



UK Economics

Outlook for 2005 & 2006

Society of Business Economists

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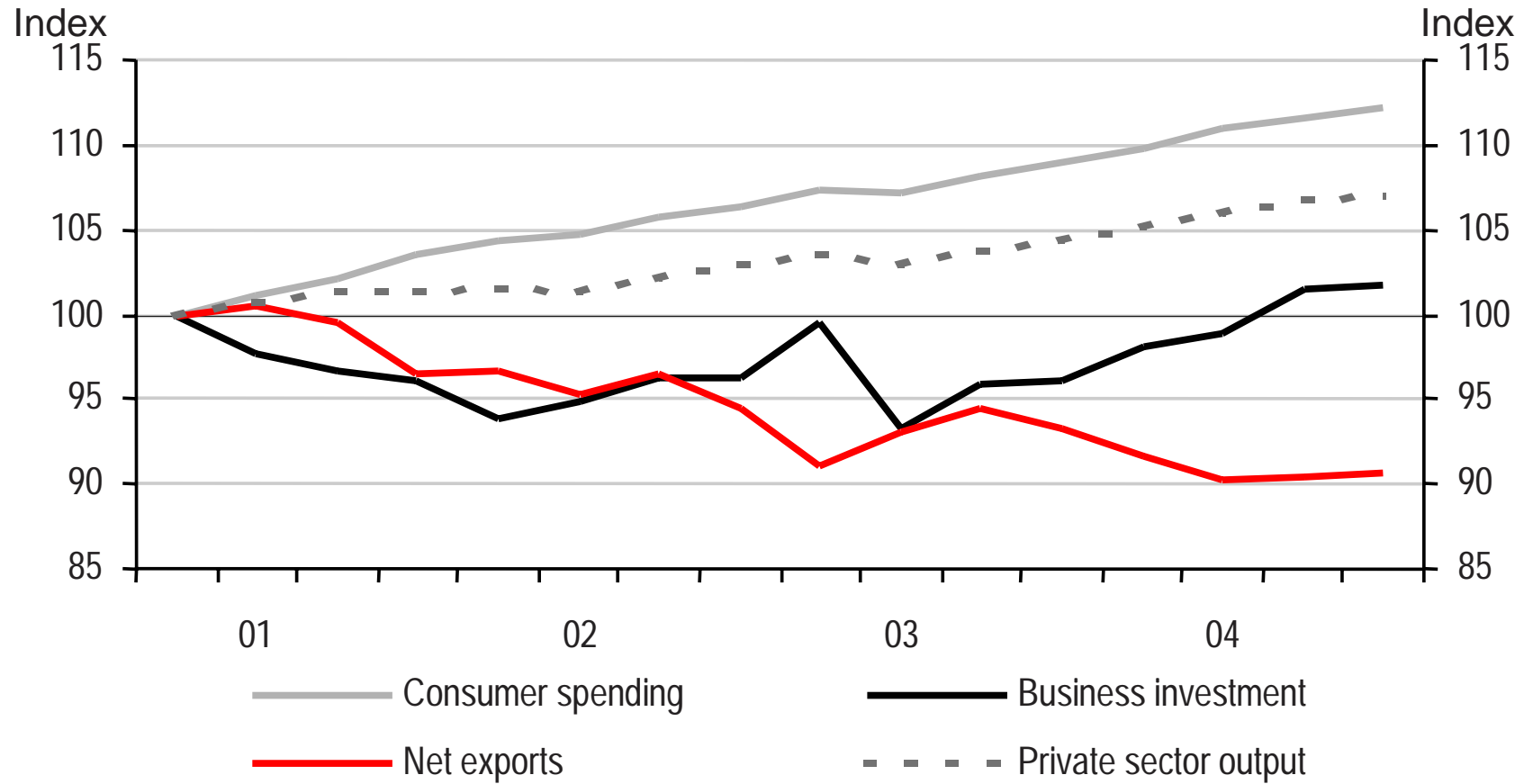
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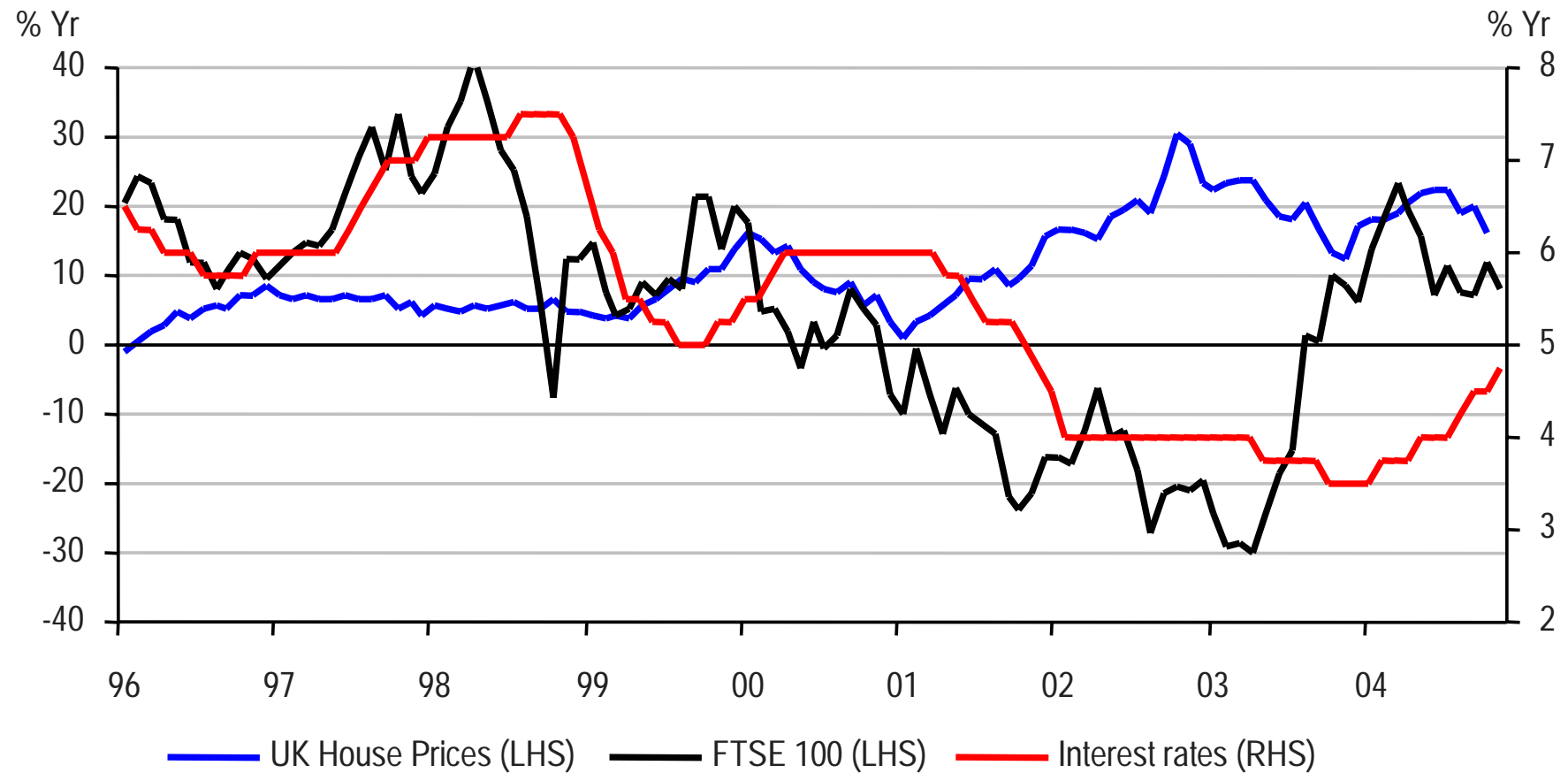
HSBC 



Unbalanced nature of growth...



