SCHRODER SALOMON SMITH BARNEY

ECONOMIC & MARKET ANALYSIS

Sterling Weekly

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United Kingdom

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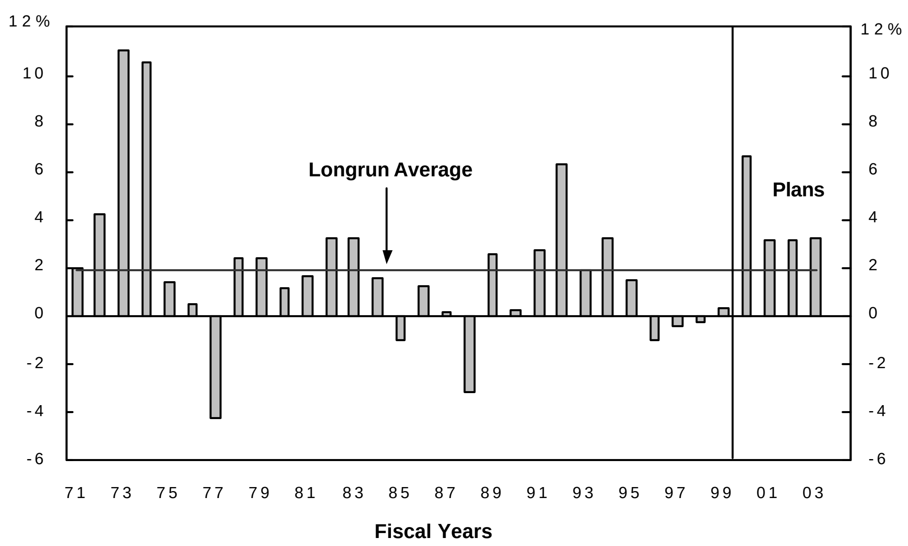
Forecasts	3-month Hence	12-month Hence
£/€	62	68
$/£	1.50	1.53
Base Rate	6.25	7.00
10 Year Yield	5.40	5.70
Spread vs Bunds	25bp	40bp
2028 Yield	4.65	4.90

Spending and EMU Poll

- The new spending plans confirm that fiscal policy will loosen by even more (from the 1999/2000 outturn) than implied by the Budget plans. The Treasury's figures show that real public spending will surge by 6.7% this year – the fastest pace for 25 years — and by 3%-3½% per year for the next three years. This huge fiscal boost, at a time when growth is above trend and capacity use is stretched, will intensify pressure for higher base rates. We expect rates to rise by 1% by mid-2001.
- Our new MORI poll shows a very sharp drop in public hostility to EMU entry. This swing probably reflects warnings by government ministers and others that if keeping sterling means job cuts in manufacturing, then the UK should join EMU (presumably at a lower exchange rate) and scrap sterling.
- The simultaneous drop in the government's popularity will mean that they probably will want to emphasise the rise in public spending rather than highlight possible gains from EMU entry. Nevertheless, markets put a low weight on the chance of an EMU referendum in late 2001 or in 2002, and the chances of a vote may be higher than markets allow.

Figure 1. UK — Treasury Plans for Real Public Spending (YoY Pct Change), Fiscal Years 1971/72-2003/04



Note: Figures are deflated by the GDP deflator.
Sources: HM Treasury and Schroder Salomon Smith Barney.

Fiscal Boost Points to Upside Growth Risk

Fiscal stance is set to loosen massively. . .

The cautious tone of Gordon Brown's rhetoric in delivering the Comprehensive Spending Review seems to have helped limit the market impact of the statement. But one should not lose sight of the underlying picture. On the Treasury's own estimates, the fiscal stance will loosen by about 1½% of GDP this year, and by a further 2% of GDP over the next three years. So the total loosening is about 3½% of GDP over the four years 2000/01-2003/04. This easing will all come via a surge in real public spending growth to 6.7% this year — the highest pace for 25 years — and 3%-3½% per year in the fiscal years 2001-2003. By contrast, the fiscal stance has tightened by a total of about 4% of GDP over the past three years and real public spending has not risen at all over that period.

