TD Bank Financial Group

TD Economics

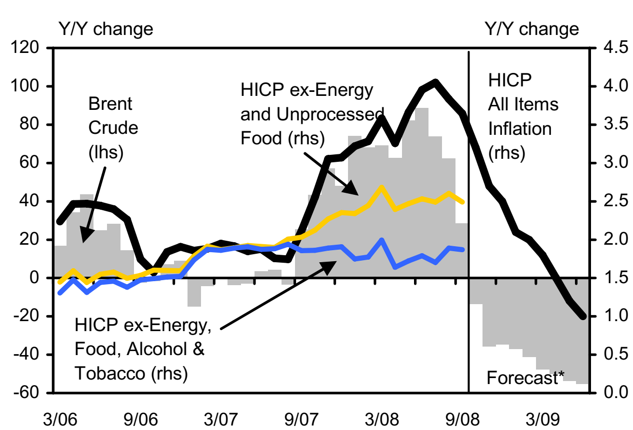
Special Report

November 5, 2008

THE ECB, THE BOE, AND THE GROWING EUROPEAN RECESSION

With the ECB and BoE policy rate meetings this Thursday, there are a number of conflicting signals as to what each should do. While certainly not claiming to be any more omniscient than any other forecaster out there right now, it is worth it to work backwards from what our current forecasts for economic growth and inflation suggest for rate changes from the ECB and BoE. What arises are twin risks. A rate disappointment from the ECB in the near term, even to the point of cutting only a quarter point this week, is very possible. On the other hand, there is a need for ongoing and aggressive easing from the BoE, and depending on how forward looking MPC members would like to be, it is possible to argue a 75bps cut is warranted this week. As we argued on October 8th (http://www.td.com/economics/comment/rk100808.pdf), the near-term risks seem to remain for a bit less easing than expected from the ECB and perhaps a bit more from the BoE.

EUROZONE CONSUMER INFLATION AND OIL



*Forecast by TD Economics as at November 2008;
Source: National statistical agencies and Haver Analytics

HIGHLIGHTS

- **There is a wider than usual spread around expectations for how much the Bank of England and European Central Bank will cut interest rates this week.**
- **The near-term risks seem to remain for a bit less easing than expected from the ECB and perhaps a bit more from the BoE.**
- **The U.K. recession risks being the most severe in several decades, arguing for aggressive, early monetary easing.**

ECB risks disappointing

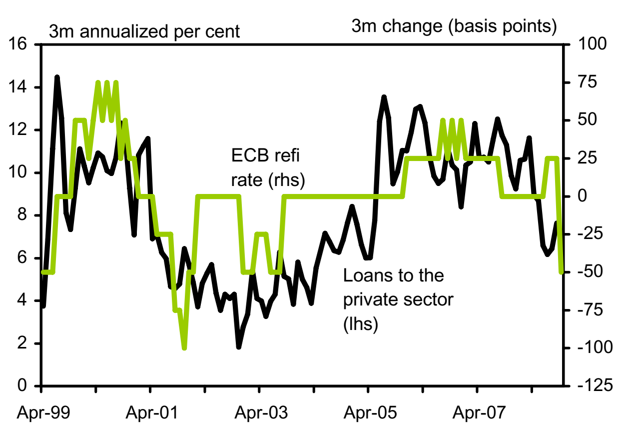
ECB Governing Council members have not deviated from the "one needle on the compass" mantra that has come to dominate Trichet's monthly press conferences. Differences of opinion and possible ECB rate actions should therefore be coaxed in the language of what is prudent to achieve price stability in the medium-term. On this account, TD Economics has argued since July that the risks were balanced that headline HICP inflation in the Eurozone would end the year at a 2.5% y/y pace and stabilize around a 1.5% trend in 2009. This was based on our assumptions then that crude oil would end the year near $100pb. The flash estimate for October inflation was 3.2% and with some base effects still to fall out, a decline by seven-tenths of one percent over the last two months of the year appears very plausible.

But oil prices have obviously overshot the $100 forecast, credit conditions have tightened further, and we now forecast the Eurozone economy will contract by 0.1% in 2009 under our base case, and place a 30-40% chance the

Eurozone contraction in 2009 will be closer to 1% (http://www.td.com/economics/qef/fcstrev_1008.pdf). These changed inputs have a much greater impact on the forecast for inflation for 2009, given inflation's lag of events in the real economy. In the current environment of risk aversion, I have opted to forecast Eurozone inflation with a pessimistic eye that it will prove sticker than underlying fundamentals might suggest given the sharp decline in oil prices. We do know that there is a persistence factor to high inflation so the assumption is stores and restaurants that before saw their margins squeezed only partially and very slowly respond now to falling price pressures as margin relief helps balance prior losses (as well as current losses from economic weakness taking away business). I have also assumed that the wedge that has developed between processed and unprocessed food, equivalent to about 0.5-0.8pp of inflation, does not fully unwind over the next year. **Even under this "sticky inflation" scenario, the pace of HICP inflation seems poised to fall to just 1% by the middle of 2009, with the risks firmly planted to the downside of that scenario.** It would take a significant further decline in oil prices to raise the specter of Eurozone deflation at this point, but it is certainly a possibility worth entertaining at a later date as more data are known.

