



**Bank
Financial
Group**

TD Economics

Commentary

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BANK OF ENGLAND CUTS AS EXPECTED; ECB STILL FIRM

The Monetary Policy Committee (MPC) at the Bank of England (BoE) lowered interest rates this morning by 25 basis points (bps), bringing the base rate down to 5.00%. The move was widely anticipated, although in recent days, there had been some rumblings that perhaps a 50bps cut was warranted – a bolder move that did not seem warranted. Inflation is now running at 2.5%, half a percentage point above the BoE's target, and is expected to rise further in the near term. However, in the statement accompanying their decision, the MPC stated that the cut to the base rate was justified by the inflation outlook in the medium term. So, in spite of rising food and energy prices, the Committee sees sufficient downside risks to growth which will act to keep inflation pressures from spreading.

We have argued since last December that the downside risks to growth would lead the BoE to cut more aggressively than the market was expecting. We still believe market expectations are behind the curve. As of February, the consensus expectation – which we did not subscribe to – was that inflation risks would likely keep the MPC from cutting until May, when they would have a more detailed picture of how inflation expectations are evolving. Instead, the MPC now sees the availability of credit worsening and the prospects for growth overseas deteriorating. Moreover, with the housing market cooling quickly, there is a significant downside risk to consumer spending in the U.K. and further deceleration of economic growth (see chart on the next page). At 5.00%, interest rates are still 25-50bps in restrictive territory, even before accounting for any implicit tightening occurring due to poor credit market conditions. As such, **we continue to look for another 25bps cut in June, with an additional 75bps of easing by January of 2009, bringing rates to a 4.00% bottom.** This is one additional quarter-point

cut than we were previously forecasting. This appears justified as we believe the MPC's faith that downside risks to growth will trump inflation pressures in the medium term will be borne out.

Meanwhile, the European Central Bank (ECB) keeps rates on hold at 4.00% for the tenth straight month. The ECB does believe economic growth moderated further in the first quarter of 2008 and does recognize that downside risks to growth prevail. However, they cited ongoing investment growth, high capacity utilization, falling unemployment rates, and no significant supply constraints on bank loans as several of the ongoing positives for the economy. Moreover, they have continued to stress that they expect inflation to moderate only slowly in the near term and believe that the medium term risks remain to the upside. Likewise, they feel that the pace of monetary expansion remains strong, even after accounting for the fact that some share of M3 growth is being driven by bank lending to the nonfinancial corporate sector in lieu of using the money markets. In spite of some recent sizeable wage contracts, looking at Eurozone inflation excluding food and energy, the second round effects on price data remain nonexistent. What is clear is headline inflation is being driven by the high level of oil prices (see charts on the next page). With the official rate at the neutral level of 4.00%, the ECB can still afford to be patient in their inflation watch – and we believe they will continue to take just this liberty. Therefore, **while we still expect to see two cuts from the ECB this year, we believe a skeptical ECB will wait until September and December to cut interest rates to a low of 3.50%.**

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