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EUROPEAN ECONOMIC PERSPECTIVES

April 8, 2005

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European Economic Perspectives

UK: Consumption Is The Key

With little spare capacity in the economy and strong growth in most components of demand, the outlook for UK interest rates is becoming more dependent on consumption. Indeed, were it not for a slowdown in consumer spending growth, it is likely that the Bank of England would already have raised interest rates. Hence, it is crucial to understand why consumption has recently been so weak.

Why Has Consumption Been so Weak?

Having grown at an average of 0.9% in the first three quarters of 2004, consumer spending growth slipped to just 0.2% during the final quarter. As **Display 1** shows, the slowdown was mainly in consumption of durable goods (such as cars, furniture and major household appliances) and semi-durables (such as clothing, small appliances and books). Moreover, the weakness seems to have continued into early 2005, with retail sales for January and February up just 0.2% on their fourth-quarter average. By contrast, services' consumption has been much more resilient.

There are a number of reasons for the weakness of consumer spending. National accounts data suggest that the fourth-quarter slowdown was mainly due to special factors (a drop in dividend income and lower government transfers) which reduced real disposable income by 0.5%. The slowdown does not appear to have been due to a rise in the savings rate or to weak labour-income growth. The savings rate actually fell in the fourth quarter, while wage and salary income rose by 1.0% in real terms.

Spending may also have been adversely affected by the weakness of the housing market. However, if this were the case, we might have expected consumer confidence to decline and the savings rate to rise. Neither has happened. Of course, quarterly changes in household income are volatile and it is possible that the data distort the performance of the savings rate. Nonetheless, the key message to take from the fourth quarter is that underlying income growth is strong.

Labour income is set to continue growing strongly. Low unemployment, buoyant job creation and high retail-price inflation all point to an acceleration in wage growth over the next several months. Barring higher base rates or a rising savings rate, consumer spending is likely to pick up.

Is Mortgage Refinancing a Threat?

Many commentators cite the refinancing of fixed-rate mortgages as a reason to expect a consumer slowdown in 2005. We are not convinced. In July 2003, shortly before base rates started to rise, it was possible to borrow at a two-year fixed rate of 3.6%. This is almost 3% lower than the current standard variable rate, implying a massive rise in interest payments. However, this comparison assumes that people coming to the end of a two-year deal will move onto the standard variable rate when a fixed or discounted variable rate would be much cheaper. In practice, this seems unlikely.

According to the Council of Mortgage Lenders, the average two-year fixed rate is now 5.3%. Although this is 1.7% above the low reached in July 2003, it is just 1.1% above the average rate for 2003, roughly the same as the rise in the standard variable rate. Nor should the importance of fixed-rate deals be overstated. Our calculations, based on data from the Council of Mortgage Lenders, suggest that the number of fixed-rate mortgages taken out in 2003 was equal to less than 5% of the outstanding mortgage stock. Moreover, not all of these would have been two-year deals. **As Display 2** shows, anyone currently coming off a three- or five-year fixed rate can refinance at a lower rate of interest.

Some borrowers coming to the end of fixed-rate deals will experience severe difficulties this year. However, these are unlikely to be important enough at the macro level to have a big impact on the future path of aggregate interest payments. We expect debt-servicing costs to rise to 9.3% of disposable income at the end of 2005 from 8.7% at the end of 2004, in part because debt itself will be higher (**Display 3**). However, barring additional interest-rate hikes, the household sector has absorbed most of the impact of higher borrowing costs.

Conclusions

A number of factors have contributed to recent weak consumer spending growth, including a slowdown in the housing market and the recent rise in fuel prices. There has also been a temporary pause in disposable income growth, but robust wage and salary growth suggest this is unlikely to continue. Barring higher base rates or a rising savings rate, consumption is likely to recover.

That said, the short-term outlook is still shrouded by uncertainty and the Bank of England will need to see evidence of stronger consumption before raising interest rates. This tends to put a rate hike in June at the earliest.

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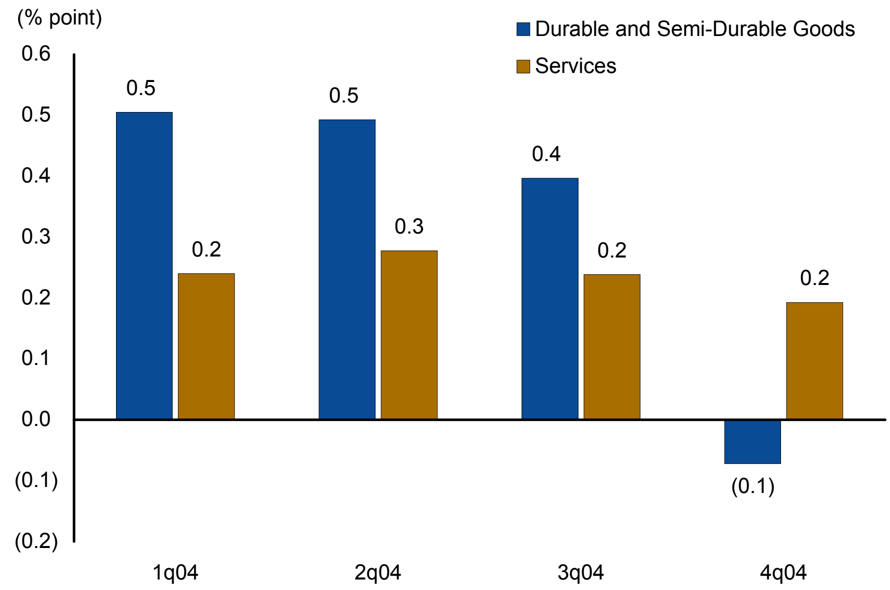
Display 1: Consumer Weakness Has Been Concentrated In Durable And Semi-Durable Goods