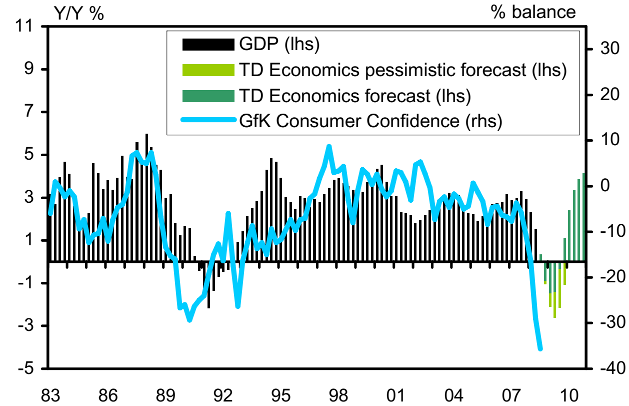
The ECB seems to be warming up to that possibility but is still not there. In fact, much of the language from GC members over the last week has been uncomfortably noncommittal just acknowledging the possibility of a cut this week. Given they have never cut by more than 50bps at one meeting or 75bps over two meetings, to argue as the

EUROZONE LOAN GROWTH AND ECB RATE



Source: ECB and Haver Analytics

UK CONSUMER CONFIDENCE AND GDP



Source: Office for National Statistics, GfK, and Haver Analytics

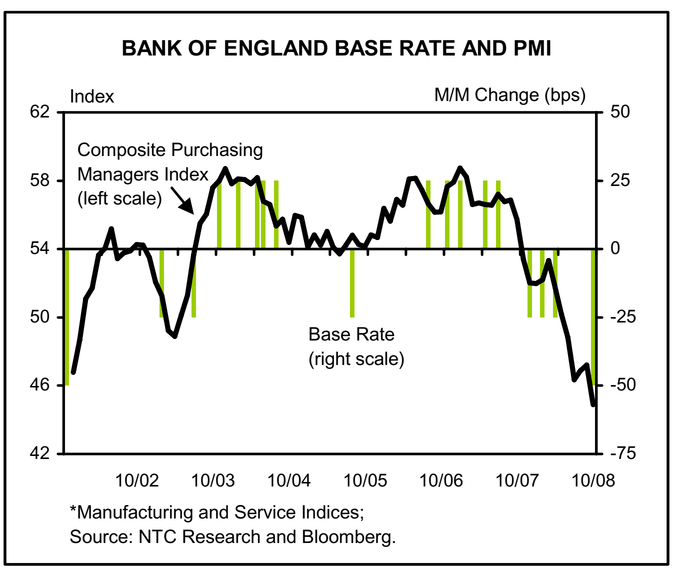
market does now that the decision is between 50bps and 75bps must be based on GC members thinking the current situation for price stability is exceptional. Looking at the indicator for private sector lending, the ECB could very well look at the 50bps October cut as having put them ahead of the curve, with the current pace of EZ lending making the rate decision one of 25bps cut or no change. Any forward-looking member right now almost certainly assumes the pace of lending will fall further so no cut does seem a bit extreme, and leaves the choice between a quarter or a half a percentage point cut. Lastly, we look at TD Economics research completed last year that highlighted the relationship between GDP growth and interest rates (http://www.td.com/economics/special/rk0608_cb.pdf). In 2007, this basic model suggested the ECB should have raised interest rates by 60bps when in fact they hiked by 50bps. With the Eurozone economy likely to post GDP growth of 1.1% in 2008, this same relationship suggests the ECB should cut by 53bps in 2008, when in fact they have cut by 25bps (25bps hike in July and then 50bps cut in October). So once again, the risks here are for a quarter point cut.