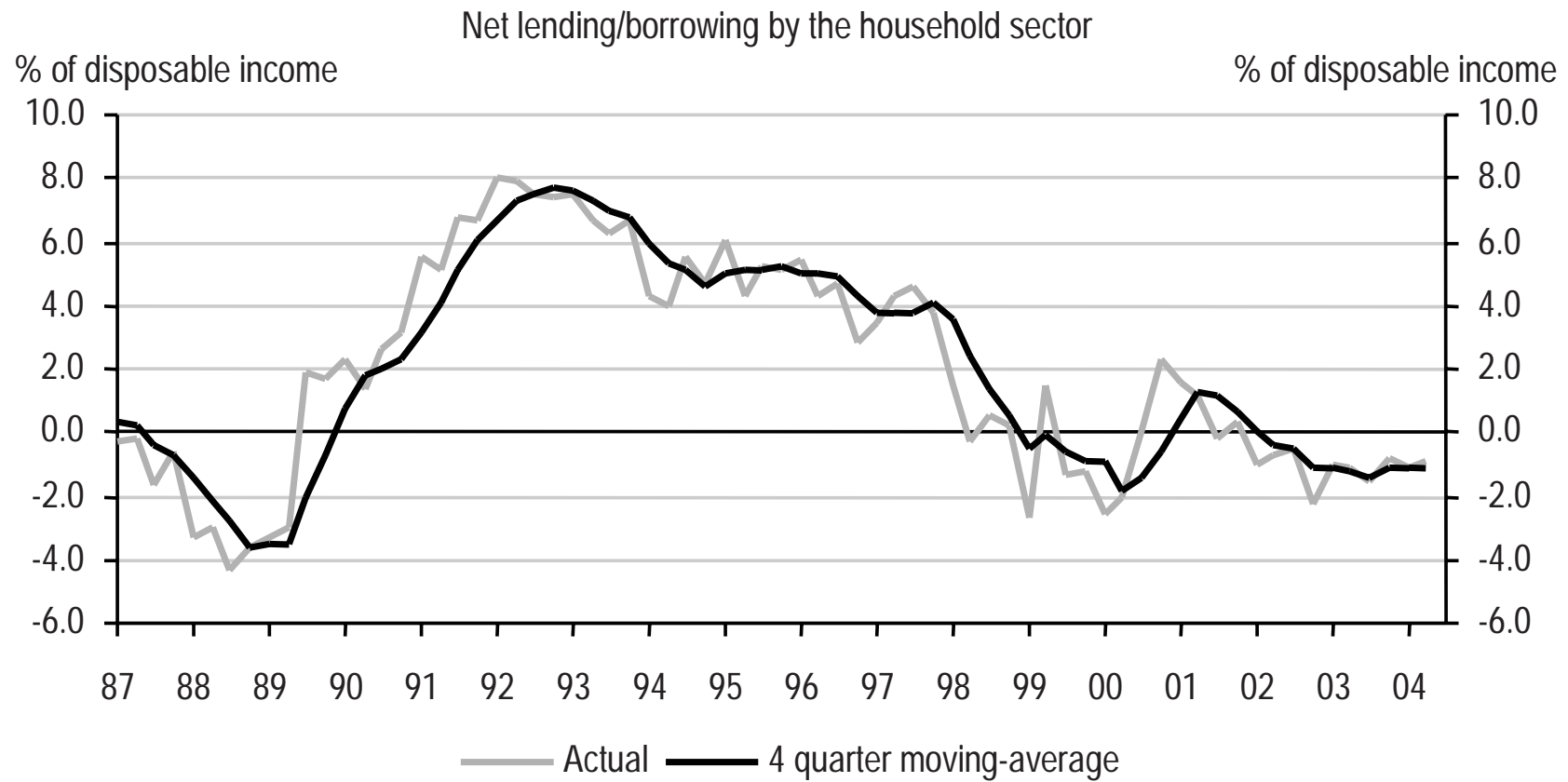
...and non-symmetric response to asset prices



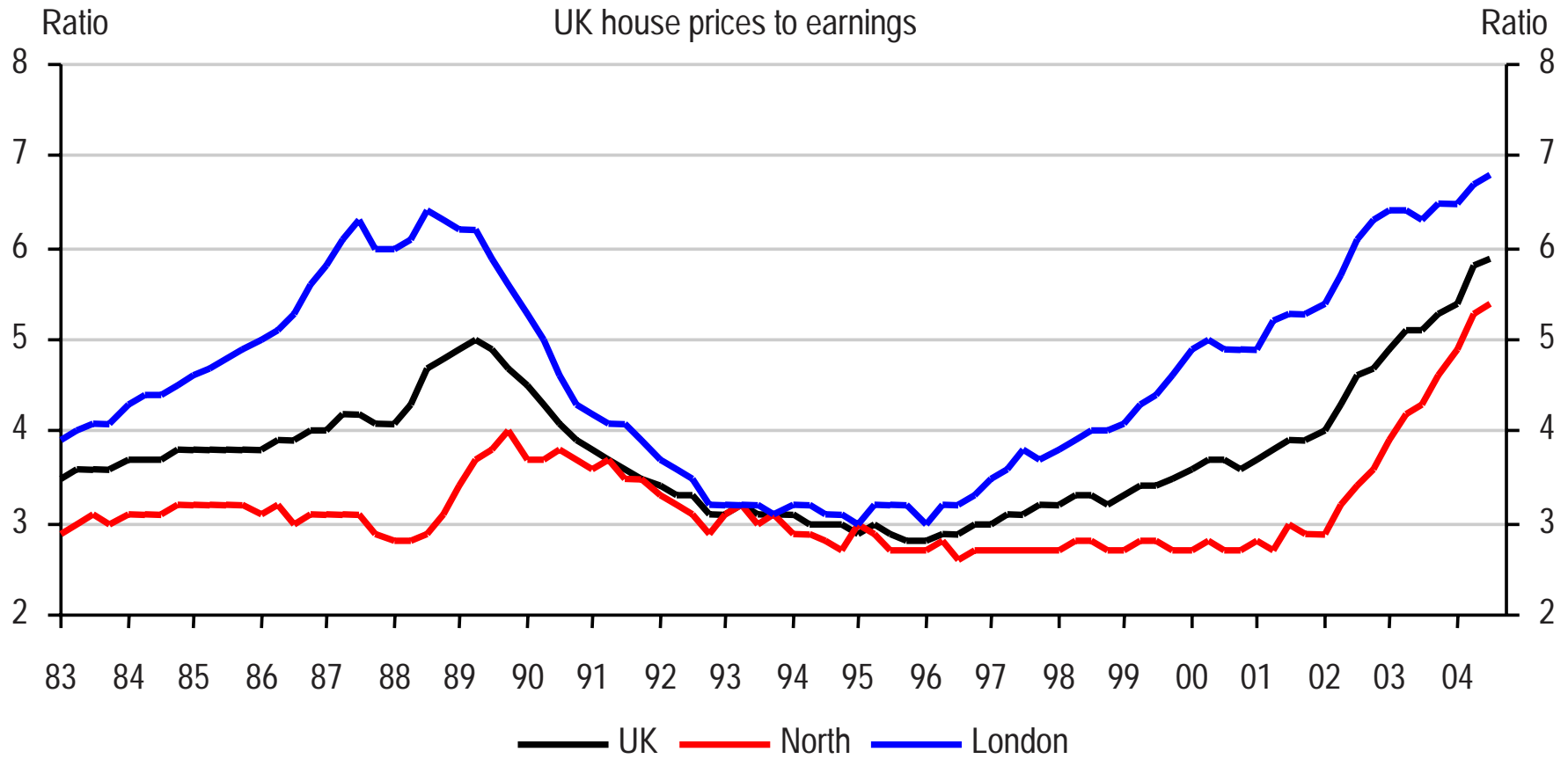
Seeds of next downturn already been sown

