Monthly Economic Review

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Balancing-out "the imbalances"

UK's success as an international investor helps to explain consumer boom

The UK's extraordinary consumer boom appears to have caused "imbalances", but

The volume of UK retail sales in predominantly non-food stores was 8.7% higher in May 2004 than a year earlier, a rate of advance which in the past has been associated with full-scale consumer booms. Allowing for the greater stability in spending on such items as housing, fuel and light, it seems likely that consumption will grow this year by about 4%. This would be somewhat ahead of output, which may show a gain of 3 ½% or so, and the ninth year in succession that consumption has increased more rapidly than output. Cumulatively, from 1995 to 2004 consumption would have risen by almost 40%, whereas output would be up about 28%. Many economists - including Mervyn King, Governor of the Bank of England - have expressed concern about these developments, saying that they represent "imbalances" which must eventually be corrected.

1. Export volumes and output may be understated, and

At first sight the UK's people have been behaving unsustainably, with their spending moving out of line with what they produce. The truth is much more encouraging. First, output growth may have been under-estimated. The apparent imbalance between spending and output is matched in the national income accounts by an imbalance between exports and imports. According to the official data, the *volume* of imports climbed by 6.4% a year from 1996 to 2003, whereas the *volume* of exports went up by only 3.8% a year. But statisticians' estimates of "volume" depend on the price series they use to deflate the numbers for "value". The gap between the growth rates of the *values* of exports and imports was much less. One possibility is that British companies have been specialising on complex products where the increase in unit values reflects greater quality or higher effectiveness, and is not a price rise. (More powerful aero-engines, and motor and aerospace components made of lighter but stronger materials, are examples.) By incorrectly deeming the increase in unit values a price rise, the national income accountants may have understated the "true" level of exports and so of national income.

2. UK earns a better return in foreign investments than foreigners earn on UK investments

Secondly, the UK's companies and fund managers have done well in their international investments since the mid-1990s. Over the nine years 1996 to 2004 inclusive the UK's current account deficit is likely to amount to about £140b. Fortunately, the UK has earned a better rate of return on its overseas investment than foreign investors on their UK investments. According to an article in the June issue of *Economic Trends*, the UK's external liabilities at the end of 2003 were £3,185.8b., whereas its external assets were £3,133.4b. But this £52.4b. deficit in valuation was offset by a better return on external assets (3.99%) than on external liabilities (3.23%), giving the UK a surplus on investment income of over £20b. Roughly speaking, the UK currently achieves a surplus on investment income equal to about 2% of national income, whereas in the mid-1990s it was only 1 ½% of national income. When the 1 ½%-of-national-income improvement is added to the benefits from the UK's better terms of trade, the "imbalances" largely disappear.

Professor Tim Congdon **30th June, 2004**

Summary of paper on

'The outlook for consumer spending'

Purpose of the paper

Concerns that the UK's eight-year long consumption boom will come to an abrupt end are once again surfacing. Rapid rates of household debt accumulation and the implications of rising interest rates are at the fore. This paper assesses the outlook for consumer spending both over the short and medium terms. Is a significant consumption downturn plausible in the next twelve to eighteen months? Must the economy inevitably rebalance over the medium-term as is commonly assumed?

Main points

- Concerns about record household debt levels, rising interest rates and adverse implications for debt-servicing costs are prompting renewed fears of an imminent consumer spending downturn.

- But interest payments are easily manageable and will remain so over the next twelve months even as interest rates are pushed higher.

- Household balance sheets are also healthy. Surging house prices have pushed wealth to all-time highs both in absolute terms and relative to incomes. With plenty of momentum left in the housing market, the value of household assets should continue to rise. Mortgage equity withdrawal will remain strong.

- Real household income growth is accelerating, as employment grows and wage inflation drifts up gently. Talk of an early consumer downturn therefore looks misplaced.

- Medium-term prospects for consumption are less clear. A common argument has been that the consumer spending boom since 1996 is unsustainable and that the economy must rebalance. But the forces enabling the UK to enjoy above-trend consumption growth may have further to run.

- The 10% improvement in the UK's terms-of-trade between 1996 and 2003 was crucial in enabling the eight-year long boom. Future trends in relative import and export prices are key to consumption prospects.

- The UK's impressive international investment performance also played an important role. Substantial investment income surpluses helped to offset the growing trade deficits. The UK thus avoided a sharp deterioration in its current account deficit and a subsequent inflationary fall of the exchange rate.

This paper was written by Martin McMahon.

The outlook for consumer spending

No early end in sight for the consumer boom

Can eight-year long consumption boom continue?

The late 1990s and first few years of the current decade have been an astonishing period for UK consumer spending. Household consumption expanded by an average 3.7% per year in real terms between 1996 to 2003 inclusive. GDP growth was a full 1% lower at 2.7%. This is the largest consumption gain in an eight-year period in the UK's history. Household consumption increased by more than a third over the period. Moreover, buoyant consumer demand continues to fuel the High Street boom, at least for now anyway. National Accounts data report that consumer spending grew by 0.9% (or at an annualised rate in the 3.5%-4.0% region) for the third quarter in succession in Q1 2004. Retail sales are currently growing at 6%-7% annual rates. Can this remarkable performance persist?

Or must the economy rebalance?

Much has been written over the past few years about the consumption boom and its imminent demise. It is commonly argued that consumer spending growth cannot exceed that of GDP indefinitely and that a rebalancing is necessary. Indeed, fears of a downturn are once again coming to the fore, with pundits suggesting a slowdown in the coming twelve months. The purpose of this short paper is to assess prospects for household consumption, both in the year ahead and over the medium term. Can the boom carry on unchecked ? Jumping ahead to the conclusion, the answer looks to be a categorical "yes" in the next four quarters. In the longer run moderation seems probable.

Surging household borrowing is stoking up fears of impending collapse

Turning to the short-term outlook first, why are fears of an imminent slowdown once again misplaced? The answer is that the necessary conditions are not in place. Current concerns seem to originate in large part from surging household debt levels and their implications for spending as interest rates and debt-servicing costs rise. Household debt should breach the headline-grabbing £1 trillion mark in June, an event which will no doubt trigger another wave of pessimism. Households are "sliding further into the mire of debt", "mortgaging their futures" and "storing up a timebomb." According to the Jeremiahs, the looming debt crisis foreshadows a collapse in consumer spending and will undermine output growth.