. . . posing upside risks to consensus growth forecasts. . .

This fiscal boost almost totally reflects government consumption and investment, and so will flow fairly directly through to domestic demand. This represents an upside threat to consensus growth and inflation forecasts (which of course predate the new public spending plans). The consensus view is that GDP growth will slow in coming quarters, so that GDP growth averages 2.9% in 2000 as a whole (from 3.0% in Q1 and 3.1% in Q2), and 2.6% next year. Within the consensus view, this slowdown will happen with little or no rise in base rates. We cannot tell what path for *total* public spending is built into the consensus growth forecasts. But we can see that the consensus assumes that real government consumption will rise by 3.1% in the 2000 calendar year and 3.4% in 2001, whereas it fell by 0.1% YoY in Q1 this year.

. . . which do not seem to allow for the full extent of the likely surge in spending

The consensus figure for government consumption growth over 2000 and 2001 combined is similar to the Treasury's Budget-time forecast. But it is low versus the new spending plans, which raised significantly the planned growth of real spending. The new plans show departmental spending ex-investment (which roughly corresponds to government consumption in the national accounts) will rise by an average of 5½% per year in real terms over the 2000/01 and 20001/02 fiscal years. This spending surge already seems to be underway. The YoY gain of central government current spending (ex social benefits and debt interest) rose to 9.3% YoY in Q2 in nominal terms, from 5.2% YoY in the 1999/2000 fiscal year.

Public spending surge will add to pressure for higher base rates.

If the consensus assumed that real government consumption would rise by about 5% YoY on average in 2000 and 2001 (rather than 3%-3½%), then — ignoring other changes or any multiplier effect on private spending — this would add 0.3%-0.4% to consensus GDP growth forecasts in both years. The consensus also may understate the likely pickup in public investment. Faster growth will add to pressure on capacity use. In practice, we expect that this fiscal stimulus, plus the signs that consumer spending and business investment are not slowing much anyway, to keep GDP growth at 3%-3½% for both this year and the next. Unless sterling soars — and we suspect that the worsening current account, rising ECB rates and growing UK political uncertainties will prevent sterling from strengthening — then over time base rates are likely to have to rise quite sharply to slow domestic demand growth back to trend. Indeed, eventually, it may be necessary to slow growth below trend. We look for base rates to rise by 50bp by yearend, and to about 7% over the next year. It is far too early to call the peak in rates.

The Pro EMU Camp Fight Back

Very sharp drop in public opposition to EMU entry, both using a simple "how would you vote" question . . .

The renewed focus on EMU in the past couple of months – and in particular the damage to UK manufacturing from the high pound — has caused a very sharp drop in public hostility to joining the single currency. Using the question "*If there were a referendum now on whether Britain should be part of a single European currency, how would you vote?*" the share that favours EMU entry has risen from 25% in May to 31% as of 13-18 July, while the share against EMU has fallen from 60% to 51%.[1] Thus, the balance of opinion against EMU entry has plunged from 36% to 20%.

Figure 2. Question 1: *"If there were a referendum now on whether Britain should be part of a single European currency, how would you vote?"* Nov 1997-July 2000

	Nov 97-Nov 99 Average	Monthly Surveys By Survey Date					
		Sep 99	Nov 99	Jan 00	Feb/Mar 00	May 00	Jul 00
In Favour	30%	30%	27%	29%	26%	25%	31%
Against	53	56	56	56	58	60	51
Don't Know	16	14	17	14	15	14	17
Balance	**-23%**	**-26%**	**-29%**	**-27%**	**-32%**	**-36%**	**-20%**
Balances Split By Voting Intention							
Labour	-9%	-9%	-10%	-11%	-18%	-18%	2%
Conservative	-54	-67	-67	-62	-64	-72	-52
Liberal Democrat	-13	-16	-23	-20	-29	-26	-11
Other/Would Not Vote/Undecided	-25	-24	-30	-29	-35	-34	-21

Note: Latest polling conducted between 13 and 18 July 2000. Sample size 2,055 people for latest survey, and similar for earlier results.
Sources: MORI Financial Services and Schroder Salomon Smith Barney.

