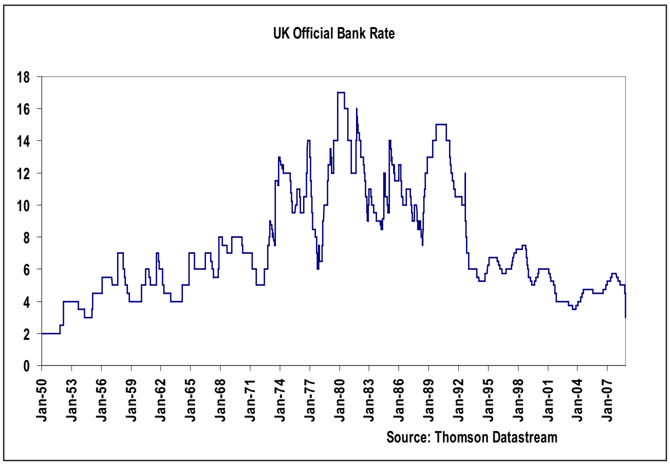
AIB Global Treasury
Economic Research

Bank of England Watch November 6th - 2008

BoE Slashes Rates by 1.50%.....With More to Come

The Bank of England's Monetary Policy Committee cut interest rates by a much larger than expected 1.50% today, leaving official rates at 3.0%, their lowest level for over 50 years. Markets had been anticipating a cut of up to 1.0% and thus were caught off guard by the sheer scale of the move. Further cuts are likely in the months ahead as the Bank looks to stave off the threat of a deep and prolonged recession.

The Bank released a comprehensive statement in conjunction with its rate announcement in which it outlined the rationale for its aggressive move. The policy committee believes that over the past two months there has **been a "marked deterioration in the outlook for economic activity".** Financial markets continue to experience severe disruption. Thus, despite supportive measures taken by governments and central banks, money and credit conditions have tightened sharply. **Meanwhile, there has been a significant downward shift in the prospects for inflation in the UK.**



The headline CPI rate rose to 5.2% in September but should fall sharply over the coming months as the contribution from retail energy and food price declines. Pay growth has also remained subdued and measures of inflation expectations have fallen back.

Up until recently the Bank had been worried about the upside risks to inflation, as a prolonged period of an above target CPI rate fed through into second round effects. However, **there has been a dramatic turn around in terms of its thinking over recent weeks. The MPC now believes that there is a substantial risk that the inflation rate, at the prevailing level of market interest rates, will now undershoot its target of 2.0% over the medium term.**

The dovish tone of the BoE's statement indicates that **further easing is in the pipeline,** despite the positive response of interbank rates to today's announcement. Much damage has already been done in terms of the real economy and the outlook for the UK over the coming quarters is very dismal indeed, as indicated by the tone of recent surveys and leading indicators.

The MPC's inflation report, due for release next Wednesday, should provide some insights into how far the Bank is prepared to go, but today's move reinforces our view that rates are set to fall to at least 2% next year.

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