Household debt is at record highs relative to incomes

These headlines may seem understandable given the extent of the current borrowing binge. Mortgage lending is still growing at 15%+ annual rates, rates which are plainly unsustainable in the long run. The MPC is concerned and rightly so. The stock of debt doubles every five years at such rates of accumulation. However, the fact that household debt is at all-time records both in absolute terms and relative to household incomes does *not* imply that household spending must collapse or even that the debt burden is necessarily a problem.

While the household sector's debt-to-income ratio is at a record high, the ratio of interest payments to income is not particularly stretched by historical standards. (See p.8.) On the contrary, income gearing is manageable at present despite edging

But income gearing is manageable,

up over the past year as both interest rates and the stock of debt rose. Admittedly, the upward trend will continue in the year ahead as interest rates are pushed higher and the credit boom runs on. But the ratio will not come even close to approaching early-1990s' recession-triggering peaks.

and nowhere near early 1990s peaks

Our estimates suggest that interest payments were roughly 7.2% of household disposable income at end-2003 compared to a peak of over 15% in 1990. To put the extent of the difference in perspective, the ratio would reach about 9.5% under the assumptions of a 15% increase in household debt this year, disposable income growth of 4.3% and base rates reaching 5% by end-2004. If interest rates jumped to 6%, the ratio would reach double-digits at close to 11%. While more of a burden on household pockets, this level would still be far short of early 1990s' highs.

Meanwhile, household wealth is also surging,

Indeed, while concerns about rates of debt accumulation may be legitimate, it is highly misleading to look at the liability side of household balance sheets in isolation anyway. Wealth has also jumped to record levels in the wake of the ongoing housing boom and last year's stock market rebound. (See p. 9.) Total *net* wealth relative to disposable income reached an all-time high at end-2003, helping to explain why there is such a "feel-good factor" and why households are more than happy to continue spending. (Total *net* wealth is equal to gross financial wealth less debt plus tangible wealth.) The ratio of mortgage debt to the value of the housing stock is actually falling at present, not rising.

and is a key determinant of consumption

The crucial point is often overlooked. *It is the aggregate or total balance sheet that matters*. Household wealth is well-known to be one of the key influences or drivers of consumption. For example, the consumer demand equation in the Bank of England's large-scale macro-econometric model of the UK economy includes both real household financial and tangible wealth as key variables. Of the two, tangible (i.e., essentially housing) wealth has the larger and more immediate impact on consumption. (see p.10.) With house prices still surging upwards, household wealth is clearly benefitting and supportive of household spending.

Mortgage equity withdrawal is at record levels

One channel through which the booming housing market influences spending is via the rampant mortgage equity withdrawal (MEW) that is currently taking place. Bank of England figures report that MEW totalled £16.2b. in Q4 2003, a level probably surpassed in Q1 2004. This was equal to 8.3% of households' post-tax income, a new record exceeding even the 7.7% recorded in Q3 1988 at the height of the late-1980s housing bubble. To put the scale of the MEW in perspective, it is worth pointing out that it was equal to 9.2% of all consumer spending in value in Q4 2003. MEW in 2003 as a whole was £52.9b., nearly double the annual increase in current price consumption last year.

Of course, this is not to claim that all MEW is used to finance consumption. If it had been, any downturn in MEW would have dramatic consequences for demand. MEW may be a transfer of wealth, with little effect on consumption. Much of the recent rise in household borrowing has been matched by an increase in households' acquisition of financial assets, many of them deposits. These may or may not ultimately feed through into higher consumer spending. But what is clear is that with household balance sheets already healthy and being supported by rising house prices, pessimism about consumer spending prospects in the year ahead is misplaced.

Busy housing market activity is also supportive of consumer spending

A second important channel through which the booming housing market supports spending is via its influence on purchases of big-ticket items such as washing machines, televisions, fridge freezers and the like. Unsurprisingly, the volume of spending on such durables items is closely correlated with activity levels in the residential property market. (See p. 12.) If more households move home, then more new washing machines and fridge freezers tend to get bought. With numbers of property transactions rising strongly in H1 2004, spending on these types of goods, the most volatile component of overall consumer spending, can also be expected to remain firm in coming months.

Real income growth is accelerating

The other major determinant of consumption, one that is also included in the Bank's econometric model, is real household income growth. Again, this should hardly be a surprise. The more household incomes grow, the more households can spend. Here too, current developments look to be supportive for High Street activity in the year ahead. Levels of employment are already rising strongly, with surveys of recruiters pointing to more of the same. Rising numbers of unfilled vacancies confirm that demand for labour is strengthening. Meanwhile, wage growth has started to drift up gently. The net result is that real household income growth is accelerating.

Talk of a consumer spending slowdown is fanciful

The general message for short-term consumer spending prospects therefore seems to be upbeat more or less across the board. A sharp slowdown on the High Street in H2 2004 or H1 2005 is highly implausible given buoyant wealth, rising incomes and ongoing firm activity in the housing market. Rather the major risk seems to be that consumption will not moderate as much as the MPC hopes for and that interest rates may have to go higher than many people anticipate.

Moderation will have to be engineered by the MPC

Our estimates suggest that UK output is currently close to its trend level, implying little spare capacity in the economy. This means that a period of above-trend GDP growth would lead to the development of a positive output gap and the emergence of inflationary pressures. Yet above-trend GDP growth looks to be the most likely outcome in the year ahead. *Budget 2004* projections suggest that government spending will remain firm, business investment is already picking up while exports are expected to recover in coming quarters. Consumer spending therefore needs to be slowed if the MPC is to keep output close to trend and meet its inflation target. Base rates approaching 6% in late 2005 may be required.

Significant house price correction is an obvious risk

Of course, there are risks to the outlook, notably the housing market. If the housing market were to experience an unexpected sharp downward correction hitting wealth and activity levels, the outlook for consumer spending would inevitably be affected. Likewise, a downward lurch of global stock markets would be unhelpful. The most likely outcome, however, is that a consumer spending slowdown will have to be engineered over the next twelve to eighteen months.

What about the medium term?

Experience of past eight years has been remarkable

Turning to medium-term prospects for consumption, the outlook looks less upbeat, although probably still reasonable. It is worth reiterating just how unique the performance of the past few years has been. Normally consumption is closely related to output. Over the whole period since National Accounts were prepared in their current form in 1948, the UK's GDP increased on average by 2.5% a year, while households' consumption rose by a similar 2.6% a year. True, there were prolonged periods where one exceeded the other, with the pattern then reversed as the economy rebalanced. But the discrepancy between the two was never as pronounced or for as prolonged a period of time as since the mid-1990s.

