AIB Global Treasury
Economic Research

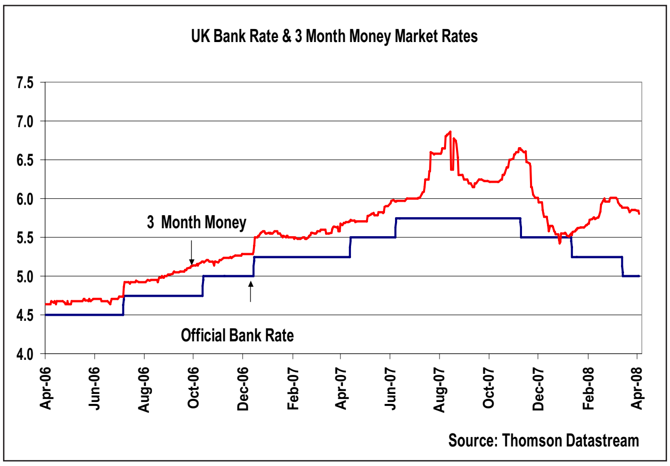
Bank of England Watch Issue: May - 2008

# Further Rate Cuts Anticipated as Credit Crunch Tightens Its Grip

**The Bank of England cut interest rates by 0.25% to 5.00% at its April policy meeting. In cutting rates the MPC once again highlighted the dilemma it faces given elevated inflation expectations and downside risks to growth. However, it also acknowledged for the first time that the problems in financial markets could lead to a slowdown in the economy that was sufficiently sharp to pull inflation below target.**

The minutes of the meeting revealed that two MPC members (Sentence and Besley, well known hawks) voted against the rate cut, fearing that a move at this juncture would indicate that the MPC was more focused on offsetting downside risks to growth rather than hitting its inflation target in the medium term. This would suggest a growing split between those focusing on the near-term upward risks to inflation and those looking at the impact that the worsening economic outlook will have on the medium term inflation outlook.

Nonetheless, **the Bank appears to have established an informal pattern of cutting rates every two months. We continue to expect the bank rate to be at 4.50% by the end of the summer (with the next move seen in June), with further modest easing likely before year end.** The increasing downside risks to growth stemming from the dysfunction on credit markets, emergence of space capacity in the domestic economy and weaker global environment all support this view.




**The 0.75% reduction in official rates since last December, as well as the BoE announcement on April 21st of measures aimed at boosting liquidity, have had little impact on short term money markets rates**, which remain at elevated levels, leaving firms and households facing tighter credit conditions.

3 month rates are currently trading at an even greater margin to the official bank rate that they were before the April rate cut. Mortgage providers have announced increases to the cost of fixed term facilities, reflecting the pressures in the market. As well as higher rates, consumers are also facing a reduction in mortgage offer/ products as lenders are forced to scale back on activity.

### *Economic Slowdown Gathering Momentum*

**Data released over the past month indicate a gradual slowing in the pace of economic activity.** Advance estimates of Q1 GDP show that the economy grew by 0.4% in the first three months of the year, the weakest rate of quarterly expansion since Q1-2005, and down from the 0.6% growth rate seen in Q4-2007. **There was a deceleration in both production and**

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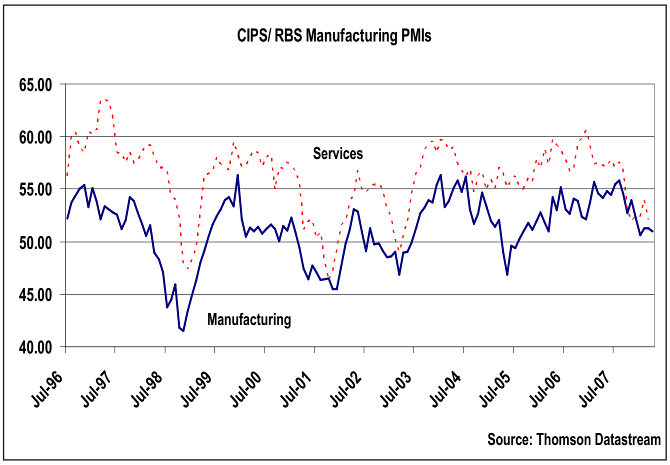
**service industries as compared with the previous period.** The year-on-year growth rate slowed from 2.8% to 2.5%, below the central projection as outlined by the BoE in its February inflation report. **Forward looking indicators point to a further deceleration in activity over the coming quarters.** Manufacturing output performed better than expected in Q1 rising by a respective 0.5% in January and February. However, total industrial production was down in the quarter as the manufacturing gain offset by a fall in output from energy related sectors.

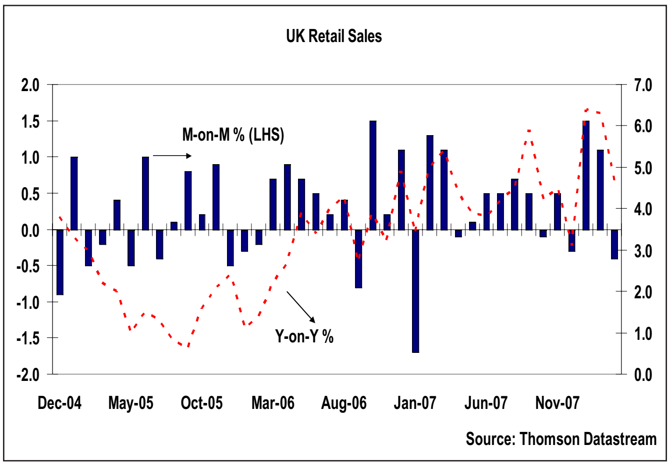



Furthermore, **the pick up in manufacturing output, which has been boosted by an increase in export related sales resulting from the depreciation in sterling, is unlikely to be sustained.** Overseas demand is forecast to fall off over the course of the year as the full global impact of the financial crisis takes hold. Indeed, the CBI's manufacturing survey for April showed a sharp fall in export orders. The manufacturing PMI for the same month (which showed the headline index falling to 51.0 from 51.3, the second weakest reading in two years) also reported a fall off in export demand.

