main factors weighing on the consumer have become more supportive. First, debt-servicing costs have stopped rising aggressively. Second, housing transactions have started to recover (**Display 2**).

There is some controversy about the degree to which house-price inflation has boosted consumption in the UK. But there is less disagreement over the impact of housing transactions. Indeed, recent Bank of England research shows that people are much more likely to buy big-ticket items when moving home (**Display 3**).

The Bank's research also shows that people tend to spend much more on home improvements when they move: an average of £3,548 per annum, compared with £1,581 for non-movers. This helps explain the problems faced by companies exposed to the home-improvement sector.

The effect of weak housing transactions on the retail sector is illustrated by sales figures for household goods stores. Although overall sales are on a modest upward trend, sales by household goods stores are continuing to fall (**Display 4**). With companies still expanding floor space (**Display 5**), it is not hard to understand why many of them have suffered.

In summary, the outlook for UK consumer spending is supported by resilient wage and salary growth; we would be much less sanguine about consumption were the labour market slowing sharply. In addition, the increase in debt-servicing costs has eased and housing transactions have started to recover. These developments are consistent with our view that consumption should start to improve in coming months.

The major obstacle for the consumer now is the oil price. According to our data, petrol prices have risen by 7% over the last two months. This, together with increases in household fuel bills, should push consumer price inflation up to a peak of 2.7% from 2.4% at present¹. However, even inflation at 2.7% still leaves real labour-income growth above 2%. This is sufficient to support a gradual improvement in consumer-spending growth.

Hence, barring a continuous rise in the oil price, the fundamentals still favour a gradual improvement in consumer spending. The timing of this is difficult to gauge and, if the consumer is slow to recover, some members of the Bank of England's Monetary Policy Committee may favour another precautionary rate cut. On balance, however, we expect interest rates to remain on hold.

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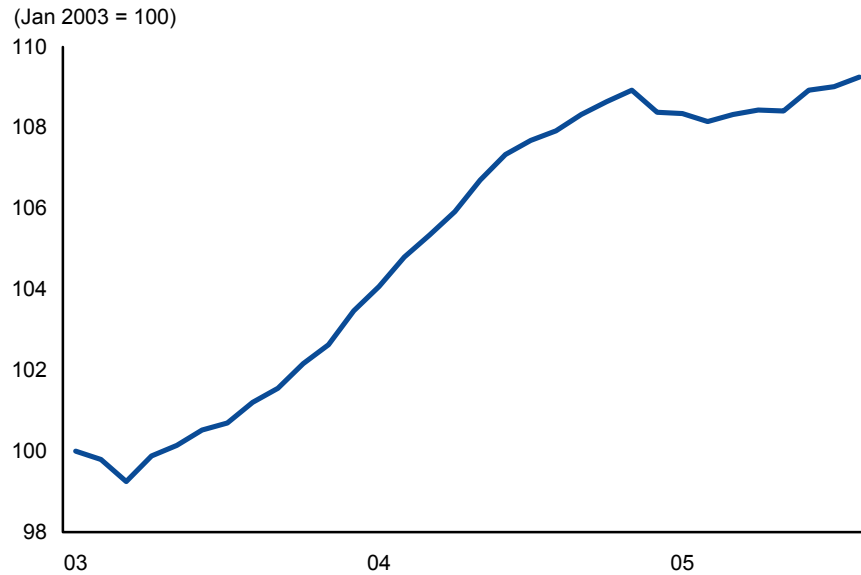
¹ Barring a further surge in oil prices, inflation is unlikely to rise much beyond 2.7% in the next few months given the sharp rise in energy prices recorded in October and November 2004.