It is therefore instructive to see how such a divergence was possible and whether it is likely to be able to continue in the future. Alternatively put, must a rebalancing of the economy put an end to the consumption boom, as is frequently claimed?

Massive swing in the UK's net exports allowed consumption continually to outpace output

A breakdown of the composition of GDP growth shows how in resource terms the consumption boom was possible, namely by import growth consistently exceeding that of exports. Imports grew by an average of 6.8% a year or a cumulative 70% over the eight-year period, with export growth more subdued at 4.4% or a cumulative 41%. Net exports made a negative contribution to GDP growth in each of the eight years to 2003, with the overall swing amounting to over 5% of GDP. (See p. 14.) The swing into deficit was the counterpart to the gap between the growth rates of domestic demand (i.e. largely consumer spending) and GDP.

Yet no equivalent swing into current account deficit

Crucially for the consumption boom, this huge swing in net export performance was not accompanied by a sharp deterioration in the UK's balance of payments and subsequent inflationary fall in the exchange rate. Had such an outcome materialised as would normally be expected, higher interest rates would have brought the spending boom to an end. The UK's current account deficit was little changed over the period at 1.7% of GDP in 2003 compared to 1.3% in 1995.

How was this benign outcome possible? The explanation has two parts. First, the

Rising surplus on international investment income

buoyancy of UK investment income from overseas investments helped to offset the deterioration in the trade deficit. Successful investment abroad helped the UK's surplus on investment income to rise from £2.1b. in 1995 to £23.4b. last year, a swing of 1.8% of GDP. This impressive performance was delivered in spite of the fact that the UK is - according to official statistics - a net external debtor.

Favourable terms-of-trade shift was crucial

Falling prices of imported goods such as computers and clothing

Secondly, and more importantly, the UK experienced a significant terms-of-trade improvement over the period. UK export prices fell less than those of its imports. The resulting 10% rise in the terms-of-trade between end-1995 and end-2003 amounted to a substantial windfall to the UK. (See p. 15.) The shift was caused by a number of factors. These included sharp falls in prices of computers and other imported electronic goods, falling clothing and textile prices due to the phasing out of the Multi-Fibre Agreement and the general emergence of low-cost Chinese and other Asian supply of many imported goods.

UK's specialisation in high value-added international business services also helped

Structural supply-side changes in the UK economy were also responsible. The transfer of resources away from the manufacture of bulk items to high valued-added sectors such as international business services (banking, lawyers, accountancy, etc.), played an important role. These were businesses with booming prices and incomes in the late 1990s bull market, and their growth helped to boost the UK's spending power. The terms-of-trade improvement allowed the growth rate of import volumes to exceed that of exports without the trade deficit and balance of payments spiralling out of control.

Medium-term outlook for consumption depends on international price developments

In terms of the outlook for consumer spending in the next five years, much therefore depends on future relative international price developments. The UK's terms-of-trade index is already at its highest level in the post-war period, with past experience suggesting that often it reverses direction. Were this to be the case or even if the terms-of-trade just stabilised, consumption growth would have to fall back in line with that of output.

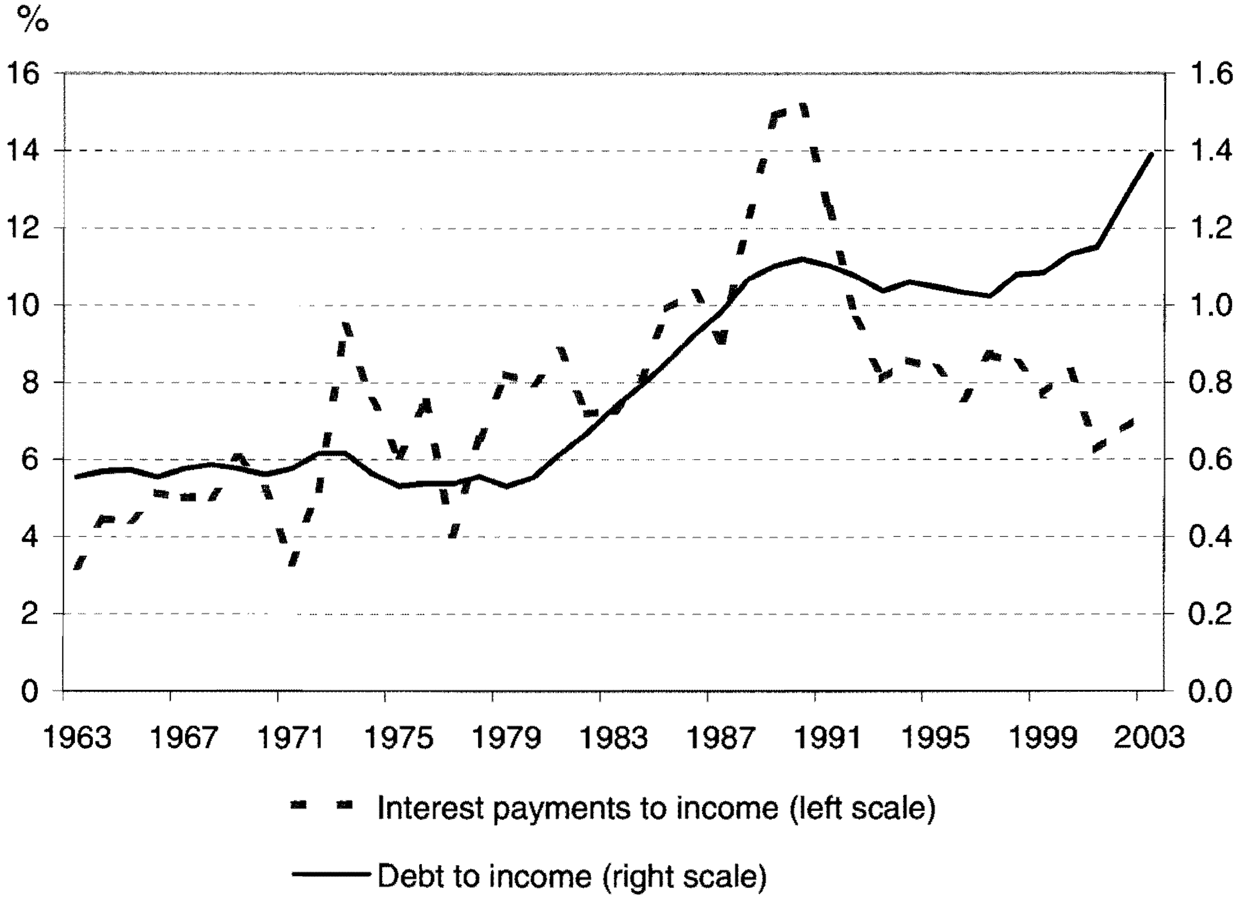
Consumption boom may be able to run further than commonly assumed

