



Weekly Bulletin – 19th February 2007

Rates in the UK start this week some 0.10% lower than a week ago following some very helpful economic data being released, combined with the influence of a very benign testimony by Ben Bernanke to the Senate on the state of the US economy. Not surprisingly US rates also eased by a similar amount.

The economic statistic that made the headlines was the latest inflation numbers that showed the CPI measure fall from 3.0% to 2.7%. There had been fears that inflation would actually rise, thus forcing Mervyn King to write a letter of explanation to the Chancellor. An event the Governor informed us last week that he has been rather looking forward to. Sadly, it would appear that the chances of this occurring have now passed. The unexpectedly large fall in inflation caused an immediate rally, although not to the extent of removing the expectation of another rate hike in the fairly immediate future. A particularly encouraging item within the inflation numbers was that only 0.1% of the reduction could be put down to the reduction in petrol prices, with the biggest faller in price being household goods.

The ammunition for a further rate increase was fairly unequivocal in the Bank of England's Inflation Report which forecast inflation back at 2% in two year's time on the basis that the rate increases currently expected by the market come to fruition. If rates were just left on hold, the forecast is that inflation will be at 2.2% in two years time. However, perhaps the most interesting aspect of the Inflation Report was its widening of the bands in which it thinks inflation might vary over the coming years. This might be loosely interpreted as a warning to both the MPC and the outside world not to read too much into any one quarterly report. It may also mean that the MPC will become much more inclined to move interest rates in months that do not coincide with the publication of the Inflation Report.

If the Inflation Report took some of the edge off the better than expected inflation figures, they were promptly reinforced by some dreadful retail sales figures that showed a fall of 1.8% in January. This may be the first sign that the consumer is having to acknowledge that higher borrowing costs and increased taxation will have to curtail spending habits. This would hardly be surprising as household spending last year was only achieved by cutting savings to levels not seen since the housing boom of the late 1980's. A further rate increase is likely to cancel out any benefit that the consumer is likely to feel from lower energy prices and the MPC's optimistic forecast of 3% GBP growth this year is going

to have to rely heavily on the corporate sector in order to be proved realistic.

If the MPC is going to raise rates again, it will need to get on with it as the CPI measure is likely to fall like a stone in the second quarter of this year. In the second quarter of last year the CPI measure rose from 1.8% to 2.5% on the back of the rapid rise in energy costs. Electricity managed to prolong that increase further in the following three months. Unless something extraordinary happens to energy prices, those increases will drop out of the inflation index by the end of June. As it appears likely that not only will they drop out, but also be replaced by lower energy costs, there is considerable divergence on what this will do to inflation during the middle part of the year. However, few economists expect the CPI measure to be above its target level of 2% by the end of June and a further fall to about 1.5% by the end of the year would seem realistic. Even the Bank of England is prepared to forecast that it will fall to below 2%, although it finds the prospect of it dropping below 1.75% inconvenient in managing to get back to the 2% level in two years time.

If the MPC wants to raise rates, therefore, it has a relatively narrow window as it will hardly appear credible to try and raise rates when inflation is falling rapidly. Given that about the only potential concern that the MPC has remaining in its catalogue of inflationary threats is the prospect of unacceptably high wage increases, it probably should go for a rate hike next month as by the time it gets to the next Inflation Report month, May, the CPI measure should already have started its descent.

This is a much duller week on the economic information front. The latest money supply data and government finance figures are released tomorrow. We should start to take money supply seriously as it is our tip to become Mervyn King's next focus of attention, once concern over inflationary wage increases has passed away unfounded, as it continues to run at high levels. The fact that it was totally ignored when running at low levels would just prove that he is Mister Consistency in being able to switch focus at a moments notice to whatever suits as the next supposed inflationary threat. The CBI monthly trends survey is released on Wednesday and confirmation of the 4th quarter GDP figures on Friday. None of the above are likely to prove influential and the main interest of the week is likely to be in the release of the minutes of the MPC's latest meeting which may give some indication on any split on the requirement for another rate hike and its timing.

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