BoE Watch

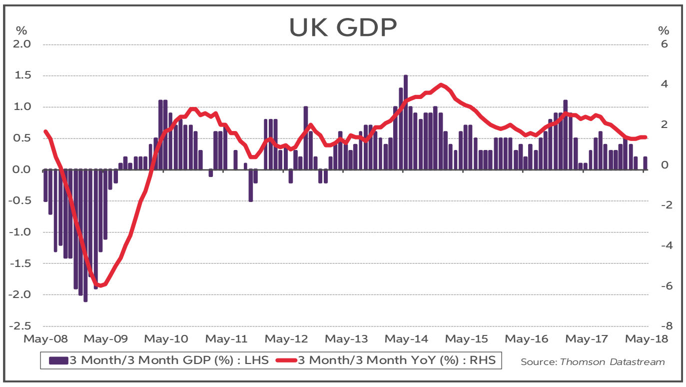
AIB Treasury Economic Research Unit

2nd August 2018

BoE hikes rates, as expected, to 0.75%

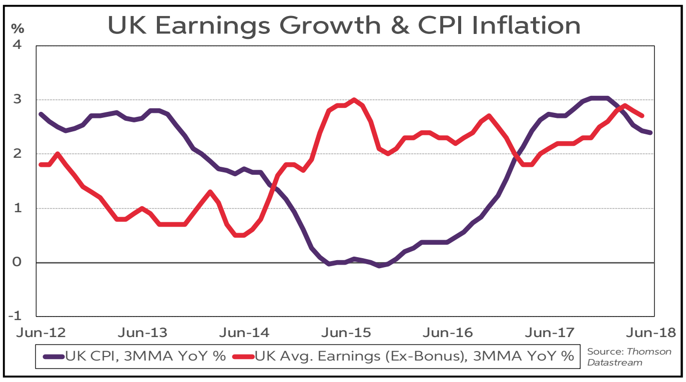
The August meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with the key Bank Rate being raised by 25bps to 0.75%. This was in line with market expectations on the back of strong indications from the BoE over recent months that a rate hike was likely in August. The rate increase means that the Bank Rate is now at its highest level since 2009. The MPC previously hiked back in November of last year, when it reversed the 25bps rate cut it implemented following the Brexit referendum. The decision today to raise interest rates was unanimous. The strength of the vote was somewhat more hawkish than the 7:2 split that the market had been anticipating.

The statement, minutes and Governor Carney's press conference outlined the rational for the decision to increase interest rates. The BoE stated that the recent data confirmed its view that the slowdown in Q1 "had been temporary" and that the economy had recovered momentum in Q2. It also noted that the labour market had continued to tighten as well as referencing a firming in labour costs. Meanwhile, Governor Carney commented that with domestically generated inflation building and the prospect of excess demand emerging, a modest tightening was now appropriate to return inflation to its 2% target.



More details on the BoE's view of the UK's economic outlook were contained in the Quarterly Inflation Report (QIR) for August. The MPC left its 2018 GDP forecast unchanged at 1.4%. It modestly raised its 2019 growth forecast to 1.8% (from 1.7%), while continuing to expect growth of 1.7% in 2020. Meanwhile, in terms of the inflation outlook, the BoE's projections "are a little higher" compared to the May QIR, due to higher energy prices and some weakness in sterling. It envisages inflation remaining slightly above 2% through most of the forecast period, reaching the target in 2020. This expectation is conditioned on the markets expectations for the Bank Rate, which currently implies two further rate hikes by end 2020, taking it up to 1.25%.

As regards the policy outlook, the BoE retains a tightening bias. This is based on its assessment that GDP is forecast to grow by around 1.75% per year on average over the forecast period. This is slightly faster than the rate of supply growth, which it is projecting to average around 1.5% per year over the same period. As a result, the BoE envisages the economy moving into "excess demand" by late-2019. This is likely to result in higher wage growth and domestic cost pressures, thereby warranting further rate hikes to return inflation sustainably to its target.



However, the BoE continues to emphasise that any future rate increases are "likely to be at a gradual pace and to a limited extent". In this regard, Governor Carney stated that monetary policy 'needs to walk, not run'. Futures contracts, are pricing in another 25bps rate increase by mid-2019. Of course, an added complication to the rate outlook is Brexit, with the UK due to leave the EU by end-March 2019. The Bank's projections are based on a "relatively smooth" Brexit transition.

In terms of market reaction to the outcome of the MPC meeting, there has been some volatility for sterling as the market digests the various BoE updates. Overall though, the moves in the currency have remained confined to relatively narrow ranges, with EUR/GBP straddling the 89p mark.