Meanwhile, data on the services side also point to downside risks. **The services PMI held up well in the first two months of the year. However, it fell sharply in March and is expected to record a further decline in April. With tighter credit conditions and faltering business and consumer confidence expected to impact further going forward, service providers are increasingly pessimistic about the outlook for Q2.** The slowdown continues to be most evident in the demand for professional and financial services, though there are increasing reports of a reduction in the demand for other services.

### *Retail Sales Growth Continues to Surprise*

**The volume of retail sales surprised on the upside in Q1, rising by 2% and suggesting that there is still plenty of life on the High Street. However, the increase in volumes seems to have come at the expense of falling margins with the retail sales deflator falling sharply in March. The official data are also at odds with survey and anecdotal evidence.**



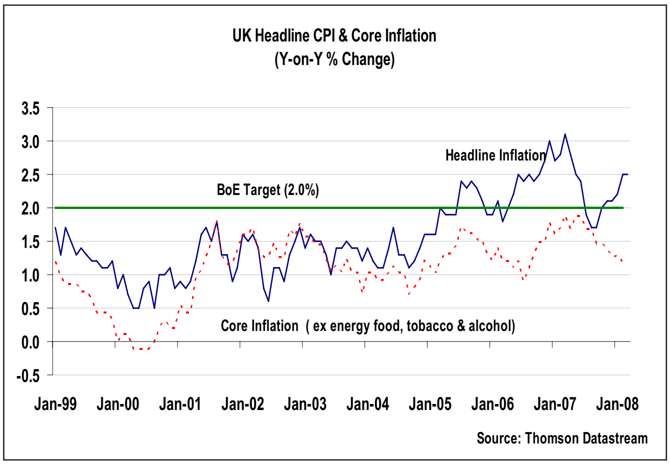

The latest BoE Agents survey reported further evidence of households reining in discretionary spending. The CBI distributive trades survey for April was exceptionally weak and the agency is in "no doubt that consumers are tightening their belts as their mood about the economy and its outlook worsens". Consumer confidence fell sharply in April and is now at its lowest since November 1992, real income growth is weak, personal savings are low and asset wealth is falling.

### *Housing Market Weakens Further*

**The latest news from the housing sector indicates that the slowdown there is gathering momentum,** with a number of key house price surveys are now showing prices falling on a year-on-year basis. Activity levels are reported down and sales times are widening as would-be buyers take to the

sidelines waiting to see how events unfold. **Banking data suggest further weakness ahead. After remaining broadly stable since December, mortgage approvals fell to record lows of 64,000 in March compared to 72,000 in the previous month.** The projected downturn in the pace of general economic expansion and likely weakness in the labour market also suggest further weakness ahead in household spending and the property market. Although official data show that the labour market remains in a healthy state, surveys show that the employment intentions are already softening.

***Inflation Still A Concern***




**While the downside risks to growth are gathering momentum, inflationary pressures are rising.** The headline rate of inflation held steady at 2.5% in March, keeping the CPI well above the BoE's 2.0% target level. The CPI is expected to climb towards the 3.0% level over the coming months as high food and energy prices impact.

The annual rate of core inflation (ex volatile food and energy) also held steady at 1.2%, the lowest level since August 2006, suggesting that there is little evidence of a pass through from higher input prices. Meanwhile, growth in average earnings remains at comfortable levels, indicating that building price pressures have yet to feed through to the labour market.

However, other **price data/survey evidence (including the PMI, CBI, BCC and BoE Agents' reports) released over the month suggest ongoing upside risks to prices, a worry for the BoE who sees it as crucial that the rise in the CPI proves temporary.** Inflation expectations, or the rate at which prices are expected to rise over the coming year, are already at record highs, heightening fears that higher inflation will become entrenched.

***But Weaker Growth to Provide Scope on Policy Front***

However, as adverse developments in financial markets and the banking system take greater affect, UK growth faces considerable downside risks for 2008. The external environment is also likely to become increasingly less supportive, with conditions in the US remaining difficult and growing signs of a slowdown in the eurozone. Thus, we predict below trend growth for the UK this year, which should help drive inflation lower over the medium term, facilitating an easing in monetary conditions.

**UK Interest Rate Forecasts**

| | Repo Rate | 3 Mth | 1 Year | 2 Year* | 5 Year* |
|---|---|---|---|---|---|
| Current | 5.00 | 5.83 | 5.80 | 5.35 | 5.25 |
| June '08 | 4.75 | 5.30 | 5.30 | 5.20 | 5.15 |
| Sept '08 | 4.50 | 4.90 | 4.90 | 5.00 | 5.00 |
| Dec '08 | 4.25 | 4.70 | 4.75 | 4.85 | 4.90 |

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

**While the case for aggressive action is not seen as compelling, rates are likely to continue to come down in modest 0.25% stages over the coming months, reaching 4.5% by the end of the summer. Some further modest easing is likely before year end with rates forecast to finish the year at 4.25%.**

***1st May 2008***



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