**<u>Pass 1</u>**

**<u>Introduction to the assignment;</u>**
I am a business advisor employed by the Federation of Master Builders, whose members include self-employed house builders and large construction companies like Barrett Homes or Laings.
I have been asked to write a report, predicting conditions in the market for house building and construction for the year ahead (2007), which will be available free to all Federation members to help them with their forward business planning.

**What is inflation?**
Inflation is the rate of increase in the level of prices for goods and services, which affects the purchasing value of money.

**What are Interest Rates?**
Interest rates influence spending and saving in the economy and the prices we pay for goods and services.

Low inflation helps to maintain a stable economy and the value of our money. Interest rates affect inflation in a big way, and this is because interest rates are increased to moderate demand and inflation, and they are reduced to stimulate demand.
If interest rates are set too low, this could encourage the build up of inflation pressure, and if they are set too high demand will be much lower.

Interest rates have to be set on what inflation might be over the coming two years, this is because after a recession when output has been failing, there will be a lot of spare capacity in the economy, which means output will be able to rise strongly without inflationary pressure.
If inflation goes up, interest rates go up, but when this happens, demand for goods go down, and inflation also goes down.

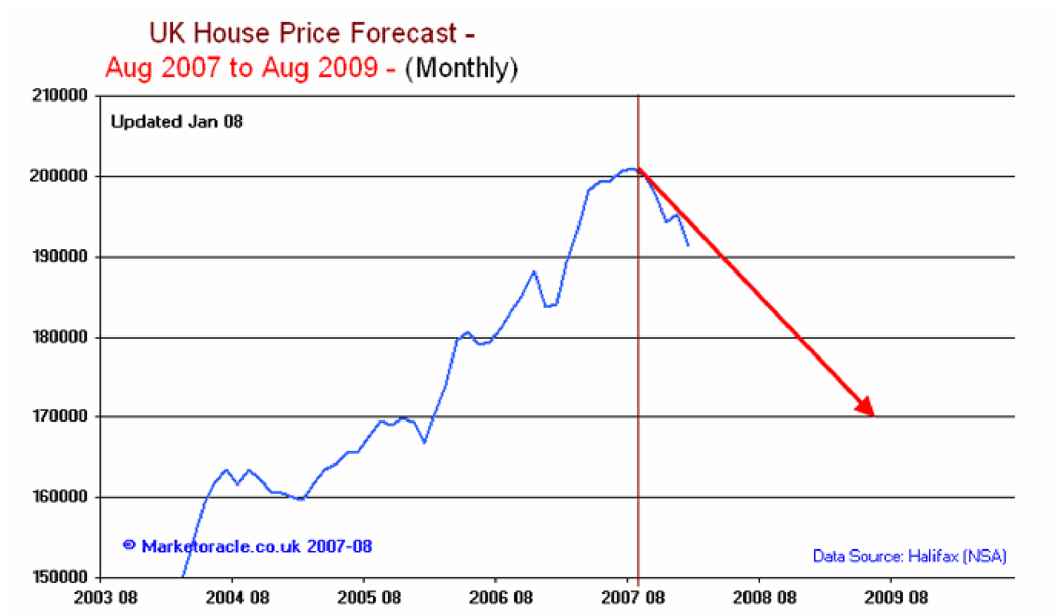
A change in the official Bank Rate could have some immediate effects, such as; consumers confidence which may influence spending straight away. Generally a change in the official Bank Rate takes time to influence consumers and businesses behavior and decisions. Basically, today, a change in interest rates will be likely to have a huge effect on output over a period of time, approximately a year, and on inflation over a period of a couple of years.

**The impact on the housing market of changes to UK interest rates;**
The housing market has been a contributor to past instability in the UK economy, and that moving to a fixed rate structure would reduce the impact of a change in interest rates.

The Bank of England changes its base rate because; when the interest rates go up, money becomes more expensive and demand for money then goes down; consumers and businesses don't borrow so much and therefore spend less, causing inflation to go down; and when inflation drops again the Bank of England lowers the base rate, and this is because mortgages get more expensive and people have less money to spend on themselves.