. . . and allowing for the effects of a pro-EMU stance from the government

The trend is similar using our second question: "*If the government were to strongly urge that Britain should be part of a single European currency, how would you vote?*" On this question, the share that favours EMU entry rose from 29% in May to 37% now, while the share against fell from 57% to 47%. Thus, the balance of opinion against EMU entry tumbled from 27% to 10%. On both questions, the balance of opinion against EMU is the lowest since early last year, and 3 percentage points below the average for 1997-99. The swing since May is the sharpest drop in hostility to EMU in recent years, although admittedly this comes after a sharp rise in hostility to EMU in late 1999 and early this year.

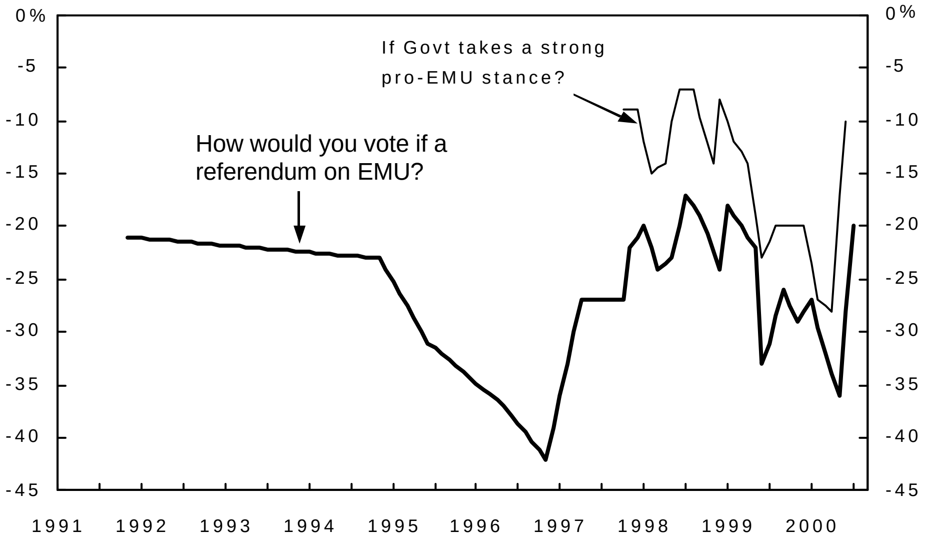
[1] See "Lower Pound and Higher Rates", *Sterling Weekly*, Schroder Salomon Smith Barney, 19 May 2000.

Figure 3 Question 2: *"If the government were to strongly urge that Britain should be part of a single European currency, how would you vote?"* Nov 1997-Jul 2000

	Nov 1997- Nov 99 Average	Monthly Surveys By Survey Date Sep 99	Nov 99	Jan 00	Feb/Mar 00	May 00	Jul 00
In Favour	36%	33%	31%	34%	30%	29%	37%
Against	49	53	51	53	56	57	47
Don't Know	15	13	17	12	14	13	15
Balance	**-13%**	**-20%**	**-20%**	**-20%**	**-27%**	**-28%**	**-10%**
Balances By Voting Intentions							
• Labour	4%	1%	4%	0%	-12%	-5%	15%
• Conservative	-47	-65	-58	-56	-58	-66	-45
• Liberal	-6	-15	-15	-12	-25	-22	-1

Note: Latest survey was conducted between 13 and 18 July 2000.
Sources: MORI Financial Services and Schroder Salomon Smith Barney.

Figure 4. UK – Balance of Opinion Over EMU, 1991-Jul 00



Note: The chart shows the gap between the share of the sample who say that they would vote to join EMU less the share opposed, using questions 1 and 2.
Sources: MORI Financial Services and Schroder Salomon Smith Barney.

The drop in public hostility to EMU probably reflects evidence that the strong pound has a downside. In 1999 and early this year, the pro-EMU case was dented by sterling's rise against the euro: why should the UK join a currency that is weak? Now, the cost of the high pound – lost jobs in manufacturing — is clearer, allowing the pro-EMU camp to link lost jobs with the UK's decision to stay out of EMU.

