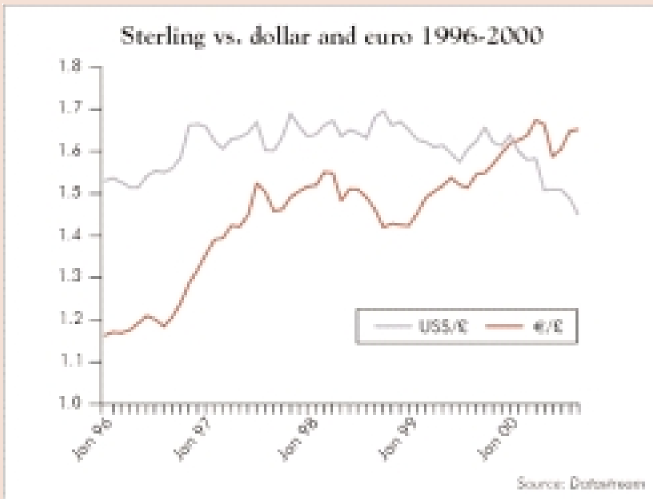
Millpond or roller coaster for the UK?

Jeremy Peat of The Royal Bank of Scotland Group looks at the three key factors which will influence the state of the UK economy.

Let me begin by being frank. The UK economic story is not an exciting one at present. A boring, benign, economy is good news for most of us, but does not make for stimulating reading. So rather than describing the domestic position and prospects, let me attempt to pick out three key issues to watch over the months ahead. Adverse developments related to these issues could transform our economy from a paddle across the millpond to a roller coaster.

FIGURE 1



US soft landing?

Perhaps the biggest question mark lurking on the economic horizon relates to the prospects over the next year or so for the US economy. US/GDP growth is generally believed to be above its sustainable trend. It is also agreed that the sustainable trend has risen in recent years, thanks to a marked pick up in productivity growth. However, there is no consensus as to how large or how lasting the increase will prove to be.

The Federal Reserve is now working on the assumptions

(a) that the increase in trend is of substance;

(b) that it will prove a structural shift rather than a cyclical 'blip'; and

(c) that the Fed's monetary tightening to date will prove sufficient to return the economy to the new trend, without inflation rearing its ugly head.

These are all major – and more or less unproven – assumptions.

The sensible, central, expectation is that the Fed will prove to be correct, and that the US will achieve a soft landing. However, assuming that there has been a fundamental shift in economic behaviour and inter-relationships is inherently risky. The clear alternative scenario is that some of their assumptions prove over-optimistic and that inflation does increase rapidly, requiring further, perhaps sharp, monetary tightening later this year. This would be aimed at slowing domestic demand growth, which in turn could de-stabilise equity and foreign exchange markets. The shock waves could ripple out widely.

Jeremy Peat

Future path of the euro

If trauma in the US is the key incipient external risk, then the over-valuation of sterling against the euro is the existing adverse external factor for the UK economy.

The good news is that the main European economies have been growing rapidly, resulting in strong demand for UK goods and services. Nevertheless, the sustained strength of sterling against the euro has limited our share of that growing market and also caused competitiveness problems in domestic and third-country markets. If there is not a significant £/€ depreciation before too long, then the continuing stability of the UK growth path will be placed at risk.

Predicting the timing and extent of sterling's depreciation against the euro is becoming increasingly difficult. Dollar strength and euro weakness are the main causes behind the current situation. Dollar strength may become more muted if the US achieves a soft landing. Fundamentally, however, a clear indication that the euro-zone is heading towards a US-style upward trend in underlying productivity growth is required.

There have been encouraging tax reforms in Germany and France, but there is no firm evidence that returns from investment in Europe will match those in the US in the next few years. Consequently, sterling depreciation is not guaranteed. The risks of continued over-valuation and competitiveness problems remain.

Sterling/dollar

Through all the traumas of the relationship between sterling and the fledgling euro, at least there has, in the past, been relative stability between sterling and the dollar. But that relative stability now looks far less reliable.

Perhaps we should not be surprised. If the dollar has remained so strong against the euro because of relative productivity trends, surely the same applies to sterling and the UK economy? The UK's trend growth rate has not risen towards 5% per annum. Our Monetary Policy Committee has internal disputes as to whether that trend rate is still 2.25% or 2.5%, or whether it might even be heading to 3%. The UK's trend growth rate is not markedly above that at the core of Europe, despite our more flexible labour force and supply side emphasis. We can operate at a lower level of unemployment, our NAIRU (non-accelerating inflation rate of unemployment) may be lower, but it is productivity growth that drives returns from investment.

The logic of this argument is that sterling could de-couple from the dollar and move more with the euro. In practice, we look set for a period in which sterling's relationship with both the dollar and euro is unpredictable and potentially volatile – and this applies even if the US does achieve that soft landing. ■

Jeremy A Peat is Group Chief Economist at The Royal Bank of Scotland.

ACT Cash Management Survey

The ACT Cash Management Survey has now closed. We are grateful to J. P. Morgan for sponsoring this survey and to our members for participating in it. Highlights appears with this month's magazine in the Liquidity newsletter insert.

The results provide a useful snapshot of treasurers' behaviours and views at a time of considerable change. I am pleased that the survey results indicate that the trend towards the use of the Internet is gathering pace particularly as the Association is investing considerable resources in boosting its services to members in this area. We hope that the 79% of respondents who use or intend to use the internet for market information will find the real time rates on our website useful.

It is also interesting that 43% of respondents are already using money market funds. This is a rather higher percentage than I would have anticipated and contrasts with the less surprising but still perhaps lower than anticipated percentage of treasurers considering outsourcing of treasury functions. It will be fascinating to see how these figures evolve in the future.

Those companies that participated in the survey and gave an e-mail address will receive a report by mid November comparing their answers with the average survey response.

Congratulations to the winner of the prize draw for the survey. The winner, who wishes to remain anonymous, has donated the prize to Centrepoint, a leading charity for the young homeless. The prize will be raffled off as part of Centrepoint's fund-raising activities. Centrepoint is a registered chartiy (no. 292411) and has been housing homeless young people for 30 years. ■

David Creed
Director General
Association of Corporate Treasurers

Note: if your copy of the Liquidity newsletter is missing and you would like a copy, please call the ACT on 020 7213 9728 for a copy to be sent to you.

Profile

IEUAN MARTIN GRIFFITH
International Financial

Age: 37

Education and Qualifications:
Llanelli Boys Grammar
1985 FCCA
1999 MCT*

Career history:
1981 Internal Auditor
UKAEA
1986 Retail Accountant
Tesco plc
1987 Regulatory Accountant
Corporation of Lloyds
Financial Accountant, Financial Analyst, ALCO Reporting Manager,
1989 International Financial Controller,
HSBC Group

"My career has been spent primarily within finance functions. First contact with treasury arose while working as a financial analyst reviewing the performance of overseas treasury operations. It was important to understand the products traded and their accounting treatment.

In 1996 I moved to HSBC Investment Bank, where I assisted in the development of the bank's asset and liability committee. I worked with the treasury teams to review liquidity and funding of the balance sheet, and I also spent time on secondment to the securities treasury team working on international equity issues.

As a result of this experience, I decided to sit the ACT examinations to increase my knowledge and it seemed the logical step to progress to MCT. My current role involves the appraisal of potential acquisitions and investments overseas, as well as considering the strategic development of our operations. In this regard, the Corporate Finance content of MCT has proved very useful. Despite not working directly in treasury, I'm glad I undertook MCT as it is much broader in content than the accounting qualifications. As for improving career prospects and salary? Well, it has certainly helped and

I'll tell you more in a few years time!"