- Remarkable performance in UK masked boom & bust living side by side
- Policymakers been busy switching rather than solving problems
 - from corporate indebtedness to consumers
 - from equity bubble to housing bubble
- Implication is that unusual downturn likely to lead to unusual recovery
- Consumer vulnerable and vulnerability is rising rather than diminishing
- Corporate in better shape but unlikely to offset consumer downturn
- Global uncertainties likely to persist, especially for UK's key trading partners

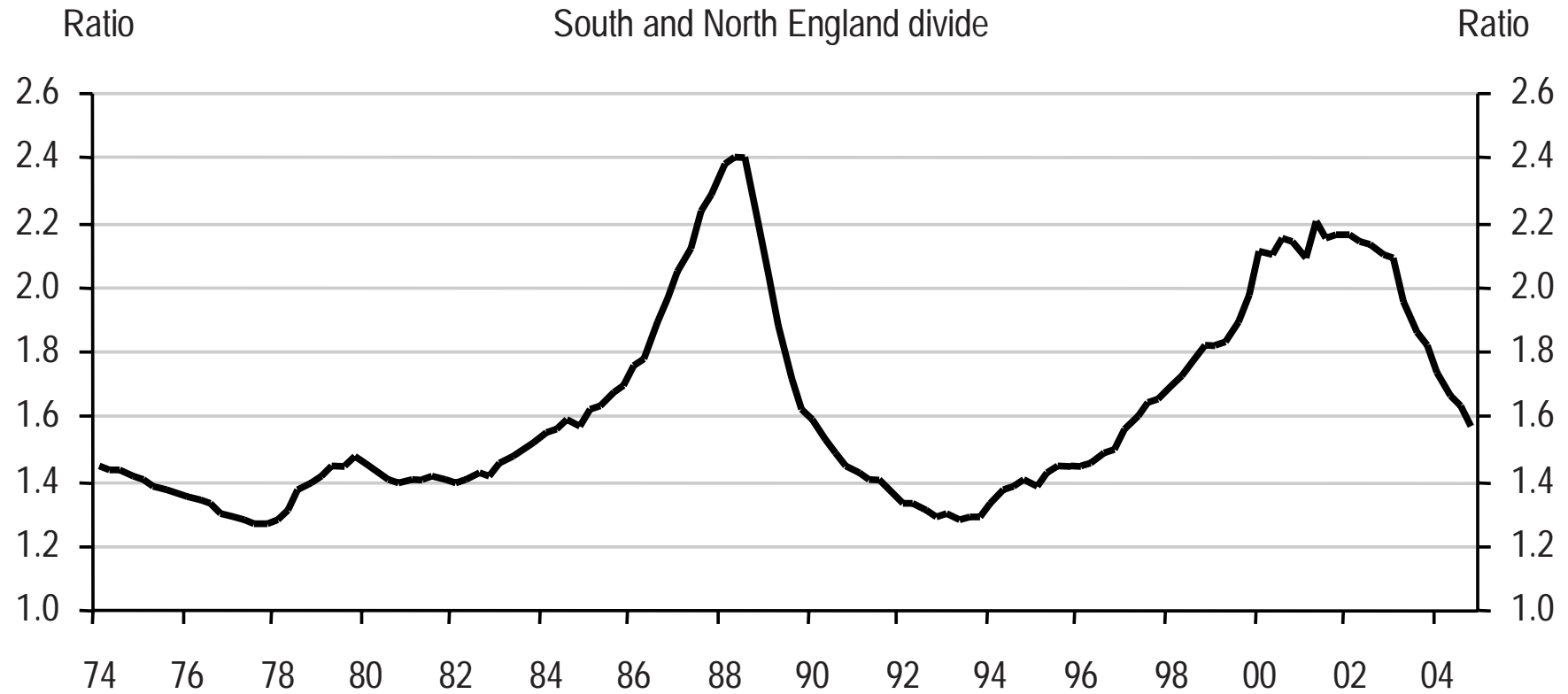
Consumer balance sheet has changed



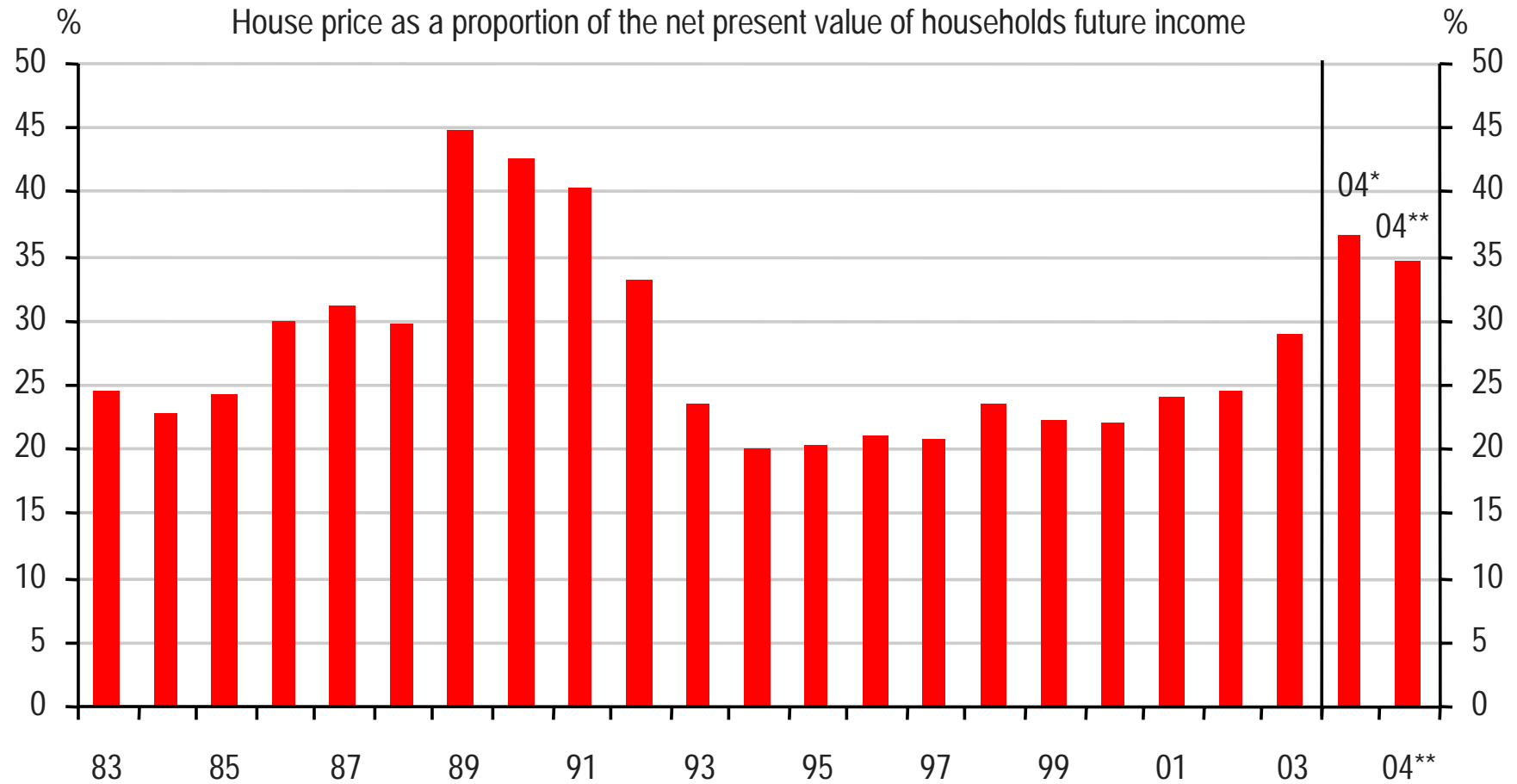
House prices look vulnerable...



