Low Inflation and Fragile Stocks to Keep BoE Inactive

The Bank of England's Monetary Policy Committee (MPC) voted 8-1 to leave interest rates at 4.0 per cent for the eighth month running in July. The central bank's Deputy Governor, Mervyn King, was again alone in calling for higher interest rates, arguing that inflation was expected to rise "quite steeply" above its 2.5 percent target in the medium term. However, the majority felt that "it was not yet necessary to raise interest rates, and there was a possibility that an increase in interest rates at this point could have an unusually sharp impact on business and consumer confidence". Despite the strength in the domestic economy, and in particular the housing market, some MPC members believed that the argument for not raising interest rates was stronger this month than when the MPC met in June. In particular, the MPC felt that the impact of the fall in equity markets on consumption and investment needed to be taken into account. The extent of the economic recovery in the United States, as well as at home, was also still uncertain.

The tone of the minutes, combined with ongoing weakness in the stock market a 27 year low underlying inflation rate have resulted in a re-evaluation of interest rate expectations. The BoE is no longer expected to hike rates in August. Indeed, reflecting the trend in other major economies, expectations for the year as a whole have changed considerably over recent weeks. Short-sterling contracts are now pricing in a 0.25 percentage point rise in rates by end year, compared to expectations of a 1 percentage point increase a number of months ago.

Despite the likelihood of unchanged rates in August, the pressure is mounting on the MPC to tighten policy. GDP growth looks to have rebounded strongly in Q2 given that domestic demand remains firm while both exports and manufacturing are recovering strongly. Above trend growth seems likely to continue in H2 2002 given the stimulatory stance of fiscal and monetary policy. On this basis, after the sluggish start to 2002, GDP growth for the year could average 1.8 per cent, little changed from the downwardly revised 1.9 per cent recorded in 2001. The economy, though, should be on course for 3 per cent growth or above in 2003.

Underlying inflation fell to an historic low of just 1.5% in June, with the aid of lower seasonal food and petrol prices. However, this is likely to prove the low point for inflation, because of negative base effects. The RPIX rate, though, should remain well below the BoE's 2.5% central target level over the balance of the year.

BoE Governor Eddie George continues to warn that interest rates will have to rise unless robust domestic demand slows. Low inflation, concerns about the durability of the upturn in the global economy as well as turmoil on the stocks markets have all provided the MPC with scope to err on the side of caution and defer rate hikes. However, with the economy moving to a trend growth path or above, the MPC is likely to act this autumn and be the first of the main central banks to tighten policy in this cycle. The market is looking for a modest 0.25 percentage point increase but with the economy picking up pace and inflation expected to trend upwards we expect a more aggressive 0.50 percentage point increase.

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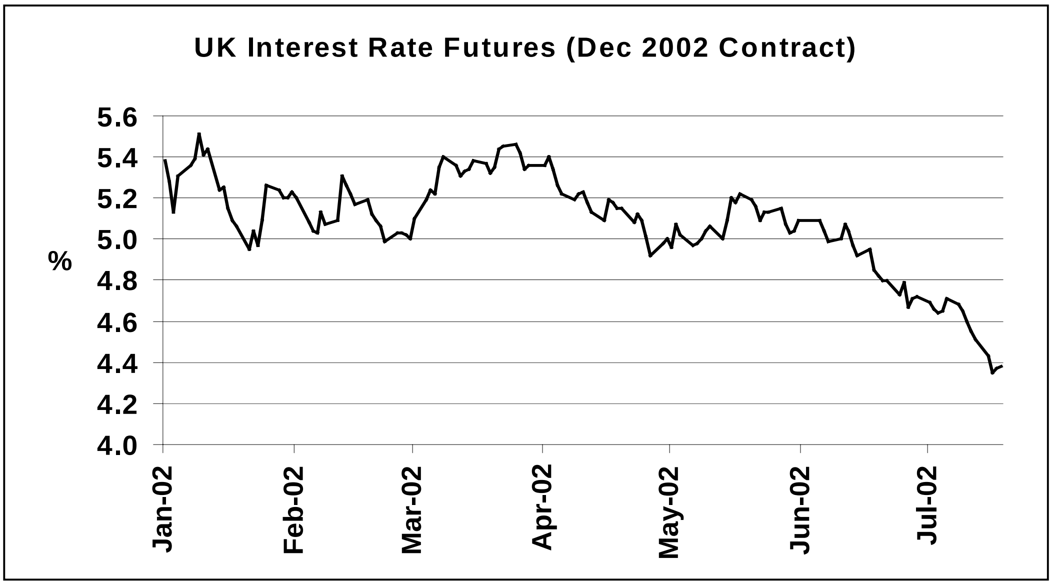
19 July 2002

Markets Revise Down Rate Expectations



As Inflation Falls to 27-Year Low