6 February 2006

The Shadow Monetary Policy Committee Quarterly Meeting and E-Mail Poll:

February 2006

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Editorial Note

The results of the latest Shadow Monetary Policy Committee (SMPC) quarterly meeting and supplementary e-mail poll for the *Sunday Times* are set out below. The rate recommendations are made ahead of the Monetary Policy Committee (MPC) rate decision to be announced on Thursday 9 February. On this occasion, four SMPC members voted to hold rates on 9 February, three voted for a ¼% reduction, and two voted for a ¼% rise. The SMPC itself is a group of independent economists drawn from academia, the City and elsewhere, which gathers once a quarter at the Institute of Economic Affairs (IEA) in Westminster, to monitor UK monetary policy. The inaugural SMPC meeting was held in July 1997, two months after the Bank of England was granted operational independence, and the Committee has met almost every quarter since.

The Secretary of the SMPC is Professor Kent Matthews of Cardiff Business School, Cardiff University, and its present Acting Chairman is David B Smith (Williams de Broë Plc and University of Derby). Other current members of the Committee include: Professor Patrick Minford (Cardiff Business School, Cardiff University), Professor Tim Congdon (Founder, Lombard Street Research), Professor Gordon Pepper (Lombard Street Research and Cass Business School), Professor Anne Sibert (Birkbeck College), Dr Peter Warburton (Economic Perspectives Ltd), Professor Roger Bootle (Deloitte and Capital Economics Ltd), John Greenwood (AMVESCAP), Professor Peter Spencer (University of York), Dr Andrew Lilico (Europe Economics), and Dr Ruth Lea (Director, Centre for Policy Studies and Non-Executive Director, Arbuthnot Banking Group). Professor Philip Booth (Cass Business School and IEA), who also attends physical SMPC meetings, is technically a non-voting IEA observer. However, he is awarded a vote on occasion to ensure that exactly nine votes are cast.

The document that follows reproduces the **IEA Press Release** (page 1) and the **Minutes of the SMPC meeting** held at the IEA on **Tuesday 17 January** (page 2). This material appears with the permission of the original authors. It has not been significantly edited by Williams de Broë, apart from the addition of margin notes and some minor amendments to achieve consistency with our 'house style' (the main exception is that it was not possible, for technical reasons, to incorporate the Charts in Dr Peter Warburton's presentation in the Appendix on page 7; these are available by enquiry to **economic.perspectives@ntlworld.com**). The opinions expressed in this document are, correspondingly, the views of the individuals concerned and do not represent a Williams de Broë house view. The next SMPC meeting will provisionally be held on Thursday 20 April 2006. The SMPC's regular monthly e-mail polls carried out in conjunction with the *Sunday Times* will continue to appear in the interim and will next be published on 5 March and 2 April.

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Please refer to risk warnings on back page

00Press Release

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Shadow Monetary Policy Committee votes to keep interest rates unchanged

The IEA's Shadow Monetary Policy Committee, a group of leading monetary economists drawn from academia and the City, voted to keep interest rates unchanged at its latest meeting. A vote to raise rates was defeated by seven votes to two and a vote to lower rates was defeated by six votes to three. The evidence presented to the committee about the UK economy contained conflicting signals, and this explained the unusually divergent views on the committee. The largest number of members believed it was appropriate to wait for more evidence before changing interest rates.

In the presentation of the international economic situation, concerns were expressed for international inflation. Across the world, the rate of broad money has been increasing to a level incompatible with current inflation levels. Future interest rate increases were likely in the Euro-zone and in the United States.

The picture was less clear in the UK. There has been a slowdown in the UK economy, but this was a result of factors such as increased taxation and reduced consumer spending, rather than as a result of monetary policy. Money supply growth is still strong. One member, Gordon Pepper, was particularly concerned about the way in which broad money growth was working its way into asset price inflation and other members expressed concern about rapid money supply growth and the prospects for inflation.

However, other members, including Dr Peter Warburton, who had delivered a briefing on the *Economic Situation* to the meeting (see: Appendix), believed that the risks of undershooting the inflation target were greater than the risks of overshooting and that, as a result, interest rates should be cut.

Note to Editors

The IEA is a registered educational charity and independent of all political parties. It accepts no corporate funds linked to research areas and allows no corporate donor to exceed more than 2% of annual income.

The minutes of the meeting are attached to this press release.