Drop in opposition to EMU probably reflects argument that keeping sterling costs manufacturing jobs

- Various companies (Ford, Corus, Toyota) have either cut jobs, announced plant closures or warned that future investment is at risk from the high pound. Speeches or statements from Foreign Secretary Robin Cook, Northern Ireland Secretary Peter Mandelson and Trade and Industry Secretary Stephen Byers have argued that the damage to manufacturing from the high pound reflects the decision to stay out of EMU. By contrast, over the first few months of the year, no one from the government was making an economic case for EMU entry.

- Although inward investment stayed high in 1999, two leaked memos (from the Invest on Britain Bureau and the British Ambassador to Japan) have warned that inward investment may fall in the future because of the high pound and uncertainties over the UK's attitude to EMU.
- The OECD argued in June that the UK economy was no less convergent with the rest of the euro area than some of the countries inside EMU.

In practice, it is not definite that EMU entry would weaken sterling much…

It is not certain that sterling would fall if the UK decided to join EMU. The exchange rate at which the UK joins EMU, if and when this occurs, must be agreed with the existing euro-area countries. For example, if the UK wanted to join EMU now, then the existing euro-area countries might argue that the UK cannot join at an exchange rate that is weaker than the average seen since EMU's start — which is 64p/euro. Although UK manufacturing has been soft over that period, overall GDP growth has roughly matched the euro-area average. For many UK manufacturers, that would still be a painfully high level.

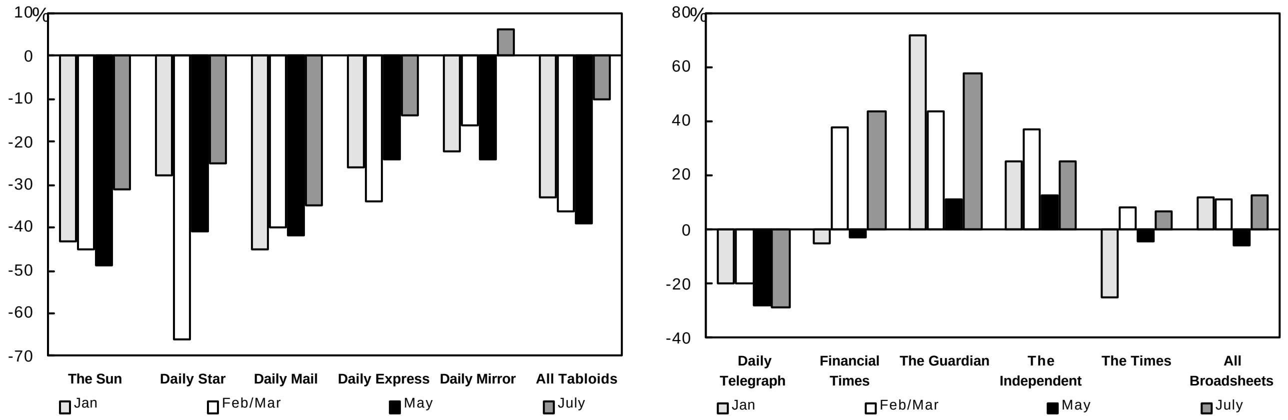
. . .but in any case at least the pro-EMU camp have had an economic argument on their side

But in any case, the pro-EMU camp at last have had an economic argument in favour of EMU entry: if keeping the pound means lost jobs in manufacturing, then it would be better to get rid of the pound. Whether this case is true or not, one cannot deny that the pro-EMU camp now have a better line of argument than previously. Moreover, gradually, UK voters may be becoming aware of the strength of both economic growth and job growth in the euro area.

