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The UK's splendid isolation

The big-spending British ignore global downturn

Sobering-up of world economy in 2001 after intoxication of early 2000

Across the industrial world the first half of 2000 was a period of financial intoxication. The worst excesses of the binge were the dotcom flotations in February and March, and the third-generation mobile phone license auctions in the early summer. Little more than a year later the hangover has been nasty. Millions of retail investors have suffered from the collapse of high-tech stocks and particularly of the dotcoms, and the adverse wealth effect has hit consumption. Meanwhile big phone companies discover that they have been duped. Investment bankers in the spring of 2000 gave them fantastic valuations of their subsidiaries, which encouraged them to take on debt. By the autumn they found that the true market value of the businesses was - in many cases - less than half the figure estimated. The ensuing shortage of cash has forced them to cut capital spending, devastating equipment suppliers such as Marconi and Lucent.

Construction slump in Japan and Germany has long-run demographic origins

Even so the downturn in the world economy in early 2001 was surprisingly severe. The sobering-up of high-tech was, in fact, only part of the story. Also important have been plunging construction orders in the world's second and third largest economies, Japan and Germany. (See pp. 6 – 7 of the accompanying research paper.) The weakness of construction spending in these economies may be related to their adverse demographic outlook. As their populations may fall by 20% - 25% over the next 30 years, they will not require the same amount of living and working space in 2030 that they do now. In the Japanese case even zero interest rates have not been sufficient to offset the deflationary force of both the demographics and the crippled banking system. In Germany also lower interest rates are plainly needed, although the European Central Bank – with its wider perspective – is in no hurry to help.

But - at interest rates higher than in Japan and the Euro-zone - UK domestic demand is buoyant

The macro-economic problems in the Euro-zone and Japan help to explain the strength of the dollar and the pound. Fears that the over-valued pound would hurt manufacturing were undoubtedly critical in the Bank of England's decisions to cut interest rates three times so far this year. But one of the most striking features of the British economy at present is the indifference of the consumer and the home-buyer to gloomy newspaper headlines about the world economy. The volume of retail sales has continued to expand by 6% a year, the sort of figure usually associated with a boom. Mortgage credit has been advancing strongly, with the value of approvals in the three months to May over 37% up on the same three months in 2000 and an all-time record. Further, big rises in the number of journeys on the rail network and London Underground demand heavy infrastructure investment (see p. 11 below), at exactly the same time that the Government has committed itself to extra money for education and health. The thickness of *The Guardian* newspaper suggests that the public sector has embarked on a massive recruitment campaign when unemployment is at its lowest for over 25 years. How much longer can Britain's easy-spending consumers and politicians live in splendid isolation from the economic strains in their neighbours and trading partners?

Professor Tim Congdon 27th July 2001

Summary of paper on

'How are the UK's economic imbalances to be interpreted?'

Purpose of the paper

2001 has seen continued buoyancy in UK domestic demand, despite a troubled international background and weak export markets. The research paper tries to answer the question, "How are the resulting imbalances to be explained and interpreted?".

Main points

* **From the demographic viewpoint, the industrial world will in the next 30 years be split into three types of nation - those with heavily falling populations (Germany, Japan, Italy); those with mildly falling or broadly stable populations (France, the UK); and those with rising populations (the USA, Canada, Australia, Ireland).**

* **The nations with heavily falling populations will need less residential and work space 30 years from now, implying lower construction activity and weaker mortgage demand than in the past. (See pp. 6 - 7.)**

* **The level of real interest rates that keeps output growing along its trend path is also reduced, relative both to the past and to the nations with more favourable demography. (At present mortgage demand is weakening in the Euro-zone at interest rates of under 5%, whereas in the UK it is booming at interest rates of over 5%. See pp. 8 - 9.)**

* **These long-run demographic influences may be part of the explanation for the puzzling strength of the dollar and, to a lesser extent, the pound. The strength of these two currencies has enabled domestic demand to grow faster than output for several years, opening up a payments deficit which is largely covered by capital flows from the nations with adverse demographics.**

* **In the British case these trends are overlaid by a structural shift in the economy, with a boom in high-value-added, internationally-traded services offsetting stagnation in manufacturing.**

* **Many of these service industries are in London, required increased office-space capacity and improved transport infrastructure. (See pp. 10 -11.) Overall the UK labour market is tight, with upward pressures on pay and prices, despite the over-valued pound. (See p. 12.)**

This paper was written by Professor Tim Congdon, with help from Brendan Baker in the preparation of the charts.

How are the UK's economic imbalances to be interpreted?

UK economic up-grade leaves manufacturing behind

World economy surprisingly weak in 2001

2001 has been a strange year for the world and UK economies. For most of the leading industrial countries, the economic news has been disappointing and stock markets have continued to retreat. Demand and output have been much weaker than expected, while inflation has been rather high, although not disastrous. Against this international background the UK has been doing well. Domestic demand has been buoyant, and production and employment have been rising. Indeed, were it not for the misfortune of foot-and-mouth disease, UK output growth would probably still be running at an above-trend rate. Further falls in unemployment in recent months are particularly striking, as they contradict a great deal of gloom-and-doom talk in the newspapers.