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Minutes of the Meeting of 17 January 2006

Attendance

Professor Philip Booth (IEA Observer), John Greenwood, Ruth Lea, Professor Kent Matthews (Secretary), Professor Gordon Pepper, David Smith (Chair), Dr Peter Warburton

Apologies

Professor Tim Congdon, Professor Anne Sibert, Dr Andrew Lilico, Professor Patrick Minford

Chairman's Comments

Future meetings

David Smith asked the committee to consider the value of continuing with the quarterly physical meeting, given the travel difficulties facing many members and the success of the monthly virtual (e-poll) meetings. There followed a short discussion and it was agreed that the SMPC should continue with the physical meetings but move the date so as not be so close to the previous e-poll. David Smith said that the usual formula implies that the next scheduled physical meeting would be on the day after Easter Monday and suggested that it should be shifted to Thursday 20 April.

The Economic Situation

David Smith invited Peter Warburton to present his analysis of the world and domestic economy.

World Economy: Low Return, Low Risk World is Misleading

US interest rates

Peter Warburton referred to his circulated notes (see Appendix, page 7). He said that no simple Taylor rule or inflation-targeting rule explains the path of the Fed Funds rate. The reticence in raising interest rates in the US can only be explained by the desire to avoid financial crisis. The side effect of keeping short-term interest rates as low as long-term interest rates, and a resulting flat yield curve, is the false impression that the world economy is a stable, low-return, but low-risk, situation.

House prices

There has been world-wide synchronised house price inflation that has decoupled from the real economy. This disequilibrium cannot persist.

World inflation to accelerate

Across the Euro-zone, broad money growth has been increasing along with the growth in housing finance. World broad money growth is now higher than in the recent past, and this is incompatible with current world inflation. Unusually, the low interest rate climate in the world economy has not resulted in a major reflation. A striking statistic is the increase in the number of personal bankruptcies in the US. However, higher world inflation is on course for the near future.

UK Economy: a Confusion of Statistics

Mixed picture

It is difficult to make sense of some of the figures for the UK economy. The inflation outlook remains benign. Households have been accumulating liquid assets as part of long-term savings, which also explains the stable but high growth of M4 held by the household sector. The slowdown in the UK economy is real. So what we have is a mixed picture of high broad money growth and economic slowdown.

Discussion and Policy Response

Banking sector

Gordon Pepper said that the paper had not referred to the banking sector and asked what the implication of world economic trends would be on bank balance sheets.

Creative accounting

Peter Warburton said that he suspected that, particularly in the US, the extent of non-performing loans has been hidden in creative accounting.

Exchange rate issues

Kent Matthews asked for clarification on the implication for exchange rates. Peter Warburton said that both sterling and the dollar would have to fall, but in the US, 6% yields on mortgage-backed securities have been helping to finance the current account deficit.

Low bond yields have boosted demand for broad money

David Smith said that changes to pension fund rules have bolstered the demand for bonds, which in turn has implications for money supply growth. In particular, a conventional demand for money approach would see the opportunity cost of an interest-bearing broad money definition, such as M4, depending on the gap between the government bond yield and the rate of interest paid on bank deposits. This means that the current negative yield gap may have encouraged people to hold money rather than bonds. The important question was whether this meant that rapid broad money growth was a passive phenomenon, which would unwind once the yield gap became positive again or, instead, represented a potential threat to sterling and the price level. The experience of previous UK money and credit booms suggests that it is too easy to dismiss rapid monetary growth as being purely demand driven, only to find out too late that major economic imbalances have built up in the intervening period.

Asset price inflation

Gordon Pepper said that the growth in broad money in the UK has worked its way into asset price inflation but, as yet, has had no effect on goods price inflation. This disequilibrium cannot persist: either goods price inflation must rise or asset prices need to fall.

Goodhart's Law applies in reverse

Peter Warburton said that, as in the past, it is usually at a time when broad money growth has low significance in policy thinking that it comes back with a vengeance to show that it matters. He said that the European Central Bank is very likely to raise rates over the year. The logic and pressure is that US rates should also move in that direction.

UK and world cycles

Kent Matthews asked for clarification about the UK monetary situation relative to the rest of the world. His impression of Peter Warburton's presentation was that the UK was in the same position as the rest of the world.

Britain ahead of the curve

Peter Warburton said there wasn't perfect synchronicity, and that the UK was ahead of the curve. In terms of the housing market, real consumer spending and nominal GDP, the UK has already decelerated.

