

## UK economic report

### Executive summary

The UK economy finished 2006 on a strong note, with services expanding rapidly and manufacturing robust. Growth should stay around its long-term trend rate in 2007. While we think interest rates have now peaked at 5¼, the risks of a further increase by mid-2007 are high. Upcoming price and wages data will be key.

### Key trends

- **Services activity buoyant while growth in manufacturing moderates.** PMI data indicates that activity in services was very strong in late 2006, with activity expanding at its fastest rate in a decade. Despite losing some momentum in late 2006, growth in activity in manufacturing remained robust.

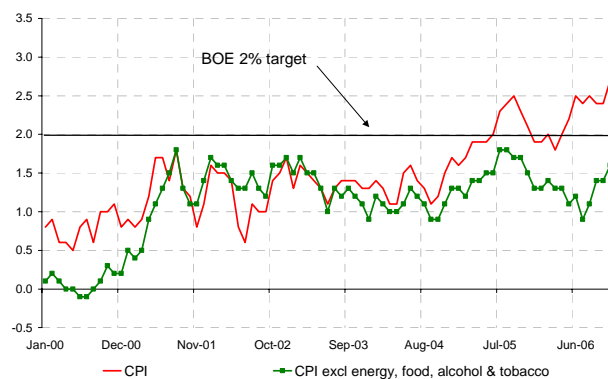
- **Household spending expands at a modest rate.** Survey data indicates that retailers' concerns of weak sales over the Christmas period were overdone, with moderate growth in sales in late 2006.

- **Housing market remains strong but may have peaked.** Survey data suggests that house price inflation remained strong in late 2006, with UK house prices up by 8-10% on year earlier levels. Demand for secured credit was also strong.

- **Annual CPI inflation hits 3% in December.** With inflation now well above the Bank of England's 2% target and likely to head higher in coming months, the risk is that higher inflation will feed into higher wage inflation

- **Interest rates forecast to remain on hold but risks are strongly to the upside.** While we are forecasting that interest rates have now peaked at 5¼%, we have not ruled out a further interest rate increase by the Bank of England by mid-2006. The outcome of upcoming wage negotiations will be a key focus over coming months, as will evidence that the cumulative increases in interest rates are feeding through into an easing in inflationary pressures.

### Annual CPI inflation (percent)



## Services key driver of growth

Partial indicators suggest that the UK economy ended 2006 on a strong note. The results from the purchasing managers' surveys (PMI) indicated that services hit a ten year high at year end while activity in manufacturing remained robust.

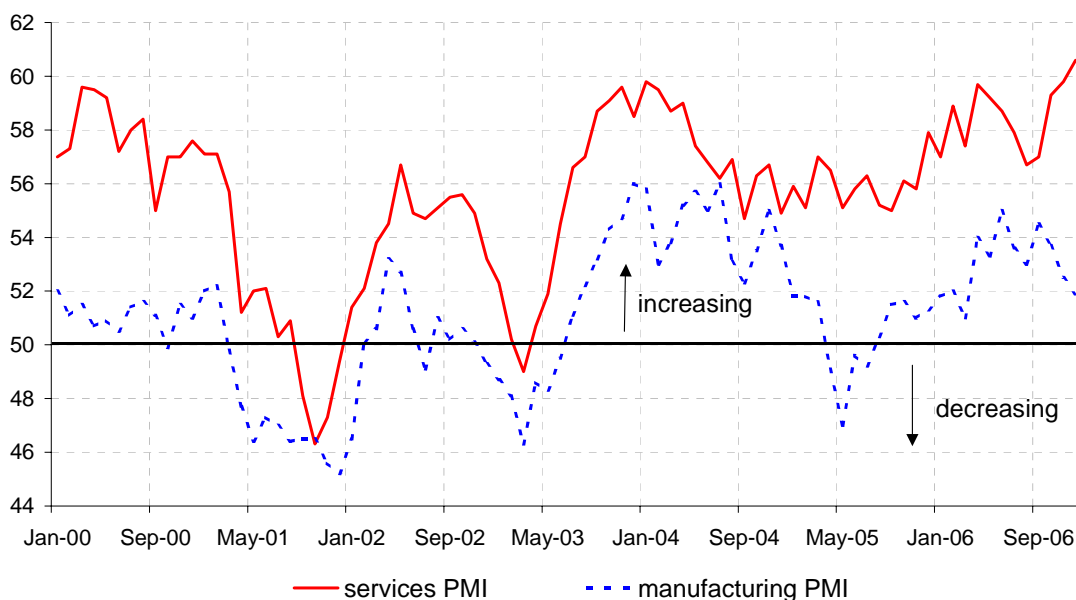
The UK's services sector expanded at its fastest rate in a decade in December 2006, underpinned by very strong growth in new business and modest growth in order backlogs. Survey respondents' expectations for future business activity were very strong, prompting further strong gains in employment and modest rises in output prices.

