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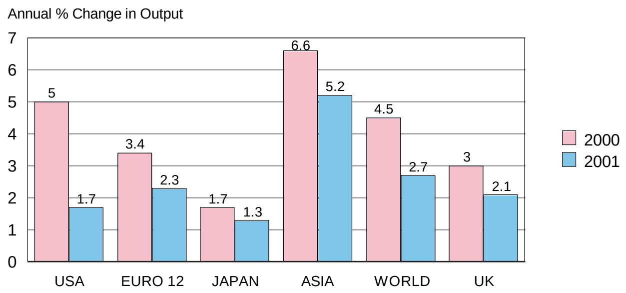
Weekly Economics Briefing

Volume 3 Issue 14

2 June 2001

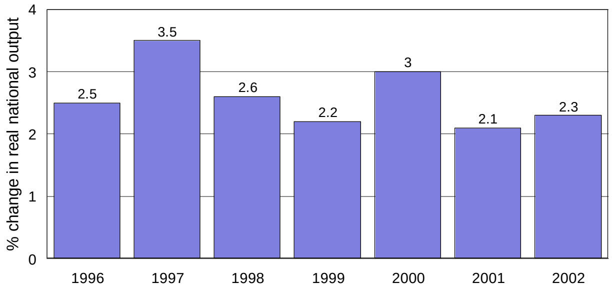
UK Economic Slowdown Held in Check

GLOBAL ECONOMY IN SLOWDOWN MODE



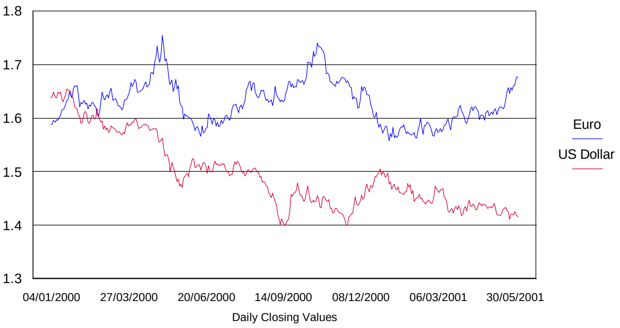
2001 forecast from Barclays Bank

BUT THE UK GROWTH STORY IS SET TO CONTINUE

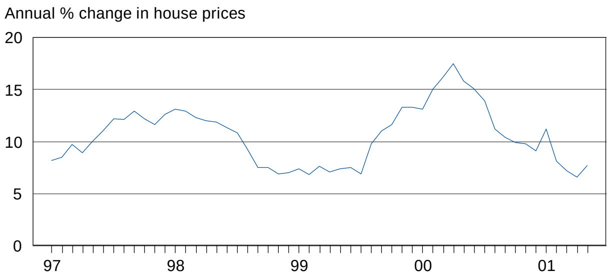


Source: Barclays Bank

STERLING AGAINST THE EURO AND US DOLLAR



SIGNS OF ANOTHER PICK-UP IN HOUSING INFLATION



Source: Nationwide Building Society

Data released last week confirmed that output in the UK economy grew by 0.4% in the first quarter of 2001. The UK remains on course to achieve growth of 2% this year even though this growth continues to show widespread sectoral imbalances. The service sector will once again provide the dominant source of growth in output and employment. In contrast manufacturing, construction and agriculture are facing stagnant output growth or worse.

Three factors highlight the extent of the deceleration in domestic output growth during the course of 2001. Firstly, household spending grew by 3.8% last year but this is likely to dip below 3% I 2001.

Export growth has also come down from the superb 8.4% year on year increase in overseas sales last year. UK export volumes are forecast to grow by less than 6% this year. Fixed investment spending is also somewhat sluggish and might be hit further by the sharp fall in business confidence picked up in recent business surveys.

Three trends are working in the opposite direction providing ballast for the domestic economy in the slowdown phase.

Fiscal policy is set to provide a stimulus to aggregate demand via substantial real terms increases in general government spending.

Recent cuts in nominal interest rates are feeding through into the effective disposable incomes of mortgage payers. There are signs of a renewed pick up in housing market activity—the Nationwide Building Society reported a 0.8% rise in house prices in May for the second month in succession, and nationally house prices are in line to rise by 7% during the year.

RPIX inflation remains below target—allowing the MPC scope for more rate cuts. Interest rates currently stand at 5.25%. Once the General Election is out of the way, the MPC is likely to agree to at least one more small cut to 5.0% before the summer is out. Rates may well start to head upwards in the early autumn if the economy starts to pick up momentum.