Asian considerations

John Greenwood said that the analysis was correct in identifying the decline in real rates in the UK, but this was also true for the US and Australia. This phenomenon explains the rise in house prices and the prices of other long-duration assets. The decline in long-term real rates dates back to the late 1990s and coincides with the rise in the Asian savings surplus, which picked up after the Asian crisis of 1997. This was exacerbated by a fall in corporate investment in UK, the US and Europe after 2000, and the more recent build-up of corporate free cash flow. And in the last two years there have been substantial surpluses among oil-producers. To see a rise in real rates, one or more of three things must happen. First, there has to be a substantial revaluation of Asian exchange rates, but this looks unlikely in the near future. Second, corporate sector investment needs to pick up, but so far CEOs appear very cautious. Finally the oil producers' surplus has to disappear, and again this does not look imminent.

Individual Votes

David Smith asked the committee to make its recommendation.

Comment by Professor Philip Booth (Cass Business School and Institute for Economic Affairs)

Vote: Raise by 0.25%

Money supply growth warranted a hike

Philip Booth said that money supply growth has been far too high and was not compatible with the target rate of inflation. He recommended that rates should be raised by ¼%. He also commented that monetary policy should not be used to achieve other economic policy objectives, such as counteracting weakness in the economy arising as a result of the government's tax and public spending policies.

Comment by John Greenwood (Chief Economist, AMVESCAP)

Vote: No change

No need to tighten so far

John Greenwood said that the economy has shown some signs of improvement in housing and the retail sector. Growth is now more balanced. The yield curve is flat and the economy is growing moderately at below potential after a period of growing above its long-run potential. There is no need at present to tighten. He voted to keep interest rates on hold.

Comment by Dr Ruth Lea (Director, Centre for Policy Studies and Non-Executive Director, Arbuthnot Banking Group)

Vote: No change

Mixed picture suggests leaving rates on hold

Ruth Lea said that the economy has no spare capacity. Inflation is under control. Wage inflation is moderate. Therefore, there is no pressing need to cut or to raise. She voted for rates to stay on hold.

Comment by Professor Kent Matthews (Cardiff Business School, Cardiff University)

Vote: No change

Liquidity trap analogy

Kent Matthews said that the growth in broad money is not consistent with the current rate of inflation and those grounds would warrant a rise in the rate of interest. However, he was impressed by Peter Warburton's argument that retail money growth had remained stable and that households were holding money for savings purposes, not unlike the liquidity trap. He also recognised that the economy was at capacity and that there had been an improvement in demand on the retail side, which did not support a rate cut. He voted to keep rates on hold.

Comment by Professor Gordon Pepper (Lombard Street Research and Cass Business School)

Vote: Raise by 0.25%

Raise rates to forestall financial instability

Gordon Pepper said that if asset prices were expected to rise more rapidly than product prices, the expected real rate of interest for purchasing assets was lower than that for goods and services. When this was happening, rates could not be raised sufficiently to moderate asset-price inflation without causing a recession. At the moment, the expectations of inflation were roughly the same and the problem did not arise. Because asset prices were already very high - witness the incredibly low yield on index-linked gilt-edged stock - he was in favour of ¼% rise in rates to discourage a further increase. The reasoning for a rate rise was to forestall financial instability and not to control goods price inflation.

Comment by David B Smith (Chief Economist, Williams de Broë and University of Derby)

Vote: No change

Risks arising from a rate cut seem worse than would stem from a hold or a rise

David Smith said that he had no strong views either way, but thought that a rate cut was more likely to lead to longer-term problems than an increase. In particular, the British economy seems to have acted a bit like the bouncing bomb in the film *The Dam Busters*: it hit the surface last autumn, but did not sink, and now seems to be rebounding again. In particular, there are signs of a pick-up in the housing market, retail sales and in industrial surveys. Recent GDP figures seem weaker than one would expect from independent surveys and could be revised upwards. Total national output has also been reduced by a tax-induced (?) run-down in North Sea output and non-oil GDP rose by 1.9% in the year to 2005 Q3. Inflation is not an immediate problem, and the labour market appears genuinely weak, but the CPI figures are slightly higher than one might expect, given the behaviour of retail prices excluding housing items. The rapid growth in its wholesale element, which rose by 18.6% in the year to November, suggests that the M4 figures are being boosted by financial speculation. Retail M4 is chugging along in comparison, but still increased by 9.7% in the twelve months to November. Global monetary conditions are likely to tighten over the next few months, with a US Federal Reserve rate hike likely on 31 January and an ECB one on 2 March. Sterling could be knocked for six if the MPC cut rates at the same time as the rest of the world tightens. It is not worth risking triggering a portfolio shift out of sterling by cutting the UK REPO rate, and we would have to raise rates if world rates rose anyway. He voted to hold interest rates.