A weakening in the terms of trade is not inevitable. Technological progress and the integration of low-cost Asia into the world economy could continue to keep downward pressure on the prices of goods that the UK tends to import. Prices of services provided by UK businesses could continue to rise. In general, the forces enabling the UK to enjoy above-trend consumption growth over the past eight years may have further to run. However, whether another 10% improvement in the terms-of-trade can be delivered must be at least questionable. Another eight years like the past eight would be truly remarkable.

Household sector indebtedness

Household debt at record levels, but interest payments still manageable

Chart shows household sector debt-to-income ratio and interest payments as a percentage of household disposable income. LSR estimates using National Statistics and Bank of England data.

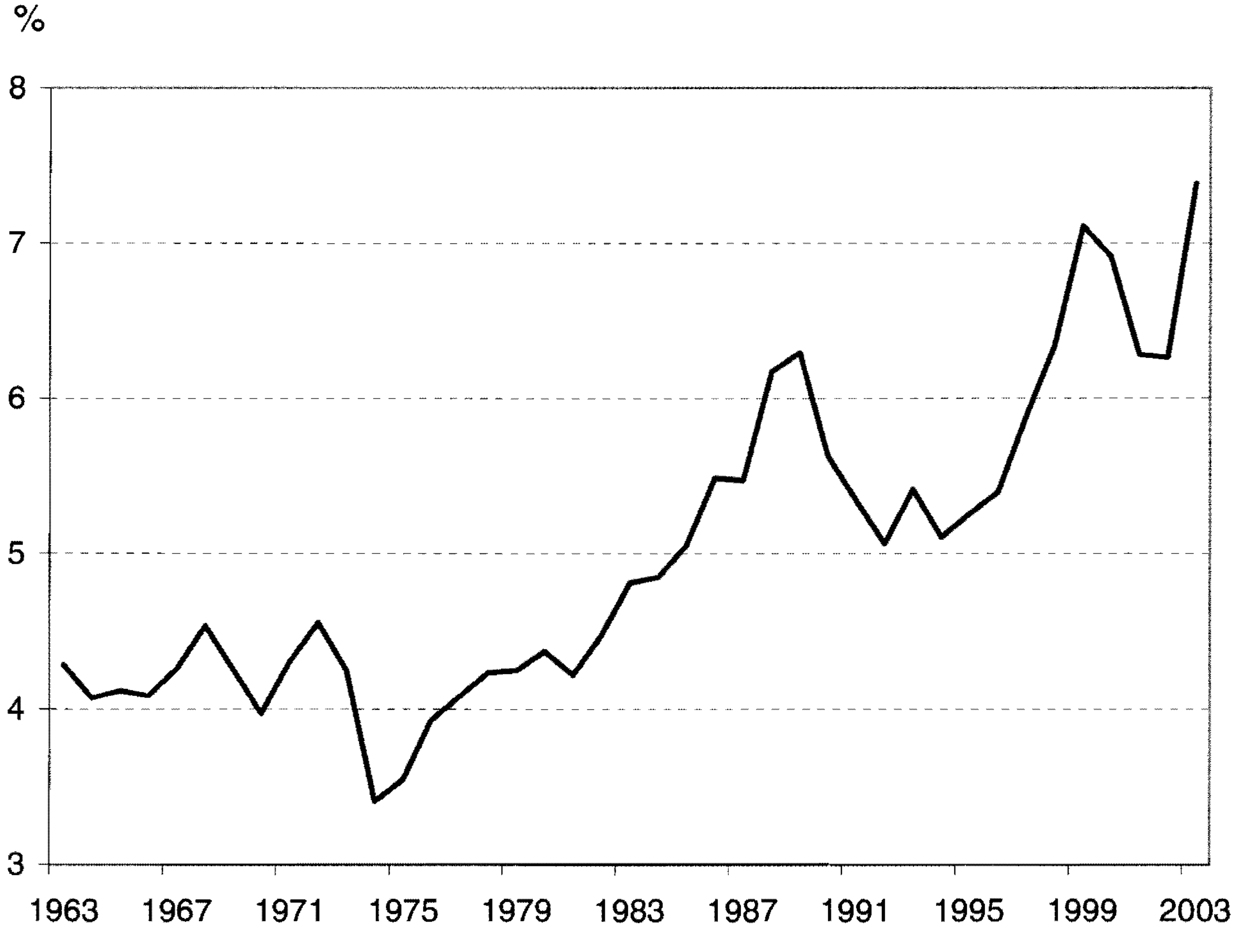


Household debt levels are spiralling in the wake of the ongoing credit boom. Mortgage lending is expanding at 15%+ annual rates, with consumer credit growth not far behind at 12%. These rates of increase are plainly unsustainable in the long run and have worried the MPC. The outstanding stock of household debt should breach the headline-grabbing £1 trillion mark in June. Buoyant mortgage approvals numbers point to more of the same in coming months. Debt has reached record levels relative to household incomes, raising concerns about future debt-servicing costs and implications for consumer spending. But, as the chart above shows, interest payments are manageable at present and likely to remain so in the future. Our estimates suggest that interest payments were a touch over 7% of household disposable income at end-2003, not particularly stretched by historical standards. Admittedly, this ratio is rising. But it will clearly not come close to approaching the recession-triggering 15%+ peak recorded in 1990. Assuming household debt rises by 15% in 2004 and interest rates reach 5%, the measure would increase to about 9.5% by year-end. Interest rates of 6% would push it towards the 11% mark, high but not a catastrophe for households.

Household wealth is also soaring

Housing boom has pushed net wealth to record levels

Chart shows household net wealth-to-income ratio reaching all-time high at end-2003. LSR estimates using National Statistics data.



