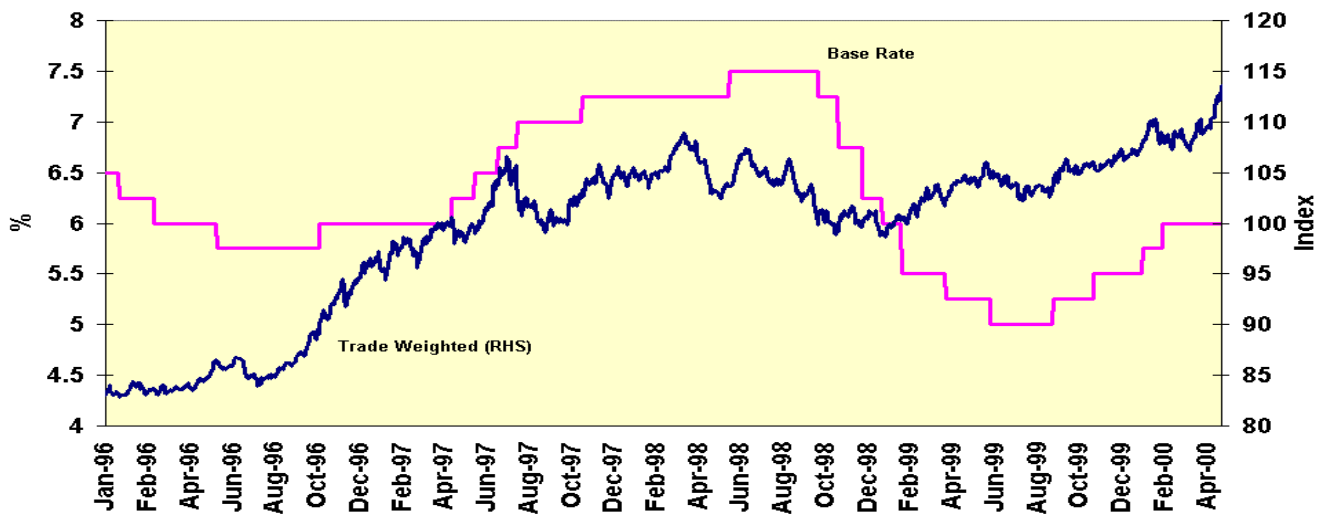


UK Base Rates and Trade Weighted Exchange Rate



The Bank of England left interest rates unchanged at May's policy meeting. The vote was likely to have been a tight one with the MPC's hawks having some convincing arguments for raising rates including the pace of growth in average earnings, a tightening labour market, above trend domestic demand growth, service inflation of 4.2%, buoyant household borrowing and 14.0% year-on-year growth in house prices. All of these factors could be seen as a threat to the BoE's long-term inflation target and we expect that they will eventually push the BoE into tightening rates again. However, on balance, the arguments for a rate hike right are not as strong as previously thought.

There are indications that recent interest rate increases are slowing the economy down to a more sustainable rate. While only first estimates have been released as yet, Q1 GDP data hinted that growth could have peaked. The economy expanded by 0.4% over the period, down from the previous quarter's growth rate of 0.8%. A downturn in manufacturing was primarily responsible for the slippage but there were also some signs of a slight slowdown in services sector output. There have also been some declines in consumer confidence levels with survey evidence showing that the rate hikes implemented to date are starting to have an impact. Apart from the tentative signs of an overall slowdown, one of the overriding reasons for keeping rates on hold is the strength of sterling which has in itself resulted in tighter monetary conditions and helped keep underlying inflation below target. Since the MPC last raised rates on 10 February, sterling has risen by 7% against the euro and by 4.6% on a trade weighted basis. After the March and April meetings MPC members have repeatedly stated that the strength of the currency has meant that rates are lower than they would otherwise be. Such sentiment makes it difficult to justify raising rates when the currency is at a 14-year high.

The tone of recent MPC minutes indicate that, although its overall bias remains towards tightening and the risk is that the next move will be upward, the BoE wants to wait and see how things develop. (Further detail on the Q1 GDP data will not be available until late May). It seems to have moved away from the activism which characterised its first couple of years as an independent authority. In terms of sterling, the decision to leave rates on hold will have little impact on the currency's strength against the euro but it will leave it exposed to downside risks against the dollar. Interest rate differentials are an important determinant in the direction of the USD/GBP rate. With the Fed expected to increase rates by up to as much as 0.50% at its policy meeting on 16 May the differential will be very much in the dollar's favour.

Geraldine Concagh
Economist
AIB Group Treasury
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