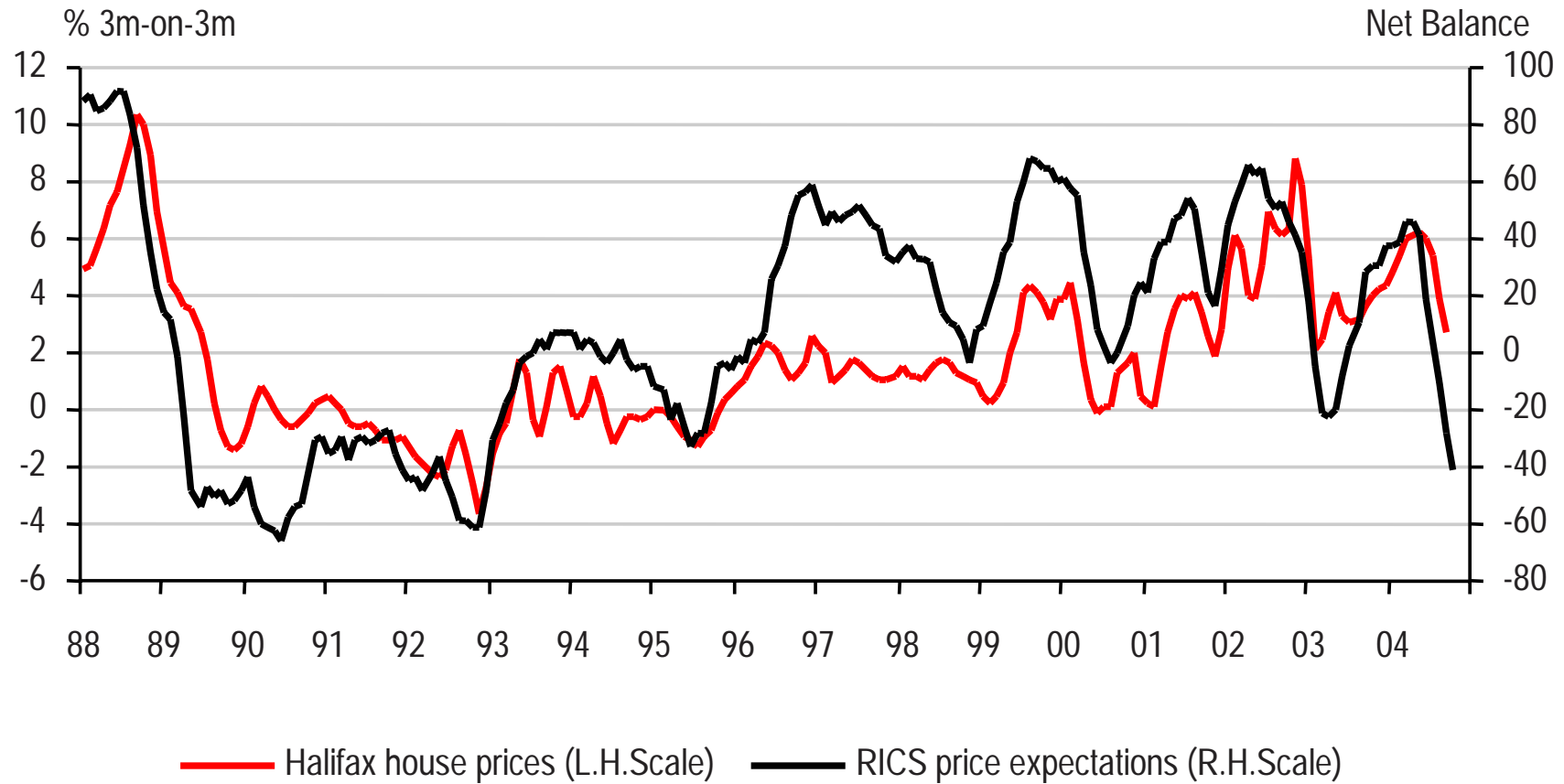
...despite demographics/lack of supply...



...and despite any productivity improvement



Recent housing indicators suggest downturn begun



Is there a link between house prices and spending?

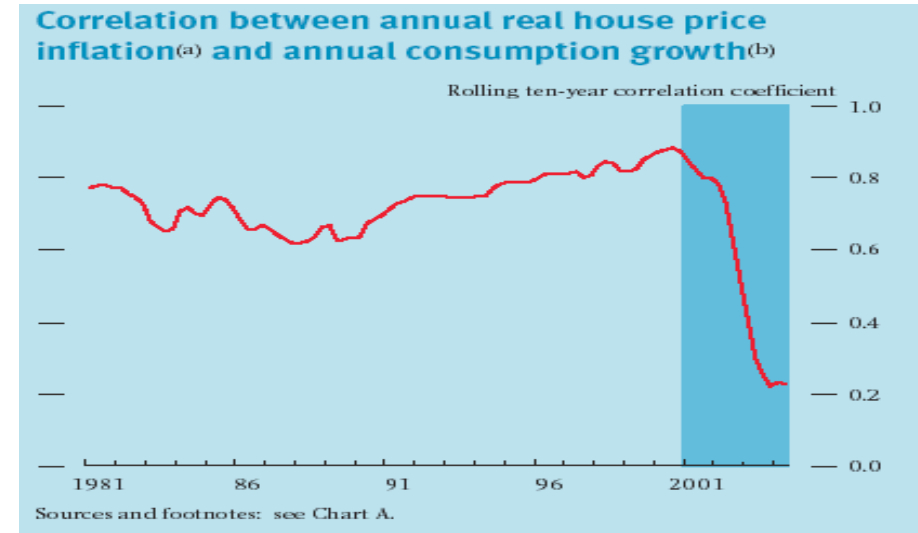
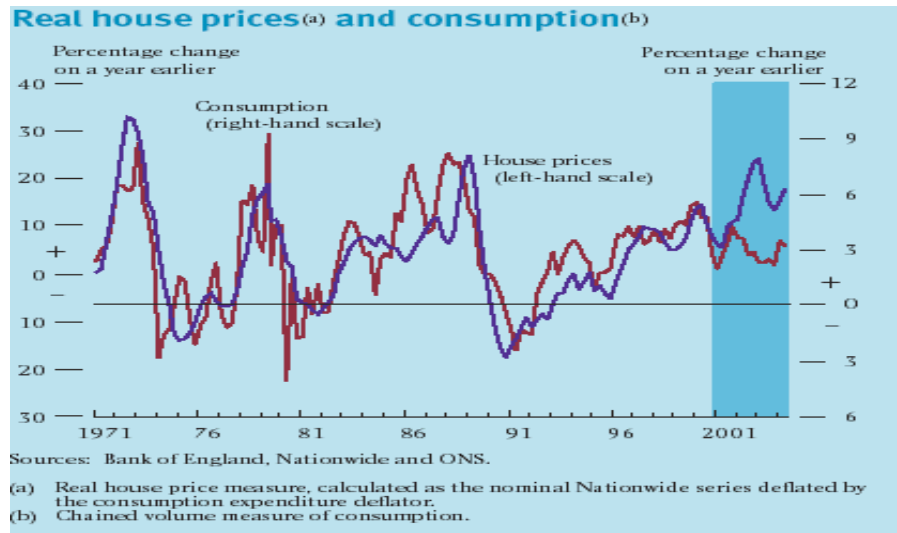
- **Professor Nickell speech:**

“The empirical relationship between household consumption and house prices is by no means a stable one, but it is nevertheless important for monetary policy because house price inflation, being positively related to household consumption, is therefore positively related to aggregate demand and hence future inflation.”

