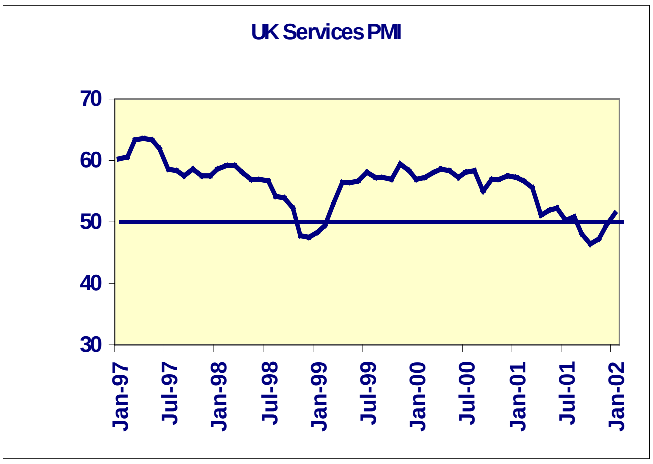
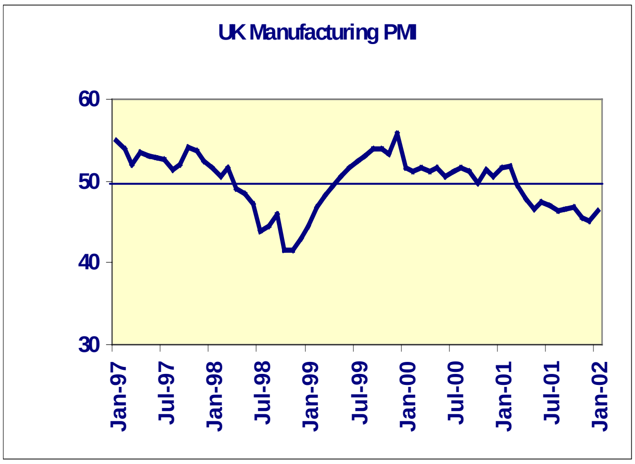
Will the BoE Be The First to Change Course





As signs of a global recovery begin to intensify the debate is now firmly centered around the timing of interest rates hikes. Given current conditions we believe that the Bank of England will be the first leading central bank to move to a tightening mode.

The UK was the best performing of the leading world economies in 2001 with GDP growth of 2.4%. This was only slightly down from the 3.0% rise seen in 2000 and was well ahead of the US growth rate of 1.1% and the eurozone's estimated growth rate of 1.6% The main reason for this outperformance was the strength of domestic demand with consumer spending holding a growth rate of about 1.% over the course of the year. Two factors underpinned this demand; low interest rates and tight labour market conditions. The housing sector also enjoyed a good year with construction output up 1.5% in Q3. The services sector slowed over the course of the year, but output was still up 0.9% in the fourth quarter, up from 0.6% in the previous three months.

There was one area of marked weakness in the UK economy last year; the manufacturing sector. The downturn in this sector reflected a sharp fall in output in the ICT sector, particularly mobile phones and electrical and optical equipment. The weakness in this sector and the global economy in general was also reflected in a marked decline in exports. The net trade performance depressed overall growth by 0.7% last year. At the end of last year the UK economy could be very much characterised as a two tier economy.

None of the data released over the last month has changed our view on this. An upbeat CBI retail distributive trades survey for January, as well as anecdotal evidence from the High Street, point to continued robust sales for retailers. The continued low unemployment rate, rising consumer confidence and record growth in consumer credit suggest that the consumer will stay in the mood to spend. The CIPS services survey is back above the 50 level, indicting expansion, while a further acceleration in house prices in January also points to continued solid growth in domestic demand. Problems however, remain in the manufacturing sector, The manufacturing PMI index for January showed the best level for three months but the index is still below 50.

There has been some speculation that because inflation is comfortably below target the MPC will cut interest rates again. However, we believe that rates have bottomed. We should get a good policy steer from this week's Quarterly Inflation report but it is worth noting that no member voted for a rate cut in January. The period of below trend growth in the UK economy is likely to be short-lived. Positive growth forces firmly embedded in the economy. Interest rates, and most notable mortgage rates, are at a 40-year low. As government spending increases, through its commitment to health and education programmes, fiscal policy will also be supportive. Inflation is running at exceptionally low levels and the outlook going forward is very favourable. Low interest rates and low inflation will provide a boost to growth in real personal disposable income.

Rates are likely to remain on hold for the coming months but once the global recovery takes hold the BoE will quickly move into a tightening mode. The track record of the MPC is one of activism in both directions and it obviously believes that fine tuning demand growth is the best way of meeting its inflation target. By the end of the year we expect the BoE to have taken back 0.75-1.0% of its 2.0% easing in 2001.

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