Big gap between growth of domestic demand and output in the UK

However, several economists - including members of the Bank of England's Monetary Policy Committee - have begun to express concern about "imbalances" which have built up since the mid-1990s. The most salient such imbalance is the excess of the growth of domestic demand over the growth of output. In 1996, 1997, 1998, 1999 and 2000 domestic demand increased by 3.1%, 3.8%, 4.6%, 3.8% and 3.7% respectively, whereas GDP in the same years went up by 2.6%, 3.5%, 2.6%, 2.3% and 3.0% respectively. As noted by Professor Mervyn King, Deputy Governor of the Bank of England, a divergence between demand and output on this scale has not been recorded since the 1870s. Two by-products are a wide deficit on the current account of the balance of payments, and a contrast between fairly prosperous service industries (mostly in London and the South-East) and depressed manufacturing (mostly in the Midlands and the North). How much do these imbalances matter? And how are they to be interpreted?

Starting-point for a UK-focussed analysis is demographics of Europe and Japan,

The current research paper tries to answer these questions. The starting-point is perhaps unexpected, the demographic problems in several European countries and Japan. The chart on p. 6, which borrows from projections made by the World Bank, shows that - between 2000 and 2030 - the population of working age could fall by a quarter in Germany and a fifth in Italy. Somewhat smaller but still significant reductions are likely in other European countries, although the UK and France are only mildly affected by the adverse demographic trends. Similar falls may occur in total population, but projections become increasingly uncertain far into the future, because it is impossible accurately to predict birth rates. The chart on p. 7 gives the World Bank's estimates of Japan's total population and population of working age from the late 1990s to 2030, and again these are projected to decline heavily.

which imply reduced need for commercial real estate

These population forecasts are not particularly controversial, but some of their implications are startling. Assuming that the amount of commercial real estate per person is unchanged, and that actual employment behaves in the same way as the working-age population, an obvious consequence is that in Japan, Germany and Italy the required stock of commercial real estate will fall by 20% - 25% over the next 30 years. Since most offices, and a fair proportion of warehouses and factories,

and less construction activity

are built to last for 30 years or longer, it follows that little or no new construction is needed for an extended period. (There may be replacement demand and a certain amount of work related to change of use.) The same comment applies to residential property, although the drop in demand may be offset by an increase in families with two homes, a decline in the average number of persons per household and other social trends.

The macro-economic disruption entailed by the inevitable fall in construction activity might not be too troublesome if it occurred gradually. But in both Japan and Germany a smooth decline to a lower and more sustainable level of construction work was interrupted in the early 1990s by special events. Japan had a crazy asset price bubble in the late 1980s, and associated heavy investment in buildings and structures (much of it speculative) which peaked in 1990 and 1991; Germany achieved re-unification in 1990, leading - understandably - to a boom in construction in the early 1990s.

Marked slide in construction orders in Japan and Germany in 2001,

At any rate, since the early 1990s in Japan and the mid-1990s in Germany construction orders and activity have collapsed. For example, Japanese private-sector construction orders in 2000 were down by almost 48% from their 1990 peak. Unfortunately, the slump has continued in early 2001. In Japan private-sector construction orders in the opening months of this year were down by another 20% from the 2000 level. For Germany as a whole the fall was smaller, but in East Germany it was greater. Roughly speaking, construction orders in East Germany in the first quarter of 2001 were less than half the level five years earlier. (Again, see charts on p. 6 and p. 7.)

which indicates need for lower interest rates

Given the demographic background, it is probably unrealistic to expect any great relief from these trends for many years. As building activity in all its forms represents about half of all investment in most industrial economies, the construction recessions have undermined demand and been a key factor in a wider macro-economic malaise. The natural policy reaction is to reduce interest rates. But in the Japanese case interest rates at the short end are already zero, while Germany is part of the Euro-zone and has no autonomy in setting its own interest rate. Nevertheless, the German demographic problem is part of the reason that the demand for mortgage credit in the Euro-zone has been weakening despite the European Central Bank's refinancing rate being as low as 4 1/2%. (See p. 8.)

UK's demographic situation is quite different,

In other words, deep-seated demographic forces are playing an important role in keeping interest rates in the Euro-zone and Japan lower than has been normal in the past. How does this relate to the UK and its imbalances? The answer is that the UK is in a very different situation, demographically and in terms of its economic geography, from both its European neighbours and Japan. Without immigration the population of working age would be roughly stable until about 2010 - 2015, while net immigration has recently been running at the highest levels (say, 150,000 - 200,000 people a year) ever recorded. At interest rates still somewhat higher than in the Euro-zone,

while mortgage boom argues for higher interest rates

UK mortgage demand is booming. (See p. 9.) It follows that the interest rate required to keep domestic demand under some sort of restraint in the UK is higher than in the Euro-zone (and appreciably higher than in Japan). This tends to buttress the pound on the foreign exchanges and so to aggravate the widening of the UK's payments deficit. So demographic differences between the UK and other countries are partly responsible for its "imbalances".