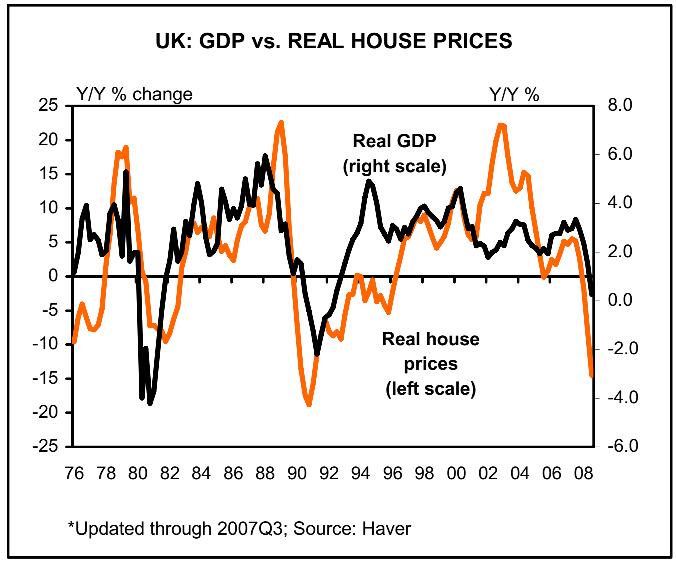
So history suggests no more than a quarter point cut at the current meeting, the GDP-interest rate relationship suggests only a quarter point the rest of the year should be priced in, while the lending indicator suggests only a quarter point as well. **The more forward looking the ECB is, the more they should cut by half a percentage point. And given TD Economics forecasts for inflation and EZ GDP growth next year, the GC should cut by 50bps or more at the current meeting, but we**

believe the risks are stacked against an aggressive ECB at this juncture. A quarter point cut (or less) on Thursday would increase the downside risks to our already pessimistic GDP forecasts and suggest inflation will decelerate even faster. Alternatively, a half point cut would be neutral for our forecasts, while it would take something more aggressive to suggest the ECB is prepared to act to stem when we believe will be a significant 2009 EZ recession.

UK Rate Cuts – Early and Often

There is a very different situation for the Bank of England. The ECB may not have internalized the potential financial issues to arise from synthetic CDOs and lending to Eastern Europe, but the dilemma is much less opaque for the UK with the burst domestic housing bubble leading the way. Moreover, the BoE's mandate provides much more wiggle room for rate cuts outside of a strict inflation targeting framework. TD Economics current forecast for UK GDP growth in 2009 is -0.5%, with the pessimistic scenario (again 30-40% probability) seeing the economy contract by a full 2%. The below chart shows that on a y/y basis, the base case would see the economy experience a shallower recession than in 1991, while the pessimistic scenario would see the economy in a deeper recession than almost two decades ago. However, many of the economic indicators to date would suggest the economic contraction could even exceed this pessimistic fate. It becomes a question of how to discount current economic indicators properly given the increased uncertainty over how much tightened credit and falling home prices will feed





into consumers and the economy. Looking at the link below between GDP and real home prices though, a y/y decline in the economy of 3% is very much a possibility.

Looking at the prospects for the BoE on Thursday, the forecasts are all over the map. 50bps is fully priced in with odds for something bigger, and about 25% of forecasters are saying 75-100bps of cuts will be delivered on Thursday. It is true that in the decade of the MPC's current mandate, they have never cut by more than half a percentage point; however, it is also true that during this last decade, they have not faced an economic threat as dire as the current one. **In the 1990s and 1980s recessions, interest rate cuts of 100bps or more were made and even adjusting for the higher rate of inflation then, suggest a 50bps should not be seen as a floor in the current environment.** The dire economic possibilities for the UK economy certainly argue that a full percentage point cut is not unwarranted, however, the near-term indicators, such as the PMI suggest only small risks for anything larger than 50bps, and while MPC member Blanchflower could very likely dissent for a 100bps cut at this meeting, it seems unlikely he can pull a quorum. The GDP outturn this year of 0.8% suggests a further 55bps of easing in 2008 is normal, so once again, 50bps is likely and more possible.

However, it is the prospects of economic growth in 2009 that raise the risk that the BoE could be much more aggressive. Taking the same normal relationship between GDP growth and interest rates as before, our base case would argue for an additional 273bps of easing from the

BoE next year. So if the BoE ends the year with a 4.00% policy rate, this would take them down to just 1.25%. **Under the pessimistic scenario, the GDP contraction of 2% next year would argue for 410bps of easing next year, in other words, taking interest rates to the zero bound.** And remember, the economy may yet underperform even this forecast. The U.K. economy is at the front end of what could possibly be a quite dramatic economic event. Inflation will dissipate in this environment and aggressive easing is needed up front in order to avoid such a fantastic outcome as UK rates at 0.00%. **A 75bps cut by the BoE is needed by the economy, and while this decision may see Besley or another hawkish member dissent in favour of less cutting, anything less than this would increase the downside risks to these already dour economic forecasts.**

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