AIB Global Treasury
Economic Research

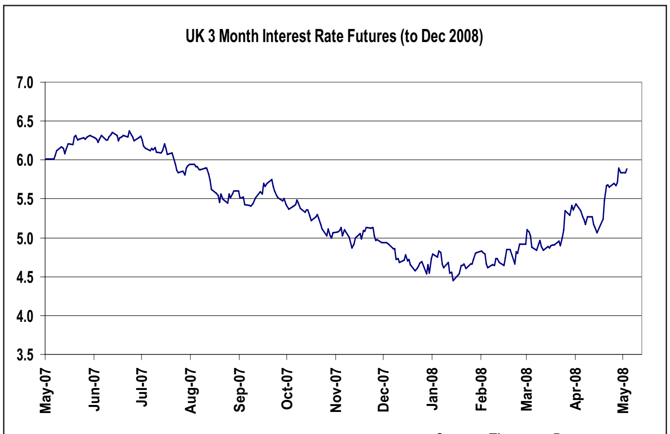
Bank of England Watch Issue: June - 2008

Inflation Concerns Rule Out Prospect of Near Term Rate Cuts

The Bank of England left interest rates on hold at 5.00% at its May policy meeting. The minutes of that meeting and the May Quarterly Inflation Report (QIR) indicate that, after three cuts of 0.25% since December 2007, UK monetary policy is now on hold. The pace of economic activity continues to slow but concerns about rising inflation are preventing a more aggressive easing in policy. We still expect rates to go below the 5.00% level but it may now be towards the end of 2008 before any further easing is possible.

QIR Shows Sharp Upward Revision to CPI Forecast

The projected path for inflation over the next two years, as outlined in the QIR, was based on the market assumption that the Bank Rate would be cut by a further 0.50% before year end. **Under this scenario, the MPC's forecast for headline CPI was revised sharply upwards with inflation above the 2% target in two years, suggesting that market expectations for interest rates were overdone.**



Source: Thomson Datastream

The CPI is seen peaking at close to 4% in Q4 (compared to just above 3% in the February report) and remaining above 3% for several quarters thereafter. This would require the Bank to write a number of letters to the Chancellor explaining what it plans to do about the fact that inflation is more than 1% above target.

The BoE's prime objective is price stability and in getting inflation back to target believes that growth needs to slow further than it has already done. Indeed, according to Mervyn King it is even "quite possible" that we may have to endure an "odd quarter or two of negative growth" in order to keep a lid on inflation expectations. **This effectively rules out the prospect of any further rate cuts in the near term.**

Inflation Hits 3.0% in April

May's policy decision was taken in the knowledge that the CPI rate had spiked from 2.5% in March to 3.0% in April. Meanwhile, pressurised by rising raw material costs, growth in producer prices is running at historic highs. There was also a worrying pick-up in the core CPI from 1.2% to 1.4%, suggesting a build up of underlying inflationary pressures. A further pick-up in the CPI is anticipated over the coming months, with leading price data/survey evidence (including PMI's, CBI, BCC and the BoE's Agents Reports) all continuing to suggest upside risks on the inflation front. **With inflation expectations already at record levels, the Bank fears that a prolonged period of an above target CPI will result in inflation becoming embedded in the economy.**

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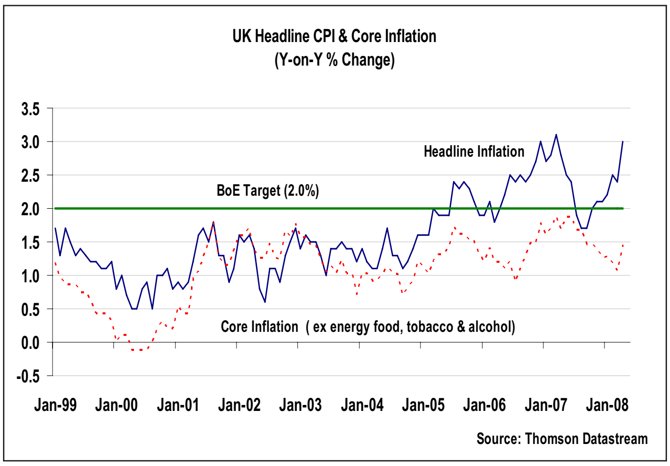
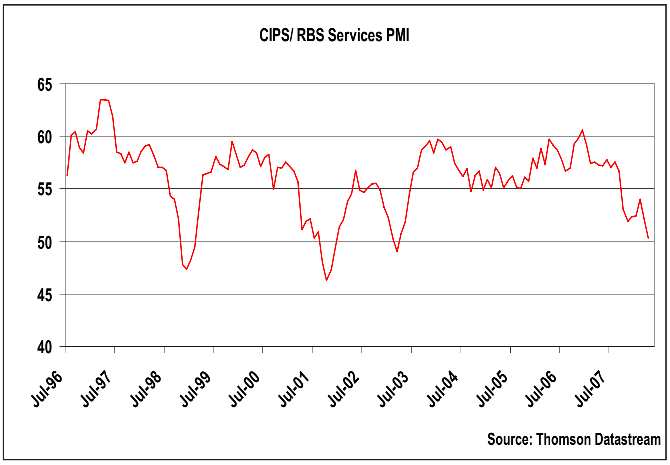
Downside Risks for Growth Intensify

The MPC's marked deterioration in its assessment of the outlook for inflation and the implications for monetary policy present, in our view, considerable downside risks for the growth outlook.