London benefits from its image as "capital of the world",

Also relevant here may be big changes in the structure of the British economy. It has been clear for some years that the UK - and particularly London and its immediate vicinity - is a favoured location for international headquarters. In an age of "globalisation" many companies have therefore centralised headquarters operations in or near London, boosting the demand for support staff of all kinds (legal, accountancy, consultancy, design, information technology). This "headquarters boom" has been superimposed on the long-running boom in international financial services, which has benefited the City of London. The results have included exceptionally high levels of take-up of office space in central London (see p. 10), sharp increases in employment in various "business services" in the London area and a surge in the number of journeys on London Underground (see p. 11). In fact, the number of journeys on London Underground has almost doubled since the trough in the recession of the early 1980s. Evidently, considerable investment in infrastructure - which will add to the workload of an already busy construction industry - is needed.

with implications for employment, office space requirements and transport infrastructure

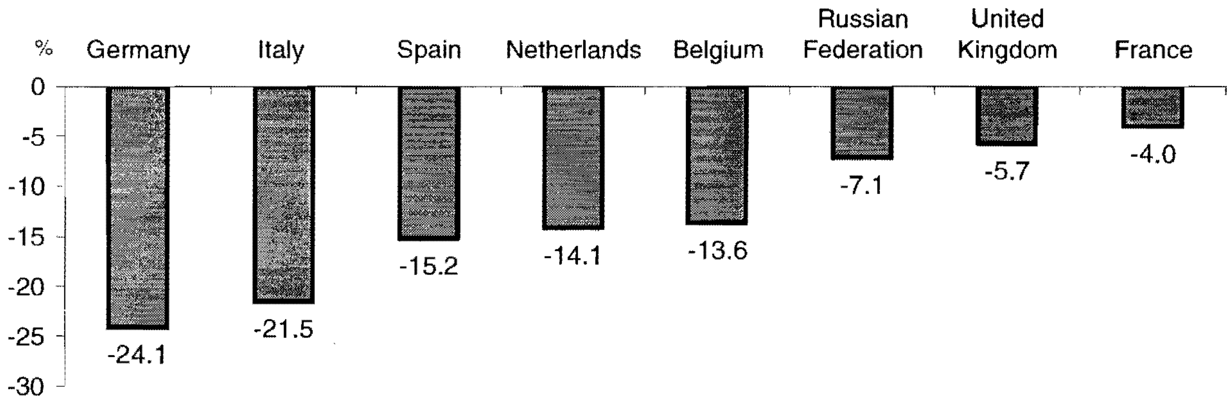
UK manufacturing is once more struggling with an over-valued pound and a weak world economy. But a case could be made that, to some extent, the imbalances between manufacturing and services, and between North and South, reflect a long-term structural shift in the UK economy. From a broader perspective, this structural shift is logical and benign, as the UK specialises on the high-value-added internationally-traded services which will keep it a fairly wealthy country in the 21st century. Germany and Japan - which will be grappling with the economic consequences of depopulation for the next two or three decades - are not an attractive model. But perhaps the UK has had too much of a good thing in the late 1990s. Quite severe labour shortages persist, and must raise concern about rising pay settlements in late 2001 and 2002. (See p. 12.)

UK's imbalances reflect changing economic structure, but may have gone too far

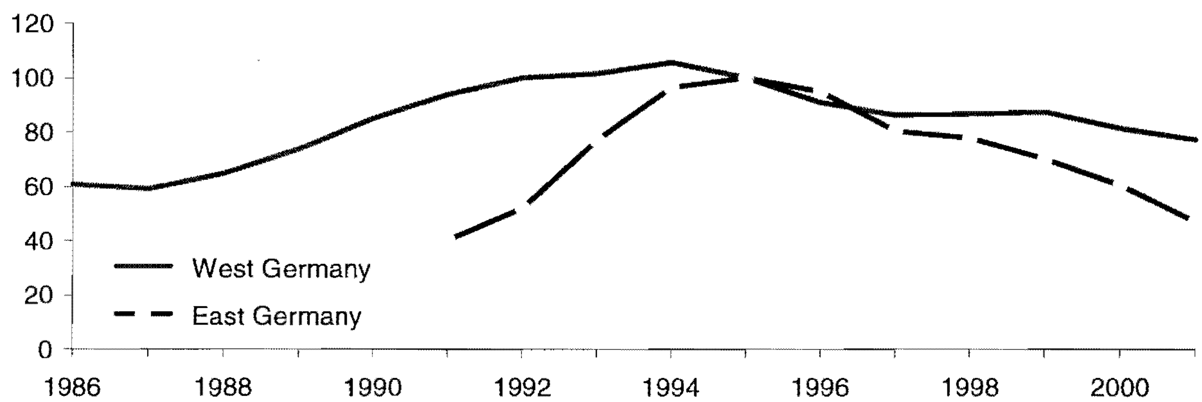
Europe's demographic problem

Falling population implies surplus real estate

1. Working age population falling in future. *Chart shows projected falls in population of working age, 2000-2030, %. Projection based on 1994 World Bank data.*



2. Construction orders in Germany. *Chart shows construction orders, using data in various issues of the Bundesbank* Monthly Report. *1995 = 100. Value for 2001 reflects change in Q1 compared with a year earlier.*

