AIB Global Treasury
Economic Research

BoE Moves Slowly Towards Policy Easing

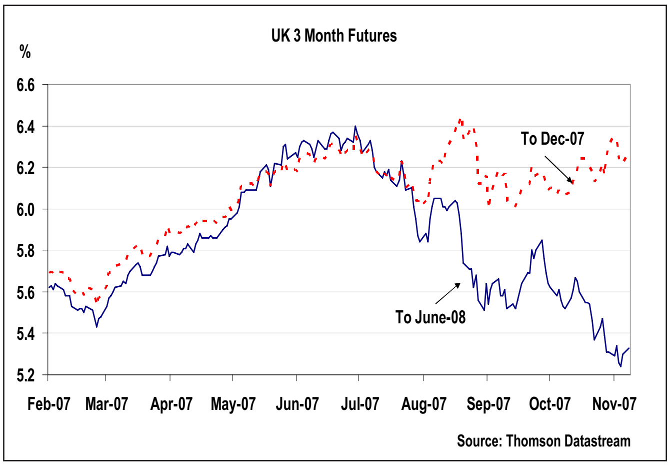
The November inflation report provided further support for a move to lower interest rates in the UK. Indeed, the report was more forthright than anticipated, going so far as to endorse the market's view that rates could fall by at least 0.50% over the coming year and still leave inflation around target over the medium term. The minutes of the last policy meeting (7/8 November) also confirmed the move to an easing bias, with two MPC members, including the Deputy Governor, John Gieve, voting for a rate cut.

Nonetheless, we remain of the view that rates will not be reduced before year end, with some MPC members concerned about lingering signs of inflationary pressures and data showing that, although activity levels have begun to slow, the economy continues to expand at a relatively strong pace.

Continuining Turmoil Poses Downside Risks

The two MPC members (Gieve and Blanchflower) who voted for a rate cut, put forward a reasonable case, arguing that the effects of earlier policy tightening were now evident in the slowing commercial property and housing markets.

There is also mounting survey evidence of a slowdown in the pace of activity in the services sector, which has been the main engine of growth in the UK economy over recent times.



Gieve and Blanchflower further argued that pay growth was muted, which should ease inflation concerns in 2008. **Meanwhile, they believe that the continuing turmoil in financial markets also poses downside risks to the economy. Waiting to cut interest rates risked making the slowdown sharper and longer than it needed to be.**

But Majority of MPC Feels There is Time to Wait

The majority of the MPC members, however, felt that a move at this point, which was largely unanticipated by the markets, would be misinterpreted. They also believed that "*there was time to wait and see whether, and to what degree, the projected slowdown became evident in real activity data*".

The Bank's August inflation report anticipated a slowdown in activity going forward but, if anything, recent data have been stronger than the BoE had expected. The economy certainly finished the third quarter in good shape. The initial GDP growth estimate (which were the only

John Beggs
Chief Economist
john.f.beggs@aib.ie

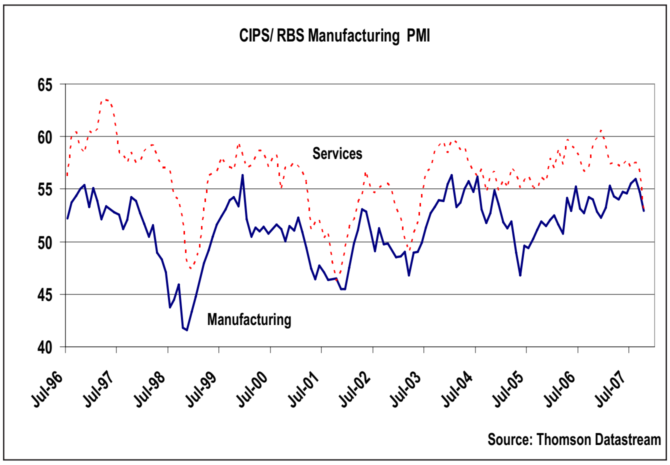
Oliver Mangan
Chief Bond Economist
oliver.n.mangan@aib.ie

Geraldine Concagh
Senior Economist
geraldine.t.concagh@aib.ie

Jenny Pollock
Senior Economist
jenny.c.pollock@aib.ie

numbers available at the time of the November meeting) was subsequently revised down from 0.8% to 0.7%. The annual growth rate slipped from 3.3% to 3.2%. However, notwithstanding this modest revision, growth was still very solid, with the year-on-year rate still above that of the previous quarter. Once again, the services sector was the main growth driver.

Falling PMI surveys for both the manufacturing and services sector, as well as a dip in the leading indices of the BoE's Agents' report, indicate this robust pace of activity will decelerate over the duration of the year and into 2008.



As Yet, Limited Evidence That Real Economy is Slowing

However, there is little real evidence, as yet, that financial markets turmoil and tighter credit conditions have impacted to any great extent on households and business activity. A survey of 900 companies carried out by the BoE's Agents as part of their recent review supported this view, reporting few direct effects to date. The review also noted that, while capacity constraints have eased, they still persist in some sectors.

