

Growing Divisions Amongst MPC Members

As expected, the Bank of England raised interest rates by 0.25% at its policy meeting in July. Official rates have now been raised by 1.25% since August 2006, bringing the key Bank Rate to 5.75%, its highest level for six years.

The statement that accompanied the move was broadly similar to the tone of the one released when rates were last raised in May. With output remaining firm, the margin of spare capacity in the economy appears limited and the MPC continues to view that the medium term risks to inflation lie to the upside. However, while it retains a hawkish bias, there does appear to be some softening in tone.

Minutes Indicate 3-Way Split

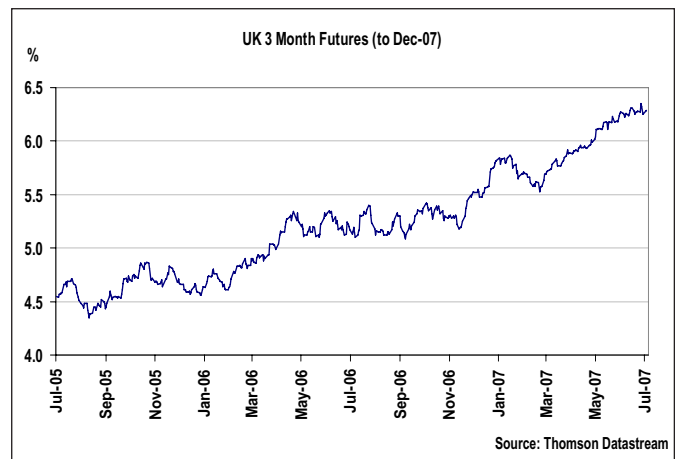
The July minutes showed that the committee voted 6-3* to change rates, compared to a unanimous vote in May. This majority was a little slimmer than the market had anticipated (BoE Chief Economist Charles Bean being the surprise vote for no change) and **divisions amongst the members are growing. There now appears to be three distinct groups.**

Those on the dovish end of the scale believe that the full effect of the significant policy tightening has yet to be felt. They fear that when this does eventually impact fully there is a risk of a sharper than anticipated slowdown in activity, particularly in household consumption.

Amongst those voting for a rate hike there seemed to be two camps. Firstly, those who felt that the risks remained to the upside but nonetheless favoured a gradual and cautious approach to further tightening. Although voting for a rate hike this month, **there was no clear presumption that further increases would be necessary** and much would depend on the tone of forthcoming data.

Finally, there are the hawks (considered to be King, Sentance, Besley and Gieve) who feel that a delay in tightening policy ran the risk of rates having to eventually go higher. This group believes that the effect of past tightening has not yet shown up mainly because the hikes seen over the past year represented the withdrawal of an accommodative policy stance. Monetary conditions were only just becoming restrictive, indicating a bias for even higher rates.

(* King, Gieve, Barker, Besley, Sentance and Tucker voted for a rate hike. Blanchflower, Lomax and Bean voted for no change)



When interest rates are coming close to their peak, the policy debate does become more tricky making it difficult to predict the future path of rates. The possibility that data over the coming months will be distorted by weather effects further complicates the picture.

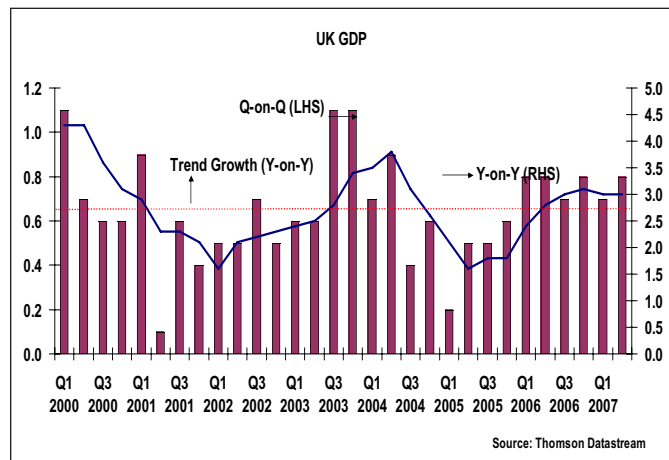
However, **those opting for a gradual and cautious approach would seem to hold the "balance of power"**. If forthcoming data indicate that the risks remain to the upside then it is likely that this group can be convinced to vote for at least one more rate hike.

Data Do Support Case for a Move to 6.0%

While tighter monetary policy should eventually slow the pace of economic growth, in our view, recent activity and inflation data do support the case for higher rates.

Provisional GDP data show that the economy grew by a stronger than expected 0.8% in Q2.

Faster growth in manufacturing and construction sectors more than offset an easing in output from services. The annual pace of GDP growth was 3.0%, the same as in Q1. It should also be noted that early growth estimates are often revised upwards.



