UNITED KINGDOM

Interest rates on the rise …

- The Monetary Policy Committee raised UK interest rates by 25 bp to 3.75% at its meeting on 6 November. This was the first increase since February 2000 and is widely expected to mark the start of a gradual monetary tightening over the next 18 months to bring interest rates nearer to their 'neutral' rate. Short sterling futures imply that three-month rates will rise to 4.09% by December, 4.46% by March 2004 and 5.25% by December 2004. Our own forecast is for rates to peak at 5% in mid-2005.

… as Bank worries about debt boom

- The Bank's decision to raise interest rates appears to have been mainly driven by its growing unease with the continuing boom in household debt and spending. Overall lending to individuals rose 14.0% in the year to September, with consumer credit up 13.4%. Moreover, there are increasing signs of renewed vigour in the housing market, with the Nationwide reporting prices rising 2% in October to a level 16.1% up on a year earlier and the Halifax reporting prices up 1.2% and 16.7% over the same periods. Similarly, retail sales rose 0.6% in September, and in the latest three months were 1.2% up on the previous quarter and 3.5% up on a year earlier. The MPC is clearly concerned to send a warning shot across the bows of households.

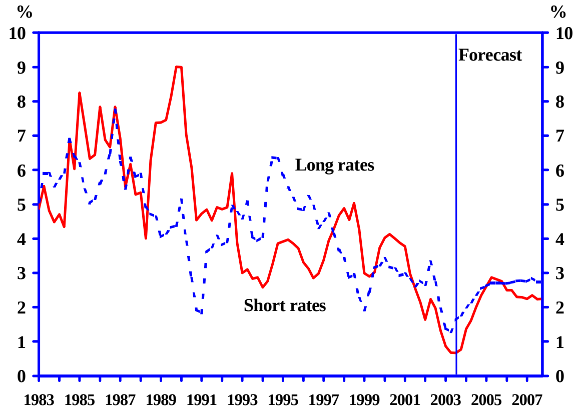
Will it push borrowers over the edge?

- This strategy raises a number of concerns among commentators. A number fear that the scale of borrowing undertaken by households has already been so excessive that many will be unable to finance even modestly higher interest payments. This seems to us much too alarmist – even on the assumption that interest rates rise to 5%, our projections show that the proportion of household incomes taken by debt servicing will be close to its historic average. Moreover, while a small minority may struggle, many households have been building up their financial assets alongside their increased debt, on which they will earn a higher return as rates rise and which they could realise to repay debt if necessary.

Will it stall the recovery?

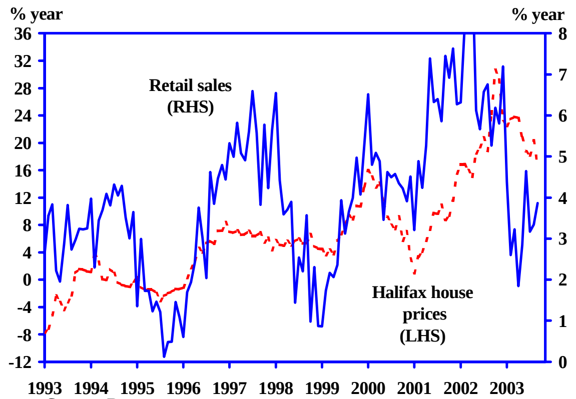
- A related concern is that the MPC's move will stall the emerging economic recovery, as consumers face cashflow constraints. It is certainly striking, for example, that the Bank of England is the first major central bank to tighten policy in this cycle, and it has done so while there is still plenty of spare

