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## EUROPEAN MARKET COMMENT: CONSUMER SPENDING SUSTAINABILITY

July 31, 2001

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## How Sustainable is Consumer Spending?

The minutes of the Monetary Policy Committee's (MPC) July meeting stated that "many of the consumption related indicators remain strong, and it was not clear what would cause this underlying strength to diminish." So why is it, given the current climate, that U.K. consumers are not cutting back?

The imbalances in Britain's "two-speed" economy continue to prove problematic for the MPC, and some believe the divergence could grow. The fact that the manufacturing sector is officially in recession and the weakness is spreading into the service sector has not stopped U.K. consumers from digging into their pockets. Although the gap between the growth of services and manufacturing output has reached its highest point in over 20 years, both sectors are suffering from the economic slowdown and many economists fear that the downturn will indeed affect the British consumer. This has yet to be the case.

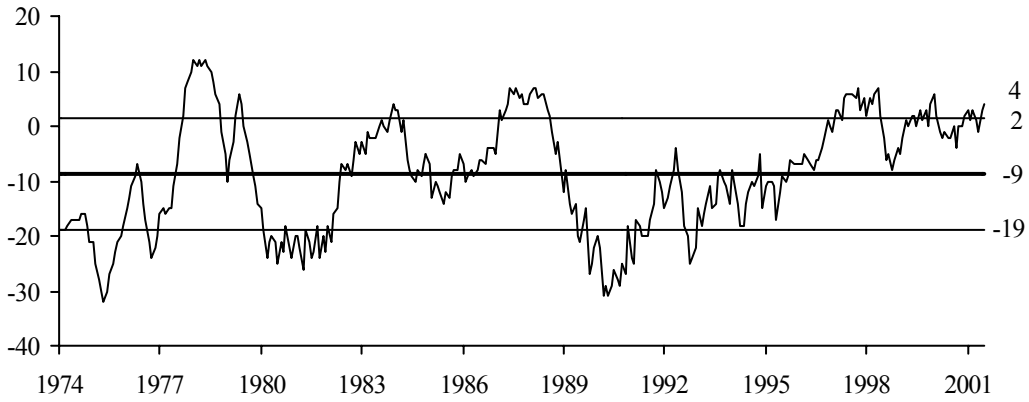
In the aftermath of the 1998 Russian default and Long-Term Capital Management crisis it has become apparent that the most important determinants of consumer spending are personal finance expectations and purchasing intentions. Fears of a recession will impact consumer confidence regarding the economic climate, but will not necessarily dampen consumers' enthusiasm for their own personal finances. As long as consumers remain optimistic in this regard, retail and other forms of consumer spending will likely remain resilient, as they did in 1998. Therefore, the biggest threat to consumer spending is income uncertainty, for which a reasonable proxy is the rate of unemployment. Although the global slowdown has led to a rise in unemployment in most major industrialised countries, the United Kingdom has remained resilient, with an unemployment rate of 3.2%, the lowest since 1975 (see the exhibit on the following page). However, the last few weeks have witnessed an escalation of high-profile job loss announcements, fuelling fears of an imminent surge in unemployment and threatening to undermine the confidence of the hitherto unflustered British consumer. In addition, the Recruitment and Employment Confederation indicates that wage growth in the second quarter rose at its slowest rate in over two years.

U.K. GDP growth has been in general decline since the third quarter of 2000, and as predicted, first estimates suggest only 0.3% growth in the second quarter. Given this slowdown, strong consumption is needed to prevent further weakness in the economy, since consumer spending (or household expenditure) accounts for roughly three-fifths of GDP. Rising financial wealth and steady growth in real disposable