This graph shows the data of; UK House Price Forecast, from August 2007-August 2009. By looking at this graph, you can see that from August 2007, a fall in average house prices will occur over two years to August 2009.

This data was found out from Britain's biggest mortgage bank, Halifax.




By looking at the table below, you can see that UK house prices will turn negative, from April 2008 onwards.

| Annualised UK House Price Inflation 2008 | Stabalised house prices | House prices fall by £500 per month |
|---|---|---|
| March 2008 | 1.1% | 0.6% |
| April 2008 | -1% | -1.8% |
| May 2008 | -3.5% | -4.5% |
| June 2008 | -4% | -5.3% |
| Dec 2008 | -1.5% | -4.4% |

"The UK housing market price trend is on target towards a 15% fall in nominal terms by August 2009. This would associate to a real terms fall of more than 20% and could push the UK into recession during late 2009."

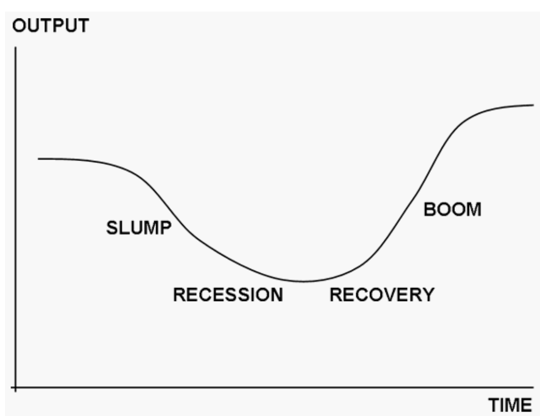
Source: http://www.financialsense.com/fsu/editorials/walayat/2008/0208.html

**Interest rates: what will happen next?**
"Uncertainty surrounds the direction in which world interest rates are going amid the turmoil on financial markets."
UK interest rates have climbed five times since August 2006 and now stand at 5.75%. And until recently, most bets were on the Bank upping rates again before the end of the year as it tried to keep inflation under control.
However turmoil in the markets, not least the crisis surrounding Northern Rock, has changed all that.
Now analysts agree that it is unlikely that rates will rise further, with many predicting a cut in interest rates, perhaps before the end of the year.

Source: http://news.bbc.co.uk/1/hi/business/7003134.stm

The news article above predicts what will happen to interest rates over coming years. From the information that I have gathered, it is possible that interest rates will not rise again due to the Northern Rock crisis.
In my opinion, it is better that interest rates do not rise and stay the same, because if interest rates go up, demand for goods will go down, and inflation will also go down. And if this does happen, we will benefit from not spending too much money on products for ourselves.

**The trade cycle;**
The economy tends to experience different trends, and these can be categorized as the "**trade cycle**", and this features; boom, slump, recession and recovery.




***BOOM***: A period of fast economic growth. Output is high due to increased demand, unemployment is low. Business confidence may be high leading to increased investment. Consumer confidence may lead to extra spending.

***SLUMP***: A period when output slows down due to a reduction in demand, and confidence may begin to suffer.

***RECESSION***: A period where economic growth slows down and the level of output actually decrease. Unemployment is likely to increase. Firms may lose confidence and reduce investment. Individuals may save rather then spend.

*Problems:*

- lower levels of consumer spending/demand in most markets
- unemployment, because businesses cut production and make workers redundant
- more business bankruptcy
- business confidence falls

*But:*

- less inflation – interest rates may fall
- business that do survive, may be forced to become leaner and fitter

***RECOVERY***: A period when the economy moves between recession and a boom.

*Advantages:*

- higher levels of consumer spending/demand in most markets
- profits rise and businesses raise production
- fewer business liquidations
- business confidence rises

*Disadvantages:*

- inflation will start to rise – requiring policy action, e.g. interest rate rises
- business may not have the capacity to respond to the increased demand

So the government would be concerned that a recession does not go too low or for too long, but on the other hand, that a boom does not go too high as this can cause economical and political problems.