Opposition to EMU entry has fallen sharply among tabloid readers

The split shows that opposition to EMU entry has fallen sharply across all people who support Conservatives as well as Labour, and across all social classes (a proxy for incomes). Split by newspaper readership, the sharpest drop in hostility to EMU is among tabloid readers, with the balance against EMU entry (using question two) down to 10% from 39% in May. This is the lowest balance against EMU entry among tabloid readers since we began our regular polls in late 1997 (the previous low was 16% in mid-1998). Among the tabloid press, the Express and Mirror have tended to highlight that staying out of EMU might mean a high pound and hence job losses, and public opposition to EMU entry has fallen sharply among their readers. By contrast, the Sun has not linked the decision to stay out of EMU with job losses in manufacturing, and there has been less swing among its readers.

Figure 5. UK — Balance of opinion Over EMU (Question 2) Among Readers of the Tabloid Press (Left) and Broadsheets (Right), Jan-Jul 00



Note: The chart shows the gap between the share of the sample who say that they would vote to join EMU less the share opposed, using question 2.
Sources: MORI Financial Services and Schroder Salomon Smith Barney.

The pro EMU camp will view this shift as being a large gain for little effort. . .

The sharp drop in public hostility to EMU will doubtless encourage the pro-EMU camp (and, within the government, Northern Ireland Secretary Peter Mandelson, Foreign Secretary Robin Cook and Trade and Industry Secretary Stephen Byers). They probably will argue that, with minimal political effort, public opinion has made a significant turn around based on fears of a weaker manufacturing sector. The pro camp might argue that by playing to these fears, they could make political inroads by saying they are the party that will protect manufacturing jobs as well as improving public services.

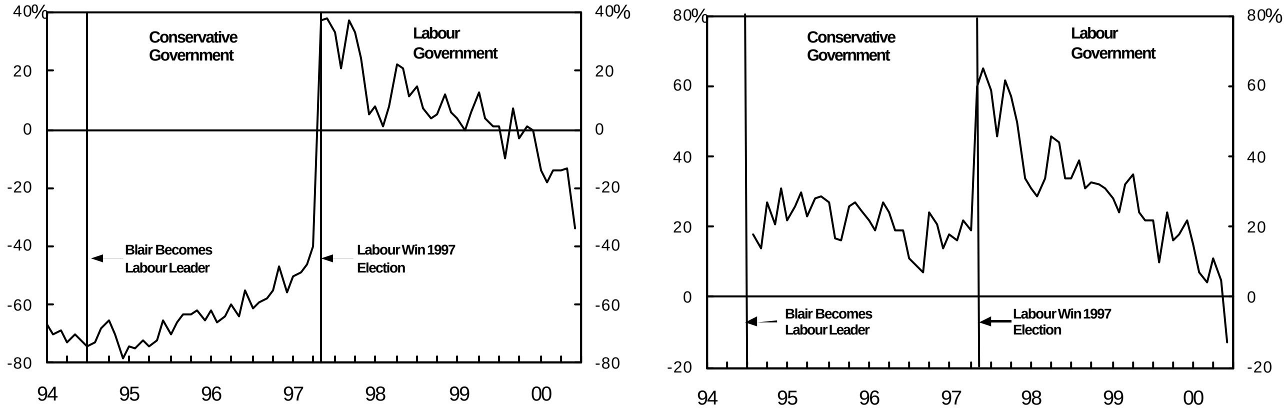
. . . but EMU is not yet a vote winner for Labour. . . .

But we suspect that Blair and Brown will remain reluctant to advocate EMU entry too strongly before the election, will continue to emphasise the economic tests and will remain ambiguous over whether or not there will be a post election referendum. EMU is still not a politically-advantageous issue for the government to emphasise in the runup to the election. A clearer pro-EMU approach from the government may succeed in converting more people in favour of EMU. But it also would elevate the issue, and make it clear to all voters and the tabloid press that Labour is the pro-EMU party. This might hurt Labour’s overall appeal to other voters who remain hostile to EMU entry.

…and the Government will want to focus on vote-winning issues

Recent polls have shown a sharp drop in public satisfaction with both the government and Prime Minister Tony Blair. MORI also report that Europe has risen to third among voters’ concerns (behind health and education, and just ahead of crime). The new spending plans aim to satisfy public disquiet over health, education and crime, with big increases in spending on each area. Labour will not want to give the Conservatives an opening to make EMU the central issue at the election, but will want to keep the focus on the low jobless rate and planned gains in public spending.