- **Why may they be correlated?**

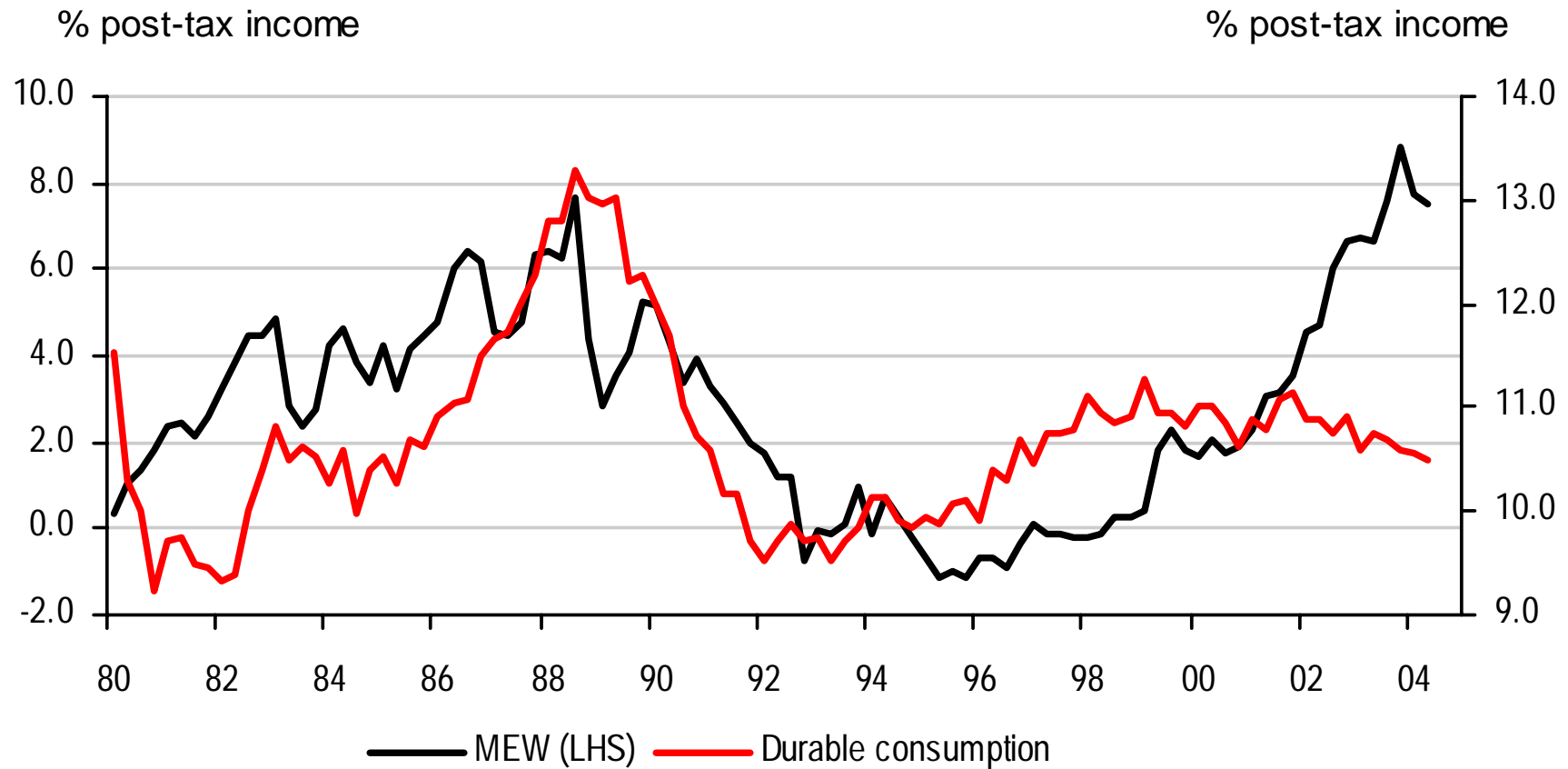
- **Common driver: higher income expectations**
- **Higher house prices increase collateral, ease credit constraints i.e. MEW**

Correlation between MEW and spending low

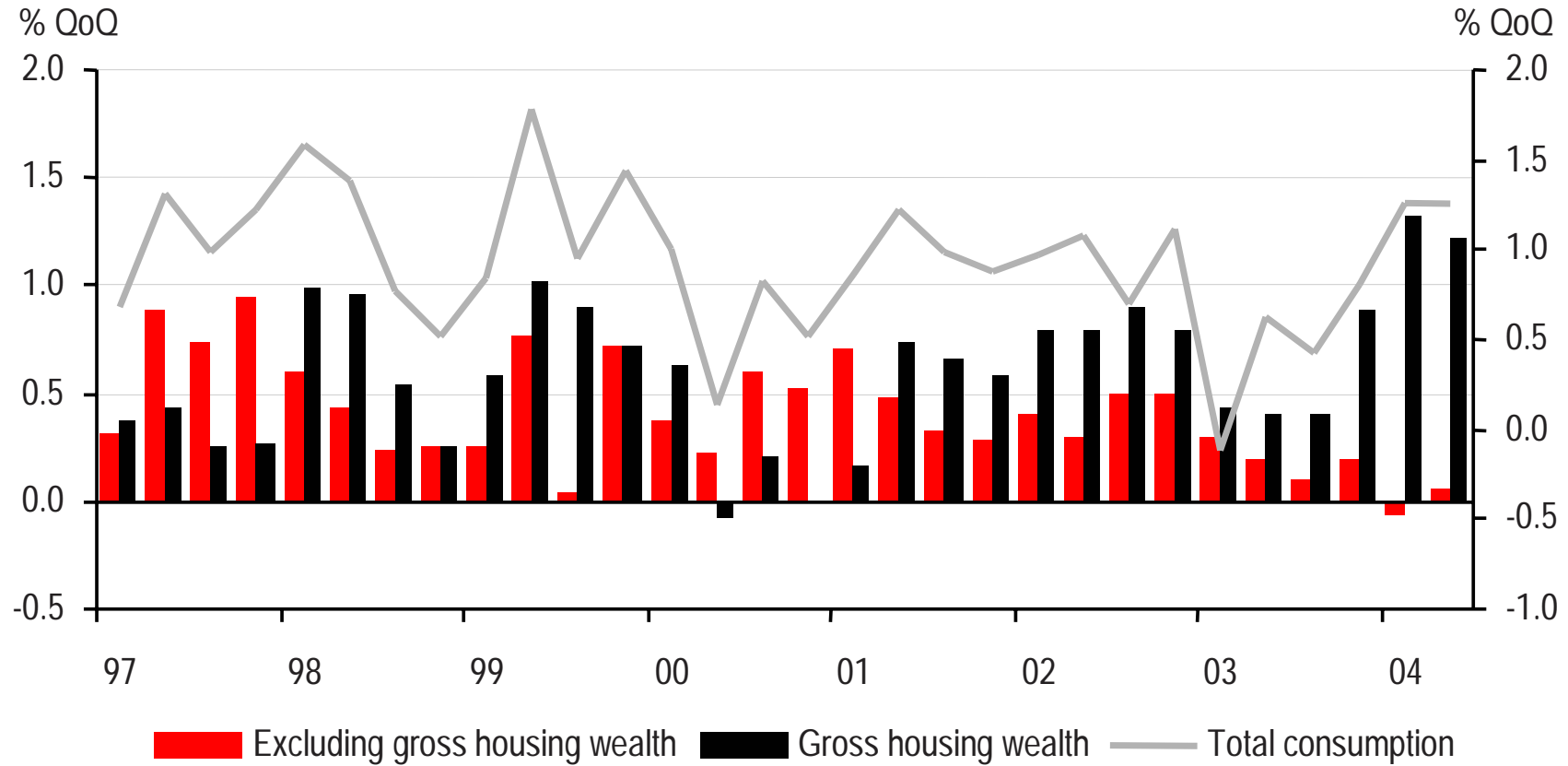


- **MEW been saved?**
- **Data uncertainties**
 - import penetration of consumer goods falling

Where has all the money gone?!