Headline-writers tend to highlight surging debt levels when delivering their gloomy prognostications. But focusing only on the liability side of household balance sheets gives a misleading picture. The value of household assets also plays an important role in determining spending behaviour. *It is the overall balance sheet position that matters.* Here, the picture is more encouraging. Household wealth surged upwards from the mid-1990s onwards, before slipping a touch as stock markets tumbled from their peaks in 2000. However, the housing boom has since pushed total household wealth to record highs, both in absolute terms and relative to incomes. Households have never been as wealthy as they are now. The chart shows the ratio of total net wealth (i.e., after adjusting for debt) relative to disposable income peaking at over 7% by end-2003. With house prices and the value of the housing stock rising more than mortgage debt so far in 2004, the measure will have edged up even higher over the past six months. It is little surprise that the "feel-good factor" is supporting rampant High Street spending.

What drives consumer spending?

Bank of England consumption function highlights importance of wealth

Table shows responsiveness of consumer expenditure to shocks to various explanatory variables in the Bank of England's consumption function. From "Economic models at the Bank of England, September 2000 update", Bank of England.

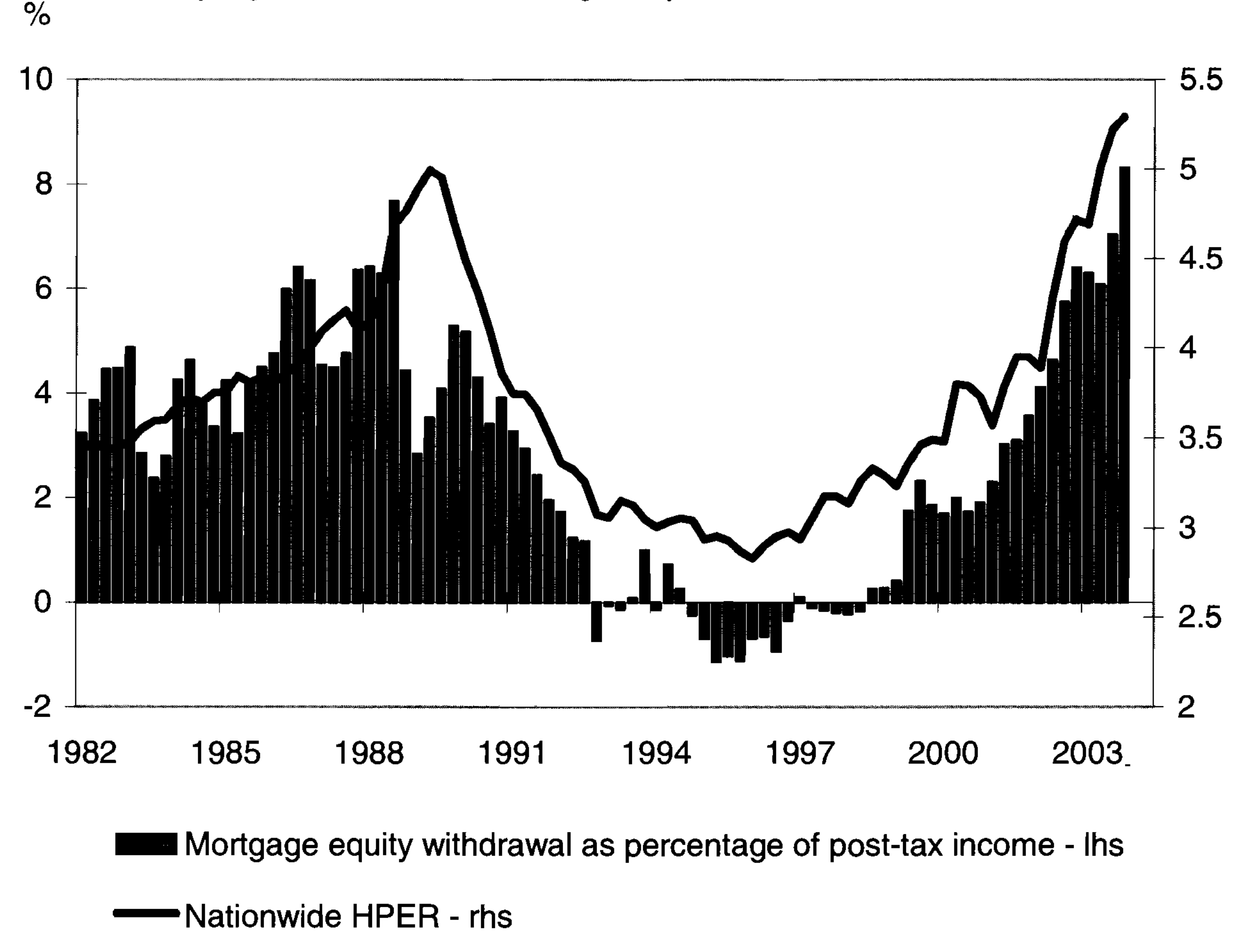
	REAL LABOUR INCOME	REAL NET FINANCIAL WEALTH	REAL GROSS HOUSING WEALTH	REAL INTEREST RATE
1 QUARTER AHEAD	0.3	0.02	0.12	0.0
4 QUARTERS AHEAD	0.6	0.04	0.09	-0.001
8 QUARTERS AHEAD	0.7	0.06	0.07	-0.002
LONG RUN	0.9	0.07	0.05	-0.003

It is widely accepted that household wealth is a key determinant of consumer spending. For example, most econometric models of consumption include measures of wealth as explanatory variables. The Bank of England's own consumption function is a case in point. In the Bank's model, long-run consumer expenditure is determined by real labour income growth, real household wealth and real interest rates. Interestingly, wealth is split between financial and housing assets. The table above shows the estimated impact on consumption of a 1% positive shock to the respective explanatory variables. For example, if real housing wealth was to jump by 1%, consumer spending would rise by 0.09% after a year. A 10% rise would lead to a 0.9% boost to consumer spending. Interestingly, changes in housing wealth have a larger and more immediate impact on spending than those of financial wealth. The conclusion must be that with house prices still rising strongly, talk of a slowdown in consumer spending looks fanciful. On the contrary, consumption is likely to continue expanding at current 3.5%-4% rates into H1 2005.

MEW at record highs

Surging house prices are fuelling rampant mortgage equity withdrawal

Chart shows mortage equity withdrawal as a percentage of post-tax income and Nationwide house price-to-earnings ratio. From Bank of England and Nationwide Building Society.

