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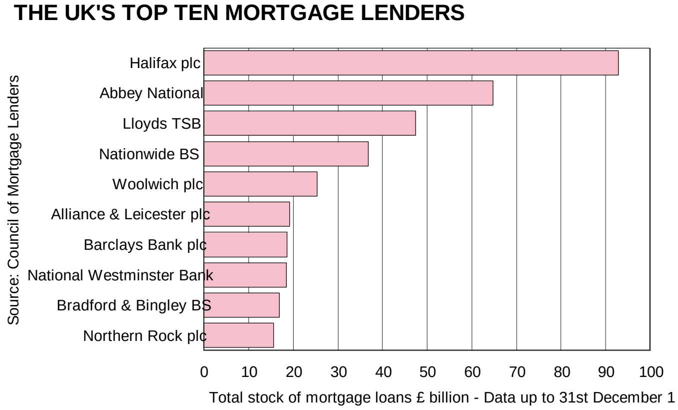
Weekly Economics Briefing

Volume 3 Issue 7

25 February 2001

Mortgage price war set to cut housing costs



The UK mortgage sector has become more competitive over recent years. The commercial banks entered the market for housing loans in the mid 1980s and more recently we have seen the entry of new mortgage lenders into the market such as Egg.

This increase in ***market contestability*** *is changing the behaviour of the existing market players. There has been a rapid expansion in the range of mortgages on offer to homebuyers and it is now easier and cheaper to switch mortgage providers. However the market is still dominated by the major players—Halifax and Abbey National*

MORTGAGE PRICE WAR IS LAUNCHED

The competitive battle for market share in the UK mortgage market gathered momentum this week with the outbreak of a price war between two of the biggest mortgage lenders. The price battle comes at a crucial time for the housing sector. The spring is the season when potential homebuyers are attracted into the market and lower mortgage costs should stimulate a renewed burst of activity in housing transactions and prices.

Halifax, the biggest mortgage provider with over 2.5 million customers, cut their standard mortgage rates in response to a decision by Nationwide, the country's largest building society (with nearly 3 million borrowers) to launch a new basic mortgage interest rate of 6.49%. Halifax announced pre-tax profits of £1.8 billion pounds for the last year (a rise of 8% on the previous year). 89% of its revenue comes from interest on mortgages and other loans. Halifax is launching a new standard rate mortgage fixed at 1% above base interest rates—available to all customers. But existing customers will have to apply for the new deal—they will now be automatically switched to this new mortgage product.

ECONOMY AT A GLANCE - UK BALANCE OF PAYMENTS

		1998	1999	2000	2001 Forecast
Balance of Trade in Goods	**£ billion**	**-20.5**	**-26.2**	**-28.2**	**-32.0**
Balance of Trade in Services	**£ billion**	**12.6**	**11.3**	**10.2**	**11.0**
Net Investment Income + Transfers	**£ billion**	**7.9**	**5.0**	**4.6**	**7.7**
Current Account	**£ billion**	**-0.1**	**-9.9**	**-13.4**	**-13.3**
Current Account	**% of GDP**	**0.0**	**-1.1**	**-1.4**	**-1.3**

Source: UK Balance of Payments Statistics and forecast from RBS Economics

Business and Industry Focus—Eurotunnel on track for profit

Is there light at the end of the tunnel for the Anglo French company charged with the responsibility of operating Channel Tunnel passenger and freight services?

Eurotunnel which operates the Channel tunnel between France and Britain saw a fall in operating losses last years as the company took achieved increases in freight traffic and revenue from car shuttle services. The company claims it is making significant progress in developing customer loyalty, reducing operating costs and smoothing the transition from profits from retail businesses to securing profits from operating its core services through the Tunnel.

Losses in 2000
Eurotunnel lost £124m in 2000 compared with an overall profit of £202m in 1999. But the figure for 1999 was distorted by a restructuring of the firm's debt levels.

No hangover from loss of duty free?
The company is boosting its freight business to compensate for lost revenue from retail sales after the European Commission ended duty-free shopping within the European Union in July 1999. The company is also developing the use of the Channel Tunnel as a route for telecommunications cables. Eurotunnel owns 12 freight trains and plans to add to its capital stock by adding another four trains by the end of 2003.

A Switch to Realistic Fares?
Eurotunnel has about 48 percent of the market for transporting freight across the English Channel and controls more than half of the market for passenger cars. Fares for car users have increased sharply partly in response to the loss of income from duty free sales. Over the course of 2000, shuttle-service revenues grew by 19% and operating costs fell by 13% through improvements in labour productivity.

Eurotunnel has had to switch the focus of its activities following the end of duty free sales. It has seen a sharp rise in freight traffic but a 15% drop in car passenger traffic. Partly this is an elastic response to the rise in customer fares announced in 1999.

During 2000 Eurotunnel ran 55,000 freight "missions" compared to 43,000 in 1999. It's share of the freight market has grown by 9% since 1999 - the result of an expansion in rolling stock and productive capacity.