Sterling has recently fallen to a six month low against the US dollar—an important trend for UK exporters facing the prospect of a cut back in demand from the world's largest economy.

Providing that inflationary pressures remain muted, the UK is well placed to weather the cold winds of an international economic slowdown.

Regional Economic Growth

Trail Blazers and Black Holes

The long term economic prospects for the regions of the United Kingdom economy hinge crucially on the potential for creating clusters of new jobs in expanding industries. No region has a monopoly on growth potential—but the employment mix that evolves over time in a particular region can have a large bearing on regional economic growth, employment opportunities and living standards.

Oxford Economic Forecasting (OEF) has recently released a study on UK main regions—focusing on the current patterns of employment in high and low growth industries. Each of the twelve standard regions was assessed by the number of people employed in each of ten employment categories (see the table at the bottom of this page).

Trail-blazing industries are those with the greatest long-run growth potential and those likely to create the highest number of jobs offering above average incomes and earnings.

Solid and Steady sectors are those where growth is likely to be close to the average growth of national income. At the bottom end of the scale, Sinking, Meltdown and Black Hole sectors require little by way of elaboration!. The overall distribution of current employment across these sectors is used to calculate a Regional growth Index (where the UK average has a base value of 100).

Regional Gaps

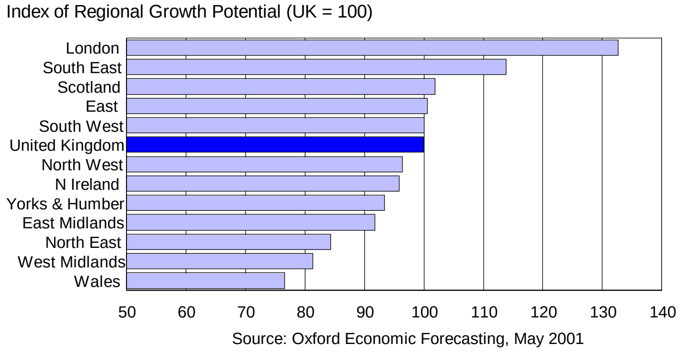
The OEF analysis finds that Wales, the West Midlands and the North East have a shortage of jobs in the fast-growth sectors. Less than 2% of jobs in the North East are identified in the Trail Blazing sectors contrasted with 5.3% in London, 6.5% in the South East and 3.7% for the National economy. In Wales only 6.3% of jobs are counted in the top two categories compared with 16.1% for London. In the principality, 22% of jobs are classified as belonging to sectors in permanent decline or in serious risk of slump.

The sectors where the UK has lost its comparative advantage to other countries (textiles, coal, steel manufacturing, shipbuilding etc) are included in the bottom categories. Regions experiencing below par economic growth, relatively low incomes and living standards must find ways to rejuvenate their economies and become more attractive to inward investment. The tasks facing the newly established Regional Development Agencies are formidable.

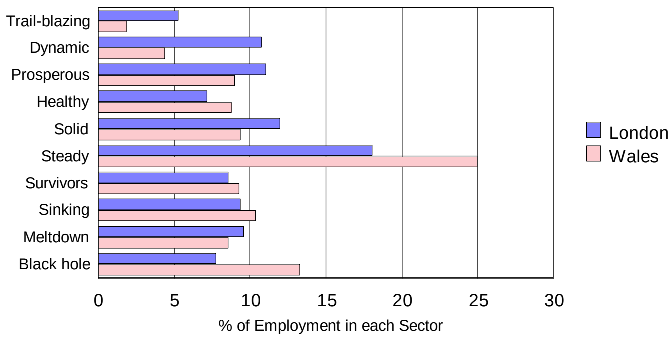
Town Crier

Of the towns that come out top from the assessment of over 400 , West Drayton has by far the largest proportion of people working in the fastest growth - businesses, closely followed by Hounslow and Hook. Those that score lowest include Swansea, Wescliffe-on-Sea and Ashton-Under-Lyme.