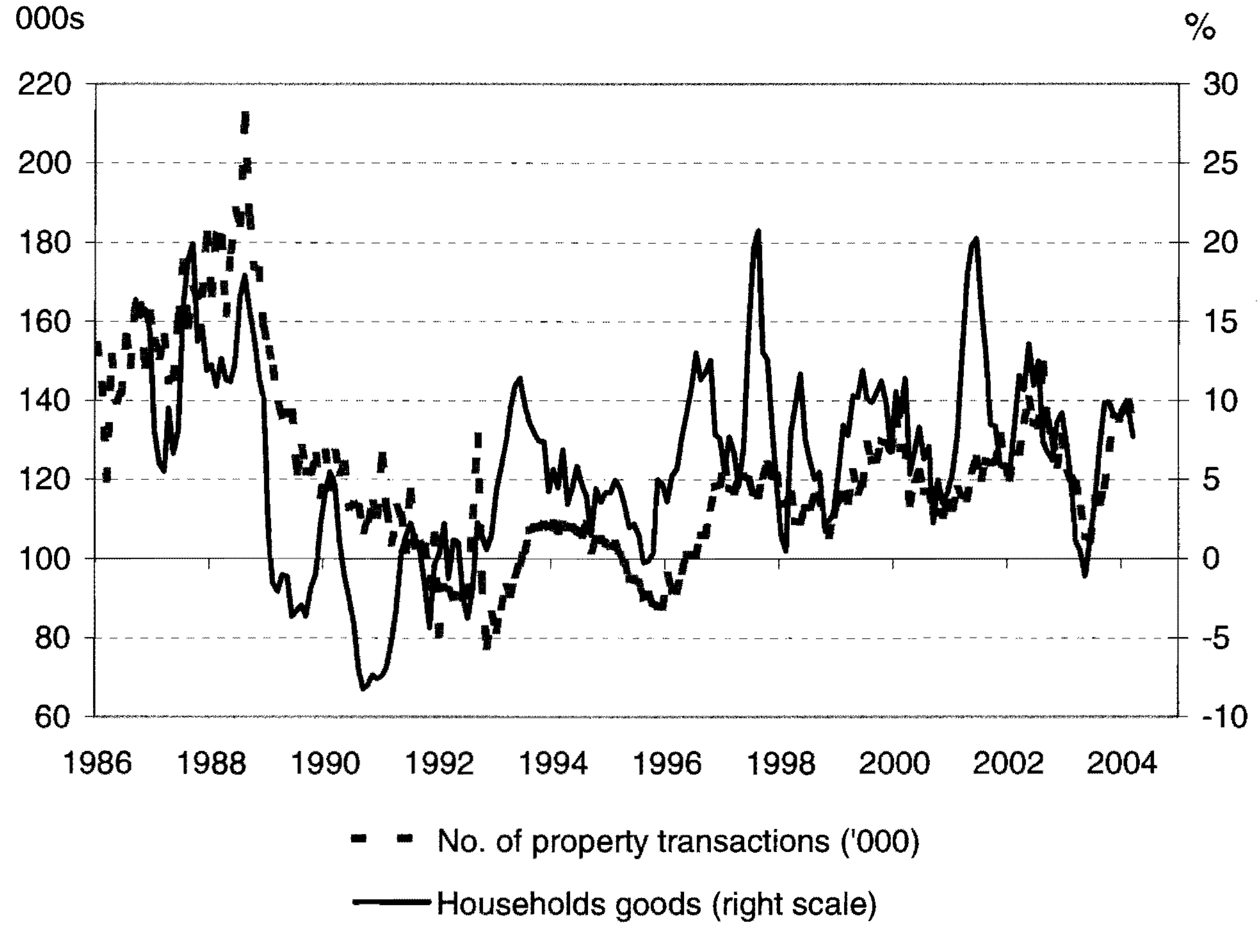


One channel via which the buoyant housing market feeds through to aggregate spending is that of mortgage equity withdrawal (MEW). Bank of England figures confirm that MEW has rocketted in recent years, reaching a peak of £16.2b. in Q4 2003. This was equal to 8.3% of households' post-tax income, exceeding the previous 7.7% peak reached in Q3 1988. MEW totalled a whopping £52.9b. in 2003 as a whole. While not all of the equity withdrawn has necessarily been spent, MEW on such a vast scale undoubtedly has a positive impact on consumption. Moreover, MEW should remain strong well into 2005 as well. The chart above suggests a relatively close relationship between MEW and the house price-to-earnings ratio. As house prices rise upwards relative to incomes, the value of housing equity that can be tapped also increases. Crucially, while house price *inflation* may be near its peak, the *level* of house prices is still rising. The house price-to-earnings ratio will continue to rise until house price inflation falls below earnings growth, an unlikely prospect in the next 12-18 months. The implication is that MEW will also remain robust in the year ahead.

Housing turnover also boosts spending

Close correlation between housing market activity and household goods sales

Chart shows number of residential property transactions and three-month moving average of six-month annualised growth rate of household goods sales. From Inland Revenue and National Statistics.