UK: Real interest rates



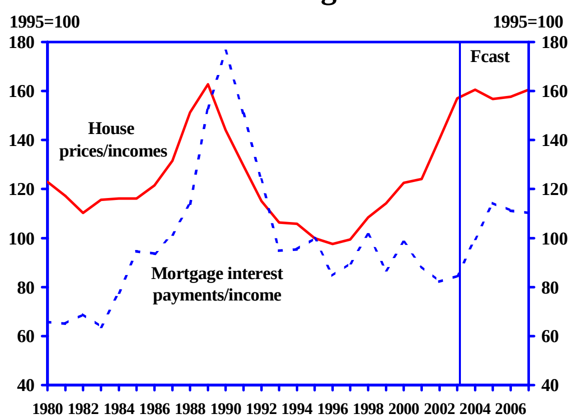
Source: OEF

UK: Retail sales and house prices



Source: Datastream

UK: Housing ratios

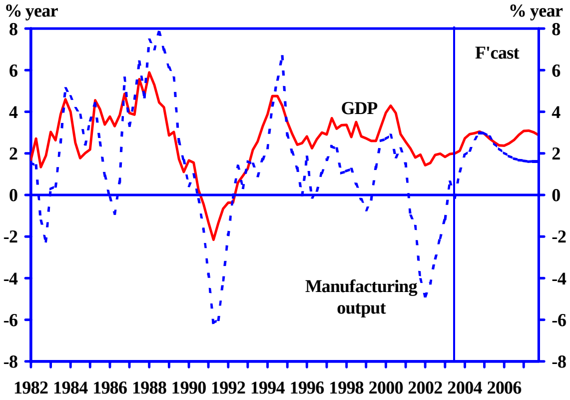


Source: OEF

capacity and before GDP growth has accelerated above its long-term trend rate. In Q3, GDP rose at an annualised rate of 2.4% - ie just below trend – in contrast to over 7% in the US. Moreover, while there are encouraging signs that business confidence and investment intentions are strengthening, the recovery in company spending is far from secure. And exports have continued to fall, dropping 2.9% in the three months to August compared with the previous three months.

- However, we were already factoring into our forecast a marked rise in interest rates from the New Year. And, as we have stressed before, interest rates remain very low by historic standards in both nominal and real terms. The MPC is simply attempting to restrain households, not choke recovery. We therefore see no reason to change our projection for GDP to rise 2.9% in 2004.

UK: GDP and manufacturing output

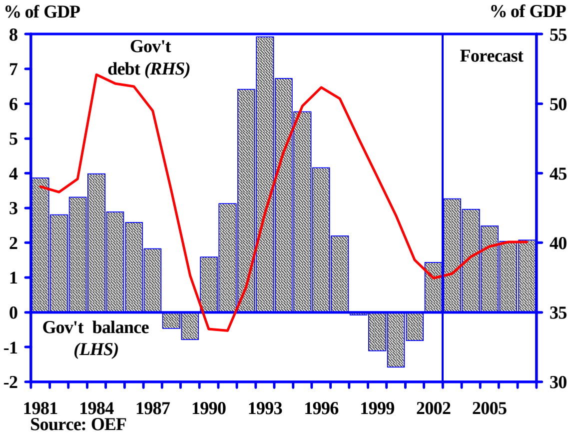


Source: OEF

Brown to admit another borrowing overshoot

- But even this acceleration in growth will not save the Chancellor from having to acknowledge another substantial overshoot in public borrowing this year when he presents his Pre-Budget Report. Our forecast shows net borrowing reaching £38 billion this financial year, breaching the Maastricht limit. And we expect the deficit to remain around 2% of GDP in the medium term, a long way from the Growth and Stability Pact's requirement of balanced budgets or surpluses. It is therefore no longer a question of whether but rather when there will be tax increases – they may even have to happen ahead of the next election to allow more money for public services.

UK: Maastricht indicators



Source: OEF

Key Indicators: United Kingdom

Percentage changes on a year earlier unless otherwise stated

	Manuf. output	Retail sales	Unempl-oyment *claimant%*	CBI total orders *% bal.*	Headline RPI	RPI ex-MIPs	Average earnings *headline*	Trade balance *£bn*
2002								
Nov	-1.6	5.8	3.1	-22	2.6	2.8	3.8	-5.1
Dec	-0.9	7.2	3.1	-32	2.9	2.7	3.8	-3.8
2003								
Jan	-0.9	4.4	3.1	-25	2.9	2.7	3.6	-3.9
Feb	-1.0	2.6	3.1	-31	3.2	3.0	3.2	-3.2
Mar	-1.4	3.2	3.1	-30	3.1	3.0	3.5	-3.7
Apr	-1.0	1.8	3.1	-29	3.1	3.0	3.3	-2.4
May	-1.7	2.8	3.1	-29	3.0	2.9	3.4	-4.0
Jun	4.8	4.6	3.1	-27	2.9	2.8	3.0	-4.5
Jul	0.2	3.2	3.1	-37	3.1	2.9	3.3	-3.0
Aug	-0.8	3.3	3.1	-24	2.9	2.9	3.4	-3.6
Sep	-0.4	3.9	3.1	-33	2.8	2.8	-	-
Oct	-	-	-	-40	-	-	-	-