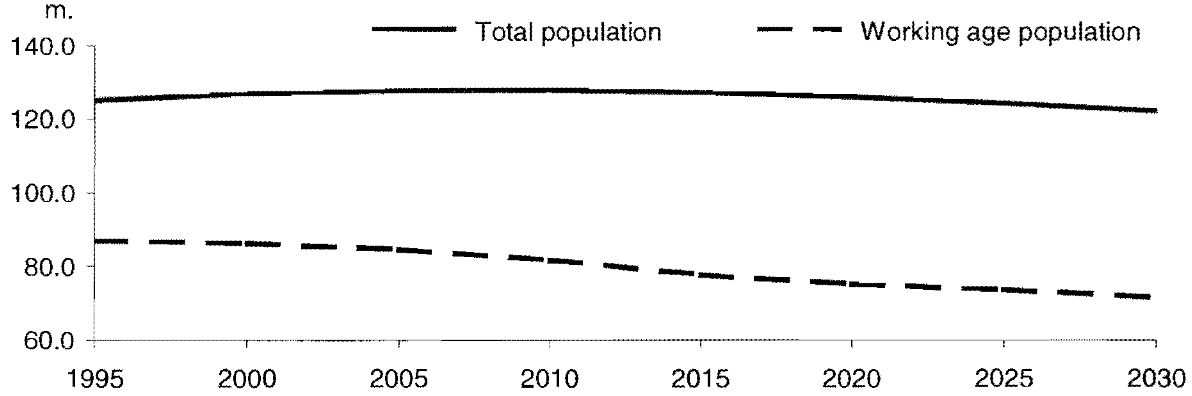


In most industrial economies construction activity represents about half of gross fixed capital formation, with the balance being investment in plant and equipment. Construction may therefore be quite small as a share of GDP (say, between 5% and 10%), but it is volatile and therefore of disproportionate importance to the business cycle. The falling population to be expected in Germany, Italy and other European countries over the next 30 years implies a reduced need for work space (i.e., office space, factory space and so on) and, hence, an even greater decline in construction spending. In Germany this was masked in the early 1990s by the re-unification boom, but the long-run demographic constraints are now very much at work. In East Germany the pattern has been marked, with construction orders more than doubling between 1991 and 1995 and more than halving between 1995 and 2001.

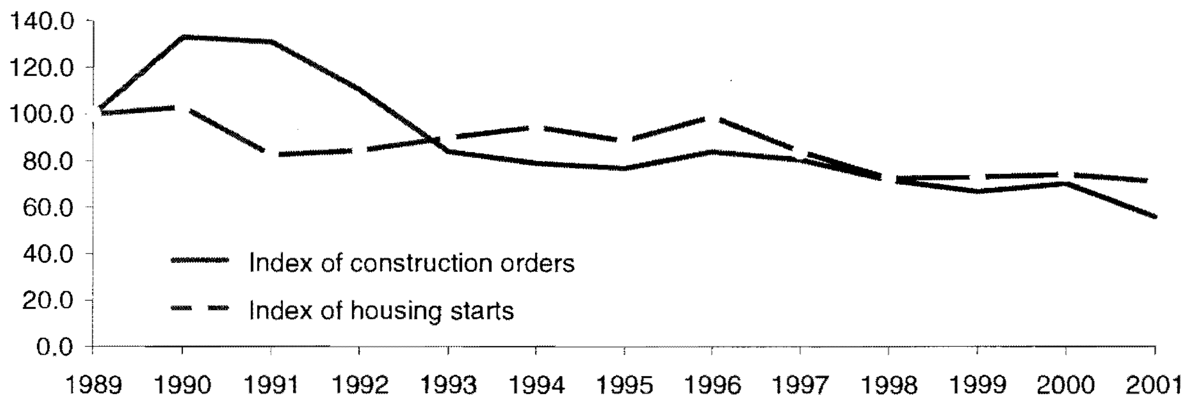
Japan's demographic problem

Construction orders weak for a decade

1. Working age population falling in future. *Chart shows both total population and population of working age projected by World Bank, using 1994 data.*



2. Construction orders and housing starts in Japan. *Chart shows private construction orders and housing starts, both indexed to 1989 = 100.*