The PMI survey results for manufacturing indicated that while the sector lost momentum during the final quarter of 2006, activity remained robust. Growth in output eased over the final months of 2006, suggesting that the combination of higher domestic

interest rates and the stronger pound had dampened activity. Growth in both total new orders and export orders also moderated, suggesting that activity may ease over the coming months. Order backlogs continued to decline, indicating that firms have sufficient capacity to cope with the current level of demand. Employment levels slipped back and both input and output prices rose at a more modest pace.

These results are broadly consistent with reports from the Bank of England's Agents in December 2006. The Agents' Summary of Business Conditions indicated that activity in the services accelerated. In particular, public sector demand for professional services grew strongly, while output growth in the professional and financial services sector remained at a high rate. In manufacturing, production growth stabilised. While domestic demand growth strengthened, this was offset by a slight deceleration in exports. That said, growth in exports remained above that in domestic markets.

**Manufacturing and Services PMI**



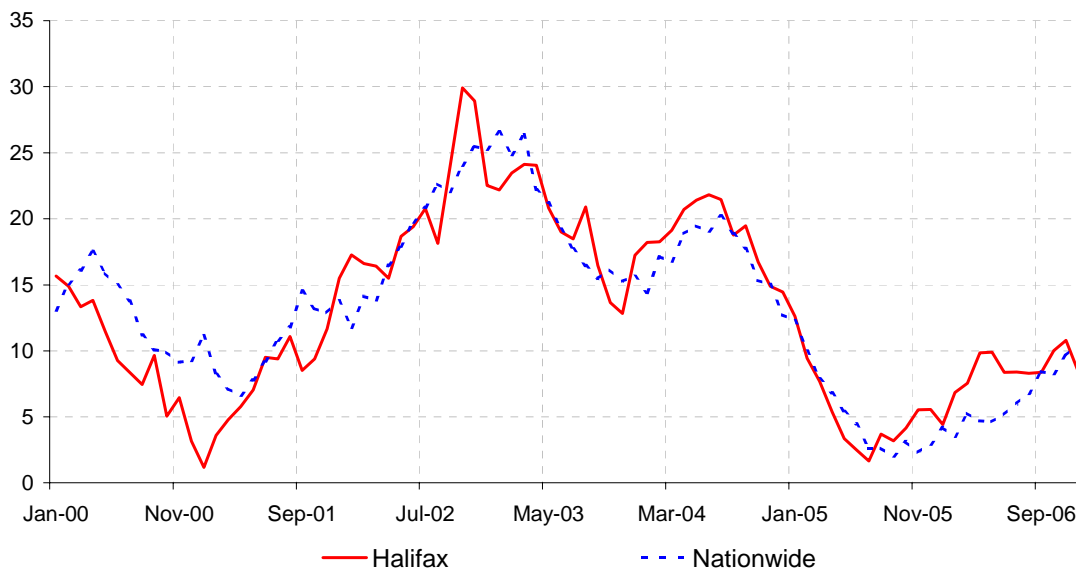
## Household spending growth modest

Growth in retail spending looks to have remained solid in the final quarter of 2006, although it has eased from the average rates of growth recorded in recent years. In the three months to November 2006, retail sales were up by 3.2% on the previous three months to be up by 0.6% on year earlier levels. Prior to Christmas, retailers were cautious regarding prospects for sales over the festive season, partly reflecting the two recent interest rate increases. The BRC-KPMG Retail Sales Monitor for December suggests that some of their concerns may have been overdone, with retail sales up by 4.4% on year earlier levels in December. The BRC Shop price index indicated that a 2.3% yoy rise in total shop prices in December 2006 largely reflected higher prices for food. Prices for non-food items were up by a more subdued 0.7% yoy in December 2006 amid evidence of heavy discounting. Retailers, particularly those in clothing & footwear, electrical and furniture, were still resorting to discounting to move stock.

Growth in consumer spending has been supported by a buoyant housing market. Both the Halifax and Nationwide surveys of UK house prices point to a gradual acceleration in annual house price inflation during 2006. In December 2006, Halifax reported that average UK house prices were up by 8.4% on year earlier levels, while the Nationwide measure pointed to annual inflation of 10.5%. House price inflation was exceptionally strong in Northern Ireland, with average house prices up by 40-50% in 2006. After outperforming the North of England for several years, the South moved ahead in 2006, led by a strong recovery in London house prices.

Lending data indicates that household's demand for credit remained strong in late 2006. Total borrowing rose by £10.9 billion in November 2006, with £9.8 billion of this increased secured on dwellings. The strong increase in secured lending reflects increased turnover in housing at higher prices. The remainder