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Display 1: A Modest Recovery in Retail Volumes

UK Retail Sales Volumes, Three-Month Rolling Average

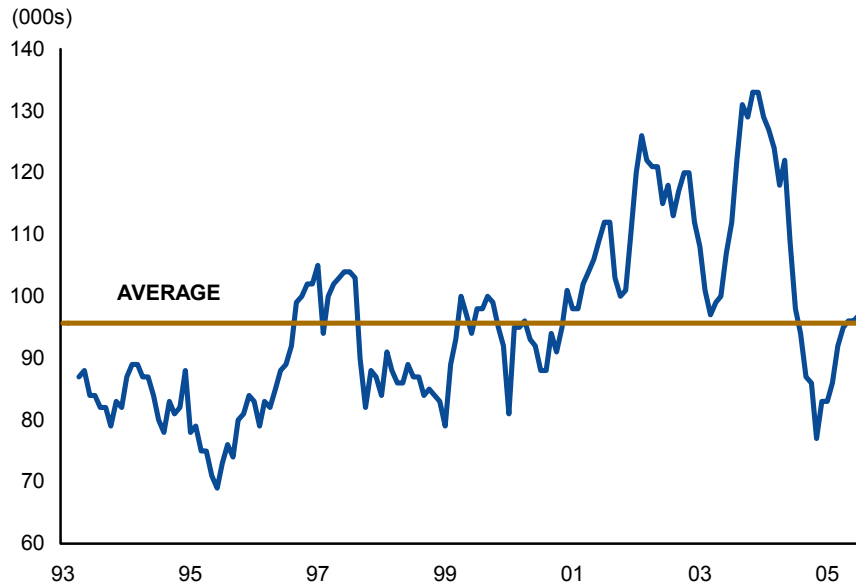


Source: Haver Analytics and Alliance Capital Fixed Income; September 23, 2005

Retail sales dipped in the second half of 2004. There has since been a modest rise, but there is little evidence of a significant improvement.

Display 2: Housing Transactions Have Started to Recover

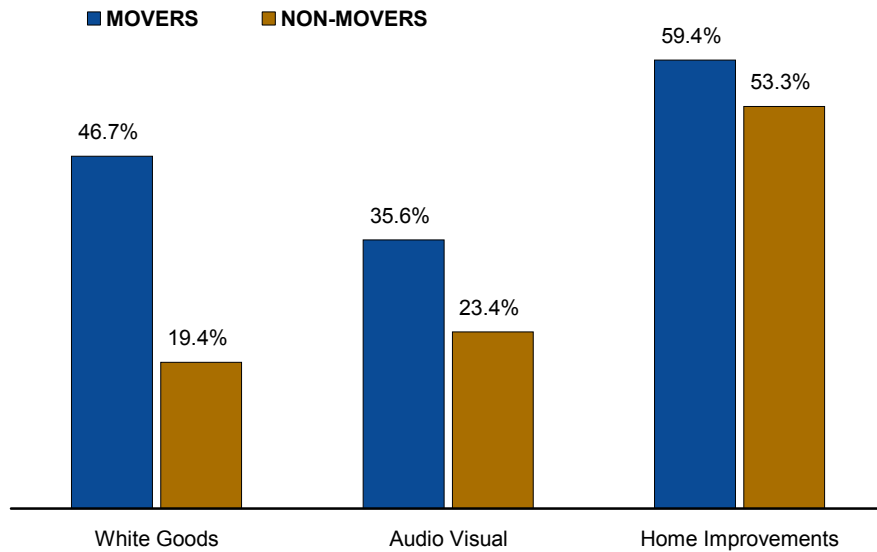
Number of Mortgage Approvals for House Purchase



Source: Haver Analytics and Alliance Capital Fixed Income; September 23, 2005

Mortgage approvals reached record levels in the first half of last year, then fell back sharply. So far this year, there has been a steady improvement. Although well short of peak levels, approvals are back above their long-term average.