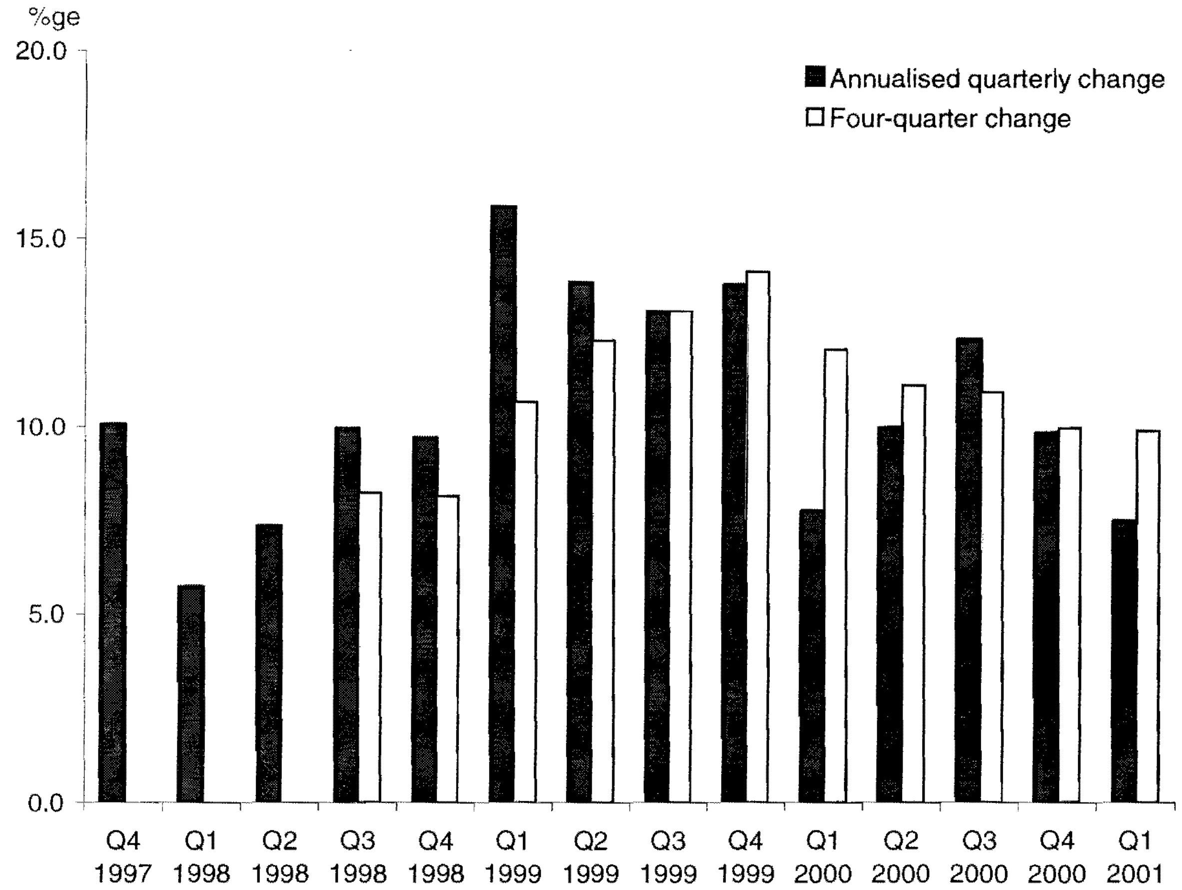
Sources: World Bank and Bank of Japan

In Japan the same sort of adverse demographic influences on the construction sector are at work as in Germany, but they have been aggravated by the fragility of the financial system. The bubble of the late 1980s spurred huge gains in the price of land and buildings, and a 30% leap in construction orders between 1990 and 1991. Since then land prices have fallen to less than a quarter of their 1990 level, undermining banks' loan collateral, profitability and capital. Private-sector construction orders in 2000 were only half of the 1991 figure. They weakened again in the opening months of 2001, partly because the private sector has been under pressure to repay bank loans. The Japanese public sector has offset the collapse in private-sector construction by increased spending on public works, but much of this has been inefficiently allocated and is now constrained by the burden of public sector debt.

Mortgage demand in the Euro-zone

Weakening, with interest rates beneath 5%

Chart shows percentage change, on both an annual and an annualised quarterly basis, in lending by "monetary financial institutions" (i.e., banks, mostly) to households for house purchase. Note that data are not seasonally adjusted.