Figure 6. UK — Satisfaction Balances for the Government (left) and Mr. Blair (right), 1994-Jun 00



Note: Figures show the difference between the share of people who say they are satisfied with the government's (or Mr Blair's) performance less the share that are dissatisfied.
Sources: MORI and Schroder Salomon Smith Barney.

The Danish vote will be an important signal for the UK

The Danish EMU vote probably will be a fairly important factor in the government's EMU tactics. A "Yes" vote in Denmark would boost the pro-EMU camp in the UK, although it would not guarantee that a "Yes" campaign could win in the UK. After all, public hostility to EMU is higher in the UK than in Denmark. Conversely, a Danish "No" vote, despite wide support for the pro-EMU camp from major political parties would make the UK government more reluctant to push EMU strongly.

Early referendum will only come into play if public opposition to EMU falls further

Previously, we have argued that the chances that the UK joins EMU in the next five or six years is about 50:50. This poll suggests that the chances of a referendum may be higher than that, and that the public may be more receptive than previously thought to economic arguments in favor of joining EMU. However, public support for EMU entry would still have to rise significantly further to allow the government to risk a post election referendum, especially if the general election produces a small Labour majority or even a hung parliament. Note that a referendum in late 2001 or in 2002-03 would not affect the monetary policy outlook for the next year, but it would open up scope for lower short rates (and higher long yields) on a 2-5 year horizon. Either way, we shall keep reporting the results.

Economic Indicators

Tue 25 Jul	***Overall Trade Balance (May)***	**Forecast: £-2.2 billion**
		Previous: £-2.5 billion
	Non-EU Trade Balance (Jun)	**Forecast: £-2.2 billion**
		Previous: £-1.8 billion

Partial data already have been released showing that the UK's trade gap with non-EU countries fell from £32.3 billion in April to £1.8 billion in May, and hence — even with a worsening in the intra-EU trade gap to £0.4 billion from £0.2 billion in April — we expect the overall trade gap to edge lower. Nevertheless, the trend in the trade gap probably will continue to widen. A figure in line with our forecast would put the average deficit for April and May at £2.35 billion, compared with £2.2 billion in Q1. May's drop in the trade deficit for non-EU countries was largely because of a favourable swing in erratic items, and hence we expect the non-EU deficit to widen again in June as this effect reverses.

Wed 26 Jul	***CBI Quarterly Industrial Trends Survey (Jul)***	
	Industrial Confidence (Jul)	**Forecast: –15%**
		Previous (Apr): –2%
	Output Expectations (Jul)	**Forecast: –8%**
		Previous (Jun): –7%
	Order Books (Jul)	**Forecast: –20%**
		Previous (Jun): –18%
	Price Expectations (Jul)	**Forecast: –16%**
		Previous (Jun): –18%

Business confidence weakened sharply in the April quarterly survey and — with the gloom over the high pound, official disarray over EMU, and the pending rise in tax bills from the climate change levy — probably will weaken further in the July survey. Such a reading would put business confidence at its lowest level since the first quarter of last year. The output and orders series tend to weaken slightly between the June and July surveys because of seasonal factors and, with the weakness in the car sector, we also expect a slight drop this year. The series for prices, however, may turn slightly less negative because of the cost pressures from the rise in oil prices.

Mon 31Jul	***M0 (Jul)***	**Forecast: 0.4% MoM, 7.3% YoY**
		Previous: 0.6% MoM, 7.5% YoY

Partial data suggest that narrow money growth again slowed slightly in July, although we may review this forecast as weekly data for the second half of the month emerge. Narrow money growth has been slowing gently in recent months, and a figure in line with our forecast would put it at its lowest annual rate since April 1999. Nevertheless, such a pace would not be soft in any significant sense, but really is very similar to the average for the past 30 years (7.5%).