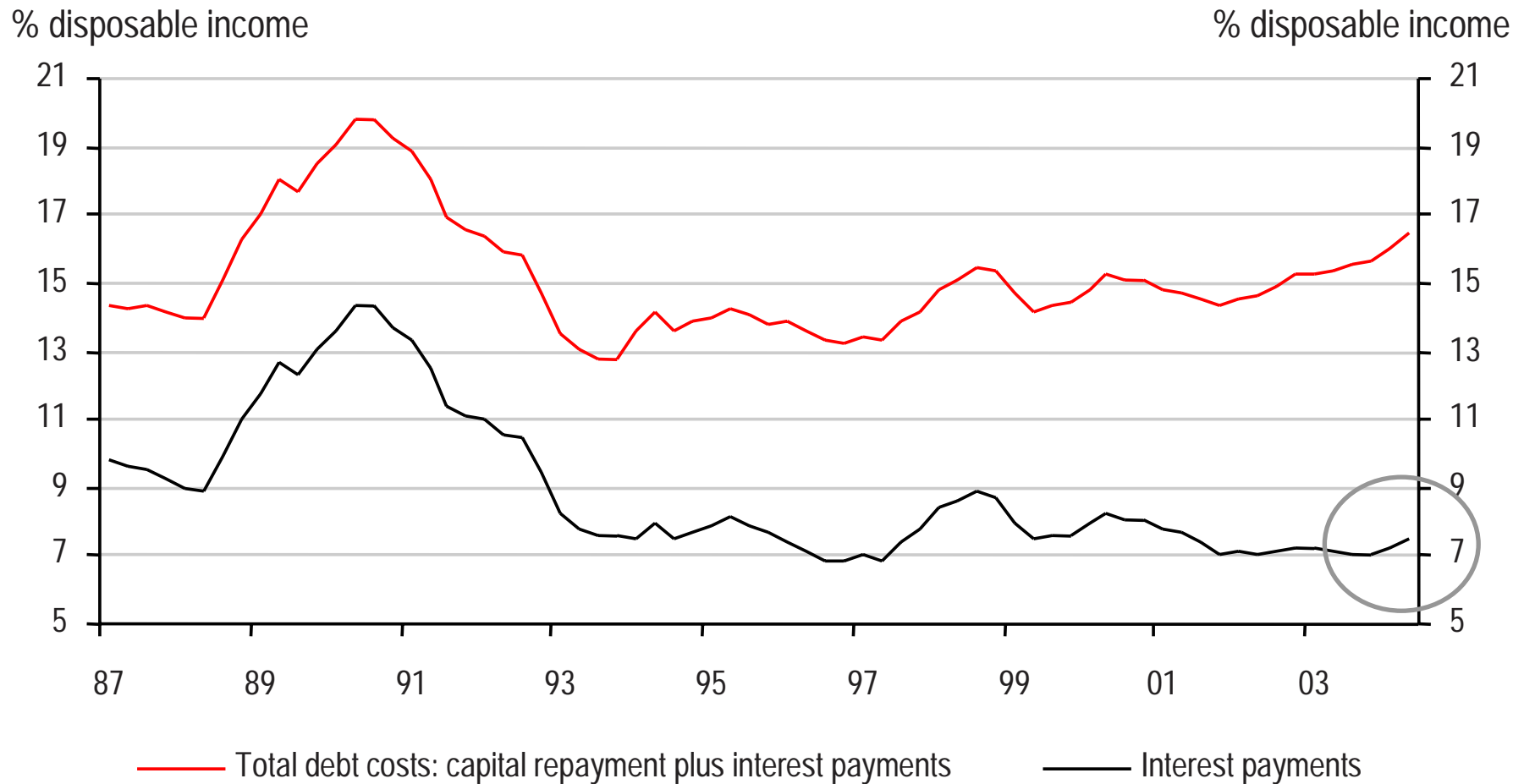
What's the counter-factual?



Strong positive correlation between house prices and consumer spending when real house prices fall

PERIOD	REAL HOUSE PRICE INFLATION FALLING/RISING	CORRELATION WITH CONSUMER SPENDING
Q1 78 - Q1 80	Rising	-0.98
Q1 80 - Q1 82	Falling	0.96
Q1 83 - Q1 89	Rising	-0.02
Q1 89 - Q1 91	Falling	0.91
Q1 92 - Q1 96	Falling	0.79
Q1 97 - Q1 04	Rising	-0.19

Fundamentals: debt servicing costs on the rise...



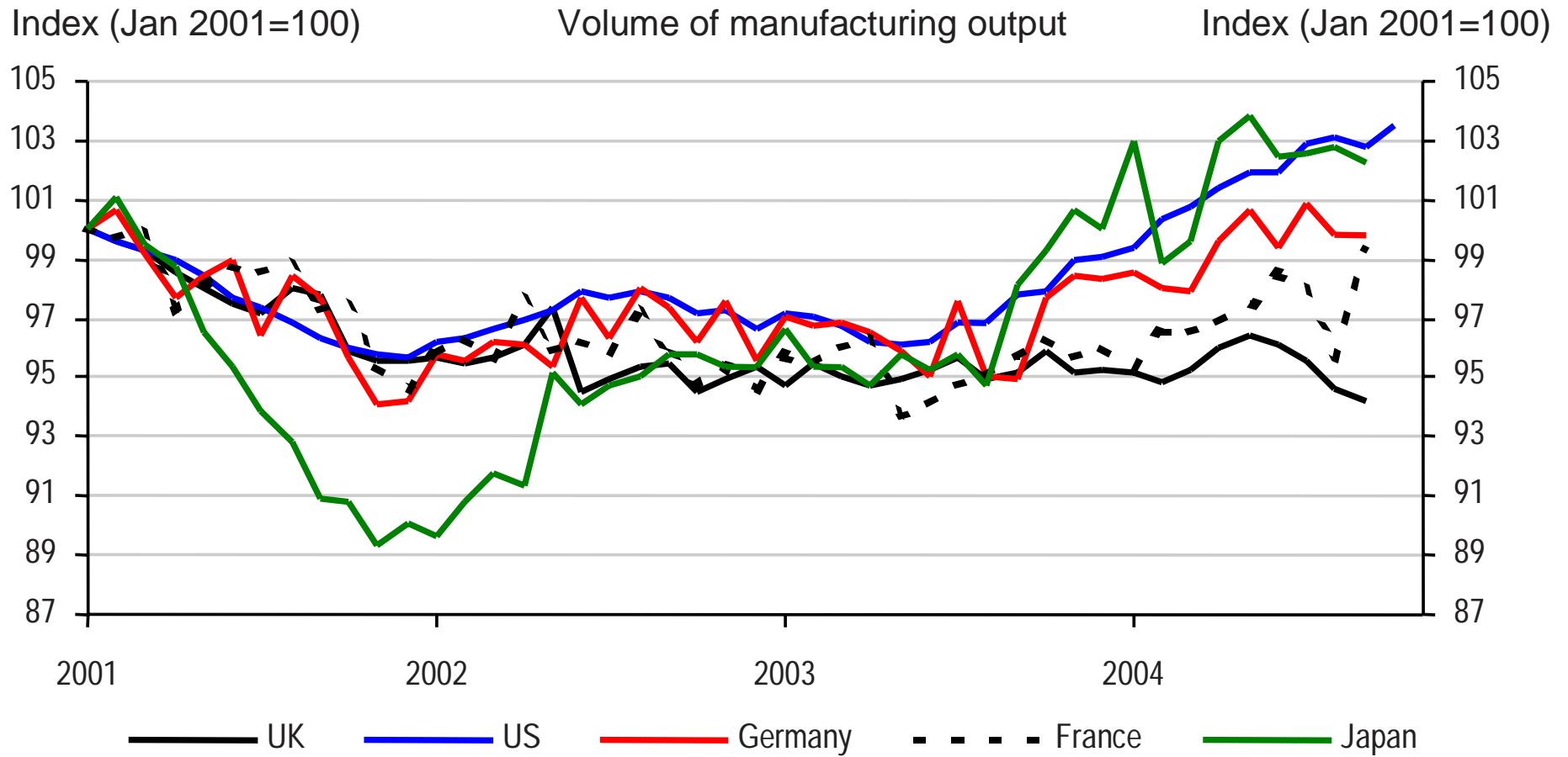
...private sector employment remains cautious....