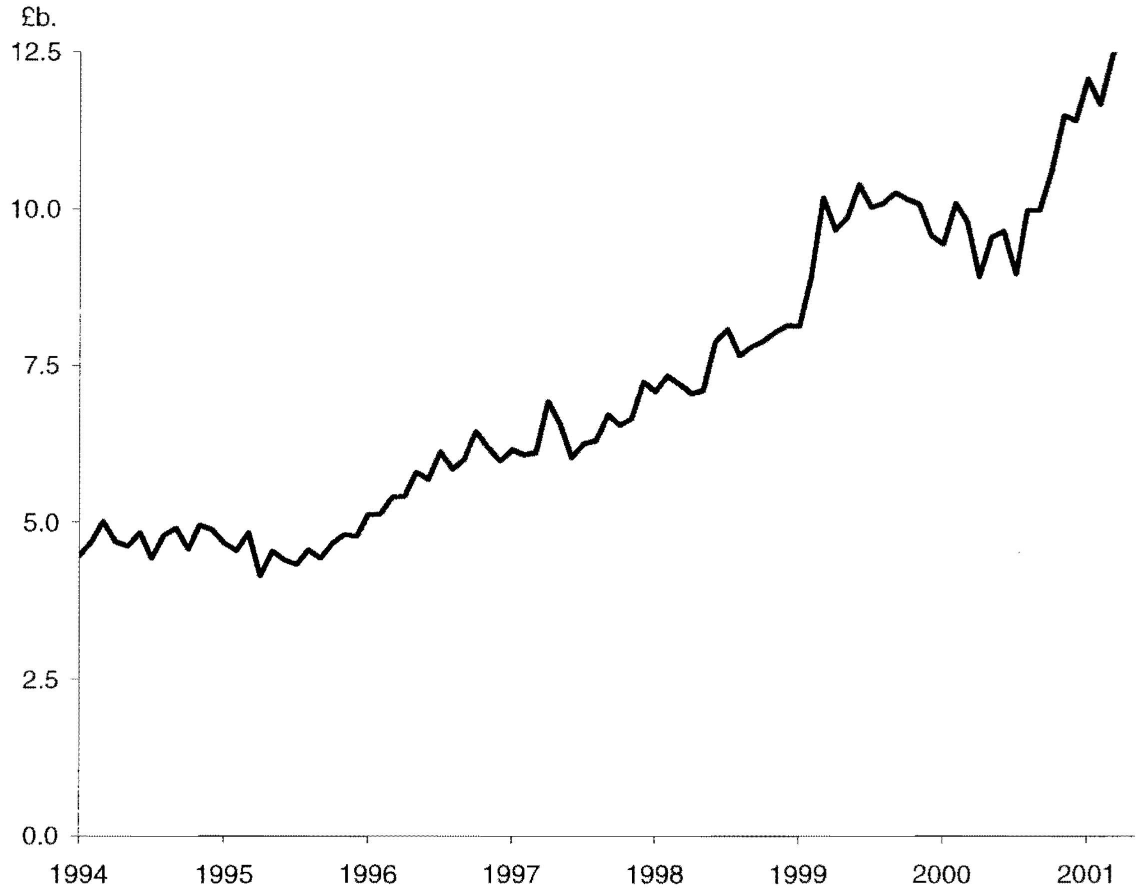
Source: European Central Bank

The UK is supposed to have a high level of mortgage debt by European standards and to be particularly sensitive to interest rate movements. In fact, mortgage debt extended by "monetary financial institutions" (i.e., banks) in the Euro-zone was above euro 1,900b. in the first quarter of 2001, compared with total MFI loans to the private sector of about 6,300b. With mortgages almost a third of bank's loans to the private sector, interest rates influence the strength of mortgage demand and the growth rate of bank assets. The drop in the ECB's refinancing rate to 2 1/2% in April 1999 stimulated a big mortgage boom, with the stock of mortgage debt rising by almost 15% in the year to Q4 1999. The refinancing rate moved up in a sequence of 1/4% steps from November 1999 to reach 4 3/4% in October 2000. A key message from the chart is that interest rates of under 5% are sufficient to curb mortgage growth.

Mortgage demand in the UK

Booming, with interest rates above 5%

Chart shows value of mortgage loans approved per month by all lenders. Gross of remortgages.