Comment by Peter J Warburton (Director, Economic Perspectives Ltd)

Vote: Cut by 0.25%

Real rates too high

Peter Warburton said that he remained a cutter, and that real interest rates to the private sector are too high. He voted for a ¼% reduction.

Votes *in Absentia*

The SMPC sometimes allows a small number of votes to be cast *in absentia* and adds their written submissions to the record of the meeting, particularly where it avoids the possibility of a tied vote. Two SMPC members who were unable to attend the physical meeting on 17 January cast votes.

Comment by Roger Bootle (Economic Adviser, Deloitte)

Vote: Cut by 0.25%

Difficult time to assess the economy

This is an extremely difficult time of year to assess the economy. As usual, there have been conflicting reports as to what has been going on. By the time of the February MPC meeting there will not be definitive evidence on the New Year period to set against the apparently strong Christmas trading, but the picture should begin to be a little clearer. Moreover, this month coincides with the Bank's regular forecast reassessment in preparation for the February *Inflation Report*. With little sign of any pass-through from high oil prices; headline inflation looking as though it is past its peak; and it looking as though economic growth will continue below trend, the Bank should cut interest rates by ¼%. This is what I would do, but it would not surprise me if the Bank waited a little longer for more evidence. I expect rates to fall to 4% this year.

Comment by Professor Anne Sibert (Birkbeck College)

Vote: Cut by 0.25%

Inflation has moderated

The prospects for UK inflation appear to have moderated. Although the average rate of CPI inflation during 2005 was 2.1%, the highest since 1997, CPI inflation peaked in September 2005 at 2.5% and was down to 2.0% in December 2005.

Labour market is slacker

While year-on-year employment still shows growth, during the last few months, employment has declined and inactivity has risen. These signs of labour market weakening are consistent with recent earnings data. Average earnings, excluding bonuses, rose by 3.8% in the year to November 2005, down from 3.9% in October. Including bonuses, average earnings rose by 3.4% in the year to November, down from 3.6% in October. Even with the rather poor underlying productivity growth of the UK economy, it is hard to see much threat to price stability from rapidly rising unit labour costs.

World growth

In the rest of the world, stronger growth in the Euro-zone and in Japan will be supportive of UK exports, but both Euroland and Japan remain fragile. In the United States, the downside risk to activity seems greater than the upside.

Inflation

With inflation more likely to be below target than above target over the time horizons that the MPC can affect it, I believe a 25 basis points cut is called for.

Policy Response

1) Putting together the seven votes cast at the physical meeting with the two votes cast *in absentia* revealed that the largest single block of four SMPC members believed that interest rates should remain on hold. However, there were dissensions both ways. In particular:

2) Three members voted to cut rates by ¼%, and:

3) Two members voted for a ¼% rise, with one emphasising the implication for financial stability rather than inflation control.

Date of next meeting

Thursday 20 April 2006, at 6.00pm (to be confirmed).

Appendix

The Economic Situation: Peter Warburton

The Monetary Situation

International

Misleading impression of stability

Underlying frailties in the global financial system continue to weigh heavily on the global yield curve. For a number of years, based on Mr Greenspan's thesis of asymmetric risks, the US Federal Reserve has held down short-term rates, first at emergency low levels and, subsequently, through a series of 13 regular instalments to 4.25% (a measured pace of increase). This unwillingness to raise interest rates more abruptly, to levels that would be consistent with long-run average real rates, has perpetuated a vibrant pace of credit creation both inside and outside the international banking system. An unfortunate side effect of policy caution has been the proliferation of leveraged carry trade activity, which continues to exert powerful downward pressure on long-term government bond yields, and on credit spreads, in various contexts. The resulting combination of fairly flat yield curves and historically low real interest rates gives the misleading impression that we are living in a stable, low-risk, but low-return world.

Exceptional OECD housing boom

Last year was characterised by a further extension of the global housing and housing finance booms. This OECD house price boom has been exceptional in a number of aspects: its longevity, its extent and its synchronicity. What is particularly unusual is its lack of correspondence with the macroeconomic cycle, represented here somewhat imperfectly by the output gap.

