

UK Economy

Five major challenges for 2008

January 2008



The UK economy has enjoyed over 15 years of uninterrupted growth, with a strong labour market, record house prices and relatively benign inflation. But can this situation last? Although the Prime Minister and the Chancellor of the Exchequer recently claimed that the UK will 'weather the global financial storms' there is no doubt this will only occur if the economy can overcome some major risks and hurdles. In this article we identify what we see as the five biggest challenges which will face the UK economy in 2008 and assess the outlook for economic growth, inflation and interest rates.

1. The Global Credit Squeeze

During 2007, problems in the sub-prime mortgage market in the US quickly escalated into a global credit market squeeze. In the UK this resulted in the interbank rate (at which banks lend to each other) surging far higher than the policy rate (which is set by the Monetary Policy Committee). Under normal conditions the interbank rate would be around 35 basis points higher than the policy rate, but this spread increased to almost 100 basis points in August, and again in November, reflecting fears about the scale of losses being incurred by some of the world's major financial institutions. This increase in the interbank rate of

interest makes it more expensive to borrow, and banks have also been reportedly inactive even at these higher rates of interest. The era of cheap financing may be coming to an end. Borrowers are already finding it more difficult to access funds, and this may delay, or even cancel, investment or expenditure plans. Although the interbank rate fell back towards the end of the year, it remains at an elevated level and there is a real risk that this will impede consumer and corporate spending in the year ahead. Both of these are of high importance for the UK economy, as consumer spending accounts for over 60% of gross final spending, and investment spending for a further 13%.

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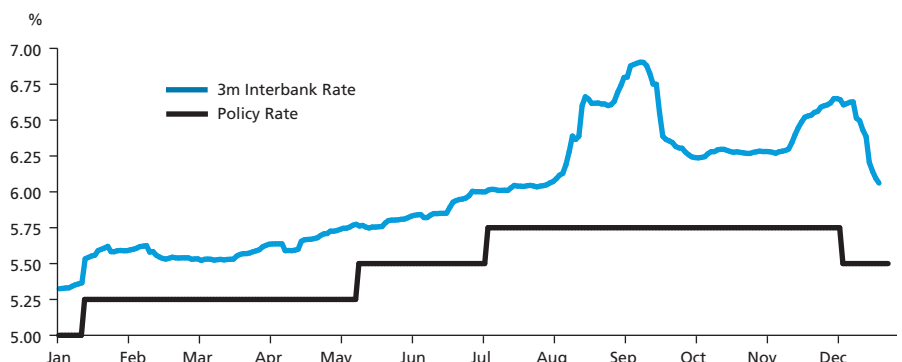
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Interbank Rate v Policy Rate of Interest

Source: EcoWin

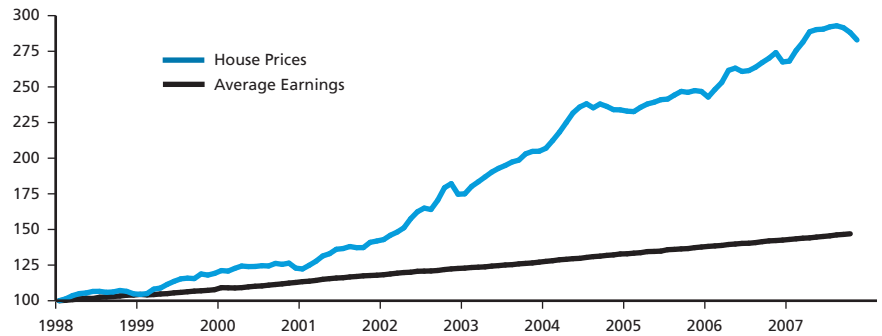


2. Potential Slowdown in the Housing Market

The UK housing market has been in boom territory for the last few years, resulting in the average house price in the UK reaching almost £200,000 and making it almost impossible for first time buyers to get onto the property ladder. However, there is now a real risk that the global credit squeeze will bring this boom to an end. Already there are reports that potential borrowers are finding it more difficult to access mortgage financing and that mortgage lenders are becoming increasingly prudent in terms of the amount of finance which they will issue. Mortgage approvals have dropped in recent months and house price growth is already slowing. There is a risk that the market slows further and that house prices fall, which could have a negative impact on consumer confidence and spending. In