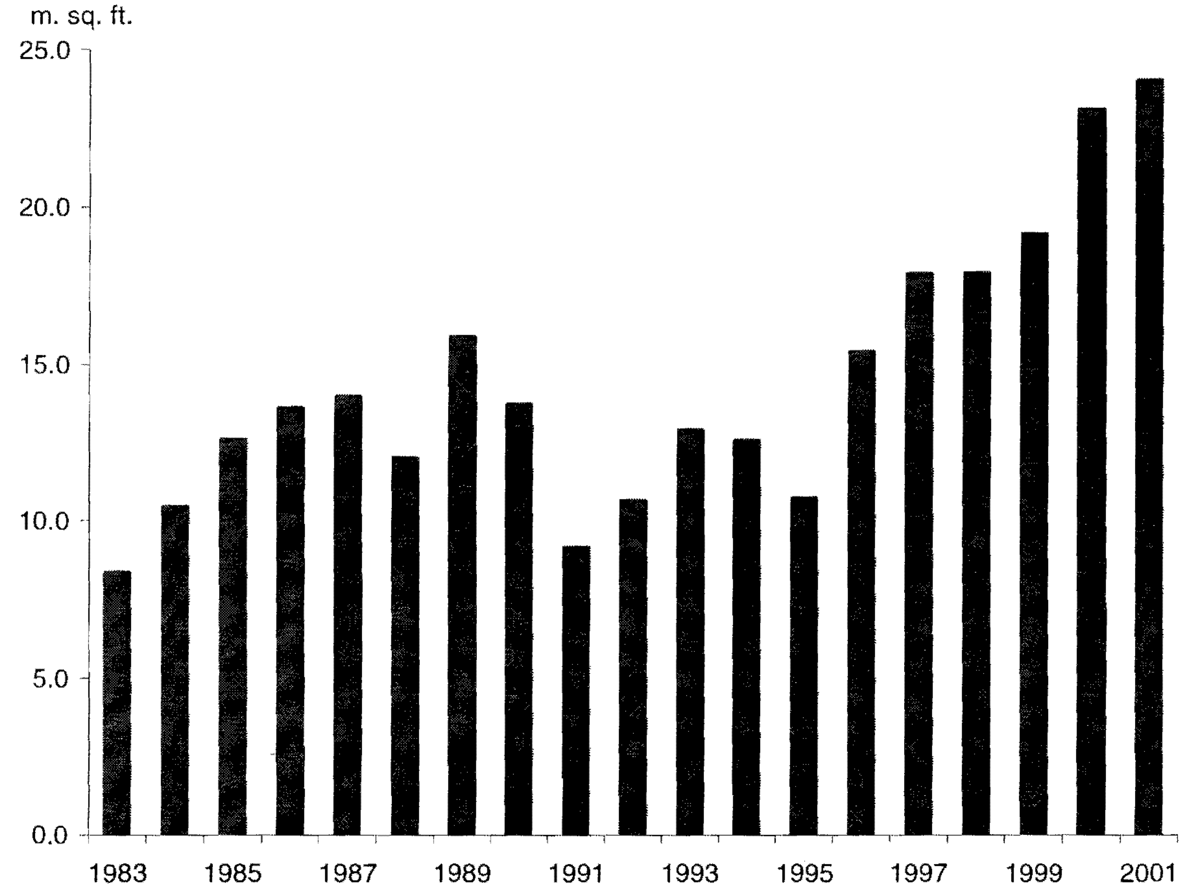
Source: Bank of England

The UK's demographic situation is different from that in Germany and Italy, with the population of working age rising slightly until just after 2010 and then declining gently. In fact, the expected pace of decline after 2010 is so small that it could be outweighed by immigration. Admittedly, the demographics for housing finance are less favourable than in the 1970s and 1980s, when the number of people of house-buying age was boosted by the "baby boomers" reaching their 20s and 30s. But interest rates today are much lower than in the 1980s, when clearing bank base rates averaged 12%. The main point of the chart is that - at interest rates of over 5% - mortgage demand is buoyant in the UK. Because of the importance of mortgage demand to the growth in bank balance sheets and broad money, this differentiates the interest-rate environment in the UK from that in Germany, Italy and other Euro-zone countries.

London's booming office-based industries

Late 1990s have bigger take-up than late 1980s

Chart shows take-up of office space in central London, according to DTZ Research. (Note that "take-up" is not to be confused with space absorption, because companies typically leave old space when they take up new space.) 2001 is first quarter times four.



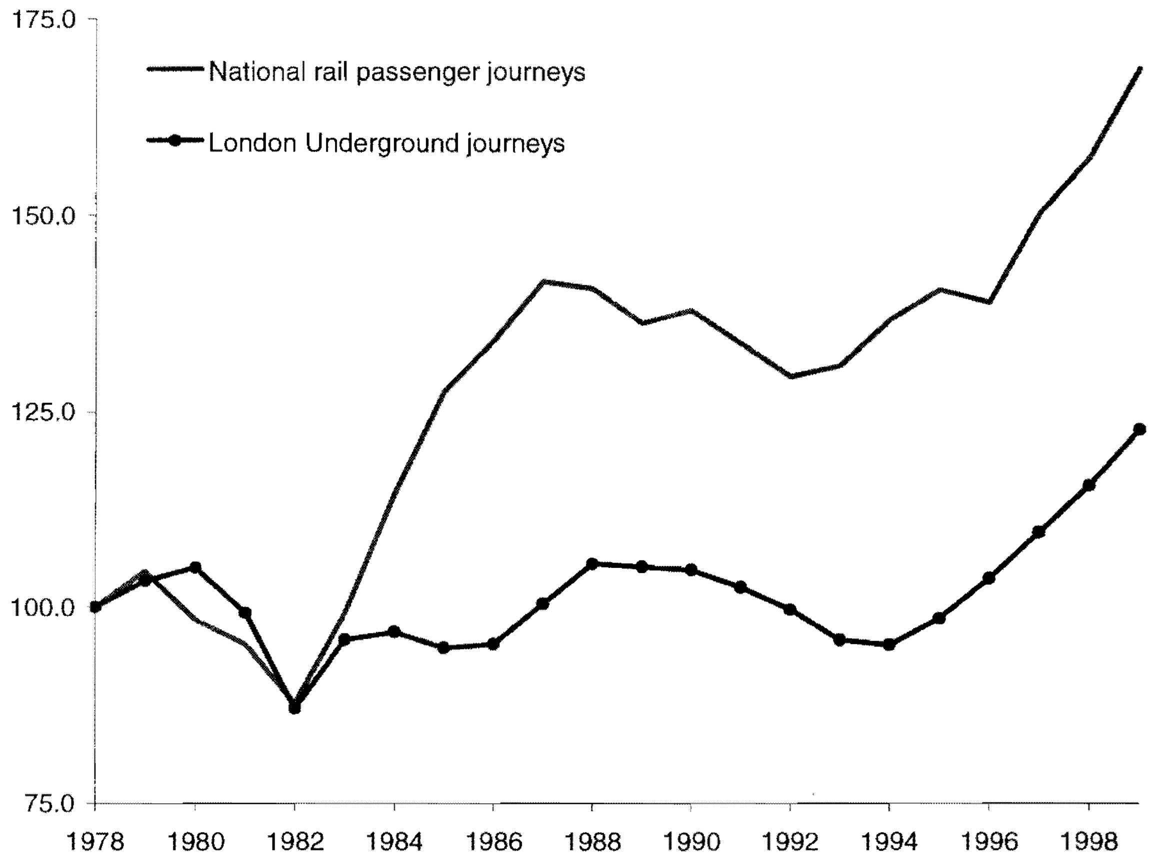
Source: DTZ Research

London's stock of office space has been rising relentlessly since the 1950s. A long-run boom in an assortment of complex, high-valued-added, internationally-traded service industries has been the key driver. Until the mid-1980s the expansion of the office stock was impeded by planning restrictions. Since the mid-1980s London Docklands has been opened up, while Labour-controlled London boroughs have changed their attitude to office development and became quite liberal in the granting of consents. The results have been a surge in office building, large increases in office-based employment and pressure on the transport infrastructure (see p. 11). Over-building in the late 1980s led to high vacancy rates in the early 1990s, but the take-up of space in 1999 and 2000 were successive all-time records. According to estimates prepared by DTZ Research, take-up in Q1 2001 ran at an even higher rate.