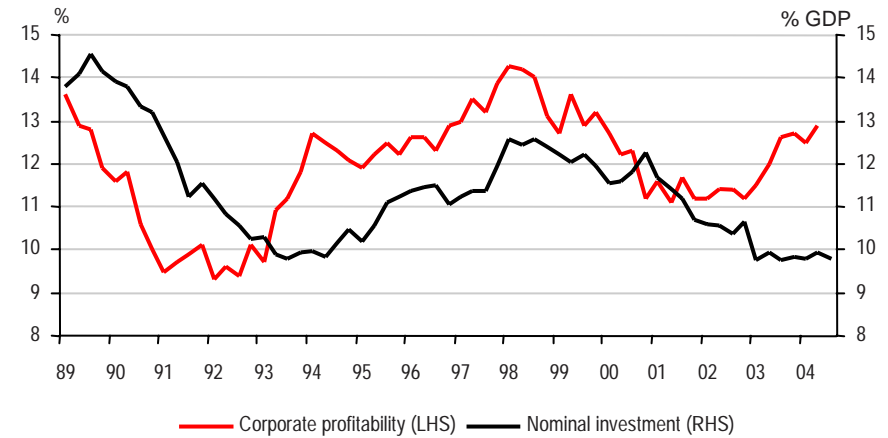
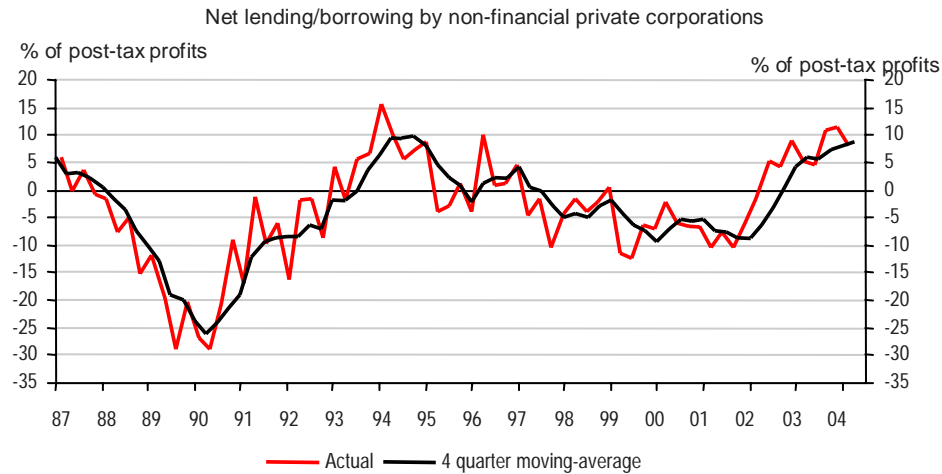
...and real income growth well below 1990s average



Industrial sector still lagging behind



Corporate balance sheet in better shape



- If corporate balance sheet concerns was source of downturn, then balance sheet in better shape
- UK plc is cash rich...
- ...and profitability points to upside on investment spending

Global risks on the downside

- Investment, exports & industry are a leveraged play on global and domestic demand
- **Global outlook** still full of uncertainties:
 - 1 **US imbalances and leverage**
 - risks to consumer outlook
 - 2 **Currency volatility**
 - dollar in long term decline as C/A deficit weighs heavy
 - at a minimum UK hit through negative impact of euro rise on eurozone economy
 - 3 **Chinese slowdown**
 - **Expect US slowdown**
 - 3% in 2005 (trend?) but below in H2 2005 & 2006
 - **Eurozone drag**
 - euro rise pull down export boost...
 - ...while domestic demand remains weak

4 alternative scenarios for UK

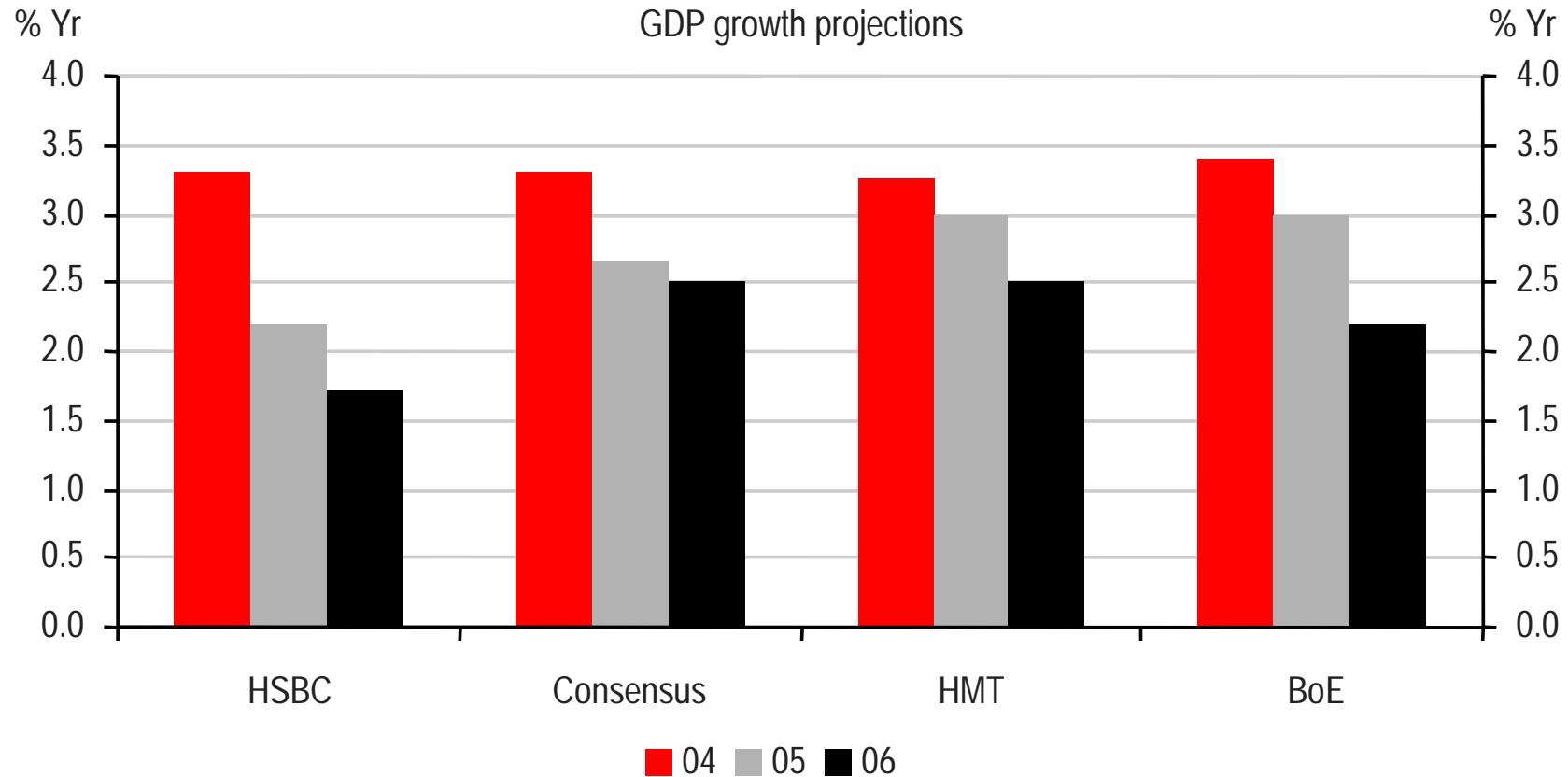
- 1 **Soft landing - 5% rates**
 - trend growth with inflation rising towards target
 - **consensus amongst economists**