House Prices v Average Earnings (Rebased to Jan 1998 = 100)

Source: EcoWin



addition, an estimated one million borrowers who had taken out fixed rate mortgages when interest rates were low in 2006, now face mortgage resets at a much higher rate of interest, and this could also have a negative impact on consumer spending growth. The biggest risk for outlook for the housing market is

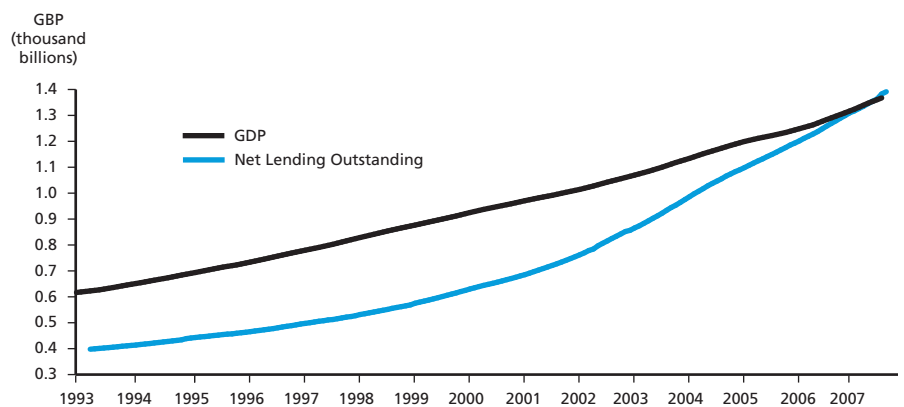
employment. If slower economic growth results in a rise in unemployment, there could be some forced sales of property, which would push house prices down and leave some late entrants into the market facing the prospect of negative equity.

3. The High Level of Consumer Indebtedness

Low interest rates, and a willingness of lenders to give consumers access to cheap credit, has resulted in an unprecedented level of growth in consumer borrowing in the UK. The chart on the right shows that net consumer lending has now overtaken GDP, indicating that we now owe more than we produce in any single year. This high level of debt leaves households with very little flexibility in the face of negative events, such as rising interest rates, loss of employment or house price falls. In addition, the global credit squeeze is likely to have some dampening effect on the extent to which consumer credit is issued, and those on low incomes, or with poor credit histories, may find it more difficult to access credit in 2008. Much of the growth

Net Lending v Gross Domestic Product

Source: EcoWin



in consumer spending which we have seen in the UK over the last few years has been financed out of debt rather than income, so any move by consumers to

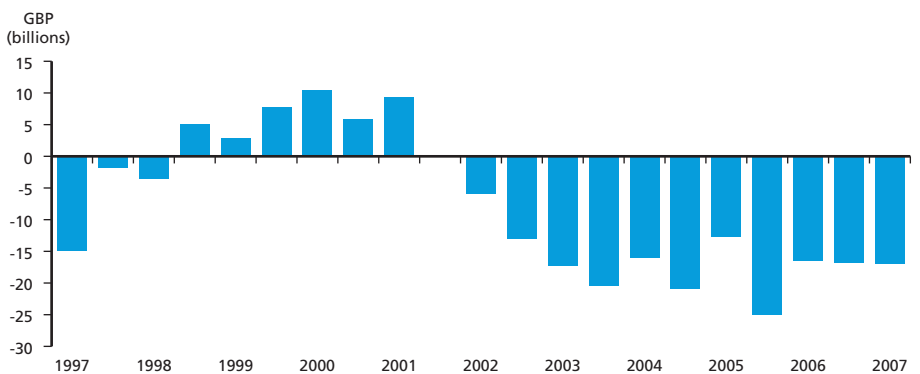
retrench, and rebuild savings, would be likely to have a negative impact on personal consumption and GDP growth.