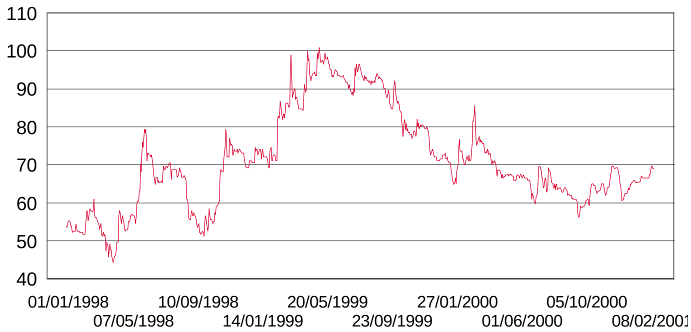
The number of rail passengers jumped from 6,593,000 in 1999 to 7,130,000 last year, an increase of 8%.

Covering capital
For the first time this year the operating revenue from tunnel users exceeded Eurotunnel's annual debt interest charges. The company has set a target of covering all interest charges and capital expenditure programmes from operating cash flow by the end of next year.

EUROTUNNEL BACK ON TRACK?

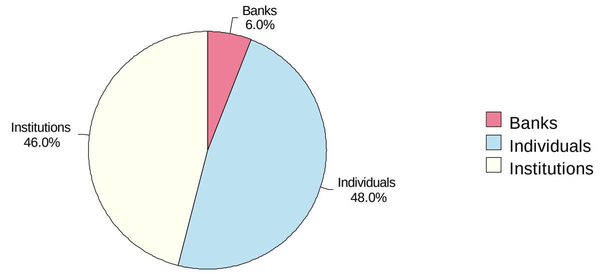
	1999	2000
Turnover	654,384	599,584
Operating Costs	-444,719	-391,770
Operating Profit	209,665	207,814
Interest Charges	361,952	341,624
Profit (- = Loss)	202,059	-123,951

EUROTUNNEL SHARE PRICE SINCE 1998



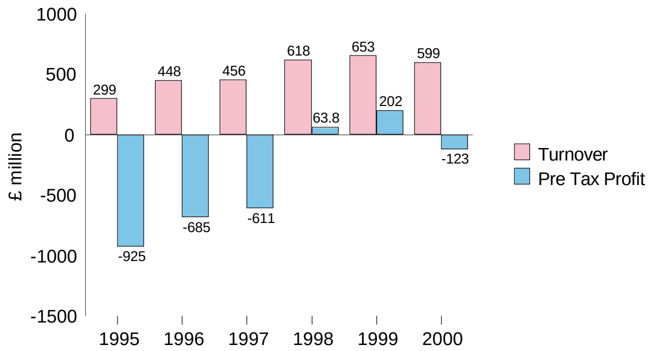
Daily closing price

EUROTUNNEL SHARE CAPITAL



Breakdown of share capital at year end 2000

EUROTUNNEL TURNOVER AND PROFIT(LOSS)



Some of Britain's leading industrial organisations are claiming that the new Climate Change Levy will cost jobs

THE CLIMATE CHANGE LEVY - JOB LOSSES?

The introduction of the £1 billion Climate Change Levy in April 2001 will harm the competitiveness of UK manufacturing industry and threaten thousands of jobs according to a new study funded by the Engineering Employers' Federation. The EEF claim that the new tax will hit smaller businesses and reduce their ability to make much needed capital investment in energy efficiency. The also criticise the agreements between some of the UK's major industrial users of energy who have managed to negotiate energy efficiency agreements with the government that allows them to offset nearly 80% of their Climate Change Levy liability.

The EEF estimate that some 2300 enterprises, employing more than 1.3 million people, will be excluded from such agreements and that these businesses will face new net costs of almost £100 million, even after a reduction in employer's National Insurance contributions linked to the levy. Some companies who have invested heavily in improving energy efficiency levels in recent years will still be liable to the full amount of the tax. For some smaller businesses, the charge is likely to be £100,000 - a significant extra cost and one which is likely to cut profit margins and cost some jobs.

Background to the Tax

As part of the Kyoto Protocol, the British government has set a target of a 12.5% cut in greenhouse gas emissions by 2012 and a 20% reduction in carbon dioxide emissions The Climate Change Levy is designed to change the behaviour of firms that are heavy users of energy. In particular it is hoped that the Energy Tax will encourage a shift towards alternative sources of renewable energy such as wind and solar power.

This green tax is designed to be revenue neutral - in other words it will not lead to a net increase in tax revenue to the Treasury. To achieve this the government is making offsetting cuts to employers' national insurance contributions. The other guiding principle is that the tax should not have a negative effect on the competitiveness of British businesses - although the recent reports from the EEF run counter to this argument.

The Climate Change Levy does not apply to fuels used by the domestic or transport sector, or fuels used for the production of other forms of energy (e.g. electricity generation) or for non-energy purposes. Exemptions also extend to electricity used from new renewable sources.