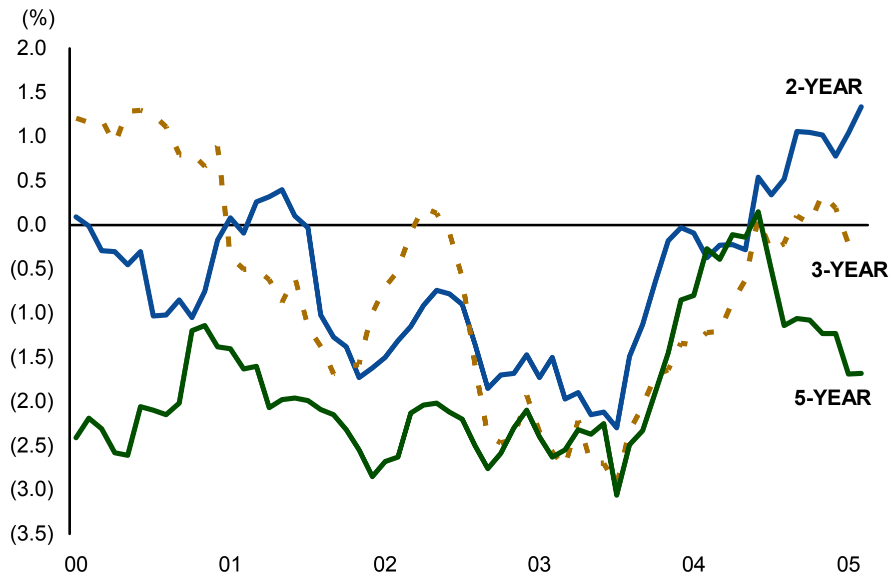
Contributions To Consumer Spending Growth



Source: Haver Analytics and Alliance Capital Fixed Income, April 8, 2005

Consumer spending growth slowed from an average of 0.9% in the first three quarters of 2004 to just 0.2% in the final quarter of the year. Almost all of this slowdown was due to a drop in spending on durable and semi-durable consumer goods. Services consumption has held up much better.

Display 2: Is Mortgage Refinancing a Threat to Consumption?
Cost of Refinancing a Maturing Fixed-Rate Mortgage*

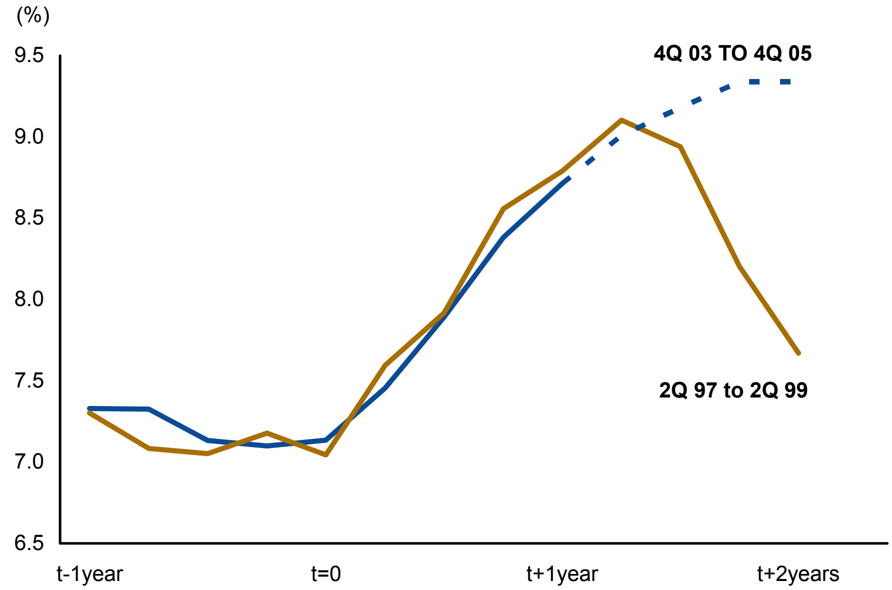


** Increase/decrease in interest rates when switching from a maturing fixed-rate mortgage to a new fixed-rate deal of the same maturity*

Source: Council of Mortgage Lenders, Haver Analytics and Alliance Capital Fixed Income, April 8, 2005

Anyone renewing a two-year fixed-rate mortgage this year is likely to pay a higher interest rate. However, the importance of this is often overstated and there is likely to be a partial offset from maturing three- and five-year deals.

Display 3: Debt-Servicing Costs During Similar Tightening Cycles
Household Interest Payments as % of Disposable Income



Source: Haver Analytics and Alliance Capital Fixed Income, April 8, 2005

Base rates have risen by 125 basis points since November 2003. Display 3 compares the resultant increase in debt-servicing costs with the 125 basis-point tightening cycle that started in May 1997. The rise in interest payments is almost the same. We expect debt-servicing costs to rise further in 2005, in part because debt itself will be higher. Nonetheless, much of the impact of higher borrowing costs has already been absorbed.