With No Sign of Marked Downturn in Activity

Both the manufacturing and services PMIs remained at high levels in June.

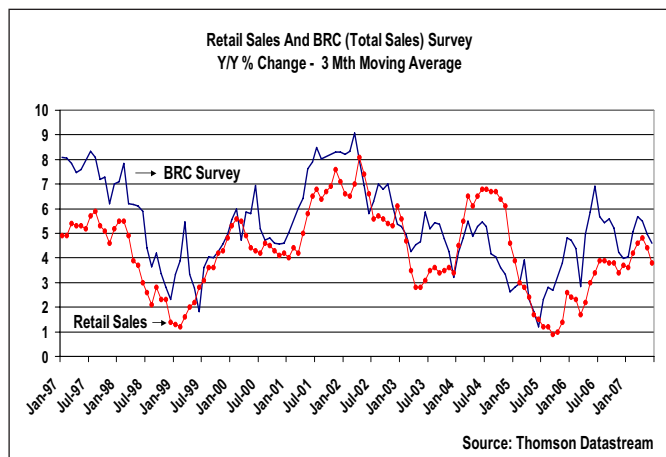
Retail sales figures for the same month indicate that the pace of personal spending is gradually slowing but the evidence is inconclusive.

Retail activity was affected by the bad weather, with food sales in particular disappointing as all those picnics and barbeques were cancelled. However, non food sales remained impressive.

There continues to be tentative signs of a slowing in housing activity amid further reports of falling buyer interest and an easing in the pace of growth in house price inflation.

Nonetheless, official data continue to show a strong market. House price inflation remains high in relative terms, with the y-on-y pace of growth in prices still above where it was this time last year.

However, the impact of past rate hikes is expected to intensify over the coming months as a high proportion of fixed rate mortgage deals expire. According to the Council of Mortgage Lenders (CML) over 2 million fixed rate mortgage deals will mature over the next 18 months, which could have a sizeable impact on the pace of consumer spending.





Core Inflation Hits 2%

Meanwhile, on the inflation front, the headline CPI rate continued its downward trend in June, falling to 2.4% from 2.5%. However, the deceleration was less than anticipated and the annual rate of core inflation (ex food energy and tobacco) rose to 2.0% from 1.9%, its highest level for a decade.

Furthermore, the costs of household goods and furniture increased again, suggesting that some retailers are still enjoying an increase in pricing power.

Food inflation also remained high. Given global supply developments, relatively high food prices could continue to exert upward pressure on inflation over the coming months.

This could offset to some extent the positive impact of year-on-year energy price developments and thus slow the rate of deceleration in the headline CPI. In the July minutes, the MPC commented that if goods price inflation continued at its current rate, then domestic services inflation would need to be lower than it has been in recent times to be consistent with the inflation target.

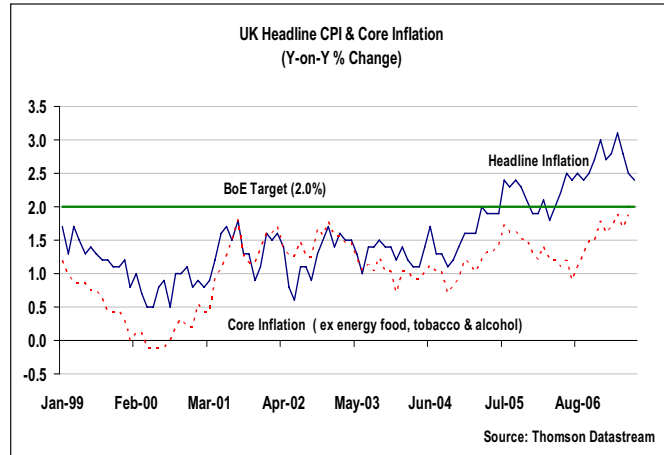
The Bank of England is also closely watching a number of surveys for guidance on underlying price pressures in the economy, and in particular pricing intentions. The evidence over the past month has shown some signs of improvement, indicating that pressure may have peaked. **However, these developments are inconclusive and may not be enough to prevent rates from rising to 6% in the coming months, with many of these indicators still at historically high level.**

Rate Move Unlikely In August

Some in the market feel that the publication of a Quarterly Inflation Report in August supports the case for a rate hike at next weeks' policy meeting.

However, some members of the MPC are likely to take a more cautious approach and will probably want to see further tightening policy again. We expect a move to 6.0% later in the year by which point data are likely to convince those in the wait and see camp to vote for a rate hike.

26th July 2007



	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.75	6.04	6.34	6.25	6.14
Sept '07	5.75	6.05	6.35	6.30	6.20
Dec '07	6.00	6.10	6.25	6.20	6.20
Mar '08	6.00	6.05	6.05	6.00	5.90

* Sw ap Forecasts Beyond 1 Year.
Current Rates Sourced From Reuters, Forecats AIB ERU