

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:

"I can't think of a better example of what it means to be stuck between a rock and a hard place. Recent news on the growth front has been disappointing, sometimes dishearteningly so, while inflation has shown no signs of subsiding. Until a stronger case can be made for a decisive move in either direction, the MPC will do what it has done today – keep rates on hold."

More daunting news from the growth front

The UK started 2008 on a weaker footing than initially reported. First quarter GDP growth was revised down to 0.3% q/q (2.3% y/y), the worst outturn since 2005 (chart 1). In particular, domestic demand now looks anaemic, contracting by 0.3% q/q, whereas the previous release had put a positive sign on its quarterly growth at 0.1%. Unless one of the remaining quarters in 2008 sees rates of expansion in excess of 0.2%, annual growth will fall short of the already sluggish expectation of 1.7%. Beating expectations seems like a formidable challenge going forward, given that clouds are gathering over key areas of the UK economy.

Businesses are starting to feel the pinch from the double whammy of weaker demand and rising costs. The Purchasing Managers' Index (PMI) for the service and the manufacturing sector slumped to 47.1 and 45.7 in June, respectively (chart 2). These are the lowest readings on this key business thermostat since the end of 2001. The deterioration was not only driven by lacklustre current output, but also by sharp declines in the more forward-looking sub-indicator 'new orders'. As if this was not enough, producer price data underscored a vicious margin squeeze stemming from rocketing input prices. Industrial input prices were up by 27.9% y/y, while producers were only able to raise their prices by 8.9% y/y in May (chart 3). These developments also explain why corporate profitability weakened in Q1 2008. In fact, manufacturing profitability dropped to 4.9% in Q1 2008, the lowest reading since the early 1990s. A quick rebound in business activity is uncertain at best, casting doubts on the prospects for capital expenditure in the remainder of 2008 and 2009.

The housing market shows no sign of bottoming. Average UK house prices slid by another 0.9% in June on the Nationwide House Price Index, taking the yearly decline to -6.2%. Moreover, mortgage approvals for new house purchases fell to a record-low of 42k in May, another 16k down from the already very weak April figure. The number of approved mortgages for refinancing of existing mortgages also fell by 10k to 90k. Since mortgage approvals tend to act as a leading indicator of house prices, these data suggest the market has yet to bottom out. At times like these, it is also useful to keep an eye on the number of housing transactions for another angle on the health of the market. Unfortunately, data from the Land Registry are hardly comforting either, with sales down by about 40% y/y. The message is that households are feeling the pinch on the back of eroded net wealth (via lower house and equity prices) and squeezed purchasing power (via higher inflation).

Inflation is already in 'letter writing territory' – and the worst isn't over yet

Inflation rose to 3.3% in May, the highest reading since the CPI series began in 1996. Since this was more than one percentage point above the official 2% target, it required the Governor of the Bank of England, Mervyn King, to write the first of what is likely to be a series of explanatory letters to the chancellor, outlining why inflation was so high and what is being done about it. The tone of the letter was relatively 'dovish', and did not signal imminent rate hikes. Instead, it focussed on international price developments (food and energy), which the Bank of England cannot influence, as the main reason for the overshoot. The letter also made it clear that inflation has yet to reach its peak, with CPI outturns of above 4% later in the year cited as a distinct possibility. We expect a peak of around 4.2% in September/October (see table).

Chart 1: Q1 2008 GDP growth (q/q) shows clear signs of slowdown

(%, q/q)

Source: Datastream

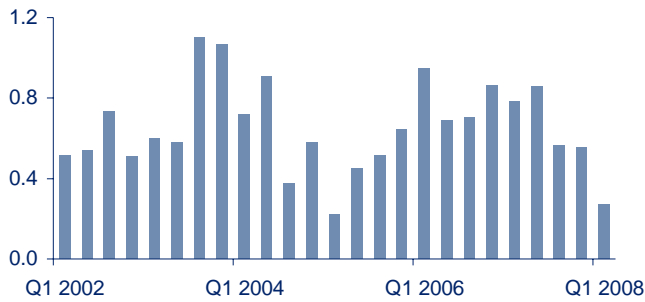


Chart 2: UK PMIs are nose-diving

Source: Datastream

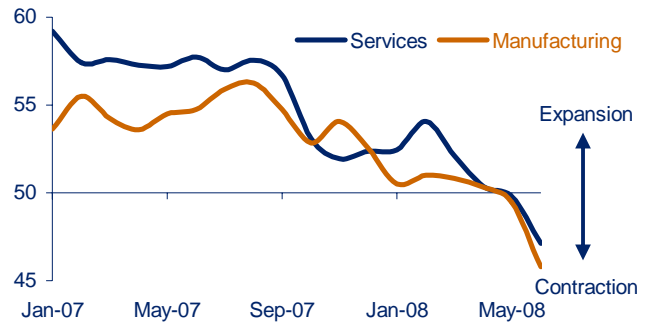
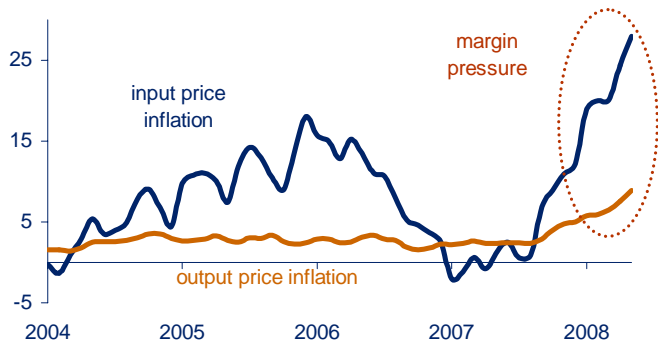


Chart 3: Manufacturers face severe margin pressure

(%, y/y)

Source: Bank of England



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: 23rd July 2008
 Next MPC announcement: 7th August 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%

| Table of Inflation Forecasts | | | |
|------------------------------|--------------------------------|---|----------------------|
| All %s | Retail Price Index (all items) | Retail Price Index (excluding mortgage interest payments) | Consumer Price Index |
| | RPI | RPIX | CPI |
| 2006 | 2.4 | 2.2 | 1.9 |
| | 3.0 | 2.8 | 2.2 |
| | 3.4 | 3.2 | 2.4 |
| | 4.0 | 3.5 | 2.7 |
| 2007 | 4.5 | 3.7 | 2.9 |
| | 4.4 | 3.4 | 2.6 |
| | 3.9 | 2.7 | 1.8 |
| | 4.2 | 3.1 | 2.1 |
| 2008 | 4.0 | 3.6 | 2.4 |
| | 4.3 | 4.3 | 3.3 |
| | 4.6 | 5.0 | 4.2 |
| | 4.3 | 5.0 | 4.2 |
| 2009 | 3.7 | 4.4 | 3.7 |
| | 2.8 | 3.7 | 2.9 |
| | 2.0 | 3.0 | 2.4 |
| | 1.7 | 2.7 | 2.0 |

Would you like to receive other forecasts? Please go to www.rbs.com/economics/registration

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