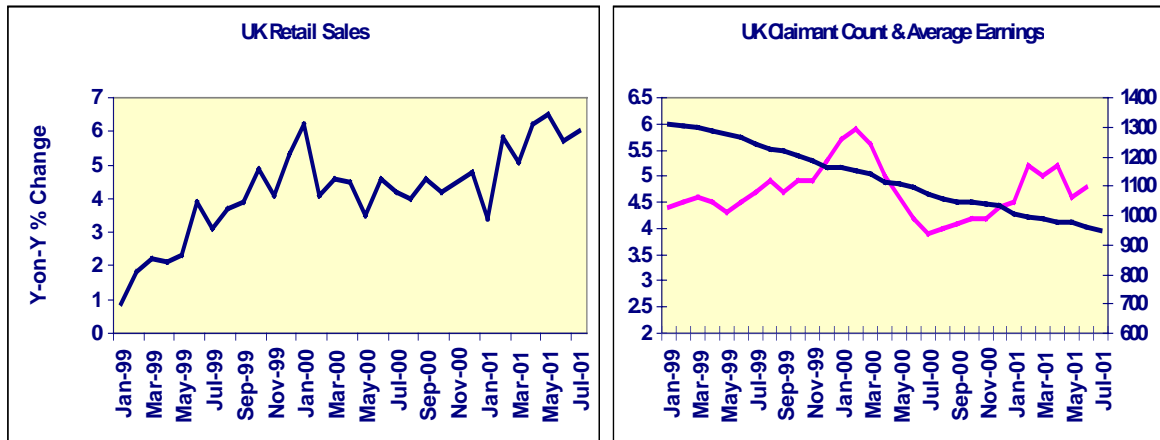




AIB Group Treasury Economic Services Unit

UK Data Justify MPC Uncertainty



The minutes of the last Bank of England policy gathering indicate that the meeting was a difficult one. It ended in a 6-3 vote in favour of another 0.25% cut but members views ranged from a 0.50% cut to no change at all.

The arguments for no change in policy were solid and were based on the underlying strength in consumption and the housing and labour markets. There is little sign that the pressures in the corporate sector are feeding through to household confidence and spending. It was felt that an immediate cut would further exacerbate the imbalances in the economy by further stimulating consumption and the housing market. As the full impact of the easing to date had still to come through, and the US was expected to recover towards the end of the year and into the early part of 2002, there was a risk of increasing the size of the adjustment that would ultimately be necessary. There was also a risk that financial markets would overreact to a surprise cut, resulting in a generalised fall in money market rates and so a greater-than-planned easing in monetary conditions. Finally, cutting rates again risked triggering a sharp declaration in sterling which could have implications for the inflation rate.

Arguments in favour of a rate cut were primarily based on the premise that as the risks to output and consumption were to the downside that there was little advantage to waiting before easing policy. While eventually voting for a 0.25% cut, the MPC also discussed the possibility of cutting rates by a larger 0.50%. Members refrained from doing so in the end as it was felt that a large adjustment would be especially surprising for the market and would entail an unnecessary risk of further stimulating the housing market. At a time of uncertainty, a gradualist approach was seen as preferable.

Data released since the meeting justifies this level of uncertainty and debate. Retail sales increased 0.6% in July, or 6.0% in y-on-y terms. However, the numbers were no threat to inflation as demand is being underpinned by heavy discounting. These numbers show little sign of a restrained consumer. For consumption to slow an adjustment in the labour market is necessary. However, July's unemployment report was surprisingly upbeat. The claimant count fell 12,800, the largest drop since January. Earnings growth also came in ahead of expectations and are now back above the BoE's 4.5% comfort level.

Given the risks attached to the global economy and in particular the US the BoE is likely to maintain an easing bias. However, data argue against any further easing in the short-term. We expect rates to remain steady at 5.0% for sometime with a move to 4.75% only likely if we see a correction in consumption and the labour market.

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