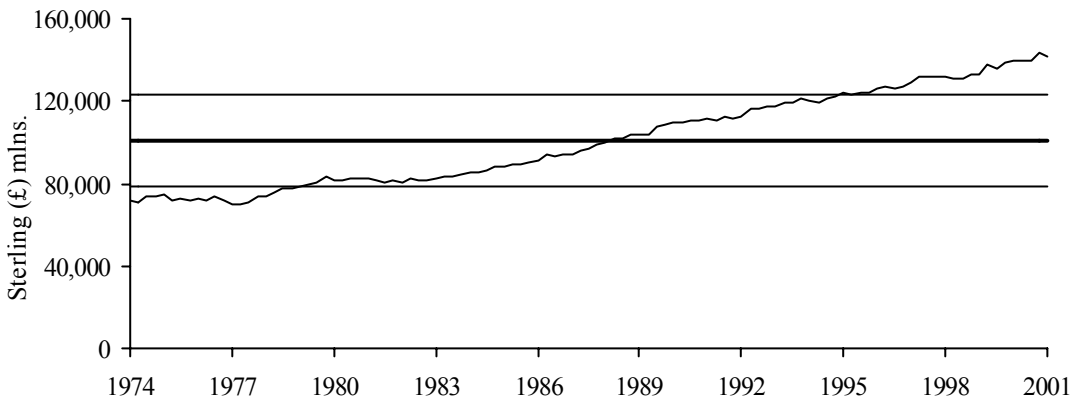
income have helped sustain strong consumption growth over the last few years, but the fall in equity value, moderating real income growth, and the threat of rising unemployment suggest that consumer spending could decelerate somewhat going forward. Since the contribution of business investment to growth is likely to remain subdued, given the deterioration of business confidence, the decline in profitability, and the deceleration of corporate bank borrowing, any serious retrenchment by consumers could well drag the economy into recession.

**U.K. CONSUMER CONFIDENCE AND SPENDING**

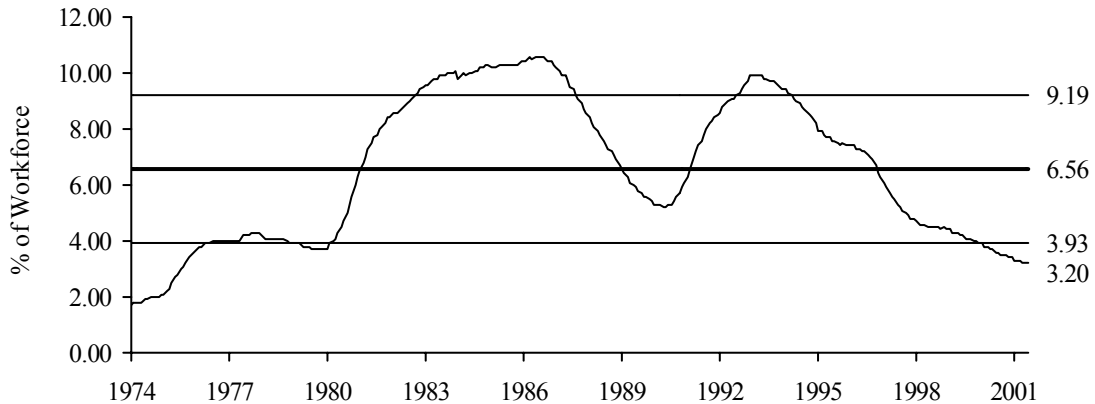
**U.K. Consumer Confidence**  
1 January 1974 - 31 July 2001



