

Caught on the hop

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OTTAWA — You would think that this autumn's spate of bank collapses and the wild gyrations of stock markets would have pummelled analysts into a state of resignation where they were beyond surprise.

Still, the Bank of England's announcement on Thursday that it was dropping its key interest rate by 1.5 percentage points to a 54-year low of 3 per cent seemed to catch just about everyone on the hop.

The instant analyses, liberally sprinkled with words like shocking, stunning, unexpected, amazing and dramatic, read like a thesaurus entry for the word surprise. And yet, the real surprise to anyone who has looked at the miserable state of the British economy is that so few anticipated the central bank's move.

It is not as though Britain only recently discovered it had economic problems that in some cases go deeper and are more serious than the ones that have driven the United States into recession.

The run-up in house prices was steeper there than in the U.S. In every region of the U.K., house prices more than doubled during the boom, according to the Halifax house index.

The bubble burst in late 2007 with a resounding pop, and in the last year the average price of a house has fallen 12.3 per cent, with more precipitous drops in the London area (16.5 per cent) and Northern Ireland (23 per cent). Negative equity is not just a U.S. phenomenon. A significant number of British homeowners now find they owe more than their house is worth.

When prices were still on the rise, British consumers piled into the market, loading up on debt to buy a house. In August, 2007, the amount borrowed through mortgages, loans and credit card balances, surpassed the entire value of the U.K. economy. The accounting firm Grant Thornton, which compiled the figures, decried the "buy now, pay later" culture that had swept the country.

Mark Allen, a Grant Thornton partner, said at the time that it was not uncommon for some individuals to have unsecured debt of £50,000 (about \$93,000) spread across four or five credit cards, with a mortgage on top of that. All it took for them to fall off what he called "a perilous financial tightrope" was an increase in costs or a rise in interest payments.

The increase in costs was not long in coming. Oil and food prices skyrocketed, pushing inflation higher. Intent on containing inflation, the Bank of England kept interest rates relatively high, dropping them gradually from 5.75 per cent in mid-2007 to 4.5 per cent, where they were until Thursday's cut.

Meanwhile, as predicted, the debt-laden British consumer was falling off the tightrope. As consumer confidence plunged, the economy went with it. The housing market froze, unemployment rose, sales of new cars dropped (they are down 23 per cent in the last year), and factory output has fallen for seven months in a row. The economy contracted at an annual rate of 2.2 per cent in the third quarter of 2008.

Most of these factors were in place long before banks started tumbling in the U.K. and the U.S. in September. As elsewhere, the financial turmoil exacerbated existing problems, even as it created some new ones. (As the North American auto makers and Canada's forest industry have discovered, the credit crunch can appear life-threatening when you are already in a weakened condition.)

As a major global financial centre, London felt the impact of the bank collapses and credit squeeze more than most. Newly unemployed bankers and a struggling financial sector now added to the weight dragging down the economy.

At some point between its modest interest rate cut in October and Thursday's move, the Bank of England realized that a severe and prolonged economic collapse was more of a threat than inflation which, while high at 5.2 per cent in September, had been dropping and is now expected to plummet. Whether this recognition of the real enemy comes too late will not be known for some time.

All of this should be of more than passing interest to Canadians. The United Kingdom is both a significant trading partner and an important source of investment to Canada. With the U.S. already on the ropes, the prospects of expanding trade and investment relations with others are much reduced with the U.K. also in dire straits.

When you look back at the steady accumulation of evidence that the country was heading for disaster, the biggest surprise is not that the Bank of England finally moved, but that so few people saw it coming. Perhaps the world was so transfixed by the political and economic drama playing out in the U.S., that other looming crises were overlooked.

Which makes you wonder how many more unpleasant surprises yet lie in store.

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