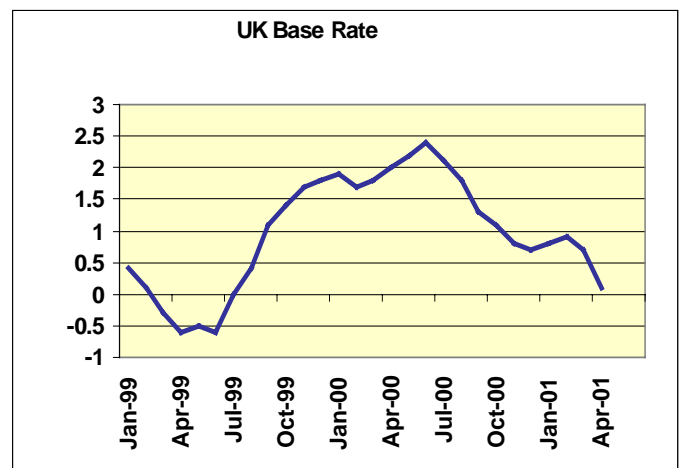
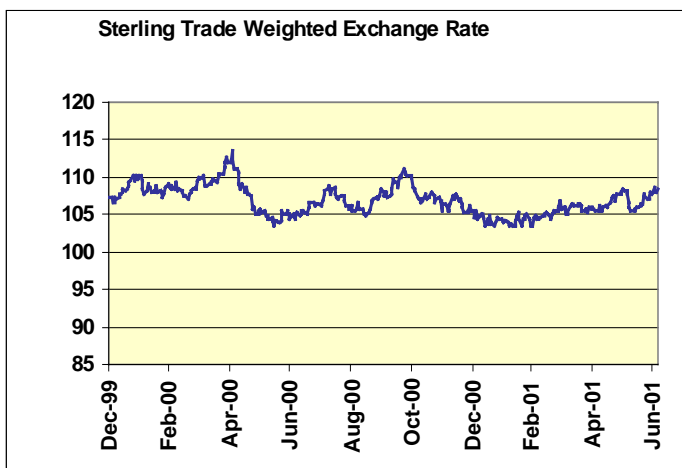




**Outlook for UK Interest Rates**

- Last week the Bank of England elected to leave official rates unchanged for the second month running. This was in line with our expectations and the market consensus and as such did not evoke much reaction. The key question is where the BoE goes from here. The market is already pricing in a rate hike but a move upwards over the next couple of months seems overly pessimistic.
- The BoE has expressed concerns about the imbalances in the economy. The manufacturing sector is in trouble but inflation is rising back towards its 2.5% target, consumer demand and the housing market remain strong and unemployment continues to fall. In each of the statements accompanying the cumulative 0.75% cut in rates seen this year the BoE has referred to the risks posed by the slowdown in the global economy. There are some indications that the US economy is over the worst. Last week we saw the non-manufacturing NAPM index surprise on the upside, indicating that the services sector has returned to growth. The index reversed two consecutive months of decline, expanding to 52.1 from 46.6 on the back of a solid jump in new orders. Recent consumer confidence surveys have also surprised on the upside. However, with the labour market continuing to deteriorate there is no guarantee that the US is on the road to recovery. There are also grave concerns about the outlook for the eurozone, which is the UK's largest trading partner.
- Although the UK labour market has held up well, there is a risk that the global downturn could yet have an impact. Rather than raising rates, we expect the BoE to leave policy on hold for some time to come, taking some comfort, on the inflation front, from the fact that sterling has recovered much of the losses that we saw in the run up to, and immediately following, the general election. If the global situation were to deteriorate further there is a risk that the BoE may even have to cut again.
- As always, forthcoming data will be key in assessing the outlook for monetary policy. There is little in the way of fresh news this week with markets holding out for more important retail sales, RPI and unemployment data the week after. On the calendar this week are producer prices for June, the BRC retail sales survey and the BCC quarterly economic survey. Input prices should reflect lower energy costs with the y-on-y rate falling significantly from last month's 4.7%. The underlying strength in consumer demand should be evident in the retail sales survey while the quarterly economic survey should reflect the growing imbalances being faced by the BoE.
- Unlike the euro's reaction to the ECB's decision to leave rates on hold, sterling held firm after the BoE's announcement. The inherent weakness in the euro will keep sterling under some selling pressure against the dollar but downside will be limited by the fact the UK economy looks set to outpace both the US and Europe this year. Our key growth forecasts show the UK economy expanding by 2.1% this year. Eurozone growth is likely to come in sub 2.0%. Growth in the US is expected to be no more than 1.5%. This leaves growth and interest rate differentials in sterling's favour.

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# AIB Group Treasury Economic Services Unit

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