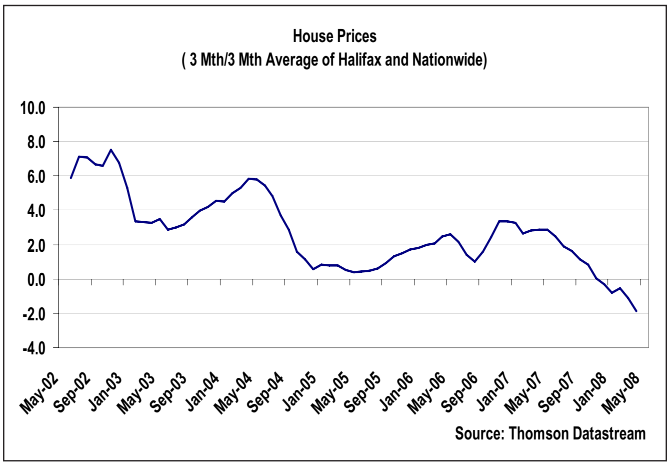
Data continue to indicate a further gradual slowing in the pace of economic activity. The economy grew by 0.4% in the first three months of the year, the weakest rate of quarterly expansion since Q1-2005. The year-on-year growth rate slowed from 2.8% to 2.5%. The increase in output was driven by consumer and government spending. However, both of these sectors are likely to lose momentum over the coming quarters, with growth in household and public spending squeezed by the deteriorating economic outlook.

Leading indicators support this expectation of weaker activity ahead. **The services PMI fell sharply in March and April, and at 50.4 is now at its lowest levels since February 2003.** The slowdown in activity continues to be most evident in the demand for professional and financial services, though there are increasing reports that the downturn is also filtering through to the demand for other services.



The services PMI does not cover the retail sector, though while **official data suggest that there is still plenty of life on the High Street this is at odds with other survey and anecdotal evidence.**

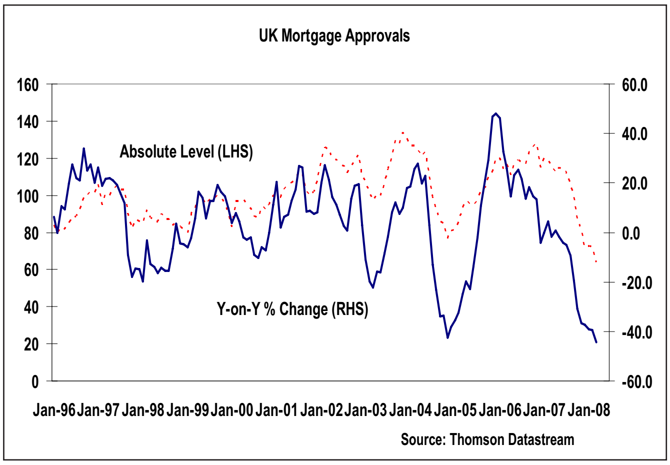
The BoE's Agents survey for May reported further evidence of households reining in discretionary spending, while other surveys show that retailers are pessimistic about the prospects for sales in the coming months. Consumer confidence fell sharply in April and is now at its lowest level since November 1992. Meanwhile, real income growth is weak, personal savings are low and household asset wealth is falling.



Housing Slowdown Gathers Momentum As Credit Crunch Tightens its Grip

The slowdown in the housing marked is gathering momentum, with the downturn here likely to weigh on household consumption. A number of key house price surveys are now showing prices falling on a year-on-year basis. Meanwhile, activity levels are reported to be well down with sales times widening.

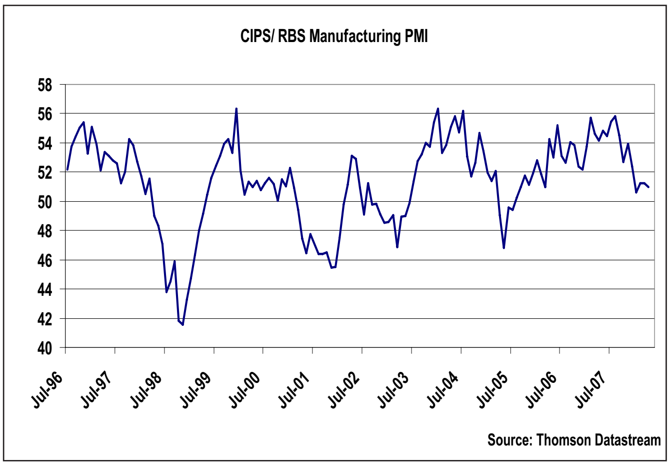
Banking data suggest further weakness ahead as households face tighter credit conditions, with the latest official reports showing mortgage approvals down over 40% in year on year terms.