Surging demand for rail travel

Strong London economy responsible for congestion

Chart shows index of number of passenger journeys on the two main kinds of rail transport in the UK (i.e., national, mainly on Railtrack, and London Underground). 1978 = 100.



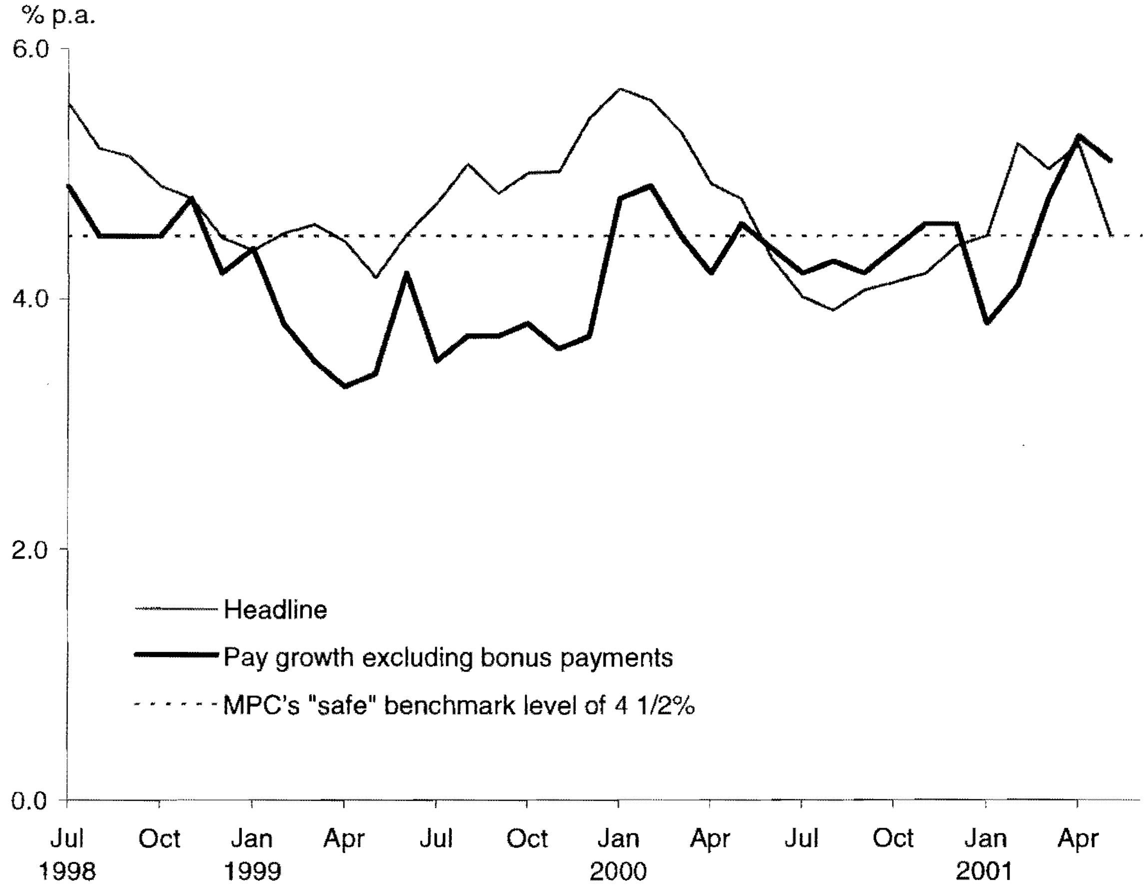
Sources: Annual Abstract of Statistics, *Strategic Rail Authority website and LSR calculations*

The much-publicised row between the Government and the Mayor of London over the plans for London Underground has become highly personalised. At times it has verged on the farcical. However, very important issues are at stake for the economy of London. The long-term boom in office-based employment in London has led to a virtual doubling in the number of journeys on the London Underground since a cyclical trough in 1982. (Note that London Underground is defined here to include the Dockland Light Railway, where the number of journeys has more than trebled in the last decade.) Passenger journeys on the national rail network have also increased strongly since privatisation in 1995 and 1996. Over-crowding, delays and deteriorating safety standards imply that heavy investment in the infrastructure is needed, but the UK construction sector is already quite busy.

Upward pressures on pay

Labour market to tighten further

Chart shows annual increase in "headline" averge earnings (i.e., pay), average earnings excluding bonus payments and the Monetary Policy Committee's guideline for "safe" pay growth of 4 1/2%.



Source: National Statistics

The London boom - illustrated on the previous two pages - reflects deep-seated trends in the world economy, including globalisation and the move of financial business to large, efficient offshore markets. (The offshore markets are - in practice - largely "located" in London.) A case can be made that the UK has adjusted to the leap in the real exchange rate in late 1996 and that the supposedly over-valued pound is in fact some sort of new equilibrium. If so, the relative decline in UK manufacturing is part of a long-run structural adjustment in the economy and does not justify an easing of monetary policy. The labour market is tight at present, with unemployment still falling and vacancies increasing. As the chart shows, the bonus-adjusted annual increase in average earnings has breached the 4 1/2% figure regarded as "safe" by the Monetary Policy Committee.