Wealth Creation in a Cul-de-Sac

Houses are unproductive assets

Domestic residences are unproductive assets, save for the utility that they provide to the occupants and the incomes that they generate in their construction and repair. Over the past ten years, a bunker mentality has developed in a least a dozen OECD countries, whereby savings have been diverted to an increasing extent towards residential housing formation, at the expense of more productive and employment-generating uses. This has come to resemble a sociological trend rather than a rational economic behaviour, in that the attraction of generational highs in corporate profitability has not yet succeeded in reversing it. The disconnection of real house price trends across the OECD group of 30 developed nations from any measure of the business cycle warns of dislocation ahead. In its latest *Economic Outlook*, the OECD authors characterise a typical national house price cycle as consisting of an expansion phase lasting about six years, with a 40% real house price appreciation, followed by a contraction phase lasting about five years, with an average 25% depreciation of real house prices.

Extent of international housing boom

The current housing upswing is some nine years old, on average, ranging from 27 quarters in Italy and Canada, to 49 quarters in Norway, 50 in Ireland and 78 in the Netherlands (although the past five years' gains have been very small). In extent, the median real house price increase is about 80% to 90%. Ireland leads the way, with total real appreciation of 243%, followed by the Netherlands (183%), the UK (137%), Norway (136%) and Spain (114%). As regards synchronicity, 2004 set a record of 12 countries (out of 17) recording a real house price gain of more than 25% over the previous five years, with 2005 tipped to match it. **By any reckoning, the 1997-2005 house price expansion is exceptional.**

House prices could halve

The historical record, since 1970, teaches that the declines in real house prices that have followed large run-ups have taken place more slowly if increases in the overall price level are small. Based on 25 such data points, a 12% inflation rate indicates that the housing market will take about four years to deflate; a 5% inflation rate is associated with an adjustment period of about six years; and a 2% inflation rate, about ten years. On this basis, it is not unreasonable to suppose that real house prices in these 12 OECD countries will be, on average, 50% lower in ten years' time

than today. Only when the moral hazard bubble bursts, will the global economy experience the degree of downturn necessary to break the upward trend in real house prices and restore a proper balance.

Broad Money on the March

World money growth has accelerated

There has been a gradual increase in the pace of world broad money growth since the summer of 2004, led by developed nations with housing finance booms. The 50-nation aggregate of broad money, weighted by size of GDP at current market prices, was remarkably docile in 2002-04, but over the past 18 months there has been a change of gear. The annual growth rate has ticked up from 6.5% in August 2004 to 8.5% in October 2005, the latest month for which most data is available. The composition of the faster growth is strongly suggestive of the influence of housing finance.

Recent monetary growth

In the US, the annual rate of broad money growth has advanced from 4.5% to 7.4%; in Italy, from 3.5% to 7.9%; in the Netherlands, from 3.2% to 9.7%; in Spain from 12% to 23%; in Ireland from 14% to 17%; in Greece, from 8% to 13%; and in New Zealand, from 3.5% to 9%. In the Euro-zone, excluding France and Germany, annual broad money growth has reached almost 14%. Little change has occurred in broad money growth rates for the UK (where the housing peak has passed), Japan, France, Germany or Canada. In Australia, money growth has receded from 13% to 8%.

Faster money growth boosts output initially, but then raises inflation

A number of implications flow from these observations. First, the OECD's synchronised house price boom is very long in the tooth and has decoupled from its past relationship with the economic cycle. Hence, the likelihood is that housing markets will exert a calming effect on global monetary conditions over the next 12-18 months. Second, the surge in various measures of global corporate liquidity over the past year or so is clearly related to the broad money development, as households have become more illiquid and debt-burdened. Conversely, the housing-related slowdown in consumer spending that appears to be taking hold in the US, as it has in the UK, will create adverse comparisons for corporate revenues and cash-flows in 2006. Third, the fact that there has been greater monetisation of the housing credit boom has unavoidable implications for global inflation in the near term, particularly in the US. If a 6.5% annual pace of world money growth sat comfortably with 4% real growth and a 2% world inflation rate, then an 8.5% pace does not. Worse, if there is a moderation in world GDP growth to 3.5% or 3% in 2006, then there is scope for an aberration in inflation to 3% or above. Having enjoyed the fillip to global growth in 2005 from an acceleration of broad money, we must now expect the unpleasant aftertaste of inflation.

