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Financial
Group**

TD Economics

Commentary

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EUROPEAN CENTRAL BANK CUTS AND U.K. BAILOUT FAIL TO SPUR MARKETS

As part of the coordinated actions of central banks, **the Bank of England this morning reduced the Bank Rate by half a percentage point to 4.50%**. This move comes just a day before their regularly scheduled decision, when we and the market generally expected this half a percentage point cut to come. In the statement accompanying the decision, the Monetary Policy Committee (MPC) stated that inflation is still expected to rise from its current 4.7% pace in the coming months. However, their concerns centered on recent data releases, which are consistent with a “sharp monetary contraction,” with weakness spread across businesses, labour markets, consumers, and external demand.

With credit flowing like mud, it is not at all clear that lowering interest rates and reducing the price of borrowing will yet stimulate new lending. As such, the MPC noted that this rate cut “could not be expected to resolve the current problems in financial markets,” and U.K. and European markets in general remained down this morning. The help for the English banking sector came in the form of a bank recapitalization plan revealed by British Prime Minister Gordon Brown this morning. The government will immediately buy 25 billion pounds in preferred shares in eight British banks, is prepared to inject an additional 25 billion pounds if needed, will provide up to 250 billion pounds of loan guarantees at commercial rates to help encourage interbank lending, and the amount of short-term lending available from the Bank of England will double to 200 billion pounds. This assistance requires these banks to lend this cash out, rather than hoarding it, and

details will be negotiated on a bilateral basis. Moreover, participation is preconditioned on stipulations regarding executive compensation and dividends.

The BoE had already forecast inflation would fall below target over their policy horizon so the question for interest rate cuts has always been how much and how soon? With the biggest cuts for the Federal Reserve in the rear view mirror, we continue to think that the BoE Base Rate is next on the chopping block. **We expect to see a further 150bps in cuts through the first half of 2009 and a bottom of 3.00%, with the bias for more aggressive 50bps cuts in the near-term.** In 2001, the BoE cut 200bps over 10 months and in 1998-1999, they cut by 250bps over nine months so this is certainly within reason. The upside risk remains that inflation fails to moderate, but the onus to change this forecast now rests on inflation risks to materialize given the fact that the downside risks are a clear and present danger.

We also expect aggressive easing across the pond by the ECB, with a further 125bps of easing, but think the risks lie towards slightly less aggressive action in the near term and larger cuts coming in the first half of 2009. In 2001, they did cut 150bps in seven months and in 2002-2003, they cut by 125bps over seven months. However, in the short history of the ECB, they have shown a predilection to only cut every other meeting, and we continue to suspect the risks of the return of inflation hawks, while slim, are highest for the ECB policymakers.

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