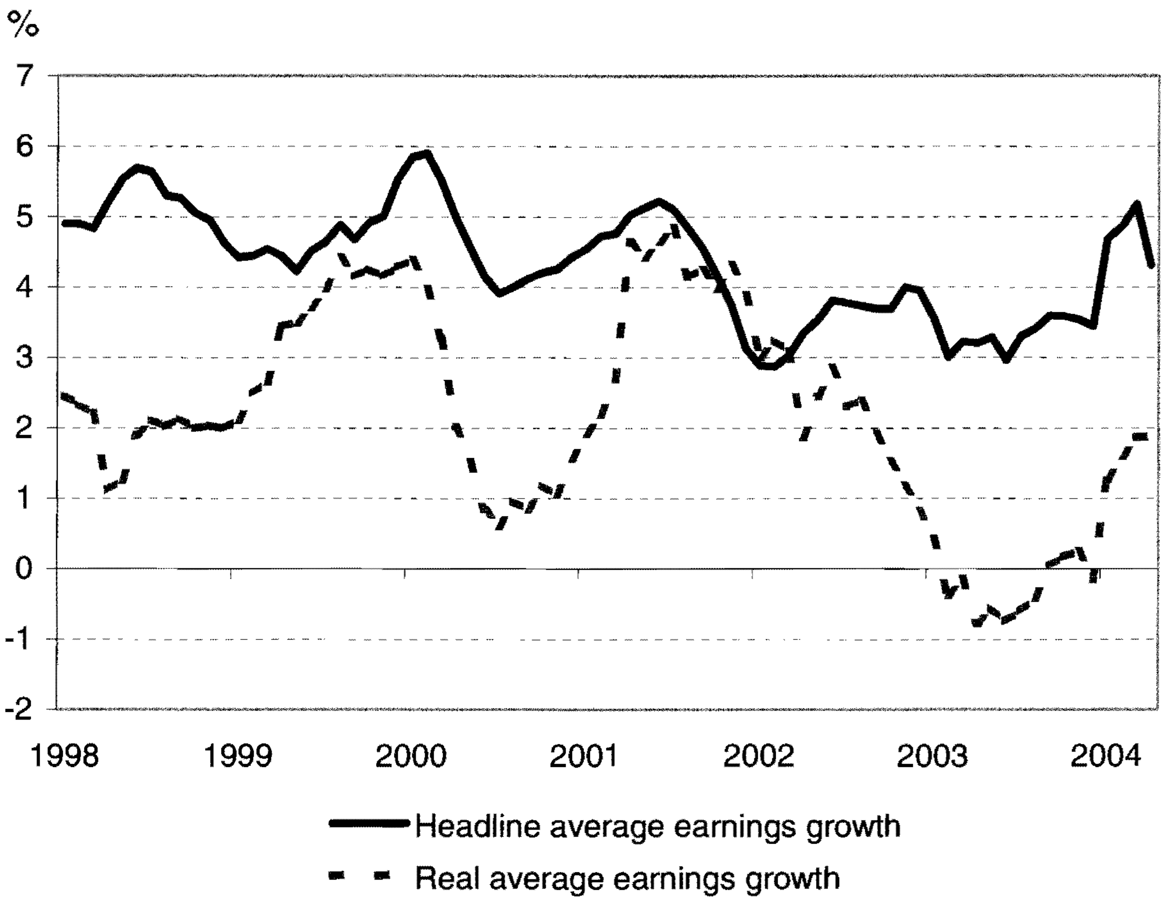


A second important channel through which the housing market drives spending is in terms of activity levels and their impact on purchases of household goods. Unsurprisingly, there is a fairly close correlation between numbers of property transactions and household goods sales. When households move home they often buy new televisions, cookers, fridge freezers and the like. Durables goods sales are the most volatile component of overall consumption and therefore crucially important in driving aggregate spending growth. The message from recent housing activity data is of more robust consumption ahead. The number of residential property transactions has jumped sharply in H1 2004. Leading indicators of housing market activity point to more of the same to come. Numbers of mortgage approvals for house purchase may have stabilised in recent months, but the stabilisation has been at high levels. Surveys of house builders are equally upbeat. According to the latest House Builders' Federation survey, a positive balance of +24% of house builders reported that site visitors were up on levels a year earlier.

Real income growth is accelerating

Rising employment and average earnings growth are boosting incomes

Chart shows headline average earnings growth, nominal and real deflated using the tax and price index. From National Statistics

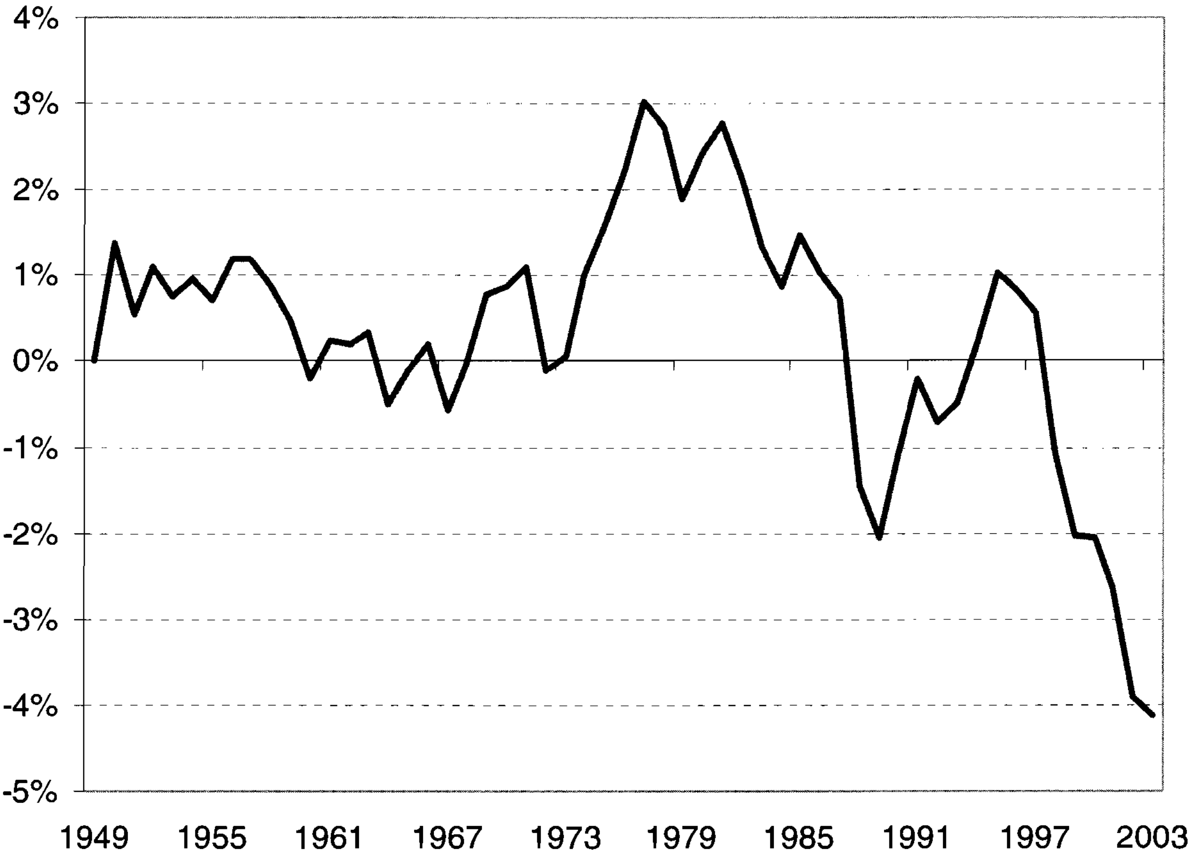


The final and arguably key determinant of consumption is real income growth. Here too, the message for the year ahead is upbeat. Employment is rising strongly, with demand for labour firm and broad-based across the economy. Unfilled vacancies totalled 631,000 in May, up 48,300 on the year. Surveys of recruiters such as the Manpower *Employment Outlook Survey* also suggest firm expansion of employment into H2 2004. Meanwhile, average earnings growth is drifting up gently. Underlying wage growth (i.e., excluding bonus payments) was up from a trough of 3.2% last summer to 4.3% by April. With retail price inflation still subdued and under control for now, real wage growth has been accelerating. The combined effect of these trends is to boost real household disposable income growth, again a positive for consumer spending. Rising household wealth suggests that there is little immediate prospect of an offsetting increase in the household savings ratio. The savings ratio at 6% in Q4 2003 was a touch below its long-run average of 8%, but not dramatically so.