Beware of bonds

In the context of a high degree of inflation complacency, even a 100bp rise in annual core (ex food and energy) inflation is likely to have a markedly adverse effect on government bond prices and on corporate risk spreads. It is liable to create the expectation of further material increases in the US Fed Funds rate, as well as a more aggressive profile of tightening moves by the ECB. If the Fed fails to respond to the re-emergence of an inflationary threat, then this could undermine the confidence of the financial markets early in the chairmanship of Ben Bernanke. **A market-driven tightening is in prospect which would restore an upward slope to the US curve and add more steepness to the slopes elsewhere.**

Bond market shake-out will be followed by deflationary distress

Many investors have grown complacent about low nominal government and corporate bond yields while this gradual monetary acceleration has taken place, having wrongly anticipated a spike in yields for the past two years. Now that faster monetary growth in the developed nations has been digested by the economic system, we should expect the core inflation rate to increase, government benchmark bond yields to rise markedly and corporate credit spreads to widen. This is unlikely to be the beginning of a serious inflationary spiral, but rather the trigger event for a relapse into deflationary distress, a surge in debt delinquency and the curtailment of credit supply.

Nominal GDP Growth in the G7

Weak growth in money GDP

In an environment of low nominal and real interest rates, it has proved extraordinarily difficult for the world monetary authorities to reflate. Nominal GDP growth for the G7 as a whole is running at only a little above 4% per annum. While the US and Canada have enjoyed some temporary successes, Japan and Germany continue to struggle with strong deflationary trends. France and Italy also display very low nominal growth rates of GDP.

US Economy

US growth/ inflation mix likely to deteriorate this year

After recording a 4.1% annualised growth rate in 2005 Q3, a quarter that included more than a month of hurricane effects, consensus expectations are for buoyant growth in Q4 and 2006 Q1, with any slowdown weighted into the second half of 2006. However, the evidence is accumulating of a consumer slowdown in the fourth quarter that may weigh more heavily on GDP growth. Rising inventories of unsold properties, slowing retail sales values and weaker mortgage volumes are all indicative of a softer tone to consumer spending, particularly when the impact of higher energy prices is considered. The price index for gross domestic purchases increased at an annualised 4.2% rate in Q3, with non-durable consumption prices rising at a 7.9% annualised pace. There is a risk of a much less favourable growth-inflation combination for the US for 2006.

Dependence on overseas central banks

The importance of foreign central bank purchases of US Treasuries diminished significantly in 2005, leaving private net purchases of agency and corporate bonds as the most important financing mechanisms for the rapidly expanding external deficit. While these net inflows continued to be powerful, at least through to October, the threat of withdrawal remains.

The UK Monetary Situation

Aggregate broad money

During 2005, the twelve-month growth rate of M4 money stock increased from 9% to 12.1% (November). Most of the acceleration has taken place in wholesale money deposits, where the increase was from 10.2% in December 2004 to 18.6% in November 2005. M2 (the retail deposits and cash component of M4) showed a milder gain, from 8.6% to 9.7%.

M4 holdings by sector

Holdings of M4 by the household sector grew by 8.1% in November, little changed from December 2004 and down from the 8.9% peak rate recorded in June. Private non-financial corporations increased their money holdings by 10.8% in the year to November, an increase from 7% for December 2004. The most significant change is for other financial corporations, whose M4 holdings picked up from 12.9% to 24.2%.

Lending

M4 lending slowed over the past year, from an 11.3% annual rate in December 2004 to 9.9% in November 2005, with the dominant influence coming from the household sector (12% to 9.6% for mortgages; 15.3% to 10.2% for consumer credit). Other financial institutions' lending growth also fell (from 17.4% to 9%) but the private non-financial corporations' growth rate rose from 7.3% to 18.6%. Financial activity, particularly Mergers and Acquisitions, appears to have been a major driver of the diverse trends in borrowing growth rates during the year.

Households' liquidity preference

Net acquisitions of financial assets by the household sector continue to show stronger accumulations of liquid assets (£14.3bn out of £25.5bn) than of long-term pension and insurance assets (£7bn) in Q3.

Inflation Performance

Petrol costs

The disturbance to the CPI inflation profile from sharply higher energy prices has been mitigated in the UK to a large extent by the high levels of taxation on motor fuels. Petrol and oil prices peaked in September, with a 17.5% annual increase and the household fuel and light component peaked in November, with a 14.6% gain.

The CPI and RPIX inflation measures have each returned to 2.0% for December, from 2.5% in September.

Benign inflation outlook

Whereas the private sector component of the RPI has edged up to a 1.2% inflation rate, as it has sought to pass on higher energy costs, this has been outweighed by a sharp fall in inflation pressures from the housing market, indirect taxation and international prices. The UK inflation outlook appears benign, as households suffer a deceleration of real disposable incomes and a decline in mortgage equity withdrawal.

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