

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:

"The April inflation figure effectively eliminated the chances of another rate cut this year. After all, cutting interest rates and the imminent prospect of writing letters to the Chancellor to explain why inflation is above target are uneasy bedfellows. Inflation seems likely to keep the MPC's fingers away from the 'cut' button at least until the end of the year. This means that the MPC is almost certain to keep rates on hold, even if the domestic economy starts to feel the pinch."

The MPC's dilemma explained

By statute, the MPC's overriding aim is to guarantee price stability when setting interest rates. The committee also considers wider economic objectives like growth and employment, but only if inflation is contained (or is expected to be contained) at around 2%, the inflation target set by HM Treasury. In the benign economic environment of the last decade, when low inflation coincided with robust rates of economic growth, these two different sets of goals hardly conflicted. However, the world has changed fundamentally since the summer 2007. Inflation has started to rear its ugly head, while economic growth prospects have worsened. This presents a formidable dilemma to policy-makers. With the outlook for growth and inflation calling for different paths of interest rates in the near term, the MPC cannot tame inflation and prop up growth at the same time. Bringing inflation back towards target will dominate policy. As a result, the MPC is now widely expected to keep rates on hold for the remainder of this year.

Inflation – the return of a phantom long gone missing

Inflation leapt to 3% y/y in April, up from 2.4% in March, and some way above even the most pessimistic forecasts. This was the second highest inflation rate since 1996. More crucially, any increase from the 3% level will oblige the Governor of the Bank of England, Mervyn King, to write a letter to the Chancellor, explaining why inflation is above target and what the MPC intends to do about it. However, the recent up-tick is driven almost entirely by spiking non-core inflation (food and energy price inflation), which is running at 8.4% y/y. Prices for these commodities are determined globally – not domestically – and there is little the MPC can do to change the state of demand in these markets. The lever left for the MPC to pull is to cool domestic demand in the hope to squeeze core inflation (inflation of domestically produced goods and services). Overall inflation should then fall back to the target range in the medium term. Companies that depend on domestic demand will see demand as well as pricing power curtailed.

Growth prospects have softened, but not collapsed

The slide in the housing market could weigh on economic activity for some time. The Nationwide house price index declined by 2.5% m/m in May, the biggest ever monthly decline (see chart 2). What is more, the number of mortgage approvals for new house purchases has hit a record low at 58k in April (average in 2007: 104k). This does not bode well for the months ahead, given that approvals are normally a good leading indicator for house prices. In addition to the potentially detrimental impact on consumer spending (please see [last month's MEU](#)), a weakening housing market also drags private residential construction activity, which represents c. 3.5% of UK GDP. If residential house-building were to contract by 15% this year (not a far-fetched scenario given that activity has halved in the US over two years), 2008 GDP growth would be at least 0.5 percentage points lower. Against the backdrop of a consensus forecast of 1.6% for 2008 UK GDP growth, a 0.5 percentage points hit poses a material downside risk to growth.

But trade has potential to come to the rescue. Sterling has depreciated by 11% on a trade-weighted basis since last summer, boosting UK exporters' competitiveness (see chart 3). There is already evidence that trade is stepping up to support activity – while GDP expanded 0.4% q/q, net trade contributed 0.2 percentage points, half of registered growth. This trend is likely to gain more momentum in the months ahead, as the trade balance only improves with a lag.

Chart 1: Non-core inflation runs some way above core inflation

(%, y/y)
Source: Datastream

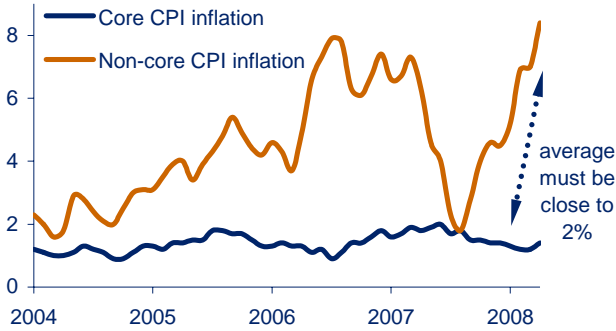


Chart 2: House prices are falling

Source: Datastream

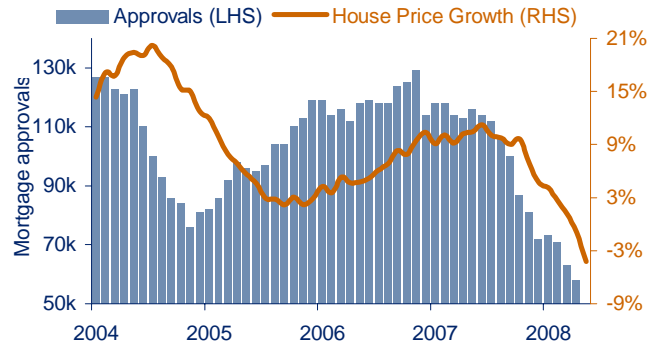
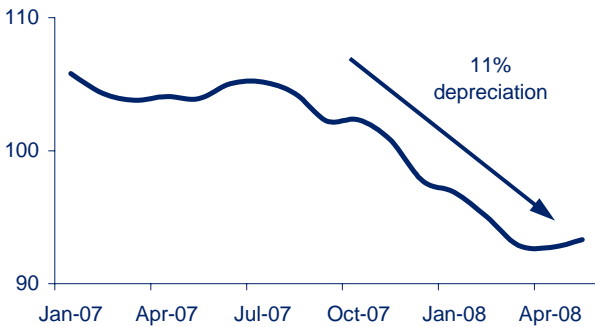


Chart 3: Sterling's depreciation since last summer

(trade-weighted index, 2005=100)
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	5.50%	5.50%

Minutes of June MPC meeting released: 18th June 2008
Next MPC announcement: 10th July 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
	4.0	4.0	3.1
	3.8	4.3	3.5
	3.4	4.2	3.6
2009	2.7	3.5	3.1
	2.0	2.8	2.5
	1.4	2.5	2.2
	1.1	2.1	1.8

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