Unprecedented eight-year consumption boom

Consumption boom accompanied by massive deterioration in net exports

Chart shows net exports as percentage of GDP, chained volume terms, National Accounts basis. From National Statistics.

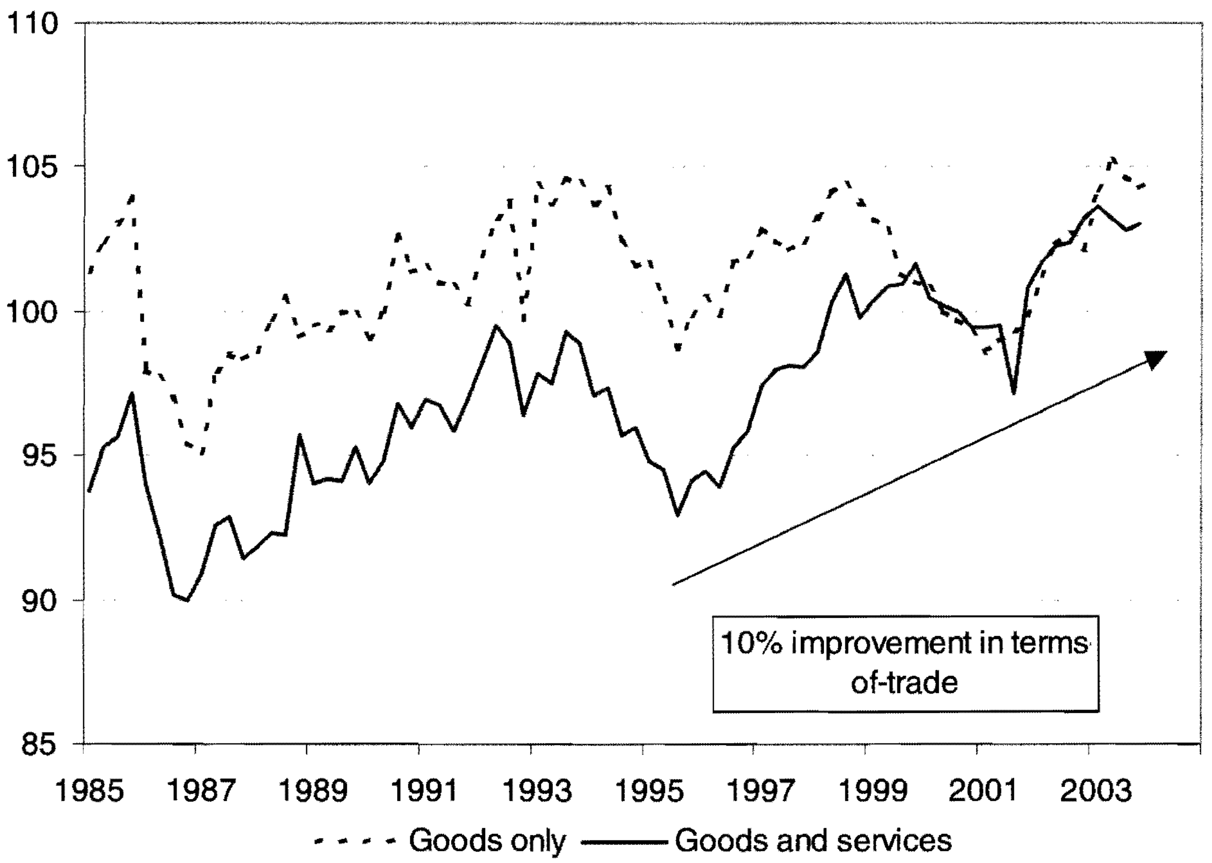


The consumption boom of the past eight years has been a truly remarkable period. Real consumer spending grew on average by 3.7% between 1996 and 2003, a full 1% more than the 2.7% of output. Over the period from 1948 to 1995, performance had been virtually identical at 2.6% and 2.5% respectively. While there had been periods where one exceeded the other, the divergence was never as prolonged or pronounced. Claims that the consumption boom is unsustainable and that spending must ultimately slow are based on this close long-run relationship. As such, it is instructive to see how the recent period of divergence was possible. Consumption was able to outpace output for such a long period because in resource terms imports consistently exceeded exports. Import volumes rose by a cumulative 70% over the eight years, with exports rising by just 41%. Net exports made a negative contribution to GDP growth in each of the years 1996 to 2003, with the cumulative swing amounting to over 5% of GDP. Remarkably this huge shift did not cause a sharp deterioration in the UK's balance of payments or trigger an associated inflationary fall in the exchange rate. The UK's current account deficit was just 1.7% of GDP in 2003 compared to 1.3% eight years earlier.

Terms-of-trade shift was key

10% improvement in the UK's terms-of-trade allowed consumer boom to last

Chart shows the UK's terms-of-trade. The lines are the ratios of the price deflators of exports to imports of goods and services combined and goods only. From National Statistics.



Two key factors helped to keep the current account deficit manageable. First, the UK's investment income surplus surged from £2.1b. in 1995 to £23.4b. last year, a swing of 1.8% of GDP. This offset part of the deterioration in the trade deficit. Secondly, and more importantly, the UK experienced a 10% improvement in its terms-of-trade. The favourable shift in the relative prices of exports and imports in effect boosted UK real incomes. The shift was caused by a number of factors including sharp falls in the prices of imported computers and electronic goods as well as clothing and textiles. Meanwhile, the ongoing structural shift of UK production towards higher value added international business services with booming prices also helped. Future trends in the relative prices of exports and imports will have an important bearing on longer run prospects for consumption. The UK terms-of-trade is already at its highest level in the post-war period. Whether another 10% improvement can be delivered in coming years must be at least questionable. However, to the extent that current forces determining such price trends have further to run, it is not clear that the consumption boom must come to an end.