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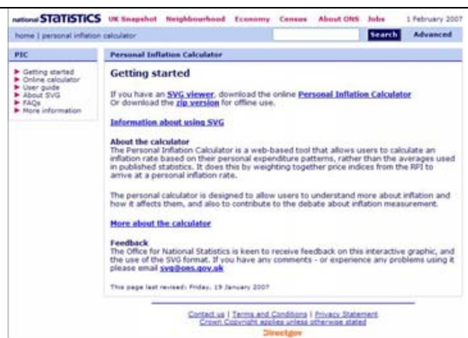
Provident Solutions Monthly Economic Review January 2007

The main news during January was a surprise quarter point hike in the Bank of England's Base Rate to 5.25%. Most commentators had been expecting an increase during 2007 – indeed, there is a general view that there is still some way to go before we reach a peak. Most people, however, felt that February was a more likely time, so an increase this early in the year was something of a surprise.

The Bank claims that the step is intended to help fight inflation – presumably by reducing demand as consumers have to tighten their belts to accommodate higher borrowing costs. But since the next round of wage bargaining is now in full progress, the fear is that pay claims will escalate now, in advance of higher interest rates actually biting, which will contribute towards "cost push" inflation. The ability of consumers (and pay negotiators) to calculate their own inflation rates (at www.statistics.gov.uk/pic/) is likely to make matters worse, rather than better.



A government site to see how high your inflation rate is

By contrast, interest rates in the US, Eurozone and Japan have remained level and US rates are generally expected to fall during the year.

Inflation

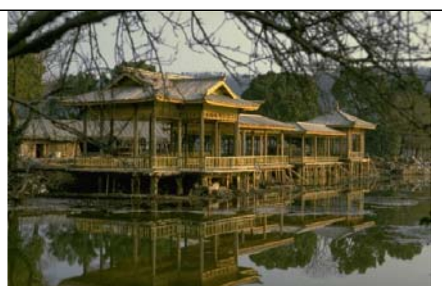
The latest inflation figures are all higher with the Consumer Prices Index (CPI) up from 2.7% to 3% (0.1% short of the level at which the Governor of the Bank of England will have to write explaining the position to the Chancellor), while the more widely used Retail Prices Index (RPI) is up from 3.9% to 4.4% and the RPIX (which excludes mortgage repayments) is up from 3.4% to 3.8%.

The problem is that, according to some pundits, the government itself is responsible for the most recent rises as a result of its fiscal policies. Increasing fuel duties by 2p per litre in early December contrasts with a 3p per litre fall in December 2005, thus contributing to the rise in prices.

Longer term prospects for inflation do not look good, however, which may be why the Bank is acting sooner, rather than later, in an attempt to stave off worse excesses to come. The problem is that we have just lived through a sustained period of relatively low inflation that has little to do with Gordon Brown's much vaunted stability but owes almost everything to world economic conditions.

> In general the RPI – used for many years as an indicator of inflation – includes a "basket" of goods and services including mortgage costs and council tax. The newer CPI was introduced to exclude mortgages and council tax also works on a "basket" of goods and services, but is calculated differently. The RPIX is the old RPI, excluding mortgage costs.

For years, we have benefited from the so-called "China effect" which reflects that we were able to import cheap goods from the Far East (and in the case of India, to export low-pay jobs within the service industries) thus keeping domestic prices low. One school of thought suggests that, as workers in those countries see the "benefits" of technology, they will demand higher wages thus increasing costs and making our imports more expensive. This could lead to levels of inflation in the UK that we have not seen since 1991.



Some parts of China are rural, but will that help?

A counter argument is that India and China are so vast that the impact of rising wages will be much slower, as only a minute proportion of the population is so far involved. However, this may prove optimistic, since number of people that could take over the work of those demanding better working conditions may be limited by the large size of each country.

Conversely, at least one economist feels that falling utility prices could cut UK inflation dramatically, this year. We shall see.

Markets

UK markets performed relatively poorly during January with the FTSE100 falling by 0.28% and the FTSE250 by 0.42%. One of the problems in the large-cap sector was the weakness of metal prices, which put pressure on the mining sector.

AIM, however, which has been underperforming the main indices for some time, managed a 1.70% rise, although it is still 5.93% down over the last 12 months. Elsewhere, the Dow Jones grew by 1.27%, the NASDAQ100 by 2.01%, the Eurostoxx50 by 1.42% and the Nikkei225 by 0.91%.

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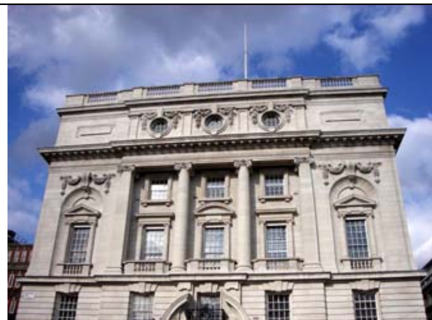
Oil prices fell by 5.69% to US$57.40, having actually dipped under US$55 during the month. This makes the price 7% lower than this time last year.

Government spending

It has been predicted that the next Prime Minister will face the worst economic mess for decades, when he (or she) takes over, thanks to the activities of the current Chancellor. The main problem facing the UK is that monetary policy has been too lax with government spending rising without corresponding increases in taxation. The gap has been filled by borrowing and the Chancellor had to change the start date of the current economic cycle in order to avoid breaching his own "golden rule" (that current account borrowing should balance over the period).



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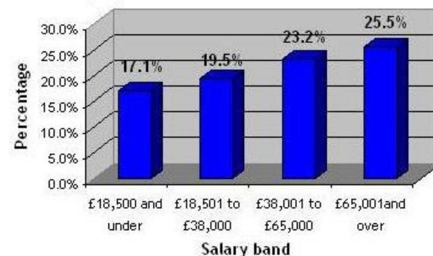
Government spending is at historically high levels

One example of this spending is the amount paid by the Exchequer towards civil service pensions. As the chart shows, at the higher end, contribution rates are more than 25% of salary; something that the private sector can only dream about. The government is looking at applying a cap on its contribution towards public sector pensions, by making employees contribute more, but it is likely to encounter strong resistance. Civil Service pensions were once more generous in order to compensate for lower pay. Whether this is any longer the case is a matter for debate.

The state sector now accounts for 45.3% if the economy; some would argue that this return to a level last seen in the 1970s is unsustainable in the modern world.



Government contributions towards civil service pensions are high

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