The projected downturn in the pace of general economic expansion and likely weakness in the labour market also suggest further weakness ahead in terms of household spending and the property market. Although official data show that the labour market remains in a relatively healthy state, surveys indicate that employment intentions are softening.

Manufacturing Activity Set to Fall Despite Weaker Sterling

Manufacturing output fell 0.5% in March, indicating that, despite the weakness in sterling, the industrial sector is unlikely to be able to compensate for the slowdown in household spending.

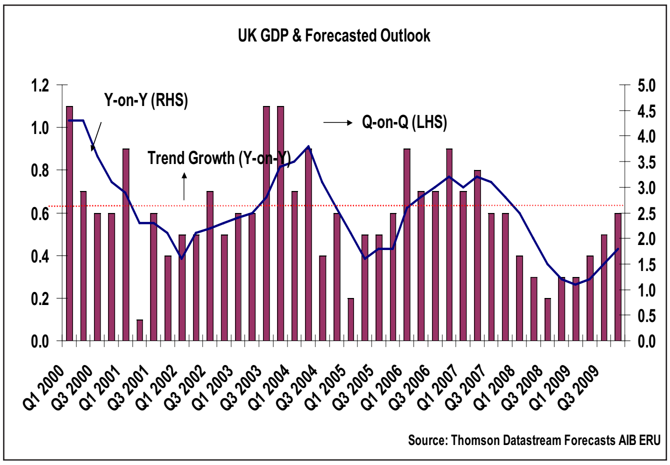


Admittedly this weak March outturn followed increases of 0.4% in each of the two previous months, leaving output up 0.3% for Q1 as a whole. However, the main surveys from the sector are pointing to a further deceleration in activity going forward.

On a downturn for a number of months now, the manufacturing PMI eased further in May, with the indices for total and export orders falling below the key 50 level. The CBI industrial trend survey for the same month showed manufacturers orders falling for the second month in a row. The export order balance was unchanged, suggesting that overseas demand is moderating.

Below Trend Growth Should Facilitate Eventual Easing in Monetary Policy

On the basis of data seen to date, we estimate that the UK economy will grow by just 1.8% this year, down from 3.1% in 2007.



As well as adverse developments in financial markets and the banking system affecting domestic demand, the external environment is also likely to become increasingly less supportive, with conditions in the US remaining difficult and increasing signs of a slowdown in the eurozone.

Below trend growth should help drive inflation lower over the medium term, facilitating an easing in monetary conditions. However, **with inflation set to rise well above 3% in the months ahead and remain above target over the balance of the year, this will constrain the ability of the MPC to ease rates in the near future.**

Thus, we have pushed back the timing of any further action from the MPC and anticipate that the Bank Rate will not be cut again until towards the end of the year, with some further modest easing possible in H1 2009

UK Interest Rate Forecasts

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.00	5.85	6.09	5.92	5.70
June '08	5.00	5.85	6.10	5.95	5.75
Sept '08	5.00	5.60	5.80	5.70	5.50
Dec '08	4.75	5.30	5.45	5.60	5.50

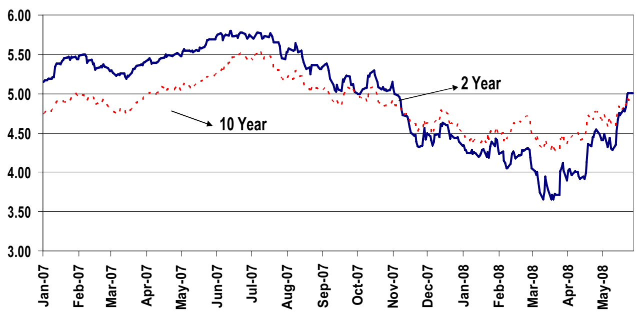
* Swap Forecasts Beyond 1 Year.
Current Rates Sourced From Reuters, Forecasts AIB ERU

Long Term Rates Rise in Line With inflation Risks

Changing interest rate expectations have seen a sharp move upwards in longer term interest rates in the UK. 2 year gilts for example have risen by more than 1.30% since their lows of 3.65% in mid March, while 10 year rates have risen by 0.60% from 4.30% to 4.90%. This rise is reflected in swap rates, with 2 year and 10 year rates up by a respective 0.80% and 0.40% over the same period.

Longer term rates have risen as market expectations for further interest rate cuts in the UK have diminished reflecting rising inflation risks. Yields have also risen in response as a stronger performance by equities and a pick in risk appetite (on expectations that the worst of the credit crisis is over) has resulted in some diversification from safe haven assets like government bonds.

UK Interest Rates
2 Year and 10 Year Gilts



Source: Thomson Datastream

The rise in UK longer term rates also reflects the global trend, with markets starting to price in interest rate hikes in the US and become even more convinced that monetary policy in the eurozone will remain unchanged for some time to come.

Given the negative inflation outlook we expect longer term rates to remain at elevated levels over the coming months and indeed there is a possibility that rates could move even higher in the short term as markets factor in the prospect of a CPI rate close to 4%. **However, there is scope for levels to come under renewed downward pressure later in the year as a sustained downturn in activity and an easing in inflation concerns sees the prospect of official rate cuts coming back onto the agenda.**

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