**Halifax and Nationwide House Price Indices  
(percentage change, year on year)**



of the increase was in credit cards, personal loans and overdrafts. Compared with year earlier levels, total lending to individuals rose by 10.4% on year earlier levels, with secured lending up by 11.4% yoy in November. The Bank of England recently reported that their discussions with lenders had pointed to some loosening in the criteria for secured lending while criteria for unsecured lending appeared to have been tightened. A further large increase in the number of mortgage approvals in November, up 129,000, suggests that secured borrowing will remain strong in early 2007.

### Annual CPI inflation hits 3%

CPI inflation rose to 3.0% in December, well above the Bank of England's 2% target. Core CPI inflation (excluding energy, food, alcohol & tobacco) increased to 1.8%. The largest upward effects came from higher petrol prices and fuel duties as well as electricity and gas prices. Retail price inflation, which includes housing costs, rose to a fifteen year high of 4.4%.

Noting that "the risks to inflation now appear more to the upside," the Bank of England surprised markets by raising the official bank rate by 0.25% to 5.25% following the January MPC meeting. This is the highest official interest rate in more than five years.

National Statistics confirmed that the MPC had access to initial CPI data at their January meeting last week. The decision by the Bank of England to raise interest rates in a non-inflation report month emphasizes the level of concern which the Bank of England must have

for the outlook for inflation. The MPC has cited pay growth as a key area of concern, with the risk that higher inflation feeds through into higher wage inflation. With the January pay round now under way, the Bank of England may have wanted to send a clear signal to wage setters to restrain wage rises. RPI inflation is often cited in wage negotiations and its recent rise to a fifteen year high, is likely to place upward pressure on workers' wage claims. The latest Pay Report from Income Data Services suggests that rising inflation is feeding through into higher wages. The Bank of England Agents' have also pointed to some upward drift in pay growth. A modest up tick in the general public's inflation expectations to 2.7% in the Bank of England/NOP November 2006 survey may also be adding to upward pressure on wages.

While we think that interest rates have now peaked at 5¼%, the risks that the Bank of England may increase interest rates again during the first half of 2007 are high. If CPI inflation heads higher over coming months, as expected, Governor King will have to write a letter to the government explaining why inflation is more than 1% above target and how it will be brought back to the 2% target rate. While the outcome of wage negotiations will be a key focus over coming months, other indicators will also be important in gauging the overall outlook for inflation. The latest RICS survey suggests that while the growth in house prices remains strong, the pace of growth may be starting to cool. We will also be looking for signs that the recent increases in interest rates are leading to a moderation in money and credit growth.

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