



## March Minutes Surprise but Rate Hike Still Likely

### *Dovish Minutes Followed by More Hawkish Testimony*

For a central bank arguing that its job is to make monetary policy boring, the Bank of England seems to be finding it difficult to meet its own objectives. After January's surprise rate hike and much speculation in the market place about further tightening, the minutes of the March meeting show little indication of a central bank on the verge of raising rates again in the near future. However, more recent testimony by Mervyn King to the Treasury's Select Committee sounded a more hawkish tone.

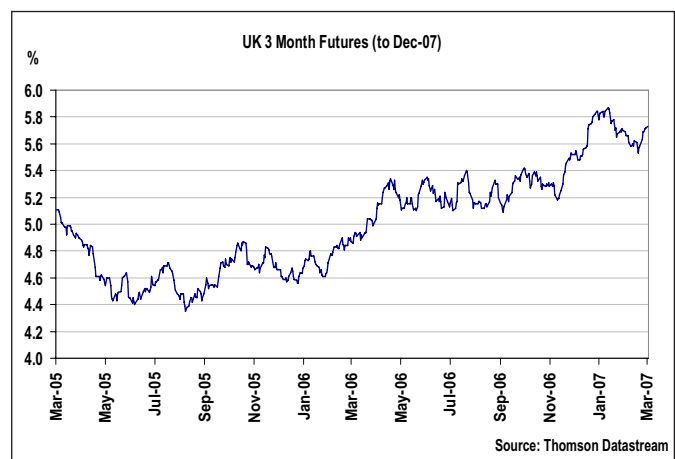
Contrary to expectations that up to three MPC members could opt for a rate hike in March, the committee voted 8-1 to leave rates on hold, with the only dissenter, David Blanchflower, voting for a rate cut. The general tone of the minutes was also more dovish than anticipated, particularly in relation to the comments on wage inflation.

The committee noted that it had previously been concerned about the potential impact of high RPI and CPI rates on wage inflation. However, wage settlements have been reasonably benign to date, with the year-on-year growth in average earnings (ex bonus) at 3.6% in the 3 months to January, well below the BoE's 4.5% comfort level.

The recent news on wage developments certainly seems to be what pushed Blanchflower into voting for a rate cut, as he remarked on the considerable evidence of spare capacity in labour markets. There was also some evidence that other cost pressures have eased, with import price inflation and manufacturer's input price inflation also declining.

The Bank sees considerable volatility in the CPI over coming months as trends in energy and other utility prices impact. **At the March meeting the short-term outlook for inflation was judged to be a little lower following the release of the January CPI data, which showed the year-on-year rate falling from 3.0% to 2.7%. However, inflation data released since then show inflation rising again to 2.8% in February. The more hawkish tone of the MPC's testimony to the Treasury Select Committee on 27th March could be a reflection of this renewed pick-up in the CPI.**

For most members, the increased level of uncertainty in financial markets in the run up to the March meeting was also considered to be supportive of the case for leaving rates unchanged this month.



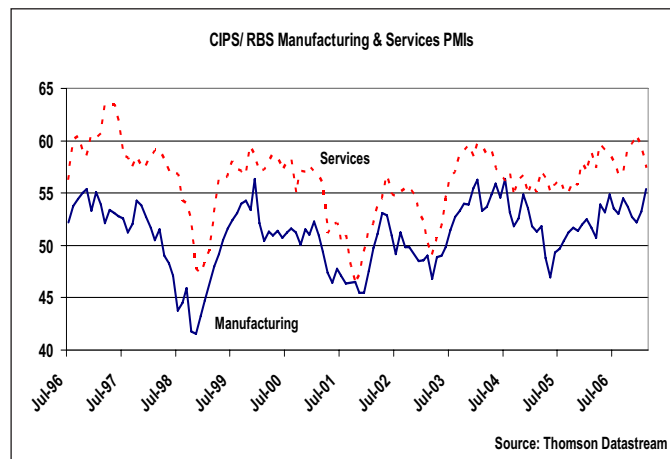
### ***But Too Early to Say That Rates Have Peaked***

**Despite the March decision, in our view, there is still a strong possibility that interest rates will be raised again. At the end of the day, the MPC still considers the medium term risks to inflation as being on the upside. Furthermore, activity and sentiment data released over the past month have, in general, been supportive of higher rates and capacity constraints remain in most sectors of the economy.**

Thanks to a sharp rise in new orders, the manufacturing CIPS index rose to 55.4 in February, its highest level since July 2004. This suggests that the fall in manufacturing output seen in January is unlikely to last.

**The survey also showed evidence of an intensification in output price pressures, with this component of the index rising to 56.9, its highest level since the series began in November 1999.**

The latest reports from the Bank's regional agents also indicate that manufacturers continue to seek to rebuild margins to the extent that competitive pressures will allow.