Mon 31 Jul	***Personal Borrowing (Jun)***	**Forecast: £5.0 billion MoM, 9.9% YoY**
		Previous: £5.0 billion MoM, 9.8% YoY
	Mortgage Lending (Jun)	**Forecast: £3.6 billion MoM, 8.8% YoY**
		Previous: £3.4 billion MoM, 8.7% YoY
	Consumer Credit (Jun)	**Forecast: £1.4 billion MoM, 14.5% YoY**
		Previous: £1.6 billion MoM, 14.5% YoY
	Mortgage Commitments (Jun)	**Forecast: £10.1 billion MoM, –3.5% YoY**
		Previous: £10.2 billion MoM, 2.0% YoY

The rebound in mortgage commitments seen in May suggests that mortgage lending itself will strengthen in June, lifting its annual gain to the highest since late 1991/early 1992. We doubt that consumer credit will accelerate further — surveys suggest that June retail sales were slower than in May — but the pick up in mortgage lending probably will keep total personal borrowing growth rising further. A figure in line with our forecast would put the annual growth of total personal borrowing at its highest since 1991. A key figure to watch is the June reading for mortgage commitments. These peaked at £10.5 billion in June last year, remained around £10 billion for the rest of last year, slipped to £9-10 billion in December-February, rose back to £10.4 billion in March this year, weakened to £9.2 billion in April and then rebounded to £10.2 billion in May. So the trend recently looks flat, albeit volatile. But mortgage commitments are a good guide to housing trends, with the advantage that they are released relatively early in the process of moving house.

Tue 1 Aug	***Purchasing Managers' Index (Jul)***	**Forecast: 50.5**
		Previous: 50.2

The PMI for manufacturing has been roughly stable in the past three months at 50-51, and we suspect that it will remain around that range in the July survey. The new orders series is not showing a clear trend, and this often leads turning points in the overall index. The prices series rose to 61.4 in June, close to the 5-year high of 63.3 seen in April. We expect this index to strengthen again in July, because of the rise in oil prices and the boost to import prices from the drop in sterling seen in May-June. This would signal that the official input price data also will show continued strong gains in cost pressures.

Economic Calendar, 17 Jul – 4 Aug 2000

Monday	Tuesday	Wednesday	Thursday	Friday
17 **ECOFIN Meeting**	18 **Gordon Brown Comprehensive Review 2000 to**	19 **Retail Sales (Jun)** May 0.2% (3.5%) Jun 0.7% (4.5%) **MPC Minutes (6 Jul)**	20 **M4 (Jun)** Jun 0.8% (6.9%) **M4 Lending (Jun)** Jun £5.6B (10.9%) **Public Sector Net Requirement (Jun)** Jun00 £7.7B (£- **Public Sector Net Borrowing (Jun)** Jun00 £2.7B (£4.4B **ECB Council Meeting** **US: Greenspan**	21 **GDP (Q2,** Q1 0.5% QoQ (3.0%) Q2 0.9% QoQ (3.1%)
24	25 **Overall Trade (May)** Apr £-2.5B MayE £-2.2B **Non-EU Trade (Jun)** May £-1.8B JunE £-2.2B **Treasury Select Gordon Brown on Spending Review** (10:45)	26 **CBI Quarterly Survey (Jul, 11:00)** **Industrial** Apr -2% JulE -15% **Output Expectations** Jun -7% JulE -8% **Order Books (Jul)** Jun -18% JulE -20% **Price Expectations** Jun -18% JulE -16%	27	28
31 **M0 (Jul)** Jun 0.6% (7.5%) JulE 0.4% (7.3%) **Personal Borrowing** **Mortgage Lending** **Consumer Credit** **Mortgage**	1 **Purchasing Index (Jul)** Jun 50.2 JulE 50.5	2 **CBI Distributive Survey (Jul, 11:00)** Sales Jun +15% YoY Sales JulE +30% YoY **BoE MPC Meeting**	3 **Services PMI (Jul)** Jun 57.2 JulE 57.5 **BoE MPC Meeting: Announcement at** **ECB Council Meeting** (Press Conference)	4

E Schroder Salomon Smith Barney estimate. P Provisional. R Revised.

Note: All data are month-to-month percentage changes, except those in parentheses, which are year-to-year changes. All data are released at 9.30 a.m., except those marked otherwise.