

Weekly Bulletin – 30th April 2007

The UK interest rate market continued its gradual drift to higher levels last week, despite efforts by various members of the MPC to apply a calming influence. In last week's Bulletin we raised the potential prospect of the MPC's eventually being forced into taking more drastic action than the occasional 0.25% rate hike to bring longer term inflationary pressures under control, with this, in turn, leading to considerably higher rates than currently anticipated by the market. This was a topic that emerged at several meetings last week and we should emphasise that we think it is longish odds against its happening – it is just that the odds are coming down.

It was also a topic that Professor Tim Congdon and a number of other illustrious economists took up in a letter to the Financial Times last week. Tim Congdon made his reputation as a firm monetarist and it is clear that his principles have not changed very much over the years. As this Bulletin has noted quite frequently, the M4 money supply measure has been running at high levels and last week saw March's figure rise a notch to 12.8%. This is well down from the 14.4% reached last September, but still represents a very high level. The MPC, while recognising that it is running at high levels, have been anxious to play down the importance of money supply as a guide to future inflation levels. Mervyn King has noted that there 'is great difficulty in making a clear numerical link between a picture growth rate of money and credit and the consequences for inflation'. More recently Paul Tucker described rapid money supply growth as being no more than an amber light.

The reticence of the MPC to give too much credence to the money supply figures is hardly surprising since the days of hard line monetarism date back to the reign of Margaret Thatcher when Sir Keith Joseph was her chief adviser. It was applied with such vigour that even Milton Friedman, who virtually invented monetarism, disowned its application in the UK. Having gradually fallen out of favour, monetarism was totally ditched by Nigel Lawson when he decided that interest rate policy should be determined by maintaining a set parity against the deutsche mark. Both policies were disastrous and set a trend of complete ineptitude that the following Conservative chancellors had no problem in maintaining.

While Tim Congdon may have mellowed somewhat over the years his views on the influence of money supply on inflation have remained constant. His belief is that if money supply remains at current levels it is inevitable that rates will rise to between 6.00% and 6.50% and, according to a quote in the Daily Telegraph 'may have to reach 7.50%'. The rationale behind monetarism is that if there is a rise in cash held by individuals or corporates, it is likely to prove to be the precursor to inflation. It is very important, therefore, to note the individual make-up of the money supply constituents. While there is no doubt that there has been a build-up in cash held by corporates, the real driver of the growth in money supply has been in the holding of 'other financial institutions'. It is not clear to us why the increase in this category should necessarily lead to inflation and Tim Congdon's message would become much more credible if it included an explanation of this point.

This week is relatively thin in terms of economic news that may prove influential. The CIPS survey on manufacturing is released tomorrow and would surprise if there were a major change, in either direction, from last month's healthy 54.4 mark. The CBI Distributive Trades survey is also released tomorrow and, having risen to a remarkable +32 in March, the median expectation is that it will have fallen back to around +25 in April. On Wednesday consumer credit and mortgage applications are released with the latter expected to show a small reduction. Thursday sees the release of the latest CIPS survey on the service sector which is expected to maintain a figure close to last month's pretty buoyant 57.6. Finally, the latest personal bankruptcies data will be announced on Friday and are expected to maintain their rapid upward momentum.

We suspect that this will prove to be a fairly quiet week in the domestic market with none of the economic data likely to prove influential enough to have much of an impact. With the FOMC, ECB and MPC all meeting next week, all the markets may well decide that rate levels have moved up to levels where most of the immediate adverse news has been completely discounted and they can afford to relax at current levels.

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