The government identified ten sectors of the economy as energy-intensive users - (aluminium, cement, ceramics, chemicals, food & drink, foundries, glass, non-ferrous metals, paper, and steel). The Department of Transport, Environment and the Regions has been in negotiations with these industries and those sectors that agree tough new energy or carbon saving targets which meet the Government's criteria can claim an 80% discount from the levy.

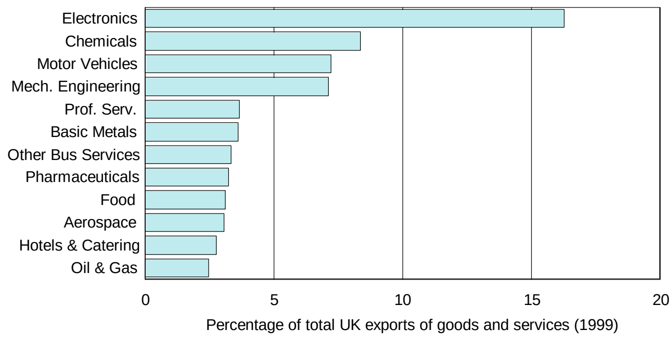
THE ENERGY TAX

WINNERS AND LOSERS FROM THE ENERGY TAX IN 2002

WINNERS	Jobs Effect (000s)	Output Effect (% change)	CCL—NIC* (£ million)
Coal	0	0	-4.34
Tobacco	0	0.07	-0.4
Oil & Gas	0	0	-5.19
Clothing	0.23	0.02	-1.1
Pharmaceut	0.04	0.01	4.34
LOSERS	**Jobs Effect (000s)**	**Output Effect (% change)**	**CCL—NIC* (£ million)**
Food	0.39	0	46.65
Chemicals	0.23	0	60.55
Agriculture	0.55	-0.03	50.64
Electricity	0	-1.75	-7.3
Rubber & Plastics	0.39	-0.06	33.89
OVERALL IMPACT	**14.4**	**-0.07**	**0.14**

CCL—NIC is payment of climate change levy minus the rebate to firms from lower National Insurance Contributions

LEADING UK EXPORT SECTORS



Cambridge Econometrics Report (1999)

"The Climate Change Levy is an important component in the Government's strategy to reduce emissions and pollution in a manner that is fair and that does not seriously damage overall competitiveness.

The most energy-intensive sectors are to be helped by lower rates of tax, and many businesses will benefit from the use of cleaner, energy-saving technologies that will be encouraged by the Levy. In addition, the figures suggest that the economy as a whole would benefit."

Mortgage Price War (cont)

HALIFAX SHARE PRICE SINCE 2000

A vigorous price war will boost the effective disposable income of millions of homeowners and add to total consumer demand. For a £60,000 interest-only mortgage, a 1% cut in mortgage interest rates means average savings of approximately £34 per month. People with home loans worth £100,000 will save £56 per month on their mortgage costs.

Around half of all homeowners are on standard variable rate mortgages. There has been an increased in fixed rate lending and other special mortgage offers in recent years. But the battle-ground for mortgage market share is now focusing on households with variable rate loans where the monthly interest costs vary with the general level of interest rates.

ITCHY FEET

The **churn rate** (i.e. the percentage of mortgage customers switching their mortgage to another lender) is rising. Recent figures from the Council of Mortgage Lenders show that nearly one third of new home loans is the result of a straightforward switch from one mortgage provider to another. This forces banks and building societies to compete more aggressively not only for new customers but also to retain their existing borrowers.

With nominal interest rates at very low levels, there have been claims that the major mortgage lenders have been over-

Will the fall in mortgage rates help to stimulate another expansionary phase in the housing market?

charging homeowners. The rates charged by lenders remain well above base interest rates (currently 5.75% but forecast to fall further this spring) and also the rates of interest on offer to savers.

In oligopolistic markets a decision by one firm to change prices does not always lead to similar price changes by other firms. The two leading mortgage lenders have made their first moves, but other building societies and banks may wait to let the dust settle before following suit or holding their standard mortgage rates at current levels.

Mortgage rates should be falling during the spring if the Bank of England feels that lower rates are justified by the continued low rates of consumer price inflation.

STOCK MARKET REACTION

Will investors pay the price for the move towards cheaper borrowing? The reaction on the stock market to the outbreak of the price way has been mixed. Lloyds TSB, Abbey National and the Halifax have all announced good profits performances in recent weeks but the short term response of equity traders has been to price down the stocks of the UK's leading domestic mortgage providers. Following concerns that lower mortgage rates will cut profit margins in the sector as a whole.

HALIFAX HOUSE PRICE INFLATION

WEB SITES ON THE HOUSING MARKET

Council of Mortgage Lenders
www.cml.org.uk

Halifax House Price Index
www.halifax.co.uk/default.asp?PageId=554

Nationwide House Price Index
www.nationwide.co.uk/hpi/

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NEXT WEEK—BRIEFING ON TRANSPORT

TRAFFIC TRENDS IN THE UK

THE ECONOMIC CASE FOR ROAD PRICING

EXTERNALITIES FROM ROAD HAULAGE

Weekly Briefing
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