**U.K. Real Disposable Income**  
1 January 1974 - 31 March 2001



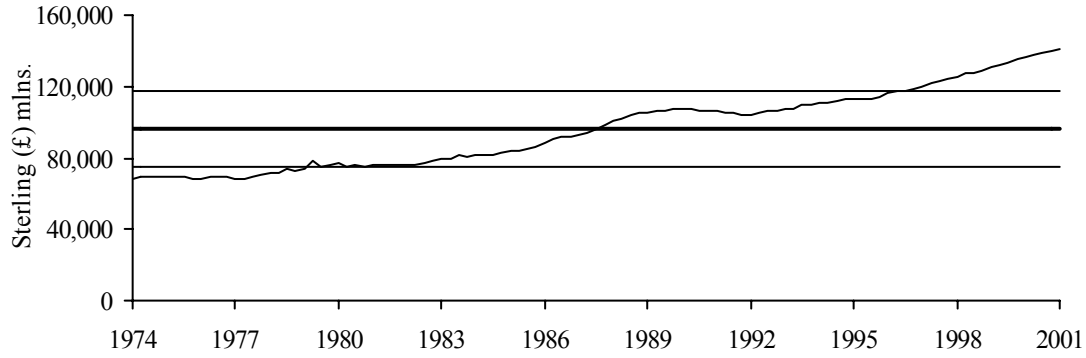
**U.K. Unemployment**  
1 January 1974 - 30 June 2001



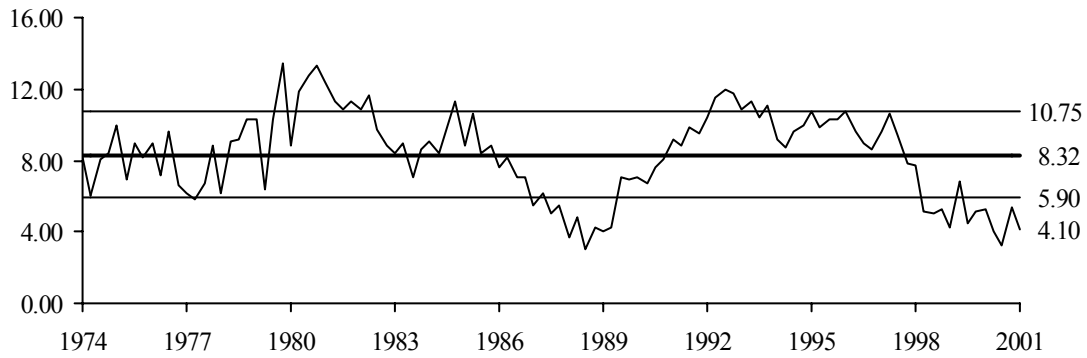
— Mean      — Standard Deviation

**U.K. CONSUMER CONFIDENCE AND SPENDING (continued)**

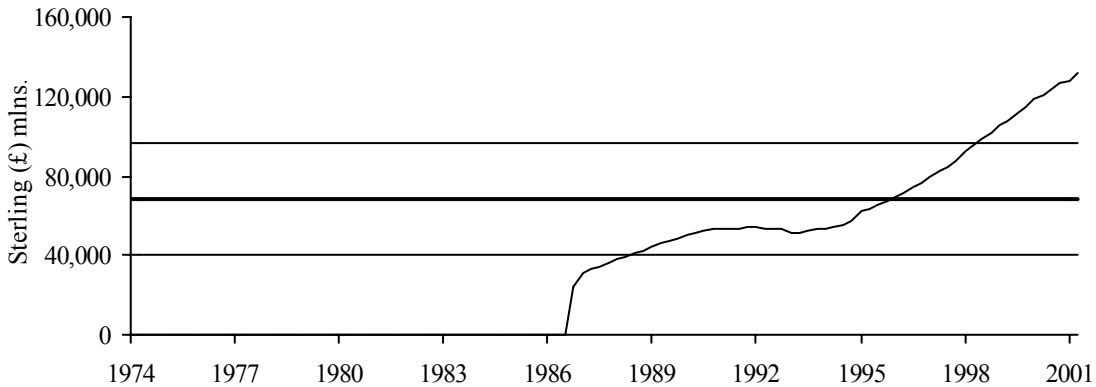
**U.K. Consumer Spending**  
1 January 1974 - 31 March 2001



**U.K. Household Savings Ratio**  
1 January 1974 - 31 March 2001



**U.K. Total Consumer Credit Outstanding**  
1 January 1974 - 30 June 2001



— Mean      — Standard Deviation

Source: Datastream International.

Note: U.K. Consumer Credit data does not begin until 31 December 1986.