

UK Monthly Economic Update

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Monetary Policy Committee (MPC) keeps the Bank Rate on hold at 5.00%

Comment from Stuart Porteous, Head of RBS Group Economics:

"No surprises today, although with UK activity slowing sharply and inflation surging, a case could have been made for a move in either direction. The Committee will likely stand pat for the remainder of the year as the tug of war between slower growth and mounting price pressures continues. We expect rates to be lowered next year as inflation comes off its peak and the economy struggles to find its feet."

2008 is shaping up to be a tough year

While 2008 was always expected to be a more challenging year for the economy, the swiftness and extent of the downturn has caught many off guard. More than halfway into 2008, the current consensus forecast for annual growth is a mere 1.5%, half the pace we enjoyed last year. The fact that economy-watchers expected growth of 2.2% last summer illustrates how much the world has changed in the meantime (chart 1). With a prognosis of growth just touching 1%, 2009 is going to be an even weaker year. Financial markets remain in a perilous state, the prices of almost all commodities have risen sharply and the housing market correction is continuing. One factor that has come into sharper focus in recent weeks, going some way in explaining the continued slide in growth prospects for this year and next, is the tougher environment for UK businesses.

The Purchasing Managers' Index (PMI) points to a significant deceleration

The PMI is one of the best forward-looking indicators of economic activity, and its latest readings sound a warning. The composite PMI was 46.3 in July, the third consecutive month below 50. This indicates that firms were scaling back their commercial activities. The most recent readings show that GDP growth is likely to drop below the 1.6% y/y rate of growth recorded in Q1 (chart 2). On a more positive note, the PMI does not suggest that growth will dip into negative territory, although the safety cushion is rather thin.

The employment subcomponent also gives us a heads up for the labour market. A reading below 50 suggests that there were more firms that reduced staff levels than firms increasing hiring. Worryingly, the employment component of the PMI plunged to 45.7 in July. This is a real concern, given that ongoing resilience in the labour market has played an important role in cushioning the slowdown so far – unemployment fell unexpectedly by 24k in May, nudging the official unemployment rate back down to 5.2%. A tick-up in unemployment is the last thing consumers would want at this point in the economic cycle. They already have to cope with higher food and energy prices and a hit to their wealth on the back of falling house and equity prices. Fewer people in jobs would imply a further reduction in income available to be spent on goods and services, which drags domestic demand and ultimately economic growth.

The inflation trajectory is still upward-sloping

Inflation has provided as many surprises as growth in recent months, just in the opposite direction. Consumer price inflation (CPI) continued to rise in June, posting yet another record high at 3.8% y/y. As recently as May, the MPC's central projection was for inflation to peak at 3.7% in the final quarter of this year. It now looks more and more likely that inflation will approach 5%, before falling next year. Output prices, another subcomponent of the PMI, stood at 57.9 in June (up from the previous series' high of 57.8 in May), suggesting that CPI inflation will continue to climb higher in the months ahead (chart 3). The detrimental effects of high inflation are worth repeating: policy-makers have less room to cut interest rates, while households see their purchasing power eroded. Moreover, as the increase is driven by higher food and energy prices, businesses' profit margins are also being squeezed (as their input costs are rising faster than the prices they charge their customers). High inflation in 2008 could therefore turn out to be a harbinger of even lower growth in 2009.

Chart 1: Steady deterioration in forecasters' call for UK GDP growth in 2008

(% of forecasts)

Source: Consensus Forecast

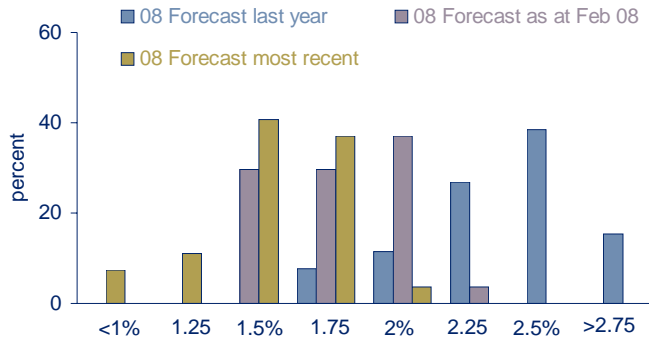


Chart 2: UK PMI tracks actual GDP growth fairly closely

Source: Datastream

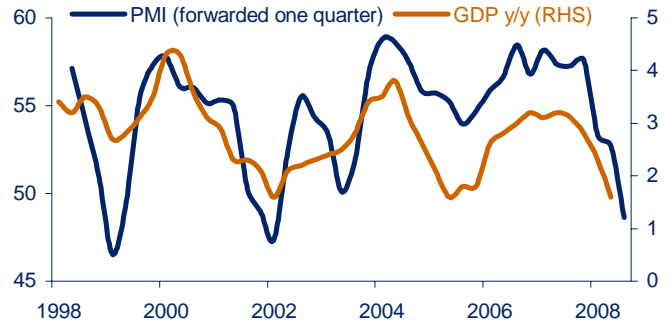
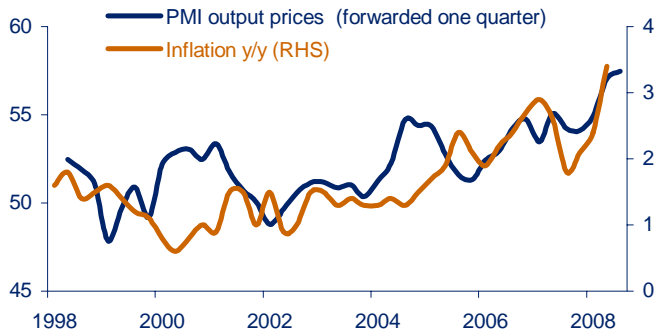


Chart 3: PMI output price series tracks actual inflation closely, too

(%, y/y)

Source: Datastream



Interest rate facts & figures

Source: Bank of England, RBS Group

	Bank of England	RBS Group
Current rate	5.00%	5.00%
Since	10 th April 08	10 th April 08
Month ago	5.00%	5.00%
Year ago	5.75%	5.75%

Minutes of July MPC meeting released: 20th August 2008

Next MPC announcement: 4th September 2008

Next Inflation Report published: 13th August 2008

Following the decision, The Royal Bank of Scotland, National Westminster Bank plc and Ulster Bank Ltd. will keep their Base Rate on hold at 5.00%

All %s	Retail Price Index (all items)		Consumer Price Index	
	RPI		CPI	
2006	2.4		1.9	
	3.0		2.2	
	3.4		2.4	
	4.0		2.7	
2007	4.5		2.9	
	4.4		2.6	
	3.9		1.8	
	4.2		2.1	
2008	4.0		2.4	
	4.4		3.4	
	5.0		4.5	
	5.2		4.8	
2009	4.7		4.3	
	3.8		3.4	
	2.7		2.6	
	1.8		1.9	

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