OEF REGIONAL GROWTH INDEX



DISTRIBUTION OF EMPLOYMENT



EMPLOYMENT GROWTH POTENTIAL

% of employees	UK	South East	North East
Trail-blazing	3.7	6.5	1.9
Dynamic	5.9	6.0	5.1
Prosperous	9.9	10.1	8.4
Healthy	9.1	9.4	8.2
Solid	10.8	10.7	9.8
Steady	19.6	10.6	20.6
Survivors	9.4	9.6	10.6
Sinking	10.9	7.9	13.9
Meltdown	8.3	8.6	8.6
Black hold	12.3	10.7	11.6
Growth Index	100.0	113.9	81.4

Source: Oxford Economics Forecasting

Economics of the Motor Industry

CAR INSURANCE PREMIUMS SET TO RISE BY 25%

The latest research from Datamonitor finds that average car insurance premiums in the United Kingdom will increase by between 10 per cent and 25 per cent during 2001. The hikes in insurance charges represent an attempt by the major car insurance suppliers to return to profitability - but some motorists are at greater risk than others. On average, premiums are likely to rise by over £100 per person.

In the late 1990s, premiums were falling because the market was becoming more competitive. The entry of non-traditional insurance providers (including one-stop seller such as Direct Line and, more recently, the entry of supermarkets into the industry) made the market more contestable and forced prices lower . This was good news for motorists who had much greater choice and lower premiums - but bad news for the long run profitability of the motor insurance industry,

Blame and Claim

The average cost of a claim in the UK motor insurance market has increased from £1,082 in 1993 to £1,580 in 1999. Partly this is the consequence of the "blame then claim, no win, no fee" culture being encouraged by businesses such as Accident Direct. Whilst the average premium rate was decreasing by 15 per cent between 1994-7, the average claim increased by around 20 per cent. This divergence between insurance premiums and claims has led to increasing losses in the motor insurance sector.

Higher premiums will be faced by those motorists deemed to be high risk customers. The insurance industry works largely on the basis on risk pooling. It is up to the insurance industry to make accurate assessments of the likely scale and cost of claims made by car users. Those drivers deemed to be higher risk must carry the burden of higher premiums.

The risk assessment includes factors such as (a) age and experience of the motorist (b) previous claim history (c) type of car / vehicle insured (d) location and (e) the type of insurance policy that the motorist wants (I.e. third party only or fully comprehensive)

Price elasticity of demand for insurance

How will the demand for premiums change as their costs rise? The market demand for car insurance as a broadly defined service is highly inelastic. Insurance is a legal requirement - motorists have little or no choice. But because the market is now much more contestable, motorists can make big savings in time and money by shopping around - not least by going online.

The paradox is that higher income motorists are more likely to have access to the internet and thus a greater opportunity to avoid some of the sharp rise in insurance premium charges.

WHO IS MILKING THE MOTOR CAR?

The inexorable growth of the car economy raises important questions about the true contribution of the motor car industry to the economy. There are clearly significant private costs and benefits arising from car ownership and use—and more research is now being put into valuing the positive and negative externalities from the private ownership of cars in the UK.

How much does each motor car produced and sold contribute to the economy during an average lifetime? A new study from the Society of Motor Manufacturers and Traders has tried to estimate how much money can be generated from a privately owned car during its life and who the main beneficiaries are.

Using simple assumptions and calculations based on mileage, tax, finance and insurance costs, the SMMT study finds that over an eight year working life, a new car costing £9.400 (including VAT) would generate over £50,000 in income—over five times the original showroom price.

Basic assumptions:

The study assumes that the new car (a mid-range saloon) is sold for £8,000 + VAT at the start of 1992. Over the next eight years, the annual mileage is taken to be 12,000 with a fuel consumption rate of 33 mpg. After two years, the car is part-exchanged and then sold onto a new owner for £5,500. The car is assumed to have six owners through to the end of its life at the end of December 2000.

Income Streams from the Car Industry

Several sectors of the economy stand to gain from the sale and use of the car over the eight year period. These include the car manufacturers, income for used car dealers, tax revenues for the government, bills paid to the maintenance and repair sector, breakdown and recovery services, spending on car finance and insurance, parking charges and warranties.

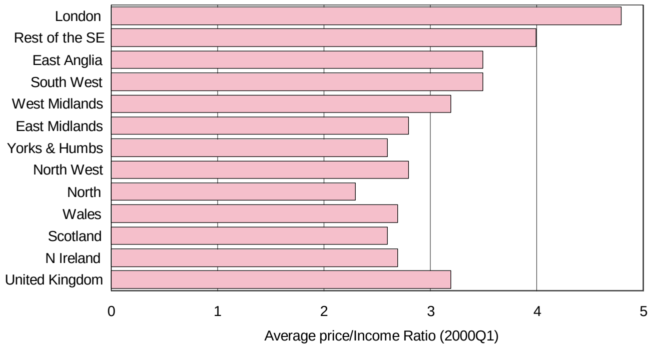
The study finds that in total, £13,900 is paid in used car sales, £11,712 is paid in taxes, over £4,000 in maintenance and repairs and over £8,000 in finance and insurance costs. Over eight years, parking fees add nearly £1,200 to the total income streams.

