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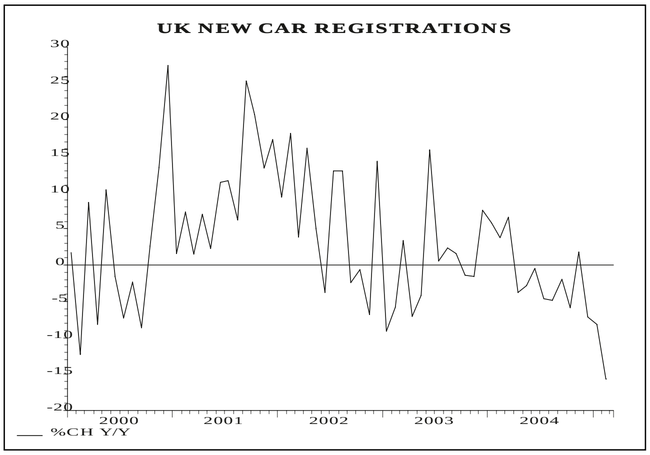
# GFC ECONOMICS

## DAILY COMMENTARY

### MPC ON HOLD

The MPC's decision to keep rates unchanged today was little surprise. While the Bank has made it clear in recent weeks that it has a bias towards tightening, it has also been at pains to emphasise the uncertainties over the outlook for the economy. Indeed, the Bank's 'confusion' was in a sense highlighted by the last inflation report. The MPC raised both its central forecasts for growth and inflation, but at the same time continued to emphasise the risks to these projections remained on the downside. It believes the main threat of an undershoot to both forecasts lies with the consumer. The Bank's central assumption, however, is that the pronounced slowdown in consumption seen in recent months will be short-lived. This contention, however, is very questionable, most obviously because housing will no longer be providing the boost it has done over the past few years. Indeed, the early signs are that consumption remained depressed in February. On balance, continued weakness in spending looks likely to keep the Bank on hold, even if the Chancellor does indulge in some pre-election sweeteners next week.




### Consumption Is The Key

The spending data over the next couple of months will probably be the key to whether or not the MPC ends up nudging rates higher again. Retail sales have already slowed substantially but further weakness may be required to convince the Bank that this slowdown is for real. As Mervyn King stated back in January, when downplaying the importance of the sharp December drop in retail sales, "the true meaning of the Christmas story will not be revealed until Easter - or possibly much later". The official retail sales numbers for February are not released until March 17th but the early, albeit not wholly reliable, CBI Distributive Trades and BRC surveys point to recent weakness continuing last month. Furthermore, new car registrations, which are not included in retail sales, were down sharply in February, falling 15.7% y/y to their lowest s.a. level in five years. While the consumer will be the most important factor determining the MPC's policy decisions over the next few months, they will also be influenced by developments on the inflation front.

Inflation has rebounded quicker than expected from its lows last September and - as with the spending data - the MPC is unsure whether this is just 'noise' or the start of a build up of inflationary pressure. We believe that it is primarily just a correction to the equally unexpected decline in inflation seen last summer (see commentary of February 21st) but the MPC may take more convincing. According to Mervyn King, the MPC's uncertainties over inflation are threefold. Consumption is the main downside risk whereas the tight labour market is the primary upside threat and import prices pose risks in both directions. On the labour front, pay settlements appear to have picked up in January, but not alarmingly so, according to MPC member Stephen Nickell. Meanwhile, there are signs that employment growth is slowing. A joint report from the Recruitment and Employment Confederation and Deloitte showed hiring slowed to its lowest level in 19 months in February. The public sector appears to have been been the source of all the employment growth over the last year and job losses in manufacturing show no signs of abating. The EEF estimates that manufacturing employment fell 131,000 or 3.9% last year, despite a 1.4% gain in output. Manufacturing production has picked up in the last three months but these gains have merely reversed the unexpected decline seen last autumn. The manufacturing PMI paints a more consistent picture of a gradual slowdown in the manufacturing sector since 2004 H1, and suggests the recent recovery in output overstates