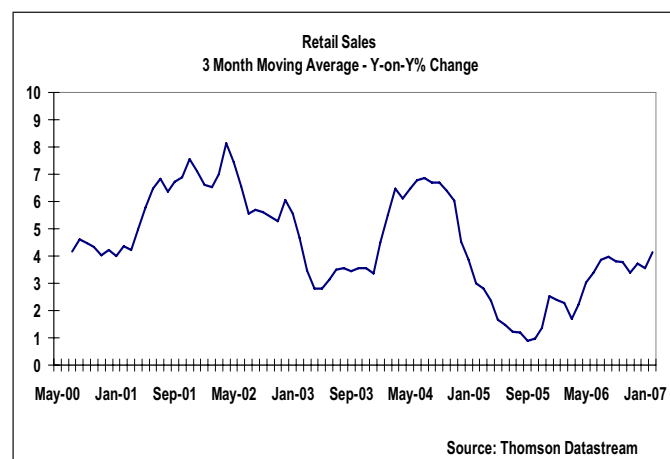
According to the services CIPS survey, activity levels in this sector fell for the second month running in February. **However, the index still remains at levels consistent with above trend growth and other survey evidence indicates that growth in services output continues at a rapid pace.** Investment decisions in this sector also remain at high levels.

### ***Consumer Spending Remains Strong***

**Despite January's sharp fall of 1.8% in retail sales there has been little else to suggest a marked deterioration in consumer spending.**

Sales bounced back in February (again this data was released subsequent to the MPC meeting) and in year-on-year terms high street spending is running at 4.9%, the fastest pace of growth since the end of 2004.

Moreover, the latest CBI distributive trades survey does not indicate any real fall off in spending going forward. It also showed a rise in the output prices balance, supporting the evidence from the manufacturing sector that firms are trying to rebuild margins through higher prices.



**Meanwhile, leading indicators continue to suggest that higher interest rates are having some dampening effect on housing market activity,** in particular in the new homes area. Sources are reporting that viewings are lower than normal, with incentives being offered to secure sales. **Generally, though, housing demand is being described as robust.**

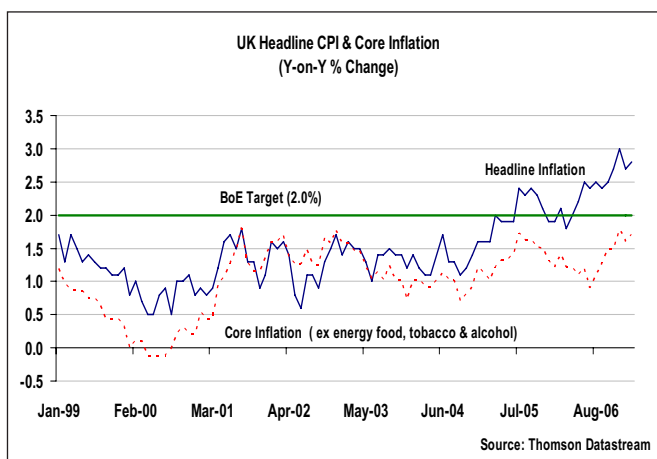


### Headline Inflation Still Well Above Target

The annual CPI rate rose to 3.0% in December, its highest level since records of this series began in 1997. It subsequently fell back to 2.7% in January before rising moderately again in February to 2.8%. Thus, the headline inflation rate remains nearly 1% above the Bank's target level of 2.0%.

Underlying inflation (ex the volatile energy, food alcohol & tobacco components) also rose again in February, rising to 1.7% from 1.6% previously.

Furthermore, the more traditional measure of inflation and the one used as the reference point for wage bargaining, the RPI, hit a 15-year high in February, rising to 4.6% from 4.2% in January. Thus, despite the recent benign news on wage settlements, the threat of a pick-up in wage growth seems likely to remain for some time.



The rate of inflation could fall back sharply over the coming months as lower utility prices impact. However, even if this spike upwards in inflation does prove to be a short-term phenomenon, **the Bank still believes that the risks to inflation over the medium-term remain on the upside** as outlined in the February inflation report. **Giving testimony on this report to the Treasury's Select Committee on 27th March, Mervyn King stated that there are no clear reasons to change this judgement and there were concerns "that there was a little more pricing power in the market".**

Meanwhile, the M4 money supply growth remained strong at 12.8% year-on-year in February, which could have implications for the medium-term inflation outlook. Again, when speaking to the Treasury Select Committee, **King identified this strong growth in monetary aggregates as an upside risk to inflation**, though he remarked that his MPC colleagues seemed less concerned about the potential impact.

### Rate Set to Rise by Another 0.25%

**On balance, we continue to expect rates to be increased by a further 0.25%, probably in May when the next Quarterly Inflation Report is due. However, this should represent the peak of rates in this cycle.**

There should be a marked improvement in the inflation profile over the course of H2, with consensus forecasts showing a Q4 inflation rate of 1.9%. Meanwhile, activity levels are also forecast to cool over the balance of the year as higher interest rates and some deceleration in the global economy impact.

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.25	5.58	5.83	5.71	5.57
Jun '07	5.50	5.65	5.75	5.65	5.50
Sept '07	5.50	5.60	5.65	5.55	5.40
Dec '07	5.50	5.60	5.60	5.55	5.40

\* Swap Forecasts Beyond 1 Year.  
Current Rates Sourced From Reuters, Forecats AIB ERU

### 28th March 2007

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