INCOME GENERATED BY CATEGORY 1992-2000

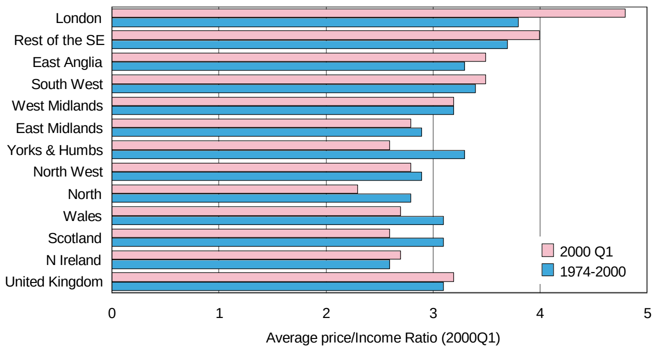
	Total
New Car Sale	8,000
Used Car Sales	13,900
Taxation	11,712
Maintenance	4,117
Finance and Insurance	8,333
Parking	1,198

Regional House Prices

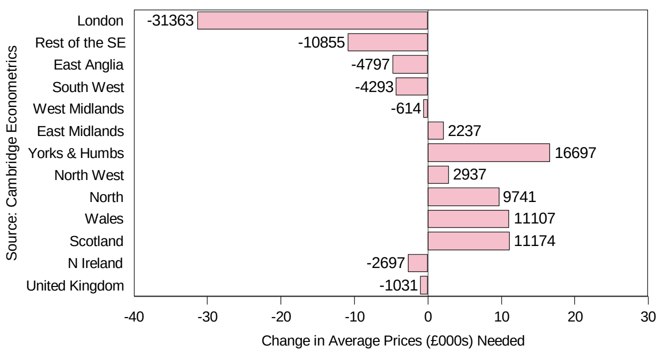
REGIONAL PRICE-INCOME RATIOS



REGIONAL PRICE-INCOME RATIOS IN LONG RUN



PRICE ADJUSTMENTS REQUIRED



A SLUMP IN LONDON HOUSE PRICES?

A new report from Cambridge Econometrics raises serious questions about the sustainability of the recent house price boom in London and the South East. This has important implications for the regional and UK economy. If there is a sharp downwards correction in house prices in the next few years, this will have a significant impact on household wealth, consumer confidence and spending on goods and services.

Consider the top chart which shows the ratio of average house prices to average incomes in each of the main UK regions in the first quarter of 2001. The UK housing market as a whole seems close to an equilibrium level. House prices are just a touch above 3 times average incomes—close to the long run rate (see the middle of the three charts) . And with mortgage interest rates at historically low levels, this poses few major problems of housing affordability for people meeting their monthly mortgage repayment commitments.

But in London, the ratio of prices to incomes is close to 5 with the rest of the South East not that far behind. Remember that these figures are averages for the entire region. In some parts of the south east, rampant housing inflation has left prices well above a long term sustainable rate. Housing affordability for first time buyers in particular is a major problem and policy issue.

The middle chart shows that the current price/income ratio for these two areas is well above the long-term average covering the period 1974-2000. A similar state of affairs exists in East Anglia and the South West although not to the same extent.

At some point house prices will adjust back towards equilibrium. Either this comes about through rising incomes or through a slower growth of house prices. In the early 1990s of course, the restoration of housing affordability came via a prolonged slump in nominal and real housing values.

The third chart on this page shows that Cambridge Econometrics estimate that average prices in London will have to fall in excess of £31K and in the rest of the SE a £11K price adjustment is required going forward.

Buyers beware! Purchasing property when the market has reached the peak growth period is a risky business. There is substantial scope for falls in house prices in some areas.

	Average Price 2000Q1	Average Income (£s) 2000Q1	Price / Incomes Ratio
London	147,983	30,560	4.8
Rest of the SE	120,871	29,970	4
East Anglia	86,797	25,028	3.5
South West	93,877	26,710	3.5
West Midlands	79,114	24,920	3.2
East Midlands	70,637	24,930	2.8
Yorks & Humbs	62,725	24,266	2.6
North West	67,903	24,543	2.8
North	54,720	23,323	2.3
Wales	63,432	23,762	2.7
Scotland	64,138	24,495	2.6
N Ireland	72,797	27,113	2.7
United Kingdom	83,976	26,505	3.2