4. The Fiscal Deficit

Although the UK has enjoyed an unprecedented 15 year period of uninterrupted growth, the government's finances do not look strong. Although tax revenue growth has been relatively robust, expenditure has been high and the government's budget remains in deficit. Recent projections by the Chancellor suggested that the government's deficit in the fiscal year to April 2008 would be £8.3bn but this requires that economic growth and tax revenue remain high. Growth forecasts are now being revised downwards in the aftermath of the credit squeeze, and tax revenues could be hit as a result. The fiscal deficit is already forecast to be equivalent to 3% of GDP (on a Maastricht basis) which could limit the government's

Central Government Net Borrowing/Lending

Source: EcoWin



flexibility to deal with any downturn in the economy. In the worst case scenario, the government could find itself having to cut spending, or even increase taxes,

at a time when the economy is slowing and a loosening of fiscal policy would be more appropriate.

5. Inflation

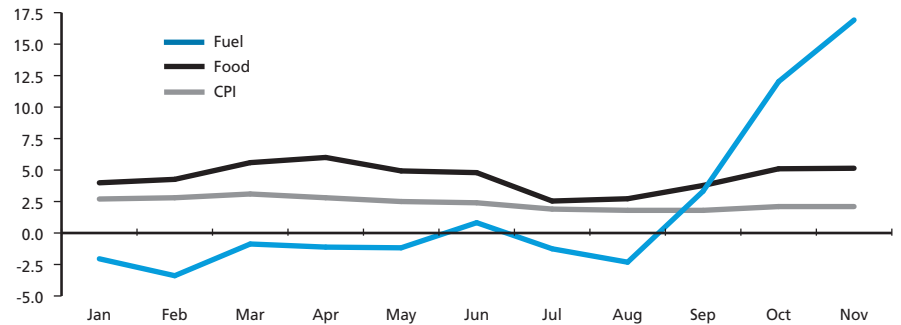
Although inflation, as measured by the consumer price index (CPI), is currently close to the policymakers' target level of 2%, there are signs of growing inflationary pressure in some sectors. The recent rise in the oil price, to almost \$100 per barrel, is pushing fuel costs higher, affecting both energy and transport costs across the whole economy. Any rise in distribution costs can quickly feed through into higher retail prices, with a direct impact on consumers. In addition, we have also been witnessing a steady rise in food prices, due to flooding, poor harvests and high levels of global demand. Food and fuel prices are now rising at a much faster rate than the headline rate of inflation suggests, and this can have a dampening effect on consumer spending, as households

Summary and Outlook

The UK economy has been strong in recent years, but several headwinds are now building and the question is whether the economy is going to be strong enough to escape unscathed. On balance, we expect that the credit squeeze, the current downturn in the housing market and record levels of consumer debt, will result in weaker levels of consumer confidence and spending, pulling the headline rate of economic growth down from its current elevated level of over 3% to a much slower rate of growth of just 1.0-1.5%.

Inflation - Food and Energy

Source: EcoWin



buy these basic goods but are left with less money to spend on more discretionary items. The biggest risk with regard to inflation is that the headline rate will start to rise sharply, impeding the ability of policy makers to

cut interest rates quickly as economic activity slows. This could result in a downturn which is deeper and more protracted.

The actual extent of the slowdown will be determined by the labour market. If employment remains relatively strong then the slowdown might be contained, particularly if the monetary authorities are able to reduce interest rates speedily. However, if unemployment starts to increase rapidly then the slowdown could become much more pronounced, and the downturn in the housing market could also turn into a much deeper and more protracted event. The outlook for inflation is also critical, as inflationary pressures could prevent the monetary authorities from cutting interest rates as

quickly and decisively as is needed. However, we view inflation as more of a short term threat and expect cooling demand to help to reduce inflationary pressures, and a more subdued labour market to help to eliminate any threat of serious wage inflation. Against this background, of weaker growth and dampened inflationary pressure, we expect the Bank of England to deliver interest rate cuts of 1.0% over the coming year, taking the base rate to 4.5%. These interest rate cuts will help to contain the extent of the slowdown in the economy.