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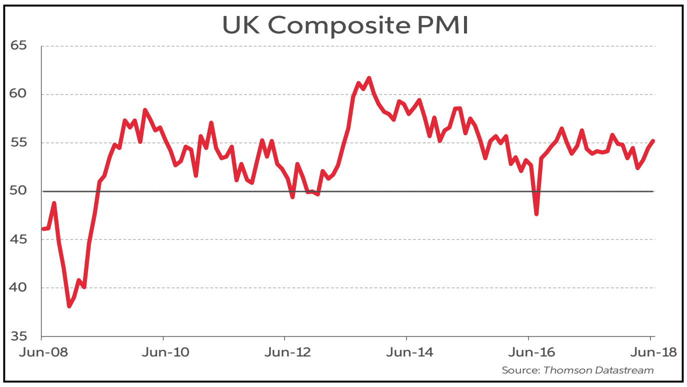
Growth likely improved in Q2, but still moderate

UK GDP rose by just 0.2% in Q1 2018, after rising by 0.4% in Q3 and Q4 2017. Year-on-year growth slowed for a fourth consecutive quarter to a six-year low of 1.3%.

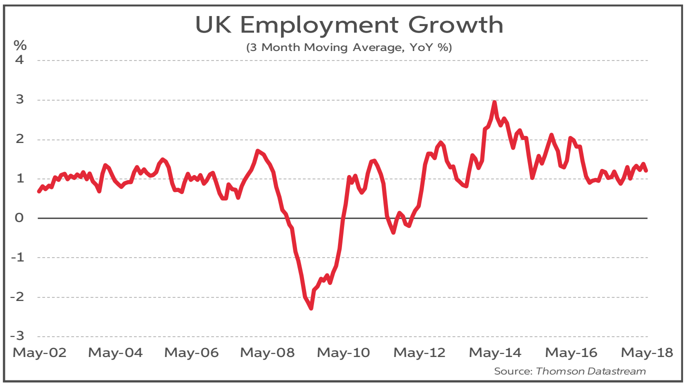


The ONS' new monthly GDP estimate shows that the economy grew by 0.2% in the three months to May, with year-on-year growth of 1.4% in the period. The underlying data show that while the services sector continues to grow at a healthy pace (+0.4% in three months to May), production (-0.6%) and construction (-1.7%) are dragging on the headline figure.

In terms of the performance of the economy in Q2 as a whole, the data suggest that growth strengthened somewhat. The Composite PMI averaged 54.3 in Q2, an improvement on Q1's 53.4 print. This reflects improvement in the services and construction sectors, while manufacturing slowed further. However, EC UK Economic Sentiment averaged 106.6 in Q2, after Q1's 108.6, its weakest performance since Q3 2016.

In terms of hard data, the results have been largely encouraging. Retail sales jumped by 2.1% in Q2 versus Q1, in which they declined by 0.3%. The very strong performance (best since Q1 2004) reflected a number of temporary boosts, such as the warm weather, royal wedding and World Cup, meaning sales growth should soften in Q3. Meantime, **industrial production declined by 1.3% in April/May compared to Q1.** This is partly due to a weakening in demand for UK exports. Goods exports were at a 19-month low in value terms in April, before edging up slightly in May. The overall goods trade deficit remains very high,

Labour market data have generally been solid of late. Employment rose by 137k in the three months to May, though year-on-year jobs growth edged back to 1.2%. A similar pick-up in labour force growth has meant that the unemployment rate has held at 4.2%, its lowest level since 1975. **Other indicators suggest that labour market 'slack' continues to dissipate, with the BoE's Business Conditions survey showing that recruitment difficulties remained near a 13-year high in Q2.**



The tighter labour market has so far failed to translate into a sustained acceleration in wage growth. Average weekly earnings rose by 2.5% year-on-year in the three months to May, down from 2.8% in the opening couple of months of the year. Although, with CPI inflation softening recently, averaging 2.4% in the three months to May, the UK has now returned to a period of real, albeit still very soft, wage growth.

Overall, the outlook for the UK economy remains challenging. It continues to be impacted by the uncertainty associated with the UK/EU Brexit negotiations, which is weighing on investment. Only modest growth in real wages is a challenge for the key consumer sector. Furthermore, the European Commission notes that it expects any potential boost from lower inflation to be offset by a rise in household saving. On the plus side, despite today's hike, the BoE looks set to maintain a very accommodative policy stance in the coming years, which should support activity. **Overall though, the European Commission expects the UK economy to grow by just 1.3% this year and 1.2% in 2019.** The BoE remains more upbeat on the economic outlook, expecting growth of 1.4% in 2018 and 1.8% in 2019.

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