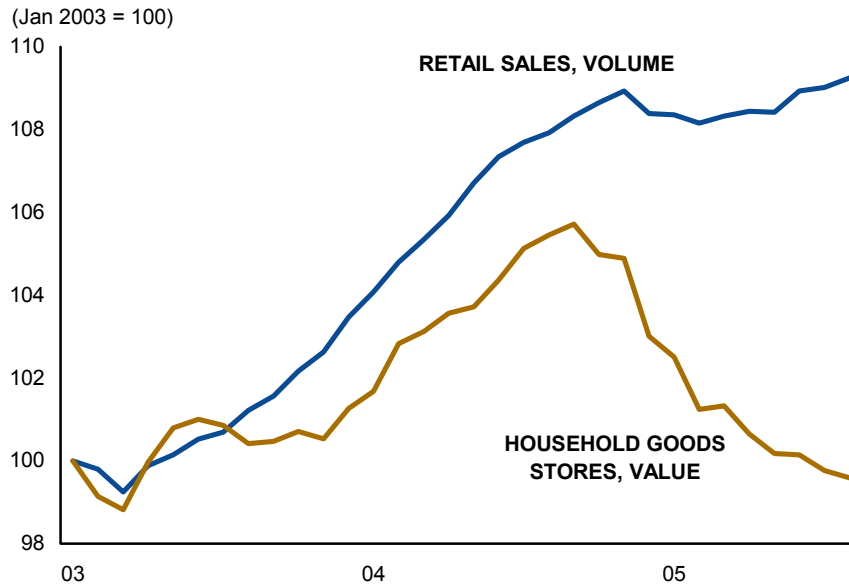
Display 3: Strong Housing Turnover Supports Consumption Percentage of Movers and Non-Movers Purchasing Durable Goods



Source: Bank of England and Alliance Capital Fixed Income; September 23, 2005

A recent Bank of England study showed that people are much more likely to buy durable goods when moving home.

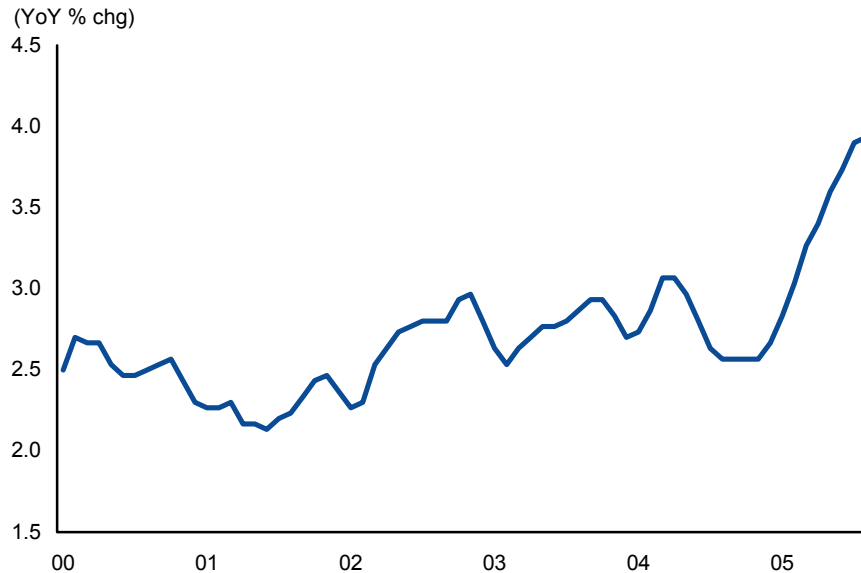
Display 4: Retailers Exposed to Housing Have Been Worst Hit
UK Retail Sales, Three-Month Rolling Average



Source: Haver Analytics and Alliance Capital Fixed Income; September 23, 2005

Although overall retail volumes are slowly starting to recover, the value of sales for household goods stores continues to fall.

Display 5: Retailers Have Boosted Capacity as Sales Have Slowed
Implied Increase in Retail Floor Space



Source: British Retail Consortium and Alliance Capital Fixed Income; September 23, 2005

Another problem for the retail sector is that a good start to 2004 and intense competitive pressures have led to a major expansion of floor space. This means that like-for-like sales have been even weaker than the macro data suggest.