



Weekly Bulletin – 2nd July 2007

While the UK debt market remains very volatile, there have been signs over the past two weeks that it has reached a level where there is some resistance to term rates moving ever higher. This week sees period rates start the week at levels very similar to a week ago.

Last week saw the long awaited replacement of Tony Blair by Gordon Brown as Prime Minister and the appointment of Alistair Darling as the new Chancellor of the Exchequer. The appointment of a new Chancellor, especially when it is the first in ten years, would normally produce acres of press coverage. Not in this case, as nobody is expecting Gordon to do anything other to continue to dominate economic policy, even when the early days of his reign are marked by the dreadful diversions of a new terror campaign. As it is, Alistair Darling was a well established previous member of his economic team and was instrumental in bringing about many of Gordon Brown's economic policies – both good and bad.

Quite apart from it being unlikely that he would wish to change very much of the current macro economic policy, Alistair Darling also suffers from the assumption by most commentators that he is only in the job on a temporary basis until it is perceived that Ed Balls, who is regarded as Brown's most influential adviser, has sufficient experience to take such a high ranking ministerial role. Certainly the markets were completely unfazed by this week's ministerial reshuffle – if somewhat aghast at the appointment of Tony Blair to do a job for which he would seem totally unsuitable.

The main focus for the domestic market this week will be the MPC meeting. A large majority of forecasters are expecting the MPC to raise rates by 0.25% to 5.75%, although there remain some who feel that the evidence of a major downturn in retail sales should be sufficient to justify holding off for another month. However, having been outvoted at the last meeting Mervyn King has been ensuring that the excuse of not raising rates as it would be a 'surprise' is not relevant on this occasion. Indeed, together with Sir John Gieve, they have made so much noise that they have completely reversed the situation so that a 'no-change' decision would be the surprise.

Unfortunately, the aspect that they, and particularly Sir John, have concentrated on is the rise in the money supply figures. Monetarism was supposed to have died several decades ago when it managed to prolong a recession for a far longer period than was justified by keeping rates at higher levels than were warranted. It appears that it has only been sleeping. The problem

with the high money supply figures is that nobody can tell you exactly why they do or should correlate with higher inflation. While it seems obvious that having a large amount of liquidity sloshing around the system may lead to higher inflationary pressures, this situation also arose in the early 1990's but, on that occasion, instilled virtually no upward pressure on inflation.

There is a further problem with taking the money supply figures too seriously as on this occasion they have been boosted by a large increase in the deposits in the 'other financial companies' category. Nobody seems to be able to explain the large rise in this category, let alone whether it has any relevance to future inflation levels. If you remove this category the money supply growth would fall to 9%, which nobody would be getting very concerned about. The danger, therefore, is that, once again, Mervyn King and other hawks on the MPC are discovering a new inflationary threat that proves to be inconsequential. As this bulletin has noted several times before, when money supply growth was at low levels, Mervyn King and other hawks never raised this as a disinflationary factor or a reason for interest rates to fall.

Whatever one's views on the importance or otherwise of the money supply figures, after last month's 5 -4 decision to leave rates on hold, it is difficult to see any of the hawks changing their voting intentions and, therefore, it would only need one change in vote from the remainder of the committee to see the rate hike being authorised at this week's meeting. For those that did not want a 'surprise', changing their vote is almost obligatory. So a rate hike would appear almost inevitable, although whether it proves to be justified over the coming months is more questionable.

This week sees little in the way of influential economic data being released with the only items of interest being the latest CIPS survey on manufacturing (today), the equivalent survey for the services sector and the latest mortgage equity withdrawal numbers (both on Wednesday) and the latest industrial production figures (on Friday). It is difficult to see how any of these, despite the fact that all are likely to support the picture of a growing economy and, possibly the potential for higher prices, will stir the market to any great activity in comparison with the result of the MPC meeting and the subsequent comments from Mervyn King and other MPC members.

JCD Rathbone