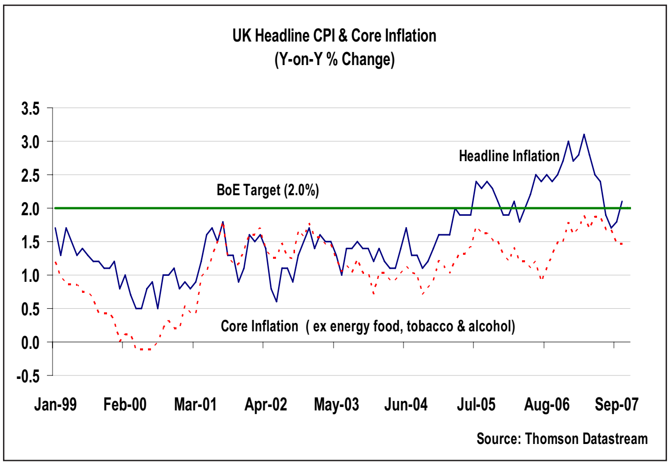
Admittedly, higher interest rates are slowing the housing market, with price surveys weakening and mortgage approvals down 19.7% in year on-year terms in September. Manufacturing output also fell sharply in September. However, **consumer spending remains resilient, despite last month's 0.1% fall in retail sales volumes.** Sales were still up 1.1% in the three months to October and are up by 4.4% in year-on-year terms and could pick up some pace again going into the Christmas period.

Meanwhile, the labour market appears to be in robust shape. The number claiming unemployment benefit fell in October for the 13th consecutive month. In addition, the pace of earnings growth picked-up further to 4.1% y-on-y in the three months to September, up from recent lows of 3.7% in the three month period to July. This acceleration in earnings was mainly driven by the services sector.

The easing in activity that is anticipated over the coming months is probably no more than the MPC deems necessary in order to meet its inflation target. Thus, it is probably too early for it to conclude that it can relax and cut rates.

CPI Moves Back Above Target

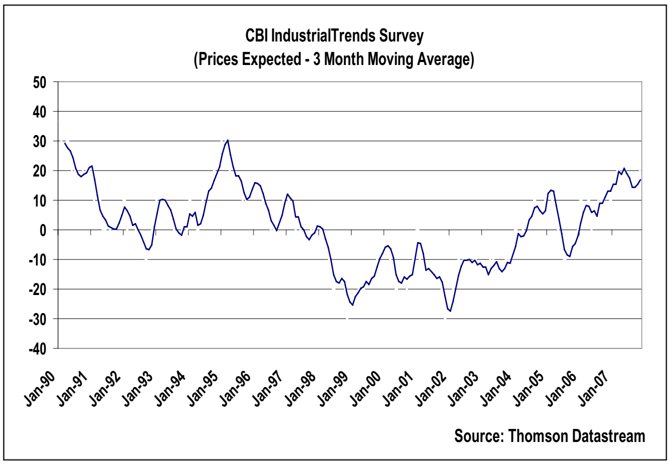
The hawks on the MPC are also likely to take little comfort from recent inflation data. The headline CPI rate moved up to 2.1% in October (from 1.8% in September), the first time in four months that it has risen back above the BoE's 2.0% target.



There was a sharp rise in petrol prices, adding 0.3% to the annual rate. However, food prices also accelerated, rising to 4.7% in year-on-year terms, up from 3.7% in September and the highest rate since June of this year. **Both of these components look set to remain subject to upward pressure over the coming months as world commodity prices remain inflated, which could push the headline rate higher.**

Upside Pressures on Prices to Remain for Now

Meanwhile, the annual rate of core inflation, which excludes volatile alcohol, tobacco, food and petroleum prices, remained at an 11 month low of 1.5%. This could also be set to rise, however, as retailers look to rebuild margins after recent heavy discounting.



Indeed, the recent survey by the BoE's Agents reports that "*despite recent discounting, most contacts expected that a low point for retail goods price inflation was near.* ***Deep discounting was not expected to be sustained....higher materials costs were beginning to feed through to retail prices of various household items"***.

Furthermore, the recent CBI industrial trends survey showed evidence that manufacturers intend to pass on higher costs to retailers by raising their selling prices. The prices expectations balance jumped to +21 in November, up from +14 in October and the highest since May's 12 year high. This rise in expected prices suggests a confidence about the future pace of activity, with the survey also reporting that the demand for consumer goods was holding up well.

Rate Cuts Unlikely Until Early 2008

Overall, current inflationary pressures may be enough to prevent the MPC from cutting rates in the short-term, until at least there is further evidence that the pace of economic activity is indeed slowing.

UK Interest Rate Forecasts

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.75	6.56	6.00	5.45	5.26
Dec '07	5.75	6.20	6.00	5.45	5.25
Mar '08	5.50	5.65	5.60	5.50	5.50
June '08	5.25	5.35	5.40	5.40	5.40

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

Recent comments from the Bank's Chief Economist Charles Bean echoed this view, as he stated that policy may have to remain tight for some time given rising inflationary pressures, even though financial market turmoil could spread.

Thus, while the November inflation report and minutes of the last policy meeting both show that the MPC is clearly moving towards a rate cut, it does not appear to be in any great hurry.

In our view it is unlikely that rates will be cut before year end. We see a rate move in Q1 2008, when official rates are likely to be cut by 0.25% to 5.50%. A further 0.25% decrease is likely in Q2 next year.

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AIB International Centre, IFSC, Dublin 1 Tel: 353-1-8740222 Fax: 353-1-6799590