 - 2 **Hard landing - <4% rates**
 - consumer squeeze and housing market correction
 - **gaining credibility in market**

 - 3 **Supply side improvements - 4.5% rates**
 - implies steeper curve

 - 4 **Behind the curve - 6% rates**
 - opportunities in short-sterling
-
- **Number 1 least likely!!**

The cost of surviving the downturn

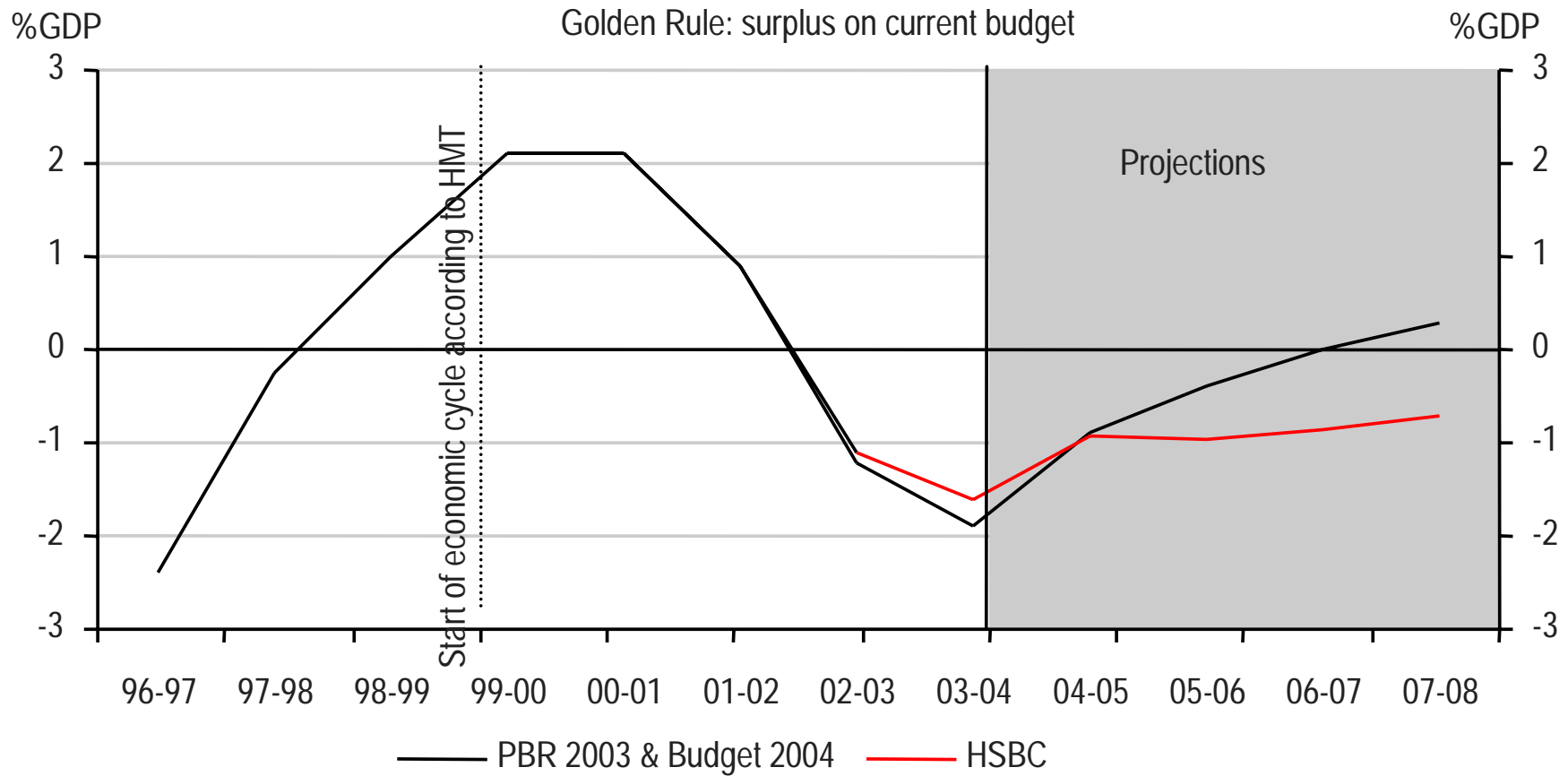


- **Unusual recovery implies shallow recovery**

- Soft or hard landing?
- Persistent weakness

- **One policy tool**

Fiscal: breaking the golden rule



Summary

- **Expect sharp and persistent downturn from H2 2005 onwards...**
- **...but risk of hard landing rising**
 - MPC balancing act: foot off brakes too soon or too late?
 - Sterling
- **Now a consensus view that house prices will slow sharply...**
 - either fall in nominal or real terms?
- **...but uncertainty surrounds relationship with consumer spending**
 - history suggests positive correlation in downturn
- **Policy stimulus to remain in place**
 - but interest rates may be less effective if consumer shifts attention to balance sheet

Summary of UK economic forecasts

% Year	2004f	2005f	2006f	Q3 04f	Q4 04f	Q1 05f	Q2 05f	Q3 05f	Q4 05f
Consumer spending	3.3	2.3	1.2	3.2	3.4	3.0	2.8	2.2	1.3
Government consumption	4.0	2.3	2.4	4.0	2.0	1.9	2.3	2.3	2.7
Investment	6.5	3.6	2.1	6.9	6.1	5.2	3.4	3.2	2.4
Stockbuilding (% GDP)	0.1	-0.1	-0.1	0.2	-0.2	0.0	0.0	-0.1	-0.2
Domestic demand	4.0	2.4	1.5	4.1	3.4	3.1	2.8	2.2	1.6
Exports	2.3	4.5	2.0	4.0	4.2	6.0	5.4	4.0	2.5
Imports	5.0	4.6	1.5	6.9	5.5	6.2	5.9	4.0	2.6
GDP	3.3	2.2	1.7	3.1	2.9	2.9	2.5	2.1	1.5
GDP (% quarter)	-	-	-	0.5	0.8	0.7	0.5	0.3	0.1
Manufacturing output	1.3	2.1	0.9	0.5	1.1	2.2	1.6	3.0	1.4
Unemployment (%)	2.7	2.9	4.0	2.7	2.8	2.8	2.8	2.9	3.0
Average earnings	4.5	4.4	3.8	3.9	4.4	4.5	4.6	4.4	4.2
RPI	2.9	2.9	2.3	3.1	3.2	3.2	3.2	2.7	2.5
CPI*	1.3	1.4	1.7	1.2	1.3	1.3	1.4	1.5	1.6
Current account (% GDP)	-2.4	-2.8	-2.7	-2.6	-2.9	-2.8	-2.8	-2.8	-2.9
PSNB (% GDP)	2.9	3.1	3.2	-	-	-	-	-	-
USD/GBP	1.81	1.79	1.80	1.81	1.78	1.78	1.79	1.80	1.80
GBP/EUR	0.69	0.75	0.75	0.69	0.72	0.74	0.75	0.75	0.75
Base rate (%)**	5.0	5.00	4.00	4.75	4.75	5.00	5.25	5.25	5.00
10yr bond yield (%)**	5.1	4.9	5.1	4.8	4.7	4.8	4.7	4.6	4.4

*Inflation target (2%) **end-year