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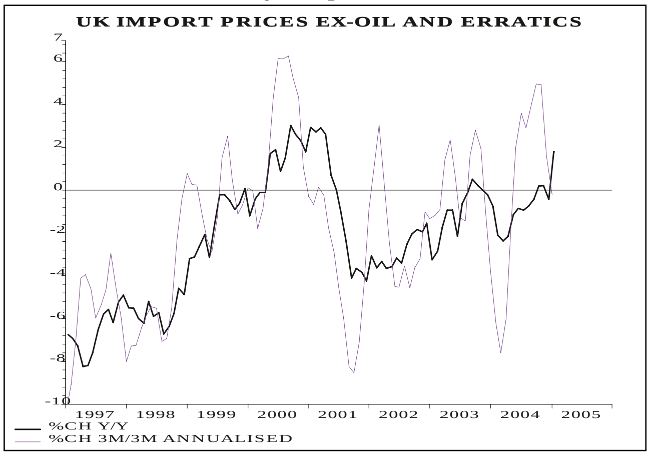
the health of this sector significantly. Indeed, the slowdown in retail sales may already be feeding through; production of consumer durables is the one area which has continued to head firmly downwards in the last few months.

Recent trade data certainly gives no reason to believe the manufacturing picture has taken a turn for the better. The trade deficit ex-oil and erratics hit a new high of £5.50bn in January, and the inexorable deterioration seen since 1997 still seems firmly in place. However, for the MPC at least, the import price data is at the moment probably as important as the deficit itself. And here the picture is superficially worrisome. Core import price inflation rose sharply in January to 1.8% from -0.4%, its first move into positive territory in four years. In mitigation, import prices have been trending lower again in the last couple of months, following their gains in Q2 and Q3 last year. Sterling has also climbed back up to $1.92, close to the highs touched in late 2004, and is up around 2% in trade-weighted terms from its January low. Moreover, the largest pick up in import prices has not surprisingly been seen further down the supply chain. Prices of imported finished manufactures were unchanged on a year earlier in January.




While the economic data will undoubtedly be the most important factor driving the MPC's decisions over the next few months, its deliberations will also obviously take into account next week's Budget. The recent ONS decision to change the way it classifies road maintenance and repair has given Gordon Brown rather more leeway to hit his golden rule. The Chancellor claimed in December's Pre-Budget Report that he had some £8bn leeway (after including a £3.5bn reserve for unexpected spending needs) in meeting the rule for the current cycle, which the Treasury deems to end in 2005/06. As a result of the ONS revisions, his room for manoeuvre has increased to around £11.5bn. This, along with a pick up in corporation and income tax receipts in the last two months, means it will be rather easier for the Chancellor to come up with a few pre-election sweeteners next week and still claim not to be flouting his golden rule. That said, any give-aways look likely to be limited. Although the cumulative effect of the ONS revision for the current cycle amounted to some £3bn, the reduction to current spending going forward is no more than around £0.4bn per annum. Any significant tax cuts next week would just make the tax increases needed after the election to hit the golden rule in the forthcoming cycle all the greater and more obvious. Indeed, only this week the IMF called for an "early correction" to the UK's public finances, so that the fiscal rules could be met in the next cycle. Although the fiscal stance over the coming year now looks set to be marginally more expansionary than before, the broader picture is that fiscal policy is no longer providing a significant stimulus. Indeed, by next year, rather than worrying - as at the moment - about having to offset a lingering fiscal stimulus, the MPC is likely to be more concerned with the need to cut rates to counter a hike in taxes at a time when the economy is already struggling.

The final reason why the MPC may decide to hold off raising rates is that it has achieved much of the potential impact from a rate increase merely by encouraging speculation that it might tighten again. The 3-month interest rate implied by short sterling for the end of 2005 has risen 50bps from its low in early January. Fixed rate mortgage rates have also increased and sterling has strengthened. All of this - but most importantly the continued weakness of consumption - suggest the odds remain slightly in favour of the MPC refraining from raising rates again.