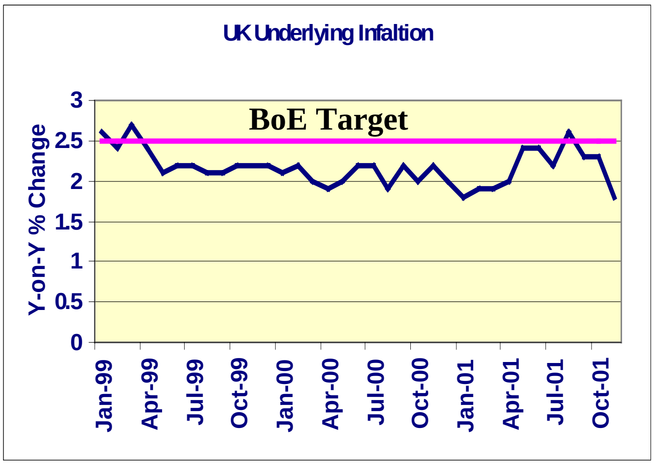
AIB Group Treasury
Economic Services Unit

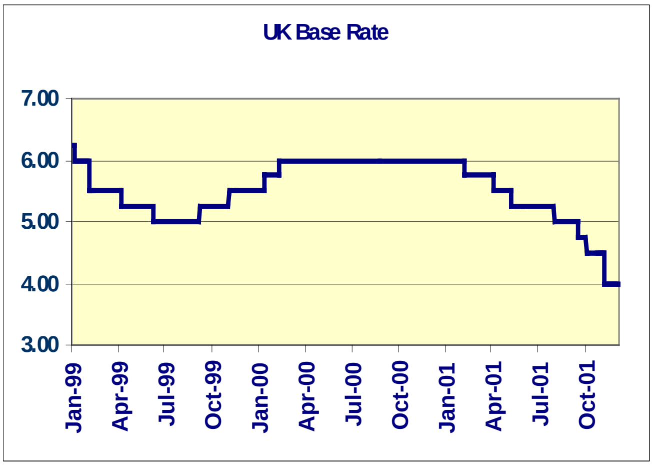
BoE Engineers Soft Landing

Since the Bank of England first reduced interest rates in February of this year, it has campaigned actively to protect the UK economy from the global slowdown, cutting the base rate by a cumulative 2.0% to 4.0%. Its attempts appear to have been successful with the UK economy projected to grow by 2.0% this year, below potential but well ahead of its peers. Activity in the manufacturing sector is at very low levels and activity in the services sector has cooled considerably over the second half of the year. However, underpinned by a falling interest rate environment, a low unemployment rate and a strong housing market, UK consumer confidence and spending have remained strong throughout the year. Latest retail sales data showed demand up 1.3% during the month of November and 7.1% on a y-on-y basis.

The Bank of England left interest rates unchanged at its policy meeting in December. The decision is unlikely to have been a unanimous one but following November's 0.50% reduction the balance of opinion must have been that the BoE has taken sufficient action to protect the domestic economy from the global downturn. Last week's stronger than expected retail sales report dented hopes of any further easing and the interest rate market is busy pricing in a sharp tightening in rates before the end of next year. At the time of writing, levels in 3-month futures indicate that the base rate would have risen by 0.75% by the end of next September.

We feel this is overly pessimistic. Not because we are anticipating a sharp correction in consumer demand but because the inflation outlook is so benign. Retail price data for November showed the headline inflation rate falling from 1.6% to 0.9% (y-on-y) in November, its lowest level since 1963. The underlying rate, for which the BoE has a 2.5% target, fell to 1.8% from 2.3% (y-on-y). This matched the lowest rate on record. It was not just lower energy costs which contributed to the decline. Clothing, footwear and leisure goods prices are all falling while food price inflation has eased considerably. The degree of competition and price discounting in the High Street was confirmed by November's retail sales report. The retail price deflator fell from 0.3% to -0.2%. While the demand for credit, house prices and sales data are all strong further easing could still materialise. The BoE's mandate is to keep inflation within a 1.5%-3.5% range, with the mid-point as a target. The BoE's target is symmetrical. Governor, Eddie George, is required to write to the Chancellor if inflation falls to 1.5% or below or rises to 3.5% or above, explaining what measures he intends to take to either raise or lower the rate. Inflation should trend higher going into the end of next year and the BoE will start to raise interest rates at that point. However, before that there is a risk that the RPIX could fall below 1.5%, making expectations of a 0.75% hike by September look overly aggressive.





Geraldine Concagh
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